Multifamily Acquisition Strategies For the New Economy

Concepts for Accessing High Value Deals

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White Paper Series
Summer 2011
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# Table of Contents

<table>
<thead>
<tr>
<th>Page</th>
<th>Section</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Executive Summary</td>
</tr>
</tbody>
</table>
| 5    | Looking Back to Look Forward  
|      | Rapid Expansion  
|      | The First Domino to Fall  
|      | The Comeback Kid  
|      | The Game Has Changed... But the Rules are the Same |
| 11   | Notable Trends  
|      | Voracious Appetite Large and Small  
|      | Cap Rate Compression  
|      | Level Playing Field is Gone  
|      | Strong Pipeline of Distressed Assets |
| 13   | Understanding Distressed Assets  
|      | Opportunities in Pre-Distressed and Distressed Assets  
|      | Foreclosure is a Common But Destructive Cure  
|      | Goldilocks All Over Again  
|      | What If...? |
| 18   | New Strategies for a New Economy  
|      | Best Practices  
|      | STEP ONE: Determine Your Investment Profile  
|      | STEP TWO: Build Your Prospect List  
|      | STEP THREE: Ready... Aim...  
|      | STEP FOUR: FIRE!! Make the Offer and Close the Deal |
| 30   | Case Study: John the Investor |
| 33   | What’s the Next Step  
|      | About Dobens Law  
|      | About Multifamily Investing Academy |
Executive Summary

Owning multifamily property is a proven strategy for wealth creation. For decades smart investors have understood the dual benefits of short term passive income generation combined with long term equity creation. Many resources and reports document the validity of this model over the long term when compared to alternate investment strategies such as stocks or bonds.

While this information is true, it only gives us the 30,000 foot view of a very large industry that is not uniform in nature. Individual investment performance can vary widely and is tied to the specific strategy chosen by the investors; property type, location, operating success, etc. In addition, this segment can be highly cyclical (as we have seen over the past few years) and is shaped by the powerful external forces of the capital markets. The best performers in this industry are those who have a deep understanding of the business and the marketplace in which it operates both at the macro and micro level only take action when the opportunity meets all their investment criteria.

Market timing is a critical element to any investor’s success and now is as good a time as we have seen for years. After taking a hard beating since 2008, the apartment business is in the early stages of recovery and on the rise again. There is ample coverage in the financial press documenting the returning momentum to this sector. Both large and small investors are hunting for great opportunities using both conventional methods and unique strategies that present themselves only at this point in the market cycle.

“For the 20 years ended December 31, 2009 domestic real estate recorded an average annual return of 9.88% compared with 8.21% for the S&P 500. Long-term government bonds had an average annual return of 8.13% during this time period.”

The National Council of Real Estate Investment Fiduciaries (NCREIF) and Standard & Poor’s
The purpose of this paper is to provide you with the necessary information and strategy to take full advantage of the high value opportunities that are presenting themselves at this stage of the country’s economic recovery. To start this process we are going to take you back in time a bit so that you can better understand the present market conditions.

We hope you learn from and enjoy the read.

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Dobens Law, LLC
Summer 2011

Disclaimer: Before we discuss exactly what these new strategies entail, let us first state for the record what it is not; it is not a “no-money-down” alternative. You need money to acquire multifamily property. In addition, you need money to run a property and you will need money to provide solutions to the owner’s problems. This is a strategy for finding opportunities before anyone else does. Alternative financing strategies are available but are not the focus of this paper. It is recommended that you always seek out professional legal advice for support in the acquisition process.
Looking Back to Look Forward

Rapid Expansion

The apartment business was the darling of real estate investing during the last economic cycle. From 2002 to 2007 and even into 2008, business was brisk. Rapid price appreciation in many markets combined with highly attractive borrowing terms set an optimistic tone and the data support this claim. Record levels of acquisition activity occurred in ever increasing levels several years in a row as demonstrated by the charts below (Marcus & Millichap):

“One availability of capital has remained elevated over the past year . . . as lenders attempted to capture greater market share. A wide pool of mortgage providers particularly conduits and portfolio lenders remain aggressive in financing apartment transactions, which is resulting in attractive pricing for buyers.”

Marcus & Millichap
2007 National Apartment Report

[Bar chart showing apartment transaction activity]

One of the biggest reasons transaction volume expanded so quickly was the ever increasing access to financing. Wall Street was flush with capital looking for a “home”. If you didn’t like the terms from the local or national bank, then you could find a conduit lender, an insurance company or a GSE (Fannie Mae or Freddie Mac) willing to offer you a better deal.

It wasn’t just the big players who were benefitting from this rapid expansion. As you can observe in the following chart capital was reaching all transaction sizes efficiently, whether you had a small transaction or large. This access to capital leveled the playing field allowing many new investors to enter the marketplace.
As the chart documents, the distribution of transactions across size and type reflects this reality: large class-A institutional deals ($40MM+) were getting done alongside the bread and butter $10-$39MM class-B to B- deals. Notably, the smaller deals ($1-10MM) with less impressive sponsorship were also getting done. It seemed like everyone wanted your business and everyone was doing deals.

With the ample availability of money to increase the appetite of lenders for getting deals done, came rising prices and a steady loosening of credit terms. Bankers and conduits were willing to structure deals aggressively in order to put their capital to work and gain market share. Maximum LTV’s were increasing, banks were permitting second mortgages (driving leverage to the 90-100% range), interest only periods were commonplace, DCR’s were lowered to 1.1x to 1.15x and most types of sponsorship were getting financed. Transactional risk was rising and the market was cresting which is to be expected during any market cycle. However, no one anticipated the depth of the impending decline.
The First Domino to Fall

To an ever increasing degree, we live in a fully global economy. What happens in one corner of the world or one specific industry can impact the performance of another industry in a different part of the world. This was true for commercial real estate in late 2007.

The first domino to fall was the retreat of the conduit market as a source of capital. This retreat occurred not because of underlying weaknesses in the apartment business; in fact multifamily was performing extremely well with loan defaults at record lows (under 1% of total portfolios). The problem was the severe weakening of the subprime residential loan market (Residential Mortgage Backed Securities or RMBS); loan defaults and foreclosures were skyrocketing. Once Wall Street stopped buying RMBS, it also lost its appetite for Commercial Mortgage Backed Securities (CMBS).

This change was monumental. CMBS had been funding upwards of 50% of apartment acquisitions in the prior three year period and now that capital was gone. The ripple effect caused by the subprime mess resulted in other sources slowing their loan originations as well. The volume of deals coming out of commercial banks and life insurance companies declined by nearly 30 percent. Think of these events as the second and third dominoes to fall.

When these collective capital resources dried up other sources attempted to fill in the gap. For the first half of 2008, GSEs ramped up apartment mortgage origination by 66 percent from one year earlier. However, it was not enough. With transaction volume already faltering, the capital markets were hit with a very powerful “one-two punch”. In September 2008, the US government forced Fannie Mae and Freddie Mac into conservatorship and Lehman Brothers, a company many felt was too big to fail, actually failed. The shock waves to the world economy were massive. All of the dominoes gave way.
The year 2009 marked the bottom for the apartment business. This year saw significant decreases to NOI as occupancies dropped and concessions cropped up across all property types due to the unprecedented spike in unemployment. Lending was highly constrained with LTVs in the 55 to 75% range. The weakened operating performance of properties, combined with general economic uncertainty and limited capital access caused overall investment volume to drop 70% off its 2006 peak.

The bloom was officially off the rose of the apartment industry. But what goes down does go back up again. The end of this last cycle meant the industry would go through a correction and recovery phase often referred to as the “Millionaire Maker”. Many investors are realizing that that is the phase that we are in right now.
The Comeback Kid

In 2010, however, to the great surprise of most industry observers, multifamily assets staged a momentous comeback by exceeding even the analysts’ expectations. As occupancy rose steadily, concessions burned off, properties re-stabilized and owners began to breathe more easily. Overall, the apartment industry delivered its third strongest annual returns since the last decade, at 14.2%, as measured by the IPD US Annual Property Index.

One of the underlying causes for this improvement appears to be the release in the pent up demand related to housing (home ownership dropped to 67% from a high of 69% releasing over a million former home owners into the rental marketplace), combined with the natural expansion of the prime renter demographic (20-34 year olds) and a overall shortage of apartment unit supply in many major markets (construction pipeline is at historic lows). Industry experts continue to anticipate a further tightening of unit supply through at least 2014. Job creation, which thus far in the economic recovery has been lackluster, has historically been the primary driver of the expansion of the multifamily market. As the economy slowly revives and job formation gains traction, further increases in demand for apartment units is anticipated.

As a result of this good news, investor interest in multifamily has surged. CoStar Group reports that more multifamily deals closed during the first quarter of this year than in any other quarter since mid-2005, with approximately 4,000 transactions totaling $9.4 billion. In comparison, the same sector recorded $6.7 billion in transactions in the first quarter of 2010 and $3.76 billion in the first quarter of 2009.
The Game Has Changed. . . But the Rules Remain the Same

Just as the capital markets shaped the multifamily business through its glory days of the last decade, the same is true today. Currently, the market is building momentum presenting quality opportunities, strong industry fundamentals and positive future trends. However, due to the colossal “hang-over” from the Great Recession, capital has yet to become universally available to all interested buyers. Institutional grade investors are flush with cash while small private investors have more limited liquid resources and capital markets are still presenting conservative underwriting.

Using the same conventional techniques used during the last economic cycle of sourcing, structuring and attempting to finance deals will likely lead to frustration and disappointment. To be successful in today’s market, the smaller investor has to be aware of the changing trends, find the best and most strategic opportunities, get prepared and take action.
Notable Trends

Voracious Appetite of Large and Small Buyers

The market is in a strong recovery! What we are seeing now is that many large institutional investors (REITs), private equity firms, life insurance companies, pension plans, and even foreign direct investors (due to the weakening dollar) are aggressively buying up large Class A and Class B properties in prime coastal and solid emerging market locations. Year over year dollar volume of transactions has increased over 33 percent and the total number of properties sold exhibited more modest improvement of 22 percent, reflecting an increase in larger-asset sales. Transactions in excess of $20 million climbed 86%.

Many of the large acquisitions in the first quarter were completed on either an all-cash basis or with limited amounts of financing. Transaction velocity has been rapid as sponsorship and financing qualifications have not been a concern. These buyers are quick, decisive, prepared and aggressive and they are here to stay.

Cap Rate Compression

Increased competition at the high end of the market has lead to significant cap rate compression most notably in Class A and Class B properties. Since peaking in 2009, cap rates for top-quality properties have fallen by as much as 100 basis points. As the year progresses, investors will move down the quality chain in search of stronger yields, resulting in more sales in the Class B and B- categories. This steady compression of cap rates is a problem particularly for smaller investors who are looking for more upside due to the fact that more cash is needed with lower LTVs.

In 2006, with a ten percent down payment, investors were satisfied with an 8 percent cap deal. There was enough yield in that deal to provide the targeted cash on cash returns. In today’s market, with
the requirement of 25 percent down, higher cap rates are needed to achieve the same investment return hurdles.

**Level Playing Field is GONE**

Lenders are still taking a more conservative approach to underwriting. Maximum LTV’s are at 75% and sponsorship qualification is more difficult. The market is no longer a level playing field when it comes to capital access. This means that smaller investors cannot move as quickly and are at a negotiating disadvantage compared with large institutional investors.

**Strong Pipeline of Distressed Assets**

The acquisition of distressed assets, including foreclosed properties, deeds-in-lieu and those with high vacancy or problem operations, constituted twenty-one percent of total acquisitions in 2010. Distressed properties accounted for up to 60% of total acquisitions in the most severely distressed markets. This pool of opportunity will not dry up quickly and offers tremendous opportunity for those who best understand it. There is a massive wave of troubled properties with financing (originated via conduit or a bank) that will be maturing within the next few years. Much of this property is underwater and will need to be recapitalized, refinanced or sold at deep discounts.

These properties represent significant investment value add investment opportunities for the smart investor. Institutional investors are less interested in these deals; more complex (not cookie cutter), longer deal cycle with more emphasis on asset appreciation than on immediate cash flow.

**The best way to beat the REIT’s and to take them out of your competitive landscape is to compete in a different way; going after value-added deals that do not fit their mold. The growing pool of distressed assets is that opportunity.**
Understanding Distressed Assets

Opportunities in Pre-distressed and Distressed Assets

In April 2011, a record high of 9.65%, or $61 billion of commercial property loans (CMBS) were reported as delinquent. The multifamily sector had the highest delinquency rate of all CMBS loans at 16.7%. The following table shows the significance of the overall delinquency problem facing the industry.

<table>
<thead>
<tr>
<th>Lender Type</th>
<th>Portfolio Delinquency Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>CMBS</td>
<td>9.18% (30 days past due)</td>
</tr>
<tr>
<td>FDIC Insured Banks/Thrifts</td>
<td>4.18% (90 days past due)</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>14.0% (60 days past due)</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>6.40% (60 days past due)</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>3.60% (60 days past due)</td>
</tr>
</tbody>
</table>

Many experts anticipate total delinquencies will continue to rise before the worst is over. These loans are in various stages of distress; from having received the first Notice of Default, to loan acceleration, receivership, forbearance or special servicing. These numbers exclude loans that have already been foreclosed upon and are now bank owned assets.

Why are so many properties struggling or in default when the metrics of the industry are so strong? There are several different reasons for these delinquencies that relate back to the rapid expansion and then decline of the industry over the past several years.

1. **Purchased at the Peak of the Market:** The owner overpaid for the property when purchased and is now finding the assets to be underwater due to increased cap rate just at the time the note is coming due and in need of refinancing. This scenario requires the owner to come to the table with additional capital at a time when owners were planning on cashing in and taking their chips off the table.
2. **High Leverage:** The property was too highly leveraged at acquisition (often up to 90-100%) with possibly several years of interest only payments resulting in no principal pay-down. The property may or may not be underwater but level still exceeds what the market is offering for maximum LTV’s (75%) at refinancing. This scenario also requires the owner to come to the table with additional capital.

3. **Limited Liquidity, Unable to Cure:** Many owners’ liquid resources and/or net worth have been depleted during the economic downturn. Perhaps this is because they have needed to inject their property or another business with cash to keep it afloat during this period. Investor partners in a transaction may not be interested in putting more cash into a deal that has not performed as expected or into an asset where the future is uncertain. This is an added problem when combined with the points 1 and 2 above.

4. **Conservative Underwriting:** New and existing borrowers cannot get financed or refinanced due to the stricter deal underwriting and sponsorship guidelines. This may preclude them from acquiring new debt.

At a time when industry fundamentals are surging and many properties are performing well, there are high barriers to success due to the mismatch in the marketplace between performance, valuation and capital access.

How can these issues be solved?
Foreclosure is a Common but Destructive Cure

We have all heard the medical scenario that the treatment is worse than the disease. Foreclosure of a multifamily property is often that exact scenario, taking a difficult situation and making is far worse for all involved parties. This approach is a classic “Lose-Lose” scenario.

For many borrowers, the only option when distress is imminent is to give up and let the property go. There may be a short battle between the borrower and the bank but ultimately if the borrower does not have financial means to right the ship, the bank may sell the note or choose to foreclose. When this happens, the borrower loses the investment (and potentially more if personally liable) and the bank takes possession its collateral that can been badly battered through the foreclosure process.

When a property goes into default, this is usually a matter of last resort. For several months if not years prior to the default, the property has been cash strapped and its capital needs and repairs not done. Deferred maintenance has been mounting. As soon as the borrower loses control of the asset through receivership, the downward spiral can accelerate rapidly. Many properties experience a mass exodus of good residents or a steep increase in undesirable residents refusing to pay rent. When vacancy exceeds 25-30%, the property starts to “feel” empty and trouble can set in with an increase in vandalism and crime. In many instances, a property can lose up to seventy-five percent or more of its value during the foreclosure process.

Many smaller investors look to the pool of foreclosed assets for high value deals to meet their yield requirements. Yet, end of pipeline foreclosed deals are usually terrible deals and extremely risky! This is the result of such conditions as; property condition is poor, due diligence is limited; property operations are severely troubled and often plagued by a poor reputation in the community. There is also a lot of competition for these deals because they are publicly marketed. Bank financing is not available for destabilized assets, limiting the appeal even further.
Goldilocks All Over Again

Let’s recap. . .

Class A and Class B properties are being purchased aggressively by REITs and other institutional investors hunting for immediate cash flow. Competition is fierce and cap rates are compressing. This market is TOO COMPETITIVE for the smaller investor.

The smaller Class B- to Class C assets are more attractive, yet cap rates are also declining and financing and sponsorship are still very conservative. A good deal is still TOO DIFFICULT to put together.

The distressed asset class, while offering best potential yields, is full of unknowns, very difficult to finance and even more difficult to operate. Overall, this deal type is TOO RISKY.

Like Goldilocks, the smaller private investor is looking and looking for the deal that is JUST RIGHT.

Does this deal exist?
What if . . .

- . . . you could find hundreds of distressed deals before they become damaged by the foreclosure process?
- . . . you could identify a property in its earliest stages of distress or even before it becomes distressed?
- . . . you could segregate that information by property size, and loan type (CMBS, bank, GSE, etc.) to concentrate on exactly the type of asset you are looking to acquire?
- . . . you could find out the borrower’s information and the terms and maturity of a property’s financing
- . . . you could use that information to give you a competitive advantage in the marketplace?
- . . . you could start communicating with the underwater property owner months before a refinancing deadline, and start the process of negotiating an asset restructuring and transfer with the assistance of the in force lender and borrower?
- . . . you used this information to acquire higher yielding lower risk transaction?
- . . . you had less competition because these opportunities were of limited interest to the institutional type buyers?
- . . . you could find deals that were JUST RIGHT for your investment strategy?

Would you be interested?

These opportunities exist if you know where to find them.
New Strategies for the New Economy

Best Practice

The best strategy for the smaller investor in today’s market is to purchase distressed deals BEFORE they suffer the perils of the foreclosure process.

Here are a few reasons why this is a great strategy:

1. These deals can be found using data subscription services available via the internet. This service is not to be confused with lists of bank owned property that are circulated and re-circulated through the broker community.

2. The REITS and other institutional investors are less interested in these deals. REITs typically pursue stable cash flowing deals that help their quarterly requirements for dividend distribution.

3. Sellers are highly motivated. Borrowers that are at risk of losing their asset and/or having significant personal liability for a failed project are looking for solutions.

4. The in-force lender is motivated for resolution as well.

5. This is a stealth approach to the market. You will be able to see opportunities and target deals many months before they would be conventionally marketed for sale. These transactions are off the radar screen of most investors and therefore subject to less competition.

On the following pages is a step-by-step method of finding the opportunity, tracking information strategically and ultimately crafting a deal.
Excerpts from article:

Money Bags  By Jerry Ascierto

As it appeared in Apartment Finance Today, May/June 2011

Many investors are . . . waiting for an unexpected bonanza of recapitalizations. Equity providers sense a growing opportunity in the recapitalization market. About $95 billion in multifamily debt will be maturing in the next three years, according to the Mortgage Bankers Association, and more than 40 percent of that debt, over $38 billion, will somehow need to be resized.

"At least 15 to 20 percent of new capital will have to be added to that pool of debt," estimates Dave Valger, a partner at New York City–based equity investor RCG Longview. "That’s about $6 billion that has to come from somewhere."

There will, however, be some class distinction in the types of recap deals that get done. The Class A properties shouldn’t have any problem finding that capital—REITs, sovereign wealth funds, and even some debt providers will find those deals desirable. But the B and C assets will largely be on the outside looking in. "That bifurcation will create an even greater opportunity, and a better-yielding environment, for new equity to come back in," Valger says.

 Equity providers are split about whether recapitalization deals with an existing owner or an acquisition by a new owner is preferable. On one hand, equity can often find better-yielding deals off-market—when an existing owner is looking to recapitalize—rather than in a sales transaction. But on the flip side, when a title changes hands, there’s generally no disagreement about value.

Whether it’s an acquisition, a refinancing, or new development, equity investors are focusing much more on quality of sponsorship. While sponsor scrutiny is at an all-time high, investors realize that pretty much anybody in the business had some economic hiccups throughout the downturn.
STEP ONE: Determine Your Investment Profile

It is essential that you develop a clear profile of the investment property you are looking to acquire. Consider transaction size, complexity, market location, type, duration of hold, and level of risk when determining your investment strategy.

1. Not all markets are created equal. Some markets have larger pools of distressed asset opportunities. This information should be considered when planning your strategy.

2. Local knowledge is essential to success. Some markets have experienced much higher levels of property devaluation (AZ, FL, and NV). This relative level of distress will have an impact on both the seller’s and their lender’s willingness to negotiate. It is very important you understand current and forecasted economic conditions of your chose market and manage the risk accordingly.

3. Match your acquisition strategy to your level of experience. This is not a get rich quick business. Start from a level that makes sense for you and build from there.
STEP TWO: Build Your Prospect List

The real estate business is a sales business. As with any sales business, you need a source of potential prospects. Once found, those prospects continue to need to be cultivated; weed out the bad ones and focus on the good ones. This will build the funnel of potential prospects and grow the business.

Knowledge is the first tool for finding these prospects. In today’s internet world, there are resources available that provide quality data regarding the ever changing landscape of distressed assets. These resources provide real time data regarding the financial performance of multifamily properties.

With this information you will be able to identify deals before they are in distress or badly damaged by the foreclosure process. This data enables you to formulate a solid strategy and take a stealth approach to targeting and pursuing deals in your chosen market. In addition, this data is not widely accessed by other small investors for this purpose thus limiting your competition.

The two premier providers of this data are Trepp and Pierce-Eislin.

1. Pierce-Eislen (www.pi-ei.com) - The Pierce-Eislen database is highly searchable and distressed apartment properties are disclosed – foreclosures, bankruptcies, and properties held in REO status – along with related Trustees, Special Servicers, lenders, and their contacts. This service offers a convenient and user friendly way to track and pre-qualify potentially troubled assets at the earliest stages of distress.

2. Trepp (www.trepp.com) - The TreppLoan Lead Finder™ module identifies refinance and workout opportunities within the multi-billion dollar securitized commercial mortgage market. By leveraging Trepp’s "capital markets quality" database of nearly all CMBS transactions, commercial real estate professionals can access the largest available catalog of securitized loans. The flexible interface makes it easy to customize searches for more targeted
prospecting and lead generation. The Trepp service provides the following capabilities:

- Source refinance and workout opportunities
- Identify borrower details
- Estimate refinance proceeds and equity take out
- Quantify prepayment amounts, yield maintenance charges and fixed prepayment premiums
- Evaluate detailed property and financial information
- Perform trend analysis, select markets and property types
- Track competitor activity

Prior to selecting one of these subscription based data resources, it is important to understand the cost of these services can vary widely by market due to the level of opportunity.

**STEP THREE: Ready... Aim...**

In steps one and two you determined your investment strategy and selected your market research tool. In step three, you are ready to narrow your focus and collect the key data points you will need to identify prospects and begin formulating a strategy. The data to be collected is at two stages, Level I is where the framework of a deal is constructed and pre-qualified. Level II is where you fill in more detail and start refining your strategy.

Level I data to be gathered is listed below. This information is readily available through the on-line subscription service discussed above:

**Level One – Prequalify Your Deals**

1. Property Location/Size/Type
2. Stage of Distress (pre-distress, notice of default, etc.)
3. Loan Balance
4. Acquisition Price
5. Acquisition Date
6. Loan Type (CMBS, Bank, Insurance Co, etc.)
7. Contact Information (Owner, Lender, Prop. Mgmt.)
Following are actual print screens from the demonstration module for Pierce-Eislen to show you how this information about prospective deals can be gathered.

Using the search function on the program, it is easy to identify all those distressed assets in your chosen market. **Note the categories of distress that this service uses below:**

1. **Notice to Cure** – Typically this is the letter that an owner will receive when they fall thirty-days past due in their payments. It is at this time that the owner’s problems are about to become public. Nevertheless, it is at this stage when things start to get moving on a downward path.

2. **Notice of Acceleration** – This is the letter that every mortgage holder dreads. This letter states that the lender has “accelerated” the terms of the note calling the whole balance outstanding due in full within thirty days. If a borrower cannot resolve the matter in a timely fashion, the lender and exercise its legal rights and begin foreclosure proceedings which will trigger the appointment of a receiver and the removal of the owner from property.
operations. If you are going after owners who have received this letter, you do not have much time to act. From the time an acceleration notice is received until the time a receiver is installed can be a matter of a few weeks.

**Borrowers at this stage of the foreclosure process can be highly motivated to find a solution to their problem.**

3. **CMBS Loan in Arrears** – This tab provides data exclusively related to the CMBS loan pool. While you will likely find plenty of opportunity in this category, remember it only represents a portion of the total field of distressed transactions in a given market. This CMBS Loan in Arrears pool excludes bank loans, GSE loans and insurance company financings.

If you were to “click through” the Notice To Cure tab on the screen shown above it would take you to a list of properties in your chosen market that fit that profile (see sample screen shot below). As you can see, in this particular market there are currently two deals in this category. The window of opportunity to take action to cure is very short (typically 30 – 60 days). Either the property gets caught back up on its payments, strikes a deal with its lender or it moves very quickly to the Notice of Acceleration.
These two properties both have loans that were taken out within a week of each other back in 2005. In addition, they are both owned by the same person. The first one looks as though it may not have much equity while the second property has approximately $5.5MM in potential equity. (It is important that this information be used as a guide and that all facts are confirmed through the due diligence process).

Let’s explore the Oakridge property a little further.

By clicking on the property name, an additional level of property specific detail can be seen from the comfort of your office. This is where it can be determined that a property is within the framework of your investment strategy.

Pierce-Eislen does a thorough job providing objective information regarding this asset. The pictures on their website are done by their own photographers and not from a broker or the property owner.
The owner's name and number is located here along with the information regarding the property manager.

As you can see by information provided at the bottom of this screen, this property was financed with a CMBS loan in 2005 with the original amount of $9.875 million and it is still interest only resulting in no principal reduction. This property was financed with a low level of debt, 64% LTV and likely has preserved some equity.

So far we have found all of the more general information that is needed to narrow your property search. This information satisfies all the Level I detail discussed earlier and opens the discussions with owner.

Once a deal has been pre-qualified then it is time to make contact with the owner and gathering the Level II information (suggested list below) and get ready to take this prospect to the next level.

**Level Two – Owner Information**

1. Owner Exposure (recourse/non-recourse)
2. Ownership Structure/Partnership Issues
3. Additional Liabilities/Second Mortgage Consideration
4. Property Condition
5. Operating Performance
6. Capital Needs (cash and financing)
When you have identified as much information as possible, you are better able to construct a quality offer that best meets the needs of all critical parties (owner, lender and investor) in a “win-win-win” scenario.

Of Note: These early stage distressed situations are great acquisition opportunities with highly motivated parties, but you have to be prepared and move quickly.
STEP FOUR: FIRE!! Make the Offer and Close the Deal

There is an age old real estate piece of wisdom that states: *You make your profit when you buy a property and you realize it when you sell it.*

Finding the right deal and asking the right questions is important to success in this business but the careful structuring and diligent execution of the transaction will make or break your deal.

In this section, we describe the two basic deal structuring strategies used to acquire either pre-distressed or distressed deals. This information is intended to give you a general framework for how to think about structuring an offer to purchase. However, keep in mind there is no cookie cutter approach to these deals and exceptions and nuances exist.

Remember that approaching a distressed deal is very different than approaching a conventional acquisition. In conventional transactions, the amount of capital required to execute a deal is easily determined based upon purchase price, structure and lender’s terms. In distressed deals, to determine capital needs, an investor must first determine the type and structure of the new deal including existing debt and equity levels, current payables, investor obligations or second notes on the property as well as refinancing expenses.

The acquisition of pre-distressed or distressed properties (prior to foreclosure) is typically structured in one of two ways. The first is the Recapitalization Option that keeps the existing owners in the deal yet at a reduced ownership position. The second is the Restructuring Option which is necessary for deals experiencing deeper levels of distress, have no equity and cannot be saved through a recapitalization process.
**Recapitalization Option:** This structure is most effective when there is still equity in a deal that can be preserved. Often the existing entity structure is retained and the investor actually purchases an existing corporation, with proper indemnifications. This strategy can be easier as existing ownership remains in the deal (albeit at a reduced level) and *deal sponsorship can remain in place*. Key elements to understand include:

- Stage of distress/stability of deal
- Valuation of asset
- Amount of Equity
- Ownership structure of borrower
- Capital needs and “cost of money” as it relates to overall deal risk

**Restructuring Option:** This strategy is used when the amount of capital needed to stabilize an asset (the recapitalization strategy) will fail to generate acceptable cash-on-cash returns. Simply stated, it just costs too much to fix the deal and it is more cost effective to just restructure it. During a restructuring, a completely new entity is formed with new ownership and new financing; all prior liabilities are erased.

The restructuring option is attractive for those investors capable of qualifying for sponsorship on their own. Keep in mind, what we are talking about here is restructuring the deal before it is has been lost to the foreclosure process.

There is an expanding field of highly valuable acquisition opportunities in the marketplace today ready for the knowledgeable and prepared investor. While these opportunities are exciting, they are not for everyone because they require specialized knowledge and experience. **The most successful investors deploy a team of experienced advisors for support and have access to capital and are ready to execute quickly.**
CASE STUDY: John the Investor

In 2005, John Investor took a buyout package from his employer, cashed in his stock options and went home, strategizing over what the next half of his life would entail. After much consideration, John decided that investing in apartment buildings was the way to go, so, like everything John has ever done, he immersed himself in the subject; buying every book and home study course and attending every seminar on the subject. After earning what he thought was the equivalent of a masters degree in the subject, John set about acquiring his first property.

Looking in the emerging market of the Dallas-Fort Worth Metroplex, John settled on a 120-unit property with a purchase price of $5,250,000. He searched the debt marketplace and found a lender willing to provide funding with the following competitive terms: 15% down, interest only, and a 7-year term.

In order to make the deal happen, John needed to raise $787,500 for the down payment and an additional $262,500 for liquidity and closing costs. Not having these funds available personally, John began contacting his friends and family and in short order, had put together an investment group made up of his three brothers and his college roommate. In addition, John successfully negotiated a no-interest second mortgage with the seller totaling 5% of the purchases price that runs concurrently with the first mortgage. The second mortgage is to be paid off upon maturity of the first mortgage.

<table>
<thead>
<tr>
<th>Sources</th>
<th>Uses</th>
</tr>
</thead>
<tbody>
<tr>
<td>$4,462,500</td>
<td>Loan Proceeds</td>
</tr>
<tr>
<td>$262,500</td>
<td>Seller Financing</td>
</tr>
<tr>
<td>$787,500</td>
<td>Down Payment</td>
</tr>
<tr>
<td>$5,512,500</td>
<td>Total Sources</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>$5,250,000</td>
</tr>
<tr>
<td></td>
<td>$262,500</td>
</tr>
<tr>
<td></td>
<td>$5,512,500</td>
</tr>
<tr>
<td></td>
<td>Purchase Price</td>
</tr>
<tr>
<td></td>
<td>Closing/Work Cap</td>
</tr>
<tr>
<td></td>
<td>Total Uses</td>
</tr>
</tbody>
</table>

Fast forward seven years. The notes are coming due. The property has had its ups and downs but all in all has proven to be a solid asset in a solid submarket. It makes money every month, pays its bills, but the property has not met all investor expectations. The exit strategy was to either refinance or sell the property outright. Regardless, the investors are expecting a payday soon. Remember, his investors are friends and family – relationships are starting to be affected.
CASE STUDY: John the Investor (cont.)

John contacted the mortgage broker who put together the financing seven years ago to start the discussion about refinancing his property. Since 2005, when John was last in this game, the terms and underwriting guidelines have changed considerably. Fifteen percent down loans no longer exist -- now maximum LTV is 75%. In order to successfully refinance this deal, John needs to conform to these new underwriting guidelines in order to keep his property.

Over the last seven years, the NOI of the property has ebbed and flowed. Some months the property lost money and some months the property was able to get caught up on all its bills. As a result of the weakening economy and increased fuel costs, NOI has increased only slightly from its 2005 numbers. When John purchased this property, the cap rate was at a solid 7%. During the last several years, cap rates have increased and then started to decline again but not yet to historic lows. For John’s asset, the current cap rate is approximately 8.25%. This rate will likely change over the next year or so until John needs to refinance, but for sake of this example, we will assume that he needs to pull the trigger on the transaction today.

Knowing the seller second is coming due John reaches out to try to renegotiate the terms with no luck. The two parties did not leave the closing table as friends, and now the prior owner just wants his 5% and is threatening to foreclose on the property to get it. Based upon the above factors, the change in the numbers on John’s deal are as follows:

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI</td>
<td>$367,500</td>
<td>$380,000</td>
</tr>
<tr>
<td>Cap Rate</td>
<td>7.0%</td>
<td>8.25%</td>
</tr>
<tr>
<td>Valuation</td>
<td>$5,250,000</td>
<td>$4,600,000</td>
</tr>
<tr>
<td>Loan Balance</td>
<td>$4,462,500</td>
<td>$4,462,500</td>
</tr>
<tr>
<td>LTV</td>
<td>85%</td>
<td>97%</td>
</tr>
<tr>
<td>Cash needed to reach 75% LTV</td>
<td>$0</td>
<td>$1,012,500</td>
</tr>
<tr>
<td>Cash needed to pay 2nd Mortgage</td>
<td>$0</td>
<td>$262,500</td>
</tr>
<tr>
<td><strong>TOTAL CAPITAL SHORTFALL</strong></td>
<td>$0</td>
<td>$1,275,000</td>
</tr>
</tbody>
</table>
CASE STUDY: John the Investor (cont.)

In order to secure new financing, John needs an additional $1.275MM. This problem has occurred entirely because the economy went down, cap rates increased and underwriting guidelines tightened. This problem was not of John’s making. Because the apartment business is so highly leveraged, it is constantly shaped and reshaped by the external forces of the capital markets; John’s deal is no exception.

Where does John get the money he needs? How does he solve his problem? Are his existing investors going to step up and put in that additional funding to keep their investment? This is where an opportunity presents itself for you.

After reviewing information provided either be Pierce-Eislin or Trepp, you find John’s property is a quality prospect. His property profile is exactly what you are looking for; size, location, steady performance, over leveraged and currently in the pre-distress stage. You gather your Level I data and then up pick up the phone and call John to introduce yourself and begin the dialogue about his property.

It may take several calls for the relationship building process with John to bear fruit. Your goal is to get to the point where conversation is collaborative and transparent, where John willingly provides enough Level II information about his property and the ownership structure for you to determine (1) deal potential or (2) if you want or need John to remain in the deal. Keep in mind that John needs you more than you need him. With multiple billions of dollars of loans to be resized, there are many “Johns” who can use a problem solver like you. This is the position you want to be in when negotiating any deal.

Your job is to present a solution to John and his partners that makes sense for you, them and the existing lender. While you continue to strategize with John, you are gathering Level I and Level II data points on as many potential deals that you find meet your investment criteria. The great thing about this strategy is that you don’t wait for a broker to bring you a deal; you go out there and find them on your own.

Happy Hunting!
What’s the Next Step?

Get educated! Knowledge is power in this business.

If you have been sourcing multifamily deals for any amount of time, you recognize that many of the concepts discussed in this report are different from the conventional strategies.

These new techniques offer a gateway into a previously untapped multi-billion dollar marketplace that has less competition and the potential to find higher yielding lower risk deals.

If these strategies appeal to you as an investor and you would like additional education or support please contact our office for a free consultation:

Dobens Law, LLC
administrator@dobenslaw.com
www.dobenslaw.com
(877) 866-4764
About Dobens Law

Working exclusively with the multifamily investor, Dobens Law specializes in all aspects of apartment investing acquisition, ownership and operation. Seeing the need for legal representation of investors, Charles Dobens, Esq., a Massachusetts attorney, founded Dobens Law to protect the interests of investors throughout the entire multifamily acquisition and ownership process. Working only with qualified clients, Dobens Law assists investors in the following processes:

- Identifying properties that meet investor buying criteria
- Analyzing financials determine property valuation
- Assisting in the drafting and negotiation of the offer, contract and other legal instruments
- Supporting due diligence process
- Assisting with the financing package and loan application
- Advising on the orderly transition of ownership
- Remaining with our clients throughout the entire ownership process as needed.

Individual Representation: Some investors prefer to engage our firm for representation through the entire acquisition and transition to ownership process. We work with our clients to establish their investment criteria, identify markets, and evaluate deals. If a client desires representation for a re-distressed or distressed asset, our experienced staff will contact owners on their behalf, collect necessary information pertaining to a particular opportunity and determine whether the Recapitalization Option or Recapitalization Option is best. At that point, discussions will take place that involve the client and current owner with an eye towards the consummation of a deal.

Individual representation for these services will be limited to a certain number of potential investors within a particular marketplace. Space is limited due to the market services that Dobens Law will provide on behalf of our clients.
About Multifamily Investing Academy

Realizing the need in the marketplace for high quality educational services for multifamily investors, Attorneys Charles Dobens and Jillian Sidoti created the Multifamily Investing Academy (MFIA) in 2010. The MFIA brings together training, educational resources and consulting services to new and advanced multifamily investors.

Bringing together the specialties of both attorney’s firms, MFIA is uniquely positioned to provide educational services for both the acquisition, financing and ownership aspects of multifamily property investing. Attorney Sidoti’s practice specializes in securities law which provides support for clients wanting to raise private money and for entities necessary to house those investments.

The MFIA has designed two separate educational programs to provide further education on Deal Recapitalization or Deal Restructuring discussed in this paper.

Three-Course “Recap” Program

The Recap Program is a three-part course designed for those investors already trained in the basics of multifamily investing. The first part of the course discusses the multifamily apartment business AS A business. It assumes a basis of understanding in multifamily in its class work. The second part of the program discusses the process of raising private money to create a “fund” that will be needed to close these deals quickly and with confidence. The final part takes you through all the steps necessary to confidently approach the owners, contact lenders, special servicers and trustees as well as structure deals that create win/win scenarios for all parties involved.
Two/Three-Day “Recap” Training Seminars

Throughout the country, MFIA and its founders, Attorneys Sidoti and Dobens, will conduct three-day seminars going into detail all the legal and technical aspects of acquiring pre-distressed and distressed multifamily property using the methods detailed in this white paper. These seminars are limited in number of attendees and are followed up with on-line access to both attorneys to answer any questions or concerns you may have regarding the process. The MFIA is unique in that it provides access for our attendees to all our teachers.

If would like to find out more about the services that we provide, or subscribe to our free newsletter please visit www.multifamilyinvestingacademy.com.