

Defensive Driving for Acquiring Apartment Buildings

Reduce Risk & Economic Downturn (Recession) Exposure

Positive Leverage & Stress Test Analysis



Leverage is the key to make or brake a investment opportunity. Acquiring investments in appreciating markets, or for renovation turnaround scenarios, high leverage is important (e.g. 10% to 20% down payment) to maximize the Return on Equity (ROE). For long term holding periods, leverage can work against the concept of maximizing ROE with Other Peoples Money (OPM = Lender Financing). The traditional concept of investing in real estate utilizes maximum leverage to put as little down and borrow as much as possible using OPM. This type of reckless driving can cause problems leading to negative cash flow to foreclosures in the event of a recession. A diligent investor would apply some type of "Stress Test" analysis for possible declining rents and increasing vacancy and or expenses.

Positive Leverage: Positive Leverage is when the Cap Rate of the property exceeds the interest rate of the financing. If the Cap Rate of the property is lower than the Interest Rate of the financing, then the investment is not positive leverage. For example, if the Interest Rate of available financing is 4.50% Fixed for 10 Years, and the Cap Rate is 6%+, then the property has good positive leverage. Negative Leverage would be a 5% Cap Rate with a 6%+ interest rate for financing.

Reducing Interest Rates of Financing with lower leverage scenarios. Typically, Banks or Lenders will **reduce the interest rate if the Loan to Value (LTV) is reduced**, due to reducing the risk. For example, a range of 20%, 35% and 45% cash down scenarios would have three different pricing breaks as the loan risk is reduced. Interest rates are further reduced if the loan maturity is shorter (e.g. 7 yrs. vs. 10yrs, etc.). The lower the interest rate the better the positive leverage will balance with the reduced risk. The typical Interest Rate scenarios would be:

20% Cash Down with 80% LTV Financing: 4.825% Fixed for 10 years.

35% Cash Down with 65% LTV Financing: 4.625% Fixed for 10 years.

45% Cash Down with 55% LTV Financing: 4.400% Fixed for 10 years.

Economic Downturn (Recession) Stress Test Exposure:

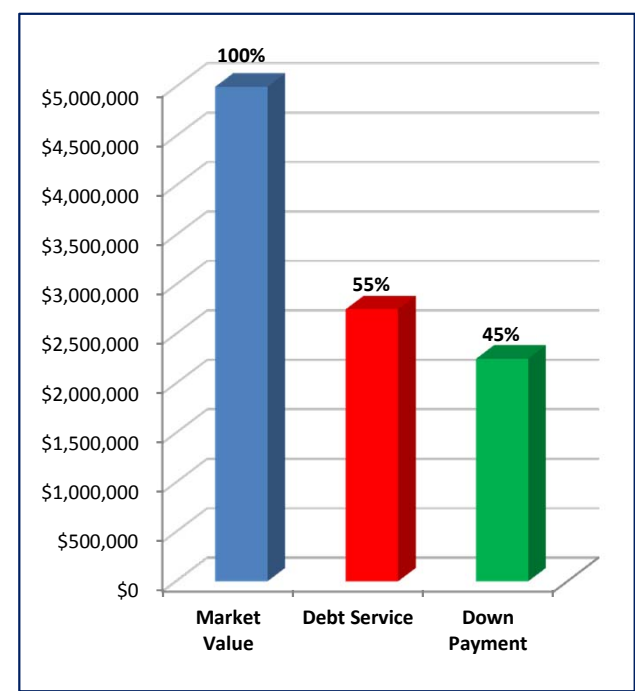
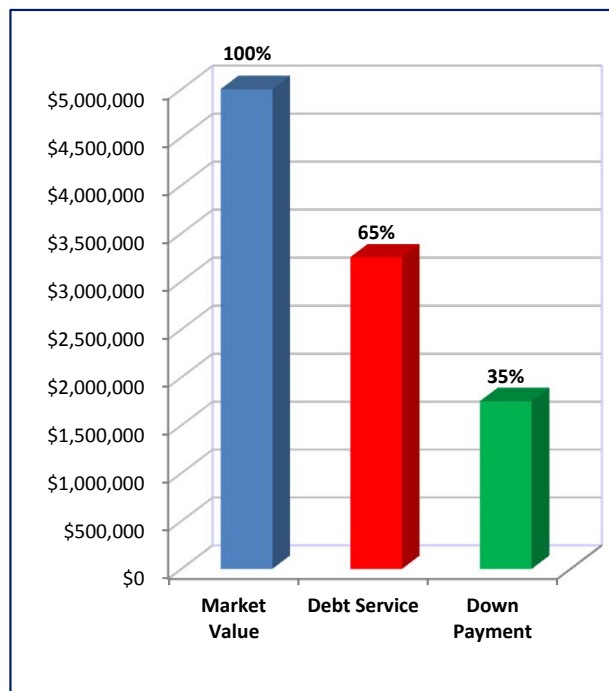
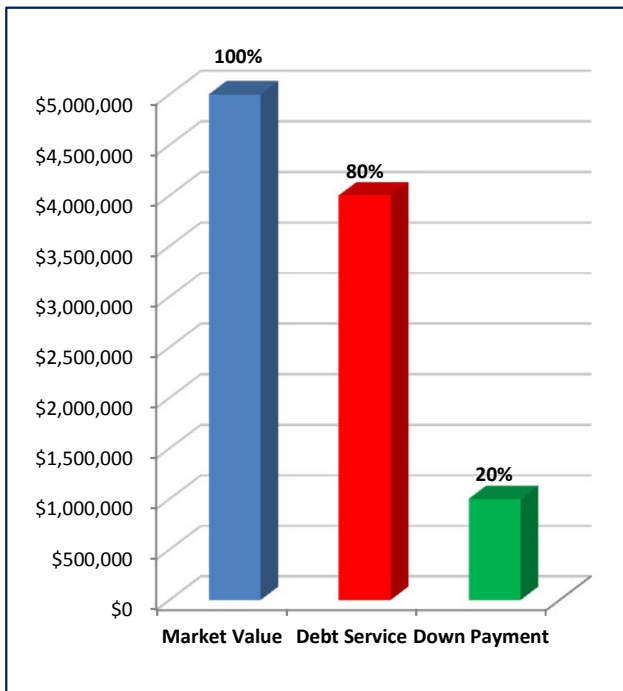
- **Market Rental Values decline from 10% to 20% for Class A, B, or C properties due to economic recession.**
- **Vacancies increase and rents decline due to high unemployment.**
- **Interest Rate Cash Flow Exposure for maturing loans (balloon payments); Refinancing at higher interest rates that could sweep the cash flow.**
- **Interest Rate exposure due to Adjustable Rate Mortgages; Increasing interest rates sweep cash flow.**
- **High Leverage Balloon Payment Risk; loan balance at maturity is issue with value for refinancing, resulting in necessary cash infusion or forced sale.**
- **Foreclosure Tax Risk: Debt Relief (Loan Principal Deficiency); Recourse vs. Non-Recourse Financing.**
- **Minimal Protective Equity due to high leverage.**

80% LTV / 20% Cash Down

65% LTV / 35% Cash Down

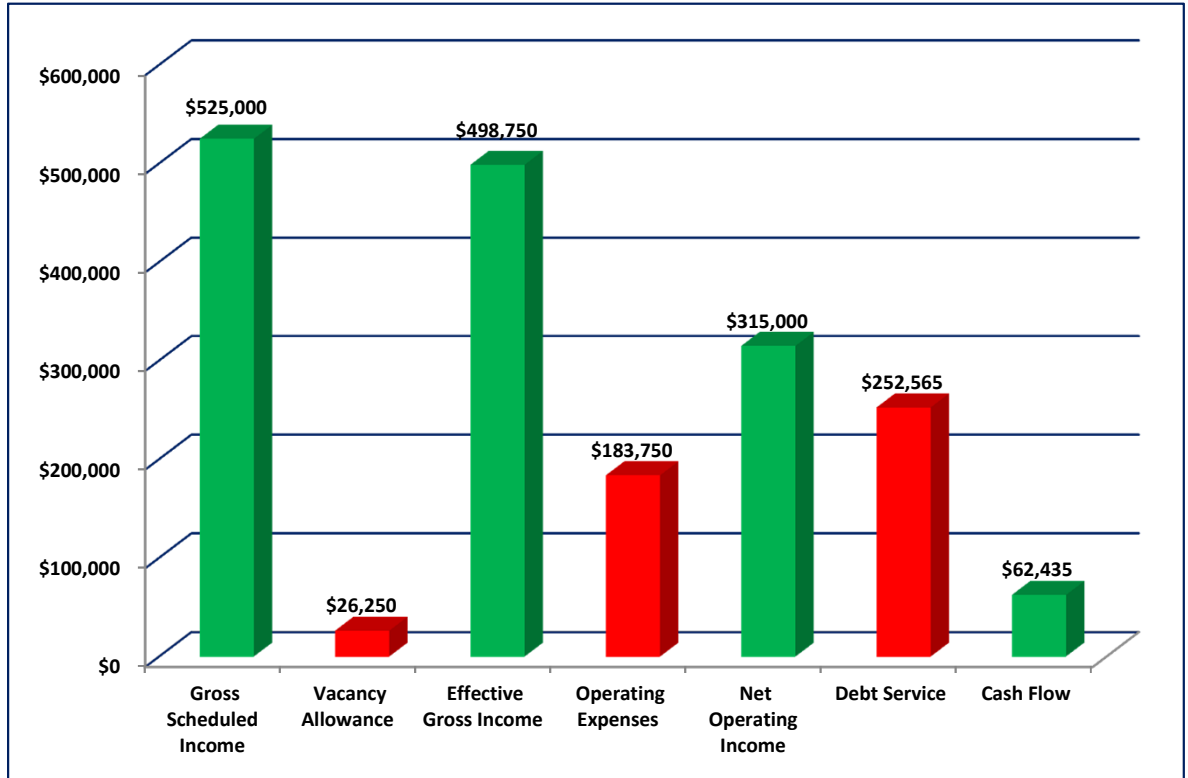
55% LTV / 45% Cash Down

Purchase Price	\$5,000,000	\$5,000,000	\$5,000,000
\$ Cash Down Payment	\$1,000,000	\$1,750,000	\$2,250,000
% Cash Down Payment	20.00%	35.00%	45.00%
Original Loan Amount (Debt)	\$4,000,000	\$3,250,000	\$2,750,000
% Loan Amount (LTV)	80.00%	65.00%	55.00%
Financing Options	10 Year Fixed	10 Year Fixed	10 Year Fixed
Interest Rate	4.83%	4.63%	4.40%
Cap Rate	6.30%	6.30%	6.30%
GRM	9.52	9.52	9.52
Net Operating Income	\$315,000	\$315,000	\$315,000
Debt Service	\$252,565	\$200,514	\$165,251
Cash Flow	\$62,435	\$114,486	\$149,749
Return on Equity (ROE)	6.24%	6.54%	6.66%
Estimated Loan Balance EOY 10	\$3,258,000	\$2,630,000	\$2,209,000
Breakeven Vacancy	16.89%	26.81%	33.52%
Breakeven Occupancy	83.11%	73.19%	66.48%
Breakeven Interest Rate	6.86%	9.04%	11.03%
Average Rent / Unit (# of Units) 50	\$875	\$875	\$875
Breakeven Rent / Unit (100% occupancy)	\$727	\$640	\$582



Positive Leverage Financing Scenarios (20% Down & 80% Financing)

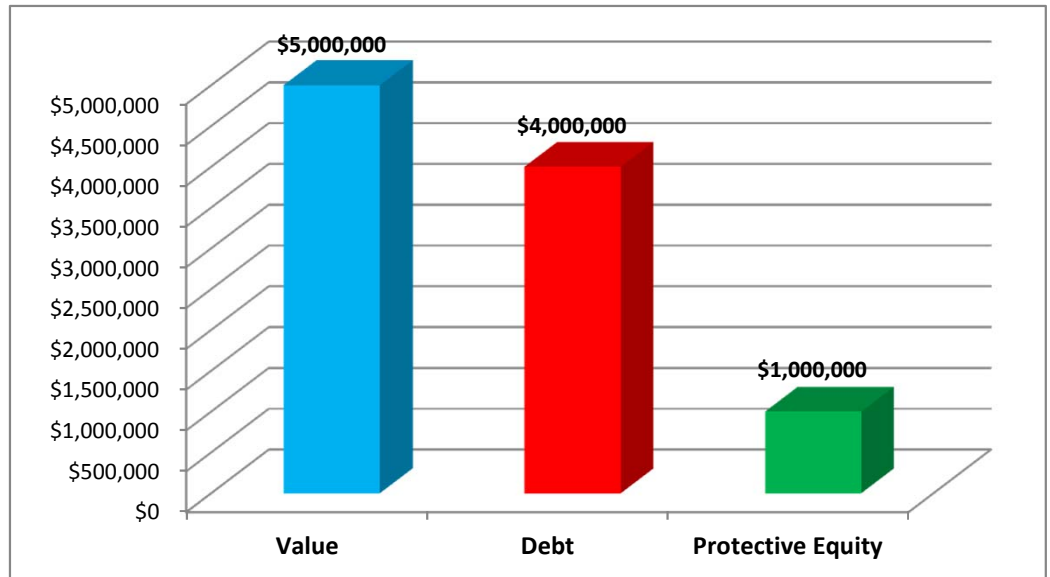
Purchase Price		\$5,000,000
\$ Cash Down Payment		\$1,000,000
% Cash Down Payment		20%
Original Loan Amount (Debt)		\$4,000,000
% Loan Amount (LTV)		80%
Financing Options		10 Year Fixed
Interest Rate		4.825%
Cap Rate		6.300%
GRM		9.52
Gross Scheduled Income		\$525,000
Vacancy Allowance	5%	\$26,250
Effective Gross Income		\$498,750
Operating Expenses	35%	\$183,750
Net Operating Income		\$315,000
Debt Service		\$252,565
Cash Flow		\$62,435
Return on Equity (ROE)		6.24%
12 Month Estimated Principal Reduction		\$59,565
Estimated Depreciation		\$110,000
Estimated Loan Balance EOY	10	\$3,258,000



Stress Test Risk Exposure (20% Down & 80% Financing)

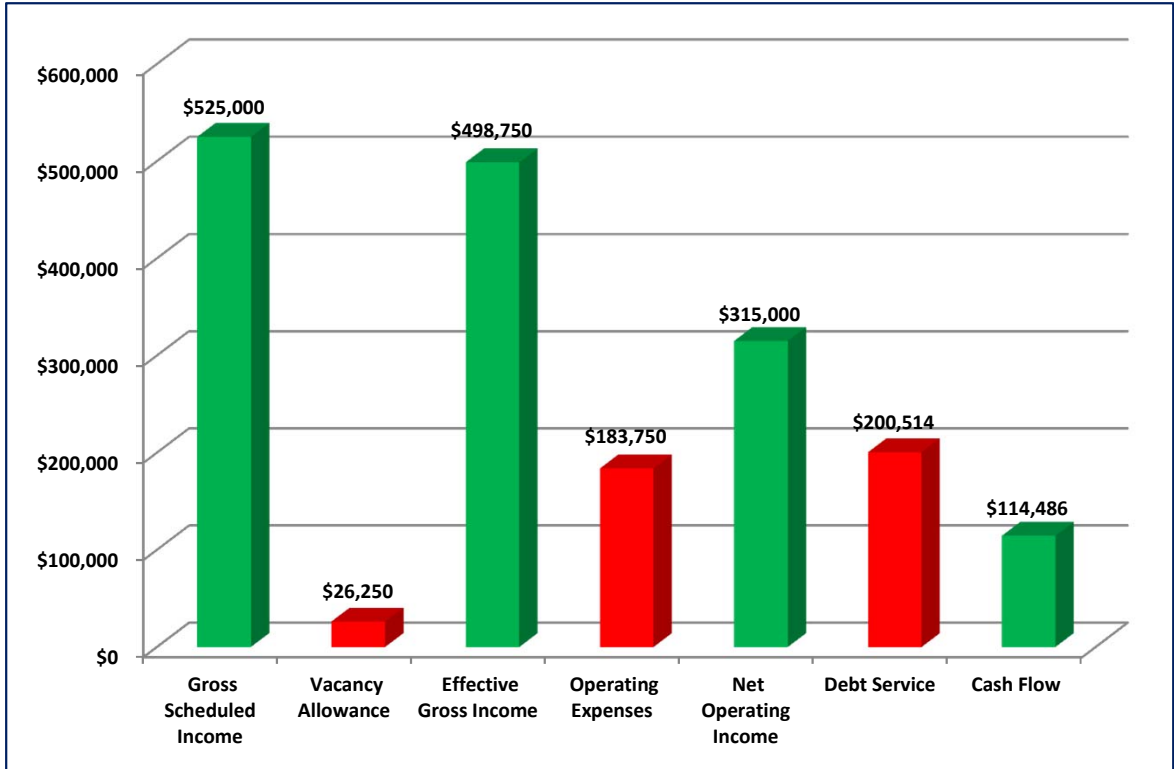
Breakeven Vacancy	16.89%
Breakeven Occupancy	83.11%
Breakeven Interest Rate	6.865%
Protective Equity (Down Payment)	\$1,000,000
Average Rent / Unit	\$875
Breakeven Rent / Unit	\$727

Breakeven Vacancy: Estimated vacancy for breakeven cash flow.
Breakeven Occupancy: Estimated % Occupancy for break even cash flow.
Breakeven Interest Rate: Estimated Interest Rate for break even cash flow.
Protective Equity (Down Payment): Amount of Cash Equity.



Positive Leverage Financing Scenarios (35% Down & 65% Financing)

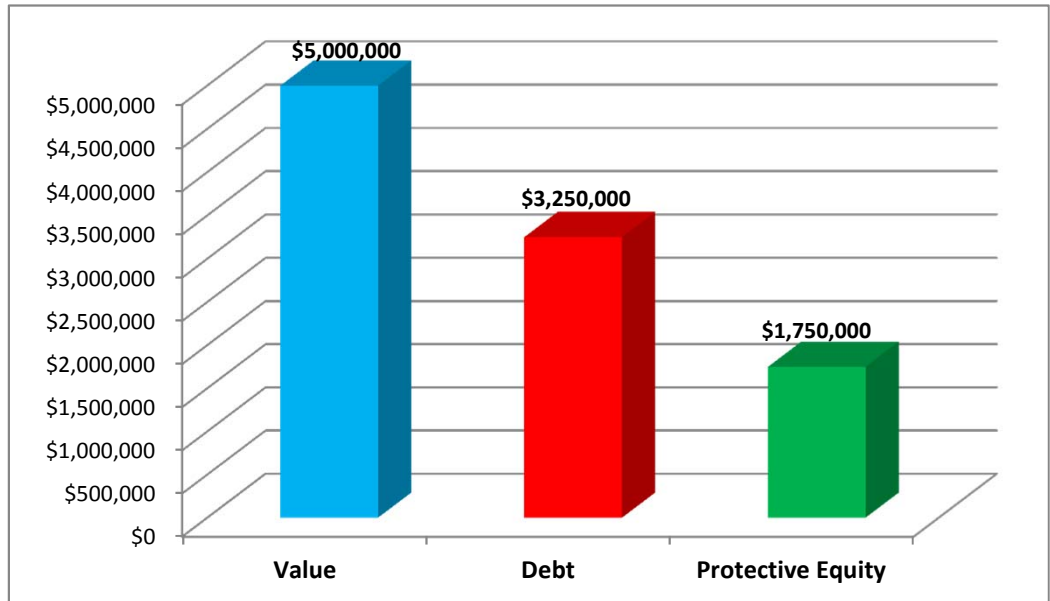
Purchase Price		\$5,000,000
\$ Cash Down Payment		\$1,750,000
% Cash Down Payment		35%
Original Loan Amount (Debt)		\$3,250,000
% Loan Amount (LTV)		65%
Financing Options		10 Year Fixed
Interest Rate		4.625%
Cap Rate		6.300%
GRM		9.52
Gross Scheduled Income		\$525,000
Vacancy Allowance	5%	\$26,250
Effective Gross Income		\$498,750
Operating Expenses	35%	\$183,750
Net Operating Income		\$315,000
Debt Service		\$200,514
Cash Flow		\$114,486
Return on Equity (ROE)		6.54%
12 Month Estimated Principal Reduction		\$50,202
Estimated Depreciation		\$110,000
Estimated Loan Balance EOY		\$2,630,000



Stress Test Risk Exposure (35% Down & 65% Financing)

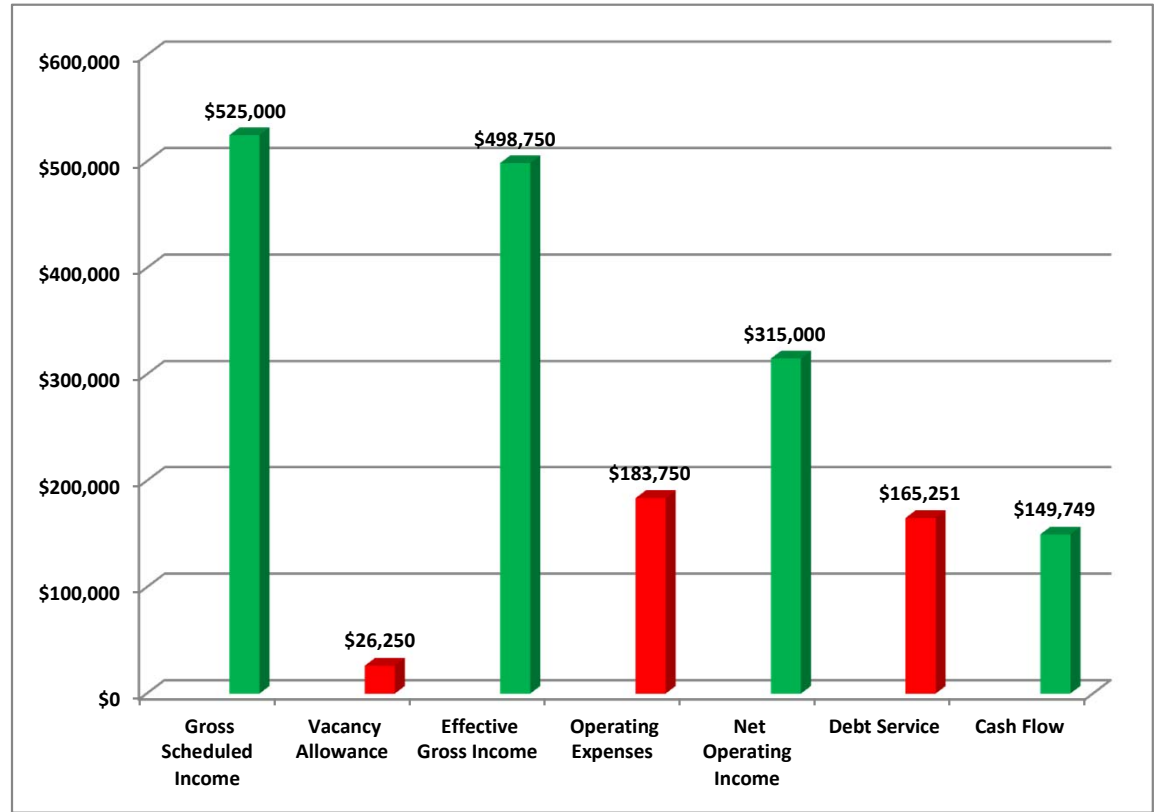
Breakeven Vacancy		26.81%
Breakeven Occupancy		73.19%
Breakeven Interest Rate		9.043%
Protective Equity (Down Payment)		\$1,750,000
Average Rent / Unit (# of Units)	50	\$875
Breakeven Rent / Unit		\$640

Breakeven Vacancy: Estimated vacancy for breakeven cash flow.
Breakeven Occupancy: Estimated % Occupancy for break even cash flow.
Breakeven Interest Rate: Estimated Interest Rate for break even cash flow.
Protective Equity (Down Payment): Amount of Cash Equity.



Positive Leverage Financing Scenarios (45% Down & 55% Financing)

Purchase Price	\$5,000,000
\$ Cash Down Payment	\$2,250,000
% Cash Down Payment	45%
Original Loan Amount (Debt)	\$2,750,000
% Loan Amount (LTV)	55%
Financing Options	10 Year Fixed
Interest Rate	4.400%
Cap Rate	6.300%
GRM	9.52
Gross Scheduled Income	\$525,000
Vacancy Allowance	\$26,250
Effective Gross Income	\$498,750
Operating Expenses	\$183,750
Net Operating Income	\$315,000
Debt Service	\$165,251
Cash Flow	\$149,749
Return on Equity (ROE)	6.66%
12 Month Estimated Principal Reduction	\$44,251
Estimated Depreciation	\$110,000
Estimated Loan Balance EOY	\$2,209,000



Stress Test Risk Exposure (45% Down & 55% Financing)

Breakeven Vacancy	33.52%	
Breakeven Occupancy	66.48%	
Breakeven Interest Rate	11.029%	
Protective Equity (Down Payment)	\$2,250,000	
Average Rent / Unit (# of Units)	50	\$875
Breakeven Rent / Unit	\$727	

Breakeven Vacancy: Estimated vacancy for breakeven cash flow.
Breakeven Occupancy: Estimated % Occupancy for break even cash flow.
Breakeven Interest Rate: Estimated Interest Rate for break even cash flow.
Protective Equity (Down Payment): Amount of Cash Equity.

