Trinity Private Equity Group

CASE STUDY: REAL ESTATE VALUE-ADD

Cimarron City Apartments

INITIAL **PROJECT PLAN**

In December of 2010, TPEG partnered with experienced value-add developer PPA Group (the "Sponsor"), to refurbish a 141-unit apartment complex in San Antonio. The $5.87m project employed $930k of preferred equity and accrued a 6% preferred return for the first four years, then 12% for the remainder of the investment. Equity investors would also earn 50% of the project's profits, after their capital was returned and their preferred return was paid. The Sponsor and TPEG shared the other 50% of the profits. Upon sale of the property, investors were to achieve a pre-tax IRR (a hurdle rate) of 18% before splitting the remaining profit 50/50 with the Sponsor and TPEG.

The property's purchase price of $5.14m represented a trailing twelve month cap rate of 8.5%, and TPEG believed this to be a good value in the strengthening San Antonio market. The $5.87m total project cost included a renovation budget of $375k ($2,660 per unit) and $355k of transaction costs and contingency funds. The $5.87 project cost was paid for with $930k of preferred equity and assumption of a $4.94m loan.

The investment lifecycle consisted of three parts:

- A **Diligence Phase** leading up to purchase of the property, including formulation of detailed renovation and property management plans.

- An **Execution Phase** of up to 18 months, commencing upon purchase and including physical renovations as well as improvement of the property management. The goal of this phase is to raise the property's net operating income by increasing rents. Local market conditions and property improvements are expected to allow for increased rents, though occupancy can typically be expected to decline as renovations are undertaken.

- **Stabilized Operations** including a refinancing and, ultimately, a sale. With Cimarron, the initial plan was to refinance the property after 18 months, when net operating income had significantly increased, and use the proceeds to repay investor equity.

TPEG and the Sponsors were initially attracted to this project for three reasons. Firstly, it appeared to be an undervalued asset and one that would provide for reasonable protection of investor principal. If the full renovation budget of $375k was spent and no significant increases in rent or occupancy were achieved, it was reasonable to believe that the apartment community could be resold at a price sufficient to return investor capital.

The purchase price of the apartment complex was lower than the cost to build a similar community. TPEG initially projected a sale cap rate of 7.5%, an improvement upon the 8.5% cap rate at purchase, and in line with the 6.75% to 7.5% cap rate at which San Antonio class B properties were selling, according to a recent CBRE study.

Secondly, the debt assumed in the purchase carried a fixed rate of 6.15%, above market at that time, and was maturing in two years. Refinancing this loan at a lower rate would improve the property's cash flow.

Finally, Cimarron was built in 1985. Modest, well thought out renovations can make a 25-year old apartment complex a much more desirable place to live. The ensuing management of rents and occupancy can increase an apartment community's net operating income, which, in turn, provides more cash available to distribute to equity investors and increases the sale price that the property will command.

Further diligence was required to conclude that rents in the immediate submarket were trending upward and that there was sufficient local demand for class B apartments. Once satisfied that the apartment rental market in northeastern San Antonio supported the investment thesis, TPEG began vetting the project.

TPEG conducted exhaustive due diligence on the Sponsor, the multifamily industry, the local market, and the submarket. TPEG worked with the Sponsor to create a detailed financial model that allowed TPEG to perform a series of scenario analyses. TPEG and its legal counsel vetted all bank documents, the purchase contract, the renovation budget and contract, the operating agreement for the project special purpose entity, the property management agreement, and other contracts and agreements, including documents related to titling.

TPEG, with the Sponsor and with TPEG legal counsel, structured the transaction in such a way as to align the interests of all stakeholders. TPEG created a special purpose entity for investors, and TPEG principals and the Sponsor made equity contributions under the same terms as TPEG investors. As with most TPEG real estate transactions, TPEG and the Sponsor would receive equity profit distributions only after TPEG investors had received a full return of the capital they invested along with their full preferred return.

TPEG then prepared a full private placement memorandum for its investors, detailing all material issues and factors related to the project and to the investment. TPEG hosted a webinar for potential investors to hear from, and ask questions of, TPEG and the Sponsor. The webinar was followed by multiple site visits that allowed potential investors further opportunity to familiarize themselves with the Sponsor, the local market, and the project. TPEG principals and employees were available to answer questions throughout the process.

THE **PROJECT**

The purchase and loan assumption were completed without issue, and the Sponsor immediately began renovations. Unlike a number of value-add projects, all improvements were made to exterior and common areas. The fact that apartment interiors did not need major updates meant that we did not have to force resident turnover. Occupancy had averaged 93% over the twelve months prior to our purchase, and the Sponsor kept occupancy between 92% and 98%.

Another benefit of exterior-only renovations was the speed at which the project could move. Without needing to wait for individual units to be renovated, we were able to aggressively increase rents. We had projected increasing gross income, which includes rent and other fees, from just over $1.0m in the twelve months prior to acquisition to just over $1.1m in the second year after acquisition. A year and a half after acquisition, the run rate, based on the trailing three months, was over $1.2m.

In addition to the increased rents, the Sponsor reduced expenses. Cimarron produced NOI (net operating income) of $434k in the twelve months prior to our purchase. Eighteen months after acquisition, NOI increased to an annual rate of $634k, based on the trailing three months.

In May of 2012, the Sponsor began actively marketing the property for sale. By July, Cimarron was under contract to sell for $7.8m, 52% above our acquisition price.

THE **RESULTS**

The property was sold in September of 2012, 21 months after the initial investment. **TPEG investors realized a pre-tax IRR of approximately 58% and a cash-on-cash return of approximately 215%.** The following table shows annual cash flows to TPEG investors. TPEG does not charge asset management fees to investors, so the cash flows represented in this table are net pre-tax cash flows.

TPEG INVESTOR RETURNS
Cimarron City Apartments

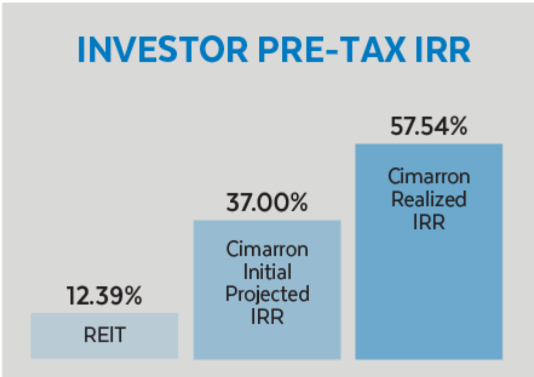
		YEAR 1	YEAR 2
CASH FLOW TO EQUITY INVESTORS			
TPEG Investor Contribution	($930,000)		
Current Yield		$48,571	$44,011
Return of Equity Capital			$930,000
Split of Remaining Cash - 50%			$976,304
Total	**($930,000)**	**$48,571**	**$1,950,315**
CASH FLOW PER $100,000	**($100,000)**	**$5,223**	**$209,711**
Annual Cash Yield		*5.22%*	*209.71%*
ACTUAL IRR	**57.54%**		
ACTUAL CASH-ON-CASH	**214.93%**		

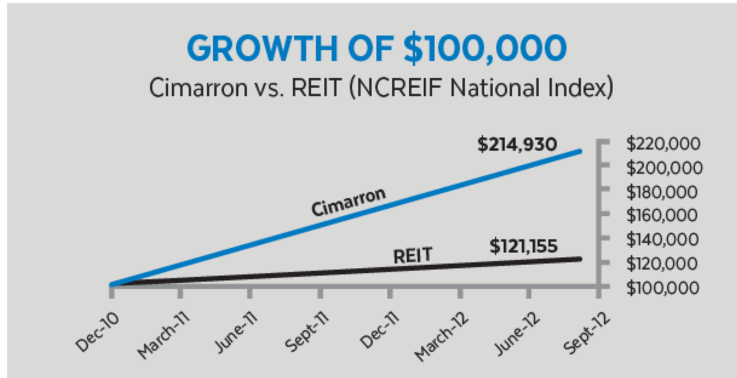
Each TPEG investment has unique characteristics, but it's common for our value-add projects to pay some or all of the preferred return on a current basis, beginning with the first quarter after closing. Delaying distributions to equity allows more financial flexibility and enhances capital efficiency. Making current payments adds financial discipline and gives investors current income.

Value-add projects also tend to involve lower overall risk than development/construction projects. To be successful, a value-add real estate project should:

- Make sense macroeconomically, with favorable trends in the local economy
- Address a significant demand in the relevant submarket
- Immediately improve the property's net operating income
- Quickly improve the property's desirability, both from the perspective of its users/residents and from investors
- Be thoroughly vetted legally
- Be thoroughly modeled financially, including stress testing in scenario analysis
- Be structured properly, aligning the incentives of all stakeholders
- Be conducted by the right people (our operating partners/sponsors)
- Include outside oversight (TPEG)

TPEG considers each of these factors a requirement and will not invest in a project that falls short in any of these areas. The Cimarron City Apartments project was TPEG's first value-add apartment investment. It was successful, and it provided a roadmap that we've used and improved over the past five years.


INVESTOR PRE-TAX IRR
12.39%
REIT
37.00%
Cimarron Initial Projected IRR
57.54%
Cimarron Realized IRR


GROWTH OF $100,000
Cimarron vs. REIT (NCREIF National Index)
$214,930
Cimarron
REIT
$121,155
$220,000
$200,000
$180,000
$160,000
$140,000
$120,000
$100,000
Dec-10
March-11
June-11
Sept-11
Dec-11
March-12
June-12
Sept-12