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Sun Arrow Apartments: Investment Analysis of an Apartment Complex Acquisition

Abstract

The Sun Arrow Apartments Case Study focuses on the evaluation of an investment opportunity for a 275-unit apartment complex in the El Paso, Texas market. After taking Sun Arrow out of bankruptcy, Frank Markowitz of Fannie Mae informs the case study's protagonist, Geoff Grayson, that he has thirty days to complete the acquisition of Sun Arrow. Grayson's task is twofold. First, Grayson must determine how to get the funds necessary to quickly close Sun Arrow. Second, Grayson must assess his risk tolerance because various market and property risks exist in connection with any Sun Arrow acquisition. The Sun Arrow case study assists students with critical thinking skills vital to the real estate acquisitions decision-making process and provides opportunities to consider quantitative and qualitative issues in real estate acquisitions.

Keywords

Cornell University, real estate, real estate acquisition, risk analysis, deal structuring, multi-family, financial analysis, market analysis

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CASE STUDY SERIES

Sun Arrow

Investment Analysis of
an Apartment Complex Acquisition

by Randy Hagedorn

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Sun Arrow

Residential Development

ABSTRACT

The Sun Arrow Apartments Case Study focuses on the evaluation of an investment opportunity for a 275-unit apartment complex in the El Paso, Texas market. After taking Sun Arrow out of bankruptcy, Frank Markowitz of Fannie Mae informs the case study's protagonist, Geoff Grayson, that he has thirty days to complete the acquisition of Sun Arrow. Grayson's task is twofold. First, Grayson must determine how to get the funds necessary to quickly close Sun Arrow. Second, Grayson must assess his risk tolerance because various market and property risks exist in connection with any Sun Arrow acquisition. The Sun Arrow case study assists students with critical thinking skills vital to the real estate acquisitions decision-making process and provides opportunities to consider quantitative and qualitative issues in real estate acquisitions.

This case study incorporates the following real estate themes and issues:

Real Estate Acquisition

Risk Analysis

Deal Structuring

Multi-family

Financial Analysis

Market Analysis

Sun Arrow Apartments

by Randy Hagedorn

Author

Randy Hagedorn graduated with bachelor's degrees in History and Political Science from the University of Utah. Randy also holds a Juris Doctor from the University of Minnesota Law School. Randy recognized early on a passion for real estate. He just never knew how his passion would evolve into a career. After graduation from the University of Utah, Randy created a plan to obtain the necessary capital to obtain real estate. It took nearly three years and during that time, Randy operated several entrepreneurial ventures. Finally, in 2001, Randy founded Hagedorn Investment Group (HIG), a real estate investment and consulting company. HIG focused primarily on the acquisition of multifamily properties but also had commercial and residential interests. HIG purchased, repositioned and sold the properties for significant profits. HIG used the gains for new acquisitions.



As Geoff Grayson hung up the phone, he leaned back in his chair and let out a deep sigh. It was 4:30 p.m. on April 30, 2002. Frank Markowitz of Fannie Mae (FNMA) called Grayson to inform him that FNMA had accepted his offer for the Sun Arrow Apartments in El Paso, Texas. All of Grayson's hard work had paid off. However, Markowitz gave Grayson until the end of May to close the deal.

Grayson pleaded with Markowitz for 60 days to close the deal but Markowitz would not relent. Grayson knew that he needed more than 30 days to liquidate a few of his assets for the \$1,000,000 down payment required by GMAC Commercial Lending. The issue Grayson now faced was how he would obtain the necessary funds to acquire Sun Arrow Apartments.

Geoff Grayson

Grayson, born and raised in Salt Lake City, Utah, graduated from the University of Utah in Banking and Finance. After graduation, Grayson enrolled in the Army Reserve and had Advanced Officer Training in finance at the United States Army Finance Center in Fort Benjamin Harrison, Indiana.

Following his stint in the United States Army, Grayson began graduate work in Computer Science at the University of Utah with the intent of pursuing a career in computer programming. However, Grayson left the program after his neighbor and close friend, Robert Eklund, persuaded Grayson to apply his finance skills to real estate. Eklund, a real estate professional, worked for a real estate syndicator that focused on the four-core property types. Eklund sparked an interest in Grayson and the two friends created a real estate partnership.

The partnership acquired multifamily properties and Grayson's real estate career began at the ground level in multifamily property acquisitions, operations, and management. The first property the partnership acquired was a 136-unit complex named Robbinsvale Gardens located in Bountiful, Utah. Unfortunately, the two dissolved the partnership after Eklund's employer discovered the partners' "side business" and threatened to terminate Eklund.

By now, Grayson had a taste for real estate. Grayson purchased Eklund's share of the ownership and in 1975 founded two companies. Grayson and his brother, Jim, formed Property Management Associates (PMA), a property management and real estate brokerage firm focused on markets in Utah and Texas. Grayson learned firsthand the complexities of overseeing a portfolio of multifamily assets and the challenges of maximizing property values. As part of company's brokerage duties, Grayson identified target markets, performed market research, and contacted potential sellers. After identifying a potential acquisition, Grayson performed the due diligence on the property for his clients.

The other company that Grayson founded was Grayson Capital Partners (GCP), a real estate syndication firm focused on multifamily real estate. "A real estate syndication combines the money of individual investors with the management of a sponsor, and has a three-phase cycle: origination (planning, acquiring property, satisfying registration and disclosure rules, and marketing); operation (sponsor usually manages both the syndicate and the real property); and liquidation or resale of the property."¹ Because of his property

¹ California Department of Real Estate, Reference Book – A Real Estate Guide, 2000, p.307.

management experience, Grayson created value for his company and clients as well as gained a favorable reputation as a solid investor of multifamily real estate. During the 13-year existence of both firms, Grayson negotiated the acquisition and disposition of over \$15 million of commercial real estate. With over 2,200 units, Grayson found success in real estate. He had two profitable companies that put him in a position to be financially independent at a young age.

In 1982, Grayson Capital Partners sold the entire multifamily portfolio through all-inclusive trust deeds also known as wrap around mortgages. Since “due on sale” clauses were not common in commercial mortgages, these types of transactions allowed Grayson to sell his properties and become a lender by creating a new trust deed that included the existing mortgage and a new subordinated mortgage. Grayson collected a down-payment equal to 20% of the property value and financed the remaining amount at a higher interest rate than the senior debt. Grayson serviced the loans and in turn paid the installments on the first mortgage. For three years, Grayson operated as a mortgagee. However, in 1985, the announcement of a second of two tax cuts by the federal government would rock the real estate world and place Grayson’s company in great peril.

With the Tax Reform Act of 1986, Congress enacted dramatic changes to tax laws eliminating many tax shelters. Prior to 1986, wealthy individuals could use passive income losses from a real estate investment to offset active income, such as one’s salary. Professionals such as doctors and lawyers offset the income from their practices with losses from these tax investments. In this way, they “sheltered” their income from federal income taxation. The government wanted to put an end to the practice of using tax shelters because it dramatically reduced federal revenues.

The relevant portion of the law classifies income derived from real estate as either “active” or “passive.” Section 469(c)(1) of the U.S. Internal Revenue Code (the “Code”) defines “passive activity” as any activity “(A) which involves the conduct of any trade or business, and (B) in which the taxpayer does not materially participate.” (Emphasis added.) Passive income does not include capital gains on stocks, interest income on bonds, or interest on money market accounts.

With the Tax Reform Act limiting the losses that could be deducted from taxable income, investors had a much smaller incentive to own or operate real estate. Without the tax incentive, investors with loss-generating properties began selling their properties, further depressing property values. With the elimination of virtually all non-real estate investors seeking the tax shelter benefits, real estate values fell by the value of the tax benefit. Grayson saw some of his property values decrease by 20 to 50%. Over the next year and a half, Grayson saw mortgagor after mortgagor either file bankruptcy or “return the keys” to the properties. For these mortgagors, paying debt service on a property that no longer served as a tax-shelter, generated revenue, and had value did not make economic sense. In 1987, both Grayson Capital Partners and Property Management Associates went out of business.

In 1988, Grayson went to work for Kirkwood Financial, a real estate syndicator that took advantage of the market downturn by taking over properties located in Texas and Phoenix, Arizona. With Kirkwood, Grayson managed a portfolio of two dozen performing and non-performing properties. In time, Grayson found working at Kirkwood challenging because of the real estate downturn. By 1991, Kirkwood Financial became one of many victims during the perilous real estate market and went out of business.

During his time with Kirkwood Financial, Grayson became familiar with the Sun Arrow Apartments in El Paso Texas. Kirkwood Financial managed Sun Arrow for a client and Grayson oversaw its operations. While managing Sun Arrow, Grayson gained a thorough understanding of the El Paso market. After the demise of Kirkwood Financial and with no inherent conflicts of interest, Grayson decided to invest in Sun Arrow.

El Paso Market

The City of El Paso is located in the far west corner of Texas, adjacent to the State of New Mexico and the Republic of Mexico. El Paso is located approximately halfway between the Gulf of Mexico and the Pacific Ocean on the international boundary between the United States and Mexico. To the south of El Paso, across the Rio Grande River is the town of Ciudad Juarez, Mexico.

The area has one major interstate highway: Interstate Highway 10 (IH-10), which serves as the major east/west traffic carrier through the area. Northeast of El Paso in the city of Las Cruces, New Mexico, IH-10 intersects with IH-25, which travels north through Albuquerque and eventually Denver. IH-10 also intersects IH-20, which travels north and east through Odessa/Midland and leads to the Dallas/Fort Worth Metroplex. To the west, the IH-10 leads to Phoenix, AZ area and to the east IH-10 leads to San Antonio and Houston.

Eight major airlines provide service to the El Paso International Airport, including American, Delta, Lone Star, Southwest, Frontier, Continental, TWA and America West. Approximately 170 direct flights arrive and depart daily from El Paso.

According to the City of El Paso Department of Planning, Research and Development, El Paso was the third fastest growing city in the United States between 1990 and 1998. See Exhibit A and B. In addition, El Paso was the fastest growing city in the State of Texas. By 2001, El Paso was the 4th largest city in the State of Texas and the 17th largest city in the United States.

The economic outlook for the El Paso economy remains favorable. With a population growth of approximately 2% per year, El Paso outpaces the rest of the nation as a whole.

exhibit A

The Nations
Fastest Growing Cities

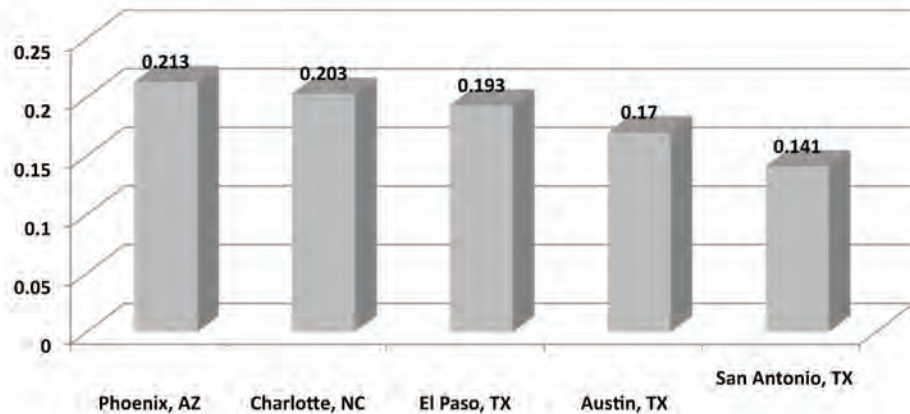


exhibit B

City of El Paso Population Trends

Personal income increased by more than 5% in 1999 and 2000.

Fort Bliss, a major contributor to the El Paso economy, is currently the largest Air Defense Artillery Training Center in the world. Fort Bliss, originally established in 1848, stretches over 1,119,700 acres into southern New Mexico. Fort Bliss supports 115,000 military and civilian personnel. With more than 6,000 civilian employees working on base, Fort Bliss has a significant impact on El Paso's economy, estimated at \$1 billion annually.

Fort Bliss, however, is only the 3rd largest employer. The following table identifies El Paso's largest employers based on number of employees:

City of El Paso Population Trends			
1989	526,380	1995	583,421
1990	515,342	1996	596,800
1991	527,194	1997	606,526
1992	540,203	1998	617,215
1993	554,350	1999	627,556
1994	570,200		

Source: Population and Housing Trends, City of El Paso Department of Planning, Research and Development

Sun Arrow Apartments

El Paso Area Largest Employers			
Employer	El Paso Employees	Employer	El Paso Employees
Ysleta ISD	8,243	Wal-Mart	2,200
El Paso ISD	8,209	Wrangler Menswear Division	2,026
Fort Bliss Civilian Employees	6,347	Department of Justice	1,715
City of El Paso	5,904	State of Texas	1,711
Socorro ISD	4,135	Furr's Supermarkets Inc.	1,600
Sierra Providence Health Network	4,000	Thomason General Hospital	1,500
University of Texas El Paso	3,526	The Lee Company	1,500
El Paso Community College	3,317	The Boeing Company	1,208
Columbia Healthcare West Texas	2,442	U.S. Postal Service	1,200
County of El Paso	2,331	El Paso Electric Company	1,052

Source: Texas Workforce Commission

Sun Arrow Apartments, a garden-style apartment community, is located in the Northeastern section of El Paso, Texas. Sun Arrow offers quick access to transportation routes, shopping areas, work centers, educational institutions and recreational facilities. The Northeastern region of El Paso is one of the fastest growing areas in the city with strong expectations for continued growth and development.

The Empire West Development Group of Tucson, Arizona developed Sun Arrow and more than 6,000 similar units throughout the Southwest, gaining a reputation for building quality communities. Empire West built Sun Arrow according to the Compact Apartment Program (CAP), which includes small units coupled with numerous community amenities. This program centered on an “outdoor living” lifestyle preferred by a growing and well-defined target market. CAP properties have enjoyed tremendous success throughout the Southwest largely due to a warm climate that promotes outdoor activities year round.

Constructed in 1984, the complex has 275 units. Within the community are detached two-story buildings resting on 9.65 acres of land. The buildings total 108,456 square feet and include a recreation room and a large main office with a 1,029 square foot manager residence connected. There are 72 studios providing 327 square feet each, 200 one-bedroom units offering 418 square feet each and two assistant and manager apartments which have 836 and 1,012 square feet respectively. **Exhibit 1** shows Sun Arrow’s unit mix. A large laundry room is located within the recreation building providing 16 washers and 16 dryers for laundering needs. There are 330 parking spaces provided around the complex; 96 of which are covered.

The Sun Arrow community has 24 two-story buildings constructed of Spanish design displaying stucco on lower levels and vertical wood siding on upper portions. The roofs are a combination of flat, with a built-up composition, and pitched with mission tile. The complex has a wide variety of desert and conventional landscaping. Red brick walkways, blue tile inlays, custom light posts and other decorative items around the community add to the southwestern effect.

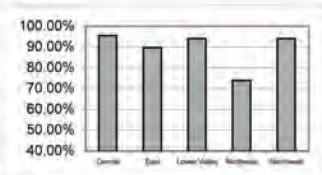
Each apartment at Sun Arrow is fitted with color-coordinated carpet, cabinets, tile, wallpaper and draperies. The units have refrigerators, range/ovens with hoods, double stainless steel sinks, garbage disposals, 30-gallon hot water heaters, wall air conditioning/heating units and dishwashers except for the studio units. Each apartment is set-up to maximize the use of space. Custom-sized appliances and cabinets allow for the efficient use of space.

Consistent with other CAP properties, a selection of recreational choices are available

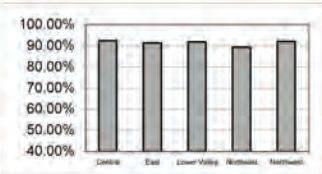
exhibit 1

El Paso Apartment Association:
1st Quarter 2002 Occupancy
Survey

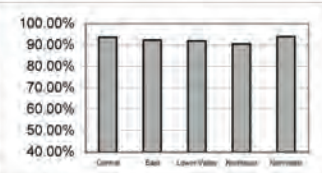
Efficiency/Studio Units								
	Total # of Units	Average Sq. Ft.	Average Rent	Average Sec. Dep.	Average Rent/SF	Total # Occ	Total # Vac	Total % Occ
Central	200	461.31	\$358.74	\$106.23	\$0.778	191	9	95.50%
East	649	438.94	\$388.01	\$116.87	\$0.884	582	67	89.68%
Lower Valley	34	400.00	\$256.00	\$150.00	\$0.640	32	2	94.12%
Northeast	126	380.67	\$345.92	\$46.43	\$0.909	93	33	73.81%
Northwest	85	550.54	\$360.71	\$171.47	\$0.655	80	5	94.12%
Total	1,094	443.78	\$371.59	\$112.09	\$0.837	978	116	89.40%



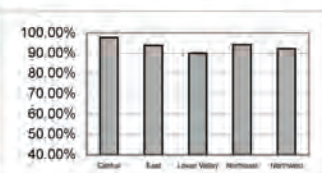
1 Bedroom Units								
	Total # of Units	Average Sq. Ft.	Average Rent	Average Sec. Dep.	Average Rent/SF	Total # Occ	Total # Vac	Total % Occ
Central	372	596.15	\$414.98	\$129.18	\$0.696	344	28	92.47%
East	4,018	635.19	\$450.08	\$118.45	\$0.709	3,670	348	91.34%
Lower Valley	792	557.59	\$360.93	\$102.74	\$0.647	727	65	91.79%
Northeast	1,348	639.24	\$427.04	\$134.09	\$0.668	1,203	145	89.24%
Northwest	2,894	673.03	\$478.45	\$133.89	\$0.711	2,666	228	92.12%
Total	9,424	639.33	\$446.62	\$124.53	\$0.699	8,610	814	91.36%



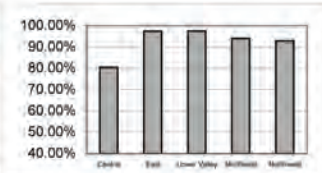
2 Bedroom 1 and 1-1/2 Bath Units								
	Total # of Units	Average Sq. Ft.	Average Rent	Average Sec. Dep.	Average Rent/SF	Total # Occ	Total # Vac	Total % Occ
Central	223	816.38	\$491.01	\$152.18	\$0.601	209	14	93.72%
East	3,136	894.88	\$518.60	\$133.50	\$0.580	2,893	243	92.25%
Lower Valley	2,039	727.09	\$416.60	\$107.41	\$0.573	1,874	165	91.91%
Northeast	1,381	822.11	\$448.73	\$159.38	\$0.546	1,249	132	90.44%
Northwest	1,744	924.09	\$539.98	\$150.35	\$0.584	1,637	107	93.86%
Total	8,523	846.87	\$486.53	\$135.39	\$0.575	7,862	661	92.24%



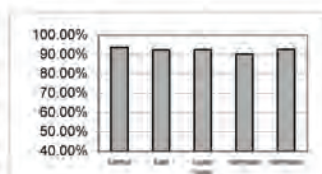
2 Bedroom 2 Bath Units								
	Total # of Units	Average Sq. Ft.	Average Rent	Average Sec. Dep.	Average Rent/SF	Total # Occ	Total # Vac	Total % Occ
Central	223	953.46	\$576.00	\$123.32	\$0.604	218	5	97.76%
East	1,585	979.23	\$614.73	\$145.13	\$0.628	1,488	97	93.88%
Lower Valley	40	856.00	\$510.00	\$125.00	\$0.596	36	4	90.00%
Northeast	449	934.33	\$553.02	\$162.14	\$0.592	423	26	94.21%
Northwest	1,702	1,002.22	\$635.86	\$183.45	\$0.634	1,570	132	92.24%
Total	3,999	981.30	\$613.59	\$161.93	\$0.625	3,735	264	93.40%



3 and 4 Bedroom Units								
	Total # of Units	Average Sq. Ft.	Average Rent	Average Sec. Dep.	Average Rent/SF	Total # Occ	Total # Vac	Total % Occ
Central	81	1,554.10	\$812.62	\$200.00	\$0.523	49	12	80.33%
East	784	1,173.83	\$657.71	\$167.60	\$0.560	763	21	97.32%
Lower Valley	402	887.41	\$530.51	\$214.68	\$0.598	392	10	97.51%
Northeast	397	1,170.34	\$595.85	\$191.54	\$0.509	373	24	93.95%
Northwest	949	1,115.81	\$665.79	\$201.83	\$0.597	881	68	92.83%
Total	2,593	1,116.60	\$635.12	\$191.85	\$0.569	2,458	135	94.79%



All Units								
	Total # of Units	Average Sq. Ft.	Average Rent	Average Sec. Dep.	Average Rent/SF	Total # Occ	Total # Vac	Total % Occ
Central	1,079	744.67	\$476.03	\$132.47	\$0.639	1,011	68	93.70%
East	10,172	797.86	\$508.90	\$130.93	\$0.638	9,396	776	92.37%
Lower Valley	3,307	704.18	\$416.59	\$119.98	\$0.592	3,061	246	92.56%
Northeast	3,701	791.44	\$465.76	\$150.11	\$0.588	3,341	360	90.27%
Northwest	7,374	863.96	\$552.09	\$158.40	\$0.639	6,834	540	92.68%
Total	25,633	801.62	\$501.80	\$140.25	\$0.626	23,643	1,990	92.24%



for Sun Arrow residents to enjoy. These include numerous sporting facilities for tennis, racquetball, volleyball, badminton, basketball, horseshoes, shuffleboard, as well as a large swimming pool with a Jacuzzi, weight and exercise room, and a jogging track with exercise stations. Other amenities consist of gazebo and barbecue areas, central outdoor music, and satellite TV system, a complete car care center for cleaning and maintenance, and a TV lounge within the laundry room.

Wasatch Capital Real Estate Corporation

After Kirkwood Financial went out of business, Grayson founded Wasatch Capital Real Estate Corporation (WCREC) in 1991. For \$500,000, the company purchased ten limited partnership interests and five of fifteen subordinated non-recourse, secured bonds (known today as mezzanine debt) in the Sun Arrow Apartments issued by the Sun Arrow Limited Partnership. Sun Arrow's financing structure included a first mortgage held by Fannie Mae (FNMA) and the fifteen non-recourse bonds, subordinated to the first mortgage. With the purchase of limited partnership interests, WCREC became one of several limited partners.²

² Garner, Bryan A., Black's Law Dictionary Eighth Edition, Thomson West, 1999, p.1152 (A limited partnership is composed of one or more persons who control the business and are personally liable for the partnership's debts called general partners, and one or more persons who contribute capital and share profits but who cannot manage the business and limited partners are liable only for the amount of their contribution).

In 1994, after a significant increase in collections and property value, WCREC along with the other limited partners located and brokered an offer from a third-party purchaser to acquire the property for \$6,300,000. The sale would pay off all of the bonds and return a small profit to the general partner and limited partners. However, the general partner chose not to counter or respond to the offer and the prospective buyer withdrew the offer shortly thereafter. The general partner later explained to the limited partners that the property was worth more than the amount offered.

In 1997, WCREC and a group of limited partners controlling over 51% of the voting interests voted to remove the general partner. The general partner sued to declare the vote illegal. After a protracted legal battle, the limited partners agreed to sell their interests to the general partner. The general partner also paid the litigation costs for both sides. After paying the legal costs, the general partner purchased the limited partners' interests in Sun Arrow. The difficulties with the general partner made Grayson nervous and unsure of the general partner's plan for Sun Arrow. The first mortgage would mature soon. Did the general partner decide to seek a new first mortgage with the intent of taking out the bondholders? Grayson worried about his situation.

In 2000, the first mortgage with a principal balance of \$3,765,000 came due, triggering the maturity of the non-recourse bonds. By this time, the amount due on the bonds had grown to more than \$2,000,000 in principle and accrued interest. The property had never defaulted on a monthly mortgage payment during the seven years FNMA held the Note, but when the general partner could not find sufficient financing to pay the balloon payment and the non-recourse bonds, the general partner filed for Chapter 11 Bankruptcy. A Chapter 11 Bankruptcy is generally used for the reorganization of a corporation or partnership. The debtor proposes a plan of reorganization to keep the business alive and pay creditors over time. However, in the general partner's case, his intent was to have the bond holders' interests wiped out through the plan of reorganization. "Confirmation of a plan of reorganization discharges any type of debtor – corporation, partnership, or individual – from most types of prepetition debts [that the plan does not require repaid]."³

During the first year of bankruptcy, 25 units became "unrentable", meaning significant repairs were needed to make the units habitable. In addition, over 30 more units were vacant but not quite ready to rent because simple requirements such as cleaning or painting the units had not been done. Sun Arrow's property management company neglected the maintenance and care of the property and rented to tenants without collecting security deposits. Grayson believed that the general partner was actively managing the property and meeting these responsibilities. However, the general partner had hoped to wipe out the bondholders' position in bankruptcy by demonstrating that Sun Arrow had declined in value.

In July of 2001, WCREC complained to the Court about the issues plaguing Sun Arrow. The 25 units were subsequently rehabilitated. The other 35 units were made rent-ready. The swimming pool was re-plastered. The sidewalks were repaired and the fencing was brought into compliance with city code.

After a long and costly effort on the part of WCREC to reorganize the property in the Bankruptcy Court, and with legal fees exceeding \$200,000, on March 5, 2002, FNMA foreclosed on Sun Arrow. Prior to the bankruptcy and through the bankruptcy process, WCREC purchased the other bonds from the other limited partner at 10 cents on the dollar and became the sole bondholder.

On April 30, 2002, FNMA accepted WCREC's offer to purchase Sun Arrow for \$4,000,000 and required that the deal be closed in one month.

³ United States Federal Courts, Chapter 11 – Reorganization Under the Bankruptcy Code, <http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter11.html#discharge>.

Financing

Markowitz held firm on the 30-day deadline and threatened to put Sun Arrow on the market if Grayson did not agree to the deadline. Grayson was unsure if he could cobble together the funds necessary to acquire Sun Arrow in such a short amount of time. He knew he would need approximately \$1,000,000 dollars to complete the transaction. Grayson had several assets he could liquidate, but not in one month. Grayson felt optimistic he could close the deal in 60 days. However, Grayson was well aware that in real estate, well-laid preparations never proceed as planned. This was evidenced by FNMA's short deadline.

FNMA's most recent appraisal of Sun Arrow was completed by Acme Commercial Appraisers. According to Acme's appraisal, Sun Arrow in its current dilapidated state was still worth \$5,830,000. Markowitz knew that Grayson would recover his initial investment and, even with the purchase of the other limited partner's interest, would make approximately \$1,000,000.

Just a few days prior to Markowitz's phone call, Grayson, in anticipation of FNMA's acceptance of his offer, secured a loan with GMAC commercial lending. Joe Rodriguez, Grayson's loan officer at GMAC, lived in El Paso and was familiar with Sun Arrow. The terms would be a \$3,000,000 first mortgage at 5.25% interest with a 20-year amortization and 10-year balloon. Grayson felt comfortable with those terms. All Grayson needed now was the \$1,000,000.

Because of the short deadline, Grayson needed to explore alternative or creative fund sources to close Sun Arrow. If Grayson couldn't liquidate his assets in the 30-day time frame, he would need to borrow the funds or structure ways to leverage the equity in Sun Arrow Apartments and Forest Hills Professional Plaza, an office complex owned by WCREC. Grayson devised three options to acquire the funds necessary to close the Sun Arrow deal.

Option 1

In the mid-90's, Grayson purchased a run-down medical and professional complex named Forest Hills Professional Plaza situated near a premier residential area of Salt Lake City, Utah. Grayson promptly rehabbed the property, and secured professional tenants such as dentists, lawyers, and accountants. Forest Hills Professional Plaza (FHPP) appealed to this group of professionals because of its prime location in one of the wealthiest areas of Utah. In addition, Grayson secured a long-term lease with Mountain West Health Care (MWHC) for an outpatient clinic. MWHC is the largest non-profit system of hospitals, surgery centers, and clinics in Utah, Idaho, Colorado and areas of Nevada.

FHPP is currently 95% occupied. Grayson purchased FHPP in 1996 for \$1,300,000 and, in 2001, FHPP was valued at \$3,500,000. In early 2000, Grayson refinanced FHPP, to take advantage of low interest rates, through California Federal (CalFed). CalFed had a prohibitive yield maintenance clause in its mortgage contract. As a result, it would be too costly for Grayson to refinance FHPP to free up the equity.⁴ To unlock his current equity in FHPP, Grayson would offer FHPP as collateral for a short-term loan with a purchase option for the investor at loan maturity if Grayson chose not to pay off the short-term loan.

Grayson's plan called for an individual investor or hard money lender to loan WCREC \$1,000,000 for a 6-month period with the option to assume the existing senior debt on FHPP. Grayson would have a provision that allowed him to pay off the loan within the 6 months

⁴ The Farlex Financial Dictionary defines yield maintenance as the extra money a prepaying borrower would have to pay to make the yield the same for the lender as if the borrower made all, regularly scheduled payments until maturity. When a borrower prepays a loan or other debt investment, the lender loses the interest the borrower otherwise would have paid. The lender may charge the yield maintenance as a prepayment penalty to ensure that it makes the yield regardless of whether or not the borrower prepays. This has the effect of making prepayment or refinancing unattractive to the borrower. *Farlex Financial Dictionary*, "Yield Maintenance", retrieved April 27 2010, <http://financialdictionary.thefreedictionary.com/Yield+Maintenance>.

and retain FHPP. During the 6 months, the lender would earn interest on the \$1,000,000 at a rate of 12% per annum. In addition, a prospective lender would probably want an upfront fee of \$50,000 or more for doing the deal. This plan would allow Grayson to purchase Sun Arrow, stabilize the property, and, shortly thereafter, refinance Sun Arrow and pull out the funds necessary to pay off the lender.

One potential investor/lender was Walt Wiggins of Wiggins Property Investors (WPI). In 2000, a mutual friend at a political fund raising event introduced Grayson and Wiggins to each other. They hit it off and kept in touch. Because of Grayson's expertise in multifamily, Wiggins would sometimes call Grayson to get his opinion on a potential acquisition.

Wiggins graduated from Cornell University with a Bachelor degree in architecture in 1971. He was a practicing architect for fifteen years and became interested in real estate investing after purchasing a small 50-unit multifamily complex in 1981. Throughout the 80's and 90's, Wiggins' "hobby" turned into a full-fledged business as Wiggins gradually acquired multifamily and office properties throughout the West and Southwest. Wiggins had a strategy for finding the "hidden gem." WPI bought properties in need of rehabilitation and repositioning in the market. Wiggins liked what Grayson did with FHPP.

Wiggins met with Grayson on May 10th and seemed very interested in loaning the funds to Grayson. Wiggins expressed his admiration for Grayson's vision for FHPP. Grayson knew that this potential deal would be a win-win situation for Wiggins. First, Wiggins could deploy his capital for a short period earning a good rate of return while he searched for his next acquisition. Second, if Grayson did not repay the funds within the six-month period, Wiggins could continue collecting interest under the current arrangement or simply assume the senior debt on FHPP.

Option 2

Because of his reputation in real estate circles, Grayson knew that he could call on several wealthy friends to collaborate in the acquisition of Sun Arrow. However, this seemed to be the least desirable option for Grayson. He understood that partnerships seemed to sour over time and he knew that it would be a costly arrangement. Usual parameters for such an agreement require a 10% set-up fee for the partnership, a 90% (investor) / 10% cash-on-cash split, and a 5-year time horizon. In addition, the investor would require his initial investment plus a participation fee of 10% of the appreciation. Grayson felt that this might be the costliest of all the options. If Sun Arrow performed well after stabilization, Grayson knew that the property had a value of approximately \$6.0 to \$6.5 million, using a realistic 8.5% to 9.0% capitalization rate. In addition, Grayson predicted that the multifamily real estate market would heat up in the next four to five years due to increased demand for housing and minimal new construction in El Paso. He anticipated that these trends would lower capitalization rates and increase values.

Grayson called on his old friend Robert Eklund to gauge his interest. Eklund was not interested in Sun Arrow but told Grayson that he had a few friends that may be. One particular friend of Eklund's was Mortimer "Skip" Henderson. Henderson was a 73-year old multimillionaire. He made his fortune through land speculation and office development in Texas. Skip and his wife Doris retired to Utah to be near their only daughter and her family. While Henderson considered himself retired, he always seemed to find himself dabbling in real estate deals. Henderson, with a thick southern drawl, said, "Real estate gets in your blood. I don't think I could ever fully retire."

Henderson really liked Grayson and Sun Arrow but needed more time to think about it. Grayson would likely need to sweeten the deal in order to get the Texan to bite.

Option 3

A final option would be to obtain a bridge loan. A bridge loan is a short-term, high interest rate loan that allows a borrower to bridge temporary funding shortfalls. Bridge loans usually have a six to twelve month term. During that period, the lender expects the borrower to secure permanent financing.

Grayson contacted Bridge Loan Funding Partners (“BLFP”) to inquire about a loan for Sun Arrow. Mark Rosenthal, a loan officer with BLFP, quoted Grayson a \$50,000 fee for setting up the loan and 10% per annum interest only payments on \$1,000,000 for a period of six months. If Grayson exceeded the six-month period, another \$50,000 fee would be required to extend the loan for six additional months. The interest rate would increase by 200 basis points if Grayson needed to extend the loan period because Sun Arrow had not fully stabilized. In addition, BLFP would be permitted to secure the loan with security interests in Sun Arrow, FHPP, and on Grayson’s free and clear house valued at \$850,000.

Rosenthal told Grayson that they could close quickly and stated that it will only take BLFP five days to put everything in place.

Property Management

Grayson worried about the condition of Sun Arrow’s tenant base. When Grayson offered to purchase Sun Arrow, he wrote a condition into the purchase agreement stating that Sun Arrow must be at least 80% occupied. During the bankruptcy, Sun Arrow’s occupancy fell below 70%. However, according to Markowitz, occupancy had risen to 85% during the first quarter of 2002.

Markowitz contracted with National Multifamily Managers (NMM) to manage Sun Arrow. NMM managed over 15,000 units in Arizona, Nevada, California, Utah, New Mexico and Texas. However, NMM had a reputation for renting to “anyone with a pulse.” NMM rarely took security deposits or performed credit checks. Grayson worried that once he took ownership that there might be high tenant turnover because of bad tenants. High tenant turnover would make it difficult to stabilize Sun Arrow and refinance it within the six-month window required with option 1 or 3. In order to get the property refinanced, Grayson needed Sun Arrow to operate at 88% occupancy or higher. **See Exhibit 2.** Grayson knew that a lender would want to see an upward trend in occupancy rates and a downward trend in rent collection delinquencies.

In order to mitigate high tenant turnover and vacancy rates, Grayson decided to get a professional property manager. He contacted the Institute of Real Estate Management (IREM) for a list of reputable managers in Texas.

Grayson settled on four management companies. One particular company, Vanguard Asset Management, operated by Steven Gallegos, had a great record of accomplishment in Texas. Vanguard managed 8,000 units in Texas and New Mexico. Of the 8,000 units Vanguard managed, institutional investors owned 5,900 units. Gallegos was a native Texan and graduated *summa cum laude* from the McCombs School of Business at the University of Texas – Austin in 1992, with a Bachelor of Business Administration in Finance, concentrating in Real Estate. Gallegos was young, energetic and personable.

Although Vanguard had no presence in El Paso, Gallegos assured Grayson that he knew the tenant type because of his history in markets such as San Antonio, Dallas/Fort Worth, and Albuquerque, New Mexico. Grayson felt comfortable with Gallegos because of his outstanding references, status as an Institute of Real Estate Management (IREM) instructor, and impressive educational background.

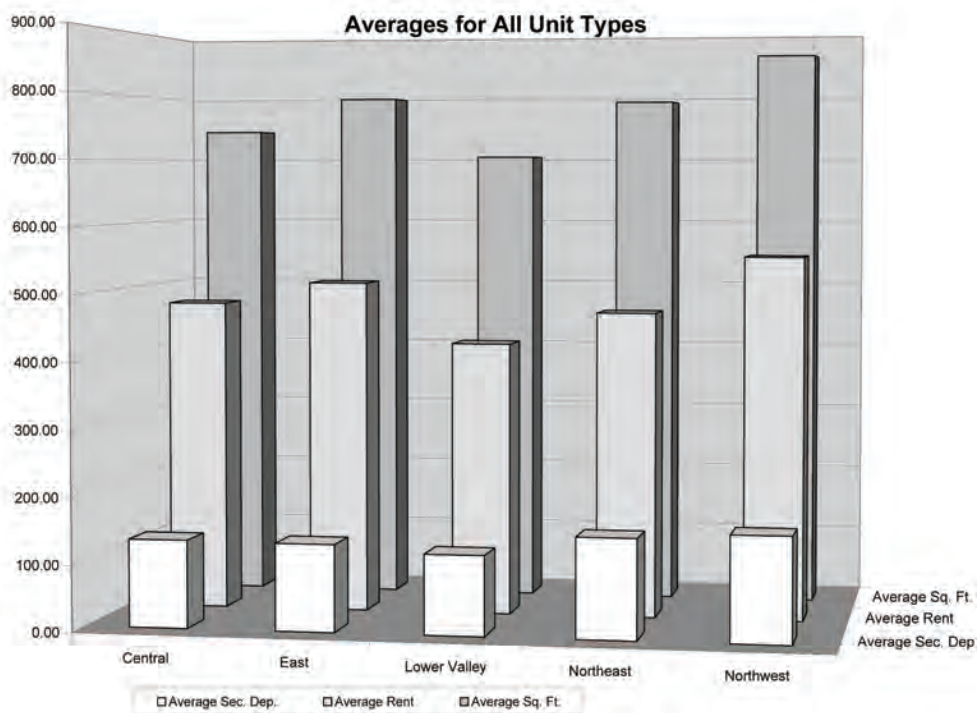
Gallegos wanted to break into the El Paso market for quite some time and saw Sun Arrow as a great opportunity. Gallegos agreed to take a 3% fee, which is less than his customary fee of 4% gross revenues, in order to secure Grayson’s business. Grayson felt

exhibit 2

El Paso Apartment Association
1st Quarter 2002 Occupancy
Survey: Market Occupancy
Report

Misc. Information

Total Properties Reported:
202
Total Units Reported:
25,633
Avg. Units/Property:
126.9



that if Sun Arrow's actual occupancy was, in the worst-case scenario, around 60% Grayson would need someone like Gallegos. Gallegos believed he could quickly turn around the property in three to four months through impactful marketing. El Paso had a market occupancy rate of 90.27% in the first quarter of 2002. See Exhibit 1.

The Decision

At 55 years of age, Grayson wondered if it was time to let Sun Arrow go. He had several million dollars in the stock market and approximately \$2,500,000 tied up in FHPP.

Average Rent History

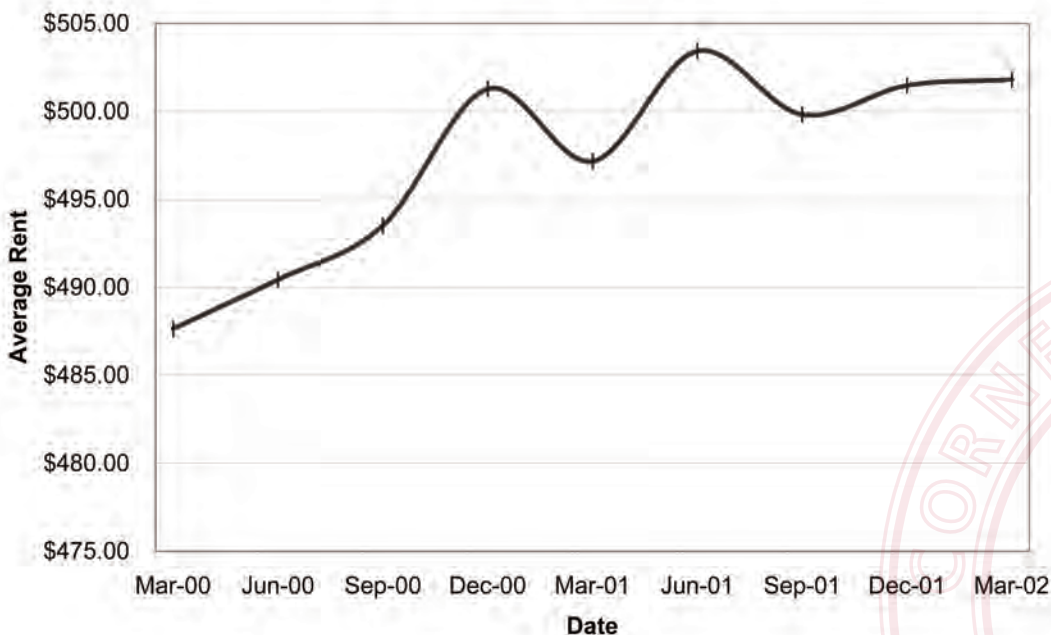
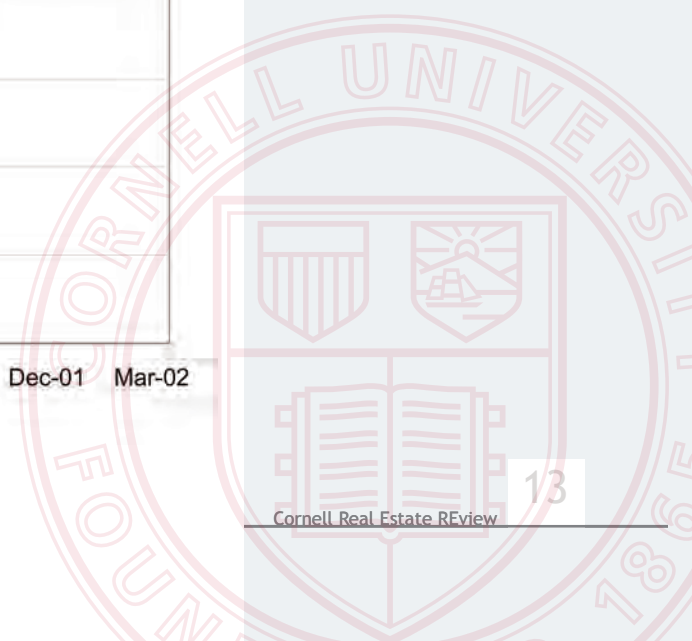


exhibit 3

El Paso Apartment Association
1st Quarter 2002 Rent Survey



FHPP also provided Grayson with a salary of \$14,000 a month. Grayson had no debt. His children were grown and were having children of their own. FHPP allowed Grayson to have a comfortable lifestyle. He often visited his five children in various states in the west. Grayson kept asking himself whether he was willing to take on Sun Arrow and the additional risk at this stage of his life.

Frankly, Grayson was bored. He missed the excitement, the “rush” of the deal. It was the same reason Skip Henderson kept looking for deals even though the Texan was “retired.” Real estate was in Grayson’s blood and Grayson loved the exhilaration of putting deals together. Another reason Grayson wanted to pursue Sun Arrow is that, if he chose not to pursue the deal, he would lose his initial \$500,000 investment and the additional \$100,000 he invested in the other limited partner’s bond interests. Moreover, Sun Arrow was worth \$6,300,000 in a stabilized condition, i.e., Sun Arrow operated at the average market occupancy and market rent. Grayson would reap an additional \$1,700,000 in equity.

Grayson needed to reflect on this decision since there were so many variables that could negatively affect this deal. He worried about the true occupancy of Sun Arrow and the amount of time needed to stabilize the property. Grayson decided that he would perform a sensitivity analysis to determine several scenarios based on varying occupancy levels. NMM rented approximately 19% of the total number of apartments. How many of the 52 tenants would fail to pay rent in the next three to six months?

Besides the occupancy issue, another major issue bothering Grayson was the potential effect September 11, 2001 would have on Fort Bliss, the El Paso market, and, specifically, Sun Arrow. On September 11, 2001, al-Qaeda terrorists hijacked four commercial passenger jet airliners intending to fly them into important United States buildings.⁵ The terrorists successfully crashed two of the airliners into the World Trade Center towers. Both buildings collapsed within two hours. The terrorists crashed a third airliner into the Pentagon building in Arlington, Virginia. A fourth plane crashed into a field in rural Pennsylvania after some of the flight’s passengers tried to retake control of the plane.

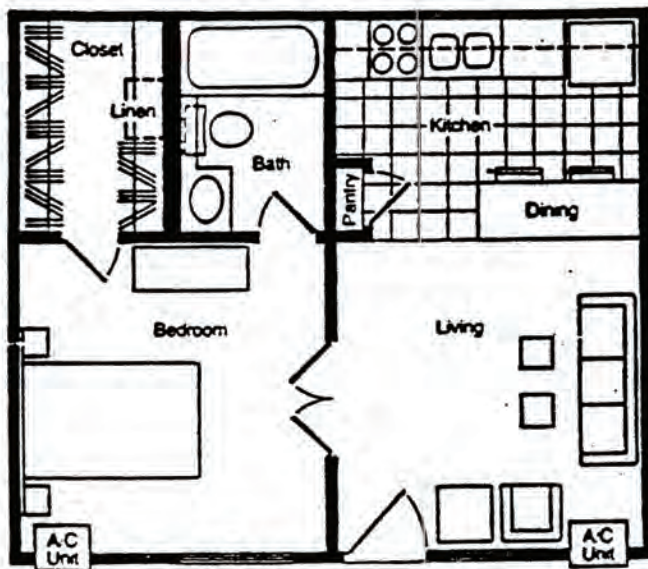
In response to the terrorist attacks, President George W. Bush launched the “War on Terror.” Thereafter, the United States armed forces invaded Afghanistan and Iraq. Grayson read in the *El Paso Times* that the U.S. planned a massive deployment from Fort Bliss in the summer or fall of 2002. He was not sure of the number of troops but knew that a massive deployment could negatively affect Gallegos’ ability to stabilize Sun Arrow.

Grayson could see the sun setting through his office windows. Grayson knew that he had much to think about and was in for a long night.

⁵ National Commission on Terrorist Attacks Upon the United States, *The Attack Looms*, 9/11 Commission Report 2004.

FLOOR PLANS

One-Bedroom Apartment

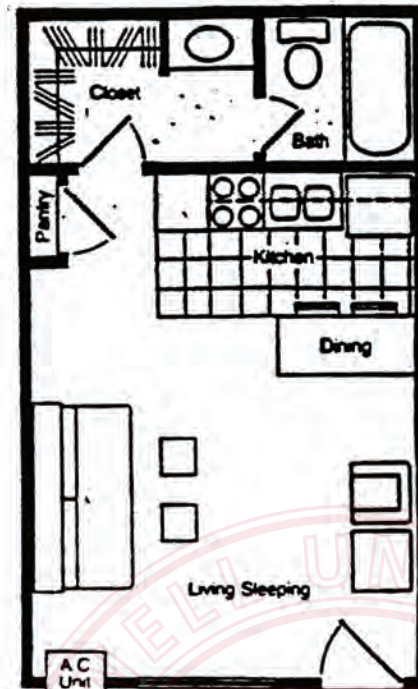


**One-Bedroom Apartment
with vaulted ceiling**

All Apartments Feature:

- Choice of color interiors
- Design coordinated furnishings
- Wall-to-wall carpeting
- Refrigerated cooling
- Walk-in closets
- Pantry
- Disposal
- Large size refrigerators
- Dishwasher (one-bedroom units only)

Studio Apartment with compartmental bath



forest hills plaza



forest hills plaza





sun arrow



sun arrow

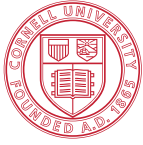


sun arrow



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