Frequently Asked Questions about Private Mortgage Investments

I. What exactly are private mortgages? Why would I choose to invest in them? What value can private mortgages add to my overall investment portfolio?

A private mortgage is a form of asset-based loan; a secured debt obligation, which produces a regular, predictable income stream to an investor, with all the security, protections and recourse that a mortgage lien can provide. While mortgages do not typically provide any capital appreciation, they do generate a steady stream of interest payments, which, in today's market, can exceed current money market rates by more than 10%. Unlike stocks, the underlying security is tangible bricks and mortar, where legal protections such as title insurance, and many other unique rights and remedies ensure the enforceability of a mortgage lien and provide substantial downside protection for the investor. In addition, many private mortgage loans are also secured by personal guarantees from the Borrowers, adding another layer of recourse beneficial to the lender/investor. It is worth noting that when we speak of private mortgages, we are specifically referring to *first mortgage bridge loans on commercial real estate* such as apartment buildings, mixed-use properties, retail properties, etc. We are specifically NOT referring to mortgages on single-family, owner-occupied homes.

II. What kind of returns do private mortgages produce? Is the interest rate fixed?

The typical interest rate for a direct private mortgage ranges between 9% and 12%, depending upon the time frame, the purpose, the loan-to-value ratio, the exit strategy, the quality of the Borrower's personal guaranty(s), the diversity and quality of the leases, if any, and other factors. There are many variables that an experienced lender weighs when arriving at a decision of: a) whether or not to lend, b) how to structure the loan, and c) what the appropriate pricing should be. In addition to the interest rate, private mortgages typically require that the borrower pay an origination fee of 1% - 2% at the loan closing, thus the rate of return that the lender receives will typically be a combination of the interest rate and the origination fee.

The interest rate can be either fixed or floating, depending upon the way the transaction has been structured. Typically floating rate mortgages always set the initial interest rate as the "floor" so that it can increase if, for example, the Prime rate rises, but cannot go down if the Prime rate drops.

Net of fees, an investor in a well-managed private mortgage fund can expect to earn high-single to low-double digit returns from this kind of investment with very strong downside protection.

III. Do private mortgage investments belong in my portfolio? If so, how can I participate in this sector?

Adding private mortgages to your investment mix can reduce volatility by adding a non-correlated component to an investor's overall investment portfolio (in other words, the returns that private mortgages produce tend not to be correlated with those of the equity or bond markets). If we look at the example of a year like 2008 when the Dow and the Nasdaq were down 30% - 40%, some reputable, audited private mortgage funds were up by more than 10% during the same challenging year. Not many investments can dependably generate a rate of return that is more than 10 times greater than a typical money market account rate, with a very well-protected downside.

A good way to participate in this investment category is through a professionally managed private mortgage fund. In order to participate in a private mortgage fund, one must meet the standard of being an "accredited investor". The following link from the SEC's website describes the current accredited investor standard: http://www.sec.gov/news/press/2011/2011-274.htm. You can also read more on this topic in Section XVI to see whether or not this type of investment is appropriate for you.

IV. How can I filter and focus my search for the best way to invest in this asset class?

The key, as with any investment strategy, is to align yourself with a proficient and ethical team of experts or an established fund with a long and verifiable track record (focusing your search on funds with several years of audited financial statements is generally a good place to start) to guide you in this highly-specialized world. The manager must have good access to a steady stream of high-quality loan opportunities. Strict discipline and astute analysis and underwriting of each prospective transaction are the essential keys to good private mortgage lending.

Manager Selection is critical:

A manager's consistent success over an extended period of time is, of course, no guarantee of future performance, but good past performance will certainly give an investor some indication of what to expect, and just as importantly, the manner in which a manager has handled past adversities and other bumps in the road will give a prospective investor insight as to how that manager is likely to respond to and resolve any future problems. Under the topic of Manager Selection, "Skin in the Game" is also a critical factor: **You should restrict your manager search to funds where the managers have a significant amount of their own net worth invested side by side with their investors**.

V. What are some of the pros and cons of this investment category? What sets this category apart from others?

Whether or not private mortgage investments are right for you will depend upon factors ranging from your investment time horizon and your risk/reward expectations, your anticipated need for liquidity (i.e., if you require ready liquidity, then this strategy is simply not a good fit for you), to the amount of capital that you are seeking to put to work (in many cases $100,000 is a minimum investment amount for a private mortgage fund). Many accredited investors find that private mortgages (especially a diversified portfolio of private mortgages) often produce stable returns and fit well within an overall investment portfolio of stocks, bonds and real estate.

One advantage of adding private mortgages to an investment portfolio is that the returns they produce tend not to be correlated with those of stocks and bonds. Many registered investment advisors and other financial advisors recognize this and see value in adding a measure of this asset class to help investors avoid volatility. Adding private mortgages to an investment portfolio may make the returns of the overall portfolio less subject to volatility, (with 2008 being an excellent example of such volatility in the equity markets: while the Dow and Nasdaq were down 30% - 40%, some well-managed private mortgage funds delivered net returns above 10% in 2008).

VI. If bank rates are so low, why would a Borrower seek a comparatively expensive private mortgage rather than a much lower rate on a conventional mortgage from a bank?

The answer is frequently either time-based or opportunity-driven. There are many reasons, but for starters, here are two:

1. *Time crunch*: The Borrower has applied for a conventional bank mortgage, but the time-of- the-essence closing date is rapidly approaching. The bank is still completing its due diligence, yet the Buyer/Borrower must close in a timely fashion in order to avoid losing a hefty contract deposit. After closing a bridge loan with a private lender, the Borrower can then take as long as necessary to arrange optimal permanent financing at low interest rates with a bank. Note that stepped-up scrutiny from bank regulators (such as the OCC and the FDIC) along with the

passage of the Dodd-Frank Act in July 2010 to increase oversight of banks, has had the effect of further slowing down the (already slow) speed at which banks are able to evaluate and approve loans, thus creating, if anything, a greater, rather than lesser need and opportunity for private lenders in the commercial real estate marketplace. In hot markets (such as New York City and Washington, D.C.) <u>sellers usually require a hard deposit and a short time frame to close</u>. Savvy buyers will often choose to close on a property acquisition with a private bridge loan, and then, without the clock ticking down to a time-of-the-essence closing, they will be able to carefully shop for bank financing with which they will repay the bridge loan. So while no one would choose to borrow at 11% or so for 5 or 10 years, doing so for 6 to 12 months and then transitioning to a 4.5% or 5% bank loan can make good business sense for active buyers who want to definitively close on a property.

2. *Transitional Property*: Another typical case would involve a Borrower that is in contract to purchase a vacant property <u>that he plans to convert to another use</u> (office to residential, for example). A bank would rather finance the deal AFTER the Borrower has executed his business plan, rented up the property and thus created stable cash flow. The private lender is willing to get more deeply involved than most banks, and to consider and weigh all relevant factors and data; evaluating the Borrower's past track record and expertise, the viability of the Borrower's current business plan to convert/improve the property, as well as the value of the Borrower's personal guarantee or other collateral. The savvy Borrower is also fully aware that he is only going to have the private loan outstanding for a short time – most commonly 12 months or less, and that paying 10% - 12% for such a brief period of time is far LESS expensive than: a) missing out on a compelling but time-sensitive acquisition or other opportunity, or b) bringing in much more expensive equity partners for the long haul. If an owner or developer raises additional equity by bringing in partners, it is certain that he will have to give up a substantial "piece of the pie", whereas a private lender will only receive a fixed, schedule rate of return and will typically not receive a percentage of the upside.

VII. **Can I invest in Private Mortgages using my IRA?**

Yes. There are many IRA custodians across the US that handle self-directed IRA's and are familiar with this type of investment and can provide this service. The following link from a recent story in the Wall Street Journal "IRA's Get Sexier" speaks of investors making greater use of alternative investments within IRA accounts:
http://online.wsj.com/article/SB10001424052970204571404577253411744719228.html

VIII. **How often will I receive interest payments?**

Programs vary, but distributions are often made on a quarterly basis.

IX. **Can I choose to reinvest the interest distributions that I receive?**

Yes. You can choose to either receive regular interest distributions or alternatively you can opt to reinvest the interest that you receive. Most people utilizing tax-deferred retirement plans choose to reinvest.

X. **What are the different options/ways that I can participate in private mortgage investments, and what are the advantages/disadvantages of each?**

There are two fundamentally different approaches that an investor can take to participating in private mortgage investments: a) going it alone, or b) investing in a professionally managed fund. The following will outline both approaches.

On the one hand, an investor can try to go it alone and take responsibility for all that entails, including: a) sourcing and vetting a loan opportunity, b) conducting all the necessary due diligence (including, but not limited to underwriting and analysis of comparable properties, ordering and reviewing all third-party reports including appraisals, environmental and engineering reports, property insurance review, background checks and credit reports on the borrowers, c) negotiating and structuring the terms, conditions and servicing protocols of the loan, d) hiring and directing an experienced real estate lender's attorney to help to structure the deal and then draft the loan documents, and then, e) after the loan closing, actively monitor and service the loan(s), insuring, among other things, that real estate taxes as well as any other required ancillary payments are being made in a timely manner.

Alternatively, an investor can choose to participate in a fund that is already staffed to do all the above by experienced professionals with a clearly documented and audited track record. A further benefit of the fund structure is the diversification that results from being invested in a carefully selected, structured and serviced "pool" of mortgages…rather than in only one or two individual mortgages.

XI. **How safe are private mortgage investments? What are the risks and how can I minimize them?**

As is the case with any type of investment opportunity, the quality of the management is of key importance. You will want seasoned professionals in charge who have many years of experience successfully originating and managing a portfolio of private mortgages and who know how to assess and manage risk effectively.

In addition, you will want to be sure that the managers are also investing their own personal funds, side by side with the other investors, and that their compensation is directly linked to the successful achievement of the Fund's stated objectives. *Be wary of any managers who earn a fee merely upon the closing of a loan.*

The best structure for a fund that originates and services a portfolio of private loans (and the structure that is most protective for investors) is one where the managers are paid based on the successful performance of the entire loan portfolio. Furthermore, you should only consider investing in a private mortgage fund where the managers have also made a significant investment (in other words, a significant portion of their personal net worth) side-by-side with their investors.

There are inherent protections unique to mortgage lending, which can significantly limit any downside risk when carefully implemented in a transaction's structure and in the loan documents.

Risks and risk management:

Realistically, the single biggest risk is poor loan underwriting and risk assessment by an inexperienced, incompetent or unethical manager. If a loan opportunity has been properly selected, analyzed and underwritten, then even in the worst possible case, if the borrower stops paying the loan and the lender needs to foreclose, the final outcome should be positive for the lender. In fact, in many cases a default can result in a much greater return and profit for the lender than would normally occur when the borrower simply pays the loan as scheduled.

The lender should be both prepared to handle any possible outcome effectively and profitably, and must be sufficiently skilled and experienced at managing litigation to ensure a positive outcome in the event that litigation becomes necessary. As there are no shortcuts to success for fund managers in this strategy, it is important to invest with a manager who has a long history of selecting and servicing successful mortgage loan opportunities, and effectively dealing with, and profiting from, any problems that may arise.

Good managers manage risk with vigorous and realistic stress-testing:

Savvy managers of private mortgage funds stress-test their loan underwriting by always estimating values at the LOWER end of the range of possibility, while estimating a longer, rather than a shorter, time frame required to resolve problems if they do occur. Any prospective deal that doesn't make the cut is dropped from consideration.

Investors should look in the rear-view mirror:

You can learn quite a bit about how a manager handles challenges by looking in the proverbial "rear-view mirror".

While there is no question that real estate values dropped during the recent economic downturn, as usual, some markets were hit much harder than others. For example, New York City and Washington, D.C. were the two strongest and most resilient markets in the country. Therefore, depending upon their lending discipline and risk profile, a few private mortgage funds emerged unscathed and continued to perform well during this time, while other funds, with less disciplined, or possibly less experienced and capable management, were hurt badly. <u>The years from 2008 through 2011 were therefore a great "acid test" for private mortgage funds and their managers</u>, giving today's investors an opportunity to <u>review a fund's audited track record throughout the downturn</u> to see how well the fund's investors fared (i.e. how robust both the managers' underwriting discipline and ability to deal with, and profitably resolve, any problems they experienced during that challenging period). **Therefore, investors considering this sector should only consider investing in funds and with managers who have been "battle tested";** and should choose among those funds **whose audited track record was strong during the challenging period from 2008 – 2011**. <u>Good performance through difficult times</u> is <u>perhaps the most important measure</u> of the management team of a private mortgage fund. If you or your financial advisor are considering a prospective fund whose performance is not audited by a major accounting firm, then you should drop it from consideration and <u>focus only on the subset of funds that are: 1) audited by credible and sizable accounting firms who understand the business and routinely audit similar funds, and 2) funds that fared well throughout the downturn.</u>

Follow the money:

While <u>accurately understanding and properly valuing real estate</u> is certainly not rocket science, it is clearly <u>a mission-critical skill set</u> that requires <u>years of experience and unwavering discipline</u> on the part of the managers.

Generally in life, "following the money" is usually a good way to determine motivations in any business. Therefore, you should focus your search only on managers *that do not earn fees simply to close loans,* but rather *only earn fees based on the good performance of their loan portfolio*. A manager who earns fees *merely to close a loan* is more likely to "stretch" his underwriting criteria to approve a new loan than a manager <u>who earns nothing upon the closing of a loan</u>, but only upon the *good performance of the entire loan portfolio and fund.*

This structure is an investor's best insurance that there is a *true alignment of interests between the investors and the manager*. (i.e., the fund management should stand behind their lending decisions, and thus get paid for closing *first-rate loans that prove out over time;* not for merely closing a loan).

XII. What is the goal of this strategy?

The goal of a fund based on this strategy is to be a "cash flow machine", producing a steady stream of reliable income for investors. Good managers in this strategy seek to hit a steady stream of "singles" rather than trying to hit "home runs", opting for lower-risk, highly-reliable loans and borrowers where the deck is stacked in favor of the fund (i.e., the property is worth much more than the loan amount, the property is well-located and being acquired at an advantageous price, and the borrower has a good track record of reliably executing his business plan to upgrade or otherwise add value to properties, etc.). Continuity of cash flow is a key target of this strategy.

Good managers in this strategy would rather make a lower-risk one-year bridge loan with pricing of 11% and 2 points, than a higher loan-to-value or otherwise riskier loan priced (for example) at 13% with 3 or 4 points. The goal is to have a portfolio of many loans that are performing as scheduled and producing a consistent stream of income for investors.

XIII. What about diversification? Is it possible to achieve diversification in this type of investment?

Diversification is one of the primary advantages of investing in private mortgages within a fund format. A fund's goal is to have a diversified portfolio of private mortgage investments in order to reduce risk as well as to achieve continuity of cash flow. (In other words, even if one mortgage is repaid…there are still many other mortgages paying the desired rate of return, resulting in continuous cash flow. Cash is recycled into new loans as earlier loans are repaid.

XIV. How often will I receive a check?

Quarterly distributions of interest are made to investors in most funds. Some investors may alternatively elect to reinvest those interest payments.

XV. What is the minimum investment that I can make?

The minimum investment varies…but $100,000 is typical.

XVI. Can I add to my investment later on?

In many cases, private mortgage funds permit current investors to add to their investment.

XVII. How liquid is my investment? What time commitment do I have to make?

Given the nature of the underlying mortgage investments and the typical term of the loans (most often 1-2 years, ranging up to 3 years), only investors comfortable with a multi-year time horizon should consider investing in private mortgages.

XVIII. Who should consider participating in private mortgage investments?

High net worth investors weary of stock market volatility desiring diversification with an alternative investment backed by hard assets may wish to consider this sector. Only "accredited investors" as defined by the Securities and Exchange Commission, may invest in a private mortgage investment fund after carefully reviewing the fund's offering memorandum and limited partnership agreement. Accredited investors must have a net worth of at least $1,000,000 (excluding the value of the investor's primary residence). Full details on this can be found on the SEC's website http://www.sec.gov/answers/accred.htm.

From a practical point of view, while one of the great strengths of investing in private mortgages is the fact that they are backed by hard assets, (i.e., real property), the corresponding fact is that mortgages are not readily liquid (meaning you may need to wait until the end of a multi-year lockup period to redeem such an investment), therefore a private mortgage fund may not be appropriate for investors requiring ready liquidity (ready access to their cash). This type of investment is most appropriate for well-heeled, sophisticated investors *who have other sources of ready liquidity*, and where the amount invested typically comprises only a portion of a well-diversified, overall investment portfolio.

XIV. **Where can I find more information about this?**

You can reach the author, Gregg Winter at (212) 532-1122 x1 or gregg@winter1.com with any questions. In addition you may wish to speak with:

(i) Other investors with experience in this type of investment.

(ii) Registered Investment Advisors and other financial advisors, accountants and attorneys capable of assisting you in filtering, vetting and analyzing prospective investments and performing due diligence on funds and managers. Tell them you want to focus your search on: a) funds that have an audited track record (with a sizable and widely recognized and respected accounting firm as the auditor) of at least five years so you can observe their past performance through the recent market downturn, and b) funds where the managers have a substantial portion of their personal net worth invested alongside their investors, and c) funds where the managers do not get paid a fee simply for closing a new deal, but rather funds where the managers earn fees based on the performance of the entire loan portfolio.

(iii) Fund managers and others who source, originate and service these types of loans (particularly those with long, successful track records and audited financial statements).