Passive Investing – Glossary

Accredited investor – an individual who satisfies one of the following two requirements:

- Annual income of over $200,000 (or $300,000 if filed jointly), or
- Net worth of at least $1MM (excluding the value of primary residence)

Acquisition fee – a fee paid to the General Partner/Sponsor for sourcing, assembling, and securing the acquisition including debt, equity, legal, etc. These fees typically range between 1-3% of the total purchase price.

Asset management fee – an annual fee paid for executing the business plan for the asset (leading construction, monitoring and overseeing the property management, providing updates on the progress of the business plan to investors, etc.). This fee typically ranges between 1.5%-3% of gross rent the asset produces. Asset management is often performed by the General Partner/Sponsor but can be outsourced to an independent 3rd party.

Cap rate – short for capitalization rate, which represents the NOI divided by the purchase price. For example, if an asset was acquired for $1MM and produced $60K of NOI for the year, the cap rate would be 6.0%. More simply put, the lower the cap rate the higher the value; the higher the cap rate the lower the value.

Cash-on-cash return – the net annual cash return percentage provided to investors in proportion to the amount invested (after all expenses and debt). For example, if $10,000 was returned annually for $100,000 invested, the annual cash-on-cash return would be 10%.

Cost Segregation – the reclassification of specific hard assets acquired in the property acquisition by maximizing the aspects which are eligible for treatment as having 5-15 years of depreciable life (carpeting, wall coverings, partitions, millwork, lighting fixtures, as examples). The purpose of the study is to utilize accelerated depreciation to increase deductions passed on to Limited Partners. This study is performed by a hired, independent 3rd party specialist.

Depreciation – a reduction in the value of an asset with the passage of time, due in particular to wear and tear. When contemplated within multi-family acquisitions, these "paper losses" appear in K-1 tax forms distributed to each individual investor which serve to offset passive income and capital gains. The impact of these losses are specific to each individual; please consult a tax advisor for more details.

Debt service – payments made for debt provided to acquire and/or improve the asset. Debt service coverage ratio (DSCR) refers to the NOI in relation to the debt service payment. For example, $125,000 in monthly NOI generated for a $100,000 per month debt payment would provide a DSCR of 1.25.

Gross Operating Income (GOI) – the income the asset generates before expenses have been paid.

General Partner – often referred to as the Sponsor/Sponsorship, the individual or group who spearheads the acquisition process and creates, implements and oversees the execution of the business plan for the acquisition.

Hold Period – the number of years the asset is expected to be held before an anticipated sale. This will be indicated in the Private Placement Memorandum (PPM).

Internal Rate of Return (IRR) – is the rate at which the net present value of all future cash inflows and outflows for a project is zero. What does that mean? In short, it provides an annualized return when taking into account when the return is provided. This serves to compare different investments types on equal ground when taking into account inflows/outflows in addition to hold periods. Take the following three examples into consideration – all three provide the same dollar amount of return (doubling your money) but the speed with which you are able to receive the return impacts the IRR:

Example 1:			Example 2:			Example 3:	
Year:	Return:		Year:	Return:		Year:	Return:
Original Investment	$ (100,000.00)		Original Investment	$ (100,000.00)		Original Investment	$ (100,000.00)
1	$ 1,000.00		1	$ 12,000.00		1	$ 160,000.00
2	$ 1,000.00		2	$ 12,000.00		2	$ 10,000.00
3	$ 1,000.00		3	$ 50,000.00		3	$ 10,000.00
4	$ 1,000.00		4	$ 12,000.00		4	$ 10,000.00
5	$ 196,000.00		5	$ 114,000.00		5	$ 10,000.00
	$ 200,000.00			$ 200,000.00			$ 200,000.00
Multple:	2.00		Multiple:	$ 2.00		Multiple:	$ 2.00
IRR:	15%		IRR:	20%		IRR:	72%

Limited Partners – equity owners of the asset who participate in the benefits of their proportionate amount of ownership.

Loan-to-value ratio (LTV)– this number represents how much debt is being utilized in relation to the value of the asset overall. Multifamily loan-to-value ratios tend to range between 65%-80% (e.g., a $1MM acquisition would typically use a loan between $650K-$800K, the balance of which would be equity).

Preferred Equity – Preferred Equity serves as an equity layer on the capital stack which sits directly above the first position debt and below the LPs and GPs. In essence, it functions similar to a second position debt instrument but does not include recourse or lien rights. What is the appeal? In exchange for this position, the investors within the Preferred Equity layer are in second position to receive payment. After expenses, the first payment must be disbursed to the first lien holder (debt), second to the Preferred Equity layer, and third to the LP's preferred return – thus reducing their downside risk. Preferred Equity typically includes a higher interest rate than traditional debt and frequently removes any upside provided for as an LP investor.

This is not to be confused with preferred return. While Preferred Equity can be structured in a variety of ways – including raising the amount from several investors via the property's offering or via a single entity to cover the entire amount – it serves as a position to investors who are looking for a more secure position in the investment but are willing to forgo the upside beyond the interest rate committed.

Preferred return - indicates the percent of annual return that investors will be paid first before additional profits are shared with the General Partner. Once a preferred return has been provided to investors, all profit above that hurdle will be shared with the General Partner. This is unique to each specific investment; the preferred return hurdle can be an annual yield or IRR (which is why it's important that the PPM be reviewed in detail).

Prepayment Penalties – Prepayment penalties are exactly what they sound like – a fee charged by the lending institution for early pay-off of the loan balance. But why do lenders seek prepayment penalties if they are receiving a full payment before it is due? They, too, need to satisfy the return expectations of their investors so, to the extent a loan is paid before it matures (that is, all the expected interest can be realized), those investors run the risk of not being able to place that investment value in another with matching returns. To avoid this, lending institutions often mandate they recoup as much of the total investment value as possible regardless of the principal balance being paid off sooner.

Because there are three types of penalties, it's important to know what type is included in the agreed upon loan and what fees are entailed. The three types of prepayment penalties are:

- Yield Maintenance – the difference between the interest the lender would have received over the remaining term of the loan and the amount of interest the lender would receive if the outstanding loan balance was invested in Treasury securities at the time the loan is prepaid. These typically include a floor (or a minimum amount) equal to 1%-3% of the outstanding principal. You may assume that a floor would come into effect if interest rates have risen from the rate provided in the loan and a more complex calculation would be utilized if the interest rate declines. It differs by loan but, in short, it is a fee to maintain the yield they'd otherwise be entitled to.

- Step-Down – a fee delineated upfront on a sliding scale depending on when the loan is prepaid. Often times, for example, on a five (5) year loan you may expect a step-down payment equal to five percent (5%) with five (5) years still remaining in the loan, four percent (4%) with four (4) years remaining, three percent (3%) with three (3), two percent (2%) with two (2), and one percent (1) with one (1) year.

- Defeasance – a specific amount of collateral (treasury securities) provided to the lender which will yield the same return to them as the loan with the existing borrower would have. This is almost exclusively used with credit mortgage backed securities (CMBS) loans.

- Fixed-Fee – a flat, predetermined amount outlined in the loan agreement.

Private Placement Memorandum (PPM) – the document provided to investors for an investment offering providing a detailed overview of the business plan of the investment.

Net Operating Income (NOI) – the income the asset generates after all expenses have been paid. This does not include debt service payments.

Syndication – a grouping of investors who maintain passive equity ownership in an investment or business.