STEP TWO:
REAL ESTATE PORTFOLIO EXPANSION FOR THE SMALL INVESTOR

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EXECUTIVE SUMMARY

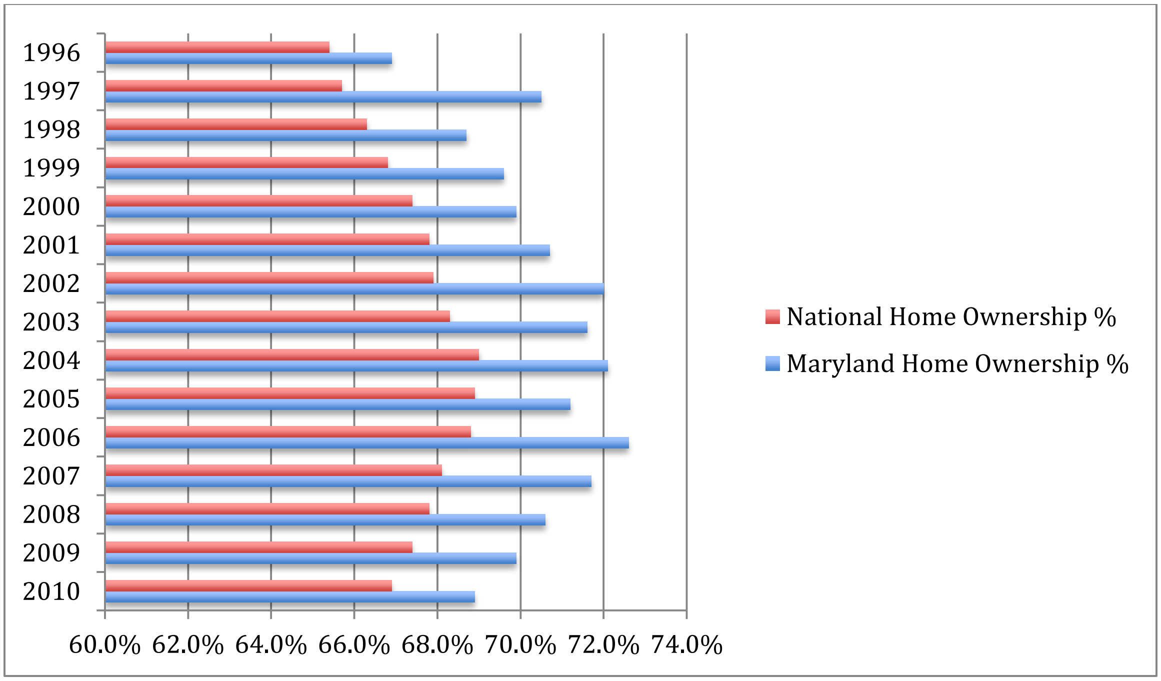
Expanding a real estate portfolio from a single property to multiple properties can be a slow and long process with many complications along the way. For many small investors the first step of acquiring an investment property can appear straightforward. Whether this property is a condo or small single family home that is leased out, conceptually the process is straightforward for even the novice. However, when the small investor wishes to expand upon this single property to create a real estate portfolio with multiple properties, the steps become more complicated. I intend to explore these steps by analyzing and documenting the tax, financial, and legal consequences of such an expansion.

For the professional investor or analyst working within a REIT or development group, the exercise of expanding a real estate portfolio is less arduous. These established entities have greater access to capital and greater access to professional resources that the small investor or individual may not have. Making these gains and advancing to the next steps of development for a small investor are steps into the unknown. This project intends to demystify the path by analyzing the tax, legal and financial implications of such a transition. Specific topics for investigation will include; effects on capital gains from a “starter property” reversion, investing with outside investors – creating a capital stack, and separation of personal and business finances.

With the wild upswing of real estate values in the mid-2000’s followed by the downturn post 2007, many individuals seized upon the buying frenzy and purchased second properties under speculation, for investment purposes. Many of these investors took advantage of historically low interest rates and liberal lending practices to purchase properties they most likely would never have had the opportunity to acquire had history changed course. Although many of these first time or small investors ultimately were foreclosed upon or otherwise became underwater, for the fortunate, a percentage did hold onto their investment properties during the storm. Entering into 2011-12, we find that although interest rates are still amongst their lowest in history, lending has all but dried to a trickle, leaving potential buyers and borrowers unable to take advantage of historically low interest rates and historically low prices. Coupled with high unemployment and a high delinquency rate; this has impacted the rental market like never before. For investors, this is an ideal time to expand their residential real estate holdings by buying up rental properties, as it is now a landlord’s market. How the small investor who weathered the downturn expands in this environment of stringent lending practices, greater government intervention, and an ever-evolving tax code changes poses significant problems to be overcome.

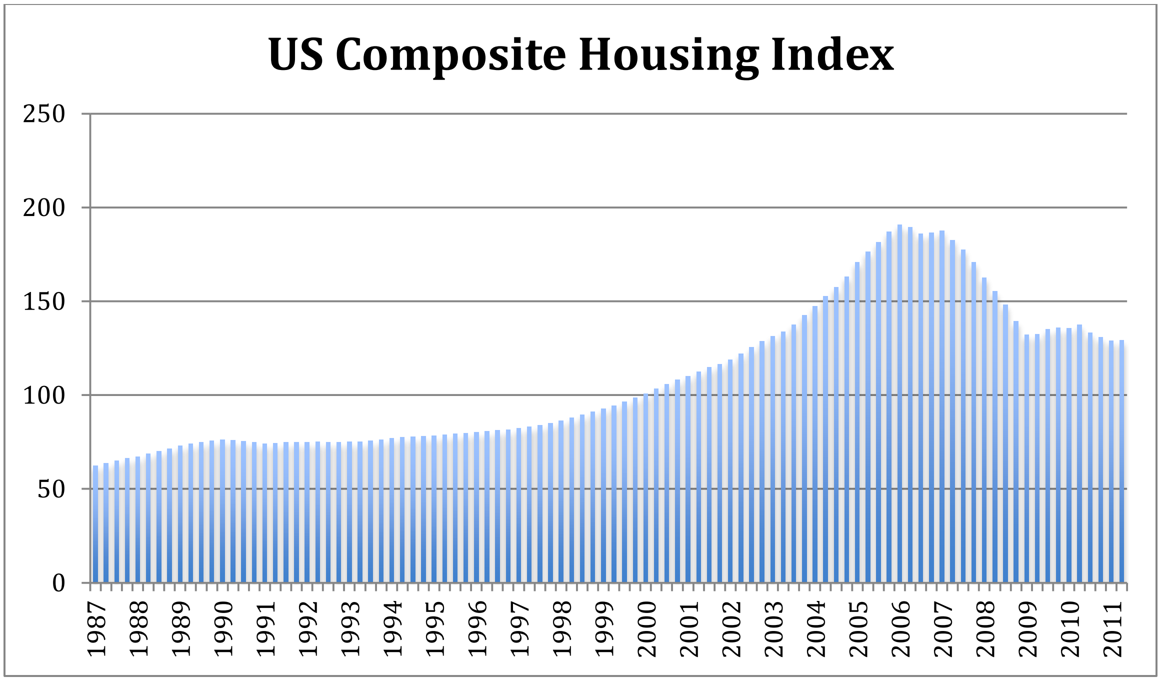
ECONOMIC BOOM………AND BUST

It is learned at an early age in the United States that to own a home is part of the "American Dream". Many people spend much of their working adult lives in pursuit of this dream of home ownership. During the mid-2000's we saw a dramatic increase in the number of American households that achieved this cultural goal as housing sales peaked. What followed was a return back to pre-boom levels as millions lost their homes, leaving the ownership market and returning back to the rental market. According to the US Census, the home ownership rate for 2010 was 66.9%, down from 67.4% in 2009, and down from an all time high of 69.0% in 2004. If we look at Maryland specifically, which has the benefit of a highly educated workforce and a generous variety of high paying employment opportunities due to the economic stability and proximity of the Federal Government in Washington, DC the numbers are even more robust.



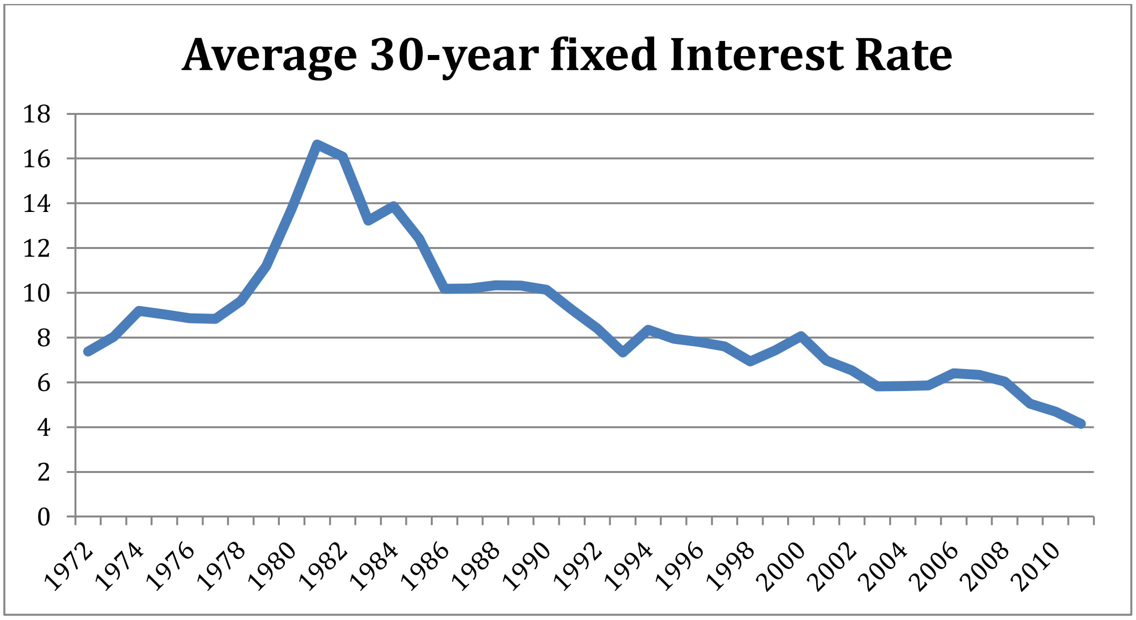
US Census Bureau, Home Ownership Rate Since 1996 (Past 15 years)

As we can see from the data, home ownership rates peaked during the mid-2000's around 2004-2006 for both Maryland and the US as a whole, only to fall back down to rates of the late 1990's by 2010. There were many factors that contributed to this boom in homeownership during this period. Arguably, the two main factors could be attributed to the push to create an "ownership society"; coupled with historically low interest rates, which were induced by the Fed in reaction to both the dot-com crash of 1999-2000 and the economic fall out of 9-11. This second contributing factor, the drop in rates, had perhaps the greatest impact on the availability of capital, which in turn spurred the buying frenzy. Analyzing the Case-Shiller Composite Home Price Indices since Q1 1987, we can see that the peak of home ownership aligns with the peak of housing sales. Fueling these two trends was the lowering of interest rates by the Federal Reserve.



Case Shiller Composite Housing Index 1987 Q1 -2011 Q2

The Federal Reserve sets both the Discount Rate as well as the Federal Funds rate. These rates in turn set the standards for which all private banks can lend funds. The two main goals of the Federal Reserve are to promote employment as well as to control inflation. In times of crisis, or economic uncertainty, the Federal Reserve decreases these rates in order to bring down the cost of capital, and in turn spur spending and growth. In times of plenty, rates are increased to curb spending and borrowing to keep inflation in check. As a result of both the dot-com crash and 9-11, the economy was disrupted and spending all but ceased. In reaction to these events, the Fed reduced their rates in order to encourage spending and borrowing. What followed was an unprecedented reduction in the cost of capital. With the push to create an “ownership society” by the President and Congress, rates were artificially held low to lead us out of a recession. Reviewing the contract rate on 30 year fixed conventional home mortgage commitment data from Freddie Mac between 1972 and 2011, we can see interest rates fell to historic lows during the mid-2000's.



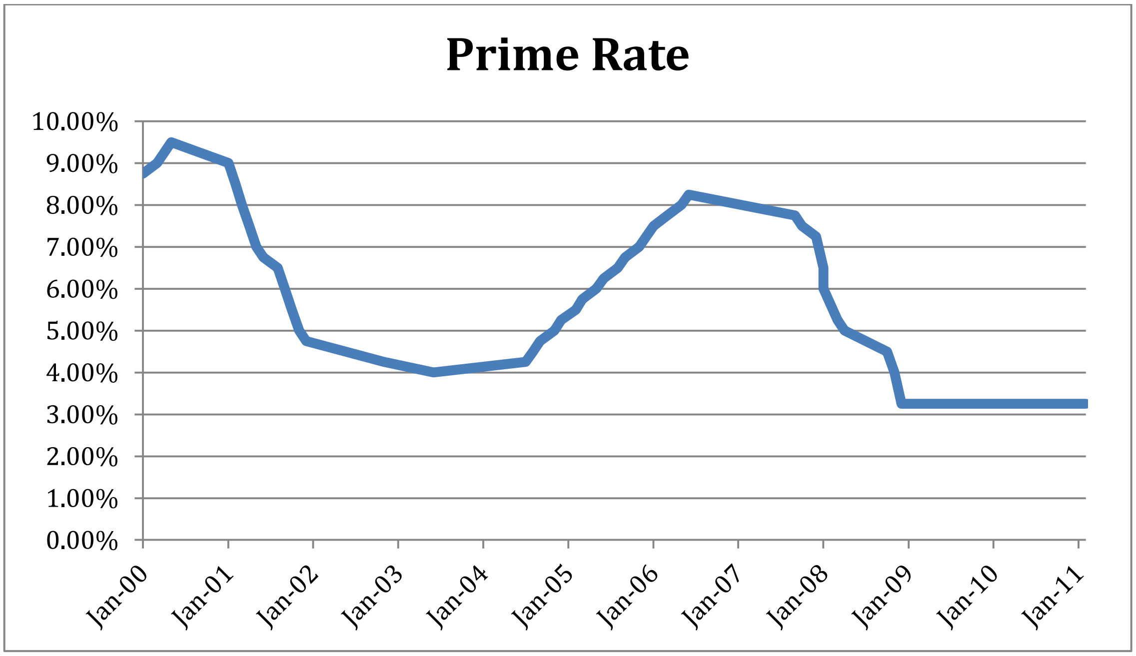
Contract rate on average 30 year fixed conventional mortgages - Freddie Mac

Low rates in isolation were not the sole contributor to the rise of home ownership and housing sales. The lending industry as a whole adopted loose oversight practices in evaluating loan applications during this time which only added fuel to the boom in lending. In turn, the behavior of borrowers themselves was also a major contributing factor. It is said that people are motivated by a combination of fear and greed. Afraid that the opportunity presented today will disappear tomorrow if they don't act now; and the desire of gaining just that little bit more than their original expectations. The result created an era of easy lending and predictable increases in home valuation that appeared for a short few years to show no signs of slowing down. Now, for the first time in generations, those who were not previously able to purchase a home, where now finding themselves in the market to buy their first property with ease. With home values on a constant uptick, it was widely believed that if you didn't get on the property ladder now, you might never be able to. In addition, with banks practically giving anyone a loan, it was now easier than ever to qualify for a mortgage that was way beyond your means.

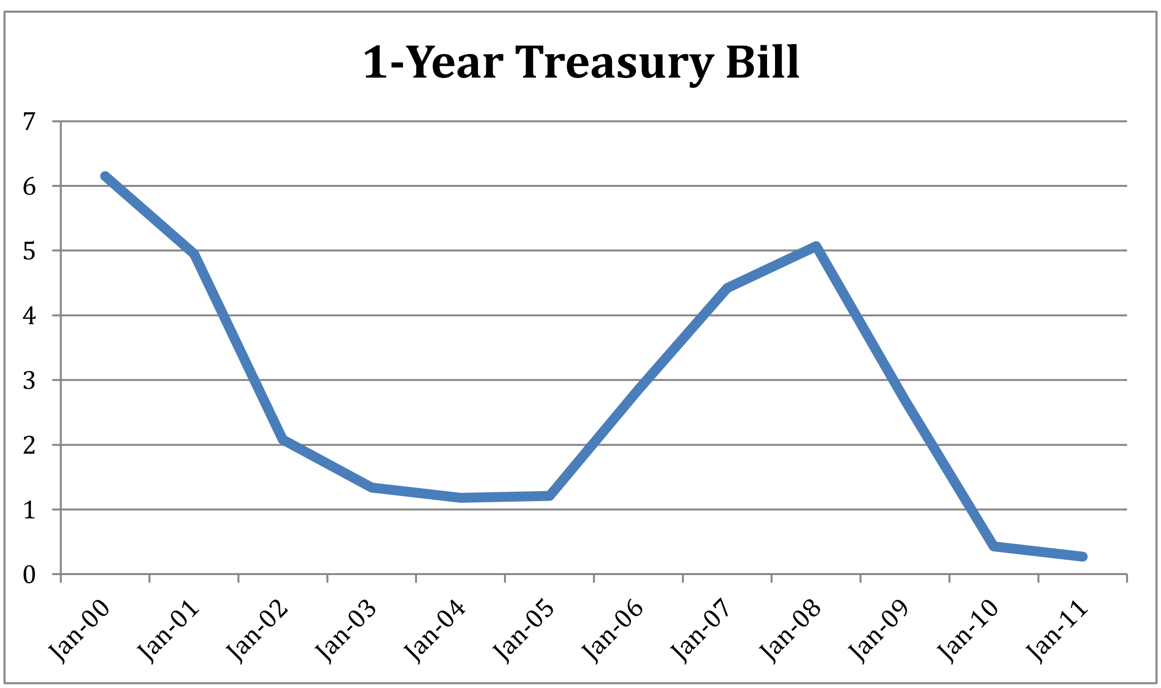
Many of these first time buyers fell into the category of “sub-prime lending” or high-risk borrowers. These borrowers had three distinct traits. One; they had low-income levels. Two, they had no real assets. And three, they had poor credit scores. Undoubtedly, all of these factors considered these borrowers as high-risk. Many also had difficulty repaying what they have borrowed in the past. Past credit histories of these individuals may have involved late payments, defaults, or financial over-extension of credit on consumer-based goods. It is no surprise that if those that fell into this category had difficulty paying off consumer credit cards, automobile loans and the like, debt on the scale of a home mortgage would be exponentially worse. Never the less, lending institutions continued to approve these individuals and securitize the debt. The trend of sub-prime lending was highlighted by an influx of first time buyers with little credit, poor credit, or no credit at all entering into the market. While some hailed this merely extending the opportunity of the American Dream to those not previously in the fold; it became a recipe for disaster. Many of these applicants also fell into the category of “NINJA” loans; “no income / no job / no assets” and “Liar” loans; where an applicant would simply lie about their true financial picture. Often the borrower of a “liar” loan would use the stated income method on their application. This simply required the applicant to write down their annual income without having to prove the amount by producing a W-2, paystub, or bank account statement that would validate the amount stated. Further troubling, was that many of these first time buyers didn’t fully understand the financial products they were purchasing or the terms they were signing up for. As we saw in the 30-year fixed interest data, rates were at historic lows during the mid-2000's. However, many of these first time borrowers did not lock into a traditional 30-year fixed mortgage product. Instead, many were approved for "ARM" or "Hybrid ARM" loan products that had terms that only required the interest on the note to be repaid for a period of time.

An ARM product has a set period of repayment where only the interest on the loan is repaid. This could be a 1-year, 3 year, 5 year, 7 year, or even 10-year period depending on the note. At the end of the set term, the note would reset to the current interest rate and the payment would amortize to an interest plus principle repayment. Hybrid ARM products such as 3/1 ARM (I/O) 's or 5/1 ARM (I/O)'s. are products that have a period of the repayment tied to a fix rate with another that is adjustable. For example, in a 3/1 ARM, the first three years of the loan have a fixed interest rate with an interest only payment period. At the end of this term, the interest rate adjusts and is set at the current interest rate for a period of one year (the "1" in 3/1 ARM (I/O)). This reset of the interest rate repeats at one-year intervals there after.

The interest rate of ARM loans are tied to an index, often the one-year US Treasury Bill or the Prime rate, with a margin added to create the actual interest rate that the borrower pays. ARM rates can be tied to nearly any type of index; Prime rate, CCI. Likewise, the margin the lender adds could vary based on the lender's exposure of risk. ARMs differ greatly from traditional 30-year fixed rate products from a lender's perspective. With a 30-year fixed rate, the lender is expecting that the locked in rate will be appropriate to balance the lender's risk exposure in the market for the next 30 years. In contrast, with a 3/1 ARM (I/O) product, the outcome can be more easily understood since the outlook is only 3 years. For this, rates for 30-year fixed products are generally higher than in a 3/1 ARM (I/O) product. By looking at the Prime rate during this time, we can see a dramatic drop in an index that these interest only products were tied to.

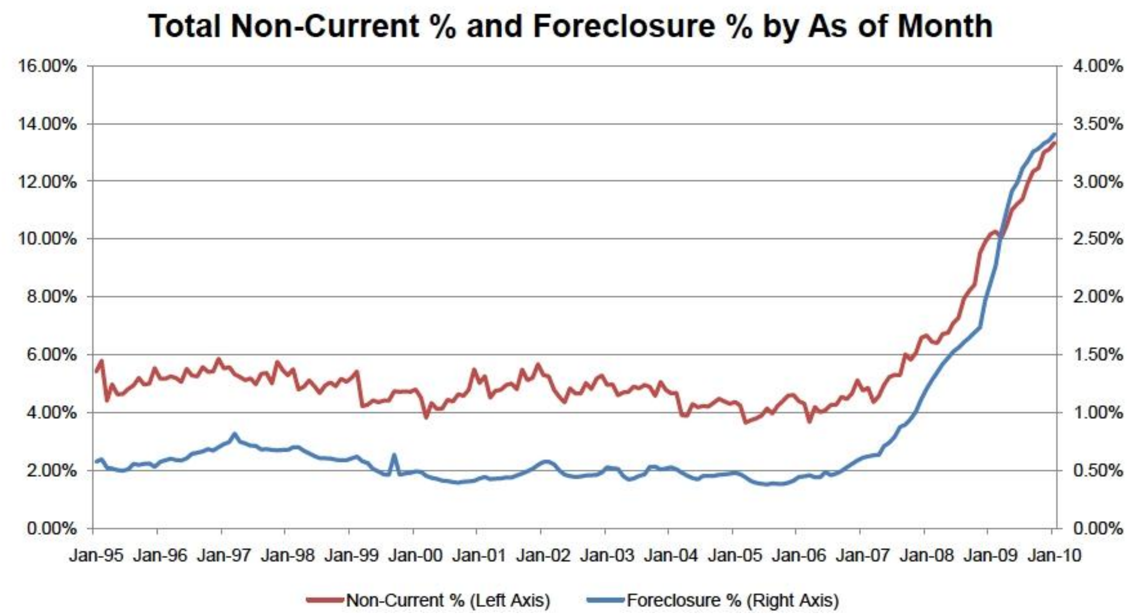


Prime Rate as reported by Wall Street Journal



US Department of The Treasury Resource Center

As we can see in the above graphs, the indices tied to adjustable rate mortgages dipped dramatically in the mid-2000's. The result was lower rates on ARM products. This drop further expanded the gap between the 30-year fixed rate and the 3/1 ARM (I/O) rate. Most people, in turn, opted for this structure in lieu of a traditional fixed rate product. Borrowers now were underwritten at historic low rates that allowed them to "supersize" they purchasing power. Unfortunately, at the expiration of the interest only period, often in the third year, the interest rate would adjust from the initial "teaser rate"; the new monthly payment would now require a contribution to both principle and interest, along with any PMI (private mortgage insurance) or escrow payment requirements. The result was a new monthly payment that could be dramatically higher than the original first 36 interest only payments. Those that were already overextending themselves by purchasing properties far beyond their means and could not afford debt service under the new higher rate. Widespread default and foreclosure resulted throughout the banking industry as these rates started to readjust a few years after the peak. Citing data on delinquent mortgage payments and foreclosure rates, we can see how within a few years of the housing peak of 2004-2006, the rates of both began to skyrocket. Naturally, the collateral on these loans, the property, reverted back to the lenders and the supply of housing far out balanced demand.



Aside from the first time borrower, or sub-prime borrower, others already in the market found it possible to capitalize on the perceived equity gain from their home experienced during this time. These homeowners were able to easily draw funds out in the form of refinancing their first mortgages. Many of these borrowers then went on to use the capital to fund the purchase of second or even third homes on a leveraged basis.

Investing in real estate was a sure winner that was the national conversation and echoed throughout the media. It was inescapable, and we all knew someone who had made easy money doing it. The plan seemed simple enough; home values were rising. A homeowner would refinance with a cash out option, leveraging their primary residence. You would then purchase another property and hold it for a short time, often less than one year. After the holding period, you would then sell it for a profit since home values at the time of sale were certain to be much higher. Subtracting closing costs and any capital gains realized during the transaction, you still came out ahead. Many homeowners saw this as a no-lose strategy.

This form of buying on speculation was especially troubling given that borrowers would borrow on a perceived equity gain and not an actual gain. With so many people borrowing and buying on speculation, the true value of housing began to inflate as a whole, which created a false sense of demand in the very investment that were purchased on speculation. We had over built and over supplied the housing market. With diminished real demand, many started having trouble “flipping” their properties. Many of these buyers, unable to sell; soon found themselves in the unexpected role of landlord as they attempted to lease their properties in lieu of selling them.

The case of the first time buyer with the teaser 3/1 ARM mortgage, over zealous purchasers of speculative properties drove up demand and in turn, drove up home prices during this time. With an inflated demand, many of the speculators were unable to find buyers or even renters and ultimately defaulted or were foreclosed upon right along side of the first-time buyer. The greed to “collect” properties was in many cases done blindly without the due diligence of market research or even a basic understanding of the legal and financial obligations of owning rental property beforehand. A segment, unable to sell, but lucky enough to hold onto their investment properties as rentals may have found themselves to be in an unexpected role as landlord.

Clearly, this is not the smart way to invest in real estate. The boom and bust of the housing market effected all sectors of the investment community; large and small. Especially troubling were the small investors who not only lost their entire portfolios, but often, their primary residences, which were used as collateral. These investors were in a sense the unlikely investors. Those that saw the trend and decided to jump on board since it appeared that everyone else was doing it, and it seemed so easy. Unlike established investors who had the benefit of past knowledge and resources, small investors were isolated and soon out of luck.

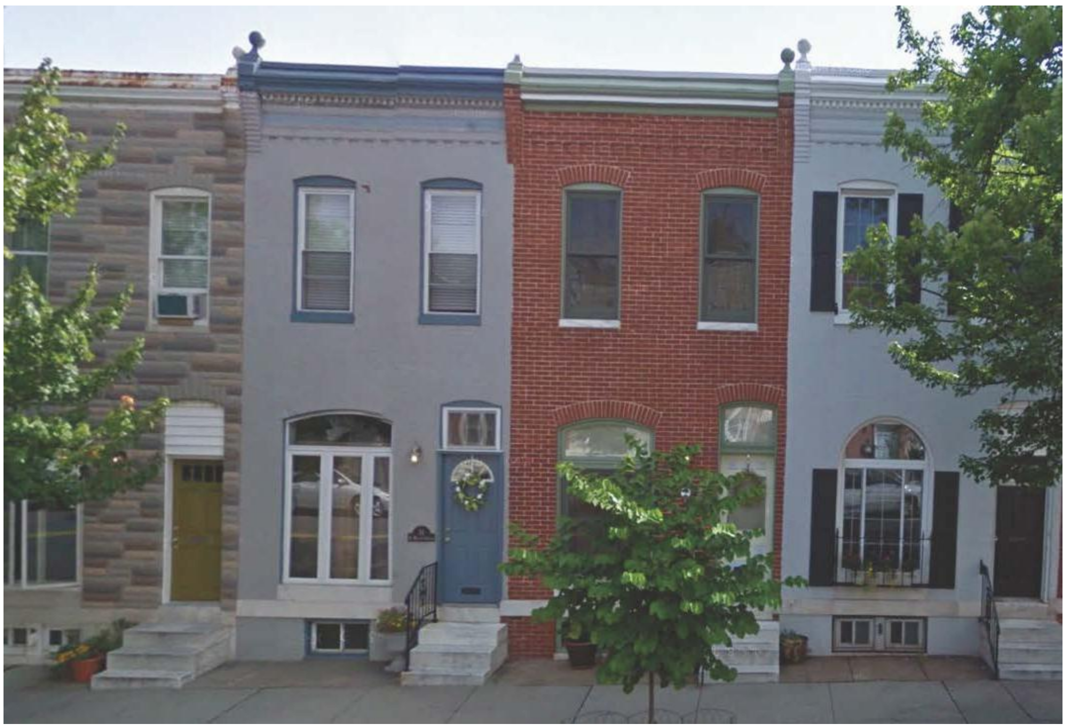
BASE PROPERTY AND INVESTMENT

The housing and lending markets have faced incredible volatility in the past decade. Many of these buyers during the boom invested in real estate out of a combination of fear and greed, driven by market forces and their desire to make easy money. If we focus on the actions of the average small investor during this time, we learn a wealth of information. Sadly, much of what we learn are lessons in what not to do to build a real estate portfolio. If learning from your mistakes is the best way to move forward, then the actions of the past decade require further investigation for anyone looking to build a real estate portfolio.

Living within your own means is advice that is heard loud and clear, but seldom followed. Who among us doesn't have non-mortgage debt obligations, the occasional blemish on their credit and less than six months living expenses in savings? I would guess most people fall into this model. For the small investor, we learn from the mistakes of the past in order to better secure a foundation in real estate investment. In order to benefit the most from this exercise, we will follow a fictional character with one modest rental property that was purchased during the boom. We will follow him as he builds upon this first investment property to create a portfolio of real estate investment properties. For simplicity, we will focus on the jump from a single property to a second, larger multi-unit property.

Before anyone begins any form of investment, it is perhaps most important to determine if the investment is best suited for your lifestyle, risk-aversion, required rate of return, and temperament. Of all the financial products available, real estate could be seen as one of the most complex. Unlike traditional stocks, bonds, or derivatives, real estate has the added complication of emotion and physicality. Further complicating matters is the element of loss. If we were to purchase a stock, the most you can lose is the purchase price of the stock and nothing more; whereas in real estate, your losses could be a multiple of your initial investment. For example, after purchasing a property there are a never ending conveyor of expenses that must be satisfied; mortgage debt, closing costs, interest, property taxes, insurance, maintenance expenses, marketing expenses, flood insurance, capital expenses, preventative maintenance, rollover costs. These are expenses that you must pay over and above the actual costs of the investment. These also do not include additional professional expenses that you may have to pay; lawyers, accountants, architects, contractors, lead paint inspectors, housing official inspections, pest control, special district surcharge expenses. These are all expenses that you will more than likely have to pay at some point in time. It bears repeating that these are all expenses that stocks or bonds do not have. After the initial investment, you either experience a gain or a loss. You will never ever be required to provide additional funds towards the initial investment with these other forms of investing. Real estate by contrast, is the investment that you might never finish paying for.

These truths are further expanded when things go wrong. Buildings require constant maintenance and attention that can often lead to high costs. In addition, if you are leasing any form of housing, the lease that you sign is a transfer of property rights to your tenants. The law offers protection to individuals leasing their living accommodation, which in turn places requirements on you, the owner. It also bears mentioning that with physical property, especially property in which the general public has access to, you have liability concerns regarding the health, safety and general well being of the public who occupy your property. Even with insurance as protection, if someone becomes injured on your property or due to perceived negligence on the part of your property, you may face legal action, which can be very costly.



Front elevation – 11 N. Milton Street

Never the less, investing in real estate can have many benefits and can be a profitable endeavor. Our fictional character, let's call him Jack, owns one rental property and wishes to expand this into a portfolio of income producing properties. To track Jack's progress we should start with the basics in order to establish a strong foundation. Since real estate has the benefit of time and place, we will be using a real address in Baltimore City for which to base our analysis on. The starter property is located at 11 N. Milton Street, Baltimore, MD. Jack purchased the property in 2009 for

$218,000. The building is a two story brick, center of group row home with 1,326 interior square feet. It was originally built in 1920, however it was renovated in 2004 and brought up to then current IRC 2000 building code (IRC: International Residential Code) for plumbing, electric and mechanical. After an initial cash investment of $60,000, which Jack had from savings, he mortgaged the balance and closing costs of $164,540 with a 30-year fixed 5.35% loan. This resulted in a base monthly mortgage payment of $918.81. Real estate taxes assessed the property value at $182,000 for 2009-2011. This translated to a yearly tax bill of $4,331.60.

Fortunately, the previous owner qualified for a ten-year property tax freeze when the major renovation occurred in 2004. The property taxes were calculated at an artificial value of $52,500 for tax years 2005-2014. Jack was able to have these credits assigned to him as part of the title transfer. Property taxes in Baltimore City are a very contentious issue. Many investors not familiar with the city soon learn a harsh lesson. As we can see from the two tables below, the difference in total tax can be staggering for a small investment property.

Without Tax Credits

Tax Description	Assessment	Rate	Tax
State Tax	$182,000	$0.1120	$203.84
City Tax	$182,000	$2.2680	$4,127.76
Total Tax			$4,331.60

Baltimore City real estate property tax calculation

With Tax Credits

Tax Description	Assessment	Rate	Tax
State Tax	$52,500	$0.1120	$58.80
City Tax	$52,500	$2.2680	$1,190.70
Total Tax			$1,249.50

Baltimore City real estate property tax calculation

In addition to property taxes, there are additional expenses over and above debt service. Property insurance was secured for a yearly premium of $835. Both property taxes and insurance were held in escrow and required a minimum two month balance, which caused the actually monthly contribution to be greater than dividing the premium by twelve. In addition to the mortgage expenses, Jack budgeted for maintenance and capital expenditure expenses of $100 per month. The two tables below illustrate the difference in expenses. It is important to note how these expenses are affected by the property tax contribution. Without tax credits, Jack's monthly expenses are $1,521.11 versus $1,221.45 with tax credits. This represents a nearly 20% increase in expenses, which could impact the "go versus no-go" decision.

Monthly Expenses with vs. without Tax Credits

Monthly Expense without Tax Credits

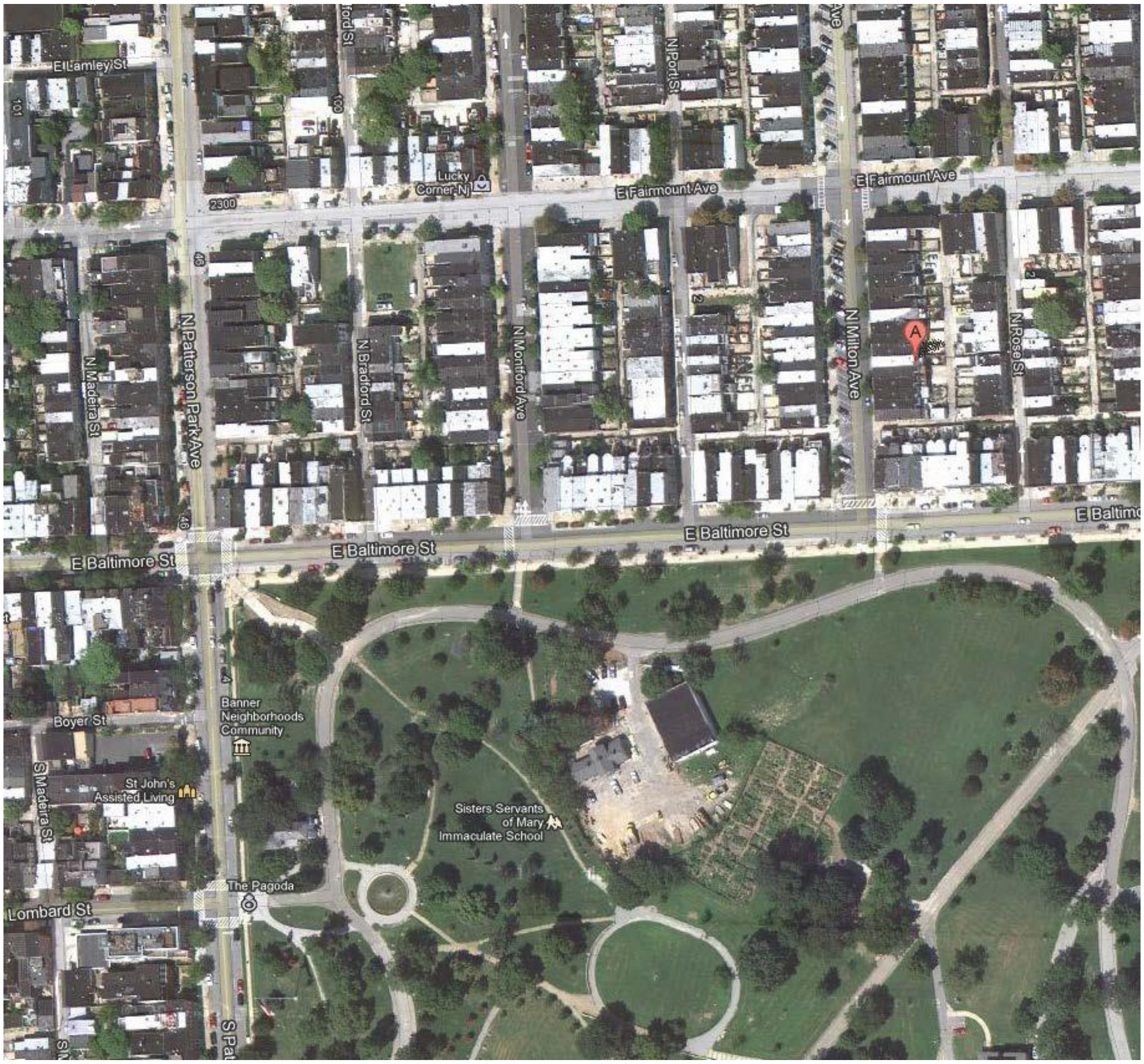
Monthly Expense	**Escrow Calculation (2 month min)**	**Value**
Debt Service	-	$918.81
Property Taxes	$4,331.60/12 = $360.97 + 1/6 =	$421.13
Insurance	$835/12 = $69.58 + 1/6 =	$81.17
Maintenance	-	$100
		$1,521.11

Monthly Expenses

Monthly Expense with Tax Credits

Monthly Expense	**Escrow Calculation (2 month min)**	**Value**
Debt Service	-	$918.81
Property Taxes	$1,249.50/12 = $104.12 + 1/6 =	$121.47
Insurance	$835/12 = $69.58 + 1/6 =	$81.17
Maintenance	-	$100
		$1,221.45

Monthly Expenses



Site Plan – 11 N. Milton Street

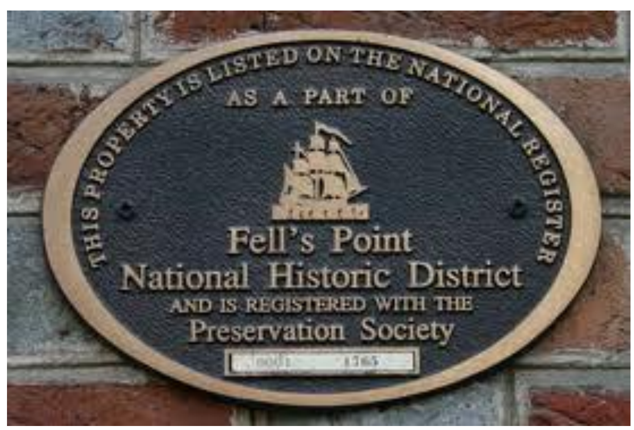
Before making the ultimate decision to invest, Jack did research on the tenant base and comparable lease rates. This was an important step to determine if his expenses would be covered by the anticipated rents. With close access to Patterson Park, Johns Hopkins Hospital, JHU School of Public Health, Canton, and Fell's Point, a highly educated young working professional tenant base would be a good audience for his marketing and research efforts. Jack researched comparable rents online by posing as a prospective tenant. It was through this research that he was able to gauge what he could realistically charge in rent and what amenities he would have to provide for the price. With the property also having already undergone a renovation by the previous owner, there were already attractive amenities that would fit in with this market group. In addition, with three modest bedrooms, the property lent itself well to young working professional tenants who would live with roommates. Jack's marketing efforts paralleled his research efforts. These consisted of placing ads on craigslist.org and posting informational fliers in coffee shops in Fell's Point and Canton, and at Johns Hopkins Hospital and the School of Public Health. Within a month he was able to sign a one-year lease for $1,600 per month with three young professionals who would each take a bedroom. At $1,600 per month, the income more than covered his expenses. Keeping in mind that he already invested $60,000 in cash over and above his mortgage, the positive cash flow was required to satisfy his return on investment. Jack postulated that by the time the tax credits expired in year five; calendar year 2014, he would have either sold the property, or hopefully have raised rents to keep up with the additional tax burden. To further insulate himself from other expenses, the tenants would be responsible for all utilities in addition to rent. Jack collected a one-month security deposit at execution of the lease; a lease he was able to find online for free.

Rental Income	$1,600.00
Property Taxes	- $121.47
Insurance	- $81.17
Maintenance	- $100.00
Debt Service	- $918.81
Cash Flow	**$378.55**

STEP TWO:
A second investment: Expansion & creation of a portfolio

Jack found success in his first rental property. He was enjoying a modest return on his investment of $378.55 per month over and above his budget of $100 per month for miscellaneous expenses. His tenants paid their rent on time, kept the property clean, and even signed an extension for a second year term. It was about this time that he considered expanding his portfolio to include more than one property. Why limit himself to one small property he pondered? In his mind he thought, “If I own a rental property that is 5-times the size, my profits would jump five fold!” It would be easy he thought. Naturally, this jump in scale would bring on more challenges, but he was able to tackle the first one fairly easily, so why not go for the challenge? For most people with the financial means, acquiring one modest rental property appears to be a simple, somewhat straightforward exercise. The expansion upon this concept and the jump to larger or more properties, I refer to as “step two”, is where complications can arise; especially when acquiring multi-unit properties. Jack will learn that an investment of this scale and the endeavor of managing multiple properties add an entirely different level of financial and legal exposure he did not experience in his first investment.

Jack’s first property was small enough that he was able to fly under the radar of most over seeing bodies, and possibly either the IRS. Taking the next step to expand his real estate portfolio, he will not have the luxury of this anonymity. Perhaps the smartest first step Jack could take would be to simply speak to someone who has done this before. Since the concept of owning multiple real estate units for investment is as old as private property ownership itself, this has been done many times before. Learning from others who have been down the road before you is a valuable important first step. To take this idea further, finding a mentor who would be willing to share their experiences is also a great idea, as real estate is a business of relationships. Jack would be wise to contact his realtor or other business contacts to see if could make a connection with someone who would be willing to speak with him. Joining civic or industry organizations such as the Rotary Club, Urban Land Institute, Neighborhood Homeowners Association, Local Historic District Community Board. The possibilities are only limited to your own creativity.



After gaining some advice, the next step for Jack would be to financially and legally separate his investments from his personal assets. In real estate investing, this often begins with setting up a Limited Liability Company, or LLC. LLC's offer a unique organizational structure for real estate investors, which combine aspects of a corporation with aspects of a partnership. The IRS has their own take on the popularity of LLC's as it states on their website:

> "LLCs are popular because, similar to a corporation, owners have limited personal liability for the debts and actions of the LLC. Other features of LLCs are more like a partnership, providing management flexibility and the benefit of pass-through taxation."
>
> *http://www.irs.gov/businesses/small/article/0,,id=98277,00.html*

In some states, Maryland included, an LLC can be established with a single-member. This allows sole proprietors such as Jack to form an LLC without other partners or investors if he chooses to do so. LLC's must be registered with the State and do require a yearly fee of $300 in the state of Maryland. They are a popular vehicle for real estate investors due to their simplicity and the protections they offer to their owner(s). To establish an LLC in Maryland, you must choose a unique name and file "Articles of Organization" with the State (of Maryland) Department of Assessments and Taxation; aka "SDAT". In filing the articles of organization, you must identify several points; the name of the LLC, the purpose, the business address, the name of the resident agent, and signature(s) of the officers. After filing at the SDAT and paying the filing fees, you will receive a Tax Identification number as well as a certified copy of the Articles. This first step is possibly the most important organizational step that one must make prior to investing in real estate. Although LLC's cannot provide complete and total protection from all legal actions, they do offer a veil of separation that is required for a venture of this scale.

The second half of the separation exercise is to have Jack set up a bank account that is separate from his personal finances. Although this should have been done prior to purchasing his first property, many owners do not do this and run into issues later. As Jack's investment portfolio grows, it will be imperative for him to keep a clear distinction between personal and business finances. Choosing a bank to work with is also a major consideration. There are benefits to both local credit unions as well as large national banks. If Jack wishes to gain financing for future projects, he may want to consider a local credit union as they will have a first hand history with him and his business. Conversely, large national banks may offer more comprehensive online banking options, which could be attractive to his tenant base. It goes without saying that which ever bank Jack choses; he should establish the account with his LLC's name and tax identification number. It is also important that Jack establishes an escrow account where he may hold a tenant's security deposit. Again, unlike his last property, it is required that these deposits remain separate from operational funds in the LLC. Certain jurisdictions require that these accounts accrue interest paid to the tenant as well.

Rounding out the organizational exercises would be to seek professional advice. Working with or at least establishing contact with a good accountant, tax attorney or real estate attorney prior to engaging in business is a good first step. Where as Jack found his lease for his first property online, as his business grows, it would be wise to have a professional review the document. Regardless of what a residential leases states, there are certain rights that tenants are afforded that may override an executed lease. Having a real estate attorney review the document or possibly draft a standard lease for

Jack's specific property could be money well spent as he establishes this next step. The use of a good accountant goes without saying as now with the establishment of an LLC and separate bank account may be too complex for Jack to file taxes on his own going forward. The use of these professionals and others as he expands, will further strengthen the foundation for which he expands his portfolio and business.

Now that Jack has created a legal and financial foundation for which to expand, the question of what to acquire next arises. Should the next project be a multi-unit? Raw land? Retail? Commercial? Fixer upper? Turn-key? The decision of which type of project could very well set the pace for what future opportunities he will have and establish the image of his portfolio. If he goes too small, this may limit his ability to expand later. If too large, it may be too much for his abilities now. How he chooses will affect his ability to gain future financing from lenders in the future, so he must choose wisely. Of course, the list of what type of property is seemingly endless. The safest bet would be to stay with residential due to his familiarity. However, this may limit his potential for future projects. It may be a good idea to investigate the possibility of a mixed-use project, which would offer the familiarity of residential with the stability of longer leases that a commercial space offers.

Just as important as the building type selection is the area that he chooses. These decisions cannot be made independently of each other. Often a neighborhood will have a building type or scale that lends itself to the local market. To assist in this market research, www.cityview.baltimorecity.gov is a good starting point in researching population figures, housing stability, and trends in employment. Jack's research has led him to focus on property in Fell's Point. The neighborhood attracted him due to its history and vibrant characteristics. It was also a stable neighborhood that was easily identifiable and has a wealth of building types, both residential and commercial. A demographic survey concluded that Fell's Point offered a variety of rental properties with healthy rents; much higher than his first property. In addition to research found on www.craigslist.org and through his realtor contact, he was able to reach out to several civic organizations within the neighborhood. His research through Baltimore City government and www.livebaltimore.com lead him to the following among others:

Fell's Point Development Corporation
www.fellspointdevelopment.org

Fell's Point Residents Association
www.fellspointliving.com

Fell's Point Community Organization
Oleta716@aol.com

Upper Fell's Point Improvement Association
www.upperfellspoint.org

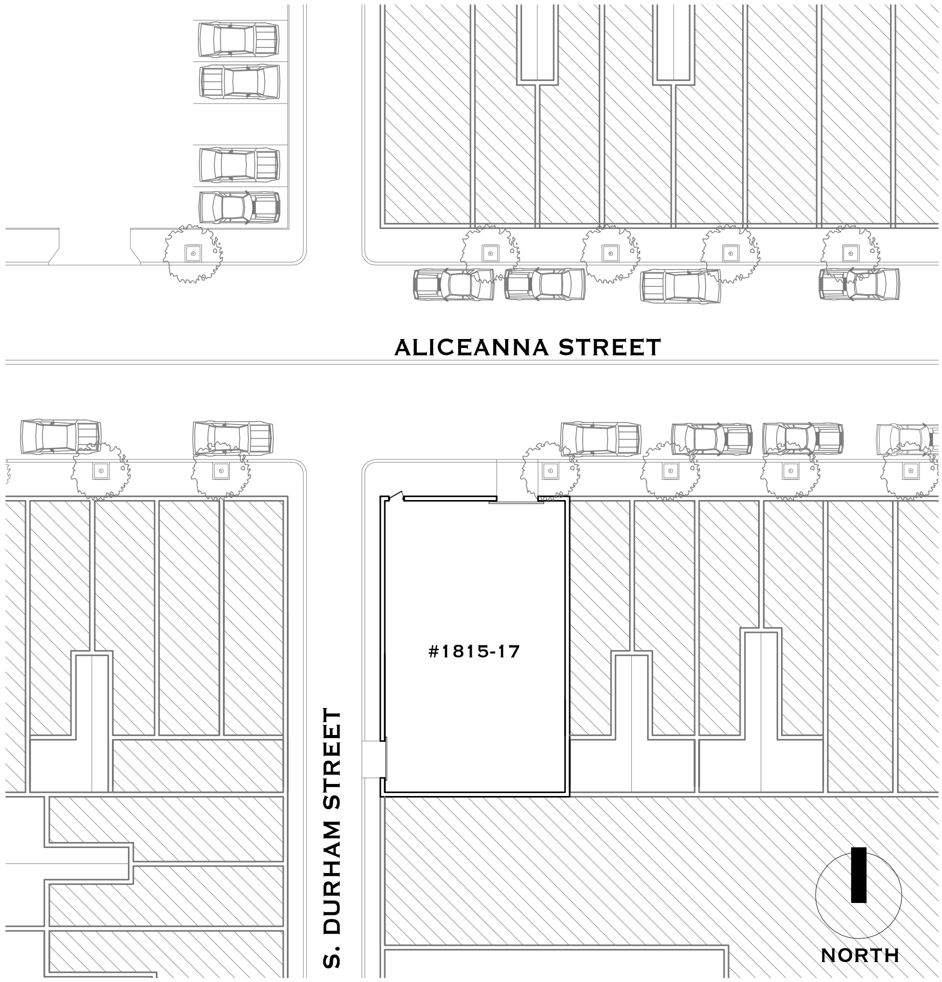
Fell's Prospect, Inc.
www.fellsprospect.org

Society for the Preservation of Fell's Point and Federal Hill
www.preservationsociety.com

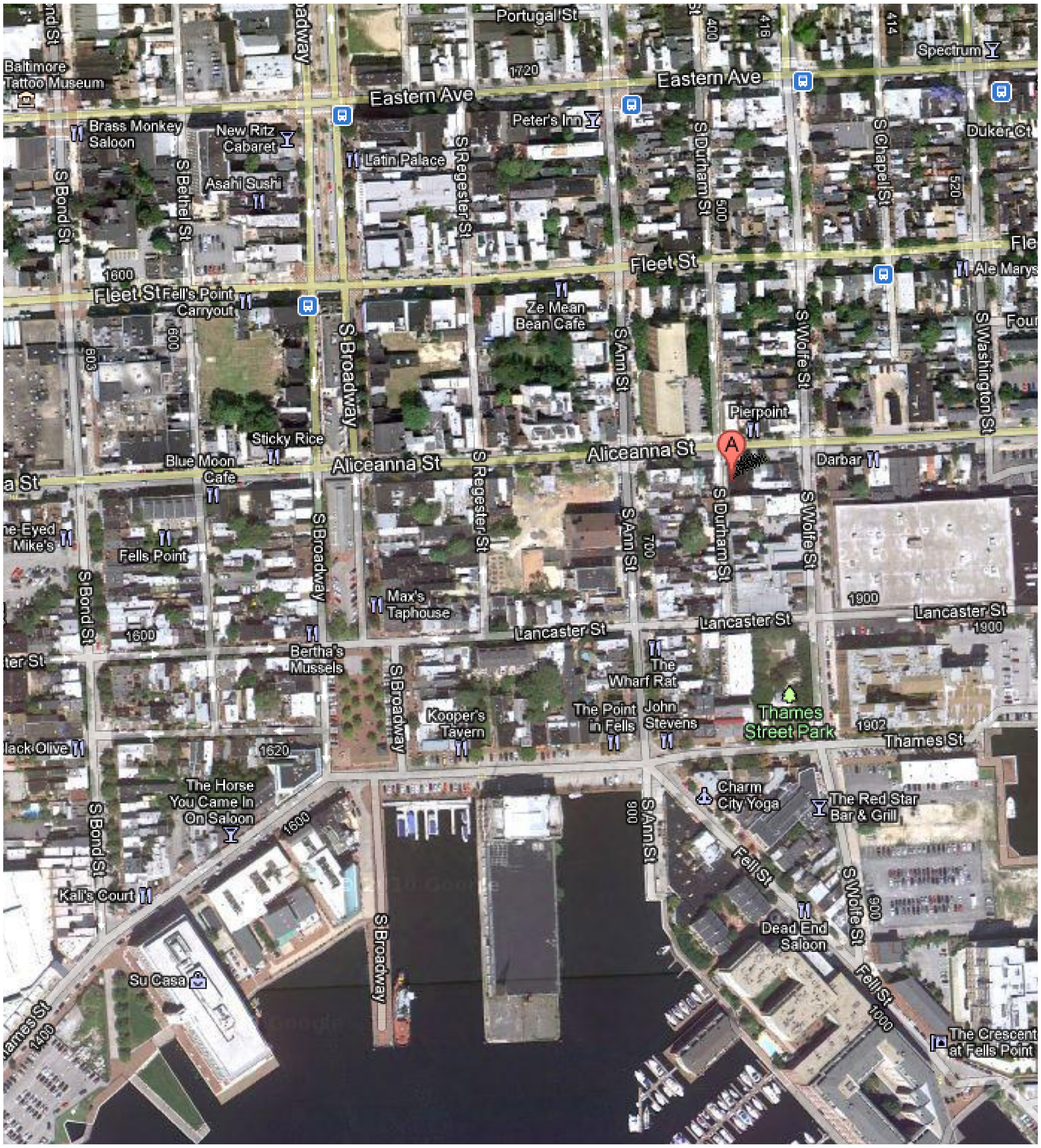
With information gathered about comparable building stock, trends in the rental market and tenant base, Jack sets out to choose a specific site. He has decided that a property that could support a mixed-use of residential and commercial would fit best within his comfort level for development. The community would also support this combination, as this is a typical building type that can be found throughout Fell's Point. William Fell, a ship builder and English Quaker in 1730, founded fell's Point. He purchased the marshy tract of land, which jutted out into the Patapsco River. It offered a deep-water port for shipping and shipbuilding. (George, Christopher T. - http://www.baltimoremd.com/monuments/sea01.html) In later years, the land was parceled, and sold as housing. Many of these homes still exist today, and thus, Fell's Point is an established Historic District.

Developing a project in a historic district offers numerous additional challenges over a traditional neighborhood. By reaching out to the community groups and historic preservation society prior to entering into a project, the standards and expectations of the community can be better understood. Certain building, zoning and procedural requirements could lead to a substantial escalation in costs if not properly understood at the planning stages. Never the less, building in a historic district has many benefits. These include a desirable, destination area and inclusion with a part of the city with a rich history. Creating a project in an area such as this will always be attractive to residents and merchants alike for Jack's development.

After much searching, Jack located a property at 1815-1817 Aliceanna; on the corner of Aliceanna Street and South Durham Street. The property was a single story, full lot coverage, former garage, which was built in the 1920's. It did not conform to any historical standards, and Denise Whitman at the Preservation Society classified the property as a "Non-Contributing Structure". This allows the building to be demolished if a new conforming structure was to be built. Much of Fell's Point is regulated by CHAP guidelines, as the neighborhood became a CHAP district in December 2007. There are also various Urban Renewal Plan areas that are governed by Urban Renewal Ordinances throughout the district.   (http://www.preservationsociety.com/DRC2011master.html) In addition, the building had been vacant for years, and thus its zoning had automatically reverted to R-8 zoning, as is policy for structures which are vacant for greater than 12 months. (www.baltimorecity.gov) Even with this variety of constraints, understanding the requirements prior to making an offer on the property was important. It was also important that this limitation be understood prior to completing a “back of the envelop” DCF to see what could be built. Certain restrictions would affect his BOE; the imposed 35-foot height limitation, parking requirements for new residential buildings (1.5 cars per apartment unit), R-8 zoning, and material requirements of the district. Jack surmised that he might be able to rezone the building and possibly get a variance on the height restriction since the building is adjacent to an apartment building that was approximately 48 feet in height. He will also seek a variance on the parking requirements since he intends to reuse the existing base building.

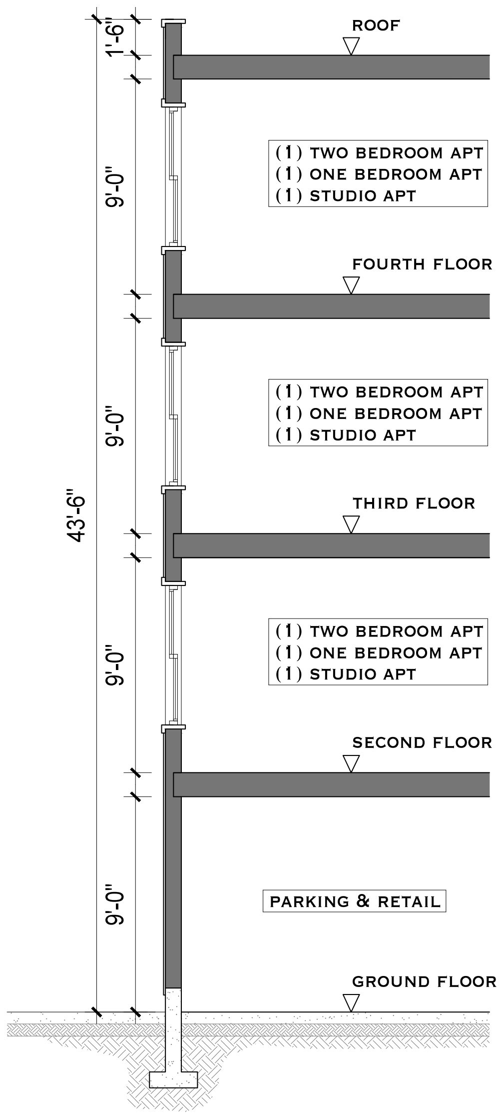


Site Plan: 1815-17 Aliceanna Street



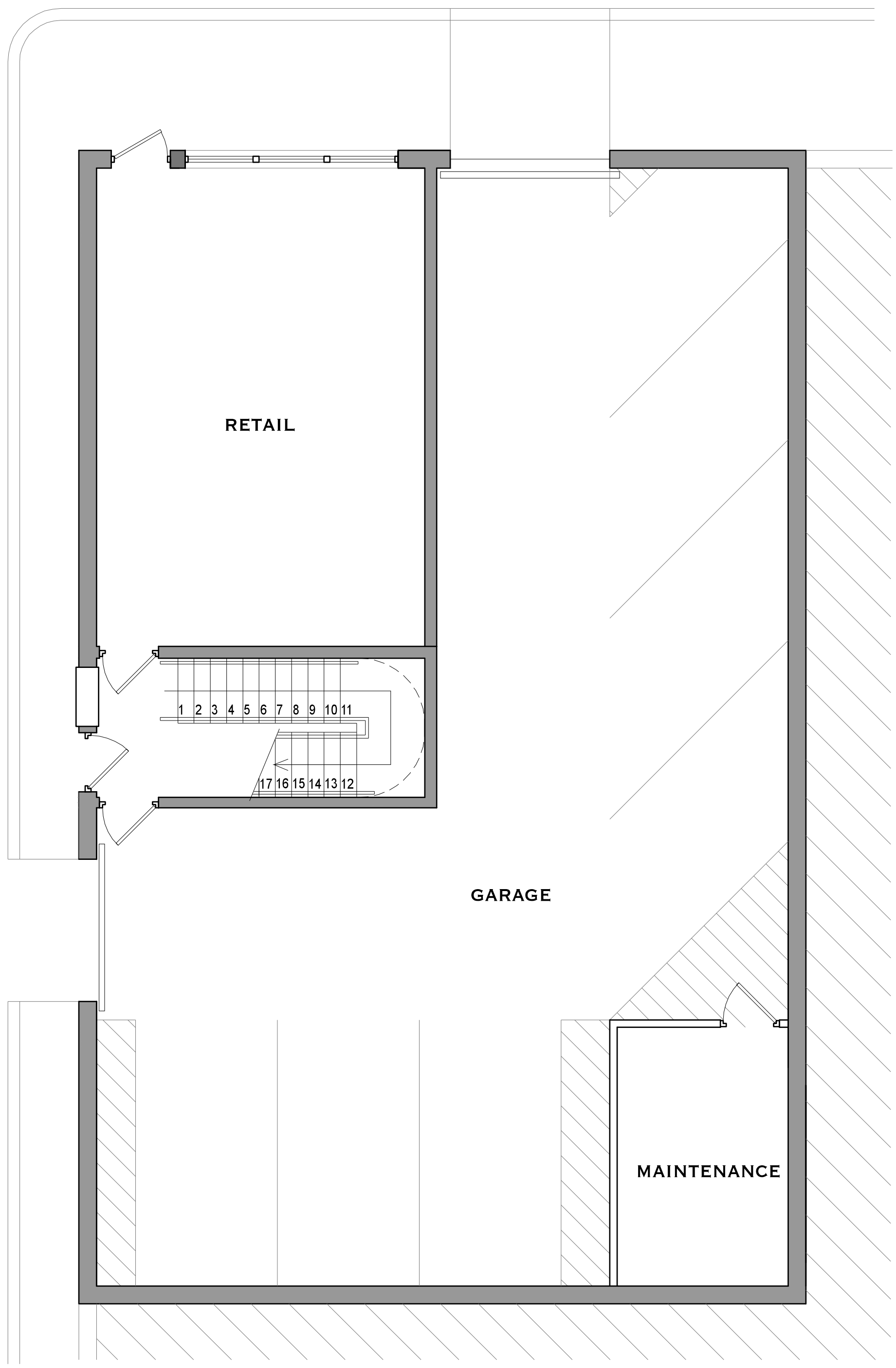
Area Map – 1815-17 Aliceanna Street

Based upon existing housing stock, Jack thinks that he can build a combination of 1 and 2 bedroom apartments with ground floor retail and parking within a 4-story envelope. The building will include ground floor retail and parking, with 1-bedroom units located on the second and third floors and a 2-bedroom unit on the fourth floor.



SECTION

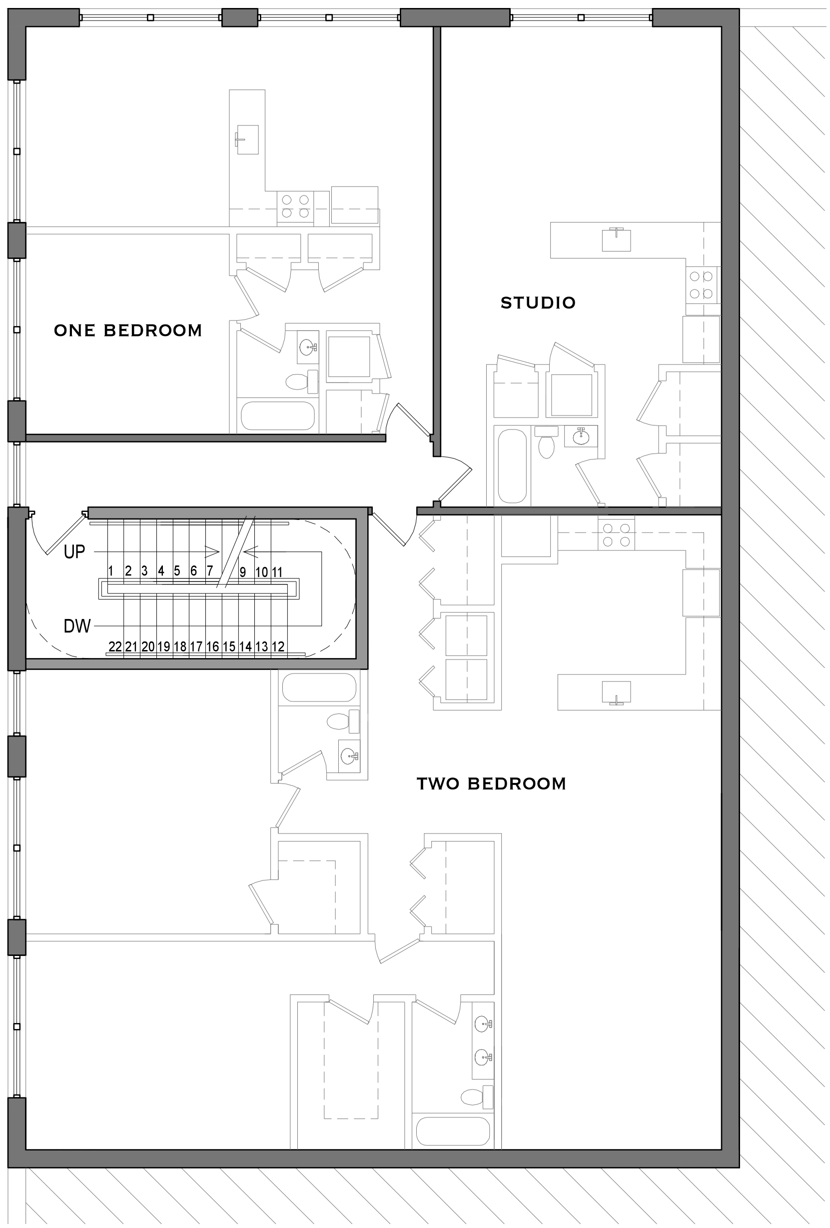
ALICEANNA LOFTS
1815-17 ALICEANNA ST



FIRST FLOOR

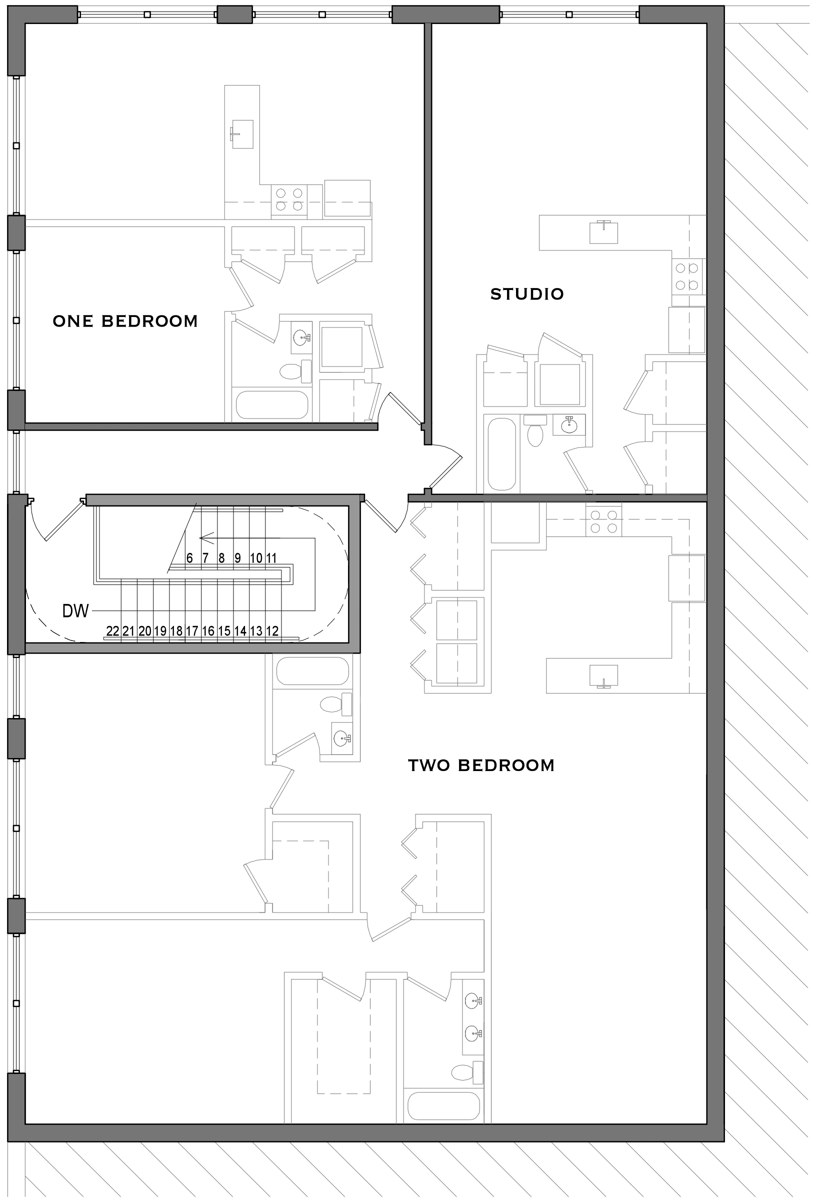
ALICEANNA LOFTS

1815-17 ALICEANNA ST



SECOND & THIRD FLOORS

ALICEANNA LOFTS
1815-17 ALICEANNA ST



FOURTH FLOOR

ALICEANNA LOFTS
1815-17 ALICEANNA ST

Creating a project that comprises of the highest and best use for the land at the time of engagement should be the goal of any project. Time and place play an important role in determining the highest and best use. For instance, the best decision may simply be to not proceed. With this in mind, Jack bases his decision whether or not to pursue the project based upon his back of the envelope analysis. He uses comparable rent rolls in the neighborhood, to predict what he can realistically collect the following in monthly rent:

Space	Quantity	Monthly Rate	Total
Retail	1	$1,800	$1,800
Garage Space	7	$150	$1,050
Studio	3	$1,100	$3,300
One Bedroom	3	$1,500	$4,500
Two Bedroom	3	$2,300	$6,900
		Total	**$17,550**

With monthly receipts of $17,550, Jack works backwards to see what he can afford to pay for the building after construction and mobilization costs are determined. He engages the services of both an architect as well as a contractor to determine order of magnitude costs. The base building measures 65'-0 x 40'-0" resulting in 2,600 square feet per floor plate; or 10,400 SF total. For concept level development, Jack paid a local architect $2,500 to create a set of plans and elevations. This mini set was used to gain pricing information from three contractors who Jack received references from his realtor. In addition to pricing, the plans were presented to the Fell's Point Design Review

Committee to review for preliminary approval. These preliminary exercises had minimal upfront costs, but provided valuable feedback for the overall analysis period.

Based upon numbers received, Jack was able to complete the DCF analysis to determine final costs. He was also able to secure valuable tax credits for his project as long as he utilized the existing base building footprint on the ground floor. As part of the tax credit review process, the City artificially limited the value of the building to $300,000 for FY2011-2020. This limited his expenses going into the deal. His analysis was as follows:

Capital Costs

Existing Building		$200,000
Closing Costs	Base x 6%	$12,000
Garage & Retail Renovation	$25 x 2,600 SF	$65,000
New Construction (2-4)	$100 x 7,800 SF	$780,000
Professional Services		$25,000
	Total Capital Costs	**$1,082,000**

Monthly Expenses (less Mezzanine Financing)

Loan to Value		80%*
Debt Service	$865,600 x 6.2% APR @ 25-yr AM =	$5,683
Taxes	$7,140 / 12 =	$595
Insurance	$0.45 x 10,400 SF / 12 =	$383
CAM	$0.25 x 10,400 SF / 12 =	$213
Management Fee	$17,550 * 3%	$525
Legal/Administration	$0.10 x 10,400 SF / 12 =	$120
Reserves		$300
	Total Expense	**$7,819**

80% LTV requires minimum up front capital of $216,400.

Property With Tax Credits

Tax Description	Assessment	Rate	Tax
State Tax	$300,000	$0.1120	$336.00
City Tax	$300,000	$2.2680	$6,804.00
Total Tax			$7,140.00

Baltimore City real estate property tax calculation

Before calculating a working balance sheet for the project Jack must determine how financing will be established. In his first project, he used $60,000 in liquidity he had from his savings to finance the deal. In his second deal, he must assemble over three times this amount totaling $216,400 prior to being approved for financing. He has several options for securing capital. His first investment property has $85,000 of available equity that he could borrow against. Most of his liquid assets have dwindled since he used most to purchase his first property. The remaining liquid assets he has equal $25,000. To pull assets from his first property Jack will have to decide if he should sell the property or borrow against it. If he were to sell, he will consider creating a 1031 tax-exchange, which would shelter any capital gains taxes that could be levied on the property at the sale. If he were to complete a refinance, he would incur an additional payment. This would also impact his overall debt service coverage ratio across his balance sheet. The lessons we learned in the past decade showed us that too many investors over-extended themselves and were left with little more than debt on top of debt with little to no equity. It only takes a short-term vacancy or unforeseen capital expense to prevent an owner who finances in this way to start to miss debt service payments. With only $25,000 in liquid cash flow, it is advisable that Jack not attempt to self finance the entire project. As much as he may want to be the sole owner, in this case, he simply does not have enough funds to do so. In previous years, investors in his same situation disregarded this advice and ultimately lost everything.

What Jack should do is either apply for mezzanine financing or to bring in outside investors to assemble the requisite up front capital costs. Both of these options pose added risk. Outside investors will require a rate of return on their investment regardless of the health of the development. This return will have to be applied before Jack received any profit at all. The investors may also want to be involved in the management of the property, which could complicate things. Mezzanine financing is another option. However the interest rates available are always much higher than primary financing due to their second lien position. It also does not help with striking a healthy debt service coverage ratio. If Jack moves forward with the project, his best course of action may be to use a combination of all of the above options. For mezzanine debt he will use the following structure:

Total Mezzanine:	- $216,400	Terms
Personal Cash	$16,400	Requires a five year payback at 6%*
Investor One	$100,000	Requires an five year payback at 12%**
Investor Two	$100,000	Requires an five year payback at 12%**

*Jack's required return of capital monthly payment equals $317
**Each investor requires a monthly recapture payment of $2,224

Table of Equity Return

Allocation of IRR						
	2012 Opp CF	2013 Opp CF	2014 Opp CF	2015 Opp CF	2016 Opp CF	Reversion
Cash Flows	$ 135,762	$ 127,129	$ 132,746	$ 138,040	$ 144,490	$ 1,415,889
PV of Cash Flow	$123,420	$105,065	$99,734	$94,283	$89,717	$879,156
% of IRR per Cash Flow	**9%**	**8%**	**7%**	**7%**	**6%**	**63%**

Return OF/ON Investment						
	Period 0	2012	2013	2014	2015	2016
Cash Flow	($216,423)	$67,566	$58,933	$64,550	$69,844	$711,492
Equity Balance		($148,857)	($89,924)	($25,374)	$44,470	$755,962
		OF	**OF**	**OF**	**ON**	**ON**

Monthly Cash Obligations

Debt Service		- $5,683
Investor One		- $2,224
Investor Two		- $2,224
Jack Return of Capital		- $317
Taxes		- $595
Insurance		- $383
CAM		- $213
Management Fee		- $525
Legal/Administration		- $120
Reserves		- $300
Rent Roll		$17,550
	Balance	**$4,966**

All told, Jack and his investors can expect to receive their required rates of return along with a small cushion, which will go towards capital expenses and contingencies. This capital structure is only viable when the building is fully leased. During the construction phase, debt service will have to come directly from the cash on hand. After a deal is struck with the seller and a closing date chosen, Jack will need at least two months for the design, documentation and the design review process prior to starting any construction. After permits are received, the construction phase will take approximately 8 months to complete. During this downtime, marketing efforts and pre-leasing exercises can take place so that vacancy is limited upon completion. If construction progresses as planned, the building should be available for tenants to take occupancy in the spring / early summer of 2012. Upon completion Jack will have to register the property with Baltimore Housing and obtain a license for operating a multi-unit dwelling.

PRO-FORMA

Aliceanna Lofts
1815-1817 Aliceanna Street - Baltimore, MD

Discounted Cash Flow (DCF)

Income	2012	2013	2014	2015	2016	2017
Retail	$ 21,600	$ 22,248	$ 22,915	$ 23,603	$ 24,311	$ 25,040
Garage 1	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Garage 2	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Garage 3	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Garage 4	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Garage 5	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Garage 6	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Garage 7	$ 1,800	$ 1,854	$ 1,910	$ 1,967	$ 2,026	$ 2,087
Studio A	$ 13,200	$ 13,596	$ 14,004	$ 14,424	$ 14,857	$ 15,302
Studio B	$ 13,200	$ 13,596	$ 14,004	$ 14,424	$ 14,857	$ 15,302
Studio C	$ 13,200	$ 13,596	$ 14,004	$ 14,424	$ 14,857	$ 15,302
One-Bedroom A	$ 18,000	$ 18,540	$ 19,096	$ 19,669	$ 20,259	$ 20,867
One-Bedroom B	$ 18,000	$ 18,540	$ 19,096	$ 19,669	$ 20,259	$ 20,867
One-Bedroom C	$ 18,000	$ 18,540	$ 19,096	$ 19,669	$ 20,259	$ 20,867
Two-Bedroom A	$ 27,600	$ 28,428	$ 29,281	$ 30,159	$ 31,064	$ 31,996
Two-Bedroom B	$ 27,600	$ 28,428	$ 29,281	$ 30,159	$ 31,064	$ 31,996
Two-Bedroom C	$ 27,600	$ 28,428	$ 29,281	$ 30,159	$ 31,064	$ 31,996
Potential Gross Income	**$ 210,600**	**$ 216,918**	**$ 223,426**	**$ 230,128**	**$ 237,032**	**$ 244,143**
Downtime	$ -	$ 15,141	$ 15,595	$ 16,063	$ 16,545	$ 17,041
Sub Total	$ 210,600	$ 201,777	$ 207,830	$ 214,065	$ 220,487	$ 227,102
Credit Loss Allowance	$ 6,318	$ 6,053	$ 6,235	$ 6,422	$ 6,615	$ 6,813
Expenses						
Taxes	$ 7,140	$ 7,426	$ 7,723	$ 8,032	$ 8,353	$ 8,687
Insurance	$ 4,596	$ 4,780	$ 4,971	$ 5,170	$ 5,377	$ 5,592
CAM	$ 2,556	$ 2,658	$ 2,765	$ 2,875	$ 2,990	$ 3,110
Mgmt Fee	$ 6,300	$ 6,318	$ 6,512	$ 6,712	$ 6,918	$ 7,130
Legal/Admin.	$ 1,440	$ 1,498	$ 1,557	$ 1,620	$ 1,685	$ 1,752
Reserves	$ 3,600	$ 3,600	$ 3,600	$ 3,600	$ 3,600	$ 3,600
Investor One Return	$ 26,688	$ 26,688	$ 26,688	$ 26,688	$ 26,688	$ 26,688
Investor Two Return	$ 26,688	$ 26,688	$ 26,688	$ 26,688	$ 26,688	$ 26,688
Owner Return	$ 3,804	$ 3,804	$ 3,804	$ 3,804	$ 3,804	$ 3,804
Total Expenses	**$ 82,812**	**$ 83,459**	**$ 84,307**	**$ 85,188**	**$ 86,102**	**$ 87,051**
Net Operating Income	**$ 135,762**	**$ 127,129**	**$ 132,746**	**$ 138,040**	**$ 144,490**	**$ 150,626**
Annual Debt Service	$ 68,196	$ 68,196	$ 68,196	$ 68,196	$ 68,196	
Cash Flow After Debt Service	**$ 67,566**	**$ 58,933**	**$ 64,550**	**$ 69,844**	**$ 76,294**	

Cash Flow Diagram (For Reversion)

	Period 0	2012	2013	2014	2015	2016
Annual Cash Flows	($216,423)	$ 135,762	$ 127,129	$ 132,746	$ 138,040	$ 144,490
Reversion						$ 1,506,265
Cost of Sale						$ 90,376
Cash Flows before Financing	($216,423)	$135,762	$127,129	$132,746	$138,040	$ 1,560,379
Debt Service		$ 68,196	$ 68,196	$ 68,196	$ 68,196	$ 848,887
Cash Flow After Debt Service	($216,423)	$67,566	$58,933	$64,550	$69,844	$711,492
Equity Cash on Cash Return		31%	27%	30%	32%	
Value	$1,391,375					
IRR	46.17%					
DSCR	1.86					

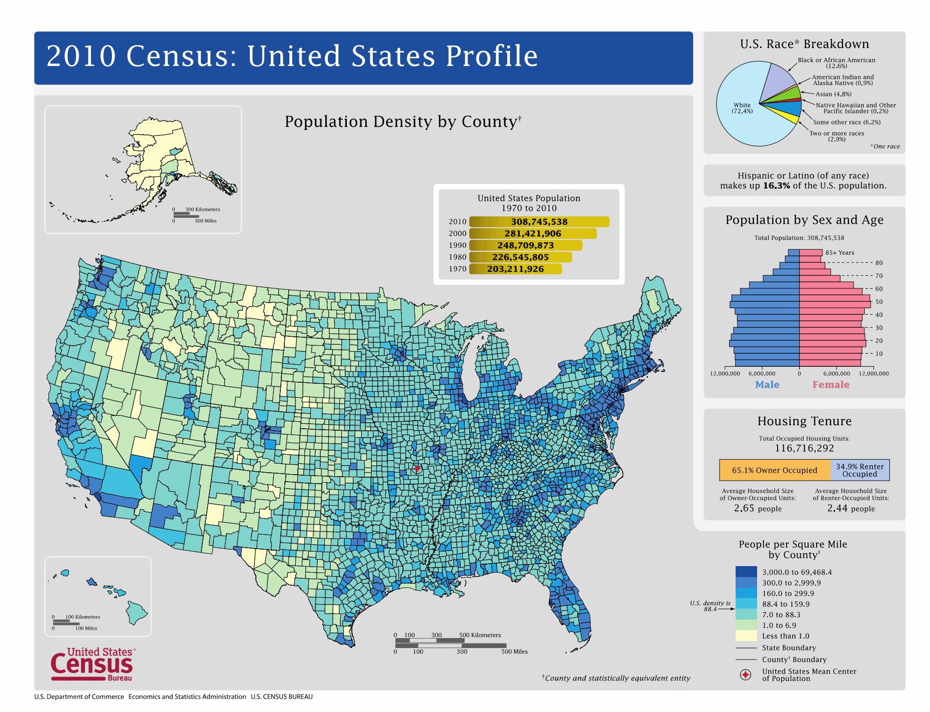
Conclusion and recommendation forward

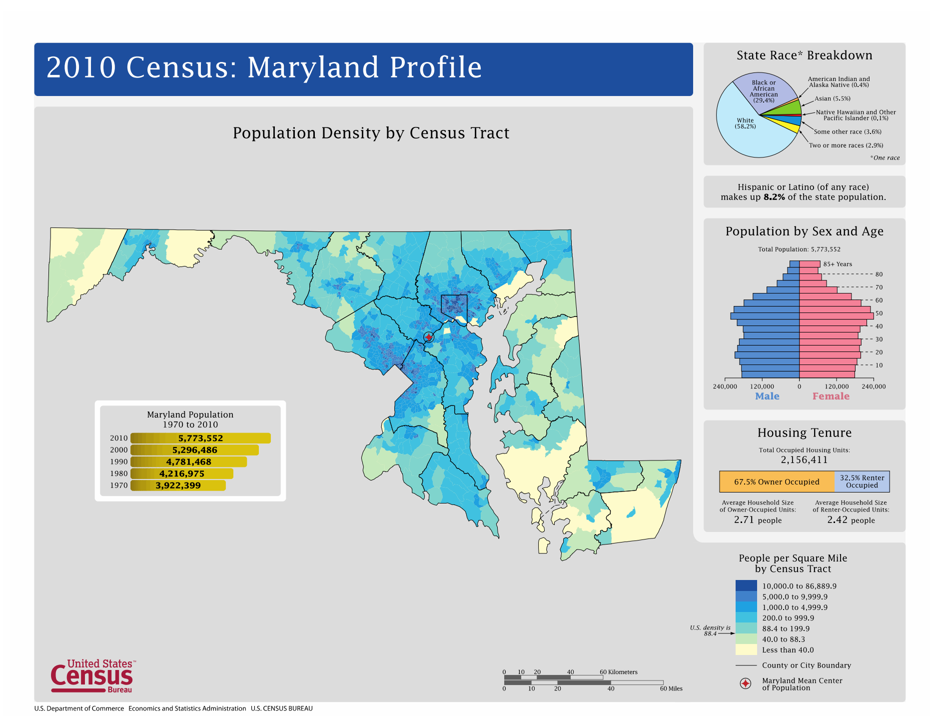
There are many factors that affect a person's decision to go forward with a project. Often these factors can render different results to different investors on the identical property. Individual talents, contacts, approaches, and methods can make up the difference between two investors eyeing the same project. For Jack, the financial foundation he laid with the Milton St property could greatly affect his ability to move forward with the Aliceanna St property. If we examine the nuance of the first deal, we must ask ourselves if this was really a wise investment? Did the investment fortify his financial standing or hold it back? From the outset he brought $60,000 of his own cash to the deal to realize a monthly return of $378. Most investors would proceed on this basis. The predicted $378 cash flow could easily be swallowed up and then some as building systems and vacancies occur. In this fictitious case study, we make assumptions that the investor is insulated to a degree against these unforeseen circumstances and that the stated return meets his requirements. These requirements may not be robust enough for other investors. Other investors may not have the same liquidity as Jack, or have the same success with leasing.

In "step two" we see Jack engage two outside investors to complete mezzanine financing requirements while bringing a modest $16,400 of capital to the table. The two investors provide $100,000 each for a stated return of their capital to be repaid within five years. The second project is a much larger endeavor with more moving pieces and a larger overall financial commitment. However for Jack, it only represents a modest out-laying of cash at the start. The decision to move ahead in this case is not whether or not the stated returns are acceptable to Jack, but whether or not he can secure funding. Looking at the capital stack on the predicted balance sheet, this appears to be a profitable project. Its success is dependent on Jack's ability to find two individuals whom are willing to post $100,000 a piece in making the deal work. In an academic setting, this piece of the puzzle is often assumed and taken for granted, however in reality for most, access to these individuals may be more difficult. These anomalies and how an investor navigates them are at the core of the decision to move ahead with a project or not.

The success of expanding a real estate portfolio for any small investor is to listen to the advice of others and pay close attention to the details of the deal. The buying frenzy of the mid-2000's resulted in a lot of poor deals which financially impaired many small investors. They found out the hard way that rushing into investing was not a guaranteed way to make money. As we have seen in Jack's case, starting off small and slowly building with the help of others may be the best way to build a portfolio. Understanding limitations and keeping a healthy balance of debt to equity results in a successful capital stack.

APPENDIX A – POPULATION DATA





APPENDIX B – 11 N. MILTON SDAT

Maryland Department of Assessments and Taxation
Real Property Data Search (vw5.1A)
BALTIMORE CITY

Go Back
View Map
New Search
GroundRent Redemption
GroundRent Registration

Account Identifier: **Ward - 06 Section - 14 Block - 1726 Lot - 006**

Owner Information

Owner Name:	BILLIET CHRISTINA N VETTER ANDREW G	**Use:** **Principal Residence:**	RESIDENTIAL YES
Mailing Address:	11 N MILTON AVE BALTIMORE MD 21224-1047	**Deed Reference:**	1) /11700/ 00464 2)

Location & Structure Information

Premises Address	**Legal Description**
11 N MILTON AVE BALTIMORE 21224-1047	13X80

Map	Grid	Parcel	Sub District	Subdivision	Section	Block	Lot	Assessment Area	Plat No:
0006	0000	0000		0000	14	1726	006	2	Plat Ref:

Special Tax Areas	**Town**	NONE
	Ad Valorem	
	Tax Class	

Primary Structure Built	Enclosed Area	Property Land Area	County Use
1920	1,326 SF		11130

Stories	Basement	Type	Exterior
2.000000		CENTER UNIT	BRICK

Value Information

	Base Value	Value	Phase-in Assessments	
		As Of 01/01/2011	As Of 07/01/2011	As Of 07/01/2012
Land	100,000	80,000		
Improvements:	114,110	102,000		
Total:	214,110	182,000	182,000	182,000
Preferential Land:	0			0

Transfer Information

Seller:	ROCCHIO, LAURA E.	**Date:**	06/02/2009	**Price:**	$218,000
Type:	ARMS LENGTH IMPROVED	**Deed1:**	FMC /11700/ 00464	**Deed2:**	
Seller:	TESSMER, JEFFREY J.	**Date:**	02/10/2004	**Price:**	$195,000
Type:	ARMS LENGTH IMPROVED	**Deed1:**	FMC /04988/ 00064	**Deed2:**	
Seller:	MANUFACTURERS & TRADERS TRUST	**Date:**	09/30/2002	**Price:**	$28,500
Type:	NON-ARMS LENGTH OTHER	**Deed1:**	FMC /02928/ 00236	**Deed2:**	

Exemption Information

Partial Exempt Assessments	Class	07/01/2011	07/01/2012
County	000	0.00	0.00
State	000	0.00	0.00
Municipal	000	0.00	0.00

Tax Exempt: **Special Tax Recapture:**
Exempt Class:

APPENDIX C – MARYLAND LLC FILIING

ARTICLES OF ORGANIZATION

The undersigned, with the intention of creating a Maryland Limited Liability Company files the following Articles of Organization:

(1) The name of the Limited Liability Company is: ____

____

____.

(2) The purpose for which the Limited Liability Company is filed is as follows: ______________________

____

____.

(3) The address of the Limited Liability Company in Maryland is ______________________________

____.

(4) The resident agent of the Limited Liability Company in Maryland is __________________________

____

whose address is ____

____.

(5) ____

____

____

Signature(s) of Authorized Person(s)

(6) ____

Resident Agent

Filing party's return address:

(7) ____

____

____

____

APPENDIX D – LEAD PAINT CERTIFICATES

Owning residential rental property that was originally built prior to 1978 requires the owner to register the property with the Maryland Department of the Environment. This also requires an annual lead paint inspection to be conducted and documented. This inspection must be completed by a licensed contractor who submits swab samples to a registered lab for analysis on an annual basis. (www.mde.state.md.us) The findings of these tests will be documented on a MDE certificate for use in obtaining a property license in the City of Baltimore. There are separate requirements for single dwelling verses multi-dwelling structures. Since the property at 11 S. Milton St was built prior to 1978, this registration and the annual inspection will be required for the life of the building. (www.baltimorehousing.org) For the Aliceanna St property, since the residential portion of the structure is new construction; the City will most likely waive this requirement. It is important to research the requirements of lead paint and your obligations as a building owner prior to moving forward with any investment property. The presence of lead paint and other hazardous materials can sustainably increase your risk exposure. Failure to comply with the requirements of the law in abatement and testing can also expose an owner to litigation from multiple parties.