# *HOW AND WHY OUR FOUR TEXAS PROPERTYS SURVIVED THE RECESSION*

### *THAYER RESIDENTIAL'S RECESSION ERA ASSET MANAGEMENT DECISIONS, 2007- 2010*

***Written by Bruce Thayer***
***Managing General Partner***

*CHAPTER INDEX*



## *THAYER RESIDENTIAL PARTNERSHIPS EARN RECORD PROFITS 2005-2006*

The account of Thayer Residential's 2007-10 recession-era asset management is preceded by the highly profitable sale of five portfolio properties. The five properties, acquired from 1995 through 2001, totaled over 1,100 units and were located in Tucson, Flagstaff, Federal Way (South Seattle) and downtown Seattle. Each had been thoughtfully renovated and aggressively managed with the goal of maximizing long-term capital gain profits upon resale.

With the nation's economy recovering from the post 9/11 recession, real estate values began to increase steadily. With the real estate market literally "on fire" in 2005, the General Partner marketed and eventually sold its longest held properties[1], achieving very substantial capital gain profits for the investors. The last property to sell, the Decatur, closed escrow at the very top of the market in December, 2006, earning a gross, pretax profit of more than $20,000,000 on an original investment of just $2,400,000. Please see "Track Record" for details.

After the sale of the Decatur, the company's only remaining apartment assets were the four apartment properties, totaling 932 units, which had been acquired in Texas since 2004. These 20+ year old properties had been purchased with the goal of materially enhancing value through renovation and strategic re-positioning.

Renovations were begun first at the 192 unit, Richland Trace Village (now the Richland) and the 264 unit, North Courte Apartments (now The Venetian) in San Antonio. The Southern Oaks purchase and renovation was next, with the Preston Trace Village (now the Manhattan) the last property acquisition in Texas.

---

[1] Barclay Ridge, Timberline Phase 1, Timberline Phase 2, Sonterra at Williams Center, Decatur.

By 2007, the renovations at all four properties were well advanced. Enhanced
apartment units earned rental rate increases of $55-$75 in San Antonio and Fort Worth, while the upscale market in Plano was targeted increases of $100 to $135 for the Manhattan.

The work was proceeding according to plan until the later part of 2007, when the sub-prime mortgage crisis kicked off what would turn out to be the worst real estate downturn of modern times. Virtually every income producing property in the nation was affected, regardless of quality, age or market. The time honored principal of location-location and location was humbled by the greater impact of timing-timing and timing.

## *REAL ESTATE INDUSTRY MELTS DOWN - 2008*

While the initial effects of the sub-prime mortgage problem were evident to the general public as early as 2007, the multifamily industry was not seriously affected until 2008. But by the second quarter of 2008, apartment owners across the nation were experiencing steady declines in the condition of their respective rental markets. By August of 2008, traditionally one of the strongest rental periods of the year, the real estate market in Texas, and everywhere else, was in the midst of a total melt down.

Apartment properties nationwide were experiencing two to three times normal vacancy and concessions, a huge spike in bad debt, a 15% to 25% drop in core rental rates, and greatly increased turnover expenses. Major cash flow deficits and vanishing reserves were the new reality. Properties carrying highly leveraged mortgage debt were in the greatest peril.

Without a doubt, the single most damaging new factor at this juncture was the unprecedented, 50% plus increase in capitalization rates (cap rates). Serious reductions in net operating income had already reduced property values quite a bit, but when cap rates increased from the range of 5% and 6% all the way up to 9%, 10% and more, multifamily property values plummeted. By the end of 2008, with multifamily property values down by 30% to 50% across the country, billions of dollars of ownership equity capital had literally evaporated.

This huge drop in net income combined with the rapid decline of multifamily property values precipitated a massive number of commercial mortgage defaults. Many properties could not pay the interest much less the principal portion of their mortgage payments. Technical defaults became commonplace as debt coverage ratios and loan to value standards fell below minimum requirements. In fact, a technical default is what eventually occurred with the four Thayer Residential properties in Texas. Even though none of the portfolio properties had missed a single mortgage payment, our lenders were threatening foreclosure due to the technical changes in the ratio of debt to the properties' recession-era value.

The financial situation for the Thayer Residential Texas property portfolio was doubly urgent because the original acquisition mortgages on the two San Antonio properties came due on December 31, 2008, while the Southern Oaks first mortgages mature on September 1, 2010. The properties' substantially lower net operating incomes, combined with much higher cap rates, resulted in a property portfolio barely worth the amount of the combined first and second tier debt! On paper, over $20,000,000 of partnership equity had disappeared almost overnight. How would it be possible to refinance these properties when their maturing loans came due?

The mortgage debt on the forth property in the portfolio, the Manhattan, still had 2.5 years to run before coming due. The mortgage's interest rate was fairly high, but would have worked out just fine once the higher post renovation rents were in place. Unfortunately, the partnership's plan for intensive renovations had been completely halted by the recession. Now, without the market strength to support our renovation plan, the partnership was suffering deficits of $25,000 to $50,000 per month.

The Manhattan's reserves were quickly consumed forcing the General Partner to decide whether to allow the bank to foreclose, or to hold on to the property by personally funding these deficits until such time as the property was able to recover. By law, a Limited, or Limited Liability Partner's risk does not exceed the potential loss of his/her original capital investment. Only the General Partner faces the potential of unlimited liability. With no end to the recession in sight, this was a very difficult decision for the General Partner, despite his complete belief in the Manhattan's location and long term investment potential.

Meanwhile, the General Partner and his property management teams were working double overtime to come up with solutions to these and many other recession caused problems. As bad as things seemed at the time, they were about to get worse.

## *REAL ESTATE FINANCING DISAPPEARS - LATE 2008*

By the end of 2008, real estate financing of every kind began to dry up. Overnight, nearly every type of long and short term bank financing disappeared, causing a very bad situation to turn into a full-blown national and world-wide crisis.

Most banks and commercial real estate lenders were under tremendous pressure from Federal regulators due to their growing number of non-performing loans. Banks with too much bad debt were taken over by the government. Others barely avoided federal takeover by engaging in creative, capital restructuring and problem solving. Some lenders were borderline solvent and simply could not foreclose and takeover any more troubled properties. This last group of struggling lenders were sometimes forced to restructure mortgage payment terms with their borrowers so the properties could afford to pay the debt thus, lifting the loans out of the non-performing category. This was exactly the case with the Manhattan's mortgage, as you will read in a later chapter.

Regardless of the solutions used by the nation's banks to weather the storm, they all had one thing in common in 2008 ...*none of them were making new loans.* The cessation of nearly all commercial lending put even greater downward pressure on property values, particularly the tens of thousands of commercial and multifamily properties whose mortgages came due from 2008 through 2010. With the failure of the TARP initiative (Troubled Asset Relief Program) to stimulate the banking industry, there was no sign of relief on the horizon as 2008 drew to a close.

## *LENDER CALLS ALL RENOVATION LOANS DUE ON JUNE 30, 2009*

In 2008, cap rates were above 9% for Class ‘B’ properties and net operating income was severely depressed. None of the Thayer Texas properties were "technically" worth more than the debt owed on each...at least on paper. Had this been publically traded company stocks instead of real estate, the low value might not have mattered since we did not intend to sell. Unfortunately, the four properties' second tier renovation loans were only secured by their partnerships' equity. Since there was no equity on paper, the loans were deemed "unsecured" by the regulators.

This technical change caused all our renovation debt to be reclassified as "non-performing"... even though we had not missed a single interest payment. With the loans in this state of "technical default" the bank advised us that all four properties' renovation loans, totaling almost $5,000,000, *would be due in full on their next rollover date... June 30, 2009.*

Combined with the fact that the *first mortgages* on the two San Antonio properties were due on December 31, 2008, and September 1, 2010 for Southern Oaks, there did not seem to be any way to meet such onerous debt repayment obligations without having to sell the properties. The timing could not have been worse, as we were in the middle of perhaps the worst real estate recession of modern times.

It was the General Partner's opinion that a sale at that time would have caused the partners to lose 100% of their original investment capital. Nevertheless, the General Partner was convinced that the properties' sound intrinsics and solid locations could save the day, if only they had time to recover. The key was to avoid selling the properties for as long as possible. If the General Partner could buy time, he and his management team would attack the operational problems one by one with the goal of recovering as much rental revenue and property value as possible.

With no other solutions discernable, the General Partner set about designing a step by step recovery plan from scratch. Executing this plan ultimately required 90% of the General Partner's time and efforts over the next two and a half years. Thayer Residential is normally an active, "contrarian market" buyer during times like these. However, the effort to stabilize the Texas properties' operations and recast their financing, in the face of this deep recession, left no time or energy for acquisitions or any other company function.

## *LIMITED PARTNERS APPROVE EXTENSION - FUND ADDITIONAL CAPITAL*

Without going into extreme detail, the General Partner opened a negotiation with the second tier renovation lender with the primary goal of extending the June 30, 2009 due dates for all four renovation loans. After several months of difficult negotiations, the General Partner won a 2.5 year extension for all four renovation loans. The new maturity date would be December 31, 2011.

As part of the agreement to extend the maturity dates, the partnerships were required to pay down the principal balances, pay a higher interest rate on the balance, make an additional 10% to 15% principal reduction at the end of each year and put up a substantial amount of loan collateral and guarantees.

The General Partner described the details of the situation to his limited partners in comprehensive partnership reports. He concluded the reports with a strong recommendation that the limited partners approve the bank's extension terms, pushing the need to sell out to at least December 31, 2011. The hope was that the General Partner's strategies for expense reductions and revenue enhancements would carry the properties through until the market began to improve.

The San Antonio One LP and the Southern Oaks Partners LP investors were asked to vote and approve one of several courses of action, generally involving staying the course by accepting the renegotiated renovation loan terms and seeking new first mortgage financing or, sell immediately to the debt, potentially losing all of the partnerships' invested equity capital.

When the votes were counted, the limited partners had voted overwhelmingly to accept the General Partner's recommendation to stay the course, accept the negotiated extension terms for the renovation loans and proceed with the effort to find new financing for the maturing first mortgages. While not all investors voting to approve this measure were able to fund the capital requested, the majority of limited partners did step up and generously contributed enough critically needed capital to secure the extension terms and pay the costs of new first mortgage financing.

Even with the additional funding from the limited partners, the General Partner still had to personally guarantee the extended loans as well as put up around one million dollars of collateral from his own assets. Additionally, the General Partner personally extended funding to meet operational deficits and to complete many critically important capital improvements that were left high and dry when the renovation lender pulled the plug on our credit line.

By negotiating the 2.5 year extension of the second tier renovation debt, a big part of the problem had been dealt with. But to avoid having to sell before then, the partnership still had to find a way to replace, or refinance the first mortgage debt for the two San Antonio properties and the Southern Oaks.

If we were to have any chance of securing new financing, the properties' net operating income, and the properties' value would each have to be greatly improved. The problem was how to accomplish such a thing when the conditions in the rental market were moving in the opposite direction?

## *THE SAN ANTONIO PROPERTIES BEGIN FIGHTING BACK IN 2008 AND 2009*

By the end of 2008, conditions in the apartment rental market were absolutely terrible. Despite the General Partner's 30-plus years in the apartment industry, together with his senior managers' decades of multifamily work, almost nothing from our combined past experience was helping. If the partnerships were going to survive, something had to be done to keep the properties' financial heads above water. With no silver bullet available, the General Partner decided to separate out every operational task and expense and to break each down into its smallest components. With each operational cost broken down and exposed thusly, we then asked a series of questions. Was the cost absolutely necessary, or could it be eliminated? If not eliminated, then cost efficiency was addressed. In this manner, every line item of the operational expenses, regardless of size, was examined and put to the test, literally one by one.

After the utility of each product or service was thusly refined and its cost reduced where possible, one final cost saving step was taken. For every expense line items that involved an outside vendor, a formal letter was sent requesting in cordial, but firm language that a savings of no less than 5% must immediately be forthcoming, lest the product or service cancelled. The letter was worded such that the General Partner's office took the "blame" for this demand. In this manner, our on site management and maintenance teams would not damage their important business relationships with the hundreds of local vendors that were ultimately contacted.

The process of breaking down and examining every expense line item, then following up with our 5% minimum cost reduction letter to vendors and following up with each by phone or in person, took six to nine months for each property to complete, but the results were worth the effort. Each of the four properties finished the next twelve month period with a fiscal savings of no less than $75,000 with two properties exceeding savings of $100,000 (includes aggressive property tax appeals).These saving went directly to increase our bottom line. Even at 2009's high cap rates, these net income gains alone added $900,000 to $1,200,000 of value to each property.

On the revenue side of the ledger, we had much the same experience with the old standard methods of marketing and promotion.  In the end, the General Partner simply threw out the book and, together with his managers, literally reinvented several new recession-era management and marketing methods in order to succeed in the new recessionary market environment. The first major decision the General Partner made was to shift a large portion of our printed media advertising over to electronic, internet marketing. He had already planned to shift 75% of all advertising to the internet over the next five or six years. But in 2008-2009, faced with the tripling of normal vacancy rates and rental concessions and believing that the internet would become more important during the recession than ever before, the General Partner decided to radically advance the planned marketing shift.

To accomplish this, the General Partner retained WHAT TO DO MEDIA (W2DM), a marketing firm specializing in modern advertising and marketing techniques. Combining our marketing knowledge and experience with the new ideas and skills brought by W2DM, the properties were displayed to the public in different and more efficient ways than ever before. Soon, our monthly financial reports began to show better results, an advancement that continues through today. Thayer Residential has since expanded its relationship with W2DM and will continue to test new methods of marketing.

By mid-2009, the Venetian and Richland in San Antonio were improving their respective bottom lines at a healthy pace. By the end of the year, both properties experiencing increased occupancies, decreased concessions and substantially lower operational expenses. All told, the two San Antonio properties finished 2009 with a 15% net operating income gain over 2008 year-end results.

## *RICHLAND AND VENETIAN APARTMENTS SUCCESSFULLY REFINANCED*

In April of 2009, all our initiatives paid off in a big way with the successful FNMA (Federal National Mortgage Association aka Fannie Mae) refinance of the Richland ($6.1m) and the Venetian ($8.0m). We repaid the original five year term, acquisition mortgages originally placed with John Hancock Life Company, and used a $700,000+ loan proceeds residual to pay down the balance of our second tier renovation loans. The new FNMA mortgages have fixed interest rates of 5.6% with a 10 year term and 30 year amortization.

The successful placement of these low interest, fixed rate FNMA mortgages adds material stability and longevity to these two assets as well as making them much more desirable to investors when it comes time for the partnership to sell the properties. Given the recession weakened condition of the nation's economy, the double digit vacancy and concession rates of 2008, the greatly reduced property values together with the near collapse of the banking industry in 2009, our successful closing of these two FNMA loans was nothing short of a Grand Slam Home Run for the San Antonio One Limited Partnership.

## *SOUTHERN OAKS AND MANHATTAN IMPROVE NET OPERATING INCOME*

The same broad based efforts for increasing revenue and reducing expenses were initiated at our two Dallas - Fort Worth properties, the Manhattan and the Southern Oaks. Both properties responded extremely well to the new strategies and initiatives. However, Southern Oaks has out-performed all the three of Thayer Residential's Texas portfolio properties with regard to cost savings as well as revenue improvements. The property was the first to move rental rates up in 2009 and the first to break through 90% occupancy when applying our new marketing initiatives.

By December 31, 2009, Southern Oaks was averaging 92%, or higher, occupancy every month. Year end net operating income for 2009 improved by more than $200,000 compared to the same period in 2008...a 40%+ improvement. The following year results were almost as strong with Southern Oaks leading the entire portfolio again in every category.

The property's successful turnaround, in the face of terrible market conditions did not go unnoticed in the multifamily industry. In fact, Southern Oaks has earned a wagon load of awards for its accomplishments over the last several years including;

- The Tarrant County Apartment Association, made up of many hundreds of properties housing tens of thousands of apartment units, voted Southern Oaks' on-site management team, the 2010 Property Management Team of the Year. They were awarded the Texas multifamily industry's prestigious *Lone Star Award*.
- Southern Oaks earned the most improved property award within Pace Realty's entire portfolio of over 10,000 apartment units.
- The City of Fort Worth awarded Southern Oaks with the city's most beautiful landscaping award (within its class) for 2009.
- Glenda Bunch, Southern Oaks lead manager - 2010 Manager of the Year.
- Jessica Bement, Southern Oaks assist. manager - 2010 Assistant Manager of the Year.
- Southern Oaks Maintenance Team - 2009 second place, 2010 first place maintenance team of the year.
- In both 2009 and again in 2010, our Southern Oaks lead manager was nominated for "Manager of the Year", placing second in 2009 and winning the honor in 2010.


*Southern Oaks - 2010 Team of the Year*

## *A NEW FNMA MORTGAGE FOR SOUTHERN OAKS*

As described earlier, the Southern Oaks General Partner asked the limited partners to vote on the same set of three choices that were put before the San Antonio investors. They approved the renovation lender's extension terms and mandated the effort to seek a new first mortgage to replace the original acquisition loan.

On September 1, 2010, the partners vote to stay the course was vindicated by the successful closing of a new FNMA loan on Southern Oaks. The loan closed with better payment terms than originally anticipated. We ultimately secured a $7,746,000, 10 year term first mortgage with a 30 year amortization and an incredibly low, 4.65% fixed interest rate.

There was more good news as well. Because of the property's increasingly strong net income performance in 2010, the property qualified for about $325,000 more loan dollars than anticipated.

Armed with the additional $325,000, the General Partner approached our second tier, renovation lender and offered to reduce the balance of the renovation debt in return for an additional one year extension. The bank liked the idea and agreed to extend the maturity date for our renovation loan from December 31, 2011, to December 31, 2012 in return for the payment. The additional year's grace proved worth its weight in gold as the market began to improve substantially, beginning in 2011, with even greater expectations for 2012.

None of this would have been achieved had it not been for the support of the Southern Oaks limited partners and the critically important capital they generously funded to complement the General Partner's personal commitment to the property.

## *THE MANHATTAN FACES UNIQUE PROBLEMS*

When acquired in 2007, our market investigations showed that the property's location and physical attributes were perfect for "repositioning" this class ‘B’ asset into a highly competitive, luxury rental that would give the area's Class ‘A’ properties a serious run for their money. But the onset of the recession in 2008 ultimately stopped our enhancement program in its tracks.

With extremely high vacancy, tripled concessions and much lower rents hammering the entire apartment rental industry, it was clear that continued renovations would serve no purpose. The market would no longer support luxury rental rates and we had no choice but to call a halt to the renovations late in 2008. Unfortunately, more than $1,500,000 had already been spent on the property's exterior, parking structures, landscaping, pools and office building prior to the recession's onset.

Without the ability to renovate the units and achieve our targeted rental rates, the partnership found itself deeply in the red, losing as much as $50,000 per month. With the original $200,000 reserve exhausted, the partnership was facing bankruptcy within a matter of months if something did not change ... radically.

## *MANHATTAN'S MORTGAGE TERMS RENEGOTIATED*

Every expenditure was closely examined and every potential efficiency; yet the partnership continued to suffer substantial monthly deficits. With no end to the recession in sight, the only remaining possibility for curtailing losses was to substantially reduce the property's mortgage payments. Unfortunately, the first mortgage could not be prepaid and replaced with more favorable debt due to an onerous prepayment penalty.

With no other course of action available to the partnership, the General Partner went to the first mortgage lender with an ultimatum: "renegotiate the payment terms of the partnership or we’ll be forced to turn over the property to the bank." With the threat of taking back yet another non-performing property, our lender was motivated to work with us, albeit one small concession at a time. Even though this effort to recast the mortgage debt was eventually successful, the seven month long negotiation was easily the most complicated and stressful transaction of the General Partner's career.

The payment concessions ultimately won by the partnership were very substantial. The mortgage interest rate was reduced from 6.15% to 3.75%. The mortgage's maturity date was extended by three years and the prepayment penalty was decreased by about 85%. A $5,800 per month capital reserve payment (unnecessary due to the exterior renovations we had already accomplished) was deleted. The partnership won several other smaller concession as well, each of which took a little more pressure off the bottom line.

In total, the Manhattan's mortgage modifications provided over $750,000 in payment relief for the partnership. Together with the very substantial expense savings and revenue gains achieved through the operational and marketing initiatives, the Manhattan finished 2009 with profitable monthly operations ... a far cry from the monthly $50,000 deficit only a few months previous.

A year later, the Manhattan finished 2010 averaging 96% occupancy over the final two quarters and retaining more than $200,000 in earnings for the year.

## *SUMMARY*

All four Texas properties finished 2009 with solid occupancy levels, modest cash flow and positive net income growth trends. In 2010, the two San Antonio properties remained very stable with occupancy averaging over 90% for the year. However, they were outperformed by the Manhattan and particularly the Southern Oaks in Dallas. All four properties frequently lead their respective market competitors in total performance. The properties have made very significant net operating income gains since the low point of the recession in 2008. However, today in 2011, the multifamily market in this country is still suffering from lower than normal, core rental rates, net operating incomes and property values.

In the real estate investment industry, success is typically measured in percentages of cash flow and by the size of a partnership's resale profit.  But with regard to the four Thayer Residential partnership properties in Texas, success must be measured by the partnerships' very survival in the face of unprecedented, horrible market conditions. The partnerships' subsequent re-stabilization and recovery paid off in a big way with the successful FNMA refinancing of the Venetian and the Richland in 2009 and the Southern Oaks in 2010, as well as the Manhattan's debt renegotiation in 2009.  The FNMA refinancings were especially remarkable considering the nation's nearly defunct banking industry during 2008 and 2009.

None of this would have been possible had it not been for the foresight and generosity of the limited partners who voted overwhelmingly in favor of moving forward and not giving up the ship. They backed up their vote by providing critically important capital when the partnerships needed it most.

At the time of this writing in early 2011, the final verdict is not yet in. It's still possible that one or more of the Texas partnerships may ultimately lose some of their original capital since the real estate market still hasn't fully recovered. Be that as it may, the General Partner is very proud of the significant financial recovery of the four properties and the creative initiatives that helped make it happen. He considers these asset management achievements, all completed during a deep recessionary period, some of the most important and financially productive work for the benefit of his limited partners, that he has ever accomplished during his multifamily career.

May, 2011

By: Bruce Thayer
Thayer Residential LLC
General Partner:
Southern Oaks Partners LP
San Antonio One LP
Preston New Vision Partners LP