WAYPOINT RESIDENTIAL

November 3, 2016

Dear Waypoint Investor:

I am writing to share with you our thoughts pertaining to our activities in the development sector. As you know, this area of our business has grown quite a bit. This is not by accident. We are strongly committed to the strategy and expect to continue this growth well into the future. In connection with that, I thought it might be worthwhile to explain how we think about the risks, the math, investment horizon, etc.

Why do we invest in development deals? It is very simple - development permits us to own <u>***brand new properties at a meaningful discount to value***</u>. This is because the underwritten value of the property upon stabilization is typically 25% - 30% or so greater than the total cost of the project (in other words, we are "buying" it for a 20% - 25% discount to value). This profit is created via the spread between "yield on cost" and market cap rate. The following is a brief example of the math (please note that these are rough numbers as their purpose is simply to broadly paint the picture of development economics):

- $50,000,000 project, capitalized with a $30,000,000 (60%) construction loan and $20,000,000 equity
- Yield on cost = projected NOI/total project cost; assume $3,500,000/$50,000,000 = 7%
- Market cap rate = 5.5% (a 150 basis point spread)
- Value upon stabilization = NOI/market cap rate, or $3,500,000 / 5.5% = $63,600,000
- Profit = $13,600,000 ($63,600,000 - $50,000,000) or a 27% "markup"
- So, we have "purchased" a property that's worth $63,600,000 for $50,000,000 (or a 21% discount)

It is very important to note - <u>***we enjoy this financial outcome in connection with owning brand new, Class A+ real estate***</u>, and all of the associated benefits – i.e. minimal capital expenditures in the near future, a lower residual cap rate (whenever we eventually sell, the property will be 10 - 20 years or so newer than our standard value-add acquisition); physical attributes that are customized for current market preferences, etc.

We now own a new, A+ property at a terrific basis. What is next? We have a couple of choices, and both are excellent outcomes:

> <u>**Sale:**</u> In this example, we would earn an approximately 1.7 multiple ($13,600,000 profit + $20,000,000 return of capital = $33,600,000; $33,600,000 / $20,000,000 initial investment = 1.7). Note – This is an oversimplification as it omits sponsorship economics and transaction costs, so the net multiple would be lower. As stated above, the objective here is to provide an overview of basic development economics in order to share with you why we believe this opportunity to be so compelling. More comprehensive and specific numbers are presented in our PPMs.
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> <u>**Refinance**</u>: If we choose to hold, as is our intention in many cases, the numbers are equally attractive. If we refinance based on 60% LTV ("loan-to-value") and a 4.5% interest rate, we would

return approximately 40% of originally invested capital and then enjoy a 15% current return on the net remaining 60%. Here is the math (all numbers are rounded):

- $63,600,000 value x 60% LTV = $38,000,000 new loan amount
- The loan replaces the old loan of $30,000,000, so there is an additional $8 million available to partially return capital; the new outstanding capital account is now therefore $12,000,000
- New debt service = $38,000,000 x 4.5% = $1,700,000
- NOI = $3,500,000; therefore, cash flow after debt service = $3,500,000 - $1,700,000 = $1,800,000
- Our new current return is $1,800,000 / $12,000,000 = 15%

As a result, we have either sold at a very strong multiple or own a brand-new property, have returned 40% of our capital and are enjoying an outsized current return on the still-deployed position. To review, ***it is crucial not to mischaracterize development as a short-term, high IRR trade versus the long term, current return profile of acquisition deals***. Development can offer the best of both worlds in a build, refinance and hold scenario. Of course, we have to wait awhile for the development to generate revenue, but that needs to be thought about as part of the long-term average current return over the entire holding period. In this context, ***development offers a higher average current return over the entire hold***, even after taking into account the first year or two.

While all of this sounds great, as everyone who has heard me talk about our investments knows, I am much more focused on the downside. You have all seen the "Lehman" scenarios in our acquisition PPMs – our investments are structured to be resilient, and as with the severe downside stress test we do with our acquisitions, the downside numbers with development are very comforting. For development deals, we approach the math differently. We do a great deal of stress testing around many variables, but to simplify, I will focus on a couple of key ones here: rent (because we all know that market movement is one of the key risks we contend with in the real estate business) and budget (since we have all heard countless stories about development projects going over budget, whether a commercial development deal, public infrastructure project, or a private home).

Because the apartment sector is less volatile than other property types, the variability around rent is much lower. Similarly, because we typically build two and three-story, wood frame construction projects, our risk around budget is also much lower. Importantly, note that these are uncorrelated variables. As far as the sensitivity analysis, we are typically able to withstand very meaningful variances to underwriting. As an example, an average of our last several deals is such that ***we would have to miss by 10% on both variables*** before we were to be under water versus value upon completion (i.e. a yield on cost lower than market cap rate). This 10% threshold is a significant outlier versus any reasonable bell curve. To better understand this, we should review some of the key risks of our development projects:

- Budget – As mentioned above, two and three-story wood construction can be much more reliably underwritten than major CBD towers. We also typically enter into guaranteed maximum price contracts with our contractors (before closing), further reducing the risk of overruns.

- Schedule – Same as above.
- Entitlement (approvals, permits, etc.) – Our projects are typically in areas where the entitlement process is very manageable. More importantly, we usually close with all of this in place so that Limited Partners invest with entitlement risk off the table.
- Financing – We normally arrange the construction loan before the closing, so as with entitlements, investors invest without financing risk.

Investing in a development deal with budget, schedule, entitlement, and financing risk largely mitigated comes with a very different risk profile than one might typically think of when generically considering an investment in a development project.

We are further protected when considering the dynamics with respect to fundamentals in the apartment sector. As you have heard from us before, there is considerably less volatility in the multifamily sector than other property types. A 10% decline in rents would represent a severe cycle. It is also crucial to consider the lease structure of apartments versus other property types. Our leases are for one year; therefore, we are never forced to contend with encumbering a large percentage of our space at disadvantageous economics for an extended period of time. Should we deliver into a down cycle, we have the ability to lease the units at the then clearing prices – "get heads on beds" **-** and then renew those leases at recovering rental levels very quickly. Since our construction loans are, as always, at a modest level (and include several extension options), we can stay with the construction financing while riding out the cycle ahead of our ultimate chosen capital event. This confluence of apartment sector dynamics, lease terms and construction financing amount and term significantly mitigates our risk around cycle timing.

None of this is to suggest that investing in apartment development deals does not come with some risk. All investing does. The purpose of this note is to explore and clarify why we believe that when all of the considerations discussed above are taken together – risks, mitigants, returns - ***the net, in our view, represents an outsized risk-adjusted opportunity***. This is why it is our intention to develop a large position in this strategy - ***brand new A+ properties, distributing at T+1,000 or so with a very conservative risk profile (and terrific tax treatment)***.

Additional information will soon follow describing our development team as well as our development track record. Both of which, I am happy to say, have evolved notably. Also, we are going to have an investor conference call shortly to walk through what is discussed in this letter as well as our overall strategy and philosophy with respect to development.

Thank you very much for your support and your confidence in us. We look forward to speaking with you soon.

Scott Lawlor

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