

The Small Apartment Building Market – How You Can Participate

Our record results last year were achieved in a very competitive, active and evolving property and mortgage loan marketplace, and the pace of market-driven activity has continued into 2004. Today, mortgage interest rates continue to hover at or near record lows and property valuations are moving ever higher. At Venture West, we continue to specialize in providing financing to owners of small-to-medium-sized apartment buildings, and we bring our deep market experience, established lender network and efficient platform to bear daily for the benefit of our clients.

Will interest rates remain low? Not likely. Interest rates move continuously and we monitor these changes closely to keep our clients well informed. We are also focused on the longer-term trends. Most of the significant indicators have been trending favorably, with job growth the significant exception. The most recent reports suggest that job growth may have been reestablished. It is likely that the Federal Reserve will move in the next several months to hike short-term rates, probably modestly, to stave off excesses in the economy, inflation concerns, and the like.

I welcome the opportunity to help you advantageously refinance your existing apartment building, commercial property or your home, or finance your acquisition of a new property.

California Offices

Corporate Headquarters
2101 Rosecrans Avenue
Suite 1225
El Segundo, CA 90245
310.364.3131

9 Executive Circle, Suite 200
Irvine, CA 92614
949.475.5573

The demand for apartment buildings remains very high, especially for buildings with less than 50 units, currently the most active sector. With the return profiles of alternative investment vehicles, such as stocks and bonds, either unattractive (bonds) or uncertain (stocks), investing in real estate in general, and apartment buildings in particular, has moved to the head of the class. That's good news for owners of apartment buildings. However, the news for new investors and active market participants is not as good, because market pricing of buildings has reached levels never before seen throughout Southern California.

Cap rates below 6% and GRM's in the teens are not unusual. At these price points, cash flow returns to current market purchasers, based upon recent historical operating results, are often no better than the low single digits, and often approach zero. The economic impetus for purchasers in this well-heated market now appears to rest largely on raising rental rates, and doing so quickly.

With market-wide rental rates projected to grow in the 6% - 7% range in each of the next two years (if not thereafter), and with new apartment construction anemic, the aggressive, experienced operator is positioned to reestablish an economic cash-flow return profile for newly-acquired buildings within months of acquisition.

Lenders – Their Reaction

Lenders continue to maintain a broad appetite for loan growth. An increasing number are focused on growing their portfolio of apartment loans, which they view as low-risk, relatively inexpensive to acquire, and more profitable than single-family mortgages.

How are lenders reacting to the realities visible in the property markets? As might be expected, many are experiencing "sticker shock" when they see the prices being paid for small apartment buildings and the leverage sought by acquirers – north of 70% in most instances, all the way up to 80%. Since late last year, Venture West has

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Why Venture West?

We are among the very few firms that combine the attributes and skills that matter to both property owners and lenders:

We control the loan process – Venture West conducts itself like a lender, creating a transparent process for our clients.

We manage a broad network of active lenders – Venture West presents the widest array of options for our clients; our intimate understanding of each lender's underwriting and processing nuances permits us to move quickly and intelligently to obtain the best execution available for our clients.

We have experience and scale – Venture West has been operating successfully for nearly 10 years, and we now have over 20 loan officers serving clients throughout Southern California; these attributes provide us with broad market coverage and the demonstrated ability to solve virtually any problem that might arise.

In a nutshell, Venture West provides: Multiple Options. Personalized Guidance. Efficient Processing. Dedicated Service. Solid Relationships. Positive Results.





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Apartment Rents Going Up

The recent Casden Real Estate Economics Forecast released by the USC Lusk Center for Real Estate in March 2004 predicts that:

- Rents in Southern California will increase an average of 6% to 8% annually through 2005. Key reasons: the area's strong economy, continued immigration and a shortage of new units.
- Strong demand will continue from new tenants moving into Southern California, especially young singles wanting efficiency units and larger Latino families needing three-bedroom apartments.
- Los Angeles County rental-rate growth will hit 6% in 2004, followed by a 7% jump in 2005, and average per-unit rents will rise to \$1,400/month.
- Orange County, rental-rate growth will hit 6% in 2004 and 9% in 2005 – one of the highest growth rates in the nation.
- In the Inland Empire, average rents will rise 8% to 8.5% annually over the next two years; average per-unit rents will hit \$1,000/month; rents for three-bedroom units will rise to \$1,400/month.
- Riverside/Corona/Moreno Valley and Southwest Riverside County submarket rents will soar by 10% annually over the next two years due to the proximity of these areas to large job markets.

Selected Indices Comparison

| | 04/02 | 04/03 | 04/04 |
|----------------|-------|-------|-------|
| 30-yr. T-bond | 5.590 | 4.780 | 5.010 |
| 10-yr. T-Notes | 5.210 | 3.960 | 4.170 |
| 12 MTA | 2.787 | 1.646 | 1.225 |
| COFI | 2.723 | 2.208 | 1.841 |
| 1-yr. CMT | 2.480 | 1.270 | 1.310 |

We're Lending in a Big Way (A Small Sampling)

- \$33 million loan to refinance a 270,000-sq. ft. retail center located in Ventura, CA
- \$18 million loan package to refinance 14 apartment buildings (with 329 units) located in Los Angeles, Inglewood, Van Nuys and Hawthorne, CA
- \$900,000 loan to finance the purchase of a 40,000-sq. ft. industrial building located in Ontario, CA
- \$4.7 million loan to refinance a 39-unit apartment building located in Santa Monica, CA
- \$900,000 loan to finance the conversion to condominiums of a 12-unit building located in San Diego, CA
- \$2.3 million loan to finance the construction of a single-family residence located in Calabasas, CA, and to provide permanent financing following the completion of construction

The Small Apartment Building Market... *(continued)*

been working closely with our large network of lenders to educate them to the current tenor of the market, and to identify ways in which they can actively participate in financing current market purchases while maintaining reasonable underwriting standards.

Virtually all of our lenders have come to recognize two things – many newly-acquired buildings have been under-managed by previous owners and, therefore, are not obtaining current market rents at the acquisition date; and market rental rates are poised to continue to rise. A bonus for purchasers is the recognition by many lenders that the artificially high "stress" rates they have used in the past are hurting their ability to compete for new business and do not reflect current or forecasted mortgage rates.

Together, these factors permit most of the lenders in our network to underwrite loan requests based upon demonstrable near-term growth in rental rates, utilizing stress rates more in line with current financing rates. In this way, purchasers are able to achieve economic leverage and to close what may have been tenuous escrows.

Refinances

Many owners of small apartment buildings simply want to refinance their existing mortgages rather than to sell and face the potentially challenging task of finding their next investment. Generally, the same underwriting standards apply to refinance and purchase transactions. However, a small difference exists – absent a prospective change in ownership (and the impetus toward an aggressive approach to bringing rental rates into line with market indicators), the onus is placed on the continuing owner of the building to demonstrate his intention to raise rental rates. Absent this demonstration, lenders tend to rely more heavily upon recent historical rental rates and operating performance to peg the amount they will lend. We have been quite successful working with our clients to advise them on strategies for achieving this desirable result.

Last Thoughts

Demand for small apartment buildings will remain vibrant, lenders will remain hungry for growth in their apartment loan portfolios, and the general level of mortgage rates will remain attractive. For current and prospective owners of these buildings, the confluence of these factors will permit everyone to win – current owners, new investors and lenders.

We are poised to ably assist our clients and our lenders to achieve their investment objectives during the remainder of 2004, and beyond.

www.venturewestfunding.com

