ARIXA CAPITAL ADVISORS

WHITE PAPER

CALIFORNIA FIRST TRUST DEEDS

Investment Opportunities and Issues

A White Paper by:

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CALIFORNIA FIRST TRUST DEEDS:

INVESTMENT OPPORTUNITES & ISSUES

White Paper

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Purpose of this White Paper

This white paper is intended to educate and inform investors regarding investing in real estate loans secured by property in the State of California. This document is not a comprehensive discussion of all the issues involved, nor does it go into great depth on any one topic. It simply explains the concept and introduces the key issues to consider. Toward the end of the white paper, the authors provide references to other sources for those interested in learning more. The final section is a glossary of key terms. These terms are shown in ***bold italics*** the first time they appear in the white paper.

Executive Summary

Trust deed investing refers to investing in loans secured by real property such as homes, apartment buildings or shopping centers. An example of a trust deed investment is the loan on a single family home, which is an investment from the perspective of the bank or other financial institution that holds the loan. Trust deed investments typically feature monthly interest payments paid to the lender/investor and they always provide the lender with options in case the borrower ***defaults*** under the loan. The main recourse is for the lender to ***foreclose*** on the underlying property. So long as the investor's loan is smaller than the value of the property, the investor should eventually get paid off, with interest, even if a borrower goes into default.

The authors believe that trust deed investments deserve special attention today (mid-2010) because of a confluence of circumstances. Some of the key factors are outlined below.

Timing: In California, real estate values have dropped 30-40% from their peak. While a further drop of 30—40% from current depressed levels is possible, the authors believe it is unlikely. Therefore a loan of 60% of current market value, which equates to about 36% of peak market value, is relatively unlikely to be "underwater" in the coming years. (The term "underwater" refers to the situation where the lender is likely to take a loss, because the property value has declined to be less than the loan amount). By contrast, loans that were 80% of market value that were made at the peak of the market were dangerous at the time and are far underwater today.

Pullback in Bank Lending: In normal times, banks are eager to make low-risk real estate loans. However, today banks are very reluctant to make loans secured by real estate unless they fit within stringent parameters. The reason is simple—banks made too many risky real estate loans in the boom period a few years ago. Banks do not want to increase their holdings of real estate loans, since they are already overloaded with this type of asset and bank regulators are warning them to trim down their

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exposure to real estate. The pendulum has swung back far in the direction of prudent lending—so far, that many real estate owners cannot find a bank willing to make even very sensible loans.

Absence of Other Good Investment Options: Today, a one-year State of California General Obligation Bond yields only 0.5%, in spite of the fact that California has the worst credit of any State in the U.S. A one-year certificate of deposit at a major bank yields about 1%. Investors seeking income without substantial risk have very few options. In contrast, California first trust deeds with a 60% loan-to-value frequently yield 8-10% and sometimes more. If one can learn to identify the safest trust deed investments, and earn this type of return, then trust deeds can make sense as part of an investor's portfolio today.

What Is Trust Deed Investing?

Unsecured Loans. Suppose an acquaintance of yours needs to borrow $50,000. One option, which we would not recommend, is for you to make an ***unsecured loan*** to this person. You would give the acquaintance your cash, and the borrower would sign a ***promissory note*** memorializing the fact that he had received the money, as well as all the key terms such as when the money needs to be repaid, the interest rate he will pay, and what happens in case the borrower doesn't hold up his end of the bargain.

Now suppose that the borrower does not pay back the money on time. What options does the lender have to get his money back, with interest? The answer is, "not many." The main recourse for the lender is to sue the borrower and get a judgment from a court for the monies owed. The lender then needs to try to collect the money by whatever means possible, which is far from easy. As a result, the lender may be lucky to sell the judgment to another party for 60 cents on the dollar. In other words, the lender is likely to take a loss if the borrower really doesn't want to pay. As a result, borrowers usually pay very high rates of interest on private unsecured loans. For example, payday loan outlets charge fees and interest that can add up to more than 100% on an annualized basis.

Loans Secured by Real Estate. Now assume that the borrower owns a house free and clear. In other words, there is no loan on the property. The house is on a street with very similar houses, and some houses nearby have sold recently for $200,000. There are families that want to live in that neighborhood, so houses priced below $200,000 attract credible offers quickly.

As relates to loans, houses have one very important quality: they are fixed to the ground and cannot be moved. For the borrower looking to borrow $50,000, he would very much like to provide his home as

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security. The lender, knowing that the home will be there in case the loan is not repaid, even if the borrower disappears, would be willing to lend at a much lower rate vs. an unsecured loan—as long as there is a straightforward mechanism for the lender to get paid off in case of a default, by taking advantage of the security that the $200,000 house offers for the $50,000 loan.

Trust Deeds - A Key Document in California Secured Real Estate Loans. Each State in the U.S. has its own way of addressing this situation. Since this white paper is written for California investors, we will focus on how things work here. In California the security instrument is called a ***deed of trust***, or ***trust deed***. This document is in addition to the note described earlier. The note describes all the terms of the loan, such as the amount, interest rate and due date. The trust deed confirms the amount of the loan, but it usually does not include the other details of the loan. However, it does contain some additional information not contained in the note. Specifically, it names a ***trustee*** which is a third party to the transaction (apart from the lender or the borrower). Frequently the trustee is a title insurance company such as Chicago Title Company or First American Title.

Role of the Trustee. Once the borrower signs the trust deed, he or she is consenting to have the trustee step in should the borrower default on the loan. The trustee is given the power and has the duty to conduct a sale of the property under certain circumstances—a ***trustee's sale.*** Trustee's sales are typically public auctions on the courthouse steps or some other public place. The proceeds from the sale go the lender, until the lender has received his or her principal and interest owed under the terms of the note.

Benefits to Lender and Borrower of Trust Deeds. To summarize, a trust deed creates a fairly streamlined process by which the lender is assured of having real leverage in case of a default by the borrower. Under the applicable laws in California, the lender should be able to force a trustee's sale within about four months of a default under the terms of the note (an exception is if the borrower files for bankruptcy, which can extend this time period; see "What Can Go Wrong and What are the Consequences", below). As long as the property is worth significantly more than the amount of the loan, the lender has a good chance getting paid back in full, with interest. That is a much better outcome than selling a judgment for 60 cents on the dollar to a collection company. The security and well-understood foreclosure process for loans secured by a trust deed give lenders the comfort to lend at lower rates of interest than would be possible otherwise. Even though trust deeds put power in the hands of the lender, it is really borrowers as a group who benefit most, by virtue of relatively low borrowing costs and transaction costs.

First vs. Second Trust Deeds. A first trust deed is a first-priority lien on the subject property. In other words, the first trust deed investor is first to be paid off in case of a foreclosure. In some cases, there are

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multiple loans secured by the same property. For example, a home equity line of credit (HELOC) is typically a second trust deed. Owning a second trust deed is riskier than owning the first trust deed on the same property. For example, suppose that a property worth $400,000 is encumbered by a $200,000 first trust deed and a $100,000 second trust deed. Now suppose the market declines, the value of the home falls to $250,000, and the borrower loses his job and stops making payments on both mortgages. If the holder of the first trust deed forecloses and ends up owning the property, then the holder of the second trust deed is wiped out. In contrast, if the owner of the second trust deed forecloses and ends up owning the house, the owner of the first trust deed must be paid off, otherwise the lender in first position can foreclose on the first trust deed. The authors prefer to invest in first trust deeds because they do not want to be responsible for making payments on or paying off another mortgage in case of a default by the borrower. A second trust deed, or a third trust deed are examples of junior liens. A junior lien has a lower priority than the first trust deed in that it came after the original loan and is therefore less secure.

Case Study of a Trust Deed Investment

One of the authors invested recently in a first trust deed that serves as a good example of this type of investment. The details are as follows:

The Property: 2,408 sq ft single family home located in Simi Valley, California, consisting of five bedrooms and three bathrooms.

Purchase: Purchased at a foreclosure sale on September 3, 2009 for $348,000. The property was appraised "as-is" for a retail value of $460,000 at that time (margins have tightened since 2009; in 2010 it is more difficult for investors to purchase at such a deep discount to retail market value).

The Loan: The lender made a loan of $261,000 on September 28, 2009 secured by a first trust deed on the property. This amount represented 75% of the purchase price of the property, or 57% of the appraised "as-is" value of the home at the time of the loan. The loan had a maturity of six months (90 day maturity with an option to extend for another 90 days). The lender charged the borrower a fee of 2% ($6,960) and the note carried an interest rate of 12.99% annualized, payable monthly, with the first three month's interest deposited in an escrow account at the time of funding.

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Sale of the Property: After an extensive rehabilitation of the property by the borrower, the home sold on February 19, 2010 for $490,000. The lender was paid off upon sale after receiving the prescribed interest. The borrower made a substantial profit and has gone on to purchase a number of other homes in same area.

As an investor in trust deeds, the most important way to control risk is to make sure that the amount of the loan is not too high relative to the current "as-is" value of the property at the time the loan is funded. The authors prefer loans where the ***loan-to-value (LTV)*** ratio is 60% or less. Another important question is, what is the ***loan-to-cost (LTC)*** ratio, or the ratio of the loan amount to what the borrower paid for the property? This may be different from the LTV because when investors purchase property for all cash on short notice, such as in a foreclosure sale, they usually buy for less than full retail value. The authors focus on loans where the LTC is 80% or less and the LTV is 60% or less. In other words, we require that the borrower has at least a 20% cash investment in the property regardless of what we think the value is. This keeps the borrower motivated to complete the project and recoup his or her cash investment, in case issues and problems come up after we fund the loan.

Advantages and Disadvantages of Trust Deed Investing vs. Buying Real Estate

If purchasing a property is akin to buying stock in a company, then investing in trust deeds is more like buying company bonds. In other words, the current cash flow is likely to be higher when purchasing trust deeds vs. buying a property, but the chances of generating a very large return are higher when buying the property itself.

The difference stems from the fact that the lender gets paid back principal and the agreed-upon interest before the owner gets paid anything. If the owner goes into default (fails to pay interest or repay principal on time), then the lender has the right to foreclose on the property as described in an earlier section of this white paper. The remainder of this section outlines the advantages of each type of investment, and provides a comparison of the two in table format.

Advantages of Trust Deed Investing. As compared to buying property, a well-structured trust deed investment has the following advantages:

- Principal is more secure. Less risk of losing money.

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- Current income is likely to be higher.
- There are fewer investors looking to invest in loans as compared to buying property, resulting in a greater availability of investments for trust deed investors as of mid-2010.

Advantages of Buying Property. As compared to investing in real estate loans, buying property has the following advantages:

- Provides the potential for appreciation in addition to income.
- Income is usually tax-sheltered to some extent due to depreciation of buildings.
- Money can be invested once for years at a time vs. short term loans where money must be reinvested each time a loan pays off.

The following table summarizes some of the differences between investing in trust deeds vs. investing in a property itself.

	Trust Deed Investing	Purchasing Property
Protection of principal	**Better protection**	More risk of principal loss
Appreciation	Little upside potential (possible profit only in case of foreclosure)	**Greater chance of appreciation**
Tax Treatment	Income is taxable (with the exception of IRA/tax exempt funds)	**Tax advantages from depreciation**
Current income	**Generally higher**	Usually lower initial cash flow
Availability of solid investments in 2010	**Good availability in California**	Low availability of good investments in California
Ease of keeping money working	Investors must find a new investment each time a loan pays off	**Money remains working for years at a time without requiring reinvestment**

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What Can Go Wrong and What are the Consequences

Listed below are some of the main problems that can occur with trust deed investments:

Default by the Borrower. Common types of default include interest default, which refers to the failure of the borrower to pay interest on time, and maturity default, in which the loan is not paid off on the due date. The lender's response to default is to begin the foreclosure process in order to recoup principal, interest and expenses associated with the foreclosure itself. In California, there is a sequence of steps in a foreclosure starting with the recording of a ***notice of default***, and culminating with a trustee's sale about four months later. At the trustee's sale, the lender submits a ***credit bid*** which is usually equal to the total amount that the lender must be paid in order to recoup principal, interest and costs. For example, for a $200,000 loan, the credit bid might be $212,000, a portion of which is to reimburse the lender's attorney who is handling the foreclosure. Typically there are other bidders at the auction and they may submit a higher bid. If so, the high bidder pays with cashier's checks and the trustee passes through funds to the lender after the auction, until the lender has been made whole. If there is no bid higher than the credit bid, then the lender is issued a trustee's deed and becomes the owner of the property. The lender/owner will then typically hire a local broker to list the property and sell it to recoup the lender's funds. If the loan was conservative relative to the value of the property and the market has not declined dramatically, then this can result in a windfall profit for the lender/owner.

Bankruptcy by Borrower. If the borrower files for bankruptcy, this can slow down the foreclosure process by several months, or longer for very large and complex transactions. The lender is treated as a secured creditor and is therefore "first in line" to be repaid as compared to the borrower's unsecured creditors. The main result of bankruptcy in this case is normally to delay repayment of the money owed to the lender.

Fire or other Calamity Affecting the Property. At the time of funding the loan, the lender must ensure that the borrower has obtained fire insurance and that lender is named as an insured party. If the property burns down, then the insurance company pays the lender first, until the lender has received principal and interest owed, with any additional insurance proceeds going to the borrower.

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Market Decline. Looking back at the past several years, by far the biggest problem for lenders has been the dramatic decline in real estate values. If the market value of a property drops below the loan amount, and the borrower fails to perform under the terms of the note (either by choice or because the borrower is unable to perform), then the lender will take a loss on the investment. For this reason, the lender needs to have a point of view as to where we are in the market cycle and whether current values are reasonable or not as compared to objective measures (such as the state of the economy and the income of the borrower). Once a given loan is "under water," it is too late for the lender to avoid a loss. To the extent that the lender sees risk of a decline in values, the lender needs to mitigate this risk prior to making the loan, by reducing the loan amount to a low percentage of current market value.

Other Considerations

Active/Direct Investing vs. Passive Investing. Active trust deed investors make loans directly to borrowers, or purchase loans that have already been originated by a mortgage banking company. To be an active investor requires the same skills needed to purchase and operate real estate, because there is always a chance that the borrower will default, in which case the lender will need to oversee the foreclosure process and then make frequent decisions regarding what to do with and how to manage the property.

Other investors may decide they want to invest in trust deeds, while delegating the selection and day-to-day management of these investments to an investment professional. This approach has advantages and disadvantages vs. lending directly. Advantages include: (i) a much smaller time commitment for the investor; (ii) less of a need for real estate expertise and current market knowledge on the part of the investor; and (iii) diversification from investing in a pool of mortgages relative to purchasing a single loan, so that the impact of one problem loan is much smaller.

On the other hand, investing in a professionally-managed fund still requires extensive due diligence—only in this case the due diligence is on the people who manage the fund and their overall approach to the business, rather than on one particular property. In addition, the returns from a passive investment are generally lower than the returns from a direct investment, since the investment manager charges a fee to oversee the investment. This cost may be partially offset by the fact that professional investors may negotiate better rates and terms since they do business in volume.

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For a more in-depth discussion about active vs. passive real estate investment, see section 9 of this white paper, Reference "c", pp. 16-23.

Special Considerations for Self-Directed IRA Investors. As discussed previously, investing in real estate itself has certain income tax advantages vs. investing in real estate loans. The authors believe that, due in part to these tax advantages, real estate values are artificially high, and returns are currently low.

For investors who do not need to pay income tax—specifically, for self-directed IRA investors—this creates an opportunity. Some investors avoid trust deed investing because interest payments are fully taxable, or simply because this type of investment is poorly understood as compared to buying and owning real property. As a result, investors in real estate loans can frequently earn double-digit annual returns without taking excessive risk. The self-directed IRA investor is able to "arbitrage" the fact that many investors have not heard of trust deed investing. He or she can collect attractive returns without being exposed to the annual income taxes that would apply to most investors.

Market Conditions in California as of Mid -2010

The Residential Market. As of mid-2010, the value of most single family homes in California has dropped from 25% to 40% depending on the location. The volume of transactions of single family homes fell dramatically after the financial crisis of 2008, then increased with Government stimulus in 2009, then began to slow again upon the expiration of Federal first-time homebuyer tax credits in early 2010. In California, 34% of homes have negative equity as of the end of the first quarter of 2010 (reference: HousingWire, http://www.housingwire.com/2010/05/10/underwater-mortgages-stabilized-in-first-quarter-corelogic). However, the pace of foreclosures has abated significantly, with 59,823 distressed homes sold in the first quarter of 2010, a 21% decline from the prior quarter and a 47% drop from the first quarter of 2009 (source: *Los Angeles Times*, http://www.latimes.com/business/la-fi-foreclosures-20100630,0,7525136.story). A primary factor in the decline in foreclosures is that banks are increasingly pursuing loan modifications with the existing owner rather than foreclosing, because of pressure from the Federal Government, among other factors.

In summary, a huge number of foreclosures remain in the pipeline in California. Many of these homes need to be rehabilitated, and banks generally are not willing to lend to the investors and companies focused on fixing up and reselling these homes. This creates an attractive and sizable opportunity for private lenders for the balance of 2010 and 2011, and possibly longer.

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Commercial Real Estate Market. Like the single family residential real estate market, most commercial real estate properties in California have declined by 25-40% from their peak value of 2006-2007 (for purposes of this white paper, "commercial real estate" refers to properties with tenants who pay rent, such as apartment buildings, shopping centers and office or industrial buildings). Also like the single family market, a large percentage of properties have negative equity, because they were purchased at peak values and financed with 75% or higher LTV loans.

However, the similarities between single family and income property generally end there. The single family market has "cleared" to a large extent, meaning that buyers and sellers have come together to determine current market values, and transaction volume has rebounded to normal levels. In contrast, the market for income property has not cleared. Instead of foreclosing, many banks have postponed foreclosing on properties with negative equity. Instead they have pursued a strategy known in the industry as "extend and pretend," namely, lowering the interest rate and extending the maturity on loans by one, two or three years in hopes that incomes will rebound and they will ultimately not have to take a massive loss on their bad loans.

The net result has been transaction volumes that are down as much as 80-90% from peak levels, and down substantially even from the levels that were typical before the real estate boom of the mid 2000s. In the absence of market clearing transactions, there are few opportunities for private bridge lenders to originate commercial real estate loans. (A ***bridge loan*** is a short-term loan, usually two years or less, designed to provide the borrower with a financial "bridge" from the present, in which the property is frequently in a distressed state for some reason, to a future time when the property is operating more smoothly and income has stabilized). As a result, opportunities for commercial real estate bridge lenders are limited in 2010 but should improve in subsequent years as the market moves back toward more normal transaction volumes.

To summarize, in 2010 the market is attractive for residential trust deed investing but commercial trust deed investing is more challenging.

Conclusion

Trust deed investing can provide steady income with less market risk as compared to buying property, assuming that the loan-to-value ratio at the time of funding is conservative. Active trust deed investors can invest directly in loans and should earn total returns in the low double digits per year. Passive investors can participate by investing in a managed fund or mortgage pool and can expect returns in the

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high single digits or very low double digits based on the state of the California market in mid 2010. The trust deed investor must always be prepared to foreclose in case of default by the borrower. The investor or investment manager can then recoup principal plus interest by selling the property after foreclosure, or by holding the property as in income investment.

References for Further Research

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Glossary

Bridge Loan = A short-term real estate loan. Borrowers frequently use a bridge loan when purchasing a property that is in transition. Once the property has been improved and stabilized, the property qualifies for permanent financing (for example, a 10-year loan), which normally carries a lower interest rate.

Credit Bid = The amount bid by the lender at a trustee's sale. The credit bid is usually equal to the amount of principal and interest due to the lender at the time of the sale. The lender can reduce the credit bid below this amount to draw other bidders into the auction and increase the odds of another bidder buying the property.

Deed of Trust = A document used in a real estate loan, together with a note, to memorialize the transaction. The deed of trust is recorded, meaning that it is available for any member of the public to see that there is a lien on the property affected by the deed of trust. Also known as a trust deed.

Default = A borrower's failure to live up to one or more terms of a loan. Examples of default include interest default, in which some or all interest payments were not paid; and maturity default, in which a loan was not paid off on time.

Foreclosure = A process by which a lender can force the sale of a property owned by a borrower who is in default under the terms of a loan.

Junior Lien = A lien placed upon property after a previous lien has been made and recorded. Junior liens such as second trust deeds are less secure than first trust deeds because they are not in first position to be paid in case of a default by the borrower. The junior lien holder needs to be in position to pay off any senior liens or else the junior lien holder may be wiped out in case of a foreclosure by the first lien holder.

Loan-to-Cost (LTC) = The ratio of the loan amount to the amount the borrower paid for the property being offered as security for the loan. While lenders are more concerned about loan-to-value than loan-to-cost, they generally do not like to see a loan-to-cost ratio very close to 100% if the property has been purchased recently. A loan-to-cost ratio of 100% would mean the borrower was able to refinance his or her entire purchase price with a loan, so that the borrower no longer had any cash invested in the property.

Loan-to-Value (LTV) = The ratio of the loan amount to the current market value of the property that secures that loan. The higher the LTV, the riskier the loan.

Promissory Note = A document that memorializes all the key terms of a real estate loan. Key terms include the amount of the loan, the interest rate and the due date, among others. Experienced real estate lenders use a trust deed in conjunction with a note to secure the property that is collateral for the loan. Often referred to simply as a note.

Notice of Default = A document that is recorded, usually by the lender's attorney, if a borrower has failed to meet one or more terms of a loan. A notice of default is recorded at the County Recorder's office and is the first step in the foreclosure process.

Trust Deed = See Deed of Trust.

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Trustee = A third party named in a real estate loan transaction whose job is to hold a trustee's sale in case of a default by the borrower.

Trustee's Sale = A real estate auction in which a special company (the trustee) sells a property after a default by the borrower on a loan secured by that property. After the sale, the lender either owns the property or gets paid off with interest, assuming the proceeds are enough to cover the amount due.

Unsecured Loan = A loan that is not secured by real property (such as a house or apartment building) or personal property (such as a car or equipment). An unsecured loan is a promise to pay that does not provide the lender with any clear path to get paid back in case of default, other than to sue the borrower.

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