Preferred Apartment Communities

Initiating Coverage



Laurier Student Investment Fund

Recommendation: Do Not Buy

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Executive Summary

Preferred Apartment Communities (APTS) is a relatively new REIT that was established in 2011 by John Williams, an accomplished multifamily real estate investor and executive. The company has an aggressive acquisition strategy mainly focused on purchasing multifamily properties in order to take advantage of favorable markets that are in an uptrend after the recession (majority in Eastern US). Secondly, the company is involved in numerous mezzanine loan agreements with other real estate developers yielding 14% returns and buy options once the developments are completed.

Revenues of APTS are made up of property revenues and mezzanine loan incomes. Property revenues are modeled by forecasting expected occupancy and rental rates over the next few years on a property-by-property basis using research on individual market fundamentals. Mezzanine loan incomes were derived from the company's stated interest rates, total expected loan commitments, and loan lengths. Expenses were calculated using company filings when possible such as property taxes, and management fees. Operating and maintenance expenses, on the other hand, were calculated by averaging the past 2 years of expenses as a percentage of property revenues and by comparing this ratio with industry peers.

The credibility of John Williams, the CEO, plays a very important role in the evaluation of APTS due to its small size and the company's odd corporate structure. Since the company has no employees of its own, it instead uses the resources of Williams' holding company *Williams Realty Advisors* (WRA) to perform due diligence and G&A services. In return, APTS pays WRA major fees on a regular basis. Also of note, six of the seven acquisitions in the company's history involved purchasing property from other entities owned by Williams. This is not to say that all future purchases will follow this pattern, but conflict of interest issues are a concern.

The evaluation of the company yielded a ~4.4% upside in the DCF valuation. On a peer comparison basis, APTS appears to be very attractive. APTS has the highest dividend yield of its peer group at 7.4% vs peer median of 4.6%, highest implied cap rate of 11.2% vs. peer median of 7.3%, and lowest P/FFO multiple of 8.8x vs. peer median of 13.4x. Performing a NAV analysis using capitalization rates, APTS appears to have a 28% upside. Overall, despite showing considerable potential, I rate APTS a *Do Not Buy* at this time due to the company's awkward corporate structure, dubious inter-entity transactions and the lack of upside in the DCF derived value.

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1 INTRODUCTION

1.1 Investment Thesis

The key thesis points are: (1) management quality acquisition potential; (2) mezz. loan buy options generate lower cost acquisitions and; (3) expected cap rate compression in secondary markets

The theses surrounding APTS's investment potential center around three main ideas:

1. **Management track record and ability to generate value** – John Williams, the CEO, has founded and built Post Properties from 1971 – 2003, successfully IPO'ing in 1993 and building a portfolio of up to 30,000 units. He averaged a 7% increase in FFO since going public. He is well connected in the real estate market and will be able to make profitable acquisitions over time. At the latest earnings call, Mr. William's said they're reviewing between 7 – 10 market deals worth $300M - $400M right now, as well as 3 to 5 off market deals being evaluated. This is not including various mezzanine loan buy options in APTS's current portfolio (1 of which is expected to be exercised this year) or that may be obtained in the future.

2. **Potentially Discounted Property Purchases Due to Mezzanine Buy Options** – Due to Mr. Williams' network and expertise, APTS has entered and continues to enter into mezzanine loan agreements with other real estate developers that have attractively priced purchase options attached to them. Using this unique strategy APTS has the potential to acquire properties at a lower cost base than competitors.

3. **Belief that secondary markets will experience cap rate compression, increasing property NAV's** – While major markets such as LA, Chicago, Boston, and NYC have seen cap rates in the 4 – 4.5% range, APTS limits itself to purchasing multifamily properties in less competitive areas with 5.5% – 6.5% cap rates. This inequality will begin to tighten as the economy picks up and money starts to flow to other markets, increasing the value of APTS's portfolio.

1.2 Road Map

This report will evaluate the APTS investment opportunity. Revenues will be forecast by assuming future occupancy rates and rental rates on a property-by-property basis. Operating expenses were forecast based on a percentage of revenues and this ratio was checked against peer ratios. Since APTS issues mezzanine loans with buy options, the value of these options will be explored. Finally, since APTS has a unique management structure and is a relatively new company I devote an entire section discussing the company's structure and how it interacts with other entities owned by the CEO John Williams.

Key Industry Terms: For the sake of familiarity of industry terms discussed frequently in this report, they are explained below:

Industry specific terms:

- **Cap Rates**
- **Net Operating Income (NOI)**
- **Funds from Operations (FFO)**
- **Mezzanine Loans**

- **Net Operating Income** (NOI) is property revenues less expenses associated with the running of properties such as maintenance, taxes, utilities, property insurance. This figure does not include corporate G&A or other non-direct property expenses.
- **Funds from Operations** (FFO) is a metric that measures how much cash properties are generating. It is Net Income + Depreciation/Amortization – Gains on Sales of Property. Depreciation is often seen as not a real expense which is why it is added back. FFO is preferable to net income in analyzing REIT's.
- **Capitalization Rates** (cap rates) indicate the returns of a REIT or individual property. It is calculated by dividing NOI by the Gross Real Estate Assets; how much income a REIT derives from its real estate portfolio as a percentage.
- **Mezzanine Loans** are a type of financing whereby the borrower receives capital without providing collateral. It is typically provided in the early stages of a real estate development when traditional bank financing is unavailable and they commonly offer the lender an opportunity to gain ownership in the project through buy options.

2 Company Overview

APTS is a small REIT that generates both property revenues from its own properties and loan income through issuing mezzanine loans to development firms

Preferred Apartment Communities (APTS) is a REIT that focuses on acquiring and operating multifamily properties in specific target markets in the US. The company was created to take advantage of the current real estate market since the financial crisis in the US occurred. As a result of the recession, management has commented they have found they can purchase properties at below replacement cost. Secondarily, APTS may issue mezzanine loans for other developer's multifamily projects with the option to purchase them in the future (*See Figure 1 below for revenue breakdown).* APTS completed its IPO on April 5, 2011 and is a relatively new company. Currently, APTS owns 6 properties in Virginia, Pennsylvania, Texas, Georgia (2), and North Carolina.

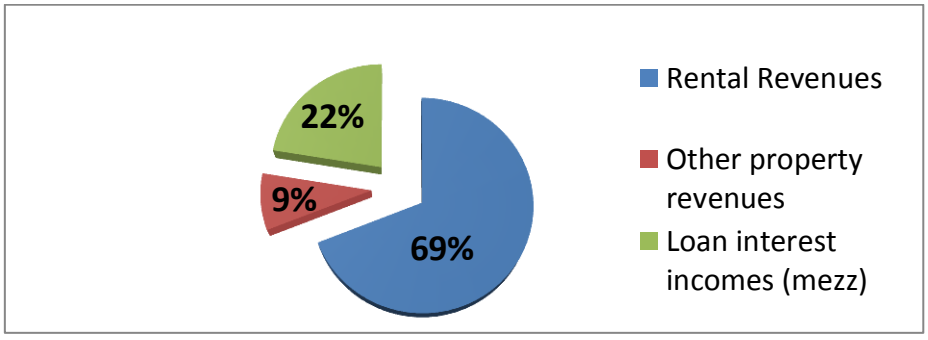


Figure 1 APTS 2013F Revenue Breakdown; Source: LSIF

APTS's main strategic tenets are to:

- Acquire assets from distressed owners at attractive prices
- Acquire assets in opportunistic, and stable markets in the US
- Take advantage of markets where multifamily development has been below historical averages during the last few years
- Target properties mainly for income, and only secondarily for capital gains

Properties sought after are generally 200-600 units with target cap rates of 6 – 7% in urban infill areas, suburban markets, and at the top of their submarket. *Targeted markets:*

APTS targets properties mainly in the East, US, seeking properties from distressed owners at attractive prices

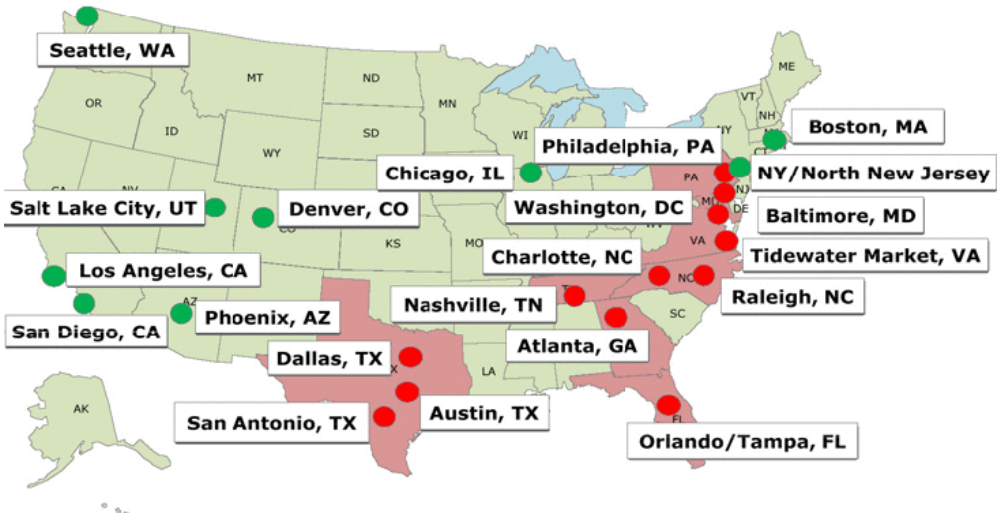


Figure 2 APTS Targeted Property Markets; Source: Company Filings

In the next section, the individual markets where APTS currently has properties will be analyzed. This will aid in creating forecasts for future occupancy rates and rental rates for each of APTS's properties and come up with the revenue forecast.

3 Industry Overview

3.1 REIT Market

3 main industry factors: (1) interest rates; (2) speed of economic recovery; (3) development activity in specific market

The three main factors that play a role in the REIT sector performance are interest rates, the economic recovery, and development activity in individual markets.

- **Interest Rates** – an increase in interest rates could have a negative impact on REIT pricing by stifling FFO growth and expanding capitalization rates.
- **National Economic Recovery** – During a robust economic recovery, capital may be diverted away from the REIT sector as investors aim to achieve higher returns in less stable sectors such as consumer cyclicals, materials vs. the more defensive REIT

sector. However, REIT's fare better in economies with modestly positive GDP growth whereby individual's rising incomes allow rent rates to increase.

- **Development Activity** – Excess supply in individual property markets likely impact rental rates and occupancy rates negatively. This is why APTS's individual property markets will be explored in the following section.

In the following subsection these factors will be analyzed in APTS's individual property markets in order to generate reasonable occupancy and rent rate forecasts over the next 5 years. All forecasts will be summarized in a graph in Section 4.1 under Property Revenue Forecasts.

3.2 APTS Markets

3.2A Cumming/Ashford Park (Atlanta), GA Market

Overview:

Atlanta is America's 8th biggest economy, with the busiest airport in the world. The city has a big area that has little supply constraints versus an enclosed area such as Manhattan. Thus, if opportunities exist, builders will continue to bring on new supply.

Atlanta may enjoy the best growth of any US metro over the next few years according to CBRE Economic Advisors

However, Atlanta's apartment market may enjoy the best growth of any US metro area over the next few years according to CBRE Economic Advisors. They estimate annual revenue growth to exceed 5%. This trend is funded by corporate expansion and population growth. Also, multifamily construction has been slower across metro Atlanta vs. the national average from September 2011 to September 2012. In the past Atlanta has experienced sluggish growth of ~3% per year in rents over past years vs. markets such as Austin & Houston, TX, Raleigh, NC, and San Francisco, CA posting 9 – 11% increases. Malcolm McComb, the vice chairman of CBRE's institutional and multi-housing group, has said "investors are increasingly intrigued with Atlanta as a late-recovery market"[1].

Apartment Stats:

In terms of market data, vacancies fell from 7.9% in 2011 to 6.8% in 2012 (peak was 2009's 11.7%), likely due to a decrease in apartment unit completions falling from 2156 in 2011 to 381 in 2012. Average rents increased ~3% from $857 to $880 per month from the end of 2011 to 2012's end[i]. According to Ryan Severino, senior economist at Reis New York, vacancy rates are expected to reach 6% to 6.5% by the middle of this decade, although they may tighten to the range in the late 1990's of 4.5% - 6%. These declines in vacancy rates will coincide with rent increases, however ultimately

[1] "Atlanta Apartments Poised for More Rent Growth." *Atlanta Business Chronicle*. N.p., 29 Jan. 2013.

this will depend on income growth so that tenants can afford the higher rents. The Bureau of Labor Statistics estimated the metro Atlanta area added 57.8k jobs in the year ending February 2013, expanding the employment base by 2.5%. This places Atlanta 5th among the top 100 markets in terms of net employment gains[ii]. MPF Research predicts an additional 63,000 jobs will be added by the end of Q1 2014. These additions should support rent growth rates.

Forecast: 4% average rent increases, with 1% increase in occupancy rates by 2014.

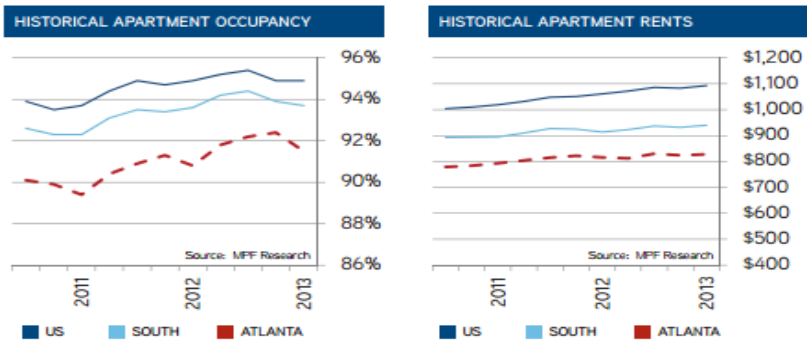


Figure 3 Comparing Atlanta Occupancy and Rent Rate Trends vs. US; Source: Collier's

Cap Rates – From full year 2011 to 2012, average cap rates increased from ~6% to 7.1%.

3.2B Austin, TX Market

Overview:

Austin is forecast to have the highest employment growth in 2013 of the major US metro markets

Austin is the fourth largest Texan urban area with a metro population of 1.6M, behind Dallas, Houston, and San Antonio. Austins unemployment rate is currently one of the lowest in the country at 5%. Additionally, the market is forecasted to have the highest employment growth in 2013[iii] at 3.6%. 60,000 new residents are expected to be added to the Austin metro area over the next 2 years[iv]. This job growth is due to expansions at Apple, Samsung, Cirrus Logic, Intel, and other tech firms. Visa also announced it is creating a new data center with 800 new employees.

Multifamily Market:

Q1 2013 saw rents rise 2.3% bringing average rental rates at $1.12psf. Average occupancies rose 0.2% to 95%.[v] The rental rates psf were $1.27/sf for Class A, $1.09 for B's, and $1.07 for C's[vi]. These numbers correspond with $954 average rents.

Despite rapid population growth, Austin is at risk for excessive unit supply growth

The biggest risks for Austin are supply growth. Completions are also forecasted to be up substantially, around 9000 units, vs. less than 3000 in 2012. This will increase inventory by 5%.From Q2/13 to Q2/14, another

9300 units are anticipated to start construction (16,400 units are currently under construction). In Austin, there are currently 142,469 rentable units. However, with the increase in expected residents over the next 2 years, the new supply may be absorbed.

Forecast: flat occupancy with a rent growth trough in 2015, followed by slight uptick.

Cap Rates: Q1/2013 TTM cap rates were 6.5% vs. a US average of 6.1% in Austin, TX.

3.3C Hampton (near Norfolk), VA Market

Overview: Virginia currently has one of the lowest unemployment rates of the US states at 5.2% vs. a US wide rate of 7.5%. Hampton sub area (population 140,000) has a 5.7% rate, with the major industry driver being the military and tourism. The Hampton Roads area has the largest concentration of military bases and facilities of any metro area worldwide (80% of economy is from federal sources).

The Hampton, VA economy relies mainly on the military and tourism sectors

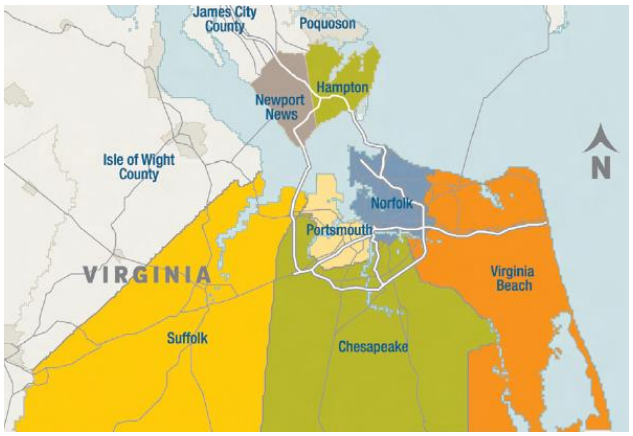


Figure 4 Virginia Major Regions Map; Source: Hampton Roads Real Estate Market Review

Apartment Market:

Norfolk-Virginia Beach area is expected to absorb between 600 and 900 units annually for the foreseeable future[vii]. Vacancy rates in the area were up 1% YoY as of October 2012, from 6.3% to 7.3%, largely due to new supply entering the market. Vacancy rates are expected to remain in the 7% range in 2013 and 2014. However, the Hampton sub area specifically tends to have a healthy vacancy rate due to the strong and consistent demand from the military bases for rental housing in the area. However, spending cuts in the military may negatively affect the Hampton market. YoY over the same period vacancy rates decreased from 8% to 6.8%. Hampton's average rents in October 2012 are ~$950. The region had stagnant rent growth over the past year. Apartments are expected to see improving fundamentals due to strengthening demand for rentals vs. home ownership.

Rents and occupancies tend to be stable in VA due to consistent military demand; however military spending cuts may have an adverse effect on the local economy

Forecast: Slight increase in occupancy to be in line with 93% occupancy forecast with slower relative growth of 2% in rental rates.

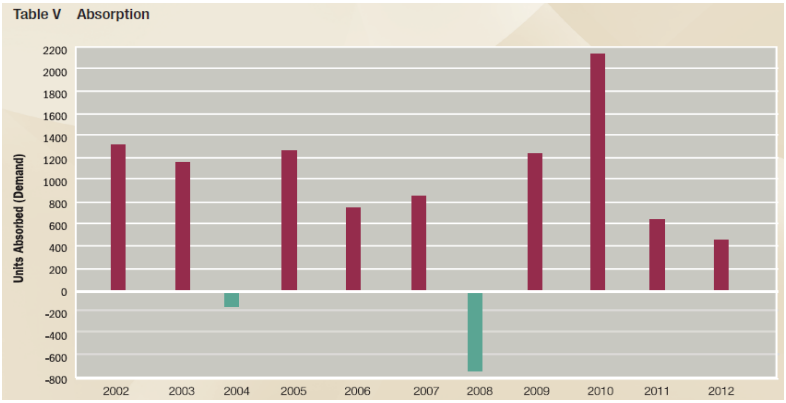


Figure 5 Number of New Units Absorbed by the Market Each Year; Source: Hampton Roads

3.4D Apex (Raleigh), NC Market

Overview:

Raleigh's strong tech industry and highly educated population has driven income levels 5% higher than the US average

Raleigh's main industries are technology, and R&D, anchored by the Research Triangle Park. This drives the city's median income that is 5% higher than the national average[viii]. Raleigh is expected to continue to lead the recovery economically due to growth in technology, professional services, and healthcare. The unemployment rate is expected to decline from 7.9% at the end of 2012 to 7.6% by the end of 2013. Raleigh also has a highly educated population making the region attractive for further growth – the average across US for bachelor's degree attainment is 28%, while in Durham it is 41%.

Multifamily Market:

Raleigh's long-term growth potential overshadows short term excess supply concerns in the area's multifamily market

According to REIS Reports[ix], Raleigh-Durham area is expected to have average rent growth of 4.4% from 2012 – 2016, with vacancy rates held constant at 4.5%. Mean price per SF was $122.50 in Q3/2012, up substantially from $97.50 in the prior quarter (sales price).

According to Earle Furman[x], average occupancies at the end of 2012 stood at 94.8%. During the year, rent growth was 3.4%, just higher than the national average. The biggest thing to watch out for is the new supply coming into the area. Ongoing construction is up to 5200 units, with 3700 of those units finished during 2013. This is concerning since annual demand was 1400 units in 2012, and is expected to be only 1450 units in 2013.

According to a report from real estate multifamily research firm Axiometrics, Raleigh, NC is forecasted to have one of the highest job growth of the major cities in the US in 2013 with about 3% growth.

Forecast: Gradual occupancy increase to the 95% average level, with rental rate growth mainly at 4% apart from lowering slightly in 2013 as new supply hits the market, followed by estimated

Cap Rates: As of Q3 2012, 12 month rolling cap rates are around 5.6%, although they averaged 5.2% in Q3 2012 (based on 6 transactions).

3.5E Glenmore (Philadelphia), PA Market

Overview:

Philadelphia is the US's 6th largest metro area with 6 million people. Over the next 5 years the population is expected to grow 136k (0.4% per year). In terms of employment, it is expected to grow at a 1.8% compound rate adding 253,320 jobs over the next 5 years.

Apartment Market:

New supply not an issue in Philadelphia; demand is expected to outpace supply

The Philadelphia multifamily market is composed of 201.6k units. Currently, 1845 multifamily units are under construction representing 1% of total inventory. Annual rent growth is expected to reach 3.5% over the next 5 years due to the US economic recovery and a lack of new supply to meet demand[xi].

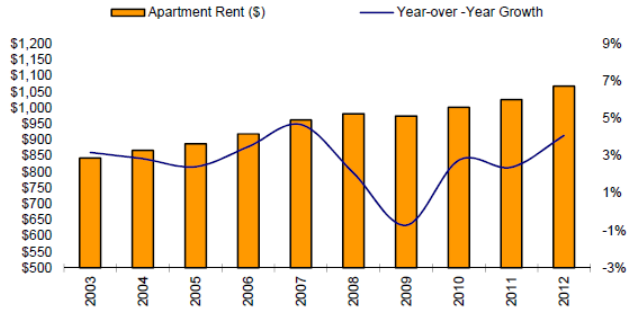


Figure 6 Philadelphia Historical Rent Rate Growth; Source: Principal RE Investors

The current vacancy rate is 5.2% and is expected to fall to 4.8% in 2013. Average rents are expected to increase 2.1% this year from $1100 to $1,122[xii].

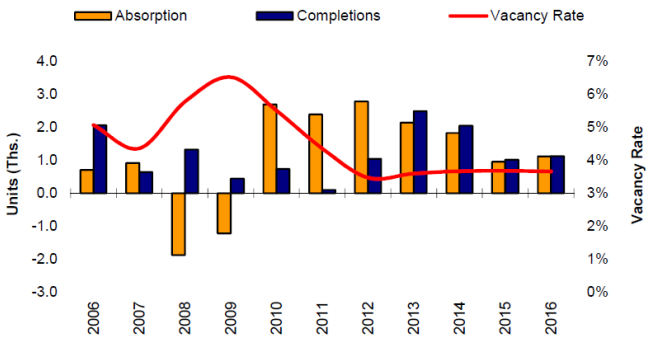


Figure 7 Philadelphia Historical Occupancy Rates vs. New Units Completed; Source: Principal RE Investors

Forecast: Occupancy increasing slightly to 95.2% with rental rates moving from 2.1% in 2013 to 3.5% level.

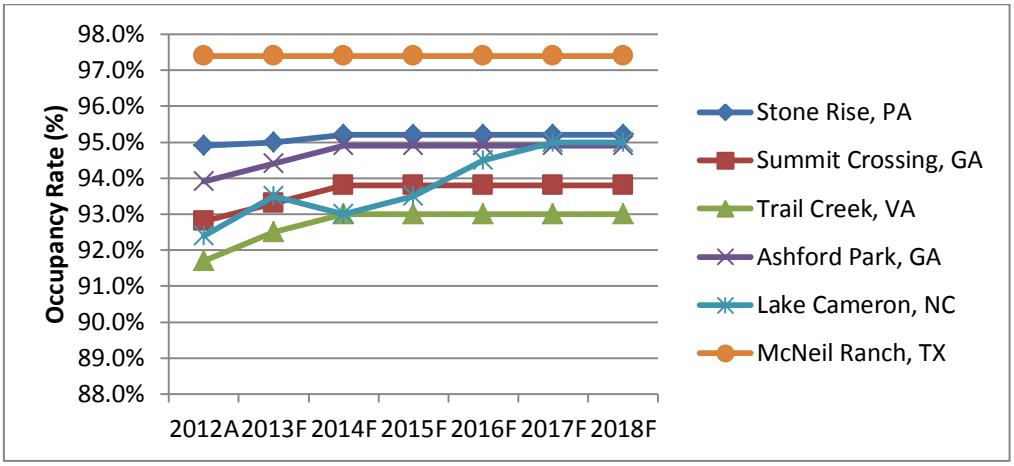
Cap Rates: 5 – 5.5% for Class A assets in upscale suburban markets, while class B in stabilized suburban complexes are 1% higher.

4 Base Case Forecasts

4.1 Property Revenue Forecasts

Revenue is composed of property rents and loan income; Property revenues derived from forecast occupancy and rental rates

- *Property revenue* is based on forecasted occupancy rates and rental rates from 2013 – 2018 on a property-by-property basis (shown below):
  - The revenue forecasted may not line up with actual values, thus an estimated value was used… the growth in the forecasted revenue was applied to 2012's actual revenue to come up with the model revenue forecast
  - This growth in the expected revenue was also applied to other property revenue since it is assumed that other property revenue will grow at the same rate as revenue



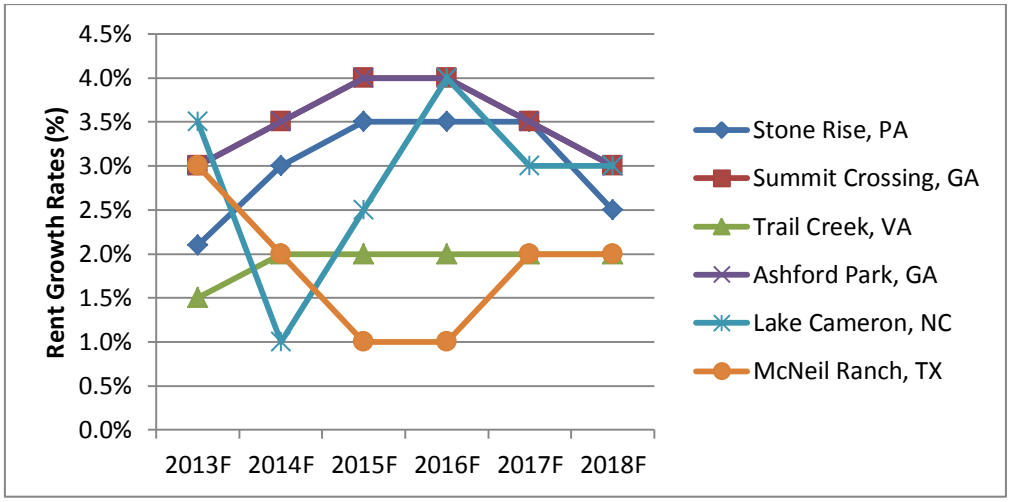


Figure 8 Base Case Forecast Occupancy and Rent Rates; Source: LSIF Forecasts

4.2 Loan Income Forecasts

Loan Income is based on forecasted mezzanine loan balances on a loan-by-loan basis and stated loan interest rates. The two main factors affecting the loan forecasts are summarized below:

Each mezz. loan has a closing date and total "committed loan amount" – these inputs were used to generate forecast loan balances

1. **Future loan balances are based on straight line increases up to each loan's stated "mezzanine loan committed amounts" in the financial reports.** Mezzanine loans are issued by APTS to real estate firms looking to build a new development that are too early in the development to obtain traditional bank loans. Generally, the real estate development company estimates how much money they will need over the time span of the project and gets APTS to commit a loan amount that will be given on a need basis. For example, a firm may say over a 3 year project they will require a $10M commitment, but may only withdraw $3M in the 1st year, and a few months later withdraw another $1M. Based on the nature of these agreements, it is assumed that the committed amounts will be reached in the future and these were extended until the stated termination dates which are shown in company filings. Below shows forecast average loan balances:

Average Loan Balances	*Total Committed*	2013F	2014F	2015F	2016F	2017F	2018F
Trail II	$4,577,270	$5,340,149	$6,103,027	$6,103,027	$6,103,027	$6,103,027	
Summit II	$2,070,970	$3,367,440					
Crosstown Walk	$0	$685,125	$2,740,500	$5,481,000	$8,221,500		
Crosstown Walk II	$2,775,049	$4,906,242	$7,663,486	$8,533,889	$9,022,593	$9,511,296	
City Park	$3,225,652	$5,549,664	$8,485,007	$9,707,672	$10,930,336		
City Vista	$2,451,042	$3,799,092	$5,205,022	$5,295,283			
Madison-Rome	$0	$1,201,281	$4,262,854	$7,441,165	$10,077,203		
Lely	$18,099,983	$29,348,993	$42,791,852	$48,562,035	$53,018,490	$34,878,644	$7,929,338
Totals	$33,199,967	$54,197,986	$77,251,749	$91,124,070	$97,373,149	$50,492,967	$7,929,338

Figure 9 Forecast Average Mezzanine Loan Balances; Source: LSIF Forecasts

It is difficult for developers to pay the full 14% of interest in cash so a portion of interest is deferred until the principal repayment date

2. **Each loan has a cash interest and deferred interest component, and the sum of these interest amounts are recorded as revenue.** The general formula that APTS uses when giving out mezzanine loans is it charges an 8% interest rate that is paid in cash at a regular interval based on the loan amount, as well as an additional 6% interest rate that is paid at the termination date of the loan. It appears the rationale behind this setup is that real estate development companies are cash-strapped and will have difficulty paying the full 14% interest payments during development. Below shows the forecast cash and deferred income amounts:

Cash Loan Incomes	*Cash Rate*	2012	2013F	2014F	2015F	2016F	2017F	2018F
Trail II	8%	$480,000	480,000	480,000	480,000	240,000		
Summit II	8%	$318,249	488,242	488,242	488,242	488,242	488,242	
Crosstown Walk	8%	$144,442	373,113					
Crosstown Walk II	8%	$0	109,620	328,860	548,100	767,340		
City Park	8%	$139,439	562,995	663,163	702,259	741,356	780,452	
City Vista	8%	$166,623	629,894	727,707	825,520	923,333		
Madison-Rome	8%	$100,850	411,771	421,032	426,213			
Lely	8%	-	192,205	489,852	700,735	911,618		
Subtotal		$1,349,603	$3,247,840	$3,598,856	$4,171,069	$4,071,889	$1,268,694	$0

Deferred Loan Incomes	*Exit Rate*	2012	2013F	2014F	2015F	2016F	2017F	2018F
Trail II	4%	-	240,000	249,600	259,584	269,967		
Summit II	*6%*	-	366,182	388,153	411,442	436,128	462,296	
Crosstown Walk	6%	-	279,835					
Crosstown Walk II	6%	-	82,215	251,578	431,103	621,399		
City Park	6%	-	422,246	522,707	583,392	647,717	715,903	
City Vista	6%	-	472,421	574,126	681,933	796,209		
Madison-Rome	*6%*	-	308,829	334,304	358,248			
Lely	6%	-	144,154	376,038	556,763	748,331		
Total Accrued Exit Fees		$718,955	$2,315,880	$2,696,505	$3,282,463	$3,519,751	$1,178,198	$0

Figure 10 Forecast Cash and Accrued Loan Income; Source: LSIF Forecasts

APTS has a property expense to revenues ratio in the middle of its peers at 38%

4.3 Margins

Property related operating expenses were kept constant as 2012's percentage of property revenues. APTS appears to be near the average of its peers in terms of the ratio between its operating expenses and property revenues at ~38% over the past 2 years. Items with specific disclosure such as real estate taxes, and acquisition costs were calculated manually. Also, working capital also was kept constant at 2012's percentage of property revenues.

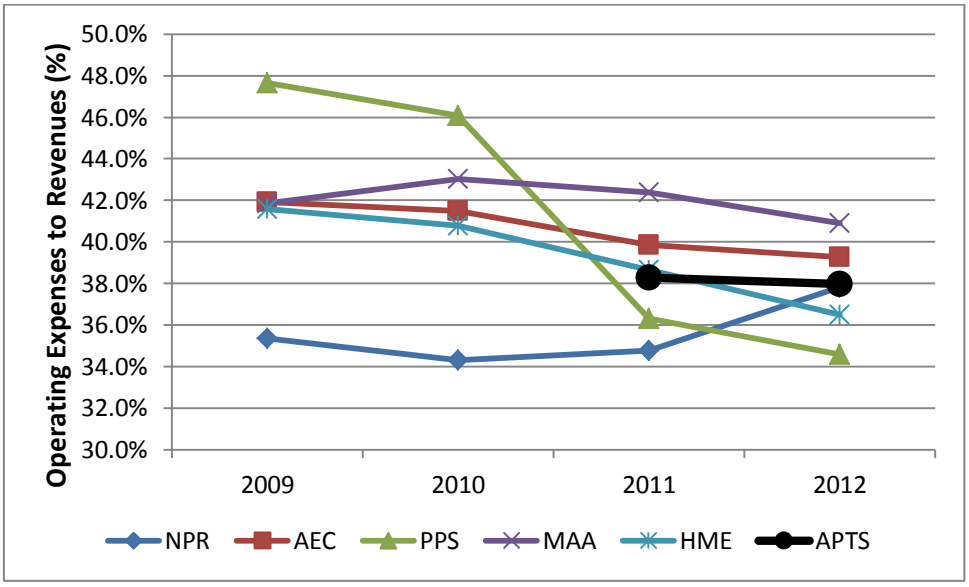


Figure 11 Comparing Property Expense Ratios vs. Peers; Source: LSIF, Company Filings

4.4 Capital Expenditures

In my view, the traditional LSIF capital expenditure and depreciation forecast methods may not apply to APTS because APTS is a real estate company and is relatively new. Each year the company's asset base has increased through acquisitions and so it is hard to find trends in the depreciation rate and CapEx.

Traditional LSIF CapEx forecasting method may not be as effective due to APTS's lack of track record

- For the 2013 forecast of CapEx I took Q1/13's CapEx amount and annualized it
- For further year's CapEx amounts I took the average of 2011A, 2012A, and 2013E as an absolute value
- For depreciation I followed a similar methodology by annualizing Q1/13's depreciation and taking a percentage of the average of 2012 and 2013's asset values (for both buildings and improvements and furniture, fixtures & equipment)
- Going forward I averaged the 2012 and 2013 depreciation percentages calculated above
- I also added the book values of acquisitions that had occurred on January 23, 2013 with 3 new properties
- For capital additions, I added 75% of CapEx to B&I and 25% to FF&E based on my own estimate

4.5 Valuing Mezzanine Loan "Buy Options"

As mentioned earlier, a secondary area of the business involves giving mezzanine loans to development firms involved in other real estate projects. Management has stated that this allows APTS to generate a large return, while also being given the opportunity to be involved with new property developments and purchase them at "wholesale" rates in the future, should they be attractive. This allows APTS to yield returns much higher than their cost of capital (~14%) while having access to a pipeline of acquisitions intimately known down the road.

					Buy option window		
Project/Property	Location	Total units	Loan Balance	Total Loan Commitments	Begin	End	Option price
Trail II	Hampton, VA	96	$5,955,231	$6,000,000	4/1/2014	6/30/2014	$17,825,600
Summit II	Suburban Atlanta, GA	140	$6,056,417	$6,103,027	10/1/2014	2/28/2015	$19,254,155
Crosstown Walk	Suburban Tampa, FL	NA	$4,680,439	$4,685,000	NA	NA	NA
City Park	Charlotte, NC	284	$7,490,276	$10,000,000	11/1/2015	3/31/2016	$30,945,845
City Vista	Pittsburgh, PA	272	$8,129,326	$12,153,000	2/1/2016	5/31/2016	$43,560,271
Madison - Rome	Rome, GA	-	$5,119,584	$5,360,042	NA	Na	NA
Lely	Naples, FL	308	$2,045,602	$12,713,242	4/1/2016	8/30/2016	$43,500,000

Figure 12 Stated Buy Option Prices and Time Windows; Source: LSIF Forecasts

Mezz. buy option values are estimated using the Black Scholes option pricing formula

I used the Black-Scholes model shown below to value these buy options. Each current "Property Price" (S) was assumed to be 20% below the buy option price (K) to ensure conservatism. Using this method, the aggregate of APTS's buy options were valued at $7.96M.

Black Scholes Option Value of Mezzanine Purchase Contracts

	Trail II	Summit II	City Park	City Vista	Lely
Expiry Date	30-Jun-14	28-Feb-15	31-Mar-16	31-May-16	30-Aug-16
PV of Strike Price (K)	$17,825,600	$19,254,155	$30,945,845	$43,560,271	$43,500,000
PV Property Price (S)	$14,260,480	$15,403,324	$24,756,676	$34,848,217	$34,800,000
Time until Option Exercise (t) - years	0.98	1.64	2.73	2.90	3.15
Risk Free Rate (r)	2.00%	2.00%	2.00%	2.00%	2.00%
Standard Deviation (s)	0.20	0.20	0.20	0.20	0.20
Property Price Mark Down Rate	20%	20%	20%	20%	20%
Option Strike Price	$17,825,600	$19,254,155	$30,945,845	$43,560,271	$43,500,000
Call Price	$245,244	$574,980	$1,722,027	$2,589,964	$2,830,232

Total Buy Option Value	**$7,962,447**

Figure 13 Black-Scholes Valuation of Mezz. Buy Options; Source: LSIF Forecasts

4.6 Other Model Assumptions

In order to find a useful beta for APTS, five peer companies' 1 year betas were found and unlevered. The average of these unlevered betas were taken and re-levered, leading to a levered beta that was used to achieve a WACC that should represent APTS's risk level.

Finding Industry Unlevered Beta

Company Name	1 Year Beta	D/E Ratio	Unlevered Beta
UMH Properties	0.73	0.952	0.374
Associated Estates Realty	0.6	1.670	0.225
Post Properties	0.41	0.975	0.208
Mid-America Apartments	0.42	1.748	0.153
Home Properties Inc.	0.37	1.627	0.141
		Average:	0.220

Industry Average UL Beta	0.2200
APTS D/E Ratio	1.7816
Levered Beta	**0.7413**

Figure 14 Determining APTS's Levered Beta; Source: LSIF Forecasts

Average peer betas were levered according to APTS's D/E ratio and in addition, the Merrill Lynch "1/3 revision" was made

I then used the levered beta to figure out a useful WACC for APTS both during the forecast period and during the terminal period. My rationale was that the risk free rate will likely change as economic conditions improve over the next few years which may change the WACC in the terminal period:

The terminal period WACC takes into account higher future interest rates and cost of debt

	Forecast Period	Terminal Period
Risk Free Rate	2%	4%
Equity Premium	7%	7%
Beta	0.7413	0.7413
Cost of Equity	7.19%	9.19%
Cost of Debt	3.37%	5.00%
Tax Rate	0.00%	0.00%
After Tax Cost of Debt	3.37%	5.00%
Shares Outstanding	5,320,000	
Share Price	$8.08	
Total Equity	$42,985,600	$42,985,600
Total Debt	$114,682,000	$102,331,249
% Equity	27.26%	29.58%
% Debt	72.74%	70.42%
WACC	**4.41%**	**6.24%**

Figure 15 APTS's Forecast and Terminal period WACC's; Source: LSIF Forecasts

5 DCF Valuation

5.1 Base Case Valuation

	2013F	2014F	2015F	2016F	2017F	2018F	TY
Operating CashFlow	$8,381,572	$9,269,862	$10,158,509	$10,681,776	$8,606,571	$7,829,016	$7,829,016
Deferred Loan Income Repaid	$279,835	$0	$1,001,380	$6,755,418	$4,956,165	$0	$0
CapEx	$355,304	$513,248	$513,248	$513,248	$513,248	$513,248	$513,248
Change in NWC	-$1,418,101	-$209,132	-$96,740	-$112,062	-$103,464	-$90,628	0
FCF	$7,598,610	$9,573,978	$11,576,397	$17,838,381	$13,972,519	$8,251,635	$8,342,264

WACC Forecast Period:	4.41%
WACC Terminal:	6.24%
PV of FCF's	$65,774,768
PV of TV	$161,616,563
Add: Cash	$2,973,509
Less: Debt	$114,682,000
Less: Preferreds	$24,200,000
Add: Buy Option Value	$7,894,266
Total Implied Value	$99,377,106
Shares Outstanding	11,265,899
PV per share	**$8.82**
Current Share Price	$8.45
Implied Upside	*4.4%*

Terminal Rate	2%

Figure 16 DCF Valuation; Source: LSIF Forecasts

DCF results imply a 4% upside to current share price

After discounting back the free cash flows of APTS, the company yielded an implied share value of $8.82. This is ~4.4% higher than the current share price. This indicates that APTS may be fairly priced. However, exploration of

the company's sensitivity to the bull and bear case may help to confirm whether this is a worthwhile investment.

5.2 Other Scenarios

In this section of the report I explore two other potential cases that may occur over the forecast horizon and how they will affect APTS's valuation. Two alternate scenarios of a bull and bear case will be reviewed in order to better understand the sensitivity of the company.

5.2A Bull Case

The bull case with 4% average rental rate growth over the 5Y forecast period yielded a 27% upside

In the bull case, I believe that the US economy will flourish and rent rates will continue to increase at rates seen by optimistic analysts over the next 5 years at a rate of 4% with occupancy rates staying in line with the base case. **These forecasts yielded a 27.2% upside in the DCF model.**

5.2B Bear Cases

Bear Scenario 1: Slow Rental Rate Growth

The bear case involving slowed rental growth yielded a 24% downside.

In this scenario rent rate growth is decreased by 1.5% vs. the base case scenario representing slowing rent rate growth due to a hampered economic recovery. **These new forecasts yielded a 24.4% downside in the DCF model. [Alternate Bear Scenario discussed under NAV analysis below]**

6 Alternative Valuation Models

In this section I will explore the value of APTS using the NAV method and by comparing the company's multiples to peers in the industry. REIT's are typically valued with the NAV method by using capitalization rates to obtain the present value of operating real estate assets.

6.1 Cap Rate Method

At a 6% cap rate, NAV analysis results show an implied upside of at least 28%

Assuming a contraction to a 6% cap rate as a reasonable valuation measure, the value of APTS appears to be above the current share price, implying an upside of at least 28%.

Present Value of NAV's	1	2	3	4	5	6
	2013F	2014F	2015F	2016F	2017F	2018F
NOI						
5.25%	$199,026,137	$207,426,859	$205,586,521	$206,037,746	$205,489,305	$202,205,957
5.50%	$189,979,494	$197,998,365	$196,241,679	$196,672,394	$196,148,882	$193,014,777
5.75%	$181,719,516	$189,389,741	$187,709,432	$188,121,421	$187,620,669	$184,622,830
6.00%	$174,147,870	$181,498,501	$179,888,205	$180,283,028	$179,803,142	$176,930,212
6.25%	$167,181,955	$174,238,561	$172,692,677	$173,071,707	$172,611,016	$169,853,004
6.50%	$160,751,880	$167,537,078	$166,050,651	$166,415,103	$165,972,131	$163,320,196
6.75%	$154,798,107	$161,332,001	$159,900,627	$160,251,580	$159,825,015	$157,271,300
@6%	$174,147,870	$181,498,501	$179,888,205	$180,283,028	$179,803,142	$176,930,212
Add: Mezz Loans	$46,089,808	$48,562,035	$55,714,701	$57,442,565	$16,103,027	$0
Add: Cash	$14,289,810	$11,664,013	$5,040,586	$5,288,576	$52,201,569	$71,217,507
Add: Receivables	$2,338,694	$4,757,039	$8,040,278	$10,559,546	$4,983,155	$27,717
Less: Debt	$114,682,000	$112,248,725	$109,889,235	$107,451,619	$104,933,211	$102,331,249
Total NAV	$122,184,182	$134,232,864	$138,794,535	$146,122,097	$148,157,681	$145,844,187
# Shares	11,265,899	11,265,899	11,265,899	11,265,899	11,265,899	11,265,899
NAV/Share	$10.85	$11.91	$12.32	$12.97	$13.15	$12.95
Current Share Price	$8.45	$8.45	$8.45	$8.45	$8.45	$8.45
Implied Upside	28.3%	41.0%	45.8%	53.5%	55.6%	53.2%

Figure 17 Comparing NAV Values across Cap Rates; Source: LSIF Forecasts

Bear Scenario 2: Interest Rates Increase Abruptly and Cap Rates Expand

A 0.5% expansion in cap rates would decrease 2013F NAV/share from $10.85 to $9.66

If interest rates continue to creep up, REIT multiples will likely be lower than has been seen over the past few years as the market prices in that REIT's will need to refinance down the road at higher rates. In an environment where interest rates are higher, REITs with a less competitive cost of capital will see their cap rates expand. "Occupancy improvement potential and highly accretive growth potential are the two most significant drivers of growth in FFO per unit" says Alex Avery, head REIT analyst at CIBC World Markets said recently. I see cap rates expanding by 0.5% in the event that the interest rates continue to rise in the future**. In the NAV model, this scenario decreases 2013F NAV/share from $10.85 to $9.66 (from a 28% upside down to 14%).**

6.2 Multiples Valuation

APTS is also compared with peers in the multifamily REIT sector in order to ascertain whether the company is undervalued on a peer comparison basis:

Company Name	Ticker	Share Price	Equity Value	Net Operating Income	Cap Rate Implied by Stock Price	P/FFO TTM	Dividend Yield (%)
Northern Property	NPR	$ 26.55	$ 851	$ 105.35	7.9%	11.8 x	5.76%
Associate Estates Realty	AEC	$ 16.52	$ 832	$ 110.05	7.3%	13.4 x	4.60%
Post Properties	PPS	$ 49.07	$ 2,680	$ 194.53	5.2%	16.7 x	2.69%
Mid-America Apartments	MAA	$ 66.32	$ 2,830	$ 307.97	6.7%	13.8 x	4.19%
Home Properties	HME	$ 65.11	$ 3,400	$ 362.18	6.0%	13.1 x	4.30%
Maximum			$ 2,680	$ 195	7.9%	16.7 x	5.76%
75th Percentile			1,766	152	7.6%	15.0 x	5.18%
Median			**$ 851**	**$ 110**	**7.3%**	**13.4 x**	**4.60%**
25th Percentile			842	108	6.2%	12.6 x	3.65%
Minimum			832	105	5.2%	11.8 x	2.69%
Preferred Apartment Communities	**APTS**	**$ 8.08**	**$ 43.0**	**$ 11.2**	**11.2%**	**8.8 x**	**7.43%**

Figure 18 Peer Comparable Ratios and Metrics; Source: LSIF Forecasts

APTS has the lowest P/FFO ratio and highest div yield at 7.4%; APTS's mezz. loan operations may distort FFO metrics slightly

On a P/FFO basis, APTS is the most discounted vs. its peers. APTS also has a significantly higher dividend yield than its peers. However, one must take into account the fact that the market capitalization of APTS is much lower than the compared companies and thus has lower liquidity and may carry more risk due to lower diversification. Also of note, since a considerable portion of APTS's business involves mezzanine loans, this may distort the FFO metrics vs. peers which solely obtain property revenues. Also, due to the recent acquisitions in January, 2013, the TTM Cap Rate Implied by Stock Price was not meaningful, so annualized Q1 2013 NOI was used instead of TTM NOI. This metric indicates that APTS is discounted vs. peers.

7 Management and Corporate Structure

Area of Concern:

Dependence on and potential conflict of interest with Manager – The "Manager" is another entity run by Mr. Williams that receives fees based on APTS's total asset balance and revenue amounts. This could lead management to use excessive leverage to increase assets and revenues, and therefore fees. Also, Mr. Williams owns other entities that interact with APTS. Thus, properties have and may continue to be acquired from affiliates of the Manager. The lack of "arms length" transactions may be cause for concern.

Questionable transactions between APTS and other entities owned by Williams cause for concern

This specific area of the report will attempt to ascertain the credibility of Mr. Williams and demystify the corporate structure of APTS in association with other relevant entities in order to evaluate the potential risks.

7.1 Management Background

John A. Williams

Williams' biggest achievement is founding and growing Post Properties up to 30,000 units in 2004

General Track Record: Mr. Williams has a vast amount of experience in the multifamily real estate industry. He has been in the industry for 47 years and his most notable accomplishment was bringing Post Properties to market in 1993 and increasing FFO since then at 7% per year until stepping down in 2003. At that point Post Properties had amassed 30,000 units, mainly focusing on managing and owning upscale multifamily apartment communities in selected markets. He is an early pioneer in green development advocating for recycling in apartment communities, superior insulation, and energy efficient appliances and his early efforts have led to many LEEDS standards in use today. He also fought for urbanism towards the end of his career, advocating "smart growth" where less investment is made in suburban areas and more in areas with infrastructure in place in the city[xiii].

Williams resigned from Post in 2004 due to scuffles with the board and a lost proxy vote

Disagreement with Board Caused Resignation from Post Properties in 2004: Williams resigned in 2004 mainly due to "board control and executive compensation issues"[xiv]. He had lost a proxy fight to replace five board members and introduce a bylaw that would require annual shareholder approval for director compensation. Williams was concerned that the board did not have shareholders' best interest at heart since they rejected what he thought was a good offer from General Investment & Development Co. in March, 2003 for $26 per share (13% premium at the time). Williams was the largest unitholder at the time and was the only board member interested in pursuing the sale. He also accused the Post board of withholding specific information from shareholders and not treating them as the true owners of the business.

Post stated, *"William's recent legacy at Post is one of overly rapid geographic expansion into unfamiliar markets, substantial cost overruns and missed schedules on new developments with lease-up rates below projections, and a series of quarterly earnings disappointments beginning with Post's Oct. 2, 2000 pre-announcement and continuing through 2001."*

Williams remarked upon his resignation:

"My activism has resulted in positive changes at Post Properties, particularly in the important area of corporate governance. And, with three new recently-elected, independent directors in place, I am now comfortable leaving my position on the Post Properties board of directors. I intend to pursue my own interests in real estate investment and development, and I will always maintain a deep affection for Post."

Post agreed to allow Williams to use the firm's private jet service through May 2013, as well as receive $400,000 annual payments over the same time frame.

After Post Properties:

Williams continues to invest in the multifamily RE market with his private WRA holding company

- In 2004 he founded Williams Realty Advisors (WRA), LLC, a real estate fund advisor
- He has spun off 13 companies from WRA, building up more than $3B in assets[xv]
- Mr. Williams is currently involved with various real estate funds all run through WRA that third party manage 25,000 units across nine states, as well as asset management of 3000 multifamily units across 4 states.

Some accolades he has received are:

- CEO Award for Commercial Real Estate in 1995
- CEO of the Year by Financial world in 1996
- National Real Estate Investor`s list of `The 20th Century`s Most Influential Developers

Overall, I view Williams as a very talented and well-connected real estate professional with an immense amount of experience in the multifamily REIT sector. Having him as CEO of APTS is likely to add a great deal of value as the company develops.

7.2 Corporate Structure Explanation

APTS has no employees of its own

APTS has no employees of its own, but instead has a Manager (Williams Realty Advisors) that provides all the managerial and administrative personnel. The Manager is controlled by Mr. Williams. Williams Group corporate map is shown below[xvi]:

APTS first company in Williams Group to go public since Post – Can Williams do it again?

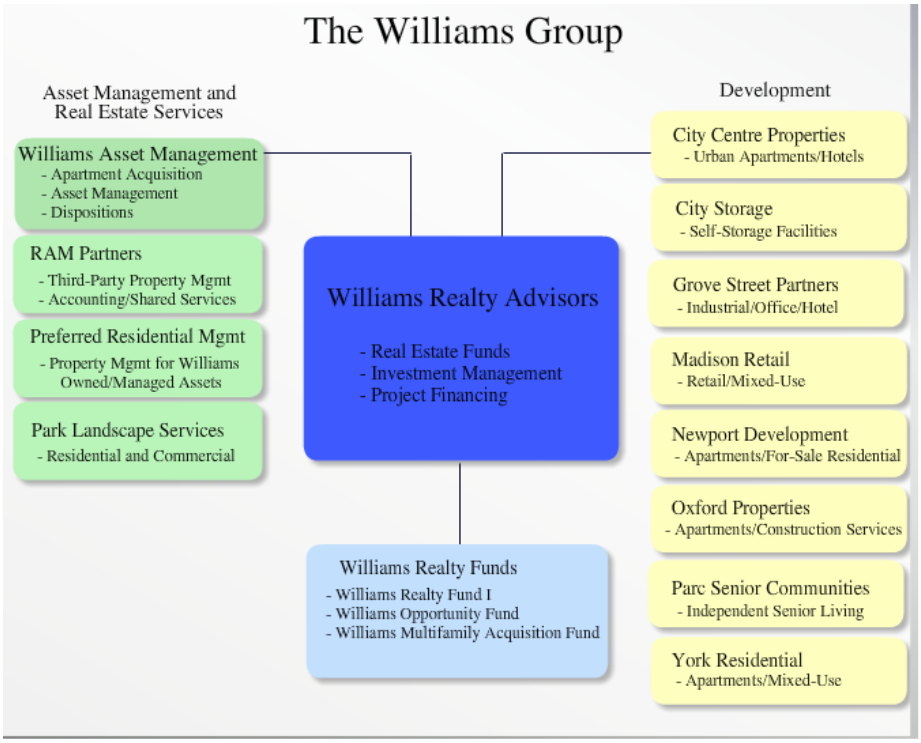


Figure 19 Williams Realty Association Corporate Map; Source: Company Filings

APTS pays mgmt & asset mgmt fees, G&A expenses, and acquisition fees to WRA

Frequent Payments to Manager for Services Rendered

- **Management Fees:** In return for services such as rental, leasing, operation, and management of communities, APTS pays 4% of gross property revenues to WRA (APTS has no employees of its own)
- **Asset Management Fees:** 0.50% of total value of assets, paid out on a pro-rata basis each month
- **G&A Expenses:** Monthly fee equal to 2% of monthly gross revenues of APTS
- **Acquisition Fees:** In the past APTS has paid WRA acquisition fees in the amount of 1% of the property purchase price for due diligence, purchase negotiation, appraisals, and other costs

Carry Applied to Gains on Sale: Also of note, in the event of the sale of an asset (has not occurred with APTS yet), WRA will receive a 15% carry on profits in excess of a 7% cumulative, non-compounded annual return on the gain of the property sale.

7.3 Acquisition Analysis:

WRA Other Funds Explained:

As mentioned earlier, APTS has entered transactions with other entities run or owned by Williams. Thus, an overview of WRA's three real estate funds that Mr. Williams controls will be provided since these funds have all

interacted with APTS in real estate transactions since APTS's inception. WRA currently owns 2 "Development Funds" and one "Multifamily Acquisition Fund".

1. **Williams Realty Fund I (Development):** Launched in February, 2005 with $100M in equity (91 investors), this fund has 34 development projects totaling $1B in capitalization, mainly in the SE and Mid-Atlantic region. As of December 31, 2009, 8 projects have been sold and proceeds have been distributed to investors.
2. **Williams Opportunity Fund (Development):** Launched February 22, 2007 with $103.1M in equity (71 investors), and 42% of investors institutional. As of December, 2009, the Fund has committed approximately 53% of its capital with 19 development projects.
3. **Williams Multifamily Acquisition Fund:** Launched in April, 2007, this fund has $300M in equity commitments from institutional partners at 65% leverage.

The majority of APTS's acquisitions have been from Williams entities – conflict of interest or win-win transactions?

Reviewing APTS's acquisitions, one can see each of these funds has interacted with APTS at some point in the company's history:

- On April 15, 2011 APTS acquired the membership interests in Stone Rise Apartments from **Williams Opportunity Fund**
- On April 21, 2011 and April 29, 2011 APTS acquired the membership interests in two properties with **Williams Realty Fund I** owning the majority of membership interests in Summit Crossing, and a 10% membership interest in Oxford Trail
- On January 23, 2013 APTS acquired three properties from **Williams Multifamily Acquisition Fund**. The purchase price for each of these properties was established by the "95% unaffiliated third party equity investor in **WMAF** pursuant to terms of the **WMAF** partnership agreement".
- On June 25, 2013 APTS acquired Trail II property after exercising a purchase option associated with a mezzanine loan on the project (appears to be an arms-length transaction)

3 criteria for attractive growth REIT's: (1) smaller market cap; (2) focus on higher cap rate properties; (3) proven management -Head REIT analyst, CIBC

Keep in mind that management has stated that APTS utilizes a unique strategy to add to its acquisition pipeline. APTS gives out mezzanine loans to real estate developers in markets they are interested in, generating not only returns averaging 14% but also a buy option around the time the property is completed. Management has stated this is a key aspect of their strategy and allows them to buy properties at wholesale prices below market cap rates.

8 Conclusion

A key aspect that was not included in the model is the possibility of accretive acquisitions in the future. John Williams has plenty of experience growing

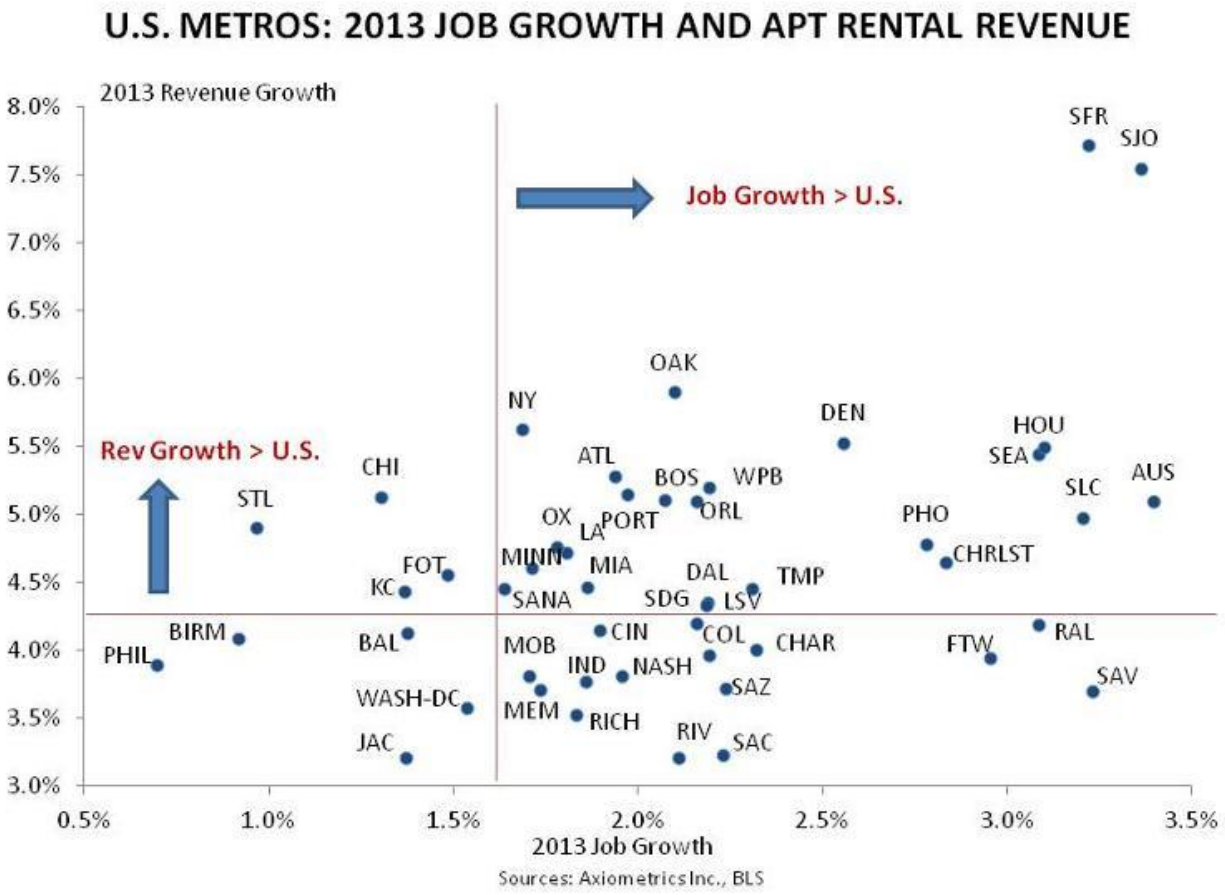
multifamily real estate portfolios and I believe he will continue to do this in the future, adding further value to shareholders.

Lack of DCF upside and awkward corporate structure lead to *Do Not Buy* decision for APTS

Alex Avery, Head of Real Estate at CIBC World Markets stated recently in his July *CanREIT's Monthly* report that there are three criteria for attractive growth REIT's: (1) smaller market caps, (2) a focus on properties with higher than average cap rates and (3) proven management teams. APTS possesses all three of these features. It is a rare to have such an experienced management team overseeing a small REIT such as APTS indicating this could be an excellent buying opportunity. However, the lack of margin of safety with the DCF valuation and dubious corporate structure is a cause of concern and compels me to rate this company *Do Not Buy*.

9 APPENDICES

9.1 Appendix A: US Metros Market Forecasts



10 End Notes

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