APARTMENT DEAL FUNDAMENTALS

Understanding the Capital Stack

Who provides the money - and who gets paid first?

Every apartment investment needs capital. Some of that capital may come from a lender. The rest usually comes from investors and the sponsor. Together, those sources make up the property's capital stack.

The capital stack shows two important things: where the money comes from and the order in which different capital providers generally have claims on the property's cash and value.

THE IMPORTANT IDEA
The lower you are in the capital stack, the earlier your claim is generally paid. The higher you are in the stack, the more risk you generally accept - but also the greater potential economic upside.

01 A SIMPLE APARTMENT CAPITAL STACK

A $10 Million Example

Consider a simplified apartment acquisition with a $10 million purchase price:

COMMON EQUITY	$3.5M	35%
SENIOR DEBT	$6.5M	65%

In this simple example, lender financing plus investor equity equals the purchase price. In an actual transaction, the total equity raise may be higher because the investment may also need capital for closing costs, renovations, working capital, operating reserves, interest reserves, or financing costs.

02 SENIOR DEBT

The Lender Is Usually First in Line

Senior debt is generally the lowest-risk position in the capital stack because the lender has a contractual right to repayment and typically holds a mortgage or other security interest in the property.

The property must generally pay interest, principal when required, and other lender obligations before equity investors receive residual cash.

THE TRADE-OFF
A more senior position generally means a lower risk position - and usually lower potential return relative to equity.

03 EQUITY

Equity Owns What Is Left After Debt

Equity investors provide capital that sits behind the lender. Equity generally participates in property cash flow, appreciation, refinancing proceeds, and sale proceeds after the property's obligations are satisfied.

But equity also absorbs losses before the lender does.

A Simple Example

Assume a property is purchased for $10 million with $6.5 million of debt and $3.5 million of equity. If the property later sells for $12 million, the lender is repaid according to the loan terms and the remaining value belongs to the equity owners after transaction costs and other obligations. If the property value falls significantly, the equity absorbs that decline first.

THE IMPORTANT IDEA
Debt has priority. Equity owns the residual. That residual can create meaningful upside - and meaningful risk.

04 COMMON EQUITY

Where Most Passive Apartment Investors Sit

In many private apartment investments, passive investors invest as limited partners or members of an investment entity. The sponsor or general partner may also contribute equity. Together, that capital may form the common equity layer.

Common equity generally receives cash after operating expenses, debt service, required reserves, and other senior obligations have been satisfied.

How the remaining cash is divided between investors and the sponsor is determined by the investment's distribution waterfall.

CAPITAL STACK	Who provided the capital and whose claim is senior to whose.
WATERFALL	How cash allocated to the equity investors is divided among them.

05 SOMETIMES THERE ARE MORE LAYERS

Not Every Deal Is Just Debt and Common Equity

COMMON EQUITY Highest risk / greatest potential participation in upside
PREFERRED EQUITY Priority over common equity
MEZZANINE DEBT Junior to senior debt / senior to equity
SENIOR DEBT First contractual claim

A straightforward apartment investment may have only senior debt and common equity. More layers can provide additional capital flexibility - but they can also make the investment more complicated.

06 WHY THE CAPITAL STACK MATTERS TO A PASSIVE INVESTOR

The capital structure affects both risk and return.

A passive investor should understand:

- How much debt is being used
- Which capital sits ahead of the investor
- Whether preferred equity or mezzanine debt exists
- The cost of each capital layer
- What must be paid before common equity receives cash
- How much property value could decline before investor equity is impaired

THE QUESTION
How much cash and property value must remain before my position begins to receive value?

07 LEVERAGE CHANGES THE EQUITY RISK

More Debt Means Less Equity - but Greater Sensitivity

Return to our $10 million example. If the property value falls by $1 million, the property is worth $9 million. The lender's claim may still be approximately $6.5 million. That leaves about $2.5 million of property value supporting the equity before transaction costs and other obligations.

Original Purchase	$10.0M
Senior Debt	$6.5M
Equity	$3.5M
Property Value After 10% Decline	$9.0M
Value Remaining Above Debt	$2.5M
Approx. Equity Decline	29%

The property declined only 10% in value, but the equity value declined from $3.5 million to $2.5 million - approximately 29%.

WHY?
Debt does not absorb the decline first. Equity does. Leverage can magnify gains - and magnify losses.

08 THE CAPITAL STACK SHOULD FIT THE BUSINESS PLAN

Financing Is Not Separate From Operations

The appropriate amount and type of capital depends on what the property is expected to do. A stabilized property with predictable income may support one debt structure. A property requiring major renovations, significant vacancy, lease-up, or an operational turnaround may require more equity, larger reserves, longer loan terms, or greater flexibility.

THE QUESTION
Does the capital structure give the business plan enough time and financial flexibility to work?

09 THE CAPITAL STACK CAN CHANGE DURING THE HOLD

The sponsor may later refinance the senior loan, add or remove debt, return equity, raise additional capital, or restructure financing. These changes can affect risk, cash flow, distributions, future refinancing, and sale proceeds.

ROBERT'S PERSPECTIVE

I LOOK AT THE CAPITAL STACK AS THE PROPERTY'S FINANCIAL FOUNDATION.

Investors naturally spend a lot of time looking at projected returns. I want to understand what sits underneath those returns. How much debt is there? When does it mature? What does it cost? Are there other capital providers ahead of me? And does the property have enough room to operate if the business plan takes longer than expected?

MY RULE

The more complicated the capital stack, the more important it is that I understand exactly who gets paid before me and what happens if the property underperforms.

Financial engineering cannot make operating risk disappear. Sometimes a simpler capital structure is easier to understand - and easier to survive.

QUESTIONS TO ASK

DEBT	How much senior debt is being used? Is the interest rate fixed or floating? When does the loan mature? Are extension options available?
OTHER CAPITAL	Is there mezzanine debt or preferred equity? What return or payment rights do those capital providers have?
EQUITY	How much total equity is being raised? How much comes from passive investors and how much from the sponsor?
PRIORITY	What must be paid before common equity receives distributions?
DOWNSIDE	How much can property value or income decline before the common equity is materially impaired?

FIVE THINGS TO REMEMBER

1. THE CAPITAL STACK SHOWS WHO FUNDS THE DEAL

Debt and equity are the basic building blocks.

2. SENIORITY MATTERS

Capital lower in the stack generally gets paid before capital above it.

3. EQUITY RECEIVES THE RESIDUAL

That creates both upside potential and downside risk.

4. LEVERAGE MAGNIFIES RESULTS

Less equity does not automatically mean less risk.

5. THE CAPITAL STRUCTURE MUST FIT THE BUSINESS PLAN

The property needs enough financial flexibility to execute through changing conditions.

THE MOST IMPORTANT TAKEAWAY

Follow the money - and follow the priority. Understand who provides the capital, who gets paid first, what obligations sit ahead of you, what is left for equity, and how that equity is divided.

Where you sit matters when things go right - and when they do not.

EDUCATIONAL PURPOSE

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