UDF Management Lacks Credibility

How UDF Management Has Not Recognized Realized Losses in a Public Affiliate

February 2016

“Only when the tide goes out do you discover who’s been swimming naked.”

– Warren Buffett
HOW UDF MANAGEMENT HAS NOT RECOGNIZED REALIZED LOSSES AND THE IMPLICATIONS FOR UDF

1. Pre-dating the financial crisis, UDF management used public shareholder capital through a public SEC-registered UDF affiliate to issue loans to private entities owned and controlled by approximately 10 UDF insiders (the “Insider Entities”), including key executives Hollis Greenlaw and Todd Etter.

2. In turn, the Insider Entities then issued loans to third-parties.

3. During and subsequent to the financial crisis, the loans to third parties stopped performing and the collateral securing these loans was foreclosed upon and sold for less than the balance of the loans, resulting in significant realized losses.

4. As a result, the Insider Entities were unable to repay the loans issued by the public SEC-registered UDF affiliate, United Mortgage Trust.

5. Rather than recognize the realized losses in the income statement of the public affiliate, UDF’s management obscures the losses and keeps them “on balance sheet” by issuing “deficiency notes” and “recourse obligations,” which are effectively IOUs.

6. This is consistent with how management operates UDF III and UDF IV – obscuring and not recognizing losses on non-performing loans.

7. When UDF management claims publicly that UDF IV has not “realized” any losses, investors should question why management used the term “realized” rather than “incurred.” Investors should question management about the extent of “unrealized” or “incurred” losses that may exist.
WHY UDF MANAGEMENT LACKS CREDIBILITY

Management and insiders suffered tremendous losses on loans issued pre-financial crisis by a public UDF affiliate (which they managed but did not own) to their own private entities (which they not only managed but also owned). When the loans stopped performing during and subsequent to the financial crisis, the insiders, through the private entities, foreclosed on the collateral and sold the underlying real estate assets resulting in considerable realized (and crystallized) losses to the insiders and their private entities. However, to date, these losses have never been recognized in the income statement of United Mortgage Trust (“UMT”), the public entity. Instead, management issued opaque and official sounding instruments called unsecured deficiency notes and recourse obligations (“Deficiency Notes”) to their private entities (currently with an outstanding balance of $73 million). As a result, the losses that resulted from poor investment decisions over eight years ago are still shown as “assets” of UMT. While management refers to these assets as “deficiency notes” and “recourse obligations,” in reality, these are just I-OWE-YOUS that management has never repaid.

Deficiency Notes issued to insiders, through their private entities, bear interest at 1.75% while similar Deficiency Notes issued to third-parties bear interest at 14.0%. Apparently, insiders and management believe that their private entities are more creditworthy than third-parties and even the U.S. government (the U.S. 10-year treasury has averaged 2.70% since 2007 when the first Deficiency Note was issued). The below market interest rate and the differential in the interest rate charged on third-party Deficiency Notes suggests (i) the insider Deficiency Notes are not arms’ length transactions and (ii) there is a conflict of interest. Not only is the interest rate on insider Deficiency Notes below market, management has not moved to collect on the $73 million in Deficiency Notes for the better part of a decade. The logical explanation as to why management has not collected on the Deficiency Notes would seem to be because Hollis Greenlaw and other insiders would be forced to collect on their own private entities (aka themselves).

The private entity that ultimately owes a considerable amount of these Deficiency Notes, UMT Holdings (“UMTH”), is owned by 10 insiders, including Hollis Greenlaw and Todd Etter (CEO and Chairman, respectively) who combine to own 60% of UMTH. UMTH also happens to be the external manager of all four public UDF affiliated programs, and accordingly, UMTH’s primary revenue source is the fee stream generated from UDF’s four public affiliates. Effectively, UMTH’s ability to repay the Deficiency Notes is heavily dependent on extracting sufficient fees from UMT, UDF III, UDF IV and UDF V. This would seem to create a significant conflict of interest that is not disclosed to shareholders of UDF III, UDF IV and UDF V – given that management needs fees from UDF III, UDF IV and UDF V to repay a debt owed to UMT while at the same time managing all four public companies.

The following analysis explains in detail what a Deficiency Note is, how Deficiency Notes came to be and the implications for UDF IV. While the specific public UDF entity involved is UMT, the management team running UMT is the same management team running UDF III, UDF IV and UDF V. Similarly, the same audit firm that audited UMT also audited UDF III, UDF IV and UDF V. This analysis raises serious questions regarding UDF management’s credibility. Not only does the analysis establish management’s poor investment track record, but more importantly, it establishes management’s practice of not recognizing actual, realized losses in the financial statements (specifically the income statement) of a public company (UMT) registered with the SEC. It further suggests that management has allowed a conflict of interest to manifest itself in the form of non-arms’ length loans to UDF management and insiders, through their private entities, with interest rates far below a market rate. This is not only how UDF management operates UMT; it is also consistent with how management operates UDF III and UDF IV – obscuring and not recognizing losses on non-performing loans.

THE I-OWE-YOUS OWED BY UDF MANAGEMENT TO PUBLIC SHAREHOLDERS
WHERE UMT FITS INTO THE UDF SCHEME

United Mortgage Trust ("UMT"), an affiliated UDF entity, lends to entities owned principally by UDF management and other insiders, including through UDF’s external manager, UMTH, for the purpose of lending to “third-parties”.

It is unclear why UMT did not issue the loans directly to third-parties, but instead lent to private entities controlled by management and insiders, which then lent to third-parties.

Source: Organization Chart sourced from UDF IV 10K (12.31.14).
Of UMT’s total “book value” of assets ($182mm), related party assets account for ~85%.

These “assets” come in the form of loans to related parties including UMTH, the external manager of UDF’s public affiliates, and UDF I.

Of the related party assets, deficiency notes and recourse obligations (“Deficiency Notes”) represent ~50%, or $73mm.

Deficiency Notes are better described as “I-OWE-YOUS” owed by management and insiders, through private entities.
WHAT ARE “DEFICIENCY NOTES”?

“[UMT] has made loans in the normal course of business to . . . related parties, the proceeds . . . have been used to originate underlying loans”

“If the borrower or [UMT] foreclosed on property securing an underlying loan . . . and the proceeds from the sale were insufficient to pay the loan, the originating company had the option of (1) repaying the outstanding balance . . . or (2) delivering to the Company an unsecured deficiency note”

In other words, a Deficiency Note is a realized loss that is not recognized by UMT in its income statement. Instead, the loss remains on balance sheet as a promise-to-pay or an I-OWE-YOU.

Source: United Mortgage Trust Form 10-Q (9.30.15).

The Translation:

UMT lent to affiliated entities that lent to third-parties; when the loans to third-parties went bad, the affiliated entities could not repay the UMT loans and instead provided UMT with deficiency notes…the ‘I OWE YOU’
WHO OWES THE “DEFICIENCY NOTES”?

“The legal entity that owes the Deficiency Notes, UMTHLC, is ultimately owned by 10 insiders, (see following page).

The balance has grown from $5.1 million as of December 2007 to $41.3 million as of September 2015.

Source: United Mortgage Trust Form 10-Q (9.30.15).

The Translation:

UMT lent to affiliated entities that lent to third-parties; when the loans to third-parties went bad, the affiliated entities could not repay the UMT loans and instead provided UMT with deficiency notes...the 'I OWE YOU's are $41mm.
WHO OWES THE “DEFICIENCY NOTES”?

**UMTHLC** owes the related party Deficiency Note; UMTHLC is 99.9% **owned by UMT Holdings (UMTH).**

UMTH is majority owned by Hollis Greenlaw and Todd Etter, CEO and Chairman of UDF, respectively.

*Source: United Mortgage Trust Proxy Statement (4.29.15)*

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**The Translation:**

UMT lent to [UMTHLC which is owned by UMTH which is owned by] the same people that externally manage UMT and UDF entities; these individuals, through UMTH, owe a significant amount of debt to UMT in the form of deficiency notes.

*Source: UDF IV 10K (12.31.14) – this footnote (2) corresponds to the org chart on page 24.*

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**Table:**

<table>
<thead>
<tr>
<th>Company</th>
<th>Affiliation</th>
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<tr>
<td>UMT Holdings, L.P. (&quot;UMTH&quot;)</td>
<td>99.9% owner of our borrower, UMTHLC and our advisor, UMTHGS</td>
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<tr>
<td>UMT Lending Company, L.P. (&quot;UMTHLC&quot;)</td>
<td>UMT Services, Inc. serves as General Partner</td>
</tr>
<tr>
<td>UMT Land Development, L.P. (&quot;UMTHLD&quot;)</td>
<td>UMT Services, Inc. serves as General Partner</td>
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<td>Wonder Funding, L.P. (&quot;Wonder&quot;)</td>
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<table>
<thead>
<tr>
<th>Governance</th>
<th>Ownership</th>
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<tr>
<td>UMT Services, Inc. serves as General Partner</td>
<td>10 Limited Partners</td>
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<tr>
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<td>99.9% owned by UMTH</td>
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<td>United Development Funding, Inc., serves as General Partner</td>
<td>41 Limited Partners</td>
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<td>UMTHLD serves as General Partner</td>
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<tr>
<td>One UMT Limited Partner serves as director</td>
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</tbody>
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(2) UMT Services serves as the general partner and owns 0.1% of the limited partnership interests in UMT Holdings, L.P. ("UMTH Holdings"). The remaining 99.9% of the limited partnership interests in UMT Holdings are held as follows as of December 31, 2014: Mr. Etter (30.00%), Mr. Greenlaw (30.00%), Craig A. Pettit (5.00%), Timothy J. Kopacka (4.84%), Michael K. Wilson (7.41%), Christine A. Griffin (1.95%), Cara D. Obert (4.82%), William E. Lowe (1.06%), Ben L. Wissink (10.09%) and Melissa H. Youngblood (4.83%).

*Source: UDF IV 10K (12.31.14)*
WHO OWES THE “DEFICIENCY NOTES”?

Not only do UDF insiders owe the Deficiency Notes through UMT Holdings (“UMTH”), but this entity has a **partners’ deficit** of **$41.3 million (negative balance)**

The primary balance sheet asset is “accounts receivable – related parties” which are primarily fees owed by UDF III and UDF IV and other UDF-managed affiliates.

It would be one thing if the entity that owed the Deficiency Notes had a balance sheet that would indicate an ability to pay; this balance sheet does not.

**The Translation:**

The insiders’ entity that owes the Deficiency Notes is balance sheet insolvent.

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WHAT IS THE INTEREST RATE ON “DEFICIENCY NOTES”? 

Primary interest rate: 1.75%

This rate of interest is below the 10-year U.S. treasury, far below a market rate for an investment grade credit and even further below a market rate for an unsecured Deficiency Note.

The interest rates on Deficiency Notes owed by insiders (1.75%) are significantly lower than the Deficiency Notes owed by third-parties (14.0%).

This does not appear to be an arms’ length transaction; instead, it appears to be evidence of a conflict of interest.

The Translation:

Apparently, insiders and management believe, despite the realized losses, that their private entities are more creditworthy than the U.S. government.

Source: United Mortgage Trust Form 10-Q (9.30.15).
AND WHAT IS A RE COURSE OBLIGATION?

The definition of a recourse obligation is almost identical to the definition of a Deficiency Note.

The recourse obligations are also owed by management and insiders, through private entities, similar to the Deficiency Notes.

The primary interest rate on recourse obligations is also 1.75%, which is far below a market rate.

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The Translation:

Recourse obligations are almost the same as Deficiency Notes. Recourse obligations are also owed by management and insiders, through private entities, and the primary interest rate is also 1.75%.

Source: United Mortgage Trust Form 10-Q (9.30.15).
This recent example from September 2015 highlights the critical issue with recourse obligations (and Deficiency Notes) and the broader implications. 

In this case, a UMT loan issued to an insider’s entity (RAFC), which was secured by real estate, was admittedly impaired by ~67% but management still did not recognize the loss.

The loan had a balance of $15.8 million; the value of the underlying real estate was only $5.1 million.

Despite this fact, management had not previously reserved for the $10.7mm loss on this loan; when it foreclosed, management simply added the loss to the insider “recourse obligation” rather than recognizing the loss in its income statement.

By not recognizing the loss in its income statement, the financial condition of UMT has been obscured.

Once again, management did not recognize a realized loss; instead, it added the realized loss to the “recourse obligation” balance owed by insiders, through private entities, which bears interest at 1.75%.

When UDF management claims that UDF IV has not “realized” any losses, investors should question why they used the term “realized” rather than “incurred.” Even when losses are “realized,” management does not “recognize” the losses. Imagine how management treats losses that have been incurred but just not yet “realized.”

Source: United Mortgage Trust Form 10-Q (9.30.15).

The Translation:

Interim Loan Portfolio Overview

We believe that a pragmatic and pro-active approach to managing our interim loan credits will allow us to maximize repayments and properly report asset values. As part of our transition away from Interim Loans:

- Beginning March 2008, ceased the origination of, and reduced our investment in, interim loans dependent on sub-prime and Alt-A mortgage products for repayment of our loan.
- Effective December 31, 2007, accepted a secured note from UMTLC for shortfalls from foreclosed properties to enable UMTLC to efficiently manage past due and foreclosed accounts throughout the duration of the credit crisis.
- In addition we have:
  - Increased loss reserves for certain deficiency loans where full collection of the indebtedness is not assured.
  - Periodically re-evaluated collateral values on specific loans deemed to be affected by current mortgage and housing environments and reserved for unsecured deficiencies.

- On September 14, 2015 the Company foreclosed on the real estate securing the one remaining interim loan. The estimated value of the real estate is $5,135,000 and is included in Real estate owned, net on the balance sheet. The deficiency of $10,695,000 is guaranteed by RAFC and was added to the RAFC Recourse Obligation balance.
As UMT’s business deteriorated during the financial and housing crisis, management decided to peg the dividend despite the fact that the company has not generated any cash, on a cumulative basis, for the six years following the crisis; UDF III and UDF IV have both provided liquidity to UMT (by acquiring old loans from UMT) which appears to be how UMT continued to fund distributions to its public shareholders.
MANAGEMENT LACKS CREDIBILITY

It appears that Deficiency Notes are used to obscure realized losses and to not recognize the losses in its income statement; the reliability of audited financial statements should also be questioned as this accounting treatment has been signed-off on for years.

- Approximately ten management insiders, through private entities, owe UMT shareholders $73 million in the form of I-OWE-YOUs that were a result of realized (but unrecognized) financial losses.

- For the better part of a decade, management has not recognized actual realized losses in the financial statements (specifically the income statement) of UMT, a public company registered with the SEC.

- It appears that management has allowed a conflict of interest to manifest itself in the form of loans to UDF management and insiders, through their private entities, with interest rates far below a market rate.

- This is not only how UDF management operates UMT; it also appears to be consistent with how management operates UDF III and UDF IV – not recognizing losses incurred on non-performing loans.
THE IMPLICATIONS FOR UDF IV

It appears that Deficiency Notes are used to obscure realized financial losses and to not recognize the losses in its income statement; the reliability of audited financial statements should also be questioned as this accounting treatment has been signed-off on for years.

• Hayman released a case study that highlights the irregular loan patterns related to UDF IV’s largest borrower, Centurion American, including eleven specific examples that show loans (i) not generating any cash, (ii) accruing larger and larger balances for years and (iii) repeatedly being extended upon maturity.

• UDF management claims that “UDF IV has not had any realized losses.”

• UDF IV has incurred losses but these losses have not yet been realized because UDF has not foreclosed on non-performing loans, which creates a misleading picture of the company’s true financial condition.

• In this case study, we highlighted how UDF management has not recognized realized losses in UMT.

• In the case of UDF IV, UDF appears to have followed a similar path by not recognizing losses incurred on non-performing loans.

• Despite having already used UDF V to provide liquidity to UDF IV (which has helped distort the reality of UDF IV’s true financial condition), it appears that the flow of new money into UDF V has just recently been shut-off, as UDF IV and UDF V’s primary fund-raising mechanism, RCS Capital’s broker-dealer, Realty Capital Securities, forfeited its broker-dealer license and filed for bankruptcy in January 2016.

• Typically losses are not realized until the flow of new money coming in runs out; that appears to be the situation that UDF III, UDF IV and UDF V are now facing.