

DVL, Inc. and Subsidiaries

Consolidated Financial Report
December 31, 2017

DVL, Inc. and Subsidiaries

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Independent Auditor's Report

Board of Directors
DVL, Inc.

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of DVL, Inc. and its subsidiaries (the Company), which comprise the consolidated balance sheet as of December 31, 2017, the related consolidated statements of operations, shareholders' equity and cash flows for the year then ended, and the related notes to the consolidated financial statements (collectively, the financial statements).

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DVL, Inc. and its subsidiaries as of December 31, 2017, and the results of their operations and their cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

RSM US LLP

Philadelphia, Pennsylvania
April 30, 2018

DVL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
December 31, 2017
(in thousands)

ASSETS

Residual interests in securitized portfolios	\$ 20,993
Mortgage loans receivable from affiliated partnerships	5,203
Allowance for loan losses	<u>(907)</u>
Net mortgage loans receivable	<u>4,296</u>
Cash	2,302
Investments	
Real estate held for sale	47,752
Real estate (net of accumulated depreciation and amortization of \$1,636)	3,068
Affiliated limited partnerships (net of allowance for losses of \$322)	399
Net deferred tax asset	1,932
Deferred charges and other assets	2,454
Total assets	<u><u>\$ 83,196</u></u>

See notes to consolidated financial statements.

DVL, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
December 31, 2017
(in thousands except share data)
(continued)

LIABILITIES AND SHAREHOLDERS' EQUITY

Liabilities:

Secured debt - real estate held for sale	\$ 33,098
Secured debt - other	20,967
Underlying mortgages payable	98
Accrued construction costs - associated with real estate held for sale	3,183
Accrued liabilities, accounts payable and security deposits	1,748
Total liabilities	<u>59,094</u>

Commitments and contingencies

Shareholders' equity:

Common stock, \$.01 par value; authorized - 12,000 shares; issued and outstanding - 5,401 shares	-
Additional paid-in-capital	96,624
Deficit	(72,522)
Total shareholders' equity	<u>24,102</u>

Total liabilities and shareholders' equity	<u>\$ 83,196</u>
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See notes to consolidated financial statements.

DVL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS
Year Ended December 31, 2017
(in thousands)

Income from affiliates:	
Interest on mortgage loans	\$ 1,111
Gain on satisfaction of mortgage loans	437
Partnership management fees	165
Management fees	314
Transaction and other fees from partnerships	402
Distributions and gains from partnership interests	932
Income from others:	
Interest income - residual interests	3,536
Rental income	2,654
Other income and interest	8
	<u>9,559</u>
Operating expenses:	
General and administrative	2,295
Rental expenses (including depreciation and amortization of \$105)	611
Asset servicing fee - NPO Management LLC	932
Legal and professional fees	826
Recovery of loan losses	(296)
Interest expense:	
Underlying mortgages	33
Affiliates	1,057
Others	1,866
	<u>7,324</u>
Net income before income taxes	2,235
Income tax benefit	<u>1,932</u>
Net income	<u>\$ 4,167</u>

See notes to consolidated financial statements.

DVL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY
Year Ended December 31, 2017
(in thousands except share data)

	Common Stock		Additional Paid-In Capital	Deficit	Total
	Shares	Amount			
Balance - January 1, 2017	5,403	\$ -	\$ 96,632	\$ (76,689)	\$ 19,943
Purchase and retirement of shares	(2)	-	(8)	-	(8)
Net income	-	-	-	4,167	4,167
Balance - December 31, 2017	5,401	\$ -	\$ 96,624	\$ (72,522)	\$ 24,102

See notes to consolidated financial statements.

DVL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
Year Ended December 31, 2017
(in thousands)

Cash flows from operating activities:		
Net income	\$	4,167
Adjustments to reconcile net income to net cash provided by operating activities		
Gain on satisfaction of mortgage loans		(437)
Gains from partnership interests		(800)
Interest accretion on residual interests		(288)
Net increase in accrued interest on debt		1,024
Depreciation and amortization		143
Amortization of prepaid financing costs		106
Recovery of loan losses		(296)
Net increase in other assets		(536)
Net increase in deferred tax assets		(1,932)
Net decrease in accrued construction costs		(3,067)
Net decrease in accounts payable, security deposits and accrued liabilities		(408)
Collections on loans receivable		1,587
Principal collections on residual interests		3,717
Net cash provided by operating activities		<u>2,980</u>

See notes to consolidated financial statements.

DVL, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
Year Ended December 31, 2017
(in thousands)
(continued)

Cash flows from investing activities:

Real estate held for sale	\$ (1,930)
Purchase of units in affiliated limited partnerships	(52)
Leasehold improvements and other	25
Proceeds from liquidation of units in affiliated limited partnerships	1,048
Net cash used in investing activities	<u>(909)</u>

Cash flows from financing activities:

Principal payments on debt	(2,540)
Proceeds from new borrowings	1,113
Payments on underlying mortgages payable	(703)
Prepaid financing costs	(41)
Purchase and retirement of common stock	(8)
Net cash used in financing activities	<u>(2,179)</u>

Net decrease in cash	(108)
Cash, beginning of period	<u>2,410</u>
Cash, end of period	<u>\$ 2,302</u>

Supplemental disclosure of cash flow information:

Cash paid during the period for interest	\$ <u>2,932</u>
Cash paid for income taxes	<u>\$ -</u>

Non-Cash Activity:

Reclassification from Mortgage loans receivables to Real Estate Held for Sale as a result of foreclosure	\$ <u>312</u>
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See notes to consolidated financial statements.

DVL, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Dollars in thousands unless otherwise noted
(except share and per share amounts)

1. Summary of Significant Accounting Policies

a. **THE COMPANY:** DVL, Inc. is a Delaware corporation. DVL is a commercial finance company which is primarily, through subsidiaries, engaged in (a) the ownership of residual interests in securitized portfolios, (b) the ownership and development of real estate, (c) the ownership and servicing of a portfolio of secured commercial mortgage loans made to limited partnerships in which DVL serves as general partner, which we refer to as Affiliated Limited Partnerships and (d) the performance of real estate asset management and administrative services. All references to “DVL,” “we,” “us,” “our,” or the “Company” refer to DVL, Inc. and its consolidated subsidiaries.

DVL’s investments consist primarily of residual interests in securitized portfolios, commercial mortgage loans due from Affiliated Limited Partnerships, limited partnership investments in Affiliated Limited Partnerships and other real estate interests. DVL has six 100%-owned active subsidiaries, all of which are consolidated for accounting purposes. All material inter-company transactions and accounts are eliminated in consolidation. DVL does not consolidate the various partnerships (the “Affiliated Limited Partnerships”) in which it holds the general partner and limited partner interests, except where DVL has control, nor does DVL account for such interests on the equity method due to the following: (i) DVL’s interest in the partnerships as the general partner is a 1% interest, (the proceeds of such 1% interest is payable to the limited partnership settlement fund pursuant to the 1993 settlement of the class action between the limited partners and DVL) (the “Limited Partnership Settlement”); (ii) under the terms of such settlement, the limited partners have the right to remove DVL as the general partner upon the vote of 70% or more of the limited partners; (iii) all major decisions must be approved by a limited partnership Oversight Committee in which DVL is not a member; (iv) there are no major operating policies or decisions made by the Affiliated Limited Partnerships, due to the triple net lease arrangements of the Affiliated Limited Partnership properties; and (v) there are no financing policies determined by the partnerships as all mortgages were in place prior to DVL’s obtaining its interest and all potential refinancings are reviewed by the Oversight Committee. Accordingly, DVL accounts for its investments in the Affiliated Limited Partnerships on a cost basis with the cost basis adjusted for impairments, if any. Accounting for such investments on the equity method would not result in any material changes to the Company’s financial position or results of operations.

b. **RESIDUAL INTERESTS:** Residual interests represent the estimated discounted cash flow of the differential of the total interest to be earned on the securitized receivables and the sum of the interest to be paid to the note holders and the contractual servicing fee. Since these residual interests are not subject to prepayment risk, they are accounted for as investments held-to-maturity and are carried at amortized cost using the effective interest method. Permanent impairments are recorded immediately through results of operations. Favorable changes in future cash flows are recognized through results of operations as interest over the remaining life of the retained interest.

c. **INCOME RECOGNITION:** Interest income is recognized on the effective interest method for the residual interest and all performing loans. The Company stops accruing interest once a loan becomes non-performing. A loan is considered non-performing when scheduled interest or principal payments are not received on a timely basis and, in the opinion of management, the collection of such payments in the future appears doubtful. Rental income is recognized on a straight-line basis in income as rent except for real estate held for sale which is recorded at the contractual rent. DVL records potential rents in the period in which all contingencies are resolved. Management and transaction fees are recognized as earned. Distributions from investments are recorded as income when the amount to be received can be estimated and collection is probable.

d. **ALLOWANCE FOR LOSSES:** The adequacy of the allowance for losses is determined through a periodic review of the portfolios. Specific loss reserves are provided as required based on management’s evaluation of the underlying collateral on each loan or investment.

DVL's allowance for loan losses generally is based upon the value of the collateral underlying each loan and its carrying value. Management's evaluation considers the magnitude of DVL's non-performing loan portfolio and internally-generated appraisals of certain properties.

For the Company's mortgage loan portfolio, the partnership properties are valued based upon the cash flow generated by base rents and anticipated percentage rents or base rent escalations to be received by the partnership plus an estimated residual value at the end of the primary term of the leases. The value of partnership properties which are not subject to percentage rents was based upon estimates of current market value rents and sale prices of similar properties. When any changes in tenants, lease terms, or timely payment of rent have occurred, management revalues the property as appropriate.

Allowances related to the Company's investments in Affiliated Limited Partnerships are adjusted based on Management's estimate of their realizable value.

e. **REAL ESTATE:** Land, buildings and equipment are stated at cost. Depreciation is provided by charges to operations on a straight-line basis over the estimated useful lives (5 to 40 years).

f. **REAL ESTATE UNDER DEVELOPMENT:** The Company capitalizes direct construction and development costs, including predevelopment costs, interest, property taxes, insurance and other costs directly related and essential to the acquisition, development or construction of a real estate project. Construction and development costs are capitalized while substantial activities are ongoing to prepare an asset for its intended use.

g. **REAL ESTATE HELD FOR SALE:** The Company has real estate held for sale that it expects to sell within one year.

h. **PREPAID FINANCING:** Prepaid financing costs are deferred and amortized over the term of the respective debt using the effective interest method. Prepaid financing costs on interest-only loans are amortized using the straight-line method over the term of the financing and are netted against the related liability.

i. **IMPAIRMENT OF REAL ESTATE INVESTMENTS:** Long-lived assets are evaluated for impairment whenever events or changes in circumstances have indicated that an asset may not be recoverable and are grouped with other assets to the lowest level for which identifiable cash flows are largely independent of the cash flows of other groups of assets and liabilities. If the sum of the projected undiscounted cash flows (excluding interest charges) is less than the carrying value of the assets, the assets will be written down to the estimated fair value and such loss is recognized in income from operations in the period in which the determination is made.

A write-down is inherently subjective and is based upon management's best estimate of current conditions and assumptions about expected future conditions. The Company may provide for write-downs in the future and such write-downs could be material.

j. **FEDERAL INCOME TAXES:** All subsidiaries are included in DVL's consolidated federal income tax return.

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carry-forwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

Guidance on accounting for uncertainties in income taxes addresses the determination of whether tax benefits claimed on a tax return should be recorded in the financial statements. Under this guidance, the Company may recognize the tax benefit from an uncertain tax position only if it is more-likely-than-not that the tax position will be sustained on examination by taxing authorities, based on the technical merits of the position. The tax benefits

recognized in the financial statements from such a position are measured based on the largest benefit that has a greater than 50% likelihood of being realized upon settlement. The guidance for accounting for uncertainty in income taxes also addresses de-recognition, classification, interest and penalties on income taxes, and accounting in interim periods. With few exceptions, the Company is no longer subject to U.S. federal, state, or local income tax examinations by tax authorities before 2014.

k. **INTEREST RATE SWAPS:** The Company uses derivatives to manage risks related to interest rate movements on its floating rate loans. All derivatives are recognized as either assets or liabilities on the consolidated balance sheet and those instruments are measured at fair value. Changes in fair value of derivatives are reported as a component of interest expense in the consolidated statement of operations.

The following table summarizes the notional values of the Company's derivative financial instruments. The notional value provides an indication of the extent of the Company's involvement in these instruments on December 31, 2017, but does not represent exposure to credit, interest rate or market risks.

<u>Hedge Type</u>	<u>Notional Value</u>	<u>Rate</u>	<u>Termination Date</u>	<u>Fair Value</u>
Interest rate swap agreement	\$3,000	3.75%	December 31, 2018	\$2

l. **FAIR VALUE OF FINANCIAL INSTRUMENTS:** As disclosed in Note 5, DVL's loan portfolio is valued based on the value of the underlying collateral. As all loans are either receivables from Affiliated Limited Partnerships or are collateralized by interests in Affiliated Limited Partnerships, it is not practical to estimate fair value of the loans. Due to the nature of the relationship between the Affiliated Limited Partners and DVL's general partner interest in the Affiliated Limited Partnerships and the authority of the Oversight Committee, the amount at which the loans and related mortgages could be exchanged with third parties is not reasonably determinable, as any such estimate would have to consider the intention of the Affiliated Limited Partners, the Oversight Committee, the amounts owed, if any, to DVL for its interests in the Affiliated Limited Partnerships and any transaction fees to which DVL might be entitled. See Note 4 for discussions on residual interests.

Financial instruments held by the Company include cash, interest rate swaps, receivables, accounts payable and secured debt. The fair value of cash and cash equivalents, receivables and accounts payable approximates their current carrying amounts due to their short-term nature. Secured debt approximates fair value due to the short-term nature and floating rate interest rates.

The fair value of the Company's interest rate swaps is the estimated amount the Company would receive or pay to terminate these agreements at the reporting date, taking into account current interest rates and creditworthiness of the Company for liabilities. Interest rate swaps are valued using level 2 inputs under the fair value hierarchy. Level 2 inputs are observable inputs for identical or similar assets or liabilities.

m. **USE OF ESTIMATES:** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The allowance for credit losses is subject to significant change in the near term.

n. **CASH AND CASH EQUIVALENTS:** The Company considers all highly-liquid investments with original purchase maturity dates of three months or less to be cash equivalents.

o. **CONCENTRATION OF CREDIT RISK:** The Company has concentration of credit risk in cash, residual interests, mortgage loans receivable and rental income. The risk associated with the residual interests is mitigated by the large number of insurance companies from which the payments are due. Credit risk associated with the mortgage loans receivable is discussed in Note 5. Credit risk associated with rental income is disclosed in Note 10.

The Company maintains cash with several banking institutions, which amounts at times exceed federally insured limits.

p. RECENT ACCOUNTING PRONOUNCEMENTS:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, requiring an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The updated standard (as amended) will replace most existing revenue recognition guidance in US GAAP when it becomes effective and permits the use of either a full retrospective or retrospective with cumulative effect transition method. The Company will adopt the new revenue guidance effective January 1, 2018. The Company has determined that the impact to the net income will be immaterial on an ongoing basis.

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*, which sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract (i.e. lessees and lessors). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight line basis over the term of the lease, respectively. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases today. The new standard requires lessors to account for leases using an approach that is substantially equivalent to existing guidance for sales-type leases, direct financing leases and operating leases. The standard is effective on January 1, 2019, with early adoption permitted. The Company is in the process of evaluating the impact of this new guidance.

In June 2016, the FASB issued ASU 2016-13, *Financial Instruments Credit Losses*. ASU 2016-13 (Topic 326), replaces the incurred loss impairment methodology in current GAAP with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. Financial assets measured at amortized cost will be presented at the net amount expected to be collected by using an allowance for credit losses. Purchased credit impaired loans will receive an allowance account at the acquisition date that represents a component of the purchase price allocation. Credit losses relating to available-for-sale debt securities will be recorded through an allowance for credit losses, with such allowance limited to the amount by which fair value is below amortized cost. This guidance is effective for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. The Company is currently evaluating the impact this standard will have on the Company's financial statements.

2. Impairment of Real Estate Asset

In 2016, during demolition process at the Kearny Site (defined below), the Company discovered significant environmental contamination of the land and buildings which required remediation and caused delays and other costs to be incurred. The Company therefore concluded it had a triggering event requiring an assessment of impairment of its long-lived assets. As a result, the Company reviewed its long-lived assets for impairment and recorded an impairment of \$20,903 in 2016. The impairment was measured under the income and market approaches utilizing forecasted discounted cash flows to determine the fair value of the impaired assets. The inputs utilized in the discounted cash flow analysis are classified as Level 3 inputs within the fair value hierarchy as defined in ASC 820, "Fair Value Measurements and Disclosures."

3. Investments

Real Estate

DVL's real estate properties consist of (i) an approximate 140,000 square foot shopping center on approximately ten acres in Kearny, New Jersey, which was placed in service September of 2016. As of April 2018

the center is fully leased, (“the Kearny Site”), and (ii) an 89,000 square foot building on approximately eight acres of land leased to K-Mart in Kearny, New Jersey which is adjacent to the Kearny Site, (iii) an approximate 37,000 square foot building on approximately six acres in Waldron, Arkansas which the company obtained through foreclosure of a mortgage loan.

The Kearny Site

In 2017, the Company completed construction and lease up of the Kearny Site pursuant to its obligations under the Redeveloper Agreement with the Town of Kearny. The Kearny Site is fully leased to 13 tenants. In addition, the State of New Jersey has approved an urban renewal grant of up to \$9.6 million paid over a period of years, based on the sales tax and other taxes collected from tenants. As of December 31, 2017 \$204 has been received under the urban renewal grant.

The payment obligations and the completion of all work to be performed by the Redeveloper under the Redeveloper Agreement are guaranteed by DVL.

The development was partially funded through loans totaling \$40.5 million (see Note 7 – Secured Debt, Loans Payable Underlying Wrap-around Mortgages).

During the demolition process at the Kearny Site a significant amount of environmental contamination was discovered both in the buildings and in the soil which resulted in significant cost overruns.

In 2016, the Company notified the prior owner of the Kearny Site and its insurance company seeking reimbursement of the Company’s costs for the removal of the environmental contamination which it asserts was the responsibility of such prior owners. A mediation during May 2017 was unsuccessful. Accordingly, in June, 2017, the Company filed suit in the U.S. District Court for the District of New Jersey against such prior owner. The defendant then interpleaded a third party as an additional defendant. Motion practice and discovery are currently in process. Because the claim remains unresolved, the Company has not included any recovery from the prior defendants in determining its impairment. There is no assurance that a successful resolution will be reached.

Cost basis, net of accumulated depreciation, of the Kearny Site at December 31, 2017 was \$68,393 and as noted above, the Company recorded an impairment in 2016 of \$20,903 resulting in a net carrying value of \$47,490. Embedded in the net carrying value is the net present value of the urban renewal grant of \$5,561 and deferred revenue of \$5,698.

In April, 2018 the Company entered into an agreement with an unrelated third party to sell the Kearny Site for \$45.5 million less certain selling expenses. This agreement is subject to certain conditions including the buyer’s right to terminate if it is unsatisfied with its due diligence. There can be no assurance that such sale will be consummated.

The Bogota Property

DVL is the owner of land underlying a certain warehouse property located in Bogota, New Jersey (the “Bogota Property”). The land and buildings are master leased to two unaffiliated limited partnerships (“Associates”). Prior to 1984, the Company subleased the Bogota Property back from Associates pursuant to a master sublease and entered into space leases with unaffiliated tenants. In October 2004, the Company agreed to cancel the leasehold of Associates and to permit Associates to acquire the land in the future for a nominal consideration in exchange for cancellation of the master sublease, payment of 50% of certain environmental remediation costs, and, upon the sale of the property, reimbursement of certain costs expended in connection with the environmental remediation described below.

The Company had previously discovered environmental contamination resulting from actions taken by prior owners of the Bogota Property. To date, the Company has expended in excess of \$1,620 to remediate the contamination and has collected approximately \$400 from the settlement of lawsuits against such prior owners. The

Company continues to process the remediation of the contamination thereof. At the present time, based on information provided by the environmental consultants, the Company has accrued \$119 as the remaining cost of cleanup to the facility.

Associates agreed to sell the Bogota Property to an unrelated third party who is currently leasing the Bogota Property. As described above, upon a sale of the property, Associates further agreed to reimburse the Company for its out-of-pocket costs incurred in connection with the environmental remediation plus \$50. To date, as a result of the environmental contamination, the sale has not occurred though the sale agreement has been extended. A sale will not occur until the Company has completed its environmental remediation or the buyer has agreed to assume the cleanup obligation in exchange for a reduction in the sales price. There can be no assurance that such sale will be consummated.

Summary of Real Estate (K-Mart property) (in thousands):	
Land and land improvements	\$ 303
Buildings	4,016
Improvements	385
Subtotal	4,704
Less: Accumulated depreciation	1,636
Total	\$ 3,068

Affiliated Limited Partnerships

DVL acquired various interests in Affiliated Limited Partnerships pursuant to the Terms of certain settlement agreements and through purchases. Allowances are adjusted based on Management's estimate of the realizable value. During 2017, DVL recorded income of \$932 from distributions received from these investments.

The activity on DVL's investments in Affiliated Limited Partnerships is as follows (in thousands):

Balance, beginning of year (net of allowance)	\$ 595
Purchase of Units	52
Cost of Units sold	(248)
Balance, end of year (net of allowance)	\$ 399

4. Residual Interests in Securitized Portfolios

The Company, through its wholly-owned consolidated subsidiary, S2 Holdings, Inc. ("S2"), owns 99.9% Class B member interests in two limited liability companies. The Class B member interests, which are consolidated into S2 for financial statement reporting purposes, entitle the Company to be allocated 99.9% of all items of income, loss and distribution of the limited liability companies. The limited liability companies receive all the residual cash flow from five securitized receivable pools after payment to any securitized note holders. The Company considered whether the member interests should be considered variable interest entities when consolidating S2's ownership of its member interests, and determined that S2's member interests do not meet the definition of variable interest entities.

Any impairment, other than a temporary impairment, if any, is recorded immediately through results of operations. The Company performs quarterly comparisons of fair value to carrying value and updates the expectation of cash flows to be collected over the life of the residual interests. Favorable changes in future cash flows are recognized through results of operations as interest over the remaining life of the residual interest.

The following table presents the key economic assumptions at December 31, 2017 and the sensitivity of the current fair value of residual cash flows to immediate 10% and 20% adverse changes in those assumptions (in thousands):

Carrying value of residual interests	\$	20,993
Fair value of residual interest	\$	20,533
Weighted-average life (in years)		2.8
Expected credit losses		2.4%
Impact on fair value of 10% adverse change	\$	50
Impact on fair value of 20% adverse change	\$	100
Discount rate		16.1%
Impact on fair value of 10% adverse change	\$	670
Impact on fair value of 20% adverse change	\$	1,302

Those sensitivities are hypothetical and should be used with caution. Also, in this table, the effect of a variation in a particular assumption on the fair value of the residual interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another which might magnify or counteract the sensitivities.

5. Mortgage Loans Receivable

At December 31, 2017, the Company's mortgage loan portfolio consisted of 9 first mortgage loans with a net carrying value of \$4,196 and one wrap-around mortgage loan with a net carrying value of \$100. Substantially all of the Company's mortgage loans are collateral for various debt.

With respect to 6 of the loans in the Company's mortgage loan portfolio with net carrying values of \$2,033 as of December 31, 2017, the tenant of the underlying property is Wal-Mart Stores, Inc. Accordingly, a bankruptcy of, or lease termination by Wal-Mart would have a material negative impact on the Company's ability to realize full value on these loans. The leases to Wal-Mart expire at various dates from 2019 through 2034.

In addition to base rent, some of the leases to Wal-Mart require the tenant to pay additional rent equal to a percentage of gross receipts from the tenant's operation of a property above a specified amount. In all cases where additional rent is payable, a portion of the additional rent is required to be paid to us as additional interest and/or additional debt service on our mortgage.

The following table presents the activity in the mortgage loans:

Activity on all collateralized loans is as follows (in thousands):

Balance, beginning of year - individually evaluated for impairment	\$	6,665
Collections ⁽¹⁾		(1,587)
Transfer to Real Estate Held for Sale		(312)
Gain on satisfaction of mortgage loans		437
Balance, end of year - individually evaluated for impairment	\$	<u>5,203</u>

(1) A substantial amount of the collections was used to pay secured lenders.

6. Allowance for Losses

Allowance for loan loss activity is as follows (in thousands):

Balance, beginning of year	\$ 1,253
Transfer to Real Estate	(50)
Recovery of loan losses	<u>(296)</u>
Balance, end of year	<u>\$ 907</u>

All loans are evaluated individually for impairment. A summary of DVL's loan portfolio is as follows (in thousands):

	<u>Recorded Investment</u>	<u>Related Allowance</u>	<u>Interest Income Recognized</u>
Performing loans with an allowance recorded	<u>\$ 4,101</u>	<u>\$ 907</u>	<u>\$ 439</u>
Performing loans with no allowance recorded	<u>\$ 1,102</u>	<u>\$ -</u>	<u>\$ 672</u>

7. Secured Debt, Loans Payable Underlying Wrap-around Mortgages

Outstanding loans payable as of December 31, 2017 which are scheduled to become due at various times through 2022 are as follows (in thousands):

<u>Creditor</u>	<u>Original Loan Amount</u>	<u>Outstanding Balance Including Accrued Interest at December 31, 2017</u>	<u>Interest Rate</u>	<u>Maturity</u>	<u>Amount due at Maturity</u>
Unaffiliated Bank ⁽¹⁾	\$ 3,000	\$ 567	Swapped to fixed 3.75%	12/31/2018	\$ -
Unaffiliated Bank ⁽²⁾	\$ 8,500	\$ 6,292	4.75%	7/5/2019	\$ -
Unaffiliated Bank ⁽³⁾	\$ 3,600	\$ 2,884	LIBOR + 220 basis points	5/1/2018	\$ 2,859
Unaffiliated Bank ⁽⁴⁾	\$ 30,000	\$ 30,099	LIBOR + 240 basis points	3/3/2019	\$ 29,688
Unaffiliated Bank ⁽⁵⁾	\$ 3,000	\$ 3,012	LIBOR + 270 basis points	3/3/2019	\$ 3,000
Unaffiliated Bank ⁽⁶⁾	\$ 500	\$ 323	4.00%	1/1/2021	\$ -
Affiliated Lender ⁽⁷⁾	\$ 5,500	\$ 5,786	8%, plus 1% origination and 1% exit	4/21/2019	\$ 5,786
Affiliated Lender ⁽⁸⁾	\$ 5,000	\$ 5,153	10%, plus 1% origination and 1% exit	12/31/2019	\$ 5,153
		<u>\$ 54,116</u>			
Less: Unamortized debt issuance costs		<u>(51)</u>			
		<u>\$ 54,065</u>			

- (1) Secured by first priority interest in five first mortgages.
- (2) Collateralized by common stock of S2.
- (3) Secured by certain real property. The Company is currently negotiating a refinancing of this loan.
- (4) During 2014, the Company entered into a \$30 million construction loan with an unaffiliated bank for the construction of the Kearny Site. As of December 31, 2017, \$30 million of the loan had been advanced. Secured by certain real property. The third amendment to the loan requires monthly interest payments plus monthly principal payments of \$34 beginning in May of 2018.

- (5) Secured by interest in a wholly-owned entity which owns the Kearny Site. Principal payments equal to 80% of amounts received under the urban renewal grant.
- (6) Office improvement loan secured by certain leasehold improvements
- (7) Loan from certain affiliates and/or officers and directors of the Company to facilitate completion of the construction at the Kearny Site. Partially secured by certain mortgage loans receivable.
- (8) Loan from certain affiliates and/or officers and directors of the Company to facilitate completion of the construction at the Kearny Site. Partially secured by certain mortgage loans receivable, subordinated to item (7) above.

The aggregate amount of debt and loans payable underlying wrap-around mortgages (Note 5) maturing during the next five years is as follows (including required principal amortization):

	Debt	Loans Payable Underlying Wrap Around Mortgages
	(in thousands)	
2018	\$ 7,752	\$ 98
2019	46,247	-
2020	108	-
2021	9	-
2022	-	-
Thereafter	-	-
	<u>\$ 54,116</u>	<u>\$ 98</u>

8. Redeemed Notes Payable – Litigation Settlement

In December 1995, DVL completed its obligations under a 1993 shareholder settlement by, among other things, issuing notes to the plaintiffs (the “Notes”). As of December 31, 2017 Notes of \$763 remain payable. This liability is reflected as a non-interest bearing liability and is included in accrued liabilities.

9. Transactions with Affiliates

Management Fee Income Earned:

The Company earned fees for providing accounting and administrative services to certain entities which are affiliated with NPO Management, LLC (“NPO”) which are entities engaged in real estate lending and management transactions and are affiliated with certain shareholders and insiders of the Company. As compensation, the Company recorded fees of \$314 in 2017.

Management and Other Fees and Expenses Incurred:

- A. The Company incurred fees to NPO of \$932 under an Asset Servicing Agreement (the “Asset Servicing Agreement”) between the Company and NPO, pursuant to which NPO provides the Company with asset management, advisory and administrative services relating to the assets of the Company and its Affiliated Limited Partnerships. During 2017, the Company provided office space under the Asset Servicing Agreement to NPO consisting of approximately 500 square feet of the Company’s New York location.
- B. The Developer Services Agreement (the “Developer Services Agreement”) with P&A Associates and affiliates of NPO (collectively, the “Developer”) provides that the Developer will provide services with respect to the development, construction and leasing of the Property as well as providing a completion guarantee to the Town of Kearny. The Developer’s obligations under the Developer Services Agreement have been satisfied.

Pursuant to the Developer Services Agreement, the Developer will be paid a development fee equal to: (X) 4% of all project costs associated with the development of the Property (excluding financing costs) as specified in the Developer Services Agreement and (Y) a 0.5% of base rent leasing commission on signed leases once the tenant takes possession of the leased space. Additionally, the Developer could be paid 20% of the net cash flow generated by the project as a result of operations, refinancing and/or sale after the Company receives from operations a 15% return on its net cash investment and in the event of a refinancing or sale, the return of its net cash investment plus a 15% return on such investment (the "Contingent Payment"). Based upon the environmental costs it is unlikely that any amounts will be paid relating to the Contingent Payment. As of December 31, 2017, the Company had paid \$627 and \$1,969 remained accrued under the Developer Services Agreement.

- C. The Millennium Group, an affiliate of NPO, received approximately \$140 for 2017 representing management and analytical services and note collection services.
- D. The Philadelphia, Pennsylvania, law firm of Zarwin Baum DeVito ("Zarwin"), of which Alan E. Casnoff, the President, Chief Executive Officer and a director of the Company, is of counsel, has acted as counsel to the Company since November 2004. During 2017, the Company paid Zarwin \$421 for legal services.
- E. During 2016 and 2017 Pemmil Funding II LLC and Pemmil Funding III LLC loaned the Company \$5.5 million and \$5.0 million, respectively, in order to facilitate completion of construction of the Kearny Site. Certain members of Pemmil Funding II LLC and Pemmil Funding III LLC are affiliates and/or officers and directors of the Company. During 2017 the Company accrued interest of \$1,004 and paid accrued interest of \$1,067 on the two loans.

10. Commitments, Contingent Liabilities and Legal Proceedings

Legal Proceedings

The Company is a defendant in a binding arbitration proceeding brought by a subcontractor on the Kearny Site seeking additional amounts due. The Company believes that the claim is without merit and is vigorously defending such action. The Company believes that it has adequately reserved an amount which it reasonably expects to be due to such subcontractor.

As discussed in Note 3 above, in 2016, the Company notified the prior owner of the Kearny Site and its insurance company seeking reimbursement of the Company's costs for the removal of the environmental contamination which it asserts was the responsibility of such prior owners. A mediation during May 2017 was unsuccessful. Accordingly in June, 2017 the Company filed suit in the U.S. District Court for the District of New Jersey against such prior owner. The defendant then interpleaded a third party as an additional defendant. Motion practice and discovery are currently in process. Because the claim remains unresolved, the Company has not included any recovery from the prior defendants in determining its impairment. There is no assurance that a successful resolution will be reached.

Commitments and Contingent Liabilities

Pursuant to the terms of the Limited Partnership Settlement, a fund has been established into which DVL is required to deposit 20% of the cash flow received on certain of its mortgage loans from Affiliated Limited Partnerships after repayment of certain creditors and 50% of DVL's receipts from certain loans to, and general partnership investments in, Affiliated Limited Partnerships. During 2017, the Company expensed approximately \$162 for amounts due to the fund based on cash flow on mortgage loans of which \$0 was accrued at year end. These costs have been netted against interest on mortgage loans, where appropriate.

The Company leases space to various tenants under lease terms that include escalation provisions, renewal options and obligations of the tenants to reimburse operating expenses. As of December 31, 2017, the Company had

two tenants that comprised 78% of the rented square footage and 70% of the base rental income. No rents were outstanding at December 31, 2017 from these tenants.

The aggregate future minimum fixed lease payments receivable under non-cancellable leases at December 31, 2017 are as follows (in thousands):

<u>Year Ending</u>	<u>Real Estate</u>	<u>Real estate held for sale</u>
2018	\$ 364	\$ 2,871
2019	364	2,903
2020	364	2,903
2021	121	2,938
2022	-	3,057
Thereafter	-	30,201
	<u>\$ 1,213</u>	<u>\$ 44,873</u>

DVL leases premises comprising approximately 5,600 square feet. The lease expires October 31, 2025. During the first extended term, from April 1, 2015 to October 31, 2020 base rent is \$315 per year. During the second extended term, from November 1, 2020 to October 31, 2025, base rent is \$338 per year. Rent expense was \$333 in 2017.

The future minimum rentals during the next five years are as follows (in thousands):

<u>Year Ending</u>	<u>Amount</u>
2018	\$ 315
2019	315
2020	319
2021	338
2022	338
Thereafter	<u>958</u>
	<u>\$ 2,583</u>

The Asset Servicing Agreement, pursuant to which NPO is providing the Company and the Affiliated Limited Partnerships with administrative, management, and advisory services, requires monthly payments of approximately \$76 through March 2017, with cost of living increases. Expense under the Asset Servicing Agreement was \$932 in 2017. In January 2017, the Asset Servicing Agreement was extended through March, 2020 under the same terms and conditions.

11. Shareholders' Equity

Stock Compensation Plans

In November 2012, the Company adopted the DVL, Inc. Stock Compensation Program for Directors, Officers and Consultants. In January of 2018 the Company granted 14 shares of common stock to the independent directors of the Company.

12. Income Taxes

The (provision) benefit for income taxes for the years ended December 31, 2017 was as follows (in thousands):

Current Benefit (Provision)	
Federal	\$ -
State	-
Total Current Benefit (Provision)	<u>-</u>
Deferred Benefit (Provision)	
Federal	1,932
State	-
Total Deferred (Expense) Benefit	<u>1,932</u>
Total (Expense) Benefit	<u>\$ 1,932</u>

The Company's effective income tax rate as a percentage of income differed from the U.S. federal statutory rate primarily due to a change in the valuation allowance.

Deferred taxes result from timing differences in the recognition of revenue and expense for tax and financial reporting purposes. The major components of deferred tax assets and the provision for deferred taxes were the following: tax basis of land and building in excess of book, net operating loss carry-forwards, residual interests, mortgage loans receivable, and AMT credits. The Company has determined that a full valuation reserve was necessary on the deferred tax assets with the exception of the AMT credits which are expected to be refunded under the Tax Cuts and Jobs Act of 2017 by the year 2022.

Deferred tax assets and the valuation allowance against deferred tax assets as of December 31, 2017 are detailed below (in thousands):

Net Deferred Tax Assets	\$ 13,900
Valuation Allowance	<u>(11,968)</u>
Net Deferred Tax Assets after Valuation Allowance	<u>\$ 1,932</u>

The deferred tax asset and valuation allowance at December 31, 2017 were reduced as a result of the enactment of the Tax Cuts and Jobs Act of 2017, which reduced the Federal Corporate tax rate from 34% to 21%.

At December 31, 2017, the Company had aggregate unused net operating loss carry forwards of approximately \$22,487. These credits expire as follows (in thousands):

2018	\$	1,022
2019		586
Thereafter through 2037		20,879
	<u>\$</u>	<u>22,487</u>

The Company has assessed the tax positions of the federal and state tax returns for all open years (2014 through 2017) and has concluded that it has no material uncertain tax liabilities to be recognized.

13. Fair Value Measurements

The following table shows the Company's non-financial assets that were measured at fair value during 2017:

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Real estate held for sale	\$ 47,752	\$ -	\$ -	\$ 47,752

See Note 2 for additional information regarding the fair value of the real estate held for sale.

During 2016, real estate held for sale with a carrying value of \$66,467 was written down to its fair value of \$45,564, resulting in an impairment charge of \$20,903. The fair value was calculated based on the projected cash flows and an estimated risk-adjusted rate of return that would be used by market participants in valuing these assets or prices of similar assets.

14. Subsequent Events

The Company has evaluated subsequent events through April 30, 2018, the date at which its financial statements were available to be issued.

In January 2018, the Company granted 14 shares of common stock to the independent directors of the Company under the Stock Compensation Program for Directors, Officers and Consultants.

In March 2017, Sears Holdings ("Sears") published their audited financial statements which indicated that the Sears Holdings may not be able to continue as a going concern. A bankruptcy of Sears, which includes K-Mart stores, could have a material impact on the value of the Company's real estate in Kearny, NJ. There were no further updates regarding Sears during 2018.