

REAL ESTATE FINANCING STRATEGIES FOR 2005

Different property situations require varying financing strategies

If you are a real estate investor, developer, or mortgage banker and haven't been lost in a deep sleep for the past 5 years, you are probably very much aware that there is an abundance of capital available for commercial and multifamily real estate throughout the United States. This capital is available to all tranches of the real estate capital stack – from senior debt to mezzanine debt to preferred and joint venture equity. Add to the profusion of capital the current low level of interest rates, which is affecting the cost of the latter tranches of capital, and we have a very borrower/sponsor-friendly environment.

The capital that is trying to enter the real estate market - and more importantly, the right real estate deals – is coming from a broad variety of sources including banks, finance companies, opportunity funds, hedge funds, high net worth individuals, pension funds, life companies and Wall Street. Additionally, many of these capital sources are targeting more than one tranche of the capital stack. For example, pension funds may provide senior loans and equity, whereas finance companies may provide bridge loans and mezzanine loans. While more expensive than senior debt, mezzanine loans are still less expensive than they have been historically due to the current interest rate environment and competitive nature of the capital markets.

With all of the relatively cheap capital available to the current real estate market, real estate developers and investors should take advantage of the present situation. The financing strategies one develops and follows should be related to one's investment and development goals. A list of a few of the basic real estate financing strategies follows.

ACQUISITION FINANCING STRATEGIES FOR STABLE ASSETS

Financing strategies will differ according to the type of underlying asset. Acquiring a stable asset can result in several scenarios.

Financing strategies used to acquire real estate are usually governed by the amount and cost of equity one has available for the investment, as well as the volume of investments one expects to make over time. At one extreme is the investor with an overabundance of equity and the intention to acquire only one asset. If this investor does not have any alternative uses for his equity, then his/her financing strategy would probably be a very simple one: a moderate level of senior debt (say, 65 percent to 75 percent of cost) with the balance of the capital requirement made up of the investors own equity.

However, for most real estate investors, personal equity is probably not in endless supply and investors may have competing demands on the available equity, including future acquisitions. In this case, the financing strategy might involve incorporating high-leverage senior debt (say, 80 percent of cost), plus mezzanine debt up to 90 percent of cost. Many investors/sponsors will also bring in outside equity in the form of preferred equity or joint venture equity to reduce the amount of cash equity the sponsor has to contribute to the transaction. These days, there are more and more real estate acquisitions financed at the 90 percent-and-higher leverage level at very competitive blended interest rates.

Obviously, the higher the leverage level of debt (or mezzanine or equity) that is required in any given real estate

transaction, the higher the cost of that capital, given the greater levels of risk. However, the higher leverage



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and the mezzanine and/or equity will allow many investors to partake in transactions in which they may not otherwise have been able to be involved. It will also allow these same sponsors to acquire more properties than they would have otherwise with the same amount of sponsor equity capital, thereby allowing them to diversify their risk and rewards across multiple properties.

DEVELOPMENT FINANCING STRATEGIES FOR ASSETS IN TRANSITION

Development projects, as well as the acquisition of transitional assets, require different financing strategies than the acquisition of stable assets. Development, by definition, is the creation of value where it did not exist before. Whether constructing condominium units, grocery-anchored retail properties, office buildings, industrial properties, hotels, or developing land by obtaining entitlements and/or providing infrastructure, developers are creating value in a property that did not exist before they

improved it. If they are not creating value, in most instances it could be argued that the project should be scrapped.

Because developers are creating value, there should be more upside- projected return or profit- in a development project than in a stable property acquisition, but there is usually more risk as well. Therefore, due to the likely upside there is more room for creative capital structures to finance viable development projects. However, development capital typically comes with price tag above the cost of capital for more stable properties.

As with acquisition financing strategies, the crucial variables for development financing strategies, after project viability, are the amount of equity capital a developer has and the size of the developer's pipeline- both anticipated and actual. If a developer is flush with cash equity and little alternative investment options, he may choose to capitalize his project with a moderate level of senior debt and his own cash equity. However, the majority of developers would prefer to ration their own equity capital and leverage the amount and size of projects they can take on by using OPM (other people's money).

To maximize the use of other people's money, first, a developer must have a viable project with a reasonable amount and likelihood of upside. Once that is established, it is very possible to put together a capital structure that optimizes the project financing for the developer. This should include high-leverage senior debt and mezzanine debt, at a minimum. In most instances, developers can further optimize the capital stack and reduce their exposure to risk by using OPM equity, which is available through institutional providers or high net worth individuals. Developers will give up a substantial piece of the project's profits in exchange for the use of OPM equity. But, again, this equity will enable most developers to complete larger and more transactions than they would have otherwise. Most developers use OPM, either from friends and family, or some of the many forms of institutional equity.

The make-up of the capital stack will vary from project to project and risk profile to risk profile. For example, it is easier to get high-leverage, low-cost senior debt for a well located multifamily apartment project than it is for a frontier-breaking hotel project. That said, both projects can get financed if they are economically viable and are sponsored by

developers with the proper amount of experience relative to the deal. However, the hotel project will probably require more equity (OPM or otherwise) and its financing will be more expensive than the apartment project.

Lower risk profile projects should be able to get senior financing of between 75 percent and 85 percent of cost. Some lenders provide higher leverage financing of 85 percent to 90 percent of cost that is in reality a blend of senior debt and mezzanine debt and is priced that way. Mezzanine debt can generally get a project between 85 percent and 90 percent of cost, and OPM equity can go up to 98 percent of cost. Note: mezzanine and equity are somewhat subjective terms because even capital at 98 percent of cost can be structured to look like mezzanine debt. However, no matter what it looks like, capital that goes to 98 percent of project cost will be priced like equity. The yield requirements on OPM equity will vary from provider to provider based on their cost of capital and targeted returns, as well as the risk profile of the underlying real estate project.

REFINANCING STRATEGIES

The following refinancing strategies typically apply to relatively stable properties. Those who are refinancing properties that are still in transition will likely use development financing strategies.

Anyone seeking to refinance a stable property, is probably doing so for one or more of the following reasons:

- It was a transitional or development property that has recently stabilized
- The existing debt is maturing
- The owner wants to take advantage of current interest rate levels and lock them in for the medium to long term
- The owner wants to take advantage of value creation and finance out some or all of the equity (cash out refinance)

Unless there is some level of value creation, it is less likely that a stabilized refinance will involve OPM equity. The property owner must basically decide between low and moderate senior debt leverage, and high senior debt leverage. As in other situations, the decision will usually be based on the investor's need for capital. If it is not needed, lower

leverage will be preferred. If it is needed, or the investor has other actual or expected uses for the capital, higher leverage debt could be used. Most conventional commercial and multifamily senior debt maxes out at 75 percent to 80 percent of value. In some cases, investors can get to 85 percent to 90 percent of value if they either use mezzanine debt or a lender that blends senior and mezzanine debt. Real estate owners can get fairly high leverage refinancing proceeds for fixed-rate terms ranging from 5 years to 20 years, with 10-year terms being the norm. Amortization schedules can range up to 30 years.

THE TWO BASIC SCENARIOS OF FINANCING STRATEGIES

The common thread that runs through the above financing strategies is the investor or developer appetite for OPM (mezzanine or equity). There are two basic scenarios with an infinite number of variations in between: one, the investor/developer is flush with equity capital and has little alternative uses for the capital and is therefore willing to invest substantially in his own real estate acquisition or project – or, two, the investor/developer would rather use OPM equity for the bulk of the acquisition or project equity requirement. In the former scenario the investor would probably use a low to moderate leverage financing strategy. In the latter scenario, the investor would use a high leverage senior debt strategy together with mezzanine debt and/or OPM equity.

The two competing overarching strategies are simple conceptually. The complexities really lie in implementing the second financing strategy: the structuring of the optimal high leverage OPM capital stack that provides the investor/developer with both the funds and cost of funds that will allow them to acquire or develop their property/project while retaining the greatest possible return. This is a worthwhile goal for most middle market investors and developers.

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