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How to leverage your acquisition financing and reduce your equity requirement

David Ross

Tremont Realty Capital

If you are a commercial real estate borrower or investor one of your primary focuses is the efficient allocation of resources, both human and capital, so that you can optimize your returns. One way to ration your equity capital so that you can acquire more properties or larger assets is to increase the leverage (debt) you are using to acquire your real estate assets. It's becoming more and more common for real estate investors to use very high leverage debt to acquire real estate. Many borrowers are using 90% leverage or more to finance their acquisitions. This is a contrast to the old life company debt model that limited senior loans to 65% to 75%.

Many investors are using high leverage debt to reduce the amount of equity that would otherwise be necessary to make the same real estate acquisition. For example, a $50 million acquisition would require at least 25% equity, or $12.5 million using the old life company model. Under the 90% high leverage model, the investor only has to contribute $5 million to close the deal – a $7.5 million equity savings. While the higher leverage debt will have an incremental cost associated with it, the cost will be much less than the usual costs associated with an additional equity investment. As an evolution from the "hard money" high leverage loan products of the past, high leverage often comes from institutional lenders, has no participation requirements and is non-recourse (with traditional lender carveouts only).

Some equity costs are hard to calculate. Many borrowers would have to use outside equity to fill the gap cited above. In that instance there is of course the return requirement from the outside equity investor and then there is the unquantifiable cost of having additional decision makers involved in the borrower's business. If you are a developer/real estate investor lucky enough to have the capital resources necessary to fund this acquisition example, the cost of providing the incremental $7.5 million is the opportunity cost on the investment. What else could you have accomplished with the incremental capital? Another acquisition? A larger acquisition? A rainy day emergency fund? All of the above?

There are several ways high leverage financing is being reached today. The first and easiest way is to find a single lender that specializes in this product and can provide a one-stop high leverage loan. The second way is to find a lender or mortgage advisor that can "structure" a high leverage loan for you. And, the third and final method is to piece the financing together yourself. I highly recommend one of the first two methods.

There are a few capital providers who specialize in high leverage loans. Most specialize in high leverage bridge loans, which are shorter-term loans that envision some sort of property transition or repositioning to allow them to be paid off in one to three years. Others can provide high leverage permanent loans. However, most of the latter fall into the second category, where they are actually structuring the debt (or a portion of the debt) rather than providing 100% of it. These lenders or mortgage advisors have the capability to put together or "structure" the high leverage debt by bringing in various tranches of debt that in the aggregate add up to the, say, 90% the borrower is seeking. For example, the lender may be a mezzanine loan provider that can fund mezzanine tranche debt in the 75% to 90% piece of the capital stack. If they can price this slice appropriately and "stack" it on a 75% or 80% senior loan, the result is a 90% loan for the borrower. The blended cost of the structured loan should be roughly equivalent to the cost of a 90% loan from a single lending entity if the individual tranches are priced appropriately. Many of the mezzanine capital providers have existing relationships with conventional senior lenders who are eager to work together to provide the high leverage debt that a greater number of borrowers are seeking.

It should be noted that the variations in structuring and tranching of high leverage debt can be almost endless. There are transactions where a senior loan was split into A and B tranches, with a mezzanine tranche above those and preferred equity tranches layered above the mezzanine, but no matter the stratification of the capital, the concept is the same: appropriately place the layers of capital so that the net total cost is most efficient to the borrower.

High leverage debt is usually priced appropriate to the risk of the underlying transaction and asset. Numerous borrowers use high leverage financing to acquire real estate assets.

In summary, high leverage debt exists and is becoming more and more common for acquisition transactions. Borrowers and real estate investors should seriously consider using high leverage financing to replace or reduce the equity requirements of real estate transactions. The debt can usually be provided at a considerable savings over a similar sized equity investment. The bottom-line benefits are: lower cost of capital, fewer equity partners, and the ability to complete more transactions with the same amount of equity capital.

David Ross is senior director at Tremont Realty Capital, Boston, Mass.