

# Real Estate Journal

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## Higher leverage financing in real estate transactions expected to continue through 2005

**A** surging phenomenon seen in 2004 and expected to continue into next year is the abundance of higher leverage real estate transactions. If you are a commercial real estate borrower or investor, in order to optimize your returns one of your primary focuses has to be the efficient allocation of resources, both human and capital. 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%.

### Why High Leverage?

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 \$50MM acquisition would require at least 25% equity, or \$12.5MM using the old life company model. Under the 90% high leverage model, the investor only has to contribute \$5MM to close the deal – a \$7.5MM 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.

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 \$7.5MM 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?

### Structuring High Leverage

There are several ways to achieve high leverage financing. 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.

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 1 to 3 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, if

the concept is the same: appropriately place the layers of capital do that the net total cost is most efficient to the borrower.

There are a wide array of high leverage “lenders” that actually stratify and sell-off pieces of the debt transaction post-closing in a fashion that is blind to the borrower. Many borrowers think that they are closing a loan with the “lender” when in fact the lender is actually the financial engineer and may be keeping only a small piece of the debt pie and selling off the remaining tranches. Some of the most recognized names in the industry are actually engineering a substantial amount of their loans, rather than wholly funding them. In any event, it should not matter to the borrower, as long as they are dealing with reputable firms with the resources to either close the loan or financially engineer it.

### **Current High Leverage Pricing**

High leverage debt continues to be priced according to the risk of the underlying transaction and asset. If one were acquiring an empty office building with the hopes of leasing it up and selling it in today’s market, the cost of the debt should be much greater than if one were acquiring a stabilized and cash flowing apartment complex. That said, the incremental cost of leverage for either of the latter transactions is sure to be less than the cost of that same increment if it were filled by equity. And, debt should be much less of a headache than an equity partner.

Numerous borrowers use high leverage financing to acquire real estate assets. Many have been the recipients of very low-priced high leverage debt. In today’s market, an experienced borrower can close on a retail or apartment acquisition with 90% financing in the mid-single digit interest rate range (say, 6% to 6.5%), if they are willing to put permanent fixed-rate debt financing in place. Less stable or more transitional properties may require a high leverage bridge loan, which will be priced in a risk-adjusted fashion and should be priced appropriate to the transaction and underlying asset. An example would be a recent apartment to condo conversion, the borrower received 90% of cost, non-recourse financing at just over 10%

### **Conclusion**

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 costly 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.

*Tremont Realty Capital, LLC is a national direct lender and real estate investment-banking firm headquartered in Boston, with offices in Annapolis, Hartford, New York, Chicago, McLean and Scottsdale. Through its principal and advisory operations, the firm engages in debt and equity placement, direct investment and institutional advisory services. Tremont Realty Advisors is also the manager of the Tremont-GRE Mezzanine Loan Program. The Boston office of Tremont Realty Capital is located in the Prudential Tower at 800 Boylston Street, Suite 401, Boston, MA 02199. The phone number is 617.867.0700 and the fax number is 617.867.0077. You can visit Tremont on the Internet at [www.tremontcapital.com](http://www.tremontcapital.com) or email David Ross directly at [dross@tremontcapital.com](mailto:dross@tremontcapital.com).*