NJPA Financial Digest

By David Ross, Tremont Realty Capital

Simplifying today's highly structured financial markets

It is 2006 and the capital markets have made great inroads into the real estate industry. In the not to distant past, real estate finance was synonymous with banking. If a developer needed financing for a real estate project, he approached his local bank for a development or acquisition loan and filled in the gap with equity from his own balance sheet and that of friends and family. Today, there are less local banks, as well as much greater financing alternatives for the real estate investor/developer **(see graph below).**

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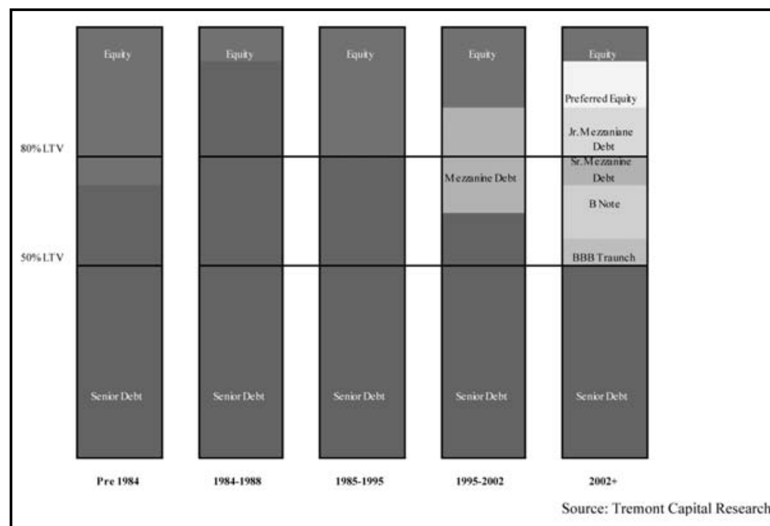

REAL ESTATE FINANCE

Evolution:

- Prior to 1984 the Real Estate Capital Markets were largely a private industry: Equity was mostly in private companies with no reporting requirements. Leverage was primarily from banks or life companies which were typically private or mutual companies with minimal public reporting requirements.
- This resulted in poor information flows and led to continued overbuilding well into recessions exasperating the general economic decline and causing major peaks and valleys in real estate investment returns. These BOOM and BUST cycles were a direct result of the lack of transparency and the primary cause of institutional capital's "red lining" real estate investment.
- Mostly as a result of the S&L crisis in the late 1980's the CMBS (commercial mortgage-backed securities) market evolved to play a significant role injecting public market regulation, scrutiny and discipline into real estate debt markets. CMBS now represent over 20% of the $1.7 trillion US real estate debt market.
- Similar to the debt market, real estate equity was essentially a private market prior to 1990. Today, the public market for real estate equity, primarily via real estate investment trusts ("REITs"), has grown from less than $2 billion in 1990 to nearly $150 billion in equity today. Including leverage and operating partnership units, the total capitalization of the REIT market is approximately $300 billion.
- From the late 1990s through today, the market has continued to mature with a stratification of the debt and equity markets into multiple risk/return tranches to mirror lenders and investors risk/return profiles **(see graph at right)**.

It is important to note that lender/investors have differing yield requirements based on the composition of their funds (their investors and/or depositors) and the amount of risk they are willing to take on. Some lenders only finance stabilized properties in one of the four main food groups (multifamily, retail, office, and industrial). Others rarely finance the latter products because they need to achieve higher yields. Some capital providers target mezzanine loans to 80% of capital, others to 85% or 90%. Each has a different risk/return threshold and borrowers can certainly expect the pricing to increase as perceived risk increases. Preferred equity providers usually play in the range above 85% or 90% and cap out at 95% to 98% of capital. Their yield requirement is going to be higher than the aforementioned mezzanine providers, all other things remaining equal. Even senior debt is becoming more and more tranched, with low-risk, low-pricing lenders taking only the investment grade components of senior loans and letting other players buy the non-investment grade tranches. While this can be confusing, it can be simplified by understanding that each capital provider is playing in the risk-adjusted space of their choosing. And, it would be inefficient for a traditional mezzanine lender to try to finance a senior loan, because the risk/return profile would not fit with the capital they had to deploy.

INVESTOR / LENDER SEGMENTATION

CLASS	LTV	Investors	Funds	Hedge Funds	CMBS, Banks	REITS	Life Co	Funds	Buyers
Equity	100%	□	■	■	□	■	□	■	■
Preferred Equity	95%	■	■	■	□	■	□	■	■
Jr. Mezzaniane Debt	85%	■	■	■	■	■	□	■	■
	80%	■	□	■	■	■	□	■	□
Sr. Mezzanine Debt	75%	■	□	■	■	■	□	□	□
B Note	65%	■	□	□	■	■	■	□	□
BBB Traunch	55%	■	□	□	■	■	■	□	□
Senior Debt	50%	□	□	□	■	■	■	□	□

■ = Provide
□ = Don't Provide

Source: Tremont Capital Research

INVESTOR / LENDER SEGMENTATION

The outlined capital market segmentation is beneficial to both lender/investors and borrowers because it allows borrowers to fill their required capital stack with the appropriate risk-adjusted tranche or tranches of capital, and it allows lender/investors to play in the capital structure where they are most comfortable. If a borrower needs financing to get 88% of his acquisition cost, he can obtain that financing from the optimal mix of lenders/capital providers who can price adjust their capital so that the borrower realizes an advantage over the "old way" of doing things or over a competitor who just uses a local bank and "family and friends" equity to complete his projects. A borrower would not want to pay for "95%" capital if all he needed was capital to get to 88% leverage. He would be overpaying.

The trick is to match the project and leverage risk with the appropriate capital provider for the appropriate tranche of capital. One should keep in mind that much of this tranching can happen behind the scenes and may be blind to the borrower. Many senior and mezzanine lenders tranche their loans after closing by selling various segments of the loans to third-party capital providers (much like a more conventional participation loan). However, by understanding what is available in the market and the dynamics of structured finance, a borrower can more readily navigate the capital waters.

	% of Stack	LTV	DSC	Current Rate / Spread	Total Rate / Spread
Equity	5%	NA	NA	0-8%	18-30%
Preferred Equity	5%	90-95%	.7-1.05x	10%	14-25%
Jr. Mezzaniane Debt	15%	75-90%	.09-1.1x	9 - 10%	11-15%
Sr. Mezzanine Debt	10%	65-75%	1.0-1.25x	7 - 8%	8-10%
B Note	10%	55-65%	1.8-2.0x	L + 4%	
BBB Traunch	5%	50-55%	2.0x+	L+ 3%	
Senior Debt	50%	50%	2.0x+	L+ 1%	

EXAMPLE OF CURRENT MARKET SEGMENTATION AND PRICING

In summary, borrowers can take advantage of the maturity and segmentation of the financial markets by identifying the appropriate lender/investors for their project. It may be beneficial to use a financial advisor that is experienced in structured finance or to approach capital providers that have or manage financing products that can fit into different parts of the capital stack (senior debt, mezzanine, and preferred equity), then to learn about structured finance on a deal by deal basis. In any event, one can materially lessen the cost of financing by efficiently matching the risk of a transaction with the appropriate capital.

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You can visit Tremont on the internet at www.tremont capital.com ■