

## The New Capital Stack: Not Just Filling Leverage Gaps

In addition to the standard changes in place for most senior loans, expect to find revised risk targets and pricing for mezzanine and equity pieces.

BY DAVID ROSS

If you are a developer currently seeking to finance a new project or an investor looking to buy a commercial property, you are aware that since last summer, the financial markets have changed dramatically.

The commercial real estate capital party that had been getting more and more frenzied every quarter for the last couple of years has finally come to an end. Now, the partygoers are sizing up the damage and trying to put the pieces back together.

If you are out looking for financing or investment partners today, you missed the party. Welcome to the financial hangover. What now?

**Understand that we are in uncharted territory in the capital markets.** If you were in real estate in the late 1980s and early 1990s, then you have seen some of this before - the rapid decline in residential real estate values, the overbuilding of condominiums and the uncertainty about where the bottom is.

However, the subprime mess - and its spillover into the rest of the capital markets - is a new factor that will affect the depth and duration of this downturn. Currently, there is no consensus on the impact. In fact, the jury is still out on the commercial real estate market. Capital market analysts' opinions vary widely on a day-to-day basis, as to where we are and where we are headed.

One thing is certain: Regardless of whether the sun comes out next quarter or

next year, we cannot deny that we are in turbulent waters right now.

**Know that underwriting, pricing and leverage parameters have changed.**

Due to the well-publicized capital markets write-offs and losses, liquidity issues and general uncertainty, risk structure and risk pricing has been adjusted (and continues to be adjusted) to reflect the new uncertain capital and valuation environment.

For example, many senior lenders that were routinely providing loans up to 80% or more of project/property cost are now either not lending or lending at greatly reduced leverage levels. In addition, most borrowers are paying higher interest rate spreads for the new lower-leverage loans.

Consequently, not only are you receiving fewer loan dollars, you are paying a relatively higher price for those dollars. Lastly, underwriting is back to basics. Lenders are underwriting loans based on cash flow, leases, real market comps and rising cap rates (lower valuations).

"Condo" is a four letter word. If you want to hear a dial tone in record speed, call up your lender and ask the officer if they are interested in financing a condo deal in Florida. Or better yet, a condo-hotel deal in Florida.

**The senior loan mantra is "less availability and lower leverage."** Many senior lenders are out of the market. The turbulence is all over the news. Investment banks are cutting staff left and right. Banks are replacing CEOs, and loan

originators that have kept their jobs are keeping their heads down.

In 2006 and the first half of 2007 borrowers could expect to readily find senior lenders that would eagerly compete to lend them 75% to 80% of cost. Some bridge lenders went higher. Today, one can expect to achieve maximum senior development and repositioning financing of 65% to 70% of real cash costs for very well-located and well-thought-out commercial real estate deals.

These deals must be viable in every sense of the word and if they are retail, office, or industrial, they must have a significant level of pre-leasing in place before a senior lender will close or fund.

### *Mezz pricing*

What can developers do to plug the funding gap? For the most part, developers and real estate investors are not coming out of pocket for the 30% to 35% of capital that is required after a 65% to 70% of capital has been located through a senior lender.

Most cannot fund that kind of gap out of pocket, and those that can prefer not to. The key to putting together the capital stack now lies more squarely on the shoulders of mezzanine lenders and third-party equity investors.

Mezzanine lenders and preferred equity investors lend capital that is subordinate to senior debt, but senior to the developer's equity. Equity investors fund capital into the equity tranche of the capital stack - sometimes senior to the sponsor's equity and sometimes pari passu - or



side by side - with the sponsor's equity (subject to the negotiated waterfall of distributions).

But what are mezzanine lenders targeting these days? Every tranche of financing has been impacted by the new realities of the market, and lenders and investors have adjusted where each tranche lies on the risk/reward curve.

Like senior lenders, mezzanine lenders have dropped their

leverage levels and increased their relative pricing (interest spreads). In 2006 and the first half of 2007, most mezzanine lenders accepted that they had to play in the 75% to 90% cost band of the capital stack to get their targeted yields.

What they discovered, however, was that they were taking equity risk for mezzanine returns. No longer. Mezzanine lenders now routinely define the mezzanine tranche of the capital stack as roughly 65% to 80% of cost.

Moreover, their pricing has widened as well. For stable income-producing assets, mezzanine money that was priced at 9% to 10% is now commanding 11% to 13%. For development deals or value-add plays, mezzanine lenders are charging in the vicinity of 15% to 18%.

What about equity? These investors have also adjusted their underwriting and expectations. What good is it to pro forma 20% or 25% returns, if you never get repaid? Equity is much more cautious now.

Much of the mezzanine and equity capital that is active is focused on trying to buy discounted existing mortgages and notes, rather than looking at new deals. That said, there is plenty of equity in the market for the right deals.

The new deals that equity players invest in have to make real sense and have to generate equity-type returns - even at the lower senior debt leverage levels and increased senior debt cost. Development deals and value-add plays need equity to generate somewhere north of 20% internal rates of return for most equity investors.

Whether that specific number is 22%, 25% or 30% depends on the type of project or property and the perceived risk

associated with executing the sponsor's business plan.

**M**ost mezzanine lenders and equity investors have products that are very narrowly structured.

Furthermore, equity comes in many flavors, forms and structures - including preferred equity, which looks and feels like mezzanine debt - to joint venture equity, which is truly bringing another partner to the table.

With these variations available, what should a developer or real estate investor do

to find the appropriate mezzanine and/or equity partners?

#### ***Seal the deal***

If you have a project or acquisition teed up and ready to go, make sure you have covered all the basics before putting together a presentation:

- Know your cash cost budget, including soft costs and contingencies;
- Have a business plan (such as build, lease-up over 18 months, sell in year three);
- Make sure your team has the experience and ability to complete the business plan;
- Create a pro-forma based on actual market and lease data (fully supportable);
- Know your market;
- Decide what part of the capital stack - senior debt, mezzanine or equity - to target first and to emphasize in your presentation; and
- Decide whether to target mezzanine debt, preferred equity, joint venture equity, or some combination of mezz and equity.

Because lenders see a large volume of financing requests, make sure you craft a detailed presentation that contains all the necessary information. It is also helpful to put it in the format they typically see. For instance; including a one- or two-page executive summary is helpful in giving the lender an idea of the big picture.

In order to get a deal done, you want to make sure you target the right mezzanine lenders or equity investors for your project and capital need. Most mezzanine lenders and equity investors have prod-

ucts that are very narrowly structured and targeted (e.g., mezzanine debt for multi-family priced at mid-teens).

Lastly, in today's environment one may not want to negotiate too hard for the last dollar on proceeds or basis point in pricing. Today, most sponsors should be happy just to get a quote that will enable them to close the deal.

The market has changed from a borrower's market to a lender's market. Most real estate developers and investors who are seeking financing will probably find themselves also searching for mezzanine and/or third-party equity partners in today's capital markets.

Borrowers should educate themselves as to what has happened and what is happening in the capital markets and should be well aware that 2009 is not 2006 when it comes to filling in the capital stack.

All tranches of capital have adjusted - and will continue to adjust - as the financial markets become known. For now, you can simply count on higher pricing and lower leverage, and the fact that cash equity is king again.

If you do your homework, align yourself with the right advisor, create a well-thought-out presentation and target senior debt, mezzanine capital and equity wisely, you should be able to get your viable project or property capitalized.

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