LESSON 5 - STRUCTURING THE TRANSACTION

STRUCTURAL INCENTIVES

Lenders and equity providers will use incentives to help align with sponsors.

THE FIRST INCENTIVE IS THE EARN-OUTS. As the property improves (the event is working), the lender advances more loan proceeds. These proceeds are typically used to repatriate equity.

THE SECOND INCENTIVE IS THE BURN-OFFS. As the property improves, the lender loosens up on requirements. This typically relates to guarantees or escrow account requirements.

THE THIRD INCENTIVE IS CREDIT MIGRATION. As the loan improves, the lender agrees to lower the interest rate, reflective of the reduced rate. The final incentive is collateral release. If collateral is provided, the lender may release that additional collateral in the event that the property performs.

STRUCTURAL PENALTIES

Lender and equity providers may also enforce penalties to align interests with sponsors.

THE FIRST PENALTY IS SPRINGING RECOURSE. If the property is not performing to plan, the sponsor is required to post a guarantee.

THE SECOND PENALTY IS A CAPITAL CALL. If the property fails to meet its benchmark, the lender may require a loan pay-down.

THE FINAL PENALTY IS A CASH-FLOW SWEEP. If the property fails to meet its benchmark, the lender will sweep cash and amortize the loan.

INVESTMENT PERFORMANCE TESTS

THE FIRST TEST IS THE NOI TEST. Tracking the NOI trend is important, but you should also keep in mind how you calculate NOI: Trailing 12 months, Trailing 6 months annualized, and Trailing 3 months annualized.

THE SECOND TEST IS THE LEASING TESTS. This may take into account the amount of new space leased.

THE FINAL TEST IS THE OCCUPANCY TEST. Project occupancy is another way to measure performance. In these cases, the investor must be cognizant of the term of the occupancy rate. The typical test is 90 percent occupied for 90 days.

GUARANTEES

FULL RECOURSE: This guarantee from the sponsor agrees to repay 100 percent of the debt, even if the sponsor needs to find alternative sources of cash (other than the property).

PARTIAL RECOURSE: This limited financial commitment of the sponsor for the “top” or most exposed, portion of the loan is typically 5 to 25 percent.

DEBT SERVICE GUARANTEE: This guarantee is limited to keeping only the interest payments current.

MAINTENANCE GUARANTEE: The borrower guarantees to fund key expenses for maintaining the property (e.g., taxes, insurance, and maintenance). These are the first items that fail to be paid upon loan default.

DEFICIENCY GUARANTEE: The collateral is sold first to establish the deficiency. This approach does not work in a single-action state, such as California.