Commercial Real Estate Capital

COURSE #

Course Objectives

1. Explain the different types of capital structures available
2. Compare and contrast mezzanine loans to preferred equity
3. Discuss the various remedies for when deals go bad

Lesson 1 - **Start Here**

Types of Commercial Real Estate Transactions

Stabilized Properties

- Permanent financing
- Fully leased with rents at market rate and current cash flow within the properties
- No more work to be done on the property to “grow or groom” the NOI
- Lenders are betting that nothing “bad” will happen to the project cash flows in the future

Types of Commercial Real Estate Transactions

Unstabilized or Value-Added Properties

- Shorter term or floating rate financing
- Not fully leased, and/or rents are not at market
- Substantial work to be done before the property becomes stabilized
- Something “good” needs to happen to the property cash flow in order to stabilize the property and achieve the business plan objectives

Types of Commercial Real Estate Transactions

Opportunistic Properties

- These properties typically require “specialized” financing.

The Total Commercial Real Estate Strategy

Sponsor and Sponsorship Equity

Sponsor equity is also known as “skin in the game.” The investor should not that not all sponsor equity is created equal!

The good investor will know the sponsor’s sources of equity. The first is cash equity.

The second equity type is market equity.

The third equity type is syndicated equity.

The fourth equity type is large investor or limited partner equity.

One final factor to consider for equity transactions is debt equity.

Sponsor and Sponsorship Equity

The sponsor, or owner/operator, in a commercial real estate transaction needs to be suitably qualified in the following areas:

Capital: Have sufficient capital to co-invest in the transaction

Infrastructure: Have the appropriate organization to take on the project

Construction: Be qualified to manage the construction needed to rehabilitate the property

Management: Be qualified to manage or oversee the day-to-day operations of the property

Leasing: Be qualified to oversee the leasing effort

Staying power: Have sufficient net worth to support the property if unexpected costs overrun the budget or delays occur.

Sponsor and Sponsorship Equity

SPONSORSHIP and SPONSOR EQUITY

THE KEYS TO SELECTING THE RIGHT SPONSOR	GUIDELINES FOR SPONSOR CO-INVESTMENT AMOUNTS
The sponsor, or owner / operator, in a commercial real estate transaction needs to be suitably qualified in the following areas:	**5%** CO-INVESTMENT: Not very desirable, as it creates an "option value" for the sponsor. Any investor who accepts a 5-percent co-investments would be well advised to make up for this low investment amount with additional structure.
INFRASTRUCTURE: Have the appropriate organization to take on the project.	**10%** CO-INVESTMENT: Marginal; must have "going-in" merits that make the probability of success high.
CONSTRUCTION: Be qualified to manage the construction needed to rehabilitate the property. **MANAGEMENT:** Be qualified to manage or oversee the day-to-day operations of the property and tenant marketing plan.	**15%** CO-INVESTMENT: Normal and acceptable; a good starting point. **20%** or MORE CO-INVESTMENT: Indicates a sponsor who truly believes in the asset and business plan.
LEASING: Be qualified to oversee the leasing effort.	
STAYING POWER: Having sufficient net worth to support the property if unexpected costs overrun the budget or delays occur.	

Lesson 2 - Capital Structure Overview

Types of Capital (Capital Structure)

There are six different capital structure products that we will discuss in this course.

First Trust Debt

- First Trust Debt is included in the “ascending level of risk” structure.
- This is the debt that we will not spend much time on since we are concerned with the “after the senior debt.”
- With this type of structure, the typical Loan-to-Value (LTV) is 60% to 75%.
- This type of structure is secured by a first trust deed.

Types of Capital (Capital Structure)

Mezzanine

- Mezzanine loans are also known as “junior mortgages” and “participating debt/equity.”
- Mezzanine financing is considered a hybrid of debt and equity financing.
- This type of financing is also included in the ascending level of risk.
- The mezzanine debt is paid after the first trust debt is repaid, and before the equity is repaid. The typical mezzanine financing deal has a LTV of 50 percent to 90 percent, depending on the deal.

Types of Capital (Capital Structure)

Equity High Leverage Mezzanine Preferred Equity

The preferred Equity Mezzanine is similar to the Mezzanine financing, but the biggest difference is that mezzanine debt is usually structured as a loan that is secured by placing a lien on the property while the preferred equity financer takes an equity investment in the property-owning entity.

The typical LTV percentage is 80 percent to 100 percent.

Types of Capital (Capital Structure)

Hard Money/Bridge Loans/Distressed/Value-Added Financing

The next type of capital structure includes Hard Money, Bridge Loans, Distressed Loans, and Value-Added Financing.

These are all similar types of financing and represents our second category of capital structures as being Super/Senior Debt.

This financing category is often considered the "last resort" or short-term loan..

Types of Capital (Capital Structure)

Debtor-in-Possession Loans (DIP)

Debtor-in-Possession Loans (DIP) is financing that is arranged by a company while in Chapter 11 bankruptcy process.

Similar to the Hard Money loans, the property itself is used as the main protection against default, so the LTV ratios are lower than the other capital structures discussed above.

The typical LTV range is 60 percent or less.

Types of Capital (Capital Structure)

Super Collateralized Loans (Super C)

Super Collateralized Loans (Super C) are also very low in LTV and are typically less than 30 percent.

This type of financing is also known as a Triage Loan. For security and collateral, first priority is required.

If the borrower defaults, the lender will foreclose on the collateral and include any additionally cross-collateralized assets.

Capital Stack

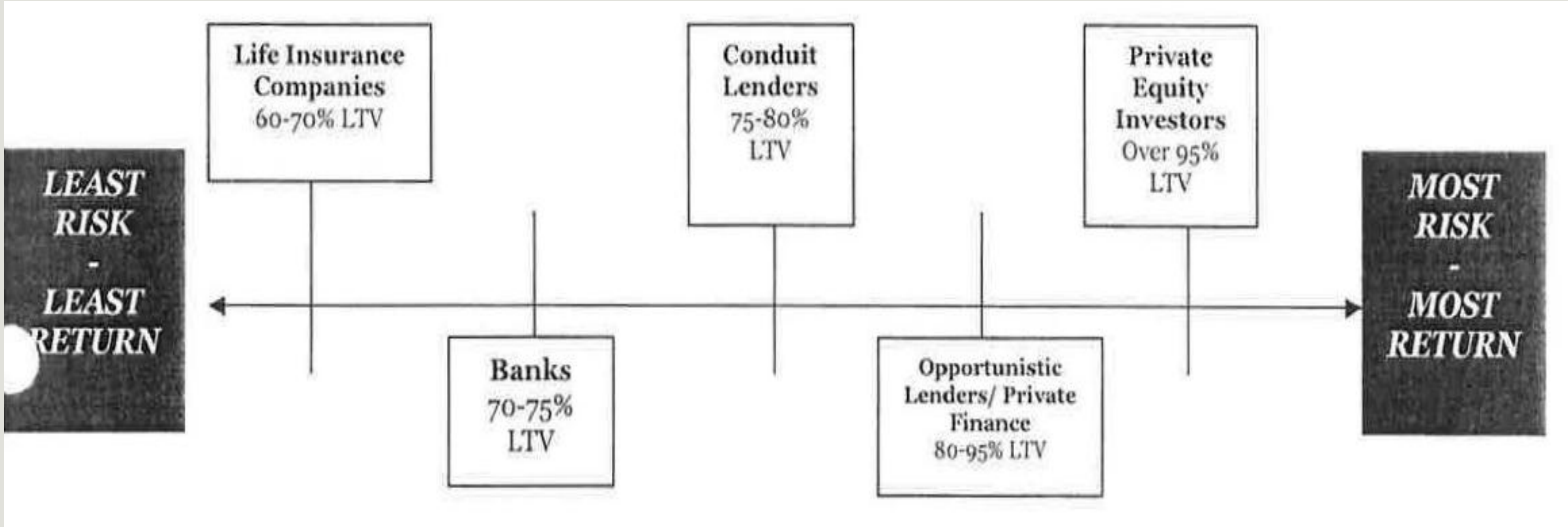
All investors need to make the right decisions and informed decisions when it comes to making sound real estate decisions.

One of the first items that the investor must understand in bridge lending is the proposed capital structure. This is what we refer to as the capital stack.

The capital stack is the different layers of financing, stacked on top of one another to show the entire risk profile of the transaction.

The capital stack is the total cost to buy and improve the property.

Continuum of Capital Providers



Lesson 3 - Mezzanine Financier

Mezzanine Debt Overview

As we mentioned in the introduction, there are three defining features of all real estate debt.

The first feature is Security/Collateral.

The second feature is the Order or Preference of Repayment.

The third feature is Default Remedies.

Mezzanine Debt Overview

Different Types of Debt Products

There are three different types of debt products for commercial real estate.

The first is the senior debt. This is also known as the first trust debt.

The second debt product is the mezzanine debt.

The third debt product is the second trust debt.

Mezzanine Debt Overview

The Intercreditor Agreement

Mezzanine loans that have Assessment of Partnership Interests as collateral will have an Intercreditor Agreement.

Point One: The Right of Notice to a First Trust Note

Point Two: The Right to Foreclosure, to “Step Into the Borrower’s Shoes,” or Replace the Borrower in the Event of Default

Point Three: The Right to Cure the Default on a First Trust Note

Mezzanine Loan Collateral

For mezzanine collateral, there are two options that are considered.

The first option is the second deed of trust.

The second option is the assignment of partnership interests.

Mezzanine Loan Risk/Reward Continuum

The mezzanine lender/investor must pay particular attention to the “type” of first trust loan that is in front of the mezzanine loan in the capital stack.

Mezzanine loans are used for stabilized transactions, value added loans, bridge/value added loans, and construction loans.

Lesson 4 - Preferred Equity

Sponsor Equity

There are three types of sponsor equity: Hard Cash Equity, Imputed Equity or Market Equity, and Syndicated Equity.

Most prefer hard cash equity rather than imputed market equity.

Cash equity makes for a stronger alignment of interests.

There may be times that an opportunistic investor or lender will do a transaction without a material amount of equity.

Equity Investment Analysis

In every real estate deal, there will be good deals and bad deals. The key is to staying away from the bad deals.

There are three ways that we can determine whether a potential deal is a good deal or a bad deal: Internal Rate of Return (IRR), Whole Dollar Profit, and Cash Flow.

Defaults and the Equity Investor

In a default or bankruptcy situation, the say or rights of the equity investors will be governed by the Partnership Agreement.

There are two types of partners: General Partners and Limited Partners.

General Partners will have a say, and typically large equity investors will become managing partners in the case of a loan default and the decision-making will flow to them.

Limited Partners will have little to no say in the plan or the resolution. They are at the most risk.

Preferred Equity Security/Collateral

	MEZZANINE FINANCING	PREFERRED EQUITY
Sponser Equity	- Requires more cash into the deal. - Typically at least 5% of the cost, and maybe 15% of the cost.	- Less cash into the deal. - Typically 3% of the cost or 20% of the "equity retirement"
Pari Pasu vs. Subordination	Sponser's return on equity and profits may be subordinate to the mezzanine lender's debt and interest.	Return on equity and profits are typically Pari Pasu.
Transaction Upside	- Typically less expensive than equity; provides more upside to the sponser. - May be priced as yield only; leaving upside to the sponser. - May be priced with fixed exit fee. - May be small participation (10%-25%). - May be a combination of the above.	- Typically more expensive, higher return requirement. - Typically structured with preferred return to the equity as preference, then profits run through an IRR waterfall.
Project Control	- Sponsor has almost all the control. - Mezzanine lender approves only major decisions. - Mezzanine lenders careful not to interfere.	- Sponser has significantly less control. - Sponser may have to get approval on all decisions from the investor. - Sponser may lose control if decisions do not workout.
Extra Sponser Fee	Typically mezzanine lenders do not allow extra fees (acquisition fees, asset management fees, etc.).	Extra fees are generally allowed (acquisition fees, disposition fees, etc.).
Guarantees	- Guarantees are not typical, but not unheard of. - Guarantees may be used if the lender has to "stretch" and can be eliminated or reduced with "burn off" provisions.	Typically do not require guarantees.
Deal Problems	- A deal problem is the sponser problem. If the problem is not fixed, the lender's recourse is forecloser. - Mezzanine lender offers little help or additional funding in solving asset problems.	- Deal problem is typically a joint problem. - Joint Venture equity will work with sponser to solve the problem. - Documents typically anticipate the problems with "Cash Call Provisions".
Exit Strategy	Mezzanine lenders typically underwrite to a refinance exit strategy.	Equity investors will typically underwrite to a sale exit strategy.
Tax Issues	Sponser will have the tax benefits of project interest, i.e.: deductions.	Sponser will have no tax benefits.
Development Transactions	Available, but hard to find.	Readily available.
Documentation	- Note. - Loan agreement. - Intercreditor Agreement.	Partnership Agreement.