ACPARE

CAPITAL PLACEMENT:

VALUE ADDED TRANSACTIONS

COURSE OBJECTIVES

1. Define value added investments and what differentiates them from other transactions.
2. Explain the investor transaction selection criteria.
3. Compare and contrast "good deals" vs. "bad deals."
4. Explain how to add value to the property

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

INSIDE BASEBALL
THE TOTAL REAL ESTATE CAPITAL STRATEGY

3 ASSET ARBITRAGE
("Crossing Trades", Wholesaling)

- Making incentives and fees net of the bid.
- Most commonly single commercial assets and Bulk REO/Non-Performing Residential Loan Portfolios.
- "Building the Book": Find out the axe of your Bulk REO/NPL buyers and cross smaller trades from a larger institutional seller or bank to smaller but qualified buyers.

2 CAPITAL FORMATION
("Principalling" or Syndication)

- Raising debt or equity to buy commercial real estate assets - ideally assets with assumable loans ("conduit loans").
- Advising others to raise equity capital and creating their pitchbooks for you to invest alongside them ("real estate investment banking").

1 CAPITAL PLACEMENT
(Financing Deals)

- **Providing Debt, Mezzanine** ("Mezz", "Pref") or **Preferred Equity** ("Pref") **Capital**
- **Credit Facilities** (Bulk REO Buyers, Hard Money Lenders)
- **Debtor-In-Possession Financing**

THESE WILL USUALLY FALL INTO TWO BUCKETS:
1. Real estate investors who have found something interesting to buy but don't have all the capital they need
2. Commercial owners who have been asked "buy their note back at a discount"; meaning that they have the opportunity to refinance their note for lower than the current unpaid principal balance ("UPB").

HOME THE BASIS

- Any deal requires you, your investors or your buyers to get in at a strong basis (low purchase price as compared to value of asset **today**).
- The basis will either make or break the deal, **and your reputation as a deal maker.**
- Deals with the lowest possible basis are technically home runs.
- For Commercial: Use the "5 Data Points" to qualify these deals and determine your basis at bid.
For Bulk REO/NPL: Use pricing expectations from your seller.

DEAL FLOW

- You will not know or really be able to control the types of deals being thrown at you due to the nature of the real estate business.
- Your job - **and where you add the most value** - is determining if you're going to hit a "single", "double", or "triple".

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

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 contruction needed to rehabilitate the property	**15% CO-INVESTMENT:** Normal and acceptable; a good starting point.
MANAGEMENT: Be qualfied to manage or oversee the day-to-day operations of the property and tenant marketing plan	**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 - VALUE ADDED REAL ESTATE

VALUE ADDED BASICS

Investors must think about the following key items in value-added investing:

- Current NOI
- Project or future stabilized NOI
- Cost to improve the property
- Occupancy (current and at stabilization)
- Lease rate (current and after improvements are completed)
- Bridge loan financing during the value-enhancement phase (also known as interim financing)
- Loan-to-value (LTV) and debt service coverage (DSC) metrics for a take-out loan or a permanent loan, after the property is stabilized
- Time required to complete the property improvements

VALUE ADDED BASICS

Value added investing allows for the opportunity to hit the real estate grand slam, which encompasses the following:

- Invest in a property
- Improve it
- Refinance out all of the equity
- Own a cash flowing asset with no equity investment

VALUE ADDED INVESTING VS. STABILIZED INVESTING

A value-added transaction always include a plan for how to make the property better and more valuable. Successful value added real estate investing is one of the greatest wealth builders available. Below is a sample transaction for a value added property:

ACQUISITION ASSUMPTIONS

		AMOUNT	PSF ($)
Purchase Price	(including closing costs):		
	Improvement Cost:	$13,000,000	$130
	Interest Reserve:	$500,000	$5
	Total:	$400,000	$4
		$13,900,000	$139

THE RULE OF SAMS

THE RULE OF SAMS:

SPONSOR: The person doing the work needs to be qualified and honest.

ASSET: The asset needs to have positive qualities (location, physical condition, and upside potential)

MARKET: The market should have positive characteristics of growth or recovery.

STRUCTURE: The investment structure should align interests and reward those taking the risk and who have the upside.

VALUE-ADDED INVESTING – UNDERWRITING 101

The key to analyzing the market is how the perspective rents and occupancy compare to the current market. There are three main types of transactions.

The first is a CONSERVATIVE TRANSACTION. With this transaction, pro forma rents and occupancy are below the current market. This profile provides the most upside to the investor.

The second is BASE CASE TRANSACTION. Pro forma rents are occupancy are right at market. These are good transactions, but have the potential risk of market deterioration.

The final type is PIONEERING TRANSACTION. Pro forma rents and occupancy are above market, and the transaction needs these above-market metrics to reach its business plan. The investor should be well compensated for these transactions.

THE SECRET TO ALL VALUE ADDED INVESTING – INCREASING NET OPERATING INCOME

THE FIRST STEP IN VALUE ADDED UNDERWRITING IS TO UNDERSTAND THE BASIC NOI NUMBERS:

1. Current NOI: What is the as-is NOI?
2. Stabilized NOI: What is the NOI after all improvements are made and after all repositioning is complete?

   The NOI delta or change: Every good value added investment has a significant change in the NOI; from current to stabilized.
3. Otherwise, no value is being added.

LESSON 3 - INVESTOR TRANSACTION SELECTION CRITERIA

FOLLOW THE NUMBERS

Just because a property looks nice does not mean that it will be a good investment! The asset needs to have positive qualities, such as physical location and upside potential, and the market must be equally positive in terms of growth. Always remember that all markets are local. Regardless of what is going on in the larger economy, real estate is a local business.

Remember…In any given transaction, you must be dispassionate about the property and focus on the numbers. This is not the time to be emotional about the property. It is necessary to be dispassionate about the property and focus on the numbers…no emotion! Let the metrics (the numbers) lead your decision-making process.

SELECTING THE RIGHT INVESTOR

The sponsor (as we discussed earlier), 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.

SELECTING THE RIGHT INVESTOR

ALIGNMENT OF INTERESTS

When finding the right partner, the risks and rewards should be equally disbursed among all of those involved in the transaction. This typically means that the sponsor's equity is at risk as the first loss money. If the project does well, everyone should do well.

The overall debt should have a fixed return and equity has an unlimited return. Remember with value added projects that the key is to increase NOI, so the potential profit could be limitless if the project becomes a success. So, understanding where the debt portion of a project stops and where the equity begins is a key to making smart investment decisions.

SELECTING THE RIGHT INVESTOR

KEY EVENTS

Every value added transaction has one or two key events that must occur for the project to be successful. A good investor identifies those events early and creates a "performance structure" to minimize risk to the investor. Key events include the following:

- A major tenant that must renew.
- A certain percentage of the building that must be re-leased.
- Month-to-month tenants that are converted into long-term tenants.
- A pad sale that needs to occur to lower the cost basis.

SELECTING THE RIGHT INVESTOR

THE BACK-UP PLAN

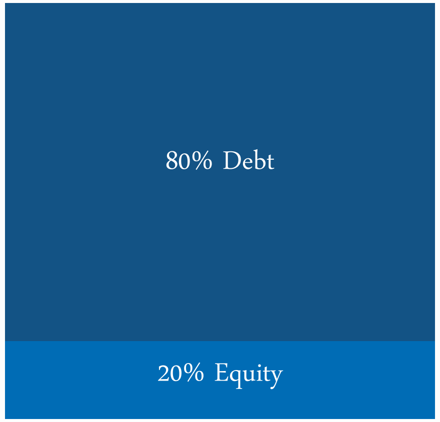
A good investor will have a contingency plan if the key event fails to occur. If the failure of one key event means that the project fails, there might be too much risk for the investor. In these situations, the investor should seek other ways to mitigate risks.

Good investors look beyond the key event and understand what the economic outcome is, should the key event not happen. In the best deals, the back-up plan has a higher probability than the key event, and if the back-up plan is implemented it means that the project makes a little money or breaks even.

LESSON 4 - THE KEY INFORMATION FOR MAKING GOOD INVESTMENT DECISIONS

CAPITAL STRUCTURE

You must understand where you are or where you want to be in the capital stack. The capital structure drives the debt and equity structure and determines your degree of financial risk. The capital stack is the total cost to buy and improve the property.



SOURCE AND USES

SOURCES AND USES OF FUNDS

	AMOUNT	PSF ($)
SOURCES OF CASH		
Equity:	$3,000,000	$30
Loan:	$10,900,000	$109
Total:	$13,900,000	$139

	AMOUNT	PSF ($)
USES OF CASH		
Acquisition costs:	$13,000,000	$130
Rehab costs:	$500,000	$5
Interest reserve:	$400,000	$4
Total:	$13,900,000	$139

CURRENT AND HISTORICAL OPERATING STATEMENTS

A good real estate investor must understand the prior and current project-level profit and loss statements (operating statements). Operating statements are the key to any property analysis. Before you can develop a plan for where your project is going, it is important to fully understand where you have been and where you stand now. Therefore, underwriting and decisions should be made with historical operating statements as a basis. The upside for the project is how much the investor can improve upon the historical results. The figure below shows an easy way to outline this information.

HISTORICAL NOI (Most Current Year)	PRO FORMA NOI (After Improvements)	CHANGE
$1,000,000	$1,500,000	$500,000 (50%)

RENT ROLL

TENANT RISKS: What are the risks of tenants defaulting or not renewing their leases?

LEASE EXPIRATIONS: When do leases expire? This information reveals your re-leasing risk.

EXTENSION OPTIONS: Look closely at the extension options of larger tenants. If they are locked in at good rates, they are likely to stay. A good investor will know whether tenants have extension options.

CO-TENANT PROVISIONS: Co-tenancy provisions are common in retail. These provisions prohibit the property owner from leasing to other similar tenants or allow smaller tenants to leave if an anchor tenant leaves.

PROJECT PRO FORMA

The project pro forma is the investor's plan for the property. It is the culmination of all the historical analyses and their projected results.

After investors finalize the capital improvements budget and study the rent roll and historical operating statements, they should prepare a future or forward-looking operating statement.

This statement shows the potential for the property and concludes with the investor formulating a future stabilized NOI. The stabilized NOI is the wealth driver in every real estate transaction. If it can be achieved, the investor should do very well.

The purpose of the project Pro Forma is to derive the property's exit value.

EXIT STRATEGIES

Exit value is a crucial number that the value added investor is trying to achieve. This value is based on the stabilized net operating income (NOI), which is derived from all the analyses that go into the project pro forma.

KEY FORMULA: Commercial Real Estate Value

NOI / Cap Rate = Value

Note: *$The NOI used should be stabilized but can be historical, current, or pro forma.*

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.

LESSON 6 - EXIT STRATEGY OVERVIEW: EXIT TYPES FOR BRIDGE & MEZZANINE LOANS

PERMANENT LOAN REFINANCE EXIT

The most common and preferred method of exit is the permanent loan refinance

There are also several permanent loan sizing criteria:

- 10-year Treasury rate or LIBOR
- Spread, which is the difference between the interest rate and the benchmark (Treasury rate or LIBOR)
- Loan amortization rate
- Loan constant
- Interest rate stress

SALE EXIT

The other possible exit is the sale exit.

Achieving a profit on a sale exit is typically more difficult.

Thus, the sale exit is viewed as a secondary exit.

In this exit strategy, the investor is looking to achieve a profit from the proceeds of the sale after paying the selling costs, and paying off the total loan amount.

LESSON 7 - ADDING VALUE TO THE PROPERTY & DIFFERENT ASSET CLASSES

IMPROVEMENTS AND THE BUDGET

Every value added deal has a budget to improve the property. The best investors get the biggest “bang for the buck” on the improvement budget. The best investors bring the improvements in on time and on budget. The best investors also differentiate between improvements that are required to maintain the property and do not add value, and those improvements that do add value.

Value enhancing improvements that will provide increase rent and occupancy and add value to the building include the following:

- New façade
- New parking lot surface or re-striping to add additional parking spaces
- New landscaping
- Interior work (e.g., bathrooms and kitchen)
- Project amenities

ADDING VALUE TO DIFFERENT CLASSES

MULTIFAMILY

Multifamily rehabilitation (rehab) can generally be divided into the following categories:

Minor: Paint, landscaping, parking surface, and so on

Moderate: New kitchens, bath, carpet, and other interior improvements

Major: Total “gutting” of units and updating the entire interior; could include updating HVAC systems

ADDING VALUE TO DIFFERENT CLASSES

RETAIL PROPERTIES

Retail rehab can generally be divided into the following categories:

Minor: Face lift to center, new/repaved parking lot, and new signage

Moderate: New center façade, re-arranging the physical spaces

Major: De-malling centers (e.g., eliminating shop space with junior anchor tenants), building out parking-lot pad space, and additional construction.

ADDING VALUE TO DIFFERENT CLASSES

OFFICE AND INDUSTRIAL PROPERTIES

This type of rehab can generally be divided into the following categories:

Minor: Improved general appearance, new parking lot, renovation of common areas

Moderate: Increased efficiency, new electrical or HVAC system, redesign of floor layouts

Major: Total gutting of property, taking the property down to concrete and rebuilding from the inside out, including the new systems and new interiors

LESSON 8 - THE KEY METRICS FOR GOOD DECISIONS

THE KEY METRICS FOR GOOD DECISIONS

- Cash-on-cash return
- Leveraged cash-on-cash return
- Debt service coverage (DSC) ratio
- Loan-to-Value (LTV)
- Price-per-pound
- Gross profit
- Profit multiple
- Capitalization (cap) rate-to-loan basis (aka debt yield)