

**Real Estate Finance  
101: The Basics**

**Tuesday,  
October 28**

**9:30 a.m. – 10:45 a.m.**

**ULI: The Urban Land Institute**  
Miami, FL

**Real Estate Finance 101:**

October 28, 2008

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**Real Estate Overview**



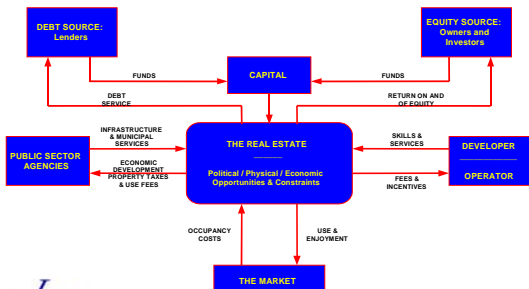
**Real Estate Investment  
Characteristics**

1. The industry is highly fragmented with few barriers to entry
2. Each property is a unique, individual business enterprise
3. Investment is long-term, illiquid in nature and not easily traded due to market inefficiencies
4. Investment, operation, and management requires technical and financial training
5. Long-term, illiquid nature of real estate ownership does not allow for instantaneous, trading-like solutions
6. Illiquid nature of real estate does not allow owner to change financial structure (leverage) quickly/without cost
7. Industry lacks transparency as compared to financial markets.
8. Transactions are complex and costly to execute and require third-party expertise



**Business Planning For Development Projects**

**THE PLAYERS**



**Real Estate Capital Overview**



## The Capital Structure Based on Costs

96%-100%	• Highest Risk
<b>Sponsor Equity</b>	• First Loss Piece
	• Profit Equals Difference in Cost and Value
91%-95%	• Current Yield: 10-12%
<b>Preferred Equity</b>	• Investor Required IRR: 15-25%
	• Participation: Typically
86%-90%	• Current Yield: 8-10%
<b>2<sup>nd</sup> Mezzanine</b>	• Investor Required IRR: 11-20%
	• Participation: Some Cases
76%-85%	• Current Yield/IRR: 10-15%
<b>1<sup>st</sup> Mezzanine</b>	• Typically pays current, but may accrue
0%-75%	• First Trust
<b>Senior Debt</b>	• Lower Rate/Lower Risk/Pays current
	• Required Yield: 6-9%



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## Real Estate "Whole Loan" Financing Continuum: The Lenders



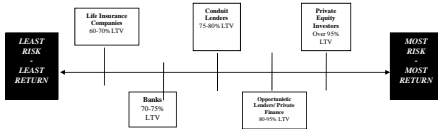
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## Real Estate "Whole Loan" Financing Continuum: The Lenders

Real estate risk can be viewed on a continuum, going from left (least risky) to the right (most risky).

1. **Life insurance companies:** Generally the most conservative underwriters.
2. **Banks:** Most banks will not do long term loans.
3. **Opportunistic lenders:** Typically lenders who hold whole loans on a balance sheet. Can include finance companies, mezzanine lenders and mortgage REITs.
4. **Equity investors:** Has the "first loss piece" of the transaction, but also has an uncapped upside.

repackage them as opportunity funds,



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## The Three Types of Commercial Real Estate Properties



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## The Three Types of Real Estate Properties

### 1. **Stabilized Properties**

Permanent financing is for stabilized properties.

**KEY POINT:** Common characteristics of stabilized properties are:

- **Occupancy:** The property is fully occupied.
- **Rents:** Property rents are at market rates.
- **NOI:** The NOI is "stabilized," meaning there will be little growth in the future.

### 2. **Unstabilized or Value Added Properties**

Typically are financed by bridge loans. Common characteristics of unstabilized or value added properties are:

- **Occupancy:** May not be fully occupied.
- **Rent roll:** May not have a good tenant mix.
- **Rents:** May be below market rates.



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## The Three Types of Real Estate Properties

### 3. **Opportunistic Properties**

These properties typically require "specialized" financing. Common characteristics of opportunistic properties are:

- **A for sale exit:** Typically relates back to the strength of the consumer. Most common on residential land and condominiums.
- **Development/construction:** The property needs to be built and leased. This creates construction risk and lease-up risk.



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## Analyzing Stabilized Properties:

### Understanding the Asset



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## Glossary of Terms

- The Capital Stack: Debt equity amounts
- Sources & Uses of Funds
- Net Operating Income
- Stabilized NOI
- Unstabilized NOI
- Asset Cash Flow
- Rent Roll: Roll schedule
- Cash on Cash Return
- Leveraged Cash on Cash Return
- Positive Leverage vs. Negative Leverage
- Cap Rate: Going in, Stabilized, Underwritten
- Loan to Value
- Debt Service Coverage Ratio
- Loan Constant
- Loan Amount



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### Understanding the Asset: The Capital Stack A \$10 Million Dollar Deal

Sponsor Equity	\$2 Million / 20%
First Trust Senior Debt	\$8 Million / 80%



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### Understanding the Asset: Sources & Uses

#### Sources of Cash:

- Loan: \$8,000,000
- Sponsor Equity: \$2,000,000
- Total: \$10,000,000

#### Uses of Cash:

- Building Acquisition: \$10,000,000
- Total: \$10,000,000



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### Understanding the Asset: Net Operating Income

From the owner's perspective:

**NOI:** The first step in underwriting any stabilized transaction is to understand the project's NOI.

**The NOI is calculated as follows:**

	Gross Revenues
LESS:	Vacancy
Equals:	Net Revenues
LESS:	(Operating Expenses)
Equals:	NOI

#### Example:

Gross Revenues:	\$2,000,000
Vacancy:	<u>(\$200,000)</u>
Net Revenues:	\$1,800,000
Operating Expenses:	<u>(\$850,000)</u>
NOI:	\$950,000



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### Understanding the Asset

#### The Stabilized NOI

For the NOI to be stabilized, it must have the following characteristics:

- **Building occupancy:** needs to be at market, typically 90% leased.
- **Building leases:** rates need to be at current market rates (not below or above).
- **Tenant rollover:** the property should not have a significant amount of tenant rollover (expiring leases) in the short term, or at the same time.



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## Understanding the Asset

### The Rent Roll

- Stabilized properties are driven by their rent rolls. All rent rolls are not created equal.
- Rent roll analysis will include:
  - ✓ Percentage of the building currently leased
  - ✓ Rate of lease (monthly payments)
  - ✓ Lease terms: how long is the lease
  - ✓ Lease expiration dates

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## Understanding the Asset

### Rent Roll Topics

- ✓ **Renewal clauses**
  - Extension options
  - Contract rate increases
  - Owner requirements over the lease term (i.e. improvements to space, building, storage, etc.)
- ✓ **Credit quality of tenants**
  - Credit tenant: "A rated" company by Moody's or S&P
  - Strong credit: A company with a good balance sheet and income statement
  - Poor credit: A "Mom & Pop" business
- ✓ **Roll schedule:** The make up of the leases, their duration, and term.



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## Understanding the Asset

### Types of Leases: Two Basic Types

- **Full-service:** Landlord pays all expenses such as maintenance, taxes, and insurance.
- **Triple Net:** Typical charges in triple net include:
  - ✓ Taxes: Paid by tenant
  - ✓ Insurance: Paid by tenant
  - ✓ Maintenance: Paid by tenant



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## Real Estate Debt: Permanent or Long-Term Financing



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## What is Permanent Financing?

**KEY POINT:** Permanent financing relates only to stabilized properties. Only stabilized properties can qualify for permanent financing.

### 1. The Stabilized Investor

- Stabilized financing most closely resembles a bond.
- Stabilized financing is generally underwritten to 70-80% loan to value and 1.25x debt service coverage.
- Stabilized investors seek a cash on cash return (like a bond return).
- Stabilized investors also seek a leveraged cash on cash return (similar to margined return for a stock or a bond).

### 2. Repaying the Permanent Loan

- **Another loan:** Permanent loans are repaid by another permanent loan or by a sale, in which case another permanent loan is obtained.

**KEY POINT:** Nothing is truly "permanent," these are 10 year loans.



## Providers of Permanent Financing



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## Providers of Permanent Financing

### 1. Life Companies

- Examples include: MetLife, Allstate, Teachers, & Great Western.
- Very conservative: Low leverage/low rate
- Very picky on: Asset quality, location, market and sponsor
- Typical underwriting: 65% LTV, 1.25x Debt Service Coverage, and high quality asset/sponsors
- Limited annual capital allocations



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## Providers of Permanent Financing

### 2. Banks

- Banks are not providers of long term debt
- Why not: They cannot match asset & liabilities
- Never: Lend "long" with short term capital
- Most banks started conduit programs
- Bank underwriting: 70-75% LTV, 1.25x Debt Service Coverage, recourse, stays in local market
- Recourse lenders
- May be local market constrained



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## Providers of Permanent Financing

### 3. Government Agency Lenders

- Provide very specific programs designed for the "greater good"
- They offer great execution if you fit inside the box

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## Providers of Permanent Financing

### 3. Government Agency Lenders

- **Fannie Mae**
  - Single family loans
  - Multifamily loans
  - **Access via approved lenders:** Mortgage companies aligned with Fannie Mae are known as DUS lenders (Delegated Underwriting and Servicing). In this model, the mortgage lender shares some of the first loss risk.

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## Providers of Permanent Financing

### 3. Government Agency Lenders:

- **Freddie Mac**
  - Single family loans
  - Multifamily loans
  - **Access via approved underwriters:** Some mortgage firms have Freddie Mac licenses. These mortgage banks originate loans for Freddie Mac directly.

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## Providers of Permanent Financing

### 3. Government Agency Lenders: Freddie Mac, Fannie Mae, FHA/HUD

- **FHA/HUD: They provide the most proceeds, 40 year amortizations, and will do business with all levels of sponsorship. This is a government subsidized lending program. FHA deals typically take a long time to close.**
  - Single family loans
  - Multifamily loans
  - Nursing homes/Assisted Living
  - **Access via approved underwriters:** Some mortgage firms have Freddie Mac licenses. These mortgage banks originate loans for Freddie Mac directly.



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## Providers of Permanent Financing

### 4. Commercial Mortgage Backed Securities (CMBS)

A fixed rate stabilized loan is originated by a CMBS lender, also known as a "Conduit Lender."

- **Pooling:** loans are "pooled" or put together with many other loans.
- **Diversification:** the loans are diversified by:
  - ✓ Size
  - ✓ Market
  - ✓ Sponsor
  - ✓ Asset type
- In theory, the risk of loss in a "diversified pool" is less than one loan or a "non-diversified pool."



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## Providers of Permanent Financing

### 4. Commercial Mortgage Backed Securities (CMBS)

- **Loans to bonds:** the loans are then "packaged" into a securitization or bonds. These are known as commercial mortgage backed securities.
- The bonds are then "tranching" and rated by the rating agencies (S&P, Moody's, Fitch).



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## CMBS Securitization Chart

Equity \$20 Million	100% of Project Costs <i>Subordination: 0% of Loan or 0% of Costs</i>	} Non-Investment Grade	
Non-Rated \$1 Million	80% of Project Costs <i>Non-Investment Grade Subordination: 0.00% of Loan or 20% of Costs</i>		
B Bond \$1 Million Spread: 950bp over 10 Year Treasury	79% of Project Costs <i>Subordination: 1% of Loan or 21% of Costs</i>		
BB Bond \$1 Million Spread: 575bp over 10 Year Treasury	78% of Project Costs <i>Subordination: 2% of Loan or 22% of Costs</i>		
BBB Bond \$1 Million Spread: 411bp over Treasury	77% of Project Costs <i>Subordination: 4% of Loan or 23% of Costs</i>		
A Bond \$2 Million Spread: 205bp over Swap	74% of Project Costs <i>Subordination: 8% of Loan or 28% of Costs</i>		} Investment Grade
AA Bond \$2 Million Spread: 145bp over Swap	72% of Project Costs <i>Subordination: 10% of Loan or 28% of Costs</i>		
AAA Bond \$70 Million Spread: 88bp over Swap	70% of Project Costs <i>Subordination: 12% of Loan or 30% of Costs</i>		

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## Basic Debt Underwriting



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## Lender Key Metrics

- Cap Rates
- Loan to Value Ratio
- Debt Service Coverage Ratio



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## The Debt Component

### Cap Rates

- **KEY POINT:** Cap rates are a key factor in determining the value of a commercial real estate project.
- Cap rates are set by the market, and is the rate or yield, that the buyers and sellers will accept on an unleveraged basis, to own the building.
- **Cap rates are influenced by:**
  - ✓ The rate of return on the 10 year Treasury Bill
  - ✓ The availability of debt in the market (the more debt, the lower the cap rates)
  - ✓ The overall health of the real estate market
  - ✓ The rent roll of the property (tenant quality, lease terms, etc.)
  - ✓ Local market factors



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## The Debt Component

### Loan to Value

- One of the key formulas that drives the loan size.
- The lower the loan to value, the greater the implied safety of the loan.
- The lower the better:
  - ✓ 70% and below = good
  - ✓ 80% and below = market
  - ✓ 90% and below = high
  - ✓ 95% and below = very high

### Quick formula:

$LTV = \text{Loan Amount} / \text{Asset Value (or Purchase Price)}$

Example: Value = \$10 million  
 Loan = \$8 million  
 LTV = 80%



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## The Debt Component

### Debt Service Coverage Ratio

- One of the key formulas that drives loan size.
- Also known as the "coverage ratio".
- If the debt service coverage ratio is over a 1.0x, it means that monthly property cash flow is equal to the principal and interest payments.
- Permanent lenders typically look for a 1.20 to 1.25x coverage ratio as the benchmark for a safe loan.

### Quick formula:

$\text{Stabilized DSC Ratio} =$

Example: NOI =

Debt service =

DSCR =

$\text{Stabilized NOI/Debt Service}$

\$950,000

\$760,000

$950/760 = 1.25x$



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## Mezzanine Debt Overview



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## Overview of Mezzanine Financing Market

- Niche market comprised of opportunity funds, investment banks, and commercial banks
- Capital sources aggressively entered the market attracted by high risk adjusted rates of return
- Capital is available for higher yielding opportunities as banks and non-bank financial institutions are attracted to the higher return associated with investment in this tranche in the capital structure



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## Risks of Mezzanine Investing

- Change in property values
- Amount and timing of cash flow
- Take-out risk
- Quality of underwriting
- Management control
- Exit strategy and timing
- Quality of asset management
- Real estate risks-development, construction, operation, etc.



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## Mezzanine Debt Overview

### Different types of debt products:

1. **Senior Debt:** First Trust Lenders
2. **Second Trust Debt:** Defined by the collateral
3. **Mezzanine Debt:** Typically does not have a recorded lien.
  - Subordinate Debt: Can mean the same as the above
  - Junior Debt: Can mean the same as the above



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## Mezzanine Debt Overview

There are three defining features of all real estate debt:

- **Security/Collateral:** What is the lender's security?
- **Order or preference of repayment:** Who gets repaid first?
- **Default Remedies:** What are the lender/investor options in the event of a default?



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## Mezzanine Debt Overview

### Mezzanine Loan Security: The Collateral Options

- **Second Deed of Trust:** This is the best security – it is a recorded lien. Most First Trust lenders will not allow them.
- **Assignment of Partnership Interests:** The most common type of mezzanine loan collateral. Typically 100% assignment, in some cases less than 100%. (i.e. 49% pledge on conduit mezzanine loans.)



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## Preferred Equity



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## Preferred Equity

### Overview

- After B Notes and mezzanine loans, next on the risk curve is preferred equity. Preferred equity can have similar characteristics to both debt and equity.
- The primary structural differentiation of preferred equity from other hybrid products are as follows:
  1. **Security/Collateral:** The preferred equity investor does not have a secured position. They are part of the equity and are governed by the Partnership Agreement.
  2. **Intercreditor Agreement:** Preferred Equity investors have no written agreements with the First Trust lenders.
  3. **Remedies:** The Preferred Equity investor cannot look to the collateral. Their primary remedy is the dilution of the General Partner's economic interests.



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## Joint Venture Equity Overview



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## Joint Ventures

- Sale and financing transactions are "commodity-like" whereas joint ventures are individually negotiated and tailored transactions
- A joint venture may be formed to:
  - Acquire a specific property, a portfolio of properties, or an operating company
  - Recapitalize an existing partnership
  - Develop a property



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## Structuring Joint Ventures

- Each joint venture is different; there are no pre-set terms and conditions
- Terms to be negotiated include:
  - Contributions
  - Preferred returns and “Claw-backs”
  - “Promotes”
  - Governance, guarantees (if any), fees and transaction costs and expenses



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## Joint Venture Equity

### Partner Overview

- **General Partner/Sponsors:** The on the ground, day to day operators. Typically the local partner.
- **Limited Partner:** Passive partner, along for the ride. Views the transaction as an alternative investment.
- **Institutional Equity:** The big money partner. Looks for co-investment from General Partner which may include investment from the Limited Partner.



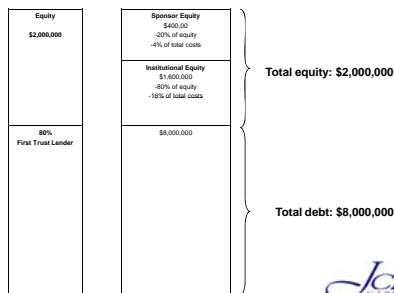
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## Joint Venture Equity

### Typical Partnership Structure Diagram:

Total Costs: \$10 Million

\$10 Million



## Real Estate Ownership Structures



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## Different Ownership Structures

- Individual
- Simple & easy to form with limited ability to raise funds
- Co-Ownership
  - **Joint Tenancy:** Held by two or more people having equal ownership rights and the right of survivorship. (If one owner dies, then the undivided estate passes to the survivors.)
  - **Tenancy In Common:** Exists when two or more entities own separate and possibly unequal positions. There is no right of survivorship. Simple & inexpensive to form with limited ability to raise funds, but generally superior to individual ownership.
  - **Tenancy by the Entirety:** Limited to spouses, and the property is not subject to claims of one spouse's creditors.



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## Partnerships

--**General Partnership:** An association of two or more co-owners to run a business or project. Moderately easy to form with limited ability to raise funds, but typically superior to individual ownership.

--**Limited Partnership:** Has at least one general partner that assumes liability and limited partners that have no personal liability to creditors. Passive tax losses & income are passed through. Limited partner has less flexibility to control or influence the project without tax & liability consequences. Moderately difficult & expensive to form and superior to general partnership in the ability to raise funds.

--**LLP (Limited Liability Partnership):** a relatively new creation that operates much like a limited partnership, but allows the members of the LLP to take an active role in the business of the partnership, without exposing them to personal liability for others' acts except to the extent of their investment in the LLP.



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## Ordinary Chapter C Corporation

- A separate legal entity in the eyes of the IRS, taxed at the corporate instead of individual tax rates.
- The C Corporation status will have a double taxation effect, one tax at the corporation level and one at the individual level upon distribution of dividends.
  - The participating owner/shareholder will be subject to payroll requirements. Any distribution from the corporation to the individual, after the payroll deduction, is treated as dividends. Income, expenses, gains, and losses that affect taxable income are reported to the IRS. Employer salaries are deductible corporate expenses subject to withholding requirements.



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## Ordinary Chapter C Corporation (Cont.)

- A collapsible corporation is typically created to avoid federal taxes and results in income being ineligible for capital gain treatment.
- A non-collapsible corporation is the typical business corporation. Complex & expensive to form with good ability to raise funds, if closely held. If publicly held, raising funds depends on the investment.



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## S Corporation

--An S corporation is a domestic corporation with no more than 75 eligible shareholders (shareholders can not be nonresident aliens).

There is only one class of stock (but can have voting and non-voting stock).

--Personal liability is limited in the same way as a Subchapter C corporation.

--It avoids double taxation.

--No more than 25 percent of the gross corporate income may be derived from passive income.

--An S Corporation can own 80 percent or more of the stock of a C corporation.

--An S Corporation is also now allowed to own a "qualified subchapter S subsidiary;" the parent S corporation must own 100 percent of the stock of the subsidiary.



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## S Corporation (cont.)

--Qualified retirement plans or Section 501(c)(3) charitable organizations may now be shareholders in S Corporations.

--An S corporation can generally provide employee benefits and deferred compensation plans.

--Not all domestic general business corporations are eligible for S corporation status. Exclusions include: a financial institution that is a bank; an insurance company taxed under Subchapter L; a Domestic International Sales Corporation (DISC); or certain affiliated groups of corporations.

--Complex & expensive to form with limited ability to raise funds—unsuited for income property



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## Limited Liability Corporation (LLC)

- Similar to Chapter S
- A Limited Liability Company is a hybrid of a corporation and a general partnership that is treated like a corporation for liability purposes, and like a partnership for tax purposes.
- An LLC, like a corporation, has not only the benefit of "limited liability," i.e., the owners, called members, are not personally liable for the LLC's debts, but also an LLC has the benefit of being treated as a partnership for income tax purposes.
  - Unlike a Subchapter S corporation, an LLC is not limited to 75 shareholders, who may be a shareholder, and is not limited by the types of business it may transact.
  - An LLC is not subject to the risks of double taxation inherent with corporations.
  - Moderately easy to form with limited ability to raise funds.



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## Real Estate Investment Trusts (REITs)

A REIT is similar to a tax conduit vehicle in corporate or trust form that combines the capital of many investors in order to acquire and hold real estate or provide financing for all forms of real estate.

REITs started in Massachusetts in 1880s, when trusts were not taxed if income was passed through to the beneficiaries. As a result of a Supreme Court ruling, all passive income vehicles that were organized and managed centrally like a corporation were taxed like a corporation (double taxation) starting in 1935. Stock and bond investment companies, including mutual funds were exempted.

After World War II, there was a huge need for real estate capital, which sparked a movement that resulted in the current form of REITs being established by Congress in 1960. That legislation provided small investors with the chance to participate in the benefits of owning larger-scale commercial real estate or mortgage lending and to receive an enhanced return, due to the fact that the income is not taxed at the REIT entity level.



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## REITS (Cont.)

REITs have had a troubled past. In the 1970s, Wall Street banks and insurance companies formed REITs that made high-risk construction and development loans and operated with a large amount of leverage. The ensuing crash gave REITs a bad image.

Most public REITs are now equity REITs, which own existing real estate portfolios with low leverage. Equity REITs are typically fully integrated with acquisition, development and property management expertise. Also, management typically owns 5 percent to 40 percent of a REIT, which helps keep the interests of investors and management aligned.

REITs are complex & expensive to form with a good ability to raise funds.



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## REIT Classifications

Equity REITs invest in and own property; revenues come principally from their properties rents.

Mortgage REITs deal in the investment and ownership of property mortgages; they loan money for mortgages to owners and operators of real estate or invest in (purchase) existing mortgages or mortgage-backed securities. Most of their revenue is from interest earned on mortgage loans.

Hybrid REITs invest in both mortgages and properties, combining the investment strategies of Equity REITs and Mortgage REITs. Health-care REITs make participating mortgages, enter into master leases, and develop & acquire medical buildings.



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## Questions/Comments



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