

**ULI Workshops
Financing and Investing in
Real Estate Projects
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Workshop Outline and Summary

- Global Real Estate Investment and Financing Practices
- Overview of Real Estate Capital Markets and Participants
- Investment Analysis and Rates of Return
- Framework for Evaluating Alternative Structures
- Financial Structuring
- Financing Process
- Sources of Financing

Workshop Principles

- Risk-return paradigm determines availability of equity/
debt capital
- Financial structure can magnify/mitigate risk and return
- Current/projected market conditions influence investor/
lender perceptions, realities, transaction structure, etc.

Global Investors in Real Estate
Equity and Debt

- | | |
|-------------------------------|---------------------------------------|
| • Equity Investors | • Debt Investors |
| Individuals/Private Companies | Commercial Banks |
| Pension Funds | Life Insurance Companies |
| Public Companies | Savings Institutions |
| Investment Banks | Government Sponsored Entities |
| Foreign (Offshore) Entities | Pension Funds |
| Opportunity Funds | Commercial Mortgage-Backed Securities |

Securities Markets v. Real Estate Markets
Efficient v. Inefficient

- | | |
|--|---|
| Characteristics of an efficient market such as the public securities markets | Characteristics of an inefficient market such as the real estate market |
| Many buyers and sellers | Few buyers and sellers |
| Transparency of information | Imperfect information |
| Very low transaction costs | High transaction costs |

Real Estate Investment Characteristics

- Industry is highly fragmented with few barriers to entry
- Each property is an unique, individual business enterprise
- Investment, operation, and management requires technical and financial training
- Long-term, illiquid nature of real estate ownership does not allow for instantaneous, trading-like solutions

- Competition is constant and continuous; real estate and the capital markets never remain in equilibrium for sustained periods
- Illiquid nature of real estate does not allow owner to change financial structure (leverage) quickly/without cost
- Industry lacks transparency as compared to financial markets and other business models
- Transactions are complex and costly to execute and require third-party expertise

Obstacles to Efficient Real Estate Investment

- Objective information sources lacking
- Limited usable research or comparable data
- Reliable price quotations unavailable of a frequent basis
- Difficult for buyers and sellers to find each other
- Transactions are cumbersome, time consuming, and paperwork intensive
- Possible title imperfections make title search and insurance policy part of every transaction
- Negotiating the deal may be difficult and frustrating
- Legal aspects, such as tax structuring, add complexity/cost

Why Individual and Institutional Investors Invest in Real Estate Equity and Debt?

- Risk versus return
- Array of structures to match risk and return profiles
- Cash flow from property operation-return on investment
- Proceeds of sale of property-return of investment and price appreciation
- Lower volatility than equity securities
- Diversification
- Matching of liabilities
- Inflation hedge
- Tax benefits

Sources of Real Estate Returns

- Sources of returns from investment in real estate
 - Cash flow from property operations
 - Proceeds of sale of property
- Sources of returns from investment in mortgages
 - Periodic (monthly) payments of interest
 - Repayment of principal (monthly and/or at maturity)

Types of Investment Risk

- Business risk
- Financial risk
- Liquidity risk
- Inflation risk
- Management risk
- Interest rate risk
- Legislative risk
- Environmental risk

What is Real Estate Equity?

- Equity-money that is invested in a property
 - Represents ownership of the property
 - Shares in the profits and losses of property operation and proceeds of property sale
 - Participates in the operating and financial risks of property ownership

What is Real Estate Debt?

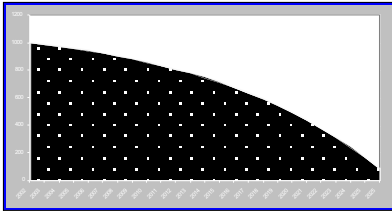
- Debt (Mortgage) Capital-money loaned to owner, developer or investor in exchange for promise to repay principal together with a specified return for the use of the funds for a specific period of time
- Lenders-intermediaries linking savers and borrowers
- Principal-the amount borrowed
- Interest-current payment for the use of borrowed money
- Mortgage is a fixed investment repaid over a long period of time

Characteristics of Real Estate Mortgage Loans

- Real estate loans categorized by term (or length)
 - Short-term or interim loans (the “Money Markets”)
 - Long-term or permanent loans (the “Capital Markets”)
- Type of loan utilized determined by stage of property
 - Short-term loans generally for planning through construction stages, or until permanent long-term financing completed
 - Long-term loans used for operation and management stage

- Recourse or non-recourse
- Secured or unsecured
- Specified term (when it must be repaid)
- Interest-fixed or variable
- Prepayment-when and if, and cost to prepay
- Amortization-how principal will be repaid (self-amortizing/balloon)

Mortgage Amortization



Example of \$40,000, 12% Interest, 25-Year Amortizing Loan, \$5,100 Annual Payment

Year 1 interest	$\$40,000 \times 12\% =$	\$4,800
Year 1 amortization	$\$5,100 - \$4,800 =$	\$300
Loan balance (end of year 1)	$\$40,000 - \$300 =$	\$39,700
Year 2 interest	$\$39,700 \times 12\% =$	\$4,764
Year 2 amortization	$\$5,100 - \$4,764 =$	\$336
Loan balance (end of year 2)	$\$39,700 - \$336 =$	\$39,364
Year 3 interest	$\$39,364 \times 12\% =$	\$4,724
Year 3 amortization	$\$5,100 - \$4,724 =$	\$376
Loan balance (end of year 3)	$\$39,364 - \$376 =$	\$38,998

Structuring and Analyzing Real Estate Equity Investments

- Equity investment can be structured as investment in:
 - Property
 - Special purpose entity formed to own property
 - Existing ownership entity
- Investment analysis-analyzing a property for its investment potential
 - What rate of return will be received?
 - How long should it be owned?
 - How should it be financed?
 - What are the risks associated with owning the property?

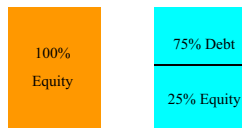
Structuring and Analyzing Real Estate Debt Investments

- Debt investments can be structured as mortgage (secured) loans secured by:
 - Property
 - Property and additional collateral
- Debt investments can also be structured as unsecured loans based upon the creditworthiness of the borrower
- Investment analysis-analyzing a property for the quantity, quality, and durability of its income

Financial Analysis and Real Estate Financial Decisions

- Starting point for financial analysis is Net Operating Income (NOI.)
- NOI is the source of economic returns for both equity investors and mortgage lenders
 - Potential Gross Income
 - (Vacancy Allowance and Credit Loss)
 - Effective Gross Income
 - (Operating Expenses)
 - Net Operating Income (NOI)
 - (Debt Service)
 - Net Cash Flow

Common Real Estate Capital Structures



- Why use debt?
 - Reduces cash investment
 - Increase return on equity through “positive” leverage

Estimating Property Value, Method I

- Direct Capitalization-determining value by converting first year NOI into value using a "rate"
- Capitalization "rate" is extracted from analysis of recent sales of comparable properties
- Example:
 - NOI = \$100,000
 - Capitalization rate = 10%
 - Estimated property value = $\$100,000 / 10\% = \$1,000,000$

Risk Versus Reward Determines Supply of Equity and Debt Capital

- What will you pay me to invest rather than save?
 - Real estate equity competes with investment in equity securities, mutual funds, venture capital, variable annuities, etc.
- What will you pay me to save rather than invest?
 - Real estate debt competes with investment in Treasury securities, corporate, high yield, and emerging market bonds, asset backed securities, fixed annuities, etc.

How are Equity Capitalization and Discount Rates Determined?

- Rates depend upon quality and durability of cash flows/proceeds of sale, tenancy, market conditions, property type and prospects, etc.
- Owners/developers, investors, lenders, appraisers, etc. use a build-up method to determine rates
 - Risk free rate (Treasury securities) 6.0%
 - Premium for general real estate risks 1.0% - 2.0%
 - Property specific risks 3.0% - 5.0%
 - Total 10.0%- 13.0%
- For leverage, add 5.0% - 7.0%

**Global Risk Premiums for Various
Real Estate Investment Strategies**

Risk-Free:	10-Year Treasury Bonds	6.00% - 6.00%
Income:	Triple net lease, investment grade CMBS, Par mortgages	1.00% - 2.50%
Balanced:	Fully leased, multi-tenant properties	3.00% - 7.00%
High-Yield:	Non-investment Grade CMBS, mezzanine debt, discounted mortgages	5.00% - 9.00%
Growth:	Partially leased, below market rents	5.00% - 10.00%
Opportunity:	Non-performing, development, lease-up, renovation, rehab, etc.	10.00% - 10.00%+

Band of Investment

Mortgage	65% LTV x Constant	65% x 8.87% = 5.77%
Equity	35% Equity Invested x ROE	35% x 10.0% = 3.50%
Total	100% of Property Cost	Overall Rate 9.27%
Mortgage	65% LTV x Constant	65% x 8.87% = 5.77%
Mezzanine	15% LTV x ROI	15% x 15.0% = 2.25%
Equity	20% Equity Invested x ROE	20% x 10.0% = 2.00%
Total	100% of Property Cost	Overall Rate 10.0%

**Factors Effecting Interest Rates
(the Cost of Borrowed Money)**

- Market trends and conditions
- Economy-inflation, deflation, growth, recession, recovery
- Compensation for risk of repayment (default risk)
- Prepayment and reinvestment risk (yield maintenance)
- Liquidity (illiquidity premium)
- Buy-side interest
- Regulatory (risk based capital rules)

Lender's Underwriting Decision, Method I

- Adequacy of value of property as collateral for loan
 - Test # 1- Loan-to-Value (LTV) Ratio
 - LTV is an absolute standard; "no loans in excess of 75% of market value"
 - Example: Market value = \$1,000,000 x 75%
LTV ratio = \$750,000 loan
 - At 75% LTV ratio, maximum loan is \$750,000

Lender's Underwriting Decision, Method II

- Adequacy of value of property as collateral for loan
 - Test # 2 - debt service coverage (DSC) ratio
 - Amount of NOI per dollar of debt service
 - DSC is an absolute standard: "no loans without minimum debt service coverage of 1.2 x 1"
 - Example: $\text{NOI} = \$100,000 / 1.2 = \$83,333$ -amount of NOI available to pay debt service
 - To calculate amount of loan, divide amount available for debt service by loan constant
 - $\$83,333 / 10.5\% = \$793,650$
 - At 1.2 x 1 DSC, maximum loan is \$793,650

What Would You Loan the Borrower? Why?

- Loan-to-Value Ratio \$750,000
- Debt Service Coverage Ratio \$793,650

Valuing Uneven Cash Flows

- Typically, real estate ownership produces cash flows that are “uneven” or “lumpy”
- How do you value “uneven” cash flows?
 - By discounting them individually to present value using a discounted cash flow (DCF) model/methodology
- When do you normally use a DCF model?
 - When the cash flows are not easily represented by a single year’s stabilized cash flow

Compound Interest

- Suppose you had \$100 to invest in a bank account that pays 10% interest per year for the next three years. What would it be worth in three years?

Initial Investment	\$100.00
10% interest for year 1	<u>10.00</u>
Balance at the end of year 1	\$110.00
10% interest for year 2	<u>11.00</u>
Balance at the end of year 2	\$121.00
10% interest for year 3	<u>12.10</u>
Balance at the end of year 3	\$133.10

The Discounting Process

- Discounting is the opposite of compounding
- Suppose you are promised \$10,000 (the future value) in one lump sum at the end of three years
- What would you be willing to accept today (the present value)?
- The answer is a function of:
 - The discount rate (the required annual rate of return on investment)
 - How long you have to wait for your money

- For example, at a discount rate of 10% per year, you could accept \$7,513.15 today instead of \$10,000 in three years
- Stated another way, at a 10% discount rate, receiving \$7,513.15 today and re-investing it at 10% per year, is the same as receiving \$10,000 in three years
- Proof:

Initial Investment	\$7,513.15
10% interest for year 1	<u>751.32</u>
Balance at the end of year 1	\$8,264.47
10% interest for year 2	<u>826.44</u>
Balance at the end of year 2	\$9,090.91
10% interest for year 3	<u>909.09</u>
Balance at the end of year 3	\$10,000.00

Estimating Property Value, Method II

- Discounted cash flow method-a \$ today is worth more than a \$ tomorrow
- Discount future stream of income* to current value at rate that reflects:
 - Opportunity cost (where else can I invest my \$\$\$)
 - Inflation expectations
 - Risk of return of invested capital
 - Risk of repayment of capital loaned
- * Future income equals
 - net operating income or cash flow to equity investor
 - debt service (principal and interest) to a lender

The ABC Office Building (Exhibit 1)

1. Schedule 1-Data Sheet
2. Schedule 2-Summary Lease Information
3. Schedule 3-Projected Base Rental Income
4. Schedule 4-Summary of Operating Expenses
5. Schedule 5-Projected Net Operating Income
6. Schedule 6-Summary Loan Information
7. Schedule 7-Estimated Sale Price
8. Schedule 8-Net Present Value
9. Schedule 9-Internal Rate of Return
10. Schedule 10-Modified Internal Rate of Return
11. Schedule 11-Partitioning the Internal Rate of Return

**Measures of Equity and Debt
Investment Performance**

- | | |
|-----------------------------------|---------------------------------|
| Equity Investment Measures | Debt Investment Measures |
| • Price per square foot | • Debt Service Constant |
| • Capitalization rate | • Loan-to-Value Ratio |
| • Equity dividend rate | • Loan-to-Cost Ratio |
| • Estimated future sale price | • Debt Service Coverage Ratio |
| • Net present value | |
| • Internal rate of return | |
| • Modified (Adjusted) IRR | |

ABC Office Building

Purchase Price	\$8,500,000	Current Market Rent per Sq. Ft.	\$15.00
Equity Investment	\$2,550,000	Gross Square Feet	100,000
First Mortgage	\$5,950,000	Projected Increase in Market Rent	4.0% per Year
Mortgage Terms		Management Fee	5.0% of Gross Income
Interest Rate	10.0%	Annual Increase in Consumer Price Index	4.0% per Year
Term	20 Years	Annual Debt Service	\$689,025
Amortization	20 Years		
Projected Sale Price	\$9,700,000		

Summary Lease Information

Tenant	Square Feet	Current Rent per Sq. Ft.	Current Rental	Remain. Lease Term	% CPI Adjust.	Expense Stop per Sq. Ft.
1	30,000	\$14.00	\$420,000	3 Years	50%	\$4.00
2	25,000	14.00	350,000	3 Years	50%	4.00
3	15,000	14.00	210,000	3 Years	50%	4.00
4	10,000	14.50	145,000	4 Years	50%	4.00
5	10,000	15.00	150,000	5 Years	50%	4.00
6	6,000	15.00	90,000	5 Years	50%	4.00
Total	96,000		1,365,000			

Projected Expense Reimbursements per Tenant per Year						
Tenant	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
1	\$13,500	\$16,905	\$25,101	\$0	\$3,848	\$7,857
2	11,250	14,088	20,918	0	3,207	6,548
3	6,750	8,453	12,551	0	1,924	3,929
4	2,000	3,315	5,867	7,099	0	1,336
5	0	1,135	3,867	5,099	6,381	0
6	0	681	2,320	3,059	3,829	0
Total	33,500	44,396	70,625	15,526	19,189	19,670

Projected Net Operating Income						
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Base Rent	\$1,350,000	\$1,392,300	\$1,420,146	\$1,589,672	\$1,639,992	\$1,699,809
Vacancy	(0)	(0)	(0)	(79,484)	(82,000)	(84,990)
Expense Reimb.	33,500	44,396	70,625	15,256	19,189	19,670
Eff. Gross Inc.	1,398,500	1,436,696	1,490,771	1,525,444	1,577,181	1,634,489
Oper. Expense	(427,200)	(438,096)	(464,325)	(476,146)	(488,460)	(501,289)
Mgt. Fee	(68,250)	(69,615)	(71,007)	(75,509)	(77,900)	(80,741)
NOI	903,050	928,985	955,439	973,790	1,010,822	1,052,459

Loan Summary					
Loan Principal	5,950,000	Loan Term	20 Years <th>Annual Debt Service</th> <td>\$689,025</td>	Annual Debt Service	\$689,025
Interest Rate	10.0%	Amort. Period	20 Years		
	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
Loan Payment	\$689,025	\$689,025	\$689,025	\$689,025	\$689,025
Interest	590,569	580,259	568,869	556,288	542,388
Principal	98,457	108,767	120,156	132,738	146,637
Mortgage Balance	5,851,543	5,742,776	5,662,620	5,489,883	5,343,245

Cash Flow from Operations					
	Year 1	Year 2	Year 3	Year 4	Year 5
NOI	\$903,050	\$928,985	\$955,439	\$973,790	\$1,010,822
Debt Service	(689,025)	(689,025)	(689,025)	(689,025)	(689,025)
Cash Flow from Operations	214,025	239,960	266,414	284,765	321,797
Debt Service Coverage Ratios	1.31 x 1	1.35 x 1	1.39 x 1	1.41 x 1	1.47x 1

- Estimated Sales Price at the End of year 5
 - Step 1: Apply annual increase in value to acquisition price: \$8,500,000 at 3.0% per year for 5 years equals:
 - \$9,850,000
 - Step 2: Capitalize net operating income at capitalization rate indicative of recent sales of comparable properties:
 - \$1,052,459 (6th year NOI) / 11.0% = \$9,567,809
 - Step 3: Reconcile values
 - Projected sales price at the end of 6 years \$9,700,000

Net Present Value / Profitability Index						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow	(2,550,000)	214,025	239,960	266,414	284,765	321,797
Sale Proceeds						4,356,755
Total	(2,550,000)	214,025	239,960	266,414	284,765	4,678,552
PV @ 18%		181,377	172,335	162,148	146,878	2,045,038
Total PV		2,707,776				
Equity	(2,550,000)					
Net PV		157,776				
Profit Index		2,707,776 / 2,550,000 = 1.06 x 1				

Internal Rate of Return						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow	(2,550,000)	214,025	239,960	266,414	284,765	321,797
Sale Proceeds						4,356,755
Total	(2,550,000)	214,025	239,960	266,414	284,765	4,678,552
PV @ 19.6%		178,895	167,650	155,581	284,765	1,908,873
Total PV	2,550,000					
Equity	(2,550,000)					
Total PV	0					

Modified Internal Rate of Return						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow	(2,550,000)	214,025	239,960	266,414	284,765	321,797
Sale Proceeds						4,356,755
Total	(2,550,000)	214,025	239,960	266,414	284,765	4,678,552
Future Value @ 6.0%		270,201	285,796	299,342	301,850	4,678,552
Total PV	5,835,551					

Partitioning the Internal Rate of Return						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flow	(2,550,000)	214,025	239,960	266,414	284,765	321,797
Sale Proceeds						4,356,755
Total	(2,550,000)	214,025	239,960	266,414	284,765	4,678,552
PV @ 19.6%		178,895	167,650	155,581	284,765	1,908,873
Total PV	2,550,000					
PV Cash Flow	772,422	30%				
PV Sale Proceeds	1,777,578	70%				

Financial Structures Used to Own Real Estate

- All cash ("Free and Clear")
- Leveraged
 - First mortgage
 - Other (subordinated) mortgages
- Hybrid
 - Mezzanine equity
 - Mezzanine debt

Structuring Real Estate Equity and Debt Investments

- Structuring-dividing a transaction into economic slices or "tranches"
 - Landowner (unsubordinated)
 - First mortgage
 - Mezzanine investment
 - Equity
 - Landowner (subordinated)
- Sum of the parts may be worth more than the whole
- Raise more money, or raise money at lower overall cost, by arbitraging appetites of different classes of investors

Impact of Financial Structuring

Total Cost of Asset	\$1,250,000
Gross Potential Income	\$270,000
(Vacancy Allowance-10%)	(27,000)
Gross Revenues	\$243,000
Operating Expenses	(118,000)
Net Operating Income	\$125,000
Return on Investment	10%

Effect of Positive Leverage on Annual Rates of Return

Based upon property cost of \$1,250,000 and variable mortgage amounts assuming 25-year, 7.5% interest rate, mortgage

Mortgage as % of Asset Cost	Equity	Debt Service	Cash Flow After Debt Service	Mortgage Constant	Return On Equity
90%	\$125,000	\$99,787	\$25,213	8.87%	20.17%
80%	250,000	88,700	36,300	8.87%	14.52%
70%	375,000	77,613	47,387	8.87%	12.64%
60%	500,000	66,525	58,475	8.87%	11.70%

Effect of Negative Leverage on Annual Rates of Return

Based upon property cost of \$1,250,000 and variable mortgage amounts assuming 15-year, 7.5% interest rate, mortgage

Mortgage as % of Asset Cost	Equity	Debt Service	Cash Flow After Debt Service	Mortgage Constant	Return On Equity
90%	\$125,000	\$125,213	\$(213)	11.13%	0.00%
80%	250,000	111,300	13,700	11.13%	5.48%
70%	375,000	97,388	27,612	11.13%	7.36%
60%	500,000	83,475	41,525	11.13%	8.31%

Impact of Operating Leverage

Building Cost		\$1,100,000
Equity Investment		\$200,000
Mortgage		\$900,000
Mortgage Terms	9% interest, 25-Year Term, 10.08% Mortgage Constant	
Income Growth		3% per Annum
Expense Growth		5% per Annum

**Favorable Operating Leverage
(in \$ thousands)**

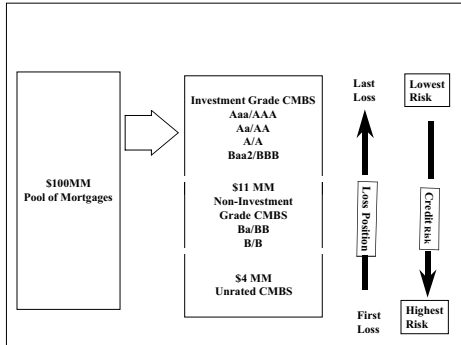
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Gross Revenues	\$200.0	\$206.0	\$212.2	\$218.5	\$225.1	\$231.9
(Operating Expenses)	(90.0)	(94.5)	(99.2)	(104.2)	(109.4)	(114.9)
(Mortgage Payment)	(90.7)	(90.7)	(90.7)	(90.7)	(90.7)	(90.7)
Cash Flow from Operations	\$19.3	\$20.8	\$22.3	\$23.6	\$25.0	\$26.3
Return on Investment	9.65%	10.40%	11.15%	11.80%	12.50%	13.15%

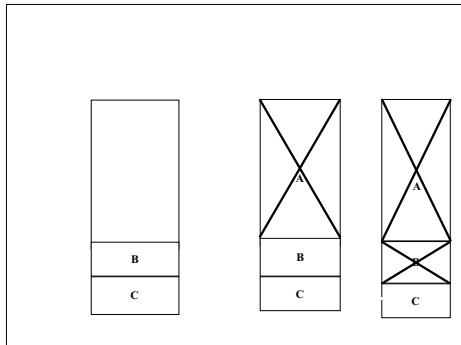
**Operating Leverage at
Varying Occupancy Levels**

Property Cost	\$1,250,000
Gross Potential Income	\$270,000
(Vacancy Allowance-10%)	(27,000)
Gross Revenue	\$243,000
Operating Expenses	(118,000)
Net Operating Income	\$125,000
Debt Service (\$1,000,000 mortgage, 7.5% interest rate, 25-year term)	(88,700)
Cash Flow from Operations	\$36,300

**Operating Leverage Based on
Varying Occupancy Levels**

Occupancy Rate	Net Operating Income	% Return on Cost	Cash Flow from Operations	Return on Equity
100%	\$152,000	12.16%	\$63,300	25.32%
95%	138,500	11.08%	49,800	19.92%
90%	125,000	10.00%	36,300	14.52%
85%	111,500	8.92%	22,800	9.12%
80%	98,000	7.84%	9,300	3.72%





Basic CMBS Structure
\$100 MM, 5-Year, Fixed Rate

Class	Size	Rating	Coupon	Expected Life	Subordination
Class A	\$85 MM	Aa2/AA	7.65%	3.6 years	15% ¹
Class B	\$11 MM	Ba2/BB	8.20%	5.0 years	4% ²
Class C	\$4 MM	NR			"First Loss Piece"

NR = Not rated
 Class C would likely be retained by issuer

Global Private Real Estate Equity
Capital Markets

- Direct equity investments and equity joint ventures
 - Available from wealthy individuals, pension funds, Opportunity funds, and others
 - All product types
 - All acquisition models-opportunistic, value creation, rehabilitation, yield, etc.
 - Utilize third-party financing (70% to 80%)
 - Term-1 to 5 years
 - Exit Strategy

Private Real Estate Equity Capital Markets-
Required Rates of Return

- Equity investor contributes up to 90% of capital required; real estate partner contributes balance
- Real estate partner's returns subordinated to equity investor receipt of:
 - Current return of 9% to 12%, cash-on-cash
 - Cumulative return (look-back IRR) of 15% to 20%
- Real estate partner handles day-today operations; paid market rate fees (which increase return on investment)

What is Mezzanine Real Estate Financing?

- Investment in debt, equity, or hybrid debt/equity position
- Subordinate to first mortgage financing and any other debt financing encumbering the property
- Senior to the property owner's equity investment
- Less security than first mortgage or any other debt financing
- Greater security than property owner

Overview of Mezzanine Financing Market

- Niche market comprised of opportunity funds, investment banks, and commercial banks
- Capital sources aggressively entered real estate markets 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

Types of Mezzanine Financing (Investment)

- Stabilized-existing property with current cash flow coverage for return on mezzanine investment
- Value added-existing property with moderate to substantial lease-up and/or re-leasing risk; generally requires cosmetic rehabilitation
- Development-to-be-built property with substantial development, construction, and lease-up risk
- Stabilized mortgage pool-purchase of non-rated tranche of commercial mortgage-backed securities

Key Terms in Mezzanine Financing

- Pay Rate: minimum current return paid to lender; may be fixed or floating rate
- Accrual Rate: Preferred return due lender before any cash flow is distributed to sponsor; may be paid currently or accrued during loan term
- Subordination: Priority of the lenders right to take action against the collateral or borrower; usually, the higher the leverage, the deeper the subordination
- IRR: Method of measuring return in mezzanine market

Pension Fund Joint Venture
(Exhibit 6)

- Purpose-to acquire existing shopping centers
- Capitalization-30% equity; 70% debt
- Equity Capital-25% real estate owner; 75% pension fund
- Term-minimum 3 years; maximum 5 years
- Call Option-prior to 3rd year, owner may acquire properties for cash sufficient to provide pension fund with 15% IRR
- Fees to owner-acquisition, leasing, property management, asset management, and disposition

- Cash Flow-pension fund receives 9% return on invested capital, owner receives 9% on invested capital; balance 75% to pension fund, 25% to owner
- Sale Proceeds-pension fund receives return of invested capital plus 9% IRR; owner receives invested capital plus 9% IRR; additional proceeds to 18% IRR 75% to pension fund, 25% to owner; additional proceeds above 18% IRR 60% to pension fund, 40% to owner

Composition of the Mortgage Capital Market

- Supply of funds
 - Savings from households, business, government
- Intermediaries
 - Commercial banks, insurance companies, savings and loan associations, credit companies, securitized lenders, mortgage REITs, pension funds, Federally related agencies
- Lending terms
 - Interest rate, principal, maturity, points, fees
- Demand for funds
 - Construction and permanent mortgages (single family residences, multifamily and commercial properties)

Sources of Debt Financing

- Commercial banks
- Insurance companies
- Savings and loan association
- Non-bank financial institutions (credit companies)
- Securitized lenders
- Mortgage REITs
- Pension funds
- Government sponsored entities

Lender General Information Requirements (Exhibits 9 and 10)

- Project information
- Market and financial data
- Government and regulatory information
- Legal documentation
- Additional information for construction lender
 - Copy of standby or permanent commitment
 - Architectural plans and specifications
 - Cost breakdown and construction budget

Financial Analysis and Feasibility Study (Exhibits 11 and 12)

- Key to securing either equity or mortgage financing is matching property risks and rewards with criteria of funding source
- Primary documents are feasibility study and detailed financial analysis
- Key ingredients are the same for both equity investors and lenders-what differs how they apply their internal criteria
- Where do most owners, developers, and borrowers go wrong?
