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Real Estate Finance

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PRINCIPAL

Basic Finance Concepts

- Financing Phases & Types
- Evaluation Tools
- Time Value of Money
- Risk and Return on Investment
- Investment Value

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Key Project Planning Questions

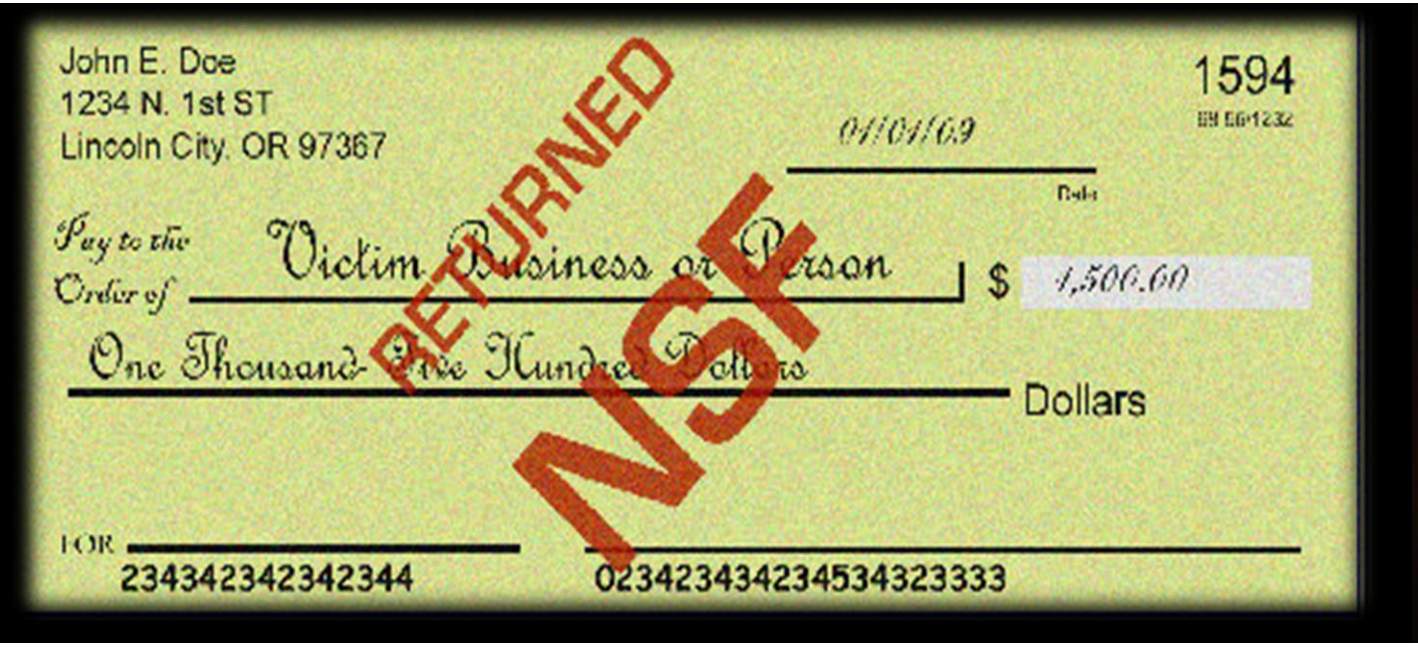
- Does the market need my project?
- Can I bear the cost of getting the project to the point of construction?
  - Scheduled tasks and costs
  - Sources of funding for each task
- Will the project, if built, be profitable?
  - Overall profitability based on project value less project cost
  - Amount of debt, amount of equity

Asset Cost

LAND	$ 1,000,000
IMPROVEMENTS	
HARD Costs (Construction)	$ 7,000,000
SOFT Costs	
A&E	
Marketing	
Finance	
Legal	
Insurance	
Capitalized Interest	
Carrying Charges	
Taxes	$ 2,000,000
TOTAL PROJECT COST	$10,000,000

Gross Operating Income (a/k/a Effective Gross Income)

	Gross Potential Income	$3,000,000
–	Vacancies	($250,000)
–	Credit Losses	($50,000)
	Gross Operating Income	$2,700,000



Simple High-Level Proforma (NOI)

- Does not include:
  - Income Taxes
  - Depreciation
  - Debt Service
- The basis of most single number value calculations

Income		
Potential Gross Income	10,000SF @ $30/sf	$3,000,000
Vacancy & Credit Loss	10%	(300,000)
Gross Operating Income		$2,700,000
Expenses		
Utilities		
Real Estate Taxes		
Cleaning		
Maintenance & Repairs		
Property Management		
Insurance		
Subtotal	Assume 37%	($1,000,000)
Net Operating Income		$1,700,000

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Capitalization Rate (Cap Rate)

- Measures the rate of return on *total* capital invested (i.e., without distinguishing between debt and equity)
- Estimated rate of return on a property at the time of purchase or initial stabilized year
- Used in rental properties
- Frequent benchmark

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{Total Capital Invested}}$$

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Cap Rate / Project Yield

Example

Current NOI (Net Operating Income)	$1,700,000
Cost to Purchase/Build	$10,000,000

Cap Rate = $1,700,000 ÷ $10,000,000 = 17%

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Risk and Return on Investment

- What's a reasonable return?
- Evaluation of Risk determines required return in relation to alternate investments
- What do you expect back from:
  - U.S. Government (T-Bills)
  - Bank (Demand Deposit)
  - Corporate Bond
  - Mutual Fund
  - Tech Stock
  - Your No-good Brother-in-Law

Risk and Return on Investment

- The difference between rates of return for different investments reflects market adjustment for comparative *perceived* risk
- Variables include
  - Safety of principal
  - Duration of investment
  - Timing of cash flows
  - Difficulty of execution
- Expected rate of return
- “Risk-Free” rate of return + risk premium

Pricing Risk

Example

Risk-free short-term rate (1-yr T-bills)	=	4.0%
+ Expected annual rate of inflation	=	6.0%
+ Liquidity risk (can't sell quickly)	=	2.0%
+ Economic, business risks	=	5.0%
+ Political Risk	=	???%
Return required:	=	17.0% + ???

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Target Returns

Each use is different

Sector	Target IRR*	Timing of sale or lease	Anchor Tenant
Land development	15 - 25%	With phasing	Depends on phase
For-sale residential	8 - 20%	Pre-sales for each phase	None
Multi-family	4.5 - 6.5%	Lease-up after construction	None
Office	5 -10%	Pre-leasing desirable	Desirable
Retail	6 - 7.5%	Pre-leasing usually req'd	Desirable
Industrial	6 - 10%	Lease up after construction	Occasional

*Unleveraged Internal Rate of Return. Higher leverage increases return on equity.

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Structuring Site and Development Financing

- Principal

So…

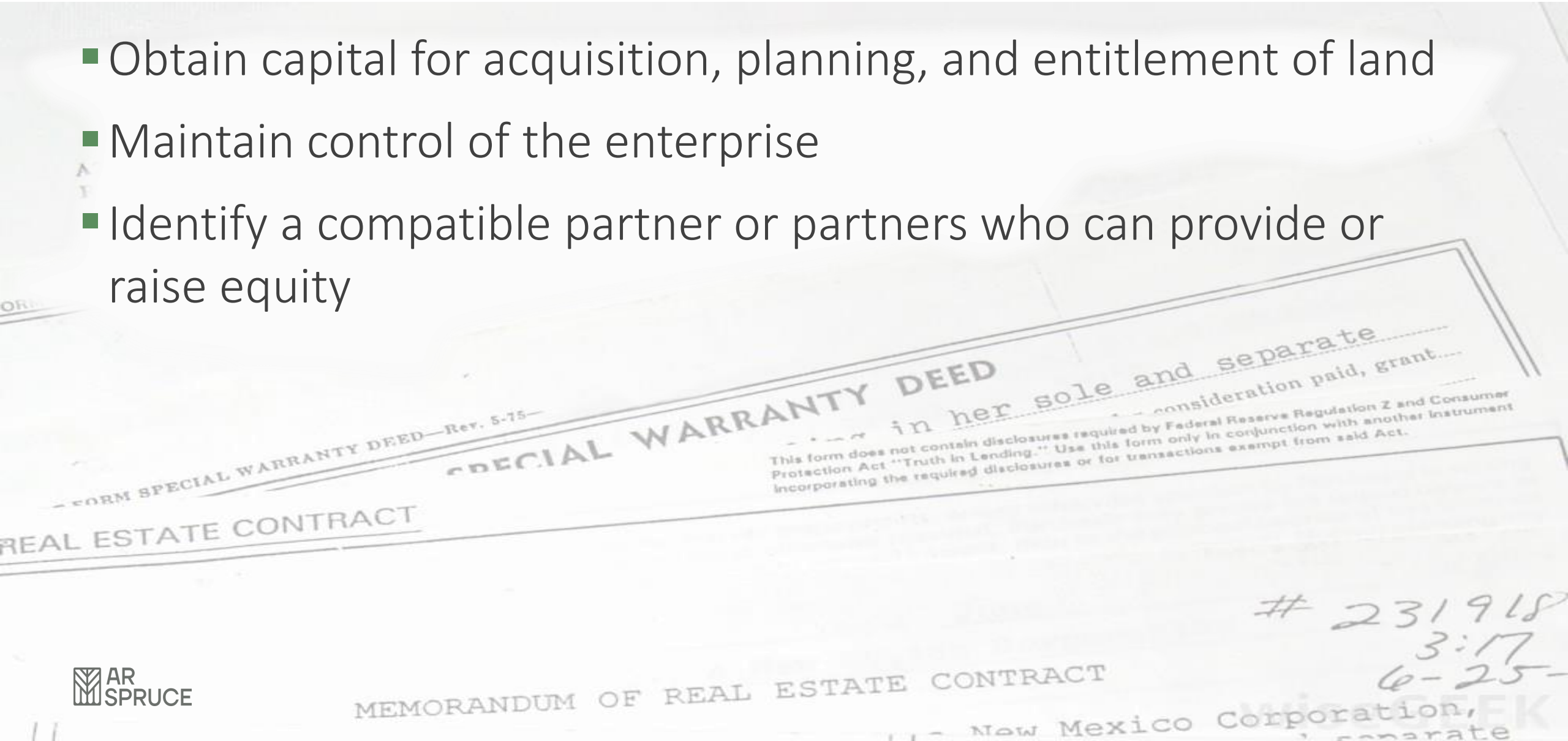
How do we pay for it?

Financing Phases & Types:

- Predevelopment
- Construction
- Bridge/Mezzanine
- Permanent
- Matching Source to Phase Risk
  - Rates are Proportional to Risk

Developer Objectives

- Obtain capital for acquisition, planning, and entitlement of land
- Maintain control of the enterprise
- Identify a compatible partner or partners who can provide or raise equity



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Large (>$30MM) Project Sources

- Debt (construction or permanent)
  - Seller
  - Bank or Thrift
  - CMBS
  - Life insurance companies
- Equity
  - Seller
  - Private investors
  - Capital firms (REIT's, life insurance, equity firms)
  - Institutions (pension, foreign wealth funds, etc.)
- Public
  - County, city and other local entities
  - Federally insured funding sources

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Small-Medium ($5MM - $30MM) Project Sources

- Developer Cash
- Investor Cash (Equity)
- Seller Financing
- Seller Joint Venture (Equity)
- Bank Loan
- Public/Government Loan or Guarantee

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Very Small (<$5MM) Project Sources

- Too small to interest institutional and PE investors
- Sources more difficult to find and manage
  - Developer Cash
  - Friends & Family (Equity)
  - Crowdsourcing (e.g.; fundrise.com)
  - Seller Financing
  - Seller Joint Venture (Equity)
- Bank Loan

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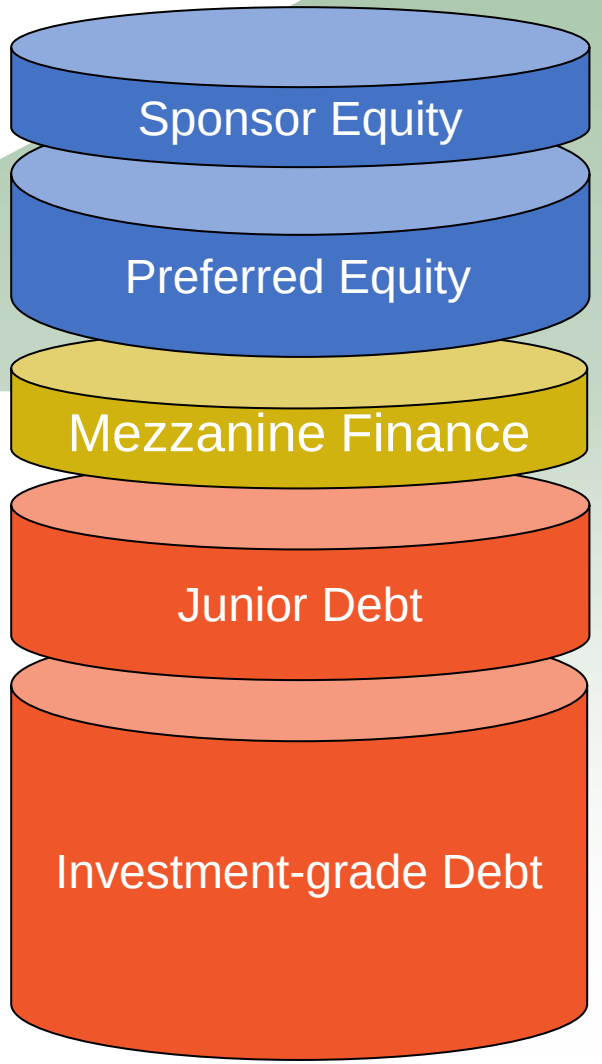
Capital Markets

	Equity (Owners)	Debt (Liens)
Private (directly held)	Individual and life insurance companies, pension funds, foreign investors	Banks, life insurance companies, pension funds, foreign investors.
Public (indirectly held)	Publicly traded companies, equity REITs	CMBS market (GSE and non-GSE-backed), mortgage REITs, mortgage funds

The Capital Stack



Equity

20% to 60% of project costs

Pays return based on performance

Mezz

Gap financing to cover costs not supported by primary debt or equity. Subordinate, more expensive, usually paid through interest + performance.

Debt

40% to 80% of project costs

Pays interest, secured by lien

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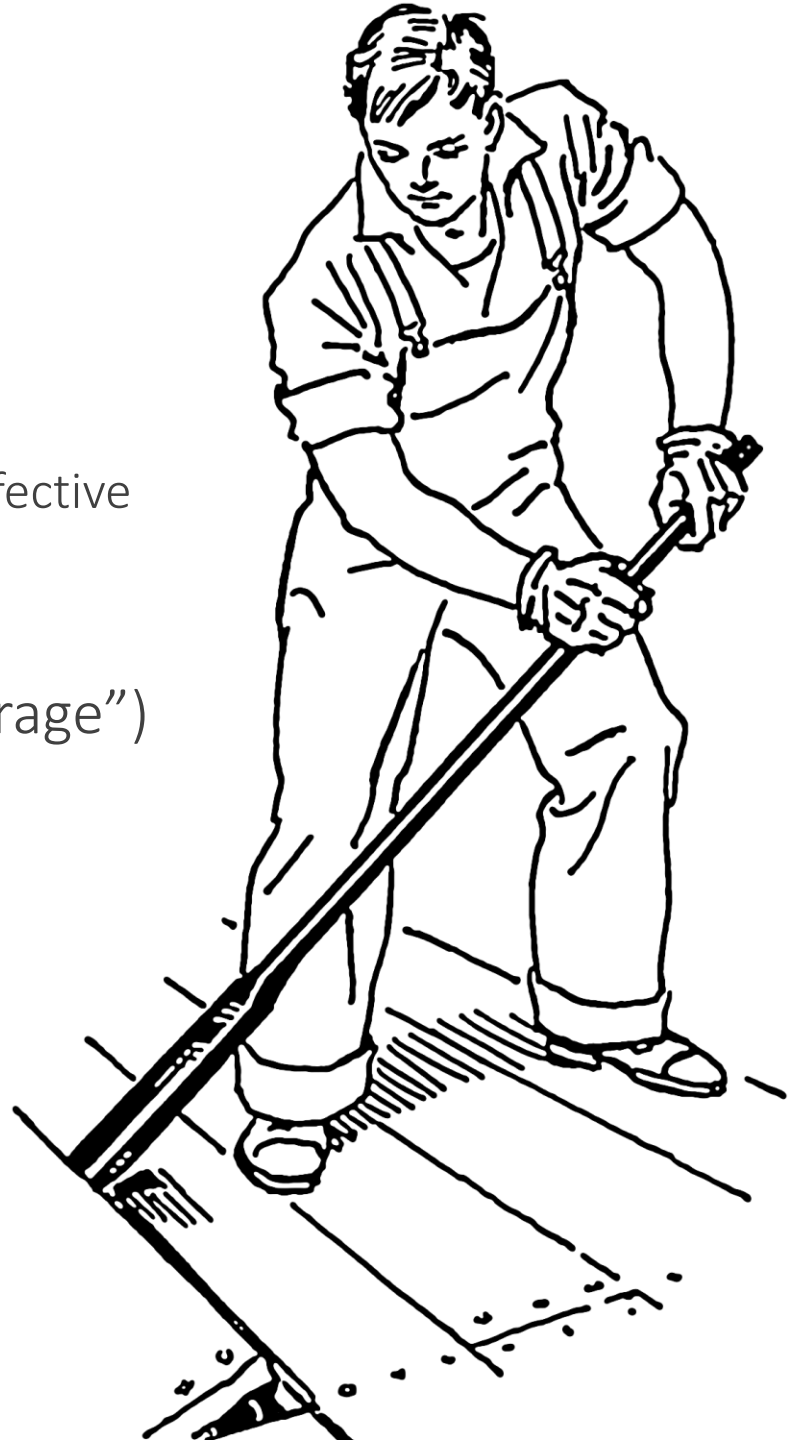
Debt

- Has a security interest (mortgage lien)
- Different loans for construction and operations periods
- Annual interest *normally* 5% to 8%, (current rates are closer to historical norms!) 10 to 30 year amortization. Rates fixed or float, usually tied to SOFR
- 5 to 15-year balloon payment
- Loan amount a fraction of asset value
- Developer/Sponsor may be required to guarantee performance through recourse provisions:
  - Project completion
  - Cost estimates
  - Lease up
- Sponsor usually has to meet minimum liquidity and net worth standards

More debt financing / More leverage

- Managing rate risk: hedging variable rates
- Debt costs less than equity (Why?)
  - Generally, the cost of equity ranges between 4% and 8% above the effective cost of debt
- Leverage: borrowing funds at a rate of interest lower than the expected rate of return on total funds invested (“positive leverage”)
- Higher leverage means higher returns on equity
- Higher leverage means more risk
- Return is expressed as
  - “Leveraged" : return on equity
  - “Unleveraged" : return on total costs



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Equity Financing

Skin in the Game

- Total target return varies by sector.
- Preferred return 9%-12%
- Usually 15% to 25% "target" total annual return.
- Developer usually must co-invest about 10% of equity (lender requirement).
- After debt, profits pay
  1. Return of principal
  2. A preferred return of 9% to 12%
  3. Additional post-preferred return to stated target, with some return to developer.
  4. After target is reached, higher promotional return to developer.

Equity Sources

Institutional & Other Investment Entities

- REITs
- Pension Funds
- Insurance Companies
- Opportunity Funds (RE Private Equity)
  - May have specialized focus
- Venture Capitalists – not a factor
- “Family Offices”
- Crowdfunders

Mezzanine Financing

"In-the-Middle" Financing to Fill a Capitalization Gap

- Almost always unsecured
- Always subordinate to senior debt
- Types
  - Subordinate debt
  - Preferred equity
  - Convertible debt
  - Participating debt
- Expensive

Development Equity Sources/Financing vs. Control

- Developer Cash - Retains Full Control of Project and Profits but Limits Deal Size
- Investor Cash - Trade Control for “Reduced” Risk (but not really…depends on investor)
- Seller Joint Venture - Developer Trades Expertise for Project Ownership
- Seller Financing - Trade Higher Interest Rate or Land Cost for Less Cash Up Front
- Bank Loan - Developer Retains Full Control (but guarantees can be harmful To Your health)
- Public/Government Loan or Guarantee - You Now “Work” for the Government

Distributions

- The major areas requiring careful consideration and negotiation skills for distributing cash flows include:
  - Preferred returns on equity invested
  - Priorities of payback of equity invested versus sweat equity
  - Developer fees
  - Split of the balance

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