FINANCING THE REAL ESTATE MORTGAGE ACQUISITION

Introduction. As of this writing (April 2010) the anticipation of deal flow, more specifically, the opportunity to purchase mass quantities of distressed real estate mortgages, has yet to be realized. "Sourcing" the deal still seems to be the most valuable component of consummating a transaction. Of course, this reference to sourcing a deal needs to imply that it's an opportunity with a realistic seller employing realistic expectations about valuations and pricing. If you are (pick one) good enough or lucky enough to source a deal you will immediately want to consider how to organize your capital for your most efficient acquisition execution. Some of your considerations should include:

Types of Financing. Depending on your access to "at-risk" equity capital and/or just your plain tolerance for risk, your note acquisition can use one or more of the following styles of capital financing:

> **Senior Debt.** Private investors, traditional bank lenders, and a new breed of mortgage REIT's are three categories of investors who have aggregated capital to provide acquisition financing in a senior secured position. Some common lending terms for this class of investor include:
>
> > **50-60% LTC**. The lender's initial advance is typically sized off of a contracted purchase price in the range of 50 to 60% of such price. Considerations for going above or below the stated range would likely revolve around the current cash flow associated with the notes. A portfolio of land loans would be very difficult to borrow against for this reason.
> >
> > **Working Capital**. A senior lender will be acutely concerned with the acquirer's ability to fund out of pocket any working capital needs prior to the assets providing any substantial cash flow to the sponsor. Working capital needs would include salaries and overhead for team members and third party costs associated with the execution of individual asset management strategies, i.e. attorney's fees for pursuing a foreclosure action.
> >
> > **Interest Only, Partially Accruing.** Senior lenders typically structure debt service payments as interest only, since loan terms are usually three years of less. In some circumstances you may negotiate a portion of the interest payment to accrue and become due at the maturity of the loan. It's vitally important to mirror the characteristics of the cash flows of the assets with those of the liability.
> >
> > **Points In & Out**. In order to enhance their own yields some senior lenders will add discount points to the initial funding of the loan, and others will tack it on as loans payoff, otherwise known as exit fees. These fees should be added to the interest costs to determine the lender's overall yield. An overall yield between 8 and 10% is pretty typical, depending upon the perceived risk of the assets, and should allow for a 200 to 250 basis point spread between an asset's unleveraged yield and the cost of the senior debt, in terms of overall yield.

Current Coverage. A senior debt investor will ensure part of its safety margin with the current coverage ratio, or how much in excess of the lender's debt service payments is the cash flow stream from the mortgage.

Expected Recovery. In addition to over-collateralizing itself from a value point of view, the senior lender will likely review the sponsors projected recovery. A loan worth $1 today may have a perceived higher payoff if the recovery strategy includes foreclosure and owning the fee simple interest in the property. However, a senior lender may perceive this "enhanced" future value as exactly the opposite, if the strategy entails far greater expenses and much greater time for realization. In other words, the riskier resolution strategy needs to convey a strong positive marginal return, otherwise your initial loan proceeds may get reduced.

Release Prices. In the context of buying multiple notes, all acting as collateral for your lender's senior position, you may be required to distribute more than the pro rata amount of the senior debt when that specific note either pays off or is sold. This is analogous to a lot release schedule for a residential subdivision, which allows the lender to receive a full payoff prior to all the assets being sold.

Equity Joint Venture. Institutional real estate investors, including hedge funds, opportunity funds, special situations groups and others typically populate this type of financing. Occasionally you will find private investors included in this group, especially for one-off deals and small portfolios. Some considerations you must look at include:

Passive vs. Active. The style of your equity partner is extremely important to your decision. Namely, does your venture partner want to be a hands-on investor, dragging you and your team along for the ride, or is the investor small staffed and reliant upon you and your team to perform the necessary asset management duties and create the value? A simple look at the investor's infrastructure will tell you which style they exhibit. Do they have 7 regional offices with 150 employees? Chances are you and your team will become additional employees.

Leveraged or Un-leveraged. Some institutional investors will want to leverage their own equity by using senior secured debt, and others won't. The advantages to employing debt are obvious, but the reasons for not using leverage not so much. Typically, an institutional investor will not use leverage for the following reasons: 1) variability of note cash flows causing a concern of not meeting scheduled debt service; and 2) the desire to employ more investment dollars to reap more of the actual investment profits. Reason number 2 moves away from an IRR perspective and toward a whole dollar return philosophy. The old adage, "you can't eat IRR", applies.

Required Co-Invest – Something Meaningful. "Skin in the game", conveys the meaning of the co-invest. Not all investors require a set percentage of their invested capital, especially when acquiring a large balance loan or a sizable portfolio. The key to this negotiated provision is that the investor realizes that the amount of co-invest is very meaningful – enough so to keep you awake at night and up early in the morning. A meaningful co-invest allows the investor to believe that all party's interests have been aligned.

Sponsorship Fees. A key item for many investment sponsors is the amount and timing of fees associated with the management of that asset. Quite often these fees help support the sponsor's infrastructure and acts as oxygen in the tank. Such fees can include the following:

> **Acquisition Fee.** At the closing of the acquisition, the sponsor can earn a fee, equal to 0.5% to 1.5% of the total purchase price. Not all investors and lenders allow this fee. Others may allow the fee to act as the sponsors co-investment, while others will require the fee to be deferred to the back end of the investment, and paid out as a preferred distribution of profit.
>
> **Asset Management Fee.** A monthly or quarterly fee usually equal to 1% of the total investment basis is paid to the sponsor for handling the off-site, day to day management of the assets. Depending upon the investor's infrastructure and the perceived abilities of the sponsor's team this fee may be shared between the sponsor and the investor.
>
> **Property Management Fee**. If your exit strategy includes owning the fee simple interest in the collateral, the sponsor may choose to operate the property. If the sponsor is staffed with qualified property managers it may be eligible to receive a fee, equal to 3-5% of gross revenues, for the on-site, day to day management of the property.
>
> **Construction Management Fee.** Part of the sponsor's ownership responsibilities may include the oversight of property rehabilitation and/or tenant improvement construction. If the sponsor is staffed with qualified construction personnel it may be eligible to collect a fee equal to 3-5% of total construction costs.
>
> **Disposition Fee.** At the time the venture sells the asset the sponsor may earn a fee based on a percentage of the sales price – typically in the range of 1-5%. This fee may be compensation for the sponsor's effort to sell the asset directly or the oversight of brokerage team charged with selling.

Asset Management. In the business of buying and selling distressed real estate notes, the term asset management covers a wide variety of real estate skill sets. The range of skills spans from the administration of loan documents to foreclosure and receivership services, to marketing and leasing of properties to the strategy development of property disposition. In order for the sponsor to rightfully demand compensation for its asset management services it must be able to demonstrate its historical ability to effectively exercise these skills. A clear, concise and accurately presented capabilities brochures for the sponsor should be assembled ahead of time and presented to your capital partners and lenders early in the capital raising efforts.

Co-Invest Capital Partners. In a $50 Million portfolio acquisition a sponsor may face a required co-investment of $2.5 to $5.0 Million. For sponsor's not possessing such financial capabilities it's possible to reach out to a class of investors known as co-investment capital partners.

Institutional vs. Non-Institutional. These investors are very diverse in nature, with both private and institutional investors playing this high-leverage game. Equally diverse are the terms they are willing to invest under.

Deal Splits. Private investors may provide 100% of the required investment and in return may demand 50-70% of the sponsor's profits. Institutional co-investment partners will typically provide a percentage of the required investment, 50-75%, and will demand repayment through a waterfall distribution schedule based on a calculated IRR.

Pursuit Costs. Prior to the consummation of an acquisition, the Sponsor must deal with the sticky issues involving pursuit costs: i.e. costs that must be incurred and currently paid in your efforts to get a deal under control. Among those costs are:

Initial Soft Deposits. Usually these are the responsibility of the sponsor. You may negotiate a sharing arrangement once a definitive agreement is in place between the sponsor and the capital party on the joint ownership of the asset.

Hard Money Deposits. Typically, hard money deposits are not made until there is a definitive agreement between sponsor and capital partner. Once that agreement is in place the sharing of hard money deposits is most often done on a prorata basis.

Underwriting/Third Party Costs. Again, these costs are typically the responsibility of the sponsor prior to definitive agreements, with the possibility of a sharing arrangement afterwards.

Closing Costs. Closing costs are a bit easier to deal with, since these expenses, can be and usually, are considered part of the cost of the deal and are financed out of the deal's capital stack. All parties are much more at ease with them since they are part of a closed transaction. These costs include:

Title and Escrow, Legal and Accounting, Broker Fees. These costs are typically included in the deal's capital stack, with the exception of either side paying their own legal costs in negotiating the agreement between sponsor and capital partner.

Underwriting Parameters. The foundation of your bid amount for the note, the lender's financing and your capital partner agreement is the asset underwriting. Thus, it is critically important that your underwriting be done in a rigorous and robust fashion. This doesn't necessarily mean overly conservative, since the market to buy loans today is rather competitive. It does mean that all assumptions must be well vetted and all elements of uncertainty taken into account.

Bottom-Up Real Estate Analysis. Note purchase analysis starts with a bottom-up real estate review. Since the value of the real estate is driving the value of the mortgage position, the review will be real estate centric. Beyond that, the analyst should look at how the specific collateral fits into the surrounding sub-market, in terms of rents, expenses, and occupancy. If the market changes how will the collateral change relative to where it is now and compared to the sub-market? Next, is how the sub-market fits into the city, state and region. Are these areas poised for growth in jobs, population and income? If so, how could those positive trends affect the collateral?

Mortgage Position Exit Strategy. The next relevant component of your underwriting is the expected exit strategy for the investment. The strategy should fit neatly with your bottom-up review. In a flat or mildly declining market, a discounted payoff to the borrower or a loan restructure and note sale to an investor may be a better play. In a soon to be appreciating market, the sponsor may get aggressive and plan to foreclose on the property and own the fee simple interests. Of course, any "loan to own" strategy must be fully vetted by legal counsel. What are the state laws concerning foreclosure, how likely is the borrower to fight the foreclosure, and what remedies do you have under the loan agreement?

Projected Property Cash Flow. The relevant information gained in the first two steps will guide you in building your property net operating income projections, as well as terminal values.

Variability of Projected Income. At this point, considerable care should be taken with regards to uncertainty. Running sensitivity analysis, testing your boundaries for downside, should help you assess your purchase price as well as assumed levels of senior debt.

Projected Exit Strategy Costs. If you do assume the "loan to own" strategy you will want to engage litigation counsel to provide you with estimates of time to achieve property ownership along with commensurate costs. Perhaps you can negotiate a fixed fee for delivering the deed in order to add an element of certainty to your projections.

Current Cash Flow to the Mortgage Position. Now you are ready to assess your current yield on your investment and the likelihood of profit. A few questions to be explored relate to income coverage ratios and the excess of terminal value over your investment basis.

Property Income Coverage. First, by how much does the net operating income from the property cover the scheduled mortgage payments due to the mortgage position? Second, by how much do the projected payments to the mortgage position exceed the scheduled payments to the senior acquisition lender you used to purchase the note? In both cases the degree of coverage will relate to safety. Any shortfalls experienced by the sponsor will either accrue to the senior principal position or will have to be serviced by the partnership. What does your partnership agreement say about debt service shortfalls? Was it planned for with a partnership reserve?

Projected Terminal Payment to the Mortgage Position. Determining this amount is very dependent upon the planned style of exit. A discounted payoff is the least risky strategy, but is likely to be the lowest payoff since a new loan, underwritten at today's values and parameters, will be used to payoff the mortgage position. A foreclosure proceeding might be at the other end of the spectrum, with a note sale to a third party investor somewhere in the middle.

Sensitivity Model of Cash Flows. In distressed note purchases uncertainty is abound. At the property level rental rates, occupancies, operating expenses, and capitalization rates, can all demonstrate significant volatility. The stigma of distressed ownership of a property can have a highly detrimental impact on a tenant's desire to continue inhabiting the property. If co-tenancy issues exist the problems can quickly multiply. At the loan document level a sponsor can incur an adverse ruling from a judge, and at the exit strategy level, take out loan underwriting can tighten, or a note buyer can fall out of escrow. Given the volatility of the environment, the sponsor needs to be well versed in sensitivity analysis, and understand what happens to its investment position if certain negative events happen. Developing a cash flow model that quickly assimilates the results of a negative event can greatly facilitate the investment committee talking through the strategy to mitigate these risks.

Distributions of Cash Flow. If all goes well you might even see some cash coming your way at the end of the investment. How that cash gets divided between lender, capital partner, co-invest partner and the sponsor is as varied as the imagination will allow. However, the following ideas should be kept in mind when negotiating all definitive agreements:

Senior Lender. In return for accepting a 9 to 10% overall return, the senior lender will demand priority of repayment on the vast majority of its distribution.

Current Interest. In some circumstances the lender will allow the sponsor to pay only a portion of the interest due on a monthly basis. This is usually driven by the nature and projected cash flow of the collateral. These payments always maintain priority.

Accrued Interest. When the projected cash flows from the collateral aren't projected to cover the full interest payment, the lender may allow an unpaid portion to accrue and add to the principal amount to be paid off at exit. To the extent that the sponsor is earning monthly fees from the collateral's income, the accrued interest becomes partially subordinated.

Exit Fee. To enhance its yield a senior lender may change the borrower a fee at the loan's payoff. Usually these fees range from 1 to 3% of the loan balance. The shorter the term of the loan, the greater the yield enhancement. These fees maintain priority over distributions made to the equity.

Equity Joint Venture Partner. Once the senior lender is paid off the capital partner will want its share. Again, the methods employed for distribution can vary widely, and are only limited by imagination. In general, the capital partner will want to receive as much capital as possible prior to the sponsor receiving any. Typically, the capital partner will want to "back-end" the sponsor with distributions as much as possible, except with regards to the cash it actually invested. Usually cash is treated the same by both parties.

> **Return of Capital.** The first level of distribution will be to pay a negotiated return on all capital invested, say somewhere between 8 and 12%. Once the return is paid, then the return of the capital is made.
>
> **IRR Hurdles.** After invested capital is returned, the capital partner will likely propose a waterfall distribution that has the sponsor taking greater and greater percentages of the distributions as the capital partner earns profits over multiple IRR "hurdles". 20% over a 10% IRR; 30% over a 15% IRR; 40% over a 25% IRR, etc., as an example. If the capital partner is a non-institutional investor you may be able to eliminate some or all of these hurdles and proceed with a straight, predetermined split.

Co-Investment Partner. In the above discussion the co-invest partner is part of the sponsorship entity. Whatever benefits the sponsor can negotiate with the capital partner, the co-investment partner will share.

> **Straight Splits vs. Waterfall Distributions.** A co-investment partner can receive distributions in a myriad of ways. They can also negotiate preferred distributions with the sponsor. This is a high-risk investment and they should know well enough to demand commensurate returns. They will risk their capital with the sponsor because they believe in the sponsors business savvy and experience in dealing with defaulted mortgages.