



commercial real estate
with a

Credit Point of View



Those of us schooled in the discipline of credit often have a different take on what is going on in commercial real estate. We thought it would be helpful to share our perspective on the market – and perhaps provoke some thought, discussion and insight. In these posts, Gunnar Branson sits down with Wrightwood Capital executives and examines the implications, the insights, the opportunities – and the risks that can be understood from a “credit view” of Commercial Real Estate.

debt investing – how does that scan?

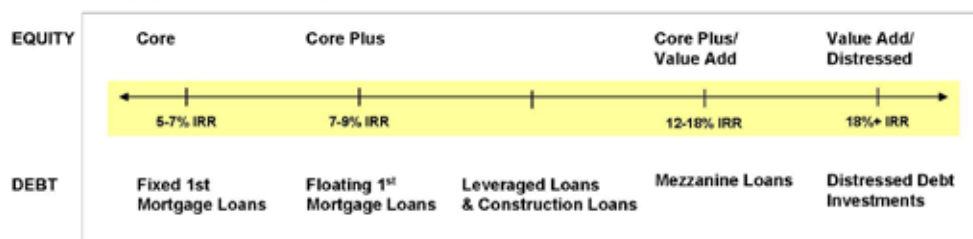
At least 80 debt funds have announced their intent to focus on investing in commercial real estate debt - reflecting a consensus that debt is a viable and growing alternative for institutional investors. Many institutional investors, experienced in evaluating equity strategies, may find debt to be a different kind of challenge with its own quirks and vocabulary. Obviously, at a macro-level, the concerns of debt and equity in commercial real estate are the same, with the same market and operational level due-diligence required; but the structures, risks and skills required in debt are a bit different.

Understanding those differences requires some time spent with experienced debt platforms to learn what works and what doesn't. As Jason Choulochas, Managing Director of Investments for Wrightwood Capital recently told me, “Investors get tripped up when they assume that debt and equity are the same. Debt and equity share a lot in common, of course, it's all connected to the same assets, but at the same time, the structures are different, the risks are different, and how you manage a portfolio of debt investments takes a very different mindset and approach.”

There are, however, some parallels to draw between debt and equity that can help accelerate the learning process. For example, over the years, institutional investors in commercial real estate have agreed upon a few basic categories of equity investing as a short hand for risk and return expectations. When assessing different equity investments, most investors understand the categories of Core, Core Plus, Value Add and Distressed and where they fit on a spectrum of risk and returns - but debt uses a different set of approaches across that same spectrum.

Fortunately, as a first step, it is possible to align familiar equity strategies with debt categories. Jason shared his take on how one can line up equity with debt.

Equity to Debt Analogue



As you can see in the chart above, it's possible to correlate the equity categories to first mortgages, leveraged debt, mezzanine loans and even distressed debt investments.

It is also more likely that the debt investor will borrow elements from equity investing to increase their potential return beyond an interest payment - even to the point of combining debt and equity structures in the same transaction.

Below is a quick overview of debt investing categories compared to their equity analogues as described by Jason:

Core = Fixed First Mortgage

A portfolio of first mortgage loans will behave somewhat like a core real estate portfolio - with typical unlevered gross returns of 5 - 7%. This "plain vanilla" lending through 5 - 10 year fixed rate mortgages on stabilized properties provides a stable and reliable cash flow through the term of the investment. There is no significant upside, but this strategy is less reliant on the asset appreciating significantly in value during the term of the investment. First mortgage lenders benefit from relatively large amounts of subordinate capital (equity) to insulate them from loss.

Core Plus = Floating First Mortgage


Focused on value added real estate with a shorter term of 3 - 5 years, typically the unlevered gross returns are between 7 and 9% for these kinds of debt strategies. This strategy is more dependent on the success of the business plan execution, as the properties are not stabilized at the outset - and some of the returns may be built into the back end of the deal.

Other Niche Strategies

Standing between typical first mortgages and mezzanine debt funds there are a number of strategies including construction lending, financing of B notes and other forms of leveraged finance that do not easily correlate with equity strategies.

Core Plus/Value Add = Mezzanine Loans

Focused again on value added property acquisitions, mezzanine structures are secured by the partnership interest of the borrower instead of the property itself, (which secures a third party first mortgage loan). Loan terms are 3 - 5 years for a 12 - 18% unleveraged IRR and is highly dependent on the execution of the business plan and improvement of the property during the term of the loan. These kinds of strategies may



include some form of equity participation as well.

Value Add/Distressed = Distressed Debt Investing

Financing for the acquisition of distressed debt instruments, although this strategy can deliver returns in the high double digits, it is very labor intensive and heavily dependent both on the level of the discount and on successfully resolving issues at the asset and ownership level (usually some form of foreclosure or other resolution mechanism) in order to achieve returns.

As the debt fund environment continues to grow and evolve, I'm certain that some form of commonly accepted nomenclature for the debt categories will evolve. Although investors' return requirements have and will continue to move up and down, it is likely that the categories themselves will not be too different than those outlined by Jason.

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