What's in Your Lending Mix?

Parcing the capital stack to achieve varying returns for multiple lenders can make an unbankable loan workable

By Jerry Sager

A direct lender's decision on whether to fund a loan is based on a few limited and straightforward factors, primarily related to loan-to-value (LTV) ratios and debt-service-coverage ratios (DSCR). The safety of investment is of upmost importance to the lenders, that live by the saying, "No one has ever been fired for making a performing loan."

Rigid lending criteria are especially common among typically conservative commercial lending institutions, which value capital preservation above all else and are governed by strict regulations. Consequently, some commercial banks often pass on good loans that have a higher perceived degree of risk and, instead, focus primarily on mortgage loans with high DSCRs involving Class A office properties.

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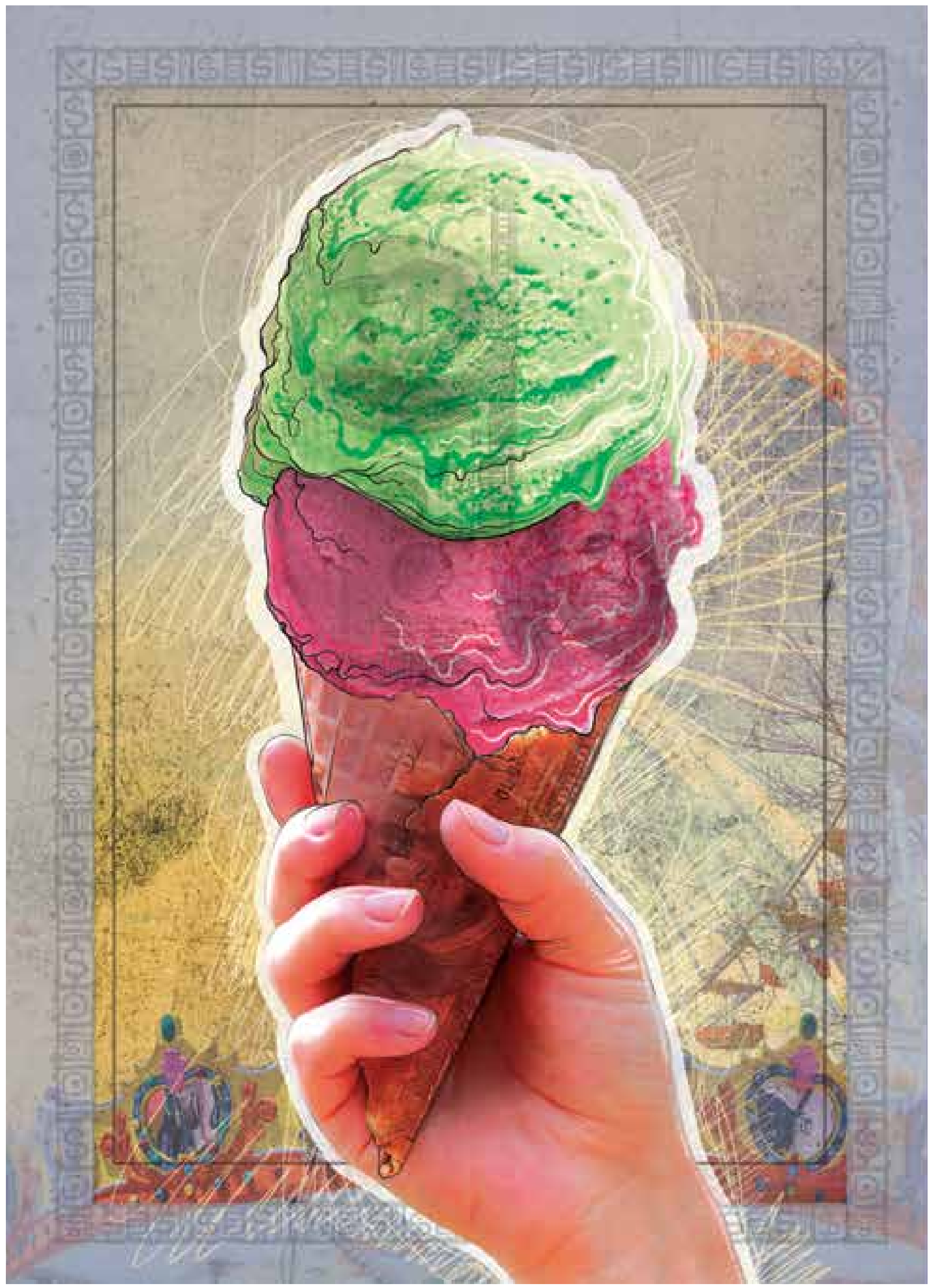

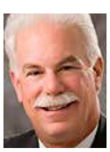

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Other direct lenders, which exist as autonomous operating groups of money-center institutions not governed by restrictive federal regulations, have more flexible lending criteria and are often comfortable assuming more credit risk. These nonbank direct lenders are regularly presented with proposals for loans in out-of-favor industries and on assets with unpredictable cash flows — often from borrowers whose credit histories would disqualify them for a commercial bank loan. Although the nonbank lenders are more likely than banks to fund such loans, capital preservation and investment integrity remain their main priority as well.

Assessing risk and return

Real estate investors seek varying high rates of returns, especially debt investors who have a more visible window into what kind of return to realistically expect. Typically, return is determined by the investment's position in the capital stack and its relationship to the underlying collateral. The higher the investment sits on the capital stack, the higher the return required. Consequently, the return on a first-lien mortgage (the A piece of the capital stack) is significantly lower than the return on common equity, due to the fact that the mortgage is secured by the underlying collateral.

As a refresher, the composition of a simple capital stack — ordered from least to most risky — is as follows: senior debt (first-lien mortgage); subordinated debt (mezzanine financing); preferred equity; and common equity. Within this stack, appropriate returns range from 4 percent for senior debt, to 20 percent for common equity.

Over the past 25 years, real estate debt investors have become more specialized and focused on a specific spot within the typical capital stack. Certain funds invest solely at the mezzanine level, while others focus on preferred or common equity. Typically, commercial banks remain the primary source of senior debt.

A challenge for nonbank direct lenders is to broaden their universe and work with funds specializing in mezzanine financing in order to put their own money to work. Achieving this requires structuring a first-lien mortgage to yield the higher return required by mezzanine investors, while allowing the senior, or A piece lender, to protect its investment. The solution can be found in the Old Testament, where King Solomon suggested cutting the baby in half.

Bifurcating a first mortgage into two distinct tranches creates, effectively, two debt instruments, one with a higher yield, more appropriate for mezzanine funds, and one collateralized more appropriately for the portfolios of a senior lender. To better understand this approach, consider the following example shown in simple math and not reflective of current actual market rates.

A mortgage broker is looking to finance a $20 million first-lien mortgage with an interest rate of 10 percent. One option is to place the debt with an institution seeking the 10 percent return. Alternatively, the loan can be divided into two tranches, one collateralized by the underlying asset, the other in a second (or "B") lien position. For this example, assume the principal amount of the secured and subordinated tranches both equal $10 million. The interest rate on each tranche will be determined by the interest rate required by the mezzanine ("B") investor — in this case, 15 percent.

In this example:

■ **The overall annual interest paid by the borrower** is $2 million — $20 million at an effective 10 percent interest rate.

■ **The total annual interest paid to the second-position, B lender** is $1.5 million — the $10 million invested by the B lender at 15 percent interest.

■ **The remaining interest available** to the secured lender is $500,000 — or the $2 million in total interest paid by the borrower, minus the $1.5 million of that amount paid to the B lender.

■ **The annual interest rate** for the secured lender is 5 percent — the remaining $500,000 in interest applied to the secured lender's $10 million investment.

A blended interest rate

In this example, then, there are two debt instruments: a collateralized loan of $10 million paying 5 percent interest, which is appropriate for direct institutional lenders; and a second position loan (or B loan) at 15 percent interest, which is appropriate for mezzanine funds. The borrower, however, receives a loan at a blended rate of 10 percent. There are many ways to structure rates of return, all of which will change the blended interest rate paid by the borrower.

An additional consideration is the liquidity risk undertaken by each lender. Assuming a 65 percent LTV, the value of the secured asset on a $20 million loan is approximately $30.2 million, providing both lenders with significant collateral in case of a default. Of course, the amount of collateral coverage decreases as the LTV increases.

Mezzanine funds are less constrained than commercial banks in the timing and amount of loan write-downs, which gives them more flexibility in recovering the principal balance without taking an immediate hit to their books. In the event of a default, the unsecured lender would protect its position by purchasing the secured lender's position, satisfying both the secured and unsecured tranches of the original mortgage. This provides additional safety for the secured lender.

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Although certain financial institutions regularly reject good loans becasue of strict criteria, nonbank direct lenders often have more flexibility. Depending on their portfolio composition or investor mandate, nontraditional lenders may be able to fund a loan in its entirety, or keep the collateralized tranche in-house using a blended interest rate approach.

To increase the probability of a successful financing, a commercial mortgage originator searching for capital for a borrower would be well-advised to ask about lenders' willingness to be flexible and structure something similar to an A/B loan — which achieves the required interest earnings for multiple lenders while assuring a manageable blended rate for the borrower. ■