

## **Getting Your Property Financed** ***Being Capital Markets Savvy in a Down Economy***

**by Brent Miller, CCIM, CPM - Managing Director**  
**Sperry Van Ness/Miller Commercial Real Estate**

I rarely have a conversation these days where the topic of financing doesn't arise as a serious concern for my clients. When the economy is robust, and the capital markets are frothy, financing a commercial real estate transaction is a relatively simple matter. However during today's recessionary times, the commercial capital markets are severely constrained. Not only is the supply of capital tight, but the demand may be near all time highs as well. Depending on which industry source you quote there is between \$150 and \$200 million dollars of CMBS debt maturing in 2009 alone. This figure doesn't include maturing loans from insurance companies, banks and other lenders, which means that many borrowers will be forced to secure financing in a market that presently offers little liquidity.

Given the current lack of liquidity and financing options described above, only the savviest of sponsors with solid projects will be receiving attention from lenders and investors. In the text that follows I'll provide you with an overview of the information you need to possess in order to speak fluent finance and to increase the odds of getting your project financed.

The first thing to keep in mind is that financing serves multiple purposes beyond rate and term considerations. The proper financing strategy can allow you to increase project velocity, improve operating efficiency, conserve internal capital, increase leverage, and lower the overall cost of capital. Good sponsors focus on developing an integrated capital formation strategy surrounding acquisition, development, construction, refinancing and recapitalization initiatives. The following items are just a few of the things commercial borrowers need to address when seeking capital:

- The selection of the appropriate capital provider;
- Level(s) of the capital structure to be addressed;
- Operating considerations;
- Control provisions;
- Rate, term, pricing and structure;
- Closing time frame;
- Third party requirements;
- Certainty of execution;
- Recourse provisions;
- Exit and pre-payment options;
- Inter-creditor or other multi-party agreements;
- Post closing servicing issues;

- The effect of the capital acquired on tax, balance sheet, future projects or portfolio considerations, and;
- A whole host of other value-added considerations.

Possessing knowledge and understanding of the commercial capital markets is a critical factor in not only determining the eventual success of a single transaction, but also an entire portfolio or operating business. The first thing that borrowers must understand is that all capital providers are not created equal. There is a definite hierarchy within the world of capital providers, and understanding the value-ads offered by different capital providers is important in choosing a relationship. Understanding how to use different types of capital providers for different types of solutions/needs will be important to structuring the proper outcome. Approaching a lender for high leverage loan in today's market without having your ducks in a row will prove to be next to impossible.

With debt service coverage ratios (DCR) nearing or even eclipsing 1.3 for many asset classes, advance rates on senior debt have certainly constricted requiring more mezz and equity investments for most sponsors to put a deal together. Making matters even more complicated is that there is no longer a clear division between debt and equity in the commercial capital markets. Given the ever increasing complexity of financially engineered structured finance solutions, it is essential for borrowers to develop a detailed understanding of the capital markets, and the structured finance options available to them. With the conservative advance noted above, it is critically important that you understand how to fill the increasing equity gap with the most affordable and effective capital markets solutions available.

The optimized use of structured finance solutions is one of the few arenas that allow commercial real estate owners to dramatically impact leverage, efficiencies and economies of scale across all business lines including acquisitions, financing ventures and operating activities. Structured finance is best defined as financially engineering the proper blend of debt, equity, synthetic, derivative, and hybrid capital in order to resolve particular transactional needs that cannot readily be met by conventional senior financing alone.

Structured financing allows for an engineered design and pricing of situation-specific financing instruments. Representative examples of typical situations that call for structured finance solutions include the following:

- Working around balance sheet or capital constraints;
- Shifting a higher percentage of the capital structure up or down in the leverage curve based upon current needs or market conditions;
- Attaining greater amounts of leverage at a lower blended cost of capital;
- Adding value and increased leverage to buyouts, yield-plays, recapitalizations, repositionings, and stress-induced financial restructuring;

- Shifting risk and better managing control at both the project and entity levels;
- Releasing trapped equity in single assets or portfolios;
- Conversion of illiquid assets into tradable securities;

While many would choose to define structured finance in narrow terms, it is rather the limitless ability to engineer hybrid, synthetic or derivative instruments. This level of flexibility makes the engineered solution provided by structured finance so valuable. While current capital markets conditions have restricted the use and/or availability of some products, typical structured finance instruments include the following:

- Senior and Junior Mezzanine Debt;
- Straight, Convertible and Participating Second Mortgages;
- Preferred Equity Structures;
- Bond Placements, Tax Credits and other Municipal Finance Alternatives;
- Index or Currency Linked Strips;
- Swaps, Options, Caps, Collars, Swaptions, Captions, etc;
- Credit Enhancement, Financial Guaranties, Standby Commitments; Forward Commitments;

Understanding how to maximize all levels of the capital structure through the use of structured finance techniques when developing the capital formation plan on your next transaction will help you create a much more effective and efficient execution. The following items are just a few of the benefits of understanding how to engineer the right capital structure:

1. **Use all levels of the capital structure to move up the leverage curve:** By using the proper combination of senior debt, subordinated debt and third party equity, even in this market it is still possible to aggressively climb the leverage curve and still maintain control of the project.
2. **Use different levels of the capital structure to prevent project ownership dilution:** By using subordinated debt (seller financing or mezzanine financing) to fill as much of the equity gap as possible you will lower your overall cost of capital while not being forced to give up as much ownership in the project as you would by closing the entire equity gap with a joint venture equity partner.
3. **Work the Lenders:** In today's market, lenders will often negotiate with borrowers where there is a benefit for doing so. It is quite possible to get a lender to write down or restructure the current financing on a property or portfolio to keep from taking back non-performing assets.
4. **Negotiating the proper type of equity joint venture can be critical to the financial success of a project:** If you move up the leverage curve with the proper combination of senior and subordinate debt the amount of equity needed from outside investors is minimized. Using the

right preferred equity investment structure can leverage the sponsor co-invest to a smaller percentage of the project equity requirement while still leaving the sponsor with the majority of project ownership.

5. **Individual Investors vs. Institutional Investors:** Decide early where you choose to seek your capital partners and investors and be willing to live with your decision. With rare exception if a sponsor can meet institutional suitability tests they will be better served by accessing commercial capital markets rather than dealing with individual investors. Institutional investors have more knowledge and flexibility when structuring transactions giving owners more operating flexibility. Institutional investors have deep pockets and can provide the appropriate level of financing to allow sponsors to engage on multiple projects at one time thereby creating the ability to grow their business with greater velocity when contrasted to the leverage provided by individual investors. Additionally most institutional investors prefer passive investments and will only exercise dilution or control provisions in the rarest of circumstances. Lastly, institutional investors often times can provide tremendous non-financial value adds in the form of knowledge base, intellectual capital, market contacts and the like.
  
6. **Resist the temptation to do "one-off" project level financings:** Disparate financings at the project level can at a minimum restrict a borrowers future ability to cost effectively monetize on value creation by subjecting the property to pre-payment issues in the case of refinancing or disposition prior to the expiration of lock-out periods. Worse than trapping equity at the project level may be the fact that one-off financings restrict the ability to pool the asset with the balance of the portfolio creating a lack of optimized leverage and timely access to credit which in turn can create capital constraints by slowing acquisitions activities or operating initiatives. Lastly, large portfolios or even smaller sub-portfolios created by a multitude of one-off financings can create a management nightmare. This is due to constantly maturing debt rollover which will subject individual assets to credit, interest rate and market risk. This type of risk is not present when financing at the portfolio level due to the ability to trade in and out of collateralized pools where pricing, sizing and structural aspects are known constants.

The year ahead will definitely be challenging with regard to capital markets issues. Understanding how to access and maneuver within the commercial capital markets, and effectively leveraging the many benefits of understanding how to work the capital stack to your advantage may be the defining difference in optimizing the scalability and efficiency of your commercial real estate venture.

Please take a moment to review my bio on the following page and feel free to reach me at any of the contact points listed below if I can offer any assistance to you. Thank you for your consideration.



**The Brent Miller Team**

### **About the Author**

**Brent C. Miller, CCIM, CPM** serves as **Managing Director and Senior Advisor** for **Sperry Van Ness - Miller Commercial Real Estate** in **Salisbury, Maryland**. Miller specializes in the sale, lease and management of retail, office and industrial property. His primary market is the **Delmarva Peninsula, Chesapeake Bay east to the Atlantic Ocean**. With more than **20 years** of real estate experience, Miller has closed more than **750 transactions** resulting in a career brokerage volume in excess of **\$150 million**.

Prior to joining **Sperry Van Ness**, Miller gained experience as an **Associate Broker** for **Long and Foster Commercial** where he specialized in commercial sales and leasing. While at **Long and Foster**, Miller was recognized with the **Top Producer award** multiple times.

**Brent Miller** is a member of the **Greater Salisbury Committee, Wicomico County Rotary Club** and serves on the **Salisbury- Ocean City Wicomico Regional Airport Commission**. Miller also serves as member of the **Board of Directors** for **Urban Salisbury and Shore Bank**.

Miller holds the prestigious **Certified Commercial Investment Member designation (CCIM)**, is a **Certified Property Manager (CPM)** and is also involved with the **International Council of Shopping Centers (ICSC)**. In addition to his experience with office and industrial transactions, Miller brings special experience in **medical properties, shopping centers and NNN retail property**.

For more information you can reach Brent at any of the contact points listed below:

Email: [brent.miller@svn.com](mailto:brent.miller@svn.com)

Phone: 410.543.2240

Web: [www.svnmiller.com](http://www.svnmiller.com)

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