Private-Equity Debt Can Save the Day

Try out a financing option for deals that don't fit with traditional lenders

By Stephen Counts and Ralph Cram

Private-equity real estate debt financing is on the rise. Preqin's 2017 Global Real Estate Report indicates that aggregate debt-focused target (or optimal) capital increased by 6.45 percent year over year as of January 2017, to $33 billion.

There is increased demand for investors seeking to place their money in debt and equity funds focused on real estate. Pension funds, endowments, foundations and other commercial real estate institutional investors are adding debt-focused funds to their real estate investment options to chase higher yields in a low-yield environment. This expanding private-equity landscape is creating additional financing options that can help commercial mortgage brokers better serve their clients.

Private-equity debt funds have been an increasing option for borrowers because banks are required to be more cautious in lending under tighter bank regulations. Pre-recession, there were numerous lending resources providing aggressive construction and bridge loans, but that is no longer the case.

This undersupply of capital from traditional lending sources, such as banks, has created an opportunity for private-equity funds to fill the void. Some banks are still involved in the private-equity space by providing warehouse credit facilities to private-equity funds for lending purposes. Most banks have reduced their exposure to construction lending in the past three years.

When banks extend credit to nonbank lenders, it is less risky than making loans directly to property owners. The private-equity funds take on the risk, protecting the bank from losses. Because private-equity funds generally have a higher cost of funds than banks, private-equity debt financing for long-term, stabilized, low-risk deals will not likely be the best solution. There are numerous circumstances, however, in which private-equity debt does make sense.

Void in the market

Private-equity debt is not cheap capital, but it addresses a void in the market. Through debt financing, private-equity funds are filling a need that other traditional lenders are not willing to consider.

Traditional lending sources tend to focus on conservative investments in traditional property types like stabilized retail, office, industrial and multifamily. When a property does not "fit the mold," traditional lenders will pass or will offer very conservative terms. Many banks, for instance, will not lend on development deals, and the ones that will require a low loan-to-cost (LTC) ratio of 50 percent to 70 percent.

In comparison, private-equity debt will, in some instances, go close to a 100 percent LTC ratio. Private-equity deals will often involve construction development, value-add properties, lesser credit, secondary locations, opportunistic strategy, less-than-perfect borrowers and other factors deemed undesirable by traditional lenders.

Quicker and less restrictive

Private-equity debt requires a higher interest rate than capital borrowed from traditional sources like banks, insurance companies, commercial mortgage-backed securities (CMBS) lenders and government agencies. Private-equity funds, however, can process loans quicker because of their less bureaucratic approval and underwriting process.

In some cases, borrowers can close deals in fewer than 14 days. In many cases, for developers, the speed and certainty of closing can result in increased profitability even with the higher cost of capital, compared with the less-expensive bank capital offered by lenders who may not close the deal on time — creating a risk that the developers will lose their escrow deposit and upfront capital.

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Stephen Counts is vice president of Envoy Net Lease Partners in Northbrook, Illinois. He has a background in net-lease investment sales and commercial real estate finance, and is responsible for reviewing incoming deals, assisting with client signings, compiling deal packages and underwriting loans. He previously worked with CBRE Capital Markets' debt and structured-finance team, as well as Calkain Co., a net-lease investment company. Reach Counts at (847) 239-7250.

Ralph Cram is president and manager of Envoy Net Lease Partners in Northbrook, Illinois. He is responsible for strategy, marketing and investment advice on all aspects of net-lease property investments in single-tenant retail, industrial, office and medical properties. He co-founded Envoy in 2011 and has underwritten, acquired or financed $1.5 billion in assets during his 25-plus years in commercial real estate. Reach Cram at (847) 239-7250.

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Traditional lending sources often are restrictive on where they are willing to lend. Large banks often focus only on major markets, and regional and local banks require deals within their region.

This requires national borrowers to have a network of different banks across the country when using traditional capital. Having multiple lenders can result in decreased efficiency, longer processing times, and increased paperwork and risk.

Private-equity funds are less restrictive on location, which allows national borrowers to partner with the same private-equity company on their entire pipeline. When the borrower has already been underwritten, the process times and paperwork on each deal shrink significantly, and loans can close faster.

Flexible financing

Many traditional lending sources need to "check all the boxes" and provide very little flexibility outside their underwriting guidelines. But private-equity funds can be more flexible with borrowers when managing and evaluating risk. Banks are required to hold a fixed percentage of cash against different types of commercial real estate loans, while private-equity funds have more flexibility when it comes to capital reserves.

If an issue in underwriting and due diligence arises, then private-equity funds can, in many cases, work around the issue or offer more flexible solutions than traditional lenders.

When a deal does not work with private-equity debt alone, it might still qualify for joint-venture equity, or both. In some cases, a deal may not qualify for private debt because of credit issues. Private-equity funds can still make the deal happen by providing joint-venture equity. Because of the difference in structure between private debt and joint-venture equity, the latter can mitigate some of the concerns that are difficult to overcome with private debt.

The cons of private-equity debt are the cost of capital and generally shorter terms. Private-equity funds require a higher cost of capital to generate accretive returns, or post-transaction value, for the fund investors. The lifecycle of private-equity capital is usually shorter than its traditional-lending counterparts. As a result, private-equity funds are not likely to provide long-term permanent loans. Private-equity funds, in most cases, will be pushing the borrower to repay the loan in less than 36 months.

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Private-equity funds find debt financing attractive because it offers consistent cash flow and it offers less risk than joint-venture equity investments. Debt financing provides an opportunity for these funds to get a decent yield and, in some cases, returns similar to mezzanine debt. Going forward, private-equity debt should be an increasing and reliable source of short-term funds for borrowing in cases of a nontraditional loan request. ■