The CRITTENDEN REPORT® Real Estate Financing

The Nation's Leading Newsletter on Real Estate Finance

Crittenden Research, Inc. • P.O. Box 1150 • Novato, CA 94948-1150 • Customer Service: (800) 421-3483

Vol. 37, No. 10 **May 23, 2011**

LIFE COMPANIES PLAY THE DEBT YIELD GAME

Debt yield is an important metric in today's underwriting and has become the main driver in getting many loans done. The majority of life companies will target debt yield right at the 10% to 11% mark, with some going as low as 9%. You can bet on most LCs to stick 10% +/- debt yield on the four main food groups, but they could get a bit more aggressive on multifamily properties. Those that dip their toes back into hospitality this year will most likely stay conservative and stick to 11% to 12% debt yield. Don't anticipate any LCs to get that number down to 8% for the time being, even to compete with the conduits who are doing 8% to 9% debt yield on 10-year money. While treasuries are expected to increase and spreads should tighten, debt yield will most likely stay consistent through year's end.

Life companies look toward debt yield when putting a loan together because they tend to be sensitive to refinance risks. Today's interest rates are coming in at 4% to 5% and lenders want to know what will happen to loans once rates go back up to 7% to 8%. Debt yield can potentially help measure or gauge the refinance risk for deals in a rising interest rate environment.

Some LCs will avoid using debt yield because it can be a dangerous number, as NOI can change from the time the loan goes under application to the time it goes out to the borrower. This can modify the loan amount and the borrower then has to come up with extra money at zero hour. Therefore, some LCs would rather focus on debt service coverage when underwriting loans. Most will stick to a 1.25x DSC.

SENIOR HOUSING STEADY, NOT QUITE READY

Senior housing will be attractive to most lenders this year, but demand for new deals could be somewhat

SENIOR HOUSING STEADY, NOT QUITE READY...

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Assisted living properties are typically more sought after because they are a need-driven property as opposed to independent living. Fannie and Freddie like to lend on independent living, assisted living and memory care, while avoiding skilled nursing. HUD prefers lending on skilled nursing, memory care, and assisted living, and typically keeps its distance from independent living. Lenders will stay away from deals involving recently constructed or poorly capitalized properties that have struggled to perform or are still only partially leased.

Senior housing was one of the strongest, if not the best performing asset type during the downturn. Even though occupancy has declined, senior housing owners were still able to raise rates and cut down on expenses, allowing continued NOI growth. Limited construction activity and stable demand for the product have allowed for fairly stable vacancy rates. Demographic trends are clearly in favor of the sector but there are some risks, such as government funding decreases and Medicaid cuts.

Red Capital Group has a big appetite for senior housing deals and plans on being aggressive in the market. Senior Managing Director **Jim Sherman** projects an excess of $500M in senior housing originations by year's end. The company lends nationwide and is very comfortable working with skilled nursing properties. Red Capital is attracted to deals involving established sponsors and operators.

Lancaster Pollard is an agency lender that also structures investment banking transactions. SVP **Nicholas Gesue** envisions more than $1B in total originations for 2011. The lender did $400M in senior

FUNDS PROVIDE AN ALTERNATIVE LENDING SOURCE...

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Funds set themselves apart by offering perks to borrowers such as no pre-payment penalties and can usually work outside the box on undesirable properties or provide non-cash flow loans. Plus, while the conduits and LCs are busy chasing perm financing, the funds can swoop up the other type of loans borrowers need, such as bridge or short term.

The reemergence of CMBS is good for the private funds since the conduits provide an exit for many of fund lenders' transactions. Funds that focus on value-add or transitional properties also have an advantage since CMBS predominately originates money for fully stabilized assets. Banks should not be a problem for fund lenders because they seek recourse and the market demand is moving toward non-recourse loans.

Mesa West's *Fund II* has $2B of lending power with around 40% committed. Count on $750M to $1B to go out this year, after approximately $400M to $500M was originated in 2010. Mesa sets itself apart by doing 100% non-recourse, interest-only loans with three- to five-year terms. Principal **Steve Fried** notes his focus is on value-added and transitional properties and will not compete with CMBS and LCs for the high-quality assets. Principal **Ronnie Gul** also points out that Mesa offers versatility in deal type and will even consider empty buildings. All core properties are on the menu and Mesa has worked with a lot of hotel and office assets recently. Target markets are the West Coast and gateway cities on the East Coast.

JCR Capital is in the market and is accepting investments for its *Fund II*, with the first close expected in October. There is a target capitalization of $100M with more than $11M already being invested by JCR shareholders. It will focus on financing distressed, opportunistic and value-added investments. The company plans to double the $23M doled out last year, with a goal of $40M in originations for 2011. Around $10M has gone out so far. Principal **Jay Rollins** will provide equity, preferred equity, debt and mezzanine loans. JCR's $30M *Fund I* has a spending capacity close to $75M and around 70% is committed. Rollins notes that targeted property types are all over the board including retail, multifamily, single-family, condos, hotels, land and even debtor-in-possession financing.

PCCP LLC is a fund management firm with $6B under its belt in both private-equity funds and separate accounts. More than $400M went out last year and PCCP hopes to beat that total this year. So far, $75M of debt and equity has been loaned out. The typical loan amount is $10M to $75M and PCCP works with all the traditional property types, nationwide.

HOTEL CMBS PUSHES INTO TERTIARY MARKETS

Expect securitized hotel financing to expand into secondary and tertiary markets within the next six to 12 months. Market fundamentals and the age of the property will be as important as the hotel's RevPAR and ADR when it comes to inking CMBS.

Initially, conduits will look at markets in the Southeast and Midwest because those areas did not see the vast highs and lows that were evident in the Northeast and Southwest during the crisis. Houston, Seattle, Denver and San Jose, Calif., have all seen some CMBS activity on the hotel front in recent months. In the last few weeks, several CMBS loans were inked in tertiary Alabama markets for Hilton and Hyatt branded assets.

New, more conservative underwriting standards have made the debt yield requirement higher than the last peak for hotel CMBS deals and credit quality requirements are also higher than before. Average metrics on a hotel CMBS deal today include debt yield around 11% to 12%, five- to 10-year terms, 5% and 6% rates and LTVs up to 65%.

After the downturn, many hotel financers took a "wait and see" approach to the recovery. Now that some time has passed and operations have improved, there are new financial numbers, indicators and statistics to boost lenders' confidence. Financing budgets at the country's major conduits and life companies have grown, and with it, an increased appetite for deals in the hotel sector, both balance sheet and CMBS. Many executives at the *Meet the Money* conference note that it is still fairly tricky to put together hotel deals today, but money for cash-flowing properties will be among the first in line for securitization.

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As CMBS expands to secondary and tertiary hotel markets, the biggest candidates for securitized financing will be newer, full-service and select-service hotels with a major brand attached. Lenders will favor select-service Marriott, Hilton, Hyatt and IHG assets in tertiary markets for CMBS loans. Boutique hotels, along with budget and economy properties, will be the hardest to underwrite.

In the last round of CMBS, many assets in secondary markets were well received. Most of these securitized loans involved newer hotel products with strong operators and the resulting performance was favorable. The expansion of CMBS into less populated markets can present investors with decent opportunities because many of these markets performed fairly steady throughout the downturn.

RECENT LOAN ROUND-UP

The Blackstone Group provides $47M in mezzanine financing for a trophy office building in Washington, D.C. Although the building has some vacancy, the lender liked the deal given the quality of the real estate, as well as the market and ownership. Chief Investment Officer **Michael Nash** believes more than half of Blackstone's anticipated loan volume will be in the form of newly originated mezzanine dollars.

Oak Grove Capital dishes out $20.7M for the fixed-rate, permanent financing of two assisted living facilities — the 66-unit Arbor Terrace in Decatur, Ga., and 63-unit Arbor Terrace in Asheville, N.C. The Fannie Mae loan carries a seven-year term, 30-year amortization and five-year yield maintenance. The properties are operated by The Arbor Company and owned by a closed-end fund managed by Prudential Real Estate Investors. The proceeds from PREI's fund were used to refinance maturing mortgage debt on the properties. Managing Director **Bill Kauffman** credits the properties' solid sponsorship and the operator's strong history with making the deal attractive.

The Pembrook Group's Managing Director of Operations **John Garth** puts together the recapitalization of a Midtown Manhattan, 31-story luxury apartment building that is long-term leased as an extended stay hotel with $5M of preferred equity. A second New York City asset, located in the Financial District, gets $9.25M in mezzanine financing. This loan is in connection with the refinancing of a 16-story office building that has been converted into a student housing facility, occupied by Pace University.

Mesa West doles out $24.5M for 207 Goode, a Class A office property located in Glendale, Calif. The borrower was a joint venture between Morgan Stanley Real Estate and Lincoln Property Co., who bought the property all cash and went to Mesa to add financing thereafter. Mesa liked that this was a brand new property, built in 2009, with a strong sponsor. The building is currently empty, but Mesa was comfortable putting together the loan because it believes the borrowers will be able to lease it up and stabilize it in a timely manner. Mesa set up an interest reserve to help fund the interest on 207 Goode, and the lender's loan terms are typically three to five years.

Terra Capital Partners backs a senior $27.3M Freddie loan with $2.6M of preferred equity for a circa-2007 apartment complex in Memphis, Tenn. The LTV is 80%, with a 13.5% interest rate and DSC of 1.15x. Even though the asset is located in a submarket Terra was not familiar with, the lender was attracted to the property because it is only four years old and the basis is well below replacement cost.

Wells Fargo lends KBS Capital Markets Group a large portfolio loan worth [illegible]

MEZZ, PREFERRED EQUITY ALMOST IDENTICAL TWINS

The most robust mezzanine market is behind securitized and agency debt on the four main food groups, plus hospitality. Look to **Transwestern Realty Finance Partners, Terra Capital Partners, The Pembrook Group, Blackstone, Redwood Trust** and **NBS Real Estate Capital** to fork over that extra bit of debt needed to get the loan. These groups usually write mezzanine loans that are larger than $5M, save NBS, which has a typical loan size of $2M to $5M. NBS aims to kick down $20M to $30M this year, two-thirds of which should go to mezzanine loans.

Currently, the blended interest rate — for a transitional asset with an LTV of 75% — is 7% to 12%. If the property has cash flow, the rate will be closer to 7% to 8%; no cash flow means it will hit the higher end of the spectrum. Mezz loans for value-added deals may see interest rates as high as 15% to 20%. Not many life companies will allow mezz debt, and neither will most banks. That said, LCs and banks are loosening their grip on this old-fashioned school of thought. Keep an eye out for **Berkshire Hathaway** to dole out mezz bucks behind agency debt, earning them strong ROIs. Conduits, on the other hand, rarely turn down mezz dollars, and some even provide it themselves. Take **Starwood Property Trust**, who acts as a REIT doing CMBS loans. Opportunity funds are certainly lending mezz dollars as it gets them a respectable yield and a good multiple on their investment.

Depending on whom you speak with, the difference between mezzanine debt and preferred equity is very slight. But if the senior lender is adverse to mezzanine dollars, a mezz loan can simply be structured to reflect preferred-equity rules. Underwriting for mezz dollars has definitely changed since the heyday, when LTVs would hit almost 100%. Today LTVs stop around 75% to 80%, maxing out at 90%. Typical DSCs are more of a situational discussion where the mezz lender needs to get comfortable with the stabilized debt yield and stabilized value.

Transwestern Realty Finance Partners would like to place $300M this year, with about $125M to $150M of that going to mezzanine loans. Although multifamily is the company's focus, it will look at all property types, including hotels. Underwriting requirements are 80% to 85% LTV, with 1.10x minimum DSC.

Focused exclusively on mezzanine and preferred-equity loans, Terra Capital is on track to provide $50M to $100M this year, with loans averaging around $5M. The lender is very comfortable going below this number, however, and has a sweet spot of $3M to $5M. Terra believes even though it takes more work to close more deals, it likes the diversification of smaller loans.

Pembrook would like to do a total of at least $200M this year, with one-third of that amount going to mezzanine lending, which can sometimes morph into preferred equity. The company targets the big four property types with first mortgage loans, as well as mezzanine financing on transition and stable assets.

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