Real Estate Finance

- Differences with business finance
- Real estate development process and financing issues
- Real estate financial statements
- Finance instruments & underwriting
- Funding gaps
- City Plaza example

Differences with business finance

- Scale of investment is large
- Financing physical, fixed assets
- Need for long-term financing
- Use of separate construction and permanent financing
- Competition and markets are regional and/or local
- More predictable income & expenses

Three Phases of Development

- Predevelopment
  - Planning & design, **site control,** permitting, pre-leasing/sales, securing financing
  - Large costs, high risk no revenue=>requires equity, grants, deferred loans
- Construction & development
  - Site acquisition, final design & contractor selection, construction
  - Limited risk => construction loan and equity
- Occupancy and management
  - Asset management=> permanent debt take-out
  - Retire debt, realize equity returns

Real Estate Financial Statements
Development Budget

- Sources and uses of funds statement
- Analogous to a balance sheet
  – Acquisition, hard costs, and soft costs
  – Contingencies and reserves
  – Per square foot basis useful for comparisons
- Sources of funds
  – Debt sources, equity investments, grants

Real Estate Financial Statements Operating Pro Forms

- Revenue, expenses and net cash flow
- CAM, escalators, and percentage rent
  - Lease terms define revenue –key to analyze
- Vacancy rates
- Operating expenses
  - IREM, ULI comparable project data to analyze
  - Replacement and operating reserves
- Cash flow, debt service and net cash flow
- Supportable debt: PV of [cash flow/DSCR]
- Supportable equity: PV of net cash flow & expected gain on sale

Real Estate Debt Instruments

- Predevelopment loan
- Construction loan
- Real estate mortgage
- Mini-perm loan
- Bridge loan

Underwriting Real estate Loans

- Development Team Capacity
  - Experience & ability of development team members
  - Management company deserves special attention
- Project cash flow risk
  - Initial lease-up risk: will property be occupied at target rent?
  - Tenant credit risk: will tenants pay their rent?
  - Re-leasing/market risk
  - Operating expense risk: are operating costs adequate?
- Collateral value and appraisals
  - Appraisals set the market value & max. Three ways to value a property: cost, comparable sales, discounted cash flow.
  - Quality of construction
  - Quality of maintenance and replacement funding

Common Funding Gaps

- Supply of pre-development and equity financing
- Weak markets:
  - Market rents do not support development costs
  - New development needed to change market dynamics
  - Lithgow block: income supported 57.5% of development costs; grant/subsidy for 42.5%

City Plaza: Supportable Debt and Financing Gap

Minimum Annual Cash Flow	$144,550
Debt Service Coverage Ratio	1.25
Cash Flow Available for Debt Service	$115,640
Supportable Mortgage Loan	$1,152,105
Round to	$1,152,000
Annual Debt Service	$115,629

Total Development Costs	$1,490,000
Total Sources (Debt & Grants)	$1,302,000
Funding Gap	$ 188,00

City Plaza: Options to Fill Gap

- Subordinate Loan from cash flow after senior debt
- Minimum Cash Flow $ 28,921
- Assume 1.10 DSCR
- Cash flow for debt payments $ 26,292
- Present value, 10 years, 10% $165,794
- Present value, 15 years, 10% $203,887
- Use 13 year term and amortization for loan
- Annual Debt Service: $25,895