Executive Summary:
Underwriting & Structuring Value Added and Opportunistic Loan Transactions

Summary

I. Overview
II. Refinance Exit Underwriting
III. For Sale Assets
IV. Sponsor Requirements
V. Intangible Deal Points
VI. Pricing
VII. Quoting the Deal

I. Overview

The Basics: What you need for any real estate investment decision

1. Property Type
2. Collateral description
3. Sources and uses
4. Loan request
5. Purpose of the loan
6. Exit strategy
7. The asset plan business strategy
8. Current asset situation
9. Project proforma (borrower document)
10. Market dynamics: i.e. vacancy, new construction, demand drivers, macro market, micro market
11. Purchase contract (borrower document)
12. Appraisal/value: as is/as completed (borrower document)
13. Location (Google Earth)

The Property Facts

- Income producing
  - Current NOI
  - Stabilized/projected NOI
  - Current occupancy
  - Market occupancy
  - Rent roll (document) with roll schedule
  - Current average rents on property
  - Current market rents
  - Market rate for tenant improvement: new leases vs. roll over
  - Exit play – describe: increase rents, increase occupancy, decrease expenses

Property Variables: Solving for the NOI (the key to value added underwriting)

- Occupancy assumptions
- Rent assumptions
- Expense assumptions
- Credit tenants
- Lease terms
- Asset physical condition

Key Underwriting Metrics

- Loan to cost: day one vs. stabilized
- Loan to value: day one vs. stabilized
- Cash on cash return: day one vs. stabilized
- Cap rate to loan basis: day one vs. stabilized
- Debt Service Coverage: Beginning and Ending
- Cap rate
  - Going in cap rate: cash on cash
  - Exit cap rate: cash on cash
  - Cap rate to our loan basis
    - Going in
    - Exit
    - Cost/loan: per square foot, or unit
- Exit constant used in refinancing
- Current property rent compared to current market
- Current property occupancy compared to current market
- What good thing(s) has\have to happen for the exit strategy to work
  - Refinance: Does the property exit on a refinance with a reasonable constant (7.5%-8.5%) and reasonable LTV (80-85%)?
  - Sale: Does the property exit on a reasonable, stressed cap rate (7%-8%)?

II. Refinance Exit Underwriting Drill Down

Conduit Loans: Conduit loans eventually turn into Commercial Mortgage Backed Securities (CMBS). Their underwriting criteria is the most rigorous and least flexible, but this type of financing is the most reliable. It is check the box underwriting.

- Debt Service Constraint: 1.20-1.25 based on Underwritten NOI*
  *Note: The term Underwritten NOI is actual NOI, less deductions. The theory is that enough value is created to allow the total floating rate debt (Bridge and Mezzanine) to be repaid from a permanent loan financing at the time the event is completed or achieved. The property must have value created to achieve this.
- Loan to Value Constraint: 75-80%
- Refinance Strategy: To accurately underwrite in the future, you must account for moving pieces:
  - Interest rates: use stress tests, or firm constants
  - Future lease rates: Contract bumps on existing rents are counted with one year future roll over rents will be at current market.
  - Tenant retention assumptions: stay vs. go, based on product type. Typical is 75%/25% on rolling space
  - Tenant improvement costs and leasing commissions:
    - Will be different for tenants who stay versus those who leave
    - Dependent upon market
- Stabilized NOI Deductions
  - Structural reserves: $0.10-$0.25 psf
  - Vacancy: 5% minimum- look at market vacancy
  - Tenant improvements and leasing commissions: $5-25 psf for T/I's and 2%-6% for LC's
  - Rollover Assumptions: Renewal vs. stay: typically 75% stay
  - Releasing down time: 1-6 months
  - Average Lease term: 3-10 years
  - Amortization: 30 years, however many deals are being done interest only today
  - Term: 10 years
  - Pricing: Spread over 10-year Treasury- based on market

III. For Sale Assets

A. Land Assets

Types of Land

- Residential
- Commercial

The Six Stages of Land

1. Raw: Agricultural
2. Raw: Zoned, but not approved
3. Raw: Preliminary or partially approved (only administrative work remains to be done. California tentative MAP)
4. Raw: Fully entitled (California final MAP)
5. Finished: Super Pad (all utilities at boundary to the site)
6. Finished Lot (all utilities to the individual lots)

Land is traded based on:

- Per acre
- Per square foot
- Per buildable square foot
- Per lot

Basic Land Lend Lending

- Debt: Typically up to 65-70% of the capital stack
- Equity: Typically top 30-35% of the capital stack
- Performance hurdles are typically required:
  - Approval dates
  - Construction dates
  - Sales hurdles

Key Metrics for Underwriting Land

- Basis per foot, per acre, per lot
- What has to be done to get the land:
  - Fully approved lots
  - Finished lots
- Approval/Entitlement Risk
- Exit strategy: bulk sale vs. individual sales
- Residual analysis: commercial and residential - see LSS
  - Current market: supply/demand
  - New product absorption rate
  - Existing homes: days on market
  - Market annual absorption: up/down

Underwriting Land

- Beginning Status of Approvals during the term
- Ending Status of Approvals during the term
- Understand time line and bench marks required in order to understand risk and return.

Risks

- Approval risk - Driven locally. Hardest to assess.
- Development risk – Typically bonded or well documented. Easiest to assess.
- Market risk – Key driver. Market includes product type, sub-market, macro market, and US market.

Land Value

Land can be valued in many ways:

- **Sales comps**: Recent sales for kind land
- **As is where is**: Land is valued without any future assumptions, and would sell quickly under current market conditions
- **Bulk sale value**: A sale to a wholesaler (builder/developer), not an end user
- **Discounted cash flow**: Assumes the property as developed, typically over a 10 year time frame (not typically used by land lender)
- **Residual Analysis**: "Reverse engineering" the land value by deducting all other costs from the sales price, less profit, to equal the only variable—land value

  Example of Residual Analysis: Residential

  House value
  (Less) Selling cost
  Equals Net house value
  (Less) Hard construction cost
  (Less) Soft construction cost
  (Less) Builder profit
  Equals Finished lot value
  (Less) Finished lot development cost
  Equals Raw lot value

B. Condominiums

Types of Condominiums

- Garden
- Tower
- Partially converted
- Never converted
- Under construction

Condominium Conversion Problems/Opportunities

- **Good problem** – Project is doing well, but financed late in the cycle. New debt lowers cost of capital, rewarding sponsor for good performance.
- **Bad problem** – Project is not doing well, or was never started. The mezzanine debt or equity is overleveraged. There is a distress opportunity exit, allowing a reset of current pricing.

Key Data Points for the Condominium Asset

- Year built
- Number of beds and baths
- Ceiling heights
- Square footage of units
- Types of units: studio, one/two/three bedrooms
- Finishes: Ceiling fans, counter tops, etc.

Key Metrics for Underwriting Condominiums

- Basis per door, basis per foot
- Cap Rate as rental: at closing/post renovation
- Cap Rate to the loan amount: at closing/post renovation
- Loan to net value: after all sales incentives
- Number of units sold (percentage) to exit the loan (70 – 85% is good)
- Investor units vs. other units
- Deposit status
- Profit margin on gross sell out
- Current market performance
    - Market price (net)
    - Sales history - recent
    - Canceled rate
    - Loan basis vs. current market price
    - As rental analysis: using current occupancy and or current market rates
        - Market rents: if rented
        - Cap rate to cost basis
        - Cap rate to loan basis (assume 38% expense ratio)
    - Sales prices
    - Hard deposits
    - Closed units
    - Recent sales prices
    - Canceled rate
    - Buy vs. rent analysis

IV. *Sponsor Requirements*

Information

- Who are the individuals
- Track record
- Who have they borrowed from before?
- Where to the live in relation to the project?
- Resumes
- Experience in this asset class
- Personal financial statements (individual or joint with spouse – ask)
    - Liquidity
    - Net worth
    - Asset make up for real estate assets: understand the following:
        - Equity investment from sponsor/others
        - Debt on property (from who, amount, rate, maturity date)
        - Valuation method used in appraisal (adjustments for ownership percentage)
        - Ability to liquidate (limited partner, general partner, etc.)
        - Current status: stabilized/unstabilized
        - Is it pledgeable?
    - Do borrowers sign recourse?
    - Contingent liabilities – what are they?
        - Project descriptions
        - Equity investment
        - Promote structure
        - Lender (rate, maturity date)
        - Property condition: stabilized vs. unstabilized

V. *Intangibles – Deal Points*

- Broker or sponsor representing the deal
- Speak to sponsor – second call: repeat the facts
- Broker exclusive – to the sponsor or to a lender
- Has broker closed with them before?
- Hard money date: when?
- Closing date: when?
- Are contract extensions available?
- Have the received quotes from other lenders?
- Who is this being marketed to?
- What are the pricing expectations?
- What are the structure expectations?
- Sponsor hot buttons – must ask sponsor
    - Pricing
    - Proceeds
    - Certainty of execution
    - Recourse
    - Structured flexibility
        - Pre-payment
        - Partial releases
        - Earn outs

A. Borrower Psychology

- What are the motivation drivers?
- Why are they doing this deal?
- Responsiveness
- Ability to address questions above

B. Secret Sauce

- What intangibles are there about this deal, if any?
    - New road
    - New employment
    - Changing demographics
    - Distress

VI. *Quoting the Deal – What You Need: Value Added*

- Sources and uses
- Beginning NOI
- Ending NOI
- Loan request
- Collateral description
- Sponsor information (not mandatory)
- Summary of key metrics

VII. Pricing

The Exit Method

A Pricing:

- Have significant equity: 15-20%
- Exit works on a refinance basis with a stressed market
- Price: L+200-250

B Pricing:

- Have at least 15% equity
- Stretch exit on refinance exit
- Easy exit on stressed cap rate
- Pricing: L+250-300

C Pricing:

- Can only exit on a sale basis but can comfortably do so
- Needs substantial interest reserve
- Pricing L+300-350

The A/B Note Pricing Method

The JCR Internal Model (see Internal Summary Model for calculations)

- This concept is to price the risk free portion of the loan and then assume the appropriate return to the free risk portion of the loan.
- Risk free portion: This is determined by:
  - Current cash flow – what a conduit loan would support today
  - On a price per pound basis
- Risk free pricing: Once you determine the risk free amount, we like to price this at L+200
- Risk portion: This portion represents the part of the deal in which something "good" has to happen in order for the exit to work. Or, said another way, this is the loss that will occur if something good does not happen. The pricing depends on the deal but typically L+600-800 is the return we need on the risk price.