The Property Line: Creative Deal Structuring with Debt Funds

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Welcome to The Property Line, a commercial real estate podcast brought to you by Seyfarth Shaw's Real Estate department. The Property Line is a brief discussion of current market trends, bringing you insights from our acclaimed national team of real estate attorneys. Each episode focuses on a key takeaway for the busy real estate professional. Now, on to this week's discussion.

Dan Evans
Hello and welcome back to The Property Line. My name is Dan Evans. I'm joined today by Terry Carroll and Mike Dowley, partners in Seyfarth Real Estate department. Gentlemen, thank you for joining us. Could you tell us a little bit about where you practice and what you do?

Terry Carroll
Well, thanks, Dan. This is Terry Carroll. I'm a partner in Seyfarth's Atlanta office, and have handled a variety of real estate transactions over my career, but these days, I'm focused primarily on lender side real estate finance, and a lot of that is with debt fund clients.

Michael Dowley
Excellent. Thanks, Terry, and thanks, Dan. Longtime listener, first time podcaster here, Mike Dowley in the Boston office. I have a broad real estate practice. You know, I handle a lot of acquisition work, but in connection with that acquisition work, we are always attempting to lever up the acquisitions with financing. And as banks have been, you know, reluctant to stretch lately, debt funds have definitely, you know, filled the void and happy to talk about it today.

Dan Evans
Wonderful. Well, thanks gents again for joining us. First question out there. So, what makes debt funds an attractive alternative in today's commercial real estate market, especially for complex or transitional deals?

Terry Carroll
Well, I think that the biggest advantage, particularly on complex and transitional deals, is the flexibility that debt funds offer. They can take deals that have hair that's a little unique to that deal and find a way to structure around it so that they're able to make the loan in a situation where the unique problem that arises might be something that an institutional lender just isn't willing to structure around or deal with. So, I think that flexibility is great, and it is really important in those two specific areas. Obviously, complicated transactions require more structuring, and transitional bills are a little riskier by nature, so we have to structure carefully there.

Dan Evans

Interesting. And Mike, from the borrower's side, what's your take on it?

Michael Dowley
Yeah. I mean, they definitely fill a void, as I was saying earlier. In order for my clients to be able to hit their projected hurdles and IRRs you need to lever the acquisitions up. So, if there's no debt, the deals generally don't pencil, and as a result, the deals fall apart. So, if you can't find, you know, a bank loan, the debt funds, you know, are definitely a good replacement for whatever deal you can find them for, and the risks are, you know, it's generally a higher cost of capital. The term on each of the loans is generally shorter, so there's some risk inherent with a shorter, long term. And then, you know, depending upon the debt fund outfit who's making the loan, you know, there's some aggressive terms, some aggressive covenants. You know, you definitely need to be very mindful of potential table funding potential syndication, you know, not knowing who your lender may be after the loan closes, there's some reputational risk if you're not working with one of the more institutional good reputation d ebt fund lenders and someone who may be looking to loan to own, which is not, you know, not a place a borrower really wants to be. But like I said, you know, if you're not able to get more traditional financing, the debt funds fill a void and are really helpful to a lot of borrower clients who are looking to take advantage of distressed debt or other assets that, you know, they can get at a good basis.

Terry Carroll
And I'd add to that, the other area where it really makes sense to look at debt funds, from my perspective, is when you have a deal that needs to move extremely quickly. I've closed a couple of, you know, seven to 10 day loans in my career, and those were always debt fund lenders. I think larger institutions just can't move that fast.

Michael Dowley
Yep, absolutely, you know. And we can get dig into the weeds a bit, Dan. But one issue that's very important a lot of my clients is that they know who they're working with, particularly construction loans or high touch loans, where you're going to need to know who you're dealing with for construction advances and reporting and cash management, and debt funds tend to not want to restrict their ability to sell and participate out loans, so there's a give and take, you know. We like on the borrower side to try to restrict that ability to syndicate and assign as much as possible, whereas lenders don't want any restriction on their ability to monetize their commercial paper. So, there's some push and pull there, and it's all part of the process, as we negotiate these loan documents regularly.

Dan Evans
So, in my experience, over however many years I've been doing this, it seems as though there's a lender, and there's a lending program for every borrower out there. Some people have cookie cutter deals that they want certain terms, and they go one location. Some people have a little bit riskier deals, riskier appetites, and they're going someplace else. It sounds as though what you guys are saying is debt funds are very good at providing liquidity when other lenders are pulling back for economic or other reasons, they seem to be very good reputationally, at quicker closes and dealing with hairier deals and stuff with more on them. But not again that other lenders don't do this, but, but that seems to be where debt funds really, really thrive. Kind of with that in mind, could you walk us through a few

scenarios where you think that borrowing from a debt fund really makes the most sense and trade offs and considerations you might have in connection with that?

Michael Dowley
Yeah. Happy to take that one on, Terry. And Dan, you know, we were talking about this earlier, but debt funds come in all shapes and sizes. And we actually disclosed a loan recently where it was a debt fund that made the loan, but it was an affiliate of an insurance company that was the debt fund. So even though it was a debt fund, it was by and large operated as if it were an insurance company. But to answer your direct question, you know bridge loans, you know loans where there's potentially no tenants on the property, so there's no cash flow, so it's a risky loan by the virtue of the fact that there's nothing cash flowing, and you need to kind of lease it up quickly. You know, bank would it be unlikely to touch that, whereas a debt fund would understand the business case and really stretch for their borrower. And you know, a lot of times, banks are very restricted by you know, if it's not within their credit box, doesn't matter what the relationship is. It doesn't matter what the borrower's reputation is. They're just not going to be able to do it. Whereas debt funds have the ability to stretch a bit more and really work for clients. So you know, clients, although they're riskier deals, although debt funds have potentially a reputation for exercising rights and remedies more quickly, if you have a good relationship with a debt fund lender who's willing to stretch and understand your business model, it's incredibly helpful. So those are a couple of examples.

Terry Carroll
That's right. And I think there are certain specific situations in which borrowing from a debt fund, or just looking only at debt funds, might make sense if you're seeking a land loan. For example, I think that funds are the easiest place to get that kind of capital, and one place that I've done a lot of work for debt funds, but not really for other lenders, is when someone's buying property out of foreclosure, and then, as those sorts of properties tend to do these, these will need capital infusions to make them nicer and get the rents up. And so the debt funds willingness to fund into a situation where there has been a failure of management already and then to really support the business plan, to turn the property around and have the mechanisms in place to make, you know, frequent advances and quickly review invoices and such of that nature is really beneficial.

Michael Dowley
Yeah. And it's also, you know, sometimes it's not even nature of the deal itself, but the willingness to loan more loan proceeds, if you have a bank that's only willing to go up to 60% loan of value, and you need 75, if you can't get a debt fund to step in and provide that 75% loan of value, you're going to need to come up with more equity, find a preferred equity slug, and that's got its own challenges as well. So if you can find a debt fund with you know that you have a good relationship with who's willing to provide the entire debt piece of the capital structure, that is a huge home run for you.

Terry Carroll
Yeah, that's right. And I think as your capital structure gets more complicated, too, the debt fund might make sense. We, you know, a lot of our deals, there'll be mezzanine financing involved or a preferred equity investor. I've even recently had a number of debt fund deals where there was a simultaneous close of a C PACE loan, which, you know, in a lot of institutional loan documents, is expressly

prohibited, but the debt funds, it's just part of their ability to be nimble, to convince their credit committees to take a risk on something, on a one off situation, and not necessarily be bound to those written policies, Mike, as you as you were describing.

Michael Dowley
Yeah, and then you'll be on the borrower side more lately, you know, there are the concerns of lenders looking for footfalls to potentially, you know, get to the asset. And we don't, you know, we don't ever like to hear those stories. And so reputationally, borrowers are low to work with that firms from time to time if they can avoid it. But debt funds don't come as one monolith. You know, they come in all shapes and sizes, and a lot of debt funds have been super supportive of borrowers who really need capital quickly, and it really enabled them to achieve great results as a result of their ability to move more quickly. So totally agree.

Terry Carroll
A space in which there are some really good actors and some really bad actors, that's certainly the case. And I think, probably unusual to hear a real estate lawyer talking about ways mortgage brokers can bring value to a transaction, but identifying the debt funds that are good to work with is a place I think that a mortgage broker really can bring a lot of value to their borrower, because my debt fund clients, at least, don't tend to have repeat borrower relationships, but they have repeat broker relationships, and those brokers will have closed 15 deals with that fund before, seen those deals through to completion, or been involved with their client, the borrower, through completion. And you know, at least know that the funds were advanced when they were supposed to be advanced. The lender didn't make us jump through any unnecessary hoops, or not too many, or whatever. And so I think if a borrower is wanting to look at debt funds, obviously someone like Mike is going to have a lot of information for you there too, because Mike plays in this area a lot with a lot of different funds. But a mortgage broker certainly could be helpful.

Dan Evans
On the downsides of debt funds, you guys had mentioned that the money tends to be a little bit more expensive as a general matter. I mean, it sounds like we're moving up the risk spectrum. So, not surprising that the money will get a little bit more expensive as folks are really paid to take on that risk.

Michael Dowley
Yeah, it's important for people to understand banks are not allowed to own real estate for very long. You know, they're regulated. They need to get it off their books. They're not an investment bank. They're a commercial bank that's typically lending, and so they don't want to take property back, and if they do, it's a giant headache for them, whereas debt funds have the capability to be able to take these properties back, manage them, fix them up, get them ready to go. And so, you know, that's the risk that they're willing to take, because they can monetize it themselves if they have to exercise remedies a lot easier than a more traditional lender would.

Terry Carroll
Absolutely.

Dan Evans
Which makes sense. You're asking lenders to get more involved in business plans and less of a stabilized property. So you're probably talking with people whose backgrounds as your debt fund lender whose background is probably more in that that development and bringing up properties that might not be stabilized. That certainly makes sense.

Terry Carroll
Yeah, that's right. Along those lines, I think some of the more onerous restrictions that people complain about in debt fund loan documents tend to be tied just to the nature of the risk of the deal rather than who the lender is. Certainly not all of them, but a lot of times that is the case in my experience.

Dan Evans
Well, thank you guys for educating me. Any last thoughts before we sign off?

Michael Dowley
No, thanks for having us, Dan. Look forward to being a more frequent contributor in the future, and yeah, hopefully hit the nail on the head here.

Terry Carroll
Oh yeah, this was great. I appreciate both of you and the time and the platform.

Dan Evans
We appreciate you both as well. Thanks for educating me and our listeners. Thanks, as always, for sharing your insights. I know you guys see a lot of deals, so it's always something new. So again, thanks for joining us today, for sharing your thoughts. Special, thanks to our listeners for tuning in. Please keep an eye out for future episodes. Thank you all.

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