The Art of the Capital Stack
The RealCrowd Podcast | Fundamentals of Commercial Real Estate Investing

June 2019

INTRODUCTION

Shahin Yazdi: In every deal, there's different layers of capital that's used to acquire or build an asset. This will be a combination of equity and some type of debt. The capital stack in every deal is important because, ultimately, that's going to tell you what the returns on the deal are.

Tyler: Shahin Yazdi, Principal and Managing Director from George Smith Partners will talk today about something which is core to every deal, the capital stack and the various components of the capital stack: debt, equity, mezzanine, preferred, different pricing, different rates, different loan to values.

Tyler: On this deep dive into the capital stack, starting from the bottom and working our way up, Shahin broke it down for us and for our listeners.

Adam: He talked about what the goals are for the different parts of the capital stack, how to arrange each source of capital in a transaction, where the art comes into structuring a transaction, and what makes the right capital stack for a deal.

PODCAST BEGINS

Adam: Shahin, thank you for joining us today. Excited to dig in on the capital stack and learn a little bit more about an area we haven't really talked a lot about on the podcast. Super fundamental to our space, so we're excited to have you on the show today.

Shahin Yazdi: I'm excited to be on. Thanks for having me.

Adam: Tell us a little bit about your current role at GSP and what you're up to these days.

Shahin Yazdi: At George Smith Partners, we're capital real estate advisors, we help our clients raise debt and equity for their various commercial real estate projects. I'm one of the Principals and Managing Directors of the company, so along with all my partners, I help oversee the direction of the company and help it grow. I also am responsible for bringing in production for the company. Along with my team of five, we do all asset types, all loan types, and all pieces of the capital stack.

Adam: Tell us a little bit about your entrance into the real estate space. I know you had a background in banking before so I'm curious how your background in the more traditional banking environment pushed you into commercial real estate on the capital market side.

Shahin Yazdi: I always had a passion for finance and real estate. After college, I realized, that the best job would be in banking. I needed to get a strong foundation, understand the principles of underwriting, and learn how the banking system worked in general. Within a few years, I eventually moved to George Smith Partners. A lot of what I learned in banking helped. First and foremost, I think every credit committee likes a detailed story. As a banker, you learn to address issues with credit before it becomes an issue. You start to think like a credit officer, underwrite the way that they like to see deals underwritten.

Additionally, I learned that there's always exceptions to be made. We had a lot of policies at the bank however, if you were able to sell your story well enough, the bank was willing to make an exception. It was a lesson that I carry into what I do now. In everything that we do, we try to be as detailed as possible, address problems and figure out solutions before the lender thinks of it. We understand that if we do a good job of laying out the foundation of the deal, that almost every lender will want to finance the transaction, or at least we can find the right capital provider for it.

Adam: Now, for listeners out there that maybe aren't as involved or in-tune with what goes on in the mortgage world. Spend a minute telling us the difference of a banker's role versus your role at George Smith Partners.

Shahin Yazdi: Even though every bank can make an exception, ultimately, they all have a box. Our job as real estate capital advisors is to find the best deal for our clients. We have no obligation to certain lenders. Our job is to underwrite the deal, create that package, and speak to every lender or capital provider out there to find our client the best deal possible, whether that's a bridge loan, a perm loan, a construction loan or a mezzanine piece.

Adam: When you say you're trying to uncover those issues before it becomes an issue, you're helping to address what some of those risks might be and how the borrower is going to mitigate those risks.

Shahin Yazdi: Exactly. We'll underwrite the transaction and if there's a shortfall, for instance, when we underwrite a bridge loan and realize there's going to be a shortfall in the cashflow, we will do a cashflow model that goes out for the next 24 months, then figure out exactly what that interest reserve needs to be, rather than have the lender guess it.

Adam: Getting it easier to get to a yes versus letting the bank come up with the reasons no.

Shahin Yazdi: Exactly.

Adam: We have transitioned to the main topic today, which is the capital stack. It's something that is very crucial to every deal. To start, what does it mean? What is it comprised of? What does it tell you about a deal?

Shahin Yazdi: In every deal, there's different layers of capital used to acquire or build an asset. This will be a combination of equity and debt. The capital stack in every deal is important because, ultimately, that's going to tell you what the returns on the deal are -how it’s structured, what the rates are, what the returns to the investors are, and what the return to sponsor is going to be.

Adam: Depending upon what rate is required for each portion of the capital stack, blended together (averaged), will tell you what the total cost of capital is for a deal structure.

Shahin Yazdi: And most importantly, what the returns are going to be.

Adam: Are all capital stacks static? Is there variability in every deal? Where does the art of arranging the capital stack come into play?

Shahin Yazdi: Every deal is so different and unique. Ultimately, the needs of the sponsor are different.

Shahin Yazdi: Some sponsors need less equity than others. Some sponsors need help raising the equity. Some sponsors prefer more debt and want to put in less equity. Every deal is always different too. The numbers aren't always the same. Every cap rate is different, every market is different, and every business plan is unique to different sponsors.

Adam: Most of the time, investors are going to see the capital stack in a consistent format. It takes the shape of a bar graph, with the bottom most portion, that being your most senior. Then working your way up the capital stack as you get towards common equity and the sponsorship co-invest capital. Why don't we start at the bottom?

Start at the debt portion of the capital stack and give us, what it means to be in that position? If you're an investor, you're either in that debt piece or in an equity piece.

Shahin Yazdi: I believe the debt piece is the most important part of the capital stack. It's what outlines the initial returns to the sponsor. It also tells you how much equity you need for the project. It's the least risky portion because it's at the bottom. If anything goes wrong, they're in the position to foreclose and wipe out anything behind them. When you think of debt, you could think of traditional banks, insurance companies, debt funds, securitized lenders like CMBS.

Adam: When we talk about seniority on the capital stack, who has control if something goes wrong? Whoever's in the most senior position kind of drives the boat.

Shahin Yazdi: That's right.

Adam: However, there's a trade-off for being in the most secure position. It usually comes in the form of a lower rate. How does the profile of debt investors differ from equity investors?

Shahin Yazdi: Debt, fluctuates on how much leverage they're offering and how risky the deal is. For instance, we're doing into a deal now where for a construction loan and the sponsor doesn't want to provide any guarantee, not even a completion guarantee, which is extremely rare, especially on a construction loan. That deal on the debt piece (because it's so risky and they're going to a high leverage loan) is going be around 8 to 10%.

On the other hand, when compared to equity, the range of debt will typically max out anywhere between 10 to 12% interest, but it's always a fixed return. Lenders receive interest and fees but no profit above that.

When you're participating in the equity however, you're taking a little more risk but you're going to get a part of the returns if the project is successful. Equity returns also depend on how risky the transaction is. If it's a multi-family deal in a prime location, an investor might be looking to get 12% on their money. A riskier deal may command northwards of 20% IRRs.

Adam: On a traditional senior loan piece, what kind of loan to value are you seeing typically? How far up the capital stack does that usually go these days?

Shahin Yazdi: Depends on the deal and on the debt type as well. If you're looking at a permanent loan, and for an asset that's basically stabilized, you want a long-term, fixed rate loan or even a short-term loan. You're going to get somewhere up to 75 to 80% loan to value. In core markets where cap rates are suppressed and they're lower, you're typically going to cap out around a 65 to 70% loan to value.

Even though the lender can go higher on LTV, they're typically tapped out by other metrics, which is cashflow. The DCR is one of the specifics that every lender looks for. The other one is debt yield, which is basically the NOI of the property divided by the loan amount of the property.

Adam: In simplistic terms, that's what the lender's return is if they had to take it back.

Shahin Yazdi: Exactly. Think of cap rate, but it's for the loan instead of the value.

Adam: How have you seen that change over the last, 12 to 18 months? Have you seen loan to values or rates move dramatically in relation to any market shifts?

Shahin Yazdi: In the last four months, rates have dropped significantly. In the last 12 to 18 months, we've been seeing more and more lenders getting more competitive. There's so much capital out there chasing deals that it's a great time to be a borrower.

Adam: Now, let's move further up the capital stack. Our loan is figured out. Now let’s get into the equity piece. Most of the time on your platform the two different types of equity are, LP equity, limited partner equity, sometimes referred as common equity and JV equity, joint venture equity. Let's talk about where that fits in the capital stack, how far that goes up the stack, and what some of the basic attributes of LP and JV equity are.

Shahin Yazdi: JV equity could be anything. It's such a fluid product. It could be a 50/50 split, it could be 90/10, 95/5, where the sponsor's bringing in 5% and their JV partner is bringing in 95% of the equity.

This is an area where crowdfunding and your platform is great because it's filling the void for smaller deals, for sponsors that are doing deals around 5 to 10 million and would typically go to friends and family for their equity. They can now go to your platform or other crowdfunding platforms to raise that money. If it's a larger deal, there are institutional equity partners who can participate in those deals. This is an area where, they're taking more risk, so they're going to look for higher returns on their investment.

Adam: How much of the remaining capital stack, say where 60% loan to value comes from the debt piece, would be filling up with this kind of common equity?

Shahin Yazdi: At that point the 40%. Depending on how the sponsor and equity partner want to structure it, if they do 90/10, that 40% is going to be split up with 90% to the equity partner and 10% to the sponsor.

Adam: In that case, 60% loan to value and if it's going to be a 90/10 structure for the equity piece, you'd have limited partners, the LP equity and senior debt, that would be, 96%? Then you'd have the sponsor co-invest, the remaining 4%, which would round out that capital stack.

Shahin Yazdi: Exactly.

Adam: Now, on the sponsorship’s co-invest side for the GP capital, tell us a little bit about how that differs from the common equity, the LP equity, and what those return profiles look like.

Shahin Yazdi: The sponsor and the GP are basically the ones managing the deal. They may put in 5, 10, even up to 50% of the deal. They'll start with a certain return and this can be structured in many ways, but typically, there's a waterfall where eventually, as the common equity or JV equity partners go through certain return hurdles, they get more of the participation and more of the profits.

The sponsor and GP may start with 95/5 or 90/10 spilt with common equity but then as the common equity hits certain hurdles and IRRs, the sponsor and GP are going to get higher returns. They can eventually move up to being 50/50, even 75/25.

Adam: That's what we commonly refer to as the promote?

Shahin Yazdi: Exactly.

Adam: Are you seeing a typical structure or any common themes in terms of simple promotes or multi-tiered waterfalls?

Shahin Yazdi: All of it is negotiable and each deal is different. For example, on larger construction deals, if we're doing equity, investors want 20% IRRs or better. Sometimes, you'll get down to 17% or better. If it is a rehab deal, you can get down to 15% IRRs. Sometimes, it could be slightly less with specific family offices. I've seen it as low as 12%. I think the best returns for the GP are always going to come from friends and family or crowdfunding. A lot of crowdfunding sites have friend and family returns where it's around 10 to 12% IRRs.

Adam: Yeah. I think that's also been the shift in the market. A lot of the early deals that were done in our industry in 2014 through 2017, were of those juicier deals where you could obtain higher IRRs. In the current nature of the market we're seeing those come in and tighten, because deals are harder to find. Those returns have compressed a bit. Much harder to find those 20-plus IRR deals anymore.

Tyler: What are the goals of each investor in that portion of the capital stack? You already mentioned debt, the investors are looking for a fixed return, but could you break it down for us for each element of the capital stack?

Shahin Yazdi: The goals for the debt is to put money out, get a fixed return, and get paid back. They're not trying to take high risk deals. They're trying to do deals where they're able be taken out. For equity, ultimately, the goal is to hit a certain return and is therefore comfortable with higher risks.

If you're investing equity, whether it's real estate or the stock market or a company, you're looking for a certain return on your money, and you have those targets. I think with real estate versus other products, it's a little bit easier to calculate because you can see where market comps are, where they're projecting to, and use that information to get comfortable with the transaction, assuming everything stays on course.

Adam: Now when the sponsor is looking at a deal, what are they trying to solve for? Are they trying to optimize one portion of the capital stack over another? Are they trying to get the most efficient blended cost of capital? How does that decision-making process unfold in terms of what the ultimate capital stack looks like?

Shahin Yazdi: That's a great question and leads us into talking about mezzanine and preferred equity. For some sponsors, they don't want to give up control, so they may not want to bring in a JV equity partner. Because, ultimately, that partner who has equity in the deal and some control rights. They sponsor will not be able to hire any management company they want and will have sale restrictions on the property with a JV Partner.

The sponsor may decide, "Hey, I don't want to live with that," so either I'm going to find an equity source, where they're not going to require those control rights, or layer-in different capital. That is where you can get a bank loan and then mezzanine or preferred equity on top of the mezzanine. In this scenario, both of those capital sources really function as debt, and are not going to have control rights, but will lever-up the deal.

For every sponsor, it differs depending on their needs. Some sponsors are flush with equity. They're lucky enough to have enough funds and are never out to the market for equity. Those sponsors are always looking for the best debt with the best rate.

Shahin Yazdi: Other people are looking for the most leverage, and that's why the first goal is to always understand the needs of the sponsor. No two sponsors ever have the same needs. It's always different.

Adam: Cost and control are the two big levers, I guess, when you're looking at the capital stack. What is the cost of both the debt and equity? Then, what are the controls that you have as a manager.

Shahin Yazdi: Control with debt can come in various forms as well. Because some debt providers, a bridge loan, for instance, might have certain cash management accounts. In return, you're going to get more leverage, and you get non-recourse money. Sponsors make that choice.

Adam: Now, two things you mentioned. Cash management, which is a cash sweep account. The ability for the lender to have some control over where the cashflow from the outside is going, so it doesn't immediately go out to the sponsor. That lender will have a lockbox. They might have the ability to get to that cashflow before the sponsor does.

Shahin Yazdi: Yes, and in return, you get higher leverage.

Adam: Explain the difference between recourse versus non-recourse loans and what that means for LP investors, not the manager. Specifically, how does recourse versus non-recourse loans impact them?

Shahin Yazdi: Typically, for the LP it will not affect them because they do not sign on the loan. As a sponsor, a non-recourse loan means they are not personally guaranteeing the loan. All they are guaranteeing is “bad boy carveouts” where they say, "Hey, I'm not going to commit fraud. I'm not going to contaminate the property. If I do any of those bad boy things, however I agree that the loan would be recourse to me."

Adam: Why would a lender choose to go recourse versus non-recourse, or vice-a-versa?

Shahin Yazdi: There are a lot of lenders that only offer non-recourse loans. For example, all securitized loans are non-recourse. They're looking at the collateral, the asset itself, and not as heavily at the sponsor. Other lenders only offer recourse loans. It may also be a function of leverage. There are lenders that will offer recourse loans up to 75% LTV, but if a different loan to value is below 50%, they may offer non-recourse.

Adam: In that case they have a heavy emphasis on the actual property because for a non-recourse loan, in the worst case, they take the property back, and then they own it at a good basis.

Shahin Yazdi: That's right.

Adam: You mentioned mezzanine debt and preferred equity. We have a few deals on the platform listed for preferred equity. We have not listed much mezzanine debt.

What is mezzanine debt? Where does it fit in the capital stack? Then contrast that with preferred equity afterwards.

Shahin Yazdi: The best way I like to describe mezzanine debt and preferred equity is to think of a hotel. In a hotel there is a lobby level, then the mezzanine level before you get to the rooms. Mezzanine debt acts as a layer between the senior debt (the lobby) and the equity (the rooms) that gives additional leverage. They both act as debt, but they do it a little bit differently.

With Mezzanine debt, you are going to have a fixed coupon. These lenders charge a fixed rate and fees. The debt acts as a second loan on the property with a lien and an inner-creditor agreement with the senior lender that gives recognition rights that allow the mezzanine lender to foreclose and take over the loan if the Sponsor does not make their mezzanine payments. The major difference of Preferred equity is that instead of putting a lien on the property they have a lien in the entity that owns the property.

Adam: Again, Mezzanine is secured by the property. Preferred equity is secured by the borrowing entity, essentially.

Shahin Yazdi: Exactly. Then for returns they both get a fixed coupon. Sometimes preferred equity may get some of the upside, but normally, it is a fixed coupon and fees.

Adam: Again, that's something we've seen. We used to call it "d-equity," where you've got preferred payments and participation.

Adam:	What does a deal with either a mezzanine loan or a preferred equity piece, mean to an investor?
Shahin Yazdi:	Many lenders don't allow mezzanine behind them and that's why the investor may do preferred equity. I personally think preferred equity is a better structure than mezzanine because the path to foreclosure is a lot easier.
Adam:	Right.
Shahin Yazdi:	If the preferred equity investor is not getting paid, it is easier for them to take over, versus a mezzanine loan, where foreclosure is a longer process. However, different lenders and investors have different views. That's just my view.
Adam:	Do you see a difference in pricing between mezzanine or preferred equity?
Shahin Yazdi:	Mezzanine typically tends to be slightly cheaper. For a cash flowing property both will be cheaper. In the end however it is more about the deal than the product type.
Adam:	Where are you seeing rates for mezzanine or preferred equity?
Shahin Yazdi:	9 to 10% and up.
Adam:	Varying on many different factors within that deal.
Shahin Yazdi:	Right.
Adam:	When adding in these different layers of the capital stack, is there a general rule for a target, blended cost of capital and what the return profile of that asset is? Or, does the situation dictate the cost of capital?
Shahin Yazdi:	It always varies on the asset. Because these kinds of loans and the debt can be invested on an asset that has no cashflow, on an asset that's just being built, or on an asset that's going to be completely rehabbed, and the going in cashflow disappears entirely. You can also do it on an asset that is cash flowing, and maybe the first trustee lender or the bank, CMBS lender, can get high leverage in the capital stack, and so you layer in a piece of mezzanine or preferred equity to arrive at the leverage ratio needed. Depending on all those variables, and the important question of, "Is cashflow in place today to cover this additional loan?" that will trigger the rates.
Adam:	Perfect.
Shahin Yazdi:	It can also become more appealing if the borrower and property can make interest or equity payments current verses accrued payments.

Adam: Explain current pay versus accrued. For example, a preferred equity piece with a rate of 10%, and a split between a current payment and an accrued portion. What does it mean for an investor if a portion is going to be accrued?

Shahin Yazdi: Accruing means that whatever cashflow does not cover the monthly interest payment (assuming the lender doesn't ask you to pay it current), the payment will be added onto your loan and it can start earning interest on interest. For instance, a loan has monthly payments of $120,000, but the property only covers up to $100,000. Then $20,000 is added onto your loan.

Adam: There are different treatments of how that accrual is accounted for. Simple accrual - where that amount just becomes an amount payable at a future date, versus compound - where payments get rolled into the loan balance and also earn interest. Do you see a standard between those two kinds of structures?

Shahin Yazdi: Everything is negotiable. There are few metrics which are always standard. Although the market dictates that we underwrite to certain things, each situation differs for each lender.

Adam: Are there any assignments that GSP has worked on lately which illustrate some of these concepts about the capital stack?

Shahin Yazdi: Yes, we recently did a construction loan where the total capital stack was about $60 million. The entire stack was non-recourse. We were able to facilitate a structure with 87% of the total cost invested from outside sources. Initially, the sponsor wanted a JV equity partner. We found several equity partners willing to do the deal. However, when the sponsor realized they would give up control rights they decided, "Hey, let's just go out and get preferred equity".

The first piece of the capital stack was the senior loan of $41 million, and the second was an $18 million preferred equity piece. The loan floats at a 25 day LIBOR + 400. The preferred piece carries a minimum return on invested money, no upside, and they have no control rights. At the end it was exactly what the sponsor wanted.

Adam: Control, was the important piece for that manager and by structuring it with preferred equity, the clients retained all the upside, whereas, a JV partner or LP equity, would share in the upside from that development deal.

Shahin Yazdi: Exactly.

Adam: How much of the decision-making is profit driven? If you can replicate that capital stack and not have to obtain LP investors, I would imagine that drives a fair part of the decision-making process as well.

Shahin Yazdi: Absolutely. However, not all sponsors are equal, and some sponsors do not have that choice. In our situation, our sponsor was able to come up with the remaining 13% equity. Some sponsors do not have that capability and need a JV equity partner which mandates giving up some control rights.

Adam: Right. If that means getting the deal done or not.

Shahin Yazdi: Exactly. The goal for a sponsor is always to go in with the lowest possible cost and the highest upside.

Adam: Most of our listeners are investors looking at equity investments in transactions with a manager as a non-active partner. What are some of the key takeaways when they're looking at the capital stack of the deal? Are there some red flags? Are there some questions that they could be asking about the manager based on a quick review of the capital stack? Or is it straightforward?

Shahin Yazdi: First and foremost, always know how much leverage is in front of you. Because that will tell how much risk you're taking and the probability getting paid. The more leverage a sponsor is putting in on a deal, the more risk there is to the equity investor.

Additionally, determine the amount of upside in the deal. Sometimes, you can layer in a great deal of leverage and a small piece can be equity. If the returns are significant on the deal, it's obviously a good deal that makes sense. Finally, you want to look at the final value of the asset.

Adam: If an investor wants to conduct more due diligence beyond the bar chart of a capital stack, what are questions they can ask of the manager, or any documents they would expect to see or review to learn more about the composition of that capital stack?

Shahin Yazdi: Review the entity documents. That is really where an investor can find the nuts and bolts of a transaction. Also, the closing statements.

The sponsors proforma is where an investor can find the projections for the project and most importantly understand how the capital stack is going to be structured. The other document to ask for is the sources and uses document which says “This is the source of all our funds, and this is going to be the use of all our funds".

Adam: That serves as the roadmap for where the capital comes from and goes to.?

Shahin Yazdi: Currently, we are in a very strong market and fundamentals continue to remain strong. Lenders in this cycle behave different from lenders in the last cycle. Even though lenders are getting more aggressive and offering higher leverage with non-recourse, fundamentals are still there.

They underwrite cashflow to assure an exit with today's rents and market conditions. With rates where they are, we're safe for at least the next 12 months. But, we will soon have to evaluate where the political climate goes from there.

Adam: That's fairly in line with other participants in CRE, nothing major foreseen in the near future will disrupt the economy. Maybe not the accelerated growth that we have realized in the last few years, but slower and steadier.

Shahin Yazdi: Let's all hope for that.

Adam: Please let our listeners know how they can learn more of what you're up to with George Smith Partners and how can they reach out to you?

Shahin Yazdi: They could reach out to me on my direct line at 310-867-2954 or email me at Syazdi@GSPartners.com.