Beyond Traditional Real Estate Debt: Custom Designing your Capital Stack

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Dealmaking is a relationship business for family offices and specialty lenders—and increasingly, more traditional lenders are looking to partner on business opportunities. At this stage in the market cycle, it's important to look at all available sources for the capital that will get a real estate deal done. And when you evaluate your options, you may want to look into new approaches to the loan itself as well.

From mezzanine debt to preferred equity participation, there are many building blocks that can be used to construct the capital stack for a real estate development. When there are so many capital providers competing for so few deals, it's important to keep as many options on the table as possible. One often overlooked structural opportunity is a loan-on-loan arrangement, which takes advantage of the attractive funding rates that oftentimes can be provided by a credit union. This construct can be an interesting way to finance transactions in asset classes such as multifamily, non-spec industrial, hospitality and self-storage.

Understanding the loan-on-loan structure

Let's examine a hypothetical example to understand the capital stack in a loan-on-loan approach. In this scenario, a developer is building a property for $20 million and obtains a construction loan from a specialty lender at a 75% loan-to-cost ratio, or $15 million. The specialty lender, in turn, partners with a credit union to provide a loan-on-loan of $7.5 million, which is collateralized by the loan to the borrower.

The loan-on-loan takes the last loss position in the capital stack. In return for the additional safety of that position, the credit union would price their loan at a lower rate than the specialty lender is charging to their direct borrower. For example, if the loan to the borrower features a rate of 8.5%, then the loan from the credit union might come in at 6.5%, thereby giving the specialty lender a spread of 200 basis points and increasing their overall margin.

The specialty lender benefits from a lower cost of capital, enabling them to offer a more attractive loan to their borrower. The credit union, meanwhile, is able to participate in a safer position versus going it alone.

When to consider a loan-on-loan

Specialty lenders may consider a loan-on-loan approach when they're close to hitting their exposure ceiling or need to share the risk of a loan. They are able to lend more to a single borrower because the loan is diluted with one or more institutions, and bringing partners on board reduces the overall risk held.

This structure is equally beneficial to the underlying borrower (the developer in our example above). A specialty lender generally has a shorter closing time frame and high reliability, allowing borrowers to access capital faster than if they were to seek traditional financing. And because the specialty lender is able to reduce their cost of capital with the loan-on-loan, they often will share the savings with their borrower. While multiple partners may be involved in financing the transaction, the transaction will be seamless, feeling like any other loan from a single lender because the specialty lender retains the primary relationship.

In the competitive field of commercial real estate lending, lenders and operators should consider any avenue that gives them a competitive edge. Employing a loan-on-loan program allows family offices, debt funds, pension fund advisors and private specialty lenders to offer better terms, distribute the risk, and hopefully win more deals. ■

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