

TIC Monthly

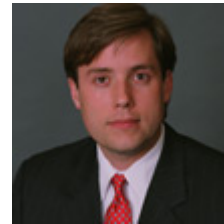
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Finance Series Part II: Pros and Cons of Different Kinds of Debt in TIC Deals

By: Michelle Napoli

New York City—With ample debt available for real estate, tenant-in-common investment sponsors are about as able as most other property acquirers to choose among numerous lenders and numerous debt options. And the gamut of debt options—fixed and floating rate, interest only and fully amortizing—is reflected in the TIC deals being transacted across the country. There is widespread agreement, however, that fixed-rate and fully amortizing debt is the most common form—and in many cases the most preferable—being used in TIC deals.

“The majority—two-thirds or more of the volume we’ve done from a TIC standpoint—has been fixed-rate financing,” says B. Jeffrey Knowles, managing director in the Houston office of Holliday Fenoglio Fowler LP. He closed four TIC deals last year, worked on another seven with a colleague and recently reported another 10 in the pipeline.



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Locking in current low rates and avoiding the risk of rising rates for the sake of investor safety are the main reasons for preferring fixed-rate financing, though knowing with certainty what the interest rate will be also helps the sponsor and the investor alike determine yield expectations. “When the offering is sent out they need to know what the rate is so they can determine what the yield’s going to be,” Knowles adds. “So the most important thing for the majority of our TIC clients has been to get the deal to market as quickly as possible, lock the interest rate on the front end so they can determine with some certainty what that yield is going to be so they can get the deal subscribed.”

Indeed, fixed-rate debt is far more preferable for sponsors, agreed Frank Satterfield, principal of Harbor Capital Group in Houston, which arranged \$415 million of financing for TIC deals last year, the company’s first year operation. “All things being equal, the sponsors that I deal with would always prefer to utilize fixed-rate debt, particularly in this environment,” Satterfield says. “The goal of the sponsors I deal with is always to present a situation for their investors that truly limits the downside, and a big part of the downside is interest rate risk.”

In fact, some TIC market observers warn against the use of floating-rate debt. “For TIC deals, for what most investors are looking for, I think it’s fairly dangerous,” says Paul Aiesi, chief investment officer of TIC Properties LLC in Greenville, SC. “What TIC investors want is a stable income stream. What you’re doing is adding an additional variable. If your assumptions are for interest rates to go up a little bit, but not much, you can be way off. It adds a lot of uncertainty.”

Still, there are circumstances where the use of floating-rate debt is considered an appropriate and useful tool for the benefit of the property and its owners. It can be particularly useful when a property is still in lease-up or otherwise needs to be stabilized, and typically the plan on the part of the sponsor is to replace the floating-rate financing with fixed-rate debt within a year or two.

"We use them all in different circumstances—it depends on the property," says Louis Rogers, president, Triple Net Properties LLC, in Santa Ana, CA. "A lot of properties need to stabilize, or need a tenant to renew, or need something. And so on occasion, we'll have a floating-rate loan while we're fixing a problem and then we'll convert to fixed rate as soon as possible. The concept is, if we believe we're going to be, say, 90%-plus leased pretty quickly but we're only 80-something now, we'll use floating-rate, cheaper money to get in, get it leased and then once we have the level to support it, immediately refi." Triple Net Properties typically does so with the same lender, keep costs and difficulties down, he adds.

The ultimate exit strategy could make floating-rate debt, with its more flexible prepayment, more appealing, says Knowles. He cites a client, with what he described as a

long track record of TIC deals including properties that have gone full cycle, who has used only floating-rate debt on his deals. "His primary requirement is flexibility to sell a property, and he doesn't want a fixed-rate loan that would be an assumption for a buyer if he were to sell the property," says Knowles. "He wants to be able to offer his properties on an all-cash basis."



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While it may, generally speaking, also be more prudent to utilize amortizing versus interest-only debt payments, there also are circumstances where IO can be a useful and appropriate tool. Though some are quick to warn that the use of interest-only debt to merely boost yields being marketed to investors can be a dangerous matter, others point out that properties where cash flow is expected to increase—perhaps from additional leasing activity or a situation where a tenant is expected to have a substantial increase in its rental rate—can benefit from interest-only financing.

"The investor should have pause for concern on the likelihood they're going to be able to get their entire investment back," says Aiesi. While TIC Properties generally likes to amortize its loans out of the gate, he won't go as far as to say TIC Properties will never use interest-only debt. "I think there are some specific circumstances where interest only can work," he concedes, using as an example deals where he sponsor will hyper-fund the property's reserve account. "In lieu of setting aside a large amount of cash at closing, you do a year or two of interest only and use the excess cash flow to put it aside in a reserve account."

But where it doesn't work, Aiesi adds, "is where you've overpaid for a property and you've got to go interest only to make your cash flow work." Using interest only to boost the yield being sold to investors is "a big red flag," he says.

Yet boosting the yield is precisely the point, says Rogers. "That's the whole purpose," he says. "If it's fully disclosed to accredited investors, I don't know how you could say it's being abused. If they don't like interest-only financing, they can buy a different deal. It's a question of, do you want more now or more later; a lot of people want more now, they want to live off the cash flow."

When Triple Net Properties uses interest-only debt payments, it's generally to smooth out cash flow, Rogers adds. "With a lot of properties, the first year or two it's pretty tight," he says. "So if you have a year or two of interest-only financing, it allows you to get the property up and running, get the transition over and preserve a stable cash flow for the investors."

And while fully amortizing might be generally the preferable option for lenders, Sutterfield says that those he works with can often get comfortable with the property story behind a sponsor's desire for two-year interest-only debt.

Bear, Stearns & Co. in New York City had done interest-only for TIC deals it has financed. "If it's low-enough leverage to begin with, I'm not sure we really care," says Jeffrey Lavine, the senior managing director who oversees the investment bank's loan closing and structuring. "If you ever foreclosed, you've got an equity cushion, even if the TIC investors bought it rich."