INVESTMENTS

by Jeffrey Giller

Real Estate Fund Recapitalizations

Sometimes Bad Balance Sheets Happen to Good Managers

Real estate private equity funds have a big issue: They need more capital, and it's not that easy to get, at least not anymore. A mere three years ago, capital was abundant. Between 1999 and 2008, investors filled real estate funds' coffers with equity capital totaling some $420 billion, nearly 80 percent of which was raised in the relatively short period between 2005 and 2008. During the same period, debt became overly abundant and very inexpensive, and underwriting standards became very loose. Nearly half of the approximately $1 trillion in commercial mortgage debt that has been originated since 2002 was issued in the two-and-a-half-year period between 2005 and 2007, right at the peak of the market.

So, until recently, obtaining equity or debt capital was relatively easy for funds, but now it is scarce, and scarce at a time when funds need capital the most. In this post–credit crisis environment, it is generally understood why fresh capital is so scarce, but why are real estate funds now so in need of capital? With all the money made available to them in their newly mega-sized funds, shouldn't managers have set aside sufficient reserves to cover their investments' long-term capital needs? Managers did in fact set aside enough reserves to carry their investments for their intended three- to five-year holding periods, but they were unprepared for the significantly longer holding periods brought on by the sudden freeze in transaction activity. In addition to being under-reserved, managers financed their investments with short-term debt to match their intended short-term holding periods, and that debt is now maturing. Not only were managers unprepared for the longer-than-expected durations of their holds, but they were equally unprepared for the devastating impact that the precipitous fall in property values would have on their balance sheets.

Executive Summary

- **Many real estate private equity funds require fresh capital to meet upcoming debt maturities or to fund their business plans.**
- **The approximately $125 billion of debt maturing in real estate private equity funds will require in excess of $50 billion to rebalance LTVs to 65 percent.**
- **To determine whether recapitalization proceeds will create value or be tragically lost as good-money-after-bad, potential investors must conduct a detailed, bottom-up analysis of each asset in a fund.**

Putting these various pieces together creates a picture of the present environment, in which vast amounts of capital were committed to real estate funds between 2005 and 2008 and substantially invested into properties after 2006, straight into the market peak. In general, these investments were over-levered with inexpensive, relatively short-term debt, and the reserves set aside were insufficient to carry the assets through the market down cycle. After 2007 when market activity ground to a halt and values dropped, real estate funds were left holding large portfolios of over-levered properties that had become in breach of their loan-to-value debt covenants, had impending debt maturities, and did not have enough capital to continue to carry their assets or fund their business plans.

How will these challenges be addressed? As in all market troughs, the real estate market today is not only replete with problems that need to be solved but opportunities that can be seized by savvy managers with a war chest of fresh capital. Below is a discussion of the critical uses that funds in today's market have for fresh capital, both for defensive and offensive purposes, followed by a brief overview of the potential sources of this capital and structures of recapitalization facilities.

DEFENSIVE CAPITAL NEEDS

Paying Off Maturing Debt and Funding Equity Gaps: Although lenders are now starting to get back into the business of making loans, they are sizing their advances at very conservative loan-to-value (LTV) ratios, typically no more than 65 percent compared with 75 percent or higher at the peak of the market. Applying these lower LTV ratios to property values that may have fallen by 30 percent to 50 percent from the time they were originally financed results in refinancing proceeds that fall substantially short of the amounts required to pay off maturing loans. The difference between the refinancing proceeds and the amount required to pay back the original loan is referred to as the "equity gap," and funds that want to avoid foreclosure must find the capital to fill it. The roughly $1 trillion in commercial mortgages coming due for maturity during the next three years will require in excess of $230 billion of capital to rebalance these assets' real market value to 65 percent, and the approximately $125 billion of debt maturing in real estate private equity funds will require in excess of $50 billion to rebalance LTVs to 65 percent.

Paying Down Maturing Debt to Secure Term Extensions: Lenders may be willing to grant term extensions to borrowers with maturing loans but, as a condition, often require some sort of a principal pay-down. Therefore, funds are in need of capital to extend maturities and avoid foreclosures.

Covering Property and Fund-Level Carrying Costs: With operating cash flow lower than originally projected and an inability to sell properties at the right prices to generate liquidity, a number of funds require capital infusions to cover property-level carrying costs and fund-level management fees and costs.

Buying Out or Covering Obligations of Defaulting Partners: Fund managers may require fresh capital to cover shortfalls caused by limited partners who are unwilling or unable to fund their future capital commitments.

OPPORTUNISTIC CAPITAL NEEDS

Buying Back Debt at Discounts: As banks' earnings and capital reserves continue to improve and regulators begin to increase pressure on lenders to mark their loans to their actual market values, the days of "extending and pretending" seem to be moving behind us. As a result, lenders are increasingly able and willing to sell their loans to borrowers at discounts. These so-called discounted payoffs create a win-win by allowing lenders to improve their risk capital ratios by removing challenged loans from their books and, at the same time, allowing funds to restore some of the equity lost through the market value decline. With credit markets now loosening, a fund's challenge is not so much to find sources to refinance loans as to find fresh capital to fund the equity gaps often required to take advantage of discounted pay-offs.

Executing Value-Added Business Plans: In most cases, fund managers intended to finance value enhancement projects such as property development, renovation or tenant improvements with debt or equity reserves. With debt availability for these uses still constricted and equity reserves depleted, managers must seek alternative sources of capital to finance these sorts of accretive activities.

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Making Opportunistic Acquisitions: In certain circumstances, funds may benefit from taking advantage of the distress in the market by raising fresh capital to make strategic acquisitions or to enhance the value of their existing assets.

POTENTIAL SOURCES OF FRESH CAPITAL

Although the credit crisis appears to be waning and institutional investors seem more open to making new investments, fresh capital for fully drawn funds is still relatively hard to come by. The potential sources of fresh capital for real estate funds and their merits and challenges are discussed below.

Limited Partners' Undrawn Commitments: There is an estimated $30 billion in undrawn capital commitments outstanding in real estate funds raised between 2005 and 2007 that could potentially be drawn to provide the much needed fresh capital to funds. However, $30 billion is an insufficient amount to fill the $50 billion equity gap that exists — let alone to take care of the other needs funds have for defensive capital. But even if undrawn commitments from fund limited partners did provide sufficient liquidity to solve funds' capital requirements, another problem exists: Some real estate fund investors either cannot, or simply will not, make additional contributions to funds, contractual commitment or not. Those that cannot fund are often suffering from their own liquidity constraints due to poor performance across their investment portfolios and declines or delays in the timing of distributions. Those that can but will not fund often express a reluctance to continue to invest in funds that have delivered poor performance and are nervous about suffering even further losses by putting good money after bad.

New Commitments from Fund Limited Partners: One of the most obvious sources of fresh capital for funds is their existing limited partners. The advantage to procuring fresh capital from existing limited partners is that they are already familiar with the manager, the fund and its assets. The challenges, however, are many. Most institutional investors have lengthy and cumbersome approval processes, they are typically not staffed to conduct deep ground-up due diligence and make asset-level investment decisions, and it requires the consensus of all participating limited partners to effectuate a single recapitalization transaction. As such, in many cases managers have elected to pursue third-party recapitalization sources to avoid the complexity and execution risks of transacting with their existing limited partners.

Traditional Lenders: Although some lenders are now back in the market and extending credit for high-quality, conservatively leveraged acquisitions, debt remains elusive for transitional assets requiring funds for capital improvements, leasing costs or to refinance near-term maturities.

Liquidating Assets: Although some funds are selectively selling off assets to raise capital for defensive purposes, most managers seek to avoid disposing of assets in a market bottom. Also, contractual limitations on recycling capital can preclude managers' from reinvesting sale proceeds.

RECAPITALIZATION FACILITY STRUCTURES AND PRICING

Fund recapitalizations are typically structured as either subordinated debt or preferred equity. In either case, the proceeds are usually the last money in and the first money out. In other words, repayment is senior to distributions to limited partners but subordinate to secured asset-level debt or fund-level subscription financing. Whether or not and to what degree a facility's return on capital is also senior to the limited partners' distributions is subject to negotiation. Since most fresh capital is being invested into highly levered positions (often as high as 80 percent to 90 percent of the real market value of the fund) and is typically not secured by properties, its risks are more equity-like than debt-like, and therefore, facilities are typically priced similarly to opportunistic equity.

CONCLUSION

Most real estate funds require some form of fresh capital today, and this need will only increase over the next two to three years, even if property values stabilize. A fund-level recapitalization can be used to fend off impending foreclosures or to avoid forcing managers to sell assets into the bottom of the market to raise capital. However, the unfortunate truth is that some funds' equity is so deeply underwater that life support is not the right solution. To determine whether recapitalization proceeds will create value or be tragically lost as good-money-after-bad, potential investors must conduct a detailed, bottom-up analysis of each asset in a fund, including a determination of its present and future liquidation value; its cash flow profile and risks; its lease rollover and tenant quality profile; its debt-level, debt-maturity, debt-covenant and cross-default provisions; and its fund-level actual and contingent liabilities.

When evaluating the opportunity to recapitalize a fund, it is critical for the investor to be certain that there will be sufficient future distributable proceeds to return the new capital advanced and the intended return thereon because no matter how attractive the stated yield, it is absolutely meaningless if the fund's equity is at risk of falling underwater. ❖

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