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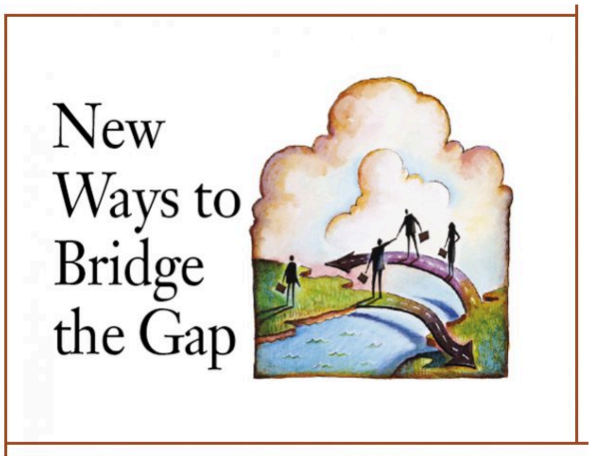
New Ways to Bridge the Gap



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By Erika Morphy

Charles Everhardt of Lockwood Property Holdings uses bridge financing to keep operations flowing, although he doesn't call the product by that name.

Lockwood typically has multiple projects going at one time as it seeks out development opportunities for a group of sophisticated investors. When it spots a deal that might work, it puts the property under contract.

At this point in the process Lockwood would be expected to put up soft or earnest money, which could be, depending on the project, millions of dollars.

That is quite a dip into its capital reserves, Everhardt says. "We'd rather use our own capital for due diligence or corporate overhead rather than tie it up for big earnest money deposits," he says.

So it turns to a new startup called Winchester Equities, based in New York City, which fronts the company the money for the deposit. Everhardt doesn't consider it bridge finance in the traditional sense in that there isn't collateral in play and the company uses the money for a far shorter term than normal bridge loans. Winchester Equities' financial product is, though, short-term money that addresses a gap in the traditional lending markets—and that is indeed bridge financing, at least circa 2014.

In short, bridge financing is expanding beyond its traditional definition of short-term money provided for such uses as paying off a loan or to adding value to a project.

It is being used, as Lockwood illustrated, to front deposit money for an acquisition. It is also being used to pay off highly leveraged and maturing CMBS loans—scenarios in which oftentimes the bridge providers are about the only source available, says Ann Hambly, founder and CEO of the Dallas-based 1st Service Solutions.

“Bridge lenders have morphed their business very creatively in recent years and are filling an important gap in the market right now by paying off these overleveraged loans,” she says.

3% BRIDGE MONEY

Perhaps the most obvious way bridge lending has changed in recent years, though, is its substantial drop in pricing.

“Bridge financing is cheaper these days because debt is cheaper overall,” says Eli Verschleiser, chairman of MultiGroup of Cos., which has used bridge financing for its own projects and offers it from its capital markets group. “Credit lines are cheaper and there are more providers in the space, so it is more competitive, too.”

For example, REITs are more active in bridge financing, he says, especially non-traded REITs, which have raised funds in recent years and now need to put that capital out in the market. Bridge lending is now being priced according to internal rate of return metrics, Verschleiser says, pointing to rates as low as the 9% to 10% range.

Within the past month, interest rates have been dropping even lower, to 3%, reports Ari Hirt, a director at Mission Capital in New York City. “We recently got a quote on a bridge loan at 3% for an apartment project in New York City,” he says. Eleven percent is reasonable, he adds—if you are talking about, say, unentitled land in California.

But good collateral in good locations can find much better rates. The company is securing a bridge loan for a hotel portfolio in North Carolina at 4%, Hirt says. “There are renovations going on, but the cash flow is still good,” he explains. For a 4% loan, a company can secure financing in the 70% leverage range. At 5%, the leverage can rise even higher.

RISKY LOANS?

Not everyone sees this drop as strictly a reflection of the price of money. A loosening of underwriting standards and investors that are eager to eke out yield are also accounting for some of these low interest rates, says Ross Yustein, chair of the real estate practice at Kleinberg Kaplan in New York City. “That is definitely part of the story.

“Development by nature is time sensitive and the sequencing is difficult,” he adds. “Bridge loan providers are taking a gamble that the next ‘step,’ whether it’s a sale or a successful renovation will happen.”

Market timing is also part of the mix that a lender should be pricing into the bridge loan product, Yustein says—but is increasingly not. “Sure, the demand for condo units in Manhattan is strong right now and it’s not such a huge gamble for the bridge lender,” he says. “But at some point, that logic runs out, even in the short term.” Markets have been known to crash suddenly, he points out.

Leverage ratios are also rising, which is making some lenders queasy especially considering where cap rates are, says Phil Long, managing director and chief credit & risk officer at Berkadia.

“Even a 75% loan today is much more aggressive than two years ago based on where cap rates have gone,” he says. “We are further along in the cycle than most people would realize, I think.”

Berkadia has kept its leverage ratios the same—it will only go to 75%, possibly 80% if there is a partner. “We’ve tried to address the leverage issue by coming in on spread,” says Long.

PAYING OFF CMBS

For some borrowers, though, the cost of the bridge loan is almost irrelevant—it just may be the only source of capital that will salvage an unfortunate position. That is increasingly the case for CMBS borrowers with highly-leveraged loans that are maturing now, says 1st Service Solution’s Hambly. Especially for loans that originated in 2005, many borrowers are finding they can’t pay off the loan via traditional lending sources.

“Bridge lending is probably the only source available to fill this need right now,” she says. The alternatives are simply too costly. Borrowers can lose their property or extend their loan, but that extension can cost up to a percentage point per year. A bridge loan with a three-year term is a more cost-effective solution.
“I personally have touched at least 10 deals like this in recent years, and the lenders I have spoken with all believe an onslaught of these deals are coming,” says Hambly, pointing to industry statistics that show that of the maturities coming due in the next year, some 34% of them are leveraged over 80%, based on current value.

“We will definitely see many more bridge loans being originated for that reason,” she says. In addition, many of these loans are getting very creative, offering such features as allowing some of the interest to accrue and then using it to improve the property, Hambly relates.

STRETCHING A BALANCE SHEET

Other bridge lenders are morphing to address other needs in the market for short-term money. Winchester Equities, which provided the loan to Lockwood Property Holdings, is one example: it specifically focuses on companies that need earnest money deposits for an acquisition. Depending on the deal size, these deposits can be significant and if a company is making several acquisitions, this requirement can quickly tap out its cash flow.

“We found an inefficiency in the market,” explains Avi Benamu, managing director of the company, which just started operations this year. “Oftentimes investors, especially mid to large syndicators or investors that pool capital from other investors, find themselves in situations where they don’t have the liquidity but still want to acquire a property. They can’t get conventional financing because they don’t have the hard asset in their possession to back up the loan.” Winchester can make that loan by structuring the deposit as a real estate option, similar to a stock option, explains Benamu.

Roughly, the transaction goes like this:

The borrower submits the application form with a $2,500 fee. That fee is used for attorneys to review the documentation and contract and escrow arrangements. Then, Winchester sets up an LLC, which will be used for the purchase agreement. It submits the option documents to the purchaser, charging him or her 2.5% upfront. So for a $1-million deposit, the purchaser would have to provide Winchester with $25,000. Once the paperwork is complete and the 2.5% paid, Winchester Equities places the $1 million in the escrow account.

If the purchaser decides not to go through with the deal, the contract is terminated and everyone walks away. If the purchaser wants an extension, he or she pays Winchester another point for another 30 days. If the purchaser decides to go through with the deal, he exercises the option, takes control of the LLC and the escrow deposit goes from soft to hard.

Winchester has a current pipeline of $45 million in soft deposits of which five to 10% are funding acquisitions, Benamu says. “These are large projects where the syndicators have experience in raising capital, but some of the deals are too large for them.”