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HARD MONEY

Private Real Estate Funds Are Driving Growth In Hard Money

With the promise of superior returns, investors are flocking to high-yield real estate funds that make nonconforming loans and offer equity financing.

BY W. JOSEPH CATON

Jeffrey Wolfer, president and co-chief executive officer of Kennedy Funding, a Hackensack, N.J.-based direct private lender, tells *CMI* of two nonconforming deals his group recently completed in which his underwriters had to look beyond a heady amount of risk to make the deals happen.

He points to a $12 million deal for the acquisition of 12.5 acres of land along the Navesink River in Middletown, N.J. York LLC, a real estate investor and developer based in Middletown, made the purchase. Wolfer says the current structure that occupies the land, a 17-room masonry and frame building, is more than a century old and could either be restored or torn down to make way for a newer structure as part of a redevelopment plan.

"Considering the very high retail value and general desirability of the Middletown and Rumson areas, this real estate acquisition is a rare and valuable transaction for the developer," says Wolfer. "Neighboring homes and lots are being sold at premium prices, including one three-acre lot with a large, modern home that sold for more than $7 million in 2004."

Similarly, Wolfer tells of a $4 million acquisition deal for the Homewood Suites, located near Kissimmee, Fla. The property is just 1.5 miles away from the main gate of Walt Disney World and across the boulevard from the $2.5 billion, 4,900-acre Celebration development - a large-scale project that will include upscale lodging and entertainment facilities.

The Homewood Suites is an existing hotel that consists of 156 standard one-bedroom/one-bath villas. It was purchased by a local development firm, Hayes Reid Development. The developer has plans to convert the hotel into condominiums, and already has contracts on the sale of 100 of the 228 units it will be selling.

According to Wolfer, who believes that these transactions could not have been done without the analytical skills of nonconforming underwriters, the major driver in these deals was the "time-is-of-the-essence" factor that required immediate funding.

Very few professionals in the commercial real estate finance space are unfamiliar with the world of hard money lending and the need for these types of fast, nonconforming debt and equity financing transactions. In fact,

Chevy Chase, Md.-based CapitalSource Finance LLC provided a $12 million senior acquisition and construction loan for the nontraditional condominium conversion of a former church located in the Greenwich Village section of New York City. The former Washington Square United Methodist Church will be turned into an eight-unit, approximately 18,236 net saleable square-foot residential condominium development.

the concept has been given various names in recent years in an effort to bring the once unknown lending practice into mainstream deal structure and financing.

For many years, hard money lend-

This granite-faced historical Hale Mill building in Norwich, Conn. will become a full-service Radisson Hotel with 142 guest rooms, 41 suites, 9 flexible meeting rooms, an 85-seat restaurant and a 5,000 square-foot ballroom. The project was funded by a $12.8 million interest-only loan from Point Center Financial Inc., for 12-months.

ing ruled the world of nonconforming commercial real estate finance deals, daring to embrace and fund deals like the York and Hayes Reid transactions, which no sane bank or mortgage finance officer would touch. Hard-money lenders had been the only source for unrestricted capital in that space, spanning the last 15 years or so. They funded the proverbial "ugly stepsister" deals of commercial real estate - often referred to as deals with hair on them - with the expectation of a big payoff upon final repositioning of such properties.

With competition in both the conforming and nonconforming lending businesses at a feverish level, and investors looking for new avenues of higher yields, the emergence of investment funds dedicated to private commercial real estate deals has created new sources of nonconforming loans, and has taken a bite out of the hefty returns that hard-money investors had become used to earning.

One hard-money lender that offers a menu of investment products to individuals and institutional investors is San Juan Capistrano, Calif.-based Point Center Financial Inc. The private money commercial and construction lending firm offers fund investors a choice of short-term (three-month) commercial paper investments or a long-term mortgage pool offering that could track maturity periods of 15 years or more.

Point Center's president, Dan Harkey, made his entrance into nonconforming real estate lending via the residential space. He speaks of the dicey proposition of hard money lending, particularly when managing a high-yield real estate investment fund which must answer to investors.

"This business is an alternative securities investment avenue to Wall Street," says Harkey. "With the baby boomers retiring in the millions and going to 'clipping coupons' for attractive rates, they are constantly looking for investment opportunities that innovate new products."

Investors

Harkey believes that real estate has emerged as one of the most popular assets used to secure private investment and retirement plans for the boomers and others alike. It also represents one of the investment areas in

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which unrestricted capital can move freely into various projects over long- and short-term periods.

He says that hard money lending - which started out in the residential arena decades ago - has evolved to such an extent that it has now made commercial real estate one of the main assets of choice in this space.

"When you think about what subprime lending programs did for the residential mortgage business 20 years ago, you cannot be surprised at the huge success that nonconforming lending has found in commercial real estate finance," says Harkey, who regularly teaches commercial real estate investment seminars and authored a 200-page textbook, "Introduction to Income Property: Lender Practices and Underwriting."

Today, there are many new private investment funds that play in the nonconforming debt and equity financing space - lending to investors and partnering with developers to underwrite high-risk projects. Hard money is usually the type of financing sought for completing deals with obstacles to overcome or a distress story.

Private real estate investment funds are instruments with exemption from registration under the Securities Act of 1933 because they are deemed as transactions not involving any public offering. They are provided for by Section 4(2) of the landmark legislation, as well as in a subsection, called Regulation D. As a consequence, participants (investors) must be aware of the lack of a liquid market for investments in these high-risk loans.

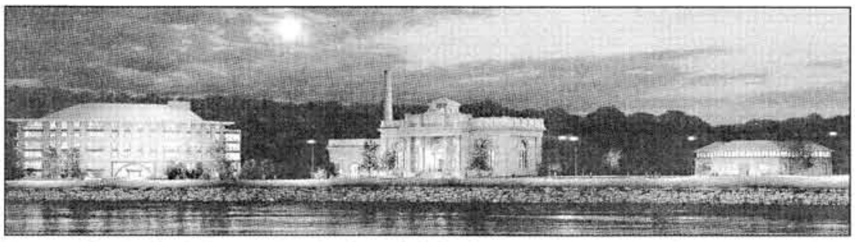
specifically designed to accommodate loan requests that require funding for acquisition, land improvement, construction, rehab and reposition, bridge, joint venture, gap equity and mezzanine loans.

According to Paul Braungart, president of Regional Capital Group, "The fund is expected to close $100 million in deals, and it serves to accommodate the lending needs of developers and investors in an underserved but rapidly growing area of the real estate lending arena."

Braungart, who has been responsible for over $2 billion of nonconforming, high-risk commercial real estate finance transactions over his career, believes that the popularity of commercial real estate will continue to draw more investors to private real estate funds like RCG-1 because the compelling yields are quite superior to returns investors are getting in the stock market.

'There is no question that investors will continue to be drawn to carefully managed private high-yield funds that invest in commercial real estate transactions.'

"There is no question that investors will continue to be drawn to carefully managed private high-yield funds that invest in commercial real estate transactions," he says. "I believe that companies with the ability to educate investors about this business, and skillfully deploy that capital in the nonconforming real estate financing business, will be clear winners over the long run."



Tremont Realty Capital recently raised capital for the acquisition and redevelopment of The Waterworks at Chestnut Hill, a new residential condo project in Boston. The deal includes a $75.1 million construction loan and a $16.9 million mezzanine loan, which together provided 98% of the total rehab and ground-up project costs. Due to the unique characteristics and size of this investment, the investor had to look to a nonconforming underwriting strategy to accomplish the transaction.

In most cases, investors are prohibited from reselling their participation in these loans, unless the securities - which are backed by the real estate loans or the real estate itself - are subsequently registered or receive some form of federal or state exemption from such registration. Under these favorable conditions, private real estate funds have been thriving as the increasing popularity of real estate investments grips the world of dissident stock market investors.

Recently, for instance, Marlton, N.J.-based Regional Capital Group, a private direct lender in the nonconforming real estate finance business, launched RCG-1. This is a private real estate fund

Brokers

Commercial mortgage brokers and transaction intermediaries have also caught on to the depth of financing possibilities offered through private high-yield real estate funds. They, too, have been active in arranging and structuring nonconforming loans on behalf of individual and institutional borrowers.

Michael Edrei, president of Fort Lee, N.J.-based Meecorp Capital Markets, says that nonconforming deals are often brought to his organization's underwriting shop by brokers and investment capital advisors.

"Although some brokers do shop nonconforming loans, I believe that the more knowledgeable brokers clearly understand that pricing is not the most important factor in getting a deal done," he says. "The brokers with that clear advantage will accurately take a potential borrower to a lender that has a proven record of successfully having done similar deals."

Edrei points out that nonconforming shops must have speed, a knack for business analysis, and an understanding of real estate in order to be successful hard-money lenders.

"The ability to structure a loan that will factor the borrower's limitations is a clear advantage," he remarks. "Plus, the ability to attract discretionary funds is vital to the long-term success of a short-term lender in this space."

Like Wolfer, Harkey and Braungart, Edrei has also developed methods in his shop for looking at distressed deals and potential owner/investor exit strategies. According to these lenders, the strength of nonconforming lending is its ability to accurately price for risk and interface with brokers or sponsors who have an interest in seeing a distressed deal completed in short time frames.

Clearly, the underwriting process for distressed assets requires an approach unlike any strategy of a conforming lender. Harkey says that his company views its investment fund activities as those of an alternative investment bank. He believes that the analysis of distressed assets is vital to the accurate pricing of the deal, even beyond the financial strength of its sponsor.

"Distressed properties have several common characteristics," says Edrei. "First, they usually exist under unfavorable market conditions. Secondly, they often have fallen under poor asset management. And thirdly, they usually suffer from a lack of funding to have an acceptable cash flow or repositioning strategy."

Edrei believes that successfully exiting an asset requires a viable repositioning strategy, a fresh and qualified management team, and ample financing to pull it off. He says that if these three conditions exist in the application process, then a lender could have the making of a good deal, regardless of the amount of equity introduced by the borrower.

As brokers continue to play an increasing role in the sourcing and structuring of nonconforming loans, lenders and high-yield real estate fund managers are aware of the potential for compressed margins. Nevertheless, these lenders are not very concerned about the lower yields that can be the result.

"Pricing is definitely tighter today," says Edrei. "But simultaneously, we have found that the quality of the transactions presented to us has improved. That is a definite credit to the fact that brokers do understand the nature of this business and are making good deals happen."

Harkey says that a broker partner program is also vital to the success of his company's lending platform. He points to his shop's focus on developing strong relationships with brokers, including extensive training programs and incentives.

"I think that successful lenders all have this one thing in common: they spend a great deal of time and resources on developing their brokers," notes Harkey. "When your brokers can feel comfortable coming to you with virtually any type of deal and asking for your opinion, you know you have accomplished the task of having a true partnership with them."

Finally, optimism abounds among hard-money lenders today. The prospects for expanding this business are apparent to most nonconforming lenders. In fact, nonconforming deals are even being considered for funding by traditional lenders, including some Wall Street players and publicly traded real estate investment funds.

With time, hard money lending is expected to simply become another form of structured financing as traditional lenders become more at ease with the high-risk underwriting processes employed by hard-money lenders.

"Fortunately or unfortunately, real estate lending is behaving like any other market," concludes Edrei. "Since the equity markets fell out of favor and the misunderstood real estate market performed well after years of slow growth, there is a lot of money chasing few deals. To get in the game, some desperate investors put their money into shaky deals and beat the banks' low rates."

He says that unsuspecting hard-money lenders and investors would be the last to recognize an inevitable downturn.

"If they're using borrowed money [to fund deals with poor exit strategies], they will suffer severe losses," he says. "If they panic and attempt to exit quickly, they will suffer too. But if they stay and view lending as a long-term venture, they will ride out the ups and downs and enjoy the fruits later."

Edrei and Harkey agree that overall - like in any financing and investment market - nonconforming lending will eventually have a shakeout and dwindle down to the prepared professionals who will control it again, until a new cycle emerges. ●