

“Backdoor” Feasibility: Debt Yield, Surrender Consideration, and Overall Capitalization Rate

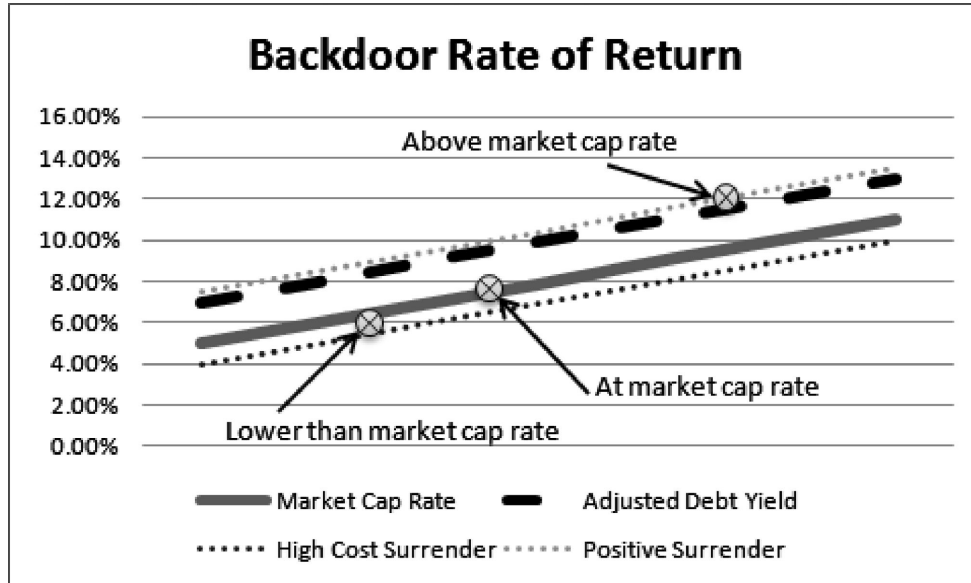
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The author of this article discusses “backdoor” acquisitions which are distinctive acquisition strategies that are being increasingly employed within the contemporary real estate environment.

Origination or purchase of real estate loans to obtain equity ownership positions via the perception of or actual exercise of the security lien granted by borrowers to secure debt is an operative definition of “backdoor” acquisition. Backdoor debt positions are distinguished from the usual business of commercial real estate lending, since non-performance status is often considered a loan attribute. Backdoor techniques are distinctive acquisition strategies that hardly could be considered to be novel but nearly always are innovative, and increasingly are being employed within the contemporary real estate environment as many borrowers are at an impasse refinancing existing obligations that are near, at or beyond maturity. Financial and market issues determining potential economic advantage from backdoor acquisitions are explored, focusing upon adjusted debt

yield as the loan variable and capitalization rates as the key market indicator. There are other notable loan transaction parameters including interim cash flow and surrender consideration, which can be viewed as influencing the adjusted debt amount. Total debt investment can then be compared on a yield basis with capitalization rates for particular property types within specific markets to determine risk and reward scenarios. Backdoor feasibility assessment tools have relevance for many parties, potential acquirers certainly have an application, but also including lenders that wish to obtain optimum pricing for the resale of loans and borrowers for the assessment of probabilities of backdoor feasibility so that defensive strategies can be designed to ward off potentially hostile acquisitions.

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Backdoor Rate of Return

The relationship for assessment of “backdoor” acquisition feasibility can be stated in equation form as:

$$\text{Backdoor Rate of Return} = \frac{\text{Operating Income}}{\text{Adjusted Debt including Surrender Consideration}}$$

Such that if:

$$\text{Backdoor Rate of Return} \geq \text{Market Capitalization Rate} = \text{Feasible Backdoor Acquisition}$$

Backdoor acquisition economic feasibility analysis involves computing a ratio of net property operating income in comparison to the amount of adjusted debt after any discounts are factored into the debt amount, inclusive of debt transaction costs and acquired loan reserves, expressed as a rate of return. Adjusted debt totals may be impacted by interim cash flows during disputed foreclosures, including debtor-in-possession financing that is senior to acquired loans. Surrender consideration also modifies the adjusted debt amount inclusive of due diligence, legal fees, foreclosure fees, court costs, any inducements granted to the borrower and payments made by borrower in connection with obligation settlement. Sur-

render consideration is a variable that may influence adjusted debt positively or negatively.

Certain observations can be made about the relationship of the variables:

- The higher the adjusted debt in comparison to property income, the lower the backdoor rate of return.
- Purchasing debt at a discount will lower the adjusted debt relative to operating income and increase the backdoor rate of return.
- If the backdoor rate of return is at a higher rate than the market capitalization rate, then there is the possibility of risk adjusted returns for the acquirer that are at a higher rates than could be accomplished with traditional purchase methods.
- Capitalization rates need to be extracted from comparables in the marketplace for accurate comparison of alternatives to the backdoor rate of return.

- Backdoor acquisitions at less than market rates indicate heightened risk of non-advantageous transactions.
- Backdoor rate of return at less than market signals that pro forma expectations may be the objective, or other goals such as preservation of capital and reputation are driving the process.

Debt Yield

Backdoor acquisitions are well advised to target high debt yield loans, the lower the debt yield ratio the less attractive a loan is for acquisition purposes. Properties that generate healthy income streams tend to have higher debt yield ratios, creating cash flow that can be utilized to make interest payments, amortize debt and provide returns to equity. Comparatively, new loan originations for properties with overall capitalization rates in the 6.75% to 7.50% range and loan to value ratios of 50% to 55% tend to “set the bar high” having debt yields of 12.25% to 15.00%, higher than debt yields for many potential backdoor acquisitions due favorable underwriting standards currently. Low capitalization rate properties, low debt yield properties and high loan to value ratios can be made more attractive from a backdoor acquisition perspective by discounting of the loan value, which has the impact of increasing the debt yield.

If debt yield should equal the capitalization rate then the loan to value ratio can be considered to be 100%. When debt yield is less than the capitalization rate then this particular type of loan represents an over encumbered situation relative to property value, making it less desirable for backdoor acquisitions barring some serious discounts. Many construction loans that were underwritten before the end of the last decade have

capitalization rates greater than debt yield indicating over encumbrance. Non stabilized properties often have low current debt yields that may become higher upon stabilization, loans that fit this description are purchased with pro forma expectations, as can also be true of properties in need of repositioning strategies.

Capitalization Rates

Capitalization rates have increased to higher levels than those which prevailed during the pre-financial crisis era. Quality assets sold during 2010 tended to trade within a range of 6.5% to 9.5% returns on an unleveraged basis. On the low end of the spectrum, a high profile landmark hotel transaction during the fourth quarter of 2010 was accomplished at a 6.5% cap rate. A Manhattan office building sold for a return of 8.49% and several geographically dispersed “name” tenant distribution industrial complexes sold for 7.51% to 9.03%. High occupancy grocery anchored retail center comparables created during 2010 ranged from 7.16% to 8.18%. Stand alone retail stores featuring national chain tenants as varied as shoe, drug, and convenience stores had capitalization rates of 7.97% to 9.37%. Specialty properties, such as assisted living facilities, can trade at higher average cap rates, as can small market properties and those in need of repositioning.

Capitalization rates can be utilized for comparative purposes to evaluate the advisability of potential backdoor acquisitions. Investors should be aware of prevailing capitalization rates for their target markets and property types. Backdoor acquisitions with inherent surrender consideration and interim cash flow risk are compared to other market acquisitions to determine target “hurdle” rates and risk premiums. The feasi-

bility issue is whether a backdoor acquisition will generate returns better than or equal to those that could be accomplished with arms length market transactions. Backdoor acquisition purchase prices can be compared to market capitalization rates to evaluate the outcome.

Surrender Consideration

Surrender consideration is highly variable from situation to situation, surrender can be a costly proposition to work through, or at the other extreme borrowers can make remittances to satisfy obligations. Inducements or “walk away money” can be made to borrowers such that an uncontested deed-in-lieu of foreclosure is the resulting outcome. Inducements are often deemed good business practices in order to eliminate risk regarding surrender consideration. There are many recent examples of “walk away money” payments to borrowers. An opportunity fund purchased a senior note secured by 400 apartment units in Ft. Myers, Florida for \$25.4 million in October 2009 and reached a settlement whereby the borrower did not to contest the foreclosure in exchange for a payment of \$300,000. This opportunity fund was granted a foreclosure judgment in March 2010 resulting in a \$5.5 million bargain purchase gain as determined by internal management procedure fair value standards. In perspective, the surrender inducement saved considerable time, expense and arguably lessened the backdoor rate of return by no more than 10 basis points, a relatively minor consideration amount in light of the entire transaction.

Another senior loan was purchased for \$33.4 million, secured by a 379,000 square foot shopping center in Birmingham, Alabama. The shopping center generated a debt yield of 11.81% in 2009, according to audited

financials, and the borrower capitulated to a deed-in-lieu of foreclosure in exchange for a 30% profit participation inducement. The backdoor rate of return would have worked out to approximately 8% after the profit participation, except the new owner negotiated for the profit participation to be subordinate to an 11% preferred return on investment. Consequently, this surrender consideration in the form of potential profit participation may lower the backdoor rate of return by less than 100 basis points if the property continues to perform as it has historically. The new owner has expressed the viewpoint that since no payments have been made to the former borrower and there is no assurance that payments will be made in the future, that no significant value that should be attributed to the potential profit participation.

Borrower payments that satisfy contractual obligations for an acquired debt represent positive surrender consideration, additional cash flow that serves to improve the backdoor rate of return. Specifically, an investment company purchased a maturing \$5.3 million loan from a bank including a partial guarantee of \$1 million with security of a beachfront property in Kona, Hawaii. The investor subsequently became fee owner via a deed-in-lieu of foreclosure and received payment of \$200,000 along with a promissory note of \$1 million from the former borrower. Backdoor rate of return for this acquisition will be enhanced substantially by \$1.2 million of borrower remittances.

Interim Cash Flow

Interim business activities during the period of time when foreclosure is contested can have a major bearing on backdoor acquisition attractiveness. Debtor-in-

possession financing is an interim cash flow variable that can serve to decrease available operating income relative to adjusted debt balances. Debtor-in-possession financing may be in the best interests of asset management and property value creation, particularly when key leaseholds are being negotiated and loan proceeds are required for tenant improvement allowances. Appointment of receivers can introduce predictability or uncertainty to interim cash flows. Receivers, charged with maintaining the physical and economic condition of properties during contested foreclosure proceedings, can be expected to have a large influence on operating cash flows for the duration of the dispute. When one company learned that the note secured by their Dallas, Texas mixed-use complex had been purchased by a company with a reputation for making backdoor acquisitions, they immediately petitioned the court to place their project into receivership. Cash flows during contested foreclosures often have uncertainty that impacts the range for probable backdoor rate of return.

Joint Venture Partners

Backdoor acquisitions arise within a wide variety of contexts including the possibility that a joint venture partner may become the acquirer. A joint venture obtained \$28.3 million in construction financing to develop a community shopping center in suburban Nashville, a loan that was guaranteed by both partners. The project was completed and leased to stabilized occupancy yet the joint venture could not attract permanent financing sufficient to satisfy the construction loan. One of the partners purchased the construction loan from the lender with the guarantee by the other partner remaining intact, resulting in surrender of the property to the acquiring partner. Joint ventures between economically

strong and much weaker financial partners, like the typical institutional investor and developer combination, are seemingly tailor made candidates for backdoor acquisitions, depending upon the circumstance of the venture.

To illustrate how a backdoor acquisition can be made at less than market capitalization rate, an Orange County, California joint venture completed a \$92 million apartment project with a \$52 million construction loan that matured. A \$20 million mezzanine loan from one of the joint venture partners enabled an extension of the construction loan but the mezzanine loan had a highly dilutive effect on the other partner. At the time of backdoor acquisition, construction had been completed, and the property was 93% occupied. The mezzanine debt was converted to equity and a new mortgage was obtained for \$53 million at 4.35%, with payments amortized over 35 years, a debt service coverage ratio of 1.20 and a debt yield of 6.44%. Even with no apparent extraordinary surrender considerations, perhaps an advantage of the mezzanine loan position, the backdoor rate of return still appears relatively low, less than 4%. This example illustrates that backdoor acquisitions can be completed for the purpose of preserving capital, reputation and making the best of an unfavorable situation, thereby accepting a rate of return at less than market capitalization rate and that mezzanine loans can precede backdoor acquisitions.

Mezzanine Loan Opportunities

Mezzanine loan positions can offer special backdoor acquisition opportunities. Added debt service burden stemming from mezzanine loan payments makes default more likely especially for stressed properties. Mezzanine loan investments are generally propor-

tionately less than associated primary mortgage financing and many times there is the possibility of acquiring this type of debt at substantial discounts. In 2007, for instance, an investor bought 50% interest in a mezzanine financing package for \$40 million. The ultimate security for the loan was a one million square foot office building in central Manhattan that was 43% occupied at the time of debt maturity in August 2009. The senior secured lender desired a lower leverage ratio, the borrower wanted to be relieved of guarantees and the other 50% owner of the mezzanine debt needed an exit strategy. The backdoor acquisition involved purchase of the other 50% mezzanine interest subject to a series of contingent payments, then conversion of mezzanine debt to equity, such that the first position lender subsequently viewed the deal structure as more sustainable and thereby extended the mortgage loan for three years at 5.0% interest. Even though the property had a high vacancy rate, the debt yield became 8.54% with the conversion of mezzanine debt to equity, and, since a consensual agreement was reached with the previous borrower, foreclosure was accomplished in January 2010.

Another example of mezzanine debt leading to a major potential backdoor opportunity was a December 2010 purchase by a hotel REIT of mezzanine financing valued at \$32 million, behind first mortgages of \$1.3 billion. The mezzanine debt purchase creates a "seat at the negotiating table" with the borrowers, equity holders, senior secured lenders and senior mezzanine lenders. The portfolio, which consists of 29 hotels with 8,667 rooms, reported \$121.5 million net operating income from these holdings in 2007, admittedly during the previous economic era. Documented historic property performance could be considered a "best case

pro forma" estimation today, perhaps "too good" to be true, but if this level of property performance were to be achieved, then the result could create a debt yield above 9.0%. The potential backdoor acquisition of this sizable hotel portfolio has not been consummated as of the date of this writing.

Conclusion

Backdoor acquisition techniques can be utilized for a variety of potentially advantageous portfolio building endeavors. There are circumstances where backdoor acquisitions may be the only avenue available for unique assets, those properties that will never be listed with any brokerage house. Optimally, backdoor deals can represent an advantageous outcome for all parties involved, the original borrower can benefit from satisfaction of obligations, lenders can obtain a more secure deal structure, and tenants can benefit from improved property management. Successful backdoor strategies create opportunities for bargain purchases, paying less than aggregate fair value for net assets received, but the process can be fraught with managing considerable uncertainty.

Costs associated with gaining title to a property are highly variable and often represent the largest unknown for such a transaction. Managing surrender considerations are a major aspect of successful backdoor deals. Techniques such as forbearance agreements and "walk away money" can be deployed to stabilize surrender and interim cash flow considerations at the front end of the acquisition process. Strategic vision may be necessary to justify the backdoor acquisition exercise particularly when managing difficult surrender situations and when pro forma or otherwise optimistic assumptions are involved for distressed prop-

erties that are not functioning at full business potential. Barring extraordinary circumstances, uncertainty regarding surrender considerations and interim cash flow would seem to make a case for backdoor rate of return needing to be significantly higher than market driven capitalization rates for similar property types. Backdoor acquisitions are an

important and growing component of the contemporary commercial real estate financial environment. Backdoor acquisitions are distinctive strategies that can result in widely divergent outcomes, including failed acquisition or acquisition rates of return equivalent to, above or below market capitalization rates.