Capital Stack

More Complete Look at Financing a Real Estate Investment

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1 Introduction

What are we going to do during this class:

- We are discussing;
  - What is capital stack?
  - Why do we need to do this?
  - How does it work?
  - Example in Excel.

1 What is Capital Stack?

- In general capital structure means how much debt you are using.
- Thus, a simple capital structure for an existing / stabilized property could be:
  - M4$ equity
  - M6$ debt (mortgage)

- However, we find that in many real estate investments the capital stack looks a bit more complex.

1 Why do we need a Capital Stack

- In other asset classes, it is quite easy to raise money to pursue positive / zero NPV deals.
  - You can issue new stocks.
  - You can issue new bonds.
  - And perhaps get a loan.

- In real estate (development) we do not have this luxury (mostly).
- Real estate is expensive, and many entrepreneurs do not have the cash to finance an investment all by themselves.
- The banks also want to see collateral when financing real estate investments, something most entrepreneurs do not have.
- Thus, they need a partner.

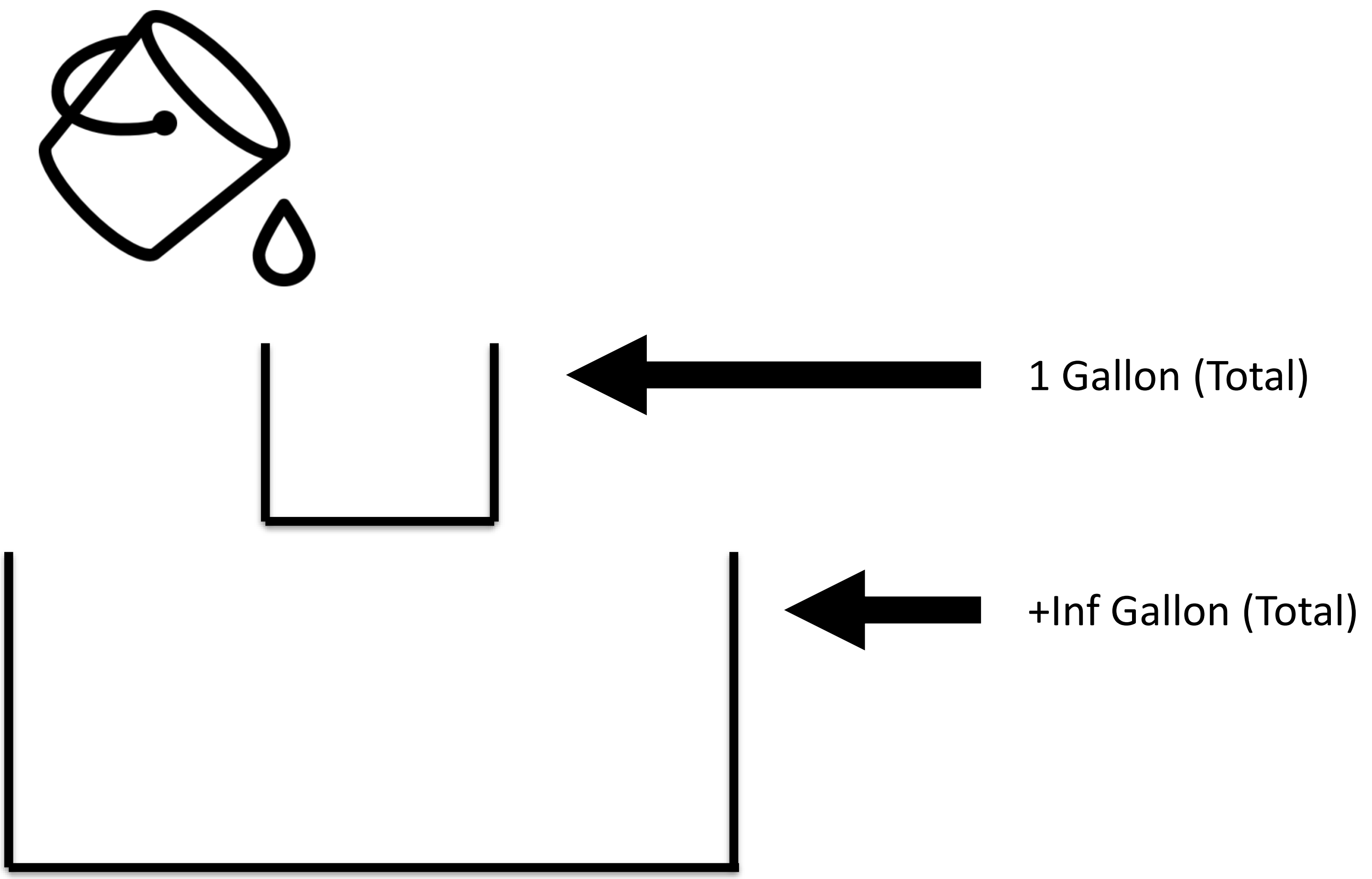
2 How does it Work (1/2)

- Together, they are in a **Joint Venture (JV)**:
  - The entrepreneur finds something we call a **money partner**, or **limited partner (LP)**.
  - In this framework, we also call the **entrepreneurial partner** the **general partner (GP)**.
- The LP will fund most of the project. The LP will also be the one that has the collateral needed for the banks to be happy.
- The GP is generally also the **asset manager**. For this, the GP gets a fee, which they typically need to pay the operating budget of their own company.
  - This is also usually the only source of stable income for them.

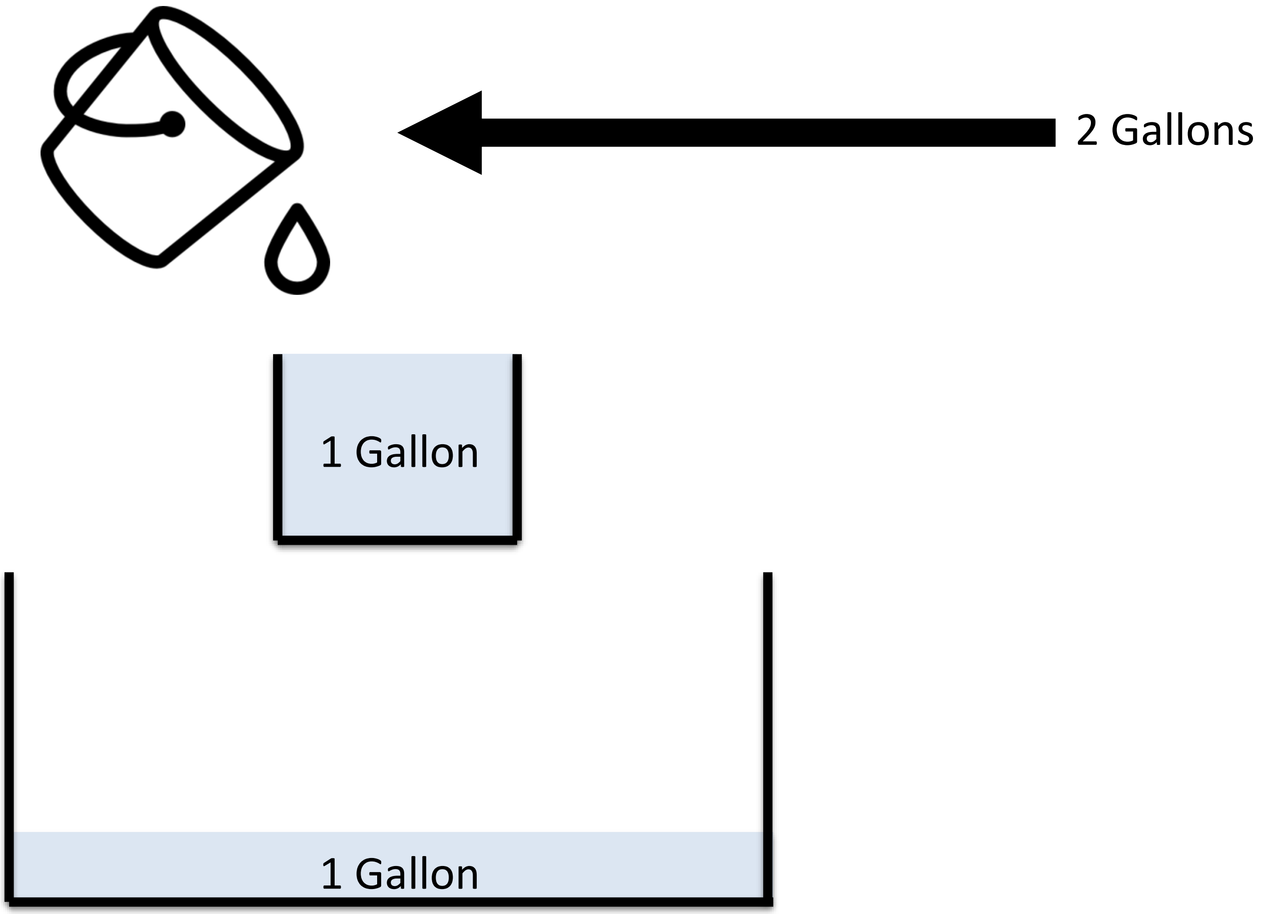
2 How does it Work (2/2)

- The LP will get a **preferred return**.
- Return will trickle down to the GP via a **waterfall**.
  - This comes in the form of a **promote** (sometimes called a **catch-up**).
- Thus;
  - The LP will get less risk, but also less return compared to just owning a stabilized asset directly.
  - The GP can get tremendous returns, while also running most risk, meaning the GP has the correct incentive.

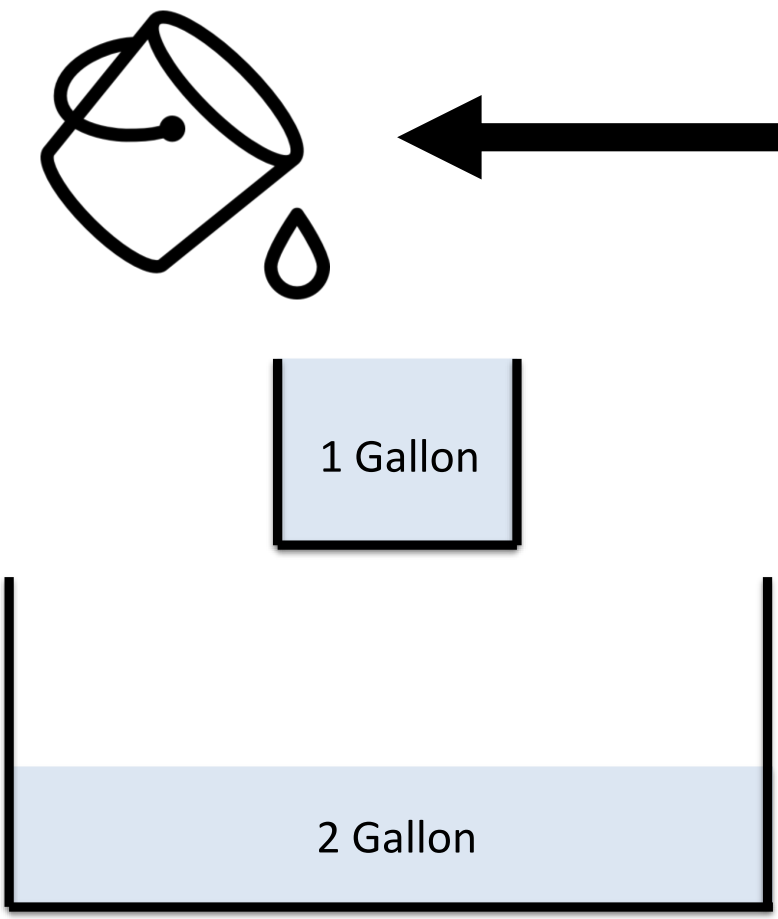
3 Waterfalls explained



3 Waterfalls explained

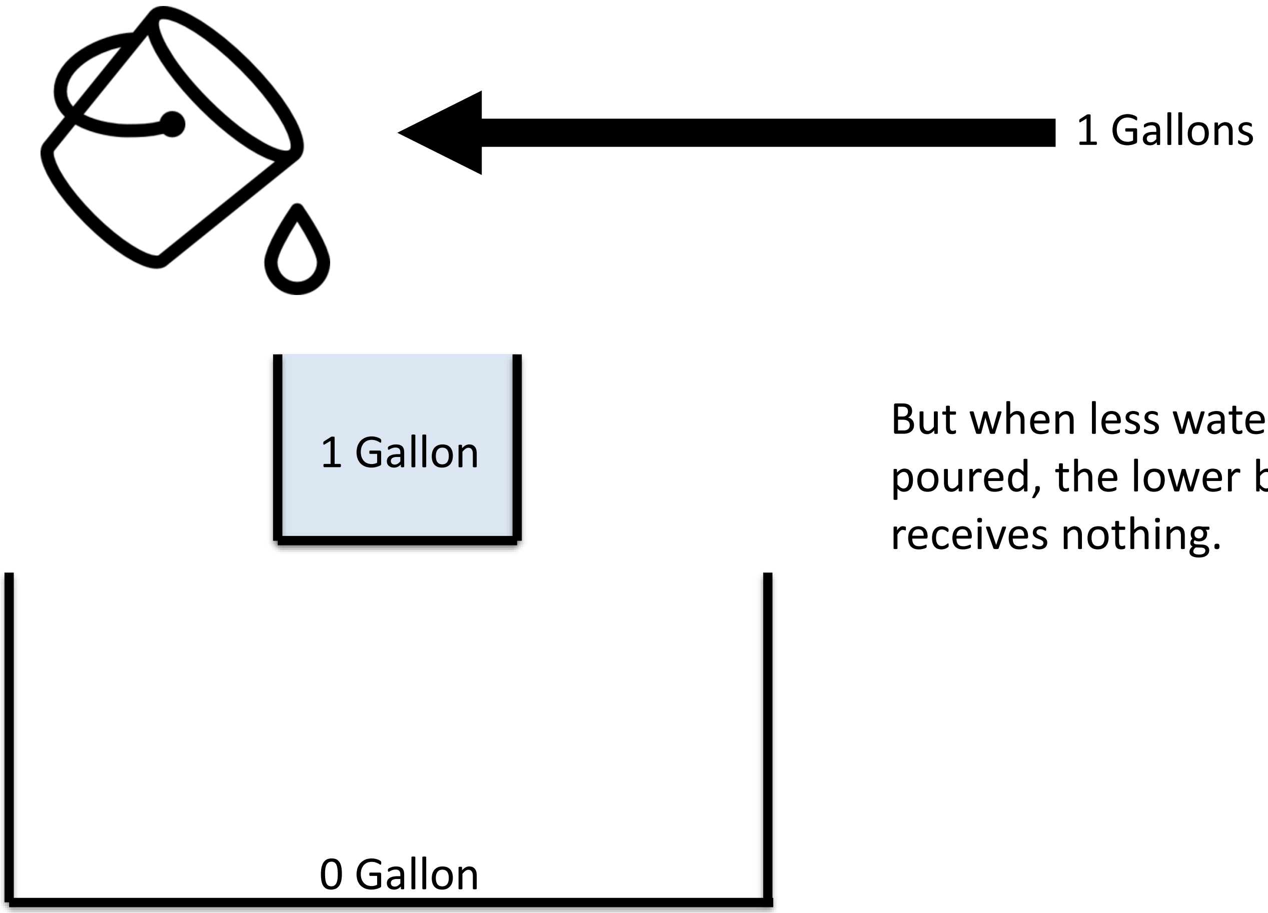


3 Waterfalls explained



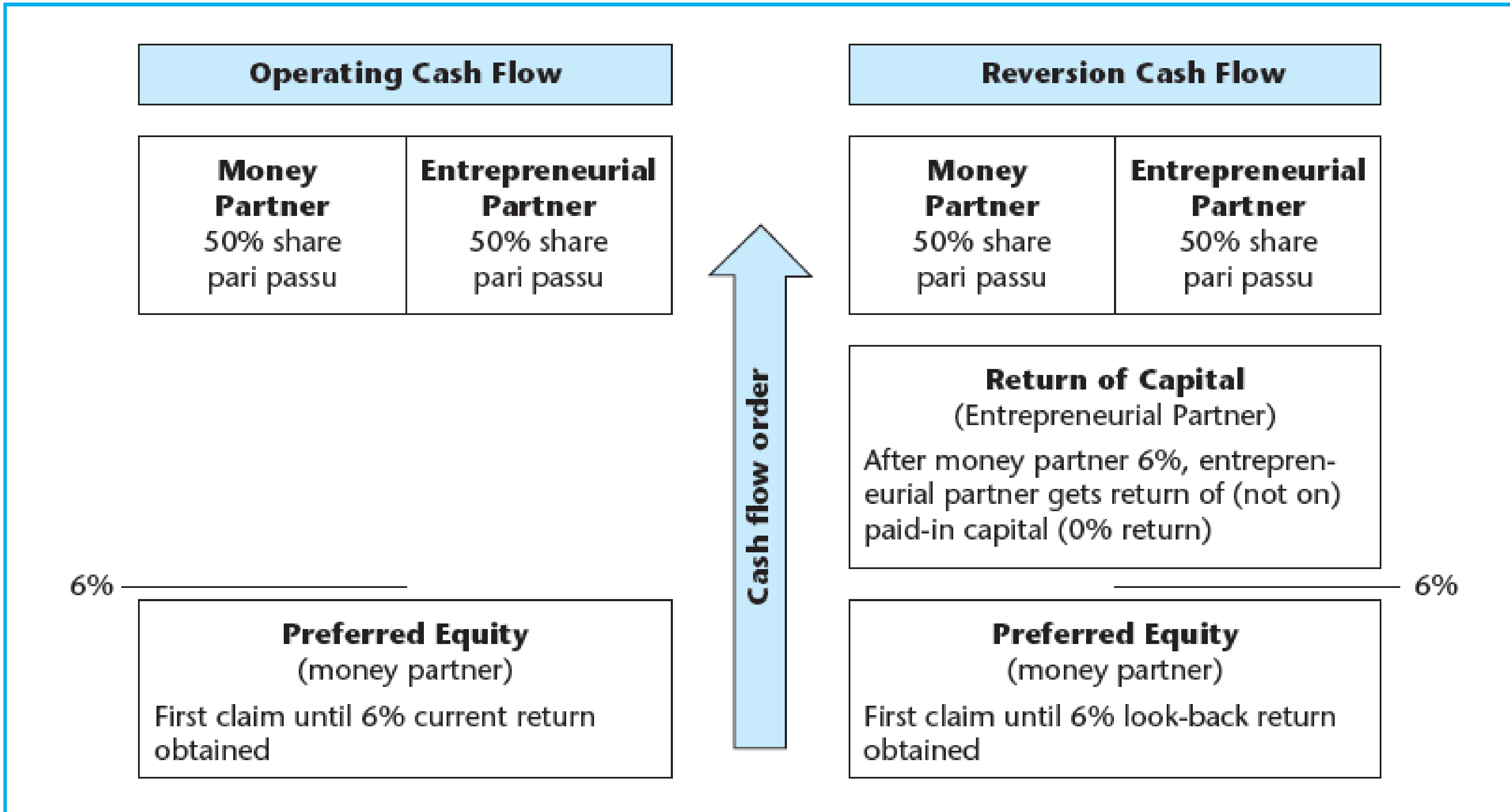
Note that by increasing the amount of water by 50% (2 to 3 gallons), the water in the lower bucket doubled (1 to 2 gallons).

3 Waterfalls explained



But when less water is poured, the lower bucket receives nothing.

3 Waterfalls explained



4 Mezzanine Debt

- A quick note on **mezzanine debt**.
- It is rather loosely defined, but my take on it is that this is company level debt, used to finance a property.
- This typically will go hand-in-hand with a normal (nonrecourse) mortgage from the same debt provider.
- Thus, mezzanine debt is **recourse**!

- “Mezz” debt became popular after the Dodd-Frank act.