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Structuring a Real Estate Investment Deal

The key is to find an investment property with a historically stable free cash flow, low risk of environmental risk/harmful material exposure i.e. asbestos, and robust supporting local economy.

The investor should be able to put down minimal equity while leveraging up on a fixed term loan. As long as the FCF/interest coverage is above 5.0x, we believe the investment may warrant a loan to value (LTV), of possibly 80% or more.

Recently, investment firms have abandoned such high leverage altogether, since some of their leveraged investments blew up when the economy imploded during the great recession. Associated with the macro events, tenants sought greater concessions, and reduced rental prices. Many home owners migrated to multi-family properties when they defaulted on their mortgage, helping to supplement the lower revenue growth with greater demand, but the lower than projected revenue growth failed to cover the operating costs and interest on the loan. They investors also failed to refinance their loans, or extend the maturity as credit dried up, leaving investors with a substantial loan balance payable when they could not sell the properties to willing buyers.

However, the principle of leveraged investing is still a great method to enhance the returns on a solid investment. Most likely, a favorably positioned property will not be trading at a discount, although it might have been the case during the height of the recession. As we approach 2013, we feel the real estate market is turning around, albeit the market noise is a distraction. Many people are pointing to QE which is artificially propping asset values across the board. So, the long awaited system flushing may be premature, and the signs of improvement are stemming from a steroid injection, rather than a sustainable, systemic recovery. On the other hand, home building activities are picking up, although a large portion may be driven by the just mentioned QE activity. Yet, 5 years of waiting for recovery plus investors' reluctance to park their capital in low yielding cash and fixed income securities, are pushing investors to look into riskier asset classes like real estate.

Most of the operating expense in a real estate investment will grow incrementally (insurance, utilities, property maintenance, taxes, marketing). Revenue, on the other hand, can be adjusted higher, once the units are renovated. So aside from the day to day operating expense, the loan + equity investment must cover renovation for the unit and overall building, which may cost anywhere from $30k to $50k a unit. In addition to the higher cash flow stream, the disposition price could price in the cost of renovation, should the market not reverse into a downturn. So, if the market does turn, or in other words, the cap rate begins to climb, the cash flows from the renovated units should cover 1) interest cost from loan, 2) daily operating costs, 3) renovation related expenses. In particular, the interest coverage ratio should not fall below 2.0x, from the pre-acquisition level at 5.0x. This ensures the investment will not run into a solvency crisis.

We will create a model illustrating this simple scenario shortly.