

Four and One-Half is the New Seven

By

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As I write this in early January, 2008, there is manifest angst and speculation swirling around in the market relating to the turmoil in the real estate capital markets environment. How will this capital dislocation effect asset pricing, investor returns and the integrity of assets and structures brought to market for syndication? Whereas I cannot answer all these questions in the space below, I can give you a sense of the impact of the debt markets on investor returns. I will answer this inquiry in the form of a very straightforward example, so please refer to the chart attached hereto.

Assume that, before the market meltdown that started in the middle of 2007 – and continues on a daily basis today – we intended to acquire a triple-net leased asset for \$25 million at a 7.0% initial capitalization rate. At that time, we would have picked up the phone to our favorite conduit lender and requested a fixed-rate, 10-year first mortgage loan equal to 75% of our purchase price with interest-only payments. At the time, the 10-year Treasury was trading at approximately 5.15% and our borrowing, or credit, spread was, say, 135 basis points, or 1.35%. As such, our coupon would have been 6.5%. Also assume that our total ‘load’ on invested equity is 20%. As such, we would have borrowed \$18.75 million and raised approximately \$7.8 million in equity. Given our cap rate, the property generates \$1.75 million in net operating income and our debt service is approximately \$1.22 million, leaving \$531,250 in distributable cash flow – or a 6.8% cash on cash return to the investors. Assuming we have a good credit tenant and respectable real estate in a strong regional market, this is a no-brainer.

Now, let’s fast forward to the current capital markets environment. The 10-year Treasury is hovering around 3.6% and credit spreads have widened materially to 290 basis points – *for the same loan*. Thus, our coupon is still approximately 6.5%, but two paradigmatic shifts have occurred: (i) interest-only periods at that leverage ratio are virtually impossible to come by, and (ii) underwriting criteria have become much more conservative. The latter shift is occasioned by a change in directional philosophy; whereas in the old days (six months or so ago), a lender would accept a forward, or pro-forma look through the windshield in its underwriting methodology, today lenders are focused on a ‘rear view window’ approach and focusing somewhat myopically on historical cash flows in which to base the loan sizing.

These shifts have resulted in two material impacts on a buyer’s ability to borrow. For one, the lack of an interest-only period requires a borrower to commence making principal amortization payments immediately. This adds, in our example and assuming a 30-year amortization period, 108 basis points to debt service. Second, a comparatively more conservative underwriting stance, coupled with the increase in debt service (which in turn negatively impacts debt service coverage ratios), causes the borrower’s absolute loan size to decrease. Let’s say, for the

sake of argument, that our former 75% loan to acquisition cost is now something akin to 70%.

Now, assuming nothing else with respect to the transaction has changed other than a lack of interest-only payment periods and a reduction in the initial principal balance of the loan, what impact do these changes have on investor returns? Well, now the new loan balance has been reduced \$1.25 million to \$17.5 million, which causes the borrower, given the same ‘load,’ to increase the equity required to be raised to \$9.375 million. Further, the initial interest-only debt service of 6.5% has increased to 7.58% given the addition of principal amortization, so, even given the lower loan amount, total debt service has increased from \$1.218 million to \$1.327 million. This results in a decline in distributable cash flow to \$422,657, which, given the increase in equity, translates to a cash on cash return of approximately 4.5%. Bear in mind, this reduction assumes the same absolute coupon, which, admittedly, may be difficult to obtain. ***As a result, 4.5% is the new 7.0% - or 6.8% to be exact.***

If we were to work backwards and ask: ‘at what initial capitalization rate would you have to acquire to same asset to achieve the original 6.8% cash on cash return,’ the answer is 7.86%. So, cap rates would have to back up 86 basis points to put us on equal cash footing with the financing available to us last June – *for the same asset*. Whereas, we have seen some evidence of cap rate increases in the market, these increases are more on the order of 25 basis points, or well away from the level required to put us at parity with last year’s achievable returns.

But wait, such an analysis is not really comparing apples-to-apples. Assuming we were to hold this investment for 10 years, the average annual principal amortization is 152 basis points. If we were to add that to the 4.51% cash distribution, the total investor return is more on the order of 6.03% – or only 77 basis points off of last year’s equivalent return, and this amortization will inure to the investor at the end of the holding period.

Further, this investment, given the lower leverage ratio, is arguably safer than last year’s more highly leveraged transaction. Instead of being leveraged 75%, the new financing structure is only leveraged 70% and, shouldn’t an investor be willing to take a lower return for this inherently less risky investment proposition? The answer should be a resounding ‘yes,’ and this reality is the fundamental underpinning to capital asset pricing theory – risk versus return.

It is clear, therefore, that the investor should be economically indifferent between a higher-leveraged, interest-only cash on cash distribution of 6.8% and the lower leveraged, amortizing 4.5% distribution, right? Perhaps, but recent history has cast doubt on whether offerings with a sub-5% initial return will sell in the marketplace. Suffice it to say, we are operating our real estate business in a dynamic and challenging environment.

GRIFFIN CAPITAL CORPORATION

EFFECT OF CHANGES IN FINANCING TERMS ON CASH ON CASH DISTRIBUTIONS

Predicates:

- (a) This analysis assumes the exact same asset in both financing scenarios
- (b) The only changes below are the leverage ratio and no interest-only payment period.

<i>Asset Size</i>	\$	25,000,000	\$	25,000,000	
		<u><i>Jun-07</i></u>		<u><i>Jan-08</i></u>	<u><i>Notes</i></u>
Leverage Ratio		75.0%		70.0%	(1)
First Mortgage Loan Amount	\$	18,750,000	\$	17,500,000	
Net Equity Required to Invest		6,250,000		7,500,000	
Fee Load on Equity		20.0%		20.0%	
Gross Equity Required		7,812,500		9,375,000	
Interest Rate Coupon (10-year debt)		6.50%			(2)
Debt Constant				7.58%	(3)
Amortization as a percentage of Initial Loan Amount				15.22%	(3)
Average Annual Amortization				1.52%	(3)
Acquisition Capitalization Rate		7.00%		7.00%	
Pro-Forma Net Income		1,750,000		1,750,000	
Debt Service		1,218,750		1,327,343	(4)
Distributable Cash Flow		531,250		422,657	
Cash on Cash Yield Percentage		6.80%		4.51%	
Average Annual Principal Amortization				<u>1.52%</u>	(5)
Equivalent Interest-Only Cash Distribution Percentage			↑	6.03%	
Initial Capitalization Rate Required to Maintain Jun-07 Cash on Cash Yield Percentage				7.86%	(6)

Notes:

- (1) Given the comparatively more stringent underwriting criteria, lenders are not lending as aggressively as in the recent past, which translates to generally lower leverage ratios.
- (2) The Interest Rate assumes a 10-year term, interest only loan such that no principal amortization is required to be paid.
- (3) The Debt Constant assumes principal amortization based upon a 30-year schedule, which results in total principal amortization of 15.22% of the original principal balance of the loan over the assumed 10-year holding period. This translates into an average annual principal amortization of 1.52% (15.22% divided by 10 years).
- (4) The Debt Service is calculated by multiplying the Loan Amount by the Coupon, in the case of the interest-only loan, and by the Debt Constant in the case of the amortizing loan.
- (5) To compare the cash on cash yields, on an apples-to-apples basis, you must add back the average annual principal amortization to the actual cash distribution percentage.
- (6) In essence, initial capitalization rates would have to increase 86 basis points to maintain the initial 6.80% cash on cash yield as a result, and specifically as a result, of the change in the debt structure outlined herein.