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Commercial Real Estate Case Study

An Innovative Financing Solution Unlocks Property Value

The Challenge

The client, a commercial architect, owns a five-story, mixed-use commercial property in midtown Manhattan with residential apartments above a premier retail location. A retail tenant had already entered into a long-term lease for the first two floors, but at a below-market rent. Now, the client sought to maximize the remaining property value by renting out the residential units on the upper three floors as corporate apartments. The national retail bank that had provided acquisition financing at a high interest rate was uninterested in refinancing, and a second, short-term loan provided by the client's firm was about to mature. With the unpredictable cash flows, seasonality and cyclicity of the corporate housing business, how would the client establish the financial business case to consolidate and refinance the loans?

The Client

The client is a senior partner at a growing, middle-market commercial architecture and industrial design firm. He has acquired a portfolio of real estate assets for his own account, including commercial, residential and retail properties located in and around the five boroughs of New York. For several of these projects, the client's architecture and design firm had performed significant renovation and rehabilitation services.

Most recently, the client purchased a five-story, mixed-use building in a prime location in the midtown commercial district of Manhattan. Built in the early 1900s, the building was acquired vacant, and the client had invested about \$2 million for renovations by his firm to create one large retail space on the first two floors and multiple residential apartments on the three floors above. The property was financed by a first mortgage from a national retail bank as well as a smaller short-term, unsecured loan from the client's business. The client needed to refinance and consolidate the two loans.

Cash Flow Volatility Complicates Refinancing

The main challenge facing the client in obtaining a refinancing was his plan for the upper story apartments. Rather than seeking long-term residential apartment tenants, the client calculated that a better return could be earned from short-term, fully furnished corporate rentals. The property was located in a largely commercial part of mid-town Manhattan that could prove highly attractive to short-term corporate tenants doing business in the city, providing a convenient and cost-effective alternative to hotel accommodation.

This repositioned business model did not, however, appeal to the client's existing bank lender. The corporate housing market is subject to both seasonal and business cycles; projecting cash flows from this model requires assumptions about an essentially unpredictable series of short-term corporate tenants. Other large banks were similarly uninterested or were willing to lend only at prohibitively high rates, citing what they perceived as the complexity and risk in underwriting and structuring appropriate financing.

Compounding the challenge, the long-term retail lease was now below market value. Based on the original mixed-used development plan, the retail tenant, a stable but unrated company, was projected to represent almost half of the rent roll on a fully rented-out basis, adding concentration risk to the uncertainty of the cash flows.

Due Diligence Reveals Financing Options and Sensitivities

Modern Bank's commercial real estate team independently tested the key business case assumptions and market variables such as comparable vacancy and rental rates, conducting financial scenario analyses and mapping out the transaction risks and mitigants. The analysis confirmed that the corporate housing model could command much higher rents than the residential model.

Next, the bank analyzed the sensitivity of net operating income growth, not only to quantify debt service coverage ratio and debt yield sensitivities, but also to conduct re-pricing sensitivities based on various amortization rates and maturities. The client and the bank have a vested interest in ensuring the continued viability of a project upon loan maturity, and understanding refinancing or exit scenarios requires significant expertise regarding interest rates, absorption rates, and other key micro- and macroeconomic indicators.

Non-Negotiable: Certainty of Execution

The client and bankers reviewed key transaction terms, working closely together to establish their relative significance (e.g., principal amount, interest rate, term, fixed/floating, recourse/non-recourse, etc.). Although the client was flexible on a variety of terms, speed and certainty of execution were of paramount concern.

Together, the bankers and the client considered a range of possible structures to provide credit support to the transaction and possibly mitigate the irregularity of the projected corporate housing cash flows. Modern Bank sought to develop a deeper understanding of this individual client – not just the client's net worth, income and cash-flow, but also the role played by this

particular transaction within the client's long-term professional goals and personal aspirations. This discovery process not only facilitates a successful transaction, but, more importantly, can lay the foundations for a mutually rewarding, long-term business relationship.

In this case, it became apparent that a successful repositioning of this property had the potential to elevate the competitive position of his firm, which had led the redevelopment. The transaction wasn't merely about the upside economics or potential losses. Rather, it had a strategic significance for the client and, potentially for his firm.

Armed with this insight, the client and bankers focused on the prospective role the client's firm could play by providing credit support to the transaction. The client's business partners saw how the firm's reputation could benefit significantly from the success of the project as a combination of innovative physical design and property use, making them more willing to share the downside risks of the transaction than a disinterested third-party financier would have been. By bringing the client's business into the transaction, the banker facilitated a tripartite conversation that aligned the interests of the client, his firm, and the bank.

Entrepreneurial Solution for an Entrepreneurial Client

The client's firm agreed to enter into a five-year master lease for the corporate housing units; Modern Bank provided the client with a \$5 million fixed rate first mortgage with a five-year term secured by the subject property; and the client provided a guarantee of the master lease. The master lease began slightly above market rate to offset the below-market rate of the retail lease, and adjusted appropriately over the five-year term; the client's financial statements were more than adequate to support the guarantee.

To address the challenges presented by the client's business plan, the bankers tailored a lending solution specifically for this transaction. As a result of this collaborative and creative structuring, Modern Bank was able to help the client unlock the highest value from this property. More importantly, Modern Bank was able to help this client take his firm to the next level by supporting a successful repositioning of this property.

About Us

Every commercial real estate deal is different, requiring a structured financial solution. But most transactions have some factors in common. Sponsors always seek to work with experienced bankers who provide not just capital, but intellectual capital – the experience, flexibility and capability to structure and deliver tailored credit products. In addition, sponsors seek certainty of execution, and prefer bankers who are empowered to move at the speed of the market.

Modern Bank's commercial real estate group has significant expertise in all asset classes and financing structures. Our focus and commitment to providing creative financing solutions allows us to provide products and service of institutional quality, regardless of sponsor size. Creative structuring, responsiveness to individual requirements, and industry expertise combine to provide what Modern Bank defines as "commercial banking, personalized."