GETTING IT RIGHT:

TOP LINE UNDERWRITING AND THE CAPITAL STACK

By Frank L Lonardelli

I am often asked what I think the number one issue is in the Exempt Market. In my opinion, it is what is a sensible capital stack and what ought to be the baseline for underwriting. This article addresses, on a high level, the best practices in underwriting (which are the fundamentals) or what we refer to as table stakes, and then it tackles the elusive capital stack and what that means for the investor.

What are the top 5 Fundamentals of private equity underwriting to consider?

The issuer should have the following:

1. Skin in the game (real skin in the game). I.e., the issuer's own capital and/or personal guarantee in the project/ investment. Not funds that were generated through a front end promotion that has been repurposed as an investment into the project, which brings us to the second point.

2. The issuer gets paid on performance, NOT on promotion. In other words, it is a real estate investment and/ or development company, and not a syndication company (there is a BIG difference).

3. The issuer has a team with a successful track record that has actually done what was promised in the past, and they are most likely going to be successful with future initiatives. Good issuers are not banking on the hope that they are going to be successful because they have a tremendous amount of optimism to coincide with their 'cool business plan.'

4. The issuer acts within the rules and regulations of a publicly traded company. In other words, it has appropriate levels of corporate governance and transparent disclosure. The issuer provides regular annual shareholders meetings for their investors complete with financial statements and continuous disclosure on the progress of its projects.

5. There is institutional capital in the deal. And ideally, a lot of it! I am speaking from my specific background and expertise in real estate, but if you do not have items one to five in any deal that you are investing in or recommending clients, then what you have, in essence, is a venture capitaldeal. Therefore, you are undertaking the same risk as an angel investor, and should expect to lose five to seven out of every ten investments.

Where are you placing your money?

If an issuer is underwritten with only the above five criteria and nothing else, one would have a significantly higher probability of achieving a successful result. More importantly, the process will have mitigated the downside. If the above underwriting criteria was adopted into the investment mandate as a dealer, agent and/or issuer, we could collectively accelerate the strength and opportunities that the Exempt Market has to offer, but that is just the beginning.

At my firm, we continuously provide ongoing disclosure in the form of quarterly updates through our project and/ or corporate communications, coupled with fulsome and transparent annual shareholders meetings that provide the opportunity for our unit holders to ask questions regarding their investment.

Do your issuers do that?

Now that the basic ground work of underwriting has been illustrated, one can look at the additional layers like the second phase of under writing and due diligence. For example, before going to the market, a multitude of professionals should look at the project.

Each Real Estate project should be vetted and substantiated by:

1. Real Estate Professionals
2. Cost Consultants
3. Land Economists
4. Appraisers
5. Development Consultants
6. Engineers
7. Planners
8. Architects
9. Financial institutions
10. Quantity Surveryors
11. Contractors
12. Lawyers

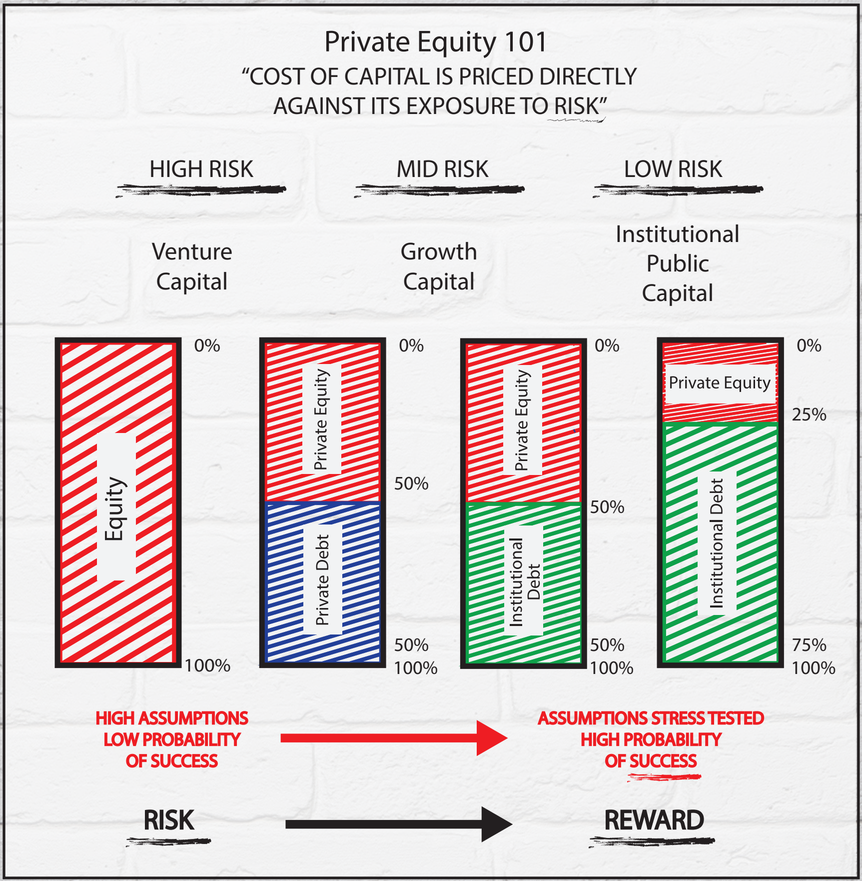
By incorporating this level of scrutiny, you will have a good sense of the viability of the development; and subsequently be able to mitigate risk, and create opportunities to optimize the project and/or investment. The above accredited professionals do not just 'look at' or 'discuss' the deal, they actually put their stamp of approval on the project.

What is a "capital stack?"

The capital stack represents the total amount of capital required to execute the project to completion or stabilization. The capital stack includes all sources of funding including equity, and debt, private or institutional.

There are various forms of debt and equity that can form a capital stack. They have different levels of performance and priority. It is extremely important to understand the nuances and 'behavior' of each type of structure and/or facility. For the sake of this article and its limitations, the breakdown of the capital stack against debt and equity will be illustrated.

Here is a set of capital stacks and what successful corporate finance companies look at as a top line before digging into the project details; before examining the other fifteen plus financing decisions and risk mitigation factors. From a real estate perspective, I would argue that the structure of this simple illustration would be endorsed by most investment houses that move billions of dollars of financing annually.



For example, our firm discloses to our investors that we only raise up to 25% of the entire capital stack with private equity. The balance is raised through institutional debt via insurance companies, pension funds, and / or Schedule A banks. This is important because the appropriate capital stack reduces the investment risk for both the investors and the issuer.

> "**The *capital stack* represents the total amount of capital required to execute the project to completion or stabilization.**"

Why would that be?

Generally speaking, most developments and/or developers cannot afford to pay the cost of capital that are directly associated with the Exempt Market if their capital stack relied solely on procuring 100% of their financing from this space.

This is because a successful development gross margin is programmed at approximately 30%. If the developer has to pay out 8-10% in sales commissions on top of paying out a dividend and/or a yield based distribution of generally 6-8%, you do not have to have a PhD in math to understand that that the developer would have a very big hurdle to overcome from the very start. Mitigating the cost of capital is a fundamental aspect of any analysis. Increased costs of capital severely hamper the viability of any development. If a developer is raising 100% of their capital requirements through private equity, under the current dealership distribution structure, then the project is built to fail.

As an investor I would be asking myself why an issuer would have to raise 100% of their funds through a private equity financier and/or dealership when any credit worthy project and/ or company can secure reasonably priced capital for a significant portion- if not all of their capital requirements. The capital markets today are flush with liquidity and are on the hunt to invest into deals that can deliver realistic returns from legitimate developers with great track records.

The fundamental reason why an investor, dealer and/or agent wants an institutional investor to come 'along for the ride' in the capital stack; and more importantly, disproportionately invest into any project is because major institutions like Schedule A banks and/or Pension funds have the highest level of financial scrutiny, underwriting intelligence and are extremely proficient on the product they are lending and/or investing into. In other words, they rarely lose money. This adds credence and credibility to the deal and is of paramount importance, from my perspective.

These institutions care about the financial analysis; the math, and the assumptions used to outline any project. Not about the marketing, and certainly do not make their lending decisions based on the personal relationship or connection they may have established with the client. They are not looking at fancy brochures, slick sales pitches and the 'flavor of the day.' They are practical, pragmatic and bottom line driven.

Of all of the deals that you are aware of over the last ten years that have 'blown up,' how many of them had the majority, or even a significant portion of their funding come from large institutions? This is not a rhetorical question, but if I had to hazard a guess, I would say less than ten percent.

A firm should want to get their deals scrutinized by financial institutions and large brokerage firms. We stress test each project long before we collect the first dollar from our investors. We want our project assumptions underwritten to ensure that everything we assumed is accurate, viable and entirely fulsome. For example, a year before we received a construction facility (debt) of $17 million from a local credit union to reposition one of our downtown Calgary projects, we ensured that the facility was secured well before we raised a single dollar from our investors to complete our capital stack.

There are iterations and variables to take into consideration based on the various submarkets of real estate with respect to the capital stack, like land banking, for example. However, when referring to cash generating assets through operations as opposed to a perceived accretive value calculation of land based on time over money, the capital stack is sacrosanct from a risk adjusted standpoint.

Exempt Market issuers should strive as a best practice mandate to focus on never losing the original equity. That should be Priority # 1. Based on this discipline, the gains always take care of themselves.

My advice to advisors and investors is to not focus solely on the potential gains. Get comfortable with the investment. Ensure the investment has mitigated its risk. Ask the right questions as illustrated in this article and you, and your clients' hard earned capital will be very well served.

Frank Lonardelli is the Founder, CEO and President of Arlington Street Investments. ASI has a 15 year track record of successful real estate investing and currently has over $400 Million dollars in commercial real estate development located in high profile inner city sites in Calgary, Alberta. In 2014 alone, ASI had more than a dozen articles written about its successful strategy and projects from both regional and nationally recognized business and industry publications. ASI exclusively raises private equity from their growing list of accredited investors, family offices and institutional investment houses.