**Saul Ewing 7th Annual Real Estate Conference**

***Panel: Finding Equity and Debt in Today’s Evolving Marketplace***

*By Paul Rodriguez*

***Baltimore, MD*** – Saul Ewing, LLP held its Annual Real Estate Conference at the Baltimore Convention Center on November 5th, 2015. The Conference, now in its 7th year, brings together professionals and leaders from all corners of the Real Estate Industry, in an effort to exchange knowledge, discuss trends, identify new opportunities, and listen to various experts. The Panel on finding debt and equity in the marketplace discussed how to finance the ideas for real estate projects discussed in the earlier panels.

The Panelists were Kieran P. Quinn, managing director and co-head of production for Guggenheim Partners; Brandon Jenkins, COO and Co-Founder of a crowd funding platform, Fundrise; Antonio F. Marquez, Executive VP of a community bank, Eagle Bank, and moderator John B. Levy, President of real estate investment boutique, John B. Levy & Company.

“The first two sessions” Levy explained “were focused on new opportunities in the market, whether that be e-commerce…millennials, technology, multi-family, just to name a few.” By contrast, he noted “This session is actually focused on ‘how do you raise that equity and debt for those ideas you got in sessions 1 and 2?’”

**The Panelists: Who They Are**

The panel began by considering how investment should be guided by money being both widely available and inexpensive. While some have the belief that ‘you ought to take all you can get’ Levy noted that the project location mattered greatly: “It makes a big difference ‘where’ you are, not just ‘what’ you have,” when it comes to raising equity and debt for real estate projects.… if you have an equity or a debt deal in the CBD of one of the so called ‘Salt Water 6,’ the response will be truly overwhelming. “However,” he continued “if your deal isn’t at ‘Main and Main’, and if it’s not in the ‘Salt Water 6,’ if it’s, as we would say, ‘one standard deviation away,’ you might find that your response and rates are quite different.” The panelists then explained their companies and the work they do:

 Quinn described his company’s work: “Well, we are pretty traditional, raising money for Life Companies…the only difference is that most Life Companies’ sweet spot is at 60 to 65% LTV, and we get interested when it’s 65, 70 and in some cases going up to 75% LTV.” Providing some wisdom, Quinn stated “I always tell my friends…find a deal that is clearly Life Company quality, but which has a story to it.” In regards to CMBS (“commercial mortgage-backed securities”), Quinn admitted that he felt little fondness for the previous decade, due to the experience of losing money on CMBS, but remarked “CMBS has come back a lot quicker than I thought, and the response from the investors has been very positive.” Finally, he noted that “CMBS gets beat up a lot of ways, but I think the best properties that work in CMBS are multi-family, because you are not doing a big upgrade” or “renovation like you would in a hotel.”

Jenkins described his company, Fundrise, as an investment platform for Real Estate utilizing Crowd- Funding or as he explained, an “E-Trade” for real estate: “Basically…we source good real estate deals, we underwrite them, we fund them off our own balance sheet with our own equity, and then we turn around and we sell investments, fractional investments, participations in that investment, online, directly to retail investors…it gives the investor a lot of flexibility to build their own portfolio of commercial real estate in a way that retail investors essentially never had before.”

Panelist Marquez explained that Eagle Bank is an 18 year old publicly traded community bank with a portfolio worth $6 billion in assets and $3.2 billion in CRE (“commercial real estate”) focused mainly in the Washington area, with some loans in Baltimore. He explained that, as a community bank, “we are just not doing ‘car-wash loans’ down on the corner, but I think the story element of it is a key,” expressing Eagle Bank’s willingness to “listen to the story,” but approach a client “from a boutique point of view rather than a wholesale point of view.” Ultimately, Marquez noted “we always lead with the fact that we are never the lowest cost provider of capital,” however, “when something goes ‘bump in the night’…we can react quickly…so, that kind of responsiveness is how we trade in the market.”

The balance of the panel focused on eight general topics framed by questions posed by both Levy, and also by audience members via instant email. As such, the following discussion will be presented here in the same Q & A format to maintain the integrity and organic feel of the panelist’s responses.

Investor Demographics, Investment Liquidity & Methodology

***Q: Brandon, are your offerings for accredited investors only, or for qualified investors? And, what is the liquidity of an individual’s investment?***

Jenkins: Today, the majority of our offerings are for accredited investors…the reason behind that is not that we have some arbitrary rule about why we only want to work with those people. It has to do with the way in which we conduct our offerings…If you are doing what is called a Rule 506B offering…you don’t have to verify it. It is self-certification. If anyone is familiar with the Jobs Act, there were several changes to how you could basically raise capital. One of them was what was called Rule 506C, which allowed for general solicitation, meaning you could actually advertise for investment, which was not possible before…We have done 506C offerings…If you go on the site today, or actually up until last week, you could actually invest in 3 World Trade Center on your phone. That was a Rule 506C offering, where we would have to verify your accreditation. We have done offerings for unaccredited investors using other exemptions called Reg. A, and we will continue to provide offerings to unaccredited investors using other regulatory exemptions outside of just Rule 506. Today, a majority of them are for accredited investors.

***Q: So, following up on that question, if somebody buys in, what is the liquidity of an individual’s investment, if any?***

Jenkins: It is very limited. We didn’t take any liquid asset, which is commercial real estate, and make it liquid overnight. So, there is no secondary market, and if somebody tried to make one, it would probably take a long time before there was enough volume in it….For the most part, you are in for the term of the deal. We actually offer “buy-back” provisions on a quarterly basis, to try and increase some liquidity, because that is something that people tend to feel like they are used to from investing in stocks or other things. But, for the most part, it is a long term investment…you are making your money primarily through cash flow and the long term appreciation of the asset.

***Q: Brandon, how much capital did Fundrise principals invest in each deal, or do they syndicate the entire amount to investors?***

Jenkins: So, the company invests the entire amount of each deal using the equity in the company. If it’s a 1, 5 or $10 million deal, we are funding it, we are closing it with our own equity from the company’s balance sheet, and then we will turn around and an investor, or all the investors, can then invest in that position, 5,000…10,000…$100,000, whatever they desire, at par. There is no markup, there is no spread. If the entire thing sells out to investors, that is great, the money comes back onto the balance sheet and we do another deal. If half of it does and the other half we have to hold onto, that is fine also, because we are not going to invest in any deal that we wouldn’t be happy owning.

***Q: So Brandon, “can small investors invest with you, ones who make, say, less than $200K annually”?***

Jenkins: Yes, just, the number of investments available to them are less.

***Q: So, these aren’t Reg. D deals, because they have to be accredited?***

Jenkins: No.

***Q: So, they are investing in Reg. A?***

Jenkins: Yes, or other types of offerings.

***Q: [to Brandon] A follow up question, “In your deal, what’s the legal status of your investor? Are they actually part owners of the property by deed, or are they stock holders? What do they own?” and “if things go really bad, and say the property turns out to be a superfund site, are all the investors on the hook for more than their initial investment?”***

Jenkins: The way that we structure a deal is that we make an investment with a real estate company. We turn around and then issue what’s called a “project dependent note,” so that as an investor, you are receiving an obligation of Fundrise. The way that note is structured, is it basically entitles you to all the economic participation of your pro-rata share in that investment, so any money that comes out of the real estate deal to Fundrise, then has to be passed along to the investor, based on your pro-rata investments.

***Q: And you pass that along without fees?***

Jenkins: No fees. We charge a 50 basis points servicing fee for having to take money in and send it out. That not is then put into a “bankruptcy remote trust,” So, if Fundrise for some reason was to go bankrupt, and the company ceased to exist, the obligation of the real estate company to pay the payer investment and for those proceeds to be passed onto the investor, are held in a bankruptcy remote trust, so you are not at risk of any Fundrise related bankruptcies…you have no risk if there is something wrong in the deal, something happens, the developer is not doing anything right, you are shielded from that. So, the principal you invest is what’s at risk.

***Q: [to Brandon] How diverse are you as far as locations?***

Jenkins: We’ve done deals pretty much across the country, but we try and focus on the top 25 metro markets. We are very active in D.C., N.Y., L.A., San Francisco, Seattle, Denver, Austin. We have done a few deals in Salt Lake City and Nashville.

The CMBS Business, Spreads and Servicing

***Q: For those of us who have been in the CMBS business over the summer and the fall…spreads went out 50+ basis points. You are a big CMBS player, so what are you going to do about that?***

Quinn: In the summer, the end of the fall, Triple A’s went from 85 basis points to 125, Triple B’s went from 2 something to 5 something. In CMBS 1.0, we had much better hedging vehicles, today we really don’t. We can hedge the Treasury, but we can’t hedge the spread effectively. There is a CMBX index that we can do some hedging, but it doesn’t always move as well with the cash that the old Lehman index did, so that is the one downturn to what we are doing, the inability to rate lock substantially before a loan closes. So, the Life Companies will always have that advantage over us.

***Q: Kieran, you are in the Life Company business with a little bit more of a “one wrinkle” deal, you are in the CMBS business. Are you competing against bank CMBS, or non-bank CMBS, or does it matter to you, and if you are competing against a bank, their cost of capital is dramatically less than yours, how does that affect the transaction that you need to do or want to do?***

Quinn: You remind me of one of the pleasant parts of our job, we compete with everybody, so the answer is yes, yes, yes and yes. The CMBS world has 40+ originators that are out there. It is dominated by 5 major players, Deutsche Bank, B of A, Wells, Goldman Sachs, Morgan Stanley. They run a great book, we try to be friends with all of them because we participate in their securitizations, and Dodd-Frank is going to complicate that for them and for us moving forward….the depositor has to now certify that he knows all the facts on all the loans, and he is more than willing to do it for people that have warehouse lines with them, which is why we hook up with one of the two shops. It’s the whole “skin in the game, know your numbers,”…We compete with all the CMBS guys and a lot of private people that pair up with them, but to me, my biggest competitor, in certain respects, its other Life Companies. If its lower leverage, I can’t touch them because we won’t go there, but the banks can really be our biggest competitor on 10 to 50 million dollar deals.

***Q: So Kieran, next year, are there going to be 40 players, or are we going to be down to the 20 that we need?***

Quinn: We basically only need 20. People didn’t make as much money in 15’ as they did in 13’ and 14’. I mean, it was wonderful those early years, nobody was making loans, so you could make great spreads. Its razor competitive now, and you have to make a pretty big investment to do any kind of CMBS loans…but, I don’t think anybody has to lose sleep. There will be enough capital for real estate for the next few years, no question about it.

***Q: Kieran…it came to our attention when spreads just ballooned out, that corporate bond spreads have gone out at the same time as CMBS spreads. Did that push your life company spreads out at all, much, some?***

Quinn: That’s very interesting. Life Companies were late to the game. They tend to move their spreads more slowly. We put floor rates in, so we were a little bit ahead of the curve, but the majority of Life Companies have not moved their spreads dramatically, whether they had a floor in place that would have protected them. I think going into the next year, most spreads have gone up fairly dramatically, and we are up to say it will be a little more expensive next year when you borrow from Life Companies. But, they typically do, they lag. They lag going down, they lag going up. Take advantage of it.

***Q: Kieran…is there a way to do a CMBS deal that you like, without worrying that the servicing is just going to be somewhere between “horrible” to “worse”?***

Quinn: That’s the other bane of our existence. The servicers, during the downturn, probably didn’t perform up to what their expectation were…I’ve said to people “if you had one of our loans, and you have a problem with a servicer, call me.” They all know how to get to me. I get very few calls. Occasionally, I would get a servicer…many of the calls were people coming to the servicer and saying “I can’t make my loan payment and I don’t have any money.” There was no plan, you know? What’s the……“Hope is not a strategy?”…We tell people, “Read your damn documents!!”…you have to pay attention to all that, and count on people to act as professionally as you act.

Recourse Lending

***Q: Tony, a question from the audience that comes up all the time, “are you in the non-recourse lending business, or recourse, or some recourse, or top recourse?”***

Marquez: …People credit real estate depending on the leverage point, and as I indicated before, we are always willing to try to work with a particular client. If you are already a depository client of the bank, that is a different answer, than if it is something coming in new or if it is a one-and-done situation. So, it really runs the full gamut. We have the benefit of a chairman who…understands that at a certain leverage point, it is almost embarrassing to ask for some level of recourse. So, the answer is that it really depends, on the particular transaction, the LTC, the LTV, what the term is. In my view, any sort of commercial bank, community bank, is not matching well to its liabilities if it is doing 10 year, non-match funded financing. So, if we are talking about a year, there is a capital event coming, and we are at the right leverage point, we are too small not to think about it and see what we might be able to structure. How is that for a hedge?

***Q: So, Brandon, we are on recourse, we are on a roll here. You are not requiring recourse on your deals, I assume. Is that correct?***

Jenkins: Depends on the deal. Some do, some don’t…more often than not, we are going to be following behind the senior lender, and, to the extent that they are getting recourse, that may get us comfortable…We do a lot of preferred equity, a little bit of mezz-debt, and we do some full senior loans.

Obstacles, Concerns & Liabilities

***Q: So, crowd funding is a hot topic, but is there a black swan event out there that keeps you up at night, where you think “oh my goodness, what happens if?” or, is it like all of us where we are worried about real estate in general?***

Jenkins: I think the core worry is the same as anyone else. It is very challenging to be in the business of putting out money when it is hard to find good deals. The invention of the internet’s online funding did not take a bunch of bad real estate deals and all of a sudden make them good. So, we have to find good deals, and that is as challenging for us as anybody else. I do fear, and I watch, basically, an industry get created in our wake, of people funding bad deals and selling them to the crowd…and those people are going to lose money.

***Q: Just to follow on a question from the audience, is there a chance in your deals that there is a capital call exposure?***

Jenkins: No. We structure all our deals, so that the position that we are taking, there are no capital call requirements on us. That would be a requirement of the sponsor to bring in additional equity

Quinn: In the rare event that the general partner does not do that, who forecloses?

Jenkins: If they don’t do it, then we have the opportunity to step in and fund that position if we think it is in the best interest of our investment and the investors that are in the deal. So, generally, we are sitting behind a reasonable cushion of equity from the developer or the sponsor. Very rarely would I say that there aren’t deals that we would be happy to own at the position that we are in, so we understand that we need to have reserves.

***Q: Tony, when you lose a deal, who do you lose it to and why?***

Marquez: The interesting thing about being in the space that some community banks, and Eagle bank, finds itself in, is that as you get to sort of that $6 billion range, what I have found in the marketplace is that from time to time we are competing with a much larger bank, and from time to time we are competing with a much smaller bank, so we are in that “two year” occasion, and I hate to keep saying it, it depends on the transaction…as a boutique bank, we never syndicate more than on a third, so that to the extent that there are decisions that need to be made, I can tell you that when we get to a Board meeting, it is not more than 8 or 9 in a book of 1400-1500 notes, so we rarely syndicate.

***Q: So, when you syndicate, are you taking down the loan and then worrying about the syndication?***

Marquez: We are always taking down the loan. It is typically “best efforts,” so we will do it later if we think we need to create a little bit more room with a particular client. Our view is that, if we don’t think we can do the whole transaction, we are not adding the kind of value that typically gets us a slightly wider margin or net interest margin than other people we compete with. So, we want to be in the whole loan position.

Shadow Banks

***Q: Tony, we have heard a lot of talk about “Shadow Banks,” non-bank banks, and Kieran, you probably see them a lot. Do you compete against shadow banks, what are you doing about that, how prevalent are they, and what are the reasons that you might lose a deal to a shadow bank?***

Marquez: I was on a panel recently, and I think what you are calling it, so one of these mortgage REIT’s?

Levy: Oh, yeah, it could be a private equity group, it could be a mortgage REIT…

Marquez: So, the answer is in a market like D.C., that’s as dynamic as it is, and frankly probably in Baltimore also, there are these players that I sort of call “fly-in,” from NY or wherever, and try to wedge themselves into transactions. We actually do compete with some of them, merely because in many instances, we’ll go out a little bit further on the risk parameter with a particular client, so they may come in. But, they are typically even at a higher spread than what we are at, in terms of the pricing and the yield on the deal, so they pop up. They are obviously willing to listen to stories, as we are, but I think it really depends on the client and the deal.

Quinn: All day long. I mean, Ladder (Ladder Capital) is on example…Fortress (Fortress Investment Group), all of them, Carlyle (The Carlyle Group), are coming out, and the advantage they have, is if they have equity, maybe they have lines of credit, they have that ability to take a really storied, you know, when you get to the 6th level of stories, or they want to go to 85 or 90% leverage, and just work the transition, whether its re-tenanting, re-positioning, total renovation of a building…It’s people that have the ability to warehouse a loan without the normal regulatory oversight that Tony goes through, and many cases we do in the Life Company, or don’t quite have the capital to hold it, they have to go to CMBS. Most of the stuff that we do, we would love to get out the door in three days, but we just don’t want to take the hedging risk for any longer than we want. And, you go back to the whole sub-prime, single-family. So many of those loans were made by people who were unregulated, and they took extra risk. When people ask lenders to “be creative,” it’s a very simply way of saying “just lend us more money, without structure and without regulation.” So yes, they are coming in droves.

Levy: Yes. We have actually seen them, and this is interesting, because at first, I thought that in our business, that the shadow banks would be good for renovations, what we call the “R” word, renovation, re-tenanting, re-leasing. So, you’ve got a gut-job and you just have to fill in the void. But, we have actually seen them in ground up construction, which is kind of interesting, and, it’s non-recourse.

Sweet Spots

***Q: Brandon, changing the subject slightly, what is the sweet spot for you for the size deal that you would like to raise? Not the biggest, not the smallest, but what really fits your platform right now?***

Jenkins: We fit very well into what I would say is kind of this middle market, where it’s too large for somebody to do the deal with just friends and family, but it’s below the radar of private equity. In different cities that may mean slightly different things, but, if the total equity in the deal is less than $10M but more than $2-3M, that becomes a very attractive place for us. I don’t know very many places you can go and get a 4 or 5, $6 million dollar check from one person. So, that space is an area that we are particularly fond of, and we find a lot of great projects that meet our institutional quality, but they’re just slightly below the size of what a private equity fund wants to spend their time on.

Regulation: Impact of and Adjustment to

***Q: Tony, “how is Basel 3 impacting your underwriting and impacting developers with their decreased leverage for new construction,” so, that they have that 15% equity component of the completed value, which is, I think, where that questions is going?***

Marquez: (Jokingly) I’ll take a chance there are no regulators in the room. I think when you look at Basel 3, and we have been looking at it for the better part of 2 years…at the end of the day, every bank is going to have a “bucket,” and in that bucket, they are going to have to have 150% of the normal capital they might keep for another transaction, if the particular loan in question meets the definition of “High Volatility CRE.” The challenge is, that when you begin to think about that and you ask questions for clarification, it’s still a pretty murky definition, especially when you think about the dynamic nature of some of the deals that we might do. So, for example, you take an additional piece of collateral, and you feel like you have lowered the risk and the leverage point of your overall transaction, because the particular borrower in question not only gave you a well margined loan on the asset in question, but they said “by the way, just to make you more comfortable, we’ll give you another piece of collateral that’s free and clear, and drives the LTV down.” But, if they don’t have 15% cash equity to the completed value, that has to go into a bucket that then requires a higher capital amount. At the end of the day, the banks are not today prohibited from doing a transaction like that, but they may give you a sense that, well, “you know, there is an additional cost in terms of capital, so the spread is going to have to be wider,” and some of them frankly, depending on who they are, will say “no, we don’t want to add anything to that particular bucket because it is so unclear.” The position that we have taken is, we are in that business, we think we price to an appropriate risk adjusted return on our capital, and if that particular bucket happens to go up for some reason, so be it. I mean, we have to just continue to do business.

***Q: When will you have the first round of regulators coming in, testing?***

Marquez: We spoke about this the other day. We have “Safety & Soundness” every year. It’s either in MD or the Feds come in, and in the soft exit interview, there wasn’t even a mention of “what are you putting into that bucket.” I suspect they are as confused as we are about specifically what should be in that bucket. We are just taking a conservative view of it, putting whatever we think is in there.

The Fed Funds Rate

***Q: So, Tony. The Fed Funds rate is virtually zero. The threat is that they’ll move it up a whopping 25 basis points. How nervous are you?***

Marquez: Not at all. Look, that’s one element that to some extent, think about how things have changed where, there’s a sneeze in China in terms of their economy, and that begins to affect the yell and stink about “what the hell they are going do with the rates in December at the 16th meeting?” A, we are a floating rate. B, Kieran said the “F” word, “Floors.” We actually still give floors on some of our deals, and you might imagine what kind of push back I get from that…

***Q: And what that might be?***

Marquez: Well, if you look at the net interest margin of our bank, again, it is a publicly traded company, it’s in the 426 range. Most of our peer group that we compare ourselves…and it’s not “hey, let’s compare ourselves to those guys cause its convenient,” it’s a legitimate peer group, but we are probably 75 bips wider than the NIM of the peer group that we compare ourselves to in the D.C. Metro. So again, look, the rates are going to bop around…

***Levy: There’s all kinds of thoughts on when the Fed Funds rates go up***. ***[To audience] How many think Fed Funds are raised this year, 2015? (Nobody raises hands) So, everybody thinks that its next year? [no response]...... Some people don’t know what the fed funds rate is? [laughter]. Or, you don’t know what year we are in? [laughter]. Ok, fair enough.***

***Q: We have time for one more question. I’m going to Start with Brandon’s take on this and then ask you guys to chime in. Question from the audience, “I would be interested on the panel’s take on the theory that the Feds keep saying that a rate hike is around the corner, because it does not want to acknowledge the economic weakness it would be seeing if it announced that it had no plans to raise rates for several months?” The hike has been around the corner and will continue to be there for a while, or is it really here? Brendan, what does Fund Rise say?***

Brendan: That is a good question [ponders]…whoever knows the answer to that will make a lot of money! I think of course the conversation needs to be around the hike, because there is only one place for it to go. There are so many factors that go into making those decisions. I think trying to predict that stuff is not really worth your time, but I would expect a hike, whether it’s December or early next year, but I’ve been…I’m sure everybody remembers doing these panels for the last 3 years. This question has come up every time, and the answer is the same every time…

***Levy: The nice thing is that we have been consistently wrong (laughter). Tony, how wrong would you like to be?***

Marquez: You know, I’m always prepared to be wrong, that’s part of my charm [laughter]. I think that this is a bunch of reading the tea-leaves…at the end of the day at some point the rates will go back to, whatever, the reversion to the mean. In the meantime, we still need to continue to do transactions, and figure out how to get the right risk adjusted return on capital, irrespective of where the rates are, and so we keep our balance sheet sort of interest rate neutral and keep doing transactions and growing the earnings per share.

***Levy: Kieran, you have the last word.***

Quinn: I know the Fed is extremely frustrated, in that, they have done everything they felt they could do on monetary policy to try to keep the economy growing. They are afraid to take the risk that a rate hike might cause damage. I don’t think it will. It creates the ability to maybe cut it later on, if they think they need to give a positive message, but the reality is they have just done everything they can do. I think it will be a non-event. I wish they would just get it over with, and slowly start increasing it next year, so that they have a weapon in case they need to cut it in the future.

***Levy: Yeah. I’m in the “non-event, do it now” camp.***