As Lending Options Get Scarcer, CRE Players Turn To 'Dequity'

By Ciara Long

With no sign that the Federal Reserve's restrictively high interest rates are coming down anytime soon, the commercial real estate industry is still looking at ways to shake loose financing as lending is set to drop around 40% this year.

One term gaining popularity is "dequity," an ambiguously defined mix between debt and equity that developers are increasingly using to fill holes in their capital stacks. The funding carries increased risk for borrowers — but not enough to discourage the commercial real estate sector from using it to plug a gap.

"It is the de facto solution to every problem," Sam Friedland, a senior vice president at Related Fund Management, the private equity arm of The Related Cos., said onstage at Bisnow's 2023 National Finance Summit last week.

Dequity is simply "not taking the last dollar of risk," Friedland said when asked to define the term. By not being the last rung in the capital stack, dequity holders are more likely to see a return and are in first position to take over a struggling building from a borrower.

"It's an open term," he said.

Perhaps helped by its lack of specific definition, dequity is taking on momentum as a new buzzword, as both inflationary pressures and the highest interest rates in over a decade are making it harder to hash out traditional loan agreements.

Where borrowers would typically have been able to replace one senior mortgage with another, they are now looking at gap or mezzanine loans or preferred equity, which all fall under the dequity umbrella and give the investors offering it more potential control over the future of their properties.

Inflation, plus increased costs for operations, insurance, labor and taxes, all are making it difficult for traditional deal structures to pencil out, Cerberus Capital Management Managing Director and Head of Real Estate Private Credit Neha Santiago said at the event, held at 180 Maiden Lane in Manhattan's Financial District.

Additionally, owners and investors are facing slowing rent growth across asset classes and markets. There's also downward pressure on net operating income, as well as more than a trillion dollars of debt maturities coming due in the U.S. over the next 12 months, she said.

"You put all those ingredients into the shaker and shake it out, and then you pour out what is a pretty unsavory cocktail," Santiago said. "That is what is putting a lot of pressure on valuations today."

Those circumstances create a ripe environment for dequity to step in, Georgette Chapman Phillips, dean of the College of Business at Lehigh University and author of a 2005 paper on dequity, told Bisnow by phone.

“What was worth $100 two years ago is worth 50 bucks now. What's the loan-to-value ratio on that?” she said. “Loans are underwater, people are walking away. It's another reckoning moment.”

There’s no recipe for what makes a dequity deal, Chapman Phillips said. Traditional debt arrangements give lenders the power to demand a certain amount of payment at a certain point in time, while traditional equity agreements give the owner power to shape a property's decisions. Dequity means creating a mixture of both, depending on the participants’ appetite for risk.

Taking a dequity position can be equivalent to a preferred equity or rescue capital position, experts said onstage. Dequity investments can offer the best risk-adjusted returns in today's market — better even than a common equity position, Santiago said.

“When borrowers — particularly well-capitalized borrowers — go to price those last [subordinate] debt dollars, those are often pricing at returns higher than what equity is projected to make on a transaction,” she said.

When Silverstein Properties and Metro Loft Management acquired a majority stake in 55 Broad St. to turn the FiDi office building into apartments, it generated conversation on what it would take to make office conversions feasible.

Besides the bones of the buildings themselves, developers said at the time, the major concern is financing a conversion. That’s where dequity came in for Silverstein and Metro Loft: Funds managed by Ares Real Estate acquired a preferred equity interest in the project, while Banco Inbursa provided a senior loan.

Private equity players are also looking at acquiring dequity positions in distressed properties to put them in pole position to take control of properties.

Masterworks Development last month bought a discounted note on a $61M mezzanine loan belonging to a portfolio of distressed Blackstone-owned hotels, The Real Deal reported. This month, 3650 REIT originated a $103M mezzanine loan to recapitalize a joint venture-owned residential portfolio across Louisiana, South Carolina, Georgia and Tennessee. The loan, provided to David Werner Investments, Onyx Partners and Carlton Associates with an initial 24-month term, allows the sponsors to recapitalize the portfolio’s existing equity structure.

These types of deals are becoming more frequent because under the current economic conditions, equity seems too risky and debt is offering returns that are too meager to attract investors, Friedland said onstage.

“Nobody wants to take equity risk, but they want upside all the same,” he said. “Either you can attract equity that's thick enough to attract debt, since it's also low leverage, or you can’t.”

The long-awaited distress may not appear in the way that experts were predicting last year. Instead, borrowers are facing circumstances where they may just need more time to help an asset that is stressed rather than a solution for distress, Bentall GreenOak Managing Director and Head of U.S. Debt Abbe Franchot Borok said onstage.

“We are starting to see ... an ability to transact in that rescue capital [preferred equity] space — so, not true distress, but assets the borrower just needs some more time and to get through the volatility,” she said. “I do think there’s going to be some interesting opportunities there.”

But just like two cocktails in a row might leave some with a headache the next day, dequity’s risk cocktail might introduce complications down the line for borrowers.

“What I think is interesting about pref right now — and I love the term ‘rescue capital’ — but there is a shift, or maybe a buyer-beware aspect to it,” said Geri Borger Urgo, Newpoint Real Estate Capital’s head of production. “I don’t want to use the term predatory financing, but it’s what comes to mind. So we’re seeing a lot more power being given over to that pref holder.”

One of the downsides could be that a bankruptcy court may have a different opinion over what the loan’s structure means for asset ownership if disputes reach the courts, Chapman Phillips said.

Still, she said, it’s a tool that could ease circumstances currently faced by lenders and borrowers alike.

“Anything that allows a more fluid exchange of value is good,” she said. “The last thing you want is a rigid market, because then nobody can move.”