



10 - Financial Leverage - ch. 12

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▼ Supplemental

▼ debt service coverage ratio (DSCR)

▼ = annual NOI / mortgage payments

▼ higher DSCR shows greater ability for borrower to make payments

▼ Lecture

▼ financial leverage

▼ allows investors to use less equity to acquire an investment
→ potentially higher leveraged ROE

Resources

https://s3-us-west-2.amazonaws.com/secure.notion-static.com/a7417adb-e616-4349-829b-0c06682f386b/9_-_FINANCIAL_LEVERAGE_AND_FINANCING_ALTERNATIVES_-_Chapter_12.pdf

- ▼ allows tax deductibility on mortgage interest
- ▼ investors might borrow at higher LTV (thus higher risk) to increase leveraged expected ROE
- ▼ positive and negative leverage
 - ▼ positive leverage: when $ROE_{w/ \text{ debt}} > ROE_{w/o}$ → implies higher LTV the higher the expected leveraged ROE
 - ▼ negative is v.v. → higher LTV → lower expected leveraged ROE
- ▼ loan underwriting
 - ▼ LTV and DSCR are key elements
 - ▼ max LTV and min. DSCR vary with mortgage market condition
 - ▼ lenders have lower risk w/ lower LTV and higher DSCR
- ▼ prepayment penalties, yield maintenance, loan lockout
 - ▼ mortgage loan terms that make it costly for a borrower to payoff or refi a loan before maturity
- ▼ interest-only loan
 - ▼ borrower pays only interest on the loan

- ▼ no principal amortization
- ▼ thus a balloon payment due at maturity → “bullet loan”
- ▼ negative amortizing loan
 - ▼ payment rate on a loan is less than accrual rate → negative amortization → loan balance increase
 - ▼ may be used when interest rates are very high
- ▼ participating loan
 - ▼ lender receives additional interest
 - ▼ based on a formula related to gross income, NOI, or cash flow
 - ▼ called participation or “equity kicker”
 - ▼ but lender has no ownership interest in the property
- ▼ convertible mortgage
 - ▼ lender has the right to convert part or all of the loan principal to an ownership interest in the property at a specified time
- ▼ mezzanine loan
 - ▼ loan secured by owners equity in a property rather than by a mortgage on the property
 - ▼ usually requires inter-creditor agreement between mezzanine

lender and first mortgage
lender

▼ preferred equity

▼ investment in ownership
interest that is not a mortgage

▼ with a preferred return that
takes priority over other equity
investors

▼ sale-leaseback

▼ alternate means of monetizing a
property where seller retains Use
of property for the duration of
the lease term

▼ with a repurchase option in
the lease, seller may reacquire
ownership of the property in the
future

▼ Discussion



SUMMARY