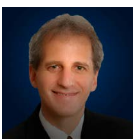
The Power of Stretch Loans for Family Office Investors

Making Stretch Loans to Earn Equity Returns while Mitigating Downside Risks

Photo illustration by Karen Steichen



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By Ron Zimmerman

Despite their relatively low profile, stretch loans to developers and others seeking real estate financing (referred to in this article as "sponsors") have been a long-standing choice for sophisticated investors that demand high returns and controlled risk. And these loans have become increasingly important to family offices and other astute investors for providing tools for financing transitional, value-add projects, and land transactions, rescue financing, and in other situations where lower cost senior loan financing is more difficult or expensive for sponsors to obtain.

In this article, we'll explore how family offices use stretch loans to deploy more capital per transaction and increase their investment returns compared to the returns that they traditionally receive on investments with similar risk profiles.

Understanding Stretch Loans.

A stretch loan or high leverage loan combine a loan and a preferred equity investment. Importantly, these loans are typically secured by first mortgages (known as a "senior stretch loan") on real estate projects owned by sponsors but can also be secured by second mortgages or UCC-1 financing statements on the sponsors' membership interests in limited liability companies (LLCs).

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Stretch loans enable investors seeking preferred equity returns to deploy their capital in a senior priority position and earn a 14-16% or higher return at a loan-to-cost ratio of up to 93%, or in a junior priority position and earn 25% or higher return at a combined loan-to-cost ratio of up to the same 93%.

Stretch loans also share characteristics with bridge equity, typically enabling family offices to receive a return of capital and their earnings on the capital in only 2 to 3 years and allowing the borrower to use the funds for 2 to 3 years without servicing the loan (if the sponsor agrees to accrue the interest). This flexibility makes stretch loans an attractive option for both family offices and sponsors.

Investor Profile for Stretch Loans.

Although a stretch loan may have up to 93% loan to cost ratio which appears to be high, the loan to value ratio after renovation or rehab is usually less than 75%. In addition, it is important to understand the underlying goals and reasons for family offices to extend stretch loans:

- A desire to deploy larger amounts of capital per transaction;
- Not wanting to be subordinate to another lender or investor in a property's capital stack;
- Sophisticated real estate investing experience;
- A willingness to partner with well-qualified and experienced sponsors who can manage properties on a day-to-day basis and oversee the redevelopment or repositioning of the underlying property;
- A desire to "ride on the coattails" of a profitable investment;
- A preference for investing higher in the capital stack while earning higher returns than making conventional senior loans;
- A desire to maximize control;
- An expectation of earning a fixed return regardless of whether or not sponsors hit their proforma numbers, and
- A desire to be paid on a gross rather than a net profit basis, avoiding the negotiation and impact of extraneous sponsor fees such as development, asset management, acquisition, and construction management fees, along with a promoted interest which would effectively reduce family office investors' return.

Based on the structure of the stretch loan, family office investors can expect to earn 14-16% or higher fixed income returns in a first lien position.

Key Benefits of Stretch Loans for Family Office Investors.

Stretch loans offer several advantages for family office investors compared to preferred equity investments:

1. **Attractive Returns:** Family office investors can expect to earn approximately 14 to 16% or higher fixed income returns with a first lien position on stretch loans at a loan-to-cost ratio of up to 93%. This typically means the loan to value rate after renovation or rehab is usually less than 75%.
2. **Increased Capital Deployment:** By providing funds that would otherwise be provided by senior debt financing and preferred equity, stretch loans allow family office investors to deploy additional capital per transaction, with most of the funds being in a senior priority position.
3. **Control Over Project Funds:** Family office investors have the ability to control and approve the release of holdbacks designated for capital expenditures and/or renovation costs, ensuring the efficient utilization of funds.
4. **Favorable Pay Rate:** By setting the pay rate on the stretch loan between 4 to 6% per annum (accruing the balance of the interest), sponsors can be required to have "skin in the game" while enabling family office investors to cover a significant portion of their cost of capital.
5. **Protective Covenants:** Family office investors can include debt covenants or milestones in the stretch loan agreement, requiring the sponsors to turn over control and ownership of the underlying property to family office investors, an affiliate, or a friendly party if the sponsors fail to meet these conditions.

Risk Mitigation Strategies.

Stretch loans offer family office investors several risk mitigation strategies that help protect their investments and minimize potential losses:

1. **Senior Secured Position:** By structuring the investment as a senior secured loan rather than an equity investment, family office investors are more likely to recover their capital if the sponsor or the underlying property fails to perform as projected. In the event of default, the stretch loan's senior position in the capital stack ensures that family office investors' claims are prioritized over other creditors. However, when structured as a rescue loan in the form of a second mortgage or mezzanine loan, family office investors' claims would be subordinate to the senior lender's position.
2. **Locked-In Returns:** Family office investors can set the interest rate on the stretch loan at a rate equivalent to the projected weighted average return, based on the 11.3% interest rate on the senior loan portion of the stretch loan and the projected 25% IRR on the embedded Class A preferred within the stretch loan. This effectively "locks in" the targeted returns, ensuring that family office investors earn a fixed rate of return, even if the sponsor fails to meet the projected performance metrics (see pages 16 and 17 of NetLeaseX's investor-version white paper, Senior Participating Preferred - Superior Returns in Commercial Real Estate with Substantially Mitigated Risk for different strategies to lock-in minimum rates of return on a preferred equity investment.)
3. **Joint and Several Recourse:** To further protect their investment, family office investors can require joint and several personal guarantees from all sponsors involved in the project. This provision

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holds each sponsor individually liable for the entire loan amount, providing an additional layer of security. In the event of default, family office investors can pursue legal action against the sponsors to recover their investment, and the stretch loan's interest rate would increase to the maximum allowable by law.

4. **Comprehensive Collateral Package:** Stretch loans are typically secured by a robust collateral package that includes:
   - A first mortgage or deed of trust on the underlying property;
   - A collateral pledge of the escrow account holding the undisbursed portion of the stretch loan proceeds;
   - A collateral pledge of the sponsor's membership interest in the ownership LLC, and
   - A collateral pledge of development rights, predevelopment work, and all other intangible rights.

   Furthermore, family office investors may request that sponsors pledge additional properties as supplementary collateral to further secure the repayment of the stretch loans. This provision offers an extra layer of protection for family office investors.

5. **Rescue Loan Structure**: Stretch loans can be structured as rescue loans, providing family office investors with enhanced security and the ability to take control of the project if the sponsor fails to meet certain milestones or obligations. This feature is particularly valuable in situations where the sponsor is facing financial difficulties or project delays. When structured as a structured as a rescue loan, family office investors typically make them secured by a second mortgage or as a mezzanine loan in conjunction with family office investors obtaining concessions from the senior lender. These concessions may include modifying the senior loan terms, such as reducing the interest rate, extending the maturity date and/or allowing the rescue loan to be secured by a second mortgage on the property. By obtaining these concessions, family office investors can better protect their investment while providing the necessary capital to help the sponsor navigate challenging circumstances.

6. **Elimination of Default and Risk of Foreclosure from Actions of other Lenders:** When family office investors' stretch loans are secured by a first mortgage or deed of trust, the investors have effectively eliminated the risk of default and foreclosure by another lender. By holding the senior secured position, family office investors' claims takes precedence over any other lenders or creditors, providing a significant layer of protection for their investments. In the event of default, family office investors have the right to foreclose on the property and recover their capital, mitigating the risk of loss due to the actions of other lenders.

In the event of default, these security provisions empower family office investors to assume control of the property at a lower cost basis, capitalizing on any predevelopment work or entitlements already obtained by the sponsor. This ability to "step in" and take over the project enables the investor to mitigate losses and potentially further increase profits as the successor owner of the project.

By implementing these risk mitigation strategies, family office investors can effectively protect their capital, minimize downside risk, and enhance the overall risk-adjusted returns of their stretch loan investments in real estate projects.

Advantages of Stretch Loans for Sponsors.

From a sponsor's perspective, securing a stretch loan offers several advantages:

1. **Streamlined Financing Process:** Stretch loans provide sponsors with speed, convenience, and certainty of execution. By working with a single capital partner, a sponsor can avoid the complexity and potential delays associated with coordinating between a senior lender and a preferred equity investor, which can sometimes involve difficult negotiations when establishing a recognition agreement between the parties.
2. **High Leverage without Equity Dilution:** Stretch loans allow a sponsor to obtain high-leverage financing without diluting their equity stake in the project. This enables sponsors to maintain a larger share of the potential upside while minimizing their initial capital contribution.
3. **Simplified Capital Stack:** By combining senior debt and preferred equity into a single instrument, stretch loans simplify the capital stack and reduce the administrative burden for sponsors. This streamlined structure can lead to more efficient decision-making and project management.
4. **Rescue Financing:** Stretch loans can serve as a form of rescue financing, allowing a sponsor to access the necessary capital to overcome obstacles and complete its projects successfully. This is particularly valuable for sponsors facing unforeseen challenges or market disruptions.

Structuring the Stretch Loan to Optimize Oversight and Returns.

To ensure proper oversight and control of the loan proceeds, family office investors can implement the following measures:

1. **Escrow Account:** At closing, proceeds from the stretch loan would be disbursed as agreed by the family office and the sponsor, with the balance of proceeds deposited into an escrow account with a title company designated by the family office investor. This arrangement allows family office investors to maintain control over the disbursement of funds and ensures that the proceeds are used for their intended purposes.
2. **Draw Requests:** The sponsor would be required to submit formal requests to the family office investors to draw down funds held in escrow. These

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requests should detail the specific fees, expenses, and costs that the sponsor intends to pay using the escrowed funds. By reviewing and approving each draw request, the family office investors can monitor the project's progress and ensure that the funds are being used appropriately.

3. **Escrow Agent Instructions:** Upon approval of a draw request, the family office investors would provide written instructions to the escrow agent, authorizing the release of the requested funds to the sponsor. This process creates a clear paper trail and maintains family office investors' control over the disbursement of loan proceeds.
4. **Dutch Interest Structure:** Family office investors can further optimize their returns by structuring the stretch loan with "Dutch interest." Under this arrangement, family office investors earn interest on the full loan amount, including any funds that are deposited into escrow at closing to pay for specified costs and expenses, such as capital expenditures (Capex) and renovation costs. As the sponsor draws down these escrowed funds, family office investors continue to earn interest on the entire loan balance, enhancing their overall return on investment.

By implementing these control measures, family office investors can effectively manage the disbursement of loan proceeds and ensure that the funds are used in accordance with the agreed-upon terms. The Dutch interest structure further incentivizes family office investors by providing a higher return on their capital, while still allowing the sponsor access to the necessary funds for project-related expenses.

Stretch Loans as a Rescue Financing Solution.

In today's market, sponsors and their limited partners may face unexpected challenges that can put their investments at risk. Whether it is a market downturn, an increase in interest rates, an increase in construction costs, delays and/or unforeseen expenses, these setbacks can create a pressing need for sponsors to raise additional capital to:

- Cover additional interest expense payable to the senior lender due to increase in market interest rates,
- Cover operating deficits,
- Pay down a portion of the senior loan,
- Gain the leverage needed to facilitate favorable loan workouts using commercial mortgage-backed securities and other types of loans to reduce interest rates, extend maturity dates, and/or release or otherwise reduce personal loan guaranties,
- Fund an interest reserve for the senior loan,
- Fund capital expenditures, unit turnover costs and/or renovations, and/or
- Fund tenant buildouts, and/or pay leasing commissions if the property type is other than multifamily.

In such situations, timely access to capital is crucial to prevent further deterioration of the properties' financial health and to ensure its ultimate success, or, at the very least, mitigate the sponsors' and their investors' losses. Stretch loans can provide sponsors with the lifeline they need to navigate these challenges and maximize the value of their properties.

When structured as a rescue loan, family office investors typically make them secured by a second mortgage or as a mezzanine loan in conjunction with family office investors obtaining concessions from the senior lender. These concessions may include modifying the senior loan terms to allow for the rescue financing, such as:

- Allowing the rescue loan to be secured by a second lien on the property;
- Agreeing to an intercreditor agreement that outlines the rights and responsibilities of the senior lender and family office investors as the rescue loan lender;
- Modifying the senior loan terms, such as reducing the interest rate, extending the maturity date, or waiving certain covenants to provide the sponsor with additional flexibility, and
- Agreeing to release or modify any existing guarantees or recourse provisions.

By obtaining these concessions from the senior lender, family office investors can structure the rescue financing as a second mortgage or mezzanine loan, providing the necessary capital to support the sponsor while mitigating the risks associated with a subordinate position in the capital stack.

Stretch loans offer several key advantages that make them an attractive rescue financing solution for sponsors:

- **Flexibility:** Stretch loans can be structured to meet the specific needs of sponsors in distress, providing tailored solutions that address their unique challenges.
- **Speed:** Compared to traditional financing options, stretch loans can be executed more quickly, giving sponsors rapid access to the capital they need to address pressing issues.
- **Alignment of Interests:** Stretch loans allow family office investors to participate in the property's potential upside while providing the necessary support to the sponsor. This alignment of interests fosters a collaborative approach to problem-solving and project success.

When structuring stretch loans for rescue financing situations family office investors can satisfy the sponsor's immediate capital needs while substantially controlling its risk. Some key considerations include:

- **Loan Amount:** Determining the appropriate stretch loan amount based on the sponsor's funding gap and the project's overall capital requirements.
- **Interest Rate:** Setting the interest rate, including the pay and/or accrual rate, that reflects the higher risk profile of rescue financing while remaining manageable for the sponsor.
- **Collateral and Security:** Ensuring adequate collateral coverage and implementing robust security provisions to protect family office investors' capital.

Stretch loans have proven to be a valuable rescue financing solution, benefiting both family office investors seeking compelling investment opportunities and, in addition,

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benefitting sponsors facing challenges. By providing flexible, timely, and aligned capital, stretch loans can help sponsors overcome obstacles, complete their projects, and/or stabilize their properties. For family office investors, participating in rescue financing deals through stretch loans offers the potential for attractive risk-adjusted returns, enhanced control, and portfolio diversification. As the real estate landscape continues to evolve, stretch loans will likely remain a powerful tool for navigating the challenges and opportunities that arise.

To learn more about rescue financing, please read the author's previous article on rescue financing published by Family Capital, "NetLeaseX Capital Offers Family Offices Direct Access to Rescue Financing Investments in Real Estate."

Case Study: Stretch Loan Transaction.

To better understand the benefits and mechanics of a stretch loan, let's explore a hypothetical investment scenario involving a transitional, value-add multifamily project.

In this example, a sponsor is seeking financing for a property that requires significant renovations to reach its full potential. Due to the higher risk profile associated with a "transitional project" like this, the sponsor may face challenges in obtaining low-cost senior debt financing from traditional banks. As a result, they may need to turn to non-bank lenders that charge higher interest rates to compensate for the actual or perceived increased risk.

Given current market conditions, the sponsor secures a senior loan from a non-bank lender at a rate of 11.3% (e.g. the secured overnight financing rate, "SOFR", plus 6%) with a loan-to-cost ratio of 65%. This leaves a significant funding gap that the sponsor must fill to complete the project. Typically, the sponsor would seek preferred equity investments to bridge this gap.

In this scenario, family office investors would typically provide 80% of the required equity in exchange for a Class A preferred interest, while the sponsor and/or other co-GP investors would contribute the remaining 20% and receive a Class B preferred interest. The family office investor and the sponsor would each receive a 10% preferred return on their respective cash investments and share any additional project profits on a 50/50 basis (see waterfall on page 15 of NetLeaseX's investor-version white paper). By investing 20% of the required equity, the sponsor would receive a 30% promoted interest in return for agreeing to:

- Subordinate its Class B preferred interest to family office investors' 10% Class A preferred interest;
- Solely provide any recourse on the senior loan;
- Solely provide any required guarantees needed on the senior lender's "bad boy" carveouts; and
- Be responsible for advancing any additional funds to cover capital shortfalls.

Under the traditional preferred equity structure described above, family office investors can expect to earn a 22% to 25% or higher IRR over a 2-3 year investment period.

However, by utilizing a stretch loan instead, family office investors will be able to deploy more capital, invest in a senior lien position at a fixed rate that is calculated by reference to the preferred return and the senior loan interest rate that the sponsor would have "paid" under the traditional structure described at the beginning of this section.

The key advantages of this stretch loan structure include:

1. **Simplified Capital Stack:** Family office investors consolidate the senior debt and preferred equity into a single investment, streamlining the financing process and reducing complexity.
2. **Enhanced Security:** With a first-lien position on the property and additional collateral pledges from the sponsor, family office investors benefit from increased protection and the ability to take control of the project if necessary.
3. **Attractive Returns:** By blending the returns of the senior loan and preferred equity, the stretch loan offers a weighted average return of approximately 14 to 16% or higher, which is higher than the senior loan alone but lower than the preferred equity return.
4. **Flexibility and Control:** The stretch loan allows family office investors to maintain control over the disbursement of loan proceeds, ensuring funds are used efficiently and in line with the project's objectives.

Key Takeaways from the Case Study.

The stretch loan case study illustrates several important lessons for family office investors:

1. Stretch loans can provide a more attractive risk-adjusted return compared to traditional preferred equity investments by combining senior debt and preferred equity into a single instrument.
2. By investing in a senior lien position, family office investors can enhance their security and ability to take control of the project if necessary.
3. The blended return of a stretch loan, which combines the senior loan return and the projected preferred equity return, can result in a higher overall return for family office investors.
4. Stretch loans offer flexibility and control, allowing family office investors to maintain oversight over the disbursement of loan proceeds and ensure the efficient use of funds.

Comparing the Capital Stack Structures: Conventional Preferred Equity and Senior Debt vs. Stretch Loan.

The illustrations on the next page show that the sponsor is projected to achieve a consistent 45% IRR across both capital stack structures. Likewise, the family office investors' 15.3% return on the stretch loan is equivalent to the weighted average return, considering the 11.3% interest rate on the senior loan portion and the 25% IRR on the embedded Class A preferred within the stretch loan.

A crucial distinction arises when considering a scenario in which the sponsor underperforms and fails to meet the projected return. Under such circumstances, the stretch loan structure guarantees that family office investors still effectively

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Senior Loan and Conventional Preferred	% of Capital Stack	% IRR/ Interest Rate
Sponsor (Class B Preferred)	7%	45%
Family Office (Class A Preferred)	28%	25%
Senior Loan	65%	11.3%

Stretch Loan	% of Capital Stack	% IRR/ Interest Rate
Sponsor's Equity	7%	45%
Stretch Loan	93%	15.3%

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earns the same 25% IRR on the embedded Class A preferred, ultimately shifting the risk associated with underperformance to the sponsor.

Structuring the Investor's Return.

There are numerous ways to structure family office investors' profit participation. Below are three options to achieve this result:

1. Percentage of Project Profits

Suppose the sponsor purchased the property for $10 million and invested an additional $2 million in capital expenditures, unit renovations, fees, and costs. In that case, the sponsor's project cost would equal $12 million. Family office investors could structure the stretch loan such that the sponsor pays 5% interest only and accrues 6.3% which together equates to the same 11.3% rate the sponsor could borrow from a non-bank lender.

If the project underperforms expectations, family office investors would capture a higher amount of project profits.

2. Purchase 50% of Common Interest in the Ownership LLC for a Nominal Amount

As discussed in the author's previous article, "Strategize with Preferred Equity", published in the *Scotsman Guide*, family office investors and sponsor could agree to capitalize the common membership interest in the ownership LLC at a nominal amount, such as $100. As part of the arrangement, family office investors could purchase 50% of the common interests in the LLC for just $50, simultaneously with providing 80% of the required equity in exchange for a Class A preferred interest. This strategy allows family office investors to gain a 50% ownership stake in the property for a minimal equity investment, while still providing the sponsor with the necessary capital in the form of Class A preferred interest to move forward with the project. Alternatively, instead of receiving the Class A preferred interest, family office investors could provide a senior loan to the sponsor.

3. Setting the Accrued Interest to Provide Family Office Investors with a Projected 50% of Project Profits

In this scenario, the interest pay rate is set at a rate that is based on an analysis of what the property can afford or what the family office investors demands on a current basis, while the accrued interest is calculated so that the combination of the pay and accrued interest approximates what the sponsor would "pay" if it had borrowed from a traditional lender and accepted a preferred equity investment from a family office.

In the author's opinion, this is the best structure among the three listed above. By setting the pay rate as described above, family office investors can "lock in" their projected returns, whether or not the sponsor hits their proforma numbers. In addition, unlike in option #2 above, where there may be some lender liability issues if family office investors were the lender and owned an ownership interest in the LLC, in option #3, family office investors earn their equity return with the accrued interest on the stretch loan.

In summary, the stretch loan transaction example highlights the potential benefits of this innovative financing structure for family office investors. By using stretch loans, family office investors can enhance their risk-adjusted returns, streamline the investment process, and assert greater control over their capital in value-add real estate ventures. A comparison of the traditional preferred equity approach and the stretch loan alternative enables family office investors to make well-informed decisions and potentially optimize their overall investment performance.

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Leveraging Stretch Loans for Family Office Investors.

Family office investors can employ various strategies to enhance returns and optimize capital allocation when investing in stretch loans. Two effective approaches include:

1. **Selling a Senior Interest in the Stretch Loan:** Family office investors can sell a senior interest in their stretch loan to another lender or investor with a lower risk profile. This strategy allows family offices to recycle their investment funds and likely raise capital at a lower cost than the sponsor while still retaining a portion of the loan profits. For example, if the sponsor is paying an effective rate of 11.3% (or SOFR plus 6%) on the senior loan tranche, family office investors could sell a senior interest in the stretch loan at a lower return, such at 7% per annum. By doing so, family office investors can recycle their investment capital, while retaining the interest spread on the embedded senior loan tranche and keep the accrued interest on the stretch loan as additional profit.
2. **Hypothecation of the Stretch Loan:** Another option for family office investors is to hypothecate, or borrow against, their stretch loan from an institutional or private lender. By pledging the stretch loan as collateral, family offices can access additional capital to invest in other opportunities. This strategy allows the family office investors to leverage their position and potentially enhance overall returns.

Conclusion.

Stretch loans offer a compelling investment strategy for family offices and high net worth individuals seeking to optimize returns and efficiently deploy capital in real estate. By combining the benefits of debt and preferred equity, stretch loans provide family office investors with an attractive balance of upside potential and downside protection. Through careful structuring and active oversight, family office investors can maximize their risk-adjusted returns and achieve long-term wealth creation objectives. Stretch loans are also a versatile tool that can be effectively used for rescue financing, providing a win-win solution for both family office investors and sponsors in challenging real estate situations.

Final Thoughts.

As the real estate investment landscape continues to evolve, presenting both challenges and opportunities, family offices and high net worth individuals must remain proactive and open to innovative strategies. Stretch loans have proven to be a valuable tool for sophisticated family office investors, offering flexibility, efficiency, and the potential for attractive risk-adjusted returns.

By carefully structuring stretch loan agreements and considering the implications, family office investors can unlock the full potential of this innovative investment strategy. However, the complexity of stretch loans underscores the importance of working with knowledgeable professionals.

Ultimately, the key to success in real estate investing lies in continually adapting to market conditions, embracing new strategies, and leveraging the expertise of trusted advisors. Family office investors who remain informed and open to innovative approaches like stretch loans will be well-positioned to navigate the ever-changing landscape of real estate investing and seize the opportunities that lie ahead.

Additional Resources.

For further insights on real estate investing strategies, family office investors can explore the following articles and white papers authored by Ron Zimmerman:

- "Senior Participating Preferred - Superior Returns in Commercial Real Estate with Substantially Mitigated Risk," Investor-version white paper, September 2022
- "Using Preferred Equity to Increase Real Estate Investors' Leverage and Enhance Returns," Sponsor-version white paper, September 2022
- "NetLeaseX Capital Offers Family Offices Direct Access to Rescue Financing Investments in Real Estate," *Famcap.com*, October 2023
- "Throw Out a Lifeline" (Part 1), *Scotsman Guide*, July 2020
- "Ride to the Rescue" (Part 2), *Scotsman Guide*, August 2020
- "Strategize with Preferred Equity," *Scotsman Guide*, December 2018

These resources offer valuable insights for both family office investors and sponsors, providing strategies to optimize returns, mitigate risk, and navigate the complexities of real estate investing. All of these resources can be accessed by clicking here.

If you would like to discuss NetLeaseX's white papers, articles, and/or explore opportunities for making stretch loans, rescue loans, and/or other structured investments, please contact Ron Zimmerman at (513) 621-1031 or via email at ronz@NetLeaseX.com. Ron is committed to helping family office investors and sponsors alike navigate the intricacies of real estate investing and develop customized strategies to achieve their financial goals.

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