



LEVERAGED BREAKDOWNS

CONQUER YOUR REAL ESTATE PRIVATE EQUITY CAREER

Technical Interview Guide

for Real Estate Private Equity Interviews

First Edition

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INTRODUCTION TO THE GUIDE

What this Guide Will Teach You

This guide will prepare you for every technical question we have ever encountered throughout our real estate private equity careers. If a student ever brings a question we've never heard before, we make sure to update this guide and include it. So if you master the concepts herein, you will not be caught off guard by technical questions during a real estate private equity interview.

Specifically, this guide is divided into subsections which will focus on: valuation, modeling, high-level comprehension of important concepts, real estate operations, accounting, development, financing and credit analysis, and M&A questions. You must master each section, none of the information herein is very "optional."

Technical Questions Overview

Technical questions are designed to probe your mental model of the REPE investments process. That said, you must develop your mental model by actually building real REPE LBO investment models. These technical questions will make a lot more intuitive sense if you work through both of our courses, the [REPE Starter Kit](#) and [Breaking Down REPE](#). This is because real estate modeling holistically incorporates all of the technical skills that are being probed via technical questions.

So if you can confidently build the Verdant Apartments model from [Breaking Down REPE](#) and the equity waterfall from [REPE Starter Kit](#), then you are in good shape to begin preparing for technical questions. However, if you start preparing for technicals before really studying real estate modeling, just know that you are putting the cart before the horse. Everything will make a lot more sense if you get why these questions are topical, and you'll understand that once you have an intuitive grasp on real estate modeling.

How to Practice These Technical Questions

There is a stark difference between passive and active learning. We've purposely designed the courses on our website to force you to actively focus and model along – we don't give any pre-built templates, and we challenge you with intermittent quizzes. Yet with this guide, the onus is on you to actively study these questions.

For instance, the worst way to work through this question bank is to read through these questions like a book. If you do that, it's like your brain is in the passenger seat. You're idly looking at the questions, and hardly forcing yourself to actively understand each question.

The best way to practice these questions is to make it feel like an interview. Of course, the #1 strategy is to have a friend or family member quiz you on these questions. They can ask you the questions, and time your response to make sure you do not ramble on past 30-60 seconds.

However, you probably won't have a friend or family member to help you every single time that you study. Do not fear, because there is a simple strategy that you can implement. First, look at the question, and do not look at the answer below. Then, turn away from the guide, and read the question out loud to yourself to a blank wall. Finally, respond to the question from memory. Actually speak out loud using your voice, not your head.

This may sound silly, but try it a few times. You will notice where you trip up pretty quickly, and you will see why this is a much more effective study method than passively reading along, or mentally responding to the questions. When you interview, you are going to use your voice. So you really must practice actually speaking out your responses to these questions.

Quiz yourself on each section in its entirety, or break them up into chunks. Either way, mark down which questions tripped you up, and which questions you got right. Then practice the questions again, and compare your new results to the previous results. Did the same questions

trip you up? If you keep flunking the same questions, set them aside and practice them twice as much. If curious, I highly recommend you look into spaced repetition as a study strategy.

When interviewing, do not ramble on. This is your first impression and can make or break the rest of the interview. Taking more than 60 seconds to respond to any interview question could kill your candidacy. With the exception of "walk me through your resume," which is allowed to last up to two minutes, your response to any other interview questions should not exceed 60 seconds. And really, you should aim for 30 seconds. Actually time yourself -- you'll be surprised how much you probably ramble on. In fact, take a video of yourself. Watch it and do it again. You will notice things while watching that you can correct.

Here are some tips to help you speed up and cut down your rambling. **With behaviorals**, cut out the fat and the backstory. Get as quickly to the point as possible, because your interviewer's eyes will glaze over if you provide excessive background detail. **For technicals**, abstract your answer to the highest level possible. For example, if you were walking through a DCF, instead of detailing the WACC equation when discussing the discount rate you use, just say that you take the WACC without describing how it is calculated. Side note, if you don't know what a WACC is, you should work through our courses [Breaking Down REPE](#) and the [REPE Starter Kit](#).

Remember, interviews are stressful. You will feel less comfortable in front of your interviewer than you will feel while practicing at home. To excel in your interview, you must be able to answer every question in this guide out loud with confidence and ease when asked point-blank at any moment, with no reference materials by your side. So train for that scenario by simulating it as closely as possible when you practice. In plain terms, yes, I'm saying you should look at a blank wall (or a patient friend), ask yourself the question out loud with your voice, then answer the question out loud with your voice.

VALUATION, MODELING, AND HIGH-LEVEL COMPREHENSION

Why would two physically identical office buildings next to one another sold on the same day trade at different prices per square foot? What differentiating factors could explain this variance?

Highest-level, this variance would be caused by **differences in the properties' NOI streams**. Split between revenue and expense items, these differences could be:

Revenue items:

1. **Occupancy:** perhaps one property is 90% occupied and the other is 50% occupied. The less-occupied property would likely trade at a lower price PSF.
2. **Tenant credit:** if one property is filled with deep-pocketed blue-chip tenants and the other has low-credit startups or co-working subleases, you'd expect the property with a higher credit tenancy to trade for a higher price PSF.
3. **Near-term tenant roll:** If both properties have high quality occupancy, but one has a weighted-average lease term (WALT) of 5 years and the other of 1 year, you'd expect the property with less leasing risk to trade at a higher price PSF. In other words, if a major tenant is set to vacate, that is a risk factor that would certainly impact pricing.

Expense items:

1. **Tenant recovery structures:** one property may be gross lease whereas the other is triple net (NNN). NNN leases might be perceived as less risky in a rising OpEx environment (e.g. aggressive tax increases under current local government). Thus, the market would bestow a higher price upon the less risky NNN property.
2. **Fee Simple vs. Leasehold:** fee simple properties (you own the land underneath the building) trade at a premium to leasehold properties (someone else owns the land underneath the building and you pay them rent). If both are on a leasehold, but one has

a ground lease expiring in 70 years and the other has a ground lease expiring in 5 years, you would expect lower pricing on the riskier asset with a shorter ground lease term. When the ground lease expires soon, the land owner may either claim the improvements on their land (i.e. take the building, unless you can pick it up and move it) or at least negotiate a material increase in ground rent.

Commentary: This is the most common real estate private equity interview question, commonly known as the “two towers question.” You should expect to be asked this question in almost every interview you have. Also note, the real purpose is to probe your understanding of what factors impact the value of a building. So I wouldn’t get too caught up on the “physically identical” bit if your interviewer starts asking questions like “what if tenant improvements are different,” etc. (even though that would imply they aren’t physically identical). If you are unfamiliar with any of the concepts referenced above, keep reading and return to this question.

Why invest in real estate?

There are three main reasons for investing in real estate:

1. First, it’s a **tangible asset class** that has been around forever.
2. Second, real estate investing can take place in **many parts of the capital stack**. From credit investing to equity ownership, there are many ways to participate in the fixed income streams that real estate provides.
3. Third, there are **more liquid options today** for owning real estate: REITs, real estate equity or debt funds, public companies with a sector focus, real estate private equity, and so on. The combination of smaller check size and better liquidity continues to open up real estate as a viable option to more and more investors.
4. Fourth, it’s a **natural hedge against inflation**. Home values and rents have historically increased during times of inflation. Thus investors fearful of increased inflation are drawn to real estate as a natural hedge.

What are the main real estate sectors, and how do they differ?

There are five main real estate sectors: Office, Industrial, Retail, Multifamily, and Hospitality.

1. The most obvious difference between each sector is its intended use.
2. Another difference is **lease length**, in order of longest to shortest: Industrial, Office, Retail, Multifamily, then Hospitality. Because of the differences in lease terms, their revenues and expenses also mark-to-market differently each year.
3. Another key difference is **capital expenditures**: on a per square foot basis, industrial tends to be the least expensive, then office, then retail, and the most expensive is usually multifamily then hospitality. Of course, depending on location and tenant, retail can get far more pricey than multifamily, but as a sector, multifamily and hospitality are the most capital intensive, especially when you consider the tenant turnover and resulting unit refreshes needed.
4. Finally, **cap rates tend to be lowest for multifamily, industrial is a little higher, then office, retail, and finally hospitality**. Industrial used to be higher, but recent appetite following demand from e-commerce and the perceived value of warehouse space has driven down industrial cap rates.

Note: There are more asset classes than the main four. It is also important to understand and acknowledge hospitality, data centers, healthcare, self-storage, data centers, and net lease. Also, don't refer to multifamily as "residential" - this is a rookie flag that interviewers take for general ignorance on the sector.

Diving Deeper: Lease term affects mark-to-market because leases define the rental rates and expense reimbursements at a **fixed point in time**. The market for those types of leases can change, but the landlord and tenant have **no ability to reset the terms** to match the current market until the lease expires. For example, on a 15-year industrial lease, rent and expense reimbursements are set (unless it's a net lease). If the market shifts to higher lease rates during that 15 years, the landlord has no ability to capture those higher rents until the existing lease

expires. In multifamily, however, where leases tend to be 12- to 24-month terms, the landlord has much more ability to reprice the leases. Depending on the direction of the market, this can be a good thing or a bad thing.

Talk to me about NOI and cap rates.

There are two key drivers to value in real estate: **NOI and Cap Rate**.

1. **NOI** is the pure cash flow that a property generates, regardless of capital structure and costs. Think EBITDA. The only exception is that in real estate, most underwriting of NOI includes maintenance reserves, which is technically a capital item.
2. **Cap Rate**, in the simplest terms, is the unlevered rate of return for an investment property. The formula that drives all real estate activity is: $\frac{NOI}{Cap\ Rate} = Market\ Value$. If you know any two variables, you can solve for the third. **Cap rates are inversely related to value**, so a lower cap rate means higher value, just like bonds. Cap rates are one of the common units of measurement for comparing one investment to another, like rent per square foot or cost per square foot.

Why include maintenance reserves within NOI? The reason that maintenance reserves are usually built into the NOI analysis is that the core asset, regardless of how you capitalize or how you depreciate the deal, **requires regular replacement in order to maintain its functionality**. This cost is, therefore, logically included in the net operating income that it generates.

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Explain the relationship between cap rates and risk.

Cap rates are the most common valuation methodology in commercial real estate. The simple formula to derive asset value is $Market\ Value = \frac{NOI}{Cap\ Rate}$. Cap rates are represented as a percentage, so an asset generating \$20M of NOI at a 5% cap rate is worth \$400M. The **market prices higher cap rates for riskier buildings than less risky buildings**. For instance, a hotel and an apartment building might both generate \$30M of NOI in a single year. But the hotel may be valued at an 8.0% cap rate (\$375M market value) whereas the apartment building would be valued at a 5.20% cap rate (\$577M market value).

Investors often say **cap rates are a measure of risk** because they explain what value the marketplace ascribes to each dollar of NOI that different asset classes generate. Today, a hotel and apartment building may both generate \$30M of NOI. But in a downturn, the occupancy of a hotel building (day-long leases) will evaporate much more quickly than an apartment building (year-long leases).

Compare a [sector type] building in [submarket] versus a [different sector type] building in a [different submarket]. Which would you expect to have the higher cap rate?

The best way to answer this question is with facts. There are plenty of free sources of data available online, such as the [CBRE 1H19 Cap Rate Survey](#). Looking at this dataset, we can create a quick matrix. Just understand that this is broad-stroke data (ignores property-level nuances) that can change over time (e.g. industrial has recently increased in favor as e-commerce expands):

Sector	Average Cap	Class A	Class B	Class C
Multifamily - Urban Infill	5.20%	4.69%	5.12%	5.82%
Multifamily - Suburban	5.49%	4.99%	5.37%	6.12%
Industrial	6.27%	5.00%	5.86%	7.99%
Office - CBD	6.67%	6.05%	6.91%	8.66%
Retail - Community Center	7.48%	5.95%	7.39%	9.19%
Office - Suburban	7.91%	7.11%	8.31%	9.75%
Hotel - CBD	8.01%	7.05%	8.04%	9.20%
Retail - Power Center	8.25%	7.16%	8.34%	9.86%
Hotel - Suburban	8.55%	7.61%	8.53%	9.74%

Using the above matrix, and even quoting the source for extra points, you can answer any variation of this question. As a rough rule of thumb when answering this question, you can think of any high-end submarkets as “Class A” (Manhattan office, downtown LA hotels, etc.), any secondary (Dallas/Charlotte/Richmond/etc.) as “Class B,” and any tertiary/suburban markets as “Class C.” Use your own judgment, but this is the general framework I suggest when answering this question, and quoting hard data expresses your diligence and attention to detail.

Let's compare a CBD office in Baton Rouge versus a grocery-anchored strip mall in a lower-income suburb of Fort Worth. Which would you expect to have a higher cap rate?

Subjectively, both properties have pros and cons against them.

For the office building:

- **Pros:** CBD implies higher tenant quality. Also, CBD is the highest quality for the submarket. Compared to malls, office buildings are generally less riskier in an economic downturn.
- **Cons:** Baton Rouge is a secondary/tertiary market. Compared to gateway cities, less employment and wage growth. Less companies moving into the area means less demand.

For the grocery-anchored strip mall:

- **Pros:** Grocery is an essential service, great anchor to have
- **Cons:** Low-income submarket means limit on the type of in-line tenants you can attract. Downturn could hit this neighborhood harder and cause faster in-line vacancies. Grocery anchors typically pay less rent, so you're dependent on those more fragile in-line shops to generate returns. Compared to office buildings, retail revenues dry up faster.

But how do these subjective facts translate into objective data? Looking at the data referenced in the above question, I'd think perhaps a bit less than an 8.66% cap for the Baton Rouge office vs. 9.19% for the lower-income suburban Fort Worth grocery-anchored strip mall. So a bit close, but **the strip mall likely has a higher cap rate (and thus a lower value dollar-for-dollar of NOI).**

What are the main strategies that real estate private equity firms use to invest in real estate?

The main investment strategies are Core, Core-Plus, Value-Add, and Opportunistic. Asset quality and cash flow predictability follow that order from best to worst, and target returns are the inverse: lowest to highest.

Core: acquires the best properties in the largest and most attractive markets, have little to no deferred maintenance, low leverage, and maintain high occupancy with credit tenants. These components result in a very low risk profile, so the returns are also the lowest, often in the seven to nine percent range.

Core-Plus: begins to take on some additional risk in order to boost returns into the eight to eleven percent range. This added risk usually comes from slightly inferior markets, tenant credit quality, shorter remaining lease terms, and slightly higher leverage.

Value-Add: generally targets returns in the mid-teens, seeking properties in much smaller markets with higher vacancies, and deferred maintenance. Part of the equation in boosting returns is higher leverage.

Opportunistic: generates the highest returns, usually 20% or better. Most ground-up development and major redevelopment projects fall into this category. Interestingly, as the economic cycle matures, funds often buy further down the risk curve because of competition for limited buying opportunities, and with lower return thresholds, they can afford to pay more.

Which asset would you rather own during an economic downturn? An hotel, an office building, or a residential building? Why?

Residential building first, then office building, and finally hotel. Demand elasticity is least sensitive to economic changes in multifamily; most sensitive in hotels.

First, a residential building is the smart asset to own through a downturn because people will cut back on other expenditures before they cut back on housing. Hotels would be the last preference to own, because both business and leisure travel decrease during a downtime. Office buildings would be in the middle of the three. While the longer-term leases may carry you through a downturn, your tenants could also go bankrupt or otherwise move out upon expiration, leaving you with a vacant space during a very difficult economic period to release.

How does the tenancy of an office building vary from that of an apartment?

An office building will have fewer tenants in larger spaces, the leases themselves will be longer term and more customized, and in most cases the creditworthiness of the tenants will be far superior. Additionally, the capital outlay for office tenants is much higher due to tenant improvement allowances and leasing commissions to fit out the office space and pay the brokers who find your tenants.

What is a waterfall returns schedule, and why do real estate investors use it?

Waterfall schedules are designed to align the financial interests of investors and sponsors, particularly when there is a significant difference in capital contributions. The waterfall returns schedule defines the internal rate of return hurdles that change the distribution of cash during the hold period. An example would be that the investors receive a 9% preferred return, then cash flow is split 90/10 to a 12% IRR (90% to the investors), 80/20 to a 15% IRR, 70/30 to an 18% IRR, then 60/40 above that. Because the sponsor can earn a higher promotion as the investors earn a higher return, their interests are aligned and the sponsor has a strong motivation to return as much to the investors as possible.

Additional detail: for a development, the 90% equity fund LP (source of capital) would want to incentivize the 10% developer GP (steward of capital) to develop wisely. For a private equity

megafund, the limited partners providing most of the capital (CalSTRS, Texas Teachers, KTPF, etc.) want to make sure the general partner fund manager invests their money wisely. If you want to build a waterfall schedule, check out the [REPE Starter Kit](#).

If you are building a sensitivity analysis for a stabilized multifamily property, which variables would you test and why?

I would test annual rental increase percentage, vacancy rate, and exit cap rate. The ability to increase rents over time can have a significant impact on NOI, driving annual cash flows and investor returns higher. On the flip side, vacancy can siphon away those gains, so understanding the interplay and impact of vacancy and rent increases is a valuable piece of information. I would also test exit cap assumptions, because the terminal value of an asset has a massive impact on the overall returns of a project. If cap rates increase enough, NOI gains from rent increases over the hold period could be entirely wiped out.

If you are building a sensitivity analysis for a development deal, which variables would you test and why?

Without question, the first variable I would sensitize is time. The sometimes-unpredictable delay between commencement and sale can have an outsized impact on returns. Knowing the impact of a three- or six- month delay will help management understand the impact of extended lease negotiations, construction delays, or a quicker sale.

I would also test the impact of changes in the cost of construction, because change orders are pretty common with construction. Understanding the impact of a cost change will inform management's response to it. Lastly, I would test rent or sale price per square foot. Helping brokers or sales staff understand the impact that negotiating an extra quarter or dollar of rent can have a meaningful impact on asset performance.

REAL ESTATE OPERATIONS

Walk me through a single-asset pro forma and explain the main line items.

In a single asset pro forma, the main cash flow line items are as follows:

1. **On the revenue side:** gross potential rent, vacancy, concessions, and other income.
2. **The most common operating expense lines are:** management fees, insurance, real estate taxes, and repairs and maintenance.

These sum to give you net operating income, which is followed by debt service, if any, then cash available for distribution.

The primary considerations on the capital side are: acquisition price, hold period, exit value and cap rate, and debt issuance and paydown.

Note: real estate private equity models typically cover between five and ten years. Merchant build scenarios may have shorter hold periods under five years, however long it takes for the asset to stabilize.

How do the cash flow profiles differ between the major real estate sectors: office, retail, industrial, and multifamily?

I would categorize the first three sectors together as long-lease commercial use. The cash flow profiles of industrial, office, and retail properties are all similar and tend to be lumpier. This is because they feature longer term leases, larger leasable areas, and are more capital intensive due to TI allowances, lease commissions, legal costs, and concessions. The cash flows for these properties are largely negative at the beginning due to capital costs, very positive and for extended periods of time during the lease, but can run negative at the expiration of leases due to longer vacancy between tenants. There can also be large changes in revenues when bringing

in a new tenant because market rents may have changed since the last time the space was leased.

Multifamily properties, on the other hand, feature only one- or two-year leases, many tenants, quicker tenant turnover, and shorter vacancy between tenants. As a result, multifamily property cash flows tend to be smoother, more predictable, and in-line with the overall market.

Walk me through a multifamily pro-forma

Multifamily pro formas are more complicated because of larger unit counts, shorter leases with quicker turnover, and increased staffing expenses. Below are the most important differences in a multifamily pro forma.

On the revenue side, you could project income for each individual unit on the rent roll. However, most investors simplify by using the quantity and type of units that rent the same. For example, 45 2x1 units, 25 3x2 units, and so on. You then apply a vacancy assumption to your gross potential rent, and perhaps a concession assumption if you plan to offer a free week or month to attract new tenants. Many multifamily complexes will have other income related to parking, clubroom rental, late fees, and other amenity and administrative charges.

On the expense side, the turnover expense line captures the cost of servicing a unit between tenants. The personnel expense line captures the salaries, benefits, and bonuses of the management, leasing, maintenance, and concierge staff. The maintenance capital reserve ranges between \$350 to \$1,000 per unit per year depending on age and quality.

Note: It may be helpful to think of your owning or managing a large property in the sector when walking through any particular pro forma.

Walk me through a hotel pro-forma

Hotel pro formas deviate from traditional pro formas given their extremely short day-long contracts and emphasis on amenities including food and beverage. The main metrics to

consider when valuing a hotel are ADR and RevPAR.

On the revenue side, key terms include average daily revenue per room (ADR), room occupancy, and revenue per available room, which is ADR multiplied by occupancy.

$RevPAR = ADR \times Occupancy$. RevPAR shows the revenue earned spread over all available rooms in the hotel, **regardless of occupancy**. Additionally, full-service hotels include amenity revenue such as food and beverage and conference room rental. Select service hotels lack these amenities and focus only on the rooms, thus their pro formas are less complicated.

On the expense side, there are staffing, cleaning, laundering, franchise fees (depending on the property) and other operating expenses in addition to the normal taxes, insurance, repairs and maintenance. The result is net operating income, which then flows into the cash flow statement and waterfall to repay debt then equity investors as usual.

In which major real estate sectors would you expect to receive food and beverage income?

First and foremost, hotels receive a meaningful portion of revenue from food and beverage (F&B) income. Using hotel landlord Host's (NYSE: HST) 2019 10K as a proxy, F&B accounted for 30% of total revenue in 2019 (see page 44). This dependence on F&B income sets hotels apart as an operations-heavy business model, much more so than self-storage facilities which are on the other side of the extreme as operations-light.

Seniors housing is the other industry where F&B could be a massive component of income because of on-site cafeterias and similar outlets for dining. You might see a bit of F&B income at high-end office buildings with catering operations and malls if the food courts are operated in-house, but these income streams are far more ancillary and less critical to the core business. Apartment buildings, self-storage facilities, manufactured housing, industrial warehouses, and most other sectors do not incur any F&B income.

What are the key differences between select-service and full-service hotels?

To understand the difference between select-service and full-service hotels, we can play to extremes. On the extreme end of full-service, you could refer to The Plaza Hotel in NYC, the Leela Palaces in India, or the Temple Hotel in Chengdu. These hotels are extremely amenitized with lush restaurants, bars, and desirable conference spaces. Flipping to self-service, think of any old Ramada Inn or Courtyard by Marriott with rudimentary or perhaps zero amenities. They may not have F&B or any conference rooms, really the focus is on providing a bedroom for guests that are more cost-conscious such as business travelers or frugal patrons. Put shortly, the difference between full-service and select-service hotels is their degree of amenitization.

Walk me through an office pro-forma.

The revenue side of an office pro forma will recognize rent from multiple tenants. Then under your rent line will be a “free rent” contra-revenue line, which new tenants often receive for the first few months of their lease. Another major revenue item is tenant reimbursements, which represents the operating expenses that tenants must cover since most office leases are triple-net. Generally, tenants pro-rate their share of reimbursements based on their proportionate occupied square footage.

Operating expenses on an office pro forma comprise the usual suspects: property taxes, insurance, utilities, repairs and maintenance, landscaping, and so on. **The key fact** to consider is that most of these **expenses are reimbursed to the landlord** by the tenants because office leases are often triple-net. Thus, your tenant reimbursements revenue line should mostly negate your operating expense line.

At move-in, new tenants often receive a capital expenditure allowance called “tenant improvements.” These tenant improvements allow the new tenant to outfit their space to their taste. Tenant improvement allowances vary by market; brokers usually know the typical TI allowance for their markets.

The net operating income, then, flows to the cash flow statement to repay debt and then pay investors.

Walk me through an industrial pro-forma.

The revenue line of an industrial pro-forma is far less complicated than an office or mall, and especially less so than a multifamily apartment building or hotel. This is because most industrial leases are single tenants. For example, a distribution center on the south corridor of I-95 that is completely leased by Amazon.

On the expense side, expect lower repairs and maintenance costs. This is because warehouses do not need to be as pretty as a class A office or mall. On the other end, the utilities expense is higher because industrial buildings rely much more heavily on electricity. Thus, the landlord must ensure that those costs are either billed directly to the tenant or properly attributed to each tenant for reimbursement is key.

The rest of the pro forma is typical, with net operating income servicing the debt and then repaying investors.

Walk me through a seniors housing pro forma.

Seniors housing projects tend to fall into one of two categories-

1. a straight lease of the facility by the operator, which would then underwrite like a single-asset deal, or
2. an investment where the operator is simply under contract to provide day-to-day care and management for a fee, but the operator doesn't take the risk of profit and loss in operations.

In the latter scenario, the investor has operating risk, and the pro forma will incorporate the full schedule of operating expenses associated with care for the residents.

On the revenue side there is rent from the residents, but then there are revenues associated with levels of care or with spouses. Levels of care may include assistance with bathing or dressing, therapy services, medications, and so on.

On the expense side, there are costs for housekeeping, meals and meal prep, nursing, compliance, medications, and marketing. Net operating income, then, services the debt and then what remains is paid to the investors.

How do Triple Net (NNN), Double Net (NN), Single Net (N), and Full-Service or "Gross" Leases differ?

First, all leases are similar in that they charge base rent. Yet where they differ is whether and how they collect expense reimbursements over and above the base rent for a leased space.

1. **Triple Net Lease:** the tenant is responsible for paying all operating expenses associated with the leased space
2. **Double Net lease:** the tenant pays their share of property taxes and insurance
3. **Single Net lease:** the tenant only pays their share of Property Taxes.
4. **Full-Service, or Gross Lease:** the tenant has no responsibility for paying any operating expenses at all

Diving Deeper: A fourth type of lease is emerging, sometimes called a Quadra-Net Lease, or Absolute Net Lease. This type of lease makes the tenant responsible for any capital replacements, such as roof, structural replacements, parking lot, mechanicals, and so on. In some investment circles the term Modified Gross is used in lieu of single net or double net. To learn more, check out [A Beginners Guide to Commercial Leases, Part Two: Expenses](#).

What are co-tenancy clauses and what are the benefits and risks?

Co-tenancy clauses are common in retail leases, where smaller tenants often benefit from the spillover business of a major anchor tenant. An example would be a hair salon that benefits from the traffic of a stable and well known nearby grocery store. Co-tenancy clauses typically permit such a small tenant to terminate their lease or significantly reduce rent if the anchor

tenant goes dark. Co-tenancy clauses are especially common in enclosed malls and power centers.

This type of clause is a significant risk mitigation strategy for tenants, allowing them to close stores or **reduce operating costs** if foot traffic drops significantly. For landlords, the benefit is leasing more space, but the risk is that losing the anchor tenant can create a domino effect of store closings and rent reductions that quickly erodes net operating income, sometimes to the point of insolvency.

What types of rent might you expect to see in a retail lease?

The first type of rent you would expect on a retail lease is base rent. This type of rent is akin to your basic apartment rent that is due each month. Using a five-year lease as an example (retail leases are predominantly multi-year), you might agree to 3.0% fixed contractual step-ups so that you'd pay \$100 per month in the first year, then \$103, \$106, \$109, and finally \$112. After base rent, retail landlords often charge overage rent. **The concept of overage rent is simple:** if a store absolutely crushes it, the landlord doesn't want to miss out on that action. **This second type of rent is called percentage rent or overage rent.** Thus, a landlord will often negotiate the right to receive a percentage of total sales revenue or perhaps a percentage only after a fixed dollar hurdle.

Answer this math question with a pen, a sheet of paper, and no calculator within sixty seconds.

The question: A tenant offers to lease 10,000 SF of space of an industrial building (20% of total space), and pays rent at a market rate of \$8 PSF per year. This tenant receives 3 months of free rent upon move-in, it's NNN, and Total OpEx and taxes are \$3 per year. Calculate the Y1 Effective Gross Income (EGI) from the tenant, assuming a January 1 move-in.

The solution: \$8 rent + \$3 NNN = \$11 PSF all-in. \$11 PSF x 10,000 SF = \$110,000 per year. 3 months free rent = 25% discount in year 1, so 75% of \$110,000 = \$82,500 Y1 EGI.

LB Comments: This is a great question to rehearse with different numbers. Challenge yourself to do the math mentally. Also, be aware of sneaky interviewers changing the time frame to a half year (assuming a 7/1 move-in).

Ready to dive deeper? Check out our article: [A Beginners Guide to Commercial Leases, Part One: Income.](#)

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ACCOUNTING QUESTIONS

Walk me through the three most important financial statements.

The three most important financial statements are the income statement, the cash flow statement, and the balance sheet.

The income statement shows the net income for a given period of time according to GAAP, IFRS, or the local accounting standards. Note, net income includes many non-cash items such as depreciation and amortization.

The cash flow statement shows the actual cash generated in a given period. Most cash flow statements work from net income, then adjust for non-cash items and other cash-generating or cash-using items not shown in the income statement to arrive at the total change in cash for the period. This most common method that starts with net income is called the indirect method.

The balance sheet shows the total balance of all accounts at the end of the period, split between assets on one side and liabilities and shareholder equity on the other side. On the asset side, typical accounts include cash, property plant and equipment, accounts receivable, and prepaid expenses. The other side of the balance sheet of course shows shareholder equity, as well as liabilities such as debt, accounts payable, and unearned revenues. The two sides of the balance sheet must always tie, hence the name.

Give examples of major line items on each of the three financial statements.

On the income statement, the major line items are rents, other revenues, property taxes, insurance, depreciation and amortization, interest expense, and net income.

On the statement of cash flows, major lines include: changes in accounts receivable and accounts payable, changes in short term and long term debt, and depreciation and amortization expenses.

On the balance sheet, the most relevant asset line items would be cash, accounts receivable, fixed assets, and total assets. Major liabilities include accounts payable, current maturities of long term debt, long term debt, and total debt.

How do the three financial statements flow together?

The income statement is an accumulation of business activity for a specific period (month, quarter, or year) that reflects profit and loss. The income statement ends with net income. GAAP rules require both cash and non-cash items to be included on the income statement, which you typically back out in the cash flow statement.

Next, the statement of cash flows begins with net income. You typically see non-cash items reversed out of net income, such as depreciation. Additionally, you must factor any many cash activities that do not touch the income statement, such as issuance of debt or capital investment. The statement of cash flows reconciles all of this activity and explains the change in cash period-over-period. The statement of cash flows is the bridge between the balance sheet and the income statement.

Finally, the balance sheet will be impacted by the activity captured on the income statement and the statement of cash flows. On the asset side, depreciation will decrease asset value, and changes in cash will impact your cash balance. On the liabilities and shareholder equity side, net income will impact retained earnings. Any debt issued will increase your total debt balance, and so on. Contrasting with the income statement and statement of cash flows, the balance sheet represents the accumulated balances of assets versus liabilities and shareholder equity at a singular point in time.

Can you please explain the difference between the direct and indirect method for cash flow statements?

There are two methods to prepare a cash flow statement: the direct method and the indirect method. The direct method, though intuitive, is painful for anything but small companies to report and is thus far less common. The direct method begins with revenues and works its way down through expenses to arrive at net cash flow. It is called the direct method because it only considers cash transactions along the way.

The indirect method is far more common. The indirect method picks up where the income statement finishes: net income. Starting with net income, the indirect method adjusts for non-cash items such as depreciation, amortization, and unrealized gains. **The indirect method is the quickest and easiest for accountants to calculate.**

Which single statement is the most important to assess the health of a company? And why?

The statement of cash flows is the single most important financial statement because it eliminates all of the accruals and non-cash items and shows how much cash the company is generating. Cash pays bills, services debt, and compensates investors. The cash flow statement also explains the hidden ways cash can be used up or freed up, or financing strategies that may mask the core operation's ability to generate cash. In lay terms, you can get fancy with reported profits, but you cannot get fancy with cash.

How would a \$10 increase in depreciation affect the financial statements?

As always, I will follow the flow of this change in the order of income statement to cash flow statement to balance sheet.

First on the income statement, a \$10 increase in depreciation would decrease pre-tax income by \$10. Assuming a 40% tax rate, post-tax net income would decrease by \$6. Second, at the top of the cash flow statement, I would adjust net income by \$10 for a net change in cash of \$4. Finally, on the balance sheet, cash would be up \$4 per the cash flow statement and my assets would be depreciated by \$10 for a net change in assets of negative \$6. On the other side, my shareholder equity would decrease by the \$6 reduction in net income. Thus, my balance sheet balances and both sides are down \$6.

When real estate portfolios such as REITs or even private funds report “same store” operating results, what do they mean by same-store?

Real estate portfolios change shape and size every year. Thus, investors and management alike need to somehow distinguish operational metrics that come from existing stores or retained properties from that of properties either opened or closed during the course of the year. Same store operational metrics, such as revenue, expense and NOI, do not consider properties that did not exist in the portfolio for the full extent of two periods being compared. The goal is to benchmark the performance of the core fleet of properties and determine if performance is improving or declining.

As investors, same-store metrics allow us to study organic growth rates. If you were to include new revenue from recent acquisitions or lost revenue from recent dispositions in your figures, your view of performance would be distorted. Thus, same store metrics do a much better job of revealing fundamental performance.

DEVELOPMENT QUESTIONS

Walk me through a real estate development model.

Development models have four main components: (1) cost to build, (2) the construction and lease-up timelines, (3) net cash flow during operations, and (4) the terms of capitalizing the deal.

1. For the first item, **cost to build**, you must consider the land, entitlements, design, permitting, and construction, but the time involved in each is critical as well.
2. The second item, **the construction and lease-up timelines**, determine exactly when you intend to spend your costs, and when your building will be complete enough to begin recruiting tenants. Merchant build models generally forecast a sale of the property at the immediate end of lease-up upon stabilization. Timing is crucial for your IRR.
3. The third item, **net cash flow during operations**, will need to take into account when leases are signed, the amount of TIs and lease commissions involved, and when rents begin. Developments will operate at a net loss until their occupancy breaks even, so it's important your investors understand they will need to fund this operating loss until it is covered by rent. On the expense side, good estimates of operating costs such as insurance, maintenance, and property taxes are critical.
4. Finally, **the terms of the full capital stack** have to be incorporated, including construction and permanent financing, mezzanine debt, if any, and the equity. Many times, the equity will be complicated in development deals, with general partners and limited partners, promoted interests, preferred returns, and tiered waterfalls.

Why are projects that involve construction automatically considered opportunistic investments?

Construction brings a new set of risks to a project that must be mitigated. Cost overruns, entitlement and permitting, weather, material shortages or price swings can impact the budget

or the timeline or both. Furthermore, there's no definite way of knowing if your costs justify the future rents until you can actually start leasing out your space. Just imagine if you can't hit your target rents, you could build an entirely new building, only to realize you'd be lucky to break even at the sale value implied by your stabilized NOI and market cap rates. These increased risks inherent in construction projects require higher compensation to the equity ownership in exchange for taking those risks. That risk profile is what pushes those deals into the opportunistic strategy.

Why is time such a critical assumption in a development model?

Development projects require a considerable amount of time where there is no revenue, and cash is being invested in construction of the property. In many projects, there can be years between the time that capital is first invested until the receipt of first rent. Additionally, the first dollars invested are usually the equity, and those dollars carry the highest return expectations of the entire capital stack. Thus project delays are very expensive, especially since most developer GPs are compensated on IRR hurdles, which are heavily influenced by timing. Yet limited partners are also greatly impacted by delays since their equity, too, is generally tied up in a fund structure with its own IRR hurdles.

Why do development models assume a "perm out" of the construction loan upon stabilization?

Refinancing a construction loan with a permanent loan is a no-brainer since it reduces the cost of debt, marks-to-market the stabilized property's potentially increased value, and allows the owner to raise the LTV and cash out the net proceeds.

1. First, perming out a construction loan **will reduce the cost of debt** on the stabilized project. This is because construction projects are inherently riskier than stabilized buildings. Lenders are aware of this increased risk, and thus charge greater interest rates on construction loans to adjust for their exposure.

2. Second, the **property value of the building could increase once it is stabilized**. This is because stabilized assets have far less to prove about their operational performance than a development project.
3. Third, **stabilized properties can support higher LTVs**. Thus, equity investors can collect an inflow on the net proceeds at the perm out.

Why do you capitalize loan fees and interest expenses during the development period? Why not set aside a reserve?

GAAP rules require that the total cost of completing a project be capitalized, and those capitalized costs depreciated or amortized over an appropriate period of time. Loan fees and construction period interest are considered part of the cost of completing the project, so they should be capitalized. A reserve may be set aside to cover interest expense during lease-up and stabilization, but at that point in the project operations have commenced, and fees and interest expense would be considered operating costs that would be entirely expensed in the current period.

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FINANCING & CREDIT ANALYSIS QUESTIONS

What is the difference between a senior loan and a mezzanine loan?

Why do investors frequently use both on a single deal?

First, you will usually only see mezzanine loans in opportunistic deals because of the risk profile. A senior loan is the loan that has seniority in terms of collateralization. Often this is a bank or CMBS loan that is secured by a first lien on the subject property. Because the loan is secured, there is less risk and the interest rate is the lowest in the capital stack, usually 200-400 basis points above the like treasury. A mezzanine loan is another form of debt, but is either collateralized secondary to the senior loan or is unsecured altogether, and repayment is secondary behind the senior lender. As a result it carries a higher interest rate, often 500-1,000 points above the like treasury. The mezzanine loan has priority of payment ahead of equity, so it has less risk than equity, but more risk than senior debt. Investors will use mezzanine loans because the rates are lower than expected equity returns for opportunistic deals, which usually start at 20%. Mezzanine loans, then, lower the overall cost of capital for a deal and help boost returns to the equity investors.

What do you think are the best kind of deals to finance with CMBS debt?

Any property with less than 70% leverage, average lease term longer than the proposed loan term, a hold period longer than the loan term, and tenants with national credit. If you have all of these, you have a good candidate for a CMBS loan. Most often assets that will qualify for CMBS loans will be Core or Core-Plus, or potentially a Value-Add deal that just signed the last few leases needed to stabilize the property, and the owner plans to hold for the long term. Since CMBS loans are expensive to break, you don't want to put them in place on a project you have plans to exit before the loan matures.

What are the differences between recourse and non-recourse senior debt?

The primary distinction is that a recourse loan requires a guarantee from a financially capable person or entity as additional security for the lender, where a non-recourse loan does not include any such guarantee. Commercial banks are typically recourse lenders, but if the LTV of the property is low enough, usually 60% or less, non-recourse debt from a bank is possible. CMBS and Life Insurance financing is usually non-recourse, but the LTV requirement is 60% or less.

What is the difference between asset-level debt and fund-level debt?

Asset-level debt is a loan against a specific property, where the loan amount and the repayment terms are customized to the cash flow and the value of the specific property being financed. For certain real estate private equity firms, this can be an inefficient financing mechanism because of the time and costs involved with negotiating loans on each property that is acquired.

Fund-level debt treats the assets of the fund as one large pool, and structures a large loan based on the value and cash flow of that pool. With this type of financing, assets are acquired with all cash, and then once the pool of assets is owned, financing is put in place to replenish the fund's cash to continue acquiring assets. This is a very efficient and cost-effective financing strategy for the borrower and the lender, because it allows lenders to place large amounts of capital in one loan, reducing fees, time, and usually the interest rate.

Where would you find information to underwrite the tenants in a commercial property?

The first place to look is for any ratings from the major agencies, S&P, Moody's, or Fitch. For publicly traded companies that aren't rated, analyst reports can be a good source of information. 10-K filings with the SEC or transcripts of earnings calls can also be helpful. Some privately held companies will publish annual reports. In some cases, the listing agent or the landlord may have

access to financial information on the tenants and can release it to prospective buyers under a confidentiality agreement.

What are the differences between a REIT and a private equity fund?

The three major differences are that a REIT is a special type of entity that is required by law to distribute 90% of its income back to owners as a dividend each year, REITs are usually long-term holders of real estate, meaning more than 10 years, and REITs typically use less than 50% debt on acquisitions. A private equity fund, on the other hand, is a very customizable structure that allows management much greater authority in distributing funds to investors, and generally have a hold period around five, or maybe ten years, and may use more leverage in order to help boost returns to investors.

What do you know about Opportunity Zones?

Opportunity Zones are designated areas across the United States that have experienced minimal capital and business investment, usually due to higher levels of poverty and unemployment. Opportunity Zones incentivize investors to re-invest their unrealized capital gains to improve areas of the United States otherwise neglected by capital. New investments in Opportunity Zones exceeding ten years are exempt from capital gains taxes, and 1031 exchanges into an Opportunity Zone project are eligible for a step up in basis of 10% after five years, and another 5% after seven years. Thus, funds targeting development in Opportunity Zones can be very attractive options for limited partners that are more exposed to such taxation. Yet certain limited partners exempt from capital gains taxes, such as pension funds, may not be as drawn to opportunity zone investing.

What is a change in control provision and how might it impact your sources and uses for a take-private M&A deal?

Change in control provisions basically say “if ownership changes, something happens.” That something is detailed in the change in control provision itself. You often find change in control provisions in debt documents, preferred equity documents, and equity awards to management.

With regards to debt, a change in control could trigger an assumption fee, immediate principal repayment, or simply require lender consent. With regards to preferred equity, you could see similar provisions as with debt as well as potential conversion to common. Finally, with equity awards, you generally would expect all unvested restricted stock awards and options to immediately vest, effectively increasing your share count at the date of acquisition.

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M&A QUESTIONS

As succinctly as possible, please describe what corporate-level REPE M&A investors do.

In real estate private equity, the corporate M&A investment teams want to purchase public companies at a discount to their relative value. That means they independently calculate their own opinion of value, then compare their opinion of value relative to the market price. If their independent opinion of value is higher than the market price, that's theoretically free money on the table.

Of course, it's easy to figure out the market price of a company. All you need to do is multiply the share price by the fully diluted shares outstanding then add in the balance of outstanding debt and pref and adjust for non-controlling interest and cash. The difficult part is generating that independent opinion of value. Doing so requires months of effort and intensive diligence. This is a high-level view of the responsibilities held by corporate-level REPE M&A investors, with most time spent developing the independent opinion of value.

What type of positions do most real estate private equity corporate M&A investment funds take?

Most real estate private equity M&A funds pursue long-only, controlling positions. This means that they only buy stocks. They do not short stocks. And when they buy stocks, they buy a controlling majority, usually all of them. That's why buyouts are also called take-privates.

REPE funds prefer to own and control companies because their strategy usually follows three steps: buy it, fix it, then sell it. First, an REPE fund buys a publicly traded company that is either underperforming, underappreciated by the public markets, or both. Second, the fund then fixes what's broken, waits for sector fundamentals to improve, or both. Finally, the fund sells the company once the issue that originally hampered value has been resolved. Shorting a company

is naturally more hands off, since the fund doesn't control management. Without control, shorting does not fit well into the REPE playbook.

Which metric most succinctly indicates whether a publicly traded company is a good relative value investment?

The discount to NAV most succinctly indicates whether a publicly traded company is a good relative value investment. If a company trades at a significant discount to NAV, you should buy that company. Of course, the devil is in the details. A third-party view on NAV must be thoroughly vetted. But once you've done the legwork, and the opinion represents the result of your own thorough analysis, a discount to NAV tells you if an investment is a good relative value investment. In lay terms, if you think the buildings and other sundry assets inside a company are worth more than its outstanding debt and price to purchase every stock at a takeout premium, you should buy that company.

What is a fully diluted share count and why is it relevant to real estate private equity investing?

When you buy a public company, you announce the share price at which you will acquire it. Then, you have to pay every shareholder that price you announced. The most obvious shareholders you need to buy out are the outstanding common shareholders. For any public company, the number of common shares outstanding is published quarterly on the front cover of every 10-K and 10-Q.

However, there are other people that will become shareholders as a result of a take private. The fully diluted share count considers not just the number of common shares outstanding, but also the other people that convert to common as a result of a transaction. These people include in-the-money warrant and option holders, owners of unvested restricted stock units, and unit holders of the REIT's operating partnership. This is relevant to REPE M&A investing because your model should always calculate the total buyout cost by using fully diluted share count.

What is the treasury stock method and how does it relate to fully diluted share count?

The treasury stock method serves to calculate the net shares created as a result of buying out all in-the-money holders of warrants and options. For example, what if we have agreed to purchase a company for \$100 per share, and this company has 100 outstanding warrants at a \$75 weighted average strike price? Well first, every warrant holder is going to exercise at their average \$75 price, so the company will receive \$7,500 of total proceeds for 100 new shares created. Now this is where the treasury stock method comes in. We will then use that \$7,500 to repurchase as many shares as we can at the market price of \$100, which means we'll immediately buy back 75 shares. So we've spent the money we made, and we bought back 75 of the 100 new shares with the proceeds. Thus, the treasury stock method would suggest we generate 25 incremental shares to add to our fully diluted share count when we assume a \$100 take-out price and there are 100 options at a \$75 weighted average strike price.

Please explain how the efficient markets hypothesis impacts take-private investment strategies.

An efficiently priced market would imply that any company's share price accurately incorporates all publicly available information. Thus, public REITs should always trade on par with their underlying asset value. However, the success of REIT take-private investments hinges on the assumption that inefficiency could exist. This inefficiency basically means that investors are pricing a company at a discount its net asset value.

In other words, take-privates only make theoretical sense if you accept that market inefficiency is possible. If markets were perfectly efficient, take-private strategies would not be successful on average over the long term. Yet if you accept that a degree of market inefficiency might exist, then a capable investor could opportunistically exploit fundamental dislocations between net asset value and share price.

What is the capital stack?

The capital stack refers to the debt, preferred equity, and common equity that together comprise the full ownership structure of a company. The most straightforward way to explain the various tranches of the capital stack is to identify who gets paid back first during a bankruptcy. Senior secured debt holders are paid first, followed by senior unsecured, then junior, then mezzanine, then preferred equity holders, then finally common equity holders. Common equity holders are special because they assume the most risk yet are subject to the greatest reward. Private equity invests at the top of the capital stack, hence the name.

Describe seniority. Who is the most senior member of the capital stack? The least senior?

Seniority represents the order in which the various debtholders, preferred equity holders, and finally the common equity holders get paid back in the event of a bankruptcy. If a company goes bankrupt and liquidates for \$140, but it has \$100 of senior debt, \$50 of junior debt, and no preferred equity, then the common equity is completely wiped out. Also, the senior debt is fully repaid and the junior debt receives \$40 of its \$50 principal and owns whatever else may be left of the company. In a basic restructuring that does not result in a liquidation, the junior debt holders would become the new common equity and the old common equity holders would lose everything.

How does the cost of capital scale between each tranche of seniority?

Put simply, the more risk you assume, the more return you demand. So senior secured debt holders expect the lowest return and common equity holders expect the higher return. Mezzanine and preferred equity holders are between the two. For an opportunistic investment, the senior debt holders may only expect a 6% to 7% annual return, but that's because their position is far more secure when compared to the equity holders, who would subsequently target a 20% return.

How does the capital stack impact net asset value?

Net asset value represents the sum of all asset value, known as gross asset value or GAV, less the balance of all debt, mezzanine, and preferred equity. In other words, when you subtract the pre-equity components of the capital stack from GAV, the difference represents net asset value. Net asset value is equivalent to the market cap of a publicly traded company. If a company is trading at a discount to its net asset value, it could represent a good investment opportunity.

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