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Hedge Funds Help Fill Gap In Lending for Property

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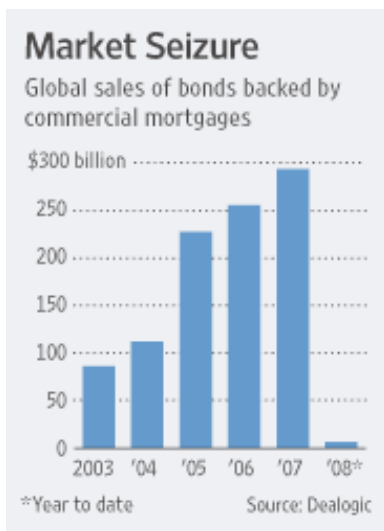
Three months ago, Eric Gray saw an opportunity to scoop up a vacant retail property in New York City's borough of Brooklyn. But he had a problem, one that has been plaguing many real-estate investors and owners: The nation's banks, burned by years of easy credit and the resulting devastating losses, are no longer eager to lend.

So Mr. Gray turned to an unlikely source for money -- a hedge fund. He took out a one-year, \$2.3 million loan from Madison Realty Capital to pay for the \$3.7 million property.

Even though the interest rate on the loan -- at 12% -- is nearly twice as much as a conventional-bank commercial mortgage, the developer took solace in the fact that he purchased the property at an attractive price and was able to close the deal fast. "For the flexibility, I can pay a bit more for the loan," he says.

As the credit crunch enters its second year, more investors seeking financing to acquire office towers, retail stores, hotels and the like are left with little choice but to turn to so-called hard-money lenders, lightly regulated businesses that charge high interest rates for short-term loans.

Right now, among the biggest players in the hard-money arena are hedge funds, which view commercial-real-estate lending as a way to diversify their traditional trading operations while still commanding double-digit returns.



"We're cranking it up," says Judd Shoval, senior managing director of Ambit Funding, a Wilkes-Barre, Pa., firm that has dedicated \$250 million in two hedge funds toward commercial-real-estate lending. David Hecht, president of Metro Funding Corp. in Paramus, N.J., says his firm launched a second hedge fund early this year to accommodate the increased demand for bridge financing from commercial-property owners and developers. "We get deals now we never got before," Mr. Hecht says, referring to some high-quality borrowers who traditionally have resorted to banks for financing.

Hard-money lenders have always played a role in commercial real estate, but mostly on the fringes. In the past, such lenders targeted desperate investors and developers who needed cash fast or had too many credit problems to borrow from conventional sources.

Scrambling for Funds

But now, even commercial borrowers with good track records and decent credit are scrambling for

funding as the market for commercial mortgages issued by banks -- which last year accounted for as much as 70% of the commercial-property financing -- has all but dried up.

Hedge funds have been quick to respond to the drought. Today, as many as 140 hedge funds specializing in distressed assets or fixed-income securities also provide commercial-real-estate lending, estimates Ken Heinz, president of Hedge Fund Research in Chicago.

Mr. Heinz says more hedge funds are looking for opportunities in commercial real estate because the sector offers "higher returns relative to the risk they are taking on." Defaults on commercial mortgages are hovering around levels of less than 1%. By comparison, about 30% of residential mortgages to subprime borrowers are at least 90 days past due.

In addition, hedge funds -- which typically operate large trading desks -- like the idea of generating returns that aren't "correlated to equity and bond markets," says Irwin Latner, head of hedge-fund practice at law firm Herrick, Feinstein LLP.

So far, some investors have been eager to put their money into the funds. Not only do these funds offer returns comparable to those of junk bonds, but investors also generally are comfortable with the risk the funds take on. The commercial-property market has avoided the kind of gigantic losses seen in the residential sector, thanks to the lack of overbuilding.

To be sure, the softening U.S. economy remains a threat. If consumer spending continues to weaken and job losses keep growing, cash flow of commercial properties could be eroded. But the hedge-fund lenders say they are protecting themselves by being much more selective about the loans they make. And unlike investment banks, which got stuck with billions of dollars of commercial mortgages they couldn't sell, the hedge funds plan to hold the loans on their balance sheets, typically for one to two years.

Josh Zegen, a managing partner and co-founder of Madison Realty Capital in New York, says his firm sees more than 500 requests a week, but only about 1% to 2% of them would pass muster.

High Standards

Among other things, he says that most of the properties the firm underwrites must have either enough cash flow to cover debt payments or high enough current value relative to the amount of the loan. The firm doesn't base underwriting decisions on any potential increase in rents or cash flow, a common trend two years ago that today is proving disastrous for some landlords and their lenders.

"We underwrite loans based on today's market and cash flow," as opposed to what the market is expected to be like, Mr. Zegen says. In addition, he says, "we don't want to lend on anything we don't want to own." Also, low leverage is the mantra for many of these lender funds. In the case of Madison Realty Capital, which has \$230 million in equity capital, it typically borrows less than 50 cents for every dollar in equity under management.

The lending model of hedge funds is similar to that of so-called balance-sheet lenders such as life insurers and pension funds, in that the funds make loans and hold on to them, as opposed to selling them. But the key difference is that while the traditional commercial-property lenders make 10- or 30-year loans, the funds lend short term -- often for less than two years -- as they usually take money from their investors for a year or two. They charge rates of between 10% and 20%.

Matthew Hoffman, chief investment officer at Weston Capital Management LLC, says the fund of hedge funds in Westport, Conn., has invested about \$40 million with seven hedge funds that provide bridge financing secured by commercial real estate.

On average, those funds generate returns of 15% a year, Mr. Hoffman says, which allows his firm to deliver to its own investors net returns -- after management fees -- of 12%.

Willing to Pay More

The borrowers, mindful of the lack of available credit elsewhere, are finding themselves willing to pay more for such bridge loans offered by those firms in order to buy time. When the markets turn for the better, as the thinking goes, they will be able to replace those loans with some cheaper debt for the long run.

Still, few expect those funds -- which usually target the market for loans less than \$50 million in size - - to compensate entirely for banks' absence. "The real void is larger transactions," says William Hughes, managing director of commercial brokerage Marcus & Millichap Capital Corp. in Irvine, Calif. "I don't think hedge funds, for the most part, are staffed up to a degree that allows them to make a large number of loans."