

THE REAL ESTATE MAGIC OF ELECTRUM® SYNTHETIC DEBT

Imagine taking out a mortgage to purchase real estate and discovering that you cannot lose your equity in the property if there is a default on the loan. Imagine that the interest rate on the loan is competitive with or better than conventional loans of comparable leverage and maturity.

For corporate buyers, imagine in addition that the accounting treatment of the loan is as good or better than the accounting treatment of conventional loans.

Too good to be true? The short answer was 'yes' until recently, but that's not the whole story.

The short answer was 'yes' simply because of the definition of 'mortgage': a mortgage is debt, and by definition debt must include a claim against borrower assets. Accordingly, buyer equity must risk forfeiture in mortgage finance if there is a default.

The complete answer is 'no,' because the buyer can have property financing with every benefit described above. The only inaccuracy is to view the financing as a mortgage: since buyer equity is not at risk if there is a default, the financing cannot be debt. However, this only means that the financing must be creatively designed equity in the property rather than debt.

Such financings are not hypothetical. Electrum Partners has developed such an equity-based financing instrument, which we refer to as Electrum® *synthetic* debt.

How does Electrum® finance work? There is no free lunch in finance. There must be some additional feature of the property that allows creative financial engineering to develop a low-risk equity substitute for debt. That feature is the requirement that the property be fully leased.

Electrum Partners hasn't attempted to redefine the concept of a fixed-income obligation. Some entity must be on the hook to satisfy the obligation, just as in the case of conventional property financings. In the case of synthetic debt, that 'entity' consists of the lessee(s) rather than the property buyer. The buyer's equity is not at risk.

Leases are analogous to debt in several ways: in both cases, (1) an obligor has a commitment to make specified payments by specified dates, (2) a default can be declared if the obligor fails to make each required payment by the specified time, and (3) the obligor is subject to legal recourse in the event of default.

Proprietary financial technology creates the synthetic debt by enclosing the leases in an equity casing to produce a fixed-income obligation of the lessees with default recourse comparable to the default recourse of lessee debt. The casing does not include any rights with respect to the buyer's equity.

Synthetic debt is a fixed-income obligation that resembles senior *lessee* debt from the financier perspective rather than real estate debt or buyer debt. Synthetic debt provides the property financier with lease default recourse superior to the lease default recourse of mortgage financiers. The superior recourse gives the financier *immediate* recourse against lessees in the event of financing default.

Immediate recourse against lessees in the event of default on the financing is often better protection for the financier than recourse against the buyer. This is always the case with commercial property when

lessees are better credit risks than the buyer or the real estate itself. Accordingly, buyer equity need not be at risk to protect the financier from default-related loss.

Better default recourse implies a lower interest rate on the financing. This raises the expected return on the buyer's investment. The higher expected return is a buyer bonus due to lessee creditworthiness. The basic benefit of lower investment risk is due to the buyer's protection against equity forfeiture.

In short, **real estate leveraged with synthetic debt can have lower investment risk and higher expected return** than real estate leveraged with similar mortgage debt.

There is nothing new about the idea of using lessee credit ratings to lower interest rates on real estate financings or justify higher leverage. Wall Street has even turned a refinement of the technique into a product known as the Credit Tenant Lease (CTL) loan. However, all debt financings of this type share one complicating factor: the financier depends on the lessee(s) for debt service, but default recourse acts against the buyer if the lessee(s) fails to satisfy the obligation. Synthetic debt creates its benefits by redirecting the default recourse against the entity that initiates the default.

Can the technology be applied to all types of real estate, including residential? The answer is 'yes,' but some applications require more support from established financial institutions than others. Electrum Partners expects to apply its patented financial technology to all types of property in the foreseeable future, but for the moment synthetic debt financings are limited to single-tenant commercial real estate with creditworthy lessees and bondable triple-net leases.

What does the buyer need to know about the structure of synthetic debt? In the case of commercial real estate, the answer is 'not much,' because of an additional feature of the financial structure: the synthetic debt and the buyer's equity are both securitized.

Securitization transforms unlimited liability assets into limited liability assets and usually enhances asset liquidity. In addition, securitization turns synthetic debt into a ratable fixed-income security. Accordingly, the main points the buyer needs to confirm are: (1) the buyer's equity position is not at risk from the financier (*i.e.*, the buyer has lower investment risk), and (2) the interest rate associated with the financing is as favorable as described (*i.e.*, the buyer has higher expected return).

The first point can be verified by buyer's legal counsel. As for the second point, institutional financiers base the interest rates of financings on the credit ratings either they or recognized bond rating agencies assign to the financings. The buyer can confirm the credit rating in advance of the financing by obtaining a credit rating for the synthetic debt from an appropriate bond rating agency.

The synthetic debt capital structure for real estate is a cross-disciplinary financial innovation based on a unique fusion of property law, trust law and financial theory. Unlike financial engineering products such as swaps and financial futures, the structure is based on deeds and trusts rather than contracts. Thus, in contrast to swaps and futures, the investment positions cannot be unwound by bankruptcy of any of the investment position holders.

Principals of Electrum Partners developed lease-based synthetic debt, and Electrum Partners is the sole source for the financial product. Property buyers generally, and buyers of single-tenant property in particular, may significantly improve the risk/return profiles of their real estate investments by taking the time to understand the benefits, requirements and constraints associated with synthetic debt finance.

To learn more about the synthetic debt structure and applications, visit our financial technology resource site online at www.syntheticdebt.com. To learn more about Electrum Partners, visit our company web site online at www.electrum.us.