PENSFORD

THE HIDDEN COST OF FIXED RATE DEBT

2020

BACKGROUND

Since interest rates are one of the biggest risks to investor returns, many borrowers opt for longer term fixed rate debt due to the certainty it brings. However, fixed rate debt can have hidden costs that many borrowers don't take into account when comparing term sheets.

Pensford recently assisted a borrower who wanted to implement a more active interest rate strategy to improve returns by reviewing 33 of their recent dispositions to look for inefficiencies in the form of hidden costs.

Here is an overview of our findings.

Asset	Term Mismatch	Prepayment Penalty*	Impact on Effective Rate	Term Premium		Total Effective Rate Increase	Total Interest Expense Increase
Property 1	36	$ 849,688	1.71%	0.52%	$ 258,375	2.23%	$ 1,108,063
Property 2	53	$ 278,222	0.38%	0.51%	$ 370,233	0.89%	$ 648,455
Property 3	38	$ 1,129,350	1.15%	0.82%	$ 802,992	1.97%	$ 1,932,343
Property 4	35	$ 229,306	0.50%	0.37%	$ 170,940	0.87%	$ 400,246
Property 5	36	$ 331,078	0.24%	0.60%	$ 826,278	0.84%	$ 1,157,355
Property 6	49	$ 1,273,586	2.06%	0.97%	$ 601,006	3.03%	$ 1,874,592
Property 7	70	$ 271,841	0.86%	0.08%	$ 25,372	0.94%	$ 297,213
Property 8	72	$ 1,545,163	2.96%	1.57%	$ 820,601	4.53%	$ 2,365,764
Property 9	69	$ 658,535	0.80%	0.32%	$ 264,880	1.12%	$ 923,415
Property 10	68	$ 658,535	0.95%	1.54%	$ 1,067,003	2.49%	$ 1,725,537
Property 11	25	$ 1,271,705	0.70%	0.62%	$ 1,131,358	1.32%	$ 2,403,063
Property 12	48	$ 644,393	0.30%	0.82%	$ 1,780,548	1.12%	$ 2,424,941
Property 13	59	$ 227,104	0.48%	1.33%	$ 631,528	1.81%	$ 858,633
Property 14	32	$ 1,653,801	1.27%	0.48%	$ 624,624	1.75%	$ 2,278,425
Property 15	62	$ 432,818	0.38%	1.17%	$ 1,328,077	1.55%	$ 1,760,895
Property 16	94	$ 821,192	1.67%	1.44%	$ 706,306	3.11%	$ 1,527,498
Property 17	21	$ 632,271	0.80%	0.55%	$ 433,558	1.35%	$ 1,065,829
Property 18	80	$ 2,457,116	3.78%	1.55%	$ 1,007,433	5.33%	$ 3,464,549
Property 19	18	$ 576,864	0.70%	0.44%	$ 360,046	1.14%	$ 936,910
Property 20	55	$ 1,493,650	2.21%	0.90%	$ 608,108	3.11%	$ 2,101,757
Property 21	16	$ 781,595	0.91%	0.56%	$ 483,489	1.47%	$ 1,265,084
Property 22	27	$ 328,251	0.55%	0.83%	$ 498,258	1.38%	$ 826,509
Property 23	76	$ 1,746,260	5.15%	1.14%	$ 386,232	6.29%	$ 2,132,492
Property 24	73	$ 2,362,192	5.07%	1.45%	$ 675,622	6.52%	$ 3,037,815
Property 25	4	$ 415,435	0.25%	0.22%	$ 365,226	0.47%	$ 780,662
Property 26	9	$ 41,195	0.15%	0.28%	$ 77,926	0.43%	$ 119,121
Property 27	38	$ 1,471,332	2.08%	0.52%	$ 367,217	2.60%	$ 1,838,549
Property 28	74	$ 1,817,038	4.66%	1.09%	$ 424,686	5.75%	$ 2,241,723
Property 29	24	$ 888,950	1.31%	0.63%	$ 428,343	1.94%	$ 1,317,294
Property 30	24	$ 97,901	0.18%	0.62%	$ 331,793	0.80%	$ 429,694
Property 31	21	$ -	0.00%	0.71%	$ 507,303	0.71%	$ 507,303
Property 32	2	$ -	0.00%	0.00%	$ -	0.00%	$ -
Property 33	0	$ -	0.00%	0.00%	$ -	0.00%	$ -

HISTORICAL ANALYSIS – PORTFOLIO

Across all loan types, this borrower's average loan term was 90.5 months.

Across all loan types, on average, they prepay 43 months prior to maturity.

- Only four loans were held to within 15 months of maturity
- Only two loans were held to within 3 months of maturity

Lender Type	Average Loan Term	Average Hold	Average Term Remaining
LifeCo	110 months	54 months	56 months
Agency	94 months	49 months	45 months
Bank	63 months	34 months	29 months

This, in turn, has resulted in additional costs:

1. Prepayment – the borrower has paid more than $27mm in prepayment penalties in the last four years.
2. Term Premium – by taking a longer fixed rate than necessary, they have overpaid by $18.3mm.
3. Floating – had they chosen floating instead of fixed on just the deals most likely to be prepaid early, they could have saved an additional $8.8mm.

1. PREPAYMENT ANALYSIS

Long term fixed rates offer the appearance of certainty, but when combined with prepayment penalties, they frequently exceed the perceived benefit of avoiding higher floating rates or refinancing in a higher rate environment.

In the last four years, this borrower has paid more than $27mm in prepayment penalties.

Lender Type	Average Prepayment Penalty	
LifeCo	$	1,262,687
Agency	$	963,594
Bank	$	350,204

Prepayment penalties are driven in large part by the amount of term remaining on the loan. If this borrower had just one year less of remaining term, they could have saved $8.7mm.

- This suggests they don't need to be overly aggressive when choosing terms in order to mitigate some prepayment penalties.

When converted to an interest rate ((penalty / hold period in years) / loan amount), **the prepayment penalties increased the borrower's average interest rate by 1.09% over the average hold period.**

2. TERM PREMIUM ANALYSIS

Generally, longer term fixed rates translate into higher interest rates. For example, a 10 year fixed is usually higher than a 7 year fixed rate.

We examined what the original index rate was (e.g. 10T) and what the ideal rate would have been based on the actual hold period (e.g. 7T) at closing for all 33 loans.

Had the borrower been able to match the term of the fixed rate with the ultimate term of the hold period, they could have saved $23.8mm in interest expense. Converted to an interest rate, **the term premium increased their rate by 0.69%.**

3. FIXED VS FLOAT

18 of the 33 loans we examined were held for four years or less. Those loans were paid off, on average, 50 months prior to maturity.

Floating almost always is cheaper than fixed. Given this borrowers aversion to rate risk, they would likely only consider floating on those loans that are most likely to be prepaid within four years.

Of the 18 loans that were prepaid in under four years, the average savings the borrower could have achieved by floating would have been 0.88%. **This translated into higher interest expense of $8.8mm.**

If we extend this analysis to all 33 loans, they could have saved $34.3mm by floating instead of fixing.

CONCLUSION

The mismatch between term and actual hold period has resulted in the following:

	$ Amount	Interest Rate
Prepayment Penalties	$27.3mm	+ 1.09%
Term Premium	$18.3mm	+ 0.69%
Total	$45.6mm	+ 1.78%

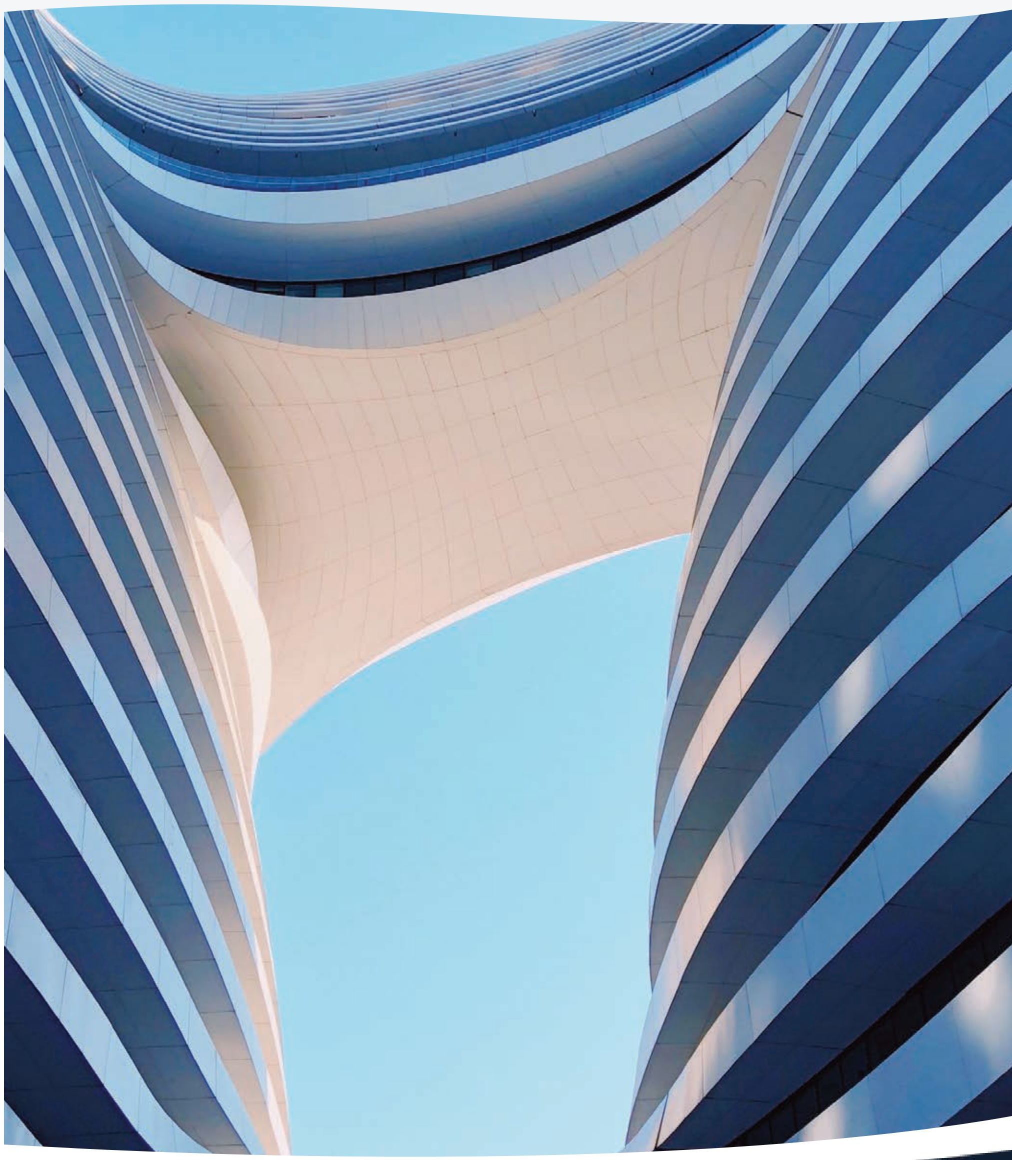
Additionally, choosing floating on the deals held four years or less could have resulted in additional savings of up to $8.8mm.

Borrowers should focus on matching the duration of the fixed rate with the expected hold period of the asset.

Borrowers who traditionally opt for fixed rate debt, when appropriate, should at least consider floating rate options on a case by case basis.

For a more in-depth analysis on optimizing debt strategies, please give us a shout or visit:

- https://www.pensford.com/resources/optimizing_debt_strategies



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READY TO DO BUSINESS WITH US?

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