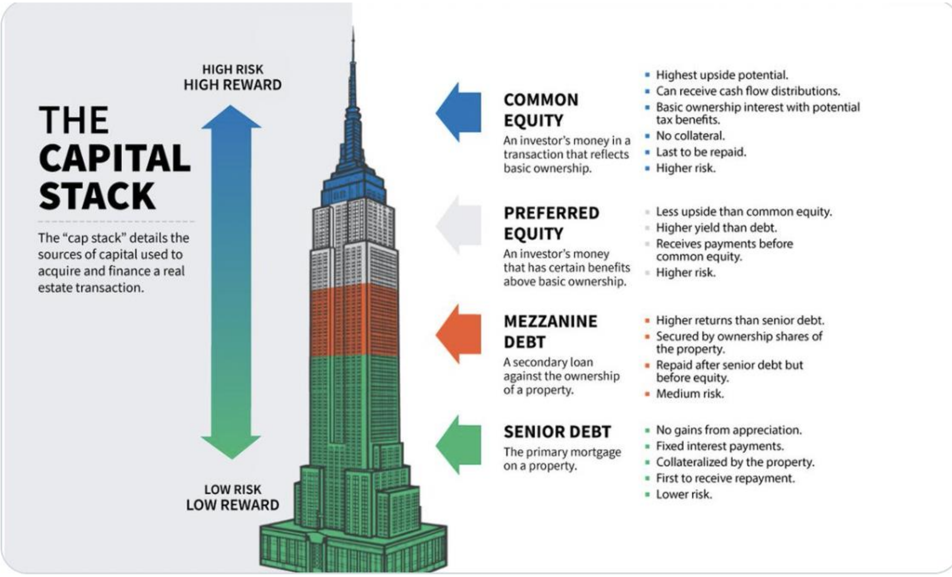
Everyone loves big IRR projections in real estate offerings.



When you see a projected IRR of 15%+ it is important to understand how the IRR is being achieved, great deal with juice or sponsors taking a ton of risk w/ leverage? To figure this out you must understand the Capital Stack.

Additionally, in situations where LPs receive a capital call for an investment, understanding the capital stack can help make well informed decision on whether to double down or cut losses.

The capital stack typically consists of up to four layers:

Common Equity

Preferred Equity

Mezzanine Debt

Senior Debt

Each layer plays a distinct role in financing and shaping the investment structure. As you add on more and more debt the risk to equity grows.

Starting at the bottom, Senior Debt is the primary layer of financing in the capital stack. It holds the first lien on the property and has the highest priority for repayment. This debt is secured by the property itself, providing stability and lower returns to the investors in this portion of the capital stack.

Above Senior Debt, we have Mezzanine Debt, which is higher-risk, higher-yield financing. Mezzanine lenders occupy a subordinate position to Senior Debt but rank above Equity Investors. This layer fills the gap between Senior Debt and Equity, providing additional leverage (and risk) to the equity holders.

Next is Preferred Equity, which combines elements of debt and equity for investors that own this portion of the capital stack. Preferred Equity investors receive a fixed return, similar to debt holders, but also are entitled to upside potential, akin to equity holders.

The topmost and riskiest layer of the capital stack is Common Equity, representing ownership in the real estate project. Common Equity investors have the highest risk and potential for returns. They participate in the project's profits but are the first to suffer losses if things do not go as planned.

Now we need to ask "what does the Capital Stack have to do with projected IRR?" Remember, Debt is first money out and the upside is capped If the property value increases and is sold, Debt is paid off and Equity gets the upside. Less equity used equals higher % return to equity.

When it works out investors are happy, and everyone makes a lot of $$$. Unfortunately, Debt is risky and if things do not go as planned the Equity Investors can be wiped out. This can happen if:

Interest floating debt and rates increase

Unexpected vacancy

Renovation projects go over budget

Asset prices fall

What this means to investors: Projected returns play an important roll in considering an investment. However, high projected returns should not sell you. You need to understand the capital stack and how the high IRR is achieved.

Don't let a flashy IRR lure you into a deal full of risk that you do not fully understand.