



Asset Financing: Residual Value Insurance (RVI)

Case Study: Property

Residual value insurance is an innovative product that can play a significant role in the purchase, sale and financing of both leased and sale / leaseback commercial property transactions. In the current climate, it may be a requirement of most lenders involved in these types of transactions.

The function of residual insurance is to indemnify the insured against a loss that might occur if the sale proceeds of a properly maintained building is less than the asset's insured reversion or residual value at the point specified in the insurance policy.

It protects the lending institution against the risk of a decline in the market value of a financed asset. What the residual insurance policy does is guarantee to the lender a specific financial amount for an asset at the termination of a lease or when the balloon payment on a mortgage is due.

Residual value insurance can create what is known as "synthetic equity" in an asset. The following outlines the benefits that residual value insurance may add to a property transaction.

Assuming a \$5 million mortgage amortized over a 15-year (180 payments) term at an interest rate of 5 percent, monthly payments would be \$40,143. By guaranteeing the balloon payment, or residual value for \$2 million, monthly payments would be reduced to \$24,086, yielding savings of \$2,890,260 over the term of the loan.

Assuming the same interest rate and loan term, but keeping monthly payments at \$40,143 the loan amount could be substantially increased from \$5 million, allowing the borrower access to additional finance.

The cost of the residual value policy would generally run between 3 and 6 percent of the residual value, or in the above scenario between \$60,000 and \$120,000. The cost of the premium would be paid at the initial time of funding.

Recent deals have included the purchase of a building that was leased long-term to a tenant with substantial cash-flow but marginal credit due to significant debt it had taken on during expansion of the business. The other involved the sale/leaseback of a corporate headquarters facility where the corporate entity was able to raise capital, but at the same time keep the balance sheet in-line.

Loan amounts are typically between \$5 and \$100 million and a lease term of 15 - 25 years is preferred. The RVI (balloon guarantee) is typically 30% - 45%, but higher limits would be considered on select properties. Premiums, based on risk and limits, are typically 4% - 6% of the insured value.

Fixed data for examples	Mortgage without RVI	Mortgage with RVI
Interest Rate	5%	5%
Cap Rate	8.5%	8.5%
Loan Term - Years	15	15
Amortisation - Years	15	20
Lease Term - Years	15	15

Example - increase cash flow	Mortgage without RVI	Mortgage with RVI
Loan Amount	£20,000,000	£20,000,000
Annual Payment	£1,926,846	£1,604,852
Lease payment @ Cap Rate	£1,700,000	£1,700,000
RVI (Balloon) Amount		£6,948,168
Cash Flow	-£226,846	£95,148
Reduction in Mortgage		£321,994
Total reduction over lease		£4,829,910
Less RVI payment @ 5%		£347,408
Total reduction over lease		£4,829,910

Example - increase loan proceeds	Mortgage without RVI	Mortgage with RVI
Project Cost	£20,000,000	£20,000,000
Loan Amount	£14,704,516	£17,654,798
Debt Service Coverage	1.2	1.2
Annual payment	£1,416,667	£1,416,667
Equity	£5,295,484	£2,245,202
Balloon as % of cost		40%
RVI payment on Balloon @ 5%		£400,000
Increased Leverage		£2,950,282
Reduced Equity		£2,550,282