PNC’s Derivative Products Group is structured to provide integrated coverage for real estate clients looking to hedge construction and permanent loans from a single platform.

With personnel in key U.S. regions, supported by an experienced and efficient operations staff, we offer insight into current market challenges, including comparisons to historical conditions, capital and risk management issues and regulatory changes.

A CLIENT-CENTERED APPROACH
CONSTRUCTION PHASE HEDGING
HEDGING FOR PERMANENT LOANS

RISK MITIGATION STRATEGIES BUILT FROM EXPERIENCE

PNC’s Derivative Products Group provides hedging solutions. We currently manage interest rate derivative transactions of $242 billion notional consisting of more than 10,800 active trades, as of December 31, 2018. We take a relationship approach to our business, focusing on expanding client relationships over the long term.

MANAGE INTEREST RATE RISK FROM A SINGLE PLATFORM

HEDGING FOR THE CONSTRUCTION PHASE

Hedging strategies to address interest rate risk during the construction phase of a project can be designed to be consistent with your strategy for approaching interest rate risk.

To mitigate the risk of short-term interest rates increasing during the construction period, you can enter into an accreting interest rate swap to fix the floating rate index. In the accreting swap, the size of the swap increases over time in predetermined amounts based on expected loan draws.

This structure gives the client the ability to have known payments for the hedged amount during the construction phase.

Risks associated with swaps include:

- Floating interest rates can average less than the swap rate over the term of the swap, and the value of a swap contract is subject to market conditions.
- If a company terminates part or all of its swap contract prior to maturity, there will be an associated termination value that the company is owed or owes.

To protect against rising rates during the construction phase, you can enter into an interest rate cap. An interest rate cap is an agreement between the seller (PNC) and a buyer (the borrower) to cap the floating rate index to a specified rate for a specified period of time.

The buyer (borrower) will receive a payment from the seller (PNC) when short-term rates rise above the cap strike rate. The notional amount set to calculate the premium of the cap may be a set amount or can be accreting to match the draw schedule during construction.

There is an upfront cash payment from the buyer associated with a cap. Once the premium is paid, the buyer of the cap has no further obligations. The premium is non-refundable, even if the buyer (borrower) does not receive any payment from the seller (PNC) because short-term rates do not rise above the cap strike rate. In the event the construction is completed prior to the maturity of the cap, the cap may be sold back to the seller (PNC) at the then-current market price (as determined by the seller, PNC).

pnc.com/realestate
HEDGING FOR PERMANENT LOANS

There are a number of useful hedging structures that can be used to manage interest rate risk during the takeout phase of a real estate development. Each of these can be tailored to the specific needs of the borrower.

If your debt is indexed to a U.S. treasury security, a treasury lock may limit your exposure to the rise in yield of a U.S. treasury security. A treasury lock is used to hedge the rate of a specific treasury security for a future funding date. On the funding date, the buyer (borrower) of the treasury lock receives a payment from the seller (PNC) if the yield on the referenced security is above the locked-in rate and the buyer (borrower) makes a payment to the seller (PNC) if the yield on the referenced security is below the locked-in rate.

If your funding date is longer than six months, a forward starting interest rate swap can hedge a potential future refinancing of a construction loan by synthetically locking in a forward interest rate swap to hedge a floating rate term loan take-out of the construction loan. On the funding date (swap start date), the borrower receives a payment from PNC if the market rate is above the locked-in swap rate and makes a payment to PNC if the market rate is below the locked-in swap rate.

If you are exposed to rising interest rates on a future borrowing, a swaption can mitigate your exposure while retaining the benefit of lower rate movements in the future. A swaption is an option typically used to hedge against swap rates rising above current levels with the swaption setting a maximum swap rate. There is an upfront cash payment from the buyer (borrower) associated with a swaption. If on the future funding date rates are higher than the swaption rate, the buyer (borrower) can exercise the option; if rates on the future funding date are lower than the swaption rate, the swaption expires worthless and the buyer (borrower) funds its borrowing at the lower rate.

MEETING CLIENT NEEDS IN THE REAL WORLD

REIT benefits from bank term debt and favorable rate profile

A public real estate investment trust (REIT) based in Pennsylvania was facing the maturity of its existing unsecured senior note and its existing five-year unsecured bank term loan. PNC Real Estate recommended bank term debt as more cost-effective than unsecured notes and sourced, and then closed, a seven-year unsecured term loan deal. The ability to lead and syndicate the term loan differentiated PNC Real Estate’s offering from those of other banks, while PNC’s financial strength and team approach helped to seal the deal. The client also obtained an attractive synthetically fixed rate profile by executing multiple hedges over time.

Privately owned developer reduces equity requirements

PNC Real Estate has provided more than $100 million in financing for acquisitions and ground-up development to a privately owned real estate company. The company maintains a conservative approach to interest rate risk and regularly elects to swap the mortgage loans that finance its stabilized real estate holdings. The company has also used derivatives to hedge interest rate risk during construction, allowing PNC Real Estate to underwrite more aggressive interest reserve levels, reducing overall equity requirements for the company.

Past performance is not indicative of future performance or success.