Land Acquisition and Development Finance Part V

In last month's "Learn" article, we discussed development financing. This article will discuss financing structures for development using OPM (Other People's Money).

Balancing Debt and Equity Financing

The majority of real estate developers look to increase their potential investment return by using "other people's money" (often called OPM). Assuming that the rate of return for the project is greater than the interest rate for the debt, the more debt placed on a property, the higher the potential return. However, the use of borrowed capital to make an investment, called leveraging, does not always guarantee a return. Negative leverage, sometimes referred to as reverse leverage, is a situation in which the project experiences losses or is earning profits at a lower rate than the mortgage interest rate. Consequently the developer receives less of a return by leveraging than he would have had he been able to finance the project with no loan. This is because the developer must pay the lender a greater rate of return for the use of the borrowed money than that earned.

Also relevant to the debt and equity balance is the risk related to recourse lending. A recourse loan is a loan in which the borrower is personally liable for the debt in the event of a default. A non-recourse loan is one in which the borrower is not personally liable for the debt. A non-recourse loan is more risky for lenders because they must look only to their collateral, or any other signer on the loan, for repayment in the event of a default.

Generally a smaller developer will be required to personally guarantee the loan. As in all investments you must balance risk with return. Debt financing has the lowest cost, but the highest risk. With debt financing if the payments are not made timely, in accordance with the agreements, the lender may chose to foreclose on its collateral. The borrower can lose the property, all its equity and may be liable for any deficiency to the lender. Equity financing has a much higher cost, but a lower risk. Equity money is sometimes referred to as "patient money" for the reason that equity investors assume more risk. They often lend without requiring collateral to secure the loan and offer more timeline flexibility for receiving a return. The more equity in a deal, the less risk of an unsuccessful project due to cash flow needs. However, there is less return because the equity investor requires a higher rate of return than a lender. The more debt financing (the greater the leverage), the higher the total return to the developer because the lenders interest cost is generally significantly below the rate of return that would be paid to an equity investor. There is higher risk though because if the lender is not paid in time, the entire project can be lost. Thus, the combination of over leveraging and a cash shortage is a common cause of project failure. To maximize your return on a project, use a strategic mix of equity and lender capital. Consider these tips to appropriately balance the mix.

Leverage Low Risk. If you feel comfortable with the risk, that is, you project enough cash flow to pay the debt service including a safety factor contingency, then leverage is the appropriate strategy to maximize returns.

Use Equity for the Gap. Use equity financing to cover the difference between what you can borrow and the total amount you require to do the project. The equity investors' return often takes the form of a share of the profits paid after the lenders are repaid their loan and interest. Consequently the equity financing involves more risk to the investor and equity investors require a higher rate of return than the interest rate that lenders chose. To the extent that lower rate lender debt can be substituted for higher cost equity money, the developer benefits from the increase in total profits resulting from the lower overall cost of the project financing.

Replace Equity Financing. Replace equity financing with bank financing as quickly as possible. This will lower your initial cost of financing to increase your project return.

Interest and Fees Over Profits. Whenever possible, pay a fixed rate of return to investors rather than a share of profits. This limits the potential payout to investors and maximizes your return.

PUBLIC FINANCING

The public sector offers a wide variety of land development financing alternatives to the real estate developer. These include, tax increment financing, tax abatement financing, and special service district assessments. Each type of financing has its advantages, disadvantages, and special regulations, and are not available in every instance, so it is important to investigate them carefully.

Tax Increment Financing

Tax increment financing (TIF) is most frequently used with larger mixed-use projects involving commercial property. Aimed at the redevelopment of run-down neighborhoods, TIF is based on the assumption that redevelopment increases property values. Following this assumption, the increase in property values leads to the "increment" component of tax increment financing. The increment in revenues is the difference between the municipality's income from property and sales taxes in the area prior to redevelopment as compared to after redevelopment.

These programs appeal to developers because the increment of taxes generated by their projects constitutes an additional source of funds that are not typically available to developers. This increment becomes available to help pay for certain project costs. For example, imagine you are a developer with a mixed-use project that you need to finance. You calculate how much of a tax revenue increase your project will generate. This incremental funding amount then typically can be used in two ways:

- It can pay directly for development improvements.
- It can be pledged to the retirement of bonds issues by the municipality at the onset of the redevelopment program.

For a developer who anticipates large expenditures for land acquisition and/or infrastructure, and who can present convincing evidence that the redevelopment will generate significant increases in land values (and the corresponding increase in tax revenues), TIF offers a potentially significant source of funds.

Tax Abatement Financing

Tax abatement programs encourage developers to undertake development projects because they offer relief from taxes. Through these programs, developers are relieved of all or part of the taxes on certain property during a specific time block. This serves as an incentive for development. Tax abatement financing frees developers from ordinary financing restrictions and thereby makes other improvements affordable or additional financing obtainable. Any individual or group can take part in a tax abatement program. Many states have adopted tax abatement programs tailored specifically for large groups of property owners. Check with your state's department of commerce to see if they have such a program. It is also possible that a portion of a project can qualify for tax abatement financing.

Special Districts

“Special district” is a general term that can include any of a number of geographically based jurisdictions created to carry out a specific function or functions. Depending on the State, these include:

- Tax districts
- Public improvement districts
- Single-purpose districts
- Community facilities districts (CFD's in California and Arizona)
- Metropolitan utility districts (MUD's in Texas)
- Metropolitan service districts

Such districts are often used to finance land development where a public purpose can be demonstrated. Public improvement districts are established within the boundaries of an existing municipality, or occasionally a county, while a metropolitan service district is established in an unincorporated area. Developers have relatively little control over their creation.

Because of the special characteristics of service districts, developers use them more frequently to finance infrastructure than the other types of special districts. A metropolitan service district can issue bonds, the proceeds of which are used to pay for the specified infrastructure. They usually issue general obligation bonds. Investors especially like the tax-exempt status of these bonds. The cost associated with bond financing, beyond the actual cost of the infrastructure, is usually added to the purchase price of the residential units in the funded project. A combination of property taxes and fees are collected to pay the debt service on the bonds and the operating costs of the district.

EQUITY FINANCING

This type of financing can be used for land acquisition, land development, and project construction. In relation to land acquisition financing, equity financing often makes up a large part of the total financing package. Equity is the funds contributed by the owners and/or investors, which together with debt provide the capital needed to acquire and/or develop the asset. Because equity is typically subordinated (junior) to debt, it is considered riskier for the provider. Typically, all operating costs for the project, and all debts, must be paid before the equity investor realizes any return. However, equity providers are often allowed to receive partial distributions even before debt has been fully repaid. Listed below are five methods of securing equity capital, in addition to that contributed by the developer/owner. These methods are joint ventures, syndications, private investors, mezzanine lenders, and management agreements.

Joint Ventures

A joint venture involves you and one or more outside parties who join forces to provide capital and/or expertise for a project. You provide the expertise, and, in some cases, also make a capital contribution. Other investors can include builders, pension funds, domestic and foreign investment groups, and wealthy individuals. Joint ventures are structured in a variety of legal forms, including general partnerships, limited partnerships (used for syndications), and corporations in which the parties hold stock.

Landowners selling to developers also frequently become equity participants in joint venture activities. The landowner typically contributes land to the project in return for a proportionate ownership interest in the project. The land may also be entered into the deal at a negotiated price, which usually covers in full the equity needed to obtain development financing. The landowner may hold a mortgage that is subordinated to the development loan. Cash flows can be distributed on a priority basis. For example,

- First, the landowner is returned the land value.
- Second, the landowner receives a preferred return on the equity.
- Third, you, as the developer, receive a development fee.
- Fourth, you split the remaining profits with the landowner.

An equity investor's confidence in you as the developer, the perceived risk of the project, the amount of equity required and your commitment all help to determine how much control they want over the project and the rate of return they will require for their investment.

Common components of joint venture agreements are:

- Goals of the partners—Individual goals should be aligned with each other.

- Risk allocation—All partners must identify and agree on the amount of risk each is willing to take.

- Amount of capital—The agreement records what is to be contributed, by whom, and when.

- Return distribution—The agreement specifies the returns to each of the partners, including any preferred return, as well as the distribution of the cash flow, tax benefits, and reversion.

- Loss distribution—The distribution of responsibility for any losses must be designated.

- Additional capital sources—The agreement details the agreed upon method for raising additional funds, as needed.

- Dispute resolution—The agreement outlines a dispute settling method, as well as provisions for withdrawal or death of a partner.

<u>Builder Cooperative Agreements</u>.

In a builder cooperative agreement, you and other builders share the risk and combine their equity and borrowing power to acquire and develop a larger project than they could take on individually. The co-op can be organized in various ways, such as:

- Each co-op party can assume different responsibilities within the project. For example, one party could be responsible for entitlement and another supervises construction of the improvements.

- Parties may prepare written agreements on architectural standards, types of building materials, number of speculative houses, quality of construction, and amount of advertising. Consensus around these considerations becomes important if co-op parties will build in the same subdivision.

- Parties can contribute service for a fee or not. For example, a builder can receive a fee for the work provided or voluntarily contribute their expertise and services.

- After development, parties can share lots by lot draws or sales of the lots to themselves at determined prices.

Co-op arrangements can have a great degree of flexibility. They are a good way for small builders to become involved in a large project.

<u>Syndications</u>

Syndication involves raising cash by selling ownership shares in a project through either a private or a public offering subject to the very strict regulations of the Securities and Exchange Commission. The cash is used to acquire land and develop the project. Because of their complexity and large amount of capital involved, developers often use a professional agency, called a syndicator, to arrange the syndication while assuming the role of information liaison of information between the lender and the investors.

Syndicators act as middlemen, who market the ownership shares to prospective investors. Or they can also purchase the ownership shares from the developer and resell them. They receive a fee, usually upfront, for their services but they can also receive a percentage of the profits based on performance as all or a part of their fee.

- If the syndicator acts as a middleman, developers often remain as general partners in the project

- If the syndicator actually purchases the ownership shares and resells them, the syndicator becomes the general partner and developers remain to provide expertise on a fee basis.

There are advantages and disadvantages to each arrangement. From your perspective as a developer, the trade-off is between liability and control. The amount of liability you incur depends on whether you are a general partner or not. Conversely, if the syndicator becomes the general partner, you lose control over the project. However, in exchange for loss of control, you receive a guaranteed fee and incur no liability. If you wish to remain the general partner, you must be willing to assume a great deal of risk. Prior to the 1986 Tax Reform Act, syndications were a primary source of equity capital for development. The Act eliminated many of the tax benefits that made syndications so attractive. They are now used much less often but may become more attractive as tax laws change.

Mezzanine Lender

A mezzanine lender provides a second loan, subordinate to a first lender, for the balance of the equity portion needed to complete the financing of a project that is not provided by the first lender. The mezzanine lender can be used to finance land acquisition, improvements, and unit construction. These loans may be secured or unsecured, but are generally secured and can be made for up to 100 percent of cost not to exceed 75 percent of the loan-to-value. The term of this loan type is generally 12 to 36 months with personal guarantees. The loan can be structured with an interest reserve for the first lender and a project overhead draw. Much like a construction loan with an interest reserve, the interest is paid from the loan instead of the cash flow. The overhead draw finances your indirect expenses (i.e. salaries, insurance, rent, office supplies, utilities, etc.) to run the project. Lenders generally charge 1 to 3 percent above the prime rate. You pay the lender monthly interest, unless funded in the loan, and upfront fees of usually 3 percent. When each unit is sold and title is transferred to the purchaser, you pay an additional release price fee of up to 10 percent of the loan amount being paid off or "released" at the time of closing, along with both principal and any outstanding interests.

The main advantages of a mezzanine loan as compared to investor joint venture equity are that you receive all the profits, the lender has no ownership, and you retain day-to-day control.

Management Agreements

As an indirect method of equity financing, you can enter into a management agreement with an investor. These are also known fee-development agreements. A typical management agreement might provide for an investor to acquire an identified parcel of land and hold it in its own name. You would agree to perform the entitlements process, the development, and the ultimate sale of the property. The investor pays for the out-of-pocket costs. When the property is sold, both you and the investor are reimbursed any out of pocket costs, the investor receives an agreed return on his investment, and you are then paid a fee based on a percentage of the profit of the project.

Management agreement arrangements present no or low-risk advantages. They provide equity financing without personal risk. Conversely, these agreements offer lower returns. The investor typically retains a substantial portion of the profits resulting in a higher total development cost than commonly realized through bank financing.

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