Land Acquisition and Development Finance Part VI

In last month's "Learn" article, we discussed financing structures for development using OPM (Other People's Money). In this article we will discuss organization business structures and selecting a lender.

BUSINESS STRUCTURES

After determining the goals of the project and the approximate amount of financing needed, you must decide on the legal structure of your business. You should make your decision based on the impact of the legal structure on your liability, initial cost, government control, impact on income taxes, and the management process desired. There are several types of business structures, each with unique legal liabilities, risks, tax liabilities, and benefits. They are:

- Sole proprietorships
- Partnerships and joint ventures
- C Corporation
- Subchapter S Corporation
- Limited liability company (LLC)

Sole Proprietorship

A sole proprietorship is a business owned and operated by one person. A sole proprietorship is the simplest, most flexible, and easiest structure to organize. The owner has the freedom of decision-making and government control is minimal. Also, record keeping can be less formal than for other structures. While there are some minor costs of doing business, they are typically less than under other legal structures. The owner files a single, personal tax return and is allowed to deduct losses from personal income. On the downside, the owner of a sole proprietorship has personal liability for any legal or financial problems in the business. For example, if the business earns taxable income, tax may have to be paid with the owner's tax return even if no cash is drawn out of the business.

Partnerships

A partnership is a business formed by two or more people joining as co-owners. It involves both shared risk and reward as all co-owners are liable for company debts to the full extent of their personal assets. Advantages to a general partnership structure include informality and flexibility. Business practices in the general partnership are usually simplified to include straightforward rules for organization and liquidation, arrangements for capitalization, profit and loss allocation, and voting rights. Tax benefits flow through to the individual partners, and the partnership itself is not taxed. However, like the sole proprietorship, a general partnership also runs the risk of unlimited liability of the partners. Each partner is an agent and a principal, thereby making him or her liable for the acts of all other partners.

Within the classification of general partnership there are two common types of partnership formed: the joint venture and the limited partnership.

Joint Ventures. A joint venture is a commercial understanding by two or more persons or entities organized to accomplish a single purpose. It differs from a partnership because its existence continues only as long as its specific purpose continues. It requires a common interest in that purpose, and the parties must have some right to direct and govern the conduct of each other in all aspects relating to the project. The expectation of a profit and the sharing of that profit are indispensable elements. If there is not any express agreement about sharing profits, an agreement for the equal sharing is implied.

Limited Partnerships. In a limited partnership, certain partners are designated general partners, and some are designated limited partners. The potential liability for limited partners is limited if certain legal requirements are met. Some limited partners have no control over the business and only take a limited profit/loss. The limited partnership used to be the most common form of partnership for real estate development. Tax benefits pass through to all partners (including limited), and the partnership itself is not taxed. More recently, other structures, such as the Limited Liability Company (LLC), and S Corporation have gained in popularity over the limited partnership due to their advantageous features related to owner liability and taxation.

C Corporation. A corporation is a business that is treated as a single legal entity and is owned by its stockholders whose liability is generally limited to the extent of their investment. The ownership of a corporation is represented by shares of stock that are issued to people or to other companies in exchange for cash, physical assets, services, and goodwill. The stockholders elect a board of directors, which appoint officers that then direct the management of the corporation's affairs.

A corporation offers stockholders insulation from personal liability thus it allow the conduct of business free of risk while at the same time enjoy full participation in the rewards. Generally, stockholders can transfer their stock interest freely. However, the incorporators are subject to more state and local regulatory control than business owners organized using other business structures. The State in which the corporation is registered, and any other state in which they do business, has the right to levy initial and annual incorporation fees and franchise taxes. Additionally, the profit is taxed twice—first the corporation pays tax on it; second the shareholders pay tax on dividends they receive.

Subchapter S Corporation. A subchapter S Corporation (S Corp) is a corporation that elects to be treated as a partnership for income tax purposes. Income and losses are passed through to the stockholders up to the amount invested. Net income is then declared by and taxed to the stockholders. To be eligible for this election, a corporation must meet certain requirements as to the kind and number of shareholders, classes of stock, and sources of income. The S Corp structure is attractive for spouses or other small groups of investors involved in one project. It eliminates C corporation problem of double taxation (taxes on profits and dividend) and permits pass through of losses only to the extent of the investment.

Limited Liability Company (LLC). The limited liability company (LLC) is a business entity created under state statute and owned by investors, called members. The LLC allows other corporations to be owners (members) and does not limit the total number of owners. The ultimate legal control of an LLC rests with its members. They outline the powers delegated to others in an Operating Agreement.

The LLC is the relatively newer business structure. It has advantages because investors are attracted to the limited liability and member control characteristics. Along with the liability protection, it also offers members the tax advantages of a partnership or proprietorship. Additionally, unlike the S Corp, other corporations can be members, which open up additional revenue sources. One of the greatest advantages of an LLC is that profit and loss can be allocated among the members in a variety of ways. For example, a member who owns 50 percent of the LLC can receive more than 50 percent of the profits if that is what the LLC agreement provides. This is helpful in situations where some members are actively involved in the venture and others are not.

SELECTING A LENDER

In today's market, there are a variety of lenders available, including direct lenders, mortgage bankers or brokers, which process your loan application through the participating banks, private and public real estate investment trusts (REITs), limited partnerships, and insurance companies. Given the diversity, you should research and prepare carefully before approaching them to determine the best source of financing and the best type of financing.

Your success in selecting lenders can increase if you look at the loan process from the lenders' point of view. Remember, the lenders are running businesses just like you. They can't afford to take big risks. Their restrictions include regulatory influences, expectations of income from certain types of loans, and geographic diversification requirements. Additionally, each lender establishes unique goals and criteria to drive its loan portfolio. Lenders in the same area may have different targets, criteria, and loan type preferences. So, if one lender turns down your application, it doesn't necessarily mean that the rest will follow suit. With this perspective in mind, the factors for your success become clear. When looking for a loan:

- Research the lender.

- Plan your approach to a successful working relationship.

- Prepare a thorough loan application package to allow the lender to accurately assess the success-rate of your venture.

Research the Lender

Research the lender to understand their business focus and strategies and apply first to lenders that have a preference for the type of loan you seek. It is common practice to check references before deciding. Consider these guidelines for selecting a lender.

- Determine the historical loan preferences by the financial institution
- Determine the current funds available for real estate lending
- Determine the maximum loan size available
- Determine the maximum credit extended to one borrower
- Investigate the federal or state regulations affecting the lender's real estate loans
- Determine the amortization required on various loan to value ratios
- Investigate any internal policies and procedures that affect real estate lending
- Determine the loan approval process required by the lender
- Determine whether the lender funds their own loans or whether they are a clearinghouse for other sources of funding

As a final step in choosing a lender, answer the following questions using your own observations and the feedback from other developers.

- What is the lender's track record for this type of loan application?
- What is the lender's view of and financing for "soft costs"?
- What is the lender's involvement in project development?
- What is the quality/experience of the lender's loan management team?
- How does the lender handle trouble signs; is it likely to pull out when trouble happens?

Plan Your Approach

Your relationship with a lender takes a thoughtful approach, including good communication. Poor communication, stemming from misunderstandings or the lack of communication, can usually be blamed for the failure of the financing deal. An opportunity to improve communication comes with status reporting. Whether you are actively seeking financing or not, supply the lenders you work with, or would like to do business with, status reports regarding your business on a monthly, quarterly and annual basis. These reports should provide details of all relevant projects, not only those the lender is financing. By supplying first-hand details about your projects, you increase the lender's comfort level and reduce the possibility of rumors and misinformation about your performance as a developer. Be sure to supply the right kind of information, as well. The margins banks make on loans are comparatively low compared to those of equity investors. Consequently, the banks cannot afford many losses. They are primarily concerned with loan repayment and interested in information that demonstrates repayment assurances, such as:

- The existence and stability of cash flows required for servicing the debt and/or collateral
- A proven (existing) market with a credible plan for reaching it
- The competence and experience of management

Additionally, assuming an entrepreneurial attitude is a crucial ingredient when dealing with a bank. In general, a developer who seems to need the loan too badly creates an impression of desperation. This can signal the potential for default in the eyes of a loan officer. Strive to create the impression that you would like the loan, but it is one of many viable alternatives you are exploring. Contrast the desperation with wanting financing for bigger and better things, and it positions your need as a means to prosperity and a potentially successful business relationship for both of you.

Prepare the Loan Package

Loan application package requirements vary from lender to lender. As a first step, ask your lender what he or she wants to see in your loan proposal. The insight you gain can help you prepare a complete package and avoid spending unnecessary time and money on providing extraneous information. The key is to make it complete and to the point.

If you provide inadequate or inaccurate information, a banker or broker may be unable to rewrite the loan submission in the format the lender demands and jeopardize your chances of obtaining financing for an otherwise viable development. Remember that you must first gain the lender's confidence. Providing all of the required information is an important part of that task. Walk the lender through your development on paper, and back up your statements with facts, site plans, credit history, photographs, etc.

There is no magic format for a loan package, because each must be custom-designed for the borrower, the project, and the lender. A description of the elements of a typical submission package follows:

Cover Letter. The cover letter explains your purpose for submitting the package and summarizes its contents. It also summarizes your project and the financial need. Brevity and a positive tone are the keys to a good cover letter. If the cover letter does not provide a good impression and generate interest, the lender may never move beyond it to review the details of your request

Loan Summary. A loan summary describes the requested transaction in a concise manner. It enables the lender to decide quickly if your loan package fits within their business parameters. Include the:

- Loan amount needed
- Rate desired
- Terms (length time, collateral, etc.)
- Borrowing entity (individual, company)

Borrower's Resume. Regardless of how well you know the loan officer, provide your professional resume. The loan officer is often not the only person involved in the loan decision. The resume is your chance to convince the decision makers that you are capable of successfully completing this job. Include information on the following:

- Your background and education—List any and all relevant information about your career history and educational and training achievements.
- Experience—List your prior experience with similar types and sizes of projects, especially those accomplished with the same lender. If you have no prior experience with the lender, provide them with information on your banking history and creditworthiness.
- References from business associates—List other banks; long term creditors and suppliers, and anyone you with whom you have done business. Always make sure that the referral contacts you provide will be positive.
- Projects currently in progress—Include pictures of past projects with letters of recommendations from clients.

Project Team Profile. Include a brief biography on each member of the development team—architects, land planners, engineers, general contractors, public relations agent, sales personnel, etc.

Market Data. Summarize your conclusions gathered through market research and analysis. Describe the scope and location of your project, the targeted customer, and market absorption projections. If the project is large and complex, then have a professional report prepared to include in the package.

Project Data. State the project goals and highlight development's features and benefits. Summarize information regarding the project and include actual documentation in an appendix, such as a map of the project, detailed plans and specifications for the units, a site plan, a project cost statement, a schedule of development activities, soil conditions report, zoning approval documentation, and written assurance of utility availability.

Financial Proforma

A financial proforma is an analysis of the expected cash requirements and profits of the project. It projects the disbursements and revenues based on anticipated sales rates and costs over the life of the project. It can be the key to the loan approval. If the numbers won't work, the lender may be reluctant to loan you the necessary funds. It is a good idea to prepare a realistic and conservative proforma because it is a big factor in negotiations with the lender.

Loan Guarantees, Bonds, and Appraisals

You may be asked to provide a personal guarantee. This is a written pledge to make good on a loan. Guarantees are usually required if you have set up a corporation specifically for the project—the lender may want your personal guarantee that you will pay the loan even if your corporation defaults. Additionally, if you are a first-time developer, you may have to obtain a performance bond and/or labor and materials bond. You purchase these as to insure the project completion in accordance with the plans and specifications. Following completion, you may have to produce a property appraisal to verify that the project complies with plans and specifications.

Presentation. The lender uses the information you provide in the loan package to confirm your creditworthiness, assess the financial feasibility of your project, and evaluate your ability to perform in a competent manner. A professional look and presentation of the application package supports a positive perception on these matters. Make sure the package is well organized, clean, legible, and appealing to the eyes. When you meet in person with the lender, remember always make sure that your appearance and personality reinforces your image as a competent businessperson.