
Weathering the Capital Crunch: A New Approach to Interim Financing of Commercial Real Estate Projects *Published: February 05, 2009*

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In today's economic environment, there is no shortage of potential projects on the books of experienced commercial developers. There are also billions of investor dollars looking for an opportunity to go to work.

Stabilized, commercial real estate—including residential rental developments—has become less available as even the best performers are not catching the valuation potential their current owners perceive.

The collapse of the credit markets has bred fear into the lending institutions and equity investors alike, especially where real estate is involved. Overcoming these obstacles of tightened investment is possible through a fundamentally new business model for equity investors and developers.

It will require creativity, flexibility and (above all) mutual trust. The bottom line: Equity investors need to put their money to work. Developers need to deliver new projects to stay in business. That's right, they still need one another. Now they need to rethink the relationship to form a sensible approach out of a situation that is currently unsustainable.

Recessive economic principles indicate that though a development market may be declining, ongoing market redevelopment is still required. When cash tightens, the need for replacement properties within the commercial and residential rental sector does not necessarily diminish. Older, unsuitable product is vacated for more efficient, newer or redeveloped properties.

In our current economic environment, where declining properties cannot secure financing to renovate, and Class A properties are not for sale, high quality ready-to-develop projects can be the best opportunity both in short term and long term.

The developers of these projects and their investor partners will need to take an even more transparent and integrity driven approach to their relationship with the proposed new financing model.

Let's explore how it would work with the hypothetical example of a 400-unit multi-family residential project fully entitled and designed. The developer currently owes \$400,000 or \$1,000 per unit. The equity investor requires a 100-unit take down in each of four phases. The agreed-upon price is \$100,000 per unit. The hard costs are \$80,000 per unit. The bank provides a partial release for a \$100,000 payment, leaving \$300,000 in residual debt.

Land for 100 units is transferred to joint entity. The 100-unit phase will require six months for construction and a six-month stabilization period. Rents are estimated at \$1,200/month with expenses of \$150/month. Net monthly rents total \$1,260,000 for the 100 units.

All parties have agreed up front on certain things:

- The Unit Land Value (minimum agreed-upon value of the entitled ground)
- The development and construction cost (hard cost and soft cost)
- A Tiered Stabilized Value (completed purchase price based upon anticipated rent revenues; a factor of attainable rents, cost, occupancy rates, etc.) as follows:
 - Up to 50% - recovered cost and land value
 - 51% to 100% - 9% CAP
- A Tiered Stabilization Valuation Schedule as follows:
 - 0-50% - \$10,000,000
 - At 75% - \$10,500,000
 - At 85% - \$11,800,000
 - At 95% - \$13,194,000

The additional percentages would be based on predicted rent revenues and applicable CAP rate for applied occupancy levels.

- A defined Stabilization Period—from close of last unit in phase to full portfolio transfer to equity investor.

Initially a legal entity must be set up to hold, unencumbered, a portion of the land and improvements. Ownership is held fully by the developer. As funding is injected by the equity partner, ownership transfers proportionately to the tiered stabilization value (0 - 50%). Construction draws are transacted as they would be with a traditional lender with the release coordinated by a qualified third party. All net pre-tax from rent revenues prior to the end of stabilization period flow into a settlement account to be distributed per a performance bonus agreement.

Upon completion of funding, ownership is completely transferred to the equity partner, less an agreed-upon retainage ownership amount held by the developer until settlement of at the close of the stabilization period. The settlement amount for retainage release will be based upon the tiered stabilization value.

If at the end of the stabilization period, the occupancy is 85%, the purchase price will be \$11,800,000. Total accumulated payments from the equity partner equal \$8,000,000 (100 units at \$80,000). Amount due at close is \$3,800,000. Total ROI is 10.6% cash on cash.

As occupancy increases during stabilization, the risk premium decreases for the investor and provides greater return to the developer. Conversely, if the project is underperforming, it is sold at a predetermined cost.

The key is that both the developer's and the equity partner's motives are aligned to benefit each to a common end. There is no disincentive for efficiency, transparency or mutual profitability. This is the cornerstone of the concept's success and continuation to potential for the partnership.

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