

Structuring the Deal to be Profitable

Fundamental Skills for
Real Estate Development
Professionals II

Goals

- Overview of Development Financing
- Review Basic Financing Mechanisms
 - Senior Debt
 - Institutional Equity
 - Mezzanine Debt
- No Answers (or at least very few), but Groundwork for Financing a Successful Project

Agenda

- Define Success
- Recap Basics of Finance
- Sample Development
 - Rental w/Equity Partner
 - Condo w/Equity Partner
 - Condo w/Mezzanine Debt
- Wrap-Up

Defining Success

- Different Goals for Different Projects
 - Unentitled land
 - New construction
 - Re-development of existing property
 - Build-to-suit
 - Stabilized property
- Different Risks for Different Projects
 - Market risk
 - Construction risk
 - Entitlement Risk

Defining Success

- Different Objectives for Different Parties
 - Wealth creation
 - Capital preservation
 - Merchant development
 - Operating business
- Actual outcome more important than pro-forma
- Profitability is not determined by rate alone
- Art is finding optimal mix of capital partners for project's risk and profitability goals

Risk & Return on Investment

- What's a reasonable return?
- Evaluation of Risk determines required return in relation to alternate investments
- What do you expect back from:
 - U.S. Government (T-Bills)
 - Bank (Demand Deposit)
 - Corporate Bond
 - Mutual Fund
 - Tech Stock
 - Your No-good Brother-in-Law

FINANCE BASICS RECAP

Finance Basics Recap

- The Balance Sheet

Assets = Liabilities (Debt) + Equity

or

Equity = Residual Claim on Assets

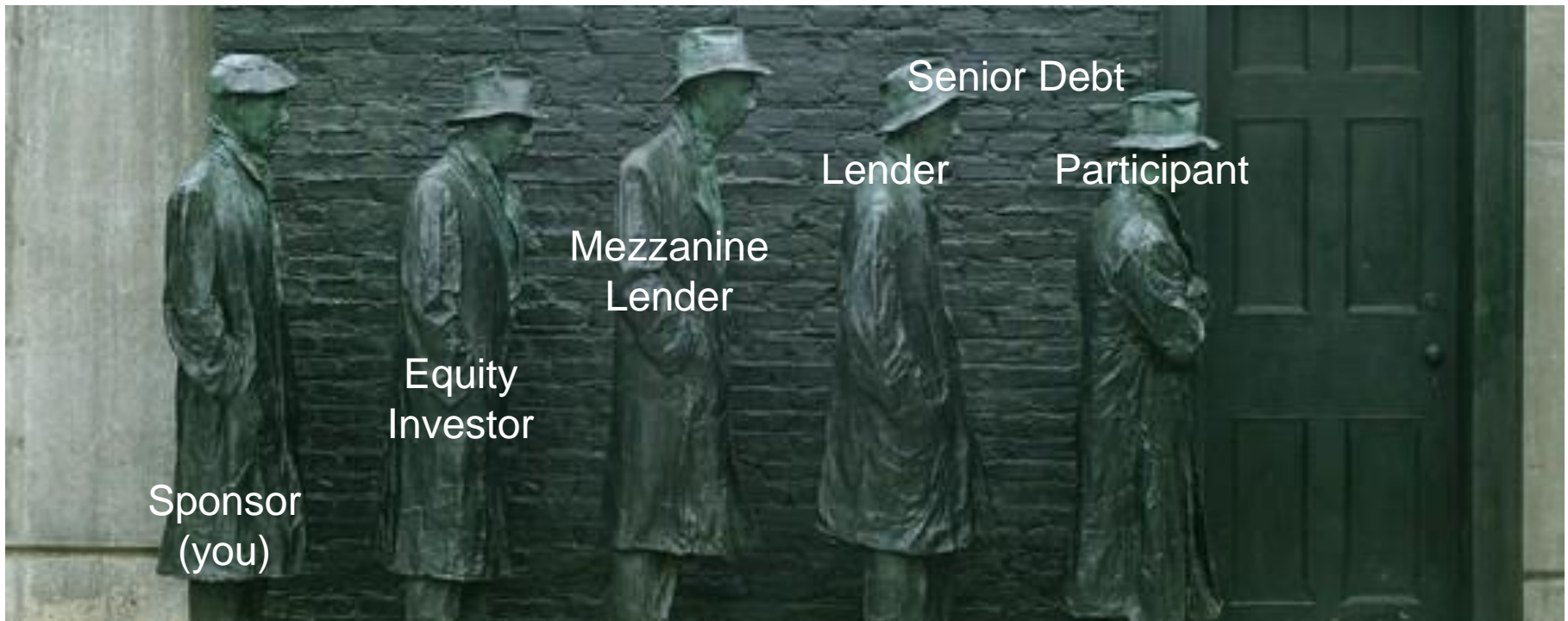
or

Uses (Assets) = Sources (Debt & Equity)

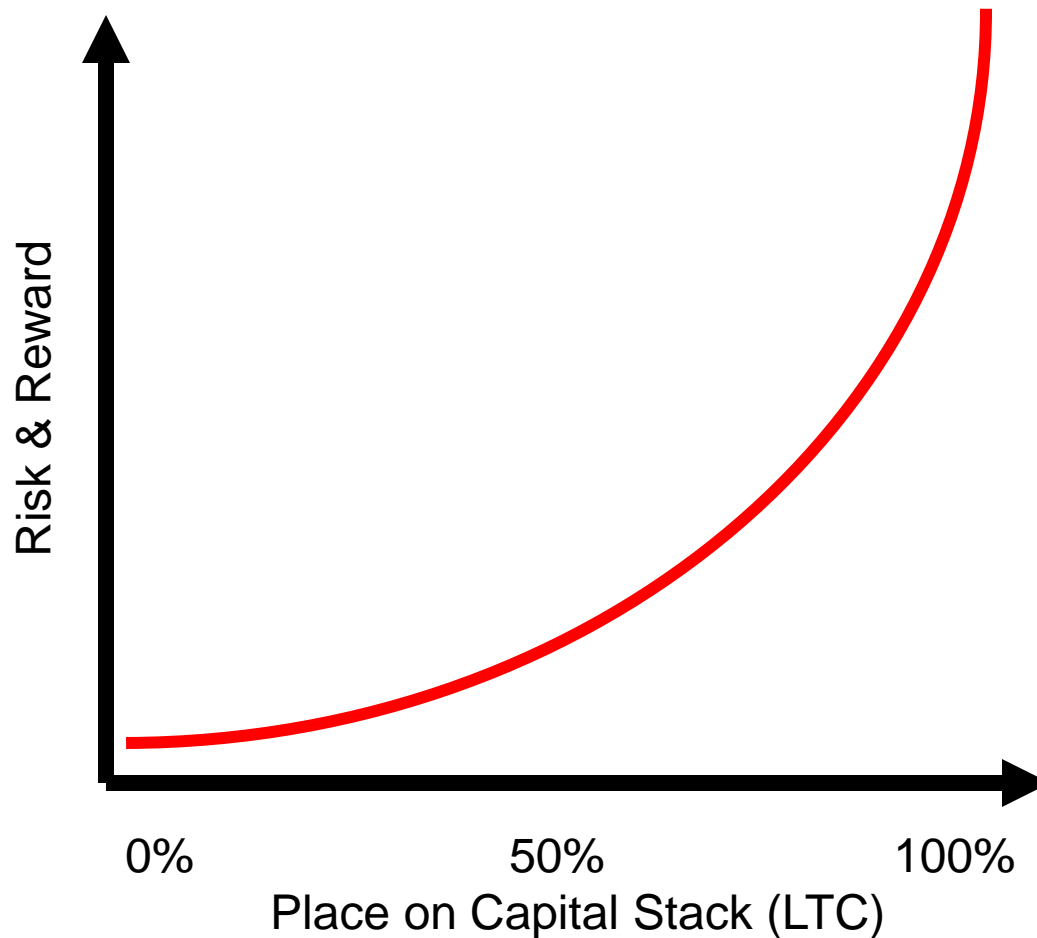
- Value of Asset is Independent of Capitalization
- Value of YOUR position is HIGHLY dependent on capitalization

Seniority & Subordination

- Priority of Payment is Key Determinant of Risk
- If the money runs out—No soup for you!



Risk of Principal vs. Seniority



Risk & Return on Investment

- Expected rate of return
- “Risk-Free” rate of return + risk premium
- The difference between rates of return for different investments reflects market adjustment for comparative *perceived* risk
- Variables include
 - Safety of principal
 - Duration of investment
 - Timing of cash flows
 - Difficulty of execution

Ways to Pay Capital for Risk

- Origination Fees
- Current Payments (interest or preferred return)
- Exit Fees
- Accrued Interest/Lookback
- Share of Profits
 - Simple Split (i.e. 50/50)
 - Waterfall Promote
 - Share of Gross Revenue

Project Balance Sheet

Uses (Assets)	Sources (Liabilities & Equity)
Land	Senior Debt (mortgage)
Construction Hard Cost	Mezzanine Debt (2 nd mortgage)
FF&E	Outside Equity
A&E	Sponsorship Partners Equity
Legal	Sponsor Equity
Taxes	Bonds
Financing Costs	TIF's & Other Grants
Operating Reserve	Vendor Financing

Residential Rental
Debt & Equity

SAMPLE PROJECT

Project Overview

- From the Developer's Perspective
- Ground-up Residential Development
 - Rental (to start)
 - 76 Units, 5 stories
 - 57,100 NSF residential
 - 12,100 RSF retail
- Project Status
 - Land is under control (not purchased yet)
 - Entitlements in place—zoning, etc.
 - Sufficient design for accurate construction estimates

Project Budget

Development Cost (Uses)		\$/sf	\$/Unit
Land Cost	2,400,000	31.53	31,579
Legal	75,000	0.99	987
Architecture & Engineering	800,000	10.51	10,526
Hard Costs	12,250,000	160.95	161,184
Retail fit-out	400,000	5.26	5,263
Miscellaneous Soft Costs	250,000	3.28	3,289
FF&E	75,000	0.99	987
Developer Overhead	950,000	12.48	12,500
Operating Reserve	29,595	0.39	389
Financing Costs	-	-	-
Mezzanine Current Interest (reserve)	-	-	-
Senior Debt Interest (reserve)	-	-	-
Total Development Cost Before Financing	17,229,595	221.01	226,705

- Budget before capitalized financing costs
- Interest reserve & fees depend on terms (obviously)

Revenue & Expenses

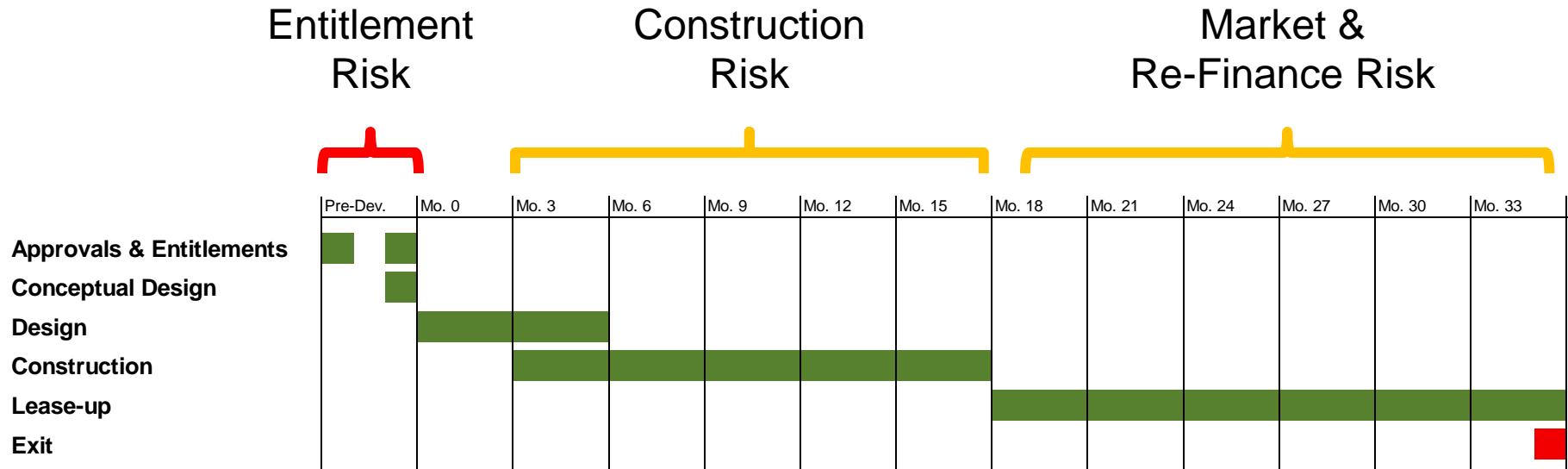
Revenue		\$/sf	\$/Unit	%
Gross Residential Revenue	1,608,000	21.13	21,158	85.8%
Gross Retail Revenue	365,340	4.80	4,807	19.5%
Vacancy	(98,667)	(1.30)	(1,298)	-5.3%
Gross Revenue	1,874,673	24.63	24,667	100.0%
Operating Expenses	(435,540)	(5.72)	(5,731)	-23.2%
NOI	1,439,133	18.91	18,936	76.8%
Cap Rate on Hard & Soft Costs	8.35%	Does not include capitalized financing costs		

- Sale at 6% cap rate
(\$350/sf residential + \$300/sf retail)
- Passes the Giggle Test
(~200bp spread between build & sale)

Project Schedule

- Schedule
 - 3 months pre-construction
 - 15 months construction
 - 18 month lease-up
 - Sale at lease-up

Project Schedule



Senior Construction Debt

- Seniority & Pricing
 - 1st mortgage, controls any second mortgage
 - Spread over cost of capital & fees
- Primary Underwriting Concerns
 - How easily can I be replaced at completion?
 - How much is invested behind me?
 - Who and what is the credit behind me?
 - What is my cost basis in a foreclosure?
 - Who can I sell the debt to after I originate it?
 - Do I make enough for it to be worth my time?

Senior Construction Debt

Common Terms for Senior Construction Debt

Proceeds	~70% Loan-to-Cost
Rate	~LIBOR (30 day) + 3.00%-4.50%
Fees	1% on origination (+ sometimes on exit)
Term	Duration of construction + extensions Not permanent financing
Sponsor Guarantees	<ul style="list-style-type: none">• Interest payments• Construction completion (beyond contractor)• Repayment of principal (recourse)
Other Terms	<ul style="list-style-type: none">• Interest reserve (big enough for rate rise and schedule slip)• Subordinated development / management fees• Early termination fee/yield maintenance (minimum hold period)

Baseline Senior Debt Terms

- Proceeds: 75% LTC (Loan-to-Cost)
- Rate: LIBOR (30-day) + 3.75% (4%)
- Fees: 1% origination fee (no exit fee)
- Underwriting Notes
 - Aggressive assumptions
 - Higher rate likely required for 75% LTC
 - Likely requires a repayment guarantee
 - Likely require a larger interest reserve

Project Sources & Uses

Uses (Development Cost)		\$/sf	\$/Unit	%
Land Cost	2,400,000	31.53	31,579	13.5%
Legal	75,000	0.99	987	0.4%
Architecture & Engineering	800,000	10.51	10,526	4.5%
Hard Costs	12,250,000	160.95	161,184	68.9%
Retail fit-out	400,000	5.26	5,263	2.3%
Miscellaneous Soft Costs	250,000	3.28	3,289	1.4%
FF&E	75,000	0.99	987	0.4%
Developer Fee & Overhead	950,000	12.48	12,500	5.3%
Operating Reserve	29,595	0.39	389	0.2%
Financing Costs	133,285	1.75	1,754	0.8%
Mezzanine Current Interest (reserve)	-	-	-	0.0%
Senior Debt Interest (reserve)	408,433	5.37	5,374	2.3%
Total	17,771,313	228.12	233,833	100.0%

Sources		\$/sf	\$/Unit	%
Equity	4,442,828	58.37	58,458	25.0%
Senior Construction Loan	13,328,485	175.12	175,375	75.0%
Total	17,771,313	233.49	233,833	100.0%

Alternate (8%, 24 month const.)

Uses (Development Cost)		\$/sf	\$/Unit	%
Land Cost	2,400,000	31.53	31,579	12.7%
Legal	75,000	0.99	987	0.4%
Architecture & Engineering	800,000	10.51	10,526	4.2%
Hard Costs	12,250,000	160.95	161,184	64.8%
Retail fit-out	400,000	5.26	5,263	2.1%
Miscellaneous Soft Costs	250,000	3.28	3,289	1.3%
FF&E	75,000	0.99	987	0.4%
Developer Fee & Overhead	950,000	12.48	12,500	5.0%
Operating Reserve	29,595	0.39	389	0.2%
Financing Costs	141,681	1.86	1,864	0.7%
Mezzanine Current Interest (reserve)	-	-	-	0.0%
Senior Debt Interest (reserve)	1,519,536	19.96	19,994	8.0%
Total	18,890,812	228.23	248,563	100.0%

Sources		\$/sf	\$/Unit	%
Equity	4,722,703	62.05	62,141	25.0%
Senior Construction Loan	14,168,109	186.15	186,422	75.0%
Total	18,890,812	248.20	248,563	100.0%

Senior Loan Underwriting

Sources		\$/sf	\$/Unit	%
Equity	4,442,828	58.37	58,458	25.0%
Senior Construction Loan	13,328,485	175.12	175,375	75.0%
Total	17,771,313	233.49	233,833	100.0%

Revenue		\$/sf	\$/Unit	%
Gross Residential Revenue	1,608,000	21.13	21,158	85.8%
Gross Retail Revenue	365,340	4.80	4,807	19.5%
Vacancy	(98,667)	(1.30)	(1,298)	-5.3%
Gross Revenue	1,874,673	24.63	24,667	100.0%
Operating Expenses	(435,540)	(5.72)	(5,731)	-23.2%
NOI	1,439,133	18.91	18,936	76.8%

- \$175/sf & \$175,000/unit cost basis
- 2.7 DSCR on pro-forma rent
- 10.8% Yield on Debt at completion

Considerations & Limitations

- Senior debt lowest cost of capital in the project
- Leverage boosts equity returns
- Lenders stay in their box (no upside for leaving)
- Lenders love to hear your development story, not necessarily interested in underwriting it
- Will beat-up assumptions: reserves, contingencies, rents, speed, etc.
- Success breeds success (lenders like proven customers)

Equity Investor (Institutional)

- Seniority & Pricing
 - Behind any debt, in front of you
 - Fees & share of the return
- Primary Underwriting Concerns
 - Sponsor track record of success?
 - Durability of the market?
 - Competition in the market?
 - Is this a sufficiently profitable deal?
 - Good risk adjusted return?
 - Does it meet minimum IRR & multiple req.?

Equity—Typical Terms

Common Institutional Equity Returns

Proceeds	up to 97% of Cost 90% of the equity requirement (sometimes impute add'l equity value)
Fees	1-3% on origination (+sometimes on exit)
Term	3-5 year hold for development
Returns	<ul style="list-style-type: none">• Paid in a waterfall, sponsor promoted after a preferred return• Target IRR >20% & multiple on equity >1.75• Driven by whole dollar profit
Other Terms	<ul style="list-style-type: none">• Control on major decisions (sale, refi, etc.)• Negative covenants (right of approval)• Sometimes guarantees construction completion• Sometimes limit leverage

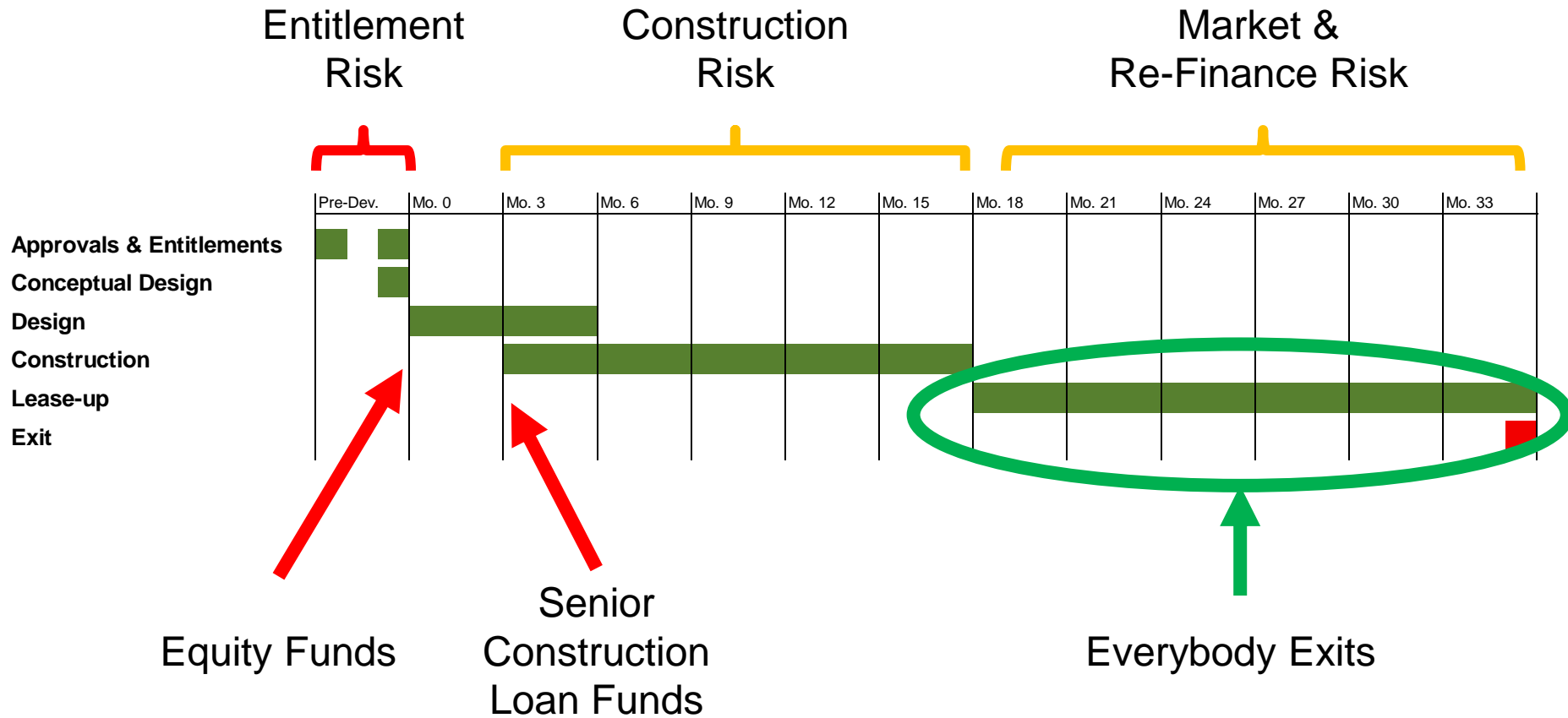
Baseline Equity Terms

- Proceeds: \$4M (90% of total equity, \$400k from sponsor)

Waterfall	IRR		Distribution	
	From	Through	Investor	Sponsor
First Tier	0.0%	12.0%	pari-passu	
Second Tier	12.0%	18.0%	80.00%	20.00%
Third Tier	18.0%	21.0%	70.00%	30.00%
Fourth Tier	21.0%	24.0%	60.00%	40.00%
Final Tier	24.0%	1000.0%	50.00%	50.00%
Total Distributions				

- Underwriting Notes
 - Usually a fee (none here)
 - Small for institutional equity (\$5M typical minimum)

Project Schedule

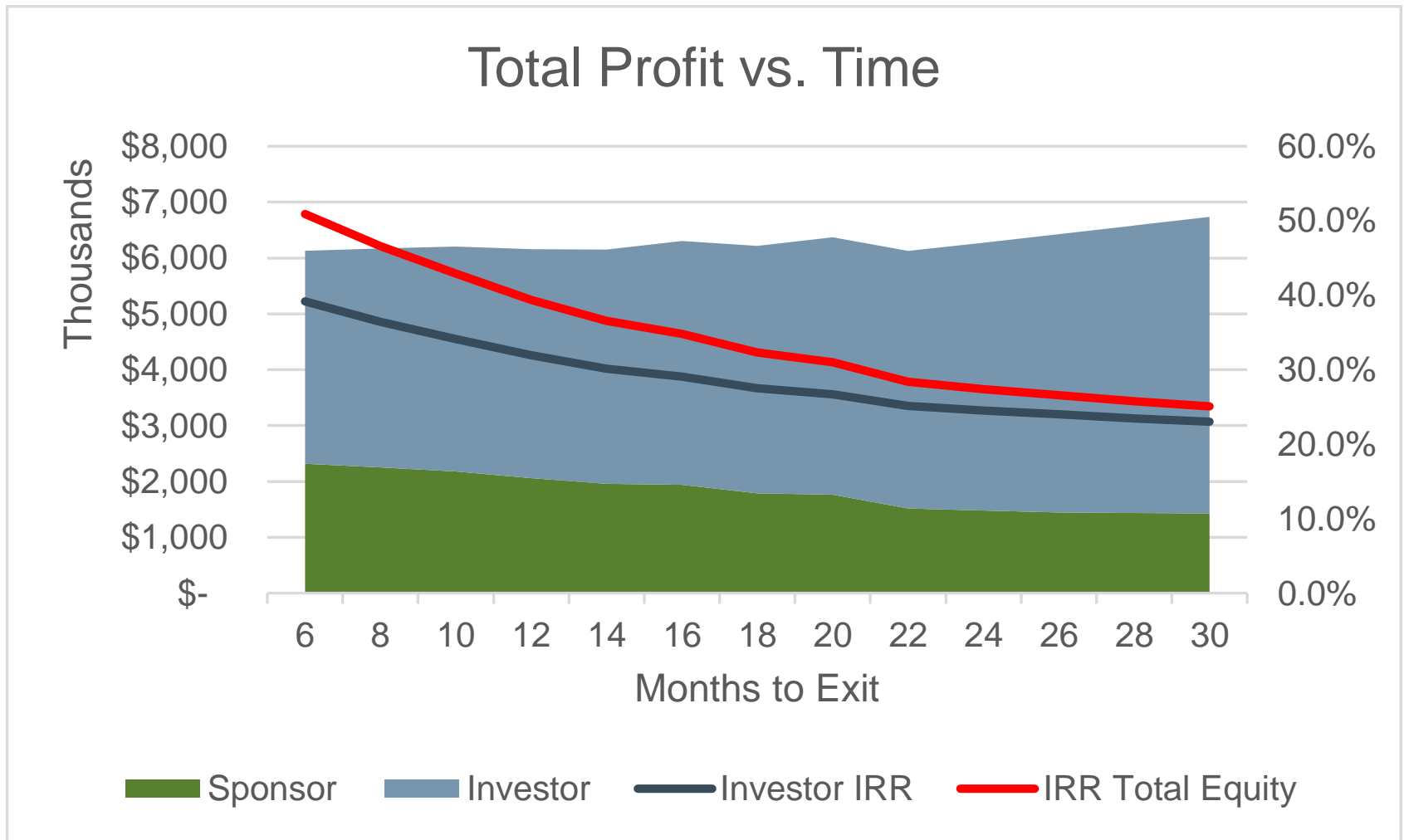


Returns & Profit

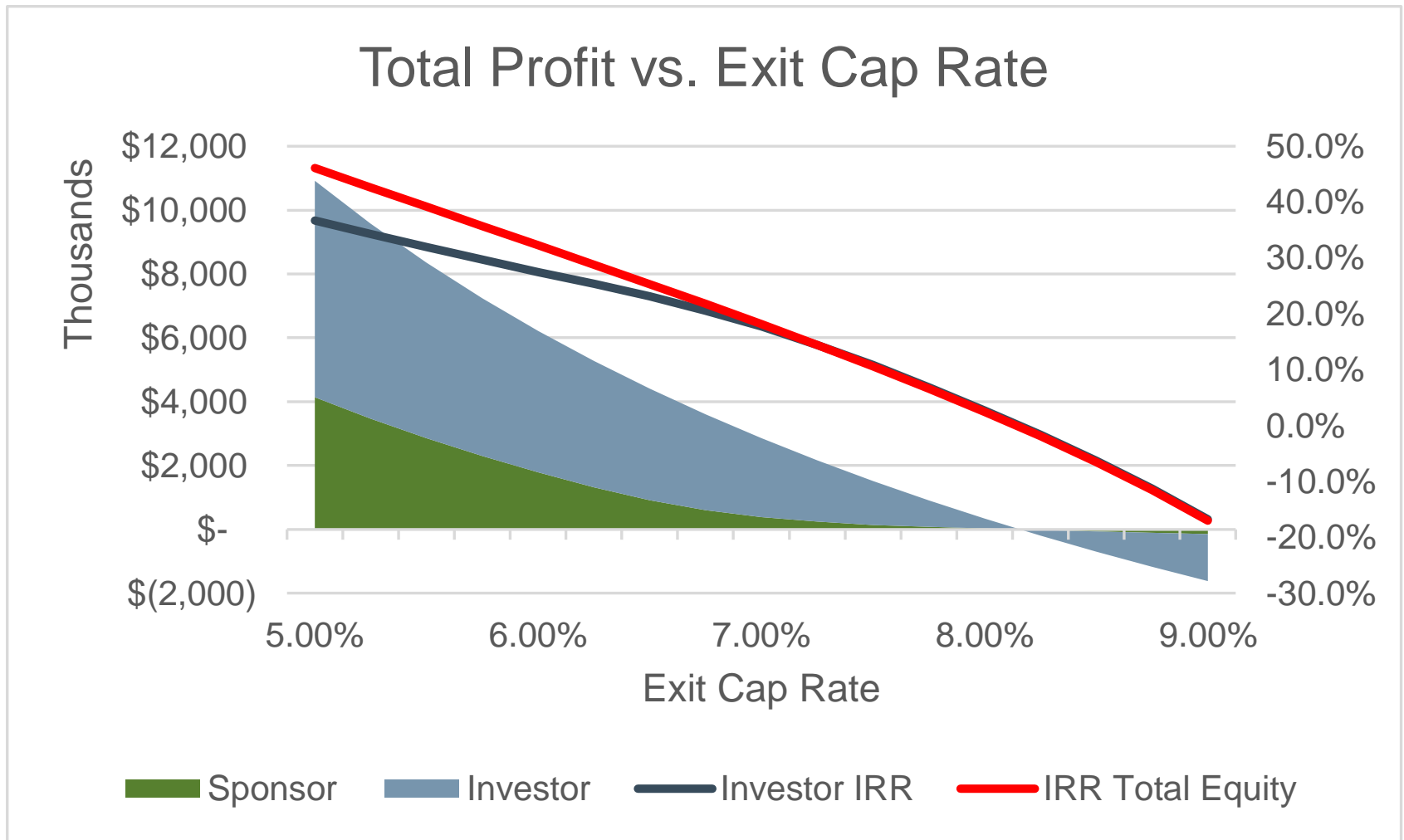
Waterfall	IRR		Distribution				%
	From	Through	Investor	Sponsor	Investor	Sponsor	Profit
First Tier	0.0%	12.0%	pari-passu		5,599,779	552,997	8.6%
Second Tier	12.0%	18.0%	80.00%	20.00%	980,322	245,081	13.8%
Third Tier	18.0%	21.0%	70.00%	30.00%	551,404	236,316	13.4%
Fourth Tier	21.0%	24.0%	60.00%	40.00%	596,558	397,705	22.5%
Final Tier	24.0%	1000.0%	50.00%	50.00%	737,660	737,660	41.7%
Total Distributions					8,465,723	2,169,759	
Investments					(4,050,497)	(400,000)	
Profit					4,415,227	1,769,759	100.0%

- 32.3% IRR to total equity
- 2.1 Multiple & 27.5% IRR on Investor Equity
- 4.4 Multiple & 61.4% IRR on Sponsor Equity (excl. fees)
- 41.6% of sponsor profit in final tier

Returns & Profit Sensitivity



Returns & Profit Sensitivity



Residential Condominium
Debt & Equity

SAMPLE PROJECT

As a Condominium

Profit		\$/sf	\$/Unit	%
Sale of Residential	22,833,600	300.00	300,442	86.7%
Sale of Retail	3,580,332	47.04	47,110	13.6%
Expenses During Sell Out	(78,962)	(1.04)	(1,039)	-0.3%
Gross Revenue	26,334,970	346.00	346,513	100.0%
Total Development Cost	(17,801,987)	(233.89)	(234,237)	-67.6%
Profit to Equity	8,532,983	112.11	112,276	32.4%

- Same project, condo exit
- \$400/sf sales price for residential
- \$300/sf sales price for retail at end of sell-out
- 18 month sell-out
- Sale of retail at end of sell-out
- Assume senior lender agrees w/same terms

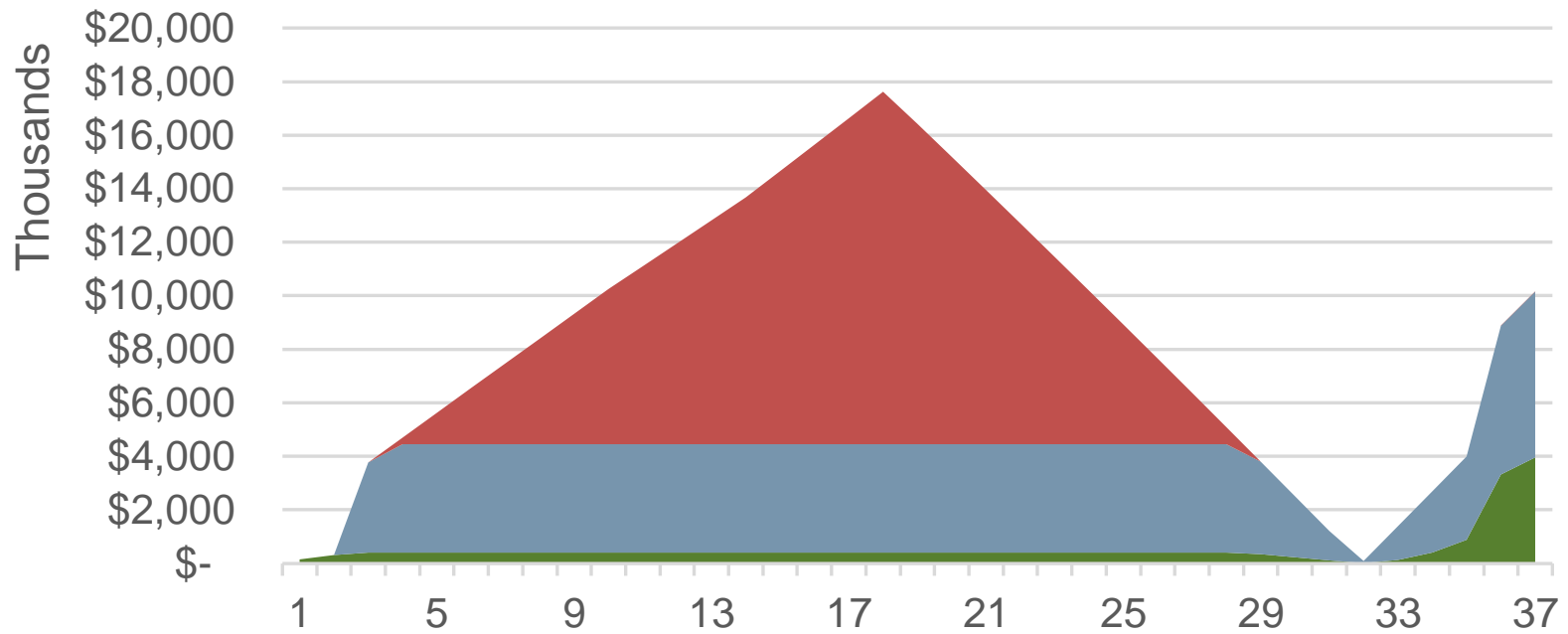
Condo Returns & Profit

	IRR		Distribution				
Waterfall	From	Through	Investor	Sponsor	Investor	Sponsor	
First Tier	0.0%	12.0%	pari-passu		5,399,780	533,246	16.7%
Second Tier	12.0%	18.0%	80.00%	20.00%	864,849	216,212	6.8%
Third Tier	18.0%	21.0%	70.00%	30.00%	495,677	212,433	6.7%
Fourth Tier	21.0%	24.0%	60.00%	40.00%	541,843	361,229	11.3%
Final Tier	24.0%	1000.0%	50.00%	50.00%	2,269,181	2,269,181	71.1%
Total Distributions					9,571,331	3,592,302	
Investments					(4,050,497)	(400,000)	
Profit					5,520,834	3,192,302	100.0%

- Much better exit for Sponsor (\$3.2M vs. \$1.8M)
- 42.6% IRR to total equity
- 2.4 Multiple & 34.3% IRR on Investor Equity
- 8.9 Multiple & 81.1% IRR on Sponsor Equity (excl. fees)
- 71.1% of sponsor profit in final tier

Condo Project Balance Sheet

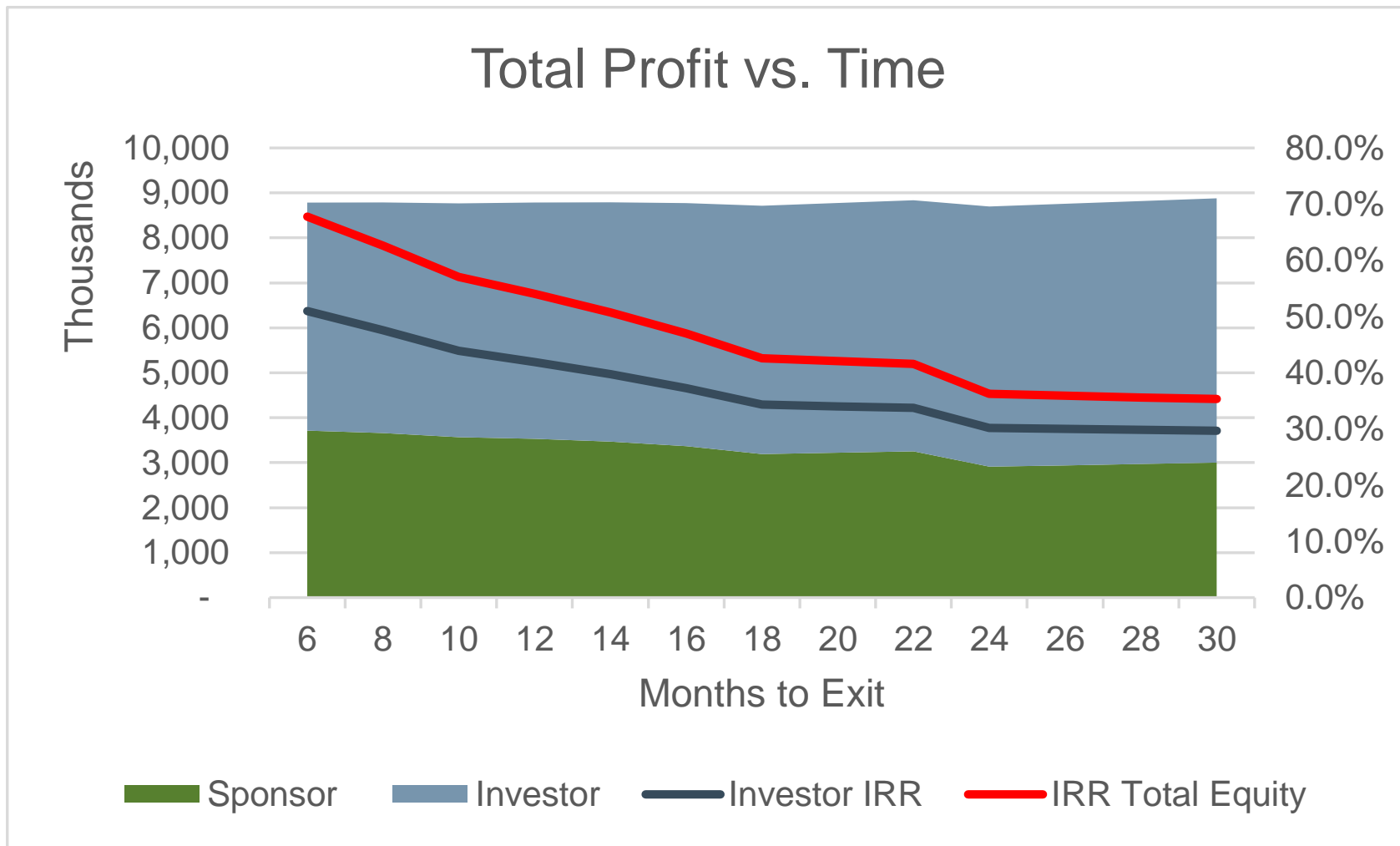
Investment & Loan Balances



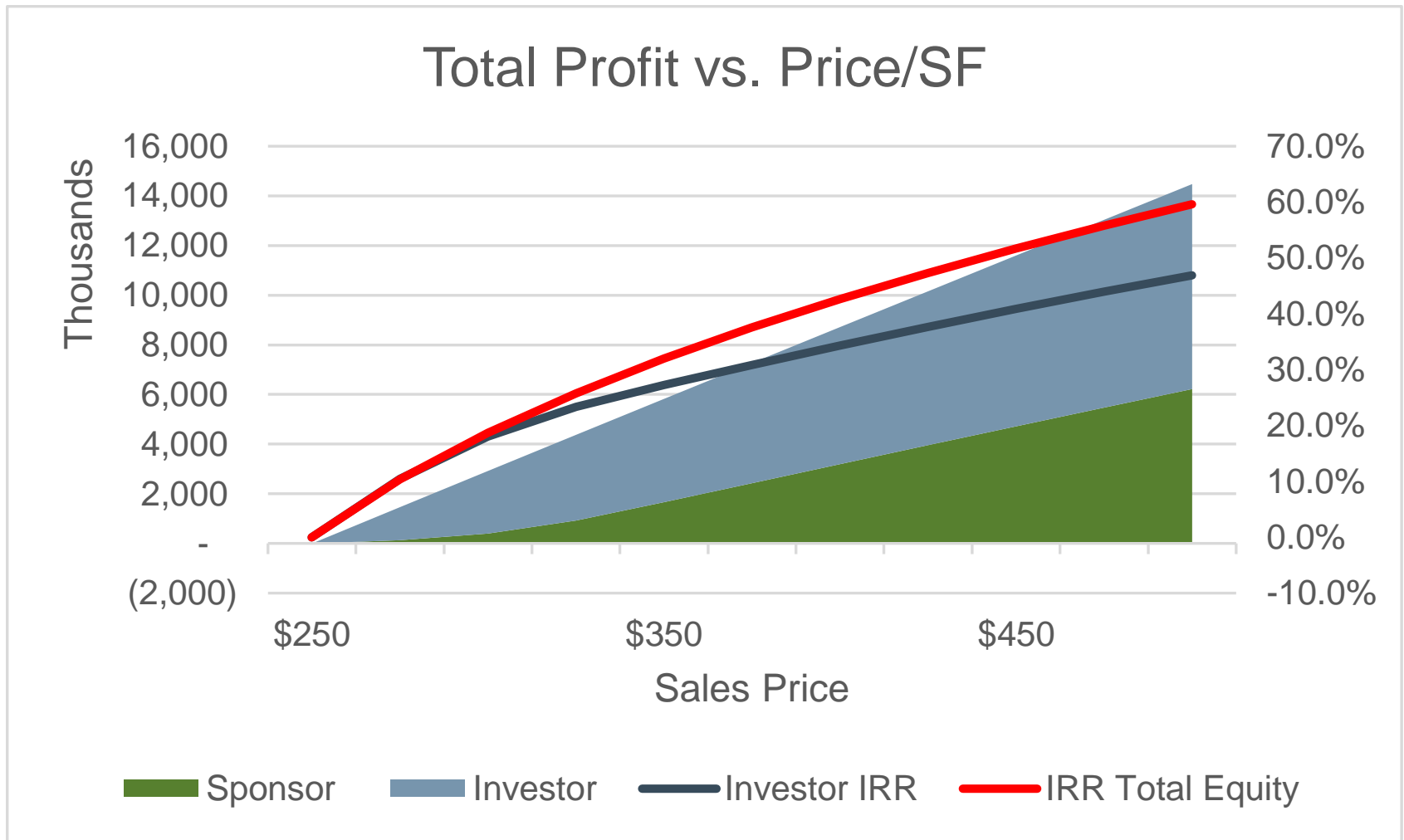
* All values are absolute value
(no negative numbers)

■ Sponsor Balance ■ Investor Balance ■ Construction Loan Balance

Condo Sensitivity



Returns & Profit Sensitivity



Equity Considerations

- Often creative partners in their underwriting
- Can stretch the edge of their boxes
- Good partner makes debt financing easier
- Good partner valuable when things go wrong
- Often likes leverage, except when they don't
- Beware smallness problem...not a big enough investment to be worth the expense and hassle
- Expensive in success (share every dollar)

Residential Condominium
Debt, Mezzanine & Equity

SAMPLE PROJECT

Mezzanine Debt

- Seniority & Pricing
 - Behind senior debt, in front of equity,
 - Sometimes a second mortgage
 - Fees, interest & share of the return
- Primary Underwriting Concerns
 - Sponsor track record of success?
 - How much is behind me?
 - How much is in front of me?
 - What is my exit?
 - What is my cost basis in a foreclosure?

Mezzanine Debt

- Sometimes included in Senior Debt
 - More proceeds @ higher rate than other Senior Debt
 - Additional proceeds but higher rate for full amount
- Incremental Cost of Proceeds Example
 - Conventional senior debt: 65% LTC @ 3.75%
 - Mezz & Senior: 75% LTC @ 4.75%
 - How much does the additional 10% cost?

Mezzanine Debt

- Solve for cost of the incremental 10%
 - $75\% @ 4.75\% = 65\% @ 3.75\% + 10\% @ X$
 - $0.75 * 4.75 - 0.65 * 3.75 = 0.10 * X$
 - $1.125 = 0.10 * X$
 - $11.25\% = X$

Mezzanine Debt—Typical Terms

Common Institutional Equity Returns

Proceeds	up to 90% Loan-to-Cost (though a lot of variability)
Fees	1-3% on origination (+sometimes on exit)
Rate	12% - >20%
Term	3-5 year hold for development
Returns	<ul style="list-style-type: none">• Current interest (~7%-9%) + lookback/profit participation• Sometimes equity profit
Other Terms	<ul style="list-style-type: none">• Negative control on major decisions (sale, refi, etc.)• Second mortgage often requires inter-creditor• Mezz. sometimes part of the first mortgage.

Mezzanine Debt Terms

- Proceeds: 90% LTC (Loan-to-Cost)
- Rate: 9.0% current (interest reserve)
17.0% accrued (IRR lookback)
- Fees: 2% origination fee (no exit fee)
- Leverage: 65% Max Senior Debt
- Underwriting Notes
 - \$4.5M size is small
 - Requires additional equity from Sponsor (assume friends & family are pari-passu)

Sources & Uses w/Mezz.

Development Cost (Uses)		\$/sf	\$/Unit	%
Land Cost	2,400,000	31.53	31,579	12.9%
Legal	75,000	0.99	987	0.4%
Architecture & Engienering	800,000	10.51	10,526	4.3%
Hard Costs	12,250,000	160.95	161,184	65.9%
Retail fit-out	400,000	5.26	5,263	2.2%
Miscellaneous Soft Costs	250,000	3.28	3,289	1.3%
FF&E	75,000	0.99	987	0.4%
Developer Fee & Overhead	950,000	12.48	12,500	5.1%
Operating Reserve	29,595	0.39	389	0.2%
Financing Costs	213,929	2.81	2,815	1.1%
Mezzanine Current Interest (reserve)	906,014	11.90	11,921	4.9%
Senior Debt Interest (reserve)	253,000	3.32	3,329	1.4%
Total	18,602,538	229.18	244,770	100.0%

Sources		\$/sf	\$/Unit	%
Equity	1,860,254	24.44	24,477	10.0%
Mezzanine Loan	4,650,635	61.10	61,193	25.0%
Senior Construction Loan	12,091,650	158.87	159,101	65.0%
Total	18,602,538	244.41	244,770	100.0%

Mezz Downside Underwriting

Sources		\$/sf	\$/Unit	%
Equity	1,860,254	24.44	24,477	10.0%
Mezzanine Loan	4,650,635	61.10	61,193	25.0%
Senior Construction Loan	12,091,650	158.87	159,101	65.0%
Total	18,602,538	244.41	244,770	100.0%

Revenue		\$/sf	\$/Unit	%
Gross Residential Revenue	1,608,000	21.13	21,158	85.8%
Gross Retail Revenue	365,340	4.80	4,807	19.5%
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NOI	1,439,133	18.91	18,936	76.8%

- \$220/sf & \$220,000/unit cost basis
- 1.7 DSCR on pro-forma rent (current pay only)
- 8.6% Yield on total debt at completion

Returns & Profit w/Mezz

Profit		\$/sf	\$/Unit	%
Sale of Residential	22,833,600	300.00	300,442	88.2%
Sale of Retail	3,580,332	47.04	47,110	13.8%
Expenses During Sell Out	(515,304)	(6.77)	(6,780)	-2.0%
Gross Revenue	25,898,628	340.27	340,771	100.0%
Total Development Cost	(18,602,538)	(244.41)	(244,770)	-71.8%
Mezz Lookback	(908,784)	(11.94)	(11,958)	-3.5%
Profit to Equity	6,387,306	83.92	84,044	24.7%
Distribution to Partners	(4,997,782)	(65.66)	(56,793)	-19.3%
Profit to Sponsor	1,389,525	18.26	27,251	5.4%

- \$400/sf sales price for residential
- \$300/sf sales price for retail at end of sell-out
- 18 month sell-out
- Sale of retail at end of sell-out
- 4.7 Multiple & 57.9% IRR to total equity

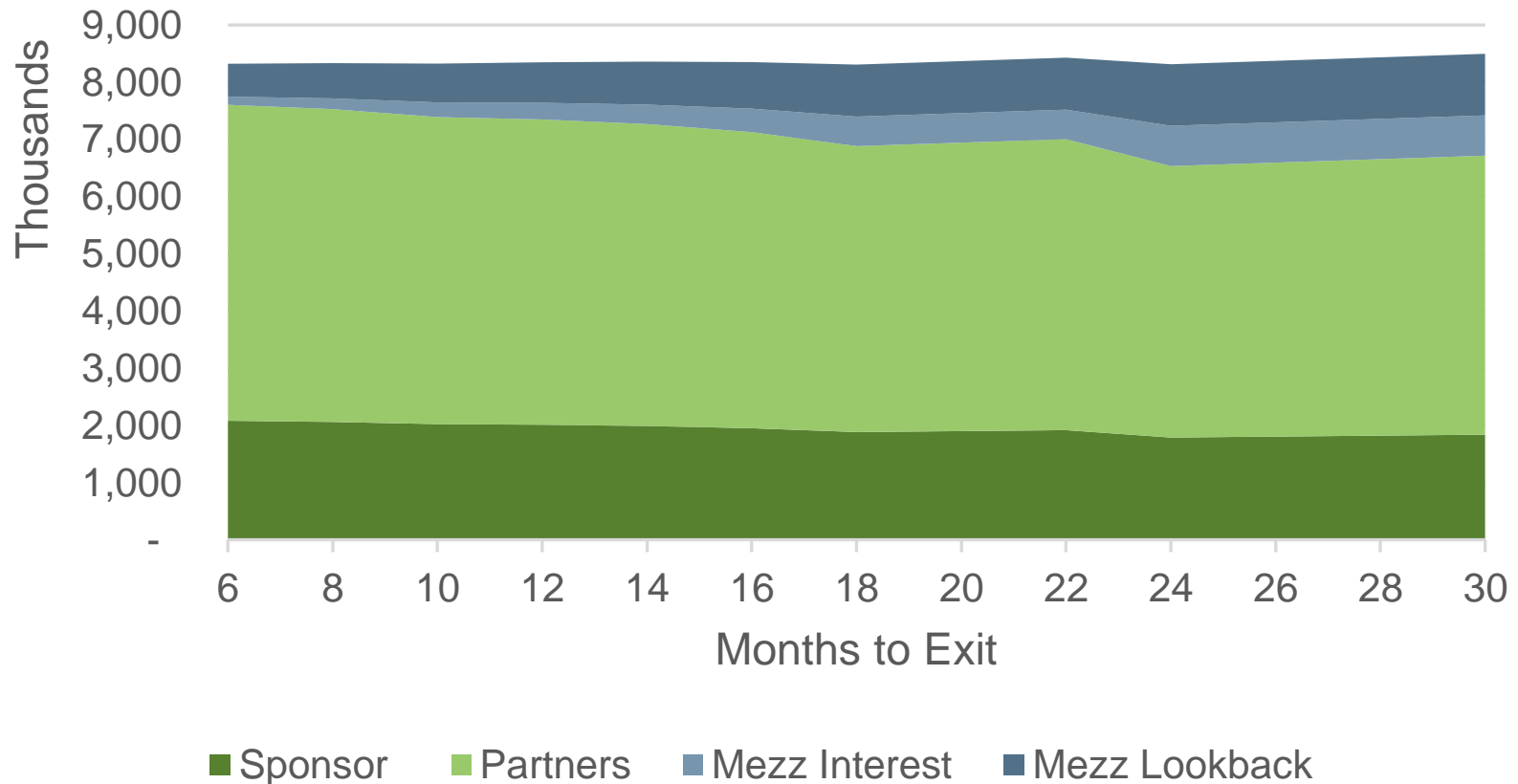
Returns & Profit w/Mezz

Profit With Mezz		\$/sf	\$/Unit	%
Sale of Residential	22,833,600	300.00	300,442	88.2%
Sale of Retail	3,580,332	47.04	47,110	13.8%
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Mezz Lookback	(908,784)	(11.94)	(11,958)	-3.5%
Profit to Equity (\$1.8M invest)	6,387,306	83.92	84,044	24.7%
Distribution to Partners	(4,997,782)	(65.66)	(56,793)	-19.3%
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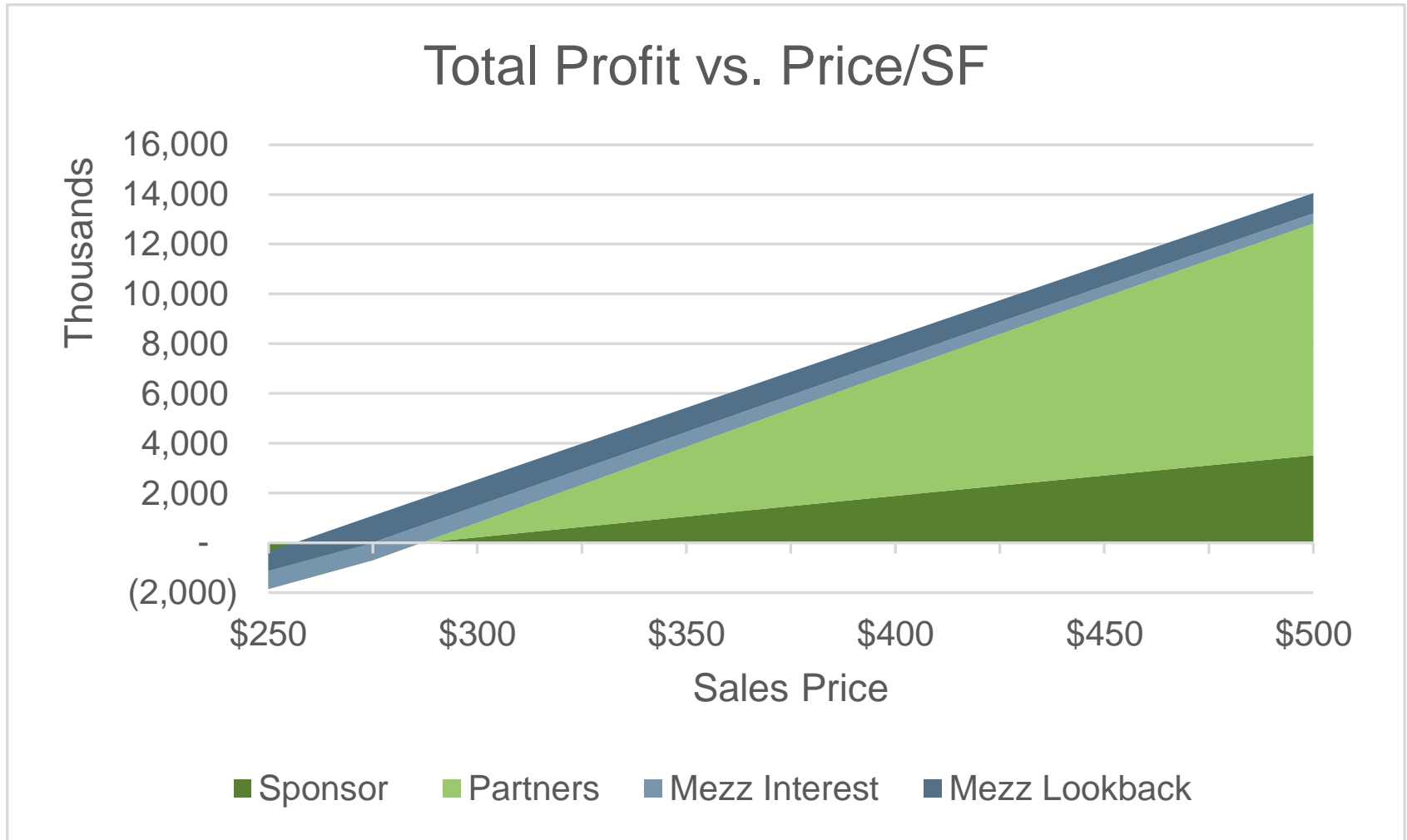
Profit With Equity		\$/sf	\$/Unit	%
Sale of Residential	22,833,600	300.00	300,442	86.7%
Sale of Retail	3,580,332	47.04	47,110	13.6%
Expenses During Sell Out	(78,962)	(1.04)	(1,039)	-0.3%
Gross Revenue	26,334,970	346.00	346,513	100.0%
Total Development Cost	(17,801,987)	(233.89)	(234,237)	-67.6%
Profit to Equity (\$4.4M invest)	8,532,983	112.11	112,276	32.4%
Distribution to Partners	(5,520,834)	(72.54)	(72,643)	-21.0%
Profit to Sponsor	3,012,149	39.58	39,634	11.4%

Condo Sensitivity w/Mezz

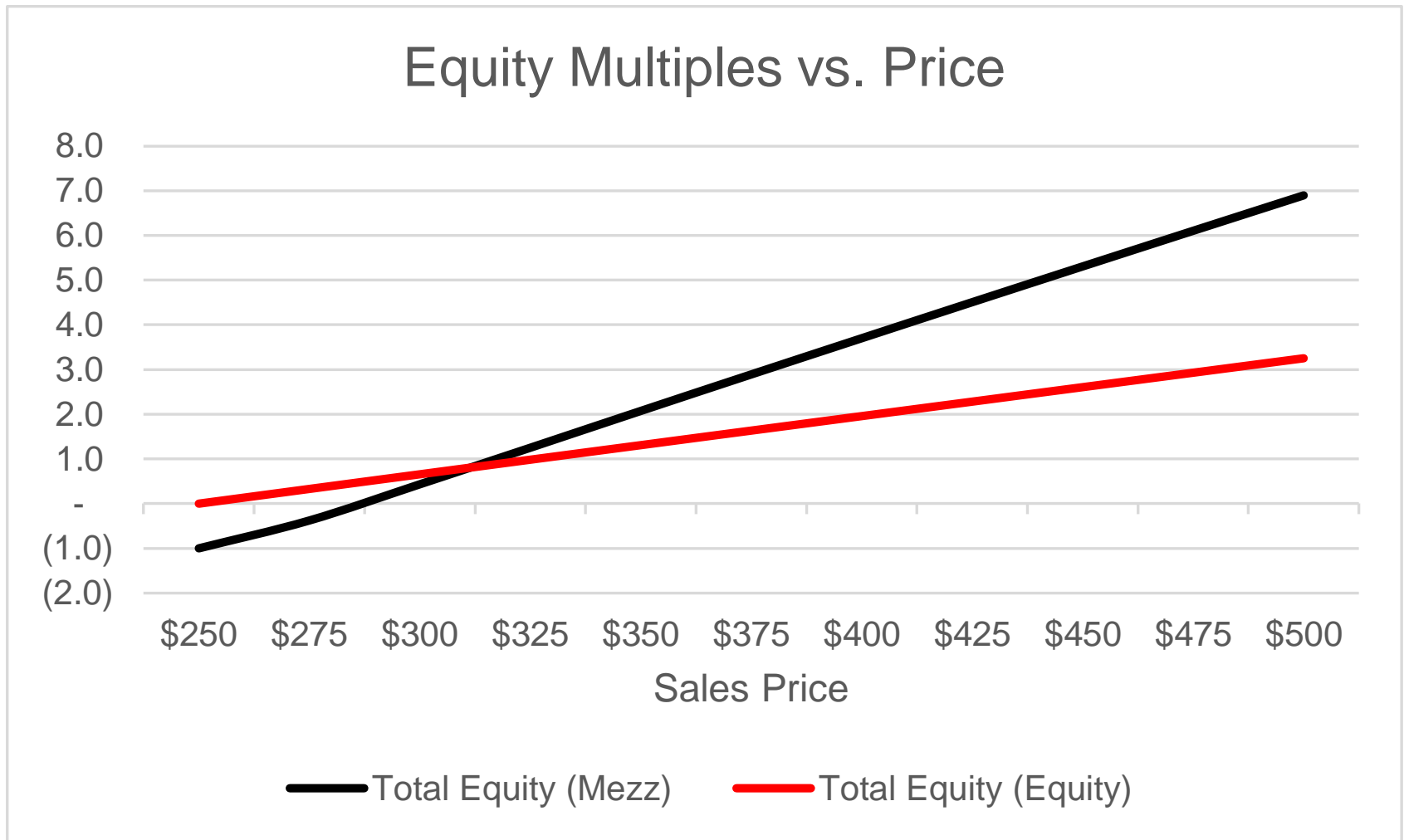
Total Profit vs. Time



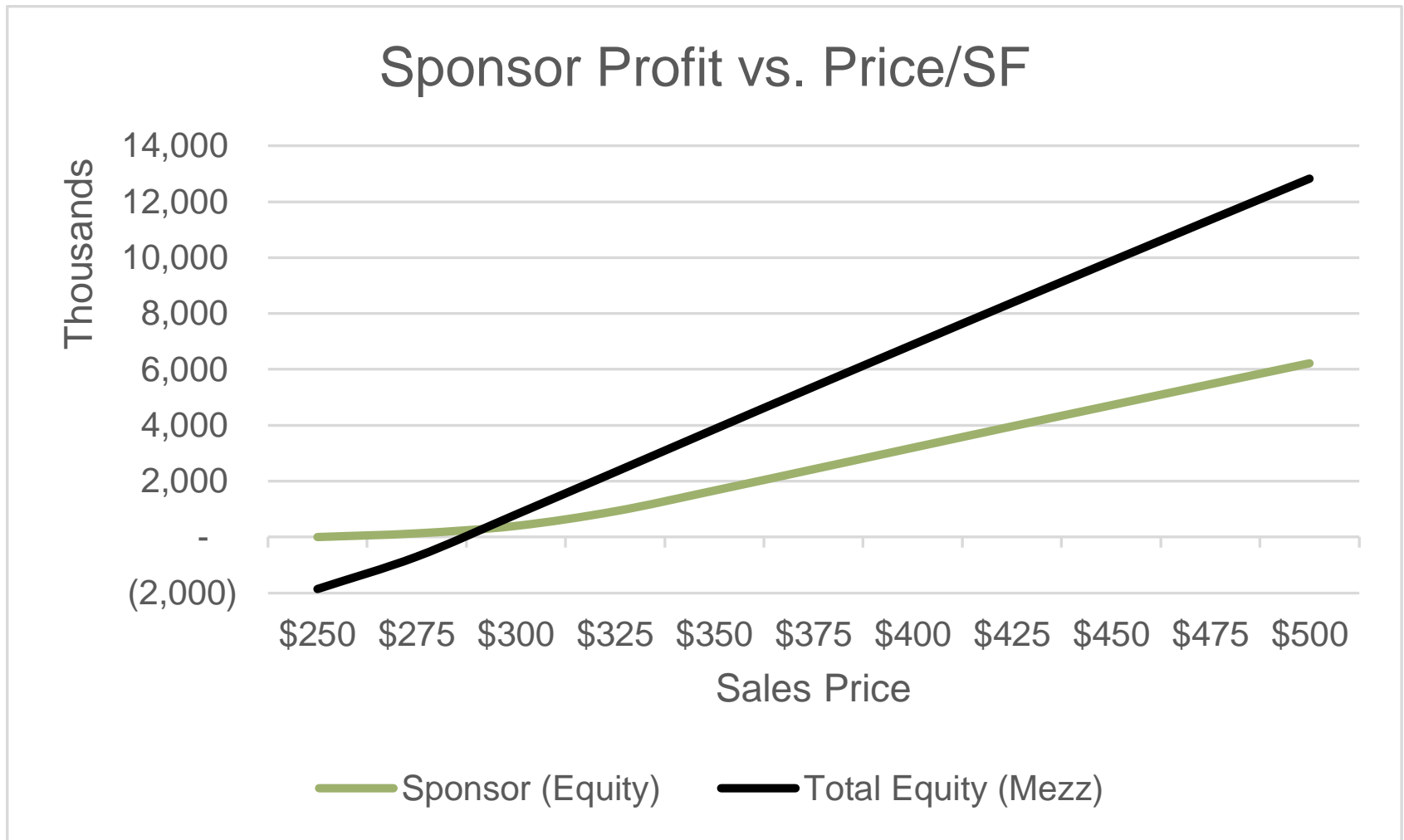
Profit Sensitivity w/Mezz



Returns & Profit Sensitivity



Returns & Profit Sensitivity



Mezzanine Considerations

- Can be creative, sometimes like equity
- Always feels expensive, even when it's cheap
- Preserves more upside for the developer
- Shortens the fuse on success
- Proceeds not usually as high equity (often fund limited)

Mezzanine Considerations

- Can be creative, sometimes like equity
- Always feels expensive, even when it's cheap
- Preserves more upside for the developer
- Shortens the fuse on success
- Proceeds not usually as high equity (often fund limited)

Summary of Considerations

- Understand the goals of the project
- Finance to manage the project's key risks
- Investors & lenders have defined limitations
- Size of the investment drives options
- The project may have to adapt to make it financeable
- Mezz. is cheaper...unless it goes badly
- Profitability is not determined by rate alone

Christopher Strom

Director of Project Development

AthenianRazak

Tel: 215.531.8163

Email: Christopher.strom@athenianrazak.com