Center for Creative Land Recycling

Education Series:

Financing Municipal Redevelopment

The Value of Time in Risk Management

Affects of Risk on the Cost of Capital;

The Capital Stack: Equity, Mezzanine, Senior, and Junior Debt Financing

&

Financing Strategies Using: Structured Seller Financing & Joint Ventures

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I. Three Main Approaches to Making Money in Real-Estate:

1. Negotiation:
   (Especially with Land Seller)

2. Appreciation:
   (Improving Property – Soft vs. Hard)

3. Tax Planning:
   (Deal structure can characterize income to defer or reduce taxes)

Managing Risk

1. Identify
2. Quantify
3. Reducing or Eliminate

II. The Five Major Risk Categories

1. Financial Risk
2. Entitlement Risk
3. Environmental Risk
4. Construction Risk
5. Market Risk

Four Ways Developers Manage Financial Risk

1. “Leverage” Equity with Debt – “The Capital Stack”

Profit Projection	=	30%
a. Total Project Cost*	=	100%
b. Sponsor Equity	=	1%
c. Investor Equity	=	9%
d. Mezzanine Debt	=	15%
e. Bank Debt	=	75%

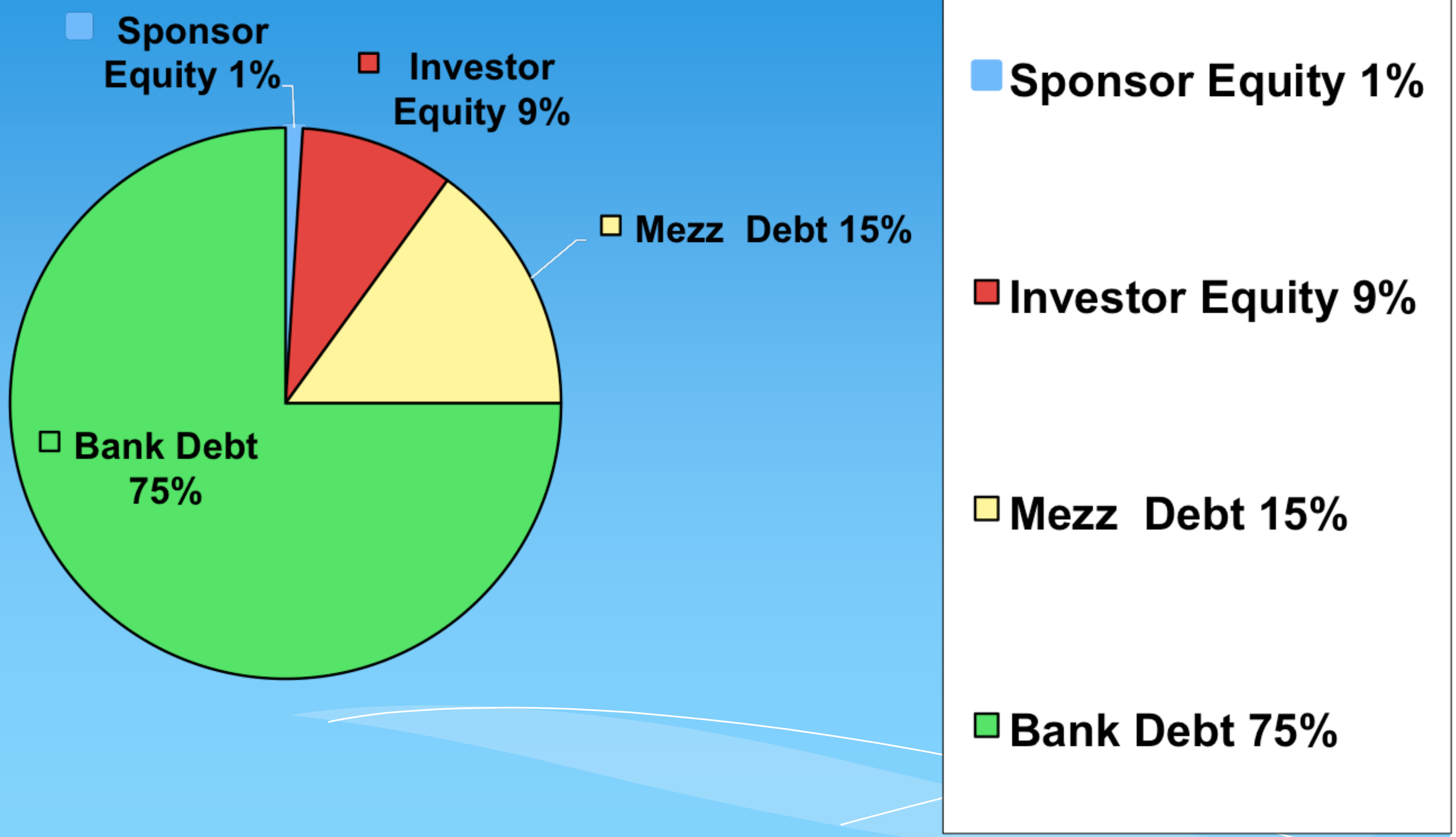
*(Total Project Cost = Land + Soft + Hard Costs)

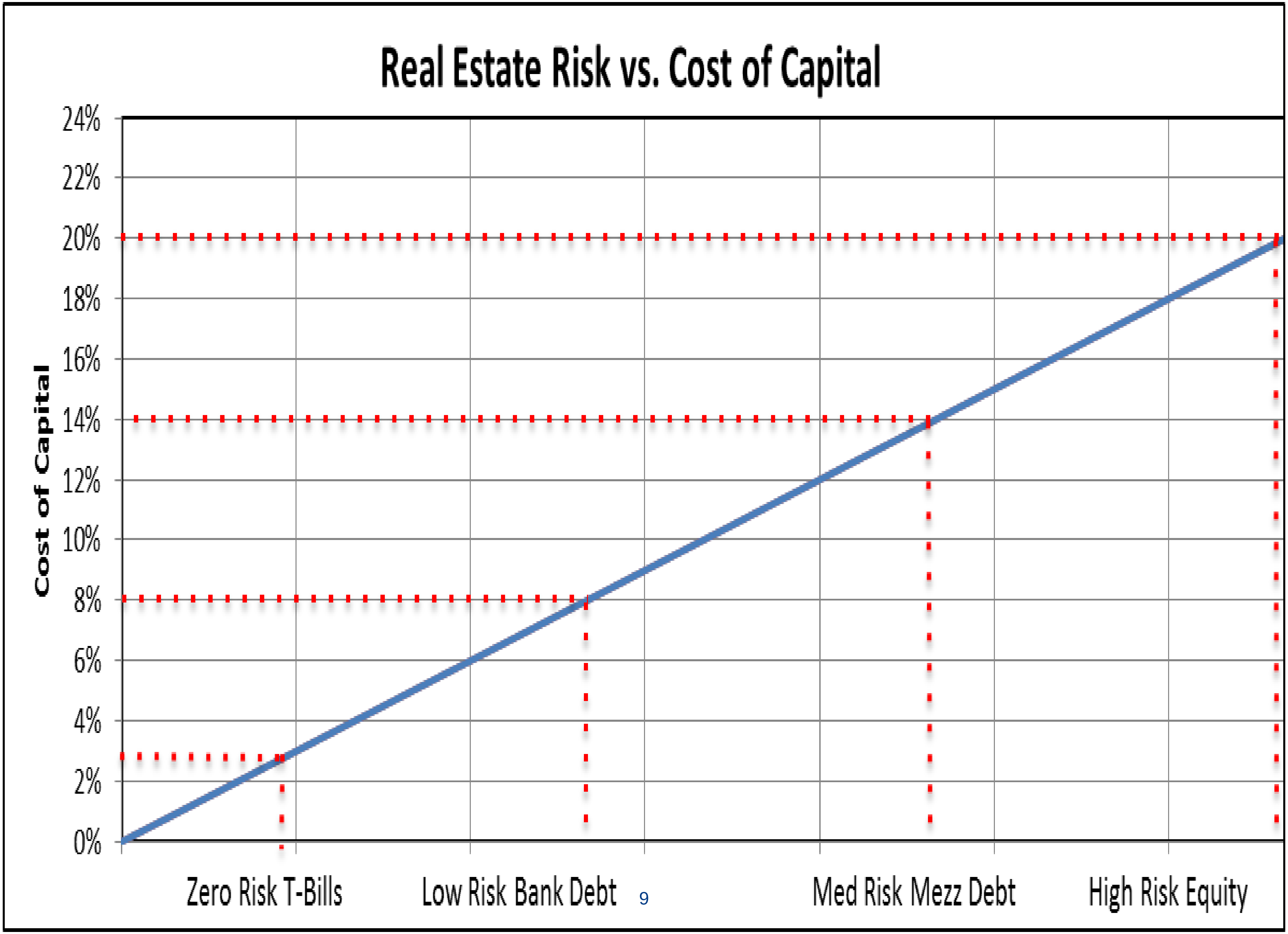
2. Invest in Prime Locations

3. Preferred Returns = Developer’s “profit deductible”

4. Waterfall Distributions = “Hurdle Rates & Promotes”

The Capital Stack at Van Leer Place




Real Estate Risk vs. Cost of Capital
Cost of Capital
24%
22%
20%
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
Zero Risk T-Bills
Low Risk Bank Debt
Med Risk Mezz Debt
High Risk Equity

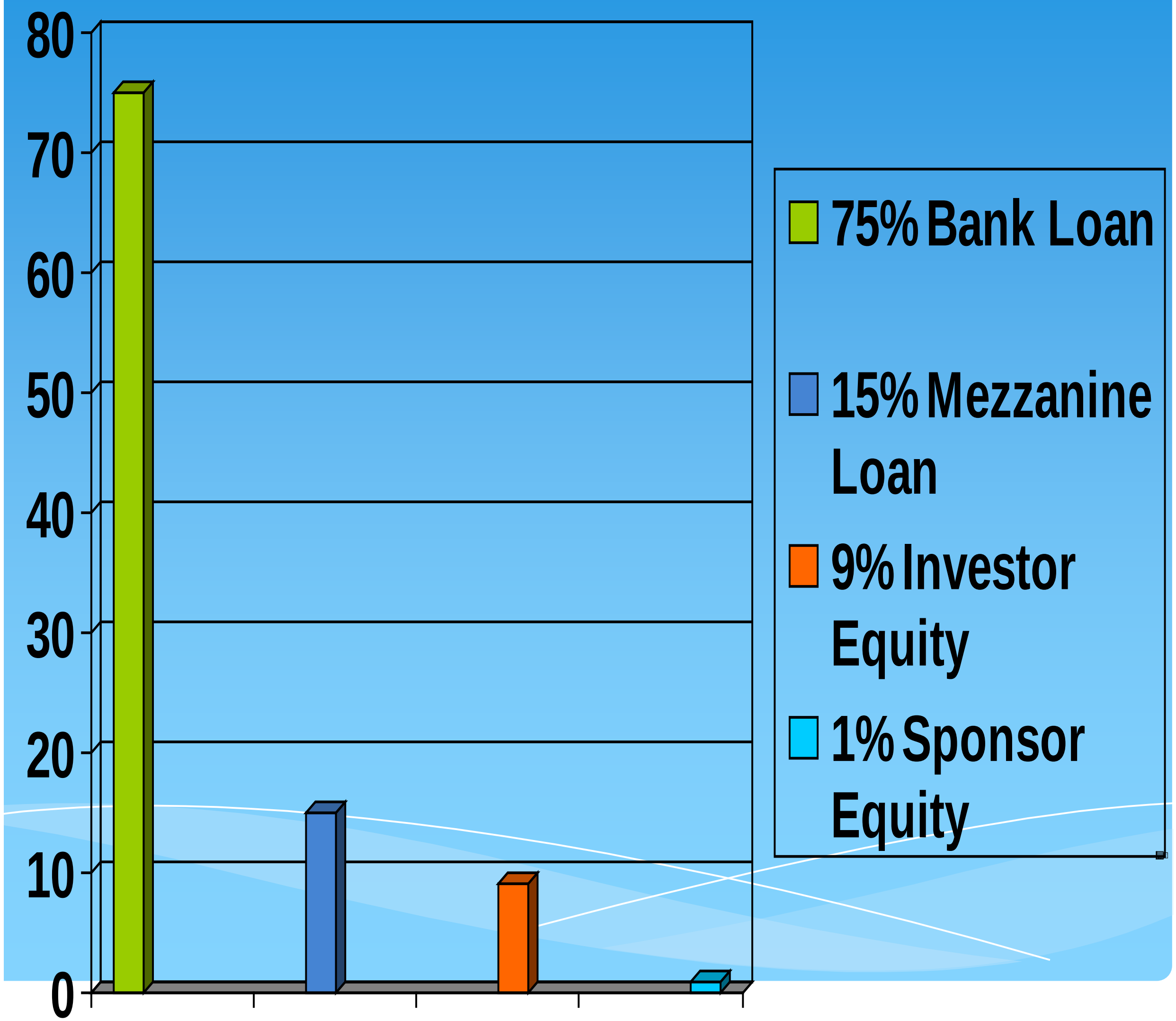
Capital Stack & Pricing Model

A. Cost of Bank Loans
1. Commitment Fees 1-3%
2. Broker Fees 1-3%
3. Interest Rates –
   a. Prime Rate + 1-5%
   b. Libor Rate + 1-5%
   c. T-Bill Rate + 1-5%

B. Mezzanine loans
1. Commitment fees 1-3%
2. Broker Fees 1-3%
3. Interest Rates 10-20%

C. Investor Equity
1. Preferred ROE 8-20% +
2. Profit Share 10-90%

D. Sponsor Equity
(After A+B+C Paid in Full)
1. Preferred ROE 8-20% +
2. Profit Share 90-10%



4. Net Operating Income (NOI)

* Explanation:
  * Income that remains after all operating expenses have been paid.
  * It is also the numerator in the quotient used to calculate value when the capitalization rate is the denominator.
* Equation:

NOI= Gross Income-Total Operating Expenses

* Example:

Gross Income	Total Operating Expenses	NOI
500,000	-200,000	300,000

4. NOI & Value - Continued…

* Additionally, NOI is key for calculating a property's cap rate value or to estimate the approximate sales price of an income-producing property

- Equation:

Sales Price= Net Operating Income/ Cap rate

- Example:

Net Operating Income (NOI)	Cap Rate	Sales Price
300,000	0.05	6,000,000

4. Internal Rate of Return (IRR)

* Explanation:
  * The IRR calculation measures the yield or rate of return on an investment rather than its present value.
  * The IRR calculation measures the yield from a series of cash flows across a specified period of time and includes the cost of the asset, the cash flows from the asset, and the salvage value of the asset at the end of its useful life.

- Equation:
  - IRR cannot be solved analytically, instead it is a guess and check method to find the rate that makes the present value of the investment's cash flows equal to zero.

4. IRR continued…

* Example:
* For a piece of equipment that costs $300,000 and will last three years. During those three years it will generate 150,000 dollars annually. In the fourth year, the company will sell the equipment for $10,000.

Period 0	Period 1	Period 2	Period 3	Period 4	IRR
-300,000	150,000	150,000	150,000	10,000	24%

Financing Techniques – By NJ State Agencies

- NJDEP Brownfield Reimbursement
- HDSRF
- Green Technology Incentives
- NJ Transit TOD Planning Grants (NJLUTrans.org), LRT, Rails to Trails Easement Leases
- NJRA, NJHMFA, NJEDA, NJEITF
- Grow NJ, Bio NJ

Municipal Tools To Aid Redevelopment

1. <u>Giving Developer time to manage risk</u>
2. Zoning – Redevelopment Areas, Expedite approvals / variances
3. Tax Incentives – Abatements / Pilots
4. Financing the Land Sale
5. Financing Infrastructure - RAD Bonds, NJEITF
6. Shared Parking Garages in TOD - Double Value
    a) Transit Commuters Use on Weekdays
    b) Residents & Neighbors Use at Night & Weekends

Project & Community Amenities Subsidized With Public Financing

Federal Highway Fund - NJ Transit “Rails To Trails” Walkway

Park Donations, Open Space Preservation structured as Charitable Donations = Tax Deductions

Historic Preservation, Facade Easements = Tax Credits

Meet Zoning Code Open Space Requirement

Transfers Park O & M Costs to City

A full Joint Venture

- Single asset LLC
- Seller's land value is time adjusted (the "Sale Price") increases with an annual appreciation rate that is added to the value of the land contribution
- Seller receives a profit share percentage for the land contribution as equity
- Seller receives a Preferred Return on his land contribution as equity
- Developer has time to mitigate risk before the land is contributed
- Developer has substantial Equity Partner with Land Owner (aka Seller)

A sale contract with Seller Mezzanine financing

* Seller finances 100% of asking price with Mezz Loan
* Mezz Loan is subordinated to the construction lender's (and any other secured debt) on the property adding to Developer's Equity %.
* The Seller PMN takes the place of the Mezz layer in the capital stack.
* Seller earns Unsecured Mezz rate from 16% to 20%+.

A sale contract with Seller secured Junior financing

- Purchase money note and mortgage (PMN & 2nd M) is subordinated to the construction lender's first lien on the property.
- The PMM <u>may</u> take the place of the Mezz layer in the capital stack.
- Secured Junior loans / Mezz rates are 12% to 16%.

A sale contract with Seller Senior secured financing

* A senior (first) secured Purchase money note and mortgage (PMN & 1st M) not subordinated to the construction lender's or any other lien on the property.
* Essentially a bridge loan because it will have to be paid off before construction financing can be placed.
* The developer <u>may</u> still need to place a Mezz layer in the capital stack.
* A senior secured mortgage rate today would be in the 6% to 10% range.

Option to Purchase in Phases

* Developer controls entire property and therefore can obtain entitlements.
* Seller has to pay taxes, insurance, cut the weeds, the fence, security issues.
* Developer can walk away only forfeiting option fee(s) actually paid (used) plus entitlement costs.
* Developer can gauge market after each phase and adjust product offering or renegotiate Sale Terms

Sale contract with a phased take down

* Like an installment sale.
* Seller holds full title for the remaining, un-purchased, parcels.
* Developer must obtain a sub-division approval – could trigger need for more variances.
* Seller has property with increased value that's fully approved - therefore it can be sold in pieces.
* Partial take down pricing can be time adjustment for each phase.

Option to purchase the entirety

* Developer controls property and therefore can obtain entitlements.
* Seller gets larger option fee payment & Full Price if Developer Closes
* Seller has to pay taxes, insurance, cut the weeds, the fence, security issues.
* Developer can walk away forfeiting (larger) option fee payment and entitlement costs.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Experienced Urban Developers
FRONT STREET
(S) TOWNHOUSE TOTAL
56,656 GSF
(N) TOWNHOUSE TOTAL
RETAIL
(2) LEVELS
HARDSCAPE
PUBLIC SPACE
PLAZA
42,670 SF
BROWN STREET
GRASS
TOWER 1
TOWER 4
HOBOKEN AVENUE