Joseph Perry, SIOR, is President of Perry Group, Ltd., a Chicago based development, brokerage and advisory firm. Mr. Perry has been an SIOR member since 2001.

Financing in the New Economy

A Quick Guide to Alternative Funding Sources

By Joseph Perry, SIOR

Professionals specializing in commercial and industrial development are all too aware of the current economic climate's impact on the viability of many otherwise promising new developments.

Commercial lenders are limited by oppressive regulatory restrictions. Pension funds and insurance companies that were active in the real estate financing space have modified their investment criteria, and the competition between deals that do underwrite to today's criteria is intense.

These dynamics have led progressive developers to identify non-customary sources of financing, often layering these more exotic or creative trenches with traditional bank financing.

In the "Good Old Days" (pre-2008), a lot of newly financed developments were predicated upon imputed values that were often speculative and sometimes too aggressive. Primary debt was plentiful and mezzanine debt, as well as equity commitments, were relatively easy to secure.

The implosion of the financial markets caused a dynamic retraction that swung the pendulum back well beyond vertical. Projects in dynamic markets that underwrite well with good credit repayment sources and stable sponsors are still not certain to secure commitments.

In today's economic climate, loan-to-value ratios are compressed. Personal guarantees are stringent. Underwriting is analyzed microscopically.

There are many available tools that can make the difference between a deal that stays in the "colored rendering" mode and those that actually go vertical. Today's professional must learn where to find these financing sources and how to apply them to the underwriting model in a manner that elevates the project viability. The following will briefly explain some of the more effective tools:

Municipal Bond Funding

With unemployment at record levels and communities desperate for new job creation to stabilize local economies, the consideration of supporting new developments with not only the bonding authority but also the credit enhancements necessary to sell this paper in the marketplace is becoming more common. Municipalities can support the financing of a desired project through the issuance of General Obligation Bonds, Tax Increment Financing Bonds, Special Assessment Bonds or other tools that the conduit financing community can use to sell the market on the security of the investment.

This risk mitigation is primarily based on some realized or anticipated benefit to the community such as an increase in real estate tax base, retail sale tax increment or primary job creation. The cost of placing this type of financing is very expensive, so the project cost must be high enough to permit these additional costs, but often the cost of these funds is lower which counters the additional capital costs, which are almost always imbedded in the debt.

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In instances where tax-exempt bonds are applicable, the investors yield demand can be met with a lower than market interest rate on the debt. Floating rates are extremely low and Credit Swaps and Rate Caps can be purchased as a hedge to rate sensitivity.

The programming of this type of financing is very cumbersome and almost always requires lengthy municipal entitlement processes, but for a project that meets the criteria for bond financing, this tool can be extremely valuable and sometimes make the difference in the financing of a development.

A community's bond rating and general economic health are critical to the consideration of the ability to sell this paper, but assuming the basic underwriting criteria are met and the municipality is progressive enough to support such a development, this funding can provide a relatively high-leveraged, low-recourse financing element.

Government Financing Programs (U.S. Small Business Administration 504) Funding

Another source for financing that has been around for many years but had been forgotten by many is U.S. Small Business Administration (SBA) financing.The SBA504 provides up to 40 percent of the total project cost, including equipment, as a subordinate loan behind a conventional 50 percent bank loan. The borrower must provide 10 percent as equity, which today is approximately one-third of what is required in a standard commercial real estate financing structure. The first mortgage is at prevailing market rates and terms but the SBA portion is fixed at below market rates for a twenty-year term. These loans are also transferable to future buyers of the real estate who meet the credit review of the SBA, which can provide intrinsic value in an exodus plan.

Borrowers must occupy at least 50 percent of the real estate financed. SBA504 loan limits are $5.5 million, so a project with a total cost of $13.75 million can enjoy up to the 40 percent leverage. Certified regional originators will work with a borrower and the first mortgage lender to package the application and commitments can be received usually within 30 days with closings in another 30-60 days. The program can be used for acquisition of existing facilities or new construction.

The SBA also administers the 7a Program, which provides debt sources for machinery, equipment, material, supplies and long-term working capital.

Other State Incentives

Most, if not all States have financial incentive programs that provide grant funds, or low-interest loans that finance industries based on job creation. Most of these programs will have little impact on the funding stack other than the preservation of working capital that would ordinarily be used for burdens like new workforce training. In most instances these programs only create value in the funding stack if the job creation is significant.

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Credit Enhancement Joint Ventures with General Contractors

One way to secure financing for projects that need a boost is to enter a joint venture with a qualified general contractor. Our firm has participated in several developments since the economic downturn by leveraging relationships with general contractors who are large enough to enhance the financing. The participation by a general contractor who has significant credit and wealth can be through a letter of credit or a limited guarantee that burns off as the development stabilizes and "seasons." The environment for commercial general contractors is directly related to the availability of debt and capital and there are many large national contracting firms that will perform their own underwriting of a project to ensure the viability and then "trade" the credit enhancement for ordinary overhead, profit and general conditions. To further induce participation in a joint venture, the borrower may be required to allow participation in the equity ownership of the asset as security against the investment, and this participation may potentially be reduced as the guarantee peels off over time.

Of course, this scenario requires a progressive general contractor with a healthy balance sheet, strong credit and a trust in their partner and the project, but if you look around hard enough, they are out there. Since 2008, our development company has financed over $62 million in new construction by leveraging this type of relationship.

These are only a few of the concepts that are out there for creative funding in the commercial/industrial real estate marketplace. The bottom line is that for the foreseeable future, the ability to finance commercial real estate will remain restricted from conventional sources, and the successful commercial real estate practitioner is going to have to get more creative about how to get deals completed.