# Alternative Financing Strategies in a World of Rising Interest Rates

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Mortgage interest rates increased through 2016 and are expected to increase periodically throughout the coming year. Because higher interest rates can make traditional financing for a commercial real estate project more expensive, other financing options should be considered to stabilize or reduce the cost of capital necessary to complete a commercial real estate project.

Larger real estate projects often use a variety of financing sources to fund the acquisition and improvement of commercial real estate. This combination of different financing sources is referred to as a *"capital stack*." As mortgage debt becomes more expensive, a diverse capital stack can reduce the amount of mortgage debt needed to finance a project, thus reducing the overall cost of the project. The capital stack takes on a different significance depending on whether a person or entity is an investor or a developer. For investors, the capital stack provides investors with valuable information relating to the pecking order of accessing cash flow, the risk of not being repaid and whether targeted returns on investment are worth such risk. For a developer, the capital stack helps to shore up the financial stability of a project and mitigate the potential transaction costs of a project.

Regardless of the perspective from which it is being viewed, each level of the capital stack must be negotiated between stakeholders (i.e., owners, developers, investors, or creditors) to ensure that the parties are in agreement, and comfortable, with their respective risks, rewards, and obligations. While there is technically no limit to the layers a capital stack may contain, a well devised capital stack will make a project much more likely to be successful. Some of the more common sources of financing included in a capital stack are briefly summarized below:

**Equity Financing**

Defined as the process of raising money in exchange for ownership, equity financing is an increasingly popular funding option. The dynamics of the stakes in ownership revolve around risk and reward. Under the provisions of bankruptcy law, creditors are first in line to be repaid when a business fails and owners (including investors) come last and are, therefore, at a higher risk. The result is that owners can generally expect higher returns than lenders upon completion


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of successful projects. The following are a couple of equity investment vehicles commonly used:

1. Investment through ownership of the project. This is a direct ownership interest in the real property and/or improvements on the real property and often through the form of tenants-in-common (TIC) ownership. A TIC interest in a project means that the owner holds an undivided percentage interest in the real estate, most often in proportion to the amount of capital invested against the fair market value of the real property. TIC arrangements have gained popularity in recent years, given they lower prices and increase choices for buyers by allowing them to pool resources and buy more real estate than they otherwise could or would independently. At the same time, TIC arrangements increase sale prices and marketing options for sellers by allowing them to sell portions of their property to buyers for prices that generally add up to more than what the seller would receive from a single buyer. Historically, TIC's were financed using a "group loan" arrangement, where the TIC Agreement would specify the percentage of each loan that was owed by each co-owner; however, in or around 2004, several lenders introduced programs under which each co-owner could obtain an individual loan secured only by such co-owner's percentage share in the property.
2. Investment through ownership of the Company. This is a direct investment in the company owning the real property and/or improvements located on the real property. There are two primary methods that businesses use to obtain equity financing: the private placement of stock with investors or venture capital firms; and public stock offerings. Private placement is more common for small to medium sized companies and start-up firms because private placement of stock (although requiring compliance with federal and state securities laws), does not require formal registration with the Securities and Exchange Commission (SEC). In contrast, public stock offerings entail a lengthy and expensive registration process with the SEC. The benefit of this type of financing is that investments need not be repaid with monthly payments, which makes it a safer funding option than loans and frees up much-needed cash flow.
3. Joint Ventures. A joint venture is a business entity created by two or more parties (or entities), generally characterized by shared ownership, shared returns and risks, and shared governance. Any securities law issues are handled by each joint venturer. Some things to consider in joint ventures is what role each party will play and what rights that party must have. For instance, a party that is primarily supplying capital for the project will often require that it be paid its return on investment before the other joint venturers receive a distribution. The party that is providing the Development and operational expertise will want to make sure it retains control of the project, and will ensure it will have access to the needed capital to develop and operate the project.

**Debt Financing**

In addition to raising capital through sale of interests in either the real property or the entity owning the real property, a traditional model of financing is the use of debt, through recourse or nonrecourse loans. Debt financing means borrowing money and *not* giving up ownership of the real estate, improvements on the real estate, or the real estate-owning entity. Debt financing often comes with strict conditions or covenants in addition to having to pay interest and principal at specified dates. There are, however, advantages to debt financing: the lender has no say in the management of the company, the business relationship ends once the money is paid back and the interest on the loan is tax deductible. Some common types of debt financing include:

1. Recourse Loans. Most individuals are familiar with recourse loans and they are the most common. Recourse loans allow the lender to foreclose on the project securing the loan in the event the borrower fails to repay it. The lender may also hold or pursue the borrower's other assets to recover any shortfall between the amount owed to the lender and the value of the borrower's collateral securing the debt.
2. Nonrecourse Loans. Nonrecourse loans are another common form of financing in which the lender agrees to only foreclose on the collateral securing the debt in the event the borrower does not repay the loan in a timely manner. The lender agrees to forego the right to pursue the borrower's other assets for any shortfall that might exist between the amount owed and the value of the collateral securing the loan. While nonrecourse loans seem to be a better option for borrowers, they are generally accompanied by higher interest rates and are typically reserved for borrowers with impeccable credit.

**Other Financing Options**

In addition to the traditional equity and debt financing options set forth above, there are several other financing options available to borrowers:

1. Mezzanine Financing. Mezzanine financing is the hybrid of debt and equity financing. It is often subordinated debt that can be converted into equity, or ownership, by the borrower if the borrower fails to comply with the loan terms. Mezzanine financing provides borrowers with the advantage of obtaining a loan with little or no collateral, while treating it as equity on the borrower's books. These loans typically have a higher interest rate because the mezzanine lender's primary remedy is to obtain ownership in the entity that was unable to repay the mezzanine loan in accordance with the loan terms.
2. Tax Incremental Financing (TIF). Tax Increment Financing (TIF) is defined as the ability to capture and use most of the increased local property tax revenues from new development within a defined geographic area for a defined period of time. This financing mechanism is a tool that municipalities

use to spur private development, by paying a developer — either up front or through reimbursement — a portion of the costs to install necessary infrastructure for a construction project. Such infrastructure may include roads, water and sewer lines and mains, storm water systems, and similar improvements.

3. Tax Credits. Tax credit programs were devised by Congress and some state agencies as a way to encourage private investment in projects and businesses that provide a public benefit to underserved individuals, families and communities; enable historic preservation; or provide clean energy. They do this by raising private capital to fill financing gaps when other public and private funding sources are insufficient or unavailable. Tax credit investments offer a dual benefit — they support the creation of positive community impacts and provide strong after-tax returns that compare favorably to other investments commonly held by corporate treasury groups. The basic tax credit concept is the same in that a borrower enters into an agreement to receive and sell tax credits to a lender at a slight discount from the full value of the tax credits. While the basic concept is the same, the numerous rules and regulations make each form of tax credit financing unique.

Given the options available for financing a commercial project, a developer's use of a diverse capital stack can help control the financial stability of a project by minimizing transaction costs. For an investor, understanding the fundamentals of a company's capital stack will help the investor ascertain: (1) the legal rights to certain assets and income; (2) the priority of payment in the event of an uncured default; and (3) the order of repayment or given authority to take over or liquidate assets in the event of a bankruptcy. From a graphic perspective, this translates to a simple concept for investors: the lower an investment appears in the capital stack, the more secure (senior) the investor's position, while the higher an investment appears in the capital stack, the greater the risks and corresponding rewards. To illustrate, if a company's capital stack consists of the following breakdown, assuming that the real estate taxes are timely paid, the first lien mortgage would be in the most senior, protected position, while the equity holder would be in the most risky position but would potentially realize the greatest returns on investment:

Equity
Preferred Equity
Mezzanine Financing
Senior Debt (First Lien Mortgage)

As companies grow and diversify their real estate portfolios, it is becoming common practice to incorporate different layers of the capital stack as a means of spreading risk and generating higher blended returns. By understanding the myriad of available sources of financing, and the company's capital stack, an investor can too become empowered to make an informed decision as to whether the risk relative to each position is commensurate with the potential reward.