Structuring the Deal to be Profitable

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Three unemployed and broke young men agree to run guns to anti-Castro rebels in Cuba. The voyage is terrifying, but things get worse once they reach the island.

Vol. 1 of a trilogy of techno-political thrillers. The USSR is gone, but what if another interest with similar goals succeeded to the assets it implanted in the USA and left behind?
Structuring Techniques

- Setting Maximum Price
  - Residual Land Value
  - Effective Cost of Debt
- Letters of Intent (LOI)
- Option Contracts
  - Hybrid: Right of First Refusal
- Lease with Option
- Seller Financing
- Joint Ventures
- Land Acquisition Loans
- Equity Financing
- Case Study
Setting the Maximum Price

1. Residual Land Value:
   Prospective Project Value at Completion & Stabilization
   - Construction Hard Costs
   - Development Soft Costs
   - Entrepreneurial/Developer Profit
   = Land Residual

Example:
$1,600,000 = 10,000 SqFt, $22/SqFt FSG (full service gross*), 8% vacancy, 35% operating expenses, 8% cap rate
Less: Construction Costs
($1,100,000) = 10,000 SqFt, $110/SqFt
Less: Soft Costs
($265,000) = $55,000 leasing commissions, $110,000 absorption, $100,000 permits, fees, etc.
Less: Profit Margin
($137,000) = 10% of hard cost and soft cost
Land Residual
$76,720
Setting the Maximum Price

2. Effective Cost of Debt (ECD)

• ECD is nominal interest PLUS all other expenses that might be incurred by the borrower such as origination fees, pre-paid interest and prepayment penalties.

• Never borrow money to acquire an income producing property (1) with an ECD greater than the CAP rate of the property at time of purchase, OR (2) an ECD greater than the discount rate which yields a zero NPV, because the discount rate used to yield zero is your “Hurdle Rate”.
1. Letters of Intent

- **Purpose**
  The LOI should express the understanding of the parties regarding the essential elements of the contemplated transaction.

- **Use**
  The widespread urban legend is that an LOI enables parties to tie property up more quickly than a full contract could.
2. Option Contracts

Options work as a hedge against not being able to assemble all the land needed or obtain necessary:

- Entitlements,
- Growth plan amendment,
- Rezoning,
- Environmental analyses,
- Investor commitments, or
- Institutional commitment for development financing

OPTION AGREEMENT FOR THE SALE AND PURCHASE OF REAL ESTATE
COMMERCIAL LOT OR LAND

WARNING: THIS CONTRACT HAS SUBSTANTIAL LEGAL CONSEQUENCES AND THE PARTIES ARE ADVISED TO CONSULT LEGAL AND TAX COUNSEL.

This Option Agreement is made on this the ___ day of ____________, 20___, by and between __________________, hereinafter referred to as the "SELLER", whether one or more, and ________________, hereinafter referred to as the "PURCHASER", whether one or more.

FOR AND IN CONSIDERATION of $10.00 and other good and valuable considerations, the receipt and sufficiency of which is hereby acknowledged, it is agreed as follows:
HOW AN OPTION WORKS

• Seller unconditionally agrees to sell to Buyer
  – Seller can take back-up contract(s)
• Buyer pays consideration ($) to Seller
  – Amount is negotiable
• Buyer has to exercise option (go hard on the contract) within a specified period of time
  – Time period is negotiable
• Seller has no tax consequences until option is exercised or expires
• Allows buyer to control the land for little initial consideration
TACTICAL CONSIDERATIONS:

– Works best in a Buyer’s market;
– Apply some or all of the option money to the purchase price (works toward equity portion for future loans)
– Make the option payments in installments (retain use of the funds for longer periods)
– Tie purchase to enhanced entitlements or zoning
**Rolling Options:**

- Allow development of contiguous parcels incrementally
- Initial take-down may be for signage, access, sales/leasing center, models

<table>
<thead>
<tr>
<th>Phase One</th>
<th>Phase Two</th>
<th>Phase Three</th>
<th>Phase Four</th>
<th>Phase Five</th>
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<td>2012</td>
<td>2014</td>
<td>2016</td>
<td>2018</td>
<td>2020</td>
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**street**
2. b. Right Of First Refusal

1 STEP SHY OF AN OPTION

How It Works:

– Does not entitle the holder of the right to force the other party to sell or lease the asset.
– If and when the other party decides to sell or lease the asset to any *third party*, the holder of the right of first refusal can require the asset to be sold or leased to him or her for the same price and terms that the owner is willing to accept from the third party.
– Doesn’t tie the land up; seller can still try to market the property
3. Lease with Option to Purchase

How It Works:

- Buyer leases the property from Seller for a specified period of time at an agreed upon rent
- Lease contains a right of Buyer to exercise an option to purchase the leased property
  - Best to have the price and terms spelled out in the lease or attached as a proposed contract
- Gain use of the property
  - 24/7 Access
  - Post signs advertising the coming project
- Works best in a Buyer’s market (no demand)
TACTICAL CONSIDERATIONS:

– Annual rent can be based on a percentage of the land’s market value

– Some of the lease payments may be applied toward the purchase price (negotiable)

– Exercise of option must occur by determinable specific date
Sandwich Leases:

- Development occurs on the *leased* land (with lease *subordinated* to development financing)

- Owner is paid for, and releases, parcels as they are sold, but the balance of the land remains under lease
4. Seller Financing
a/k/a Purchase Money Mortgages

• Generally involves the seller’s level of sophistication (more is better) as well as his or her financial circumstances, plus the current market situation

• Down payments typically range from 10% to 30% of the purchase price
GOALS:

Acquire land:

• With minimal equity upfront
• Avoid institutional lenders
  – Better mortgage terms and less cost involved
• Avoid additional equity investors
• Minimize interest rate
• Maximize term
• Get releases
**Releases:**

- A *formula* will have to be negotiated that satisfies *both* the seller’s need for adequate security and the buyer’s development plan.
The release provisions should be in the original contract for purchase of the property, then copied into the PMM

- Releases generally “stay out in front” of the principal balance at 1.20 to 1.50 x original principal balance

- Example:
  Original Principal Balance = $5,000,000
  Property Size = 100 acres
  $5,000,000 ÷ 100 = $50,000 per acre
  Release Parcel = 20 acres
  Release Formula = 1.25
  Release Price = $50,000 x 20 x 1.25 = $1,250,000
Tips For Releases

1. Releases should be structured from the down payment as well as future principal payments on the PMM

2. Releases should be *cumulative* to the scheduled payments

3. Advance payments for releases should apply toward the *next accruing* principal payments
5. Joint Ventures

• Usually a type of partnership with a single specific purpose in mind for example:
  
  Partner A = Landowner
  Partner B = Developer
  Partner C (maybe) = Investor (Capital Partner)
How It Works:

- Seller contributes the land in exchange for an equity interest equal to the agreed upon value of the land relative to the overall value of the project
- Seller agrees to subordinate title to a construction loan
- Seller may get a preferred return - cumulative or noncumulative
- Developer provides cash equity and/or sweat equity (knowledge, experience, and the grunt work)
- Developer receives agreed upon amount or percentage as compensation (in lieu of or in addition to developer/management fees received during the construction and leasing periods)
- Landowner and Developer split any remaining balance per an agreed upon formula for priorities and percentages
- A 3-tiered structure may be used if third party equity investors are involved
Tips For Joint Ventures

- Be prepared for partnership disputes
- Be prepared for dissolution of the venture
- Don’t put yourself in a position to lose control of the venture
- Have a viable backup plan
6. Land Acquisition Loans

- Generally institutional lenders loan only to their strongest and best customers who have fully entitled land and other assets or sources from which to repay the loan
CAVEAT: Institutional lenders generally say they will finance “up to 50%” of the acquisition price of unimproved land if at all, but the actual loan-to-value may be less depending on:

1. The lender’s risk tolerance
2. The lender’s determination of the actual value versus the contract price
3. The extent of the borrower’s equity contribution
4. The borrower’s relationship with the lender
5. The borrower’s financial strength and credit history
6. The borrower’s level of experience with the planned development
7. Estimated time before take-out will occur
8. Conditions in the market
TACTICAL CONSIDERATIONS:

– Expect to provide personal guarantees to adjust for the absence of an income stream produced by the land
– Consider using a revolving line of credit
– Use builders’ precommitments, presales, preleasing, agricultural leases
7. The Use Of Equity

Equity Vs. Debt

Generally, the cost of equity is considered to range between 4% and 8% above the effective cost of debt (ECD)*

*ECD was discussed in an earlier slide.
Developer’s Objectives:
– Obtain capital for acquisition, planning, and entitlement of land
  • Don’t give away the farm up front
  • Carefully balance all participants’ risks and rewards
  • Remember developer/management fees
– Maintain control of the enterprise
– Prepare from the beginning for the possibility of dissolution of the venture
– Communicate frequently and clearly with the investors
A word about Developer & Management Fees

- *Developer’s fees* for overseeing the development of the project; typically 3%-4% of hard and soft costs
- *Management fees* for overseeing day-to-day management of the project: typically 3%-4% of effective gross income (adjusted gross income)
Distributions of Cash Flow from **Operations**

- **Preferred Return ("Pref")** – initial distribution of cash flow goes to investors in a specified % before any other distribution
- **Pari Passu** – the developer receives a % of the distributable cash proportionate to the % of his equity contribution
- **Promote** – distribution of the remaining cash to the developer in an amount disproportionate to his actual % of equity invested (as an incentive)
Distribution of Cash Flow from *Sale*

- After payment of expenses of sale and repayment of debt
- Then distributed to all parties in the amount of their initial capital investment
- The balance is distributed in predetermined proportions (50/50; 60/40, etc.)
- Exception: *IRR Preference*, an investor’s specified IRR must be achieved before the balance is distributed
- *IRR Lookback* – if an investor was to receive a specified IRR and it isn’t achieved in the final distribution, then the proportions of other investors are adjusted to cover it
Outside investors put up 90% of the equity required and developer puts up 10%.

Outside investors have a 9% return on equity

Project is 3 years in development stage, then produces cash flow for 5 years of operations.

Property is sold at the end of the 5th year of operations.
Annual cash flow:

1. is distributed to outside investors until a specified hurdle return (c.f., 9%) is received (the “Pref”);

2. Next, the developer may receive a larger share, disproportionately to his 10%, of any additional distributions (the “Promote”);

3. All remaining money may then go to the investors;
Distributions – Example slide 3

At sale (*The so-called “waterfall” effect*):

1. The net proceeds after repayment of debt goes to investors until they have received return of equity in full
2. Next cash goes to investors until they have received their priority return on equity (their 9%: cumulative or noncumulative)
3. Then cash goes to developer until the agreed amount or percentage is reached (hopefully in addition to developer/management fees paid during operations)
4. Any balance is divided according to the previously agreed split
The investment vehicle can be a:

- Partnership,
- Limited partnership,
- LLC, or
- Corporation (C or S)
A Word About Syndications:

– Syndicators, promoters, or sponsors raise capital from investors and charge fees and/or may retain an interest in the venture

– Complex tax and securities laws are involved
  • Violation of the securities laws carries severe penalties
The Last Resort - *Example*:

– XYZ, an *opportunity fund*, is actively seeking investments in joint ventures with current owners and developers.

1. The developer monetizes part of the asset value of *entitled* raw land, OR

2. Acquires a financial partner for acquisition and development financing.
– XYZ’s parameters include advancing to the developer ($$$$) per unit for all units approved for the site on one of the two following bases where the developer takes the advance from the closing table on a *non-recourse* basis:
1. Put the unencumbered land into a joint venture with XYZ. Upon sale of all or a portion, XYZ would receive back all of its investment plus an 8% compounded return. Additional distributions would occur on the following XYZ/Developer basis:

1. XYZ 75%/Developer 25% until XYZ receives a compounded 15%
2. XYZ 60%/Developer 40% until XYZ receives a compounded 22%
3. XYZ 30%/Developer 70% on all further distributions

- OR -
2. XYZ would loan to the money to the Developer for up to ten years at an interest rate of 20%, which would include an interest reserve for 2 years. After two years, there would be a pay rate of 8% with the balance accruing.”
An Example…

THE PROJECT:

– Purchaser – Joe Developer
– Acres - 60
– Purchase Price - $3,000,000
– Zoning – Multifamily
– Existing Entitlements – 5 DU/acre (300 total DUs)
THE LAND PURCHASE:

– $750,000 down
– 7% interest
– 3 annual payments including interest
– $857,366/year
– Subordinated to construction loan
THE MECHANICS:

- XYZ provides $3,000/DU ($900,000) to Joe on a non-recourse basis and acquires a joint venture interest with a priority payout position at sale.

- Joe gets the money for the down stroke and some working capital, but acquires an equity partner, a backseat for payout, and possible loss of control of the deal.
CONCLUSION:

– Joe gets construction and permanent financing from lenders
– He builds a 300-unit apartment complex on the property
– He sells the project (after the three years needed for construction and lease up) at a price of $27,000,000.
– His net after paying off the bank loan and costs of sale and accounting for other development expenses is $2,000,000.
Payout Of The $2 Million (IN THE ACTUAL ORDER):

1. XYZ gets its $900,000 plus 8% compounded = $1,133,741 / Joe gets $0

2. XYZ 75%/Developer 25% until XYZ receives a compounded 15% ($235,046/$78,349)

3. XYZ 60%/Developer 40% until XYZ receives a compounded 22% ($176,984/$88,492)

4. XYZ 30%/Developer 70% on all further distributions ($86,216/$201,172)
Joe’s Bottom-line:
$78,349 
+ 88,492 
+ 201,172 
$368,013 = 18.4%

XYZ’s Bottom line:
$1,133,741 
+ 235,046 
+ 176,984 
+ 86,216 
$1,631,987 = 81.6%

Caveat: when you swim with sharks, you’re probably the lowest link in the food chain.
CASE STUDY

The Man With No Name Neck:
Cast of Characters

- **Owner** – The Man With No Neck (MWNN)
- **Owner’s Attorney** – that would be me
- **Buyers** – father son team who didn’t seem to know anything about real estate
- **Buyer’s Attorney** – former judge and member of State’s largest law firm
- **Postman** – everyone in Florida has a real estate license
- **The Mob** – The Mob
- **Others** – assorted country boys who can shoot the eye out of a squirrel at 500 yards; gorgeous young lady
- **The Property** – an obsolete, but strategically located, rundown former motel
The Property
The Deal

• The Postman rings once
• Asking price versus actual value
  – Justification for the difference or “the hole in the donut”
• The Buyers’ response
• The Postman rings twice (much later)
• The contract is signed
• Contract Extensions and “value added”
• Default: the “Mob” enters the scene
• The Owner’s response to “the Mob”
• The “New Deal”
• The closing (“triangulation”)
• Post-closing: the car and the cutie
Thank you for your time, attention, and participation.

Best of luck in your careers going forward.

Please don’t forget to check out: