Capital Structure in Mixed-Use Development

by

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ABSTRACT

A survey-based approach was employed to determine the most important factors contributing to the successful financing of mixed-use development. Individual real estate developers were contacted to discuss their specific projects along with construction and permanent lenders. These projects contained three or more uses and were located in major metropolitan infill locations across the US. Specific questions were asked about the entire capital structure including equity, construction and permanent debt.

The thesis contains a background on mixed-use development and its growing importance in the marketplace, discussion of equity and lending fundamentals within commercial real estate, a presentation of the data and finally an analysis of the findings.

From the data, three main factors were derived that affect the ability of mixed-use developments to successfully receive financing. These include the size of the developer in relation to the project, the amount of pre-leasing and pre-sales completed and the ability to compartmentalize the project by use. These conclusions are important for any developer attempting to complete a mixed-use development of any size or complexity. To successfully build the project and appease any lender concerns, the developer must address each issue.

Thesis Advisor: Brian Anthony Ciochetti
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Chapter 1

Hypothesis

Mixed-use development has become a hot button for many in the design and development fields as well as the public realm. The renewed interest in cities and walkable, people-oriented places has been well documented and continues to draw interest in how to build these mixed-use projects. With increasing support from public officials, urban planners and design professionals, mixed-use projects are proving to have an important place in our built environment. However, the unique nature and recent emergence of mixed-use developments in the marketplace have caused developers to devise different strategies when attempting to finance these projects. Many financial institutions have a narrow lending criterion for real estate and mixed-use does not fit the traditional single product type familiar to lenders. Nonetheless, developers and lenders are finding solutions to structure these deals to be financially profitable for both parties involved.

This thesis hypothesizes that there are certain factors evident in mixed-use developments that contribute to their ability to successfully receive financing. This thesis will investigate the capital structure of mixed-use projects in an attempt to identify the most important factors driving the capital structure allocation decision. Capital structure can be defined as the total financial resources involved in a real estate project. Depending on personal and market conditions, the developer has the opportunity to structure deals in various ways dependant upon numerous factors. Due to the

complexity and unique nature of many of the deals, certain general factors will be identified that are present across a range of projects. These factors affect the entire capital structure from equity to construction to permanent debt and must be considered in order for mixed-use developments to continue to gain acceptance in the marketplace. If certain factors can be identified and found to be significant, these results could help developers understand how to successfully conceive and build mixed-use projects in a more efficient manner.

Methodology

In order to identify the most important factors affecting the capital structure allocation, a survey-based approach was implemented to gain knowledge and insight from developers of mixed-use projects. This survey delved into individual project information from different developers in different geographic areas. Fifteen developers were approached to complete the survey in addition to interviews with one construction lender and one permanent lender. The entire capital structure was discussed and what factors drove the developer to seek that particular structure for the project. For the basis of this thesis, a mixed-use development was defined as containing three or more uses as defined by standard real estate product types and been initially conceived as a mixed-use project. The survey was divided into three sections addressing the project overview, the equity structure and the debt structure. The survey can be found in the appendix of this thesis.

The survey was conducted over a period of two months where individual developers were contacted and asked the questions from the survey. The data were collected and then compiled to determine what factors were present across the broad range of mixed-use deals surveyed. These factors were then ranked according to their prevalence in the data. The highest-ranking factors were then analyzed to illustrate how they affected the mixed-use projects in the data and how they could affect a broader spectrum of mixed-use projects in the marketplace.

Thesis Outline

This thesis will begin by illustrating the history of mixed-use developments and why they are becoming more important in the marketplace today. A more in-depth look at these developments will be presented to help the reader understand what they are and who is looking to build these types of projects.

The financial aspects of these developments will then be explored including the financial markets and the different participants involved in commercial real estate finance. Each of their goals and strategies will be outlined to show how they affect development and what kind of money they bring to the deal. The specific allocation of capital within real estate developments will be described with additional discussion on mixed-use projects in particular.

Next, the data will then be presented from the survey. The individual projects will be detailed in-depth as well as summaries from interviews with construction and permanent lenders for mixed-use projects.

The data will then be analyzed to ascertain what factors are most prevalent across the range of included projects. The most prevalent factors will be compiled and then discussed for their role in the success of mixed-use developments.

Finally, the conclusion will attempt to describe how the findings from the data relate back to the original hypothesis and what implications can be made for the future of mixed-use development.

Chapter 2

Mixed-Use Development Background

Mixed-use development can be defined as different real estate uses combined on the same site in one development project. These uses generally are complementary with each other and can include residential for-rent and condominium, office, retail and hotel. Two or more uses together can be considered mixed-use by the real estate industry as the developer tries to create an environment where the two uses work together financially and aesthetically. "These projects are often in expensive, in-fill locations that necessitate largely vertical development, and therefore tend to be more expensive than equivalently sized, horizontally developed projects with distinct uses. This increased expense arises from higher costs relating to the land, vertical development and structured parking, increased carrying costs (since these projects tend to take a longer time to complete) and higher design and legal costs (due to their complexity)." [1]

Despite the more complicated nature of the mixed-use development, their returns can be substantial over time for the developer willing to understand and have patience for the project. The infill location delivers developed infrastructure, a known market and potential high barriers to entry for competing developments. The combination of uses can actually create synergies between the product types as office users want retail and hotels nearby or residential occupants want retail and work space in proximity to their

[1] Jones, David H. Financing for Mixed Use/Planned Development Projects. The Real Estate Finance Journal, Spring 2003. p. 1

home. For many users, the ability to walk to a different product type is a welcome change. Mixed-use developments seize on this feeling and attempt to create a better "sense of place" for its occupants who are willing to pay to live, work and shop in these types of projects.

Zoning for these types of developments is increasingly common in municipalities pushing for higher density near transit stops, main streets and high profile locations. Much of the current thinking surrounding "new urbanism" and "smart growth" focuses on innovative ways to create density in an intelligent way to give people options to constantly driving the car. Commute times and distance have consistently increased during the past few decades in almost every major metropolitan area contributing to pollution, congestion and growing commuter anger. Many communities are now considering possibilities on how to alleviate these pressures and are increasingly looking to mixed-use developments as one of the solutions.

Different organizations such as the Congress for New Urbanism, are promoting communities such as this and are working with local governments and communities to make them aware of what traditional neighborhood design entails and what they can do to encourage this type of development. [2] "New urbanism advocates sidewalks, grid network, an integration of housing, retail and office, a neighborhood/town center within walking distance to residents, and bicycle paths. It also promotes connectivity with

[2] Congress for New Urbanism, http://www.cnu.org.

surrounding neighborhoods, developments, or towns, while also protecting regional open space." [3]

Another form of this policy promoting mixed-use is the transit-oriented development. The Northeastern Illinois Planning Commission defines Transit-oriented development as "the design and development of land around transit stations that encourage people to use mass transit within a neighborhood, between neighborhoods, and throughout a region. Transit-oriented development brings more people and more businesses to a station area, increasing the sense of community and promoting a thriving market place."[4] While obviously not every area has transit available, many metropolitan areas either have and are expanding their transit options or are building new transit systems to supplement their formerly car dependant travel options. The public advocacy group, Sprawl Watch, comments that, "TOD advocates the importance of coordinating land use and transportation decisions and the need to cluster housing, commercial activities, and overall density along transit routes." [5] Mixed-use development plays a key role in this strategy as the many uses are clustered around transit stops to preserve open space and create communities that encourage public transit and diminish daily car trips.

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[3] Hikichi, Lynda. New Urbanism and Transportation. CE 790, University of Wisconsin-Milwaukee, December 2003. p. 10

[4] Northeastern Illinois Planning Commission. Building a Regional Framework: Transit Oriented Development. January 2001.p. 2

[5] Transit Oriented Development: Development with People in Mind, http://www.sprawlwatch.org/reducingmotor.html, accessed December 4, 2003.

Real Estate Finance

Traditionally, the real estate finance industry was quite simple. The developer would build a relationship with the local bank that would provide all the necessary financing for the project from conception to typical long-term mortgage debt. During the last few decades, the entire capital structure has become much more sophisticated as the industry has learned to specialize in different aspects of the real estate development-financing arena. There exist both large, multi-national lending institutions offering every aspect of the capital structure and small local banks catering to local developers construction loan needs. The entire capital structure now contains many participants who have gained immense knowledge and sophistication in their respective capital ventures. For this thesis, the separate capital structures will be divided into equity, construction and permanent debt providers and their role in the real estate development finance process.

Before continuing with the description of the separate capital structures, a quick discussion of the concept of risk versus return must be made. Any type of participant in real estate must thoroughly understand the theory of risk versus return. Investors, developers and lenders constantly reevaluate their position in regards to the risk versus return of the project. By nature, investors are risk averse. Fundamentally, as a project becomes riskier, meaning there is a greater chance it will fail, the more return an investor will require to compensate for the added risk. Lenders provide loans at interest rates based on this concept. If the lender believes there is a higher chance the

borrower will be unable to make payments on the loan, a higher interest rate will be charged to compensate for the additional risk accepted by the lender. This is a simplistic explanation of the theory of risk versus return but it is necessary to understand in order to comprehend the actions and decisions of participants in commercial real estate. [6]

The following sections will present an overview of capital structure in real estate development. The first section will discuss equity and the various forms of equity present in development deals. The second section will discuss debt in the form of construction and permanent loans. The third section will then detail how mixed-use financing compares to traditional financing of single-use real estate projects.

Equity

Equity is a crucial component to any development deal. It can come in one of three forms: developer equity, outside equity or a combination of both. Banks require equity in almost every deal and the developer must weigh their options to determine what form of equity will be provided in the deal.

The first form of equity is the developer's own funds. In this scenario, the developer has enough cash on hand to satisfy the requirements of the potential loan. The developers

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[6] Geltner, David M. and Norman G. Miller Commercial Real Estate Analysis and Investments. South - Western Publishing, 2001. p. 195-197

are willing to fund the project with their own money. This requires large amounts of capital from the developer and is rare in the marketplace today. Very few developers have the net worth to satisfy the equity requirements of a potential loan for a large project. Many are also unwilling to commit much of their net worth to one project. Despite this fact, there are developers today, including several in the data, who provide the necessary equity themselves for their projects. Reasons for this can include the desire to maintain control of the project and unwillingness to pay potentially exorbitant returns to equity partners. By including equity partners, many developers feel they must relinquish some control over their projects because the equity partner now demands some say in any decision.

The second form of equity is an outside partner. Employing outside equity can be advantageous to a developer because it allows the developer to seek out well-capitalized partners to contribute money to a deal that a developer would otherwise not have the funds to do. In this scenario, the outside equity provides all the needed funds to support the equity requirement in the deal. "From the developer's perspective, the equity investment allows the developer to generate fees and returns based on his development skills and activities, rather than the investment of [his] capital. It allows the developer to preserve [his] capital to support guaranties made by the developer to lenders, and for use in a range of future fee-generating projects [by the developer]. From the equity investor's perspective, investment in a development deal allows the opportunity to generate leveraged returns in an optimistic environment at a level that is rarely available in real estate except in the case of riskier distressed or turnaround

situations."[7] As the real estate industry has become more sophisticated, so too has the number and scope of equity providers. There are three primary outside equity investors in development projects: joint venture (JV) partners, passive investor partners and mezzanine fund partners.

Joint venture partners generally consist of other real estate operating companies or entities that take an active role within the development. REITs, public corporations and private companies are all examples of potential JV partners. In this scenario, the developer forms a partnership with the other entity to co-develop all or a portion of the project. The partner brings their own capital to the project in the form of additional equity and is able to provide the needed funds to satisfy the equity requirements of the lender. JV partners may be responsible for one component of the project or share responsibility with the developer for the entire project. Needless to say, they take an active role in decision making for the development.

Passive investors are another form of equity for a development. These partners contribute capital to the developer but do not take an active role in the project. These types of investors can include opportunity funds, institutional investors, high net worth individuals and friends and family. Each of these passive investors has different investment criteria and parameters. Depending on the equity partner, their investment timeline can be as little as 1 year to as much as 10+ years for larger projects. The passive equity partner is looking for a return on their money corresponding to the risk

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[7] Kane, Meredith J. Equity Investment in Real Estate Development Projects: A Negotiating Guide for Investors and Developers. The Real Estate Finance Journal, Spring 2001.p. 5

they feel is evident in the development project. Opportunity funds can seek returns in the low to mid 20's and expect to remain in the project for a short period of time. Institutional money, such as pension funds, can remain in the project for a much longer period of time and expect returns in the 10 to 15% range. Passive investors are sought by the developer to contribute money to the project without taking an active role in the development process. This type of equity investment may require the developer to produce high returns for the investor but it also allows the developer to receive additional equity that was not available before as explained in the previous paragraph on general outside equity.

Mezzanine funds are the third form of outside equity partners. Mezzanine lending is a fairly new phenomenon and is gaining popularity in today's marketplace. It can act as equity or debt depending on the capital structure of the deal and the needs of the developer for the particular project. The mezzanine piece can help to fill the gap between the first mortgage and outside equity. Since permanent lenders and construction lenders will only lend to a certain loan to value ratio, and the developer does not want to pursue vast amounts of costly outside equity, mezzanine lending can help to bridge the gap. [8] "The challenge in supplying supplemental finance is that risks and transaction costs are relatively high, thereby restricting the kinds of financial claims that can be offered and limiting the set of potential suppliers. Debt-like claims are generally favored over equity-like claims to address risk and information issues, and an increased level of standardization is required to reduce contracting and monitoring

[8] Rosenthal, Shawn Comparing Mezzanine to Alternative Debt and Equity Products. Briefings in Real Estate Finance, July 2004.p. 65-66

costs. The ability to fund senior as well as mezzanine positions in the capital structure is particularly important in addressing hard-to-control investment risks and contractual provisions that sometimes limit property owner access to supplemental financing sources." [9] Mezzanine funds are increasingly common in the marketplace today and provide yet another source of outside equity to the developer.

Debt

The other component in the capital structure is debt. In development projects, debt takes the form of construction and permanent loans from lenders. Like equity, debt is a crucial component to the capital structure and affects many of the decisions made by the developer. The following sections will focus on construction lending, permanent lending and mezzanine debt lending.

Construction Lending

The construction lending industry mostly involves local banks where the project is located. These banks have a local presence and an intimate knowledge of the market. Construction loans are generally made on a short-term basis to include the time of construction to the point of stabilization. These loans can be considered risky for the bank, as there is no collateral in the form of physical real estate to ensure the bank will

[9] Riddiough, Timothy J., Optimal Capital Structure and The Market for Outside Finance in Commercial Real Estate. University of Wisconsin-Madison, Graduate School of Business, August 2004. p.23

receive its money back. Construction loans often require personal guaranties from the developer or proof of a well-capitalized equity partner to ensure the project will be completed. "Development loans are much riskier than long-term standing investment commercial mortgage loans. There are limited differences in delinquency (default) rates between single-family loans, commercial loans (nonresidential/non-farm), and multi-family loans; on the other hand, however, [commercial] development and construction loans show twice the delinquency rates of commercial [permanent] loans." [10]

These types of loans will often require a permanent loan to already be arranged to take-out the construction loan when the property is completed and reaches a stabilization point. Construction lenders are not in the business of making long-term loans and want the borrower to provide an exit for the bank in the form of a take-out permanent loan on the project. Construction loans generally are made on a floating interest rate basis where the rates can move up and down according to the movements of the market. The interest rate is reset during periodic intervals through the life of the construction loan according to prevailing market interest rates.

Many banks will only lend to a certain loan to cost of the project, generally around 70 to 75% of LTC. This is done to be sure there is sufficient equity in the project and to incentify the developer to complete the development. If the developer does not have or does not want to provide their own money for the required equity, they may have to seek outside equity as explained in the equity portion of this thesis.

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[10] Lea, Michael J. The Risks of Commercial Real Estate Lending. The Urban Institute, December 1997.p. 10

When these loans are made, the construction lender is not only underwriting the specific deal, but also looking at the strength of the borrower and their ability to successfully complete the project on time and within the budget. The banks want to be comfortable with the track record of the developer and frequently analyze the integrity and reputation of the sponsor in addition to the fundamentals of the specific development.

Banks are underwriting deals on a more conservative basis due to the S&L crisis of the early 1990's. This crisis occurred partly because of the reckless lending attitudes toward real estate in the 1980's. The federal government passed legislation in the early 1990's outlining new underwriting policies for lending institutions. FIRREA was one of the most important pieces of legislation to affect the banks. It outlined stricter underwriting standards and strengthened capital standards for lending institutions. [11] Modern banks have developed their lending criteria based on the legislation standards contained in acts like FIRREA.

Some industry participants and observers say the roles of banks have changed since that legislation. One observer believes that the banks, by "imposing financial, qualitative, and most important, quantitative restraints, have asserted their role as 'policemen' of the development industry". [12] This reputation has been established due to the level of underwriting risk banks will use. "To assess the risk of development lending effectively, an institution must first develop a set of underwriting parameter on which the decision to proceed or not will be based. These requirements provide the

[11] Seidman, Ellen FIRREA: 'Tough Medicine'. America's Community Banker, August 1999. p. 28
[12] Gordon, Ken Risk Assessment in Development Lending. Briefings in Real Estate Finance, June 2003.p. 8

underwriter with the necessary tools to determine whether the project meets corporate portfolio requirements. In addition, they provide an effective means of monitoring the construction process. Management of development risk thus takes place both before the borrower's request is approved and during the construction process." [13]

The due diligence process undertaken by the banks prior to funding a loan may include several elements. These can include:

- Location and market analysis
- Land value
- Design and zoning approvals
- Construction budget and schedule
- Developer history and financial strength
- Necessary recourse and guarantees
- Degree of leverage – LTV, LTC
- Exit strategy of bank/ability to receive permanent lending[14]

Permanent Lending

A permanent loan is arranged to take-out the construction loan when the property reaches stabilization. There are several lenders who provide permanent financing.

[13] Ibid p. 8-9
[14] Ibid p. 8

These lenders can consist of life insurance companies, investment banks in the form of CMBS and quasi-governmental entities like Fannie Mae. While Fannie Mae is generally considered to be a residential lender, they will consider projects with several uses. The non-residential uses must not generate more than 20% of the total revenue for the project. Each permanent lender has a different appetite for risk and quality of property but all generally lend on completed projects near or at stabilization. Stabilization can be determined as a preset leasing level for the project where the income in-place can support a permanent loan.

Permanent debt is usually in the form of a long-term, fixed-rate loan with unchanging monthly payments for the life of the loan. Since the project is stabilized at this point, the cash flow will be of a more stabilized nature and can support the reoccurring monthly debt obligation to the permanent lender. Permanent mortgage lenders seek long-term investments to match their long-term liabilities. Commercial real estate fills that need because of its structure and investment timeline. "Commercial real estate is a durable asset that generates cash flow for many years into the future. And because fixed-term lease contracting is standard practice in the industry, commercial real estate produces fairly predictable near-term cash flows. Predictable cash flows give mortgage lenders confidence that the debt will be serviced. Furthermore, long-term durability increases the likelihood that asset value will be sufficient to offset the remaining loan balance at maturity, and, if not, that the asset will retain significant resale value to mitigate loan

default losses."[15] The reoccurring monthly payments are also beneficial to the borrower as annual budgets and standardized leasing arrangements can be made.

There are permanent lenders who can act as both a construction and permanent lender for the same deal. These are generally large institutions that have large amounts of capital devoted to different lending criteria. Especially attractive projects can encourage lenders to provide all the necessary debt for the borrower when they feel the project is well conceived and will be successful.

Permanent loans are made to a certain loan to value (LTV) or loan to cost (LTC) level of the project. These levels can range from 40-80% with permanent lenders. On development projects, the permanent lender will generally lend up to the same amount as the construction lender, approximately 70-75% of LTC. This ensures that the developer still has an appropriate amount of equity within the project.

Another factor affecting the pricing of the loan is the quality of the tenants' credit. The better the credit, the less likely the tenant will default on its lease, therefore, the lower the chances the borrower will default on their loan. This credit can translate into more attractive permanent loan interest rates and forces developers and borrowers to seek out credit tenants for their properties.

[15] Riddiough, Timothy J., Optimal Capital Structure and The Market for Outside Finance in Commercial Real Estate. University of Wisconsin-Madison, Graduate School of Business, August 2004.p. 4

Mezzanine Debt

As mentioned earlier in the section on mezzanine equity, mezzanine funds can also act as debt. Depending on the needs of the developer, the mezzanine fund can be structured to act like debt for the project. Many times the developer is hoping to increase the total LTC of the project to 80%+ and mezzanine funds help him to accomplish this goal. The permanent loan is placed on the project and given a first lien on the cash flow, meaning that the permanent lender has the first right to any revenue to pay off their loan. The mezzanine loan is then placed on the property in a second position whereby any cash flow remaining after the first mortgage has been paid will pay down the mezzanine loan.

This is a riskier position for the mezzanine lender and they will price their loans accordingly. Their interest rate will generally be higher than the first mortgage but lower than returns required by outside equity. Mezzanine loans provide the developer an opportunity to increase their leverage in the project at a price that is lower than using outside equity. Like mezzanine equity, mezzanine debt is increasingly common in the marketplace today indicating the increasing sophistication of the commercial lending environment.

Mixed-Use Financing

The basic tenets of commercial real estate financing have been discussed and it will now be related to mixed-use development financing. Mixed-use financing can create an added level of complication because more uses are placed together in the same project. The developer and the lender must understand how mixed-use developments are different than traditional single-use developments and plan accordingly as to how successful financing will be achieved.

According to Christopher Leinberger, there exist "a short list of 19 real estate products acceptable to financial market makers, (which) has been driven by the desire for conformity, which, when combined with discounted cash flow methodologies that focus on short term returns, has led to an investment environment in which sprawling strip commercial space and subdivision housing are the preferred investment types. The financial profile of [mixed-use] development does not fit the criteria uniformly employed today in evaluating prospective real estate investments". [16] This kind of traditional lending environment leads many developers to build single-use projects that fit into one of the standard product types easily understood by the lenders. But as discussed in the section on the growing popularity of mixed-use, developers and municipalities are continuing to build these types of projects due to city and consumer demand. As lending has become more sophisticated, individual product types can be measured for risk to a certain degree from years of data compiled from previous loans on similar

[16] Leinberger, Christopher B. and Howard Kozloff, Financing Mixed-Use. Multifamily Trends, Fall 2003. p. 37

properties. Because the developer has combined the different product types into one project, the lender must underwrite each standard product individually and then go one step further to combine the products into one loan.

The increase in the quantity of REIT's and their general focus on one property type has also influenced the standardization of lending. "Because REITs are publicly traded and must create investment portfolios that can be bought and sold, they tend to focus on investing in one of the 19 standard product types, which serves to perpetuate the narrow focus of investors." [17] The REITs and their investors have become very comfortable with their property type and have developed expertise in all facets of their portfolio. There is currently no motivation for REITs to construct anything except their standard product type. Their stock price and market cap are a direct result of their ability to successfully develop and manage their product type. Trying new real estate product types would simply be too risky and not within their strategic business plan. Despite their insistence on developing standard product types, REITs are a small percentage of the total number of developers in the US and there are many other developers actively pursuing mixed-use development.

There are several considerations that must be taken into account when trying to finance mixed-use development. These are elements of the deal that many lenders will consider when underwriting a mixed-use development. Developers should pay close attention to them when planning and developing mixed-use. They include:

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[17] Ibid p. 37

- Structure of Borrower Entity
- Underlying Real Estate Ownership: Condominiums and Easement Agreements
- Managing Construction Risk
- Allocation of Project Cost to Different Components
- Issues with Separate Take-Out Sources [18]

Each of these elements presents an important aspect of mixed-use development and lender underwriting. Each one should be carefully considered to reduce risk for both the developer and lender. By addressing each issue, a mixed-use project can become more successful from conception through completion.

As mixed-use has become more familiar, developers and lenders alike have sought out different ways to arrange the appropriate financing for the respective projects. The basic equity, construction and permanent loans are still apparent but in a more complicated nature. In mixed-use developments, more entities may become involved, additional equity may be needed or several permanent loans on specific components of the project may be arranged. These are just a few examples of the additional levels of complication mixed-use projects can produce.

[18] Kane, Meredith J. Multiple Sources: Financing the Mixed-Use Development. The New York Law Journal, September 29, 2004 p. 1-2

Currently there are several ways to finance mixed-use projects in the marketplace. The three examples to follow are the most common and provide the best and easiest way for the developer and lender to successfully finance a mixed-use development.

The first example includes the developer seeking a construction loan for the entire project and then financing each particular product type with separate permanent lenders who are comfortable with that specific type. The different property types or components become separate condominium entities and are then separately financed for permanent mortgages. With one construction loan, the developer only has to work with one lender during the construction process. The lender and the developer understand the project and are comfortable with the mixing of uses and ultimate project scope. By creating separate entities for each use, the developer can more easily obtain permanent financing for the specific product types because lenders are more comfortable with the 19 standard product types. A negative for this example is that the developer may be able to obtain permanent financing for one component because it is a currently favored product type but unable to obtain favorable permanent finance for the other components. The developer may have to accept high interest loans for the other components. [19]

A second type of capital structure involves separate construction lenders and permanent lenders for each property type. The project may be phased by product type or the developer may prefer to separately finance each component initially. This allows the developer to find lenders who are most comfortable with the specific property type

[19] Ibid p. 1

and obtain the most favorable financing. In addition, separate equity providers can also be found for each of the property types by matching their strategy and objectives with the particular real estate type. Benefits to the developer for this strategy include the ability to seek lenders who will provide the most aggressive rates for each of the components of the project. By phasing, the developer can also better time the market for each of the property types to receive the best returns. A potential problem with this financing is the number of equity providers, construction and permanent lenders involved in the project. Every individual has their own ideas and way of doing things and the more people involved in the project financing, the more complicated and hectic it can become.[20]

The third capital structure is the simplest in form. One construction lender finances the entire project and one permanent lender provides the take-out loan for the entire development project. There is no separation of product types in the lenders view and the project performs as one entity. The development supports one loan. Benefits to the developer include only having to work with one construction lender and one permanent lender. The developer can help them to understand the project and feel more comfortable that the separate uses will successfully work together. Another benefit is the ability of strong components in the project to support weak components. An example is a 100% pre-leased office component, which would receive favorable financing on its own, and a hotel component in a weak market, which would struggle to receive financing, offset each other and help the developer to attain a good interest rate for the entire project. Potential negatives for this financing include the inability of the

[20] Ibid, p. 1

developer to capitalize on the strength of one component in the marketplace. By collateralizing all the uses into one loan, the developer must accept the underwriting of the lender on the combined uses. By employing this financing, the developer may limit himself to a decreased number of lenders who are willing to lend on entire mixed-use projects. Less competition among lenders can lead to less favorable interest rates.

The three capital structures described are the most common in the marketplace today. From conversations with developers and lenders, the first example is the most prevalent for mixed-use developments. It allows the developer to find one lender for construction to build the project at one time and then the flexibility to seek out different lenders for the different components. The second example can still be found but it is often seen as a last resort as developers do not want to work with multiple lenders. The developers also feel they have less control of the project in this scenario. The third capital structure is not as common but is becoming more available as lenders understand how the respective property types interact with each other. They feel more comfortable lending to an entire project as they learn how the different uses can actually support each other and create a more successful development.

Chapter 3

Data Overview

The survey method was employed to collect data. The survey was completed over the telephone with developers and lenders from all over the country. Conversations ranged from approximately 30 minutes to 1 hour in length to discuss appropriate development projects for this research. Some developers had only completed one such mixed-use development with 3 or more uses while others had completed several to this point. Their responses were noted and will be detailed in more length. The developers were selected based on their completion or current involvement with mixed-use developments. Total project costs in the data ranged from $10 million to over $1 billion. The survey was an attempt to collect data from a broad range of mixed-use projects in order to determine factors evident across developments of varying size and complexity.

The survey focused on the capital structure of the deal. The survey first asked about background information including size of components, entity structure, pre-leasing, and any other non-financial information pertinent to the development. The second section relates to the equity structure of the deal. It asks about equity partners, return information, reasons for equity decisions and equity in mixed-use in particular. The third section includes questions on debt, including construction and permanent. LTV levels, loan details, number and structure of loans made and timing of the loans are a sample of questions from this section. The last section asks questions on other topics related to

the deal including ground leases, divestiture of components and general strategy of the developers for their projects. The survey can be found in the Appendix section of this thesis.

To protect the identity of the project and the developer, names of companies and projects will not be used. Several of the developers were hesitant to discuss proprietary information such as return numbers or equity information. Total project costs were also a sensitive subject and will be included if known. There was an understanding between the author and the developer that this type of information is of a sensitive nature and by agreeing to omit some information, many were forthcoming in discussing their projects in detail.

The projects are listed below and each one is divided into five sections. The first section outlines the project including the uses and any pertinent information about the development. The second section details the equity structure of the development. The third section discusses any kind of construction loans used in the development. The fourth section is on the permanent loan structure the developer used for their mixed-use project. The final section presents a synopsis of key points from the project.

Project Detail

Project #1

The first project is a large mixed-use development in the Northeast. It consists of 630,00 square feet of office, 155-room hotel and 136 condominiums in a prominent infill location. The office portion was 100% preleased prior to construction and there were significant condo presales. The project was entirely built out at one time by the developer.

Three additional equity partners were brought in for the project. The first partner was a public company who has had a long-term relationship with the developer and was comfortable with the developer's strategy and ability to complete a project of this scope and complexity. This partner was more familiar with the office portion and felt more comfortable if other equity was arranged who understood the additional real estate uses in the project. An additional equity partner in the form of a public company was sought out for their experience in this type of development. The last partner, a private opportunity fund, came to the developer looking to invest in the project. A preference was given to each of these partners for their equity stake but the developer was reluctant to divulge the actual return numbers for each partner. Due to the large nature of this project, the equity contribution was required upfront from each of the partners.

There was one construction loan used for the entire project through one lender. A forward interest rate hedge in the amount of $20 million was bought for three years to control for interest rate spikes during the construction of the project. The construction loan was made for 50% of the total project cost.

The construction loan converted to a permanent loan upon issuance of a certificate of occupancy for the project. The permanent loan was arranged through the same construction lender and was also at a 50% loan to cost. The developer felt the permanent loan interest rate was slightly higher than a conventional single-use loan due to the hotel within the project. Hotels had been struggling in this market for some time and lenders were reluctant to provide loans for this particular use. By collateralizing all three uses into one loan, the project was able to be financed because the other two uses, office and condominium, were strong enough to carry the struggling hotel. The developer decided to use this structure because they ultimately felt mixed-use creates situations where each use feeds off the other uses. While the interest rate they received may have been a little higher, it was still very attractive as rates were very low and many lenders were aggressively seeking to provide debt for this project.

Project #2

This project consists of 335,000 square feet of office, a 336-room hotel and 414 multifamily units in a major northeastern city. There was a fractured ownership

structure with three different entities for each use within the development. The fractured ownership combined with the phasing of the construction of the project added to the risk factor for the developer. The addition of joint venture partners meant an additional level of decision-making and a prolonged construction process. The developer felt they ultimately did not have as much control over the entire project.

The multi-family rental apartments did not have any equity infusion as a 100% loan from a major lender was given to the developer for these units. The developer sold the office pad to an investor and retained a 25% interest in the deal as a joint venture partner. The hotel portion required a 45% equity stake from the developer, as hotels were difficult to finance at that time. The lender wanted to lessen their risk considerably by requiring a large equity stake from the developer.

The multi-family apartments obtained a 100% loan to cost construction loan from a leading lender. A 55% LTC construction loan was used for the hotel portion. The hotel rate was 550 basis points above LIBOR and contained a no prepayment clause. The developer had a difficult time finding construction financing for the hotel portion and was forced to accept a high interest rate loan.

As for permanent debt, the multi-family rental apartments were converted to condominiums during construction and no longer needed permanent financing as each unit was sold individually. The office portion was also sold prior to construction as

described earlier. The hotel is currently under construction and is locked into the construction loan.

This project has taken several years to build and is finally nearing completion. The fractured ownership structure has caused the developer to seek out financing for each individual use and bears the market interest rate at that time. The capital environment during initial planning was not as aggressive as it is today and lenders were more conservative in underwriting mixed-use deals.

Project #3

This project is an approximately 300,000 square foot office, retail and residential mix currently under development in a major northeastern city. The site includes two existing office buildings, a parking lot and vacant land. The $100 million dollar project will be constructed using one LLC. The residential portion will be for-sale condominiums. The office portion will be renovated and then sold and a grocery-anchored retail center will be constructed. The grocery tenant has been pre-leased for the retail component.

Equity for this project is coming from an internal fund within the developer. The equity amount is $30 million which then equates to a 70% LTC. This discretionary fund has been arranged in conjunction with an outside equity partner who provides money to the developer to be invested on their behalf. The fund is comfortable with the combination

of uses within the project and can be considered patient capital due to the timeline for completion of the project.

One construction loan was arranged for this project. There will be phasing of the project for complete build-out and the loan covers all phases. The two existing office buildings will be renovated while the new retail and residential are built.

The construction loan will have a take-out provision by the lender. The lender is very comfortable with this development and its mix of uses. The developer feels the respective construction and permanent loan interest rates are not any higher than a loan on a more traditional single-use development. The office portion, upon renovation, will be sold off to another investor while the condominiums will also be sold. The borrower feels the appreciation in value of the office buildings will be very high upon sale due to their renovation and inclusion within a mixed-use development. The lender felt very comfortable with this project due to the location, strength and quality of the borrower, pre-leased anchor for the retail and strong residential component.

Project #4

The next project is a large mixed-use development in a major city in the Southeast. There are four components in the project consisting of 300,000 square feet of biomedical office, 30,000 square feet of retail, 180 units of affordable housing and a

parking garage serving the other three uses. The entire site is ground leased from the county on a 125-year lease. The project entity is LLLP with an LLC as the operating company within the LLLP. It will be a three-phased project over three years with the biomedical building and parking garage built first. The biomedical was 100% pre-leased prior to construction.

There is no outside equity for this project. The ground lease from the county acts as implied equity because of its fee simple arrangement. All language pertaining to subordination to the county was removed from the lease to make it appear as a fee simple transaction. The county was willing to work with the developer to arrange this type of lease to make financing more available. Most lenders do not like to finance deals with ground leases subordinated to the ground lessor.

Construction has commenced on the first phase of the project with no definite construction loan in place for the office portion. The developer has paid for construction costs thus far with his own money. The developer is currently reviewing several potential construction loans from banks, which are very interested in lending on the 100% pre-leased office space. The parking garage is receiving construction funds from the county. The housing and retail components will have a 40-year HUD construction to permanent loan but they will not be built until phase two.

The only component that will seek a permanent loan is the office building. Because it is already pre-leased with strong quality tenants, the developer is confident a permanent

loan can easily be attained. The project was also arranged where each use could be sold off individually if needed. This remains an option for the office building. In addition, all the uses have cross-easements to access the garage, which is another reason the county was willing to provide construction and permanent financing for the parking structure. The federal government was also very interested in providing more affordable housing in this area and was willing to provide the financing for the construction and permanent loans for the residential and retail portion.

Project #5

This project is also in a major northeastern city and consists of 480,000 square feet of residential, 305,000 square feet of office and 125,000 square feet of retail. It is in very close proximity to a mass transit stop and has very favorable demographic statistics including one of the highest average incomes of the metropolitan area. There are four LLC entities associated with the project; one for each use and a fourth containing the other three LLCs as members. The fourth LLC was used for the infrastructure and underground parking portion of the project.

JV partners for the office and residential portions were needed for this project as additional equity. Each partner brought specific knowledge for that particular use. The original developer did not have expertise in office or residential and felt additional partners would help the development succeed. They wanted JV partners who could

bring financial strength and experience, thus an office REIT was selected for the office portion and a residential REIT for the multi-family. A straight-up ownership structure was conceived for each use with no preference given to the JV partner. The office component thus contained the office REIT and the developer as co-owners and the residential portion had the residential REIT and the developer as co-owners. The developer was not comfortable providing the ownership percentages.

The project is currently under construction as the infrastructure and underground garage are built that will service the entire site. One lender was found to finance all the initial infrastructure costs including the garage. The developer also had to pledge the rights to each of the components as security for the bank. When the garage is completed, each component will arrange its own construction loan. The current construction lender is very comfortable with the project and is receiving an interest rate comparable to a tradition single-use project.

Permanent financing has not yet been arranged but should not be a problem based on a number of factors. Each component will act as a fee-simple condominium with easement rights to the garage. A leading large grocer has already been pre-leased in the retail portion and the history and success of the developer with retail should appease any concerns from a lender. The office has no pre-leasing but the reputation of the JV partner and the location should make that component very attractive to a lender. Finally, the residential portion should have no difficulty attaining financing as the borrower is a leading national apartment REIT and the location is very attractive for

rental apartments. The combination of location, borrower strength and project conception should make the permanent loans easily accessible for the development.

Project #6

The next project is located in a major city in the western US and consists of 175,000 square feet of office, 155,000 square feet of retail, 25 residential condominiums and a 196 room hotel. The total project cost was $110 million. Each component was organized as a different LLC. The construction lender required this legal structure. There were four phases of construction and the project was 100% complete in 2004. The location was an infill site with strong demographics and strong pre-leasing. The office component was 100% pre-leased by a credit financial services company and the retail portion had a strong grocer and anchor retailer pre-leased before construction began on their respective phases. In addition, the residential condominiums had reservations for 20 of the 25 units the first day of sales. The hotel portion of the project was not included with the development, as the banks would not lend on hotels at that point in time. The developer was forced to sell the hotel pad to a hotel developer who could receive financing due to his experience and expertise in hotel development.

Equity for this project came in three forms. The largest portion was from an anchor retail tenant who provided the land for the development. This tenant was a partner in the project and their land contribution was the majority of the equity in the amount of

$16.5 million. A second form was cash raised by the developer from friends and family of $5 million and the deferment of his development fee of $1 million. The third portion was a mezzanine loan of $3 million to bridge the gap in equity required by the bank. Each contributor was given a straight-up ownership percentage except the anchor retail tenant who was given a promote structure over the other equity partners for their land contribution.

There were three construction loans to coincide with the phases of the development. The first loan was the largest and covered the first two phases. The developer felt he received a higher interest rate from the bank for this phase because the lender was not as comfortable with all the uses and had not done projects like this before. But the developer had few other options and thought it was the best deal he could receive from a construction lender. The third and fourth phases received loans from a different bank that syndicated the loan to other banks. The LTC was the lowest common denominator for all the banks and it resulted in a 77% LTC for the entire project.

A permanent loan was arranged for only the retail and parking. The office building was sold to another investor. The hotel pad was sold as previously explained and a hotel was built on the site. The residential condominiums sold out quickly before construction was completed. The developer arranged a permanent loan interest rate of 285 basis points over LIBOR for the retail portion, a rate slightly higher than a more traditional standalone retail center. The significant pre-leasing of anchor retail tenants and the

resulting strong leasing of inline tenants made the entire project very successful as all components worked well together.

Project #7

The project is located in a west coast city in an infill location consisting of four uses: 91 rental apartments, 10,000 square feet of office and retail and a community theater. There was one LLC for the entire project and it was built out at one time. By including the theater, the developer also received a density bonus from the city to include more apartments in the project. There was no pre-leasing of any of the components.

Equity for the project came in three forms. The first was a contribution of land from the existing landowner, the second was cash from a wealthy individual partner and the third was the developer's fee. The equity from the wealthy individual was contributed in stages throughout the project timeline to keep costs lower. The individual's entire equity contribution initially would have resulted in interest owed on the entire amount instead of on their gradual increased contribution. An 8% preferred return was given to the cash equity partner and the profits were divided 66% to the equity and 33% to the developer.

A two-year construction loan was used for this project. It had an 80% LTV and used a tax credit allocation bond for construction financing. This bond allowed the developer

an interest rate 200 bp below market rate in exchange for including 20% affordable units in the project.

A permanent loan was arranged through Fannie Mae at an 80% LTV and 1.15 DCR. The loan covered all the uses in the project but Fannie Mae stipulates that not more than 20% of the income come from non-residential uses. The strength of the apartments in that area was the driving factor in underwriting the deal.

Project #8

This project is in a west coast city and consists of 100 residential units, 12,000 square feet of retail and a community theater. There was one LLC used for the project and it was built out at one time.

The land was bought by the developer and included as equity for the project. Additional equity came from a high net worth individual. An 8% preferred return was given to the equity partner and the profits were split 66% to the equity and 33% to the developer.

No construction loan was used for this project. Instead, tax credit allocation bonds were issued for construction costs and the bank provided credit enhancement. The bonds could be used if 20% of the apartments were affordable units.

A Fannie Mae permanent loan was placed on the project with an LTV of 80% and a 1.15 DCR. The retail and theater were not a problem to include in the loan as the strength of the apartments anchored the deal. Again, Fannie Mae requires that 80% of the income come from residential uses.

Project #9

This project is in an infill location in the western US and includes 21 residential units and 6,000 square feet of office and retail. One LLC was used for the project and it was built out at one time.

A high net worth individual provided the equity for the project and was paid an 8% preferred return for his contribution. The profits from the project were split 66% to the equity and 33% to the developer.

A two year construction loan was used for this project at an 80% LTV. A tax credit allocation bond was also used as 20% of the units in this project were designated as affordable.

A permanent loan was placed with Fannie Mae at an 80% LTV and a 1.15 DCR. The strength of the apartment market in this location was the main factor for Fannie Mae to lend on this project.

Project #10

The next project is a mixed-use facility consisting of 44 residential units and 3,000 square feet of office and retail located in a west coast city. One LLC was used for the project and it was constructed at one time.

One partner contributed the land as his equity share and a high net worth individual contributed cash in the form of equity. The equity partners were given an 8% preferred return on their contribution and the profits were divided 66% to the equity and 33% to the developer. The equity contributions were staged during construction so as to avoid paying interest on one lump sum.

A two-year construction loan was used for the project. A tax credit allocation bond was also used as the project had the prerequisite 20% affordable units. To qualify for living in these units, the tenant must have an income of at most 50% of the average monthly income for the area.

Fannie Mae provided the permanent financing for the project. They used an 80% LTV and 1.15 DCR to underwrite the deal. Other mixed-use projects had succeeded in this area and the strength of the apartment market, especially affordable units, anchored the financial viability of the development.

Project #11

This large mixed-use project is located in an infill location in a major northeast city. It has several uses consisting of 309 residential condominiums, a 191 room hotel, 100,000 square foot sports club and 19 movie theaters. The developer had a relationship with both the hotel chain and the sports club owner and was able to pre-lease space to them. The movie theaters were also pre-leased prior to construction to a national movie theater chain. The residential condominiums did not have pre-sales but the developer was very confident in their ability to sell due to the location and prestige of the project. There were three LLCs used in the project: one for the residential, one for the retail and one for the hotel.

A large Wall Street investment bank was sought to provide the equity for the project. The equity partner was very familiar with the developer and the location and felt confident the developer could build a project of this size. 25% equity was achieved for this project through a combination of outside and developer equity but the developer was unwilling to disclose further equity information.

A construction loan in the amount of 7% was arranged for the project. The developer also had to buy an interest rate hedge due to the length of construction for a project of

this size. The construction loan was also syndicated to five other banks. Approximately 10% of the project was completed before the construction loan was arranged.

No outside permanent loan was sought for this project. The developer had a series of internal funds arranged through outside partners that "purchased" each piece of the development according to its use. Upon completion, each use was individually valued and then "sold" into the corresponding fund for that use. The developer wanted to, in essence, sell off the different components within the project into internally managed funds that acted like individual operating companies.

Project #12

The next project is a very large mixed-use development located in a major northeastern city. Upon full build out, it will contain a mix of 3.1 million square feet of residential condominiums and apartments, 75,000 square feet of retail, 2 million square feet of office/lab, 90,000 square foot hotel and several civic uses. Construction time will take 10 to 15 years depending on market conditions. It is currently under construction with infrastructure and housing beginning to rise. It is a very complicated deal involving city officials, numerous public agencies, and significant private investment. There is one LLC for the ground and development rights of the entire site. Within that LLC is the general partner, which is the developer, and a very wealthy majority owner. As each vertical component rises, a separate LLC will be formed for that particular parcel.

There is a large amount of equity in this project provided solely by the majority partner. They have owned the site for decades and in addition to contributing the land, have also provided upfront cash for the entitlement process and the infrastructure work. They have a long term view for the site and have very patient capital to ensure the project continues smoothly for the next decade. They feel their returns should be substantial over time as all permits are in place to transform the former industrial parcel into a viable infill neighborhood. The wealthy owner has brought the developer in to construct the project due to the developer's expertise with large-scale projects and contacts within the city. TIF financing was also arranged for the site along with federal grants for the redevelopment of the under-utilized parcel. Additional mezzanine equity could also be arranged if necessary.

No construction loan has been acquired for the project to date. All required money has come from the equity partner who would prefer to not seek out loans. There is no anticipation of further construction loans but the entity was formed where separate buildings could have construction loans if necessary for each parcel.

As with construction debt, there is no anticipation of permanent debt. The equity partner would prefer to wholly own the entire parcel with no lenders of any kind for any buildings. They do not want to give up a first position to a lender and have their real estate subordinated to someone else. They have the resources to accomplish this yet also have the flexibility to separate the parcels if needed to seek out separate financing.

If separate financing were pursued, the land from the master LLC under the building would be valued and contributed to the component as equity. The developer desired this arrangement for maximum flexibility for the owner over the long build out time of the project. The ability to compartmentalize the large project will give a potential lender the ability to more easily underwrite the specific parcel where it contains a majority of one use.

Project #13

The last project is also a large $375 million mixed-use facility in an infill location in a western state. It has a broad list of complimentary uses including 700,000 square feet of retail, 400,000 square feet of office, hotel, and 500 residential apartments and condominiums. The retail is the largest component of the project and will help to revitalize the downtown as a shopping destination. There was one LLC for the entire project but several components were sold off as their own LLCs before and during construction. All the components were built at the same time including the separate uses sold at an earlier date. The hotel, residential apartments and residential condominium pads were sold to developers with more expertise in those uses. The developer had experience with office and retail and felt more comfortable in only developing those uses.

Originally there was no outside equity used in the development. The developer had a considerable net worth and was able to provide the necessary equity. The developer considered outside equity but ultimately wanted to retain control of the project. By selling off the pads, additional equity was created for the project in addition to the internal funds brought to the deal. Near completion of the retail portion of the project, a partner was brought in to add an equity infusion. This further bolstered the retail as the anchor component and supplied additional money to the developer. The developer had to provide more equity than originally anticipated partially due to their inexperience with a project like this as well as the large scope of the development.

There was one construction loan for the pieces still under control of the developer, the retail and office. The lender underwrote a 70% LTC for the project and was more nervous about the size and scope of the development than the combination of uses. There was no additional premium in the interest rate due to the mixing of uses. A five-year loan was arranged. Different leasing thresholds were arranged for the construction loan where the rate would lower upon further pre-leasing of the space. This acted as a buffer for construction risk as the bank priced into their rate the different risk ratios associated with pre-leasing.

Permanent loans were sought and attained for each of the separate uses. One of the office buildings was sold upon completion but a permanent loan was arranged for the other two office buildings. This was a standard loan for 95% leased office space. The

extensive retail portion also received a permanent loan with an interest rate on par with standard regional malls.

Interview with Construction Lender

A Vice President of construction lending for a major national lender was interviewed to gain her insight on lending construction loans for mixed-use developments. She was emphatic that the mixing of uses does not bother the bank. They will look at any type of deal including mixed-use projects. The only uses they will not lend on are hotels. Not because hotels are risky but because they have never financed hotels and have no plans to do so in the future.

The bank will look at each use separately and underwrite that specific use as if it was a standalone product. The market vacancies for that component will be used as well as the current leasing and rental rates in the market. The individual underwritten uses will then be combined into one large deal that is very similar to a single-use deal. She mentioned construction loan interest rates are in the 7% range nationally and that includes mixed-use deals. A standard loan, including mixed-use, will have an 80% loan-to-cost with a 1.20 to 1.25 debt service coverage. There is no distinction made for mixed-use as it is underwritten in the same fashion as a typical deal.

The bank will also look at the quality of the sponsor. This includes their net worth, projects completed and ability to successfully complete the proposed project. The more

sophisticated the borrower, the more likely the bank will believe that the sponsor has conceived of a potentially successful project. If the sponsor is strong, the bank can make some alterations in their underwriting to relax their standards. The larger borrowers will have more money on hand or access to capital if the project does not go as exactly planned. They will be able to sustain a downturn much better than a smaller borrower. If the sponsor is small and developing a larger project, the bank will look to see if there is sufficient equity in the deal to feel comfortable. The equity partner will also be analyzed to determine their net worth and ability to sustain the small development partner.

The construction lender will underwrite their loans to similar standards as the permanent market. They want the sponsor to be able to obtain permanent take-out financing. The bank is constantly looking at the permanent markets to determine where their interest rates should be in relation to the permanent market. Sensitivity analysis is done to determine the correct sizing of loans and to assess the risk the bank is taking on not only the project but the interest rate environment as well. Developers are risk-takers by nature and the bank must decide how much risk they will take on the project and price accordingly.

Interview with Permanent Lender

A principal of a large lending institution was interviewed to determine the factors affecting their decision-making to lend permanent loans to mixed-use developments. They have placed permanent debt on all types of mixed-use development and are very familiar with the operations and risks associated with this product type. Like the construction lender, they will consider any type of mixed-use but feel a hotel component to be a particularly tricky asset and one that must be carefully underwritten.

When asked about the most important aspect of underwriting the deal, the lender responded with sponsorship. Above all, they feel the developer/sponsor is an extremely important aspect of the deal due to three reasons. The first is the sponsor's financial strength. They will look closely at the net worth of the sponsor and their liquidity, in particular. They want the sponsor to be able to "write checks" if something goes wrong or the market softens. The second reason is the experience of the developer in the mixed-use product type. The lender wants to feel comfortable that the sponsor cannot only build these developments successfully but that the project is financially secure in the long run. If a hotel component is present, the lender feels this product type is very different than other product types and wants to see experience with hotels. The third reason is the reputation of the developer in the marketplace. They feel it is very important to build and maintain a solid record of integrity in the industry. It can be much easier when times are good but when something bad occurs, the lender wants to know if the developer will "do the right thing when problems arise" and work with the lender to

correct the problem. Reputation can only be earned through time and the actions of the developer during problems can speak very loudly of their future integrity and relationships with lenders.

The permanent lender will look at each component of the project separately to underwrite the deal and then combine into one large loan. Each use will be compared to other similar uses in the marketplace to determine such criteria as vacancy, rent levels and tenant improvements. This particular lender will apply an LTV of not more than 70 to 75% for the project and that loan amount cannot be higher than the total cost of the development. The lender wants the sponsor to maintain equity in the deal.

Unlike the construction lender who will consider deals will significant guarantees and recourse; the permanent lender generally offers non-recourse loans for the property. The permanent lender underwrites the real estate while the construction lender underwrites the guarantor in addition to the real estate. Permanent loans debt service must be met from the operations of the real estate alone with no help from the sponsor. This permanent lender will look at the reputation of the construction lender as one indication of the quality of the project but ultimately looks at the ability of the project to meet its debt service through the life of the loan.

If the property is not stabilized or fully leased upon completion of construction, the permanent lender will still consider placing a loan on the project. By nature, the lender will want to see a fully leased building but there are other options to consider. An earn-

out provision can be made with the lender where the developer leases the property over time and receives loan increments in relation to the value created. Another option is additional guarantees that are used as a recourse function to meet the concerns of the lender that enough money is in the deal to fully lease the project.

The permanent lender is very comfortable with mixed-use and has many examples of successful loans made to these types of projects. Any premiums added to the interest rate are a function of the specific use in the marketplace and the risk factor placed on the sponsor. The underwriting performed has little difference from standard single-use products.

Chapter 4

Data Analysis

The data bears out several interesting occurrences within mixed-use projects. While the mixed-use developments were located in various locations around the US, there were similarities that can be gleaned from analyzing the responses from participating developers. Each project was, at least, a little different from any other whether it was the mix of uses, the equity structure or the final permanent loans on the property. No mixed-use site can be exactly the same due to their more complicated nature and typical infill location. While that can be said of most real estate, it applies particularly to mixed-use, as it is a product type that would be hard to duplicate many times over across the country. It is not a regional mall or distribution warehouse that can look the same in any location but a careful mixing of uses designed for a specific location. Similarly, no financial structure can look exactly the same but there are similarities across the board that will be addressed.

From talking with both developers and lenders, financing is being arranged for mixed-use developments. The developers are pursuing these projects because they make economic sense and lenders are financing them because they see an opportunity to lend on quality developments. There has been a shift in the lending industry, as they have gained confidence in the long-term viability of mixed-use development. As short as three years ago, many lenders would refuse to consider mixed-use developments or

would charge very high interest rates because of their perceived risk in these types of projects. One developer noted that he would not have even attempted his project five years ago due to the limited financing available but feels it is not a problem now if the project is well conceived. A construction lender felt that the once prevailing feeling in the industry that mixed-use is much more risky is actually wrong. She feels that the uses compliment each other and can decrease the risk of the project as each use acts as a buffer against the other. The more diverse streams of income generated by the property are better for the lender and the underwriting of the project. Several developers interviewed agreed with this line of reasoning and felt it was one of the driving reasons why they will continue to pursue mixed-use development.

While perceived risk has mostly been eliminated as a reason mixed-use development cannot be completed, there are many criteria that emerged from the data that provide evidence of the many factors critical to the success for mixed-use. These factors are listed and ranked in the Appendix on page 70. The most important factors from the data include: the size of the developer in relation to the project, the amount of pre-leasing and pre-sales completed and the ability to compartmentalize the project by use.

Size of Developer in Relation to Project

One of the most important aspects to emerge from the data was the fact that the size of the developer is in direct correlation to the size of the mixed-use project. These types of

projects require considerable resources of both time and money. Only the most sophisticated and experienced developers can complete the largest projects. They have the experience and relationships with lenders and tenants to piece together the mixed-use development. Smaller developers can complete smaller projects as seen in the west coast examples but they may encounter stricter underwriting standards from the banks and may not have the resources to dedicate the many years it can take to finish these projects. Mitigating factors that can help the developer and override lender conservatism are the ability to bring in equity partners of substantial worth and design of projects where one use can carry the entire project.

Equity in a project is a must for most lenders and it can come from outside sources or internal funds but the developer must be able to show they have a stake in the project through sufficient equity resources. Banks are very hesitant to lend over a 75-80% LTC, causing the developer to provide enough equity or seek enough outside equity to satisfy the lender. Smaller developers do not have the financial resources themselves to fund a larger project and either seek smaller projects or more outside equity. The outside equity does their own underwriting of the developer and their project and is not willing to risk their money on inexperienced developers or ill-conceived projects. The lender will then look at the equity in the project and make its determination on whether there is substantial capital involved to successfully complete the development.

Every project in the data addressed this issue. Sophisticated developers who had substantial net worth and experience in large-scale development completed the largest

projects. The smaller projects, like numbers 7-10, included an equity partner of substantial net worth. Construction lenders, especially, need the sponsor to have enough capital to guarantee the loans for their projects. To satisfy this requirement, developers must have their own capital or enough outside equity.

The larger the developer, the more likely it is they have the financial wherewithal to complete a complicated mixed-use development. Lenders constantly underwrite the net worth of the sponsor and their experience in the marketplace. The construction lender noted that if they receive a possible project from a less experienced developer they often wonder where the other more experienced developers are and why they did not consider that project. The permanent lender also echoed these statements and acknowledged that the sponsorship of the deal is the first criteria they will consider. The net worth, experience and reputation of the developer must be in relation to the size and complexity of the proposed mixed-use development.

Pre-Leasing and Pre-Sales

The second most prevalent factor in the ability of a mixed-use development to receive financing is the level of pre-leasing and pre-sales. The ability to pre-lease any kind of development is important to securing financing from a lender. The risk for the lender is considerably less as more unknowns are removed from the underwriting equation. There is no question as to when tenants will be signed or what level of rent they will

pay. Mixed-use development is no different, as every project within the data had, at least, some form of pre-leasing. In the current market, very few single-use buildings are being constructed on a speculative basis because lenders are refusing to extend loans on 100% vacant projects. This illustrates the importance of pre-leasing for mixed-use because if standard product type, single-use buildings cannot obtain financing without significant pre-leasing, than mixed-use projects will have an even more difficult time without pre-leasing. Several uses within the development may have high market vacancies and if underwritten as one large loan, the resulting risk factor is very high.

The ability to attain significant pre-leasing or at least sign a major anchor tenant is a common theme among the data. The developers would not have been able to move forward without these leases and often times, designed their project around a specific lease. The pre-lease is usually for one of the riskier components of the project and was the office portion in many of the examples. Projects 1,2,3,4, and 6 all had significant, if not 100%, pre-leased office space before construction. Projects 5,11, 12 and 13 had significant pre-leasing of anchor tenants in other uses before construction began. If the riskiest use is pre-leased, the remaining uses will keep the lender more at ease because they generally will have an easier time leasing up. Other uses, like residential and retail, will be assessed a risk level but they are both currently favored in the market and allow the developer to attain easier financing for them.

The quality of the pre-leased tenant can also lower the risk level for the developer. Lenders always look at the credit worthiness of tenants and if credit tenants can be pre-

leased, the risk level and correspondingly, the interest rate can be lowered. The lender knows the financials of the tenant and understands their strategy and ability to pay their rent on time. This in turn, creates a better chance for the developer to receive the rent and keep current on their mortgage.

The west coast projects, 7-10, and project 4 also illustrate the power of pre-leasing from a different angle. While the residential portion of these projects cannot be leased until they are completed, they have a built-in pre-lease because they both offer affordable income housing. The waiting list for occupancy in these apartments is quite long in these locations and by including affordable housing in these projects; they are able to have significant pre-leasing due to the demand for this type of housing. By including affordable housing, the developer was also able to qualify for favorable loans through the government, usually consisting of lower interest rates and/or construction to permanent financing.

Condominium pre-sales are also a form of pre-leasing. Many of the projects had significant pre-sales prior to construction allowing the developer to attain favorable financing. These projects include 1, 3, 6, and 12. The deposits also provided extra cash for other portions of the development including additional developer equity. By illustrating to the lender that the residential portion would be close to 100% occupied at completion, the bank would feel more comfortable with other uses, such as retail, because these residential tenants would add even more foot traffic in the development.

Whatever form it takes, pre-leasing is an important aspect of mixed-use development and was included in every project from the data. It can be a powerful tool for the developer to attain a more favorable interest rate from lenders and persuade other tenants to occupy space at the development.

Ability to Compartmentalize by Use

The third most important factor from the data was the ability of the developer to compartmentalize the project according to specific property type. As the construction process can take many years, the market may change at any time and severely affect one component. Many lenders realize this fact and like the developer to design the project architecturally and legally so that the individual property types can act as separate entities. This can allow the developer, outside equity and construction lender flexibility in deciding what to do with the separate components. Several options for the component include outright sale, joint venture partner and separate permanent finance.

Many of the projects included in the data set went so far as to create separate buildings for each use. These include projects 2,3,4,5,6,12 and 13. The developer intentionally designed these developments to separate the uses on the same site. By architecturally designing the project in such a way that any one component can survive on its own, the developer has many more options if things go wrong. An investor would be attracted to a specific component if it could survive on a standalone basis and it was a specific

separate legal entity. This would help in selling the parcel or component to an investor. Several developers interviewed mentioned this specifically as an exit strategy if the market turns. The lender may also require these provisions as in project 6.

The timeline for these projects from conception to build-out to full lease-up can take many years and the real estate market can go through a full cycle during that time. The lender may want the developer to have the ability to sell off one component in order to retain enough cash on hand to finish or maintain the project. Most lenders do not want to foreclose on properties and by giving the developer more options, like selling off portions when the market is right, the lender will ensure the developer does not go bankrupt.

Another option for the developer is to bring in joint venture partners on different components, further limiting their exposure to the entire project. The partner may have more expertise in the particular use and be able to develop or revive the component. This can further appease lenders as more capital and more expertise decrease risk for the project.

Thus far, the ability to compartmentalize the project by use has only discussed the benefits to the lender. This arrangement can also benefit the developer. If one component is especially attractive in the marketplace, the developer can sell at a high price and receive a premium from that use that was not originally in the proforma. This can allow the developer to receive larger profits from the project by selling the

components when the market is attractive. Projects 2,3, 6 and 13 employed this technique and were able to reap larger rewards from that particular use. By selling off a particular piece of the project, the developer can then have more cash available for another piece that may need improvement or to help with the capital structure of the deal. Less outside equity may be needed once one component is sold and some profit redeployed back into the project.

When lenders underwrite mixed-use deals, they look at each piece individually and analyze if that particular piece can survive on its own and within the development. Because lenders underwrite to this standard, the developer can be more comfortable in knowing that if they compartmentalize the project by use, they will have more options going forward. If the specific property type, as underwritten by the lender, can operate on its own, then it will enjoy even more success if it is surrounded by complimentary uses in a mixed-use development.

Data and Analysis Review

While the data provided interesting projects to analyze and compare for this thesis, more exhaustive research could be performed to include additional mixed-use projects from developers around the country. The timeframe for employing a more exhaustive survey was not available for this thesis. Due to the nature of the questions and time it takes to survey each project, there were developers unwilling to set aside time to

complete an interview with the author. Additional construction and permanent lender interviews would also provide additional lender reaction to questions regarding mixed-use development. A greater amount of data provides an opportunity to observe a broader range of mixed-use developments and the corresponding factors affecting the capital structure financing. An increased number of samples to include in the study could also allow a more statistical approach to be used in analyzing the data. This includes advanced regression tests pinpointing the specific factors in each project compared to all the other projects in the dataset.

As apparent in the data, the same developer with the same capital structure completed deals 7-10. By including these deals in the data, they comprised 30% of the projects and possibly contributed to an overweighting in the analysis. While the author believes the factors contributing to successful financing of mixed-use development outlined above are significant, additional research and data could provide further evidence for their validity across a broader range of mixed-use projects.

Another aspect of the research that could be addressed is the current status of real estate lending and investing. There are large amounts of capital in the marketplace waiting to invest in real estate. Because lenders and investors feel real estate will provide the best returns for their capital, they are aggressively seeking development projects that will provide them an attractive return. Because of their desire to provide capital at the current moment, it remains to be seen whether mixed-use developments are truly an attractive investment or whether they are a by-product of the current

frenzied atmosphere in the capital markets. The future will unfold the truth because when capital starts to seek alternative investments in bonds or the stock market, less capital will be available for real estate investment and lending. Mixed-use could witness a reduction in interest if the capital feels they can receive a better risk/return ratio on traditional single-use product types.

Conclusion

Mixed-use development continues to thrive in the marketplace today, as more developers, financiers and municipalities understand the important impact these types of projects have on today's communities. Despite initial difficulty a decade ago in receiving financing, developers today are employing various sources of capital to successfully complete these projects.

The factors uncovered in this research teach important lessons about how lenders perceive of mixed-use and what developers should consider when trying to successfully finance these types of projects. No one is denying that additional underwriting for these developments may be required but the lender's risk level for mixed-use projects can actually be lessened as heard from the construction lender and several developers. Important aspects to consider when financing these projects for both potential developers and lenders are the three main factors derived from the data. By addressing these issues, mixed-use projects can more easily obtain financing and ultimately be more successful.

Mixed-use projects are here to stay and address many of the concerns communities have with sprawl and city planning. Developers have now begun to realize the potential returns projects like this can have for them. Although they can be more complicated and can require more resources, with proper planning and appropriate capital structure, they can create a "win-win" for all parties involved.

Appendix

Survey Questionnaire Mixed-Use Development Capital Structure

Thank you for agreeing to participate in this research project. Your participation in this research is strictly voluntary and confidential. You can decline to answer any questions or to continue your participation in this work at any point without any adverse consequence. The information you provide will be safeguarded under specific guidelines provided by MIT.

The purpose of this thesis is to investigate the capital structure of mixed-use projects in an attempt to identify the most important factors driving the capital structure allocation decision. These developments must contain 3 or more uses as defined by standard real estate product types and been initially conceived as a mixed-use project. The survey will be divided into three components to address these specific projects as follows: project overview and description, equity structure and debt structure. The following questions pertain to these components and the factors affecting the capital structure decisions. Your responses will be held in strict confidentiality. Names of your company and projects will not be revealed in the report.

1. Project Overview
    a. Can you give me a more detailed description of the project? (Physical description, total SF, tenant base, setting, history)

2. Equity
    a. What was the legal entity?
    b. Who was the equity partner? (pension, tic, 1031, high net worth, opportunity)
        i. Why did you choose them?
    c. What were the general terms to the investor? (pref, pre-leasing, exit)

        i. Why did you decide to structure the equity in this way?
        ii. Did the nature of mixed-use developments, including longer build out times and increased risks, affect the terms and the type of equity investor?
    d. What was the timing of the equity contribution?

3. Debt
    a. Construction
        i. How was this loan structured? Was the entire site built out at one time or in phases? Were different loans used for different phases?
        ii. What was the relationship between the construction and permanent loans?
    b. Permanent
        i. What was your permanent financing arrangement? (pricing, LTV level. Pre-leasing)
        ii. Did you create separate entities for each use (i.e. retail condo) and seek out perm loans for each entity?
        iii. Was there an increased spread due to the lenders perceived higher risk because they were not as comfortable with how these different uses would interact with each other?
4. Other Issues
    a. Deal Overview
        i. With respect to users, was there pre-leasing or pre-sales?
        ii. Did you use ground leases or sell off different components of the project?
            1. How did this affect your capital structure arrangement?
            2. Was this the plan from the beginning or did plans change midcourse due to unforeseen circumstances?
    b. Any other comments or issues that you feel would add to my research?

Ranking of Factors Affecting Ability to Finance

Rank	Factor		Project
#1	Correlation Between Size of Developer and Size of Project	Projects:	All
#2	Significant Pre-Leasing or Pre-Sales	Projects:	All
#3	Opportunity to Compartmentalize By Use	Projects:	2,3,4,5,6,11,12,13
#4	Significant Outside Equity	Projects:	5,6,7,8,9,10,12
#5	Affordable Units Included	Projects:	4,7,8,9,10,12
#6	Federal Financing Eligibility	Projects:	4,7,8,9,10,12
#7	Phased Construction	Projects:	2,3,4,6,12
#8	Use of One Loan for Construction and Permanent Debt	Projects:	1,7,8,9,10
#9	Pure Location	Projects:	1,5,11,12
#10	Construction Began More Than Five Years Ago	Projects:	2,6

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