

## HOW CAN DEVELOPERS ACCESS CAPITAL WHILE MINIMIZING RISK? STRUCTURED FINANCE



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The Twin Cities of Minneapolis and St. Paul continue to be a very attractive marketplace for multifamily investing due to an average vacancy across the metro of 3.1 percent, as well as average 2019 rent growth of 5.8 percent, according to a recent report issued by Marquette Advisors. The Twin Cities currently has nearly 30,000 multifamily units in the development pipeline that are expected to be delivered between 2020 and 2022.

With all of this development activity and an abundance of local and regional banks in the area, the Twin Cities continues to be a very well-banked market, particularly with regard to apartment construction. Local and regional banks are all very active. In addition, national banks are eager to invest in the healthy, consistent Twin Cities multifamily market.

But despite capital being relatively plentiful and accessible, local, regional and national developers are exploring more efficient ways to capitalize on the abundance of development activity. They also pursue ways to stretch their own equity through a variety of financing alternatives. Developers may be tapped out with their current banking relationships, or as projects get larger and more expensive, desired loan sizes may drift higher than their banks' lending limits.

Lenders and developers alike are cognizant of and sensitive to where we are in the current cycle. Though most metrics still provide cause for optimism, multifamily developers are exploring creative ways to mitigate their risk and structure deals to minimize their individual capital contributions.

Developers are increasingly seeking non or limited-recourse construction loans. FHA/HUD provides high leverage, nonrecourse construction financing, though, not all projects qualify for FHA/HUD, and because of the long lead time necessary, it may not be conducive from a timing perspective. For other lending options, it's important to note that the level of recourse is typically directly proportional to leverage. As a result, we are routinely seeing developers opt for lower leverage (think 50 to 65 percent loan to cost (LTC)).

Many developers grew by accessing capital via friends and family or "country club" equity. As the amount of projects the developer takes on in-

creases, they may conclude that raising equity capital from high net worth individuals is often inefficient. Finding institutional alternatives allows developers to do more numerous and larger projects, in an efficient way, while simultaneously minimizing out-of-pocket capital and risk through the use of structuring financing.

### Alternative financing

Structured finance vehicles are financing programs that fill the gap in the capital stack between a traditional first mortgage and developer equity. These programs are utilized more and more frequently as developers get more sophisticated and work to mitigate their risks.

Some examples of these programs include:

- Mezzanine financing
- Preferred equity
- Participating debt
- Joint venture equity

**Mezzanine debt** goes on top of the first mortgage to achieve higher leverage. Mezzanine debt takes the debt from 50 to 55 percent LTC to 80 to 85 percent LTC. Current pricing is approximately 9 to 12 percent.

**Preferred equity** reaches a little further up the capital stack to 85 to 90 percent LTC. Cost of capital is generally low- to mid-teens. The preferred equity provider is typically paid first, up to a specified return prior to the

developer receiving any proceeds from cash flow, refinance or sale.

**Participating debt** is a hybrid debt/equity option whereby the lender funds 90 to 95 percent of the project's cost. Available cash generated by the project through operating cash flow or a sale is used to pay a pre-determined rate on the lender's funds, then split between lender and developer roughly 45 percent/55 percent.

**Joint venture equity** allows the sponsor to complete a project with the least amount of out-of-pocket capital. Institutional joint venture partners will provide as much as 90 to 95 percent of the overall equity requirement for a project.

There are a multitude of sources for each of these options. Institutions such as life companies, pension funds and other opportunistic funds simply looking to generate a return can be suitable options. Additionally, there are groups that participate across the entire spectrum noted above. Some union pension funds and debt funds have programs whereby they provide virtually the entire capital stack, from first-mortgage financing and on up through leverage reserved for joint venture partners. It's a "one stop shop" with the rate ultimately based on blending the rates at various points along the leverage curve.

Of course, for each of these structured option's benefits, there are also

tradeoffs. For instance, the primary objection most developers have to structured finance is a potential loss of control. Generally, as you move further and further up in leverage, the institution providing the additional capital tends to want more and more of an active role in decision making regarding the project. This includes everything from major decisions such as a recapitalization or disposition, to more minor issues such as finishes and marketing.

A recent transaction in Minneapolis began with a comprehensive search for development debt and equity on a to-be-built market-rate apartment project in the Twin Cities. The developer had already sourced its first mortgage through an existing bank relationship. The developer then hired NorthMarq to provide options for additional third-party leverage. After considering multiple avenues, the developer opted to utilize mezzanine debt as it provided the best combination of pricing and additional leverage while preserving developer control.

Of course, regardless of the scenario, the structured vehicle utilized needs to align with a developer's timing and exit strategy. The good news is that as capital remains plentiful, we are able to identify a variety of options to satisfy short- and long-term capital needs at a range of leverage points.



The 307-unit City Club Apartments opened in downtown Minneapolis this fall. The 17-story apartment building features a sky park with a rooftop pool, outdoor movie theater, bark park and lounge seating.