

FINANCING THE SMALL DEVELOPMENT

Banks want to lend you money if you have a good project.
All you have to do is learn how to ask.

by John Brown

You're a small-volume contractor, custom builder, or remodeler. Although you may have started out as a subcontractor in carpentry, plumbing, or some other trade, you have gradually become more of a general contractor or perhaps even a small developer. Many of your friends and associates have moved on to larger scale development projects and you're considering doing the same. Once you have a specific project in mind, however, how do you go about getting the financing?

Financial Feasibility

Before you even consider seeking financing, you must "do the numbers" to determine the economic feasibility of your proposed project. Although we'll get to the specific requirements of lenders in a moment, your first-cut analysis must determine two things: (1) Is the project do-able? (2) How much equity (investment capital) will be needed?

Assuming that you have a solid background in the building field and good contacts with subcontractors and suppliers, you can estimate the construc-

tion costs related to your project. If you will be managing the property, you must also talk to experienced property-management people about current operating costs. You must then prepare what are called *pro forma operating projections* to determine if anticipated income will be sufficient to pay projected operating costs and debt service.

Debt service is the principal and interest on your loan. If you are developing for immediate sale—for example, condos or homes—rather than for longer-term investment property, your pro forma will take on more of the characteristics of a cash-flow projection and should probably reflect quarterly or monthly periods rather than annual projections.

At this point, you should compare alternative scenarios related to the size of your loan, interest rates, equity investment, and annual constant. The *annual constant* is the percentage of the original loan amount that must be repaid annually and includes the interest and principal. A personal computer is very helpful in looking at these "whats-ifs."

Generally speaking you can borrow

up to 75 to 80 percent of the value of the property. First compute the hard and soft costs. Hard costs are the actual building costs. Soft costs include interest, points, taxes, and insurance during construction; marketing, legal, and accounting costs; and other administrative costs. By subtracting the anticipated loan from the total hard and soft costs, and allowing appropriate rent-up or sell-off periods, you can readily determine the amount of equity needed. If you need help in doing these analyses, consult a CPA with real estate experience or a real estate counsellor.

Do not seek to borrow more than you can repay. Although the temptation may be to "borrow out" (a 100-percent loan), if the rental or sales process is slow, you will be "carried out." And a foreclosure is one of the most painful processes in the real estate and development business.

Sources of Capital

You will need three sources of capital: (1) equity investment capital, (2) permanent loan, and (3) construction loan.

If you are building or developing for

immediate resale (such as condos), you will need so-called "take-out" financing rather than a permanent loan. *Take-out financing* is a commitment from a lending institution that they will provide loans to the buyers of your units. But your first priority is finding equity capital.

Equity capital is your down payment on the property. If you already own the land and it represents approximately 20 to 25 percent of the value of the completed property, this could represent your equity contribution. If not, you will have to raise the capital elsewhere—through use of your personal savings, bringing in an equity partner, or some other method. In a larger project, you might consider syndicating the property by bringing in investor limited partners.

Some developers make equity partners of lenders or landowners. This may be appropriate if you are a high-volume developer with lots of experience in structuring such agreements. If not, try to avoid lender participation. Lenders usually don't know much about the development process and can seriously delay your project if they shut off or slow down your funding.

Besides, it should not be necessary to joint venture with a lender unless money is in extremely short supply, which is not the case today.

Next, you must obtain your permanent loan. Although regulation of lending institutions has loosened up in recent years, lenders are still subject to many state and federal regulations that control how they lend their money. A savings and loan institution is usually the best source of funds for a modest size development loan—say under \$2 million. Larger projects may require using larger regional banks or more than one smaller bank. If a project loan is over \$5 million, insurance companies and pension funds are another good source of permanent loans.

Once you have obtained your permanent financing (or buyer take-out commitment) it is relatively easy to obtain a construction or short-term loan. Most commercial banks provide such loans and you should probably approach your own commercial bank first. If developing residential homes or condos, be careful to determine if your buyer loans will be resold by the lender on the secondary market. If so, you will need to get prior "Freddie Mac" (Federal Home Loan Mortgages Corporation) or "Fanny Mae" (Federal National Mortgage Association) approval. Your

Cash Flow & Investor Position Pro Forma

Sunny Dell Acres Rental Apartments

Purchase Price 1,200,000	1986	1988	1990
Cash Flow			
Income (scheduled)	216,000	242,698	272,695
Vacancy factor (5%)	10,800	12,135	13,635
Net income	205,200	230,563	259,060
Operating expenses	72,000	77,875	84,230
Net operating income (NOI)	133,200	152,688	174,830
Cap Rate =	11.10%		
Mortgage expense	25yr/13.5%		25yr/15%
850,000 1st	118,898	118,898	0
100,000 2nd-10%	10,000	10,000	
Refinancing:			
1,070,000 25yr/15%	0	0	164,459
Cash Flow	4,302	23,790	10,371
Debt Coverage Ratio			
(DCR) - 1 st mortgage	1.12	1.28	1.06
Investor Position ¹			
Investors cash flow	3,657	20,221	8,816
Investors equity	320,000	320,000	214,361
C/C ret. (cash-on-cash)	1.04	6.32	4.11
Investors Loan Amortization	4,412	5,771	4,242
Investors Depreciation	49,180	49,180	49,180
Other Amortization	6,375	6,375	6,975
Taxable Income	-47,486	-29,563	-43,097
Tax (50%B)	-23,743	-14,781	-21,549
Net tax	-23,743	-14,781	-21,549
After-tax return	27,400	35,003	30,364
After-tax rate of return	8.56%	10.94%	14.27%

(1) Operations only (not including refinancing on sales proceeds). Investors receive 85% in this project; syndicator receives 15%.

lender can explain this to you and provide you with the necessary forms and instructions.

Seeking a Lender

Lenders are in the business of lending money. You are in the driver's seat if you have a good sound project and are not seeking to "borrow out." You must consider your objectives and your lender's before preparing your presentation package.

As a developer and borrower seeking permanent financing, you will be seeking the following:

- As high a loan-to-value ratio as is feasible (so as to maximize leverage and return on investment).
- Avoidance of lender participation or second mortgages.
- An amortization period as long as possible (25 to 30 years) so as to reduce your constant and annual debt service as much as possible.
- Avoidance or reduction of personal liability for loan repayment (the property itself should be sufficient collateral).
- No restrictions on prepayment of the loan and the right to transfer the loan.
- A commitment period long enough so that you can complete the building and development process.
- As low an interest rate (including points) as possible.

Lenders are coming from a different (although not necessarily opposite) direction. They want:

- Sound income-producing real estate to secure their loan.
- A loan-to-value ratio that makes you and your investors true partners in the financial venture.
- Debt coverage ratios that will assure the repayment of the loan even if your optimistic pro forma projections prove to be faulty.
- As high an interest rate (including points) as the market will allow.
- Hedges against future contingencies (such as inflation).

With regard to the last item, the lender will prefer a loan that will keep you in for the long term (if your project is successful), but will get you out or raise your interest rate if that is in the lender's best interests.

You will rarely obtain all of your objectives, nor will the lender. The terms are a matter of negotiation.

Commitment letters have become very lengthy documents in recent years because of the lender's desire for protection. They cover everything from hazardous waste on the site to indices for interest rate increases to repayment upon transfer or sale of the property.

Your Presentation

If you have done your homework and have a sound project, your presentation package need not be overly exotic. It should include the following as a minimum:

- A description of the project in clear and precise terms. Simple drawings and location maps can be helpful.
- Objectives of the borrower in terms of holding period of the real estate, tax objectives, etc.
- The legal structure of the owning entity (individual, partnership, corporation) and the background and experience of the principals.
- The amount and type of financing that is being sought.
- Alternative pro formas showing financing at varying rates of interest and amortization periods. These pro formas should highlight the debt coverage ratio. *Debt coverage ratio*

(DCR) is the ratio of the annual net operating income (gross income less operating expenses) to the annual debt service. For example, if net operating income (NOI) is \$120,000 and debt service is \$100,000, the DCR is 1.20. In other words, there is expected to be 20 percent more money available to pay off the debt service than will be required. DCRs required by lenders range anywhere from 1.05 to 1.30, depending on the type of project and the borrower's track record and financial resources.

- A source and use-of-funds tabulation showing from where funds will come and how they'll be spent (including both hard and soft costs).
- Personal financial statements of all principals involved in the project and financial statements of the entity to be used, if relevant (frequently new entities are formed for each project).
- A market analysis indicating that your product can be absorbed by the market. This can range from a survey of the local condo market or office vacancy rates to a sophisticated document prepared by a regional economist—depending on the size of the project.

Additional information may be needed by specific lenders, but if you have done your homework, this shouldn't be a problem.

Approach

The best way to proceed is to discuss your project (in general terms) with other developers or investment property owners in your area. If this is not possible, consult a real estate counsellor and read as many local financial publications as you can. If you are friendly with a lender, seek to find out what kinds of loans are in good supply and on what terms. You will need all of the above information in order to prepare realistic alternative pro formas. Do not approach your bank until you know where your equity capital will come from and have at least good preliminary plans of your project.

Prepare your presentation package and then call a number of lenders. Tell them what kind of loan you are seeking and ask them if they have such loans available. Also ask them about current interest rates and points (up-front charges) and amortization periods. If it appears that they may have the type of loan you seek, ask if you could send them a package of information about your project. They will usually say yes.

Call a number of lenders—say four or five—before sending out the package. What you learn may lead you to revise the package before sending it. Within five to seven days you may hear from the lenders. They will have studied your proposal and will tell you whether they have any further interest. If so, set up an appointment to meet with them personally. They will probably tell you what additional information to bring to such a meeting.

If you do not hear from a lender in five to seven days, call the lenders you've contacted to find out their interest and proceed from there. Be straightforward and courteous. You need not grovel. Lenders want your business if your project makes sense. As time goes by, the process will get easier and easier. Eventually they may call you to ask if you have any new projects coming on line that need financing. When that happens you'll know you've made it.

Good luck. ■

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