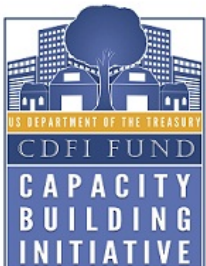


# *Training Module: Real Estate Restructuring*

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# Why Real Estate Restructuring?

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**Unique opportunities** in current market environment for CDFIs to support **start-ups** and **small business expansions** through **strategic investments** in and providing financing for real estate transactions.



# Why Real Estate Restructuring?

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Why support start-ups and small business expansions through strategic investments in and financing of real estate transactions?

- **Strong business opportunity for CDFIs to:**
  - Extend existing real estate-related business channels
  - Open new business channels for real estate-related business
- **Strongly aligns with core CDFI mission by supporting:**
  - **Wealth creation** opportunities for community members
  - **Job creation** within the community
  - Improvements to physical **fabric of the community**
  - Higher **quality of life** for community members



# What will we be covering today?

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## Real Estate Restructuring will cover:

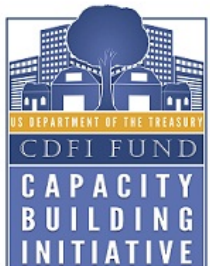
- Real Estate as an **Asset Class**.
- State of **Small Business Real Estate Lending** generally:
  - Acute unmet needs for real estate-related loans \$250K - \$1M
  - Opportunity for CDFIs to make much-needed community investments
- **CDFI SBREL Opportunities:**
  - **Strengthen communities** CDFIs already serve
  - Job creation and business expansion within customer base
  - Help remediate/resolve portion of bad CRE Loan Portfolio
- What is the **Low-Hanging Fruit** for CDFIs?
- What Do CDFIs **Need to Know** to Take Advantage of These Opportunities?



# Understanding Real Estate Asset Class in Today's Market

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- Real Estate assets are a **lagging indicator** of economic recovery
- **Values** have already started to come back in robust markets
- Some **pent-up demand** for certain segments of asset class
- A lot of **capital remains on the sidelines**
- Like politics, **all Real Estate is local**
  - Local Real Estate **markets**
  - Local Real Estate **sub-markets**



# Major Trends for Real Estate Restructuring

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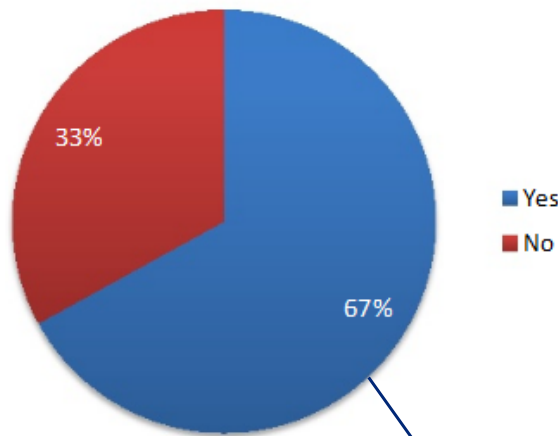
- 1. Low Credit Access** - Financing remains the top challenge in the commercial real estate market
  - Loss of traditional real estate equity sources to small business
  - Historically low interest rates, but also low access to credit
- 2. Depressed Market Values** - Potential for acquiring properties at low costs due to “resolution” of bank-owned properties by the FHFA
  - Low Values + Low Interest Rates should = OPPORTUNITY... but
- 3. Rising Impact of Deferred maintenance** - Providing channels for financing affordable space can drive job growth and support existing small businesses (e.g. construction and repair contractors). Indirect job creation can be fueled by tackling the backlog of deferred building maintenance.



# Trend #1 – Low Credit Access

- Small/Mid-sized Commercial Real Estate **loans aren't a target for National Banks**
- **Private lending plays an important and necessary role for small businesses**

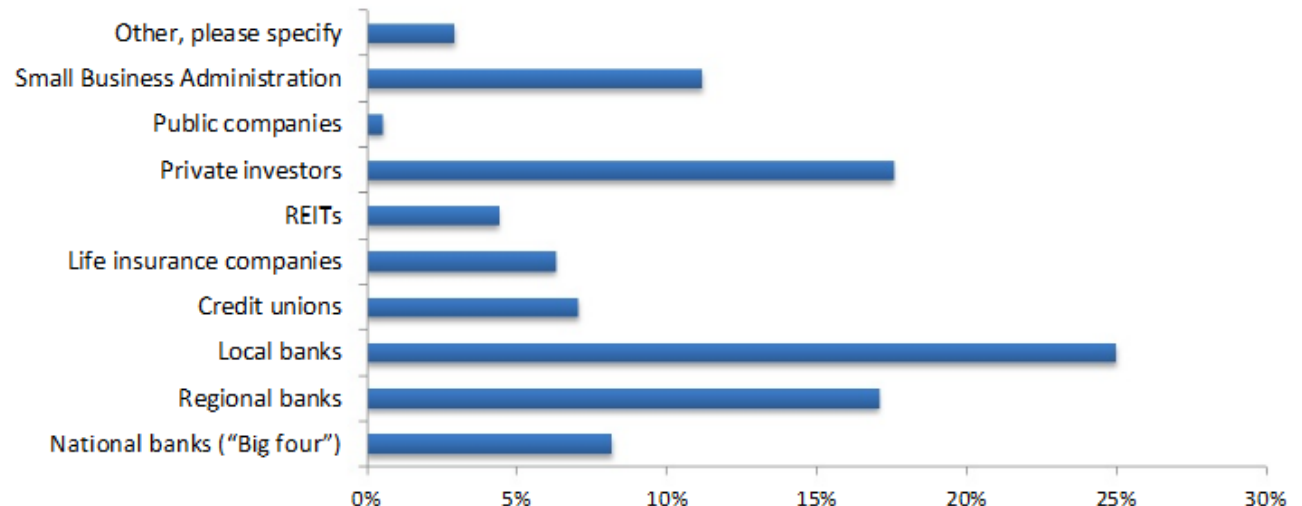
Have you had a sales transaction fail during the past 12 months due to lack of financing?



National Association of Realtors Commercial Real Estate 2012 Lending Survey

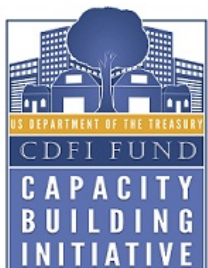
*67% deals fall through due to a lack of financing*

Current sources of financing for commercial deals



National Association of Realtors Commercial Real Estate 2012 Lending Survey

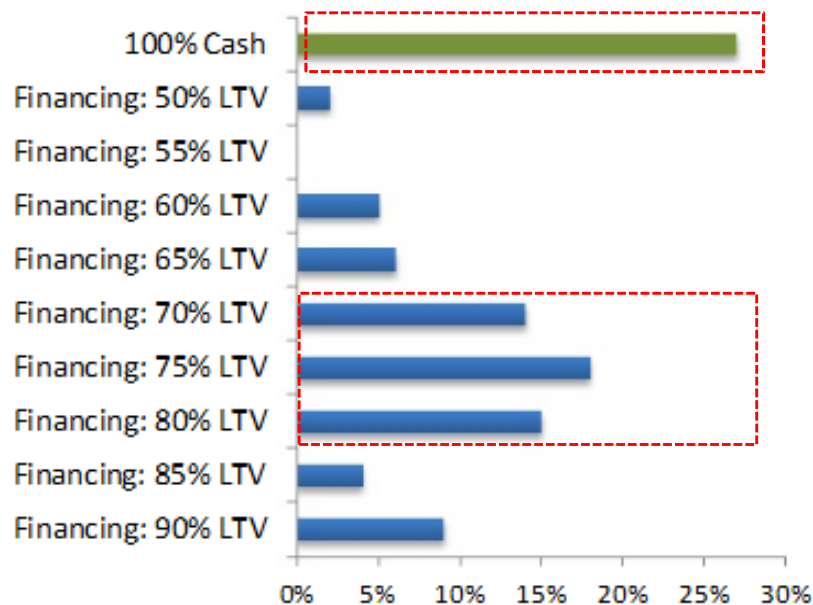
*Local and Regional Banks do over 40% of Commercial Lending compared to National Banks (~8%)*



# Trend #1 – Low Credit Access, Attainable Deal Ranges

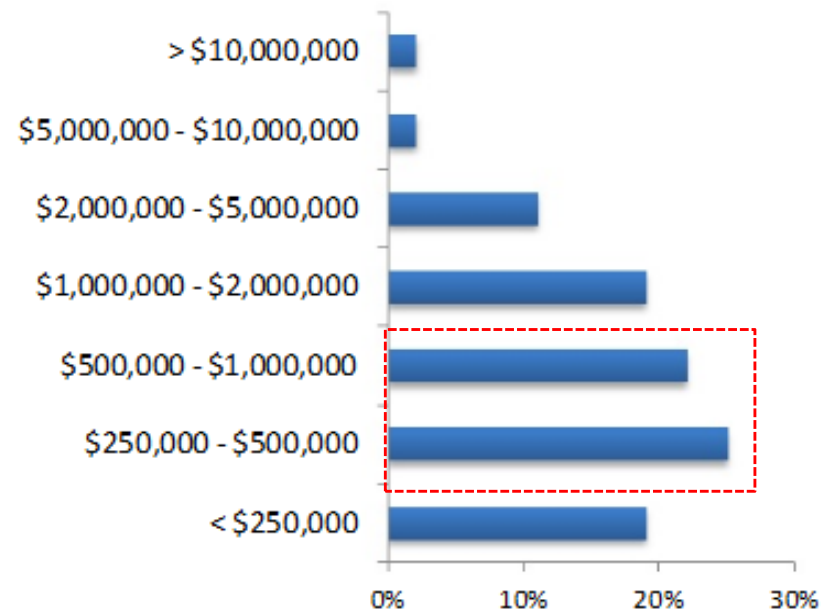
- **Most sales transaction values were in sweet spot for larger CDFIs with small business lending:**
  - Greatest concentration in the \$250,000-\$1M range
- **There is a need:** Most sale transactions in the last year were **100% Cash** or in the **70-80% LTV** range

How were most of your sale transactions in the past 12 months completed?



National Association of Realtors Commercial Real Estate 2012 Lending Survey

Value of most recent sales transaction



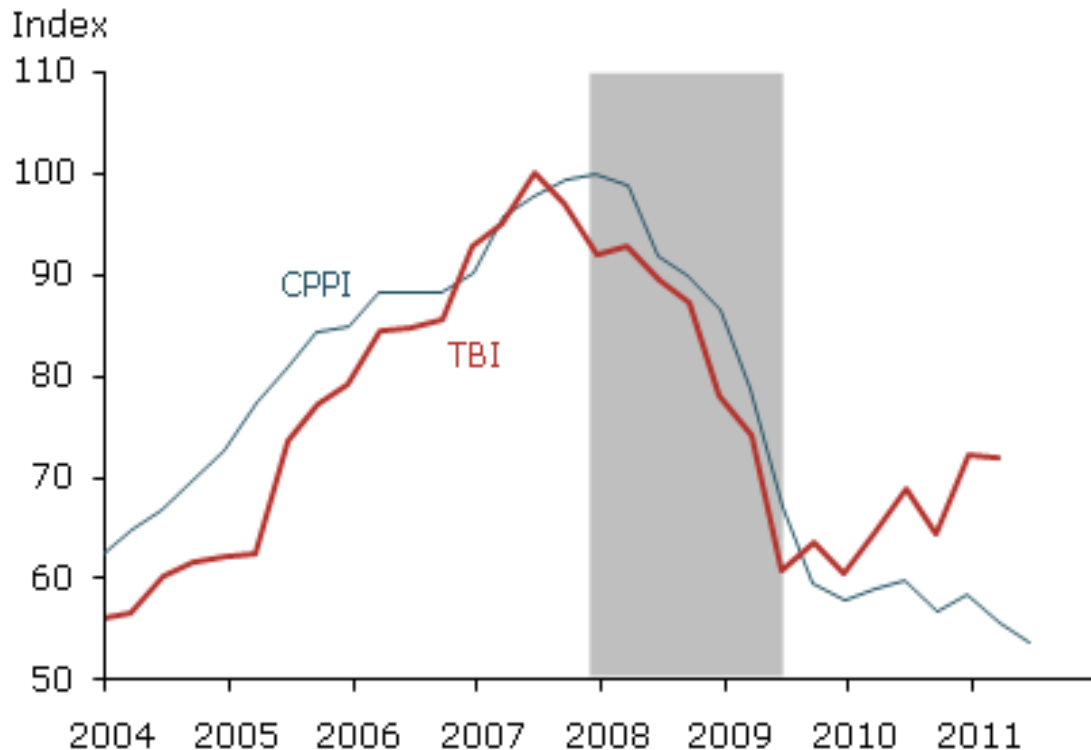
National Association of Realtors Commercial Real Estate 2012 Lending Survey





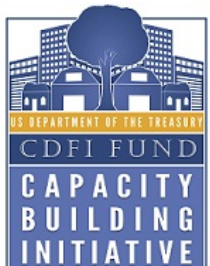
# Trend #2 – Depressed Market Values

## Two Valuation Measures of Commercial RE



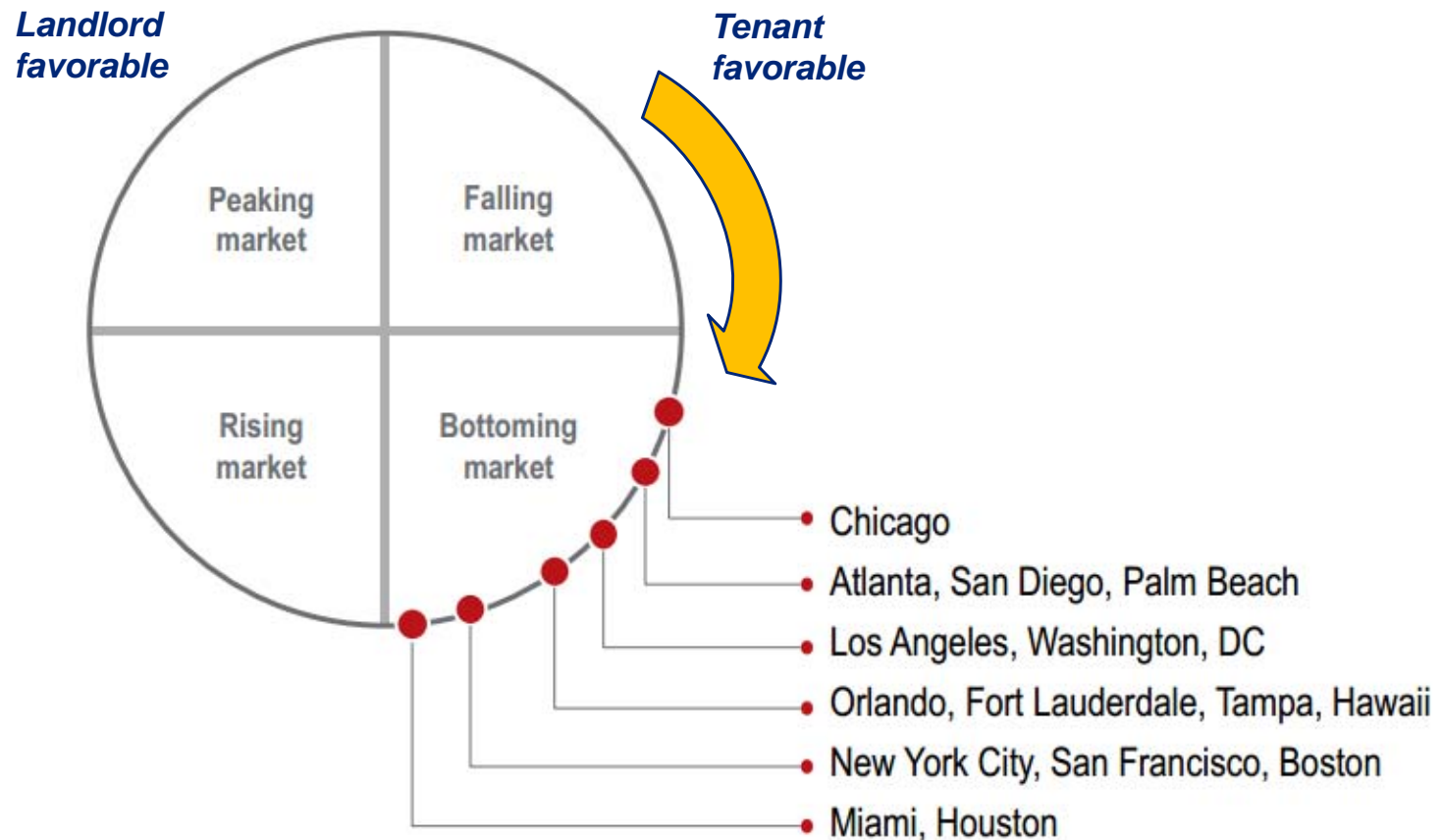
FRB of San Francisco and Moodys/MIT Center for Real Estate. Both indexes are based on “all properties.”, 2011

- **Small businesses (SB) could purchase bank-owned inventory at lower market prices and revitalize the property for rent or sale**
- **60% of CRE loans are “underwater”. Most roll over before 2015.**
- **Banks and other mortgage lenders have negative net-worth portfolios that must be resolved:**
  - Write mortgages down
  - Refinance to other lenders
  - Meet regulatory ratio goals.



## Trend #2 – Depressed Market Values (continued)

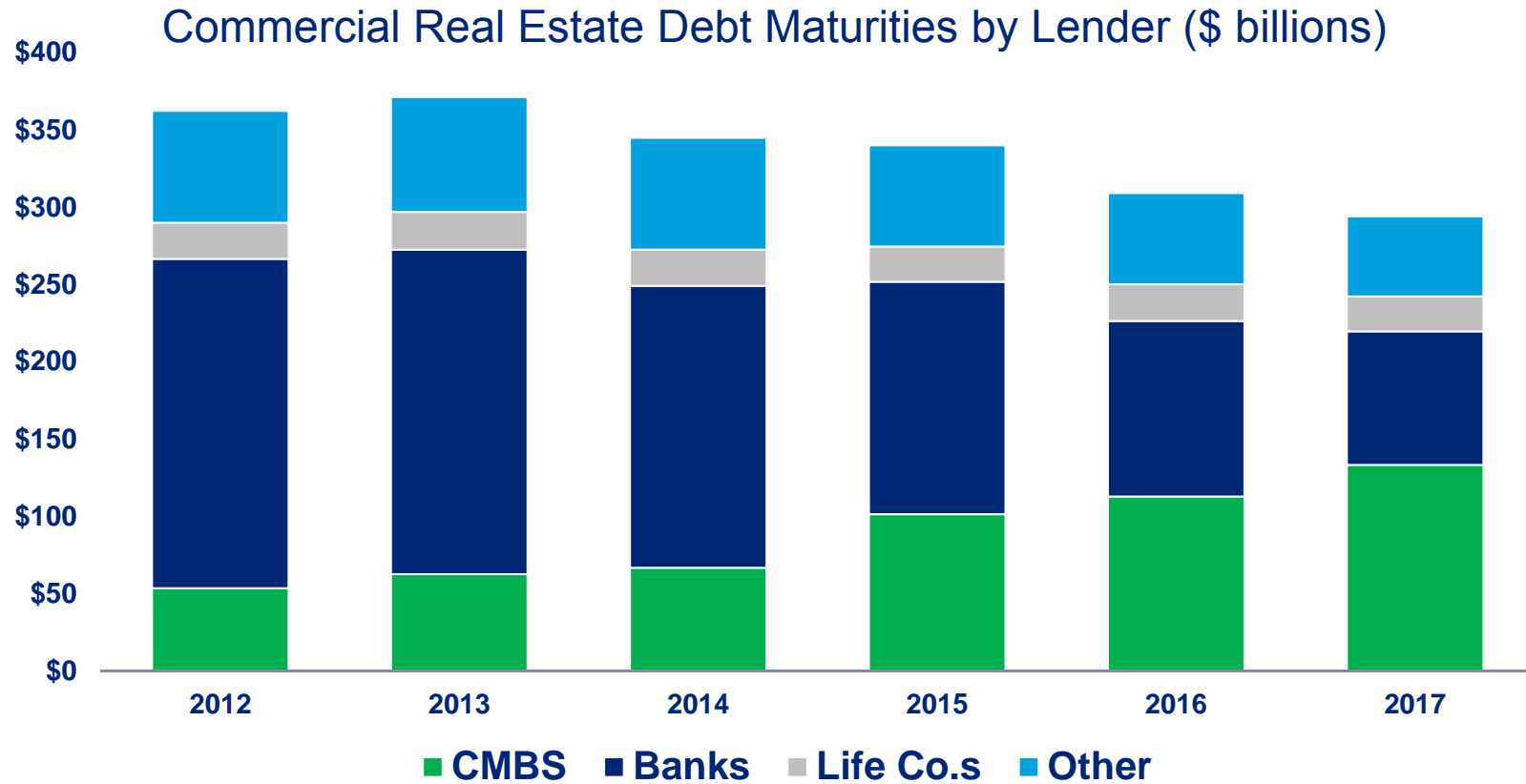
Bottoming out rents can also indicate that the retail “clock” is about to move into a Rising Market in some areas.



Source: Jones Long LaSalle, “Retail Outlook United States Q2: 2012,”  
[http://www.us.am.joneslanglasalle.com/ResearchLevel1/United\\_States\\_Retail\\_Outlook\\_2012-interactive.pdf](http://www.us.am.joneslanglasalle.com/ResearchLevel1/United_States_Retail_Outlook_2012-interactive.pdf)



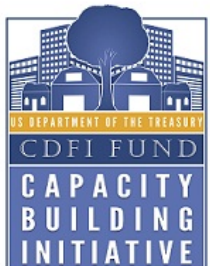
# The CRE Loan Wall Gets Hit In 2015-2017 (\$2 Trillion Total)



Source: CastleOak Securities, LP & Trepp

## How CDFI's can participate:

- Repurposing properties (e.g., conversions; REO to rentals)
- Property management
- Demolition as a Community-Enhancer

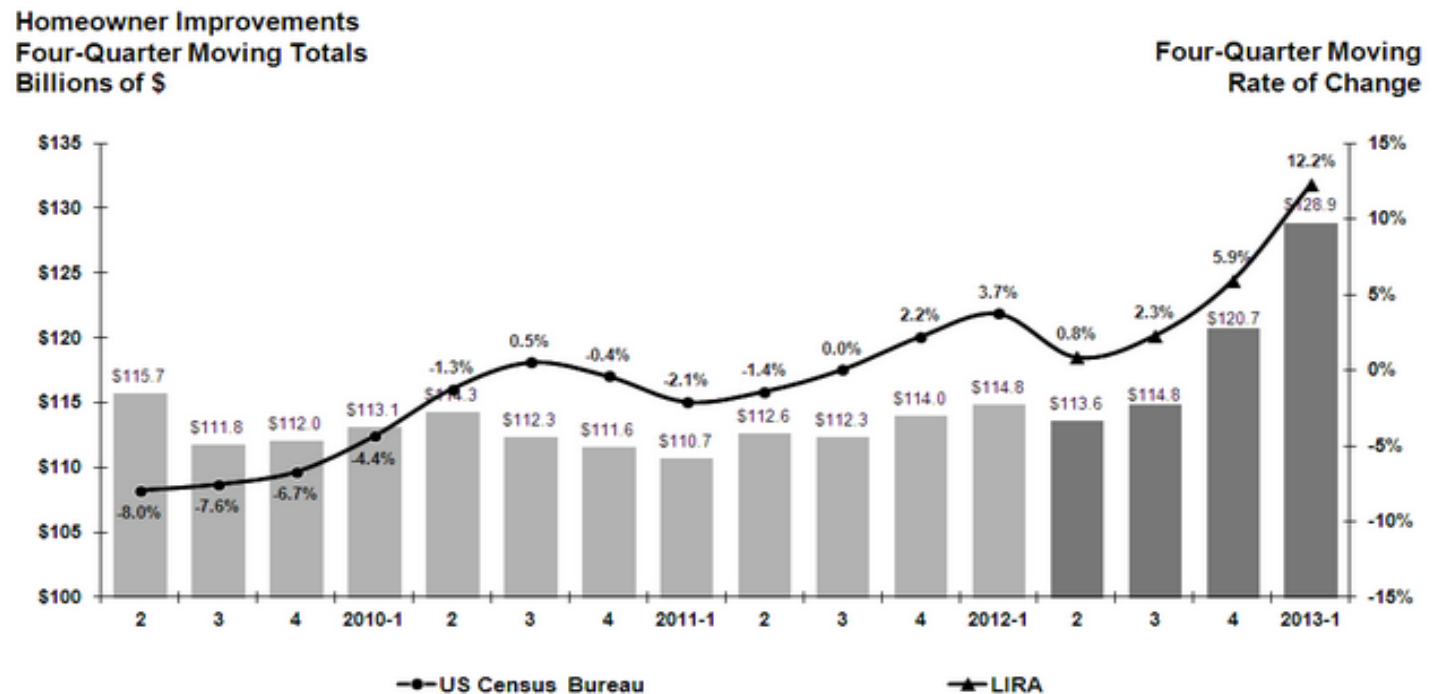


# Trend #3 – Rising need for deferred maintenance (Another \$2 Trillion)

Deferred maintenance for households over the last 2 years has opened up opportunities for small businesses dedicated to construction and maintenance in the near future.

Modernization needs offer potential for cost savings through updating buildings, including households

*Leasing Indicator of Remodeling Activity, As of Second Quarter 2012*



Source: Joint Center for Housing Studies of Harvard University.



# Potential CDFI Roles

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## **As a Lender:**

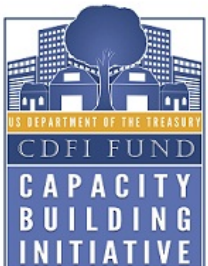
- Lend for SB real estate expansion
- Lend for SB equity take-out debt, using RE for collateral
- Lend to small/medium-sized private developer that is renovating/restoring community real estate into mixed use space (retail / housing / etc.)

## **As a Property owner (lease to small business owner):**

- Finance sale-leasebacks to provide cash capital to business
- Lease to start-ups getting on their feet
- Provide local property management services

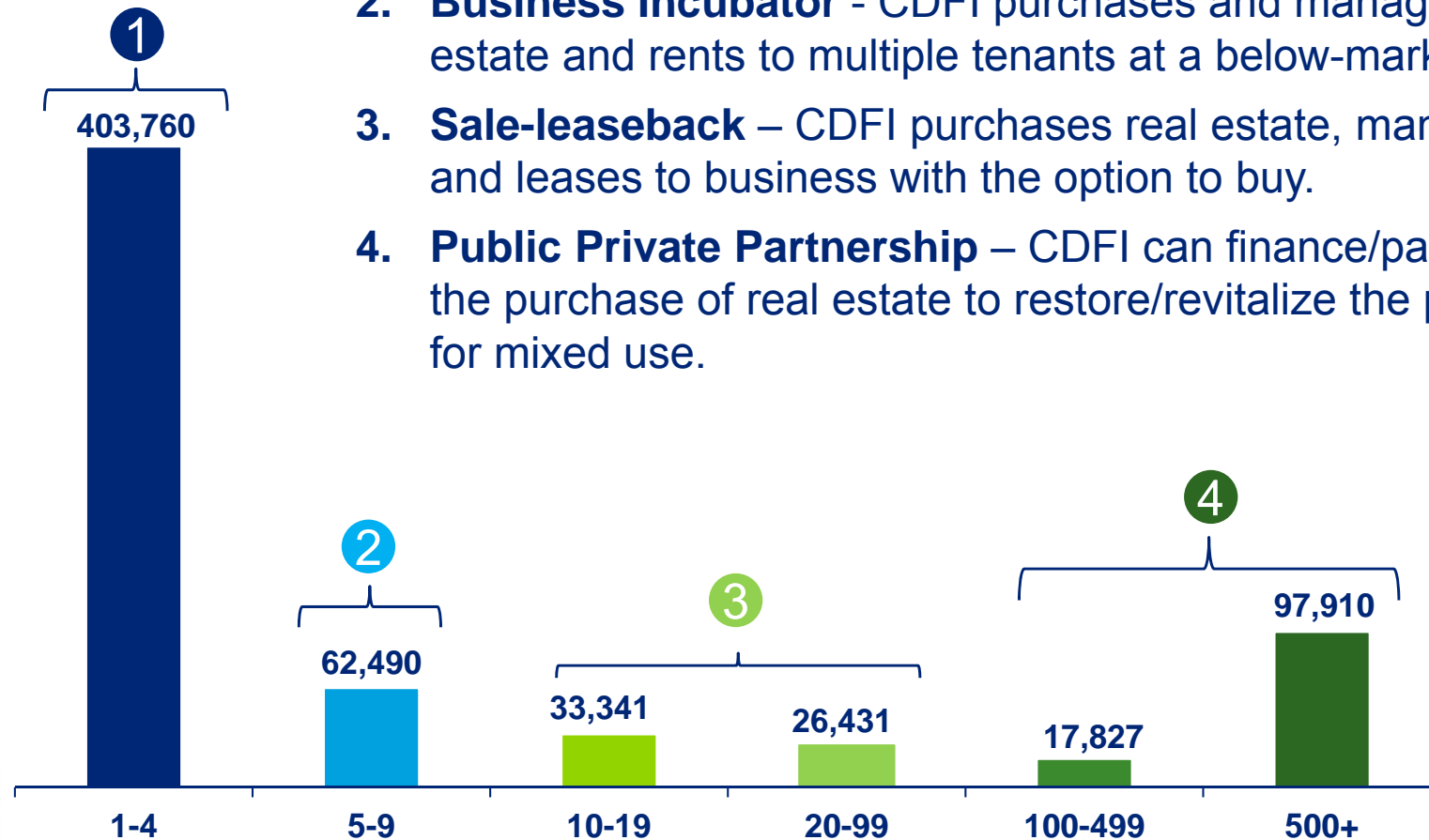
## **As a Partner CDFI to structure financing:**

- Operate as an originating lender or transaction/syndicate lead
- Provide technical assistance in accessing federal / state / local funding



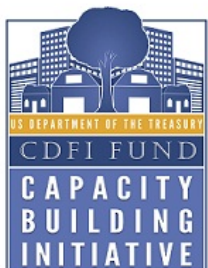
# CDFIs can target small businesses by level of maturity

No. of Enterprise "Births" by Enterprise Employment Size



Statistics of U.S. Business, Census Bureau, 2009

1. **Establish Home-based Operations** – CDFI lends to small business owners to improve property for business uses.
2. **Business Incubator** - CDFI purchases and manages real estate and rents to multiple tenants at a below-market rate.
3. **Sale-leaseback** – CDFI purchases real estate, manages, and leases to business with the option to buy.
4. **Public Private Partnership** – CDFI can finance/partner in the purchase of real estate to restore/revitalize the property for mixed use.



# Business Incubators

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Designed to provide space for **start-up** companies and **emerging small businesses** to enable them to grow during their early years.

In addition to space, may provide business support services such as copying, faxing, specialized services (marketing, accounting, etc.)

Types of tenants in business incubators:

- Early stage start-ups
- Commercialization stage companies
- Business service companies
- Manufacturing firms



<http://www.famerenaissance.org>

# Public Private Partnerships

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Public Private Partnerships (PPPs) are used by many lenders and investors to salvage and reposition distressed real estate

CDFIs may be able to enter in a PPP to repurpose distressed community assets

- **Example:** Distressed public assets in North Dakota are being restructured as residential housing for natural gas workers to accommodate influx of new residents

Many cities have incentives for business development.

- **Example:** Certified Capital Company Program in DC consists of 3 venture capital companies which have been certified by Department of Insurance, Securities, and Banking to provide \$50 million in long-term equity (and debt) for new or expanding small businesses based in DC ([www.brc.dc.gov](http://www.brc.dc.gov))





# Risks and Challenges in Real Estate Restructuring

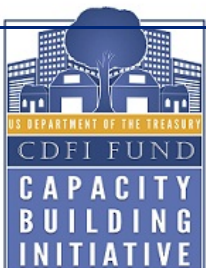
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1. **Weak Demand** - Lack of population base to support businesses or occupy housing (due to out-migration)
2. **Underwriting / New Risks** - It is more challenging to make Real Estate loans given stricter underwriting standards. CDFIs may also face new types of operational, legal and execution risks
3. **Partnerships**- CDFIs may lack a strong base of Real Estate referral partners to help fill the gaps in outreach efforts. Borrowers may typically look to Real Estate developers and other larger banks for these kinds of loans, rather than CDFIs
4. **New Territory Capital (Liquidity)**- Real Estate loans may require more capital to be tied up for longer period than other opportunities
5. **Tax Considerations** - CDFI may have tax obligations that flow from the transaction that need to be considered in DCF analysis



# Strategies to Overcome the Challenges in Real Estate Restructuring

<b>1. Weak Demand</b>	<ul style="list-style-type: none"> <li>• Work with business &amp; community leaders to develop a sustainable &amp; comprehensive redevelopment plan</li> <li>• Develop and implement strategies to encourage former residents to return and encourage new entrants into the community</li> </ul>
<b>2. Underwriting/ New Risks</b>	<ul style="list-style-type: none"> <li>• Establish underwriting criteria to mitigate such specific risk factors.</li> <li>• Develop multi-partner financing options</li> <li>• Cost/benefit analysis of outsourcing (e.g. monitoring and construction management); be wary of OJT in critical areas (e.g. underwriting)</li> <li>• Maintain good contact/relations with public sector staff/officials to help resolve potential issues.</li> </ul>
<b>3. Partnerships</b>	<ul style="list-style-type: none"> <li>• Community &amp; civic organizations, professional associations, foundations/non-profits, youth entrepreneurial or cultural initiatives &amp; other entities (faith community, educational, etc.)</li> </ul>
<b>4. Liquidity</b>	<ul style="list-style-type: none"> <li>• Leverage relationships to identify potential partnerships and/or joint venture options for deals.</li> <li>• Use leverage to establish financing between borrower &amp; local commercial bank (ex: finance down payment)</li> </ul>



# Innovation #1: “Sale-Leaseback w/Purchase Option”

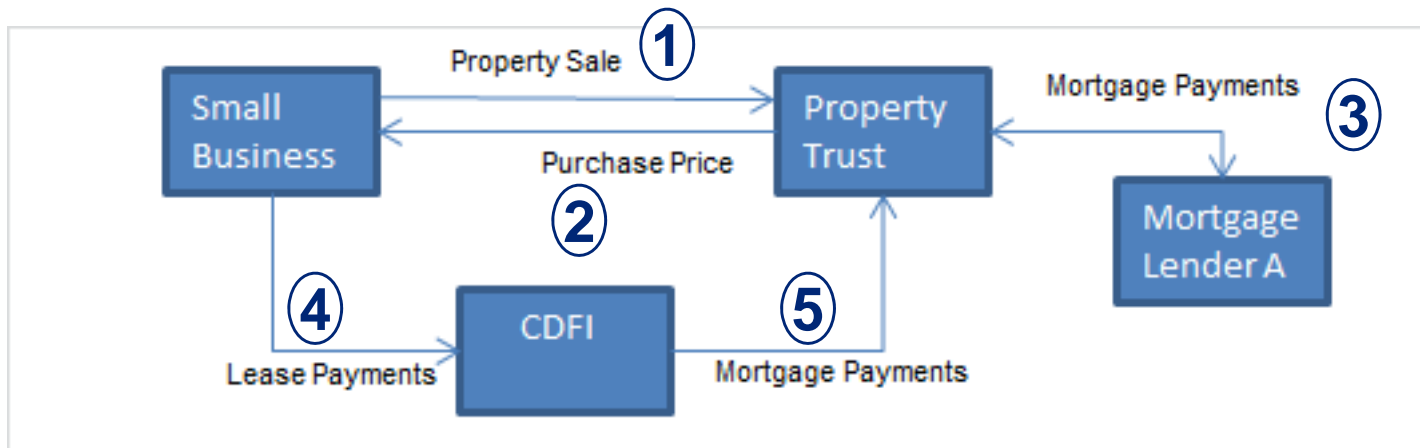
Historically, small businesses have relied on cash-out mortgages (on their homes or business properties). This source of funding has dried up

Cash can be freed up from properties by doing a sale-leaseback, where the small business sells their building (to get cash) and leases it back with a possibility of re-purchase

- Relatively straightforward asset-based transaction
- Provides cash for business expansion

# Sale-Leaseback with Purchase Option

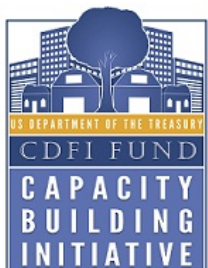
- Historically, small businesses have relied on refinancing real-estate assets to “cash-out” the equity built up in their residential and-or business properties. In the aftermath of the Great Recession of 2008, this source of funding has evaporated.
- Cash may nonetheless be freed up from business properties by entering into a sale-leaseback transaction, where the business sells its building to free up the equity (sales price – mortgage balance – transaction costs) and leases it back from the purchaser.



# What are the benefits of sale-leaseback to a small business?

- **Frees-Up Cash** – by turning real estate equity into a liquid asset that can be deployed in other aspects of the business
- **Better Aligns Facilities Costs with Operations** – Seller/Lessee and Purchaser/Lessor may be able to **customize terms of the leaseback**, so long as they are commercially reasonable and the leaseback payments do not appear to resemble a sale back to the Seller/Lessee.
- **Improved Balance Sheet** – increased liquidity; sales proceeds may be used to invest in other business assets; mortgage debt removed from Liabilities.
- **Ability to redeploy capital** into other valuable aspects of their business (new equipment; R&D; market expansion; etc.)
- **Potential Tax Savings** – Cumulative, monthly lease payments should be fully expensed each year and deducted from Gross Income, whereas mortgage payments are not.

**Sale-leaseback transactions have multiple benefits and incentives for small business owners**



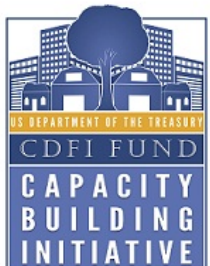
# How is this beneficial to the CDFI and community?

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- **For CDFIs:** Opportunity to:
  - meet needs of small businesses
  - capture a new fee stream (property management fees), and
  - add a productive asset to its balance sheet.
- **For Community:** Opportunity for property / façade improvements, as well as professional property management, particularly if Seller/Lessee devoted portion of cash received toward tenant improvements.
- **For Small Business Owner:** Seller/Lessee will be able to focus 100% on running the businesses, not managing the property.

## Tip:

There are many financial institutions that provide sources of funds for sale lease-backs; see your training binder for a list of sources.



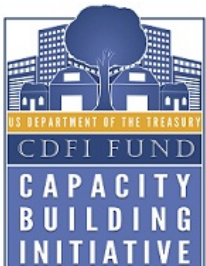
# Real Estate Revitalization: Where CDFIs Fit

***Under utilized  
community assets***

***Financing  
challenges for small  
businesses that  
need building/space  
grow their  
businesses***

***CDFIs can  
reinvigorate  
depressed  
communities by  
supporting credit  
access to small  
businesses for  
renovating /renting  
commercial real  
estate.***

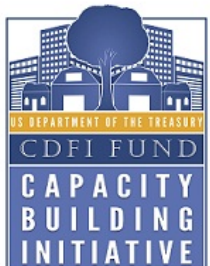
***CDFIs help small  
businesses through  
financing projects, rent-  
to-own programs, &  
business incubators, and  
even affordable housing.  
Creates jobs and adds  
value to community  
(taxes, real estate)***



# Relationships needed to assemble this deal

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- **Willing Seller of Property (a small business)**
- **A Property Management Company (if CDFI lacks expertise/staff)**
- **Mortgage Lending Source to finance CDFI's acquisition**
- **Tax Advisor to make sure transaction is recognized by IRS**
- **Experienced Real Estate Attorney to prepare the documents**
- **Trustee and Fiscal Agent (if CDFI does not have this capacity)**





# Sample terms

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- **Lease Term – typically 10 to 25 years, including renewal periods**
- **Annual rent and other lease terms must be commercially reasonable; lease payments cannot look like disguised mortgage payments from Lessee to Lessor**
- **Periodic lease payments (usually monthly)**
- **Business continues to own and control the business activity conducted in the same facilities and retains all business profits**
- **Property conveyed by general warranty deed; Purchase/Lessor must have fee simple ownership interest in the property**
- **Seller/Lessee's Options at end of lease:**
  - Renew/renegotiate the lease
  - Exercise option to purchase the property (if given up front); price to be determined
  - Move the business and terminate the Lessor/Lessee relationship



# What are the capacity needs for this innovation?

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- CDFI has the legal vehicle and ability to own real estate properties
- Mortgage lender willing to negotiate prepayment terms
- CDFI has adequate internal cash flow, and has prepared a tax analysis model for sale leaseback
- CDFI has participated in a similar transaction on a smaller scale to determine their ability – perhaps participated in a test transaction with a mentor financial institution
- Defined rules and responsibilities for staff, with necessary Board Oversight, for this specific type of transaction.



# Innovation #2: Supporting the Catch-Up On Deferred Maintenance

Millions of homes have deferred maintenance and home improvements during the recession. This creates ample opportunity for small business tradesmen as families and individuals begin to reinvest in their homes.

CDFIs can finance small business maintenance and home improvement providers across the U.S.

# Supporting Maintenance & Improvements in Real Estate

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In addition to owning and leasing properties / managing incubators, lending for property improvements has the potential for impacting small community businesses.

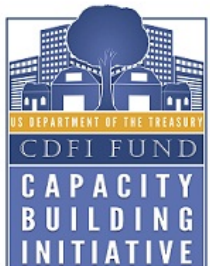
- Residential **remodeling is expected to rise** 12% in 2012 and 7.9% in 2013
- Over 80% of homeowners expect to invest the same amount or more on home improvement in 2012 & 2013 as they did in 2011
- Growth in home improvement sales are forecasted to average 5.9% in 2014 & 2015



# What are the benefits?

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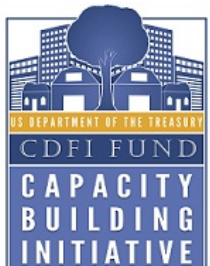
- **For small businesses:** Providing sources of revenue for small contractors/construction companies; operating out of the entrepreneur's home keeps overhead costs very low; this is a very low-barriers-to-entry business
- **For neighborhood:** Lifting property values in neighborhoods. This may lead to increased tax revenues for local government and schools
- **Environmental impact:** Has the potential to increase energy efficiency with improving windows, insulation, roofing, upgrading to energy efficient appliances, etc.
- **Social impact:** Job Growth. For example, Construction was one of the most affected industries during the recession; this provides new job opportunities for these workers
- **For CDFIs:** Opportunity to engage in Real Estate without taking on large loans / acquiring real estate



# What are the small business opportunities?

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- **Licensed Home Inspectors** - can evaluate issues regarding building codes and housing regulations
- **Tradespeople** - skilled tradespeople and other service providers may offer a variety of services (some licensed) to rehabilitate structures suffering from deferred maintenance: Skilled trades (plumbing, electrical, and HVAC); carpentry; roof repair/replacement; mold remediation, interior/exterior painting; etc.
- **Residential Real Estate Appraisers** – independent and qualified appraisers will be needed for refinancing and home purchases



# Breakout Session: Joe's Demolition Company

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Joe has approached your CDFI to obtain equipment financing (\$100K) and working capital (line of credit up to \$500K) to help him grow his demolition business.

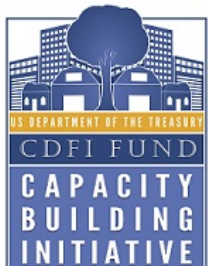
Over a 5 year timeframe, Joe wants to:

1. Take advantage of Detroit's revitalization plan to demolish 200 more homes per year and then expand into demolition of industrial facilities, growing his employee base from 3 to 12 staff
2. Buy equipment to support his strategy

## Joe's Financials and Experience

- \$300k in gross revenue per year
- \$200K in net assets
- 15 years of experience in the industry; 3 years as a sole proprietor
- Bonded, licensed and insured

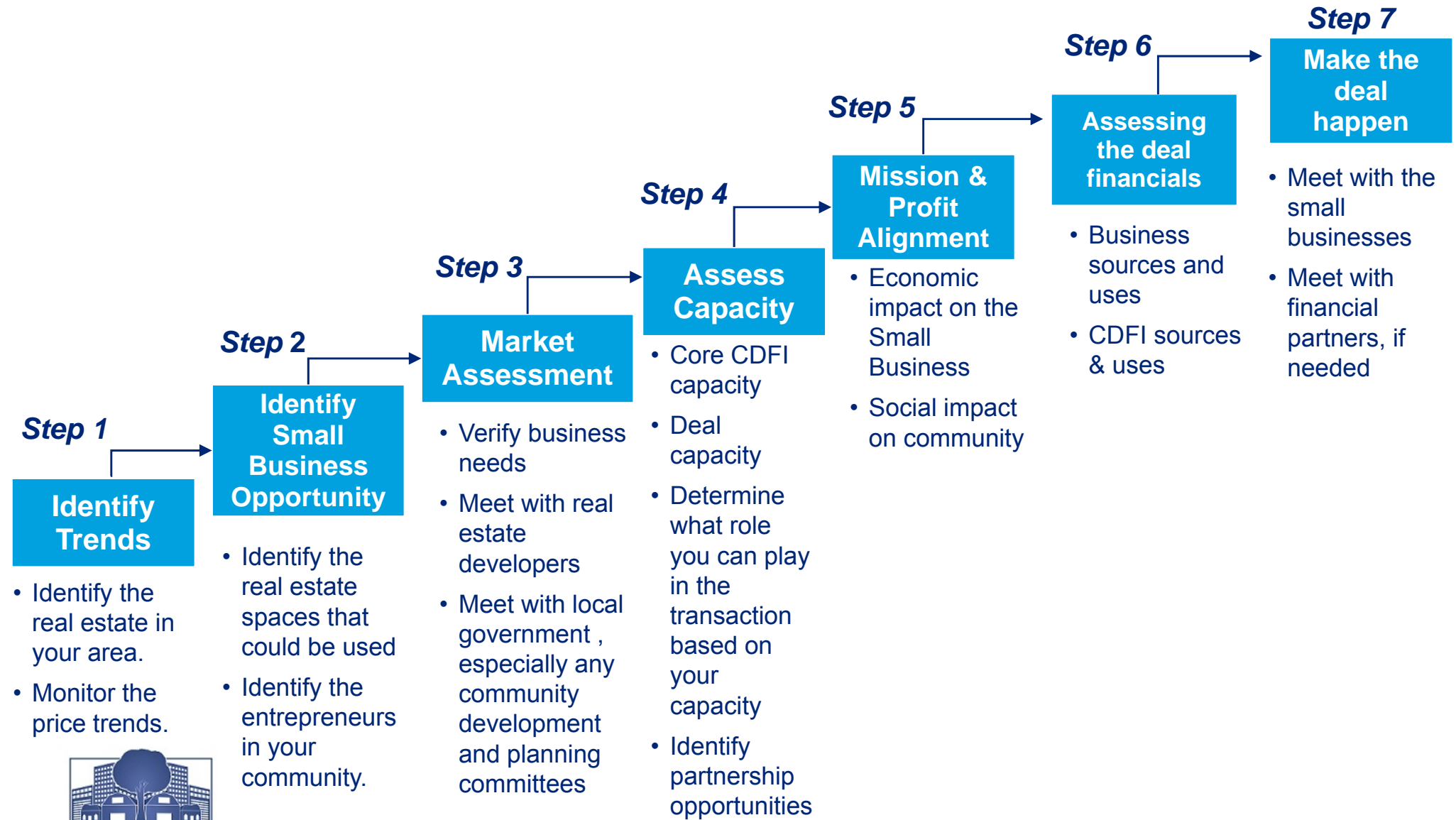
**Task: what do you need in terms of additional information to underwrite these loans?**



# Session Wrap-Up



# Process for Innovating New Business



For sources and further information, see the “Real Estate Restructuring” section of Virtual Resource Bank

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