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Multiple Sources

Financing the Mixed-Use Development Project

PROJECT FINANCING

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A COMMON type of real estate development in central city locations is the mixed-use project. Containing varying combinations of hotel space, office space, retail space and residential space, the mixed use project responds to a number of market imperatives in real estate.

First, it makes good urban planning sense — lively street-level retail at the base; office or hotel use in the mid-rise, where floor plates, and not views, are the paramount concerns; and high-rise residential to maximize the use of the land parcel and the value of the developed space.

Second, mixing uses allows the value of each component to be maximized. By creating hybrid uses, the different pieces add value to each other — consider, for example, high-end residential projects which offer hotel services, transient hotels that bolster their daily occupancy with an ownership component, and multi-use retail space that has a built-in 24-hour office and residential population as customers.

Third, mixing uses diversifies the project risk, by reducing the reliance of a project on a single market sector, and reducing the amount of space of a single type that must be absorbed by the market.

But for the very reasons that mixed-use developments make economic and market sense, the financing structures for these projects require developers to mix and match financing to ensure that optimum debt and equity sources can be tapped for each component. Not all financial sources invest in all product types — certain lenders may refuse to finance hotels, for example, and certain institutional equity partners may seek only residential, or credit-tenant leased office, asset classes for their portfolios. Credit tenants may want to finance their own take-outs through lease-based financing rather than building-wide mortgage financing to minimize their own costs of space. Different debt and equity sources have different return parameters and time horizons for their investments.

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Optimum Financing

In order to optimize the financing of a project — that is, to create the greatest combined return to equity over all project components, and the maximum leverage at the lowest overall interest cost — developers of mixed-use projects increasingly turn to separate debt and equity financing sources for both construction and permanent financing. To achieve a successful financial structure involving multiple sources requires structuring the ownership of the real estate and the underlying asset security in such a manner that the separate risks of each project component do not create undue risks affecting the other components.

While the combinations of multiple debt and equity sources that can be brought to a project are of enormous variety, two deal structures illustrate the types of project structuring issues which are common to almost all mixed-use mixed-finance projects.

In the first type of deal structure, separate project components are financed by a single construction financing debt source, but with separate means of take-out financing for each component. A variation may occur with separate equity sources for each component during the construction period.

In the second type of deal structure, separate construction financing sources (debt as well as equity) are utilized in the project construction, in addition to separate take-out financing.

Following are some of the structure considerations that must be brought to bear in each type of deal structure.

- **Structure of Borrower Entity**. With a single construction financing source across all project components (which may consist of senior plus mezzanine debt, not differentiated by project component), the lender will seek a single borrower entity which owns all project components to lend to and to develop the project. Where separate equity owners are identified and desirous of investing separate equity in the separate project components at the outset of the project, that single borrower

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entity may be a single limited liability company (or a tenancy in common, applicable in 1031 exchanges), the members of which are the separate equity investors in the separate project components. All members agree to pool their equity into a common ownership structure through project construction, with each investor redeeming its interest in the entity for a condominium interest in the real estate upon completion of construction. With multiple construction financing sources for the separate project components, there is no unitary borrower entity. Rather, each project component is owned by a separate entity which is a separate borrower, and all sources of construction financing — debt and equity — must be funneled through a common construction administrative mechanism to ensure coordinated funding of the entire building.

• **Underlying Real Estate Ownership: Condominiums and Easement Agreements**. With a single construction financing source across all components, there is need only for a single mortgageable estate to secure the construction loan (in addition to any applicable mezzanine security). Thus, while there is no need to create a condominium-type ownership structure during construction, condominium documents which define and describe the units, cost allocations and governance of the different components post-completion, should be prepared and agreed to by all equity owners at the outset of the project in order to ensure a smooth take-out of the separate components post-completion. With multiple construction financing sources for the separate project components, there is need to create separate mortgageable estates to secure each loan during the construction period. This typically takes the form of the so-called "common-law condominium" in New York, where air space is divided into separate ownership units and tax lots based on the construction plans for the building, with all lots joined by an easement declaration that contains provisions similar to a condominium declaration.

• **Managing Construction Risk**. Because the typical urban mixed-use project consists of a single building, it is of paramount concern to each participant — lender, equity investor and occupant — that the entire building be timely completed and that overall building construction not suffer delays or cost overruns that may negatively impact all project components on account of disputes applicable to individual project component. With separate construction loans funneled through a single administrator, this is of particular concern to a lender, since the loan security — consisting of an airspace tax lot — is of minimal value unless the balance of the building, in which the lender does not have security, is completed. Techniques for managing the risk consist of administering construction funding through a single pool, with a single construction representative and lender's inspector, to ensure common standards for advancing the loan; assurances of funding by each lender to the pool, which may include funding into the pool in a lump sum in the case of a bond issuance; pari passu funding into the project by each loan source, so that all loan sources are current in their advances and each has a proportional stake at risk in the project; and an agreement among lenders as to the common and coordinated exercise of remedies for construction default.

Allocating project costs to the different project components is a critical factor.

• **Allocations of Project Cost to Different Components**. Whether a project has a single construction loan with separate up-front equity or take-out sources, or has separate construction sources, the issue of allocating project costs to the different project components is a critical factor. Initially, equity contributions and take-out or release prices will be tied to an allocated cost of each component. Where funding streams that require application to particular costs are involved, as is typical with government funding, there is the need to trace costs throughout construction. Where one project component requires construction change orders, costs impacting the entire project must be allocated to the component in question, which may also include indirect costs of delay to the entire project, in addition to direct costs. Where separate equity or financing sources are used in the construction, funding for the change order must be provided by the affected unit owner timely during construction. In the case of a single construction lender with separate take-outs for each project component, where the take-out obligation may be reallocated based on increased costs of a component, it is critical that any disputes be settled promptly prior to completion so that timely take-out of all portions of the loan can occur. A typical requirement is to have the affected unit owner post an equity contribution in the amount of the change order in question prior to its execution, or, in the case of involuntary change orders, to provide for expedited arbitration.

• **Issues With Separate Take-Out Sources**. Where a project undertaken with a single construction loan has separate take-outs for the separate project components, the construction lender bears multiple credit and market risks. Consider a project with residential, hotel, retail, and credit-tenant leased office space. The take-outs are likely to come from multiple sources — the residential component may be taken out by condominium unit sales or a permanent institutional loan source, the hotel component by a specialized lender, typically with a large equity or mezzanine piece; the retail component by a REIT, and the office component by a sale-leaseback acquisition by the credit tenant. The construction lender is dependent on each of these sources, with their different credit risks and market factors, to accomplish full take-out of the loan.

To minimize risk, it is important at the outset of the project to secure as much uniformity as possible in conditions to the obligations of each take-out source. In particular, it is critical to ensure that construction completion conditions will be uniform across all take-outs. The separation of the condominium ownership units of each component must also be completed promptly at the time of take-out, so that separate project components can be conveyed to each take-out source. In the event of a failure of a take-out commitment of any project component, the construction lender will have a single-use marketable unit to foreclose and sell, which may provide an easier route to recouping the construction lender's investment than a foreclosure and sale of a multi-use project.