

Equity Investments in New Cooperatives

WHY COOPERATIVES SHOULD BE ATTRACTIVE TO
DEVELOPERS AND INVESTORS

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Equity Investments in New Cooperatives

Development Model under FHA 213

Real World Development Model

- Senior Cooperative being developed outside of Philadelphia
- Marketed to middle income seniors
- Cooperative provides ala carte services and meals to the residents
- Has common dining area and kitchen as well as many amenities
- Contains 90 units, including 78 one bedroom and 12 two bedroom units

Real World Development Model

- Carrying Charges are \$1,500 for one bedroom units and \$1,750 for two bedroom units
- Share prices average \$45,000 per unit
- Annual expenses are \$6,100 per unit
- Cooperative qualifies for a blanket mortgage of \$17,806,700 at 4.50% with a 40 year term
- HUD is requiring a 50% pre-sale requirement to close

Real World Development Model – Development Budget

Senior Cooperative Development Budget

<u>Total Improvements</u>	<u>Per Unit</u>	<u>Total</u>
Hard Costs	\$140,117	\$12,610,499
Bond Premium	\$889	\$80,000
Tap Fees/Other Fees	\$19,861	\$1,787,463
Architect's Design Fee	\$3,333	\$300,000
Architect's Supervisory Fee	\$1,111	\$100,000
Total	\$165,311	\$14,877,962
 <u>Charges and Financing during Construction</u>		
Construction Interest	\$5,843	\$525,849
Taxes	\$148	\$13,333
Insurance	\$148	\$13,333
Mortgage Insurance Premium	\$2,727	\$245,396
FHA Exam Fee	\$584	\$52,585
HUD Exam Fee	\$974	\$87,642
Financing Fee	\$3,895	\$350,566
Permanent Placement Fee	\$974	\$87,642
Developer's Fee	\$19,476	\$1,752,831
Marketing Costs	\$2,500	\$225,000
Title and Recording	\$444	\$40,000
Total	\$37,713	\$3,394,177
 <u>Legal, Organizational, and Audit Fee</u>		
Borrower's Legal	\$333	\$30,000
Organizational Estimate	\$833	\$75,000
Other Costs	\$111	\$10,000
Total	\$1,278	\$115,000
 Total Development Cost	 \$204,302	 \$18,387,139
Land Value	\$28,778	\$2,590,000
Total Replacement Cost	\$233,079	\$20,977,139

Real World Development Model – Sources and Uses

Senior Cooperative Development Sources and Uses of Cash

Sources of Cash

FHA 213 Insured Mortgage	\$17,806,700
Share Sales - 50% pre-sale requirement	\$2,025,000
Borrower Equity	\$1,857,671
Total Sources of Cash	\$21,689,371

Uses of Cash

Total Development Cost	\$18,387,139
Land Debt	\$2,590,000
Initial Operating Deficit Reserve	\$356,102
Working Capital Reserve	\$356,130
Total Uses of Cash	\$21,689,371

Equity Investments in New Cooperatives

The Need for and Timing of Cash Investment

The Need for and Timing of Cash Investment

Pre-Development Funds Needed:

- Due Diligence Costs
- Preliminary Architect Fees
- Preliminary Marketing Fees
- Organizational Fees
- Documentation Fees
- Estimate of pre development cost - **\$200,000 to \$300,000**

The Need for and Timing of Cash Investment

Pre-sales of Cooperative Shares:

- Sales of shares prior to loan closing
- HUD requires 50% pre-sale to close
- Average share prices is \$45,000
- Funds must be held secure in escrow until loan closing
- Total funds collected - \$2,025,000

The Need for and Timing of Cash Investment

Loan closing upon 50% pre-sale:

- Total cost of project development required at loan closing
- Costs is covered between pre-sold shares, blanket debt, and additional borrower equity
- Borrower may (will) have Investor pay in equity needs at closing
- Additional equity need at closing - \$1,857,671

Cash Payments available to Developer/Investor at Loan Closing

- All Pre-development costs paid through loan proceeds at closing – approximately \$300,000
- A portion of the developer's fee will be available at loan closing – estimate $\frac{1}{3}$ - \$580,000
- A portion of the marketing fees will be available from loan proceeds at loan closing – estimate $\frac{1}{2}$ - \$112,500
- Any difference between land value and debt on the land may also be available at loan closing

Equity Investments in New Cooperatives

Sources of Profit for
Developer and Investor Equity
Return

Sources of Profit for Developer and Investor Equity Return

Land Profit

- If a cooperative loan is not constrained by debt service, the developer may be able to recapture the difference between the land value and the purchase price of the land, taking the difference as profit/equity on the transaction

Sources of Profit for Developer and Investor Equity Return

Marketing Fees

- Given the unique nature of a cooperative as a form of home ownership, HUD allows the developer to include and charge marketing fees as a cost of development of the project. While there is a cost to selling shares, there is the ability to capture “profit” from marketing fees and can be seen as a source of income for the developer in the transaction

Sources of Profit for Developer and Investor Equity Return

Development Fees

- HUD allows Development Fees to be underwritten as part of loan proceeds for cooperative developments. This is a direct source of income/profit for developers and a potential source of investor equity return

Sources of Profit for Developer and Investor Equity Return

Share Sales

- Share Sales can be a direct source of income/profit in a cooperative transaction. Often, the relationship between share sales, development fee and equity required are equal and therefore there is no excess profit in share sales. However, share sales may exceed the equity required and generate additional developer profit.

Equity Investments in New Cooperatives

Attracting Equity Investors

Risk Profile in a Real Estate Transaction

- Debt/Lender – has lowest risk in transaction, rate or return structured as such, interest rates are much lower than anticipated rate of return for investor or developers. Debt holders are always first in line to be paid.
- Equity Investor – Typically second in line for repayment. May have a preferred repayment structure on a portion of the equity. Rates of return dependent on a variety of factors, may range from 10% to 20%.
- Developer – Typically last in line for repayment, typically has the highest rates of return and the most risk.

Equity Investors – Who are they?

- Individual Investors – Doctors, Dentists, and Lawyers...
- Family Offices
- Institutional Investors – Pension Funds, Endowments, Private Equity Firms
- Crowdfunding Platforms

Investor Requirements

Institutional Investors and Family Offices

- Typically require very experienced developers with excellent track records
- More risk averse
- Looking for longer term investments
- Since they are looking at lower risk investment, return requirements are at the lower end of the range
- Looking for large investments - \$10 million and over

Investor Requirements

Individual Investors

- More flexible in their risk profile
- More likely to take a chance on a developer with less experience if they feel good about the project
- May be looking for a quicker exit on the investment
- Looking for a return at the higher end of the range
- Will invest in smaller projects

Investor Requirements

Crowdfunding

- Tremendous flexibility
- Allows for everyone to invest in real estate projects, does not require high net worth
- Brings a lot of like minded potential investors to the table
- Open to new ways of doing things and creative ideas
- Will invest in all types of projects with varying returns

Investors for Cooperatives

Given the high debt leverage of cooperatives, typically the equity requirement at loan closing will be less than \$5MM, and in some cases less than \$1MM. For this reason and their other unique qualities, the best investors are individual investors and may include small mission oriented corporate investors. In addition, existing real estate crowdfunding platforms or a new cooperative specific crowdfunding platform may also be a good source.

Coop and Condo Investors

There are many similarities between potential cooperative investors and Condo and other for sale investors:

- Deals attract shorter term investors with investment time frames of 18 to 48 months.
- Investors looking for higher rates of returns
- Willing to look at investments less than \$5 million
- May be willing to look at Pursuit capital/pre-development costs as part of their investment
- Cooperatives should be attractive to Condo/For Sale Investors, at a lower risk due to pre-sale requirements

Equity Investments in New Cooperatives

Equity Investor and Investment Objectives

Options for Structuring Investment

The critical concept in structuring the investments is to achieve the appropriate risk-adjusted return for the investor:

- Initial equity needs are in the form of Pursuit Capital/Pre-development costs. These costs are typically between \$200,000 and \$300,000. In our real world scenario, they are \$250,000.
- These funds will require a higher return given the greater risk associated with the timing of expenditures. The project has not been approved yet and typically no pre-sales have occurred.

Options for Structuring Investment

- Most of these funds would be required subsequent to a concept meeting with HUD. Invitation to an application following a concept meeting should give investors a strong indication of HUD's desire to move forward on the project.
- Land may be available as security for the investment of until loan closing.
- Returns on Pursuit Capital should be anticipated to be 20% given the greater risk

Options for Structuring Investment (Continued)

- Often equity requirements at loan closing can be covered by deferring developer fees. However, if share sales profit is not “baked in” to developer fees or the pre-sale requirement is not as significant (70% to 90%), some additional equity pay in maybe required.
- Equity required at loan closing is less risky due to the fact that a great percentage of the shares have been pre-sold and debt capital is also injected at that point.
- Equity repayment typically will come from the sale of remaining shares
- Investor’s typically get a portion of the profit on the sale of each unit/share in a for sale project. That is where there return on investment is determined for the investor.

Options for Structuring Investment (Continued)

- If the investor provides 50% of the equity, their share of the profit from the sale may be 50% of the profit. The investment and return come directly from the unit sale.
- Since profit is typically built into the transaction via the developer's fee (developer's fee is directly correlated to share sales typically), a return on a portion of the developer's fee attributable to "sales profit" needs to be negotiated with the investor. The investor should see a return of up to 12% to 15%.

Conditions for Equity Pay-In

Pursuit Capital

- \$20,000 to \$25,000 of pursuit capital/pre-development funding may be required prior to the Concept Meeting at HUD. This would be used to cover market/feasibility studies and some upfront legal fees associated with creating the borrowing entity
- HUD will review project feasibility and adherence to HUD requirements during the Concept Meeting. If it is felt the project is feasible and fall within the parameters of HUD requirements, HUD will invite an application for Mortgage Insurance. This should give some level of comfort.
- Once application is invited, remaining Pursuit Capital will be required to complete architectural work and preliminary marketing. Timing for Pursuit Capital investment will be 12 to 18 months.

Conditions for Equity Pay-In

Remaining Capital

- Any additional equity requirements will be paid in at loan closing.
- Prior to loan closing, HUD will require a certain level of pre-sales to residents. This requirement will be between 50% and 90%, depending on the strength of the market and other determining factors.
- Pre-sales and a full underwriting of the transaction should give investors a strong sense of comfort with the additional investment prior to funding the investment in full.

Operational Control/Rights and Responsibilities

- Investor oversight of the developer and management of the deal can vary widely depending on the level of sophistication, experience, and nature of the Investor and developer
- Typically, given and experienced developer, the investor will permit the developer to have control over the basic development aspects of a project, including land assemblage, permitting, design, contracting and marketing.
- When an equity investor is involved at the very inception of a project such as providing Pursuit Capital or being involved in land acquisition, the investor may demand consent rights over all of the basic planning and design of a project.
- Investors will generally agree that consent will not be unreasonably withheld.
- Certain actions specified as “major decisions in the agreement may always require written consent of the investor.

Exit Strategy

Pursuit Capital

- Pursuit Capital will be repaid at loan closing directly from loan proceeds.
- Items funded at closing of the loan available for repayment of Pursuit Capital will include, due diligence costs, architectural costs, some legal costs, and a portion of the marketing costs.
- Typically a portion of the developers fee will be available at loan closing. Funds from the developer's fee can be used to pay anticipated returns on Pursuit Capital.
- Timing of investment of pursuit capital is anticipated at 12 to 18 months.
- Amount of investment is between \$250,000 and \$300,000. Return on this investment \$50,000 to \$90,000 depending on timing.

Exit Strategy

Other Equity at loan closing

- Other equity needs will be funded at loan closing if necessary.
- This money effectively bridges the remaining share sales at the property.
- Equity will be repaid from Share Sales directly as additional shares are sold in the property.
- A pre-negotiated return between 12% and 15%, will be paid as funds become available based on budgeted developers fee and marketing fees.
- Timing for this portion of the investment is 12 to 18 months, timing of project start to finish is 24 to 36 months.