Equity Investments in New Cooperatives

WHY COOPERATIVES SHOULD BE ATTRACTIVE TO DEVELOPERS AND INVESTORS

Table of Contents

Table of Contents (continued)

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

Total Improvements		**Per Unit**	**Total**
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
Charges and Financing during Construction			
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
Legal, Organizational, and Audit Fee			
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

<u>Sources of Cash</u>

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

<u>Uses of Cash</u>

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

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 - **$300,000 to $400,000**

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 $250,000
- A portion of the developer's fee will be available at loan closing – estimate 1/3 - $580,000
- A portion of the marketing fees will be available from loan proceeds at loan closing – estimate ½ - $112,500
- Any difference between land value and debt on the land may also be available at loan closing

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.

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 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

Structuring Investment in Cooperatives (continued)

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

- Equity required at loan closing, although typically greater than the pursuit capital, 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 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. It is not pre-determined but based on what sales price can be achieved in the market place. Investor's like to see returns between 15% and 20%.

Structuring Investment in Cooperatives (continued)

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

- 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 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 50% of the “sales profit”.

Developed by Hugh Jeffers

hjeffers@centennialmortgage.com
202-415-1862

As senior director, Hugh Jeffers is responsible for originating new business around the country. He is located in Pittsburgh, PA. Prior to joining Centennial Mortgage, Mr. Jeffers was senior director with Love Funding. Prior to Love funding, Mr. Jeffers was with Bellwether Enterprise responsible for originating FHA, Fannie Mae and Freddie Mac multifamily and healthcare loans. Before his time at Bellwether Enterprise, Mr. Jeffers was director of FHA financing at Oppenheimer Multifamily Housing and Healthcare Finance, where he was responsible for FHA originations. Mr. Jeffers also spent time at Arbor Commercial Mortgage in New York as the screening director for FHA originations for the entire company. Prior to that, he was manager of the affordable housing group and the FHA multifamily lending operation of NCB Development Corporation in Washington, DC. He has almost 20 years of multifamily and healthcare origination and underwriting experience. He has developed a particular expertise in affordable and senior housing. He is a board member of the National Association of Housing Cooperatives and chairs the Development and Preservation Committee. Mr. Jeffers holds a bachelor's degree from Lafayette College in Easton, PA, where he was a double major in Economics and Art. He holds a master's degree from New York University, Stern School of Business.