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TIC Plan Capitalization Strategies & Transaction Structures for Affordable Housing Development

How commercial real estate syndication financing can work for your affordable housing development ambitions and sidestep construction mortgage financing altogether.

Abstract.

This white paper provides an overview of the use of a hybridized Tenants-In-Common commercial real estate syndication sales plan in combination with a retail distribution channel to provide pre-construction phase capital financing for affordable housing development programs, reducing capital costs and extending benefits to more citizens. The white paper uses a realistic scenario to demonstrate these benefits and transaction structures you can adopt to increase housing opportunities for all major property group classes within the affordable housing spectrum.

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Key Point Summary of White Paper Findings & Conclusions

The white paper was prepared by Clint Lovell of Rainmaker Marketing Corporation, Inc., for the purposes of demonstrating the opportunities for extending the capital financing bubble beyond the classic “debt and equity financing” regimen by virtue of introducing pro-rata tenants-in-common deeded ownership syndicated sales financing into the capital financing structure of the project. The case for this approach is based upon the following key benefits for affordable housing programs:

- **Distribution Channel Access.** All capital financing is dependent upon its availability and that availability is based upon having a defined distribution channel that allows for the maximum number of potential investors to be exposed to the opportunity in the smallest timeframe to ensure the highest potential outcome of success (i.e.: a completed subscription sales process in the least amount of time and cost). The sale of commercial real estate is an established channel in our country and this white paper demonstrates how the same distribution channel processes that are used to sell other big-ticket retail items can be turned to this benefit, making it more efficient than security sales transactions.
- **Timing.** Debt financing usually requires the commencement of construction in order to commence funding. Equity financing requires an extended sales period and usually requires a complete pre-construction due diligence presentation and underwriting of the debt capital, placing the sponsor in the classic “cart before the horse” paradigm the finance industry uses to its exclusive advantage. The commercial real estate syndication neatly bypasses these issues and the retail distribution channel means the timing for the sales cycle is incredibly short.
- **Flexibility.** Commercial real estate financing works because it doesn’t require an equity interest be granted; and, in the case of the public housing agency, the real estate financing allows the public housing agency to structure a private-sector opportunity that is achievable based upon a realistic appraisal of today’s public housing agency’s financial resources. This financing tool makes these resources go considerably further – serving more members of the public and that’s the name of the game for all units of government.
- **Cost.** The cost of obtaining the capital is very competitive with those costs the developer/sponsor and public housing agency face with other processes, with rebated costs being a real bonus that cannot otherwise be contrived for the developer/sponsor’s benefit.
- **Regulatory Envelope.** The sale of commercial real estate is not enjoined from a public sale as would be the case with securities. This means the regulatory envelope is more favorable, less costly and less fraught with opportunities for failures and inter-agency disputes that only add to the cost of the development of housing. There’s no reinventing the wheel here – existing law serves the cause.
- **Total Capital.** Commercial real estate syndication sales financing can account for approximately one-third of the total capital financing for a given project, making commercial real estate syndication sales financing far too materially-significant to ignore. In the case of the public housing agency capital development budget increased by a third and this increase adjusts for inflation into perpetuity. This means the quality of the construction can be dramatically increased, thus lowering long-term deferred maintenance risk exposure for properties by using advanced construction

systems that are very resistant to tenant damage, but are typically not considered simply due to the impact of economics.

In terms of impacts this method will likely manifest for the benefit of public sector public housing agencies and private-sector entrepreneurs who participate in the affordable housing development, finance and operations continuums, the following issues have to be given consideration:

- **Enhanced Public Sector Revenues.** The additional economic activity generated by the sales will have a likely indirect impact and magnification of public revenues from taxes on construction-related activities, increased property tax valuations on private-sector affordable housing properties, increased employment opportunities and overall growth of the local area market economy. This additional capital access is a direct stimulus to economic output and an indirect stimulus for employment and those issues cannot be ignored when the entire continuum of issues and challenges facing government efforts to eradicate poverty have to be considered. This is an activity that can be added without regulatory or legislative relief as it already exists within civil code, you have to just use it in a way that works for your goals.
- **Budget Efficiencies.** The addition of capital financing enhancements translates into lowered maintenance costs, thus having the potential to add significantly to the affordability mission by making inventory replacement more efficient, thus lowering overall operating budgets and capital budgets – the budgetary impacts cannot be understated once a cost/benefit analysis of the housing life cycle is given full consideration at all levels of operations.
- **Housing Dispersal.** One of the goals of today's developer/sponsor (and public housing agency) is to provide a wider dispersal of housing and decentralize the production of affordable housing away from inner-city areas (especially those in blighted areas). This increase in capital financing provides the opportunity to acquire more desirable locations that would have not otherwise been possible. The impact on the overall economy (by virtue of blighted area eradication efforts) can only be a plus, leading back to the enhancement of revenues issue and increased economic opportunities that attend thereby for the benefit of the local area market.
- **Private-Sector Capital Access.** This is one of the most far-reaching impacts of all and the true depth of its impact is all but easy to ignore. This transaction structure provides the opportunity to continually reintroduce affordable housing to the market and create new opportunities for developers to enter the market and use more solutions for addressing the economic needs of our society because now there is a defined path to obtaining capital investment that is efficient and controllable. It would be impossible to overstate the value of this benefit to society by increasing private-sector participation in the process.

These appear to be the realities that come into play and help set the stage to fundamentally change the nature and scope of how housing is financed, produced and operated in the 21st century as a result of using what has already been provided for the benefit of the affordable housing sector.

About Rainmaker Marketing Corporation

Rainmaker Marketing Corporation, Inc. (“Rainmaker”) produced this white paper as a public service and as an educational item designed to also highlight the structured finance expertise of Rainmaker. Rainmaker is a commercial real estate development finance, due diligence and development management consulting firm established in Houston, Texas in 1993, though the company can trace its roots back to 1989. Rainmaker specializes in housing industry transactions, but services all major commercial income-producing property classes having completed assignments throughout North America and the Caribbean Basin totaling billions of dollars in new construction and development programs. Rainmaker provides structured finance reviews, project feasibility studies (market, finance, real estate, etc.), capital finance consulting, development management consulting and owner representation services. For more information, please visit us online at www.rainmakermarketing.com or via telephone at 281.537.1200.

Purpose of the White Paper

This memorandum (the “White Paper” or “Memorandum”) has been issued for the express purpose of demonstrating the efficacy of incorporating fractional commercial real estate ownership syndications into the capital financing structure of new construction commercial income-producing properties, with a focus on their use in affordable multifamily housing transactions. The Memorandum provides specific instruction on how to assemble a transaction, how transactions can be structured to achieve the goals of public housing agencies regarding the production of affordable housing, how these transactions can be administered, how the transactions are marketed and an analysis of the resulting impacts. Finally, a key milestone schedule is provided that focuses on costs and timing of cash flows to demonstrate the benefits of this model of capital financing.

The transaction assembly discussion focuses on the production of the necessary due diligence documentation to support the transaction and the reasoning as to why these documents are required in order to sustain the capital financing cycle.

The transaction structure discussion focuses on how the economic benefits are structured to achieve the results necessary for a successful retail sales distribution channel to be realized for each sales cycle. The discussion includes alternatives and an example of how these structures may impact the capital finance structure for a new construction affordable housing project.

The transaction administration discussion focuses on the administration of the syndication sales process, the tasking and the reporting requirements necessary to ensure an optimal chance of success.

The transaction marketing discussion focuses on how the retail distribution channel is created using the same tactics and advertising mediums that have been in place for other high-ticket retail sales programs for decades.

The analysis discussion focuses on the likely impacts the benefits of this course of action may commend to a public housing agency and units of government on a variety of levels.

Before the discussion on the transaction process begins, the first goal is to understand the nature of the challenges we face in capitalizing housing development. Once this understanding is accomplished, we can then update our understanding of the fractional commercial real estate sales syndication plan and its various components before moving into the heart of the discussion.

Understanding the Challenge of Capital Financing for Affordable Housing

Essentially, there are three (3) stages to the capital financing structure of a commercial income-producing property, of which the affordable housing industry is a class participant:

- The Stabilized Operating Phase.
- The Construction/Interim Phase.
- The Pre-Construction Phase.

The Stabilizing Operating Phase is the easiest to capitalize, as the project is already completely built out and operating at its highest sustainable capacity, therefore; it presents the smallest level of risk to the market and can command the highest levels of financial investment leverage for the benefit of its sponsors. The majority of projects that make it to the Construction/Interim Phase succeed in achieving the milestones required to qualify for Stabilized Operating Phase capital financing.

The Construction/Interim Phase is the middle phase and represents a higher level of risk, but there exist commercial benchmarks that can be used to prove-up the particulars (underwrite) and guide investment decisions based upon a sober appreciation of the odds of achieving success in the build-out process, budget management processes and the initial operational start-up. The key issues here are the additional management operations and coordination that must be orchestrated to sustain the required outcome that exceed those of simply managing the ongoing operations of the resulting business. The majority of projects in the Pre-Construction Phase never make it to the Construction/Interim Phase due to a lack of capital access that chokes these fundamental wealth creation activities.

The Pre-Construction Phase capitalization conundrum presents the highest level of investment risk and is typically avoided by institutional and commercial investors who prefer to wait until the gap financing opportunity presents itself, thus leaving the entirety of the economic opportunity largely available due to a lack of alternatives available. The Pre-Construction Phase presents all of the challenges of the Construction/Interim Phase, plus the additional burden of proving the market risk exposure is an acceptable level given the current local market conditions. This requires extensive investigations on a number of levels to sustain and only the well-heeled entrepreneurs can consistently undertake these endeavors due to the restrictions on the timing, amounts and terms owing to capital investment.

The key to understanding the challenges facing commercial real estate development financing, is to understand the importance of the distribution channel to the process. Most developers think in terms of the debt security/construction mortgage lending distribution channel conduit and the equity financing/investment banking distribution conduit. The actual results of operations demonstrate that this exercise is largely self-defeating for the developer (who is not well-heeled) due to the following considerations:

1. The purpose of the equity financing is to provide the cash to cover the financing gap not sustained by the construction mortgage loan. The construction mortgage underwriting process requires the developer to provide evidence of sufficient cash financing proceeds available to cover the gap as a pre-condition to serious underwriting consideration. The equity finance underwriting process requires the developer to provide evidence of availability of the construction mortgage loan financing to cover the gap not provided for by the equity financing. These processes and practices create problems the developer cannot solve unless the developer has a large measure of capital in hand, thus reducing the development and wealth creation opportunities the local market would otherwise benefit from sustaining. In the end, everyone loses as a result of the restrictions placed on the development financing process by the lender/gatekeeper and the investment banker/gatekeeper. The developer needs a solution that can untie this Gordian knot that binds capital investment.
2. Typically, third-party financing is only made available during the construction phase of the project, thus requiring the developer to sustain the project through the entire process. This reduces the capital pool and there exists a practice of redlining development expenses, thus increasing the reliance upon third-party financing to close the transaction gaps and this all comes at the expense of the developer's equity interest. Developer/sponsors are placed in the position of having to accept the capital market equivalent of Hobson's choice – take the money and a total pounding that equates to working for wages and not for an entrepreneurial gain.
3. The equity financing results in dilutions of the equity interest and this makes the project a bankruptcy risk as the economic opportunity can be reduced to a state where the developer has no interest in continuing to sustain the enterprise under the current capital financing structure.
4. The distribution channel doesn't really exist for the benefit of the developer/sponsor; it exists for the benefit of the commercial banking industry (for lending), the investment banking industry (for equity syndications) and the real estate brokerage community (for real estate sales) as all of these "gatekeepers" have conflicts-of-interests and/or are allowed to commit moral hazards for which the developer/sponsor is made to be responsible. This makes the risk associated with these approaches inappropriately high and that makes the financing inefficient as there is no real competition where corruption exists.

The solution is to create a separate distribution channel that would force the finance industry to compete and make the financing more efficient on all levels. Fractional commercial real estate syndications offer this opportunity and it needs to be more clearly understood.

Overview of Fractional Commercial Real Estate Sales Syndications

Fractional ownership of real property has existed for centuries, with the condominium ownership structure being (by far) the most common fractional ownership structure for real property interests. In terms of commercial income-producing properties, the tenants-in-common (TIC) plan ownership structure is now the evolving darling of the industry with sales expected to exceed \$10 billion on a continuing basis. This is a well-established ownership structure that is common to most countries that have real property laws based upon the English civil code as a precedent of property ownership. The

key to understanding its impact comes in using it as a capital finance tool for development. Traditionally, developers and sponsors of commercial real estate development think of their capital financing needs in terms of the construction mortgage financing, the at-risk equity contributions that fill most of the financing gap, and in some cases, the use of real property sales as the construction process rolls out (as in resort ownership, timeshare ownership and residential housing sales), totally ignoring the use of fractionalized real estate sales structures for the benefit of the capital financing requirements owing to the critical pre-construction phase of the project's genesis; the area where the greatest risks are perceived (wrongly) to exist. The practice has been to saddle the developer with all of the at-risk capital finance contribution requirements at this stage and this entry-barrier dramatically reduces the potential for wealth creation in the local economy (the biggest sin of all) and strangles employment gains that would otherwise be created.

Now a structure has been developed that threatens to turn these issues on their head and create a whole new level of opportunity at all levels of commercial income-producing property development – including the development of affordable housing. The key to understanding this approach is to understand the limitation of the other approaches to fractional ownership that contend with the TIC plan for primacy. In most states, the condominium ownership fractional ownership plan approach is constrained by consumer protection laws. These laws force the developer/sponsor to escrow the sales proceeds from condominium sales contracts until construction is complete, thus eliminating, by and large, the availability of these funds for use by the developer/sponsor during the critical pre-construction phase. Condominium plan based fractional sales aren't a tool that creates the outcome we seek to sustain.

The TIC plan approach is not constrained in most states, so the TIC plan offers some opportunities that are very attractive:

- The use of proceeds is governed by contract. This means it can be accessed while the project is still in the pre-construction phase *and that means it can augment and/or replace the developer's capital investment* (i.e.: the housing agency or developer/sponsor can use this to continually "rollover" its "seed capital" investment and increase financial investment leverage dramatically without necessarily increasing risk or sacrificing project control).
- The structure of the economics – the business deal – can be quite creative and that means it can be adapted to the needs of the affordable housing industry that require longer performance windows in order to achieve economic milestones (i.e.: TIC plan structures can give the "breathing room" the transaction needs to create long-term gains based upon increases in income production).
- The TIC plan provides the opportunity for the developer/sponsor (or housing agency) to create its own distribution channel conduit that can be used to control costs and increase efficiencies in a way that cannot otherwise be contrived for the benefit of the industry in the current organization of capital markets. This ends the monopoly held by investment banking and mortgage banking firms to the detriment of affordable housing industry.

The key to making this a reality is to understand the benefits of this new financing when put in motion.

The 21st Century Affordable Housing Capital Financing

The main benefit of the fractional real estate syndication sales plan (i.e.: the TIC plan approach) to the project's capital financing is to provide up to a third of the total capitalization required to sustain the development and inject it while the project is still in its pre-construction phase to augment and/or replace the developer/sponsor's capital. This percentage of capital makes it materially-significant to a degree that ignoring it constitutes negligence. In terms of the affordable housing industry, this amount of capital financing means the affordable housing developer can use a combination of tax credits and a TIC plan to finance their development ambitions – *side-stepping construction mortgage financing altogether*. Understanding the role that fractional real estate sales can play in the project's development needs to be understood in terms of its execution, including:

- Creating the supporting due diligence documentation trail; and
- Structuring the fractional sales business deal documentation; and
- Creating the necessary initiatives to manage the actual sales process; and
- Creating and implementing the advertising and marketing programs to complete the retail sales process and close the sales.

ASSEMBLING A TRANSACTION – DUE DILIGENCE DOCUMENTATION

The intended distribution channel for the sales of these fractionalized real estate deeded interests is the retail channel. This means the investing-public will be largely dependent upon the documentation provided by the seller and the opinions of any third-party advisors the investing-public may choose to consult. Accordingly, the due diligence burden becomes, more or less, the same as it would be for underwriting a commercial construction mortgage loan or a public offering of securities. While this isn't a security and security laws do not apply to the sale of real property, there has to be a reasonable standard of evidence provided to substantiate the material representations regarding the economic prospects of the transaction and serve as a basis for the ultimate structure of the sales transaction itself.

Rainmaker's experience in commercial real estate finance has shown that anything less than complete disclosure and transparency is a recipe for problems and potential liabilities that no party to the transaction can reasonably afford, so the due diligence presentation would have to include the following major areas¹ (and are also typically seen in the affordable housing industry underwriting process):

1. Feasibility. A complete market feasibility study and pro forma financial presentation (or financial feasibility study) is necessary as the basis for the structure of the transaction.
2. Real Property. All the basic exhibits pertaining to the real property interest must be provided including site control (deed or purchase agreement), title insurance, utility access, property tax disclosures, entitlements and flood zone certification.
3. Architecture. The standard is at least Schematic Phase Architectural Design Documents and Schematic Phase Outline Construction Specifications, as there has to be sufficient documentation of

¹ A due diligence documentation checklist for the typical commercial income-producing property fractional ownership sales program is available at www.rainmakermarketing.com.

the design to induce the construction contractor to issue/offer a gross maximum price construction contract as evidence of the sponsor's ability to control the construction costs portion of the development budget.

4. Engineering. The standard is an approved site plan, development plat, structural engineering review, MEP documentation, soils hydrology, environmental and any specialty engineering necessary to support the goal of having the construction contractor issue the construction contract.
5. Construction. The standard is a design/build contract as this transfers second dollar change order cost risk exposure away from the project and to those parties that actually have control of it (contractor and architect). In any event, there has to be guaranteed construction cost serving as the primary evidence the retail distribution channel participants can rely upon regarding construction risk exposure.
6. Operations. The standard is a complete business plan of operations that details operations of the project at all levels as evidence supporting the material representations that the completed property will be managed in a professional and competent manner.
7. Sponsor. The standard is to provide all the legal/organizational document disclosures, resume of sponsor team manners and corporate financial disclosures.
8. Project Team. The standard is that all key team members provide a background disclosure that demonstrates their competence, experience on similar undertakings and related information (bonding and financial disclosures for contractors, professional licenses, insurance, etc.).

The key is that all these documents must be provided in a homogenous electronic file format that can be made available as part of an online set of presentation materials the public can access in their own capacity of discovery regarding the prospects of the project and the economics plan backing the fractional ownership sales syndicate. The totality of the due diligence documentation serves as the basis for the completion of the next step in the process – structuring the transaction.

STRUCTURING A TRANSACTION – THE ART OF THE DEAL DEMYSTIFIED

As was the case with the due diligence burden, the transaction structure of a fractional real estate sales plan that seeks to use the retail distribution channel has to exceed the expectations of the retail market psychology. In other words, the structure of the sales plan has to play to the emotional needs of the investing-public or the transaction is placed at-risk for failure. The goal of the retail distribution channel is to provide quick access to capital that is not largely dependent upon the actions of third-party “gatekeepers” by focusing on having the public supplant the underwriter's role *as the public would determine that role and those duties to be for these purposes*. This means the transaction structure has to sustain the following market psychological requirements to succeed:

1. Greed. The yield must be relatively attractive enough to ensure an adequate market response. This is a function of the perceived risks of the transaction and current public capital market opportunities the investing-public would otherwise be able to access. The goal is a premium that is large enough to astonish and also serve as a “call to action”. If there is a nice yield, people will pay attention, but not necessarily be inclined into taking the immediate action necessary to sell-out the plan. The

practical application here is that the yield opportunity has to border on the incredible so that people feel they must immediately subscribe or lose out on the opportunity (high teens to mid-twenties).

2. Fear. The transaction has to offer the means of assuaging the investing-public's craving for safety and security of their investment. The TIC plan approach can address this issue in the strongest possible terms as the security provided to the TIC plan participant is better than that position provided to a mortgage lender as the mortgage lender must go through foreclosure in order to enforce the lender's rights and the holder of the TIC plan interest does not (they already own the real property interests).
3. Impetus for Action. The TIC plan isn't a used car and can't be advertised as "buy today at this low price as we will be selling it for more come the dawn of the morrow". These sort of shenanigans that have frequented the marketing and sales of other high-ticket retail items destroy credibility and credibility is a key psychological point in the process of selling out the issue. This relates back to the greed issue and the resolution is always recommended to be the yield component.

These are the realities that must be dealt with and in terms of the economic structural limitations they help create for commercial real estate development finance that include:

4. Financing Limitations. Generally, the total share of proceeds in the transaction contributed by the real property sale will not exceed one-third of the deal's capital structure, but not exceed the enterprise value upon stabilization.
5. Security. This can't be secured with a mortgage lien as the mortgage lender will require first lien position and most lenders will not accept a second lien position lender. This means the deal has to be structured, more or less, like a commercial "build to suit" deal where the developer owns the real property and the lender has a first-lien position on the improvements (buildings and chattel) as security. Some lenders may reject this position, but the lower overall loan-to-value (LTV) ration of the construction mortgage loan will attract more potential prospects than would likely to be rejecting the loan. Having said, the goal here is to replace the lender and sidestep this entire issue.
6. Holding Period. Generally, the holding period is flexible, but shouldn't exceed a seven (7) year holding period horizon. The most common structures are:
 - 6.1. Long Syndicate – a syndicate having a projected holding period of seven (7) years; and/or
 - 6.2. Short Syndicate – a syndicate having a projected holding period of three (3) years.

The result of an appreciation of these factors leads to the following typical transaction structure (as it may apply to affordable multifamily housing):

7. Holding Period: 7 years (not enough gain is created to use a short syndicate in affordable housing deals in usual and typical circumstances).
8. Yield: a planning range of 150% to 175% gross – 20% to 25% average annual cash-on-cash return for holding period should be considered optimal.
9. Ownership: TIC plan pro-rata 99% ownership of the real property only – 1% by developer/sponsor.
10. Security: fee-simple deed that includes a ground rent contract to the development that is coterminous with the holding period and without an option for renewal – only a redemption feature (equal to the gross yield) so that the sponsor (housing agency) must refinance and pay-off the

syndicate participants or the syndicate retakes the property and the sponsor's ownership of the buildings, improvements and business are terminated (thus providing strong insurance of performance). This works essentially similar to the classic sale/lease-back structure used by REITs.

Now that a basic structure exists, the next step is to take those actions that allow the sponsor to manage (self-administer) the resulting transaction to create the odds for sustaining the highest likelihood of success, maintain control and inculcate cost-efficiencies throughout the transaction stream.

SELF-ADMINISTERING TRANSACTIONS – THE TRUE PATHWAY TO SUCCESS

Self-administration sounds really complicated and intense, but all that needs to be remembered is the fact this is the sale of real property interests (and there is a well-established management system for this process) that uses a retail distribution channel (the advertising, marketing and sales functions also owing to a well-established set of management protocols). The key management tasks to be managed are:

1. Create a web portal for the documentation. Either create a whole new website or new web space and place all files on the server. A bulletin board system must be created for each due diligence division to provide answers for questions from the investing-public. A user system must be created to track usage and a user agreement must be created to protect all intellectual property.
2. Assign a title company to the transaction. Each contract accepted will be closed through a title company. One title company will be used and have the master documentation set necessary to close escrow on each transaction and issue the necessary title insurance documents, deed and supporting agreements.
3. Create the final transaction documentation file that includes all of the contracts owing to the sale, the ground rent program, the redemption requirement, the security agreement and the power of attorney requirements to manage the program.
4. Create the advertising and marketing materials program (see below) that are necessary to generate sales interest in the transaction like any other real estate sales and marketing program.
5. Create a call-center program to field questions from the public and provide direction on how to obtain information, due diligence documentation and complete the contract offer processes.

Once all of these measures are in place, you are ready to create the advertising and run the syndication.

THE TRANSACTION DISTRIBUTION CHANNEL – MARKETING & ADVERTISING COMPONENTS

The distribution channel is the heart of the matter. In business, the best distribution channel is always the one that you have created and owned because third-parties cannot take economic advantages due to your lack of alternatives. The same has proven true in capital financing. The issue of having "gatekeepers" – so-called "licensed" professionals who create so-called "orderly markets" for loans, equity investment and the sale of real property interests – has devolved into a morass of moral hazards that only serves to promote the worst kinds of economic discrimination and concentrations in wealth aggregation in our population that make capital financing a treacherous, complicated and expensive process that just doesn't have to exist. If only we had alternatives, then true competition would fix this.

For the developer/sponsor of affordable housing, the room for error is incredibly slim, so every opportunity to introduce more cost-efficiencies into the process is necessary to survival and the continuation of the service owed to constituents.

The marketing and distribution channel development is actually quite simple and its patented ability to deliver marketing and sales for all sectors of our economy makes it the natural selection. Having said, a firm understanding of the alternatives needs to be considered so that a clear understanding is provided as to which advertising mediums should be considered. This would necessitate consideration be given for the following:

- Direct Mail. Prior to the advent of the Internet, the use of direct mail was a proven winner. Today, multiple piece mail-outs mean the cost per piece must be strictly controlled. The nature of the advertisement's credibility requirements would dictate the direct mailer suffers under a dichotomy – we need multiple mail dumps to get the response rate, but we can't afford to spend an inordinate amount of money to do any single mailer. Mailers are not a clear candidate that would offer a high likelihood of creating a distribution channel on the basis of cost.
- Signboard. Signs may work for the purposes of the advertising program, but would have only a local impact as a national or regional program could easily cost millions and take weeks to prepare and a number of weeks to execute. Outdoor advertising is a local medium and not really suited to the nature of the requirements of a distribution channel.
- Television Advertising. Cable television offers the opportunity to create a targeted advertisement program on a regional or national basis and can easily generate the numbers, but television is designed as maintenance advertising and not for "one-off" programs such as a syndication due to the costs of producing the television advertisement itself. Television won't get us there.
- Radio Advertising. Radio advertising is an ideal medium that targets large numbers of people with a message that can be cheaply produced and run on a concentrated basis. Talk radio is the ideal conduit as these programs have large numbers of listeners who have significant monetary assets and are interested in investment opportunities. Radio advertisement on a regional or national basis through one of the syndicated talk radio formats should be part of the core advertising program every developer/sponsor is seeking to perfect.
- Print Advertisements. Regional/national newspaper advertisements offer the opportunity to focus on the segment of the population most concerned with investing. This reduces the realistic pool of providers to *The Wall Street Journal*, *Investor's Business Daily* and perhaps *USA Today* as those having the necessary circulation to support the program because circulation is the key. Display advertisements blitzed on a daily basis for a single-week run should be the primary focus of the affordable housing syndication marketing program. ***This approach turns the retail channel from a possibility into a probability because of the sheer weight of numbers.*** By way of example, a project in Texas could be advertised in the Southwest Edition of *The Wall Street Journal*. This would reach approximately 700,000 subscribers (plus over-the-counter sales). Retail distribution channel response rates for big-ticket items advertised in print media have an expected initial range of 0.50% to 2.00%. If we assume the response rate (due to novelty) is half that of the minimum expected 0.50% rate, we would expect to see more than 1,700 contracts produced from a week-long blitz.

The typical syndication will be for less than \$15 million and this means less than 75 contracts would be realistically required to sustain any syndication sales program, providing a large margin of error in the calculations (thus creating a reciprocal high likelihood of success for the retail distribution channel approach that cannot be matched by the other channels – investment banking, commercial banking or commercial real estate brokerage services providers) that occur in a very short time.

In essence, the combination of syndicated talk radio advertisements and regional/national newspaper display advertisements are the key to creating a retail distribution channel that suits the timing requirement and satisfies the developer/sponsor's need to have a defined path for obtaining capital that can be budgeted in terms of times and investment (seed) capital with an expectation of success as the routine outcome.

The Impact Analysis of Benefits

The result of this approach to capital financing for affordable housing demonstrates the following benefits:

- **Local Market Economy.** This method attracts private-sector capital to the market area economy, providing a boost to business investment with concurrent increases in wealth, employment and the tax base. As far as units of government are concerned, this approach only creates good outcomes for the market.
- **Housing Quality.** The increase in capital resources means that higher-quality housing construction sub-systems can be employed. This means the costs of deferred maintenance can be reduced and this means the benefits for capital budgets only increase with time as the life-cycle costs come down. The public perception of creating future slums now has a resolution that is not dependent upon the backs of taxpayers.
- **Housing Quantity.** The increase in capital funding resources means more housing can be built. The decrease in maintenance costs means more housing can be built. The decrease in utility operating costs means more housing can be built. More affordable and safe housing is a good outcome.
- **Increased Capital Budget Elasticity.** The capital budgeting process can now change for the developer and the PHA with their budgets now focused on “seed stage” capital investment with third-parties providing the brunt of the capital financing necessary to sustain housing production. The benefits of this approach are practically incalculable to both developer and PHA.
- **Cost-Efficiencies & Competition.** This approach creates new levels of cost-efficiencies and competition for capital financing of a nature that will force the commercial banking and investment banking industries to compete on an entirely new level with the developer/sponsor and the PHA being the obvious primary beneficiaries, but the cost-efficiencies realized mean more low-income/mod-income households can be served and that's the biggest impact of all.

A Sample Transaction Structure

Happy Faces Apartments (the “Project”) is located in Dallas, Texas and is being developed by a for-profit developer who will turn over the completed housing property to the housing agency upon completion of development. The Project consists of 144 apartments that are expected to cost approximately \$130,400

per unit to develop – hard, soft, finance and carrying costs (total interim period expense to build and stabilize the project). The developer/sponsor must make a profit on the transaction and be induced to produce the opportunity on a contractual basis with the housing agency as the merchant building client.

Exhibit 1: Operating Statement

Basic Income Statement - 144 Unit Property		
		% of Total Revenue
<i>Gross Rental Income</i>	\$ 1,124,928	105.42%
<i>Ancillary Income</i>	22,499	2.11%
<i>Collection/Vacancy Loss</i>	(80,320)	-7.53%
Total Revenue	\$ 1,067,107	100.00%
<i>G&A</i>	\$ 48,117	4.51%
<i>Management</i>	56,246	5.27%
<i>Payroll</i>	151,865	14.23%
<i>Repairs & Maintenance</i>	82,080	7.69%
<i>Utilities</i>	50,011	4.69%
<i>Water/Sewer/Trash</i>	50,470	4.73%
<i>Property Insurance</i>	36,570	3.43%
<i>Property Taxes</i>	95,230	8.92%
<i>Maintenance Reserve</i>	36,000	3.37%
<i>Compliance/Oversight Fees</i>	11,249	1.05%
Total Operating Expense	\$ 617,839	57.90%
EBITDA (Operating Income)	\$ 449,268	42.10%
Real Enterprise Value @ 7.5% Cap. Rate	\$ 5,990,237	

The developer/sponsor will have the following \$620,000 in costs for creating the project and getting it to the point where the developer/sponsor's capital may be refunded out of the transaction:

1. Land deposit: \$10,500.
2. Feasibility Studies: \$15,000.
3. Design/Build Pre-Construction Services: \$45,000.
4. Environmental: \$4,500.
5. Business Planning: \$5,000.
6. Legal/Organizational: \$55,000.
7. Tax Credit Application Costs: \$45,000.
8. Project Management/Other Costs: \$100,000.
9. Syndication Pre-Closing Consulting: \$25,000.
10. Syndication Legal: \$15,000.

11. Syndication Advertising: \$300,000.

The developer receives a reimbursement for approximately \$620,000 from the syndication and tax credit fund proceeds and then receives an additional income of \$1,572,394 in the form of development management fees. The project has a 24-month cycle, so the developer invested \$620,000 and received back a total of \$2,192,394. The developer had actual project management expenses of approximately \$300,000 for the period, so the net gain for the developer was \$2,192,394 less total outlays of \$920,000, or \$1,272,394 over and above all costs. This transaction required little, if any, PHA involvement over and above administrative reporting, the initial contracting cycle and the legal work.

A closer look at the budget issues will show the efficacy of the transaction.

THE PRO FORMA CAPITAL FINANCE PLAN

The capital finance plan has to be “backed into” in order to create as the remainder enterprise value is the first issue that must be dealt with in order for the transaction to proceed.

Exhibit 2: Pro Forma Sources & Uses Statement

Pro Forma Statement of Sources & Uses of Funds		
Uses of Funds	Total Cost	Cost Per Unit
<i>Site Acquisition</i>	\$ 534,105	\$ 3,709
<i>Offsite Construction</i>	318,575	2,212
<i>Site Work</i>	1,174,950	8,159
<i>Vertical Construction/Structures</i>	9,802,160	68,071
<i>Contingency</i>	564,784	3,922
<i>Construction G.C./C.O./B.P.</i>	1,443,987	10,028
<i>Soft Costs</i>	1,518,100	10,542
<i>Intangibles/Other</i>	901,380	6,260
<i>Development Fee</i>	1,572,394	10,919
<i>Interim Finance Expense</i>	455,820	3,165
<i>Reserves</i>	490,000	3,403
Total Use of Funds	\$ 18,776,255	\$ 130,391
Sources of Funds		
<i>Tax Credit Funds (Net)</i>	\$ 13,894,429	\$ 96,489
<i>Syndication Net Proceeds</i>	4,881,826	33,902
Total Sources of Funds	\$ 18,776,255	\$ 130,391

The rents for this market average out to an assisted rate of \$651 per living unit in the property. Once an allowance for vacancy and collection losses is factored into the underwriting (7%) and a 2% ancillary

revenues assumption is factored in, the property would be expected to generate approximately \$1,067,100 per annum (note Exhibit 1, above). Underwriting suggests the real-case scenario operating expenses will run approximately \$4,290 a unit, for a total annual operating expense expectation of \$617,840, creating an operating income (EBITDA) of approximately \$450,000 for the property. This suggests the real enterprise value in the market to be approximately \$5.9 million to \$6 million.

For affordable housing transactions, a general rule is that the fractional real estate syndication cannot exceed a third of the total capitalization or the total capitalized (real-world) value of the enterprise using the income-approach, therefore; the total amount of the syndication funds required cannot exceed \$6 million in this example.

From a capital financing standpoint the total interim financing appears to be approximately \$18,776,250, with an assumed 10% development fee (of eligible basis) in the transaction. The developer's tax credit exchange funds (a grant exchange in the case of Texas projects) are expected to provide \$18,394,420, leaving approximately 26% of the funding not otherwise provided for in the plan. This meets the first capital financing test associated with fractional real estate financing – the capital gap cannot be more than a third of the transaction and it is not in this example. The second test owes to the total cost of syndication to “gross up” the number and make sure it does not exceed the second threshold value – the total income-based appraised value of the continuing enterprise (“backing into the financing”). The net capital funds required (note Exhibit 2, above) amount to approximately \$4,881,826. The costs are, more or less, computed on an inter alia basis with a total load of 10% at this level, so the total funds are divided by 0.90% and this yields a total syndication sales plan of \$5,424,251. This underwrites because the maximum limitation for the plan would be the \$5,990,237 limitation (see Exhibit 1, above – last line), providing a cushion of \$565,985. The final test is the valuation test in order to derive the yield the transaction can be realistically expected to sustain. This uses the baseline housing inflation rate being applied to the fully stabilized EBITDA to derive the annual values and then capitalizing the exit refinancing to pay off the syndicate position, to wit:

1. Expected EBITDA (Year 3): \$464,992.
2. Expected EBITDA (Year 4): \$481,267.
3. Expected EBITDA (Year 5): \$498,111.
4. Expected EBITDA (Year 6): \$515,545.
5. Expected EBITDA (Year 7): \$533,589.
6. Supportable Debt at End of Year 7 (35-Year/4.5% Loan w/1.15x DSC): \$8,170,170.
7. Total Gross Yield to Syndicate: 150.62% ($\$8,170,170 \div 5,424,251$).
8. Total Annual Average Cash-On-Cash Yield (Guaranteed Contract Yield): 21.52% ($150.62\% \div 7$).

To put it into motion for the developer/sponsor a key milestone development schedule of the costs owing into the program are provided through the point of closing the fractional ownership syndication is provided on the following page. This includes costs for initial phase capital raises for the developer/sponsor's risk capital, but assumes site control and tax credits are already in hand.

THE KEY MILESTONE DEVELOPMENT SCHEDULE

Exhibit 3: Pro Forma Key Milestone Schedule – Pre-Construction Phase (Tax Credits & Land Control Assumed)

Pre-Construction Phase Key Milestone Execution Schedule															
Happy Face Apartments 144-Unit Low/Mod Income LIHTC Development Dallas, Texas															
Reporting Period:	16-May	23-May	30-May	6-Jun	13-Jun	20-Jun	27-Jun	4-Jul	11-Jul	18-Jul	25-Jul	1-Aug	8-Aug	15-Aug	
Division	Activity Description/Nomenclature														
Syndication Feasibility/Execution															
		\$ 3,500	\$ 1,500	\$ 1,500											
			\$ 2,500	\$ 2,500	\$ 2,500										
				\$ 10,000	\$ 5,000	\$ 5,000	\$ 5,000								
								\$ 7,500		\$ 7,500					
								\$ 25,000		\$ 15,000					
								\$ 3,500		\$ 6,500					
											\$ 250,000	\$ 50,000			
												\$ 2,500	\$ 2,500		
Due Diligence Documentation															
						\$ 25,000				\$ 20,000					
						\$ 3,500				\$ 15,000					
						\$ 3,500				\$ 2,500					
										\$ 7,500					
										\$ 1,500					
										\$ 2,500					
										\$ 7,500					
										\$ 10,000					
Total Expense	\$ -	\$ 3,500	\$ 4,000	\$ 14,000	\$ 7,500	\$ 37,000	\$ 5,000	\$ 32,500	\$ 3,500	\$ 56,500	\$ 39,000	\$ 250,000	\$ 52,500	\$ 2,500	
Cumulative Total Expense	\$ -	\$ 3,500	\$ 7,500	\$ 21,500	\$ 29,000	\$ 66,000	\$ 71,000	\$ 103,500	\$ 107,000	\$ 163,500	\$ 202,500	\$ 452,500	\$ 505,000	\$ 507,500	

Additional Information & Transaction Assistance

For additional information regarding fractional commercial real estate financing, obtaining a license to use Rainmaker's proTIC transaction management system and/or assistance with structuring a transaction for your project or housing agency, please feel free to contact Clint Lovell. Clint can be reached via email at clint@rainmakermarketing.com or at 281.537.1200.

End of White Paper