
REAL ESTATE FINANCING:
CURRENT TRENDS AND OPPORTUNITIES

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REAL ESTATE FINANCING: Current Trends and Opportunities

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Introduction

There is a genuine concern about the availability of funds for the long-awaited and much anticipated real estate market recovery in Arizona. With the literal collapse of the savings and loan industry and the current problems being experienced by the banks, these traditional sources of financing cannot now play the role that they did in the past. The apparent redlining by many out of state lenders and investors has magnified the problem.

This article will give an overview of commercial real estate funding. It will touch on several sources, with an emphasis on current trends, including those that are now developing. Although the title refers to "financing", sources of investor funds and capital formation will also be reviewed.

Many of the areas that are covered are highly specialized and are subjects in themselves. The intent is to heighten the awareness of the reader and identify opportunities, rather than lose the big picture to detail. The material is based upon actual experiences, not just theory and opinion.

A New Economic Cycle

Except when disrupted by major events such as a deep national recession or major war, economies tend to be regional or even local in performance. One area (such as metropolitan Phoenix) can be experiencing a severe economic downturn while another (such as Southern California) is enjoying a robust economy. This phenomenon has been called a "rolling economy."

Arizona has historically experienced five to seven year real estate cycles. At any point in a cycle, up or down, there are always opportunities. Obviously, a region that is at the bottom and starting up offers more, and certainly safer, opportunities. Many believe that the Arizona market is now in that elusive "six month to two year" period that will lead to better times. Certainly, the current activity indicates this.

The changes to the real estate and related businesses and professions have been dramatic. Most of those who remain are well seasoned and, given the opportunity, will not make the same mistakes. The survivors and the newcomers will need money to take advantage of the potential. The challenge for all of them will be to find the sources of funds and to draw on them.

Current Trends In Funding

One fact is certain. Money is always available for quality real estate. Although now held in other investments that are considered to be safer or promise better yields, more of these funds will become available as the market and the general perception about it improve. Pension funds will be one of the leaders in the transfer of money from the stock market to real estate.

During the recovery, the loan workout (or refinancing) should continue to dominate the financing activities. It is the rare occasion that a lender is in place and only the price and terms need be negotiated. As part of this, there will still be out-of-court settlements, but the reorganization in bankruptcy will be more common.

The seller who can finance a substantial part of the sale price will have an advantage. The Resolution Trust Corporation ("RTC") must do this to realize much of the value of its immense holdings.

The banks and savings and loans will not be in the forefront as they were in the past. Because of their own problems and stringent regulatory oversight, they are being replaced by less traditional sources. The financing arrangements will have different structures and often will have more than one independent source of funds involved in the same project or entity. Although many of the local sources who are currently in the market will increase their share over time, a great deal of the liquidity will be from out of state and foreign ones.

Capital alliances will become commonplace. These are combinations of financial and development capabilities under long-term credit arrangements. Even if the funds are for an entity (such as a development corporation) there will be parameters for each project.

Although expensive and time consuming, public financing will be regularly used. Other less traditional and more costly sources will also satisfy the early demand for funds.

Securitization of real estate will occur on both a large and small scale, and funds will come from a variety of sources. The small investor will be back (there is a future for the local syndicator). In addition, there will be a greater number of large public funds, not only for capital alliances, but also for project funding. Wall Street will play a significant role in the real estate arena.

The days of 100% plus financing are over. In addition to having a good track record, the borrower will be required to put up its own money or money from an equity source. Although an exceptional project may cause some compromise, the reputation, experience and skill of the investor, developer and builder will be extremely important. Also, despite lender liability risks, greater control by the lender will be imposed.

The often forgotten source of repayment will not be ignored this time. The "bigger fool" theory never works for the last buyer and lender. Credit lending considerations will be more important, although the collateral certainly must have sufficient value and marketability.

There will again be a strong market. Memories will have faded and some of the same mistakes that were made the last time will be made again. The difference will be the size and significance of them. Although there will be losses and failures, they will be smaller and more isolated. There will not be a total collapse of industries as recently experienced. There will, however, continue to be real estate market and general economic cycles.

Loan Work-Out

A loan work-out is a compromise involving the payment or refinancing of existing debt. With a captive lender, it is one of the best sources of financing. The problems leading to a workout usually fall into two categories. Either the collateral is worth less than the debt or the borrower is unable to make the loan payments on a current basis. The options that are typically available in a work-out situation are:

1. Reduction of the amount due, whether principal, interest or both.
2. Deferral or reduction of payments (possibly a cash flow mortgage).
3. Addition or replacement of collateral.
4. Infusion of cash from either or both the lender and borrower.
5. Addition of or increase in a profit participation to the lender (assuming there is equity in the collateral).

If the project will not succeed with one or more of the above options, then the usual alternative is to minimize the losses to both the lender and the borrower. This may involve a deed in lieu of foreclosure and, possibly, a negotiated deficiency. A deficiency can either be paid in cash or become a new loan that is separately collateralized.

The additional cash may come from a new equity partner that recognizes an investment opportunity. If cash is paid, this may put the borrower in a position to bargain with the lender (for example, to change a recourse loan to non-recourse).

A discounted payoff may be a part of a principal reduction. This can be substantial depending on the lender's motivation. For example, a lender may wish to close a branch office and leave the market.

At the beginning of any discussions regarding a work-out, the flexibility of the lender should also be considered. As a practical matter, the lender may not have the management

time and skills available to it to take over a troubled property. This is an economic and not a legal decision. On the other hand, the lender may also be limited by established internal policy, regulatory controls or accounting standards that will dictate the decision.¹

A loan may be divided into good loan and bad loan categories (similar to what the RTC has done with banks). The repayment terms may be significantly different between the two. As an example, one may be a first lien and the other one may be subordinated to new funds from an outside source.

It is recommended that an individual or team of specialists be utilized in connection with a work-out. This will add emotional objectivity and the necessary knowledge and experience. Depending upon the potential consequences and the ability to pay, a team could include experts from a variety of disciplines such as law, accounting, finance, construction and brokerage.

The usual process in a work-out is to negotiate if the lender is willing and able to do so. Failing this, litigation may be an alternative, particularly if there is a claim of lender liability. Even if a claim may ultimately be found invalid, the fact that a recovery or defense is possible, may cause the bank to choose negotiation.² The last choice is usually bankruptcy.

Unless there is a liquidation, a bankruptcy will involve a reorganization under Chapter 11 for a business or a Chapter 13 for an individual.³ The decision to file is much easier with a single asset entity than one that owns many assets, some of which may be performing and not in need of protection.

Upon the filing of a petition, a separate bankruptcy estate is created, with the resulting court appointment of a trustee. Separate income tax returns are filed and a fiduciary duty to the previous owner of the asset will shift to the bankruptcy estate. As with most everything, there are advantages and disadvantages to bankruptcy. These must always be weighed.

The most sought after advantage is the automatic stay order that is issued by the court.⁴ This is usually used to stop a foreclosure and the more immediate remedy of a receivership (to collect rent).⁵ During the period in which the stay is in effect (which can last for a minimum of possibly six weeks but usually six months to a year) the trustee can operate in the ordinary course of business without creditor interference. In addition, the debtor can obtain orders from the court to reject certain onerous contracts or to sell an asset free and clear of a lender's lien. In the latter case, the lien would attach to the proceeds of the sale.⁶

One of the more important tax considerations in a workout is the avoidance of ordinary income from the forgiveness of debt. This could arise out of a foreclosure or a

deed in lieu of foreclosure. Even after successful negotiation with a lender, it may be wise to use a bankruptcy proceeding to fit within the Internal Revenue Code provision that will allow recognition of the income to be avoided.⁷

On the disadvantage side, it will be necessary for the debtor to file reports and attend hearings, all of which will be time consuming and delay normal processes. In addition, there are the public relations problems and the potential loss of vendor credit. One that is not often considered is the possibility that a retirement plan or recent contributions may become part of the bankruptcy estate and subject to creditor claims.

The plan of reorganization will ultimately determine the success of the bankruptcy. In addition to being well documented and supported, it must be both economically feasible and relatively fair. Only a small percentage of the proposed plans are ultimately approved. Approval can be obtained, however, with the consent of less than all of the creditors.⁸

Pre-planning for the filing of a bankruptcy is extremely important. It allows for time to prepare important creditors and business associates and to develop a plan of reorganization without undue pressure. During this stage, only those payments necessary to operate should be made. These would be ones that are critical to doing business on a normal basis. The pre-planning period will also allow for the passing of time for certain payments and transfers that may otherwise be set aside as preferential.⁹

A successful reorganization usually involves the infusion of new money. This can come from either a capital investment or financing. Although lenders usually avoid loans to borrowers in bankruptcy, the court's ability to give a super priority lien can make such a loan extremely secure. Also, with the borrower already in bankruptcy, the possibility of a future bankruptcy to protect the borrower will be less of a concern to the lender.

Seller Carryback

Whether a farmer whose property has been in the family for years or a financial institution holding real estate acquired through foreclosure (commonly known as "real estate owned" or "REO"), the seller is usually the easiest lender. Its primary interest is the sale. In many instances, the financing is offered as an inducement to the purchaser to complete the transaction. The seller may, however, have some practical or legal limitations and these must be understood.

Terms are usually available, but the ability to extend financing may be influenced by factors such as the seller's need for liquidity or the terms of an existing loan against the property. Often an important concern is to exchange the property to defer paying income

taxes on capital gains.¹⁰ This will be more prevalent when lower capital gain tax rates are non-existent or negligible.

In addition to controlling the seller's ability to give terms, a lender's lien may make the loan due upon the sale of the collateral.¹¹ And, the due date of this financing will dictate the maximum time period for the seller carryback.

A sale will normally involve a down payment of between twenty to thirty percent with an interest rate that is usually near current permanent loan rates. The carryback can be either long or short-term. It should, however, be tailored to the anticipated use of the property, with one for development typically having a short term and one for investment a long one.

Random releases of collateral will be replaced by more thoughtful patterned releases. The right to prepay will be standard, and subordination will be resisted. To achieve higher sales prices, subordination may, however, be allowed by sophisticated sellers under tight controls.

A seller carryback is the best chance for non-recourse financing. This is often in the form of what is commonly (but incorrectly) called a "rolling option." Also, the use by the buyer of a single asset entity may be advisable to avoid resultant credit damage from a foreclosure if the investment is not successful or if there is a later discovered environmental hazard.

Use of Leases

A sale with a lease back to the seller is still an effective financing tool. The seller may wish to improve its financial statement (such as eliminate long-term debt) and add liquidity. In such an instance, the buyer is in reality a lender, with the seller a borrower. A carefully structured option will give the seller the right to reacquire the property and still allow it to keep the favorable financial statement presentation.¹²

Using income property investment criteria, the purchaser will be most concerned with the ability of the seller (who has now become the tenant) to perform under the lease. Future increases in the value of the property may be shared by both parties.

Credit-worthy companies with warehouse and manufacturing or other business-related facilities may be good candidates for a sale/lease-back. Also, many of the State of Arizona buildings are built and occupied under such arrangements.¹³ An additional risk with the State, however, is that the leases are subject to annual appropriations for rent by the legislature.¹⁴

Tenant equity programs will still be utilized. If the tenants are essential for

financing, ownership to the tenants of between twenty-five and seventy-five percent (based upon their space and rent) will not be unusual. With the over-building of office space, this financing vehicle will be more commonly found in the markets that are enjoying lower vacancies, such as industrial.

Resolution Trust Corporation

With all that has been written and spoken about the Resolution Trust Corporation, this article will deal only with the RTC's ability and willingness to finance the sale of its recently acquired property.¹⁵

Although the auction or bidding process is preferred, the RTC will negotiate directly with a purchaser. Also, bulk sales are favored over the sale of a single property. This will provide an unprecedented opportunity for large trading companies that can buy in bulk for cash and then resell individual assets at marked-up prices with financing.

The quick sales have been and will continue to be performing income property with the prices occasionally being at or near market. At the other end of the spectrum, much of the speculative land will be held for a long time, probably even with deep discounts being offered.

The debate will continue as to whether or not the need for cash should prevail over the desire to minimize losses. The RTC can give terms with as little as fifteen percent down, but it is short on guidelines and precedent. Market competition should dictate in this area (as evidenced by recent terms sales by the RTC and the introduction of a new program for more).

As with any bureaucracy, the process will continue to be slow and difficult. The more frustrating part of this is the delays for reappraisals which always seem to be requested when a transaction is ready to close. The unclear rules governing appraisers, who now must be licensed, will just add to this problem.¹⁶

It is best if the decision-making authority is with the local managing agent for the defunct institution. This legal authority should be verified and the necessary signature should be obtained early in the process. If a decision must be made beyond the local level, a well written and adequately supported proposal is essential.

Financial Institutions

Banks and savings and loan associations have long been a major source of acquisition and development funds. With all of the financial institutions regulated and many now

closely supervised or managed by regulators, it is important to confirm the institution's ability to perform.¹⁷ Although it is comforting to have a willing lender, it is devastating to have a partially completed project with a lender who is unable to continue to fund the project or does not have the flexibility to work out a problem. Even worse is a regulatory takeover and rejection of the loan agreement.

Even if the institution is healthy, it may not be willing to lend or it may try to package a new loan with the sale of an REO. One fact that is certain, it will not likely be willing to refinance another lender's problem loan.

Whatever the reasons, the unwillingness of banks to renew performing lines of credit for many real estate companies is creating a serious problem. If such a financing arrangement is continued, a bank will likely require that it be secured (if not already). And, the financial statement and value ratios must be maintained or the line will be called. If the RTC replaces the lender, a termination or refusal to renew can be expected. Renewals should be negotiated well before the lines of credit are due.

The real estate loan process will take longer (closer to seventy-five to one hundred days) and at least twenty to twenty-five percent cash equity from the borrower will be required. The lender will also demand immediate additional funds if it appears at any time that the loan proceeds will not be sufficient to complete construction. The debt coverage ratios will be up in the 1.2 to 1.25 range and the loan to value ratios will be from sixty to seventy-five percent.

In a departure from an earlier position, institutions are now more willing to allow equity financing. This will be secured behind the first lien of the institution. However, the lenders will not be seduced by the profit participation carrot. The loan must stand on its own under stringent underwriting criteria. It should not be surprising if bank policy goes well beyond the regulatory requirements.

The banks are back to the basics. The four Cs (character, capital, capacity and collateral) will prevail. Most important will be the source of repayment of the loan, with a greater emphasis on credit considerations rather the collateral itself. Land loans will not be added to bank portfolios for a long time.

The relationship with the borrower, whether existing or new, will be extremely important. Even when their current problems are behind them, the banks will be extremely careful in selecting their borrowers. They will be looking for well-managed companies with successful track records in addition to a good reputation and a strong financial statement. The competition for the banks' dollars will be intense.

The lender will require independent appraisals, environmental reports and, possibly, market or feasibility studies. These will be carefully analyzed, and those preparing them

should be pre-qualified. An ever present objective will be not only to determine if there is environmental contamination but also what effort is necessary to allow the lender to take advantage of an "innocent purchaser" defense if contamination is later discovered.¹⁸

It is reasonable to assume that a financial institution must lend in order to stay in business. But, a lender may refuse a good loan to avoid an unbalanced loan portfolio or one in an area in which the lender does not have sufficient expertise. If the lender is interstate, it may simply be using its local deposits for loans in other regions that are stronger. If able and willing, a bank will loan for the construction, with the commitment for the permanent take-out loan being more important than ever. Given the right circumstances, a bank may consider a "mini perm".

A tri-party agreement between the bank, the permanent lender and the borrower will usually be required. For the benefit of the borrower as well as the bank (as construction lender), discretionary outs on the part of the permanent lender should be removed or severely limited. Otherwise the purpose of this important agreement is frustrated.

Although the bulk of the loans will be made on a normal point and interest rate basis, some bank pricing will be more expensive than before. And, the additional reports alone will result in a greater expense to the borrower.

Many post-closing controls over the borrower will be more strictly enforced. Also, the payment by the borrower of dividends or loans to shareholders and bonuses to officers may not be allowed. And, if these are paid in violation of the loan agreement, the bank may pursue separate claims against the individual recipients of the monies.

Standard provisions such as cross-collateralization and cross-default should be carefully reviewed. These may result in the inability to finance or refinance other assets. If there is a due on sale provision for the death of a major partner or shareholder, this risk should be eliminated with life insurance.

Although unusual, it may be possible to remove or limit personal guarantees.¹⁹ In the past, a borrower was often able to sign as a "married person dealing with his (or her) sole and separate property". Now, the subject will be directly addressed. If a non-recourse provision cannot be eliminated, it may be possible to agree on a maximum deficiency or the termination of a guarantee upon certain events such as a minimum lease-up. In any event, the guarantee documents should also be carefully reviewed for such provisions as a waiver of all rights and defenses and a subordination of payments from the borrower to the guarantor.

Although part of the bank organization, there is usually a separate trust department.

Using different officers from the lending side, this department can make construction and permanent loans. Oftentimes, it may be less restricted in its dealings since it is regulated primarily by internal policy of the bank. These and independent trust companies may be good sources of funds.

Other Institutions

The other institutional sources are primarily the large pension funds and insurance companies. Holding most of their funds in marketable securities, they are usually motivated by the desire to preserve principal. They will hold a varying percentage of their funds (small in comparison) in the real estate market, with the emphasis on comparative return and safety.

Although the pension funds and insurance companies will invest in an equity position, they will usually act as a lender with a possible participation. Having "patient money", particularly the ever growing pension funds, they are often the permanent lender that will take out the construction lender upon certain conditions being satisfied. A condition may be completion of construction or the achievement of minimum leasing goals. When lending on a project basis, they want their borrowers to have a local presence and knowledge and, probably, to be focused in a specific area of specialization such as shopping centers.

Contrary to the usual financial institution practice, funds will fix their rates. Because they are matching their source of funds with the pricing of the loan, they will either prohibit prepayment or charge for that right. Usually there is a prohibition for a period of years and then a penalty that is based upon a formula to maintain the yield. After that, the penalty may be removed or stepped down to one percent.

In addition to being very sophisticated either through their own personnel or with advisors and correspondents, the pension funds and insurance companies are controlled by well established (and often inflexible) policy and some regulation.²⁰ Look for them (large and small) to play a major role as the money partners in capital alliances.

Mortgage Lenders

Mortgage lenders are significantly less regulated than financial institutions. They do not take insured deposits and the mortgage broker and banking laws are directed primarily toward the consumer rather than commercial loan.²¹ Even though a loan may be prohibited by institutional lender policy, it may still be made (and well underwritten) by a mortgage lender. For example, the borrower may have a poor credit rating, or the

position of the collateral may be junior to one or more loans. The collateral may also be unusual, such as liens against corporate stock or a partnership interest in a real estate company. In many instances, the only difference may be that the turnaround is quicker because of fewer layers of decision makers.

The collateral, rather than the credit of the borrower, is usually the most important part of the underwriting. A mortgage lender may still make a land loan, but the loan to value ratio will probably be in the fifty percent range and the land will be ready to be developed. The pricing for the loans is usually higher, with the annualized points and interest rate often being more than ten percent greater than the lender's cost of money. Institutional rates may, however, be available for an equity participation ranging on the average between forty and sixty percent to the lender.

A mortgage lender may be involved in a traditional institutional loan as the source of equity that is required by the institution. This equity may be provided either as an investment with a preferential return to the mortgage lender or as a loan. Recent bad experiences with joint ventures have caused a shift to a loan structure. Even though a loan may be non-recourse, the lender has better control and remedies. Foreclosure, for example, is a preferred choice over arbitration or litigation when the "borrower" does not perform as promised.²²

Public Financing

Many governmental agencies, particularly the federal ones, have programs for direct loans or for guarantees of loans from other lenders. On the commercial side, these programs can involve new development or redevelopment of multi-family housing projects. They also capitalize or finance small businesses with limitations on amount based upon the size of the company and its kind of business. The Small Business, Federal Housing and Veteran's Administration guarantees are examples of government assistance.

Local governments have programs for redevelopment of blighted areas, installation of public improvements (such as streets) and for general economic development purposes.²³ The extent of the assistance will depend upon the financial or other tangible benefits to a community. The use of government/private partnerships as well as development and intergovernmental agreements will become more common.²⁴

The Department of Housing and Urban Development has several programs that are available and administered through the Federal Housing Administration.²⁵ Although extensively utilized in the eastern United States, they have not been as popular elsewhere. Because of the tight financial market, more investors and developers in other parts of the country are turning to these programs.

With the apartment market continuing to improve, we can expect programs that assist in the financing of new and existing apartment complexes to be utilized. In fact, what is called the Section 223f Program will insure permanent financing for up to eighty-five percent for apartment projects three years and older. The rates are set off of the bond market, and all other terms and conditions of these assumable loans are quite conventional.

Now on a more limited basis, industrial development bonds (also referred to as private activity bonds) will remain an important source of funds. Planning, acquisition and development costs that are incurred before the inducement resolution from the local authority is obtained cannot be reimbursed. Also, patience will be required while burdensome governmental requirements are being satisfied.²⁶

Although improvement districts have been utilized for many years, this financing technique has been expanded by the enactment in Arizona of the Community Facilities District Act.²⁷ This should greatly assist developers in the acquisition and improvement of public infrastructure, including parks and other landscaped areas. With the limited availability of funds from the banks and savings and loan associations this form of financing should become commonplace.

A community facilities district ("CDF"), which is a separate entity, can use traditional municipal methods of financing, such as bond issues, tax levies, special assessments, user fees and private contributions. It is established with city approval and by a majority of the landowners in the CDF (on the basis of acreage owned).

An obligation created by the district is not shown in a title report as a financial lien, such as a deed of trust. It is usually payable over a ten-year period and, although the total obligations of the CDF can be up to sixty percent of the value of the land, the ratio should be substantially less.

The disadvantages of most public financing arrangements are the amount of time involved, some of flexibility and the high fees and costs. With these being some of the few available sources of funds, the disadvantages may not matter. Also, they may be more than offset by the lower interest rates for tax-exempt debt instruments such as bonds.

Securitization of Real Estate

The securitization of real estate will become a more important method to raise money. With the significant reduction in loans from the banking and savings and loan industries, it will be necessary, in effect, to go directly to the bank depositor.

Typically, a securities offering combines smaller sources of funds into a larger pool. This can be small in scale and for a single project, with land syndication being a recent

example. Or, it can result in a large fund that is available for numerous projects, including capital alliances.

Usually the investors are individuals, businesses or retirement plans. A securities offering allows an investor to take advantage of a real estate investment potential without possessing the necessary expertise. It can limit the investor's liability while allowing liquidity and diversification. For many sophisticated investors, the ability of the issuer rather than a particular investment will be more important.

Often the security will represent an ownership interest in a business organization such as a corporation, partnership or trust. It can also be a debt instrument such as a promissory note or bond. In any event, a security must be registered with appropriate state and federal agencies unless an exemption from registration is available.²⁸

Because of the time and expense involved in a securities registration, an exemption is usually preferred. A more commonly used one is limited to a maximum of 35 investors with accredited investors not being counted. The amount of funds that can be raised is unlimited.²⁹

Another exemption that has been available for a number of years on the federal level, but has just recently been adopted in Arizona, permits the offering of up to \$1,000,000 of corporate stock without any limitation as to the number of investors.³⁰ Although stock is not the usual form of security for a real estate investment, it may be used to capitalize a real estate company rather than fund a particular investment.

The use of a subchapter S election may make it easier to use a corporation for a particular real estate investment.³¹ This will avoid the double taxation for distributed real estate gains. However, there are limitations on the kind and number of stockholders, and capital, which may be sorely needed for credit financing, is drained from this kind of corporation.

Investors will be more careful than they have in the past. Many have learned that some individuals and companies are better at raising funds than using them. Also, if a broker-dealer will be used in the fund raising effort, it will want to see a successful track record of profitable real estate investments.³² On the other side of this, the issuer should be satisfied that the broker-dealer can perform by raising at least the minimum amount required.

The use of the proceeds from the offering will be important to the investor. A specified investment is the easiest to sell if the issuer has enough time. This could involve the roll-up of several existing properties previously syndicated by the issuer. Otherwise, it may be necessary to use a blind pool with sufficient parameters to alleviate

most of the uncertainties. This may even require a favorable vote of a minimum percentage of the security holders prior to expending funds.

If not the only one, a securities offering may be the best method to raise money for a particular investment or issuer. If a registration is involved, it should be appreciated that even a highly qualified issuer must go through a long and expensive review by the federal and state regulators to satisfy their disclosure and fairness requirements. After the sale of the securities, performance will be demanded by the investors, many times on a short-term basis.

Despite all of the obstacles, the securities offering will increase in use. The real estate investment trust ("REIT") and Real Estate Mortgage Investment Conduits ("REMIC") will gain new popularity³³, and the project syndicators will return. Those holding small amounts of money will need them in order to take advantage of the upcoming real estate opportunities. The investors will, however, expect a securities promoter to have a financial stake in the success of the investment and to take most of its fees after the return of the investors' capital.

Mortgage-backed bonds will be one of the more frequently used securities. The bonds are secured by real estate, which could be one or more parcels. They can be purchased by investors who may be unwilling to or even prohibited by regulation from investing directly in real estate. The bonds can be shown as a current rather than fixed asset and, in many instances, may be marketable. Unless privately placed, the bonds must be rated, and the issuer usually is required to provide certain credit enhancements to increase the rating, including over-collateralization, a letter of credit, guarantees or other devices.

Mortgage-backed bonds should play an important role in the purchase of the extensive real estate holdings of financial institutions and the RTC. Many large funds already exist or are in formation for this purpose. With increasing investor acceptance and the further understanding of the advantages of this form of security, many of the smaller syndicators will use it on single asset purchases.

Non-traditional Sources

Venture capital companies will invest in an entity (usually a corporation) that is engaged in the real estate business. This is not for the purchase or financing of real estate assets but, instead, is an investment in the company itself. Sound management and a good market position for the company will be essential. Just as important, however, will be the ultimate return on the investment.

The merger of two companies or acquisition of one by another may result in total capability that is missing in both. For example, one may have excellent real estate assets

but limited liquidity and inadequate management. The missing ingredients for success could be added by another company in the same or even a different business.

Credit or financial service companies, material suppliers and utilities can be valuable sources. Construction activity creates the need for their services and products. Their assistance may be in the form of loans, other credit arrangements or installation of improvements.

Although not yet sufficiently tested, credit unions may emerge as significant sources of funds for the real estate recovery. These federally insured non-profit organizations are formed on the basis of a common bond of interest (such as employment). And, loans can only be made to members. Aggressive regulatory enforcement in the wake of the savings and loan disaster may limit the ability of the credit unions.³⁴

Not to be forgotten are the large established and well-capitalized companies that want to diversify. If management is convinced of the current opportunities in real estate, it should be interested in an acquisition, venture or financing arrangement. Many large companies have formed subsidiaries for this purpose.

Investors from Other States

As previously indicated, the good and bad economies seem to roll through the country. While Arizona is at the bottom of its cycle, other regions in the country may be at the top. Before those markets turn down, many investors will have time to liquidate their positions and, flush with cash, will be looking for good opportunities elsewhere. A good example of this is the surge of investors from southern California.

The out-of-state investors may be private individuals or public companies who previously left the Arizona market or those who have never been here. They are fresh and able to make objective evaluations. Their approach is more statistical rather than emotional, and they are driven by opportunity rather than need.

Many of these investors will bring with them their existing lender relationships, with substantial lines of credit. An Arizona subsidiary of a national or regional company may be able to obtain its needed money just by making a request to its home office. This will depend upon the overall health of its parent company and its continued good relationship with its source of funds.

Foreign Sources

Since the mid-1970s, Arizona has clearly been a part of the global economy. Investors worldwide have been attracted to the United States because of its political and

economic stability and investment opportunities. Although some attention and money may be diverted to the opening Eastern European markets, the foreign sources of money will play an increasingly greater role in Arizona real estate.

Despite the language and cultural differences, there are surprising similarities in the investment evaluation process. As with Americans, the spectrum of investment objectives may range from a high risk/reward ratio to a small safe return. The more familiar a foreign investor is with the market, the more likely it will move from investments in signature properties in major cities with institutional partners to secondary cities where it may act on its own. It is doubtful, however, that foreign investors as a group will drop below institutional grade properties.

If a partner is used, the priorities will be a relationship first, with the investment a close second. The foreign source will also want its partner to share in both the capital contribution (including calls) and the return. In effect, it will want a true partnership, not just a funding arrangement.

A convertible mortgage may be useful to a foreign investor. While avoiding a complicated approval process or treaty limitations, it could allow an opportunity to evaluate a borrower and property.

If the cultural and language differences are significant, the use of an intermediary who is intimately familiar with the thought process and language of both sides is crucial. This way it can be quickly determined, for example, whether the word "possibly" is a polite way of saying "absolutely not."

Although the foreign sources will bring cash to a transaction, it should be determined if the funds have been borrowed or syndicated. This may change the investment horizon to a very short one, and flexibility may be reduced. In any event, whatever cash is needed should be obtained initially. This avoids an interruption of the cash flow, whatever the reason may be.

Conclusion

The Arizona real estate industry is just now coming out of a very deep and wide down market. Those who have survived and new ones entering the market will have excellent opportunities. The problem confronting many of them will be the general inability to obtain funds. There is available money. It must be found and directed into the marketplace. Much of it will come from non-traditional sources and the funding arrangement will be under different structuring.

It may be necessary to engage a mortgage broker or some other licensed fund raiser. The broker's qualifications, performance record and general sources should be verified. The

broker may require a commission of anywhere from one to ten percent of the funds that are raised by the broker. But, this should be paid out of the funds and not in advance. This will protect against the front-end fee scams which are so prevalent in bad times. If the fund raising involves a major effort, including the preparation of a marketing package, the broker may want an exclusive right for a period of time.

Once the source of funds is found, it will be an equally difficult task to extract the money. This will require a well documented and supported package and a sensitivity to applicable external regulation and internal policy.

After finding them, the funds should be spent wisely. A dynamic growing economy and major cycles seem to go hand in hand. Early warning signs of a downturn should be quickly detected, such as a reduction in job and population growth and a general overbuilding. And, the impact of federal tax legislation with sweeping changes should never be forgotten.³⁵ The safest course may be to liquidate when those from other fields again enter the marketplace in large numbers as syndicators and developers.

Michael E. Tiffany
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ENDNOTES

1. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. 101-73, Aug. 9, 1989, 103 Stat. 183; and Financial Accounting Standard No. 15.
2. Lenders have been held liable for exercising excessive control over their debtors. See, e.g., In re Process-Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964), rev'd on jurisdictional grounds, 369 F.2d 513 (7th Cir. 1966), cert. denied, 386 U.S. 957 (1967) (lender controlled cash and took pledge of all assets and stock); In re American Lumber Co., 5 Bankr. 470 (D. Minn. 1980) (bank took possession of plant and controlled cash disbursements); In re T.E. Mercer Trucking Co., 16 Bankr. 176 (Bankr. N.D. Tex. 1981) (lender controlled debtor's day-to-day operations); In re Teltronics Services, Inc., 29 Bankr. 139 (Bankr. E.D. N.Y. 1983); State National Bank of El Paso v. Farah Manufacturing Co., Inc., 628 S.W.2d 661 (Tex. 1984) (\$19 million jury verdict against bank for fraud, duress and interference with borrower's management); K. Thor Lundgren, Liability of Creditor in Control Relationship with its Debtor, 67 Marq. L. Rev. 523 (1984).
3. 11 U.S.C.A. Chapters 11 and 13.
4. 11 U.S.C.A. § 362; Fed. R. Bankr. P. 7062; Fed. R. Civ. P. 62.
5. Ariz. R. Civ. P. 66.
6. 11 U.S.C.A. § 363(f).
7. I.R.C. §§ 61(a)(12), 108, 1001, 1017, 1245 and 1250.
8. 11 U.S.C.A. § 1126.
9. 11 U.S.C.A. § 547.
10. I.R.C. § 1031.
11. Garn-St. Germain Depository Institutions Act of 1982, Pub. L. 97-320, Oct. 15, 1982, 96 Stat. 1469; Ariz. Rev. Stat. Ann. §§ 33-438, 33-806.01, 33-1571.
12. Belz Investment Co. v. Commissioner, 72 TC 1209 (1979), affirmed 661 F.2d 76, 81-2 USTC ¶ 9734, 48 AFTR 2d 81-5916 (6th Cir. 1981).
13. A.R.S. §§ 41-790, et seq.
14. A.R.S. § 41-791.02.
15. 12 U.S.C.A. § 1441a; 12 C.F.R. §§ 1609.1, et seq. (sales of residential properties).
16. A.R.S. § 32-3603.
17. Veribank, Inc. has established an S&L Solvency Hotline. For more information call 1-800-442-2657 or write to Veribank, Box 461, Wakefield, Massachusetts 01880.
18. Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended (42 U.S.C.A. §§ 9601, et seq.; Superfund Amendments and Reauthorization Act of 1986 (42 U.S.C.A. §§ 11001, et seq.); Resource, Conservation and Recovery Act of 1976, as amended (42 U.S.C.A. §§ 6901, et seq.); Clean Water Act (33 U.S.C.A. §§ 1251, et seq.) Toxic Substances Control Act (15 U.S.C.A. §§ 2601, et seq.); A.R.S. Title 49 and §§ 5-348, 3-341, et seq., 3-361, et seq., and 3-381, et seq.

19. Consolidated Roofing & Supply Co. Inc. v. Grimm, 140 Ariz. 452, 682 P.2d 457 (App. 1984).
20. 29 U.S.C.A. §§ 29-1001, et seq.
21. A.R.S. § 6-901, et seq.
22. A.R.S. §§ 33-721, et seq. (judicial foreclosure of mortgage or deed of trust); A.R.S. §§ 33-807, et seq. (non-judicial foreclosure of deed of trust); A.R.S. §§ 33-741, et seq. (forfeiture of agreement for sale); A.R.S. §§ 12-1501, et seq. (arbitration).
23. A.R.S. § 33-721, et seq.; SBA, SBIC, FAA, VA legislation.
24. A.R.S. §§ 9-500.05, et seq. and 11-951, et seq.
25. See the numerous National Housing Acts in 12 U.S.C.A. §§ 1701, et seq.
26. A.R.S. §§ 35-701, et seq.
27. A.R.S. §§ 48-71, et seq.
28. Section 5, Securities Act of 1933, as amended (15 U.S.C.A. § 77e); A.R.S. § 44-1841.
29. Section 4(2), Securities Act of 1933, as amended (15 U.S.C.A. § 77d[2]), and Rule 506 of Regulation D (17 C.F.R. § 230.506); Ariz. Admin. Code Rule 14-4-126.
30. Section 4(2), Securities Act of 1933 (15 U.S.C.A. § 77d[2]), and Rule 504 of Regulation D (17 C.F.R. § 230.504); A.R.S. § 44-1902(a).
31. I.R.C. §§ 1361, et seq.
32. 15 U.S.C.A. § 78o.
33. I.R.C. §§ 856, et seq.
34. 12 U.S.C.A. §§ 1751, et seq.; A.R.S. §§ 6-501, et seq.
35. Tax Reform Act of 1986, Pub. L. 99-514, October 22, 1986, 100 Stat. 2085.