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LEGAL ALERT

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USING PRIVATE CAPITAL FOR COMMERCIAL REAL ESTATE DEVELOPMENT

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EVIDENCE OF PERSISTENT TRENDS

The tightening in lending standards experienced over the last year is attributable to factors beyond credit quality of borrowers and lenders' concentration in credit risk in CRE, namely: (1) lenders' expectation of deterioration in collateral values for CRE; (2) difficulty in appraising CRE within the same asset classes (due to varying returns and occupancy rates); and (3) the potential of the Federal Reserve to increase capital standards for large banks further. The expectation is that these persistent trends are here for the remainder of this economic cycle, which may persist beyond the 2024 presidential election. [1,2]

UTILIZING A PRIVATE PLACEMENT

As a proactive response to market conditions, many developers are raising private capital. The capital costs of this strategy are balanced out by the access to bank capital that it provides for the capital stack. Increased private capital may: maintain deal volume, strengthen balance sheets, provide additional lender access and diversity, and eliminate the need for a guarantee or reduce the risk of it being utilized.

Aspects of private placements and deal structure that we see clients utilize, include:

- Utilizing limited partnership units for investors;
- A developer's affiliate retaining a larger percentage for its role as initial limited partner;

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[1] The July 2023 Senior Loan Officer Opinion Survey on Bank Lending Practices available at https://www.federalreserve.gov/data/sloos/sloos-202307.htm (visited on Apr. 16, 2024).

[2] The January 2024 Senior Loan Officer Option Survey on Bank Lending Practices available at https://www.federalreserve.gov/data/sloos/sloos-202401.htm (visited Apr. 15, 2024).

- Puts and calls to facilitate buyback by the developer;
- Utilizing preference payments, much like a debt security; and/or
- Providing tier one mezzanine debt that is functionally equivalent to a second mortgage.

Navigating deal term conflicts is also something we are accustomed to handling for our clients. For example, it is not uncommon for institutional investors or lead investors in a private placement to receive greater return, more governance, information, or board observer rights. Our team of attorneys is familiar with navigating these aspects of private placements to ensure the best results for the issuer and its offering.

Another proactive response to the CRE market is utilizing private funds to group CRE investments and fuel deal volume. In our next alert, we will address fueling deal volume through a private fund (including an exempt private fund) and harnessing certain real estate asset classes to establish exemptions under the Investment Company Act.

CONCLUSION AND RECOMMENDATIONS

Attorneys Molly Brown, Joel Cooper and Andrew May have experience working with developers to raise private capital through private placements and private funds to ensure ongoing securities compliance. Clients interested in pursuing these deal options may contact Molly Brown (216.274.2336) to discuss using a private placement in your funding strategies. Brown advises issuers and private funds on structure, portfolio investments, and maintaining compliance.

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