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FINANCING MIXED-USE PROPERTIES

A look at the challenges of and strategies for obtaining a market-rate loan for your next mixed-use project.

Michael Rodgers

In recent years, the number of completed and proposed mixed-use developments has increased noticeably within our nation's urban and inner-city communities. Frequently, these mixed-use projects have been built vertically with retail on the street level and hotel rooms and residential condominiums on the upper floors. In other instances, mixed-use properties have been integrated horizontally, with retail, office and residential uses sharing common infrastructure, such as parking decks and green space.

Many factors have contributed to this market segment's growth including, but not limited to, an increase in market demand for live/work/play environments, land scarcity in the inner-city and in-fill markets, and the developer's ability to take advantage of special zoning districts, which encourages this higher density development. However, notwithstanding the positive attributes of mixed-use properties, obtaining traditional development equity and construction financing for this type of development can be problematic for many developers and in certain regions of the country. The purpose of this article is to address strategies that

SEE FINANCING, PAGE 58

Multifamily Lenders Resource Guide p. 40

Revitalization on the River p. 56

Understanding Commercial Leases p. 62

REVITALIZATION ON THE RIVER



Penn Circle is being redeveloped in Anacostia, just outside of Washington D.C. The revitalization of this multifamily project, formerly a vacated government housing venue, is part of a massive renovation taking place throughout the Anacostia region, which is planned to spur economic growth and retail services back to the area.

SEE PAGE 56

FINANCING MIXED-USE PROPERTIES

FINANCING from page 1

can be employed by the real estate developer to increase the likelihood of obtaining competitive, market-rate financing for its next mixed-use development.

Before addressing specific strategies for obtaining development financing, it is important to understand the inherent obstacles that mixed-use properties pose for commercial banking and equity finance institutions. Over the past several decades, financial institutions like most other service industries have become specialists in a variety of real estate development niches — strip center retail, high-rise office, high-density apartments and so forth. With respect to each of these product categories, these institutions have developed sets of firmly established underwriting standards upon which they rely when evaluating potential projects. Additionally, the density of these different uses can vary widely between each mixed-use project, making performance comparisons between like properties all but impossible. Finally, the rise of mortgage securitization and syndication markets have contributed further to use-specific real estate loans, which are capable of being resold by the originating bank into a pool of similar loans. Accordingly, mixed-use properties pose a problem for these financial institutions because they do not fit neatly within any one of their many specific lending categories.

The best solution to these financing obstacles is to identify methods by which a project's multiple uses can be divided for the purpose of obtaining financing. One should strive to have each of the mixed-uses fit neatly within the established lending products and underwriting categories of the available pool of investors and lenders.

SEPARATE PROPERTY COLLATERAL BY USE

The developer's goal is to isolate each portion of the mixed-use property in order to meet the requirements of established lending products and underwriting standards, so it must first create distinct property boundaries for each use so that the real estate loan can be underwritten solely on the basis of that specific use and, thereafter, the specific real estate can be secured as collateral for that loan and only that loan. There are three primary methods for accomplishing this objective.

Subdivision of Land and/or Air Space

In the example of the horizontal mixed-use property (for example, a neo-traditional town center), it may be possible to subdivide each of the multiple mixed-uses into separate land parcels. Generally, a local land surveyor would map out each applicable land parcel, including those improvements and green spaces to be shared by all, in order to prepare a subdivision plat. However, this approach often can be difficult to implement successfully with mixed-use properties. In many instances, the subdivision of the property will be problematic due to local zoning code requirements, such as maximum density allocations and minimum setback restrictions, which would be imposed on each subdivided parcel independent of the whole project.

In cases involving vertical mixed-use property (such as street-level retail and hotel and residential uses on upper floors), one may consider the use of an air space subdivision of the property, which essentially means creating cubes of air space via the use of common law easements. In this method, one would hire both a surveyor and an architect to prepare a subdivision plat that divides a vertical building into multiple layers by floor, thereby creating air space easements that can be bought, sold and mortgaged. Oftentimes, a portion of each vertical parcel may actually "attach" to and include a portion of the land by way of a dedicated elevator shaft or utility chase, depending upon the requirements of the building. While this option may sound intuitive and desirable, especially for commercial-oriented properties, it retains potential problems. First, many states have no statutory and common law that addresses this form of ownership, which creates uncertainty (and, therefore, higher risk) among the potential investors and lenders. Second, in such instances, the type of title insurance policies and endorsements that may be needed to satisfy the traditional mortgage lender may not be available in all jurisdictions. Finally, one may have to wait until the building's shell is completed substantially before finalizing the air space subdivision in order to account for construction variances encountered in the field.

Condominium Ownership

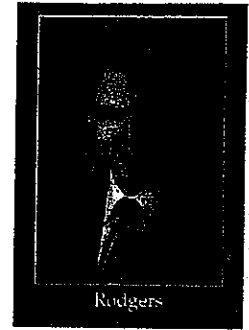
The application of a state's condominium act provides another method by which developers can create distinct

property boundaries for each use in either the vertical or horizontal mixed-use project. This method is similar to the air space subdivision described above, but it holds one major advantage: all states have provided a statutory scheme by which one can create and sell cubes of air space as condominium units; this statutory scheme provides greater certainty to the parties on how the arrangement will be enforced judicially over time. Title insurance also is available widely to insure this form of property ownership and the mortgages that may encumber it. However, as with the air space subdivision process, and depending upon the governing law of the jurisdiction, one may have to delay filing the necessary documents in order to create the condominium regime until the building is completed. This action allows the surveyor and the architect to fully certify and record the necessary condominium plats and plans used to create the condominium units. The potential loss of development flexibility is another disadvantage of the condominium approach, as certain aspects of the project may be controlled by statutory requirements that the developer cannot modify to fit its particular needs.

Ground Leasing

When the traditional subdivision of the land is not practical or available, and the use of the state's condominium statute is not desirable, one also may consider the option of leasing each parcel under long-term ground leases. Most traditional mortgage lenders and title companies are accustomed to using leasehold estates as property collateral for mortgage loans. Additionally, there is a bounty of established statutory and case law considering landlord-tenant issues. Another advantage for some developers (but a disadvantage for others) is the prospect of regaining control of the property at some point in the distant future.

As with the other options, there also are disadvantages associated with this approach. First and foremost is the long-term relationship between the fee owner (i.e., the entity that owns the land) and each of his multiple ground lease tenants and their respective subtenants. Each time one of the leasehold estates is bought and sold (and sometimes when major subleases are negotiated), its respective lenders and attorneys will want to negotiate various assignment, subordination and



non-disturbance agreements with the fee owner. For the term of the lease, the fee owner also will have to address ongoing requirements under the master lease including, for example, the allocation of property taxes between the various ground tenants. In short, ground leasing requires the developer (or some successor) to maintain its interest in the property in perpetuity. This form of occupancy is not acceptable in various markets and for certain uses, which provides another disadvantage. For example, upon termination of the master ground lease, the ownership interests of residential condominium unit owners also will terminate, a prospect that makes many homebuyers uncomfortable.

Regardless of which type of "subdivision" process a developer implements, one also must provide a means to unify the entire mixed-use project under one umbrella set of restrictions, covenants, conditions and easements in order to provide for, among other things, the long-term maintenance and operation of all common areas of the property, restrictions on how each parcel may be used so as to not interfere with the peaceful use and enjoyment of the other occupants, and easements necessary to construct the initial improvements and to maintain them over time. In a traditional land and air space subdivision, these objectives will be accomplished through a master declaration of covenants, conditions and restrictions. With regard to condominium projects, the pertinent document is a master declaration of condominium, which complies with the applicable state condominium statute. Finally, in a ground lease division of space, the master ground lease will provide for these terms and agreements. Each of these documents must be custom drafted by an experienced attorney in order to accomplish all of the requirements unique to the developer's mixed-use project and overall development vision. The same attorney also can

advise the developer on how to best structure the mixed-use property given the variety of pros and cons associated with each subdivision technique within one's jurisdiction and the requirements of available debt and equity partners.

interest to them.

Of course, there are many other factors that influence how to best structure the ownership of a mixed-use property, including income tax considerations. The purpose of this

article is merely to highlight the underlying debt and equity market requirements. A developer should consult with a skilled attorney to review the best options for a particular mixed-use project.

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SEPARATE PROPERTY OWNERSHIP BY USE

In addition to the goal of creating distinct property boundaries for each specific use, a developer also may be required to separate the corporate ownership structure for each such parcel in order to meet the underwriting criteria of the commercial lending and equity finance markets. Developers of single-use projects already may be familiar with some of these ownership requirements, but it's important to address at least two of the supporting reasons for separate ownership entities as they relate directly to mixed-use properties.

*First, many commercial lenders require that their borrowers only own a single real estate asset so that another poor performing property will not affect adversely the financial health of its borrower and, ultimately, its loan collateral. In some instances, these lenders also may require that their single-asset borrower be structured as a "bankruptcy remote entity" so that the bankruptcy of an affiliated company or primary investor unintentionally will not draw their borrower and collateral into the bankruptcy proceedings. These single asset entities sometimes are referred to as "special purpose entities."

Second, many equity investors and mezzanine debt lenders are specialized highly and only will invest funds in certain defined types of real estate that are capable of producing either long- or short-term returns. For example, an equity investor who traditionally invests in strip center retail may desire a low risk, constant return over many years, which only a big box retail lease may provide. Similarly, some mezzanine lenders desire only high-rate returns on their loans in which the loan must be repaid on a short-term basis with an identifiable exit strategy by the developer. Accordingly, just as a developer may find many mortgage lenders interested only in financing a specific portion of its mixed-use project, the same may hold true for equity investors. Such investors and mezzanine debt lenders only will want to invest in a single purpose entity tied to the specific use and real estate parcel of