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INNOVATIVE FINANCING

Why Banks Should Look At Equity Stakes In CRE

Big Payday Could Bolster Building Balance Sheet, Business Relationships

BY GARY MARKOFF | SPECIAL TO BANKER & TRADESMAN

Consider this unlikely scenario: A major national full service bank, unwilling to make real estate loans -- even to its best customers -- above 50 percent of appraised value, nonetheless decides to take an equity position in the projects of its best customers. As a result, these projects manage to get up to 90 percent of their total capital needs satisfied through an innovative combination of mortgage loans and equity investments—sometimes through the bank and its own equity affiliate.

What advantage could such an arrangement possibly offer a bank? For one thing, this type of equity investment would allow the bank to maintain and enhance good will with its best customers. When the economy finally turns upward, those customers should feel a sense of loyalty to their equity partner who stood by them in these stressful times; the notion being that they will be less likely to develop wandering eyes for competing lenders. Then, too, by only offering these kinds of deals to its very best customers, with proven track records, the bank participates in potentially lucrative ventures in a manner that manages risk. In other words, the bank can make money.

Arms Trading

Such an approach could be used for new projects or for deals in need of recapitalizing in today's tight credit markets. In many cases, the equity investment could be in a deal with a mortgage loan placed with an entirely separate banking institution. But since the debt and the equity of these deals are underwritten separately and through separate legal entities, the mortgage lender's affiliate could just as easily end up with an investment in a project also debt-financed by a different arm of the same bank.

Some retail banks may find that too close for comfort, and the potential risks unacceptable. Bankruptcies remain a continuing problem. If the borrower goes bankrupt, a creditors' committee, the debtor, or other interested party could argue that the two forms of financing, one from the bank, and the other from an affiliate should all be re-characterized and lumped together and treated as equity. If that argument held up in bankruptcy court, the bank would lose its favored position as a secured creditor.

But while the risk is real, there are ways of structuring the financing to minimize any potential downside. For one thing, most banks providing a loan in a major real estate project require that the borrowing entity be a single asset, single purpose entity, or commonly referred to as an SPE (Special Purpose Entity). That should limit the number of unsecured creditors who could possibly raise the doctrine of equitable subordination which would treat the bank's loan as equity causing.

The SPE, moreover, should have a relatively limited amount of unsecured debt. If bankruptcy did occur, the amount of unsecured debt would likely be small enough to allow the bank—either as lender or investor—to buy the unsecured debt at some percentage of face value.

Equal Standing

At first blush, this arrangement may seem like a way for a bank to get preferential treatment for its equity investment particularly when the bank is also the mortgage lender. In those situations, banks need to be careful not to overreach, since that could blur the line between equity and debt and leave these deals open to legal challenge. Instead, banks could structure these deals so that equity repayment is proportionate to its share in the deal and be treated the same as equity of the other investors, including the sponsor.

These deals, however, aren't just hypothetical. Already a couple of national retail banks are quietly making use of equity ownership in their borrowers' real estate ventures to both solidify their customer base and make money.

This approach, however, should only be considered by banks that have successfully weathered the financial crisis and have sufficient capital to invest. Banks able to innovate in this way may be laying the groundwork for a new way of doing business in tight credit markets which should put them in good stead when the good times come back, none too soon to be sure.

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