

Hotel Financing Structures and Options in the Hospitality Industry Upswing

Leveraging CMBS Capital Market Financing, Preferred Equity, Tax Credit Funds and EB-5 Financing

TUESDAY, SEPTEMBER 23, 2014

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Today's faculty features:

Bradley Kaplan, Partner, **Ulmer & Berne**, Cincinnati

Guy Maisnik, Partner, **Jeffer Mangels Butler & Mitchell**, Los Angeles

Jonathan Falik, Founder and CEO, **JF Capital Advisors**, New York

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HOTEL FINANCING STRUCTURES AND OPTIONS IN THE HOSPITALITY INDUSTRY UPSWING

September 23, 2014 Webinar

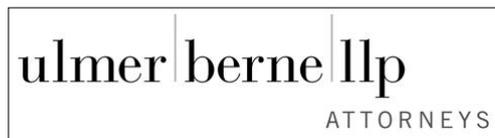
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Jonathan Falik
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Jonathan Falik is the Founder and Chief Executive Officer of JF Capital Advisors. Mr. Falik leads the firm's hospitality business, which includes equity and debt placement, asset acquisitions and dispositions, portfolio transactions, joint venture structuring, asset management, management company and brand evaluation, and strategic and capital markets advisory services.

Mr. Falik was a Senior Managing Director and the Head of Hospitality Capital Markets at BGC Real Estate Capital Markets. Simultaneously, Mr. Falik was the Head of Hotel Investment Sales for Newmark Grubb Knight Frank. Previously, Mr. Falik was a Managing Director and Head of the Lodging and Leisure Investment Banking group at Cantor Fitzgerald & Co.

Prior to joining Cantor Fitzgerald, Mr. Falik was the founder and CEO of JF Capital Advisors, a lodging advisory and principal investment firm. While at JF Capital, Mr. Falik led the acquisition or development of 25 hotels with over 5,500 keys and an aggregate cost of approximately \$1 billion. Additionally, Mr. Falik was the CEO of Eagle Hospitality Trust, a 13 hotel-property private REIT. Mr. Falik has led the sales of single assets and portfolios of 88 hotels for over \$2.2 billion of value. Prior to founding JF Capital in 2004, Mr. Falik was an investment banker at Bear Stearns in the Gaming, Lodging and Leisure Group. Mr. Falik began his career as a CPA at Price Waterhouse.

Mr. Falik has over 20 years of experience in the real estate and lodging sector. He has worked on numerous M&A and financing transactions involving well over 2,000 hotels and over \$25 billion of transaction value. He has been actively involved with mergers and acquisitions of public and private companies, portfolio sales and single asset sales, equity financings, high yield financings and mortgage financings. Mr. Falik has extensive hospitality experience as an agent, advisor, principal, owner, borrower, guarantor, franchisee, lender and asset manager.

Mr. Falik received a BA in economics with high honors from Rutgers College and an MBA from Columbia Business School with a concentration in Real Estate Finance. Mr. Falik has been an adjunct professor at NYU's Real Estate Institute and is an active lecturer and panelist at industry events.

Bradley D. Kaplan

Partner
Ulmer & Berne LLP



Brad assists Owners, Operators and Receivers of Hotel, Office and Industrial properties with their Real Estate, Finance, Leasing, Construction and Organizational challenges; specifically, negotiating and drafting hospitality, purchase, sale, financing, leasing, construction, franchise and management agreements. He has in the past and presently serves as general counsel and national real estate counsel to several domestic and internationally based public and privately held companies. Brad represents foreign businesses doing business in the United States and U.S. businesses doing business abroad; and is a former Chairman of World Services Group (www.worldservicesgroup.com) an international consortium of legal and other professionals.

Brad has achieved the highest rating, AV Preeminent®, from Martindale-Hubbell®. He is an active member of the Illinois Bar and maintains an office in both the firm's Cincinnati and Chicago offices.

Brad is the editor of the Real Estate Advisor Law blog (www.realestateadvisorlawblog.com), a tool that highlights articles and observations of Ulmer & Berne attorneys on various trends and opportunities affecting the commercial real estate and construction industry, and is a frequent speaker on internet and social media issues.

Brad has extensive experience negotiating, drafting, and managing all legal aspects of hospitality, commercial/industrial and residential real estate projects. Additionally, he is an expert at providing legal counsel to domestic and international manufacturing concerns doing business in the United States.

Brad is a graduate of Indiana University, where holds a B.A. in Economics. Brad also holds a J.D. from Capital University Law School.

Guy Maisnik

Partner, Vice Chair Global
Hospitality Group
Jeffer Mangels Butler &
Mitchell LLP



Guy Maisnik has nearly three decades of commercial real estate finance with a strong expertise in hotels. He is a partner and Vice Chair of JMBM's Global Hospitality Group®, a senior member of JMBM's Chinese Investment Group, and a partner in the Real Estate Department. Guy advises clients on hospitality transactions, representing lenders, opportunity funds, banks, special servicers, owners, REITs and developers in hotel transactions, including senior mezzanine and project financing, workout and debt restructure, co-lender, participation and securitization arrangements, joint ventures, management agreements, buying, selling and ground leasing of hotels, complex mixed used resort development, fractional and timeshare. For troubled hotels, Guy develops and executes strategies for CMBS and whole loans, and REOs. He also assists investors with recapitalization of distressed borrowers and purchases of troubled assets. Guy has also assisted many lenders in recapitalization and structuring their hotel lending programs and documentation.

Guy's practice is both domestic and foreign, where he has advised on matters throughout the United States, Mexico, Canada, South America, Caribbean, Eastern and Western Europe, Australia, Middle East and Asia. He has been recognized in *The Best Lawyers in America*®, *California Real Estate Journal's* Best Real Estate Lawyers, *Los Angeles magazine's* Top Southern California Lawyers, as well as a Top Real Estate Lawyer in *Real Estate Southern California* magazine.

Guy is a graduate of University of California, Santa Barbara and holds a J.D. from Loyola Law School.

1. PRE-RECESSION/RECESSION

CLEANING OUT DISTRESSED PROPERTIES AND LOANS

- Recession expectations were that there would be substantial opportunities to acquire distressed debt and distressed assets
- Most lenders embraced the “Extend and Pretend” strategy
- RevPAR and NOI steadily increased, liquidity in the debt and equity markets also increased
- Currently only a limited number of hotel assets and hotel portfolios in special servicing
- Substantial CMBS maturities (approximately \$750 billion) are coming in 2015 – 2017 as 10 year CMBS loans issued at the height of the market come to maturity.
 - Many of these maturing loans will be challenging to refinance at the same leverage or proceeds levels

EASY MONEY

- For stabilized cash flowing assets, “debt is on sale”
- The CMBS market has re-emerged aggressively
- Banks are making loans; specialty finance companies and mortgage REITs are actively and aggressively lending
- 10 year treasury yields currently at around 2.5% are well below their long term historical averages
- With 70% leverage and a 6% in place yield, an investor can achieve an 11 - 12% leveraged return on an investment
- CMBS loans are generally being quoted at a 10% debt yield which approximates 65 – 68% LTV
 - Coupons are approximately 5%

2. CURRENT AVAILABLE SOURCES OF FINANCING

PRIVATE INVESTOR DOLLARS (PRIVATE EQUITY)

- Substantial amounts of private equity funds have been raised focused on all real estate classes, including some that are solely Hospitality focused
- Private equity investors are generally seeking 20% leveraged IRRs through the larger funds are generally structured with a 20% promote over a 9% preferred return
- Deals are being fueled by:
 - Attractively priced debt financing
 - RevPar growth well above long term historical averages
 - Muted supply growth in most markets
- Private equity investors have been especially active pursuing portfolio transactions

PRIVATE INVESTOR DOLLARS (PRIVATE EQUITY)

- Real estate private equity funds have raised more capital in any year other than 2008.
- Real estate investors have been deploying significant amounts of capital (over \$200 billion in the last 2 years)
- Real estate private equity funds have also exited / divested of significant holdings.
- Real estate private equity funds raised \$76 billion in 2013, \$67 billion in 2012 and \$64 billion in 2011.
- 55 percent of "allocators" are below their target allocations to real estate.

PRIVATE INVESTOR DOLLARS (PREFERRED EQUITY)

- There is a structural difference between private equity and preferred equity
- Private equity is looking for highly opportunistic returns
 - Targeting 20% levered IRR's
 - Willing to accept 16 -18% levered IRR's in top markets
- Preferred equity is structurally senior to common equity or sponsor and as such commands a lesser return
- Many historical private equity investors are making preferred equity and mezzanine debt investments
 - The return for preferred equity is more attractive to certain investors on a risk adjusted basis
- Preferred Equity is looking for opportunistic returns
 - Targeting 14-17% levered IRR's
 - Willing to accept 12-14% levered IRRs in top markets
 - Expecting mandatory redemption usually after 3-5 years

PUBLIC REITS AND PUBLIC C-CORPS

- Public hotel companies generated 18% returns year to date, and 23% returns over the last 12 months
 - This compares to the S&P 500 of 7.6% YTD, and 19% over the last 12 months
- The C-Corps generally do not acquire assets and the REITs have been acquiring selectively
 - During 2014, REITS have acquired over 119 hotels
- The size of the public REIT universe is smaller than the size of Apple or Microsoft

TAX CREDIT FUNDS (NEW MARKET/HISTORIC TAX CREDITS)

- Tax credit funds or financing can substantially enhance returns or facilitate a transactions
- Tax credits require substantial amounts of legal structuring
- Tax credit structures often require certain holding periods, restrictions on refinancing and on property sales
- Many municipalities provide TIF financing or tax abatements in order to stimulate economic development and growth

EB-5 FINANCING

- EB-5 financing can substantially enhance project returns by introducing very low cost medium term capital
- It is difficult to time the start of the start of a project to coincide with the EB-5 capital raising and the ultimate investor approval process
- EB-5 is well suited for hotel development which creates substantial amounts of new jobs (especially due to significant labor involved in Food & Beverage)
- EB-5 investors tend to be attracted to luxury projects, major gateway markets and major international brands

WHAT IS THE EB-5 INVESTOR VISA PROGRAM?

- a. Employment Based immigration category 5
- b. Permits any investor in a business that can reasonably demonstrate the probability of creating at least 10 new, permanent, full-time jobs to receive a 2-year conditional visa upon filing an I-526 visa petition
- c. Permits any investor who invested in such a business and can show that the jobs have been created within 2.5 years from entering the U.S. to receive a permanent visa (i.e., green card) upon filing an I-829 visa petition
- d. The investor can receive these visas for themselves, their spouse and all children under the age of 21 - all for one investment
- e. Originally adopted in 1992, but not used significantly until 2009 -- usage began increasing after U.S. financial crisis in 2008
- f. Annual U.S. quota of 10,000 visas. The EB-5 program did not become popular until 2009 when the Congress decided to add construction jobs to the eligible employment created by EB-5 projects to make the visa application easier.

WHAT ARE THE REQUIREMENTS TO BE ELIGIBLE FOR EB-5 INVESTOR VISAS?

- a. Investment amount - \$1,000,000 minimum, unless project is in a "targeted employment area" ("TEA") defined as a geographic area with over 150% of the national unemployment average, in which case investment amount is \$500,000 minimum
 - i. each state is allowed to designate its own TEAs - and some states (like New York and Florida) are more flexible than others (like California)
 - ii. almost all EB-5 investments are sold at the \$500,000 level - competitive market conditions make it very difficult to sell at the \$1,000,000 level in the broad market

WHAT ARE THE REQUIREMENTS TO BE ELIGIBLE FOR EB-5 INVESTOR VISAS?

- b. Job creation - Each investment (whether \$1,000,000 or \$500,000) must show at least 10 new, permanent, full-time jobs will be created as a result of the project
 1. Without a Regional Center, project owner must itself be the employer of all eligible employees
 2. With a Regional Center, jobs are estimated using one of 4 approved economic models (Implan and RIMS II are most popular), and jobs may direct and indirect - resulting in substantially higher job counts than direct investments
 3. jobs must be permanent - so direct construction jobs are typically not counted because they are not considered permanent (unless the project takes over 2 years to complete - which must be proven to satisfaction of USCIS)
 4. Jobs must be full time - can split a job, but cannot count "part-time" employees

WHAT ARE THE REQUIREMENTS TO BE ELIGIBLE FOR EB-5 INVESTOR VISAS?

- c. Participation in business - EB-5 investors must participate in the business - unless they are limited partners of a limited partnership or members of a limited liability operating company in which they have the rights typically accorded a limited partner or member.
- d. Exit strategy - not a legal requirement, but investors are looking for clear way to receive their money back in about 5 years
 - i. EB-5 investment must stay invested and "at risk" until EB-5 investors receive I-829 approvals
 - ii. EB-5 investment can be paid through sale or refinancing

WHAT ARE THE REQUIREMENTS TO BE ELIGIBLE FOR EB-5 INVESTOR VISAS?

v. Tenant occupancy issue - USCIS used to allow jobs of tenants to be counted (which worked for office buildings and retail shopping centers), but then changed its policy last year

- (1) USCIS December 2012 Policy Memo states that project developer must show reasonable evidence that the project will "facilitate" the creation of new jobs that would otherwise not be created in the area
- (2) USCIS has not yet shown any examples of the kind of evidence it will deem satisfactory on this issue
- (3) it might include "build-to-suit" projects where the developer is building for a particular tenant with special requirements
- (4) it might include a geographic area that has no shopping area (maybe a large grocery store?)
- (5) appraisers will be needed to show that there are no suitable alternatives to building a project to create the jobs

WHAT ARE THE REQUIREMENTS TO BE ELIGIBLE FOR EB-5 INVESTOR VISAS?

vi. Hotel guest expenditure issue - USCIS used to allow jobs created as a result of hotel guests spending in the local area on other goods and services, but then changed its policy last year

- 1) USCIS began issuing "Requests for Evidence" ("RFEs") asking project developers to explain how a new hotel was creating new guest expenditures rather than simply taking existing guests from other local hotel, which do not create new guest expenditures
- 2) Project developers need to show that there is excess demand in a given local market that cannot be accommodated by existing hotels in the area
- 3) We have filed a presentation with the USCIS with a demand study that provides the evidence we believe should demonstrate that new guests are being accommodated - but USCIS has not responded.
- 4) this is a big issue for large hotel projects, because often times the only way to raise large amounts of EB-5 capital is by using jobs created by guest expenditures

WHAT ARE THE TYPICAL PROJECTS FINANCED?

- a. In the past, many different types of projects - Vermont ski resort (Jay Peak), dairy operations, meat packing plant, office developments, infrastructure projects (California in particular before 2008)
- b. Today, projects that attract EB-5 investors:
 - i. brand names, high employment, reasonably predictable development and lifespan, in good markets, with reasonable probability of sale or refinancing in about 5 -6 years.

WHAT ARE THE TYPICAL PROJECTS FINANCED?

- a. JMBM's "preferred" EB-5 financing program for developers and projects:
 - i. Experienced developer with a strong track record and a solid project that can qualify for "preferred" status.
 - ii. Project cost (or the cost of a series of projects) is at least \$50-60 million (so that 30 to 40% of the total project cost provided by EB-5 financing will meet the minimum of \$20-\$25 million for our preferred EB-5 capital raise).
 - iii. The project's capital stack could benefit from mezzanine financing with an all in cost to the developer of 5 to 7% per annum
 - iv. Except for the EB-5 financing portion (of 30 to 40% of the capital stack), the rest of the capital stack is in place or can be confirmed prior to the EB-5 offering
 - v. The project involves real estate development or redevelopment, preferably in preferred types of real estate such as hotel, restaurant, resort, spa, and senior living, or mixed-use projects involving such components
 - vi. The project's EB-5 calculation of new jobs created will support the amount of EB-5 financing desired

WHAT ARE THE TYPICAL PROJECTS FINANCED?

- vii. The project shows great potential for "EB-5 fundamentals"
- xiii. The project has strong economic fundamentals showing ability to pay back the EB-5 financing at the end of the 5 or 6 year term
- ix. Takes 6 to 8 months to complete funding from signing the deal with the financing source
- x. May be structured as debt or preferred equity

WHAT ARE THE TYPICAL PROJECTS FINANCED?

Projects that are not good for EB-5:

- i. High tech startups - too risky - jobs might not be there in 2-3 years when investors file I-829 visas, money might not be there in 5 years
- ii. Existing businesses - unless they meet the definition of "troubled business", in which cases jobs "saved" are counted as new jobs:
 - "Troubled business" means an existing business that experienced net losses over the last 12 or 24 months equal to at least 20% of the net worth of the business
- iii. Office and Retail Developments - unless they can show the development "facilities" jobs that would otherwise not be created
- iv. Residential construction - not enough jobs unless construction project goes on for more than 2 years

WHERE DOES THE MONEY COME FROM?

- a) China - nearly 85% of all EB-5 visas today are issued to investors from China
- b) Anywhere else in the world - there are no restrictions or quotas
- c) Every investor must show proof of "validity of funds" - usually done through a report issued by a firm in China (PKF Shanghai is a large provider of these reports)
 - i. funds can be from sale of a business, sale of property, gift, inheritance - anything that is legal

HOW ARE THE PROJECTS “PUT TOGETHER?”

- a) In the past, there were few approved Regional Centers, and they would buy land for their own projects - office building, warehouse, hotel, ski resort (Jay Peak); there were a few film finance deals (CanAm did large studio loans secured by studio real estate)
- b) Today, there are many project developers actively seeking EB-5 investments for their projects - they seek out Regional Centers to sponsor their projects
 - i. Typical EB-5 project path is to:
 1. determine if project is in a TEA
 2. determine how many jobs could be created to set the EB-5 maximum amount (this is where appraisers may be needed to support analysis of tenant occupancy or excess hotel demand)
 3. determine where the other sources of financing will come from (if project developer will contribute land as its equity in project, need appraiser to set the value of the developer's equity)
 4. find and negotiate sponsorship with a Regional Center

HOW ARE THE PROJECTS “PUT TOGETHER?”

5. prepare EB-5 offering documents (PPM, Partnership Agreement or Operating Agreement, Subscription Agreement, Escrow Agreement)
6. take project to market
8. investors file I-526 applications - 6 to 8 month processing time for each
9. take money out of escrow sometime between date money is deposited and date I-526 petitions are approved (terms vary)
10. build project
11. three years later - provide documentation of project completion and job creation for I-829 applications
12. pay back investors in about 5 years

HOW ARE THE PROJECTS “PUT TOGETHER?”

- ii. Typical cost to project developer - about \$100,000 transaction costs (for developer's and Regional Center's attorneys, economic report, business plan), plus 5% to 7% per year preferred return or interest on EB-5 investment (split between Regional Center, marketing agents, and a small amount to EB-5 investors)
- iii. Typical time line - 9 to 12 months - to complete steps (1) - (8) above

ARE EB-5 PROJECTS EVER FINANCED? IN OTHER WORDS, IS EB-5 MONEY AN ALL CASH INVESTOR?

- a) 100% of every EB-5 investors must be invested before the investor can file the I-526 petition
- b) money could potentially be from a loan, but it is rarely characterized that way in visa petition - usually a gift

WHO ARE THE LENDERS THAT PARTICIPATE? DO THEY HAVE DIFFERENT UNDERWRITING CRITERIA FOR EB-5 FINANCED PROJECTS?

- a) Some commercial lenders will make a senior secured loan with EB-5 financing structured as preferred equity
- b) Commercial lenders do not want mezzanine loans on secured property, so EB-5 financing of bigger projects that comes in as 20%-30% of project financing will usually be structured as preferred equity with a 5 year redemption right
- c) Some EB-5 financings are structured as senior secured loans - where EB-5 financing represents more than 50% of total financing (this only works for projects financed through Regional Centers - not direct EB-5 offerings)

HOW WOULD EB-5 AFFECT VALUE, IF AT ALL?

- a) EB-5 financing is not different than a loan or preferred equity due in 5 years, so should not affect value of property

ARE THERE SPECIAL CONSIDERATIONS AND REQUIREMENTS WHEN VALUING A PROJECT FINANCED BY EB-5 MONEY?

- a) Not for land valuation
- b) For excess demand or "facilitation analysis" used to determine job creation, must establish a methodology that is acceptable to USCIS - this is still a "work in progress"

3. CMBS CAPITAL MARKETS FINANCING

CMBS CAPITAL MARKETS FINANCING

- After grinding to a halt, in 2009, the CMBS market has re-emerged
- CMBS market is hot for cash flowing assets
- Fixed rate CMBS market is underwriting debt yields (NOI divided by debt balance) of 9.5-11% which translates to about 65-69% LTV. CMBS loans are getting done at 4.75-5.5% interest rates in the 10 year fixed rate market. These interest rates may tick up a little with higher interest rates
- Underwriters are getting more aggressive on pricing, but for hotels are thorough on underwriting standards — Not sloppy, but definitely more aggressive for strong sponsors/owners and for good quality cash flowing deals
- Floating rate CMBS and non-CMBS loans getting done at 70-75% and in some cases just shy of 80%, at what looks like a 5 year loan with 1 point in (origination fee), 1 point (exit fee) out and 30 day LIBOR +350-500 bps

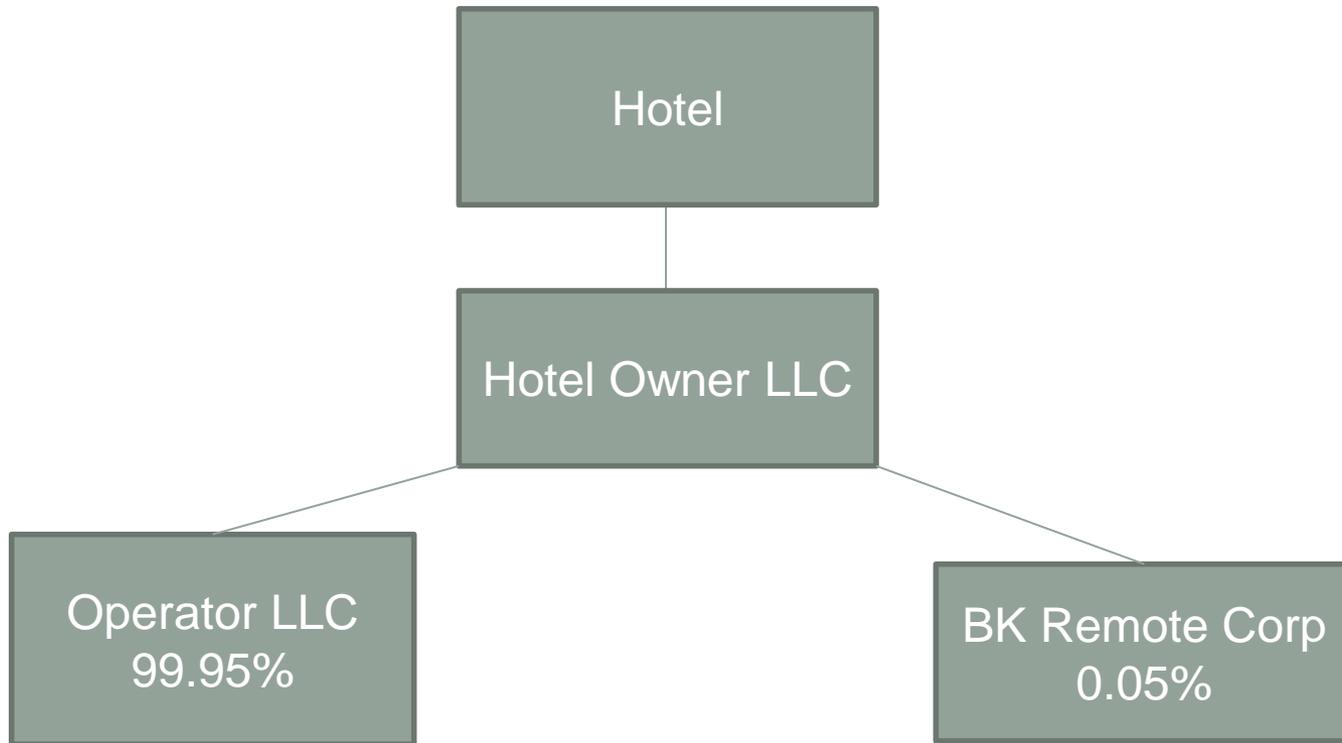
4. CMBS TYPE LOAN STRUCTURES AND REQUIREMENTS

BANKRUPTCY REMOTE ENTITIES

Purpose:

- Insulate project entity (special purpose entity “SPE”) to only the liabilities of the subject property
- Insert separateness covenants into borrower designed to ensure borrower will not be consolidated or file for bankruptcy protection.

BASIC BANKRUPTCY REMOTE ORGANIZATIONAL STRUCTURE



SEPARATENESS COVENANTS

- Insert in Operating Agreements/By-Laws/Partnership Agreement
- Restrictions on additional indebtedness
- Limitations on purpose of SPE
- Prohibition on consolidation, liquidation, sale of assets
- To maintain books and records separate from any other person or entity;
- To maintain its accounts separate from any other person or entity;
- Not to commingle assets with those of any other entity;
- To conduct its own business in its own name;
- To maintain separate financial statements;
- To pay its own liabilities out of its own funds;
- To observe all partnership formalities;
- To maintain an arm's-length relationship with its affiliates;
- To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;
- Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;
- Not to acquire obligations or securities of its partners, members, or shareholders;
- To allocate fairly and reasonably any overhead for shared office space;
- To use separate stationery, invoices, and checks;
- Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity;
- To hold itself out as a separate entity;
- To correct any known misunderstanding regarding its separate identity;
- To maintain adequate capital for contemplated business operations.

INDEPENDENT DIRECTOR

- Required to protect against a voluntary bankruptcy petition being filed by the shareholder, member, partner, director or managers (as applicable) of a subject SPE
- Definition of “Independent Director”: A duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment or at any time while serving as a director or manager of the relevant entity and may not have been at any time in the preceding five years, any of the following:
 - A direct or indirect legal or beneficial owner in such entity or any of its affiliates;
 - A creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or any of its affiliates; or

INDEPENDENT DIRECTOR

- A person who controls (whether directly, indirectly, or otherwise) such entity or any of its affiliates, or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.

Two cases worth noting on Independent Director issues:

- Kingston Square Associates, et al., 214 B.R. 713 (Bankr. S.D.N.Y. 1997)
- General Growth Properties, Inc. et al. CH. 11 Case #09-11977 (Bankr. S.D.N.Y. 2009)

CMBS – IT'S ABOUT THE RATING AGENCIES AND POOLING AND SERVICE AGREEMENTS

- CMBS loans – significant differences in origination from other permanent loan.
- Target asset types - stabilized commercial properties.
- CMBS loans are not intended to be held by the originating financial institutions.
- Are transferred into a real estate mortgage investment conduit trust pool of other qualified mortgage loans.
- Each pool is divided into separate tranches of securities.
- The securities are priced according to the risk by the rating agencies.
- Each tranche is sold to institutional investors. Originator's capital is recycled and reallocated to additional CMBS loans.
- Loan originator makes about 100 representations and warranties regarding loan structure, due diligence and legal issues.

CMBS – IT'S ABOUT THE RATING AGENCIES AND POOLING AND SERVICE AGREEMENTS

- Representations and warranties and the lack thereof are key in determining the risk rating of a particular asset within a pool - Key is that the pool assets do not breach REMIC tax rules.
- Breach of a representation may require an originator to repurchase the faulty loan. Further, breach of a REMIC tax rule can taint an entire loan pool subjecting it to 100% tax.
- Each loan within a loan pool is governed by pooling and service agreement. The pooling and service agreement is primarily designed to prevent an event that could violate the REMIC's special tax treatment.
- Initially, the pool is managed and administered by a master service - collects mortgage payments, handles accounting, divides debt service payments, pays pool expenses, works directly with borrowers for loan administration matters.
- If an actual or imminently likely default, the servicing of an individual loan will be transferred from the master servicer to a special servicer which has greater flexibility to resolve issues and exercise remedies than the Master Servicer.

COMFORT LETTERS

- Comfort letters don't always provide real "comfort"
- To continue operations pursuant to the comfort letter, the lender or owner may be required to fund significant amounts of capital expenditures in order to be compliant with brand standards and even to satisfy normal course operating and working capital need

5. TAX CREDITS

WHAT ARE THE DIFFERENT TYPES OF CREDITS AVAILABLE FOR REAL ESTATE PROJECTS?

- Federal Historic Tax Credits
- State Historic Tax Credits
- Federal New Market Tax Credits
- State New Market Tax Credits
- Low Income Housing Tax Credits
- Facade and Lost Development Easements
- Renewable Energy Credits

WHAT IS A TAX CREDIT?

- An indirect federal or state subsidy used to finance rehabilitation of historic and older buildings, low income housing or projects in depressed areas, or renewable energy projects
- Eligible taxpayers receive the subsidy by claiming a dollar for dollar tax credit against tax liability and in some cases receive a refund
- It is not a tax deduction, unlike the easements

FEDERAL NEW MARKET TAX CREDIT

- The New Market Tax Credit Program was established in 2000 by Congress and administered through the Community Development Institutions Fund of the US Dept. of Treasury
- Designed to energize investment in low-income communities through operating businesses
- The NMTC Program attracts investment capital into low income communities by permitting investors to receive a tax credit against their Federal business tax return in exchange for making equity investments in specialized financial institutions called Community Development Entities or CDE's
- CDE's must be certified and are usually found operated by Lenders IRC §45D9(c)(1)
- CDE's apply for NMTC allocations to offer its investors in exchange for interest in the CDE
- A 39% credit taken over 7 years for qualified investments made in a qualified census tract (5% in years 1-3 and 6% in years 4-7) to a qualified business

FEDERAL NEW MARKET TAX CREDIT

- The allocates / CDE's cannot control the Qualified Active Low-Income Community Business (QALICB) so most of the investment comes in as subordinate debt that is forgiven at the end of the 7-year recapture period
- No more than 80% of revenue can come from the rental of housing
- Cannot be combined with LIHTC
- Qualified census tracts are where poverty rate exceeds 20% or median income is below 80% of state or metropolitan median income
- QALICB rules are complicated, but must be an active business, usually real estate related and subject to non qualified financial property rules
- Subject to allocation at the federal level to CDE's – very competitive

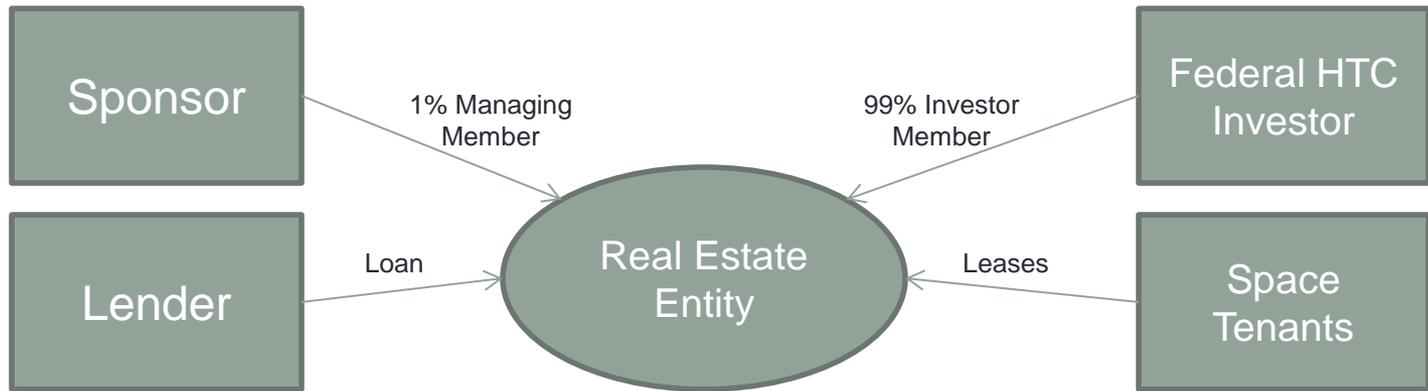
STATE NEW MARKET TAX CREDITS

- Similar to federal, except no more than 15% of revenue can come from the rental of real estate / targeted to end users (i.e., corporate headquarters or theatre renovations)
- First 2 years no credit and the rest is accelerated over the remaining 5 years so the PV discount is greater than the FNMTTC
- Capped at approximately \$2,500,000 in investment or \$1,000,000 in credit per project or \$550,000 in debt / equity
- \$10,000,000 state max per year
- Allocations have been awarded to CDE's that have a federal allocation
- It is a 7 year program

FEDERAL HISTORIC TAX CREDIT

- 20% or 10% credit against QRE's (qualified rehabilitation expenditures) for "certified historic structures"
- Credit claimed when building is placed in service
- No allocation process as long as it meets the Secretary of Interior Standards
- Not for acquisition costs
- Must be an historic landmark on the National Register or a contributing factor in an historic district (Part 1 approval)

SINGLE-ENTITY FEDERAL HTC STRUCTURE



STATE HISTORIC TAX CREDIT

- Established in 1976.
- Owners of historic properties can obtain partial financing for the costs of renovations, rehabilitations and restoration of certified historic properties by selling the “credits” to a third party (many instances through a national bank).
- Administered by the National Park Service within the US Dept. of the Interior and the Internal Revenue Service in partnership with state historic preservation offices.
- Benefit = up to 20% of the Qualified Renovation expense (QRE) for certified historic, 10% of non-certified historic.

STATE HISTORIC TAX CREDIT

- Each year each state allocates/authorizes funds for state HTC's
- 25% credit / refunds against the same QRE's
- Capped at \$5,000,000 with \$3,000,000 refund cap (\$20,000,000 rehab) and the balance is a credit that can be carried forward or back
- 100% refundable if CAT tax payer
- Credit against taxes and then refund
- The refunds or loss of deduction makes it subject to federal income tax (assume a 35% tax rate)
- Subject to an application and award process twice a year – awards based in large part on economic impact

INVESTOR BENEFITS OF HTCS

- Tax Benefits:
 - Immediate tax credit delivery upon placement in service of the building.
 - One year credit carry back; twenty-year carry forward for unused credits.
 - Credits can offset alternative minimum tax.
 - Credit prices vary based on market conditions. After-tax yields vary based on market conditions and equity pay-in schedule (often based upon achievement of various development, and financing benchmarks).

INVESTOR BENEFITS OF HTCS

- Social Benefits:
 - Community Reinvestment Act qualification potential, depending on location of building for banks and savings associations.
 - Some projects may be considered green or socially-responsible investments.
- Cash Distributions:
 - Most investments feature a modest cash return.
- Financial Reporting:
 - Transactions may be structured so that depreciation is allocated to the building owner rather than the investor.

KEY CONSIDERATIONS

- “Certified Rehabilitation” of a Historic Structure IRS § 47(c)(2)(B) & (C) Treas. Reg. § 1.48-12(d) application is made to the NPS through the State Historic Preservation offices.
- The rehabilitation must be consistent with the historic character of the structure and/or the applicable historic district.
- Generally, the developer has 24 months to get the project in service.

HOW AND WHEN DO YOU TURN A TAX CREDIT INTO CASH FOR YOUR PROJECT?

- For FHTC you need to identify an investor who has tax liability to shield and is not subject to the passive activity loss rules. They will pay between \$.85-.95 cents on the dollar of credit in return for being allocated the credits. Generally speaking these investors are large C corporations and banks because of passive activity loss rules, community reinvestment act requirements and the size of the tax liability to be shielded
- SHTC bring about \$.55 on the dollar
- The investors become passive members in the for-profit fee simple owner or master tenant in the case of a pass through of the credits
- The entity is a single purpose entity (SPE) LLC set up for this project only
- At the end of 5 years in the case of FHTC the investor is bought out for a predetermined or FMV price through a call / put agreement

HISTORIC TAX CREDIT STRUCTURES

- Can be a direct investment into the fee simple owner but due to foreclosure / recapture risks most deals are structured as a master lease pass through
- A master lease pass through brings the investment in through a master tenant who is allocated the credits
- Investor wants SNDA with limited foreclosure rights

HISTORIC TAX CREDIT ISSUES

- For profit entities are easier to work with
- It is best if the same investor is allocated the state and federal credits
- Boardwalk case (*Historic Boardwalk Hall LLC v. Commissioner*, 136 T.C. 1 (2011), Doc 2011-80, 2011 TNT 2-15 rev'd, No. 11-1832 (3rd Circuit 2012), Doc 2012-18101.2012 TNT 167-7) has created the need for real economic substance to the investor's investment, not just the allocation of the tax credits

MIXING CREDITS

- Very complicated, but you can do multiple credit transactions. The bigger the project the more they make sense (\$7 million at least)
- The easiest credits to combine are the federal and state historic. Historic credits are often combined with new market tax credits depending on their location
- If you successfully combine credits it can account for 50% or more of the total project financing

FACADE AND LOST DEVELOPMENT EASEMENTS (PRESERVATION EASEMENTS)

- Unlike credits, these easements create a charitable contribution deduction equal to the value of the easement (approximately 35% of the value of the donation)
- Must be used on an historic building
- Facade easements are based on a percentage of the value of the building (approximately 13%)
- Lost development is based upon the lost potential from the site. For example, the difference between the cost to build condos on top and the price at which they could be sold
- Lots of audits and very limited market, but deals are getting done
- Need full working drawings, market study, appraisal and the legal and physical ability to build up

RENEWABLE ENERGY CREDITS

- 30% Investment Tax Credit
- Eligible projects are:
 - Solar
 - Wind
 - Geothermal
- Captive solar companies are an option for large real estate holdings
- Substantially fewer tranches of subordinate or mezzanine debt than in last up-cycle leading to simplified overall capital structures
- Subordinations
- Collateral assignments



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