THERE'S MORE THAN MEETS THE EYE WITH HARD MONEY - Borrowers should look closely at the numbers when comparing joint-venture equity to hard money.

When choosing between these options potential borrowers must carefully analyze the numbers. Many borrowers do not want to pay the interest rates associated with hard money and think joint-venture equity may be the better option and you may be surprised at what hard-money financing can offer.

There is a strong case to be made for the use of a hard-money lender instead of joint-venture equity. Three main advantages of a hard-money loan are:

**Short-term deals:** A joint-venture equity partner retains ownership in the property for the life of the deal, whereas a hard-money loan generally is paid off in one to three years.

**Quick funding:** Joint-venture equity deals are complicated and difficult to get completed and documented quickly, but many hard-money lenders can close quickly.

**High return on investment:** The return on investment to the borrower can be considerably higher with a hard-money loan.

For example: A borrower wanted to acquire a newly constructed retail strip center in a secondary market. The property was completed but not stabilized because the developer could not fund the necessary tenant improvements or leasing commissions. The borrower was in contract to acquire the property at a large discount to the construction cost through a tri-party sale agreement with the developer and lender. The lender did not give the borrower much time for due diligence, forcing the borrower to close quickly.

The borrower first considered using equity partners instead of debt. The borrower in this case was sophisticated, well-educated and experienced. As such, their access to equity capital was abundant and at favorable terms. As the borrower entered discussions with potential equity partners, however, it became clear that a hard-money loan was far less expensive. Even with high-quality, blue-chip borrowers, the potential equity partners wanted about 75 percent of the profits after a preferred return of 10 percent and required the borrowers to contribute 15 percent of the initial capital stack.

In the comparison shown below, the cost of joint-venture equity is compared to the cost of a hard-money loan. In this scenario, the purchase price is $5 million, and after a two-year holding period, the property is sold for $7.2 million with no periodic cash flows from operations. The internal rate of return for this investment scenario is 20 percent.

<table>
<thead>
<tr>
<th>JOINT VENTURE EQUITY</th>
<th>HARD MONEY LOAN</th>
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<tbody>
<tr>
<td>15% borrower cash equity: $750,000</td>
<td>25% borrower cash equity: $1,250,000</td>
</tr>
<tr>
<td>85% JV equity: $4,250,000</td>
<td>75% loan amount: $3,750,000</td>
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<tr>
<td>10% JV equity preferred return: $850,000</td>
<td>15% loan interest: $1,125,000</td>
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<tr>
<td>Profit available: $1,350,000</td>
<td>Profit available: $1,075,000</td>
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<tr>
<td>Profit available: $1,075,000 borrower split</td>
<td>Profit available: $1,075,000 borrower split</td>
</tr>
<tr>
<td>75% joint-equity split: $1,012,500</td>
<td>0% lender split: $0</td>
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<tr>
<td>Total profit for borrower: $337,500</td>
<td>Total profit for borrower: $1,075,000</td>
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<tr>
<td>Borrower annual return: 20%</td>
<td>Borrower annual return: 36%</td>
</tr>
<tr>
<td>Cost of JV equity: $1,862,500 (21%)</td>
<td>Cost of loan: $1,125,000 (15%)</td>
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The all-in cost of the joint-venture equity in this scenario is about 21 percent. The borrower received a sweat-equity component (the difference between the 15 percent capital contribution and the 25 percent ownership) but would own only a portion of the deal and still was required to pay the preferred return to the equity investors.
In the joint-venture equity scenario, the borrower had a cash equity contribution of $750,000, or 15 percent. In the hard-money scenario, the borrower had a cash equity contribution of $1.25 million, which was an additional $500,000 (10 percent).

To break this down further, by contributing an additional 10 percent of the total capital, the borrower could buy back 75 percent of the profits. This increased the borrower’s rate of return from 20 percent in the joint-venture equity scenario to 36 percent in the hard-money scenario.

The typical all-in costs (including points and interest) for hard-money loans generally range from 12 percent to 15 percent. This is a positive leverage scenario to the cost of joint-venture equity. In this particular case, 15 percent was used as the all-in cost of the debt to illustrate that even at the upper end, there is still positive leverage compared to joint-venture equity.

Although not all borrowers can contribute additional capital, there are other potential options. In some cases, lenders may be willing to increase leverage in exchange for an equity kicker (a small participation in the profit realized from the deal). For example, if the borrower could not contribute the additional 10 percent at closing and looked to the lender for those funds, the requested equity kicker may have been between 10 percent and 30 percent, compared to the 75 percent of the deal desired by the joint-venture equity partner.

In addition, although it may be hard to price, many investors would agree that it is valuable to keep ownership of the entire deal and maintain control of the property without having to contend with partnership issues.

When borrowers are considering joint-venture equity as a means to finance a deal, they should ensure all options are explored. A hard-money loan may be more advantageous financing than you may realize.

**REASONS WHY HARD MONEY LOANS MAKE SENSE**

- If you have a non-stabilized property you want to acquire and the banks say NO then hard money is a likely alternative.
- If the property is stabilized but has some major leased rollover exposure many traditional lenders will pass. Hard money lenders will likely take a closer look.
- If you have a loan maturity approaching quickly and traditional lenders can’t close quick enough then hard money may save the day.
- If you need to pull out locked up equity or if your lender pulled out at the midnight hour on an important acquisition then hard money can step in.
- Hard money many times is still cheaper than bringing in an equity partner and sharing the profits with them.
- If you have to close quick hard money lenders can close in time...as long as they have everything they need to close.
- If your lender has agreed to discounted payoff of your existing loan then hard money can finance the payoff.
- If you are a 3rd party investor that wants to buy and finance a discounted note purchase on a property you ultimately want to take control of then consider hard money.
- Less red tape than traditional lenders.
- Hard money lenders will look at traditional commercial properties but they’ll also look at the weird stuff if it makes sense.

Best wishes for a Happy Thanksgiving

Brad

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