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Loan to Own

Seller financing attracts potential buyers in a constrained market.

by Jeffrey A. Usow, JD, and Jade Earl Newburn, JD

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One Capital Structure

50% — Third-party senior lender
30% — Seller financing
20% — Buyer equity

Given the current credit-market constraints, seller financing may be a way to bridge the financing gap facing buyers and sellers in today's commercial real estate market. Seller financing is a transaction in which the seller makes a secured loan to the buyer to finance a portion of a property's purchase price. The two most common forms are traditional mortgage loans, which are secured by a lien on the underlying real estate asset, and mezzanine loans, which are secured by a pledge of the borrowing entity's ownership interests.

Property owners should carefully examine their ability and preparedness to be lenders, their economic motivations for selling particular assets, and the potential seller-financing capital structures.

Lender Requirements

Sellers must satisfy a number of threshold requirements before becoming lenders. They first must review their organizational documents; joint venture, fund, and upper-tier debt agreements; and statutory and regulatory obligations. If they find they are not authorized to make loans, sellers must amend or modify organizational documents or meet any applicable statutory or regulatory obligations.

In addition, sellers must consider if they have the underwriting and monitoring capabilities necessary to effectively service individual loans or a lending portfolio. If not, they must either build internal systems or outsource to appropriate loan servicing agents. In the context of such activities, sellers also must know the laws, regulations, and other legal restrictions that apply to lenders. These include lender licensing requirements and potential lender liability that may arise from real estate loan originations or servicing.

Seller Motivations

Sellers authorized and otherwise prepared to be lenders also should consider their motivations for entering into seller-financing transactions. The key economic questions in any seller-financing transaction are how much cash the seller needs to receive at closing either to pay off existing property-level debt or generate liquidity, how much cash the buyer can pay at the closing, and the assets that the seller may choose to sell.

Assets that are encumbered by little if any property debt have the greatest potential to be sold in seller-financing transactions. However, seller financing is likely to be more challenging if the existing property-level debt is a significant percentage of the property's current value. In theory, the seller could sell a portion of the seller-financed loan at closing or convince the senior lender to accept partial lien payment, allowing the buyer to assume the remaining debt and junior liens to attach at closing. However, these solutions will be challenging to implement in practice. Fortunately, the choice of capital structure may solve these problems.

Capital Structures

The difference between the amount of closing cash that the seller needs to receive and the buyer is able to pay forms the basis for two primary capital structures in seller-financing transactions. Sellers may be able to serve as either senior lenders or junior lenders to facilitate such transactions.

Accordingly, in one possible capital structure, the buyer pays a portion of the purchase price — for example 40 percent — with its own equity, and the seller lends the remaining 60 percent of the purchase price to the buyer as the first priority lender. This structure works best when the existing property-level debt is relatively small in comparison to the asset's sale price. The seller has greater flexibility in determining the amount of cash it is willing to accept at the closing; however, the usefulness of this structure is dependent upon the extent to which a buyer is able and willing to contribute cash at the closing.

Alternatively, suppose a buyer can only contribute 20 percent of the purchase in cash and the seller needs more cash at closing. Then the buyer may be able to borrow a portion of the purchase price from a first position third-party lender and borrow another portion of the purchase price from the seller. The seller becomes a junior lender, either through a second priority lien on the underlying asset or by a pledge of the ownership interests in the title-holding entity in a mezzanine loan. In such a transaction, the third-party senior lender might loan 50 percent of the purchase price in first position, the seller might loan 30 percent of the purchase price as a junior lender, and the buyer might pay equity at closing of 20 percent. Accordingly, the seller would receive 70 percent of the purchase price at closing and the buyer would obtain an aggregate loan-to-value ratio of 80 percent.

With the cumulative leverage of both a senior loan and a junior loan, potential buyers also may be able to maintain a relatively high debt-to-equity ratio and have the potential to earn greater yields on their equity investment. Thus, they may be more likely to enter into commercial real estate transactions in the near term. Also, sellers may be able to charge higher interest rates than the senior lenders but would be in a first loss position relative to the senior lender.

Sellers looking to sell multiple assets should consider setting up a program with other lenders that are willing to lend in first position in relation to the seller's junior loan. By doing so, sellers may be able to pre-negotiate the intercreditor agreement and subordination agreement and present prospective buyers with complete financing solutions during the purchase agreement negotiations.

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