Revenue Recognition Certificates

An Attractive Alternative to Debt for Master-Planned Communities

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Master-Planned Communities

- Are large-scale residential neighborhoods with thousands of houses +
  - recreational amenities
    - golf courses, tennis courts, parks, playgrounds and, in some locations, lakes and swimming pools
  - commercial zones
    - shopping centers: stores and restaurants
    - Some may have schools and office parks
- These communities need infrastructure:
  - Roads, sidewalks
  - water and sewage treatment plants,
  - principal distribution lines

Current Financing

- But it takes time to monetize the investment
  - Sugarland in Texas started in 1973: there is still land available - 45+ years on
- And it is risky:
  - In those 30 to 40 years the developers must weather multiple recessions
- Debt financing gives
  - *dollar certainty* to the lender by *saddling* the borrower with an iron clad contract
- To make a bad situation worse,
  - One can't get a long-term mortgage like commercial buildings or apartments
  - This void was filled by banks with 3 – 5 year rolling loans: now 2ndry suppliers
    - Plus MUDs in Texas and Mello Roos in California

Investor

Can we do better? Let the contract read:

Borrower pays investors a % of sales for the life of the contract, say, 20 years.*

- The investor buys:
  - A no-load, no management fee, term annuity
  - With growth
  - And inflation protection
  - If securitized, it would also be marketable
- Taxed as a Contingent Claims Liability
  - Appeal to tax-favored investors
- Pension plans, 401(k) plans, endowments - $30 trillion in assets not participating

* Developers are used to paying a large % of sales to the “banks” in order to repay principal

Borrower

The borrower:

Raises long-term money with a self-amortizing instrument,

(like a mortgage)

Buys financial flexibility

Sells inflation insurance ??

Sells time-limited, non-voting, non-intrusive equity in the project.

Chart & Excel Demo

		Return	
	Investor Real Estate Risk	Investor	Developer
20-Year Mortgage	1	0.06	0.10
Sales Certificate	2	0.07	0.09
Property	3	0.08	0.08
Equity	4	0.10	0.10

Assumption: Initial Position is that of a 20-yeqar mortgage

Sales Certificate 1: % of Sales contract lowers risk for developers & increases return for investors at little increase in risk to investors because they can diversify.

	Price Increase		Equity Risk Premium	Beta		Inflation Rate				
Assumptions;	2.0%		4%	0.25		2.0%				
Starting Year	3					3				
Lot Price	$165,000		Annual Sales	105 Lots		Discount Rate	6.0%			
			5-Year Results					Percent of Sales Required		20-Year Results: $50 Million Certificates
Year	1	2	3	4	5		Total			
Sales ($ mill)	8.40	8.40	8.40	8.40	8.40		42.00			
PV of Sales Certain DEBT	7.92	7.48	7.05	6.65	6.28		35.38	42.39%		48.65%
PV of Sales Risk Adjusted	7.85	7.34	6.86	6.41	5.99		34.44	43.55%		52.67%
Data (demonstrates that the formula will amortize the principal by maturity)										
Remaining Debt	15	12.3	9.5	6.5	3.4					
Participation Payment	3.6	3.6	3.6	3.6	3.6					
Interest Payment	0.9	0.7	0.6	0.4	0.2					
Principal Payment	2.7	2.8	3.0	3.2	3.4					
Remaining Debt	12.3	9.5	6.5	3.4	0.0					

	Table			
Percent Differences: Formula Present Value / Simulation Present Value				
	Debt	Growth & Risk		
Average	0.174%	2.390%		
Std Dev	0.554%	2.169%		
Max	1.730%	10.553%		
Min	-0.655%	-1.701%		

Term Sheet

- The borrower shall pay the investor “x%” of sales for the next “y” years.
  - Define “sales”
- Employ the services of a trustee to ensure that:
  - The borrowed funds are spent correctly
  - The properties are released correctly
  - The proceeds of sales are escrowed for the benefit of the Certificate holders
  - Regular distributions are made to Certificate holders with a true-up after audit
  - The first mortgage on the property is sufficient to provide adequate collateral

Applications

- Long-lived projects:
  - Large real estate developments like Pinehills or Sugarland
    - 20 or 30-year secured financing with provisions for bad years; selling time-limited, non-voting equity and inflation insurance.
  - Large rental projects, residential, retail & commercial
  - Banks are now out of the real estate development business
    - Dealing with 2ndry suppliers at higher cost
- Institutional Investors need this exposure
  - Simpler vehicle than a combination of debt and illiquid equity
  - Leaves voting control, income statement and equity residual in the developer’s hands

Summary

- We explained the difficulty of financing Master-Planned Communities
  - Financing the underlying infrastructure with short-term loans
- We outlined a longer-lived security that better aligned interests by shifting
  - Specific risk to investors
  - Inflation risk to developers
- We modeled this security mathematically and ran simulations to check ball-park assumptions
- Now, all we need are clients.