



Inside the Capital Stack

What Economic Development Staff
Should Know

Why This Session Exists

Development financing is layered & complex



Municipalities are asked to evaluate requests for public financing



Decisions made now carry long-term impacts

What We'll Cover Today

How capital stacks are built



How investors think about risk and return



Where public assistance fits into the financing

What This Session is Not

Deal
structuring

Legal or tax
advice

Trying to make
everyone
experts!

We'll focus on overall understanding for better negotiations.

What is the Capital Stack?

- All sources of funds to complete an economic (re)development project
- Ordered by repayment priority & risk



Payment Priority Matters

“Payment Priority:” Who gets paid first if there are shortfalls

Cashflow
priority

Loss
absorption

Municipal
exposure
(*PAYGO*
preferred)

Simple Capital Stack

Sources		Uses	
Equity	3,500,000	Land	750,000
Debt	6,500,000	Construction	8,750,000
Total	10,000,000	Financing	300,000
		Reserves	200,000
		Total	10,000,000

Debt



What is Debt Financing?



Funds borrowed from external sources



Obligation to repay with interest



Secured by real estate, project income, asset sales – without giving up ownership

Types of Debt Financing



Construction mortgage

Short-term loan
18 to 36 months, matures once
the project is complete
Interest only



Mini-perm mortgage

Hybrid, shorter-term loan
3 to 5 years, loan converts to a
permanent loan after
stabilization



Permanent mortgage

Long-term loan
10 to 40 years
Repayment of principal &
interest

Senior Lenders



BANKS



CREDIT
UNIONS



LIFE
INSURANCE
COMPANIES



PENSION
FUNDS



GOVERNMENT-
SPONSORED
ENTERPRISES

What Lenders Focus On

- Loan-to-cost
 - ✓ 60 - 75% of total development cost
- Loan-to-value
 - ✓ 50 - 80% of development value
- Debt service coverage
 - ✓ Net Operating Income over loan payments
 - ✓ 1.15x to 1.25x typical (construction loan can be lower)
- Sponsor experience
 - ✓ Relationships matter!

Subordinate Debt



Subordinate means lender isn't first in line!



Junior in priority to senior lenders



Higher risk, higher cost of capital



Used when senior debt is limited or constrained

Mezzanine Financing

- Specific type of subordinate debt
- Acts as a hybrid of debt and equity
- Unlike debt, mezzanine financing generally secured by pledge of the equity interest – ownership of the asset!
- Higher risk, higher cost of capital

Local Units of Government Loans

- Favorable underwriting requirements vs. the market
- Deferred repayment, sometimes forgiven
- Supports senior lending, often subordinate to first mortgage
- Highest risk, cheapest capital
 - ✓ Community benefits must outweigh risk!



Equity



What is Equity?

- It's the 'down payment' on a project
- Ownership capital
 - ✓ Syndication sponsors: general partners
 - ✓ Passive investors: limited partners
- No guaranteed repayment
- Highest risk position

Types of Equity Investors



Individual &
Personal Investors



Angel Investors



Institutional
Investors



Real Estate
Investment Trusts
(REITs)

What Equity Investors Care About

- Stability
- Risk mitigation
- Predictability
- Risk vs. reward
- Structure
 - ✓ Determines who bears downside risk
 - ✓ Impacts long-term stability

Equity Sources

- Developer equity: cash or deferred fees
- Private equity: outside investor
- Tax credit equity
 - ✓ Returns driven by tax benefits
 - ✓ Lower return expectations
 - ✓ Strong compliance requirements
- IP equity
- Public assistance: sometimes functions as equity

Investment Return Metrics

Metric	Definition
Internal Rate of Return	<ul style="list-style-type: none">Analyzes time value of money over a specific holding periodEstimates project profitability from initial equity investment by accounting for annual net cashflows, sale proceeds & debt repayment from a future sale
Cash-On-Cash	<ul style="list-style-type: none">Measures project net cash flow (<i>after debt service</i>) divided against the total amount of equity invested
Yield-On-Cost	<ul style="list-style-type: none">Calculates net operating income (<i>before debt service</i>) divided by total development cost less upfront grants and deferred loans

Public Assistance: Role of Municipality



Why Projects Often Need Public Support

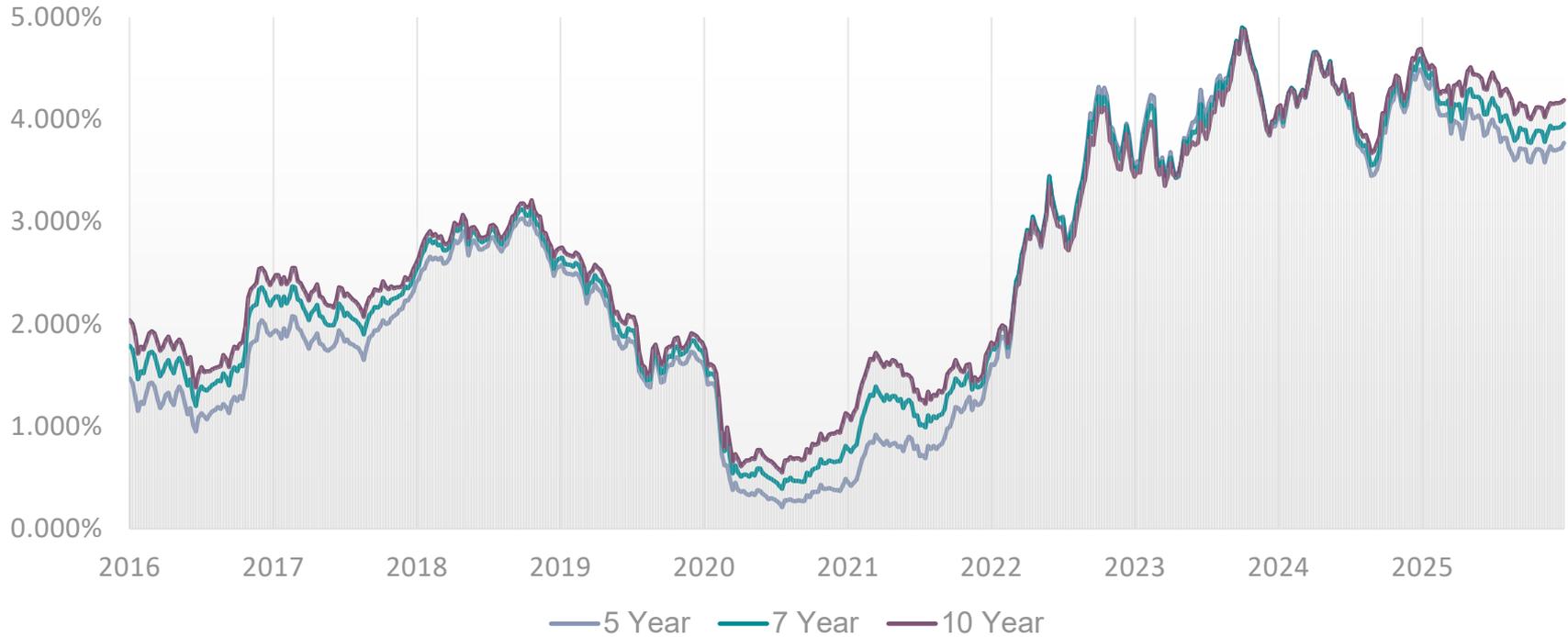


COSTS EXCEED MARKET
RETURNS

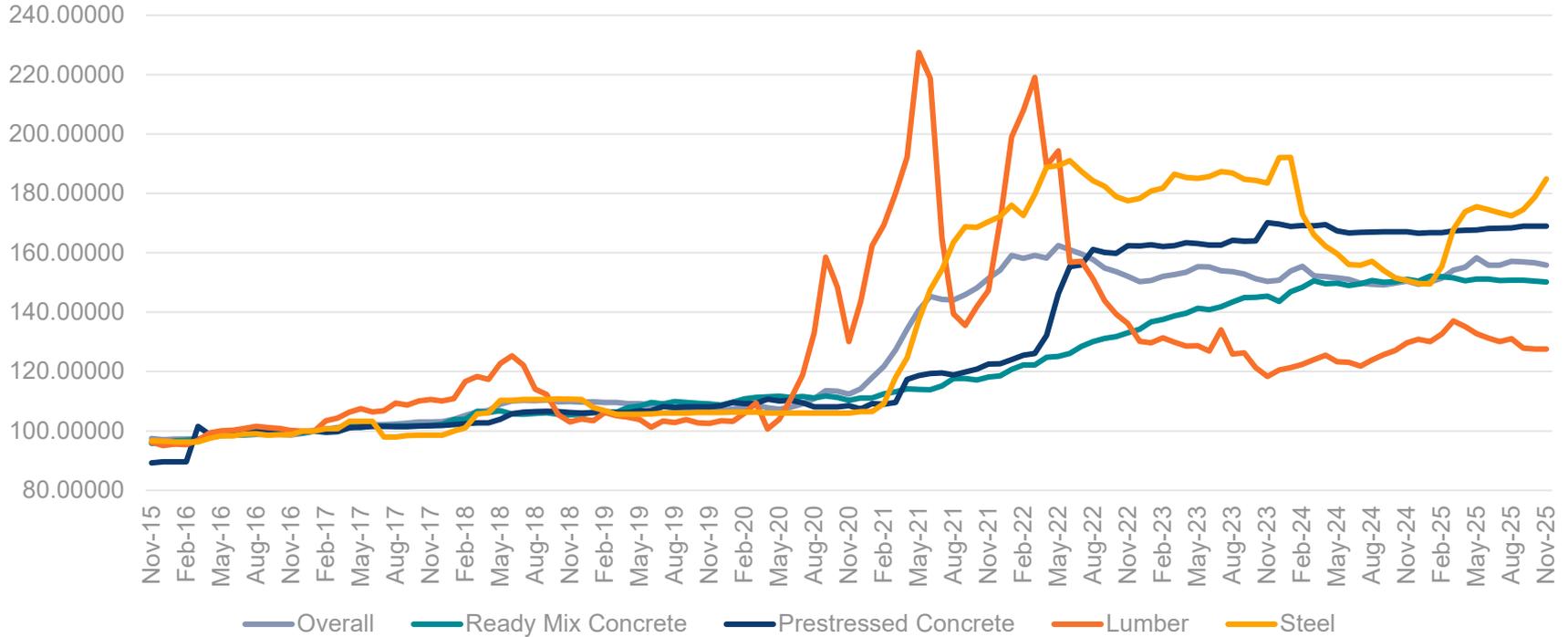


PUBLIC BENEFIT EXCEEDS
COST OF PUBLIC SUPPORT

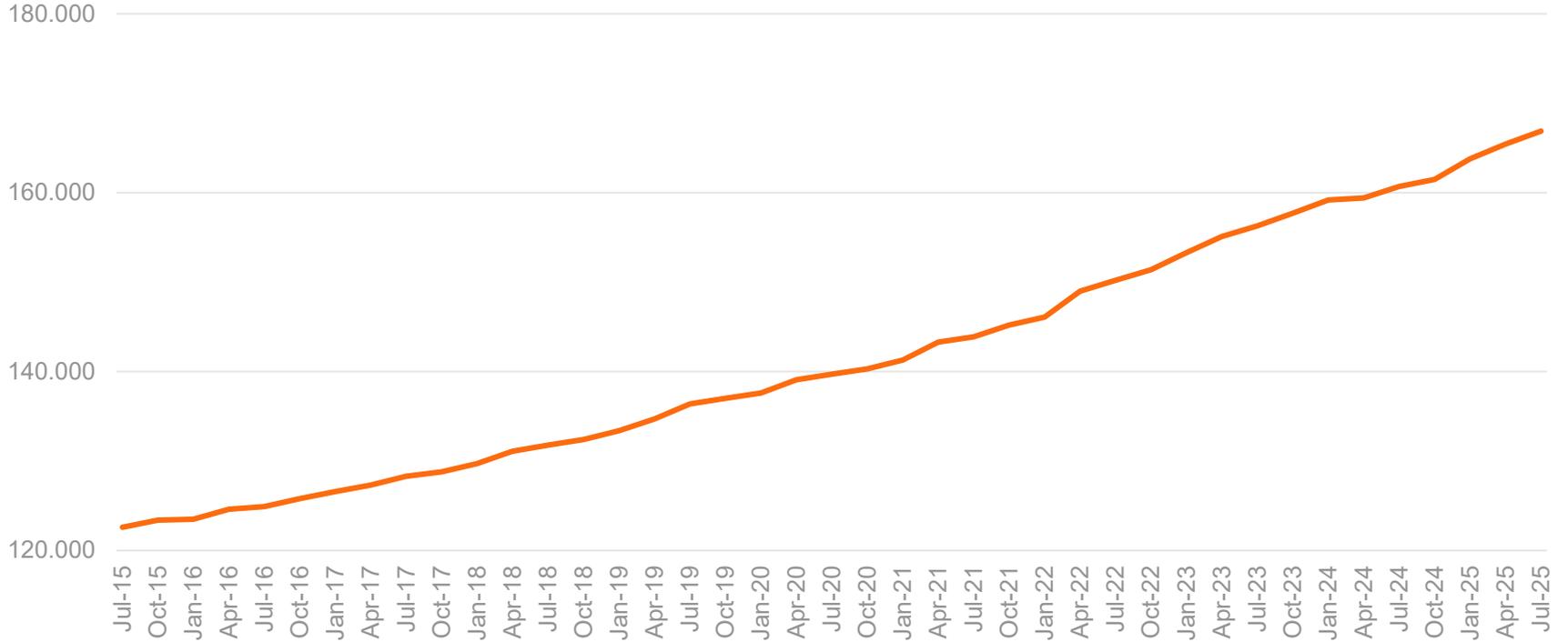
U.S. Treasury Rate Trends



Construction Material Trends



Construction Labor



What Does This Mean?!?!?

48%

...Increase in construction cost from 2020. Mortenson reports 2025 cost 48% more for the Milwaukee area.

It Also Means...

Communities must carefully
evaluate all requests for public
assistance in order to protect
local resources, BUT
How much is enough?!

Develop Strategic Plan & Policy

**Identify
community
needs**

**Prioritize focus
for limited
resources**

**Consider
available
financing tools**

Why Consider Providing Assistance

PART OF AN ECONOMIC DEVELOPMENT STRATEGY

- Create or retain jobs
- Redevelop blighted areas
- Remediate polluted sites
- Construct housing and/or affordable housing
- Increase tax base
- Change community market conditions

Identify Appropriate Funding Sources

Tax increment financing (TIF)

Grants

Deferred loans

Local fee waivers

Existing fund balances

Public land contributions, write-downs

Local regulatory requirements (zoning, etc.)

How Funding Can Be Deployed

PAYGO - Tax
Increment
Financing (TIF)

Loans
(forgivable or
payable)

Grants

Most
common



Public
borrowing

Risk reduction

Municipal Role in the Capital Stack

- Gap filler
- Risk reducer
- Credit enhancer

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		Total	10,000,000

How Municipal Tools Interact With Equity



REDUCE DOWNSIDE
RISK



IMPROVE INVESTOR
CONFIDENCE



SUPPORT TAX
CREDIT EQUITY

Understanding the Gap

Fundamentally: Financial barriers preventing the private market from developing a site in accordance with City vision

- Contaminated land and/or existence of blighted buildings
- High development fees
- Market rents too low
- Infrastructure costs too high
- Cheaper alternatives elsewhere
- City vision incompatible with market

pro forma Analysis: The Goal

FIND THE GAP

Analyze Assistance Requests: *pro forma*

Compare
developer's numbers
against industry
standards

- Land acquisition
- Construction Costs
- Developer Fee
- Debt Assumptions
- Return on Investment

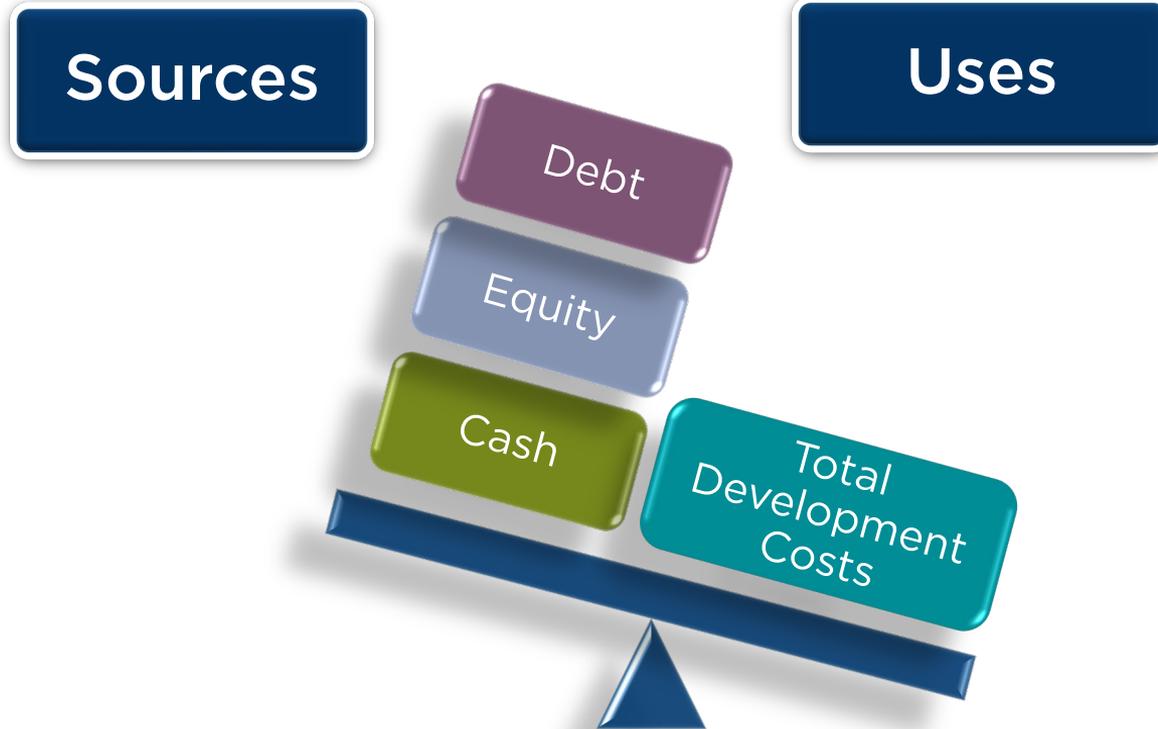
Ensure development
components
accounted for
correctly

- Revenues
- Expenditures
- Debt service

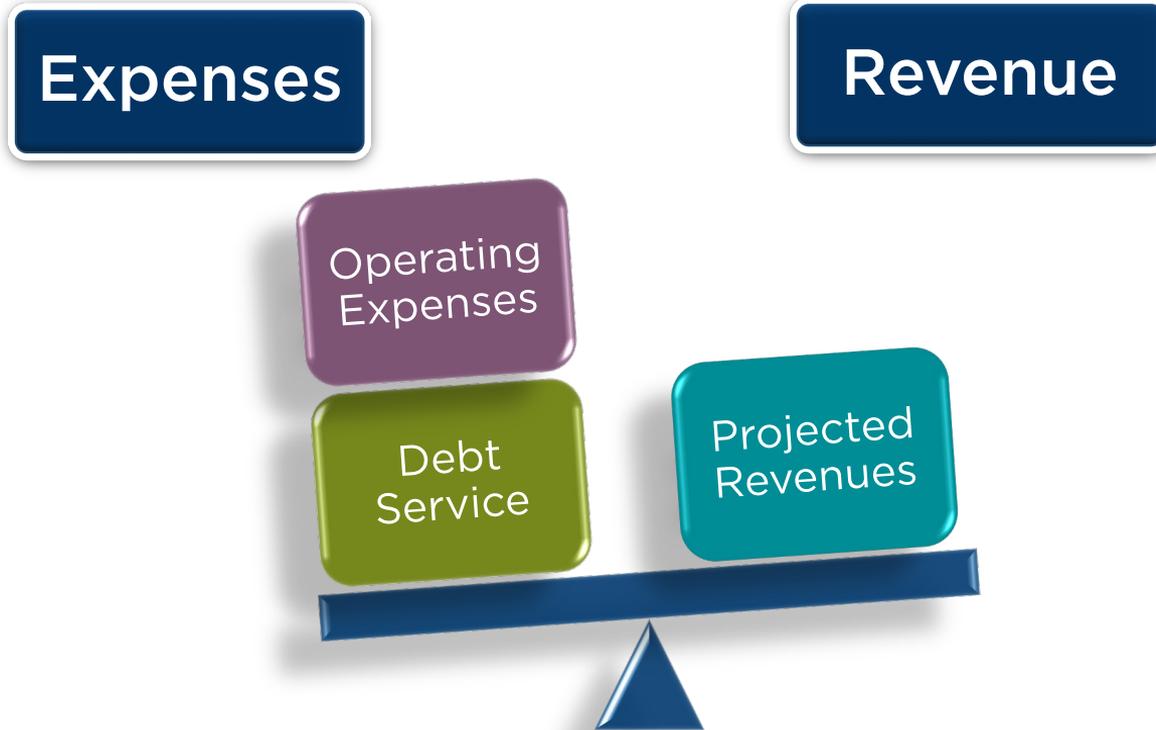
Common Red Flags

- Aggressive assumptions (if public borrowing/risk)
- Low revenue projections (if asking for public assistance)
- Thin equity
- Subsidy replacing private risk

The Financial Gap: Sources & Uses



The Financial Gap: Ongoing Operations



Asset Classes



Why Asset Class Matters

- Risk varies by use type
- Financing structures differ
- Larger financing gaps
 - ✓ Housing, especially affordable housing
 - ✓ Downtown retail & office
 - ✓ Infill redevelopment

Pulling it all Together



What a Strong Capital Stack Looks Like

Private capital leads

Public tools are targeted, minimized & contain protections such as lookbacks

Debt apportioned correctly

Risks are clear

Understanding Investor Motivation



DEBT SEEKS STABILITY



EQUITY SEEKS RETURN



TAX CREDIT EQUITY SEEKS
COMPLIANCE (PLUS LOWER
TAXES & RETURN)

Key Questions to Ask

1. Who is taking the most risk?
2. Who benefits most if successful?
 - ✓ Lookbacks to right-size public assistance

Final Takeaways

- Capital stacks reflect risk & goals
 - ✓ Debt vs. equity
 - ✓ Requesting public assistance to reduce risk
- Tax credit equity is one tool
- Understanding improves decisions



Download the Presentation





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