Is the Convergence of EB-5 Capital with Traditional Private Equity the **Next Big Thing?**

REID THOMAS
EXECUTIVE VICE PRESIDENT, NES FINANCIAL

The EB-5 industry has lived in relative obscurity for most of its history. The employment-based fifth preference category that was first created in 1990 as part of an initiative to produce U.S. jobs was barely used in its earliest days. When the financial crisis of 2008 came along, the use of the EB-5 visa program and deployment of EB-5 capital began to grow. In the last few years, the program has reached capacity with a waiting list of EB-5 investors ensuring that the program will remain at capacity for years to come.

The tremendous growth in the program began as it became recognized as an important financing tool and job creation engine. Both were critical needs during the Great Recession. EB-5 funds were no longer an obscure form of foreign capital. Today, it is commonly used within the capital stack of some of the largest and most prestigious developments and projects in the country.

The most recent Department of Commerce report confirmed that between 2012 and 2013 over 174,000 jobs were created as a result of the EB-5 program. The 174,000 jobs represents 4.3% of all U.S. job growth during that period. These are staggering numbers that are not lost on Congress. Considering the ambitious objectives under the Trump administration, EB-5 will most definitely get consideration as one of the engines that can be used for job creation and infrastructure upgrades.

One noticeable development of the program is that the use of EB-5 capital has gone mainstream in the last few years. Today, EB-5 funds are regularly used by developers of all sizes on projects of all sizes in locations across the country. A key benefit of this program maturation has been the positive impact it has had on industry best practices. Because many of these larger firms also raise capital from more traditional sources such as private equity capital from institutional investors, rigorous processes and due diligence protocols are already in place. Compared to your typical EB-5 investor, these institutional investors are extremely demanding. They are very concerned about the security, transparency, and compliance practices of the developers they invest with. These developers naturally embrace higher standards of best practices, such as third party fund administration and controls, specified in the recent iterations of EB-5 proposed legislation.

The focus of this article is the latest step in the evolution of EB-5 capital: EB-5 funds are increasingly being used alongside traditional private equity funds. This emerging trend is likely to have a very positive effect on the EB-5 industry and its stakeholders, including issuers, developers, and investors. There are several forces that can be identified as contributing factors as to why this is occurring.

BANKS ARE TIGHTENING CONSTRUCTION LENDING STANDARDS

Post financial crisis the banking industry is one of the most heavily regulated in the United States. One key metric bank regulators look for is how well capitalized banks are relative to their outstanding loans. Regulators require that banks hold a minimum amount of capital in reserve to absorb any anticipated losses on the loan books. The capital reserve requirement is a ratio against the banks' total assets (which include loans). These minimum ratios were established in order to act like a buffer against bank failure during economic downturns.

As part of the new Basel III regulatory framework that banks are subject to, a new regulation called the High Volatility Commercial Real Estate (HVCRE) rule went into effect in 2015. This rule says that loans classified as HVCRE must maintain a higher ratio of capital reserves than non HVCRE loans. Commercial Real Estate construction loans fall into this HVCRE category under the regulations. As such banks are required to hold 50% more capital in reserve than on other loan types, they are less attractive loans from the banks' perspective.

Bank regulators have not hesitated to go public with their concerns. In December 2015, bank regulators issued a letter expressing concern about the growth and concentration of commercial real estate construction loans on certain bank balance sheets. In addition, the letter also criticized the underwriting practices at some banks and warned that loan standards were beginning to show signs of weakness.

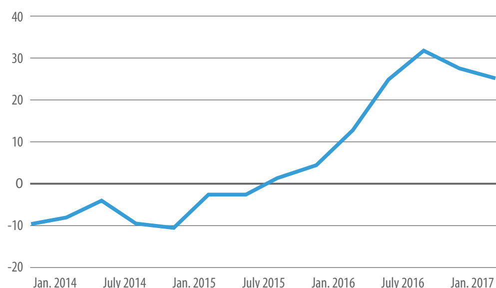
In mid-2016, the Office of the Comptroller of the Currency (OCC) released their Spring 2016 Semiannual Risk Perspective Report. After the report was released, the head of the OCC was quoted as saying, "With commercial real estate lending, we are signaling a flashing yellow or a caution light."

With the increased regulatory focus and more stringent compliance requirements in place, banks have begun to pull back and take a more conservative approach to construction lending. The resulting market fallout is beginning to be felt in a number of ways. Compared to recent years, construction loans are harder to get and loans that are being made typically contain

more demanding terms, higher costs for borrowers, and lower funding levels.

The chart above, published by the U.S. Federal Reserve System shows the dramatic shift in

Net Percentage of Domestic Banks Tightening Standards for Commercial Real Estate Loans with Construction and Land Development Purposes



Source: Board of Governors of the Federal Reserve Sustem (US)

banks tightening their lending standards with the implementation of these new regulations beginning in 2015.

The majority of EB-5 projects today involve commercial real estate development and therefore are often dependent on construction loans to complete the overall capital stack. With banks reducing the amount they are willing to lend, project principals are left with wider gaps in financing than they have seen in the past.

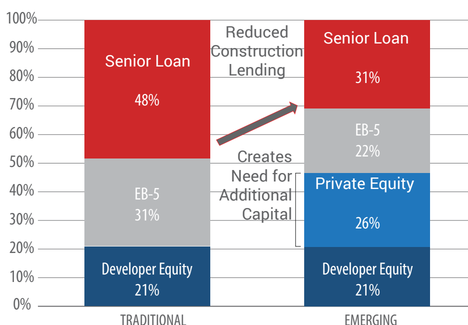
In the earlier years of EB-5, closing this incremental gap with additional EB-5 funds might have been a possible solution. However, as this article will explain, that is no longer a realistic possibility in this new era of EB-5. As a result, one solution that is emerging with increased frequency is to fill this gap with private equity capital.

EB-5 INVESTORS ARE MORE DEMANDING

As the EB-5 market has become more mainstream, the due diligence carried out by EB-5 investors and migration agents has become much more sophisticated. Investors evaluate a project through a number of lenses to determine factors such as the likely immigration result, the security of investment, and the potential for any return.

A successful immigration outcome is dependent on creating enough jobs to satisfy USCIS requirements. To that end, the number of jobs expected to be created per investor has become a key due diligence item. Projects that do not have any room for error and have only enough

Shifting Trends in EB-5 Project Capital Stack



Source: NES Financial Database 2010-2016

jobs to meet the minimum requirement are much less attractive than projects that have jobs that exceed minimum requirements, or a "job-cushion." A big focus item in due diligence is the "job-cushion" associated with a project. The higher the "job-cushion" the better.

An obvious way to create a higher job-cushion is to decrease the percentage of EB-5 funds within the overall capital stack. In the early days of EB-5, it was not uncommon to see EB-5 funds representing 70%-100% of the overall project financing! But with the demand for greater job-cushions, it is much more common to see EB-5 capital limited to 20%-30% of the overall project cost.

Therefore, attempts to make up the shortfall in construction lending through additional EB-5 capital works against strong market forces. As a result, most projects find themselves with an additional gap in the capital stack that must be filled. This creates an opportunity for more traditional private equity capital raises, and issuers are beginning to respond.

GLOBAL INVESTMENT IN US REAL ESTATE IS AT RECORD HIGH LEVELS

The United States has always been viewed globally as a desirable target for investment. This has become particularly obvious over the last few years. Foreign investment into U.S. real estate in particular has reached all-time high levels.

Since 2010, the growth in investments from all parts of the world has been increasing. Of particular note is the explosive growth in real estate investments between 2014 and 2015 from China, which was almost 300% year over year.

With economic uncertainty in many foreign markets, the surge in the strength of the US Dollar creating concern about the stability of foreign currencies, and a new administration perceived to be real estate friendly, demand from foreign investors looking for U.S. real estate opportunities is expected to remain robust.

Private equity firms are well aware of this demand and are increasingly putting real estate investment opportunities together to appeal to foreign high net worth investors. According to the Private Equity Real Estate (PERE) 2016 Annual Report, private equity funds raising capital in two or more regions of the world represented 35% (the largest portion) of all private equity real estate funds raised last year.

As such, the competition amongst private equity funds competing for foreign investors continues to grow. Private equity funds are beginning to differentiate their offerings by adding an immigration investment opportunity alongside traditional private equity real estate investment opportunities.

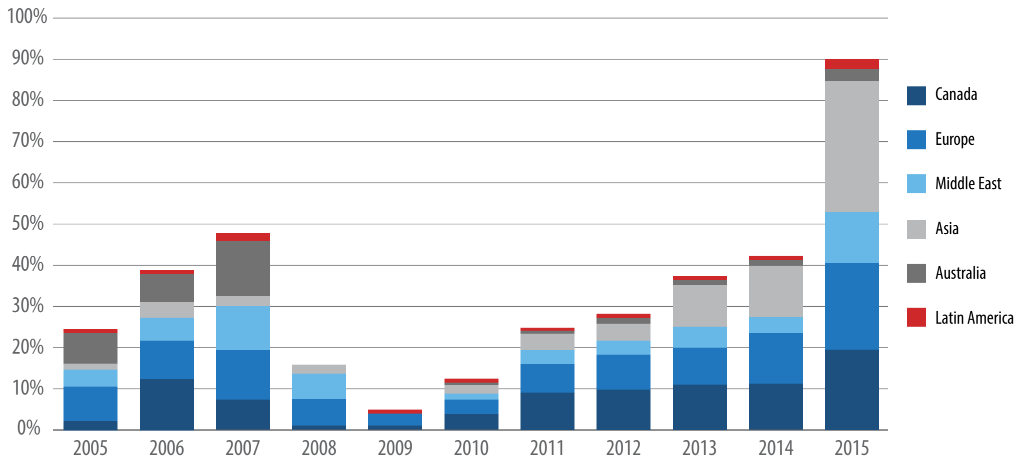
This is a logical strategy. Presumably, if an investor is interested in making a larger equity investment into a real estate venture, adding an additional nominal amount for the potential of a Green Card creates a significant added incentive.

CONSIDERATIONS FOR EB-5 REGIONAL CENTERS

All of the above are contributing factors to what could be another shift in the market toward institutional practices. It will and has already impacted the way EB-5 projects are structured, how and where projects are marketed, and the operational and compliance platforms that Regional Centers need to implement.

In many cases, structuring projects within this new environment will require new expertise to be hired and developed. The private equity offering will need to be competitive with offerings from traditional private equity firms. Not only will a competitive offering need to include comparable investment returns and risk profiles, it will also require a significantly more sophisticated degree of investor servicing, reporting, and transparency than the EB-5 industry is accustomed to. The marketing of these offers will become more complex as each of the EB-5 and private equity investment offerings will have their own characteristics. When investing solely for an immigration benefit, the expected return (i.e., a Green Card) is an acceptable market norm for most countries. However, when it comes to traditional private equity investments, a wide range of variance from country to coun-

Cross-Border Capital Invested in U.S. Commercial Real Estate (By Region of Origin, in Billions of Dollars)



Note: "Latin America" includes all countries in North, South and Central America except the U.S. and Canada.
Source: RCA US Capital Trends, January 2016

try should be expected.

This parallel investment offers benefits to investors and Regional Centers at the same time. A successful immigration outcome for an EB-5 investor will, in many cases, create a desire to transfer wealth into the United States. Presumably after doing due diligence on a potential EB-5 project, investors will become familiar enough to consider making a parallel private equity investment into the same project. From an investor perspective, this has the benefit of providing a greater overall return while facilitating the transfer of wealth into the United States.

From the Regional Center point of view, this has the potential of significantly reducing marketing costs. Enabling an investor to make a larger investment than required by USCIS into a project means that the capital stack may be filled out more quickly and thereby reduce marketing costs. From an operational perspective, the number of limited partners required to fund the project is ultimately going to decrease, meaning reduced operational costs for investor servicing and reporting.

EB-5 regulations may introduce additional complexities, both for investors and for the Regional Center, relating to the lawful source of investment funds. EB-5 investors making a parallel private equity investment may be required to demonstrate the lawful source of those investment funds in addition to the source of the EB-5 capital. Additionally, the regulations at 8 C.F.R. 204.6(g) permit USCIS to require identification of all investors and documentation of the lawful sources of all capital, including capital from private equity investors and other non-EB-5 capital. These provisions may take on new significance with the introduction of more private equity into EB-5 projects.

All EB-5 stakeholders benefit as the market expands. The EB-5 program is limited to 10,000 visas annually and is likely to remain at that level in the near term. Traditional private equity offerings are not bound by similar restrictions and as such create broader opportunity.

While there are certainly going to be challenges for Regional Centers, those that embrace the coming changes early and get ahead are likely to be rewarded. ■

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