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Lending to Charities It's Good Business!

Dramatically increasing rental rates, stricter zoning laws, and more generous donors are driving a significant number of charitable organizations to purchase real estate. A charity facing the challenge of moving from renter to owner may find itself struggling to identify funds to bridge the gap between money raised through a "capital campaign" to purchase the real estate and the total amount needed to purchase and renovate the property. Adding to the pressure can be an expiring lease, a sudden increase in employees due to the funding of a new project, or deadlines established in the purchase contract. At this critical point, the charity will consider borrowing the funds necessary to complete the transaction and obtain possession of the property.

More and more banks and other funding institutions are demonstrating that lending to charitable organizations can be good business. A thorough understanding of the operating differences between for-profit and not-for-profit entities will smooth the way for a successful transaction and a mutually beneficial relationship.

Charitable organizations differ from for-profit organizations in three primary ways:

Decision-Making: Charities have a longer decision making process. Charities must build consensus among board members, staff, major donors, and often several committees working on the project covering such areas as acquisitions, finance, fund-raising, and facilities management. Reaching consensus among all these different groups is time consuming and requires patience on everyone's part.

Unique Needs: Charitable organizations often serve constituencies that challenge the traditional real estate market. Clients that are dealing with substance abuse, domestic violence, a handicap or disease can intimidate other tenants in a multi-tenant office building. In addition, the charity may need optimum handicap access, after hours and weekend building services, abundant parking, convenient public transportation , unique security arrangements and/or special zoning. For these and other reasons, charities often find renting difficult and are faced with the option of purchasing their own facility.

Financial Constraints: Lastly, charities operate on tight budgets that require the lowest cost real estate options available. Annual budgets are zero-based with funding derived from multiple sources that must be renewed on an annual basis. The rental option has become less attractive with recent sharp increases in rates. Add to that the fact that donors often prefer to fund programs rather than operating expenses such as rent which makes finding the money for increased rental costs a problem.

Capital Campaigns

Fortunately, the upbeat economy has created a significant number of new wealthy donors, enabling many charities to consider purchasing real estate. For a charity, a purchase of this significance requires many difficult choices for the board and staff.

Most charitable boards of directors are adverse to debt and are uncomfortable borrowing money. In order to buy a significant property, the board and staff need to conduct a capital campaign to purchase, renovate or build and maintain the property. Raising $1-5 million to accomplish these goals is not unusual, nor are significantly larger sums in excess of $20 million, when a charity is purchasing several properties and combining these needs in one campaign.

The charities will seek the funds or equity to buy the real estate from foundations, corporations, individuals and, in rare instances, governmental sources. Most of these entities will not contribute or pledge funds until the charity has the real estate "under its control." This generally means either under contract or already purchased. Many foundations only give for capital expenditures or special programs and will not contribute toward the debt reduction. The charities will attempt to raise funds from these sources at the beginning of a capital campaign before they have to incur debt.

The charity often must place the real estate they wish to purchase under contract with a closing date as far in the future as possible, allowing it sufficient time to raise the funds necessary for purchase. In some cases, an interim step may be taken where the charity buys the property with cash and delays renovation or new construction until the balance is raised. Obviously, these are ideal circumstances and for many charities, the closing date cannot be delayed and the organization must move into the property as soon as possible. At this point, the board generally makes the decision to borrow the funds to complete the project, with the knowledge that by incurring debt the capital campaign will be extended.

Not-For-Profit Loans

Most charities seek a hybrid bridge loan. The loans can range from three to five years with a balloon at the end of the term. Lenders should expect the charities to be fairly demanding in their loan requirements and to bid the loan to competitive lending institutions. As providers of needed services to the community, they often expect the lender to make special concessions. Some concessions are not difficult; others may require significant negotiation. Expect the charities to ask the lender to consider the following when making a loan:

Security: The charity will request that the loan be secured only by a lien on the property. It is unlikely that any of the board members will personally guarantee the lien or that the charity has any sizable assets to add to the collateral.

Loan amount: Since the charity should already have raised a portion of the funds necessary to purchase the property, a loan-to-value ratio of 70 percent to 85 percent should not be difficult. Capital campaigns with six months to a year under their belt should already have received a sizable number of contributions and pledges.

Rate: Charities expect below-market rates. Expect them to request a rate as close to prime as possible with a 15 to 30-year amortization.

Points and other fees: The charity probably will request minimal to no points and a waiver of any of the legal and appraisal costs incurred by the lender. The strength of the charity and its connections to key people employed by the lender often influence the negotiation of these items.

Prepayment: The charity will request the ability to repay the loan as soon as possible without any penalty for early repayment. The lender may want to negotiate a fixed duration for part of the term to guarantee some yield from the loan.

Obviously some of these requirements are more difficult and it is the responsibility of the lender to determine how far they are willing to go to meet special concessions. The strength and track record of the charity will go a long way in helping the lender to be more comfortable doing so.

Determining the Viability of the Charity

To assist in making that determination, there are a number of items that will help the lender assess that strength:

Longevity of the Agency: Most foundations will not give to a charity unless it is at least five years old. This should be an absolute minimum for a lender.

Services or Programs: Does the charity have a narrow focus or does it offer a broad range of services that enable it to adapt to changes?
Financial Support: There is no standard regarding comfortable percentages of funding from various sources. However, agencies that are dependent on one source for the majority of their funds are more likely to experience cash flow crunches, particularly if the source is governmental.

Board and Charity Management: Charitable board members take their fiduciary responsibility quite seriously. The lender should review the list of board members. A strong board will have directors who hold leadership positions in business and have previous charitable board experience. Also, the lender should review the resumes of the executive director and development manager for previous fundraising experience.

Financial Reporting: The charity should have recent audits and a financial management system, which includes a board finance committee that reviews expenditures/income on a monthly basis.

Previous Experience with Capital Campaigns: If a charity has a previous, successful capital campaign in its history, prospects for another success are very high. However, lack of experience with capital campaigns should not disqualify a charity from a loan. Capital campaign experience can be obtained by retaining the services of consultants specializing in conducting such endeavors. The lender should request information from the consultants detailing the size and type of campaign experience.

Collateral: The loan, usually, will be secured by a lien on the property with full recourse to the charity. Most charities do not want to be landlords, so presumably there will not be any revenue generated by the property. The lender should obtain an appraisal of the property and closely review the renovation or new construction plans.

If the property is being used for a special use, such as a day care center, shelter or community service center; alternative uses for the property should be discussed in the unlikely case that the lender must assume responsibility for the property and place it on the market.

Charitable Lending is Worth the Effort

Given all the demands and due diligence required when making a loan to charity, is it worth it to the lender? Absolutely. A lender can protect its interests in several ways, including:

- Require at least a three-year note with the first year interest only. This will help with the loan's yield even if the charity starts paying off the debt in lump sums in years two and three.

- Require the charity to deposit all of the capital campaign proceeds with the lender. Those proceeds can be used to pay down the note or renovate the property.
- Require a seat on the board of directors with the lender's representative serving on the organization's finance and/or investment subcommittees. It is good community exposure for the lender and places the lender in a position to monitor the charity's financial decisions.

Lending to charities can be fairly low risk, add another avenue to build a loan portfolio and expose the lender to donors and business leaders who have made a commitment to their community and are always looking for good business relationships.

Not-for-profit loans can create goodwill in the community. Enabling a popular and much needed community service to expand its capabilities in a new location provides the lender with multiple public relations opportunities at ground breaking and ribbon cutting ceremonies, in press releases, and in all materials related to the capital campaign.

So feel confident in lending to charities and enjoy that table you will be buying at the charity's next major fund raising event.

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