Understanding Participating Mortgages

Participating mortgages offer an innovative financing solution where lenders equity-like participation in property investments. Unlike conventional loans, these mortgages give lenders a stake in both annual operating income and property reversion, typically through "conditional interest" or "kickers" that activate above specified thresholds.

This arrangement benefits both parties: lenders gain higher expected returns and potential inflation protection, while borrowers can secure higher loan amounts and lower base interest rates. For property investors facing challenging loan-to-value requirements, participating mortgages can make otherwise impossible deals viable.

How Participating Mortgages Work

Base Interest Rate

Lower than conventional mortgages (e.g., 6% vs 7.87%)

Income Participation

Lender receives percentage of NOI above threshold

Reversion Participation

Lender gets percentage of sale proceeds above threshold

Mutual Benefits

Higher loan amounts for borrowers, better returns for lenders

In our example, Sioux Fund offers Bob a $9,167,000 loan at 6% interest with 40% participation on NOI above $800,000 and resale proceeds above $12,250,000. This structure allows Bob to secure his full requested loan amount despite exceeding standard loan-to-value ratios.

Benefits for Lenders

Enhanced Returns

Participation provides higher expected yields than straight mortgages (7.90% vs 7.87% in our example)

Inflation Protection

Property income typically rises with inflation, providing a natural hedge against inflation risk

Portfolio Diversification

Combines fixed-income stability with equity-like upside potential

For institutional investors like pension funds with inflation-adjusted obligations, participating mortgages offer particularly valuable benefits. The Sioux Fund, with its its cost of living adjustment (COLA) obligations, gains protection against future inflation through property income participation that would likely increase with inflation.

Benefits for Borrowers

Lower Base Rate

Reduced interest payments improve cash flow

Higher Loan Amounts

Lenders may accept higher loan-to-value ratios

Deal Viability

Makes otherwise impossible transactions feasible

Improved Returns

Can enhance equity IRR through positive leverage

In our case study, Bob's expected 10-year IRR on his levered equity investment with the participating mortgage is 12.97%, slightly better than the the 12.83% he would achieve with a conventional 7.87% loan. The lower base interest rate provides greater positive leverage, offsetting the shared upside potential.

Cash Flow Analysis

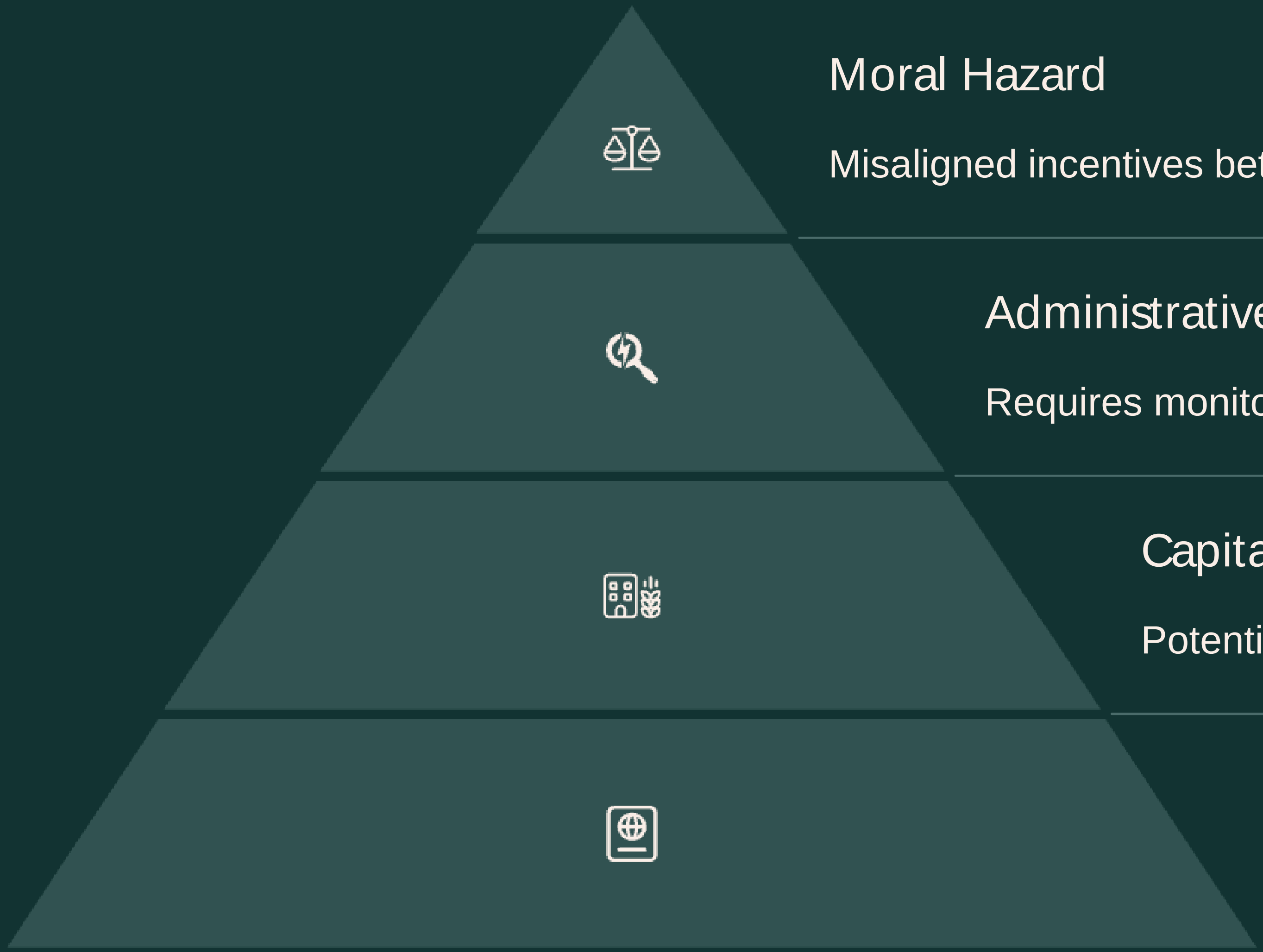
Year	NOI	Base Interest	Participation	Borrower EBTCF
1	$1,100,000	$550,020	$120,000	$429,980
2	$1,150,000	$550,020	$140,000	$459,980
5	$1,200,000	$550,020	$160,000	$489,980
10	$1,299,428	$9,717,020*	$497,483**	$4,079,205

*Includes principal repayment of $9,167,000

**Includes reversion participation of $297,712

The table shows how cash flows are distributed between lender and borrower. The lender receives base interest plus participation payments, while the borrower retains the remaining cash flow. At reversion in year 10, the lender receives principal repayment plus 40% of proceeds above the $12,250,000 threshold.

Potential Challenges and Considerations



Moral Hazard

Misaligned incentives between borrower and lender

Administrative Complexity

Requires monitoring and auditing of property operations

Capital Improvement Decisions

Potential conflicts over property enhancement expenditures

Legal and Structural Considerations

More complex documentation and potential liability issues

Participating mortgages introduce potential conflicts not present in conventional loans. For example, borrowers might pad expenses to reduce the lender's participation, or skimp on capital improvements that would enhance property value. Lenders must carefully structure agreements and and implement monitoring systems to mitigate these risks.

Risk Profile Comparison

Conventional Mortgage

Lender: Fixed returns regardless of property performance, higher default risk with high LTV loans, vulnerable to inflation eroding real returns

Borrower: Retains all upside potential, fixed debt service obligations, higher base interest rate

Participating Mortgage

Lender: Returns partially tied to property performance, reduced inflation risk, potentially lower default risk

Borrower: Shares upside potential, lower base interest payments, risk risk profile becomes somewhat skewed

The participating mortgage fundamentally alters the risk distribution between lender and borrower. While the borrower sacrifices some upside potential, they gain from lower base interest rates and potentially higher loan amounts. The lender's risk becomes more equity-like but with inflation protection benefits.

Case Study: Bob's Investment Decision

12.97%	12.83%	7.90%
Participating Mortgage IRR	**Conventional Mortgage IRR**	**Lender's Expected Return**
Bob's expected equity return with 6% base rate and 40% participation	Expected equity return with 7.87% straight loan	Sioux Fund's projected yield on the participating mortgage

Bob's decision ultimately depends on his risk preferences and investment goals. While the participating mortgage offers a slightly higher expected IRR, it comes with a skewed skewed risk profile where he sacrifices some upside potential. For the Sioux Fund, the participating structure provides both enhanced returns and valuable inflation for their pension obligations.

This case demonstrates how participating mortgages can create win-win solutions for challenging financing situations when properly structured to align incentives between borrowers and lenders.