Why High Net Worth Individuals Choose to Borrow

Wealth creation often comes with hard work, sacrifice, and risk. The objectives of individuals and their families evolve throughout this process, with wealth creation often shifting to wealth preservation over time. When it comes to funding financial decisions, high net worth individuals have the choice to do so using cash, liquidating assets, partnering with another individual or entity, or taking out a loan. We view borrowing as a risk management tool to help achieve wealth objectives.

Borrowing can help smooth cash flow and create liquidity when needed. It can allow you to be fully invested yet opportunistic; for example, you may be interested in financing real estate, private assets, or other goals. Borrowing can also help optimize returns on capital, improve tax efficiency, and manage interest rate and currency risk in some cases.

Reasons for Borrowing

Individuals and their families borrow for several reasons:

Investments: You may use loans to invest in marketable securities, alternative investments such as private equity and hedge funds, commercial and residential real estate, private businesses, and oil and gas ventures.

Personal capital expenditures: Individuals may borrow to finance purchases such as homes, ranches, vineyards, fine art, private aviation, and yachts.

Other needs: Leverage can be an efficient tool to manage or defer capital gains, execute carry trades, monetize illiquid or non-income producing assets, facilitate estate planning transactions or optimize returns on capital.

Acquire Assets

Another reason for borrowing is to acquire assets. Although many individuals could use cash to purchase assets, they use lending solutions such as residential mortgages and securities-based loans instead. Why? These options enable deployment of capital more efficiently and provide convenient and cost-effective access to liquidity without disrupting long-term investment goals.

A line of credit can give you flexibility, especially if it's set up before it's needed. This "dry powder line of credit" can be beneficial if an investment requires a quick cash closing or you choose to finance an equity contribution for a real estate purchase. For residential home purchases, many individuals choose interest-only adjustable-rate mortgages (ARMs) that are fixed for a specific time period, including 7/1 and 10/1 ARMs.

Case Study 1: Financing a Residential Property

A New York City-based client leveraged her portfolio of marketable securities to buy a vacation residence in Florida with a securities-based loan. Timing was essential in this transaction because the seller was only accepting cash offers. After successfully closing on the home, the client utilized the remaining availability of the securities-based loan to renovate the home, as construction financing was too restrictive.

After the renovation, the client requested a fixed-rate mortgage to pay down the variable-rate securities-based loan. The mortgage allowed the client to avoid variable interest rate exposure by locking in a long-term, fixed-rate financing solution.

Create Liquidity

Private banks play a key role as liquidity providers for high net worth individuals, who may have less liquid balance sheets. Recourse-based loans can vary significantly based on your short or long-term needs. For example, you can use short-term financing as a bridge to a near-term liquidity event, such as an IPO or sale of a private company. A bridging event can be as short as 30 days. During this time, you may sell a real asset with a delayed closing or a financial asset with restrictive redemption periods or insider windows. Our Private Bank lending advisors understand every client situation is different and work with you to explore available options.

A trust may use a bridge loan to effectively manage the timing of distributions and gift obligations to beneficiaries. This type of loan can be effective in instances where an individual passes away with sizeable estate tax obligations or other liabilities, and liquidating the estate's assets too quickly could be detrimental to its beneficiaries.

Longer-term leverage can provide liquidity on assets that won't be sold in the near term, such as low-cost basis restricted stock, hedge funds, private equity, collectibles, or real estate. This solution allows the borrower to stay fully invested and still make opportunistic investments, while smoothing out episodic cash flows.

Leveraging liquidity can provide capital and flexibility for other investments. It can also give families more control over the timing of asset sales, helping minimize opportunity costs (including future appreciation and tax consequences) associated with premature liquidation.

Although liquidating marketable securities may seem like the simplest and most convenient solution to generate liquidity, it is not the only avenue. Your trusted financial team can help you see what options make the most sense for your goals and needs.

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> **Case Study 2: Monetizing a Non-Income Producing, Appreciating Asset**
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> A client borrowed against his fine art collection to monetize a non-income producing asset and create liquidity. His wealth was concentrated in illiquid investments and he was able to extend the holding period on his appreciating assets through a loan. The loan proceeds were used to fund co-investment obligations in his private equity funds and purchase new art to expand his private collection. As an active art investor, this client wanted the flexibility to purchase art opportunistically, and the line of credit provided him the liquidity he needed while retaining a favored asset.

Enhance Returns

Using leverage strategically can propel wealth creation. You can use a loan to expand your business or acquire, develop, enhance, and reposition an asset until it reaches its full potential valuation. These types of loans are typically repaid with cash flow from an enhanced asset, the sale of an asset, or other available liquidity. In some instances, the loan can be replaced with more permanent debt financing. Leveraging income-producing assets (such as commercial real estate, alternative assets, oil, and gas production, private businesses, copyrights, and royalties) is one of the most common strategies to obtain enhanced returns from borrowing. Many commercial real estate developers, for example, rely on recourse-based private bank financing until they finalize the capitalization for a real estate deal or the property reaches stabilization.

While rates have risen in recent years, there are still opportunities to consider a prudent level of leverage.

A common way to achieve enhanced returns is through strategic portfolio leverage. Known as an "interest carry" loan, these loans are carried or maintained as long as the tax-effected interest costs are lower than the tax-effected expected portfolio returns. An important consideration to note: Collapsing the trade (i.e., liquidating the financed investments to repay the loan) could have an adverse impact on the economics of the trade if you must liquidate lower-basis assets or sell assets with depressed market values at an inopportune time. Carefully review these trades with an advisor.

By providing personal recourse to a project or asset, borrowers can benefit from more flexible loan structures and pricing than they would receive if they secured a loan solely by a project or asset.

Mortgages are another strategic form of leverage that can be utilized as a cost-effective source of fixed-rate debt to hedge interest rate risk. Fixed-rate financing has benefits over floating-rate debt, which may require an upfront cost to purchase an interest rate derivative. Minimizing interest costs or locking in positive spread is particularly compelling for individuals seeking an "interest carry" loan.

> **Case Study 3: Reducing Equity Needs in a Real Estate Transaction**
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> A boutique real estate development firm recently used a loan to purchase a five-story, mixed-use property and finance pre-development work on the site, including a demolition of the existing structure. The firm's sponsors provided their personal guarantees to improve the borrowing terms. The strategic use of leverage in this transaction reduced the amount of upfront equity the sponsor and developer had to contribute toward the deal, improving expected return on equity. The pre-development loan will eventually be replaced with a construction loan to build a new luxury condo building on the site.

Defer Capital Gains

Individuals often use leverage against low-basis financial assets (e.g., stock acquired through exercised options, founder shares or real estate operating partnership units) to defer capital gains. While these assets are often liquid, accessing the liquidity through a loan can be more economic than selling the assets. A premature sale could result in a capital gains tax, realize only a fraction of the after-tax liquidity, and forego future appreciation.

You may want to borrow to hold onto personal investments longer, extending the holding period of appreciating assets. Many families have an emotional attachment to certain assets, so borrowing lets them monetize the value while retaining those favored assets. Many non-income generating assets (such as homes, aircraft, ranches, and fine art) are long-term holds and require significant capital investments.

Case Study 4: Borrowing Against a Low Basis Concentrated Stock Position

A public company senior executive contributed low-basis stock into a trust to facilitate the transfer of wealth to his beneficiaries. He recently utilized leverage to freeze appreciated values held in the trust. This loan, secured by the stock, eliminated the single stock risk for the remaining tenor of the trust and successfully "locked in" a substantial transfer to the trust's beneficiaries in a cost and tax-efficient way.

Transfer Wealth

As individuals age, they generally transition from capital accumulation to capital preservation and ultimately to asset disposition. Many families look to transfer wealth to future generations by creating trusts for children, grandchildren, and philanthropic purposes. Financing these transfers allows individuals to lock in attractive intra-family loan rates, finance annuity payments to grantors or charitable beneficiaries, purchase replacement property, minimize tax implications, and/or insulate themselves from change of control concerns associated with asset sales. Individuals can borrow funds secured by their own personal assets or assets held within trusts to achieve their wealth transfer and preservation goals.

Case Study 5: Meeting Charitable Obligations

The patriarch of a wealthy family created a long-term Charitable Lead Annuity Trust ("CLAT") to fund the collective charitable interests of his family after his passing. Due to the depreciation of the CLAT assets (including a concentrated position) over the past several years, the client hoped to hold on to assets instead of liquidating at depressed values. A customized lending solution allowed the CLAT to meet its year-end obligations deadline.

Refinance Existing Debt

Some individuals have existing lending arrangements put in place to support a particular objective at that point in time. Macro-economic factors, broader industry dynamics, and underlying collateral valuation changes can have a material impact on financing structures available at any point in time, and as such, it's a good idea to periodically review existing arrangements and ensure the loan continues to optimize capital requirements.

Many refinance their existing debt to receive additional flexibility, and improve the structural conditions, and commercial terms on their existing debt.

Case Study 6: Cash Out Refinance to release additional liquidity

A multi-generational real estate family was evaluating their lending relationships as part of their long-term capital planning to support their ongoing real estate development activities. They had two income-producing commercial real estate properties with existing debt facilities. However, through the term of the existing loans, the properties had appreciated such that the leverage was quite conservative.

The family refinanced the two existing facilities and secured competitive loan to values, which resulted in increasing the loan amount on each property to release additional liquidity. The additional loan proceeds were redeployed to fund the family's equity requirements for future commercial real estate construction projects and enabled them to complete their projects without impacting their wider liquidity and investment strategy.

Conclusion

High net worth individuals require curated borrowing solutions. The bespoke lending options outlined in this article reveal tools you can use to acquire assets, access liquidity, defer capital gains, enhance returns, and transfer wealth.

Our Private Bank lending advisors work closely with you and your advisory teams to ensure borrowing solutions are customized to your individual goals and needs, while addressing liability and risk management.

If you have any questions about these borrowing solutions, reach out to your Goldman Sachs representative.

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