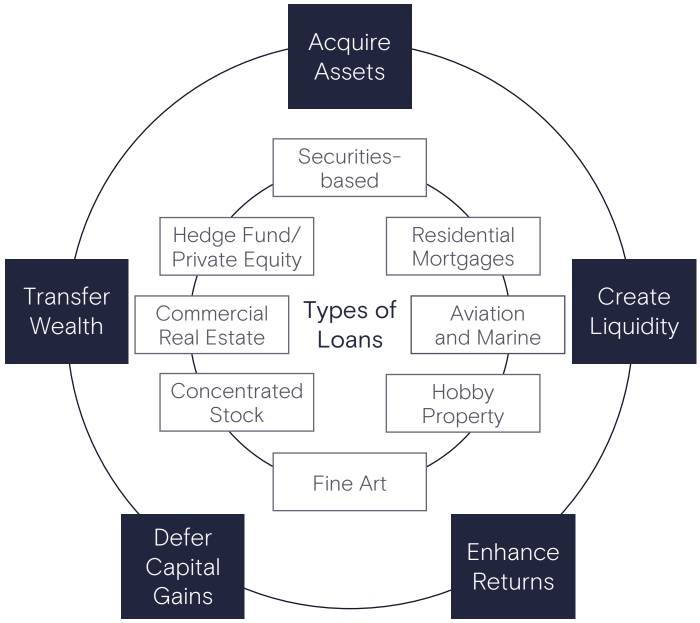
Why the Wealthy Choose to Borrow

Private Bank Lending

The personal balance sheets of high-net-worth individuals can resemble those of complex businesses. As such, many utilize debt as a tool to optimize their return on capital. Wealthy individuals frequently must decide whether it makes sense for them to fund acquisitions or expenditures using cash on hand, liquidating assets, partnering with another individual or entity or by taking out a loan.

Reasons for Borrowing:



Wealthy individuals often have high expectations and seek best in class advice tailored to address their specific needs. To achieve their financial goals, clients work collaboratively with private bank lenders and their advisors to ensure they receive thoughtful and holistic advice and excellent execution on both sides of their balance sheet. There are several reasons why high-net-worth individuals choose to borrow:

- Wealthy individuals and their families borrow for both investment and personal reasons:
  - For investment purposes, people may use leverage to invest in commercial real estate, private businesses, oil and gas ventures, private equity, hedge funds and of course, marketable securities.
  - For personal capital expenditures, individuals may borrow to finance purchases such as homes, ranches, vineyards, fine art, private aircraft and yachts.
- Leverage is also used as an efficient tool to manage or defer capital gains, execute carry trades, monetize illiquid or non-income producing assets, facilitate estate planning transactions, and enhance investment returns to optimize their return on capital.

Acquire Assets

Wealthy individuals often borrow to acquire assets. Although many individuals could easily purchase assets for cash, they utilize lending solutions such as residential mortgages and securities-based loans because it is an efficient use of capital. These facilities are not only used to acquire assets but also provide access to liquidity in a convenient and cost-effective way.

Having access to a line of credit provides individuals with optionality and flexibility, especially when a private bank lender can advise a client to set one up early, before it is actually needed. Wealthy individuals take comfort in having access to a “dry powder line of credit” in the event they find an investment that requires a quick cash closing or choose to finance an equity contribution for a real estate purchase. For residential home purchases, many individuals gravitate toward adjustable-rate mortgage loans that are fixed for a specific time period. The flexibility provided by the interest-only adjustable-rate mortgages (i.e., 7/1 and 10/1 ARMs) is commonly utilized.

Case study 1

Financing a Residential Property

A client residing in New York City leveraged their portfolio of marketable securities using a securities-based line of credit to acquire a vacation residence in Florida. Speed was of the essence in this purchase, as the seller of the property was only accepting cash offers. Subsequent to the purchase, the client utilized the remaining availability of the securities-based loan to extensively renovate the home as they found construction financing too restrictive. Upon completion of the renovation, the client requested a fixed-rate mortgage in order to pay down the variable-rate securities-based loan. The mortgage allowed the client to avoid variable interest rate exposure by locking in a fixed-rate financing solution.

Create Liquidity

Private banks play a key role as providers of liquidity for wealthy individuals with less liquid balance sheets. Loans can vary significantly based on a person's short or long-term needs. Short-term financing can be used as a bridge to a person's near-term liquidity event, such as an IPO or sale of a private company. A bridging event can be as short as 30 days, where an individual has sold a real asset with a delayed closing or is selling a financial asset where restrictive redemption periods or insider windows apply.

For example, a bridge loan may be utilized to effectively manage the timing of distributions and gift obligations a trust has to its beneficiaries. A bridge loan may also 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 a financial asset when an individual does not intend on selling in the near term (such as low cost basis restricted stock, hedge fund or private equity interests). This allows them to stay fully invested while still able to smooth episodic cash flows and make opportunistic investments. Although liquidating marketable securities may seem like the simplest and most convenient solution to generate liquidity to satisfy wealthy individuals' capital expenditures, it is not always the best solution.

Leveraging these assets can provide capital and flexibility for other investments. It can also provide the family with more control over the timing of asset sales, which helps to minimize the opportunity costs (including future appreciation and tax consequences) associated with prematurely liquidating these assets.

Case study 2

Monetizing a Non-Income Producing, Appreciating Asset

A client borrowed against their modern and contemporary fine art collection to monetize a non-income producing asset and create liquidity. The individual's wealth was concentrated in illiquid investments and, through leverage, they were able to extend the holding period on appreciating assets. The loan proceeds were used to fund co-investment obligations in their private equity funds and to purchase new works of art for the private art collection. As an active buyer in the art market, this client wanted the flexibility to purchase art opportunistically, and the art line of credit provided them the liquidity needed while retaining a favored asset.

Enhance Returns

The strategic use of leverage can be a tool to perpetuate wealth creation. Loans can be used for business expansion or to 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, producing oil and gas, private businesses, copyrights, royalties and alternative assets) is among the most common method to look for enhanced returns from borrowing. Many commercial real estate developers, for example, rely on private bank financing until they finalize the capitalization for a real estate deal or the property reaches stabilization.

Current loan rates for wealthy individuals willing to provide personal recourse are relatively low when compared to the income produced from these private assets, so borrowing at a prudent level is compelling to many of these individuals.

By providing the credit enhancement of their personal guarantee behind a project or asset, borrowers benefit from lower pricing and greater flexibility than they would receive with a loan secured solely by a project or asset.

A common way that wealthy borrowers 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 is that 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 lower basis assets must be liquidated to collapse the trade, or assets whose market values are depressed must be sold at an inopportune time. These trades should be considered carefully with an advisor. 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 mortgage financing has benefits over floating rate debt that 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

A boutique real estate development firm recently used a loan to purchase a five-story mixed-use property and to finance pre-development work on the site (including demolition of the existing structure). The strategic use of leverage on this transaction reduced the amount of upfront equity the sponsor and developer had to contribute toward the deal, improving expected returns on invested equity from 30% to 42%. The pre-development loan will be replaced with a construction loan that will be used to build a new luxury condo building.

Defer Capital Gains

Wealthy individuals often utilize leverage against low basis financial assets (i.e., 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 is typically far more economic than selling the assets, prematurely incurring capital gains tax, realizing only a fraction of the after-tax liquidity and foregoing future appreciation if the asset is sold. The combination of a low interest rate environment and increasing capital gains tax rates has amplified the positive economics of this solution in recent years. If an individual expresses a bullish view on the asset being considered for sale, a deeper analysis of the available options should be conducted. Private bank lenders help clients who express bullish views on assets being considered for sale and guide them on structuring optimal solutions.

Frequently, private bank lenders make loans to individuals that allow them to hold onto personal investments longer, thereby extending the holding period of appreciating assets. As many families have an emotional attachment to certain assets, borrowing provides them with the ability to 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

An insider of a public company contributed low basis stock into a trust to facilitate the transfer of wealth to beneficiaries. They 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 tenure of the trust and successfully “locked in” a transfer of close to $150MM to the trust’s beneficiaries (to be transferred upon trust expiration) in a cost and tax-efficient way.

Transfer Wealth

As wealthy individuals age, they generally transition from capital accumulation to capital preservation and ultimately to asset disposition of their wealth. Many individuals look to transfer wealth to future generations by creating trusts for the benefit of their children and grandchildren and for philanthropic purposes. Financing these transfers allows individuals to lock in attractive intra-family loan rates, finance annuity payments due 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 head of a wealthy family created a long-term Charitable Lead Annuity Trust ("CLAT") to fund the collective charitable interests of the family. 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 was structured on short notice, which allowed the CLAT to meet its year-end charitable obligations deadline.

In Conclusion

Unique situations arise for wealthy individuals that require tailored solutions. These bespoke lending solutions outline some of the ways individuals can acquire assets, access liquidity to minimize opportunity costs, defer capital gains, enhance returns and transfer wealth.

Private bank lenders work closely with clients and their advisory teams to ensure the highest quality service and advice on liability and risk management.

For more information on how The Goldman Sachs Private Bank works with wealthy individuals and their families to create customized borrowing solutions, clients are encouraged to contact their private wealth advisors.