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Creative Capital: Financing Hotels via EB-5

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Abstract

Administered by the United States Citizenship and Immigration Service (USCIS), the EB-5 program (Employment-Based Immigration, Fifth Preference) allows foreign nationals to invest as little as \$500,000 or as much as \$1 million in a U.S. enterprise, in consideration of potentially receiving permanent residency in the United States. In recent years, EB-5 financing has grown exponentially and has become a highly utilized funding source for hotel development projects.¹ Congress created the program in 1990 to stimulate the U.S. economy through foreign direct investment to create jobs. Despite the growth of the program, the EB-5 market is opaque and inefficient, and availability of EB-5 financing may encourage development of speculative (and potentially economically marginal) hotel investments. This report explains the mechanics of conducting an EB-5 transaction, examines the motivations of investors and hotel developers to participate in the program, outlines potential for fraud in EB-5 capital raisings, and demonstrates the potential for bringing marginal projects through an economic simulation of a hotel financed with EB-5 capital.

Keywords

EB-5 immigrant visa, hotel finance, non-traditional finance, hotel real estate, private equity

Disciplines

Business | Corporate Finance | Finance and Financial Management | Hospitality Administration and Management | Real Estate

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Creative Capital: *Financing Hotels via EB-5*

by Arian Mahmoodi and Jan A. deRoos

EXECUTIVE SUMMARY

Administered by the United States Citizenship and Immigration Service (USCIS), the EB-5 program (Employment-Based Immigration, Fifth Preference) allows foreign nationals to invest as little as \$500,000 or as much as \$1 million in a U.S. enterprise, in consideration of potentially receiving permanent residency in the United States. In recent years, EB-5 financing has grown exponentially and has become a highly utilized funding source for hotel development projects.¹ Congress created the program in 1990 to stimulate the U.S. economy through foreign direct investment to create jobs. Despite the growth of the program, the EB-5 market is opaque and inefficient, and availability of EB-5 financing may encourage development of speculative (and potentially economically marginal) hotel investments. This report explains the mechanics of conducting an EB-5 transaction, examines the motivations of investors and hotel developers to participate in the program, outlines potential for fraud in EB-5 capital raisings, and demonstrates the potential for bringing marginal projects through an economic simulation of a hotel financed with EB-5 capital.

Key Words: EB-5 immigrant visa, hotel finance, non-traditional finance, hotel real estate, private equity

¹ One indicator of the popularity of EB-5 financing is the advent of conferences devoted to the topic. An example is the August 3, 2015, California EB-5 Investment Conference; see: www.eb5investors.com/conferences/2015-california-eb5-conference.

ABOUT THE AUTHORS



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Creative Capital:

Financing Hotels via EB-5

Arian Mahmoodi and Jan A. deRoos

A federal program for foreign direct investment in the United States has become a growing source of funding for hotel developments. The program, commonly known as EB-5 (Employment-Based Immigration, Fifth Preference), offers U.S. residency and citizenship to foreign nationals willing to invest at least \$500,000 in job-producing projects in designated U.S. locations. As described in this report, the structure of the EB-5 program is arcane, and the potential for misuse is considerable. Moreover, the typical financing terms of EB-5 loans may stimulate the development of speculative projects. Later in this report we present a simulated hotel development project that demonstrates the economically distorting effects of the EB-5 financing.²

² The information presented in this report is based on author Arian Mahmoodi's extensive primary and secondary research as part of an honor's thesis at the School of Hotel Administration.

Methods of Structuring EB-5 Investments

The EB-5 program mandates specific investment and job creation levels for foreign investors seeking U.S. residency. Two methods of structuring EB-5 investments have emerged: the direct method and the regional center method. Because of program strictures, the direct EB-5 structure is little used, representing no more than 2 percent of investment through the program. This structure requires a minimum investment of \$1 million per investor, and each million dollars of investment must show creation of ten direct, full-time jobs. Direct jobs are defined as “actual, identifiable jobs for qualified employees located within the commercial enterprise into which the EB-5 investor has directly invested their capital.”³ Consequently, the amount of EB-5 financing that can be directly invested in a project is limited by the number of jobs it creates. For example, if a developer is planning to build a hotel that will result in 50 full-time employees, only \$5 million in EB-5 financing could be included in the project’s capital stack.⁴

Instead, the regional center method has become the dominant method of structuring EB-5 investments, with at least 98 percent of EB-5 visas. The regional center method allows a minimum investment of \$500,000, effectively pools investments, and (most critically) relaxes the definition of jobs created. This method still requires creation of ten full-time jobs per investment, but it allows indirect jobs to be counted, including those from construction employment, household earnings, taxation, and economic output. By using the regional center method, EB-5 financing can constitute a larger portion of the capital stack and thus allow a greater number of EB-5 investors per project, as compared to an investment structure under the direct method.

Regional Centers and Target Employment Areas

A regional center is essentially a license granted to an organization by the USCIS that allows that organization to raise EB-5 capital in \$500,000 increments. A regional center can be “any economic unit, public or private, engaged in the promotion of economic growth, improved regional productivity, job creation, and increased domestic capital investment.”⁵ Regional centers must be located in a “Target Employment Area” (TEA), which is defined as “an area that, at the time of investment, is a rural

area or an area experiencing unemployment of at least 150 percent of the national average rate.” A rural area is defined as “any area outside a metropolitan statistical area (as designated by the Office of Management and Budget) or outside the boundary of any city or town having a population of 20,000 or more according to the decennial census.”⁶ The language the USCIS uses to describe TEAs makes it appear that EB-5 projects utilizing a regional center must be located outside of cities or in high unemployment areas. However, as with electoral districts that are gerrymandered to slant in one political direction or another, the TEA may be designated to include census tracts that are both high and low in unemployment, as long as the average unemployment level qualifies. Thus, it is possible to gerrymander a TEA to include EB-5 financing for projects located in low unemployment areas. In such an instance, the parcel for a hotel development may not be located in a high unemployment area, but surrounding census tracts that have high unemployment can be included in the TEA to help satisfy the unemployment requirement.

The greater the number of census tracts that can be included in a TEA designation, as set by each state, the easier it is for developers to gerrymander the TEA.⁷ The result is that many EB-5 projects are located in areas with low unemployment. For example, Abigail Browning, who is involved with EB-5 regulation at the California governor’s office, said, “Even though there are some very high employment areas in California, it is hard to find something that doesn’t qualify [as a TEA]. ...I’ve qualified [projects] that are in the middle of Beverly Hills. You’d think that wouldn’t be a high unemployment area.”⁸ Noting EB-5’s purpose of stimulating job growth, we could not find evidence to show that EB-5 has effectively done so, and the USCIS expressly disclaims this task.⁹ In summary, developers do not have significant difficulty locating projects where they wish using the TEA rules.

Establishing a Regional Center

Since nearly any organization can establish a regional center, developers themselves can choose to establish their own regional center, or they can contract with an existing regional center. The ownership of regional centers has become a business of its

³ EB-5 Immigrant Investor.” U.S. Citizenship and Immigration Services, n.d. Web. 06 Oct. 2014. www.uscis.gov/working-united-states/permanent-workers/employment-based-immigration-fifth-preference-eb-5/eb-5-immigrant-investor

⁴ Calculated as follows: 50 full-time employees / 10 full-time employees per investor = a maximum of 5 investors for the project. 5 investors x \$1MM = \$5MM maximum EB-5 capital raised.

⁵ “Definition of an EB-5 Visa Regional Center.” EB-5 Visa Information, viewed 06 Oct. 2014; www.whicheb5.com/%2Fdefinition-of-an-eb5-regional-center-visa.php.

⁶ EB-5 Immigrant Investor,” *loc. cit.*

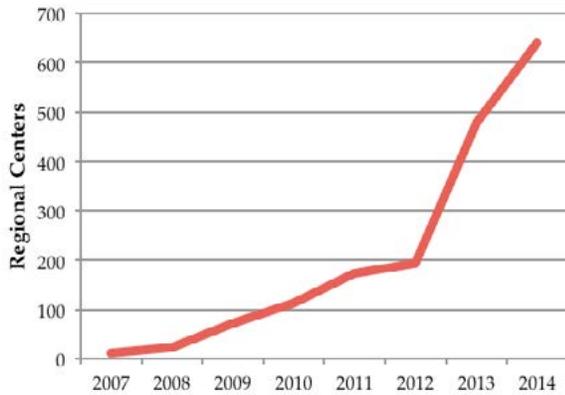
⁷ North, David. “Gerrymandering the Investor Visa.” Center for Immigration Studies, 11 Nov. 2013. Web. 19 July 2015; cis.org/north/gerrymandering-investor-visa

⁸ Koch-Weser, Icaob, and Garland Ditz. Chinese Investment in the United States: Recent Trends in Real Estate, Industry, and Investment Promotion. Rep. U.S-China Economic and Security Review Commission, 26 Feb. 2015. Web. 27 Mar. 2015; origin.www.uscc.gov/sites/default/files/Research/Ch%20invt%20paper_2%2026%2015.pdf

⁹ See: Office of the Citizenship and Immigration Services Ombudsman’s 2014 Annual Report to Congress, p. 29

EXHIBIT 1

Number of EB-5 regional centers (2007–2014)



Source: U.S. Citizenship and Immigration Service

own, as individuals are applying for regional center designations for the purpose of renting them out. As a result, the supply of regional centers has increased dramatically, as shown in Exhibit 1. Due to the time and cost of starting a new regional center, however, the current trend is for developers to rent a regional center on a project-by-project basis. Establishing a new regional center takes 6 to 15 months and will cost about \$100,000.¹⁰ In contrast, the cost to rent a regional center is as low as \$15,000 plus \$3,000 per investor and as high as 2 percent of the capital raised. Because this market is fragmented, pricing is quite variable, but is generally decreasing due to competition.

The EB-5 Investor's Incentive

The EB-5 investor's goal is to receive permanent residency—and ultimately a visa—in the United States. Monetary considerations are less important, and, as we discuss below, financial return on these investments is often negligible. To obtain an EB-5 visa, an investor must have an “at risk” investment of at least \$500,000 in a U.S. enterprise—meaning that the investor cannot be guaranteed any type or level of return. In today's market, EB-5 capital is most often utilized as interest-only debt for commercial real estate projects. Investors are typically compensated with a return of up to 1 percent interest per annum on their capital.¹¹

As currently constituted, the EB-5 program is particularly useful for investors' families. A single EB-5 investment of \$500,000 allows an investor, a spouse, and their unmarried

¹⁰ David L. Bennett, head of U.S. commercial real estate, Salmon Run Capital, message, August 2015.

¹¹ See: Arian Mahmoodi, “Alternative Capital Stacks for Hotel Investments.” Thesis. Cornell University, Ithaca, NY, 2015.

children under age 21 to receive permanent U.S. residency.¹² In 2014, the *Los Angeles Times* reported an estimated 85 percent of EB-5 investors were from China, “where concerns about the country's environmental and economic health has led families to consider migrating to the United States.”¹³ At the same time, many Chinese entrepreneurs who participate in the EB-5 program operate profitable companies in China, where they intend to continue to reside. These individuals may participate in EB-5 so they can have the future option to live and work in the U.S. Additionally, some investors believe that it will be easier for their children to receive admission at U.S. colleges and universities by applying as a U.S. resident as opposed to a foreign national student.¹⁴

Typical EB-5 Loan Agreement

In this section, we will describe the typical EB-5 loan agreement from the perspective of the EB-5 investor. Although it is possible for EB-5 capital to be utilized as equity, as we said, most agreements are being structured as interest-only debt. EB-5 loan agreements tend to be biased toward the borrower, who is the project developer in almost all cases. In basic terms, in an EB-5 loan document the borrower essentially tells the investor:

Lend us \$500,000 USD. In return, we will pay you no more than 1 percent interest per annum for at least 5 years. We have the right to extend the loan for one or two additional years at the same interest rate, with no penalties. The loan is non-recourse to the borrower with no minimum debt coverage ratio (DCR) and no maximum loan-to-value (LTV) ratio. The loan will likely be subordinate to all other debt in the capital stack. The loan is being used to finance property XYZ, and we will do our best to get you permanent U.S. residency and to return your \$500,000 with the stated interest. Any shortfall in repayment will not constitute a default.

In addition to the \$500,000 investment, EB-5 investors generally have to pay an administration fee, which is usually \$50,000.

Although we just summarized a typical loan structure, we must point out that there is no standard EB-5 loan agreement. There is variability in the market, as borrowers may write their own language in the loan agreement and try to find investors who will agree with it. The language of an EB-5 loan agreement reads similarly to the language of a conventional equity

¹² EB-5 Immigrant Investor Process.” EB-5 Immigrant Investor Process. U.S. Citizenship and Immigration Services, n.d.; viewed 23 Mar. 2015; /www.uscis.gov/working-united-states/permanent-workers/employment-based-immigration-fifth-preference-eb-5/eb-5-immigrant-investor-process>

¹³ Shyong, Frank. “Visa Program for Wealthy Investors Maxed out by Chinese Demand.” *Los Angeles Times*, 29 Aug. 2014. Web. 11 Nov. 2014; www.latimes.com%2Flocal%2Ffla-me-0830-chinese-visas-20140830-story.html

¹⁴ Rich Marin, “Creating Project Driven Alpha.” Cornell University Johnson Graduate School of Management, Ithaca, NY. 13 Apr. 2015.

Start-up costs for EB-5 financing

Start-Up Cost	Direct Method	Regional Center Method
Private Placement Memorandum (PPM) and Attorney Fees	\$60K-\$200K	\$60K-\$200K
Business Plan	\$10K-\$12K	\$10K-\$12K
Economic Impact Study	Not necessary; full-time jobs of the project being developed are counted.	\$10K-\$15K
Regional Center	N/A	Can be rented for as low as \$15K plus \$3K per investor or as high as 2% of the capital raised.
Total	\$70K-\$212K	\$80K-\$227K, plus regional center fee

investment. The primary difference is that a conventional equity investment will not limit investors' returns. Therefore, in comparison to conventional project financing options, the terms of EB-5 financing are more favorable for the developer than equity financing would be.

The Developer's Incentive

Developers may be attracted to EB-5 financing for the following reasons: **(1)** inability to obtain financing from conventional lenders due to a variety of issues, including the lack of a track record, lack of additional collateral, the nature of the project; **(2)** more favorable financing terms, relative to conventional options; or **(3)** reduced financial risk. The simulated hotel development project that we present in this report illustrates why a developer may be motivated to utilize EB-5 financing, particularly if the project is marginal.

Cost of EB-5 Capital

As we said above, the cost of EB-5 capital and services related to EB-5 are widely variable, due to a fragmented, inefficient market. Although this issue is beyond the scope of this report, we note that the sourcing of EB-5 investment capital can involve numerous intermediaries that operate a highly opaque, relationship-based fundraising enterprise.¹⁵

The effective cost of EB-5 financing varies according to the start-up costs associated with the structure of the EB-5 investment and the amount of capital raised (see Exhibit 2). One primary difference between the direct and indirect approach is that the indirect regional center method requires the developer to lease or establish a regional center. Due to the fixed costs of either of the EB-5 methods, the effective cost of capital inherently decreases as the capital raised increases. Ultimately, the fixed cost, time, and effort associated with establishing an EB-5 structure creates an incentive for developers to raise large amounts of EB-5 capital and therefore plan larger projects.

¹⁵ See: Mahmoodi, *loc. cit.*

Simulation Overview

This simulation of the economics of an EB-5 project illustrates why a developer may be motivated to utilize EB-5 financing and why a project that could not qualify for conventional financing may go forward with EB-5 support. Let's consider the development and financing of "Hotel ABC," an upscale, \$20 million, chain-affiliated, select-service hotel development project.¹⁶ Appendix 1, on the next page, shows a simulated *pro forma* income statement of Hotel ABC. Based on this *pro forma*, we calculate the theoretical investment returns for Hotel ABC under three financing structures, as depicted by the three capital stacks in Exhibit 3. (Note: Inputs and assumptions for the *pro forma* are summarized in Appendix 2, page 14.)

Conventional financing vs. EB-5. In the hypothetical conventional capital stack, the sponsor contributes \$2 million of equity, with limited partners contributing the remaining \$5 million of equity. In EB-5 Stack A, the sponsor also contributes \$2 million of equity. However, in lieu of a limited partnership for the additional \$5 million of equity, the sponsor funds this as \$5 million of junior EB-5 debt from ten EB-5 investors who each invest \$500,000. The senior debt remains at 65 percent of the capital stack in these two scenarios to show how the replacement of the limited partners with EB-5 debt would affect the sponsor's returns. In EB-5 Stack B, we explore the impact on the sponsor's returns of replacing senior debt with an increasing amount of EB-5 debt. It is common for sponsors to maximize the number of EB-5 investors accommodated in projects, given that hotels have the potential to create significant employment. Our Stack B simulation expands the projected number of EB-5 investors from ten to twenty, increasing the job creation requirement from 50 to 100. Because the project may fall short of that job-creation require-

¹⁶ See: 2015 STR U.S. Chain Scales. For simplicity, the development cost and capital contributions presented in this report are approximate. However, precise figures were utilized to compute investment returns.

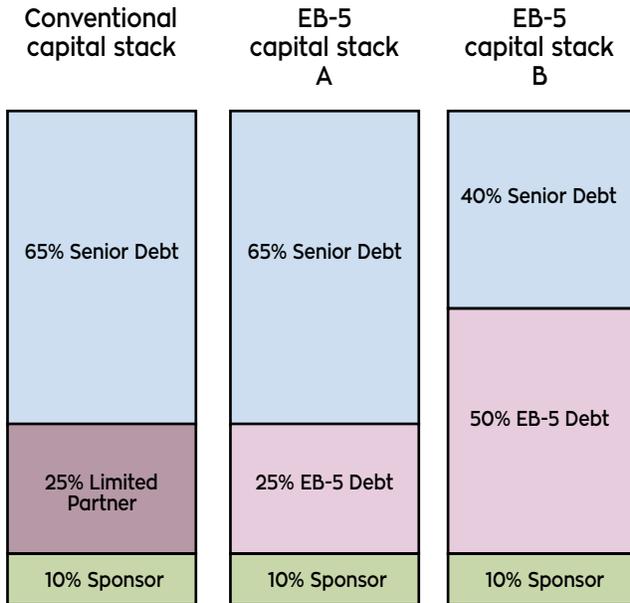
Appendix 1: Hotel ABC simulated pro forma

Chain-Affiliated Select Service Hotel	Year 1		Year 2		Year 3		Year 4	
Number of Rooms	170		170		170		170	
Occupancy	62.0%		68.0%		74.0%		78.9%	
Average Rate	\$135.22		\$137.89		\$140.62		\$143.41	
Days Open	365		365		365		365	
Rooms Occupied	38,471		42,194		45,917		48,957	
Revenues								
	\$(000s)	Percent	\$(000s)	Percent	\$(000s)	Percent	\$(000s)	Percent
Rooms	\$5,202	96.2%	\$5,818	96.3%	\$6,457	96.4%	\$7,021	96.5%
Food	\$42	0.8%	\$46	0.8%	\$50	0.7%	\$53	0.7%
Beverages	\$11	0.2%	\$12	0.2%	\$13	0.2%	\$14	0.2%
Rentals and Other Income	\$33	0.6%	\$35	0.6%	\$37	0.6%	\$39	0.5%
Other Operated Departments	\$113	2.1%	\$120	2.0%	\$128	1.9%	\$134	1.8%
Total Revenue	\$5,409	100.0%	\$6,040	100.0%	\$6,695	100.0%	\$7,272	100.0%
Departmental Expenses								
Rooms	\$1,404	27.0%	\$1,480	25.4%	\$1,558	24.1%	\$1,629	23.2%
Food & Beverages	\$48	90.6%	\$50	86.2%	\$53	84.1%	\$55	82.1%
Other Operated Departments and Rentals	\$69	61.1%	\$72	60.0%	\$75	58.6%	\$77	57.5%
Total Departmental Expenses	\$1,521	28.1%	\$1,602	26.5%	\$1,686	25.2%	\$1,761	24.2%
Departmental Income	\$3,888	71.9%	\$4,438	73.5%	\$5,009	74.8%	\$5,511	75.8%
Undistributed Operating Expenses								
Administrative & General	\$552	10.2%	\$577	9.6%	\$602	9.0%	\$625	8.6%
Marketing	\$315	5.8%	\$329	5.4%	\$343	5.1%	\$356	4.9%
Franchise Fees	\$265	4.9%	\$297	4.9%	\$329	4.9%	\$358	4.9%
Prop. Oper. & Maintenance	\$289	5.3%	\$302	5.0%	\$315	4.7%	\$327	4.5%
Energy Costs	\$269	5.0%	\$276	4.6%	\$284	4.2%	\$291	4.0%
Total UDOEs	\$1,690	31.2%	\$1,781	29.5%	\$1,873	28.0%	\$1,957	26.9%
Income Before Fixed Charges	\$2,198	40.6%	\$2,657	44.0%	\$3,136	46.8%	\$3,554	48.9%
Fixed Charges								
Management Fee	\$216	4.0%	\$242	4.0%	\$268	4.0%	\$291	4.0%
Property Tax	\$302	5.6%	\$308	5.1%	\$314	4.7%	\$320	4.4%
Insurance	\$69	1.3%	\$70	1.2%	\$71	1.1%	\$73	1.0%
Reserve for Replacement	\$119	2.2%	\$133	2.2%	\$147	2.2%	\$160	2.2%
Total Fixed Charges	\$706	13.1%	\$753	12.5%	\$800	11.9%	\$844	11.6%
Net Operating Income	\$1,492	27.6%	\$1,904	31.5%	\$2,336	34.9%	\$2,710	37.3%

Note: For financial data and assumptions, see appendix 2, page 15.

EXHIBIT 3

Simulated hotel capital stack comparison



ment, this may create additional risk for the EB-5 investors during the verification phase of the project, which starts at the end of the second year. The issues surrounding verification are discussed below.

Analysis of Simulation Results

In our simulation, replacing the limited partners in the conventional stack with an equal amount of EB-5 debt more than doubles the sponsor’s profit. Although the conventional stack has a 65-percent LTV and EB-5 Stack A has a 90-percent LTV, EB-5 Stack A provides the sponsor with lower risk, relative to the conventional stack. This is because the EB-5 investors do not have any recourse in the event of a default, which is unheard of in conventional mezzanine debt markets.

Increasing the amount of EB-5 debt in the capital stack yields a substantial, but not dramatic increase in the sponsor’s returns, which seems to limit any incentive to include too many EB-5 investors in a project relative to the direct and indirect job requirements. The small increase in returns may not compensate the sponsor for any reputational risk of failure to qualify during the verification process.

As an extension to the simulation, we examined the impact of a stress test on the returns. Exhibit 5 compares returns under a financially stressful scenario, in which occupancy does not meet the *pro forma* expectations. All simulation assumptions reflected in Exhibit 4 are held constant, except that we assume

EXHIBIT 4

Comparison of financing structures and investor returns in simulated hotel

Return Metrics	Conventional	EB-5 Stack A	EB-5 Stack B
Sponsor IRR	27.18%	51.27%	56.10%
Sponsor Profit	\$4,371,275	\$11,198,206	\$12,460,347
Adjusted Sponsor IRR	36.98%	57.28%	61.92%
Adjusted Sponsor Profit	\$5,973,355	\$12,600,026	\$13,862,167
LP IRR	19.62%	N/A	N/A
LP Profit	\$6,753,589	N/A	N/A
EB-5 Investor IRR	N/A	1.00%	1.00%
EB-5 Investor Profit	N/A	\$250,325	\$500,650

Note: Sponsor IRR excludes asset management and developer fees. These are included in Adjusted Sponsor IRR and Adjusted Sponsor Profit (See Appendix 2.)

Hotel ABC’s average occupancy is 50-percent during the hold-ing period, rather than the original stabilized projection of 78.9 percent used in Exhibit 4. This 50-percent occupancy test demonstrates how EB-5 financing can turn a financially questionable project into a viable investment for the project sponsor.

It is clear from Exhibit 5 that when Hotel ABC is financed conventionally, the sponsor will be unable to convince limited partners to invest in this hotel when it is projected to operate at 50-percent occupancy. In EB-5 Stack A, however, the limited partners are replaced with the EB-5 investors who have a primary interest in citizenship and a secondary interest in investment returns. Therefore, a hotel development that is projected to have a stabilized occupancy of 50 percent may be pursued with EB-5 financing, as the sponsor obtains a profit and a positive, albeit below-market return. The EB-5 Stack A return metrics in Exhibit 5 indicate that a sponsor may be motivated to pursue development of Hotel ABC, as it results in an adjusted sponsor IRR of 11.61 percent, and EB-5 Stack B has even better returns to the sponsor under the stressed scenario.

Considering the results for EB-5 Stack B, our simulation indicates that a higher allocation of EB-5 financing may motivate sponsors and developers to pursue projects that would not be feasible when financed conventionally or to pursue speculative projects. We draw this conclusion because the sponsor’s project returns are significantly higher in the stressed scenario

in EB-5 Stack B than in EB-5 Stack A. As a result, we speculate that EB-5 financing may cause hotel rooms to be developed in markets where the economics would not make sense if the projects were financed conventionally. Further research is needed to determine whether certain markets are at risk of overbuilding hotel rooms due to the combination of availability of EB-5 capital and manipulation of TEA census tracts.

Risks for EB-5 Investors

As we indicated above, the qualification and verification processes involved with EB-5 financing carry additional risks for EB-5 investors. Potential issues with the qualification and verification processes are depicted in Appendix 3, on page 15.

Qualification. A foreign investor who would like to participate in the EB-5 program starts the process by working with a capital raiser (often a developer or sponsor) to invest in a qualified investment project and to pass a security check. The foreign investor then must file form “I-526” with the USCIS, to demonstrate that he or she has invested or is investing the required, lawfully gained capital in a U.S. company and that the investment will create at least ten full-time jobs in the U.S.¹⁷ Upon approval (which takes ten months at this writing), this form grants the EB-5 investor a two-year conditional residency in the U.S.¹⁸ If the I-526 form is denied by the USCIS, the EB-5 investor’s \$500,000 investment (but not necessarily the \$50,000 administrative fee) is typically refunded. Therefore, the approval process for form I-526 is a risk to EB-5 investors in terms of time and money.¹⁹ If form I-526 is approved, funds are invested in the project.

Verification. The essential issue for verification revolves around job creation. Two years into the process, to gain permanent residency, the investor must complete form “I-829,” which demonstrates that the requisite jobs have been created. The capital raiser must provide the documentation regarding the project’s progress and job creation to the EB-5 investors so they can complete form I-829. The USCIS will deny approval if it finds that the EB-5 investment did not create at least ten jobs per investor. If approved, the immigrant investor obtains permanent residency and may apply for U.S. citizenship. On the other hand, investors whose form I-829 is denied can receive their principal back. However, this does not always occur, because those funds are an “at risk” investment, and they are likely to be illiquid, since the developer may not have free cash flow at that time.

¹⁷ An Overview of the EB-5 Green Card Process.” Zhang & Associates, P.C. - U.S. Immigration Attorneys and Counselors, n.d. Web. 23 Mar. 2015; www.hooyou.com/eb-5/overview.html.

¹⁸ EB-5 Immigrant Investor Process.” *loc.cit.*; and *Ibid.*

¹⁹ Time is a risk for EB-5 investors who have children close to age 21, as form I-526 must be approved prior to age 21 in order for any children to qualify for an EB-5 visa.

EXHIBIT 5

Comparison of financing structures and investor returns in simulated hotel stressed by a 50-percent occupancy

Return Metrics	Conventional	EB-5 Stack A	EB-5 Stack B
Sponsor IRR	-2.19%	-12.13%	9.18%
Sponsor Profit	-\$194,172	-\$606,262	\$655,879
Adjusted Sponsor IRR	14.72%	11.61%	24.53%
Adjusted Sponsor Profit	\$1,407,908	\$795,558	\$2,057,699
LP IRR	-2.19%	N/A	N/A
LP Profit	-\$485,431	N/A	N/A
EB-5 Investor IRR	N/A	1.00%	1.00%
EB-5 Investor Profit	N/A	\$250,325	\$500,650

Potential for Fraud

As a relatively new and unregulated market, there have been numerous documented cases of fraud with EB-5 programs. According to *Fortune*, EB-5 financing “has become a magnet for amateurs, pipe-dreamers, and charlatans, who see it as an easy way to score funding for ventures that banks would never touch. Meanwhile, perhaps because wealthy foreigners are the main potential victims, U.S. authorities have seemed inattentive to abuses.”²⁰ In this section, we detail an apparently fraudulent deal that took advantage of the EB-5 program.

A key driver for EB-5 fraud appears to be a lack of education about the EB-5 program coupled with a failure of due diligence on the part of the would-be investors. According to Bradley Gillenwater, an investment promotion official in Maryland, there are capital raisers in China who forge their documentation to make it appear that they are from a federally approved regional center.

These capital raisers will say, “I have an escrow account set up. You, the Chinese investor, will provide me money now in exchange for a green card in the U.S. If you do not end up getting your green card, you’ll get your money back.”²¹ Ultimately, some of these individuals disappear with investors’ money. One

²⁰ Peter Elkind and Marty Jones, “The Dark, Disturbing World of the Visa-For-Sale Program.” *Fortune*, 24 July 2014. Web. 10 Feb. 2015; fortune.com%2F2014%2F07%2F24%2Fimmigration-eb-5-visa-for-sale%2F.

²¹ Koch-Weser, Icaob, and Garland Ditz. Chinese Investment in the United States: Recent Trends in Real Estate, Industry, and Investment Promotion. Rep. U.S.-China Economic and Security Review Commission, 26 Feb. 2015. Web. 27 Mar. 2015; origin.www.uscc.gov/sites/default/files/Research/Ch%20invt%20paper_2%2026%2015.pdf.

apparently fraudulent scenario that has come to light involved a hotel project supposedly planned for suburban Chicago, Illinois.

SEC v. A Chicago Convention Center *et al.*

A 25-year-old alleged scammer by the name of Anshoo Sethi began raising EB-5 capital in 2011, purportedly to finance the “world’s first zero carbon emission platinum LEED certified” hotel near Chicago’s O’Hare Airport. Projected to cost \$913 million, the hotel was advertised as including 995 rooms, four levels of convention space, a green roof with a spa and yoga studio, a miniature golf course, a 1,720-car “automatic robotic” parking garage, and a “biometric self-service check-in.”²²

For the proposed hotel project, Sethi fraudulently sold over \$145 million in securities and collected \$11 million in administrative fees from over 250 investors, primarily from China, each of whom invested \$500,000.²³ Despite a promise to return this money to investors if their visa applications were denied, Sethi and his companies spent more than 90 percent of those administrative fees.²⁴ Sethi had agreed to keep the approximately \$145 million of principal in escrow until the investors’ provisional green cards were approved by the USCIS. However, the USCIS would not approve any visas until documentation of the project was provided. When asked for his franchise agreements, Sethi submitted a “comfort letter from Hyatt Hotels that was not genuine.”²⁵ Similarly, when the USCIS also asked for evidence of Sethi’s non-EB-5 funding, his lawyer responded by mentioning that the project was expecting \$340 million in bond money from the Illinois Finance Authority. Sethi also submitted a false backup-financing letter from the Qatar Investment Authority.²⁶

Based on Sethi’s actions, it appears that he never intended to build the proposed hotel. Instead, it appears he created a scam to steal the principal investments from EB-5 investors by providing false documentation to the USCIS that would release the EB-5 investments to him from escrow. (Note that the project would have had to produce in excess of 2,500 jobs if it were genuine.) Fortunately, before Sethi was able to abscond with the principal investments from the EB-5 investors, a whistleblower offered information leading to an SEC enforcement action that recovered the principal investments of the EB-5 investors.²⁷ Under the SEC’s whistleblower program, the anonymous whistle-

blower received an award of over \$14 million—the largest-ever SEC whistleblower award to date.²⁸ At this writing the SEC is seeking “other monetary relief” (perhaps the administrative fees that Sethi collected).²⁹

The SEC’s investigation is still continuing.³⁰ However, the disheartening aspect of this situation is that there is no indication that the USCIS would have caught Sethi’s fraud in the first place, were it not for the whistleblower.

EB-5 Politics: View From Washington, D.C.

There is almost unanimous bipartisan support in the Congress for the EB-5 program. The 2012 reauthorization was passed by the House of Representatives in a vote of 412 to 3 and was passed unanimously by the Senate.³¹ In September 2012, President Obama signed a three-year reauthorization of the EB-5 program, which still must be renewed every three years.³² At this writing, Senators Patrick Leahy and Chuck Grassley have proposed legislation to reform the EB-5 program. Noteworthy changes proposed in the Leahy-Grassley proposal (S.1501) include:³³

- Extension of the program for five years;
- Limiting high-unemployment-rate TEAs in metro areas to only one census tract;
- Raising the investment threshold to \$800,000 for TEAs and \$1.2 million for non-TEAs;
- Increasing authority to the Department of Homeland Security (DHS) to deny or terminate applications where there is fraud, criminal misuse, or a threat to public safety or national security;

²⁸ According to the SEC, “The SEC’s Office of the Whistleblower was established in 2011 as authorized by the Dodd-Frank Act. The whistleblower program rewards high-quality original information that results in an SEC enforcement action with sanctions exceeding \$1 million, and awards can range from 10 percent to 30 percent of the money collected in a case.” See: *Ibid.*

²⁹ *Ibid.*

³⁰ “Securities and Exchange Commission v. A Chicago Convention Center, LLC, Anshoo Sethi, and Intercontinental Regional Center Trust of Chicago, LLC, Civil Action No. 13-cv-982.” U.S. Securities and Exchange Commission, 8 Feb. 2013. Web. 20 Mar. 2015; www.sec.gov%2F litigation%2F litreleases%2F2013%2F1r22615.htm>.

³¹ Salmon Run Capital Presentation, “Everything You Wanted to Know About EB-5 But Were Afraid to Ask,” prepared for Arian Mahmoodi on 11 Nov. 2014.

³² Bill Text Versions 112th Congress (2011-2012) S.3245. The Library of Congress, n.d. Web. 15 Mar. 2015; thomas.loc.gov/cgi-bin/query/z?c112%3AS.3245%3A

³³ American Job Creation and Investment Promotion Reform Act of 2015, S. 1501, 114th Cong. (2015); see also: “Leahy & Grassley Introduce Legislation to Improve & Extend Job-Creating Foreign Investment Program.” Press Release. 4 June 2015. Web. 12 Aug. 2015; www.leahy.senate.gov/press/leahy-and-grassley-introduce-legislation-to-improve-extend-job-creating-foreign-investment-program.

²² Elkind and Jones, *op.cit.*

²³ “Securities and Exchange Commission v. A Chicago Convention Center, LLC, Anshoo Sethi, and Intercontinental Regional Center Trust of Chicago, LLC, Civil Action No. 13-cv-982.” U.S. Securities and Exchange Commission, 8 Feb. 2013. Web. 20 Mar. 2015; www.sec.gov%2F litigation%2F litreleases%2F2013%2F1r22615.htm

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ Elkind and Jones, *op.cit.*

²⁷ “SEC Awards More Than \$14 Million to Whistleblower.” Securities and Exchange Commission, 1 Oct. 2013. Web. 25 Mar. 2015; www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258#.VRh2dVxuZhM

- Establishing an “EB-5 Integrity Fund” in which regional centers would pay an annual fee to be used by DHS to conduct audits and site visits to detect and investigate fraud in the U.S. and abroad;
- Requiring background checks of regional center and project developer principals;
- Requiring DHS to vet EB-5 projects earlier in the process, before investors submit applications and give money to developers;
- Requiring increased disclosures to investors regarding business risks and conflicts of interest;
- Requiring more oversight of projects and closer monitoring for securities compliance; and
- Adding an option to pay a fee for expedited processing of business plan applications.

Should the program be renewed, Robert Divine, former acting director and chief counsel of the USCIS anticipates the following possible changes:³⁴

- The minimum investment may be raised;
- Fraud and security-related measures may be imposed to make it easier to deny or terminate regional centers;
- The definition or process of creating a TEA may be changed;

³⁴ Robert Divine, Shareholder, Baker Donelson. Personal interview.

- The USCIS may deny EB-5 investors for national security-oriented reasons without disclosing why; and
- If visas could be taken from somewhere else such as the “Diversity” visa program, family members of EB-5 investors could cease to be counted against the annual 10,000 EB-5 visa quota, thereby increasing the number of EB-5 investments by a factor of two or three.

Despite the political support for the EB-5 program and the many proposals we just listed, we will watch to see whether substantial changes are made to the program, which is set to expire on September 30, 2015. The many potential proposals for change could have a major impact on developers, capital raisers, and prospective EB-5 investors.

Summary and Conclusion

In conclusion, EB-5 financing may be a worthwhile financing approach for developers and for immigrant EB-5 investors. As compared to conventional financing, utilizing EB-5 can provide higher risk-adjusted returns for project sponsors and limited partners, as the risk shifts to the EB-5 investors. This is evidenced by our quantitative simulation of the “conventional capital stack” and “EB-5 Stack A,” in which the conventional stack yielded \$6 million in adjusted sponsor profit while the EB-5 stack yielded \$12.6 million. Our research also implies that EB-5 financing may stimulate the development of speculative (and potentially economically marginal) projects. However, the process of securing EB-5 financing is complex and is likely to be revised by Congress. Due to the limited property rights typically associated with EB-5 financing, EB-5 investors must select projects carefully. It will be interesting to see how proposed federal legislation will change the EB-5 landscape for investors and developers. ■

Appendix 2: Hotel ABC pro forma assumptions

Item	Assumption	Source
Cost of Land	12% of development cost. Note: This was calculated by multiplying the development cost (indicated in the rows below) by 12% (median percentage allocated to land for a midscale hotel w/o F&B in the U.S.). ($\$117,800 \times 180 = \$20,026,000 \times .12 = \$2,403,120$)	2014/2015 HVS Hotel Development Cost Survey, p. 9
Land Option Contract	Cost of option is 10% of the exercisable land value ($\$2,403,120 \times .1 = \$240,312$). The option contract is considered to be an expense for the sponsor and is independent of calculating investment returns.	Typical Practice
Number of Hotel Rooms	170	Simulation Input
Cost Per Key	$\$117,800$ (median cost for a midscale hotel w/o F&B in the U.S.)	2014/2015 HVS Hotel Development Cost Survey, p. 9
Construction Cost (including land)	$\$117,800 \times 170 = \$20,026,000$	Based on the assumptions above.
Construction period	15 months	Typical Practice
Holding Period (including construction time)	5 years	Simulation Input
Construction Interest/Draws	Draws are distributed evenly across the 15 month period, with interest accruing monthly	Simulation Input
Terminal Cap Rate	9.63%	PWC 2015 1Q Real Estate Investor Survey, p. 57
Brokerage/Closing Fees	3.0%	Typical Practice
Capital Raising Period (i.e. time to raise funds equity OR EB-5 funds before construction)	1 year. This allows us to compare investment returns apples-to-apples. We assume each option will take 1 year: (1) raise 25% of the capital stack with GPs; (2) raise 25% of the capital stack with EB-5.	Simulation input based on typical practice
Conventional Capital Stack	35% equity; 65% I/O Debt	Simulation Input
Conventional Capital Stack Equity Structure	Sponsor contributes 10% of the capital stack. LPs contribute 25% of the capital stack. Thus, the sponsor contributes 28.6% of the equity.	Simulation Input
Conventional Capital Stack Deal Structure	Tier 1 = 10% preferred return to LPs and to GP, then Tier 2 = 15% cumulative return with 66.4% to LPs and 33.6 to GP, then Tier 3 = 20% cumulative return with 51.4% to LPs and 48.6% to GP, then Tier 4 = 41.4% to LPs and 58.6% to GP thereafter	Simulation Input
Sponsor Fees on Conventional Capital Stack	Asset Management Fee: 1% (paid starting in Year 2); Development Fee: 4% of total project (paid in Year 3)	Typical Practice
EB-5 Capital Stack	10% of the capital stack is sponsor equity; 25% is EB-5 I/O debt; 65% is I/O debt	Simulation Input
EB-5 Interest Rate	1% per annum; I/O	Author's Thesis
Financing Assumptions on Senior Debt (all capital stacks)	Mini-Perm Loan; 1.00% origination fee; 3+1+1 term; 0.25% per extension; LIBOR + 3.00%; interest only. (Our model assumes both extension options are exercised.)	Reputable Lending Institution, updated on August 20, 2015
Methodology of Modeling Interest for Senior Debt	Utilized forward monthly LIBOR rates to forecast debt service.	Bloomberg, updated on August 20, 2015
EB-5 Administration Fee & Start-Up Costs	$\$50,000$ administration fees are collected, but these fees cover the start-up costs associated with EB-5 financing.	Author's Thesis
Software Utilized to Simulate Pro Forma Income Statement	Software inputs include hotel occupancy, ADR, expenses, revenues, and inflation. These input assumptions are outlined below.	Jan deRoos and Steve Rushmore, 2011, Hotel Valuation Software, Version 3
Occupancy	Stabilized occupancy is constant at 78.9%.	2015 STR HOST Almanac, p. 50, Upscale Hotels
ADR	The base year ADR is $\$132.59$, calibrated so that the first year ADR = $\$135.22$.	2015 STR HOST Almanac, p. 50, Upscale Hotels
Expenses & Revenues	All revenue and expense assumptions, except for Franchise Fees, Management Fees, and Reserve for Replacement are from the 2015 STR HOST Almanac.	2015 HOST Almanac, pp. 50 and 54, Upscale Hotels
Inflation	1.98% per annum, according to the estimate for 10-year annual-average PCE inflation rate.	The Survey of Professional Forecasters, Q2 2015, p. 4
Hotel Cash Flows	The hotel cash flows are based on an annual pro forma that is assumed to have no intra-year seasonality.	Simulation Input

Appendix 3

These are the steps EB-5 capital raisers and investors follow when participating in the EB-5 investor program.

Step 1: Pre-Development

- Capital raiser approves EB-5 investment in line with underwriting guidelines.
- The following items are prepared: private placement memorandum (PPM) to outline the project, required EB-5 investment, potential returns, job creation forecast, and exit opportunities.
- Capital raiser establishes project-specific companies and related bank escrows, distributes PPM through all marketing channels and briefs all support staff and participants on project scope and investment criteria.
- Complete project package (including PPM, application forms, and supporting USCIS information) and follow up contacts made available to potential investors for due diligence purposes.
- Investor reviews materials with capital raiser and appoints business, legal, immigration, and tax advisors, as appropriate.

Step 2: EB-5 Investment Application

- Assuming potential investor would like to undertake investment in a project, capital raiser and investor's advisors review the application package to confirm that the investor is qualified.
- Qualified investor appoints local immigration attorney to assist with the execution of the application and send passport copies to escrow bank for security checks.

Security Check

Security Check Passes

- Qualified investor submits complete application and places funds in escrow.
- Qualified investor's local immigration attorney completes I-526 petition on behalf of his client and submits all required documentation to the capital raiser for review.

Security Check Fails

- Investor is unable to participate in EB-5 program. Process stops.

Step 3: USCIS Review of I-526 Petition

- USCIS reviews complete I-526 application package

I-526 is Approved

I-526 is Denied

- Principal is returned to investor.

Step 4: Permanent Residency

- Within 90 days prior to the end of the second year (21-24 months) of the investor's admission to the U.S. under the EB-5 program, the capital raiser provides documentation (including impact study) to confirm project progress and required job creation.
- Qualified investor's immigration attorney prepares I-829 petition and submits it to the capital raiser for review.
- Once the application is complete, the capital raiser authorizes the investor's immigration attorney to file the I-829 petition with the USCIS.

I-829 is Approved

USCIS removes conditional immigration status. The investment remains in the project subject to agreed terms and conditions.

I-829 is Denied

Project developer returns investment to investor. Investor may choose to invest in another project or withdraw from the EB-5 program.

Step 5: U.S. Citizenship

Approved investor may file for U.S. citizenship within 90 days of the fifth anniversary from the date permanent U.S. residency was first granted.

Source: "Investment Process." America Regional Centers EB-5 Visa Programs, 22 Mar. 2010. Web. 07 Nov. 2014; www.americaregionalcenter.com/eb5/index.php?option=com_content&view=article&id=16&Itemid=36&lang=en.

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