The Urban Developer

Get Funded.

TUD

EPISODE 4

Bank funding alternatives:

Breaking down mezzanine funding

Produced in partnership with DFP Development Finance Partners

Mezzanine Funding

Mezzanine funding is fast becoming a popular alternative source of funding for Property Developers. In the recent 12 months, DFP has seen an increase in Developers accessing mezzanine funding for their projects.

A recent survey run in partnership with The Urban Developer revealed that 30% of developers who had investigated non-bank alternative finance for developers had accessed mezzanine funding (compared with 24.5% in 2016).

Mezzanine funding, or second mortgage funding, is ideal for Developers who want to preserve their own equity and don't want to bring in a Joint Venture partner. In this e-book we give a thorough break-down of mezzanine funding, to help you determine if it's the right fit for you. As part of the 'Get Funded' series, this and other e-books have been developed by Development Finance Partners in partnership with The Urban Developer.

DFP are a leading national specialist finance advisory firm for developers. DFP have extensive experience and a strong track record in helping Developers turn their plans into reality.

DFP have been recognised by SmartCompany magazine as one of Australia's most innovative and fastest growing companies in the Smart50 Awards in 2015 and 2016 and have structured many ground breaking and unprecedented finance solutions for their clients.

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What is Mezzanine Funding and What Are the Benefits?

Thanks to the tightened lending conditions created largely by APRA this financing product is becoming increasing popular to both investors and Property Developers, but what exactly is it?

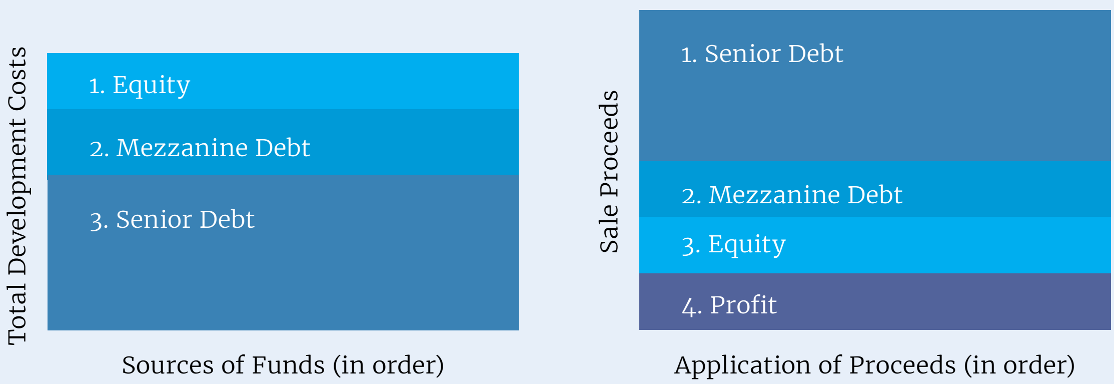
To answer this let's look at the characteristics of mezzanine financing. By definition a mezzanine loan is a hybrid of debt and equity and is subordinated to any senior lender.

Given its subordinated or second ranking position, the mezzanine lender usually receives a higher rate of interest for a higher level of risk.

This allows for sufficient capital to fund opportunity purchasers of land or key staff to build the development pipeline and operational capacity to deliver upon its commitments.

Let's compare mezzanine funding with traditional bank funding to help explain the differences:

THE CAPITAL STRUCTURE AND CAPITAL STACK



A typical property development project requires three funding sources:

- **Senior Debt** provided by a bank or bank-like financial institution. Contributed last and repatriated first.
- **Mezzanine Debt** required where the Senior Debt plus Equity is inadequate (often unavailable in the current market)
- **Equity** provided by the developer (either preferred equity or ordinary equity). Contributed and repatriated last.

How Does Mezzanine Funding Work?

A simple way to illustrate how mezzanine funding works is shown in the scenario depicted in the table below:

Funding Table (excl GST)	*Purchase Price*	*Total Equity*	*Soft Equity*	*Cash Equity*	*Vendor*	*Mezzanine*	*Senior*	*Total*
Land	$12,000,000	$5,000,000	$2,000,000	$3,000,000	$4,000,000	$5,000,000		$14,000,000
Land Transaction Costs		$425,000		$425,000				$425,000
Construction Costs		$1,000,000		$1,000,000		$7,000,000	$37,000,000	$45,000,000
Professional Fees							$1,830,000	$1,830,000
Statutory Fees & Contributions							$6,720,000	$6,720,000
Project Contingency							$2,250,000	$2,250,000
Marketing							$1,000,000	$1,000,000
Lender Establishment Fees						$426,250	$172,525	$598,775
DFP Advisory Fee						$225,750	$831,765	$1,087,515
Mortgage Document Fee						$10,000	$10,000	$20,000
Interest					$643,019	$3,100,000	$559,300	$4,302,319
TOTAL COSTS (excl Mezz & Vendor Interest & Fees)	$6,425,000				$4,000,000	$12,265,750	$50,373,590	$73,064,340
Loan to Cost Ratio	9%				5%	17%	69%	100%
Loan to Cost Ratio (cumulative)	100%				91%	86%	69%	

Mezzanine funding works by utilizing the key elements of funding as follows:

Capital draws down or ‘waterfalls’ into the cashflow from left to right and is repaid from sale proceeds in reverse from left to right.

The ranking priority of security is matched against who gets paid first and therefore we start with the highest ranking position being the Senior Lender and then moving from left to right to Mezz (2nd Ranking) and then the Vendor (3rd Ranking) and last the ordinary equity from the borrower.

In this case to settle a land purchase contract of $12M the following occurs:

1. The Developers equity is contributed in the form of $3M in cash and soft equity, being the difference between the actual land purchase price and what the senior debt lender’s land valuation recommends.
2. The Vendor of the land agrees to contribute equity of $4M in the form of Vendor finance secured via Joint Venture agreement with the Property Developer.
3. The Mezzanine Lender finances $5M at settlement of the land.

By leverage of the land uplift value, vendor finance and mezzanine finance the Property Developer has preserved a total $9M in cash which can be more effectively redeployed into his/her development pipeline to increase return equity. This means the developer makes more profit, reduces risk by increasing working capital, grows his/her business and reduces risk by diversifying into a larger portfolio of investments.

An important note to increasing leverage in this way is to clearly state the importance of group cashflow forecasting to ensure the Property Developer is able to sensitize improvements or detrimental impacts on each project with respect to time, revenues and costs.

In this way the Property Developer can ensure adequate headroom in overall cash requirements is maintained to mitigate against changes in the underlying assumptions of time, cost and revenue.

The most important benchmarks to measure changes in the above assumptions is against each of the individual project and the individual senior and mezzanine loan covenants that apply to either the actual approved loan covenants or what the Property Developer conservatively expects to achieve.

An important benefit to creating mezzanine finance relationships to a Property Developer business is that it mitigates against acute changes in senior debt lender appetite resulting from a deterioration in the credit cycle. In this way when banks change their lending guidelines from say 80% TDC to say 70% in a matter of months mezzanine finance can be used to plug the resulting gap of 10% of TDC in total debt required. This improves the maintainable ability of the Property Developer to successfully finance and deliver upon his/her pipeline to ensure his/ capital plus profits can be realized in a reliable way.

The only obvious downside is the increased overall cost of capital, however for any viable project an increased cost of overall capital is for most Property Developers a far better outcome than not being able to finance the majority of their projects.

Most successful Property Developers use mezzanine finance once their projects have derisked with DA and pre-sales achieved. They do this to settle the land, finalise design and approvals, fund sales and marketing costs to achieve pre-sales. This is the most sustainable use of mezzanine finance.

What Are the Benefits?

So how can mezzanine financing benefit your business. Given the continuing tightening of the banks with respect to LVR's, borrowers are being forced to put more equity into projects than they originally anticipated. Many Property Developers are looking to use as much leverage as possible, keeping them liquid and maximizing their return on their money.

Cash in the world of the Property Developer is a precious resource like water in the desert required to preserve life. The key benefits of maintaining sufficient levels of cash are summarized as follows:

- Ability to demonstrate a maintainable level of cash equal to a minimum of 10% of your total current and non current debts is a good benchmark to show that you have sufficient working capital to finance your operational cashflows
- Demonstrates an ability to fund cost overruns beyond the standard contingency budget of 5% against the construction costs
- Indicates that Property Developer is allowing for sufficient resources to help fund the growth of his/her business.

ALL OF THE ABOVE CONSIDERATIONS ARE ESPECIALLY IMPORTANT TO THE SENIOR DEBT BANKERS AND CREDIT OFFICERS WHEN ASSESSING THE LIQUIDITY OF THE APPLICANT.

VALUE OF MEZZANINE DEBT

> Bring your project to market sooner

> Lower the amount of pre-sales required

> Significantly increased IRR resulting from circa 50% equity being recovered along with profit in 20% less time

> Precious cash is free to drive the rest of the developers pipeline

> You can actually decrease portfolio risk by increasing diversification and increasing your liquidity

WACC – THE REASON WHY MEZZANINE FUNDING IS CHEAPER THAN YOU THINK

In instances that a project or company has more than one cost of finance, e.g. where a senior debt and mezzanine finance for property development are used, weighted average cost of capital ('WACC') is essentially the calculation of the overall cost of all sources of finance combined.

Because bank funding is currently so cheap, combined with the fact that mezzanine debt is typically a relatively small percentage of the total debt, the WACC of bank plus mezz debt is actually very low.

As a simple and typical current example, if senior debt is 65% and mezz is 10% of the project's GRV, with the true 'all up' cost being say 6% and 25% respectively, then the WACC would only be:

((65% / 75%) x 6%) + ((10% / 75%) x 25%)

= 5.20% + 3.33%

= 8.53% WACC

So what seems expensive on the surface is, when averaged out, actually *lower* than what bank rates for development loans were only a few short years ago.

CALCULATING THE VALUE OF MEZZANINE DEBT

The key to calculating the value of mezzanine funding is in considering:

1. the WACC of the senior and mezzanine debts; and
2. how much less equity you need to put into the project as a result of the mezz; and therefore
3. what the net effect to your return on equity ('RoE') is.

1. Calculate the WACC
Let's use the above example of 8.53%.

2. Equity reduction
If the bank will fund 80% of total development costs, you would need to put in 20%.

If, however, you use mezzanine debt of say 10%, you would only need to put in 10%. Therefore, the required equity is *half* of what it would be solely with bank debt.

3. Effect on RoE
Because the cost of mezzanine debt increases your WACC, your net project profit will naturally be lower than if you only used bank debt. However, given the WACC is only marginally higher than the bank's rate, the effect on RoE is profound – see this typical example calculation:

	Bank Only	*Bank + Mezz*
TDC	$10,000,000	$10,000,000
Bank Debt @ 80% TDC	$8,000,000	$8,000,000
Mezz Debt @ 10% TDC	$ -	$1,000,000
a. Equity Required	$2,000,000	$1,000,000
Dev Margin, 20% of TDC	$2,000,000	$2,000,000
Cost of Mezz at say 25% all up, 12 months	$ -	$280,732
b. Net Project Profit	$2,000,000	$1,719,268
Return on Equity (b / a)	100%	172%

The low WACC, combined with resulting significantly higher RoE, is a key reason why many of the country's leading developers are currently taking advantage of mezzanine debt or preferential equity, either to complete larger or more projects than they would otherwise be able to.

Whilst higher gearing does present higher risk on a single project, used appropriately to spread your equity across various projects or investments, it can actually decrease portfolio risk by increasing diversification.

What You Should Know Before You Consider Mezzanine Funding

GETTING YOUR DUCKS IN A ROW

Information to prepare before you talk to a funder

1. Who is the applicant?
2. What is being developed?
3. What is the loan amount?
4. Funding table.
5. Indentify the amount of cash you are committed to invest into the project otherwise known as your 'hurt money'.
6. Summary of Loan to Cost, Loan to On Comp Ratio, Initial LVR against the Land and Debt Cover Ratio.
7. Status of senior debt approval and key loan terms and conditions of the senior debt lender and their willingness to enter into a Deed of Priority with a mezzanine finance lender.
8. Project feasibility.
9. Project location.
10. Applicant's experience.
11. Borrower's and guarantor's A&L.
12. Security offered and overview of your organisation shareholding and control.
13. Break down of the pre-sales into FIRB sales, local sales, quality of the local sales.
14. Exit strategies i.e. pre-sales, refinance of residual debt, sell down of unsold stock during construction with an explanation of the marketing strategy and budget you have allowed to achieve this.

14\. Capability of the builder.

Connect With Our Finance Experts

Our specialist finance advisory team have the experience and connections to help you effectively structure a finance solution to help your development plans turn into reality.

Baxter Gamble
Founder & Director, New South Wales Office

Baxter has over 20 years of practical experience in providing creative funding solutions for some of Australia’s landmark developments. Baxter has developed strong relationships with the decision makers within a large and diversified range of banks, building companies, institutional equity providers as well as high net worth individuals. These relationships are critical to DFP’s clientele.

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Matthew Royal
Founder & Director, Queensland Office

Matthew has extensive experience in the property development and investment industry; he has exceptional knowledge and understanding of the financial criteria and methodology used in assessing property development and investment proposals.

Matthew has participated in the negotiation and consummation of numerous significant property development and investment acquisitions and joint ventures, as well as being responsible for the finance raising and due diligence enquiries and processes with DFP.

Matthew is also an expert speaker and commentator.

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Vincent Bengasino

Associate Director, Melbourne

Vincent Bengasino has worked in financial markets and professional services for 14 years and brings a unique skill-set to the Development Finance Partners team. Prior to joining DFP Vincent worked for a leading Australian alternative investment management firm. Following that Vincent founded his own firm and headed-up the operational compliance and legal function, building it from the ground up, managing accounts of offshore and onshore clients and acquiring its own AFSL license.

Most recently Vincent was a consultant with a boutique Melbourne-based law firm consulting on private equity and debt opportunities to SME's and property developers of varying size and experience. Vincent has a double degree in Commerce (specialising in Finance) and Laws, graduating from Melbourne University in 2004.

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Bronko Kozel

Associate Director, New South Wales Office

Bronko holds a Graduate Certificate in Management from Charles Sturt University, Bathurst and has been a member of the Mortgage and Finance Association (MFAA) since 2005. He has held senior relationship management positions with Westpac and ANZ working across the construction, property development, medical, legal, education, not for profit, investment and local government sectors.

Bronko has strong client relationship and management skills working with closely with key lending authorities and decision makers enabling him to deliver results to his clients and referral networks.

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Peter Stubley

Associate Director, New South Wales

Peter has over 35 years experience in financial services, primarily involved in corporate and commercial relationship banking across 5 Australian banks including NAB, CBA and Westpac.

Peter has extensive property finance experience including construction, development, joint venture and investment finance. Peter has been involved in the finance of significant property transactions and projects including residential and commercial developments, shopping centres, community facilities and land acquisitions along with a multitude of property investment acquisitions.

Peter has a business degree in Banking and Finance from Charles Sturt University, Graduate Certificate in Leadership and Diploma in Financial Planning as well as mortgage broker qualifications.

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Graeme Boyd

Associate Director, New South Wales

Graeme has over 30 years of experience in the financial services industry and holds a Graduate Certificate in management from Charles Sturt University Bathurst, and Cert IV in Finance and Mortgage Broking. He has held senior roles across two of the four major banks in relationship management.

Graeme has sound knowledge and experience across the Property Investment/ Development, Manufacturing, Agricultural, Hospitality and Professional Services sectors. His strong understanding of risk and balanced view between credit risk and sales enables him to deliver solutions.

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Michael McCluskey

Associate Director, Queensland Office

Michael has over 30 years experience in the banking and finance industry having held senior relationship management positions with Westpac, NAB and ME Bank. Michael is skilled in management complex banking relationships with groups that have widespread and varied business interests. He has been involved in the structuring of numerous transactions including many iconic development projects in south east QLD.

Michael has also owned and operated his own finance brokerage and consultancy and is a member of the Mortgage and Finance Association of Australia as well as holding a Diploma in Finance and Mortgage Broking.

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Adam Callaghan

Associate Director, Queensland Office

Adam has over 20 years experience in the real estate and finance industries in Sydney and Brisbane, having held positions at Macquarie Bank, Grant Samuel, PPB Advisory and CVS Lane Capital Partners.

Adam has relationships with a strong network of major financiers, corporate entities consultants, not-for-profits, public and private property developers and investors.

Adam has been involved in all aspects of the financing process from origination through to due diligence, transaction execution and management. Adam holds a Bachelor or Property Economics from UTS, and a Graduate Diploma in Applied Finance from FINSIA.

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Dino Di Costa

Head of Credit

Dino has over 18 years experience as an Investment Banking and Property Finance Professional specialising in Private Equity Syndication, ASX listed company capital raisings and Debt Capital Markets origination and trading.

Dino was a Director and European Head of Commercial Real Estate and Mortgage Backed Trading for Credit Suisse London. During his tenor at Credit Suisse (1999-2009) he was responsible for distributing real estate loans originated and securitized in UK and European Office Markets, Retail and Multifamily asset classes. He was also responsible for originating and managing institutional relationships for the issuance and distribution of European and Australian Residential Mortgage Backed Securities.

Dino has most recently focussed on the syndication of Private Equity Capital for Multi Storey Residential, Commercial Development and Residential Land Subdivisions in Western Australia. He was responsible for the Asset Management of the developments from pre-acquisition, construction funding, through to completion and hand over of the projects.

Dino has been the responsible manager and licence holder of his own Australian Financial Services Licence. He was also a previously a partner in boutique advisory and stockbroking firm and has held executive and non-executive positions in numerous public and private companies.

Dino holds a Bachelor of Commerce from Curtin University of Technology. He is also a qualified Chartered Accountant.

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Bob Hunter

Senior Credit Manager, New South Wales Office

Bob has over 30 years' experience in the banking and property finance industry. His career has included roles in the commercial, investment and non-bank sectors, including appointments with NAB, Bank of Boston, Aussie Home Loans and Eurofinance Corporation.

During that time Bob has held managerial and executive positions, including board representation. His capability covers a wide range of disciplines including sales, marketing, credit analysis and administration.

In more recent times, Bob's focus has been in assisting developer clients in financing projects, utilising his experience in the debt, equity and mezzanine capital markets.

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Kate Rundle

Analyst

Kate has over 7 years of banking experience spread across retail banking, lending and credit roles. Most recently Kate has spent four years working as a Property Investment and Development Finance account executive for St George Bank assisting a diverse range of clients from small builder-developers through to listed property development and investment companies.

Kate has been involved in all aspects of the financing process from origination through to due diligence, credit structuring and risk management, transaction execution and portfolio management. Kate holds a Bachelor of Banking and Finance from Queensland University of Technology.

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