The Urban Developer

Get Funded.

TUD

EPISODE 3

Bank funding alternatives.

A comprehensive overview of alternative funding options for developers

Produced in partnership with

DFP Development Finance Partners

Bank funding alternatives

The Banking environment in Australia has become increasingly difficult for developers in recent years and tighter conditions are unlikely to change soon.

Developers with sound projects that have strong market fundamentals are not able to access bank funding. Those who are innovative will be the ones who succeed in the next few years.

This e-book is a guide for those developers, to help them make the most of opportunity and think beyond bank funding to get their projects off the ground, to market quickly and deliver profitable outcomes.

'Get Funded' has 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 groundbreaking and unprecedented finance solutions for their clients.

CONTENTS

JARGON

We've broken down some of the finance 'gobbledygook' below to help make this e-book more useful:

Jargon	*Descriptions*	*Meaning*
TDC	Total development costs	Sum of all project related costs ex-GST and including consultants' fees. Excluding DA, pre-sale commissions, marketing and advertising costs, bank interest finance charges, construction contingency budget, all statutory costs, council contributions, land cost at valuation, land purchasing costs (i.e stamp duty etc), land holding costs (i.e rates etc), development and project management fees, QS and valuation fees
GRV	Gross realisable value	Value of the completed development stock ex-GST
On Comp	On completion value	Valued of the completed development stock ex-GST
Pre-sales debt cover		Value of qualifying pre-sales ex-GST divided by the bank loan
MOC *or* **P&R** *or* **Development margin** *or* **Profit margin**	Development profit margin	Net sale proceeds of the development after GST minus the total development costs divided by the total development costs
TDC LVR	Total development costs loan-to-value ratio	Loan amount divided by the total development costs
On Comp *or* **GRV LVR**	Gross realisation value/ Loan-to-value ratio	Loan amount divided by the gross realisable value
Residual LVR	Residual loan-to-value ratio	Amount of the loan following the settlement of the pre-sales ex-GST divided by the value of the remaining unsold stock
BBSY	Bank Bill SWAP rate	Bank's wholesale cost of funds
Bank's margin		The percent on top of the bank's wholesale cost of funds
Mezz	Mezzanine finance	Additional debt secured 2nd ranking to the bank
Pref Equity	Preferential equity	Very similar to mezzanine finance with the main exception being second mortgage is unregistered

Mythbusting: Non-Bank Finance Is Too Expensive - True or False?

Let's look at mezzanine finance as an example.

When looking at the cost of development finance, the two most common questions from property developers are:

1. "What is the 'all up' rate of the bank's facility?" – i.e. BBSY (Bank Bill Rate) plus margin plus line fee; and
2. "How high is the rate for mezzanine debt?"

What many do not realise is that the common answers to these questions are generally not the correct ones.

WHY 'ALL UP' IS ACTUALLY MORE THAN YOU THINK!

With bank finance, the key here is the line fee, which is charged on the facility limit – not the loan balance.

With development finance, because the loan progressively increases in balance each month, the average balance over the life of the facility is typically about 60% of the facility limit.

So, if line fee is 1.5%, then the true cash flowed rate is 1.5%/60% = 2.5%.

Because of this amplifying effect which many developers overlook, consider these 'equivalent' all up rates:

BBSY	Margin	Line Fee	"All Up"	True Line Fee Rate	Real "All Up"
2.15%	2.50%	0.50%	5.15%	0.83%	5.48%
2.15%	1.50%	1..50%	5.15%	2.50%	6.15%
2.15%	0.50%	2.50%	5.15%	4.17%	6.82%

With exactly the same "all up" rates, there is a variance of 1.34%.

This oversight of true cost also applies to mezzanine property finance where financiers often quote rates anywhere from 12% to 25%. Again, the true cost can be found in the fees – however given Mezzanine Finance is generally fully-drawn from day 1, the true cost is calculated differently. Consider these examples over say a 12 month term:

Interest Rate	Establishment Fee	Exit Fee	Exit Charged On	"All Up"	True All Up
12.0%	5.0%	1.5%	GRV	18.5%	32.1%
20.0%	5.0%	1.0%	Mezz Limit	26.0%	27.5%
24.0%	3.0%	0.0%	N/A	27.0%	28.0%

Note that with the lowest rate, I've used a common example of an Exit Fee being charged on the Gross Realisation Value of the project, instead on the Mezz facility's limit – which can be a massive effect given Mezz is often only up to 10% of GRV.

Clearly, when comparing finance costs from different lenders, it is vital to truly compare apples with apples.

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 Mezz 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.

OTHER BENEFITS OF NON-BANK FINANCE

- Bring your project to market sooner
- Lower the amount of pre-sales required
- Almost twice the return on the cash you need to invest
- 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

Overview of the Various Non-Bank Finance Options

PRIVATE LENDING/MORTGAGES

What is it?

Private lending is commonly referred to as 'the oldest form of mortgage lending'. In its simplest form, there may be one investor providing capital to one borrower. Generally, private lenders and mortgage trusts (typically referred to as "non-banks") are less stringent than Banks.

How does it work?

A non-bank lender will generally lend up to 65% of the completed value of the security property, and require no or nominal pre-sales (depending on the property, project size, amount sought and strength of personal guarantor). Loan terms are an average 12 months, with longer terms priced accordingly.

Who should consider it?

- Developers with equity in their property, but who are unable to go to the banks
- Developers with equity in their property who do not have time to satisfy onerous bank covenants to wait on the loan approval process.

The Pros

Speed – A private lender will act much faster than a bank or institutional lender. Many private lenders commit to an indicate loan response within 24-48 hours.

Simplicity - A private lender will primarily look at the underlying security property and the exit or 'take-out' strategy. Lenders tend to look at the deals merits versus adhering to a lending policy.

Flexibility -No set lending requirements. Borrower and lender may come to their own terms on pricing and loan conditions.

The Cons

Cost - Higher interest rates and establishment fees than standard bank funding combined with legal fees for documentation at the borrows cost.

Consequence - Default provisions and loan terms are generally stricter than bank funding, with penalties and extension fees unlikely to be waived.

MEZZANINE FINANCE (2ND MORTGAGE)

What is it?

Mezzanine finance bridges the gap between standard bank or 'senior' debt, and equity investment. The mezzanine lender sits above your equity in the capital structure, but is subordinate to the senior debt (which is repaid in priority). A well-planned mezzanine facility produces an increased return to the developer and allows them to preserve equity.

How does it work?

Mezzanine debt will be introduced to fund a portion of the development costs, often the land component, leaving the senior lender a first mortgage over the site to completely secure the bulk of the debt via a construction loan. The mezzanine debt generally has the interest capitalised to the loan amount for the anticipated duration of the project – that is, loan serviceability is not required during construction. On the pre-sales settlement date, the sale proceeds from the off-the-plan sales are used to pay down first the construction loan, and secondly the mezzanine debt

Who should consider it?

- Developers who want to use their equity elsewhere
- Developers who want to avoid the loss of control and potential complications of having a 'joint venture partner'
- Developers with projects forecast to have 'above-average' profitability to tolerate the higher interest cost.

The Pros

Simplicity – The loan qualification process is often less complex, with mezzanine funders often having less onerous lending criteria then senior debt providers. Satisfying the senior lender with the merits of the project goes a long way toward satisfying a potential mezzanine financier.

Cost – It's often a cheaper financing option than raising equity: pricing is less expensive than raising equity from equity investors like family offices, venture capital firms or private equity. All this means owners give up less, if any, of their additional equity to fund the growth in their business.

The Cons

Cost – Higher interest costs due to adding an additional lender, higher establishment fees than standard bank funding combined with legal fees for documentation at the borrowers cost.

Consequence – Not all senior lenders will be comfortable to fund a project with a second mortgage sitting behind them in the capital structure.

STRETCH SENIOR / UNITRANCHE DEBT

What is it?

Stretch senior is a loan provided by a single lender, sometimes in a single tranche, that goes to a higher leverage position with more layers of debt. These loans offer leverage going up to 70-75% of the development's 'on completion' value in one fund. This can mean that in some cases up to 85-90% of the total hard and soft costs are able to be funded.

How does it work?

The stretch senior loan does the work of both a senior loan (up to a maximum of 65% of an 'on completion' valuation) and a mezzanine loan (which covers the second 'tranche', from 65 up to an established ceiling of about 75% of 'on completion' valuation).

Borrowers are able to borrow at much higher leverage with a single loan, instead of securing funding separately from two or more sources. Lenders are willing to make stretch senior loans because they have a senior (first registered mortgage) claim of security on the asset, and the greater interest rates and establishment fees charged can mean a higher return to the lender than either of senior or mezzanine funding may separately yield.

Who should consider it?

- Developers with projects forecast to have 'above-average' profitability to tolerate the higher interest cost.

The Pros

Simplicity - A single loan facility vs multiple lenders means just one approval process, one documentation process, one set of covenants and conditions and just one lender relationship that the borrower needs to manage. The loan qualification process is often less complex, with funders often having less onerous lending criteria then senior debt providers.

The Cons

Cost – Higher interest costs combined with legal fees for documentation at the borrowers cost.

PREFERRED EQUITY & JOINT VENTURE FINANCE

What is it?

While often compared with mezzanine finance, preferred equity is not secured by a second mortgage over the property.

How does it work?

The capital partner is essentially providing capital in return for equity, this means the investor will usually receive a fixed percentage of the profit upon successful completion of the project, as well as a 'coupon' or interest payment on their funds invested.

The capital partner's capital amount (often taking the form of a different class of shares) and return are treated differently to developer's – ranking above, but always behind the senior lender.

Who should consider it?

- Developers who are short on the equity they need to cover the total development cost of the project
- Developers with projects that whilst profitable would not be able to sustain the cost of Stretch Senior or Mezzanine finance

The Pros

No lock-ins - Only a temporary arrangement between the parties, often project-specific.

Shared risk and rewards - Both parties' interests are aligned, working toward a mutual and specific goal. Jointly the parties can complete a project they may not have had either the capability or financial strength to complete on their own.

More bank-friendly – Banks are often more willing to provide senior debt with mezzanine finance than with other forms of private finance.

The Cons

Increased potential for conflict - Parties may have different modus operandi or different decision-making strategies. Different cultures and management styles between the parties.

CASE STUDY

Turning Plans Into Reality Through a Hybrid Finance Structure

Scenario:

Purchase and construction costs of Brisbane residential apartment development: $xx million

Background:

Developer required help to finance the acquisition of land via company share sale agreement and finance the construction costs associated the development of thirty eight (38) residential apartments located in northern Brisbane.

Financing challenges:

1. Developers had no development experience.
2. Developers price list was well below market rates.
3. Valuation came in significantly lower than land purchase price.
4. The developer had no pre-sales at land settlement, and insufficient equity to finance the development.
5. Local apartments in the area were in oversupply.
6. Builder was forced to renegotiate construction contract due to cost escalation.

Solution:

1. DFP raised the required capital to settle the share agreement which effectively settled the land.
2. DFP negotiated a vendor finance facility with the vendor of the land.
3. DFP advised, arranged and settled a construction finance from a retail bank on favourable terms.
4. DFP advised, arranged and settled a mezzanine finance facility.
5. DFP negotiated a significant reduction to the builder’s construction cost escalation based upon unconditional finance offers.
6. DFP advised upon a 5% increase in the sale prices of the 38 apartments.

How the numbers stacked up:

Funding Table	*Soft Equity*	*Cash Equity*	*Purchase*	*Vendor Finance*	*Mezzanine*	*Senior*	*Total*
Land	-$500,000	$1,225,000	$2,750,000	$550,000	$975,000	$0	$2,200,000
Land Transaction Costs	$78,572			$0	$0	$0	$78,572
Construction Costs	$0	$602,000		$0	$485,000	$7,613,000	$8,700,000
Consultant & PM Fees	$0			$0	$0	$405,448	$405,488
Statutory Fees	$0			$0	$0	$978,218	$978,218
Project Contingency	$0			$0	$0	$435,000	$435,000
Land Holding Costs	$0			$0	$0	$38,000	$38,000
Miscellaneous	$0	$329,865		$0	$0	$287,421	$617,286
Finance Charges	$0			$0	$174,000	$152,400	$326,400
Interest	$0				$610,000	$353,842	$963,842
Total Costs	**-$471,428**	**$2,156,865**		**$550,000**	**$2,244,000**	**$10,263,329**	**$14,742,766**

Results:

- **Senior Debt: 60% of GRV and 73% of TDC**
- **Mezz: 73% GRV and 85% TDC**
- **Vendor finance: 90% of TDC**
- **Development profit margin**
  - 22% at land value
  - 11% at land cost net of all costs
- **$2,200,000 net project profit vs forecasted loss of $750,000**
- **Return on investment: 115%**

CLIENT TESTIMONIAL

"I understood the level of value that a good finance partner could add. I found the terms that DFP provided were more favourable than what I could see elsewhere.

We had low equity for the size of deal we where doing. This was my first deal. I had no background or experience in development. I wanted to work with someone who wasn't tied to a bank. Someone I could bounce ideas off who would know what was right vs just going direct to a bank.

We got the deal done which is the main thing. I got all the money I needed to do the project. The banks were comfortable with everything that was presented. Given it was my first time, it could have gone either way so I was happy. The terms were as agreed. Any hiccups were overcome without too much trouble. I made sure that I wanted to be involved as much as possible, at each step of the way Matt would break things down and explain where they were at and why. I now have the confidence to go ahead and do more deals.

I was pleasantly surprised by the level of advisory that DFP provided. I would recommend DFP to other Developers and already have."

– Lachlan Cottee
Developer, Brisbane

Setting Up For Success

START WITH THE END IN MIND

Regardless of what finance structure you want to work with, it makes sense to start with the end in mind. Ideally before you settle on a site you want to have put together the basic elements of a finance application as part of due diligence on the project.

Build a development model based on:

- Who the developer is, the experience and credentials of the stakeholders involved
- What's being developed
- What the loan amount required is
- A funding table showing finance structure and ultimate returns
- Loan to value ratios
- Project feasibility
- Project location
- Borrows and guarantors (Assets and liabilities)
- Security offered
- Quality of the sales
- Exit strategies
- Capability of the builder

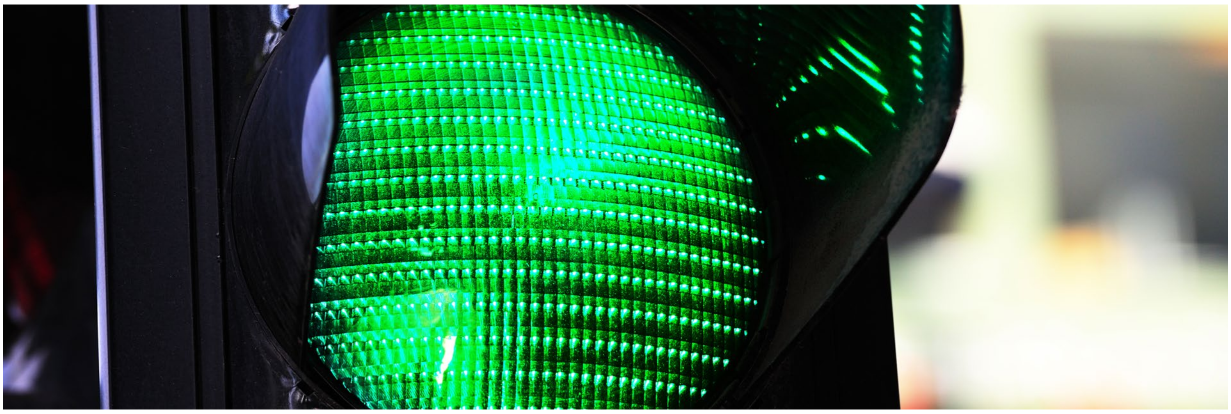
What you can do to reduce your risk and increase return on equity:

1. Restructure your debts across multiple debt providers
2. Put firewalls between your liquid assets, sources of your cash flow and your development risk
3. Raise undrawn LOC's against surplus security
4. Consider D&C contracts
5. Consider capital partners who will consider stand alone facilities with high LVR'S, lower or no pre-sales, less restrictive
6. Utilise no doc capitalised interest
7. Keep some mystery
8. Utilise pref/equity mezzanine
9. Heavily prioritise interest payments
10. Invest in assets with strong maintainable earnings to show interest cover and debt amortization
11. Don't burn your goodwill: keep your plans evidence based which can be reported against over time.

Green Lights and Red Flags

Understanding what a funding partner will look favourably upon (or unfavourably) when it comes to agreeing to provide finance.

Likely to get bank finance	*Less likely to get bank finance*
• Borrower has a significant amount of cash invested and at risk.	• Limited cash or equity to invest.
• Demographic profile supports and acceptable level of demand for residential accommodation of the nature size and cost proposed.	• Development is in a market that has significant competition or existing residual stock that is unsold.
• Developments for which the program of works is scheduled to commence within 12 months of approval.	• The timeline to commence the development exceeds12 months
• Minimum forecasted project profit margin of 20% of development costs (inclusive of valuation uplift if no prior DA held).	• The development profit margin sits below 20%.



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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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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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, Agricutural, Hospitality and Professional Services sector. 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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