WHITE PAPER

The 5 mistakes developers make when seeking funding

AND HOW TO AVOID THEM

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Are you spending large sums of money conceptualising your project?

Are you working with teams of consultants for months on end, getting everything just right?

Yet when it's all said and done, you need your project funded in order to develop it.

Financing your project is a skill no different to: selecting the right site; designing the right product; negotiating the right approvals; developing the right marketing plan; negotiating the right build contract.

In this white paper we discuss the 5 mistakes developers make when funding projects and how these mistakes can be avoided.

MISTAKE#1

Mistaking your lender's objectives with your objectives

Ever found yourself in the situation where:

a) you get along famously with your banker (or lender's relationship manager);

b) you meet the credit officer and they like your project;

c) you accept their discussion paper / indicative approvals; and

d) they decline to fund the project without notice.

If so, you are not alone. This occurs routinely in all market conditions and is driven by something that is even beyond the complete control of even the banks: *lending appetite.*

First and foremost, your banker is in the business of profitably lending money.

In order for bankers to profitably lend money, they need:

a) the bank to continually satisfy the constant and ever changing requirements of

   i) financial regulators (i.e. increasing deposit to lending ratios)

   ii) rating agencies (i.e. credit requirements, project location/exposure limits); and

b) the bank hierarchy to clearly formulate its policies and lending appetite; and

c) the bank hierarchy to successfully communicate the message around the business it would like to attract.

Whilst these steps are essential for the sustainability of the financial system and the bank, it does not give you or the banker any certainty of outcome.

To mitigate the chance of being caught without funding we recommend:

a) you accept that lending appetite is ever changing;

b) you accept you may meet bank policy but not bank appetite;

c) you always have alternative funding options.

MISTAKE#2

Confusing cost, price and value

Have you ever said any of the following to your banker?

a) "I can sell the site for more than it's valued at."

b) "I can sell the completed stock through marketers at higher prices than it's valued."

c) "I can build the project for less than the quantity surveyor has reported."

d) "I am happy to make a small profit on a deal."

If so, you likely know that it did not change the funding outcome.

This is because banks need to fund projects that have:

a) an acceptable risk-adjusted return.

b) a valuation on the basis of the prices and sales period of the local market

c) costing on the basis of an external party completing the project.

To reduce your risk of being frustrated by the numbers, we recommend you ask yourself:

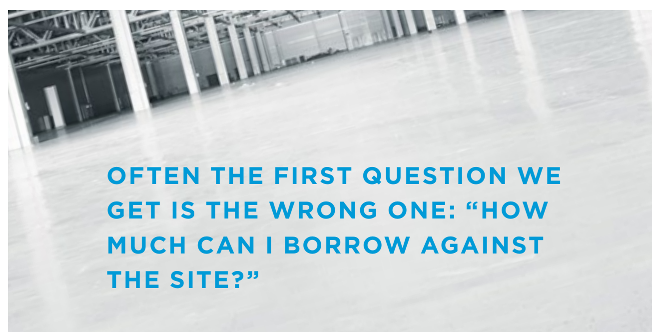
a) Is the project's margin of safety (i.e. profit) sufficient for the bank?

b) How would the bank, if I was not here,

   i) complete construction?

   ii) sell the completed project?

   iii) sell the development site?



MISTAKE#3

Insufficient equity to complete

Routinely we help developers to fund:

a) raw sites for future development

b) approved development sites

c) construction.

Often the first question we get is the wrong one: "How much can I borrow against the site?"

Whilst it's a natural question – it's great if you can control the project with less equity – it inhibits developers asking an even better one: "How much equity do I need at each stage of the project?"

As a consequence of not asking better questions, we often find developers have been 'successful' getting large borrowers and 'successful' in ensuring they can never develop the property in their own right.

To ensure this problem does not happen to you we recommend:

a) begin with the end in mind: develop a plan for funding the project from conception to completion.

b) seek the services of independent project finance experts to model and plan the outcomes.

c) avoiding borrowing against a site for purposes other than progressing the site after careful deliberation.

MISTAKE#4

Incorrect comparison of funding options

Irrespective of the industry, experienced and successful operators are the minority and routinely make the majority of industry profits. There are McDonalds stores that lose money and bookstores that make money. Geography is one consideration – but the true difference is the operator. The difference between operators is ultimately the questions they ask themselves, the answers they generate and the actions they ultimately take.

The finance strategy for inexperienced developers is often driven by the key tangibles they understand – interest rates, price and presales. They ask themselves:

a) "How can I save money on finance to increase my profit"?

b) "How can I minimise my equity contribution"?

c) "How can I minimise presales"?

"OPTION B MAKES THE DEVELOPER AN EXTRA $13M OVER 10 YEARS..."

The finance strategy for the experienced developer is very different. Of paramount concern to the experienced developer are the conditions. They ask themselves:

a) "How can I maximise my rate of return (p.a.) for the risk I am willing to take"?

b) "Who is the lenders' valuer, and what is their forecast presale expectations on a month by month basis"?

c) "How many complying presales do I need to help the lenders' valuer arrive at my listing price, my estimated site value and to satisfy loan conditions"?

d) "What due diligence (i.e. build quotes) do I need to help the lenders' quantity surveyor to arrive at my estimated site value"?

e) "How much market risk (i.e. site valuation volatility) in time am I willing to take prior to construction to achieve pre-construction conditions"?

For example, a developer with $10m cash is looking to acquire a site approved for 100 units and has advice that his sales rate will be 3 per month pre-construction and 6 per month post-construction.

Apartments	100
Equity	10,000,000
Sales rate (pre-construction)	3
Sales rate (during construction)	6

The developer has two finance offers on the table. Does Option A or Option B make the developer more money?

DETAILS	OPTION A	OPTION B
Facility limit	25,500,000	25,500,000
Fees	0.5%	2.0%
Interest rate	8%	13%
Presales required	60	30
Lead-in period (Presales required / sales rate)	20	10
Construction period (inc. settlement)	18	18
Project period	38	28
Profit	8,470,000	7,470,000
Rate of return on equity	20%	24%

Option B makes more for the developer.

If the developer reinvested his equity and profits after tax into similar deals, Option B makes the developer an extra $13m over 10 years:

DIFFERENCE IN 10 YEARS	OPTION A	OPTION B
Projects completed	3.2	4.3
Net equity after Project #1 after tax (30%)	15,929,000	15,230,000
Net equity after Project #2 after tax (30%)	25,380,000	23,200,000
Net equity after Project #3 after tax (30%)	40,430,000	35,340,000
Net equity after Project #4 after tax (30%)	–	53,830,000
Net equity at end of 10 years	40,430,000	53,830,000

To ensure you select the correct project finance solution we recommend professional advice.

MISTAKE#5

Fail to seek advice regarding a finance strategy before commencing the project

Late American President Abraham Lincoln is famously quoted as saying “If I had six hours to chop down a tree I would spend four hours sharpening my axe”. Whilst this appears extreme and outdated, it does remind us of the value of being strategic with our decisions.

Seeking the services of an experience and professional development finance consult, like sharpening the axe to cut down a tree, may not be essential to deliver the project. However, for some of you reading this, it will be the difference between compounding your development profits for the next 20 years and being forced into bankruptcy in the near future.

When looking for professional advisers we recommend you look for consultants who:

a) boast a verifiable track record of results.

b) listen more than they speak

c) never settle for near enough is good enough. ●

DANIEL HOUNSELL has over 13 years of experience structuring joint venture opportunities within a range of industries (property development, hotels, franchising, proprietary financial trading) and over 10 years experience with property finance. Prior to joining DFP, Daniel held a National Manager’s role (Franchising – Industry Partnerships) with Bank of Queensland and was jointly responsible for expanding the bank’s capacity and capability for industry banking (professional, franchising, hotels/motels etc). He is a former chemical engineer at Goodman Fielder Limited.

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