ADVANCED PROPERTY SYSTEM
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In Part 2 of the Finance Secrets section, we will be covering further detailed aspects of the development funding model. Financial templates can now be used to assist the modelling process and provide guidance on achieving target project returns. You can access the link to questions based on this section here.

6.1 LEVERAGE

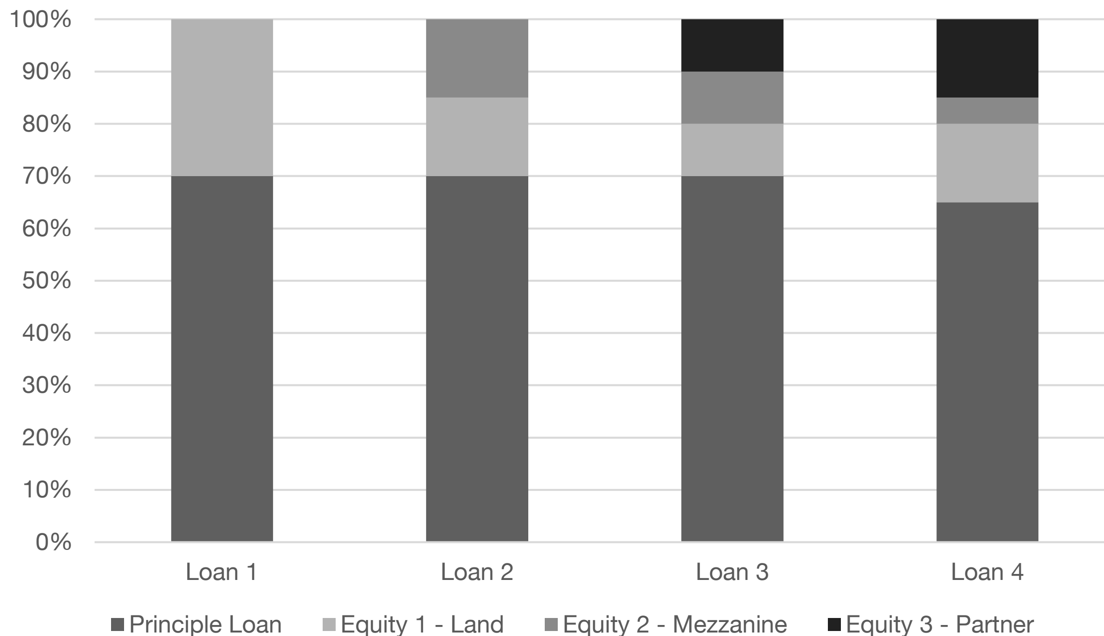
The concept of leverage can be applied in real estate by using borrowed money to make a return on your investment. When unlocking development finance for your project, you provide leverage by maximizing the loan amount relative to the equity in the deal. Increasing the leverage means borrowing more in proportion to the equity invested in the project.
It is very uncommon for developers to keep all their money tied up in property deals, and if this is the case, it is usually only for a short period of time. Typically, we want to minimize the hold on capital, free up cashflow and allow our money to be used to its maximum potential – this means unlocking the highest available leverage. In some instances, property entrepreneurs use cash as a negotiating tool to purchase an opportunity when speed is a crucial factor and can sway a seller. Following a cash purchase, however, it is a good idea to immediately refinance the property and mobilise your cash in the next transaction.

6.2 TYPES OF LOANS

Development loans can be structured in many different ways, depending on the project requirements and the lender's objectives. Loan structures vary in duration and can also differ in terms of interest rates or contain special conditions. The period of time that the loan is in effect, or amortized, is known as the loan term. It is usually fixed over several years but can in some instances be settled early, before the term is up. Early settlement may attract a penalty against the remaining interest but can generates a considerable saving by reducing the compounding effect of interest over time. The interest rate of the loan can be either fixed or variable over the loan term. There are different types of loans for development funding, which is typically short-term, compared to long-term finance which can be taken over 20 years.
Depending on your financial goals, a loan with a fixed interest rate may provide the stability that you need to manage your cashflow. Securing the interest rate in a loan also protects investors against risk, should interest rates be adjusted or variations occur during the loan term. On the contrary, variable-rate finance can provide a benefit to your development in the event of falling interest rates. A long-term outlook can help in understanding the potential impact of macro- and micro-economic factors on the health of a development.

6.3 THE LOAN STACK

Property developments are financed by gathering funds from a variety of sources to contribute towards a common goal. The availability of resources, the level of gearing offered to you by lenders, and the valuation of the land play a role in determining the overall mix of inputs that make up your financial loan structure. These elements can be visually described by grouping them together into a stack. This makes understanding the ratios and relationships between components easier.



In the diagram above, Loan 1 shows a typical commercial development with a 70% gearing, which requires a 30% equity contribution. In this case, the land has been valued to adequately represent the full equity portion and the loan is balanced to 100%. The land value in Loan 2 is lower, and so only makes up half of the overall equity required. In this situation, a further 15% is required and so a mezzanine loan has been obtained to cover the shortfall. Loan 3 shows an even lower land value, and how this loan can be supported by bringing in a development partner to contribute equity, perhaps in the form of a cash investment into the project. The final example, Loan 4, looks at a lower gearing of 65%, and includes a 5% mezzanine loan with two development partners, each contributing 15% in equity towards the project.

One thing to note from these examples is that all loans are not created equal. The senior debt has a different ranking to the mezzanine debt, and cash equity may outrank land equity. The position held by each element in the loan stack is defined in the development agreement, as well as the shareholders agreement associated with the development vehicle. A fundamental step in creating the development funding structure is defining the ranking of loans, the interest generated by these loans and the length of time that these loans will be available to the project. This also influences the sequence in which they will be repaid and establishes the nature of transactions into and out of the development.

Exercise

If your development can unlock a loan at 70% gearing, answer the following questions.

1. What are the proportions of the other ingredients that make up your loan stack?
2. What loan terms will they attract, and are they interest bearing?
3. How can changing the mix of land, equity, mezzanine debt and a partnership stake improve the overall feasibility?

6.4 REDUCING EXPOSURE

When looking at the loan stack, it is clear to see the proportions of risk that each party is taking in the project. In exchange for providing funding for your project, lenders will require assurances in the form of a guarantee. A common way of reducing risk for the lender is to register a bond over the property in favour of the bank or institution providing principal debt finance. This will allow for the recovery of some of the lender's losses if something goes wrong, but unfortunately also means that developers can be at risk of losing their initial investment. One way of reducing the exposure to financial loan risk is by increasing your proportion of equity in the development. This improves your gearing ratio (reduces it) by reducing the overall loan amount required. In this way there is less interest payable, monthly repayments are lower and guarantees required by the lender are also less onerous. A scarcity of available capital and restrictive finance terms could make this impossible, in which case it may be worthwhile taking on a development partner.

Applying for the maximum leverage can be important to the developer, but also increases the project risks for an investor. In large development projects, the focus of the lender may shift from the individual or company to the financial feasibility of the project itself. In this case, the guarantees required by the lender are of a less personal nature and become more directly associated with the development site or property. Once the building has reached a certain point of completion, these guarantees may be relinquished as the risk reduces.

6.5 HUNDRED PERCENT LOANS

Achieving a full loan from a lender or getting finance for one hundred percent of the development cost is possible. This is especially the case in mortgage markets where first-time home buyers can demonstrate an excellent credit score and show sufficient stable income to repay the loan. In a commercial development, however, the likelihood of achieving a fully financed project low, and we must find alternative funding structures that don't require you to put cash into your development. The following examples are clues to how this may be possible.

Creating Land Value

It is possible to unlock substantial value as a developer using entrepreneurial skills to uncover overlooked potential in real estate. For example, you may hear of a personal friend wanting to sell a well-located piece of land at a below-market price. By securing the property with an option agreement you can prepare a plan to redevelop the property. Value can be created by rezoning the property at a marginal cost. Your proposal to an investor will include the land at a markup relative to the benefit you have unlocked. This value can come to represent your equity in the transaction. A back-to-back sale into the development SPV can then be concluded with the land transferring at the higher price. Ordinary development funding can then be secured, without any material financial contribution on your part.

Sweat Equity

Imagine a group of investors that you have brought together to coinvest in a new development through syndication. Your role as developer is to set the vision and generating profit for the project. This work represents a certain value, which can be agreed upfront with the partners to be classified as sweat equity. Instead of them paying you a fee for your

efforts, the time and energy that you contribute can be calculated and converted to equity in the project. Sweat equity can count towards the overall equity stake that enables development funding to be raised, and for you to participate in a development without contributing any hard cash to the deal.

On-selling

This example is based on creating a product with a particular end-user or purchaser in mind. A development proposal can be formulated and presented to this purchaser for approval. Next, the project scope must be agreed as one of two options – *open book* where costs and profits are shared, or *turnkey* where only the total sales price is agreed, and profit can be made by the developer. A sales agreement can then be concluded, which can form the basis of your development finance. In this situation, the lender will look to the credit history and balance sheet of the purchaser, allowing you to complete the development with no money down.

6.6 BUYING WITH FULL LOANS

Fully financed deals can also apply to developers when purchasing a property. For example, you may be able to buy some land for R1,500,000 entirely with borrowed money when the real value of the deal is R2,000,000. This effectively means that your purchase has a Loan to Value (LTV) of 75%. The additional value has been created by your ability to negotiate a good price and is effectively equity that has been unlocked in the transaction.

A hundred percent financed property can, however, be a risky investment. This is especially true if the property has been purchased for close to its full value. Being fully financed so close to the value threshold will affect your ability to refinance, resulting in increased exposure to vacancies and interest rate adjustments. If interest rates climb, you will need to then dip into other resources to cover loan repayments and maintain cashflow in the deal. It is always a good idea to create a value buffer between the purchase price and the development value. The following points can help safeguard your loan from undue risks when buying at high gearing.

- Market timing. Are you buying in an overinflated market?
- Context. What is the short- and long-term economic outlook?
- Value Padding. Are you buying below value? Can you demonstrate a new value-add? How can you create a buffer of value to protect the project from risk?
- Loan Term. What is the holding period of the deal, are you planning to redevelop?

6.7 GEARING RATIOS

The terms of your loan qualification will depend on the strength of your financial status as well as the commercial outcomes contained in your application. It is therefore critical to ensure that your development feasibility demonstrates a favourable yield, and that any project assumptions are free of significant risk. By outlining the foreseen development risks and then answering each item in your investor pack shows the lender that you are competent and responsible in your financial planning. Being open and upfront about your shortcomings and how you plan to deal with them ensures your best chance of favourable funding terms and loan gearing.

Short-term development debt is typically financed at the following gearing ratios.

Type	**Gearing**
Affordable Housing (Multi-unit)	70%-85%
Multi-unit Residential	65%-75%
Commercial	60%-70%

Long-term investors, managers of listed property funds and REITs will often seek to lower the finance gearing to below 40% to protect conservative investors from risks. These institutions have a further advantage as their funding is typically at below market interest rates, which enables them to invest in low-yielding property stock.

6.8 KEEPING LAND IN THE DEAL

One option to offset the equity required to raise development funding is to keep the property in the project for as long as possible. The value of your land will increase significantly on approval of the development rights, and again once the development has been completed and the asset has been established. By not withdrawing the land from the development (cashing out), the value added continues to grow and can serve as an equity waterfall if you intend to develop in a phased approach. Another way to unlock significant value is if you can convince a landowner to keep their land in your development for an agreed price that will be paid on completion of the project. This mitigates interim holding costs and allows you to build your project on borrowed equity.

6.9 LONG TERM VS SHORT TERM

When embarking on a new development, it is important to distinguish between which loans are long-term and which are short-term. High-interest, burdensome loans should be dealt with in the short term if possible. Development funding typically lasts for the duration of the building construction and can be restructured into long-term finance on project completion.

Long term finance, such as a 20-year loan, allows more flexibility when it comes to interest rates and repayment terms. The interest that these long-term loans attract are tax deductible and may benefit your overall property strategy. Shorter term loans will allow you to pay off your asset faster but reduce cashflow and so increase risk. A higher monthly repayment may also impact your affordability rating by lowering your debt ratios. This may limit your lending score on the next development as the bank may consider you to be overleveraged.

6.10 CHOOSING A FINANCIER

Providers of development funding may vary, and deciding which lender suits your project may depend on several factors. Flexibility is of primary concern, and it is worthwhile to take your time to find a financial relationship that works for you. It is possible to establish trust between parties by proving your knowledge and experience as a developer. In this sense, you should make a point of meeting deadlines and delivering in accordance with your project plan. With first-time clients, banks normally appoint a *watching-brief* quantity surveyor to assist in the financial structuring, day-to-day operations and to report back on project progress.

The size of an institution may also impact on the availability of funds for new projects. Smaller lenders may be more selective with specific project criteria and may even elect to not finance certain project types based on their specialization. Either way, you want a designated representative who can provide individual attention to your development.

Some considerations when choosing a lender are as follows.

- What number of clients do they serve?
- Do they operate on a project fee commission basis?
- What are their credit requirements for a development?
- How many loans are issued in your field of development?

6.11 PRESENTING YOURSELF TO LENDERS

Making an impression as a credible developer is fundamental to securing project finance from a lender. It is therefore crucial to be well organised and present your development in the best possible light. As previously mentioned, the investor pack has been specifically structured to follow the evaluation sequence that banks follow when considering an application. The development will be assessed based on the strength of this information, the outcomes of the development feasibility study and the proposed project team's experience. Each lender has their own guidelines for development funding, but all include key considerations such as the applicant's credit score, monthly income, and the strength of their balance sheets (a list of assets and liabilities). When preparing the for a loan, build strength in the application under the following points.

- Credit rating
- Income
- The Development Property
- Equity in the deal