ADVANCED PROPERTY SYSTEM
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In the finance secrets portion of the program, we unpack how to prepare for investors and attract development finance. So, what is the purpose of financing your development project? The main objective is leveraging your capital to its full potential. In this way, you can use a small investment to unlock a much larger project that by fully financing it yourself. Leverage, otherwise known as gearing, is a unique advantage to investing in property over other asset classes. One of the implications of obtaining a loan is that we are effectively deferring payment of the development costs, giving us time to generating income by taking a product to market.

Developers can raise project finance (known as *senior debt*) from a variety of sources such as banks, private equity individuals or in syndication with other development partners. Raising money against a prospective development allows you as the developer to use time to your advantage, and trade with the commitments made by end-users (pre-sales) to obtain financial backing before a single brick has been laid in our development. The following are some advantages of unlocking good development finance

- Leveraged debt, so you can raise against your capital
- Property is an immovable asset, which banks are eager to loan against
- Flexible repayment terms can be arranged over a long period
- Refinancing is possible, depending on exit strategy

To avoid risks and reputational damage, it is important to have a financial plan that describes the responsible management of funds in your development. Using input from your market research and the advice of your professional team, it is possible to make informed assumptions to use as inputs for projected income, expenses and sales values. In this way, we can build a financial model, including a development feasibility study, cashflows and repayment options. During the feasibility stages, maintain a big-picture view of the development goals and plan these milestones to track your financial progress throughout the project. The essential financial information should be condensed into a financial summary (single A4 page) for easy reference and presentation to potential investors.

You can find the questions relating to Finance Secrets part 1 here.

5.1 INVESTOR PACK

A summary of important development information for investors. The benefits are that it easy to read, and presented in a brief, condensed form. Important to highlight the strengths, and benefits of the project. Project overview with a cover page showing essential information that investors are looking for such as the return. The basic structure of the investor pack is as follows.

1. Project Overview
    a. Feasibility
    b. Presentation Brochure
    c. Location Map
2. Professional Team
    a. List of professional team
    b. Company Profiles and CV's
    c. Specific project experience
3. Architectural Designs
    a. Site Development Plan (SDP)
    b. Floor Plans and Sections
    c. 3D Renderings
    d. Look & Feel Presentation of Finishes
4. Engineering Information
    a. Civil/Structural
    b. Electrical
    c. Wet Services
    d. Outline Scheme Report
    e. Geotechnical Study
5. Property Information
    a. Title Deeds
    b. SG Diagram
    c. Site Survey
    d. Property Valuation
6. Legal
    a. Development Agreement
    b. Partnership Agreements
    c. Professional Appointments
    d. Health and Safety
    e. NHBRC Registration
7. Town Planning
    a. Zoning Certificate
    b. Letter of Approval
    c. Bulk Contributions Calculation
8. Market Research
    a. Market Research Study

<u>Exercise</u>

Using the structure outlined above, gather and organise your property information into folders to prepare your investor pack. These files will be collated into your final presentation, and form addendums to the supporting documentation in your finance application.

5.2 BASIC YIELD CALCULATION FORMAT: RENTAL SCHEME

To perform a basic yield or capitalisation calculation, we first need to calculate the total gross income from our development. Once this has been worked out, we deduct our expected expenses – usually by using an expense ratio or percentage. We multiply the amount remaining after deductions by the number of months in the year that we will be receiving income to get our net annual income. Next, we need to work out our total development cost. This can be done by using a basic feasibility template or can be estimated as a calculation of the development rate per square meter multiplied by the total project area. Finally, to calculate our estimated project return (or expected development yield) we divide the net annual income by the total development cost and multiply that by 100 to get a percentage. To recap, the steps are as follows.

1. Gross Income
2. Less Expenses
3. Net Annual Income
4. Development Costs
5. Calculate Development Return

5.3 BASIC YIELD CALCULATION FORMAT: SALES SCHEME

The yield calculation for a sales development is similar to that of the rental scheme, but with some minor differences in calculating the income. Since you are earning a development profit when you sell units, there is no need to calculate the projected net annual income of your scheme. Instead, you estimate your total selling price and deduct your total development cost to work out your total gross profit (before taxes). To calculate your return, you have two options. You can divide the profit into the total development cost to get your return on total cost, or you can divide the profit into the equity portion that has been contributed to the scheme to get return on equity. In summary, the steps are as follows.

1. Total Sales Price
2. Less Total Development Cost
3. Equals Profit (before tax)
4. Calculate Development Return, or
5. Calculate Return on Equity

5.4 ELEMENTS OF THE CALCULATION

<u>Gross Income</u>

Total income including primary sources such as unit rentals and secondary sources such as parking or rentals of storerooms.

<u>Operating Expenses</u>

The operating expenses depend on your development model. In a commercial development, say offices, the lease may or may not include expenses (referred to as a *gross* or *net* lease). In residential developments, your allowance for expenses may include management fees, maintenance and rates and taxes. A total *expense ratio* allowance of 25% is typically used for estimating purposes.

<u>Net Annual Income</u>

This is the total development income, after deductions projected over a year (multiplied by 12 months).

Escalation

This refers to the annual rental increases that can be expected during and after construction. Escalation can have a dramatic impact on your feasibility due to the compounding effect on project income. Allowances for annual escalation are estimated as follows, depending on your property location and building classification (grade).

Type	Escalation
Residential	4% - 6%
Commercial	6% - 8,5%

Development Costs

This is the total cost to complete the development, including land costs, building costs, professional fees and finance expenses. It is worthwhile to note that the development costs may also escalate during the construction period.

Return

The development yield calculated as a factor of net annual income and total development cost. The return is typically expressed as a percentage and in South Africa, target returns should typically range from 8,5% upwards to be considered attractive to investors.

5.5 SUSTAINABLE RETURNS

Achieving sustainable, long-term returns depends on income and costs becoming stabilized. During the initial project stages such as the first year following completion, the development income, vacancies, and cost items may be volatile – taking time to normalise. For instance, your vacancies may reduce from 15% in the first year to less than 5% in the second or third year. With a good management team, it is possible to plan for a rapid tenant turn-over, optimise the building's operations and reduce ongoing maintenance expenses. In this way, you can reduce the outgoing costs significantly and allow the development yield to stabilise. Rental risk also reduces as the building becomes tenanted and establishes itself in its location.

Your ongoing development objectives may come into consideration here, as the feasibility will improve over time due to rental escalation. For estimation purposes, investors may consider either the development yield in the first year after completion and will typically have a target return in mind when looking at the project's feasibility study. This target is known as the *hurdle rate* and gives developers, investors, and financiers a clear objective to work towards. Institutional investors that have a more long-term view may base their calculations of the development yield over a longer term such as five or ten years. This is known as a *blended* return and is calculated as an average of the lower returns in the first few years and the much higher returns after year 5 of the development.

5.6 FINANCE COSTS

When calculating the feasibility study, developers need to anticipate the costs of raising project funding. These expenses may include factoring in loan interest into the operating cashflow, allowing for a finance raising fee, and taking note of potential legal expenses associated with development finance. The bank may charge a facility fee (typically 1,25%-2%) and other fees such as those associated with a revolving VAT facility.

5.7 INTEREST

Developers seeking to raise funding for their project (senior debt) should consider the development gearing ratio offered by the lender, as well as the interest on the loan capital. The interest is typically calculated in direct proportion to the anticipated project risk and the credibility of the developer charged with delivering the end product. Subprime lending rates

are typically offered to developers with substantial access to capital either in the form of surplus cash, guarantees, or strength in their balance sheet. Interest is calculated as a factor (%) above or below the base interest rates put forward by the Reserve Bank.

The interest for a project is based on the proposed sales model, and typically endures the length of the development period. This includes the pre-contract portion (approximately 6 months) as well as the contract period (12-18 months depending on project size). Expenses may be kept low during the initial project stages, and this greatly aids cashflow and reduces interest on capital raised from the lender. Once the development is completed, it is possible to restructure the finance from a *short-term* development loan to *long-term* funding based on an extended loan period. It is important to note that long-term debt restructuring may assist in reducing the monthly debt service ratios but will ultimately result in a substantially larger interest bill at the end of the term. Developers should, therefore, aim to settle the principal loans in as short a term as possible considering the disposable income that is available to the development.

5.8 EQUITY PARTNERSHIPS

When structuring a new development, one option to raise additional equity is to attract a development partner. This partner should ideally take on an equity finance position in your property development. By increasing the amount of equity available to the project, it allows you to enter into larger transactions without overextending your available resources. When short of capital for a project, taking on a financial partner is also seen by the senior debt lender (the bank) as a means to reduce risk and distribute the project exposure. The format of the equity arrangement is typically structured as a percentage shareholding calculated on a rand-for-rand basis in proportion to the total development value. One downside in finding a co-investor for your project is that in general, equity funding is considered riskier for an investor than debt finance due to the presence of development risk. If presented in a comprehensive way, however, this risk can be mitigated by putting construction guarantees in place and requiring the professionals to sign due diligence agreements with the developers.

Other equity partnership agreements may be agreed with the investors or banks through direct shareholding, mezzanine loans, or profit-sharing arrangements. When taking on a new project, you should be comfortable with your equity partner as being the right partner whom you can trust. When presenting the proposal, you must be able to clearly demonstrate the inherent value upside to an equity investor, showing your exit strategy and projected profits.

Mezzanine Funding

Mezzanine funding is short-term finance that is intended to supplement the senior debt offering. It is normally calculated at a higher interest rate but could be taken into consideration as a supplement to your finance if the total amount makes up a small proportion of the senior debt (which is at a lower interest rate). In this regard, mezzanine debt can provide just the right amount of start-up capital required to top up the project funding. One further note is that mezzanine funding usually ranks first, above the senior debt in terms of repayment, followed by partnership equity which ranks last.

Partnership Advantages

Including partners in a deal comes with many advantages. For one, having the right co-developer on your team brings the assurance of another developer that can contribute their knowledge and market experience to the project. In addition to this, your partner may also provide the following.

- Enhanced risk mitigation through diversification
- Improved leverage due to equity injection
- Broader access to network. This includes access to potential investors and experienced professionals
- Knowledge/experience of alternative transaction structures

5.9 FUNDING MODEL

Typical development models rely on the establishment of a Special Purpose Vehicle (SPV) which is a registered company through which the development transactions can be performed. By establishing a new company, all parties to the project can be assured of a clean start free of pre-existing debts, tax liabilities or underlying problems from the past. On commencement of a project, parties sign a development agreement and contribute their respective proportion of equity towards the project in exchange for shares in the SPV. A shareholder's agreement will need to be in place regulating the rights, roles and responsibilities of each shareholder, and defining the common objective of the development.

5.10 AFFORDABLE HOUSING FINANCE

An increased demand for affordable housing in South Africa has encouraged banks and lenders to create specific offerings for developers that operate in this sector of the property market. In this manner, developers can become aligned with institutions seeking to make transformative change in communities where adequate housing is in short supply. Finance incentives for these types of projects are available including a selective partnership approach, favourable lending rates and higher gearing.

5.11 USING THE TEMPLATES

The spreadsheet templates provided can be used for development calculations of different types and apply to both commercial and residential projects. All worksheets are linked, and inputs should be made only in the yellow, highlighted squares to allow the formulas to carry out the calculations.