



PROPERTY DEVELOPMENT
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Module 10: Property Development Finance

Contrary to popular belief, property development is not all about building and construction. It is mostly about funding and managing the budget before and during construction. Indeed, the main reason for failure in property development is lack or mismanagement of funds.

Property development finance is unique. It is absolutely crucial that you, as CEO of a property development business, learn how to determine correctly the source and application of funds for your project.

Here I'll begin by outlining the basics of property development finance before demonstrating some fundamentals to making sure your project is fundable by the cheapest source of this finance: the bank.

As already noted, before providing finance, the bank will look at two components of the deal: the financial feasibility of your project (whether it 'stacks up') and your experience as a developer. I will discuss these two components in detail later in this chapter.

Basically, there are two types of funding: equity and debt. Further, there are two types of equity: actual equity and notional equity, and two types of debt: first mortgage or senior debt and mezzanine debt.

You may utilise a combination of funding sources, as illustrated below. It's important when deciding the best funding structure that you also determine the costs of funds and how those costs will affect your financial feasibility.

Funding Pyramid

- Senior debt (first mortgage)
- Mezzanine debt (2nd mortgage)
- Notional equity
- Initial
- equity



Funding Structure

Initial equity. Initial equity is that part of the purchase and development cost that is not provided by the first mortgage provider. It can be viewed by the first mortgagee as the developer's 'hurt money'. It can be borrowed from another source against other security, and indeed could be made up using mezzanine finance, although this is not recommended as it is a costly form of finance and increases project risk significantly.

The Bank will insist that your initial equity is used first before you will have access to the bank funds.

Notional equity. Notional equity is the gold nugget that's hidden in every good property development deal. You can create notional equity in many different ways, and indeed you can create so much of it that often you don't need to inject any money into the deal.

Some of the ways that notional equity can be achieved are rezoning of the site, adding value by obtaining a DA for redevelopment, removing easements and strata titling an existing building. Asset value can also increase when a move in asset prices occurs over a period of time (for example, in cases where delayed settlement terms have been agreed), or simply when the first mortgage lender recognises increased value (on-completion valuation).

Mezzanine debt. Mezzanine debt sits *behind* the senior or first mortgage debt. It is therefore subordinate to the first mortgage, and usually requires second mortgage security as well as directors' guarantees.

However, it sits *before* owner's equity and can be a combination of both debt and equity. It has a predetermined income yield and is sometimes referred to as seed capital.

Utilising mezzanine finance for property development is not recommended as it can be expensive, both to establish the loan and because it commands high interest rates. The terms and conditions are also often very stringent. While there is a place for mezzanine funds in some circumstances, this finance is generally to be avoided. If your feasibility analysis is such that it requires mezzanine finance, I would recommend finding another project with less risk.

Senior debt. The senior debt, or first mortgage, will be financed through your principal lender. Assuming that lender is a bank, for example, it will take first mortgage security over all assets in the deal and it will require directors' guarantees. Currently the terms and conditions for lending typically include the following (bear in mind, however, that these are constantly changing based on market conditions and the bank's policies, so determine the latest criteria when you are ready to borrow or when doing feasibility studies).

Financial modelling and funding

Once you have completed your financial feasibility, the next steps are to build the following:



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- A funding table showing that the deal meets lending criteria and is fundable by the bank and/or other preferred sources of funds
- A source and application table demonstrating the source of funds, how they will be utilised through the project, the return of seed capital and the distribution of profits
- An investor and cost of funds model
- Sensitivity models showing the effects on profit, loan to value ratios (LVR) and funding
- A cash flow forecast.

Your funding model should allow you to determine the best funding structure for your project and whether it will be fundable by the bank, while at the same time allowing you to maximise notional equity and provide you and your investors, if there are any, with maximum returns.

Development funding submissions. Typically, the following information is required when preparing a submission for funding:

- Detailed feasibilities indicating all the costings estimated to complete the project, including council contributions, professional fees, project manager, demolition
- Details of leases or potential leases (if applicable)
- Copy of tenancy schedule (if applicable)
- Copy of valuation (if available)
- Copy of quantity surveyor's report (if available)
- CV of borrowers/guarantors (brief only)
- CV of builder (if available) or list of past projects if owner-builder
- Details of facility required
- Copies of the business's last two years' financial statements (balance sheet, profit and loss statements) for all related **company** and/or **trust** accounts
- Copies of last two years' tax returns for any **director**, **partner** or **guarantor** related to the application
- Statement of assets and liabilities for each borrower/ guarantor
- Contract of sale (if purchasing property)
- Details of any other loans and/or credit facilities, including hire purchase and leasing (e.g. balance, term remaining, repayments, residual/balloon)
- Trust deeds, including the names, addresses and ages of all beneficiaries
- Diagram showing the borrowing entity and any other related entities, if applicable (including trusts, companies, etc.)
- Copy of lease profile for each asset detailing income, expenses, lease start date, lease completion date, options and non-recoverable expenses.

Here are the top tips from one of the big four banks to avoid common errors in submissions for (senior debt) development funding:

- A project **funding table** must be prepared and should include all project development costs (other than selling costs, which are payable at settlement)



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- Where the project is being sold upon completion, **GST on development costs** should be excluded from the funding table. GST is to be separately funded by the borrower or via an overdraft account, which is self-liquidating and then cleared by input tax credits
- If the development site has been recently purchased, the **land value** in the project funding table should be the lower of cost and valuation. If the site has been held for some time (twelve months or more), unless it has been enhanced with a development approval and land value is adopted in lieu of cost, the acquisition costs should *not* be included in the funding table. When you're using an 'as is' valuation that assumes the payment of fees/ costs (e.g. council contributions), these fees/costs should *not* be separately shown in the funding table in order to prevent (a) double-counting and (b) overstating equity
- Where the quantity surveyor's estimate of **construction costs** exceeds the borrower's estimate and/or the building contract, it is the QS's estimate that should be used in the funding table
- One hundred per cent of **equity** must be contributed upfront, prior to any debt funding. This is to ensure that once debt funding commences, the bank holds sufficient approved funds to complete the project (including a minimum 5% contingency allowance within the facility limit)
- The proposed **facility amount** must reconcile to total debt required per the funding table
- The **security value** is the total project development cost (per the funding table), *not* the 'as if complete' value. The 'as if complete' value is used only to confirm the development project's viability
- A **project feasibility** must be prepared, calculating the margin between the 'as if complete' value (net of selling costs and GST) and the total project cost (per the funding table). This margin as a percentage of total project cost is termed the return on cost
- **GST** on both **gross realisations** (if residential) and **selling costs** must be included in the project feasibility, even when the property is to be retained on completion (in order to determine the theoretical development profit/project viability). As selling costs are a settlement adjustment, they should *not* be included in the funding table (unless incurred upfront in relation to pre-sales)
- A **return on cost** below market expectations of 17–20% may indicate that (a) the adopted land value is overstated and (b) the gearing is understated
- A **borrower's CV** and **builder's CV** are to be provided, as the bank needs to understand the borrower's and builder's experience
- **Serviceability** pre- and post-sales is to be completed so the bank can understand the debt levels the client has the capacity to service should they be seeking less than policy on pre-sales – 100% debt cover
- **Statements of assets and liabilities** and financial accounts are to be provided and cannot be mitigated by pre-sales.



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How the bank assesses your funding submission

It is important to have a pre-submission meeting with your bank representative and to understand the bank's assessment criteria. Here are one of the top four banks' internal guidelines for assessing development finance. Not all of the information provided here will be applicable to every funding submission, but you can use this as a guide to see whether you meet the bank's criteria before committing to a particular project. It will provide you with a basis for discussion with your chosen bank.

Here's what the bank will be looking for:

Purpose. A statement of purpose for each credit facility should say what the funds are expected to be used for *and* what has caused your underlying need to obtain financing. Your stated use for a loan may not be the whole story. The bank will want to understand the true borrowing cause so that it can provide the solution that best meets your needs and that of the bank.

History. This includes:

- Basic past account history, including background to relationship, risk of loss to other banks, industry background, recent large projects and any other relevant customer background information
- Background purpose/borrowing cause of existing facilities.

The following details will be required by the bank:

Borrower/customer group:

- Corporate structure
- Length of customer relationship.

Type of transaction:

- Property development.

Type of property:

- Office
- Retail
- Industrial
- Leisure/hospitality
- Residential development
- Other (please specify).



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Property/project details:

- Type (see above)
- Size/area/number of units
- Total development cost/budget
- Time to complete project
- Sales value (on completion)
- Rental income and tenancy details if appropriate (break down into pre-committed and speculative).

Property/project cost:

- Cost of development, broken into component parts including land and acquisition costs, development/consultants' costs, construction costs, finance costs, marketing costs and project contingency
- Include a copy of the development appraisal and cash flow with the credit application.

Use of funds:

- What are the funds being used for?
- How is the transaction being financed?
- Include funding table showing:
 - Total development cost Equity/borrower stake
 - Debt (bank and other third-party borrowings)
 - Equity + debt = cost of development
 - Show relative percentages – debt/equity.

Funding must be on a cost to complete basis with all equity injected into the development ahead of bank debt.

Loan details:

- Amount (loan to cost ratio), term (loan maturity must be after anticipated completion date).

Repayment source:

- Sale of property upon completion
- Summarise sale expectations for the property/project and anticipated completion timetable

Compliance:

- Compliance with policy – Any non-compliance issues for both existing and new facilities proposed will be determined
- Compliance with existing approval conditions or covenants. Determine any breaches.



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Debt servicing

Analysis of the debt servicing capacity of the property being developed depends on the anticipated method of repayment of the development loan.

There are two primary means of repayment of a commercial property development loan: sale of the property/development at practical completion and refinance of the development loan by the drawdown of a term loan.

For our purposes, we are referring only to the first point above, where repayment is to be from the sale of the property/development on completion.

Sale of the property/development.

Usually interest will be capitalised during the construction/development phase of a property or project. The loan amount, inclusive of interest capitalised, will be repaid on completion through the sale of the property. In such circumstances, the expectation is that the borrower will not need to service the facility post completion.

Debt servicing analysis.

The bank undertakes a debt servicing analysis, which is based upon a hypothetical calculation of what the debt servicing position would be if the property did not sell as expected. The primary analysis focuses on the debt servicing position of the borrower. The borrower's debt servicing capacity is determined based either on cash flow or profit.

However, the borrower may not be able to demonstrate debt servicing capacity from its historic financial information. This will often be the case if a special purpose vehicle without trading history is undertaking the development. The ability to service the proposed debt may then depend on rental income from the subject property or on resources or income external to the project (such as guarantors/project sponsors).

Where the ability to service depends on rental income from the property/project, this capacity will be detailed and critically assessed by the bank by considering factors such as:

- The level and strength of any pre-committed leases (if applicable)
- Current market rents for equivalent properties. These will be sensitised to determine the discounts that could be applied while still servicing the proposed debt
- Current market demand conditions and ease of letting (where pre-commitments are not held).

Where the borrower does not have the capacity to service and repay the proposed debt (for example, where 'special purpose' entities are used for the development), there may also be reliance on the resources of guarantors or project sponsors. It would then be appropriate to include further assessment of the financial position of guarantors or project sponsors. In such circumstances, an additional debt servicing table using financial information obtained for the guarantors or sponsors is detailed. The bank will also determine if there is a legally enforceable right of recourse to other parties.

The credit assessor's comments are provided on the following, as applicable:

- Is a deficiency in debt servicing capacity evident?



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- Is a material change evident in the historic results or likely during the term of the facility? The assessor will look at changes occurring in historic results (year on year) and between historic results and projections.

Material changes could be either positive or negative. Comment will be made where an item in the debt servicing calculation moves from positive to negative, shows a downward trend (particularly after a number of growth periods), or shows positive or negative changes that are above normal. As a guide, movements in any item greater than 10% (positive or negative) must be considered.

Where historic financial statements can be analysed for the borrower, the assessor will comment on sensitivity analysis in accordance with current policy.

Cash flow forecast

In *all* property development loan applications, cash flow forecasts for the development/construction phase are required.

The borrower should provide the bank with a cash flow forecast for the development and sales phases (sometimes known as the Development Budget or Project Summary). This should outline all cost items required to bring the development to practical completion and when they are expected to be incurred. This will need to be tabled and analysed by the banker.

Cost items to be included in the cash flow forecast include, but are not limited to:

- Land cost and acquisition costs
- Development costs
- Consultants costs
- Planning/permit costs
- Construction costs
- Marketing costs
- Lease incentives
- Finance costs (legal, valuation, etc.)
- Bank interest
- Project contingency.

Assessment will be made of the reasonableness and achievability of the project cash flow forecast/project summary, with particular comment under the following headings:

Development costs budgeted. The credit assessor will assess the project costs budgeted to ensure all appropriate costs are included and that cost estimates are reasonable, given the development type and current market/industry conditions. The assessor will also confirm that adequate allowance has been made for Goods and Services Tax or other equivalent taxes that may affect development costs.

Funding of borrower's equity in project. The assessor will comment on the amount, timing and source of the forecast equity contribution to the project. Equity contributions are made prior to any bank (debt) funding.



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Adequacy of debt funding. The assessor will confirm that the level of funding sought is sufficient to complete the project, after the borrower's equity contribution has been made.

Sales revenues projected. The assessor will:

- Comment on the level, timing and source of sales revenue forecast
- Assess assumptions made about current/expected economic and property market conditions
- Consider demand conditions within the project's target market, what levels of pre-sales are forecast, what pre-sales have been achieved to date, what sales prices are expected, what reliance there is on speculative sales, whether these assumptions are reasonable and adequate allowance has been made for taxes that may impact on sale proceeds.

Cash flow forecasts:

borrower/guarantor/sponsor

The assessor may also obtain and assess cash flow forecasts for the borrower, guarantor(s) or project sponsor(s) (as appropriate), with specific comment on:

Capacity to make the required equity contributions.

Where is the equity contribution being sourced? Are there any factors that could adversely impact on the capacity of the party to make such contributions when required?

Ability to cover potential cost overruns.

What capacity exists to cover potential cost overruns or contingencies on the project? Assessment of other resources and income sources of the borrower/guarantor(s)/sponsor(s)

Capacity to service proposed debt facilities.

What capacity does (do) the borrower/guarantor(s)/sponsor(s) have to service the proposed facilities in the event of project delays or delays in settling (or failure to complete) sale contracts?

The assessor will comment on the scope/requirement for interest rate hedging. Analysis of cash flow quality flows directly through to exit analysis (as discussed later in this chapter).

Management/management information systems



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Management's actions may directly affect the performance of a business and hence the risk of any credit. The impact of management in property development lending is primarily a function of the level of experience of the developer and the level of market/speculative risk in the project. The greater the experience (as evidenced by the developer's track record of successful property development in projects of similar size and nature to the subject project), the less the management risk. The higher the market/speculative risk (as evidenced by factors such as the development of property/space with pre-committed sales or leases), the greater the reliance on management to mitigate the market risks inherent in such a development. The less the market risks (as evidenced by acceptable levels of pre-commitment), the more the developer has demonstrated his or her management expertise and reduced market risk.

This analysis demonstrates the impact management skills and experience might have on changes in cash flow. Assessment of management takes into consideration the following:

- Experience of management (noting any recent management changes)
- Depth of management (considering succession planning and key person insurance)
- Breadth of management in key functional areas
- Integrity of management
- Use of appropriate and independent advisers on an ongoing basis
- Management's track record in achieving successful results and the management information systems used to track them.

Specifically, the credit assessor will want to evaluate and quantify management's historic performance in the following areas:

- Coping with economic/property market downturns
- Maximising the level of pre-commitment (whether leases or sales) prior to the development commencing
- Maximising the level of income from a partly or wholly developed property on a speculative basis
- Achieving the balance between pre-committed and speculative revenues to maximise development profit consistently
- Managing interest rate risk and changes in interest rates
- Delivering projects on time and within budget. Success in these management areas requires that managers:
 - Understand how economic conditions affect the performance of the market/property, anticipate the effects of those conditions and have plans for coping with them
 - Understand how competitors are likely to affect the business's/development's performance
 - Anticipate and manage the effects of actions by competitors.

The credit assessor will provide comment on the following, as applicable:

- Family tree, noting consolidated/inter-company relationships including ownership of assets and flow of income
- Nature and composition of board and senior management.

Customer rating system and risk profile



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The bank's Customer Rating System and Risk Profile identify and quantify an objective view of the customer's financial position by analysis of their current and projected financial statements. The risk score and resultant profile is intended to focus financial analysis on the riskier elements of the borrower's financial statements in a predetermined range of, say, 1–15. Financial risk is concerned with the viability and stability of the customer's repayment sources. By performing a financial statement analysis, the assessor will quantify the company's ability to repay its debt. A trend analysis of the customer's financial position is undertaken where possible, with brief comments on the results documented. Further in-depth analysis may also be required if the financial risk score exceeds the bank's current minimum threshold. The **liquidity/cash flow risk component** measures the ease with which a customer can meet their short-term cash needs via the cash flows generated by the property. In property development lending, the focus of the analysis should be on the borrower's ability to fund cost overruns occurring during the development/construction phase and the borrower's ability to service interest on the facility post construction.

The **capital structure risk component** measures the relationship between borrowed funds (debt) and company funds (equity). Analysis is based on the cost of the development, not the anticipated end value. It also indicates the extent of financial risk carried by the owners and creditors respectively.

The **market risk component** measures the amount of market risk in a transaction and is a function of the level and quality of pre-commitments (either lease or sale or both) of end users of the property.

Commercial property development lending – specific guidelines

Assessors will also consider the following:

- The borrower's experience/track record in property development in terms of the size and complexity of the development, the proposed market sector and the borrower's success in previous developments
- The level of pre-commitments (leases or sales) relative to debt servicing requirement or debt level
- The quality of cash flow, split between pre-committed and speculative sales and rentals (if appropriate)
- Tenant quality (if appropriate)
- The lease maturity profile (if appropriate).

Property/project risk and competitive position

While the analysis, to this point, has focused on the developer's future projections, it is important for the assessor to compare the project's likely success against peer/comparable (by location and type of property) or competing developments. This will enable a better determination of whether the proposed development is potentially successful or unsuccessful.

To complete this analysis, the assessor uses a group of properties/developments of a similar size and type in a similar location to the subject development to compare their respective merits. In particular, they consider how the characteristics/variables of the subject development (sales prices, location, tenants, cost, property features, etc.) compare with other examples in the market. This analysis is particularly important where a substantial level of



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market/property risk is inherent in the development (where pre-commitments are not a significant feature of the development).

It is also important to compare pre-commitment variables (sales value per sq. m., rent per sq. m., lease terms, lease incentives, tenant quality, etc.) with those being achieved elsewhere in the market by comparable product.

In using any information for comparative purposes, the bank's assessor will be sensitive to several considerations, including:

The size of the comparative group. If only two comparable properties/developments are included, the resulting average may not be representative of the property type.

The date of the peer group data. If the data is several years old, then a comparison using current data for the subject property may be of little value.

The geographical mixture of the peer group. Comparing the property with others in a geographical region may be more relevant than comparing a cross-section of properties across a state or country.

The quality of the data. How reliable is the data being used and are ratios calculated in the same manner as for the subject property?

The assessor will make comments under each of the following headings, specifically considering market conditions and the property/project's competitive position (with reference to peer comparison, as appropriate):

Property/project risk assessment. The fit of the property/ project (that is, the type, quality and price of the project on offer) for that particular location and in comparison with competing properties/developments. Is it the right development, in the right location, at the right price, at the right time?

Professional team. The assessor will detail and assess the make-up and capabilities of the professional team supporting the project, so demonstrate where possible that they have the expertise and track record appropriate for a project of this type and scale.

Developer's experience. Demonstrate to them that you as the developer have the track record/expertise appropriate for a project of this type and scale.

Location/site. How does the property's location compare with competing properties? Are there others in the area competing for the same purchasers and tenants? Is the development appropriate for that location?

Enforceable pre-commitments – pre-sales and pre-leases (if appropriate). The assessor will look at the quantity, quality and spread of pre-sales and pre-leases (if appropriate) *relative to the debt proposed*. Are contracts unconditional, arm's length and enforceable? Are there sunset clauses (for completion) in the contracts? How do prices compare with the market?



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For single purchasers, assessors will comment on financial strength and ability to complete the transaction. For multiple purchasers, they will assess the quantity and quality of pre-sales with comments on:

- Level and type of deposits/security bonds
- Diversity of purchasers
- Related party purchasers
- Sales to non-residents
- Sunset dates for completion
- Allowance of sales commissions, taxes, legal costs in contracts.

Demand analysis (uncommitted portion of project)

The assessor will analyse existing and future market demand for the portion of the property not subject to pre-sale commitments (keeping the depth of analysis relative to the level of commitments already achieved).

Marketing strategy. They will comment on the marketing strategy the developer is adopting in relation to the uncommitted portion of the project.

Quality of construction/fit-out. How does the property/ project compare with competing properties in terms of quality of construction and fit-out? This is particularly important if the development is proceeding on a speculative basis (that is, a low level of pre-committed tenants/purchasers).

Construction and assessment of builder. How complex or simple is the construction? Who is the builder?

What is their technical and financial capacity to meet their commitments under the building contract? Is a performance guarantee being obtained or required?

Building contract. The assessor will require an outline of the key features of the contract. Is it fixed term/fixed price? Does it conform to acceptable industry standards? What are the security retention provisions, and do they meet the bank's policy requirements?

Property market and other risks It is appropriate to consider the broader market risks that could specifically impact on the project/development. These risks may impact on the borrower's ability to repay the development facilities as expected.

The assessor will make comments under each of the following headings. Note that the depth of such analysis will be relative to the level and quality of pre-commitments already achieved at the time of the borrower's finance application.

Market maturity. What is the stage of maturity of the market (emerging, maturing or declining)? Typically, emerging or declining markets have the highest risk.



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Focus on the future and consider the likely market maturity when your development is scheduled to reach practical completion.

Market cyclical. What is the impact of economic business cycles on the market? Generally, markets that are highly cyclical (or counter-cyclical) have higher risk. Consider the likely property market cycle when your development is due to reach practical completion.

Demand and supply analysis. Where a high degree of market risk exists in the property/development (i.e. there is a lower level of pre-commitments), provide evidence of the level of demand for the type of property in the relevant location and the level of competing supply.

Property market outlook. The assessor will comment on the outlook for the commercial property market. Focus on the same type and location as your subject property. Where possible, refer to independent market analysis/ research.

Quality of securities. The following are some of the general issues that the assessor will consider:

- Is a Registered Mortgage Debenture/Floating Charge/Mortgage Debenture/Lien over the assets of the business borrower held or required? If so, is the value of these pledged assets quoted in the financial statements realistic and are they saleable?
- Are directors' guarantees held/appropriate? (Is there a statement of position of guarantors and their worth as guarantors? What is the realisable value of securities if sold?)
- Does the bank have effective control of the securities and are they readily saleable?
- Do the securities require monitoring (for obsolescence, market variations, nearby detrimental activities, environmental concerns, etc.), and if so, are appropriate covenants or conditions in place and known to you?
- Are there any preferential claims, subordination retention of title or other conditions attached to any security (e.g. voting rights of other lenders/creditors, structural subordination)?

Securities for commercial property development lending – specific guidelines

The assessor will:

- Explain any proposed deviation from policy
- Comment on loan to cost ratio and explain any deviation from policy
- Ask whether the property is freehold or leasehold.

If leasehold, terms of head lease/sublease(s) (e.g.start/end dates), current passing rent and rent review provisions (rent review dates and basis of reviews) should be detailed

- Advise as to whether a professional valuation has been obtained in accordance with Global Credit Policy, detailing:
 - Date of valuation
 - Whether valuation is from an approved valuer



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- Who instructed the valuer
- Whether the valuation methodology is acceptable
- Confirm that the Relationship Manager has inspected the property securities (mandatory)
- Comment on ease of realisation, considering property location, alternative uses (if specialised property) and development status
- Comment on whether any planning issues or conditions, environmental issues or orders or other matters need to be addressed
- Detail insurance cover for the property
- Detail the contractor's all-risk insurance policy, including the limit of indemnity and expiry dates. Also detail claims history and current outstanding claims
- Comment on the borrower's capacity to fund cost overruns as and when they occur. If you do not have adequate capacity, guarantees/undertakings from the project sponsors or some other party of substance should be taken
- Confirm that the building contract is of a fixed time/ fixed price nature
- Assess whether a tripartite (step-in) deed between the bank, the builder and the borrower (in respect of the building contract) is necessary.

Minimum security requirements

These include:

- Registered first-ranking charge over freehold/leasehold interest in the property
- Floating or registered mortgage debenture over the assets and undertakings of the borrower
- Personal guarantees of directors
- Appropriate cross-guarantees of associated entities
- Tripartite deeds relating to building contracts, sales contracts, agreements to lease (as appropriate)
- Charge over pre-sale contracts (including deposits) where appropriate.

The assessor is likely to make comments where these minimum requirements are not met.



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Conditions precedent

Standard conditions precedent for property development lending are applied irrespective of loan details. The bank's into each new loan. Where individual conditions are Standard conditions precedent for commercial property development loans include:

- Builder and building contract must be acceptable to the bank – building contract to be executed
- Appropriate levels of pre-sales (normally between 80% and 120% of proposed debt) or pre-committed leases, depending on local conditions and project and market risk assessment
- The site is to be clear of contamination or other environmental problems. You will be expected to complete a satisfactory environmental questionnaire, with site investigation reports if deemed necessary
- The construction period should not exceed eighteen months
- An independent QS is to be retained for all building projects where construction costs exceed \$1 million. A consulting engineer is required for all land subdivision projects where cost exceeds \$1 million
- All progress payments/drawdowns under the facility should be made on a cost to complete basis
- Pre-commitment documentation (agreement for lease/lease or pre-sales contracts) is to be reviewed and be acceptable to the bank and its advisers
- Where pre-commitments feature, certification requires that the plans and specifications of the building contract accord with the plans and specifications of the pre-commitment documentation
- Professional valuation is to advise the value of the property 'as is', the value upon completion, feasibility of the project and demand/supply analysis.

Minimum valuation amounts should be loan conditions

- A tripartite deed is required for larger or more complex projects
- Capitalisation of interest is permitted, but not after practical completion

The borrower must demonstrate a capacity to fund cost overruns

- All acceptable insurances must be in place in relation to the development
- Confirmation that the contractor has sufficient levels of insurance in place (including public liability) is required
- One hundred per cent of net sales proceeds must be applied to the repayment of bank debt and reduction of limit
- Adverse material event covenants are to apply
- Construction is to commence within ninety days of issuance of letter of offer
- Shareholder or director contributions, where required, are to be made by way of share capital and/ or shareholder's/director's loans, repayment of which is to be formally postponed or subordinated to repayment of bank facilities
- A satisfactory search of relevant corporate registry records, in particular jurisdiction, is required.



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Standard conditions precedent to the initial and each subsequent drawdown include:

- Certification from the independent quantity surveyor of:
- Total expenditure to date on the project
- Expenditure on the project since the date of the most recent drawdown
- The cost to complete the project
- The anticipated date of practical completion for the project
- Funds requested for drawdown shall not exceed expenditure on the scheme since the date of the most recent drawdown
- Cost to complete to be less than or equal to the funds available within the facility less the amount of the drawdown request before the bank. In the event that the cost to complete exceeds funds available within the facility, a cost overrun will be deemed to have occurred and no further debt funding will be permitted until the full amount of the cost overrun has been funded by additional equity
- Anticipated date of practical completion to be no later than the expiry date of the facility.
- Certification to be provided by the architect and relevant project consultants that actual construction is proceeding in accordance with the plans and specifications of the building contract
- Certification from the builder to be obtained confirming that all amounts due and payable to subcontractors, consultants, supplier and employees have been paid.

Covenants/ratios disciplines/conditions

A loan agreement is a contract between the bank and a customer that specifies the rights and obligations of each with regard to a certain loan or credit arrangement. It sets forth the conditions under which the loan is granted and establishes the parameters within which the borrower must operate.

A covenant is a clause in an agreement that specifies actions required (affirmative covenants) or prohibited (negative covenants). Covenants should be clearly defined and reasonable.

Covenants can do several things, including:

- Establishing a maximum ('...shall not exceed...')
- Forcing a minimum ('...shall not be less than...')
- Maintaining ('...shall not change...').

The overall purpose of establishing covenants, default provisions and remedy provisions is to give the bank the opportunity to act if the risk in a loan changes. A good covenant will be tight but will not interfere with a borrower's operations. Ratios should be sufficiently close to the actual or forecast position to ensure the covenant is breached in the event of a material deterioration in the financial position the covenant is designed to measure.

Covenants can be financial or non-financial in nature. Financial covenants usually address issues such as cash flow, profitability, efficiency, liquidity, solvency, capital structure and asset quality. Non-financial covenants will often assure full disclosure, management continuity and quality and the borrower's continued existence, and establish reporting requirements.

The credit assessor provides comment on the following, applicable:



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- The major covenants and ratio disciplines that will be relied upon and their adequacy or otherwise to mitigate key risks
- The historic performance of the borrower with regard to previously existing covenants, including comments on any non-compliance and corrective actions taken during the period.
- Non-financial covenants include: the usual financial reporting covenants are not in place/proposed
- An outline of the major covenants and ratio disciplines that will be relied upon and their adequacy or otherwise.

If a new covenant is added, the assessor will make comments as to what risk is to be negated by this covenant.

Covenants for commercial property development lending – specific guidelines

Conditions/covenants that should apply in all commercial property development loans include:

- Minimum level and type of enforceable pre-commitments (pre-sales or pre-leases) required
- Basis for equity contribution and payment of progress claims, specifying the required equity contributions and the timing of them (must be contributed in full prior to any bank funding being provided). All progress claims are to be paid on a cost to complete basis. Responsibility for cost overruns should be clearly stated. Funding will be permitted only where the cost to complete the development is less than or equal to the funds undrawn/available under the facility (less the amount of the progress payment/drawdown request before the bank)
- Requirement for quantity surveyor/consulting engineer certification of progress claims. Appropriate certification from independent advisers must be received and be acceptable to the bank prior to payment of each progress claim
- The anticipated date of practical completion *must* be before the maturity date of the development loan facility.



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Exit Analysis

Comments will include a meaningful and realistic assessment of the sources of repayment or 'exits' available to the bank. The assessor will define such exit(s) showing how the bank can be repaid without loss under normal circumstances.

Primary exit. The primary source of repayment of a commercial property development loan will be the sale of the property/project at practical completion.

Sale of the property:

- The assessor will comment on the capacity to sell the property at completion
- In the normal course, the sale of the property should be pre-committed by a pre-sale agreement/ contract (or a series of them for residential development) entered into before the development commences. This would be a condition precedent to funding
- For commercial property (office, retail and industrial), if a pre-sale does not exist, the likelihood of a sale occurring before or at completion should be assessed as a function of the level of lease pre-commitments in place and the investment market for the type of property being developed
- Where an element of market risk is involved (that is, where the level of pre-sales is less than the loan amount), assessors will comment in detail on the risk involved in securing additional sales during the development phase to enable repayment at loan maturity
- A break-even analysis should be conducted for the property/project
- The assessor will ask what percentage of the proposed debt facility is covered by pre-committed sales. What percentage of the unsold/uncommitted portion of the development needs to be sold (and at what price) to ensure repayment of bank debt? The assessor will sensitise this analysis, considering the impact of less than 100% of pre-sales being settled. The completion percentage used for this sensitivity analysis will depend on an assessment of the settlement risk inherent in the project.



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Secondary exit. A secondary exit is one that is not related to cash generated by the customer in the normal course of business.

The assessor will assess secondary exits provided by:

- Rental income, commenting on the ability to let the property and service/amortise the debt if the anticipated sales are not achieved
- Other assets/income of the borrower
- Other assets/income of guarantors or sponsors.

Property development finance can be challenging for the novice. I would recommend using a broker who has had the relevant experience in procuring property development funding for the type of development you're contemplating. Nevertheless, as a property developer you need to understand the fundamentals of property funding as this will determine the establishment of your project, project structure, in the first instance.

Marketing your project

When does the marketing for a project start?

Is it when you have obtained the DA and are beginning your pre-sales?

Is it when you begin construction or when you have completed the building?

I suggest your marketing should start the minute you create the vision for your development. If you return to the Site Sourcing Funnel™ introduced in Chapter, when you take that first step of choosing your location, at the same time consider the marketing aspects of

Funding Structure

Initial equity. Initial equity is that part of the purchase and development cost that is not provided by the first mortgage provider. It can be viewed by the first mortgagee as the developer's 'hurt money'. It can be borrowed from another source against other security, and indeed could be made up using mezzanine finance, although this is not recommended as it is a costly form of finance and increases project risk significantly.

The Bank will insist that your initial equity is used first before you will have access to the bank funds.

Notional equity. Notional equity is the gold nugget that's hidden in every good property development deal. You can create notional equity in many different ways, and indeed you can create so much of it that often you don't need to inject any money into the deal.



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Some of the ways that notional equity can be achieved are rezoning of the site, adding value by obtaining a DA for redevelopment, removing easements and strata titling an existing building. Asset value can also increase when a move in asset prices occurs over a period of time (for example, in cases where delayed settlement terms have been agreed), or simply when the first mortgage lender recognises increased value (on-completion valuation).

Mezzanine debt. Mezzanine debt sits *behind* the senior or first mortgage debt. It is therefore subordinate to the first mortgage, and usually requires second mortgage security as well as directors' guarantees.

However, it sits *before* owner's equity and can be a combination of both debt and equity. It has a predetermined income yield and is sometimes referred to as seed capital.

Utilising mezzanine finance for property development is not recommended as it can be expensive, both to establish the loan and because it commands high interest rates. The terms and conditions are also often very stringent. While there is a place for mezzanine funds in some circumstances, this finance is generally to be avoided. If your feasibility analysis is such that it requires mezzanine finance, I would recommend finding another project with less risk.

Senior debt. The senior debt, or first mortgage, will be financed through your principal lender. Assuming that lender is a bank, for example, it will take first mortgage security over all assets in the deal and it will require directors' guarantees. Currently the terms and conditions for lending typically include the following (bear in mind, however, that these are constantly changing based on market conditions and the bank's policies, so determine the latest criteria when you are ready to borrow or when doing feasibility studies).



Financial modelling and funding

Once you have completed your financial feasibility, the next steps are to build the following:

- A funding table showing that the deal meets lending criteria and is fundable by the bank and/or other preferred sources of funds
- A source and application table demonstrating the source of those funds, how they will be utilised through the project, the return of seed capital and the distribution of profits
- An investor and cost of funds model
- Sensitivity models showing the effects on profit, loan to value ratios (LVR) and funding
- A cash flow forecast.

Your funding model should allow you to determine the best funding structure for your project and whether it will be fundable by the bank, while at the same time allowing you to maximise notional equity and provide you and your investors, if there are any, with maximum returns.

Development funding submissions. Typically, the following information is required when preparing a submission for funding:

- Detailed feasibilities indicating all the costings estimated to complete the project, including council contributions, professional fees, project manager, demolition
- Details of leases or potential leases (if applicable)
- Copy of tenancy schedule (if applicable)
- Copy of valuation (if available)
- Copy of quantity surveyor's report (if available)
- CV of borrowers/guarantors (brief only)
- CV of builder (if available) or list of past projects if owner-builder
- Details of facility required
- Copies of the business's last two years' financial statements (balance sheet, profit and loss statements) for all related **company** and/or **trust** accounts
- Copies of last two years' tax returns for any **director, partner or guarantor** related to the application
- Statement of assets and liabilities for each borrower/ guarantor
- Contract of sale (if purchasing property)
- Details of any other loans and/or credit facilities, including hire purchase and leasing (e.g. balance, term remaining, repayments, residual/balloon)
- Trust deeds, including the names, addresses and ages of all beneficiaries
- Diagram showing the borrowing entity and any other related entities, if applicable (including trusts, companies, etc.)
- Copy of lease profile for each asset detailing income, expenses, lease start date, lease completion date, options and non-recoverable expenses.
-



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Here are the top tips from one of the big four banks to avoid common errors in submissions for (senior debt) development funding:

- A project **funding table** must be prepared and should include all project development costs (other than selling costs, which are payable at settlement)
- Where the project is being sold upon completion, **GST on development costs** should be excluded from the funding table. GST is to be separately funded by the borrower or via an overdraft account, which is self-liquidating and then cleared by input tax credits
- If the development site has been recently purchased, the **land value** in the project funding table should be the lower of cost and valuation. If the site has been held for some time (twelve months or more), unless it has been enhanced with a development approval and land value is adopted in lieu of cost, the acquisition costs should *not* be included in the funding table. When you're using an 'as is' valuation that assumes the payment of fees/costs (e.g. council contributions), these fees/costs should *not* be separately shown in the funding table in order to prevent (a) double-counting and (b) overstating equity
- Where the quantity surveyor's estimate of **construction costs** exceeds the borrower's estimate and/or the building contract, it is the QS's estimate that should be used in the funding table
- One hundred per cent of **equity** must be contributed upfront, prior to any debt funding. This is to ensure that once debt funding commences, the bank holds sufficient approved funds to complete the project (including a minimum 5% contingency allowance within the facility limit)
- The proposed **facility amount** must reconcile to total debt required per the funding table
- The **security value** is the total project development cost (per the funding table), *not* the 'as if complete' value. The 'as if complete' value is used only to confirm the development project's viability
- A **project feasibility** must be prepared, calculating the margin between the 'as if complete' value (net of selling costs and GST) and the total project cost (per the funding table). This margin as a percentage of total project cost is termed the return on cost
- **GST** on both **gross realisations** (if residential) and **selling costs** must be included in the project feasibility, even when the property is to be retained on completion (in order to determine the theoretical development profit/project viability). As selling costs are a settlement adjustment, they should *not* be included in the funding table (unless incurred upfront in relation to pre-sales)
- A **return on cost** below market expectations of 17–20% may indicate that (a) the adopted land value is overstated and (b) the gearing is understated
- A **borrower's CV** and **builder's CV** are to be provided, as the bank needs to understand the borrower's and builder's experience
- **Serviceability** pre- and post-sales is to be completed so the bank can understand the debt levels the client has the capacity to service should they be seeking less than policy on pre-sales – 100% debt cover
- **Statements of assets and liabilities** and financial accounts are to be provided and cannot be mitigated by pre-sales.



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How the bank assesses your funding submission

It is important to have a pre-submission meeting with your bank representative and to understand the bank's assessment criteria. Here are one of the top four banks' internal guidelines for assessing development finance. Not all of the information provided here will be applicable to every funding submission, but you can use this as a guide to see whether you meet the bank's criteria before committing to a particular project. It will provide you with a basis for discussion with your chosen bank.

Here's what the bank will be looking for:

Purpose. A statement of purpose for each credit facility should say what the funds are expected to be used for *and* what has caused your underlying need to obtain financing. Your stated use for a loan may not be the whole story. The bank will want to understand the true borrowing cause so that it can provide the solution that best meets your needs and that of the bank.

History. This includes:

- Basic past account history, including background to relationship, risk of loss to other banks, industry background, recent large projects and any other relevant customer background information
- Background purpose/borrowing cause of existing facilities.

The following details will be required by the bank:

Borrower/customer group:

- Corporate structure
- Length of customer relationship.

Type of transaction:

- Property development.

Type of property:

- Office
- Retail
- Industrial
- Leisure/hospitality
- Residential development
- Other (please specify).

Property/project details:



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- Type (see above)
- Size/area/number of units
- Total development cost/budget
- Time to complete project
- Sales value (on completion)
- Rental income and tenancy details if appropriate (break down into pre-committed and speculative).

Property/project cost:

- Cost of development, broken into component parts including land and acquisition costs, development/consultants' costs, construction costs, finance costs, marketing costs and project contingency
- Include a copy of the development appraisal and cash flow with the credit application.

Use of funds:

- What are the funds being used for?
- How is the transaction being financed?
- Include funding table showing:
 - Total development cost Equity/borrower stake
 - Debt (bank and other third-party borrowings)
 - Equity + debt = cost of development
 - Show relative percentages – debt/equity.

Funding must be on a cost to complete basis with all equity injected into the development ahead of bank debt.

Loan details:

- Amount (loan to cost ratio), term (loan maturity must be after anticipated completion date).

Repayment source:

- Sale of property upon completion
- Summarise sale expectations for the property/project and anticipated completion timetable

Compliance:

- Compliance with policy – Any non-compliance issues for both existing and new facilities proposed will be determined
- Compliance with existing approval conditions or covenants. Determine any breaches.

Debt servicing

Analysis of the debt servicing capacity of the property being developed depends on the anticipated method of repayment of the development loan.

There are two primary means of repayment of a commercial property development loan: sale of the property/development at practical completion and refinance of the development loan by the drawdown of a term loan.



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For our purposes, we are referring only to the first point above, where repayment is to be from the sale of the property/development on completion.

Sale of the property/development. Usually interest will be capitalised during the construction/development phase of a property or project. The loan amount, inclusive of interest capitalised, will be repaid on completion through the sale of the property. In such circumstances, the expectation is that the borrower will not need to service the facility post completion.

Debt servicing analysis. The bank undertakes a debt servicing analysis, which is based upon a hypothetical calculation of what the debt servicing position would be if the property did not sell as expected. The primary analysis focuses on the debt servicing position of the borrower. The borrower's debt servicing capacity is determined based either on cash flow or profit.

However, the borrower may not be able to demonstrate debt servicing capacity from its historic financial information. This will often be the case if a special purpose vehicle without trading history is undertaking the development. The ability to service the proposed debt may then depend on rental income from the subject property or on resources or income external to the project (such as guarantors/project sponsors).

Where the ability to service depends on rental income from the property/project, this capacity will be detailed and critically assessed by the bank by considering factors such as:

- The level and strength of any pre-committed leases (if applicable)
- Current market rents for equivalent properties. These will be sensitised to determine the discounts that could be applied while still servicing the proposed debt
- Current market demand conditions and ease of letting (where pre-commitments are not held).

Where the borrower does not have the capacity to service and repay the proposed debt (for example, where 'special purpose' entities are used for the development), there may also be reliance on the resources of guarantors or project sponsors. It would then be appropriate to include further assessment of the financial position of guarantors or project sponsors. In such circumstances, an additional debt servicing table using financial information obtained for the guarantors or sponsors is detailed. The bank will also determine if there is a legally enforceable right of recourse to other parties.

The credit assessor's comments are provided on the following, as applicable:

- Is a deficiency in debt servicing capacity evident?
- Is a material change evident in the historic results or likely during the term of the facility? The assessor will look at changes occurring in historic results (year on year) and between historic results and projections.

Material changes could be either positive or negative. Comment will be made where an item in the debt servicing calculation moves from positive to negative, shows a downward trend (particularly after a number of growth periods), or shows positive or negative changes that are above normal. As a guide, movements in any item greater than 10% (positive or negative) must be considered.

Where historic financial statements can be analysed for the borrower, the assessor will comment on sensitivity analysis in accordance with current policy.



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Cash flow forecast

In *all* property development loan applications, cash flow forecasts for the development/construction phase are required.

The borrower should provide the bank with a cash flow forecast for the development and sales phases (sometimes known as the Development Budget or Project Summary). This should outline all cost items required to bring the development to practical completion and when they are expected to be incurred. This will need to be tabled and analysed by the banker.

Cost items to be included in the cash flow forecast include, but are not limited to:

- Land cost and acquisition costs
- Development costs
- Consultants costs
- Planning/permit costs
- Construction costs
- Marketing costs
- Lease incentives
- Finance costs (legal, valuation, etc.)
- Bank interest
- Project contingency.

Assessment will be made of the reasonableness and achievability of the project cash flow forecast/project summary, with particular comment under the following headings:

Development costs budgeted. The credit assessor will assess the project costs budgeted to ensure all appropriate costs are included and that cost estimates are reasonable, given the development type and current market/industry conditions. The assessor will also confirm that adequate allowance has been made for Goods and Services Tax or other equivalent taxes that may affect development costs.

Funding of borrower's equity in project. The assessor will comment on the amount, timing and source of the forecast equity contribution to the project. Equity contributions are made prior to any bank (debt) funding.

Adequacy of debt funding. The assessor will confirm that the level of funding sought is sufficient to complete the project, after the borrower's equity contribution has been made.

Sales revenues projected. The assessor will:

- Comment on the level, timing and source of sales revenue forecast
- Assess assumptions made about current/expected economic and property market conditions
- Consider demand conditions within the project's target market, what levels of pre-sales are forecast, what pre-sales have been achieved to date, what sales prices are expected, what reliance there is on speculative sales, whether these assumptions are reasonable and adequate allowance has been made for taxes that may impact on sale proceeds.



Cash flow forecasts

borrower/guarantor/sponsor

The assessor may also obtain and assess cash flow forecasts for the borrower, guarantor(s) or project sponsor(s) (as appropriate), with specific comment on:

Capacity to make the required equity contributions.

Where is the equity contribution being sourced? Are there any factors that could adversely impact on the capacity of the party to make such contributions when required?

Ability to cover potential cost overruns. What capacity exists to cover potential cost overruns or contingencies on the project? Assessment of other resources and income sources of the borrower/guarantor(s)/sponsor(s)

Capacity to service proposed debt facilities. What capacity does (do) the borrower/guarantor(s)/sponsor(s) have to service the proposed facilities in the event of project delays or delays in settling (or failure to complete) sale contracts?

The assessor will comment on the scope/requirement for interest rate hedging. Analysis of cash flow quality flows directly through to exit analysis (as discussed later in this chapter).

Management/management information systems

Management's actions may directly affect the performance of a business and hence the risk of any credit. The impact of management in property development lending is primarily a function of the level of experience of the developer and the level of market/speculative risk in the project. The greater the experience (as evidenced by the developer's track record of successful property development in projects of similar size and nature to the subject project), the less the management risk. The higher the market/speculative risk (as evidenced by factors such as the development of property/space with pre-committed sales or leases), the greater the reliance on management to mitigate the market risks inherent in such a development. The less the market risks (as evidenced by acceptable levels of pre-commitment), the more the developer has demonstrated his or her management expertise and reduced market risk.

This analysis demonstrates the impact management skills and experience might have on changes in cash flow. Assessment of management takes into consideration the following:

- Experience of management (noting any recent management changes)
- Depth of management (considering succession planning and key person insurance)
- Breadth of management in key functional areas
- Integrity of management
- Use of appropriate and independent advisers on an ongoing basis
- Management's track record in achieving successful results and the management information systems used to track them.

Specifically, the credit assessor will want to evaluate and quantify management's historic performance in the following areas:



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- Coping with economic/property market downturns
- Maximising the level of pre-commitment (whether leases or sales) prior to the development commencing
- Maximising the level of income from a partly or wholly developed property on a speculative basis
- Achieving the balance between pre-committed and speculative revenues to maximise development profit consistently
- Managing interest rate risk and changes in interest rates
- Delivering projects on time and within budget. Success in these management areas requires that managers:
- Understand how economic conditions affect the performance of the market/property, anticipate the effects of those conditions and have plans for coping with them
- Understand how competitors are likely to affect the business's/development's performance
- Anticipate and manage the effects of actions by competitors.

The credit assessor will provide comment on the following, as applicable:

- Family tree, noting consolidated/inter-company relationships including ownership of assets and flow of income
- Nature and composition of board and senior management.



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Customer rating system and risk profile

The bank's Customer Rating System and Risk Profile identify and quantify an objective view of the customer's financial position by analysis of their current and projected financial statements. The risk score and resultant profile is intended to focus financial analysis on the riskier elements of the borrower's financial statements in a predetermined range of, say, 1–15. Financial risk is concerned with the viability and stability of the customer's repayment sources. By performing a financial statement analysis, the assessor will quantify the company's ability to repay its debt. A trend analysis of the customer's financial position is undertaken where possible, with brief comments on the results documented. Further in-depth analysis may also be required if the financial risk score exceeds the bank's current minimum threshold. The **liquidity/cash flow risk component** measures the ease with which a customer can meet their short-term cash needs via the cash flows generated by the property. In property development lending, the focus of the analysis should be on the borrower's ability to fund cost overruns occurring during the development/construction phase and the borrower's ability to service interest on the facility post construction.

The **capital structure risk component** measures the relationship between borrowed funds (debt) and company funds (equity). Analysis is based on the cost of the development, not the anticipated end value. It also indicates the extent of financial risk carried by the owners and creditors respectively.

The **market risk component** measures the amount of market risk in a transaction and is a function of the level and quality of pre-commitments (either lease or sale or both) of end users of the property.

Commercial property development lending – specific guidelines

Assessors will also consider the following:

- The borrower's experience/track record in property development in terms of the size and complexity of the development, the proposed market sector and the borrower's success in previous developments
- The level of pre-commitments (leases or sales) relative to debt servicing requirement or debt level
- The quality of cash flow, split between pre-committed and speculative sales and rentals (if appropriate)
- Tenant quality (if appropriate)
- The lease maturity profile (if appropriate).

Property/project risk and competitive position

While the analysis, to this point, has focused on the developer's future projections, it is important for the assessor to compare the project's likely success against peer/comparable (by location and type of property) or competing developments. This will enable a better determination of whether the proposed development is potentially successful or unsuccessful.

To complete this analysis, the assessor uses a group of properties/developments of a similar size and type in a similar location to the subject development to compare their respective merits. In particular, they consider how the characteristics/variables of the subject development (sales prices, location, tenants, cost, property features, etc.) compare with other examples in the market. This analysis is particularly important where a substantial level of market/property risk is inherent in the development (where pre-commitments are not a significant feature of the development).



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It is also important to compare pre-commitment variables (sales value per sq. m., rent per sq. m., lease terms, lease incentives, tenant quality, etc.) with those being achieved elsewhere in the market by comparable product.

In using any information for comparative purposes, the bank's assessor will be sensitive to several considerations, including:

The size of the comparative group. If only two comparable properties/developments are included, the resulting average may not be representative of the property type.

The date of the peer group data. If the data is several years old, then a comparison using current data for the subject property may be of little value.

The geographical mixture of the peer group. Comparing the property with others in a geographical region may be more relevant than comparing a cross-section of properties across a state or country.

The quality of the data. How reliable is the data being used and are ratios calculated in the same manner as for the subject property?

The assessor will make comments under each of the following headings, specifically considering market conditions and the property/project's competitive position (with reference to peer comparison, as appropriate):

Property/project risk assessment. The fit of the property/ project (that is, the type, quality and price of the project on offer) for that particular location and in comparison with competing properties/developments. Is it the right development, in the right location, at the right price, at the right time?

Professional team. The assessor will detail and assess the make-up and capabilities of the professional team supporting the project, so demonstrate where possible that they have the expertise and track record appropriate for a project of this type and scale.

Developer's experience. Demonstrate to them that you as the developer have the track record/expertise appropriate for a project of this type and scale.

Location/site. How does the property's location compare with competing properties? Are there others in the area competing for the same purchasers and tenants? Is the development appropriate for that location?

Enforceable pre-commitments – pre-sales and pre-leases (if appropriate). The assessor will look at the quantity, quality and spread of pre-sales and pre-leases (if appropriate) *relative to the debt proposed*. Are contracts unconditional, arm's length and enforceable? Are there sunset clauses (for completion) in the contracts? How do prices compare with the market?

For single purchasers, assessors will comment on financial strength and ability to complete the transaction. For multiple purchasers, they will assess the quantity and quality of pre-sales with comments on:



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- Level and type of deposits/security bonds
- Diversity of purchasers
- Related party purchasers
- Sales to non-residents
- Sunset dates for completion
- Allowance of sales commissions, taxes, legal costs in contracts.

Demand analysis (uncommitted portion of project).

The assessor will analyse existing and future market demand for the portion of the property not subject to pre-sale commitments (keeping the depth of analysis relative to the level of commitments already achieved).

Marketing strategy. They will comment on the marketing strategy the developer is adopting in relation to the uncommitted portion of the project.

Quality of construction/fit-out. How does the property/ project compare with competing properties in terms of quality of construction and fit-out? This is particularly important if the development is proceeding on a speculative basis (that is, a low level of pre-committed tenants/purchasers).

Construction and assessment of builder. How complex or simple is the construction? Who is the builder?

What is their technical and financial capacity to meet their commitments under the building contract? Is a performance guarantee being obtained or required?

Building contract. The assessor will require an outline of the key features of the contract. Is it fixed term/fixed price? Does it conform to acceptable industry standards? What are the security retention provisions, and do they meet the bank's policy requirements?

Property market and other risks It is appropriate to consider the broader market risks that could specifically impact on the project/development. These risks may impact on the borrower's ability to repay the development facilities as expected.

The assessor will make comments under each of the

following headings. Note that the depth of such analysis will be relative to the level and quality of pre-commitments already achieved at the time of the borrower's finance application.

Market maturity. What is the stage of maturity of the market (emerging, maturing or declining)? Typically, emerging or declining markets have the highest risk.

Focus on the future and consider the likely market maturity when your development is scheduled to reach practical completion.



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Market cyclical. What is the impact of economic business cycles on the market? Generally, markets that are highly cyclical (or counter-cyclical) have higher risk. Consider the likely property market cycle when your development is due to reach practical completion.

Demand and supply analysis. Where a high degree of market risk exists in the property/development (i.e. there is a lower level of pre-commitments), provide evidence of the level of demand for the type of property in the relevant location and the level of competing supply.

Property market outlook. The assessor will comment on the outlook for the commercial property market. Focus on the same type and location as your subject property. Where possible, refer to independent market analysis/ research.

Quality of securities The following are some of the general issues that the assessor will consider:

- Is a Registered Mortgage Debenture/Floating Charge/Mortgage Debenture/Lien over the assets of the business borrower held or required? If so, is the value of these pledged assets quoted in the financial statements realistic and are they saleable?
- Are directors' guarantees held/appropriate? (Is there a statement of position of guarantors and their worth as guarantors? What is the realisable value of securities if sold?)
- Does the bank have effective control of the securities and are they readily saleable?
- Do the securities require monitoring (for obsolescence, market variations, nearby detrimental activities, environmental concerns, etc.), and if so, are appropriate covenants or conditions in place and known to you?
- Are there any preferential claims, subordination retention of title or other conditions attached to any security (e.g. voting rights of other lenders/creditors, structural subordination)?

Securities for commercial property development lending – specific guidelines

The assessor will:

- Explain any proposed deviation from policy
- Comment on loan to cost ratio and explain any deviation from policy
- Ask whether the property is freehold or leasehold.

If leasehold, terms of head lease/sublease(s) (e.g.start/end dates), current passing rent and rent review provisions (rent review dates and basis of reviews) should be detailed

- Advise as to whether a professional valuation has been obtained in accordance with Global Credit Policy, detailing:
 - Date of valuation
 - Whether valuation is from an approved valuer
 - Who instructed the valuer
 - Whether the valuation methodology is acceptable
- Confirm that the Relationship Manager has inspected the property securities (mandatory)



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- Comment on ease of realisation, considering property location, alternative uses (if specialised property) and development status
- Comment on whether any planning issues or conditions, environmental issues or orders or other matters need to be addressed
- Detail insurance cover for the property
- Detail the contractor's all-risk insurance policy, including the limit of indemnity and expiry dates. Also detail claims history and current outstanding claims
- Comment on the borrower's capacity to fund cost overruns as and when they occur. If you do not have adequate capacity, guarantees/undertakings from the project sponsors or some other party of substance should be taken
- Confirm that the building contract is of a fixed time/ fixed price nature
- Assess whether a tripartite (step-in) deed between the bank, the builder and the borrower (in respect of the building contract) is necessary.

Minimum security requirements

These include:

- Registered first-ranking charge over freehold/leasehold interest in the property
- Floating or registered mortgage debenture over the assets and undertakings of the borrower
- Personal guarantees of directors
- Appropriate cross-guarantees of associated entities
- Tripartite deeds relating to building contracts, sales contracts, agreements to lease (as appropriate)
- Charge over pre-sale contracts (including deposits) where appropriate.

The assessor is likely to make comments where these minimum requirements are not met.

Conditions precedent

Standard conditions precedent for property development lending are applied irrespective of loan details. The bank's into each new loan. Where individual conditions are Standard conditions precedent for commercial property development loans include:

- Builder and building contract must be acceptable to the bank – building contract to be executed
- Appropriate levels of pre-sales (normally between 80% and 120% of proposed debt) or pre-committed leases, depending on local conditions and project and market risk assessment
- The site is to be clear of contamination or other environmental problems. You will be expected to complete a satisfactory environmental questionnaire, with site investigation reports if deemed necessary
- The construction period should not exceed eighteen months
- An independent QS is to be retained for all building projects where construction costs exceed \$1 million. A consulting engineer is required for all landsubdivision projects where cost exceeds \$1 million
- All progress payments/drawdowns under the facility should be made on a cost to complete basis
- Pre-commitment documentation (agreement for lease/lease or pre-sales contracts) is to be reviewed and be acceptable to the bank and its advisers



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- Where pre-commitments feature, certification requires that the plans and specifications of the building contract accord with the plans and specifications of the pre-commitment documentation
- Professional valuation is to advise the value of the property 'as is', the value upon completion, feasibility of the project and demand/supply analysis.

Minimum valuation amounts should be loan conditions

- A tripartite deed is required for larger or more complex projects
- Capitalisation of interest is permitted, but not after practical completion

The borrower must demonstrate a capacity to fund cost overruns

- All acceptable insurances must be in place in relation to the development
- Confirmation that the contractor has sufficient levels of insurance in place (including public liability) is required
- One hundred per cent of net sales proceeds must be applied to the repayment of bank debt and reduction of limit
- Adverse material event covenants are to apply
- Construction is to commence within ninety days of issuance of letter of offer
- Shareholder or director contributions, where required, are to be made by way of share capital and/ or shareholder's/director's loans, repayment of which is to be formally postponed or subordinated to repayment of bank facilities
- A satisfactory search of relevant corporate registry records, in particular jurisdiction, is required.

Standard conditions precedent to the initial and each subsequent drawdown include:

- Certification from the independent quantity surveyor of:
- Total expenditure to date on the project
- Expenditure on the project since the date of the most recent drawdown
- The cost to complete the project
- The anticipated date of practical completion for the project
- Funds requested for drawdown shall not exceed expenditure on the scheme since the date of the most recent drawdown
- Cost to complete to be less than or equal to the funds available within the facility less the amount of the drawdown request before the bank. In the event that the cost to complete exceeds funds available within the facility, a cost overrun will be deemed to have occurred and no further debt funding will be permitted until the full amount of the cost overrun has been funded by additional equity
- Anticipated date of practical completion to be no later than the expiry date of the facility.
- Certification to be provided by the architect and relevant project consultants that actual construction is proceeding in accordance with the plans and specifications of the building contract
- Certification from the builder to be obtained confirming that all amounts due and payable to subcontractors, consultants, supplier and employees have been paid.

Covenants/ratios disciplines/conditions



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A loan agreement is a contract between the bank and a customer that specifies the rights and obligations of each with regard to a certain loan or credit arrangement. It sets forth the conditions under which the loan is granted and establishes the parameters within which the borrower must operate.

A covenant is a clause in an agreement that specifies actions required (affirmative covenants) or prohibited (negative covenants). Covenants should be clearly defined and reasonable.

Covenants can do several things, including:

- Establishing a maximum ('...shall not exceed...')
- Forcing a minimum ('...shall not be less than...')
- Maintaining ('...shall not change...').

The overall purpose of establishing covenants, default provisions and remedy provisions is to give the bank the opportunity to act if the risk in a loan changes. A good covenant will be tight but will not interfere with a borrower's operations. Ratios should be sufficiently close to the actual or forecast position to ensure the covenant is breached in the event of a material deterioration in the financial position the covenant is designed to measure.

Covenants can be financial or non-financial in nature. Financial covenants usually address issues such as cash flow, profitability, efficiency, liquidity, solvency, capital structure and asset quality. Non-financial covenants will often assure full disclosure, management continuity and quality and the borrower's continued existence, and establish reporting requirements.

The credit assessor provides comment on the following, applicable:

- The major covenants and ratio disciplines that will be relied upon and their adequacy or otherwise to mitigate key risks
- The historic performance of the borrower with regard to previously existing covenants, including comments on any non-compliance and corrective actions taken during the period.
- Non-financial covenants include: the usual financial reporting covenants are not in place/proposed
- An outline of the major covenants and ratio disciplines that will be relied upon and their adequacy or otherwise.

If a new covenant is added, the assessor will make comments as to what risk is to be negated by this covenant.

Covenants for commercial property development lending – specific guidelines

Conditions/covenants that should apply in all commercial property development loans include:

- Minimum level and type of enforceable pre-commitments (pre-sales or pre-leases) required
- Basis for equity contribution and payment of progress claims, specifying the required equity contributions and the timing of them (must be contributed in full prior to any bank funding being provided). All progress claims are to be paid on a cost to complete basis. Responsibility for cost overruns should be clearly stated. Funding will be permitted only where the cost to complete the development is less than or equal to the funds undrawn/available under the facility (less the amount of the progress payment/drawdown request before the bank)
- Requirement for quantity surveyor/consulting engineer certification of progress claims. Appropriate certification from independent advisers must be received and be acceptable to the bank prior to payment of each progress claim



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- The anticipated date of practical completion *must* be before the maturity date of the development loan facility.



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Exit analysis

Comments will include a meaningful and realistic assessment of the sources of repayment or 'exits' available to the bank. The assessor will define such exit(s) showing how the bank can be repaid without loss under normal circumstances.

Primary exit. The primary source of repayment of a commercial property development loan will be the sale of the property/project at practical completion.

Sale of the property:

- The assessor will comment on the capacity to sell the property at completion
- In the normal course, the sale of the property should be pre-committed by a pre-sale agreement/ contract (or a series of them for residential development) entered into before the development commences. This would be a condition precedent to funding
- For commercial property (office, retail and industrial), if a pre-sale does not exist, the likelihood of a sale occurring before or at completion should be assessed as a function of the level of lease pre-commitments in place and the investment market for the type of property being developed
- Where an element of market risk is involved (that is, where the level of pre-sales is less than the loan amount), assessors will comment in detail on the risk involved in securing additional sales during the development phase to enable repayment at loan maturity
- A break-even analysis should be conducted for the property/project
- The assessor will ask what percentage of the proposed debt facility is covered by pre-committed sales. What percentage of the unsold/uncommitted portion of the development needs to be sold (and at what price) to ensure repayment of bank debt? The assessor will sensitise this analysis, considering the impact of less than 100% of pre-sales being settled. The completion percentage used for this sensitivity analysis will depend on an assessment of the settlement risk inherent in the project.

Secondary exit. A secondary exit is one that is not related to cash generated by the customer in the normal course of business.

The assessor will assess secondary exits provided by:

- Rental income, commenting on the ability to let the property and service/amortise the debt if the anticipated sales are not achieved
- Other assets/income of the borrower
- Other assets/income of guarantors or sponsors.

Property development finance can be challenging for the novice. I would recommend using a broker who has had the relevant experience in procuring property development funding for the type of development you're contemplating. Nevertheless, as a property developer you need to understand the fundamentals of property funding as this will determine the establishment of your project, project structure, in the first instance.