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Spicing up finance

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Key points

- Capital markets have opened up and some new alternatives and tentative returns are appearing
- The Big Four banks retain a hold on the development sector, with few funding options for borrowers
- Focus is on equity and preferred equity; banks are avoiding mezzanine finance
- Volumes and quality of credit are down in construction loan to total development costs and investment loan to value ratios, but are structurally similar to pre-GFC levels

When the global financial crisis effectively shut down capital markets, some alternative sources of funding were extinguished and others went into hiatus, causing a sharp contraction in the supply of real estate finance.

Lending from tier-two banks dried up, the $20 billion-plus mortgage trust industry was destroyed virtually overnight by the Government Guarantee and commercial mortgage-backed securities (CMBS) disappeared for a time.

Gone, also, were the financial engineers of pre-GFC times – the Babcock & Brown-types, which used special investment vehicles to tap into securitisation capital.

But a greater focus on equity, a more innovative approach to funding and moves from the superannuation funds show there are now opportunities to capitalise on the gaps. These more innovative funding arrangements include joint ventures and co-investment, such as the Abacus Property Group/Heitman $600 million joint venture and the Future Fund's recent partnership with Peet Limited.

"There's not many vanilla deals at the moment," says Nick Crockett, head of corporate finance Asia Pacific for Jones Lang LaSalle. "Because either investors want to minimise their downside risk … [or] they want far more decision-making control over what's happening in a project. So that's why we're seeing more joint ventures and … why we're looking at more co-investment deals."

Michael Hynes, director of Stamford Capital, flags the return of diversified fund managers to the market, Challenger, for example, has an allocation of super funds. Domenic Lo Surdo, also a director at Stamford, suggests the mortgage trust industry will come back in some form, more along the lines of single account type mandates with super funds that have already begun to happen, adding depth to a constrained borrowers' market.

Crockett similarly signals the participation of non-bank lenders to meet anticipated demand, particularly for commercial secondary grade assets.

"There's a market there where you can make fairly good margins," he says.

Meanwhile banks remain conservative, according to Alton Abrahams, principal at Ashe Morgan Winthrop (AMW), who says this is prompting new entrants.

"We are starting to see signs of lenders that were in the market previously coming back into the market and doing different things," he says. "So at the moment, for example, we're doing some 80 percent senior debt deals, but these are on larger assets with good cash flows. And these are from non-bank lenders, institutional players."

As for the rise in interest from the super funds, Challenger's Gerard Hargraves – director, real estate funds management – says there are worthwhile reasons to be a lender to real estate.

"There's a very compelling argument to be a high yield investor in debt, as opposed to being an equity investor in the property for a similar yield and all the uncertainty on the capital growth return or component of the return."

No stranger to the property market, super funds have previously invested in the space through CMBS. It is now a matter of disintermediation, says Hargraves – super funds are essentially investing directly into the loan by being a

lender, as opposed to a CMBS investor.

"And so, in this market, where capital rules, capital gets to call the shots in terms of how it's going to invest."

While CMBS took a break, there have been some small issuances this year.

"[CMBS is] a wholesale product, it has a good understanding in the marketplace as to what it is and what it looks like," Hargraves says. "So I think it's a matter of just comfort in terms of property valuations, the CMBS structure and pricing. It's probably those three things that will determine the pace of growth in the CMBS markets."

As for how super funds will fare against banks, Hargraves says they are not looking to compete directly with them.

"The banks have a very efficient cost of capital, which we're not looking to compete with… we're looking to be, essentially, the next rung down. We're still looking for quality, we're still looking for good risk-adjusted returns."

The key point, as Trent Alston, head of real estate at Challenger, emphasises, is that super funds can offer different terms.

"When it comes to the all-in cost of funding, the banks have a better cost of funding for shorter-term lending, whereas super funds and life companies like Challenger more naturally have a very competitive cost of funding for long-term debt."

As for what borrowers want, Hynes says they are worried about concentration risk with a particular lender. "So I suppose borrowers are seeing value in having a spread on their lender base, just to manage that risk." Alston agrees that, apart from debt duration considerations, borrowers are keen to ensure they have a diversity of relationships in the lending market.

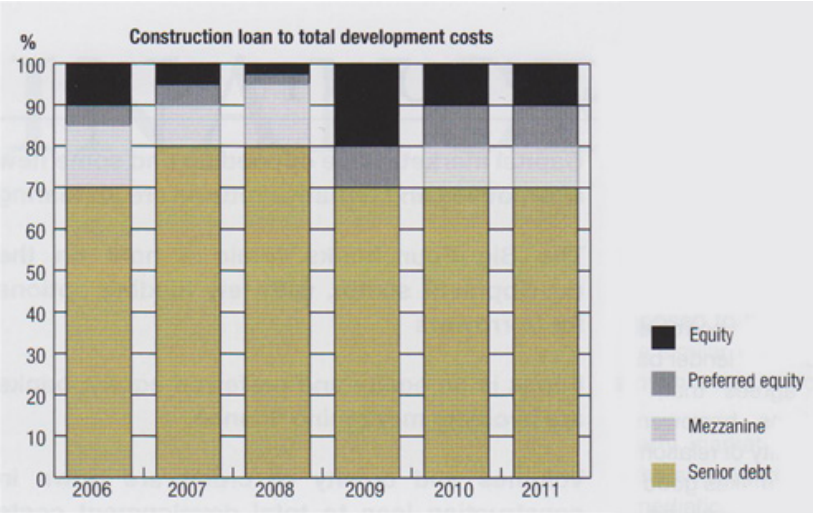
"That just makes good business sense, because all funders can variously be affected by different market conditions and the availability and cost of their debt varies."

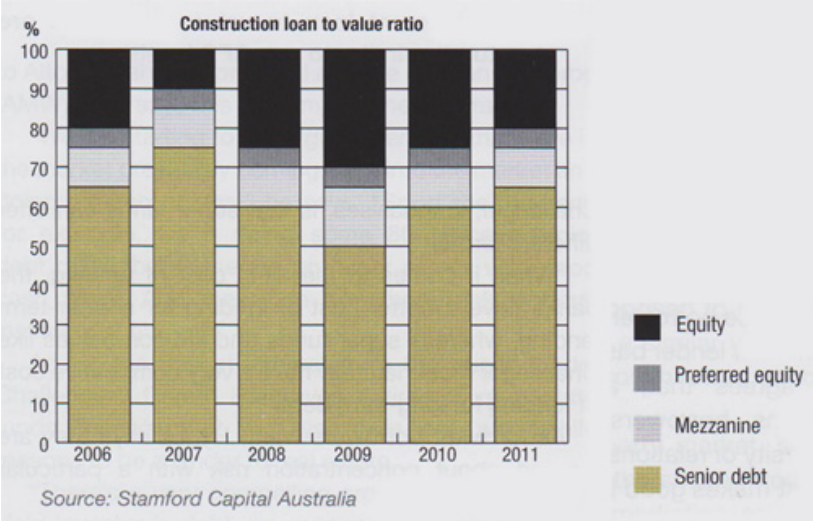
The lending market remains constrained, with pre-sale and pre-lease expectations shaping the success of funding.

"Key stakeholders in a development (bank and tenant) certainly have a preference for the big players (both developers and builders) to reduce risk," says Nick Rathgeber, director, institutional services at Colliers International.

"Medium-sized groups and developers can certainly still participate in the market, however, it is more difficult and expensive for these groups."

Meanwhile, an analysis of construction loan to total development costs and investment loan to value ratios (see charts below), tells an interesting story. While volumes are, of course, down, structurally the ratios are similar to those pre-GFC. In 2006, construction saw senior debt totalling 70 percent, mezzanine 15 percent, preferred equity 5 percent, and equity took up 10 percent. The 2011 figures show 70 percent senior debt, and mezzanine, preferred equity and equity each sitting at 10 percent.





However, far from being back to GFC levels, the key difference between pre- and post-GFC, Hynes points out, is the quality of credit.

"In construction, the required level of pre-sale or pre-lease cover is significantly greater than pre-GFC," explains Hynes. "This is being required by both senior and mezz/pref providers.

"Also, given yields have increased, particularly for secondary assets, there is greater interest cover available from investment assets."

Besides deal fundamentals, lenders are also focused on the quality of sponsors, Hynes adds.

He argues that mezzanine and preferred equity post-GFC could really be grouped into one bucket.

"Mezzanine often now looks more like preferred equity, with senior lenders fully subordinating such capital (that is, no acceleration or enforcement rights)."

Perhaps one of the most profound shifts, then, has been the growing emphasis on equity and preferred equity over mezzanine finance.

Abrahams says AMW is undertaking equity and debt deals for clients, but it's also sourcing large amounts of preferred equity for clients with complex transactions from various institutions and investment banks. It is about to close on two deals worth about $80 million in total.

"The take-away for us is that the market's shifted, and the market's shifted in that there isn't large and varied sources of senior debt out there – it's pretty commoditised," he says.

"We think that mezzanine debt per se is a dangerous place to be in general, but there are transactions that are appropriate. We much prefer either preferred equity or equity … And we're doing some interesting large preferred equity pieces into some interesting assets, mainly developments."

Crockett agrees we're seeing more preferred equity, which is a way of getting around the banks – there is no second mortgage, and you get your capital and preferred return before the sponsor/borrower does. This is, effectively, sitting in a mezzanine position without the same security.

The shift back to equity is in project and investment financing, driven primarily off the back of banks' conservatism in their lending ratios, say Hynes and Lo Surdo.

"And the fact that, particularly in the institutional market, most of the large listed REITs have recapitalised and so have the benefit of a big chunk of equity now sitting on their balance sheets, which they're happy to drive into projects and to investments," adds Lo Surdo. "And I think you'll see ... relatively low gearing levels on balance sheets."

While lending in development remains a conservative proposition, mezzanine finance is a difficult option to get past the Big Four.

Abrahams says banks are not comfortable with mezzanine debt in transactions, for a number of reasons – it says the borrower lacks the necessary capital and adds another layer of complexity should any issues arise.
When they do consider, he adds, they ask for a fully subordinated position, allowing the bank to do whatever it likes "without too much reference to the second mortgage or the mezzanine debt lender".

"So in our view ... as a lender, mezzanine debt is not a good place to be."

Lo Surdo agrees, saying banks have certainly become more stringent on inter-creditor terms and conditions, and some are reluctant to have mezzanine finance in their capital structure.

"But … if you do have a strong sponsor that is using mezzanine in an appropriate manner, the banks will support it."

Hynes says mezzanine has always been risky, however, and should be a capital replacement tool for a developer. Stamford has done two private mezzanine placements on residential apartments projects, which were substantially

built and had pre-sales. But you pay a premium for it, Hynes says.

Hargraves agrees it is becoming a difficult landscape for mezzanine finance.

“The issue is that we’ve now gone into an environment where capital structures are now reverting to being vanilla – a lot of equity in the first loss position and moderately geared passive debt in the senior secured position.

“And so, it’s been a 180-degree flip from the pre-GFC … overly structured, overly complicated, numerous financial parties with numerous inter-creditor relationships, that’s all gone out the window, and now it’s a lot of equity and pretty vanilla debt being sent into fund assets.”

He believes there tends to be opportunity in the smaller sector, with some privates doing smaller ticket, private mezzanine deals.

Alston says it also comes down to the inter-creditor arrangements.

“If it’s brand new mezzanine on a brand new senior loan, then you can be relatively certain that there’ll be quite poor inter-creditor arrangements to protect the mezzanine provider.”