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How to negotiate a smooth transfer between development lenders and investment lenders

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Abstract
The paper focuses on the benefits to a borrower from differentiating between the commercial perceptions of different specialist property lenders. This is expanded into an overview of how CLP has systemised this 'arbitrage' potential into a product called 'Hand in Glove'. The paper rounds off with a demonstration of how this much-neglected facet of the market can harbour competitive advantages for the companies utilising it.

OVERVIEW

The structure of Hand in Glove is best illustrated with an example of a quality pre-let development taking, say, two years to build. Why, it would be reasonable to ask, would a development lender prefer a take-out facility from another lender when, on completion, they will have an income-producing investment? There are a number of reasons.

The property lending sector in the UK comprises well over 100 lenders although only a much smaller proportion of these would be considered to be very active. Virtually all lenders who are active in property will lend on investment property, ie property which is already built with a tenant or tenants committed to a lease for a number of years and paying rent.

A much smaller number of lenders also provides development funding and herein lies the opportunity to improve the financing structure for borrowers while giving both the development and the investment lender what they want.

All lenders are in a competitive environment, particularly investment lenders in the so-called vanilla sector of the market. That is, those properties that are let to quality tenants (ie those with strong credit ratings and balance sheets) on long leases and preferably in good locations. Leaving aside the qualitative, but very important aspects of flexibility and deliverability, there are really only three variables that a lender can compete on in these sorts of transactions:

- Maximise the loan
- Cheapest pricing
- Softest repayment (meaning the lender will be taking a measured

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risk assessment of the vacant possession value of the building at the end of the lease).

This competition between investment lenders means the terms, both in amount and interest margin, that they are prepared to offer to borrowers are increasingly keen. The development lender for this hypothetical pre-let, on the other hand, has to take all sorts of other factors into consideration:

- How good is the contractor and the contract documentation?
- How experienced is the borrower in this type of development?
- How do the commercial aspects of the transaction impact on the lending — for example, are the long-stop dates appropriate for what is involved? Long-stop dates are deadlines after the expiry of which parties may no longer be contractually bound if certain events have not occurred.
- Are there any planning or s. 106 issues (in essence, planning gain to the local authority) the lender may have to take a view on?
- Are there issues such as contamination, refurbishment, archaeological etc that could extend the cost or time estimates significantly? If so, is the lender able to get recourse from the borrower on these aspects and how meaningful is this recourse in the context of the borrower?

In short, there is a lot more that can go wrong during a development than with an investment and this is one of the reasons why there are fewer lenders with the appropriately experienced personnel to handle this well.

Lenders in pursuit of their own returns are constantly having to balance and re-evaluate risk assessment against market pressures to remain competitive both in amount lent and pricing.

The different players

Typically on a pre-let transaction the 'average' development loan may be only 70–75 per cent of total costs. However, this figure is an average among lenders and as has been indicated there is always a small but significant layer of lenders that can substantially exceed these parameters.

The lending community is made up of all types of lenders who are differently capitalised and have different corporate structures. Some lenders will have no retail deposits or mass-market presence to speak of and have to use their particular specialities to make their required returns. They do this, in the case of development property, by being able to lend more than the average, because they have expert personnel, specialising solely in property, who can better assess risk on individual projects. This also necessitates those personnel having very good contacts with the appropriate chartered surveying firms for professional valuations as well as solicitors and project monitors (who ensure that development on the ground is proceeding correctly).

However, for two reasons even these lenders will try to minimise their exposure both in time and loan amount. The time factor reason is that if a merchant bank, for example (which does not have the benefit of millions of cheap retail deposits), lends for a long period, the return on capital employed is very thin as that capital is probably costing more in the first place. This competitive position can be eroded still further by the fact that some foreign banks lending direct from their 'domestic balance sheets' operate under different (more favourable) capital weighting requirements from their regulatory authorities, enabling them to undercut the competition.

There is, therefore, a premium placed on the specialist development lenders to earn fees from loan originations knowing that they will be refinanced at a much more competitive margin at the end of the development period. In this way they are earning appropriate returns on capital but the downside for them is that their bankers have to keep paddling very hard to maintain the size of the loan book, as loans are constantly maturing and being repaid.

Restricting the loan amount is simply a function of asset price volatility. A lender is more protected against a drop in values if he has lent less on a property. Even the specialist development lender will, therefore, be pitched somewhere above the average but probably less than 100 per cent of costs (although not always).

SHORTFALL AND SOLUTION

According to this analysis the circumstances described above usually lead to a shortfall between what the development lender is prepared to advance vis-à-vis the investment lender's advance. This is to be expected as it is only at practical completion, when the lease is finalised and the tenant irrevocably committed, that the profit in the transaction can truly be counted as being firmly embedded in the value.

With the investment lender providing a very firm take-out loan for the development lender, a significant element of market risk and credit risk on the tenant is mitigated. The development lender can now focus primarily on the development risks associated with the transaction and can normally increase the loan.

It is very important that the two lenders are comfortable with each other and that includes the key personnel who will have to liaise closely and ensure that any little glitches (as there usually are on property transactions) can be quickly and effectively resolved. Indeed for medium ticket deals (£5–£50m) CLP has set up an arrangement with an investment lender and development lender where they use both the same solicitors and valuers and effectively create a one-stop shop. The purpose of creating a 'product' out of this is to ensure that the process becomes systematic and the transition from development to investment loan is virtually seamless.

Key criteria for a smooth transition

The main aspect from the development lender's point of view is to ensure that, once it has completed the construction of the building to the proper specification and the tenant is satisfied and has taken up the lease, it can exit the loan. *It is the certainty of this exit that alters the development lender's risk-mix and therefore facilitates an increase in the development loan*. To this end the development lender, at the end of the project, needs to ensure primarily:

(1) That the tenant still passes any creditworthiness tests imposed by the investment lender.
(2) That the income-cover covenants (promises to maintain a certain amount of interest cover on the debt) imposed by the investment lender are not breached (see hedging below).
(3) That the loan to value covenants are not breached at exit.

As to point one, this is normally a risk that the development lender is content to take. If discussing a substantial pre-let with a capital value of somewhere around £50m then the likelihood is that it is a fairly significant tenant covenant (probably in the top 250 UK quoted companies) and the two-year view that the development lender may have to take is not particularly onerous. It is entirely possible for the development and investment lenders to agree parameters between themselves such as net worth, profitability, credit rating etc, and if the tenant continues to exceed those benchmarks at the end of the development then the investment lender is obliged to lend.

The second point is one where most frustration arises and many borrowers have come unstuck at a critical stage in securing the deal by being unable to satisfy the criteria of all parties. Normally borrowers are advised to focus on the core activity; if the property deal itself is making a good profit it is not sensible to jeopardise this by leaving interest rates unhedged. Hedging should be looked on as insurance and no one feels at the end of the year that if only their houses had burned down they would at least be getting value for money for their premiums!

The attraction of Hand in Glove is that the two lenders agree to put in place the hedge at the outset and it simply gets passed from one to the other at the appropriate point. Again the compatibility of the lenders is paramount here. When a lender enters into a hedging instrument such as a swap, on behalf of a borrower, there is a counterparty risk somewhere in the chain. What may be an acceptable counterparty to one bank may not be to another, so when two lenders are involved this needs to be agreed between them before costs are incurred.

This seamless transfer of the hedge is an added bonus of the structure as it removes the requirement for swaptions, caps and similar instruments, which can entail quite substantial up-front costs.

The third point of loan to value covenants is a key aspect. Given where yields currently are on good quality pre-lets (6–7 per cent) it is generally possible for the investment lender to create some slack in the loan to value covenants because the determining factor on the loan is more likely to be income cover. If the investment lender is lending 85 per cent of completed value based on the income it is not too difficult to put in a covenant at say 90 per cent or even higher provided the income cover remains the same (which it will because of the hedge).

THE IMPORTANCE FOR THE BORROWER

Why should the borrower want to adopt this approach? It mainly allows the borrower to undertake a much larger deal than would have been possible under conventional funding. Alternatively, by restricting equity input, a greater number of deals can be undertaken at the same time — and, of course, time really is money. It is one of the most neglected aspects of assessing property deals by borrowers.

There follow two simplified development appraisals of a hypothetical project. The project is assumed to have a life of two years.

Scenario A is a conventionally funded development with the borrower putting in 25 per cent of total costs amounting to about £4.54m (with interest being rolled-up by the lender — although sometimes conventional lenders insist on the interest being met by the borrower too)!

Scenario B, on the other hand, is a Hand in Glove structure where the equity is limited to only 5 per cent or £908,000 (see Table 1).

The striking figure here is the return on equity employed. This figure is what the borrower is earning for its shareholders (tax ignored). Bearing in mind this is a two-year project it means the Hand in Glove Scenario B produces an annualised return of 144 per cent as against Scenario A's 44 per cent.

This is, of course, simplified in that no tax is taken into account and assumes that Company B cannot only find the increased number of acceptable proposals that this financing puts within their orbit, but also that they are resourced to manage them effectively.

That aside, to put the effect of these different rates of return in their truly staggering context; Company B would be worth *ten times* as much as Company A in less than five years, and that's why it is important.

No free lunches?

It may be wondered that if the returns are so much enhanced by such a structure why is it not done by everybody. The main reason is lack of awareness of the product. The other might be a perception of taking on an increased risk.

Table 1: Scenarios A and B

Scenario A: Development Appraisal

	Sq.ft.	Rent/ft.	Rent	Yield	(£000's)	
Completed value	80,000	22.50	1,800,000	7.00%	25,714	
Less purchaser's costs @				5.75%	1,398	
Net Development value						24,316
Site					5,500	
Acquisition Costs @			5.75%		316	
					5,816	
Int. on 75% of site @				8.00%		
over 24 months					749	
Build						
Construction	89,000 sq.ft. @		£120.00		10,680	
Professional fees @			10.00%		1,068	
Contingency @			5.00%		587	
Sub total					12,335	
Int. on 75% development @				8.00%		
over 18 months					584	
					12,919	
Total costs						19,484
Profit						4,832
Equity employed						4,538
Annualised return on equity employed					44%	
Income cover on development debt			12.0%			

Scenario B: Development Appraisal

	Sq.ft.	Rent/ft.	Rent	Yield	(£000's)	
Completed value	80,000	22.50	1,800,000	7.00%	25,714	
Less purchaser's costs @				5.75%	1,398	
Net development value						24,316
Site					5,500	
Acquisition Costs @			5.75%		316	
					5,816	
Int. on 95% of site @				8.00%		
over 24 months					948	
Build						
Construction	89,000 sq.ft. @		£120.00		10,680	
Professional fees @			10.00%		1,068	
Contingency @			5.00%		587	
Sub total					12,335	
Int. on 95% development @				8.00%		
over 18 months					739	
					13,075	
Total costs						19,839
Profit						4,477
Equity employed						908
Annualised return on equity employed				144%		
Income cover on development debt			9.5%			

Note: Interest is only calculated on the bank debt not on the equity introduced.

The main aspects of risk on this two-year development example are:

(1) the tenant fails during the development period;
(2) the tenant fails following the development period;
(3) there is a significant cost over-run;
(4) interest rates move up sharply during the development phase.

Looking at each in turn it can be seen that the risk impact for the borrower is not really increased by this structure. The risk is being greatly shared by the lenders.

The tenant fails during the development period

In this case the partly completed building may experience a downward shift in value. The borrower would, de facto, have the option here to put in more equity which may keep the development lender on board or, alternatively, to sit down with the development lender to best assess the way forward to maximise the gain or minimise the loss in the newly arrived circumstances. The important point for the borrower to note is that much less equity was committed at the outset and the option to increase it rests with *him*,

which would not be the case if it had been injected at the outset. Furthermore the non-recourse nature of the loan encourages the lender to look to the project to minimise loss, and usually the borrower is the best person to maximise the returns from it.

The tenant fails following the development period

The same situation applies here except it is a question of whether the borrower brings any investment skills to the arena. The lender may have experienced a sharp drop in value at the loss of the tenant and will look again to minimise loss, which may be by sale of the property. The important thing to note from the borrower's point of view is that the eventuality of the tenant failing is completely independent of the borrower's financing structure so again it can be argued that this reduces the risk for the borrower.

There is a significant cost over-run

This is perhaps the one area that a borrower needs to focus on clearly. Most development lenders will still require a cost over-run guarantee as they are already at the limits of their lending parameters and cannot afford to increase them because of increased costs. It should be noted, however, that this is not a risk feature of the Hand in Glove structure — it exists for any borrower. Indeed it is a quite separate factor and is really about whether the borrower has the development skills to bring home a project on time and on budget. If the lender does not think so it is unlikely they will lend in the first place!

Interest rates move up sharply during the development phase

Interest risk rates are very important to manage, as if these 'tails' are allowed to wag the property dog it is quite possible that the wrong macroeconomic environment can render a perfectly good development into an economic disaster for the borrower. As we have seen, an important feature of Hand in Glove is to hedge these risks out precisely because they can be so potentially damaging.

One final point to note is that extending the simplistic example of the two hypothetical companies cited earlier, the position five years on would result in property holdings with a ratio of 10:1.

Risk theory would suggest that other things being equal, the company with ten times the amount of property and hence a greater spread of locations and tenants would be in a better position to weather a recession than the smaller one. The larger company is also more likely to have a greater number of 'blue-chip' tenants, which is also of great value in recessionary times.

So, ironically, following what intuitively may appear a risky strategy of leveraging up the assets at the development stage can, in fact, if managed correctly, actually lead over time to a company with a lower overall risk profile.

Perhaps not a free lunch, but certainly something to chew over!