

DOMINIC LAMBRINOS

THE INIC INSTITUTE

FINANCIAL COURSES THAT MAKE SENSE



How to Understand Commercial Property Finance in One Day

COURSE TWO - 17 MODULES

Message from the author



Why Learn About Commercial Property Finance? - By Dominic Lambrinos

The commercial property market is the second largest property market in Australia after the residential property market, with the vast majority of owners looking to finance part of their investments with either one of the large banks or within the non-bank lending sector.

In addition, home loan mortgage brokers have seen their upfront and trail commissions dwindle over the past several years in particular after the recent Royal Commission into the Financial Sector.

This course is provided to show you how to gain access to providing commercial property finance in addition to home loan mortgages especially if you already have an established database.

You will receive both practical and technical skills as well as access to a support community in order to service clients' commercial property finance needs, and produce a stream of upfront and ongoing income at levels higher than available through today's home loan mortgage transactions.

The author is the founder of one of the largest business finance brokerage practices dealing in 22 products with access to over 230 private and bank lenders and 32 years experience in professional business services in Australia.

The material contained in this course embodies much of the practical experience and technical competence attained in developing commercial property finance as a profitable working income stream.



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- ❖ The user of this information accepts full responsibility for the use of materials and information contained.
- ❖ The author/s also accept no liability regarding the ability of a person/ organisation to provide commercial property finance to a client. It is the responsibility of the user of this material to endeavour to determine if they are qualified to provide commercial property finance as this course discusses.



Module 1

Course Summary

The purpose of this course is to provide mortgage brokers with an introductory package of information, skills and tools in order to establish commercial property finance as an additional profitable working income stream.

The objective is:

- ❖ To introduce you to commercial investment finance and property development finance, and provide you with new opportunities in your business offerings.
- ❖ To better understand the intricacies of commercial investment finance and property development finance.
- ❖ To understand how you would structure your fee schedule.

This course will delve into two types of commercial property finance:

1. Commercial Investment Finance, and
2. Property Development Finance.

Whilst there are similarities between these types of finance, the financial considerations to ensure a successful application remain different. This course provides an explanation of each of the fundamental areas required to ensure that you are able to prepare a submission that would properly consider the lender's requirements.

This course goes further to discuss how to prepare a submission for each type of finance described above and how to structure fees in order to ensure a profitable outcome for the mortgage broker.

The intention of this course is to equip you with an understanding and a valuable set of skills so that you can offer commercial property finance to your clients in addition to home loans, and is designed to ultimately differentiate you from your competitors so that you can enjoy a competitive sustainable advantage.

With the development of these skills it is intended that you will increase revenues via new income derived from these services. Further, you will benefit from improved client retention, increased referrals and the ability to earn a higher level of ongoing fees.

INTENDED PARTICIPANTS

This course has been designed for those who hold a Diploma in Financial Services (Finance/Mortgage Broking) although new entrants may also benefit as they develop the skills to deliver these services.

Participants will likely be mortgage brokers who wish to increase their product offerings and provide a more holistic service to their clients.

The course focuses on both the practical application and technical skills required to introduce commercial property finance as an additional stream of income.



CPD HOURS

Industry bodies apply their own individual criteria for the awarding of continuing professional development (CPD) hours.

At present this course provides for 6 hours CPD for the Finance Brokers Association of Australia.



Module 2

Concepts Of Commercial Property Finance

2.1 What Constitutes A Business?

- ❖ It's important that we start on the right foot and clarify that the type of loans this course relates to are property loans for a Business Purpose (commercial purpose).
- ❖ People can make money through two different means; they can work for a company and receive a salary, or they can operate their own business.
- ❖ Consequently, a business is an activity or enterprise that exists to make a profit.
- ❖ A business can make a profit by buying and selling goods, manufacturing goods for sale or it can be entirely service-based.
- ❖ This is clearly quite broad, so a business can be something obvious such as Google or a single professional IT consultant, a property developer or investor.

2.2 Types Of Businesses – Discussion With The Author

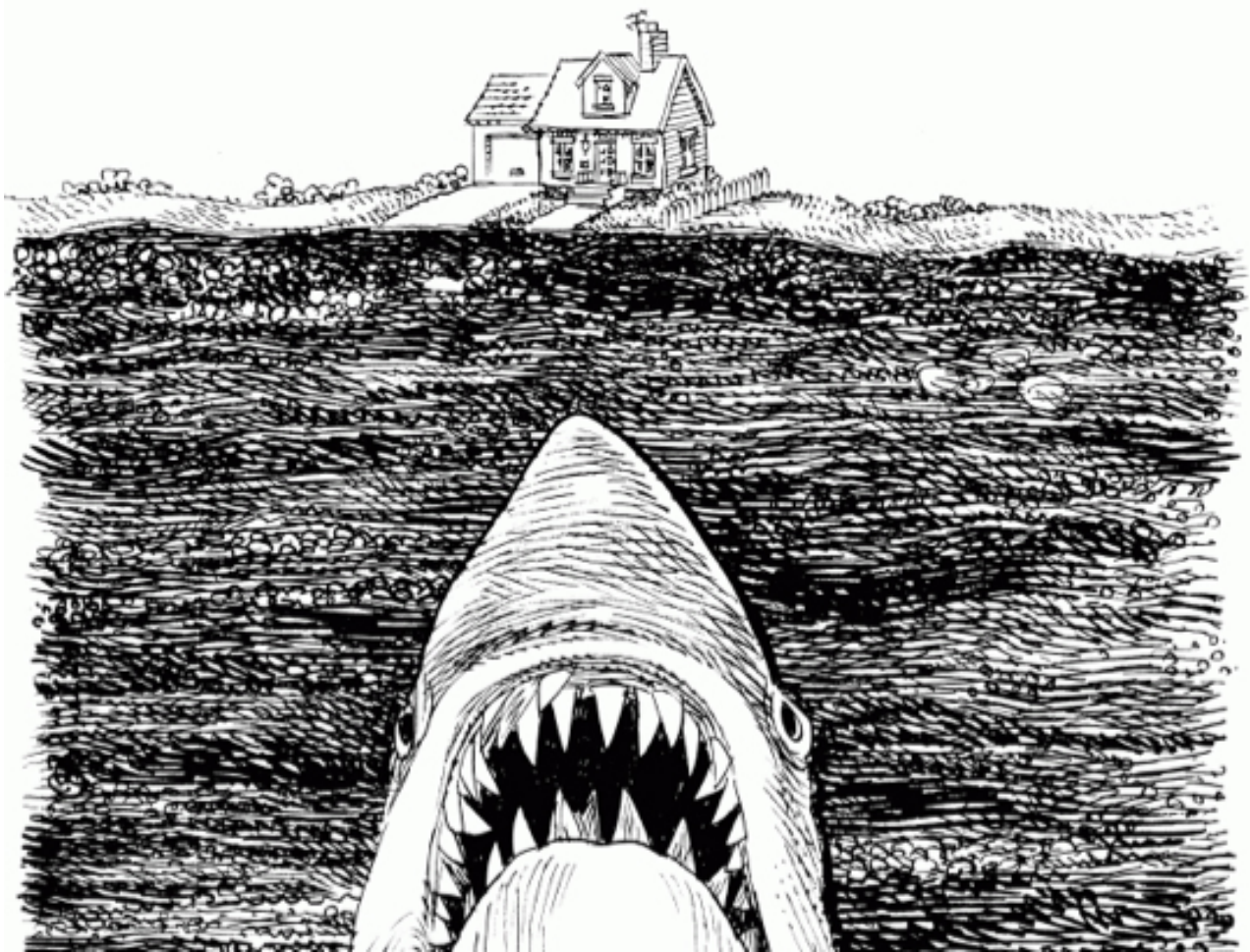
There are several different types of business structures, but in Australia the main structures are:

Sole trader	This is the most common form for a small business. It suits a small/ single operation such as a tradesman, small accountant or solicitor, and even the typical small corner store. Generally sole traders do not employ many employees, if any at all.
Company	<p>A company is a separate legal entity, used by people in business to delineate their business activities from themselves.</p> <p>You can have a small company such as a family company where the directors and owners are the husband and wife, all the way to a public company where there is an independent board of directors and many shareholders, whose shares are traded on a stock exchange.</p>
Partnership	A partnership is when two or more people or companies agree to work in business together and share the profits in accordance with agreed percentages.
Joint venture	Joint ventures are like a partnership, but are usually used for a specific activity that has a limited life like a property development or an oil exploration platform.

Trusts	<p>A trust creates a relationship between a person acting as a Trustee who is entrusted to hold property or other assets for the benefit of a group of persons, referred to as the Beneficiaries.</p> <p>The Trustee is the nominal owner of the property and assets and the Beneficiaries are only entitled to hold their interest in the trust. Unlike companies a trust is not a separate legal entity, however some businesses are carried out through trusts.</p> <p>The ultimate say rests with the Settlor who has the authority to appoint and remove Trustees.</p> <p>There are three main types of trusts:</p>
Discretionary Trusts	<p>A discretionary trust permits the Trustee to distribute any surplus to beneficiaries at their discretion.</p> <p>This enables families, for example, to establish a business within a trust that allows their family members to act as beneficiaries to the trust without being involved in how the business is operated.</p>
Unit Trusts	<p>The Trustee of a unit trust has no discretion and income must be distributed in proportion to the units the beneficiaries hold (this is akin to a company distributing profits to shareholders via a dividend – the more shares you own the higher your dividend income).</p>
Hybrid Trusts	<p>Hybrid trusts combine elements of both unit and discretionary trusts into a more complex trust.</p> <p>For example, a hybrid trust can distribute surpluses discretionally, and distribute capital or capital profits in accordance with unit holdings. Overall hybrid trusts are not widely used and, as such, are not widely accepted by lenders.</p>

2.3 What Is A Commercial Purpose?

- ❖ Commercial property finance can only be approved for property with a commercial purpose, so what is a commercial purpose?
- ❖ The opposite of commercial is residential property finance, also known as a common mortgage - where one borrows money to purchase their home.
- ❖ So on the other hand, a property with a commercial purpose means a property that is made use of throughout ordinary business operations or in the pursuit of financial gain.
- ❖ A commercial purpose can be quite broad, and can include:
 1. An owner occupied business premises (where the building/office is owned by the company that works from it)
 2. A commercial investment property (where the investment property is used for business activities, say, an office block, as opposed to a residential investment property)
 3. Property development (including homes, duplexes, multi-storey apartments, office blocks, factories, etc)
- ❖ Property developers can build residential property using commercial property finance because this is their ordinary business operations and they are seeking financial gain. The purchasers of their finished products, however, could not use commercial property finance to purchase the residential properties.



2.4 Example

- ❖ Bruce has an important management position working for an investment bank. Consequently, he earns quite a hefty salary and lives in the expensive Sydney suburb of Vaucluse.
- ❖ Bruce borrowed money from the bank to buy and renovate his home. This is a mortgage and is a residential property loan not a commercial property loan.
- ❖ However, Bruce has a company with money in the bank and he decided to purchase an investment property. Bruce purchased an office block in the growing inner-city suburb of Redfern and rents out the offices to businesses in that area. Since the property itself is used to house business operations of these companies and Bruce is seeking a financial gain the purchase of this office block is facilitated through a commercial property loan.
- ❖ Bruce decided to purchase his office block investment because he understands how commercial strata works. In fact, the Investment Bank Bruce works for actually builds office blocks in the city that they then rent out to professional services firms and other businesses in the area. For the same reasons as above, the construction costs of developing these office blocks can also be financed through a commercial property loan.
- ❖ Bruce used the same company to go into business with his mate who is a builder. They want to purchase a house and knock it down to build a duplex but they are unsure at the moment whether they would like to end up selling the duplex properties for a profit or instead keep them and earn rental income from leasing them out. Either way, because Bruce and his mate are in the pursuit of financial gain the costs associated with purchasing this house and building a duplex property in its place are all funded through a commercial property loan.
- ❖ This example highlights a variety of different ways to apply a commercial property loan. Because these different applications are quite involved, this course will only focus on the strict commercial investment facilities and property development finance.

2.5 What Is Commercial Investment Finance?

- ❖ Commercial investment finance is quite a simple form of finance and basically mirrors a mortgage just as you would have on your home except for business premises.
- ❖ This commercial property could either be purchased by a business for the purpose of housing that business' operations, or it could be purchased as an investment vehicle and then leased out to another businesses for the purpose of housing their operations.
- ❖ Similar to a personal investment property, the purchaser would seek to earn a yield (rental income) as well as capture an increase in the property's value over time (capital gain).

- ❖ The challenge in commercial investment finance lies in assessing the strength of the client as well as the financial strength of the subject property and then assigning this package to an appropriate lender. That lender could range from a first-tier bank to a non-bank lender to a private lender happy to settle a low-doc (low amount of supporting documentation) facility in return for a higher interest rate - it all depends on the risk-reward compromise like in all areas of finance as well as the risk appetite of the lender.

2.6 The Commercial Investment Loan Market In Australia

Demand for commercial properties in Australia are growing and major banks still represent 90% of the market (the balance being taken up by Private Finance).

Accordingly, "Banks dominate the Australian real estate development debt market. However, they are actively reducing their exposure (\$216bn) to commercial real estate lending, leaving many developers struggling to obtain alternative funding¹" Most of this gap is being filled by the Private Finance Sector. *1. 2018 Real Estate Outlook; Deloitte*

The problem is that the major banks are typically quite stringent in who they decide to lend out to – and they price their rates accordingly. Banks typically cap their allowed LVR at 65% (see below for explanation) and they value the property based on rental yield that is also capped at different rates depending on the zoning, locations and other factors (generally between the high 5% to 9% in major cities).

However, this market attracts a significant amount of borrowers who do not meet the major banks' lending criteria or do not fit into their risk profile.

Consequently there are a variety of non-bank lenders in the market to meet this demand in addition to the traditional banks.

2.7 Specific Advantages Of The Non-Bank Lending Sector

There are many differences between the traditional banks and the private lending sector when it comes to commercial investment finance.

Some of the following differences could be advantageous for certain borrowers:

- ❖ Non-bank lenders are more asset-driven than serviceability-driven like traditional banks. This means that borrowers would not need to show as much evidence of serviceability to a non-bank lender as they would to a traditional bank.
- ❖ Non-bank lenders allow borrowers to capitalise the interest component so that they can borrow all interest and expenses for the first year so that they are not out of pocket at all:

	\$
Loan	1,000,000
Interest @ 6% p.a.	60,000
Legal/professional fees	40,000
Total	1,100,000

So in this example non-bank lenders will allow borrowers to borrow \$1.1m so that they can use the extra \$100,000 to meet first year expenses whereas bank lenders will require borrowers to meet these obligations on their own and only lend out \$1m.

- ❖ Non-bank lenders also tend to be more flexible with statutory requirements such as certificates of completion, tenure of leases, etc. This means that if you have a 2-year lease signed with a client most banks will only offer you a 2-year loan whereas non-bank lenders are more likely to assume that you would be able to renew the lease agreement at the end of the initial 2 years and offer you a longer term.
- ❖ Non-bank lenders also offer a greater scope for negotiating terms and are more flexible with the LVR. Sometimes traditional banks will also exceed an LVR of 65% however they will require you to pay the excess borrowing in a short space of time so that they can restore an LVR of 65% as soon as possible.
- ❖ In other words, if they go up to an LVR of 70%, the banks will require you to pay the extra 5% of principle in a short time period, typically 12 months.

HOWEVER, ALL OF THESE BENEFITS COME AT A COST AND NON-BANK LENDERS TYPICALLY CHARGE HIGHER INTEREST RATES FOR TAKING ON A LARGER DEGREE OF RISK.



Module 3

Important Elements of Commercial Investment Finance

Commercial Property Finance Submissions

Commercial property finance submissions are quite lengthy documents compared to home lending submissions because:

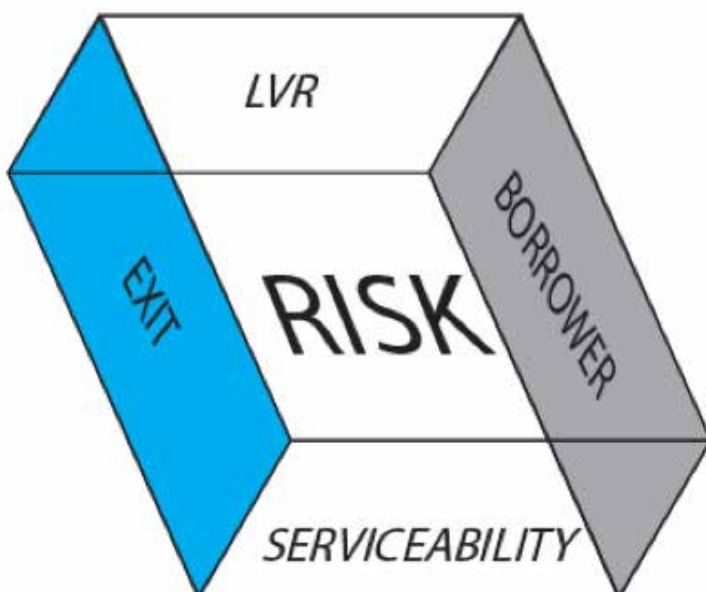
- ❖ The loan amounts tend to be significant
- ❖ There are more risk factors to consider, and
- ❖ Because this is a smaller market than the residential property market there is more qualitative consideration attributed to the transaction

All commercial investment finance submissions focus on mitigating the risks that a lender may encounter. These risks are essentially:

- i. Loan to value ratio (LVR) risk
- ii. Serviceability risk
- iii. Character of borrower risk, and
- iv. Exiting the transaction risk

3.1 The All Important – RISK Box

Therefore, by boxing-in these risks through a formal submission, we do our best to ensure that no lender feels they are exposed to an uncomfortable level of risk.





Module 4

LVR Risk

LVR Risk

The LVR is essentially the percentage of the property's value that is being financed. Therefore, if the borrower is seeking a loan of only \$1,200,000 on a commercial property worth \$2,000,000 then the LVR would be 60%.

The lower the LVR the safer the loan is considered to be. That is, the lower the level of the loan in relation to the value of the property the higher the chance of the borrower repaying the loan in full, even if this means selling the property to do so.

The LVR is calculated using a formal valuation from an approved property valuer.

This formal valuation will go into a significant level of detail about the property and the factors that influenced the end value.

In addition to providing the lender with this formal valuation as a supporting document, you will also be required to publish a summary of the site information in your formal submission.

This information will include:

Address, zoning and lot number
Land size
Brief description (property structure, proximities, current tenant, property attributes, etc)
Gross and net lettable areas
Lease details
Encumbrances
Current lender
Visuals (aerial/map and street views)

"The lower the level of the loan in relation to the value of the property the higher the chance of the borrower repaying the loan in full".

4.1 What is a Capitalisation Rate?

The LVR is based on the value a valuer attributes to a property.

A capitalisation rate is the method valuers use to value a commercial property investment on behalf of lenders, and is essentially the inverse of the rate of return on that property.

So let us first consider the rate of return on a property. If the subject property is used for commercial uses and is in a good area then this would be considered a safer investment and therefore warrant a lower rate of return, say 6%. However, if the subject property is used for industrial purposes, is far from the central business district and has many substitutes (high supply) then this would be a riskier investment and warrant a higher rate of return, say 9%.

In other words, we are just applying the basic risk-reward relationship to commercial property.

Therefore, the capitalisation rate for the first property would be:

$$\frac{100}{6} = 16.65$$

And the capitalisation rate for the second property would be:

$$\frac{100}{9} = 11.11$$

This means that if the commercial property returns a net profit of \$1,000,000 then the bank would value the first investment at:

$$\text{\$1,000,000} \times 16.67 = \text{\$16,670,000 (6\% return)}$$

And the second investment at:

$$\text{\$1,000,000} \times 11.11 = \text{\$11,110,000 (9\% return)}$$

A valuer would then take the above results and compare them to recent sales and tenancies to make sure the results “make sense”.

“A capitalisation rate is the method valuers use to value a commercial property investment on behalf of lenders, and is essentially the inverse of the rate of return on that property”.

4.2 Leverage and Capital Gains

Return on cost and capital gains are similar in so far as they both use the increase in the value of the property in their calculation. Return on cost is calculated on the initial equity investment whereas capital gains are calculated on the entire purchase price of the property.

For example, consider the following commercial property:

	\$		\$
Property cost	10,000,000	Fund through 35% equity	3,500,000
		65% debt	6,500,000
			10,000,000

If in one year's time the value of this property increases to \$11m, then the capital gain would be \$1m on the initial \$10m, so:

$$\frac{1,000,000}{10,000,000} = 10\%$$

However, the leverage would be calculated as \$1m on the initial \$3.5m equity component, so:

$$\frac{1,000,000}{3,500,000} = 29\%$$

“Return on cost is calculated on the initial equity investment whereas capital gains are calculated on the entire purchase price of the property”.



Module 5

Serviceability Risk

Serviceability Risk

Serviceability simply addresses the borrower's ability to meet the repayment obligations of the commercial investment finance facility.

Clearly this is an important part of the formal submission because the lender will undoubtedly want to minimise the risk that the borrower lands in a position where they are unable to repay the loan.

Interest cover is the way most lenders like to quantify serviceability risk because it calculates how easily the borrower would be able to meet the proposed monthly interest expenses.

5.1 Interest Cover

The first step in completing this calculation is determining how much cash the borrower has to service the debt, and this is referred to as the future maintainable earnings amount.

That is, future maintainable earnings are simply an extrapolation of how much money will be available in the future to meet interest payments based on how the business has performed in the past.

Adjustments are made to the business' Profit & Loss Account called Addbacks.

For example, an addback would be the director's salary as a director can always pay herself slightly less to meet these obligations. Furthermore, expenses such as depreciation and amortisation are not actually cash outgoings each year.

Consequently, these types of expenses need to be added back to net profit in order for the lender to get a real idea of the level of cash on hand.

Some of these 'addbacks' could be, for example:

		\$
Net revenue		200,000
Addbacks:	Tax	100,000
	Depreciation	80,000
	Amortisation	50,000
	Director's salaries	200,000
	Director's superannuation	18,000
	Extraordinary (unusual) expenses	50,000
Future maintainable earnings		698,000

INTERESTING NOTE

If the borrower is refinancing a current facility, then the interest paid on this current facility also becomes an addback when calculating the future maintainable earnings for the new proposed facility.

DISCUSSION WITH THE AUTHOR

Example:

In this example we see that whilst the net revenue of the borrower is only \$200,000 the amount of cash on hand that can be used to repay the loan is actually closer to \$700,000.

This \$700,000 value is what is important to the lender.

The next step to calculating the interest cover level is to determine how many times over the borrower would be able to meet the interest payments.

So if the loan amount were, say, \$6,700,000 and the interest rate were 6% then the borrower would need to pay:

$\$6,700,000 \times 6\% = \$402,000$ per year in interest
(assuming this is an interest only loan).

Continuing our previous example, we know the borrower really has \$698,000 on hand per year. **This results in an interest cover calculation of:**

$$\frac{698,000}{402,000} = 1.74$$

In other words, the borrower would be able to repay the interest amount 1.74 times over.

The interest cover level can be calculated using a borrower's single source of income, or if they earn revenue from multiple streams then you can use an all sources income approach.

Generally private lenders like to see an interest cover ratio of at least 1.25 - 1.5 times.

5.2 Interest Capitalised

Non-bank lenders allow borrowers to capitalise the interest component so that they can borrow all interest and expenses for the first year so that they are not out of pocket at all :

	\$
Loan - net	1,000,000
Interest @ 6% p.a.	60,000
Legal/professional fees	40,000
Total	1,100,000

In this example non-bank lenders will allow borrowers to borrow \$1.1m so that they can use the extra \$100,000 to meet first year expenses whereas mainstream bank lenders will require borrowers to meet these obligations on their own and only lend out \$1m.

5.3 Tax Implications

There may be a positive tax implication of implementing the commercial investment finance facility.

If we are considering an investment property, then one such positive could be negative gearing. That is, any net loss between the monthly rental income from leasing the property to a tenant (cash inflow) and the monthly loan repayments (cash outflow) is tax deductible.

However, a negative tax implication could be a capital loss where any loss suffered on a bad property investment decision (say, if you bought it for \$10m but could only sell it for \$9m) is not offset against revenue (so that you could reduce taxable income) but is rather considered a credit against future capital gains.



Module 6

Character of the Borrower Risk

Serviceability Risk

Due to the generally high loan amounts associated with commercial property, the lender will like to receive some measure of the borrower's character before approving a facility. This should also provide the lender with some comfort that the borrower is the type of person to repay their debts.

In this section you will be required to provide both qualitative and quantitative measures of character for the borrower.

6.1 Qualitative - What Kind of Person is the Borrower?

You will need to provide a brief CV of the borrower and why a commercial property finance facility is desired. You will undoubtedly need to include the business background and description, as well as a synopsis of the borrower's credit file.

A good measure of the borrower's ability and willingness to pay their debts off in time is to review their conduct for any other loans they may have, and therefore reviewing copies of loan statements for the past 12 months would assist in this process.

Another way lenders like to gauge a borrower's repayment conduct is to look at their position with the ATO. For banks, borrowers will most likely have to be up to date with all taxes, whereas non-bank lenders will be content to see a formal ATO arrangement in place if borrowers have outstanding taxes.

6.2 Quantitative - Borrower's Financial Information

If the loan is going to be serviced and paid say monthly in arrears, you will need to attach financial statements as part of your supporting documentation,

If the interest is going to be capitalised, then there will be no need to supply financial statements nor income tax returns with your private loan application.

What is important though is that the loan borrowed makes some sense against the borrower's personal statement of assets and liabilities (also known as a statement of position).

This is essentially a personal statement of assets and liabilities so that the lender can see if there is any substance behind the borrower. In saying this, the borrower need not have a significant amount of assets because a first mortgage over the commercial property should provide the lender with sufficient security.

This statement is more to build upon the lender's perception of the borrower's character and display the borrower's nature in regards to building and accumulating wealth.

An example of a statement of personal assets and liabilities could look something like this:

Joe Bloggs - Statement of Assets & Liabilities				
Assets	\$	Liabilities	\$	Notes
Real Estate		Mortgages		
123 Beach St, Sydney NSW 2000	1,500,000	CBA	800,000	\$3,310/month
Cash at bank		Personal loans		
CBA	50,000	NAB	20,000	
NAB	15,000			
Superannuation				
AMP Super	55,000			
Cars		Leases		
BMW 335i	60,000	BMW finance	40,000	
Mini Cooper S	35,000	BMW finance	20,000	
Other assets		Credit cards		
Furniture	90,000	CBA Visa	10,000	\$25,000 limit
Shares in RIO	10,000	AMEX	20,000	\$25,000 limit
	1,840,000		910,000	
Net Assets	930,000			

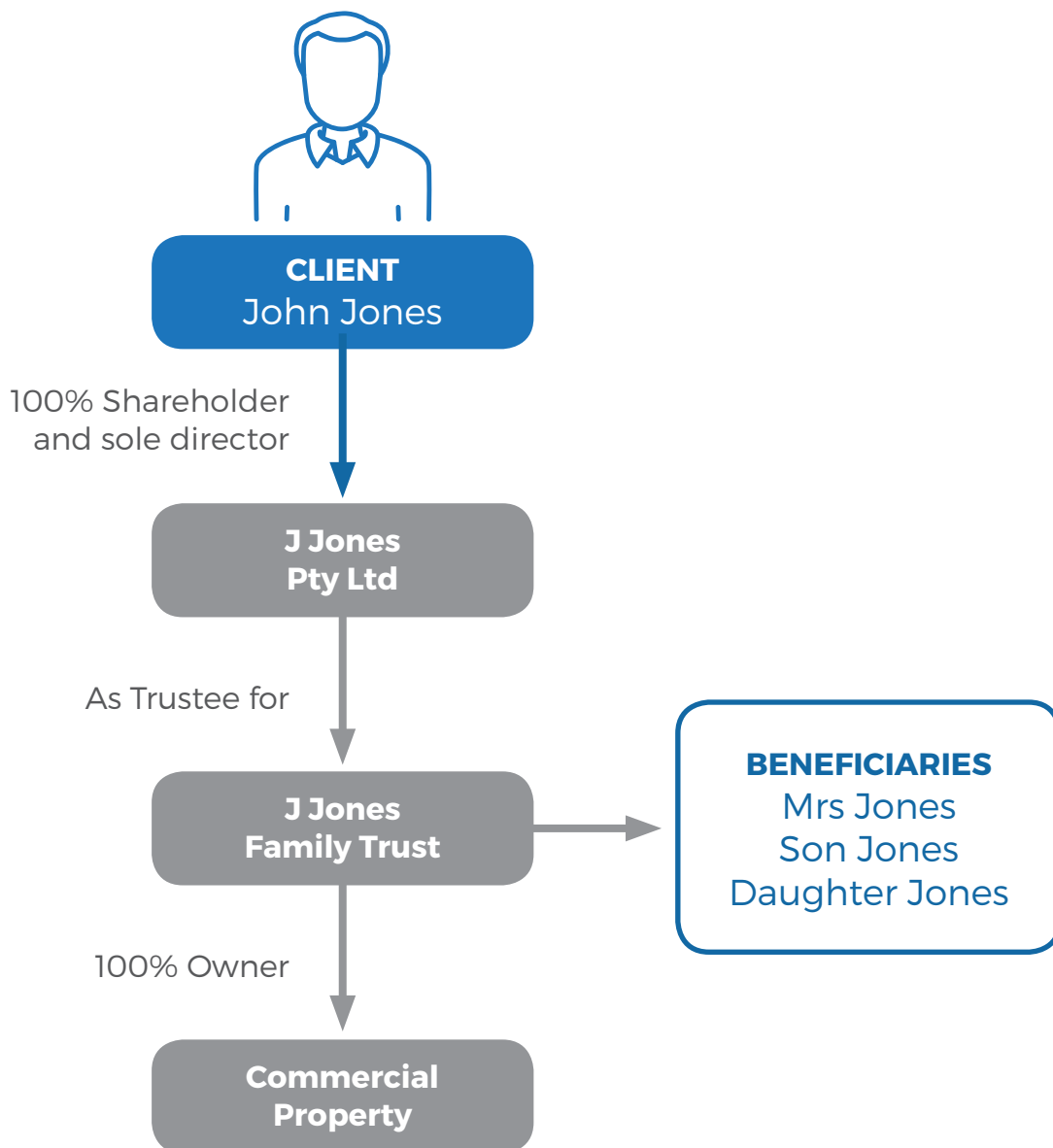
6.3 The Corporate Structure

The purpose of including the corporate structure is simple; it shows the lender 'who's who in the zoo' (who the important people and entities are) as well as who owns what.

This ensures that the lender has a gauge on everyone's character and knows who is responsible for what.

The corporate structure is also a check to ensure that you have all of the relevant entities' financial statements and tax returns attached to the submission.

For example;



6.4 Personal details

The personal details section forms the conclusion of your formal submission and merely provides the important contact information should the lender wish to contact the borrower or any other person important to the process.

These details should include:

A contact for the borrower
The borrower's address
The borrower's contact number
The borrower's delivery address for notices
The borrower's accountant, and their contact number and address
The borrower's solicitor, and their contact number and address



Module 7

Exiting the Transaction Risk

7.1 Risks & Mitigants

Before assessing the exit strategies, the transaction's main risks and mitigants need to be reviewed.

The four main risks and mitigants are

1. Property & business risk
2. Loan repayment risk
3. Sponsor risk
4. Servicing Risk

Each of these risks need to be mitigated. By way of example:-

Property & Business Risk	<p><i>For example...</i> Security property will not retain its value</p> <ul style="list-style-type: none"> • The Property Portfolio has longevity and has been accumulated over a period of 10 years. • The area has strong demand in industrial and commercial rental. • The properties are well located in an established area with good access to arterial roads. • The loan to overall assets value is acceptable at 65%. <p>Conclusion: Mitigated</p>
Loan Repayment Risk	<p><i>For example...</i> After selling the property there will not be sufficient funds to extinguish the debt</p> <ul style="list-style-type: none"> • The loan to overall assets value is acceptable at 65%. • The net assets of the sponsors reflect an additional \$Y. • The net rental return of the portfolio reflects an interest cover of Z times. <p>Conclusion: Mitigated</p>
Sponsor Risk	<p><i>For example...</i> Sponsor Lack experience or financial capacity</p> <ul style="list-style-type: none"> • The sponsor has successful experience in operating commercial property investment. • The sponsor is aided by the intervention of professional legal and financial counsel in managing the portfolio. <p>Conclusion: Mitigated</p>

Servicing Risk	<p><i>For example...</i> Being able to meet all financial obligations as and when they fall due</p> <ul style="list-style-type: none"> • The sponsors' CRAA reflect the diligent payment of interest and accounts. • The sponsor has always paid his interest on time with all of its creditors and there is a history of monthly payments to evidence this. <p>Conclusion: Mitigated</p>
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Clearly risks may differ with borrower-specific issues and you may be required to expand beyond the issues highlighted above.

After a brief discussion of each risk you should conclude that each risk has been mitigated.

7.2 Strengths and weaknesses

Similar to the exit strategies assessment, the strengths and weaknesses of the submission as a whole need not be overly analysed.

You are merely required to provide the lender with some guidance when it comes to the strengths and weaknesses of the deal as you are expected to understand the intricacies of the deal to a higher degree than the lender.

This strengths and weaknesses section may simply look as follows.

Strengths	<p><i>For example...</i></p> <ul style="list-style-type: none"> • Security property is located in an established and growing area of Y. • All of the units available for rent in the Z properties are fully leased out. • There are experienced and professional advisors to the sponsor in managing the property investment. • History of timely interest payments. • LVR of 65%. • Diverse tenancy schedule.
Weaknesses	<p><i>For example...</i></p> <ul style="list-style-type: none"> • Limited assets available outside the security assets. • The security assets are only geared to X%. <p>Weakness mitigated.</p>

7.3 Exit Analysis

Once the main risks and mitigants have been determined, the exit strategies can be formulated. The exit strategies represent the final layer of risk management for the lender.

Exit strategies are essentially contingency plans so that if all goes belly up, then the lender can implement these exit strategies to recuperate their funds.

For example, some exit strategies that may be relevant could be the following, however these are also transaction specific and should be considered on a case-by-case basis much like all aspects of a formal submission for commercial investment finance.

First way out	<i>For example...</i> Repaid through the trading operations of the property portfolio - historical trading results and interest cover calculations support this as the first way out for a medium to long-term strategy. Considered Acceptable
Second way out	<i>For example...</i> Repaid through the liquidation of the security assets. LVR on security 65%. Considered Sound
Third way out	<i>For example...</i> Net asset position of the Guarantor offers some additional comfort by providing security outside the direct security asset. Considered Acceptable

3.6 FINAL STEPS

“Keep in mind that the synopsis should be concise and succinct”.

Once all of these sections have been completed, the final thing you will need to do to complete your formal commercial property finance submission is write a synopsis, a transaction overview and a snapshot of the loan requirements at the beginning of the document.

The synopsis should simply outline how the commercial property came to be in the possession of the borrower and why, a brief note of the corporate structure and an acknowledgement to who the incumbent facility is currently with. You may include other points in your synopsis as you deem necessary, however keep in mind that the synopsis should be concise and succinct.

The transaction overview will generally be a short list to immediately highlight to the lender some of the more salient details that they should keep in mind.

Finally, the loan requirements snapshot should be a quick breakdown of the loan amount to show where this amount is being derived (if more than one property).

Once this amount has been justified, you should then show how the funds will be used. Most commonly this will involve two parts; the refinancing of the current debt and the finance/legal costs of establishing the facility.

Then you will just need to list any special features of the facility if there are any. Perhaps the borrower has requested an interest only loan. Or perhaps there are some outstanding leases that need to be executed prior to settlement, etc.



Module 8

Example of a Submission

Example of a Submission

A commercial investment finance submission could be structured as follows, for example:

Overall transaction description
Transaction overview
Loan requirements
Interest cover
Site information
Applicant details
Corporate structure
Financial information
Risks and mitigants
Exit strategies
Strengths and weaknesses
Personal details

In addition to this submission, you will also need to provide some supporting documentation, and this could include, for example:

Most recent two years financial statements (if servicing, otherwise none)
Most recent income tax return (if servicing, otherwise none)
Council rates for the property
Trust deed (if there is a trust in the corporate structure)
All relevant leases
Formal property valuation
Other information required by the specific lender



Module 9

Important Elements of Property Development Finance

Important Elements of Property Development Finance

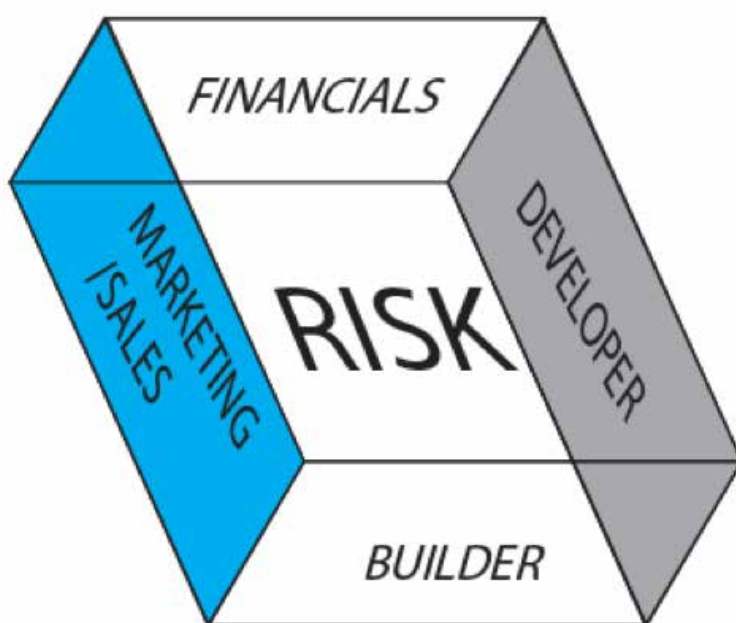
Property development finance is arguably one of the most difficult forms of finance that you can engage in. This is because it takes the precepts of commercial investment finance and redefines them for its own specific uses.

The most important point to note with property development finance is that it is for a set period; there is a clear beginning and a defined exit once the development is completed. So in this regard, you can think of it as project finance.

The glossary surrounding property development finance is fairly specific and can be different from other forms of finance and that is because it includes the jargon of builders, quantity surveyors and the multitude of experts required to simply complete a development. The purpose of this unit of the course is not to teach you about how to finance multi-stage developments, commercial skyscrapers, resort hotels or private hospitals.

The purpose is to cut through some of the difficult elements and provide a basic and sound understanding by simplifying the easier type of property development finance transactions, such as single-stage residential unit blocks.

The best place to start is to again (like commercial investment finance) find the salient elements to the transaction that minimise the risk to the lender. By identifying and boxing in these risks, we are able to develop a detailed proposal based on a sound financial offering.



For the purposes of property development finance the four salient elements of risk to be managed are:

1. De-risking the financial side of the transaction.
2. Understanding the sponsor/ developer.
3. Ensuring strong building contracts are in place, and
4. Ensuring the marketing and sales processes are identified and sound.



Module 10

De-risking the Financial Side of the Transaction

De-risking the Financial Side of the Transaction

Every development project should be accompanied by a detailed cashflow projection. This can be done on Microsoft Excel, however the better projections are made on industry-specific software such as Estate Master, which is a great starting point for lenders to be confident in the project's feasibility.

Even industry-specific programs prepare property development projections from the point of view of the developer, and therefore do not necessarily consider a financier's point of view.

The simplistic funding table on the following page would extract information from a program like Estate Master and present it in a format that quickly identifies the salient precepts a financier is looking for in deciding to fund or 'cost-out' a project.

“Every development project should be accompanied by a detailed cashflow projection”.

10.1 Feasibility Example

Quick Feasibility Example

Client:	XX Road Apartments
Project/Client:	27091A
File Number:	123456C
Address:	22 XX Road, YY'Ville

			Income	%
Presold Apartments			8,000,000	
Unsold Apartments			8,000,000	100.00%
	Average Price	800,000	16,000,000	
Less Sales Costs		5.0%	800,000	5.00%
Less GST Liability	Using the margin scheme		1,181,818	7.39%
Net Income			14,018,182	87.61%

	Equity	Borrowing	Costs ex GST	%
Land @ Valuation	1,200,000	1,800,000	3,000,000	60.00%
Professional Fees		750,000	750,000	100.00%
Statutory Fees		450,000	450,000	100.00%
Construction	2,150,000	3,850,000	6,000,000	64.17%
Contingency		300,000	300,000	100.00%
Stamp Duty and Legals		200,000	200,000	100.00%
Interest		366,000	366,000	100.00%
	3,350,000	7,716,000	11,066,000	69.73%
Development Profit			2,952,182	26.68%

Salient Indicators	%
Project return (on cost)	26.68%
Percentage of borrowing on land	60.00%
Percentage Borrowing of total costs	69.73%
LVR on Completion	48.23%
Percentage of total costs covered by presales	72.29%
Percentage of borrowings covered by presales	103.68%
Percentage of project sold	50.00%
Average price per apartment	800,000

10.2 Things To Look Out For In The Feasibility

Component	Explanation
Sales	<p>The first question to ask the developer is if this figure is inclusive or exclusive of GST, and what the basis of the end product value is in 18-24 months time.</p> <p>Further questions may arise as to how that compares with current values for similar units in the area and whether the developer has calculated their sales on an individual unit basis because different prices may be attributed to different units in the development. It is good to split sales into presales and not presales.</p>
Sales Costs	<p>Marketing costs are normally calculated as a percentage of gross sales inclusive of GST and each project would have a different percentage.</p> <p>Please note that in the cashflow some marketing costs are paid on exchange and not on settlement.</p>
GST Liability	<p>It is important at this stage to know whether the client will apply the margin scheme, which is explained in more detail below.</p>
Land Costs	<p>Generally the land is included in the funding table at valuation. This is because most land that is acquired at cost has its value improved through the lodgment of successful development applications.</p>
Professional Fees	<p>It is preferable at this stage to have quotations for all professional services, including architects or consultants, landscapers, project managers, quantity surveyors, etc.</p>
Statutory Fees	<p>These are generally fees payable to the council, such as Council contributions, or warranties and bonds payable, etc.</p>
Construction Costs	<p>Construction estimates need to be as accurate as possible, and generally carry the highest risk of errors occurring.</p> <p>The problem in this area lies with the fact that construction drawings are not ready and construction certificates are not issued at the time that funding is requested.</p> <p>It is important to apply a detailed costing approach where possible and compare this against general industry standards for the construction of the same quality units.</p>

10.2 Things To Look Out For In The Feasibility

Component	Explanation
Project Return	<p>This calculation is normally determined as development profit divided by total development costs.</p> <p>Project return can also be a calculation of development profit over equity contributed.</p>
Land Borrowing	<p>Whilst construction costs can be leveraged up to 70-80% of total development costs, the percentage borrowed against the land will always be limited to up to 65%.</p>
Percentage Borrowing of Total Costs	<p>This is calculated as borrowing divided by total development costs. Lenders like to see this percentage to be no more than 70-80% depending on the risk profile of the lender.</p> <p>A developer can increase their leverage by taking out a second mortgage and there are various institutions that have different appetites for risk in this category.</p>
LVR on Completion	<p>This is calculated as total development costs divided by gross sales. This percentage calculates how much risk the lender has at the end of the project and is one of the more important ratios.</p>

10.3 Valuation

The next part of the financial process is the independent valuation. Most valuations will have two different values attributed to the property development:

1. The 'As Is Value' - what the particular block of land is worth if liquidated in its current state.
2. The 'End Value' - the independent valuer's assessment of what the project will be worth once it is completed.

Having a valuation in place prior to commencement of funding is extremely useful; however in a practical world the valuation is almost always done after a lender receives a submission.

Valuation "As Is"	Residual Analysis Derived Value	\$16,826,727 - \$14,129,574
	Derived Profit & Risk	21.21%
	Derived Internal Rate of Return	20.24% before interest or 14.45% after interest
	Direct Comparison Value	\$16,380,000
	Adopted Rate Per Unit Site	\$140,000/unit

Subject to the assumptions and qualifications outlined in this report, we are of the opinion that the market value of the subject development site as at 5 April 2018 is:-

'As Is' Market Value with Consent for 117 units

\$16,380,000 Including GST

(Sixteen Million Three Hundred & Eighty Thousand Dollars)

Or

\$16,380,000 Excluding GST

**(Sixteen Million & Sixty-Four Thousand Five Hundred &
Forty-Five Dollars)**

Jones Lang LaSalle Advisory Services Pty Limited

10.4 The Margin Scheme for GST

Sales are almost always stated inclusive of GST and an error that often occurs is how GST is calculated as a deduction from sales.

In the majority of cases GST is calculated using 'the margin scheme'.

Using the margin scheme, GST is payable only on the margin, where the margin is equal to the sale price less the purchase price. For example:

	\$
Property sale price	1,000,000
Property purchase price	450,000
Difference	550,000

In this example GST is only payable on the difference of \$550,000 (GST equal to \$50,000).

If the property was purchased prior to 1 July 2000 you are able to replace the purchase price (which would not be relevant if the property were purchased in, say, the 1970s) with a formal valuation of the property, usually as at 1 July 2000 (done by professional valuers).



Module 11

Understanding the Developer

Understanding the Developer

Understanding the character of the developer involves assessing four key areas:

1. Background and experience of the developer
2. The financial strength of the developing entity
3. Statement of assets and liabilities for the developer
4. The entire support team

Component	Explanation
Background and Experience of the Developer	<p>In this section you will need to consider:</p> <ul style="list-style-type: none"> • The developer's past projects. • Where there have been any problems relating to completion or funding with other financiers. • The developer's experience and ensure it is in line with current project. For example, if the developer has only ever built half a dozen town houses at a time this does not provide sufficient experience to build a 15-storey apartment tower.
The Financial Strength of the Developing Entity	<p>In this section you will need to consider:</p> <ul style="list-style-type: none"> • The developing entity's financial statements and tax returns for last two years. • Whether previous projects have been completed and whether they were sold entirely. • The developing entity's current tax position to make sure they are up to date with their ATO liabilities.
Statement of Assets and Liabilities for the Developer	<p>Property development loans are typically quite large and therefore lenders will like to see that there is equity in the developing group. The lender will feel more comfortable with their risk exposure if they can see some substance behind the significant loan amount.</p>
The Entire Support Team	<p>In this section you will need to introduce the developer's support team, including any:</p> <ul style="list-style-type: none"> • Architects • Consultants (e.g. environmental, financial, etc) • Landscapers • Project managers • Quantity surveyors <p>Or any other important person involved in the developing team.</p>



Module 12

Ensuring Strong Building Contracts are in Place

Ensuring Strong Building Contracts are in Place

There are two principle ways a developer can construct their development.

The first way is by being an owner-builder, where the developer has their own building and construction license and the building and development profits are both earned by the developer/builder.

Obviously if the proposal involves a developer-builder further checks have to be done to ensure that the builder has sufficient experience to successfully complete the construction on time and on budget.

The second method is to engage the services of a professional builder and the developer only earns the development profit on the project.

Builders need to have appropriate financials with sufficient assets and operating income to fund the construction. This is important because builders are paid in arrears, where they front the costs of their subcontractors and sometimes, materials. Consequently, the builder must have sufficient cash on hand to meet these costs before being reimbursed.

One of the main concerns of lenders is that the builder does not have sufficient backing to complete the construction and is put in receivership during the construction phase where another builder must be engaged to complete the project.

Therefore, the scenario where there is a developer-builder is not favourable to many lenders who would much rather see the right kind of builder (properly experienced and equipped) engaged to complete the construction.

Some of the attributes a third party builder should have are as follows:

- ❖ They are appropriately categorised for the type of development being constructed. For example, if the development consists of a 60 unit residential tower, a lender would like to see a tier one or tier two builder in place.
- ❖ They have a balance sheet with sufficient net assets to fund the construction.
- ❖ Whether they offer a 'Fixed Price' contract (one price with everything included).
- ❖ Whether they offer 'Turn Key' service (Where the end owner has no input throughout the construction phase and is only handed the property once it is in a 100% completed state, rather than the builder completing the construction in stages).



Module 13

Ensuring the Marketing and Sales Processes are Identified and Sound

Ensuring the Marketing and Sales Processes are Identified and Sound

The last area of risk for a lender is the assessment of the exit strategy.

The exit strategy for any development is the realisation and settlement through the sale of all of the units.

A large contributor to minimising this risk is the need for developers to have presales in place before construction finance can be drawn upon. The main question is what level of presales does a developer require.

The level of presales is reliant on the net asset backing of the developer and the inherent risk of the development project. Given that, as a general rule the Big 4 banks take a conservative approach and require that at least 100% of the borrowings to be covered by presales.

Some private lenders may not require any presales, however to reward the additional risk will charge a higher interest rate and additional fees and costs.

Another point to note in respect to presales is to review the quality of the presales. In other words, they need to be supported by exchanged contracts with sufficiently long sunset clauses so that they do not expire during the construction phase.

Some lenders will also limit the amount of contracts exchanged with deposit bonds and insist the majority of contracts be exchanged with cash or bank guarantees.

13.1 Sales Process

It is also important to review the quality of the sales program. In this regard you may wish to consider:

Advertising program.
Spread of advertising over different media channels; press, radio, television, magazines, etc.
Quality and detail of the website.
Whether the developer is using 3D graphic interfaces in their website.
Public relations programs.
Sales incentives for sales staff and likely purchasers.



Module 14

Example of a Submission Structure

Example of a Submission Structure

A property development finance submission could be structured as follows, for example:

Overall transaction description
Transaction overview
Funding table & feasibility
Site information
Terms of the Development Approval (DA)
Description of the development
CV of the developer
Statement of assets and liabilities for the developer
CV of key consultants
CV of builder
Sales program
Summary of presales
Corporate structure
Financial information
Risks and mitigants
Exit strategies
Strengths and weaknesses
Personal details

14.1 Final Steps

Once you have written the submission, you will need to review your synopsis and ensure that it is still a succinct snapshot of the loan requirements.

In the case of a property development, this should outline where the property is, what is intended to be built on that property, how much equity has been invested by the borrower and estimated percentages of borrowings as well as presales. Any special terms that you may require should also be highlighted in the synopsis.



Module 15

Short Discussion on Private Finance

6.1 – Who are the Private Financiers?

- ❖ Private Financiers work outside but alongside the main banking system.
- ❖ They are often referred to as third or fourth tier financiers depending in the country they are operating in.
- ❖ In most instances they are not regulated in the same way as Deposit Taking institutions normally are.
- ❖ There are various names by which these organisations go by and these may include:-
 - Private Finance
 - Private Banking
 - Non-Bank Finance
 - Non-Bank Lending
 - Shadow Banking

6.2 – Where do Private Lenders Get their Money From?

- ❖ Deposits from individuals normally through a prospectus.
- ❖ High Net Worth individuals and their family offices.
- ❖ Superannuation Funds.
- ❖ International Investment Groups.
- ❖ Private Equity Firms.
- ❖ Overseas REITs.
- ❖ Money Markets – Asset Management/Government etc.

These are not the only groups but are a representation of where some of the private money can come from and includes funds from local as well as international sources.

6.3 – Why to Borrowers Use Private Financiers

- ❖ Private Finance finances transactions most mainstream banks won't.
- ❖ Private Finance will look more favourably on borrowers who don't comply with mainstream banks.
- ❖ Where loans need to be done more quickly than mainstream banks.
- ❖ At times a borrower doesn't want to comply with all of the bank's requirements and prefers to show less information for a due diligence and is prepared to pay more for it.
- ❖ Where mainstream banks have stopped funding an asset class.

6.4 – Private Financier v's Mainstream Banks

- ❖ Private Finance manage risks differently to mainstream banks.
- ❖ Private Finance operates in a traditional Risk Reward Model.
- ❖ Higher Risk does not mean a NO, but it will cost more money.
- ❖ Sometimes pricing is dictated by Supply & Demand and RISK.
- ❖ Sometimes the model extends to Risk Reward and Opportunity.
- ❖ Generally Private Finance offers an easier approval process compared to mainstream banks.
- ❖ Different credit process whereby more emphasis is placed on the asset and transaction over the sponsor.
- ❖ Quicker settlement time.
- ❖ More flexible with amending terms.
- ❖ Easily add 2nd mortgages, vendor finance or preferred equity.
- ❖ Generally, provides for better access to decision makers.
- ❖ Private Finance lends itself to offering a more entrepreneurial approach.

6.5 – What Private Lending Lends On?

Private Finance is a basic Asset Lender and looks for the most appropriate asset to lend to meet their Investor's requirements.

This will include but is not limited to:-

- ❖ Commercial Property.
- ❖ Construction Finance.
- ❖ Land Banks.
- ❖ Specialised assets such as aged care, private hospitals, child care facilities, medical centres, hotels etc.
- ❖ Some residential property may be included in this.

LVR for Private Financiers vary greatly usually we see the higher LVR's to go up to as much as 80% plus and the average is 65%.

In many instances interest is capitalised in the loan as well as the finance fees.



Module 16

Things to Look Out for When a Transaction is Brokered

Things to Look Out for When a Transaction is Brokered

5.1 Commissions

There are up to four likely revenue streams in property financing. These include:

1. An upfront (or establishment) fee paid by the client
2. A success (or brokerage) fee paid by the client
3. A commission fee payable by the lender
4. Trail payable by the lender

A property finance transaction can have one or all four of these commission elements.

It is important that when quoting your fees you take into account all of the possible revenue streams in order to put up to the client a fair and competitive mandate.

5.2 Mandate

It is essential that you have a mandate signed by the client as this will set out the terms by which you may represent your client to potential lenders.

In preparing such a mandate, it is important to be as clear as possible in stating your fees and costs, however do not make promises relating to the success of the transaction at this time.

As the largest form of commission payable to you is in respect to the success/brokerage fee paid by the client, it is important that the mandate authorises you to collect this sum from the lender on settlement.

5.3 Capabilities

Property finance is filled with litigation in Australia. It is therefore important that you honestly work within your capabilities.

Do not forget that property finance, and in particular property development finance, is the most difficult type of mortgage finance in Australia. So, if you find yourself in a situation that is beyond your capabilities do not be afraid to ask your governing body for help.

5.4 Timing

It is not unusual for non-bank commercial finance to take up to four weeks or even more to settle. Property development finance, on the other hand, could take up to six weeks to settle.

The important point is to make sure that if you are going to work in this type of brokerage that you have either other streams of income to support you or that you have a large enough pipeline.



Module 17

Learning Exercise

Module 17: Learning Exercise

1.	These course notes are designed to provide you with an all-encompassing understanding of property finance.		
		<input type="checkbox"/> True	<input type="checkbox"/> False

2.	Tick which of the below would represent commercial investment finance:		
	Buy a warehouse for your business		<input type="checkbox"/>
	Extend your garage to make room for a business you want to start one day		<input type="checkbox"/>
	Renovate your home so that one bedroom can be used as an office to see clients		<input type="checkbox"/>
	Buy a commercial strata property in an office block		<input type="checkbox"/>

3.	Tick which type of finance is applicable to each case:		
		Commercial investment finance	Property development finance
	Buy a warehouse	<input type="checkbox"/>	<input type="checkbox"/>
	Build 6 townhouses	<input type="checkbox"/>	<input type="checkbox"/>
	Release equity in an already-owned office block	<input type="checkbox"/>	<input type="checkbox"/>
	Buy and renovate an office building	<input type="checkbox"/>	<input type="checkbox"/>
	Build a 10-storey apartment tower	<input type="checkbox"/>	<input type="checkbox"/>

4.	If the capitalisation rate for a commercial property is 8%, what is the rate of return on the investment?	
	10.50%	<input type="checkbox"/>
	12.50%	<input type="checkbox"/>
	13.75%	<input type="checkbox"/>
	15.00%	<input type="checkbox"/>

5.	Continuing this example, if the rent is \$500,000/annum, what is the value of the property?	
	\$5.00m	<input type="checkbox"/>
	\$6.25m	<input type="checkbox"/>
	\$7.50m	<input type="checkbox"/>
	\$8.25m	<input type="checkbox"/>

6.	If my adjusted future maintainable earnings are \$600,000 and the interest on my new warehouse is \$400,000, what is my interest cover?	
	1.5	<input type="checkbox"/>
	1.6	<input type="checkbox"/>
	1.7	<input type="checkbox"/>
	1.8	<input type="checkbox"/>

7.	What are the four risks that need to be boxed in for commercial investment finance?	
	The developer, the builder, serviceability, risks	<input type="checkbox"/>
	Risks and mitigants, the property, value of property, the borrower	<input type="checkbox"/>
	LVR, the borrower, serviceability, exit strategies	<input type="checkbox"/>
	The borrower, serviceability, size of property, corporate structure	<input type="checkbox"/>

	True or false?	True	False
8.	You do not need property as security for commercial finance.	<input type="checkbox"/>	<input type="checkbox"/>
9.	Commercial investment finance and property development finance work exactly the same.	<input type="checkbox"/>	<input type="checkbox"/>
10.	The character of the borrower is not important, only the value of the property is.	<input type="checkbox"/>	<input type="checkbox"/>
11.	Pre-sales in property development finance relate to the sale of units that are exchanged and settled before construction commences.	<input type="checkbox"/>	<input type="checkbox"/>
12.	Property development clients can be rich and expect you to take them to expensive restaurants.	<input type="checkbox"/>	<input type="checkbox"/>