CHAPTER 2

Structured Real Estate Financing

In a similar manner to project finance operations, structured real estate finance involves the funding of a transaction in which the bank accepts the cash flows generated, or which may be generated, from the property financed as collateral for the repayment of the debt.[1]

The due diligence carried out by the bank when granting these loans involves an assessment of the economic and financial equilibrium of a specific real estate asset or project, which will preferably be legally and economically independent of the other initiatives carried out by the sponsors which conclude the transactions. The real estate project to be financed will generally be implemented by its sponsors by creating a special purpose vehicle (SPV) which permits the investment to be separated in economic and legal terms.

A real estate project is assessed by the banks and its sponsors principally with reference to its capacity to generate revenues from the lease and/or sale (also partial) of the properties financed. The cash flows associated with the real estate transaction provide the source for servicing the debt as well as paying a return on the equity capital invested by the sponsors.

The guarantees may be real (e.g. pledge on SPV shares, mortgage on the property) or contractual (e.g. assignment of receivables as collateral, contractual covenants), although it is the contractual guarantees which actually assure the banks that the cash flows generated by the real estate asset will be the primary source for servicing the debt. These loans may be of two different kinds.

- *Non-recourse* or *without recourse*, when no right of recourse is specified (for example through the issue of guarantees or comfort letters) against the sponsors of the project or third parties. The capacity of the real estate project to generate sufficient cash flows (which are only potential in cases involving development projects) in order to repay the debt, along with a contractual structure that guarantees the success of the real estate investment and the repayment of the underlying debt, are the main elements to be assessed by the lending banks.
- *Limited recourse*, that is with recourse limited to situations in which rights of recourse are provided against the sponsors or third parties upon occurrence of situations specified in advance under contract. For example, in a development project where construction costs are only partially financed by the bank, the latter will demand from the sponsors a commitment or a guarantee to inject into the project both any capital shortfall arising during the construction phase, as well as funds to cover unexpected costs.

[1] Vinter (1994).

Obviously, the bank will also carry out a financial credit check for non-recourse loans in order to verify the solvency of the shareholders and/or of the financial group of the borrowing company. The aim is to avoid any default by the transaction's sponsors affecting, even indirectly, the real estate project financed as well as to assess the resoluteness and reliability of all parties involved in the transaction.

The cash flows result from rent (either property leases or going concern leases), whilst in development projects they will be generated from the sale (or lease) of the individual units when construction work has been completed.

Debt financing is generally available for all types of real estate, provided that they can generate cash flows, both actual (for existing income producing properties) or expected (for development projects). Accordingly, the following properties, existing or to be developed, will be eligible to be financed:

- offices;
- high street retail/shopping centres/retail parks/factory outlets;
- entertainment centres/theme parks;
- multiplexes;
- hotels;
- logistic warehouses and industrial;
- retirement homes;
- residential portfolios (to rent and/or to sell).

The loan may be intended to support construction costs or to pay the acquisition price. In the former case, it will be necessary to provide a precise estimate of the costs of the project and of the cash flows which the property may generate once completed: the granting of the loan may also be conditional upon the sale of units successfully sold (particularly in case of residential development projects). In the latter case, it will be necessary to pay particular attention to the relevant clauses in the lease agreements.

The capital structure of a real estate project may be made up of three parts:

- equity (shares and shareholder loans);
- debt capital;
- hybrid financing (mezzanine finance and preferred equity).

The debt amount financed will mainly depend on three elements:

- the reliability of the borrower;
- the transaction for which the loan is intended and its operational risk;
- any guarantees provided.

This amount may be granted as one single credit line, although alternatively secondary credit lines may also be granted, such as for example a specifically dedicated VAT line.

In all cases, the equity that is to be injected by the sponsor cannot usually be less than 20–30% of the overall cost of the property. In development projects, this equity level often corresponds to the acquisition cost of the area to be developed. Since lower equity percentages will entail higher leveraging and higher risks for the bank, credit lines exceeding 70–80% of the construction cost (also defined as mezzanine finance) come with significantly higher costs.