Property Finance: An International Approach

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Introduction to Property Financing

Chapter 1

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1.1 Forms of Financing: Debt and Equity

Debt	Equity
An amount of money borrowed by one party from another. A debt arrangement gives the borrowing party permission to borrow money under the condition that it is to be paid back at a later date with interest.	All forms of capital contributed by shareholders and any money pertaining to such contributions. In addition to paid-in capital or contributed capital, equity also includes retained earnings and treasury stock, if any.

1.1 Forms of Financing: Debt and Equity

Debt	Equity
• Contractual definition of an explicit cost • No link between debt cost and actual return of the financed investment • Contractual determination of repayment procedures and maturity • Tax deductibility of debt interests contributing to enhance the equity's return by reducing the tax burden	• Implicit opportunity cost • Remuneration depends upon actual economic performance and it is payable after all other investors • Lack of a maturity date for repayment and of any formal obligation to repay
• Even in absence of tax benefits, debt financing is used for: i) capital rationing ii) risk diversification iii) increase in projected earnings in return for a greater risk iv) greater control over management	• Non-tax deductibility • Expected remuneration depending on the overall risk, including the operational risk (investment type, procedure, and sector) and the financial one (amount of capital with higher seniority than equity)

1.1 Forms of Financing: Debt and Equity

Debt in Real Estate Financing

- ✓ High debt-financing use due to capital rationing constraints of operators
- ✓ Preference of tax-exempt investors for debt financing for reducing the portfolio risk concentration given the absence of tax shield benefit
- ✓ Good suitability between properties and high debt financing because their value is easily quantifiable and they represent sound collateral for mortgage guarantees
- ✓ Lower bankruptcy cost than in other sectors
- ✓ Favorable disposition of lenders towards financing properties because of the risk reduction, even if the guarantees value depends on the law frame and on the timing for enforcement procedures

1.1 Forms of Financing: Debt and Equity

Debt in Real Estate Financing

Two main categories of financing categories among the different forms of RE financing agreements tailored to the individual operation, the parties involved, and market conditions:

1. **financing instruments** identifying a **specific contractual form** (i.e. mortgage loans, financial leases or ordinary shares)

2. **financing techniques** which specify methods made up of **multiple instruments** (i.e. hybrid mezzanine financing with a mortgage loan and an equity kicker)

1.2 A different approach to property financing

	Advantages ✔	Drawbacks ✗
Equity	Entitlement to control or manage the transaction	Subordinated right to repayment
Debt	Priority right to repayment	Less control (or indirect control only through covenants and guarantees)

1.3 Corporate Finance versus Project Finance

	Corporate Finance	Project Finance
Focus	Reliability of the borrower in terms of management capability	Project's ability to generate cash flows
Example	Loan	Investment Project
Adopted Approach	**i) Pure Corporate Finance:** focus on a loan disbursed to one party **ii) Asset Based**: lending activity is directly associated with a specific asset (i.e. mortgage loan or financial lease) **iii) Cash Flow Based**: loans are disbursed to a project (i.e. RE developments or projects under concession as Private Public Partnerships)	Assessment of the project future capacity to generate cash flows to make payments for remunerating investors

1.3 Corporate Finance versus Project Finance

	Corporate Finance	Project Finance
In or off balance?	Inside the balance-sheet of lenders and sponsors	Legal and financial separation from other assets of the sponsors through the creation of a dedicated SPV
Creditworthiness evaluation	1) Assessment of the economic and financial equilibrium of the company/borrower 2) Impact of new investments and the relative financing 3) Evaluation of the company's future performance by identifying the internal factors and the external factors	Assessment of the economic and financial equilibrium of the project to be financed

1.4 Bank Financing

1. **Property loans granted to private (retail clients)**
   (a) for the purchase of a residential property
   (b) to refinance the purchase of a residential property with a new loan
   (c) to provide liquidity in order to cover an expense or home refurbishment

2. **Property financing granted to companies intended to cover the company's financial requirements**
   (i.e. new investments or capital expenditures on existing properties/investments)

Bank's due diligence focuses on the capacity of the borrower to generate sufficient income to repay the loan (corporate finance approach).

3. **Structured property financing granted to companies or real estate funds (including SPVs)**
   (a) to finance the acquisition of an income producing property or a trading portfolio of properties (investment)
   (b) to finance the construction costs of properties to be leased or sold (development)

Bank's due diligence focuses on the property and its immediate or projected capacity to repay the loan through the income generated from lease or sale (project finance approach).

1.5 Fund raising, securitization and syndication

Fund raising ➔ a necessary activity by which the bank collects money on the market in order to reallocate it to the disbursement of real estate loans

Securitization ➔ process of conversion of illiquid assets into securities which can be readily traded on the security market

Loan syndication ➔ the procedure whereby the initial lending bank shares the loan with other banks, or assigns all of the amounts due through securitization. Syndication and securitization are optional activities

1.5 Fund raising, securitization and syndication

1.5.1 Traditional funding and securitization

	Traditional Funding	Securitization
How?	The bank grants the borrower the loan and the relative receivable remains due to the bank for the full loan term	Conversion of various forms of assets into securities which can be readily traded on the market
Features	• The relationship between the bank and the borrower has the same duration as the loan • The value of loans granted is directly proportional to the banks' assets • Any default by the borrower will affect the lending bank	• The banks assign their loans to third parties which issue notes on the market in order to finance the operation • No interest of the lending bank in attending the fund raising activity nor in establishing a lasting relationship with the borrower • Any default by the borrower will affect the parties which bought the notes issued on the market, but not the lender

1.5 Fund raising, securitization and syndication

1.5.2 Funding for RE loans and syndication

	German System	French System
What?	Close relationship between the fund raising activity and the lending activity	Separation between the fund raising activity and the lending activity
How?	Covered Bonds	Recourse to the interbank market in order to raise funds at a cost which depends upon the market's perception of the risk (rating) of the borrowing bank

1.5 Fund raising, securitization and syndication

Covered Bonds Main Features

- ✓ Guarantee of a return on capital and interest since part of the bank's assets are dedicated for their remuneration and repayment
- ✓ Impossibility to remove the transaction from issuer bank's balance sheet with attribution of the credit risk to the bank
- ✓ Greater security compared to traditional bonds, and consequently greater liquidity accompanied by higher ratings and lower returns
- ✓ Lower return compared to long-term fund raising systems: covered bond holders may enforce their rights directly against the assets set aside which are beyond the reach of the bank's other creditors
- ✓ Guarantee relating to the ring-fencing of the receivables assigned to the vehicle which ensures that they will be dedicated, along with the cash flows, exclusively to satisfy the subscribers of the covered bonds
- ✓ Guarantee of the issuing bank relating to its assets and a self-standing commitment by the vehicle in the event of default by the issuer

1.5 Fund raising, securitization, and syndication

1.5.2 Funding for RE loans and syndication

If the lending bank is not able or willing to underwrite the loan in full, or if it is required to reduce its credit exposure towards certain clients or sectors, it will be necessary to involve other banks: this operation is generally referred to as "Syndication".

1) **Club Deal** when syndication occurs upon conclusion of the loan agreement: the operation will be concluded in a pool with other banks. In such cases it is settled practice to conclude an interbank agreement, also specifying which bank is to act as the agent bank with the task of coordinating the interaction
   → **No default risk**

2) **Other cases** when syndication occurs after the loan agreement is concluded. When it is not possible to wait for a long time, the bank will finance the transaction with a bridge loan. Before the bridge loan matures the bank and/or the borrower will contact the other banks in order to make provision for the mortgage on a pooling basis with a long-term loan which will redeem the existing loan
   → **Potential default risk**

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