Property Finance: An International Approach

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Structured Real Estate Financing

Chapter 2

Agenda

2.1 Introduction

Structured RE Financing (project finance approach)

Definition	Transaction in which the bank accepts the cash flows generated from the property financed as collateral for debt repayment
Implementation	Creation of an SPV
Suitability of the project	With reference to its capacity to generate revenues from the lease and/or sale of the properties financed
Types of guarantees	1. Real (i.e. pledge on SPV shares, mortgage on the property) 2. Contractual (i.e. receivables as collateral, contractual covenants) 2.1 Without recourse 2.2 Limited recourse
SPV Capital Structure	• equity (shares and shareholder loans) • hybrid financing (mezzanine finance and preferred equity) • debt capital
Determinants of the amount financed	• reliability of the borrower • operational risk of the transaction • any guarantees provided

2.2 Agent Bank role in a syndicate

In case of a large debt amount there might be the need to arrange a syndicated loan because it cannot be provided by a single lender in terms of volumes and risk levels.

A bank will receive a mandate as syndicate manager from the borrower. Concluded the agreement with all the participating banks, the syndicate manager is usually appointed as the **agent bank**, i.e. the bank which manages the relations with the borrower for the full term of the loan.

Agent Bank Activities

- ✓ monitoring compliance with covenants
- ✓ collection of installments
- ✓ reports to oversight authorities
- ✓ recovery actions
- ✓ notification to other banks of advances/drawdowns by the borrower
- ✓ all activities concerning the conclusion of agreements

2.3 Bank loan contractual forms

1. **Bank account overdraft facilities** where amounts exceeding those deposited may be withdrawn, thus giving rise to account overdrafts (negative balances for the borrower and positive balances for the bank)
    a) unsecured overdrafts
    b) secured overdrafts
    c) documentary overdrafts
    d) revolving secured credit lines → most flexible form of financing for RE development/refurbishment projects
    e) revolving unsecured credit lines
    f) bank account advances on stocks or goods
2. **Fixed maturity loans**: such loans are disbursed in one or more predetermined installments and must be repaid at specific maturity dates

2.4 Loans for development projects

An initial conditional loan agreement specifies the **term of the loan** and the duration of the initial **pre-amortization period** (construction work phase).

Subsequently, **individual loan installments will be disbursed during the pre-amortization stage**.

Upon conclusion of construction works, a definitive loan agreement will be concluded, which will regulate the capital repayments for the sums financed, determining:

- interest rate
- frequency of repayments
- definitive terms of the loan

2.5 Stages of a structured loan

1. Meeting between the bank and the borrower in order to analyze the RE project
2. Technical appraisal and feasibility analysis:
    - analysis of expected costs and revenues
    - market and catchment area studies
    - analysis of operating income and definition of the financial plan
    - estimate of open market value and mortgage lending value of the property
3. Financial due diligence or solvency analysis of the parties involved
4. Legal and tax due diligence
5. Identification and finalization of risk mitigation instruments (security package, insurance policies, hedging of interest rate risk, contractual covenants)
6. Identification of the transaction's credit risk in accordance with Basel Accords
7. Loan pricing and issue of an offer to the borrower
8. Negotiation
9. Conclusion of the agreement, issue of guarantees and insurance policies
10. Monitoring of the loan
11. Syndication or securitization of the loan, if necessary

2.5 Parts and stages of a structured loan

2.5.1 Analysis of Transaction and Term Sheet

The information exchanged between the bank and the borrower during the initial negotiations regards:

- description of the project’s sponsors
- illustration of the structure of the company applying for the loan (borrower)
- project business plan,

with the presentation of an **information memorandum** (single document setting out the details of the RE project to be financed along with the project’s sponsors and a working proposal for its capital structure)

During the meetings with the bank, the borrower may ask the bank to draw up a document setting out the main terms and conditions of the loan, named as the **term sheet**.

It is updated when the real estate project is finalized and during the loan negotiations.

2.5 Parts and stages of a structured loan

Typical Term Sheet content

- ✓ amount and term of the loan
- ✓ max % of LTV and/or min ICR and/or min DSCR
- ✓ % of the purchase price/construction costs (loan to cost)
- ✓ purpose of the loan and property description
- ✓ forms and procedures regulating the drawdown and the repayment of the loan
- ✓ determination of the applicable interest rates, margin and fees
- ✓ interest hedge (in case of variable interest)
- ✓ repayment
- ✓ main rights and obligations of the parties
- ✓ covenants
- ✓ events of default
- ✓ any other terms and conditions and choice of law/jurisdiction

2.5 Parts and stages of a structured loan

Term Sheet from a legal point of view

Settled view → pre-contractual act which is capable of establishing a pre-contractual liability and an obligation to compensate damage as protection for the legitimate expectation created for the counterparty

Neither the delivery nor the acceptance of term sheet nor any previous or subsequent discussions will create any obligation by the lender with respect to the transaction described in this term sheet.

In this way (no binding offer) the term sheet is not considered (in most jurisdictions) an offer. The above applies unless the borrower requests a binding commitment, that is an irrevocable proposal corresponding to a binding commitment by the bank.

Though it does facilitate the parties during negotiations, the signature of the term sheet is not essential in order to conclude a financing agreement.

2.5 Parts and stages of a structured loan

2.5.2 Real Estate Valuation

Estimating the value of properties involves ascertaining its value as expressed in monetary terms with a double determination:

- **Open Market Value** (OMV) defined as "*the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion*" (RICS Red Book)

- **Mortgage Lending Value** (MLV) defined as "*the value of property as determined by a prudent assessment of the future marketability of the property taking into account long-term sustainable aspects of the property, normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the Mortgage Lending Value*" (TEGoVA)

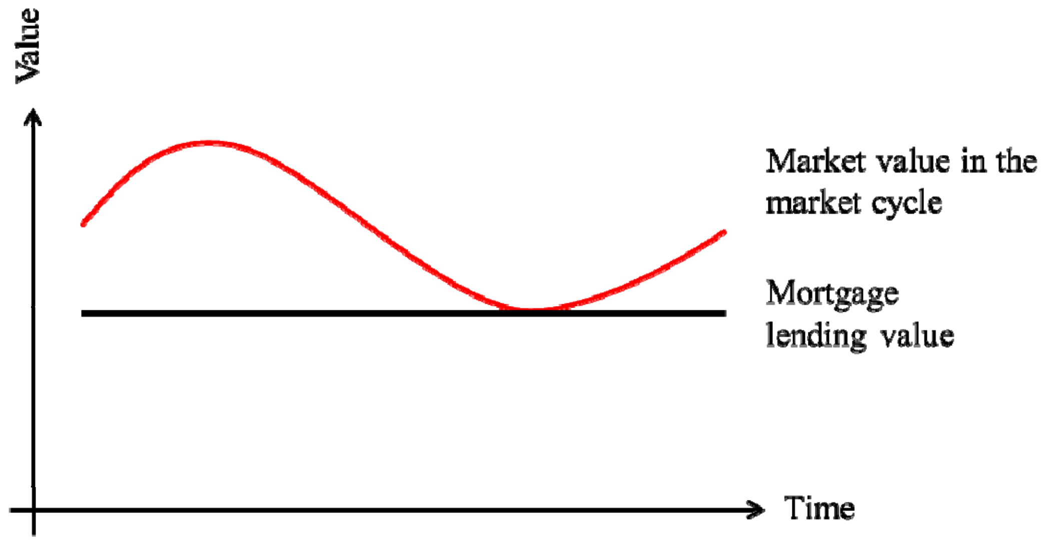
2.5 Parts and stages of a structured loan

MLV key facts

- ✓ long-lasting/sustainable value limit used by the financial services industry in the credit decision process and in risk management defined in detail by legislation, directives and additional country specific regulations
- ✓ defined by adaptation of the rental income to a stable obtainable rent level based on the current use of property, adjustment of the capitalization rates to the long term market development and customization of the management costs
- ✓ regarding its technical transposition, the long-term validity of MLV requires some precautions aimed at eliminating short-term market volatility or temporary market trends, namely:
  - Careful and prudent assessment of the future marketability and salability of the property
  - Calculation of the rental income on past and current long-term market trends without taking into account any uncertain elements of possible future yield variations
  - Exclusion of all short-term expectations regarding the return on investment
  - Application of a minimum depreciation rate for administration costs and capitalization of rents
  - In case of derivation through comparison values or depreciated replacement costs, need for the application of appropriate discounts

2.5 Parts and stages of a structured loan

Differences between OMV and MLV



OMV → point-in-time assessment of the value of a property

MLV → long-term sustainable value, evaluating the suitability of a property as a security for a mortgage loan independently from future market fluctuations

2.5 Parts and stages of a structured loan

2.5.3 Basics of Property Appraisal

Comparison Approach	**Sales Comparison**	Value of an asset based on comparable transactions with the assumption that no rational buyer will pay a price higher than the cost of buying similar assets → mainly for residential units
	Hedonic Models	Regression models based on the notion that supply and demand for heterogeneous assets are comprised of supply and demand for each characteristic of those assets → not frequently used, mainly for research or in residential mass appraisal
Cost Approach	• Assumption that no rational buyer will buy a property at a price higher than the cost of land in the same area plus the cost of building a comparable property, after accounting for the value loss in value resulting from depreciation → **NO MV** • Principle of highest and best use → the value of an asset is dependent on the most probable use which is physically possible, financially feasible, and legally permitted and which offers the highest return on investment	
Income Approach	**Direct Capitalization**	Principle of expected future economic benefit → presupposition of the determination of an economic benefit (which may be defined as single income or future cash flows), i.e. the rental income, and a time coefficient which takes account of risks inherent in its future economic benefit (capitalization rate or discount rate)
	Financial (DCF)	

2.5 Parts and stages of a structured loan

2.5.3.1 Comparison Methodologies

Necessary assumptions:
- ✓ sufficiently broad historical set of transactions relating to similar assets
- ✓ possibility to identify the characteristics contributing to determining property value

Approaches:

1) Multiplier Approach, adopted when determining the value of a given business, rather than a specific real estate asset. The valuation will generally refer to the business's core operations and the characteristics of the property used for it. The object of the valuation will therefore be both the property and the business carried on within it (i.e. cinema, sports centre, hotel...).

2) Sales Comparison Approach, which estimates the value of a property on the basis of prices of comparable properties, recently sold at normal market conditions (excluding prices resulting from testamentary succession or, normally, from auctions)

1. selection of comparable properties taking into account elements affecting supply and demand, physical characteristics and location
2. normalisation of the sale prices for comparable properties
3. adjustments

2.5 Parts and stages of a structured loan

2.5.3.2 Cost Methodologies

Assumption:

✓ Calculating the value of a property is equivalent to looking for the correct value of the property originally built to which the value of the land is added

Steps:

1) Calculation of the cost of rebuilding the property as new, breaking up the number of sqm. into different components and multiply the surface area of each component by the relevant construction cost
2) Quantification of the property's loss in value compared to the cost of rebuilding
   i. wear and tear (depends on its age, building quality, level of ordinary and extraordinary maintenance, and use)
   ii. functional obsolescence (i.e. the failure of the property to meet up with the functional requirements of contemporary buildings)
   iii. economic obsolescence (necessary to assess whether there is real demand for this property or whether there is no demand for some of its characteristics)

2.5 Parts and stages of a structured loan

2.5.3.3 Income Methodologies

Assumption:

- ✓ value of a property as a function of the future economic benefits which it will be able to produce over the course of its lifetime

Two different criteria:

1) Direct Capitalization Approach used in order to convert the forecast for expected income over one single year into an indication of value, whereby the estimated income is divided by an appropriate capitalization rate (one income and one rate)

2) Financial Approach (based on DCF) used in order to convert all future economic benefits into a present value, discounting all expected benefits (cash flows) at an appropriate discounting rate (expected total return)

2.5 Parts and stages of a structured loan

2.5.3.3 Income Methodologies

	Direct Capitalization Approach	Financial Approach
Definition of economic benefit	Accounting measure of income (revenues)	Cash flow
Time horizon	Determination of the value of an asset through an annual income and a capitalization rate related to this single reference period	Analysis extended to more than one period
Calculation algorithm	Capitalization of a future benefit, transforming a current indicator of income into an indicator of value	Discounting principle in order to anticipate future cash flows
Rate	Capitalization rate, which compares the value of an asset with one single-period income	Discount rate, which represents the total return required by the market for an investment with the same risk level
Return	Expected yield, that is a measure of income return only (yield equal to income divided by price or OMV)	Expected IRR, i.e. a measure of total unlevered return (including both income and capital gain returns)

2.5 Parts and stages of a structured loan

2.5.3.4 Choosing the correct approach to valuation

	Approach
Commercial properties	Conjunction between the Comparison Approach and the Income Methodologies
Residential properties	Comparison Approach
Atypical assets	Cost Approach → NO MV
Residual value of an area	Cost Approach (Residual value with Financial Approach)

2.5 Parts and stages of a structured loan

2.5.4 Due Diligence

Basic Due diligence	a) carry out an administrative check, regarding commercial permits (if required) or verifying the status of the application to obtain those permits b) review the compliance with the town planning requirements and building regulations, including consultation as well as an analysis of the relevant permits c) review mortgage and land registry documents d) structural and technical plants check on the building and its facilities as well as of the state of maintenance e) carry out an environmental check f) check the energy certification documents and certificates
Legal Due diligence	a) full ownership of the property to be mortgaged by the party offering the security b) property is not subject to any other securities or charges, or any other formality specified in the public land registers which may be otherwise detrimental to the mortgage security c) legal capacity of all individuals involved d) lease agreements e) corporate and tax due diligence (SPV)

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