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Property development finance

It is a truism to state that finance is a critical resource in the process of property development. Nevertheless, when compared to the other resources that combine to produce a development scheme, there often appears to be a disturbing lack of proper understanding about the sources and types of finance for construction and property development, and the arrangements and procedures that accompany them. This is of growing importance, for not only are the margins between revenue and expenditure finer than ever before, but those responsible for providing the bulk of finance to the industry are much more closely concerned, and a great deal better informed, about the management of construction and development projects than they have been in the past. Consequently, they expect and demand development agencies, and those involved in managing their projects for them, to be equally well versed in the evaluation and control of the financial structure and progress of a scheme of development. This is as important as never before. The credit crunch which began in 2007 caused lenders to make much more rigorous demands of borrowers than they had in the preceding few decades.

A variety of ways exist in which finance for property development can be obtained from a wide array of agencies. The choice normally rests upon the status of the developer and the degree of risk attached to the proposed project. It can almost be stated that every deal dictates its own terms, but for convenience, and to facilitate description, several general areas have been identified below in order to consider the more conventional relationships established between borrowing developers and lending financiers.

In order to explore the increasingly complex subject of property development finance, the chapter is organized as follows:

- Sources of development finance
- Types of finance
- Criteria of funding
- Choice of fund
- The financial agreement
- Trends and prospects.

Sources of development finance

Most developers will have access to existing sources of finance. Larger companies will usually have multiple funding arrangements with a variety of financial agencies. Nevertheless, the field is becoming so complex and competitive that effective project management is increasingly concerned with the way in which control over a particular scheme will be influenced by the origin and nature of the development finance.

The following selection of possible sources of development finance has no pretensions to be exclusive or exhaustive. However, it does provide an indication of the principal sources that are currently available to the aspiring developer.

Insurance companies and pension funds

Insurance companies and pension funds enjoy a relatively high degree of stability in the availability of funds for investment in development projects, but take a longer-term and more cautious view than most other lenders.

The most popular form of finance provided by the insurance companies and pension funds is the 'forward sale', often coupled with short-term bridging finance at preferential rates. Some funds are also prepared to enter into 'sale and leaseback' arrangements, mortgage advances or an overall borrowing facility.

The lending policies of those financial institutions are characterized by their 'project-based' nature. This means that they tend to exercise extremely tight control over the entire project, including the land acquisition, design, construction and sale or letting programmes. Financial arrangements themselves are almost pre-ordained in terms of yield, interim fixed-rate loans, pre-letting and forward sale. Because of these constraints, a developer might experience problems in maintaining authority, especially once a purchaser or tenant has been found. This situation is further exacerbated where the fund appoints a consultant to monitor development, as happens increasingly.

Another feature is that, because institutions are such big investors in new development, they will usually look for fairly substantial schemes in which to invest. And, not surprisingly, the larger the fund, the larger the average size of scheme financed. But, by far the greatest hurdle a proposed development project must clear before it attracts institutional finance from either an insurance company or a pension fund is that it must be competitive when compared to other forms of investment such as equities, gilts and other forms of property.

For a developer, this provides a more open and flexible climate in which to work, where such factors as time, cost and quality can be traded off against the client's ability to generate funds or produce additional collateral. Bank finance, therefore, must be carefully tailored to fit the purpose to which it is applied, and a well designed package must be prepared to meet overdraft, term or equity financial requirements. Sometimes the additional flexibility afforded by more expensive arrangements is worthwhile.

Some clearing or retail banks became over-committed to the property development industry during the boom years of the 1980s, 1990s and early 2000s and found themselves embarrassed by the experience – none more so than those who lent to sub-prime borrowers in the early to mid-2000s, especially those in the USA. This encouraged them to step aside in the 1980s and 1990s and to retrench somewhat in 2007 and 2008 as a rapid reduction in liquidity in lending markets caused a reduction in the availability of development finance, as well as a hardening of the terms upon which any available finance was offered. Nevertheless, they show a propensity to return quite quickly to the market once a resurgence is evident, and a similar trait to retreat at the first signs of a slump. Although their policies vary widely, not merely between different houses, but within individual banks, they are generally a great deal more flexible and adventurous than the insurance companies and pension funds, being willing to consider, for example, the refurbishment and redevelopment of older buildings and the development of less conventional commercial properties. One principal reason for this is that a clearing bank is as interested in the business as it is in the property, if not more so. This applies whether the business is the intending occupier or a property development company.

Merchant banks have a reputation for having an even more enterprising approach towards development finance. Being concerned primarily with supplying short- and medium-term money to the development industry, they have evolved packages for linking their short-term lending with other investors' longer-term aspirations. Most leading merchant banks have established their own specialist property investment departments capable of tailoring bespoke financial arrangements to suit the individual needs of a particular developer. In this way, it is by far the most sophisticated sector of the institutional finance market. The more refined yet venturesome stance of the merchant banks is reflected in the high cost of borrowing from them, and their relative opportunism in respect of equity participation. Because of the risks which they are prepared to adopt and the international nature of their activities, the credit crunch which began in the USA and spread elsewhere rapidly thereafter in 2007 hit them harder than other lenders and caused development finance from this source to diminish significantly.

One of the more lucrative activities recently undertaken by merchant banks is arranging funding packages or syndications, which are then dissipated to other banks. Indeed, it has been reported that in this way some banks can make up to half their income from fees.

Trusts and bonds

Within the category of trusts and bonds can be included real estate investment trusts, investment unit trusts, property unit trusts and property bonds. The structure and purposes of these different media for investment are not explained in detail here, because from the standpoint of the developer their policies and practices are much the same and largely resemble those of the insurance companies and pension funds. However, their performance has been extremely variable, and their role in the development field is as yet not great.

Internal finance

Even though it is often alleged that the first rule of the developer is 'never use your own money', quite commonly property development agencies either deploy their own surpluses and reserves to support current projects or seek an expansion of their capital base.

Almost by definition, virtually all development undertaken by the major financial institutions, directly or by way of joint venture, can be categorized as internally financed. Similarly, many construction firms acting as developers use their own financial resources to fund projects, as do certain leading business and retail organizations. Funding by prospective owner-occupiers in all sectors of the commercial property market is quite popular. For as long as the capital is available, the risk acceptable and the opportunity cost satisfactory, internal finance has the great attraction of ensuring full recoupment of future rental growth.

A property development company can extend its capital base by increasing its share capital or its loan capital. In simple terms, the holders of the share capital (equity) own the company itself, and the holders of loan capital are creditors of the company. Thus, the holders of share capital are not creditors and have no security, and the holders of loan capital have no rights in the company beyond the receipt of interest and the repayment of the loan in accordance with the terms on which they were issued. The amount a company may borrow by way of loan capital is laid down in the articles of association of the company. There are two principal types of loan capital: debenture and loan stocks. Debentures and debenture stocks are roughly similar to mortgages and are secured either on certain specific assets of the company or as a floating charge over all the company's assets. Secured debts of this kind rank for repayment before unsecured debt in the event of the company being wound up. Unsecured loan stocks, the other form of loan capital, are debts, as their name implies, which are not charged on the company's assets. If the company falls into liquidation, they rank after secured loans along with other general creditors but before the holders of share capital. One kind of unsecured loan stock carries with it the right to convert into share capital on pre-arranged terms and within a limited period: this is known as convertible unsecured loan stock and it comes with a variety of conversion rights. A final form of fixed income company finance is preference shares, which do not form part of the loan capital, and on a winding-up do not rank for repayment until all creditors have been paid in full. Again, there are various types of preference shares, such as 'cumulative', where the right to a dividend can be carried forward from one year to another; 'non-cumulative', where once a dividend is passed for one year the right to receive it is lost; and 'participating' preference shares, where there are rights to share in profits above the fixed dividend.

The share capital held as ordinary shares is usually referred to as the equity. Equity in this sense means that which remains after rights of creditors and mortgagees are cleared and, although different forms of share capital exist, most public property companies do not have very complex share capital structures. The risk-bearing nature of equities is reflected in the 'gearing' of a company, that is the ratio of loan or fixed income capital to share or equity capital. In a period of growth and profitability, in a highly geared company, where loan capital is proportionately greater than share capital, holders of ordinary shares gain commensurately. In bad times, the reverse is true, and profits can easily be wiped out.

A detailed examination of how capital can be raised on the stock market is beyond the scope of this text. Suffice it to say that there are two types of new issue by which this can be achieved. First, the bringing to the market of companies that have not previously been quoted. Second, the raising of additional capital by companies already quoted. The former will normally be effected by an 'offer for sale', whereby an institution such as a merchant bank buys a block of shares from the existing shareholders and offers them to the general public at a fixed price; by a 'placing', where an institution may buy the stock or shares and arrange for the placing of the issue with various funds or companies known to be interested; an 'introduction' when a company already has many individual shareholdings and Stock Exchange quotation simply provides a public market for shares that previously could only be dealt in privately; or a 'tender', which is exactly the same as an offer for sale except that the price of the shares is not fixed in advance.

One way in which companies already quoted can raise additional internal funds without increasing their debt charge is the issue of further equity capital. This is normally done by way of a ‘rights issue’, that is, the issue of shares to existing shareholders at a concession.

The performance of the stock market in the early years of the twenty-first century has prompted some property companies to ‘de-list’, i.e. buy back their shares and withdraw from the stock market, because their view is that the value of their property assets is not effectively reflected in the value of the company’s shares.

As with most financial matters, the question of timing is important, not merely in respect of the general climate for borrowing but also the class of capital to be selected. In times of depressed equity prices, a rights issue is normally to be avoided and, if interest rates are at a reasonable level, a prior charge to increase loan capital is usually preferable. Conversely, when equity prices are high, leading property companies might be best advised to make a rights issue rather than increase their loan capital. However, it must be remembered that, although substantial sums can be raised from the market, the costs involved may be considerable, comprising not only the legal and valuation fees but also the costs of underwriting the issue, producing a prospectus, advertising and stockbrokers’ charges.

It is in the field of internal or corporate finance that most innovation has been shown by property development companies over recent years. The range of devices, instruments and techniques has appeared endless, with many American mainstream corporate financing practices being adapted and adopted in global financial markets. The amount of ‘commercial paper’ issued by property development companies since the late 1980s has been enormous, largely because of its low cost, high flexibility and simplicity to the borrower, and its competitive yield, liquidity and range of maturities to the lender. However, the inherent dangers of such promissory activity were apparent in a period of worldwide recession during the first half of the 1990s.

The construction industry

Development finance is commonly supplied by the major building firms, either directly from their own cash reserves or through sources with whom they have a funding facility. From a pure funding point of view, this form of finance can be very attractive, because the loan-to-value ratio will often be very high, to include the cost of land acquisitions, building costs and fees. Speculative work will also be considered, and the debt rolled up at a small mark-up on the cost of finance to the construction company. From the stance of the developer, however, it is very important to be assured that the right contractor, on the right building contract, is appointed to work to the right price. There is always the danger that the authority of the developer and his project manager is diminished where the contractor is also the funder.

Conversely, this familiarity with the property development industry can often be an advantage and help limit risk. Such collaboration is often the result of a limited loan, say 70 per cent of cost, on the part of a bank, and the need by the developer to fund the shortfall through the good offices of an established construction company. Increasingly, this form of finance takes the form of a joint venture between the two parties. On the other hand, the degree of accountability on the part of the contractor during the construction stage and upon completion is likely to be heightened, and the extent of financial control throughout the building period much tighter than normally experienced. A construction company, however, will normally need to see a clearly identifiable exit in the form of a long-term take-out by a financial institution.

Property companies

A less familiar means of obtaining short-term finance is through one of the larger property investment and development companies. This can be by direct loan or by guarantee, and the principal motive is usually a desire to participate in the equity of the project. Apart from an erosion of profit, another disadvantage is that, as far as the developer is concerned, his funds are coming from a source thoroughly conversant with all aspects of the development process, who is likely to exercise an unusual degree of scrutiny.

Government

In a period of continuing worldwide public sector spending constraint, governments find themselves with little enough money for their own national and municipal development projects, let alone to be in a position to fund the private sector. Nevertheless, grants and loans are made available in certain circumstances, and projects are supported in other ways.

The Private Finance Initiative (PFI) is a long-term concession used by the UK government to capture private capital to fund public projects. Instead of following the usual practice of borrowing money, the government commissions services, not buildings or other works, and the contractor (usually a consortium) carries on providing that service for a pre-defined period of time (frequently more than twenty years). Thus public projects are paid for out of annual revenue rather than capital budgets.

Most straightforward is the direct provision of total development finance, which is usually undertaken to promote ventures that would not otherwise attract commercial funds. Government can also provide financial assistance to new or established businesses through loans for land and buildings. A method employed in many industrial development projects has been the ‘headleasing’ arrangement, whereby a government agency takes a lease from the developer to guarantee rental income and then sublets the floorspace to occupiers.

It may be that a government agency acts as a conduit to other funds. Many cities in various countries now offer incentives to encourage firms to invest in designated areas to promote economic and physical regeneration. This includes guaranteeing long-term loans for the conversion, improvement, modification or extension of existing buildings. Some local government authorities have also set up their own enterprise boards to stimulate economic activity. This often includes an extensive programme of property development and refurbishment projects, either independently or more usually in partnership with the private sector.

Another way in which a local government authority can participate in the overall funding of a scheme, without committing actual cash resources, is by providing land already in their ownership. Similarly, although there is a cost to the authority, the supply of certain kinds of directly associated site infrastructure may often be seen as a financial contribution to a development scheme, and treated accordingly in any negotiations surrounding the apportionment of profit.

There is really no limit to the potential sources available to borrow money for property development. Trading companies, financial services firms, charities, churches and wealthy individuals, either alone or in consortia with others, are but a few. Given sufficient time, therefore, a developer could unearth many sources of finance. Indeed, considerable time and effort can often be wasted by directing attention towards inappropriate sources, and it is surprising what an imperfect market the development industry is in respect of a central pool and comprehensive understanding of sources of finance.

Types of finance

Traditionally, the different types of development finance have been examined within the classification of short-term, medium-term and long-term. Although this remains a perfectly acceptable approach, it tends to oversimplify what has become a more sophisticated and complex market. Indeed, so refined are some funding arrangements that it is increasingly difficult to place them in any particular category, except their own. However, the following description attempts to outline the main methods currently employed in the financing of development.

Development finance

Development finance is also known as building, bridging or construction finance and is used to describe the short-term interest-bearing loans made for periods of anything up to about three to four years, covering all or part of the costs of development. These costs will include land, acquisition, building works, professional fees, marketing, finance itself and any contingencies involved in the development process. Customarily, there have been two main sources for such funds, the commercial banks and the merchant banks, but over recent years other sources have been tapped and other methods of funding employed.

The banks, however, have two basic requirements. First, that the developer must show that they will be able to meet the interest charges, which will usually be ‘rolled-up’ or ‘warehoused’ until the development is completed. Second, they must show that they will be able to repay, on time, the principal sum borrowed. This latter requirement implies in most cases the availability of long-term investment funds, out of which the short-term finance may be repaid. The linking of short- and long-term finance must normally be firmly established to the satisfaction of the lender before the development finance is approved. In some circumstances, it is possible that the lending bank might be prepared to assume that long-term financing will be forthcoming before the development is completed, or that the scheme will be sold outright on completion for investment or occupation, and advance the construction finance unencumbered by a forward sale commitment.

As previously intimated, the commercial and merchant banks tend to have slightly different attitudes towards development financing though both participate in securing their own borrowing from similar sources, which caused them to shift from their traditional approaches to setting lending rates during and subsequent to the credit crunch which began in 2007. The commercial banks frequently require security over and above that derived from the project in question and traditionally have sought to exact a rate of interest based upon prevailing swap rates equivalent to about 2–4 per cent above base lending rate, depending upon the standing of the borrower. They do not usually demand an equity share and they provide a procedure that is a relatively simple and standard format, so that the loan is issued quite quickly and with comparative ease. The merchant banks, in most instances, only require the development presented to them as security, but traditionally charged a higher rate of interest at an equivalent of about 4–6 per cent above base rate or, more usually, sought to share in the equity of the scheme. In return for the additional cost of the finance, however, the developer will probably find a merchant bank more enterprising than a commercial bank in bearing risk and structuring a loan. As discussed above, the credit crunch, however, resulted in both clearing and merchant banks pulling their lending margins in 1.25–1.5 per cent above LIBOR rather than basing margins on swap rates because the climate of the liquidity crisis meant that using LIBOR gave banks a decent margin from which to exact their own profits. By 2008, sources of finance to developers was all but dried up: debt was dead and cash was king.

Short-term development finance in the institutional market is often being provided as part of a complete funding package. A fund will normally acquire a site once planning permission has been obtained and will advance development costs throughout the construction period against architects' certificates and other relevant invoices. Interim finance, as it is known, is rolled up on the various advances and is payable at an agreed rate that invariably lies mid-way between the prevailing short-term borrowing rate and the ultimate investment yield. Both parties can be seen to gain from such an arrangement. The developer enjoys cheaper finance and the purchaser is afforded more control over the design and progress of development.

Mortgages

For many years up until the early 1960s, the fixed interest mortgage was the predominant form of long-term development finance. Rapid and prolonged inflation then drove lenders away from mortgages towards methods of investment that allowed them some level of inflation-proofing through participation in rental growth. From the early 1970s onwards, high interest rates discouraged borrowers from pressing for long-term mortgage advances on fixed rates. The late 1980s and early 1990s witnessed the return of long-term fixed interest mortgage finance to the property development market. Since then, with inflation continuing to run at relatively low levels and interest rates at forty-year lows, fixed interest mortgage finance is still available. The willingness of lenders to provide fixed interest loans depends upon market conditions and can rapidly diminish during periods of interest rate volatility.

When it is available, the loan term will vary, usually running between ten and twenty-five years, depending upon the needs of the borrower and the nature of the development project, and the maximum level of advance invariably will be limited to approximately three-quarters of the agreed value of the project acting as security. For other than prime schemes it will often be less, and here lies the biggest drawback in mortgage finance, for a developer will often have

to find substantial funds from his own resources if the project in question does not meet certain standard criteria in respect of design and letting.

Unless there are immediate and reliable prospects of an uplift in rents, say within a year of the draw-down of the mortgage facility, then the lending institution will wish to be assured that the initial income produced by the development is sufficient to cover the loan servicing costs. The rate of interest attaching to a loan is usually determined at the date of release of funds by reference to a margin of 1.75–2.25 per cent over the prevailing gross redemption yield on a comparable gilt-edged security on completion. Interest is mostly payable quarterly or half-yearly in arrears.

With most mortgages there will be a choice between interest-only and interest plus capital repayments. Generally, it is only the shorter mortgages of around ten years that are on an interest-only basis; the longer-term loans of fifteen to twenty-five years normally require at least 25 or 50 per cent of the capital to be repaid during the term, although they may often begin with a five-year moratorium to allow for rental growth to take place, thereby making the debt easier to service. It is commonly accepted that the annuity-certain method of repaying or reducing a mortgage is probably the fairest and least expensive, both in real terms and as far as cashflow is concerned, as it involves an effective sinking fund under which the benefit of a compound interest rate equal to the mortgage rate is received. Moreover, some companies operate a variable rate system. Although this might seemingly be a more volatile and potentially expensive way to pay off a loan, it will usually be operated on an ‘even spread’ basis, whereby the capital repayments are calculated at a median that, if market interest rates are lower for most of the term, means the loan will be repaid early, and vice versa.

Although mortgages are commonly considered to be medium- to long-term funding arrangements, it is sometimes possible to obtain interim finance against a limited number of architects’ certificates as building works progress, in which case adjustments might have to be made to allow for fluctuating interest rates during construction. In any event, this kind of facility would only be countenanced with a pre-let to a good covenant on acceptable terms.

On the question of whether or not a developer should take up long-term fixed interest moneys, one leading specialist in arranging property finance has summarized the situation as follows:

Our advice to borrowers has always been never to rely on one particular type of finance or one particular lender. A mix of different types of finance is essential to the well-balanced portfolio and a combination of part variable-rate and part fixed-rate mortgage monies will enable the borrower to take advantage of any further fall in interest rates while protecting against an increase. What can be said with reasonable confidence is that the present interest scenario presents an excellent opportunity for borrowers to switch a significant part of their present funding to, or to organize new acquisitions on, a fixed interest rate basis.

(Burgess 1982)

As with all other forms of funding, however, mortgage finance has become increasingly sophisticated. For example, repayment patterns can be straight-term, amortized, partially amortized, graduated, renegotiable, shared appreciation or reverse annuity. Interest rate provisions can be straight rate, straight rate with escalator, or variable rate. And the types of security given might relate to what are known as deeds of trust, purchase money mortgages, open-end mortgages, participating mortgages, junior mortgages, and package or blanket mortgages. It has also been reported that financial institutions have started to provide funding in the form of debenture issues as opposed to straight mortgages. A mortgage debenture issue is a method of raising corporate finance whereby the institution makes a loan as a debenture secured against the developer's entire property portfolio. The return from the debenture may be fixed, or yield a 'stepped coupon' linked to the rental value of the property. At the end of the loan period the capital is repayable as a lump sum. This type of loan is known in banking circles as a 'bullet' loan. A variation upon this theme is the 'balloon' mortgage, where the coupon, incorporating both capital and interest repayments, increases and then decreases throughout the duration of the loan.

Two popular hybrid varieties of mortgage designed to match the requirements of lenders to the needs of borrowers are the 'convertible' mortgage and the 'participating' mortgage. These are employed where a borrowing developer is seeking to improve the conditions relating to the loan to value ratio, or the rate of interest, by surrendering a portion of equity or profit. Both the convertible and the participating mortgages are debts secured by way of a full charge over the property concerned and a share in the equity of the scheme at some predetermined point in the future. The convertible mortgage will continue to have an interest in the equity of the development following repayment of the principal and any interest secured under the mortgage. This interest will continue to exist until the agreed profit share is received by the lender at some future time. The participating mortgage is similar, in that the lender has an interest in the equity, but the sharing must be made by a certain point in time. The value of the 'equity charge' is usually predetermined, either by amount or by formula, and, whether or not the profits have been realized, the lender's share becomes due. These two instruments are said to be particularly useful in a development scenario where the lender can share in the profits for a higher level of risk (Shayle 1992).

Sale and leaseback

Over the years, the sale and leaseback has been a familiar form of long-term financing in the prime development market. Particularly popular in the 1960s and early 1970s, it returned to favour in the late 1980s and early 1990s. In essence, it involves a developer selling the freehold interest in the completed development to an investor while taking back a long lease at a rent that equates to the initial yield reflected in the selling price. The developer then aims to sublet the property, preferably at a rent in excess of that paid to the investor, thereby creating an immediate profit rent. Sometimes the freehold is owned by a third party,

often a local authority, in which case a similar transaction known as a 'lease and leaseback' can be conducted, with the investor buying a long lease of, say, 125 years and the developer taking back a sublease of a slightly shorter term.

An alternative approach frequently adopted when the developer is hoping to trade the scheme (that is, to complete, let and sell it), is the 'leaseback guarantee'. By this arrangement, if the development is not let within, say, six months of practical completion, the developer receives a balancing payment from the fund, representing his profit in return for providing a leaseback guarantee at an agreed base rent. This base rent is usually the same as the rental income estimated at the outset of the scheme, and provision is made for the guarantee to be extinguished once a letting to an occupational tenant has been achieved. If a rent in excess of the base rent is eventually obtained, the agreement will normally provide for that extra rent, often known as ‘overage’, to be capitalized at a more favourable yield to the fund, usually at half the year’s purchase applied to the base rent. In this way, the fund is able to share in the growth of rents between commencement and ultimate letting.

Returning to the conventional sale and leaseback, in which the developer is retaining an interest in the project, the most important part of the negotiation between the developer and the fund is the apportionment of rental growth at review. Few funding agreements are now concluded on the basis that the developer receives only an exposed ‘top slice’ income once the fund has taken a guaranteed ‘bottom slice’ return. Most arrangements these days involve some kind of ‘side-by-side’ or ‘vertical’ leaseback, whereby the two parties share the equity in predetermined proportions at, say, three- or five-year review. They also usually include a device in the contract known as a ‘participation clause’, which, like the overage adjustment mentioned above, allows the parties to share in any increase in rental income that is achieved at letting over and above the original estimate of likely rents. The possible permutations by which the returns from property development may be divided between the developer and the fund are many and varied. Different slices of income can be treated in different ways at different times. Inevitably, the eventual contract will be the result of negotiation and compromise, with the outcome depending upon the financial leverage and bargaining powers of the respective parties to the transaction. Who needs whom most is the real key.

One disadvantage of the straightforward sale and leaseback is that the developer is often left with an interest that is difficult to dispose of or refinance except at a value determined by a low capitalization factor. One way of overcoming this disability is to enter into a ‘reverse leaseback’, in which the developer retains a freehold interest at a peppercorn rent and grants a long lease to the fund under which a reviewable ground rent eventually becomes payable on full letting, but one that is subject to a prior charge in favour of the fund in respect of their share. The legal interest held by the developer is thereby made more marketable.

The principal advantages usually claimed for the lessee or vendor is that: it frees up capital at a lower cost and for a longer period than would otherwise be available; it can provide 100 per cent financing for a project; the funds released can be used to better advantage or at a higher return; problems of refinancing can be avoided; there can be an appreciation of the leasehold value; it might be possible to pass on certain management responsibilities; retention of use or occupancy can be achieved; and there might be certain tax advantages. In the same way, the main advantages to the lessor or purchaser are said to be that: the term of investment is long and thereby early repayment exposure is reduced; it provides an opportunity to invest in large amounts, which reduces management costs; most arrangements, by definition, provide a good covenant; the rate of return after amortization of the principal of the investment is normally relatively high; control over the management of the asset is much higher than with a conventional mortgage; and there may be a substantial remainder of value after the expiry of the lease. There may also be tax advantages to one or both parties.

Forward sale

As mentioned above, most short-term financiers will look for a guarantee that there is an arrangement with a long-term investor or a prospective owner-occupier to ‘take out’ their interest when the project is completed and often occupied. Contractual details regarding the precise sale date, effect of delays in building work, void lettings and rental growth during development will naturally be the subject of negotiation between the various parties. An outright forward sale along these lines takes place, of course, where a developer is trading and not investing. In such circumstances, the main concern of the long-term investor is to secure a guarantee of rent upon completion, and two principal methods are commonly adopted – the ‘profit erosion’ method and the ‘priority yield’ method.

Profit erosion

Also known as the ‘profit dissipation’ method of funding, profit erosion is a form of rental guarantee arrangement whereby the developer wishes to trade-on a scheme. Instead of taking up a leaseback or entering into a lease-back guarantee if the building is not let within, say, six months of practical completion, the developer stakes his profit, no more, against rent and other outgoings. The developer’s profit as a balancing payment is placed on a joint deposit account, with interest accruing to the developer, and the fund draws down the base rent and other outgoings at quarterly intervals.

Once this balancing payment has run out, the developer ceases to have an interest and the fund assumes responsibility for letting the scheme. However, if letting takes place at more than the agreed base rent, the overage provision mentioned before generally applies for a limited period as an incentive to the developer.

Profit erosion schemes are held to be particularly useful where a scheme is large and the developer is either of insufficient strength to offer a satisfactory rental guarantee or, more likely, is of sufficient strength but unwilling to enter into a full leaseback agreement. The objectives of both the fund and the developer can be met in this way so long as sufficient rental cover is provided. Two years is generally thought to be an absolute minimum, and in a difficult letting market four might be more appropriate. In any event, given the greater risk borne by the fund, a slightly higher yield of, say, 0.25 per cent for prime properties is frequently required.

Priority yield

Priority yield is another variant on the financial sharing theme in trading situations where a fund is looking for a given yield on a development of, say, 6 per cent and is not prepared to share in anything below that level. If the developer produces a completed development showing an initial return of 7 per cent, then the fund will capitalize this extra point as an additional profit to the developer. Over 7 per cent, and some form of participation would be agreed, usually on an equal share basis.

Priority yield fundings are especially popular when a project of development is difficult to plan in respect of time and cost for one reason or another. It brings the developer and the fund into a close partnership where each party accepts a degree of risk against the potential profit inherent in a speculative development. There is also a considerable incentive for the developer to keep costs down and to complete and let the project as quickly as possible.

Project management fee

Another form of funding relationship is based on the ‘project management fee’. This is used primarily as a method of funding for major development schemes where the size, impact on the market and time taken to complete and let the premises are such that neither party would wish for anything less than that the funding institution bear the full risk. In most circumstances the developer would have identified the potential for development and investigated the planning and market conditions. They may even have taken out options on the land and obtained outline planning permission. Upon successful introduction to a fund, a separate fee will usually be agreed. Subsequently, the developer simply receives a fee for project managing the development, which can either be calculated as a fixed percentage of construction cost or geared to the eventual profit of the scheme. Most project management fee arrangements tend to combine both elements, so that a basic minimum fee is agreed as a fixed sum and a proportion of profit over a certain level is offered as a kind of performance incentive.

General funding facility

‘General funding facility’ refers to an arrangement whereby an overall financial facility is provided to a development company and is not specifically related to any one project. It is secured across the company assets and it enables the developer to carry out a series of projects working within a pre-set lending limit. The loan may be repayable over a period of decades, thereby keeping repayments during the early years, when yields may be very low, to a minimum. A comparatively new kind of development finance is the ‘drop lock loan’, which is also a form of general funding facility. In general it allows a developer to have access to predetermined amounts of money over a given period of time. The loans may be for terms of anything between ten and thirty-five years, and the period during which a developer may exercise his option to use them between three and seven years. The special feature of a drop lock loan is that, if prevailing interest rates fall below a predetermined base rate during the option period, then the option can be exercised in reverse against the developer who is obliged to take up an agreed tranche or all of the loan at that rate, which is then ‘locked’ for the entire term. If the developer chooses to take up the loan before the predetermined interest rate is reached, he will pay a variable rate linked to that base rate until it falls to the predetermined level, when it is converted into a fixed rate for the rest of the term.

Another option is the unsecured multiple option financing facility, whereby large loans are made available to property development companies on a broad basis for fixed, but usually extendable, periods of time. One bank will normally act as arranger and facility agent, with anything from between six and thirty other institutions supplying or guaranteeing the loan as managers or co-managers. Multi-option financing facilities encompass a variety of alternative financing methods within one package. Short-, medium- and long-term lending can be related in a versatile manner. Syndicated loans, multi-currency arrangements, commercial paper loans and bankers’ guaranteed loans can all be selected and mixed, together with choices of swaps, fixed or floating interest rates, bonds with warrants and the like (Pugh 1992). In this way the borrower can choose the best financing package to meet his individual requirements.

Term loans

Term loans provide a development company with the facility to borrow a certain amount from a bank or syndicate of banks, which may be drawn upon immediately or in stated amounts throughout the life of the loan. The loans are always made at rates of interest in line with prevailing market rates during the period of the loan. Such loans will specify the date or dates and manner by which the amount advanced by the banks is to be repaid.

Term loans can also carry the option to convert into a limited recourse loan, where the funds are for a project that will produce income soon after completion. In some cases, the interest rates charged on the loan will fall to a pre-specified level when the property under development has been pre-let. Term loans cannot be called in for repayment before the agreed date, which gives them a distinct advantage over overdrafts. Within the property development sector, most term loans are for amounts of less than £100 million, although loans of up to £350 million are not uncommon.

Overdrafts

In familiar terms, an overdraft occurs when a customer of a bank draws on an account to the extent that he falls into a negative balance. Company overdrafts may be for any size, provided the bank is satisfied by the asset backing and credit standing of the company concerned. Interest on overdrafts is charged at a pre-agreed rate or at the bank's currently published lending rate. Pre-arrangements regarding the interest rate are normally possible only for large corporate customers.

The main disadvantage of overdraft facilities is that repayment may be called for at any time and without notice, and could, therefore, come at a bad time when the company's liquid resources are low. Conversely, the principal advantage of an overdraft facility is that the borrower can repay the whole or part of the debit balance on his account at any time, also without giving notice. This contrasts with a term loan of a fixed amount, where the bank is not obliged to accept repayment before the agreed date, or may charge a penalty for so doing.

In the property development field, overdraft facilities are normally used only as supplementary funds to a principal loan, for exploratory work at the appraisal stage, for financing options to purchase land or for contingency payments.

Standby commitments

Standby commitments arise where a developer needs a temporary loan while seeking a permanent commitment for development finance from another lender. Unlike a take-out commitment in the form of a forward sale, neither the borrower nor lender expects the standby facility to become binding. The developer generally hopes in due course to borrow on more favourable terms elsewhere, but wants to begin development as soon as possible. Often, standby commitments are never concluded and funds never deployed – rather, the facility is used to enhance the confidence of a potential permanent lender in a proposed project. Few permanent lenders of development finance are willing to make loans against a standby commitment alone, unless there are very special circumstances.

Syndicated loans

The early 1990s witnessed the emergence of the ‘syndicated’ loan, sometimes known as ‘project’ or ‘consortia’ funding. Often arranged by way of tender panels and normally only appropriate for very large schemes, the essential requirement will usually be a blue chip covenant of considerable means, reflected in a substantial asset base, profitability and turnover. This may not be found in the developer client, but with prospective occupiers prepared to lend their covenant to the scheme. The number of parties involved, with their separate interests, can therefore pose problems of authority and control for the developer, as well as time and expense.

Nevertheless, the concept of the syndicated loan has come into prominence because it offers greater flexibility with regard to currencies and interest rates. Other advantages have been said to include flexible maturity, amortization schedules and credit structures, with less rigid documentation requirements than for a securities issue.

Securitization and unitization

Loan syndication has been supplemented by the securitization of debt, whereby the more conventional loans made by financial institutions are replaced by smaller monetary instruments that can be traded in the investment market. At the time of writing there have been several years of debate about the potential for ‘unitization’, which is very much the same thing as securitization. The idea is to provide a financial vehicle that facilitates the funding of large single development projects, increases liquidity in the market, enables the smaller investor to participate in the market, increases the flow of capital to the property industry, achieves homogeneity of the market by divisibility, permits wider ownership of property, and increases market information and public awareness. Various issues emerge from the debate concerning such matters as valuation, the size and membership of the market, potential conflicts of interest, and the management of the property, liquidity, marketability and taxation. Only time will tell how successful will be the notion of unitization.

One of the principal problems with securitized (and unitized) property vehicles has been that of double taxation – the management company pays tax on the rental income from the property and then the shareholder also pays tax on the dividend income from their investment. This means that if dividends are paid out of rental income it is effectively taxed twice. Real Estate Investment Trusts (REITS) are tax-efficient investment vehicles – there is limited tax payable if the majority of the income and gains are distributed. Such trusts have recently become available on the UK investment market.

Non-recourse and limited recourse loans

Non-recourse and limited recourse loans seek to restrict the lending institution to recovering any unpaid debt from the property in question rather than the borrowing developer. From the developer's point of view it obviously limits the risk, minimizing exposure while maximizing profit, and allows him to structure the transaction so that it is 'off balance sheet' through a joint venture company. From the lender's viewpoint he can expect higher fees and wider margins. Nevertheless, in reality, no loans are truly non-recourse as such, for the bank will impose conditions relating to the front-end injection of equity finance into the project by the developer as well as seeking guarantees against cost overruns and completion date. These facilities are only made to property companies with a proven track record in the management of development projects.

Joint ventures and partnership

Property companies without an adequate financial base to enable them to fund and carry out their own developments often have recourse to joint venture or partnership schemes. Likewise, public and private landowners lacking construction finance and development expertise have frequently entered into similar arrangements.

The advantages of joint ventures are generally obvious and do not need much explanation. However, they can be summarized as follows:

- to spread risk among participating parties
- to enable the development of large projects
- to attract market knowledge and development expertise
- to secure sufficient development finance.

In like manner, the main disadvantages are:

- control over the development project is dissipated
- disposal of a particular interest in a partnership scheme is more difficult
- the value of a part interest is invariably less than the proportionate share in the whole
- there may be double taxation.

Before embarking on a joint venture, the participants will need to identify the most appropriate form of structure to be used. This will normally depend upon the following:

- the number of participants

• the nature of the proposed scheme and the relative risks inherent in development

• the timescale involved, and the policy towards disposal or retention

• how the venture is to be financed, and the desired mix of debt and equity

• responsibility for losses and limitation on liability

• the tax position of the respective parties

• the way in which profits are to be distributed

• any relevant statutory legislation

• the ability and ease of disposing of interests by the parties involved

• any special balance sheet requirements.

There are various legal vehicles by which a joint venture can be effected. These include a trust for sale, a partnership agreement, a limited partnership, a joint venture company and a property unit trust. There are also potential investors looking to collaborate with reputable property development companies. These include: local government authorities with land and planning powers but no money; statutory undertakers with surplus land; trading companies and business enterprises looking to participate in the development of property, either for their own occupation or as an investment with shared risk; overseas investors on a learning curve for a particular market or location; life companies and pension funds with money but little expertise; and high net worth individuals. It has been stated that all of the above tend to be looking for the ‘perfect development property’, well let, high yielding and with potential growth. Most of them wish to enter into a 50:50 deal as equal partners, with each party putting up approximately 15 per cent of the equity and the joint venture vehicle borrowing the rest over a five-year term.

Venture or private capital

A phenomenon that has emerged since the mid-1980s is that of ‘venture capital’. In the 2000s, private capital providers achieved a degree of notoriety because of the profits they achieved on a number of high-profile corporate ventures. This phenomenon can mean different things to different people, but is usually employed to describe those sources of finance willing to invest in higher-risk proposals in return for equity participation and a say in project control. The venture capitalist delves much more deeply into a proposition than does a lending banker, and will often seek a close involvement in the management of a project. Venture capital is also expensive, both in arrangement and through profit sharing. The ‘hands-on’ approach can constrain a developer, and it is preferable to try to obtain a ‘layered’ financial package commencing with bank finance, followed by any other loans or grants available and topped off with the venture capital tranche.

Mezzanine finance

With mezzanine finance, a developer seeks the assistance of a second, ‘mezzanine’, financier. Some prime debt lenders may consider providing a limited facility in excess of 70 per cent of value in consideration of a higher interest rate, or a single fee being taken out of the sale proceeds. It is more likely, however, that the top slice of funds will come from a separate specialist lender. These mezzanine financiers have in the past lent up to 100 per cent of the balance of funds required, but now they more usually look for an input from the borrower, in the form of either cash or collateral security. Nonetheless, they are still able to achieve effective gearing of around 85–90 per cent. There are also occasions when the prime debt financier is not prepared to provide as much as 70 per cent of value and the mezzanine financier may again top up the hardcore facility. This form of arrangement is also sometimes known as ‘wrap-around’, ‘junior’ or ‘subordinate’ financing.

Because there are obviously greater risks involved in providing this top slice loan, the mezzanine financier will seek a return that reflects a share in the anticipated profit from the development. Some lenders will insist on taking shares in the development company, whereas others prefer to take a second charge on the project, although the collateral security will rank behind the prime debt financier. The amount of profit share required will naturally depend upon the individual circumstances of the project concerned. The mezzanine financier tends to become more involved with both the developer and the project, often employing a team of property professionals, which can give considerable comfort to the prime debt financier, because in looking after its own interests it will also protect theirs (Berkley 1991).

Deep discount and zero coupon bonds

A deep discount bond (DDB) is a debt instrument issued at significantly less than its par value and which is repayable in full on its redemption. It may also carry a low rate of interest, with the lender being compensated by the high capital repayment at the maturity date. A zero coupon bond (ZCB) is similar, but no interest is ever paid during the loan period. The discount is, therefore, like the rolling-up of interest at a full rate until the redemption date. There is also the stepped coupon bond (SCB) whereby the coupon, or interest rate, rises at fixed intervals over the period of the loan by specified amounts. These different versions of the bond may be combined to form variations on the same theme.

The general terms for the issue of such bonds can be summarized as follows:

- maturity between five and ten years
- an interest rate margin of 2–4 per cent over base lending rate for development projects
- fees for arrangement, underwriting and participation totalling around 2 per cent of the loan
- security normally in the range of 70–75 per cent of loan to value, using the full redemption value of the bond

• income cover of at least one times, and preferably one and a half

• a good covenant

• borrower responsible for all associated costs

• early redemption penalties.

Although comparatively rare instruments in the property development finance fields, DDBs, ZCBs and SCBs offer attractive rewards in terms of cashflow, running yield and redemption value, as well as certain tax advantages.

Hedging techniques

Hedging techniques are used by a borrower to 'insure' against adverse interest rate and currency trends. There are a variety of such techniques, the most common of which are:

• 'Swaps', where a borrower is allowed to raise capital in one market, and can swap either one interest rate structure for another, or swap the liability for

he maturity value and interest from one currency to another. In other words, the simultaneous exchange between two parties of one security or currency for another where there is mutual benefit to both.

• 'Caps' and 'floors', which are derived from the options and futures market, and guarantee that during the loan period the interest rate paid by the borrower will not rise above (cap) or fall below (floor) a set limit.

• 'Collars', where an agreement is reached combining a cap and a floor, putting both a maximum and a minimum level on the interest rate paid by the borrower. A premium is normally paid by the borrower for a cap and by the lender for a floor.

• 'Droplocks', as already mentioned, this facility enables the borrower to change the loan from a variable to a fixed rate of interest for the remainder of the loan period once long-term interest rates reach a predetermined level.

• 'Forward rate agreements', where a borrower can sell the currency in which he has obtained a loan forward by, say, twelve months in order to lock into a more favourable exchange rate.

Criteria for funding

In most circumstances developers will have well-established relationships with the funds from whom they seek development finance. Where it is the first time that a developer approaches a particular source of finance, understandably close scrutiny will be given to the property company as well as the proposal. For new developers setting out to undertake a first project, it is virtually an impossible task to attract financial support from conventional sources, unless on an individual basis they have successfully managed similar schemes for someone else.

In examining the criteria by which development propositions are judged, the following section is based on an established developer making the first approach to a fresh source of funds from a major financial institution.

Past performance

The starting point is bound to be the track record of the developer who is making an application for funding. However subjective the appraisal may be, the financier will probably form a fairly immediate opinion about the developers. In particular, if they were active during the downturn of a previous property cycle, it will reveal quite a lot about their judgement. Increasingly, it is expected that developers should themselves exhibit an expertise in the actual process of development, and the demonstration of true project management skills within the development company is now almost a prerequisite. Moreover, it is not sufficient for those skills merely to exist within the company. It must clearly be shown that they will be fully applied to the scheme in question, for even the most able of project managers can be expected to be responsible for only three or at most four major projects at any one time.

The necessary skills sought are not confined to the physical production of the property. A thoroughgoing competence in all aspects relating to the financial performance of the scheme is of paramount importance, because, when all is said and done, every facet of the development programme has a pecuniary effect. For this reason, it may occasionally be the case that proven financial expertise in another field of business aside from property could be considered as relevant in assessing a request for development funds.

Consideration will also be given to the supporting professional team selected by the developer. Some architects are best suited to particular types of development and certain projects demand the injection of specialist building, engineering, service, surveying and agency skills. The previous record of all the contributing disciplines and their likely corporate chemistry will, therefore, be taken into account.

It should almost go without saying that, even at first blush, the selection of the project by the developer should appear sound and attractive to the fund, for it is well accepted that where a developer sees opportunity a financier sees risk.

Company accounts

The accounts of a property company should tell their own story and will always constitute an essential part of an initial application for development finance. In appraising the assets of the company, the fund will look to see properties of a good physical quality occupied by tenants of repute on beneficial terms with regular upward reviews of rent. They will take note of the portfolio mix of properties owned, with special regard to geographic and sectoral spread. The development programme currently in hand should not appear to be too large for the financial and management resources of the company, and not all the assets of the company should be pledged.

On the other side of the coin, in examining the accounts of the company, an intending financier will be reassured to find a healthy proportion of equity to balance the liabilities. The total term debt borne by the company should ideally have a good balance of fixed rate loans with any variable loans they have taken on. In addition, it is important to ensure that in their financial planning the property company have managed to avoid the bunching of repayments on existing loans and not placed undue reliance on short-term borrowing, both of which could lead to unfortunate pressure to refinance in a manner that might have repercussions upon the security sought by the fund. Where a property company have an overseas position, it is also necessary to establish that their foreign currency liabilities are generally matched by their overseas assets and sources of income.

Overall, therefore, the profit and loss account should demonstrate that the quality and amount of present income should not only be adequate to meet current outgoings, but should also be sufficient to meet any future rises in interest rates and cover any unforeseen exigencies that might occur. In this respect, cash-flow is difficult to fudge, but some company accounts are otherwise less than revealing. This is especially true when it comes to the policy adopted towards the revaluation of existing property assets, and most funds pay close attention to how often the property portfolio is revalued, on what basis, and by whom. A careful watch will also be kept for the possibility of any off-balance sheet items, such as guarantees, being in existence and affecting the financial credibility of the company.

The project

From the fund's standpoint, the proposed project must not only meet the portfolio objectives of the developer – more importantly, it must meet their own. Broadly speaking, the project should be of a suitable size in terms of value, with no single investment property forming more than about 5–10 per cent total portfolio. It should be in accord with the sectoral balance of the property portfolio, which might be distributed along the lines of 35 per cent to 40 per cent offices, 35 per cent to 40 per cent shops, 10 per cent to 15 per cent industrial and 5 per cent to 10 per cent other forms of land and property investment. Locationally, it should meet the geographical spread adopted by the fund and critically it must be within easy reach of the developer to make certain of proper project management control.

More specifically, the fund will probably wish to assure itself of detailed property considerations, particularly if the developer is not a previous borrower. This might include conducting its own investigations relating to such matters as precise siting, local demand for space, flexibility of use, and market comparables. Design factors and performance standards loom large in meeting the criteria set up for funding approval by financial institutions, and are dealt with elsewhere according to their special requirements, sector by sector. Furthermore, virtually all funding agreements will reserve to the fund the right to approve tenants for the scheme and, although in practice this condition rarely proves a stumbling block, it is viewed as being a vital power of control over the project and the developer.

Amount to be borrowed

Most financiers will lend only a proportion of the total amount required to fund a development, normally on the strength of a first legal charge over the development, but although with mortgage finance this is usually limited to 70–75 per cent of cost, banks will usually advance anything up to 80–85 per cent for a quality development with a top-class covenant already agreed, and long-term leaseback or forward sale loans from the institutions covering the interim funding during development can often provide 90 per cent or more of total development cost. However, above 70–75 per cent, borrowings will often be considered as equity and deserving of a higher pricing. Almost as a matter of principle, it is felt right that the developer should make a contribution, however small, towards the financing of the project. As a rule of thumb, however, 25–30 per cent is frequently sought.

Sometimes developers will seek a loan geared to the value of the completed development as opposed to the cost. This may be countenanced by the lender, but usually a lower level of advance is made to compensate and ensure security of the loan. Obviously, different lenders in different markets will view funding applications in different lights and adopt differing criteria in relation to acceptable percentages of cost or value accordingly.

Loan periods

Few banks currently wish to consider commitments of longer than five years, but in exceptional circumstances will consider up to ten years. The insurance companies and pension funds will consider periods of up to thirty years, and often set ten years as a minimum term.

Interest rates

How rates are set has been explained above. As also already explained, some funding agreements adopt a fixed rate throughout the term, some a floating rate linked to the base rate, and some adopt a mechanism that combines fixed and floating rates. Increasingly, however, the rate of interest applied to a loan is traded against equity participation.

The timing of interest payments is also important, and methods of calculation vary from lender to lender. For example, a few lenders still calculate interest on the balance outstanding at the beginning of each year. If a loan of say £50 million is fully amortized over a period of twenty years at a fixed rate of 12 per cent, it can be shown that this could result in an additional payment of £8 million compared with a calculation on a day-to-day balance.

Yield

The factor by which income, anticipated or actual, derived from a development is capitalized will depend upon the relative degree of risk involved, and the relevant investment yield will be adjusted accordingly.

Where a fund was providing long-term finance for a scheme already completed and let, the appropriate yield might be, say, 5 per cent. If the finance was agreed on a forward commitment only once the scheme was completed and let, with no interim funding, then the yield might be 5.5 per cent. Where a forward commitment also provided interim development finance but a pre-let was concluded on full and acceptable rental guarantees supplied, then the yield could move to 5.75 per cent. If there was no pre-let and rents were only guaranteed for a limited period of, say, two years following practical completion, then a forward commitment with interim funding would require a yield of around 6 per cent. In the highest risk situation, where the fund was working on a priority yield, project management or profit erosion basis, then it would almost certainly look for a yield of about 6.5 per cent.

Rental cover

Very much as a rule of thumb, both fund and developer will be seeking sufficient rental cover in the margin allowed for developer's profit, and held as a balancing payment, to allow the completed building to stand empty for a period of around two-and-a-half to three years. Exactly how long the contingency period should be will rest on the strength of the market at the time. The stronger the market, the less the cover necessary, and vice versa.

Another way in which rental cover is used as a measure of ascertaining the degree of security is the ratio of initial estimated rental income against interest repayments. A ratio of 1.1 or 1.2 to 1 is normally sought.

General funding facility

As already indicated, where a developer has generated a high degree of confidence with a fund, it may often prove beneficial to both parties to agree that a general funding facility should be made available to the property company. These are usually provided by the merchant banking sector. The terms and conditions upon which such loans are made will vary, but they will commonly refer to such matters as the total amount available, the take-up rate, the level and compounding of interest charges, proportion of facility devoted to any individual project, maximum percentage of development cost allowed for any particular scheme, restrictions as to planning consent and land assembly position, right to approve individual projects, obligation to offer certain other development projects over a given period, revaluation rights, buy-out provisions for schemes slow in starting, equity-sharing arrangements, institutional long-term take-out requirements upon completion, repayment, and reporting and review procedures. Funding facilities of this kind can either be of a fixed term for, say, five or seven years, or 'revolving', subject to review at pre-ordained intervals. Security for the loan may also be attributable to particular assets of the company or arranged as a floating charge across all the company's assets.

More open-ended arrangements

The greater the degree of flexibility and discretion sought by a developer in a funding arrangement, the more a lending institution will look for further security to cover their risk. If the proposed project is anything less than conventional in respect of size, location, design, occupancy or letting terms, then a fund might be persuaded to relax its standard criteria on one or more of the following grounds: the land might already be owned by the developer; the company might be providing a substantial equity injection into the development; castiron collateral providing complete cover might be offered from elsewhere within the company's holdings; another financially strong partner such as a major construction firm might put up security alongside the developer; or bank guarantees may be supplied. Although they might not mean much in financial respects, personal guarantees undertaken by principals within the property company are thought to concentrate the mind wonderfully upon the successful outcome of development projects.

Sensitivity

It would be unusual for a lending institution not to conduct its own analysis of the sensitivity of a development scheme to changes in such component parts as rental income, initial yield, construction cost, finance charges and period to complete and let the development. Indeed, they would normally expect to see such an exercise performed for them by the prospective borrower in presenting the development for approval.

Tax

Although tax considerations are rarely the most significant issues in determining whether or not a scheme should be funded, they can affect the way in which a financial package is arranged. For example, because in some countries certain financial institutions are either wholly or partially exempt from tax, it is important to structure the funding agreement so that any concessions such as industrial building allowances or capital allowances relating to plant and machinery pass to the developer so that he can write them off against construction costs and improve his net profits position after tax. Further, it is sometimes the case that, whereas capital repayments do not attract tax relief, interest payments do, and in such circumstances borrowers are well advised to ensure that so far as is possible all fees and charges associated with funding the development are expressed in the formal finance agreement, so that they too become eligible for relief.

Costs

Apart from the obvious cost of interest on the loan and any equity share forgone, it should be recognized that the financing of a development can be an expensive business. There are arrangement fees of between 0. 25 and 1 per cent, payable to the fund or to intermediaries for effecting an introduction and putting a funding package together; commitment fees, which are usually about 1 per cent of the loan amount upon acceptance of a formal offer, and are repayable on completion of the advance but forfeitable if the borrower does not proceed; legal costs, which on the loan can amount to about 1.0 per cent of the advance, although it might be lower if it is a very large loan and higher if the deal is especially complex; valuation fees, which on average can cost up to a further 0.5 per cent of the advance; revaluation fees, during the currency of the loan; penalty fees, if by any chance the developer seeks early repayment of a mortgage advance; tail-end or exit fees; and the costs incurred in making the presentation itself.

Choice of fund

So far, attention has been focused upon the necessary attributes of the developer in the eyes of the fund. However, it is just as important that developers should carefully select their source of borrowing.

General considerations

In the same way that developers' underlying resources would be examined, it is for them to be assured about the financial strength of the fund, although this requirement is not as imperative as it was when regulatory control of financial systems was more lax. Of greater concern to the developer these days is the speed of response made by funds to a request for finance. Associated with this is the extent to which delegated authority is conferred upon the fund manager or executive director. The very location of the finance house can be a consideration in selecting a likely lender, for some funds can have a special regard for, or relationship with, certain towns or regions. It usually helps if the fund has developed an interest and expertise in property matters, particularly at the development end of the market. If so, it will often pay to make a few inquiries of other borrowers as to their experience of dealing with that fund.

The general attitude of the fund towards an approach for development finance will usually give a fair indication of what kind of business relationship is possible and how it is likely to evolve. As with most transactions, the level of success depends upon mutual trust and confidence, and even within the largest of organizations this often comes down to individual personalities on both sides. In this context, stability of management within both the property development company and the financial institution can only assist in forging close and effective links between the two agencies, but large organizations are notorious for moving people about. With this in mind, therefore, and for several other reasons, it is not always a good idea for a developer to rely too heavily upon a single source of money for funding their development programme. People and policies can change.

Given that most major development schemes in the prime part of the property market are funded either by insurance companies and pension funds in the 'institutional' sector, or by clearing, merchant or overseas banks in the 'banking' sector, it is worth considering the different characteristics of these alternative sources from the developer's viewpoint.

Institutional lending

By and large, the lending policies of the major insurance companies and pension funds are characterized by their project-based nature. This means that they tend to exercise extremely tight control over the entire project, including the design, construction and letting programmes.

But although institutions are very risk-averse and maintain strict standards of building design and performance, some will lend up to 100 per cent of development finance to favoured borrowers.

What is required of the developer is a good knowledge of the institutional funding market. This includes an understanding of the locational and sectoral preferences of different funds, their recent transactions, investment objectives, portfolio balance and the amount of money currently available for particular projects. Some will tend to specialize in certain forms of financial arrangement – short-term bridging loan, medium-term mortgage, long-term leaseback or forward sale. Some will not consider a project costing less than £5 million to them, others concentrate on smaller schemes of, say, £1–3 million, and will have a ceiling figure beyond which they cannot lend. Particular funds will also either favour certain types of development – small industrial workshops, provincial shops or city offices, for instance – or be seeking to acquire them in order to balance their portfolios. A shrewd developer will always shop around. Consequently, contact has to be maintained with a range of fund managers and the agents who act on their behalf, so that by knowing who acts for whom, and which funds prefer a direct approach, careful targeting to selected institutions, rather than a shot-gun blast across the market, can be accomplished.

In the same way, the basis of agreement for obtaining finance can vary among funds and between projects. Some funds, for example, are less keen upon sale and leaseback arrangements than others. Similarly, with regard to the desire for a degree of partnership with a developer, some funds prefer the borrower to bear a reasonable proportion of risk, whereas others are less favourably inclined towards side-by-side arrangements, taking the view that too large a share to the developer gives him a disproportionate involvement in overall responsibility. The reverse can also be the case. It may be that the developer in question has no choice and, having to trade on, must opt for a forward sale. The manner in which such matters as bridging finance, rental projection and additional tranches of loans are agreed also varies across the market, and is often a question of careful negotiation.

A critical factor is the need to establish the extent to which potential profits are placed at risk. In this context, some form of equity-sharing leaseback arrangement tends to be less contentious than a straight taking of a capital profit through a forward sale, because both parties share a common interest. Nevertheless, whether the arrangement provides for rental guarantee, profit erosion or priority yield commitments from the developer, he must be aware of the respective consequences from each kind of agreement. In particular, attention should be paid to the length of the agreed letting period, and thus the amount of rental cover provided.

Pre-letting will also frequently be an important consideration. In fact, it will often be a condition of funding. However, despite what might be seen as the security and certainty afforded by a pre-let, for the developer there can be drawbacks that affect time, cost and quality. Not only might the demands of the tenant be in contradiction to the stipulations of the fund, but the added involvement of the tenant and his professional advisers in the construction process and upon completion can cause extra problems. Furthermore, it can affect the overall planning and phasing of the development programme, especially in respect of common parts and facilities. Nevertheless, the securing of a pre-let can attract a premium and avoid contingency payments, void rental periods and heavy marketing costs.

One area of increasing sophistication is that of funding documentation. In the thrill of the moment of approval, or during the cut and thrust of negotiations, certain matters can be overlooked or onerous undertakings entered into too lightly. Thus, the aim of the developer should be for an agreement that is not too tight and not too loose, but, above all, that the offer letter is binding and operable. Care must be taken about conditions relating to every aspect of the project – design, construction, funding and letting – and the result is usually a compromise between strict compliance with institutional criteria and cost minimization to optimize profit. It is more and more common for an institution to appoint their own consultant firm to monitor development, an arrangement that if not properly formulated can be very irksome to the developer and his project manager. Another important aspect of this kind of funding agreement is to ensure that the client's potential liabilities to the fund are matched by those of the contractor to him, and likewise between the developer, the project manager and the other members of the professional team.

Bank lending

Banks are traditionally more concerned with the 'asset' base of those to whom they lend rather than upon the particular project in hand. The emphasis, therefore, will be more upon monitoring and controlling the balance sheet and security cover offered by the borrower. For the developer this can provide a more open and flexible climate in which to work, where such factors as time, cost and quality can be traded off against the client's ability to generate funds or produce additional collateral. However, bank finance is founded on profitable lending rather than by direct investment in a scheme, and, because banks normally neither provide risk capital under conventional arrangements nor seek to participate in equity profits, it is common for only a proportion of development finance (typically around 70 per cent) to be loaned. It is, therefore, imperative for the developer responsible for securing finance to have an understanding of the policies, practices and procedures that determine bank lending. This is of greater moment here, for although institutional negotiations are invariably conducted between surveyors, bank lending is more usually transacted with a banker. Furthermore, the lending market is far from homogeneous. The banking sector broadly comprises major stock banks, the merchant banks, finance houses and overseas banks. All are different, and all are competitive, so bank finance must be carefully tailored to fit the purpose for which it is applied, and a well-designed package prepared to meet overdraft, term or equity financial requirements. And, as interest rates in the market tend to move closely together, so the aim of the developer is to seek the best deal in respect of such matters as quality of service, fees, costs and repayments. Indeed, sometimes the additional flexibility afforded by more expensive arrangements can be worthwhile. For example, the objectives with a smaller project might be for a quick decision, flexibility in execution and an ability to revise arrangements without excessive penalties. With a larger scheme, detailed arrangements regarding the term of the loan, interest rate options and adjustable repayment schedules might be of more concern.

Term loans, which impose a contractual obligation on the bank to provide finance for an agreed period, have become a popular way of funding development projects. Banks are increasingly experienced in tailoring proposals that give flexibility of approach on the one hand but are matched by covenants on the other, which can have considerable effect on the running of the borrower's business in the future. For instance, financial ratios are a valuable tool of control, the breach of which puts the lender in a strong position to call for initial or added security or for changes in the terms of the loan, with such options as accelerating the loan or cancelling any unused part of the facility. There are other alternatives of varying efficacy – the negative pledge, sharing-round clauses and contractual right of set-off. Additionally, where the loan is unsecured, which now is sometimes the case, the bank might also consider various forms of direct involvement in the borrower's company, ranging from the appointment of a nominee director, to a working capital maintenance agreement, with shareholders undertaking to ensure the maintenance of the borrower's capital to satisfy covenanted ratios. Thus, in general, term-lending can afford a flexibility that, depending upon the circumstances, can be preferable to long-term mortgages, sale and leaseback arrangements or debenture borrowing.

A feature of bank lending is that there has been a tendency for the borrower to rely upon the lender to propose the basis and structure of the lending facility. This occurs often through ignorance, and sometimes through a misplaced desire to please. Such a lack of initiative or awareness in negotiations on the part of the developer can all too easily lead to a costly and mismatched facility being accepted.

Customer relationships are a critical factor in bank lending policy. The early training of young bankers used to dwell on the 'canons of lending' – character, ability, means, purpose, amount, repayment and income (for which the acronym CAMPARI serves as a handy reminder). It is perhaps significant that there was not an 'S' for security, for banking theory held that a perfect loan arrangement should be unsecured. Modern practice, however, dictates otherwise. In many cases the prospective borrower will have developed a relationship with his bank through ordinary business and overdraft lending, and it is a golden rule in the clearing banks that the current account forms the basis of mutual confidence between banker and developer. Where there is no previous relationship, then it will be necessary to establish the financial status of the borrower and the viability of the proposed scheme with great care.

Several other factors warrant attention on the part of the developer when negotiating bank lending. These are:

• The extent to which standby facilities might be required, and the terms that might be attached to them.

• The type of charge secured over the assets of the borrower – making sure that they are neither overcharged, which can reduce the ability to obtain further loans, nor unduly restricted, so that, for example, disposal is limited.

• Ensuring that a proper presentation is made of the man, the market, the margins, the management information systems and the money requirement concerned with a particular project.

• Confirming the 'facility letter' from the bank to the borrower setting out the terms on which the loan has been agreed. Apart from specifying the amount, rate of interest, repayment terms and brief details of the security, if any, it will also normally include specific terms and conditions in the form of negative or positive covenants relating to such matters as default, other borrowings, supply of information and provision of warranties.

Whatever detailed arrangements are finally made, the project management objective must be to seek elasticity. Full allowance for the possible effects of inflation, time and cost overruns should be built in. Even the location of the bank and its officials, together with their speed of response, can be of importance. And these days, the very stability of the financial source is equally significant.

Problems in funding

Apart from the basic thesis that lack of knowledge and understanding of the principal sources of finance for property development and their respective policies, practices and procedures presents a major problem for aspiring developers, there are other issues that condition the climate for lending. A few of these are described, in brief, below.

Location

Within and among funding institutions a preferential treatment exists towards certain situations in, around and between selected cities and facilities. Some of this has the smack of hindsight about it, but much has to do with perceptions regarding environment, accessibility and communications. From the point of view of a developer approaching a potential source of funds, therefore, it is helpful to know the attitude and commitment of individual fund managers to particular towns, areas and regions.

Presentation

It is astonishing how little attention is paid to the professional presentation of proposed development schemes. Although not always the declared reason for turning a proposition down, poor presentation probably accounts for many funding refusals. At the very least, the following are required – a detailed appraisal of planning and market conditions, a cashflow analysis and a reasonable set of drawings, together with an explicit statement of the financial position of the intending borrower, contained in a well-illustrated, succinct and coherent document.

Personality can also play a part. Character assessment is always a matter of personal judgement, but it is nonetheless important to ensure that any presentation is made in an open, confident, informed and enthusiastic manner.

Speculation

It is almost a cliché to say that one man’s profit is another man’s risk. Nevertheless, it is probably true to say that developers as a breed are eternally optimistic, whereas bankers, and those of their ilk, are notoriously cautious in their approach towards new developments. Moreover, it is often harder for the small developer to borrow money than for the large established property company, for if one project goes wrong for the former, it will have a more profound effect upon overall security and performance than for the latter.

From the standpoint of the developer or project manager, it is always worth considering the way in which potential profits are placed at risk by the manner whereby funds adjust their yield parameters according to the financial arrangements agreed. For example, depending upon market conditions, an office scheme might variously be finely tuned as follows:

5%	completed and let
5.25%	pre-let, interim finance and forward commitment
5.5%	leaseback or lease guarantee
5.75%	profit erosion basis
6%	priority yield basis.

Collateral

A frequent explanation for funding agencies turning down applications to support proposed development projects is the inadequacy of existing collateral guarantees and proffered future equity participation. In fact, research indicates that this is probably the single most common reason for rejection.

Valuation

Lenders will invariably seek their own valuation of a proposed development project. This may often be at odds with the value perceived by the prospective borrower. In stagnant or recessionary markets, for example, the emphasis by the lender and his valuation advisers will normally be placed upon secure cashflow rather than anticipated capital value allowing for potential growth, which can lead to a wide divergence in estimating current open market value.

Thus, although regard is still paid to the loan to value ratio, the ability of the transaction to service the debt becomes of paramount importance. Preletting to a high-quality covenant on beneficial terms is, therefore, a vital factor in obtaining full financing in a falling or static market. In such markets it is always advisable to check that the lender's chosen valuer is prepared to confirm an approximate value, albeit verbal, prior to paying commitment fees, solicitors' costs and, of course, the valuer's full fees for a written report (Berkley 1991). Nevertheless, there are always the twin dangers of initial valuation or appraisal of a proposed development scheme being either too conservative or overoptimistic. Great care must be taken to explore the constituent components of rent, yield, building cost, finance, land cost, profit and time.

Currency

Given the global nature of property development finance, foreign currency loans have become increasingly popular. Interest rates can be lower, capital sums higher and terms easier. Foreign currency markets, however, are prone to constant fluctuations, and, in order to take advantage of such borrowing arrangements, developers should ensure access to any one of a number of different currencies, and be able to switch with ease. There are now versatile 'multi-currency' banking facilities available from leading international banks.

Refinancing

In many markets the issue of refinancing is extremely topical. Proper handling of this can often mean the difference between a property company's survival and its insolvency. Refinancing development property presents a particularly formidable challenge in depressed markets, as uncompleted and unlet projects lack the two basic attributes required to reassure a financier – cashflow and marketability.

Developments are most likely to be refinanced as part of an overall corporate refinancing exercise. Alternatively, where the scheme is in an area of strong demand or very prime, a development may be refinanced by the injection of fresh capital by a new equity investor, either as a joint venture partner or as a long-term investor. The unpredictability of development projects is not often compatible with the fine tuning of debt-oriented refinancing packages. A new financier's willingness to provide additional finance will primarily depend upon the quality of the security offered, although the company's past record will also play an important role. An existing financier will look especially at the feasibility of the company's corporate plan in comparison with other realization options, although it has been pointed out that the ultimate decision will invariably turn on the strength of the relationship between the parties involved (Clark 1991).

Loan workouts

In a period of widespread overbuilding, sluggish leasing activity and other demand-side problems, many development projects are faced with a situation where schemes seem unlikely to service their debt charges upon completion. In these circumstances a lender may agree to what is known as a 'loan workout', which provides the developer with sufficient time and support to achieve a turn round in their project.

Essentially, a workout is the debt restructuring for a single project or many projects or properties normally requiring assiduous management, new money and additional collateral.

A developer should seek a workout as soon as a problem is identified and should try to persuade the lender to participate (not always an easy task). At a minimum, a financial workout will allow the developer to make the best of his current position. Ideally, it will enable him to satisfy his obligations while maintaining equity in the property. Thus, a workout provides better odds that the developer will emerge from the crisis with his business intact.

What a developer basically wants from a workout is: temporary relief from all or part of the required debt service payment; an extension of a maturing loan without large extra fees; minimal additional encumbrances on the property or further dissipation of equity; personal liability relief; debt reduction, or even forgiveness; minimization of potential tax consequences; and cooperation to sell existing holdings. The incentives to the lender are: a belief that with temporary concessions the problem can be solved; minimization of the risk of foreclosure; reduction or elimination of negative media attention; lessening of the impact on the lender's loan portfolio and income recognition; and the avoidance of protracted litigation. It has been stated that the keys to a successful loan workout are the development and implementation of a financial plan that addresses the maximization of return to creditors, and the long-term survival of the debtor as a going concern, together with the smooth interaction of various functions, including legal, accounting, information systems, asset marketing and management, and business operation. A workout can be a very sobering process to even the most sanguine of developers.

From the above, it can be appreciated that it is essential to establish the correct financial base for the project, and for the developer to balance their aims with the aspirations of the lending agency, whose risk/reward criteria will determine the scope for negotiation between the parties. It can, therefore, be suggested that three basic elements of funding have to be assessed in any scheme:

• Availability – in terms of knowing the range of possible sources of finance, methods of approaching them and their current position

• Economy – in respect of interest rates and how they might fluctuate, as well as equity participation, incentives and penalties, and any hidden costs of borrowing

• Practicality – which integrates the elements of availability and economy into a feasible arrangement that might otherwise detract from the viability of the project or invalidate it completely.

Financial adaptability on the part of the developer at a time when the investment character of property is changing is now a must.

The financial agreement

Inevitably, perhaps, the aims of the funder and the developer will often conflict. It is increasingly important, therefore, that the respective responsibilities for control during the development period are clearly apportioned and understood, and that the financial agreement is properly documented. Although a developer or project manager will doubtless have recourse to competent legal advice, the cut and thrust of negotiation is often such that certain matters may be misinterpreted or overlooked in the false hope that, once building has begun, the financial agreement will be forgotten or set aside. However, the opposite is more often the case, for it is at those moments of crisis during development that the parties are more likely to spring to the small print and come to realize the true consequences of their earlier bargaining. A better understanding of the objectives and procedures of financial control and documentation on the part of the developer will normally enable him to negotiate with greater confidence and to deploy his professional team more effectively.

The funder's objectives

In structuring the financial arrangement, the funder will aim to control certain aspects of the proposed scheme, including the:

• criteria by which tenants are selected and leasehold terms agreed

• negotiations conducted and agreements concluded with third parties

• entry by the developer into any special legal agreements with the local government, authority, and the consequent liability if the developer defaults

• nature and level of indemnity policies and collateral warranties held or offered by the developer, his professional team, the contractor and the subcontractors, so that in the event of failure the developer can be dismissed and the fund can assume full authority for the completion of development

• taxation implications of the project

• the purchase price of the completed project, so that unnecessary premiums and over-renting are avoided.

The developer's objectives

In contrast, the developer**,** whilst wishing to retain long-term goodwill with an interested fund, will seek to ensure that the terms ultimately accepted in the finance agreement provide:

• a smooth flow of funds

• speedy responses by the funder

• minimum interference by the funder's professional consultants

• smooth letting arrangements without undue constraint by the funder.

The 'offer' letter

One of the most important stages of the documentation relating to the finance of development arises well before the formal issue of arrangements. This is the initial 'offer letter' by the funding agency or its professional representatives. In effect, it will set out the basic terms of the deal and outline the intentions and expectations of the funder. Such a letter will have particular significance if the developer has to commit himself to the purchase of land prior to the full finance agreement being formalized. Any condition precedent in the correspondence must, therefore, be carefully appraised as to its implications.

There is no such thing as a standard offer letter, but the following list represents the more usual draft proposed heads of agreement:

• description of the parties concerned

• intention to purchase and basis of acquisition

• type and amount of loan

• rate of interest and method of repayment

• identification of site and ownerships

• description of the proposed development

• planning position and local authority interests

• estimate of construction costs

• prospective letting agreements

• initial yield and resultant purchase price

• staged payments of costs and fees

• sharing of surplus rental income

• rental guarantees by developer

• approval building contract

• insurances and warranties.

The contractual agreement

The financial agreement will put into final contractual form the exact degree of control over the scheme the funder will expect to have. It is important for the developer, therefore, to ensure that the conditions imposed are not so onerous as to prejudice the proper management of the project or jeopardize the profitability through no fault of their own.

Apart from confirming the contents of the original offer letter, renegotiated or otherwise, the financial agreement, which is made under seal, will normally start by defining all the terms, procedures, parties and dates involved in the transaction. Of special concern to the funder will be the terms and conditions relating to any actual or proposed building agreements, or agreements for a lease. If the developer defaults, or if some other specified event takes place, the funder will wish to protect its position in respect of the determination of those agreements. The three main remedies normally incorporated into the financial agreement are:

• The power for the funder to assign the benefits under the agreement to another developer

• The power by the funder to complete the development and sell the created investment without any continuing liability

• An agreement whereby if a third-party freeholder exercises their right to re-enter for any reason under another contract, then the funder receives a payment relating to the improved value of the property achieved by the works to date undertaken by the developer.

Practical problems

It is impossible to cover all the matters that may be included in a financial agreement, and ultimately it is up to the developer whether or not the various terms and conditions are acceptable. Nevertheless, there are issues that recur, and they merit close attention on the part of the developer. In no particular order, these are:

• Design documentation attached to the agreement should clearly set out the objectives of the scheme and, as a general rule, the more details provided by the developer the better, so that subsequently the funder’s surveyor cannot alter the initial specification.

• A developer is well advised to attempt to restrict the number of outside consultants the funder may appoint to act on their behalf in relation to the project. A single firm of surveyors should suffice.

• The necessity to obtain written approval for the appointment of subcontractors should be avoided by agreeing a list of nominated subcontractors, although difficulties might arise in the case of a management contract involving many subcontracts, all of which may not initially be known.

• A clear understanding of the definition of the date of practical completion should be established and, wherever possible, the views and visits of the developer’s architect and the fund’s surveyor should be harmonized.

• The date on which capitalization and transfer of purchase price takes place should be explicit, and not dependent upon the actions of third parties.

• Access to the site by the funder’s surveyors and facilities to inspect and test materials and workmanship should be kept within reasonable bounds. Notice of any defects should also be notified at the time of discovery.

• A procedure for arbitration should be agreed.

• It may be necessary for the developer to consider the inclusion of a ‘walk-about’ clause, so that he can approach other sources of finance if a top-up of funds over and above the funder’s maximum commitment is required.

• There should be some mitigation in respect of those delays that push the completion date beyond the agreed date, especially where such delays are outside the control of the developer.

Little has been published in the professional press about funding agreements, although a specialist breed of solicitors have grown up who seem to be developing ever more complex documentation, usually for funding-clients. The aspiring developer, therefore, must be increasingly aware of the many pitfalls ahead.

Trends and prospects

This chapter concludes where it started, by stating that finance is a vital dimension of property development, and a principal concern of project management for the real estate industry.

• The globalization of property finance markets will continue.

• Developers and financiers alike will have to become even more aware of occupational demands by property users, and willing to accept greater innovation in the design, construction and management of commercial premises.

• Construction companies are already an attractive source of short-term development finance, not only providing interim funds but also acting as security for a long-term take-out, and entering into a fixed-price contract in return for an equal share of the eventual profit, and it is probable that the number of joint venture schemes between contractors and developers will grow or, indeed, that ‘contractors’ will increasingly become ‘developers’.

• Specialized markets in high-risk development schemes will continue to develop, depending upon more sophisticated market research, superior management skills and the spreading of risk over a well-balanced mix of investments and among enterprising investors. Active risk management through various methods of syndication has been successful in America.

• Joint venture and partnership agreements between public and private sector agencies will gain in popularity, as public sector finances dwindle.

• The consortia approach towards investment in all forms of property development will become increasingly common – small private, as well as public, investors being grouped together to finance relatively small schemes, and large institutional investors collaborating in funding the major development projects.

• Refined funding techniques, which can reduce dependence upon cashflow in the early years after the completion of a development project, will be introduced on a wider scale than hitherto, as will funding schemes that allow for the future consolidation of debt charges into equity interest, such as convertible mortgages, which permit the translation of fixed interest loans into equity shares once an agreed rate of inflation is reached.

• Among new arrangements structured specifically to attract additional funds for property development will be ever more complex multi-layered agreements in which each tranche of investment funding is designed to meet the tax needs and positions of the various parties to the deal, so as to take maximum advantage of tax allowances and relief.

• A new funding ethic needs to be formulated towards the regeneration of older building stock in inner-city areas.

• Environmental aspects of property development will play a larger part in the appraisal equation, progressing from mere checking of potential environmental liabilities in due diligence activities to more sophisticated consideration of the future-proofing of assets.

• Higher standards of professionalism will be demanded at every level.

• Worldwide, there is likely to be a contagious reappraisal of the concept of value.

Over the last few years more innovative approaches have, again, started to appear in the UK property market. Debt and asset-backed securitization have become more common, the traditional long UK institutional lease has shrunk in length of term and, with the expansion of the serviced office sector, new rent arrangements have emerged. All was well and good until the credit crunch which began in the late summer of 2007. It will take some time for normality to return to lending markets.

The search is always on for liquid, tax-efficient funding vehicles. Changes in the US, much influenced by tax changes, state intervention and the growth of the REIT market may have in turn influenced the introduction of REITS in the UK in 2007/08. The impact of these on development finance will be interesting to see.

The changing UK environment and innovations in the US are calling into question conventional attitudes to low-risk property development opportunities. Times they are a-changing!