TICKING THE BOXES

A SUCCESSFUL FUNDING APPLICATION IS KEY TO MOST NEW DEVELOPMENTS OR INVESTMENTS IN COMMERCIAL AND INDUSTRIAL REAL ESTATE. A PROPERTY FINANCE VETERAN WHO HAS VIEWED HUNDREDS OF APPLICATIONS REVEALS WHAT LENDERS ARE LOOKING FOR AND HOW YOU CAN MAXIMISE YOUR CHANCES OF SECURING A LOAN.

GIVEN THE CURRENT historically-low interest rates, now should be a great time to be borrowing money to buy commercial property.

Not only are borrowing costs low, but the return on equity from a leveraged investment in commercial or industrial property is generally significantly superior to other investment options such as bonds and bank deposits, which are much less appealing in a low-interest-rate environment.

There has been one snag, though. Our major banks, which have been the dominant lenders to the commercial real estate sector since the global financial crisis (GFC), have been tightening their lending policies.

It's a trend that has become evident over the past two to three years and it has been further exacerbated by the Reserve Bank's announcement in December that it will require banks to hold more capital.

This is expected to further constrict the availability of bank finance for commercial real estate and possibly increase bank margins, as banks seek to be more selective and reduce their overall market share in this space.

Non-bank lenders have been moving in to fill the resulting funding gap, particularly in areas such as land acquisition, value-add opportunities and development projects.

Despite this evolving market, one thing remains unchanged: applicants who understand and provide the information funders are looking for will stand the best chance of gaining finance.

EXPERT TIPS TO SECURE INVESTMENT FUNDING

Mark Farrands has viewed hundreds of loan applications in over 20 years of working in finance. Many of these were with Westpac and more latterly ASB Bank, where he was Auckland regional manager, property finance.

Last year he was appointed to head the New Zealand operation of MaxCap Group, a leading Australian non-bank commercial real estate lender which has established a joint venture in New Zealand with Bayleys and Forsyth Barr.

Farrands identifies the following key considerations for property investors when seeking funding, and outlines situations where non-bank funders may be able to help facilitate a transaction.

LOAN-TO-VALUE RATIO

Farrands says it's vital to know what level of debt lenders have an appetite to fund in the current environment. Banks will only lend up to 60 percent of the value of a commercial property, and at that level may require monthly principal reductions from the outset of the loan.

Non-bank funders may provide a higher level of funding. However, this usually comes at a higher cost.

INTEREST COVERAGE RATIO (ICR)

This lending ratio measures how many times the annual income generated by a property services the annual interest of a loan. Pre-GFC, banks were willing to accept ICRs below 1.5 times – nowadays they are seeking at least two times.

If you are purchasing a property that has vacancies and cannot initially hit the bank's ICR hurdle, a non-bank funder may be able to provide a short-term facility to allow a landlord to lease up a property until it's in a position to be refinanced by a bank.

SEISMIC STRENGTH AND ASBESTOS

"What is the building's seismic rating?" and "does the building contain asbestos?". Financiers will always request this information, and may not fund the property without a strategy to address any associated risks. To confirm a property's seismic rating a purchaser should request an engineer's assessment from the vendor, or commission one of their own.

A building report should provide confirmation on whether the property contains asbestos. Non-bank lenders may be more flexible around the treatment of these risks and may be able to assist with the initial settlement of the property and funding to address the issues to position the property for a main bank to refinance.

LOCATION

Invest in areas where there is a catchment suited to the property. For example, for retail look for high pedestrian flows and good parking and public transport; for residential, availability of schools and public amenities is important. Also consider changes that are proposed for the area surrounding the property by government or local authorities. A lender is likely to look at all these factors.

TENANCY PROFILE

The quality of the tenants in the building and average lease durations are factors financiers will assess, and will expect you to have considered. Most lenders will look for certainty of income from strong tenants with long lease terms to confirm the loan interest can be serviced.

"If all the above factors are not de-risked sufficiently for a bank to initially have an appetite to fund a transaction, you could consider approaching a non-bank lender that can provide more flexibility," says Farrands.

MARK FARRANDS,
HEAD OF MAXCAP NZ

"This could allow you to reposition the asset for sale or for refinance to a bank once the asset has been stabilised and value added."

He says there are also areas of the market where banks are increasingly reluctant to venture, and where alternative lenders may be able to help facilitate a transaction, such as land acquisition for development.

"It can also be difficult now to obtain bank finance for projects where the funding requirement is large ($40 million upwards).

"While there is occasional appetite from main banks for loans in these areas that meet their criteria, parameters continue to tighten, with lower gearing, larger equity requirements, higher debt coverage from presales, etc."

Farrands says another challenge for property developers in a market where construction costs are rising rapidly is locking down their development costs sufficiently for a funder to become involved.

"Often costs can increase further while presales are being sought. It's not uncommon for projects to need to be redesigned once builders have priced the initial plans, in order to 'value engineer' the costs to an acceptable level so a project is profitable."

An option for countering this is early contractor engagement – choosing a good builder early on to partner with and involving them in design to achieve cost efficiencies.

"The good news for developers is that there are now experienced alternative lenders in the market filling the gap left by the main banks and providing flexible financing solutions. MaxCap is active in this space, providing developers funding for site acquisition and more flexibility on gearing and presales for construction loans.

"As projects tend to take longer to achieve presales in the current market, we are seeing a growing trend of borrowers prepared to pay a premium for debt coverage flexibility. The size of the premium will depend on the level of flexibility required.

"This facilitates project certainty and momentum. There are now options for a borrower to commence with less than 100 percent debt coverage from sales."

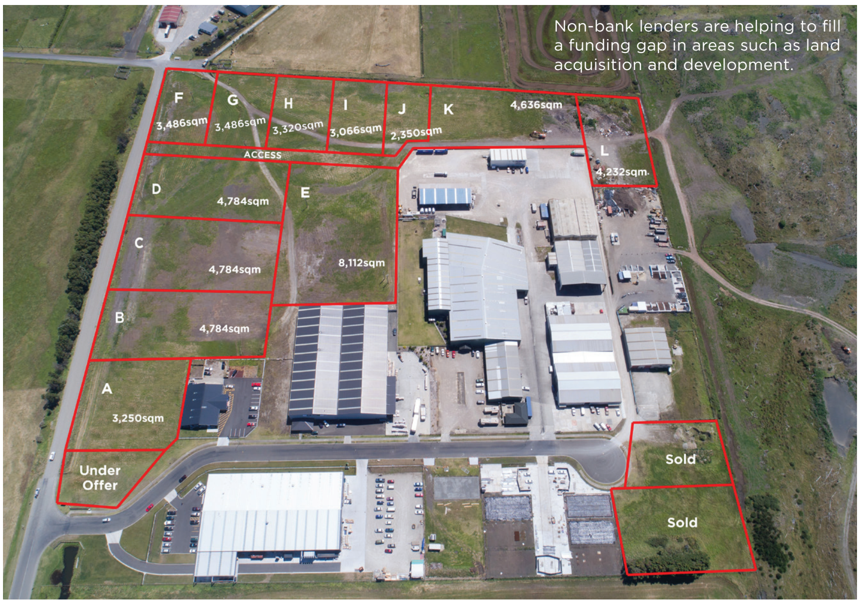
WINNING FORMS: TIPS FOR DEVELOPERS

How can commercial property developers put themselves in the best position to obtain finance for their projects? Mark Farrands offers the following tips:

- Don't take on too many projects at once if it's going to stretch your team's capacity.
- Keep your finance application simple – and factual. Don't embellish the truth or exaggerate.
- Show that you understand the risks, and mitigate them where possible – for yourself and the funder. Undertake legal due diligence reports to provide to the lender, using a specialist commercial property lawyer to identify the key legal issues and risks.
- Advance your project design as far as possible before asking builders to quote – the more scope for changes in design, the more scope there is for cost creep. Lenders recognise this.
- Surround yourself with experienced, well-credentialed people. Financiers evaluate the entire team delivering the project. Check the reputation of your proposed consultants with the lender, or use word of mouth recommendations from other developers. Those with the cheapest fees are not necessarily the best. Use a head contractor that has a strong reputation and has not taken on too many projects at once.
- Banks typically have strict criteria for what they will accept as presales. If you need flexibility from the lender on presales (whether it be lower debt coverage, allowing purchasers who have bought more than one unit/section, allowing less than 10 percent deposits, etc), it is vital to consult financiers early, so you understand pricing and what other factors may be considered. If you get this wrong, it could result in lack of funding options or considerably higher pricing.
- Use property debt specialists to assist you with your financing options to ensure optimal funding outcomes.
- If using a broker, ensure you do not use multiple brokers who will shop your deal to the same parties.
- When putting together feasibilities to calculate return on equity and internal rate of return, assume realistic time lines and funding costs. For larger projects consider how delivering the projects in separable portions can deliver lower funding costs.

Finally, Farrands says, developers should try to choose a lender whose interests are aligned with their own.

"A profitable project should be able to be funded at reasonable rates so that the lender is comfortable with the risks and lends at rates which enable their loan to be repaid and for the developer to make a decent profit also at the end."



Non-bank lenders are helping to fill a funding gap in areas such as land acquisition and development.