Buletin Geoinformasi, Jld. 2, No. 1, ms. 224 - 229, Mei, 1998
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Financing An Office Development

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Abstract

The issue of financing is very important for developers and real estate professionals. This issue has becoming more serious during the economy slowdown. The developers and the real estate professionals are in doubt on how to finance an 200,000 sq. ft. office development in major city such as Kuala Lumpur. Once they know how to finance this major development, they will have the confidence to carry out the office development effectively and efficiently.

1.0 INTRODUCTION

Proper funding is a prerequisite of successful property investment and development. Finance or capital is an essential input whose cost and availability can influence the viability of development. It is also a medium through which new and relatively complex investment interests in property are created. Just as borrowers must select an optimum mix of financial liabilities, financiers must also maintain a balanced and diversified portfolio of assets. For financing to take place, therefore, the arrangement must not only reflect the needs of the borrowers, but also fulfil the investment needs of the financiers.

The paper attemts to discuss the ways in which an office development of about 200,000 sq. ft. located in a major city i.e. Kuala Lumpur may be financed. The discussion covers the two basic types of development finance i.e. debt or equity finance which generally takes two forms, namely, corporate finance or project specific finance. Figure 1 illustrates the funding option available under the debt or equity finance.

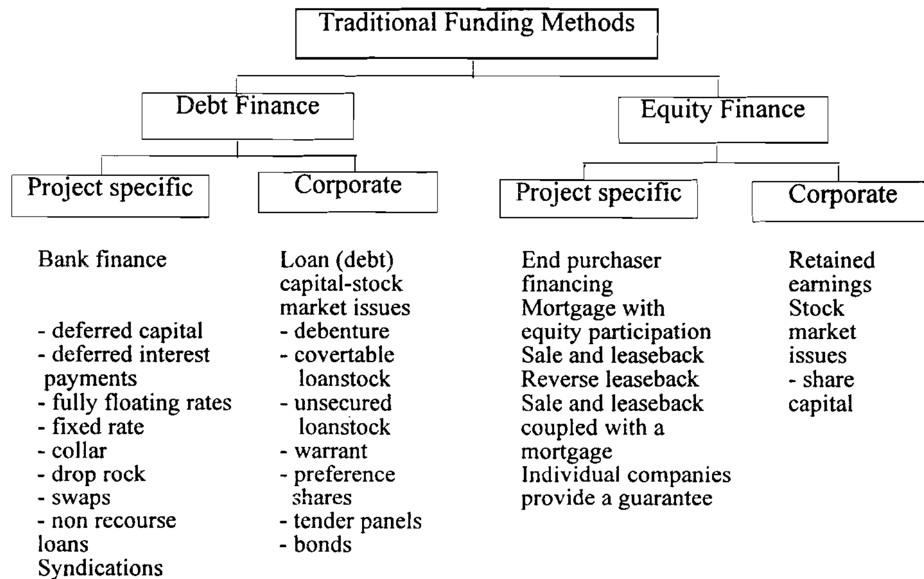

Figure 1: Funding option

2.0 EQUITY FINANCE - PROJECT SPECIFIC

2.1 End purchaser financing

Where the property company is able to sell the scheme from "plans", the investor is the end-purchaser who commits to buy the scheme at the conceptual stage if and when built and let in accordance with the plans and rental projections. A forward sale is usually a pre-requisite for short-term loans, where delivery is at a future date but a price is agreed now. Though repayment of the bridging loan capital will be protected, it is invariably at expense of part of the developer's profit. If the interim development funding is obtained from the purchaser, the developer can expect a more favourable interest rate on the bridging finance. The attraction of this method to the developer is that his financial liability is minimal and he receives an attractive fee for managing the project. Considering the current market condition, where it was predicted that there will be an oversupply of office spaces (particularly in the city of Kuala Lumpur), it can be said that this type of funding is doubtful to be available to subject office development.

2.2 Mortgage with equity participation

One of the earlier forms of equity sharing in individual developments. The advantage is lenders were willing to charge lower initial interest rates on their capital in exchange for a proportion of future rental growth eg. a 30 % participation in the equity income.

2.3 Sale and leaseback

The advantages to the developer include the creation of an immediate profit rent and a continuing participation in it; the provision of total permanent finance, the possible elimination of the need to find bridging finance from third parties, the elimination of an initial income shorfall problem and the creation of a saleable interest which can be used to raise further capital for other projects. The disadvantages include the loss of the freehold interest, much of the equity and gearing advantages. If the leaseback is geared, the chances of obtaining negative cashflows due to onerous rental commitments are greater. The developer may not share in future income growth after certain bench-marks are reached. Oher cons are a limited interest in the property, fettered by leaseholder's covenants and frequent rent reviews; tax complications; the requirement that a minimum return be guaranteed by the developer; and inability to re-finance the project at some later date if market conditions improve.

Over the years this method has undergone a number of refinements and modifications. These changes, with consequent changes in the balance of advantage for the parties, were the result of perceptions of injustice by one side, and also as a result of underlying changing demand-supply condition in the funding market. The main methods of sharing the investment income from the completed project are:

- (i) top/bottom slice arrangement
- (ii) side by side or vertical leaseback shemes
- (iii) geared top slice arrangement
- (iv) ungeared i.e. proportionate sharing agreements.

2.4 Reverse leaseback

The developer retains the freehold and grants a long lease to the lender to retain a superior position and a more valuable interest. A long leasehold is granted to the lender at a pepper corn rent during the period of development. The developer acts as a project manager at this stage. On completion, the developer retain the freehold and receives a proportionate ground rent subordinated to the first change on the project income in favour of the financier.

2.5 Sale and leaseback coupled with a mortgage

The developer sells the freehold to an investor and then leases it back subject to a mortgage being granted to him by the same investor of the leasehold interest - this interest created by the developer via the leaseback. The advantage to the developer is that he retains greater control and full use of the leaseback and the resultant income, subject only to securing the mortgage loan. With declining interest payments on the reducing amount of the outstanding loan and increasing rents, the developer enjoys an increasing surplus, anticipated rental growth need not be shared with the lender until rent reviews.

2.6 Individual companies provide a guarantee

Individual companies, consortium or venture capitalists provide a guaranteed source of collateral against which the developer can raise debt finance. The equity partners have no physical involvement in the development, do not form a joint development company and none of their money is used directly to meet the costs of development. They simply underwrite a lump sum in excess of development costs (including interest) with an agreement to pay at a later date; and it is against security that the borrower obtains finance.

3.0 EQUITY FINANCE - CORPORATE

3.1 Retained earnings

Two alternatives for generating funds internally are; first, to undertake development for sale as opposed to investment, and second, to undertake a programme of disposals of existing property, especially low yielding and reversionary property. The lender, in the above cases, is not involved if retained earnings are used, as "finance" comes from the developer's existing resources.

3.2 Stock market issues - share (equity) capital

There are two options open to the developer for increasing the capital of a company: loan (debt) capital or share (equity) capital. The capital structure will typically be a mixture of both. Equity share capital is restricted to the issuing of ordinary shares either through a public planning or through a "rights issue". Ordinary shares, or the equityin the company, participate in the true profit of thė company once the demands of priority interests have been met. However, not all the profits are necessarily distributed through dividends to the equity share-holders, a part of the profits are usually ploughed back to finance further expansion and development. A right issue raises additional capital by offering existing shareholders the right to purchase a stated number of additional shares, usually at a favourable price.

Ordinary share issues are relatively attractive source of new capital when interest rates on debt are relatively high and when share prices are high with divident yields correspondingly low. Initially, share issue are a very cheap source of finance because the initial cost is essentially the divident yield paid on the issue, plus under-writing and administrative costs. However, in the long run, the effective cost is much higher because it includes the dividend growth, investors receive overtime. Raising new equity capital by rights issue results in "equity dilution". i.e. an expansion in the amount of share capital without a proportionate expansion in growth potential. Thus, the degree of control and profit participation of existing ordinary shareholders are reduced. This type of arrangement is far simpler to make when a company is newly formed than by altering the share structure of an established company. It is attractive to lenders seeking a share in the overall comnpany rather than debt repayment as profit participation in an individual project. Developers, however, would be better off if the proposed expansion was financed by sales of existing property (low yielding and reversionary property), or in the case of lower geared companies by borrowing.

4.0 DEBT FINANCE - PROJECT SPECIFIC

4.1 Bank finance

Bank loans for property have been akin to mortgage loans whereby the capital and interest are repaid simultaneously at regular intervals throughout the term at a rate of interest set at a fixed margin above a safe point of reference borrowing rate or cost of capital. The advantage to developer is that once loans and interest have been paid, he can receive or release the full profit from his investment (office development) without sharing with lender. Inflation, however is one of the factor that developer should bear in mind. This type of financing has been argued to be suitable for short term rather than long term, unless an appropriate fixed interest rate has been accepted by both developers and lender.

A number of techniques have been devised which introduced flexibility with respect to the precise amount and timing of a loan in order that the developer is more able to adopt to changing market condition by deferred of payments, compartmentalisation of risk and reduction of corporate liability exposure to particular projects such as:

(i) deferred capital
(ii) deferred interest payments
(iii) fully floating rates
(iv) fixed rate
(v) collar
(vi) drop lock
(vii) swaps
(viii) non recourse loans

4.2 Syndications

These are typically a group of banks, corporate entities or individuals who combine to meet the costs of a project too large for a single lender or investor. It benefits the very large developer.

5.0 DEBT FINANCE - CORPORATE

The principle is that developers borrow a lump sum of money against their corporate assets in return for which they undertake or make a "bond" to pay interest on until the principal is redeemed. Traditionally, fixed interest debt was the most popular form of long term funding for quoted property companies, and large amounts of capital were raised by the issue of debentures and unsecured loan stock. Set out below are the variations on a theme:

(i) debenture
(ii) convertable loan stock
(iii) unsecured loan stock
(iv) warrant
(v) preference shares
(vi) deep discount bond issues
(vii) tender panels
(viii) commercial paper
(ix) eurobonds

After considering the appropriate option of funding for subject office development the next section deals with the short term and long-term financing.

6.0 SHORT-TERM FINANCE

Unless also provided by the end-financier, short-term loans are usually obtained from the clearing banks and merchant banks. The interest rate can be fixed or floating variable rate basis. Only 60% to 80% of value is advanced, equity is not required an interest may be rolled-up over the development period. A borrower of a large amount is vulnerable to fluctuations in market rates.

Occasionally, the major financial institutions will provide short-term finance as part of an overall package where they are supplying the long-term finance in which case, interest will be rolled-up at a relatively inexpensive mortgage rate during the development period and will become payable as part of any sale and leaseback or purchase agreement once the scheme is completed and let. A refinement to such an arrangement is a "forward commitment" whereby short-term money is obtained from a bank but an investing institution guarantee to acquire the development once it is built and let.

7.0 LONG-TERM FINANCE

Long-term finance normally will take the form of debentures and mortgages, and for freehold and very long leasehold interests, i.e. 99 years, through a sale and leaseback. More recently various forms of syndicated long term loans have been designed for property companies. Borrowers pay fixed or variable interest rates and effectively depends upon the share of the profits or equity participation the lending institution expect to receive in addition to a basic return upon their loan. Generally, the lower the rate of interest on the original loan, the greater the expectation of equity participation.

8.0 RECENT DEVELOPMENTS IN PROPERTY DEVELOPMENT FUNDING - PROPERTY SPECIFIC INNOVATIVE TECHNIQUES

With the advent of very large development schemes in the form of multi-million dollar developments, traditional forms of debt and equity financing have proved insufficient in meeting the massive cost of such mega-projects. These schemes have given the impetus of creating new and more property specific innovative techniques of development finance.

The concept of unitisation evolved essentially in relation to large properties where liquidity has previously been restricted as a result of the relatively few investors able to make the required financial commitment. The relatively low denominations of the individual share certificate or other securities issued under a unitisation scheme, coupled with the fact that such securities are marketable, open up the market in those major properties to modest, small seek investors with a consequent increase in liquidity. The developer can only raise a relatively low level of conventional debt finance based on the level of rents from large properties or a stand-alone basis. More finance can be raised for a given current rental level using unitisation as its features are income growth linked to rental growth, and capital growth linked to property appreciation.

There are three main vehicles in unitisation; property income certificate, unitised property market and securitisation. Property income certificate and unitised property market have in common that they are in essence means of selling or sharing in the rents that the development produces. In the case of property income certificate the investor gets a contracted share in the income that the scheme produces whereas in the case of the unitised property market, he gets a percentage interest in the ownership of the freehold property with the benefits that flow to that share of the ownership.

Securitisation is a property specific bond issue guaranteed against the underlying cashflow and capital value of the property. The technique combines instruments of debt, preferred equity and ordinary equity secured on a single property asset in order to access the widest possible pool of investment capital and thereby, enhance liquidity through tradeability in established daily markets. The advantages of securitisation are that it is flexible, and it works within existing law and tax rules.

9.0 CONCLUSIONS

The various financial formulae that have evolved are a result of the symbiotic relationship between developers and financiers. Developers require finance, both to undertake a project and to retain an investment interest in it thereafter, whilst the financier needs to obtain modern equity investments. Both parties need each other to achieve their respective needs and the deal that is struck will tend to depend on the cost and availability of finance, investment market and property market conditions, and the relative bargaining strengths of the two-parties.

Whereas traditionally, development financing has tended to be a straight-forward balance between equity and debt (normally mortgage debt) finance, today's more complex market dictates that development finance is part of the much wider field of business and corporate finance. Property development funding represents an even changing system of financial ingenuity responding to a wide variety of different circumstances.

A developer sees a proposed development in terms of opportunity for the exercise of his entrepreneurial skills and risk bearing, whereas the lender sees it as a potential investment. Any funding formula depends on mutually profitable experiences i.e. the creation of a viable end-product in the market place. And it is in this common aim of both the developer and the financier to maximise their returns for any given level of risk, that their fonflicting requirements are reconciled in the choice of a funding formula.

Considering the subject office development, it can be concluded that for short term finance, it is feasible for the office development to be financed by borrowed funds. With an upward trend of inflation, the developer should seek an appropriate fixed interest rate for his loans. If however, the objectives of the property company (i.e. developer) is to hold the office development for longer term as investments, there needs to be a reasonable proportion of equity finance to counter the initial negative yield. With the assumption that immediate sale or pre-sale is doubtful, perhaps the property specific innovative techniques of funding this office development is highly recommended.

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