A GUIDE TO PROPERTY DEVELOPMENT FINANCE IN NEW ZEALAND

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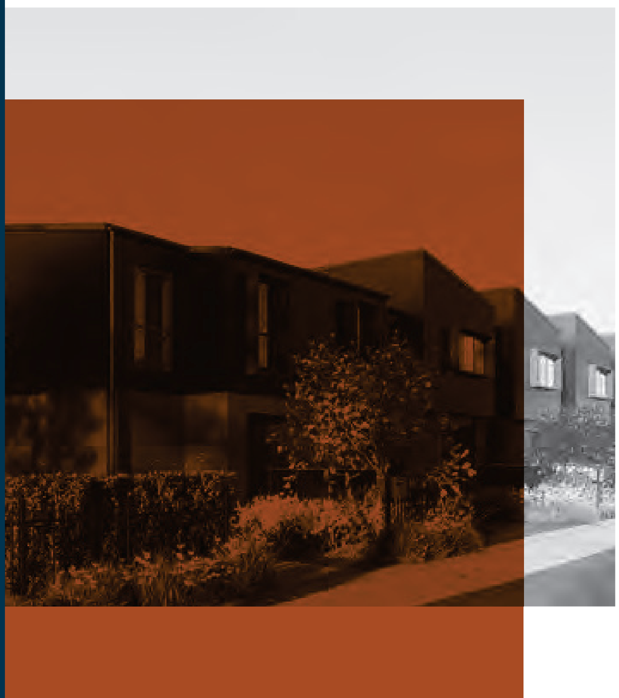

If you are able to develop your property, it's probably the best strategy for getting the maximum profit out of any piece of land.

Development finance (also called construction finance) is the money used to subdivide and/or construct building(s) on a piece of land – whether those buildings are residential, commercial or industrial. Banks have traditionally been the first port of call for developers looking for finance where cash equity is limited.

However, development is a risky business and banks are nervous animals. Finding funding for your small-scale development is not straight forward anymore. The major banks are usually only interested in lending to experienced large-scale developers – and current strict criteria requirements mean even those people are often turned down when they apply for a loan.

Since 2016 banks have become more reluctant to lend to developers, particularly new developers, and consequently other lenders who also fund such borrowers have become more prolific in recent times.

Arranging your finance, from who to approach to how to apply, can be complex and sometimes stressful. This e-book is designed to help you have a better understanding of the challenges and opportunities of development finance.

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Banks, non-bank lenders and private lenders

If you or your company has enough cash to pay for your development, you won't need borrowed finance. For most people though, borrowings are necessary for their development to proceed. Before 2016, your best bet for obtaining funding for your development was to go to your local bank branch and speak nicely to the manager. That might have been ANZ, Westpac, ASB, BNZ and latterly Kiwibank. Depending on the deal size you may have been referred to their in-house Property Funding Unit.

The bank would evaluate your project, and in particular would look at the expected cost of building, generally confirmed by a Quantity Surveyor (QS).

So how can you get your development off the ground without securing many (or any) presales?

Banks

Surveyor (QS). The manager would also consider the sales price of the completed development and how much profit was in the project. If that profit was high enough, you'd probably get your loan approved. The bank manager would usually give you a number of presales required – how many units you need to sell 'off the plans' in order to help repay debt on completion, and off you would go.

But since 2016, banks' loan criteria has tightened up considerably. For example the bank is likely to demand presales that will more than fully cover the debt, which might be up to 125% of the loan amount to allow for possible settlement defaults. A target like that makes it difficult to start construction, since getting presales in a flat market is challenging. Banks are not interested in the fact that completed properties are usually sold very quickly. They want a contracted exit for the debt on day one.

Non-bank lenders

Over the past five years non-bank lenders have stepped up to fill the gap in the market left by the banks. These finance companies have quickly upskilled to learn more about the development market, getting to know the potential risks and rewards inside out. They are sometimes referred to as specialist development funders.

These lenders usually have money available to lend to developers. That money comes from a range of sources, often including private high-net-worth individuals, trusts, wholesale investors, large investment companies and ironically bank lines.

The main advantages of using a non-bank lender? They will often lend you more than a bank, they generally ask for fewer presales (sometimes none) and overall you need less equity when compared to a bank. That means your development will probably be able to get going much more quickly.

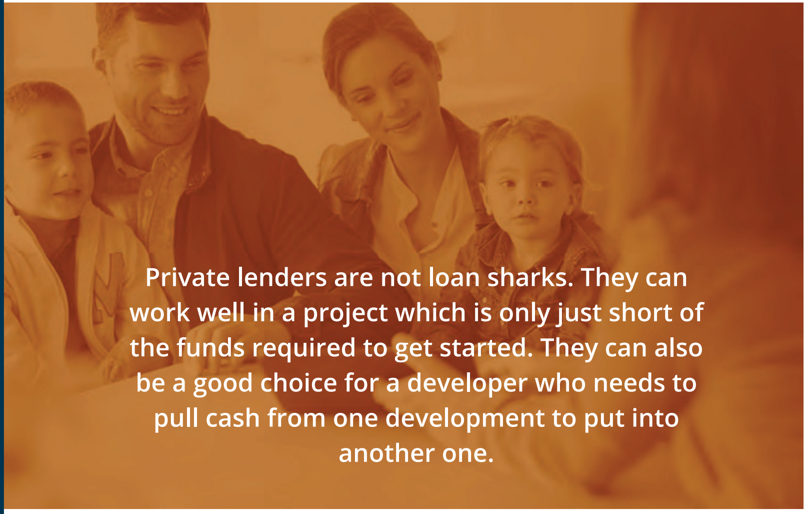
Non-bank lenders and specialist development funders can help get your development started much more quickly.

Private lenders

Private lenders can give you the most flexibility when it comes to your development loan, in both terms of both presales and greater leverage (you are able to borrow a higher proportion of the development's value). The funding from private lenders includes mezzanine funds, which when combined with senior debt is known as stretched senior debt. (Senior debt and mezzanine funding are priced in two tranches then blended together in this instance.) Mezzanine funding also can be a separate second mortgage.

You can usually borrow more from a private lender, sometimes up to 90% of TDC, but in every case they want to ensure there's some 'hurt money' in the project. That protects them if something goes wrong and gives them some margin to offset the risk of loss should sell-down proceeds be inadequate to repay the debt.

Because of the reduced 'hurt money' and because generally they use their own money to fund your loan, private lender funding is typically the most expensive funding option.



What are GRV & TDC?

GRV stands for gross realisable value. That is the value on completion of the development project – what it will all be worth when all the houses are finished. This is a term commonly used by banks and finance providers, and it's an important number when it comes to calculating how much you can borrow.

In some cases, banks will lend you up to 65% of the GRV with non-bank lenders sometimes lending up to 70%. For instance, if the final total value of the two townhouses on your section will be $3.5 million, you can borrow up to $2.275 million (65%).

TDC stands for total development cost. It is the sum of all the costs of the development, including buying the site, getting consents, construction, sales, financing and holding costs – plus more. If you subtract the TDC from the GRV, you have your profit.

The size of the profit margin (GRC-TDC) is a factor in determining the amount of equity (hurt money) required.

Borrowing from banks and other senior debt funders

Banks prefer to support developers with experience. If you've already completed five successful developments, the bank is likely to be far more receptive to your loan application. If, on the other hand, this is your first development, the bank will be scrutinising your situation far more closely.

As at late 2019, New Zealand banks are under increasing regulatory restrictions from the Reserve Bank. These are designed to make our banks more robust in the event of another global financial crisis. This means banks have less appetite for risk. They are less likely to lend into certain asset classes, one of which is property development – this is an area that is 50% more capital-hungry than other types of lending because of its high-risk classification.

As a result, banks are currently lending almost exclusively to existing development customers, and not taking on any 'new to bank' business – even if it complies with their lending standards. This is frustrating for borrowers and it's a great reason to develop relationships with more than one bank. Consider splitting your home loan, investment property loan or other investments across two or three banks; it can help out when it comes to requiring development finance.

How much can you borrow?

• Multi-residential, terraces and apartments: banks were previously lending up to 80% of the TDC, but that is now down to around 65 – 67% of GRV (excluding GST).

• Commercial property: similar to the above, but it will depend on the development characteristics and location – banks may be slightly more conservative than residential development.

• Maximum facility limit: this varies amongst the banks, but the big Aussie-owned banks usually look to 'club a deal' (link up with another bank on a 'pari passu', aka equal footing, basis) if it is over $50 million.

How much can you borrow?

• Maximum term: Usually around 12 to 24 months, depending on your construction programme.

• Interest: Usually capitalised.

• Interest costs/fees: Case by case. Typically it might be a 1.00% establishment fee and a 1.00% line fee. An interest margin over the 90-day bill rate of 2.50% to 4.00% (in mid August 2019 all up 6.00% to 8.50% with the bill rate at 1.50%.)

• Repayment source: Generally selling down the finished properties, or your rental income if you're developing to hold.

• Presales: Very few transactions are funded without full debt cover from approved presales. Sometimes you will be required to have 125% of the debt amount covered by presales in case some of the sales fall through – without this the Australian-owned banks have to report the transaction to their Australian head office as a loan exception, which they prefer to avoid.

• Residual stock lending: This depends on the location and the gearing level of the project's financing, so it's case by case.

What type of projects are best suited for bank lending?

Large projects, strong presales, experienced sponsor

Banks are ideal for any project where you can qualify for the funding, but presale and other requirements such as QS input generally relegate bank funding to larger projects, particularly those which have made sufficient presales. They offer the cheapest funding because they take the least amount of risk compared to the non-bank lenders.

The pros and cons of borrowing from a bank

Advantages	Disadvantages
The lowest interest rates when compared to other funding sources	More presales are required to get the project underway
Potentially more flexible about developments in the regions, outside the main centres	Likely to lend a lower proportion of TDC than other types of lenders
More convenient payment management	More paperwork and hoops to jump through, so it can take longer to put funding in place; QS reports usually required
Experienced developers can get good deals from banks	QS required to process monthly drawdowns (cost circa $4,000 pm)
Can be more tolerant in the case of a significant delay on the project	More restrictive terms for ower- builders and developer- builders – the bank may want to see independent project management if not using an independent main contractor

What will be used as security?

• First mortgage over the properties that will be constructed, and any collateral security required.

• A general security agreement (GSA) over the borrowing entity, and guarantors providing all rights over the security property, all present and future presales, and any other related assets.

• Full recourse guarantees for the director and shareholders (sometimes limited recourse may be able to be negotiated where appropriate).

• Tripartite agreement between the bank, the developer and the builder (on larger projects, otherwise the contracts and documentation are assigned to the lender via a specific security agreement).

• Assignment over any present and future presales and/or pre-leases.

What do their lending criteria focus on?

• Sponsor experience: If the sponsor is inexperienced, it is likely that a bank will want to see suitable professional management and more QS input to mitigate risk.

• Equity: Is there are suitable amount available and sufficient collateral available? Is there acceptable financial strength demonstrated in the statement of position and projected income?

• Presale cover: Will it cover at least the full debt?

• Location: The banks want to see a good location, which is necessary to mitigate the risks of settlement defaults and then finding replacement purchasers.

• Design: Ideally, the banks prefer recognised architects and engineers. This makes them feel more confident in the quality of the final product.

• Suitable ground conditions: A geotech report will be needed and it should show no contamination (or how any contamination will be mitigated). Also, an appropriate foundation design in terms of cut/fill requirements, compaction, piling etc.

• Experienced contractor: The contractor should be confirmed acceptable by the QS.

• Contract: A NZS 3910 fixed price contract and a 3916 contract (design and build with independent engineer).

• Experience: Currently most banks are not funding new to bank customers.

• Feasibility: The project must have a suitable profit margin, generally over 20%, and the QS is required to check and confirm budget is acceptable.

• Sale and purchase agreement for site: How long has it been owned? Are there any historical issues? Are the title encumbrances acceptable?

• Valuation: This must be by a bank-approved "panel" valuer.

• Consents: All the consents must be granted and with acceptable conditions that have been properly reflected in the budget if there's a cost involved.

• Other consultants: These must all be approved by the bank and also the QS.

• Programme: Is it realistic? This should be approved by the QS.

Borrowing from non-bank lenders

Non-bank and specialist development funders are willing to take more risk, but they charge more for their money. Whilst many of the banks' criteria are taken into account by these lenders, they generally focus on the ability to complete and what the gearing will be on completion.

Non-bank lenders assess development finance slightly differently
Non-bank lenders obviously want to ensure you have sufficient funds to complete your development. However, where banks are more concerned with your experience as a sponsor, non-banks spend more time analysing the project itself and whether it can realistically be delivered with the proposed builder/consultant. They want to know: Can it be completed? Can it be sold down easily? If it goes wrong, would they be happy to own it and complete it if necessary?

How much can I borrow?

• Multi-residential development: Generally you can borrow up to 85% of the TDC. But more importantly, up to 70% of the value on completion (excluding GST).

• Landbank funding: Around 50% to 60% of land value, provided the project is in a good location that would be easy to resell if necessary.

• Maximum facility limit: Up to $20 million. (The larger the amount you're looking to borrow, the smaller your pool of available lenders will be.)

• Maximum term: This will be based on the construction programme; generally 12 to 18 months.

• Interest: Interest is usually capitalised.

• Repayment source: Generally from the sell-down or refinancing on completion.

• Interest costs/fees: Usually a 2.00%-4.00% per annum lenders fee, with an interest rate of 9 to 13% depending on the risk of the deal.

• Presales: On smaller deals, up to $5.0 million, presales often won't be required in suburban areas where there is good demand for the product. Otherwise a sample demonstrating market acceptance of the product is usually required.

• Residual stock lending (after completion): LVR will depend on the location, rental income and sponsor financial strength. It generally requires a 1.00 to 1.5% fee and an interest rate of 7.5% to 10%. Rates can be lower for lower geared transactions.

What will be used as security?

• First mortgage over the properties that will be constructed, and any collateral security required.

• A specific security agreement over construction documentation and contracts.

• A general security agreement (GSA) over the borrowing entity, and guarantors providing all rights over the security property, all present and future presales, and any other related assets.

• Full recourse guarantees for the director and shareholders (sometimes limited recourse may be able to be negotiated where appropriate).

• A specific security agreement over construction documentation and contracts.

What does their lending criteria focus on?

Non-bank lenders ideally would like to see that you have experience as a property developer as this helps reduce risk. However, specialist non-bank lenders assess every project on its own merits, looking at the site itself, the location, and how saleable it would be if any sales fell through (so they can recover their funds).

The benefit of this is two-fold: First, non-bank lenders generally spend less time analysing your financials, which as a developer can be somewhat misleading due to the “lumpy” nature of the cashflows when work is in progress.

Second, if you are planning a good quality development project in a good location, non-bank lenders can be much more flexible with presales.

Depending on your gearing and the size of your development, non-bank lenders may even take the full speculative risk and not require any presales. However, their assessment will be based on their view of how easy it will be to sell down the completed product, and this varies from deal to deal. That’s why it’s important to really do your homework on the product you’re developing. You need to be able to show that it is marketable and it’s size and affordability are appropriate to the area.

With the current demand for rental property, BTR (build to rent) developments are becoming more popular for developers with sufficient equity to hold onto the end product. Ideally gearing on holds should be kept to 50% LVR or thereabouts, to ensure ongoing financing at acceptable rates.

Who are the non-banks good for?

The non-bank lenders and specialist development lenders are ideal for projects of between two and 30 units. Large projects, those which require debt of over $10 million, are generally staged if possible, and those that aren’t have fewer lenders to choose from. This doesn’t mean those large projects can’t be funded, but with less choice the price sometimes goes up.

When you don’t need presales to cover the full debt, you can get your project started much faster, and potentially sell for more – because you won’t need to use expensive investment channels or discount the prices to make sales.

The pros and cons of borrowing from a non-bank lender

Advantages	Disadvantages
Often no presales will be required – so your project can start sooner; consequently lower sales costs	Higher interest rates and fees than banks
You can borrow a higher proportion of your TDC and GRV when compared to banks	Many will only lend to projects in the cities, with limited regional lending
There's not as much documentation when compared to the banks	The maximum lending is usually $20 million Extending the facility may be expensive if the timeframes are overrun
More likely to lend to owner-builders and builder-developers than banks	Some specialist lenders charge project monitoring fees each month

Borrowing from private lenders

Non-bank lenders comprise finance companies as well as private lenders. They are similar in their criteria but sometimes private lenders can be even more flexible. However, this flexibility comes at a cost. The cost depends on the investor/lender's appetite for your project and whether or not they are prepared to own the development if it doesn't go to plan and they are left having to finish it themselves.

A private lender may take an equity position where the debt available is insufficient to fund the deal but it promises to be a profitable project. A good finance broker will make a huge difference to the lender's ability to assess the project favourably. The ability to demonstrate a project's strength helps get a good lending decision and appropriate pricing - and that can make the difference between your development going ahead and your land sitting idle. The average first-time developer will be disappointed with the results of a DIY financing effort, or even an inexperienced broker. A specialist funding broker provides enormous value at this point in the process.

Finance rates (interest and fees) usually start at around 14% per annum. For a mezzanine facility (second mortgage debt), rates start from around 20% to 25% per annum, including fees. For this reason, mezzanine facilities usually sit behind a senior bank so the overall finance cost is tolerable. A private lender is shouldering more risk than the first mortgagee, which is why they charge more.

Your loan may be structured as preferential equity (or pref-eq). Preferential equity doesn't necessarily involve a second mortgage, but usually the lender takes a shareholding in the development entity, the rate is even higher and the lender wants a 30% pa minimum return on the funds employed and/or 50% of the profit.

The benefit here is that you can contribute less equity and possibly withdraw that equity before the project is completed, allowing you start your next development. This has to be weighed against the cost, but a profitable project that is enabled this way can pay off well, and is often used on large projects.

Stretched senior finance:

When a lender lends a higher amount than a normal first mortgagee would lend, this is known as 'stretched senior finance'. It is usually priced as if it were two loans – a first and second mortgage with the appropriate interest rates – then blended to produce an interest rate applicable to the full debt amount.

Landbank loans:

Banks are less keen on landbank loans, particularly if there are no plans for development in the foreseeable future. If they can be convinced to lend, it is usually because of a wider relationship or other compelling reasons.

The price of non-bank funding often precludes long-term landbanking as land is a non-income-producing asset. Unless the gearing is very low or there is the independent ability to service the loan, debt may build up to an untenable point requiring repayment or restructure.

However, if you own the land with little or no debt, and you intend to develop, getting a landbank loan can be a way of providing funds for the initial soft costs involved in getting all the required development consents.

The pros and cons of borrowing from a private lender

Advantages	Disadvantages
Less equity needed, and potentially less senior bank debt, so you need fewer presales and you can get your development started sooner	Higher charges means you'll need a bigger profit margin to make the project viable
Documentation and verification tend to be less onerous than what banks require	Depending on how it's structured, you may need consent from the holder of the first mortgage (usually the bank)
Private lenders will work with owner-builders and builder-developers	Private lending can carry more risk if you are more heavily leveraged with a deed of priority signed
Excellent for settling a site quickly or borrowing for a residual stock facility	Not many investors/lenders prepared to take on such risk (generally they may as well be a developer themselves and take all the profit). Suitable for lenders dealing with experienced developers who lack sufficient equity or are undertaking large projects.
Potential to structure it as preferential equity so it doesn't need to be structured as second mortgage	

GRV or TDC: Which one is right for you?

This is one of the biggest differences between the banks and the specialised non-bank development finance providers.

For a lot of developers, a Gross Realisable Value Loan (GRV) can work out much better. Although it costs more, it is usually more highly geared, and as it is provided by a non-bank lender there are fewer hoops to jump through and lower presale requirements.

	Bank Lending 67% of TDC	**Non-Bank 65% of GRV**
On completion value (excluding GST)	10,000,000.00	10,000,000.00
Land cost / value	3,000,000.00	3,000,000.00
Construction + Other Costs	5,000,000.00	5,000,000.00
Interest & fees	360,000.00	650,000.00
Total Costs	8,360,000.00	8,650,000.00
Maximum loan	5,600,000.00 (67% of TDC)	6,500,000.00 (65% of GRV)
Developer equity required	2,760,000.00	2,150,000.00
Profit after finance costs	1,640,000.00	1,350,000.00
Net Profit %	19.6%	15.6%
Return on equity %	59%	63%

All figures are excluding GST, assuming the following:
- Bank lending 5.50% interest rate plus 2.5% fees (1.00% establishment fee and 1.50% line fee)
- Non-bank lending 11.5% interest rate plus 2.0% fees
- Construction term 12 months

This is a demonstration of how by using a non-bank, the additional finance cost reduces the developer's net profit by $290,000.

However, for the deal to qualify for bank funding, the bank will ask for presales that are enough to cover the debt, plus significantly more equity ($610,000 in this case). So despite the reduced profit, the non-bank lending looks like the better option because you can get on with the project more quickly and with lower equity.

If the "opportunity cost of equity" were taken into account, in spite of the better profit figure, the bank option looks even less favourable.

Time is money – and it's a lot of money when it comes to property development.

Presale Requirements - Banks

Presales are genuine, unconditional, arm's length (ie. not sold to the developer, his family or related entities) property sales that are made by a developer before construction is completed. Banks need certain conditions to be met in order to consider a presale 'conforming' – the main one is a 10% non-refundable deposit, which held in a solicitor's trust account.

Why do the banks require presales?

The Reserve Bank wants to make sure our banking sector is strong enough to weather another GFC or major recession. To do that, the Reserve Bank is putting in place additional requirements for banks, including increasing capital holdings. Holding more capital means there's less capital to spend in riskier investments like property development. As a result, banks are using various strategies to filter the deals so that only the best ones get funded by them.

Prior to the GFC, pre-sales were less of a requirement. Part of the reason was that residential developments were less costly and tended to be built at a smaller scale than they are today. The demand for housing has remained historically strong. Banks only required enough sales to show some demand for the finished units, and the bank was generally happy with a certain amount of residual debt on completion (usually no more than 33% LVR on larger projects).

Larger projects today, however, may contain 300 or more units and banks now require acceptable presales that cover 100% plus of the development debt, which provides a contracted exit for the debt on settlement of sales.

Lenders want presales for these reasons:

- To prove a market exists for that development before it is constructed. Presales give an indication of a minimum current price for the completed units and shows buyers are willing to put their money into the location and trust the developer.
- Presales form part of the lender's security, reducing risk. They provide a contracted exit to the debt on settlement. Normally a developer cannot afford to hold (service) the construction debt without using sales and/or rental income to offset the cost. Banks don't want to speculate that sales might be achieved or that the property can be rented. They want to see commitments that reduce the future servicing risk.

• The 10% presale deposits are secured by way of assignment to the lender so that when the project is completed the debt can be reduced.

• Fair and genuine sales. Banks will make sure their solicitors review all the presale contracts. They may need to confirm there are no undisclosed incentives, like cash rebates, and that sales weren't obtained under pressure (without an appropriate cooling-off period). Any sales with incentives or made under pressure could artificially inflate the valuation and affect security, as they may not be genuine market sales.

What makes a qualifying presale? Presales must meet certain criteria from the bank's perspective:

• The purchaser, if not a person (a trust or a company for instance), must personally guarantee the purchase.

• The purchase must be acceptable to the lender. It must be unconditional and arm's length – the contract can't be rescinded even if the borrower is placed in liquidation or administration or a mortgagee assumes control of the project. It's only when the project is completed and the Certificates of Title are issued that the contract is complete.

• A single buyer can only buy a maximum of two (sometimes three) residential units. There is also a limit on foreign purchasers. Bulk purchasers are not acceptable to the bank because it increases the risk of settlement problems – if the purchaser drops out it puts the entire project in jeopardy.

• The 10% deposit (generally 20% for foreign sales) is non-refundable and must be paid in cash and held in the solicitor's trust account; or by bank guarantee (normally assigned to the lender). The bank guarantee must be from a bank that's acceptable to the lender – another major bank, ideally.

• Though less popular now, "deposit bonds" may be considered in lieu of cash deposits as a minority part of presale purchases.

• No pre-sales can be rescinded or cancelled without the bank's written consent.

• Sales related to the Borrower are assessed by the Lender on their merits to ensure settlement capability, as generally only arm's length transactions are treated as valid pre-sales; and

• The pre-sale contracts exchanged – how many and their values – need to be confirmed by the solicitor on a monthly basis.

Development Valuations

Putting a cost on the construction of your development and the value of its end product is one of the most critical parts of getting your finance approved.

Valuations will make or break your development. Ideally, a valuation will confirm the potential future revenue from the completed development and thereby its feasibility. Or a valuation can show that a development isn't worth undertaking.

What information is required for a development valuation?

Lenders will have their own approved list of Registered Valuation companies (panel), which will provide the lender with a report on your project. The report assists the lender with their due diligence by including:

• All the available property details, including zoning and title information

• The values 'as is' and 'if complete'

• An analysis of the development project – risks, market, site and more

• Reviews of any environmental issues on the site, potentially recommending further reports such as contamination or geotech

These reports are usually long – up to 100 pages – and they will be an important decision-making factor for the lender when they choose to approve or decline your loan.

To create the report, the valuer will need you to supply copies of:

• Council fees, infrastructure charges and notices

• Building specifications and preliminary plans

• Finished unit sizes (floor areas) and/or a preliminary survey plan, if you have one

• Specifications of internal finishes

• Proposed asking prices for the finished properties

• Any pre-sale contracts for the proposed units, including any conditions

• Building contract

Valuation considerations

An 'in one-line' valuation is when the valuer puts a value on the as-if-complete development, and then assesses the property value as if it were being sold in a single transaction to a single buyer.

Typically, an in-one-line valuation is about 15 - 25% lower than the gross realisable value. For example, if your completed 25 units were valued at $10 million, the in-one-line valuation would be between $7.5 and $8.5 million. As a developer, the in-one-line isn't very helpful, because it may mean your lending is based on a lower figure.

Another thing that lenders may ask valuers to do, is to value the 'forced sale' value of the development. This is an estimation of the value that the property would sell for if put up for sale by the mortgagee – often referred to as the 'fire-sale' value.

These are considerations a lender will take into account when deciding whether or not to lend on any particular transaction. The more you want to borrow, the more weight the lender will put on risk mitigation and worst-case scenarios.

The information you'll need to complete a property finance application

When you're developing a site with more than one unit, the finance application is much more complex than simply building a single house.

To get your development funding approved, you'll most likely need to already have resource consent and ideally be well on the way to getting building consent, so you can lock down a builder and a construction contract.

What information is required for development finance?

Before you approach anyone about financing your development project, you'll need to make sure you have at least the following information:

• The location and how many units will be in the finished development

• The 'as is' value (the purchase price) and any outstanding debt

• The estimated value on completion: the total expected sales revenue

• An estimate of the council costs and professional fees

• Estimated construction costs

• Proposed project programme

• The loan term required

• Details of any presales

• Your estimate of the project's total profitability (feasibility)

At the next stage, when you actually apply for finance via your finance broker, for either a bank or non-bank loan, you'll need to provide the following information:

• Borrowing entity details

• The developer's background and experience, plus projects completed – provide brief details of the last few completed

• The project overview: its location, unit details, pricing, any available marketing material, photos etc.

• Sale and purchase agreement for the property to be developed.

• Details of any available collateral security.

• Copy of the resource consent, and the building consent if available

• The plans and specifications

• Financial feasibility for the project

• The proposed building contract (preferably not signed as the lender may have some specific requirements to include)

• A profile and resume for the proposed builder.

- Consultant list including the accountant and lawyer.

- Whether or not a QS is involved (this could possibly be switched over to the lender's QS if required but must be on the lender's panel)

- A statement of financial position for each sponsor and guarantor

- If there is more than one entity involved, details of the group structure.

- The registered valuation report (from an accepted valuer who is on the bank's pre-approved panel).

- A rental appraisal on the finished units.

- A schedule of any pre-sale contracts and a copy of the proposed Sale & Purchase Agreement, preferably prior to being be signed by the purchasers. The lender's solicitor will want to take a look to ensure all the details meet the bank's requirements.

Realistically, you almost certainly won't get your development finance application accepted, let alone approved, without resource consent, and most, if not all, of the above information. Up to this point any debt required would be landbank finance, perhaps sufficient to cover the upfront soft costs of obtaining resource consent, and perhaps building consent.

The property development financing process

Getting funding for your property development is not the same quick, straightforward process as borrowing to buy a house. Your residential mortgage broker can't do much to help you with development finance; this is a whole different ball game. (Be careful... some unqualified brokers will try to help, lured by the fees, but will often mess it up for you through a lack of understanding of the complexities, resulting in a poor/unworkable financing strategy, improper presentation, and not using the appropriate lenders.)

It's essential that you use knowledgeable specialists at every stage of your development. Before you get to the construction stage, this includes concept design, feasibility and option analysis – as well as your finance application. Any of these key aspects not done properly could jeopardise the viability of the project. Done right, it can maximise your profit margin.

Your development will cost millions of dollars – don't start by cutting corners on the very first part of the process. An inexperienced broker, or trying to do this yourself, is most likely to result in your development failing to be financed, or costing you more than it needs to. Our business spreads through word of mouth because our clients keep doing developments and making serious profits – we wouldn't have it any other way.

When you work with Cotton Consulting Ltd, we offer you a wealth of experience and insight into the development process, as well as being the best choice for securing the funding you need.

Once you have your consents in place and are ready to apply for funding, the finance process is generally as follows.

1 **Workshop scenario analysis, quote funding options, start discussions**

At the outset of your project, we can help you workshop your various finance scenarios. It starts with the feasibility of the project, which we can help to translate into an assessment of the project. It will help you establish what equity and presales, if any, may be required. At the early stages, we can initiate high-level conversations with banks and non-bank lenders, but we'll generally wait until you have all the information together. A competent broker will know how to manage this process appropriately, but it is critical to get this right.

2 **Lodge your finance application with funders**

When you have resource consent and other key aspects lined up, we will pull together a credit proposal tailored to the lender or lenders that will best fit your project. The proposal will summarise the details their credit team wants to know: the project overview, the risks and the market summary. We then manage the subsequent discussions with the senior credit managers as appropriate. We'll also talk to lenders to get a better understanding of any reservations they have about the project, so we can address them.

3 **Initial assessment by the funder**

When you have resource consent and other key aspects lined up, we will pull together a credit proposal tailored to the lender or lenders that will best fit your project. The proposal will summarise the details their credit team wants to know: the project overview, the risks and the market summary. We then manage the subsequent discussions with the senior credit managers as appropriate. We'll also talk to lenders to get a better understanding of any reservations they have about the project, so we can address them.

4 **Initial assessment by the funder**

When we lodge the finance application, we assess the market and find a lender (or more than one) that will be well matched with your project. In some cases, depending on the size of the project, we might shop around across several lenders to find out who's offering the best possible deal. Then the funder, or funders, will do a rapid assessment of whether the project is bankable.

5 **Indicative letter of offer issued**

When a lender does its initial assessment, it will make sure the project meets the lending team's criteria, then the lender will usually issue an indicative offer letter, which is still subject to many more criteria. These include: more verification, reaching presales targets, valuations, QS assessments and other factors.

This is helpful to the developer because it gives you an indication of what the lender wants to see. On the other hand, this is a non-binding offer, so they're far from a promise and the lender isn't necessarily going to proceed with the funding. Non-bank lenders are usually much quicker in their assessment process compared to a bank. Sometimes non-bank lenders will go straight to a formal loan offer requiring a quicker decision on acceptance, so as not to lose the deal.

6 →

6 **Valuation and initial QS report**

A valuation is a critical part of the process – you need to get it right. Experienced developers often get the valuation even before approaching the bank; the valuation provides a way of independently gauging the potential profits. Other developers may wait until they have some presales (just to show there's enough of a market), before they get the valuation.

A quantity surveyor is also helpful at this stage: they can assist with the budget and provide other advice. If the QS is on the bank's panel, they can provide the initial QS report required by the lenders before formal approval is granted. A QS is normally required by both banks and some non-bank lenders, and generally for any significant construction works with costs over $2.0 million.

7 **Formal assessment**

Once you have your QS report and valuations in hand, you then commit to a lender and work towards formal approval. Usually the presale targets won't yet have been met, and the lender will approve the loan subject to the project meeting its presale requirements. This is the point at which a non-bank lender or possibly a stretched senior facility can get your project out of the ground more quickly.

8 **A formal offer of funding is issued**

When the lender is satisfied with their assessment, they will issue a letter of offer. The letter will outline all the terms and conditions attached to the proposed loan. Then if you accept the offer, the lender's solicitors will issue all the documentation: facility agreements, GSAs, mortgage agreements, guarantees, assignments, specific security agreements etc.

9 **Settlement and initial funds released**

Once all the documentation is returned by your solicitor, all properly completed and executed, and all the pre-settlement conditions have been satisfied, the lender will settle the loan and advance the initial funds you need to get started.

10 **Project monitoring and progress payments**

Property development facilities are structured to be drawn down progressively as expenses are incurred. The lender will provide monthly drawdowns to pay outstanding accounts, predominantly progress payments to the builder. The quantity surveyor will certify that the works are being completed and provide a drawdown certificate on a 'cost-to-complete' basis, then the lender will release another payment. A GST overdraft facility is generally also provided, which is used to pay the GST portion of expenses and is refunded regularly following GST claims to Inland Revenue, so the facility balance fluctuates back to zero.

If a non-bank lender is being used and they have agreed not to require a QS (usually if the project is relatively small), payments will be drawn down on achieving pre-determined milestone payments, usually based on the Master Builders' standard contract. The final drawdown is normally on issuance of the Code Compliance Certificate, which, in conjunction with title issue, also provides for presale settlements (generally two weeks after title issue and CCC). If the project is not going to be sold down, refinance of the more expensive construction debt into an investment phase is then able to be completed.

Getting help with your development finance

If you would like to talk to one of our specialised development finance brokers, we can discuss your feasibility with you and put together a funding assessment to assist making your development project a successful reality.

Please contact one of the writers:

Ammon Acarapi, Registered Financial Advisor

Ammon began as a mortgage broker, guiding everyday Kiwis through the process of restructuring their loans to save them money and get them into property investment. That was when he started his own residential investment portfolio. Ammon then started a business that specialised in minor dwellings (aka granny flats) – Fuzo built 350 minor dwellings in Auckland, involved in everything from buying the land, to planning, consents, civil works, construction and then handing over the keys at the end.

For two years Ammon worked for ANZ as a mobile mortgage manager, giving him behind-the-scenes insight into how banks operate and assess risk. Then he founded SuperCity Mortgages, which has grown to be one of New Zealand's premier residential lending businesses.

Ammon then started Fuzo Projects, which undertook several major developments. He and his business partner developed four 12- to 15-lot terraced townhouse developments in Papatoetoe, Auckland, between 2014 and 2018. He also brokered development funding for clients, including funding and consent for a $24 million six-level apartment building and a 90-apartment building. This has given him a thorough understanding of feasibility, bank PFUs and the challenges of being a developer.

Seeing a gap in the market where small-scale developers had nobody to help them secure funding who could explain the process effectively, in 2018 Ammon started Strategic Mortgages and Development Funding. He believes only someone who has had their own bank balance on the line really knows what it's like to be a developer – and only a fellow developer can give you the best advice for your project.

Peter Cotton, MNZIQS; Dip Bus Fin

With over 25 years in the banking industry, and many years as a finance broker and property consultant, Peter has a comprehensive knowledge of all types of property transactions: residential, commercial and developments. He has a background as a fully-qualified Quantity Surveyor, working for professional QS firms as well as with residential and commercial building firms. That gives him strong insight into the processes of properly evaluating any development project.

Peter has worked managing ASB Property's capital budget, but most of his time at ASB was as a senior property finance lender. After the GFC he spent three years in senior management at Kiwibank and set up their corporate, commercial and property finance teams. More recently he has been working as a consultant to the finance industry, primarily sourcing funding for property developers and investors, but including working with ICBC and being an expert witness to the High Court. With a venture capitalist associate, he also assists in sourcing funding for all types of businesses that have potential to grow but are short on capital.

His main focus now is on helping developers and investors find the money they need to realise their projects and purchases. With banks less welcoming to property operators currently, Peter is an expert at finding specialist lending for developers who are starting out or equally those more seasoned. He has a broad network of industry contacts that allows him to have an unparalleled knowledge of how to help you get the funding you need.

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GLOSSARY

Collateral security
Any assets used as security against a borrower's loan. For example, if your lender has a claim over your home as part of a loan, the home is collateral security.

Drawdowns
In this context, a drawdown is accessing more money against a loan that is not withdrawn to its maximum. If you have a revolving loan of $100,000 and have only drawn down $40,000, you could still draw down another $60,000 without penalty.

Feasibility
A measure of how financially feasible a development is: whether it is possible, the likely costs and calculations of potential profits or losses.

Fire sale value
The price your development would probably fetch if the lender had to sell it immediately, below fair market value – the lowest likely amount you could definitely get for it.

Full recourse debt or full recourse guarantee
This is a type of secured debt that provides the lender with a way to recoup all their money if the borrower defaults. It is a loan that assures the lender they will be paid 100% of what they're owed – very low risk for the lender.

General security agreement
This is a type of security where the borrower gives the lender a security interest over all the assets of a development (or business) or over a specific group of assets.

Gross realisable value (GRV)
Total pre-tax sales value of all the finished units in a development.

Hurt money
Money put in up-front by the developer to show commitment to a project.

In one line valuation
A value provided for multiple dwellings as though they were sold to a single buyer, rather than each one to a separate buyer. Also known as a sale in one line or single transaction valuation.

Line fees
A lender fee that is a percentage of the value of the loan. The line fee will vary as the loan is drawn down.

GLOSSARY

Mezzanine funding
A top-up loan to the senior debt, to fund completion of the project when costs run over the original forecasts. More expensive than the senior debt.

Non-bank lender
A financial institution that lends money but is not a bank. Usually a credit union, building society or similar.

Pari passu
Latin for 'on equal footing'. A new loan that has equal payment priority with existing loans.

Preferential equity
A loan that is a combination of debt and equity. It's a type of loan that gives the lender the right to take ownership of a share of the project if the borrower defaults.

Presales
Properties sold 'off the plan' and unconditional before the development commences. These must not be to people or entities related to the developer – you can't sell all your units to your brother.

Property funding unit
Within a bank or non-bank lender, the specialist team of people who deal with property funding.

Quantity surveyor/QS
The professional who calculates what labour and materials are required to complete a build, and how much they will cost.

Residual stock lending
Loans against completed dwellings so the developer can hold onto one or more of the finished units.

Senior finance/senior debt
The first and original loan taken out to fund the development, usually at up to 65% of GDV or 80% of TDC.

Stretched senior finance or stretched senior debt
Senior finance that lends more than 65% of GDV or more than 80% of TDC.

Total development cost (TDC)
The sum of all the costs of a development, including everything: building costs, sales costs, holding costs, etc.

Tranche
A portion of a loan; usually used to describe each lump of money released by the lender in order, ie first tranche, second tranche of the development loan.