FINANCIAL PRODUCT GUIDE FOR
JUNIOR DEBT & PREFERRED EQUITY

WHAT IS THE DIFFERENCE AND WHEN DOES EACH APPLY?

Junior or Mezzanine Debt is best described as a debt top-up. It is used to cover a shortfall of debt where there is a gap between the Developer's equity contribution and the level of debt available based on the lender's Loan to Cost ratio policy. That said, beyond a certain Loan to Cost ratio or where the junior debt piece becomes larger than the amount contributed by the developer, it generally transitions into a preferred equity structure. In some cases the junior debt can exceed the developers contribution but there would need to be strong mitigating circumstances such as an elite developer with a demonstrably strong track record and or sponsor personal net wealth position to demonstrate they can contribute more capital if required but they are electing not to for sound commercial reasons. The old saying applies that if you prove that you don't need the loan then they will be more likely to approve it.

WHAT IS THE COST?

Junior debt ranges in cost from as low as 15% up to the more usual range of 22-24%pa. It is risk and reward balanced, so if the debt piece is low down in the capital stack where say the bank peaks at 70% LCR and the junior debt is topping up to 80% LCR and it is covered by presales with a good developer, a strong builder and metro location then the likely funding cost could be as low as 15%pa. Start diluting or removing some of those mitigating factors and increasing the risk by increasing the LCR beyond 85 or 90% and or lowering the resale cover and the cost will escalate. Upfront fees range from 3-5%, again based on risk and transaction size.

Preferred Equity is exactly that, Equity. And as such it needs to generate equity style returns. Developers often ask what is the least I can pay the investor, they argue that investors are only getting 2% in the bank so a return slightly above that should be seen as a bargain. That is fine if you want to deal with uneducated investors, take their money whilst they are playing lawn bowls, and then answer questions on a national current affairs program when things don't go quite as planned. Alternatively, you can deal with educated capital which understands the market, risk and return and can provide many other advantages which we spell out in a number of articles available on our website. The cost of this capital which is market tested regularly, typically involves what is referred to as a 80/20 - 50/50 deal where the developer puts in 20% of the capital component after the Senior debt funds 80% of the Total Development Cost and charges suitable DM fees, assuming they do not outsource that function.

WHAT IS THE COST?

The investors fund the remaining 80% of the "equity" component in return for which they receive 50% of the profit. Sometimes that gets fixed upfront as an exit fee, and often a coupon applies, either for the project duration, or sometimes there is a trigger for it to commence after project completion so any delays don't drastically reduce the Investor IRR, and to time motivate the developer to complete.

There are occasions where a capital partner might agree to fund up to 100% of TDC, however this is not widely available and would only be done in special circumstances based on very strong project metrics and an impeccable developer pedigree. The other thing to remember about this style of capital is that it usually only gets involved in a project that is shovel ready, if it needs to be involved earlier on in the project time line where more risk is involved and the cost will be comensuratly higher.

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RETAIL AND COMMERCIAL PROJECTS

The beauty of retail and commercial projects is that there is a tenant(s), preferably with a strong trading history, who will be committed upfront to pay rent once the building is complete. This avoids the risk of of multiple end buyers completing their purchase allows the construction debt to be refinanced promptly. This type of transaction brings its own form of market risk into play but is one that is easier to determine upfront. As such, capital partners will usually take a stronger view of these types of projects and a rough metric for a starting point in determining if the capital partner will be debt or preferred equity is their gearing relative to the on completion value. For example, if it is say 70-72% and below, then a refinance on completion is likely to be readily available with their exposure viewed as debt. If the combined debt package is higher than that gearing, a refinance and immediate repayment on completion is less likely to be achieved, and therefore the capital partner needs to rely on an asset sale or a debt reduction program over a longer period of time, all of which increases the risk and will generally result in a profit share or similar style requirement.