



ARGYLL

PROPERTY PARTNERS LTD



A GUIDE TO MEZZANINE FINANCE FOR PROPERTY DEVELOPERS

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INTRODUCTION FROM PAUL MARKOVITZ



These are challenging times for small developers small developers and housebuilders in general. According to Property Week, in 1988 there were 12,200 small housebuilders in the UK, but this had fallen to 5,700 by 2006 and collapsed to just 2,400 by 2014. These are alarming statistics for the industry at a time when the challenge to build enough new homes for the UK population has never been greater.

These smaller developers have been squeezed out of the market by a number of factors: the ever-rising cost of land and property; the dominance of the larger developers; the practice of landbanking, which according to prime minister Theresa May is being carried out by some of the large housebuilding companies; and inevitably, the difficulty of raising finance.

The latter is where we come in. Mezzanine finance not only plays an increasingly important role in the development market, it also helps smaller developers build momentum and generate a pipeline of future projects.

In 2017, the government promised to help SME builders gain access to public sector land and bring forward smaller sites. This is all well and good but as The Federation of Master Builders' CEO Brian Berry said at the time: "Almost a decade after the financial crisis, access to finance for small house builders is getting worse instead of better." Nothing has changed since then.

In this white paper, we look at why developers should consider using mezzanine finance for their developments. We then examine how they can put themselves in the best position to secure mezzanine funding. And finally we explain how we work with brokers and primary lenders to help developers receive the funding they require.

As ever, if you would like to discuss mezzanine funding with us, please do not hesitate to get in touch.

Paul Markovitz, Director

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WHY DEVELOPERS SHOULD USE MEZZANINE FINANCE

Some people see mezzanine finance as a form of last resort lending, but this is wrong. Many of our clients choose to use mezzanine finance even though they are able to fund their developments themselves. Argyll Property Partners director Paul Markovitz asks, why?

Mezzanine finance is used to fill the gap between a developer's equity and the senior debt provided by a bank. In a typical case, a developer will put up equity of around 10% of cost, the bank will lend around 60% of cost and the mezzanine lender will make up the difference. The mezzanine is provided as part of the equity required by the bank on day one, with the bank funding the building and professional costs plus part of the land acquisition costs.



2 WHY DEVELOPERS SHOULD USE MEZZANINE FINANCE

Contrary to what you may think, mezzanine funding is rarely used because a developer is short of funds. In most cases, our clients choose to use mezzanine funding even though they have the necessary cash available. Here's are six reasons why:

1. TO INCREASE THE INTERNAL RATE OF RETURN (IRR)

By using mezzanine finance a developer can significantly increase the IRR on his investment. This is best illustrated by an example:

TYPICAL 18-MONTH DEVELOPMENT CYCLE

	WITH MEZZANINE (£'000)	WITHOUT MEZZANINE (£'000)
GROSS DEVELOPMENT VALUE (NET) (GDV)	5,000	5,000
GROSS DEVELOPMENT COST (INCLUDING BANK LOAN) (GDC)	4,000	4,000
DEVELOPMENT PROFIT	1,000	1,000
PROFIT ON COST	25%	25%
PROFIT ON SALES	20%	20%
BANK FACILITY	2,400	2,400
MEZZANINE FINANCE	1,200	0
TOTAL BANK AND MEZZANINE FUNDING	3,600	2,400
EQUITY	400	1,600
MEZZANINE INTEREST AND EXIT FEE	315	0
NET PROFIT TO DEVELOPER	685	1,000
DEVELOPER'S RETURN ON EQUITY	171%	63%

As you can see, by using mezzanine finance the developer has been required to put in only £400,000 of his own money, compared to the £1.6m he would have had to put in without it. Not only he has he more than doubled the return on his investment (171% compared to 63%), he has freed up £1.2m to use on other projects.

2. IT OFFERS MORE CONTROL

Developers will often bring on board equity partners to help fund their schemes. This can lead to a host of issues not least of which is a lack of control. In our experience, equity partners nearly always want a say on how a development is run, and causing stress, conflict and delay. In addition, equity investment can be expensive.

Many developers see mezzanine funding as "cheap" (and stress-free) equity. In most situations, more than 80% of the profit will accrue to the developer, with the balance going towards the cost of the mezzanine finance.

3. MUCH OF THE COST IS A CHARGE ON PROFITS

The bulk of the cost of the mezzanine finance is payable as an exit fee on redemption of the loan. This means most of the cost of finance is a charge against profits earned rather than an additional working capital requirement.

"Not only he has he more than doubled the return on his investment (171% compared to 63%), he has freed up £1.2m to use on other projects."



4. IT'S A HIGHLY FLEXIBLE AND SIMPLE SOURCE OF FUNDS

Mezzanine funding is by its very nature flexible. Every project we work on is different and we make sure we put in place a funding package that works for both the developer and the senior lender. For example, in some instances we will accept alternative security in place of the normal 10% cash commitment from the developer.

In addition, we will rely on the same valuation and quantity surveyor's reports prepared for the bank rather than our own advisors. This is not always the case with equity investors.

We also have an extremely rapid turnaround on decision-making and the provision of funds. This ensures a smooth interaction between us, the bank and our respective solicitors. In fact, many of our clients are referred to us by banks.

5. IT CAN GET DEALS OVER THE LINE

It would be wrong to suggest mezzanine finance is never used to get deals over the line. Bank lending to the property sector has reduced dramatically in recent years with mezzanine funding doing much to fill the lending gap. Many successful developers and profitable projects have made use of our mezzanine support to overcome the lending shortfall.

6. MEZZANINE LENDERS OFFER STRATEGIC ASSISTANCE

Our business is to analyse each prospective project on the basis of its financial, marketing and construction viability to see if it fits within our lending criteria. This analysis includes the project timeframe, past experience of the developer and the availability of senior debt finance from a bank. This gives us huge knowledge and experience and we share this with our clients where it can help the success of a project.

Paul Markovitz, Director,
Argyll Property Partners

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5 THINGS A DEVELOPER SHOULD DO TO SECURE MEZZANINE FUNDING

If you want to secure mezzanine funding you will need pull several threads together so that the lender has a complete picture of the project and who they are lending to. Here's our guide to the essential steps developers should take to get their funding in place.



3 5 THINGS A DEVELOPER SHOULD DO TO SECURE MEZZANINE FUNDING



Here are the top five things a developer should do when applying for mezzanine finance:

1. MAKE A PROPER PLAN

Let's be clear about this, a list of figures haphazardly entered on to a spreadsheet is not a proper plan. Don't expect the lender to try to work out why the development stacks up. Comprehensive numbers showing how you have arrived at the gross development value (GDV), the gross development cost (GDC) and the cost of finance will give you the best chance of getting your loan.

2. BE REALISTIC ABOUT SALES PRICES

Tempting as it may be, don't pluck sales prices out of the air based on nothing more than wishful thinking. Be realistic about sales figures and back them up with empirical evidence.

3. EXPLAIN THE PROJECT IN WRITING

Buyers may be impressed by glossy sales brochures, but that doesn't go far enough for a lender. Tell us why you have bought or are buying this property, in this location and for this price. Explain your thinking behind the scheme, what

your target market is and what the key selling points are. Support it with data and facts.

4. TELL US ABOUT YOURSELF AND YOUR TRACK RECORD

We are interested not just in this development, but the people behind it. Who are you, who's on your team and what have you done before? Give us as much information as possible and don't sugar coat it. You need to be able to explain to us the reasons behind your less successful schemes as well as impress us with the ones that went well. If you can support what you've told us by recommendations and testimonials, all the better.

5. BE TRANSPARENT ABOUT YOUR SENIOR DEBT

If the legals, putting in place the security and the release of the funds is to go smoothly, there needs to be a relationship of trust between the lenders and their respective professionals. This starts with you being transparent with both the senior lender and us and providing identical information to each

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WORKING WITH BROKERS AND PRIMARY LENDERS.

Most of our new clients are referred to us by brokers and primary lenders. Likewise, we refer many of our clients to primary lenders and brokers and enjoy excellent relationships with many of the leading players in the market. Here, we talk about our relationship with brokers and lenders.



4 HOW WE WORK WITH BROKERS AND PRIMARY LENDERS.



WHY USING A BROKER CAN HELP DEVELOPERS

There are many advantages for developers using a broker when trying to obtain property funding. In a nutshell, what they bring is interpretation and presentation.

What we mean by interpretation is that brokers understand what lenders require. They know the information that needs to be included in an appraisal, how to do a desktop valuation and what biographical details about the developer lenders will want.

They also know which lenders to approach and how to present the relevant information in the best possible way. There is no doubt that a good broker adds value to both developers and brokers.

WORKING WITH PRIMARY LENDERS

Similarly, it is important to recognise that primary lenders and ourselves complement each other. We add value by introducing business to senior lenders and they recommend clients to us, so it is a two-way relationship. We know what they are looking for and vice versa.

We do a different job. In many instances, we allow developers to do deals that would otherwise be out of their reach and in turn this enables primary lenders to make loans that otherwise would have been denied to them.

ABOUT ARGYLL

Argyll has over 60 years' experience in property lending, real estate finance and mezzanine funding. With our years of experience, we are able to produce practical funding solutions geared to your needs. We are known for the speed with which we evaluate schemes and report back to applicants.



Paul Markovitz
DIRECTOR

Paul has over 20 years' experience in the UK property business, both in development and finance. Prior to this, he spent six years within the banking division of Citibank in New York. Paul Markovitz's focus is on the UK residential sector.



Michael Dane
DIRECTOR

Michael is a chartered surveyor. His career commenced with Knight Frank in 1983 before becoming a director of the property division of Robert Fraser, which provided joint venture funding for development projects. He continues to specialise in mezzanine funding for UK developers and housebuilders.



ARGYLL

PROPERTY PARTNERS LTD

argyllpropertypartners.co.uk

info@argyllpp.co.uk

Argyll Property Partners Ltd
3rd Floor, 52-53 Margaret Street
London W1W 8SQ

0344 472 3750

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