Dear

The Re-emergence of Structured Real Estate Capital

In this edition of ***Stamford Insights***, we look at the status of the structured capital market for commercial property, covering:

- current supply and demand dynamics;
- market pricing for structured capital (including mezzanine debt, preferred equity and equity); and
- security structures available.

We also touch on the use of structured capital to complete the whole capital stack where senior debt is not available.

Stamford has arranged over AUD $60 million in structured finance for our clients over the past 12 months (from both domestic and offshore sources).

The Structured Capital Market – 2012.

The Bigger the Better - from our experience over the past 12 months, the market for structured capital can be split into two distinct groups;

- Below $5M transactions; and
- Above $5M transactions.

Prior to 2008, the $2.6 billion structured capital market for commercial property was, in our experience, more liquid in sub $5 million exposures as opposed to larger mezzanine deals. This was a reflection of the market risk appetite and demand at the time given structured debt facilities of $1 million to $5 million were associated with deals with a total cost of approximately $10 million to say $40 million.

Michael Hynes
Director
d. +61 2 9046 8901
m. +61 412 224 178
e. michael.hynes@stamfordcapital.com.au

Domenic Lo Surdo
Director
d. +61 9046 8902
m. +61 411 879 398
e. domenic.losurdo@stamfordcapital.com.au

David Scardoni
Associate Director
d. +61 2 9046 8903
m. +61 403 609 585
e. david.scardoni@stamfordcapital.com.au

Mark Algie
Associate Director
d. +61 2 9046 8905
m. +61 401 532 231
e. mark.algie@stamfordcapital.com.au

During this time mezzanine funds were often required as a result of the small cap developers stretching themselves into projects, in certain cases beyond their delivery capability & experience. Limited balanced sheet saw such developers use structured capital to fill the equity gap.

Fast forward to 2012 and despite the reduction in the number of sophisticated/institutional structured lenders in the market; strong supply of mezzanine/preferred equity capital has re-entered the market. The difference however lies within the size of exposures. There has been a shift in the demand from capital providers for larger structured debt pieces ranging from $5 million up to $50 million.

The shift has been fuelled by the supply of capital seeking higher quality credit exposures. Projects requiring $5-$50 million structured facilities are driving developments with a total cost of $50 million to $500 million. Such projects are generally associated with experienced developers who do not require structured funds to complete a particular project, but rather utilise such capital to efficiently spread their equity over multiple projects. Such developers are also the ones receiving funding and support by the relatively thin senior debt construction market.

This is not to say that there is no supply of capital of sub-$5 million structured capital, however, such providers are now generally limited to the private or the high net worth market.

Competition = Interest Rate Compression - Given the lack of transparency associated with the structured finance market; it is difficult to ascertain what truly constitutes a ‘market’ interest rate. Based on the deals we have seen and executed over the past 12 months, the increase in supply of capital seeking larger structured exposures, coupled with the lack of funding opportunities & projects in the current market, has seen a noticeable compression in structured finance pricing.

Increased capital supply is apparent both from offshore funds, driven more recently from government changes to MIT withholding tax making debt investments look more attractive compared to equity, and local institutions including super funds.

It is however important to note that the capital available for the structured market will only invest in a project once it is relatively mature. Generally speaking, the project would need to have at least planning approval in place in order to attract structured funding. Of course, the more de-risked a project becomes (i.e. builder, presales/pre-commitments in place), the sharper the pricing.

Alternative Security Structures – Prior to the GFC, the banking market was open to allowing subordinated debt exposures to be secured by 2nd registered positions (both mortgages and company charges). Their current position however is somewhat different and many banks have openly informed the market they have a blanket policy that they do not allow subordinated capital to be secured.

Despite this, we are aware of a few recent transactions in which the registration of 2nd ranking security has been allowed. It is our view that the Banks policies have shifted to focusing on not just the quality of the project and developer, but also who the subordinated lender is.

Regardless of the banks polices, sophisticated structured lenders are adapting to the new market dynamics and are becoming more tolerant of preferred equity structures. Such lenders are utilising innovative/alternative security structures which may not give them the same rights as granted under a registered 2nd position, however, provide sufficient comfort commensurate to their risk appetite. As mentioned above, the increase in supply of structured capital has also been a contributing factor to pushing the capital providers to accept alternate security structures.

Structured Capital – whole of capital solutions…………

Moving down the security chain to 1st ranking positions, we have also seen an increase in structured capital providing ‘stretched’ senior debt facilities secured across one mortgage. Such lenders provide higher gearing loans with a blended interest rate equivalent to a traditional senior debt and mezzanine funding structure.

The market is generally unaware of the existence of this capital which is suitable for borrowers requiring debt in special situations which typically don’t meet the banks normal lending criteria. Such capital is ideal for:

- Borrowers seeking re-capitalisation of their current debt facilities driven by pressure from existing financier;
- Insolvency / workout exposures with clear exit strategy;
- Construction projects which fall outside the banks criteria;
- Asset rich / cash flow poor borrowers;
- Non-recourse exposures; and
- Providing equity underwrite for property syndicators.

Along with a number of new mortgage/warehouse funds, we have seen an increase in private capital looking for real estate debt exposures. As an example, we recently arranged a $4 million construction facility for a residential land subdivision in a regional NSW area. The developer had secured 100% presale of the sub-division to a project home builder, however as is typical with land projects, the presale was supported by a low holding deposits. Despite being an experienced developer, the low holding deposits meant the banks would not provide construction funding. Stamford arranged a $4 million, 90% of cost construction facility from a private investor which enabled the developer to commence project works.

Stamford prides itself on having market best knowledge of capital for real estate and welcomes the opportunity to work with and assist clients.

Regards,

David Scardoni
Stamford Capital Australia.

Stamford Capital Australia Pty Limited ACN 146 899 612
Level 5, Goldfields House - 1 Alfred Street Sydney NSW 2000