

THE PRODUCTS, PROCESSES AND RISK  
INVOLVED  
IN PROPERTY FINANCING

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# THE PRODUCTS, PROCESSES AND RISK INVOLVED IN PROPERTY FINANCING

by

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**University of Pretoria**

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## DECLARATION BY STUDENT

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I, the undersigned, hereby confirm that the attached treatise is my own work and that any sources are adequately acknowledged in the text and listed in the bibliography.

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DWJ SCHMIDT

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## ABSTRACT

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Title of treatise : The products, processes and risk involved in property financing

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Obtaining financing for property development is of fundamental importance to the development process. If the financing for a project cannot be secured, the project cannot continue. Property development is generally financed through a combination of owner's equity capital and debt capital.

The methods for obtaining financing for property development are diverse. However, with a larger part of property development normally being financed through debt equity, lending institutions play a major role in the property financing business. These lending institutions have a number of products available which are diverse and range from standard to customize and are complex in nature.

Lending institutions generally also have a standard process which they follow to obtain the information required to approve the debt capital needed by the property developer. This is a process developers sometimes have little understanding about and consumes a large amount of resources.

Property development is a risky business and therefore has a number of associated risk elements that should be managed with great care. The effective management of risk in property development is of fundamental importance.

With the financing of property development through debt capital, a relationship is established between the borrower and lender that can last for as little as a few months to a number of years.

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## INTRODUCTION

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### 1.1 Background

Property development has attracted much attention over time for a number of reasons and has subsequently enjoyed the attention of many different individuals, institutions and professions. It had contributed in a large scale to the wealth of individuals, companies, and the economy as a whole.

Property is seen to be a safe investment in the economy by many, even in troubled times. This investment harbor is therefore an attractive place for any investor seeking a safe port to anchor their wealth.

However, property development will not be possible without the financing required to get projects off the ground and to carry them through till they become income generating and self sustaining. This requires large amounts of finance which is normally extended over a period of time that can extend from a few years to decades.

Financing for development can be obtained through a number of means such as speculators seeking a return on their investment, lending institutions that lend money for fees and interest on the outstanding amount, etc. with the latter option being, by far, the path followed by many developers.

The involvement of lending institutions, however, differs from project to project depending on the financing required by the developer. A combination of private investment and financing from lending institutions are also common phenomena in the property financing business. Either way, lending



institutions form a major part of the property financing business. Lending institutions, in actual fact, require some sort of investment to be made by the developer himself before they will consider becoming involved in the financing of any development.

The financing structures available from the lending institution sector are diverse, ranging from standard to more complex in nature. The financing model required depends, to a large scale, on a number of circumstances such as the complexity of the project, amount of financing required, the period of the loan, type of borrower, etc.

The complexity of the project and the financing required also have an influence on the amount of resources that need to be allocated to the process. With different processes and methods, different resources will need to be applied to the application process. The management of the process, the relationship between the borrower and lender and also the identification and management of the risks involved all have an influence on the type and amount of resources needed.

The application process for financing and the management thereof is complex and requires highly skilled professionals to set it in motion, administer and to control. This is a concept that not all property developers understand or grasp due in part to the lack of literature on this issue. The more experienced and existing developers are aware of the complexities in the field of property financing and normally appoint individuals with experience and knowledge in this field to administer the process on their behalf due to their own lack of knowledge on the subject.

Smaller firms and new developers on the other hand are mostly unaware of the complexities in this field and have no sense of direction on where to start,

what the process entails, or the amount of resources needed to administer the process. Developers, new and existing, need to acquaint themselves properly with the different processes and procedures applicable to the financing of property in order to obtain the financing structure and package that best suits their needs, maximizes their gains and prevents unnecessary losses.

## **1.2 Stating the problem**

What are the products and processes in the property financing business and what are the associated risks involved?

It is the objective of this treatise to provide developers with a sense of direction on where to start the process of property financing, how to manage and administer the process and identify the risks that are associated with property financing.

## **1.3 The sub-problems**

### **1.3.1 Sub-problem one:**

What property finance sources and products of financing are available for property development?

### **1.3.2 Sub-problem two:**

What resources and processes are used in the financing of property as well as the management and administration thereof?

### 1.3.3 Sub-problem three:

What are the risks involved in property financing and how can these risks be managed and controlled?

### 1.3.4 Sub-problem four:

What is the relationship between the borrower and the lender? Why will the borrower want to borrow and why will the lender be willing to lend money?

## 1.4 The hypothesis

The main hypothesis:

Property financing strategies are diverse and complex in nature and differ from project to project. An understanding of the basics of property development financing, the sources and products available, the processes as well as the risks involved will be of tremendous benefit to the property developer.

### 1.4.1 Hypothesis for sub-problem one

There are various sources available for the financing of property development even though they may all be referred to as “banks” and normally have very much the same products and processes available. Property financing products differ from standard and simple products to structure debt, finance and/or funding.

#### 1.4.2 Hypothesis for sub-problem two

The loan application process normally follows a fixed process from client contact to registration. The process can differ to some extent, depending on the loan type and lending institution, but will normally follow the same basic structure.

#### 1.4.3 Hypothesis for sub-problem three

The future is a matter of the unknown and it creates the possibility that things could turn out to be different than what had been anticipated. The risks for the lender and borrower are of a different nature for both parties, yet are also still a reality that needs to be managed from both sides.

#### 1.4.4 Hypothesis for sub-problem four

The borrower and lender (financier) each have their own agendas when it comes to the financing of property.

### 1.5 Delimitations

The core intent of the treatise is to concentrate on the banking sector as the lender (financier). Even though lending institutions are not the only financiers in the property finance business, they do take up a large part of the market share in the property financing business.

The treatise therefore does not concentrate on other financing institutions even though mention may be made of these financial institutions at some point or another.

### **1.5.1 The appraisal**

The appraisal of the development determines the amount of money the financing institution will be willing to lend the borrower. It forms an important part in understanding the financing of property development and aspects thereof may be addressed but a full explanation of this concept falls outside this treatise.

### **1.5.2 Mortgage bonds for the individual**

Mortgage bonds for private home such as houses, townhouses, flats, etc. are excluded from the scope of this treatise as the purpose of the treatise is to concentrate on the financing business for property development and construction.

## **1.6 Definitions of terms**

- 1.6.1 Amortization: “Refers to the length of time it will take for a given periodic payment of principal and interest to extinguish a debt” (Collier SN. et al, 2008:183)
- 1.6.2 Annuity: “Refer to any terminating stream of fixed payments over an specific period of time” (Wikipedia, 2009)
- 1.6.3 Appraisal: “Real estate appraisal, property valuation or land valuation is the practice of developing an opinion of the value of real property, usually its market value” (Wikipedia, 2009)
- 1.6.4 Borrower: The word “Borrower” will refer to the property developer and vice versa.

- 1.6.5 Capitalization rate: “Is a measure of the ratio between the net operating income (NOI) produced by an asset and its capital cost (original price of asset)” (Wikipedia, 2009)

$$\text{Capitalization Cost} = \frac{NOI}{\text{Cost Value}}$$

- 1.6.6 Debt: “Is that which is owed.” “A debt is created when a creditor agrees to lend a sum of assets to a debtor, normally granted with expected repayment plus interest.” (Wikipedia, 2009)
- 1.6.7 Deficiency judgment: “Is a judgment lien against a debtor, defendant or borrower whose foreclosure sale did not produce sufficient funds to pay the mortgage in full. This option may or may not be available to the lender, depending on whether they have made a recourse or nonrecourse loan” (Wikipedia, 2009)
- 1.6.8 Discount point: “Involve adjusting the stated interest rate with an initial charge to effect a desired yield” (Wurtzeback, 1994:428)
- 1.6.9 Equity: Equity generally refers to the ownership interest in an entity. For the purpose of this treatise, equity will refer to the contribution of the developer to the development process.
- 1.6.10 Gearing: “Gearing is the ratio of debt to equity capital, that is the ratio of money borrowed to the amount of the clients own money invested in the property” (Wight and Ghyoot. 2008:97)
- 1.6.11 Interest: “The amount of money received, usually quoted as a percentage of the capital lent or invested (interest rate). Interest is the

remuneration of price paid for the use of money.” (Wight and Ghyoot. 2008:96)

1.6.12 Interest rate: The percentage of “interest” charged by the lending institution.

1.6.13 Lender: Lender will refer to the institution that will lend the money to the property developer (Borrower). In this treatise the word “Lender” can also be substituted with the word “Bank” and vice versa as the focus of the treatise is on the banking institution as financier.

1.6.14 Liquidity: “Is a business, economics or investment term that refers to an asset’s ability to be easily converted through an act of buying or selling without causing a significant movement in the price and with minimum loss of value. Money, or cash on hand, is the most liquid asset” (Wikipedia, 2009)

1.6.15 Loan: The word “loan” will mean the capital amount as well as the interest payable in the capital amount.

1.6.16 Loan to value (LTV): The amount of the loan as a percentage of the value of the property. The loan to value will therefore be an indication of debt financing in relation to equity financing.

1.6.17 Mortgagee: Lending institution with a first right over the proceeds of the sale of a property over which it has a bond secured, normally to recover the outstanding loan amount on the specific property.

1.6.18 Mortgagor: Owner of the property and debtor to the lending institution.

- 1.6.19 Net operation income (NOI): Total income generated by the property less total expensed from the property through maintenance, etc.
- 1.6.20 Origination fee: “An administrative charge made by the lender that is a direct cost to the buyer” (Wurtzeback, 1994:428)
- 1.6.21 Prime lending rate: This is the interest rate used by lending institutions as a reference point to determine the interest rate for loans based on the risk profile of the borrower. The prime lending rate is normally based on the repo rate of the South African Reserve Bank and is normally about 350 basis points (3.5%) above the repo rate.
- 1.6.22 Resolution: A resolution is defined by the free dictionary as: “A formal statement of a decision or expression of opinion put before or adopted by an assembly”
- 1.6.23 Term: “Length of time a debt is to be owed.” (Collier SN. et al, 2008:183)

## 1.7 Assumptions

The following abbreviations shall be assumed to be known by the reader:

- 1.7.1 LTV: Loan to value
- 1.7.2 NOI: Net operation income
- 1.7.3 ROE: Rate of return on total equity
- 1.7.4 ROR: Rate of return on total capital



## **1.8 Importance of the study**

- 1.8.1 The borrower is introduced to the business of property finance in order to provide him with the information needed to start the process of property financing, how to administer and manage the process, and to provide him with a general understanding of the property financing business.
- 1.8.2 Financing is a complicated process that is constrained to the development process and requires professional skills to manage. This treatise provides both the borrower and lender with an understanding of each other's needs, intentions and requirements so that informed decisions can be made by all parties involved.
- 1.8.3 Provide new as well as existing developers with a better understanding of the property financing business so they know the risks involved at an early stage. Thus equipped, the developer can take calculated risks based on informed decisions and manage these risks as best as possible.

## **1.9 Research methodology**

### **1.9.1 The Internet**

The internet provided a multitude of information but it must be consulted with caution due to the fact that there are no authorities regulating the information being published and any person can freely publish anything without validation. This could mean that the information provided by some authors on the Internet could be purely

speculation having no academic accreditation, which could influence the creditability of the treatise.

### **1.9.2 Books and articles**

These sources will be obtained from libraries and other academic and professional institutions and organizations provided information of a full accredited nature, but were not easily available as information from the internet.

### **1.9.3 News-papers and magazines**

These sources are of a less formal nature but still have some accreditation. They provided information related to current market conditions in the business of property financing as well as possible future trends and predictions as to what could be expected in the business of property financing.

### **1.9.4 Interviews**

Interviews with property developers and personnel from lending institutions will be conducted. Including both sides of the financial transaction provides a better understanding of the views and intentions of the different parties involved. The intention is to get a complete understanding of the property finance business by reporting from both sides of the fence. Interviews will also refer to electronic correspondence conducted with the parties involved.

## METHODS AND PRODUCTS FOR FINANCING PROPERTY DEVELOPMENT

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### 2.1 Introduction

In order for property developers to obtain the financing needed for their planned developments, it is important that they know where to look, what to look for and how to go about obtaining the financing that will best suit their needs and requirements. It is therefore important that the property developer should have a clear understanding of his financing needs.

In this chapter, the different methods, as well as the different sources of financing, that are available in the business of property financing are mentioned and discussed.

This chapter also contains a brief outline of the key functioning mechanisms of the property financing business, time value of money and gearing (leverage). It will also include a brief description of the difference between long, medium and short term financing.

Assuming that it is the intention of the property developer to maximize the return on his investment, this chapter will present numerous financing products, from standard to customized, which are available through different loan structures.

## **2.2 Methods for obtaining finance for property development**

### **2.2.1 Banker vs. Broker**

It is to the property developer's advantage to be aware of the fact that there are brokers that are available to assist them in obtaining the financing they require. Brokers will normally manage the loan application on behalf of the borrower, and their extensive knowledge of the complex process can greatly improve the possibility of success.

The property developer, however, needs to understand what a broker are, what services they provide, and what the difference is between a broker and a banker if they are to fully utilize the benefits a broker can provide. With the help of Collier, et al (2008) the difference between the broker and banker can be explained.

The broker is a person or institution that brings the borrower and lender together and facilitates the financing process for a fee. The banker on the other hand is the person or institution that provides the debt capital for the loan and then requires compensation, normally in the form of interest payments and fees, for providing the debt capital and also taking the associated risks involved.

The broker therefore provides the borrower with a service of managing the process for obtaining the debt capital required, whereas the banker provides the debt capital for the loan.

The broker can be of tremendous help to the developer in the financing process. They generally perform the same functions as internal loan officers at commercial banks by preparing the loan application on behalf of the

borrower. Brokers gather all relative information on the borrower, the site, the development, etc. and will then comment on the possible success to the outcome of the loan. This will provide the developer with an idea as to where the application may need adjustment and attention before submitting it to the lender.

Brokers are well informed about the different lenders in the market as well as the products that are available, and they can therefore be a valuable guide to the property developer in the process of obtaining the financing that best suits their needs and requirements. Brokers will also be able to expose the borrower to a wider variety of lenders in the market and by so doing be able to negotiate better loan terms for the borrower, such as lower interest rate, fees, appropriate structures, etc.

Brokers provide the property developer with the service of the loan application process and it is therefore their business to be aware of all the lenders and their products available in the market. This not only exposes the property developer to more sources of financing but also reduces his risks and exposure in the application process and after loan closing.

### **2.2.2 Sources of debt capital**

It is important for property developers to have some understanding of where the financing they require for their developments comes from. It is therefore important to have an understanding of the different forms of debt capital that are available in the financing market.

Debt capital is basically divided into three categories, depending on the period of the loan. These categories being long term, medium term, or short term. (Wikipedia, 2009)

- Long term financing is normally used to finance long term assets and will expend over a long period of time ranging from ten years and longer.

Examples of long term financing would be:

- Share capital
- Mortgage
- Debentures
- Project capital

- Medium term financing is the middle ground between short term and long term financing, and will therefore normally range between the periods of one year to ten years.

Examples of medium term financing would be:

- Term loans
- Leasing
- Hire purchases

- Short term financing is normally for a limited period and would usually not exceed a period of one year.

Examples of short term financing would be:

- Bank overdraft
- Trade credit

According to Cloete (2005) it is good financial management to finance long term assets with long term financing and short term assets with short term financing. Property is a long term and durable asset and therefore long term financing is the appropriate form to utilize. The reason for this is the illiquidity associated with property.

An understanding between long term, medium term and short term capital also requires a better understanding of the money and capital markets. The money market is the market where short term savings are used to make short term loans. The capital market is the platform where long term loans are bought and sold. In South Africa the Johannesburg stock exchange is that platform, providing a centralized place for companies and the like to raise capital.

The capital markets can further be subdivided into the primary and secondary markets. The primary market is the market where companies sell shares to the public, and the secondary market is where the public buys and sells shares in companies. (Cloete, 2005:55)

The property developer should also be aware of the different institutions that operate within the money and capital markets. These were identified by Isaak (1996) as follows:

- High Street/Clearing banks also known as commercial banks
- Foreign banks
- Building societies
- Merchant banks
- Insurance companies
- Finance houses

### **2.2.3 Joint ventures (JVs)**

Joint ventures are another method for obtaining financing for property development. JVs are a way for joining capital and investment-management skills with the intention to form an ongoing relationship between the parties

even though each joint venture's legal structure is often technically a once-off joint venture.

There are a number of not only large institutions and companies but also individuals that are constantly on the lookout for good investment opportunities and reliable partners with whom they can entrust their capital.

It is important to note that, as a developer starting out, there are many sources of capital available in the form of joint ventures but it will most likely require that some personal control over the development being lost to the investor as well as giving up some of the return on the project. There will, without any doubt, also be a degree of reporting and paperwork to be done as well as a structure of rules, policies and procedures to follow. It is important that the developer understands this and tries to find a balance between financial capital and intellectual capital invested in the project.

It is therefore important for the beginner developer, to understand that in order to gain ground in their industry, sacrifices will have to be made. As a new developer, the funds may not be as readily available. But, by balancing out options and giving up some control and profit for the first development project or two, the developer can obtain that 'foot in the door' needed to establish his career.

It is also important for the developer seeking for a joint venture to look for a partner with whom he feels comfortable and trusting, and a partner who is interested in what the developer will bring to the table. As an example, if the developer will be developing a residential complex, there will be little use in approaching investors whose interests are in the retail sector. The reason for this is that investors generally invest in areas of their own expertise, where they are familiar with the market, the risks involved and the expected returns



that can be made within that type of market. Investors will generally also be on the lookout for properties that will compliment their existing or intended portfolio.

Investors are reluctant to invest in investments that fall outside their areas of expertise as this will expose them to more risk and the research required to make calculated decisions in an unknown area will also increase their costs.

Having taken the above into consideration, investors will not be completely adverse to new areas of investments. This is because of the fact that by diversifying their portfolio's investors will reduce their risk exposure to a specific market sector and also smooth out their returns.

Collier, et al (2008) provided the following point of interest to consider for the possible terms of a joint venture:

- Majority Investor
- Investment strategy
- Stabilized expected returns
- Equity investment percentages
- Gearing (Leverage)
- Program capital
- Expected holding period
- First look rights
- Pursuit cost
- Conditions precedent to preferred funding
- Cash flow / residual waterfall/portfolio
- Governance, control, investment committee
- Property management
- Shortfalls

## **2.3 Property financing products**

### **2.3.1 The difference between construction and permanent financing**

Short term financing and long term financing were discussed earlier and one is reminded that it is important for the property developer to understand the difference between these forms of financing as both are normally made use of in the construction industry.

However, these forms for financing are applied differently in the development process and the property developer should be able to make distinction between short term and long term financing.

In the development process, short-term financing is also normally known as construction financing or development financing. It is the financing used to fund the construction stage of the development itself where as long-term financing, also known as permanent financing, is the financing used after the construction phase had been completed and the project has stabilized. Collier, et al. (2008) described stabilization of a project as the point at which a project has fully leased up to the market level of occupancy and has an income on which a lender can rely in making a permanent long term loan.

#### **2.3.1.1 Short-term financing (Construction financing)**

Preconstruction short-term financing, for example land purchase loans, land development loans, and 'gap' financing can be obtained by the developer if required from time to time. This will be the financing needed to obtain the land, develop the land in order to prepare it for construction or fill the gap should there be a difference between the short term and long term finance obtained for the project.

These loans are normally expensive and rare due to the fact that they provide a level of high risk for the lender and little collateral or security for the loan amount. Lenders will in general be very cautious in providing finance for these kinds of loans. Developers are generally advised to seek alternative methods to obtain the land and developing it, such as own capital, JV's, etc.

The loan for the construction period is usually the first "institutional-quality" loan that is secured in the development process. Construction loans are mostly made by commercial banks, and therefore lead this treatise to place emphasis on commercial banks. Commercial banks, however, are not the only players in this field and construction loans can also be obtained from institutions such as insurance companies and various finance companies.

Short term construction financing is sometimes awarded only when, or with certain requirements specifying that, long term financing is in place. In some cases the short term and long term finance will be done by the same lending institution.

These requirements will differ in nature from lending institution to lending institution, depending on the lending institutions risk portfolio, interest in specific markets, etc. but will normally be some form of either of the following: (Collier, et al, 2008:170-171)

- A take-out commitment (promise of permanent financing) from a lending source considered credible.
- A percentage of secured pre-sales contracts on residential units or signed leases agreements for commercial development.

The possibility also exists that short-term financing can be obtained without the pre-requirements mentioned above. If the developer is an experienced

developer, placing a development on the market of which there is great demand, long term financing may be readily available in the industry and therefore the lending instructions providing the construction finance may not have a need to make any pre-requirements.

### **2.3.1.2 Long term financing (Permanent financing)**

To understand long term financing better in a development context, Cloete (2005) made use of Reekie and Lingard's (1986) explanation of the term as follows: "Long term financing is provided for the duration of a firm's life. Generally, however, it means more than ten years in the case of shares or owners' capital, and ten to 15 years in the case of debentures."

Long term financing are mostly obtained by making use of a combination of owners own capital as well as taking out loans (debt) (Cloete, 2005:52)

It is also important to note that long term financing through loans are often amortized over a period of 25 to 30 years, whereas the term of the loan may only be 10 years. This brings about the consequence of a single large payment having to be made at the end of the term. In this case the debt is said to "balloon".

Collier, et al. (2008) provides the following reasons for the term of long term financing to be shorter than the amortizations.

- Lenders wish to avoid lending too far into a distant and murky future.
- Borrowers frequently expect their properties to appreciate and believe that significant tax-free capital may be obtained by refinancing at periodic internals.

- The owners intend to sell within the 10-year time period and are aware that new owners typically refinance the properties themselves.

### 2.3.2 Time value of money

It is important to have an understanding of what time value of money entails and how it works in order for investors to know how to profitably utilize their capital investments.

Very simply stated, time value of money means that money received today is more valuable than money to be received in the future. There are three factors that are the cause for this.

- Opportunity cost: This is the potential profit value of opportunities not pursued because funds were instead invested into the project in question. “Opportunity cost therefore equals the yield of the investment or profit that is forgone.” (Wight and Ghyoot, 2008:95) This profit that is forgone should be measured against the profit to be made by investing in the project in question to determine the implication of opportunity cost.
- Inflation: This is the diminishing purchasing power of money due to the increase in cost of goods and services. The following should therefore be considered. Money borrowed today will require future repayments, therefore, should inflation have occurred in the period of repayment, the money used for the repayment of the loan will have less value than the money originally borrowed.
- Risk: Every investment has an element of risk associated with it and this is the possibility that the money invested may be lost either in part

or in full. Cloete (2008) described risk as “the likelihood of an unfavorable event occurring” This should be considered carefully by any property developer. High risks may bring about high returns, but the possibilities that losses would realize are high as well.

Time value of money should be considered carefully when making any investment decisions as it is crucial to the analysis of property investments.

### **2.3.3 Gearing (Leverage)**

Gearing is the phenomena where debt capital is measured against equity capital. This is the relationship between the money borrowed from the lender and the money provided by the borrower into the development process.

Gearing, also known as debt leverage has its advantages as well as disadvantages and does not come without its element of risk. It normally works to the advantage of the developer where inflation growth (rental income) is higher than the cost of the gearing (interest rates on the borrowed debt capital amount).

On the other hand should there be a default on the payment of rents or a decrease in rent payments, the developer will be in a situation where his cash flow will be reduced, which leads to less money available to service the cost of debt capital. This could lead to the developer having to pay the cost of the debt capital from another source.

Another advantage of making use of debt capital is that the cost of the debt capital, interest, is tax deductible, therefore decreasing the cost of the debt capital. This is due to the fact that interest is serviced out of pre-tax income. (See chapter 5, table 4 for example)

There is yet another hurdle to overcome when it comes to the development of property. By making use of debt capital, financing, the developer will have to make interest payments on the funds borrowed to obtain the land as well as to start and complete the construction phase. Yet, the construction site will not be producing any income till the construction phase is completed and tenants can move in or the development can be sold. The developer will therefore have to find alternative methods in order for him to meet his obligations in terms of servicing the debt capital. This can be done either by paying the interest himself through funds out of his own pocket, or by “rolling up” the cost of the debt capital, meaning that the interest payable will be added to the amount of the loan which will have to be repaid at the end of the day.

### **2.3.4 Standard products**

Standard products are loans types that are mostly available as a standard across all lending institutions that are usually easily understood by clients, and that have been part of the industry for a long period of time.

These products can be enhanced and personalized to fit each borrower's individual needs and situations and will be discussed in more detail under 'Structured debts' and 'Structured finance'.

#### **2.3.4.1 Amortised loan (Long term)**

The amortised loan is one of the most common loan types available to borrowers in the property industry. With the amortised loan the intention is to repay both the capital and interest on the outstanding debt capital amount over an agreed period of time through regular fixed installments.

The benefit of this type of loan is that both the borrower and lender rely on a fixed repayment profile, which reduces uncertainty as well as administration. This therefore reduces the cost involved and the resourced needed for the process significantly.

The amortised loan is normally repaid over a period of time as agreed by the borrower and lender. The lender will assess the income generating capability of the property and compare it with the repayments to be made periodically, with the repayment being adjusted for possible increases in interest rates.

Where there is a shortfall between the income of the property and the payments to be made, the lender will assess the clients other income-generating capabilities in order to compensate for the shortfall.

#### **2.3.4.2 Development loans (Short term)**

Property developers make use of development loans to assist them with their cash flow during the development process as well as the final sale of the property.

For these types of loans lending institutions profits are normally not large, due to the short term of the loan, they therefore make their profits through administration and release fees. These types of loans are also resource intensive in terms of administration and do provide the lender with a risk where the property does not cover the loan amount and may therefore call for collateral to compensate for a possible shortfall. This can also be overcome by the lending institution requiring a certain percentage of the development to be pre-sold, which will then cover the loan amount as discussed before.



Lending institutions normally require some sort of investment to be made by the developer himself first, before the lending institution will come on board. This can be done though providing the land, paying the professional fees, etc. In this way the lender is assured of the property developer's commitment to the project through a sharing of the risks involved.

As noted earlier, that loans for land and land development are generally scarce and expensive and the reason for this can now be understood as the lending institutions generally see this to be the contribution to be made by the developer.

#### **2.3.4.3 Bullet payment – Interest only (Long term)**

This form of loan is where the borrower only repays the interest on the loan itself, never paying part of the debt capital amount, over the term of the loan with the full debt capital amount becoming due on the end of the loan term.

This form of loan is to provide the borrower with tax shelters. Normally, as debt capital is repaid on a loan, the interest payments on the outstanding amount also reduce. Interest is tax deductible and as the interest reduces on the ever-reducing debt capital amount the developer is faced with a situation of having to pay more tax versus less interest. It will be important for the developer to measure tax payable against interest payable.

This however exposes the lender to an additional risk, namely that that borrower will not be able to repay the debt amount at the end of the term of the loan. To eliminate this risk, lenders normally ask a sinking fund to be ceded to them which will be liquidated at the end of the loan term.

#### **2.3.4.4 Stepped interest rate loan (Long term)**

With the amortised loan, it was seen that the possibility of a shortfall between the income of a property and the repayment to be made to the lender may exist. The stepped interest rate loan is provided to eliminate this problem by providing the borrower with a stepped interest rate which matches the increasing net rental income of the property.

This has advantages for both lender and borrower and, though it may seem simple, it is important to note that the time value of money has to be taken into consideration for this type of loan.

Also, the present value of the discounted interest payments of a normal amortised loan will be compared with that of the stepped interest rate loan and the lender will only accept a stepped interest rate loan if it delivers a higher present value than the standard amortised loan.

#### **2.3.5 Structured debt (Using interest rate derivatives)**

Wight and Ghyoot (2008) explained structured debt as a more sophisticated method of financing whereby interest rate instrument and derivatives are used first as a hedge against the risk associated with gearing and second to maximize the return on the property investment. Structured debt is therefore used to enhance the standard products.

It is important at this stage to take note that the interest rate is normally agreed to by the parties in the negotiating stages of the loan and will then stay unchanged over the life of the loan. The fixing of interest rates in this manner, however, is normally relative to one of the common yardsticks for

interest rates such as the prime lending rate and does not guarantee the fixing of interest rate in absolute terms.

This situation creates the possible problem that should interest rates rise dramatically, a property developer's cash flow can be damaged severely. It is for this reason that property developers seek protection against the possibility of unplanned interest rate hikes.

It is also important to take note of the fact that property developments normally have a negative cash flow or negative leverage in the early part of the loan term. This usually occurs during the first few years till a gradual increase in the rental income equals out the negative leverage, turning the negative cash flow for the project to a positive flow. It will therefore be advisable for the property developer to make provisions for protection against interest rate hikes in the earlier part of the loans term, when his cash flow will be more vulnerable.

Protection against interest rate hikes can be obtained through a number of methods. Among these methods are:

- The cap (maximum rate): Cloete (2005) explained the cap as a top limit on the amount on interest you might have to pay. It is separated from the loan itself and can even be obtained from another lending institution. The cap reimburses you when the interest rate cost rises above a certain level and therefore can be seen as a sort of insurance policy which is normally paid for at the outset of the loan and extend over a predetermined period, normally three to four years.
- The floor (minimum rate): A floor on the other hand is a limit on the amount of interest rates cuts a developer will be allowed to utilize. In

this situation, the developer foregoes some of the benefits from a reduction in interest changes on his loan. This is something the property developer sell to the lending institution and the proceeds from this sale can be used to offset the cost of buying the cap.

- The collar: The collar is simply put, a cap and floor together.
- The forward rate agreement: Wight and Ghyoot (2008) explained a forward rate agreement (FRA) as an agreement whereby a borrower and an investor agree to fix an interest rate for a specified period, beginning at a specified date in the future. Once again this type of hedging is a method of compensation for the effect of a rise in loan rates rather than freezing the cost of the loan itself. Cloete (2005) explains it as follows: “Buying or selling an FRA is simply taking a bet on the movement in interest rates. If you bet right, you are paid; if you bet wrong, you pay out.”
- Interest rate swap: This is the situation where one borrower, having a floating interest rate, can swap it with another borrower who has a fixed interest rate. It is important to note that no transfer of capital takes place. This is only a situation where each party assumes the other’s interest payment obligations.

### **2.3.6 Structured finance (Structures to minimize income tax exposure)**

Structured finance is driven by tax payments. In other words, loans are structured in such a manner that legal structures are utilized to minimize the tax burden on the borrower.

The first priority for lenders in considering structured financing is the ability of the property to generate a healthy and positive cash flow. This means that the lease (rental income) agreement of the development and its capability to generate an income on a continued basis forms the foundation on which the lending institution will make their decision. Other important criteria, which lending institutions will take into calculation, will be the location, quality and saleability of the building, although these items will be of secondary importance to the lending institution.

Wight and Ghyoot (2008) pointed out that there are three fundamental objectives of structured finance:

- Tax shielding of rental income: Capital repayments are deducted after taxable income and interest repayments are deducted before taxable income. This has the implication that interest payments can be reclaimed from taxes where-as the payment on the capital amount of the debt cannot be reclaimed. For this method, capital repayments are structured as interest rate repayments.
- Moving the property from the balance sheet: Where long-term liabilities that are associated with long term assets, such as property, are removed from the balance sheet, and consequently enhancing the share rating of the company.
- Utilization of bank's tax base: It has been seen before that a properties cash flow is quite often negative in the first few years of the life of the loan. By making use of the banks tax base during this period, the client's taxes payable are reduced and the client consequently benefit through a reduction in the interest rate.

It is important to note that to utilize structured finance to the maximum a distinction between the different business entities, sources of income and the Income Tax Act, No 58 of 1962, must be understood. It is also important that the source of the property developer's income should provide no uncertainty as to the type of the business of the property developer.

Wight and Ghyoot (2008) identified mostly two type of income that should be distinguished between:

- Income (revenue) is where income is produced from the capital asset itself. This is where the property developer will buy and sell property, develop and sell property etc. and in this case the purchase price will be tax deductible. This is also known as property speculation.
- Income (capital), on the other hand, is where income is produced from the operation and management of the property through rental income, the escalation of the rental income, etc. In this case the purchase price will not be tax deductible but the operating cost of managing and running the property will be tax deductible.

What is also important to note is that depreciation and interest expenses also form part of structured finance and that buildings can be depreciated but only as calculated by the receiver of revenue (SARS) and interest expenses are tax deductible no matter the source of income from the property.

Structured financing is a customized loan type for clients and includes the following:

- Lease discounting: This is the process whereby a loan is based on the lease agreement of a particular development and where the risk

assessment is focused on the lessee rather than the building itself. Lease discounting can be made use of to obtain 100% financing on a property without any initial capital outlay or deposit by the lessee.

- Compulsory convertible loans: CCL is where a loan is converted to shareholding thus reducing the tax burden on the property developer (Wight and Ghyoot. 2008:116)
- Bare dominium: A bare dominium requires specialist tax advice and can be explained as follows: “Bare dominium (eventual ownership) of the asset lies with another person, who will acquire full ownership of the asset when the usufructuary’s rights end. The bare dominium holder (the person who owns the asset) has no control or use of the asset until such time as the usufruct has ended.” (Cameron, 2005)  
A usufruct being the right to use an asset of which the ownership lies with another person. This right to use the property includes the right to the proceeds of the property, such as rental income, etc.

### **2.3.7 Structured funding**

Structured funding mostly has to do with lending institution making use of alternative sources of funding to support their loan portfolio. This is not of paramount importance to the property developer.

The property developer only needs to take note of the fact that lending institution’s traditionally fund their loans by making use of the lending institution’s capital, deposits and money market instruments and that these sources of funding are at risk and that losses do occur. It is for these reasons that lending institutions, just as any other investors, diversify their portfolios to prevent possible liquidity problems.

## 2.4 Summary

Property developers should be aware of the sources available to them if they want to acquire the appropriate financing needed for their developments.

There are a number of methods available to the property developer for obtaining the financing they require, such as brokers, JVs, lending institutions, etc. It is important that the developer should establish what his requirements are before pursuing any of the methods available to him. This will assist the developer in obtaining financing that will best suit his needs and requirements.

The property developer should also be able to distinguish between short and long term financing. The developer will make use of both of these forms of financing in the development process and it is to his advantage being able to distinguish between these forms of financing as well as having knowledge on where they originate from.

The time value of money and gearing (leverage) are of fundamental importance in the business of property financing. These are the two most important functioning mechanisms that the developer should consider in the decision process for financing development.

The products provided by the lender for property financing are diverse and range from standard products to specially adopted products which are structured according to the developer's needs and the ability and willingness of the lender to structure these loans.



## 2.5 Conclusion

Brokers should be made use of as a form of outsourcing the financing process to facilitate the transaction. This will be particularly useful where the developer has little understanding or experience in the financing process. There will however be an extra cost to the developer but should be placed in perspective to the developer's own experience, possibility of an increase in success and possibility of failure.

For new developers starting out, JVs will reduce the return they make on a development but they will gain valuable experience which is required by lending institutions for future financing requirements.

It is advised that new developers start out with JVs, to acquaint themselves with the money and capital markets as well as the different forms and products of financing available for property development.

The products available for financing property can be diverse and it is of fundamental importance that the developer determines his requirements in advance. If the developer knows what he is looking for and he needs, he will be more likely to succeed in his search for financing. It will also provide the lender with the impression that the developer is professional in his conduct, which may assist with the financing process.

## 2.6 Testing of hypothesis

“There are various sources available for the financing of property development even though they may all be referred to as “banks” and normally have very much the same products and processes available.

Property financing products differ from standard and simple products to structure debt, finance and/or funding.”

From the above text it is clear that there are numerous products available to the property developer for the financing of their development. These products can range from standard to customized, depending on the developers needs and the ability and willingness of the lender to accommodate the developer.

However, in most cases these products would be standardized products adjusted to accommodate the specific needs of the developer. In the very least, specialized products would rely on standard products to serve as a guideline or check list, to make sure all aspect of the financing process had been addressed and attended to.

## THE RESOURCES AND PROCESSES USED IN THE FINANCING OF PROPERTY DEVELOPMENT

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### 3.1 Introduction

In the forgoing chapter, the property developer was introduced to the different products and methods available for financing property development. To obtain these financing products, the developer needs to go through an application process. The purpose of the application process is to determine if the lender will be willing to take the risk of lending to property developer as a client through evaluation all the information required by the lender.

The first part of this chapter describes the functionalities that operate within the application process and the organizational structures required to manage the application process and functionalities for the lender. This will provide the borrower with an understanding of the lender's internal personnel that will be responsible for the loan application process and will introduce the borrower to the type of persons he may end up dealing with in some form or another.

The second part of this chapter provides the property developer with a view of the loan application process. The developer will be introduced to the information required for the loan application process which will provide the developer with an understanding for the reasons behind the required information.

## **3.2 The resources utilized in the loan application process.**

### **3.2.1 Functionaries**

Functionaries are defined as follows in the free dictionary: “One who holds an office or a trust, or performs a particular function.” (The free dictionary 2009)

The functionaries are therefore the personnel that are responsible for the management of the application process on behalf of the lender as well as the personnel the borrower will come into contact with at some point or another through the course of the application process. Wight and Ghyoot (2008) identified the following functionaries as being of importance to the application process:

#### **3.2.1.1 Relationship manager**

“Relationship managers are employed to generate new business (loans) for the bank, to develop new relationships and to maintain existing ones.” (Wight and Ghyoot, 2008:47)

The relationship manager will normally be the first person the borrower will deal with as well as the person he will most likely deal with the most. He will be the borrower’s point of contact to the lender throughout the loan application process, from preparing the loan motivation to negotiating the final loan agreement and loan proposal.

A close bond will be formed between the borrower and the relationship manager. The advantage for the lender in a close relationship will be the hope of returned business and for the borrower, better loan terms and correct and up to date information on the loan process.

It is the relationship manager's responsibility to meet the banks budget target as well as present loan structures to borrowers that fall within the lenders risk profile and the client business objectives and requirements. If the relationship between the relationship manager and lender therefore becomes too personal it is very likely that a situation of conflict can arise.

### **3.2.1.2 Valuer**

“Valuers are employed to produce objective, high-quality and well-motivated property valuations and to advise the business on the property market in general” (Wight and Ghyoot, 2008:47)

The valuer is the banks eyes and ears on the ground. He is the person that will be well aware of current markets conditions which will cover capitalization rates, vacancy factors as well as declining and growth areas. The valuer will also keep track of the disbursements of the construction loan to forecast the possibility of an overrun.

The valuer will most likely be conservative in his evaluation of the property development in order to protect the interest of the lender, whereas the developer may be over enthusiastic in his valuation and assessment. The middle ground between the two should therefore provide a good indication of the value of the project.

### **3.2.1.3 Credit analyst**

“Credit analysts are employed to assess the risks associated with loan applications and to manage arrears in accordance with the policies of the bank.” (Wight and Ghyoot, 2008:47)

The credit analyst will establish the risk profile of the borrower and the project development itself to determine the exposure of the lender before the loan is granted. The credit analyst will also predict the possible problems that may surface with the loan, and will make suggestions intended to prevent these or proactively correct these problems.

It is important that the borrower know who the credit analyst is. If he should experience any problem with his loan obligations, he can address these to the credit analyst as soon as possible so that a solution and new terms can be negotiated.

#### **3.2.1.4 Administrator**

“Administrators are employed to manage the administration process effectively and efficiently through the implementation of the Bank’s policies and procedures.” (Wight and Ghyoot, 2008:47)

The administrators are, as stated by Wight and Ghyoot above, responsible for the administration of the loan. In other words the administrators are those that are responsible for the paper work regarding the legal structuring of the loan, the registration process documentation as well as the mortgage and bond registration documentation preparation.

#### **3.2.1.5 Regional manager**

“Regional managers have to provide effective leadership and management to the marketing, valuation, credit and administration functions in order to achieve regional objectives.” (Wight and Ghyoot, 2008:47)

The borrower isn't very likely to deal with the regional manager as he is mostly responsible for the internal functions of the lending institution such as setting their market strategy, development of staff, setting policies and guidelines for the lenders lending criteria, etc.

### **3.2.2 Organisational structures**

Specific organisational structures exist for the property finance business because it is such a risky and complex field. For this very same reason, lending institutions have started to appoint professionals from within the fields of construction, financing and law with the skills and experience needed to manage these risks and complexities in the field of property finance business.

Wight and Ghyoot (2008) make mention of three organizational structures that exist for the financing business, which are listed below with a brief purpose for each structure.

- Functional structure: "The objective of this functional structure is to group functional areas together, thereby providing the bank with functional management and control of functions."
- Team structure: "Independent teams create a sense of ownership of the entire loan application process. The structure is flat and major accountability and responsibilities are delegated to a team leader, thus facilitating fast and efficient decision making."
- Specialist structure: "This structure is similar to and incorporates the functional structure. Its objective is to provide the bank with dedicated

resources for every specialist function, thereby encouraging best practice methodologies.”

### 3.3 The loan application process

#### 3.3.1 Introduction

The function of the loan application process is to manage the information that is needed by the lender for the approval of the debt financing, from the point where the borrower and lender makes contact, to the point where the borrower accept the loan conditions which will lead to the registration of the loan and related securities.

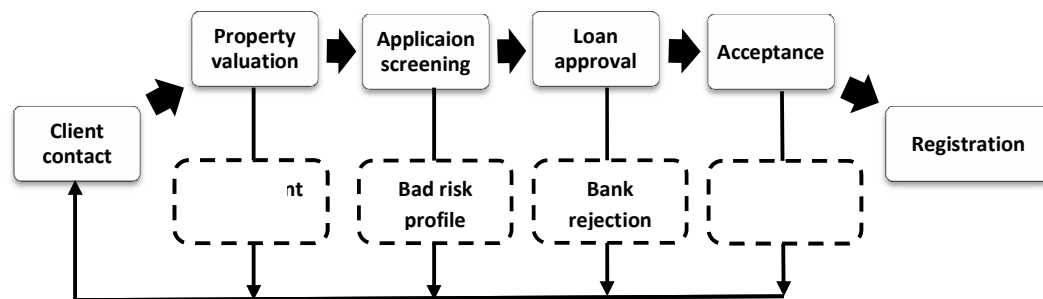


Figure 1 Loan application process (Wight and Ghyoot, 2008:7)

Figure 1 depicts Wight and Ghyoot’s (2008) interpretation of the loan application process. They described each process in short as follows:

- Client contact: “Establishing the requirement parameters for the loan.”
- Property valuation: “Establishing the market value of the property or proposed development”
- Application screening: “The initial determination of associated risks and the likelihood of approval”
- Loan approval: “The formal approval of the loan and conditions”



- Acceptance: “The formal offer and acceptance of the loan”
- Registration: “The registration of the mortgage bond (security) and disbursement of the loan”

### 3.3.2 Client contact and loan motivation

Client contact, being the first stage in the application process, is an introduction to the lender of the borrower’s requirements. This will provide the lender with ‘a feel’ for the borrower’s needs, enabling the lender to determine the information required to process the application, compile the estimated timeline as well as determining the process the application will have to follow for approval. It is critical at this stage that the borrower and lender both make it clear as to what their respective requirements are. This is critical not only for the loan application process but also to establish a ground base for the relationship that will be formed between the borrower and the lender. (See chapter 4)

Every borrower’s requirements are unique, depending on factors such as the property location, the type of development, loan duration (short, medium or long term), acceptable price (interest rate) of the debt capital acceptable, the timing of the disbursements, etc.

The borrower needs to present the lender with all his requirements and expectations so that the lender can evaluate the information to see if he will be able to deliver on the borrowers needs and expectations based on the lender’s own risk profile.

The lender will have to advise the borrower about their risk profile as well as the field of financing in which he generally operates. This information is vital

to the borrower to establish whether his requirements and expectations will be addressed according to his needs.

Should the project not fall within the banks risk profile or field of operations, it is best the borrower be informed of a rejection at the offset period.

The borrower also needs to be aware that even though he, himself, has been through the feasibility process of the project, the lender will do his own feasibility and profitability testing. This can be frustrating to the borrower, but the lender will not make decisions based only on the information provided by the borrower. The borrower must take note of this fact and make provisions for this in his time planning for the project as well as the setting of deadlines.

### **3.3.2.1 Information requirements**

Wight and Ghyoot (2008) identified two methods that are used by lenders to obtain the information required for the application process.

- The first method for obtaining the information is through the use of loan application forms and documentation that is completed by the borrower. This is normally done at the beginning of the loan application process.
- The second method is where the information is obtained through source documentation. This is a method used where the documents required are obtained throughout the course of the process to verify information supplied by the borrower.

Wight and Ghyoot (2008) provided the following example of source documentation:

- Copy of identification document

- Statement of assets and liabilities
- Audited financial statements
- Title deed
- Leases
- Rate assessment
- Feasibility study
- Building contract
- Building plans, etc.

The reason for the above mentioned methods are to obtain the information needed to compile the loan motivation as well as the loan approval documentation.

The information is also used to determine the risk profile of the borrower as well as his ability to repay the loan. For long term finance the ability of the property to generate an income will be of fundamental importance, where as with short term financing the borrower will have to prove his ability to repay the full loan amount at a specific date, normally after construction.

### **3.3.2.2 Concurrent activities**

- Credit checks: The purpose of credits checks is to determine the credit worthiness of the borrower and is done by means of making use of court records to check for borrower's history on insolvency, fraud and crime. Another method that is made use of is to establish the standing of the borrower with institutions such as the Information Trust Corporation (ITC), etc.

- Deeds office search: Lenders will do a search at the deeds offices for title deeds and bonds on the property in question. The reason for this search will be to establish the following points of importance:
  - Title holder
  - Property's legal description
  - Servitudes
  - Restrictive conditions
  - Endorsements
  - Bonds over the subject property
  
- Desktop valuation: The desktop valuation is a preliminary estimate of the value of the property. The main reason for determining the valuation of the property at this stage is for the lender to determine the LTV for the account as well as the possible need for provision of security. The desktop valuation is by no means the final valuation that will be undertaken. A more comprehensive valuation will follow later known as the 'Mortgage valuation' which will be compiled by the valuer.

The desktop valuation is determined as follows (Wight and Ghyoot, 2008:11):

Gross lease income	(Market value)
- <u>Operating expenses</u>	(Market value)
= Net lease Income	
÷ <u>Capitalisation rate</u>	(Market value)
= <u>Property value</u>	(As at a specific date)

- Preliminary cash flow activity: The purpose to the preliminary cash flow is to determine the ability of the property to repay the loan. The properties performance factors and ratios are also verified and

stress-tested for possible interest rate increases as well as operating costs and vacancies.

- System interaction: System interaction is the process whereby the borrower's information as well as the loan data is entered into the system to set up the account details. This is done at different stages in the loan application process by different lenders for internal reasons such as limits to the systems capability, the lenders resource constraints and therefore the effective allocation of resources.

### 3.3.2.3 Common problems

Common problems that are encountered in the offset of the loan application can be either one or a combination of the following.

- A mismatch of the borrower and lenders requirements: It has already been stated that both parties have their own requirements and the borrower wants his requirements met as does the lender. The borrower will normally have the following requirements as a priority:
  - Timing
  - Cost of financed capital
  - Security
  - Repayment profile

The borrower should, in light of the above mentioned, consider lenders that can deliver on these requirements. If the borrower and lender cannot match their requirements, problems will arise. It is important that the borrower and lender find mutual ground on which to build a sound foundation.

- Incomplete or incorrect data: This is another common problem that can cause unnecessary frustration and delay to the process. The borrower should make sure that he provides the lender with the correct information to evaluate the loan. Wrong information can cause the process to restart from scratch which will be a waste of time and resources for both parties involved.
- Lack of management information: It has already been stated that lenders are often reluctant to capture a loan in its system before it is approved. This can lead to a delay in the process and it is advisable that the borrower approaches a number of lenders simultaneously and measures the different proposals against each other in order for him to make an informed decision regarding the lender that best addresses his requirements and needs.
- Banks cash flow: Banks also have to attend to their own cash flow and make sure that their lending portfolio does not exceed their income. Borrowers should be aware of this fact as economic and interest rate cycles will influence the decisions banks make when it comes to the approval of loans

#### **3.3.2.4 The loan motivation (See Appendix A)**

The loan motivation is compiled when all the relevant information needed for the loan is received and the lender is happy with the quality and type of information received.

Due to the cost involved in the loan application process and the amount of resources required, lenders tend to reject a loan that does not fit their risk profile as soon as possible. The borrower will be informed of a negative

outcome of the loan application process as soon as possible. This has its advantages for both the lender and the borrower.

The lender will minimize the costs and resources spent on a loan which could be more problematic than beneficial, whereas an early rejection of the loan will provide the borrower with time to source finance elsewhere.

A rejection of the loan can also provide the borrower with valuable information as to why the loan was rejected. The reasons for the rejection can be addressed by the developer to restructure his next proposal as well as attend to problems in the development itself, as pointed out with the rejection. The results of this refinement after rejection can reduce the developer's risk and increase his return. With possible problems being identified and addressed, the possibility of the development's success will also increase.

When all the relevant information is received, the loan motivation will be prepared by the relationship manager. The loan motivation will be prepared taking into consideration all the information received up to this point in time. However, the following important information will not be contained in the initial loan motivation and will be added to the process as they become available.

- Full Valuation
- Credit comments
- Final loan structure (See chapter 2)

A typical loan motivation, as identified by Wight and Ghyoot (2008), will include the following:

- Introduction: The borrower and property are introduced with the financing requirements for the development.

- Purpose: An explanation as to how the funding will be utilized.
- Structure: The loan amount, term, interest rate, period of interest payment and disbursement requirements are proposed.
- Serviceability: The ability of the property development to repay the loan, which can include the financial status of the client, is outlined.
- Security: The security will mostly comprise the registration of the bond but can also include other forms of security such as cession of shares, other property, etc.
- Recommendations: A statement written by the relationship manager that place highlight on the risks, how it had been covered and his support of the loan.

### **3.3.3 Property valuation**

#### **3.3.3.1 Introduction**

A formal valuation of the property will be required and called for once the preliminary analysis of the loan has been completed and meets the risk profile of the bank. The formal valuation will provide the lender with the first accurate indication of the loan to value (LTV), which will be used to compile the maximum loan amount, excluding any additional securities.

The LTV is the primary indicator of the viability of the application for the lender. This is because it provides the lender with an indication as to possibility that a force sale will cover the loan amount. The LTV is normally about 70 – 80% of the value of the development.

The LTV will also provide the developer with an indication as to the portion of the development that will have to be self financed or additional security provided for.



Other important factors that are addressed by the valuation include the following:

- **Lettability:** This is an indication of the demand for the development, and the ability of the development to let and re-let as it becomes necessary, as well as the possibility for rental growth, etc.
- **Saleability:** Saleability is seen in conjunction with the LTV amount. It is the ability to sell the property and the rate at which the sale can take place for the lender to cover the loan amount should the borrower default on the repayment. The higher the LTV and the lower the saleability the more of a risk it will be for the bank to approve the loan.
- **Condition:** This is the current indication of the state of the property and improvements itself and the effect it may have on expenses, lettability and saleability, etc. Condition should not have too significant of an impact on new developments, but it will have an impact on other existing structures and buildings.

### 3.3.3.2 The valuation process

The valuation process is briefly discussed below and depicted in figure 2.

- **Instruction or brief:** The valuer is normally briefed on the property through the following means
  - **The specific property:** It is important that the valuer knows exactly which property he is to value. It is preferable that the relationship manager, valuer and client visit the property together so that there can be no misunderstanding as to which property should be valued.

- Rights to be valued: Rights consist for both the property and the client; examples will be zoning and ownership rights. For property financing, it is usually the ownership rights that are valued but specific leases can also be relevant.
  - The date of valuation: There are a number of factors that influence the value of a property, as has been seen before. For this reason, the valuation of a property only holds true for a specific time. When changes takes place in any of the relevant factors, the value of the property will be affected, this could leave the original valuation invalid.
  - The purpose of the valuation: There are normally two reasons for property valuation. The first of which is to determine the LTV amount which will provide the bank with the security needed in the case of the client defaulting on repayment of the loan amount. The second is to determine the amount for which the property must be insured.
  - The valuation definition: “In terms of providing security for the loan, the market value of the property is required, along with an indication of how this may change under adverse market conditions. For insurance purposes, a replacement cost valuation is also required.” (Wight and Ghyoot, 2008:19)
  - Other conditions: Time is just about always of the essence when it comes to the approval of a loan. Developers tend to set deadlines for tenders, the construction period, etc. but none of these are material without the required financing being in place. The valuer will normally communicate to the relationship manager a guideline as to when the borrower can expect a decision.
- 
- Preliminary investigation: The preliminary investigation will continue once the valuation instruction is clear and the valuer knows exactly

what is required of him. The preliminary investigation will then commence which is where the influence of the macro-environment and trends in the market on the development are investigated. Wright and Ghyoot (2008) identified at least four influences that will be investigated.

- Exposure: This deals with the location of the property and the elements in the property's proximity that will have either a negative or positive effect on the development
- Economics: This is the local population's ability to support the development through renting, owning or utilizing the development
- Government: Examples of government influence on valuations will be zoning, taxes, building regulations and the land rights act.
- Social preference and characteristics: This refers to the community's acceptance of the development and the characteristics of the community such as population density, age levels, education crime, etc.

Other factors that can also have an influence on the value of developments are interest rate cycles, business confidence and industry growth patterns.

The valuer will also analyze the specific market that the development will be intended for including the productivity of the proposed development compared to that of similar development in the area.

- Highest and best use analysis: At this point the valuer should be able to decide on what is the best use of the subject property. This can then be compared to the proposed project of the developer to determine if the development will be viable.

- Valuation approach(es): Wright and Ghyoot (2008) identified the following three approaches that can be undertaken by the valuer.
  - Sales comparison approach: The preferred approach by most lending institutions, this sale comparison approach is based on recent sales of comparable properties which is, in turn, based directly on market evidence. Elements that will also be considered with this approach will be the conditions of the sale, finance terms, market conditions at the time of the sale and the productivity-generating abilities of the comparable properties.
  - Income approach: This approach considers the net income of the property being capitalized or discounted to present value in addition to the property's income generating capability, vacancies, operating expenses and the likely resale value. These concepts however require extensive research which is expensive and time consuming.
  - Cost approach: The approach considers the construction cost of the development as a method of establishing the value of the development, which will be calculated as follows.

Construction cost

- Depreciation (Time related, min impact on new developments)

+ Land value

= Replacement cost

- Value decision and report: The valuer will compile a report on which the bank will make their decision. The valuer will in most cases compile a report based on all three valuation approaches and an average between the approaches will determine the actual value of the development.

The bank will, however, require the insurance of the property to be based on the cost approach value, as this is usually the highest and will be further escalated each year to maintain a market-related replacement cost.

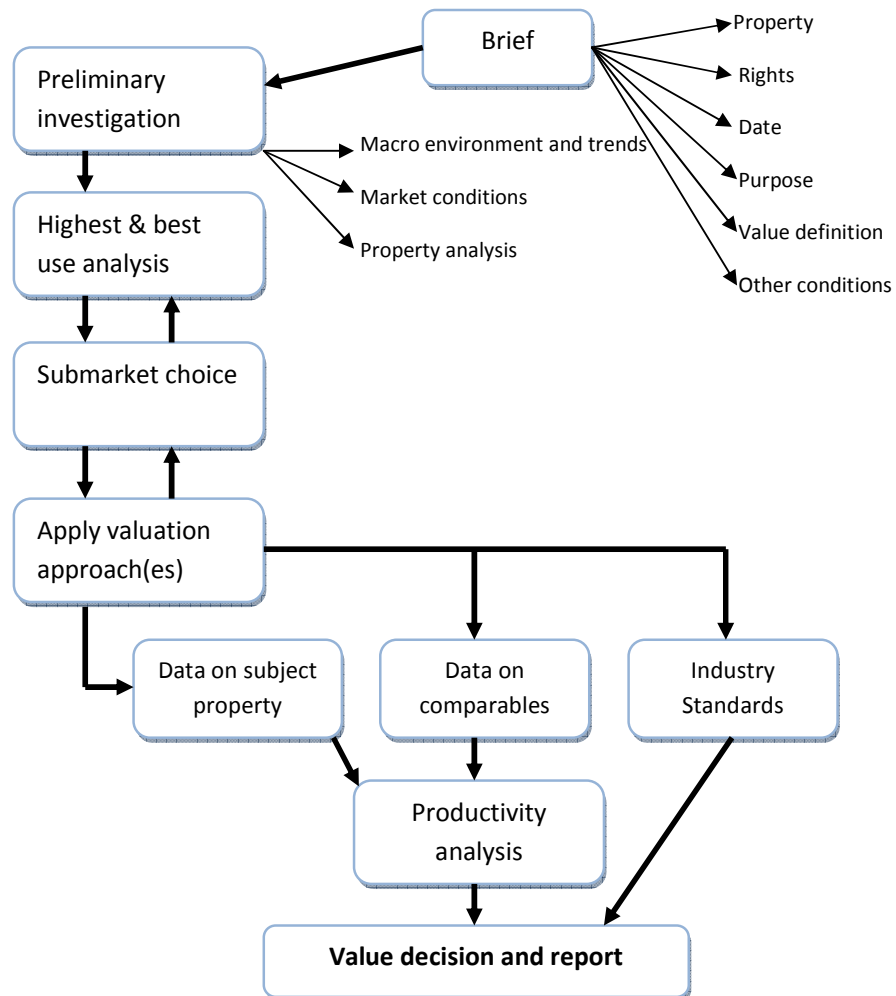


Figure 2 The property valuation process (Wight and Ghyoot, 2008:19)

### **3.3.4 Application screening**

#### **3.3.4.1 Introduction**

After client contact and the valuation process enough information should be available to make a decision about the viability of the loan and the likelihood of the approval thereof. The decision can be undertaken by a committee established for loan approvals or through the process of credit assessment based screening.

#### **3.3.4.2 Committee based screening**

The committee for the assessment of the loan will consist of representatives from the marketing and credit divisions of the lending institution and will also include an approval authority with the following objectives:

- Making a primary assessment: The loan transaction will be discussed in its entirety, to combine the information received to date as well as the experience of the committee.
- Identifying application shortcomings: The application may have value but can be incorrectly structured with some concerns not address appropriately. This will be pointed out by the committee and the account executive who can then address these items and resubmit the loan.
- Limiting resource wastage: As stated before, the lender would reject the loan as soon as it believes the loan to be unfavorable. This is for the simple reason that the banks do not want to waste resources on a loan that is considered too risky.

### 3.3.4.3 Credit assessment based screening

Credit assessment is the systematic approach by which to identify the ability and willingness of the client to repay the debt capital amount and interest. It is performed by a credit analyst, who will be an independent functionary.

The assessment of the loan will be based on the facts in the information collected to date. It will be analytic and objective and will provide a balanced view of the loan, as there will be strong and weak points to consider.

Wight and Ghyoot (2008) set the following framework for the credit assessment.

- Managerial quality: Where the emphases is placed on the client's personal ability, experience and expertise.
- Economic situation: Current trends, opportunities and threats in the market are analyzed in relationship to the proposed development of the borrower.
- Financial stability: The property developer's liquidity, profitability, cash flow and business projections are analyzed to determine the sustainability of his business and his ability to repay the loan.
- Client requirements: The client's requirements will be matched against the bank's lending policy to ensure compatibility
- Security: The security offered by the borrower will be measured against the risk exposure of the bank. The valuer's report and

comments will carry much weight in the credit analyst's recommendations.

- **Profitability:** Banks are profit making, business orientated organizations and would like to maximize their profits on any transaction. Therefore they will measure their profits against the expenses and resources they will have to invest to determine the profitability. For example, a (short term) construction loan's management is much higher than that of a normal (long term) mortgage loan.

Most financial institutions will have a standard model against which to measure the risk inherent to a loan. (See chapter 6)

### **3.3.5 Loan approval**

#### **3.3.5.1 Purpose**

The loan approval process is a vital part of the loan application process from the banks perspective. The reason for this is that the approval of a loan will affect the operations of the bank, be that negative or positive. Because of this, the granting authorities will consider all information and will double check all information before a final decision will be made.

The borrower should therefore make sure that he provides the bank with all the information they may seek, and make sure that it is correct and free from ambiguity or error which would lead to the rejection of the loan.



### 3.3.5.2 Granting authorities

The granting authority can consist of a group of people or an individual who will then be responsible for the approval of the loan. The number of people making up the approving authority will depend to a large extent on the loan amount. In general though, a group of people are normally preferred above an individual.

### 3.3.5.3 Loan approval document (See Appendix D)

The loan approval document will contain a summary of all the information obtained thus far. (See figure 3)

- Loan motivation (Relationship manager)
- Valuation (Valuer)
- Risk-rating model (Credit analysis)
- Cash flows (Developer)

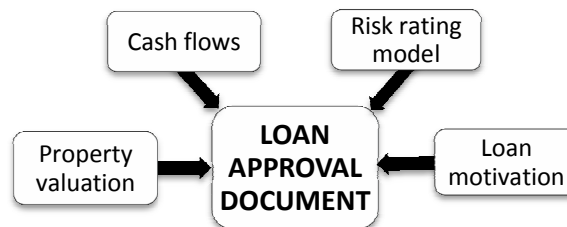


Figure 3 Loan approval document with supporting documents (Wight and Ghyoot, 2008:28)

### 3.3.6 Acceptance

#### 3.3.6.1 Purpose

Wight and Ghyoot (2008) stated that there are two reasons for the purpose for the acceptance activity in the loan application process.

- “To reformulate the loan approval conditions into a loan agreement that will be presented to the client as a formal offer of finance:
- “To gain the client’s acceptance of the terms and conditions through his/her signature on the loan offer or agreement.”

The borrower provides the lender with his funding requirements, which will be formulated into terms and conditions proposed by the relationship manager. These terms and conditions will, without any doubt, be changed and adjusted by the granting authority before becoming a formal offer by the lender. This offer can be negotiated and it is here that the relationship manager will be tested as a negotiator as he will have to arrive at terms and conditions which both parties will find agreeable.

#### **3.3.6.2 The loan offer**

When the loan application is approved, the information will be sent to the administration department to compile the official loan offer. The loan agreement may be compiled in different methods but will always be based on standardized legal documentation to limit possible errors in documentation.

The loan offer will be provided to the borrower along with the following documentation for his assessment. (Wight and Ghyoot, 2008:32)

- Resolution: This is the resolution passed by the entity confirming the intention to obligate the entity in terms of the loan.
- Special resolution: Same as above but entity becomes the surety to the loan.

- Exchange control certificate: Applicable where foreign ownership of the entity exceeds 75% and is issued by the reserve bank of South Africa
- Consent to arrange insurance: Document that gives the bank permission to arrange for the insurance on the property.
- Outside broker appointment letter: In the case where the client arranges the insurance, this letter confirms appointment and states the obligations of the insurance company towards the lender.
- Cession of fire insurance policy: Should the development be destroyed by fire, the insurance payout will go the bank and will be used to their discretion, either to rebuild the property or repay the loan amount.
- Debit order mandate: The authorization for the bank to withdraw the loan repayments, as agreed.

The loan offer can be presented to the borrower in either one of two methods. The first method being the loan agreement method, which is a legal binding document obligating both parties. Should the client sign this agreement he accepts the offer and the offer becomes a binding contract. This method of presenting the offer to the borrower can also be seen as the lending institution's unwillingness to negotiate the terms and conditions.

The second method of presenting the loan offer is the loan summary method. (See Addendum B) With this method the bank recognizes that further negotiations are likely and will therefore only state the terms and conditions on which they would be willing to offer the finance. No formal offer is made as

yet. This will be the more favorable option to the borrower as it indicates the lenders willingness to negotiate.

### **3.3.6.3 Acceptance of the offer**

The loan offer and agreement documentation will be delivered via the relationship manager. He will be responsible for explaining all the terms and conditions to the borrower.

The items of the agreement mostly questioned by the borrower will be also the items the borrower will most likely bring up for negotiations. These items are identified by Wight and Ghyoot (2008) as follows:

- Interest rates: The borrower should apply at different lenders for financing. This will allow the borrower the opportunity to have the lenders compete against each other for his business and can provide him with a better interest rate. The borrower should also consider the different loan structures discussed in Chapter 1 as a method to improve interest rates.
- The term of the loan: The term of the loan has an influence on the banks cash flow and tax responsibility. A longer term will provide the borrower with a better cash flow and tax options. A shorter term will have the opposite effect.
- Fees: The resources discussed earlier in this chapter have a cost implication for the lenders who want to recoup these costs. Loans use resources and they do require some effort by the lender which leads to costs the lenders have to cover. Borrowers may feel that they have to 'dock-up' for unsuccessful loans.

- Early repayment penalties: The term of a loan effect the return on assets and equity rations and in the case of early repayment lenders may experience a loss due to the risks involved. For this reason penalties are usually applicable which are not a problem at the loan agreement stage, but can become a problem later on. Borrowers should take note of these penalties and compare the penalties with the savings on interest payments should this becomes an option later in the life of the loan.
- Insurance: The mortgage bond registered for the property is the security for the loan, which has the implication that the lender carries the risk should something happen to the property. For this reason, insurance is required to cover this risk and as a condition of the loan agreement should be calculated at the replacement value of the property. This means that the insurance premium is calculated on the replacement value of the loan which will normally be the higher value and therefore more expensive. This once again has a negative effect on the borrower's cash flow, and becomes a bigger issue if the borrower is not allowed to use his own insurance company, who usually provides the client with a discount on his insurance premium for managing his complete portfolio.

### 3.3.7 Registration

After acceptance of the loan agreement by the borrower, the registration of the mortgage bond will take place. As stated before, this is the security for the loan and should the mortgagor default on the loan obligations the mortgagee is entitled to sell the property to recover the loan amount. The mortgage bond however is not the only form of security for a loan. Other forms of security also include: (Wight and Ghyoot, 2008:39)

- Collateral bond: Bond over another property
- Surety bond: Bond over another property owned by third party
- Suretyship: Lending institution can claim against third party
- Pledge: Real right over movable property, e. g. jewelry
- Cession: Other security, e.g. shares, by agreement between parties
- Notarial bond: Bond over movable property belonging to borrower

The above mentioned forms of security can also be used in the registration process for a short term loan, such as construction financing.

By law only a conveyancer can prepare, sign and execute deeds and documents for the lodgement and registration with the deeds registry. Therefore, an attorney can be selected by the client, but banks normally make use of their own attorneys to, at the very least, over see the process of registration.

#### **3.3.7.1 Bond lodgement**

Bond lodgement will not take place before the lenders consent is obtained, and the lender may require the following before they will give their consent: (Wight and Ghyoot, 2008: 41)

- Copy of the signed leases acceptable to the bank
- Copy of audited financial statements acceptable to the bank
- Approved building plans that do not differ materially from the draft plans used in the valuation
- Confirmation from the attorneys that no onerous title deed restrictions exist
- Confirmation from the attorneys that the subject property concerned is not subject to any land redistribution claim

This is normally the first point of conflict between the borrower and the lender, especially where the borrower is under time constraints.

The registration of the bond will take a few days and is open for registration only ten days after the documents are lodged, if the time laps the attorneys will have to resubmit.

### **3.3.7.2 Bond registration**

Once the mortgage bond has been registered the following will take place: (Wight and Ghyoot, 2008:44)

- The borrowers ledger account will be credited with the loan amount
- Fees will be deducted from the above account
- The borrower will be advised of the disbursement
- The borrower will be advised as to the commencement date of the loan, the repayment installments and the repayment period
- The administration system will be updated which will include the installment amount and the debit order (repayment method) will be activated.

### **3.3.8 Application process for long term finance versus short term financing**

In chapter 2, distinction was made between the two different forms of financing available to property developers, short term financing (construction financing) and long term financing (permanent financing).

After having gone through the loan application process, the question arises: What is the difference between the application process for short term

financing and long term finance? The answer is very simple, there is no difference in the application process between the two forms of loans and normally the short term loan and the long term loan will be approved at the same time as the bank will not disburse on the short term loan before the long term loan is in place.

For the lender to be provided with the required security, if the development is going to be sold, then pre-sales would be required by the lender. The developer will only have a profit realized at the end of the development once all debt and costs to the lender had been paid in full from the proceeds of the sale of the units. Some developers may choose to take these profits in the form of units, thereby not selling all units but holding on to some of the units themselves.

If, on the other hand, the development is going to be held for a long term basis, then the development finance would be secured by pre-lets (long term lease agreements with tenants) and once the development is completed and tenants start paying rental, the development finance will convert into a long term finance loan. It should be noted that long term lease agreements are normally only applicable with commercial development such as retail and office developments. In the residential sector lease agreements very seldom exceed a five year term, with the norm being one to two years. In the case of residential developments that will be hold-on to, the bank will require thorough market research to be undertaken of the rental market in the area, as well as detail information on the agent responsible for the letting of units as well as their experience and reputation.

The long term financing will be used to settle the short term financing, with the long term financing then being secured with a first mortgage bond over the property as the major form of security.



The requirement for residential, commercial and industrial property development loan application of Nedbank corporate property finance can be seen in Appendix D

### 3.4 Summary

The application process requires the resources of various personnel, normally employees of the lending institution, to determine whether the property developer and the proposed development fit the risk profile of the lending institution. The actions and activities of these personnel will determine the final decision to be taken by the lending institution regarding the loan application process. For the property developer, the most important of all the various personnel will be the relationship manager, the valuer and the credit analyst.

The loan application process will consist of a fixed process, covering the following activities:

- Loan negotiation: In this process the needs and requirements of both the borrower and lender will be established to arrive at a mutually beneficial agreement for both parties
- Valuation: Through this process the value of the property in question will be determined to measure the security that the property will provide the lender as well as the sustainability of the property
- Credit assessment: This process assesses the risk associated with both the borrower as well as the associated property in question

- Loan approval: Through this process final adjustment will be made to the loan to make sure both the borrower and lenders needs have been met.
- Administration: This will be the finalization of the loan, where all legal documentation will be completed and all securities will be in place.

The loan application process will be the same no matter whether the loan is for short (construction) or long (permanent) term financing. The short and long term financing will normally be undertaken at the same time should it be from the same lending institution. Should this not be the case, short term financing will not be approved without long term financing being in place from another accredited financing institution.

### **3.5 Conclusion**

The borrower should be well aware of who will be responsible for the loan application process. Through familiarity with the responsible personnel, the borrower can make sure that the correct information is provided to the right personnel.

The loan application process can be extremely complex or very standard. It is up to the borrower to determine his exact needs and negotiate those needs through the correct personnel to make sure a loan structure is established that will fit the requirements of the borrower.

### **3.6 Testing of Hypothesis**

“The loan application process normally follows a fixed process from client contact to registration. The process can differ to some extent, depending on

the loan type and lending institution but will normally follow the same basic structure.”

The loan application process does follow a fixed process no matter whether the loan is for short or long term financing.

The needs of each and every borrower differ as do the circumstances of each associated property. For this reason, the normal loan structure is sometime adjusted to fit the specific requirements of the borrower and circumstances of the property type. However, the loan application process will normally follow the same process no matter the loan structure involved.

## RISKS ASSOCIATED WITH PROPERTY FINANCE AND HOW IT IS MANAGED

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### 4.1 Introduction

Risk is generated from uncertainty. In the property financing business, decisions are taken today based on calculations and estimations predicting possible outcomes for the future. These calculations and estimates have been adjusted and perfected to a large extent over a period of time, but this still does not eliminate the possibility that future outcomes may, or most likely will be different from those being predicted. There are just too many variables outside the control of both the borrower and lender.

It is almost impossible to eliminate risk from any loan no matter the structure, conditions or any other precautionary measures that may be taken to do so.

There are associated risks for the borrower and lender. These risks may be applicable on either one or both of the parties involved and with a relationship being formed between both parties that can last for decades. Risk associated with one party will affect the other as well in one way or another.

It will therefore be to the benefit of both the borrower and lender to take note of all the risks associated with property financing no matter which party is most at risk as both stand to gain from the information available.

Since both the borrower and lender should be aware of the risks associated with property financing, the best possible solution to lessen the effects of these risks is to identify any possible things that may cause the

materialization of these risks as soon as possible and manage them effectively. “In the property finance business, the lever of control that an institution exercises over risk determines its profitability.” (Wight and Ghyoot, 2008:132).

The purpose of this chapter is to address the risks associated with property financing and how it affects both the borrower and lender no matter the nature or source of the risk. Therefore, risks associated with property financing will be addressed highlighting whether the borrower or lender is most at risk and what the benefit of taking note of the associated risk will be to both parties.

## **4.2 Generic risk**

Generic risks refer to the general areas of risk that apply to most macro-lending institutions. The purpose is to achieve a better understanding of property finance risk elements within the broader risk context.

Distinction should be made between micro, which is the loan itself, and macro, being non-loan-specific, levels of risk. These levels form the framework within which property finance operates.

### **4.2.1 The seven C’s of credit**

The seven C’s of credit are the elements that the lender will attend to regarding the risks associated with the borrower as an individual and should the borrower not be an individual but a legal entity, the management of the legal entity will be assessed.

Wight and Ghyoot (2008) pointed the following seven C's out applicable to the individual.

- **Character:** This will be an analysis of the borrower's qualities such as morality, honesty, integrity, responsibility, trustworthiness, etc. which can be established through stability of residence, employment and the borrower's standing within the business community.
- **Capacity:** This will be the borrower's ability to meet the loan repayments obligations, which can be established through the borrower's qualifications, experience, health, age, etc.
- **Capital:** This is the net worth of the borrower to establish the borrower's ability to liquidate the debt, meaning that should the borrower default on payment, how the loan amount can be recouped, normally established through an offset between the borrower's assets vs. his liabilities.
- **Conditions:** This refers to the macro-environment of the economy the borrower operates in, which he has no control over and which can affect his operations.
- **Collateral:** A tangible asset used as additional security to strengthen a perceived weakness in the credit rating of the borrower, such as lack of capital or a credit history.
- **Credit history:** This will entail payment of past loan obligations which can be verified through trade references, the credit bureau, and bank reports from the borrower's bankers.

- Common sense: Considering all the above mentioned criteria, this will entail a reasonable decision to be made by the lending institution.

The main risk in the above mentioned, lies with the lender. But with the borrower being aware of these elements, he can attend to these to improve his chances of a successful loan application outcome due to the fact that the seven C's overlap with the way in which property finance risk is assessed from the lenders perspective.

#### 4.2.2 Interest rate risk

Interest rate risk for the borrowers is associated with the cost of servicing the repayment obligation. In a market where interest rates rise, the borrower will be faced with additional repayment requirements brought about by higher installments. The higher installment payable on the loan amount could reduce or eliminate any positive cash flow from the property which will be discussed in more detail under "Repayment certainty (serviceability)"

For the lender, changes in the interest rate can also impact severely on the lenders profits. The risk associated with interest rate arises when the lender mismatches the maturity dates of his funding sources and lending profiles.

Wight and Ghyoot (2008) explained it as follows:

*"In a property finance context, an institution's treasury department employs various financial instruments in the money and bond markets to fund its lending portfolio. The institution's net interest income (margin) is then generated by providing funds to its portfolios at the funding rate plus a percentage (the lending rate), which is the reward (profit) for the risk taken on each loan. This is the margin that can be reduced or, in extreme cases,*

*become negative when the funding rate and lending rate maturity dates are mismatched.”*

From the above it can clearly be seen that it will be best for lending institutions to make loans that have the same maturity dates as their funding sources.

As a rule of thumb, Wight and Ghyoot (2004) identified that, in a rising interest rate market, longer terms should be applied where funding costs are fixed for an extended period of time and in a market of falling interest rates a shorter period should apply.

#### **4.2.3 Political or country risk**

Political risk is created by governments such as, international, national and local governments, etc. These bodies have the authority to change the environment in which business operates through items such as:

- Taxes
- Exchange controls
- Trade restrictions
- Trade tariffs
- Nationalization policies, etc.

Stable countries and governments will provide a safer environment to operate in but structuring techniques can be negotiated to negate political risk where this is not the case provided that acceptable security is reachable.



#### 4.2.4 Other macro-risk

Other macro-risks that should be considered to demonstrate the framework within which property finance business operates will be: (Wight and Ghyoot, 2006:136-137)

- Business risk: This is the risk associated with the ability of a business to continue to generate sufficient operating income. In the property finance business this will refer to the physical, location and legal attributes of a property which will influence the income generating potential of the property such as the lettability and saleability of the property.

Business risks refer to the “*probability that the required rate of return on total capital (IRRTC) will not be realized*” (Cloete, 2008:6 cite the work of Phyr et al., 1989)

- Management risk: This relates directly to the management of the property. Poor management can reduce income, whereas effective management can increase income
- Liquidity risk: It has already been seen that liquidity is the possibility of an asset to be converted into money.  
Property is not very liquid and the process of liquidating it can be time consuming and expensive. Overcoming liquidity by reducing the price on the property will increase the risk exposure to the borrower and lender
- Environmental (Location) risk: Property is immovable and therefore very much subject to various environmental factors, such as rezoning

of land adjacent to the property, etc. These factors are not always negative but are a reality that should be considered.

The borrower and lender should be aware of the above mentioned macro-risks as these risks can affect the income generating capability of the property. This could lead to problems with the servicing of the loan amount. The best counter action against the above mentioned risks is for the borrower and lender to be proactive in their approach to these risks.

### **4.3 Elements of property finance risk**

The borrower and lender should both be aware of the fact that there are elements that create risks for property which also have an influence on the value of the property. This influence can be either positive or negative and are unknown to both the borrower and lender. It is a matter of forecasting the unknown and the longer the loan term the greater the risk.

The loan term should be considered very carefully in the calculation of the risks involved. For long term loans, such as bonds, etc, the longer economic conditions would be of greater importance, where with a short term loan such as a development loan, more consideration would be placed on the current economic conditions.

Wight and Ghyoot (2008) pointed out that location is one of the main driving forces behind the forecasting of risk in property which rest mainly on three major pillars:

- Lettability: Lettability is as described by Wight and Ghyoot (2008) “an indication of the attributes that tenants require from a property, such as area suitability (declining or growth), utility of space (ability to utilize

rented area), technical infrastructure (hi-tech or basic) and tenant mix (anchor tenants to attract customers and complementary tenants).” Income from leasing the property is therefore the main source for servicing the loan. For the borrower the risk is in his cash flow and return on his investment as where for the lender, his risk lies in the constant servicing of the loan.

- **Saleability:** This will be important to the borrower should he plan on selling the property after development. For the lender it, on the other hand, it would be important in determining how quickly the property can be sold to cover the loan amount should the borrower default on his repayments, therefore referring to the liquidity of the property. Saleability therefore refer to the indication of investor demand for a particular property
- **Conditions:** This refer to the physical condition of the property, it is an element that will have little to no impact on new developments, depending off course on the building standard and quality of the construction.

The three above mentioned aspect forms the bases for property finance risks and will be further expanded below. This will provide the borrower and lender with a better understanding as to which property risk weights the heaviest on the scale of risk assessment.

#### **4.3.1 Other property finance risk areas**

The below mentioned risks areas are the areas that receive the most attention when it comes to the assessment of property finance risk. The nature of the risks will be explained, stating whether it is the borrower or

lender carrying the biggest risk load for that particular risk. There are advantages for both parties in being aware of all the risks associated with property financing. The more information is available to both parties the better prevention methods can be taken for risk management and identification.

#### **4.3.1.1 Client attributes**

This is a risk for the lender and is the risk profile of the borrower himself. Wight and Ghyoot (2008) stated that client risk mainly resolve around two issues:

- Net asset value (NAV): Net asset value is the borrower's net worth, calculated as the borrower's assets less all his liabilities. The lender will be very conservative in calculating the borrowers net worth, and the borrow should be aware of this fact as his calculations of his own net worth will very likely differ from that of the lender.
- Historical performance: Historical performance on the other hand will be the borrower's past track record of servicing his debt. This may be as simple as the repayment of a clothing account and will provide the lender with an idea as to the character of the client. Does the borrower service his debt regularly and is therefore responsible, or is the client unreliable in his debt repayments and therefore a bigger risk for the lender?

It has been stated that this is a risk associated with the borrower, however, in being aware of this, the borrower can make sure he has a clean track record or change his behavior in order to improve the likelihood that his loan application to be successful.

#### 4.3.1.2 Repayment certainty (Serviceability)

The repayment of the loan is a major risk assessment issue for both the borrower and lender. Wight and Ghyoot (2008) identified two types of risk that can have a profound effect on the serviceability of the loan amount.

- Financial risk: *“Financial risk is the additional risk caused by a firm’s use of debt financing.”* (Cloete, 2008:6) Financial risk therefore relates to the income generating capability of the property as well as the reliability of that income. This relates directly to the developers capability to service the loan amount. To address this risk, it is of fundamental importance that the tenants are assessed in the light of how capable they are to meet their rent payments as well as paying those rents on time. It is important to not only assess current rental conditions but also future escalated rental possibilities. It is also important that the borrower make sure that in the case of a tenant default on his rent repayment, he, as the landlord, will be able to recover the outstanding rental amount. The landlord should make provisions for the possibility that a tenant may become insolvent realizing that it can become very difficult to obtain the outstanding rent.
- Contractual risk: Contractual risk refers to the term and the legal bounding of the tenant. This risk can largely be addressed through making use of sophisticated contract documentation and astute lawyers.

The following statement made by Wight and Ghyoot (2008) should be noted by all developers: “The risk of contractual default is usually greater in new developments than in the case of established properties and tenants. Since new developments require significant

pre-letting (proof of demand) before a bank will consider financing the project, attention should be focused not only on the actual leases, but also on the client's meeting the construction deadlines to enable tenant occupation as stipulated in the lease agreement.”

For the above mentioned reason, Wight and Ghyoot (2008) identified the following issues that a lender will consider:

- The building design, finishes, facilities and conditions should meet the tenants expectations
- Occupation dates for major tenants should be realistic
- Occupation dates of the other smaller tenants should be arranged so that a multi-tenant building materialises, and
- Occupancy levels should be maintained as a vacant building will lead to an emigration of tenants.

These issues could lead to tenants calling for discounts on their rental rates and penalties and fees to be payable, all which will affect the developer's cash flow negatively.

It is important that the serviceability of a loan be stress tested. This is a process whereby the repayment will be placed under strain making use of vacancy factors, increase interest rates, etc. This is important as fluctuation in the economy is common place and changes will occur. By stress testing the serviceability of a loan the lending institution will make sure that the borrower will be able to repay and service the loan even in trouble times.

Generally rent escalations reduce this risk associated with the serviceability of a loan. The reason for this is that the loan amount stays constant as rental income increases and the capital amount of the loan decreases, subsequently decreasing the interest payable on the loan.

There are methods to reduce this risk, such as constant interest rates for the first few years of a loan, structured debt (See chapter 3), etc. but these methods require careful consideration as the time value of money and net present value will determine the profitability of making use of these methods.

#### **4.3.1.3 Loan to value (LTV)**

LTV is the relationship between debt financing and equity financing, meaning that it is a risk shared by both the borrower and the lender. The LTV is based on the risk associated with the type of property to be financed. Some properties will have a lower LTV than other properties due to the fact that risks differ from property type to property type. As an example, the LTV for agricultural land would be lower than the LTV for the commercial land, due to the higher risk associated with agricultural land.

Lenders make use of the LTV as a safety net. The LTV amount is seen in the light of the amount the lender would most likely be able to recover should the property in question need to be sold in a forced sale. This is a method of making sure that the outstanding loan amount would be repaid should the lender default on payment. Whoever, Wight and Ghyoot (2008) identified the following reason why the LTV amount may not be recovered in full:

- Time: The time that passes from the actual default of the borrower to the time the property actually gets sold can be substantial. This is in part due to the illiquidity of property, the legal procedures involved in the process, and the fact that the borrower can protest the forced sale. During this time, rent escalations on the outstanding loan amount increase, which also increases the LTV amount for the lender.

- Legal cost: The legal process that will have to be followed will further increase the LTV amount in the form of attorney's and advocate fees, etc. It is a cost that can be reclaimed from the borrower but will not always be possible as the client may become insolvent. Where the client does not become insolvent, recovering these costs can span over a long period of time, affecting the lending institution's cash flow.
- Difference in value: The value of the property at the time of sale of the property can be different from the value of the property as with the time of the original property valuation. The reasons for this change in value can be for a number of reasons. 1) The market conditions could have changed. 2) The effectiveness of the income generating capability of the property can be different than being predicted. 3) Due to the fact that the property had come to be known as a bad income generating property, the reputation of the property can be damaged, leaving the property much less desirable.

The risk mentioned above are those associated with the lending institution, however, some of them can also be applicable on the borrower, such as the legal cost.

For the borrower, his risk in the LTV amount lies in his contribution in making up the shortfall between the actual cost of the development and the LTV amount.

This amount will be lost to the developer should he default on his payment. It should also be noted that the developer's contribution to the cost of the development is at greater risk than the lending institutions LTV amount contributed. The reason for this is that the lender has a first claim over the income generated from the sale of the property, and the borrower holds a second claim. Meaning, that the lending institution will be paid back first from



the proceeds of the sale of the property, including the extra costs he may have incurred. Only after the lending institution had been paid back in full will the developer be entitled to any proceeds left from the sale.

#### **4.3.1.4 Property type**

Properties are categorized into different types according the elements such as zoning, use, etc. with each property type having its own inherent risk for both the borrower and lender. Each property type has its own characteristics that are associated with the success of the type of property and the absence of any or all of these characteristics are directly related to the risk associated with the property.

These characteristics should be analyzed in detail by both the borrower, through his feasibility study, and the lender, in their valuation report.

Lending institutions tend to rely on past experience to identify possible risk areas and the characteristics that have in the past been the cause of problems. These risk areas, as discussed below, are normally the areas of risk that lending institutions will focus on and the borrower can only gain from addressing these problem areas himself as well.

- Agricultural (Farm) properties: For the property developer, agricultural properties are not really of any interest. These properties are normally located outside business districts and provide very little to no potential for development. For this reason, lenders, especially commercial banks, are also reluctant to approve loans for these types of properties. Should lenders consider this type of loan, the LTV amount will be relatively low and high security will be required to secure the

loan. For the above mentioned reasons these type of properties will not be discussed in detail.

- Shopping and retail properties: Distinction can be made between a number of different types of shopping and retail properties. (See table 1 below)

CATEGORY	SIZE(GLA)	NO OF SHOPS	ANCHOR TENANTS
Super regional shopping centre	75 000m <sup>2</sup> +	150 +	Three or more department stores, plus two or more national grocers
Regional shopping center	30 000m <sup>2</sup> +	75 +	Two department stores, plus one or more national grocers
Community shopping center	15 000 – 30 000m <sup>2</sup>	50-75	Small department store and national grocer
Neighbourhood shopping center	5 000 – 15 000m <sup>2</sup>	1-25	National grocer
Local shopping center	Up to 10 000m <sup>2</sup>	1-25	Independent superette or 7-11 type franchise

Table 1 Shopping centre classification (Wight and Ghyoot:2008:148)

The bigger the development the more likely it is that lenders will involve their competitors to share in the risk, and also the income generated by, the development. The original lending institution will be the leading institution responsible for the administration of the property and will therefore receive a higher fee or margin than the other lending institutions involved.

Lenders identified the following risk area for shopping and retail centers. (Wight and Ghyoot 2008:149-150)

- Location: Location is the cornerstone to the success of any type of development and shopping centers are no different. Location will determine the reach of the shopping center which will identify the customers to be targeted. This along with competition, disposable

income and city growth patterns should be well researched and evaluated in the feasibility of the borrower. The success of the development will relay to a large extent on the ability of the shopping center to attract customers. Success will increase tenant demand, which will limit the possibility of vacancies, and therefore increase cash flow and the ability of the borrower to service his debt obligation. It is for this reason that this analysis should be done as accurately as is possible.

- Access: Access refers to the convenience and ease of traffic flow. Customers should be able to access the shopping centre with no difficulty from main routes and the flow of traffic inside the parking areas should also contribute to their feeling of comfort. Should customers have an uncomfortable experience, they will most likely go and shop elsewhere.
- Shape and size of site: This is important for the possibility of expansion, the visibility of the centre for advertisement and awareness of existence, as well as convenient and sufficient parking.
- Topography: The physical characteristics of the site and the design of the shopping centre are of fundamental importance to the success of the center. A level site will be the easiest to develop since all functions will be on the same level, allowing traffic flow to be equal all over the site where as in a multi level shopping center top levels may track less traffic.
- Adjacent land zones: Adjacent properties can influence the shopping center. Residential and commercial property will have a positive effect whereas an industrial property will have a negative effect.
- Anchor tenants: Anchor tenants are of fundamental importance to any shopping development. They attract the customers and should

be spread across the shopping center to encourage movement through the shopping center, which will attract other smaller tenants that will pay higher rents. Anchor tenants are also more likely to sign longer lease agreements as they tend to be more stable in business practice.

- Tenant mix: If there is too much competition between the type of tenants in the center, it will lead to vacancies and problems with cash flow. A mix of tenants will provide the customer with a variety of products, making the center a 'one stop' center. There should also be a good placement of tenants which means that tenants should be located to complement each other. As an example, a butcher and a beauty salon will not work well next to each other.
- Commercial properties: Commercial properties generally consist of shops and offices. Shops were generally covered by the discussion of shopping centers earlier so this topic will concentrate mostly on office developments.

For office buildings, the following risk areas have been identified by Wight and Ghyoot (2008).

- Decentralization: This is the process where a major transfer of activity moves from a certain part of the city to another. This was the case with most of the central business district's (CBD) in South Africa. This led to lending institutions withdrawing their funding from these areas and made obtaining financing in these areas very difficult if not impossible.
- Parking: If the required parking for an office development is not sufficient there will be no investment from the lending institution. Insufficient parking would most likely lead to the failure of an office

development as tenants will require parking for their employees and customers.

- **Obsolescence:** This refers to the age of a building and how likely and readily it can be adjusted to meet the latest requirements. The cost of adapting the building to meet these requirements should be calculated to determine whether the income will justify the cost.
  
- **Industrial properties:** An industrial property is where the process of producing goods and products from raw materials take place. When the risks are assessed for industrial properties, the adjustability of the property for new use should be assessed. Should the property be highly specialized, the possibility of a sale or re-letting the property could be difficult due to a limited number of users. For this reason the lending institution will assess the buildings saleability, lettability, and building conditions.

Other considerations that will also have an impact on the value of the property would be:

- Design (How fit for purpose the property is, normally single level)
- Loading facility (Parking, loading facilities, etc.)
- Location to related industries (complimentary product such as cars factories and car part factories, etc.)

#### **4.3.1.5 Property location**

Wight and Ghyoot (2008) pointed out that the key aspect of location is “the linkages between a property and other land uses.” It would therefore include not only access to the property but also access to other facilities from the property.

The location of the property and the access to and from other properties is of fundamental importance for the saleability and letability of the property and as seen before, these are directly linked to the lending decision made by lending institutions.

Wight and Ghyoot (2008) make mention of a “linkage analysis” that should be undertaken for each type of property to determine the “convenience factor” which they described as the ability of transportation networks to provide an infrastructure that will complement the property type.

- Residential properties: Residential properties will require convenient access to (1) bus and railway stations for transportation, (2) local shopping centers, (3) community centers, (4) schools, etc. The close proximity to major roads and highways can also have a positive effect on properties because it allows for easy access for residents to commute to work, school, etc. But, it can also have a negative impact on the property in question as noise from the associated road or highway will result in resident frustration and cause lower demand (letability and saleability) for the property.
- Industrial properties: For industrial properties, the most important consideration regarding access would be transportation routes such as railways, airports, harbours, etc. for the effective and quick movement of products. Should products need to be commuted over long distances, the producers cost will increase as well as his ability to compete effectively against time. A second aspect of importance that should be considered for labour intensive industrial properties will be the availability of labour.

- Commercial properties: High traffic areas with easy access for departure and arrival of clients are key to the success of commercial properties. An added advantage would be the ability of the property to allow for advertising, the ability of the advertising to draw the attention of the client, and its ability to provide the client with useful information.

Wight and Ghyoot (2008) also identified views, smells, noise, weather, etc. from adjoining properties as aspect of a location that can influence saleability and lettability.

#### **4.3.1.6 Property quality**

The quality of the intended development will have a major influence on the value thereof. The property should therefore be able to attract tenants or purchasers through elements such as the functional layout of the development, design and quality of finishes, quality of materials and workmanship, etc. All the above mentioned aspects should be market related in order to meet client's requirements.

The developer should take the above mentioned aspects into consideration in the design and planning phase with the professional team as the following items of relevance would be considered by the lender in the valuation process. (Wight and Ghyoot, 2008:154-155)

- Maintenance: Maintenance is directly related to the construction materials and finishes used in the building process. Better quality and choice of material normally will reduce the cost to maintain the original appearance of the building. This will not only reduce maintenance cost but also limit vacancies for the client.

- Operation experience: The operation of the building should be done through experienced personnel. Buildings consume large amounts of resources and if these are not effectively managed, the cost for maintenance and operation will run amok.
- Utility costs: Utility cost is directly linked to the design of the building. In the design process the professional team should very clearly establish the needs of the client/end-user in order to produce a building that is cost effective in the sense that it can be utilized to the fullest with no unnecessary utilities.
- Economy of construction: The building should be constructed using the correct methods and materials to fulfill the intended use and purpose of the building, thereby delivering on market requirements
- Insurance: Expensive finishes and building materials, such as marble, etc. will result in higher insurance premium which can increase drastically over time. If the rental income does not increase at the same rate, the profitability and cash flow of the development will decrease, which may affect the serviceability of the loan amount.

#### **4.3.2 Property insurance**

It is to both the borrower and lender's advantage to make sure the proposed development is sufficiently insured. This is a risk that will affect both parties as the income generated by a property will immediately cease should the property become unable to function due to fire, natural disasters, etc.

The value of the property can fall to below the value of the vacant land, as the remaining building may still need to be demolished. It is therefore



important that a building be insured for more than just its replacement cost. Possible loss of income should also be insured so that the borrower can continue to service his debt responsibility.

The lender will therefore make appropriate insurance a condition of the loan agreement which should include the following items: (Wight and Ghyoot, 2008:156)

- Fire and additional perils
- Gross rentals
- SASRIA (Damage from political and non-political riots)
- Property owner's liability (Borrower covered for any damaged caused as a result of work or activity performed on the insured property)

#### **4.4 Risk categorization**

##### **4.4.1 Purpose**

Lenders allocate a risk category to each loan in order to determine the following: (Wight and Ghyoot, 2008:158)

- Pricing: For the pricing of a loan the associated risk and returns on the investment is considered. The general rule is that the higher the risk the higher the return (interest rate) and vice versa.
- General provisioning: This is where the lender builds up their reserves to make provisions for possible losses.
- Financial performance: Higher risk loans require closer monitoring and therefore increased administration costs. This reduces profits as it increases resource allocation, time and costs.

- **Portfolio value:** Lenders tend to build up a diverse portfolio in order to minimize their risk and exposure. These portfolios can be valued based on the risk associated with them for the purpose of sale or securitization.

#### 4.4.2 Method of risk categorization

Through making use of the major risk elements associated with property, lenders tend to analyse and rate each category to provide a weighted and overall score to a loan. (See table 2 below) This will allow the lenders to allocate the loan to a specific risk category for pricing, etc.

It is important for the borrower to be aware of how the lending institution will calculate this risk category. With the borrower being aware how the risk category is calculated, he can address the associated items to lower the risk category and by so doing, decrease his cost through lower interest rate, consequently having the effect of an increased cash flow.

<b>RISK AREA</b>	<b>RISK RATING</b>	<b>EXAMPLES</b>	<b>SCORE</b>
Client	1-High risk	No track record, financial standing uncertain	4
	2-Marginal	No track record, financial acceptable	
	3-Acceptable	Track record, financials acceptable	
	4-Low risk	Track record, financials good	
	5-No risk	Blue chip company or exceptional individual wealth	
	Weight 15		15 x 4 60
Repayment certainty	1-High risk	No lease	3
	2-Marginal	Short-term leases, no national tenants	
	3-Acceptable	National anchor tenants, minimum 3-year leases	
	4-Low risk	National anchor tenants, minimum 5-year leases	
	5-No risk	National anchor tenants, minimum 10-year leases	
	Weight 25		25 x 3 75

RISK AREA	RISK RATING	EXAMPLES	SCORE
Property type	1-High risk	Specialised, e.g. motor car showrooms	2  10 x 2 20
	2-Marginal	Large industrial units	
	3-Acceptable	Established suburban shopping centres	
	4-Low risk	High-demand office or industrial complexes	
	5-No risk	Non, except structured loans around listed, blue chip companies	
	Weight 10		
Location	1-High risk	Non-established area, demand not quantifiable	3  25 x 3 75
	2-Marginal	Established area, stagnant growth potential	
	3-Acceptable	Established area, demand still evident for foreseeable future	
	4-Low risk	Growth area, demand outstrip supply	
	5-No risk	Exclusive, no competition, guaranteed tenants, e.g. Robben island as a tourist attraction	
	Weight 25		
Quality	1-High risk	Property poorly designed and maintained	3  10 x 3 30
	2-Marginal	Good design, lacking maintenance and management	
	3-Acceptable	Good design, maintenance and management	
	4-Low risk	Low-maintenance construction, excellent condition	
	5-No risk	Excellent condition, fully repairing lease with blue chip company	
	Weight 10		
<b>WEIGHTED SCORE</b>			<b>305</b>

Table 2 Risk category allocation table (Wight and Ghyoot, 2008:160)

The above table is an example of how lenders make use of the weighted scores of each risk area to arrive at an overall weighted score for the loan. This score will determine the risk category of the loan. (See table 3 below)

RISK CATEGORY	MINIMUM WEIGHTED SCORE	MINIMUM MARGIN	GENERAL PROVISION (% OF LOAN AMOUNT)
A	350	2.00%	0.100%
B	300	2.50%	0.125%
C	250	3.00%	0.150%

Table 3 Risk categories and required margins (Wight and Ghyoot, 2008:160)

Having determined the risk category of a loan, lenders will generally have a standard pricing mechanism for the associated risk category. In table 3 above it can be seen that should a loan fall within risk category (B), the lending institution will only be willing to provide a loan with a minimum margin of 2.5%, meaning 2.5% above the repo rate.

This model will differ from lending institution to lending institution, but with the borrower being aware of how the process works and how interest rate for the loan amount will be calculated, steps can be taken by the borrower to decrease the interest rate through addressing the aspects that will determine his risk category.

#### **4.5 Group risk**

A group generally refers to the allocation of a loan into a group of loans with similar characteristics. This is generally an internal function of lending institutions, which they use to determine their exposure in that particular group, set limits to the number of loans being made in that group and identify a possibly under performing loan from the rest of the group.

The borrower cannot change the allocation of his loan to a group, as it will be done internally through the lending institution. The only benefit to the borrower of being aware of the grouping of loans, will be to determine from the offset of the loan application whether the lending institution will still be willing to make loans in a particular loan group.

#### **4.6 Portfolio risk**

It has been seen before that lending institutions tend to diversify their portfolio risks. This is usually done through securing a diverse number of properties that support a broad spectrum of businesses and undertakings.

The reason for this is that lenders, as investors, diversify their portfolios to shelter themselves against risk. Should there be a downturn in one sector of the economy, the effect on the lending institution with a diverse portfolio will not be as hard felt as it might for the lending institution that specializes in only one sector of the economy.

For the borrower, this is useful information. It can provide one with an indication as to which lending institution to approach for a loan. Lending institutions with a diverse portfolio may have limited funds available for a specific loan group (see section 4.5 hereinbefore). However, should a downturn in the economy realize, lending institutions with a diverse portfolio may be more stable in providing the borrower with continued service than lending institutions specializing in only a specific property sector.

#### **4.7 Materialized risk (Bad debt)**

The borrower may very well end up in a situation where he may struggle to service his loan or even become unable to make any repayment. This can be due to any of the elements associated with property finance risk, discussed above. Default on the servicing of a loan is a real risk to the lender and will most likely influence their profitability. Should this happen, lenders will take all necessary steps to protect their interests.

Lenders will continuously be monitoring the servicing of the loan to predict any possible default and it is advised that the borrower do the same. Should the borrower identify any possible problems in servicing the loan, it is advisable that negotiations are undertaken with the lender as soon as possible in order to establish possible solutions. Solutions can be a new loan structure (see chapter 2) or a longer term. Either way, the borrower should be aware of the possible actions the lender may take to protect their interest. The more informed both parties are regarding each other's point of view, the better they will be to address the problematic situation.

#### **4.7.1 Cost of bad debt to the lender**

Wight and Ghyoot (2008) described bad debt as an asset that has lost its ability to generate a profit (net interest income) for the lending institution.

Should the lending institution decide to take legal action and liquidate the asset, the cost associated with this process will be directly attributable to the asset. Wight and Ghyoot also stated that it will be these costs associated with the liquidation process of the assets that will eventually determine the balance of the profit or loss for the lending institution regarding the bad debt.

With the liquidation of the loan, lenders tend to recover two principal amounts on the loan. The first amount that lender would recover will be the original capital amount, with the second amount being the income reserved amount. The income reserved amount is the rent that had escalated on the loan from the default date till final settlement on the original capital amount.

It is important for the borrower to note that should the property be liquidated, the possibility of receiving any return from the property will be very limited if not impossible. The reason for this is that the lender will first settle the capital

amount and followed by outstanding rent escalated on the capital amount as well as all cost incurred through the liquidation process. This along with the fact that the property would most likely have been sold in a forced, below market value sale means that it will be the borrower's investment that will be most at risk. The LTV will form the basis for the forced sale with little consideration for the borrower's contribution to the total value of the property.

## **4.7.2 Early identification methods**

### **4.7.2.1 Procedural**

Wight and Ghyoot (2008) identified the following two procedural areas that lenders will make use of to identify a potentially troublesome account.

- Arrears reports: "These reports provide a historical, time-segmented track record of payments." (Wight and Ghyoot, 2008:17) Borrower are very likely to miss a payment due date on a loan amount at some point or another, this does not necessarily constitute a problem. However, a trend in missed due dated can be the first sign of a possible problem. This does not mean the loan currently has to be in arrears.
- Reviews: South Africa in general has a dynamic and even volatile economic environment. This is visible in the fluctuating interest rate of the last few years. For this reason, it only makes sense that the lending institution reviews its property-lending portfolio, through property inspection, review of tenants and leases, analyzing the borrower's latest financial position, etc. Making use of this process the lender should be able to identify possible weaknesses which the borrower can use to prevent any possible problems.

For development/construction loans, the lender will usually have a project representative to assess the construction schedule for progress, adherence to the cost projections, etc.

Project meetings to address problems with the project are of fundamental importance to all development. These meetings normally help in identifying problem at an early stage, which provide the borrower and lender with a 'heads up' on problems and the opportunity to take corrective action as soon as possible.

#### **4.7.2.2 Networking**

Lending institutions will be active in participating in the local property industry. They will deal with brokers (see chapter 2), clients, attorneys, etc. on a daily basis to gather information as to what is happening in the property market. Developing and maintaining these links in the property network will benefit the lender by providing him with information as to market perspective, tenant default trends, vacancy factors as well as other risks associated with lending. Borrowers themselves stand to gain from networking in the same manner as is done by lending institutions.

#### **4.7.3 Factors that influence the creation of bad debt**

##### **4.7.3.1 Management**

Management is the knowledge, experience and ability to manage property effectively and profitably and require specialist expertise on property management, financial management, negotiation as well as product experience. (Wight and Ghyoot, 2008:175)



The most important aspect that should be addressed by management in property is maintenance and cash flow segmentation. (See also section 4.3.1.6 hereinbefore)

#### **4.7.3.2 New developments**

New developments in the immediate area to the property in question can have a negative impact on leases and vacancies as tenants may prefer the new development due to better location, more business, etc. This will therefore increase competition, leading to decreased rental income, etc.

#### **4.7.3.3 Declining area**

Declining areas are a reality of life and undergo changes as demand and social conditions in society change. Loan terms for long term finance normally expand over a long period of time and the possibility exists that when a loan was granted the value of the property was substantially higher due to higher demand than what is the case 10 or 20 years later.

#### **4.7.3.4 Local authorities**

Local authorities derive their income from rates and taxes on properties and are in competition against each other for more income. This has the consequence that more development may be made available with fierce competition between rivaling properties, causing an unbalance in the market forces of demand and supply.

#### **4.7.4 Corrective actions and loss limitation**

Wight and Ghyoot (2008) identified the following corrective actions that can be taken by lending institutions in order to limit their losses.

##### **4.7.4.1 Obtaining judgment**

This is where the property is repossessed and liquidated as soon as possible in order to limit the lender's possible losses. The idea behind this approach is that the sooner the property is liquidated, the less the lender will be exposed to additional cost through interest, legal cost, etc. This option is normally pursued by lenders where missed payment or partial payment had taken place for a period of three months.

##### **4.7.4.2 Playing nurse maid**

This is mostly where the property in question may be performing adequately but due to mismanagement repayment obligation cannot be made. In these cases the lending institution may very well provide the borrower with its experience, legal expertise or financial structuring capabilities to overcome the miss management of the property.

##### **4.7.4.3 Attaching rentals**

This is an option that can only be exercised by the lending institution where provision has been made for it in the loan agreement. Generally this will be provided for in the default section of the agreement.

In this case the cash flow generated by the property through rentals, etc. will be directed towards the servicing the loan amount. It is rarely a solution to

the problem and only delays the inevitable, as other creditors will eventually place the borrower in “mora” (default), which will eventually result in the borrower becoming insolvent.

#### **4.7.4.4 Finding investors**

Lending institutions usually have an extensive client base with possible investors looking for a better return on their investments. The lending institution may very well go into negotiation with its existing client to take over the property in question. This can result in a positive situation for the borrower, lender and possible investor should the terms be negotiated successfully.

#### **4.8 Summary**

The risks associated with property financing business are unavoidable and can influence either one or both the borrower and lender to some extent or another. This chapter identified the risk associated with the financing of property development, and identified which party is more at risk, the borrower or lender.

Risk exposure comes from both the micro and macro environments, forming the framework within which property financing operates.

The elements of property financing risk are mostly those associated with both the borrower and the lender and will affect the value of the property which form the basis of the security for the loan. The longer the loan term the greater the risk associated with the property.

Lenders tend to categorize loans. This assists the lender in determining the pricing for the loan, provisions that have to be made for the loan, the amount of monitoring needed for the loan as well as how the loan fits into the lender's overall portfolio.

Lenders will take all necessary steps to protect their interest should the borrower be in default. The lender will monitor the borrower's situation to identify possible early warning signs of default and will take corrective action accordingly.

The development process is a risky business and if it is not planned and managed correctly it will result in problems for both the borrower and lender.

#### **4.9 Conclusion**

In some instances one party may be exposed more to a specific risk than the other, but this does not mean the other party should ignore the associated risk as their knowledge reduces their own risk and exposure.

It is to the advantage of both the borrower and lender to be aware of all the risk associated with property financing, no matter which party is at risk most. Due to the relationship that forms between the parties involved, risk associated with one party will no doubt affect the other as well. Dillon, C (2003) explained it very simple and straight forward: "Your knowledge is your risk reducer."

The associated risks of property financing should be monitored and managed on a constant and continued basis to identify any possible problem and preventive action should be taken as quickly as possible.

It is also advisable that a “what if” analysis be done to establish possible solutions for all known risks and possible threads beforehand.

#### **4.10 Testing of Hypothesis**

“The future is a matter of the unknown and it creates the possibility that things could turn out to be different than what had been anticipated. The risks for the lender and borrower are of a different nature for both parties yet still a reality that needs to be managed from both sides.”

It has clearly been established that risk is associated with the unknown nature of future events. No matter how well an organizational structure does in eliminating risks, no future can be predicted with 100% accuracy.

The risks for the lender and borrower are sometimes of a different nature but mostly are of the same nature and origin. The loan will be structured around the associated property, meaning any risk associated with the property will be a risk to both the borrower and the lender.

Even where the risk is of a different nature, it does, by no means, mean that there will not be an effect on the other party. The property being financing creates a relationship between the borrower and lender and therefore risks associated with one party will have an influence on the other party as well.

## THE RELATIONSHIP BETWEEN THE BORROWER AND LENDER

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### 5.1 Introduction

The borrower and lender each have their own agendas when it comes to the financing of property development. However, they have the same intention as any business enterprise, namely to minimize their risks and maximize their expected returns.

The first part of this chapter concentrates on the borrower and the reason why the borrower would make use of debt financing to finance his developments.

The mechanics of calculating the cost to finance the development, making use of debt, will be addressed to determine why the borrower will consider debt financing as an option.

The second part of the chapter considers the lender's perspective on the financing of property and provides reasons as to why the lender will be willing to provide borrowers with the funds they need for their developments.

Lenders have their own mechanics on which they rely to calculate their risk exposure. This helps to determine whether establishing a relationship with a potential borrower will be worth their while.

A summary will review the intentions of both the borrower and the lender, as these intentions will form the undertone on which the relationship between the two parties will be established.

The chapter will be concluded with a finding addressing how the intentions of each party will influence the relationship that will form between them.

## 5.2 The relationship between debt and equity financing

By financing property development through a combination of debt and equity financing, the NOI of the development is effectively divided between the borrower and lender, placing them in direct competition against each other for the NOI of the property (See figure 4 below)

It is important to understand that the financing of property through a combination of debt and equity divides the claim on a properties cash flow between the borrower and the Lender, with the lender having a preferential claim to the property's income.

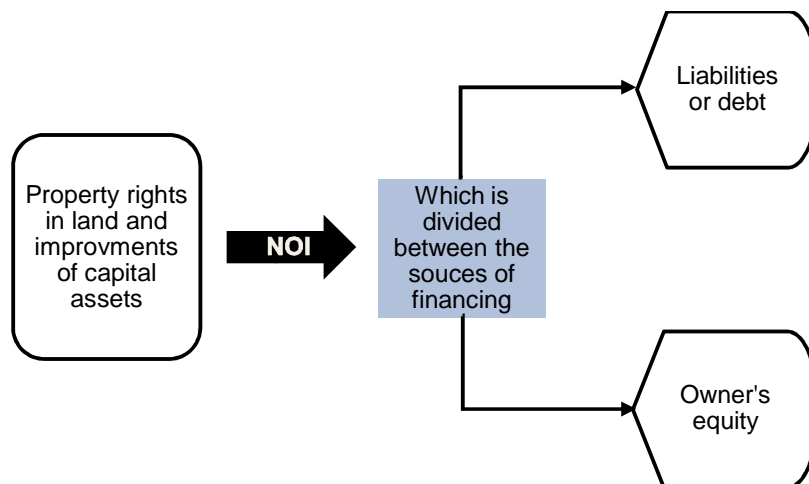


Figure 4 Division of NOI (Wurtzeback, 1994:417)

It is also important that both parties involved feel that they are making a return on their investment and that their returns are proportionate to their risk exposure.

For this reason it is of paramount importance that the borrower and lender should understand each other's investment requirements. This will allow for a mutually beneficial relationship which will ensure the funding for the development.

In figure 4 above the NOI is divided between the lender and the borrower. With that in mind it should be stated that the portion of NOI that covers the cost of financing is limited. Rent income and operating expenses are determined by market conditions and the economic theory of supply and demand. These are variables that cannot be adjusted beyond market related prices without the possibility of vacancies being experienced due to rent that is too high, or a rapidly decaying building suffering from insufficient maintenance.

### **5.3 The borrower's perspective on debt financing**

#### **5.3.1 The benefits and cost of financing to the equity holder**

Developers generally make use of a combination of debt and equity financing with the ratio for the LTV amount generally ranging between 60 to 90 percent according to Wurtzeback (1994). This brings about the question: "Why is it that this ratio seems to be the norm?" There can only be one answer. There has to be a point where the benefits associated with debt financing equal the costs associated with the debt financing. Beyond this point the cost of debt financing will outweigh the benefits, leading to a negative situation for the developer.



- Benefits of using debt financing

Wurtzeback (1994) stated the following regarding the benefits of using debt financing: “When the cost of debt financing (the interest rate) is lower than the return generated by the property (NOI divided by cost), then positive leverage is created. In such situation, the percentage return to equity is greater using debt than it is with no debt.”

- Interest rates are tax deductible
- Debt financing reduces the minimum amount of equity required by the developer himself, which means that he can make use of the rest of his equity to diversifying his portfolio by investing it somewhere else.
- “Flexibility to tailor the investment to suit the client is an additional benefit of using debt financing.” (See chapter 1 for different products of financing available)

- Cost of debt financing

The more debt that is used, the more cash flow is used to service the debt which means that the less NOI is available to the equity holder. The more claim is made to the NOI of the development’s cash flow, the more the equity holder will be exposed to risk and increase risk decreases the value of the development for the equity holder. This means that as you add debt to gain the advantages associated with it, the risk to developer’s equity is also increased. Also, with the lender having to finance a bigger portion of the development, his risk will also increase. Therefore, he will also increase this cost to cover this risk.

Wurtzeback (1994) therefore stated that the optimal percentage of debt financing is reached just before “incremental cost” outweighs “increment benefits”

Increment cost consists of the following:

- Cost of capital (interest rate)
- Fees for services and admin and the lenders time and resources used
- Making use of “middle men” such as lawyers for registration, bond originators, etc.

Incremental benefits being:

- Tax benefits
- Minimum investment of own equity from developer
- Tailor made financing structures and investment opportunities.

### **5.3.2 Financing computations**

Financing computations are the mathematical and financial calculations that developers will have to understand in order for them to make well informed and calculated decisions regarding potential developments. Their calculations will be discussed in brief below.

#### **5.3.2.1 Time value of money**

The time value of money was discussed in chapter two in detail where it was established that the time value of money consist mainly out of three items.

- Opportunity cost
- Inflation
- Risk

It is now important to note that, as identified by Wurtzeback (1994), these three items make up three of the four components of the capitalization rate,

which is the income approach to value. These three items also make up the components of the interest rate which will be the lenders perspective.

However, when the risk premium of the project is calculated by capitalizing the NOI through the income approach to appraisal, the calculation is based on the overall risk potential of the project.

This method of calculating the risk premium, in actual fact, reflects an imbalance in the risk profile shared between the borrower and lender. In reality the borrower will carry more of the risk than will the lender. The reason for this is that because of the lender's prior claim over the NOI of the property the lender will be assured to receive his debt service from the NOI before the borrower will be allowed to take his part of the NOI. Should there be a change in NOI, it will be the borrower's share of the NOI that will be reduced and not the lender's. Therefore, the developer is in a greater risk position than that lender due to the lenders prior claim over NOI.

### 5.3.2.2 Compound interest and the discounting process

- Interpretations to financing computations

FV = future Value

PV = present Value

r = interest rate

n = period applicable (Number of payment in period)

i = the periodic interest rate

- Compounding: Compounding is, simply put, interest on interest, where the present value is known and the future value is to be calculated based on a specific period and interest rate.

The formula for compounding is:

$$FV = PV(1 + r)^n$$

- Discounting: Discounting is simply the reverse of compounding with the future value known and the present value unknown.

The formula for discounting is:

$$PV = FV / (1 + r)^n$$

- Series of payments: A series of payments are simply an expansion of the compounding and discounting formulas to be able to deal with an annuity (series of payments or receipts).

A series of payments is best used with the concept of a sinking fund, which is quite helpful when an investor needs to determine how much must be set aside for replacing fixtures that will wear out over time, such as lifts, floor coverings, etc.

The formulas for the present and future value of an annuity are:

$$PVA = \frac{1 - (1 + i)^{-n}}{i} \times (\text{payment})$$

$$FVA = \text{payment} \times \frac{(1 + i)^n - 1}{i}$$

- The mortgage loan constant: The mortgage loan constant answers the question of the borrower: “What is the amount that I must pay each month (or other period) sufficient to repay the principal I am borrowing and to pay sufficient interest on the declining balance to exhaust the loan over its term?” (Wurtzeback, 1994:425)

The mortgage constant (K) consists out of two factors, the first being the interest payable on the capital (loan) amount and the second being

the capital amount itself and can be influenced by a change in the term or the interest rate of the loan.

- Effective yield: Effective yield is a more accurate measure for calculating the lender's rate of interest than calculating a simple annual interest rate because effective yield takes compounding into account.

For the lender, it is important to take note of the statement by Wurtzeback (1994) that the effective yield usually exceeds the contract rate of interest if an origination fee (administration costs) and the like are charged.

For the borrower, the lender's effective pretax yield is of importance as this will be the borrower's effective pretax cost.

The formula for effective yield being:

$$\text{Effective yield} = \left(1 + \frac{i}{n}\right)^n - 1$$

### 5.3.3 Effect of financing on before-tax cash flows

#### 5.3.3.1 The before-tax cash flow statement

The before-tax cash flow statement is used to determine which part of the NOI the lender and the borrower will receive. Since the lender has a prior claim over the NOI, he, of course, will be paid first from the income of the development. This will leave the borrower with the proceeds, which will be return on equity before tax. (See table 4 below for example)

Before-tax cash flow statement	
Gross rental receipts	R 81 000.00
Plus: other income	R 7 200.00
Gross potential income	R 88 200.00
Less: Vacancy and Credit loss	(R 5 292.00)
Effective gross income	R 82 908.00
Less: Operating expenses	(R 31 752.00)
Net operating income	R 51 156.00
Less: Debt service	(R 47 104.00)
Before-tax equity cash flow	R 4 052.00

Table 4 Before-tax cash flow statement (Wurtzeback, 1994:417)

Taking the above mentioned into account, two important return measures can be calculated that will provide the borrower with an idea as to the profitability and effectiveness of the proposed transaction and the combination use of debt and equity financing.

There two methods being discussed in more detail below will be:

- Rate of return on total capital (ROR)
- Rate of return on equity (ROE)

### 5.3.3.2 Rate of Return on Total Capital (ROR)

The ROR measures the overall productivity of the income producing property, which is an indication of the return on equity should the project be financed through equity only.

The formula for calculating the ROR is:

$$ROR = \frac{NOI}{Total\ capital\ investmet}$$

### 5.3.3.3 Rate of Return on Equity (ROE)

The ROE measures before-tax cash flow to equity investment after NOI is calculated and debt service deducted.

The investor can make use of the ROE, through comparing it with different projects and products of financing, to indicate how financing can affect current return.

The formula for calculating ROE is:

$$ROE = \frac{\text{Before tax equity cash flow}}{\text{Equity investment}}$$

### 5.3.3.4 Positive and negative Leverage (Gearing)

In chapter 2 it was established that leverage is the combined use of borrowed funds from the lender and the developers own equity. Consideration is now placed on the implication of negative and positive leverage to the developer. Wurtzaback (1994) stated that debt financing has two effects on the residual cash flow of a project

- The percentage return to equity may be increased or decreased
- The variability of the cash flow to equity will be increased

*“The impact of leverage on equity return (ROE) can be analyzed by comparing the ROR with the annual constant (K). The general rule is that if K is greater than ROR, leverage is negative and works against the equity investor by reducing the percentage return to equity. If K is less the ROR, leverage is positive and works for the equity investor by increasing the percentage return to equity.” (Wurtzeback, 1994:432)*

Taking the above into consideration, the conclusion can be made that should  $K > ROR$ , the cost of financing will be greater than the overall productivity of the project, which means the cost of the borrowed funds will be more than what the project can generate, which further means the ROE will suffer.

Steps can be taken to counteract negative leverage, namely to reduce  $K$  through negotiating a lower interest rate or longer term. The ROR can also be increased through rental increases, decreasing operating cost or decreasing the capital investment. These are however normally market driven and not under the direct control of the developer. According to Wurtzeback (1994) the only variable within the developers control is the offering price of the property and development.

Wurtzeback (1994) also stated that even though some developments may have negative leverage, they may still attract developers in an inflationary economy, where the developer will be willing to give up the NOI of the property knowing that the properties capital gains will not be shared with the lender.

#### **5.3.3.5 Leverage and variability of cash flow**

It doesn't matter whether leverage is positive or negative, it will affect the cash flow of the development. Since the lender has a prior claim over the NOI, this has the consequence that should there be a change in the income of the property, this change in income will be felt by the developer, equity holder, and not the lender. (See table 5 below for example)



	Outcome 1	Outcome 2
I <i>Unleveraged/return:</i>		
NOI	R 12 000.00	R 8 000.00
Total Capital investment	R 100 000.00	R 100 000.00
Percentage ROR	12%	8%
II <i>Leveraged/return:</i>		
NOI	R 12 000.00	R 8 000.00
Annual debt service	R 7 700.00	R 7 700.00
Before-Tax equity cash flow	R 4 300.00	R 300.00
Equity investment	R 30 000.00	R 30 000.00
Percentage ROE	14.33%	1.00%

Table 5 Leveraged-Income variability (Wurtzeback, 1994:417)

### 5.3.3.6 Additional debt and equity distinctions

There are many other forms of debt and equity available, such as first mortgage, second mortgage, and third mortgage. There can also be a group of equity holders with no debt, etc.

It doesn't matter how the players are participating in the game, the motive will be the same for all. Each and every player will want to increase their return while at the same time minimizing their risk. All will be in competition with each other for the NOI with the only common goal for all being to maximize the NOI of the project.

## 5.4 The Lender's perspective

### 5.4.1 The lender as an investor

The lender is also an investor in his own right. Wurtzeback (1994) stated that the lender is a kind of intermediate property investor. The reason for this is that the lender operates as an intermediary. They make use of funds from

their own sources and savers, and then distribute these funds to the borrowers, making their profit through:

- Fees
- Debt service payment
- Income participation, or
- Equity participation

The lender, also being an investor, will require a return on his investment and this return can be obtained through either one or a combination of the above mentioned methods. What is important to take note of is that the return the lender will require will consist of these four elements (Wurtzebach, 1994: 438)

- Real return (Compensation of deferred consumption)  
“The annual percentage return realized on an investment, which is adjusted for changes in prices due to inflation or other external effects. This method expresses the nominal rate of return in real terms, which keeps the purchasing power of a given level of capital constant over time.” “Adjusting the nominal return to compensate for factors such as inflation allows investors to determine how much of their nominal return is actually real return” (Investopedia, 2009)

From the above, it can be concluded that real return would be the return on an investment, less the reduction in its value as a result of inflation, taxes, etc. The bigger the percentage of required real return by the lender, the less the borrower will make on his own equity invested.

- Inflation premium (Compensation for the declining value of money)

The inflation premium will be determined by the inflation trends in the economy and will move up and down according to market trends, which will affect all loans of similar maturity.

- Inflation risk premium (Compensation for the possibility that the inflation premium was underestimated and that the loan will be paid back with money that will be worth less than expected) The inflation risk premium will vary depending on the lenders ability to make accurate forecast regarding possible movement in inflation.
- Default risk premium (Compensation for the possibility that the loan may not be repaid as agreed) The default risk premium are mostly determined by the borrowers profile as well as the safety and liquidity (ability of property to generate an income or converted into money) of the particular loan or property development.

The three premiums mentioned above are normally the factors on which the lender will rely and make use of to calculate the interest rate for the loan.

The return for lenders will have to cover three items for them to be a profitable institution. Firstly, the lender's sources will require an acceptable return on their funds and, apart from this cost, the lender will also need to cover his operating cost and make a profit himself. The last two items mentioned, the lenders cost and profit, are known as his spread and the intention of any lender will therefore be to maximize his spread, just as would any other profit making enterprise strive to maximize their profits and minimize their costs.

### 5.4.2 The exit strategy

WiseGEEK (2009) explained an exit strategy as follows: “An exit strategy is basically a plan to get out of a situation. An exit strategy is recognized as being crucial to help bring about a positive conclusion to either a business investment or military undertaking”

Wikipedia (2009) on the other hand explained an exit strategy as “a means of escaping one’s current situation, typically an unfavorable, situation.” The idea behind the exit strategy for the lender is to, in the worst case scenario, break even and if possible to achieve an objective that is worth more than the cost of continued involvement.

For this reason, lenders tend to prefer working and structuring their documentation in such a manner that they are always aware as to what the cost to complete a project would be should the borrower be in default and the lender be in a situation where they will have to complete the project.

### 5.4.3 Major considerations for the loan application process

The borrower must understand the lender’s perspective if he is to obtain the best possible financing for any given project.

There are a number of elements lenders will take into consideration when they evaluate a loan proposal: (Wurtzebach, 1994: 470)

- Their own position
- The property itself
- The security agreement, and
- The loan requested to the projected net operating income of the property or the borrowers income.

The lender has a great deal of flexibility in structuring a loan to fit a particular property or borrower. (See chapter 2) The concepts behind all the alternatives in the structuring of loans allows for creative people to structure loans that will meet the needs of both the borrowers and lenders.

#### **5.4.3.1 First-mortgage position and good title**

The lender will require a first mortgage over the property in question. This will provide the lender with a first claim over the property in the event of a default by the borrower.

The lender will also make sure that the borrower is the true owner of the property over which the mortgage will be required. Should the borrower not be the owner of the property in question the lender could very well have no claim over the associated property.

#### **5.4.3.2 Economic issues - Market analysis**

A market analysis will cover information regarding the general economic health and urban development patterns that will have an influence on the associated property. This will provide the lender with valuable information regarding the sustainability of the development as well as the strength of the location of the development over the term of the loan.

The valuer will be the responsible person who will undertake the analysis on behalf of the lender. (See chapter 3) It should be noted that this analysis is a prediction of possible outcomes to future events. Problems with an analysis based on prediction into the future is that changing and unforeseen market conditions can cause problems, and the analysis itself is only as good as the experience and integrity of the valuer that compiled the analysis

### 5.4.3.3 The property and the borrower

The lender will undertake an appraisal of the property in question to determine the LTV ratio as well as the debt coverage ratio, which will provide the lender with an indication of the risk commitment it is willing to undertake.

The lender will also assess the borrower's financial position as an individual. The reason for this is that should the borrower be in default, the lender would seek a "deficiency judgment" against the borrower which will only be good if the borrower has other resources which were secured against the loan amount.

Lenders would tend to increase their return through higher interest rates while at the same time limit their exposure to risk, this being nothing other than normal business practice.

This being said, Wurtzeback (1994) stated that there are two elements that lending institutions will consider in order to achieve their goal of maximum return with minimum risk exposure:

- Safety of the loan amount: Lenders want to be assured that the property in question is sufficiently insured. The insurance required is normally to cover the possibility of a short fall with the force sale of the property as well as damage that may be caused to the property due to natural disaster, etc.
- Liquidity: Lenders tend to also be more attracted to loans for which there is a secondary market, meaning the loan itself including all of its associated privileges can be sold in the open market to improve the lenders cash flow in a short period of time. Lenders especially prefer a

secondary market for loans where the maturity dates of the loan and the sources it was funded with do not match up. Lenders also tend to prefer loans with a variable interest rate. This is to protect them against a possible upward movement in interest rates. Should lender have loans with fixed interest rates as assets, an upward movement in interest rates could cripple their liquidity fast.

#### **5.4.3.4 Lender portfolio considerations**

Each and every lender has their own risk profile which they will make use of to assess loan applications. Borrowers will go through a the loan application process (see chapter 3) where the lender will analyze the loan to determine the degree of risk involved and weather it fits the profile of the lender. Having determined the risk profile of the loan, lenders will take all kinds of measures possible to limit their risk.

These measures will include increasing interest rates, making loans with LTV amounts not equaling 100% effectively requiring the borrower to contribute equity capital. Lenders, normally, will also stick to making loans that are of the same term as the term of the lenders own sources of finance. By making loans that are of the same term as the term of the lenders sources of finance, the lending institution is protected against inflation. The reason for this being that any movement in inflation experienced by the lender will simply be passed down to his sources of finance (savers). Wurtzeback (1994) explained it as follows: “the inflation will move up and down in accordance with inflationary trends in the economy and will, in general, affect all loans of similar maturity equally.”

It is understood that lenders are investor’s themselves, and just as any other investor prefers to diversify their portfolios in order to reduce their risk,

lenders are no different. Diversification may reduce their risk profile to any particular property type but at the same time also increase their cost due to the need for more resources, skill and expertise to manage and administer their loans effectively.

The reason for lenders to match the term of their loans with the term of the sources of its funds was explained earlier. This term will therefore also affect the portfolio of the lender.

Wurtzeback (1994), made a very valid point regarding the awareness of a lenders portfolio for the borrower.

*“The winning players in the real estate game know the needs of the lenders. With this knowledge, they are able to find the right source of financing for any particular deal. If you want to be a winner, ask for financing from the appropriate institution and deal with a loan officer who has a special interest in your type of project.”*

“In the property finance business, the level of control that an institution exercises over risk determines its profitability. Usually this includes securing the most beneficial loan conditions in terms of the bank’s policies.” (Wight and Ghyoot, 2008:132)

#### **5.4.4 Legal Aspects (Mortgages)**

##### **5.4.4.1 Security interest**

A mortgage creates a security interest for the mortgagee over the associated property. The security interest that is created with a mortgage only allows the mortgagee to retain priority against other claimants and the mortgagee has



no right to possess or use the property. (See first mortgage above) The mortgagee will also have a senior claim over the property, above the claim of the equity investor.

#### 5.4.4.2 Elements of the mortgage

Wurtzeback (1994) listed the following major elements that make up the mortgage:

- The parties: The parties to a mortgage will be the mortgagor (borrower) and the mortgagee (lender)
- Loan amount and repayment period: This section contains the amount of the loan and the terms of the repayment, etc.
- Interest rate: The interest rate applicable as well as all fees associated with the mortgage and loan will be set forth in this section.
- Description of property: This is the physical address of the property, rights and legal description of the property
- Priority of the mortgage: A borrower can provide a number of mortgages to different lenders against the same property. If no specific agreement exists as to which lender has the priority claim over the property such priority claim will be established the dates of mortgage registrations, with the first mortgage registered having the priority claim.
- Prepayment clause: This section addresses any possibility of an early payment of the loan amount. The lender will either not allow for the

early repayment of the loan amount or attached a penalty fee to the early repayment of the loan amount.

- Due-on-sale clause: Should the borrower sell the property in question this clause will allow the lender to “call the loan in”, meaning the maturity date will be accelerated.
- Escrow provision: This section will address the payment of rates and taxes on the property
- Condition of property: The value of the property must be maintained for the security of the loan. For this reason the mortgagor is usually obligated to (1) maintain the property in good repair, (2) clear any demolition or structural changes with the lender, and in general (3) prevent the occurrence of which could devalue the property
- Default clause: The default clause section normally address the consequences should the mortgagor default on any of a number of events such as (1) failure to pay the agreed repayment amount (interest and capital amount), (2) failure to pay property taxes and insurance premiums, and (3) failure to keep the property in good repair.
- Foreclosure: This section will address the legal process that will be followed should the property be sold by the mortgagee in a forced sale due to the mortgagor being in default for whatever reason.
- Personal liability: The lender will in most cases wants the borrower to be personally liable for the loan, no matter whether the borrower is an

individual or a business entity. This section will therefore provide additional security to the lender should it be required.

#### **5.4.5 Mortgage loan analysis. (Income property loans)**

Lenders are generally more flexible and open for negotiations regarding the loan structure when it comes to properties that will generate an income. Lenders also tend to concentrate more on the income generating capability of the property itself than the financial stability of the borrower. This is due to the fact that the income generated by the property will be the main source for the repayment of the loan.

Lenders will however acquaint themselves properly with market conditions before going into any negotiation process with the borrower. The lender's analysis will consider the following aspects: (Wurtzeback, 1994:455)

- The market
- Government and dynamic rules of the property game
- A formal appraisal
- Long term marketability and manageability of the property
- The compatibility of the property loan with the lender's sources of funds
- Income tax implications
- How the loan measures up against the risk portfolio of the lender
- New development and emerging trends

##### **5.4.5.1 Ratios and rules of thumb**

Lenders rely on basic ratios to evaluate their risk exposure which will ultimately determine the relationship that will develop between the borrower

and the lender. The risk associated with property development was discussed in chapter 4.

The ratios discussed below will concentrate on the influence they have on establishing a relationship between the borrower and lender. The lender will make use of these ratios to determine the terms for the loan motivation and ultimately the loan agreement. (Wurtzeback, 1994:455-460)

- Loan to value ratio (See also chapter 4): The loan to value ratio will determine the contribution made by the borrower and the lender to arrive at the total value needed for the development. Lender will opt for a lower LTVR value, which will lower their risk where as the borrower will opt for a higher LTVR, which will increase the rate of return on his own equity.

The loan to value ratio is calculated as follows:

$$LTVR = \frac{\text{Loan amount}}{\text{Project value}}$$

- Debt coverage ratio: The reasoning behind the debt coverage ratio is for lenders to measure the risk associated with receiving their return should a force sale be needed on a property. The debt coverage ratio measures the “buffers” or “cushion” between the NOI and the debts service, which is calculated as follows:

$$DCR = \frac{NOI}{\text{Debt service}}$$

- The maximum loan amount: Lender will address the relationship between the expected NOI, the desired DCR and the mortgage

constant (K) to determine the maximum loan amount to which they willing be will to commit. (See also section 5.2.2.2 above)

The maximum loan amount will therefore be calculated as follows:

$$\text{Maximum loan} = \frac{NOI}{K \cdot DCR}$$

- Operating expense ratio: Lender will be concerned with the relationship between the operating expenses and effective gross income of a property as this will directly affect the cash flow of the property responsible for servicing the loan.

The operating expense ratio will be calculated as below and will be compared to the market norm for a comparative analysis.

$$OER = \frac{\text{Operating expenses}}{\text{Effective gross income}}$$

- Breakeven ratio: Lender's makes use of the breakeven ratio to determine the gross potential income needed by a property to meet the operating expenses and the debts service. The break-even ratio is calculated as below with an expectable norm for lenders usually being between 60 to 95 percent.

$$BER = \frac{\text{Operating expenses} + \text{Debt service}}{\text{Gross potential income}}$$

#### 5.4.5.2 Loan terms

The lender will also consider a number of other loan terms besides the standard terms associated with the financing of property development. Wurtzeback (1994) identified mainly three loan terms lenders tend to pay a special consideration to for the loan agreement.

- Prepayment or early payment: With the origination of a loan, lending institutions will experience a cost implication and will rely on their expected return from the loan to cover this cost. It is for this reason that lenders tend to assign a penalty to the early repayment of a loan. Also, once a loan had been repaid, the lender will have to reinvest those funds which will result in more originating costs for the new loan/investment.

The interest rate on the original loan may be more variable to the lender than the new loan, which will result in a profit loss to the lender.

- Escalation clauses: Escalation clauses are normally incorporated in to the loan agreement to protect the lender from rising interest rates. Should the property be sold before the maturity date of the loan agreement, lenders tend to make provision for the renegotiating of the interest rate on the loan amount. This provision then provides the lender with protection should interest rates have risen in the mean time.
- Acceleration clause: An acceleration clause is where the lender makes provisions should a default on the repayment of the loan amount realize. In this situation, the complete loan amount becomes due, speeding up the force sale of the project to cover any possible losses the lender may experience. These clauses, as stated before, speed up

the forced sale of the property and thereby effectively reducing the possibility of a loss to the lender.

Lenders may also place restrictions on the operation of the project, guaranteed levels of maintenance and insurance and may also require additional security and personal liability of the borrower for all or a portion of the loan amount

#### **5.4.5.3 Analysis of the borrower**

Lenders rely strongly on the past experience and investment history of the borrower. Appendix C contains the requirements set forth by Nedcor corporate finance for development loans where item 1.1 clearly highlights this requirement. (“The applicant must be experienced in property and development (at least 5 completed projects)”)

The lender will also assess the project in light of current and future business conditions. Where, as an example, a development will expand over a period of several years, the lender will make some effort to anticipate where the business cycle will be when the building is ready to start generating an income. Once again, the experience of the borrower is very important here, as it is extremely common that inexperienced developers in the height of a boom become enthusiastic about development, undertake the development only to find out that once the development is complete the cycle has turned with vacancy rates beginning to rise.

### **5.5 Summary**

Property financing are more often than not financed through a combination of debt and equity capital. This is where the property developer uses part of his

own equity to finance the development with the rest being financed by a lending institution.

There are benefits and costs associated with the financing of property making use of debt capital. The borrower, property developer, relies on a number of financing computations to determine the best possible combination of debt and equity capital for each development. The developer will also need to take into consideration the implications of the effect of tax on financing of property through debt capital.

The lender is an investor in his own right and will also want to make the best return on their investment as is possible. With this in mind and with the fact that lenders are responsible towards their depositors, it is understandable that the lenders are risk adverse and will always tend to have an exit strategy should things go wrong to limit their losses.

To safe guard themselves further, lenders will have a number of requirements that borrowers will have to adhere to before a loan will be approved. The application process will contain and capture all the requirements from the lender.

## **5.6 Conclusion**

The property developer tends to want to make use of as little of his own equity as possible in order to maximize his return. It should be remembered that debt capital has a cost associated with it and that at some point the cost of debt capital as financing method outweighs the benefits. This is a calculation developers should consider carefully when deciding on the combination of debt capital verses equity capital.



It should also be stated that a mismatch generally exists between the borrower and lender when it comes to risk taking. The borrower, developer, being an entrepreneur is someone that will take risks in delivering a project and expect the lender to take the risk with him, something lender are generally not willing to do as they are very risk adverse. Lenders tend to only provide funds on the basis that is guaranteed to be repaid.

### **5.7 Testing of hypotheses**

“The borrower and financier (Lender) each have their own agendas when it comes to the financing of property.”

It is very clear that the borrower and financier (lender) both have their own agendas when it comes to property financing.

The developer wants to make use of as little as possible of his own equity in the development process. This is because developers are entrepreneurs and for them the best deal is where they don't need to put in any of their own equity. This is known as making money using someone else's money.

For the lending institutions, they are using 'other people's money', that of their investors, when funding is provided so the best deal for them is a no risk deal. Lending institutions are responsible towards their depositors and savers, while the developer is not and, for this reason, lending institutions will be reluctant to approve loans covering 100% of the financing.

Therefore, both parties are on the opposite side of the scale and they eventually meet on a solution that meets both the borrower and lenders requirements in order to balance out the scale.

## **SUMMARY, CONCLUSION AND RECOMMENDATIONS**

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### **6.1 Summary and conclusion**

#### **6.1.1 Chapter 1: Introduction**

Property development requires financing to get a project started from the planning phase right through to the point the project becomes income generating and self sustaining.

It is of fundamental importance that property developers should have an understanding of the property financing business if he wants to successfully obtain, manage and administer the financing of a proposed development.

#### **6.1.2 Chapter 2: Methods and products for financing property development**

For the property developer to obtain the required financing that will best suit his financing needs and requirements and those of the associated project, the property developer have to know where the financing will come from. There are a number of methods and products available to the property developer that can provided the property developer with his financing needs.

The property developer can make use of brokers to assist him in determining his financing needs as well as obtaining the appropriate financing. The developer also has to option of obtaining the required financing through a JV, or from lending institutions.

The products provided by lending institutions are diverse and range from standard products to more complex, customized products structured around the specific financing needs of the property developer.

- **Hypothesis one**

*There are various sources available for the financing of property development even though they may all be referred to as “banks” and normally have very much the same products and processes available. Property financing products differ from standard and simple products to structure debt, finance and/or funding.*

There are a number of sources available to the property developer to utilize in order to obtain the financing needed for property development. For the developer starting out, a JV will most likely be the best option available. The reason for this is quite simply that lending institutions are very reluctant to provide financing to developers that do not have the needed expertise in property development. Some control may very well be lost to the partners in the JV but this should be seen by the new developer starting out as ‘school fees’, where he is provided with the opportunity to learn in order to climb the ladder in the industry of property development.

For the more experienced developers, financing will be more readily available from lending institutions. Lending institutions are in the business of lending money and in order for them to be competitive, provide a wide variety of products to the industry. These products range from standard loan structures to customized structured products depending on the needs and requirements of the property developer and the project itself. It is therefore of fundamental importance that the property developer determine his needs before approaching a lending institution for financing. If a property developer does

not know his needs and requirements before approaching a lending institution, it is very likely that the developer may end up with a loan that will not fulfill his requirements.

### **6.1.3 Chapter 3: The resources and processes used in the financing of property development**

A number of resources are utilized in the process of obtaining the financing needed for property development. These resources are mostly in the form of personnel associated with the application process and their function towards the process. Each functionary, ranging from relationship managers and valuers to regional managers, is responsible for his own contribution towards the application process.

The loan application process generally follows a fixed process and is generally standardized throughout all lending institutions. The reason for this being that due to the inherent risks associated with property financing, defined policies and procedures limit the risks and thereby maximized the benefits of the process.

Though the application processes are fixed and standardized, it is important to take note that the terms and conditions as defined in the legal documentation of the loan are not always standardized. The reason for this is that loans are quite often customized to fit the conditions and requirements of each individual loan application's associated property and borrower.

- **Hypothesis two**

*The loan application process normally follows a fixed process from client contact to registration. The process can differ to some extent, depending on*

*the loan type and lending institution but will normally follow the same basic structure.*

It has been established that there are a number of products available to the property developer for obtaining the financing needed for property development. These products cover the needs of the property developer from construction (development) financing to permanent financing.

The processes of obtaining the financing are none the less the same no matter the nature of the financing required. Lending institutions generally rely on a fixed process to obtain, analyze and assess all the relevant information. The process has been compiled to near perfection over a period of time by lending institutions and provides all the relevant information that may be needed. These processes are followed by lending institutions quite diligently in order to eliminate any possibility of mistakes.

#### **6.1.4 Chapter 4: Risks associated with property finance and how it is managed**

Property development is a risky business. This is due to the fact that property markets are subject to diverse forces that include economic growth, market preferences, interest rate fluctuations and competition. This does not provide for a static environment, but generates a great deal of uncertainty. It is to the property developer's own benefit to acquaint himself thoroughly with the risks associated with property development.

Property financing is generally affected by risk from a micro and macro level. Micro being risks associated with the loan itself and macro being risks from non-loan-specific conditions such as markets conditions, etc.

The risks associated with property development can affect either or both the borrower and lender. Generally though, these risks will affect either party to some extent or another. It will only be to the benefit of both parties to be aware of all the risks associated with property development, no matter which is more at risk.

The main driving force in determining risk for property financing is the location of the property itself. The location of property determines three major considerations in risk assessment, lettable, saleability, and condition. These factors form the bases of property finance risk.

The identification of risk contributes to the management thereof. Risks are identified in the hope of preventing the materialization thereof. However, risk does materialize which creates problems for both the borrower and the lender. It is for this reason that risks should constantly be monitored in order to identify early warning signs so that corrective action can be taken as early as possible to limit losses for both parties.

- **Hypothesis three**

*The future is a matter of the unknown and it creates the possibility that things could turn out to be different than what had been anticipated. The risks for the lender and borrower are of a different nature for both parties yet still a reality that needs to be managed from both sides.*

Property financing is generally assessed on information based on past and future events. The future can never be predicted with 100% accuracy as there are just too many variables affecting property that are outside the control of both the borrower and lender. Risk is the uncertainty of an

outcome, be it positive or negative. The future, being uncertain and unpredictable, is therefore directly linked to risk.

Risks associated with property development financing are threefold. There are risks associated with the property, the borrower and the lender. The financing of the property (loan) creates a relationship between the borrower and the lender. The loan is directly linked to the property and therefore the risks associated with the property are the most important risks to be considered by both the borrower and lender.

Risks associated with the borrower and lender are of a lesser influence on the financing of property development, however, with the relationship that exists between the borrower and lender, risks that affect one party will affect the other as well to some extent.

The risks associated with the property, the borrower and the lender are therefore all of a different nature, yet all relevant to the financing of property development due to the relationship that exists between the parties.

#### **6.1.5 Chapter 5: The relationship between the borrow and lender**

The lender and borrower both have their own reasons for lending to and borrowing from one another. However, a relationship is established between the borrower and lender that can last from a few months to decades with the financing of a project. The relationship between the borrower and lender will to a large extent be influenced by the combination of equity capital from the borrower and debt capital from the lender.

The borrower is in the business of property development. It is his business to determine whether a development is worth undertaking or not. This is done

through making use of a number of computations, his experience and markets trends and conditions. The borrower wants to maximize his return on his investment and it is for this reason that the borrower will consider debt financing. By making use of debt financing, the borrower is earning a return through making use of capital supplied by others, effectively earning a return on less investment by himself.

The lender is in the business of financing property and not property development. The lender therefore wants to maximize his return through providing the funds needed by the developer. The lender has a number of considerations that will need to be addressed by the developer before he will consider providing the developer with the financing needed. Should the lender be satisfied that his conditions have been adhered to, the funds will be made available to the developer after all legal aspects, such as securities being in place, etc. have been completed.

Both the borrower and lender therefore have their own requirements that they want met and for a mutually beneficial relationship to exist, requirements of the borrower and lender have to be balanced. This requires a process of communication, negotiation and consideration.

The biggest mismatch in the relationship between the borrower and lender is regarding risk taking. The lender is very risk adverse while the borrower is willing to take risk. The borrower being willing to take risks believes (or hopes) that the lender will be willing to share in this risks, which is not the case.



- **Hypothesis four**

*The borrower and lender (financier) each have their own agendas when it comes to the financing of property.*

The borrower and lender have the same intentions with the financing of property development. Both parties want to maximize the return on their investments. Even though both parties have the same intentions, their agendas are quite different from one another.

The property developer wants to maximize the return on his investment through decreasing the cost of the loan, having a maximum LTV amount and is willing to take some risk in achieving his goal.

The lender also wants to increase the return on his investment through increasing the cost of the loan, providing a conservative LTV amount and wants to take as little risk as possible in the process.

It is clear that the borrower and lender have different agendas when it comes to the financing of property development.

#### **6.1.6 Main hypothesis**

*Property financing strategies are diverse and complex in nature and differ from project to project. An understanding of the basics of property development financing, the sources and products available, the processes as well as the risks involved will be of tremendous benefit to the property developer.*

Property financing is a balancing act between the expectations of the borrower and lender. The principal that brings the two parties together is capital, which the borrower needs and the lender has available for lending. It is the terms at which this capital is being made available by the lender to the borrower that need to be balanced out and agreed upon as both parties will opt for terms that will maximize their benefit.

The lender follows a fixed process in determining their terms for the loan agreement. This process will also determine the products which the lender will be able and willing to offer to the borrower. It will therefore be to the borrower's advantage to be familiar with this process. By having an understanding of this process and the products available, the borrower can take the necessary steps needed to negotiate better loan terms.

Upon the consummation of the agreement, a loan is established. This creates risks for both the borrower and lender because of the fact that decisions are made on future events which can turn out different than anticipated. The realization of these risks is very likely due to the unpredictability of the future. The best possible solution to these risks is therefore the knowledge to identifying these risks and managing them effectively so that precautionary steps can be taken to prevent them from occurring or limit their affect.

## 6.2 Recommendations

- The property developer has to have a clear understanding of his financing needs and requirements. A solution to the property developers financing needs cannot be obtained if the property developer himself is not sure as to what his needs are.

- The property developer should acquaint himself thoroughly with the application process. This will assist in speeding up the application process as well as increase the chances of a successful application. Due to the fact that the application process generally follows a fixed process
- Property finance risk management should be seen as a holistic function where control should be dictated centrally and executed uniformly for both the borrower and lender.
- Borrowers and lenders should negotiate for the best possible loan terms. Both parties have different agendas and negotiations should balance these agendas out to come to an agreement that will be beneficial to both parties.

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**LOAN MOTIVATION DOCUMENT**



## Loan motivation document

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### ABC INVESTMENT BANK LIMITED LOAN PROPOSAL

**Group:**

**Applicant:** Scooter properties CC for NEWCO

**Introduction**

It is the intention and confirmed at our last meeting to form a new entity (NEWCO). The deal is referred to us by Gary Tyler ex Eagle Properties Manager (Western Cape) who will be an indirect shareholder with J Robbie CEO of Redshold Ltd in an entity Doreast CC which will own 50% of the development. The other shareholder will be: Schooter Properties CC – 40% which is owned by AV Debeer – 50% and CB Pilar – 50% and Fannic trust – 10% which is owned by MH Draggnet 100%.

Gary has extensive experience in commercial and retail developments. The development will however be driven by Andre Debeer, a shareholder and also project manager. He has successfully developed a parking garage in Long Street for Messrs Sharp Training consisting of 200 parking bays, 2 000m<sup>2</sup> office and 1 000m<sup>2</sup> of retail space. Andre was employed for 7 years by Standard Bank in the Corporate Advance division. He then joined Mark Sloth to from Steeff Slots projects and completed various development in Cape Town. He was also employed by BP (service station developments) and worked with Mike Leveten for 4 years where he gained lease negotiation experience. He was also employed by ABC Developments and Blind Projects (Durban-based company which started an office in Cape Town). He has been on his own since 1995

Andre has teamed up with Chris Pilar and Mike Draggnet and will operate under a new entity called Driftwood Projects (Pty) Ltd. Chris Pilar, a Civil Engineer and MBA (ex MD Group Ten Residential East London and Western Cape, ex CEO NEWCO – Western Cape) will not be actively involved with the development. Mike Draggnet (ex MD Old Mutual Properties and ex MD ABC Developments), now with Brolly Property Group, will not be actively involved in the development. Mike is also a consultant to Airports Company (ACSA)

The clients have ample experience to develop such a project and will only proceed with the development if tenants are committed. The following prospective tenants have approached the client:

- Land Rover, Nissan, Alfa and Jaguar (wholly owned by Combined Motor Holdings Ltd) – 3 000m<sup>2</sup>  
(will have to be joint development with Edge Properties – known to the Gauteng office)
- Incredible connection (Computers)
- 2223 Long Street – 50 p/bays
- Submarine House – 75p/bays – Old Mutual
- The Terrace – 50p/bays – RMB

### **PURPOSED/PROJECT DESCRIPTION**

The client has signed a deed of sale to acquire 1657, 1658, 1653, 158870, 1673, 9307 and 9308 Cape Town, which forms a parcel of properties situated in Riebeeck Street and flanked by Bree, Loop and Assurance Lane. The buildings are fully tenanted by retail businesses paying an average gross rental of approx. R27 per m<sup>2</sup> (Gross). (See valuation report)

The site is located directly between the established CBD of Cape Town (more toward foreshore) with modern high-rise buildings and successful developments such as Safren House and The Terraces as its immediate neighbours. To the north is the rapidly expanding Waterfront area. This infill activity will soon be further consolidated and upgraded with the construction of the new Exhibition Centre and canal linkage to the V&A Waterfront. In addition, this mode will be strengthened with the completion of the Investec Cape Town, Head Office.

A further opportunity exists to develop the full city block with the owners of the adjacent half-block. Discussions have been held with them in JHB and they have indicated that they would consider a joint development. This will increase the parking efficiencies of the developments as well as other building in the area.

### **LOAN STRUCTURE**

The loan had been structured as a “vacant land” loan for a period of 3 years (interests only) and it is proposed that the client pay a penalty fee, each year, of R 37 000 (plus VAT) for not commencing with the development. Should the development not commence within 3 years

period the outstanding loan must be settled and/or cancelled and an exit fee of R111 000 (plus VAT) is payable at that stage. Also, should the clients not provide us with an opportunity to quote on the proposed development during the loan term, a fee of R111 000 is payable.

Interest at Prime – 1% and an administration fee of 0.5% (R 37 000 + VAT) is payable on bond registration

### **FINANCIAL ANALYSIS/SERVICEABILITY**

The income of the property is sufficient to service a loan of R7 400 000 (66% LTV including the collateral)

Purchase Price R7 500 00.

In addition the clients will deposit into the bond account at registration an amount of R400 000 to be utilized for the payment of fees and any interest shortfall during that three year period.

### **Sureties to the transaction**

- Doreast CC – 50% - R7m NAV
- AV Debeer – R0.65m NAV (providing cash contribution of R400 000)
- CB Pilar – R1,026m NAV
- MH Draggnet – R6,6m NAV
- Scooter Properties CC – 40% - Holding entity for Debeer and Pilar
- The Fannie Trust – 10% - Holding entity for Draggnet

Note: Assets have been verified and all parties are cleared on credit check.

Redshold shares to the value of R2,5m will be pledged as additional security. The value of the shares to remain at R2,5m throughout the 3 year period (top-up clause)

### **Redshold LTD**

Redshold started 10 years ago (91) when a bank backed MD Jacques Robbie's consortium in a management buy-out of the Sichard Groups retail liquor division. Label was purchased from Rembrand and Gilbeys in Oct. 1995. The company has since expanded into wholesale distribution of food-related products and international freight forwarding/clearing.

The current market cap of Redshold is R4 billion with annual growth earnings of 35-40%.  
Currently share price – R15.70/share.

## **SECURITY**

First Mortgage Bond in the amount of R7 400 000 over Remainder Ervin 1657, 1658, 1653, 158870, 1073, 9307 and 9308 Cape Town.

Securities as per the loan approval

Other security:

Redshold Ltd shares to the value of R2 500 000

## **RISK ASSESSMENT/RECOMMENDATION**

We recommend the loan be based on the following:

- Ability and experience of the project team
- Strong financial banking from the sureties on whom full reliance can be placed
- Collateral security which results in an acceptable LTV
- Early exit, with appropriate price should the development not proceed

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ACCOUNTS EXECUTIVE/OFFICER

G Botha

Staff No. 1859

Date 2 June 2000

CREDIT DEPARTMENT COMMENT/RECOMMENDATION

I have applied my mind to the provision of:

- (a) Section 38 of the Companies Act (Act 61 of 1973)
- (b) Section 226 of the companies Act (Act 61 of 1973)
- (c) Section 40 of the Close Corporations Act
- (d) Section 26 of the Insolvency Act

So as to establish whether the above mentioned loan would contravene any of these sections. In my opinion, there are no such contraventions.

REGIONAL CREDIT ANALYST                      NAME:

DATE:

SIGNATURE:

REGIONAL CREDIT MANAGER                      NAME:

DATE:

SIGNATURE:

**LOAN SUMMARY DOCUMENT**

## Loan Summary Document

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### APPLICATION No. 1

### LOAN SUMMARY

#### 1. AGREEMENT OF LOAN

1.1 This document contains a summary of the essential terms and conditions upon which ABC bank limited has approved the application for the under mentioned loan. Not all the terms and conditions applicable to the loan are included in the summary and it does not constitute an agreement with, or bind ABC.

1.2 The terms and conditions relating to the loan will be incorporated in an agreement of loan which is to be signed by the borrower and ABC

#### 2. NAME OF BORROWER

**NEWCO (Company Registration no.....)**

#### 3. LOAN DETAILS

3.1 Amount

R7 400 000

3.2 Type of loan

Ordinary

3.3 Loan expiry period:

A period of (thirty-six) 36 months, reckoned from the last day of the month in which the capital or any part thereof is advanced to or on behalf of the borrower.

3.4 Loan amortization period:

An overall period of (thirty-six) 36 months, reckoned from the last day of the month in which the capital or any part thereof is advanced to or on behalf of the borrower, which period shall be used by ABC for the purpose of calculating an installment which comprises capital and interest.

3.5 Initial annual finance charge rate: On percent (1%) below the prime overdraft rate charged by ABC Bank Limited from time to time, as certified by any manager of the said bank whose authority need not be proved.

Reckoned from the date on which the loan or any part thereof is advanced to the borrower or on the borrower's behalf, provided that if the loan is subject to the provisions of the Usury Act, 1968, ABC will be entitled to finance charges on the amount of the loan in accordance with the provisions of section 2A of the Act from the date of the agreement of loan until the date immediately preceding the date on which the loan is paid to the borrower or on the borrower's behalf.

3.6 The annual finance charge rate applicable to the loan may be subject to repricing at the option of ABC at any time and from time to time after a period of 24 (twenty-four) months, provided that where the rate is a prime-linked rate, ABC will not be entitled to vary the prime-linked factor which initially applies to the loan by more than 1,5% (One comma five per cent)

#### 4. PAYMENT OBLICATIONS

4.1 Repayment structure: The capital shall be repaid in such amounts and at such times as the borrower deems fit provided that the capital is repaid in full on or before the last day of the 36<sup>th</sup> month (the loan expiry period") following that in which the capital or part thereof is advanced.

4.2 Monthly installments: Not applicable



## 5. SECURITY

- 5.1 A first covering mortgage bond for the sum specified in 3.1 over the following property/ies ('the property') – Erven 16578, 16588, 16583, 1588780, 93087 and 98308 Cape Town.
- 5.2 The mortgage bond, including the existing mortgage bonds, if any passed by the borrower in favour of ABC, will secure inter alia borrower's indebtedness to ABC in terms of the agreement of also all present and future indebtedness of the borrower to ABC.
- 5.3 The mortgage bond will be registered by ABC's attorneys and all costs of and incidental to the preparation of the relevant documentation, including bond registration costs and stamp duty, are to be paid by the borrower on request.
- 5.4 No mortgage bond may be registered over the property in favour of a third party without the prior written consent of ABC
- 5.5 In support of its suretyship, Scooter CC will pledge and cede to ABC all its right, title and interest in and the JSE-listed shares in Replehold Ltd to the value of R2 500 000.

## 6. SURETYSHIP

- 6.1 The loan is subject to Cyvest CC (C.K. No. 1999/052785/07) guaranteeing the indebtedness of the borrower to ABC, from whatever cause arising, up to an amount of R3 700 000, together with finance charges and costs and charges incurred by ABC, upon such terms and conditions as ABC requires.
- 6.2 The loan is subject to Andre Victor (I.D. No. 470614 5038 084) guaranteeing the indebtedness of the borrower to ABC, from whatever cause arising up to an amount of R1 850 000, together with finance charges and costs and charges incurred by ABC, upon such terms and conditions as ABC requires.
- 6.3 The loan is subject to Christopher Bryant Baker (I.D. No. 591018 5068 080) guaranteeing the indebtedness of the borrower to ABC, from whatever cause arising up to an amount of R1 850 000, together with finance charges and costs and charges incurred by ABC, upon such terms and conditions as ABC requires.
- 6.4 The loan is subject to Michael Howard Oraggnet (I.D. No. 550611 5287 005) guaranteeing the indebtedness of the borrower to ABC from whatever cause

arising up to an amount of R740 000 together with finance charges and costs and charges incurred by ABC, upon such terms and conditions as ABC requires.

- 6.5 The loan is subject to Scooter Properties CC (C.K. No. 1996/085430/23) guaranteeing the indebtedness of the borrower to ABC from whatever cause arising up to an amount of R3 700 000, together with finance charges and costs and charges incurred by ABC upon such terms and conditions as ABC requires.
- 6.6 The loan is subject to The Franuck Trust (Trust Deed No. IT1128/2000) guaranteeing the indebtedness of the borrower to ABC from whatever cause arising up to an amount of R740 000 together with finance charges and costs and charges incurred by ABC upon such terms and conditions as ABC requires.

## 7. PROPERTY INSURANCE

- 7.1 All improvements on the property are to be insured in terms of a standard South African Market Buildings Combined Insurance Policy plus SASRIA extension for their full replacement value with an insurance company nominated by ABC. Such insurance will be taken out and arranged by ABC on the borrower's behalf and the policy ceded to ABC. Such insurance will, unless otherwise agreed in writing, be effective from the date on which the loan or any part thereof is advanced to or on the borrower's behalf.
- 7.2 The minimum replacement value for which ABC requires such improvements to be insured is: erven 16857, 16858, 1588870, 16783, 93087 & 98308 Cape Town R14 654 094.
- 7.3 In the event that the borrower requires the improvements to be insured for an amount that exceeds the minimum amount required by ABC, the sum insured will on receipt of written request be increased to such amount as the borrower requires.
- 7.4 In the event that the property comprises a sectional title unit, the borrower shall procure that the body corporate amount being not less than the full replacement value of the unit is allocated to the property. Such insurance is to be effected by and in the name of the body corporate. In the event that the borrower fails to comply with the provisions of this sub-clause, the foregoing provisions of this clause apply to any such insurance mutatis mutandis

## 8. FEES AND CHARGES

- 8.1 The borrower shall pay ABC a service fee, which fee shall be paid as follows:
- 8.1.1 R18 500 (eighteen thousand five hundred rands) on acceptance of the offer of loan facilities.
  - 8.1.2 R148 000 should the mortgage bond be cancelled within a period of 12 months from the date of registration of the said mortgage bond.
  - 8.1.3 R37 000 should the mortgage bond be cancelled within the period from the 13th month to the 36th month after registration of the mortgage bond.
- 8.2 ABC shall be entitled to charge the borrower a fee, as determined from time to time by ABC in respect of any administrative accounting or other banking service rendered by ABC at the request of the borrower or on the borrower's behalf in connection with the loan. The aforesaid fee is payable in addition to other fees for which specific provision is made.
- 8.3 Where a fee is payable in terms of the above paragraph, such fee shall be payable on or before the last day of the month during which the fee is levied.
- 8.4 To the extent that value-added tax is payable in respect of any fee or charge levied by ABC, such fee excludes the value-added tax which is payable by the borrower.

## 9. SPECIAL CONDIONTS

The loan will be subject to the following special conditions:

- 9.1 In the event of NEWCO taking transfer of the property, an agreement of loan can be prepared once the Company has been formed and the requirements specified in the annexure are furnished to the bank.
- 9.2 The standard terms and conditions of the readvance option will apply to the loan. This permits the borrower to make additional capital repayments and borrow further amounts from time to time as set out hereunder:
  - 9.2.1 The borrower may make early payment in reduction of the capital without penalty at any stage provided payments do not in the aggregate exceed 50% of the capital and provided that the loan is not subject to either a fixed interest rate or SAFEX-linked interest rate structure.

- 9.2.2 Minimum advances, against such early payments (excluding the amount of R400 000 for the fee and interest rate period) or a SAFEX-linked interest rate period other than a BA future reset period date.
- 9.2.3 Subject to 3 days' written notice per advance.
- 9.2.4 Limited to one advance in any 30-day period, and
- 9.2.5 An administration fee of R500 per advance.
- 9.3 ABC is to be provided with a conveyancer's certificate confirming that the title deeds of the principal property to be bonded contain no onerous servitudes, endorsements or conditions of title.
- 9.4 The borrower shall ensure that ABC is provided with an auditor's certificate confirming that non-resident shareholders do not own 75% or more of the issued share capital of the borrower. Should it materialize that this is the case, then ABC must be provided with a copy of the relative Reserve bank approval in terms of Exchange Control Regulation 3(1)F.
- 9.5 Northwest CC shall provide ABC with a written undertaking to pledge additional security in the form of Replehold Ltd shares should the market value of the pledged shares in terms of clause 5.5 reduce below R2 350 000 which additional share should be pledged to ABC within a period of ten (10) business days of the reduction of the value of the original shares, failing which ABC reserves the right to place the borrower on notice to repay the capital or the balance thereof outstanding together with finance charges and all other amounts owing to or claimable by ABC.
- 9.6 It is recorded that ABC will be afforded the first opportunity to quote on the financing of the proposed development of the property.
- 9.7 The capital will be disbursed as follows:
  - 9.7.1 R7 000 000 (seven million rands) on registration of the mortgage bond.
  - 9.7.2 R400 000 (four hundred thousand rands) for the service fee and for the capitalization of the shortfall between the interest due to ABC and the amount paid by the borrower each month.

## 10. STANDARD TERMS AND CONDITIONS

The loan will be subject further to ABC's standard terms and conditions applicable to loans

## **RIGHT OF WITHDRAWAL**

10.1 ABC will not be bound by the agreement of loan until such time as the original thereof, duly signed by the parties and completed as required, is received by ABC.

10.2 ABC will be entitled to withdraw from the loan at any time prior to the registration of the mortgage bond or, if no mortgage bond is to be registered, at any time prior to payment of the loan to the borrower or on the borrower's behalf if in the sole discretion of ABC:

10.2.1 registration is for whatever reason unduly or unnecessarily delayed;

10.2.2 incorrect or misleading information is furnished to ABC;

10.2.3 any relevant fact or information has been withheld from or becomes known to ABC or

10.2.4 there is a change of circumstance that might prejudice the rights or security of ABC or materially alter the risk factor relating to the loan.

**LOAN APPLICATION REQUIREMENTS**

## Loan Application Requirements

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### NEDBANK CORPORATE PROPERTY FINANCE

#### REQUIREMENTS FOR RESIDENTIAL, COMMERCIAL AND INDUSTRIAL PROPERTY DEVELOPMENT LOAN APPLICATIONS

These documents are the qualifying criteria under which Nedbank Corporate Property Finance will consider finance for loan applications.

Once the applicant is satisfied that all the documents are ready as set out in the criteria, they are requested to compile a pack and forward it to the Relationship Manager from Property Finance for assessment and consideration.

#### 1. General Qualifying Criteria:

- 1.1 The applicant must be experienced in property and development (at least 5 completed projects).  
Short history on previous developments completed.
- 1.2 The property on which the development is planned must be zoned to permit the proposed use.
- 1.3 The proposed development must be desirable, viable and located in a stable, sustainable area.
- 1.4 The development must show an acceptable Return on Cost (at least 15%)
- 1.5 The loan must be redeemed in the short term (12 to 24 months)
- 1.6 The applicant would be required to commit equity, up-front of at least 40% of the land cost and  
30% of the total development costs.
- 1.7 Personal Sureties required.
- 1.8 No owner-builder development applications will be considered.
- 1.9 No first time developers will be considered.
- 1.10 Loan amounts of under R10 million will not be considered.

**2. Information required on application:**

- 2.1 Background Information regarding the Applicant/Developer.
- 2.2 Property details – description, extent, location, controlling authority, zoning controls, etc.
- 2.3 Property acquisition agreement (if applicable) and/or Title Deed.
- 2.4 Project overview
- 2.5 Company Documents
- 2.6 Written Consent to Credit Checks and Verification on the Borrower/Shareholders/Sureties

**3. Information required on Development.**

- 3.1 Plans or a concept layout plan (if plans not available) and details of the proposed units ie. Size of the living areas, balconies, garages/parking bays etc.
- 3.2 Selling prices and operational expenses.
- 3.3 Feasibility and cash flow.
- 3.4 Professional team (if finalised) with their fee structure, i.e. architect, quantity surveyor, engineer, project manager, land surveyor, broker etc and all the relevant CV's.
- 3.5 Building contractor (if finalised)
- 3.6 Marketing plan (brief)
- 3.7 Copy of the proposed “end – purchaser” sales document with a minimum of 10% deposits.
- 3.8 Timeline description of the project from transfer, rezoning etc, through to sales, services and transfers to exit the loan.
- 3.9 Short description of proposed project (mention project finance for land and services not top structures).
- 3.10 Summary of project costs and split of bank owner equity (if developed in phases)
- 3.11 Any Guarantees
- 3.12 Servicing of Loan
- 3.13 Position on bulk services and costs.
- 3.14 All other documents supporting costs.
- 3.15 NHBC registration Certificate with registration status and expiry date.



3.16 Copy of Town Development approval.

3.17 Copy of agreement of sale.

4. **Financial Information:**

4.1 Copy of Certificate of Incorporation.

4.2 Audited Balance Sheet

4.3 Audited Statement of assets and liabilities of each shareholder

4.4 Identity number and personal banking details of each shareholder

4.5 Banking details of borrowing entity's bankers and branch.

4.6 Details of person(s) standing surety.

4.7 Details of other securities, which may be made available if required.

4.8 Organogram.

4.9 Details of any guarantor.

5. **Development Finance:**

5.1 Amount of finance required and period of loan (generally not more than 70% of market value)

5.2 Amount of equity injected by the client.

5.3 Should costs overrun, how are these funds to be financed?

5.4 Projected cashflow

5.5 Finance excludes VAT

6. **FICA Documents:**

6.1 Copy of I.D documents for all Companies, Directors and Shareholders

6.2 Copy of utility bills for all Companies, Directors and Shareholders

**General Terms and Conditions:**

1. Funds are to be retained and disbursed on a "retention to complete" basis. Disbursements will only be made as work progresses and on presentation of original Invoices signed by the QS or site/project manager and authorised by the borrower.
2. The development is to be insured and the Banks interest noted, to the satisfaction of the bank.
3. The loan to be settled from full sales proceeds (net only of VAT and sales commission)
4. All terms and conditions to be met as set out in Letter of Grant before any funds will be distributed.

**LOAN APPROVAL DOCUMENT**

## Loan Approval Document

### ABC BANK LIMITED

Matrix Approval Requirement

GA2

Risk Category: C

Group No.: 1232

Group Dcse: Scoot

Review: Yearly

BRANCH: Cape Town

BORROWER: Scooter Properties CC  
CO/CC REG No.:86/15120/23  
Contact: Mr G. Flat  
Telephone: 489548

POTAL ADDRESS: PO Box 1328065, Wynberg, 7824

PURPOSE: The purchase of the property for later  
redevelopment

EXISTING NIB: R692 688.03

ACCOUNT BALANCE:  
  
A/C No.107

EXISTING APPROVED  
NIB FACILITY: R900 00.00  
(This A/C)

OVERALL GROUP

EXPOSUREE COMPRISING:	1. Loan	R7 900 000.00
	2. Loans (Total exposure)	R8 457 000.00
	3. Surety exposureeee:	
	Gerald Pokrass Flat	(Limited R500 000)
	Michael Pokrass Flat	(Limited R500 000)
	Marion Finant	(Limited R500 000)
VALUATION:	R14 653 000	Date: 12 Feb. 1999
	Capitalisation Rate: 15%	
	Ratings: L Low S Low	
	C Low/Moderate	
	Erven 85063 to 85068 Cape Town at Salt River	
EXPOSURE:	54%	
DOMICILIUM:	1374-1376 Sir Lowry Road, Cape Town	
AMOUNT:	R7 207 312	
	(Service fee included in loan amount)	
SERVICEABILITY:	Net Rental Income:	R248 000
	Actual serviceability:	R205 860
	Annual surplus:	R 42 140
	Test serviceability rate:	R220 344
	Annual surplus:	R 27 656
INTEREST RATE:	ABC Bank's prime lending rate minus 1%	
	debited montly in arrear	
DISBURSEMENT TERMS:	Upon signature of security documents and	
	compliance of special conditions	
REAPMENT PERIOD	Period 8 years (expiring 28/2/2007)	
AND TERMS:	Instalment R15 814 (subject to alteration)	
SECURITY:	Principal: Existing bond No(s). B4152/87 passed	

by the debtor in favour of NIB shall serve as security of the loan

SURITIES:	General Pokrass Flat	(Unlimited) R1 000 000
	Michael Pokrass Flat	(Unlimited) R1 000 000
	Marion Finant	(Unlimited) R1 000 000

FINANCE CHARGES: (EXCLUSIVE OF VAT)

Conveyancing fees:

(Approximation per tariff)

R

Service fee:

% = R30 000 (included in loan amount)

Commitment fee:

R

Building fee:

R

Valuation fee:

R

When payable:

On acceptance R

On disbursement R1 000

Penalty fee:

R20 000

(as provided for in loan agreement)

RETURN;

R.O.A. 15%

R.O.E. 18.72%

INSURANCE:

In house

Name:

Contact:

Adress

INTRODUCER:

Name:

MA Buck

B I code:

1232

Intro commission:

% = R15 000

Intro category;

Agent

ATTORNEYS:

CK Friedlanderr