12 STEPS

OF THE DEVELOPMENT PROCESS

STEP SIX: DEVELOPMENT FINANCE

35 LATITUDE PROPERTY DEVELOPMENT

Before you commence any development project, it is obviously crucial to first establish how much you can borrow and how you will be able to manage all associated costs of the development.

As a property developer you will have to understand finance and what the banks look for when lending for development projects.

Lenders look after their own safety first so when deciding whether to finance your project they will assess the risk, firstly with regard to you as an individual and your ability to repay the loan, and then on the viability of the development itself.

In other words, banks don't simply lend based on the security of the project; they also want to establish the track record of the people behind the development.

Until you develop a good reputation with the bank and a soundtrack record in property development, lenders will also assess your development team as well as the professionalism of your finance presentation to them.

Therefore it is important to submit your loan request in a professional manner, including a detailed feasibility study to show that you have allowed for all contingencies.

Generally your development loan will be structured so the lender provides up to 60 to 70 percent of the final cost of the project, rather than its end value and they will expect you as the developer, or your equity partners, to provide some funding.

The amount you can borrow is known as the Loan to Value Ratio or LVR.

Many lenders class 2 or 3 unit projects as residential developments and use less stringent lending criteria for this type of project, whereas with larger developments they may require a greater contribution of equity or a level of pre-sales.

Typically, you will need to provide 20 percent of the funds for a 2 dwelling project and 30 percent, and above, for larger projects, which lenders class as commercial loans.

In other words, you may be able to obtain a development loan at 60 or 80 percent LVR, depending on the size and nature of the project.

This means if your total development cost is $1.5 million, your financier will expect you to contribute $300,000 to $600,000 of your own equity into the project. This might come from equity you already have in another property or cash savings.

Not unlike a regular residential new build loan, development loans offer staged payments to be finalised at the end of each regular building stage being;

- The deposit,
- Base Stage,
- Frame stage, lock up stage,
- Fixing stage,
- Balance of development funds supplied on completion of the project.

Interest is capitalised alternatively, or larger projects (including Multiple Dwellings), progress claims may be made on completed works each month. These figures are often confirmed by a licensed valuer or quantity surveyor.

If you intend to retain your finished project, you would pay out the development loan by refinancing the property and taking out a long term investment loan.

However at no stage will the banks allow your loan to go above the agreed maximum percentage, such as 80 percent.

You therefore need to show your lending institution that you will be able to service the loan, including the interest repayments.

You may require different types of lending for the various stages of a project, including:

- An acquisition or development loan to cover the purchase, development application and pre-construction costs.
- A construction loan to cover the building of a project and
- An investment loan if you are retaining your project as a long term investment.

YOUR LOAN APPLICATION

To ensure you have the best possible chance of obtaining the development finance you require, you will need to put together a professional finance submission, a sort of "business plan" for your development project.

This should demonstrate to the lender that you can construct a viable project with numbers that "stack up" to make a financially successful development.

Loans for development finance require a detailed application, beginning with an executive summary that should point out the viability of the project and the design features of the development being considered.

Then each of following points should be explored in detail in your application;

- Site description
- Zoning
- Design
- Concept
- Resume of your development manager and major consultants
- Costings/Feasibility study
- Projected sales figures
- Net result
- Timelines

SOURCES OF FUNDING

Banks remain the major source of funding for developers and while most banks are keen to lend to experienced developers, the truth is recent changes have seen many of the major players really tighten their lending criteria.

As a result, private funders and joint venture funders are increasingly becoming a popular alternative for some developers.

Proficient mortgage brokers with the right expertise and knowledge can assist you when it comes to obtaining development funding.

Keep in mind that if you are undertaking a large project, your financing may need to be split over more than one lender and in this case particularly, a good mortgage broker can be of great benefit.

PRE-SALES

For larger projects most lenders require a certain level of pre-sales to minimise their risk of the development. The percentage of the project they require to be pre-sold before they are prepared to hand over property development finance varies, but can be around 50 percent. Obviously this is a way for lenders to minimise their risk. Pre-Sales can be a major factor in obtaining finance, particularly on larger projects. Generally, the closer you have complete debt coverage the better chance you have of negotiating good finance terms.

By the way... you can't use the funds from the presales to help fund your development - they have to remain held on trust until settlement.

PROJECT UPDATES

Most lenders will require formal proof of budgetary and cash controls prior to and during the course of your development project. This reassures them that you have done your homework and allowed for any budget blowouts or contingencies that may arise.

Before approving your loan, a lender may request all or some of the following elements;

- A fixed priced building contract.
- Detailed construction costings from your builder or a quantity surveyor's report.
- Evidence of pre-sales in the form of deposits that are required to be held in trust. These deposits are generally cash to the value of 10 percent of the purchase price.

As the project progresses you will need to keep you financier updated with;

- Progress claims made by the builder
- Reports from your project manager
- Cash flows and revised financial projections
- Any delays in the project
- Any changes to the feasibility study
- Any sales that may have occurred

Prior to making progressive payments to the builder the bank will require assurance that the particular stage of construction they are paying for is completed. Sometimes they even require proof that the builder has paid all of his suppliers and trades so no claim can come back to the lender.

To ensure that the building stage has been completed the bank may send out its own valuer or request certification from a project manager or quantity surveyor.

WHAT LENDERS LOOK FOR

When assessing your development, project lenders look carefully and critically at the quality of the security you are offering; that is the end product of the development.

Their primary considerations in doing do so are;

- The fire sale price of the security. What would they achieve if they had to take possession as mortgagee and sell it?
- The end value of the dwellings you are building. If they are significantly higher than the median price in your area they see these as lower quality security as they may be more difficult to sell.
- The zoning of your security. Residentially zoned land is the most highly regarded as it is the easiest to sell. Rural properties would be seen as less secure and hence the banks willl end a lower proportion on these.
- Lenders don't like to lend against small apartments. If your apartment is less than 45 sqm the lenders will not be keen to lend on your project.
- The postcode in which your development is situated. Lenders prefer to lend against properties in areas that have a long history of strong capital growth and in large population centres.
- The usage of the security. Banks prefer to lend against the security of residential real estate compared to holiday resorts or serviced apartments.

When assessing the feasibility of any potential development project, it is important to keep the lender's criteria and expectations in mind.

Afterall, a development can look wonderful on paper, but unless it ticks all of the right boxes with the banks, it will never even get off the ground.