

An aerial photograph of a dense urban skyline, likely Hong Kong, featuring numerous high-rise buildings and a mountain range in the background under a cloudy sky.

Jameson Educational Series:

'Shortfall funding gaps': a guide on how to play an emerging thematic for investors and developers

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Jameson Capital

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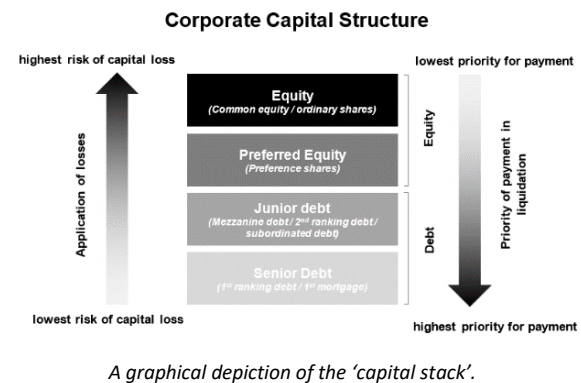
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Key points:

- Real estate projects are funded by a mixture of sources of debt and equity capital, commonly referred to as a 'capital stack'. Each component of capital brings with it different risk and return characteristics.
- Increasing risk-aversion from providers of debt and equity capital coupled with building material and labour cost inflation is leading to an increased incidence of property developers with 'shortfall funding gaps' on their projects.
- Unless further security/collateral is pledged, developers are typically unable to access further senior debt financing to fill these 'shortfall funding gaps'.
- Developers are typically loathed to raise equity in periods of economic stress and uncertainty where investor risk premia is high as such new share issues are typically deeply dilutive to their existing stake in the project.
- Alternative financing solutions such as mezzanine debt, hybrid or structured debt may offer solutions to developers looking to fill 'shortfall funding gaps'.
- For investors, the existence of 'shortfall funding gaps' represents a fleeting investment opportunity to achieve disproportionate levels of return relative to the risk being assumed.

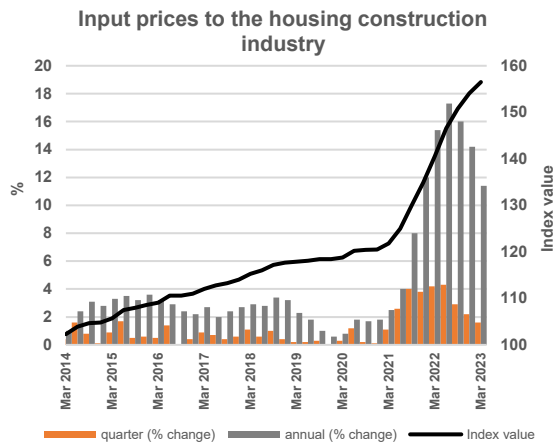
A real estate development is funded via a number of different sources of investor capital (such as senior debt, mezzanine debt, preferred equity and common equity), each with different risk and return characteristics. The combination of these sources of capital is commonly referred to as the 'capital stack'.



Current market dynamics

In the prevailing economic environment, there is an increased incidence of 'shortfall funding gaps' in developers' capital stacks due to the reduced supply of capital and the inflationary environment. There are three common themes which are driving 'shortfall funding gap' requests from developers seeking additional funding:

1. **Reduced availability of senior debt funding** to finance real estate projects due to increased risk-aversion amongst bank and non-bank lenders;
2. **The significantly reduced supply of inexpensive equity capital** due to sharply increased risk-free rates and widening risk premia; and
3. **Construction cost increases** due to higher financing costs, elevated building material prices and labour cost inflation.



Source: Australian Bureau of Statistics

On the following page, we have illustrated a **theoretical** 'shortfall funding gap' scenario which has occurred as a result of **all** three of the aforementioned scenarios playing out. Assuming a \$100m project cost, the shortfall funding gap in the below scenario is 15% of the total capital stack, or \$15 million.

So the question arises: ***"how will this shortfall funding gap be filled?"***:

Question: 'can't the developer just borrow more from the senior lender to fill the gap?'

In the current environment of rising building costs, elevated interest rates and subdued real estate price growth, we are observing that senior lenders are reducing the amounts that they are willing to lend developers as a risk reduction measure.

This is manifesting in two main ways:

1. **Reductions in LVRs** - senior lenders are reducing the LVRs that they are

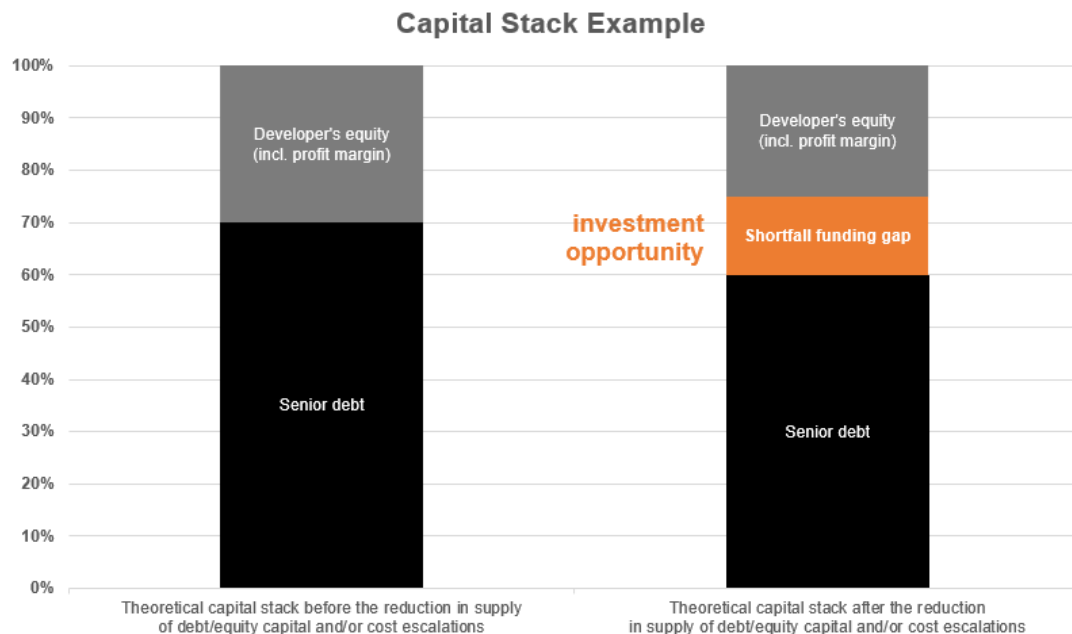
willing to lend at. For example, lenders that once loaned an amount of up to 70% on the end value of the project are reducing this to (say) 60%; and

2. **More conservative outlooks on property valuations** – subdued housing price growth means that lenders are maintaining or – in some cases – reducing the amount that they are willing to lend against the completed value of the property, as the rate of increase in the 'V' (value) in the loan-to-value ratio (LVR) equation slows or plateaus due to rising interest rates.

One way that developers **could** secure additional financing from senior lenders is by providing additional security/collateral for the loan, however developers sometimes don't have additional security available or are unwilling to 'post' additional collateral (such as their primary place of residence) for the loan.

Question: 'can't the developer just raise more equity?'

Generally, in periods of elevated economic uncertainty investors will demand a higher level of return as an incentive to take on additional levels of actual or perceived risk. For providers of new equity capital, this additional return generally takes the form of a larger equity stake (ie. more shares) in a development which gives the new investor the legal right to a greater share of profits and upside from the development.



A graphical illustration of a developer's 'shortfall funding gap' which represents a unique investment opportunity for investors.

Issuing a large number of new shares can be deeply dilutive to existing shareholders' ownership stakes in the project (ie. existing shareholders own a substantially less proportion of the development and have a significantly reduced share of the development profit). **Deeply dilutive equity raisings are something which existing equity holders in a project are typically loathed to do.**

In addition, with higher risk-free rates (government bond yields) this means that equity investors' return hurdles have increased and equity holders are much more selective over the projects that ultimately receive their capital.

From the above, we have ascertained that in periods of economic stress and higher risk-free rates, lenders are increasingly unwilling to lend more money and equity providers are increasingly unwilling to provide fresh equity capital which leaves developers '*stuck in the middle*'.

So, 'what can developers do'?

As a DEVELOPER, why consider alternative sources of development funding?

In situations like those described previously, developers may want to consider financing solutions that sit **between** senior debt and equity in the capital stack to avoid posting additional collateral or undertaking deeply dilutive and costly equity raisings. Such financing solutions come in many forms such as mezzanine (i.e second-ranking or junior) debt, hybrid-debt (ie. debt with potential equity upside via the use of warrants and options) or preferred equity (equity capital that is entitled to a pre-determined rate of return before ordinary equity holders) to fill the gap left by senior lenders and/or providers of ordinary equity capital.

There are potentially a number of reasons for developers to consider these alternative funding solutions:

1. As these financing solutions don't require the immediate issuance of

new shares in the project, they are typically **not** dilutive to existing shareholders' stakes in the development, yet achieve the same objective of filling a shortfall funding gap in the capital stack;

2. Compared to traditional sources of bank finance, the turnaround times for providing these sources of finance by non-banks is typically quite short (generally, up to a maximum of four weeks);
3. The securing of this relatively small sliver of additional finance may be the difference between a successful development proceeding (and profits being realised) and not (where significant 'sunk costs' may be written-off and large losses crystallised).

If finance is not secured for the project and it is not able to proceed, this may mean the developer has to wear large write-offs of 'sunk costs' such as planning, legal and architect's fees (just to name a few). In most cases, the size of these potential write-offs far exceeds the additional costs to be incurred in securing alternative financing.

'How can investors play this unique opportunity and thematic?'

As an INVESTOR, why consider investing in alternative sources of development funding?

There are a number of reasons to consider investing in mezzanine, hybrid and structured debt in the current economic environment.

One constant in investment markets is the existence of risk. This is an inherent feature

of financial markets that – no matter how hard investors and financial engineers try – cannot be removed and has to be accepted by investors.

The two most important objectives in investing to build wealth sustainably are to:

1. **avoid realising permanent capital losses on investments**, as this has both an immediate and ongoing impact on investment performance and wealth creation. This is due to the concept of 'opportunity cost' and the diminished ability to compound investment returns into the future if losses are realised today; and
2. **to be fairly compensated with an investment return that is at least adequate for the risk that is being assumed by the investor.**

Alternative financing has the potential to achieve both of these objectives due to:

- the higher repayment priority that debt enjoys in the capital stack relative to equity;
- real asset-backing, which acts as an additional layer of investor protection in the event that the borrower is unable to fully repay the loan;
- the ability of the lender to build in a number of protections to reduce risks to investors, such as taking additional security against the loan, personal and/or corporate guarantees (just to name a few); and
- its ability to deliver a return that is higher than inflation thereby providing investors with a real return on their capital.

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