



**A GUIDE TO
MEZZANINE
FINANCE
FOR PROPERTY
DEVELOPERS**

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INTRODUCTION FROM MARK DOWELL



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

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

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

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

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

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

Mark Dowell, Director



WHY DEVELOPERS SHOULD USE MEZZANINE FINANCE

Some people see mezzanine finance as a form of last resort lending, but this is wrong. Many of our clients choose to use mezzanine finance even though they are able to fund their developments themselves. Hadrian Capital Finance director Mark Dowell asks, why?

Mezzanine finance is used to fill the gap between a developer's equity and the senior debt provided by a bank. In a typical case, a developer will put up equity of around 10% of cost, the bank will lend around 60% and the mezzanine lender will make up the difference of around 30%. While separate from the developer's equity contribution, the mezzanine finance is provided as part of the funds required of the developer by the bank on day one. The bank then lends sums to cover the remaining land acquisition cost, and the building and professional costs.



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

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

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

TYPICAL 18-MONTH DEVELOPMENT CYCLE

	WITH MEZZANINE (£'000)	WITHOUT MEZZANINE (£'000)
GROSS DEVELOPMENT VALUE (NET) (GDV)	5,000	5,000
GROSS DEVELOPMENT COST (INCLUDING BANK LOAN) (GDC)	4,000	4,000
DEVELOPMENT PROFIT	1,000	1,000
PROFIT ON COST	25%	25%
PROFIT ON SALES	20%	20%
BANK FACILITY	2,750	2,400
MEZZANINE FINANCE	750	0
TOTAL BANK AND MEZZANINE FUNDING	3,500	2,400
EQUITY	500	1,600
MEZZANINE INTEREST AND EXIT FEE	220	0
NET PROFIT TO DEVELOPER	780	1,000
DEVELOPER'S ANNUAL RETURN ON EQUITY	104%	42%

As you can see, by using mezzanine finance the developer has been required to put in only £500,000 of his own money, compared to the £1.6m he would have had to put in without it Not

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only he has he more than doubled the return on his investment, (an IRR of 104% compared to an IRR of 42%), he has freed up £1.1m to use on other projects.

2. IT OFFERS MORE CONTROL

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

Many developers see mezzanine funding as “cheap” (and stress-free) equity. In most situations, more than 75% of the profit will accrue to the developer, with the balance going towards the cost of the mezzanine finance.

3. MUCH OF THE COST IS A CHARGE ON PROFITS

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

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

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

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

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

5. IT CAN GET DEALS OVER THE LINE

It would be wrong to suggest mezzanine finance is never used to get deals over the line. Bank lending to the property sector has reduced dramatically in recent years with mezzanine funding doing much to fill the lending gap.

Many successful developers with profitable projects have made use of mezzanine support to overcome the lending shortfall.

6. MEZZANINE LENDERS OFFER STRATEGIC ASSISTANCE

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

Mark Dowell, Director



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

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

1. MAKE A PROPER PLAN

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

2. BE REALISTIC ABOUT SALES PRICES

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



3. EXPLAIN THE PROJECT IN WRITING

Buyers may be impressed by glossy sales brochures, but that doesn't go far enough for a lender. Tell us why you have bought or are buying this property, in this location and for this price. Explain your thinking behind the scheme, what your target market is and what the key selling points are. Support it with data and facts.

4. TELL US ABOUT YOURSELF AND YOUR TRACK RECORD

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

5. BE TRANSPARENT ABOUT YOUR SENIOR DEBT

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



We refer many of our clients to primary lenders and mezzanine lenders when needed or indeed wished for and we enjoy excellent relationships with many of the leading players in the market. Here, we talk about our relationship with the lenders.

WHY USING A BROKER CAN HELP DEVELOPERS

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

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

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

WORKING WITH PRIMARY AND MEZZANINE LENDERS

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

At the same time, mezzanine lenders do a different job to primary lenders. In many instances, it will allow developers to do deals that would otherwise be out of their reach and in turn this enables primary lenders to make loans that otherwise would have been denied to them.



Mark Dowell
DIRECTOR

From an engineering background and have ran my own businesses, I know how hard it can be and love to help others. We will do everything possible to deliver a solution to meet your finance needs in property and business. Based in Newcastle Upon Tyne we build relationships and endeavour to find the best funding solution for our clients.



Joy Dowell
DIRECTOR

After 25 years of working in various customer service environments in both Finance and Retail I decided to take my passion for helping others into a Mortgage Advisory and commercial finance role. My past experience means I approach all my clients with a caring, personal approach and I strive to achieve the best results.



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