

360 Capital



Understanding Real Estate Debt

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“360 Capital Group (ASX:TGP) and its managed funds have originated and financed over \$225 million of loans, with a focus on first mortgage construction and residual stock finance.”

TGP has recently announced the proposed listing of 360 Capital Finance Group (ASX:TFT) an integrated real estate finance business providing investors with a target distribution of 6.0% p.a. paid monthly.



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Real Estate Debt as an Investment

Real estate debt has re-emerged as mainstream investment class over the past few years as changes to banking regulation and capital requirements led to a retreat of traditional lenders creating a funding gap in the market.

Whilst once focused on mezzanine, preferred equity and other more structured debt instruments, the non-bank market has matured, providing senior or first mortgage finance to property developers and investors.

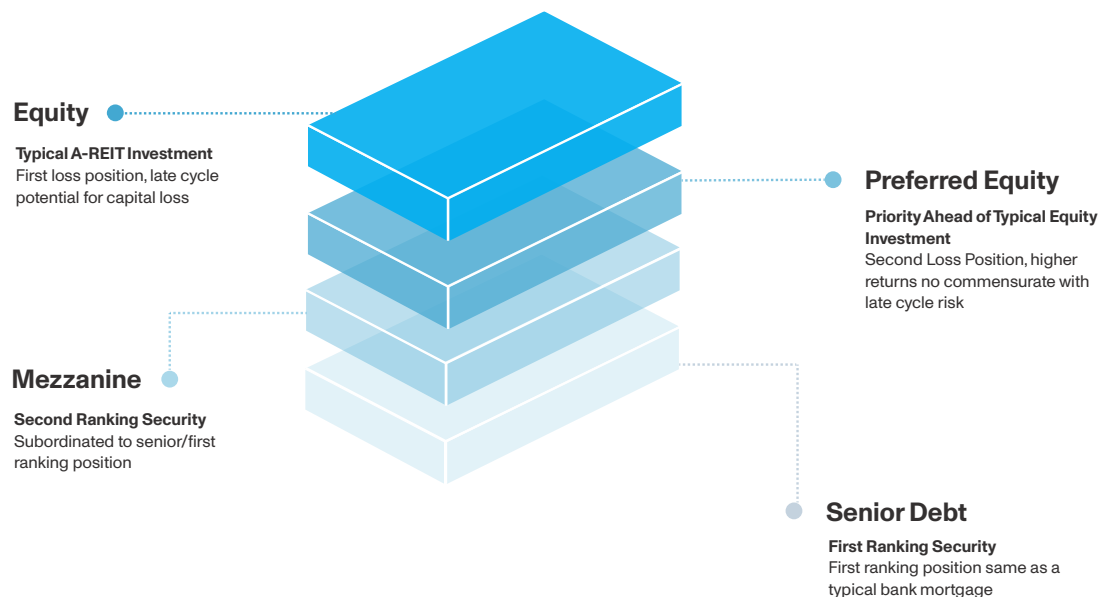
As an asset class Commercial Real Estate Debt (CRED) offers investors monthly recurring income in the form of interest payments and as CRED is secured via a mortgage on the real estate asset, the debt must be repaid in full before any return is made to the owners of the real estate asset.

What is a Commercial Real Estate Mortgage?

A mortgage is a debt instrument, secured by the collateral of a specified real estate property, that the borrower is obliged to pay back at a date, commonly referred to as a 'bullet repayment' or via a predetermined set of payments commonly referred to as 'principal and interest payments,' like a home loan.

The Real Estate Capital Stack

Risk is the trade-off for return. Equity investors (across any asset class) theoretically have limitless return, in exchange for greater risk of capital gain or loss. Conversely, debt investors receive a fixed return and their claim on the property asset ranks ahead of the equity in a property or project. As mentioned above, this is typically secured by mortgage registered on the title of the property.



Types of CRED Loans

Site Finance

When a site is sold prior to having the necessary development consents and pre-sale contracts in place, the developer will typically need finance. Site loans are popular with non-bank lenders as they are relatively efficient from an operational perspective. Loans are advanced against the purchase price or current site valuation. The interest is generally 'capitalising' meaning as time passes the amount of money owed to the non-bank lender increases by the outstanding interest.

Investment Loans

Typically, CRED loans for income producing properties like office buildings, shopping centres or industrial assets are 'serviced' with interest paid monthly from the rental income received from the property and the principal or monies lent to the borrower repaid on expiry of the loan.

Development/Construction Finance

Loans for property developments typically capitalise the interest on a monthly basis. So rather than pay the lender interest every month from rental income, the interest 'capitalises' to the loan balance and is repaid once a project is completed. Typically, this is through the settlement of pre-sale or 'off the plan' sales contracts. Most lenders require a minimum 'debt cover' before money is advanced and construction can start. 'Debt cover' is the value of pre-sale or 'off the plan' contracts (net of GST) divided by the loan amount, for example if I have \$5 million of sales (net of GST) and need to borrow \$10 million the debt cover ratio would be 50.0%. Whilst traditional banks typically require 100%+ debt cover, non-banks are generally more flexible requiring anywhere from 0.0% to 70.0%.

Residual Stock Loans

From time to time, residential development projects reach completion with apartments/townhouses still available for sale. Developers typically look to residual stock finance to repay the balance of any construction debt and to release some equity from the project. Residual stock loans are repaid through the proceeds of sales.

Mezzanine Finance

Mezzanine debt is secured by a second ranking mortgage on the property, which means it is subordinated to the senior or first ranking security. For this reason, mezzanine debt is more expensive, given the additional risk.

Generally, the senior or first ranking security holder requires and second or mezzanine debt to enter into a subordination deed which outlines the rights of the second mortgage holder and subordinates them to the senior lender.

Preferred Equity

Preferred equity is a structured finance product, requiring an understanding of real estate development and finance structures, as such, preferred equity should be considered by more sophisticated investors.

Preferred equity is generally secured by a registered or unregistered second/third mortgage and is subordinated to all other debt security holders.

Developers often use preferred equity to limit the amount of ordinary equity required in a project. Typically, preferred equity is structured with a coupon or fixed return component and a profit share.

Other CRED Terms and Typical Covenants

Facility Limit

The total loan amount, comprising principal, interest (if capitalising) and establishment or loan application fees.

Loan to Value Ratio

The loan to value ratio is calculated as the Facility Limit divided by the property valuation. In the case of residential development, GST is excluded from the valuation figure.

Loan to Cost Ratio

The facility limit divided by the total development cost. This is a measure of equity in a project.

Hard Equity

The amount of actual cash equity in a project, excluding any valuation uplift on the development site.

Interest Cover Ratio

Annual interest payable divided by the annual net rental income generated by the property. A typical covenant for investment property debt facilities.

If you would like to hear more about TFT click below

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