

Development finance in practice

Most developers do not have enough capital to carry out capital-intensive projects using 100% equity. The building 22 Bishopsgate, for example, had a final cost of over £1 billion. Lipton Rogers needed access to significant equity from investors.

In practice, there are more options than simple debt and equity. Common structures include development joint ventures (JV), land JVs, forward fundings and forward sales.

In development JVs, a developer joins forces with an equity investor who becomes a funding partner. It may be that the developer expects his/her share to be bought out at completion; alternatively, the developer might retain an interest in the long run. Ideally for the developer, the JV will be set up on a 'promoted' basis. Under this arrangement, developers are paid a development management fee for their efforts - 5 per cent of all construction costs - and the developer also earns a profit share based on a formula that gives the investor a priority or promoted first share of the development profit and splits anything over this amount in pre-agreed proportions.

Under a side-by-side arrangement, all profits are split in proportion to the equity invested, but the developer still earns a development management fee.

Table 6.14 shows the capital structure of a London development. The project will take two years to complete at a cost of £70 million, plus a development management fee of £2 million payable to the developer. Construction debt finance of £35 million is available at a total cost of £3m. The developer can or will only put up £5 million of the required equity of £35 million, so a JV partner is found to put up the remaining £30 million.

The parties agree on the following distributions of the final sale price or valuation. The first £37 million received from the sale will be used to repay the construction loan and the development management fee. The next £35 million received will be distributed *pari passu* (in line with the equity invested).

The return hurdle is agreed to be 10 per cent. It is calculated that a sale at £79.35 million (a profit of £7.35 million over the costs of £70 million plus the development management fee of £2 million) is enough to produce an IRR of 10 per cent. This £7.35 million will be distributed 25 per cent to the developer and 75 per cent to the investor. Anything above this will be distributed 50:50.

The scheme is sold for £88 million.

The first £40 million received from the sale is used to repay the construction loan, interest on the loan and the development management fee. The next £35 million is paid according the equity invested (£30 million to the funding partner, £5 million to the developer). The next £7.35m is split 75% to the investor, which is £5.5125 million, and 25% to the developer, which is £1.8375 million. The final £5.65 million (£85 million - £79.35 million) is split 50:50 or £2.825 million each.

Table 6.14: Promoted development JV¹ (£m)

¹ This example is based on a talk by Marc Mogull (2013).

Project cost	70
Debt	35
Interest	3
Developer fee	2
<i>Developer equity</i>	5
<i>Investor equity</i>	30
Total equity	35
Sale proceeds	88
Profit	13

Source: author, after Marc Mogull

Table 6.15: Promoted development JV (£m)

	Bank	Developer	Capital partner	Total
Capital invested	35	5	30	70
		14.3%	85.7%	100%
Sale proceeds				88
Capital returned	35	5	30	70
Interest on loan				3
Developer fee				2
Profit				13
<i>First hurdle distribution</i>		1.8375	5.5125	7.35
<i>Second hurdle distribution</i>		2.825	2.825	5.65
Total distributions to equity		9.6625	38.3375	48
(%)		20.1%	79.9%	100%
IRR		39.0%	13.0%	17.1%
Equity multiple		1.93	1.28	1.37

Source: author, after Marc Mogull

The project delivers a profit of £13 million, an IRR of 17.1 per cent and an equity multiple of 1.37 (£48 million/£35 million). The investor or capital partner earns a total of £38.3375 million, a profit of £8.3375 million, an IRR of 13 per cent and an equity multiple of 1.28. The developer earns a total of £9.6625 million, a profit of £4.6625 million, an IRR of 39 per cent and an equity multiple of 1.94, in addition to the development management fee of £2 million (table 6.15). The promoted nature of the joint venture delivers a greater slice of the profit to the developer than his/her equity funding partner.