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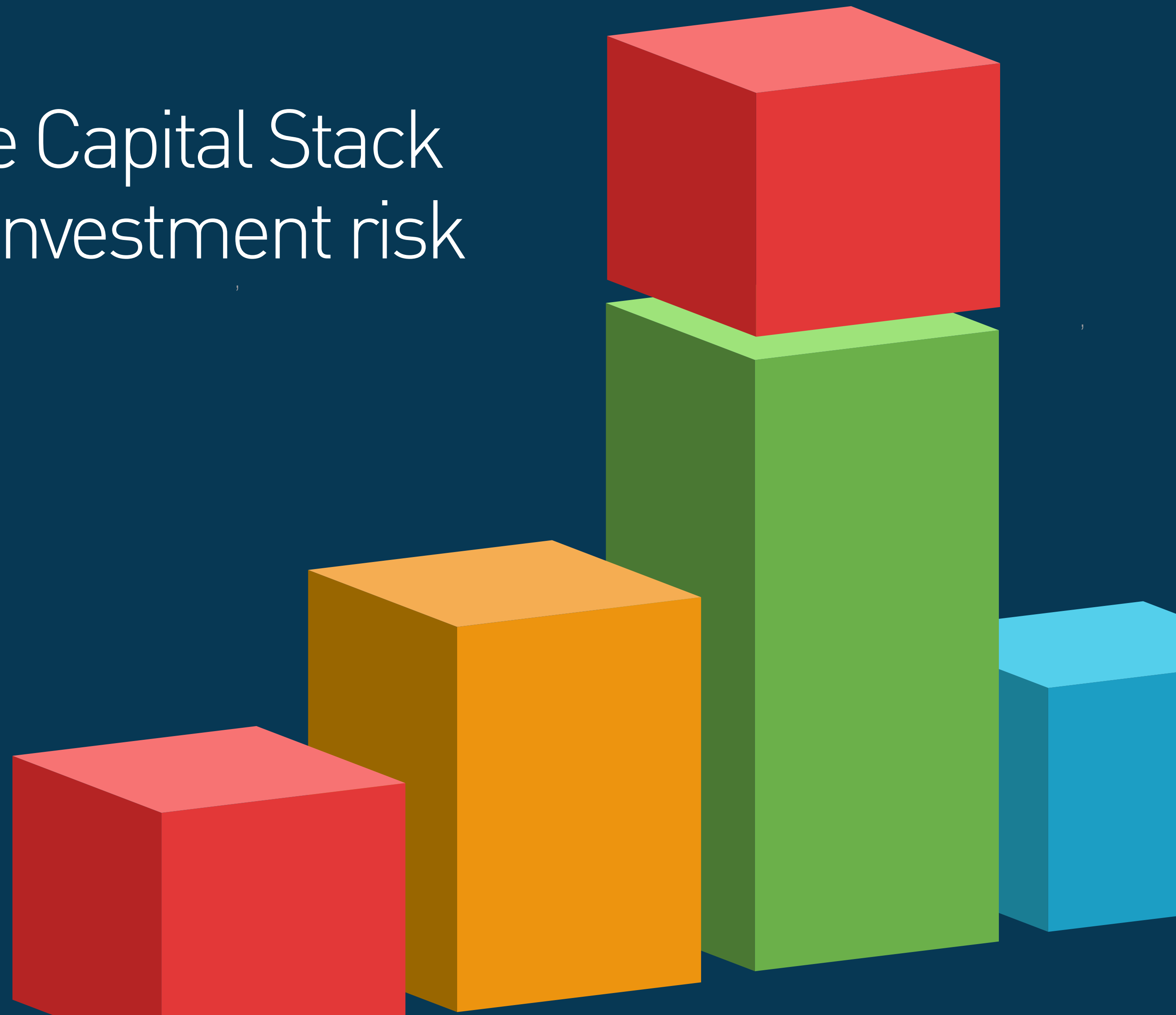
CREATING WEALTH IN THE UK

Understanding the Capital Stack & Mitigating your investment risk

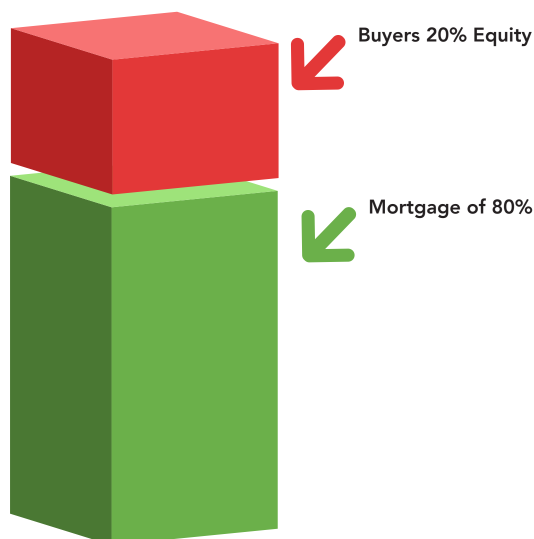


All Property Development Finance is made up from a number of sources, most projects consist of a mix of senior debt, junior debt and equity finance. Senior and junior debt is derived from well known lenders including challenger and high street banks. Equity Finance can be sought from a number of routes such as Funds, Family Offices, High Net Worth Individuals or Sophisticated Investors. This blended structure is called the Capital Stack.

Understanding the Capital Stack is crucial for any investor looking at the opportunities available via Development Finance. Why? Because your position within the stack indicates your level of exposure but also your level of expected reward.

The make up of a particular Capital Stack may differ but they follow the same fundamental structure. Let's look at some examples, starting with the most basic, your own residential mortgage.

Illustration A: A typical home buyer will fund 20% of the purchase (the equity) while the mortgage will provide the outstanding 80%.

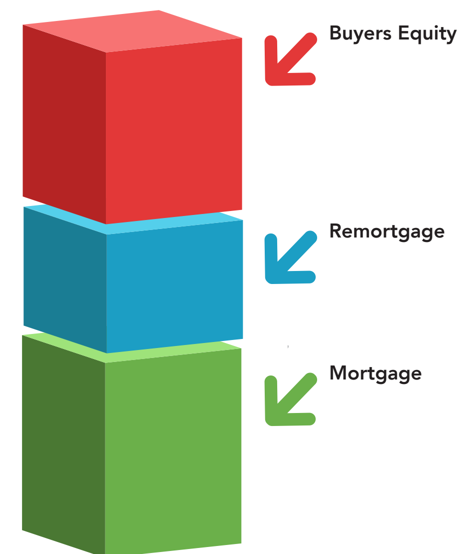


Typically, a home buyer places a deposit and then takes out a mortgage for the balance of the purchase. Given a £300,000 house, let's assume the buyer puts down 20% - £60,000 – This is the equity portion of the Capital Stack. We now need a mortgage to provide the outstanding 80% of the total purchase price. This is the senior debt portion of the stack which will look like illustration A.

As we all know if we don't pay our mortgage the property will be repossessed, the lender has a legal lien or charge over our property to mitigate their risk in lending us the money, and depending on our circumstances the lender will offer us different rates of interest to further protect themselves against risk.

Fast forward a number of years, the value of the property has risen to £400,000 and the debt portion of the Stack has been reduced by the ongoing payment of the mortgage, so the Equity in the Stack has increased and debt decreased. Our homebuyer wants to add an extension to their property. A second mortgage is taken out. The original lender maintains a first position at the bottom of the stack. The new mortgage slots into the second position and the homeowner is now in third position at the top the Capital Stack with their increased equity. Assuming that the first mortgage has been decreased by £25,000 since purchase, the new capital stack for that same home now looks like Illustration B.

Illustration B: Our home buyers equity has increased while their mortgage has reduced, though a second remortgage is now included for the property extension.



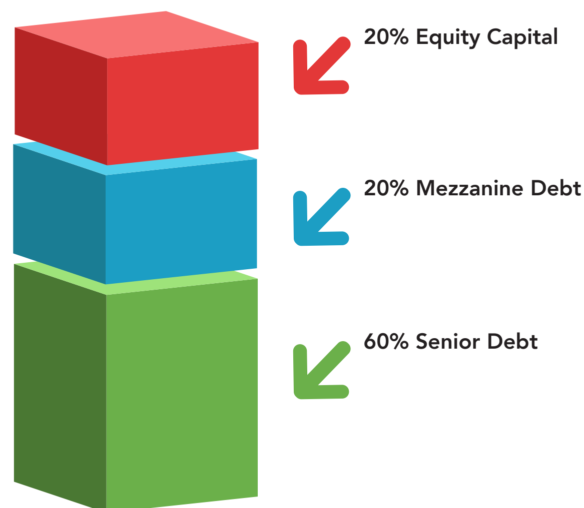
Should the worst happen in this case the senior debt still has the first charge on the property with the junior debt coming second. Meaning the junior debt would get paid out after the senior upon repossessed sale of the property. For this reason, the junior debt will have applied a larger

rate of interest to hedge their risk accordingly.

These residential based examples give us a basic understanding of the Capital Stack but how does this apply in the commercial world and what are the effects on your potential investment? Well it's still fundamentally about risk and reward. Understanding the Capital Stack will give you valuable information as to where you fall in the pecking order of cash flow. But it will also tell you where you're positioned in terms of returns. The higher up the stack you are, the greater the return.

While there is theoretically no limit to the number of layers a capital stack may contain, we will keep our analysis to the three most commonly used types of capital in ascending order of priority:

Illustration C: A typical example of a commercial Capital Stack

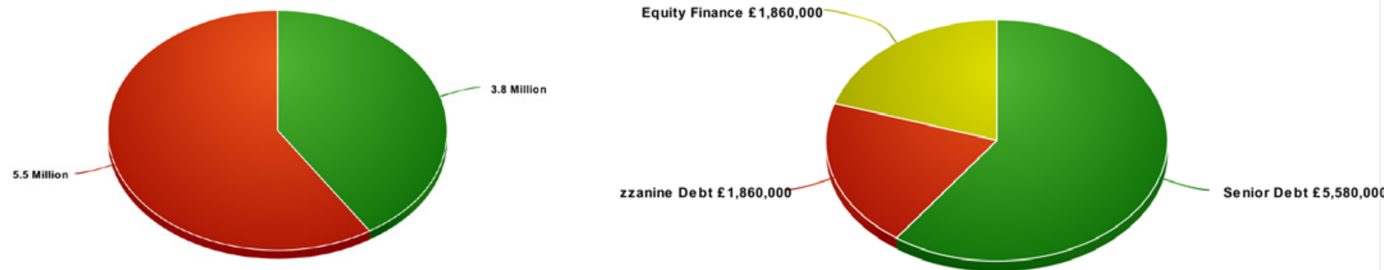


Here are some key points to consider when analysing the capital stack of any opportunity.

1. Each capital source has seniority over all capital sources located above it in the stack.
2. Each capital source is subordinate to all capital sources located below it in the stack.
3. Typically, only the senior and mezzanine debt positions are able to secure charges or record liens against the underlying asset.
4. Upon sale or refinance, the bottom position gets paid first until fully repaid and so on.
5. To the extent that there are insufficient funds to fully repay all capital then losses are incurred from the top down.
6. This means that risk increases as you move higher in the capital stack.
7. This also means that returns increase as you move higher up the capital stack.

It is important for investors to understand that in a well-constructed capital stack, there is no right or wrong position but, rather, positions that incur more risk or less risk and, in exchange, pay out larger or smaller rewards. By understanding the capital stack, you become empowered to make an informed decision as to where you feel comfortable as well as whether the risk relative to each position is commensurate with the potential reward.

But let's put these percentages into better perspective by adding some real world numbers. Here we look at an office building with permitted development to be converted into a 85 room hotel.



Target GDV - £13.5Million. **Project profit – £4.2Million**

What are the implications for your Investment strategy?

First of all, it's important to understand that investment products like this will most certainly be offering higher than normal rates of return. You need to establish that these products are indeed based on the equity finance model. If not be sceptical. These higher rates of course bring risk, so once you're clear that the product is correct you need to do your due diligence. We would advise starting with the following.

1. Who is the developer? This will mostly likely be different to the investment product provider, standard practise.
2. What is the developers track record? Which other buildings have they delivered? Did they deliver them on time? What was the build quality? Go and visit them perhaps, seeing after all is believing?
3. Has the developer 'held' any previous projects? This is a great question, by 'held' we mean has the developer held on to any previous projects? It shows their own belief in their work and means they have retained high value assets.
4. What are the precise details of the proposed project? Location, timescales (ask for a schedule of works), Who is the end user?
5. Do the numbers make sense? You'd be surprised how many don't.
6. What security is being offered? A lien? A charge? Other assets in the developers' estate?
7. What's the term of the investment?
8. Are funds going to be held with an SPV (Special Protection Vehicle)
9. What is the exit strategy? Will you need to wait until any residential units are sold in order to repay your principle capital or is the project going to be re-financed towards the back end of the development?
10. Is the product provider willing to meet you face to face?

The Equity Finance portion of the Capital Stack is a great way to achieve high end returns, but like all investments just be careful. Let common sense prevail.

I hope you've found this guide insightful, for more guides and reports just visit www.investorlive.co.uk.