A historical evolutionary and cyclical perspective on models of development finance

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Abstract
Speculative development (and hence its financing) in Western economies was very limited up to the end of the 1930s except in the residential sector. The focus of this chapter is therefore on the evolution of the different models of funding development from World War II. The traditional model takes the form of a property company receiving incremental debt funding from a bank to pay out outlays through the development period. The debt is then repaid on completion through selling or taking out a mortgage on the property. However, market conditions rarely enable this simple model to work, and property cycles dominate the availability and terms of debt finance from banks with easy credit in booms followed by droughts in downturns. One alternative is forward funding/equity sharing partnerships between developer and a financial institution. Other innovations include non-recourse or limited recourse loans, usually involving a separate property vehicle for the sole purpose of individual developments, and very occasionally mezzanine finance. Another source of finance for property companies listed on a stock exchange is the issue of shares, bonds, and commercial paper. This approach is seen to transmute into asset securitization of properties set within a single purpose vehicle. Global integration has meant that development finance is available on a competitive basis from banks around the world, a trend that has gone hand in hand with larger construction projects. Large-scale development projects are also often dependent on a funding partnership with a public agency.

Introduction
Availability of development finance is a crucial component of the real estate market as no finance means no building. This finance can take a number of different forms, partly linked to the future ownership of the property and any investment or funding partners in the development process. In the case of construction by owner occupiers, this finance is almost certainly intricately tied up with their own businesses, often internally generated, and is not considered here. The focus of this chapter is on development finance for development with a degree of risk, primarily speculative, defined in terms of being either for future occupation or ownership. Before looking at this issue in detail it is useful to set the context.
Looking back through time, property development is interwoven with the evolution of towns and cities. High street shops evolved from housing conversions to individual purpose-built entities by proprietors, with shopping centers a very new phenomenon. Offices emerged as a separate property form in the first half of the nineteenth century and although from the beginning there was some speculative development most were built for their occupiers (Scott, 1996); many are still known by the name of the original occupier. Factories were traditionally specialism bespoke buildings but the first industrial estates for tenants were built around the world in the 1890s. Even so they were on a small scale, with only 48 commercially built estates in the UK by 1939 (Scott, 2001). Overall the scale of speculative development up to the end of the 1930s was very limited, and almost exclusively in the residential sector. While the focus of this chapter is on the post-World War Two period, its starting point is a model of development finance that can be traced back well beyond this date.

A further focus of the chapter is on cycles as research on property development has identified booms and downturns back to before the Industrial Revolution (Lewis, 1965). Since the 1950s there have been many well documented cycles. This period was initially one of reconstruction for countries impacted by the Second World War, stimulating commercial property development booms. In the UK for example, Churchill announced in November 1954 the lifting of all building restrictions setting off a ten year boom (Rose, 1985). Japan experienced a parallel boom (Dehesh and Pugh, 1998). Elsewhere, post-war booms were later: in the late 1960s through to the early 1970s there were development booms for example in New York, Sydney, and Dublin, driven primarily by structural changes in the macroeconomy (Daly, 1982; MacLaran et al., 1987; Schwartz, 1979). Barras (2009) has identified three global office cycles since the 1980s beginning with the speculative boom of the late 1980s, followed by a more subdued upturn in the late 1990s and another speculative driven boom in the mid-noughties. In the housing market, Jones (2012) reports on parallel booms across many countries from the mid-1990s, but also individual cycles in the 1970s and 1980s. So, while much of the evidence presented in this chapter is drawn from the UK, the commonality of these dynamics within the property market means that it has a resonance across the developed world.

The period since the 1950s has also experienced the growth of a greater services-oriented economy that has led to a long-term rise in the demand for offices and a decline in the role of manufacturing in Western economies. Since the 1970s this trend has been augmented by decentralized forces fashioned by the motor age and information communication technology improvements that can be characterized as a new long-term urban development cycle. New property forms, such as retail parks, have been established; traditional city cores have been supplanted by a more polycentric urban form, and many existing buildings replaced as obsolete because of new technology. These modern developments are larger in scale than their predecessors, for example individual high street shops are being replaced by shopping centers (Jones, 2010), and provide a context to innovations in development finance.

In addition, the world has seen economic globalization, and specifically the emergence of world capital markets with the growth of international financial services from the 1980s. Underneath these trends is the liberalization of capital movements that has also seen global real estate investment strategies (Lizieri, 2009). Development finance too is now an integral part of these international capital flows as banks and investors fund projects around the world. With foreign banks and investors competing with national banks to offer finance (see Bank of England, 2015), this has stimulated international knowledge transfer and commonalities of practice. This chapter therefore examines the evolution of development finance for commercial real estate against a backdrop of urban transformation and redevelopment, new property forms, globalization of the real estate investment, and a series of property booms and busts.
The chapter will briefly outline basic forms of finance and introduce the classic roll-up finance model (Fraser, 1993). It will then chart the evolution of the different models of funding development, explaining the significance of differential market conditions and investment sentiment driving innovations. These will include forward funding/equity sharing partnerships between developer and financial institutions, non-recourse or limited recourse loans usually involving a separate property vehicle for the sole purpose of individual developments, and very occasionally mezzanine finance. It will explain the potential benefits and disadvantages in terms of the balance of risk and return and partners in the development process. Property companies/REITs’ issue of debentures and shares on stock exchanges, together with equity securitization will also be assessed.

A cyclical perspective will examine the balance of debt and equity capital in development funding through its phases including in particular the changing lending requirements of banks linked to perceived risks. It will also highlight the changing shape of development finance through cycles and present a chronology of innovations within a cyclical framework. Innovation is also considered in the changing context of the investment sentiment of financial institutions.

The fundamentals and logic of public–private partnerships will be similarly reviewed, encompassing the spectrum from local authority city center redevelopment partnerships, central government support via for example grants to developers as part of urban regeneration initiatives, through to tax incremental financing.

**The basics of the development finance process**

It is useful to start with some definitions, distinguishing between short-term finance for private development and long-term/investment finance once the building is complete but the two are inter-related. Short-term finance covers the financing of construction or more precisely the development period encompassing potentially the purchase of land through to the point at which the property is completed and let, or either sold or kept as a long-term investment. In the USA this is known as a “construction loan” (Fergus and Goodman, 1994). Long-term finance, sometimes referred to as funding, can be sought once the building is complete to pay off the costs of development including the short-term finance. Alternatively, the property can be sold to pay off the development costs and take any profit. Long-term finance, for example in the shape of a mortgage, will usually be applicable for the developer to retain an equity interest. In reality, as discussed later, this distinction between short- and long-term finance can be clouded as often short-term finance stretches into the medium term.

The traditional model of short-term finance is roll-up finance whereby the developer receives incremental funds, usually from a bank, to cover outlays at the different phases of the development process from land purchase, stage payment of the construction costs, through to the letting period. On completion, the developer repays all these outlays with the built-up interest. Short-term finance can be provided on a fixed rate basis but in the UK today for example it is normally on a variable rate basis linked to a set number of base points (bps) above the bank base rates set by the Bank of England. The precise rate paid is therefore a function of the level of interest rates. Credit facilities with variable interest charges may be subject to a “cap” or “floor” limiting upward and downward movement of the interest rate to be charged.

An unfinished building is of limited worth and hence a poor security for a bank. Finance terms offered by a bank are dependent on the financial standing of the developer, taking into account other assets and existing borrowing. Notwithstanding a developer’s track record and financial standing, repayment is related to the ultimate “success” of the completed development.
As this is a function of the state of the macroeconomy and the property market these may have an over-riding influence on the availability and cost of finance. This is discussed in more detail below.

**Historical perspective on development finance**

These underpinnings of the development finance process provide a framework for an examination of the changes that have occurred since the 1950s. Useful insights can be gauged from the office development boom in London. First, the property market conditions were very benevolent. There had been few offices built since the 1930s, first because of the depressed macroeconomy and then because of the Second World War and subsequent building material shortages. At the same time, there were many potential sites because of bombing during the war and demand was expanding, which meant shortages of offices and rising rents and capital values (Marriott, 1967).

Furthermore, there were other factors that favored developers. The government was following a low interest rate for growth strategy. Contractors were normally paid on completion of the building, reducing the need for finance. Usually the final development value exceeded costs by 50 percent and developers on completion were able to receive mortgages based on two thirds of a property’s value. As a result, the mortgage could pay off construction costs. Marriott summarizes the implications:

> Since all the money to buy the site was usually lent by the banks, all of the construction costs paid for by the contractor or the bank, and the total repaid from a long term mortgage borrowed from an insurance company, the developer seldom had to find any money at all, once his credit was established.

*(Marriott, 1967, p. 5)*

Interest payments on mortgage finance were less than the rent received. In other words the whole process was “self-financing,” a very lucrative business that stemmed from the specific market conditions of that time.

Self-financing of speculative development has never occurred again in the UK, not even in the property booms of the 1980s and 2000s. However, during the 1980s boom this form of development finance was subject to innovation. The length of the loan term was extended from the initial development to the first rent review point after five years. The logic was that rents would have risen sufficiently by then to permit long-term financing. Later in the decade, short-term debt finance became more sophisticated through the arrangement of general credit facilities/options that enabled a developer to tap into funds at prior agreed interest rates up to agreed limits. These arrangements were often syndicated across a panel of banks, expanding finance opportunities to the developer and reducing the specific risk of large developments for banks (Lizieri et al., 2001). These facilities could also last up to 35 years blurring the short and long term.

The late 1980s also saw a range of other innovations that still apply today. Traditionally, banks have had a ceiling of 75 percent of development costs. Specialist lenders emerged that topped up this finance with “Mezzanine Finance.” This enabled developers to borrow normally up to 90 percent of their costs. This top slice is more risky and financiers require a higher rate of return and a share in any profit. Mezzanine finance in this instance is the junior debt and owners of the mezzanine finance will only receive the payments they are owed once the senior debt has received its repayment, including interest in full. Mezzanine finance incorporates
interest charges and sometimes an equity share of the final value of the development. Mezzanine finance supporting development in this way applies primarily to a property boom, and then probably rarely. Many banks have subsequently required not just interest payments on the senior debt but similarly an equity return from the completed development. There are also “exit” charges in the UK – their form can vary but they are usually an additional charge based on either the total debt borrowed or the value of the completed development.

Another innovation introduced in the 1980s was “limited recourse” or “non-recourse” finance loan arrangements (Fraser, 1993). In these arrangements, the bank lends only to the development project which is set up as a subsidiary company of say a property company or two companies. Today the terms have changed and the equivalent are now special purpose vehicles (SPVs) and limited legal partnerships (LLPs). The former is a general term for these partnerships. LLPs set legal limits to the liabilities of the partners, although the law varies across countries.

Non-recourse or limited recourse loans usually involve the creation of a separate SPV or company/subsidiary for the sole purpose of the individual development. The collateral for the loan is secured (restricted) to the assets of this company with no recourse to the parent company or to its other assets if the project fails. The arrangement protects the developer from the project’s major risks, beyond the initial capital required, but not the lender. The advantage to the lender is that the project is sheltered from any wider problems that may occur for the parent companies. In some instances the opposite may be true and the lender could require some form of guarantee from the parent company. A further advantage to the parent company is that in certain circumstances the subsidiary and its debt will not have to feature in its balance sheet, so the subsidiary is taken off the balance sheet thereby masking some of its liabilities.

Sale and leaseback schemes began to emerge in the late 1950s as an alternative to long-term mortgages for developers when the UK government introduced occasional freezes on borrowing – known as “credit squeezes” at the time – to stop the economy overheating (Marriott, 1967; Darlow, 1988). In fact, sale and leaseback have a long pedigree. Scott (1996) notes their existence in the 1890s and how they had been used by individual retailers to expand their business, particularly from the 1930s on. A retailer could enter into a sale and leaseback arrangement on one store, and use the finance to buy another, and by this process establish a chain of shops. A retailer could also enter into such an arrangement with an insurance company to finance the building of a store (Scott, 1996). The innovation of the late 1950s was their use for speculative development. Under these schemes a developer (pre)sells the property on completion (usually) to a financial institution and at the same time takes out a long lease of the order of 100 years.

The structures of these sale and leaseback arrangements vary but the developer would retain a proportion, say 20 percent, of the equity, selling sufficient to pay back the rolled-up development costs. The developer then sublets and manages the property, with the financial institution receiving an agreed (share of the initial market) rent, a guaranteed income so that it receives the “bottom less risky” element. This type of arrangement is often referred to as a top/bottom slice partnership. There were initially long rent review periods on these arrangements – up to 33 years – reflecting the lack of inflation in the 1950s. The essential drawback of sale and leasebacks in this form was that each interest was not easily sold.

By the end of the 1950s, financial institutions became more interested in taking equity interests in property. This was partly because of the high returns made in the boom and partly because the 1960s saw the beginning of inflationary pressures with consequences for their investment business to provide endowment payments and pensions to policy holders that kept pace with rising prices. Property as a real investment fitted this new paradigm. As a result, the
1960s saw a move from the use of elementary sale and leasebacks into complex equity sharing partnership models of development finance. A financial institution became involved from the outset of a development, providing the finance for the project including land purchase and construction costs. Initially the basic sale and leaseback partnerships did not involve arrangements about sharing future rental (equity) growth (Darlow, 1988). In the late 1960s these schemes began to include a proportional formula to share future rental income, often collectively referred to as “side by side schemes.” A further development was a priority yield arrangement that combined both elements of the side by side and top/bottom slice. The development company prioritizes the financial institution to receive a set yield on its investment, with the next say 1 percent going to the developer, and the rest (if any) split equally. The breakdown of returns is shown by Figure 14.1 in which the priority yield is the bottom slice, the property company receives its share if there is sufficient profit, and the rest of the profit is shared in a side by side arrangement.

With the property market collapse of the mid-1970s the prioritized/guaranteed income proved an illusion. This led to the evolution of the “profit erosion” model in the 1980s, in which if the guaranteed return on completion is not forthcoming the developer is subject to penalties (Darlow, 1988). If the profit erodes to a certain point, the developer disappears and the fund is left with the building and to find tenants. A common feature of these partnerships is that they provide incentives to the property company in the development stage and its ultimate returns are based on its performance in completing the project on time and within budget. The funding institution shoulders most of the risk as it is its capital, but the developer risks losing the right to profit in the development process (Fraser, 1993). Generally, these arrangements include a buyout by the institution at an agreed yield on an agreed base rent, and a higher yield on surplus rents known as “overage.” The ultimate step in the changing partnership forms between developers and financial institutions is the appointment of the property company as a project manager to the development. Payment then takes the form of a basic fee plus a performance incentive.

Listed property developers have always had another source of finance; in common with firms more generally they can issue shares, bonds, and commercial paper. Raising capital to

![Figure 14.1](image-url)  
*Breakdown of returns in a priority yield arrangement*  
*Source: Fraser, 1993*
finance property company activities on a stock exchange is usually based on a prospectus explaining what it plans to use the additional funds for to justify the issue and persuade investors to purchase. An evolution from debentures is asset securitization of properties set within a “single purpose vehicle.” Essentially they are bonds secured against rental income, but rather than being issued on the stock exchange they are placed by a bank with investors supported by a risk grading from rating agencies. Both can be cheaper than borrowing debt capital from a bank, especially when share values are high, and can be used to repay development loans. They can also raise up to 90 percent or even 100 percent of real estate value compared to a bank loan of up to 75 percent (Lizieri et al., 2001). However, any conditions placed on securitization by investors may bring constraints on restructuring a company’s real estate portfolio or its management such as subsequent lease terms.

An extreme example of the use of securitization is Olympia and York, a private Canadian property company that just before it filed for bankruptcy in 1992 owned trophy buildings in Toronto and London, together with 75 percent of Manhattan’s office space. It was then revealed that it had non-recourse loans owed to 91 creditors across the globe secured against the company’s real estate and public stockholdings. Over $1 billion alone was securitized against Canary Wharf in London, its main underperforming asset and the primary instigator of the company’s downfall (Ghosh et al., 1994). Despite the problems of Olympia and York, the 1990s saw the slow rise of asset backed securitizations, many of them trophy buildings or offices to be occupied by a blue chip company with an excellent credit rating.

**Real estate cycles and the role of development finance**

Upturns in the property cycle are normally associated with readily available bank finance, while the reverse happens in the downturn. This can be explained in terms of relaxed bank lending criteria involving the under-pricing of risk in a boom followed by a more conservative approach engulfed by fear (over-pricing of risk). Banks who typically lend up to 75 percent of development costs with low mark-ups over base rates in a boom turn volte-face during the bust. This debt finance then may not be available at all or only under strict conditions, for example only for developments that are pre-let with tenants waiting, and even then banks may offer less generous sums based on a lower loan to cost ratio, the order of say around 60 percent. Such a short-term development finance “famine” for example occurred in the years following the global financial crisis after 2008, and also can be seen in previous major downturns.

The inter-relationship between development finance and the performance of the economy/property cycle goes much further than this relationship with bankers’ lending criteria and funds available. The historical perspective above also demonstrates that forms of development finance available also vary with the state of the economy. Table 14.1 summarizes the cyclical nature of finance forms and contrasts the funding droughts during recessions and the availability of loans in upturns. Corporate finance in general is most attractive during periods of economic growth when property and share prices are rising. For example, 1987 was a record year for share issues in the UK when both were soaring. These rights issues can also be issued to support a company in downturns when external funding is not available. In this case, the company’s shareholders are called upon to safeguard their existing investment by providing more capital.

However, superimposed on these relationships are the portfolio investment strategies of non-bank financial institutions. Property as an investment in comparison with other investment modes – equities and government bonds – has had periods when it was seen as relatively attractive, such as the 1960s and 2000s, but also when sentiment moved in the opposite
direction such as the 1990s. These opinions influenced the nature of the development finance available and certainly when positive stimulated investment partnership models.

Property booms also brought innovations in development finance. For example, the late 1980s saw the arrival of non-recourse lending and mezzanine finance. The busts often exposed the flaws in these innovations, such as the lack of transparency in equity securitization and unexpected high levels of gearing. In the distress of the bust, energies focused on addressing the financial consequences, not stimulating further evolution. One such novelty in the post credit crunch period is the use of mezzanine funding for refinancing completed buildings (Giostra, 2011).

**Public–private partnerships and development finance**

Modern commercial (re)development is no longer a small incremental process, and individual schemes have increased in size. From the late 1950s, UK local authorities were also conscious
of the importance of large-scale city center development, especially shopping centers, to the local economy and engaged in entrepreneurial partnerships with the private sector to attract investment (Shapely, 2011). Local authorities had a critical role in these developments contributing through planning support, already owning the land central to the project, or acquiring it compulsorily, so unlocking land’s development potential. As a result, an authority also has an equity interest in the development. Sometimes a public authority or agency may also seek a joint venture with a private sector partner to provide finance for a project that is not commercially viable. In these cases, the financial return models above (see Figure 14.1) were reformulated at the time with up to three partners to reflect the different roles and risks (Fraser, 1993).

Local economic development is arguably even more important today for communities. Public authorities continue to initiate and take a role in major real estate projects, often reconfiguring city centers or reviving key sites. The evolving urban economy as noted earlier, with its closure of traditional businesses, brought fundamental policy challenges from the 1980s in terms of a legacy of large tracts of vacant/derelict buildings and land. The schemes are now generally mixed use, a potential combination of commercial, residential, and leisure. The precise mechanics vary between countries depending on planning systems and the local fiscal regime/freedoms (Munoz-Gielen, 2014). They may also be underpinned by significant transport links supported initially by public funding.

The scale and location of the projects often mean a lack of private sector confidence to invest and there are market doubts about the viability of regeneration. There are a range of solutions that encompass state subsidies/tax incentives and a variety of types of area strategies in which the state focuses and coordinates resources to set a direction and vision for the future. Enterprise zones are one model that has been applied around the world offering tax incentives for development (Jones, 2006, 2013). Another approach is the use of “development corporations” for defined areas that buy up extensive land tracts, provide modern infrastructure such as new access roads, and provide subsidies for development and market user-friendly land parcels (Jones, 2013). These are pump-priming strategies in which initial public sector expenditure/tax incentives, ultimately for a limited period, are provided to stimulate private real estate investment.

These schemes provide public support as one element of a broader development funding package. Government involvement offers positive and reassuring signals to private financiers for what are generally more risky projects. The initial public support is also crucial to the viability of such development, not only in terms of crude profitability but also by reducing the required equity required to meet the available finance in the development equation. There are a range of ways to seek to repay the public funding via any rise in land or property values. This can be simply through land sales, forms of development land gains tax, or tax incremental financing in which local rises in rental/capital values are translated into higher occupancy property taxes (Squires et al., 2015).

**Conclusions**

Development finance schemes are products of the contingent market conditions applying at a particular time. Notwithstanding a gamut of sophisticated innovations over the last 50 years, the long-standing financing model of a property company receiving incremental debt funding to pay out outlays through the development period is still the mainstream approach. However, property market conditions rarely enable this simple model to work with the repayment of development funding having to stretch into the medium term until rents/capital values rise.
The distinction between short- or long-term finance is therefore arbitrary, reflected in the use of general credit facilities from banks and equity securitization. Global integration has meant that much of this finance is available on a competitive basis from banks around the world and standardization of approaches in different countries. This trend has gone hand in hand with a move toward larger development projects as noted earlier.

Property cycles dominate the terms and forms of development finance, with booms stimulating innovations and the busts dealing with the ramifications of their shortcomings. The changing attitudes of financial institutions toward real estate in any particular decade have also been a factor in the prevalence of the form of development finance of that period. More generally the availability and terms of debt finance from banks are very pro-cyclical with droughts in downturns.

Large-scale development projects are often undertaken in partnership with a public agency seeking to promote local economic development. Public support is crucial to the viability of many of these projects not just simply in terms of profitability but also to the provision of private development finance. More generally, finance is the key to successful individual developments, but as we have seen, its form has gone through many guises and its availability is very much dependent on the economy, general real estate sentiment by investors and ultimately the risk of the project itself.

References


Models of development finance


