SOMETHING BORROWED, SOMETHING NEW

Why alternative lending is paying dividends for many builders

BY TRACY HANES

As the real estate market has cooled dramatically and interest rates increased, not only homebuyers are finding it more difficult to arrange financing. Already plagued by the increased cost of materials and labour, developers and builders are also finding the traditional lending environment challenging when it comes to securing financing for land and construction.

Brian Dorr, founder of Dorr Capital Corporation, a commercial real estate mortgage lender and broker that focuses on the Greater Toronto Area and Greater Golden Horseshoe, says until recently there was a lot of capital chasing a lot of builders, but the reverse is now true. "Lenders don't feel that compelled to lend to builders. They are very risk-averse," says Dorr, noting that traditional lenders are not opening their relationships beyond the developers they have a history with.

Consequently, the current lending climate has many developers and builders looking at other options. That's why alternative lenders, who have played a role in the development and building industry for decades, are seeing a rush of new business.

"The tightening of traditional financing parameters has pushed some developers/builders into the alternative lending space for the first time, as they may require more flexibility in their deal structures," says Michael Carragher, V.P., Mortgage Investments, at Firm Capital Corporation, a non-bank lender that has been providing real estate funding to small, medium and large builders and developers in Ontario for more than 35 years.

Land financing is particularly challenging. "In today's market, it's very difficult to get money. A lot of lenders who were doing land have put a pause on that financing," says Rena Malkah, president of CYR Funding Inc. Her firm represents institutional lenders such as pension funds, insurance companies, banks, credit unions and more than 2,000 private lenders that supply capital for land purchase, construction financing and income-producing properties.

Land money is scarce, but Malkah says it was typically financed by private lenders anyway. "Only big builders would get land money from typical lenders. Land may be agricultural property that has to be rezoned. Then when it's rezoned, its value goes up, then again after the Official Plan amendment, and then after the site plan approval. After each stage, as the land value goes up, it becomes more desirable for a lender to finance."

"Land financing is very tight in today's marketplace," concurs Riccardo Plati, executive V.P. of Dorr Capital. "Construction loans are getting tighter for less experienced builders."

Malkah says a lot of financial institutions are more cautious due to the rising costs of building and the drop in home sale prices. "That reduces the profitability of a project. In some cases, deals aren't making sense anymore." If a builder is plausible and the borrower has a strong record, Malkah says they may still be able to go to a lending institution. "However, if the borrower doesn't have a strong net worth, lenders are concerned about cost overruns and that the borrower doesn't have deep enough pockets." In that case, it would have to be a private deal—including for first projects, even if a builder has experience.

Alternative lenders are experiencing a bump in business not just because clients are finding it harder to source funding the traditional way, but because they have the ability to structure loans to meet each client's unique needs, explains Carragher. "Unlike traditional lenders, we do not need to fit a transaction into a specific lending box or set of parameters." For example, due to the current slower pace of sales, a builder may need a more flexible pre-sale structure. Carragher says there is also comfort for clients using alternative lenders such as Firm Capital Corp., as they know they can call and speak directly to the decision makers throughout every step of the financing process.

Even established builders with good relationships with traditional lenders often opt to use private lenders, says Malkah. Time is money and the quicker they can get a project started, the better. Construction funds are advanced in draws, based on an inspection and report by a cost consultant to a lender. And while a bank may take a couple of weeks to provide an advance, it can take only three or four days with a private lender.

Interest rates at the time of publication ranged from 9-12% on land financing and 8.5-10% on construction financing, plus fees, says Malkah. While banks may offer slightly lower rates by a

Trends identified by alternative lenders

- Low-rise housing will continue to be in demand, especially for units priced less than $1 million.
- High-rise condo units by transit lines will continue to sell well.
- Some builders and developers are looking at projects smaller in scope than they normally would, as this allows for shorter project timelines, the ability to better match project revenues and costs, and a clearer exit strategy.
- There is still demand in some smaller communities beyond the Greenbelt, but it makes it even tougher to secure financing.
- Big banks are not willing to deal with medium-sized developers at this time (according to information gleaned from the RealCapital conference in February).

Advice for developers and builders seeking funding

- Listen to lenders and be very patient.
- Have a strategy mapped out to discuss with lenders, including market analysis and risk assessment. For example, can you secure zoning and permits, and do you have a financing plan in place if costs change or there are delivery delays?
- Have budgets locked down.
- Make sure presales are solid.
- Be prepared to add more equity.
- For land purchases, see if the land seller will hold a vendor take-back mortgage until construction is ready to start, at terms favourable for the buyer and seller.

percentage point or two, as well as slightly lower fees, there is more red tape and most banks have paused on taking on new builder/developer clients.

THE PERSONAL TOUCH

Alternative lenders play a big role in projects of all types across the province. Firm Capital has provided construction financing to Ontario builders and developers for 35 years for infill, low-rise, mid-rise and high-rise condominium projects, site servicing, land financing, inventory financing and mezzanine/equity capital. Loan amounts range from $1 million to $50 million.

Firm Capital treats every real estate project, whether small or large, as unique. To understand the needs of the project, Firm holds a face-to-face meeting or call with the builder or developer. When considering an application, Carragher says his company wants to see that the scale of the project fits with the builder's (or developer's) track record, skill set and experience. Firm's business is lending and it does not get involved in managing projects, but does keep tabs on their progress. Following a meeting with a borrower, it will present a financing structure within 24 to 48 hours to a client. If that's accepted, they'll move ahead with a financing commitment and funding date required by the borrower.

"We have the ability to react quickly, given our collective industry experience and the fact we are a direct lender with proprietary capital," says Carragher.

Dorr Capital operates in the private debt market and has placed $2.2 billion in loans with private and institutional investors over the past decade. Dorr Capital's business has grown significantly since it was launched 13 years ago, with the average loan size nearly $19 million in 2021, with some deals close to $200 million.

Dorr, who is also president/CEO of RealAlt Investments, started his career as a default analyst at CMHC and saw deals go bad because customers didn't have great exit strategies. The credit crisis of 2008/2009 created a huge gap in the market for development and land financing. He subsequently started Dorr Capital as a broker, tacked on loan administration, then six years ago started syndicated mortgages from private individuals. Two years ago, RealAlt was created, a mortgage fund that spreads out risk by investing in multiple loans in land, and new multi-family home developments.

Dorr Capital works with developers that are typically building 10 to 500 units annually, providing financial advice and assistance through every stage of a project. It has recently provided a loan ($30,720,000) for construction of 36 townhomes in Richmond Hill.

Dorr's underwriting process is stringent, as it wants to be assured that developers can get the necessary approvals. It does thorough market research on aspects such as location and demographics, using its own internal resources as well as third-party consultants. This involves budget review, in addition to timing, cost escalation and risk assessment to determine whether a developer or builder has the necessary experience to carry out a project and handle the scale.

ANOTHER LINK IN THE CHAIN

As most lenders will not lend 100% of the cost of a project, developers or builders have to come up with either their own capital in equity or seek a source of equity funding. That's where companies such as Harbour Equity Capital Corp come in.

It is a private equity company that raises pools of capital, then invests in and owns a portion of the projects, generally on a joint venture basis with developers.

“We invest with the developer at the time of land acquisition, as well as later stages, but we generally provide capital from day one,” says Harbour President and Principal Ari Silverberg. Harbour Equity provides development partners with the time and resources required to facilitate the completion of the project and helps ensure that the joint venture maximizes project profit. The company acts as an advisory partner to help mitigate any issues and facilitates the progress of development, while the developer provides the day-to-day management of the project.

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Harbour deals with everything from land development to condo developments, but mainly focuses on low- to mid-rise infill projects that include single-family homes, townhomes and stacked townhouses, as well as urban and suburban condo and rental buildings. With rental projects, Silverberg says the goal is to get in and out—to sell and not hold those buildings long-term.

The majority of Harbour Equity’s projects are in Ontario, typically valued at $40 million to $120 million. “Our focus is Southwest Ontario (London, Kitchener-Waterloo, Cambridge, Hamilton, Guelph, etc.), although we have projects as far east as Clarington and north to Barrie,” says Silverberg.

Harbour bases its investments on the quality of developer, their experience and the value they see in the land. “We look at a developer’s reputation for sure, we look at past experience,” Silverberg notes. “We generally make decisions reasonably quickly and are pretty transparent.”

Partnering on equity financing with Harbour allows developers to leverage their equity and do more deals than they would otherwise with their own capital, says Silverberg. They pay market management fees, but Harbour adds value in terms of financing and strategy. Some developers are facing situations where units were sold some time ago and costs have gone up, so Harbour works through those situations with its partners to find solutions, expedite projects and attain profitability.

Currently, Harbour has $60 million in equity capital that it intends to deploy over the course of the next year. It has invested in more than 65 projects since 2011, which on completion will comprise more than $2.5 billion in real estate assets, including for-sale residential, purpose-built rental and industrial developments.

“Banks appreciate that we’re not registered on title in second position on these projects, that our interest in the property is through our joint venture and having title to the property,” says Silverberg. Thus, builders that Harbour deals with are able to borrow from ‘A’ lenders such as banks and credit unions. “Lenders also appreciate that we are required to help with cost overruns through our joint venture agreements, providing them comfort that our projects will be completed and they will be repaid.”

Harbour has invested $140 million for its investors over the past two years, and Silverberg believes the push from the Ontario legislature to reduce red tape and approvals challenges at the municipal level will continue to make the real estate market an attractive place to invest.

Some examples of recent projects include committing $20.80 million for a 50% interest in the community of Courtice, with 500 low- and medium-rise residential units to be developed on a 58.8 acre site. Harbour Equity, as fund manager, committed $10.97 million for a 26.4% interest in the project, while co-investors committed to $9.83 million for a 23.6% interest. It also provided $7.80 million for a 50% interest in a 1.1 acre site to be developed into a 30-storey, 250,000 sq. ft. mixed-use condo tower in Toronto.

But while alternative lenders offer builder and developer clients many advantages over traditional banking, there can be a few disadvantages. “There is a flight to quality and part of that flight is to get large, large loans,” says Dorr. “I suppose the Achilles heel of alternative lenders is loans of $50 million or more. That’s still the domain of banks.” **OHB**