the nation's national parks and wildlife to the present and future generations.

Professor John Skidmore of the University of Technology, Sydney, in a paper this year, ranked the most damaging impacts on Kakadu National Park in order of severity as: water buffalo, a South American weed *Salvinia*, fire and tourism. He said other activities, including mining, have been "relatively minor so far".

Tourism has led to noise pollution, litter, car tracks and over-fishing and while some of these effects have been overcome, it has been "at the expense of an increasingly intrusive park infrastructure and road network".

Professor Skidmore said:

> "What was formerly a tranquil wilderness occupied by a small number of Aborigines, mining prospectors and government officials is now a well regulated and extremely popular park for tourists from the ends of the earth."

And the Prime Minister said recently that tourism was projected to increase three-fold by the turn of the century, from the two million visitors last year.

Many of those tourists will want to visit Kakadu. The sustainable development argument will throw up consideration of what sort of national parks Australia wants - is it pristine wilderness or areas in which high access fees will have to be charged to pay for park services which try to keep these areas in the natural condition they once held.

Or will access need to be restricted? And who will explain that to the camera-toting tourist who has travelled thousands of kilometres to see some of Australia's "natural" environment?

The sustainable development argument is about to get underway. It is a massive task the Federal Government has taken on and the public should be aware that costs, as well as benefits, will be involved.

This is not to argue that the exercise should not be attempted but to indicate that people should enter the debate with their eyes open.

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CREATIVE LENDING

With traditional lenders shying away from new projects, developers now have to give a large part of their profits to those prepared to accept the risk. Florence Chong reports.

The forest of towers rising in the heart of our capital cities, particularly Melbourne and Sydney, probably owes as much to the ingenuity of financial engineers as to the structural engineers, to whom office blocks are no longer a great challenge.

With commercial interest rates at about 20% against commercial property yields of 5-6%, a large gap must be covered, largely by the capital gain when the completed building is sold.

Traditionally, that gap was covered by the developer, who had to contribute at least 30% of the cost of a building in equity funds. But CBD towers of any substance now cost $300 million or more and few developers have the capital base to support that level of equity contribution. Whatever happens to the property market, costs are likely to keep rising.

Now, the risks inherent in a commercial property boom are being carried by non-traditional investors, ranging from blue-chip companies to adventurous merchant banks and the public. They have been attracted by the returns promised by "mezzanine" finance, also known as subordinate or second-ranking debt, which provides the investor with a fixed return as well as capital gain. The risk is similar to that of an equity holder. Instruments such as convertible notes, preference shares or participating mortgages are used.

An example is the package put together by Project Finance Indosuez for Australia's most expensive building, the $1 billion Chifley Square in Sydney. Since Bond Corporation's stake in that project is now up for tender, the financing is in abeyance, but Indosuez director Peter Elliott explains how he intended to cover the financing gap.

> "If the total project cost is $1 billion and you take the total net rental income of $65 million a year, the income cannot support a loan, even when working on a conservative interest rate of 16%. The income can only support a debt of up to $400 million, so you have a gap of $600 million or thereabouts," he says.

The only way such a project can be financed, he says, is to capitalise the interest and halve the amount of debt the developer has to service.

> "You get someone in from day one to take up quasi debt in the form of, say, convertible notes, and raise $200 million from the notes. You can get rid of another $200 million by leasing plant and equipment over 10 years," he says.

Elliott says lenders of the quasi debt will get an income of 8-10% during the term of the construction. On completion, the building will be worth $1.4 billion, which will give the investor an effective annual yield of 16%. Elliott says the investor would receive half the returns in cash and the other half as equity in the completed building.

He says this approach can be taken only because Chifley Square is an "A1" site and there will be no problem in leasing space in its top-class building. Elliott stresses that any bank involved in financing projects of this size has to be sure that the developer will be able to meet its interest obligations.

Second-tier debt is being used to finance the gap between equity and debt in many of the $3 billion worth of projects now under way in the central business districts of Sydney and Melbourne. Many of these projects are believed to have no developer equity. They would be 100% financed using primary and second-ranking debt.

There was a sharp rise in the use of mezzanine debt at the height of the property boom when merchant banks, some corporations and institutional investors bought these instruments.

The industry says it is impossible to pinpoint the level of second-tier debt in the building industry, let alone identify the investors. Project financiers say that when the market was good, investors included Australia's top 100 companies. But the main takers appeared to be merchant banks, including financially troubled Tricontinental and NZI (in the process of being taken over by General Accident Corporation), which were anxious to build up a portfolio in the then booming property industry.

A leading financier told BRW:

> "They (Tricontinental and NZI) were very aggressive, but are no longer in the marketplace. This is one reason why it has become harder to place subordinate debt."

The industry has little doubt that its heavy involvement in second-tier funding (not just in property but other corporate lending) has contributed to its heavy losses.

"This style of financing can be attractive," the financier says. "If done properly it is very remunerative and safe. But it went wrong when people got a rush of blood to the head and got into deals without fully understanding the risks involved."

More importantly, he adds, investors should have the management skills to oversee their investments.

Another financier with a big US bank says the overall returns from mezzanine debt can be 4-8% above bank bill rates, but is usually 4-5% above. In the current market, he says, lenders will receive up to 1.5% over the bill rate or swap rate over five years. The lender receives a coupon payment every six months of about 17.5% and the balance can be converted into equity participation. The overall return is about 23.5% a year. The risk arises from the fact that during the five years, the subordinate debt cannot be repaid unless the primary lenders get their money back first.

Other organisations involved include the AIDC (the Australian Industry Development Corporation) and Japanese construction companies. Projects such as Melbourne Central would not have proceeded if the financiers had not received a guarantee for the loans from Kumagai Gumi. Indeed, many projects would not have gone ahead in Australia without financial guarantees by Kumagai.

As investors retreat from an uncertain property market, so have takers of subordinate debt. The remaining players, such as IEL, which has profited from its long connection with the development industry, often in joint venture arrangements, are highly selective. The main source of funds for second-ranking debt is now coming from insurance companies.

Where possible, financiers are arranging put options as added security for their loans. A project financier with a leading American bank says:

> "Our risk is not so much the economy, but cost overruns. We want to know that the project will be completed on time and that the developer can do it within his budget."

If there are problems with the developer repaying the loan, the lender can recover the debt from the holder of the put option who, apart from earning a fee, will have the opportunity to buy the project at cost.

Two well-publicised deals have been able to proceed through the use of put options. One is the $530 million Becton project at 333 Collins Street, Melbourne, where the State Government Insurance Commission of South Australia bought put options for a reported upfront fee of $40 million. In another deal, the developer of the QVI office plaza project in Perth was able to place put options worth $340 million to BT Property Trust and the NSW State Authorities Superannuation Board.

David Webb, senior lending manager at Hambros Australia Ltd, says the merchant bank has done a number of put options and he is working on one at present. Obviously, the use of put options reduces the profitability of a project because participants are in it for a share of the profit. Webb says: "I have seen fees as low as 2% and as high as 8%."

If the developer pays 8% as fee, it will reduce his profit in the deal by 30%. But as the market tightens, banks are lifting the equity requirements to at least 35% of a project's cost, as well as limiting the level of mezzanine debt to no more than 15% or 20%. The most cost-effective approach is to find a joint venture partner in an arrangement where the financier provides the funding for a 50% share in the profit.

Joint venture is the most conventional and preferred way of funding property developments. A more unusual joint venture is the unit trust arrangement, such as that involving 20,000 investors who have placed $131.5 million in the development of 1 O'Connell Street, Sydney. The investors are being paid interest for the use of their funds during construction and will own 30% of the building on completion, scheduled for the first quarter of 1991. After that, they will get an annual yield based on rental income and the capital appreciation of the building. They expect their return to be comparable to investment in prime blue-chip buildings in Sydney's CBD.

The investors are unitholders in two trusts - Australia's Flexi Property Fund and Aust-Wide Trust - managed by the Aust-Wide group. The group's chairman, Ron Kerr, tells BRW that the investment has effectively provided the deposit to enable the developer, Northbourne Development, to take out a loan for the project, expected to have a value of $600-700 million on completion. The development cost will be at least $400 million.

Kerr says that under the deal investors will be paid an interest rate of 14-17% for the cost of funds during the construction period. When the building, which is about 60% pre-leased, is occupied investors will get a yield based on rental income (about 5%) plus growth in the value of the property. He expects the yield to be comparable to Grosvenor Place, which returned 18% last year, but which is expected to return 22-23% next year, following the current rent reviews.

Kerr says Aust-Wide placed the money in three instalments, the first in April 1988, when the project was at advanced design stage and site preparation had not begun. Construction is now well under way. He says the trust is well aware that there are risks involved in participating in a development, but those risks were carefully assessed before it committed itself to the project. The rewards for taking the risk will be a share in the profit - usually about 30%.

Some financiers are looking to so-called credit-enhancement products to further dilute their risk. These include rental income guarantees and insurance on the value of assets. Specialist companies are prepared to buy the head lease of a building in return for the letting-up allowance - equivalent to the rental income of up to 18 months in a large project - and fees payable to property agents. In return, they will guarantee the developer yield (that is rental income from the day the project is completed) and cream off a percentage of future rent increases.

Another product is asset insurance. The Sydney-based Asset Underwriting, for instance, will write a policy to insure the agreed value of a building at an agreed time. But Peter Elliott of Project Finance Indosuez says:

> "My feeling is that if you are a banker in the business of providing finance and if you need things like insurance or guarantee, you should not do the deal."

The New World of Participating Mortgages

Not long ago developers could expect to get 100% funding for their projects. Today, banks are becoming highly selective in what they finance; it is not unusual for them to demand 50% of the project cost in equity before agreeing to a loan.

In response to more stringent lending criteria, the project finance team at Westpac Project Advisory Services has spent the past six months working out a new instrument to enable the developer to build up equity in a large commercial project in the Sydney CBD. The instrument, known as participating mortgages, a hybrid of debt-equity instruments, has not been used in Australia previously.

The paper, currently being placed in the money market, is expected to raise more than $100 million. Graeme Richardson, director of Westpac Project Advisory Services, told BRW that the investors are expected to be Australian and overseas institutions rather than individuals, although it could be marketed to the retail market if the team had time to draw up a prospectus.

Associate director Richard Ng, who worked on the instrument, says that the main advantage for the developer is access to lower-cost funds during construction. The equity component of the package will be 45% against a debt of 55%.

Richardson says that the participating mortgages will provide the second-tier finance and, in this instance, the investors will get a running yield of 8%. He says that their overall yield will be higher than in pure property investment, which is about 5% a year in Sydney's central business district.

He says the return is not indexed for inflation but rather to Sydney property prices which, historically, have increased more quickly than CPI figures. Potentially, the investors can expect to earn a yield of up to 30%, with a minimum of 16%.

At the end of the five-year term, the paper can be converted into equity in the completed building. The advantage of this approach is that investors can take either a small or large stake, and get the same sort of potential increase as in any property investment, that is, a share in the profit from the development.

Ng says: "What we are really doing is selling an interest in the property itself." The concept is similar to convertible notes or mortgage notes which are quite common in the US. "Essentially the concept is the same," he says, "but it does not have the adverse tax implications connected to convertible notes under the rigid Australian taxation system. We have to ensure that the structure complies with certain Australian legal and taxation requirements."

Richardson and Ng say that, depending on the reception from investors, this could become a forerunner of other packages using participating mortgages. It is felt that the instrument may be more attractive than unitisation, which offers ownership in a single building in small parcels of units.

Ng explains that some overseas institutions are daunted by Australian trust deeds. The structure of participating mortgages, however, is more in line with the thinking of overseas investors. He expects that through the new facility, overseas investors will be able "to dip their toes" in the Australian property market.

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