INSIGHT · DEBT STRUCTURING

Beyond the Cheapest Rate

Structuring debt capital for real estate

By Kiran Patel ACA, Co-founder, Venture Finance

> *In the £1m–£50m property market, the interest rate is rarely what makes or breaks a deal. The structure is. Chartered Accountant, property investor and Venture Finance co-founder Kiran Patel ACA explains how to think like a credit committee and build debt that works for the business plan, not against it.*

I started my career in audit. Auditors are trained to ask one question of every number: what has to be true for this to hold? It turns out to be the most useful question I know in property finance.

When Joanne and I began building our own portfolio, we asked what most borrowers ask first: who has the best rate? Experience taught us a different order. The rate is visible, easy to compare and sits in the headline of every term sheet. But on a mid-market development or portfolio, it is often one of the least important terms.

A facility 0.5% cheaper that is sized too tightly, runs out before the exit or fails a covenant in month nine can cost far more than it saves. The deals that go wrong rarely fail because the margin was too high. They fail because the debt did not fit the deal.

> **Take a simple illustration.** A developer borrows £2m to convert a building into flats: a 12-month build and a 6-month sales period. One lender offers 18 months at 0.5% a year less than another lender offering 24 months. Over 18 months, the cheaper facility saves about £15,000 in interest.
>
> Then the build runs four months late, as builds often do, and sales start later than planned. The cheaper facility expires with most of the loan still outstanding. Now the developer faces an extension fee of perhaps 1–2% (£20,000–£40,000), default interest while terms are agreed, and possibly a rushed refinance with a new arrangement fee, valuation and legal costs. Add those together and it is easy to lose £60,000–£100,000, or to drop prices to sell units quickly. The

> £15,000 saving has cost several times its value. The 24-month facility would have absorbed the delay without anyone needing to pick up the phone.

That is the case for debt capital structuring: designing the whole funding package around the asset, the cash flows and the exit, before choosing a lender.

What debt capital structuring actually means

Structuring answers four questions before any lender is approached:

1. **How much debt should this deal carry?** Not the maximum a lender will offer, but the level the cash flows and the exit can support with room to spare.
2. **In what layers?** One senior facility, or senior debt plus a stretch or mezzanine tranche to reduce the equity required.
3. **On what terms?** Term, drawdown mechanics, interest treatment, covenants, fees, security and guarantees.
4. **From whom?** Clearing banks, specialist lenders, debt funds, private credit and family offices each price risk differently and suit different deals.

The order matters. Most borrowers start with question four and work backwards, which lets the lender's product shape the deal. I did the same on our early purchases. Structuring starts with the deal and finds the lender whose appetite fits it.

The capital stack, layer by layer

Every property deal is funded by a stack of capital, and each layer is paid back in order. The higher up the stack, the more risk the provider takes and the more it costs.

Layer	Typical reach	Indicative cost	Security and rights
Senior debt	Up to about 60–65% of GDV on development, 65–75% LTV on investment	Lowest margin in the stack	First legal charge, paid first
Stretch senior	Up to about 70–75% of GDV, in a single facility	A premium over senior, one lender and one set of documents	First legal charge
Mezzanine	Fills the gap from senior to around 75–85% of costs	Significantly higher, often with a profit share	Second charge, behind senior via an inter-creditor agreement
Equity	The balance, typically 10–35% of costs	Highest expected return, last to be paid	Owns the upside and the first loss

Figures are indicative ranges for the UK mid-market and move with lender appetite.

The skill lies in choosing the mix. More debt means less equity and a higher return on the cash put in, but every extra layer adds cost, complexity and sensitivity to delays or falling values.

Matching the debt to the business plan

Good structure starts with the plan for the asset, then works back to the debt. Four terms do most of the work.

- **Term.** The facility should outlast the plan with margin. A 12-month build with a 6-month sales period needs at least 18 months, plus an extension option. A term that only just covers the base case turns a minor delay into a forced refinance.
- **Drawdown.** Development debt is drawn against certified costs. Getting the land advance, the equity-first rule and the monitoring surveyor's process right avoids cash gaps on site.
- **Interest treatment.** Rolled-up or retained interest suits a scheme with no income during the build. Serviced interest suits an income-producing asset and usually prices better.
- **Exit.** Every facility needs a credible way out: sales, a refinance onto term debt, or both. Lenders underwrite the exit as closely as the asset, so the structure should name a fallback before anyone asks for one.

The common thread is time. Most structuring problems are timing problems: debt that expires before the exit, or costs that fall due before the funds arrive.

As an investor, I have learned to build the timetable before the funding. On our own projects, we map every cost and every receipt month by month before we speak to a lender. It is not glamorous work, but it is where the right term, drawdown profile and exit route reveal themselves.

Reading the deal like a lender

A credit committee does not ask whether a deal looks good. It asks how it fails, and whether the loan is still repaid when it does. Borrowers who answer those questions before they are asked get faster decisions and better terms.

The tests that matter most:

- **Loan to value and loan to GDV.** How far values can fall before the debt is at risk.
- **Loan to cost.** How much of their own money the sponsor has at stake.
- **Interest cover (ICR) and debt service cover (DSCR).** For investment debt, whether rent covers interest or full repayments, usually tested at a stressed rate.
- **Profit on cost.** For development, whether the margin can absorb overruns. Many lenders look for 15–20% or more.
- **Break-even.** The fall in values, or rise in costs, that wipes out the profit.

This is where an accountant's discipline pays. A month-by-month cash flow, rather than a headline appraisal, shows the true peak debt, the real interest cost and the point where covenants are tightest. Stress testing values, build costs and the programme together, not one at a time, shows how much room the structure really has.

My years in audit and in-house finance taught me to read a set of accounts the way a sceptic does. I bring the same habit to every appraisal: test each assumption, follow the cash, and find the weak point before a lender does. Walking the site as an investor adds the other half: whether the build programme and the sales values are realistic on the ground.

One scheme, three structures

The cheapest debt does not always produce the best deal. Here is how I compare the options on an illustrative office-to-residential conversion: 16 apartments, a gross development value of £3.11m and total costs of about £2.5m before finance.

	Bank, low leverage	Senior debt	Senior + mezzanine
Senior debt	£1.71m (55% LTGDV)	£2.02m (65% LTGDV)	£1.87m (60% LTGDV)
Mezzanine	—	—	£0.47m (to 75% LTGDV)
Total finance cost	£152k	£219k	£268k
Sponsor equity	£671k	£423k	£163k
Developer profit	£634k	£567k	£518k
Return on equity	**95%**	**134%**	**318%**

Illustrative figures for a fictitious scheme, using indicative pricing.

The bank route makes the most profit but needs about £250k more equity and a longer credit process. Adding mezzanine slashes the equity and lifts the return on it, but it is the most expensive option and the most exposed if values dip or the build runs late. For most sponsors the single senior facility is the balanced answer. For a sponsor with capital to spare, or one running several schemes at once, the answer may well be different. That is the point: the right structure depends on the borrower, not just the building.

The mistakes I see most often

Some of these I have seen across clients' deals. Some I have made myself, as an investor building our own portfolio.

1. **Borrowing the maximum because it is offered.** Leverage is a tool, not a target. The most a lender will lend is rarely the most the deal should carry.
2. **A term with no slack.** If the plan takes 18 months, an 18-month facility is a bet that nothing slips. Something always slips.
3. **Ignoring the exit until the end.** By the time the refinance is needed, the rent roll, valuation and interest cover have to line up. That work starts on day one.
4. **Comparing headline rates, not total cost.** Arrangement, exit, non-utilisation and monitoring fees, plus interest on rolled-up interest, can outweigh a lower margin.

5. **Overlooking covenants.** An ICR or LTV covenant tested quarterly can trigger a default on a deal that is otherwise performing.
6. **Structuring in the wrong entity.** Buying personally, then needing to move the asset into a company later, can cost more in tax and fees than it saves. Take tax advice before the structure is fixed, not after.

Five questions to ask before you sign a term sheet

1. If the build runs six months late, is the debt still inside its term and limit?
2. If values fall 10%, what happens to my profit, and to my loan-to-value covenant?
3. What is the total cost of this facility over its life, not just the rate?
4. What is my exit, and what is my fallback if the first one fails?
5. Does this structure suit my next deal as well as this one?

If you cannot answer all five with numbers, the structure is not finished yet.

> *The cheapest loan and the right loan are not always the same thing. Structure first, then the lender, then the rate. In that order, the rate tends to look after itself.*

About the author

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