Real Estate Advisor

Israeli Debt-Based Financing for Real Estate

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Prominent real estate owners and developers are sourcing a new form of capital—bonds issued and traded on the Tel Aviv Stock Exchange (TASE). It's a creative concept, with benefits for both sides of the transaction. The funding technique is also attractive to technology companies, looking for capital to expand with a less-onerous due diligence process than U.S. securities funding often demands.

It's a massive market—and growing. In 2013, nearly $9 Billion of real estate financing was completed. In 2014, more than $14 Billion was sold. Owners and developers crave affordable funding for their projects, and traditional U.S. credit sources, beset by problems from the real estate meltdown that peaked in 2008, are understandably cautious. That caution gets expressed through high rates,[1] reams of paperwork, and arduous regulatory hurdles.[2] In Israel, an abundance of liquidity and yield-starved investors seeking diversification into U.S. real estate, coupled with a favorable exchange rate between the shekel and dollar, have helped to push the Tel Aviv Bond 40 Index to a near-record high.

Funding costs for U.S. owners and developers frequently run between 10%-11%.[3],[4] Compared to paying a fixed coupon of less than 5% to garner credit through Israeli bonds. Bonds that are locally rated A with 5 year terms are currently trading with a fixed coupon of 4%-4.5%. Global supply and demand metrics have pushed U.S. high quality bond yields to less than half that rate in recent years. The bonds can be issued without collateral and with limited covenants (i.e. debt to capital ratio, dividend policy and coverage ratios). However, the company must maintain a rating and certain financial criteria. If the bonds are issued with collateral, rating may not be needed.

Typical funding size for Israeli bond deals is between $150 Million to $500 Million, collateralized by commercial properties such as shopping centers or commercial office buildings. A deal of that size is considered small by U.S. underwriters, but is attractive to Israeli investors, and thereby encourages medium-sized developers to seek the benefits of debt-based financing on the TASE. A typical structure will be for a 5 year term with semi-annual coupon payments. The costs of these bond deals approximate 50 to 75 basis points per year.

These deals are not without risk, and borrowers must be prepared for what can be an unfamiliar and

[1] http://www.recapitalnews.com/us-developers-vying-piece-israeli-bond-market/ (paragraph 15)
[2] Ibid. (paragraph 12)
[3] http://www.globes.co.il/en/article-2-us-real-estate-firms-to-raise-nis-400m-on-tase-1000983917 (paragraph 2)
[4] http://www.rew-online.com/2014/08/27/lower-yields-draw-new-york-developers-to-israeli-bonds/ (paragraph 3)

complicated process. You typically have privately owned operators and developers of real estate companies contemplating this financing structure, and they are not used to the regulatory and continuous reporting responsibility. To begin with, the regulatory environment is different. Rather than adhering to the U.S.'s Generally Accepted Accounting Principles (GAAP standards), Israeli bond financing must comply with International Financial Reporting Standards (IFRS), and overcome a different set of compliance hurdles. For example, IFRS requires reporting for several quarters and years on a comparative basis.

Another issue is the way in which assets are reported on the financial statements. Under GAAP, real estate is reported on the balance sheet at its historical cost, with depreciation applied for wear and tear. Conversely, under IFRS, real estate is reported at fair value, reflecting a more accurate representation, and construed to be more informative to investors in terms of its true performance. It can often be higher than the historical cost method used for GAAP.

These deals require a degree of specialization and contacts with which U.S.-based companies may be unfamiliar. A successful transaction requires an accounting firm with expertise in both Israeli and U.S. taxation, as well as experience to complete the audit in accordance with IFRS. In addition, appraisals are required, and structuring the deal to minimize its tax impact makes it vital to have tax advisors and local Israeli CPAs familiar with both countries' tax laws. It also demands an investment banker or underwriter with experience marketing the transaction through Israel's TASE.

Before an owner, developer (or company) enters into an Israeli debt-based funding transaction, he must understand the value of the asset in relation to the market opportunity on TASE. He will want to evaluate key performance indicators to determine whether a deal makes sense. That's where a valuation expert, in the form of an MAI appraiser certified to render real estate values, can make an important difference. An accounting firm may have these experts in house, but independence rules preclude them from performing both the audit and the valuation. In that case, a third-party appraiser is needed.

We are seeing several companies contemplating Israeli debt-based financing as an attractive alternative to obtaining capital, whether for real estate development or to fund acquisitions. Technological advancements in Israel have created an enormous appetite for yield, diversification, and expanding their international reach. But it demands specialized expertise to meet the burdens of the complex regulatory and compliance environment. Any company entering into such a transaction must be prepared for the additional scrutiny that a public debt offering engenders. Working with a firm that has boots on the ground in Israel should be step one.

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