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The growing business of Israeli Bond financing

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Financing U.S. real estate by issuing corporate debt through the Israeli bond market is a growing business, and major owner/operators and developers are using it for acquisitions and the development of new projects. Although figures vary as to the size of the Israeli bond finance market, NIS 40 billion in debt capital was raised in 2013, up from NIS 32 billion in 2012.

As of November 2014, nearly $15 billion in real estate capital had been raised through Israeli bonds, versus around $9 billion the previous year, according to Bloomberg News. That trajectory should continue as long as global interest rates stay low. The bonds, paying premium rates compared to other debt, are both attractive to investors and a desirable source of capital for domestic commercial real estate.

These smaller bond offerings were previously of interest primarily to high net worth individuals and family offices. Now institutions, such as Israeli pension funds, have entered the mix.

Those funds, whose annual payouts require higher rates of return than may be available across the capital structure, are investing in U.S. real estate and obtaining extra yield, as are mutual funds, who seek higher returns for their investors.

Owners/operators and developers can raise funds at less than half the cost of raising additional equity or when compared to the 11%-12% required from a U.S. mezzanine fund capital partner.

The funds raised may be used as either equity for new acquisitions or to develop existing properties.

Favorable exchange rates, flexibility, and looser debt covenants are other motivators for Israeli bond financing.

For example, as long as there is adequate cash flow to maintain the bond rating and service the debt, owner/developers are not obligated to lock up their underlying properties throughout the debt term.

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The bonds are also governed by International Financial Reporting Standards (IFRS), rather than the U.S.'s Generally Accepted Accounting Principles (GAAP).

Under IFRS, deals are structured using appraised values, rather than historical cost, as mandated by GAAP. A portfolio with a gross value of $250 million, for example, may have a net equity value of $130 million, and could support from $80 million to $100 million in Israeli bond debt.

Developers who build and hold properties, and owner/operators with quality holdings that generate significant cash flow, have already financed projects with Israeli bonds in San Francisco, Chicago, Miami, Washington DC, and New York City.

Some developers hold assets in different vehicles with separate equity structures and can use Israeli bonds to finance their properties without having to unwind the LLCs that hold them.

Also, the borrower is not initially obligated to reveal his purpose for borrowing, which can be advantageous in a competitive marketplace.

Those considering Israeli bond finance should be aware of the legal structure and multi-step process entailed. First, the designated properties are contributed to a special purpose vehicle (SPV), typically formed and domiciled in the British Virgin Islands (although other off-shore countries can be used).

The assets are then appraised by an independent appraiser and the SPV is rated by an Israeli rating agency.

A prospectus is prepared, and the underwriter presents the deal to potential investors through a Dutch auction. All bids are then submitted and the highest price at which the offering can be sold determined. Although these steps can take up to five months to complete, follow-on financings can be done much faster, and if the value of the SPV has increased, additional debt can be issued.

A representative transaction carries a five-to-six percent interest rate, depending on the quality of assets in the SPV and a five-year term, with semi-annual coupon payments and two principal payments in years four and five.

The rate is governed by the covenants, security, and the project's debt-to-capital ratio. Transaction fees can run 50 to 75 basis points annually, for an all-in cost of roughly 5.75% to 6.75%.

Owner/developers should be prepared for a substantial time investment. The upfront costs for forming the SPV, having it rated and appraised, and legal and accounting fees to prepare the prospectus can run $250,000-$300,000.

If the projected cash flow required to service the debt does not materialize, owner/developers could potentially lose control of their assets. Some newer properties may not have a record of producing income, or may be in an area that now has wide appeal but could cool in the future. Perceived as having higher risk, those properties may be funded at higher rates.

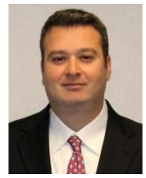
Owner/developers also must issue quarterly financial reports both to investors and to the Israeli rating agencies.

In addition, there is increased scrutiny: a subset of their private company is now in the public domain. For example, being forced to divulge occupancy rates and the status of condo sales may give competitors information that developers would prefer not to share, and are not required to reveal when arranging domestic financing.

Investors face risks, as well. In case of a default, the bondholders do not have first claim on the asset—investors are paid from the property's cash flow. If the funds are not there, returns will be affected.

A successful deal starts with a team of experts. These include an Israeli accounting firm to provide audited financials of the SPV, a U.S. accounting firm to convert the company's financials from GAAP to IFRS, Israeli lawyers to create the SPV, professionals to collaborate with rating agencies to ensure the highest rating possible, and attorneys and underwriters with bond execution expertise.

For more information contact:



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