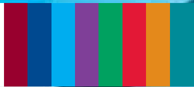
Research Programme 2011-2015

The Association of Property Bankers

SHORT PAPER 15

Outlook for Development Finance in the UK

This research was commisioned by the IPF Research Programme 2011–2015



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Property Banking Forum: Outlook for Development Finance in the UK

IPF Research Programme 2011–2015

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Property Banking Forum: Outlook for Development Finance in the UK

IPF Research Programme 2011–2015

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About this research:

This research was originated by the Property Banking Forum, a group formed by the Association of Property Bankers (APB) and the Investment Property Forum (IPF) to carry out and disseminate research and to inform those involved in real estate funding and investment about issues affecting property finance. This second paper to be initiated by the PBF is a short research project to identify the current level of lender support for development finance, as well as the prospects for this type of finance.

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Executive Summary

This is perhaps the worst economic crisis that any of us have experienced and, just when there seemed to be a degree of stability in the first half of 2011, the concerns of a Greek default and the consequential knock-on effect to other European economies is sending the markets into further turmoil. Picking up on one of Reuters' headlines on the morning of 1 October 2011:

> **"Worst quarter for UK, German, and French stocks in nine years"**

It is also the case that five-year credit default swap (CDS) spreads (a weather vane for marginal funding costs) for some of those banks participating in this research have moved between 50 and 100 basis points (bps) wider since interviews took place in July/August 2011 and, so, some of the pricing data is likely to be out of date. However, even though this may result in developers' financing costs being higher, directionally the impact on their business is expected to be the same as the findings in this report.

Summarising the results by category of contributor:

Lenders

- Of the 29 lenders who participated in this research, 16 banks are currently working on development finance transactions in the UK, of which 11 have already concluded deals in 2011 year-to-date. In aggregate, these 16 banks expect to issue over £2bn of finance by the end of 2011. Transaction sizes range from £250,000 to £125m, and 13 banks are lending regionally. Finance is available across all the main property sectors, with office and retail predominating.
- Five institutions contributed to the research but none of them is currently involved in development finance for commercial property nor has plans to do so.
- The majority of pricing lies within the following ranges:
  - upfront fees 100-300 bps;
  - margin 275-450 bps; and
  - exit fees from zero to 250 bps.
- Although pricing is increasing, many loans are becoming more recourse, with cost overrun guarantees (and sometimes interest shortfall guarantees) often unlimited.
- Four of the banks surveyed state that they are willing to look at speculative development, but no deals have been concluded so far this year.
- The regulatory minefield is still not fully known as banks are waiting for clarity on Basel III, with the final details yet to be published. However, all agree that the new capital adequacy requirements will only make lending more expensive.

Borrowers

- While some developers (also known as sponsors) have been offered pricing that continues to make their developments economically attractive, there are several that are finding the cost of finance too expensive. The reduction in loan-to-cost ratios (LTCs) to 55-65% means they have also to find significantly more capital to contribute to the project than they did before the crisis. This has resulted in developments being delayed and/or alternative sources of finance being sought.

Executive Summary (cont'd)

- Those with stronger balance sheets are taking opportunities to leverage up by accessing capital markets or using corporate banking facilities. Others are using equity, internal cash flow, entering into joint ventures with those who have access to finance or, where possible, using forward funding from insurance companies and pension funds (the institutions). While these investors generally buy properties at a 10-15% discount, providing the developer can make a profit of 15-20%, using the forward funding approach may be seen as a 'win-win' result.
- Those developers with access to alternative sources of finance clearly see themselves as having a competitive advantage compared to some of their smaller colleagues. Whereas before the crisis the highest bidder was likely to win an acquisition, today the most important criterion is availability of cash. Few vendors want to accept bids subject to bank finance.
- Speculative development is a particular challenge, with some sponsors considering preferred equity in the event that banks are not willing to provide debt finance. Others are considering using cash (assuming this is available internally) to commence building with the expectation that bank finance will become accessible once pre-lets are in place.
- Although there is a lack of development finance available, many developers take the view that this is a new world and that they will have to adapt their business models in order to survive. The winners will be those who come up with creative solutions to providing liquidity. For those with limited access to the debt capital markets or funding at a corporate level the challenges will be harder.

Introduction

Background

There is a widespread concern within the real estate industry that, since the debt crisis emerged in 2007-2008, there has been a general withdrawal by banks from the market to fund the development of commercial property. The purpose of this research is to establish what, if any, funding is available and, if so, whether such debt is economically attractive to borrowers; if not, then to consider the implications for borrowers. In addition, the study acknowledges that regulatory issues such as Basel III may have a substantial impact on future development lending.

To place the study in context, it is worth highlighting some of the relevant data findings on the UK commercial property lending market, as provided by contributors to the De Montfort University survey, published in May 2011 capturing around 90-95% of the UK lending market:

- At the end of 2010, the total value of debt (excluding CMBS and loans in the Irish Government's National Asset Management Agency, NAMA) outstanding against UK commercial property was £207bn, of which £28bn related to development finance;
- The value of new loans originated against all UK commercial property in 2010, both investment and development, was £20bn.

Methodology

The research adopts a forward looking approach, with the focus on how developers are funding their development pipeline and which lenders, if any, are providing this funding. In effect, this means examining transactions that have closed recently and also those where terms are currently in discussion. A degree of caution is necessary therefore, in the interpretation of findings since, by definition, some evidence is anecdotal rather than based upon actual deals.

As the basis of the research for this report, the author sought the views of key participants in more than 50 organisations involved in commercial property development, including banks, institutions and developers. The author and the PBF wish to thank these contributors for their invaluable insights into the current state of the development finance market. From the lending side, around 35 organisations were identified as being active lenders in the UK market. Of these, 22 banks, one building society, five institutions (all insurance companies) and one mezzanine fund contributed to the research. For ease, the building society has been classified with the banks since it is a lender of commercial property finance.

In terms of borrowers, 24 developers were approached, on the basis that they were known to be the most active in the market currently (or recently) in the development sector, as well as fund management houses also recognised to be major developers. Of these, five have headquarters outside London.

The majority of interviews were conducted between 18 July 2011 and 31 August 2011 with two further meetings in early September.

Lenders

Are Lenders Open for Business?

Twenty-three banks, five institutions and one mezzanine fund participated in this survey. Of these, 11 have already closed development finance transactions in 2011, 10 have no plans to be active in the development finance market at all and the remaining eight show encouraging signs for lending in the future. Five of this last group are currently working on terms for specific developer sponsors, although two of them stated that development finance is not part of their core business and so they should not be perceived as generally open for development finance business. Of the remaining three, one hopes to receive approval to proceed once Basel III rules become clearer, while, for the other two, future prospects are encouraging, given that some of their overseas branches are considering deals currently.

Table 1 looks at the nationalities of those participating in the research, with just over 50% (six lenders) of those organisations who had already completed development finance transactions in the UK by mid-2011 being non-UK banks.

Table 1: Breakdown of Lending by Origin of Capital

	Deals completed	Potential 6-12 months	Potential over 12 months	No intention	Total
UK banks	5	1	1	-	7
German banks	2	3	2	3	10
Other non-UK banks	4	1	-	1	6
Institutions & Mezz. fund	-	-	-	6	6
Total	11	5	3	10	29

Institutions

Turning to the institutions, none of those that participated in the research are active in development finance for commercial property lending, nor have intentions to do so. The majority are only involved in development finance in a 'forward funding' capacity. Typically, they look for a regular fixed-income flow from their investments to provide a better return than government bonds. Even where specific debt funds exist within institutions, the short-term nature of development finance is cited as a reason why it does not match the desired investment profile for their client base.

Mezzanine Funds

There are reported to be in excess of 30 mezzanine property lending funds in the UK and there is speculation that some of these funds will turn to development lending as a way of achieving their target returns. Specific research in this area fell outside the remit of the study, although the one mezzanine fund contacted stated that the mandate of their fund does not permit development lending and they are not seeking a change to this currently.

Lenders (cont'd)

Relationship Banking

Active lenders confirmed that they are open to new relationships as well as supporting existing clients. In many cases, relationship banking was emphasised as being of greater importance in the current economic environment than before the crisis. New relationships, as well as key existing relationships, are based on the sponsor having an excellent track record in completing developments in a timely and cost effective manner, as well as the ability to lease, asset manage and/or sell as appropriate to the nature of the sponsor's business.

In terms of further defining what 'relationship' means to lenders, it is clear that some are more focused on the relationship from a broader financial perspective, i.e. looking for ancillary business, be that taking roles in debt and equity capital market activity and/or the opportunity to work with the sponsor on international business. Most banks no longer want a minority role in a financing, i.e. being seen as 'just another lender'. This approach, of course, stretches across many lending platforms and is not limited to development finance. However, many developers do not have much ancillary business to offer.

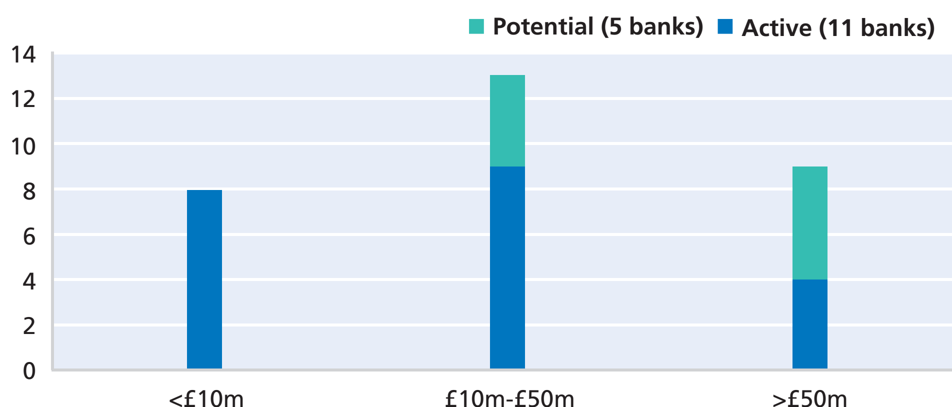
Lending Profile

An encouraging output from the research is the forecast of the total amount of development finance available for new lending. The 16 active banks predict an aggregate amount in excess of £2bn for the year 2011. While a significant quantum of this is anticipated to take place in individual deal sizes in the £10-£50m range, many lenders are also open for business below £10m. The minimum transaction size of these lenders is between £250,000 and £2m. Of those prepared to lend in excess of £50m, some will consider deals of up to £125m, but generally implied that this would only be for the best sponsors with excellent development opportunities. One banker defined its preference as:

> **"A sponsor with a good track record, the perfect location, the perfect development team and a substantially more profitable project."**

The distribution profile of lending by the banks is set out in Figure 1. The five banks identified as potential lenders are those mentioned previously as currently working on terms for specific developers.

Figure 1: Profile of Available Debt



N.B. The data reflects the intended strategy for the banks but, for the right sponsor, they would be flexible.

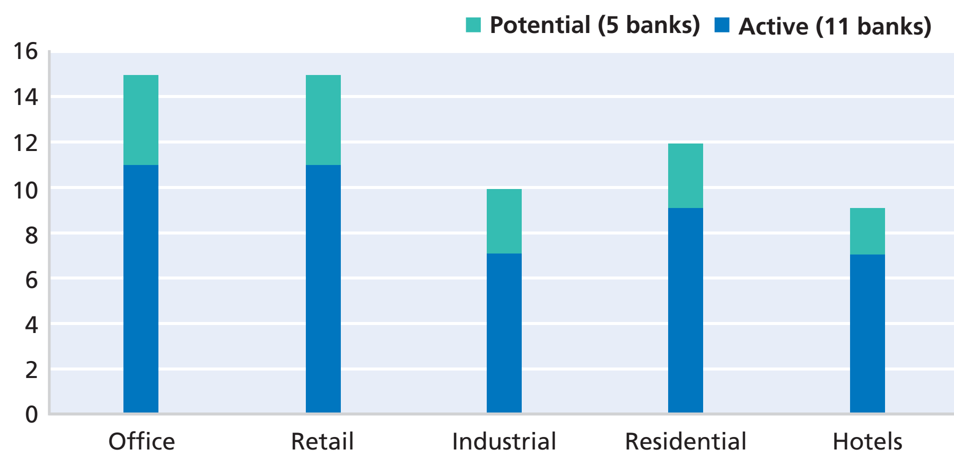
Lenders (cont'd)

Most lenders prefer to operate on a bilateral basis so that if consent to a variation in terms is required - often a feature in development finance - the matter is wholly within their control. If the size of a project exceeds a preferred level of exposure, banks may be inclined to create a club deal with like-minded lenders. Although there was some evidence of syndication, this was very much the exception.

Sectors and Regions

Of the 16 active lenders, six confirmed that they are prepared to lend in the five sectors specified, namely office, retail, industrial, residential and hotels. The predominant areas of interest are office and retail, but there is a reasonable level of interest across all property types, as shown in Figure 2. In the case of hotels, however, many participants use the word 'selectively'. Other areas of interest include student accommodation, data centres and care homes.

Figure 2: Profile of Support for Project Types



In terms of regional bias, three lenders focus exclusively on London, another mainly on London and the southeast, while the remainder tend to cover all, or most, of the major regional cities. Locations mentioned included Birmingham, Bristol, Edinburgh, Glasgow, Leeds, Manchester and Newcastle. Locations outside the major regional centres will only be considered for sponsors with good track records.

Pricing

Table 2 summarises the range of pricing and fees. Banks approach pricing in a variety of ways, with some taking all fees upfront and others splitting them between arrangement and exit fees. In a number of cases, the reasoning for the latter is to assist in the sponsor's cash flow management. In other instances, however, lenders may be prepared to waive exit fees in the event the sponsor converts the facility into an investment loan on completion of the development. Where banks' exit charges are based on a share of the development profits or on the exit value at completion, this is usually where the project is perceived to be slightly riskier, or if the bank is providing mezzanine finance as well.

Lenders (cont'd)

Table 2: Fee Analysis

Type	Pricing
Arrangement fee	100-300 bps
Margin	275-450 bps[1]
Exit fee	0-250 bps[2]
Commitment fee	50% of margin

[1] Two banks charge 'wider', i.e. higher.
[2] Or a possible share in development profit.

Margins vary according to the perceived risk profile of the project and start at a minimum of 75-100 bps above investment loan margins. Office, retail and industrial, all assuming pre-lets, tend to be priced at the lower end of the range, while hotels, residential and speculative office space attract the higher rates. Commitment fees, calculated on the undrawn balance of the agreed facility amount, are typically 50% of the margin.

While certain developers complain that borrowing costs are too high, one lender stated that margins were still too low to reflect the true risk of financing developments. Another made the comment:

> **"Developers are typically looking for a return on cost of at least 20%. Finance costs are only a small proportion of total costs, and therefore an increase of 1 or 2% in margins and fees does not result in a commensurate reduction in the return for the developer."**

Key Terms

When lenders determine their terms for a loan, they focus on the individual nature of the development projects. One lender made the comment:

> **"Once I am comfortable with the sponsor, the location and the development programme, I run the numbers through my model and, if it makes good economic sense, then I decide the amount I am willing to lend; and only then do I set the covenants according to what I think is appropriate for that specific project."**

Irrespective of the approach, once the covenants are set, there does seem to be a considerable level of consistency, with most banks lending in the 55-65% loan-to-cost (LTC) range. One bank said it would be prepared to provide up to 70% if the additional monies were to fund 'Category A fit-out', the assumption being that this would be for a specific pre-let. Three banks said they would consider mezzanine finance if they were also the senior lender.

Interest cover ratio (ICR) covenant tests are primarily a function of pre-let activity and might be used to control drawdown amounts and margins. Where once cost overrun guarantees were set in the region of 10%, some banks are now asking developers to take on more of the risk; guarantees with a 20% requirement are more the norm and sometimes unlimited. In addition, many are also asking for interest shortfall guarantees. Lending is therefore becoming more recourse to the parent than before the economic crisis, although lenders still expect special purpose vehicles (SPVs) to be set up to ring fence the development from the rest of the company, leading them to take a charge over the shares of the SPV.

Lenders (cont'd)

Table 3: Covenant Summary

LTC	Mainly 55-65% range
ICR	Not a specific focus, other than at least 1:1 for a partially let development. Used to set drawdown levels and margins as a building is let up
Pre-let	Level of pre-let set to match ICR coverage and drive drawdowns
Pre-sales (for residential)	Usually none required, but in some cases, some minimum thresholds may be set along with sales targets throughout the build period
Cost overrun guarantees	Minimum 10%, some 20%; more are becoming unlimited
Personal guarantees	Unusual, but used by some
Charges over shares in SPV	Yes

Four banks stated they would consider speculative non-residential transactions, one of which operates in the sub-£10m lending category. Notwithstanding this encouraging picture, no terms have been agreed to date with sponsors for speculative development.

Borrowers

Who is Looking for Development Finance?

Twenty-four property companies and funds participated in the research for this report. They comprised seven property companies with REIT status, 13 property companies of non-REIT status, three opportunity funds and one institutional fund.

Table 4: Analysis of Financing Requirements

	Finance required/ recently acquired	Finance not required, not actively developing	Finance not required, but actively developing	Total
Property Co. – REIT	1	-	6	7
Property Co. – non-REIT	9	1	3	13
Opportunity fund	1	1	1	3
Institutional fund	-	1	-	1
Total	11	3	10	24

Eleven of the 24 developer sponsors who took part in this research are actively seeking development finance or have recently secured funding; three are not active currently; and 10 are undertaking development projects but have no requirement to source development finance. The majority of this last group have access to corporate funding such as internal cash flow, corporate banking facilities, bond issues and/or private placements, while some also use forward funding provided by the major institutions.

Of those in the first group who are looking for development finance, a number also have access to corporate funding and/or forward funding. However, these sources are either insufficient in quantum or not suitable for certain types of project, especially where development is being undertaken through joint ventures.

The three sponsors who are not actively developing have made a strategic decision to focus on investment opportunities rather than development. For one, this is a permanent move, but the other two are waiting to see whether the market for speculative finance re-opens, thus keeping a flexible attitude to their future strategy.

In terms of who sponsors are borrowing from, in aggregate they confirmed the identity of a number of banks that contributed to the research who in turn had stated they were open for business.

Is the Price of Debt Affordable? If not, How are Developers Coping?

While some sponsors have been offered pricing that could work for them, and this was typically at the tighter end of the pricing spectrum, there are several who have found the cost of finance economically unattractive, thus making projects unviable. In one particular example, a developer was offered financing with a margin of 4.5% together with arrangement and exit fees also adding up to 4.5%. This finance was to support a development that was expected to complete in less than 18 months, thus the weighted average margin on offer was c.7.5%. In addition, the sponsor was expected to contribute equity of up to 40% ahead of any lender funding (i.e. the LTC would have been 60%).

Borrowers (cont'd)

While many borrowers understand that margins needed to rise, as a result of the increased funding costs to banks, many felt pricing had moved too far and that the size of the upfront arrangement and exit fees now being quoted can make borrowing costs prohibitive. One developer explains the problem as follows:

> **"With the dropping of LTCs from 80 to 60%, which has doubled the equity and therefore halved the return on any deal, how can developers also afford the significant increase in fees that we have seen in the last few years?"**

The concern about the significant increase in margins and fees extends to a number of schemes in London and the southeast and is not solely a regional phenomenon. Conversely there is evidence of deals in the regions being priced at affordable levels, e.g. arrangement fees of c 100-150 bps, with margins at 275-350 bps.

On some deals sponsors have turned down finance and are using their own equity. In other instances, some are simply unable to start development and will continue to look for cheaper financing. In two instances, sponsors found it economically more efficient to enter into a forward-funding deal with an institutional investor rather than take the debt package on offer; for one of these sponsors this included taking into account the cancellation and breakage fees of a loan already signed.

This trend can be seen elsewhere. Some developers who, prior to the crisis, used a combination of forward funding and development finance to fund their construction programmes, have moved much more towards the forward funding model. While institutional funds generally buy properties at a discount of 10-15% using the forward funding approach, as long as sponsors can make a developer's profit of 15-20%, this is seen as a 'win-win' result.

On a more positive note, some developers find themselves in a position of relative strength when seeking smaller development loans. Those with attractive investment portfolios to refinance can find that they become preferred borrowers in the current economic climate, thus allowing them to attract development finance on more agreeable terms from the same lender.

One sector for which sponsors seem to have relatively few problems finding development finance (providing the size is sufficiently small to be done on a bilateral basis) is central London residential. The high demand from wealthy non-UK investors makes this a very attractive market. While, in most cases, banks do not require pre-sales on residential deals, some sponsors have been actively selling off-plan in order to de-risk projects. What is unclear is how long the central London residential market will continue to thrive.

Sponsors were asked whether there had been a thaw in the market with respect to finance for speculative office space. Responses were that if there was some appetite for such financing, then it was highly selective. One sponsor in advanced discussions with banks was very positive, but was waiting for the outcome of credit committee approval and documentation before considering the market open. Although some developers may be fortunate, others are likely to have to look elsewhere for their finance. One market being considered is that of preferred equity, while other sponsors may simply have to delay development until they have secured a pre-let. However, this encourages letting at a discount, which, in turn, could result in projects being uneconomic. For those sponsors large enough, they have the option to leverage up other parts of their balance sheet to generate the cash required.

Borrowers (cont'd)

Impact on Business

Although there is a lack of development finance available at prices sponsors would like, many of them take the view that this is a new world and, in order to survive, they have to adapt their business models. The winners will be the ones that (a) have more cash to put into deals and (b) come up with more creative solutions to the liquidity crisis:

> **"We are masters of our own destiny and so we have to create liquidity."**

Many property companies have raised additional equity over the last few years, not only to build up their balance sheets but, also, to create surplus cash in anticipation of opportunities. They have also been raising funds in the capital markets, taking advantage of pricing opportunities in the US private placement and convertible bond market, as well as the corporate bond market.

So will more companies get themselves rated in the future in order at access the capital markets? Those developers with access to alternative sources of finance clearly see themselves as having a competitive advantage compared to some of their smaller colleagues. Whereas before the crisis the highest bidder was likely to win an acquisition, today the most important criterion is to have available cash. Few vendors are keen to accept a bid that is subject to bank finance.

The economic crisis has also brought with it some welcome changes: some developers who acted prudently prior to the crisis found they often lost out on land and property acquisitions to those using highly leveraged finance. A number of these heavily indebted developers are either in trouble or no longer around - and the same is true of some of the lenders who provided these loans. Those companies who acted with caution are now in a position to win opportunities again.

The price of land is also falling back to more reasonable levels, especially outside central London. One of the consequences of cheap finance was to push up the price of land, as well as rents and capital values. Many developers are pleased to have the opportunity to buy sites at reasonable prices before the next upturn.

Economic Environment

Generally, most sponsors believe that the availability of development finance will improve over time, albeit at a very slow pace, and may take three to five years to recover fully. One of the main concerns is the economy, partly because we have yet to see the full impact of the public sector cuts in the UK, but, more significantly, because the consequences of the sovereign debt crisis in Europe are yet to unfold. The regulatory environment is also a major cause for concern, with the general sentiment being that it will only worsen.

Conclusion

This research has identified that there is debt available for many developers but, with the exception of residential projects, pre-letting is a prerequisite. Finance has become much more expensive, however, and developers find it economically unattractive in many instances. While most developers and lenders expect some recovery in the lending market, this will be slow and unlikely to return to the levels seen before the crisis, either in terms of availability or price. In summarising the current market, one lender commented:

> **"It feels not dissimilar to the mid 90s, and 2002-2008 was just an aberration (or madness). Today there are fewer banks lending, leverage is at a more measured level and pricing allows lenders to make a return on their money. The relationship between lenders and borrowers is more balanced."**

While some borrowers still have the ability to leverage themselves in the capital markets, many developers will need to find new ways of doing business. As one developer said:

> **"It is a new world and there is likely to be less development finance around. Creative companies with the ability to adapt will be the winners."**

Although currently there is no evidence that institutions will step in to take the place of the traditional banking sources in the development finance arena, many banks and developers expect them to do so in the future. While institutions are engaging more fully in the investment side of the market, development finance does not fit well with the returns demanded by their investor base. It also requires a very different skill set and uses up far more resources than direct investment acquisition. Specialist debt funds may start to fill the gap but more research is needed to understand the opportunities in this market.

Notes

Notes

Research Programme
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