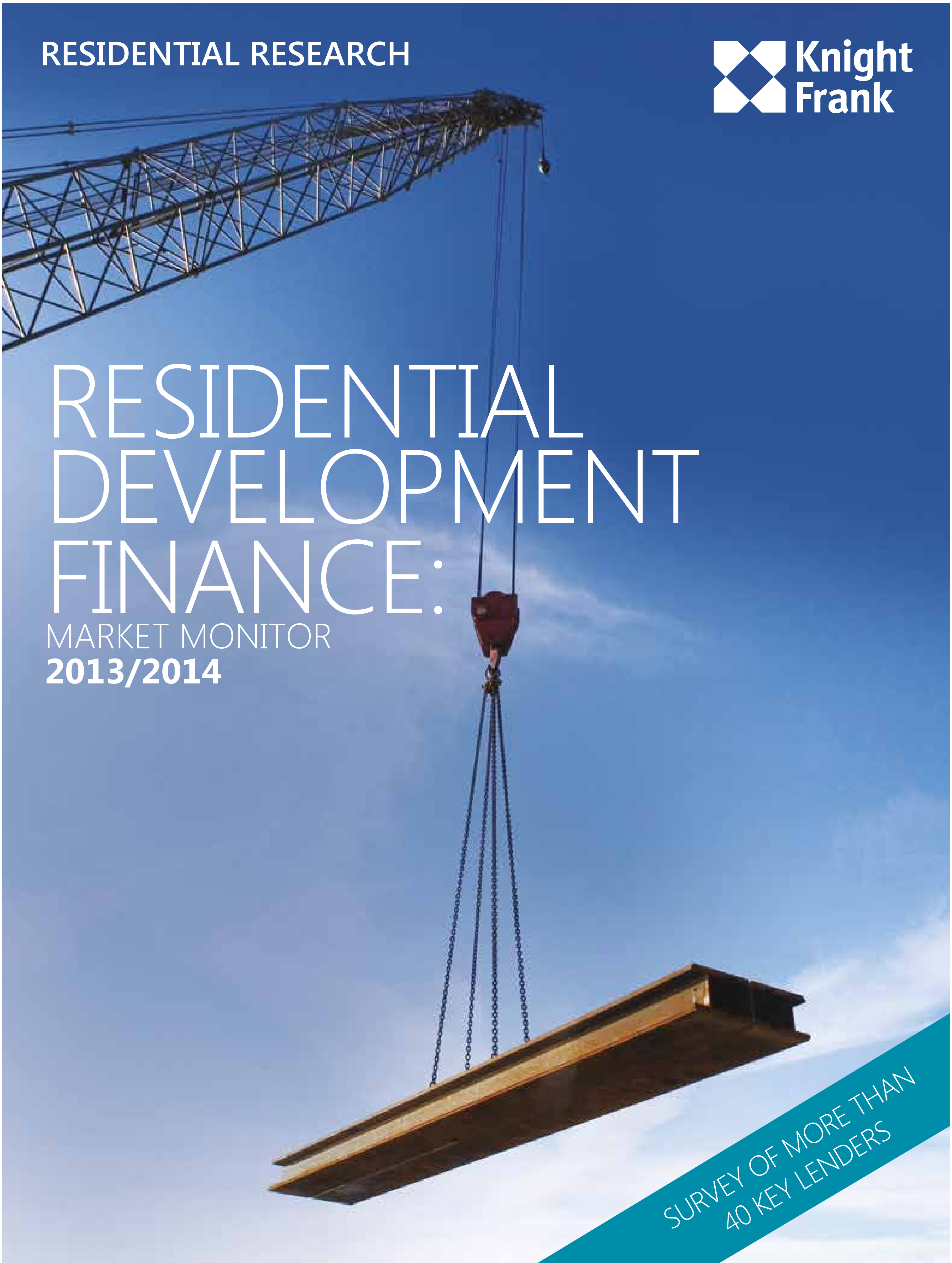
RESIDENTIAL RESEARCH

Knight Frank

RESIDENTIAL DEVELOPMENT FINANCE:
MARKET MONITOR
2013/2014



SURVEY OF MORE THAN 40 KEY LENDERS

DEVELOPMENT FUNDING SURVEY | RISK APPETITE AND GEOGRAPHICAL BREAKDOWN | OUTLOOK FOR 2014

UNLOCKING DEVELOPMENT FINANCE

Knight Frank's inaugural residential development finance monitor gives an unrivalled insight into the funding environment for developers and house builders in the UK. Gráinne Gilmore examines the trends

KEY FINDINGS

A net balance of 70% of lenders expect to increase their level of residential development finance over the next 12 months

The average interest rate charged for senior debt, across all loan covenants, is 5.29%. This rises to 10% for stretched senior debt

91% of respondents say they would consider funding mixed-use and multi-housing schemes

More than half of respondents will consider a scheme with planning risks

Residential development finance is coming from a wider range of sources than in recent years, reflected in the diverse range of respondents to our survey.

FIGURE 1
Survey respondents

Our unique survey of more than 40 funding providers, ranging from UK clearing banks to hedge funds, shows that the finance landscape is improving.

In the wake of the financial crisis, many clearing banks scrambled to cut their exposure to real estate, causing a dearth of funding. In the last few years some banks have returned to the fray in earnest. However they are now in competition with a wider range of funders, offering a range of finance options which are typically more flexible than traditional loans. Nearly 10 per cent of our respondents offer five types of finance, while a third offer two types of finance.

Sebastian Wallis, head of residential development valuations at Knight Frank, says: "We have seen a marked increase in the range of funders coming to us for specialist residential development valuation advice. Development finance is a sector that a growing number of participants find attractive in view of the risk/reward profile in a market that is facing a significant imbalance between supply and demand".

It is perhaps not surprising that respondents to our survey are most likely to fund schemes in London and the South East (fig 4). After all, these markets have demonstrated resilient demand throughout the economic downturn. However it is striking that there is some appetite among lenders to fund schemes outside these areas. This may well reflect the pick-up in demand for housing underpinned not only by government interventions, such as Help to Buy, but also be the improving economic outlook.

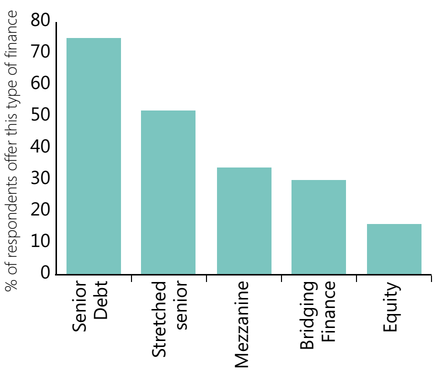
The growing acceptance of risk is also highlighted by the fact that just over half of providers would consider a scheme with planning risks (figure 6). Peter MacAllan, head of residential development finance at Knight Frank, says: "Three years ago this would never have been the case. In late 2010 it was a struggle to obtain senior debt on already consented schemes. Our developer clients look for value, so it is very encouraging to see increased lender appetite regarding planning risk".

So will the picture continue to improve? Our respondents suggest that it will. Four out of five expect to increase their exposure to residential development over the next 12 months, with less than 10 per cent saying that they will reduce finance in this area.

This 'unlocking' of finance will have a material effect on small to medium-sized housebuilders who have had funding struggles, especially outside the South East, since 2008/9. Yet we are some way off a market where funding is flowing freely. 'Best in class' schemes carried out by developers with a proven track record will continue to attract the most attention from funders.

The types of finance have also become more sophisticated, with our respondents offering five types of funding – however senior debt, and the relatively new 'stretched senior' debt is the most widely available.

FIGURE 2
What types of finance do you offer?

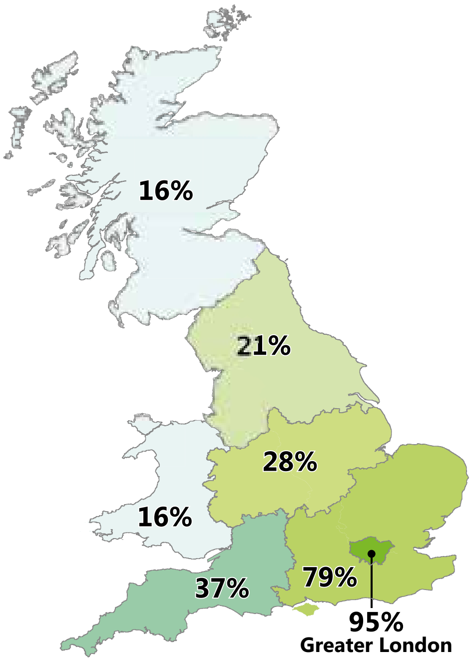


The availability of funding is set to improve next year as the majority of lenders are also planning to step up their lending in the next 12 months. Nearly four fifths of respondents indicated that they planned to increase funding for residential development.

FIGURE 3
Plans for the next 12 months

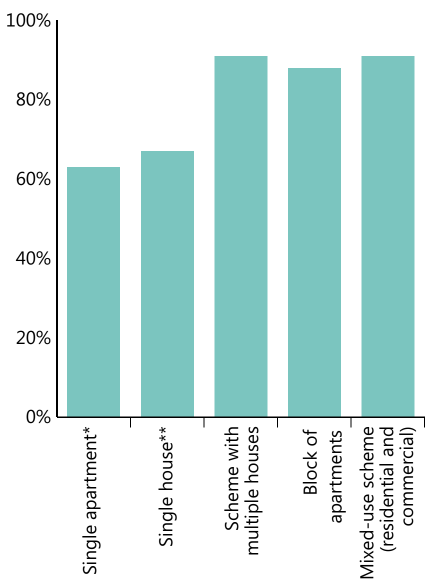
As for where they will extend funding – the majority will look to London and the South East, but there is also interest in schemes across the rest of the country, with one in five respondents indicating they would finance a scheme in the North of England.

FIGURE 4
Where would you consider finance in the next 12 months?



Multiple unit and mixed-use schemes are the most popular, with 91% of respondents saying they would consider funding such schemes.

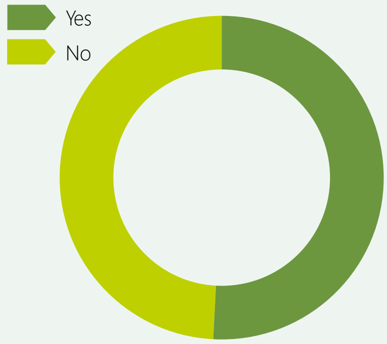
FIGURE 5
Types of schemes
% of respondents who will fund...



*refurbishment **development/refurbishment

Just over half of our respondents said they would consider a scheme with planning risks, quite a difference from several years ago when only the most 'oven-ready' schemes were considered.

FIGURE 6
Would you consider a scheme with planning risks?

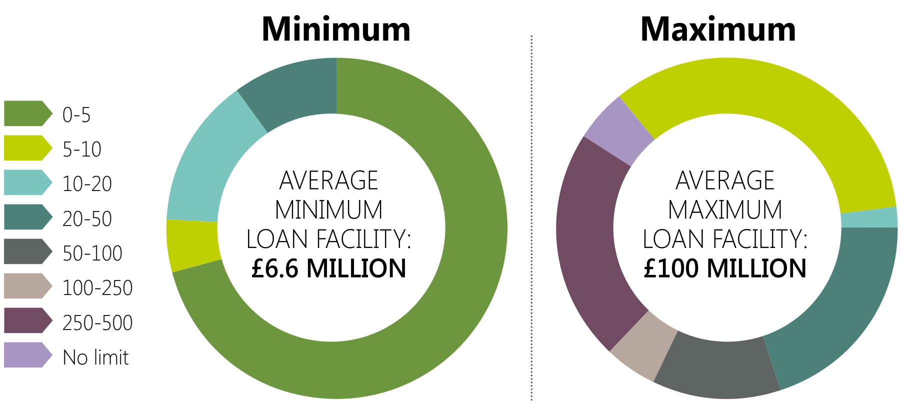


A lenders' view of risk will necessarily be subjective, and the risks can range from onerous planning conditions to concerns that planning may not even be granted. However Peter MacAllan suggests that lender appetite for risk may be influenced by some of these factors:

- There may be more appetite for risk on re-development schemes where there is an existing commercial use, meaning an exit strategy to revert to existing use is available
- Cautious day one loan-to-values (50-60%) usually underpinned by a 2nd exit strategy linked to the site's existing use e.g. re-configuration / refurbishment / re-letting of existing space
- New lenders with no legacy loan books are less constrained by lending policy limits
- There are better returns on offer to lenders willing to accept planning risk
- The Government's target for increasing housing delivery seems to be having a positive impact on planning approvals at a local level

The average minimum loan size is £6.6 million, while the average maximum loan size is £100 million, although a fifth of respondents said they would lend between £100 and £250 million, and 5% said there was no limit on loan sizes.

FIGURE 7 **What are your minimum and maximum loan facilities?**



Loan rates are heavily influenced by arrangement and exit fees, as well as Loan Covenants (LTV, GDV, LTC), but on average, the typical rate for a senior debt loan is 5.29%, while for stretched senior finance, it is 10%.

FIGURE 8 **Average loan rates and fees**

	SENIOR DEBT	STRETCHED SENIOR
Arrangement fee	1.20%	1.25%
Interest rate	5.29%	10%
Exit fee (GDV)	1%	1.40%
Exit fee (GLF)	1.40%	1.90%

Loan rate by LTC	LTC 60-69%	70%-79%	80%+	90%+
Senior	4.57%	5.25%	7%	
Stretched senior		7.50%	11%	11%

Source for all charts: Knight Frank Residential Research

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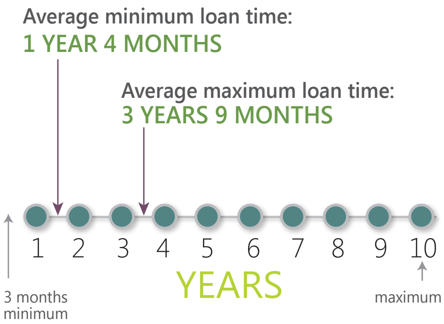
While developers can access funding from our respondents for any time-frame from 3 months to 10 years, the average time-frames are relatively short, as shown below.

And when it comes to more detailed arrangements, 81% of lenders said they would consent to a mezzanine arrangement behind their first legal chart, while two-thirds said they would fund a scheme where the equity is provided by a third party.

FIGURE 9
What are your minimum and maximum loan facilities in years?

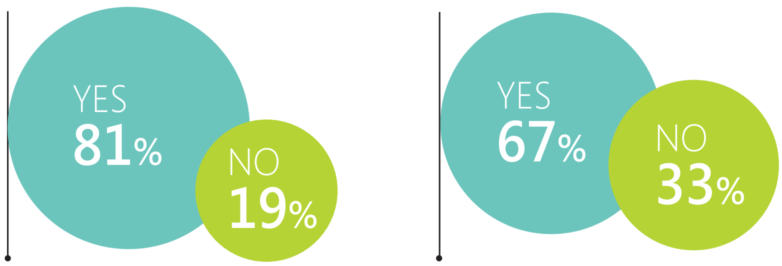


Source: Knight Frank Residential Research

FIGURE 10 **Will you...**

Consent a mezzanine arrangement secured behind your 1st legal charge?

Fund a scheme where 100% of the equity is provided by a 3rd party investor?



Source: Knight Frank Residential Research

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