RESIDENTIAL RESEARCH

Knight Frank

RESIDENTIAL DEVELOPMENT FINANCE REPORT

2016/2017

2016 SURVEY RESULTS | REGIONAL LENDING ANALYSED | BREXIT FOCUS

Knight Frank's survey of more than 45 key operators in the development finance sector found:

Lending for residential development in outer London and regional markets looks set to increase next year

Over two-thirds of respondents have seen business activity increase since the EU Referendum

Over a quarter of respondents expect the loan-to-value to fall as lenders look to lower their risk

VIEWPOINT

PETER MACALLAN
Head of Structured Development Finance

"Following the referendum result we have seen lenders, in some instances, taking a more cautious approach and reducing leverage levels by 5-10% of project cost.

This has resulted in more developer equity going into projects, giving lenders more comfort regarding sales risk in a more uncertain environment.

Alternative lenders and projects have been at the mercy of their often "multi strategy" investors, while some loans have been put on hold, others have been pulled altogether."

Overview

The last year has been one of change, both politically and economically, including the vote to leave the EU and the appointment of a new Prime Minister and Cabinet. The road to Brexit is still unclear, but the fundamentals of the housing market remain largely unchanged, with the overriding need for new homes to be built remaining front and centre of policy.

The Government's recognition of the role that small and medium-sized housebuilders have to play was underlined as they revealed a new fund to help finance development. But the role of lenders in this market remains fundamental.

In order to assess the residential development finance sector we have surveyed almost 50 major operators in the market. The results suggest appetite amongst lenders remains strong, despite the recent political and economic uncertainty. There remains a wide range of funding on offer, ranging from senior to mezzanine and bridging finance, while more lenders are willing to consider funding schemes on a wider geographical basis than in 2014 and 2015.

With Article 50 due to be triggered next year, formally launching the UK's detachment from the EU, the expectation is that this will create further periods of economic uncertainty. However, given the UK's long term under-supply of housing, residential development remains an attractive option for investors.

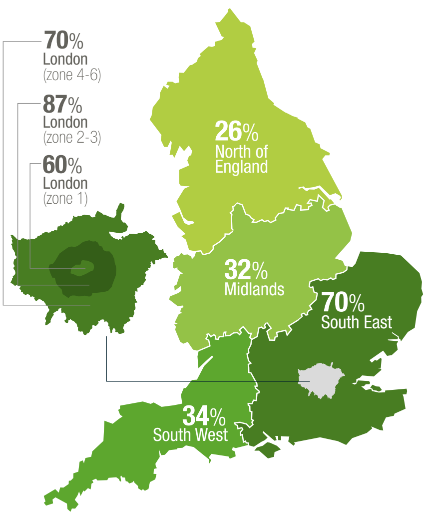
A national perspective

As highlighted in figure 1, which shows where residential development finance has been arranged in the last 12 months, London remains the primary focus for lenders. However, there is growing interest in the regions. It is worth noting that in the 2015 survey, 78% reported that they had operated in central London (zone 1) over the previous year. This year, that proportion fell to 60%, perhaps reflecting a slight slowdown in activity in this market.

While there has been a modest rise in activity in inner London, encompassing zones 2-3, it appears the South East is becoming a key market for residential development. 70% of participants had arranged finance in the region over the last year, up from 59% in 2015.

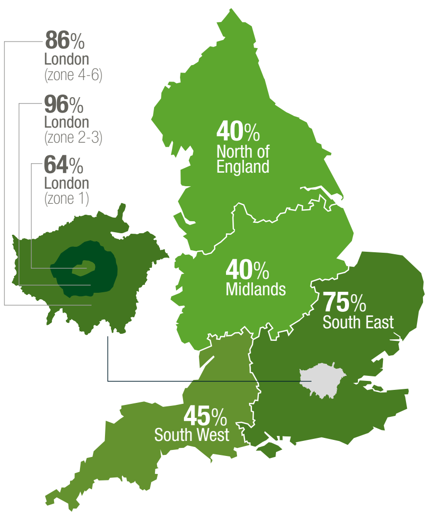
Outside London and the South East, lending activity has risen once again in both the Midlands and the North of England. This is indicative of the improving picture in both markets and increasing levels of residential development, particularly in the Midlands.

FIGURE 1
In which locations have you arranged residential development finance in the last 12 months?
% of respondents



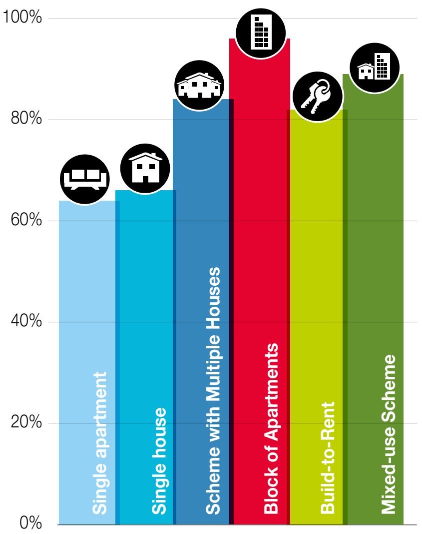
Source: Knight Frank Research

FIGURE 2
In which locations do you expect to provide residential development finance in the next 12 months?
% of respondents



Source: Knight Frank Research

FIGURE 3
Which of the following will you fund?
% of respondents



Source: Knight Frank Research

The outlook for the next 12 months suggests a further movement towards London's commuter belt. Inner London is poised to remain the most popular market with 96% of respondents expecting to arrange finance in zones 2-3.

However, almost nine in 10 of those surveyed believe they will arrange residential development finance in outer London (zones 4-6), a significant increase from seven in 10 over the previous year.

In the South East, activity is likely to remain at a similar level seen over the last 12 months, while results from the survey suggest the South West, Midlands and North of England will see activity levels increasing once again.

In central London lenders anticipate a modest rise in development finance in 2017, albeit below the levels expected in the wider London and South East markets.

This reflects the trends that have been in evidence over the last 18-24 months, with house price growth in outer London and the South East outpacing the central and inner London markets.

Despite the expectation for a small rise in activity in central London next year, the majority of respondents expect the residential development finance sector in central London to be most affected by Brexit.

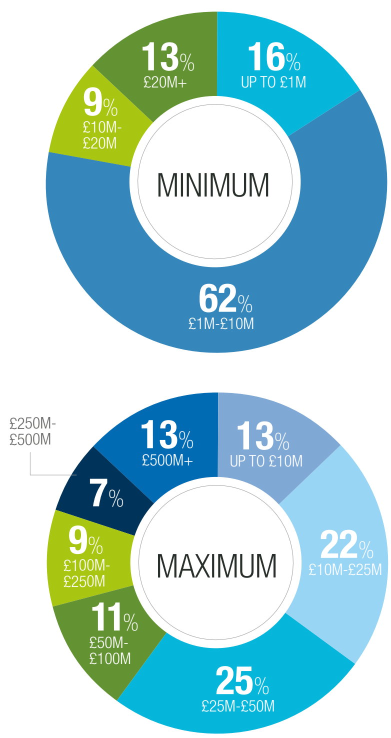
Regarding the type of developments that lenders will fund, blocks of apartments remain the most-popular option. Additionally, multiple houses and mixed-use schemes are also prevalent. The appeal of mixed-use schemes in London is significant given the number of regeneration projects currently live across the capital.

Over 80% of respondents said they will fund build-to-rent developments, an increasingly attractive sector given its flexibility and faster build periods. Interestingly, 22% of those willing to finance a build-to-rent scheme said they would be willing to invest in developments with GDV exceeding £100 million.

This compares to 26% for blocks of apartments. The latest Knight Frank Tenant Survey emphasises the growing importance of the Build-to-Rent sector, suggesting a further £5 billion will be invested by 2020.

When asked whether they would provide finance for a scheme with planning risks, 60% of those surveyed said they would do so, provided that the viability of the scheme is not affected.

FIGURE 4
What are your minimum and maximum loan facilities in millions(£)?
% of respondents



Source: Knight Frank Research

VIEWPOINT

SEBASTIAN WALLIS
Head of Residential Development Valuations

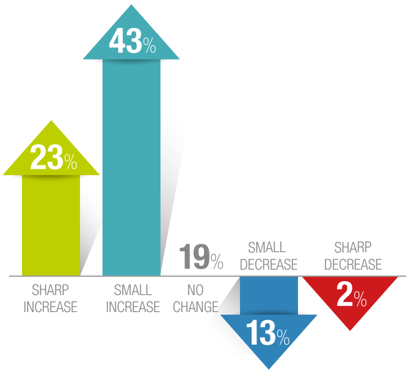
"Deal flow since the Referendum has slowed and many of the clearing banks are reassessing their lending terms. Credit papers and term sheets are being scrutinised to ensure that risks remain within acceptable limits.

Despite this, we are seeing activity across all of London's sub-markets including the core prime post codes, where the alternative lending market has filled the gap as traditional sources of development finance gravitate towards inner and outer zones of London where there is currently less sensitivity around pricing. The results of the survey suggest that this trend may continue."

The post-BREXIT vote landscape

FIGURE 5

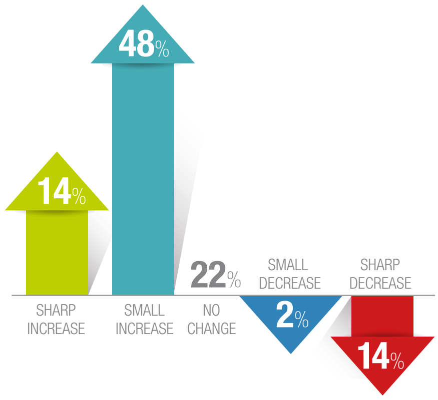
How do you expect your busines activity to develop over the next 12 months?



Source: Knight Frank Research

FIGURE 6

Has your business activity changed following the EU Referendum?



Source: Knight Frank Research

The over-riding view among lenders suggests they have adopted a bullish outlook for the market in the wake of the vote for Brexit. When asked if the Brexit vote result had led them to consider leaving the sector, the answer was an unequivocal no.

Meanwhile, in the three months after the referendum, nearly two thirds of participants have witnessed an increase in business, with only 16% seeing a fall. Of those to experience a drop in activity, reasons for this include less inward investment from overseas investors while others have noticed signs of adjustment in activity levels in London.

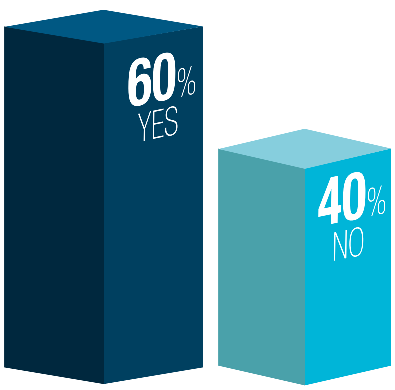
Over the next year some 68% of respondents believe their business activity will increase, with nearly a third of these saying they expect a sharp rise in activity.

While the prevailing opinion amongst respondents suggests loan-to-value to GDV will be unchanged by Brexit, just over a quarter believe the loan-to-value will fall, as lenders look to lower their risk.

Overall, the results of this survey portray a positive outlook for the residential development finance sector. Financers expect business levels to increase over the next 12 months while activity is expected to rise throughout the country, particularly in outer London. Meanwhile, lenders have been predominantly undeterred in the months following the EU Referendum.

FIGURE 7

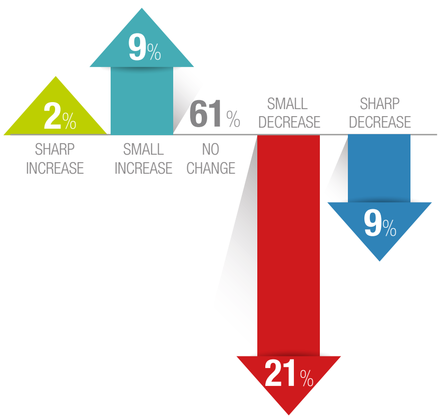
Would you consider a scheme with planning risks?



Source: Knight Frank Research

FIGURE 8

Will the loan percentage to GDV be affected by Brexit?



Source: Knight Frank Research

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