All fund and games

Five years ago, property development funding was a free-for-all; now, all but the most attractive developments cannot secure funding. How did this happen so fast, and what does it mean for developers, now and in the future? **Lucy Trevelyan** investigates

Of all the industry sectors, property development probably took one of the biggest hits during the recession. Land values plummeted, making many development proposals suddenly unviable; schemes were shelved – often indefinitely – as likely profit margins narrowed or disappeared; and banks which had previously fallen over themselves to fund development schemes suddenly tightened their purse strings and pretended to be out if developers came a-calling – unless, of course, those developers had oodles of equity and a vast number of pre-lets.

So now we are out of recession, are things looking up? As Andrew Hutchinson, real estate partner at Dechert's London office, puts it: "Development funding all but came to a complete halt at the start of the credit crunch and during the recession, but we are now seeing a gradual and cautious return, albeit on a far more selective basis and on much tighter terms."

Property development funding is certainly still less than buoyant, with some potent hindrances hitting the sector, including greater regulation, higher funding costs, low tenant demand and a fall in property values and returns.

All this means that loans are still difficult to come by, although there is, perhaps, some cause for cautious optimism: a recent study, published in March, by the Investment Property Forum and Association of Property Bankers – 'Property Banking Forum: Lending Intentions Survey 2011' – found appetite, among the 27 lenders surveyed (24 banks and three insurers) for new lending for the UK's commercial real estate to the tune of £18-£21bn in 2011 – an increase of around 30-50% on the lending undertaken by the lenders in 2010.

This sounds like good news, but, as Simon Johnston, head of real estate finance at CMS Cameron McKenna LLP, points out, a large proportion of the available debt identified by the survey will be required to refinance, and "amend and extend" existing loans – recovery to date appears to be "mainly limited to the cream of the prime property sector".

CREAM OF THE CROP

And that "cream" doesn't encompass very much – Johnston says it is limited to the best deals on the most favourable terms. He identifies a preference among those surveyed for "pre-let developments, [especially] central London offices". Hutchinson agrees. "There is some speculative development of prime office space in London, where commentators have suggested that under-supply is likely to lead to increased demand, and therefore increased rental values when a large number of leases expire in a couple of years."

Forsters LLP partner Victoria Edwards also agrees that there are still specific developments which are clearly more attractive to banks, but identifies a different type: high-end residential developments (or one-off houses) in affluent areas, particularly Mayfair, and other similar parts of central London and Surrey where the market is not depressed (in fact, quite the opposite). Sheds pre-let or pre-sold to supermarkets are also still popular, she adds. And all such developments will need to be substantially pre-let or pre-sold, and with "a defined exit strategy".

But for some banks, high quality, great location and substantial pre-letting or pre-selling are still not enough. Wragge & Co real estate finance partner, Colin Hurt, says that those development finance transactions that are coming to fruition at the moment are predominantly on a relationship-banking, existing client basis. And according to Falcon Chambers' Timothy Fancourt QC, vice-chairman of the Chancery Bar Association, to get funding, developments will also need to have a conservative funding structure (that is, lots of equity) and a developer or sponsor with a proven track-record and deep pockets.

"In residential, similar tough criteria apply," he adds. "Selected lenders are attracted to central London and prime south-east markets; others are staying away altogether."

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And even if the banks are prepared to provide funding, criteria attached to lending may still be off-puttingly tough, says Edwards: "The banks are reflecting the risk in the pricing – 3.5% above LIBOR [the London Interbank Offered Rate] at least, plus large arrangement fees and large exit fees."

Hutchinson adds: "They are generally far more risk-averse than previously, demanding lower loan-to-value ratios and wider margins. The cost of borrowing has increased significantly."

Meanwhile, Fancourt says, the numbers of lenders has dramatically reduced, largely because there is now little incentive for banks to provide development finance.

"In commercial, most banks are out of the market altogether, and some well-funded property companies are stepping in to an extent, but with tough terms and very selectively. In residential, the position is a little better, with experienced lenders back in the market, though with tough criteria."

ONCE BITTEN

So why the (some might say) excessive caution among the banks? One obvious reason is regret over their former willingness, five or so years ago, to throw money at all types of development – even fairly on-spec developments.

As Fancourt says: "Criteria 10 years ago were more flexible, and five years ago, much more flexible – almost any scheme could obtain 90%+ funding then."

This has left many banks in a difficult position, says Edwards. "Lots of banks were left with half-built developments on their books, and there was the difficult decision of whether to mothball it, have a fire sale or continue to pump money in and build it out to attempt to recoup their underwater loans. I expect many of these are still on the banks' books."

The banks' exposure also extends to developments for which they have promised funding, but which are yet to be built, as Johnston points out. "On a number of development projects, loan commitments put in place between 2006 and 2008 remain undrawn, with the developments having been delayed awaiting an improvement in the property market, and the lenders involved are still required to set aside capital for this exposure."

John Ralph, head of property at Dickinson Dees, says that, although it might seem that lending criteria are now unusually conservative and restrictive, this may just be by comparison with terms given during the prolonged boom years – some would say that they are now, in fact, simply more realistic.

He says: "Contrary to popular commentary, it would be perverse to pressurise banks to lend in greater volumes through politically motivated targets, as this would slow or reverse the move back to more prudent lending, especially given the criticism levelled at the banks for the excesses of the boom years."

Charles Bezzant, real estate finance partner at Reed Smith, says the banks that are in the market for development funding now are largely the ones that did not over-lend five years ago, and seem relatively confident that their cautious approach then and now will keep them safe. "Nobody is 'filling their boots', and credit committees remain cautious, but former lenders are returning to the market in increasing numbers," he says.

TOUCHING BASEL

A complicating factor in the property development sector, says Johnston, is that all deals are being considered against the backdrop of the new regulations of Basel III, the global regulatory standard on bank capital adequacy and liquidity.

The changes to the international regime regulating the capital requirements for lenders, he explains, are redefining both the total amount of debt a lender can allocate to real estate, and the type of real estate loans. "As a result, it will be more expensive for a bank to lend longer term and on riskier real estate, which includes development projects".

The Basel III rules will be introduced in 2012, and although they don't come into force fully until 2019, banks are currently preparing themselves by reviewing their loan books and rearranging their business accordingly.

LOSING FAITH

The caution in the marketplace goes both ways, says Ralph; a significant number of borrowers have lost faith with traditional high-street banks – unsurprising perhaps, given that even some of those funders which have been more accommodating towards existing real estate investor and developer customers have limited capacity for new facilities.

"This starves companies of working capital for expansion, at a time when entrepreneurial businesses are looking to exploit opportunities in the marketplace. Likewise, the cost of funds charged to the banks means that borrowers face increased margins if facilities are to be secured from traditional sources," he says.

EXAMINING THE OPTIONS

All this has led, says Ralph, to significant numbers of investors and developers deleveraging away from institutional borrowings and turning, instead, to private sources of funding, through joint venture vehicles and simple debt or equity structures.

"The terms for such funding, while delivering a significant return to the private funder, are more flexible and avoid some of the strings attached to institutional funding, such as early redemption penalties, exit fees, contractual constraints and significant arrangement fees. This allows property investors and developers the ability to manoeuvre with greater speed in a moving market than might otherwise be the case with traditional facilities," he adds.

Hurt has seen the same trend. "The main providers of real estate development funding in our experience appear to be sovereign wealth funds and high net-worth individuals forming partnerships with developers who are unable to obtain traditional sources of funding. This type of funding can be geographically

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sensitive – that is, which country will present the best returns on the development.

"We also have experience of UK insurance funds forming limited partnerships with developers for commercial developments in eastern Europe. The provision of debt is also often linked to an equity return," he adds.

Hutchinson says joint ventures are now a feature of most large developments, as developers seek to spread the risk, as well as bring in additional sources of finance.

"Those advantages generally outweigh the disadvantage of loss of total control over the project, but it is essential to have robust procedures to resolve disputes, so that they do not paralyse the development.

"Developers unable to find bank financing on reasonable terms to purchase and develop a site may instead agree with the landowner that it will fund the works in return for a profit share. This can provide a good solution for both parties, but there are various risks involved, such as the risk of the other party's insolvency, and disagreement over allowable costs."

There are still various sources of public finance available for development, he says, including the Regional Growth Fund, which offers a limited (£1.4bn) replacement for the funding previously provided by the Regional Development Agencies, which have now been abolished.

"There is also the EU JESSICA [Joint European Support for Sustainable Investment in City Areas] programme. Under its umbrella, the Northwest Urban Investment Fund will use finance from the European Regional Development Fund (ERDF) to match finance from banks and pension funds for projects on brown field sites in the north west. One disadvantage here is that the ERDF insists that new developments must meet the Building Research Establishment's Environmental Assessment Method 'excellent' rating, and refurbishments must rate at least 'very good'."

Tax increment financing (TIF) is another potential source of funding, he says; it has not yet been used in England, but there are plans to use it in Scotland to fund the upgrade of Edinburgh's waterfront and the redevelopment of the former Ravenscraig steel works. He explains: "TIF allows local authorities to fund development by borrowing against the projected increase in business rates which will be generated by the completed development. The scheme has been used successfully in the US, but there it allows for developers, rather than local authorities, to borrow the funds to pay for infrastructure works, and they are later reimbursed out of increased business rates. The model to be used here is less flexible, as it only provides for funds to be borrowed by the local authority."

POLITIC SOLUTIONS

Meanwhile, the coalition government, since it came into power in May of last year, has made a number of proposals intended to help breathe fresh life into the traditional funding sector.

However, some of its actions thus far – including the scrapping of several government investment schemes, such as the Building Schools for the Future programme, and the crackdown on government departments taking new leases – have helped depress the market further.

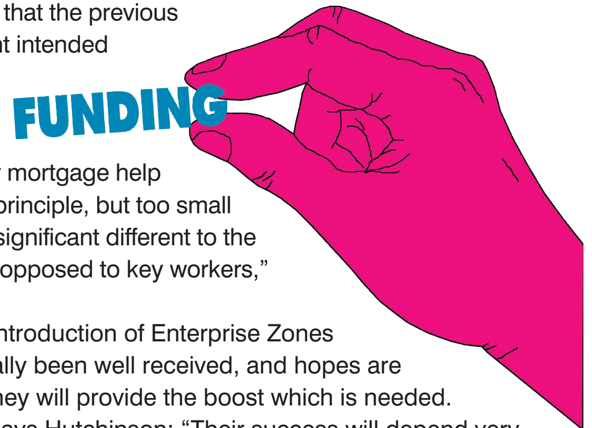
And even the changes it proposes to make to improve the situation – including tweaks to the stamp duty land tax regime, simplification of the planning regime and deferred consideration to promote housing development – may not have the desired effect.

"In reality, a lot of the proposals are not well thought through and, as ever, the devil is in the detail," says Ralph. "Without further clarification of some the proposed legislation and how it will operate, real estate activity could end up further depressed."

For example, he says, the Localism Bill runs to over 400 pages and has received almost universal criticism. "One of the consequences of it could be to thwart large-scale regeneration projects, through the involvement of local objectors or, indeed, individuals or community groups seeking to exercise their right to purchase assets under the terms of the legislation."

Judith Gershon, real estate finance partner at Davenport Lyons, says the general feeling is that the government has not done a lot, apart from giving Home Buy Direct a further lease of life, but even that is quite limited.

"The Localism Bill is expected to restrict the opportunities for new residential development on the large scale that the previous government intended (though it did not deliver it). Key worker mortgage help is good in principle, but too small to make a significant different to the market, as opposed to key workers," she adds.



The reintroduction of Enterprise Zones has generally been well received, and hopes are high that they will provide the boost which is needed. However, says Hutchinson: "Their success will depend very much on the detail of the incentives to be provided to businesses within the zones."

Another proposed initiative is land auctions, whereby local authorities invite landowners to propose a price for their land, which is then auctioned to developers with the benefit of planning permission, enabling the authority to realise the increased value generated by the grant of planning permission. The idea, however, has been widely criticised, mainly because it is hard to see why the landowner would agree to forego the additional value attributable to the development potential of the land. Hutchinson says: "It is unlikely that the scheme could be workable, unless the local authority decided, for commercial reasons, to grant planning permissions which would not otherwise have been available, and that would presumably be open to challenge."

Predictions for the future of the real estate funding market are mixed: the development of more innovative funding solutions, greater overseas investment and more collaboration between different parties are expected, but overall, most feel the road to recovery will be a slow one.

As Johnston says: "Few are expecting a swift recovery in the commercial property lending market; it is safe to expect that the more conservative and cautious approach will prevail for the time being, particularly for development." ■

Lucy Trevelyan is a freelance journalist.