Development Finance: Scarcity and Opportunity

Andrew Antoniades reviews the availability, challenges and opportunities for the UK's development finance market against the twin pressures of Covid-19 and being late in the economic cycle.

Development debt will be harder to find and more costly for most, and some asset classes will be able to attract more than others, but it is there for those who know where to look.

It feels we are at a crossroads with real estate development finance, where a perfect storm of factors is coming into play: new lending becoming scarcer, end of cycle market forces compounded by Covid-19, set against a movement towards Impact Funding that supports development.

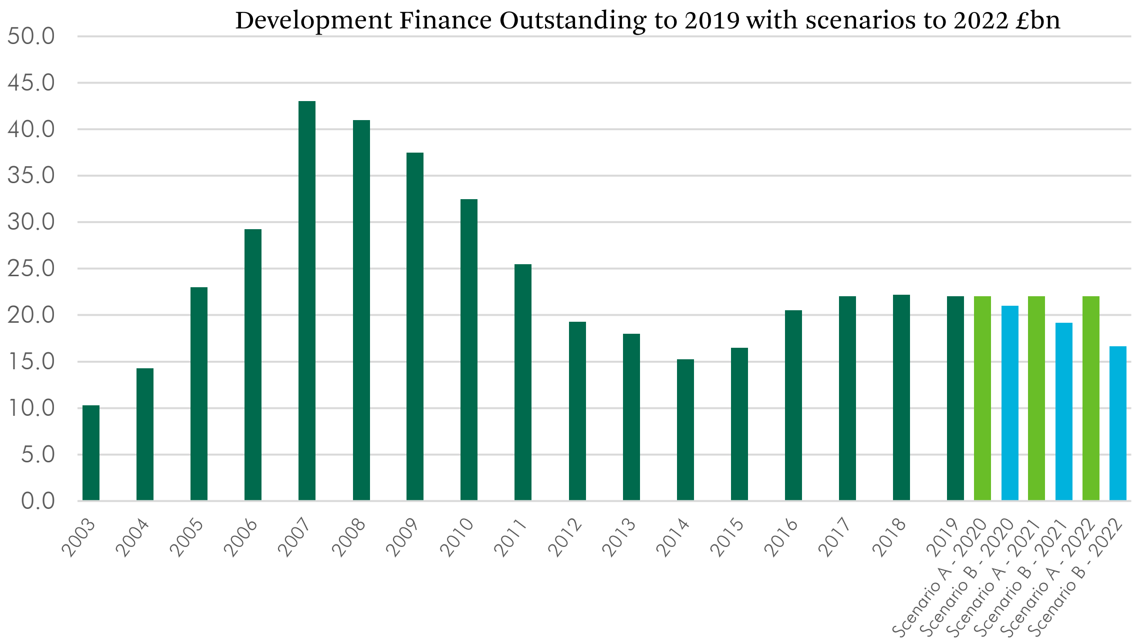
Development finance availability has contracted in the space of a few weeks since Covid-19 made its way to the UK. Few lenders are willing to commit to new opportunities and many are focusing on their existing loan books. This is particularly true for development finance, where lenders are facing many inhibitors:

- Challenges of financing something for a fixed period of time where the exit dates and values are uncertain.
- Valuers now including material uncertainty clauses.
- Banks being scrutinised by regulators for capital adequacy and their borrowing costs increasing.
- Scheme level issues such as delays due to Covid-19 and contractor insolvencies.

COST OR AVAILABILITY

Although lending seems to have dried up at present, it is true that some lenders are still active. They see the chance to increase their returns to reflect the greater risk or finance developments they would have not been competitive enough on previously. Borrowers who want to proceed with their schemes, in some cases, appear willing to pay higher interest rates, where 400 bps can easily become 500 bps or more. This is a trend we saw in the aftermath of the Global Financial Crisis (“GFC”) where pricing of debt seemed a secondary issue compared to its availability.

Looking back a decade, the gap in the debt market was routinely talked about as everyone questioned if availability levels would return to the levels borrowers had previously become accustomed to. The answer to that is perhaps it will remain at a new lower base. Whilst overall liquidity did rise from a low point as confidence returned and new lenders entered the market, it still never reached anywhere near its previous peak levels. Banks fundamentally changed their approach to lending, curtailing leverage to far more conservative levels. This meant there was far more equity being provided by developers and a greater reluctance to finance schemes that had not been de-risked in some way, either through pre-lets or pre-sales.



Source: Cass business school and CBRE

Figures include aggregated development finance from Pre-let commercial, speculative development and residential for sale. Scenario A assumes 2019 remains stable from years 2020 - 2022.
Scenario B showing a theoretical decline, by applying the same % decrease year on year as seen from 2008 - 2010.

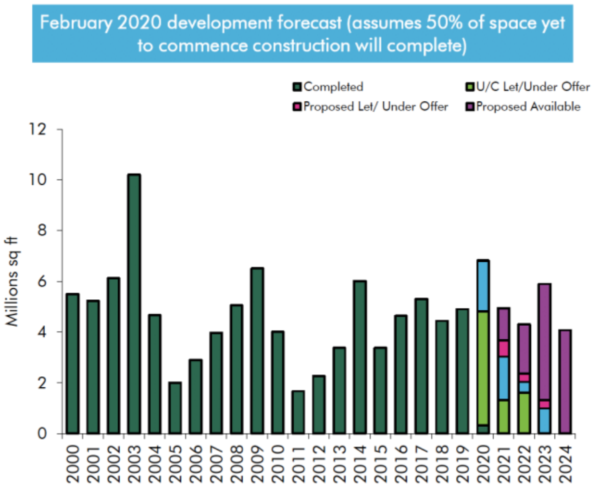
The Cass Real Estate Lending report for year ended 2019 highlights how the market has evolved in recent years (see chart above). Debt Funds and other new lending entrants did provide significant capital, though not enough to offset the reduction in debt provided by banks, which has ensured that finance has remained at a new lower norm. The Covid-19 crisis may not only crystallise this new lower level but could also see it reduce further, at least in the shorter term.

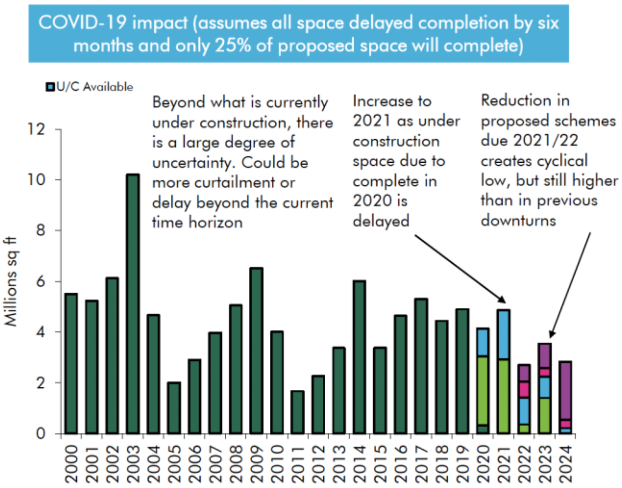
However, it must be said that this is different to the GFC. The clearing banks are not as dominant as they were in the lead up to the GFC and there are established debt funds which are active in the market. How they will react, and what other new entrants may emerge, are significant unknowns. There is the possibility they could provide material liquidity to “fill the gap” as they did in the last downturn.

Looking ahead to development debt in the coming years, if the same pattern seen in the years after the GFC is repeated, new lending will likely fall, and outstanding aggregate loan books will reflect that contraction. The question is whether that reduction will eventually reverse in part or become a new rebased norm. What we can expect though is an increase in the cost of debt for borrowers. As with any commodity, the scarcer it gets the more expensive it becomes.

DEBT DEMAND

It is useful to consider the need for such finance from the other end of the equation. How much development will there be to actually fund in the short to medium term? Although there will be a contraction in the availability and terms of development finance, the question is what will this imbalance be between liquidity and the requirements of sponsors willing and able to bring schemes forward?





Source: CBRE Research

Despite any potential downturn, there will still be development, demonstrated by the Central London Development Pipeline (above) which shows estimations from before the Covid-19 impact compared to the current view. The pipeline will reduce, through a combination of developer and lender reluctances to take speculative risk, reduced demand in leasing and the impact of building site closures. Therefore, although there will be less debt for development, this decrease will be offset, at least partially, by some contraction in the demand for it.

Commercial	Residential
• Speculative offices will become harder to finance with banks reluctant to take such risks. • However, the schemes that have very strong business cases, such as those with a clear pre-let and those in growth industries (such as technology, science and logistics) will make them attractive irrespective of external market forces.	• Despite the under-delivery of homes to meet demand, if a residential scheme is funded, the exit of that loan requires homeowners to afford the units and obtain mortgages. Both factors will become more uncertain in a downturn. Therefore, even if developers of these residential schemes can find the finance to build, will their purchasers by able to obtain mortgages to buy their units?
• Likewise, local economies will be keen to make sure they are providing the commercial space that is needed to retain occupiers, build state of the art assets to attract businesses and stimulate their local economies in a period where it will become increasingly vital. Local government will intervene and finance where it can to stimulate the pipeline of such properties.	• The counter to this is more of a shift towards build-to-rent, as that takes away the end user risk of house price uncertainty and mortgage product availability. Developers may repurpose "for-sale" schemes to "for-rent" models.

POST COVID-19 WINNERS, LOSERS AND NEW BEHAVIOURS

Coronavirus will drive a behavioural change that will impact what buildings we need and are consequently financed. Some sectors will come out strongly, others will continue to be challenged and new ones will emerge. Shifting work patterns and distancing could mean we need less office space or potentially the same amount but with fewer occupants. Similarly, development finance may become more selective and made more readily available to schemes that are future-proofed for these new societal norms.

Looking to alternative asset classes, we will see increased interest and demand for science, laboratory and tech space. The UK Government will reflect on what private sector resources have been available in the UK during the pandemic and attracting pharmaceuticals and science-based businesses will become high on the national agenda. These businesses will need specialised new buildings and consequently there could be a rise in finance providers specialising in this.

SEIZING THE MOMENT

Caution at this moment in time is understandable. However, timing is crucial for developers to emerge with the right asset for the market at the optimum time, while more cautious competitors have waited.

A typical development loan would be around three years to allow for a build period and some stabilisation. When things start to recover, developers who have brought schemes forward may find that new, high quality assets are scarce, and they consequently hold more power in securing tenants. Developers will need to assess their window of opportunity carefully.

This exact same scenario applies to lending: wait too long and other lenders will have taken the opportunity. If competition returns quickly, attractive loans will be harder to make. The concept of first mover advantage, as with any other industry, is key. Those who can accept the risks and access debt, perhaps using their corporate strength with, perhaps offering recourse to attract debt on better terms, will have the best choice and the chance to get ahead.

PUBLIC DEBT: UNDERESTIMATED BUT VITAL

Whilst many may be cautious, there are those who cannot afford to be. When the private sector contracts, concerned over the risk-return balance, the public sector is motivated by different factors entirely. These include ensuring local development happens, that new occupiers are attracted to create employment, that income is created for essential services and new housing is built. Whilst this capital is hard to quantify and cannot replace the sheer volume from commercial lenders, it is surprisingly powerful. For them, a challenging economic backdrop is not a reason to cease financing, but rather a reason to increase their lending intervention.

With private sector development finance liquidity under pressure, now is the time for the myriad public sources to show just how vital they are to development. At a national level, the work undertaken by entities such as Homes England to finance residential development on scale is a good example, underpinning the national effort to correct the supply demand imbalance of housing.

At a local level, Councils and Local Authorities can take matters into their own hands. Many are unwilling to wait for banks to finance developments considered vital to their local economies. For them, waiting is a greater risk than the capital invested. To not have new development risks employment and economic stimulation. The Northern local government bodies have led the way in this field in intervention through Impact Funds such as The North West Evergreen Fund, low carbon initiatives and the Manchester Housing Fund. They use their resources to finance viable schemes that can advance their economies.

Whether local or national, all seek to make sound investments that serve a grander ambition to make a difference. So, what does this mean for the coming years? The public sector, in all its forms, will become an even more important provider of development finance. It will have no choice if private sector development liquidity diminishes, whilst regeneration, housing and growth targets exist at a local and national level. I can quite easily foresee local authorities lending more, new Impact Funds being launched and more central funding for initiatives like Homes England.

WHAT DOES THE FUTURE HOLD?

How the landscape will evolve in the coming years will be interesting to watch. What happens and when, will be hugely influenced by the long-term impact of the Coronavirus pandemic, but it is likely that we will see significant economic challenges. Regardless of whether development finance contracts, the best sponsors with the strongest schemes will find finance regardless. Even if there is lender reluctance at the scheme level, then corporate borrowing is an option for such developers.

Whilst the market for development finance partially hibernates, the public sector and ESG-style lending conduits will attempt to fill the gap. Their belief in their local economies coupled with their commitment to delivering buildings that their communities need will provide a precious and admirable lifeline to developers. It will be fascinating watching the development finance landscape evolve.

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