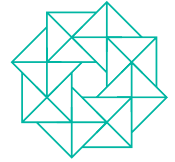
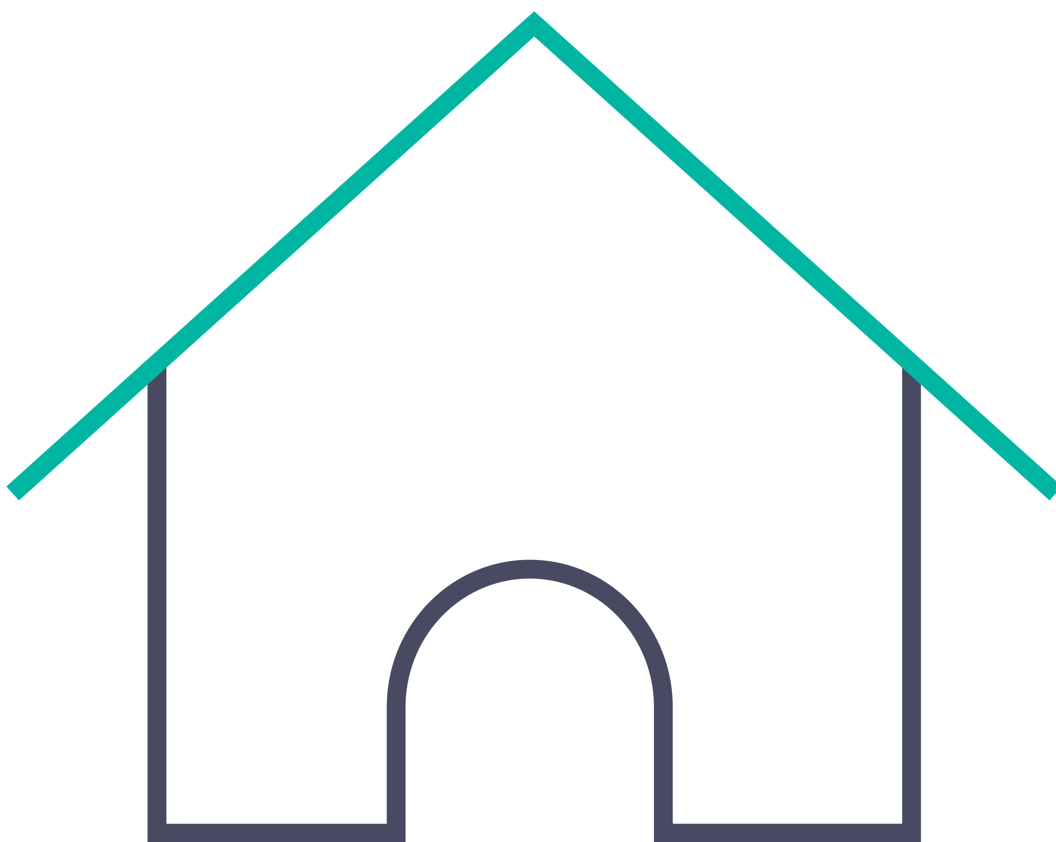
Guide to Development Finance

for Small and Medium Size Housebuilders





October 2018

Introduction

We know that accessing finance as a small-scale housebuilder is typically one of the most critical elements of the development process and can be a real cause of concern. This guide is aimed at helping you to better understand development finance, where it sits within the housebuilding process and why finance providers look for the information they do. There is a wide range of support available in terms of finance options, as well as people who can support you on this journey.

According to research undertaken by the FMB, since the financial crisis in 2008 many smaller scale housebuilders have faced significant hurdles in accessing the development finance they need to continue building new homes. The FMB continues to engage with key stakeholders to address this situation. At the same time, it is important that SME builders and developers understand what to expect when seeking development finance, the options available and the process they will go through.

UK Finance recognises this challenge, and our members are committed to supporting housebuilders on their finance journey. While lenders will all have their own risk appetite, and specific focuses, it is clear that the range of finance options available has never been greater. Borrowers are no longer solely reliant on large banks (though these remain a very important source of finance in the market), and there are a number of other lenders actively seeking out opportunities to lend to housebuilders like you.

We hope that this guide provides a useful overview of the key considerations you should make when looking at access to finance, whilst highlighting some of the characteristics of development finance and demonstrating the diverse options available to housebuilders today.

Stephen Pegge, Managing Director, Commercial Finance, UK Finance

Brian Berry, Chief Executive, Federation of Master Builders

View from the Government

We warmly welcome this collaboration between UK Finance and the Federation of Master Builders. Britain's 5.7 million small and medium enterprises are the backbone of the economy, not least in construction where they account for the great majority of the skilled subcontractors and tradespeople on whom the industry relies.

As part of our modern Industrial Strategy, the Government and the construction sector are working together through the Construction Sector Deal. This provides for modern procurement methods; new apprenticeship standards across the sector; an aspiration to increase the number of construction sector apprenticeships to 25,000 a year by 2020 and a new, fairer approach to contractual and payment practices to ensure that smaller suppliers are not unfairly disadvantaged.

Finance is the lifeblood of all businesses, yet we know that smaller housebuilders in particular face real challenges in accessing the finance they need. Improving access to finance is critical in helping small and medium sized housebuilders to grow and build the homes the country needs. Too many viable projects do not get built because they are not presented to lenders in the right way, or because businesses are discouraged when they are turned down by the first lender whom they approach.

This guide will help dispel some of the myths about development finance. It offers smaller housebuilders practical information on finance options and how to present their project to lenders. The Government is also playing its part through the British Business Bank and Homes England, as described later in the guide.

We will continue to work with UK Finance, the FMB and their members to ensure that smaller housebuilders have the finance and skills they need to achieve their full potential.

Kelly Tolhurst MP, Minister for Small Business, Consumers and Corporate Responsibility

Kit Malthouse MP, Minister of State for Housing

Contents

Introduction	2
View from the Government	3
Purpose of using external finance	5
Example housebuilding journey	6
Working with your chosen lender	8
Where to look	11
Government Support Schemes	12
Glossary	14
Partners	15

Purpose of using external finance

There are multiple considerations to make when planning a small-scale housebuilding development, and finance is clearly a critical element. By choosing to take finance from a lender you may be able to undertake a larger project than your own cash would allow. It may also enable you to fast track a scheme or work on more than one site at a time. However, it is important to recognise that all lenders will seek to ensure that you have the appropriate plans in place, the appropriate initial investment and that you are approaching them at the right stage of the project.

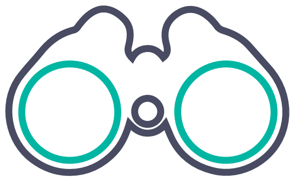
External finance can help spread the risk in both the construction and sales phases, by providing certainty of sufficient funding until houses have been sold and the lender is repaid. As it involves financial risk to the lender, it is important that your plans are sufficiently clear and advanced to ensure the lender can make an informed decision on their ability to fund. In order to mitigate this risk, please note that guarantees and security are likely to be required.

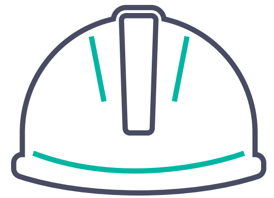
There are additional advantages that can be obtained from using a reputable external finance provider. This might include utilising their expertise and relevant professional contacts (e.g. for land valuation, compliance experts, legal protection and identification of insurance and building warranty requirements to name but a few areas). This might be of particular use if this is your first development, or your development represents a larger project than you might previously have undertaken.

Once you have successfully completed a development it affords you greater experience to leverage in future projects and can also provide you with capital to invest in future developments. If you don't have previous development experience, it may be advisable to also team up with an experienced developer that has successfully seen through similar projects before. This might provide the lender with the assurance they need.

Remember that finance – while important – is not the only, nor necessarily the first part of that journey. It is always easier for a lender to provide finance once you have clear plans for the development, including the purchase of land and planning permission. Make sure you fully consider these parts of the below journey before approaching a lender. An illustrative housebuilding journey can be found below.

Example housebuilding journey





Step 1: Identify land for sale

Small sites make up the minority of housing delivery identified in local plans. SME house builders should make use of all resources available to identify suitable small sites, including the local plan and the brownfield register.

You should also provisionally check with local authorities about the likelihood of planning permission for particular sites and understand the scale of developer contributions (Section 106, Community Infrastructure Levy) which will be required from a site.

Step 2: Purchase land and get planning permission

Once you have identified a site, purchasing and obtaining planning permission are the key next steps. Significant delays with planning permission can be a problem. These can be beyond the control of the applicant, but the chances of delays are reduced by high quality applications. Some lenders will not lend unless planning is permitted - hence the need for house builders to have 'own funds' in place.

Step 3: Hurdles

Consider the need to pay Community Infrastructure Levy (CIL) and water infrastructure charges.

Lack of Highways Authority participation in pre- planning discussions increases costs and delays. Discharging planning conditions can take longer and prove more difficult than might be expected.

Step 4: Seek development finance

Approach your intended finance provider in good time. Note that funding will need to be lined up several months prior to the start of construction. You may wish to have funding lined up six months in advance, and terms agreed 1-2 months before you start on site.

Some lenders may be prepared to lend if there is a high probability of planning permission, even if not formally approved.

Step 5: Construction phase

For most builders, the construction phase will seem like the easy bit, but you will need to be aware of lead in times for materials and products, especially if these are relevant to planning. You should also speak to utilities companies about connections at the earliest possible stage in order to minimise being held up by this.

Step 6: Sell units

It is important to challenge sales assumptions to ensure they are realistic. Some lenders will want details of pre-sales or off-plan sales during development.

Step 7: Repay loans

Sales assumptions can often prove misguided, and lenders normally have a mechanism for stepping in if things don't go to plan. This relationship needs to be managed, and it is important to be aware of alternative options available to you if units are not selling as originally expected.

Step 8: Use profit from completed site to begin on next site

This re-invested capital can increase the amount of 'own funds' in place for future projects.

Working with your chosen lender

The lenders will assess the viability of your proposal on a scheme-by-scheme basis known as a

"fully funded" approach. For example, between bank funding and the developer's own cash, is there sufficient funding available for all land, development and professional costs before any houses are sold and without relying on any further contributions?

Lenders will be very keen to understand your track record in developing houses, particularly demonstrating experience on similar product and location to the proposed scheme. It is normal for them to ask questions around this, and you should come prepared to discuss.

Lenders may seek to understand and challenge your business plan/development appraisal in areas such as:

- The projected sales values for house types (depending on size/specifications) by comparing sale prices on other nearby sites
- Projected rate of sales
- The projected land values
- Forecast build costs
- Professional fees including selling agent's costs
- Bank costs for arranging the loan and for interest on the drawn amount
- Warranties in place, as well as suitable accreditation such as a NHBC
- The level of developer profit in the proposal (too high might indicate that some costs have been underestimated or receipts over estimated, too low means the scheme may not be viable or extremely sensitive to market fluctuations)
- Allowances to deal with variations both in terms of cost and in time (i.e. contingencies)

The exact approach of each lender will vary, but all providers should be able to outline broadly their requirements on request.

What is the lender's perspective?

Remember that as lending involves risk sharing, lenders will seek as much certainty as possible that their loan will be repaid in full and on time. In instances where doubt exists or where risks are perceivably heightened, the lender may choose not to make an offer or may seek additional mitigating items, such as extra recourse to the borrower in the form of personal guarantees.

Lenders will usually want to keep close control over the release of funds and make sure that developers have fully costed the project. They will ask the developer to put all their contribution in first – usually to buy the land and directly fund the first elements of the development phase.

To make sure that developers have sufficient liquidity available to fund the completion of the entire project lenders will usually require developer cash to go in first. Lenders will not normally release or "drip feed" funds in alongside the developer in the early stages of developments and will typically only release funds after the developer has already made significant investments of their own.

Different lenders will typically apply their own criteria and thus may have more appetite for one form over another. Lenders are likely to require separate representation on both valuation (from a chartered surveyor) and legal process (from a specialist solicitor).

Recourse vs non-recourse lending

Almost all lenders will seek some form of security as noted above. You may come across options for 'non-recourse' lending, where in the case of a default, a lender can seize the collateral, but cannot pursue the borrower for further compensation.

This will generally be more expensive than other lending arrangements, because while the lender could take security over the land/development, unlike other forms of lending, other assets held by the business are not subject to recovery. Some lenders may require step-in rights on certain contracts

Understanding the source of developer funding

As well as seeking to ensure that developers have sufficient funds for the initial investment (whether through personal funds, private equity investment or other forms), all lenders have responsibilities under anti-money laundering rules to ensure they are satisfied that contributions come from legitimate sources. This might mean providers asking more questions than in previous applications you may have made, including seeking to understand firm and individual wealth. While this can be frustrating, it is common, and you should come prepared to discuss this with your lender.

The lender will also be keen to understand your experience through market cycles and how the retained earnings in your business have built up as each successful project has been completed. The ability to demonstrate a clear track record, even if on smaller developments, can make lenders more comfortable in the robustness of your proposals and experience.

Repayment

Once the houses are built and ready for sale the lender will seek repayment from the first sale proceeds and will typically be repaid from the first 75 per cent of house sales on the site. As well as being 'first in', the developer's own funds will therefore be 'last out' once the lender has been fully repaid. This needs to be fully considered when the housebuilder looks to invest in the next 'follow on' scheme.

If your first lender turns you down

Remember that lenders cannot approve every housebuilder lending application. This may be due to several factors, including appetite for exposure to the sector. It is important to many finance providers that they do not build up too much exposure to a specific sector. However, there are many sources of finance you can consider. The market is extremely diverse and you should feel confident shopping around to find the one that suits you best. Since the financial crisis, banks tend to lend to SMEs on a site-by-site basis. This increases the amount of entry, exit and legal fees and slows down the reinvestment of equity into new sites.

If you are a business with turnover of up to £25m and are declined finance, you may find yourself offered the right to appeal the decision, and to have your application looked at again. You may also be eligible for a referral to a government-designated finance platform which can also help, depending on which lender you apply to.

A summary of both schemes can be found at: https://www.ukfinance.org.uk/unsuccessful-lending-applications-and-lending-declines/

An example funding structure

An example project with an end value of £2 million can be seen below. Note that there is much more than just the total cost of the development to consider – and lenders will not generally provide the full amount of the costs. This is why own funds and equity are an important part of the calculation.

Please note that funding agreements such as stretched senior loans for some providers may allow funding with a higher loan-to-cost ratio. To discuss such agreements, speak to your finance provider.

Item	Typical experience for the Borrower and the Lender
Gross Development Value (Aggregate value of all the units for sale, plus ground rents)	£2,000,000 (Two Million Pounds)
Land value (representative of lower land value area)	£600,000 (Six Hundred Thousand Pounds)
Construction cost	£900,000 (Nine Hundred Thousand Pounds)
Other development costs (professional and finance fees etc.)	£100,000 (One Hundred Thousand Pounds)
Total development cost	£1,600,000 (One Million Six Hundred Thousand Pounds)
Developers profit	£400,000 (Four Hundred Thousand Pounds) representing approx. 20 per cent on sales
Developer contribution (cash/land)	Typically, around 40 per cent of the Total Development Cost upfront i.e. £640,000 (Six Hundred and Forty Thousand Pounds)
Bank loan	Typically, around 60 per cent of the Total Development Cost after the developer contribution has been demonstrated £960,000 (Nine Hundred and Sixty Thousand Pounds)[1]
Bank requirements	First legal charge over: the development site, company assets and cost overrun contingencies. Some lenders may require a personal guarantee, recourse and warranties.
Other considerations	Independent Valuation & Banks Monitoring Costs to access the bank funds the house builder will need to allow for the cost of 'Bank Draw Down Report' costs, likely to be incurred monthly.
Contingencies	Typically entails setting aside 5-10 per cent of non-land costs.

[1] Please note that this is indicative, some lenders may be prepared to lend higher percentages, and developers should feel able to discuss options with them

Where to look

- High street banks and building societies: these are the largest providers of finance to the SME sector and continue to provide significant levels of lending to the sector.
- Other banks (including challenger and overseas banks): there are more banks and lenders out there than ever before. Whereas some high street banks may have less appetite for smaller-scale housebuilding than before the financial crisis, challenger banks represent an important alternative for SME housebuilders still seeking to use the same sort of debt finance that a high street bank would provide. Challenger and overseas banks may be willing to provide higher-risk leverage but may seek higher pricing. A starting point is the list of members of UK Finance as the trade association for the whole sector. This can be found at https://www.ukfinance.org.uk/about-us/uk-finance-members.
- Non-bank lenders: there are many non-bank lenders who can provide debt finance. These are often funded through other sources such as institutional investors.
- Private equity: for those not already using private equity, this is typically introduced via brokers or financial intermediaries. This involves the provision of additional capital to that which is already in the business. Equity can be sold to third-party investors with no existing stake in the business. Alternatively, it can be raised solely from existing shareholders, through a rights issue.
- Finance Brokers: The National Association of Finance Brokers has a network of member firms that can assist as brokers to identify potential funders for your development project.
- Crowd funding: this is increasingly common for businesses looking to raise finance which can vary from equity to debt funding. It allows developers to connect with potentially thousands of investors (often by matching through internet-based platforms).
- Government supported funds:
  - Home Building Fund – a summary of the Fund can be found below.
  - Housing Growth Partnership – This is a social impact investor backed by Lloyds Banking Group and Homes England, which 'partners with proven small housebuilders and developers who are developing, on average 5-175 units per year and that have a passion and desire to grow'. More information can be found at: https://www.housinggrowth.com
  - Housing Delivery Fund- This £1 billion housing development fund is backed primarily by Barclays, in conjunction with Homes England. It aims 'to help suitable development schemes looking for debt funding comprising senior and mezzanine tranches'. Loans of between £5m and £100m are available to borrowers able to demonstrate the necessary track record, who are looking to accelerate the progress of house building in the UK. More information can be found at: https://www.barclayscorporate.com/sector-expertise/real-estate/housing-delivery-fund.html
  - The Enterprise Finance Guarantee Scheme, which is provided by the British Business Bank and accessed through finance providers, also provides support for this sector. A summary of the scheme is below.
  - Devolved administrations will also have schemes applicable to Wales and Scotland specifically.

Information hubs

You can further explore finance options and find funding to suit your business with the British Business Bank Finance Hub (https://www.british-business-bank.co.uk/finance-hub/), which offers independent information on different finance options and a finance finder tool to enable businesses to explore and identify finance options that might work for them.

FINANCE HUB

Also helpful is UK Finance's Better Business Finance website (http://www.betterbusinessfinance.co.uk/) which includes a finance finder tool, helping businesses find a suitable finance provider in their area.

BETTER BUSINESS FINANCE.CO.UK

Government Support Schemes

The Home Building Fund

Homes England administers the Fund on behalf of the Government. If you're a private sector business that builds new homes for sale or rent you can find more information including the eligibility criteria, how to apply for a loan, interest rates and arrangement fees on https://www.gov.uk/government/publications/home-building-fund

A brief summary of the Fund and how it operates:

- The Fund is open to new enquiries on a continuous basis.
- Development loan finance is currently available to draw down up to March 2023. The Fund operates in a similar way to traditional bank funding and will undertake a similar level of due diligence as part of the application process.
- To be eligible for funding you must, as a minimum, meet all the core criteria i.e. demonstrate the project would not progress or progress as quickly, or at all without the Fund's support; the development project must be in England and deliver a minimum of five new homes; the borrower must be a private sector entity with majority control of the site; the project must demonstrate good value for the tax payer; a minimum loan of £250,000 except for innovative housing solutions and serviced plots for custom build; and the borrower must be a UK registered corporate entity. The Fund does not provide funding for land banking.
- You can contact Homes England at an early stage to find out how the fund works by first completing a short on-line enquiry form. However, to progress further your project must be ready or almost ready to proceed i.e. in receipt of detailed or outline planning permission, be in control of the land, have a good understanding of total project costs and how the loan will be repaid. The speed at which your application is considered depends upon the quality of the information you provide.
- Similar to any other development loans you will need to provide information about your experience, source of equity, business plans and finances. In addition, 'Know Your Customer' checks are undertaken by Homes England in order to comply with legal and regulatory requirements.
- The Fund will not pay 100 per cent of the total development costs, equity contributions from the borrower can include the land and uplift from planning gain.
- Terms are up to five years for development finance loans, which require appropriate security typically secured against property assets – preferably a 1st charge on the land. Once contracts are signed and any conditions met, the loan is drawn down in tranches against work expended on site once validated by a monitoring surveyor.
- A 0.5 per cent arrangement fee for development finance loans is charged. The pre-agreed variable interest rate has two elements – the EC Base Rate plus a margin. The margin set by Homes England is based on an assessment of your creditworthiness, risk profile of the investment and collateral offered. Sales proceeds recycling can be considered in order to reduce the loan requirement and interest costs.

The British Business Bank

The British Business Bank is 100 per cent government owned, but independently managed. It was set up to improve finance markets for smaller UK businesses, enabling them to prosper and grow. The British Business Bank does not lend or invest directly. Instead, it works alongside more than 120 partner organisations that provide equity or debt finance to businesses. Its programmes are facilitating over £5.2 bn of finance to over 74,000 small and medium size businesses and participating in a further £7.1bn of funding for small mid-cap companies.

Enterprise Finance Guarantee

The British Business Bank's Enterprise Finance Guarantee (EFG) facilitates business finance to smaller businesses that are viable but unable to obtain finance from their lender due to having insufficient security to meet the lender's normal requirements. In this situation, EFG can provide the lender with a partial guarantee in place of the security that the business would otherwise need to provide, potentially enabling a 'no' credit decision from a lender to become a 'yes'. EFG loans are available for amounts from £1,000 up to £1.2 million and periods ranging from three months to ten years.

Although the EFG programme does not target construction or housebuilding specifically, the British Business Bank has highlighted the potential use of the Enterprise Finance Guarantee (EFG) for house building, as there are circumstances where an EFG loan can address lack of collateral and support additional lending. The CBI has also endorsed greater use of EFG in the house building sector.

Since its launch in 2009, EFG has supported the provision of over 29,000 business loans to a value of over £3.1bn (as at end March 2018). A list of lenders who offer EFG supported lending can be found on the British Business Bank's website.

https://www.british-business-bank.co.uk/ourpartners/

ENABLE Guarantees

The British Business Bank's ENABLE Guarantee programme is designed to encourage additional lending to smaller businesses. In exchange for a fee, participating banks receive a government-backed guarantee to cover a portion of the net credit losses arising on a designated portfolio in excess of an agreed 'first loss' threshold. Banks who participate in the scheme are able to increase the amount of lending to smaller businesses as a government-backed portfolio guarantee reduces the capital they need to hold against their loan portfolio.

The amount of capital a bank needs to hold against development lending can be very high, so the British Business Bank has been working with lenders on transactions to support lending to small housebuilders.

A list of lenders who have agreed ENABLE Guarantees can be found on the British Business Bank's website.

https://www.british-business-bank.co.uk/ourpartners/

Glossary

- Challenger bank – A smaller retail bank set up to compete with the more established Big Five banks of Barclays, HSBC, Lloyds Banking Group, RBS/ NatWest and Santander
- Collateral – Assets (for example, property) pledged by a borrower which act as security for bank facilities
- Crowd funding – A method of raising funding for a project by obtaining small amounts of capital from a large number of investors
- Development appraisal – Financial assessment of the viability of a development scheme which will detail each line item of cost and value, also allowing you to derive scheme profit
- Draw down report – A report supplied by an Independent Monitoring Surveyor which advises the lender of the progress of the works on a development site and approves the drawdown of funds requested by the Borrower
- First legal charge – A legal charge is the means by which lenders enforce their rights to a property. The holder of a 'first charge' has the legal right to make the first call on an asset in the event that the borrower defaults on repayments.
- Fully funded approach – Development financing structured to ensure that all costs of the development are committed from the outset of the agreement by a combination of the borrowers' equity and the funders facility
- Joint enterprise / Joint venture – An arrangement entered into by two or more parties to create a separate entity for the purpose of carrying out a particular project or business activity, in which each party shares ownership and associated risks and rewards
- Leverage – Percentage of debt in the capital structure to either the development or current value of a project or business
- Mezzanine finance – Subordinated financing which sits between senior debt and equity, carrying a higher rate of interest than the senior debt facility with all collateral ranking behind the senior debt provider
- Monitoring costs – Expenses associated with the ongoing monitoring of a development, which typically involves the appointment of an independent monitoring surveyor who carries out due diligence on a regular basis on behalf of a lender
- Non-recourse lending – Lending provided to and secured only by the assets and the vehicle which are being funded
- Personal guarantees – A written promise from a business owner or director providing the lender with recourse to them for a specific circumstance, which would be outlined within the guarantee wording
- Private equity – Entities concerned with the investment of equity into companies or projects not listed on a public exchange
- Recourse lending – Lending secured both by the assets being funded as well as other assets of the borrower. In an event of default, the lender is entitled to claim other assets owned by the borrower in order to satisfy outstanding debts.
- Senior debt – Outside of an administration process, the highest ranking creditor in the event of default, usually backed by a debenture, guarantee and / or legal charge over specific assets
- Step-in rights – Grants one party the right to take over the rights of another in a contract between two third parties. For instance, in an event of developer insolvency, step-in rights may grant a lender the right to assume the role of the developer in contracts with consultants and building contractors.

In partnership with:

UK FINANCE

UK Finance is a new trade association which was formed on 1 July 2017 to represent the finance and banking industry operating in the UK. It represents nearly 300 of the leading firms providing finance, banking, markets and payments-related services in or from the UK. UK Finance has been created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association.

Our objective is to work with our members to build a more customer-focused and innovative finance and banking sector, cementing the UK's role as a global leader in financial services for the benefit of the wider economy. The interests of our members' customers are at the heart of this work.

Federation of Master Builders

The Federation of Master Builders (FMB) is the UK's largest trade association in the construction industry, and with over 8,000 members it is the recognised voice of small and medium-sized (SME) construction firms. Established in 1941 to protect the interests of small SME construction firms, the FMB is independent and non-profit-making, lobbying continuously for members' interests at both national and local levels. The FMB is a source of knowledge, professional advice and support for its members, providing a range of modern and relevant business services to save them time and money.

www.ukfinance.org.uk
UK Finance
1 Angel Court
London, EC2R 7HJ
United Kingdom