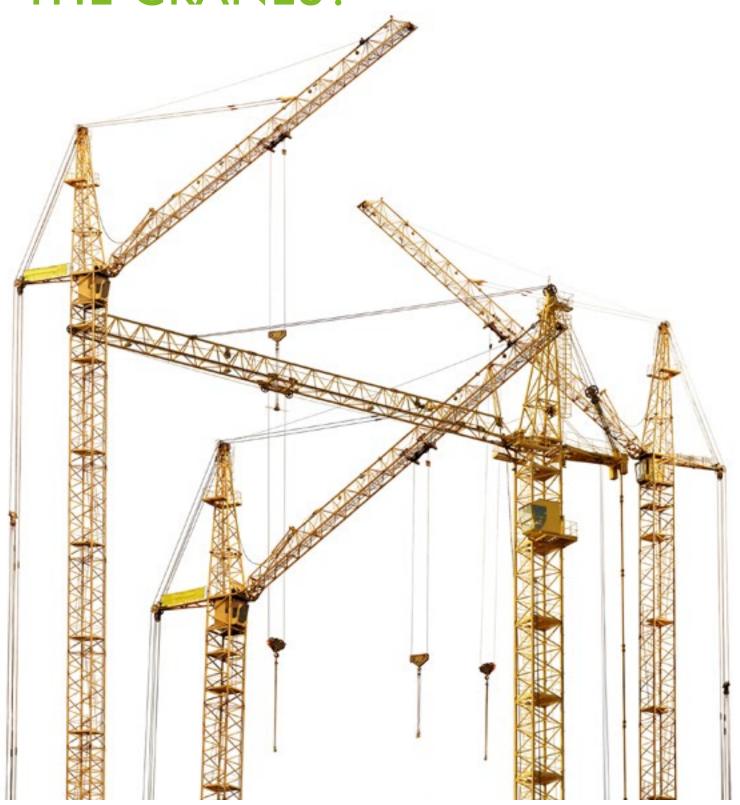
Capital Advisors

DEVELOPMENT FINANCE: IS THERE CAPITAL TO FUND THE CRANES?





INTRODUCTION





Development finance availability has increased in the last 12 months, but it is still highly selective and often only available for the most desirable schemes. There is still a need for more funding on a wider range of schemes and it is needed from a more diverse group of lenders. As a result, we are witnessing the establishment of an increasingly evolved and sophisticated UK development funding market.

Andrew AntoniadesDirector, CBRE Capital Advisors, Investment Advisory

- Availability has increased in the last 12 months, but it is selective and is biased towards the best schemes.
- For the most attractive opportunities, senior lenders have been prepared to reduce margins and have become more tolerant on the level of pre-letting on commercial assets or pre-sales for residential. However, they are more reluctant to increase leverage primarily as it is a risk metric but also because it increases their holding costs.
- In order to reach the desired leverage levels, many borrowers need to secure mezzanine debt or seek whole-loan solutions from alternative funders.
- Previously seen as "alternative lenders", debt funds are now becoming well-established and considered "mainstream".
- Mezzanine has become an accepted part of the funding stack for many borrowers in order to allow them to reach leverage of 75% to 85% loan-to-cost

 For a fully functioning development market, development funding is needed from additional sources with different risk appetites.

Future trends:

- Banks to come under more competitive pressure compared to IRR driven debt funds.
- Residential development may be polarised, with the best schemes having access to bank debt funding, while smaller schemes turn to funding from smaller specialist debt funds, leaving medium sized schemes falling in-between the two.
- Many lenders outwardly state their intention to increase the amounts of funding they will provide.
 However, it remains to be seen whether their credit committees and lending criteria will match this optimism.

IS THERE FUNDING OUT THERE?

Since last year's report, development funding has improved. More developments are coming forward and funding allocations have increased alongside improved appetite from lenders.

However, this is from a low base, far below historical levels. More complex and creative development funding is needed for more schemes from a wider range of sources.

DEVELOPMENT ACTIVITY (DEMAND) VS. FUNDING (SUPPLY)

Demand

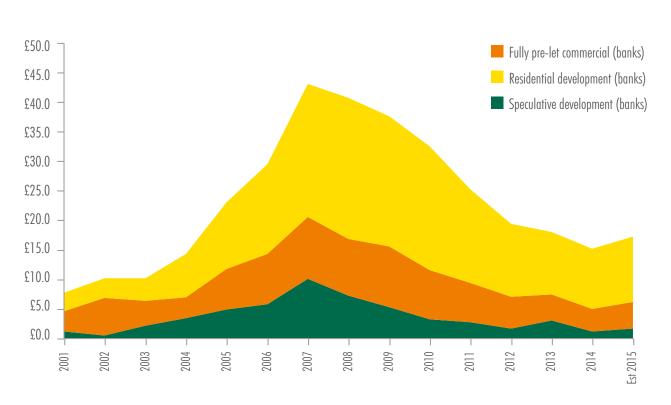
- Development activity has increased, mainly in London but also now in key regional cities such as Manchester and Birmingham.
- Developers are keen to secure funding at various points in the capital stack. Some are content with modest leverage at c. 50% to 60% loan-to-cost, whilst others are keen to return to higher leverage levels achieved in the last market cycle of 80% 90% loan-to-cost which now requires mezzanine, whole loans and even preferred equity.
- However, the market for obtaining development finance for such schemes remains relatively challenging. Typically only the strongest schemes by the most credit-worthy sponsors can attract finance.

Supply

- Allocations to development finance remain considerably compressed. Simultaneously, Central London and South East dominate funding.
- Of the £45bn of new loans made in 2014 (see "New Loan Originations" chart), 5% (c. £2.4bn) were for commercial and 12% (c. £5.5bn) were for residential development.
- Allocations to development finance were less than half the historical peak.
- Only 3% of bank loan books are allocated to commercial development. This compares to 22% for alternative lenders.

Finance Directors are increasingly focused on the all-in cost and are less impressed by lower margins that include an array of extra fees.

CHART 1: ALLOCATION TO DEVELOPMENT FINANCE

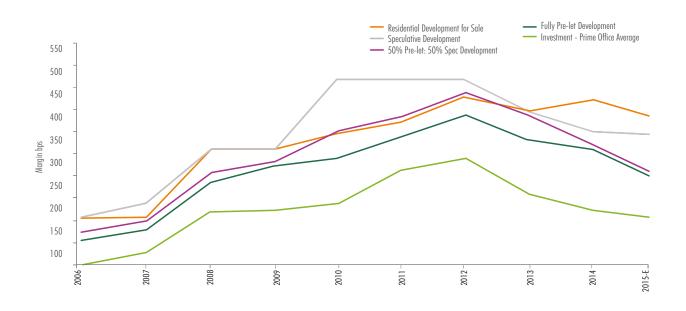


Source: De Montfort and CBRE

The most high-profile schemes in the strongest locations with best-in-class sponsors still attract the most funding, both in terms of quantum and combinations.

MARGINS AND LEVERAGE: SENIOR DEBT DEVELOPMENT TERMS AND EXPECTED TRENDS

CHART 2: PRICING VARIOUS DEVELOPMENT STYLES BENCHMARKED AGAINST OFFICE INVESTMENT

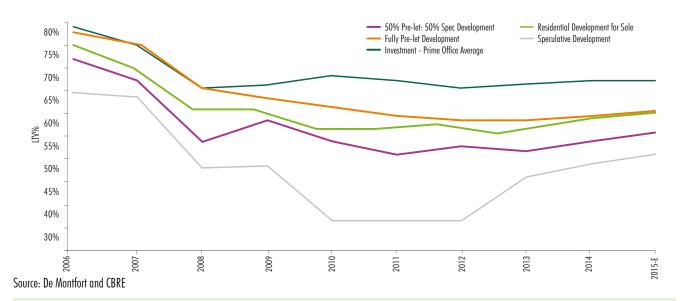


Source: De Montfort and CBRE

- A significant difference exists between speculative development and pre-let development in both cost of debt and leverage offered. De-risked pre-let schemes achieve the best terms.
- Unsurprisingly, there is a meaningful spread between development and investment loan margins.
- Comparative value is demonstrated by the c. 100bps spread between prime investment loans vs. 50% pre-let developments where the risk has been significantly reduced through pre-letting.

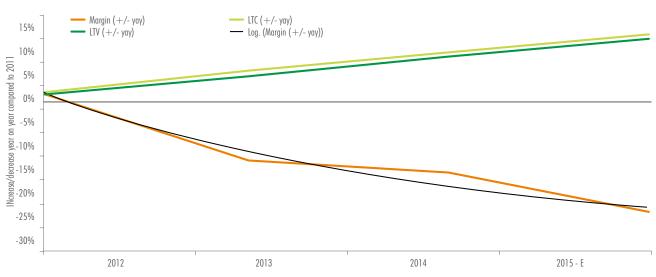
Over the last few years, banks have compressed margins at a faster rate than the increase in leverage offered.

CHART 3: LEVERAGE FOR VARIOUS DEVELOPMENT STYLES AGAINST OFFICE INVESTMENT



- Leverage for senior debt has stabilised across all development types. This is largely due to banks' diminished appetite for risk.
- However, the data for margins and LTV hides the lack of availability for schemes that fail to secure pre-lets.

CHART 4: CUMULATIVE DECREASE IN MARGIN VS. INCREASE IN LEVEAGE OFFERED BY LENDERS



- Source: CBRE
 - Over the last few years, banks have compressed margins at a faster rate than the increase in leverage offered.
 - This is because leverage represents a risk, whilst margin represents returns and the latter is more willingly compromised as lenders compete for the best developments.

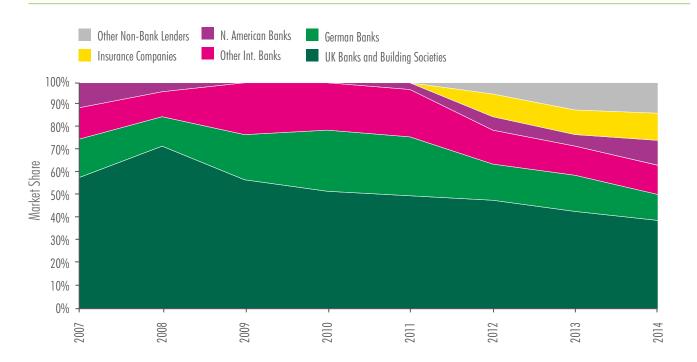
(The chart above compares the year-on-year yield compression of margins compared to increasing leverage offered from 2012 onwards. This takes a simplified average of all development types).

COMPETITIVE LANDSCAPE: WHO IS LENDING?

- Over the last three years the diversification of the UK commercial property lending market has steadily deepened.
- The variation in types of lenders has broadened with overseas lenders entering the market along with funds and insurers. German, American and other non-UK banks now account for more than a third of loan originations. Alternative lenders effectively represent a quarter of the market compared to being near nonexistent as recently as four years ago.
 - Insurance companies now represent 12% of total debt (though most are adverse to development funding).
 - Other non-bank lenders, principally debt funds, represent 13.5%.

- There are many more lending structures: senior debt is now complemented by whole loans, junior debt and preferred equity (quasi-debt) from specialist, alternative providers.
- There has been a dramatic decline in market share by UK banks and building societies, falling from a peak of 72% in 2008 to 39% at the end of 2014.
- The level of market diversification is evidenced by the share of outstanding debt held by the top 12 lenders, which stood at 66% in 2014 compared to 72% in 2013 and 82% in 2009.
- This diversification is due to several factors but primarily new entrants (including insurers and funds) competing alongside restrictive forces impacting traditional lenders.

CHART 5: MARKET SHARE OF ANNUAL LOAN ORIGINATIONS 1999 TO 2014



Source: De Montfort and CBRE

Banks

Banks remain adverse to speculative development, often demanding significant pre-sales schedules for residential and meaningful pre-letting for commercial.

Traditional banks and building societies have increased their allocations of funding over the past 12-24 months, but at leverage levels that are significantly restricted compared to pre-2007.

They have been prepared to reduce margin and in some cases even be more tolerant on the level of preletting and pre-sales. However, leverage is an altogether different story. They are reluctant to increase leverage primarily as it is a risk metric but also because of risk ratings and associated holding costs. Therefore, leverage is harder for traditional clearing banks to negotiate on.

UK clearing banks (such as Lloyds, RBS and Barclays) as well as German, American and Asian institutions continue to be active and able to take significant debt positions of up to c. £100m.

In some cases, there is also a dichotomy between what relationship directors / originators for banks would like to do and what they can actually get through their credit committees. Some major new institutions with significant funding capabilities have now become active in the market. For example Sumitomo Mitsui Trust Bank's and Sumitomo Mitsui Banking Corporation's funding of Television Centre in London. However, such examples are predicated on corporate relationships and considered to be the exception, not the norm.

Alternative debt providers (e.g. debt funds)

Debt funds are more willing to finance development, largely due to the potential for higher returns.

They will consider greater leverage (up to around 75% loan-to-cost).

They can also be relatively relaxed on pre-sales and pre-lets, as well as even being willing to fund speculative development, but demand high coupons in return for this risk

Banks remain adverse to speculative development, often demanding significant pre-sales schedules for residential and meaningful pre-letting for commercial

Regulatory pressure

- Regulation is having a particular impact on clearing banks (under the Slotting regulations) as well as other lenders, including insurers (under Solvency II).
- Regulation has impacted the costs of capital and can restrict allocations to certain property types, considered less risky at the expense of more alternative real estate sectors such as operational assets.



- Many of these funds can be highly flexible in the structures they can work with, providing senior, whole loans, mezzanine positions and preferred equity depending upon the situation. This allows them to provide a bespoke solution for each transaction.
- Alternative lenders however, constitute a relatively small part of the market and can, therefore, afford to be selective as demand for finance currently exceeds supply.
- There is a relatively limited number who can provide development loans over £50m. Starwood, Apollo, Blackstone and some others being the major houses capable of large scale positions.
- Such lenders are now being joined by sophisticated institutions who now wish to enter real estate lending either through diversification or through being led by the opportunity for attractive returns, such as Daiwa Capital Markets.
- At the other end of the scale-spectrum, funders such as LendInvest, Omni Capital Partners and Pluto Finance target lower loan quantum with often greater leverage, whilst putting more emphasis on the quality of the scheme over a borrower's financial resources.
- Insurer activity for development debt funding is limited to just a few. Insurers are more likely to take development exposure as investors or via forward fundings through their direct property arms.

Mezzanine

- In previous years, mezzanine was considered a relatively immature, complicated and opaque financing instrument. However, it has now become an accepted and essential part of the funding stack for many borrowers.
- Lenders such as LaSalle IM, ICG Longbow,
 Highbridge and Macquarie are active and targeting mezzanine more specifically.
- This has come about through necessity, in order to allow borrowers to reach leverage at the 70% to 80% level. Several have been active for some time and act with transparency in their inter-creditor principles.

Public debt

- Government backed debt funds with a regional focus and regenerative targets can play a vital role in areas, providing development debt where other lenders will not
- Funds such as the North West Evergreen Fund and SCR JESSICA, servicing the North West (including Manchester) and the Sheffield City Region respectively, have been supporting a range of developments that would otherwise not have been financed.
- Such funds are in demand in many regions across the UK and more are needed.

RESIDENTIAL FOCUS – HAS LUXURY LOST ITS LUSTRE?

The ability of lenders to fund high-end residential development could become increasingly challenging:

- Some banks are believed to be near to capacity for exposure to super-prime apartments and other trophy residential units, with any capacity being reserved for the highest profile borrowers and strongest relationships.
- A major part of lenders' concern is liquidity, and lack of certainty that buyers will be found for the most expensive units that can carry a significant portion of a scheme's value. This concern exacerbates as value increases.
- In response, some banks are recalculating leverage to exclude the most expensive apartments, effectively considering schemes as higher leverage propositions and scaling back lending accordingly. This is often in spite of significant headroom between the debt sought compared to the development cost and GDV, even once stress tested.
- Developers will increasingly encounter demands for pre-sales and other milestones in order to achieve the leverage they require. Alternative lenders such as the debt funds appear more willing to take this risk. However, there are relatively few lenders who can take large participations of c. £50m to £100m.

Going forward there could be a gap where only the best or the smaller schemes can be more readily funded.

Type and Scale	Characteristics	Prospects
Large-scale major residential schemes	Core, desirable locations Strong equity backers Best in class developers £100m+ of costs to fund	Can secure the larger ticket lending from the major banks and lending institutions. For those debt providers, the emphasis will be on relationship lending.
Smaller residential schemes	All types Up to £25m of costs to fund	Will attract the higher cost debt funds which are able to make smaller loans and are willing to take more risk. Such debt funds are relatively abundant and creative in their funding approach.
Medium-sized schemes	Unproven or less attractive locations or with less proven developers £25 - £100m of costs to fund	Could struggle to be funded. They risk being unable to gain the support in quantum typically only offered by large banks and a few major debt funds, and too large for the opportunistic smaller debt funds. Such schemes may become wholly reliant on equity.

COSTS OF FUNDING: IRR VS. MARGIN AND FEES

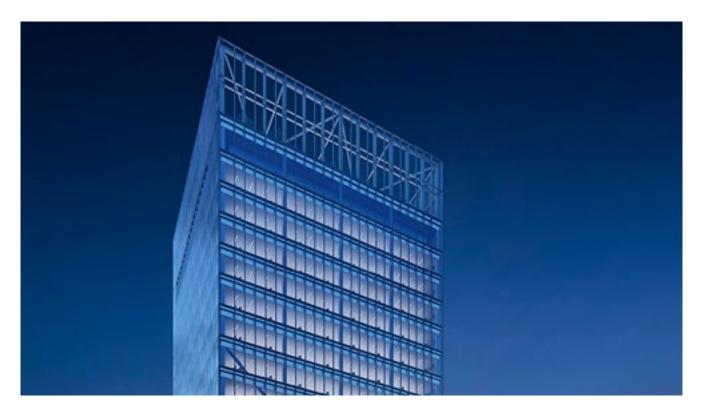


In the market, there is a split between the total cost of borrowing from alternative lenders (i.e. debt funds), compared to how banks and traditional lenders charge.

- Banks typically charge a margin and fees for arrangement, commitment and exit as well as various ancillary fees. By contrast funds target an IRR and can be flexible on the margin and fees as long as they reach their IRR.
- Traditional lenders who price with margins and an assortment of fees can be less competitive over the short term. After all, the one—off fees of arrangement and exit are being spread over a shorter timeframe, increasing the average annual cost, while the upfront arrangement fees apply from day one.
- It can also create a cash flow and forecasting issue for borrowers. The variability between commitment fees and the onset of the full interest rate means that the cost profile of a loan can vary significantly. Inherently, development activity carries the risk of delays, cost over-runs and non-utilised amounts incurring a finance fee before the borrower has even drawn the debt.
- With IRR based lending, a borrower knows the return. IRR based lenders are aligned with their borrowers on how they typically price the deals. Finance Directors are increasingly focused on the all-in cost and are less impressed by lower margins that include an array of extra fees.
- Going forward, considering the all-in cost of debt and the effective debt IRR will be an increasingly important force behind competition to lend to borrowers.

CASE STUDIES

LARGE-SCALE, PRIME COMMERCIAL DEVELOPMENT



Example: One Spinningfields, Manchester

In April 2015, Allied London finalised the funding package for One Spinningfields, Manchester, a 300,000 sq ft commercial scheme. With £100m of development costs to be funded with c. £60m senior debt from Lloyds, £12m mezzanine finance from the North West Evergreen Fund and the balance from Pramerica.

This funding package highlights some crucial points about the state of the funding market:

- Crucially, this development has such a very low level
 of pre-lets (c.15% pre-let to PwC) that it is virtually a
 speculative funding. As recently as six months ago,
 most bank lenders would have required a minimum
 50% pre-letting level to fund this development.
- This demonstrates that the very best schemes can get finance, even selectively in the best regional locations.
- It was highly structured, requiring senior debt alongside mezzanine to reach the developer's leverage target.

- If progress has been made on the willingness to finance, it also demonstrates that there has been little progress in terms of leverage. In the previous cycle, a development such as this would have been mostly financed through bank senior debt, but in today's market that is restricted to around 50% - 60% loanto-cost.
- This means there is still a funding gap where schemes need more forms of capital in order to complete the funding.

The most high-profile schemes in the strongest locations with bestin-class sponsors still attract the most funding, both in terms of quantum and combinations

SMALL SCALE RESIDENTIAL DEVELOPMENT

At the other end of the spectrum are transactions such as the one below. These are numerous and are often financed by debt funds and peer-to-peer lenders, such as LendInvest, who specifically target residential development. These funders are often the only choice for such developers, who cannot secure bank debt, due to a combination of the relatively small size of the scheme or being a lesser-known, smaller scale developer.

Such schemes typically have strong fundamentals but due to the selectivity of development finance have few options. In return for taking risk via relatively high leverage against cost and less proven developers, lenders can achieve a high return.

These lenders are more willing to consider higher leverage, lending relatively high loan-to-costs, taking more comfort from headroom on their loan-to-value ratios and gaining personal guarantees from developers as standard.



Example: Residential conversion, Clapham, London

LendInvest (the peer-to-peer lending platform, which provides funding for developers) is understood to have provided a first charge loan for the purchase of a development site in Clapham with planning consent for the development of a cluster of townhouses. In total, c. £5 million of funding was provided to the developer, against the site value and construction, with a loan-to-GDV of c. 70%.

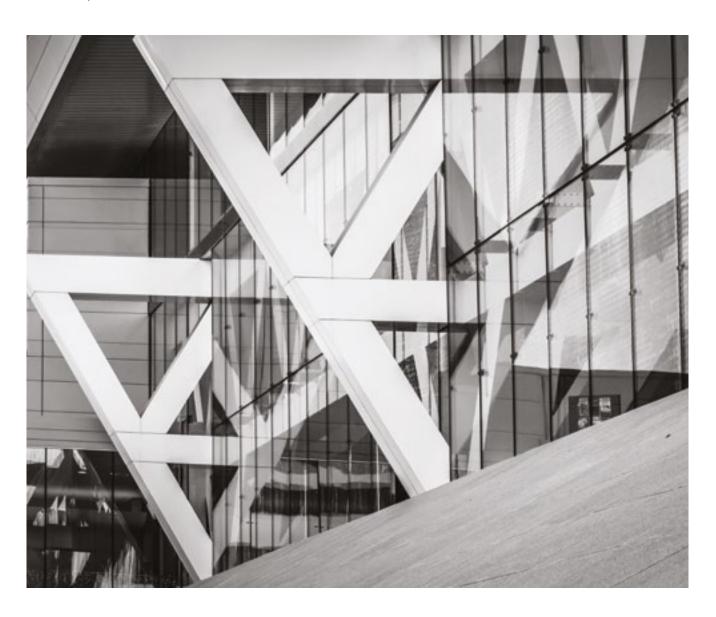
Debt funds and peer-to-peer lenders are more willing to consider higher leverage

FUTURE TRENDS

- A continued, but selective, stable increase in development funding due to competition in the investment lending space.
- The best residential schemes from established developers will have the best chances of securing bank funding, with less established developers obtaining finance from smaller specialist debt funds. Intermediate developers and schemes risk falling outside of these two capital sources.
- Pre-sales and pre-letting will remain a significant requirement for traditional debt. However, levels of these may be reduced for the strongest schemes and developers.

- Alternative funders will be willing to take more risk and fund schemes that banks will not.
- More insurers may start considering funding developments through senior debt. Though on a very selective basis, as risk and asset-liability matching will remain challenging for these lenders.

There is a huge opportunity for funders willing to take development exposure whilst managing the risks. Time will tell who is willing to seize it.



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CBRE CAPITAL ADVISORS

Capital Advisors provides the full range of corporate, structured finance and capital raising services, together with non-discretionary investment advice for funds, portfolios, individual properties, indirect ownership services and complex situations.

This includes debt advisory and structured finance, corporate recovery services, specialist wholesale unlisted equity raising, loan servicing and derivative brokerage across EMEA.

We bring together a unique mix of expertise in order to meet client needs. Our team of over 130 globally includes accountants, bankers, financial analysts, fund managers and property professionals.

DEVELOPMENT FUNDING EXPERTISE

CBRE Capital Advisors provides creative development funding solutions for investors and developers. We have arranged over £2 billion of development funding in the UK over the last 2 years across the real estate sectors. We specialise in structured solutions and have arranged funding as equity, preferred equity, mezzanine debt or senior debt.

For investors, we provide impartial, long-term investment advice and development underwriting. We work in partnership with our clients to understand their objectives and to set investment and risk parameters.

We provide a complete service, whereby we originate, structure, underwrite and manage investments into developments to maximise our lender clients' returns.

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