

# UK bridging market study

A view for 2018 and beyond



Building a better  
working world

# Welcome



**Nick Parkhouse**  
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Welcome to the first market study from the EY Financial Services Corporate Finance team. In this edition, we cover the UK bridging market, a sector in which we as a team have completed a number of engagements across the last two years covering acquisition and debt advisory, vendor and commercial due diligence, and business modelling. It's the subject of our first study, as we've gained a number of unique insights from our discussions and noting that it is currently fragmented, we believe there will be increasing transactional activity in the near term, which you will read about throughout this report.

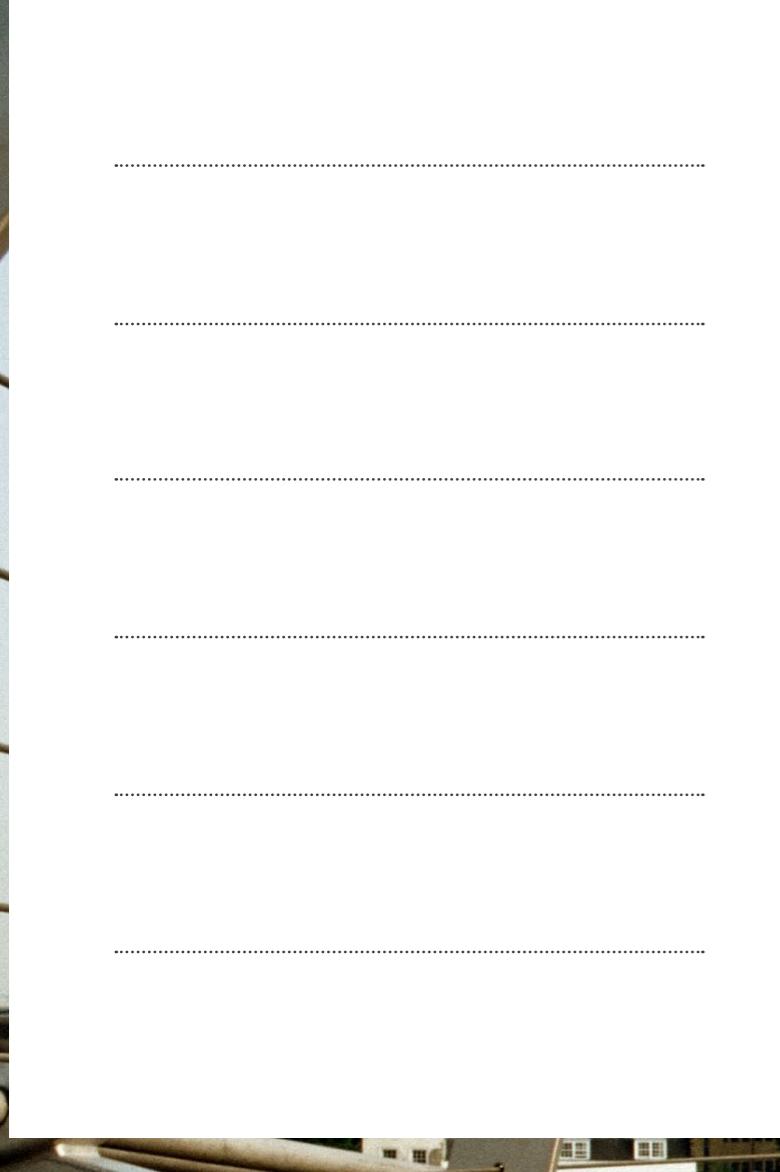
This report provides insights into recent trends and a view on market trajectory, incorporating the results of a survey that we conducted with 11 market participants. We would like to thank those that participated and provided their interesting perspectives on the development of the sector.

The report then covers the strategic options available to a bridging business; many of these would require additional capital, which leads us onto the next sections covering debt and equity financing.

Finally, we discuss our approach to valuations in the sector and how to prepare for a major capital transaction.

We hope that you find this an enjoyable read and whether you are a buyer or seller, seeking capital or providing funding, we would welcome the opportunity to discuss this more thoroughly at your convenience.

# Contents





**45%**  
average loan  
to value (LTV)



**11 months**  
average term



**0.84%** average  
monthly interest rate



**46%**  
regulated

A bridging loan is a short-term loan (typically less than 18 months) secured against property. It is usually used by the borrower as a temporary financing solution, whilst transitioning to another financial arrangement or prior to selling the property.

### Purpose

The most recognisable purpose of a bridging loan is additional finance to buy a new property, whilst the sale of another property is still being completed. However, bridging finance is increasingly being used for alternative purposes, including:

- ▶ Buying a property at auction
- ▶ Property refurbishment and development finance
- ▶ A form of short-term capital for business use

### Key attributes

- ▶ Typically, no early repayment penalties
- ▶ Single bullet repayment at maturity
- ▶ Faster execution, a bridging loan can be completed within two weeks
- ▶ No monthly interest payments, interest is typically rolled up over term
- ▶ Underwriting focused on property, borrower and repayment option

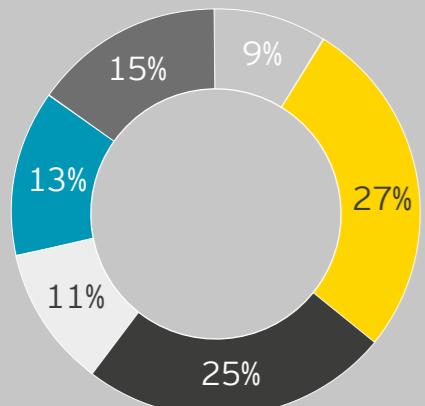
### Focus

Understanding how the loan will be repaid is particularly important for bridging loans due to their property focus and bullet nature.

Typical exit routes include:

- ▶ Sale of property
- ▶ Conversion to long-term financial arrangement (mortgage, buy-to-let product and development finance)
- ▶ Redemption of loan with operating cash flows (for businesses)

### Purpose breakdown



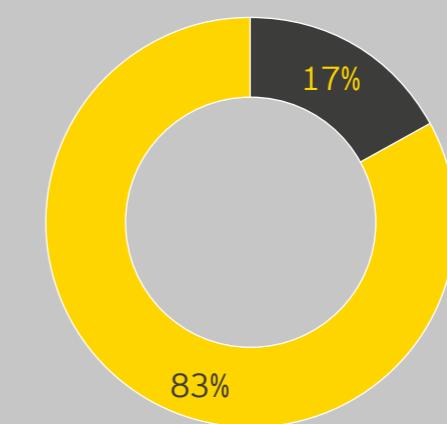
- Auction purchase
- Refurbishment
- Mortgage delays
- Business purpose
- Re-bridge
- Others

### Regulated vs. unregulated bridging loans

Regulated loans are generally those secured against a property that is currently or will be occupied by the borrower or their close family, or where the property is mixed use and the borrower or family occupy at least 40% of the property.

Unregulated loans are generally secured on a commercial property or on a residential property being used as an investment. Second charge loans secured on the borrowers home are also unregulated if the loan is for more than £25,000 and the borrower is using the money for business purposes.

### Bridging market breakdown



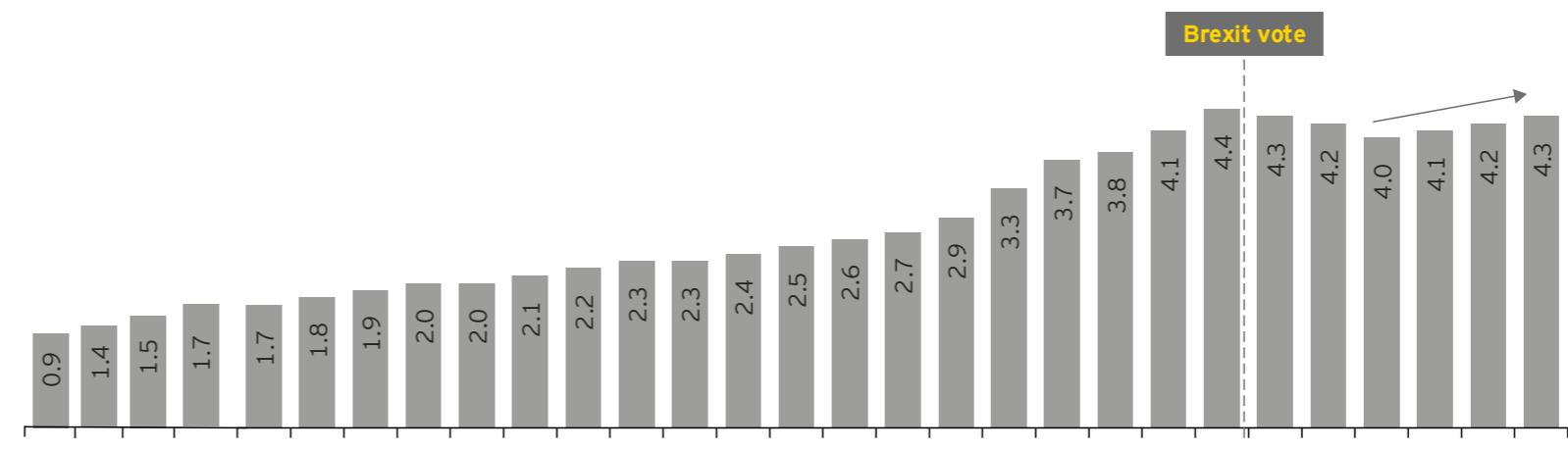
- First charge
- Second charge

In the year to June 2017, UK gross bridging lending amounted to £4.3bn, with strong historical growth at a compounded annual growth rate (CAGR) of 26.1% since 2013.\*

## Long-term supporting factors:

- ▶ Strong history of housing liquidity and value creation in the UK, driven by shortage of housing supply
- ▶ Inefficiencies of mainstream lenders in providing short-term property finance because of increased regulation and capital requirements
- ▶ A previously strong buy-to-let market, which enabled buyers to refurbish properties with confidence of obtaining longer-term financing
- ▶ The need for a more tailored approach in this segment due to the focus on speed in property execution
- ▶ An influx of new market entrants that has serviced the borrower demand

UK gross bridging lending (£bn) last twelve months (LTM)



\*Source: WestOne Loans

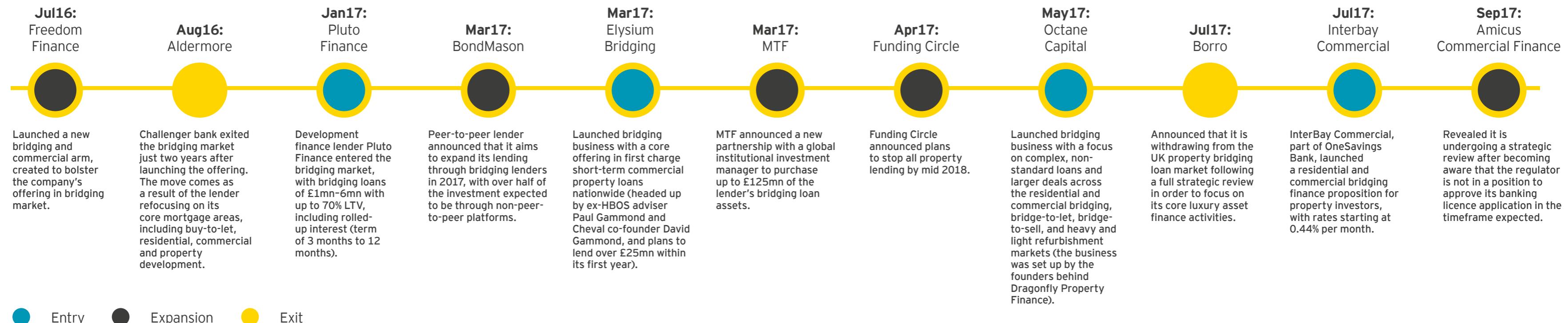
### Recent trends:

Despite increasing economic uncertainty and headwinds facing the buy-to-let market, the bridging market has proven to be relatively resilient over the last 18 months. Following the Brexit vote, we saw the market contract slightly, but it has since recovered in the first half of 2017. Certain areas of the market have changed significantly in this period, such as the price of high-value London assets, but the conservative LTV's and reactivity of the market has meant that most players have adjusted their underwriting to this and continue to see good lending opportunities.

# Market landscape

- ▶ Post the financial crisis, the market became underserved as high street lenders tightened their risk policies and retrenched to core markets, and specialist lenders struggled to maintain their funding lines. Only a handful of lenders continued to trade through this period.
- ▶ This departure provided capacity for new market entrants, keen to capture a share of the strong demand seen by borrowers. The majority of these players were initially funded by high net worth individuals who were seeking strong yield from their savings and because of the funding capacity of individuals, this led to the market being highly fragmented.
- ▶ Over the last three years, the market has become more institutionalised as larger bridging lenders and challenger banks have been able to secure more scalable funding; we estimate the top 10 players to account for more than 75% of the market activity. The remaining market share is covered by approximately 30 smaller independent players who operate in niches of the market and are typically funded through family or high net worth money.

## Notable participant announcements



# Market growth

## Where is the UK bridging market heading?

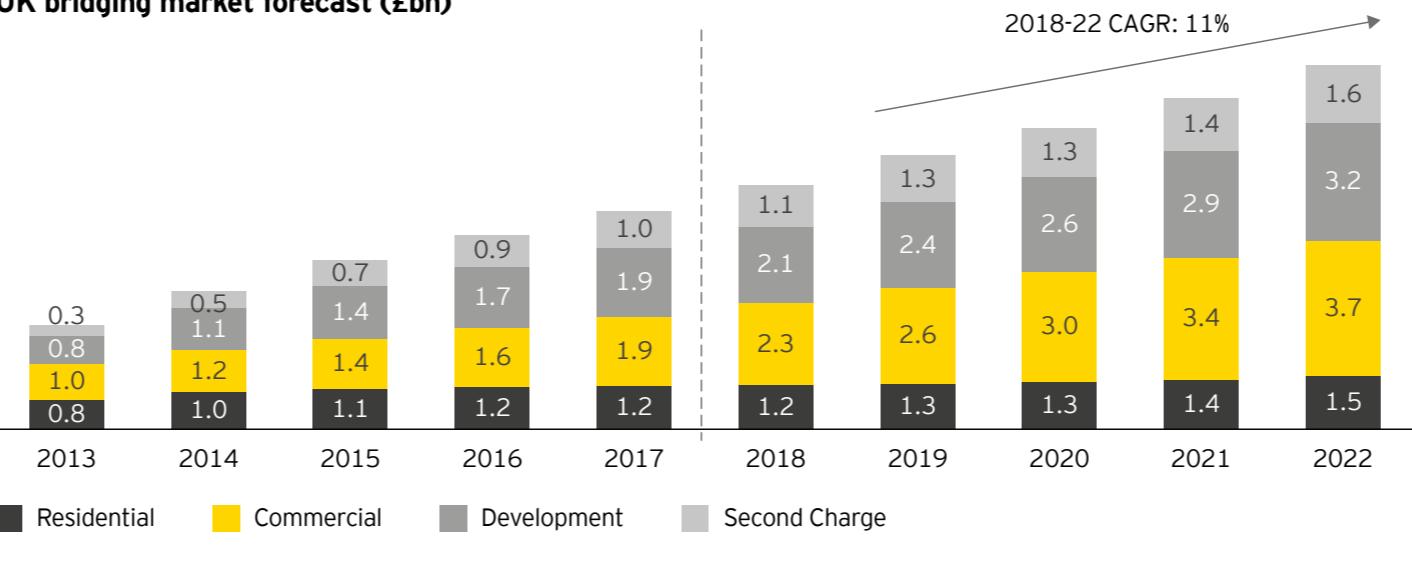


**Matthew Tucker**  
Associate Partner  
Corporate Finance Strategy  
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EY undertakes a wealth of commercial due diligence on markets for corporates and private equity firms. Our research into the UK bridging market includes a survey of 11 key market players and analysis of the most relevant industry research. These findings, alongside our own insights, provide an informed outlook on the future of the UK bridging market.

- ▶ In the short term, most of our survey respondents believe that bridging market growth will be flat because of the general economic uncertainty and property pricing.
- ▶ In the long term, Mintel forecast\* the market to still grow strongly, albeit at half the rate experienced since 2013. Mintel expects strongest growth to be seen in the commercial and development markets, with residential bridging only growing at 5% CAGR.
- ▶ House prices, which is a key market driver for residential bridging, are expected to grow by 4% in 2017, remain flat in 2018 and resume growth in 2019, according to Oxford Economics.

**UK bridging market forecast (£bn)**



\*Source: Mintel Forecasts

### Risks to market growth: survey responses

Key impediments to growth and potential risks that the market players have pointed out are related to macroeconomic uncertainty, market reputation (borrowers' perception of the bridging market) and property market correction.

Some respondents believe that regulatory changes in the bridging market and adjacent markets (e.g., buy-to-let) could significantly affect the market. The challenges to grow the book include access to talent and human capital as well as flexible and efficient funding to support growth.

**We agree that the biggest challenges to bridging market growth in the medium term could be further correction in property prices, macroeconomic risks and investors' confidence due to UK macroeconomic environment. That being said the key supporting fundamental of need for housing will, in our view, counterbalance these headwinds.**

# Market competition

We've seen increasing competition in the UK bridging market over the last 24 months. So, we asked our survey respondents for their views on the direction of the market and what attributes are key to remain successful.

Three key trends emerged:

## Margin compression

Pricing in the bridging space has gone down significantly in the past three years, largely driven by the benign interest rate environment, and the inflow of market entrants advertising and offering lower rates.

Most of our survey respondents believe that this trend will continue in the short to medium term and market players need to adapt to this by securing efficient low cost funding.

## LTV cap increase

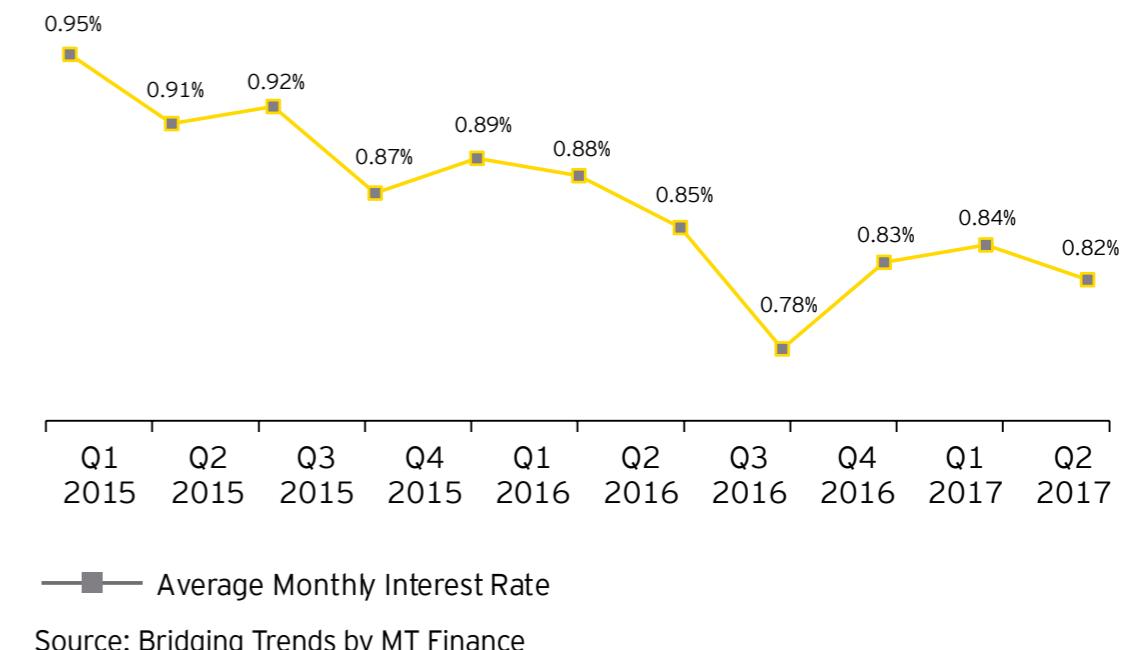
In some cases, the market has seen lenders assuming higher risk loans and increasing LTV above the historical cap of 75%.

Almost all our survey respondents did not view this as being sustainable going forward. However, a few respondents noted that higher risk higher return is an alternative business model, which has worked for some lenders in the past.

## Increased flexibility

Growing competition requires lenders to be more flexible in terms of product features, and ability to adapt to movements in key parameters during the process.

Our survey respondents believe this flexibility and delivering a high-quality service to be one of the main differentiators in the market, a trend, which is likely to continue.



## Key winners' capabilities: survey responses

- Increased market competition requires lenders not only to be competitive in terms of the speed of execution, pricing and flexibility to the borrower, but develop a range of other capabilities in order to be successful in the market.
- The respondents pointed out key capabilities that are required for a bridging lender to be successful in the market:
  1. Market reputation and commitment to deliver on the terms set out to a borrower
  2. Strong origination capabilities in the niche that a lender is targeting through relationship with brokers and direct channels
  3. Efficient and scalable underwriting practices, and risk management procedures

# What happens next?

## Survey responses

Many respondents expect the number of players in the industry to decrease in the next few years because of:

1. Market correction forcing some riskier and more aggressive market players without unique selling propositions to exit the market
2. Top existing players organically growing larger and diversifying across adjacent market segments
3. Further consolidation in the midsize and niche segments where smaller lenders will be acquired by larger ones

It was expected that lenders that have strong origination capabilities, scalable underwriting and are more diversified in their product offering to be a more attractive target in the industry and to have a higher value to shareholders.

However, a number of respondents also believed that monoline lenders could be interesting to larger diversified players within the challenger banks segment planning to enter the market or use it as a bolt on to their own book in the future.

## EY summary

We agree that the bridging market will see consolidation amongst the smaller players, as the unregulated bridging market is still highly fragmented and there are synergies in increasing market share by acquiring a competitor or a business with a unique selling proposition, such as proprietary funding costs, origination routes, underwriting and best in class technology.

Companies, which can demonstrate winners' capabilities and have a diversified business model (in terms of product offering or additional revenue channels, such as broker capabilities) will be more attractive from an M&A perspective.

We expect the consolidation to be driven by nonbank lenders and private equity investors.

We believe that challenger banks are less likely to become buyers of bridging businesses, following recent regulatory changes to capital requirements, which make this business significantly less attractive from a capital perspective for banks. In addition, we have seen challenger banks finding it increasingly difficult to pay goodwill and so, whilst they will look at acquisitions, we think we will continue to see private equity dominate in the short term.

# The impact of technology on the market

## Survey responses

The opinions of the respondents were split on the potential disruptive impact of technology:

Many respondents believe that technology could have a disruptive impact in the bridging market in terms of:

- ▶ Client origination
- ▶ Funding (peer-to-peer platforms)
- ▶ Complete automation of certain functions and processes.

Other respondents believe that because of the bespoke nature of the product, the market will remain broker-led and customer service processes will not move away from human interaction.

## EY summary

We believe that technology has scope to significantly impact the market. In general, we agree with participants that underwriting is likely to remain manual because of the bespoke nature of the product. However, we think that almost all other elements could be disrupted by new and innovative technological alternatives. Some examples could be:

- ▶ **Client journey:** We are seeing increasing use of artificial intelligence (AI) to provide robo advice as alternative to human conversation.
- ▶ **Underwriting:** Whilst the ultimate decision will remain a human one, we believe that developments, such as API Open Banking links and tools, that scrape your public social media profile, improve the efficiency of this approach by giving underwriters quicker and more insightful data to review.
- ▶ **KYC:** Facial recognition technology, finger print scanners and electronic identification tags are all currently available, but have low adoption in this market.
- ▶ **Data analytics:** As greater data is available and captured through underwriting, machine learning could then be used to analyse input data and historical performance data to find trends that impact loan performance.
- ▶ **Staff structures:** With technology, now capable of being trained to undertake simple repeated tasks, the staff base will need to adapt to a task structure, which is more review focused or relationship driven.

# Strategic routes

## What options are available?



**Stuart Mogg**  
Director  
Corporate Finance  
Ernst & Young LLP

On the next few pages, we consider six options that we believe are available for a bridging company wishing to grow or realise its investment on the basis of our assessment of the market trends. Many of the selections are dependent on obtaining financing, the options for which we will address in later sections.

### Merge

- ▶ With the bridging market showing signs of reduced growth, organic growth may only be achieved through increasing market share, which can be costly.
- ▶ A merger, on the other hand, can achieve immediate growth in the loan book and the associated economies of scale.
- ▶ Integration, however, may be complicated if businesses run bespoke systems or have materially different underwriting and collections processes.

### Sell now

- ▶ We are aware of a number of bridging lenders targeting a sale of the business in the next two to five years, though there are few currently up for sale.
- ▶ One of the reasons for this is that many small- and medium-sized bridging lenders are not yet at the size that would achieve the shareholders' target exit valuation.
- ▶ If the market becomes crowded in future with several businesses being sold at the same time, valuations may be adversely affected, meaning it could be preferable to sell now.

### Expand overseas

- ▶ Another option to achieve growth in a maturing UK market could be to expand overseas.
- ▶ The most similar overseas model is the US 'fix and flip' market; though we have seen limited examples of US 'fix and flip' lenders entering the UK bridging space and vice versa except where under common equity ownership.

### Buy a broker

- ▶ Broking fees are an alternative source of recurring revenue (without additional burden of capital requirements), which can be created by launching or acquiring a broker.
- ▶ The additional benefit of owning a broker is that it provides a view on overall market activity. However it is important to assure other lenders on that broker panel, that the acquisition will not create a conflict of interest.
- ▶ Acquisition of a minority stake in a broker is a potential route to secure a long-term relationship and access to market intelligence without eroding the value of a broker.

### Retrench from the market

- ▶ The bridging market is becoming increasingly competitive and some market players may choose to refocus their business and exit the market rather than to deploy more capital and risk making a loss.
- ▶ We've seen this approach from Aldermore, Borro and Funding Circle in the last 18 months.
- ▶ This could be most applicable to lenders with unique origination routes who may be able to reposition management expertise into becoming more like a broker.
- ▶ This option would be most challenging for small bridging - only lenders who lack both firepower and diversification.

### Expand product range

- ▶ The short-term nature of bridging lending means that intense origination activity is required simply to maintain the loan book.
- ▶ For lenders focused on growing assets, adding longer-term products can be complementary to bridging in generating more recurring revenue.
- ▶ We have seen this recently in the case of ENRA Group, which launched its own book second charge lending product in May 2017 through the West One brand.
- ▶ In addition, Lendinvest recently announced it was expanding into buy-to-let lending.

# In Focus: International expansion

## Survey responses

- ▶ Bridging lenders generally believe that the UK market provides sufficient growth opportunities for their business. The primary route to expansion is geographically in the UK rather than going international.
- ▶ If they were to consider international expansion, the US market appeals to many bridging lenders, as they can offer a similar product proposition and there is capacity to grow quickly.
- ▶ Most lenders discounted Europe because of more customer-friendly legal systems and language barriers.
- ▶ Some lenders believe that it would be a more appropriate opportunity for brokers to first explore and gain the necessary market knowledge and expertise before sharing with lenders.
- ▶ The key barrier to entry for international expansion is building market knowledge in a new jurisdiction. Furthermore, the potential regulatory differences and the additional resources needed to build the expertise (and educate the customers in another jurisdiction where the product is not commoditised) make this challenging.



# In Focus: Buy a broker?

## Survey responses

- We asked the respondents if they expected any changes in the current value chain, in particular, through vertical integration with brokers or funders.
- Many of our respondents had considered buying a broker in order to gain a competitive advantage around origination, as the market becomes increasingly competitive. However, most did not act on this, because of the concern that by acquiring a broker and increasing origination, onto their lending book, they would erode the value of the broker.
- In order to avoid value attrition in a lender-broker transaction, findings suggest that the broker has to remain independent and prove the ability to treat all lenders on their panel fairly, though built-in processes and controls. Therefore, acquiring minority stakes in brokers and developing long-term relationship is viewed as a more common way to strengthen origination and obtain valuable market insights, but may not be equity enhancing.
- In addition to buying a broker, the majority of our respondents were also considering direct origination channels. Our respondents noted that this was being driven by the broker market asking for increasingly higher shares of the deal economics. Despite many considering this route, it is acknowledged that direct activity is currently limited; partly, because of how this may be perceived by key broker relationships and also the additional market costs that need to be incurred.

## Key considerations

### 1. Direct origination channel

Reduces reliance on third parties who are becoming increasingly expensive  
Defendable market position, but comes at the cost of origination  
Determine the extent to which, owning a broker reduces cost to originate vs. paying broker fees

### 2. Increase origination

Market participants are wary of majority stake acquisitions of brokers, which is likely to erode the value of a broker, unless it remains independent.  
However, remaining independent would then unlikely increase originations.

### 3. Increase market visibility

Can this be obtained through the existing strong broker relationships already in place?  
The correct funding platform is important to ensure the business can act upon market intel (i.e., responding to reduced pricing and flexibility).

### 4. Diversify revenue streams

Fees charged by the broker to originate from other lenders provides a new source of income that is independent of growing the business's own loan book.  
Owning a broker introduces the ability to earn fees, when the market is overheating, by increasing broking activity. In turn the lender may choose to scale back operations.

### 5. Secure origination

Increase defensibility of market position and prevent a competitor from acquiring a key route to market

### 6. Regulatory burden

Acquiring a broker would require the necessary compliance procedures to be in place to meet Financial Conduct Authority (FCA) standards.  
The broking division would be required to demonstrate that the customer has received the best outcome and this will involve removing any cherry-picking bias.

# Debt funding overview

## Debt funding



**Jordan Blakesley**  
Senior Manager  
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Ernst & Young LLP

Debt funding is important for bridging companies, as it enables growth of the loan book beyond the means of equity capital and enhances the returns available. It comes at a cost; however, not just interest rates, but primarily in the form controls, which govern the underwriting standards. With an increasing number of options available, it's important to choose a structure and partner with the right balance between funding amount and cost. The next couple of pages discuss the options available and the broad advantages and considerations for each.

- ▶ Funding for nonbank lenders was significantly impacted by the financial crisis. Pulled funding lines and a lack of institutions willing to refinance lenders was one of the main drivers for pre-crisis players retrenching from the market.
- ▶ Post crisis, the majority of new entrants used funding from founders and high net worth individuals to establish a track record. For some, this continues to be an attractive form of funding because of flexibility, albeit becoming more expensive comparatively.
- ▶ We've seen more institutions willing to support nonbank lending, due to strong growth of the wider speciality finance market, better underwriting practices and a more stable regulatory environment. The bridging market also follows this trend and we've seen several banks and funds offering to support more established players as well as newcomers able to demonstrate origination growth, scalability and a good quality of underwriting.
- ▶ In recent months, we've noticed a shift in market sentiment with funders gradually becoming more cautious on bridging. A few funders have highlighted increased competition, emergence of a multitude of small players focused on the same target customers and competing on pricing, which makes it challenging to build long-term differentiators. Many funders believe the market to be overheated and predict there will be some winners and losers in the short run.
- ▶ All this being said, the number of funding options for a bridging business has grown recently and the bridging market has been innovative in accessing unique pools of capital, such as retail bonds, private securitisations and capital raises on market place platforms.

# Debt funding options

|                     | <b>1<br/>HNW and P2P funding</b>  | <b>2<br/>Senior and mezzanine structure</b>   | <b>3<br/>Unitranche funding</b>  | <b>4<br/>Capital markets</b>   | <b>5<br/>Forward flow arrangement</b>   | <b>6<br/>Retail deposits</b>  |
|---------------------|---|---|--|--|---|---|
| <b>Outline</b>      | <ul style="list-style-type: none"> <li>Whole loan funding provided by wealthy individuals directly to the company or via a marketplace platform</li> </ul>                              | <ul style="list-style-type: none"> <li>A wholesale facility with one or more lenders and tranches</li> </ul>  | <ul style="list-style-type: none"> <li>Typically bilateral facility with one lender who is willing to provide leverage beyond traditional senior levels</li> </ul>   | <ul style="list-style-type: none"> <li>Accessing funding through capital markets, in the form of tradeable notes or retail bonds</li> </ul>  | <ul style="list-style-type: none"> <li>An ongoing sale agreement with an investor where the originator benefits from a set fee or a share of future profits</li> </ul>  | <ul style="list-style-type: none"> <li>Access to retail funding in the form of deposits from households and small companies</li> </ul>                              |
| <b>Key features</b> | <ul style="list-style-type: none"> <li>Funding level: 100%</li> <li>Uncommitted</li> <li>Expensive as viewed as equity investment</li> <li>Security only over specific loans</li> </ul> | <ul style="list-style-type: none"> <li>Funding level: 70% -75% (senior); 80%-90% (mezzanine)</li> <li>Pricing: 2.5%-5.0% (senior) and 8%-15% (mezzanine)</li> <li>Committed if loans meet certain eligibility criteria</li> <li>Numerous covenants</li> </ul> | <ul style="list-style-type: none"> <li>Funding level: 80%-90%</li> <li>Pricing: 5%-9%</li> <li>Committed if loans meet eligibility criteria</li> <li>Numerous covenants</li> </ul>   | <ul style="list-style-type: none"> <li>Funding level: 95%-100%</li> <li>Pricing: 3-6%</li> <li>Not rated by a credit rating agency</li> <li>Starting at £30mn for retail bonds and £100mn for private placement</li> </ul> | <ul style="list-style-type: none"> <li>Funding level: 100% - whole of the loan funding is committed</li> <li>Committed</li> <li>Pricing similar to high net worth and peer-to-peer funding</li> </ul>   | <ul style="list-style-type: none"> <li>Funding level: subject to regulatory capital</li> <li>Pricing: 1%-3%</li> <li>Flexible capital with no conditions</li> </ul> |
| <b>Advantages</b>   | <ul style="list-style-type: none"> <li>Flexible</li> <li>Light reporting requirement</li> <li>Available at start-up</li> </ul>  | <ul style="list-style-type: none"> <li>Committed funding for three years</li> <li>Cheaper than HNW funding</li> </ul>   | <ul style="list-style-type: none"> <li>As dealing with less parties can potentially be less complex and quicker than the senior and mezzanine structure</li> <li>May be more flexible regarding covenants than senior and mezzanine options</li> </ul> | <ul style="list-style-type: none"> <li>Potentially fewer covenants</li> <li>Relatively cheap pricing due to liquidity of notes and funding</li> </ul>  | <ul style="list-style-type: none"> <li>No additional equity required up front</li> <li>Ability to rapidly grow loan book, subject to investor eligibility criteria restrictions</li> <li>Ability to demonstrate origination capability to future potential investors</li> </ul> | <ul style="list-style-type: none"> <li>Cheapest of all funding options</li> <li>Flexible</li> <li>Less volatile than capital markets</li> <li>Efficient</li> </ul>  |

# Debt funding options

|                       | <b>1<br/>HNW and P2P funding</b>   | <b>2<br/>Senior &amp; mezzanine structure</b>  | <b>3<br/>Unitranche funding</b>  | <b>4<br/>Capital markets</b>  | <b>5<br/>Forward flow arrangement</b>  | <b>6<br/>Retail deposits</b>   |
|-----------------------|--|--|--|---|--|--|
| <b>Considerations</b> | <ul style="list-style-type: none"> <li>No commitment to fund new loans</li> <li>A number of bridging lenders have launched peer-to-peer platforms (e.g., LendInvest, Kuflink). As a result, attracting investors could become harder</li> <li>Attracting investors into a P2P platform involves additional regulatory and marketing costs</li> </ul>   | <ul style="list-style-type: none"> <li>Track record of lending performance typically required</li> <li>Increases equity requirement vs. HNW funding and P2P options, but business retains key economics of the loan</li> <li>Numerous covenants around concentration, performance and control of cash flow</li> </ul>  | <ul style="list-style-type: none"> <li>Limited number of funders are able to provide a unitranche facility at a competitive price</li> <li>Usually appetite begins at £50mn so unavailable for smaller companies</li> </ul>  | <ul style="list-style-type: none"> <li>Would usually be first funded through a bank's warehouse facility</li> <li>Requires public reporting of performance</li> <li>Because of the short-term nature of bridging loans, they have not become part of the public markets yet and this can't be currently regarded a well-established source of funding</li> </ul>  | <ul style="list-style-type: none"> <li>Increases reliance on one investor to fund loan book growth</li> <li>Limited equity upside due to foregoing economic interest in loan book</li> </ul>   | <ul style="list-style-type: none"> <li>Specific to large financial institutions and challenger banks</li> <li>Subject to regulations and capital requirements</li> </ul>   |
| <b>Key insights</b>   | <ul style="list-style-type: none"> <li>Whilst HNW is still a common source of funding for bridging market players, we see it as an initial form of funding for companies, which is quite costly and less efficient than funding through asset-backed facilities and capital markets.</li> <li>We've noticed a recent shift toward larger professional investors in marketplace lending.</li> </ul> | <ul style="list-style-type: none"> <li>Limited liquidity for smaller debt facilities, particularly at mezzanine level</li> <li>Decreasing appetite from both senior and mezzanine perspective for mono-product lenders, as some senior funders have reached a high concentration of bridging loans.</li> <li>However, we still see strong appetite for lenders able to differentiate themselves in the market and evidence good origination channels and scalability.</li> </ul> | <ul style="list-style-type: none"> <li>For smaller players who would otherwise have a small mezzanine requirement, which is difficult to place, this can be a more attractive way of increasing leverage, whilst growing.</li> <li>Taking pricing alone, this option is typically more expensive than the senior and mezzanine structure.</li> </ul> | <ul style="list-style-type: none"> <li>There has been only one public placement of listed notes collateralised by a pool of bridging and development loans, the £100mn securitisation by Amicus Mortgage Finance in August 2015 (listed on the Irish Stock Exchange's Global Exchange Market).</li> <li>The other recent capital market issuance was Lendinvest's £50mn retail bond.</li> <li>Together Money has also accessed the capital markets through their high-yield bond programme</li> </ul> | <ul style="list-style-type: none"> <li>We think this is an attractive option for companies to demonstrate strong growth without requiring significant third-party equity.</li> <li>Once this track record is established, then on-balance sheet funding options will be more readily available.</li> <li>We see continued appetite for forward flow transactions, including in some niche segments, such as larger loans, or bridging loans secured by commercial property.</li> </ul> | <ul style="list-style-type: none"> <li>There are a number of new capital requirements being introduced for bridging loans, which may at least double the risk weighted assets required for a loan book.</li> </ul> |
| <b>Examples</b>       | <ul style="list-style-type: none"> <li>Kuflink</li> </ul>  | <ul style="list-style-type: none"> <li>Roma Finance</li> </ul>   | <ul style="list-style-type: none"> <li>Together Money</li> </ul>   | <ul style="list-style-type: none"> <li>Amicus</li> </ul>  | <ul style="list-style-type: none"> <li>MTF</li> </ul>  | <ul style="list-style-type: none"> <li>Shawbrook</li> </ul>  |

# Equity funding options

## Equity funding



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Partner  
Corporate Finance  
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Equity funding is a more secure and flexible way to grow the loan book, but comes with its own downsides, including ownership dilution and in the case of a listing, ongoing regulatory compliance. It's therefore important that equity options are considered in line with the wider growth strategy. On the next few pages, we lay out the available options, summarise the recent deal activity in the sector and outline steps for ensuring that valuations are maximised.

### Equity raise from current shareholders

- ▶ It is relatively quick to access meaning accelerated business growth.
- ▶ This option is typically limited in terms of size.
- ▶ It could be challenging, particularly where one group of shareholders (i.e., management), have limited capacity to invest further in the business, but at the same time do not want their equity share to be diluted.

### Sale to a strategic buyer

- ▶ Sale to a trade buyer provides balance sheet capability, to ensure accelerated book growth on day one and often results in immediate realisation of value to existing shareholders (some deals may also include future pay-outs through an earn-out mechanism).
- ▶ However, a trade sale would usually involve a majority or 100% shares sale with strategic decision-making yielded to the buyer.
- ▶ This may provide value above and beyond capital through realisation of synergies, such as geographical footprint or systems.

### Equity raise from private equity players

- ▶ Private equity (PE) involvement makes significant equity capital available on day one, which helps accelerate loan book growth and allows for acquisitions.
- ▶ To attract PE investors, companies need to demonstrate strong record of growth and financial performance.
- ▶ We are aware of a number of players interested in purchasing within the bridging market.

### Public equity issuance

- ▶ Rather than selling to a specific third party, equity capital could be raised via a listing on a stock exchange.
- ▶ Equity markets could then be used for future equity raises as opportunities arise.
- ▶ This would result in immediate value realisation for existing shareholders as well as improved market perception as a public limited company (PLC).
- ▶ However, the cost and time (one year) required to go through a listing process and ongoing cost of regulatory compliance are usually quite significant.

# Recent equity transactions in the bridging market

- There has been a limited number of transactions in the bridging market since the financial crisis. Where we have seen trades, this has primarily involved brokers and deal values have often not being disclosed.

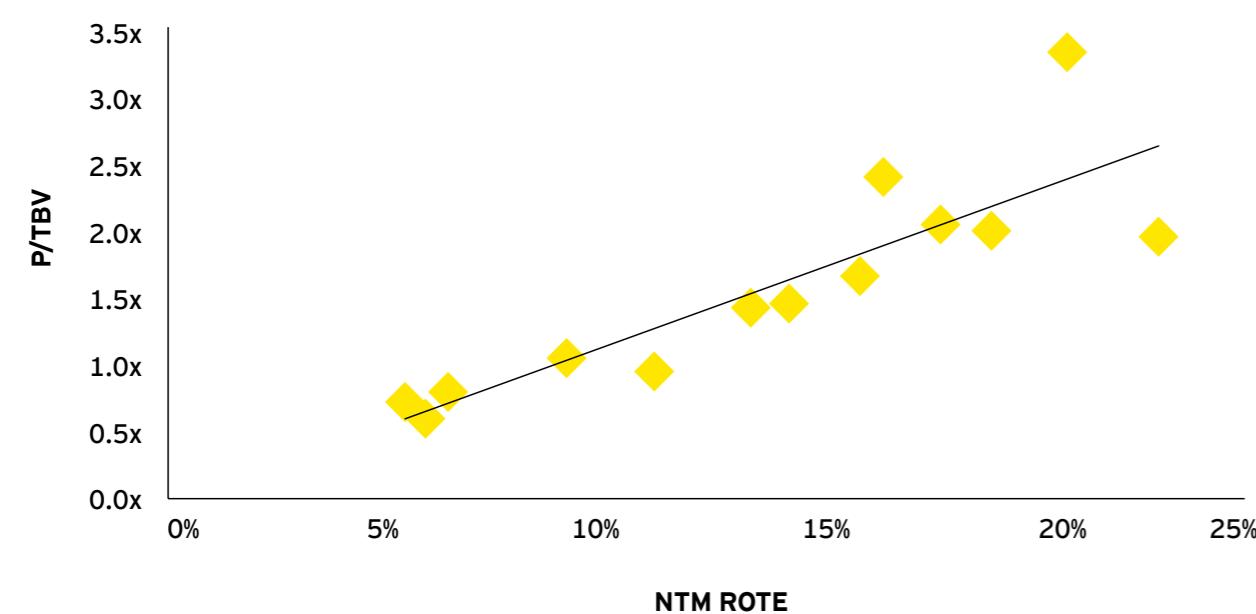
| Date announced | Target                       | Target description  | Acquirer                         | Stake (%) |
|----------------|------------------------------|---|----------------------------------|-----------|
| Mar 2017       | Intelligent Loans (iLoans)   | Brokerage engaged in the packaging of secured bridging loans, second charge loans and commercial mortgages - £2mn deal value  | 1pm plc                          | 100%      |
| Dec 2016       | Pink Pig Loans               | Master broker that offers specialist second charge loans and bridging loans   | Y3S Group                        | 50%       |
| Nov 2016       | Enra Group                   | ENRA lends and brokers short-term bridge mortgages as well as distributing specialist second charge and buy-to-let products. Owns West One Loans and Enterprise Finance | Exponent Private Equity          | Minority  |
| Jul 2015       | Brightstar Financial Limited | Lending distributor that offers specialist residential and buy-to-let mortgages, second charge loans, bridging loans, and commercial finance                            | Omni Equity Partners LLC         | Minority  |
| Dec 2014       | Chaseblue Loans              | Mortgage and loan brokerage; bridge and commercial financing; and consultancy services  | Y3S Group                        | 50%       |
| Nov 2014       | Mayfair Bridging Limited     | Residential and commercial bridging finance   | Capital Bridging Finance Limited | 100%      |
| Sep 2014       | West One Loans               | Short-term bridging finance for residential and commercial properties   | Enterprise Finance Limited       | 100%      |
| Feb 2014       | Enterprise Finance           | Specialist distributor of secured loans, and also specialises in bridging finance and commercial mortgages; the transaction was valued at £28mn                         | Livingbridge                     | Minority  |
| Nov 2013       | Dragonfly Property Finance   | Bridging lender. Octopus had provided a funding line to Dragonfly since its launch in 2009  | Octopus Investments              | 100%      |

# Valuation approach for the speciality finance market

The bridging market is a subset of a wider speciality finance market encompassing all niche lending institutions across various asset classes, including but not limited to, asset financing, leasing, unsecured consumer lending, working capital, small and medium enterprises (SME) lending and mortgage lending. As the bridging market is often recognised as part of this market and does not have a wealth of recent transactions in its own right, it would make sense to apply a similar valuation approach, which we have detailed below.

- ▶ The graph below plots the listed speciality finance companies Price to Tangible Book Value (PTBV) against its next twelve months Return on Tangible Equity (ROTE).
- ▶ Despite certain outliers, the relationship between the two metrics is evident. We then typically use this relationship when valuing a business to convert the companies ROTE to the multiple of Tangible Book Value (TBV) that should be used.

## Speciality finance market regression analysis



## Valuation of speciality finance businesses

There are a number of listed speciality finance companies, which enable a multiple-based approach to be used. These companies have a broad range of lending asset classes and as such the population of multiples used needs to be as reflective as much as possible of the underlying business model being valued; typically our population includes both speciality finance companies (with a few abnormal exclusions) and Challenger Banks.

Within the speciality finance segment in the UK, we have historically observed that earnings year on year tend to be volatile compared with some of the larger peers, such as listed high street retail banks. As such, when valuing speciality finance companies, we prefer to base our valuation on book values (i.e., net tangible assets), which are more stable over time.

It's common to use a price-to-earnings (P/E) multiple in other markets. Within speciality finance, this multiple-based approach is typically used as a sense check or where the asset base of the business is inconsistent with the lending capabilities, for example, a broker.

Source: CapitalIQ; EY Analysis of certain selected listed companies; valuation date is 12th December 2017;  
NTM is next twelve months from the valuation date or FY2018

# Valuation approach for a bridging lender

- ▶ Whilst some of the listed speciality finance companies offer short-term financing (mainly unsecured consumer loans), there are no listed 'pure players' offering bridging finance only, as such listed comparisons mentioned on the previous page are not perfect.
- ▶ Short duration loan books are a characteristic unique to bridging. The reduced certainty of long-term revenue, would indicate a bridging lender should trade at a multiple lower than, previous regression analysis of the speciality finance market would suggest.
- ▶ In addition to short duration loan books, the low barriers to market entry and currently high number of players could provide support to a lower multiple being used.
- ▶ How much of a discount is applied is dependent on a number of things (as indicated on the right), but a key driver is its loan book. As such, the companies' data tape will be heavily analysed as part of the valuation approach. For small loan books, we may perform a loan-by-loan valuation taking into consideration contractual terms, risk, collateral assessment, market conditions and borrower characteristics. However, our standard approach is to take a portfolio approach to value the loan book with appropriate segmentation.

## Top five factors that may lead to a premium to the multiple used

- ▶ Sizeable market share
- ▶ A scalable platform
- ▶ Unique, diverse and market leading funding sources
- ▶ Distribution capabilities or strong relationships with intermediaries
- ▶ Strong underwriting standards underpinning the quality of the loan book

## Top five factors that may lead to a discount to the multiple used

- ▶ Lack of scale, i.e., relatively small loan book of £10mn-£20mn
- ▶ Data quality issues highlighted in due diligence on loans
- ▶ High concentration risk in the loan book
- ▶ Uncertainty in collateral valuations
- ▶ Lack of pipeline and no or limited visibility on future earnings

# How to improve your valuation

- 1** Instill strong corporate governance, particularly around the policies that govern underwriting and collections. These should clearly detail the processes undertaken, such that a third party could quickly understand the approach taken
- 2** Focus on strong data capture and data quality; the loan book is the major asset of the business and should be free from input errors and sufficiently detailed to control risk
- 3** Diversify revenue both geographically and by offering a wider range of lending products, (e.g., longer term loans) this would likely increase value
- 4** Strengthen relationships with intermediaries and show understanding of the value of key intermediaries, including tracking longevity of relationships
- 5** Build capability and infrastructure to scale the business efficiently
- 6** Develop long-term, diverse and committed funding lines to provide a sustainable source of finance to drive growth
- 7** Have a clear management succession plan in place such that the business is not overly reliant on founding shareholders

# Preparing for a transaction

Preparing for a debt or equity transaction involves setting clear objectives and expectations of the transaction and preparing the relevant data, systems and polices for due diligence (for equity raise) and agreed upon procedures (AUPs) (for both).



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When a bridging lender decides to pursue equity or debt financing, it needs to ensure that it is adequately prepared. Being prepared means having defined objectives and expectations, and communicating consistent information to potential investors and funders. This reduces execution risk and ensures that deals are executed efficiently. In the next few pages, we run through the steps required to protect value during an equity or debt raise.

## Set clear objectives

- ▶ Be it an equity or debt raise, the business should have a clear idea of what it is seeking to achieve from the fundraise and what is the expected timeline for completion.
- ▶ The quantum of capital should be driven by the lender's business plan and projected book growth.
- ▶ The company should be able to support this by a three to five year origination plan and financial forecast, and to break down each key component of the capital requirement and articulate how it will drive incremental value for the business.

## Desired transaction terms

- ▶ For both equity and debt transactions, it is important to have a clear view of what success looks like and what the deal-breakers are before embarking on a fundraising process.
- ▶ For an equity raise, the business should benchmark expectations against bridging lender valuations, transaction terms and structures. In addition, the business should assess the potential implications for the company, e.g., drag and tag rights, vetos on distributions or certain decisions beyond the ordinary course of business.
- ▶ For a debt raise, the business should determine which transaction structure is most appropriate given the growth strategy, the required level of flexibility (given the stage of the business) and expected target pricing.

## Data and preparation

- ▶ It is critical for a bridging lender to capture all the portfolio data in the system and be able to extract it in a convenient format for buyers or funders, as the loan datatape is one of the key areas of due diligence focus.
- ▶ The company should have an executable business plan covering all elements of the business (market opportunity, product and unique selling points (USPs) competitive landscape, origination strategy, underwriting, technology, operations, personnel and financial forecasts) and be able to clearly set it out to investors and funders in a management presentation.
- ▶ It is important to have the company's operational processes properly documented and evidenced by a set of policies, which gives comfort to investors and funders, and decreases key people risk in a transaction.

## Process

- ▶ It is critical to have a well-prepared and timed process, targeting the right set of investors or funders simultaneously to generate and maintain competitive tension.
- ▶ Ongoing or perpetual market conversations may lead to a sub-optimal outcome giving market the impression that the business can't raise funds and encouraging them not to put their best foot forward on pricing and key terms.
- ▶ The process should have a shortlist of targeted investors or funders who have the relevant sector experience, track record in the bridging market and appetite to support projected business growth.

# Preparing for a transaction

| Investment thesis  | Distribution capability   | Underwriting consistency  | Portfolio performance  |
|--|---|---|--|
| <ul style="list-style-type: none"><li>▶ Due diligence preparation should start with a clear articulation of the investment thesis that will be provided to potential investors and a robust assessment of the potential risks that could reduce value.</li><li>▶ Knowing what you want for the business and delivering an achievable business plan helps demonstrate business growth trajectory and sense check exit price for potential buyers.</li><li>▶ Information gathering and analysis should seek to provide potential investors with consistent information that supports (or at minimum does not contradict) the equity story.</li></ul> | <ul style="list-style-type: none"><li>▶ Evidence stable and diversified distribution arrangements through relationship start dates and volumes by channel or broker. Any significant relationship wins can be emphasised and losses put into context. Exclusive distribution relationships can be highlighted.</li><li>▶ If a direct sales capability sits alongside broker channels, there should be a clear articulation of how potential conflicts are managed.</li><li>▶ A robust broker onboarding and monitoring process should be demonstrated, particularly where regulated bridging products are sold.</li></ul> | <ul style="list-style-type: none"><li>▶ The rapid growth of many bridge lenders, a competitive market and the availability of funding makes demonstrating underwriting (and pricing) consistency critical for bridge lenders.</li><li>▶ There should be a well articulated through-line between the overall strategy, credit risk appetite, lending policies and the underwriting in practice as evidenced through loan files.</li><li>▶ Any significant changes to underwriting strategy or implementation should be documented and supported by the reasons for the change.</li></ul> | <ul style="list-style-type: none"><li>▶ Loan datatape information should be clean, consistent and the trends properly understood before being provided to potential investors.</li><li>▶ Areas of focus for due diligence, on bridge lending portfolios includes; concentration risk, shifts in risk characteristics (and whether the increased risk is being appropriately priced), the basis of collateral valuations and an analysis of defaults and arrears relative to expected exit dates.</li><li>▶ Given the customised nature of much bridge lending, a portfolio analysis is frequently supplemented with reviews of loan files.</li></ul> |

# Preparing for a transaction

| Funding capacity and strength   | Accounting policy stability   | Scalability   | Regulatory exposure   |
|---|---|---|---|
| <ul style="list-style-type: none"><li>► Sufficient funding capacity to support future growth plans should be demonstrated.</li><li>► The due diligence preparation should include an evaluation of diversified sources of future funding, particularly where the business is a nonbanking entity (and therefore unable to access retail deposits and certain Bank of England programmes) and new product types are planned.</li></ul> | <ul style="list-style-type: none"><li>► As bridge lending repayment typically occurs at maturity, arrears estimation can be more subjective than some other types of lending. Changes to provisioning methodologies should be supported by clear explanations for the basis of the change. Similarly, the circumstances under which forbearance is granted should be transparent.</li><li>► The estimation of conditional prepayment rates can be particularly subjective for bridge lending and assumptions can become out of date faster than longer term products.</li></ul> | <ul style="list-style-type: none"><li>► Potential investors will want to understand whether the current operating model is fit for purpose and can support future growth, particularly as competition tightens.</li><li>► Automation can be a source of competitive advantage. Articulating this well means, addressing the extent to which technology can be leveraged, to deliver a customised product accompanied by a realistic assessment of delivery costs and future benefits.</li></ul> | <ul style="list-style-type: none"><li>► Governance and control of new and existing regulatory requirements is critical. For example, the interpretation of Capital Requirements Regulation (CRR) applicable to regulated bridge lenders subject to capital requirements is a complex area and changes to the categorisation can result in a change in risk weights and the associated capital requirement.</li><li>► Those bridge lenders acting as both lender and broker (or planning to do so in the future) should ensure that they can present evidence that it considers the fair treatment of customers.</li></ul> |

# Preparing for AUPs

## AUPs

Potential buyers of a business or lenders of a facility will look for factual and independent reporting on key aspects of the strength of the operational controls and processes, and the underlying quality of data.

- ▶ AUPs are usually performed by an independent party in accordance with an appropriate reporting standard - typically ISRS 4400 in the UK.
- ▶ The procedures to be performed can vary depending on the nature of the due diligence sought. Specifically, buyers look at data integrity and operational due diligence via AUPs.



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- ▶ Key to a expeditious due diligence is the organisation, quality and access to underlying data records and documentation of policies and procedures
- ▶ Provision of required data and access to policy and procedural documentation (for example, through a data room) and availability of key staff will facilitate a smoother sale process

## Operational processes AUPs

- ▶ These procedures will relate to the review of the servicing of the bridging loans, i.e., key policies, procedures and documentation already in place, and by observing the entity level policies, procedures and controls implemented by the firm with actual data being checked.
- ▶ Typical operational areas that are reviewed include:
  - ▶ New business approvals
  - ▶ Underwriting
  - ▶ Settlement reporting
  - ▶ Cash collection
  - ▶ Receivables ageing and write-offs
  - ▶ Internal and external audit reports
  - ▶ Disaster recovery framework, including data backup
  - ▶ Stakeholder reporting, where relevant

## Data integrity AUPs

- ▶ These AUPs will relate to the integrity of the underlying static data via a listing and datatape that sets out various standing data attributes of customers and receivables to ensure that the underlying data can be agreed to substantiating documentation or similar evidence.

There is a long list of fields, but the most important include:

- ▶ Borrower name
- ▶ Contact details
- ▶ Property details (and any other collateral)
- ▶ Amount lent
- ▶ LTV as at the relevant date
- ▶ Loan term
- ▶ County Court Judgements (CCJs), etc.
- ▶ Documented signatures and correspondence address

# Concluding comments

The market is highly fragmented suggesting future consolidation.

Data capture has not been a strength of the market, but is critical to demonstrate track record.

External debt funding remains a key issue, with banks becoming more cautious in recent months.

Robust policies are important to ensure supplementary information known by directors is reflected in business practice.

The recent acquisition of ENRA Group by Exponent Private Equity demonstrates that there is equity investor appetite.

We believe there is opportunity for better use of technology to assist underwriting decisions and to make them more efficient.

Strong and differentiated origination channels will ensure a continued competitive position.

Unique product positioning can ensure growth, but could be detrimental to external capital if too unusual.

# How EY can help

## **Advising shareholders on strategic options**

- ▶ Our combined M&A and Debt Advisory offering in the Corporate Finance team allows us to fully consider the available options.
- ▶ For potential buyers of bridging lenders, we can advise on capital structure options through the M&A process.

## **Advising bridging lenders on raising finance**

- ▶ The EY Debt Advisory team previously worked at banks providing wholesale financing to speciality finance companies.
- ▶ This experience means that we are able to structure transactions well and understand key areas of focus for funders.
- ▶ Our strong relationships with funders across the capital structure means that we can access the right pools of liquidity to meet a company's financing strategy.

## **Analysing data tapes of bridging lenders**

- ▶ Our transaction experience in the sector means that we are able to analyse datatapes and compare against best-in-class operators.
- ▶ We recently advised a private equity firm on an acquisition in the speciality finance sector, providing insight on the loan book and data quality.

## **Securitisation advisory**

- ▶ We recently advised a secured lender on the appointment of arrangers for its first public securitisation.

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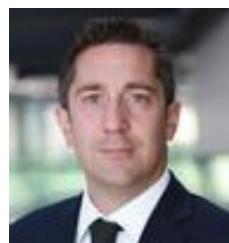
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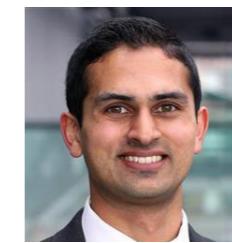
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## EY | Assurance | Tax | Transactions | Advisory

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