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UK Development Finance Review 2015

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Author

Kate Gimblett, *Kathleen Gimblett Consulting and Research*

Project Steering Group

Malcolm Frodsham, *Real Estate Strategies*
Sue Forster, *IPF*
Elma Morris, *Lend Lease*
Chris Parker, *Argent LLP*
Jim Prower, *Argent LLP*
Shirley Smith, *EY*
Margot Waddup, *Wells Fargo*
Matthew Webster, *HSBC*
Pam Craddock, *IPF*

CONTENTS

1. EXECUTIVE SUMMARY

- There has been a marked increase in the availability of development finance since the last IPF report of October 2011.
- The lenders surveyed for this study increased their annual development lending by over 140% during the period 2012-2014 and are collectively aiming to increase their lending by a further 34% in 2015, from £7.5 billion last year to nearly £10 billion this year.
- Although the annual percentage growth rate in development finance provision peaked in 2013 at 75%, volumes have continued to increase, albeit at around half that rate. In absolute terms, however, provision remains far lower than the funding available for income-producing property.
- Banks still dominate the market for senior lending on pre-let and pre-sold developments, but alternative lending platforms provide much of the speculative funding available.
- Most UK banks are willing to lend anywhere in the UK provided it is for the right sponsor with the right scheme in the right place. The survey sample indicates their development finance provision will increase by around 13% in 2015.
- Non-UK bank lending for development has increased at a much steeper rate than UK bank lending, albeit from a lower base. In 2015, those surveyed collectively hope to increase their development lending by 73%.
- The non-UK banks are more 'London-centric' than their UK counterparts but the number that will consider financing a deal in the regions has quadrupled since 2014.
- Non-UK banks are targeting larger transactions than UK banks. They tend to focus on financing office, retail and mixed-use developments but are open to financing assets of other types.
- Every bank wants their developer clients to have in-depth experience and an outstanding track record. Most also want the prospect of a long term relationship and cross-selling opportunities.
- Current loan to cost ratios (LTCs) offered by UK and non-UK banks are in the 50% to 70% range and average margins lie between 245 and 315 basis points over LIBOR.
- A comparison of all-in financing costs between lenders is challenging because of the variation in fees. Many lenders with the lowest margins have higher fees or more fee types.
- For non-speculative loans, non-UK banks have lower requirements for pre-lets and pre-sales than UK banks, which can be attributed to differences in regulation.
- Following the introduction of Supervisory Slotting, UK bank regulation has become more restrictive and regulatory capital has imposed additional costs on development lending, particularly on loans for speculative development.
- Non-bank alternative lenders are not subject to the regulatory costs imposed on banks. They are funds deploying their investors' equity, operating diverse business models that are structured to meet investors' IRR expectations.
- Alternative lenders' IRR targets range from 7% to 20%, which they aim to achieve through a varied mixture of margin or coupon, fees, profit participation and other types of return participation.
- The alternative lenders previously focussed on schemes in London and the South East but now lend in many UK regions. The majority target residential and residential-led mixed-use schemes but, in aggregate, these funding sources finance assets in all sectors.
- Alternative lenders surveyed collectively aspire to a 50% increase in lending in 2015 but many are sceptical that their competitors can achieve their growth targets without lowering their IRR hurdles.

1. EXECUTIVE SUMMARY

- The main source of mezzanine finance is from the alternative lenders and this market is likely to grow as the hunt for yield takes investors further up the risk curve.
- The availability of finance for small developers remains minimal. There are only a handful of UK clearers and alternative platforms that will lend to them.
- Future funding for small developers may come increasingly from Peer-to-Peer platforms but current provision is small.
- Listed developers with strong balance sheets and low gearing primarily use corporate or capital market funding rather than development finance.
- Revolving Credit Facilities (RCFs) are the most frequently mentioned form of bank finance for REITs and non-REIT listed companies. Competition is fierce among lenders to attract this business and RCFs of over a £100 million are not uncommon.
- Unlike REITs, non-REIT listed companies will finance some of their schemes with senior development loans, particularly when the schemes are joint ventures (JVs).
- The general availability of debt is perceived to be very good for the listed developers.
- Unlisted property companies and opportunity funds also find there is little difficulty in obtaining debt finance if they are a large, established developer with a good track record.
- The past year has been seen as a cyclical ‘sweet spot’, with ample provision of debt and equity and increasing prices for completed schemes.
- The majority of companies and funds are optimistic about the next 18 months but there are increasing concerns regarding rising site costs and potential overheating.
- London pricing is posing problems for all organisations. Many are now seeking new projects in the regional cities and the UK may be poised to see a great deal of development materialising in the regions.
- Build cost inflation is constantly cited as an industry-wide problem. Shortages of skilled and experienced personnel have appeared ranging from workmen to managers, marketers and planners.
- The hollowing out of the construction industry during the recession has left a legacy that inhibits current development capacity. Inward migration has been the primary means of mitigating shortages through the provision of skilled workers from other countries.

2. INTRODUCTION

Background

This research updates and expands on an earlier IPF study[1], published in October 2011 following the global financial crisis. At that time, there had been a general withdrawal from the market to fund the development of both commercial and residential property. The purpose of this research is to establish how the market has changed in subsequent years and examine what level of funding is available to developers in 2015.

This study also seeks to ascertain the debt terms that are currently available and whether developers consider there is adequate financial provision to serve their needs. Finally, the research highlights the views of market participants as to the outlook for the market over the next 12 to 18 months.

The study takes a granular approach to the different types of development finance provider, to examine the terms on which they are lending to the many different types of developers in the UK market and how their pricing varies according to business model and target borrower.

The research also examines the current impact of Banking Regulation on development lending, describing the diverse treatment applicable depending on regulatory jurisdiction. The analysis summarises regulatory capital implementation in the UK, the rest of the EU and the US, including recent developments and possible future changes in approaches to regulation.

To place this study in the wider context of total UK commercial real estate lending, the data findings of the De Montfort University survey of the UK lending market published in May 2015[2] showed that, at the end of 2014, the total value of debt outstanding against UK commercial property was £165.2 billion (excluding CMBS and loans in the Irish Government's National Asset Management Agency). According to De Montfort, approximately £17.3 billion of total outstanding debt at end-2014 related to development finance. The total value of new loans originated against all UK commercial property in 2014, both investment and development, was approximately £45 billion.

Methodology

This research adopts a forward-looking approach in keeping with its predecessor report, with a focus on how developers are funding their development pipeline and which lenders are providing this funding. In practice, this required an examination of transactions that had closed in the recent past and those where terms were currently in negotiation.

As the basis of the research for this report, the author obtained the views of key participants in over 70 organisations involved in commercial property development or banking regulation, including banks, institutions, funds, alternative platforms and developers. The author and the IPF thank all contributors for their invaluable insights into the current state of the development finance market and its regulation.

On the lending side, some 45 organisations of all types were ultimately identified as being active development lenders in the UK market. Of these, 35 lenders agreed to be interviewed including UK, European, US and Far Eastern banks, debt funds, alternative lending platforms and Peer-to-Peer platforms.

In terms of borrowers, 48 developers known to be currently active were approached. Of those contacted, 31 agreed to be interviewed including REITs, listed developers, private property companies, opportunity and other funds, institutions and other entities engaged in development.

The majority of interviews for this study were conducted between early February and May 2015.

[1] Outlook for Development Finance 2011, IPF London

[2] The Commercial Property Lending Market Research Report - Year End 2014, De Montfort University, 2015.

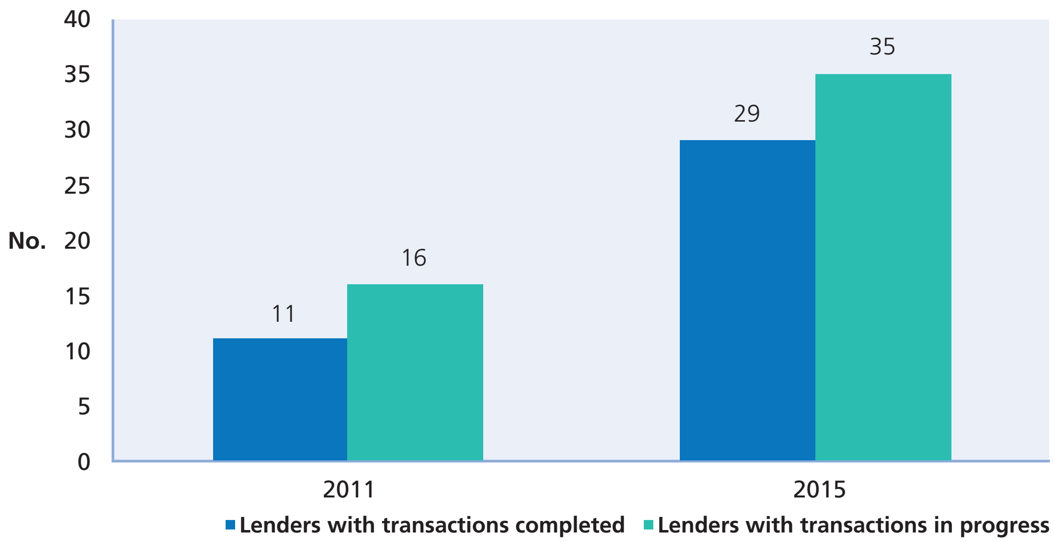
3. LENDERS

The previous IPF short paper on development finance – the *Outlook for Development Finance in the UK* – was published in October 2011. Of the lenders participating in that survey, 11 had completed a UK development loan transaction during the first three quarters of 2011, while only 16 lenders were working on transactions at the time.

The real estate market environment has changed profoundly since then and, unsurprisingly, so has the availability of development finance. There are now a considerable number of lenders targeting the UK development finance market and successfully transacting deals, including a growing phalanx of new entrants. Some lenders that withdrew from the market in the depths of the recession have returned and more are considering re-entering in the future.

> "There is increasing interest in providing development finance. The market in investment loans is crowded and the margins are falling, so development looks more attractive now."

Figure 3.1: Active Lenders – 2011 versus 2015



However, development finance is not a core product for most banks operating in the UK. Many banks that engage in very substantial lending on income-producing real estate assets avoid development lending because the risk profile of development finance is very different, as is the expertise necessary to transact these deals successfully. As one lender put it, "There are lots of investment transactions available, they're easier to evaluate than development, they're less risky, less 'reg cap' is needed and the returns are still good."

The fundamental difference between income-producing investment transactions and development lending is the bespoke nature of development finance. Every development loan has to be tailored to the circumstances of the sponsor (developer), as well as the characteristics of the project, and most projects encounter unanticipated difficulties at some stage. As one lender said, "You have to design each transaction individually and you are never entirely in control once the build starts".

3. LENDERS

For this report, 79 real estate lenders were contacted in total. Of those, the majority did not count development finance as one of their core lines of business and many did not engage in this type of lending at all.

The 35 lenders that agreed to be interviewed were variously involved in ground-up development, major refurbishment (where the majority of the income stream has been lost from the asset) and major 'repurposing' of assets (e.g. office to residential conversion).

Participating lender types included UK clearing banks, other UK banks, non-UK bank subsidiaries, non-UK bank branches, debt funds and 'other' lenders (i.e. unregulated lending platforms deploying equity sourced from institutions, high net worth individuals, foundations and sovereign wealth vehicles). A selection of the newest type of market entrant, Peer-to-Peer lending platforms, were also interviewed and their activities are described in Section 3.9.

Insurance companies have secured considerable market share in lending on UK income-producing properties and they were contacted to ascertain if their participation in the UK real estate loan market extended to originating development loans. Their responses showed that insurers are deeply involved in development, but not in lending on developments in a conventional sense. Although several insurers are considering entering the development lending market, none had done any development loan transactions at the time of the survey, other than those executed through arm's-length platforms or debt funds run by in-house investment management divisions.

The lenders interviewed comprised many of the names most frequently mentioned in the UK development finance market. As not all development lenders were available for interview, the data is not fully comprehensive and, thus, should be viewed as indicative rather than definitive – the research findings provide a representative view of the market and insights into current trends and the market outlook.

The lender interviews were primarily conducted between early March and the end of April 2015.

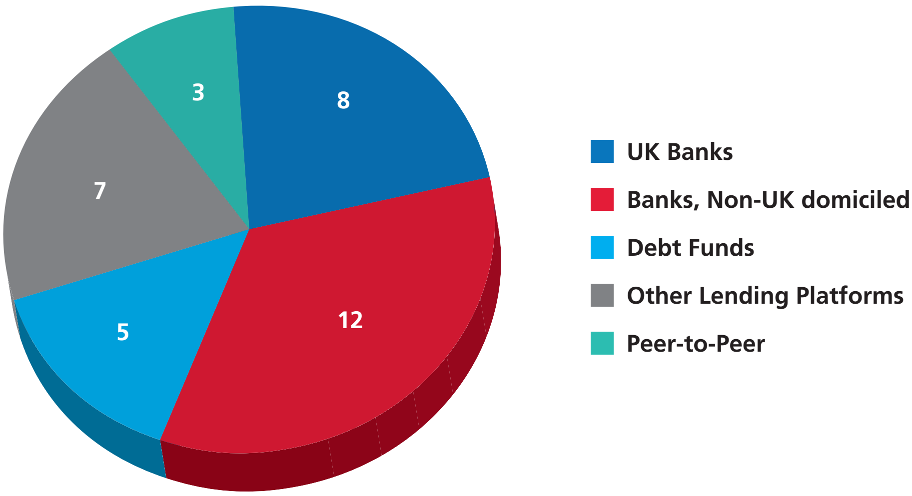
3.1 Survey Sample

Pre-2007, development finance in the UK was dominated by banks and, currently, they remain the largest source of senior secured development finance. However, on the basis of the 2015 research sample, the banks' overall dominance has been severely eroded by the increasing prominence of the alternative lenders (often misleadingly called 'shadow banks'). These lenders include debt funds and alternative non-bank lending platforms deploying professional or institutional money from multiple sources. All types of alternative lenders are primarily seeking returns based on target internal rates of return (IRRs). For the small borrower (seeking loans under £5 million) there is also a new funding source, the Peer-to-Peer platforms.

> "There will be more competition and more options for borrowers over the next couple of years."

3. LENDERS

Figure 3.2: Profile of Lenders Surveyed



The banks (both UK and non-UK) continue to dominate the market for senior lending on pre-let and pre-sold developments. However, sponsors seeking higher leverage or loans for speculative developments are more likely to succeed in securing finance through the debt funds and alternative lending platforms (although some banks offer stretched senior loans and source mezzanine and a few are also willing to lend speculatively on specific asset types).

The small developer is underserved by the market generally and the SME developer without a spotless track record is unlikely to be offered finance from any source.

3.2 UK Banks

A small number of UK clearing banks continue to provide a nationwide presence across a wide spectrum of loan sizes and asset types. However, when asked about minimum and maximum loan sizes, few banks were prepared to contemplate undertaking small property development lending (sub £5 million). In contrast, for the right developer client with an excellent project, all lenders will advance up to £100 million – and the majority will exceed that level – provided that the sponsor is within appropriate exposure limits.

Table 3.1: Lenders Minimum & Maximum Loan Sizes

Loan Size £m		0-1	1-5	5–20	20–100	100+
UK Banks	Minimum	2	1	4	1	-
	Maximum	-	-	-	3	5
Non-UK Banks	Minimum	-	-	1	8	1
	Maximum	-	-	-	4	6
Debt funds & Alternative	Minimum	-	2	8	2	-
	Maximum	-	-	-	8	4

Sample comprised 8 UK banks, 12 non-UK banks and 12 debt funds and other lending platforms.

3. LENDERS

There are many commercial and regulatory factors that underlie the banks' preference for large transactions. The costs of a small transaction are largely the same as those incurred in a large deal when in-house time and management are considered. Consequently, a small transaction will either be less profitable for the bank or will need to be priced commensurately higher. In addition, the regulatory risk weights that determine the capital costs associated with a loan are often higher for small loan exposures than for large loans because SME developers tend to have weaker credit ratings.

Where the UK clearing banks dominate is in their consistent willingness – and, in some cases, commitment – to enter into development transactions throughout the UK. Of the eight UK banks surveyed, seven have been lending across all UK regions during the entire 2012-2015 period covered by this research. Most indicated that they have no particular target regions and will lend in all UK locations 'provided it is the right client with the right project in the right place'.

The UK banks also claim to have completed transactions across a wide variety of sectors in the past three years, as summarised in Table 3.2, and are open to financing even more asset types in 2015.

Table 3.2: UK Bank Sector Lending

Sector	2012	2013	2014	2015
Office	6	6	6	All
Retail	3	3	4	5
Retail Warehouse	3	3	4	5
Industrial	3	3	4	5
Logistics	2	2	3	5
Residential	5	5	5	All
PRS	2	2	4	All
Hotels	2	2	2	5
Leisure	1	1	1	5
Mixed use	4	4	5	7
Student housing	5	6	6	7
Other	2	3	3	3

Sample comprised eight UK banks.

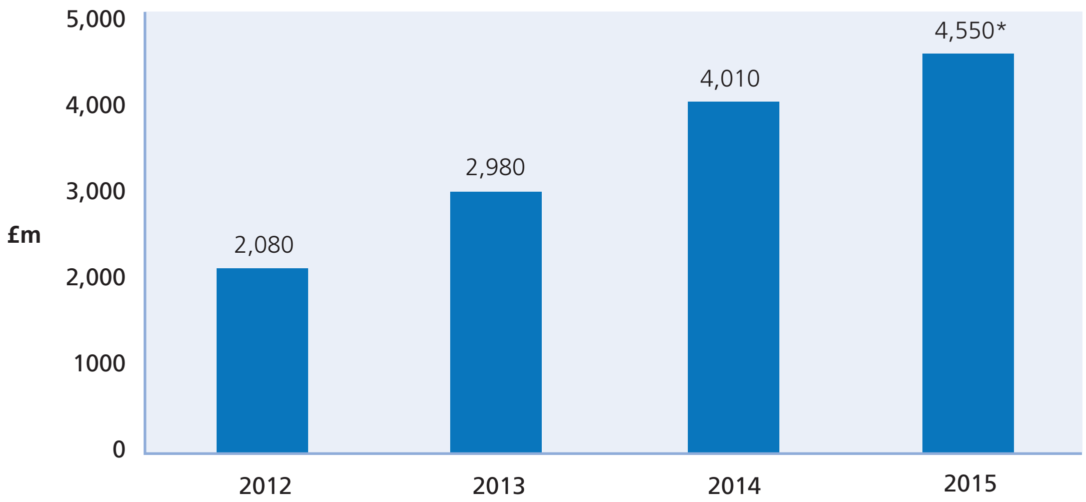
Despite being open to funding an increasing range of asset types, UK banks (and, indeed, all lenders) differ in terms of their willingness to enter into new lending relationships. Two participants within the UK banks surveyed will lend only to existing customers. However, the remainder are keen to acquire new business, as well as to retain existing clients.

All UK banks seek developer clients with a depth of experience and an outstanding track record. Many also look for the prospect of a long-term relationship with some cross-selling opportunities.

The UK banks in the research sample expect to increase their lending to development in 2015 in continuation of the rising trend that has been in place throughout the period 2012-14. The forecast illustrated in Figure 3.3 is based on the subset of banks that were willing to indicate their lending intentions for 2015. The ultimate total for 2015 may prove to be higher.

3. LENDERS

Figure 3.3: UK Bank Lending 2012-2015



*2015 forecast – 13% increase.

3.3 Non-UK Domiciled Banks

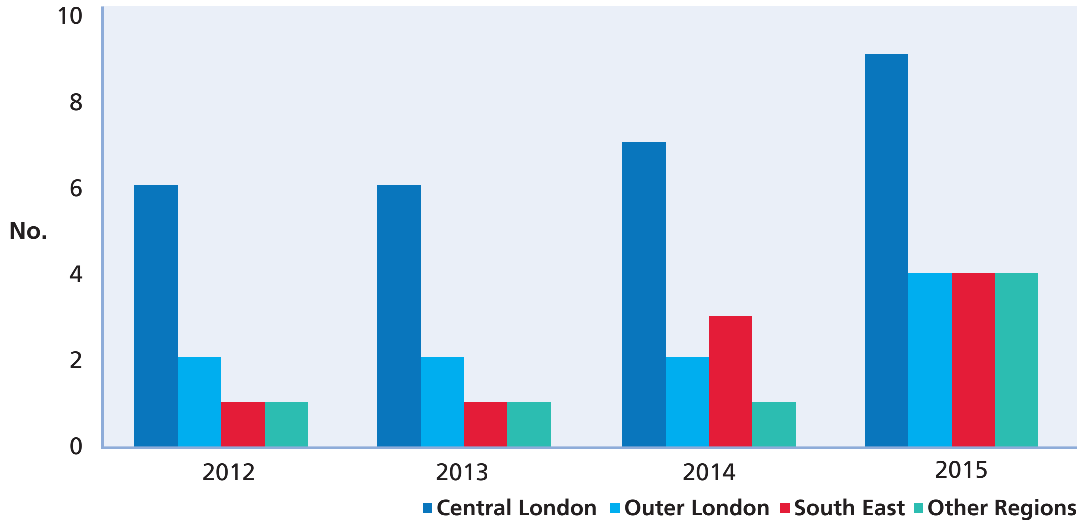
The non-UK banks tend to focus on large transactions with well-known sponsors when lending in the UK. They set their minimum loan sizes at a commensurately higher level than the majority of the UK banks and transactions of under £20 million are not generally undertaken. Many prefer to deal with existing clients whom they have dealt with in their home market, although that is not their exclusive focus and many prominent UK-based sponsors have longstanding relationships with foreign domiciled lenders.

However, some of the largest UK deals in the public domain have been transacted by non-UK banks for existing non-UK clients solely because that client wants their relationship bank to finance a UK development. These banks are not 'open for business' in the UK generally and, therefore, are not included in this survey sample. Details of minimum and maximum exposures are set out in Table 3.1.

The non-UK banks are more 'London-centric' than their UK bank counterparts and the overwhelming majority have only financed deals in London and the South East over the past three years. However, that strategy is changing in 2015 and the number that will consider financing regional developments has quadrupled in the last year. These banks say they will be client-led and, if the sponsor wants to carry out an attractive project outside London, they are prepared to evaluate the proposition.

3. LENDERS

Figure 3.4: Non-UK Bank Regional Lending 2012-2015



Sample comprised 12 non-UK banks.

The majority of non-UK banks have tended to focus on financing fewer asset types over the past three years than their UK counterparts, these being mainly office, retail and mixed-use developments. However, this has also changed in 2015. Within this group, non-UK bank lenders are now open to considering assets of all types if the transaction meets their lending criteria (see Table 3.3).

Table 3.3: Non-UK Domiciled Bank Sector Lending

Sector	2012	2013	2014	2015
Office	3	3	5	8
Retail	1	2	3	7
Retail Warehouse	-	2	2	4
Industrial	-	-	-	1
Logistics	-	-	1	3
Residential	2	1	3	3
PRS	-	-	1	4
Hotels	-	1	1	4
Leisure	-	-	1	2
Mixed use	2	1	3	7
Student housing	1	-	1	4

Sample comprised 12 non-UK banks.

"More banks will come back and they'll be active in riskier areas."

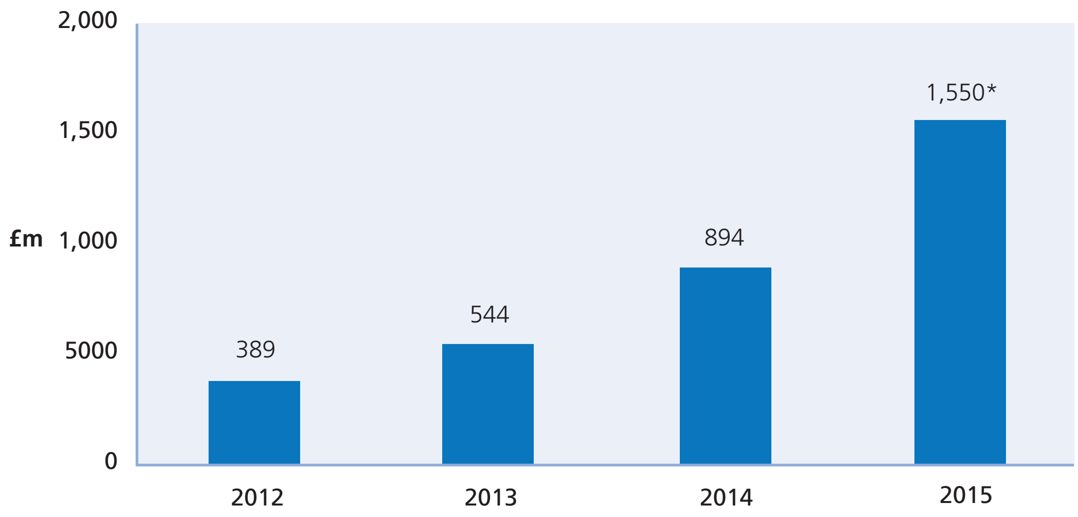
3. LENDERS

Non-UK bank lending on UK developments has increased at a much steeper rate than UK bank lending, albeit from a lower base. In 2014, the non-UK banks in the survey loaned 64% more on UK development than in 2013. In contrast, the UK banks increased their lending in 2014 by 35%, but from a base that was over three times higher.

Given the increased openness of non-UK banks to financing more types of assets in more locations, and the fact that more non-UK banks are now competing for UK development finance business, their stated intent to substantially increase the amount they lend in 2015 is wholly credible. It is also consistent with the steeply rising trend of the past three years.

The banks that gave indications of their lending intentions and current deals form the basis of the 2015 forecast in Figure 3.5.

Figure 3.5: Non-UK Bank Lending 2012-2015



*2015 forecast – 73% increase.

3.4 All Banks – Pricing for Pre-let/Pre-sold UK Development Loans

A review of the pricing and terms available at the time of the last IPF development finance report in October 2011 provides an illuminating basis for comparison with the terms that emerged in this research. According to that survey, loan to cost ratios (LTCs) were mainly in the 55-65% range and margins were mainly in the range of 275-450 basis points (bps) over LIBOR although a small number of outliers were noted.

The current market exhibits greater diversity as the cycle is clearly in an upswing and competition has been exerting downward pressure on margins. However, over this period, bank regulation has become much more restrictive and regulatory capital has imposed a large cost on lending for development finance, particularly where the development is speculative (see Appendix: Regulatory Capital Requirements for Development Loans for details).

Against this background, Sections 3.4 and 3.5 consider current bank pricing and key terms.

3. LENDERS

Loan to cost ratios (LTCs) and loan to value ratios (LTVs or Loan to Gross Development Value) have moved up by a relatively modest 5% since 2011, which has been one of the key factors in the rise of the alternative lenders described elsewhere in this report. A more startling change has occurred in margins, where quotes at the top end of the average margin range have fallen by 135 bps since 2011, which is substantive evidence of competitive pressures in the lending sphere.

It is also notable that bank lending margins for residential development loans are a good deal higher (50-65 bps on average) than for commercial development. This stands in contrast to the alternative lenders, who generally prefer residential loan exposures and price them more keenly than commercial development loans.

Table 3.5: All Banks Senior Lending Criteria

Loan Term	Commercial	Residential
LTC Range (%)	50-70*	50-70
LTV/Loan to GDV Range (%)	40-65	40-65
Average Margin Range (bps)	245-315	295-380
Actual Margin Range (bps)	150-550	150-550

*One bank will lend up to 75% LTC.

Fees are a significant feature of development finance and they often pose a challenge when attempting to compare all-in financing costs because of their variation. Many lenders offering the lowest margins will demand higher fees or impose more types of fees.

Table 3.6: Lending Fees

Loan Type	Front end (bps)	Exit (bps)	Non-utilisation (% of margin)
Commercial	50-150	0-200	35-50
Residential	50-200	0-200	35-50

The spectrum of fees a bank lender may require will include front end (i.e. arrangement) fees, exit fees, non-utilisation fees, hedging fees, booking fees for residential (as each unit is sold) and, occasionally, pre-payment fees. In addition, there may be an array of management and monitoring fees, while agency fees will be payable if the deal is a club or syndication.

The majority of banks will enter into club deals if the client wants another bank to participate in the financing. Club deals also feature when, as a consequence of a bank's exposure limits, it cannot fund the entire transaction bi-laterally. Occasionally club deals are motivated by a non-UK bank wanting a partner bank more familiar with the local market. However, club deals can complicate a transaction and slow the completion of the financing.

Syndications are not as common as club deals but are increasing in number and most UK banks are willing to enter into them. They are less popular with non-UK banks but there is evidence that the latest non-UK bank entrants are more open to syndication participation. However, like club deals, syndications complicate transactions and can slow the completion process considerably.

3. LENDERS

3.5 Key Terms for UK Development Finance Deals – Banks

The terms in loan agreements can vary extensively depending on the sponsor, the characteristics of the development and the build contracts in place. The most standard clause in these contracts is a charge over shares in the special purpose vehicle (SPV), which is the usual legal structure adopted for an asset being developed.

UK Supervisory Slotting regulatory requirements make it very important for a project to be 'de-risked' through pre-lets and pre-sales. UK banks always demand a minimum hurdle for pre-lets, based either on the percentage of space pre-let or interest cover, in order to grant more favourable terms for their development loan funding. These hurdles range from 50-100% and the pre-let(s) must be in place prior to finance being made available. The main objective of the bank is to obtain 100% interest cover from strong tenants to minimise the regulatory capital required to back the loan.

Likewise, pre-sales are important in securing favourable terms for residential or mixed-use funding. To be considered for pre-sold finance, a development must commence with pre-sales that, depending on the bank, can vary from 10-50% or deliver 100% interest cover.

Table 3.7: All Banks Key Lending Terms

Loan Terms	Always		Usually		Occasionally		Never	
	UK	Non-UK	UK	Non-UK	UK	Non-UK	UK	Non-UK
% Pre-let by target date	All	All	-	-	-	-	-	-
% Pre-sold by target date	All	All	-	-	-	-	-	-
Projected ICR or DSCR in terms	4	5	1	2	1	1	2	1
Cost overrun guarantees	3	6	2	2	1	1	2	1
Completion guarantee	2	4	2	2	3	1	1	2
Interest reserve/guarantee	2	4	1	2	3	2	2	1
Share in development profit	-	-	-	-	4	1	4	8
Charges over shares in SPV	All	All	-	-	-	-	-	-
All equity in first	3	5	5*	4*	-	-	-	-
Personal guarantees	-	-	1	-	3	1	4	8
Other terms	All	9	-	-	-	1	-	-

Sample comprised 8 UK and 12 non-UK banks.
* Depends on borrower; these lenders will enter into pro rata or other arrangements for important clients.

Given the current issue of rising build costs, it is interesting that cost overrun guarantees are not universally required. These guarantees were more prominent in the 2011 research. However, many build contracts were fixed price until recent months and, as these contracts are becoming increasingly difficult to obtain, a rise in lender demand for cost overrun guarantees may occur.

The non-UK banks also incorporate as standard a charge over the SPV in their contractual terms. Notably, more of them also demand cost overrun guarantees. However, the major difference between UK and non-UK

3. LENDERS

banks is the hurdles for pre-lets and pre-sales, which are much lower for the lenders that are not primarily regulated by the UK Prudential Regulatory Authority (PRA). This difference is clearly attributable to the different regulatory strictures in force outside the UK. The reduction in regulatory capital for high pre-lets and pre-sales is not as clearly delineated in non-UK regulation as in the UK.

3.6 Banks – Speculative Lending

Few banks will undertake speculative lending on a wide range of developments at present – and even fewer will contemplate large loan sizes. The number of banks covered by the research that provide some speculative finance is similar to the number that do not. However, most banks confine their speculative lending to low risk residential developments or office refurbishments in prime locations with a high degree of unfulfilled occupier demand. The major current exception is foreign banks that follow their sponsors to the UK market for specific development opportunities.

Table 3.8: Speculative Senior Loan Terms

	UK & Non-UK Banks
LTC Range (%)	45-60*
LTV/Loan to GDV Range (%)	35-60
Average Margin Range (bps)	Insufficient data
Actual Margin Range (bps)	250-700

*Two banks indicated a willingness to lend up to 70% LTC.

> "Spec bank lending will make a come-back because office supply is limited and the economy is strong. Also margins are currently attractive."

3.7 Alternative Lenders – Funds and Lending Platforms

The non-bank alternative lenders defy uniform description because each is trying to define and target a different area or niche in the market. They operate very diverse business models, structured to attract particular types of target borrower and to fulfil their investors' return expectations.

> "There will be more new entrants and they are going to continue to stir things up."

Target returns for alternative lenders are based on IRRs that range from 7% to 20%, depending on the fund or platform strategy. Most target IRRs average in the low double digits, which the alternatives aim to achieve through a mixture of margin or coupon, fees, profit sharing and other types of return participation.

The alternative lenders demonstrate considerable diversity in terms of the loan sizes they are willing to offer. For the majority who contributed to this research, the minimum loan size is in the £5-£20 million range but some platforms will make smaller loans. At the upper end of the scale, the alternatives can and already have delivered some of the very largest development finance transactions. Details of the maximum and minimum loan sizes this category of lenders is willing to advance are set out in Table 3.9.

3. LENDERS

Table 3.9: Debt Funds & Alternative Platforms – Minimum & Maximum Loan Size

Loan Size £m	0-1	1-5	5-20	20-100	100+
Minimum	-	2	8	2	-
Maximum	-	-	-	8	4

Sample comprised 12 debt funds and alternative lenders.

Transactions by alternative lenders were primarily focussed on London and the South East in 2012-2013 but they are now lending in several regions across the UK, as demonstrated by the numbers illustrated in Figure 3.6

Figure 3.6: Debt Fund & Alternative Platform Lending by Region

A significant number of alternatives will fund pure commercial property transactions, but the majority target residential and residential-led mixed-use schemes.

> "Provincial cities will attract more lenders and more affordable units will be built in the North."

3. LENDERS

Table 3.10: Debt Fund & Alternative Platform Sector Lending

	2012	2013	2014	2015
Office	-	1	4	6
Retail	-	1	3	5
Retail Warehouse	-	-	-	3
Industrial	-	-	1	6
Logistics	-	-	-	6
Residential	4	6	10	All
PRS	1	1	3	8
Hotels	1	3	6	7
Leisure	-	-	2	4
Mixed use	2	4	7	10
Student Housing	1	3	3	8
Other	-	-	1	5

Sample comprised 12 debt fund and alternative lenders.

Alternative lenders dominate the markets for speculative lending that banks now largely avoid due to regulatory capital charges. Typically, alternatives offer stretched senior loans or whole loans and they are currently originating a large proportion of this type of development lending in the UK.

Given these lenders operate across a wide spectrum of risk and return, the range of risk profiles is reflected in the range of LTCs, margins or coupon rates, fees and fee structures that they will accept. These are described in Table 3.11.

Table 3.11: Debt Fund & Alternative Platform Speculative Stretched Senior & Whole Loan Profiles

Loan Ratio	**Range**	
LTC (%)	50-95*	
LTV/Loan to GDV (%)	50-80	
	Commercial	**Residential**
Coupon Rates (%)	5.5-15.0	4.5-15.0
Alternative Platform Fees		
Front end (bps)	100-250	100-250
Exit (bps)	100-300**	100-300**
Non-utilisation	Varies widely	Varies widely

* High LTC loans require profit participation.
** And/or profit participation.

3. LENDERS

Alternatives use a wide variety of terms for mitigating risk. However, the term that almost all debt funds and alternative platforms share in common with both banks and each other is the requirement to take charges over shares in the SPV.

Table 3.12: Debt Fund & Alternative Platform Key Loan Terms

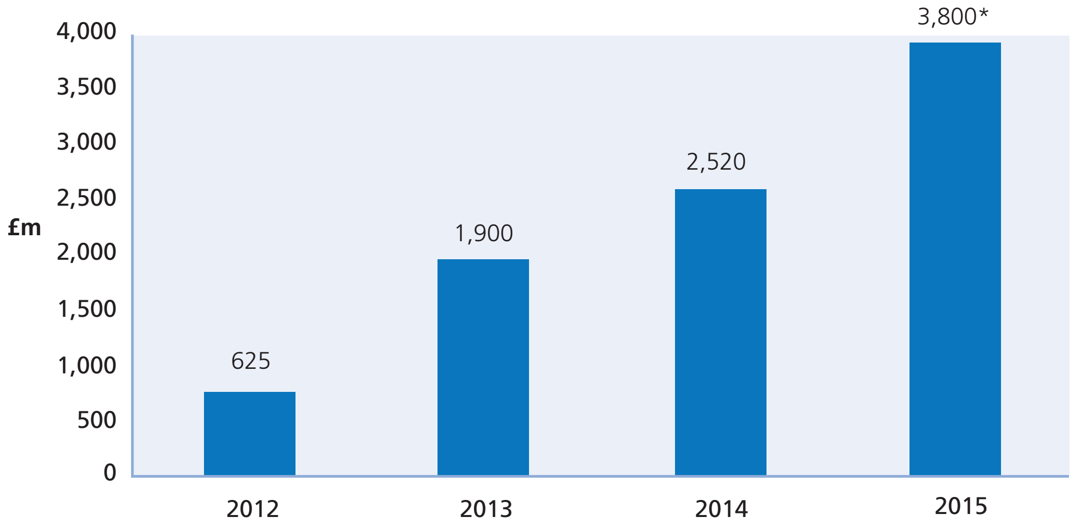
Loan Terms	Always	Usually	Occasionally	Never
% Pre-let by target date	2	2	3	3
% Pre-sold by target date	4	-	4	3
Projected ICR	3	2	-	5
Cost overrun guarantees	8	2	1	1
Completion guarantee	7	4	-	-
Interest reserve/guarantee	5	2	2	2
Share in development profit	2	2	3	5
Charges over shares in SPV	11	-	1	-
Other	10	1	-	-

Sample comprised 12 debt fund and alternative lenders.

Alternative lenders have achieved very rapid growth in UK transactions over the period 2012-2014 and they aspire to increase their aggregate lending further in 2015. However, a small number of international platforms are becoming wary of increased competition in the UK market and now seek better risk-adjusted returns elsewhere in the world.

Figure 3.7 incorporates a forecast for 2015 of a 51% increase in lending for 2015, which reflects the upper end of the contributing alternative lenders' aspirations. However, it is open to question whether sufficient transactions will become available to meet existing IRR expectations. Many within the industry are sceptical that competitors will achieve such ambitious growth without lowering their IRR hurdles.

Figure 3.7: Debt Fund & Alternative Platform Lending 2012-2015



* 2015 forecast - 51% increase.

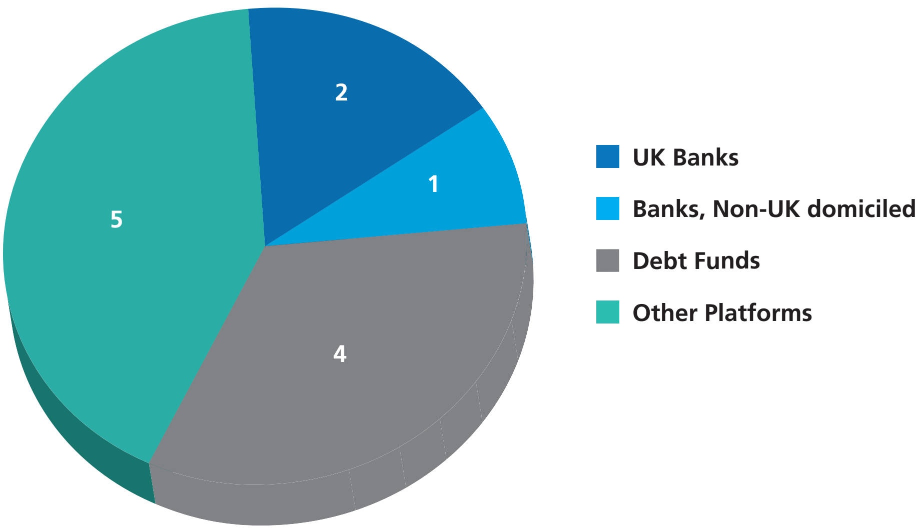
3. LENDERS

3.8 Mezzanine Finance

Mezzanine finance (or 'mezz') is not a product that many banks provide. It is often outsourced, with costs aggregated into a 'whole loan' or a 'stretched senior' loan. Some banks do not provide stretched senior debt but are comfortable with clients obtaining mezzanine funding elsewhere "as long as it is for IRR reasons and not indicative of a shortage of equity".

The main source of mezzanine finance is through alternative lenders and this market is likely to expand in the next 12 months as investors move further up the risk curve in search of higher yields. In some cases, providers of whole loans are, in reality, only seeking the high yielding mezzanine exposure. Once the whole loan is transacted, these lenders retain only the mezzanine exposure and sell the senior portion to another platform or fund.

Figure 3.8: Mezzanine Lender Survey Participants



Mezzanine finance is primarily available for developments that are at least partially pre-let or pre-sold. Currently, there is less scope for mezzanine finance on speculative projects and this type of finance is typically associated with projects funded on a profit share basis.

Table 3.13: Pre-Let/Pre-Sold Mezzanine Loan Pricing

	UK & Non-UK Banks
LTC Range (%)	Up to 85
LTV/Loan to GDV Range (%)	Up to 70
Average Margin Range (bps)	Insufficient data
Actual Margin Range (bps)	700-1500

"A year down the line there will be more mezz at 100 bps cheaper than today and more specialist players to provide it."

3. LENDERS

3.9 Peer-to-Peer Lenders

Not many lenders cater for small developers. There are several alternative lenders that specialise in funding them and three UK clearers that will lend conservatively in the sub-£5 million space, but the funding options for the small developer are very limited compared with those available to their larger counterparts. However, this may be changing. In the past two years, a new type of 'fintech' lending platform – the Peer-to-Peer Lender – has emerged to target the underserved small developer.

Peer-to-Peer (P2P) lending platforms are differentiated from Crowd Funding in that a P2P originates loans while Crowd Funding platforms raise equity. This is an important distinction: P2P lenders can reasonably claim to offer their investors fixed income-style returns that are much higher than those available on UK savings accounts with considerably lower risks than taking exposure to a typical equity crowd funding portfolio. This is because P2P lending platforms take first charge over the property asset on behalf of their investors and usually supplement that first charge with personal guarantees from the borrower. Hence, there are very strong incentives for borrowers to repay their P2P loans.

P2P platforms offer a familiar borrowing process to developers. All projects are evaluated using processes akin to those used by a bank and many of the P2Ps are staffed by former property bankers. If a potential transaction receives approval, it then passes to the funding stage. P2Ps are not UK banks, so do not have to comply with any regulatory capital requirement and will not be delayed by return on equity or further risk evaluations once the origination team has vetted the transaction.

From this point, the P2P platforms diverge in their funding processes because each has its own business model. The term Peer-to-Peer can be something of a misnomer since some platforms originate loans using an existing pool of money, pre-sourced from high net worth individuals, professional investors or government funds. The P2P then sells down all or a portion of the loans to small investors or, in some cases, to other professional investors.

In contrast, platforms that fit the more usual concept of a P2P approve the loan and then post it on their website for their investors to evaluate. No funding is made available to the borrower until the money has been raised from investors for that specific loan.

"The technology is expensive and must be immaculate. The origination side is the same as a bank but the investor side must be robust and scalable."

There are relatively few P2P platforms currently engaged in UK development lending because of considerable upfront expenses. P2P start-ups must initially secure substantial finance themselves in order to fund their platforms, which constitutes the major barrier to entry in the market. As a result, only five platforms currently have a notable presence in the UK, although at least one well-known US platform is likely to enter the market and there are a number of new P2Ps that have recently commenced operation.

Most of the existing UK platforms have been facilitating development loans for less than three years and total transactions to date are relatively low, but growing rapidly. The P2Ps interviewed for this research had funded just under £27 million in development loans as of Q1 2015 but were looking to increase this to £87 million during the course of the year.

3. LENDERS

The main sector focus of P2P development lending is residential, but some platforms will consider student accommodation, care homes, commercial and small mixed-use developments. Collectively they will fund a project anywhere in mainland UK if the borrower and project pass muster. The borrower's experience and track record are important in the vetting process and P2P originators claim their assessments are as thorough as those of any bank.

Speculative loans are available, although it helps to lower costs on some P2P sites if a project is de-risked by pre-sales. Some P2Ps differentiate the loan rates available for speculative and non-speculative, with the latter being defined as where sufficient pre-sales have been obtained to fully service the loan during the build and marketing period.

The loan sizes available range from very small (sub-£1 million) up to £10 million or more, depending on the platform. Target LTVs/Loan to GDVs range from 50-75% and the borrower's equity is usually required up front, although there are platforms that will make exceptions.

Loan pricing varies widely, with margins ranging from 8% to 14%, depending on assessed risk and LTV/ Loan to GDV. Arrangement fees of 2-5% cover the loan evaluation and loan marketing process. Some platforms charge exit fees of up to 2% as well. Most want some form of interest rate reserve, cost overrun guarantees, personal guarantees and a first charge over the property. Typically, a contingency of 10-20% is built into the loan.

At present, the regulation of P2P lending is 'light touch' with only Financial Conduct Authority (FCA) oversight. The FCA is still considering how best to regulate the sector, since the platforms are not banks and, thus, do not fall under the ambit of the Prudential Regulatory Authority (PRA). The introduction of more stringent rules would be welcomed by some in the industry because the major concern expressed by survey participants is that a failure by one lax P2P lender (or even a Crowd Funding platform) could bring the whole sector into disrepute. A number of P2P lending platforms have already set up protection funds to partially compensate investors for loan losses, even though all investors are informed from the outset that their money will only be returned if and when the borrower repays the loan.

As to future developments in the sector, there are many possibilities. The 'originate to distribute' to other investors (small and professional) could scale up to something much larger. Plans are already in train to include P2P exposures in tax-free UK Individual Savings Accounts (ISAs), starting in April 2016, and there are now vehicles to enable the inclusion of P2P loan exposures in Self Invested Personal Pensions (SIPPs). Banks could move into the P2P space with a conduit approach, using separate subsidiaries instead of just referring their small developer customers to the existing P2Ps.

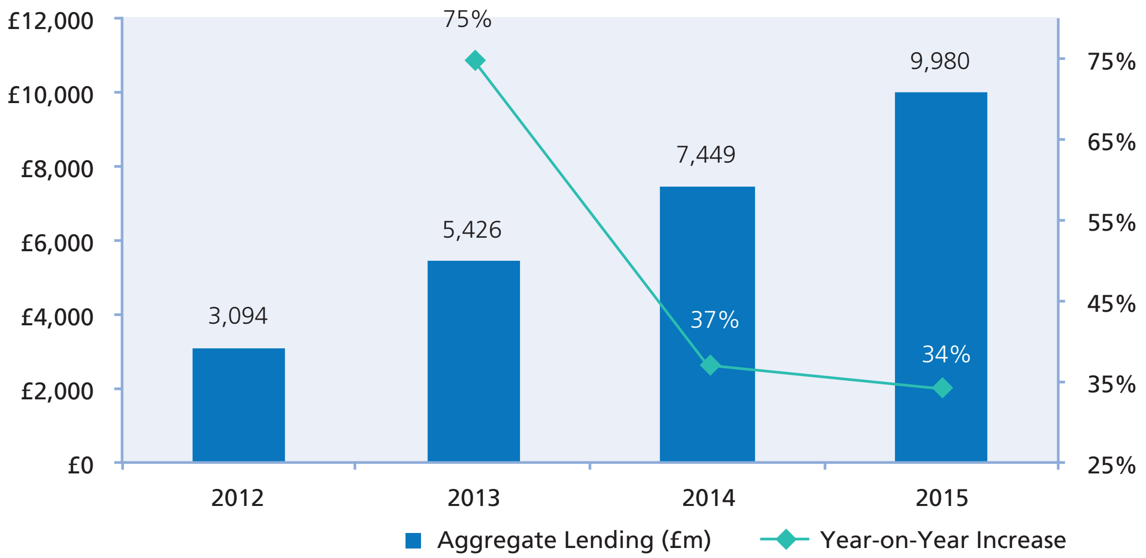
On the downside, many worry that the sector's growth could be adversely affected if HM Treasury decides to impose withholding tax on investor returns. It will certainly suffer damage if disproportionate investor losses are incurred when property values next turn downward. As P2Ps have only been in material existence since 2013, the resilience of the industry has yet to be tested.

3. LENDERS

3.10 Outlook for Development Finance Provision

The lenders surveyed for this study increased their annual development lending in aggregate by over 140% between 2012 and 2014 and are collectively aiming to increase their lending by a further 34% in 2015. This implies an increase in total transactions from £7.5 billion in 2014 to nearly £10 billion in 2015.

Figure 3.9: Aggregate Lending (All Lenders) 2012-2015



The anticipated 34% increase in development lending forecast for 2015 is a steep rise but, put into context, the growth rate trajectory has flattened since its 2013 peak, when there was a 75% leap in provision.

4. BORROWERS

A plethora of business models exists in the property development industry and this section of the report endeavours to capture the methods of debt finance employed by a cross-section of them. Each business model fosters its own approach to finance in order to generate the target returns sought by the sponsor. In addition, property development has many facets and each facet is inherently risky. From the initial planning of a project to its final completion and exit, there is much that can go wrong, so financing strategically is one of the key means developers have to manage their risks, as well as engineer their returns.

The 31 developers (sponsors) that were interviewed for this research included a wide variety of organisations representing an even greater number of business models. Participants included UK REITs, listed non-REIT property companies, unlisted developers, opportunity funds, insurers and ‘other’ entities, including private equity, development fund advisors and a small number of unique sponsors.

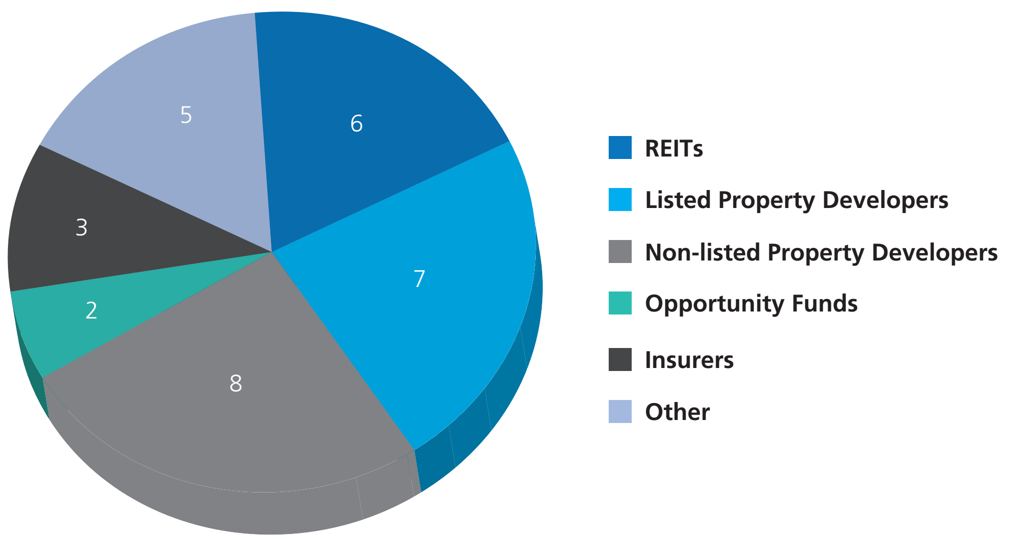
The developers that contributed to the 2015 research included 19 of those that participated in the previous 2011 study. At that time, only 11 of these developers were actively seeking development finance or had recently secured funding. A further three had been totally inactive, due to market conditions, and the remainder of the previous developer sample were pursuing schemes financed using corporate funding or forward funding from institutions rather than development finance.

By contrast, all of the contributors in the 2015 survey are active in the market and all have recently sought and obtained finance variously from banks, alternative lenders, the capital markets or some combination of these sources.

The developer interviews were conducted primarily between early February and mid-March 2015.

4.1 Survey Sample

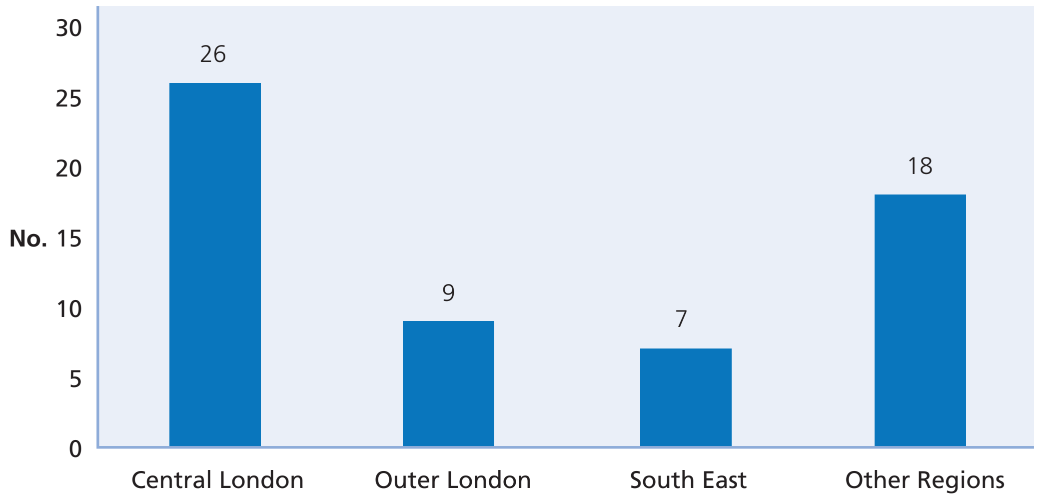
Figure 4.1: Sponsor (Developer) Survey Participants



4. BORROWERS

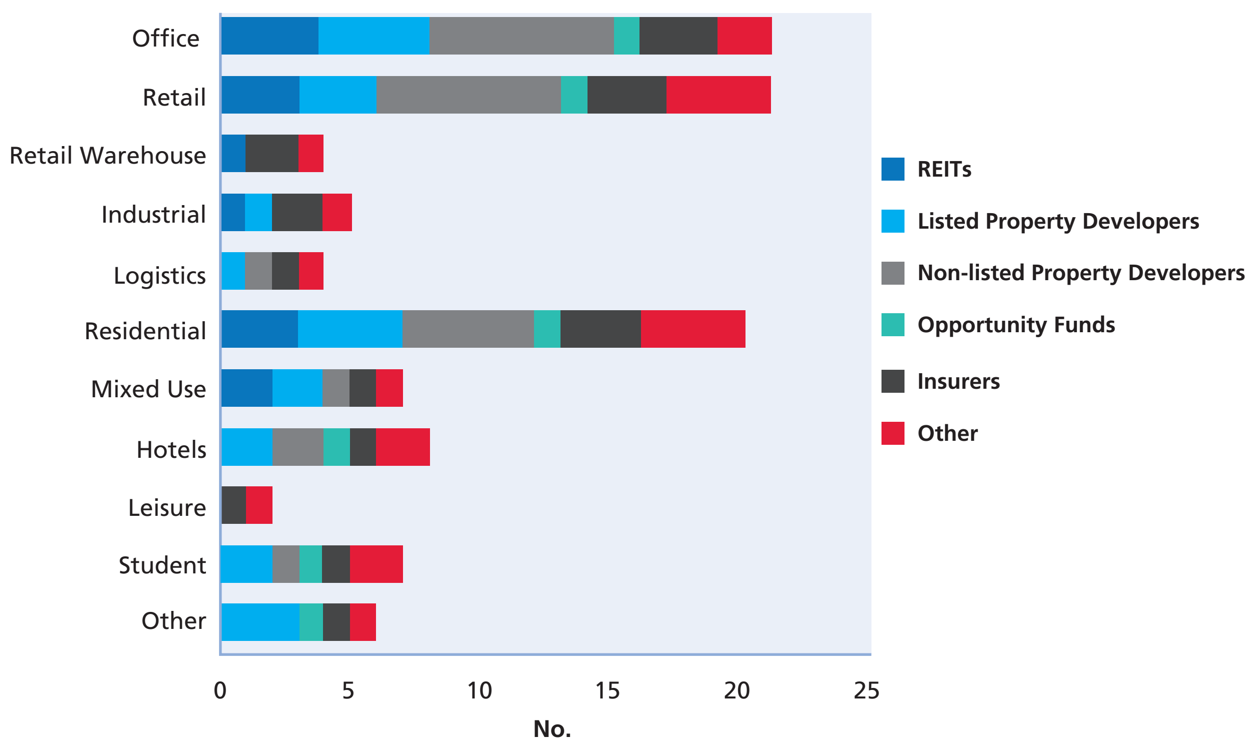
The developers that contributed to this research ranged from medium-sized private entities to the UK's largest REITs. Some have been developing exclusively in London, some are dedicated regional developers or specialists in certain types of assets while others are active throughout the UK in multiple asset types.

Figure 4.2: Regional Developer Activity



The contributing sponsors were actively undertaking developments that collectively encompass most property asset types, but three types – office, retail and residential – dominate the collective pipeline, as shown in Figure 4.3.

Figure 4.3: Sector Activity by Developer Type



4. BORROWERS

One notable finding from the 2011 research remains equally applicable in 2015: those developers with a strong balance sheet primarily use corporate banking facilities or capital market funding (corporate bond issues, convertibles and private placements) to fund their development activities. The reasons for this are multiple, but a fundamental one is that of cost – revolving credit facilities (RCFs) and corporate loans with no specific collateralisation are much cheaper for a company with a strong credit rating than a development finance loan secured on an individual asset or an SPV.

It may seem counter-intuitive that it is cheaper to borrow without collateralisation than with a first charge on a specified asset and it is likley that banking regulation has created this anomaly – or at least contributed to it. The regulatory capital requirements for loans with recourse to a company's balance sheet are determined by corporate credit models and, hence, UK banks are not required to 'slot' their corporate loans to property companies. Corporate loan models allow a greater degree of downward variation in risk weights than Supervisory Slotting permits and the models are more sensitively calibrated according to the risk of the company. If a large company has a strong balance sheet and a good credit rating, the risk weight and resultant regulatory capital can be much lower than the risk weight required for the best 'slot' for a collateralised real estate loan. This, in turn, has a consequently positive impact on the cost of the corporate facility relative to the cost of a development finance loan.

For those developers that require conventional real estate development finance loans, the number of potential lenders has increased dramatically since 2011. Hence, those borrowers that participated in both surveys have seen a material increase in their funding choices over the intervening period. Margins have become keener and LTC ratios have risen somewhat. However, the cost of funding with real estate development loans remains higher for organisations with the strongest credit ratings than the cost of corporate funding.

4.2 Real Estate Investment Trusts (REITs)

REIT developers have considerable flexibility in how they fund their developments. All use their balance sheets, often recycling funds from the sale of standing assets to part-finance new developments. When REITs use bank debt, it is generally through corporate facilities, which are cheaper and more flexible than senior debt for development.

Revolving Credit Facilities (RCFs) are the most frequently mentioned form of bank finance for REITs. Competition is fierce in the lending market to attract this business and RCFs of over a £100 million are not unusual. Very large RCF requirements of several hundred million pounds are often fulfilled by multiple banks. Apart from matching a borrower's funding needs, group RCF arrangements can also fulfil the mutual desire of the borrower and multiple lenders to maintain long-term relationships with each other. The appetite among lenders to establish or maintain these relationships with major REIT clients is such that one REIT said, "We had over 10 banks wanting to be part of our RCF."

4. BORROWERS

Table 4.1: Use of Debt Funding Sources

Number*	REITs	Listed Non-REITs	Unlisted Property Companies
Bank funding			
Senior	-	6	6
Mezzanine	-	1	2
RCFs	6	2	3
Corporate Loans	3	0	0
Whole Loans	-	-	1
Debt Capital Markets			
Corporate Bonds	3	3	-
Convertible Bonds	2	2	-
Private Placements	4	0	-

*Survey participants comprised: 6 REITs, 7 listed non-REITs and 8 unlisted property companies.

All REITs surveyed have been funding their activities in the capital markets. Private placements (issued in US$, € and £ Sterling), corporate bonds and convertible bonds are typical. The yield compression that has occurred in the bond markets in recent years has made tapping the fixed income capital markets more attractive than ever for listed corporates given the number of investors seeking higher yields.

The UK equity market has had similarly buoyant periods since 2013 and those REITs that have sought equity have been able to access the market with considerable success. The property sector has delivered a strong performance in comparison with the overall UK equity market and, although relative sector performance varies with market sentiment, the REITs offer dividend incomes that are very attractive to large numbers of investors. One FD remarked, "We could raise a lot more equity if we wanted, but we don't need it." Another remarked that they had called a convertible early and most of their investors had chosen to convert to equity in preference to taking cash.

4.2.1 Availability of Debt

The general availability of debt is perceived to be very good at present and none of those surveyed had encountered any difficulty in obtaining finance. One FD said, "There is more debt available than I can ever remember before."

However, REITs occupy a particularly advantageous position in the development market and many of those interviewed emphasised their low level of gearing. Most also pointed out that not all developers have such privileged access to finance. An observation made by several REIT FDs, and reinforced elsewhere in this research, is that the debt market is not serving the needs of the small developer.

4. BORROWERS

> "The debt market is polarised." It is "over-provided for good covenants with a track record and difficult for many smaller regional players."

4.3 Listed Developers (Non-REIT)

Like REITs, listed developers have considerable flexibility in how they finance their developments through their ability to use their balance sheets. However, unlike REITS, a significant proportion of those surveyed use banks for both corporate finance and senior development loans, with senior loans particularly employed where joint ventures (JVs) are concerned.

The lenders these companies use are primarily banks but they are also seeking quotes from, and occasionally financing with, alternative lenders. The fees, margins and terms for recently concluded deals are consistent with those reported in Section 3.

Several contributors said they found alternative lenders too expensive and inflexible to meet their needs. High pre-payment costs were cited as a particular impediment to obtaining finance from alternatives.

> "The new lenders charge too much and they're less flexible – you need flexibility for development finance but the funds charge penalties for early redemption."

Listed non-REIT property companies also use the capital markets for funding and half of those surveyed had tapped either the corporate bond market or the convertible market. Investor appetite is such that one interviewee advised: "We issued at a record low coupon and the issue was seven times oversubscribed."

Debt is readily available for listed developers, with all of those interviewed seeing few near-term barriers to growth emanating from financing constraints. In the words of one developer: "There's an appropriate amount of debt available, including more for regional developments. Our firm is inundated with offers ..."

Similarly, those that have raised equity via the capital markets have been well received.

> "The equity market really picked up in 2013/2014 and we had a good reception when we last raised funds."

Many reiterated the observations of their REIT counterparts that the development finance market is strongly bifurcated and the needs of smaller builders are not being met.

> "Availability is fine for us and all the blue chip players, but it's harder for newer or unlisted developers."

4. BORROWERS

4.4 Unlisted Property Developers

Unlisted property companies, in contrast to their listed counterparts, rely more heavily on debt from banks and alternative lenders to fund their developments. This does not indicate a lack of financial strength but, rather, a business model choice. Every company surveyed in this group had ample equity and all are funding their developments using an average of 35-40% equity and 60-65% debt.

The size of those surveyed ranged from some of UK development's largest names to medium-sized innovators. Some are considering listing in the future, whereas others were listed previously, but none were examples of the oft-cited private firm starved of finance. Multiple attempts were made to garner the views of SME developers that might be encountering problems in accessing finance, but none of those contacted were available for interview.

All the unlisted companies that participated in the research have substantial equity, variously provided by private equity funds, foundations, sovereign wealth funds, government programmes or through strong internal cash flows generated by their standing investments.

Unlisted developers tend to fund their debt requirement using senior development loans and RCFs, although, for some, whole loans and mezzanine finance were also present in the funding mix. None of those interviewed had experienced problems in obtaining debt finance on competitive terms. All said they had a number of lenders to choose from when sourcing finance.

The fees, margins and terms for senior loans, whole loans and mezzanine cited by the unlisted companies were consistent with the terms described in Section 3.

Of these organisations, two had funded in the capital markets historically but none were doing so in 2015. Reasons given included: "We need more flexibility than can be obtained in the capital markets" and "It doesn't work for our business model." However, one fairly new developer was issuing a bond and using a crowd funding platform for the bond's distribution, which is a very innovative approach to development finance.

Many of the companies interviewed said that equity capital was generally plentiful or even too abundant. A common complaint was that development sites and property assets were becoming too expensive because the market was flooded with equity.

> "There's too much equity. The current returns are too low given the risks of development. There is increasing pressure to place investor capital and fund managers are incentivised to invest, even if they do it unwisely."
>
> "... capital is readily available ... site values have doubled in the last 18 months so it is increasingly hard to procure new opportunities at sensible pricing."

When asked about the availability of debt, opinions varied. Some felt the market was verging on over-provision, while others felt more debt finance was still needed – especially for the small developers.

4. BORROWERS

> "I think that there is ample availability of debt finance in the market at the moment. If anything we are seeing the banks begin to push the boundaries again, which creates the danger of a bubble and a crash."
>
> "Banks are coming to us so there is sufficient finance. There is plenty of funding for good projects that are of a requisite size, but the smaller players in the £2-5 million range find things harder."

4.5 Opportunity Funds

The opportunity funds interviewed finance in a similar manner to the unlisted property companies. They primarily source senior loans from banks and occasionally obtain finance from the alternative lenders.

The pricing of their debt is slightly higher than that cited by the listed and unlisted property companies but consistent with their opportunistic return targets. Those interviewed said they have had no problems in obtaining debt or equity and quoted a financing split of 35-40% equity and 60-65% debt, similar to that of unlisted developers.

> "The big banks are happy to lend to the right sponsor for 18 to 27 months now, so the period for development loans has been extending. Also, conversions to stabilised loans are on offer for five years or more."

The participating opportunity funds had backers with 'deep pockets', so they had no shortage of equity, but concerns were expressed for small developers.

> "There's plenty of equity for big development companies but not enough for small ones."

The most frequently mentioned concern is that the market will overheat due to the abundance of equity capital. London is already posing problems for opportunistic players, particularly the pricing of development sites, so these funds are seeking new projects in the regional cities.

> "We need to look outside of London for our future projects. We'll also have to move up the risk curve on asset types, perhaps in an opco/propco space ..."

According to those interviewed, there is now plenty of finance for development projects in the regions provided developers have the right track record and an experienced team.

Again, the general availability of debt is perceived to be good for established opportunity funds but inadequate for small builders. One opportunity fund is doing something about the small builder finance problem:

> "Risk is not priced correctly and our firm is actually lending to small builders now."

4. BORROWERS

On development opportunities by sector, there is a clear preference for residential schemes, with the exception of super-prime residential in London, which many perceive as a bubble. Residential development is generally thought to be low risk almost everywhere in the UK and there is optimism that profits can be generated in the sector for years to come.

In contrast, some funding problems were noted in obtaining bank finance for niche sector assets.

> "Some assets are harder to get finance for, like serviced apartments. They don't fit into resi or hospitality."

4.6 'Other' Developers

These organisations comprise private equity (PE) real estate funds, opportunity fund advisors, public/private property developers and estates. With the exception of estates, they fund solely through senior bank debt or stretched senior loans from alternative lenders.

Many have found sourcing 'unconstrained' finance for development a challenge. They complain that there are not enough banks in the market willing to lend on reasonable terms and this has forced them to finance expensively through the alternative lenders.

The PE funds, somewhat surprisingly, tend to think that there is less equity available to them than in the past.

> "There's just about sufficient equity now. There used to be more in the past but the situation is improving."
>
> "There's less unconstrained equity than we would like to have on tap for opportunities..."

Others were more comfortable with equity provision.

> "In general there's lots of equity because investors want the income."

This group of developers had surprisingly similar opinions on debt availability, despite being quite diverse in terms of business model. The pricing and availability of leverage poses the greatest constraint for the PE players, who are the least happy with the current market.

> "There is insufficient debt available. There aren't enough lenders. We use alternatives only if we have to and we don't like to because they're more expensive."
>
> "More traditional lenders are needed along with better terms in larger size. At present we have to use new lenders to fund."

The rest of this group expressed a desire to see more development lending from the UK clearers.

4. BORROWERS

> "We hope the UK banks will come back because it's in the interests of the market. Relationships are important so we value them above the cheapest quote."

Consistent with other developers, these entities also cite rising land and build costs as problematic.

> "We're seeing mergers in the supply chain that are potentially anti-competitive. There's a lack of resilience in the supply chain with Tier I firms unable to bid for projects because the Tier 2 firms they hire to do the work are not available."

4.7 Insurance Companies

Increases in prime standing asset prices, particularly in London and other major UK cities, have led the insurers to become much more enthusiastic about development. They are primarily involved in forward funding projects.

> "It's a very competitive market in long secure income streams of 20-plus years. Hence we're more prepared to develop."

Real estate is perceived to be an attractive asset when compared to fixed income alternatives. Most believe it has permanent role in portfolios and it is tactically very attractive in relative terms at present. The decision to develop rather than buy standing assets is, itself, tactical and many insurers now consider the risk-adjusted returns to development justify further investment.

> "ROEs are high enough to justify developing. We will be doing more in the future because there are good risk-adjusted return opportunities."
>
> "We're doing much bigger lot sizes now – we've done £500 million in development funding over the past five years. In 2010 it was more like £50 million."

All insurers interviewed believe there is likely to be sustained demand for new assets due to growth in the economy. There is also the issue of increasing obsolescence and a shortage of prime properties in the growth sectors of the UK.

> "The undersupplied areas look very attractive and there an increasing number of pockets of undersupply."

The insurers use little leverage outside their core-plus and opportunity funds. Leverage is often applied at the 'pool level' so most do not engage in development finance in a conventional sense. They do, however, monitor the market.

> "There's loads of equity in the market – it's not scarce. What we see as scarce is land, skilled construction workers and tenants."

5. OUTLOOK FOR DEVELOPMENT FINANCE

5.1 Lender Perspective

All lenders were asked for their views on how the market for development finance is likely to evolve over the next few years. For the most part, they were optimistic but cautious about the cycle.

Typical responses included:

> "We expect a steady increase in activity over next 18 months as the economy continues growing. More occupier demand will lead to more development."
>
> "There will be more liquidity and leverage will rise. More non-bank lenders will come to the market and capital will get cheaper. There's lots of development to come and prices are swinging in developers' favour. Many more club platforms will come to the fore and PRS will take off."

Optimistic but slightly more cautious lenders expressed views such as:

> "We have a strong appetite to support the market through the cycle but will reduce origination as the market overheats. More liquidity is coming in and eventually the market will get too frothy – not in the short term, but eventually. Margin squeeze will be a factor driving our origination policy ..."

Many lenders emphasised their concern about margins:

> "There will be further margin compression as more market entrants arrive and compete."
>
> "There's an oversupply of finance coming that will lead to a decline in pricing, followed eventually by the usual market crash. We always want to get in early and stop early."
>
> "Pricing needs to stabilise. It's dropped so quickly over the past 18 months that it's cheaper to borrow now than ever before. The market got to current levels too quickly and it worries me."
>
> "More and more market entrants are coming – and that's dangerous! The market is now almost back to its peak and people are becoming overconfident. When lenders want to originate – and they do now – it's a signal for caution."

Looking further down the line, one lender summed up the sentiment of many:

> "There will be more spec development and more finance available for it over the next year or two. But ... there's a need to be cautious about where the market will be in a few years time – we think large projects that take 3-5 years to complete are to be avoided now."

5.2 Borrower Perspective

Borrowers see the outlook as generally very positive. Nevertheless, all sponsors are alert to the cyclicality of real estate returns and mindful of the particular vulnerability of real estate development to cyclical risks.

5. OUTLOOK FOR DEVELOPMENT FINANCE

5.2.1 REITs

REIT FDs are largely optimistic about the next 18 months.

> "The UK economy is in good shape. There's not enough product which is good for development returns."
>
> "Occupier demand is rising and rents are too."

However, there are concerns regarding market conditions, particularly potential overheating in the next 12 to 18 months. The amount of money flowing into the UK market from the Far East and elsewhere has been cited frequently:

> "There is too much liquidity now. The average premium of our sales against December 2014 valuations is 40%. This can go on ... but equally the next crash could come at any time from any number of triggers."
>
> "The huge weight of money is making it hard to source new projects. On the flip side, it's a very good time to sell assets!"

Build cost inflation is constantly mentioned as an industry-wide problem, along with the shortage of skilled and experienced personnel. The shortage now encompasses skilled tradesmen, managers, marketers and planners. Many contributors pointed out that the contraction of the construction industry during the recession has left a legacy that inhibits the capacity of the entire development sector. Inward migration has provided a lifeline over the past few years in providing skilled workers from other countries.

5.2.2 Listed Property Companies

Listed non-REITs are also very optimistic about market conditions for their business and most expect a year or more of strong growth.

> "The next 12 months will be very good for the housing market. The population is rising and delivery is not back to 2007 levels. There is a massive undersupply of housing everywhere there is connectivity to London."
>
> "We believe that London will prosper for the next 10 years. There's a structural shift leading to ongoing demand from more diversified businesses. Staff retention concerns are driving their requirements now."
>
> "Our pipeline will grow across the country. Industrial demand will grow as medium and smaller businesses gain the confidence to invest."

The growth inhibitors mentioned were almost entirely non-financial: planning constraints, construction personnel shortages and the challenges of managing very large long term schemes across economic, political and financial cycles.

5. OUTLOOK FOR DEVELOPMENT FINANCE

"We're under relentless pressure to deliver product. Construction inflation is tough on us and there aren't enough people with expertise. Both the contractor and sub-contractor markets are very tight."

"The planning environment remains difficult – that's good for us as we have the expertise to deal with it but it poses lots of problems for others."

"In development and regeneration you have to navigate across political cycles as well as market cycles. A lot of interaction with politicians is required and that can be challenging."

When asked about how they thought the market would evolve in the medium term, some FDs issued a note of caution:

"Underwriting is a problem going forward – how do you make the numbers stack up? So many developers underwrite assuming a rising market but there is a real chance that rents won't climb to the levels that current land prices discount."

"The problem for resi developers is affordability for the house purchasers. The banks' mortgage lending criteria has become far more stringent."

On the issue of inward investment, opinion diverged. While some worry that demand from foreign buyers will cease or that they will exit the UK market when capital gains opportunities disappear, others think foreign investors will ride out the cycles.

"The Chinese are likely to stay in the UK regardless of the cycle. They would rather lose 30% of their investment here than subject themselves to the home political risk of 100% losses that their grandparents endured."

5.2.3 Unlisted Companies

Unlisted companies have a positive outlook for the market segments they operate in but most are undecided about the market in 12-18 months time. Widespread awareness of the unusual cyclical 'sweet spot' experienced in the past year means the real estate cycle is never far from their minds.

"... life was too easy last year and site acquisitions are tougher now."

"The trend is long term positive and very positive for 2015 funding availability. The long term outlook for London is good, but, real estate is still a cyclical market."

"This will be a long cycle. Yields will fall to 2% on West End commercial and stay low for years. But, resi could be a different matter. If interest rate deductibility is withdrawn for buy-to-let there could be untold damage to the market in short order."

The unlisted companies mirrored the concerns expressed by the listed sectors on problems with the planning system, skill shortages and build cost inflation.

In addition, anger was expressed that some banks insist borrowers buy their hedging and several mentioned instances of transactions that were slowed or even aborted due to the inexperience of the bankers.

5. OUTLOOK FOR DEVELOPMENT FINANCE

5.2.4 Opportunity Funds

The main barrier to profitability that these funds perceive is the rise in build costs across the UK. Criticism of government policy regarding skilled immigrants was strongly expressed, together with a belief that any government move to limit immigration would have a very adverse impact on future build costs and capacity.

> "Developments are getting expensive. Construction costs and site costs are seeing double digit increases. That rise in construction costs means rents need to rise."
>
> "There will be more cost inflation until additional workers come into the market. The politicians have been savage in what they say about immigrants when we clearly need them."

Future rises in interest rates do not appear to worry market participants because the loan term is short for development, but there is more concern about the potential damage of a UK exit from the EU.

> "We feel comfortable with our future prospects because all our assets are defensible, but an EU exit is scary because of all the unknowns."

Complaints were expressed about the skill sets at some of the banks, echoing similar comments from unlisted company FDs:

> "Many loan officers in banks are inexperienced and unfamiliar with development lending. Lots of the 'old hands' have moved on to alternative platforms."

Uncertainty regarding the future impact of Solvency II regulation on insurers' appetite for property was also mentioned as a concern since many of the assets developed by opportunity funds are sold to insurers. If real estate carries too high a regulatory capital weighting under Solvency II, these funds fear it will have an adverse impact on the market where they have previously found a reliable exit.

5.2.5 Other Developers

This group holds very diverse views on the outlook for their businesses.

> "The market will be fairly subdued in the next few years because demand from occupiers is still fragile."
>
> "There are always good deals to be done because there are always underperforming assets. We have no idea where the market will be in 1-2 years. It will rise until there's another crash."
>
> "We hope funding availability will continue to grow. I am a bit worried that hotels and resi may pose some problems for the future."
>
> "Where are we in the cycle? 2014 was a great year and we think it's still early in the cycle. London is not representative of the rest of the UK."

5. OUTLOOK FOR DEVELOPMENT FINANCE

5.2.6 Insurers

Insurers see development as part of their wider universe of opportunities and any decision to deploy funds to development is an asset allocation decision. Those interviewed generally saw the outlook as favourable for their continued involvement. Their dilemma is where to deploy their funds.

> "We have to create assets in the desired places with desired characteristics. Low returns in other asset classes are driving money to real estate."
>
> "Conditions look generally good to us but it's hard to find new opportunities in London. We're now looking in the South East, Manchester and Edinburgh."

There is interest in new investment concepts, such as hybrid funds, rather than sole reliance on direct investment in order to achieve their desired investment characteristics.

> "More funding is needed from the capital markets and the REITs have this access. We're seeing more combination listed/unlisted hybrid funds. REIT returns really do correspond to direct returns but many in the market remain sceptical."

Like all developers, insurers have their concerns about the impact of build cost inflation and the substantial wave of foreign equity capital that has driven prices to current levels.

> "We're concerned about the risk that foreign equity will be withdrawn. Equity has replaced debt – mainly foreign equity. But who are the investors behind the vehicles and will they leave if, for instance, there's a Brexit?"

In summary, all developers – including insurers – are optimistic about prospects for the future. However, regardless of business type, they have similar perceptions of the emerging vulnerabilities in the market and concerns that these factors will adversely impact the profitability of future development.

APPENDIX: REGULATORY CAPITAL REQUIREMENTS FOR DEVELOPMENT LOANS

Every bank operating in the UK is required to hold regulatory capital against each loan exposure that it retains. Given the scarcity of capital, banks closely monitor their return on capital and, as a consequence, the amount of regulatory capital required is a key component in determining the pricing of a loan. The precise amount of regulatory capital needed to be held against a development loan is calculated by reference to a risk weighting methodology as governed by the rules of the financial regulator responsible for that lender.

In 2006, the Basel II regulatory regime[3] was adopted by all EU countries, including the UK, promoting an approach to capital adequacy intended to be more risk sensitive than the previous Basel I rules.

One of the main Basel II objectives was to encourage each bank to model its risks using its previous experience of defaults and losses. This required each bank to have sufficient historic data, as well as risk modelling expertise, to develop a model for predicting the riskiness of its loans. The intention was for each bank's resulting internal ratings based model (IRB model) to be used by the bank to calculate its own regulatory risk weights and its own regulatory capital.

The top level parameters governing the application of capital rules are mandated by the Basel Committee on Banking Supervision, with each country's regulatory body applying its own interpretation of these parameters. UK banks (and UK subsidiaries of foreign banks) are regulated by the Prudential Regulatory Authority (the PRA), which is part of the Bank of England. However, the PRA does not regulate branches of foreign banks operating in the UK market.

The UK branches of non-UK banks are regulated in each bank's home country, e.g. German bank branches are regulated by the Bundesbank and BAFIN, US banks by the US federal banking agencies (the OCC, the Fed and the FDIC), etc.

All these regulators require the banks under their supervision to supply a 'risk weight' for each loan exposure, which is a measure of risk for each loan. Basel II designates three permissible model types for calculating regulatory capital on real estate loans:

1. The 'standardised approach' with pre-determined supervisory risk weights;
2. The 'foundation internal ratings based approach' (F-IRB), by which the bank calculates its own probability of default (PD) for each loan using an internal model but uses supervisory loss given default (LGD) estimates;
3. The 'advanced internal ratings based approach' (A-IRB), by which the bank calculates its own probability of default (PD) and its own loss given default (LGD) for each loan, using an internal model.

For banks using the standardised method, all risk weights are prescribed for the asset class. For banks using the IRB methodologies, the risk weights are derived from a model where the inputs are produced by the bank in accordance with its regulator's guidelines. That 'risk weight' is then used in a prescribed way to determine the amount of regulatory capital the bank has to hold against that particular loan.

However, risk weighting inputs differ between countries and, around the world, risk weighting methods vary depending on the sophistication of the bank's risk modelling capabilities and the attitude of their home regulator. A single loan, therefore, may have multiple different risk weightings depending on the regulatory jurisdiction and the methods used by each lender.

[3] Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework - Comprehensive Version, Basel Committee on Banking Supervision, July 2006.

APPENDIX: REGULATORY CAPITAL REQUIREMENTS FOR DEVELOPMENT LOANS

The European Central Bank (ECB) conducted an exercise in which it gave many different banks the same portfolio of loans and asked each bank to risk weight these loans. The resulting risk weights varied so much from bank to bank that the ECB gave notice it would be reviewing the issue. There is now an ECB drive to introduce more uniformity into the risk weighting process through the Single Supervisory Mechanism (SSM), which commenced operation in November 2014.

Regulatory Capital in the UK – The Move to Supervisory Slotting

Basel II envisaged that banks that elected to use the IRB approaches for most of their loan books would not necessarily have sufficient data for every type of exposure. In the event a bank elected to use an IRB approach for most of its loan books, but had insufficient data to support a robust internal model in a certain asset class (e.g. real estate), the lender could be required to use the 'specialised lending' (SL) approach – also known as Supervisory Slotting or 'Slotting'.

The Slotting approach lies between the standardised and the F-IRB approaches in terms of risk weighting sensitivity, but uses specified supervisory risk weights that are attached to 'slots' instead of a bank's own estimates.

In December 2010, following the financial crisis and a precipitous decline in UK commercial real values, the UK authorities decided they would not accept that any UK bank was capable of estimating its own PDs for real estate loans – or least not with sufficient robustness for regulatory capital purposes. As a result, all UK regulated banks were required to use 'Slotting' to calculate their risk weighted capital for real estate loans. Despite most of the major UK banks having developed real estate IRB models, in order to meet with the requirements for the institution as a whole to apply an IRB approach in their other loan books, they accepted this blanket edict.

Slotting uses a scorecard specified in the original 2003 Basel II documentation. Each loan exposure is placed in one of five categories (or slots), with each slot representing an unalterable supervisory risk weight. The bank must assign each of its loans to a slot on the basis of the underlying credit risk, as evaluated by aggregating all the factors listed in the slotting scorecard. The riskier the loan is, the weaker the slot and the higher the risk weight that is required. The final risk weight is also dependent upon the remaining maturity of the loan.

Each supervisory slot broadly corresponds to a range of external credit assessments of BBB- or better, BB+ or BB, BB- or B+ and B to C- (or their equivalents). The fifth category covers default.

Table A1: Slotting Risk Weights

Remaining maturity	Category 1 (Strong)	Category 2 (Good)	Category 3 (Satisfactory)	Category 4 (Weak)	Category 5
Less than 2.5 years	50%	70%	115%	250%	Write off 50% of outstanding loan
Equal or more than 2.5 years	70%	90%	115%	250%	Write off 50% of outstanding loan

APPENDIX: REGULATORY CAPITAL REQUIREMENTS FOR DEVELOPMENT LOANS

The rules also state that the expected loss (EL) for each slot must conform to the guidance in the table below.

Table A2: Expected Loss Weights

Remaining maturity	Category 1 (Strong)	Category 2 (Good)	Category 3 (Satisfactory)	Category 4 (Weak)	Category 5
Less than 2.5 years	0%	0.4%	2.8%	8%	50%
Equal or more than 2.5 years	0.4%	0.8%	2.8%	8%	50%

The 'Strong' slot for less than 2.5 years has the lowest risk weight but it specifies that there must be a 0% EL (nil expected loss) for that loan, which may be viewed as a considerable hurdle in the context of any commercial loan, let alone a real estate development loan. Hence, a very robust case has to be made to the PRA to allocate an exposure to the 'Strong' slot.

Slotting Score Card Categories

Development loans are allocated into a Slot on the basis of scores in five categories:

1. Financial strength
2. Cash flow predictability
3. Asset/Scheme characteristics
4. Strength of sponsor/developer
5. Security package

Slotting Implementation Dilemmas

Slotting did not receive detailed regulatory attention in the run up to Basel II implementation, which resulted in the belated identification of a number of issues. In particular, the slotting scorecard does not weight the relative importance of each risk factor to be evaluated. Queries arose such as: 'Does recourse to a respected sponsor with deep pockets in the event of problems rank as no more important than projected equilibrium market conditions?' and 'Which slot does a bank use if a project ticks most boxes for the 'Good' slot but a few boxes for the 'Satisfactory' slot?'

A further problem is the lack of differentiation in risk weights for exposures with a very low LTC and implied Loan to Gross Development Value (LGDV). The 'Strong' slot has a minimum risk weight of 50% or 70% depending on remaining loan maturity and does not reward the lender by reducing the risk weight further for a loan with relatively minimal risk. For example, a 15% LGDV receives the same risk weight as a 50% LGDV exposure, all other factors being equal.

The motivation behind the UK's adoption of Slotting was to require banks to use expert judgement in allocating loans to slots, rather than relying on the mechanistic use of sophisticated models, based on input data, that could be of questionable reliability or quality. Each UK regulated bank was asked to find its own way to interpret the scorecard and implement their slot allocation. The PRA then either approved what the bank had done or sent it back for further analysis.

APPENDIX: REGULATORY CAPITAL REQUIREMENTS FOR DEVELOPMENT LOANS

As a result of this process, UK regulation has adopted a pragmatic approach. An example might be of an office development that is nearly 100% pre-let, other than for some ancillary retail space. On a literal interpretation of the slotting scorecard, the entire loan would be relegated to a lower slot with a much higher risk weight due to the minimal un-let ancillary retail space. However, if the proposed development is sufficiently pre-let to provide 100% debt service cover, such a loan would generally be seen as 100% pre-let and thus qualify for a 'Strong' or 'Good' slot, subject to the rest of the scorecard supporting its qualification for one of those slots.

Regulatory Capital in the rest of the EU

In contrast to the UK, most other EU regulators have remained open to allowing IRB models for real estate. Banks in other EU countries that have received supervisory approval for their IRB models can currently use their own estimates of risk components to determine their capital requirement for a given development loan exposure. Those EU banks that have not received supervisory approval for IRB models often use the standardised approach and there are European banks outside the UK that also use slotting.

The EU is currently reviewing its Specialised Lending legislation, including slotting for real estate. The European Banking Authority (EBA) issued a consultation in May 2015 for response by mid-August 2015. The current focus on slotting suggests that the EBA may consider moving to a wider use of slotting following their recently expressed desire to create a more unified approach to the risk weighting of assets. The ECB, through the SSM, proposes a review of all IRB models used by banks under their jurisdiction over the next two years or so, as a result of which changes are expected.

The Basel Committee on Banking Standard (BCBS) also recently issued two Consultation Papers on the use of Standardised Capital Floors and Changes to the Standardised Regime, which could impact on regulatory capital requirements for real estate lending in the EU.

Regulatory Capital in the US

The US approach to regulatory capital differs from that of the EU, in that the US regulators have never allowed the vast majority of their banks to apply for supervisory permission to use an IRB model. All banks with assets below a $500 million threshold were directed to use Basel I standardised risk weights to calculate their regulatory capital for real estate loans.

However, the situation has changed with a move by US regulators to a Basel III/Dodd-Frank reform regime effective from 1 January 2015. As a result, the standardised approach capital requirements for development loans has been tightened, with a mandatory 150% risk weight if a loan is designated as a 'High Volatility Commercial Real Estate' (HVCRE) loan.

Even the largest US banks are now subject to the HVCRE rules. Banks with consolidated total assets of greater than $250 billion or consolidated on-balance sheet foreign exposure of at least $10 billion may still use advanced approach IRB models, but they must calculate their risk weights using the standardised approach in parallel and apply the higher of the two resulting risk weights in accordance with new rules on the required capital floor.[4]

[4] This dual calculation was mandated by the Collins Amendment to the Dodd-Frank Act, which requires the federal banking agencies to establish minimum risk and leverage capital requirements on a consolidated basis. The minimum requirements may not be less than "the generally applicable" leverage or risk capital requirements and may not be quantitatively lower than "the generally applicable" risk and leverage capital requirements that were in effect for insured depository institutions as of July 21, 2010, when Dodd-Frank was enacted.

APPENDIX: REGULATORY CAPITAL REQUIREMENTS FOR DEVELOPMENT LOANS

Since some previously underwritten development loans might now fall into the HVCRE category (and any previously originated loans still outstanding will not be exempt) the US stance on regulatory capital has become more stringent as of January 2015.

The HVCRE designation may be avoided through careful underwriting but, to escape the 150% risk weight, US bank development loans must meet three specific criteria:

1. The loan must have a loan-to-value ratio (LTV) of less than or equal to 80%;
2. The borrower must contribute equity to the project in the form of cash or unencumbered marketable assets of at least 15% of the appraised 'as complete' value (not a percentage of the LTC as is usual elsewhere) and;
3. The borrower's equity must be contributed prior to all bank funding and remain in the project throughout the life of that project. (The life of the project concludes only when the credit facility is converted to permanent financing, sold or repaid in full.)

Clearly, the US approach to regulatory capital for development loans differs substantially from the current EU approach, but the US rules on HVCRE, like the EU rules, were derived from pre-existing Basel II language.

The original 2003 Basel II documentation designated a separate 'specialised lending' category for HVCRE that specifically referenced development lending, defined as "any of the land acquisition, development and construction (ADC) phases for properties" that "are categorised by the national supervisor as sharing higher volatilities and portfolio default rates."

Many non-US lenders may have overlooked the Basel II language to single out development loans for more stringent HVCRE treatment, possibly due to the EU (and Australian) decision not to adopt the separate HVCRE sub-class of specialised lending in their 2006 Basel II implementation legislation. However, a current review of the 2006 decision may result in EU regulation similar to the US approach.

Risk Weighting Differences – What are the Implications?

The multiple methods available for risk weighting and regulatory calculations between different jurisdictions gives rise to the question, "Do foreign banks have a competitive advantage over UK banks in development lending due to differences in regulation?".

This is a difficult question to answer as it may seem that those banks allowed the use of internal ratings based models would be at an advantage over those obliged to use Supervisory Slotting or HVCRE risk weights. However, the pricing data collected in this research shows little differentiation between UK and non-UK banks; nor does the LTC data show much evidence in this regard. The one area where the differences between UK and non-UK banking regulation is highlighted is in speculative lending, where fewer UK banks than non-UK banks are willing to consider such financing due to the heavy risk weighted capital burden required for speculative lending under Slotting.

The similarity in UK development loan pricing across the banks, regardless of regulator, may be a result of competitive pricing pressures and in response to the terms generally on offer in the market. Banks have the freedom to price according to factors other than risk weighted capital. However, if loans are under-priced in relation to a lender's regulatory capital requirements, this may have adverse implications for profitability.

APPENDIX: REGULATORY CAPITAL REQUIREMENTS FOR DEVELOPMENT LOANS

Alternatively, the banks that are required to hold less regulatory capital may choose to price similarly to others in the market in order to increase their profit margins. A further possibility may be that the IRB models that have passed regulatory scrutiny outside the UK are actually quite conservative. It is apparent that US banks now face substantial regulatory capital costs for highly geared development lending or entering into transactions in which the borrower's equity is injected pro rata, although US regulation permits banks to be very competitive on other terms.

Ultimately, the relevance of regulatory competitive advantage may be limited in a market where each transaction is designed as a bespoke product for the borrower and their development scheme. The advantage in winning business often lies in the detail of how well a lender can tailor the transaction to that sponsor's needs. Since lender flexibility on individual terms varies across the regulatory regimes, some lenders can meet specific borrower needs that others cannot. In development finance, it is essential to seek out the best terms available in the market across the regulatory spectrum.

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Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk

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