Dealing with change

Why developers must review their corporate financing strategy

Julian King, Senior Asset Adviser at Arc & Co., highlights the issues facing portfolio developers/investors and provides some diversification options

At the time of writing this article, the world is experiencing a seismic shift in its ability to function under normal conditions, with all our lives having been changed at a moment's notice due to the threats posed by the COVID-19 virus.

While the long-term effects of this mayhem on the property market remains an unknown, many construction sites are closed or under pressure to close with the availability of materials becoming more difficult due to builders' merchants not being open. This pressure on the supply chain will undoubtedly have an effect on the practical completion of projects and has resulted in a delay to the sales process – further compounded by the Government's instructions to pause property transactions until it is safe to proceed.

Lenders and developers will have to work together to extend debt facilities, so they are in-line with the anticipated construction and sales programme. But what if a developer has already reached practical completion and maybe even completed some sales? What are the other potential options available? The answer to this question depends on the corporate strategy of the developer, which may change from a 'build to sell' scenario to a 'build to hold' one. Is the developer implementing a strategy for the short, medium or long-term? Perhaps it is a mixture of all three to blend risk and reduce market exposure, which crystallises immediate gain with long-term passive income.

Looking at the specific exit options, we can divide this into three categories:

- Short-term: immediate sales
- Medium-term: exit bridge up to 24 months
- Long-term: buy-to-let up to five years.

Initially, the developer may want to crystallise some immediate sales to reduce debt exposure and lower the loan-to-value (LTV) percentage. The developer should consider the most appropriate strategy, which takes into account their lender's exposure limits and the number of units for sale at one time.

Medium-term development exit finance

Development exit finance may provide some of the following benefits:

- The ability to refinance with an existing lender
- A better rate of interest
- A longer sales period
- Equity release.

Development exit finance works by paying back the senior debt lender and resetting the debt facility either in full or in part. However, negotiating part repayment is likely to be difficult, unless the appropriate levels of gearing are equally matched. In some instances, interest may be reduced and if the gearing allows, then the developer may also be able to release some equity that has been created through the added value in the project. Most borrowers will use development exit finance when sales have been slow, or they want to release capital to roll into other projects and keep their business moving forward. Typical exit bridging facilities will include:

- Term: up to 24 months
- Gearing: up to 70% LTV
- Interest: from 0.5% per coming month.

Long-term investment

The next part of the strategy is the consideration of the longer-term investment options. It is logical to hold properties, using the asset to create passive income and help service the overhead figure in more challenging times. There are many options available including commercial portfolio finance – which is good for reducing exposure limits, but this can result in higher levels of interest cover ratios (ICR), which may impact the LTV rate.

Depending on how many properties a developer is seeking to hold, it may be beneficial to use a buy-to-let mortgage. This reduces the ICR and protects the LTV but may have exposure limits when financing with one lender – meaning the developer will have to use multiple lenders. Typical buy-to-let terms that may be offered include:

- Up to 75% LTV (subject to ICR at 125% on a 5% pay rate)
- Term: Five years fixed
- Interest rate from 3% per annum.

If a developer uses all three sales options to their advantage, they have protected their profit margin and spread their sales risk, giving them time to protect the asset and its value until a more favourable sales environment unfolds. Many developers may have already had conversations with their lenders on how best to work through this period of change and uncertainty. The only certain thing that we don't know at this point, is how long we may find ourselves in this position. Banks remain liquid with strong capital reserves, but many have reduced their gearing or made amendments to pricing while they make their own adjustments to risk.

Similarly, choosing the right debt adviser is crucial to obtaining the correct advice and ultimately the right debt facility. This is where Financial Conduct Authority (FCA)-regulated brokers can offer access to a wider pool of lenders, giving borrowers both market and price transparency. An FCA-regulated broker will also be able to advise you on regulated and unregulated products for both personal and limited company purposes.

If your client is a property developer or buy-to-let investor and currently has a portfolio under pressure due to the sudden change in economic activity, now might be a good time to consider diversifying their corporate development strategy. You may want to explore how diversifying the strategy could help the business, resulting in minimal disruption and asset protection in the weeks and months ahead. It is vital that the property and lending industry work together to navigate these uncharted waters in this war against the invisible COVID-19.