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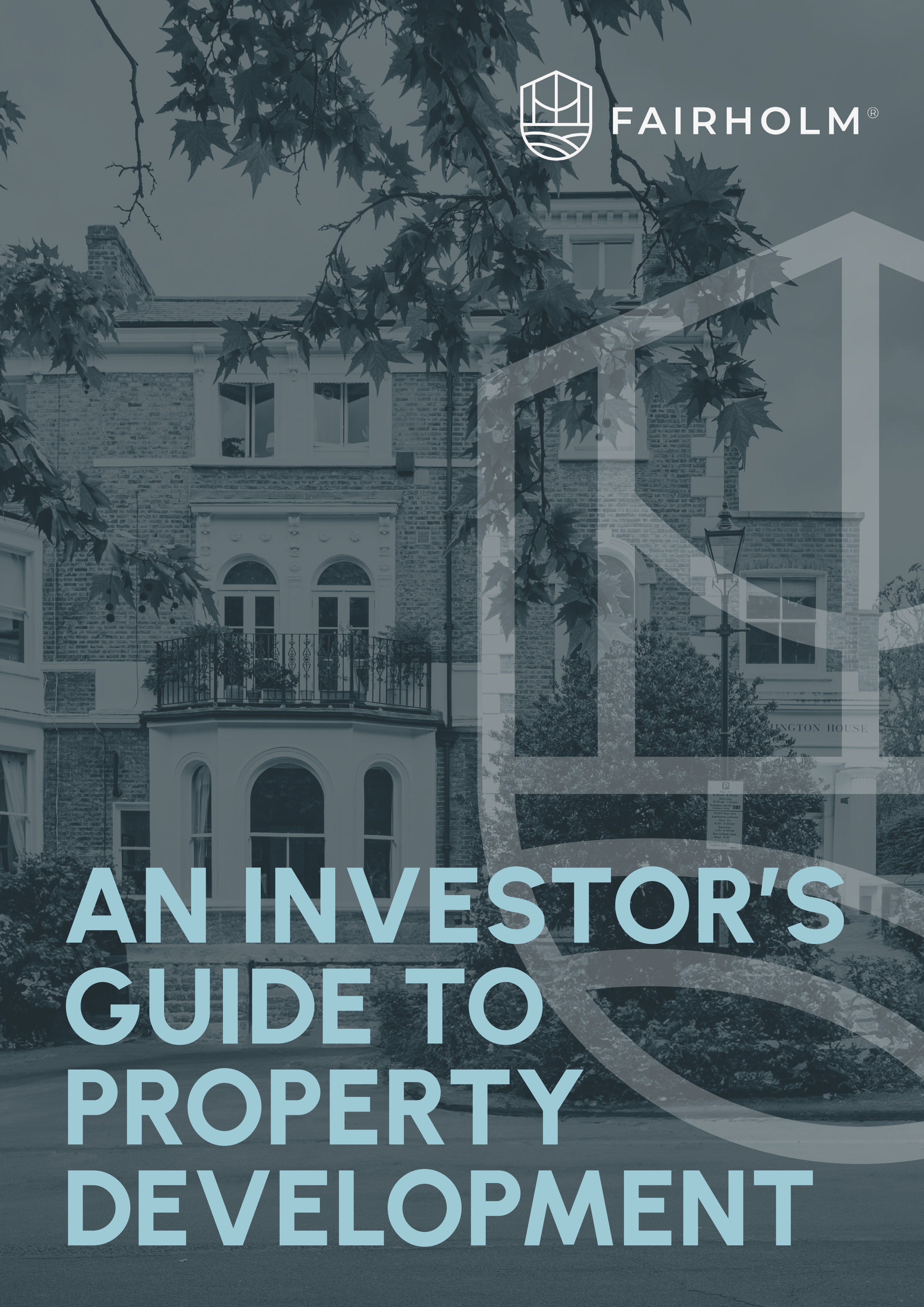


AN INVESTOR'S GUIDE TO PROPERTY DEVELOPMENT

INTRODUCTION

Directly investing in a property development project delivers one of the main strategies available for investors looking to incorporate the benefits of property assets into their investment portfolios, alongside options like Buy-to-Let, creating Co-Living/HMO accommodation, participation in larger managed funds such as REITs or investing in publicly listed housebuilders.

The turmoil of recent years has underscored the resilience of property as an asset class, driven partly by an enduring supply and demand imbalance that could take many years to address. This guide recognises property development as a short to medium-term investment, typically concluding within 12 to 18 months, so investors gain the advantage of aligning their investments with expected market dynamics during a project's timeframe. Beyond potential returns, supporting agile, small-scale developers allows investors to contribute to addressing the scarcity of high-quality homes.

To the uninitiated, development finance is a complex area to assess and compare with other property strategies.

The premise of this guide is to encourage readers to adopt a developer's perspective, or even more crucially, that of a commercial development finance lender, highlighting the key elements these stakeholders scrutinise when evaluating a project proposal.

Important to note – this guide provides general information for educational purposes only and should not be construed as investment advice. Investing in a specific property development project carries the inherent risk of partial or total capital loss. Investors should seek professional advice from a suitably knowledgeable and authorised advisor tailored to their individual circumstances before making any investment decision.

"THE PREMISE OF THIS GUIDE IS TO ENCOURAGE READERS TO ADOPT A DEVELOPER'S PERSPECTIVE."

THE EXIT
STARTING AT THE END

For most developers and professional property funders the end result drives the feasibility of a potential project, both the value of the exit and the range of options available to realise capital.

At the core of this strategy lies the Gross Development Value or GDV, a metric estimating the overall sales value of the completed project. GDV is generally reached by combining the internal area of a development with an estimate of the value for that area, taking account of factors such as the site location, the local market, type of property, target buyers, competing developments and any features of the project that might increase or reduce value, such as outdoor space or parking.

Establishing GDV involves a nuanced calculation, blending subjective and objective assessment, mainly using comparable sold prices aligning with the type of property being developed, location and time since the comparable was sold. It can be a complex area to assess that requires detailed analysis, but there is a simple solution to run alongside an investor's own due diligence – the Red Book valuation. This is an invaluable document that a senior development lender commissions, where a RICS qualified and registered surveyor prepares a full appraisal of the project viability and GDV. Whilst addressed only to the senior lender, investors can leverage the surveyor's expert opinion and utilise their in-depth knowledge on reaching the Red Book valuation to complement their own research.

Most development projects are set up with a view to swift sales of the properties as soon as possible to repay funders, either on completion or off-plan. But even over the short-medium term, market dynamics can shift leading to unforeseen challenges. The market may not absorb properties as rapidly as anticipated, necessitating exit finance or price adjustments that both impact profits.

To mitigate such risks, developers should outline viable secondary exit plans. This could involve considering refinancing and repayment of investors through term loans, targeting the rental market, or evaluating the potential for sales where the primary strategy is "build to rent". Ahead of development commencing there may also be ways to lock in sales and mitigate exit risks, such as lining up a portfolio investor or housing association, or securing a sales guarantee. Such measures help safeguard the exit strategy and enhance the overall viability of the project.

THE FINANCIAL APPRAISAL

ACCOUNTING FOR COSTS

Similar to any business venture, the profit derived from a property development is the gross revenue, represented by the final realised GDV, less the associated costs. The initial step in safeguarding and managing this profit involves a detailed development appraisal.

The construction phase is the most likely area to experience variations during development. Most financiers therefore insist on applying a contingency to build costs generally, usually set at 10% or at least 5% of the anticipated expenditure, and to any specific areas of concern.

THE PRIMARY CATEGORIES COVERED IN A DEVELOPMENT APPRAISAL TYPICALLY INCLUDE:

ACQUISITION

encompassing the purchase of the development site or property, inclusive of SDLT, legal fees and sourcing fees.

PLANNING & DESIGN

involving initial design work, securing necessary surveys and reports, and obtaining consents from the local planning authority, if not already granted.

PROFESSIONAL FEES

incorporating services linked to the build, such as full architectural and structural design, surveyors and final planning requirements.

CONSTRUCTION

costs associated with work undertaken by the main contractor, usually under a standard JCT construction contract, covering site clearance, groundworks, main structural construction, internal fit out and external landscaping.

LOCAL & STATUTORY

covering costs linked to highways, access, utilities and requirements such as a planning or "Section 106" agreements with a local authority, for example a social housing contribution or a community infrastructure levy.

FINANCE

including valuations, legal and arrangement fees, monitoring and interest costs.

SALES

comprising marketing costs, conveyancing legals and agency fees.

EXAMPLE DEVELOPMENT APPRAISAL

GROSS DEVELOPMENT VALUE	£ 4,000,000
ACQUISITION	£ 1,200,000
PLANNING & DESIGN	£ 60,000
PROFESSIONAL FEES	£ 100,000
CONSTRUCTION (INCLUDING CONTINGENCY)	£ 1,250,000
LOCAL & STATUTORY	£ 200,000
FINANCE	£ 300,000
SALES	£ 50,000
TOTAL COSTS	**£ 3,160,000**
GROSS PROFIT (BEFORE TAX)	**£ 840,000**
RETURN ON COSTS	**27%**
RETURN TO GDV	**21%**

FINANCE PLAN

	GBP	LTGDV	LTC
SENIOR LOAN	£ 2,520,000	63%	80%
MEZZANINE LOAN	£ 480,000	12%	15%
DEVELOPER EQUITY	£ 160,000	4%	5%
TOTAL FINANCE	**£ 3,160,000**		

Once an appraisal tailored to the project has been established, it is prudent to conduct sensitivity analysis, assessing how changes in key variables impact profit and capital repayment.

The primary variables that can influence outcomes are interest rates and, the most often encountered problem area, the duration of the building work.

THE CAPITAL STACK

UNDERSTANDING DEVELOPMENT FUNDING

Once the estimates for the two main development criteria, the GDV and total costs, are established, the costs required to achieve completion, so ignoring sales costs, lender exit fees and any deferred costs, need to be financed for the development to commence. For most developments, funding comes from multiple sources, known as the capital stack.

The capital stack sets out the funding in terms of risk vs. reward, with the cost of capital reflecting where a funder sits relative to the underlying security priority over the land / building and the repayment order. The earlier a funder is repaid, the lower the risk and cost of finance.

Two key risk metrics to be aware of in the capital stack, illustrated below, are:

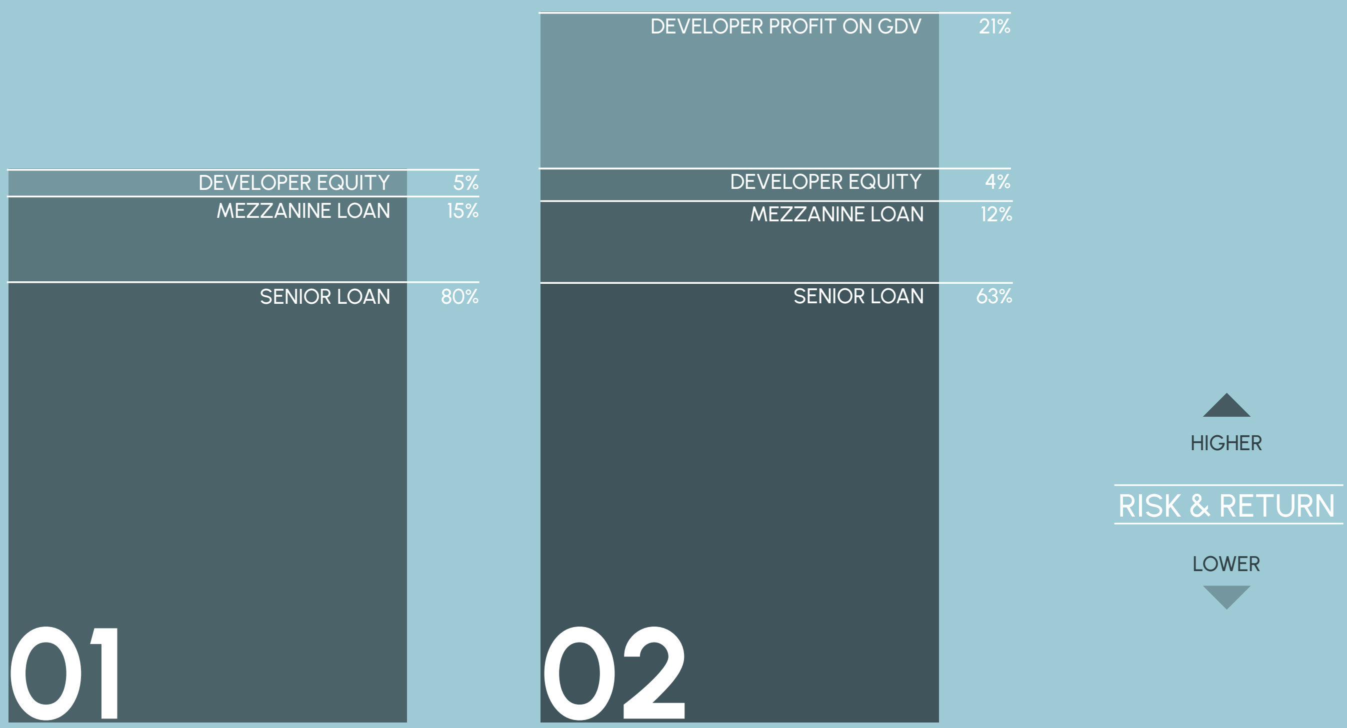
01	LOAN TO COST (LTC)
02	LOAN TO GDV (LTGDV)

LTC represents how much of the development costs a funder, along with the funding sources that sit behind them, is covering. Similarly, LTGDV represents how much of the end sales value is required to cover repayment of finance.

Development funders manage risk by capping their LTC and LTGDV and ensuring someone else, usually the developer or equity funders, or a subordinate loan, is behind them.

A contribution by the developer is usually expected within the mix of finance, on a first-in, last-out basis, to ensure they have capital at risk and are focused on a successful exit that achieves profit, or at least gets a funder repaid.

Capping funding in this way is not necessarily a reflection on the development project, but a means to ensure other parties with direct control of project management are engaged with delivering an effective outcome.



LOAN TO COST (LTC)

LOAN TO GDV (LTGDV)

In this illustration, a senior lender that funds up to 80% of costs or 65% of GDV is providing a loan of 63% of the expected GDV, confirmed by the Red Book valuation, and capped at 80% of costs. A junior or "mezzanine" lender is covering a further 15% of the costs, representing a 75% LTGDV including the loan advanced by the senior lender. The developer, along with any equity investors, are then covering the final 5% of costs required to complete the capital requirements.

What can be seen from the indicative interest rates illustration is the higher the risk, the higher the cost of capital / investor return, with funders taking more risk rewarded with better returns. The capital stack also shows the security priority, with each funder having more control over how security is enforced than the funder behind them. The junior funder is subordinate to the senior lender, but has priority over the equity that sits behind them. Similarly, the capital stack sets out the repayment order, so the senior lender has to be paid in full before the junior lender, even though the developer contribution/ equity and junior loan have to be spent first and before the senior loan is drawn down.

A key point to note for an investor in a project is that just because a senior lender might be recouped when sales are 63% of GDV, the senior lender still needs the development to be completed in order to exit. Therefore, the investor can benefit from the steps the senior lender, which has by far the most funding on the line, will take to ensure the project is correctly managed and exited. However, the exit still needs to be at a level that covers the investor funding. In this illustration, the senior lender can successfully exit on completion and is fully repaid if the GDV has fallen 37%, but if the GDV falls over 21%, the developer/ investor would start to suffer a capital loss.

"...A SENIOR LENDER STILL NEEDS THE DEVELOPMENT TO BE COMPLETED IN ORDER TO EXIT."

THE TEAM

EXPERIENCE COUNTS, BUT CAN ALSO BE BOUGHT

Successfully delivering a property development on time and on budget, even a modest scale project, can be a complex and highly specialised undertaking. Under the pressure of time, an efficiently run project requires the co-ordination of multiple suppliers and external contractors, the services of which will interconnect. Any delay in one aspect can have a knock-on effect with the delivery of other project areas, leading to further delays or additional costs to realign the project.

The linchpin of this process is the main developer, akin to the CEO of the project. It's crucial to assess whether they have prior experience in similar projects, even if the current endeavour represents a scaling up. While a track record of delivering profitable projects is undeniably important, given the multifaceted nature of property development, it's impractical for a developer to be a master of all trades.

KEY DEVELOPMENT TEAM ROLES

MAIN DEVELOPER

PLANNING CONSULTANT
Provides advice on planning regulations and procedures

ARCHITECT
Designs the overall concept and appearance of the building

STRUCTURAL ENGINEER
Ensures the structural integrity of the building

QUANTITY SURVEYOR
Manages costs and financial aspects of the project

PROJECT MANAGER
Oversees the entire development process

EMPLOYERS AGENT
Represents the developer client's interests during the project

M&E DESIGNER
Designs the mechanical and electrical systems within a building

BUILDING REGULATIONS CONSULTANT
Ensures compliance with building regulations

CDM (CONSTRUCTION DESIGN & MANAGEMENT)
Coordinator ensures health and safety during the construction phase

The paramount quality to seek in a developer is the ability to identify, recruit and manage a team tailored to the project's specific needs.

Building a team with diverse experiences relevant to the project and across multiple developments is the key to success.

SECURITY

WHAT IT DOES AND DOES NOT MEAN

It is generally accepted that the majority of startup ventures will have failed by their third year, long before any exit is contemplated, and with capital usually long since spent on trading costs such as marketing, staff and stock there is little if anything left over for investors when the business is wound up.

The appeal of investment in a property development project is the venture's objective to take a tangible asset with a predetermined value and progressively enhancing its worth through successive stages of capital infusion. This increasing value should ideally align with the capital expended, offering a safety net even in projects facing challenges, ensuring the potential recovery of most, if not all, invested capital.

When investors opt for advancing debt financing, obtaining legal security becomes paramount to leverage the asset-backed nature of property. This is typically achieved through a legal charge over the asset, which can be formally registered to safeguard against conflicting claims. In scenarios involving multiple lenders, a deed of priority or inter-creditor agreement is essential to determine the order of precedence.

Generally, this order reflects the cost of capital, with senior lenders enjoying the "first charge" and assuming lower risk. Subordinate lenders, taking second or even third charges, balance this added risk with a higher rate of return.

SECURITY HIERARCHY

1 FIXED CHARGE HOLDERS
First and second charges over specific assets. First charge holders have priority in terms of repayment and in an insolvency usually have control over the decisions once a default occurs

2 INSOLVENCY EXPENSES
Costs directly incurred by the practitioners engaged to oversee the process of realising assets to pay debts

3 PREFERENTIAL CREDITORS
Certain debts are given preferential status, typically those owed to employees

4 FLOATING CHARGE HOLDERS
First and second charges over assets that are not covered by fixed charges, normally where they are transitory in nature

5 UNSECURED CREDITORS
Debts that are not secured by a specific asset, usually trade creditors/ suppliers

6 SHAREHOLDERS
Shareholders receive any remaining funds after all the above categories of creditors have been paid in full

In the case of equity investments, where investors generally acquire shares in the company formed to undertake the development, security is derived from the rights associated with these shares. Effectively, investors own a portion of the company's net assets. Shareholders' rights are subordinate to company debt repayment, positioning them at the top of the capital stack with the potential for a higher, performance-linked return. Equity shares can be further categorised into different classes, such as "preference" shares offering a higher level of security and a fixed rate of return before "ordinary" shares, with the developer normally taking ordinary shares that are last in the order of payment in a capital distribution.

A clear understanding of security levels and an investor's position in the distribution hierarchy are pivotal for balancing risk and return. It's essential to note that "security" does not equate to a "guarantee". Even with security over an asset, if its value falls below the funds advanced, a capital loss occurs, and no repayment guarantee exists.

RISKS

AND RISK MANAGEMENT

Investing in small-scale property development holds the promise of potential rewards, but it also comes with its share of risks. The main risks to consider are Revenue Risk and Operational Risk.

Revenue Risk is where the projected end value of the developed property lowers over the course of the work to the extent that the profit margin on a sale is reduced or a loss incurred, or the funds available from a re-financing are not sufficient to repay the existing funding. The main Operational Risks are cost increases that can hit profits and even capital repayment, usually resulting from a rise in material costs, or delays resulting from unforeseen issues or unplanned breaks between the stages of construction.

As with assessing the viability of an overall development proposal, a smart investor will look to the senior lender and the professional team that have been hired for their ability to manage risks effectively.
Although the senior lender will have a lower level of risk in a project, they will still be funding based on a robust and experienced assessment of the project and with the advantage of seeing how similar projects have progressed.

For the Revenue Risk, the Gross Development Value they plan to use to set the level of risk on their loan should carry weight, so an investor can look at the market and evaluate the scale of reduction that would jeopardise their capital. More importantly, the senior lender will ensure that the team has the ability to run the development to an agreed plan and avoid the Operational Risks.

Ultimately the developer is in control, making it essential for investors to assess the stake developers have in the project's success. Whilst a reduced developer profit will motivate focussed project management, of more significance is loss of the developer's own capital contribution. So an investor can review where their own investment sits relative to the developer, and also what form of investment has been made - is it hard equity in the form of cash or soft equity like unrealised profit from an earlier planning gain.

Whilst the developer's capital contribution to the project may seem enough, if there is not considered enough at risk to focus the developer then a personal guarantee could be requested, where part of the investor's funds are personally guaranteed by the key members of the development team.

"ULTIMATELY THE DEVELOPER IS IN CONTROL, MAKING IT ESSENTIAL FOR INVESTORS TO ASSESS THE STAKE DEVELOPERS HAVE IN THE PROJECT'S SUCCESS."

GLOSSARY

Q&A

AFFORDABLE HOUSING	Residential properties that are made available at below-market rates to individuals or families with lower incomes.
BROWNFIELD SITE	Previously developed land that may have been used for industrial or commercial purposes and is now earmarked for redevelopment.
BUILD TO RENT (BTR)	A development strategy where properties are specifically designed and built for the rental market rather than for individual ownership.
BUILD WARRANTY	A form of insurance covering the costs of fixing structural defects caused by faulty materials or poor workmanship during construction.
BUILDING REGULATIONS	Standards set by the government to ensure the health and safety of people in and around buildings. Compliance is necessary for construction projects.
BUILDING USE CLASSES	Categories that define the use of a building, as specified in the Town and Country Planning (Use Classes) Order. Classes include residential, commercial, and industrial uses.
CIL (COMMUNITY INFRASTRUCTURE LEVY)	A charge levied by local authorities on new developments to fund local infrastructure projects.
GANTT CHART	A visual representation of a project schedule, useful for planning and tracking progress during the development process.
GDV (GROSS DEVELOPMENT VALUE):	The estimated market value of a completed development project, often used to assess its potential profitability.
GREEN BELT	Designated areas of countryside around cities and towns where development is restricted to prevent urban sprawl.
JCT (JOINT CONTRACTS TRIBUNAL)	Standard forms of contract used in the construction industry, outlining the rights and obligations of parties involved in a development project.
PARTY WALL AGREEMENT	An agreement between property owners sharing a common boundary, outlining rights and responsibilities for any construction or renovation work affecting the shared structure.
PERMITTED DEVELOPMENT RIGHTS	Rights granted by the government that allow certain types of development without the need for full planning permission.
RESIDUAL VALUATION	A method of valuing a development site based on the estimated value of the completed project minus the development costs, finance charges and a minimum level of developer profit.
RICS (ROYAL INSTITUTION OF CHARTERED SURVEYORS)	A professional body that sets standards for property professionals, including surveyors and valuers.
RICS VALUATION	A property valuation conducted by a chartered surveyor following the guidelines set by the Royal Institution of Chartered Surveyors. The RICS Red Book sets out professional standards and guidance for property valuation, ensuring consistency and transparency.
SECTION 106 AGREEMENT	A legal agreement between a developer and a local authority, outlining obligations and contributions to mitigate the impact of a development on the local community.

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