PERE

Residential

June 2024 • perenews.com

KEYNOTE INTERVIEW

Funding development in today's market

Development viability has changed, but that may be good news for debt investors, says ICG Real Estate's Jai Patel

The real estate development landscape has considerably changed over the past 18 months, notes Jai Patel, co-head of real estate debt at Intermediate Capital Group, but this provides excellent opportunities for investors today.

"While development viability has changed, the type of capital that is relevant for developers to progress schemes across the living sectors are somewhat different than in 2022 and prior," says Patel, whose firm manages over €6 billion in real estate debt and equity. The firm continues to deploy capital into sectors with structural tailwinds, including credit investments in living sector markets across Europe and the UK, and up and down the capital structure in Asia.

SPONSOR
ICG REAL ESTATE

Q What has been the most considerable change in the residential development market?

Focusing on the UK, the rise in interest rates has had serious implications for the viability of development, both in terms of debt costs but also movements in cap rates across the sector. The entire UK living sector seems to have seen cap rates rise anywhere between 50 and 100 basis points from an average of about 3.5 to 4.5 percent. At the tighter yielding end of the spectrum, that is a gross development value decline of over 20 percent, purely based on the capital markets.

For developers, previously a large proportion of their capital contribution into a development scheme came from the equity contribution of the land after the hard graft of securing a planning consent. A lot of the residential schemes, particularly on the rental side, were purchased/funded by forward funders. Now the land contribution that funders will give developers credit for is materially lower. They can no longer make the same types of funding work, meaning that alternate sources of capital are increasingly relevant.

This is where ICG and similar institutions can work with developers to provide stretched loans at a higher

loan-to-cost than banks are prepared to provide. This can be in replacement, or in combination with fresh equity capital that might be injected, which means we can create a more viable funding solution for developers than doing a deal today that marks down land cost by half.

Q Have banks largely withdrawn, or are they competing alongside private lenders?

No, the banks are still there, but they will only lend up to a certain level. They might only lend developers 60 percent of the project cost. Alternative lenders are typically comfortable lending more.

It is becoming a more competitive market as new entrants see the financing opportunity in front of us. Two years ago, I would have named our competitors on the fingers of one hand, but today I need a few more hands to do that.

So, differentiation is key. We work hard at demonstrating our experience in funding development projects which often have many variables for a financier to consider. Developers need to be able to trust the ability of their funding partner to navigate through the delivery challenges and to be a responsive and trusted partner for them. For a lot of the new entrants coming in, they will have to build that experience over time or build teams to demonstrate their credibility.

Q The UK is facing a change of government, is this also a challenge for residential developers or owners?

Even with a constant governing party, we have had lots of regulatory change during their tenor. Think about the number of housing ministers we have had! There have been experiments with rent controls in the Scottish market which do not appear to be working well, choking off development. It feels unlikely that a new government would go down this path. However, we are aware of the significant pressure to manage affordability for renters, so nothing seems completely off the table yet.

I think we may see an attempt to boost supply with various stimulants, whether through forms of grant funding, contributions of land or other subsidy schemes, to help developers work through viability issues. But ultimately the fundamental housing shortfall in the UK, and indeed in many other parts of Europe, is so pressing that, irrespective of political efforts, it will remain an attractive investing market from a supply-demand dynamic. We invest in the sector because it helps address a longstanding societal problem, so we have a clear runway in front of us to meet the risk-adjusted returns our clients are seeking.

Q What is the supply situation in the residential sector?

The UK market feels like it has switched from being a build-to-sell-focused market into being a rental residential market.

Across most subsectors of residential, the supply situation has been challenging for a few years. Planning has been difficult, as can be seen in London where there is constant jostling between the different political entities, local boroughs, GLA, the planning inspectorate and various other stakeholders involved. This means that supply can take a long time to come onto the market, putting more pressure on serving the demand which continues to increase as more residents delay purchasing on the grounds of affordability or lifestyle choice.

There has also been a constant shifting of regulation, more recently on construction standards post Grenfell. A lot of developers are looking at their existing portfolio and at the potential need to remediate historic cladding systems, for instance. The time spent and potential financial liability is naturally detracting time spent on delivering new product.

We track London closely. Developers should be delivering between 80,000 and 90,000 new homes a year to meet required demand. In 2023, developers only delivered roughly 35,000, or 40 percent of what was required. Given the current challenges in London, in Q1 of this year there were only 3,500 construction starts, which would equate to 14,000 units annually, so a 60 percent drop off.

With existing supply also coming out of the market after the historic regulations that impacted private rental landlords, net supply available is probably falling.

Q What are you seeing happening in student housing?

The UK continues to be an attractive destination for global students, largely because of the quality of our universities, the advantages of our language, the accessibility to a vibrant job market and very good connectivity into Europe. On a relative basis, it is still much more affordable to be a student in the UK than the US.

While there has been a decline in EU students coming to the UK, that has been more than made-up for by an increase in students from other parts of the world, so overall the numbers seem to be increasing.

What we have been seeing for several years is a bifurcation in the market. Strong ranking universities continue to attract both domestic and international students – the student housing markets in those towns and cities remain largely robust. At universities where student numbers have been falling, the prospects of strong performing student housing look weaker.

Q What is the supply situation like in the student housing market?

In the UK, we see 35-45 percent provision in terms of purpose-built housing in the cities we like. Each city is different; for example, in Exeter I think it is closer to 50 percent. But there is still plenty of potential. A lot of accommodation is still houses in multiple-occupation stock, which is not of the required level and will need to be upgraded.

At the same time, developers must be careful that rents do not become too elevated. To make a UK student housing development viable nowadays, you have to be at the higher end of the rental chain. This means investors must think carefully about what part of the student housing market developers are targeting, and whether they have truly thought through the dynamics in that part of the market. To give you an example, we looked at one student scheme in London where the rental price was £700 ($877; €815) or £800 a week, which is probably only serving the top 1-3 percent of students.

“It is becoming a more competitive market as new entrants see the financing opportunity in front of us”

“The UK market feels like it has switched from being a build-to-sell-focused market into being a rental residential market”

Q Do the European and Asian housing markets remain attractive today?

Across some of the larger European cities, we are seeing similar supply demand dynamics to London and parts of the UK. This is acute in some areas; for example, high-quality student housing across parts of Iberia is very unprovided for. Or affordable product offerings, such as co-living, in the major cities of France serve a renter base that is undersupplied for. We like the idea of backing strong operators who will build, own and operate quality rental housing in their local markets.

But at the same time, you have to think about how to provide capital in these markets. The model we have used in the UK does not necessarily work in all countries. Depending on the country and the capital markets in each, the types of loans may vary – more mezzanine loans rather than the first mortgages, for example.

In Asia, we really like the demographics at play: growing and young populations, very tight land supply, and so there we are deploying higher returning capital up and down the capital structure to support residential development. As a group, we remain excited about the development financing opportunity because it is a large and global marketplace to play into, and also reasonably opaque, allowing us to secure strong risk-adjusted returns for our clients working with best-in-class developers, with local knowledge, who are delivering relevant housing in the markets they operate in. ■

PERE Network

The network for institutional real estate

Connect with global private real estate decision-makers based on your investment strategy and fundraising needs. Your membership gives you access to:

Events

Where decisions are made

Comprised of industry-leading Summit and Forums across the world, these are the meeting places of the global network to make decisions that shape the future of private real estate.

Connect

Networking tailored just for you

Grow your connections by accessing our network of over 1,200 investors, managers and partners. A dedicated PERE Network team will connect you to the right people at the right time.

Special Interest Groups

Join discussions with like-minded peers

Join Special Interest Groups to connect with investors, managers and partners and join deeper discussions around the strategies and sectors closest to you.

Insight

Gain knowledge for future growth

Access to thought-leading webinars on the biggest themes impacting institutional real estate investment.

Scan the QR code for more information

Be part of global real estate's most influential community today

perenews.com/pere-network/

To join the Network, please contact:
perememberhip@peimedia.com

PEI