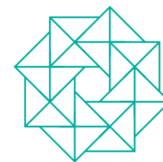
Guide to Development Finance

for Small and Medium-Sized Housebuilders



UK FINANCE

Project of FMB Member, Keigar Homes Ltd

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Introduction

This guide is an update to the original which was published in 2018 and is aimed at SME house builders operating in England. The Federation of Master Builders (FMB) and UK Finance have continued to work closely with one another over this time to help builders with development finance. This guide was developed in collaboration with the Department for Levelling Up, Housing and Communities (DLUHC).

Accessing finance as a small-scale housebuilder is one critical element of the development process. This guide will help you to understand more about development finance. It will look at where financing sits within the housebuilding process and why finance providers look for some of the information they do. There is a wide range of support available in terms of finance options, guidance and advice. This guide provides more information on development finance as well as signposting additional sources of help and advice.

Many smaller scale housebuilders face significant challenges to building new homes, including material and labour shortages, cost increases and access to finance. The FMB, as the largest trade association in the construction industry, is playing a vital role in engaging with key stakeholders to address these issues. At the same time, it is important that SME builders and developers understand what to expect when seeking development finance, the options available and the process they will go through.

UK Finance recognises this challenge and our members are committed to supporting housebuilders on their finance journey. While lenders will all have their own risk appetite and specific market focus, there is now a significant range of finance options available. While large banks remain an important source of finance in the market, there are also a number of other lenders actively seeking out opportunities to lend to housebuilders.

We hope that this guide provides FMB members and the wider industry with a useful overview of the key considerations you should make when looking at access to finance. It will also help highlight some of the characteristics of development finance and demonstrate the diverse options available to housebuilders today.

Stephen Pegge, Managing Director, Commercial Finance, UK Finance

Brian Berry, Chief Executive, Federation of Master Builders

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Using external finance

There are many considerations to make when planning a small-scale housebuilding development, and finance is a critical element. By choosing to take finance from a lender you may be able to undertake a larger project than your own cash would allow. It may also enable you to fast track a scheme or work on more than one site at a time. However, it is important to recognise that all lenders will seek to ensure that you have the appropriate plans in place, the appropriate initial investment and that you are approaching them at the right stage of the project.

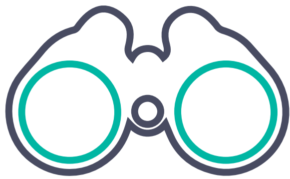
External finance can help spread the risk in both the construction and sales phases, by providing certainty of sufficient funding until houses have been sold and the lender is repaid. As it involves financial risk to the lender, it is important that your plans are sufficiently clear and advanced to ensure the lender can make an informed decision on their ability to fund. In order to mitigate this risk, please note that guarantees and security are likely to be required.

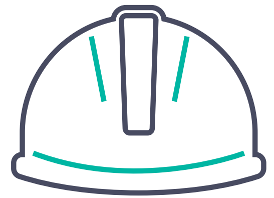
There are additional advantages that can be obtained from using a reputable external finance provider. This might include utilising their expertise and relevant professional contacts (e.g. for land valuation, compliance experts, legal protection and identification of insurance and building warranty requirements). This might be of particular use if this is your first development, or your development represents a larger project than you might previously have undertaken.

Once you have successfully completed a development it affords you greater experience to leverage in future projects and can also provide you with capital to invest in future developments. If you don't have previous development experience, it may be advisable to also team up with an experienced developer that has successfully seen through similar projects before. This might provide the lender with the assurance they need.

Remember that finance – while important – is not the only, nor necessarily the first part of that journey. It is always easier for a lender to provide finance once you have clear plans for the development, including the purchase of land and planning permission. Make sure you fully consider these parts of the journey before approaching a lender. An illustrative housebuilding journey is set out below.

Example housebuilding journey





Step 1: Identify land for sale

Small sites make up the minority of housing delivery identified in local plans. SME house builders should make use of all resources available to identify suitable small sites, including the local plan and the brownfield register.

You should also provisionally check with local authorities about the likelihood of planning permission for particular sites and understand the scale of developer contributions (Section 106, Community Infrastructure Levy) which will be required from a site.

Step 2: Purchase land and get planning permission

Once you have identified a site, purchasing and obtaining planning permission are the key next steps. Significant delays with planning permission can be a problem. These can be beyond the control of the applicant, but the chances of delays are reduced by high quality applications. Some lenders will not lend unless planning is permitted - hence the need for house builders to have 'own funds' in place.

Step 5: Construction phase

For the construction phase you will need to be aware of lead in times for materials and products, especially if these are relevant to planning. You should also speak to utilities companies about connections at the earliest possible stage to avoid any hold ups by this.

Step 4: Seek development finance

Approach your intended finance provider in good time. You will need funding in place approximately six months before the start of construction with terms agreed one to two months before you start on site.

Some lenders may be prepared to lend if there is a high probability of planning permission, even if permission is not formally approved.

Step 3: "Red Tape" hurdles

Consider the need to pay Community Infrastructure Levy (CIL) and water infrastructure charges. Lack of Highways Authority participation in pre-planning discussions increases costs and delays. Discharging planning conditions can take longer and prove more difficult than might be expected.

Step 6: Sell units

It is important to challenge sales assumptions to ensure they are realistic. Some lenders will want details of pre-sales or off-plan sales during development.

Step 7: Repay loans

Sales assumptions can often prove misguided. Lenders normally have a mechanism for stepping in if things don't go to plan. This relationship needs to be managed, and it is important to have alternative options available to you if units are not selling as originally expected.

Step 8: Use profit from completed site to begin on next site

This re-invested capital can increase the amount of 'own funds' in place for future projects.

Working with your chosen lender

Your chosen lender will assess the viability of your proposal on a scheme-by-scheme basis known as a "fully funded" approach. They will consider if lender funding and the developer's own cash is for all land, development and professional costs before any houses are sold and without relying on any further contributions.

Lenders will want to understand your track record in developing houses, particularly demonstrating experience on similar developments and location to the proposed scheme. They will also want to know how you plan to deal with issues such as labour and material shortages and input price inflation. It is normal for them to ask questions around this, and you should come prepared to discuss these issues.

Lenders may seek to understand and challenge your business plan/development appraisal in areas such as:

- The projected sales values for house types (depending on size/specifications) by comparing sale prices on other nearby sites
- Projected rate of sales
- The projected land values
- Forecast build costs
- Professional fees including selling agent's costs
- Bank costs for arranging the loan and for interest on the drawn amount
- Warranties in place, as well as suitable accreditation such as a NHBC
- The level of developer profit in the proposal (too high might indicate that some costs have been underestimated or receipts over estimated, too low means the scheme may not be viable or extremely sensitive to market fluctuations)
- Allowances to deal with variations both in terms of cost and in time.

The exact approach of each lender will vary, but all developers should be able to outline broadly their requirements on request.

The lender's perspective

As lending involves risk sharing, lenders will seek as much certainty as possible that their loan will be repaid in full and on time. In instances where there are higher risks, the lender may choose not to make an offer or may seek additional mitigating items, such as extra recourse to the borrower in the form of personal guarantees.

Lenders will usually want to keep close control over the release of funds and make sure that developers have fully costed the project. They will ask the developer to put all their contribution in first – usually to buy the land and directly fund the first elements of the development phase.

To make sure that developers have sufficient liquidity available to fund the completion of the entire project, lenders will usually require developer cash to go in first. Lenders will not normally release or "drip feed" funds in alongside the developer in the early stages of developments and will typically only release funds after the developer has already made significant investments of their own. Lenders are likely to require separate representation on both valuation (from a chartered surveyor) and legal process (from a specialist solicitor).

The lender will typically appoint a project monitor to assess and verify the developers costs incurred each month, and monitor the costs against your appraisal and budget. The project monitor's monthly report will then enable the lender to release funds to the developer.

Loan to Value ratio

The Loan to Value ratio is the ratio of the debt to the value of the development. Generally the higher the LTV, the greater the likely cost of the money lent. The LTV the lender might offer is affected by the risks associated with the development and the lender's appetite for that risk. This means that it will vary from lender to lender.

Recourse versus non-recourse lending

Almost all lenders will seek some form of security as noted above. You may come across options for 'non-recourse' lending, where in the case of a default, a lender can seize the collateral, but cannot pursue the borrower for further compensation. This will generally be more expensive than other lending arrangements, because while the lender could take security over the land/development, unlike other forms of lending, other assets held by the business are not subject to recovery. Some lenders may require step-in rights on certain contracts.

Additional checks by lenders

As well as seeking to ensure that developers have sufficient funds for the initial investment (whether through personal funds, private equity investment or other forms), all lenders have responsibilities under anti-money laundering rules to ensure they are satisfied that contributions come from legitimate sources. This means that providers may ask you questions that seek to understand firm and individual wealth. You should come prepared to discuss this with your lender.

The lender will also be keen to understand your experience through market cycles and how the retained earnings in your business have built up as each successful project has been completed. The ability to demonstrate a clear track record, even on smaller developments, can make lenders more comfortable in the robustness of your proposals and experience.

Repayment

Once the houses are built and ready for sale the lender will seek repayment from the first sale proceeds and will typically be repaid from a percentage of the first house sales on the site, determined in agreement with the lender. As well as being 'first in', the developer's own funds will therefore be 'last out' once the lender has been fully repaid. This needs to be fully considered when the housebuilder looks to invest in the next 'follow on' scheme.

If your first lender turns you down

Remember that lenders cannot approve every housebuilder lending application. This may be due to several factors, including appetite for exposure to the sector. It is important to many finance providers that they do not build up too much exposure to a specific sector. However, there are many sources of finance you can consider. The market is extremely diverse and you should feel confident shopping around to find the one that suits you best. Since the financial crisis, banks tend to lend to SMEs on a site-by-site basis. This increases the amount of entry, exit and legal fees and slows down the reinvestment of equity into new sites.

If you are a business with turnover of up to £25m and are declined finance, you may find yourself offered the right to appeal the decision, and to have your application looked at again. You may also be eligible for a referral to a government-designated finance platform which can also help, depending on which lender you apply to. You can find more information at the Better Business Finance website.

An example of the funding structure

An example project with an end value of £2 million can be seen below. Note that there is much more than just the total cost of the development to consider and lenders will not generally provide the full amount of the costs. This is why own funds and equity are an important part of the calculation.

Item	Typical experience for the Borrower and the Lender
Gross Development Value (Aggregate value of all the units for sale, plus ground rents)	£2,000,000 (Two Million Pounds)
Land Value (Representative of lower land value area)	£600,000 (Six Hundred Thousand Pounds)
Construction Cost	£900,000 (Nine Hundred Thousand Pounds)
Other Development Costs (Professional and Finance fees etc.)	£100,000 (One Hundred Thousand Pounds)
Total Development Cost	£1,600,000 (One Million Six Hundred Thousand Pounds)
Developers Profit	£400,000 (Four Hundred Thousand Pounds) representing approx. 20 per cent on sales
Developer Contribution (Cash/Land)	Typically, around 40 per cent of the Total Development Cost upfront i.e. £640,000 (Six Hundred and Forty Thousand Pounds)
Bank Loan	Typically, around 60 per cent of the Total Development Cost after the developer contribution has been demonstrated £960,000 (Nine Hundred and Sixty Thousand Pounds)1
Bank Requirements	First legal charge over: the development site, company assets and cost overrun contingencies. Some lenders may require a personal guarantee, recourse and warranties.
Other Considerations	Independent Valuation & Banks Monitoring Costs to access the bank funds the house builder will need to allow for the cost of 'Bank Draw Down Report' costs, likely to be incurred monthly.
Contingencies	Typically entails setting aside 5-10 per cent of non-land costs

Please note that funding agreements such as stretched senior loans for some providers may allow funding with a higher loan-to-cost ratio. The example below is indicative. Some lenders may be prepared to lend higher percentages, and developers should feel able to discuss options with them. To discuss such agreements, speak to your finance provider.

Finding finance

High street banks and building societies: These are the largest providers of finance to the SME sector and continue to provide significant levels of lending to the sector.

Other banks (including challenger and overseas banks): There are more banks and lenders out there than ever before. Challenger and specialist banks represent an important alternative for SME housebuilders still seeking to use the same sort of debt finance that a high street bank would provide. Challenger and specialist banks may provide higher-risk leverage but may seek higher pricing. You can find out more at Better Business Finance.

Non-bank lenders: There are many non-bank lenders who can provide debt finance. These are often funded through other sources such as institutional investors.

Private equity: For those not already using private equity, this is typically introduced via brokers or financial intermediaries. This involves the provision of additional capital to that which is already in the business. Equity can be sold to third-party investors with no existing stake in the business. Alternatively, it can be raised solely from existing shareholders, through a rights issue.

Finance Brokers: The National Association of Finance Brokers has a network of member firms that can assist as brokers to identify potential funders for your development project.

Crowd funding: This is increasingly common for businesses looking to raise finance which can vary from equity to debt funding. It allows developers to connect with potentially thousands of investors (often by matching through internet-based platforms).

Government supported funds

Homes England, the Government's housing delivery and regeneration agency, provides finance to help build homes across England and encourage innovation, both in the kind of homes that are built and the way they are delivered. It does this in two ways:

- by providing development finance to qualifying micro, small and medium house builders
- by providing infrastructure funding to support developers, master developers and landowners.

The Levelling Up Home Building Fund provides investment directly to developers to help unlock and accelerate land for housing development.

Although the Levelling Up and House Building Fund predominantly provides loan finance, Homes England supports partnerships to provide other forms of financial support. One of these partnerships is the Housing Accelerator Fund, which is a five-year alliance between Homes England and United Trust Bank. It has been created to improve financial support for the building activities of small and medium-sized housebuilders and developers.

Small Builders Loan Company is a Partnership with Invest and Fund to support small builders with construction loans of between £400k and £2.5m, funding schemes of two homes and upwards, at up to 80% of development costs.

Greener Homes Alliance provides both loan finance and expert advisory support to SME housebuilders, enabling them to build more high quality, energy efficient homes throughout England.

The Alliance will provide loans of between £1 million and £20 million to finance new SME development projects. Homes funded must achieve a minimum Energy Performance Certificate (EPC) rating of B and will benefit from increasing interest rate margin discounts as the energy efficiency of the homes increases above this.

You can find out more about Government funds here.

Devolved nations funding

The devolved nations may also offer funding support for housing development. Do check to see what is available.

Net zero and the Government's Future Homes Standard

Reaching net zero targets will not be achievable without the construction industry playing its part, especially that of small, local builders. Many of the changes aimed at making new homes energy efficient and fitted with low carbon heating solutions are wide ranging, with some builders noting these are the most significant changes to housebuilding in many decades.

There will be additional cost in delivering homes that meet the interim uplift building regulations and the Future Homes Standard in 2025. The new rules will have to be factored into financial plans and any long term projects will need to plan, as best you can, for what is yet to come.

Unfortunately, SME builders are more likely than larger developers to feel the financial burden. Therefore, the correct financial products and prudent financial planning from the outset are vital to ensure a robust bottom line. Further information on the changes to building regulations can be found here.

List of useful resources

- The SME Finance Charter
- British Business Bank Finance Hub

- Better Business Finance

- Homes England Funding support for new residential-led development

Glossary

- Challenger bank – A smaller retail bank set up to compete with the more established Big Five banks of Barclays, HSBC, Lloyds Banking Group, RBS/NatWest and Santander
- Specialist lenders – specialise in providing finance to certain sectors or in certain regions.
- Collateral – Assets (for example, property) pledged by a borrower which act as security for bank facilities
- Crowd funding – A method of raising funding for a project by obtaining small amounts of capital from a number of investors
- Development appraisal – Financial assessment of the viability of a development scheme which will detail each line item of cost and value, also allowing you to derive scheme profit
- Draw down report – A report supplied by an independent monitoring surveyor which advises the lender of the progress of the works on a development site and approves the drawdown of funds requested by the borrower
- First legal charge – A legal charge is the means by which lenders enforce their rights to a property. The holder of a 'first charge' has the legal right to make the first call on an asset in the event that the borrower defaults on repayments
- Fully funded approach – Development financing structured to ensure that all costs of the development are committed from the outset of the agreement by a combination of the borrowers' equity and the funders facility
- Joint enterprise / Joint venture – An arrangement entered into by two or more parties to create a separate entity for the purpose of carrying out a particular project or business activity, in which each party shares ownership and associated risks and rewards
- Leverage – Percentage of debt in the capital structure to either the development or current value of a project or business
- Mezzanine finance – Subordinated financing which sits between senior debt and equity, carrying a higher rate of interest than the senior debt facility with all collateral ranking behind the senior debt provider
- Monitoring costs – Expenses associated with the ongoing monitoring of a development, which typically involves the appointment of an independent monitoring surveyor who carries out due diligence on a regular basis on behalf of a lender
- Non-recourse lending – Lending provided to and secured only by the assets and the vehicle which are being funded
- Personal guarantees – A written promise from a business owner or director providing the lender with recourse to them for a specific circumstance, which would be outlined within the guarantee wording
- Private equity – Entities concerned with the investment of equity into companies or projects not listed on a public exchange
- Recourse lending– Lending secured both by the assets being funded as well as other assets of the borrower. In an event of default, the lender is entitled to claim other assets owned by the borrower to satisfy outstanding debts
- Senior debt – Outside of an administration process, the highest ranking creditor in the event of default, usually backed by a debenture, guarantee and / or legal charge over specific assets
- Step-in rights – Grants one party the right to take over the rights of another in a contract between two third parties. For instance, in an event of developer insolvency, step-in rights may grant a lender

In partnership with:

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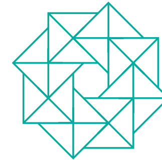


UK Finance is the collective voice for the banking and finance industry.

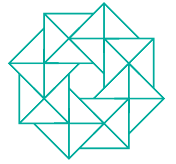
Representing around 300 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation. We work for and on behalf of our members to promote a safe, transparent and innovative banking and finance industry. We offer research, policy expertise, thought leadership and advocacy in support of our work. We provide a single voice for a diverse and competitive industry. Our operational activity enhances members' own services in situations where collective industry action adds value.

Federation of Master Builders

The Federation of Master Builders (FMB) is the UK's largest trade association in the construction industry, and with over 7,000 members it is the recognised voice of small and medium-sized (SME) construction firms.

Established in 1941 to protect the interests of small SME construction firms, the FMB is independent and non-profit-making, lobbying continuously for members' interests at both national and local levels.

The FMB is a source of knowledge, professional advice and support for its members, providing a range of modern and relevant business services to save them time and money.



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www.fmb.org.uk
Federation of Master Builders
David Croft House
25 Ely Place
London
EC1N 6TD

www.ukfinance.org.uk
UK Finance
1 Angel Court
London
EC2R 7HJ