



# Constructing a new rental concept

**Banks and alternative lenders are slowly getting to grips with financing the development of purpose-built rental properties in the UK market, writes Lauren Parr**

**T**he UK's nascent purpose-built residential private rented sector is often cited as a prime lending opportunity, although development finance deals in the sector are limited.

While European countries such as Germany have well-established 'multifamily' markets, the concept is only now taking hold in the UK. Lenders are getting to grips with taking development risk on schemes that aim to cater for punters willing to pay higher than average rents for modern apartments in city centres.

"PRS is a huge opportunity given there is more chance of people being able to afford a purpose-built flat for rent than to buy", says Mark Bladon, co-head of origination at Investec Structured Property Finance.

An acute lack of housing stock and high house prices are forcing more and more people

into long-term renting. In London, up to 98 percent of the total £1.4 trillion of existing PRS stock is in the hands of buy-to-let landlords, according to Savills research. The total number of PRS units estimated by the British Property Federation to be completed or underway across the UK – 70,000 – will only go so far to address undersupply.

"We've seen a weight of institutional money getting behind the sector in the last few years, with institutions like M&G and Greystar targeting portfolios of scale," says Bladon.

Long-term income streams which match pension fund liabilities have attracted institutions into the space, explains Chris Lacey, founder of Lacey Capital Partners, an advisory firm dedicated to residential capital markets. "Investors got wise to the opportunity in 2011-12. Funds including M&G started buying-in

expertise in residential early on, deploying capital from 2013-14. It takes a long time to get a scheme locked into development."

Early movers have sought modest or no gearing, with institutions using group level capital to fund schemes.

However, momentum is building, with around £20 billion of projects committed to across London and the south-east and a few key cities, Lacey says. A wider range of developers are bringing forward schemes, with a subsequent need for development finance. "An awful lot of blockages have been largely eased, relating to education and expertise in the sector, management teams being established, product design and the long-awaited acceptance by commercial property sector participants that PRS is a sustainable, scalable and attractive asset class for the market."

Royal Bank of Scotland last year earmarked £1 billion for development and early-stage investment of UK PRS schemes, while Lloyds recently issued its first loan on a standalone project, backing real estate investment company Aprirose's forward funding of the Left Bank apartment block in Birmingham with a £17.8 million, three-year facility.

Lending to the sector has taken time to evolve, partly due to a lack of comparable purpose-built assets for lenders to price financing against. "All deals are underwritten by current prevailing rents which are only found in the BTL market, which is like comparing apples and pears," says Lacey.

Banks are slowly getting to grips with the asset class but are still taking a cautious approach (see panel). "People are very keen to put money to work in a growing sector and we want to support clients with whom we have a relationship in markets that are not oversaturated to date. We're seeing a lot of concentration in cities, so we need to be careful where we go," says Madeleine McDougall, acting head of Lloyds' commercial real estate division.

Birmingham ticked the box as a result of job creation after moves by HSBC and others, McDougall says: "When you look at place making, some occupiers are making a decision about where to have offices based on sufficient residential stock in the local area to put young talent."

Several thousand units are expected to come on-stream in Manchester, including Apache Capital and Moda Living's Angel Gardens. The £153 million scheme will deliver 466 apartments over 34 floors in two phases between 2019 and 2020. Familiar with the multi-family model in its home market, pbb Deutsche Pfandbriefbank in January agreed an £85 million financing of the premium development.

There are real issues securing small ticket finance, says Anil Khera, former head of European debt capital markets at Blackstone and now founder and CEO of boutique PRS company node. "Local plc banks in the UK are super lowly leveraged to the point it's almost unworkable, which means smaller operators are forced into the debt fund world," he says.

Funds like Venn Partners, ICG-Longbow,



Anil Khera

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Cheyne Capital and DRC Capital can command mezzanine-like returns for taking senior risk at elevated loan-to-cost ratios of 75-80 percent. In practice, borrowers are willing to accept a high cost of capital in the high single digit territory providing the duration of a build is no longer than 12-18 months, seeking take out financing after which point.

"Bigger, cheaper sources of capital are often not available to the smaller operators or are just too cumbersome," says Khera.

Banks' willingness to finance PRS development will increase, predicts Bladon. The sector's similarities with the purpose-built student accommodation market attracts Investec, he says. That market sees £5 billion of stock traded annually and Bladon says the potential for purpose-built PRS is vast.

"PRS is a small part of our residential development funding at the moment but we see it becoming a much larger percentage," adds Bladon. "With proper purpose-built product coming to the market in the last year or so, we can see what rents they are creating as well as the costs of managing them. As more assets are built and traded even national house-builders will start to look at PRS as a viable option as opposed to a pure build-to-sell model. More activity equals more finance for PRS." ■

## Banks approach PRS with caution

"Many banks don't understand PRS really; they ought to be thinking it's pretty safe but they're burnt out by bad experiences in the speculative buy-to-let market and are therefore sheepish in their analysis," says Anil Khera of node.

The Commercial Real Estate Finance Council Europe has launched a BTR finance initiative, partly to educate lenders on the sector.

"Banks don't know how to operate it; what valuation will be on exit as there have been virtually no transactions," says Khera.

Progress has been made with regards to valuing PRS however. "Two to three years ago banks' approach to valuation on a PRS scheme was generated in the same way as a valuation on a block of flats for sale, by way of a vacant possession valuation. Transactions are now being valued on an investment basis, whereby you take rents, less running costs and apply an appropriate yield," says Investec's Mark Bladon.

Yet the asset class is still viewed as being riskier than might be justified, as without an institutional lease banks treat it as an operating model. Another risk factor is the fact clients are somewhat unknown, since many banks have not lent to the sector before.

At 65 percent LTV, margins are around 250 bps. "Banks are willing to finance logistics and offices at a cheaper price than PRS, when the risk profile is much lower for residential rentals versus offices that can become completely obsolete in a decade or two," Khera points out.

He believes PRS pricing should be 50-100 bps lower than current levels or leverage should be 5-10 percent higher for the same pricing in order to fairly reflect risk.