COSTAR INTERVIEW

Development finance in 2025: Is a Gateway to success opening?

With a seemingly pro-development government but increased regulations, what are the opportunities?

The debate took place at Leumi's London offices. (Ellie Sweeney)

By Paul Norman
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CoStar News recently chaired a debate hosted by alternative lender Leumi focused on financing real estate development and the challenges and opportunities facing the industry. A varied panel of developers, lenders and advisers focused on a wide range of issues, not least the opportunities created by a seemingly pro-development government and the challenges of an increasingly complicated regulatory environment for the built environment.

The panel comprised:

- Nick Lee, development director, Commercial Estates Group
- George Edwards, Frogmore
- James Molland, principal associate, Eversheds Sutherland
- James Wilmot, development manager, Forge Developments, part of the Steyn Group
- Steve Jones, managing director, MDA Consulting
- Pete Clayton, head of property finance, Leumi UK
- Chris Stallard, relationship director, property finance, Leumi UK
- Guy Brocklehurst, relationship director, property finance, Leumi UK

CoStar News: Is now a good time to be in real assets and what are the opportunities?

Nick Lee: There is a significant shortage of supply across the country in all sectors; we haven't built very much of anything for the last 10 years or so, and that presents an opportunity for us as specialists. And where you can find the right funding partner, deliver the product, you can hopefully see the rewards of the scarcity value of your product.

And we're seeing rental growth, for instance, at the building that we've built in Bristol recently, EQ. It has set a provincial city rent record three times and it is just a classic example of a shortage of supply in the market. Rents are at £48 per square foot and it is thought that another building in Bristol may break £50 per square foot soon.

Peter Clayton: I'm interested in this because our perception is that you need to be at £50 per square foot to actually develop anything in a regional city, in terms of headline rents, to make new office development work. I just wondered whether that holds true?

Nick Lee: Yes. If you look at your development appraisal, use the current prime yield and construction costs, then you have to be at £50 square foot to deliver a grade A building with the sustainability credentials and amenity needed to attract occupiers.

Steve Jones: You are assuming £50 per square foot everywhere but that will be impossible to achieve. You will have cheaper build costs elsewhere though.

And obviously, you've sold on the building now as well, so it's told the whole story working there, as well in terms of the investment exit.

NL: Yes, we're very proud of the building: we handed over a larger proportion of the building to amenity and we saw the benefits of that through the high rents in the building. We were 85% let at practical completion. So obviously again demonstrating that if you're delivering a product into a market and there is a scarcity value for it, you can be very successful.

George Edwards: I'd support what Nick has been saying. Where you can identify gaps in the market. I think probably Bristol and constrained supply was an example there. We've just completed refurbishment and extension of a building on Bedford Row [London] where we have been developing to deliver a best-in-class office into a market with constrained supply. The prior owner was capable of undertaking a refurbishment, but they didn't have the funds to provide an office with the amenity and green credentials now required. We've been able to come in afresh and get that to happen.

Our focus is understandably where you can repurpose buildings; there is a supply of buildings and opportunities where they are not fit for purpose, and we can develop to meet that need. Another example of identifying occupier demand is in building the Ruby Zoe Hotel, the site of a former retail unit at Notting Hill, the hotel has been very successful. Our issue on selling on the hotel was finding empty rooms to show investors where we were 100% full in the first weeks as opposed to needing six months or mor to stabilise a hotel.

Peter Clayton: How do you deal with the [environmental social and corporate governance] question on repurposing – and obviously repurposing in itself has a benefit – but in terms of amenity, in terms of ESG and hitting certain criteria?

James Wilmot: Everyone should have the same benchmark. So, that you're not sitting there thinking "which is my better option"? That's something that we all need to start looking at and getting involved in as an industry, so we can sit and understand acceptable net-zero targets that are achievable by all without compromising quality and associated cost.

SJ: Yes, if you've got the money and if you've got the knowledge, if you know what you're doing, are a good company and you've got some cash to buy some of the buildings and get these things away, then I think it is a good time to be in development. If you don't know what you're doing, then you can probably lose a lot of money.

PC: I think you need a very focused look at what your exit is when it comes to delivering a product and what's the target market for that product? Because let's say you're producing a student accommodation scheme at a certain price point, does it need to be the most ESG-compliant and highly amenitised scheme or does it need to be a scheme that ticks a relevant number of boxes for that market that you're aiming for? And I think that appraisal is something that we're really conscious of.

GE: I would say here, as a holder of a green loan on a scheme with preferential terms, that you need to consider the actual costs that you're having to fund to make all of those pieces fall into place, it exactly comes back to your point. It's very good to have and welcome, but does it offset those additional costs? Perhaps not.

Now let’s talk about challenges. Labour has talked about kickstarting economic growth through easing planning to allow development on green belt. Is this just hot air? Is the planning piece the biggest obstacle to new development in the UK?

SJ: Planning is clearly a challenge, isn't it? There's no doubt about that. There are other challenges as well. I mean there's viability, labour, lack of resource, lack of knowledge, lots of challenges, and planning is certainly one of them. Sales and demand for residential is a challenge in the residential sector. Funding is a challenge; confidence is a challenge. There are numerous challenges. Whether the Labour initiative will make a difference is to be seen, but I've got my doubts to be honest.

GE: Anything which can streamline the planning system is obviously an improvement. One thing that strikes us now, is not only the uncertainty, but the cost of going through the planning process, and the amount of work that is now needed to be completed up front. Even five years ago, if you said, you know, this planning journey is going to cost you £2 million to £3 million, you'd be surprised.

I'd like to see a system where your bulk height and massing could be set earlier on, similar to an outline consent with further detail completed down the line once you have greater certainty on the outcome; this would also aid the agility of developers reducing the time and costs associated with making changes to planning permissions. To add to this, a planning process potentially taking years over what should be an eight to 16 weeks process is a big barrier.

Is there any evidence that that's changing at the moment under a new administration?

GE: Not at the moment. There are obviously announcements and the desire in what they're talking of doing, and it's good to hear the government wanting to streamline planning and to undertake infrastructure investment. I’m sure we will feel the benefits down the line. But in terms of action that we've seen so far, no, we’re still commissioning and paying a lot of consultants and waiting for answers from planners.

SJ: And what about the resources in the planning departments, George? I mean, you're not getting answers within the statutory period of time for things.

GE: No, you're not. There is under-resourcing, and I think that's something we've been used to now for the last almost 20 years. We're in a capital environment now which is very much risk-off. So certainly, when we look at our investors and they want you to partner in front of the development process with quite an opaque planning system in there and they want everything to be as derisked as possible, that's one of our challenges.

James Molland: As with delays in the planning system, a good microcosm of the challenge Labour faces at the moment is the Building Safety Act which wasn't introduced by the Labour government, but the under-staffing of the Building Safety Regulator is a huge problem. I'm particularly talking about higher risk buildings, but the potential delay in going through Gateway 2 [the design phase] is anecdotally up to six to nine months, possibly adding more. So, it’s incredibly difficult for developers to try and plan ahead when there's such a vast unknown, and where is the apportionment of risk between developers, contractors and lenders? Are lenders willing to sign up to facilities where there's a potentially unknown period of delay (possibly an event of default), and where does that risk sit?

James Wilmot: The hard part as well is you're in an industry where you have very definite deadlines. So, for instance, student homes, if you miss that academic pickup in September and you push into December, you've lost a year of revenue. Even if you come on in January, February you are not going to fill that back end because everyone's found their accommodation and they settle. So where is the accountability on the planners and the regulators to hit their statutory timeframes, which they're not right now, but it has such devastating effect on us in our returns when we start missing academic intakes?

Some industries will be more resilient to those delays, if there is a bit of a delay, you can push through and you can pick up. But inherently that's one of the big obstacles we have right now, that time frame, especially on gateways. Gateway 3 [applying for a completion certificate] you have a complete building that sits vacant and it's ready to go. But now you have this all this money deployed into this asset that is just sitting still and it's not generating income. That's a huge hurdle for everyone. Funders, contractors, developers.

PC: It's also a huge additional cost. If we're funding a scheme such as that and there's nine months delay, then you've got interest to pay on that facility so the roll-up costs in financing is astronomical.

Guy Brocklehurst: That point is absolutely right. As a development funder, you're effectively having to potentially buy into headline rents or market-setting rents in the viability appraisals. You are accepting longer planning and development risk, the Gateway risk on top of that and as a consequence, you're having to sensitise for a greater inflationary risk because of the longer period. This makes lenders a bit more conservative in their development appraisals. And that all then comes back to the [internal rate of return] and the impact on IRR for the investors. So, it's all linked together.

SJ: Have you thought about how you're going to deal with the new Building Safety Act in terms of loans? I mean, will you lend money without Gateway 2 approval, it's very early days and we are all feeling our way.

Chris Stallard: I'm currently trying to answer that question now and you guys are being very helpful in helping us come to a conclusion. But I mean the whole debt market is currently considering that question and some of them have said if it is a high-risk building, then it's out of our policy, effectively.

For us it's a case-by-case basis. So, does debt come in post-Gateway 2 and do we consider Gateway 2 akin to planning risk, effectively because of the uncertainty in the time that it takes? So, that's a decision debt markets are making. Is the programme long enough to absorb delays? Is there enough liquidity for our sponsor to absorb delays? I think where you can tick a lot of those boxes we can still make a rational decision if we can quantify the risk, and we have a contingent recourse to a sponsor that can absorb that risk. So, it's really difficult because you guys are trying to find out what's happening and how long does it take, what's the statutory period and what's it going to be extended by? We're trying to understand that with far less knowledge and technical expertise.

JM: The hope and intention are that this is a period of short-term pain, which leads to better practices. On a positive note, I would say [acting for lenders and developer/borrowers], it is not a total bar. We are seeing funding into new developments, and early engagement with lenders to try and go through that process, as you say, and what that looks like. In terms of portfolios, nobody seems to be turning their noses up at those which include higher risk buildings already built. In terms of the liquidity point, it doesn't seem to be preventing many lenders on either the traditional clearing bank or more alternative lender side.

SJ: I think banks will continue to lend to their existing customers who they've got a track record with and know they can deliver probably before Gateway 2. It is the new customers you've never worked with before now, and they're always in the market. They're the ones you need to look at.

PC: We see this as a great opportunity to get under the skin of what other people perceive to be problems. If, as a lender, we can get our head around who knows what they're doing and how do we choose to partner with those people that know what they're doing, then there is real opportunity.

For context, we had a scenario over the last 15 months where a major contractor went bust and it was a three-phased site, and all had started or were at different points of their construction. And it's taken just over 12 months to go through the process of our sponsor, our borrower engaging different new contractors, going through all the due diligence phases that needs to happen, working through all the elements of what's been constructed on site thus far.

The potential risks that are associated with that, to get a contractor to a level where they're comfortable that they can appraise the costs to go on site and develop out. From a lender's perspective, I think we perceive that contractor solvency issue mid-term on the development to be one of the worst things that could possibly happen. What are the early warning signs? What are the bits that you are on top of regularly? We employ someone to be our eyes and ears but we're always that bit removed.

SJ: Strange thing about this is we all get more experience, we all get older, but I wonder how much we learn any lessons really. The same issues for contractor insolvency now are exactly what they were 40 years ago. All the signs are the same. The chasing payment, there's no one on site, people are drifting away, people are going bust. All the signs are the same. The rumourmongers start. The answer is prevention is better than a cure. If a contractor goes bust halfway through, you could be looking at 30% to 40% extra cost.

JW: We've been very lucky in that we've had two contractors go bust on us recently, but on [practical completion]. So, very lucky. It's hard because you do your due diligence, you send your [pre-qualification questionnaire], you look at their balance sheets, you dive into their management accounts. It's so difficult, even with that information, to see what's really going on in the background. All we can do is our due diligence on a contractor. Build the relationships, because if you have a strong relationship you will potentially see the signs of issues because you've got a lot more knowledge of them.

Yes, it is a big problem that we all face unfortunately. Tier one contractors have been going out of business quite a lot lately; projects are over three to four years and over that time some of those bigger companies you thought were stable go bust. If you asked anyone if that would be the case they always said no chance. Because their book was so big and so heavy, and you'd think they'd be able to leverage themselves out. It's not the case, so I think it's just ensuring that our due diligence up front is robust.

PC: I'm assuming as a generic thing that a lot of it has been hugely impacted by inflationary pressures and agreeing to contracts at a price that they can't deliver because of the cost. Are we beyond that or do some of those pressures still exist?

JW: I think the pressures have changed. Now you have Gateway pressures.

SJ: The huge jump and huge exposure of massive cost inflation has gone for the time being. It’s not like it was three years ago but as you say other pressures are coming in.

How are lenders getting comfortable with developers and development in a radically changing world for offices, shops and hotels?

PC: This is an interesting question from a psychology perspective because lenders, to a large degree, buy in to experience and confidence. And if I'm engaged with a sponsor on a project, I want utter confidence that they are into the weeds. They understand the details and can show a clear path to achieving what they want to achieve. So, it's that articulation of how they will produce what they say they are going to produce.

JM: There are still additional "duty holder" competencies developers have to demonstrate. They're probably already doing all of that good stuff anyway, but now have to, at the end of the project, warrant the competence of the supply chain, so that should give lenders some comfort of that formal process now as well. But I don't think much has changed otherwise in terms of the diligence.

PC: It's a really fine balance. So, the diligence piece and the advice that we take, to a degree, is a continuum. I don't really see a dramatic change on that side of the equation, from our perspective. My colleagues might disagree with me. But I think the change for us as lenders is to really understand the points and topics that we've talked about today. What does the Building Safety Act actually mean? Do we understand the nuances of it? Have we worked out how it impacts our lending and therefore we can ask the right questions of our sponsors when we're looking at the opportunities? That's still a path of discovery.

How can digital transformation and technologies drive efficiencies in construction particularly AI and [building information modelling]?

NL: I think it's a massive area and I think the use of technology on construction sites will accelerate very quickly. I went around a site the other day and traditionally, if you pour concrete, you'd have to take samples and they go off to a lab and four weeks later, you get told whether it had the necessary strength or not. Now you can embed sensors in the concrete and the analysis can be done in real time with no delay. The Building Safety Act is all about making sure that the buildings are constructed to a certain design.

I saw a guy walking around a building site the other day with a GoPro on his head and I had always assumed that the data was too vast to manage, but this thing was coordinating with the plans, the digital plans. The GoPro operator knew where he was at any given moment in time, he could tap on whatever device he had and visually check off what needed to be done in the sequencing and recording and hold it as a record that could be transferred into a BIM model.

The Premier Inn on the Cut in Southwark. (CoStar)

If you were a developer or a lender, what, this year, are the most exciting areas to be in or are the most foolproof?

CS: For me, a refurbishment of an office in the regions where there's no supply-side pressure and there's huge reversionary potential, I think the data really supports it well. And there aren't too many people delivering Grade A sub-10,000-square-foot floorplates in regional office markets. And debt liquidity for us we see as an opportunity as it is fairly limited for that sector. So that's something I really like at the moment, the data supports that well.

GE: I'd like to see more done in a regional market. I think we are now more settled on people's working practices and we're seeing occupiers willing to pay a premium for better and smaller footprints. That's what we've seen in some of our London holdings. Whether that's happening across the country and where – the £50 a square foot for the best-in-class buildings – I am not sure, and that's all of the big 10 cities. We have continued to have success with hotels from delivery of the Premier Inn on The Cut in Southwark; the Ruby hotel in Notting

Hill; and we've achieved planning permission for a big transformation of the Hilton Hotel next to Kensington Olympia. A focus now is how we take that forward to transform it from 400 rooms to over 900.

SJ: Ageing population and population growth so care homes, I would say, and obviously cheap affordable housing for everybody.

JM: We're seeing lots of deals involving hotels, either building or selling them, including portfolios. Care homes exactly the same, notably both of which are not caught by the new Gateway regime.

We're doing a lot with housebuilders, which we haven't done historically, which is probably quite relevant in the new administration regime and their targets. From a lending perspective, we're being asked about single family, [private rented sector] and [build to rent] quite a lot, and what that might involve. That's relatively new for some lenders, and we're seeing a meeting of different worlds there. Lenders want their usual warranty package and all that good stuff, but housebuilders historically, dare I say it, have been a bit more "Wild West" and rely instead on working relationships over the contracts, all that sort of stuff. So, I think there's a meeting of cultures there. We are doing a lot of work on data centres too.

PC: We are sector-agnostic, so I think this is all about opportunity, the right opportunity. It doesn't matter what the sector is for us, but it's working with the right people on the right opportunities. What I am encouraged by is in this conversation today is that with all the challenges that have to be overcome, actually what people are talking about is producing better buildings. If we're producing better buildings, I think that's a great thing.

NL: There are pockets of opportunity in all sorts of places, but I think as a general trend I quite like what Chris was saying. Those refurbishment projects which perhaps can solve a supply issue. It might not necessarily be the very top – I don't know what the classification is, there's sort of prime-plus, new builds with all the sustainability credentials – but very good quality refurbishment that can get to the market quickly. That will be a good place.

JW : We are looking at alternative real estate quite a bit at the moment, specifically the self-storage landscape. That's very interesting and quite exciting. I think it's quick in and quick out, which is really helpful.

GB: For me it's house building. It is front and centre of our strategy this year and I think what's interesting in housebuilding is we're looking at a scheme in the South West at the moment which is 500 units, so it's a decent scale, but of those 500 units, 70% will be presold, and that's to a mixture of PRS and affordable housing operators. So, there's an immediate derisking of that from both the housebuilders; perspective and for us as a lender. So that's quite interesting.

And then around existing buildings, I just feel there's an opportunity for the government around reimagining permitted development. Because it's so difficult to build from ground up, there's so many buildings that are no longer fit for their intended original purpose. They're talking about quick ways of stimulating growth and I think this is a solution.

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