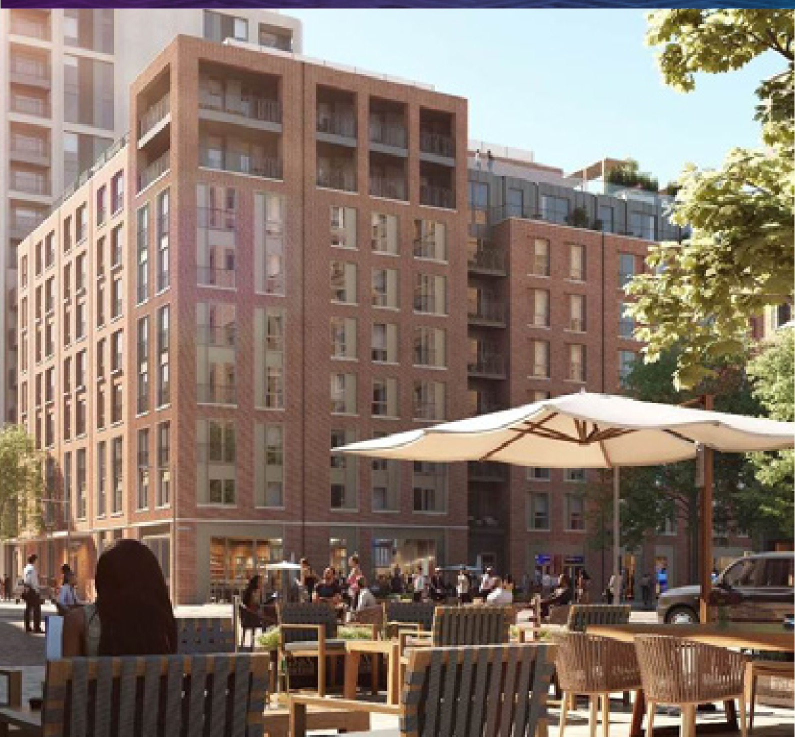
BTR Financing
An Analysis of Key Principles

March 2021



CREFC Europe

Cover images:

Top
Image of Vantage Point,
Islington, courtesy of Essential Living

Middle
Image of Angel Gardens,
Manchester, courtesy of Moda Living

Bottom
Image of Brent Cross South,
Brent Cross, courtesy of Argent

Contents

Summary

Image of Brent Civic Centre, Wembley, courtesy of Quintain

The aim of this document is to support the growth of the UK's large-scale residential build-to-rent (BTR) sector by providing insights into the financing of BTR projects. The perspectives of developers, operators and lenders are all reflected with a view to fostering improved understanding and thus greater liquidity. The paper seeks to recognise some of the difficulties faced, especially by lenders in adapting their traditional models for evaluating and managing risk.

The paper explores why traditional underwriting and lender risk management approaches based on loan to value and interest cover ratios are inadequate in the context of an operationally intensive asset class like BTR.

It considers the key issues at the different stages of any project, focussing on the construction process, the phase during which the completed BTR scheme is being let and the fully operational (or stabilised) stage. It looks at the different perspectives of equity and debt and seeks to summarise mitigants to some of the identified risks and ways in which common ground can be found.

There are a number of factors beyond the scope of this paper that are likely to play an important role in the evolution of the BTR financing market, such as planning and other policy matters (including VAT and other tax considerations), valuation methodologies and the emergence of operating cost, rental comparables and other performance data. Against that broader backdrop, it is hoped that this paper will be a helpful guide to some of the issues and potential solutions and an encouragement to a deeper understanding of the perspectives of both borrower and lender so that both are prepared and better able to address the concerns of the other.

The paper does not focus on two issues that have been dominant at the time of writing: Brexit and the Covid-19 pandemic. Undoubtedly, these issues will affect both credit markets and housing markets, but as it remains difficult to predict how either of them will unfold, we have remained tethered to the fundamental characteristics of BTR finance, which we believe will persist, more or less regardless of how Brexit and Covid-19 play out.

This work was based on contributions from many industry participants – lenders, operators, equity investors and advisors. Those contributions were provided through a series of meetings and written comments. They were brought together, organised and incorporated into this paper by Partha Pal and Carol Hopper of Greenberg Traurig LLP, who had identified the need for such a piece of work when the market was even more in its infancy, and proposed it to CREFC Europe. Partha and Carol, of course, added perspectives from their professional experience and drew on the perspectives of other Greenberg Traurig professionals, including partners with expertise in construction and property development, corporate real estate and real estate tax. A special mention should go to Rachel Whittaker of Greenberg Traurig LLP, a senior know-how lawyer who contributed at many stages of the preparation of the work, and to the team at Town Legal, which Rachel coordinated and who provided input in relation to the section on planning.

Introduction

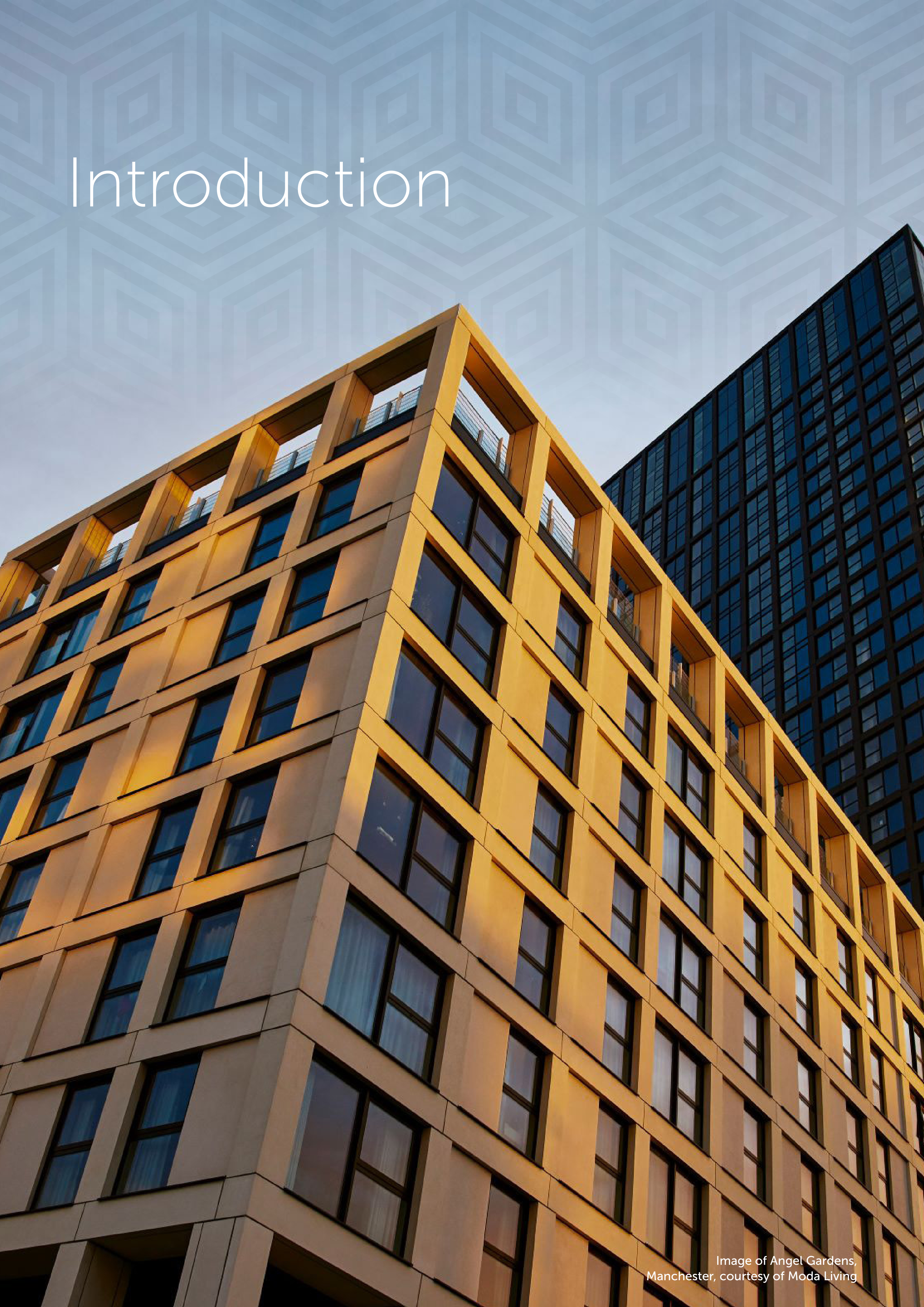


Image of Angel Gardens, Manchester, courtesy of Moda Living

BTR & the Housing Crisis

A great deal has been written about the housing crisis in the UK and the need to find innovative solutions to increase the housing supply. Notwithstanding a common tendency among the media and politicians to focus on home ownership, it seems clear that a major contribution to addressing these shortfalls could come from the build-to-rent (BTR) sector – especially, perhaps, if economically challenging times lie ahead.

In referring to BTR, it is perhaps first worth distinguishing between BTR and the wider PRS. PRS (the Private Rented Sector) is a UK government classification of housing tenure, which distinguishes private renting from other tenures such as owner-occupied and rented from local authorities or housing associations (registered social landlords or registered providers). PRS is thus a very broad category, encompassing everything from professionally managed large-scale blocks to single homes owned as an investment and rented out by individual landlords, and the quality of both product and customer experience varies greatly. The term BTR was adopted by the UK government after the 2012 Montague Review of the barriers to greater institutional investment into the PRS, to differentiate the professionally managed, large-scale and institutionally invested product from the wider PRS. The growth of the UK PRS was constrained from the 1980s by a regulatory regime that strongly discouraged landlords and sought to accelerate owner occupation. Meanwhile, other markets saw dramatic growth in institutional investment into the rental market. In the USA, the sector is known as multifamily housing - a term used interchangeably with BTR by many in the UK market. For consistency and clarity, this document uses the term BTR.

The idea that the BTR sector can make a major contribution towards addressing the housing shortfall is a logical one: a BTR developer will build a block of quality apartments for the purposes of letting them rather than selling them. It will appoint an experienced operator, possibly within the same business group, to manage the apartments. Individuals or families will take up residence and pay a monthly rent. The developer will have no incentive to drip-feed stock into the market as can be the case with homes built for sale. The design, quality and adaptability of the stock will be critical in determining how efficiently it can be operated over the long-term. The importance of delivering high quality homes with low running costs makes BTR a good environment for innovation with modular construction (also known as modern or advanced methods of construction, or MMC/AMC).

Benefits of BTR

Residents do not have to worry about arranging a mortgage loan (and therefore saving for a deposit), taking responsibility for maintenance, paying a ground rent to the freeholder or a service charge to the freeholder's management company, as they would have had they purchased the same apartment. Nor do they have to worry about arranging and paying for utilities, at least in some schemes, or wait for an amateur buy-to-let landlord or his or her managing agent to organise maintenance when needed, as they would in the context of a traditional rental apartment.

A report commissioned after the Grenfell Tower disaster by Shelter, the homelessness charity, estimated that to address the housing crisis in England, 1.27 million homes are required for those with the greatest need for housing (including those who are homeless and those with disabilities or long term illness); 1.17 million homes are required for those categorised as 'trapped' renters (including younger families who cannot afford to buy a home) and 600,000 homes are required for older households who face housing insecurity after retirement.

Residents will have a safe, clean, convenient and modern, custom designed place to live with the developer and the operator taking responsibility for all, or at least many, of these matters, as well as the provision of amenities like recreation and concierge facilities. The emphasis is on treating residents like clients whose welfare they wish to look after – rather than just tenants – a key distinction as real estate increasingly becomes a service industry. In addition, the residents will be part of a community, able to enjoy a level of social interaction that might not otherwise have been available to them as well as having the confidence that they will be able to move homes flexibly if they need to. In this rental market, dissatisfied occupiers will walk (no doubt leaving bad reviews as they go), whereas good quality providers will have no difficulty maintaining, replacing and growing their income.

For this exciting vision to become a reality, it needs financial backing, both from equity and debt.

BTR Finance

From the equity perspective, BTR assets have the potential to provide a steady long-term income stream which is capable of rising to reflect inflation – in many respects the Holy Grail for institutional investors. But while developers and operators have been quick to grasp the opportunities presented by the BTR sector and equity investors have been enthusiastic to back them, lenders have been more reticent.

Lenders are typically exposed to the risk of losing their capital if a scheme fails, without enjoying the upside that a very successful scheme can generate (they simply get the fixed financing charge and their loan repaid). To make matters worse, in the context of an emerging new sector they cannot rely on data or track records, and de-risking techniques and financial covenant protection used in the commercial real estate or built-for-sale residential development markets may not work. However, the strength of equivalent asset classes (multifamily) in North America and continental Europe suggests that it should be possible to overcome these challenges.

Recognising the importance of the emerging UK BTR sector in both public policy terms and as a commercial opportunity, the Commercial Real Estate Finance Council (CREFC) Europe formed a working group to improve understanding of, and seek to remove, the constraints on the availability of informed credit for the BTR sector in the UK.

We would like to take this opportunity to express our thanks to the many individuals (and their firms) who generously shared their time, knowledge and ideas, without which this paper would not have been possible.

A Credit Perspective on a Project

Image of Blackhorse Mills,
Waltham Forest, courtesy of Assael Architecture

In very broad terms, the analytical framework that lenders rely on in assessing a real estate project (where there is no recourse to a sponsor) is broken down into the following key elements:

- Loan to value;
- Interest cover;
- Debt yield; and
- Operational expertise.

We consider each of these elements in further detail below.

LOAN TO VALUE

The difference between the value of the asset and the amount of the loan provides a cushion of safety, particularly in an event of default situation, where the lender has to rely on a sale of the asset in order to recover what is owed to it. The bigger that cushion, the more comfortable the lender will be – there is a recognition that asset values can decline rapidly, not just for idiosyncratic reasons connected with that asset but also for systemic reasons (as was seen during the Global Financial Crisis) and for sectoral reasons (as seen more recently, in the changing market place affecting the retail sector) and so, the importance of a cushion of safety to a lender should not be underestimated. A lower LTV (and thus a larger cushion) will also typically imply that the equity investor has more 'skin in the game' and is therefore likely to go the extra mile to protect the asset.

INTEREST COVER

The difference between the income that an asset generates and the interest that must be paid to the lender also provides a cushion of safety. The greater the difference, the more comfortable the lender will be. In the context of traditional real estate assets subject to long leases, determining the income that a lender takes into account is straightforward – it is based on the rental income that tenants are contractually obliged to pay or actually have paid over a particular period, adjusted to strip out rental income that is regarded as unstable (for example, rent payable by a tenant that is in arrears or rent payable under a lease that may come to an end because the tenant has a break option during the relevant period which it may exercise) less the costs of operating the asset over the same period, unless such costs are met by the tenants from tenant contributions, such as service charges. The interest on a loan over the same time period is even easier to calculate, being a function of the rate of interest charged and the amount of the loan outstanding.

Loan to Value

An asset providing security for a loan must generally have a value which comfortably exceeds the amount of the loan being provided.

Valuation of real estate assets is both an art and a science, but an important part of the methodology valuers employ is looking at comparables – the price at which similar assets have been bought and sold in arm's length, open market transactions. In the context of the BTR sector in the UK, this is difficult because the sector remains at an early stage in its development. Even lenders keen to enter the BTR sector felt that there was an insufficient basis for acceptable valuations that would satisfy the requirements of their credit committees. The key determinants of valuation are annual rental income and the likely operating expenditure. The RICS has also been considering the income driven valuation approach that this asset class requires and has produced a guidance note that offers advice as to the approach to be adopted for BTR and which seeks to reflect market practice.[1]

1.https://www.rics.org/uk/upholding-professional-standards/sector-standards/valuation/valuing-residential-property-purpose-built-for-renting/

Interest Cover

An income-producing asset providing security for a loan must generate an income that comfortably exceeds the interest payable on that loan.

Calculating the income that a BTR asset generates is not straightforward, at least when the financing is first made available. For a start, developers and operators often aspire to, and base their financial modelling on, a rent that is in excess of what is achievable in similar locations for traditional rental properties. Their rationale is that they offer more to residents than traditional rental properties – the combination of amenities and the quality of the accommodation justify the payment of a premium rent, in their view. Indeed, some of the early entrants to this market are beginning to build up evidence to back this up, but it will take time for this to be the norm and so, in the absence of comparables, this is difficult for a lender to verify.

Another tricky area is the treatment of inflation in the borrower's business plan. Borrowers will typically want to assume that rental income will increase in line with inflation – but while that may be informative for a lender's forecasting purposes, lenders will typically strip inflation back out for testing purposes, on the basis that there is no contractual certainty of rental increases. On the other hand, lenders will expect inflation in operating costs to be addressed in the borrower's business plan. The broader challenges around estimating the borrower's ongoing operating costs are discussed below.

Finally, there is the fundamental matter that rental income in the context of BTR assets is, by its nature, short term, and not fully recoverable due to deduction of operating expenses which can be difficult for the operator of a scheme to estimate particularly at the outset. Tenants will often, if not typically, occupy a BTR residence pursuant to assured shorthold tenancies with a duration of 12 months often with a six month break and commonly with a right to terminate on a two month notice period at the end of any fixed term. Often this is the initial arrangement which gets rolled over at the end of the fixed term to become a statutory periodic tenancy capable of termination in line usually with its payment terms. However, this is an area of keen legislative interest and whether rent can be reviewed at the end of the fixed term and when and how any tenancy can be terminated by a borrower, also requires careful consideration.

Following the traditional approach, as described above, all such short-term income would be excluded by a lender in determining the income side of a typical forward-looking interest cover ratio – an approach that is plainly unsuitable in the context of BTR. Lenders have to find a methodology therefore that allows this shorter-term income to be accounted for and tested. This is obviously not an insurmountable problem – solutions have been found in the context of hotel and student accommodation assets – but for now, no established methodology is in place for BTR. One solution might be to assume that certain income levels will continue throughout the test period subject to an appropriate level of voids based on historical patterns or other agreed levels for the particular market, the particular asset or the particular stage in the stabilisation process. These are, however, all areas of significant difference between the perspective of lenders and borrowers.

Debt Yield

This is a metric that many lenders have increasingly used in the low interest rate environment that has prevailed since the GFC, and that can flatter interest coverage. Indeed, in the context of operating assets, lenders are often willing to use debt yield as an alternative to interest coverage.

A debt yield test compares net rent (or, in the context of a BTR asset, net operating income) over a period to the principal amount of debt outstanding at the start of that period and can operate as a useful additional metric for testing the sustainability of the debt.

The application of financial covenants during the operational phase should not differ from the generality of real estate financings, with LTV and ICR being tested on a quarterly basis, with debt yield used in some cases (either in addition or instead of ICR).

Operational Expertise – Service is Key

In addition to these factors, a lender in the context of a BTR asset (and indeed any operationally intensive real estate asset) must be comfortable that the operator of the asset is capable of managing it efficiently and effectively so as to attract and retain tenants. This may come under particular scrutiny where the operator aspires to charge a premium rent or expects to incur especially low running costs.

BTR assets, by their nature, involve a high degree of operational complexity, particularly where the intention is to treat residents like clients such that, unlike most commercial real estate businesses, the business is directly consumer-facing.

Providing a concierge service, recreational and social facilities and maintenance for people's homes is far more labour intensive and fraught with the risk of a major loss of goodwill than ensuring the lifts, air conditioning and sanitation in an office building are functional. While arguably not as severe as in the context of a hotel, the possibility of reputational and financial damage in the context of a BTR asset through operational failure is very serious. This is particularly the case if it occurs in a way that impacts upon the resident experience, the undefinable but important quality at the heart of the 'offer' from many BTR operators. BTR is people driven; the residents of course, but also those providing the services to them which in many cases will be an on-site team. The quality of that team, as well as the systems and support for that team behind the scenes, is a critical aspect of BTR that is often overlooked, underestimated or not fully understood. Likewise, customer service both as to the initial 'draw' and in the important matter of resident retention rates, is often overlooked.

Lenders therefore need to undertake operational due diligence on the operator, specifically its experience, team and resources, and be confident that if there was to be an event of default that is continuing such that the lender desires to take action under the terms of a financing, the disruption to operations would not materially compromise the functioning of the assets. This may be achieved through having an operating company in the borrower structure and the possibility of a back-up operator who can take over operations in the event of a default. We address operational due diligence in the context of BTR assets in further detail below.

The Pre-Project Stage – Planning and Site Assembly

Image of Vantage Point, Islington, courtesy of Essential Living

KEY POINTS

- Timing – most lenders would expect a developer or operator seeking debt for a BTR project to do so after it had secured the site on which it wished to build and had obtained the necessary planning permissions. There are specialist lenders who support earlier stages in the process such as land acquisition and planning, but it is generally advisable to fund and complete site assembly and planning before approaching lenders to finance the development itself.
- Planning permission & conditions – development lenders generally expect the necessary planning permission(s) to have been obtained; usually the relevant judicial review period to have expired and the developer to have identified and understood all planning conditions including in relation to affordable housing.
- PRS covenant – this is unique to BTR schemes and relates to the agreement by a developer that the homes will remain in the private rented sector (PRS) for a specified minimum period, failing which the developer will be liable for a clawback payment to the local authority. A developer should quantify the liabilities that could arise in the context of a PRS covenant being breached and how they could affect a lender.
- Site assembly – a developer should be able to confirm to a lender that there are no material unknown physical or legal complications with the site for development and operational purposes. Any risks identified need to be flagged to the lender together with a proposal as to how such risks will be mitigated. This is particularly important in the context of modern methods of construction, where access to the site is particularly important.
- Due diligence – the more detailed the due diligence the more helpful to the lender particularly where there are unusual factors. Granular information reflecting both qualitative and quantitative considerations should be summarised in a user-friendly format e.g. certificate of title.

Timing

Most development lenders would expect a developer or operator seeking debt for a BTR project to do so after it had secured the site on which it wished to build and had obtained the necessary planning permissions. Debt funding is available from specialist lenders to support land acquisition and the planning process, but those preliminary stages are outside the scope of this paper.

Planning

Most traditional lenders will expect that planning permission has been granted and that the judicial review period for the planning permission has expired without a challenge being raised (albeit there are exceptions), before seriously considering involvement in a project. This is consistent with the approach to development finance generally and is not specific to BTR schemes.

While lenders accept that planning permissions will typically be granted subject to planning conditions and section 106 planning obligations, the satisfaction of these conditions or obligations must be within the control of the developer or the operator and must not undermine the financial viability of a BTR scheme. It is thus important that developers or operators can demonstrate an understanding of the planning conditions and obligations that have been imposed on them, and control of both the process and costs involved in fulfilling them, to prospective lenders.

It is worth noting that a local authority may levy a specific charge for the grant of access rights. Where that is the case, a lender will expect that there is liquidity available to the borrower to pay this at the required time as non-payment can result in disruption of the development process.

Affordable housing is housing provided at a discounted rent from local market rent levels (but where rent increases, subject to the same discount pattern, occur in line with local market rents). Social housing, on the other hand, is housing provided by registered social landlords at a more deeply subsidised level and with stricter controls on rent increases.

Affordable Housing

Particular attention should be paid by developers and operators to affordable housing conditions and obligations. In this context, affordable housing is to be distinguished from social housing.

The Ministry of Housing, Communities & Local Government has provided guidance on planning for BTR schemes and in particular the expectations around the provision of affordable housing.[2] This guidance suggests that developers and operators of potential BTR schemes should as a benchmark make a 20% allowance for affordable housing within any scheme, with a minimum 20% discount to market rent on the affordable housing element, though alternative provision and/or approaches may also be acceptable and/or adopted. Note, as part of the liaisons with the relevant planning authority, discussions around the quality of affordable housing, tenure mix, and the design are also likely to be had. The guidance also indicates that the affordable rent homes and the market rent homes should be in common management control and the affordable homes should be managed in the same way as the other elements. Local policy requirements and guidance may override elements of the government's guidance, in particular in respect of the quantum of affordable housing which must be provided in the context of a scheme (subject to viability testing). Likewise, the level of discount may vary and can be up to 50%. The Mayor of London has published his own guidance on BTR schemes and is promoting a BTR policy in the new London Plan with specific (higher) requirements applicable to BTR schemes.[3] It is worth noting there is a definite interplay (albeit dependent on other factors such as the relevant planning authority) between reduced affordable housing elements and the length of a PRS covenant (see further below).

2. https://www.gov.uk/guidance/build-to-rent

3. https://www.london.gov.uk/what-we-do/planning/london-plan/new-london-plan

Assessment of the scheme

In assessing a BTR scheme, lenders should seek evidence that the affordable housing conditions have been factored into the developer's business plan and that, with the allowance for the provision of affordable housing, the scheme still generates sufficient income to be able to service interest on the debt that is being provided, as well as providing the cushion of comfort in relation to income referred to above. As with a great deal of BTR, understanding the granular detail is important. The positive difference in dynamics of interspersing affordable housing for key workers across the BTR scheme, rather than putting all affordable homes together in one area that can isolate/stigmatise, being just one example.

In terms of process management, it is important that a developer or operator seeking finance covers planning conditions and obligations in the real estate due diligence material that it provides to potential lenders so that they have clear visibility in respect of these matters and an ability to assess the approach of the developer at an early stage in their analytical process.

Unlike the points discussed above, the so called 'PRS covenant' is an aspect of the planning framework in the UK that is unique to BTR schemes.

PRS Covenant

The PRS covenant is an agreement by a developer or operator seeking planning permission to keep the homes (both affordable and market) for which planning permission is sought within the private rented sector (PRS), failing which it will be liable to pay an amount to the planning authority. This obligation – which would most obviously arise if the homes in the scheme are sold rather than being rented out – is known as a 'clawback payment'. It is often a reappraisal of the initial viability assessment completed for the section 106 agreement and so may or may not result in an actual payment being made, dependent on the differentials between build to sell and build to rent values.

Where affordable units are being lost, the purpose of the clawback payment is to ensure that alternative provision of affordable units is made. In this instance the section 106 planning agreement may require the developer to convert other market units to affordable or make a payment to the local planning authority to reflect the quantum of discount that is being lost from within the scheme. Where a payment in lieu of provision is made, the authority will use this towards the provision or improvement of affordable units elsewhere within the locality.

Default

The PRS covenant can affect a lender in a default scenario where it determines that its easiest path to recovery is selling individual homes, if and to the extent that clawback payments have to be made to the planning authority. It would therefore be usual for a mortgagee in possession to obtain protection in the drafting of any PRS covenant allowing it to sell without any clawback payment if the asset is no longer viable for the private rented sector/BTR. Developers and operators seeking debt should ideally quantify what liabilities could arise in the context of a PRS covenant being breached and how these may impact on recoveries.

In assessing the impact of the PRS covenant in a recovery situation, lenders may wish to avoid relying on the fact that they will be secured creditors while the planning authority will be an unsecured creditor and thus at an inherent disadvantage. This is because of the reputational impact of a secured creditor appearing to sidestep provisions in favour of a public authority for public benefit. Lenders should also bear in mind that a planning authority can have a cause of action against the lender, as well as the owner of a scheme, if the lender were to enter into possession. As mentioned above, most authorities would be willing to give protection to a mortgagee in possession in circumstances where they are taking action because the asset is no longer viable as private rented accommodation.

Site Assembly

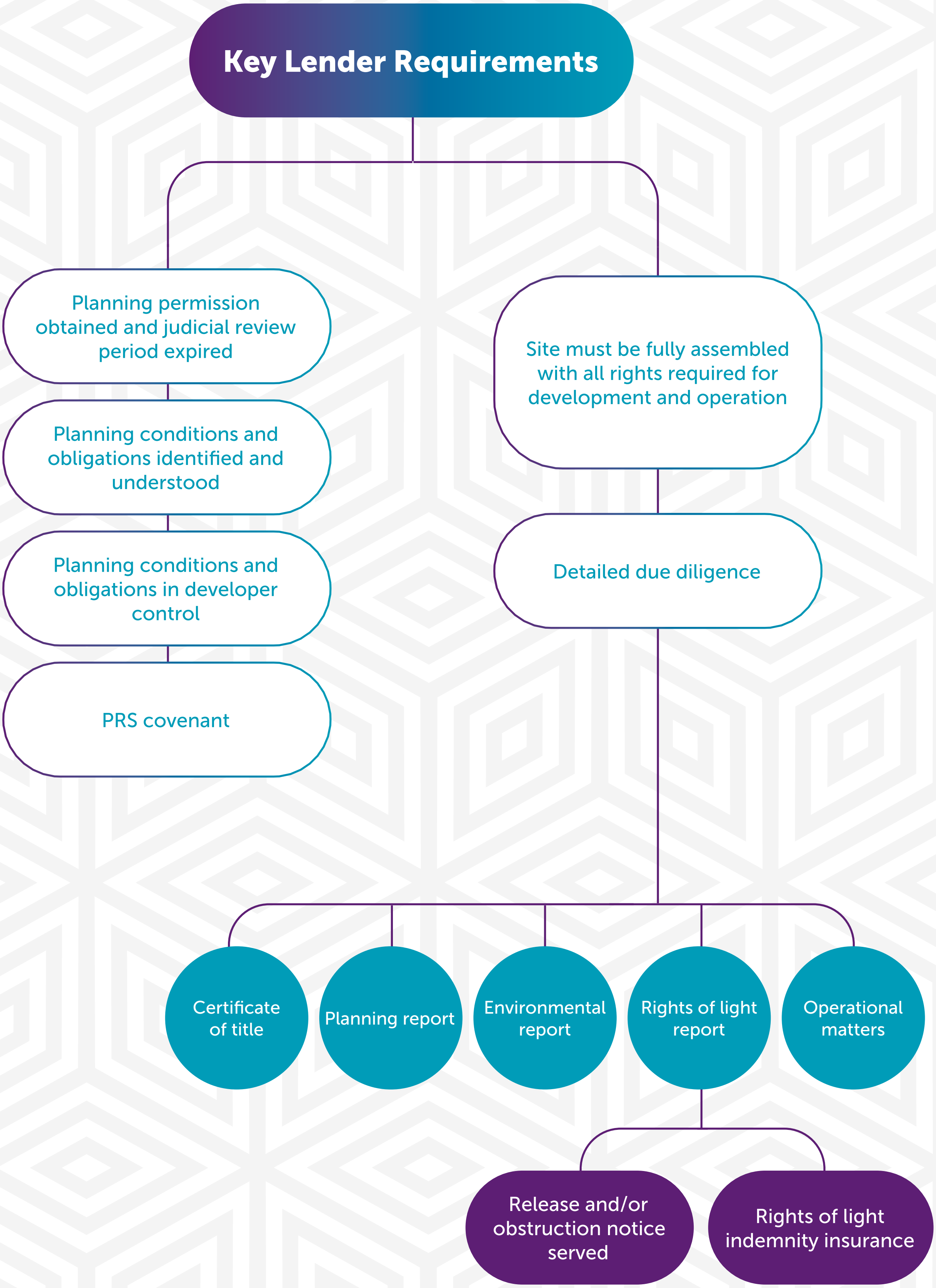
With respect to site assembly, most lenders will expect there to be no material physical or legal complications with the site – both for the purposes of developing the scheme and for the purposes of operating it – that are not appropriately addressed or cannot reasonably be mitigated by the developer. Additionally, lenders will want to ensure that all rights that need to be obtained from neighbouring landowners have been obtained (or there is a clear path available to the developer or operator to obtaining them), and conversely that no neighbouring landowner will be able to assert rights in respect of the site which could have an adverse effect on the development and operation of the BTR scheme (or there is a clear strategy for releasing or managing such rights).

The access rights to the site can also be particularly complicated where a developer uses modern (or advanced) methods of construction (MMC or AMC), as described below, which require individual units to be manoeuvred on to the site and installed within the shell of the building, this being a logistical matter as well as a legal one, in terms of assessing the adequacy of the access rights. This is particularly difficult in city centre sites and may require the grant of access rights by the local authority.

As BTR schemes are predominantly appearing in city centres, a rights of light assessment will generally be essential and, where appropriate, releases will have to be obtained and/or obstruction notices served, usually with the benefit of an indemnity insurance policy.

A developer or operator seeking debt for a BTR scheme should recognise the need to provide details of these matters in the real estate due diligence material that it makes available and a considered explanation of how it has addressed or proposes to address these identified risks. Again, this is consistent with any development financing proposal and so should come as no surprise. However, the more detailed the real estate due diligence the more helpful, and impressive, this will be to a prospective lender, particularly where there are unusual factors such as the use of MMC/AMC.

Summary: Planning and Site Assembly



The Construction Phase

Image of Duet,
Salford Quays, courtesy of More. Superenting

KEY POINTS

- Construction team – lenders must be satisfied as to the overall robustness of the construction team such that a development can be carried out on time, to an agreed budget and to quality standards. Providing lenders with information on the operational and financial capabilities of a contractor (whether in the context of a design & build, construction management or management contract arrangement) is imperative and should include information on any parent or holding companies where relevant.

- Addressing contractor default risk – the means of dealing with contractor default so the construction process can be completed will be important to lenders. This can include guarantees from the contractor's parent or the provision of a performance bond allowing completion of the works to be paid for (albeit the ideal scenario is a developer or equity provider committing to provide the financial resources to fund completion itself).

- On track progress – there are a number of ways to ensure the works progress, including financial incentives for developers, collateral warranties addressed directly to lenders with step-in rights (or third party rights notices with the same result), and independent third party monitoring of the construction team as organised by the lender.

- Certainty and control – lenders will also want to ensure price stability and contractor liquidity to mitigate any financial risk in the absence of accentuating factors. A lender will want to be able to step in and take control of the management and construction process if there has been an event of default.

Construction arrangements in the context of any development financing can often be complex and BTR schemes are no different.

It is important first to distinguish between the traditional way in which a developer might finance a BTR scheme, on the one hand, and the different, but widely used, approach of forward funding, on the other.

Whether in a traditional development financing or a forward funding, the lender will typically need to be satisfied in respect of three matters:

- The identity, quality and experience of the proposed construction team;
- Certainty on price and programme; and
- What happens on an event of default (under the loan agreement and construction documentation).

Overall Robustness and Identity of Construction Team

First, a lender must be satisfied that the proposed construction arrangements are robust and will result in the completion of the project within the agreed timetable, to the agreed budget and to the requisite quality standards.

This goes beyond the contractual framework, important though that is. A lender should undertake appropriate due diligence on the contractor and the professional team which the developer is proposing to appoint in order to ensure that the construction team has the appropriate track record and is experienced in carrying out construction projects of a similar size, scope and value and has adequate professional indemnity insurance and resources available to carry out the particular project. It also must be satisfied that the chosen construction team has an appropriate supply chain in place with a series of reputable trade or sub contractors which it will engage to complete the development.

TRADITIONAL APPROACH

Developer develops a property using debt to fund a substantial element of the purchase price, build costs and development expenses. Only upon completion of the development might the developer sell the asset on to another investor or an owner occupier.

FORWARD FUNDING

Developer agrees the future sale of the asset at the outset, obtaining cash from the forward funder to help pay for the development. From the forward funder’s point of view, this can be an attractive way of obtaining scarce stock. The developer may also use debt to cover the costs of the development as it progresses (and is assumed to do so for the purposes of this discussion).

Certainty of Contract Price

Secondly, a lender will wish to ensure that there is sufficient certainty as to the contract sum and any allowances or contingencies that the contractor has made. The lender may prefer for the contractor to enter into a fixed price contract with the developer, but that is often difficult to achieve without either removing variations under the building contract or incorporating a guaranteed maximum price.

The rationale for this is to mitigate the financial risk of construction by ensuring that price stability is maintained in the absence of changes to the construction specification or changes to the construction timetable, and that the contractor is responsible for matters such as an increase in the costs of raw materials and labour.

At the same time, a lender must be satisfied that, so far as possible, the construction team has access to sufficient liquidity to carry out its work and that it will not be subject to financial distress during the course of the construction process compromising its successful completion. Indeed, many instances of construction industry insolvency have been the result of contractors being subjected to liquidity pressures that they have not been able to endure.

Control in an Event of Default

Thirdly, a lender must be satisfied that if there is an event of default in respect of the finance that it has provided, it will be entitled, both legally and practically, to step in and take control of the management to secure completion of the construction process. Conversely, if there is a default under the construction contract, a lender will want to ensure that the contractor has no right to terminate without first giving the lender the opportunity to cure/step in. These basic parameters are not peculiar to BTR schemes.

Procurement route

Lenders in the context of BTR schemes have a strong preference for a financially strong contractor who is appointed by the developer under a lump sum contract price design and build contract and whose obligations are enhanced by some form of performance security, such as a performance bond or a parent company guarantee. The value of such an arrangement from the perspective of a lender is both the relative cost certainty and the fact that a single entity has the responsibility for undertaking the design and construction, providing a single point of contact and responsibility for performance.

That said, a number of lenders are willing to consider the use by developers of construction management or management contract forms of procurement. Such arrangements involve the developer appointing a team of trade contractors to carry out and complete the different aspects of the development project rather than a single contractor with overall responsibility for the development (in the case of construction management), or a management contractor who, in turn, appoints a team of contractors (in the case of a management contract). However, lenders will only be disposed to consider construction management or management contract arrangements where the developer is experienced or is proposing to engage a recognised and competent construction manager who, in each case, is able to demonstrate a significant record of managing a team of trade contractors itself as well as having the financial resources, itself or through an equity provider, to be able to deal with cost overruns which are more probable in the context of such arrangements.

Indeed, in an era where insolvency in the construction sector is increasingly common, having a team of contractors employed directly by the developer could, in practice, be less disruptive than having a main contractor which becomes subject to financial distress in the course of construction – provided the team of contractors can be properly managed from the outset so that the construction process is co-ordinated and the risk of cost overruns is appropriately mitigated. One of the sacrifices for the developer and the lender if either management contracting or construction management is used is that it is extremely difficult to achieve cost certainty. The advantage, however, is cost saving, if the process is properly managed from the outset.

Image of Duet,
Salford Quays, courtesy of More. Superenting

Modern Methods of Construction

MMC, as modern methods of construction are known, is playing an important role in the development of the construction industry. Unlike traditional construction, which involves a labour intensive, on-site construction process, MMC involves the manufacture of 'units' (such as rooms or entire apartments) in a factory environment using precision technology and then transporting them to the site to be fitted into the shell of the building. MMC gives rise to both operational and credit considerations.

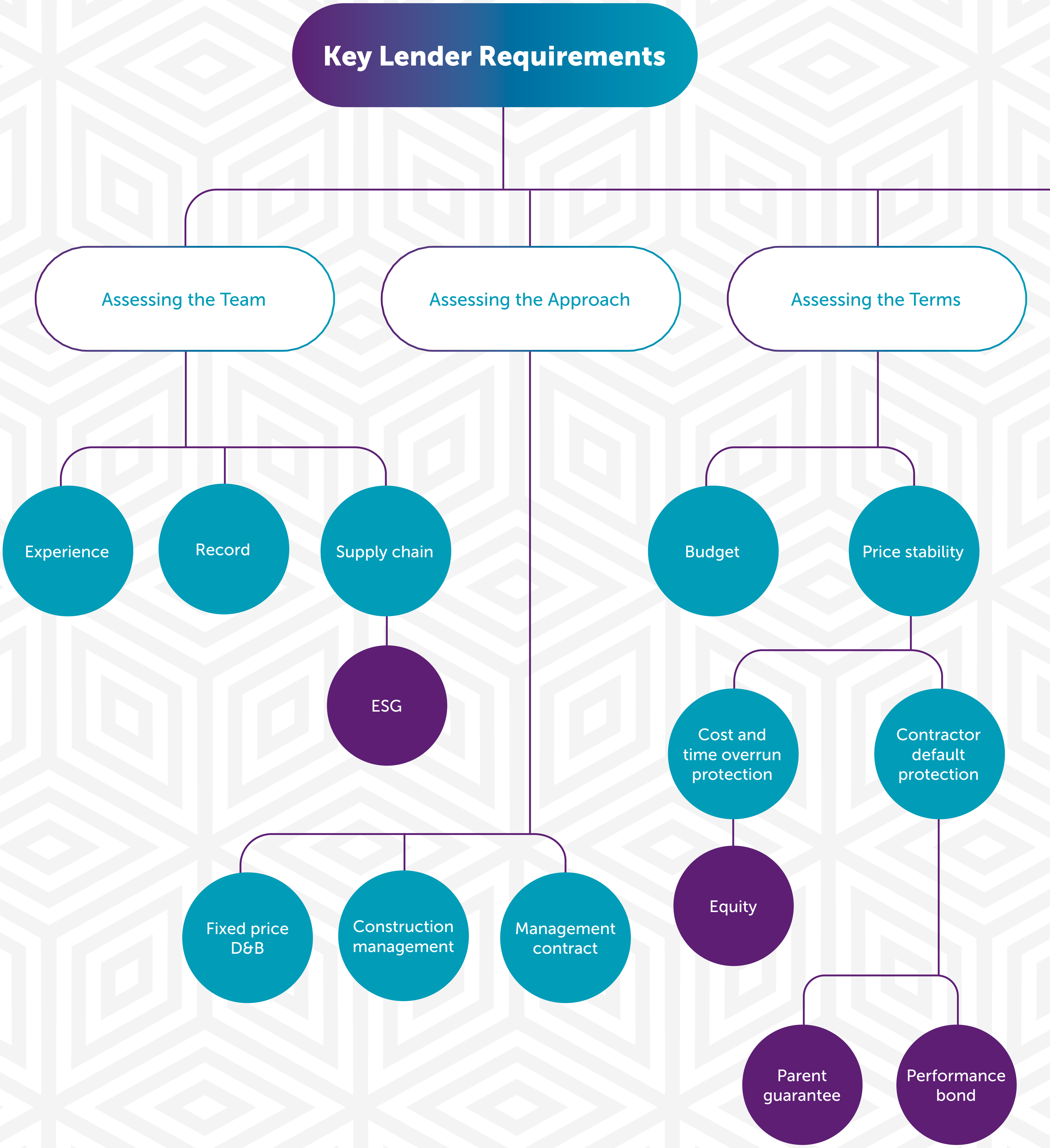
From an operational perspective, a key advantage of MMC is that work can progress in a safe, controlled, factory environment able to deliver consistent quality precision manufacturing, whatever the weather. A key disadvantage is the reliance on that factory environment. If the factory or the machinery is damaged or destroyed, it may not be possible to source the requisite capacity and quality of production elsewhere in line with specifications and the timetable. That can also have implications for the availability and cost of insurance in respect of buildings using MMC. Particularly in city centre locations, the logistics of transporting large units to the site can also present challenges, so that too should be considered carefully at the planning stage.

From the credit point of view, the lender (like the equity investor) should have an understanding of the risk of insolvency of an MMC contractor. While a contractor insolvency is always disruptive, in a traditional project it should always be possible to find an alternative contractor to complete the works. In the MMC context, even assuming a new contractor can produce new units to the required measurements and specification, there may be part-finished units or finished but uninstalled units that still belong to the insolvent contractor, even if part-payment has been made. It may be necessary to negotiate with the insolvent contractor's administrator (assuming there is one) to allow such work-in-progress to be completed. The administrator will have to consider whether it makes more commercial sense to complete the works or to default. None of this is likely to be easy to resolve.

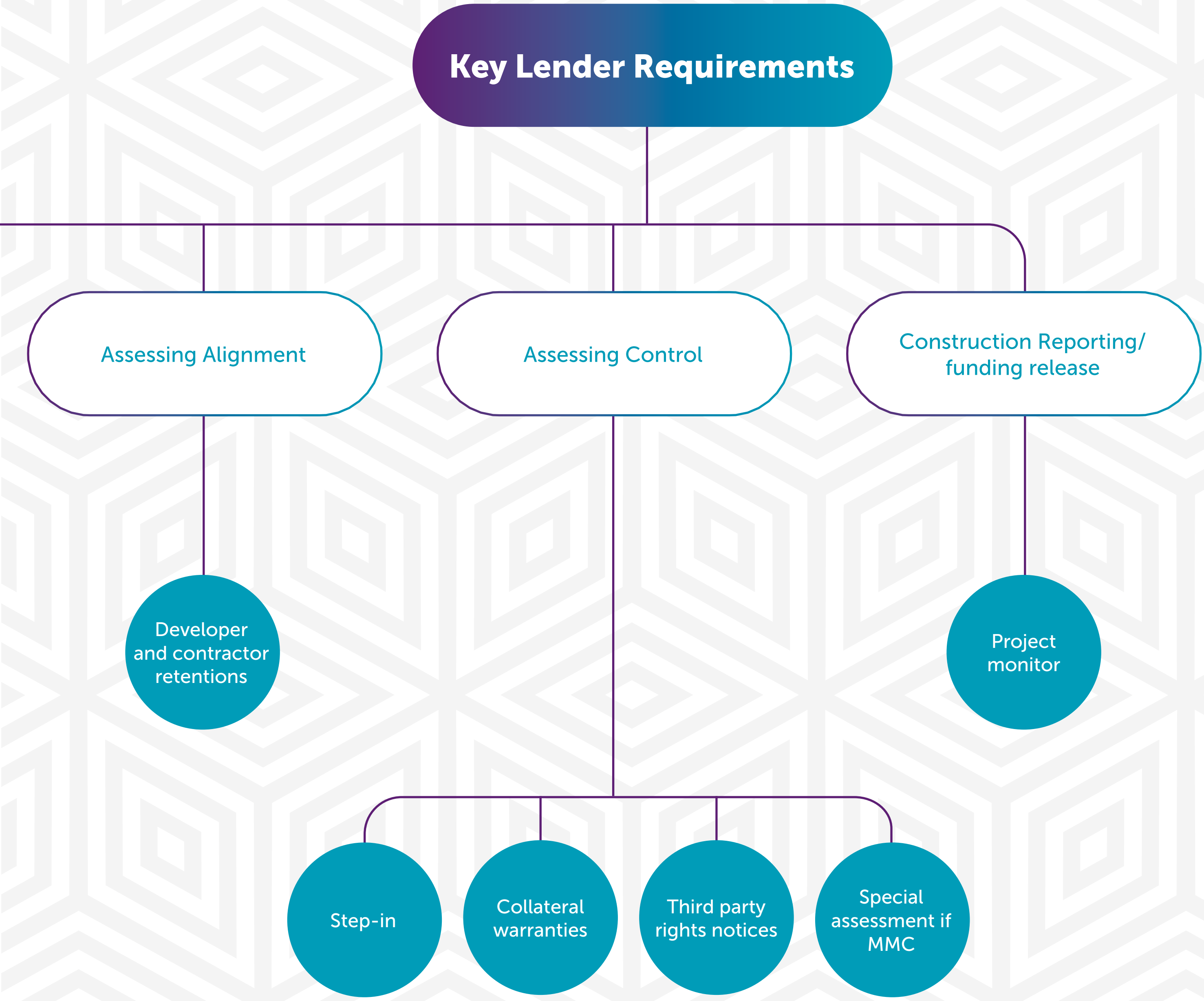
MMC is also evolving. 3D printing technology is already being used to construct single family homes and it is only a matter of time before that and other emerging technologies are applied to larger construction projects.

We set out some further considerations about construction (including MMC) in the Appendix.

Summary: Construction



Summary: Construction



Equity

Image of The Trilogy,
Manchester, courtesy of Allsop

KEY POINTS

- Equity - the commitment of equity:

  - enables progress at site acquisition and planning stages enabling the works to progress before development finance is drawn/available;
  - covers cost overruns;
  - represents a financial commitment that ensures equity will work co-operatively with the lender both to prevent the occurrence of an event of default and to avoid equity being put at risk;
  - and thus will affect the extent of other forms of protection that lenders may seek.

- Equity before debt – generally, lenders have a strong preference for equity to be committed before debt.
- 'Side-by-side' – where there is an existing relationship with a financially strong developer or equity provider, some lenders may consider equity and debt being contributed on a pro-rata basis, proportions being based on their respective percentage commitments. A modified approach of this is based on a certain amount of equity being contributed first after which equity and debt may be contributed pro-rata.
- Risks of 'side-by-side' – the lender takes the risk that the equity provider becomes subject to financial distress. To address that, an equity provider or developer should be able to demonstrate the debt provider has a seat at the table with the means of a suitable remedy such as equity commitment letters and/or parent guarantees should things go wrong.

Significance of Equity Commitment

The commitment of equity to a BTR scheme is a matter of considerable comfort to lenders, for two reasons. The first is economic. The commitment of a material amount of equity enables progress to be made in terms of site acquisition and planning, which, as described above, are risks that most development lenders are not able to take, enabling the construction work to be progressed before debt is drawn, as well as covering cost overruns. The second is behavioural. The commitment of equity ensures that a developer, or its equity partner, will have a meaningful financial interest to protect and so has an incentive to work co-operatively with the lender both to prevent the occurrence of an event of default and to resolve an event of default in a constructive way if one does arise, both of which situations put equity at risk.

In addition to the level of equity commitment, the financial strength of both the developer/sponsor and the contractor will have an important bearing on the sizing of the cost and interest overrun protection that any lender will seek.

Structuring of Equity Commitment

As a general rule, lenders have a strong preference for equity to be committed before debt is provided. However, lenders recognise that many, particularly smaller, developers, are constrained by the amount of equity they have available and that they need to spread their equity over multiple projects. With this in mind, lenders may be willing to consider equity being provided either on a 'side-by-side' basis or on a 'modified side-by-side' basis. The former approach is based on equity and debt being contributed on a pro rata basis, the proportions being based on their respective commitments. This is clearly very advantageous to equity and is generally only available where the lender has a strong pre-existing relationship with the developer or its equity provider and confidence in their financial strength. The latter approach is based on a certain minimum amount of equity being contributed first, after which equity and debt may be contributed on a pro rata basis.

As a practical matter, it is very important that developers are able to demonstrate, accurately and transparently, equity contributed. This may be by way of site acquisition and planning costs, due diligence reports or early stage infrastructure works. Where a developer expects to refinance those costs, this is particularly important.

Image of Duet,
Salford Quays, courtesy of More. Superenting

Lender Considerations where Equity Not Contributed Up Front

If a lender is to consider an approach other than one which involves the contribution of equity ahead of debt, it will want to be familiar with the developer and its equity provider and be confident that the developer or its equity provider will have both the financial strength and the liquidity to be able to provide equity as the development progresses. In any case this approach can be risky for lenders, so it is typically only adopted on the basis that an equity commitment letter and/or a parent guarantee is provided by the developer. A developer's undertaking in respect of its equity stake may be an acceptable alternative.

As mentioned, deviating from the approach of equity being committed first is not without risk for a lender. A developer or provider of equity to a developer may be willing to be subject to periodic information provision obligations in relation to its financial strength and liquidity position and may be willing to ensure that it has access to liquidity in excess of a certain amount at all times but it is unlikely to constrain its commercial operations further. Accordingly, the lender takes the risk that the equity provider becomes subject to financial distress caused by its other operations and therefore is unable to provide the equity when required. Moreover, in a joint venture arrangement between a developer and its equity provider or in a forward funding arrangement, there is always the possibility that there could be a dispute between those parties resulting in the situation that the equity provider does not provide the equity it is supposed to at the time it is supposed to, even if it has the means to. The lender's obvious remedy is to call an event of default under the debt arrangements. However, that is not necessarily optimal unless it has a way to unlock any disagreement at the level of the joint venture or forward funding arrangement. It also means that the lender has to understand the equity arrangements and make sure that it has a way to manage the risk that equity is not contributed as it is required to be, imposing an additional due diligence burden.

If a developer or operator, or an equity provider, requires side-by-side or modified side-by-side equity funding arrangements it should, in addition to having a good track record with a lender, be able to demonstrate that its equity documentation works in such a way that the lender has a high degree of confidence that equity will be provided as committed and, if there is a dispute or circumstances of financial distress, the lender has a seat at the table and the means of having a suitable remedy.

Other

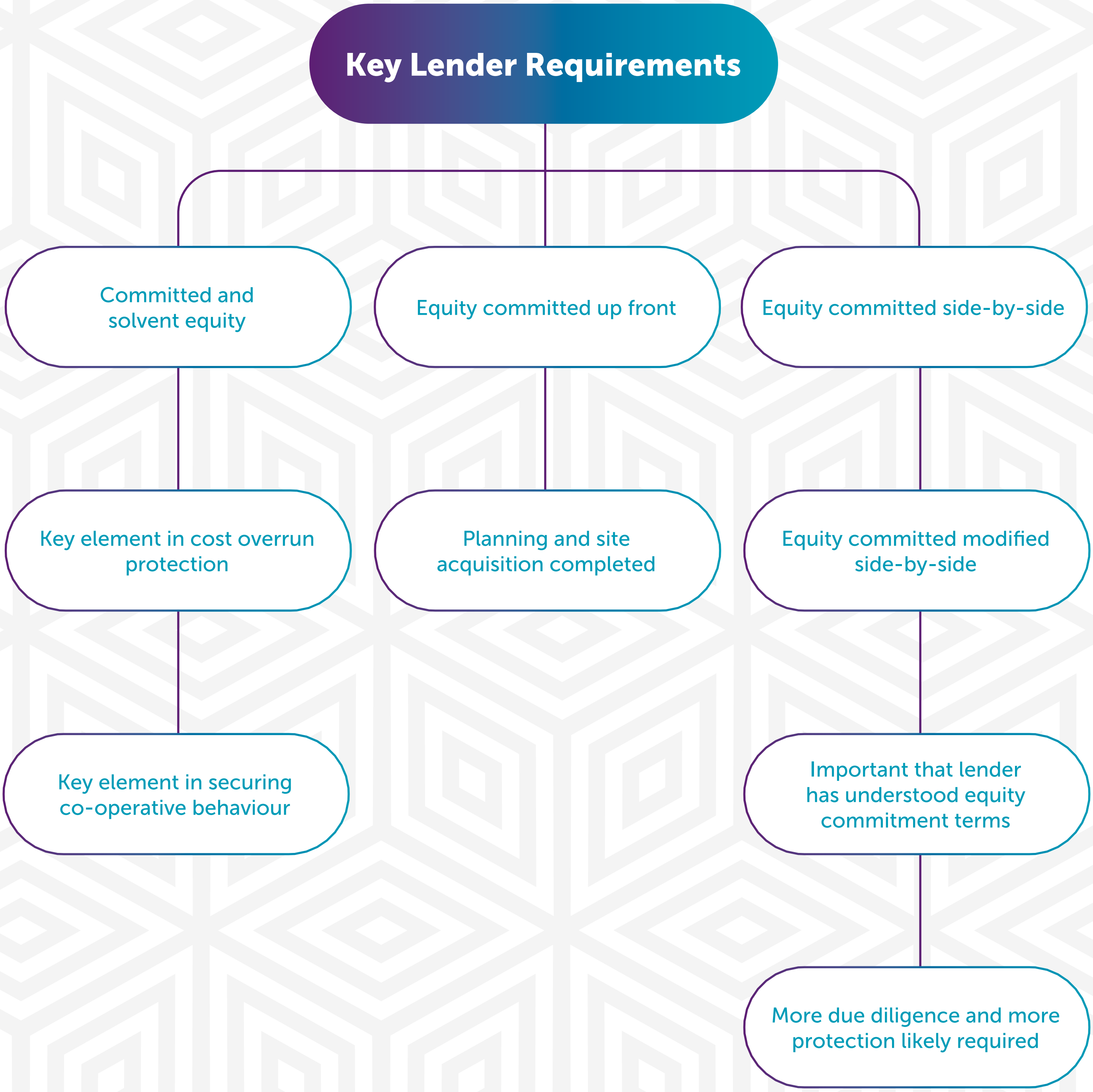
As mentioned, other tools that may be helpful in this debate would include:

- The use of equity commitment letters or guarantees that are tied to the side-by-side fund commitments of equity; it may be appropriate to consider the lender having the right to call for an equity contribution directly from an equity provider if an event of default has occurred;
- Parent company guarantee more generally; and
- The retention of the developer's profit.

Lenders should recognise that while they may be comfortable with the matters described above, there is always the risk that unforeseen circumstances could undermine the provision of equity, compromising the progress of the development and the viability of the project as a whole.

Understanding the full extent of commitments during, in particular the construction and stabilisation phases (see below on Debt Service for more detail) will also be key. This will include for example planning, especially section 106 agreement financial commitments.

Summary: Equity



Debt Service

Image of Vox,
Manchester, courtesy of Barings Group

KEY POINTS

There are three key phases with different characteristics from the financing perspective:

- Construction – during this phase no cash flow will be generated and therefore debt service payments will need to be structured in one of four ways: (i) capitalised so that they are added to principal without there being any cash flow implication; (ii) debt facility made available to fund interest; (iii) interest payments to be met by equity; or (iv) drawing an amount under the debt facility to constitute a debt service reserve (or using subordinated debt to the same effect).

- Stabilisation – assets operate initially with a cash flow deficit. There must be structural protection to ensure that there is a source of liquidity so that debt service payments can be made, the options being similar to those that are appropriate during the construction phase.

- Operation – at this stage the asset should be self-sustaining in terms of cash flow and so should not require additional support. There is the possibility of voids during the operation phase and so a developer should set its debt burden taking some level of void risk into account. At this stage, financing terms should adjust (whether under the original facility or following a refinancing) to reflect the lower risk of an income-producing investment asset.

The Construction Phase

During the construction phase, a BTR asset will generate no cash flow. There are four ways in which debt service payments can be structured during the construction phase:

- The first is for debt service payments (in effect interest payments) to be capitalised so that they are added to principal without there being any cash flow implication.
- The second is for the debt facility to be available to fund interest. Thus, at the time of making a periodic drawing, an amount would be drawn to fund the construction costs of the BTR project and an amount would be drawn in order to fund interest. The amount drawn in order to fund interest would, in effect, be retained by the debt provider and offset against the interest that it was owed. In this approach, the commitment under the debt facility has to be sized to allow for interest drawings as well as construction cost drawings.
- The third is for interest payments to be met by equity, by providing subordinated debt or otherwise.
- The fourth is by drawing an amount under the debt facility to constitute a debt service reserve or using subordinated debt to fund a debt service reserve.

It is, of course, possible to conceive of variations and permutations to the above. What is clear, however, is that during the construction phase there will generally be no asset income which can be used to pay interest on loan amounts already drawn, so structural means have to be deployed instead.

The Stabilisation Phase

The stabilisation phase is probably the most interesting stage of a BTR project from a debt structuring standpoint.

Clearly, the sooner the stabilisation phase starts, the sooner the BTR scheme will be cash flow generative. However, even with a highly effective letting strategy commencing during the construction phase, it is unlikely that the scheme will be fully let very soon after practical completion. Developers and operators should temper their optimism and adopt conservative assumptions for the speed at which lettings will be achieved during the stabilisation phase. That will allow for a realistic runway for the letting process.

The stabilisation phase commences when residents start to move into a BTR scheme and so should start as soon as possible after practical completion is achieved (subject to the right to have snagging items and any defects identified and addressed promptly).

Image of Alameda, Wembley, courtesy of Quintain

Low level income

What makes the stabilisation phase of a BTR scheme complicated is the fact that income will start at a low level and there will in all likelihood be void costs such as rates/council tax liability. In addition, as already mentioned, whilst the income will start low and, it is expected, increase over time, the expenses of operating the scheme (other than those relating to voids) will start high as money is spent attracting potential tenants to the asset (including incentives) and operating the scheme for its early residents, and will become consistent over the long term. This cannot, realistically, be avoided. Thus, the operator will have to pay for the costs of utilities, staff and the provision of amenities from the commencement of the stabilisation phase, as it would create a bad impression among the initial residents if they received a sub-optimal service.

Cash flow deficit

It is expected that at least during the early part of the stabilisation phase, a BTR scheme will operate with a cash flow deficit. It follows that there must be structural protection to ensure that there is a source of liquidity so that debt service payments can be made, the options being similar to those that are appropriate during the construction phase. Indeed, there is some merit from the perspective of a lender in having a source of liquidity to deal with cash flow fluctuations that may arise until the operation phase has run for some time and the asset is generating a stabilised cash flow. This cash flow deficit may also be met with equity in the form of a guarantee. Operational costs will differ from asset to asset and the support required through mechanisms such as guarantees will likely taper off as stabilisation progresses.

How lenders approach stabilisation phase milestones may differ, focusing more on lettable units or overall income.

Contractual protections around levels of operating income will be a key focus during this phase.

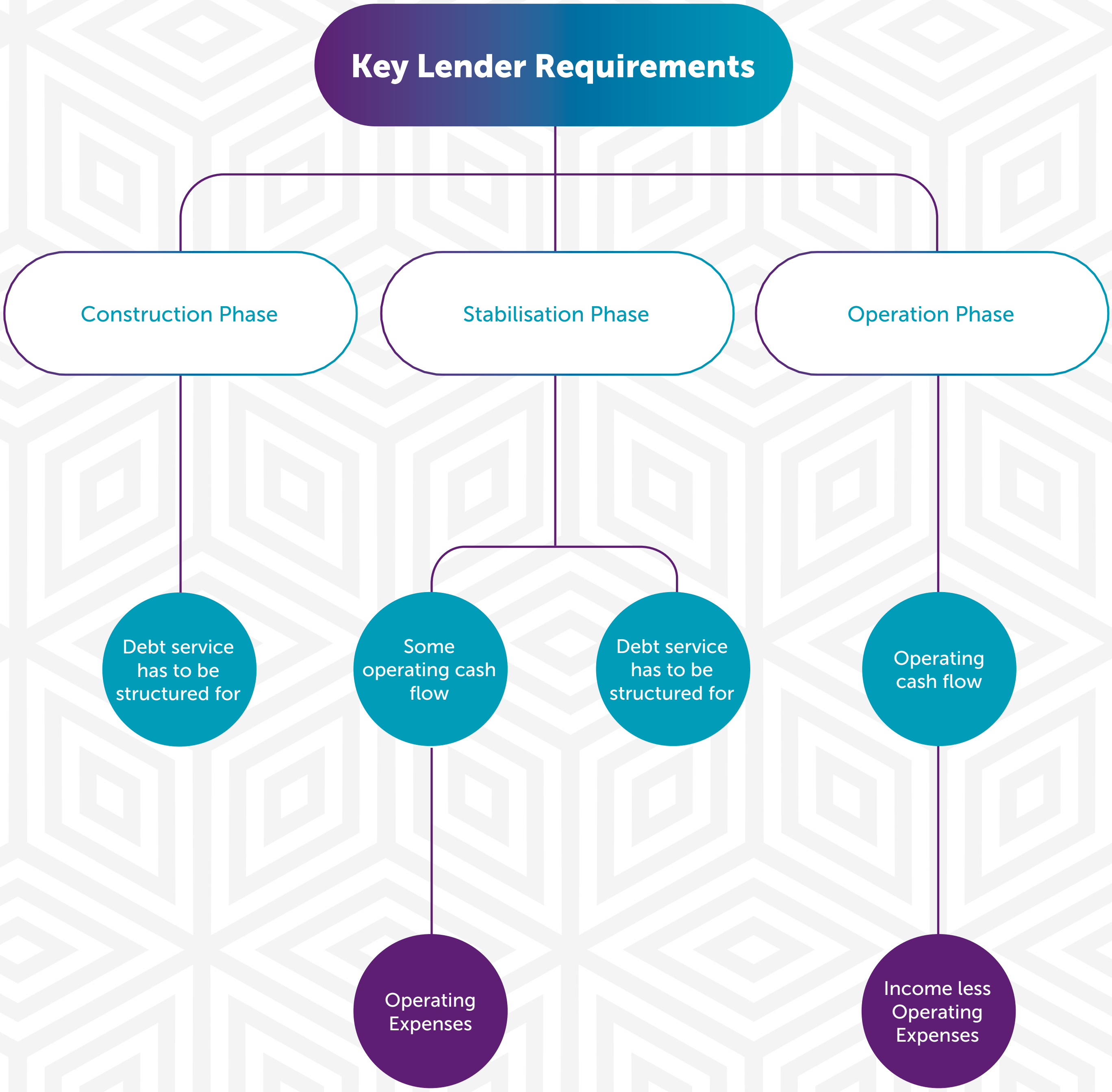
Image of Duet,
Salford Quays, courtesy of More. Superenting

The Operation Phase

The operation phase starts when a BTR scheme is stabilised (i.e., it has reached a certain level of occupancy and it is generating a certain level of net operating income). At this stage, the BTR scheme should be self-sustaining in terms of cash flow and so should not require additional support of the types described in relation to the construction phase and the stabilisation phase. There is, of course, always the possibility of voids during the operation phase and so a developer or operator should set its debt burden taking some level of void risk into account.

Ultimately, there is no single way to structure debt service during the construction phase and stabilisation phase of a BTR project. What is important is that by the time the operation phase commences, the debt burden is sustainable. What constitutes net operating income will be a key discussion between debt and equity in this context.

Summary: Debt Service



Financial Covenants

Image of Vox,
Manchester, courtesy of Barings Group

KEY POINTS

- Loan to Value (LTV) or Loan to Gross Development Value (Loan to GDV) – during the construction phase the amount of funding to be advanced may be determined using the LTV or Loan to GDV test. Even in the absence of comparables, valuers have been creative in determining methodologies that provide comfort based on the net operating income that an asset is expected to generate when construction is complete, though during the construction phase there has to be a special assumption made that the scheme is complete and is fully let.

- Loan to Cost (LTC) – this is a useful, more conservative financial covenant that can be applied during the construction phase for the purposes of sizing the loan. Provided that both the developer and the lender have been comprehensive in setting the construction budget, the LTC test is valuable in ensuring that the developer, or the equity provider, is required to contribute to the costs of the construction in a meaningful way.

- Stabilisation – lenders will undertake LTV testing during the stabilisation phase, though the valuation of the asset will be based on the special assumption that it is fully let. A preferred and more rational approach to testing income is a 'growth oriented' test, involving a combination of letting and net income milestones designed to ensure lettings are increasing. To the extent stabilisation criteria (e.g. a target occupancy level of 95% or more and a target net operating income level) are not satisfied at the end of the stabilisation phase, a developer, or its equity provider, should recognise that there is a need to take curative action such as prepaying a certain amount of the debt.

- Operation – LTV and interest cover should be tested on a quarterly basis. In addition to a traditional interest coverage ratio (ICR) test there may be merit in considering a debt yield test.

The relevance of different financial covenants varies across the construction phase, the stabilisation phase and the operation phase of a BTR scheme.

Three Roles Financial Covenants Play

In any real estate financing, financial covenants play three roles:

- First, they are used to determine how much funding will be made available by a lender, both initially and on an ongoing basis in the context of a development financing.
- Secondly, they are used to determine whether a particular scheme is displaying signs of financial distress – the so-called amber light phenomenon – that warrants the imposition by the lender of a cash trap – a mechanism designed to ensure that any surplus cash generated by an asset is held within controlled bank accounts and is available for debt service purposes rather than being released to the borrower or its equity provider. The expectation in respect of a cash trap triggered by this type of financial distress is that the distress is neither excessively severe nor permanent.
- Thirdly, they represent a default trigger – indeed one of the default triggers that lenders regard as material and in respect of which they are pre-disposed to take action. The breach of a financial covenant default trigger is regarded as evidence of structural (rather than transitory) financial distress and entitles a lender to exercise remedies available to it in a default scenario, though there will generally be some level of borrower cure right provided before the lender does so.

LTV and Loan to GDV compared to LTC

Much as for any development financing, the amount of funding that will be advanced in the context of a BTR project is determined during the construction phase. There are only two meaningful financial covenants that can be used for this purpose. The first is the Loan to Value or Loan to Gross Development Value test, pursuant to which a lender will provide a percentage of the value of the asset. In the context of a BTR scheme, the LTV or Loan to GDV approach is somewhat problematic because of the difficulty of accurately estimating the value of the BTR asset (a difficulty that is greater than for more established and mature types of real estate). That said, even in the absence of comparables, valuers have been creative in determining valuation methodologies that provide some degree of comfort based on the net operating income that an asset is expected to generate when construction is complete, though during the construction phase there has to be a special assumption made that the scheme is complete and is fully let.

A more objectively meaningful (and inherently conservative) financial covenant that can be applied during the construction phase for the purposes of sizing the loan is the Loan to Cost test. Provided that both the developer and the lender have been systematic and comprehensive in setting the construction budget (and that the construction budget has been scrutinised by the lender's project manager), the LTC test is valuable in ensuring that the developer, or the developer's equity provider, is required to contribute to the costs of the construction in a meaningful way.

> The Loan to Cost test determines the amount the lender will provide as a percentage of the budgeted construction costs.

Given that a BTR scheme will not generate any cash flow during the construction phase, there is no logical reason to impose a cash trap test during the construction phase and the only meaningful default test will be a periodic (typically, quarterly) LTV or Loan to GDV test. However, this is not particularly meaningful because the determination of value will be based on the special assumption described above and there should only really be a change if there is a material change in real estate market or financial market conditions, such as occurred during the Global Financial Crisis. It is therefore more common to test on an LTV or Loan to GDV basis at practical completion (and possibly at the outset in determining the size the loan).

The application of financial covenants during the stabilisation phase is more nuanced. During the stabilisation phase there should be no additional funding being provided, except possibly to provide liquidity for ongoing debt service payments and so the financial covenants should be applied to determine whether there are signs of financial distress or default.

Direction of travel compared to ICR

Lenders will undertake LTV testing during the stabilisation phase, though again, the valuation of the asset will probably be based on the special assumption that it is fully let. As the asset starts to generate income, however, there is a logic in testing the quantum of income that is being generated. In real estate finance transactions, the traditional approach to testing income is an interest coverage ratio (ICR) test which compares the net income generated or expected to be generated by an asset over a specified period to the interest payable during the same period. During the stabilisation phase of a BTR project, this traditional approach is unlikely to produce a satisfactory result, because gross income is expected to grow from nothing towards target levels during the stabilisation phase, whereas costs are likely to be at more or less normal levels from the outset. This means that for much of the stabilisation period, the net income may not even be sufficient to cover the interest payable, much less achieve a multiple.

Growth oriented test

A better approach to testing income during the stabilisation phase is a 'growth oriented' test designed to ensure that lettings are increasing in line with expectations. This essentially involves a combination of letting milestones (so that at particular points in time during the stabilisation phase target occupancy percentages have to be reached) and net income milestones (so that at equivalent points in time during the stabilisation phase target net income levels have to be reached). These tests should be set with some degree of flexibility to recognise that, in the real world, the letting process does not necessarily involve smooth progress to the ultimate goal and that there may be seasonal or other fluctuations in the pace of achieving lettings. Missing a single letting or net income generation target would not necessarily warrant action by the lender. If a second target is missed, that may suggest a structural problem affecting the BTR project and justify action by the lender.

To the extent that the stabilisation criteria are not satisfied at the end of the stabilisation phase, a developer, or its equity provider, should recognise that there is a need to take curative action such as prepaying a certain amount of the debt or cash collateralising it, with the possibility of release in the future.

Image of The Forge, Newcastle, courtesy of Allsop

Time limits

As with debt service considerations, the application of financial covenants during the stabilisation phase requires a thoughtful approach. A further element of a sensible approach would be to set an outside time limit for the stabilisation phase of a BTR scheme. This should be based on a conservative estimate of how long it is expected to take to achieve a target occupancy level (say 95% or more) and a target net operating income level, these being the 'stabilisation criteria'.

When LTV and ICR or debt yield become the norm

The application of financial covenants during the operation phase should not be different from the generality of real estate financings, with LTV and ICR being tested on a quarterly basis. As in the wider real estate finance market, many lenders are likely to test (alongside or instead of interest cover) the debt yield. As explained above, debt yield (comparing net operating income to the principal outstanding at the start of the relevant period) is especially useful in low interest rate conditions that can flatter interest coverage.

It may be appropriate to continue LTC testing for some time even after the scheme is stabilised, because of the capitalisation of interest and the interplay of ongoing operating costs.

Capital expenditure

In determining net operating income, in the context of both ICR and debt yield testing, some allowance should be made for capital expenditure that will have to be incurred over time. The logic for this is similar to that applicable in the context of a hotel financing: in order for a BTR scheme to attract and retain residents it is necessary that the asset is maintained to a high standard. This requires replacement of items that are subject to breakage and wear and tear as well as the need to account for one off expenses (such as the costs of refurbishing recreation facilities after several years). While these costs are not necessarily material when an asset is being built, they could become material when it is time to refinance the asset and could act as an impediment to refinancing, absent growth in value of the asset by the time refinancing is required.

Lettings test

As with any financial covenant testing, care should be taken to ensure that the tests are being appropriately applied. Thus, in determining whether a lettings test has been satisfied, only residents who occupy under approved form leases for a certain minimum period should be taken into account – otherwise, informal or transitory residents could cause a target to be satisfied. Approved leases are those entered into on an arm's length basis by residents who are not connected with the developer or operator; and if a group of residents are connected (for example, several units occupied by members of the same family) a thoughtful approach should be taken in determining how this should be taken into account in relation to the financial covenants.

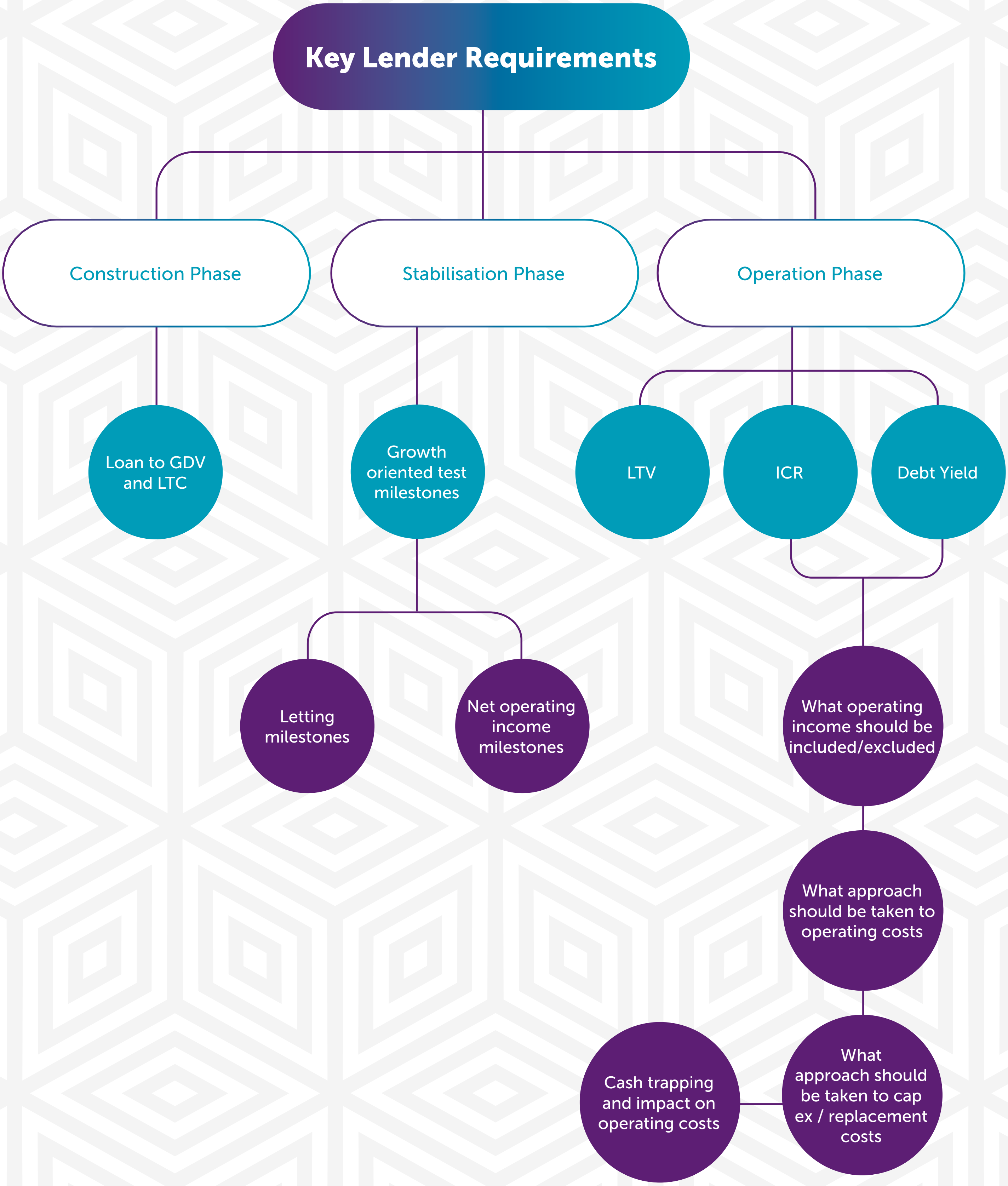
The typically short-term nature of occupational leases in a BTR scheme has implications for how financial covenant testing should be calibrated. For example, a test based on a 12 month look forward would not be helpful where few leases will have a fixed term that exceeds 12 months. It may be that incorporating a three month look forward and a three month look back would give a fairer assessment of sustainable letting patterns.

Inflation

As a final point, it is interesting to note the impact and treatment of inflation in the context of financial covenants, particularly those relating to income, given the conventional view that residential rents are typically linked to inflation. While it is undoubtedly appropriate for inflation to be clearly addressed in the business case (which is obviously a document that any lender is keenly interested in), lenders should not be expected to accept inflationary rent increase assumptions in any income projections.

Thus, while the approach to financial covenant structuring during the construction phase of a BTR scheme is similar to other development financings, there may be differences in the context of the stabilisation phase and potentially also in the operating phase. As in any real estate financing, transaction participants will need to undertake a careful assessment of financial covenants, particularly during the stabilisation and operating phases, to determine an appropriate approach in the context of any particular transaction.

Summary: Financial Covenants



Structuring During the Stabilisation Phase

Image of Angel Gardens, Manchester, courtesy of Moda Living

KEY POINTS

- Commencement of the stabilisation phase – stabilisation is a challenging period because it is inherently uncertain, with limited performance data, but it is the essential step between the construction phase and the operation of an income-producing asset. It should start as soon as possible after practical completion, but marketing of units can commence even earlier. This would involve setting up a marketing infrastructure while construction is ongoing, together with a marketing strategy, including incentives for residents' early commitment, arrangements for taking deposits and committing to residents that the asset will be operational by a certain date.

- Phase milestones – there are two lender-endorsed approaches which can also be combined as one. The first (which lenders would typically prefer) is to set stabilisation milestones requiring a certain amount of lettable space to be let by certain points coupled with a certain amount of rental income being achieved by those same points. The second approach (which is often more popular with developers) requires a certain level of occupancy and rental income to be achieved by a specified long-stop date.

- Duration of stabilisation – stabilisation must be long enough to provide the developer with a fair opportunity to achieve the ultimate stabilisation targets. From the perspective of the lender, there should be a long-stop date at which the parties acknowledge that commercial expectations for the scheme are not likely to be realised. Having said that, failure to achieve the stabilisation targets by the end of the stabilisation period should not automatically be an event of default – the lender can be de-risked through deleveraging or the provision of cash collateral.

The stabilisation phase of a BTR project – when the developer and operator start to let the asset – is the most unusual and structurally challenging: the construction phase, as described above, has many variables, but these are consistent with development projects generally and are matters which development lenders understand. The operating phase is consistent with other operationally intensive assets such as care homes, flexible offices, student accommodation or hotels. During the stabilisation phase, however, both the developer and operator, on the one hand, and the lender, on the other, are in a position of uncertainty – somewhat comparable with flexible offices, student accommodation or hotels, which also depend on the flow of short-term customers. They are testing the concept of a particular development to determine whether the commercial assumptions they made will prove to be correct. In the BTR context, performance data is limited and may be especially lumpy.

There are three dimensions that are important in determining how to structure the stabilisation phase of a BTR development:

- What triggers the start of stabilisation?
- What marks key progress milestones during stabilisation?
- What constitutes full stabilisation?

The Start of the Stabilisation Phase

The first key element to determine is when the stabilisation phase should start. Logically, this should, at the latest, be as soon as possible after practical completion. However, the sooner that marketing of the asset can start, the better, and it may well be possible for that to be before practical completion.

This has practical implications: it involves setting up a marketing infrastructure involving a show apartment as well as a functional sales team while construction is ongoing – a matter that requires coordination with the contractors. It also involves devising a marketing strategy, including incentives that will be provided to prospective tenants who commit at an early stage, putting in place arrangements for taking deposits (if they are to be taken) and being in a position to make cast-iron commitments to residents that they will be able to move into an operational scheme by a certain date.

The practical difficulties and additional work notwithstanding, commencing the marketing process prior to practical completion being achieved is in the interests of all concerned, even if this is not formally part of the stabilisation phase. It should also be borne in mind that there are certain times of the year that are more popular for finding a home than others and so there is merit in selecting such a time to commence the stabilisation phase.

> The operator's business plan will be a key lender due diligence item as part of these discussions.

Stabilisation Phase Milestones

The second key element to determine is what milestones should be set to assess the progress of the stabilisation phase. One approach is to set stabilisation targets along a defined timeline. This involves requiring that a certain, increasing amount of lettable space will be let by specified dates (the 'Occupation Targets') coupled with particular levels of rental income being achieved by those same specified dates (the 'Income Targets'). Both elements are important – it is potentially easy for a developer or operator to achieve Occupation Targets simply by lowering rents, though this would not be for the ultimate benefit of the scheme (and should also get picked up when LTV is tested). It is also possible that Income Targets could be achieved by certain apartments being over-rented, which may not be scalable or sustainable. This approach allows the trajectory of progress to be monitored.

Another approach involves requiring that by a certain ultimate point in time, say 18 or 24 months after the start of the stabilisation phase, a certain level of occupancy and rental income will have been achieved. This approach allows a greater degree of flexibility during the stabilisation phase.

While lenders might traditionally respond to missed targets by using sanctions (essentially, having the ability to call an event of default and exercising the rights that a secured creditor typically has), lenders may see merit in a more incentives-oriented approach where, the developer is rewarded for achieving stabilisation targets through a reduction in the margin of the financing (reflecting the fact that the lender's risk is reducing as the asset moves closer to being stabilised).

The two approaches to setting targets are not mutually exclusive: it is possible to set intermediate stabilisation targets which, if achieved, result in incremental margin step downs (which may be reversed if the results are not sustained), coupled with an ultimate stabilisation target which, if not achieved, would result in the occurrence of an event of default albeit mitigated with the possibility of a cure, through either deleveraging to a level consistent with the level of occupancy and rental income achieved or the provision of cash collateral to achieve the same result but which could be released as and when the ultimate stabilisation targets were met.

Among members of our working group, an ultimate target for a BTR project of between 95% and 97% of the total lettable area/ number of units was generally regarded as appropriate.

Whichever approach is adopted, it is obviously important to ensure regular information and monitoring during stabilisation.

The Duration of the Stabilisation Phase

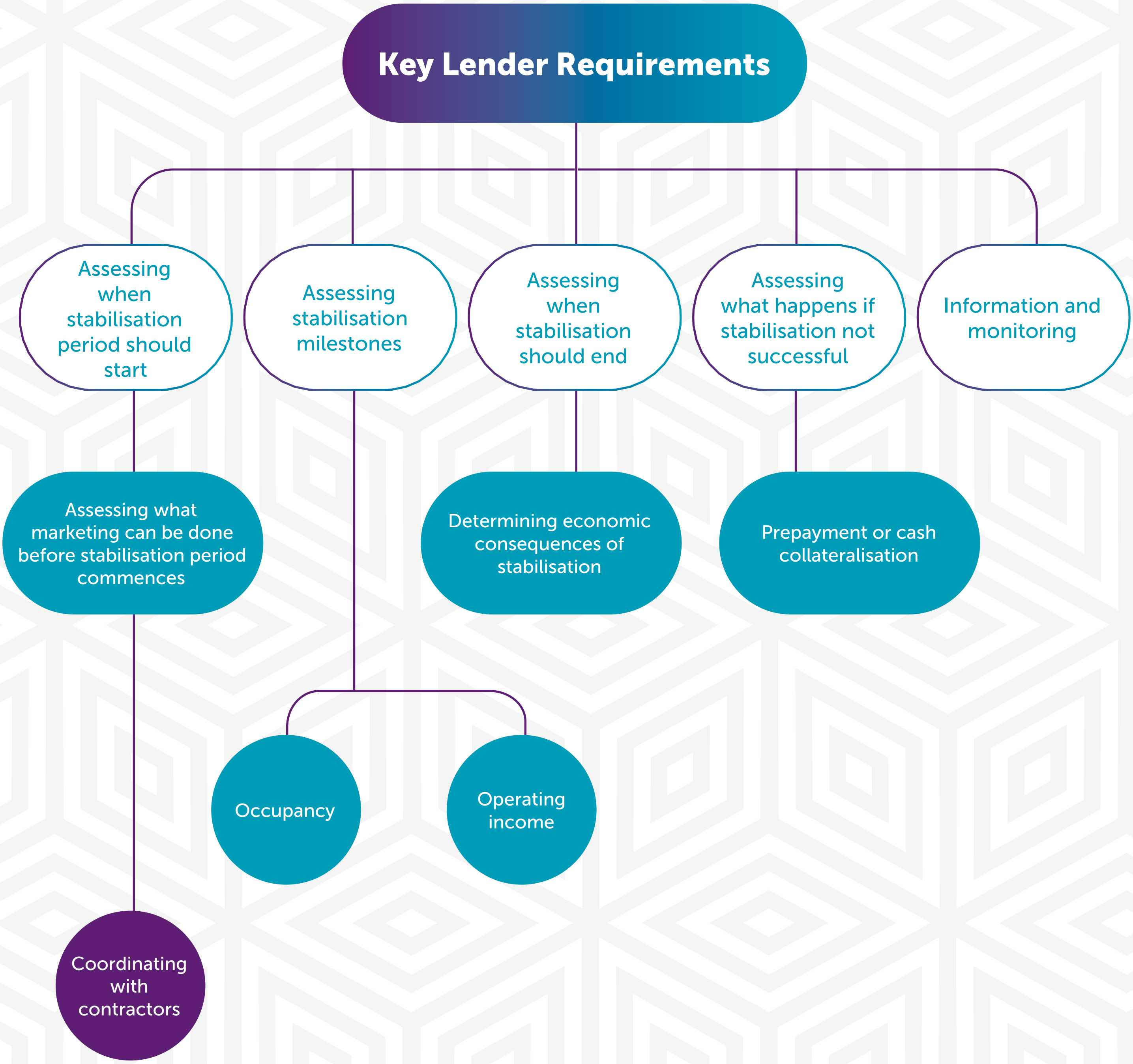
The third key element to determine is the length of the stabilisation period. This involves a certain amount of judgment. It must be long enough to provide the developer with a fair opportunity to achieve the ultimate stabilisation targets that have been set, allowing for a level of seasonal variability. At the same time, from the lender's perspective, there should come a point where the commercial reality of there being insufficient demand for a particular scheme as envisaged should be recognised. It does not necessarily have to be the case that, if the developer has failed to achieve the stabilisation targets by the end of the stabilisation period, that constitutes an event of default. The lender can equally be de-risked through deleveraging or the provision of cash collateral, as described above.

As indicated previously, another unusual feature of the stabilisation phase in the BTR context is the fact that, while rental income is expected to increase, expenses will be running at around the same level as they would during the operation phase. Indeed, it would not necessarily be in the overall interest of the scheme for expenses to be reduced during the stabilisation phase as this could hamper its marketing and affect the experience of the early residents. From a financing perspective, however, it is necessary that the developer and operator have made provision for there to be sufficient liquidity during the stabilisation phase for expenses to be met.

Thus, from a structuring and an operational perspective, the stabilisation phase of a BTR project necessitates a thoughtful approach from both the developer and operator on the one hand and the lender on the other.

Image of The Forge,
Newcastle, courtesy of Allsop

Summary: Stabilisation Period



Operational Due Diligence

Image of Vantage Point, Islington, courtesy of Essential Living

KEY POINTS

- Operational complexity – this is a defining feature of BTR as an asset class. A developer that intends to operate the asset should be able to clearly demonstrate the services it contemplates providing; how such services will be organised (whether in-house or outsourced) and the cost of providing such services.

- Employees – employees will typically be employed by an entity other than the one that owns the asset (and is the primary borrower), conforming to the common expectation in real estate financing that the real estate is owned by an SPV with little or nothing by way of other assets or liabilities. Departing from that norm, which may suit certain operators, will require being able to establish that the employment costs are limited and that systems exist to prevent/limit employment-related claims arising.

- Legislation – there is a considerable body of law and regulation that has a bearing on the operations of a BTR asset, governing matters including fees charged to tenants; levels of deposit; standards of repair and safety measures; and fire and electrical safety. Operators will also be managing a considerable amount of personal data which has GDPR implications.

- Replacement – one of the justifications for charging a premium rent (as is often the goal for BTR schemes) is the quality of the accommodation. Ordinary wear and tear has a bearing on the overall quality of a BTR asset and therefore operators should take account of how repairs, maintenance and updating will be managed and budgeted for. This should in turn feed into how financial covenants are set; there should be an expectation that there will be elements of repair and maintenance in the budgetary regime.

Operational Complexity

As described above, one of the defining features of BTR as an asset class is its operational complexity. There are a number of services that will have to be provided by the operator of a BTR scheme, if it is to attract and retain residents. These will typically include reception and concierge services, security, cleaning and maintenance and highly responsive repairs, recreational amenities and hospitality services. The higher the specification of services in any BTR scheme, the more complex the operational due diligence will be. Understanding the extent of what is being or to be provided and how is a vital element in any due diligence process. At the same time, there will always be those matters that are essential to the resident experience, providing the key means of creating resident loyalty. This is important given the profile of average lease length terms under the assured shorthold tenancy framework and the need to maintain occupancy levels whatever the extent of facilities to be provided.

It is consistent with the norms of real estate finance for employees to be employed by an entity other than the one that owns the asset and that is the primary debtor. An operator that wishes to depart from that norm should be prepared to demonstrate how employee-related liabilities and risks will be managed and controlled.

Employees

A developer and operator seeking debt finance should be in a position to articulate to a proposed lender what services it contemplates providing; how the provision of such services will be organised and the cost of providing such services. These are all basic matters but it should be recognised that developers and operators may have more experience and greater visibility of these matters than the lender and so it is helpful to a lender to have this information presented in a methodical, granular way, so that it can be appropriately assessed.

There are, broadly, two ways in which the provision of these services can be organised:

- On an in-house basis, where the operator employs the staff to provide the relevant services; or
- By outsourcing the provision of the services.

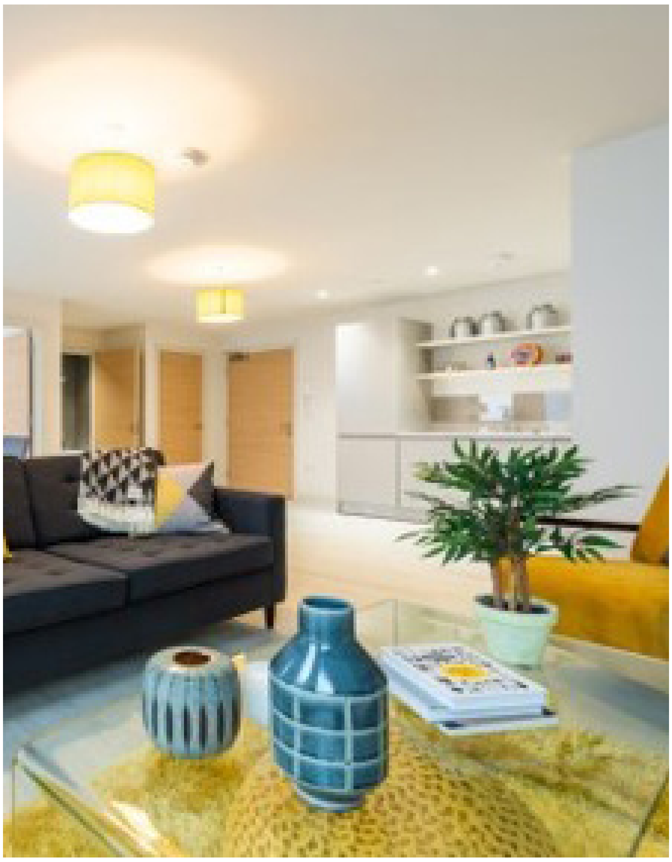


Image of The Trilogy, Manchester, courtesy of Allsop

Each approach gives rise to different considerations from the lender's perspective. If the services are being provided by the operator on an in-house basis, the lender has to be satisfied that the operator has sufficient staff who are appropriately trained, and not likely to have an unacceptably high level of turnover, particularly in key roles or in roles where it may be difficult to find replacement staff. The operator should also be able to demonstrate in detail the determination of staff costs. A lender should also consider what alternative provision may be available in a downside scenario.

Outsourcing

If the services are being provided on an outsourced basis, the operator should be able to demonstrate to a lender its rights and obligations under each of the outsourcing contracts and both the financial strength and operational experience of the contractor that is being retained. The outsourcing contracts should provide as much price stability as is possible. The operator should also be able to demonstrate what the termination arrangements under the outsourcing contracts are. Just as it is not desirable for a contractor to be able to terminate the outsourcing contract too easily it is also not desirable that an operator cannot remove a contractor which is not performing adequately (or if such a situation can arise, the lender may want to ensure that it is able to step in). In other words, any lender should have visibility on and some control over what happens if an outsourcing relationship is not working, just as it does in the context of an asset management agreement or property management agreement in the context of a traditional real estate financing. Finally, a lender should have some level of comfort that there are alternative contractors who will be able to provide the necessary services if the contractor which is originally appointed is subject to financial distress or is otherwise unable to perform the relevant services and that the costs associated with a replacement contractor would not compromise the financial viability of the project.

These are all matters that require both initial due diligence and ongoing monitoring. As a documentation matter, a lender will ideally like to take security over all of the operator's rights under any outsourced operating contracts so that, in an event of default scenario, the rights against the third party can be enforced and operational continuity maintained. It would be normal (as for other real estate lending) for any asset manager/property manager to enter into a direct duty of care agreement with the lender giving the lender comfort that in an enforcement scenario, only the lender (and not the manager) will have the unilateral right to terminate the key operational agreement.

Legislation

A considerable body of law and regulation has a bearing on the operation of a BTR asset. As with any industry where there is an element of unskilled labour, it is necessary to be aware of the Modern Slavery Act 2015. Failure to comply with obligations under this legislation could result in financial penalties being imposed on the operator (or the entity owning the asset). Other examples of legislation impacting upon the operation of a BTR asset include the Tenant Fees Act 2019 which limits the fees and level of deposit (now capped at five weeks' rent) that a landlord can charge a tenant. There is a large body of legislation governing the standard of repair and safety measures that landlords must observe, starting with the Housing Act 1988 through to the Homes (Fitness for Human Habitation) Act 2018. Landlords are responsible by statute for the repair and maintenance of the structure, external parts, sanitary ware and boilers and heating systems. They must carry out gas safety checks on an annual basis (failure to do so is a criminal offence). Other landlord responsibilities include electrical safety (PAT testing of appliances and fixed wire tests), and the provision of fire alarms and carbon monoxide indicators. Given the risk to human life and health, many of these regulations carry a criminal penalty if violated.

It is also worth remembering that all residential tenancies (with some very limited exceptions) benefit from the Protection from Eviction Act 1977. This means that a court order will always be required to evict a residential tenant. It is also worth noting that the operator will be managing a considerable amount of individual personal data of the tenants and therefore compliance with the Data Protection Act 2018 and General Data Protection Regulation (EU) 2016/679 will need to take place and the roles of data controllers and data processors must be made clear in the contractual matrix.

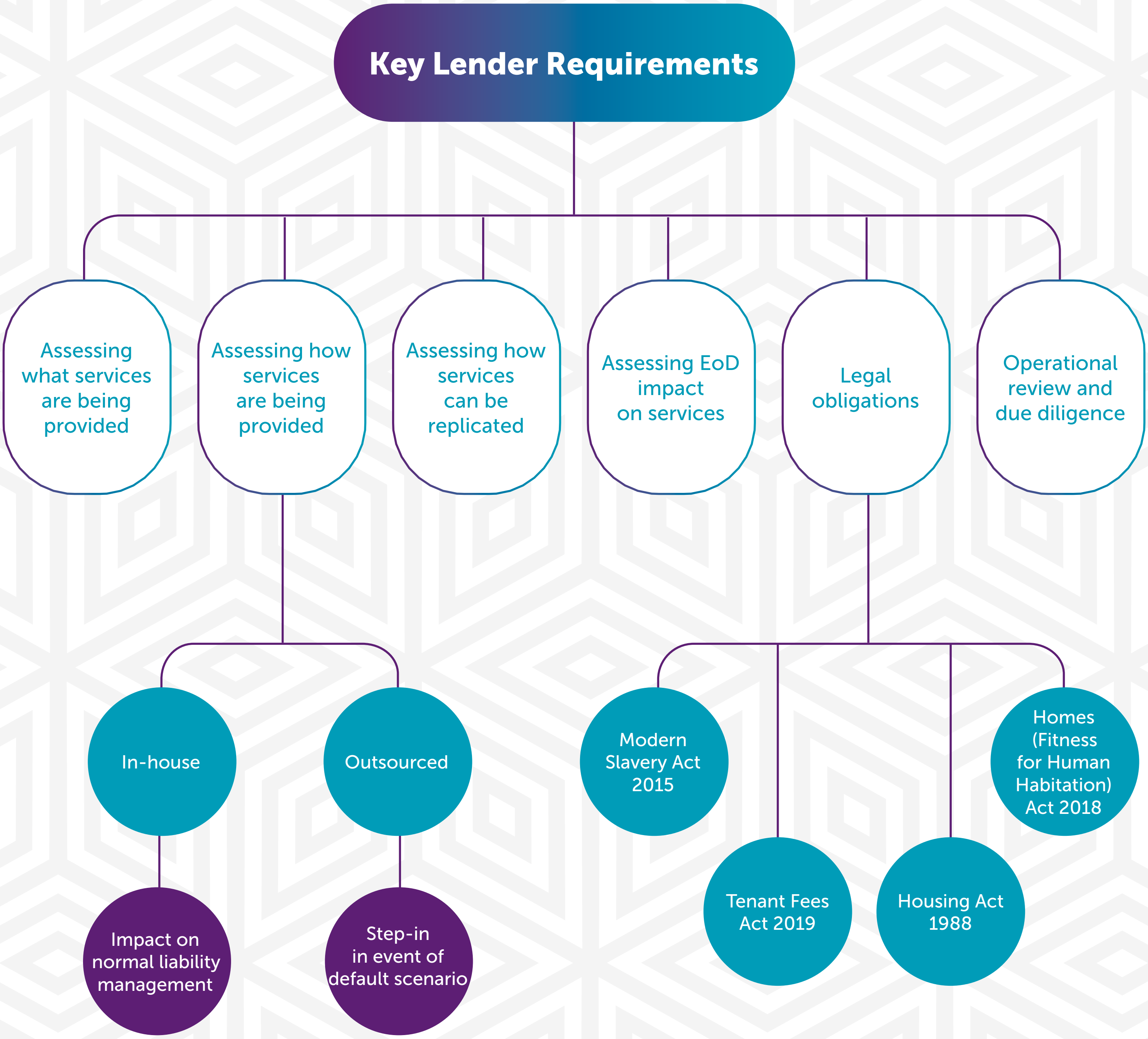
For lenders coming to BTR finance from the mainstream real estate financing market, this level of regulation will require an unaccustomed degree of attention to detail, additional due diligence and rigorous compliance systems, both at the time any debt is provided and on an ongoing basis.

Replacement

Finally, another operationally complex area with financial ramifications is the process of replacing or updating assets. While the BTR sector is in its early stages, replacement of assets may seem a problem for tomorrow. However, a key justification for charging the premium rent that many schemes aim for is the quality of the accommodation provided to residents. For more budget offerings, the net returns from managing the asset will also depend on the frequency and cost of repairs, maintenance and replacement of fixtures and fittings, and that in turn depends on the initial design and build quality.

Ordinary wear and tear clearly has a bearing on overall quality of a BTR asset and so operators and lenders should take account of how these processes will be managed and budgeted for in the agreed approach to capital expenditure, reflecting that in financial covenant calculations. There should be an expectation that there will be elements of repair and maintenance in the budgetary regime and from around year five, possible a sinking fund to address longer term needs.

Summary: Operational Due Diligence



Cash Flow Control

Image of Blackhorse Mills,
Waltham Forest, courtesy of Assael Architecture

KEY POINTS

- Control of cash flow – unlike traditional real estate assets there is no earmarked cash flow for a BTR asset that can be appropriated to meet the operating costs. BTR assets are operationally intensive and it would be administratively cumbersome to have to approach the lender for every payment and/or for there to be different accounts. Parties will devise their own mechanisms, depending on the financial strength and experience levels of the developer/operator, and ways of funding working capital for unexpected costs, depending on the circumstances of each project or protecting against identified risks.

- Rent account – one approach is for all receipts to be paid into a single rent account, with a budgeted amount being released on a monthly or quarterly basis to the operator to meet operating expenses. The inflexibility of this approach can be problematic in the event of an unexpected expense, or if expected rents are not received after funds have been released.

- Cash flow release – a less traditional approach is for all receipts to be released to the operator with the lender paid the amount owed under the loan facility on a quarterly basis (unless there has been a deterioration in operational performance/net operating income beyond an agreed level, in which case receipts are diverted to a lender-controlled rent account. It is potentially more difficult for the lender to assert control over cash flow when there is a deterioration in the performance, so this requires careful consideration.

- Hybrid approach – on this approach, residents pay into a rent account but the lender releases all amounts collected once a certain balance is achieved. There is a cash trap mechanism whereby if there is credit deterioration beyond a certain point, no funds are released to the operator without specific lender approval. The operator has control over the excess cash flow, while the lender is protected by retaining control over sufficient cash flow to cover debt service payments and by being able to extend control in the event of performance deterioration.

Different Approaches to Cash Flow Management

It is well understood that real estate lenders place great emphasis on having control over the cash flow generated by the assets that they are financing. This is for three reasons:

- First, control of cash flow is the most effective way to understand the performance of the asset in terms of income generation. If occupational tenants are paying rent as expected and this is reflected in the balance of the bank account in which rent is collected (typically known as the Rent Account), this is evidence of satisfactory performance.
- Secondly, if the developer or operator requires funds for any reason, such as an unexpected expense, the lender will have both meaningful oversight and control over the process by which application is made to it to release the necessary funds.
- Thirdly, from a risk management perspective, there is no better asset than cash for a lender to have immediate access to in a default scenario.

There are two reasons why the traditional real estate asset approach is not suitable in the BTR context. First, the amount paid by residents does not include a service charge element – indeed, one of the attractive features from the perspective of a resident is that it is only required to make a single, all-inclusive payment of rent, out of which the landlord or operator must fund repairs and other services. Thus, there is no identifiable cash flow that can be appropriated to meet the costs of operating the asset. Secondly, the fact that BTR assets are operationally intensive means that there are a greater number and variety of expenses to be paid by the operator and it would be administratively cumbersome for the operator to have to approach the lender for every payment that it was required to make and/or for there to be different accounts for the payments to be made to. It is probably also the case that, at least until UK BTR has established a track record at scale and over many years, it will not be easy to predict with confidence the level of operating costs that can reasonably be expected for a particular scheme.

TRADITIONAL REAL ESTATE ASSET

Periodic payments paid by tenants (rent and service charges) are collected by a managing agent who typically retains the service charge element and pays the rent into the Rent Account. This approach ensures that the managing agent has access to liquidity to meet the running costs of the property. At the end of each quarter period, the lender applies funds held in the Rent Account to pay amounts owed to it in respect of interest, principal, fees, costs and expenses and, absent any evidence of performance deterioration, will release the balance to the owner of the asset.

Alternative structuring approaches

Against those conflicting priorities, three alternative structuring approaches might be adopted by lenders. The first is the traditional one of all rent payments being paid into the Rent Account, with a specific, budgeted amount being released on a monthly or quarterly basis to the operator to meet operating expenses. This is attractive for the lender but can be problematic from the perspective of the operator if there is an unexpected expense that has to be met. Issues can also arise for the lender if rents expected later in the quarter are not collected, and cash that would have served to make payments to the lender have already been disbursed to the operator.

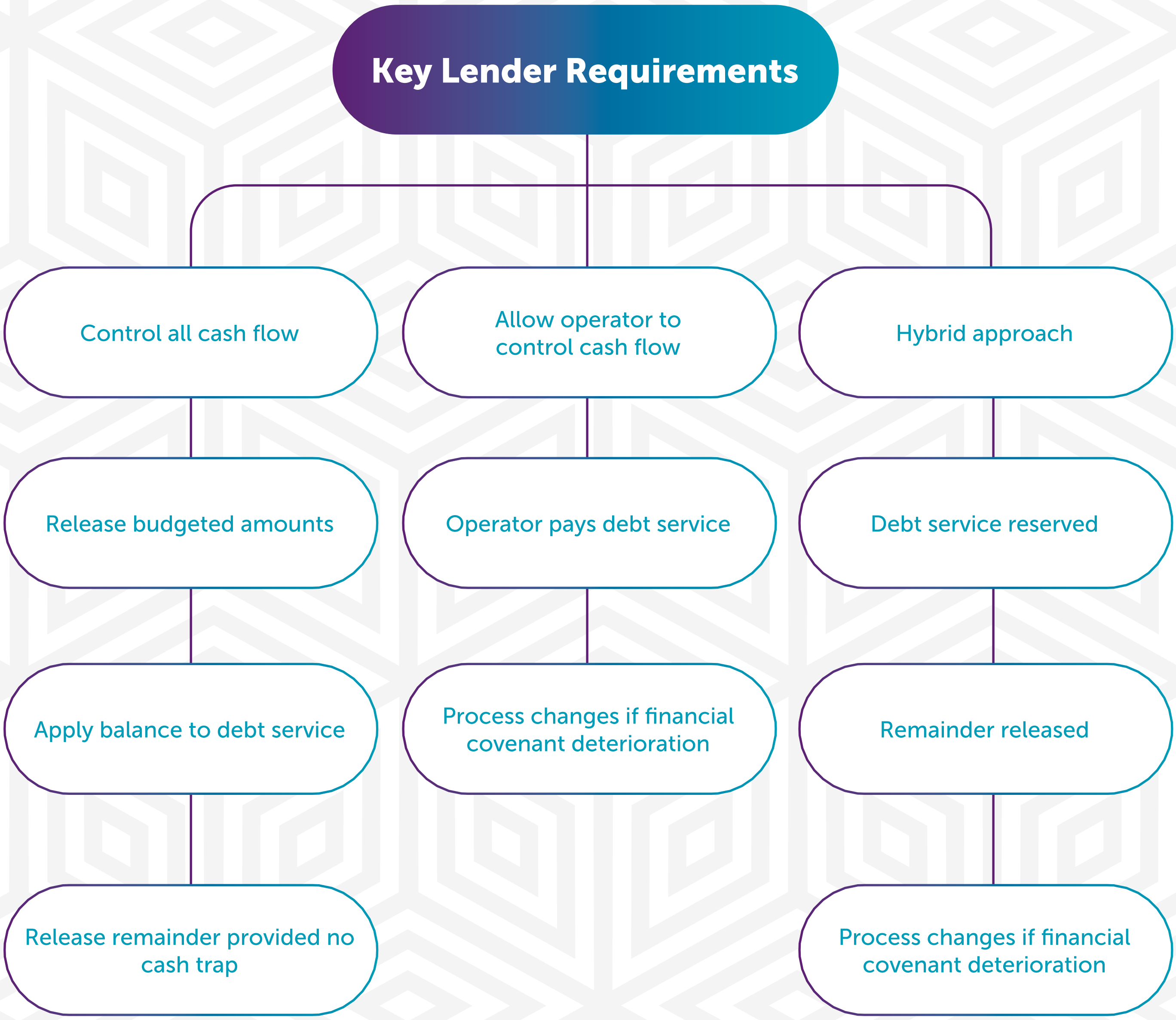
A second approach is the less traditional one of all cash flow being released to the operator and the operator paying the lender the amount owed under the loan facility on a quarterly basis, unless and until a sufficient deterioration in operational performance is flagged by the financial covenants, at which point cash flows are diverted to the lender-controlled Rent Account. While this approach recognises the operational value of easy access to liquidity, it leaves the lender exposed with less visibility and control over cash flows. The lender may even have problems taking control over cash flow when there is a deterioration in the performance of the asset, as residents will have set up their rent payment methods and may not be willing or able quickly to alter them so that they make payment to the Rent Account.

A hybrid approach involves requiring residents to make payment into the Rent Account, but on the basis that the lender releases all amounts collected during a quarterly payment cycle once a certain balance is achieved, this being sized to take account of the interest, principal, fees, costs and expenses payable under the loan facility, potentially also retaining a liquidity buffer. In the event that there is credit or performance deterioration beyond a certain point, release of funds becomes subject to specific lender approval. This is effectively a cash trap mechanism, giving the operator a good degree of control over the cash flow while there are no concerns from an operational perspective, while protecting the lender through its underlying control of the Rent Account.

Clearly, the parties can be creative in devising their own mechanisms for structuring control of cash flow. A range of factors will be relevant, including the financial strength and experience levels of the developer/operator, the relationship between lender and borrower and consideration of how expected and unexpected working capital needs can be funded so as best to balance the priorities of each party.

Image of The Keel,
Liverpool, courtesy of Barings Group

Summary: Cash Flow Control



Conclusion

The working group's journey towards this paper was a long and winding one, but it was also scenic, involving a great deal of valuable sharing of perspectives and information. We hope this analysis of BTR finance makes a useful contribution to supporting the growth of BTR into a significant element of the UK's real estate investment landscape and, indeed, housing market. The members of the working group were generous with their time and their experiences. Whilst there is no doubt that as BTR becomes more established, market practices will emerge, it is hoped that this work will help market participants, both on the borrower side and the lender side, in transacting and in establishing a more liquid financing market.

It is intended to maintain the connections established in the working group so that follow-up work can be conducted if it is felt to be valuable. Market feedback should be directed to the report authors or to the CREFC secretariat.

Image of Vantage Point,
Islington, courtesy of Essential Living

Appendix

Construction

There are a number of actions that developers or operators can take to provide lenders with comfort that the construction work of a BTR scheme will be appropriately undertaken, particularly around:

- Contractor and construction budget due diligence;
- Contractor default risk; and
- Construction monitoring

Facilitating Contractor Due Diligence

To facilitate the first requirement around the identity and robustness of the construction team, the borrower/sponsor should provide the lender with adequate information about the contractors (whatever the contractual approach) so that their operational and financial capabilities can be properly assessed by the lenders at the outset. This should include checking professional indemnity insurance levels from appropriate members of the professional team including the main contractor and those with design responsibilities and, in the context of a construction management arrangement, verifying the amount and type of professional indemnity cover for each of the contractors (all of whom will owe a direct duty of care to the developer). Albeit contractors are typically contractually and professionally required to maintain professional indemnity insurance, the amount of PI cover can vary considerably. This diligence should also, ideally, extend to include any parent or holding company of the contractor as well as reviewing how a contractor organises and deals with its supply chain. The supply chain and who the main contractor proposes to appoint is extremely important, particularly as many main design and build contractors sub-contract as much of the works as possible. It is important, where possible, to ensure that the lender is reasonably involved in this selection process and any changes to the team, provided that does not unduly interfere with the timing of the process.

The reason for this is that any material disruption to a contractor's supply chain could have a bearing on the construction process and so even in the context of a lump sum contract price design and build arrangement, there is a commercial rationale in looking behind the main contractor. Further, lenders (and developers and operators, equally, as well as their equity backers) are increasingly likely to have ESG policies and commitments and want to ensure they are respected by their counterparties. These are issues that a lender would often expect to be addressed in negotiating the construction package of contracts, appointments and warranties or third party rights that are available. For most developers/operators of substance, they are likely to have their own ESG guidelines and a good starting point for any lender therefore would be to ask to see these.

> The construction industry, by its nature, is more susceptible to violations of best environmental, social and governance (ESG) practice than many others and should be subject to diligence, from a developer or operator (equity) perspective but also from a lender (debt) perspective. ESG violations are not only a source of financial liability but could have a reputational impact that adversely affects the marketing of a BTR scheme.

Some BTR operators are adopting certifications of environmental performance and social impact, and industry bodies including the British Property Federation and Urban Land Institute are continuing to produce research and guidance in this area.

Budget

In addition to due diligence in respect of the contractor itself, a lender will typically undertake a detailed review of the construction budget. This is often undertaken using a third party expert. It is very important that the construction budget is comprehensive and well considered and that the developer is able to defend its contents. A failure to do so can result in a lender losing confidence in the process that it is being presented with.

> BTR lends itself to being a great vehicle for demonstrable change in the ESG field, offering significant scope for addressing both climate and social concerns in the same project.

Environmental Social and Governance

ESG considerations have become an increasingly hot topic across much of the business and financial world - and they are very much in point in the context of BTR.

Elements for consideration include:

- the use of sustainable natural materials in construction
- environmental impact of construction methods
- life cycle/durability considerations
- water conservation and management processes
- carbon reduction and renewable power sources
- electricity efficiencies
- sound and noise insulation
- recyclable waste provision
- reduction in use of cars/increase in use of 'clean' transportation
- diversity in workforce
- access to housing
- investment opportunity in wider local community
- anti-corruption
- anti-modern slavery

Demand for change is driven by employees, investors and customers but in BTR it is the institutional investor that is driving this change fastest (although all three cohorts have moved from being passive to active about ESG, and therefore no lender should ignore this element). Whilst ESG commitments can be project/investor specific, transparency is a vital part of the make-up of any ESG analysis.

Finally in this context, we should also specifically mention 'green' financing, which is another emerging trend that is widely perceived as being here to stay, with both the International Capital Market Association and the Loan Market Association having established principles as voluntary guidelines to those seeking to lend to green investments or developments or on a sustainability-linked basis suggesting, amongst other matters, what would constitute a green project to which any green bond or loan might apply. Further movement in this area is expected under evolving national and international climate-related policies, but it is beyond the scope of this paper to address that broader topic.

Addressing Contractor Default Risk

To ensure a BTR scheme keeps to time, cost and quality, it is necessary to have the means to deal with contractor default from a financial perspective. The traditional approach for that is to obtain a guarantee from the contractor's parent or the provision of a performance bond issued by a suitably creditworthy third party which allows the completion of the construction work to be paid for. Whilst undoubtedly helpful from the perspective of lenders, in practice, these measures do not always operate in a manner which is optimal – the financial strength of a contractor's parent may well be impacted at the same time as the contractor's default and the provider of a performance bond will impose its own processes in respect of a claim being made, which may be a source of friction and delay. Even where the solvency of the contractor's parent remains intact, delays in recoveries under performance bonds can mean that some developers would prefer to address payment through equity for the new contractor and then recover those sums from the performance bond in due course (rather than the bond paying out to meet payments direct, so as to keep the construction on track). An additional consideration in the case of a performance bond is that it will be limited, typically to an amount equal to 10% of the contract sum and will usually expire at practical completion of the development (although this may be extended, in which case there is usually a contractor's overhead for dealing with such extension).

Developers can also consider delayed start insurance which will insure the developer against the financial consequences of the project as a whole being delayed. The reality is sometimes things do go awry and such insurance adds an extra layer of protection for lenders and equity providers alike. The availability and acceptability of such insurance very much depends on the profile of the borrower.

What is considered more helpful is having a developer or operator with sufficient financial resources of its own, or the backing of an equity provider (which may be a forward funder), to be able to fund the completion of construction. Developers and operators generally accept the need to provide these forms of support but equally have noted that a considerable amount of time is spent negotiating the terms of such arrangements and that it would be helpful if lenders outline their requirements as early as possible and adopt an approach which reflects the financial strength and commitments of the parties involved.

Where modern methods of construction are used (see further below), advance payment bonds may also typically be provided as a means of giving a layer of payment security.

> MMC typically involves the construction of the building shell on site, but the creation of the interior, at least in part, in an offsite manufacturing facility, using precision engineering techniques. In the context of a BTR scheme, this would involve building the interior of flats off site and then slotting them into the shell of the building.

Modern Methods of Construction

One aspect of the construction arrangements in respect of BTR schemes that was beyond the scope of this paper but came up often in industry discussions is the use of modern or advanced methods of construction (MMC or AMC).

The use of MMC is relatively familiar in the context of purpose-built student accommodation and hotels, but it is not yet well established in housing. MMC offers benefits when compared to conventional construction techniques both from a cost and timing perspective as well as from a qualitative perspective. Because the MMC units are constructed within a factory setting and so are not subject to the vagaries of the weather (save for the transportation of any MMC units to the relevant site), they achieve a high degree of homogeneity between units and can be built within more controlled time frames. There are still, however, some practical constraints on the use of MMC such as the height of the structure within which MMC may be used.

Challenges

These advantages notwithstanding, MMC does pose certain challenges for lenders. The most glaring of these is in relation to the significant front-loading of the assembly costs and the risk of insolvency of the offsite contractor, payment of large sums of money in advance of receipt of the completed asset and title in the asset itself. If the offsite contractor became subject to insolvency during the construction process, the units that were being constructed off site, if they were assets belonging to it legally, would be available to meet the claims of the generality of its creditors. In order to protect against this situation, it is possible for the developer to use retention of title or security techniques, but it is unlikely that an off-site contractor will accept restrictions on the business it undertakes so as to minimise its exposure to insolvency risk or agree to financial strength testing.

More operationally, if an off-site contractor was unable to complete the work in respect of a BTR scheme because it became subject to insolvency, or because its manufacturing facility was destroyed, another such contractor would have to be found, or the developer would have to revert to a more traditional means of construction. Such alternative contractors are not necessarily easy to locate, however, and there would, in any event, be issues around transporting part finished units from one contractor's site to another's, as well as around consistency in and replicability of measurements, materials and configuration.

It will generally make sense for lenders financing a scheme using MMC to ensure that the development management agreement includes clear requirements for the development manager to manage MMC-specific risks. Reporting requirements and step-in rights and the hierarchy of how step-in rights are to be managed between the developer and the lender vis-à-vis the contractor and the rest of the professional team also need to be carefully considered.

Developers who use MMC have developed some operational mitigants, such as limiting the number of units that are being constructed off-site at any one point in time and moving them on-site at regular intervals. It is hoped that as the use of MMC increases, we will see more legal and commercial protections being developed to deal with these matters, as well as the emergence of more MMC contractors. It seems clear that MMC can play an important role in the delivery of more housing of consistently good quality quickly and cost effectively in due course. In the meantime, any lender involved in an MMC construction will have to proceed in a thoughtful manner to mitigate those risks.

Keeping the Construction Process on Track

While in this respect BTR finance is similar to any other significant development financing, it is worth highlighting three ways in which lenders can try to ensure that the construction process stays on track from a practical perspective, so that a successful conclusion is reached:

- the role of the developer as the prime interface;
- collateral warranties/third party rights notices; and
- use of a project monitor.

Developers

The first area considers the role of the developer, insofar as it relates to its development management function. Lenders recognise that the developer plays a critical role in managing the construction process and is the primary interface with the construction team. The developer can be incentivised to ensure that the construction is completed in a satisfactory manner by putting an adequate 'developer's retention' in place until practical completion and then a further sum until all snagging defects are made good. Thus, while the developer may be entitled to periodic payments under the terms of the development agreement/forward funding agreement, a significant portion of such payments should, if such an approach is being adopted, either not be funded or if funded, be retained within lender-controlled bank accounts and only be released once the construction is complete and any rectification period has elapsed/defects made good. Having a suitable retention regime between developer and contractors is also helpful in aligning interests and cash flows for the successful completion of the project.

Collateral warranties and third party rights notices

The second way is the more traditional means of collateral warranties provided by the contractors directly to the lenders with attendant step-in rights in the lender's favour and more recently, third party rights notices served on professional team members. These allow lenders to exercise rights directly against the contractors and/or other professional team members, upon the occurrence of relevant triggers. Whilst this gives the lender recourse directly to the contractor, professional team and any principal sub-contractors, a lender would not typically seek to enforce these rights if there is an event of default under the finance agreement until all recourse against the developer has been exhausted. Only then is it likely to exercise its rights of step-in to complete the development or to transfer to a purchaser to enable them to do so.

Project monitoring

The third route is through the ongoing monitoring of the construction process by a third party appointed by the lender who is independent of the construction team. The role of the project monitor is seen as a vital independent verification process of the works done and the monies spent on site on the lender's behalf.

Thus, while BTR schemes are no more complex than other construction projects they are by no means simple. Developers and operators should exercise a degree of care to ensure that all the moving parts are being dealt with in a systematic way and that any requirements that a particular lender has, particularly in relation to financial support, are identified early and before the construction arrangements are finalised. The same goes for arrangements in respect of the developer's profit, for example in the context of a forward funding – these would need to be revisited if lenders did not regard them as acceptable. Conversely, it is helpful for lenders to be able to provide early clarity in terms of their requirements in relation to the matters described above.

One area that might usefully be considered when drawing up the construction arrangements is ensuring that show homes are complete and available for viewing before (and possibly significantly before) practical completion is achieved and that there is a means for prospective tenants to view them without taking health and safety risks or disrupting the construction process. This is intended to enable a developer or operator to approach the letting process efficiently, starting such activity well before construction is complete. More can be found on this topic, in the context of the stabilisation period, on page 42.

crefceurope.org

CREFC Europe