Guide To propery Development Finance

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Welcome

Many successful property investors would like to get involved in property development as the next step of their property journey but feel they lack the knowledge to do so. One of the main barriers to entry is understanding about funding such a project.

In this guide, we explain what development finance is and how it works. We will explain how projects are typically funded, and the cost you would expect to pay. We also include a list of common questions people ask about this side of property development.

If after reading this guide you feel that property development might be for you, but would like to know more about development finance then contact your designated consultant who will be happy to give you further information.

Whilst this brochure is restricted to development finance, we can also help you with the other areas of property development too. So if you would like to know more about construction and regulation then contact Esper Wealth today to gain access to all the information you need.

What is development finance?

Property development finance is a type of business finance which is used to fund a residential, commercial or mix-use property development. It's a fairly broad category that covers a multitude of lending arrangements. This can include term loans, mortgages, and bridging loans. However, development finance is predominantly concentrating on larger-scale funding for developments from the ground up. In this context, we are typically talking about property development for apartment blocks.

Projects which require lighter work, such as internal refurbishment are probably better suited to bridging loan finance.

Interest is calculated differently compared to residential mortgages. Usually, the lender retains interest upfront at each stage of drawdown. This means there are no monthly payments to make. As soon as the development is complete, the loan is redeemed along with any accrued interest.

This way of doing things suits the borrower and lender alike. This is because cash flow can be difficult to manage during a development build. Removing the need for monthly repayments makes the loan easier for the developer to manage. The lender they have the security of interest upfront.

How does development finance work?

Development finance can be more complex compared to residential mortgages. Funds are advanced upfront and then at various stages throughout the build

At stage one, money is initially advanced against the value of the site. Typically, lenders advance up to 60-65% of the value. Though some lenders offer more.

Once the build has started, additional funds are released at agreed intervals. Lenders are often happy to fund up to 100% of the build costs. At the time of each stage release payment, the site will be re-inspected by a lender representative or a third-party surveyor. If the lender feels the work is progressing to plan, they will release the next stage of funds. Essentially, the lender is looking for confirmation that work is being carried out to a high standard and that there is sufficient value in the site to warrant the next stage of funding.

This process of reinspection and further staged drawdown are then repeated a number of times. This cycle finishes when the development is completed.

Cost Of Finance

This is the million-dollar question. And the rate charged will depend on a multitude of factors. The main factors are listed below.

Interest rate

The headline cost is always the interest rate. There are a number of factors which determine this rate. The biggest ones are as follows:

- **Loan size.** Loans of £500,000 or more, typically cost 4-9% per annum depending on other factors. Larger loans can be as high as £100 million. Whilst small loans of a value below £500,000 will usually cost 9-12% per annum. However, if the deal is sound this cost could be reduced to 6.5% per annum.
- **Gearing.** A higher percentage of borrowing from the lender will result in a higher interest rate. This is because the lender has less security, so it perceives the deal to be riskier.
- **Creditworthiness.** Lenders look at the directors of the business and the solvency of the company and will make a decision as to risk. If a company is financially sound and so are the directors, then the lender will offer preferential rates.
- **Experience.** Lenders like a track record. If the management team is experienced, then this will give the lender confidence and will be reflected in the rate.
- **Wider economy.** Lenders will look at outside factors when determining how to price. They will look at things like the current base rate, and inflation, as well as take a view on the strength of the property market.

Other fees

There will be some other fees. The main ones include:

- Lender arrangement fee. This is typically 1-2% of the loan amount.
- Lender exit fee. This fee is not charged by all lenders. If it is, it can be 1-2% of the loan amount.
- Broker fees. Most brokers expect to earn 1% for arranging a property development loan. This could be paid directly from the borrower, or indirectly via the lender.
- Surveyor fees. These can vary widely and is in part determined by the requirements of the lender.

Lending Criteria

Lenders use several key metrics to calculate the maximum loan for development finance. These metrics include:

- **Loan to gross development value.** Otherwise known as a loan to GDV, this is the maximum percentage of the loan that the lender is willing to offer. Gross Development Value is the anticipated end value of the development when the project is complete. So if a £10,000,000 scheme had a maximum loan to GDV of 70%, the maximum total facility would be £7,000,000.
- **Loan to value (LTV).** The loan to value ratio is used to calculate the maximum available advance at any given time. The monitoring surveyor will revalue the site throughout the build to ensure the lender is never overexposed.
- **Loan to cost (LTC).** – Lenders want you to put up a percentage of the money yourself. This way you share the risk. Loan to cost is used to calculate this. For example, a maximum loan to cost of 90% would mean that the lender will only put in 90% of the total cost of works into the scheme. This means you would pay 10% of the total project as a deposit.

A lender will combine all three of these factors to calculate the maximum loan. Where there is a discrepancy between these figures, the most conservative one will be chosen to cap the loan.

Repayment

When the development is finished the loan will need to be repaid. At this point, you can refinance to a term loan such as a mortgage, or switch to a specific development exit product until the development is fully sold. Restructuring finance at completion is a better option for maximising profit, as development finance is more costly compared to other forms of lending.

Frequently Asked Questions

In this section, we look at the most commonly asked about property development finance. These questions include lending criteria and the cost of borrowing.

1. How long will a development finance application take?

There is no set time period as it will depend on a number of factors. These include:

- How quickly you can return the required documents
- How quickly a surveyor can complete a valuation
- The complexity of the development project
- Whether the lender has any additional questions

At Esper Wealth we aim to complete the process within six weeks. Our preferred lending partner can help if time is an important consideration.

Generally speaking, the industry standard is on average a lot longer. Underwriting typically takes 3-4 months and then another 4 weeks for the drawdown of funds.

2. What is the average interest rate on property development finance?

Interest rates vary significantly depending on the project. Smaller loans will carry higher interest rates than larger applications since there isn't an economy of scale available.

Typical interest rates for the larger most viable projects start at 4.5%. However, a good benchmark would be 7%. Please bear in mind that as funds are not given to you all at one time, you only pay for what your current borrowing is. This has the effect of bringing down the real interest rate.

3. Are there any other charges on property development finance?

Yes, there are additional charges. These include the following:

- **Lender arrangement fee.** This is usually 1-2% of the loan amount.
- **Lender exit fee.** This fee is not charged by all lenders. If it is, the rate is 1-2% of the loan amount.
- **Broker fees.** Most brokers expect to earn 1% for arranging a property development loan.
- **Surveyor fees.** These can vary a lot. They depend on the requirements of the lender.

4. When do I repay my property development loan?

The loan is usually paid back upon completion of the project. Most developers convert the loan into other finance arrangements at this stage as it is cheap to do so.

It is important to note that the interest is rolled into the loan. The total capital plus interest is repaid when the development is completed.

5. Can I apply for development finance for any property?

For most types, you can. Esper Wealth works closely with lenders in a range of areas. These include:

- Environmentally friendly builds
- New builds
- Mixed-use properties
- Refurbishment projects
- Residential and commercial conversions

6. Can I borrow money as a new property developer?

Yes. Each project is analysed on merit. As a new developer, your application will be considered to be of a higher risk, as you don't have a track record. This is why it is important to get specialist advice. You can speak with us today to evaluate your options.

7. Can I get development finance without planning permission?

In short yes. However, it is easier and cheaper with planning permission granted.

Another important consideration is that planning permission increases the value of the plot. With this in mind, you are likely to be able to borrow more with planning permission in place. More importantly, you can start developing straight away, so you pay fewer loan fees.

8. When should I apply for property development finance?

This depends on a number of factors, which are listed below:

- Do you already own the land? Or do you need the financing to fund the initial purchase?
- How soon do you expect to start work?
- How far along you are in the development forecast? Do you have detailed plans and budgets ready to include on your application?

It is difficult to give an appropriate time, because if you need finance to facilitate the purchase, you may not have planning permission, or detailed plans in place yet.

We recommend getting started with the application as soon as you can. This is because the selected lender will take time to evaluate your proposal before approval.

9. What costs should I include on an application?

The more the better. Any lender will want to see that you've included all of the overheads associated with financing a UK property development. They will also want to see a reserve for any unexpected problems.

We recommend including:

- Materials, labor and contractors carrying out the building work.
- Professional fees including solicitors, architects and project managers.
- Lending fees from your lender. This should include arrangement and exit fees as well as interest payments.

Whilst you might not know the exact cost for every element of your project, it's important to include provisions and estimates to ensure the development finance value covers the full cost of the project.

10. Should I Include a contingency figure in my budget?

Yes, yes and yes! Contingencies are expected. There are going to be some unexpected delays and escalating costs. Inflation, for example, is a major concern for developers in the current market.

It is prudent to build in a 20% contingency fee across your whole budget. Lenders understand risk and insist that a contingency fee is incorporated into the budget.

11. How do building regulations affect my application?

Build regulations mean that every new development or construction must be built to national standards to ensure they are safe for the people living in them.

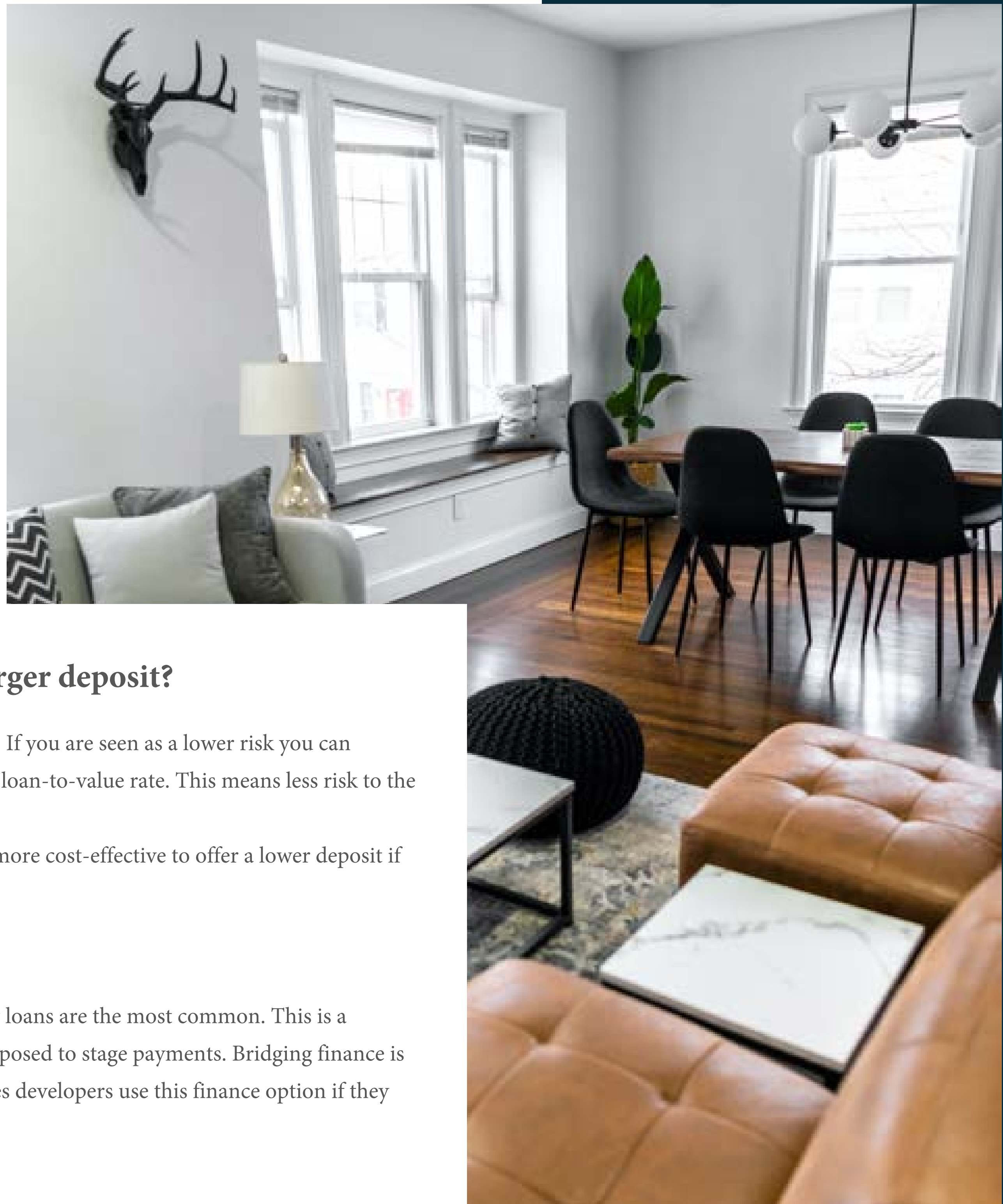
Most buildings are covered, and you can apply for Building Regulations Approval via the relevant local council. This means you will receive visits from an inspector at key stages of the build.

There are some contractors which will manage the building regulations process for you. They will provide certifications that everything is compliant with existing regulations.

If the builder isn't managing building regulations inspections, then you will be liable as the property owner. If things go wrong you could be served with an enforcement notice to correct any aspects of the build that don't comply with health and safety standards.

12. How Can I secure the best deal on development finance?

Our partner is a specialist lender who can secure you the best rate. By fully evaluating your project they can advise you on how to get the best deal for you. There are no upfront costs and you will only pay a broker's fee if you select finance through them. Contact your property consultant to arrange a free no obligation meeting.



13. What if I have bad credit?

Any circumstances outside the standard lending criteria mean you will need to consult with a specialist who understands the underwriting requirements of each lender. Bad credit increases the perceived risk to the lender. However, there are several lenders who will evaluate any project on its merits. In short, bad credit history means you will pay a higher rate unless you can provide extra security.

14. What are the benefits of offering a larger deposit?

Development finance is very similar to other types of lending. If you are seen as a lower risk you can get a cheaper rate. The bigger deposit you give means a lower loan-to-value rate. This means less risk to the lender, which means a lower interest rate for you.
However, deposits aren't the only consideration. It might be more cost-effective to offer a lower deposit if that means you have a higher contingency fund.

15. What about bridging finance?

There are some alternatives to development finance. Bridging loans are the most common. This is a short-term loan, where the borrowing is in a lump sum, as opposed to stage payments. Bridging finance is more expensive compared to development finance. Sometimes developers use this finance option if they don't have planning permission.

Esper Wealth

You can find out more about development finance via our website. We work with developers to find funding solutions for their projects. Contact us today to see how we can help you to fund your next project.

Our lending partner is well versed in development finance. They have helped many developers secure the finance they need, at very preferential rates. As a specialist broker, they have access to a range of funds outside of the high street. Contact your property consultant today to discuss your options.