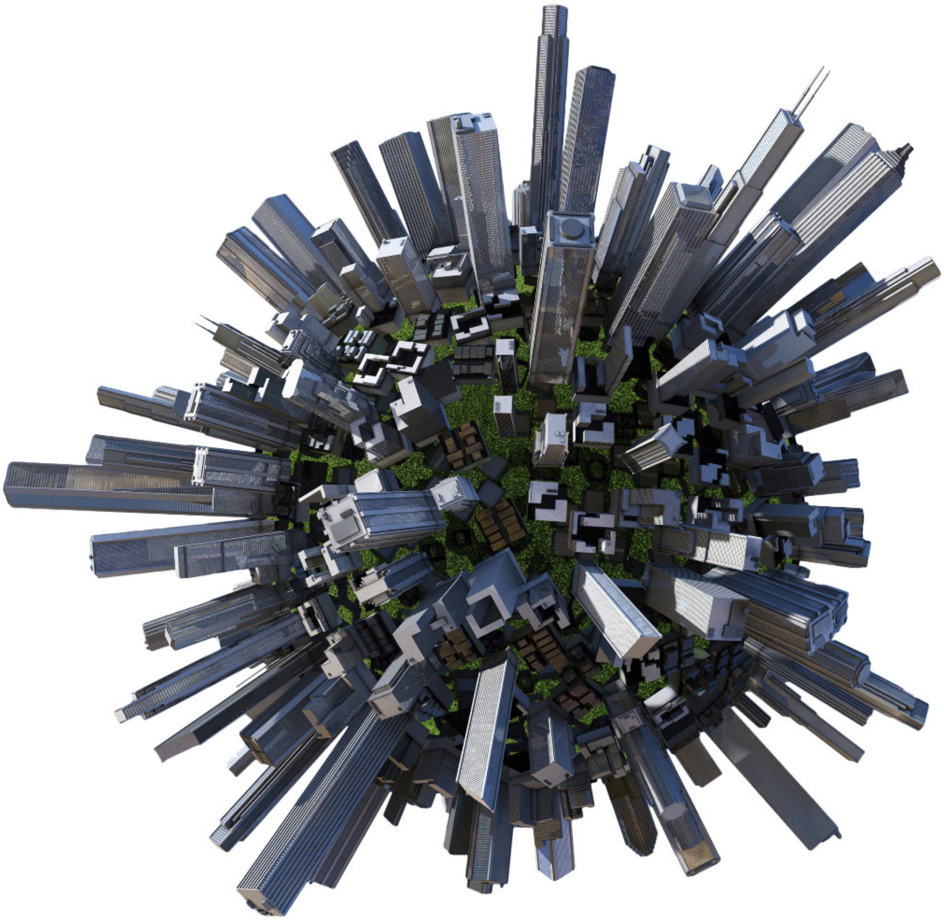

Residential development funding landscape

In this article, Daniel Lockley, a manager in Deloitte Ireland's Debt & Capital Advisory team explores the Irish residential development funding landscape.

"...building levels in Ireland have been exceptionally low for a number of years, resulting in housing stock levels falling to their lowest point since 2007[1]."

Overview of the Irish housing market

House building levels in Ireland have been exceptionally low for a number of years, resulting in housing stock levels falling to their lowest point since 2007[1]. This housing shortage stems from the low levels of house building during the period 2011 to 2016.

The low level of house building was principally due to following:

- Many developers exiting the market with significant debt exposures, as a result of the property crash in 2007/2008
- A dysfunctional housing market, where sale prices fell below the cost of construction in many areas around the country
- A lack of access to capital, particularly conservative bank led funding

These key factors have led to a clear differential between the demand for housing and the capacity of the industry to supply housing. While demand for housing remains strong (c.40,000 new dwellings required per annum[1]), the supply of houses over the past number of years has not been sufficient to meet this demand. Housing output for the period 2004 to 2016 is shown overleaf.

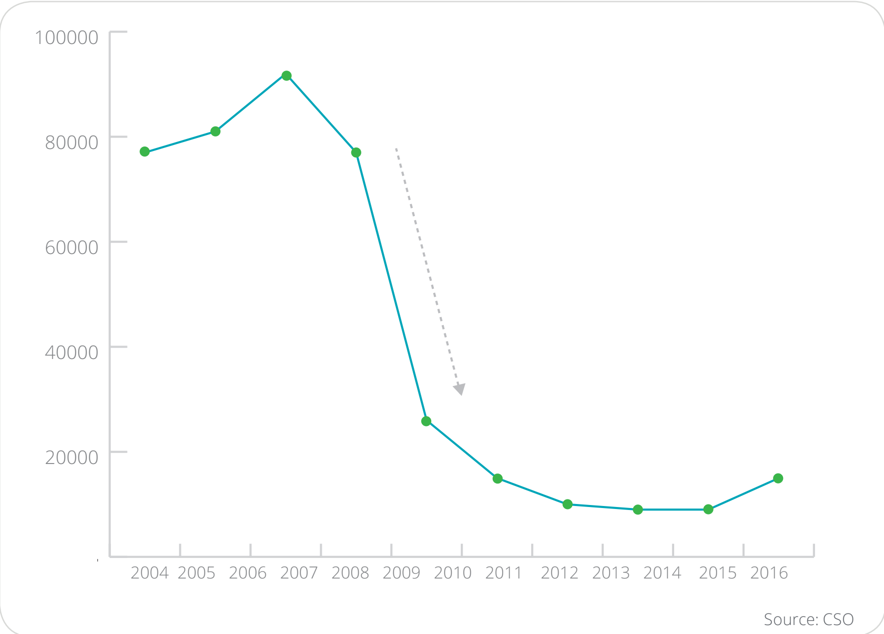

Figure 1: Housing Completions

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Housing output has fallen from a peak of c.93,000 units in 2006 to c.14,000 in 2016 with many of these being one-off rural dwellings. This supply deficit has left a significant differential between housing supply and demand.

On the demand side, the Central Bank has recently introduced more flexible lending rules on banks, which has resulted in a reduction in the level of deposit required by first time buyers ("FTBs") for houses costing more than €220,000. Under the Central Bank lending rules introduced in February 2015, FTBs required a deposit of 10 percent up to a value of €220,000 and a 20 percent deposit thereafter. Under the new rules which were effective from 1 January 2017 this €220,000 cap has been removed resulting in a 10 percent deposit requirement for FTBs. In addition, the Government launched a new Help-to-Buy scheme in 2016 which assists FTBs with the deposit requirements on a new build house.

The policy changes above have resulted in a significant cohort of FTBs requiring only a 5 percent deposit to acquire a new build house. These changes have made the purchase of a new build house more accessible to FTBs, driving demand for these properties.

Evidence of this strong demand can be seen across a number of new developments such as St Marnock's Bay, Portmarnock (launched in February 2017)[2] that was somewhat reminiscent of the mid noughties with house-buyers queuing overnight to secure a purchase.

Given the pent up demand for new houses in attractive locations and the shortage of housing stock available, many housebuilders are looking to scale their business in order to capitalise on this opportunity.

Residential development debt providers

Deloitte debt and capital advisory advise property acquirers and housebuilders on implementing appropriate funding strategies to support this growth strategy. We are working with several housebuilders (both in ROI and NI) who are seeking to raise site acquisition and working capital funding, the providers of which are both traditional high street banks and several alternative lenders who are now truly active in the Irish market.

Set out below are the typical financing options available to Irish housebuilders, in the current market;

Senior debt providers (banks)

The banks are lending to the residential development sector, however this is typically in selective urban locations with clear visibility on house sales. The banks current preference is to lend to house-builders on a "site-by-site" basis, with limited evidence if any of Banks providing corporate type facilities (save for large, well established house-builders with significant levels of equity in the structure).

Banks are typically lending at c.50 percent loan to value ("LTV") for sites acquisitions with full planning permission ("planning") and c.70 percent loan to cost ("LTC") on work in progress ("WIP"). There is little or no appetite from the Banks to fund sites without planning or to take on risk through the planning process. In some instances a level of pre-sales is required especially if the site is not in a key urban location such as Dublin, Cork or Galway.

While the banks are offering development facilities, the level of equity required often limits the ability of many housebuilders to scale their business and increase housing output.

This inability to scale in a timely manner has given rise to an opportunity for non-bank lenders to enter the Irish market and offer alternative sources of funding.

1 Daft House Price Report Q4 2016
2 Irish Times

Alternative lenders

In recent years, many non-bank or alternative lenders have entered the Irish market and these alternative lenders are now actively targeting the Irish residential development sector. This trend follows the UK and U.S. models where many house-builders would consider it the norm to deal with alternative lenders instead of, or in conjunction with, a traditional lender, such as a bank.

Alternative lenders offer house-builders the ability to scale their business with a smaller amount of equity input (than required by banks) by offering leverage levels of up to 90 percent LTC on both site acquisition and WIP facilities. Alternative lenders are also more likely to have a stronger appetite for planning risk and therefore offer more flexibility than a traditional bank when funding sites without full planning.

Typically, alternative lenders in this sector provide unitranche and mezzanine debt facilities which attract margins in excess of 10 percent. This pricing structure typically comprises of an upfront arrangement fee and a coupon. In some cases alternative lenders are also seeking an equity participation or exit fee depending on the leverage levels being offered. In order to lower the overall borrower's cost of capital many alternative lenders also have the ability to co-fund with senior lenders.

The higher leverage levels offered by alternative lenders enables housebuilders to deploy more capital than would be possible with a traditional bank, given the lower equity contribution typically required. We are seeing many alternative lenders looking to support a small number of strong promoters, thus ensuring an effective use of their capital and resources. However, the targeting of a small number of promoters has resulted in strong competition for capital, with more established housebuilders with a strong pipeline of sites, more likely to secure funding.

Set out below is a summary of our **key observations of the residential development funding landscape**:

1. There is a significant increase in the level of capital available for strong promoters
2. There is a strong appetite to fund residential developments in the main urban centres of greater Dublin, Cork and Galway with more limited appetite outside of these regions
3. The range of capital available for the residential development sector includes senior debt, unitranche, mezzanine debt and equity with some funders having access to capital from the 'Irish Strategic Investment Fund'
4. The key to accessing this capital is a well prepared proposal that will stand up to a funder's due diligence process. A typical due diligence process focuses on the promoter's previous experience, management team, building capacity, key contractor relationships, execution ability and access to pipeline sites
5. Funders are currently favouring site-by-site funding structures as it gives them greater visibility and control. We expect to see the evolution of a more corporate type debt funding market for this sector in the medium term.

Please feel free to contact us should you have any queries or want to explore funding options on behalf of your clients.

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Deloitte Debt & Capital Advisory works with all of the major banks and alternative lenders that are active in the Irish market. We assist clients with raising new funding to support their growth objectives. Given our strong relationship with lenders in this space, we can assist our clients in tailoring their funding proposals to attract a focused number of lenders and enhance prospects of securing the most appropriate and competitive funding terms.

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