DEVELOPMENT FINANCE

community led housing london

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GUIDE SUMMARY

Unless you have internal resources which means access to equity, you will need to borrow appropriate finance for the project on favourable terms. You will normally arrange finance at several stages:

“Development finance” is needed to cover costs during the development process. Borrowing or ‘debt’ will make the major contribution, but you will also you’re your own ‘equity’ in the scheme.

“Long-term finance” will pay off the development finance when the development is completed, and itself be paid down by the income from rents after allowances for maintenance costs, or take the form of individual mortgages if residents are buying completed units.

You may also need ‘pre-development finance’, paid off with development finance.

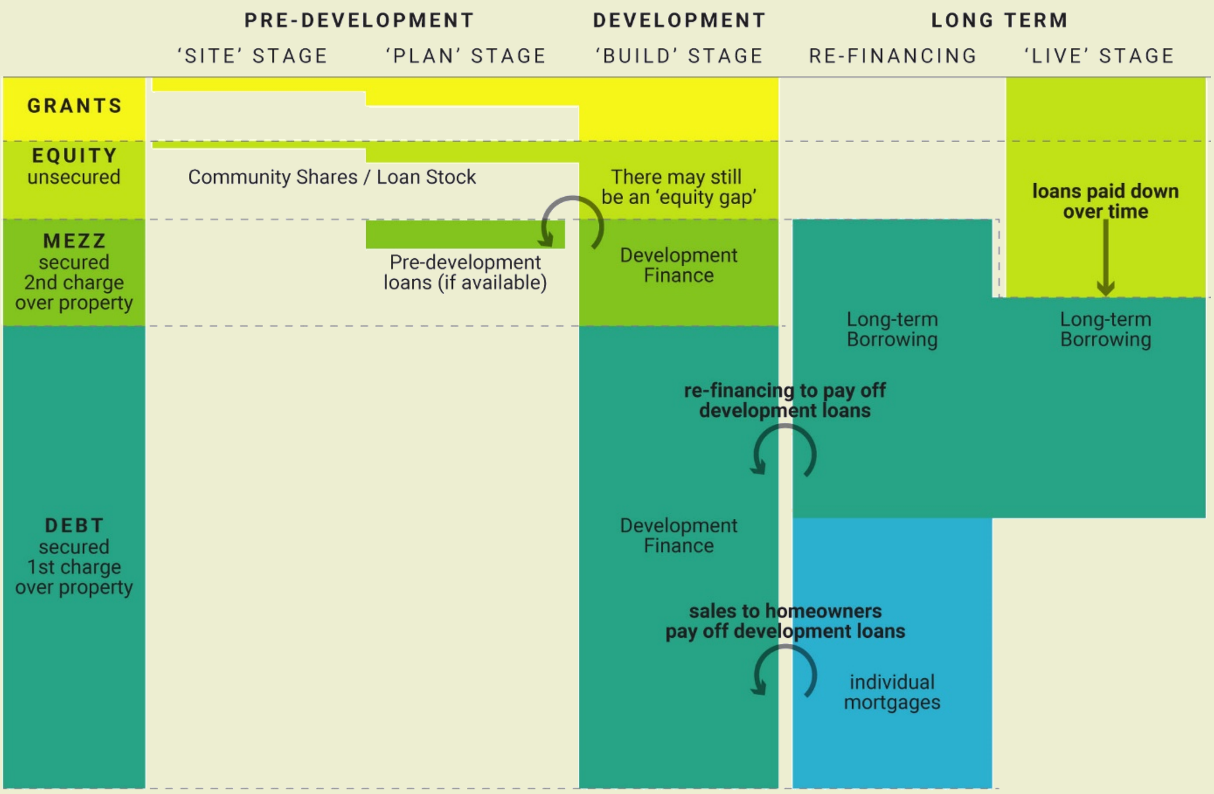
For further information on how we can support these opportunities, go to our website at: communityledhousing.london/our-support

HOW TO READ THIS GUIDE

Throughout the guide, there are links to useful documents and websites for further reading as well as a resources section at the end. We have also suggested group activities and outputs.

Links throughout the document look like [this]()

If at any point you would like advice and guidance, you can contact us at info@communityledhousing.london



FUNDING PRE-DEVELOPMENT

While most established players can fund the initial work of securing a site and obtaining planning permission, from previous projects or reserves, it is likely most start-up groups will need to apply for grants and other loans.

Although the amounts of funding required tend to be smaller at this stage, there is far less certainty a project will go ahead, and lending will be unsecured, so it is very risky.

www.communityledhomes.org.uk/get-funding has a good summary of funding available at this stage.

The London Community Housing Fund, provides 'revenue' grants which you may have to pay back at the end of the project.

There may be other relevant funders such as the Tudor Trust, Oak Foundation, Esmée Fairbairn Foundation, Local Trust, Key Fund etc to cover organisational costs.

It is generally better to have fewer funders, as managing too many small funders and answering all their requirements could become a burden.

Another approach might be to ask your professional team to share risk at this stage, but be aware that working "at risk" means you will still have to pay them if the project goes ahead, and you should still follow all the guidance about working with consultants, to ensure there is clarity over the arrangements.

DEBT FINANCE FOR DEVELOPMENT

Funding for development is typically made up of two parts; ‘debt’ and ‘equity’. Most banks will lend against equity met by the developers’ own resources. Debt will be paid back with interest at the end of the project. The lender will also take ‘first charge’ over any ‘security’ (such as the property) to ensure they are paid back if there are problems with the project. Problems will typically erode your margin or contingencies, but the lender is able to sell the site as a last resort to get their money back. If the project goes better than expected, lenders do not see any benefits.

FINDING LENDERS

High street banks, merchant banks and building societies are all possible sources of development loans or finance. Each will have their own lending criteria and terms.

Traditionally CLH has tended to borrow from banks and building societies such as Charity Bank, Triodos Bank, Ecology Building Society, or Unity Trust Bank. However these organisations have a limited pool of funds.

You may also get good terms looking at high street banks and specialist development lenders such as LendInvest, Close Brothers, United Trust Bank, or Heritable Bank, particularly if you have a larger project.

Institutional investors such as pension funds have billions looking for asset backed long term investment opportunities. While CLH usually fits this profile, individual projects are often not large enough to be worth investing in, without ‘aggregating’ schemes.

SECURING LOANS

The level of information required by lenders varies, but all will require convincing evidence of your experience and ability to deliver the project, and the soundness of the preparation and appraisal, including values and cost estimates (see Guide 2B). The decision will ultimately be made by the credit committee, rather than public facing sales team.

Lenders will assess their exposure to different risks, by understanding the creditworthiness of your organisation and the project. They will look at:

- Appraisal assumptions and contingency
- sensitivity analyses
- impacts and costs from unexpected events, whether direct or indirect.
- The possibility that you become unable to service financial obligations.
- The ability to continue or re-establish the organisation following unforeseen events.

The bank will ask to see site survey reports, employ its own consultants, or require insurance, guarantees or warranties, as part of the funding agreement.

Even established developers will have problems arranging finance on reasonable terms for a risky project. Poorly prepared and poorly organised CLH groups will not be successful in attracting funding. You will need to embrace a level of financial literacy to tell your story well, using language that is relevant to potential lenders. Lenders and investors tend to be focused on values, returns, certainty of income flows, security of capital. However, managing the financial risk depends on being able to recognise and manage other risks, such as political and organisational risks (ie good governance, fair, competent and consistent decision-making).

It is worth engaging with lenders early on, to see if the project can be structured in a way that works for them. For example, flexibility in the sec 106 may provide fall-back positions on the level and nature of affordability, to give greater value if there are any problems.

LOAN AMOUNTS

Loans are usually limited to around 60-70% of the expected end-value of the project (Loan to Value ratio), or to a percentage of the development cost (Loan to Cost ratio). This may be influenced by the risk they see. The bank may ask you to transfer your accounts to it, so it can keep a watch on your overall activities.

Many banks have minimum lending amounts, as the amount of work a lender has to do for each scheme, may not be covered by the margin on the interest rates for a small loan.

LENDER PERSPECTIVE

Groups need to understand the position of funders, particularly the difference between senior debt lenders and mezzanine funder who carry the most risk: these lenders need to know they can recover their money in the instance of overspend or delays. Quality financial modelling can help reduce risk, but this requires professional expertise.

Banks and lenders need to be transparent with groups from the outset. This could involve difficult conversations about their view on self-build or the requirement for a right to sell at market value if the affordable units fail, but it’s better to know upfront.

Local authorities have a critical role to play and it doesn’t have to be financial. Many groups have benefited from asset transfer or grant, but land could also come on a deferred consideration to ease cash flow. In some cases, LAs have provided “make or break” support.

What are the costs?

The bank will charge interest on the outstanding balance of the loan at a margin above the base rate. The margin will be influenced by the risk factors they see, and competition with other lenders.

The finance is only paid out against surveyors' certificates that show the value of the property, as enhanced by the completed construction.

In addition to charging interest on the loan, the bank will wish to recover its costs in approving the loan. These will include legal fees related to the finance agreement, a valuation surveyor to advise on the value of the existing site and the completed scheme, and a quantity surveyor to review your cost estimates. You will also be expected to pay a commitment fee, around 0.5% of the total loan, to secure the terms of the agreement and for the bank to hold the money.

SENIOR DEBT

Senior debt is debt and obligations which are prioritized for repayment in the case of bankruptcy.

Senior debt has the highest priority and therefore the lowest risk. Thus, this type of debt typically carries or offers lower interest rates.

Senior debt is most often secured by collateral, also making it relatively less risky. This collateral is referred to as a first charge. This is always secured against the asset which is this case is the site.

MEZZANINE FINANCE

Mezzanine Debt also known as subordinated debt or junior debt , is debt that is unsecured and is lower on the debt hierarchy than other debt claims. *Mezzanine debt* is provided without any collateral to back it and is often subject to an inter creditor agreement with the senior lender.

When a company goes bankrupt mezzanine debt is low on the repayment food chain. Since it is subordinate, it means that the loan will most likely not be paid back if the company goes bankrupt, and other debts that are of higher importance will be paid back first.

Mezzanine loans are very high-risk debt, and generally have higher interest rates than senior debt to compensate for this high risk. It has a risk profile close to an equity security, due to the fact that it is uncollateralized and that its principal is only repaid upon the long term growth of the business.

If a company is liquidated, it is repaid after senior debt and government tax agencies are repaid. Shareholders and parent companies are generally the ones who purchase junior debt.

The reason the shareholders and parent companies are looking to purchase junior debt is because they have close relationships with the companies and they are willing to provide it at lower interest rates due to their knowledge and familiarity with the company.

While it is a risky loan for a lender, it is a growing and increasingly popular form of borrowing for mid-market companies. With junior debt and mezzanine debt, the lender's incentives are very much aligned with the long term interests of the shareholders and management.

Mezzanine finance sits between debt and equity. It is important where you are trying to raise a higher percentage of the development value or cost than would normally be loaned by a bank or building society (senior lender). The "junior lender" can provide more finance. However, this is riskier than the senior debt, as it will rank second in any claims if the project fails, hence the financier will require a higher margin on the interest rate, which also means you'll be looking for smaller amounts.

These are sometimes called 'bridging loans', or similar arrangements can be found from 'social investors'.

PUBLIC SECTOR LOAN FINANCE

Public-sector loan finance in the form of 'gap-funding' is intended to make up the difference between the cost of a development project and its end value where costs exceed values. This is typically available on commercial terms due to EU State Aid rules, which aim to prevent governments giving preferential treatment to different economic undertakings. However, there may be exemptions for start-ups, small and medium enterprises (SMEs), and innovation, which allow a little more flexibility. There may also be exemptions for affordable housing.

Local authority lending for development costs or long-term finance can come from their own sources or from the Public Works Loan Board and lending on. Although this still depends on their perception of risk and motivations.

COUNCIL UNDERWRITING

Where councils agree to pay off loans if the project does not go as intended, this can act as a guarantee or security for lenders, resulting in lower interest rates. However this would depend on the council's appetite for risk, and would go on their balance sheet as a liability. Although some are already doing it for their own development companies which take the liability off balance sheet.

THE 'EQUITY' FUNDING GAP

MEMBER CONTRIBUTIONS

Members can contribute their individual savings or assets into your CLH organisation, although significant funding from this source is likely to be from those getting a home.

It is important that groups have a realistic conversation about access to equity as early as possible. The pool of equity that a group can commit to the project will have significant effect on any subsequent dealing with funders. Facilitating a conservation about who has how much equity should be part of the initial group work and clearly articulated. If members of the group own properties that they are willing to sell to fund the development this needs be articulated as follows;

Who has a property that they will sell?

How much is the property worth?

When does it need to be sold so funds are made available to the group?

Your equity is like the deposit to a mortgage if you were buying a house. While the bank or senior lender will expect to be paid back in full, equity is at the greatest risk and will bear the brunt of anything going wrong, but therefore can expect the greater returns / savings if things go better than expected.

Projects where there are 'pre-sales' - commitments from residents to buy the completed units, with a deposit paid - are easier to finance than those that are entirely speculative.

CROWD FUNDING

Crowdfunding is about raising money from a large group of people, instead of asking the bank for one large sum of money. It's also a good way to help raise awareness of a community led housing project and create a sense of collective ownership.

There are a range of online crowdfunding platforms listed on sites such as www.crowdfundchampion.com, www.raisemoney.com and www.eurocrowd.org. They may involve seeking donations as well as investments and loans.

Crowdfunding is about stories. Tell it how it is, and in a way that resonates with people, through and social media, videos and websites.

LOAN STOCK

You can invite individuals or other supportive organisations to make fixed-term unsecured loans. The process is easier to do with Co-operatives as they are exempt from some FCA rules.

This could be seen as a form of crowdsourced mezzanine debt as investors do not get voting rights in the CLH organisation. Although it is possible for co-op members to loan to the co-op as individuals. One would expect investment decisions to be be based on the credibility of the project business plan. So it's important to get this right for your loan stock offer.

COMMUNITY SHARES

Community Benefit Societies can raise community shares which also give voting rights in the organisation. Community Share Offers can raise some money but will need a large well organised effort to make a significant contribution, although they can also increase participation.

To offer community shares a community-led housing organisation has to be registered as a Community Benefit Society.

Community share issues can attract tax breaks, earn interest and be repaid, and with shares comes ownership of the development which together can form a powerful mix.

www.ethex.org.uk is a platform that has run a number of recent community share offers for community led housing projects.

EQUITY FINANCING

Equity financing involves the lender or investor taking a stake in the project, by buying shares and taking part of the profit, in addition to loan interest, which may be at a slightly reduced rate. Payments are made direct from the lender to the contractors to ensure that the funds are not diverted elsewhere. This profit-sharing Joint Venture may mean a loss of control for the developer.

It is possible for a Council to own an equity stake or a percentage of the scheme, usually in the form of land. Depending on the decision-making power relationship, this could be a similar Joint Venture.

LAND AS EQUITY

It is common for the value of land to form equity for development loans. Typically, it is purchased mostly through the developers' own resources. Deferred payments or nil consideration transfers can help make use of the value of the land as equity, without having to find the capital for it (upfront or ever).

The usual basis for this is that you build under a building license, with the freehold or long leasehold interest only being transferred on completion of the development. Whilst this has the advantage of reducing costs in the early stages of the development, it may create complications in using the land as equity to arrange debt finance, as the bank will not be able to take a charge on the land as security for the loan.

The ultimate fall back would need to allow the lender to sell the land off for it to be used as equity for the scheme. This may conflict with what the council or the group are prepared to do, even though this fallback option is rarely used by lenders, who prefer to try to restructure loan repayments or find other ways of dealing with problems, as they don't want to be left with a half-finished site. The council could place 'step-in rights' to allow the council to step-in and take control of the land and finish construction and try to pay back a lender (this could be a form of underwriting).

GRANT FUNDING

Public sector grant funding is available to help subsidise affordable housing, and is exempt from State Aid rules, as it is seen as a Service of General Economic Interest. However, grant rates are relatively low compared to historic investment in affordable housing, and the GLA is seeking value for money. Some housing associations can build affordable housing with lower grant rates, due to historic assets, and cross-subsidy from market sales

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