9. Development Finance in the PRS Marketplace

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The Private Rented Sector (PRS) is an established component of the overall delivery of housing stock across OECD economies.

RENTAL DEMAND GROWING

The demand for rental accommodation in Ireland is growing, particularly in our urban centres, where according to the CSO c. 36 per cent of the population is now renting (across both the PRS & State sectors), having increased from c. 24 per cent in 2002. The demand side is fundamentally underpinned by urbanisation, population growth and the increasing desire for accommodation to reflect the various stages of housing need.

Pension funds and investment firms globally have long identified that well located PRS accommodation is a secure and predictable investment asset class and are strongly investing in it. These trends are equally true in Ireland and today facilitate the much-needed scale production of apartments in our cities. As Ireland has one of the lowest levels of built apartment stock in the EU, institutional investors are increasingly seeking to acquire newly built apartments here, creating in parallel what is known as Build to Rent ("BTR") sector. While there has been much public commentary about this phenomenon, it is worth noting that historically c. 20 per cent of the Irish mortgage market was comprised of non-professional investors acquiring newly built residential units for the purposes of rental. While these investors were in the past the primary supplier of new PRS accommodation to the market, they have since largely disappeared, thus creating a supply-side void that the professional institutional investor has started to fill.

DEBT & EQUITY REQUIREMENTS

BTR accommodation is primarily delivered as new apartment developments and the level of debt and equity required to construct is often underestimated. For example, a 300-unit apartment block could cost > €100 million to complete and thus €1 billion of capital might deliver only c 3,000 apartments. This is in the context of a market with an estimated overall annual new home requirement of c 35,000 per annum. Without a broad, deep and diversified debt marketplace, advancement of these much-needed projects would be materially curtailed.

So, who in Ireland provides debt capital to the BTR market and what matters to them in their decision to invest? In assessing this it must first be recognised the role that NAMA, as a lender, played in the creation of the BTR market. They actively funded the Cosgrave Group with early projects in Dún Laoghaire and Santry. The BTR debt market has deepened materially subsequently and is now well served by AIB, Bank of Ireland, HBFI and Specialist Development Lenders. All lenders will look to the track record of the customer, the realism of rental, occupancy and yield assumptions, and ultimately the likelihood of securing an exit on completion via forward sale to an institutional investor.

There are attractions to both the developer and purchaser in phased apartment delivery. For the developer, it may reduce the peak working capital need and thus the required equity commitment. Equally, for the purchaser, it provides the optimal circumstances within which to stabilise the building/investment. Increasingly, it is likely that renters, institutional investors and lenders will differentiate by location. It is notable that in excess of 10,000 PRS units have been approved by An Bord Pleanála over the past 12 months alone, however, some of the peripheral locations may be challenged in attracting development capital.

DEVELOPERS ARE RISK FOCUSED

In the funding by Activate Capital of eight BTR projects to date we have learned that developers are very focused on the fine balance between retaining maximum optionality and containing risk. In many cases this drives their selection of development lender. All projects commence with site acquisition and in most cases the site acquired has residential zoning but is not (optimally) planned. Some lenders will only finance fully planned land so the field of potential lenders at this stage is more limited. On securing a viable planning permission, the developer may explore the option to forward sell the development pre the commencement of construction, or to delay the engagement with institutional investors for a period of say (12) months. The delay decision is usually anchored in a conviction that a better price (via tighter yield) can be achieved in the future. The implications of this decision on debt funding options will likely be reflected in lesser leverage until the forward purchase is locked in. Another example, in the developer decision tree, is whether to self-build or third-party contract. Many forward purchasers seek the risk containment attractions of third party contracting, however this can come at increased cost to the developer.

As one might expect for such large scale development projects there is substantial alignment between the developer and lender regarding the commercial and legal terms of the forward purchaser relationship. Both parties will want to see in the Forward Sale Agreement that the contracted off-taker has substance, or if it is a subsidiary of a larger group that adequate intergroup guarantees exist. Both parties will equally want to ensure that an adequate delivery Longstop is in place, to address potential delays in construction. It is essential that the specification of the units to be delivered is clearly established with the purchaser. Some of our customers have used precedent delivered units as the template, whilst others fully mock-up the agreed unit. In addition to the Forward Sale Agreement there is always also a Direct Agreement between lender and the forward purchaser.

FORWARD FUNDING

In the UK, Continental Europe and the United States an alternative to Forward Sale exists and is called Forward Funding. In that case the institutional investor acquires the site from the developer at commencement, agrees to fund the construction, and makes a final payment including a profit margin on completion. This may have a role in the Irish market in the future, but few, if any, of these have closed to date. Most institutional investors prefer to acquire the completed building through forward purchase, rather than to step-in the shoes of the developer via a forward fund. For a variety of reasons Forward Funding transactions tend to be slower to consummate. I would equally suggest that from a developer perspective, a Forward Fund transaction may reduce risk but minimise development flexibility and economic optionality. BTR developers are now delivering well built, high quality apartments in our urban conurbations. Over the next 24 months the scale of delivery will materially contribute to the overall residential accommodation delivery. Institutional investors, who are typically long term in outlook, are motivated to run and maintain these developments well. Crucial to the generation of apartment output is a well-functioning and broadly based debt funding marketplace. Real strides in this regard are evident and continued thoughtful evidenced based risk assessment will underpin longevity of this lending.