Financing the UK Build to Rent sector

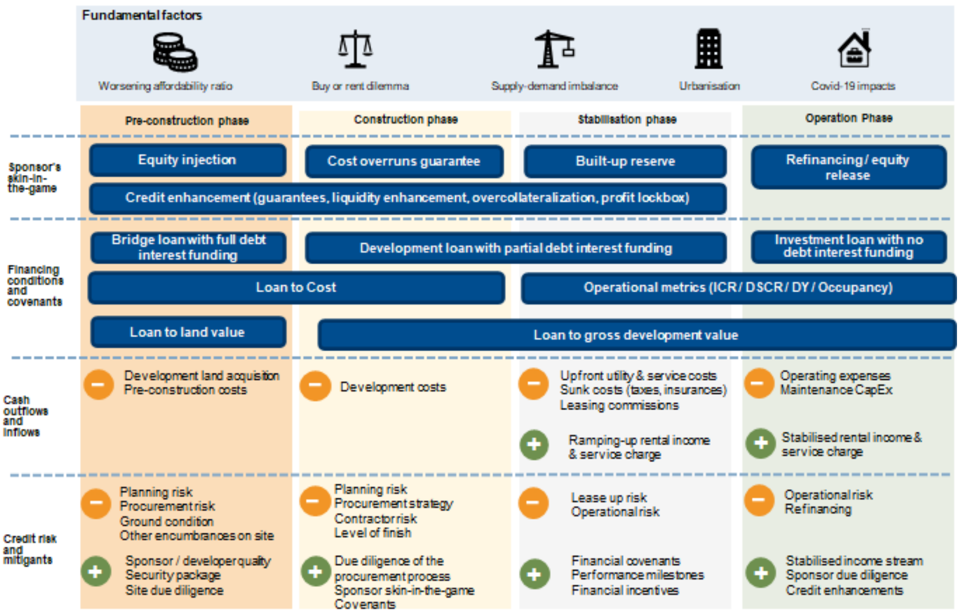
Credit risks to consider for lenders

The recent rise of the Build to Rent (BTR) sector in the UK has the potential to address the UK housing shortage, so it is receiving a lot of attention from investors, occupiers, trade associations[1] and the government alike. In this report, we examine the supporting macro factors and the key risks associated with four distinct BTR development phases. We conclude with a case study highlighting how some of the credit risks can be evaluated.

Build to Rent is purpose-built, institutionally owned and professionally managed long-term private residential rental accommodation. BTR aims to address the UK's under-supplied residential housing market while providing high-quality accommodation with full amenities. Worsening affordability ratios, mortgage financing difficulties, supply and demand imbalances against the backdrop of sustained urbanisation and Covid-19 impacts are all fundamental elements favouring UK BTR.

The construction of a BTR project can be split over four phases: i) pre-construction, ii) construction, iii) stabilisation and iv) operational phase; all of which expose BTR lenders to distinct credit risks.

Figure 1: Build to Rent overview



Source: Scope Ratings

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[1] See CREFC Europe's guide "BTR Financing: an analysis of key principles" for further details.

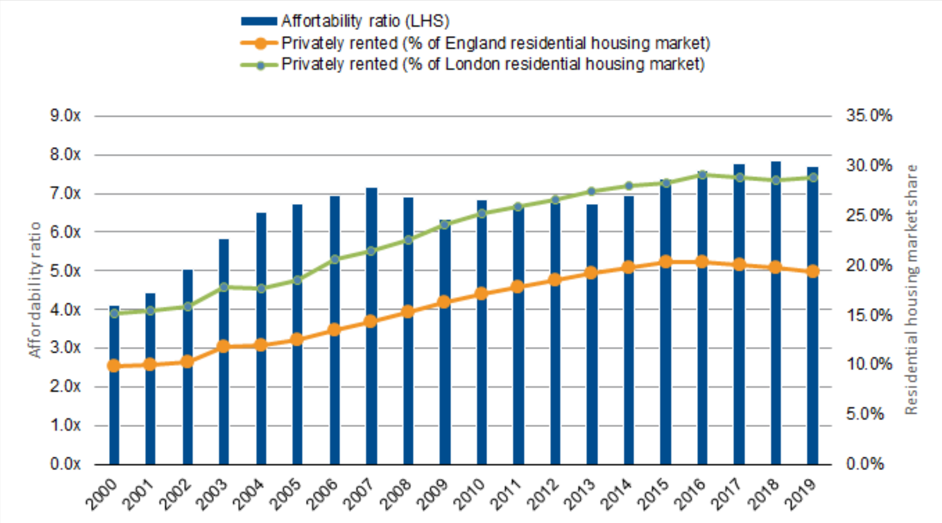
1. Strong fundamentals drive demand for the BTR sector

UK privately rented housing sector doubled since 2000

Worsening affordability

Worsening affordability, defined as the property price-to-earnings ratio, is a major obstacle for UK residential home ownership. This has contributed to the doubling of UK privately rented housing since 2000, which reached 19.4% in England and 28.9% in London in 2019 (see Figure 2). The England and Wales property price-to-earnings ratio is circa 7.7x (4.0x in 2000) while the affordability ratio stands at 12.1x in London

Figure 2: Affordability ratio and share of the private rented residential sector



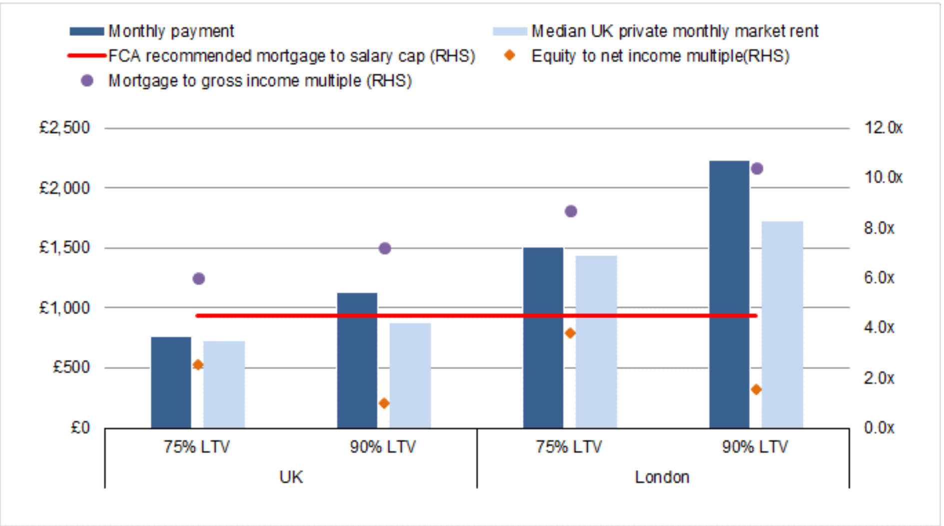
Source: ONS, Scope Ratings

High deposit requirements and salary caps limit prospect of home ownership

Mortgage financing difficulties

As Figure 3 demonstrates, the monthly payment of a 75% LTV mortgage (with repayment on a 25-year term) is comparable to the median market rent. However, a 75% LTV mortgage requires a significant deposit equalling multiple years of gross median salaries (2.5 years in the UK and 3.8 years in London). A 90% LTV mortgage could negate this issue, but the remaining mortgage required is far beyond the FCA recommended regulatory mortgage-to-salary cap of 4.5 times while increasing the monthly financial burden by more than 20%. Consequently, purchasers must borrow as a couple or earn significantly above median UK/London income (see Appendix I. UK purchasing or renting dilemma for further details about calculations).

Figure 3: UK buy or rent dilemma[2]



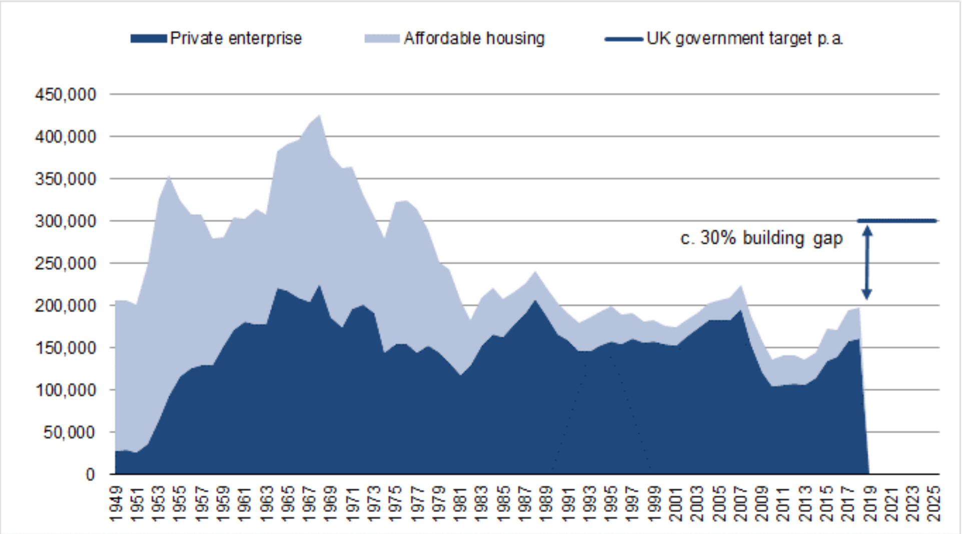
Source: Scope Ratings

Supply and demand imbalances

UK residential housing completion 30% below government target

House building continues to lag government target levels by around 30% (see Figure 4). The building gap is even more pronounced for social housing (see Scope research: UK affordable housing: public policy uncertainty vs assets in high demand). Recovery has been underway to some extent since 2012, pushed by government initiatives such as the Housing Infrastructure Fund and Affordable Homes programme.

Figure 4: UK housing completions



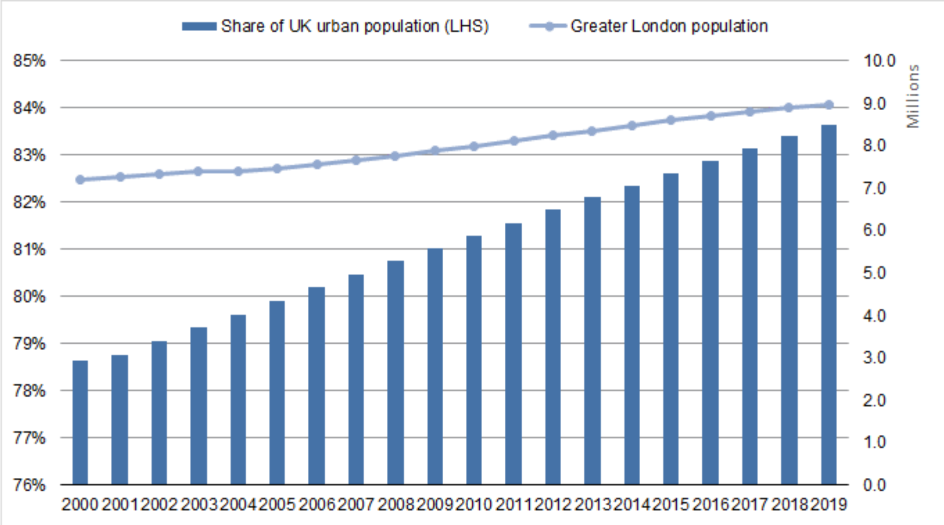
Sources: Ministry of Housing, Communities & Local Government, National Housing Federation, Scope Ratings

Urbanisation reinforces supply/demand imbalance

Urbanisation continues to trend upwards in the UK to c.84% in 2019 (from c.79% in 2000). At the same time, the population of Greater London increased by 25% at an average annual increase of 1.2% to reach 9m inhabitants (see Figure 5). Urbanisation favours BTR developers, who need urban locations where sufficient population would sustain current and future rental demand.

[2] See Appendix I. UK purchasing or renting dilemma for further details. Based on Scope own calculations and assumptions.

Figure 5: UK Urban population evolution



Sources: UN via Macrobond, OECD, Scope Ratings

Covid-19 impacts and ESG demand will benefit the BTR sector

Covid-19 sped up ongoing structural changes and new social trends (e.g. working from home, requirement of more outdoor/communal space) while it further exacerbated demand for higher-quality rented accommodation. (see Scope research: What will the European CRE sector look like when the dust settles?). BTR is also attractive from an ESG perspective. The sector has been a pioneer in using modern methods of construction to build higher-quality homes faster, with a lower environmental impact by relying on modular delivery of housing structures and components that are pre-manufactured off-site and assembled into high-rise buildings.

2. BTR: Credit risk analysis

BTR lenders are exposed to four distinct development phases

BTR development projects are exposed to different risks according to which of the following phases they finance: i) pre-construction, ii) construction, iii) stabilisation, and iv) operation.

a. Pre-construction phase

Debt finances land acquisition and planning expenses

Sponsors may require debt funding for the purchase of development land and to fund pre-construction costs (including statutory costs) alongside up-front equity injections. The debt funding is typically in the form of a bridge loan with interest capitalised, sized against the land value. The security package can consist of fixed legal charge over the land and potential sponsor credit enhancements such as guarantees.

i) Key risks

Planning-permission risk: The lender is highly exposed to the ability of the sponsor to obtain suitable planning permission in a timely fashion, which would impact the viability and profitability of the project.

Procurement risk: Cost certainty is difficult to obtain at this early stage. An under-budgeted project can affect its viability and increase risk of over-leverage over the land value or future gross development value.

Ground condition: Uncertainty in ground conditions is potentially high at the pre-construction stage, especially if the land was of alternative use, giving rise to the risk of ground contamination.

Other encumbrances on site: Any encumbrances to the land may expose BTR developers to over-estimated profitability assessments, or present obstacles towards the completion of a BTR project (e.g. access to site, party wall agreements and rights to light, restrictions on the leasehold title).

ii) Risk mitigants

Sponsor/developer quality assessment. The sponsor track record, experience of management, staff and financial capacity are critical. It is also key to identify their ultimate incentives and “skin-in-the-game”. A good indicator is the amount of cash equity invested, as opposed to notional equity arising from the land value increase post planning completion.

Security package. Titles over the land, sponsor guarantee, additional collateral, developer’s profit lockbox or other forms of liquidity should all be carefully considered to assess their strength and effectiveness upon enforcement. The relationship between equity disbursement and debt drawings must also be assessed (i.e. equity first, equity/debt side-by-side, etc.)

Site due diligence. Previous site use, ground conditions and the planning process must also be assessed. Third-party consultants may provide assurance via environmental reports or early feasibility studies as well as reference to relevant local and national governmental legislation.

b. Construction phase

Debt finances construction costs and statutory costs

Sponsors will seek a development loan post land acquisition and planning permission to finance development costs. Lenders will underwrite a development loan including partial debt interest funding based on loan-to-cost and loan-to-gross-development-value ratios. Securities may consist of titles over the land, assignment over the main contracts/collateral warranties and potential sponsor credit enhancements.

i) Key risks

Constructions phase expose lenders to contractor and construction risks while above-mentioned and planning risk:

Planning risk. Once full planning-permission is granted, there are still factors which may impact profitability like the share of social housing and affordable rent units required or clawback payment risk to local authorities if the property were sold.

Procurement strategy: BTR developers will have to choose between a sliding scale on price certainty and control in choosing the type of procurement route. In traditional construction management, the sponsor appoints trade contractors, and the construction manager oversees them. This approach provides enhanced control over costs but provides no guarantees regarding the final total cost and completion timeline.

Alternatively, a fixed-price contract provides more cost and time certainty. The main contractor would usually be contracted to absorb any cost overruns and be penalised for any delays in achieving practical completion. However, this places more responsibility on the main contractor and provides less control for developers, with no opportunity for additional cost savings. The main contractor could also prioritise ease of fabrication/cost savings above aesthetic quality.

Default risk: Default of a main contractor under a fixed-price contract will jeopardise the entire project given the level of involvement and knowhow. This could lead to significant delays and cost overruns, which can jeopardise the viability of the project if the sponsor cannot support the burden.

Level of finish: The level of finish can be an important factor in the success of a BTR scheme, as above-average quality delivery is one of the major selling points and ultimately impact on the level of occupancy and rents achieved.

ii) Risk mitigants

Due diligence of the procurement process. Lenders should review key contractual elements like: i) details of the fixed-price contract, ii) financial strength and experience of the contractor, iii) delay penalties/insurance and iv) collateral warranties/third-party rights and guarantees. An independent project-monitoring agent may assess the above-mentioned points and monitor development progress while providing a sufficient professional indemnity insurance.

Sponsor skin-in-the-game. Lenders should assess equity invested prior to debt funding and make sure that no equity distributions are allowed before the debt is fully repaid. Covenants must be carefully monitored to ensure that sufficient cash equity remains in the transaction and the transaction is not over-levered (loan-to-cost). Meanwhile loan-to-gross-development-value (LTGDV) should be regularly reassessed to ensure the project continues to be commercially viable.

Retention/Snagging Period. The developer will need to ensure that a sufficient snagging period is included in the construction contract with appropriate retention.

c. Stabilisation phase

Debt finances operating and leasing costs during the stabilisation phase

After practical completion (PC), the development facility can provide for a period of stabilisation until rental income achieves expected levels to finance upfront operating expenses. Given the lower levels of rental income post PC, the debt facility during the stabilisation phase usually allows an element of interest capitalisation while retaining early profits to build up liquidity reserves (i.e. profit lockbox). Lenders should monitor performance based on financial covenants alongside performance milestones (occupancy, ICR, DSCR, Debt Yield) as well as on LTGDV.

i) Key risks

Lease-up risk should be assessed against the sponsor's business plan both in terms of rent achieved (profitability) and the time required to achieve stabilised occupancy levels.

Operational risk – Under-estimating operating costs can have a negative impact on interest service and the gross development value (GDV) of the property.

ii) Risk mitigants

Financial covenants. The valuation may be revised at practical completion to confirm the expected Vacant Possession Value (VPV) and Gross Development Value (GDV). Ratcheted debt yield and interest-cover ratios must ensure increasing debt serviceability as the property reaches stabilisation.

Performance milestones. Income and occupancy milestones allow the lender to monitor asset performance and ensure the business plan is being executed.

Financial incentives. Lenders may consider a ratcheted loan margin when better-than-budgeted milestones are achieved, while no equity release should be allowed prior to full debt repayment (i.e. profit lockbox).

a. Operational phase

Debt refinances stabilised properties and frees up equity

Once full stabilisation is achieved, the sponsor can look to repatriate equity via re-leveraging via an investment facility or sale of the property. Investment lenders will finance such projects on a LTGDV basis and based on net operating income financial covenants.

i) Key risk

Operational risk. The sponsor/operator is expected to maintain the property to a good standard to maintain targeted rental and occupancy levels while adhering to budgeted operational costs.

Refinancing. Adverse operating performance compared to budget could lead to a lower property value, which could result in a lower refinancing amount and higher refinancing costs. A lower refinancing amount would require additional equity injection or mezzanine finance.

ii) Risk mitigants

Stabilised income stream. During the operational phase, properties are expected to generate sufficient stabilised long-term inflation-indexed rental income to service the debt.

Sponsor due diligence. The sponsor's experience and ability to execute the business plan is key. At the same time, the sponsor's balance-sheet strength needs to be considered in case an additional equity injection is required. The business plan should be scrutinised in terms of expected rental growth, occupancy rate, operating costs, as well as supply and demand projections to estimate sustainable net operating income.

Credit enhancements such as interest reserve, sponsor guarantee, scheduled amortisation and limited equity release.

3. Scope UK BTR case study

Below, we provide a simple credit approach to a potential BTR development through its various phases including illustrative numbers at each stage (see Figure 6 and Figure 7).

Prior and post practical completion phases determine simplified two-step approach

We consider BTR probability of default and loss given default over a simplified two-step approach: i) prior to practical completion for both the pre-construction phase and the construction phase and ii) post practical completion for both the stabilisation phase and the operation phase.

i) Prior to Practical Completion

During the pre-construction phase and the early construction phase, any financing is typically based on a loan-to-cost approach and loan-to-land value. Interest is capitalised as there is no income. Lenders will focus on planning and construction milestones during this phase.

Lenders will also assess the LTGDV covenant, which refers to the value of the completed property at a fully stabilised position. LTGDV provides an indicator of the expected profitability of the project after practical completion.

Credit risk analysis will focus on the ability of the sponsor to deliver the business plan on time and on budget, while giving credit to credit enhancements such as budgeted contingency plan, additional sources of security or liquidity lines and guarantees.

Probability of default prior to PC focuses on sponsor incentives and capacity

As a proxy, lenders can project an event of default when i) the sponsor has no incentive to complete the project (i.e. insufficient residual equity) or ii) when the contractors, and the sponsor as an ultimate recourse, lack the capacity to sustain the project.

LGD equals drawn debt net of site value

An estimated loss given default will net the outstanding drawn loan amount (including capitalised interest) against the site value, net of enforcement costs. Site value may be calculated using an income valuation approach by discounting future income at an appropriate capitalisation rate net of undrawn capital expenditures. Alternatively, the site value can equal the land value plus capital expenditures spent to date.

ii) Post Practical Completion

Following practical completion, the debt facility provides allowance for a stabilisation period during which part of the interest continues to be capitalised. Available non-stabilised income will service the remaining interest. The facility can be refinanced by an investment facility once stabilisation is reached. That will be based on the fully stabilised GDV of the property.

If the property achieves the expected GDV, the uplift in the collateral value should allow the full refinancing of the debt facility with a potential equity distribution to the sponsor. Lenders will focus on operational and financial milestones during this phase.

Credit risk analysis will focus on the timescale required to reach full stabilisation, on rental value levels achieved and on operating expenses

Probability of default post PC a function of exit debt yield and exit LTGDV

We will consider a default under the Scope CRE Security and CMBS Rating Methodology either during the term relating to the borrower's failure to service its contractual debt obligations, or at refinancing relating to the borrower's failure to refinance at maturity. We assume a refinancing default if the portfolio exit debt yield is below the Scope all-in refinancing rate or if the stressed CRE security LTGDV is equal or exceeds 100%.

LGD is function of a collateral income valuation approach

We will estimate a loss given default following an income valuation approach of the collateral value where recoveries will equal the collateral value net of liquidation costs.

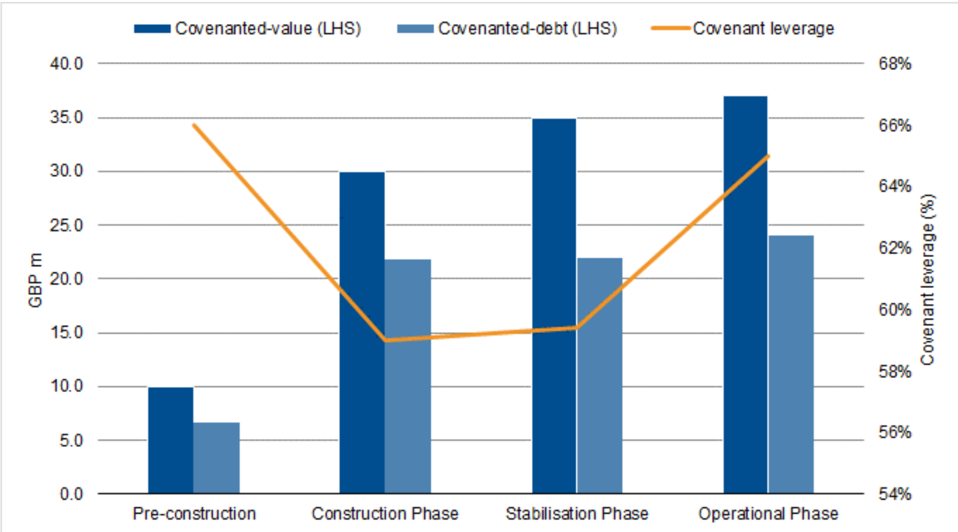
Figure 6: Financing of a BTR scheme in various stages

		Pre-construction	Construction Phase	Stabilisation Phase	Operational Phase
Collateral value	Land value with planning permission	**10.00**	**10.00**	10.00	N/A
	Construction costs		**20.00**	20.00	N/A
	Vacant possession value		35.00	**35.00**	35.00
	Gross development value		37.00	37.00	**37.00**
Income	Net operating income			0.35	1.67
Equity	Injection	4.00	7.10	0.00	0.00
	Distribution	0.00	0.00	0.00	2.07
Debt	Land bridge facility	6.00			0.00
	Construction facility		19.50	21.84	0.00
	Investment facility				24.05
	Interest accrual	0.60	2.34	0.14	0.00
	Total debt (end of period)	6.60	21.84	21.98	24.05
Leverage ratios	Loan to land value	*66.0%*			
	Loan to cost		*72.8%*	*73.3%*	
	Loan to gross development value		*59.0%*	*59.4%*	*65.0%*
Income ratio	Debt service coverage ratio			0.27x	2.77x
	Debt yield ratio			0.0%	0.0%
	Profitability (net of financing costs)		6.3%	11.8%	
Covenants	Covenanted-value	10.00	30.00	35.00	37.00
	Covenanted-debt	6.60	21.84	21.98	24.05
	Covenant leverage	66.0%	59.0%	59.4%	65.0%
Milestones	Planning milestones	✔			
	Construction milestones		✔	✔	
	Operational milestones			✔	
	Financial milestones			✔	✔

Source : Scope Ratings

Figure 7 illustrates a typical BTR scheme characterised by increasing covenanted debt along an increasing estimated covenanted value. Firstly, the covenant leverage metric decreases after the pre-construction phase due to a change of approach from loan-to-land value to loan-to-gross-development value. Secondly, it increases as interest capitalises and construction risks reduce.

Figure 7: BTR debt cycle



Source : Scope Ratings

Appendix I. UK purchasing or renting dilemma

UK home buyers are severely limited by the cost of property deposits, which may take several years to accumulate. If purchasers are able to pay a sizeable deposit, more favourable mortgage terms with lower rates are available.

The monthly repayments on a 75% LTV mortgage with a 25-year repayment period with a two-year fixed interest rate of 1.62% p.a. are comparable to the median monthly rent for both London and the UK as a whole. However, even with a 25% deposit, the size of mortgage required for the average UK property is still 6x the UK median salary. This increases to over 8x for London.

In this respect, the FCA and PRA's recommended loan to income ratio of 4.5x weighs on the issue of affordability from a mortgage borrowing perspective[3]. Indeed, for more expensive properties, purchasers with an average salary will still need to borrow as a couple even if they have a 25% deposit.

With a more highly geared mortgage, although it will take less time to potentially save for a deposit, the loan-to-salary ratios are higher still. At over 10x, even purchasing as a couple will be challenging with such high leverage. Even if borrowers were able to secure a mortgage at 90% LTV, the financial burden of mortgage repayments are significantly higher compared to estimated rental costs of BTR, with 20% premium applied over median rents.

Figure 8: UK purchasing or renting dilemma

	UK	London
Average Property Price December 2020[4]	GBP 251,500	GBP 496,066
Median Salary[5]	GBP 31,461	GBP 42,848
Net Median Salary[6]	GBP 24,929	GBP 32,672
75% LTV mortgage scenario		
25% Deposit	GBP 62,875	GBP 124,017
Mortgage amount	GBP 188,625	GBP 372,049
Mortgage to income multiple	6.00x	8.68x
2-year fixed mortgage rate[7]	1.62%	
Monthly payment (assuming 25-year mortgage)	GBP 765	GBP 1,509
Median UK private market rent per month	GBP 725	GBP 1,435
90% LTV mortgage scenario		
10% Deposit	GBP 25,150	GBP 49,607
Mortgage amount	GBP 226,350	GBP 446,459
Mortgage to income multiple	7.19x	10.42x
2-year fixed mortgage rate	3.50%[8]	
Monthly payment (assuming 25-year mortgage)	GBP 1,133	GBP 2,235
Median UK private market rent per month plus estimated BTR premium of 20%	GBP 870	GBP 1,722

[3] Financial Conduct Authority - Guidance on the Financial Policy Committee's recommendation on loan to income ratios in mortgage lending August 2014.
[4] UK House Price Index summary: December 2020
[5] Employee earnings in the UK and Inner London median weekly wage GBP 824 in 2020.
[6] Tax year 2019/2020
[7] Bank of England
[8] Bank of England

Appendix II. Scope's commercial real estate snapshot

Figure 9: CRE rated transactions

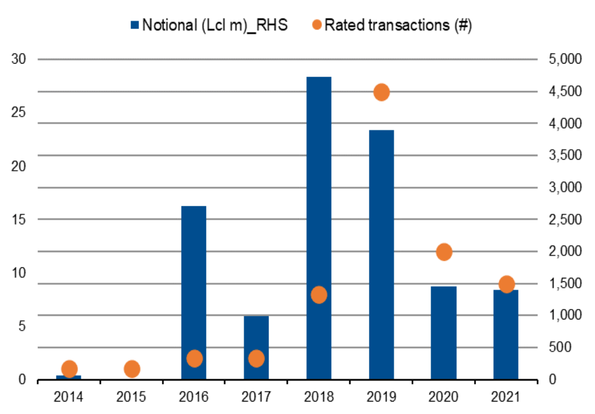


Figure 10: Financing type coverage

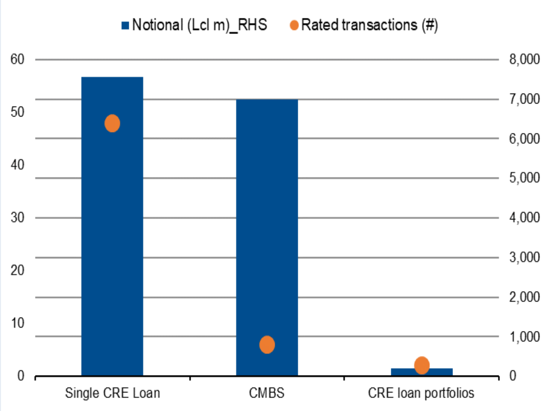


Figure 11: European geographic coverage

Figure 12: Asset type coverage

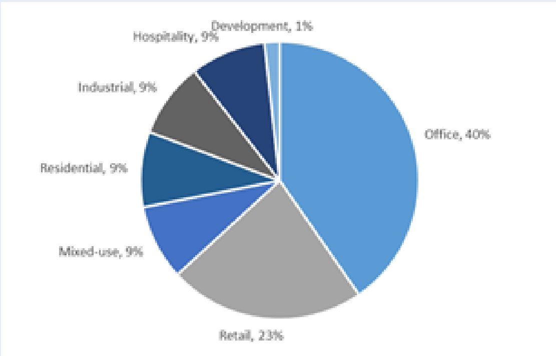


Figure 13: 12-month-to-date real estate research

Franchise	Asset-type	Topic (link)	Geographic coverage
Structured Finance	Crossed	Investor should assess debt yield alongside traditional financial covenants to capture CRE risks	Europe
Structured Finance	Crossed	CRE security and CMBS rating methodology: What makes us different?	Europe
Structured Finance	Residential	Residential real estate: Lisbon's secure rental income initiative unlikely to stop gentrification	Portugal
Structured Finance	Crossed	Covid-19 : What will the European CRE sector look like when the dust settles?	Europe
Structured Finance	Logistics	European logistics CRE: outdated assets won't ride growth momentum	Europe
Structured Finance	Retail	Maroon Loan: autopsy of a default	UK
Structured Finance	Crossed	Leasehold property: attractive investment opportunities with diverse risk drivers	Germany
Structured Finance	Healthcare	Healthcare real estate investment from a rating agency perspective	Europe
Corporates	Residential	Residential real estate: spotlight on Hungary How tax policy can drive the housing market	Hungary
Corporates	Office	Europe office property: evolution, not revolution; Covid-19, remote-working have uneven impact	Europe
Corporates	Crossed	European real estate credit outlook 2021: overall resilience; pandemic's uneven impact hurts retail	Europe
Corporates	Logistics	Logistics real estate: safe-haven status grows Nordic sector reveals lure, risks for investors	Nordics
Corporates	Crossed	Sweden real estate sets trend for Nordic hybrid issuance: investor scrutiny grows	Nordics
Corporates	Retail	Commercial real estate: the retail challenge. Outlook for sub-segment remains negative.	Europe
Corporates	Retail	Europe commercial real estate: retail-exposed firms can weather Covid-19 crisis in the short term	Europe

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