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Markets

Future of real estate finance

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Mike Bristow has every reason to be pleased. In October, the CrowdProperty CEO witnessed his peer-to-peer lending platform hit a milestone of £50m issued loans. It was a record month for the lender, completing £5m of deals. But that level of activity hasn't emerged in a vacuum. In some ways this was a culmination of a decade-long evolution that has taken real estate finance from a market centred on a few large lenders to one where new entrants seem to crop up all the time. While lofty ideals of the 'democratisation' of the market are thrown around, necessity has been the major driving force.

“The global financial crisis created a sea change in approach, almost a revolution,” says Ian Malden, head of Savills' valuation division. In the wake of the crash, banks that would have previously been comfortable lending at an LTV of 85% or more found themselves restricted by regulatory pressures. With the introduction of a capital allocation process called 'slotting', Financial Conduct Authority effectively required banks to hold substantially more capital against loans secured on commercial property.

“It certainly curtailed the traditional banks' modus operandi,” adds Malden. “As a consequence, it has given rise to a new plethora of lenders to fill that gap.”

That gap is particularly wide for parts of the market such as development. When he talks about why CrowdProperty does what it does, Bristow cites Balfour Beatty data that shows that the number of homes built by SME housebuilders fell by about two-thirds between 2008 and 2017. Half of respondents in a recent survey CrowdProperty carried out said that the main constraint they have is funding. “Banks and non-bank lenders have moved right away from funding SME developers,” Bristow says, citing some of those same regulatory constraints.

The platform combines institutional and retail capital — investments made by regular people — to fund residential and mixed-use developments throughout a property's lifecycle. In theory it means opening up the potential for a wide range of investors to tap into the property market while retaining the stability offered by institutional backing.

Although that strategy seems to be working for CrowdProperty, which proudly declares its 100% payback rate and 700 funded homes on its site, others have failed. Lendy made headlines in May after going into administration and leaving customers who had invested more than £150m out of pocket. After administrators warned that investors could lose up to 93% of all their investments, debates ensued over why the regulator authorised the platform in the first place.

By June, the FCA had introduced new rules limiting investments into P2P platforms.

For Bristow, a successful platform is built on more than the tech behind it. "In any maturing market, there is a spectrum of operating practices. Where this sector has picked up a bad name is businesses that consider themselves just a tech platform that matches capital." He says the best platforms are ones that are built on expertise in the field they lend in. For CrowdProperty, that involves a combined 75 years of real estate expertise among its founders.

But scepticism remains toward even the most established platforms. Funding Circle, which listed on the London Stock Exchange a little over a year ago, is now trading 76% below its listing price. It might take more success stories before the industry — and the public — regains confidence in the market.

Bridging the gap

P2P lenders represent a fraction of the growing alternative lending market. Native Finance, a platform that advises clients on their real estate financing options, tracks about 370 lenders. Co-founder Prasanna Kannan says the sheer number of lenders has ushered in new challenges for borrowers, which is why they exist. "I don't think our business could have existed 10 years ago. You could have just relied on 5-10 lender relationships," he says.

"But now you've got to be a lot more knowledgeable in terms of who's lending on what and where."

One of the major developments is the growth of bridge lending. Gross annualised lending in this space hit £5.6bn in Q2 2019, according to the West One Bridging Index. That has been a steady rise from just £1.7bn in Q2 2013. LendInvest, for example, was launched as a direct response to a shortage of short-term loans around the time of the financial crisis. Among its products, it offers up to 75% LTV on bridging loans of up to 18 months. It also covers other areas banks are wary of considering, including development finance (at a maximum of 70% LTGDV). Combining institutional and retail backers, LendInvest has invested £1.5bn in loans since 2008.

Another lender, Octopus Real Estate, similarly offers up to 75% LTV on residential bridging loans (70% on commercial) and offers up to 85% LTC for stretch senior development loans. By comparison, 80% of the UK's outstanding loan book in 2018 had LTVs of 60% or less according to the Cass UK Commercial Property Lending Report.
For many of these firms, their selling point isn't just that they tap into niche parts of the market. It's that they do it quickly. Unlike traditional clearing banks, these players specifically promise a fast response, often underpinned by in-house data management systems that make their work more efficient.

Some 60% of respondents in a real estate debt survey by **Oxane Partners** said the biggest operational challenge they face is over-reliance on manual processes and spreadsheets. Just over a fifth used in-house or third-party technology to source deals.

"The traditional lenders are feeling the heat from the new institutions," says Kanav Kalia, director at Oxane Partners. He argues that those traditional lenders won't be able to compete on returns if the competition has invested in systems that streamline their businesses.

"If your operations are more efficient, your costs are low and you're a tech enabled business you're able to offer better returns," Kalia says. "It's about how responsive, how efficient you are."

Share an office investment

But tech isn't everything. In recent years, a number of cryptocurrencies have popped up in an attempt to tokenise real estate: essentially selling chunks of buildings to investors. But none of these have taken off, and part of the problem is the lack of regulation within the crypto market. A lack of support from central banks alongside suspicion among investors wary of rampant fraud in initial coin offerings have dampened their appetite.

The general idea of selling chunks of buildings has, however, (nearly) materialised through IPSX. Unlike crypto tokens, IPSX is a regulated securities exchange that lists individual prime buildings. Where crowdfunding opens up the opportunity for greater investment into smaller assets, IPSX opens up that opportunity to assets valued at a minimum of £50m.

"Structurally, we're in a world of excess capital looking for a home," says David Delaney, group chief executive of IPSX, which received regulatory approval in January. With fixed income yields approaching zero, investors continue to target alternatives like property for their returns.

While large institutions already invest in property, smaller pension funds and retail investors who can't afford to build a large diversified portfolio could increase their exposure to property by investing in shares of individual buildings.

Delaney sees similar potential from open-ended property funds, a number of which closed to redemptions after the Brexit vote and have since built up cash reserves in an effort to increase liquidity if another wave of redemptions hits. Instead of holding cash, those funds could hold shares in buildings for their liquidity.
But for anyone who has followed IPSX, the project has appeared to be on the cusp of launching for years without doing so. "The regulators are very cautious about signing off

new vehicles, particularly something that has a retail angle to it," says Delaney. "They took an awfully long time to sign off on it. Did they take too long? Maybe, but it's understandable that they would take a long time, particularly post-the financial crisis."

With the FCA finally giving IPSX the green light in January, discussions with issuers and investors are underway. Delaney's team is speaking to 28 issuers and is carrying out an 'early look process' on two assets, checking whether the buildings and their prices are of interest to investors.

He expects the first IPOs to take place in January, given that the UK Listing Authority will likely take longer than the usual six to eight weeks to approve the first prospectuses. As always, caution is the defining feature of post-financial crisis regulation.

Has the market destroyed the status quo?

Despite these developments and despite growing number of funding options, the market is still largely built on traditional lenders who account for about three-quarters of all lending in the UK.

"If you could borrow from a clearing bank today, then you would," says Native Finance's Kannan. As long as you can wait longer and meet their requirements, he adds, "they are cheaper than any alternative fund as far as I know."

The decision to approach those alternatives, then, can be seen as a necessity. Major alternative players like LendInvest or CrowdProperty don't directly challenge the banks; they fill what would otherwise be a gap in the market.

Although Bristow will argue that his product is more efficient than banks and can, therefore, offer a better deal to both borrowers and investors, his goal is to offer a service banks simply don't. These platforms could serve larger developers, but that would miss the point. "There's no reason why it wouldn't work, but the competitive environment is a lot tougher," he says.

"The birth of Funding Circle in 2008 – that was founded because banks stopped lending to SME businesses. The same is the issue here: banks do not like lending to SME property developers.

"But with more efficient systems, these alternative finance players can serve that market economically well — as long as they're doing good lending. It all comes down to that."