How does development finance work? An interview with a TAB expert

Education

19.01.23

In this interview, Eli Korman, TAB's head of development finance and CIO, answers questions about development finance such as how it works, and what the benefits and challenges borrowers might expect.

What is development finance?

Development finance is a form of specialist funding that is used to assist with property developments. The funding allows a borrower to enhance the value of the asset or land, either through construction, refurbishment or conversion. The finance is considered against the development's future value (loan to gross development value, LTDGV) and secured against the property or land that is being offered as collateral.

Whilst LTV (loan to value) is the ratio between the value of the loan you take out and the value of the property used as security, then expressed as a percentage, LTGDV is the projected ratio at the point of exit, and takes into account future sales risk.

As the development project moves into each stage, funds are provided to the borrower in drawdowns, also known as tranches. These are funded in arrears in accordance with the budget. This means that once a part of the project has been completed, the borrower can request the next tranche of funds, which will be assessed by the monitoring surveyor assigned to the project. Development finance is provided in this way so that the lender can monitor the progress of the project and reduce their risk.

What are the challenges of development finance?

As with any form of lending, development finance has risks associated that need to be fully considered.

Developers can and often go over time and budget, which is why it is important to have a deep understanding of the construction process. To allow for this, lenders will require a quantity surveyor as well as a traditional valuer so that they can appraise the build costs for the project and ensure they are viable for the fulfilment of the scheme.

It is also likely that the process of acquiring development finance will take longer than a normal bridging loan as there are more reviews to be undertaken and risk assessments to get through.

One important criteria used when determining whether to provide financing is gross development value (GDV). As noted above, the GDV is based on future value and properties are subject to appreciation or depreciation based on various factors. This is more problematic if your project is long term as you may have an estimated value in mind however unexpected costs, macro economic changes, and other factors may affect the value of your property, leading to a developer having to pay more than first intended.

GDV can be volatile and because of this development finance can be more expensive to obtain from a specialist lender. The amount you can borrow or LTGDV is usually not as high as standard LTVs due to the turbulent nature of the future property market. This means although specialist lenders will provide higher levels of funding, you may still not receive your required loan amount. Lenders will generally charge more to borrowers because of the added risks involved, making development finance to be more expensive than standard bank loans.

What are the benefits of development finance?

One benefit of development finance is the way the loan is delivered to the borrower, aiding their cash flow. The project is monitored throughout, with the monitoring surveyor acting as the lender’s eyes and ears on the scheme. By controlling the drawdowns, the monitoring surveyor can ensure each stage is completed satisfactorily before providing funds for the next stage. This close monitoring reduces the risk and ensures the project is well managed and that not all of the money is spent at the start.

From a borrower’s perspective, the main benefit of development finance is that they can secure higher levels of funding than what they usually would receive from a high street bank loan because of the lender's more flexible lending policy, which looks at the future value and what the potential of the asset will be.

As well as the availability of higher funds, development finance also uses rolled interest repayments. Normally when taking out a bank loan such as a mortgage, the borrower will pay a monthly interest repayment on top of what they already owe to the bank. With rolled interest, the estimated interest is calculated at the start before the borrower receives any money, and added to the loan facility, meaning that it is paid back at the end of the loan and the borrower does not need to worry about any monthly interest payments, known as servicing.

Another benefit of development finance with a specialist lender, such as TAB, is that the borrower has the flexibility to move the loan to a different product, if suitable. For example, a development loan could be refinanced swiftly into a more standard residential bridging loan if the construction of the residential units have been completed. High street banks, on the other hand, do not have the speed or efficiency to switch between products in this way.

What happens when you reach the end of a development finance term?

Whether you built from scratch, converted, or refurbed, the finance you accepted to complete your development is going to need to be repaid.

When you applied for property development finance you will have been lent up to 65% of the gross development value of your project. Interest will have been added, normally on a monthly basis, and at the end of the predetermined term time you will be expected to pay back the capital, interest, and any fees accrued.

We have an article on what happens when you reach the end of a development finance term, but to summarise: you can sell the developed property, sell another asset, produce the funds from elsewhere, or consider long term refinancing.

TAB is a lender that prides itself on five key values and by working with you to help you achieve your goals we actively demonstrate them. Our offices are open Monday to Friday and you can contact us anytime via email or our enquiry form.

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