Putting finance first: the alternative route to funding Britain’s SME housebuilders

April 2018
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In some respects we’ve come a long way since we published our first report into the conditions facing SME housebuilders in early 2017. We’ve had a Housing White Paper from the government that recognised the essential role played by small housebuilders and property investors. Promising to “fix the broken housing market”, it paved the way for the pledges made later in the year by the Chancellor and the Prime Minister, who in particular promised to dedicate her premiership to the issue.

In many other ways, little progress has been made. At the time of publication, the landscape looks alarmingly familiar a year on for small property businesses developing, refurbishing and investing in homes up and down the country. While housing is now an ever more common topic for debate between politicians, these SMEs are still struggling to secure financial backing for their projects to increase housing supply.

Our experience as a lender to professional investors and developers tells us it is impossible to engage in an adequate conversation about increasing the supply of housing without acknowledging and dealing with the difficulty for property developers to get financing. More than half of all SMEs still cite access to finance as a major challenge to delivering more homes.¹

A squeeze on skilled workers and the challenges of the planning system matter little to aspiring home builders who cannot secure the funding to get a project off the ground in the first place. With not one of the top ten housebuilders being founded after 1990, it is clear that there is a growth impediment for small property businesses. The retrenchment of bank lending to SMEs as a response to increased regulatory pressure, capital requirements and the fallout of the financial crisis has contributed negatively to the decline of finance available for SME housebuilders, and, as a result, SME housebuilding.

In many ways it is now the non-bank alternative lenders, like LendInvest, that are investing in the future of the nation’s property entrepreneurs, who in turn invest in new and improved housing stock. We know that the answer to the housing crisis is by starting small to build more homes, which is why we’ve made it our mission to reinvent property finance for entrepreneurs and small businesses.

As the finance ecosystem evolves, alternative lenders are playing a vital role in maintaining the flow of funds to SMEs in all sectors. The Basel III framework has been responsible for a shift change in the provision of development finance to small housebuilders. Capital requirements are acutely punitive towards project finance, meaning banks have chosen to deploy resources into assets which attract lower capital charges rather than offering competitive development finance.

¹Federation of Master Builders Press Release, November 2017
Unimpeded by the burden of legacy loan books and regulatory constraint, it is the alternative lending sector that has established a permanent place in the property SME value chain, as well as contributing to the growth of the UK economy. Spreading portfolio risk across a greater number of specialist lenders is an investment in the UK financial industry’s health too.

However, to encourage property entrepreneurs to get building, all stakeholders, including government, must exploit the opportunity presented by new business models and technologies to improve the deployment of finance to these small businesses.

Restoring a vibrant SME housebuilding sector is a central ambition of this government, but so too must ministers recognise the scale of opportunity presented by alternative finance to enrich the housing sector by financing the complex, niche or custom developments and regenerations.

To this end, the government should channel its finance products through alternative lenders and empower local authorities to back the new generation of builders.

Christian Faes
Co-founder & CEO of LendInvest
Solving the nation’s housing crisis is as complex as it is urgent. No singular intervention will immediately impact the availability and affordability of homes, nor can we point the finger of blame in one direction. The truth is that our housing markets have been dysfunctional for decades. The attrition of smaller housebuilders since the 1980s has coincided with declining choice, constrained supply, and crippling cost increases in housing across all tenures. The collapse of entrepreneurship in this sector has changed the contours of the property market for the worse.

Both as a constituency MP and a chartered surveyor, I know that enterprising small businesses investing in and building homes are vital for a healthy housing market. I firmly believe that it is the responsibility of government and industry to act determinedly to improve business conditions for these crucially important businesses.

I have said before that we must think boldly about solutions to the interlocking challenges to increasing the number of homes brought forward. What follows in this report is an acknowledgement by LendInvest that all parts of the industry have a role to play in unlocking the potential of small businesses, and an enterprising trio of initiatives that could be taken forward.

The evolution of fintech and the emergence of new finance models are an opportunity for government to explore alternative routes to funding future homes. And it is right that we seek to solve the finance conundrum. Identifying and acquiring land and navigating the complex planning system are not problems for SMEs if they cannot secure the finance to start a project in the first place.

What is required, as this report emphasises, is a combined effort by government and private partners to ensure small builders have access to the finance they need, to help effect the change.

Mark Prisk MP
Former Housing Minister (2012-2013) and Member of the Communities & Local Government Select Committee (since 2015)
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3. Contributed foreword by Brian Berry

It has become a truism that we need to be building many more new homes than we currently are in this country. But to achieve this will require a housebuilding market that is significantly more dynamic and more diverse than the one we currently have. Crucially, this means that our small and medium-sized (SME) builders need the ability to more easily enter the market and increase their output of new homes.

The Federation of Master Builders (FMB) has played a leading role in recent years in highlighting some of the key barriers to growth these firms face and how we can help to tackle these. One of the most consistent restrictions over the last decade has been the serious difficulties which many SME builders face in accessing development finance.

As this report highlights, the FMB’s 2017 House Builders Survey found over half of all SME house builders still report that access to finance is one of the major barriers to their ability to build more homes. Although our surveys have shown some improvement in this situation over recent years, qualitative evidence strongly suggests that this may have primarily been driven by increased appetite and presence in the market by smaller challenger banks and specialist non-bank lenders, like LendInvest.

So, lenders like LendInvest are in themselves a part of the answer. The FMB wants to see a flourishing market for smaller scale development finance, with strong participation by a wide range of private providers, and public sector financing where this is necessary to support, and plug gaps in, the private sector market.

Therefore, I fully concur with the strong case put forward by this report for improving access to finance for small developers. Above all, I warmly welcome the contribution that this report makes to an important conversation around the different ways in which government (both central and local) can work with private sector lenders and developers to build a healthier housebuilding industry in this country, one which will be able to build the many more new homes we are all agreed that we need.

Brian Berry
Chief Executive of the Federation of Master Builders
4. Introduction

It is no coincidence that Britain’s most productive housebuilding period also saw the highest numbers of SME developers in operation. Back in 1988, the number of small builders stood at 12,200 in the UK. Their sustained decline correlates with falling housing completion figures and an increasingly strained funding environment.

Among the numerous challenges facing Britain’s property entrepreneurs, 54% of small builders believe that a lack of access to finance is a barrier to delivering new homes. This is not a new problem. The decade since the global financial crisis has seen a retrenchment of banks lending to the sector, starving SMEs of finance and consolidating the position of the largest housebuilders in the country.

The growth of alternative finance has plugged the gap, providing the finance desperately needed by SMEs. Today, private credit is a globally established source of finance, and the Alternative Investment Management Association describes the shift from mainstream lenders to the alternative credit space as a permanent one.

While the UK faces a desperate shortage of affordable homes to rent and buy, a constrained funding environment for SMEs significantly reduces the capacity of new entrants to reverse the housing crisis.

It cannot be left to the largest housebuilders to solve the housing shortage. The top ten firms will only develop what the market will absorb, while protecting their margins. Building more social housing will not meaningfully improve affordability and the availability across tenure and housing types. Only when the number of property entrepreneurs grows and their businesses scale will we see resolution to the undersupply of homes across the nation.

Government cannot fix the broken housing market alone, but there is a role for policymakers to increase diversity in the market. Efforts to date have focused on improving access to land and reforming the planning system, but these changes mean little if property entrepreneurs cannot secure the confidence of lenders or raise capital to get their projects off the ground.

In this report, we set out a number of proposals that maximise the government’s intention to fix the broken housing market by leveraging private and public sector investment alongside one another to deploy capital to the most appropriate SMEs, at pace.

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2 Federation of Master Builders Press Release, November 2017
3 Financing the Economy 2017, AIMA
Who counts as a property SME?

The SME developer: These are the small builders, developing 100 units or fewer per year on brownfield and greenfield sites. These homes are sold to homebuyers or landlords. Often they have transitioned from other professions, having spotted an opportunity to pursue self-employment in the property development market. Their numbers have been in decline for many years, correlating with the slowing delivery of new homes in the UK.

Small-scale landlords: Making up the majority of the housing stock in the private rented sector, landlords diversify housing tenure options for those for whom owning a home is unaffordable or undesirable. HMRC’s most recent figures report there are 1.75 million landlords operating in the UK. The small-scale landlord draws his or her income primarily from their property portfolio.

The property regenerator: These property investors renovate, refurbish and improve old, outdated and uninhabitable properties for resale. These may be old residential dwellings or converted commercial space. By bringing such properties that would struggle to secure mortgages by non-professional buyers back into the market, these investors are helping to maintain market liquidity and increase the stock of homes available across the UK.
5. The finance conundrum

By the Government’s own admission, Britain’s property sector is dysfunctional. The Prime Minister recognises that this is unsustainable and has made a personal pledge to break up the oligopolistic housebuilding sector:

“We will diversify the housing market, opening it up to smaller builders”

Rt Hon Theresa May MP, Prime Minister – February 2017

With housing becoming an increasingly urgent public priority, the question of how we finance the delivery of new homes becomes ever more pressing. Improving access to finance is among the priorities of the government’s flagship white paper on housing, which promised to “fix the broken housing market”. A central ambition is to overcome the challenge of finance experienced by SMEs which constrains their ability to enter and succeed in the property market. Planning reforms and unlocking land for development help SMEs to get on and build, but property SMEs are starved of capital to get their projects going in the first place. A year on from the publication of the housing white paper we have seen the government’s response but access to finance remains critically low.

While Homes England (formerly the Homes and Communities Agency) is getting the government back into the business of building by offering development finance to SMEs, the real impact of the £3bn Home Building Fund is not clear. Homes England and the Ministry of Housing, Communities & Local Government have not published data on the deployment or performance of the loans. Over a year on from its inception, it is not known how many new entrants the Fund has supported into the sector, through actual deployment of funds, nor how many units have been developed as a result of Homes England loans. What is known, however, is that a key recommendation of the 2016 Tailored Review of the Homes and Communities Agency – to use the skills of established lenders to act as intermediaries to disperse funding – has not happened anywhere near as extensively as the industry would like to see.

Bank lending to SMEs has not recovered either. The Federation of Master Builders observed a deterioration in lending conditions for SMEs in 2016/17. What remains is a funding gap for small businesses that is not being filled by mainstream lenders and is not yet met by the Home Building Fund. It is from this increasingly complex lending environment that alternative finance providers have grown to provide a better route to funding for SMEs.

4 Fixing Our Broken Housing Market, DCLG, February 2017
5 Federation of Master Builders Press Release, November 2017
Where can property SMEs go for finance?

**Equity**

Unlike startups in other sectors, equity investment is less accessible for small builders. New entrants and early stage property companies with equity are usually unable to leverage it for future projects as the capital remains tied up in previous projects, stifling their ability to scale up at pace.

**Banks**

Once the mainstay of development lending, banks are cautious about lending to small builders, despite having concordedly improved lending conditions for SMEs in other sectors. Where they do lend, the terms require upfront equity participation by the business which can lock out creditworthy new businesses. After they are turned down, many businesses do not go on to secure finance as they are not aware of alternatives. Because the turnaround process with banks can be slow, developers often lose sites when competing with equity buyers.

**Homes England**

Homes England offers development finance between £250k and £250m as part of the Home Building Fund. To date, it is unclear what level of uptake of this finance route has had. The Homes England product is not widely known. Another challenge for SMEs securing finance through this route is meeting the eligibility requirements. Applicants are required to demonstrate that the scheme would not proceed quickly, or at all, as delivering a minimum of five units. Anecdotally, this route can be bureaucratic and slow for borrowers to navigate.

**British Business Bank**

2017 saw the British Business Bank extend its product range to the property sector, announcing that the ENABLE guarantee would be piloteted with one property lender. This encourages banks to increase lending to small builders by reducing the level of capital needed to be held against such lending. The government pledged to extend this type of activity to provide £8bn in further guarantees.

**Specialist alternative lenders**

Less burdened by the capital constraints and lending costs of our traditional counterparts, it is alternative, “non-bank” lenders that are increasingly plugging the funding gap at the smaller end of the development market by building a suite of swift and flexible loan products to serve SMEs’ needs.
The UK’s alternative finance market grew 43% in 2016, now worth £4.6bn.

In the decade since the global financial crisis, the landscape for SME finance has evolved rapidly as mainstream lenders have withdrawn from the sector. Property development finance lending by banks to small builders has not returned to its pre-crisis levels, the market share for banks shrinking by more than 20% since 2008.

The ability of banks to lend against property projects has been disabled by costly regulation and time consuming processes. Strengthening of the regulatory architecture should be welcomed, but the knock-on effects of increased capital requirements for banks on development lending has made finance inaccessible for SMEs in the sector.

Why aren’t banks lending to small housebuilders?

Reforms to the regulatory capital ratios through the Basel III framework has made development finance a more costly business activity for banks. Under the regulatory requirements, higher risk lending like development finance obligates lenders to maintain greater capital conservation buffers against each loan. Strengthening the regulatory architecture protects these systemically important organisations from encountering system-wide financial shocks.

The increased cost of development finance has incentivised banks to pursue lending requiring less regulatory capital.

As small developers are seeking project finance, fewer firms are obtaining loans from banks. Instead, these companies will secure funding from alternative providers who are not bound by the same regulatory requirements as banks.
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The plodding, byzantine process of obtaining finance from banks disadvantages SME borrowers too. Too often the timescales banks work to do not tally with the needs of the borrower, where finance is needed swiftly and on flexible terms. Without it, deal flow for small businesses is endangered.

Meanwhile, the alternative lending industry has seen “explosive growth”\(^6\) in the last decade, and now plays a more significant role in plugging the finance gap for SMEs. In fact, the UK’s own alternative finance market grew 43% in 2016 alone.\(^7\)

During this boom, alternative finance providers have distinguished themselves from their mainstream counterparts in a number of ways:

**Stepping in where incumbents won’t go**

Alternative finance providers are more willing to lend on complex projects that carry a higher level of risk, so have begun to lend where the mainstream banks will not. For small-scale property entrepreneurs, this can unlock sites and accelerate the completion of projects.

**Flexible, innovative products**

Offering tailored, flexible funding, alternative financiers can alleviate the pinch points for SMEs seeking project-specific finance, even after they have been turned away by the traditional lenders. For example, borrowers select alternative providers when buying property at auction (where 28-day completion deadlines are the norm) or securing finance for pre-construction costs (a product that LendInvest is only one of a small handful of lenders to provide). It is at these junctures that projects are often stalled or abandoned if finance dries up.

By default, alternative lenders must raise capital from third parties. The result can be a diverse base of funding that builds resilience in the business and allows for flexible, tailored products.

The relationship between alternative finance providers and banks is strengthening too. Alternative lenders, crucially, can hold investments on their balance sheets which it is uneconomic for banks to do. Because of this, partnerships are forming across the industry, with alternative lenders taking up credit facilities from banks, and in doing so, reopening the door to the SME market for mainstream finance firms.

**Accelerated by fintech innovation**

Alternative lenders are not encumbered with the legacy systems or clunky processes that slow up mainstream counterparts. Instead, new entrants are using technology to enhance the process of obtaining finance. At LendInvest, for instance, we’re using tech-based innovation to make refinancing to a new product simpler, to bring the application and loan management process online, and to create a marketplace in which borrowers and investors can connect.

In short, alternative lenders are transforming the decades-old specialist finance sector, using technology to fine-tune business models and build new lending processes from the ground up.

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\(^6\) *From Peer2Here: How new-model finance is changing the game for small businesses, investors and regulators*, CSFI, May 2017

\(^7\) *Entrenching Innovation: the 4th UK Alternative Finance Industry Report*, Cambridge Centre for Alternative Finance, December 2017
Diversity in finance supports variety in housebuilding

With a persistent shortage of credit supply for property, alternative lenders are leading in providing fast, commercial and flexible finance to SMEs where banks fail.

With funds from alternative finance providers, SMEs are transforming sites that larger housebuilders would not touch: converting homes above shops on high streets; refurbishing unmortgageable properties to bring them back into use; and building on small plots of land which are uneconomic for larger housebuilders to develop.

By lending to these businesses, alternative finance providers are promoting diversity in the sector and funding the development of quality, affordable homes that communities want and need.

Commentary by Jiří Król
Deputy CEO and Global Head of Government Affairs at the Alternative Credit Council

Non-bank lenders have now established themselves as a credible alternative to traditional sources of finance for SMEs. The sector is on track to reach $1 trillion globally by 2020 with UK SMEs likely to be one of the main beneficiaries of this growth. Alternative sources of finance increase the funding options available for businesses and promote healthy competition in the market. Non-bank lenders can also reduce the impact of economic shocks during times when banks are unable or unwilling to lend. This supports a resilient economy and better outcomes for customers and borrowers.

Our research shows that borrowers value the flexibility of non-bank lenders and their ability to rapidly provide financing on terms tailored to the borrower’s circumstances. The attractiveness of non-bank lenders to borrowers is also evident when one considers the growing trend of repeat business when SMEs require further financing to fuel their next stage of growth. SME owners wary of diluting their equity stake in their businesses often find the flexible approach of non-bank lenders more attractive than other forms of growth capital.

The flexibility shown by many private credit managers is matched by their focus on lending standards and commitment to robust credit analysis. Non-bank lenders typically source capital from institutional investors with a long term investment horizon. These investors ultimately bear the risk of their decisions and non-bank lenders have a duty to act in the best interests of their investors. This creates a strong alignment of interests and encourages responsible lending practices. This structural feature has been an essential ingredient in the sector’s growth to date. It is likely that this rigour will remain a key feature of the non-bank lending market as it continues to develop.
Future solutions to increasing housing supply must not rely on cash injections from the state. Instead, central and local governments must build sustainable funding lines that are available to SMEs for the long term.

Alternative lenders can be the answer, but credit allocation to SMEs requires alternative lenders to source capital sustainably. To provide appropriately priced products for SMEs, these lenders must pursue cheaper capital to fund the right homes in the right places.

What follows are three initiatives that combine the strength of the government to improve access for SMEs with the expertise of non-bank lenders to identify and service loans to scaling property businesses.

A. Leveraging the Home Building Fund through alternative lenders

Homes England should deploy the £2.5bn Home Building Fund through funding lines agreed with alternative lenders.

Homes England introduced the Home Building Fund in 2016 to support housebuilders in accessing finance for development. The Fund, designed to improve the speed of delivery of new homes and promote new approaches to housebuilding, offers £2.5bn in development finance for borrowers and is administered by Homes England.

To date, however, Homes England has only appointed one commercial partner officially. The major bank does not administer the Home Building Fund, but instead works with Homes England to deliver public housing.
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What is the Home Building Fund?

Comprising £2.5bn for development finance and £2bn for infrastructure finance to SMEs, the Home Building Fund represents the government’s concerted effort to increase the availability of finance to SMEs building homes in England.

Applicants to the Home Building Fund must deliver five or more units, and projects that deliver the maximum amount of housing for the funding given are prioritised.

Our research indicates that the Home Building Fund has contracted 153 schemes delivering 88,000 homes to date. Yet, it is not clear how much of the Home Building Fund has actually been deployed to developers as of yet.

Homes England is not making use of the network of commercial lending partners available to accelerate the deployment of capital, despite similar models existing in other government-backed bodies, including the British Business Bank. In the Tailored Review of the Homes and Communities Agency (now Homes England), it was recommended that the organisation make greater use of commercial partners to ensure the uptake of finance by small builders.8

How it would work

With alternative lenders already financing the building of new homes through flexible and tailored project and development finance products, the Home Building Fund could be administered by alternative finance companies as partner lenders. These partners could co-invest in loans, ensuring alignment with the Home Building Fund’s objectives while also amplifying the ability of the Fund to deliver more homes.

Homes England can provide alternative lenders with funding lines from the Home Building Fund to deploy its funds to the most creditworthy borrowers, and without delay.

8 Tailored Review of the Homes and Communities Agency, DCLG, November 2016
A £200m funding line from HBF could be combined with £100m of capital from an alternative lender creating £300m for lending to SME developers. Assuming an average loan size of £3m, this could provide 100 loans, which could deliver more than 2,000 homes in 2 years. As loans repay capital could be recycled into new projects creating more houses.

By designating funding from the Home Building Fund to selected lending partners with experience in lending to SMEs, Homes England can accelerate the pace of deployment and the number of homes delivered.
Case Study

Yogo Group development

Gross development value: £25m

Family-run developer Yogo Group purchased a site known as the former Thomas Lipton Care Home, a Grade II listed building in Southgate, North London, on which they plan to build 24 apartments and six houses. The established development firm, which has been building uniquely-designed homes in the area for 15 years, would not have been able to progress the purchase and subsequent development on the site without the swift turnaround in funding which secured the site after a previous lender pulled out. A common challenge for developers is keeping to vendors’ timeframes, in this case needing to complete before the vendor accepted a competing offer. The finance, in this example, took only three weeks to secure.

“LendInvest achieved the unachievable, ensuring a quick and smooth three week completion”

George Phillippou, MD of Yogo Group

Traditional lenders

Average 3–6 month completion

Alternative finance

Can be as swift as 2 weeks

By leveraging specialist alternative lenders, Homes England will maximise the Fund’s economic impact:

**Funding the most productive small home builders:** Alternative lenders are experienced in assessing the creditworthiness of a borrower and the realistic prospect of their project being delivered.

**Reducing administrative costs for the taxpayer:** By outsourcing loan management and administration costs to alternative lenders, Homes England can deliver better value for money to the public.

**Responding to market demand for the right homes in the right places:** Property businesses that borrow from alternative lenders make a living from identifying, preparing and delivering on sites that larger housebuilders would not be interested in. By working with alternative lenders, Homes England can support these businesses to expand their activity across the UK.
B. Empowering local authorities to invest and co-invest in residential development loans

Local authorities should co-invest with alternative lenders in local developments, utilising the Public Works Loan Board mechanism to provide discounted capital for SMEs.

Through the Public Works Loan Board (PWLB), local authorities have borrowed £29.7bn to invest in infrastructure since 2010.\(^9\) £2.7bn has been invested in commercial property by local authorities since 2015. Much of this lending will have been drawn from the Public Works Loan Board.\(^10\)

Local authorities should use the Public Works Loan Board mechanism to invest in residential property, delivering a greater economic and social benefit to communities.

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\(^9\) House of Commons Library

\(^10\) Andrew Ellson (2017) Ban on local council investments in risky property portfolios, The Times, December 2017
### What is the Public Works Loan Board?

Drawing from the National Loans Fund, the Public Works Loan Board (PWLB) is situated within the Debt Management Office in HM Treasury and makes loans to local authorities and other public bodies including parish councils and drainage boards.

The mechanism has been providing infrastructure loans to local government for well over a century, allowing local government to access finance at low interest rates.

Local authorities can access finance at rates as low as 0.6% if projects are nominated by Local Enterprise Partnerships.

### Eligibility

The PWLB does not require information on the purpose of a loan. As the responsibility for local authority spending and borrowing decisions remains with the locally-elected members of the council, the PWLB only requires that local authorities borrow under prudential borrowing rules.

### What does the PWLB lend against?

The PWLB is responsible for most recent loans to local authorities.

The use of its funds by local authorities to develop commercial property portfolios has been widely criticised recently.

Other uses are to fund the development of community infrastructure, including roads, schools and hospitals.

Local authorities can use the PWLB mechanism to borrow capital to build homes only where headroom exists in their Housing Revenue Accounts. Local authorities already building new homes are able to bid for increases on their Housing Revenue borrowing caps from 2019-20 to 2021-22.
How it would work

A joint venture by local authorities and alternative lenders would make bridging and development finance available and more affordable for SMEs. By accessing rates as low as 0.6% through the Public Works Loan Board, local authorities can bring down the cost of capital for alternative lenders and, in doing so, reduce interest rates for small-scale development borrowers.

1. **Finance facility agreed by local authority and lending partner.** Each local authority will negotiate individually tailored deals with the PWLB for lending in its area and with lending partners. This will include determining the types of deal to be funded.

2. **Local authorities apply for finance through the PWLB for nominated deals.**

3. **Borrower makes enquiry to lending partner.** The product will be marketed distinctly from other lending products to ensure it is recognised as a government-backed programme.

4. **Lending partner conducts eligibility assessment.** All deals will benefit from the alternative lenders’ experience in conducting due diligence assessments to determine the creditworthiness of borrowers, providing value for money for the taxpayer.

5. **Loan deployed and managed by lending partner.** Lending partners manage and service the PWLB-backed loans, providing periodic updates to local authorities. This will include managing extensions and collections.

6. **Loans mature.** When loans reach the end of their lifetime, local authorities will have made a return on the capital invested, as well as having delivered a number of homes to their local areas. The capital can be recycled into the scheme.
Case Study

Shepway Council, Kent

A LendInvest developer was interested in purchasing a disused NHS office which was available for sale with permitted development rights for residential use. The developer approached Shepway Council with a view to renting the completed units back to the Council to assist with its housing requirements. Shepway Council offered to purchase the completed 16 residential units from the developer.

The client entered into a back-to-back contractual purchase and completion contract with both the vendor and the council, which enabled the developer to obtain swift finance from LendInvest with certainty of an exit once the development reached practical completion.

The deal is currently progressing ahead of schedule, providing sufficient comfort to Shepway Council to build a pipeline of further deals for the developer to consider. The developer has also been introduced to a neighbouring council with a view to undertaking similar schemes for them to assist with their local housing requirements.

Both of these councils are keen for the client to undertake more refurbishment, redevelopment and new build projects. Indeed, there are countless local authorities across the nation that would benefit from this type of coordinated investment. The only delay for these schemes is in accessing appropriately priced finance.

Plugging the finance gap for local authorities

The Local Government Association estimates that there will be a funding gap of £5.8bn for local councils by the end of the decade. By encouraging local authorities to enter into public-private partnerships of this kind, councils will become increasingly self-sustaining and able to raise finance independently. Private lenders bringing forward deal flow will increase the capacity of local government to deliver homes, while maintaining skin in the game to ensure government is not unduly exposed to residential development investment.

Value for money for taxpayers

Where local authorities have spent billions in recent years on investing in shopping centres, retail parks and supermarkets, criticism has been made of the decision to make risk-heavy investments of public money on commercial property that often does not directly impact on the local community.

Social impact

This proposal would see PWLB funds directly benefit the local economy and social infrastructure through the provision of new and improved homes in the local region. By increasing local development, local authorities will make strides towards meeting their housing need targets.

Local Government Association Briefing, Local Government Finance and Arrangements Beyond 2020, House of Lords, July 2017
Delivering more homes

By participating in private development projects, local authorities will benefit from the expertise and resources of its partners, profiting from the development of local homes that are truly needed by the community.

The PWLB could be leveraged to fund the development of housing in local communities, contributing to meeting the local housing need figure. Alternative lenders will help local authorities identify appropriate deals that meet the tenure and specification requirements of the local area.
C. Radical extension of the ENABLE guarantee to include non-bank lenders

The British Business Bank should appoint more alternative lenders to use the ENABLE Guarantee programme to underwrite property investment and development loans.

Until recently, the property market has been an untapped and overlooked market for the British Business Bank (BBB), which has focused on providing finance solutions for SMEs in almost all other markets across the UK economy. In its 2017 report, *The Benefits of Diverse Small Business Finance Markets*¹², the Bank highlights a truth known all too well by small businesses: the finance needs of many small businesses to date have not been matched by accessible products designed for them. This came with an acknowledgement that the BBB’s products have been largely inaccessible to SMEs in the property sector.

The Chancellor used the 2017 Autumn Budget to promise a further £8 billion in loan guarantees, through mechanisms including the BBB, broadening the government’s stake in property investment. The opportunity therefore exists to open up the ENABLE mechanism to a new generation of alternative finance lenders.

By extending the ENABLE Guarantee to non-bank lenders, more lending to SMEs using both bank and non-bank-generated finance becomes possible. This is especially important for alternative lenders raising capital from third parties (most likely, traditional or challenger banks), since it’s alternative lenders that typically face the greatest access to finance issues. By reducing the risk of lending, it gets financiers working together to make more money available for housebuilders.

What is the ENABLE Guarantee?

The ENABLE Guarantee is a British Business Bank programme designed to support finance providers to increase lending to SMEs.

Participating lenders are incentivised by a state-backed portfolio guarantee that covers a portion (often as much as 50-75%) of a designated lending portfolio’s net credit losses in excess of an agreed ‘first loss’ threshold, which they receive in exchange for a fee.13

The mechanism is intended to support financiers to offer more products to SMEs.

How is the ENABLE Guarantee currently used?

Under current capital adequacy requirements, a bank must hold in reserve capital against all loans that it facilitates. In the case of property development lending, there is a capital risk weighting of 150%, whereas consumer mortgage lending is as low as 35% under the standardised approach.

The cost implication of holding such an amount in reserve reduces a bank’s potential return on exposure and often, in turn, reduces that bank’s appetite to lend at all.

In the event that a bank secures an ENABLE Guarantee, the BBB will cover a proportion of net credit losses of the bank’s loan portfolio.

This can significantly reduce the size of the portfolio that is required to be covered by capital held in reserve. At the same time, it boosts the potential return on exposure of the loan portfolio, increasing the bank’s appetite to lend.

How it would work

Alternative lenders typically rely on capital sourced from third party debt providers (very often banks) in order to originate loans. In most cases, an alternative lender supplies equity or mezzanine capital in the deal.

In the event that the BBB extended the ENABLE Guarantee to an alternative lender, it would help to reduce further the cost of capital for the third party senior debt provider, and ultimately the alternative lender.

This is thanks to the inclusion of equity supplied by the alternative lender in the composition of the loan portfolio. Its presence means that the portion of the total portfolio that is subject to capital adequacy provisions can be reduced significantly, potentially to zero, as the alternative lender’s equity would provide the first loss position. Here, the BBB would take considerable comfort from the alternative lender having ‘skin in the game’.

This increases the potential return on exposure for the senior debt provider. Not only does this make the capacity to lend more attractive to the senior debt provider, but it will enable it to reduce the cost of the capital it is providing to the alternative lender. Subsequently, the alternative lender will be able to price its debt at a lower level to its eventual borrowers.

The BBB has acknowledged that capital requirements for development finance can prevent lenders from being able to deploy capital to small housebuilders.\textsuperscript{14}

By turning its attention to how it partners with alternative lenders in this way, the BBB would help to reduce the cost of finance available to SMEs in the property space while, at the same time, putting more of it into circulation and promoting greater diversity and viability in the housebuilding sector.


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\textbf{Case Study}

\textbf{In pursuit of affordable finance}

“As a small to mid-size developer, the major issue that gives my partners and me concern in delivering more units is the cost of funding and restrictions that come with funding terms.

“On bigger, more complicated schemes, execution risk becomes a bigger consideration and ultimately makes it harder to procure competitive funding for an SME especially. Therefore shifting risk over to larger name developers and contractors is tempting, who inevitably get cheaper rates as well given their covenants.

“In short, if we could access better rates, we could deliver more units.”

Nick Harvey-Jones, Colvestone Real Estate Ltd
8. Why finance must flow to SMEs

It is a well-acknowledged idea that when SMEs are active in the property market, the impact on communities is positive. The absence of new entrants and flourishing SMEs in the market allows the largest housebuilders, which account for the majority of the UK’s annual housing output, to prioritise higher margins in place of much needed homes. The market cannot expand to build the homes the country needs without a dynamic, well-resourced number of SMEs supporting competition and quality in every region of the country. By extending greater access to finance to these companies, local property enterprises can start up and scale.

Financing these firms will dramatically increase the number of homes delivered year on year. The Home Builders Federation predicts that if we were to return to pre-financial crisis numbers of SMEs active in the housebuilding market, we would deliver 25,000 more homes each year. In its 2017 report Reversing the Decline of Small Housebuilders, it said:

“It is no coincidence that the late 1980s spike in net additions to the dwelling stock occurred at a time when small builders were flourishing in a freer, more entrepreneurial market…”

In 1980 there were over 10,000 SME housebuilders, providing 57% of the UK’s housing. After decades of structural decline, the financial crisis saw a third of the remaining SMEs wiped out of business. In 2015, only 12% of new housing was provided by small-scale businesses.

The shortage of funding to these small businesses has led to the formation of an oligopolistic sector, where low supply impacts on housing affordability. We cannot build cheaper homes to buy and rent if housing is not developed in the local economies that need it most. But the top housebuilders do not align their building with housing need; rather, they go where they can maximise their profits.

15 Reversing the Decline of Small Housebuilders, Home Builders Federation, January 2017
16 Profits Before Volume? Major Housebuilders and the Crisis of Housing Supply, Tom Archer and Ian Cole, Centre for Regional Economic and Social Research, Sheffield Hallam University, October 2016
17 NHBC Press Release, NHBC, May 2017
Enterprising property entrepreneurs play a crucial function in regional economies

**The right homes in the right places**

SMEs bring forward small sites of land that larger housebuilders would not develop. SMEs are responsible for putting old homes back into the system by refurbishing uninhabitable properties and converting commercial units into residences. This can preserve buildings and is often a cost-efficient way of modernising towns and cities. Alternative finance providers provide the specialist finance needed for these deals.

**Affordable local homes**

Rather than building prime residential units to attract higher returns, SMEs build homes that local markets need, resulting in property that is within reach of local residents.

**Quality development**

Volume housebuilders have been criticised for a lack of diversity in housing design, poor workmanship and for being unsympathetic to local circumstances. This contributes towards reticence by local communities to development in their areas. The Federation of Master Builders found, however, that homeowners are twice as likely to be satisfied with their property if it was constructed by an SME. Often this means more complex projects, which alternative finance providers work flexibly around.

**Supporting a professional private rented sector**

Many small-scale property entrepreneurs invest in property as part of a portfolio. Where they make property available to the private rented sector, they contribute towards building a professional landlord sector. Specialist alternative lenders are financing these professional landlords through the lifetime of the property value chain.

**Creating employment**

In every postcode, SMEs are creating local employment to deliver new schemes. As well as providing an income for employees and contractors, these businesses are often where young people get a start in the sector.

Commentary by Nick King

Former Special Adviser (2015–2017) to Sajid Javid MP, Secretary of State for Housing, Communities & Local Government

The current dearth of SMEs in property development is one of the most serious issues restricting housing supply across our country and, as a former government adviser, I can say with absolute confidence that the government is determined to do something about it.

The 2017 Autumn Budget was a Budget for small builders, with planning reform, new sites and increased funding all aimed at increasing the number, and success, of SMEs.

But it is clear that the planning changes and the public purse can only take us so far.

The big banks are not lending as they once did, so the efforts of alternative lenders and the allocation of alternative finance will be critical if we are to rejuvenate the SME sector.

Policy needs to reflect those facts and policymakers need to ensure that capital gets where it needs to – directly into the hands of the SME developers who will help build the homes this country so desperately needs.

This report makes that case in compelling terms and is vital reading for all those interested in this topic in Westminster, Whitehall and beyond.

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9. Conclusion

Small housebuilders, property investors and professional landlords are finding a lifeline in the growing alternative finance industry. A decade on from the financial crisis, it is largely accepted that the role of these SMEs must be enhanced if we are to reverse the undersupply of homes. Yet policymakers have barely realised the potential of alternative finance providers in fuelling the SME economy.

Stimulating the growth of SME housebuilders is central to the public effort to increase housing supply. Despite the strategic infrastructural importance of the property sector, its entrepreneurs face the most significant challenges to starting, maintaining and growing businesses. Access to finance is the first critical problem a housebuilder or landlord faces. If we do not encourage a new generation of entrepreneurs to succeed in the sector, there can be no realisation of the ambitious housing targets set by ministers.

To truly fix Britain’s broken housing market, the government must be willing to equip as many sector constituents as possible with the tools to create sustainable solutions to increase housing supply, shifting responsibility for delivery away from governments. With unrivalled access to land and the power to untangle the complex planning regime, good progress is being made on improving SMEs’ access to land. Now policymakers must use the state’s power to make lasting reform in the finance arena by priming lenders to SMEs.

Specialist non-bank finance providers are changing financial services for good. By applying the use of technology to investment and lending markets, alternative finance is the new normal in SME lending and it has enriched the finance ecosystem, reconnecting traditional finance providers with markets that have become inaccessible to them as regulatory and market conditions change.

It is time that government collaborates with this clutch of lenders to bring property finance into the 21st century and to provide an alternative route out of the UK’s housing crisis.
10. Acknowledgements

In addition to the organisations and institutions referenced in the footnotes throughout this document, LendInvest would like to extend its thanks to Mark Prisk MP, the Federation of Master Builders, the Alternative Credit Council and Nick King for their valuable contributions to this report.