ARC & CO. SUMMER REAL ESTATE FUNDING REPORT

H1 2024 OVERVIEW AND OUTLOOK FOR H2 2024

AUGUST 2024

Arc&Co.

AUTHENTICITY

ENTREPRENEURSHIP

EXCELLENCE

Follow us on LinkedIn

enquiries@arcandco.com

Visit our website www.arcandco.com

60 – 62 Margaret Street,
London, W1W 8TF

FOREWORD

ANDREW ROBINSON
CEO, ARC & CO. GROUP

In the first half of 2024, the number of new clients we supported doubled. This was driven by an investment in the growth of our team, as well as our marketing and origination channels, but it was also a product of market shifts. Land price adjustments and interest rate stabilisation improved the viability of projects and boosted confidence in developers, professional investors and residential purchasers.

The interest rate market has occupied most advisors' time, with speculation on when the next rate cut was going to happen creating volatility in the swaps market which led to fluctuations in lenders' rates.

The first base rate cut since 2020, announced on August 1st has removed some of that volatility, with swaps reducing significantly on both two- and five-year indices. While tracker/variable rates look tempting as rates reduce, the value for money is still in the fixed rate market where the arbitrage between fixed and variable has been over 100bps.

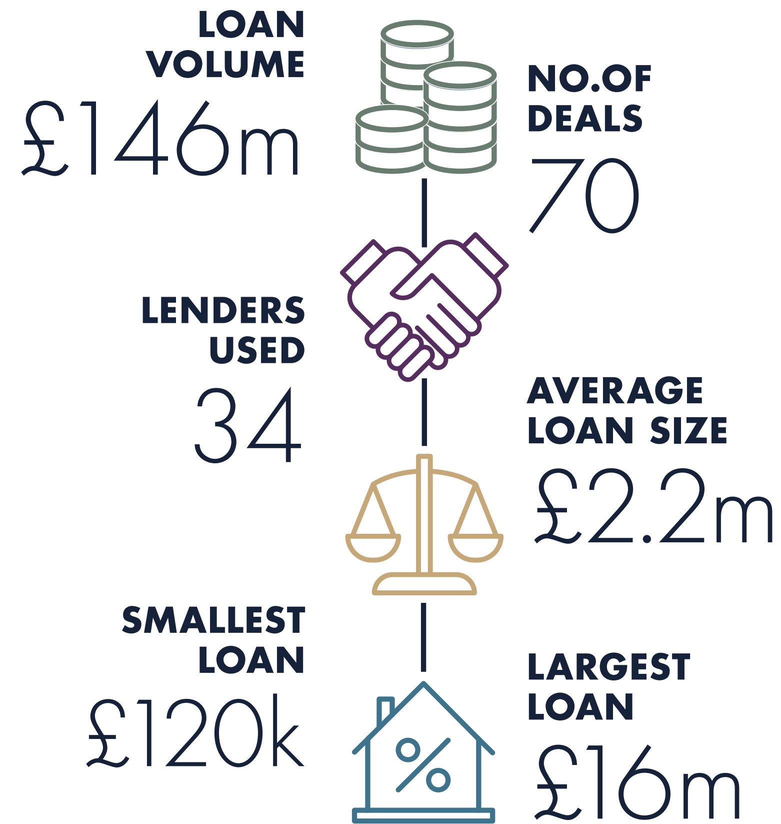
The fixed rate market has provided many benefits as swaps have reduced significantly—loan amounts for the professional investor and the residential mortgage consumer are now higher due to more viable Interest Cover and Debt to Income Ratios, improving available leverage and freeing up opportunities.

Bridging has continued to be dominant for both the developer and professional investor, as evidenced in our refinance figure which is up more than 25% on the previous six months. Developers are still seeing value in refinancing completed schemes, allowing them to optimise their sales value. In some cases, it has improved their cost of borrowing due to previously higher development finance costs.

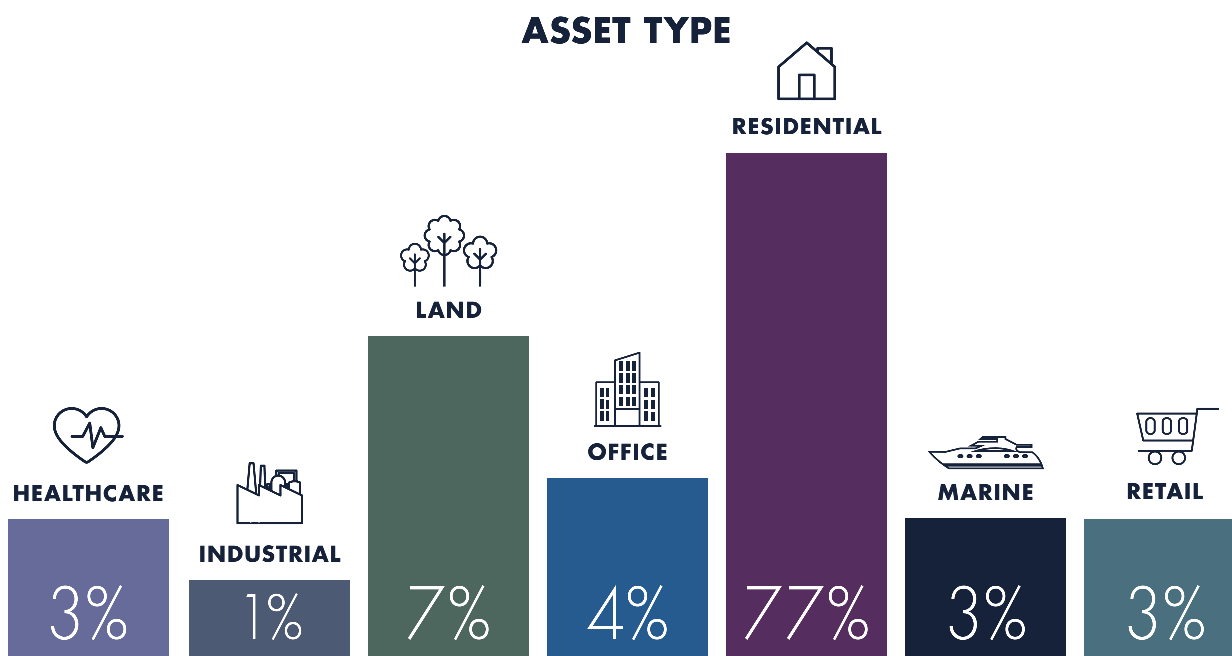
Professional Investors have been using bridging for up to 24 months to give them a higher day one loan amount, while allowing them to improve the asset through re-gearing the leases and capex programmes to meet occupier demand and ESG requirements.

Many of our expectations for the first half of 2024 were correct, and the team at Arc & Co. have worked hard to set in motion an incredibly strong pipeline of cases due to complete over the next few months. Our clients remain supported through every cycle and every market.

The data below is based on Arc & Co. H1 2024 completions across all parts of the business. Percentages are worked out on the number of deals funded, rather than loan volume, unless otherwise stated.



ASSET TYPE

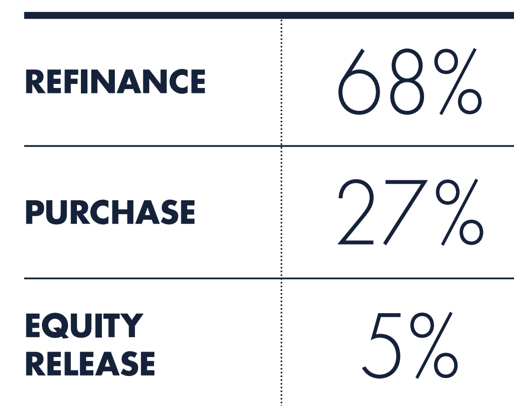


LOAN TYPE BY £ VOLUME

FINANCE TYPE

CLIENTS

PURPOSE



OUTLOOK

EDWARD HORN-SMITH
MANAGING DIRECTOR

As we enter September, we're looking at the strongest pipeline of loans in execution we've seen in nine quarters—over 40 deals.

July was a mammoth month for Arc & Co., in which we completed over £50m, spurred by political and base rate stability.

Confidence is rebuilding and pricing continues to readjust, and with that we expect a more increased appetite from mezzanine and equity providers. In turn, we are already seeing far more purchases on the books, as these cases begin to stack up more sensibly.

Our average loan size is trending upwards, fuelled by the return of large ticket portfolio refinances and opportunistic acquisitions. While many borrowers have put off refinancing larger assets, confidence is increasing, and competitive funding options are on the rise.

As mentioned in January, we've witnessed the realisation that the base rate reduction was not going to be the sharp decline we'd hoped for. The more moderate adjustment confirmed our anticipation that significant new investment will only be taking place in the latter half, if not final quarter, of 2024.

We note the slow return of the high street; bank/balance sheet lending is good for borrowers looking to get the lowest possible margins.

Ground-up transactions are now taking three to six months to complete, and accounted for just 4% of our loan book in H1. However, the coming months show a strong number of cases moving into later stages of our pipeline as the rate of schemes getting funded picks back up and developers recommit to getting projects out of the ground.

We remain plugged into the requirements of our clients, and look forward to joining them on their property journeys during the remainder this year and into 2025.

INSIGHT

Michael Strange, Director, Funding 365

As a short term property lender offering a wide range of funding requirements, Funding 365 is well placed to identify trends in the professional market. Being a CBILs accredited lender, for example, meant that we witnessed first-hand the unprecedented surge in demand for development exit bridging loans from developers whose projects had experienced significant delays as a result of the lockdowns. 2024 to date has seen us deliver a broad spectrum of funding with Arc & Co. for residential and commercial property purchases, property refurbishment, development exit and short-term buy-to-let uses. It is therefore clear to us that the specialist mortgage market is in excellent health. Market confidence in house price stability has returned, reinforced with the knowledge that interest rates have peaked and the latest movement has been downward.

Amidst the activity levels, however, it is also evident that there have been a few shifts in property professionals' behaviour. We have seen a reduction in heavy refurbishment and PDR conversion projects. Developer nervousness is understandable against the backdrop of increased wages, material costs and spiralling financing costs. At the same time, we have identified increases in investment activity from housing associations and social housing landlords. This has stemmed from the government's steps to combat the problems that are being caused by the chronic lack of housing combined with the relatively rapid population growth.

Looking to the second half of the year, with a new government bringing a bold pledge to deliver 1.5 million new homes during this parliament, many eyes in our industry will be on development – and specifically how planning policy reforms will affect housing development. After all, if there is any hope of these homes being delivered, they will need to be funded, and the specialist market is going to play a very significant role in this.

Anish Vora, Structured Finance

The Structured Finance division at Topland Group has seen the first half of 2024 get progressively busier. We have continued to deploy capital across all real estate sectors, with a particular focus on well located hotels, Prime Central London and City based office and residential assets. Investors' and developers' confidence is growing, facilitated by a more stable economic and political backdrop alongside prices and valuations which reflect yields normalising in line with the higher interest rate environment.

As a lender, we have adapted to the lower-than-average deal flow seen earlier this year by continuing to be as competitive as possible on both gearing and pricing. While high street and private banking funders are increasingly risk-averse, our multi-billion-pound diversified real estate portfolio—along with our significant value-add development pipeline—leverages our extensive in-house experience, facilitating well thought out commercial decisions.

We continue to observe that offices in the City and West End, particularly those with best-in-class ESG credentials, are continuing to attract high-quality covenants. We are actively providing acquisition and capex facilities in this sector. Additionally, hotels in prime locations have been strong performers recently. Solid demand for occupancy and higher room rates have counterbalanced inflationary cost pressures.

We look forward to the remainder of the year and will continue to support investors and developers with flexible funding solutions on acquisition, refinance, and capex facilities against well located assets.

LANDBAY

Helen McKinney – Head of Sales, London

As a buy-to-let lender we are incredibly positive about the sector. Not only has this resilient sector survived countless crises and changing governments over the years, it continues to thrive.

Our recent landlord survey revealed that more landlords are intending to buy properties than when we last asked them about their future plans at the end of 2023. Fewer landlords are feeling negative about their prospects and those who are positive cited increased or steady demand. The strongest positive sentiment is among those landlords with portfolios over 20 properties.

We remain committed to innovating to meet the needs of landlords. We have made sizeable reductions across our product range including our five-year standard products, two-year standard and two-year like-for-like remortgage products, and our two-year small HMO/MUFB products.

Being a tech-centred lender means we are agile and able to respond to changes and new demands in the market very quickly. This allows us to best support our broker clients with a range of products that is not just competitive, but wide enough to meet a broad range of needs.

Our objective is to support broker clients of all shapes and sizes. This is not just about purchase, although it is clearly important, the sector has done great work to ensure options are there for those still facing the challenge of a tricky remortgage. From a Landbay perspective, we've continued to strengthen our like-for-like remortgage range for those with no change to their borrowing requirements. This includes a lower stress test of just payrate to help with those affordability calculations.

Outlook for the sector for the rest of the year feels more optimistic, given the prospects for inflation and the recent base rate reduction. With affordability still a real challenge for residential buyers, and demand continuing to outstrip supply, there is an abundance of tenants ready to rent across the country. Decent rental properties, run by responsible landlords, are key to the health and prosperity of the housing market, helping to provide much-needed accommodation.

HOLLIS

Steve Hughes, Director

At Hollis, we carry out technical assessments for investors, including ESG, to help them maximise the performance and value of their assets. We work with clients on getting their office assets into institutionally investable condition for the next 10–15+ years.

Many thought that strong demand for office space would not return, changed forever by the lockdowns. This has turned out not to be the case; instead, tenant requirements are healthy and have shifted notably towards A-grade offices that are energy efficient and offer amenities that make people *want* to come in to work.

This, coupled with the looming MEES regulations and refinancing events, has forced investors to consider the value of upgrading their assets in order for future-proof them and bring them in line with institutional standards.

Commercial rented properties will need to achieve a minimum EPC rating of C by 2027, increasing to a B by 2030, or to otherwise prove a valid exemption.

Fundamental changes to non-domestic EPC methodology in June 2022 has had a considerable impact on how EPCs are calculated. Investors should be cautious when making investment decisions or budgeting capex based on EPC prepared prior to when these updates came into effect.

Investors seeking to refinance assets with ratings of D and below will be required to evidence to funders how they intend to improve this over the course of the loan term.

In addition to costs for the improvements, vacant possession of part of the whole of the building may be needed for the construction period. As this has an impact on rental income, very often a project is commenced at the end of the lease term.

On loan refinance, investors may be asked to put more equity in to balance the loan to value ratio; if they haven't got the equity, they'll either go to another loan provider or the investor may need to sell—this often results in price chipping because there's plenty of buyer demand at today's market price.

A vulnerable asset is created when it is underperforming, and tenant expiries clash with the refinance date. This, in turn, creates an upgrade opportunity, or the chance for an incoming buyer to offer a below-market rate for the property.

Current office investors will be assessing if the highest maximum rental potential for that building can stand that investment. If not, offloading (likely at a loss) may be the only option.

Tenant demand is strong—and they want five- to 10–year leases (with break options) for offices with top amenities, EPC ratings and good governance. There is a healthy tenant audience who will clamour for A-grade premises and the price-tag that comes with it.

Bridging finance can be used to undergo an asset management programme for 12–18 months before cheaper term debt can be secured.

Although some may assume that these EPC milestones will be pushed out, pension funds, for example, cannot take that risk. These institutions will be assessing their portfolios and, in some cases, deem a proportion to be in need of selling down.

We anticipate that within two to three years, 60% of office stock is going to be out of kilter with where the market is. Investors who own one of these assets, or are considering buying one, will need to work towards ensuring it's in an institutionally tradable state—in line with the optimal market they'll eventually be selling into.

Pre-refurbishment value, asset improvement costs, and loss of rent (void period) all need to be considered against the value of the improved asset.

It would be prudent for clients to seek advice on the level of additional investment needed to achieve Grade A status. In this sector, EPC B should be the minimum target.

Follow us on LinkedIn

enquiries@arcandco.com

Visit our website www.arcandco.com

60 – 62 Margaret Street,
London, W1W 8TF