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Welcome to Berwin Leighton Paisner’s second Real Estate Development report. The trends highlighted are based on a survey of our clients carried out in spring 2010, assessing the prospects for development funding as we look to the start of the next cycle.

There is no doubt the market remains challenging, not only for developers, but also for investors and banks. With low interest rates and a shortage of available prime assets, combined with a potential “double-dip” recession, there are both opportunities and uncertainties about how this year will progress. Many of our respondents do not anticipate development restarting until at least the spring of 2011, with the availability of funding providing the most significant barrier to developments commencing in the near future.

The most promising theme to emerge in the paper that follows is a consensus amongst developers, investors and banks in favour of a shift in the approach to development finance, with all three welcoming moves towards joint venture arrangements and equity participation. There are clear signs that these equity arrangements will continue to play a part in filling the funding gap, with joint ventures, forward-fundings and forward-sales being considered as the way forward.

The last two years have been amongst the most challenging seen by the UK real estate sector and bridging the funding gap continues to be a very real concern. Although some banks are still offering finance, the criteria required to lend is proving to be a stumbling block. As a consequence, we have been working across the market to deliver creative, workable solutions to get projects off the ground despite reduced levels of bank debt.

With the arrival of a new UK coalition government, and a clear focus on reduction of the deficit, there are questions being raised about what they can do to stimulate the market. The obvious economic measures around tax breaks and incentives, to encourage lending and investment, may be challenging to implement for some time to come.

Please don’t hesitate to get in touch with me, or your usual BLP contact, if you’d like to talk more.

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Executive summary

The UK’s real estate development market has been on hold since the downturn began, and has inevitably suffered from the most obvious impact of the credit crunch: an unwillingness amongst the banking community to lend money. A lack of development finance, amongst other factors, quickly stalled a wide range of schemes and continues to prevent development on a significant scale, despite a willingness across the industry to find ways through the current standstill.

We surveyed 100 major players in the real estate sector on the development market, taking a sample of views from banks, developers and investors. Our goal was to take the temperature of the current state of the market, to uncover the sense amongst participants about when schemes might be brought forward and to see what can be done to help the process of recovery.

A number of interesting themes have emerged. Looking at the current position, it was surprising to find half of the bank respondents telling us that they are offering development finance. There is a general awareness of a lack of debt in the market, with developers identifying the availability of finance as the biggest stumbling block stalling developments in the next 12 to 24 months. It is likely that the perceived lack of availability is more to do with the viability of schemes and the stringent criteria required than a halt to lending.

When it comes to predicting the upturn, the majority of respondents are reticent about improvement in 2010, suggesting instead that it will be spring 2011 before development commences in earnest. Asked about the sectors that might move forward first, there appears to be a consensus amongst banks, investors and developers that it will be retail-led schemes that are most attractive, with the office market also favoured.

This report uncovers a significant trend towards equity participation in place of debt. There is an appetite for a greater use of joint venture arrangements, forward-fundings and forward sales to overcome the financing hurdles of new developments. London and the South East - perhaps unsurprisingly - look set to lead the revival of activity and established industry players will be the best-placed to secure funds. Turning the clock back to 1992, following the last major recession then too equity replaced debt, as institutional investors dominated and forward fundings were commonplace. In contrast to the early 1990s, however, the commercial property landscape today is marked by low interest rates that have given rise to equivalent low gilt and bond returns. The result is a recovery in the prime property investment market, both in London and in the leading European cities, but the impact on development is less clear cut.

This report reveals a feeling of anticipation and optimism, with the industry looking to continued recovery. Much will depend on the early initiatives of the new government - with calls for action on planning legislation and property taxes as a means to kickstart the industry’s recovery - and on the bank lending market, but there is no doubt that the developers, investors and banks alike are keen to get things moving.

“This report uncovers a significant trend towards equity participation in place of debt.”
The reduced levels of available debt are driving the need for equity to play a significant role in moving the market forward. The appetite for development is still significantly reduced when compared to pre-recession, and there are clear indications that projects are unlikely to get off the ground until at least spring 2011.

The start of the credit crunch was soon followed by a reduction in the number of cranes silhouetting the skyline signalling the almost complete collapse of property development. Of the projects that remained, the majority were either government backed (the Olympic village site), backed by overseas investors and sovereign wealth funds (the Shard, the Pinnacle/Helter Skelter), were relying on equity to fund the already committed development project or had already secured committed funding from lenders. Very few new property development loans were being written by banks and the real estate development market came to almost a complete standstill.

Opportunity mismatch
A major stumbling block has been the availability of funding, but what emerges from our survey is the need to overcome the current mismatch of expectations and appetite between developers, investors and banks.

When asked about the sectors that they found most attractive, given the current market, the three parties responded differently, with developers favouring retail projects, and banks and investors preferring to fund office developments.

There was limited interest in residential developments going forward, with investors, banks and developers all showing little appetite for such projects.

The residential housing shortfall has been highlighted on a national scale but the results of this survey will make grim reading for the new government who must place this deficit firmly on its new agenda. The current Homes and Communities Agency, a government backed agency charged with building new residential housing, has put new commitments on hold pending clearer plans and policies from the new Lib-Con government.

Given the current market, please indicate how likely you are to undertake or fund the types of development listed (1=very unlikely, 5=very likely)

<table>
<thead>
<tr>
<th>Type</th>
<th>Developers</th>
<th>Investors</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office</td>
<td>4.0</td>
<td>3.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Retail</td>
<td>3.5</td>
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<td>2.5</td>
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<tr>
<td>Industrial</td>
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<td>1.5</td>
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<tr>
<td>Residential</td>
<td>1.5</td>
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<td>0.5</td>
</tr>
<tr>
<td>Mixed use</td>
<td>1.0</td>
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Real Estate Development: The future of funding/6
On a more positive note, retail developments continue to prove popular with developers and funders alike, despite the uncertainties about the high street economy. Developers are telling us they are keen to get retail developments up and running and banks and investors both place such initiatives second only to office space in their lists of priorities. However, how does this fit with a gloomy post-recession market where many retailers have gone bust? Who is going to take occupancy of such newly built retail schemes? With the majority of respondents expecting developments to remain on hold for at least another 12 to 18 months it is likely that they are waiting for consumer confidence and the economy to recover before taking any firm action.

Around eight million square feet of retail was opened in 2008. That dropped to two million square feet in 2009 and 2010 has not seen a glut of new retail developments coming on stream. This will lead to a reduction in supply in the short term and is similar to the effect of the last recession in the 1990s. However, compared to the early 1990s, developers are more attuned to retailers’ needs and business models. The top 50 retail locations in the UK are where retailers want to be, taking attractive and efficient new space, and so will continue to attract development. Retailers are able to demand flexible terms from their existing landlords and coupled with an increase of the number of units coming up for renewal under the Landlord and Tenant Act 1954 they are able to wait for the right alternative new space to be developed.

Learning the lessons of the 1990s, bold developers will be looking to provide the new space to fill the supply gap since those are likely to be popular with shoppers and retailers and consequently more successful.

Stumbling blocks
Today, the availability of financing remains a major inhibitor of developments commencing, according to developers.

Among the other stumbling blocks identified by developers were a slow supply of stock and concerns around the current planning system.

Despite these findings from the developers, in terms of available debt, half of banks say they are still providing development finance.

What do developers view as the main stumbling block in the next 12 to 24 months to commencing development?

- Availability of financing 37%
- Viability of the scheme 30%
- Securing occupiers 22%
- Other 11%

In respect of development finance, select the statement that most reflects your bank’s position

- Currently providing development finance 50%
- Have provided development finance in the past but not currently doing so 40%
- Have never offered development finance 10%
40% of bank respondents say that they have provided development finance in the past but have currently put it on hold. However, there was no indication of when they plan on coming back to the property finance market.

When asked why they are not providing development finance, the banks say they are lending in other areas, but still consider development finance to be too risky.

Other reasons given included looking for opportunities and wanting to see the current development book unwound before lending again.

Turning to investors, they say their decisions on whether to provide funding to development projects continue to be heavily influenced by levels of return and geographic location. There is no ‘surge’ of developments commencing at the moment but we anticipate that when development finance becomes more readily available, then there will a gradual growth of development projects taking off.

Geographically, it would appear that London and the South East will spearhead this return to property development with the rest of the country to follow.

Other factors influencing the investors who responded to our survey included the availability of bank guarantees, the quality of the tenants, and the developer’s track record.

"Banks say they are lending, but consider development finance too risky."
The scarcity of prime office developments, and falling vacancy rates, has highlighted a growing realisation in the market that the development pipeline needs to be turned on sooner rather than later. As the recent Deloitte Central London “Crane Survey” reported, there have been no new starts recorded in the City since October 2009 with London heading for the acutest shortage of new supply since the early 1980s. A key factor in kickstarting the market has to be unlocking funding.

A two-tier market
Two key themes stand out, the first being an emergence of equity as a means to plugging the funding gap and enabling investors to realise a buying opportunity. Many of the early buyers of central London offices in 2009 used a large amount of equity, and sometimes no debt at all, to make acquisitions. 2010 has so far has seen some significant London developments progress using equity to fund them, at least at the outset. Equity is still present in large enough amounts to make good some of the shortfall caused by the lack of debt but investment opportunities remain few and far between. Where they can be found however, joint ventures, forward-fundings and forward-sales are also back on the agenda, with some developers going so far as to hedge their exposure through derivatives.

The second theme is the emergence of a two-tier market place, with London and the South East clearly looking more attractive than the rest of the country in the first wave of new developments. London started 2010 with renewed optimism, with development coming back on the agenda and an assumption of rental growth returning to valuations. But safe bets are paramount going forward and, with investors and banks agreeing that the level of pre-lets and the track record of the customers asking for finance will be key to development financing decisions, the market will also favour the more established market players at the expense of new entrants.

Comments from investors about the criteria they were looking for from developments included, “The developer should provide a demonstrable track record, experience, and be willing to commit equity to the deal”.

Another said, “We will look for a realistic financial appraisal that offers a suitable profit margin or buffer. We also want a track record in delivering projects on time and within budget, and the development of high quality design and specification capable of being let to decent occupiers under leases in acceptable form”.

Development criteria - key requests from investors
- A willingness to commit equity
- Cost, time certainty and quality control
- A good track record - of pre-lettings and guarantees of completion
- Realistic business cases and high quality specifications
- Signed leases with strong tenant/s, subject only to the completion of the development
The road ahead
We asked developers when they see development restarting and more than half of our respondents said the recovery would be at least a year away. 44% of respondents predicted projects beginning to get off the ground in the next 12 to 24 months.

In terms of particular sectors or geographical areas where development looked most likely to restart, the overwhelming response from developers was Central London, with some expanding that to include Greater London and the South East.

It also seems clear that stringent criteria will be a key factor to banks determining whether to lend on particular development schemes. We asked the banks what their criteria would be for providing development finance going forward and how their treatment of development finance has changed since the credit crunch.

Please select the three main considerations that will encourage your bank to provide development finance in future.

How has your bank’s treatment of development financing changed since the credit crunch?

- Stopped providing it for a while but now lending on a reduced scale 32%
- Will only consider scaled down range of assets for a limited number of customers 32%
- No change - never provided it 21%
- Have stopped providing it 15%
Joint ventures
All of the respondents recognised the need for changes in the financing structures of new or stalled developments. Indeed, joint venture arrangements with investors are now seen as the most popular source of development finance for developers.

Other sources of development finance being considered include bank debt, joint venture arrangements - where contractors commit some equity and take on some development risk - and private equity.

The acceptance that forward funding and joint ventures are now viable options for investors is an encouraging sign. Other options under consideration for investors include self funding and forward commitments, without interim finance.

The re-emergence of joint ventures between investors and developers, a typical feature of the development finance market historically, is clearly driven by a desire to spread risk between parties.

However, the complexity around the structuring of any joint venture is clearly an issue. Last year’s deal between Great Portland Estates and EuroHypo over Marcol House on London’s Regent Street - where GPE is committing £88m to the scheme and will keep the first £26m of profit - is one of the few examples of a true bank-developer joint venture so far. On the next page we’ve outlined some of the headline areas that are crucial to consider before putting a deal together.

“the complexity around the structuring of any joint venture is clearly an issue.”
Equity participation
With equity participation emerging as a key element of development schemes, contractors are increasingly getting financially involved as the market looks to innovative ways of progressing projects.

In the current market, we are seeing contractors on some projects putting in significant sums as equity pre-construction to get schemes going, giving them a position like normal shareholders once the scheme takes off and sells with the added advantage of picking up the construction work.

We are also seeing, in circumstances where schemes are in difficulty, that lenders or developers may ask contractors to defer or waive payments for a period of time, for which they get paid at significantly higher rates than they could elsewhere and even get an arrangement fee. They then get paid once the scheme is sold.

Both trends look likely to continue, as savvy contractors with equity in the bank look to get schemes moving and use their equity to get not only returns but involvement and employment for their workforce.

“...contractors are increasingly getting financially involved as the market looks to innovative ways of progressing projects.”

Issues to consider when entering a joint venture:

• **Structure** - the parties will most likely be subject to different tax treatment and therefore consideration should be given to the most tax efficient structure for the joint venture vehicle and the ultimate investors.

• **Control and decision-making powers** - is the joint venture to be a 50/50 deadlock vehicle where all decisions require unanimity or are there majority and minority interests and if so, what level of protection will the minority have? Will the joint venture vehicle have built in mechanisms to resolve deadlock or will the parties rely on negotiations at the time?

• **Distributions/Funding** - are the parties required to provide funding on an equal basis? Is either party entitled to a priority return?

• **Default** - what events will constitute default? What is the consequence of default - buy out?

• **Exit/Termination** - in what circumstances will the joint venture “terminate”? Will the parties have the ability to exit voluntarily or buy the other party/parties out?
The government dimension

For the new coalition government, elected on 6 May 2010, kickstarting the real estate development market presents particular challenges. We asked respondents what the new government could do to assist development and most developers called for a simplification of the planning system and an easing of stamp duty.

In our last real estate development survey, conducted in the autumn of 2009, we focused on the planning system and asked developers how the system could be improved. Back then, developers called for local authorities to be more commercial in their appreciation and understanding of the job that the developers themselves are trying to achieve.

One commented, “Local authorities need to recognise there is not an endless flow of cash to be obtained from developers. The increase in building costs, due to codes and other eco-taxes, means there is less money available for section 106 contributions.”

It is clear that, six months on, there has been little change.

This survey reveals a continuing need for the government to act to improve the planning system.

“A new government must provide more clarity in the planning system,” said one developer in response to our questionnaire, whilst another added, “The new government must reduce planning gain, abolish stamp duty and relax building regulations.” One investor said: “The government should make the process more prescriptive and less open to interference by conflicted parties or political manipulation.”

Whilst there were some calls from developers for the government to force banks to start lending again, this was unsurprisingly resisted by the banking respondents surveyed. When asked whether they thought banks should be obligated to provide a certain amount of development finance as a matter of public policy, just 13% of bankers said yes.

Instead, one banker commented: “The government should provide a clear, well-contemplated approach to the financing associated with real estate in the capital markets to facilitate the redevelopment of liquidity on investment facilities. Until liquidity is restored in this segment, financing of investment assets will remain quite difficult and selective.”

A priority for the new government will clearly be the need to stimulate residential developments again, where moves to offer second-ranking loans to entice banks on to residential schemes are to be encouraged. Such initiatives have so far been limited in scale and scope, however, and will need to be enhanced if they are to overcome the reluctance among developers, investors and banks towards the residential sector.

“Until liquidity is restored in this segment, financing of investment assets will remain quite difficult and selective.”
“This survey reveals a continuing need for the government to act to improve the planning system.”
The current pressures on the real estate development market are numerous and complex. It is challenging to pinpoint a single issue that is holding up development schemes, but in addition to the impact of the wider economic climate—funding, viability and innovation are key.

Interest rates remain low and confidence appears to be returning, with Land Securities and British Land both announcing in May that they are stepping up their development programmes in order to deliver higher returns. How this will impact and stimulate the wider market remains to be seen.

Equity will play a major role in driving forward the next development cycle. In the London office market this is already apparent: Land Securities is in talks with a number of parties, to form a joint venture to develop its “Walkie Talkie” tower and Great Portland Estates announced in April a 50/50 joint venture with Canadian fund manager Brookfield to build a 40-storey, 770,000 sq ft tower at 100 Bishopsgate.

Across the broader market the trend continues with Legal & General Property’s £1bn UK Property Income Fund announcing a £47m forward funding of the 470,000 sq ft regional distribution centre at Andover Airfield (20 year pre-let to the Co-operative Group) and Invista Real Estate Investment Management forward funding a 33,000 sq ft retail warehouse in Guildford, Surrey. This looks set to continue—with a focus on London and the South East—but care needs to be taken over the structure, control, risk allocation, distribution and exit strategy to ensure success.

While it is clear that debt remains comparably scarce, there are banks that will lend on development schemes. The criteria required to lend are tougher, with banks looking for schemes primarily in London/South East on which there is a significant, quality pre-let and the developer has an excellent track record. However, even with these criteria met, that debt which is available will only push to 70% of loan to value, unless an investor is deleveraging a legacy position and using out-of-the-money swaps.

There is only so much that developers, banks and investors themselves can do to break through the wider deadlock on their own. Calls for government intervention to stimulate investment into the real estate market continue. The reality of what is viable—given the wider economic pressures—may fall short of expectation, but a stronger UK economy will certainly be a step in the right direction.

With the right support, all parties are expressing a clear desire to work together to overcome the current funding issues with real, commercial solutions. As such, the outlook can only be brighter.

> It is challenging to pinpoint a single issue that is holding up development schemes, but funding, viability and innovation are key.
BLP delivers first-rate, pragmatic legal advice that helps clients to achieve their goals. Our clients are at the forefront of our business. We are committed to excellence in the legal service that we offer and take great pride in our personal approach to delivering that service.

Our real estate group is the leading practice in the UK. Through our reputation for quality, and breadth of expertise, we have an unparalleled expertise to offer. Transactions are often more difficult to unlock and then to execute in the current economic climate. We work closely with our clients at the formative stage to find the optimum deal structure. Our broad exposure to the market, and our knowledge of key trends, provides us with a unique capability to add value for our clients and to facilitate deals.

With over 60 partners and nearly 300 lawyers, our dedicated real estate team has the resources and expertise to meet any requirement. Much of the complex work we carry out requires a multidisciplinary approach that we are particularly well placed to deliver, given the depth of real estate sector expertise within our tax, finance and corporate teams.

Across the real estate disciplines we have consistently been ranked by the legal directories as number one. This includes commercial real estate, planning, construction, real estate finance and real estate litigation. Many of our lawyers are also independently recognised as leaders within their various disciplines. These rankings are not only driven by our direct deal experience, but also by what our clients and peers have to say.