Residential & Development

Q&A: Will interest rates undermine developers?

Mutual Finance MD Raed Hanna assesses the likely impact of high inflation

Lem Bingley

High inflation and consequent base rate hikes from the Bank of England have shifted the ground beneath the feet of developers and investors. Raed Hanna, managing director of debt intermediary Mutual Finance, assesses the extent of the earthquake.

How are property investors responding to rising interest rates?

We have had a calm and predictable interest rate market for more than 10 years, which has enabled investors to close deals with relative certainty that their equity will not become 'toast'. But too many have forgotten the fate of investors in 2007 and 2008. Back then, lenders got comfortable assembling a stack of senior, junior and mezzanine funding to reach loan-to-value (LTV) ratios of up to 90%. At this dizzy level, even the smallest correction in rates or yields can make your investment toast very quickly.

Recent ultra-low interest rates have led to whole loans with LTVs of circa 80% being readily available, but rising rates will rapidly cut the quantum of debt that can be sustained.

We are seeing a number of investors tightening their belts. Interest covenants are greatly affected, and the pressure is on to amortise and reduce debt levels. This is all before the borrower can take any profit from surplus income.

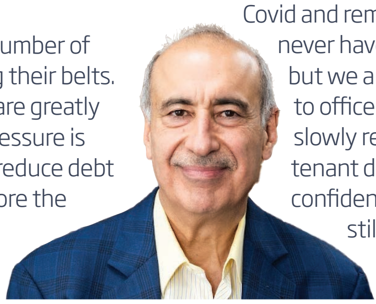
How might this dynamic affect foreign investment in the UK?

The UK real estate market is exceptionally liquid and there is no shortage of investors willing to invest here. The UK has always been seen as a safe haven and good place to park money. Overseas investors with cash will see the market as increasingly attractive.

Are some sectors more vulnerable to the impact of rising rates?

The industrial and logistics sector recently reached all-time highs in terms of capital values and yield, and I fear it will be the first affected by the squeeze from lenders. This correction is probably overdue.

Offices have taken a bizarre turn. Covid and remote working could never have been predicted; but we are seeing a return to offices and rents are slowly retuning, as is tenant demand. However, confidence from investors is still lacking and yields remain stagnant.



Generally, the leisure sector is seeing an improving picture, while supermarkets, food retailers and other essential suppliers will be OK in the retail sector. But I think retail in general is still a daunting asset class.

How is the residential sector responding?

Having arranged a significant amount of residential development finance in the past 12 months, we have seen developers making much more detailed appraisals. Greater scrutiny has been driven by the steeply rising cost of construction.

Conversely, there are few signs of slowing sales in the residential market. Developers are often selling off-plan to PRS investors in bulk, and the traditional owner-occupier market is still strong.

Where do you think rates will go from here?

I think over the next 18 months we will see more steady increases in UK base rates, peaking at around 3% – a level some in the market will never have experienced.

I expect inflation to hover at 8% to 10% until at least 2024. As a result, RPI-linked leases will be a popular asset in the medium term. However, a note of caution is to be aware of substantially over-rented assets, with rents so far wide of the market that they appear too good to be true.

Less experienced property professionals may not realise they have been working in a champagne market of late. They may need to get used to the taste of lemonade for a while. ■

This week's vital stats

4.4 million

▲ The number of privately rented homes in England that are in poor condition, according to a report issued by the DLUHC

2,000

▲ The number of new homes that Newham Council's housing developer Populo Living plans to build at Carpenters Estate in Stratford, east London

£4.6m

▲ The cost of a bridge loan that Hilltop Credit Partners has provided to Pascoe Homes for a 388-unit new-build residential development in Leeds

1,548

▲ The number of new homes that Abu Dhabi Investment Authority and US firm Greystar Real Estate Partners are planning to build in Bermondsey, south London, after acquiring land in the area

105

▲ The number of affordable flats DWS plans to build in Dublin after it acquired a site near Raheny DART Station from Earlsfort Group

NUMBER1411/SHUTTERSTOCK