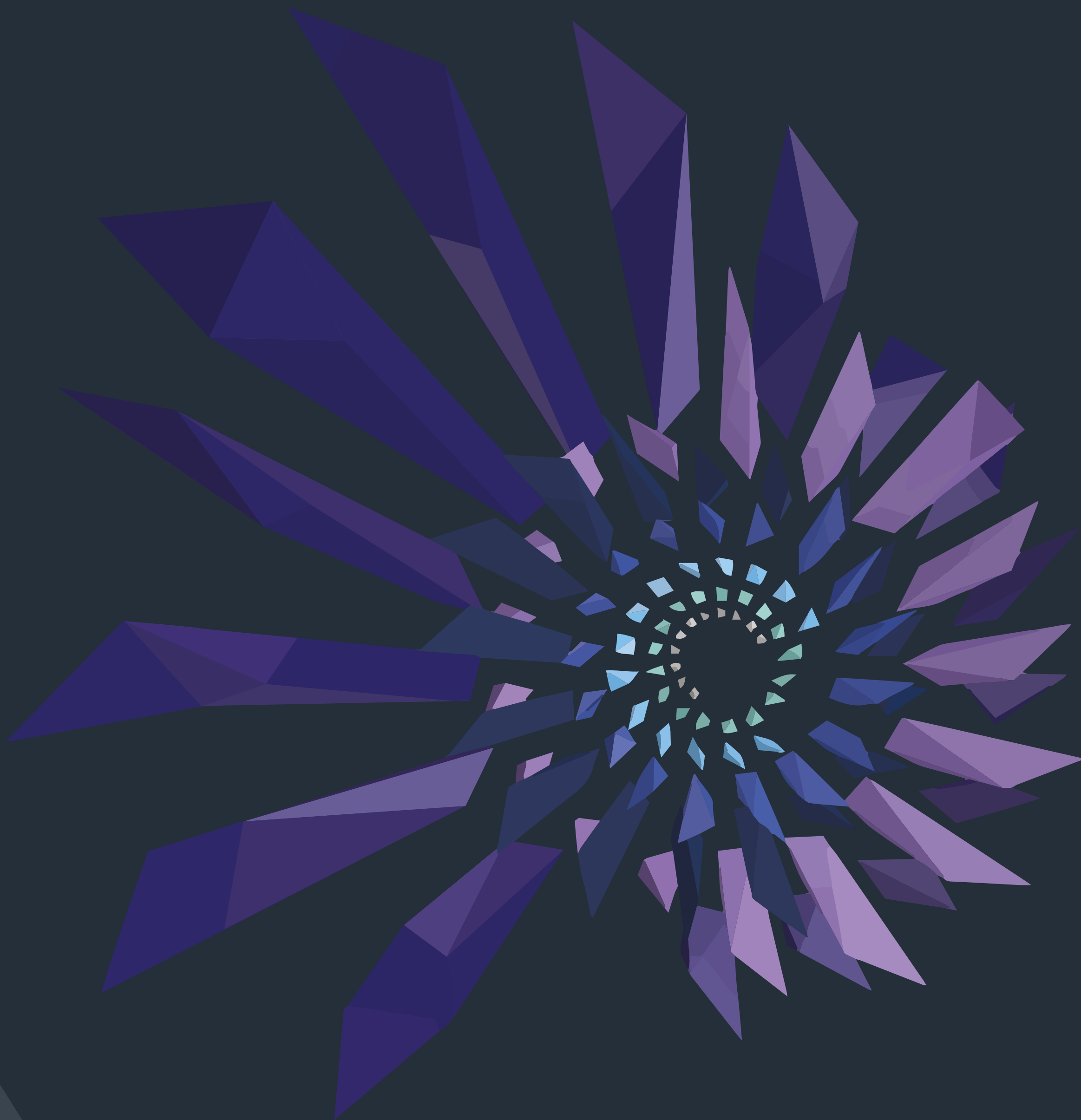
TH Real Estate

UK Commercial Real Estate Debt

An introduction and the market opportunity



Data generating art

Using data from this report, the graphic represents a spatial analysis of UK average loan-to-value ratios across different investment sectors.

This document is solely for the use of professionals.

Introduction

Commercial Real Estate Debt (CRE Debt) has a long history as an investment category in international investment portfolios, but in Europe commercial real estate finance was generally viewed as a product offered to borrowers by commercial banks and retained by the lending banks on their balance sheets. This perception was correct, based on the fact that until the Great Financial Crisis of 2008–2009, an overwhelming percentage of CRE Debt in Europe, 90–95% by most estimates, was provided by the banking sector, with only a relatively small portion available in the capital markets, mostly through Commercial Mortgage Backed Securities (CMBS), and from certain insurance companies.

For a variety of factors, ranging from regulatory pressures to investor requirements, banks have now reduced the leverage of loans, tightened underwriting standards, and increased loan pricing for certain segments of the market, all of which has reduced the total quantum of bank CRE Debt lending.

This reduction in supply, the repricing of CRE Debt risk, and low-yield capital market conditions, have led CRE Debt to become a more attractive and competitive investment asset class for an increasing number of investors, who value the diversification it brings to their portfolios.

In January 2016, Derek Williams, Managing Director of bfinance, wrote that "Real estate debt is an attractive and useful 'add on' to a real estate portfolio. Given the size of the underlying asset class, there are a range of strategies, from senior, to stretched senior, to whole loans, that seem interesting to investors looking for a decent return over the medium term."

While the CRE Debt market was severely disrupted in 2009-2011, which resulted in increased pricing and low transaction volumes, market pricing and transaction volumes have since normalised. Recent Brexit-induced volatility has been positive for lenders/debt investors like TH Real Estate. While the interest rate and swap curves have dropped to historically-low levels, credit spreads on CRE Debt have widened, maintaining absolute return levels and enhancing the relative value offered by CRE Debt.

At TH Real Estate, we believe investors should strongly consider and include CRE Debt as an investment class in their portfolio. Investors can gain exposure to secured CRE Debt by investing in loans directly, (either through separate accounts managed externally or setting up their own origination platform), or indirectly (through externally-managed CRE Debt funds). Each of these avenues has its own relative merits, such as regulatory requirements, accounting and staffing. At TH Real Estate, we have a fully-integrated debt investment platform, from which we leverage our specialist knowledge, resources and investment experience in direct commercial real estate and CRE Debt, offering investors access to this asset class through separate accounts and funds.

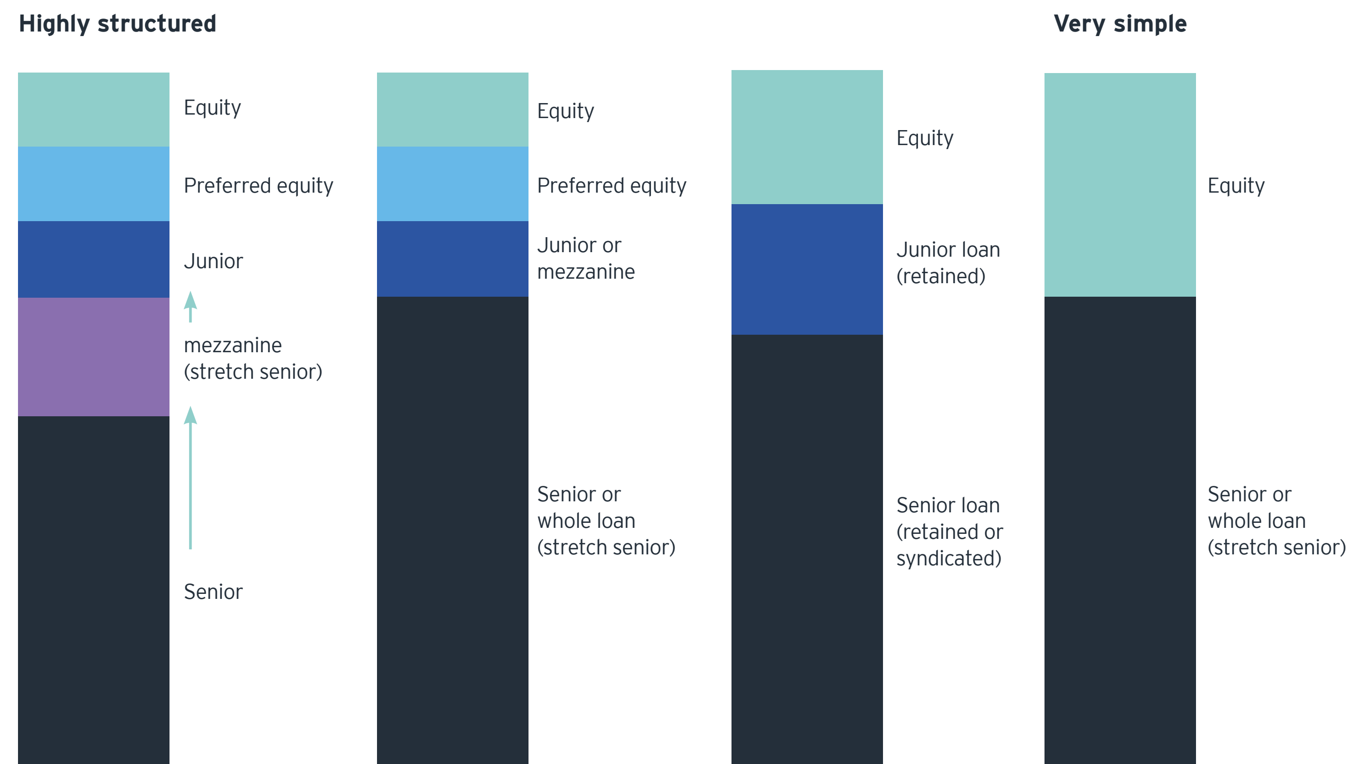
In this report, we focus on CRE Debt products in which we currently invest on behalf of both discretionary and advisory capital. These non-recourse loans to property owning borrower SPVs are generally secured by a mortgage over one or more income-producing properties.

What is CRE Debt?

CRE Debt comes in different shapes and sizes, secured by a variety of asset classes and with wide-ranging security packages, tenors and structural features. It has multiple definitions, which industry participants often do not uniformly agree on. However, nearly all forms of CRE Debt hinge upon the underlying concept of a loan secured by a commercial real estate property, whose tenants' rental income support quarterly loan interest payments.

We outline some of the most frequently seen capital structures in Fig.1.

Fig.1: CRE loan structures and terminology

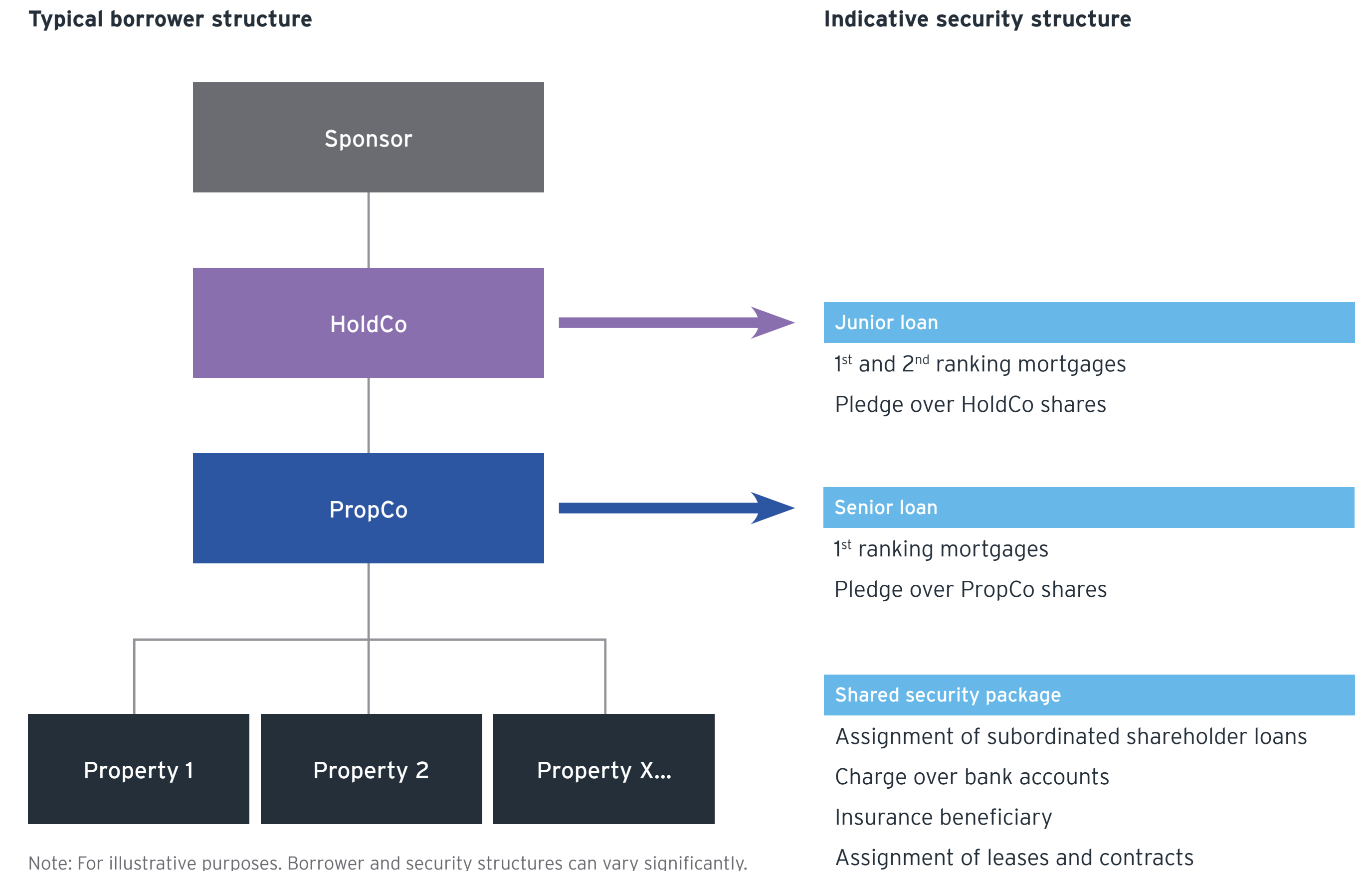


Note: Not drawn to relative scale. For illustrative purposes only.

While CRE Debt structuring offers a high degree of customisation, borrowers and investors/lenders prefer simpler structures with fewer counterparties. We support this approach and generally arrange our financings as senior and junior loans, or as whole loans.

Commercial real estate loans (CRE loans) are secured by commercial real estate properties, and generally offer comprehensive security packages. This ensures that, in case of distress and potential enforcement, the lender can quickly and effectively take control of the assets. They can then implement asset management plans, or liquidate and monetise the assets and protect the debt investment, making it a less volatile asset class than equity real estate investments.

Fig.2: Borrower and security structure



Note: For illustrative purposes. Borrower and security structures can vary significantly.

Characteristics of different types of debt

The loan types shown in Fig.1 (senior, junior loans) represent layers of risk. As the leverage (i.e. detachment point) and attachment point of a loan increase, the risk also goes up, and the pricing of each layer should increase accordingly to compensate for the incremental risk.

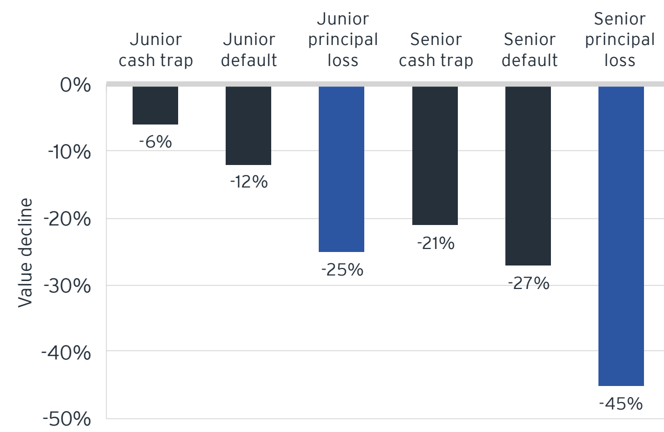
There are no market standards for the leverage thresholds of each layer or debt class. A senior loan could range from 0–50% LTV, but it could also reach 65% or higher. Junior loans could also have attachment points of 50%, 65% or higher, and detachment LTVs of 70%, 80% or more. In the current market, senior loans are expected to reach up to 50–65% LTV, and junior loans will typically cut off at 70–85% maximum LTV.

The allocation of cash flows derived from the rental income, and from refinancing or property sale proceeds, is determined by legal requirements – secured creditors first, unsecured later – or defined contractually by intercreditor agreements. Most senior loans are paid first, and more junior or subordinated loans later on, following a well-defined allocation process (i.e. cashflow waterfall).

Different debt classes will have, in a well-structured financing, different rights and financial performance covenants. These could include enforcement and intercreditor, as well as property and lease approval rights. The main performance covenants are cash-flow based (interest cover ratio or debt service cover ratio) and value-based (loan-to-value ratio). A well-structured senior/junior financing package will structure its covenants so that the junior covenants are triggered before the senior, and before the loan is at risk of becoming distressed or impaired. The ability to proactively address negative performance issues is a critical feature of CRE Debt, as shown in Fig.3.

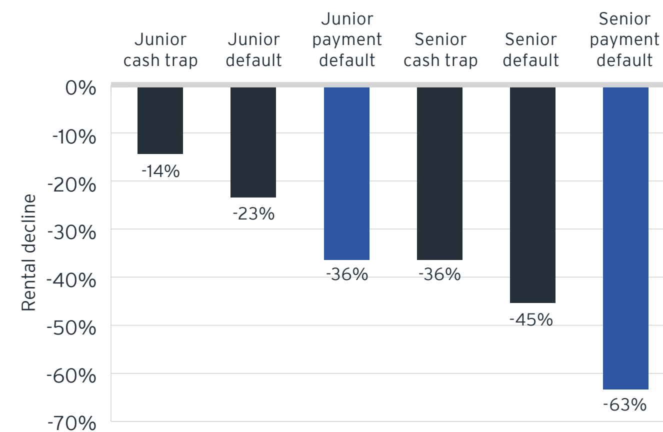
Fig.3: Value decline thresholds

LTV covenant and loss thresholds example



Rental decline thresholds

ICR covenant and shortfall thresholds example



Key
Cash trap and default
Loss

Source: TH Real Estate. For illustrative purposes only

The threshold sequence allows the junior lender, who has the higher risk exposure, to address the situation first. If the loan performance deteriorates further, the senior lender will take control, subject to intercreditor provisions. This ensures control, subject to intercreditor provisions transfers from equity to junior lender, and then to senior lender as conditions deteriorate, so that economic incentives remain aligned.

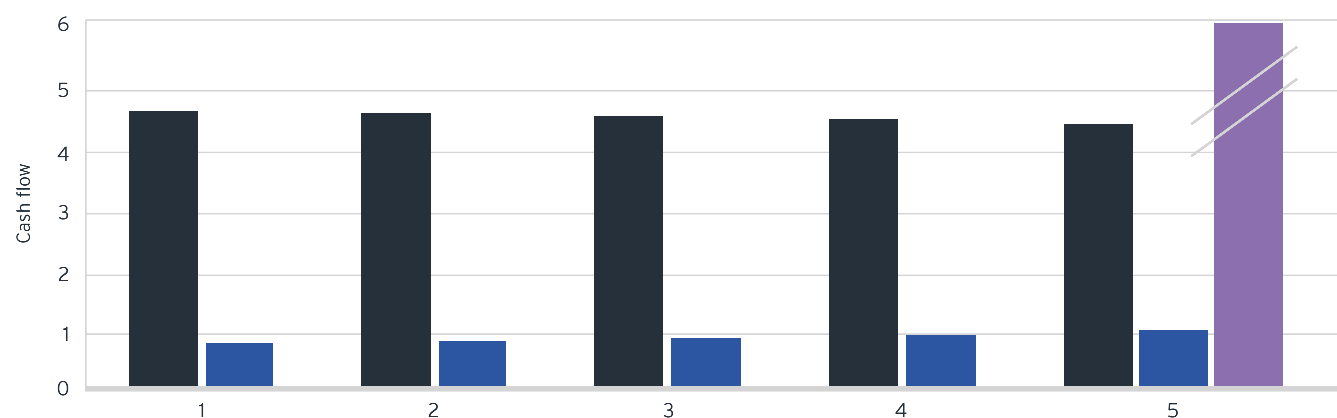
Why is CRE Debt an attractive investment?

Stable income returns

CRE Debt can be perceived as a defensive and conservative investment, given the structural flexibility shown, however, these investments can be tailored to match the risk-return profile of a specific investor.

In many aspects, CRE Debt performs similarly to a fixed-income, bond-like investment. It pays a quarterly coupon and, in certain loan structures, partial principal amortisation, generating a steady and predictable income and cash-flow stream.

Fig.4: Illustrative loan cash flow to lender on 5-year loan



Key
Interest
Amortisation
Maturity repayment

Note: For illustrative purposes only. Not drawn to scale. Shown as annual cashflows.

CRE Debt loans may additionally benefit from a form of minimum coupon/income protection, by means of call protection, i.e. the investor/lender receives prepayment fees or yield maintenance if the loan is repaid before its scheduled maturity. This structure gives the investor in CRE Debt a very high certainty over their future cash-flows.

Downside protection

At its simplest, CRE Debt is an investment secured on a property, comprising an agreement between the borrower and the lender, in which the borrower makes periodic payments to the lender and repays the loan in full at the contractual maturity. CRE Debt is generally structured as a non-recourse obligation, meaning the debt service, regular interest and principal amortisation payments, are paid by the income that is generated by the property portfolio. The sponsor or property owner is not obliged to use external resources to service the debt. Final repayment of the loan will be made by the refinancing of it, or with the proceeds from selling the property that secures the loan.

For the typical property loan, the net rental income generated by the property is higher than the debt service requirements, and the value of the property is higher than the loan amount. This fundamental feature underpins the conservative and defensive risk-profile of a CRE Debt investment. For example, a £100m property, generating £6.5m of rental income, financed by £75m of debt with an interest rate of 5.0%, will have an interest expense of £3.75m. The ICR is 173% and the LTV is 75%. This implies that rental income needs to drop by 42% before the borrower cannot pay the interest in full, or the property value needs to drop by 25% (ignoring any amortisation the loan might have benefited from) before the loan is not repaid in full if the property is sold.

Absorbing significant income and property market volatility, without negatively affecting the return profile of a CRE Debt investment, makes it a stable, predictable and attractive investment. This would be suitable for an investor with limited risk and that volatility tolerance, or one looking to diversify its risk profile and overall asset allocation to create a balanced portfolio. This characteristic is explored further in Fig.5 on page 9.

The equity property investment return profile is directly correlated to changes in property values, while a debt investment remains stable for longer during periods of property value declines. However, it must be noted that CRE Debt is not immune to market value declines, and that significant declines will also lead to a deterioration of returns.

If property values and rental income increase, debt investments do not participate in the increased returns that equity real estate investments provide, as illustrated in Fig.5.

Targeted investment strategy

The features of CRE Debt investments can be tailored to satisfy investor requirements. A portfolio can be constructed around traditional real estate parameters, i.e. loan/project type (development/construction, income-producing investment), collateral asset type (single asset class, diversified, concentration limits, exclusions), jurisdiction (single country, pan-European) and the related currency (hedging strategy), locations (regional, large cities, city centres) etc.

Additional features can be included to meet needs: interest. Interest rates (fixed rate vs. floating rate loans), term/maturity bridge loans (approximately one year), traditional medium term (five years), longer dated (10+ years), call protection (prepayment penalties, yield maintenance, make-whole) etc.

The scope and diversity of investment options available to CRE Debt investors are further positive and attractive features of the asset class.

UK vs. Continental Europe

TH Real Estate is initially focusing its CRE Debt investments in the UK. While in certain European jurisdictions there are perceived additional risk and liquidity premiums to be earned, those increased returns are also accompanied by actual increased risks and liquidity constraints.

The UK is the largest real estate and real estate finance market in Europe. It provides the most liquid and transparent investment environment, with the highest level of market and transaction data. In 2015, total transaction levels were £66bn[1] in the UK, up from £63bn in 2014.[2]

The UK also has the most effective, transparent and creditor-friendly legal framework in Europe. This is critical in economically-depressed scenarios, where investments might underperform and loans default, and where an enforcement of the security might be necessary. In the UK, enforcement of security takes a matter of days, while elsewhere it can be 3-18 months (Germany), 2-3 years (Spain) or longer (Italy, even after the recently implemented regulatory changes). While there are some ways to devise legal structures that can make the enforcement process less cumbersome in those jurisdictions, their effectiveness is not assured and might involve additional risks and costs.

It is generally acknowledged that the UK and Germany have the most developed and liquid CRE Debt markets. Germany is still dominated by banks, while the UK market is more diversified with insurance companies, pension funds and other investors providing CRE Debt directly, either with their own lending platforms, through specialised asset managers or by investing through funds.

[1]Propertydata.com
[2]Real Capital Analytics, December 2015

While in some Continental European jurisdictions the commercial real estate finance market attracts relatively higher returns, we have seen pricing tighten significantly over the past 12–18 months. For example, in 2013, senior loans secured against good assets in good locations were being priced at L+400–500bps in Spain and Italy, or in Ireland and the Netherlands at L+300–400bps. In 2014, the market shifted 100–150bps and 50–75bps in 2015. In 2016, credit spreads remained relatively stable.

CRE Debt pricing is competitive in other jurisdictions, such as Germany, and in some cases is tighter than L+100bps for senior loans.

The UK market has experienced significant margin compression in the past year, but there are indications that this has stabalised. Senior loans, for which there are more public data points, are being priced from L+125–225bps for comparable quality assets.

The pricing differential for CRE Debt between the different jurisdictions is not simply a function of supply and demand dynamics, but reflects each country's economic reality, credit rating and risk, underlying real estate market liquidity and dynamics, as well as the legal framework controlling CRE Debt security and enforceability process.

By combining these findings with our knowledge of market sizes, and the quantum of transactions and financings possible in each jurisdiction, we concluded that the UK provides the most attractive and executable investment strategy for performing investment CRE loans, in the current state of relative market pricing.

We have a strong presence in the UK real estate market, with c.£12bn* of commercial real estate assets under management. Over 50* investment professionals in the London office have class-leading investment and asset management expertise, from which the debt team benefits.

*Source: TH Real Estate, 30 June 2016

Market opportunity

CRE Debt – Key characteristics

CRE Debt offers a return profile comparable to other fixed-income investments such as bonds, with contractually-agreed periodic interest and principal payments, and a balloon principal payment at maturity. The key risks of debt secured on real estate are driven by the loan structure, property collateral characteristics, tenant performance, and macro-economic factors such as changes in interest rates, availability of refinancing, and property market pricing. Due to predominantly transaction-specific risks, CRE Debt can often serve as a diversifier in larger investment portfolios and enhance returns with an illiquidity premium.

In comparison to direct property investments, commercial real estate loans benefit from the downside protection that is provided by the subordination of the sponsor's equity stake. While there is typically no additional upside to CRE Debt returns in a rising property market, the sponsor will absorb the first loss experienced by the property collateral in a falling market. In addition, contractually-agreed interest and principal payments insulate the lender from the volatility of rental income, over the term of the loan. Managing the rent roll is a key focus for competent sponsors, and a decline in rental income will impact the equity investors first. The lender, conversely, often benefits from cash-flow covenants set at a level that provides appropriate protection in case of a significant decline in rental income.

Since the beginning of the Global Financial Crisis in 2008, the European CRE Debt market has undergone fundamental changes. A number of lending institutions have failed, or withdrawn from the market, and active lenders are more reluctant to provide higher LTV loans, or accept secondary or non-stabilised assets as security. While the market has benefited from a phase of stabilisation and recovery since 2012, lending volumes remain below pre-2007 levels, and a refinancing gap remains in part of the market (Fig.16). Loans are structured more conservatively in terms of LTV (Fig.8) and are more attractive for the lender in terms of pricing (Fig.9). Against a backdrop of increasing bank regulation and continued weakness in European CMBS issuance, the current investment opportunity for CRE Debt is likely to persist and form part of a structural, long-term adjustment in the debt finance market.

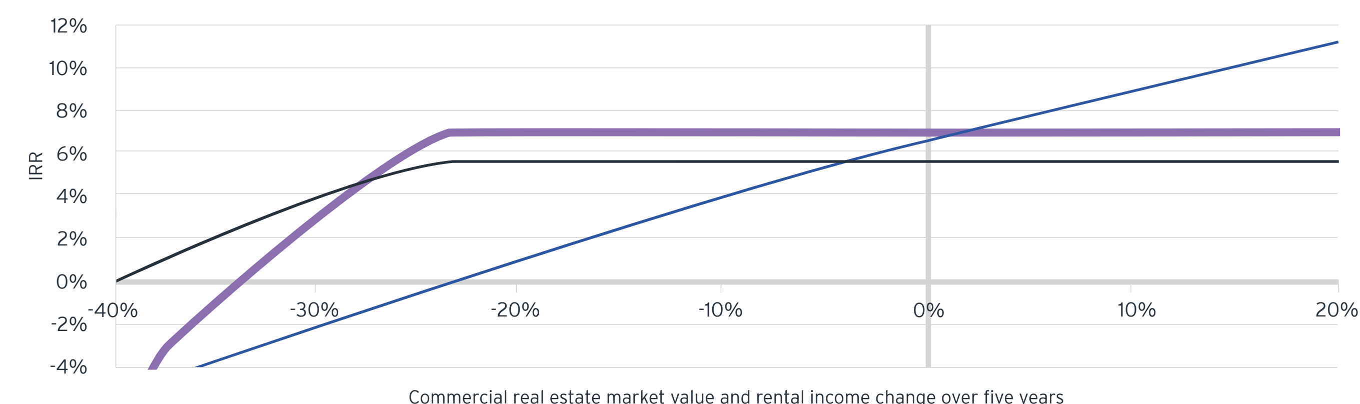
The Brexit vote has caused some moderate real estate value declines, and triggered a further reduction of CRE Debt availability by banks. The reduction in supply has been met with an increase in loan margins. The clear beneficiaries of the current market conditions have been the non-bank lenders. Loans are being underwritten more cautiously, at a lower basis and at higher pricing.

Risks around uncertainty in economic growth, global political stability and pace of interest rate increases remain. Meanwhile, the appeal of the less volatile returns available from debt investments (financing good quality non-prime, core-plus and regional assets, where the secured debt investor is in a priority protected position in the capital repayment order) becomes apparent. The Global Real Estate Debt Partners – Fund I (UK) offers investors the opportunity to participate in an investment vehicle, managed by an experienced CRE Debt team, which has the infrastructure, governance structure and expertise of the wider TH Real Estate platform.

Attractive risk/return proposition for UK CRE Debt

The provision of whole loans and selected junior loans in the UK market offers an attractive risk/return profile, whilst benefiting from downside protection from the subordination of the equity investor in the underlying property. Fig.5 illustrates the stable level of returns afforded by an unlevered CRE Debt investment, compared to the potentially more volatile and unpredictable returns associated with commercial real estate equity investments. The Global Real Estate Debt Partners – Fund I (UK)'s maximum, day-one LTV of 75% provides a cushion of at least 25% (representing the sponsor's equity contribution) before declines in property value erode any CRE Debt investment returns.

Fig.5: Impact of commercial real estate and rental value changes on CRE Debt and direct commercial real estate investment returns over five years (annualised IRR)



Source: TH Real Estate. For indicative purposes only

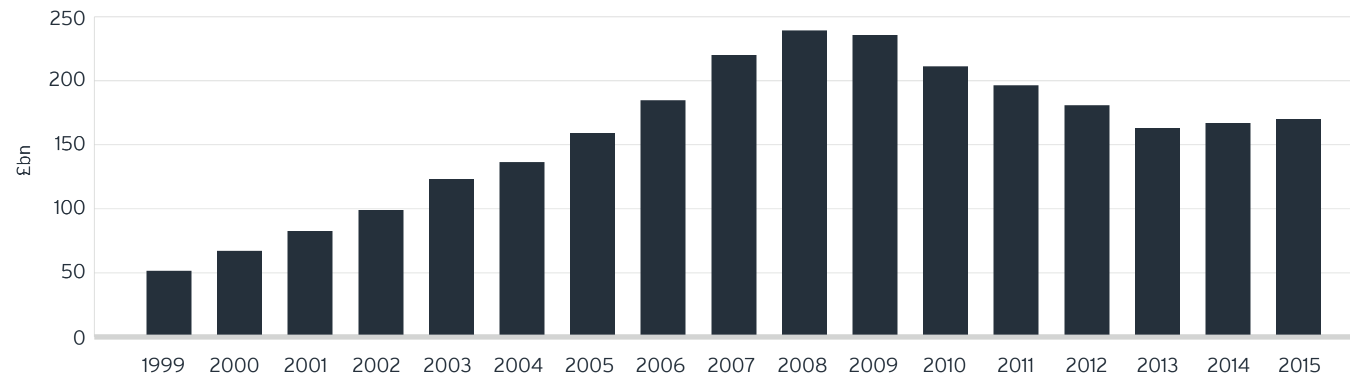
Historic market context

In the years immediately prior to 2007, a significant expansion of real estate debt occurred in Europe and the UK, with lenders providing unprecedented leverage at historically low loan margins, coupled with weak or non-existent financial performance covenant packages. In addition to portfolio lenders, many relied on an 'originate-to-distribute' model which saw most, if not all, of the risk in a transaction transferred to a third party post-origination. However, from mid-2007, the ability to securitise or syndicate commercial real estate loans virtually ceased in the UK primary market, and secondary market volumes slowed considerably. Many traditional bank lenders retained significant exposures to low-yielding, over-leveraged commercial property loans. With the objective of cleaning up and reducing their balance-sheet exposure driven by economic and regulatory pressures, primarily Basel III, CRD IV and the FCA's prudential requirements (slotting), a much diminished capacity and risk appetite currently exists in the bank-lending market.

Historically, banks and building societies have provided the majority of traditional debt finance to the UK commercial real estate market. In 2012, according to Morgan Stanley Research, banks and bank-related lending comprised approximately 90–95% of the market in Europe and the UK[3]. Asia-Pacific displays similar reliance on bank financing. These figures compare to 55–57.5% in the US[4], where the market has a more diverse lender base, including insurance firms, other financial institutions, and a highly-developed CMBS market.

[3]Morgan Stanley Blue Paper, Banks Deleveraging and Real Estate, 15 March 2012
[4]Federal Reserve Statistical Release, Financial Accounts of the United States, L.220 Commercial Mortgages

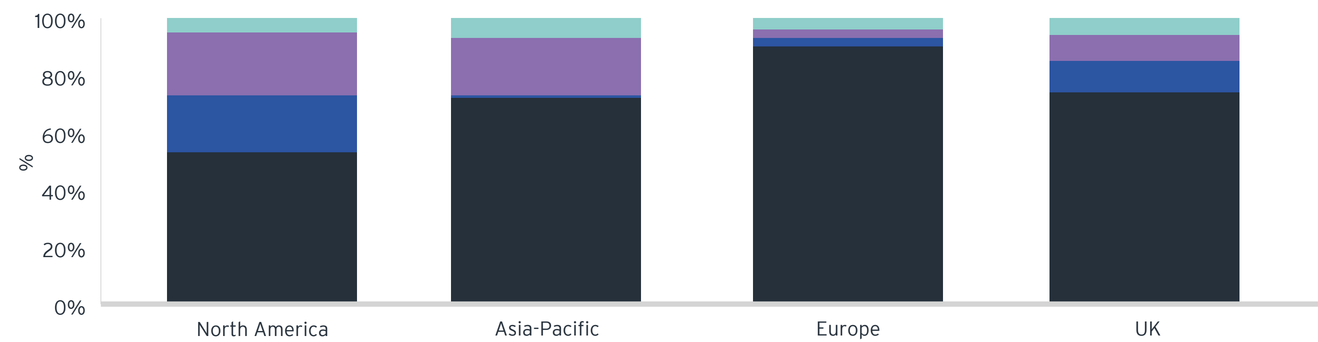
Fig.6: Aggregate value of outstanding CRE Debt in the UK



Key
Aggregated loan book size reported

Source: De Montfort University, The UK Commercial Property lending Market Research Findings, 2015 Year-End Report (excluding outstanding CMBS, loans backed by Social Housing and loans held by NAMA)

Fig.7: Debt by lender type across regions, 2013



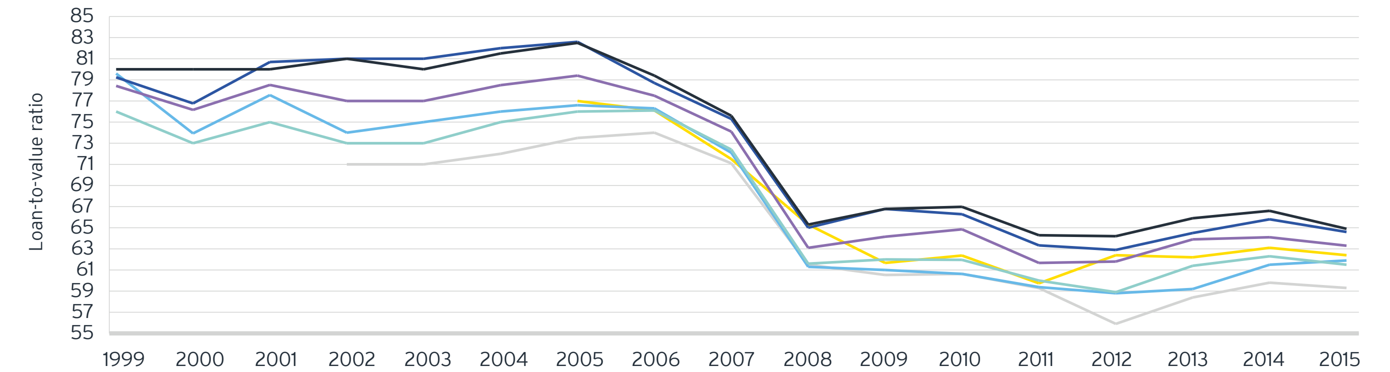
Key
Banks
CMBS
Non-bank lending
Property company bonds

Source: DTZ Research, December 2013*

*Note: This is the latest data from DTZ Research and the report has since been discontinued.

From the onset of the Global Financial Crisis in 2007 to the CRE Debt market's stabilisation in 2012, average margins for new lending in the UK increased dramatically (see Fig.9), while average loan-to-value ratios decreased over the same period (Fig.8), from a peak of 74-82% across different sectors in 2006, to a low point during 2012, where average loan-to-value ratios ranged from 56-64%. While these are the average recorded ratios, it was not uncommon prior to the crisis for individual LTVs to be as high, or in excess of, 90% of market value.

Fig.8: Average value LTV by investment sector

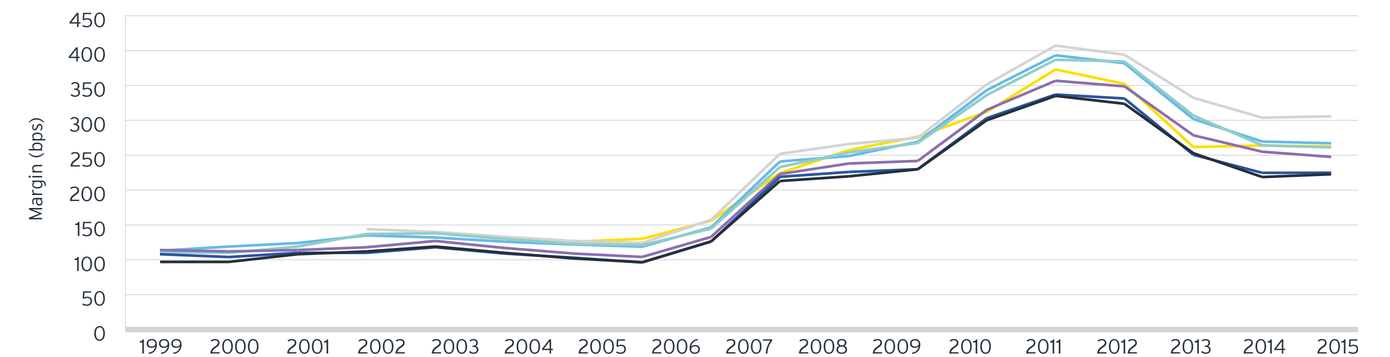


Key
Prime office
Prime retail
Prime industrial
Secondary office
Secondary retail
Secondary industrial
Residential investment

Source: De Montfort University, The UK Commercial Property Lending Market Research Findings, 2015 Year-End Report

In the years immediately prior to 2012, commercial real estate financing became expensive across the market, as illustrated in Fig.9, with lower LTV ratios and a strong preference for providing real estate debt secured by prime assets. Over the past few years, the CRE Debt market in the UK has improved, however the main lenders' focus on prime assets remains broadly intact. The non-prime, well-performing secondary and regional real estate sector of the market continues to suffer from a lack of available financing, even though its prospects are enhanced by improving economic conditions across the UK, and some additional lenders are starting to enter this segment of the market.

Fig.9: UK average loan pricing (margin, bps)



Key
Prime office
Prime retail
Prime industrial
Secondary office
Secondary retail
Secondary industrial
Residential investment

Source: De Montfort University, The UK Commercial Property Lending Market Research Findings, 2015 Year-End Report

Bank retrenchment and regulation

Banking is still the dominant source of financing for UK real estate. However, the sector has come under increased pressure following the Global Financial Crisis, forcing lending volumes below levels seen prior to 2007. This pressure is a result of four principal factors:

- a need to manage down legacy and non- or under-performing commercial real estate loan portfolios;
- increased bank funding costs;
- increased and shifting bank capital charges for carrying real estate loans on balance sheet; and
- an onerous and uncertain regulatory environment.

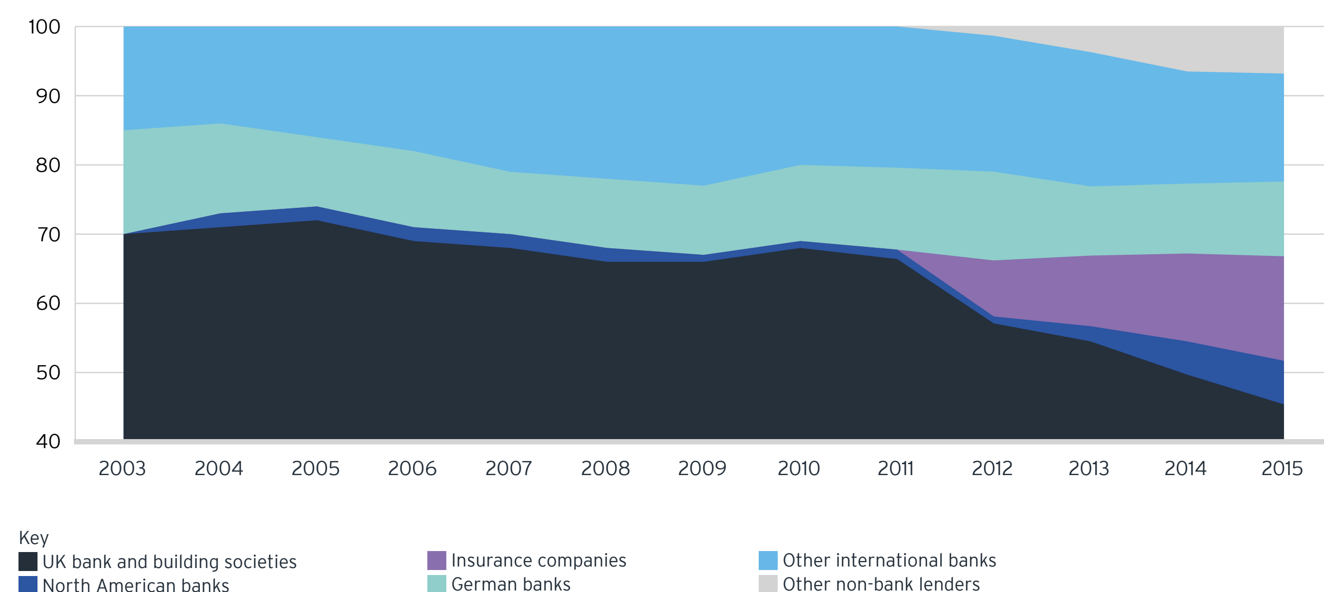
Commercial banks are rationalising which type of lending is most viable, with many scaling back their real estate lending to finance only prime assets at low-leverage levels, or withdrawing from the market completely.

Basel III is impacting commercial real estate lending, as a global regulatory standard seeking to strengthen bank capital resources, while introducing new regulatory requirements on bank liquidity, and balance-sheet term funding and leverage. Through the Financial Conduct Authority (FCA) and its guidance on slotting, a method for assigning risk weights to lending exposures, greater scrutiny is placed on the internal models used by banks when calculating their risk-weighted capital in lending to specialised income-producing assets, including commercial real estate. Banks are expected to reduce their exposure to balance-sheet intensive asset financing and commercial real estate lending, which was previously one of their biggest on-balance-sheet activities.

Insurance companies are a notable entrant to the UK lending market. Under Solvency II regulation, insurers have an incentive to lend against real estate, rather than own it directly. As a result, the asset class has become more appealing to insurers, and there has been a notable increase in the number of insurers setting up, or expanding, their lending operations in the UK. We expect this trend to continue and result in a more diverse commercial real estate lending sector. Insurance lending tends to target stabilised assets at the higher-quality end of the real estate and location spectrum, and at lower-leverage levels, currently up to a maximum of approximately 65% LTV.

Fig.10 illustrates the change in the composition of lenders in the UK commercial real estate market since 2003.

Fig.10: Allocation of outstanding debt secured by commercial property by category of lender



Source: De Montfort University, The UK Commercial Property Lending Market Research Findings, 2015 Year-End Report

These new regulatory and capital requirements mean that new lending or refinancing opportunities from traditional lenders have become more conservative, focusing on senior lending against prime and fully-stabilised assets, which comprise approximately 42% of the total UK real estate universe[5].

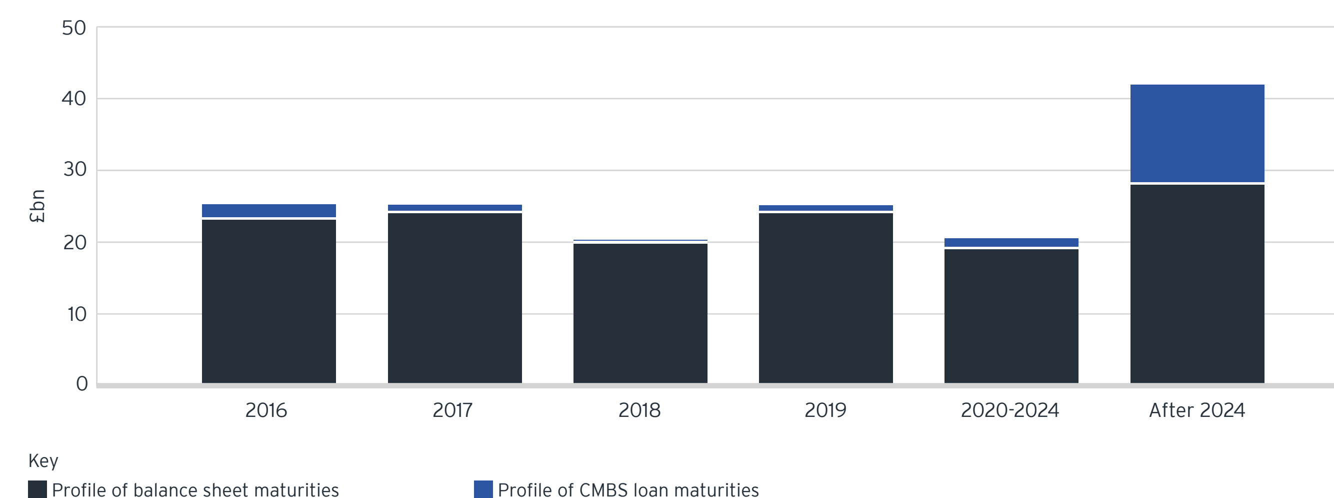
In addition, investment banks, which traditionally operate a 'lend-to-distribute' model through securitisation or syndication, and generally retain no exposure or a small percentage on their balance sheet, are being forced to retain a higher proportion of the debt on their balance sheets. As a consequence, many investment banks have reduced their market share of lending, as the returns previously obtained through fee income and margin retention are no longer profitable, relative to the significant amount of capital which must be held against commercial real estate assets.

The broad deleveraging of the European banking sector, and the reduction in bank appetite for CRE Debt, now further exacerbated by the Brexit vote, represents a significant change in market dynamics. Savills does not expect the UK banks to return to their prior lending volumes and leverage levels for a long period of time, as a result of increasing Tier 1 capital requirements, which will offer long-term opportunities to invest in CRE Debt for a broad range of new capital providers[6].

Refinancing profile

The expansion in real estate debt, prior to 2007, is leading to a number of loans maturing, and the majority that are not recapitalised or degeared with cash equity will require refinancing. De Montfort University estimates the total value of outstanding UK CRE Debt to be £208.8bn, with a significant proportion of these assets maturing over the next five years. Fig.11 shows the maturity profile of outstanding UK CRE debt based.

Fig.11: Maturity profile of UK CRE Debt – balance sheet and CMBS (£bn)



Source: De Montfort University, The UK Commercial Property Lending Market Research Findings, 2015 Year-End Report

Bank lending to the commercial real estate sector is unlikely to return to pre-2007 levels. It is expected that the UK and European lending landscape will improve and develop, however, a uniform, blanket upswing in lending conditions across countries, regions, sub-sectors and asset quality, is unlikely. Mirroring the activity in the direct investment market, lending for prime assets in core locations, with strong tenants and top tier sponsors, will remain in favour with the traditional providers of commercial real estate finance. An increase in the availability and size of the debt offering from an increasingly diverse capital base, particularly for prime assets in major cities, has led to increased competition between traditional lenders and significant margin compression over the past 24 months.

Lending against non-prime or regional assets is currently subdued, but a reduction in systemic risk in Europe, healthier funding conditions and better economic forecasts, would support wider commercial real estate lending. Competition and pricing for assets in the prime sector, coupled with better economic news, has encouraged investment activity in the secondary and regional markets of the UK, and a wider set of asset classes, in search of enhanced returns. However, available finance for these investments remains muted. Our Fund's investment strategy intends to capitalise on this gap between supply and demand, to provide appropriate risk-adjusted financing to well-performing assets in these locations.

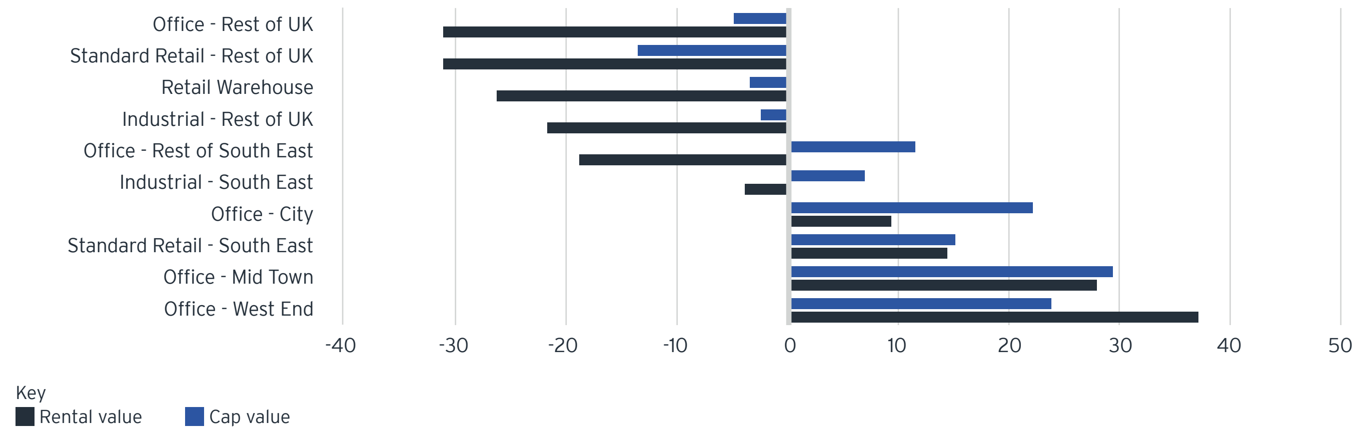
[5] IPD UK Quarterly Digest Q4 2015, top quartile by yield
[6] Savills Financing Property 2014, June 2014
[7] De Montfort University – The UK Commercial Property Lending Market Research Findings, 2015 Mid-Year Report

Direct real estate equity market: The case for debt

The change in sentiment towards commercial investment, risk and market confidence in 2013, reflected an improved macro-economic outlook, as fears about the Eurozone collapsing abated. CRE Debt and a rebound in commercial real estate investment volumes have benefited from this change in sentiment. In the UK alone, £66bn of direct commercial real estate transactions took place in 2015, up from £63bn in 2014 and £53bn in 2013[8]. This compares to a peak of £62bn in 2006. Commercial real estate yields have been tightening for the last 24 months, although capital values for most sectors across the UK remain significantly below their 2006/2007 peak levels, with the exception of super-prime assets.

The gulf in pricing that has emerged between prime and secondary commercial real estate, as well as London versus regional assets, since the beginning of the recovery in mid-2009 has been widely reported. The spread between mid-yield (good secondary) and low yield (prime) commercial assets remain at relatively wide levels.[9] There are certain tertiary markets that are susceptible to further write-downs, or unlikely to record any valuation appreciation, but good quality, secondary assets in the UK, with solid fundamentals and strong covenants, remain attractively priced and lie outside the largest current global capital flows.

Fig.12: UK Q2 2016 pricing peak vs. market peak of June 2007 (%)

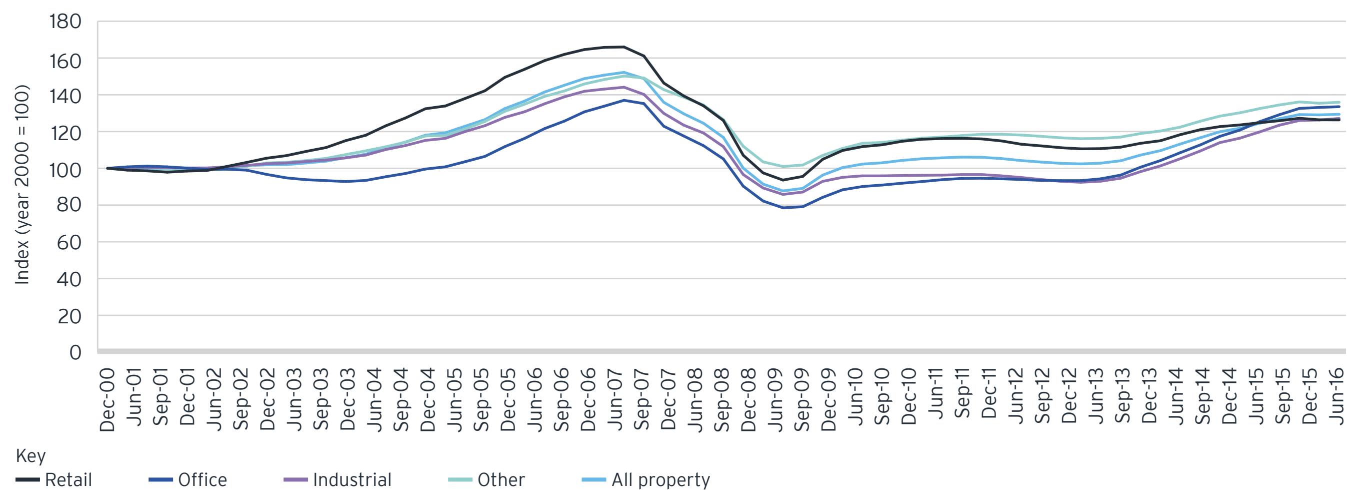


Key
Rental value
Cap value

Source: IPD UK Quarterly Index, Q2 2016

Average capital value movements in the UK since 2000, across all major real estate property types, suggest the market is broadly correlated and has moved in unison through the various cycles. However, the pace of recovery in UK commercial real estate values has shown significant divergence, as illustrated in Fig.13.

Fig.13: UK real estate capital value progression since 2000



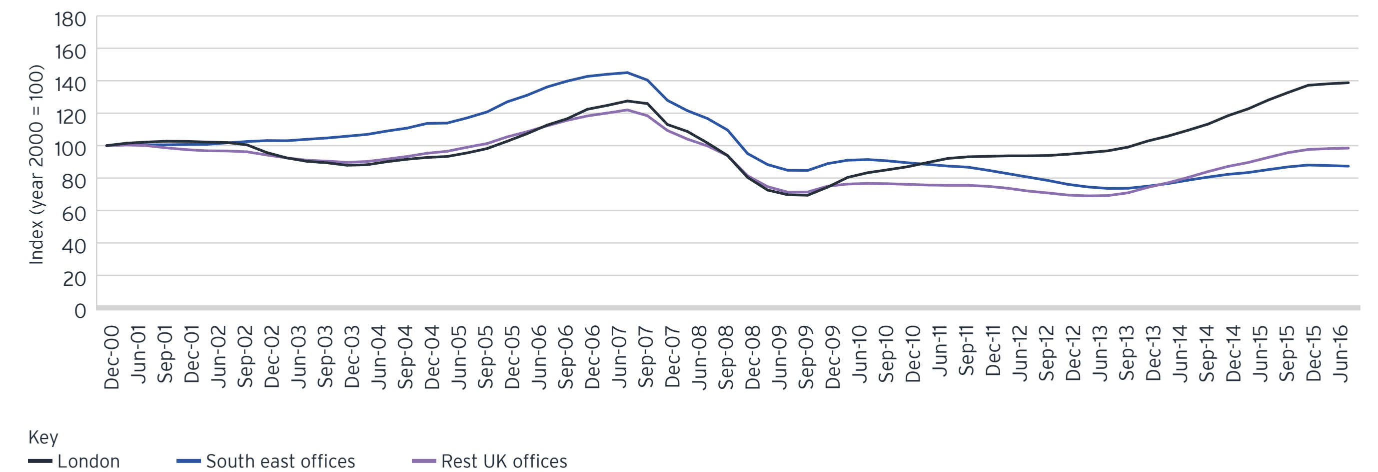
Key
Retail Office Industrial Other All property

Source: IPD UK Quarterly Property Digest, Q2 2016

[8]Propertydata.com
[9]IPD UK Quarterly Property Digest, Q2 2016

Using the office sector as an example (see Fig.14), it is clear that performance between London assets and the rest of the UK has diverged substantially. Performance of the regional and non-London sub-markets since 2009, has remained close to their trough valuations and is well below their peaks, or even below historical market values, dating as far back as 2000.

Fig.14: UK offices capital value progression since 2000



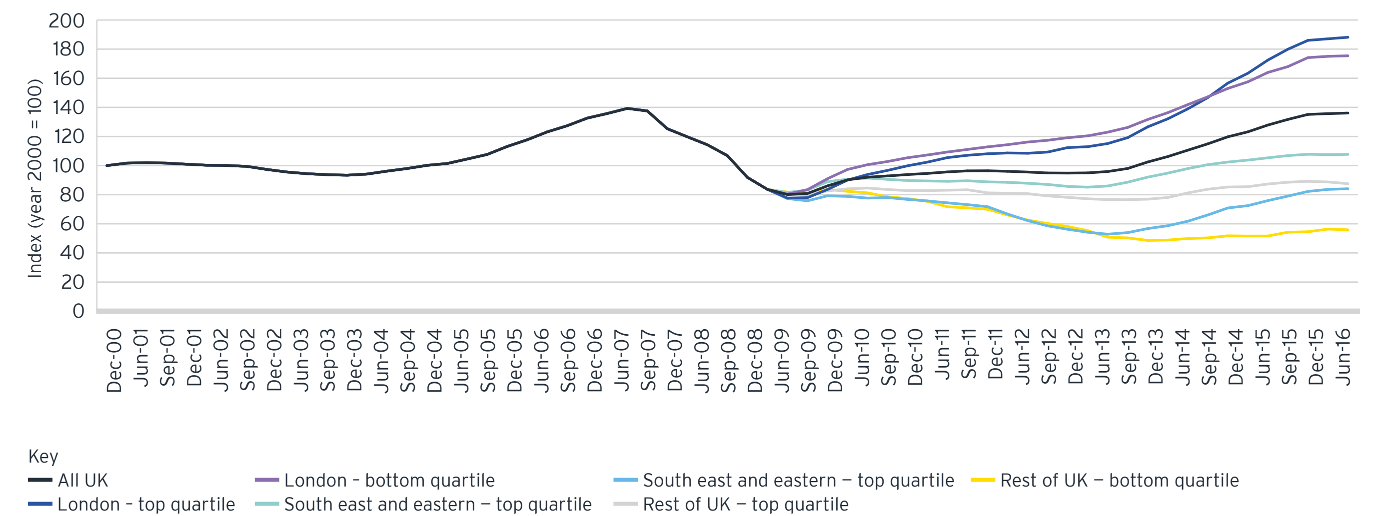
Key
London South east offices Rest UK offices

Source: IPD UK Quarterly Property Digest, Q4 2015

In the regional and non-London sub-markets, performance varies depending on the quality and location of the asset, as shown in Fig.15. Asset selection in these sub-markets is a critical component of the investment decision process.

With our direct real estate investment expertise, an experienced CRE Debt team and leading market research platform, we are uniquely positioned to seek out the best debt investment opportunities in these under-valued markets.

Fig.15: UK offices capital value progression since 2000, from 2009 top and bottom quartiles



Key
All UK
London – top quartile
London – bottom quartile
South east and eastern – top quartile
South east and eastern – top quartile
Rest of UK – top quartile
Rest of UK – bottom quartile

Source: IPD UK Quarterly Property Digest, Q2 2016

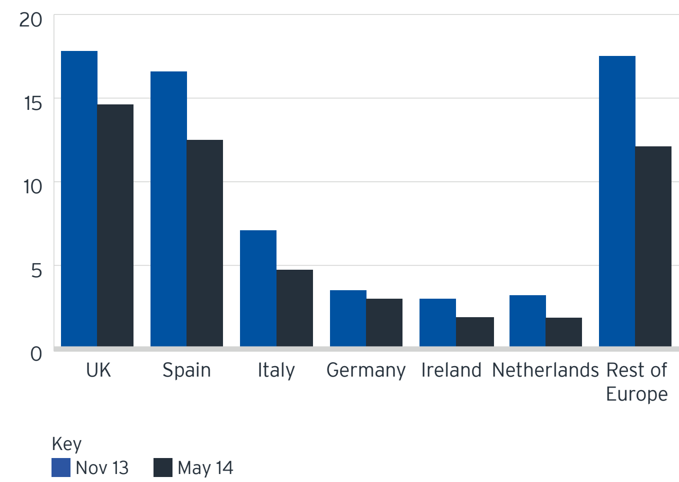
Polarisation of the commercial real estate lending market

Based on the preceding analysis, there is a strong argument to deploy capital into well-positioned core secondary and regional markets. With traditional credit channels constrained, and banks unable to exploit the lending opportunity that exists in the market, we believe there is an opportunity for new providers of CRE debt to enter the market, and selectively fill some of the gaps left by the retreating banks. A distinct credit supply and demand mismatch between debt providers and borrowers exists, particularly for certain strong secondary, and well-positioned regional assets.

A study by DTZ illustrated that a meaningful funding gap (30% of Europe's total financing) existed in the 2013-2014 period. TH Real Estate believes that repercussions of this situation persist in the current market resulting in inefficient financing structures for non-prime and core-plus secondary assets and locations.

Traditional bank lenders focus on prime assets, as they are considered to be safer by virtue of the perceived higher quality and liquidity of the underlying real estate. Conversely, when considering the likelihood of rising interest rates, and with risk premiums on prime stock already significantly compressed and potentially excessive valuations, lending on secondary and regional assets may be safer, more stable and more remunerative.

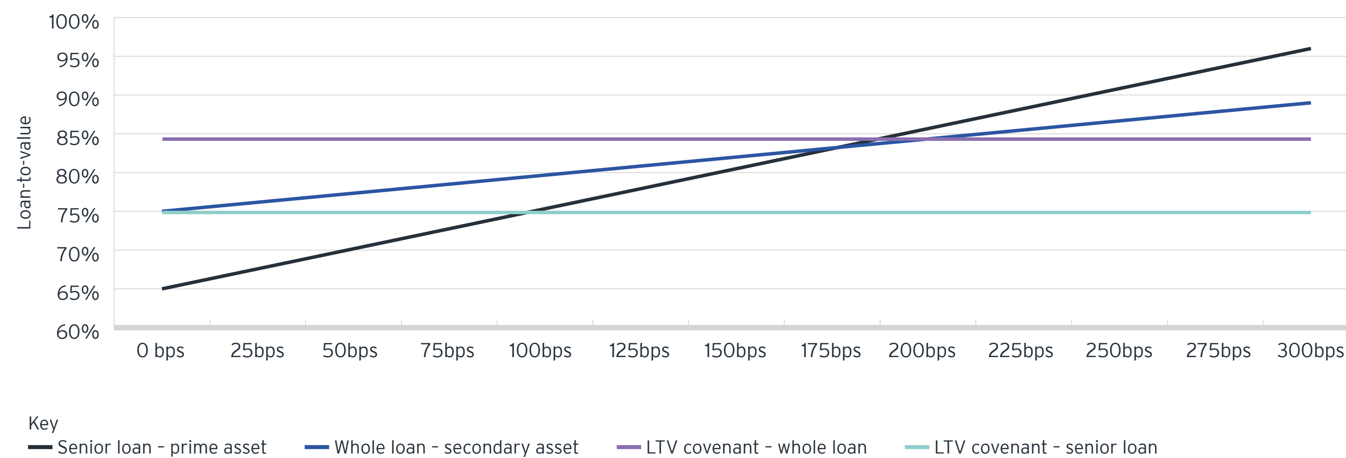
Fig.16: Refinancing gap 2013–2014, €bn



Source: DTZ Research*
Note: While for prime assets there is no shortfall, there is a gap for those assets that we seek to finance.

Market data suggests that recent movements in prime property yields in the UK were more highly correlated with changes in interest rates (at approximately 80% correlated), than yields on secondary assets (at approximately 50% correlated).[10] Given their greater sensitivity to interest rate changes, a material shift in interest rates may result in more rapid valuation reductions, and therefore LTV increases and potential covenant breaches on prime assets as yields expand. Fig.18 illustrates these findings in relation to a whole loan comparable with the Global Real Estate Debt Partners – Fund I (UK)'s target yield profile, and lending strategy versus a senior loan, secured on a lower yielding, prime asset.

Fig.17: LTV changes as function of interest rate increases



Source: Partners Group, TH Real Estate, 2015

*Note: This is the latest data from DTZ Research and the report has since been discontinued.
[10]Partners Group, Private real estate: Opportunity in Europe's real estate debt markets; March 2015. For indicative purposes only

Whole loans

The supply of junior debt for secondary assets is relatively limited in the UK and, from a borrower's perspective, there is execution risk in transacting with separate senior and junior lenders. These risks include a lack of certainty in execution, delays in timing, increased costs and complex documentation, including intercreditor agreement rights. Borrowers are therefore often willing to pay a premium for whole loans provided by a single lender, providing a complete financing solution and improved certainty of execution.

From a lender's perspective, whole loans can offer enhanced returns, compared to the equivalent junior and senior loans, improved transaction sourcing and control of the underwriting, execution and governance process. Even in circumstances where a whole loan lender structures the financing package as a combination of a senior and a separate junior loan, the lender will have increased control over the borrower due diligence package, the structuring of a coherent covenant package, and the mortgage security and intercreditor rights.

Attractive risk/return proposition for good secondary and regional investments

Provision of whole loans and select junior loans in the UK market offers a compelling risk/return profile, whilst benefiting from substantial downside protection from the subordination of the equity investor in the underlying property. Fig.5 illustrates the stable level of returns afforded by an unlevered CRE Debt investment, against the more volatile and unpredictable returns associated with a commercial real estate equity investment.

The Fund's maximum, day-one LTV of 75% provides a cushion of at least 25% due to the sponsor's equity contribution before eroding any investment returns. The debt position does not generally benefit from real estate market value increases, however in moderate downside and stressed scenarios, debt continues to offer stable cash on cash returns, with full repayment of the principal investment; real estate values need to fall significantly before impacting returns. Under a severe downside scenario, the market needs to fall substantially before the debt position is impaired and suffers negative returns.

Market opportunity summary

The UK remains an attractive investment destination, with a high and stable commercial real estate risk-return profile, aided by a liquid, transparent market place, a creditor-friendly jurisdiction and a well-understood legal framework. CRE Debt provides a strategic opportunity for the medium and long term, and offers diversification benefits for a traditional portfolio, where access to high quality commercial real estate assets in the direct market will remain competitive for domestic and global investors. Lending criteria has been rationalised and tightened from the parameters seen before the financial crisis. For enhanced returns, lending against strong secondary and well-positioned regional assets now presents a compelling investment opportunity. It is those assets currently 'off-the-radar', namely good secondary assets in established markets, which present the most appealing opportunity for cherry-picking transactions with robust return characteristics.

There are still headline risks, including uncertainty around economic growth, global political stability, and the timing and pace of interest rate increases; volatility is expected to remain particularly after the Brexit vote. Rental growth prospects for secondary assets remain muted and prime property is more exposed to rises in base rates.

With this uncertainty in mind, the appeal of core-like, higher relative returns available from the financing of good quality assets is obvious. This is especially the case when considering the structural protection against 25% CRE value declines. The TH Real Estate Enhanced Debt Fund is managed by an experienced CRE Debt team which, we believe, has the skills, support, infrastructure and expertise of the wider TH Real Estate business to meet the Fund's investment objective and deliver stable, risk-adjusted returns.

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TH Real Estate

Financing

The real estate finance sector continues to evolve into a more diverse market place, with a broader spectrum of lenders offering new alternatives to borrowers.

What does the future spell for real estate?

Find out in our A-Z guide to investing in Tomorrow's World real estate:
threalestate.com/tomorrows-world/a-z

Source: TH Real Estate

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