Loan Market Association
the authoritative voice of the EMEA market

REF Conference
11 May 2016
London

LMA Real Estate Finance Conference – Key Themes

The LMA's fourth Real Estate Finance Conference was held in London on 11 May 2016. The conference consisted of a series of panel discussions and presentations spanning a wide range of topical issues impacting the commercial real estate (**CRE**) finance market both domestically and globally.

The conference covered the following themes, which will be summarised in this briefing:

- the current outlook in real estate;
- the key challenges for the market;
- the key opportunities for the market; and
- a vision for the future.

Please note that there will be a separate section on 'Non-Performing Loans (NPLs). In addition, an in-depth overview of Green Lending will be available separately.

CURRENT OUTLOOK OF CRE MARKETS

2015 was a record year for CRE investment in Europe, with domestic investment reaching almost $150bn, and international investment being dominated by US capital flooding the UK market. However, the current outlook for European CRE is not as promising, with there having been a noticeable slowdown in activity in the first quarter of this year.

Macro and microeconomic influences, such as weak global growth in China, is weakening investor appetite across Europe. In addition, low yields, caused by the supply shortage of quality CRE in Europe, and increasing uncertainty, caused by global economic and political instability, have made investors pause for thought about where and when to invest.

However, despite all of these factors, real estate finance still offers strong yields and returns in the right areas.

Central London and the regions

Office vacancy levels in the City and West End are at an all time low. However, despite this, there are only a few development projects on the horizon, most likely a result of high construction costs and a low availability of contractors. In addition, and as a result of the financial crisis, investors (both senior lenders and equity) are being more conservative about which development schemes to back.

In contrast, regional CRE is outperforming London. There is significant scope for development, supported by an ever increasing corporate focus on cities outside of London, with the growth of the regional CRE activity being underpinned by true economic fundamentals.

Development finance

Currently only 10% of CRE lending is invested in development finance, with speculative development only available for listed companies, but only in conjunction with developers with a strong track record. This is primarily because regulation of UK regulated banks greatly restricts their ability to fund speculative development.

Retail sector

New technology, services such as "Click and Collect", and online services are bringing about long-term structural and cultural changes in the retail sector. This is shown by the recent troubles of UK retailer BHS, which has now entered insolvency proceedings and faces a £571m pension deficit. In the UK, total returns in the retail sector from 2015 to 2016 dropped by approximately 4%.

However, historically the performance of retail has been fairly robust, and there are still strong returns to be made, with the attractiveness of shopping centres depending primarily on geography and management expertise. In Q1 of 2016, total returns of shopping centres in Europe was approximately 7.3% of European Prime total returns. Internet retailing has become a huge part of this success, with the average annual growth rate increasing year on year, particularly in France and Germany.

One example of a successful retail transaction is Liverpool One, which was financed in December 2015 for £410 million, led by the Grosvenor Group. After two rounds of competitive bidding between lenders, the end result was a self-arranged club with a tenor of seven years and five lenders across various nationalities. The criteria which Grosvenor looked at in choosing lenders were price, commercial terms, flexibility and the lender's reputation and long-term commitment to the market. Other recent successful projects in this area have included the Arts Complex in Southampton.

Residential sector

In the residential sector in the UK, demand is almost infinite, being simply a function of price. Significant development would drive price down and meet demand in the majority of the market, although there is currently very little activity at the top end, i.e. £1.5mn plus.

Private rental sector

The private rental sector in the UK is an evolving market, although is not yet considered to be a stable asset class. The nation has not yet evolved to becoming a nation of renters, so behavioural change is required to truly drive this market. In addition, there appear to be mixed messages coming from government, with recent regulation looking to hinder the private rental sector, as opposed to promote it.

Outlook

Going forward, we are likely to see a rise in activity levels. When this will take place will depend on the result of the Brexit vote on 23 June 2016. However, whilst Brexit is an issue, it should be remembered that it is only one of the issues impacting trends in CRE in Europe.

KEY ECONOMIC AND GEOPOLITICAL CHALLENGES FOR THE MARKET

Macroeconomic issues – Economic and Political uncertainty

The potential referendum risk of the UK leaving the European Union (**EU**) has had clear implications for CRE. Whilst there is still interest from Asian lenders, other geographies are taking a much more cautious approach to investing in the UK. The CBRE Flash Investor Survey conducted in February 2016 showed that approximately 47% of respondents believed a potential Brexit made the UK a slightly less attractive location to invest in, while 26% believed it made the UK a much less attractive location. These results show the uncertainty the CRE market is currently facing as a result of the upcoming referendum.

If the outcome of the referendum is that the UK remains in the EU, there is expected to be a bumper second half of activity for 2016, as the supply and demand currently sitting on the sidelines enters the market. In contrast, if the outcome is to leave the EU, there may be a pause of breath and the market may enter into lockdown and illiquidity for a few months until investors get more comfortable with the investment climate.

Referendum concerns are compounded with a weak global economy aggravated by China's stock market volatility, emerging market economies in crisis, and low commodity prices threatening emerging market oil and commodity producers, energy and mining companies. In addition, political instability caused by Russian and Iranian sanctions, recent terrorist attacks, and activities in the Middle East (e.g. Iran after Implementation Day) have collectively contributed to investor uncertainty.

Microeconomic issues

Different parts of the industry are at different stages of recovery/growth. Whilst London may be recovered and growing, some areas such as Dublin and Madrid are still recovering from the latest recession, whilst Milan and Birmingham are growing.

There are also noticeable differences in the performance of the different sectors, with the industrial sector picking up, whilst (by comparison) the retail sector is struggling. These differences are having an inconsistent and ultimately negative impact on European total returns.

Furthermore, there is excess supply in some areas that is imbalanced with the demand side.

Monetary issues

Interest rates have been very low in recent years, and it is uncertain when they will rise again. Low interest rates encourage spending and investment, as it reduces the cost of borrowing. This has fuelled a boom, but also aggravated the recession. Nominal interest rates are currently lower than they have been for a long time, and predictions suggest that they will continue to be low for a few years to come, with any increase in rates likely to be muted.

KEY OPPORTUNITIES FOR THE MARKET

Rise of non-bank lenders

Non-bank lenders have grown significantly in the last few years, and have become as diverse as ever, ranging from debt funds, pension funds and insurance companies to crowd funders. These lenders all have their own unique capital sources, structure and finance offerings, allowing them to be competitive against traditional lenders, and amongst themselves.

The diversification of products is beneficial for the CRE market as it enhances stability. In Europe, the financial crisis of 2008/2009 hit hard as the market's primary source of finance, the banks, retrenched from the market.

From a borrower perspective, the rise of non-bank lenders has several advantages. It provides greater flexibility, tailored solutions to complex problems, generally fewer covenants and a faster decision making process. In particular, non-bank lenders tend to provide longer-term financing (i.e. 7 years +), which is typically outside the remit of banks. This provides a good opportunity to provide good relative value to investors.

From a lender perspective, non-banks can compete on the flexibility of the product and can diversify amongst themselves. Bank capital requirements restrict them from satisfying the long-term financing demands of borrowers, allowing non-bank lenders to seize the opportunity and charge more competitive prices. However, it is not only about competition. By offering a difficult product to that of the banks, non-bank lenders often complement the banks, promoting the development of a diverse, liquid and stable CRE market.

Development Finance

In recent years, there has been a huge growth in the residential development sector in the UK. However, due to economic uncertainty (largely due to the upcoming Brexit referendum in the UK), the market has slowed down and there are concerns that overseas purchasers may look to walk away from their deposits should threats of political instability grow.

From a financing perspective, traditional lenders are becoming more selective in their funding strategy than ever before. However, mezzanine investors retain appetitive for development finance, and provided the deal is in the right area and with the right sponsors, it is likely to be able to secure finance. Development finance is inherently more difficult than an investment deal, with it taking 1 – 2 years to get a development online, and therefore it is important that all players in the transaction work together.

NON-PERFORMING LOANS (NPLs)

Turning to trends in NPLs in CRE, it was noted that the market is now seeing a wave of much more granular loans hitting the market, as institutions come to the end of the cycle and are selling off the end of their book. This makes due diligence, which is already a heavily time sensitive area, even more pressured. Buyers have to put greater reliance on vendor due diligence, lacking the time and/or resources required to undertake a thorough due diligence of the whole portfolio. They therefore have to take broad assumptions with regards to enforceability of security, tax and so on. Even if time was not restrictive, a full scale due diligence of a granular portfolio would likely negate the economic fundamentals of the deal.

This may explain why the UK and Irish markets have been particularly buoyant in this area, when compared with the rest of Continental Europe. Generally, the UK and Ireland are perceived as creditor friendly jurisdictions, where buyers are able to get a clear view on the underlying businesses to which the NPLs relate, and have a clear view on how enforceability of assets may play out in the courts. In addition, with a majority of buyers originating in the UK or the US, having English as the native language is also a large draw. Finally, sellers have looked to actively repair their books, assisting liquidity in the market.

VISION FOR THE FUTURE

Green Finance

Green lending is effectively lending dependent on environmental criteria for the planned use of funds and the borrower's sustainability strategy to mitigate any environmental risk. This has been encouraged by the 'Green Agenda', which looks to implement sustainable development strategies and deliver big cuts in carbon emissions, domestic flights, waste and water usage. With the UK's target to reduce its carbon emissions by 80% by 2050, it seems obvious that Government will target Real Estate heavily as part of its general clampdown, and the Committee on Climate Change has already set targets for the reduction of emissions in residential and non-residential buildings. It is therefore incumbent on the real estate sector to lead from the front, and align its policies with the aims of the Green Agenda, as failure to do so could result in increased regulation and increased costs for those who fail to meet Government policy.

The Real Estate industry is clearly anticipating where Government is heading and is constantly innovating in its own right - stretching the boundaries of design, streamlining the efficiency of operations, and increasingly generating renewable and low-carbon power on-site. There is no doubt the industry has the capacity to become even more creative going forward, and it is likely that the clamour for greener, more resource efficient properties is here to stay.

For more information on this, see the LMA's article "What is Green Lending?"

The LMA would like to give special thanks to the speakers who devoted their time to this year's Real Estate Finance Conference. To view further information about the event, please visit the LMA website: www.lma.eu.com and click on Education & Events/ Past Events.