REF Conference
17 May 2017
London

LMA Real Estate Finance Conference – Key Themes

INTRODUCTION

On 17 May 2017, the Loan Market Association held its fifth annual Real Estate Finance (REF) Conference at One Bishops Square, London. With interest in the European real estate market as strong as ever amongst our members, it was another successful conference with over 400 market participants in attendance. The programme comprised an impressive line-up of speakers who shared their views on the key issues and challenges currently shaping the REF industry.

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

- Economic and geopolitical challenges for the market
- Microeconomic trends – challenges and opportunities
- Legal focus and setting standards

ECONOMIC AND GEOPOLITCAL CHALLENGES FOR THE MARKET

Macroeconomic Issues

Following the slowdown in activity in 2016, the European REF market has remained stable despite the geo-political uncertainty that resulted from the UK's vote to leave the EU and President Trump's election in the US. However, the current stability is fragile, with Brexit negotiations threatening to increase volatility and dampen confidence across the economy, leading some investors to air a greater tone of caution than 12 months ago. With interest rates having barely moved, yields well above the base rate and excessive liquidity fuelling an abundant supply of real estate debt, 35% of market participants surveyed prior to the conference believe that the market is at the peak of the property cycle. High liquidity on the supply side, however, contrasts with a general demand for smaller transaction sizes and lower deal volumes, helping to explain why 30% of survey respondents agreed that too much competition chasing too few suitable assets will be the greatest challenge of 2017.

Brexit

Undoubtedly Brexit remains at the forefront of investors' decision making in the UK, which will continue until more certain exit arrangements have been agreed upon by the negotiating parties. This uncertainty, coupled with a surprisingly resilient core Eurozone market, is driving investors to diversify their portfolios away from the UK, and if it were not for the shortage of sales volumes the European market may be even more active.

UK real estate does, however, have some redeeming qualities to balance the negativity. Depreciation in sterling has made the UK more attractive to overseas capital, with Chinese and Middle Eastern investors looking to acquire trophy assets. The London market for office space remains buoyant and greater real estate financing in regional cities could ease investors' reliance on the London market.

Pricing

Pricing across Europe is varied, reflecting past shocks and current hotspots. In the UK, long-dated income is pricing inside that of pre-Brexit referendum levels whilst short-dated income, in contrast to expectations, is not. Yields in Paris and Munich are at their lowest ever, influenced by the eventual impact of the ECB's quantitative easing programme. Political uncertainty in Italy and the risk of a potential banking crisis have pushed Milan to be more expensive than London's West End. From a borrower's perspective, however, there is still room for prices to fall across Europe, and this is not being helped by the lack of new transactions coming to market.

Future Outlook

Over the next 12 months, the market is likely to see little progress in identifying the exact shape of Brexit, therefore some level of uncertainty will continue, which may lead to a reduction in London prime rents and an increase in the vacancy rates. Since liquidity remains abundant, the market should remain resilient, although sourcing finance for esoteric deals may well be more challenging. Germany could be considered a relatively safe haven for investment and Spain may be the country of choice for less risk-averse investors seeking new opportunities. Going forward, there is a desire for more investment activity, larger transactions and some volatility to energise the market across Europe.

MICROECONOMIC TRENDS – CHALLENGES AND OPPORTUNITIES

Sector and Geographic Activity

The world economy has largely strengthened, with significant improvements seen across Europe. Germany, France and Italy are performing better than expected, primarily due to the general global macroeconomic upwards trend and increased liquidity in European markets. The market has also seen increased competition due to decreasing loan volumes and smaller transactions, driving investors to look outside of their comfort zones. In this respect, central Europe has become a hotspot for value-add investors attracted by asset quality and higher yields. Greece, Portugal and Italy are also increasingly attractive targets for investors. Further afield, more global transactions are anticipated, particularly in the Middle East and China.

Within the UK, there is growing activity in the regions, and a slight move away from London in terms of office space, potentially due to better spreads in the regions, and reduced volumes in London. In addition, rents in London are either static or falling, and Birmingham has become a key area of focus for market participants to invest outside of the capital. There is an abundance of cheap capital available for office builds, which provide stable returns for investors; further interest in this sector is anticipated, although this has not yet materialised. Europe follows a similar trend, with office space accounting for over a third of the market. While this is expected to decrease from 37% to 35% by the end of Q1 2019, rental value for office space is anticipated to increase by 4.4% over the same period. This is especially true of peripheral inner city areas, with Stockholm, Berlin, Amsterdam and Dublin at the forefront due to technology driving occupancy and rental growth. Outside of this sector, the market has also seen increased investment in the hospitality and private rented sectors (PRS).

Construction finance currently accounts for only 10% of total UK debt, with much of this comprising residential construction activity. In this respect, there are serious capacity constraints for construction development financing with domestic banks unlikely to extend capital beyond current levels despite the need and demand for it. Infrastructure investment has also been especially weak for a number of years, and the impact of this can be seen within the regions. Further consideration should be given to the necessary infrastructure associated with trends such as online shopping, and the resulting shift in demand from retail to logistics. This trend is mirrored in Eurozone markets, with logistics activity predicted to double from 10% to 21% in March 2019, while retail is set to fall from 27% to 16% over the same period.

Going forward, market participants would like to see increased certainty and stability in the market, coupled with reduced competition and regulation. In particular, there is a desire for a reinstatement of mortgage relief on buy to let properties and the removal of stamp duty surcharges.

Private Rented Sector

PRS, which includes build-to-rent, build-to-let and traditional rental space, has seen an upsurge in activity in recent years, with 33.3% of our survey respondents selecting it as the hottest UK REF sector. The majority of the current pipeline in this nascent sector is moving towards the regional cities, in contrast to deals to date being focused in the South East of the UK. Although most volume is situated in the primary market, the secondary market is likely to develop in the next 3-5 years once projects complete their development and stabilisation phases, and as bank financing, which is generally focused on short-term returns, is sold to more suitable long-term debt providers. The PRS sector, much like the student housing sector, has a long income stream of approximately 25-30 years, and therefore the composition of financing is likely to change significantly during the life of a project.

PRS appetite is growing, but there are a number of points that investors should take note of. Firstly, the sector operates at a premium to the market rate and therefore underwriters should take into account the differences in rental incomes in the local area, as well as net operating income, cost of services and ramp up rates. Secondly, there is a more difficult process regarding valuations, especially since rental income is unpredictable given the lack of historical data. Borrowers should be challenged to be realistic and the figures scrutinised more carefully. Finally, there is an array of financing models to choose from and therefore investors should pay close attention to which structure is most suitable, whether that be forward purchase, forward funding, cost plus or a joint venture.

It is estimated that 46% of 24-30 year olds currently rent, representing a significant market opportunity for those choosing to finance PRS. This is reflected by the growth in US financing to over US$1bn each month and, since US trends also tend to take hold in Europe, the European REF market is likely to see continued growth over the next 12-18 months.

Lender Appetite

The composition of lenders in the REF market has remained relatively consistent since 2016, showing that recent macroeconomic and geopolitical changes have not provoked significant knee-jerk reactions by any particular type of lender. The senior debt market continues to be dominated by traditional banks, as a result of borrowers remaining concerned about sourcing large financings from outside the banking sector. In the near future this competitive advantage is likely to disappear as speed of execution, flexibility and certainty of funds become critical to making opportunistic acquisitions and closing deals quickly. Alternative lenders may therefore increase their share of senior debt financing, potentially by working alongside traditional banks in order to drive the market through any potential volatility by utilising long-term capital which banks are unable to provide.

Investors in REF largely fall into two groups: those who wish to be heavily involved in a project, knowing precise details to influence the process and secure their financing, and those investors who are agnostic as to the property they are investing in and are solely concerned with achieving a strong return. The investor make-up between the UK and Europe reflects this, such that many opportunistic funds are heading to Ireland, Spain and the Netherlands, which offer higher risk-adjusted returns whilst the return opportunities in the UK are much less obvious and therefore the market is dominated by more risk-averse traditional lenders.

Non-Performing Loans (NPLs)

Turning to trends in the NPL market, Europe has continued to be a busy hub for sales, most notably in Italy and Spain where institutions have focused on de-leveraging their portfolios. This has been aided by recent initiatives to improve the poor information sets on borrowers and by fostering greater collaboration with local partners to advise on the more complex jurisdictional enforcement processes pertinent to these countries. Residential exposures comprise the majority of portfolios in Spain, whilst the Italian market has more cross-sector activity, which helps to provide a more balanced and continuous stream of deals for buyers.

Continuing the 2016 trend of more granular loans entering the market, buyers are now relying much more on external third parties to provide valuation data and due diligence information in order to meet the shorter time frames for these deals. The greater cost and complexity associated with these transactions saw the market briefly pause in the first half of 2017, however it is anticipated that activity in the REF NPL market will increase later in 2017, with greater deal flow in Southern Europe, as well as in the Middle East and China.

LEGAL FOCUS AND SETTING STANDARDS

Documentation

One theme highlighted throughout the conference was the strength of the UK's legislative and documentary framework: strengths that should not be underestimated in light of the uncertain regulatory and geopolitical environment. In recent years, the market has seen lenders pushing for standardisation of documentation, with lenders becoming increasingly prescriptive about the terms to be included. Whilst standardisation of documentation within REF transactions is especially difficult given that parties, situations and structures vary significantly, where market practice can be established and reflected in template documentation, this can greatly reduce the delays and costs caused by excessive negotiation.

In acquisition scenarios, the cost of deals can vary depending on the scope of the due diligence conducted; in more established markets, it may be appropriate to use more standard documentation and less due diligence than in newer markets. Costs can also vary depending on the buyer's negotiating strength and the seller's experience. Lenders are beginning to recognise that borrowers have become increasingly experienced in dealing with syndicated loans and financings, and are therefore more willing to concede on particular terms during the negotiation process. This negotiating experience has resulted in lenders competing on both price and the terms of the share purchase agreements, including representations, warranties, and agreed transitional arrangements.

The market has seen an increasing prevalence of defined lists, known colloquially as white and black lists, within documentation. While these lists can resolve a number of issues, they are ineffective in reducing the extent of know your customer checks to be undertaken during a transaction.

More recent trends include the emergence of trustee protection language within documentation, with Article 6 BEPS language on anti-treaty shopping anticipated in 2019, once this legislation has been implemented. Speakers from the conference highlighted the significance of standardisation of REF documentation. In this respect, a number of benefits were identified, including increased transparency in the market through usage of a common, recognised standard which reflects both the borrower and lender position. Further advantages include risk reduction for parties – as credit teams become more comfortable with an expected outcome based on the protections available – and the ability of documentation to facilitate the right discussions and progressions within transactions. On the latter point, one example includes the removal of discussions surrounding boilerplate provisions, which allows for deals to come together much quicker, thereby improving liquidity due to the ease of distribution. Standardisation also provides for more consistency and certainty for all parties.

Setting Standards

In recent years, the market has seen various organisations attempt to measure and improve sustainability through imposing market standards. This transformation has been undertaken on the premise that energy efficient buildings attract better quality capital, providing a clear incentive for the market to incorporate energy statistics and promote sustainability.

GRESB, for example, has created green standards which can be used to assess buildings in the hope that if market participants demonstrate that they are taking an active role in improving efficiency, this may negate the need for regulatory involvement in the future. These standards, which evaluate the environmental, social and governance (ESG) performance indicators used to measure economic sustainability, seek to enhance and protect shareholder value through empowering sustainability practices in the real asset sector. In relation to such standards, benchmarking is of key importance in order to understand where one institution is performing compared to another. This information is essential for investors pursuing greater returns associated with effective ESG performance.

There are clear tangible benefits to environmental standards being implemented, including the opportunity for certainty, consistency and harmonisation. The advantages of standardisation are also particularly evident when considering valuations. Initially, the market saw significant inconsistencies in contractual valuations for the same properties, attributable to different calculations being adopted by valuers. In particular, measurements for square footage of buildings could fluctuate by up to 21%. In response to market concerns, RICS formulated and distributed a universal standard to all valuers, enabling institutions to gain a more accurate understanding of the true value of their portfolios. In this respect, standardisation has the potential, therefore, to not only drive increased efficiency across the market, but also expand the market through attracting new capital by facilitating transactional certainty and consistency.

Going forward, from a sustainability perspective, it would be useful for participants to be provided with a demonstration of what the ideal efficiency standards look like in practice, thereby setting a more comprehensible standard for the market to follow. This would be particularly useful given the minimum energy efficiency standards that will take effect in 2018 and impact all loan books which hold property. The key takeaway points are, therefore, that green lending standards facilitate harmonisation, certainty and greater returns on investments. However, the market requires further clarification and increased institutional engagement in promoting sustainability if real progress is to be achieved.

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, including the agenda and speakers, please click here.