SPLASH
AUGUST 2011 THE NEWSLETTER FROM KINGFISHER PROPERTY

Property Lending Woes Continue

Three years into the Great Recession as it is now termed by Sir Samuel Brittan, there is no sign of lenders in the commercial property market regaining their appetite for risk. Transactions with unexpired terms on leases of less than 5 years or with tenants of other than good quality, are tough to finance.

At the same time, suitable opportunities for lending are difficult to find. Margins reported to the De Montfort Survey for prime loans are at an all time high of 230 bps. Average LTV's for prime are at a low point of 65% and interest only periods are only available for the best opportunities. The market is polarising between loan opportunities of greater than £20 million and those of less than £10 million. Whilst 66% of current lending is sourced from just 6 lenders, there is a posse of German lenders seeking exposure to larger loans and sub 2% margins for the right quality is possible. For loans of a size less than £10 million, margins can range anywhere from 2¼% up to 4% or more depending on lender. That being said, we have seen isolated loans where the level of risk taken by the lender has surprised us. One can only ask.

Generally lenders have now had time to identify those loans which are or could be in trouble, although the Bank of England has expressed doubt about the levels reported. The amount reported to the De Montfort Survey as being in breach or default totalled £37 billion at the end of 2010. Yet some 43% of commercial property exposure held by Lloyds and RBS is reported as being in intensive care and if this proportion is applied across the drawn commercial property loan book, it suggests that a figure of circa £114 billion could be nearer the mark. In fact, a Property Industry Alliance report to the Bank of England in February 2011 suggests that 80% of all loans made since 2005 are probably in either breach or default, amounting to some £130 billion.

More worryingly, the amount of the entire commercial property loan book secured on secondary and tertiary properties is estimated by lenders reporting to the De Montfort Survey to be in the order of £165 billion. It is these loans which are thought to form the bulk of those in intensive care. The same report goes on to suggest that the value of this stock has continued to decline since the low point in June 2009 on account of incentives required for new lettings and renewals, capex for bringing properties up to standard, shorter lease terms and weak income growth. What is for sure is that lenders will be absorbing yet more losses from their commercial property loan books which will further reduce their equity base. This together with the new proposed Basel III regulations will have the effect of constraining capacity to lend. Higher margins are here to stay for a while yet. The only driver we can see for lower margins in the future would be the renaissance of the CMBS market. Competitive pressure to put on loans which can form part of issuances so that lenders can churn their books drove margins down in the past; but if the CMBS market does re-establish itself in the short term, it is likely to be only for prime lending opportunities.

Our conclusions are that margins are likely to remain high, lending capacity constrained and LTV's at current levels for at least the next 12 months. We are also seeing an increasing level of secondary property acquisitions where asset managers intend to exploit value enhancement opportunities. Encouragingly we are having success in finding lenders to support these acquisitions.

"Which bank did you say you were from?"

Required Equity Returns Remain High

Throughout the early to mid 2000's, equity investors increasingly sought to gain exposure to a very wide spectrum of real estate investment opportunities. During this period we arranged joint venture finance to help asset managers acquire anything from secondary shopping centres to caravan parks and even strategic land. Since the Great Recession, appetite for risk has diminished drastically, with focus shifting towards high quality, income producing investments in the core real estate sectors which have become available at historically attractive prices.

There are signs though that this is changing. We are now arranging joint venture equity in sectors as diverse as student accommodation, healthcare and serviced offices. Some market commentators have suggested that the world is awash with equity. Availability of equity combined with low interest rates would suggest that return requirements might soften. This has not happened. Whilst there may be plenty of equity out there, it remains highly selective, with pricing remaining remarkably similar to what we saw in the good times.

TRANSACTIONS

Office Investment, Bournemouth

This 87,000 sq ft office building constructed in 1975 was multi let and 56% occupied upon purchase. The tenants had break options exercisable in the short term and terms were agreed with the principal tenant for a new 6 year term. We arranged finance for 55% of the purchase price over a 3 year term at a competitive margin sub 3% p.a.

Town Centre Retail, Lymington

Kingfisher Property has raised finance for the acquisition of this freehold town centre retail unit in Lymington. A senior debt facility representing 60% of value was achieved even though the tenant's lease had expired. The lender relied on the tenant's intention to renew.

Office Investment, London EC1

A developer client has acquired this property with a ground floor A3 unit and 5 floors of offices above. The upper floors of the property are vacant whilst the ground floor bar is well let with 11 years unexpired. We arranged nearly 60% LTV finance at a sub 3% margin on an interest only basis.

Residential Development, Stamford

This residential development on a brown field site in an attractive setting on the edge of Stamford town centre is now under construction. The development is for 13 private town houses totalling approximately 19,565 sq ft (1,818 sq m). The scheme is anticipated to have a completed value in the order of £5.8 million and we arranged a development facility for 50% of gross development value at attractive rates.

Headquarters Office, Northampton

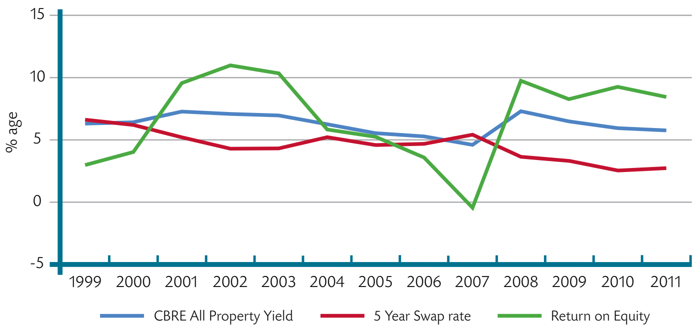
We have raised an investment mortgage to assist a private investor client in acquiring the Avon Cosmetics Ltd 90,739 sq ft (8,430 sq m) UK headquarters. There was considerable interest from lenders on account of the quality of income and the length of lease. Lenders offered finance for both 5 and 7 year terms, the latter being more expensive and more difficult to source.

Student Accommodation JV, London E1

Kingfisher Property recently arranged joint venture equity finance for a specialist development company to acquire and refurbish a large student accommodation property on the outskirts of the City. The purchase price was in the region of £25m. There is an acute imbalance of demand over supply of suitable stock in certain locations in the UK, with many existing operators and universities under financial pressure. Because of significant barriers to market entry reducing this imbalance will take time. We helped our client develop a business plan focused on exploiting their track record of success in delivering value. The business model is focused on refurbishing and re-positioning the existing accommodation, and re-letting at enhanced rents on a direct let basis.

Return on Equity

Kingfisher Property Finance Return on Equity Yields and 5 Year Swap Rates 1999 – 2011



The return on equity (ROE) to debt financed investors has been stable over the last 3 years at between 8-10%. The (ROE) analysis is in respect of prime property and whilst yields have sharpened, the cost of money has continued to fall, resulting in a relatively stable and unchanged return. Normally one would have expected prices to rise and the ROE to settle at closer to 5%.

The continuing high return possibly reflects the anticipation of rising interest rates, the lack of rental growth prospects and little possibility of further yield compression.

The graph can be found in the Market Data section of the Kingfisher Property website. The return is measured by comparing the CBRE All Property Prime Yield with a notional loan based on a 5 year swap. A loan amount equal to the average LTV for prime security and priced at the average margin, both as reported to the De Montfort Survey, are assumed. Surplus income is then expressed as a percentage return on the implied equity in the transaction. Before 1991, the return on equity was always negative going back to before 1980. Since then it has always been positive.

News on Limited Partnerships

Over the last 12 months, Kingfisher Property Partnerships and Kingfisher Property Trustees, our two FSA regulated companies, have been appointed operator of 9 new collective investment schemes. All of the schemes we operate involve commercial property. Funds under management total in excess of £4 billion and have been built up since 2001. A feature of more recent appointments has been the lack of blind funds and the predominance of both joint ventures and small private investment "clubs".

KINGFISHER
PROPERTY FINANCE LIMITED

41–43 Maddox Street, London W1S 2PD

T 020 7491 0380 **F** 020 7491 9202
E info@kingfisherproperty.co.uk
W www.kingfisherproperty.co.uk