SPLASH

SEPTEMBER 2012 THE NEWSLETTER FROM KINGFISHER PROPERTY

Real Estate Debt and the Great Recession

The best estimate of total outstanding debt secured against commercial property as at December 2011 is circa £300 billion. Of this, some 60%, or £180 billion, is secured against secondary and tertiary property. It is this segment of the loan book which is causing lenders most anxiety as much of it continues to lose value. Lease expiries are leading to renewals on less favourable terms; generous incentive packages are required by potential tenants and secondary office stock requires capital expenditure to bring it up to lettable standard.

We have not experienced a crash before when so many lenders, as opposed to borrowers, have experienced financial difficulty. Nor have we ever seen so much private sector cash following a crash. These two features distinguish the Great Recession from previous crashes. Last year, lenders deleveraged their property books by £32 billion, of which 40% was through contractual repayments, 21% by voluntary repayments and only 14% by loan sales. It is surprising there have been so few loan sales and so much contractual and voluntary repayment. Resources are available to facilitate the required deleveraging, suggesting that it might just be a question of pricing before this process mushrooms. But can lenders afford to absorb the losses implied by current prices for secondary and tertiary property? Whilst Irish lenders have been keen to recoup what they can, other lenders and particularly the British clearers, have been more reluctant. Meanwhile pressure is beginning to mount for additional regulatory capital in support of weak loans, encouraging lenders to clear out their balance sheets. Their response to date has been to decrease real estate loan books – a smaller amount of equity supporting fewer loans.

Against this backdrop we have seen lenders becoming progressively risk averse and terms more expensive as the recession has proceeded. There are no signs of this abating.

Even for the best quality loan opportunities at an undemanding LTV of 50%, it is difficult to secure a sub 3% margin. Margins normally start higher and if the security is secondary or development is involved, margins increase steeply. Arrangement fees range up to 1½% - more for development. Whilst there is still a healthy number of lenders interested in prime and good secondary opportunities, the number interested in secondary has declined substantially. Moreover, regulatory influence is focussing lenders on relationships rather than one-off, limited recourse loan structures. Loan terms from lenders other than insurance companies are limited to 5 years. The few willing to offer 7 years charge a premium. Interest only is largely history. Lenders want to see loans fully paid down over the unexpired term of occupational leases or to conservative levels of vacant possession value. Only the best quality security can attract offers at more than 65% LTV.

New entrants are appearing in two separate areas. An increasing number of insurance companies wish to lend, but almost all are targetting loan sizes of £20 million. Indeed the De Montfort survey reports that 60% of all lenders now wish only to provide loans in excess of £20 million. The new lenders of greatest interest are real estate debt funds. As yet their capacity is small but there are indications they will be building loan books with a view to securitisation, when that market reopens, giving them a chance to recycle capital. There are also early indications that they will provide variety, seeking different loan characteristics in order to achieve different returns. Not much business has been written yet but when signs of general improvement return, we expect these funds to provide downward pressure on margins and increased appetite for risk. It will take a realistic prospect for rental and capital growth to tempt investors sitting on cash to start buying the secondary and tertiary stock currently supporting loans in trouble. The challenge will be to source the debt to support them.

Property Fund Regulation

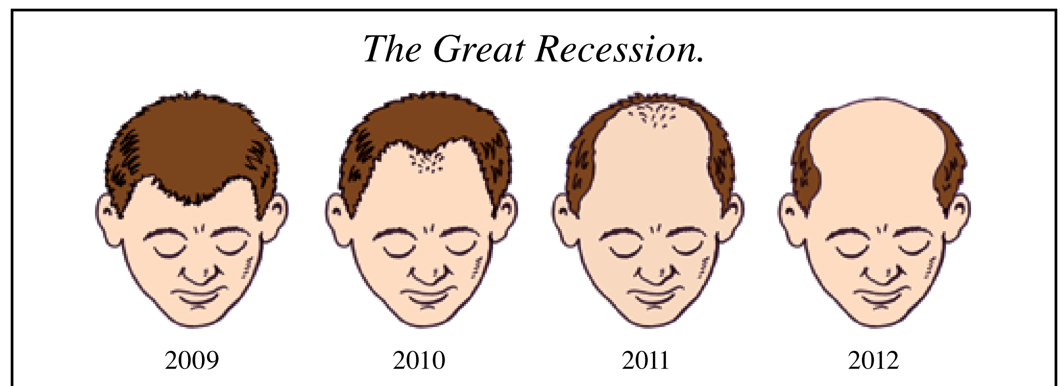
We should learn more about the implementation measures which will be introduced by the FSA in response to the EU's Alternative Investment Fund Management Directive shortly. This directive will have widespread impact on the conduct of new collective investment schemes (including real estate funds) and at the same time HM Treasury is reviewing the principles for determining what a collective investment scheme is.

For larger funds of over £80 million, among other changes, we expect:

- A splitting of the current role of operator between a FSA regulated fund manager who can be employed externally, and a regulatory "depositary", leading to significantly increased regulatory costs.
- A significant increase in the regulatory capital requirement of fund managers.
- A requirement for formal risk management and increased reporting to the FSA.

For smaller funds the changes may be less onerous, although smaller funds might wish to opt into the larger fund regime because of promotion restrictions.

The new rules are due to come into effect in July 2013 with full implementation to be achieved by July 2014.



TRANSACTIONS

National Commercial Portfolio

We have arranged an investment mortgage for a portfolio of some 50 secondary properties valued at approximately £80 million.

The loan is for close to £50 million representing almost 60% LTV from one lender. The loan term is 5 years and a sub 3% margin was agreed.

Day Care Nursery, Richmond

A private client investor based overseas instructed us to raise debt to assist with his acquisition of a day care nursery near Richmond, leased to a small company operator. The lease is for a term in excess of 25 years and is RPI linked. We arranged close to £1 million representing 65% LTV.

Residential Development, South London

This project was a new 14 unit development including penthouses with views over greenbelt located in a Conservation Area.

Kingfisher Property succeeded in sourcing close to 100% of the total development costs of approximately £6 million with no requirement for a cash backed cost overrun facility in spite of extensive remediation works. The loan was for a term of 2 years and there was no requirement for presales.

Equity Release, Bournemouth Offices

This property is a 1970's constructed half vacant office building in Bournemouth which our client wished to refurbish for back office use.

We arranged debt to support the property acquisition. Following refurbishment the client let the remaining 45,000 sq ft within 9 months and we arranged equity release by way of a 3 year term loan for £5 million representing 50% LTV.

Mixed Residential & Retail Investment Portfolio, Home Counties

We raised an investment mortgage to assist a private investor gear up on an unencumbered retail and residential portfolio comprising four properties.

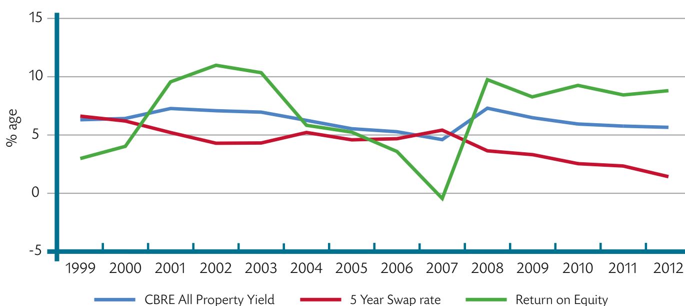
A senior debt facility representing approximately 60% LTV was achieved. A number of the flats were either vacant or required extensive refurbishment and the cash flow was underpinned by income from mainly residential lettings.

Mixed Use Portfolio, Central London

Kingfisher Property raised debt for the refinancing of a mixed use portfolio in Central London comprising 8 retail investments with office or residential upper parts. Of the 8 retail units, four were restaurants. Kingfisher Property raised approximately £4.5 million, close to 60% LTV. The margin was just over 3% p.a. and the loan was for a 5 year term.

Prime Property – High Return on Equity

Kingfisher Property Return on Equity
Yields and 5 Year Swap Rates 1999 – 2012



On the face of it, the return on equity (RoE) to debt financed investors in prime property has remained stable over the last 4 years at 8-9%. Continuing falls in the cost of money over the last 12 months have been offset to a large extent by a general deterioration in the lending market and rising debt margins. However this is not quite the full picture since lenders are now focusing more on debt amortization and charging more for arranging loans. Taking the median amortization requirement reported to the De Montfort Survey (1.5% of the loan amount per annum) and spreading the average arrangement fee (114 bps) over the life of a typical 5 year loan, prime property is generating a pre-tax cash return of 6%, which remains very healthy by comparison with historic returns on property and cash.

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 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.

An Alternative Home for Equity

The flight to quality over the last couple of years has seen demand for UK prime property rise substantially, leading to yield compression and a dearth of supply. Equity rich investors have become frustrated in their desire to acquire quality stock at an acceptable return. The result is that many are exploring alternative property sectors where strong demand characteristics are capable of driving superior risk-adjusted returns. These sectors include hotels, student accommodation, self storage, data centres, serviced offices and senior living. Few however have the necessary expertise to either manage or access suitable stock, creating an opportunity for experienced, specialist operators to make investment opportunities available and to capitalise on this latent investment demand.

Kingfisher Property has worked with operators active in each of the alternative property sectors mentioned above and structures joint ventures, raising the necessary equity.

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 12 new collective investment schemes. Each of the 55 schemes we now operate involve commercial property, with funds under management totalling approximately £4.7 billion. The majority of these latest appointments relate to joint ventures with a strategy focussed on the re-development or asset management of a single property asset.

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