Research Programme 2011–2015

SHORT PAPER 20

Zombies and Beyond: A Further Update on UK Real Estate Debt

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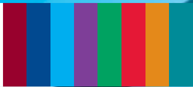

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Zombies and Beyond
A Further Update on UK Real Estate Debt

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Zombies and Beyond: A Further Update on UK Real Estate Debt

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1. INTRODUCTION

Previous Short Papers published by the IPF (in 2009 and 2010) identified significant problems in the UK real estate lending markets. Those papers concluded, amongst other things, that the workout of distressed real estate lending would be a five to 10 year process.

The author of those papers predicted that lending banks' desire to control write-offs and avoid bringing too much property to the market would lead to a degree of stagnation. Losses would be concentrated in loans where income was insufficient to cover debt service. Refinancing would occur, but at a price, and banks would prefer to avoid receivership because of the costs involved.

The purpose of this Short Paper is to provide an update, describing the effects of the continuing workout on borrowers, lenders and the market, as well as offering some tentative conclusions about what might lie ahead.

Previous IPF Research into Real Estate Lending

The IPF has published two Short Papers on the subject of real estate lending and two further ones on the subject of Commercial mortgage-backed securities (CMBS). The first debt paper (SP1) published in August 2009 was entitled *UK Real Estate Debt – A Problem for Borrowers and Banks*. The second paper (SP7) followed on from this in February 2010 to provide *An Update on Real Estate Debt*.

SP1 included a number of conclusions/highlights, two of which remain particularly relevant.

- The most important issue for the banks was to avoid crystallising losses on loans. For banks this would result in them following a five to 10 year workout process.
- Default was and continued to be called only on loans with income issues. Whilst a small proportion of existing loans, this was set to increase as the recession of 2011-2012 put rents under pressure.

SP7 included a comment that said

> "Despite the fact that there is no likelihood of forced sales from banks driving values down, how banks deal with this [lack of ability to refinance high loan-to-value ratio loans] remains a problem to which no one has yet given me a decent answer."

2. OVERVIEW OF THE CURRENT POSITION

As predicted by the 2009 and 2010 Short Papers, the workout process has been a gradual one, so there is still a significant number of 'In Default' and 'High LTV' loans[1].

Banks have been working through distressed loan portfolios, concentrating on larger and more complicated loan exposures and where there are operating company issues (e.g. hotels and house builders). Bank lending to real estate fell by over £50 billion between 2009 and 2013[2]. There has been no common model as some banks have been reducing exposures aggressively, and looking to dispose of loans, while others have taken a longer term approach.

Also, as predicted, lenders have largely avoided refinancing of smaller loans where debt service has continued to be met, and lenders have attempted to avoid enforcement, which is perceived as a costly option. There is no definitive data on the costs of enforcement; but discussions with banks, other lenders and receivers suggest that they expect a substantial reduction in net proceeds from property disposals and an increase in costs, when compared with a consensual solution.

What was not predicted by the earlier papers was the degree to which banks have conducted sales of portfolios of loans. This is a trend that has been driven, in part, by changes in bank regulation, which have increased the cost of retaining non-performing loans.

2.1 Estimating the Amount of In Default and High LTV Loans

The year-end 2013 De Montfort University (DMU) survey, *The UK Commercial Property Lending Market,* identified a total of over £59 billion of debt where loan-to-value (LTV) ratios were in excess of 70%, below which lenders would be comfortable to refinance. Above 70%, a loan would be considered to be a 'High LTV Loan'.

As Table 2.1 shows, there has been a reduction of £36 billion in High LTV Loans since 2011. However, these still represent more than one third of all the loans covered by the DMU survey.

This £36 billion reduction is the result of a combination of debt restructurings, collateral value increases, loan amortisation and loan portfolio sales taking lending outside the scope of the DMU survey.

According to DMU, loan sales may account for about £5 billion of that reduction, which means that about £31 billion of loans have moved from High LTV to below 70% LTV in the past two years. If that rate were to be maintained then there is perhaps another four years before the £59 billion of High LTV loans reduces to (or close to) zero.

Table 1: Current LTV Ratios by Proportion and Value of Outstanding Debt

	2011 Year end		2012 Year end		2013 Year end	
LTV less than 70%	50%	£96 bn	53%	£93 bn	63%	£99 bn
LTV between 71% and 100%	30%	£57 bn	24%	£42 bn	18%	£28 bn
LTV greater than 100%	20%	£38 bn	23%	£40 bn	19%	£31 bn

Source: Survey into The UK Commercial Lending Market 2013, De Montfort University.

[1] Loans in default are loans where there has been a breach of payment or other covenant and such breach has not been waived by the lender. High LTV loans are loans where the principal outstanding exceeds 70% of the value of the property(ies) against which the debt is secured (i.e. charged).

[2] Survey into The UK Commercial Lending Market 2013, De Montfort University, published June 2014.

2. OVERVIEW OF THE CURRENT POSITION

2.2 High LTV Lenders

Over the last five years, many (but not all) banks have faced increasing regulatory pressure, for example the UK regulator's decision to require the use of a slotting approach, which seeks to standardise risk assessment models and determine how much regulatory capital the bank is required to hold against each individual loan[3]. The principal consequence of these requirements has, in general, been to increase the cost to banks of holding In Default and High LTV real estate loans.

The issues that this creates for banks varies depending on factors such as balance sheet strength, the amount of High LTV loans on the lender's book and whether real estate lending remains a core activity for the lender. Whatever the relative importance of each driver for each individual bank, large swathes of High LTV and non-performing loans (NPLs), were designated as 'non-core'.

The massive stock of non-core loans held by banks has been married with to strong demand from private equity. There is a clear arbitrage opportunity for non-bank purchasers that are not subject to the same regulatory strictures. They can hold and workout loans more efficiently than a traditional bank because, without the additional regulatory costs, they are able to achieve a higher return. Provided that the discount is not too large, the original lender is able to exit early with less risk than holding and working-out those loans itself. Whilst the discount that the banks are prepared to take to dispose of NPL and High LTV loans is sufficient to provide private equity with their required return, there will be a continued incentive for large scale transfers of loans from banks to non-banks. The 2013 Ernst and Young report *Flocking to Europe*, NPLs, showed that investor expectations of returns from NPLs had narrowed into the 16%-20% range - see Table 2.2.

Table 2.2 Investment Return Requirements (Unleveraged Internal Rate of Return)

Investment return requirements	2013	2012	2011	2010
below 10%	-	3%	-	2%
10%-15%	29%	20%	30%	40%
16%-20%	49%	52%	62%	42%
above 20%	22%	25%	8%	16%

Source: Question 7, Flocking to Europe Ernst & Young 2013 non-performing loan report

Accordingly, the workout of individual positions continues. Should banks reach a position where they can start writing back their provisions due to improved collateral values and reducing their regulatory capital the discounts may narrow and choke off the flow of portfolio sales.

Recent DMU surveys have shown a significantly lower level of loans in breach or in default than the level of High LTV loans. With many loans having reached final maturity, it appears likely that this lower level of default and in breach loans is because lenders have provided loan extensions, particularly on loans where interest can be serviced from income.

[3] See Property Banking Forum Lending Intentions Survey 2012 for an overview of this and other relevant regulations, such as Basel II, Basel III and Solvency II.

2. OVERVIEW OF THE CURRENT POSITION

Discussions with banks and borrowers in support of this report suggest that, where loans are in forbearance and/or extensions have been agreed, additional fees and margin increases have been required by lenders by way of compensation. Such increased margins may not necessarily fully cover the cost of holding the loans for the bank but do go some way to mitigate the additional holding costs. On occasion, default interest is rolled-up into principal, leading to increases in amounts owed and, therefore, LTV ratios.

A further complication for lenders is that a proportion of these High LTV loans have long-term swap contracts linked to them. These contracts have maturities that often exceed the length of the loan by many years. With falling interest rates, these have given rise to large 'mark-to-market' exposures for the borrower. Those mark-to-market exposures will reduce over time (and will reduce even further should interest rates rise) and, where there is sufficient income to meet the borrowers' liabilities, banks are particularly reluctant to enforce loans, as such enforcement would force a close out of the swap contract, leaving a significant cost payable by the borrower that might not be covered by the value of the security.

Enforcement Costs

There have been a number of studies over the years that have attempted to estimate the cost of enforcement and level of recoveries in the event of insolvencies. Many of these studies focused on markets outside the UK and there does not appear to be any direct evidence of recoveries from UK real estate insolvency.

The studies suggest levels of loss, including foregone interest, fees, expenses and principal ranging between 20%-35%.

The most relevant study on real estate is probably the 2005 Esaki and Goldman study[A] on US CMBS defaults, which study concluded, "For the entire 1972-2002 period, the average severity of loss on foreclosed loans is about 33%. As in earlier studies, the range of severities for individual loans is large. Some loans had severities over 100%, while others recorded no loss."

Discussions with lenders suggest that the combination of enforcement costs and the discount that is commonly experienced when properties are marketed as 'In Receivership' reduces recoveries by 20% or more when compared with a consensual solution.

A significant part of that discount relates to the fact that properties in the UK are normally sold with a full title guarantee, which allows the seller to sue the purchaser for any breach of that guarantee. Properties sold on behalf of a mortgagee will normally provide only limited or no title guarantee which means that the purchaser carries more risk than for a 'normal' purchase. That, in turn, means that purchasers will often (although not always) expect to pay a lower price.

[A] *Commercial Mortgage Defaults: 30 Years of History*, H Esaki and M. Goldman, 2005.

2. OVERVIEW OF THE CURRENT POSITION

2.3 High LTV Borrowers

Borrowers with High LTV loans face considerable uncertainty.

With banks having dealt initially with their very large exposures (in excess of £100 million), the vast majority of High LTV loans currently in forbearance are below this amount and most are significantly smaller.

Typically, loans in forbearance will have a higher degree of supervision by lenders and many will have imposed 'cash sweeps' where net income exceeds interest and amortisation liabilities, in order to accelerate the repayment of the principal and reduce the LTV ratio whenever possible. With those capital and revenue constraints in place, 'normal' investment decisions become much more difficult.

In these circumstances, further investment expenditure may be funded by equity or by additional debt, the latter being provided by the lender. The borrower needs to weigh up the equity return from any proposal, whilst the lender will also require a commercial return to justify providing additional debt.

With a loan in forbearance, it is almost impossible for a property owner to assess the returns on any additional equity invested, given that a lender is able to take control of the property by enforcing the loan (or by selling to a third party who could enforce the loan) at any time. As equity bears the first loss, in view of the security the lender is able to exercise over the underlying asset, this is high-risk capital without high-risk returns, unless the borrower is able to negotiate a priority return with the lender.

However, a lender is faced with the dilemma of being able to make a higher (and less risky) commercial return through new third-party lending where LTVs and the regulatory cost of capital are lower. The result is that there is often little incentive for the existing lender to commit further capital to a borrower for improvements to properties or incentives to new tenants, even if it would protect existing lending. (See illustration below.)

2. OVERVIEW OF THE CURRENT POSITION

Illustration

The lease of an office building is due to expire shortly. The tenant is willing to commit to a new lease but it requires a substantial capital contribution to allow it to refurbish the building. The re-letting will secure income for a further 10 years and trigger a substantial valuation uplift.

There is a loan (subject to forbearance) secured against the asset, with a current LTV of 90%. That LTV would reduce to 75% if the lease were to renew.

In this illustration, the assumption is made that the borrower has adequate capital available to provide additional equity (although outside this example that may not be the case). The lender could also provide additional lending, subject to its normal credit committee approvals.

If the borrower provides additional equity, it benefits from a reduction in LTV and potentially improves its chance of refinancing the building and returning to a more stable situation. However, at 75% LTV the loan is still not easy to refinance in the current market and the lender still has the option to enforce. With average recoveries in enforcement situations of 70%-80%, the borrower would risk losing a substantial amount of the additional equity invested.

The lender could commit additional capital, but the cost of capital for the loan would remain high under the slotting regime (assuming this is a bank subject to UK regulation). The return that the lender would make on the additional advance would be substantially lower than the return on alternative new lending. In these circumstances, its credit committee is unlikely to approve any further lending.

Neither borrower nor lender is incentivised to commit further funds, yet any failure to invest is likely to lead to a greater loss for both parties should the tenant not renew its lease.

3. CHARACTERISTICS OF PROPERTIES SECURED BY HIGH LTV LOANS

There is little visibility into the nature of the properties that are secured against High LTV loans. The DMU survey does not break down lending by sector or geography and it has not been possible to source any other direct data on loan size, geography or sector for the purpose of this report. However, using the general information and research available on the commercial property market and through discussions with banks and purchasers of loan portfolios, some insight has been gained into the type of properties that act as security for this category of loan.

3.1 Asset Type

Given the time that has elapsed since the start of the banking crisis, and the fact that these would be non-income producing, there is little exposure to loans originally made against commercial developments. However, there may be some exposure to obsolete properties that have very low existing use values and, therefore, need to be redeveloped.

3.2 Asset Quality

It is likely there will be a substantially lower proportion of high-quality property securing the remaining High LTV loans. The larger lot sizes, security of income and the yield tightening that has occurred in such properties, together with the healthy property and lending markets for such assets are all factors that suggest that these will have been early candidates for re-financing or sale.

The conclusion is supported by the analysis undertaken by Frodsham and Gimblett[4], based on IPD data to end 2011, which assesses the possible effect of the ‘slotting’ regime on real estate assets. The research suggests that there was little differentiation in losses across sectors and property types from peak to trough but that the subsequent recovery in asset values was focused on assets with higher levels of income security.

There is, however, a slightly less obvious conclusion, which is that High LTV loans will also exclude a significant element of the very worst performing properties where action has had to be taken by lenders because of income shortfalls.

Overall asset quality is therefore assumed to be of lower or indeed poor quality.

However, the difficulty of assessing the types of asset secured against High LTV loans is illustrated by the recent publicity surrounding the receivership of 30 St. Marys Axe (The Gherkin). Receivers were appointed after the banks providing the senior lending were unable to agree a consensual restructuring. The receiver, Deloitte, said that the building remained “well leased” and “in trophy condition”. However, “adverse interest rate and currency movements have caused the total senior liabilities to increase substantially since closing”.

3.3 Geographic Bias

There is likely to be a bias towards the regions, given the comparative strength of central London and, to a lesser extent, the South East as against the provincial markets. This has been most evident in offices and residential assets, which form the bulk of the stock in London. The DMU Survey reported that the distribution of NPL debt portfolios was weighted 22% to Central London and 4% to the rest of the South East.

Such a regional bias has been less pronounced in prime assets in other sectors, with large shopping centres, in particular, having attracted investor interest.

3. CHARACTERISTICS OF PROPERTIES SECURED BY HIGH LTV LOANS

Although the last few months have seen a significant improvement in both occupational and investment markets in some regional and provincial sectors, it is still probable that High LTV loans, as a whole, have a bias away from London and towards the regions.

3.4 Sectoral Bias

Occupational demand has varied across sectors. There has been much reporting, including significant evidence from The Local Data Company and others, to suggest that secondary retail has been very badly affected through the recession, with high vacancy rates and occupiers struggling under the burdens of reduced consumer spending and high business rates. As well as the high street retail sector, leisure, industrial and regional offices have all been adversely impacted by the lack of occupational demand.

It is somewhat harder to draw conclusions about any sectoral bias without more data; sectors where occupational demand is weak are more likely to suffer income shortfalls and lower estimated rental values (ERVs), which will adversely affect valuations and, consequently, increase LTV levels.

4. WHERE ARE WE NOW?

Significant progress has been made, with a headline reduction of £36 billion in High LTV Loans since 2011. However £59 billion remains to be dealt with, which represents 37% of 'DMU' real estate loans. The overall face value of these loans, factoring in CMBS, may well be higher than that. There is thus still a long way to go before the UK returns to an entirely 'normal' real estate lending environment.

The IPF Lending Intentions Survey 2013 shows that there is a significant debt capacity at LTVs of up to 65%, (albeit there remains a preference for the most secure assets) but beyond that LTV level there are relatively fewer lenders. The large banks appear to have settled on a workout process, as opposed to creating a Northern Rock-type 'bad bank' to hold distressed assets. However, the increased regulatory burden on bank balance sheets has created an arbitrage that makes loan portfolio sales comparatively more attractive to banks than a longer term, on balance sheet, workout.

A large number of borrowers remain in an uncertain situation. An example of this is those borrowers who took a loan from Anglo Irish Bank, where the liquidation and subsequent loan portfolio sales process meant that many borrowers to whom we have spoken were unable to get consent to sell or re-let properties even where it appeared to be advantageous. However, the recently concluded Project Rock and Project Salt loan sales to Lone Star are likely to change the position for those particular borrowers.

The long term over which workouts have been conducted/executed has had an impact on the property market. The lack of evidence in some sub-sectors may be attributable, in part, to the slow rate of workout and to the consequent valuation uncertainties.

The extraordinarily low interest rate environment (it has been five years since the Bank of England set Base Rate at its current 0.5%) has been a further factor in preventing more income defaults – even when additional costs are factored in – although, in some cases, the use of interest rate swaps has negated that benefit. The DMU study backed this up when stating that "lenders continue to identify the crucial importance of low interest rates that keep historic loans profitable".

There has not been a glut of enforcement and forced sales due, mainly, to the costliness of the process and the discounts required to achieve a sale. This has, to a degree, prevented property portfolio aggregation, where different properties from different borrowers are brought together into portfolios that could be more efficiently managed, as it is very hard to achieve that without a formal enforcement process being undertaken.

The UK property market remains attractive to private investors, institutions and overseas buyers. Inward investment flows have been significant and have now started to spread beyond prime and outside London and the South East, demonstrating that equity is available provided that pricing is correct. It is likely that an increase in property values is the factor that will have the single greatest effect in reducing LTV ratios.

[4] The Slotting Approach to IPRE Risk Weighted Capital – A UK Simulation Study using IPD Data, M. Frodsham and K. Gimblett (2012)

5. WHAT MIGHT HAPPEN NEXT?

5.1 Portfolio Sales to Continue

Loan portfolio sales will continue to provide an exit route for banks.

Having spoken to a number of purchasers and potential purchasers of loan portfolios in the UK, this market is now well-established and transparent. Purchasers are not expecting to achieve significant discounts to underlying property valuations. However, the lower cost of capital for non-bank loan purchasers still provides an opportunity for good returns to be made.

These purchasers tend to have greater flexibility than the traditional banks, as they can more easily purchase assets from borrowers or provide additional capital where required. However, that is countered by a greater unwillingness to 'blend and extend' and, generally, no mandate to provide new lending. Purchasers are attempting to undertake consensual[5] deals to avoid the costs of enforcement.

Purchasers are also more able to take a 'portfolio' view and will expect there to be winners and losers. They will measure returns at a portfolio level rather than on a deal by deal basis.

A flavour of the size of that market is given by the prospectus, dated 25 February 2014, for the launch of Kennedy Wilson Real Estate Europe plc (KWRE) (formed to invest in "real estate and real estate loans in Europe"), which suggested that the combined amount of UK non-performing commercial real estate loans held by Lloyds Banking Group and Royal Bank of Scotland amounted to €65.2 billion.

KWRE expected RBS to sell £38 billion of non-core assets between 2014 and 2017.

5.2 Impact of the Workout Process

The degree to which there is a stock overhang to come to the market in future years is uncertain, but it is likely that a substantial volume of property will be sold, or need to be refinanced, as these High LTV loans continue to be worked out. This is contributing a 'known unknown' to the pricing of some sub-sectors.

When this is allied to a lack of transactional evidence in those same markets, there is an acknowledged degree of additional valuation uncertainty, which is likely to result in pricing volatility in certain sub-sectors over the next few years.

[5] The term of a mortgage may be extended on the basis of the lender capitalising interest (and/or break penalties) into the principal of the loan and extending the lending term.

5. WHAT MIGHT HAPPEN NEXT?

Case Study of a Consensual Workout

The Borrower is a UK company with a portfolio of three regional office buildings.

Debt finance was originally provided by an Irish bank and the loan was sold (at a discount) as part of a portfolio to a distressed debt fund (the 'Lender').

The loan was for £7 million, secured against the properties that had a value of about £4 million at the time of the loan sale. There were a number of vacancies, caused, in part, by lease expiries but also by the inability of the borrower to obtain (prior to the loan sale) consent from the Lender to re-let.

The Borrower continued to pay interest until, coincidental with the time of the loan sale, increased vacancies resulted in the rent being insufficient to covered interest payments. Without further action, the Borrower would have no longer been able to pay its debts and, thus, become insolvent.

Immediately following the loan sale, the Borrower approached the Lender with a proposal for a consensual restructuring. Given the degree of excess leverage, there was no value in the equity. However, the Borrower believed that it could obtain a better recovery for the Lender than through insolvency.

The Borrower's proposal was that, for a small management fee and the support of the Lender to prevent an insolvency, it would undertake a sale of all three properties on behalf of the Lender. The first would be sold in the market immediately, with a small proportion of the proceeds retained to fund capital works at the second of the properties. Those capital works would allow the letting of an additional floor of the building to an existing tenant, thus increasing value.

Following completion of the works and the re-letting, the second property would be sold. Meanwhile, the third property, which was vacant, would be marketed for sale/re-letting.

The consensual nature of the deal allowed an orderly marketing of the properties and sales with 'full' title guarantees.

A deal was agreed and, although the Lender's recovery was reduced by the need to pay a small number of unsecured creditors and a fee to the Borrower's management, the re-letting and sale of the three properties realised a substantial (nearly £1 million) premium over the anticipated value of the properties.

5. WHAT MIGHT HAPPEN NEXT?

5.3 Economic Influences and Impact of Interest Rates

The weakness of certain sectors of the economy, which feeds through to occupational demand, remains a concern for some parts of the market. As a consequence of this weakness in occupational demand, the amount of vacant space is higher than the historic average. The inability of owners to undertake capital investment in their vacant properties, because of existing High LTVs, may result in increased obsolescence and accelerated depreciation. That, in turn, will lead to certain locations being unable to regenerate effectively.

Rising interest rates are an indicator of a growing economy, which should, in theory, be a positive for property values. However, rising interest rates will make existing debt burdens for many borrowers more expensive to service whilst rising rents, which should come from increased occupational demand in an improving economy, may not be seen until some time after such interest rate rises occur.

5.4 Banks to Pursue Range of Solutions

Loan sales accelerate write-offs but reduce the on-going administrative burden on banks and the use of loan sales does, to a degree, militate against banks undertaking individual loan restructurings. The ability to workout loans with borrowers is part of the attraction for purchasers of these portfolios. If that workout had already been conducted by the bank then there would be a more limited upside for loan purchasers.

However, given the amount of High LTV loans still remaining, lenders will have to continue to workout loans with borrowers on a case-by-case basis in order to spread losses and ensure that value is not eroded.

New capital will need to be introduced to facilitate such restructurings.

6. CONCLUSION

The number of High LTV loans outstanding suggests that the workout period still has some way to go.

The pace of the workout is inevitably linked to the health of the UK economy and, in turn, the UK property market. However, even in an improving environment, the scale of the loans left to be refinanced means that the original IPF estimate of five to 10 years from 2009 still appears reasonable.

The focus now is likely to move to those loans where ‘blend and extend’ has, to date, been sufficient to protect the lender’s position. The current situation appears to dis-incentivise borrowers from properly investing in their portfolios, even when they have the capital to do so.

Whether remaining in the hands of banks or sold on to third parties, in the author’s view the answer lies in an increased awareness amongst borrowers that the status quo is not an acceptable situation.

Borrowers will benefit from proactive engagement with lenders to extend loans against a background of specific performance targets, which may require the introduction of additional capital, asset sales, debt for equity swaps, profit sharing of upside or, even, just a fee for conducting an orderly workout.

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