Mapping demand for debt in the UK property market

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Commercial mortgage investment is evolving very quickly. Since 2000, commercial property lending has moved from bank domination through dislocation to a 'new normal' that involves a broad range of investors. The asset class now sits alongside other fixed income investments for global pension funds, insurance companies and sovereign wealth funds. Benchmarking and rating commercial mortgages is challenging since quantifiable asset data needs to be balanced with more subjective analysis of sponsor capability and macro-economic factors (e.g. interest rate fluctuation and loan/asset liquidity), and there is no uniform view on how this is done.

Risk in lending is also very much linked to the type of capital represented. Some equity investors are comfortable converting an under-bidder position to a 90% debt piece, having already underwritten and assigned capital to the equity, but the same loan from a bank would be considered unthinkably risky in the new era.

The Laxfield UK CRE Borrower Barometer[1], published six-monthly, collates requests for finance from owners of UK property assets and reports on changing patterns of demand. The Barometer is based on consideration of loan characteristics (leverage, loan purpose, term and quantum as indicators of risk appetite) and the underlying security by property type (geography and sector) to show concentration of debt-related investment activity. The analysis, which aims to capture forward market direction, is complementary to the Commercial Property Lending Report, published by De Montfort University in that the latter sets out to map actual transacted lending activity.

Since Laxfield Capital started recording loan requests formally at the beginning of 2013, a total deal pipeline in excess of £45bn and more than 400 individual loan requests have been analysed. The loan requests included in the Barometer have been restricted to those secured on income producing assets between £5m and £500m and concentrate on senior/whole loans in order to keep data samples consistent – smaller ticket lending and the development market having different characteristics.

The Barometer is therefore just a piece of a large jigsaw in terms of market information, but has been a useful tool in providing an early indicator that the market is moving in a different direction.

Transformed in 12 months

When the first Barometer was published in 2013, there was clear evidence of a changed market between Q3 and Q1-Q2 data. It is hard to recollect now that just a year ago the UK's recovery from recession felt highly tenuous. Now the observations from the first report feel old hat – investment activity spreading through the regions on a broader range of property types is patently obvious, but at the time it was more anecdotal than evidenced.

1 The third **Laxfield Debt Barometer** will be published towards the end of October 2014. To subscribe for a free copy, please email kelly.edwards@laxfieldcapital.com

Now with seven quarters of data to compare, the changes over time are obvious and there are plenty of 'touchpoints' that are worth watching closely.

Leverage is obviously an area which attracts interest for possible signs of overheating. Since the first report, when average LTV requirement was just 51%, the leverage requirement has increased steadily. The second iteration of the Barometer shows that the average request increased to 58% during the period. Laxfield anticipates the figure will be in excess of 60% when the third report is published later this year.

Polarised use of gearing

The Barometer indicates that typically the more conservative borrower groups – (generally REITs, institutions, and conservative private property companies) maintain highly restricted gearing policies. They sit largely within a stratum of investors seeking less than 55% LTV and the availability of more debt is not producing a change in approach.

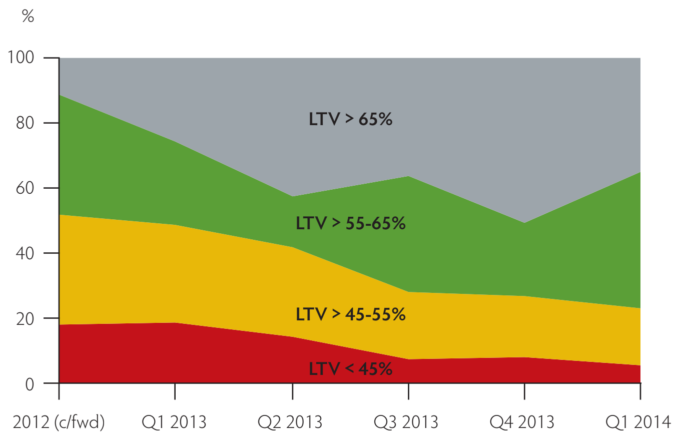
Not surprisingly, the group with greater appetite for debt has a high component of IRR-driven, private equity style property investors. The polarisation of approach between these two groups has increased.

Those borrowers looking for more than 65% LTV are growing in number, and indeed many of them are now requesting still higher levels of finance, so a shift in sentiment is now entrenched, with more investors seeking more leverage – see Figure 1. This ties in with a shift in use of debt. Remarkably, at the beginning of 2013, 86% of the pipeline analysed by Laxfield was refinancing of legacy loan positions (this was a volume-based analysis, and took into account some huge 2006-08 positions coming due for refinancing). The May 2014 report showed a market back into a more balanced state, with a split in Q1 marginally in favour of acquisition related requests, as shown in Figure 2.

Acquisition financing is increasing, and provides strong correlation with the higher levels of debt being sought. There is confidence that debt is available to meet acquisition timescales, and the equity is factoring in more ambitious use of gearing in the business plan.

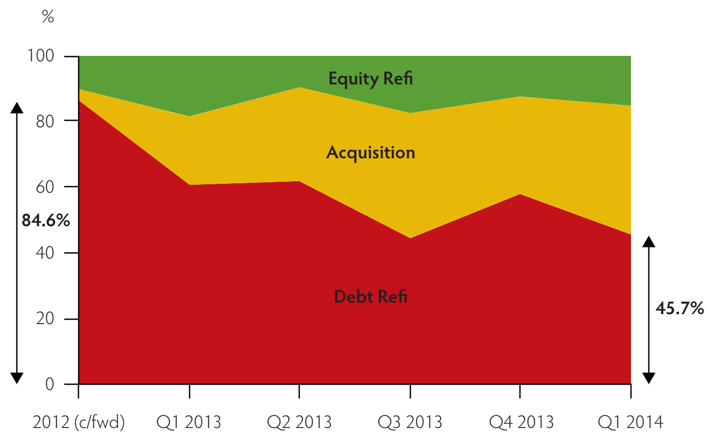
The higher use of leverage in a rising market is being monitored closely by Laxfield. Set against a picture of 2006, the picture is still relatively conservative. Then again, would anybody suggest that 2006 is an appropriate benchmark for future use of debt in real estate!

Figure 1: **Loan requests by leverage band**



Source: Laxfield UK CRE Borrower Barometer

Figure 2: **Loan requests by purpose**



Source: Laxfield UK CRE Borrower Barometer

No US-style market yet

Other loan characteristics worth highlighting are that despite the availability of large pools of capital for long-term lending, there is limited interest from the borrower market. Loan requests in excess of seven years formed just 12% of the pipeline in the last Barometer.

In addition, familiarity with insurers as lenders has not produced a US-style fixed-rate market, despite the consensus that long-term rates offer good current value. During the same period, the corporate credit markets have broadened the scope of their offer substantially, and some potential borrowers of long-term secured debt have switched to private placement or retail bonds. The 'other side' of some of the institutions who would like to provide secured lending are buying into private placements or CMBS products instead.

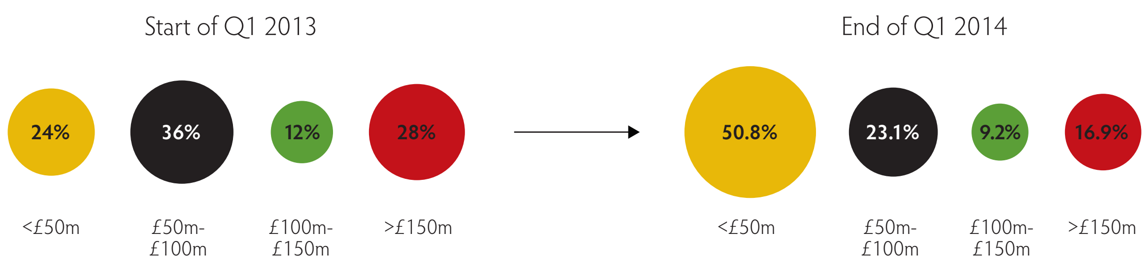
For now, it would seem that secured lending in the UK remains largely a five-year market, backed by a shorter-term trading horizon of many of the owners of property.

Loan quantum & geography

Appetite for debt against smaller investments has seen a revival over the past 18 months. Factors that come into play are the recovery of values in regional markets, availability of finance to acquire these assets, and capital forced to look beyond London to source investments in a very competitive environment.

There is a relatively even split between London and regional deal requests by volume, but more requests by loan count for finance on smaller assets in the regions, as sponsors have to work hard to acquire properties piecemeal in a competitive market.

Figure 3: **Change in size of loan requests**



Source: Laxfield UK CRE Borrower Barometer

The loan request pattern would suggest an uptick in regional lending over the course of 2014, also reflecting the greater number of finance providers going beyond the confines of London.

Borrowing by sector

2013 was a year where investment and borrowing activity was dominated by office but 2014 has seen greater diversity in terms of types of assets seeking funding. The beginning of the year saw a big uplift in requests for finance secured on retail assets, which has now rebalanced slightly, but the trend of diversification continues as borrowers seek yield from alternative sectors. Funding has also become much more widely available in operational assets such as student housing (where Laxfield Capital has placed £336.85m since the beginning of 2014), hotels and the private rented sector (PRS). Requests for finance secured on alternatives looks set to increase by quite a noticeable proportion over the course of 2014.