The UK commercial property lending market

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In May 2014, De Montfort University published its fifteenth research report on the lending patterns of the major commercial property lenders operating within the UK during the year up to 31 December 2013. A total of 82 lending teams operating out of 76 lending organisations contributed data to the survey. The lending organisations comprised 52 banks and building societies, eight insurance companies and 16 other non-bank lenders, including debt funds, asset managers and other organisations that are prepared to provide junior debt, mezzanine finance and, more recently, senior debt.

Throughout this research, 'commercial property lending' is taken to mean all lending secured on UK commercial property and held on the balance sheet of lending organisations. This includes residential investment and development but excludes owner-occupier residential mortgages. Where reference is made to the commercial property loan books of lending organisations, this is taken as the net exposure to UK commercial property excluding equity finance (i.e. net of any loan amounts sold down to other lenders and net of any securitised loans unless otherwise stated). The nationality of the banks is determined by the location of their head office. The term 'Insurance Companies' refers to all insurance companies irrespective of the geographic location of the head office.

Value of outstanding loan books

Figure 1: **Category of lender and type of finance**

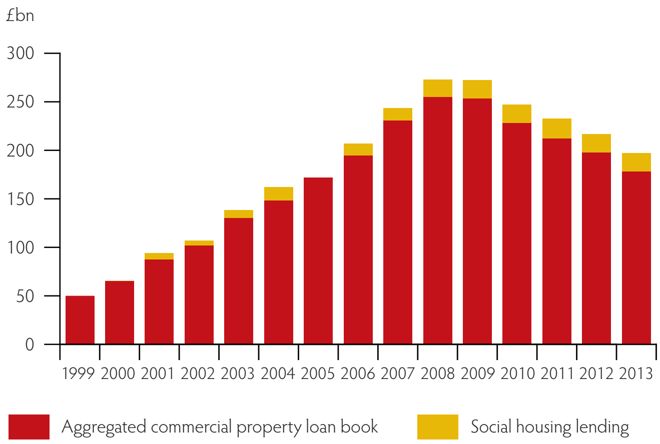
Categories of Lender	Reported UK outstanding senior debt loans including social housing £m	Junior debt mezzanine finance £m	Total £m	Reported amount of committed funds not yet drawn £m
UK Bank and Building Societies	116,316	235	116,551	11,296
German Banks	18,111	–	18,111	656
Other International Banks	35,179	147	35,326	980
North American Banks	3,789	98	3,887	316
Insurance Companies	18,139	200	18,339	418
Other Non-bank Lenders	4,012	2,189	6,201	–
All Lenders	**195,546**	**2,869**	**198,415**	**13,666**

A total value of £198.4bn (£217.1bn last year) of outstanding debt, including loans of approximately £18.6bn secured by social housing (but excluding equity participations) was recorded, with a further £13.7bn (£15.2bn at 31 December 2012) of loans being committed but not drawn at 31 December 2013.

Figure 1 presents the categories of lending organisations and their value of outstanding senior debt, junior/mezzanine finance and undrawn amounts.

Figure 2 shows the aggregated value of outstanding debt recorded in loan books and secured by UK commercial property only, together with loans secured by social housing since 1999 shown separately. The 2013 figure for commercial property loans represents a fall of 9.1%. Of the total £179.8bn, £173.6bn is held by banks, building societies and insurance companies and £6.2bn held by Other Non-bank Lenders. The reasons for a reduction in loan book size (excluding new loan originations) were recorded as being scheduled amortisation and repayments (30% of total), customers paying down and bank/lending organisation influenced sales combined (30.0%) , the value of loans written off 16.0%), loans sold (16.0%), and 'Other' (9.0%).

Figure 2: **Aggregated value of outstanding debt**



Total size of the UK commercial property lending market

It is extremely difficult to ascertain the total size of the commercial property lending market in the UK. In addition to £179.8bn collected by the research, the following amounts of outstanding debt have been identified:

- Approximately £19.9bn from the published financial statements of non-contributing organisations.
- Approximately £4.8bn of UK debt sold during 2013 by those lending organisations that have contributed data to this research.
- Data from Fitch Ratings on the balance of outstanding CMBS issuances that include loans secured by UK commercial property suggests that at year-end 2013 this amounted to £23.6bn.
- By September 2013, NAMA held assets of an approximate value of £6.2bn (at par value) located in the UK and which will not have been reported to this research.

With these additions, an estimated total value of £243.5bn (£267.5bn at year-end 2012) of outstanding debt was secured by commercial property at year-end 2013. In addition, a further £13.7bn of loans were committed but not drawn at year-end 2013.

Value of loan originations completed

Figure 3 shows the amount of new senior debt loan originations, junior debt/mezzanine finance and loan extensions completed during 2013 and secured by commercial property and social housing – the latter accounts for £1.1bn (£1.3bn in 2012) of the total £31.0bn (£25.7bn in 2012) of new lending. UK Banks and Building Societies recorded 43.0% of the total loans originated when identifiable extensions to loans and social housing are excluded.

Approximately 48.0% of the £29.9bn of new lending completed during 2013 was undertaken by just six organisations and 63.0% by the 'top 12' organisations. This compares with 57.0% and 72.0% respectively, recorded at year-end 2012. The decline in proportion originated by the top 12 demonstrates the increasing influence of new lending organisations entering the market – in fact, two Insurance Companies were amongst the most active loan originators.

Figure 3: **Value and allocation of loan originations in 2013**

Categories of Lender	Value of senior debt lending excluding extensions to maturing loans £m	Junior debt and mezzanine originated £m	Value of extensions to loans that should have matured during 2013 £m	Total £m
UK Bank and Building Societies	13,884	17	1,132	15,033
German Banks	4,722	–	181	4,903
Other International Banks	3,860	21	2,753	6,634
North American Banks	1,435	74	8	1,517
Insurance Companies	3,460	-	117	3,577
Other Non-bank Lenders	2,371	1,154	–	3,525
All Lenders	**29,732**	**1,266**	**4,191**	**35,189**

Of the £26.4bn of loan originations (excluding social housing loans) undertaken by banks, building societies and insurance companies, 81.0% was allocated to investment projects, 7.0% to commercial development, and 12.0% to residential development. The allocation of the £3.5bn of new lending by Other Non-bank Lenders is slightly different – 70.0% to investment projects, 19.5% commercial development and 10.5% to residential development.

In addition to the value of £29.9bn of loan originations on commercial property reported to the research, £3.1bn of lending was identified as having been completed by those organisations that do not participate in the research.

During 2013, 14 (23.0%) of the banks, building societies and insurance companies respondents completed no new loan originations whatsoever (and not including extensions to maturing loans). All the Other Non-bank Lenders that responded had completed new loan originations.

Respondents from banks, building societies and insurance companies were also asked to indicate at what ticket size (loan size) they would be willing to lend. Only 11 of the respondents would be prepared to write a loan of £5m or less but conversely 30 would be prepared to write a loan of between £51m and £100m, and 25 at above £100m.

Securitisations, syndications and club deals

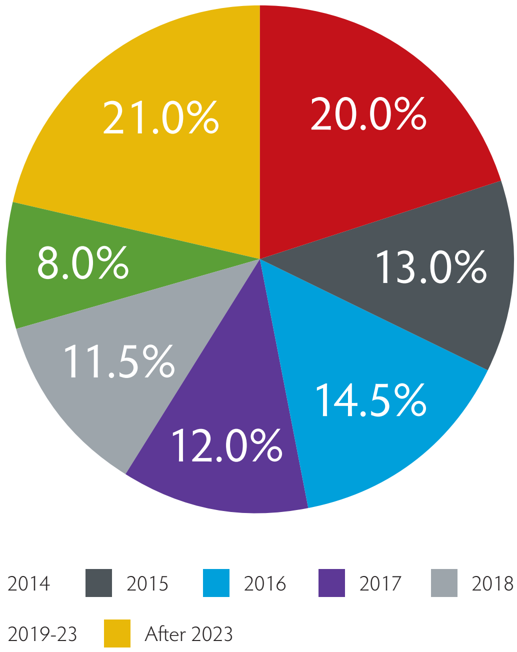
Three CMBS issues, one of which was a private placement, during 2013 amounting to £0.761bn were reported to the research. Approximately £2.1bn of debt was reported as being syndicated and a further £4.7bn as the value of participations in club deals by organisations that contribute to this research. This total of £6.8bn (being syndications and participants in clubs combined) compares with £6.5bn similarly reported at year-end 2012 and £6.9bn at the end of 2011.

Profile of outstanding debt

Figure 4 shows the proportion of outstanding debt due for repayment in each of the next five years individually from 2014 to 2018, from 2018 to 2022 and finally after 2022. This is presented for all lending organisations that contributed data to the research.

During the next five years between 2014 and 2018 inclusive, approximately 71.0% of all outstanding debt (£127bn) is due for repayment. This proportion is slightly lower than 72.0% reported at both year-ends 2012 and 2011, higher than 69.5% that was recorded at year-end 2010 and the same as 71.0% that was recorded at year-end 2009. It is still significantly higher than the proportions recorded by this research in previous years; for example, at year-ends 2006 and 2007, the proportion of debt due to mature within the following five years was 61.0% and 60.0% respectively. The reason for this change in maturity profile is that, in certain situations, lending organisations that have legacy debt in their outstanding loan books have continued to extend loans that the borrowers have been unable to refinance at loan maturity.

Figure 4: **Proportion of debt due for repayment – All Lenders**



With regard to the loan-to-value (LTV) of the outstanding debt allocated to investment projects, 63.0% of this had a LTV ratio of 70.0% or less. When applied to the aggregated loan book allocated to investment projects (£158bn), this equates to approximately £99bn. Proportionally, this compares with only 53.0% so reported at year-end 2012. At year-end 2012, 24.0% of outstanding debt had a LTV ratio of between 71.0% and 100.0%, equating to a value of approximately £42bn. A year later this had fallen to 18% (approximately £28bn). The proportion of outstanding debt with a LTV ratio of above 100.0% also fell during 2013 from 23.0% to 19.0% and in monetary terms from a value of £41bn to £31bn.

Figure 5 shows the profile of the outstanding debt held by banks, building societies and insurance companies in terms of current income-to-interest cover.

Figure 5: **Current income-to-interest cover by proportion of outstanding debt – All Lenders**

Level of cover	Variable rate % proportion of loan book		Fixed rate % proportion of loan book	
	2012 Year-end	**2013 Year-end**	**2012 Year-end**	**2013 Year-end**
1x or less	4.5	3.5	12.5	8.0
Over 1 and up to 1.2x	3.0	2.0	14.0	10.0
Over 1.2 and up to 1.4x	3.0	2.0	8.0	5.0
Over 1.4 and up to 1.6x	5.0	3.5	18.0	5.5
Over 1.6 and up to 1.8x	2.0	2.5	4.0	5.0
Over 1.8 and up to 2x	2.5	2.5	2.5	5.0
Over 2x	13.0	24.5	8.0	21.0
Total	**33.0**	**40.5**	**67.0**	**59.5**

At year-end 2013, 43 lending teams (65.0%) holding £114.5bn (72.0%) of approximately £158bn of investment loans responded to this aspect of the research. The data indicated that 11.5% of outstanding investment loans had an income-to-interest cover of less than 1x, equating to £13.2bn of loans. If the proportion of 11.5% is applied to the whole sample of investment loans of £158bn in value, then the amount of debt with an income-to-interest cover of less than 1x could potentially be £18bn. A similar analysis at year-end 2012 suggested that the comparable figure was circa £30bn.

Whilst conclusions from this particular section of the research can only be indicative, it does appear that during 2013, the proportion and value of loans that had an income-to-interest cover of less than 1x had declined since the previous year. Also, it appears that there has been a decline in the proportion of fixed-rate loans and a corresponding increase in variable rate lending.

Overall at year-end 2013, 60.5% of investment loans had an income-to-interest cover of greater than 1.6x. This compares with 32.0% recorded at year-end 2012 (on a smaller sample size). A cover of 1.6x is typically close to the minimum income-to-interest cover ratio required for 'new' lending in the market at year-end 2013.

Problem loans

The value of loans in breach of financial covenant at year-end 2013 and reported to the research was approximately £15.8bn, representing 9.7% of the total aggregated loan book of the survey respondents. This compares with £19.9bn (11.0%) at year-end 2012. Loan defaults during the 2013 totalled £24.5bn, compared with £21.5bn reported at year-end 2012. The increase in value of defaulted loans reported at year-end 2013 was as a consequence of the improvements in liquidity and capital values experienced in many commercial property sub-markets during the second half of the year. Lenders generally were taking advantage of these circumstances and were prepared to ‘pull the plug’ on under or non-performing loans.

If the proportion of distressed loans so reported is applied to the whole sample of participating loan books, then an estimated distressed value at year-end 2013 would be £44.7bn or 25.7% of the debt retained on balance sheet. This compares with £45.3bn similarly reported at year-end 2012.

During 2013, lenders reported that the rate of new problems occurring had slowed to a ‘trickle’ and that generally the overall rate of impairment was significantly lower than for year-end 2012. However, leisure and regional office properties were mentioned as being ‘particularly problematical’ and loans secured by secondary and tertiary retail property were cited as ‘really struggling’.

Senior debt loan terms for investment property

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

Between year-end 2012 and year-end 2013 interest rate margins declined for all sectors. The average margin for loans secured by prime office, for example, declined by 70.9bps from 323.8 bps (2012) to 252.9bps (2013). For loans secured by secondary offices, average interest rate margins declined slightly more steeply by 77.6bps from 384.5bps to 306.9bps.

Average LTV ratios for all sectors, except for residential investment, increased over the year. For example, the average LTV ratio for loans secured by prime offices was 65.9% at year-end 2013, compared with 64.2% a year earlier. Those for loans secured by secondary offices increased from 58.9% to 61.4% over the same period.

During 2013, average arrangement fees for loans secured by all property sectors declined across the board. For example, loans secured by prime office property saw arrangement fees set at an average of 122.5bps at year-end 2012, compared to 111.8bps at year-end 2013. Loans secured by secondary office property saw average arrangement fees decline from 134.8bps to 111.9bps. The range of arrangement fees for loans on all types of property of between 108bps and 115bps was the narrowest recorded by the research since year-end 2004.

For loans secured by prime property, income-to-interest cover ratios broadly declined slightly and uniformly during 2013. For example, for loans secured by prime offices, average income-to-interest cover ratios declined from 1.59x to 1.57x between year-ends 2012 and 2013. Similarly, for loans secured by prime retail property, income-to-interest cover ratios declined from 1.65x to 1.62x.

The income-to-interest cover ratios for loans secured by secondary office and industrial property declined more steeply than those for prime property. Secondary office and industrial property declined from 1.89x to 1.79x and 2.05x to 1.88x respectively while average income-to-interest cover ratios for loans secured by secondary retail property remained virtually static during the period at 1.87x.

Figures 6 and 7 compare the terms for senior, junior and mezzanine loans from banks, building societies and insurance companies for prime and secondary office investments respectively.

Figure 6: **Terms for loans secured by prime office investment property from banks, building societies and insurance companies**

Year	Senior debt		Junior debt		Mezzanine	
	Max LTV%	**Margin bps**	**Max LTV%**	**Margin bps**	**Max LTV%**	**Margin bps**
2008	55.0	170	60.0	250	70.0	400
2009	65.0	224	72.5	620	79.0	850
2010	67.5	209	75.0	350	80.0	738
2011	64.0	350	78.0	1,050	75.0	1,000
2012	65.0	331	70.0	550	77.5	775
2013	66.0	267	73.0	613	81.0	750

Figure 7: **Terms for loans secured by secondary office investment property from banks, building societies and insurance companies**

Year	Senior debt		Junior debt		Mezzanine	
	Max LTV%	**Margin bps**	**Max LTV%**	**Margin bps**	**Max LTV%**	**Margin bps**
2008	55.0	170	60.0	250	70.0	400
2009	60.0	300	70.0	700	–	–
2010	62.5	238	–	–	75.0	775
2011	60.0	413	78.0	1,050	–	–
2012	60.0	375	65.0	800	75.0	1,200
2013	62.5	271	70.0	775	78.0	867

OTHER NON-BANK LENDERS

Those organisations that were prepared to offer senior debt would have done so for loans secured by prime property within a range of 60.0% to 80.0% (60.0% to 65.0% at year-end 2012) loan-to-value ratio, 175bps to 400bps (225bps to 800bps at year-end 2012) interest rate margin, 0.75% to 2.0% arrangement fee (1.0% to 2.0% at year-end 2012) and exit fees to 1.0%.

For senior debt loans secured by secondary property, LTV ratios were recorded within a range of 50.0% to 80.0% (60.0% to 65.0% at year-end 2012), interest rate margins 250bps to 400bps (300bps to 800bps at year-end 2012), arrangement fees 1.0% to 2.0% (1.0% to 2.0% at year-end 2012) and exit fees to 1.0%.

Junior debt and mezzanine finance loan terms

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

At year-end 2013, six organisations were prepared to provide finance at a senior debt level and above for loans secured by prime offices, compared with four organisations the previous year. For senior debt, the average maximum LTV ratio increased from 65.0% (2012) to 66.0% (2013) and the average interest rate margins declined from 331bps to 267bps. For mezzanine finance, the average maximum LTV ratio increased from 77.5% to 81.0% and the average interest rate margin declined from 775bps to 750bps. For junior debt, the average maximum LTV ratio increased from 70.0% year-end 2012 to 73.0% a year later, as did interest rate margins, rising from 550bps to 613bps. Internal rates of return (IRRs) ranged from 7.0% to 10.0% for junior debt and 9.0% to 15.0% for mezzanine finance.

Four organisations provided data relating to funding at and above a senior debt level for loans secured by secondary offices. Compared with 2012 (when only one organisation provided data), the average maximum LTV ratio for all types of finance increased and interest rate margins declined. For senior debt, the maximum LTV ratio increased from 60.0% to 62.5% and interest rate margins declined from 375bps to 271bps. The maximum LTV ratio for junior debt, increased from 65.0% to 70.0%, whilst interest rate margins declined from 800bps to 775bps. For mezzanine finance, the maximum LTV ratio increased from 75.0% (2012) to 78.0% (2013) and interest rate margins declined from 1,200bps to 867bps.

OTHER NON-BANK LENDERS

The organisations that were prepared to offer junior debt for loans secured by prime and secondary property would have done so within a range of 50.0% to 80.0% (60.0% to 70.0% in 2012) LTV ratio, 9.75% to 15.0% (10.0% to 12.0%) interest rate margin/coupon, 1.0% to 3.0% (2.0% to 3.0%) arrangement fee, 1.0% to 3.0% (2.0% to 3.0%) exit fee and seek an IRR of 7.0% to 17.0% (8.0% to 15.0% at year-end 2012).

At year-end 2013, those organisations that were prepared to offer mezzanine finance for loans secured by prime and secondary property, would have done so within a range of 50.0% to 85.0% (60.0% to 85.0% at year-end 2012) LTV ratio, 11.0% to 15.0% (9.0% to 15.0% at year-end 2012) interest rate margin/coupon, 1.0% to 3.0% (1.0% to 2.0%) arrangement fee, 1.0% to 3.0% (same as at year-end 2012) exit fee and seek an IRR of 9.0% to 17.0% (10.0% to 17.0% at year-end 2012).

Development finance loan terms

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

At year-end 2013, only 14 lending teams from banks, building societies and insurance companies provided data for loans secured by fully pre-let commercial development. This is the same number as last year. The average interest rate margin was 369bps, a decline from 421bps reported at year-end 2012. The average LTV ratio was 58.0%, unchanged from 2012, and the average loan-to-cost ratio was 68.0% (61.0% year-end 2012).

Data on loans for 50.0% pre-let: 50.0% speculative development schemes was provided by nine lending teams, compared with seven the year before. The average interest rate margin was 419bps, a fall from 471bps reported at year-end 2012. The average LTV ratio was 51.0% (52.0% in 2012) and the average loan-to-cost ratio was 62.0%, up from 59.0% in 2012.

At year-ends 2011 and 2012, no organisation provided terms for speculative commercial development but this year four did so. The average interest rate margin was 369bps, the average LTV ratio was 45.0% and the average loan-to-cost ratio was 50.0%.

OTHER NON-BANK LENDERS

Those organisations that were prepared to fund senior debt for fully pre-let commercial development projects would offer a LTV ratio 50.0% to 70.0% (50.0% at year-end 2012), an interest rate margin from 450bps to 1,000bps (1,000bps) and an arrangement fee of between 1.5% and 3.0% (3.0% at year-end 2012). Junior and mezzanine finance was also available for this type of development.

Some mezzanine finance was obtainable for speculative commercial development to a maximum LTV ratio of 85.0%, loan-to-cost ratio of 100.0%, interest rate margin of 1,000bps. At year-end 2012, the corresponding terms were 55.0% maximum LTV ratio, 60.0% loan-to-cost ratio and interest rate margin/coupon of 1,700bps.

Residential loan terms

BANKS, BUILDING SOCIETIES AND INSURANCE COMPANIES

At both year-ends 2013 and 2012, 20 lending teams provided terms for loans secured by residential investment property. Interest rate margins were recorded in the range of 175bps to 450bps with an average for All Lenders of 262bps, compared with 352bps the previous year. LTV ratios remained essentially static, recording 62.2% at year-end 2013

For residential development projects, 14 lending teams provided loan terms – slightly down on the 17 teams at year-end 2012. Average interest rate margins declined from 458bps to 432bps as did average typical LTV ratios: 54.5% compared with 57% at year-end 2012. Loan-to-cost ratios increased to 67.0% from 63.0%.

OTHER NON-BANK LENDERS

Those organisations prepared to provide senior debt to loans secured by residential investment property did so within a range of 57.5% to 80.0% (60.0% to 65.0% 2012) LTV ratios, a 250bps to 400bps (225bps to 350bps) interest rate margin and a 1.0% to 2.0% (1.0% 2012) arrangement fee. Junior debt and mezzanine finance was also available.

With regard to finance for residential development for sale, senior debt would have been provided between 55.0% and 70.0% (75.0% 2012) LTV ratio, a 60.0% to 80.0% (90.0% 2012) loan-to-cost ratio, an interest rate margin/coupon of between 650bps and 1,500bps (1,200bps 2012), an arrangement fee of between 1.0% and 3.0% (2.0% 2012) and an exit fee of between 1.0% and 2.0% (2% 2012). By comparison, mezzanine finance was available within a range of 40.0% to 85.0% (same as 2012) LTV ratio, 50.0% to 100.0% (40.0% to 100.0% 2012) loan-to-cost ratio, an interest rate margin/coupon of 10.0% to 27.0% (16.0% to 20.0% 2012), an arrangement fee of between 2.0% and 3.0% (2.0% 2012), an exit fee of between 2.0% and 3.0% (2.5% 2012) and an IRR of 9.0% to 35.0% (12.0% to 30.0% 2012).

Future Lending Intentions

At year-end 2013, 62.0% of banks, building societies and insurance companies intend to increase their value of loan originations compared with 54.0% the previous year. All of Other Non-bank Lenders, except one, intended to increase loan originations and 100% intend to increase their loan book sizes. Figures 8 and 9 show the future lending intentions of banks, building societies and insurance companies.

Figure 8: **Future lending intentions: loan book size and originations**

Year-end	Intension to increase loan book size All Lenders %	Intention to increase loan originations All Lenders %
2008	24.0	23.0
2009	49.0	56.0
2010	46.0	57.0
2011	38.0	44.0
2012	46.0	54.0
2013	58.5	62.0

Figure 9: **Future lending intentions by category of lender**

Categories of lender	Increase loan originations % 2012 year-end	Increase loan originations % 2013 year-end
UK Lenders and Building Societies	46.0	48.0
German Lenders	54.0	73.0
Other International Lenders	74.0	75.0
North American Lenders	86.0	78.0
All Lenders	54.0	62.0

Key points from the 2013 research

- There was a rapid change in the commercial property lending market from an almost a complete absence of loan finance at the beginning of the year to receiving a flood of available money by year-end. It remains to be seen whether lending organisations will preserve underwriting standards when competing for lending opportunities.
- During 2013, traditional lending organisations were successful in reducing their exposure to legacy debt. The lending market appears to have stabilised and laid the foundations to move forward in a more robust form than was previously the case.
- However, it is believed that there remains a long way to go before a full recovery in the lending market is achieved. This is indicated by problem loans accounting for approximately 25.0% of the aggregated loan books of the traditional lenders at year-end 2013. Also, active lenders were far less willing to originate loans of less than £5m, which suggests that the more diverse and competitive lending environment is only really available for the larger deal sizes of £25m and above.
- It was stated by lending organisations that a 'hidden problem' was that if interest rates increase, the capital value of commercial property tends to decline. This may cause problems in the refinancing market. Thus, a key question becomes that of the speed at which future UK interest rates increase.
- New loan originations by non-bank lenders points towards a diversified and more balanced provision of real estate finance in the UK.