



# Where next for commercial property lending?

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**Dr Stewart Hotston, director at Hatfield Philips, looks at the funding problems within the commercial space, which is only buoyant in a few areas inside the M25**

According to a survey by the Royal Institution of Chartered Surveyors (RICS), commercial property sales are on track for a strong first quarter in the UK, with their surveyors reporting the best figures since 2007.

This was supported by the IPD figures in the tables below, which showed growth in 2010

### Five year capital movements and total return for the UK, Germany and France

	Total Return %					
	2006	2007	2008	2009	2010	5yr
France	21.9	17.8	-0.9	-1.4	10.0	9.1
Germany	1.7	4.5	3.3	2.4	4.2	3.2
UK	18.1	-3.4	-22.1	3.5	15.1	1.1

Source: IPD All returns in local currency

	Capital Growth %					
	2006	2007	2008	2009	2010	5yr
France	15.4	11.8	-6.0	-7.1	4.0	3.2
Germany	-2.8	-0.2	-1.7	-2.8	-0.9	-1.7
UK	12.6	7.7	-26.3	-3.6	8.3	-4.4

Source: IPD All returns in local currency

However, such optimism hides the fact that the recovery, if indeed there is actually a recovery, is only taking place inside the M25, and in reality is confined to very tight pockets in and around London, with specific areas such as the West End and the City being the major beneficiaries. This fact is proven by recent research from BNP Paribas, which showed that in the City prime rents rose to £54.50 per sq ft in the first quarter of 2011, which represents a 17.5 per cent increase from Q1 2010, whilst in the West End top rents have reached £92.50 per sq ft, an increase of 19 per cent from the same period last year. Midtown rents have remained stable at £50 per sq ft for the last two quarters and are up 14 per cent from Q1 2010, whilst the Docklands has seen a more modest increase of 4 per cent over the last year with headline rents now at £36.50 per sq ft.

The optimistic view would be reinforced if one were to take a cab ride from our offices in Canary Wharf to Oxford Street; that ride would leave you thinking the commercial property market was far from being on its knees. However, as every lender knows, a slender sliver of land in central London is not representative of our regional towns and cities.

For the foreseeable future, describing the commercial property market as a 'market', whether in the UK or across continental Europe is misleading. In reality, there are only two markets: London Prime and everything else. The same is true for every country in the EU, with the only variable being just how much 'prime' there is in their capital city.

It is worth mentioning that the true picture is often obfuscated by the commercial real estate indices that aggregate the data with the 'overview' presenting a rosier picture than is often the case. In our experience, the current position is so polarised that the 'average commercial property price movements' could be compared to putting your head in the oven and feet in the fridge and suggesting that 'on average' you're at the right temperature.

## **Funding**

This fact is very important when looking at the commercial funding issues as traditional lenders are now only interested in prime properties, which leaves much of the £600 billion of property loans that need to find a home in the next two years out in the cold.

In reality, the picture is not even as clear cut as that, as you have two types of borrower - the one that found its funding through the CMBS (commercial mortgage-backed securities) route and those that used a balance sheet lender.

The CMBS market, whilst much smaller, does afford a snapshot of the whole of the market and is also in the position of being publicly scrutinised and its servicers forced to act in a timely fashion. The woes of the balance sheet lender can, at least for the time being, be hidden from sight - a strategy aptly termed delay and pray. Indeed in a perverse turn of events, capital allocation rules means it may actually be cheaper for banks to hold these problematic loans on their balance sheets rather than enforce or sell them on at a discount. Being very pragmatic, having these loans in many respects 'out of sight and out of mind' is actually no bad thing as public disclosure could very literally lead to a calamitous event, possibly worse than the residential meltdown.

The reality that we are facing currently is that, at least for the time being, the need for funding is critical, but the availability is simply not there unless the property falls into the prime category as outlined earlier.

There are a number of reasons why funding does not exist. Probably the largest is the impact of Basel, which means that even lenders with a strong balance sheet have to be more cautious about where they lend. Next in line is where the former lenders don't exist anymore, probably the best known being Lehman's, but there were very many more. Other issues include the sheer size of some of the loans, which any single lender would almost certainly balk at in today's market.

Most of the above will be very familiar to lenders; what's important is to establish is how we are going to extricate ourselves.

## **Sovereign funds**

Firstly, I would like to dismiss any belief that readers may have that sovereign funds were going to come to our rescue. Even before the very dramatic events of recent months in the Middle East, the appetite for lending of these sovereign funds was restricted to very specific and extremely high profile developments.

Probably the best example is the Shard of Glass in London which will, when complete, be one of, if not the most recognisable modern building on London's skyline. Financed by The Qatari Diar Real Estate Investment Company, it is an extreme example of prime real estate with probably the best office space in London, but with other features such as the five star Shangri La hotel occupying 18 floors; residential apartments rumoured to cost in excess of £10 million; and a public viewing gallery - the tallest of any building in Europe, at 243.8 metres, which is expected to attract two million visitors a year.

So, where is the funding for the business park outside of Glasgow, the distribution centre on the M1 or the chain of care homes going to come from? In short, traditional lenders will have to play their part, but only for a minority of loans; unless government pressure dictates otherwise.

### **Insurance and pension funds**

The single largest source is likely to be insurance and pension funds, which have large amounts of capital, but have traditionally, largely because they were priced out in the boom, not invested extensively in commercial real estate (CRE). However, a history of cautiously investing in this market means that many are neither properly equipped to assess these types of loans, nor staffed up enough to cater for demand; as a result uptake is likely to be slow.

Whilst the investment from these institutional investors is definitely good for the liquidity of the CRE market, there should be a degree of caution as there is a danger of history repeating itself. Specifically, the capital rules which these institutional investors work with are completely different and thus they can treat the debt differently to traditional lenders.

The same words of caution should be applied to the retail property funds, whose ability to attract cash in a rising market was on occasions greater than the ability to make prudent property purchases.

### **Venture capitalists**

We are also likely to see venture capitalists cherry picking some assets, a good example being Cerberus Capital Managers picking up Maxim just outside of Glasgow, Europe's biggest speculative office development and the UK's largest enterprise zone – the Tritax EZ Eurocentral Unit Trust. Cerebus reportedly picked up the £95 million loan at a deeply discounted £30 million.

### **Return of CMBS**

Finally, whilst there is no CMBS market currently, it will return at some point within the next few years. Furthermore, many senior and junior noteholders are still active and would be more active if a way were found to allow them to exit positions in what should be a public and, within reason, liquid market.

However, in order for the industry to move forward, there will also need to be some significant changes in the way that all the parties involved operate.

### **Re-education**

Starting with the borrowers, many will need to be 're-educated', as will the processes of many lenders. For most borrowers, the processing environment the last time that the loan was taken out was substantially different to today and certainly that of at least the next five years.

The extent of the information that will need to be supplied for new borrowing, refinancing or extending the loan will, in most cases, be far in excess of that produced to secure the loan in the first place.

The European Commission is also looking at increasing the amount of information that even balance sheet lenders have to collect on loans.

Whilst this may seem obvious for many readers, we have seen numerous occasions where millions, and occasionally billions, of pounds have been lent on a business plan that was hardly more than a few pages and a ropey excel spread sheet. For readers more familiar with the residential market, think 'self-certification' on an almost fanciful scale.

Lenders should now expect borrowers to present a cohesive package of information in the form of a business plan that shows clear and concise information relating to the historic and current income and expenses of the site, coupled with projections for development and, if a pre-existing loan, a plan to redress any income shortfalls.

Lenders will also need to change their practices to managing loans. Setting aside systematic lack of relevant information and documentation that is, at best, frequently ambiguous in its prescriptions, one of the biggest problems they have is the lack of experience that many face with loans that are failing.

## **Work outs and defaults**

The same is probably true in the residential market for some lenders, especially those that entered the 'sub-prime' market. But, the complexities of the commercial market make work outs much more complex and the results much more dramatic when things do go wrong.

Effective work outs need teams who understand the derivatives, the loans, the real estate and the legal issues that arise in each jurisdiction. Specialists, such as servicers, are well placed to re-underwrite problem loans and manage their work out. That said, questions remain over those who have tumbled out of extinct jobs in origination and find themselves transferred to work out the loans they originated – both over whether they have the right skill set or whether they are incentivised to maximise recoveries. In our experience poachers rarely make the best gamekeepers.

For commercial loans in default, lenders are often faced with costly and drawn-out enforcement and, unless they are outsourcing to a servicer, each and every loan will in essence require them to start from scratch, which normally requires expensive external legal resources and similarly expensive internal management resources.

Our experience shows that modifications, extensions and refinancing all take time, creativity and possibly a depth of experience that some lenders wouldn't have been expected to have historically.

## **Ratings agencies**

Rating agencies will also need to change the way they operate. Last year the IMF's half-yearly Financial Stability Report called for transparent methods and no conflicts of interest. The current model, where rating agencies are financed by firms that arrange and sell debt to investors, is a model which has been widely criticised in both the popular press and academic journals for creating conflicts of interest.

Furthermore, rating agencies can have a significant influence on macroeconomic stability and sentiment due to the profound impact their ratings can have on funding costs for sovereigns, debt issuers and for fund managers thinking on which bonds to hold.

There also needs to be a consistent approach to ratings, especially given that we operate in a global market. Many overseas investors, particularly those from the US, now have regulated ratings out of their own process.

Additionally, as has recently been the case, if organisations can enter a market without ratings and it makes no difference to how the market perceives them, it begs the question do ratings even matter?

As an industry we need to work out whether the market is going to want ratings or not, and if they do, we need to decide what standards do lenders, borrowers and other stakeholders want to apply across the industry.

In summary, the industry needs to make some fairly fundamental changes and integral will be lenders' willingness to push forward some fairly radical changes and adapt to the new environment.

*Hatfield Philips is Europe's largest independent commercial property primary and special servicer*

<http://www.mortgagefinancegazette.com/article/Where-next-for-commercial-property-lending-230967.html>