Real Estate

UK commercial real estate lending in a state of flux

Following several years of retrenchment after the financial crisis, UK commercial real estate lending has stabilised and is currently in a much better place. Will this state of affairs continue?

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A market in transition

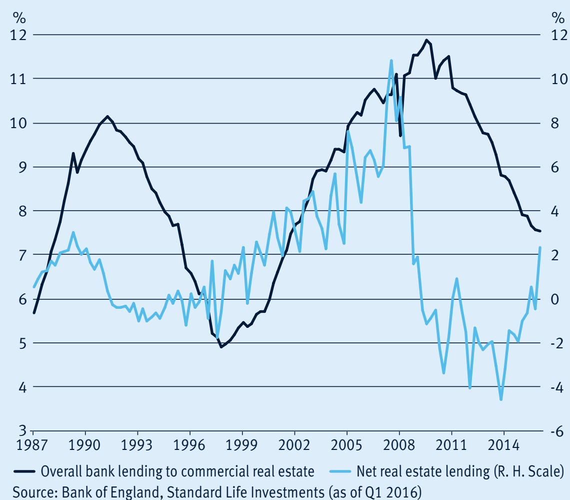
UK commercial real estate lending has gone through a period of change and the make-up of different lending groups continues to morph. UK banks and building societies had dominated the market over the past few decades, accounting for close to 70% of lending by the start of the financial crisis (Source: De Montfort University Commercial Property Lending Market Report 2015). That event was a key inflection point for the commercial real estate debt market. Traditional lending banks were over-exposed to the asset class, as several years of strong returns from UK real estate coupled with elevated competitive lending pressures had outweighed normal lending prudence. Following a large number of loan defaults and lending covenant breaches, these typical lenders have steadily retrenched. Increased caution on the part of the banks coupled with more punitive regulation curtailed the amount and type of lending that they could carry out.

In turn, a range of new lenders has appeared, attracted by the potential for secure income and long leases that the underlying UK real estate market provides. From a negligible presence in 2011, insurance companies and other non-bank lenders now account for around 22% of the outstanding debt market. North American banks have also grown their lending books and command 6% of the market compared to 1.5% in 2011. The share attributed to UK banks and building societies has fallen to 45.5% and German and other international banks account for the remaining 26.5%.

In terms of liquidity, the amount of debt secured by UK commercial real estate has fallen from a peak of £250 billion (bn) to around £168bn. Broadly, as the market has recovered, new debt originations have increased steadily on a year-on-year basis from the low point in 2009. Originations totalled £53.7bn in 2015 compared to £45.2bn in 2014 and £15.1bn in 2009. Similarly, the amount of distressed debt written off has fallen steadily post the financial crisis. The amount of loans in breach of financial covenant also fell from £3.5bn in 2014 to £1.3bn in 2015.

Despite limited evidence of falls in capital value following the EU referendum, some discounted transactions involving motivated sellers suggest possible double-digit declines in the year ahead. This is in line with what is being priced in to the listed equities market. Against this backdrop, real estate lenders have naturally become more cautious and are demanding a higher risk premium for lending against the asset class. Senior lending margins have therefore increased from around 125 basis points to 200 basis points for core assets, while development lending, which had started to materialise, is likely to decrease sharply.

Chart 1
Banks tearing down buildings exposure



Source: Bank of England, Standard Life Investments (as of Q1 2016)

Can this state of affairs continue?

Prior to the EU referendum, the UK commercial real estate lending market had stabilised and lending was far more cautious than was witnessed in the last market downturn (see Chart 1). Lenders should therefore be in a better position to sustain some of the expected post-EU referendum decline in capital values. Relatively robust economic fundamentals will also mean that debt interest will continue to be paid, although some loans may technically breach loan-to-value covenants. Given wider market uncertainty, it is anticipated that the decline in capital values resulting from Brexit should be modest compared to the 2007/2009 period and the income will look attractive relative to a low level of income elsewhere. However, the downside risk for lenders could be more elevated if political uncertainty becomes more protracted and business and economic confidence falters more than is currently anticipated.

Our strategy within global real estate

Generally, we have a preference for prime and good secondary assets in a range of different countries. In the UK, given the uncertainty generated post referendum, we prefer high-quality, higher-yielding industrial-type assets and resilient, high-quality retail assets that are well located in areas with a lack of competition. On the Continent, expectations have not changed dramatically following the EU referendum; core European markets are forecast to produce attractive risk-adjusted returns supported by low development and accommodative monetary policy. Meanwhile, recovering markets continue to experience a rebound, generating higher absolute returns. Expectations for continued US economic expansion amid low supply growth will drive sturdy growth in cyclical office markets. 'Gateway' office markets continue to attract well-heeled foreign buyers and support pricing. Turning to Asia, relatively high property yields in Australia and new development opportunities given a shortage of prime office space in Tokyo are supporting double-digit returns in these office markets.