WHITE PAPER

Finance & Corporate Real Estate

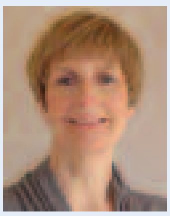
Executive Summary

Debt is a key issue in the property sector, with values in commercial property plummeting by almost 45% from 2007-2009.

The Banks have had to seek taxpayer funds to cover their losses to the value of £9,000 bn. Lending criteria has tightened with developers needing greater security to secure finance. Despite taxpayer bailouts and Government intervention, criticism remains that bank finance is difficult to obtain.

Changes to the Empty Property Tax have put further pressure on the sector. It has been claimed that the tax will inhibit economic recovery as older, lower rent properties are demolished, removing more affordable properties from the market and putting further pressures on emerging businesses, pivotal to economic recovery.

The UK property market is struggling but opportunities remain, especially in London and the South East.



About the author

Helen Hide-Wright is an independent freelance researcher specialising in commercial research. Prior to and after graduating with a degree in Business, Helen initially worked in the United States before returning to the UK to work at Leeds Metropolitan University where she was involved in researching, writing and producing commercial reports which were used within the banking sector to influence investment decisions. In recent years Helen has undertaken bespoke research on a variety of subjects within the commercial sector.

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Introduction

The Government Spending Review in October outlined the biggest UK spending cuts for decades, totalling £81bn. Individuals and businesses are cautious about where they are investing their money. Property is a major investment sector and historically has been viewed as being relatively secure in the long-term. To put it into context, "The commercial property sector contributes a significant amount to the economy, employing millions of people and contributing over £45bn to the Exchequer." (6.)

The recession is deep, with the possibility of a double dip and with economies across the globe fighting to recover; the outlook remains uncertain. It has been claimed by the Chancellor George Osborne that the UK credit rating was under threat and that cuts had to be deep and immediate. The jury is out on whether the Government's strategy will pay off and the cuts will stimulate confidence in the UK as a good place to invest, or will backfire, deepening the recession.

Debt within the property market is a major issue, "JP Morgan analyst Harm Meijer estimates that the loan-to-value ratio of the entire UK commercial property investment market is around 100% - the debt secured on commercial property of £250bn is roughly equivalent to its value." (20.)

Professional bodies, such as the British Property Federation, have lobbied the Government. In the letter dated 3rd June 2010 they stated, "The UK's commercial property stock is a major factor of production which underpins a significant amount of lending by the financial system and represents an important institutional investment asset class. Our industry's primary concern is that the primary focus on deficit reduction may undermine enterprise and growth." (7.)

"From mid 2007 until mid 2009, the commercial property market saw an unprecedented fall in capital values of close to 45%. The volume of outstanding loans made directly against UK commercial property is close to £300 bn. It is vital that the unwinding of that position is managed carefully, so as to allow borrowers to deleverage and banks to reduce their exposure to property, without major new shocks to the financial system or the economy." (7.)

"Strong growth has essentially been limited to the City of London, the West End and certain other prime areas, with commercial property values overall still standing 36% below the 2007 peak. Development activity also remains very weak in the wider market because of a weak occupier economy, the scarcity and cost of debt finance and continuing tax regulatory uncertainty." (7.)

What went wrong?

"The boom (of the 1980s) caused oversupply. By 1991 the city of London vacancy rate was 20% and interest rates soared to 15%." (13.) "The collapse of Lehman in September 2008 hurt the UK property market as never before. By August 2009, commercial property values had, on average, dropped 45% since the onset of the credit crunch in summer 2007. The property market then entered its second recessionary phase. Values bounced back around 15% and then plateaued a year later this summer, leaving them still at least a third below their June 2007 peak. Many commentators believe values, overall, will drop again next year." (20.)

The role of the banks

- **Banking Strategy**

  Deleveraging is the name of the game, not just for Lloyds and RBS, but also for many other lenders to property. Banking experts believe as much as half – £125bn – of the debt secured on UK commercial property is not wanted." (20.)

- **Availability of Investment Finance**

  "One of the main contributors to what looks like a severe recession in the UK is a contraction of lending by our banks. Euro area banks reported an increase in the net tightening of credit standards compared with the first quarter, exceeding expectations from the previous survey round. Banks reported that access to wholesale funding became difficult compared with the first quarter. (1.)

- **Lending Criteria**

  "We are lending – but only with caution and security," said Ian Martin, Head of Corporate Real Estate, Midlands, at Lloyds Banking Group. (12.)

  "There is a dawning realisation that, if a developer believes in something, wants to build it, and needs finance to back it up, it needs to provide investment assets as security. Continual rolling-up of interest leads to a debt spiral. Income is essential for a property company somewhere within the structure." (12.)

  "Most banks now lend over LIBOR (London Interbank Offer Rate) rather than the base rate." (12.)

- **Access to Bank Financing**

  "According to the Institute of Directors, nearly 60% of businesses seeking bank finance in 2009/10 were rejected by their bank." "Inadequate security," followed by, "high risk," were the two top reasons for decline, whilst others were, "let down by their credit score." (30.)

  Conversely, "there has been a significant trend towards equity participation – whereby the lender is given a share in the business as an incentive to provide a loan." (28.)

  "New data released by the Institute of Directors (IoD) reveals that businesses are still having difficulty accessing finance from their banks despite a fall in decline rates. There is evidence that lending criteria have become more restrictive with regard to the amount of security requested by banks…..IoD members stated… they had noticed an increase in the amount of security being requested against any lending that their organisation sought." (24.)

  "Commenting on the survey results, Miles Templeman, Director-General of the IoD, said: "The survey indicates that some access problems relate to lending criteria becoming more restrictive with regard to the amount of security requested by banks. This raises a question about the functioning of the Government's Enterprise Finance Guarantee scheme (EFG)" (24.)

"The EFG is a guarantee facility for small businesses, intended to improve the availability of working capital through term loans and the consolidation of overdrafts. It also supports lending for business growth and development in cases where a sound proposition may otherwise be declined due to a lack of security." (26.)

- **Tier 1 Capital and Hybrids**

  Banks have a hierarchy of capital. "Tier one capital is the best form of bank capital – the money that the bank has to support all the risks it takes. According to banking rules, banks must keep a certain amount of tier 1 capital to protect them against failing." (19.)

"In recent years, tier 1 rules have been loosened to allow in less top-notch capital, such as hybrid debt. Hybrid – halfway between debt and equity – was issued in massive amounts, particularly by European banks, in recent years as a means to gear up in size without damaging credit ratings, or diluting shareholders. When the financial crisis hit, hybrids were unable to absorb losses." (19.)

"Investors in big banks seem to like the new capital standards" whereby "the ratio of equity capital (core tier 1 capital) to assets, would be rising from 2% to 7%. Investors are, "simply relieved that most big banks already have enough capital to meet the new standard." (9.)

"We borrowed too much, especially in the US and the UK. The process of paying the money back is precipitating very significant changes in how the global financial economy operates. For the UK the ratio of our borrowings to our annual economic output is slightly over 300%, or over £4,000 bn. Our banks have been forced to reduce their dependence on (the) diminishing sources of wholesale funds, which is why they've been lending less to us. Taxpayers financial support for the banking system is now equivalent to more than one quarter of global GDP, or more than £9,000 bn." (10.)

Commercial property pressures rise at european banks

"European Bank's commercial real estate (CRE) exposures (will) remain a material credit issue through 2010 and refinancing will be a particular concern in 2011 and 2012." (29.)

"Loans written prior to 2006-7 at lower loan-to-values (LTVs) will be better placed to withstand additional pressure. A prolonged period of economic weakness and/or further asset value declines could result in a significant rise in defaults." (29.)

"Banks are adopting a more conservative approach in terms of new underwriting and pricing of commercial property loans. Many banks are also under significant pressure from regulators, shareholders, politicians and other market participants to de-risk their balance sheets, which has potential to reduce the overall supply of credit to the sector." (29.)

Debt within the property sector

"Debt is, alongside equity, a vital component of the market for capital that supports business generally and investment in particular, but the legacy of too much cheap debt is a problem for the UK today." (7.)

"The principal problems facing business (and by the property industry in particular) today, are the burden of historic debt, which in many cases exceeds the value of the property on which it is secured, and the difficulty of raising

new debt – whether to refinance old debt, or to support investment in new projects." (7.)

"Lloyds Banking Group and RBS are collectively looking to reduce their exposure to commercial real estate by about £60bn between now and 2014. This deleveraging exercise holds the key to how the UK property market pans out. Between them, the two banks account for around a third of UK commercial property debt. At the end of June Lloyds had £61.2bn of UK commercial property exposure - £40.3 bn to commercial property, £17.5bn to residential property and £3.4bn to house builders – and £26.3bn of non-UK exposure." (20.)

Refinancing loans

"The banks have adopted two main strategies to get rid of existing loans, other than foreclosing and taking write downs: managed run-offs and disposals. Run-offs, where the bank simply refuses to refinance a loan and asks for its money back, is the favoured route. RBS says 80% of its debt reduction will be done via run-off and 20% through disposals – it hopes to see up to £3bn of property loans in a single package." The big question is, "Who is going to buy these assets?" (20.)

Government spending cuts

The recently announced spending cuts will have an impact upon the economy. The big question is whether they will exacerbate the recession.

The case for spending cuts: "The Chancellor has the support of Mervyn King. The likes of the IMF and the OECD have also broadly endorsed the coalition's approach." (8.)

Mr Osborne could claim that "if the Government hadn't announced a tougher approach to the deficit, Britain would have seen its international bond yields go up in the past few months – as they have in Portugal and Spain. Instead we have had new falls in interest rates – which means lower borrowing costs for the taxpayer and for businesses. People now talk of the UK as a "safe haven" for international bond investors." (8.)

"Interest rates are unlikely to rise before 2014, according to the latest Ernst and Young ITEM Club Forecast. The tightening implemented by the new coalition should not choke off the recovery, but it will slow UK economic growth over the next two years, according to the forecast." (18.)

"The chancellor's five-year plan to cut the deficit while keeping the pace of the economic recovery is very ambitious. But ITEM Club believes that in the long term it will lead to more sustainable high-quality growth from 2013 because it will be led by business investment and exports, rather than public spending." (18.)

The case against the cuts: Lord Robert Skidelsky, Professor of Political Economy, University of Warwick, in a highly critical speech to the Lords in July, accused the government of "grotesque exaggeration of the dangers of debts and deficits."…."To advocate capital cutting at a time of recession is the worst remedy that one could possibly have." (2.)

Lord Richard Layard, Emeritus Professor, London School of Economics wrote in a letter to the financial Times: "History is littered with examples of premature withdrawal of the government stimulus, from the US in 1937 to Japan in 1997. We shouldn't see government cuts until we've seen the recovery well under way and unemployment on its way down." (2.)

Empty property tax

"The tax was introduced in April 2008 to hit landlords who preferred to keep properties vacant rather than cut their rents. But as the slump hit the economy, many landlords could not find tenants or buyers for their properties and found the only way to escape the tax was to demolish buildings." (3.)

Whilst in opposition Vince Cable warned that, "the levy was potentially making the recession worse for many businesses. The tax changes were "spectacularly badly timed," he said. (3.)

"Changes to modernise empty property rates came into effect on 1st April 2008. The main change has increased the empty property rate from 50% to 100% of the basic occupied business rate, after initial void periods have elapsed. For most properties, excluding industrial, the void period is three months. For industrial purposes the void period is six months. (4.) "The timing coincided with the start of the biggest economic downturn this country has seen for generations, with record numbers of empty commercial properties, particularly on high streets. It has had a number of adverse consequences that are having an impact on the economy. These include the delaying of regeneration and redevelopment schemes, and the demolition of old empty buildings (with the consequent loss of cheap business space.)" (5.)

The change to Empty Property Tax was intended to encourage owners to re-let, re-develop or sell non-domestic buildings. (4.)

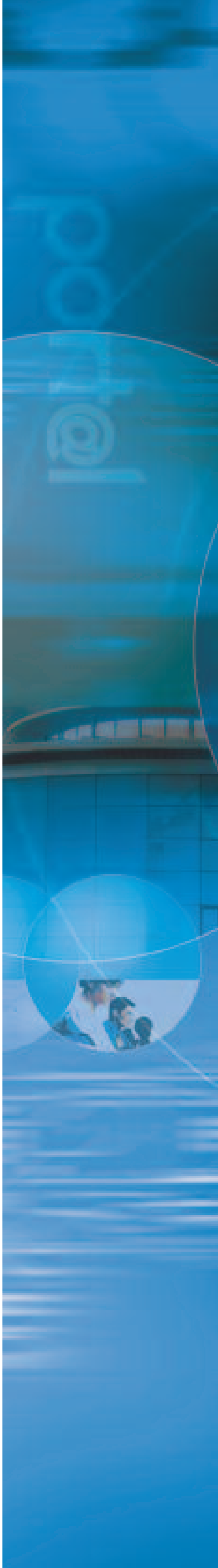
Until the changes, "Landlords of empty commercial properties did not pay business rates, or paid reduced rates, for their empty properties. This empty property rate relief was scrapped by the government." (5.) "The economic crisis that has developed since the reform (of Empty Property Relief) was conceived and implemented had greatly aggravated its negative impact." (21.)

As a consequence of EPR, demolition is an economically viable option for the owners of older properties. "Such properties typically command lower rents and are subject to shorter leases. Partly for those reasons, they are often particularly important for SMEs, new businesses and businesses that are struggling." (21.)

REITs

"REITs or Real Estate Investment Trusts are companies that provide a tax efficient way for investors to invest in commercial property. When the government introduced them in 2006, it only allowed property companies listed on the London Stock Exchange to convert to REIT status." (23.)

"Following flat performance in the early part of the last



decade, the economic profit performance of the five leading REITs was markedly negative after 2007. Between 2006 and 2009 the five lost a collective £22.3 bn." (25.)

Asset protection scheme

The Asset Protection Scheme, launched in February 2009 is "an insurance scheme designed to help banks with lots of bad loans. These have tumbled in value, making banks reluctant to engage in further lending because their capital base is under threat." In March 2009, "Royal Bank of Scotland announced that it was placing assets valued at £325bn with the scheme. RBS negotiated its share of the risk down to 6% rather than 10% and so will be liable for only the first £19.5bn of future losses on the assets, with the government covering the rest." (15.)

- **Special Liquidity Scheme**

  Under the Scheme, banks could "for a period, swap illiquid assets of sufficiently high quality for Treasury Bills. Responsibility for losses on their loans, however, stays with the banks. The scheme aims to improve the liquidity position of the banking system and increase confidence in financial markets." However "the swaps are available only for assets existing at the end of 2007 and cannot be used to finance new lending." (16.)

  "The Special Liquidity Scheme (SLS) "Will not be extended or replaced," Paul Fisher, the Bank of England's executive director of markets, told a Loan Market Association conference in London. Ending the state funding support is among the most pressing problems for the banks, and particularly Lloyds Banking Group, which is 40% owned by the taxpayer. Mr Fisher conceded the decision is likely to make credit more expensive and less available. An alternative state-backed scheme could be provided, he indicated, but by the Treasury, not the Bank." (17.)

  "The last of these bonds have to be returned by the end of January 2012, but "to prevent a refinancing "cliff" at the end of 2011," the Bank has been urging lenders to get on with their refinancing. Of the £185bn extended through the SLS, £57bn has already been repaid, Mr Fisher said." (17.)

  "In addition to the SLS, the Treasury is providing a further £125bn of help by attaching state guarantees to bank loans under the Credit Guarantee Scheme (CGS) – which rolls off between 2011 and 2014." (17.)

  "The Bank has indicated the cost of refinancing for the banks could be as much as £10bn. Mr Fisher added: "The supply of bank lending to businesses during the recovery is likely to be more expensive than it was pre-crisis and possibly constrained in quantity."" (17.)

- **Company Voluntary Arrangement (CVA)**

  "A Company Voluntary Arrangement offers a legally binding agreement between a company and all or certain number of its preferential and unsecured creditors to repay a proportion of the Company's liabilities. The purpose of this procedure is to allow companies the opportunity to avoid liquidation and to continue trading." (22.)

  "CVAs are flexible agreements. Typically they do not promise the repayment of all debt built up by the failing company. Crucially, the management of the company remain in place during the term of the CVA." (22.)

The future of the market

"The pace of rental decline is slowing. (Property Week's) forecast nine months ago of a 4%-5% dip in values looks increasingly likely, and property derivatives are indicating a marked deterioration into 2011." (11.)

"The key question for the commercial property debt market is: who is going to refinance the huge number of loans that are reaching maturity?" (14.)

"The most recent survey undertaken by De Montford University into the UK commercial property lending market revealed that, at the end of 2009, the amount outstanding to banks was estimated at £240-£254 bn with 52% of this due to be repaid to the banks from 2010 to 2012." (14.)

"……those banks that have an interest in lending on UK commercial property fall into two camps. There are those who lent heavily to commercial property in the first six years of the new millennium. The Irish banks have sold many of their non-performing loans to the National Asset Management Agency (NAMA)." (14.)

"The UK government set up the Asset Protection Scheme, but this has only been used by the Royal Bank of Scotland. Lloyds Banking Group, which acquired Bank of Scotland, declined to sign up for it." (14.)

"The second camp comprises banks that were less affected by the credit crunch and are enjoying the opportunity to lend at a time when the economics are very much in their favour." (14.)

"Banks are more able to set the terms on which they lend, and it is rare to see loan-to-value ratios of more than 65%, compared, with the 80% that was prevalent before the credit crunch. Those borrowers fortunate to secure loans are taking advantage, by locking into five and ten-year swap rates now at rates that compare well with the investment yields from their property acquisitions." (14.)

Conclusions

The commercial property market is likely to face a difficult period of recovery as it tries to obtain investment finance and refinance loans. The finance will be more expensive and harder to obtain as banks are more cautious in their lending strategy. The Chancellor stated "The availability of credit to support business expansion is limited and needs to improve." (27.)

Banks simply do not have the funds to lend out and their lending strategies are being scrutinised to ensure they are low risk. "But low interest rates, a shortage of available prime investment assets, and tightening margins for investment debt, mean some real opportunities are appearing." (28.) Opportunities remain in the market for those willing to take a risk, buying while the market is depressed and holding onto the stock ready for the upturn.

"London and the south-east are likely to lead the revival of activity and the established industry contenders will be

best placed to obtain funds. The scarcity of prime developments and the anticipation of a sweet spot for occupier demand in 2013-14, are resulting in significantly higher levels of interest in City of London offices. Falling vacancy rates have shown that the development pipeline needs to be turned on soon." (28.)

"Although many do not anticipate debt-funded development restarting until at least spring 2011, as funding gradually returns to the market, confidence may increase. Land Securities and British Land both announced in May that they were stepping up their development programmes to produce higher returns." (28.)

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