UK commercial property lending market ‘distorted’ by Brexit fall-out

The UK lending market was strongly affected last year by the fall in investment transaction activity and other market volatility due to the EU referendum vote

BY **JANE ROBERTS**

The UK lending market was buoyed by a shift to more refinancings of existing loans in 2016, according to Emma Huepfl, a director of UK debt advisory firm Laxfield Capital. ‘It was a market where incumbents were able to capitalise on their position to take bigger market share, but of a distorted marketplace. There just wasn’t as much to go at in terms of new lending and therefore those with a big loan book were in a great position to go back and talk to their borrowers.’

Huepfl made the comments following the release of the latest 2016 Year-End De Montfort Commercial Property Lending Report in late April. The report records total new lending in 2016 was down 17% to £44.5 bn from £53.7 bn (€63.5 bn) in 2015. This was not such a significant drop, especially when the fact that 2015 was a post-crisis record year is taken into account. But financings of investment transactions fell harder, by 39%, a knock-on effect of the decline in investment activity in the lead-up to the EU referendum vote. By contrast, refinancing accounted for 61% of all new lending last year compared to just 44% in 2015. Huepfl said the switch amounted to a 40% drop in acquisition financing and an almost 50% jump in refinancings year-on-year.

‘There just wasn’t as much to go at in terms of new lending in 2016’

EMMA HUEPFL, DIRECTOR OF UK DEBT ADVIORY FIRM LAXFIELD CAPITAL

NO STRUCTURAL SHIFT BACK TO BANKS

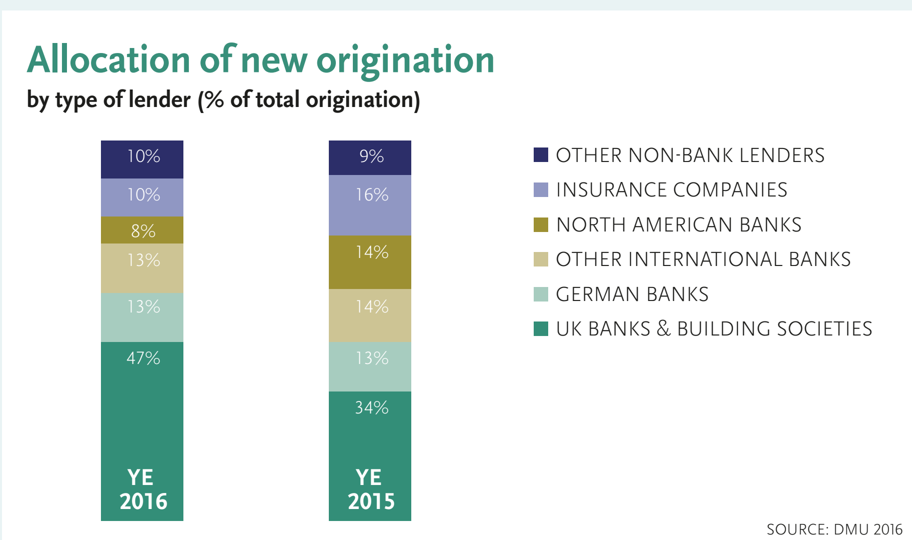
Debt experts believe this picture explains a pick-up in market share achieved last year by UK banks, from 34% of new originations in 2015 to 45% in 2016, according to the report. These lenders have the biggest client relationship bases and therefore the most opportunities to potentially refinance within their books.

It would mean last year’s change does not represent a structural shift to banks regaining market share lost to non-bank lenders after the financial crisis.

Huepfl said that the environment was particularly favourable for refinancing because interest rates were so low. Although they have been abnormally low for years, after the vote for Brexit, the sterling five-year swap traded as low as 35 basis points and the 10-year gilt fell to about 60 bps. ‘With underlying interest rates so low, banks were in a strong position to persuade borrowers of the benefit of extending loans early, and guarding that business from going back out to the lending market.’

John Feeney, global head of commercial real estate at Lloyds Bank, said: ‘Acquisition financing volumes have to reflect what’s going on in the underlying market. In this sort of environment you concentrate on the few deals that are out there and then look at the opportunities to take loans away from other lenders.’

He said Lloyds Bank had found some opportunities in sponsors who had been planning to sell but in the uncertainty around the vote, decided instead to wait and refinance.



ASIAN BUYERS BYPASS UK MARKET

While UK investment trading did pick up in Q4 2016, particularly as Asian investors bought in London after the fall in the pound, Huepfl said: ‘A lot of these deals bypassed the UK secured debt markets completely, either because they were funded with all equity or by investors’ domestic lenders.’ Many lenders were more risk-averse in the face of last year’s uncertainty. The report says this was manifested in a number of ways including a fall in average loan-to-values and a concentration of lender activity in London and the surrounding region. Average loan-to-values for prime office senior loans fell to 59% from 65.6%, year-on-year, the report found.

Neil Odom-Haslett, president of the UK’s Association of Property Lenders, said: ‘Lenders as a rule don’t like uncertainty or surprises and over the last 12 months, there has been a fair share of both. As a result, it is clear that the lending community has become more cautious. The bias towards lending in London and the South East continues, and development finance remains scarce, and this will not change in the short term – unless of course the regulators and policymakers intervene in some way.’

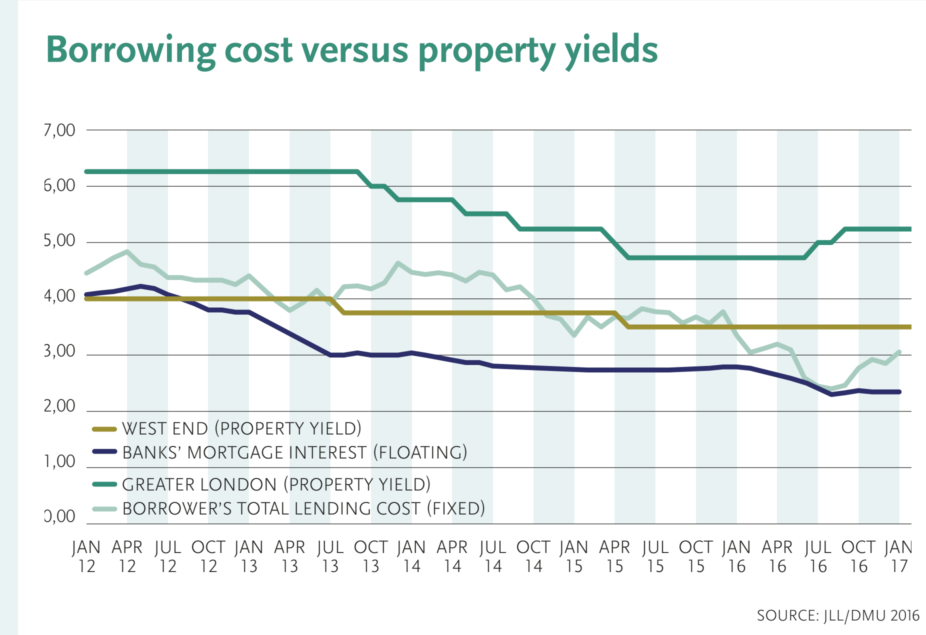
Although property yields did rise for some assets, in London they began to fall again in the second half of the year, with the sale of The Leadenhall building in the City of London at a yield of about 3.5% widely viewed as a very full price.

RECORD LOW PROPERTY YIELDS

Nicole Lux, author of the De Montfort report, highlights the potential danger for lenders of prime property yields falling to record lows. ‘It is difficult to add more than 45%-50% leverage to achieve a sustainable interest payment coverage ratio,’ she says in the report.

Feeney said: ‘It’s been a feature of West End property for a while, where yields are so low that making the ICR (interest cover ratio ed.) work is very challenging, sometimes even at modest senior leverage. Now, with City office yields in some cases very low as well, that provides some challenge.’

Anecdotally, lenders seem to be factoring in minimum 2% interest rate rises over the forward rate curve for the life of loans written now.



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JOHN FEENEY, GLOBAL HEAD CRE LLOYDS BANK

Feeney said Lloyds Bank continued to lend in London and the South East but was increasing its focus on the UK regions. ‘That’s partly because we see healthier cash flows and partly because we see a market that has less weight of capital and we think better priced risk in some cases.’

The De Montfort report says average margins for senior loans secured by prime offices declined 25 bps to 198 bps at year-end 2016 from 223 bps recorded at year-end 2015 while margins for secondary offices were stable.

MARGINS UP ACROSS THE BOARD

However, Huepfl felt refinancings might have been distorting those figures slightly. ‘I think margin pricing for acquisition financing may have been up a bit more than the averages show,’ she said, but added that pricing of core prime loans had compressed again once syndication activity picked up from Q4 onwards.

Feeney agreed: ‘Margins are up across the board. Maybe some assets buck the trend, but this aspect of the report doesn’t reflect the reality we see.’

One noteworthy trend was the concentration of lender activity on London and the surrounding region, with almost two-thirds of all debt secured against property in the capital and the South East. Industry body the British Property Federation, one of 13 sponsors of the report, flagged this as a possible issue.

LONDON FOCUS

Ion Fletcher, the BPF’s director of finance policy, said this was a trend ‘that could be important from a policy perspective’. Together with the high cost and ‘relative dearth’ of development finance, ‘these contrast with the government’s objectives to promote economic growth across the whole country and stimulate new development activity, particularly for new homes’, he said.

The slow recovery in the health of banks’ UK books since the global financial crisis continues, with 91% of outstanding loan exposure now held in loans at LTVs at or below 70%. Loans in default, reported to the research, were £2.6 bn, or 3% of the total (£10.4 bn and 7% reported at the 2015 year-end). The proportion of legacy debt still hanging over the market since the time of the GFC is now at ‘an insignificant level’ the report says. ■