High LTVs out, regional funding difficult, old habits die hard...

Laxfield's latest debt barometer throws up three trends that are impacting the lending markets

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Laxfield Capital is a UK-focused debt advisory business which, four years ago, had the ingenious idea of publishing a regular survey of financing requirements.

Its six-monthly Laxfield UK CRE Debt Barometer contains top-line figures about the lending market that are collated from borrower requests for finance, representing roughly half the secured lending market's forward pipeline. These cover useful things such as debt capital demand, pricing and leverage.

However, it is the more nuanced comments about borrower/investor behaviour which make it such an interesting read. In the latest survey, out this week and covering Q4 2016 - Q1 2017, three points stood out.

The first is that without some kind of external shock, habits take a long time to change in real estate. In the UK lending market, this is manifest in loan maturities. In the four years since the barometer launched, the average loan term request has stuck at just under six years.

In the latest survey, 71% of the pipeline comprises requests for loans of 3-5 years. This despite something like a tripling in lenders with a long-term, fixed-rate UK product, able to offer competitive margins, while at the same time the underlying funding costs, usually benchmarked against gilts, remain at historic lows.

Notwithstanding all the talk, since the crash, of real estate being a long-term investment, it seems UK investors are still obsessed with keeping their options open, and in Laxfield's view, 'appear not to tolerate the higher prepayment costs of long term facilities'.

The second point is that requests for higher leverage loans, of above 65% loan-to-value, have halved in the last 12 months to £5.22 bn, compared to the 24 months prior which saw £11.2 bn and £8.26 bn of requests respectively.

Laxfield's co-principal, Emma Huepfl, counsels against overstating one 12-month snapshot, but she does believe it shows a couple of trends. One is that fewer US private equity firms, natural users of higher leverage, are buying assets to improve and sell on than 24 months ago.

'We are not seeing so much appetite for opportunistic trading at the moment because no one really knows how easy it is to add value to assets and sell them on at a higher price in 18 months,' Huepfl suggests. 'Instead, people are buying because they think the income looks cheap.'

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> **Emma Huepfl, Laxfield**

She thinks the fall in requests for high leverage also ties into a general awareness that loan structures are vulnerable to interest rate hikes. This applies to lower leverage loans secured on prime property too, where values are arguably inflated by a shortage of other yielding asset classes. As the barometer says: 'Sensitised debt yield and interest cover ratios often require much more conservative lending than a reasonable headline LTV might indicate.'

MARGIN COMPRESSION

In this context, it is notable that the survey finds there is margin compression on both safer, core financing at LTVs up to 55% where most banks and institutions like to lend, and high LTV lending, where high-yield debt funds are jostling for fewer deals.

The cost of the 55%-70% LTV slice in the middle has gone up. It is particularly noticeable for secondary assets 'where margins have risen substantially' – secondary regional retail, for example, showed a 115 basis points differential to core. These are the hardest deals to finance, often shunned by more risk-averse senior lenders.

Unfortunately, many borrowers are in the middle. And this is the third stand-out theme in the survey. Almost two-thirds of lending last year was in London and the south east according to De Montfort University's last *Commercial Property Lending Report*, yet Laxfield's barometer shows half of debt requests are to finance regional assets. There is a supply-demand mismatch.

'To source accretive funding for regional, value-add properties is difficult,' Huepfl says. 'If you have something outside the core category you need to persuade your bank to do something a bit outside their comfort zone or go to a more expensive debt fund.'

One way round this Laxfield sees is investors raising money against their core assets to finance value-add business plans for others, some give up on debt if too expensive and use all equity.

Huepfl does not believe the debt shortage will depress property values. 'It's a much less debt-driven market than a decade ago. Debt isn't driving pricing as much as equity.'