LAXFIELD UK CRE DEBT BAROMETER

Issue 4: Q4 2014-Q1 2015, published April 2015

Laxfield Capital presents the 4th issue of the Laxfield UK CRE Debt Barometer, an overview of current financing requirements in the UK commercial real estate market. The report references requests for funding received since January 2013, drawing on a **total sample of £58.8 billion loan requests across 624 deals** analysed by Laxfield Capital.

This issue has been kindly sponsored by the Property Finance Forum whom we thank for their interest and support in producing this report.

"Demand for finance from real estate investors in the UK is increasingly two tier. Institutional and private investors as a whole continue their highly restrictive approach to using debt finance. By contrast, more investors with short term, high return strategies are currently seeking high leverage debt.

Funding costs have reduced significantly, with lower interest rates and margins proving highly accretive to returns. It does not surprise us to see this stimulating demand for greater leverage. It has also produced more interest in longer duration financing, which UK investors have been slow to respond to previously.

As yields tighten significantly in core sectors, debt backed purchasers have more appetite for operational assets where better yield is available. Sponsor capability is clearly a key area for lenders in providing finance secured on these assets."

Emma Huepfl, Co-Principal Laxfield Capital

KEY FINDINGS FROM THE PAST HALF YEAR:

1. Volumes steady but distinct **increase in appetite for leverage** noted among some borrower groups
2. Very strong **demand for acquisition related finance**, with confidence in delivery
3. Sharp **uptick in sub £20m finance requests** but large deals still dominate the market overall
4. Noted increase in borrowers seeking quotes for **long term finance** after long period of muted demand
5. Very substantial demand for **finance secured on alternative assets**, with hotels and student housing together forming 25% by volume, and non-core sectors comprising 50% of the pipeline overall

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We believe that statistical information on the debt market is necessary to inform all market participants and give borrowers and lenders early indications of changing risk. Drawing upon real time loan data, Laxfield gives valuable insight into market direction through this report. A clear note of caution comes from the assessment that leverage is increasing among some borrowers. Despite the continued attraction of real estate relative to other asset classes, values have increased rapidly and a different interest rate environment could challenge the refinancing of highly leveraged loan positions at term.

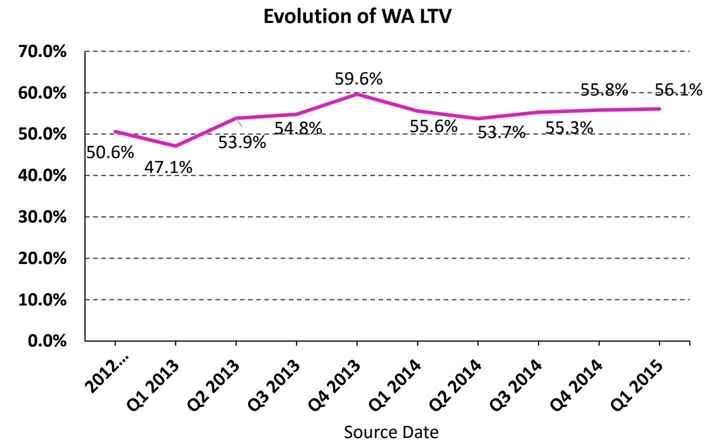
Julius Gottlieb, Property Finance Forum

Volumes

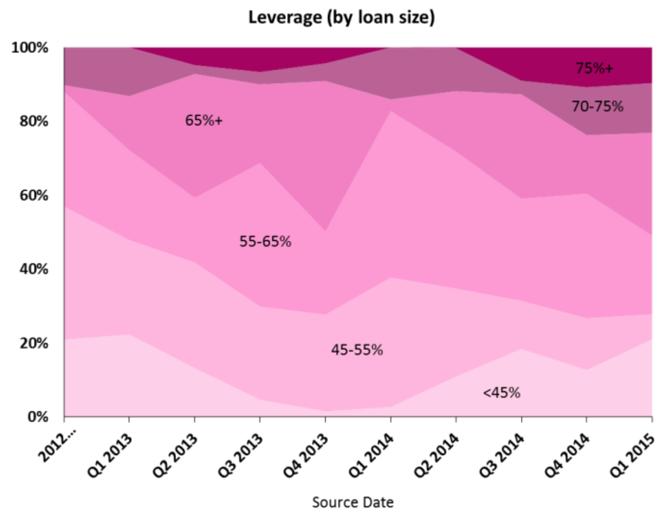
- Overall, volumes were in line with the last three year average. Bumper Q3 volumes in 2014 were followed by a relatively steady half year period, with requests totalling £11.3bn during the report period.

Leverage

- Weighted average LTV across the market remains steady at 56%. We have previously commented that this reflects a market which is conservatively geared. **Evidence suggests this is now changing.**
- The average figure masks a market which is increasingly two-tier. Institutions and conservative investors remain firmly restricted in their appetite for gearing, but a growing band of investors seeks higher leverage, and there is increasing **disparity between the financing strategies of these groups.**
- Investors in the sub 45% LTV category are predominantly institutions, REITS and some private family companies.
- Investors seeking more than 65% LTV comprised more than 50% in Q1 2015, demonstrating that restraint towards gearing is no longer characteristic of the market as a whole.



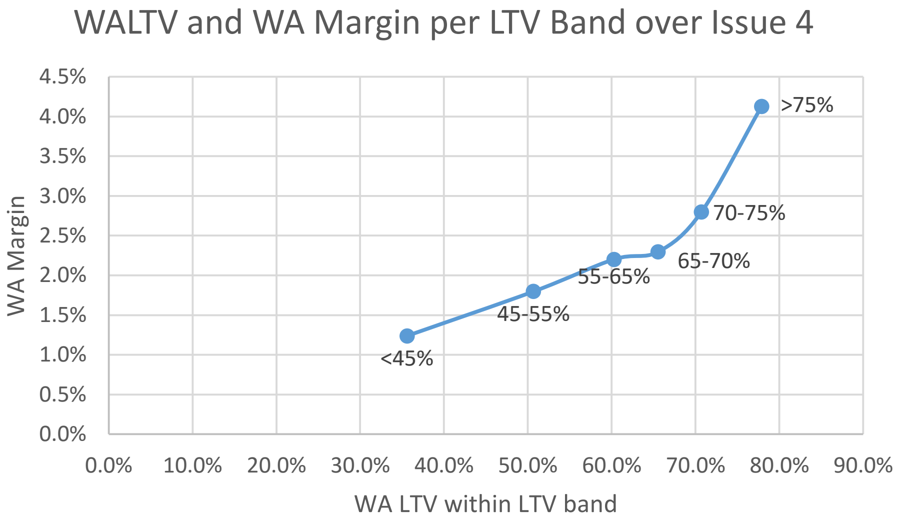
...Average LTVs kept low by conservative gearing of large institutional investors



..But high leverage is making a very notable comeback among other borrowers

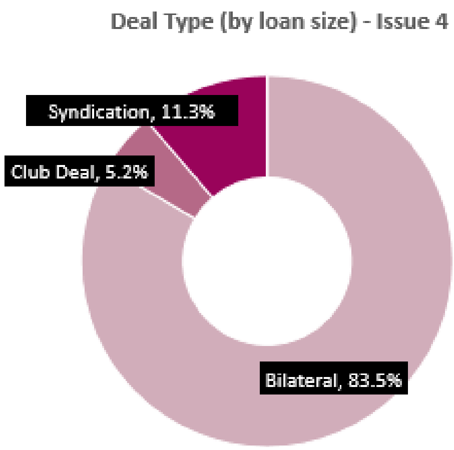
Further comment:

- The cost of taking debt has declined substantially through reduced swap costs and margin compression, and because the leverage point at which senior lenders are prepared to fund has become generally higher.
- In the years immediately post GFC, senior debt was limited to c60% LTV, which increased in 2013/14 to c.65%. We have seen increasing evidence of lenders stretching this figure closer to 70% in the past half year.
- We demonstrate this in the graph below, with expected pricing across the pool of mixed assets from our pipeline. The trend line clearly demonstrates a sharp uptick in marginal cost of extra leverage above 70%, but relatively low differential between 60 and 70% LTV, indicating that the inflexion point where mezzanine pricing is more widely deployed is above 70%



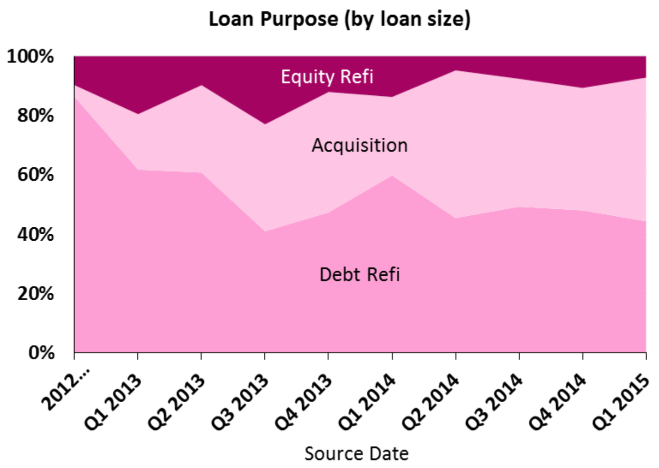
Syndication

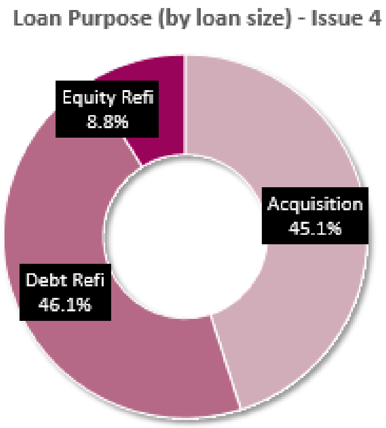
- Observing a growing trend of the secondary debt market reactivating in the UK, Laxfield has measured the proportion of loans likely to be retained by one lender, and deals where syndication is likely. Reasons for syndication vary, and may include size, additional leverage and price sensitivity.
- We estimate that 16.5% of the loans seen in the past 6 months will involve more than one lender. Club deals – (ie more than one lender at closing) account for 5.2% of these, and syndication post-closing 11.3%.



Loan Purpose

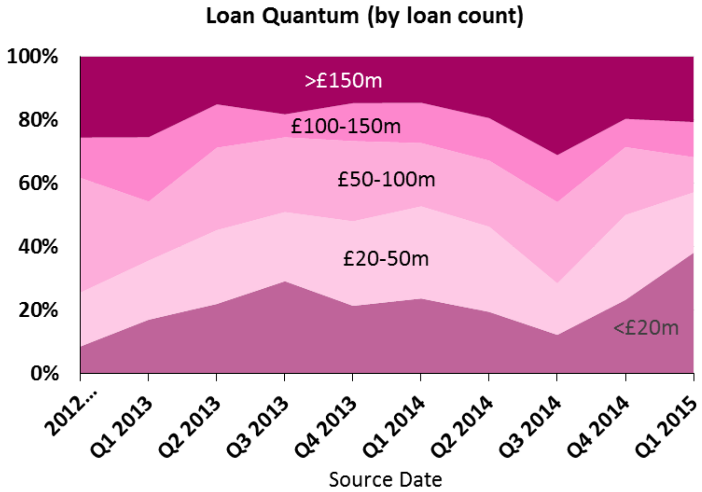
- Continuing the trend from Issue 3, acquisition-related financings comprise an increasing proportion of the finance requests seen in the report period, reflecting strong investment market turnover. The figure increased from 50.1% across Issue 3 to 53.9% in Issue 4.
- Confidence in the availability of finance at acquisition continues, and the low number of deals where equity is refinanced after acquisition, indicate that borrowers wish to avoid any drag on IRR in utilizing cash reserves. Anecdotally, sponsors also prefer lenders to work alongside them during acquisition to maintain momentum during execution, with all parties focused on a closing date.
- Despite this, debt refinancing volumes are also strong. In the current interest rate environment, many borrowers with flexibility to do so are refinancing facilities secured in the past 3-5 years at tighter pricing. Long term holders of assets are also showing more interest in fixed rate funding (see below)
- A substantially lower average expected margin was observed for the debt refinancing pool vs the acquisition finance pool. This correlates with lower average LTVs, but also reflects the desirability for lenders of sponsors who hold assets longer term, and have proven management capability. The expected spread differential has increased from 16% in issue 3 to 30% in issue 4.



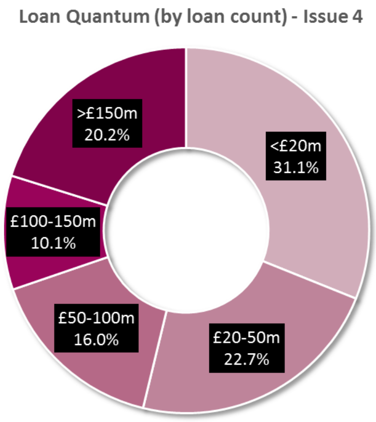


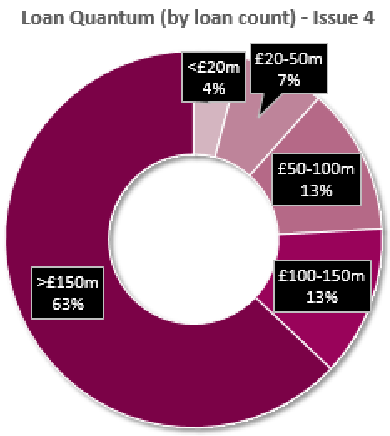
Loan Quantum

- Small ticket (<£50m) loan requests increased substantially over the past six months. There has been a corresponding decrease in average loan size to £94.3m in the past six months (from £101.2m in Issue 3)
- We have subdivided the small ticket loan requests for this report, adding a <£20m category, after a spike in requests at this level. By count, this category accounted for 31.1% of the pool over the past 6 months, a high figure.
- On a volume basis, the market is naturally skewed towards big deals with 75.9% (£8.6bn) of finance requests being in excess of £100m over the past 6 months.
- In the past six months, deals below £50m have an expected margin premium of 43bps to deals above £50m across the mixed portfolio of assets reviewed.



.......Gradual trend line towards demand for small ticket finance increasing as regional markets

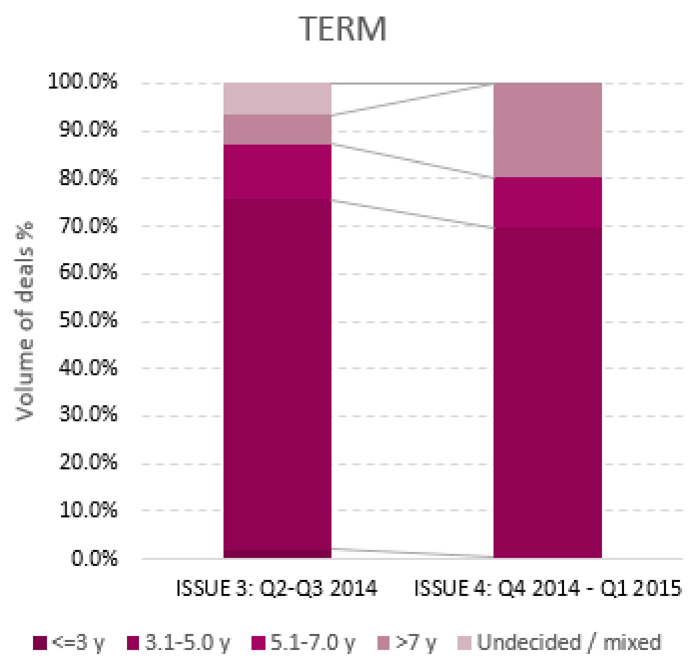




.....Although finance requests for smaller deals are going up, large loans still dominate the market by volume with 75% of demand being in loan requests of £100m or more

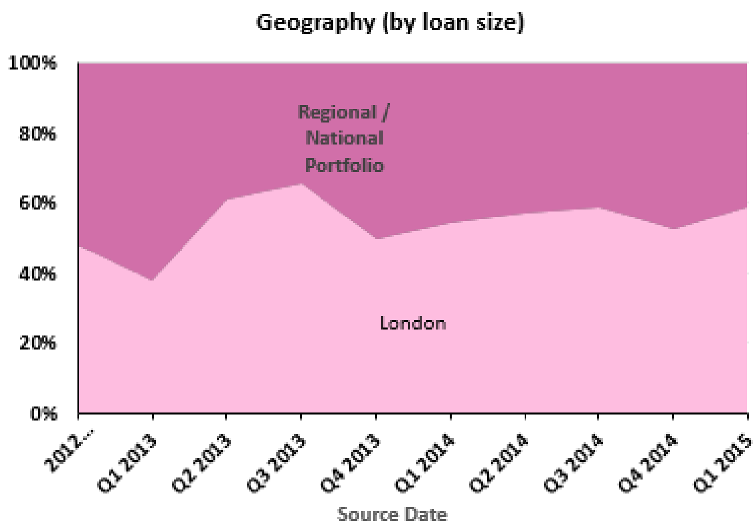
Loan Term

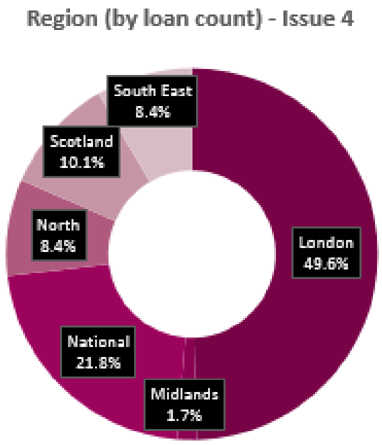
- The wider market continues to finance on a 3-5 year basis, with 69.5% of requests by volume falling into this category, and weighted average loan term of 5.9 years over the total pool. This is in tune with the 3-5 year investment horizon of the majority of investors.
- In every previous issue to date we have commented on the very muted take up of long term debt despite its wide availability and competitive pricing, and interpreted this as a reluctance to accept the yield maintenance requirements associated with fixed rate financing. In the past 6 months, however, we have seen a notable increase in requests for quotes on a long term basis.
- Published market pricing during the report period evidenced total borrowing costs secured on core assets for 10 years at under 3% and 15 years at c.3.25%, and it does not surprise us that more property investors who hold assets long term are exploring longer dated funding. Lenders and borrowers have also engaged in active dialogue to adapt the product to the market through substitution and portability provisions, and if low gilt yields persist, we might expect more take up of long term debt capital.
- We have also noted that some European banks have been more willing than previously to extend the term of their financing beyond five years, providing competitive tension with gilt based lenders in the 5-10 year area.
- Pricing contraction has been seen in the >7 yr band, with the longer end now at a discount of 30bps compared to the next shortest band (6-7y), or a 50-100bps discount compared to 5y deals. This does not just reflect lender appetite but also the security pool which suits long term finance – sponsors are generally conservative, long term holders of assets, and offer high quality security to lenders.



Geography

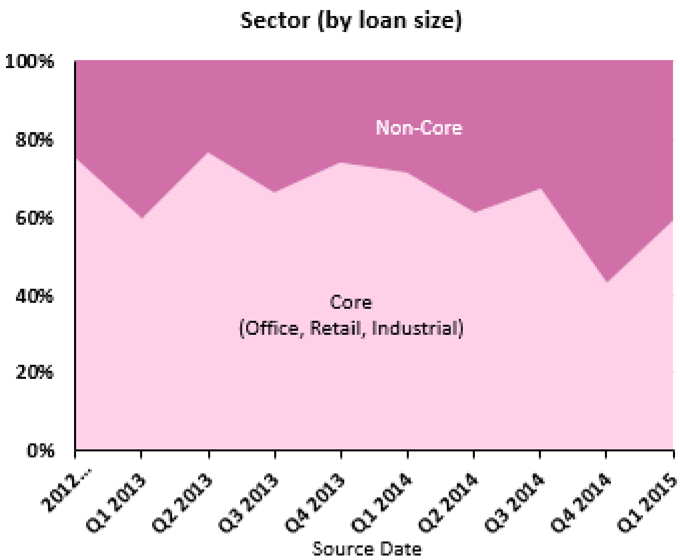
- Geographic split stayed remarkably consistent. By volume, London accounted for 56% vs 44% Regional / National portfolio. However, by loan count, requests for finance in the regions are slightly higher, reflecting a greater spread of deals nationally.
- A fairly consistent pattern of higher pricing for deals outside London has been seen over the past 12 months, and in the past half year this amounted to an expected pricing differential of 25bps across the pipeline. However, regional deals were associated with higher LTV requirements so the higher margin may not fully compensate for all relative risk factors.

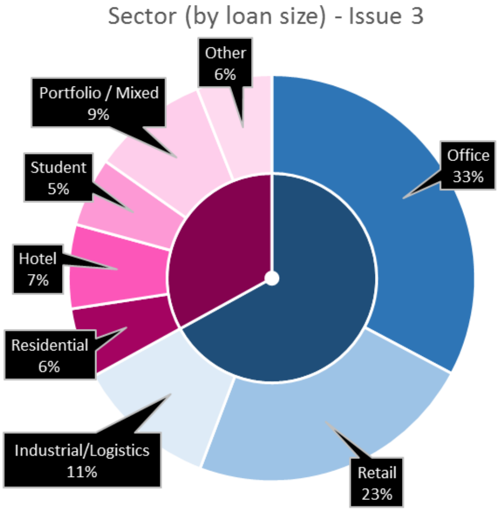


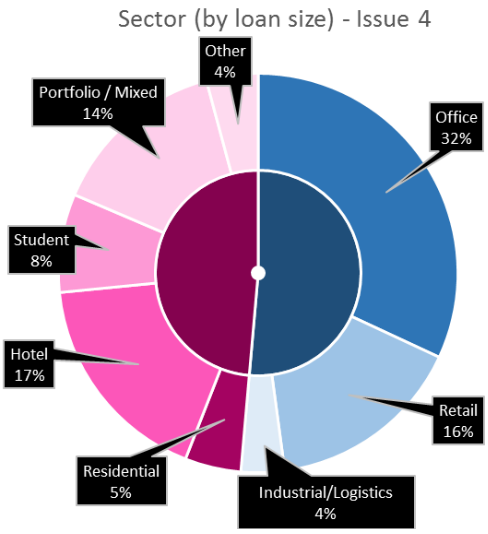


Sector

- The sector split shows strong continued diversification from the three main asset classes
- Office contribution remained steady (contributing 31.9% to Issue 4's pipeline, compared to 30.4% of Issue 3) but the share of retail and industrial declined against sharp increases in finance requests on non-core and mixed portfolio assets
- There was a noted strong increase in funding requests secured on Hotels (from 6.2% to 17.5%) and Student Housing (from 5.1% to 8.0%), reflecting wider interest from mainstream investors in these assets classes.







BACKGROUND:

METHODOLOGY:

Added Loan Data: Over the past 2 quarters, Laxfield Capital reviewed 119 requests totalling £11.3bn of debt.

Reference Period: Finance requests for funding between 1 Jan 2013 – 31 March 2015, with focus on Q4 2014 and Q1 2015

Loan Parameters: Senior and stretch senior loan requirements secured on mainstream income-producing assets in the UK. Loan sizes span £2m-700m, fixed & floating rate, 2 – 20 year terms and up to 85% LTV.

Capital Representation: during the subject period Laxfield Capital worked with capital providers with appetite for fixed and floating rate loans, senior / stretch senior and junior loans, deal sizes of £5m - £250m, secured on income producing assets in good locations within the UK markets.

ABOUT LAXFIELD CAPITAL:

Laxfield Capital is a commercial mortgage origination and investment management business, which has arranged >£2bn of lending since 2008 on behalf of global institutional investors, including life companies, banks and a sovereign wealth fund. Laxfield Capital provides a comprehensive range of services, including origination, investment selection, execution, syndication, investment management and strategic advisory.

Since 1995, the Laxfield Capital principals have originated and managed £9bn of commercial mortgages in the UK and several European markets and assisted nine international investors in building or expanding their UK commercial mortgage platform.

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