IPF Research Programme 2006-2009

Real estate debt: an update

IPF Research Programme Short Paper Series Paper 7

January 2010

This research was commissioned by the IPF Research Programme 2006–2009

IPF Investment Property Forum

This research was funded and commissioned through the IPF Research Programme 2006–2009.

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The programme is funded by a cross-section of 24 businesses, representing key market participants. The IPF gratefully acknowledges the continuing support of the contributing organisations.

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Mike Phillips, *Finance Editor, Estates Gazette*

In April, the Investment Property Forum commissioned a paper to look into how banks which have made loans against UK property are acting in dealing with problems that have arisen. The paper was published in July, and its conclusions, briefly summarised, were:

The conclusions

While there was likely to be an increase in the amount of property banks brought to the market, there was unlikely to be a flood. This could cause stagnation in the market. To a certain extent, this has proved true.

Banks have not decided to bring to market the properties against which breached loans are secured. The July paper predicted stagnation in the investment market, and while there is the probability that this stagnation will be seen in 2010, in the second half of 2009, investment volumes have increased compared to the same period of 2008, and prime values have rocketed. This is because the lack of supply, primarily controlled by lenders, runs counter to the large amounts of equity currently looking to invest in prime UK real estate.

Against this background, this update will look at how banks are behaving as the year ends, and what trends are likely to be seen in the first part of 2010. It takes as its centrepiece a round table debate session held in October, present at which were 15 senior real estate lenders, investors and advisers. It will also focus in detail on the recent joint venture deal struck between Great Portland Estates, Eurohypo and Istithmar World, which has seen the former take over a development project in a deal which could be seen as a potential model for working out distressed real estate loans.

Don’t expect a cheap deal

Several of the participants in the round table debate expressed the opinion that it might be wise for banks that wish to reduce their exposure to real estate and trim loan books to sell into the current strength in the market. As stated above, the current imbalance between supply and demand means that real estate prices saw their biggest monthly rise on record in November, according to the IPD monthly index. The example of the Silverburn shopping centre in Scotland, which is being sold by Lloyds Banking Group, was cited, with the fact that more than 40 bids were received seen as a sign that banks could remove property from their loan books at a price not much below or even at par to the level it is held at in their accounts.

However, there is a general consensus that, while there will be some selective sales from banks to take advantage of the current market strength, there will not be a big increase.

Several reasons for this were cited:

- At the banks with the largest loan books, Lloyds Banking Group and Royal Bank of Scotland, while there are large teams of people on the ground in loan workout divisions, they don’t necessarily have the property expertise needed to take specific decisions. While these banks may have stabilised themselves on a wider corporate level, and taken strategic decisions on a macro level as to what they want to do with property loan books, they have not yet started taken decisions on most of their individual loans and borrowers.
- Banks wanting to avoid crystallising losses on loans are looking at the process of restructuring property loans as a five to 10 year process. In many cases they have Government support in terms of liquidity measures and loan protection schemes to help them focus on long-term goals.

- The general improvement in the market reduces the pressure on banks to act. While an investor would argue that banks should sell into strength (speaking out of self-interest, because they raised an opportunity fund earlier this year and need to buy something for it), equally, if good quality, income producing property is rising in price, then the bank does not necessarily want to shift it. If selling the property realises a better result than the cost of the capital the bank needs to set aside in order to hold it, then it might sell. But on prime property, this is probably not the case. Secondary and tertiary is a different matter (more on this later).
- It was pointed out that often, it is very difficult to remove the existing borrower and take control of the underlying security, especially in a manner that does incur a large loan loss provision.

An interesting tip came out of the session. One real estate banker complained that half of every day was taken up with meetings with investors looking to 'help the bank work through their loan book'. These meetings were a waste of time, the banker said. "If you're a banker who's been around for 15 years and you don't know who to call about a certain project then you're doing something wrong." A counterpoint is that not all real estate lending departments are being run by experienced property bankers.

The idea was posited that rather than contacting the bank to try to offer a solution, a better bet would be to get in contact with a borrower who was underwater on a loan and seeking an exit. Strike a deal with a borrower that sees them take a small payment and some slice of future upside, and involves a restructuring of the debt that helps them avoid huge losses and gives them a share of future upward revaluations. If you can go to the bank with this holistic solution for a specific loan, you have a much better chance of getting through the door.

Great Portland Estates

A very specific example of this can be seen in the recent deal which will see Great Portland Estates take over from Istithmar World as the developer of an office and residential development scheme at 289-295 Regent Street.

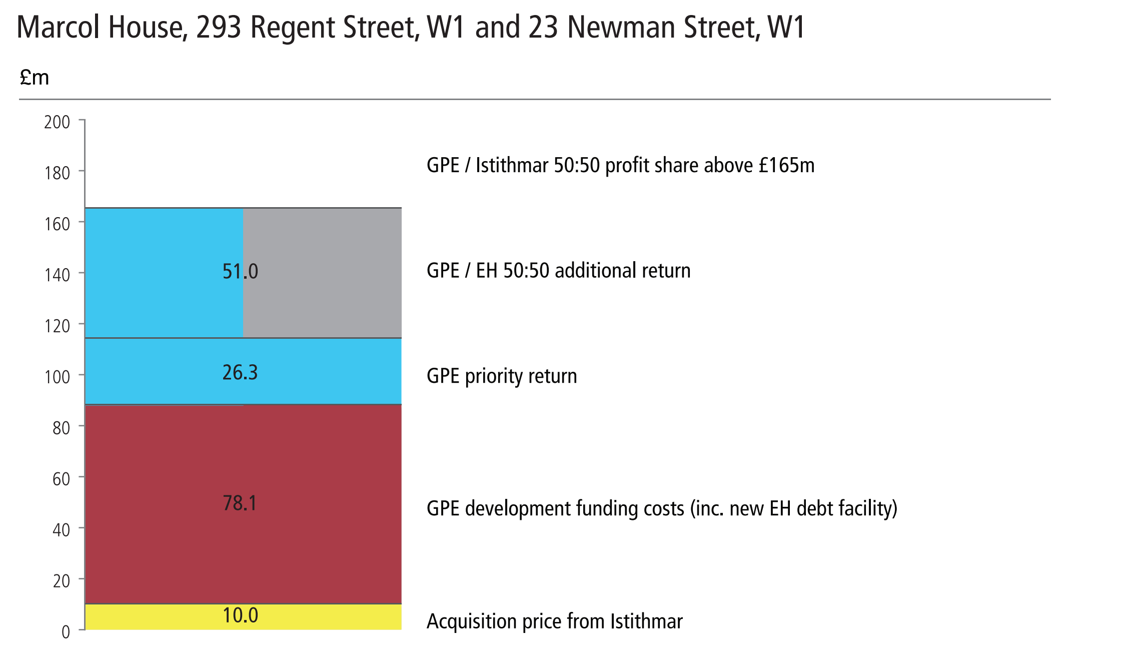
GPE chief executive Tony Courtauld recently told *Estates Gazette* that the deal was likely to be replicated. "I absolutely think that this is a template we can use in other situations. The bank avoids crystalising its losses and lives to fight another day, and we share in the profit, too. We will be talking to other lenders about possible situations where this [structure] could be applied."

It is the first deal of its kind to be made public, and in that sense offers a potential model, but it also highlights the difficulties of restructuring real estate debt: the deal took five months and a lot of hard work to strike, Courtauld said.

The capital structure is presented in Figure 1 below, but bears a some explanation. At the bottom of this revised capital stack, GPE paid Istithmar £10m for its stake in the project. Eurohypo has provided a restructured debt facility, with GPE putting in further equity, totalling £78m, which will cover the development cost of the scheme. Eurohypo takes a loan loss provision much smaller than if it had simply pulled the plug on Istithmar. If the scheme rises in value beyond that initial £88m, then the spoils are split. GPE takes the first £26m of profit, and a £26m uplift represents a 30% profit on its investment. After this point, GPE and Eurohypo take a 50/50 profit share, allowing Eurohypo to take a writeback on the loss provision it had previously made against the scheme, and further enhancing GPE's return. If the value of the scheme rises beyond £165m then GPE shares the profit with Istithmar, as a further incentive to the original owner of the scheme to sell out – an important element of any deal as otherwise the original borrower might not see any reason to part with a scheme.

As laid out previously, these deals will take a long time to come through – they are complicated. Bank, borrower and new partner all need to be incentivised; the bank needs to find a new partner with the specific skill set to manage assets in a particular sector or location, and for this reason it is not easily scaleable; banks are only just starting to look at the specifics needed to manage individual loans. However, the huge plus point for this model is it offers a solution for problems with loans that are not providing income, which, in terms of the problems banks face with capital requirements, are far more pressing than loans with a simple loan to value breach.

Figure 1: Capital structure



Source: Great Portland Estates

Problems on the horizon

At a recent conference hosted by EG, one delegate in the audience made the point that the perception exists that banks have such a large property overhang, and the need to deleverage is so large, that investors feel that at some point banks will have to flood the market, and thus there will be an inevitable second fall in values, as supply starts to outstrip demand. Most property professionals canvassed for these debt papers have pointed to the opposite happening, ie banks keeping hold of property for years.

However, in the opinion of this author there is one question that people have not been able to answer adequately, and that concerns the fate of loans secured against secondary and tertiary property. The market recovery, and the rise in values exhibited in the IPD and CBRE indices has been driven entirely by the prime sector of the market. A large part of the money chasing the sector at the moment comes from UK and foreign institutions, which want to buy property with long-dated secure income, as it provides a better yield than cash. They only want very prime kit. The strength of such property is increased in that those banks which are now starting to look at lending to the sector are happy to finance this sort of property. So if banks do want to sell this sort of property (eg Silverburn), they can.

For secondary and tertiary property, the opposite is true in every sense. Equity-rich institutions don't want to buy it, and banks are not willing to fund it, because covenants are not as strong and leases are not as long. And by definition, prime property is only a small proportion of the stock banks have loaned against. As one member of the round table pointed out, the IPD average lease length is now only 4.8 years.

So what will happen to this unloved stock? The opportunity funds raised over the last two years would be willing to buy big portfolios of it, but only at prices which remain unacceptable to banks. As banks continue to hold it, leases are getting closer to their expiry, rents are moving down, and they are using up capital, either in terms of money that might need to be spent on property to improve its value, or in risk weighted assets in the banks' accounts.

This is the type of property that banks don't want to refinance. The recent De Montfort survey into bank lending for the first half of 2009 showed that interest rate margin spreads between prime and secondary property had increased from 20 basis points to 32 basis points, a widening that author Bill Maxted said is caused by the almost complete absence of appetite among lenders to fund investment in secondary property. It is being passed over by the current market recovery, and remains the biggest unknown for banks and investors. Despite the fact that there is no likelihood of forced sales from banks driving values back down, how banks deal with this remains a problem to which no one has yet given me a decent answer.

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Investment Property Forum
New Broad Street House
35 New Broad Street
London EC2M 1NH

Telephone: 020 7194 7920
Fax: 020 7194 7921
Email: ipfoffice@ipf.org.uk
Web: www.ipf.org.uk