# Hot spots and cold

AFTER TWO YEARS ON THE SKIDS, THE COMMERCIAL PROPERTY MARKET HAS BEEN SHOWING SIGNS OF REVIVAL, BUT IT'S AN UNEVEN TWO-TIER RECOVERY. **GRAHAM BUCK** REPORTS.

The UK commercial property market's transformation from boom to bust was swift and steep. After peaking in mid-2007 as the credit crunch started to bite, capital values slumped by 44% over the next two years until the market bottomed out in July 2009. The drop was dramatic enough to make the sector attractive once more to investors, though; over the subsequent 15-month period the market delivered an impressive 27% in total return (income plus capital growth).

It's unlikely that such an outstanding performance will be repeated during the course of the next few years. Prime yields are nearly back to pre-crisis level and may come under pressure as government bond rates rise, says Tony McGough, global head of forecasting at real estate adviser DTZ. "There is also little expectation for strong rental growth outside of London and a few key markets and super-prime sites," he suggests.

The recovery has been driven by two main factors: yield rerating caused by investors' renewed interest in property – which, in turn, has had a positive impact on capital growth – and strong income returns that have managed to outperform most other UK assets. But the overall picture is rather less positive. Rental values, which reflect demand and supply conditions, have continued to decline. At the end of October 2010 they were down 1.7% on a year earlier; higher rental values for office space in central London were offset by steep falls in many other areas, especially high-street retail properties outside the capital and southern England.

The resulting two-tier market appears likely to continue in the near term. Overseas investor interest in London is considerable, with the capital regarded as a safe haven and its attraction heightened by a favourable exchange rate. The high-end residential sector has also experienced continued strong demand for new developments driven by interest from overseas investors.

Real estate investment trusts (REITs) have been able to access the equity markets and are once again well capitalised, with substantial resources to make further investments and to undertake development.

New developments mothballed at the start of the downturn, when investors were unsure how far the market would fall and responded by conserving their capital, are back on track. They include developments planned for the City such as the "Walkie Talkie" tower in Fenchurch Street and the "Cheesegrater" in Leadenhall Street.

**WITH THE OUTLOOK FOR THE COMMERCIAL PROPERTY SECTOR UNCERTAIN, MANY BANKS HAVE BEEN ATTEMPTING TO REDUCE THEIR EXPOSURE TO NON-CORE REAL ESTATE.**

"London is fairly constrained in its supply of property," says Stephen Leung, corporate finance director for Land Securities. "Occupiers are looking forward with their space requirements, but there isn't very much around. Rents have been bouncing back as a result, although they remain affordable."

The deepening austerity regime is very apparent outside of the capital, though, with regional markets still in the doldrums, particularly for secondary retail. Leung says the major retail chains want their outlets to be in the dominant malls such as St David's in Cardiff, Manchester's Trafford Centre, and Westfield and Bluewater in London. "As high-street leases come up for renewal there is an increasing struggle to fill them. There are still many retailers in a very weak position and higher VAT plus tax rises mean their situation won't improve for some time."

There is opportunity for further recovery in the property market outside London says Richard Dakin, managing director of Lloyds Banking Group's corporate real estate business support unit, particularly in the major cities that have a shortage of prime office space. However, that recovery is limited to "a handful of areas and only in certain segments".

**SELECTIVE INVESTMENT** Lloyds' quarterly Commercial Property Market Confidence Monitor, which provides a snapshot of conditions and general sentiment, confirms that London is a law to itself. The more recent (the latest was issued in January) have been more downbeat in tone; they show that most businesses expect the government's public sector spending cuts to hit the market, with job losses translating into more office vacancies. Yet at the same time companies also indicate a willingness to invest selectively in commercial property, with 65% of major businesses saying they want to commit a little further to the sector and a further 5% planning a substantial increase in their investment.

With the outlook for the commercial property sector uncertain, many banks have been attempting to reduce their exposure to non-core real estate. Basel III and other impending legislation will force them to deleverage their balance sheets, so action is already under way. Royal Bank of Scotland is seeking to sell a basket of loans to reduce its exposure further and, according to a report in the Financial Times in January, Lloyds plans to package its first portfolio of distressed property assets as part of its publicly stated target for cutting back.

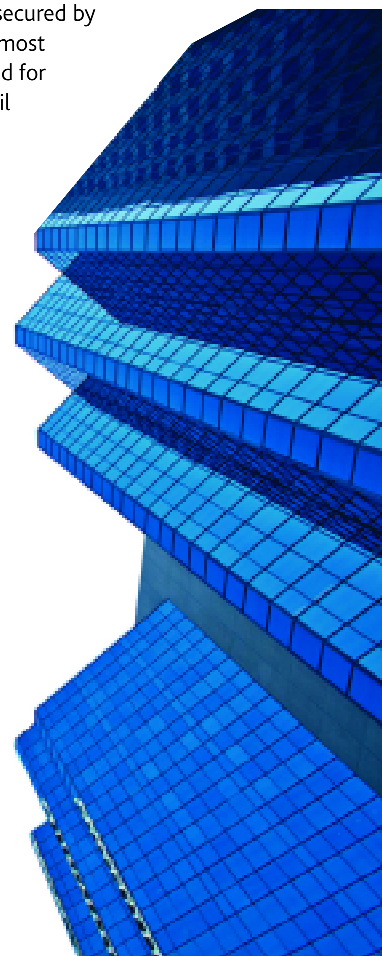
The banking sector's reduction in exposure, the first in more than a decade, is reflected in De Montfort University's most recent report on the UK commercial property lending market. The university first issued data in 1998, since when lending has more than quadrupled. However, after average annual growth of 18% for the first 10 years, the aggregate loan book size secured by commercial property ended 2009 at £228.3bn, a year-on-year rise of only 1.2%, and last year recorded its first decline, to £215bn.

De Montfort also reported that around £28bn of this total loan book consisted of loans in breach of financial covenants. Defaulted loans in the total accounted for a further £22bn. So an estimated £50bn was either in breach or in default of lending terms, reflecting either the post-2007 slump in values or an inability to pay interest.

Bill Maxted and Trudi Porter, who produce De Montfort's study, summarise the UK market as follows in their latest report: "… a lending market that is slowly contracting in size is continuing to experience an acute lack of liquidity which, together with the sustained decline in commercial values from their peak in 2007, prevents organisations from refinancing maturing loans".

They add that such a scenario may be thought to boost the loan terms that those lenders that remain active in the market can command. However, the average interest rate margin for loans secured by all property sectors was lower in mid-2010 than it had been at the end of 2009.

The survey suggests that German lenders are offering the lowest margins across loans secured by the commercial property sector, while in most sectors loan-to-value ratios have increased for loans – the two exceptions are prime retail (which has stayed flat) and residential (which has fallen).



Retrenchment by UK banks appears relatively modest when compared with Ireland, whose peak to trough has been 60% overall but as high as 80-90% for some residential developments and with no immediate signs of recovery. Most banks have imposed a total moratorium on lending and, in varying degrees, are effectively in wind-down, as is ultimately the National Asset Management Agency (NAMA), which was set up as a "bad bank" by the Irish government in late 2009 after the country's property bubble burst.

The UK commercial property market's rather better fortunes are due in part to many of Germany's banks, which stepped in as major lenders via the Pfandbrief debenture market, as previously dominant groups such as Royal Bank of Scotland and HBOS began to lose their appetite. But as Dakin notes, although lending volumes from the German banks were strong over the early months of 2010 there was a noticeable tailing off in the second half,

and the Pfandbrief market has generally restricted its attentions to the top-end commercial properties.

German interest might continue to fade. One of the main players in the British market, HSH Nordbank, is closing its UK property lending arm and winding down its operations here to focus on its core lending business at home. Late last year DG Hyp, part of the DZ Bank Group, said it planned to pull out of all international markets and would close its offices in New York, Paris and Warsaw in addition to London. The announcement surprised many as DG Hyp had been one of the most active lenders in the UK market and involved in several major deals in 2010, including the refinancing of 5 Canada Square in London Docklands.

So this year began with speculation that other German banks might join the exodus, particularly as Basel is sparking mergers and a focus on capital adequacy that does not sit easily with the UK property market's periodic volatility; Germany's own tight planning restrictions provide relatively stable market conditions.

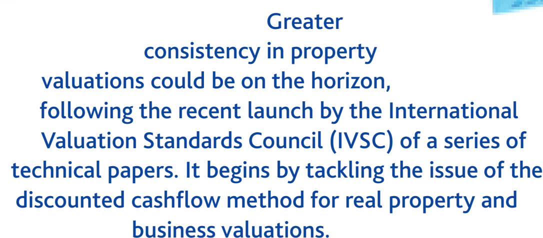
That raises the question of how the resulting gap can be funded while the banks are deleveraging. "There is more equity out there," says Dakin. "There's much expectation also that several major insurers will enter more into the debt market. However, they too are likely to restrict this capacity to the prime end of the market."

Leung agrees there is "an enormous amount" of equity looking to make investments. He says: "The CMBS [commercial mortgage-backed securities] market in its historical form is closed; however, the CMBS market in the US reopened in 2010 and there is a good possibility of a tentative return of CMBS to Europe this year – although they will be much simpler. You also have various mezzanine funds looking to bridge what is available via the senior debt market – generally up to, say, 65% of property value and equity."

The prospects for the commercial property market elsewhere in Europe are similarly clouded, with sovereign debt issues affecting finance and its availability, reports Andrew Grant-Duff, group treasurer for Rockspring Property Investment Managers. "A number of countries, like the UK, have probably come off the bottom, but Greece and Spain remain of concern and Portugal, where a severe austerity package has yet to be introduced, is still falling," he says. "Belgium is also now on the radar regarding sovereign debt concerns, although the Belgian market makes rather greater use of local banks than the major players. Spain has fewer banks willing to lend and those that are price in the cost of funds, so are passing on much higher margins."

This mixed picture is reflected in the European Office Property Clock, Jones Lang LaSalle's regular research on office rents in major

## A consistent approach



Greater consistency in property valuations could be on the horizon, following the recent launch by the International Valuation Standards Council (IVSC) of a series of technical papers. It begins by tackling the issue of the discounted cashflow method for real property and business valuations.

As the IVSC notes, the use of discounted cashflow models – which estimate current values based on anticipated future net income streams – has grown in recent years, but too often they are not fully understood by investors and regulators.

"There are many variations of discounted cashflow models in use in different markets around the world," says Jean-Florent Rerolle, chairman of the IVSC's professional board. "This paper does not attempt to examine or comment on each one of these but instead sets high-level principles to which developers and users of these models should have regard. Our objective is to provide consistency in the fundamental application of the technique while recognising that in dynamic markets there has to be room for flexibility."

“WHILE PROPERTY MANAGEMENT IS VERY MUCH A SEPARATE PART OF THE COMPANY WITH ITS OWN CONTROLS AND PROCESSES, IT IS ALSO VERY MUCH PART OF THE TREASURER’S REMIT.”

cities. JLL reports that European office rents rose 0.8% in the fourth quarter of 2010 and 5.4% for the year, but this figure reflected accelerated rental growth in German and Nordic cities offset by declines for Athens, Dublin, Lisbon and Madrid.

JLL does not expect much difference this year. “While 2011 will see continued improvement, better economic fundamentals are required for sustainable traction in the leasing market,” says Bill Page, its head of European office research.

Modest expectations also mark the tone of Emerging Trends in Real Estate 2011, a report published by PwC and the Urban Land Institute. Its most positive note is a prediction that real estate equity will be more accessible this year as more Asia Pacific investors, insurance companies and private equity funds come into the market, although “they will take a long time to do so and will only partly relieve congestion”.

The PwC/ULI forecast, based on the opinions of 600 industry experts, also pours cold water on hopes that 2011 will prove a turnaround year for European real estate. A more likely scenario is that the gap will widen between “investment hot spots and second-tier property markets”.

**METROPOLITAN MAGNETS** As capital remains so risk-averse, cities such as London, Paris and Munich with robust tenant demand will continue to absorb investment. In line with JLL’s findings, Istanbul, Stockholm, Berlin and Hamburg are also picked as likely investor favourites, and Budapest is one more on the list of those to avoid.

Both the challenges and experiences that corporate treasurers working in the commercial property sector can expect are varied, says Will Cooper, group treasurer at real estate adviser DTZ. They range from the usual issues, such as FX and interest rate exposures, funding and cash management, but also a focus on improving cash forecasting and working capital management nationally and/or internationally. Regulatory issues include supervision by the Financial Services Authority for companies offering investment and asset management, and property managers are overseen by the Royal Institution of Chartered Surveyors (RICS).

“While property management is very much a separate part of the company, with its own controls and processes, it is also very much part of the treasurer’s remit,” says Cooper. “Depending on the size of the organisation that the treasurer works within, they can then expect to be involved in commercial issues in the business, so it evidently presents a challenging and rewarding sector for ACT members to be involved with.”

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