CREFC Europe November Conference, day 2

With the governor of the Bank of England in the news this week after the Bank raised its growth forecast for this year and next, the CREFC Europe Conference keynote speaker on day 2 said it was an “apt day” to be talking about the prospects for the UK economy.

Simon Wells, HSBC’s chief UK economist, suggested that the Bank may have “made its life unnecessarily complicated” over the forward guidance strategy the Bank announced in the summer in an attempt to persuade the financial markets that interest rates were unlikely to rise before 2016. The government asked the Bank to consider forward guidance in the first half of the year, Wells pointed out, when we were still in fear of a triple-dip recession and the government was putting together its Help-to-buy policy to stimulate the housing market. But since then, the economy had rebounded swiftly. “Have we added a further push to the ball that is already rolling down the hill?” he wondered in relation to the housing stimulus.

There was no doubt in Wells’ mind though that the growth coming through now was no “false dawn”. The data is stronger; in fact the Q3 0.8% and Q2 0.7% GDP figures were ones we “could only have dreamt of in 2012” and there has been a rapid turnaround in consumer confidence that was about more than the feel-good factor of Andy Murray winning Wimbledon!

What he did query was the sustainability of this pace of growth. This year’s recovery is largely consumer-led and fuelled by consumers saving less, rather than through wage growth (real wages have fallen for four years), which at some point “has to stop”. Meanwhile, there has been a complete lack of rebalancing of the economy that is still needed. Manufacturing has fallen by 9% since 2007 and the UK is more reliant on services than before the crash, while the current account deficit is at its worst since 1989.

On the key question for real estate of when interest rates will start to rise, Wells felt it was still unlikely that the Bank will move earlier, despite being wrong footed by its key measure - unemployment - falling faster than expected. He said the “knockouts” the Bank has at its disposal to avoid raising rates, including higher inflation or its prospect, development of a housing bubble, or simply the slack in the economy and the fact that the growth coming through follows “such a long stagnation” would allow the Bank to take take its time. This economist’s prediction is that rates won’t rise in 2014 and are “pretty unlikely” to rise in H1 2015. “The earliest the bank will tighten policy is the back end of 2015”.

Wells reiterated, as yesterday's speaker from the Bank of England, Oliver Burrows had pointed out, that the Bank's financial policy committee has its own tools "that they would be keen to use to control pockets of instability rather than changing interest rates". Then of course, there is an election in 2015.....

Views from borrowers and lenders

Ken MacNaughton made one of the memorable comments of the day in the first of three interlinked sessions on borrower and lender perceptions of the lending market. Benson Elliot's chief financial officer said he was receiving up to 20 positive responses/term sheets for some deals, illustrating just how strongly liquidity has returned to the debt markets: "Three years ago we would have had two or three offers, and one would have been just a means of getting on the page for the future. Now we're getting, 12, 15 or 20 positive responses that we can narrow down to a strong shortlist".

Borrowers from Hines, Quintain and Ares who also gave their views on the market were all seeing a much more positive lending environment. Liquidity is abundant for core deals and margins have come in by more than 100 basis points for core and core-plus London deals this year.

Both borrowers and lenders feel more positive about fundamentals, with "European political uncertainty starting to recede" according to MacNaughton. "This gives us a great deal of confidence that we're on the same page to get what suits the business, and a key focus is the right calibration between debt and equity so that we can quickly progress initial asset management initiatives - and then talk to lenders about more attractive terms than had we financed at close".

This has also given lenders the confidence to branch outside core markets into Spain and Italy over the past two quarters.That said, Ian Brown, Hines' UK finance director, would like to see more lending in Ireland after he recently secured six term sheets there "at a struggle".

What came across in the borrowers session, was that as well as maintaining relationships with existing banks, borrowers are broadening their sources of funding."We're having more conversations with investment banks with a sell down model and have even seen the return of some lenders, like the French banks. And I'm astonished at the number of hedge and debt funds that come to visit," said Brown.

Panel moderator, CREFC Europe's new chief executive Peter Cosmetatos, noted there seemed to be "a general sense of optimism and a mix of valuing existing relationships and really liking all the diversity and breadth that has appeared in the market recently".

Borrowers feel it's important to develop new relationships and "give people a look" explained Brown in light of the traditional banks having gone away over the past couple of years."It's tricky to know which banks are prepared to work on innovative and creative solutions for value added deals where there are income gaps," he admitted. In these situations, "we will talk to new entrants".

However, Max Sinclair, head of Wells Fargo lending in the UK, warned "debt funds may be too late in the game given the way margins have responded to market stimulus over the last six months". Deutsche Bank's Gad Caspy felt there was currently too much capital chasing too few opportunities, although refinancing will mean there is enough market share for all participants over time. "If you are patient, you'll be able to do mezzanine again at 9% as opposed to 7-8% today."

The picture is not so rosy regarding refinancing from borrowers' point of view. It's frustrating "when your debt is given to a work out team within the bank, or a servicer, that you don't have a relationship with. 'Dialogue' becomes a series of ultimatums; it's been tough," said Mike Pashley, Ares Management's European CFO. His experience has been particularly difficult, since the firm hadn't been told by its bank that one of its loans was in a portfolio that is up for sale. "Banks have to realise there's a situation where relationships need to be dealt with," he insisted.

The entrance of insurers “in scale” has been the biggest impact for Hines. The private firm secured £170m last year from a single insurer. Yet, panelists highlighted the new challenges brought in dealing with insurers: namely fixed-rate deals and prepayment penalties.“We need flexibility to sell out in due course,” said Brown.

With more capital out there, pricing is becoming more competitive and there is renewed appetite for the secondary market. Pashley reckoned margins had come down from 350 bps to 225 bps on a 65% LTV, for example. For core London deals, pricing falls into the 175-200 bps range added Brown.

Lenders see the market heading for “normalisation” however, said Deutsche Pfandbriefbank’s Charles Balch. “Pricing has tightened but there’s little further it can go,” believed John Feeney, global head of corporate real estate at Lloyds. “Return on capital is a key driver for banks, which puts a floor on pricing”. What banks will focus on next year, they agree, is distribution models.

Leverage has come down overall, acknowledged Pashley. But the cost of borrowing is still at an all time low commented Caspy. “We can still make our [high teen] returns using stretched senior and mezzanine”, assured Pashley.

Insurers - a new force in CRE lending

A whole session was devoted to the growing presence of insurers lending on European real estate, and chair Catherine Webster of TIAA-CREF asked her panel how their culture differed from banks.

Drew Abernethy, principal at Pricoa Mortgage Capital, said that as Pricoa is a fixed-rate lender, on 5-15 year terms, “the culture is taking long-term views and not placing a lot of confidence in where the market is today. We spend so much time talking about cashflows rather than values with our credit committee which plays into yesterday’s discussion about long-term sustainable values (a recommendation of the ‘Vision’ report). In a way, that is what we are doing already”.

MetLife which also brought its US platform to Europe is focused on “making sure we can exit, say in seven years’ time when interest rates are not (going to be) so low” said managing director Paul Wilson. He added, though, that MetLife’s product is “flexible; we could do a three-year floater or 10-year fixed”, he said.

This didn’t necessarily mean insurers were more conservative than other lenders. Wilson said MetLife preferred core deals but had taken B notes in the UK and mezzanine in the US. “In the US we’re used to multi-tenanted offices with lots of rollover and we don’t have LTV ‘boxes’. Though most of our deals have been 50-65% LTV we could go higher and that’s about being paid for it. We do like to see income coming through”.

Aviva Investors, which has lent fixed rate debt in the UK since 1984 on behalf of its in-house annuity business, recently branched out into investing for other clients via a senior debt fund. Aviva’s James Tarry said lease terms didn’t necessarily have to match the loan term, citing City landmark Tower 42, which Aviva financed last year with a 20-year term loan but where most of the leases are short-weighted. Lloyds Chambers, a City fringe building that Tarry financed recently for the new debt fund which lends 5-10 year money, is “a transitional asset” he said.

Another perception of borrowers is that insurers are less flexible than floating rate lenders because of their requirement for yield maintenance said Webster. This was true in Pricoa’s case, Abernethy said, “because we fund everything in dollars and an early pre-payment makes it expensive”. “We have to consider the liability match of our investors” said Roland Fuchs, Allianz’s new head of European real estate finance. He said it was “easier to absorb a standard pre-payment” in a higher margin, higher loan-to-value deal “where there is more flexibility to play the yield”.

“We focus on the right borrowers” Abernethy added. “Otherwise pretty early on the meeting can go

cold and they start talking about soccer or the weather".

Allianz now has €1.5bn invested in European debt, mainly in Germany and France though it is also targeting Central Europe, Benelux, Italy and Spain. "Expansion into debt is part of diversification for our investors" explained Fuchs. It is also "to leverage existing relationships with sponsors, and to benefit from a different point of entry to markets that might be too hot from the point of view of equity investing".

The audience plainly felt insurers would play a bigger role in European real estate finance, despite, or because of, the differences. Nearly 70% thought 10-20% or more was a healthy share for the sake of diversity. Most of the panel said they had teamed up with banks to make loans and regarded themselves as complementary rather than competitors.

CMBS 2.0 - how will it be different this time?

In a discussion on CMBS 2.0, the audience's estimation of transaction volumes next year, €5-10bn, fell short of certain panellists' more optimistic view - €10-15bn according to Brookland Partners' managing partner Nassar Hussain. Hussain, it is worth mentioning, correctly predicted this year's level at a previous conference - when 80% of the audience thought he was too bullish. Already, 2013 has seen €7.7bn of issuance with three deals in the pipeline, (Hussain's prediction for 2013 was €5bn-€10bn), which is on track to end up at 2003 levels.

Putting the issuance into context, Hussain said: "CMBS was in a dark place 12-24 months ago. Today, it's got a good foundation to restart the market." Referring to similar a trend in the US, Ravi Joseph, managing partner of servicing firm Mount Street, noted "this could be a natural progression back to a healthy market".

Robert Marshall, head of ABS credit research at M&G, qualified the return of CMBS as the point at which there is diversification in relation to parties and asset classes. "We need the bank origination machine to creep back into life," he said. "Although it's understandable that banks' credit departments are queasy about committing resources to make that happen", he admitted.

"Banks' cost of capital for holding these loans is considerable when it's by no means clear they're going to be able to get if off their balance sheet quickly" reminded Peter Voisey, Clifford Chance partner. "A lot of investors got badly burnt in the last cycle".

Marshall also denied that a "meaningful step forward [had been made] in the simplification of structures". What's more, new deals have been "dominated by a small number of investors with deep pockets". His advice was: "We need market participants to stop being too cute; we need to put together less complex deals to attract new investors".

Wells Fargo managing director Caroline Philips' concern centered on the problems created by pushing for greater disclosure in new deals under CMBS 2.0. "It's a sensitive area involving issues of confidentiality. I worry if you bring disclosure into the public arena it could put off borrowers unless there's a clear benefit to securitisation from a pricing standpoint," she said during a later discussion on loan servicing.

The role of valuations in legacy CMBS deals was discussed in a panel chaired by LBBW's senior manager Craig Prosser. Two problems for many parties is that there haven't been enough valuations and, in relation to those that were commissioned, lack of explanation about the basis on which valuations were undertaken, points raised by both Barclay's research director Christian Aufsatz and Fitch's Euan Gatfield.

"Lack of updated valuations through the crisis meant we had to look at deals from scratch from the bottom up" Gatfield said. "We have developed an autonomous set of property assumptions that doesn't rely on reported values, but instead on long term trends visible in historical data on rents and

yields. It is not that valuers are wrong, but simply that they are answering a different question to the one debt investors should be asking. I broadly agree with the insurers' panel earlier which focused not on where values are today, but on where they may be at loan exit".

"There can be very good reasons why the security is not worth what it was at the outset" said lawyer Georgina Squire of Rosling King. "But sometimes it was because the original valuation was overstated by such a margin that it was negligent and claims can be brought against the valuer".

The valuer on the panel, Nick Knight of CBRE, outlined the dramatic and often rapid changes in UK property values over the last 10 years and remarked on how, after the last couple of years when prime values were recovering in isolation, there has been a marked change of sentiment again since May or June. "There is renewed interest and trading volumes in more secondary and regional markets, accompanied by new availability of debt. We've seen more demand and there is tentative evidence of prices starting to rise in the regions" he said. "A valuer is an observer of the market at a key point in time and I hope I've brought out that valuation conditions do change fast".

Hugo Raworth, managing director at Situs, thought "the argument here is about the application of valuations". He said he had seen special assumptions in legacy deal valuations, for example valuing on the basis of an acquisition of the assets in an SPV - thereby reducing stamp duty and increasing the value - in circumstances that were not appropriate.

CBRE has the largest market share of any UK valuer and Knight's UK team has 200 valuers. He was asked about his views on the recommendation for using long-term sustainable valuations for lending, proposed in the 'Vision' report. "I clearly recognise the importance from a lending perspective of trying to understand how an asset is going to perform over the life of a loan" he said. "And it may go some way to help. I would probably favour a more regular (Red Book) valuation regime".

Summing up

Four key themes stood out for new CREFC Europe chairman Peter Denton who wrapped up the conference with co-chairs Ravi Joseph, Catherine Webster and CREFC Europe's Peter Cosmetatos. They were: the more encouraging macro-economic picture, painted by the keynote speakers; the striving for financial stability as proposed in the Vision for real estate finance in the UK report discussed on the first day and developed by Oliver Burrows from the Bank of England; the continuing dialogue about lessons from the CMBS market; and the rapid evolution of the lending market.

Joseph and Webster both agreed they were struck by the changes in the diversifying lending market: "It's clear there is an anticipation of more to come in terms of the amount of capital available from lenders and their wider variety", Joseph said, "though I'm still not all that clear about what and where it's available for." "When you hear of 15-20 term sheets, I think that's the definition of liquidity in the market" added Webster.

Asked about which aspects of the 'Vision' report delegates had been discussing since it was unpicked on the Conference's first day, Peter Cosmetatos thought the loan database and long-term sustainable valuation recommendations. The second "gets misconstrued because people think its about getting rid of market values, which it isn't" he felt. "It's intended to provide an additional reference point, giving context for market value against the cycle, as well as allowing regulatory capital rules to work in a more risk sensitive and counter-cyclical way".

Joseph said one surprise to him, taken from the panel on CMBS 2.0, was that the outlook on capital markets seemed surprisingly cautious. "There was no unanimity about the right way to do deals going forward".

Nevertheless, CREFC Europe's chairman was "excited about the optimism and the sense we are moving from one point to another, in a real state of flux". He was keen for the industry, helped by CREFC, "to ingrain the lessons of the last few years and not to lose them. As he said in his introduction to day 2, "We are at a pivot point, not far enough removed from the crash to forget the

worst, but in a new market where we can apply those lessons”.

Lauren Parr and Jane Roberts, Real Estate Capital