‘Like the end of the world’

When Lehman Brothers failed, banks’ real estate lending units pulled down the shutters. The implications are still being dealt with a decade later, writes Doug Morrison

Ten years on, the collapse of Lehman Brothers and the shock waves that reverberated around the world still evoke strong memories for Peter Denton, finance director of Hyde Housing, who was at the time a leading UK real estate debt financier.

Denton recalls the gloom among business acquaintances and colleagues at German lender WestImmo while attending EXPO Real in Munich, the first major property gathering following that dark day on 15 September 2008 when Lehman filed for bankruptcy.

“Lehmans had gone, Hypo [Real Estate] had gone, and RBS was wobbling,” he says. “It just felt like the end of the world. We were genuinely trying to transfer our personal deposits and cash into HSBC. There was a common theme that if HSBC went under then we’d be knocking things together to make fire.”

Around the same time, former Merrill Lynch head of real estate trading, Nassar Hussain, was working in private equity, based in Dubai, and “getting the odd text message from friends in London: ‘if you have a deposit with RBS, you should think about moving money to another bank”.

The bankruptcy of such an iconic banking powerhouse as Lehman brought the world’s financial system to the brink of collapse, completely shaking confidence in the sector for years to come. But in those first weeks and months, it was turmoil.

“People were being let go,” recalls Hussain, now managing partner at London-based real estate investment banking firm Brookland Partners. “Organisations weren’t necessarily set up to deal with the issues that they had because the people that had originated many of those positions were no longer around. Many organisations were just trying to figure out what they had.”

It was partly the banks’ rapidly disappearing skills base that prompted Hussain to return to London and launch Brookland in early 2009, initially as a specialist real estate debt advisor. “Debt dried up relatively quickly,” he says. “There were high-quality, fully performing deals which, because of their size, couldn’t be refinanced. And then you had deals that were obviously distressed and needed restructuring.”

In New York, it was a similar scene. “By the end of 2008, liquidity seized up – because after Lehman, the money market flow of funds broke down,” says Chris Lee, KKR’s head of real estate America, who was then a vice-president in Goldman Sachs’ Real Estate Principal Investment Area. “From a real estate perspective, by the beginning of 2009 there was literally no liquidity. Banks were not making loans, a lot of alternative lenders were under water, and new alternative lenders in the US had not emerged yet.”

This was, of course, the chaotic start of the global financial crisis, from which, to a greater or lesser extent, the major economies are still recovering and only because of unprecedented intervention by governments and central banks. Interest rates have remained lower for longer, quantitative easing will remain in place in Europe until the end of the year.

EXUBERANCE

Over the past decade, banks around the world have strengthened their balance sheets, held more capital and invested in risk management, all largely due to greater regulation – the quid pro quo for huge bailouts by the taxpayer. “No more Lehmans,” declared former US Treasury Secretary Timothy Geithner, setting the regulatory tone in the early days of the crisis although it was only last December that a global agreement was reached for the final Basel III package of capital requirements for banks.

Yet anyone with a real estate perspective tends to look back beyond 15 September 2008 for some context here, specifically to 2007, or as Lee puts it, “the absolute peak of exuberance in the real estate capital

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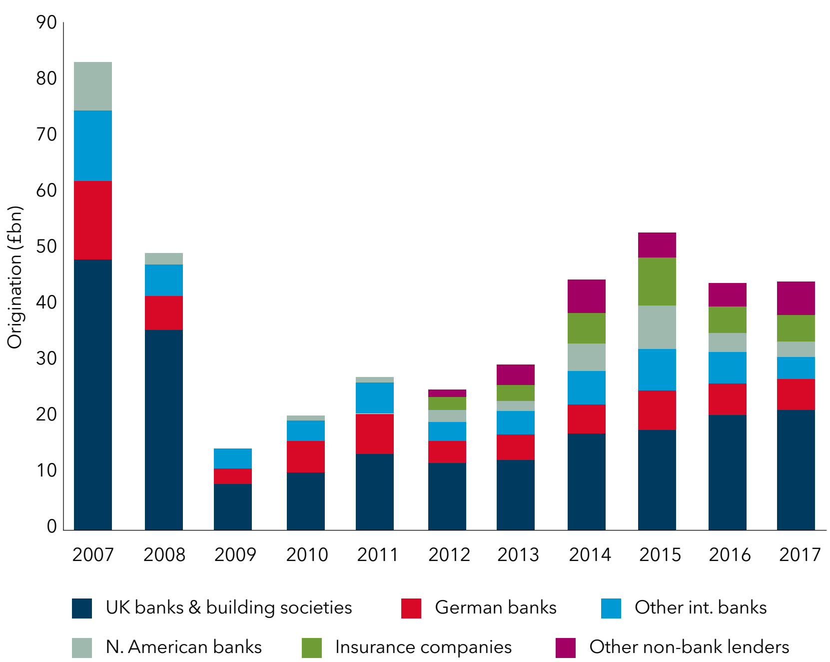
markets". Such exuberance lay at the heart of Lehman's troubles, not least its $23.7 billion leveraged buyout of Archstone, one of the largest owners of apartments in the US.

"A lot of damage was done in the first two quarters of that year because valuations were extremely high, not based on fundamentals but how much leverage people could get – and how cheap the leverage was – and a lot of irrational expectations of future growth," says Lee. "The structure of that debt was also quite lax. Values dropped and that paper traded, and there were significant mark-to-market losses and in many cases realised losses on paper that was created in the first half of 2007."

Yet, for at least a year before September 2008, there had been a global credit crunch. The US economy was already blighted by the subprime housing mortgage crisis, which ultimately forced the US Treasury in the week before Lehman's collapse to place the

UK MARKET MIX

UK commercial property lending, indicative of the European trend, plummeted after 2008, although the composition of lenders has become more mixed.



Source: Cass UK Commercial Real Estate Lending Report two largest multifamily lenders, Fannie Mae and Freddie Mac, into conservatorship – where they remain. Six months earlier, JPMorgan Chase & Co completed a rescue takeover of Bear Stearns following emergency talks brokered by the US government. Bank of America Corp extended a similar corporate lifeline to Merrill Lynch the same weekend that Lehman crashed.

Given the rocketing real estate values on both sides of the Atlantic, there were enough warning signals in the year leading up to Lehman's bankruptcy, if only the bankers paid heed. Some did. Before moving to Dubai, Hussain, while managing director at Merrill Lynch, exited all his European real estate positions by early 2007.

"By 2006, the market was clearly becoming overheated and that was reflected in both the debt terms and the lack of alignment between pricing and risk," he says. "Lenders were aggressively trying to outbid one another, not only CMBS lenders but also the commercial banks. A number of commercial banks and building societies were buying junior debt, and I'm not sure they were the right type of organisations to be building exposures to higher-risk debt."

Ten years on, have lessons been learnt? The question becomes increasingly pertinent the longer lenders and borrowers work their way through this current economic cycle – during which, real estate has outperformed other asset classes, yet pricing of prime property is a widespread issue today in major European cities. There have been well-aired concerns, too, about the health of the banking sector in some countries – notably Italy – and specifically Deutsche Bank, which is currently trying to shake off comparisons with Lehman following years of poor financial results.

Brian Stoffers, CBRE's veteran global head of debt and structured finance, recalls the early stages of recovery in the US when real estate only attracted "the more progressive banks" that had relatively clean balance sheets. "They viewed it as an opportunity to provide some liquidity at nice yields," he says. US real estate lending has since recovered strongly, although, as Stoffers acknowledges, this late in the cycle and with the prospect of rising interest rates, risk and returns must be adjusted accordingly.

A BIGGER CUSHION

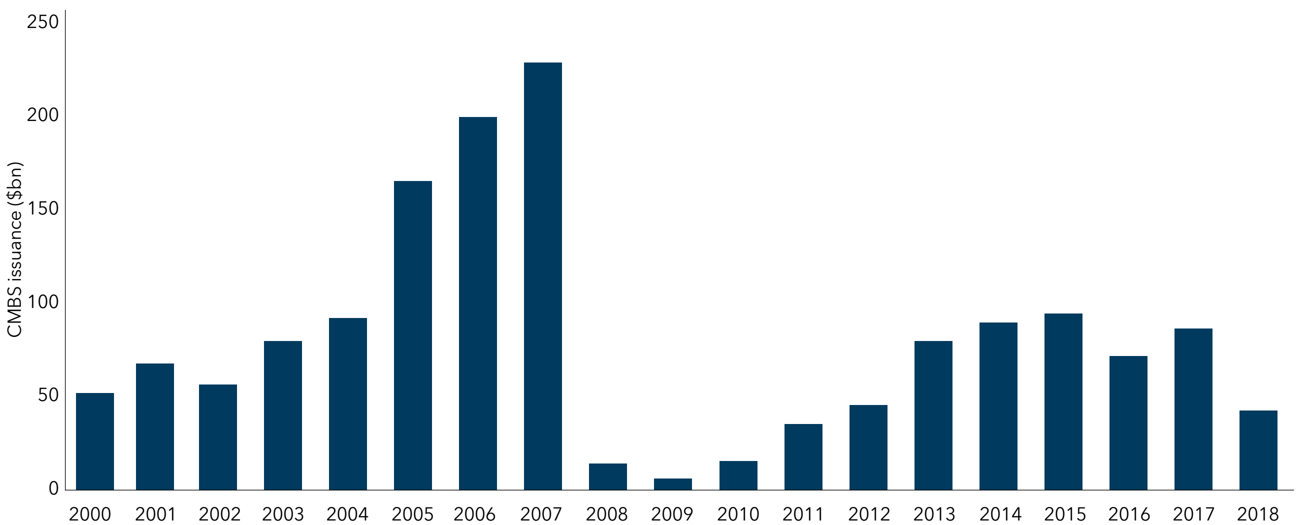
"History has a way of repeating itself," he adds. "But what I would say – and I've been through five cycles in my 37-year career – is that this time around I don't see the overbuilding I've seen in the past. I don't see the crazy capital coming and very high leverage levels. I see a lot more equity in transactions than I have in prior cycles, so that gives me relief that there is a bigger cushion. But I do think there are pockets of risk."

According to KKR's Lee, what the world saw through Lehman was a banking system "so levered and so interdependent on the maintenance of valuations at very high levels" that it did not have enough capital to shock-absorb when there was a period of extreme volatility and price declines. "In the current environment," he says, "you can still have people make mistakes or bad decisions but what the regulations have tried to do is not have some bad decision-making in one place bring down an entire global financial system."

Lee adds: "There's a lot more discipline

US PEAK AND TROUGH

US CMBS issuance, indicative of overall commercial real estate lending activity, has not returned to peak levels, post-Lehman



Source: Morningstar/CREFC

in the banking system. A lot of riskier assets are not being held on the balance sheets of banks, and the incentive models today for people who originate these riskier products are much different at banks but also outside of banks. Most people who originate risk are also holding that risk, versus the model pre-Lehman's bankruptcy, which was to originate risk to distribute. That's a very different paradigm today and creates a different level of discipline because if you originate something and hold it, you own the outcome."

Some potential borrowers are losing out from this discipline. Brookland's Hussain points out that, in the UK, many banks are reluctant to provide small loans, bridging loans or undertake intensive but low-margin business due to increased costs caused partially by increased regulation.

One positive by-product of the banks' caution, however, has been the emergence of a new wave of alternative lenders – from debt funds to well-capitalised insurers. They may not entirely fill the funding gap left by the banks but as Denton and Hussain agree, they bring diversity and a spreading of risk.

"There is a cycle here, and people will lose money," says Denton. "But what we should care about as a country is not that individuals lose money, because they take the risk to get the return. But rather, is it likely to have a material impact on us all because it's our main clearing banks that are exposed? And I just don't think that's the case."

As Hussain suggests, debt capital markets today benefit from a diverse range of lenders and "generally speaking a moderate level of risk exposure".

He adds: "You also have a lot of experienced individuals who are aware that they spectacularly misjudged both the coming and the long-lasting impact of the downturn, and that in itself creates a certain amount of control. The danger, as always, is that, over time, those experienced individuals are no longer around or are ignored, and then the same errors are repeated." ■

The rise of non-bank lending in Asia

The emergence of alternative lenders as a force in real estate finance has been one of the post-Lehman legacies, and their influence is destined to grow in Asia-Pacific, according to one of the region's key players.

"The market is continuing to drive the growth of alternative lenders," says Robert Scholten, head of real estate finance Asia-Pacific for ING. "We see strong investor activity in Korea and Japan for debt-fund products, and strong appetite from such funds for assets in gateway cities in Japan and Australia."

As in other regions, says Scholten, the alternative lending movement has gathered pace due to increasing liquidity among insurers and debt funds as they fill the post-crisis funding gap left by banks. But he points out: "A key factor in their growth has been the fact that they are able to be more competitive than traditional banks tenor-wise, often willing to offer loan tenors of seven years and upwards, depending on the quality of the asset."

Scholten points out that the development of alternative real estate lending still depends to a large extent on the needs of the borrower. "Clients who require more flexibility may prefer to work with a bank that offers a tailor-made financing solution. Alternative debt providers, at this juncture at least, require a debt product which is relatively less flexible, functioning more like a bond with set terms, rather than a structured loan which a bank is able to provide."

According to Scholten, the rise of alternative lending in Asia-Pacific is largely because the region suffered similar problems in the financial crisis as Western markets. Liquidity very quickly dried up and finance became

> "Banks and investors are more alert to the refinancing and liquidity risks associated with debt"
> **Robert Scholten, ING**

a major challenge due to increased costs. Asset valuations were negatively impacted as yields climbed, which led to LTV ratio breaches, rights issues to repay or reduce debt, and resetting of transactions. "Several international financial players withdrew operations or stopped real estate lending in some parts of Asia, which then forced borrowers to seek alternative financing solutions at significantly higher margins," he says.

Today, says Scholten, Asian real estate finance generally is "clearly in better shape than it was before, regulatory-wise", and more transparent: "Banks and investors are more alert to the refinancing and liquidity risks associated with debt, LTVs are lower, and financing structures are tighter."

He adds: "Banks have evolved their strategies. Banks are more thoughtful about the selection of sponsors during the deal evaluation process. There is greater emphasis on knowing clients and how to support them through the cycle: banking is becoming less transactional and more relationship-driven."