Key Findings

Welcome to the third issue of the Market Trend Analysis from Link Asset Services.

This year we analyse the visible market trends through our datasets across the last three years and assess market prospects for 2019 as a whole. As with our last report, we focus on lender sentiment, appetite, intentions and projections for the year ahead.

Many thanks to all of our respondents.

There is caution amongst lenders
As they consider prospects for 2019, noticeably fewer are expecting to grow than in previous years. Amortisation is also the subject of renewed focus.

Asset values are expected to fall in both commercial and residential markets
Commercial values are expected to be under the most pressure during 2019.

Bridge loans become cheaper
This is perhaps owing to the short durations which can provide greater asset liquidity in an uncertain market.

Many lenders are retrenching into core markets and products.
Most selected fewer geographic areas and fewer asset sectors as a preference.

The provision of longer term debt continues to grow
Supply is perhaps still outweighing demand for very long term loans.

Lenders are looking for bigger tickets
Some of the best loan pricing is only available on significant transactions.
The number of lenders expecting their origination teams and loan volumes to grow in the year ahead fell quite noticeably, by -10% and -18% respectively. This is significant as the data had previously been consistent showing just a 1% variance in both from 2017 to 2018. Although not as strong as 2017, it is recognised that 2018 was another good year for transactional volume; this supported very strong debt origination. Lenders are clearly less confident about their prospects in 2019 but still see upside possibilities on origination volume. This is broadly in line with market consensus which indicates a soft landing despite the continuing risk of a no-deal Brexit.

Respondent Expectations

There is a very strong consensus for the UK Base Rate and UK Treasury Gilts to remain stable during the year. Most respondents had forecast an increase in last year’s survey and that was realised in the latter part of 2018, although Gilt rates have since declined. This year’s predictions are in line with market forecasts.

Leverage and pricing are expected to remain similar for the next 12 months with most risk highlighted on the downside to LTVs. Despite the market risks, transactions are taking no longer to complete than they were a year ago, still averaging 52 days from agreeing terms to drawdown of funds.

Notably, the vast majority of respondents are now forecasting a decline of more than 2.5% in both residential and commercial property prices in the year ahead. Interestingly, commercial prices are anticipated to be under greater pressure than residential prices in 2019 which is a reverse on last year’s forecasts. Three quarters of all respondents believe commercial property prices will decline by more than 2.5% in 2019.

Unsurprisingly, Brexit has dominated respondents’ market fears, with 51% of respondents considering it the greatest risk in the year ahead. A whopping 74% highlighted UK political dangers with the top three answers being Brexit (51%), a change of Government (14%) and general political uncertainty (9%).
Leverage & Pricing
– Investment Loans

Last year, two thirds of respondents expected LTVs to remain stable in the UK market. Heading into 2019, we’ve seen average maximum LTV across all loan types drop by a modest 2% from 2018 data to 69%.

Alternative Lenders offer the highest average maximum leverage at 80%, up from 76% last year, taking over from Debt Funds, whose leverage has declined to 77% from 83%.

Pension Funds maximum leverage fell by 17% to 60% LTV, the largest decline ever recorded. Some Pension Funds do not have specific real estate debt origination functions, but rather bundle all ‘alternative investments’ into a single origination unit. Several have taken a step back on real estate lending and are investing into other alternatives which are seen to offer a better risk-reward balance at present. It will be interesting to see if this trend continues as the government seeks to increase options for illiquid asset investment.

Mezzanine leverage has fallen slightly, being limited to an average of 80% LTV with some providers stretching as high as 85-90% before entering preferred equity territory.

European Banks are increasingly competitive, pricing Senior Loans at an average margin of 175bps alongside Pfandbrief Banks. However, on average, Pfandbrief Banks will still provide the lowest cost overall as their average arrangement fee is 63bps compared to 75bps for European Banks. Pension Funds, at 200bps, and Insurance Companies, at 204bps, are also offering very competitive senior pricing.

Interestingly Bridge Loans have become significantly cheaper this year, with margins declining 275bps to now stand below 750bps as an average. This certainly correlates with Link’s experience in the market. Lenders have increasingly come to view the short term nature of these loan assets as a liquidity benefit in an uncertain market.

The cheapest Mezzanine Debt is available from North American Banks who also offer the best priced Whole Loans and Bridge Loans. However, you’ll need a large ticket to attract that pricing as their average minimum ticket size is £32.5m.
Leverage & Pricing

– Development Loans

Alternative Lenders offer the highest leverage for development finance in 2019, leading the way on both maximum LTC (87%) and LTGDV (71%). However, that comes at a price as average development margins for this category are over 1100bps.

The lowest cost development finance is provided by different lenders depending upon the type of project being financed. As with last year, we have examined the best financing options for development projects under the given assumptions including margin, arrangement, exit and non-utilisation fees.

Despite offering limited leverage, European Banks provide the lowest cost development finance across all types of commercial scheme as well as Residential Development for Hold & Rent. Middle Eastern Banks offer the cheapest financing for Residential Development for Sale and UK Banks are the best priced of lenders which consider Land Loans both with and without planning.

ICR covenants continued their downward trend this year with lenders requiring lower interest cover. However, unusually, we saw DSCR covenants tick upwards, meaning a convergence of ICR and DSCR. We had not expected to see a decoupling of these indicators, which may suggest a greater focus on amortisation of debt during loan terms. This new trend is certainly one to keep an eye on.
For our ‘relative value’ chart in development loans we have used what we consider to be the most important indicators of leverage and pricing; average maximum LTC and average margin. The best ‘relative value’ in development loans is offered by Hedge Funds who dropped pricing significantly from 952bps to 590bps but kept leverage relatively unchanged at 80% LTC versus 81% LTC in 2018.

Interestingly, we have two lender categories which have ceased development lending; North American Banks and Pfandbrief Banks. We believe this is driven by the cautious approach of both in the short term to UK market. For North American Banks this is because they are primarily operating an ‘originate to distribute’ lending model which has been impacted by the weakness in UK securitisation and syndication markets in the run up to Brexit. For Pfandbrief Banks the caution around the UK is primarily legislative as there is some uncertainty as to if and how UK loans can be eligible for Pfandbrief post-Brexit. In contrast, Insurance Companies broadened their lending scope to include Development Loans for this year. For now, they offer poor ‘relative value’ overall but we will see how this lender category matures into development lending in the future.

 Availability: Development Loan Types

<table>
<thead>
<tr>
<th>Lender Type</th>
<th>Residential Dev for sale</th>
<th>Residential Dev for Hold &amp; Rent</th>
<th>Commercial Dev 100% Pre-let</th>
<th>Commercial Dev Part Pre-let</th>
<th>Commercial Dev Speculative</th>
<th>Land Finance with planning</th>
<th>Land Finance without planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK Bank</td>
<td>78%</td>
<td>57%</td>
<td>21%</td>
<td>7%</td>
<td>21%</td>
<td>7%</td>
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<tr>
<td>Pfandbrief Bank</td>
<td></td>
<td></td>
<td>50%</td>
<td>50%</td>
<td>25%</td>
<td>14%</td>
<td></td>
</tr>
<tr>
<td>European Bank</td>
<td></td>
<td></td>
<td>25%</td>
<td>14%</td>
<td>14%</td>
<td>14%</td>
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<tr>
<td>Asian Bank</td>
<td></td>
<td></td>
<td>50%</td>
<td>28%</td>
<td>14%</td>
<td>14%</td>
<td></td>
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<tr>
<td>Insurance Company</td>
<td></td>
<td></td>
<td>50%</td>
<td>35%</td>
<td>47%</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Debt Fund</td>
<td>47%</td>
<td>47%</td>
<td>47%</td>
<td>47%</td>
<td>47%</td>
<td>47%</td>
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</tr>
<tr>
<td>Peer to Peer Lender</td>
<td>85%</td>
<td>50%</td>
<td>16%</td>
<td>47%</td>
<td>50%</td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Hedge Fund</td>
<td></td>
<td></td>
<td>50%</td>
<td>35%</td>
<td>50%</td>
<td>33%</td>
<td></td>
</tr>
<tr>
<td>Middle Eastern Bank</td>
<td></td>
<td></td>
<td>50%</td>
<td>33%</td>
<td>50%</td>
<td>33%</td>
<td></td>
</tr>
<tr>
<td>Alternative Lender</td>
<td>76%</td>
<td>38%</td>
<td>38%</td>
<td>38%</td>
<td>50%</td>
<td>38%</td>
<td></td>
</tr>
<tr>
<td>Pension Fund</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td>50%</td>
<td></td>
</tr>
</tbody>
</table>

This chart shows the proportion of responding lenders who can fund various Development Loan types. Land without planning remains difficult to finance and speculative commercial development has become significantly more challenging to find lenders for.

Availability – Sector & Geography

Notably, we have seen a decline in preference across all sectors; it appears lenders are retrenching to their core market segments. This might be a further sign of caution.

Industrial/logistics moved up to second place behind office perhaps explaining, in part, the Midlands similar rise in lender appetite. The retail sector had shown one of the largest declines in preference last year but in 2019 it is the clear loser amongst all sectors as it falls from second to fourth.

Availability: Sector Preference

- No lending appetite
Loan Maturity & Ticket Size

For investment loans, we have seen a clear increase in preference for longer term debt, particularly 10 years+. More lenders than ever are offering loans of 10 years+ with a steady increase since 2017, 3-5 year loans remain the most keenly supplied type of funding.

Maximum loan amount has increased exponentially for investment loans from an average of £134m in 2017, to £154m in 2018 and up to £226m in 2019. There are now five lender categories which can lend a maximum of £500m or more on investment loans.

Loan Maturity - Investment loans

Average Maximum Ticket Size

Maximum Investment Loan Ticket Size by Lender Category

Maximum Development Loan Ticket Size by Lender Category
The Real Estate Finance division of Link Asset Services can source, secure and structure finance for investors and developers. Connected with almost every major real estate lending institution active in Europe, we aid our clients in establishing long-term relationships with the most suitable lenders on optimal financing terms. Using an established, targeted process we help to move transactions along quickly and efficiently providing end-to-end assistance.

Link Asset Services is part of Link Group and provides the infrastructure to help capital flow through financial markets. We process £45bn of payments annually and are the largest independent loan servicer in Europe, with over £100bn of commercial and residential loans under management.

Our annual report is part of an initiative to increase knowledge and transparency in the UK lending market. The research is based on the collection of primary data over the first two months of 2019. The anonymous open market survey was sent out publicly, resulting in a data set of 100 respondents from 81 separate lenders active in the UK Real Estate Lending market. This means that our data comes direct from lenders, giving a true reflection of their expectation, capacity and appetite for the year ahead.

Ours is the largest dataset of any report on the UK real estate finance market.