Welcome to the inaugural Market Trend Analysis report from Capita Real Estate Finance

This uniquely forward looking report, which is based on appetite, intentions and projections, documents the current market for real estate finance and the key trends. It is based on detailed lender survey data.

Many thanks to all of our respondents.

Key Findings

- Hugely diverse lender pool with 12 distinct lender categories
- Stability in pricing and leverage forecast to continue with increasing loan origination volumes
- A divergence in pricing between lender categories means there is more of a relative value consideration for borrowers to make
- Long term borrowing is well priced at the moment but fewer lenders are able to provide it and income covenant requirements on such debt are high
- Almost everything is financeable – black spots of availability exist where two or more negative deal aspects combine (e.g. undesirable sector plus weak location)
- Allowing a longer time to complete a financing can result in superior pricing
- Very little macro nervousness - Lenders have broad ambitions to increase loan volumes as well as manpower

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Capita Asset Services is Europe’s largest independent loan servicer. We are connected with almost every major real estate lending institution active in Europe. Real Estate Finance focuses on structuring, sourcing and delivering financing for investors and developers.
Lending institutions and funding costs: the year ahead

Overall lenders are seeing a more positive macro environment in which to originate loans this year than last and believe this will continue. Approximately half of lenders see their company increasing head count in the next year but even more, over 70%, saw their new loan originations increasing in the same period showing that there are a number of lenders who believe they can do more with what they have in a competitive environment.

Interestingly no banks see a decrease in head count or loan originations coming in the next year which does beg the question as to whether the UK clearing banks are now through the worst of the restructuring cycle or whether their origination teams are still in denial about their prospects. We have seen UK clearers increasing market share in recent years after several years of decline so perhaps the corner has already been turned.

Stability seems to be the consensus on LTVs and a continuing rebound in transactional volumes a year on from the referendum seems likely to support the view that lenders will be able to maintain underwriting standards and risk appetite while increasing loan originations.

On funding reference rates, the view is that we won’t go lower than a 0.25% UK Base Rate and Gilts are unlikely to dip again but there’s a healthy split in opinion as to whether funding costs will remain stable or whether rates will rise in the next 12 months. It’s currently possible to obtain non-recourse finance at fixed all-in interest rates of below 2.50% for 5 year terms and below 3.00% for 10 year terms on the best investment stock, it remains to be seen how long this will continue.
Leverage and Pricing

On average across the UK market, the maximum achievable senior LTV for investment loans is 72%. For development loans, the average maximum leverage on offer is 76% LTC equating to 65% of a project’s GDV. However, these broad averages hide a wide variation in maximum leverage between lender categories.

Maximum leverage for both investment and development loans is obtainable from Hedge Funds with maximum LTVs on investment loans exceeding 90% and, for development loans, LTCs just shy of 90% or 80% LTGDV.

One lender category which popped a bit of a surprise on leverage was Insurance Companies which averaged at 70% maximum leverage matching or exceeding all banking lender categories. We see this seemingly high leverage point as skewed by a focus on income rather than value. This is evidenced by the fact that insurers required the highest coverage of debt service payments through income at an average of 1.92x. Other lenders require 1.2x – 1.7x.

It is important to note that the leverage points quoted are maximums and therefore for any individual transaction, the indicated maximum may not be achievable. Another key point of note is the pricing variation which may limit the desirability of additional leverage even if it is achievable.
German Banks and Insurance Companies offer the lowest cost of senior debt reflecting average margins of 200bps with Asian, European and local UK Banks all following closely behind. For bridging and mezzanine debt, if you can fund these types of debt through a bank, you will secure the lowest funding costs. The same is true of whole loans with Debt Funds following closely behind but if you are seeking preferred equity or participating debt, then you will need to approach Alternative Lenders and Funds.

“German Banks and Insurance Companies offer the lowest cost of senior debt reflecting average margins of 200bps”
When we average data within each lender category, we can assess their ‘relative value’ based on maximum leverage offered against margin pricing. The lender categories above the trend line are relatively ‘good value’, offering higher maximum leverage for lower average margins when compared to those below the trend line.

Of course, such averages hide significant pricing and leverage variations even within lender groups and leverage is not the only consideration when pricing a loan. However LTV vs margin does give us a useful ‘relative value’ assessment and also shows us how much relative competition there is between lenders to lend at average margins of between 200bps and 350bps. Capita Real Estate Finance has recognised a trend of diverging pricing in the market as a result of regulatory creep affecting lender categories differently and the gradual splintering of market share giving rise to greater amounts of issued debt being funded through alternative funding sources.

**Income Covenants**

We can determine from the average ICR and DSCR requirements of lenders that insurers and banks are the most income focused in terms of underwriting with funds and Alternative Lenders being more open to a sponsor’s returns being capital weighted. This is also borne out in the leverage maximums (i.e. higher LTV loans generally indicating that a lender sees an increase in the value of the asset(s) coming).

**Average ICR and DSCR Covenant by Lender Category**

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*Relative Value: Average Max LTV vs Average Margin*

*Average ICR and DSCR Covenant by Lender Category*
Availability: Sector and Geography

All sectors and locations are fundable but for each sector or location, market depth varies widely.

Office is the most popular investment asset followed closely by retail and, in development, residential is by far the most preferred with student housing and office neck-and-neck in second place.

Hotels are the most challenging to finance both in investment and development. We must put part of this down to the fact that many bank lenders will separate this asset class into a different origination team who would be less likely to respond to an all-real estate survey; however other lending categories also favour most other asset classes over hotel.

Development finance is one area which does present notably more challenges in securing finance. For 100% pre-let commercial and for residential development for sale projects, 68% and 71% of all lenders would consider funding, respectively. For residential projects that number falls, only slightly, to 66% when the units are to be held and rented rather than sold. For commercial projects, however, 71% falls to 58% when projects are only part pre-let and falls dramatically to 30% on speculative commercial development.

Land without planning is the hardest asset type to finance although we did find a number of respondents willing to lend against it and have received multiple competitive bids on recent land finance transactions where the land is well located.

“Hotels are the most challenging to finance both in investment and development.”
Focus on development Loans

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<thead>
<tr>
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<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>
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<tbody>
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<td>European Banks</td>
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<td>40%</td>
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<tr>
<td>Asian Banks</td>
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<td>Debt Funds</td>
<td>73%</td>
<td>64%</td>
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<td>45%</td>
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<td>Pension Funds</td>
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<td>Alternative Lenders</td>
<td>82%</td>
<td>76%</td>
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<td>71%</td>
<td>47%</td>
<td>65%</td>
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<td>Peer to Peer Lenders</td>
<td>100%</td>
<td>75%</td>
<td>25%</td>
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<td>50%</td>
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<td>25%</td>
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This chart shows the proportion of responding lenders who can fund various development loan types.

Geographical Preference

Unsurprisingly London and the South East top the charts for regional lending appetite. Scotland is the least preferred region of the UK, we put this primarily down to the intricacies of the legal system and the threat of a second independence referendum rather than the depth of the real estate market.

This diagram shows the proportion of responding lenders who can fund loans in these areas of the UK.
Loan profile: Loan Maturity and Ticket sizes

In reference to loan maturity, longer term money is more difficult to come by with only 30% of lenders lending in excess of seven years and only 11% over ten years. Of these, Insurance Companies were the most prevalent lender.

For investment loans, the market for very large tickets (>£500m) is thin on the number of active lenders but highly competitive on pricing whereas the market for very small tickets (<£10m) is awash with lenders but pricing is notably higher. This is predominantly due to the higher relative cost base for lenders in the small ticket space.

We did still find five respondents willing to underwrite £500m+ tickets on investment loans and three who would consider development loans in excess of £250m (19 would do so at £100m+).

“Longer term money is more difficult to come by with only 30% of lenders lending in excess of seven years and only 11% over ten years.”

Maximum Investment Loan Ticket Size by Lender Category

*UK Banks & Pension Funds reported a maximum ticket size for investment loans of £1bn.
Maximum Development Loan Ticket Size by Lender Category

- UK Banks
- German Banks
- European Banks
- Asian Banks
- Middle Eastern Banks
- North American Banks
- Debt Funds
- Hedge Funds
- Alternative Lenders
- Peer To Peer Lenders

Ticket Size (£m)

Median
Respondent
Range
Deal Completion

For banks in general, it takes 1-3 months to complete a financing. If a borrower is a ‘new-to-bank’ client, then it is safe to leave closer to three months than one to complete. Insurers and Pension Funds are somewhat longer still with some indicating a longer process than three months as an average. Hedge Funds tend to be the quickest with a 2-4 week average, Alternative Lenders and Debt Funds are not far behind.

We can see there is some negative correlation between pricing and deal completion time. Those lenders taking in excess of three months to complete a deal generally price at around half the cost of those completing quickly, so perhaps good things come to those who wait.

“Those lenders taking in excess of three months to complete a deal generally price at around half the cost of those completing quickly.”

Average Senior Margin by Deal Completion
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