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

This year we analyse the visible market trends through our datasets across the last two years and assess market prospects for 2018 as a whole. As with our last report, we focus on lender sentiment, appetite, intentions and projections but with a broader set of compiled data direct from lenders.

Many thanks to all of our respondents.

KEY FINDINGS

- **Confidence abounds** at the start of 2018 with a significant majority of respondents expecting loan volumes and team sizes to grow.

- Lenders have **converged on leverage** offered for investment loans but show far greater sensitivity to risk for development loans.

- **Pricing has only increased in the higher risk categories of debt**; mezzanine, preferred equity and bridging finance; but has done so considerably.

- The **supply of long term debt continues to grow.** With many expecting rates to rise, locking in low fixed rates of interest now may be a shrewd move.

- Lenders’ **preference has shifted into industrial/logistics assets and hotels** and away from the residential and retail sectors.

- Property values in the **residential market are considered to be more at risk** than those in the commercial sectors.

**Contents**

- Market sentiment 3
- Leverage & pricing – investment loans 4
- Leverage & pricing – development loans 7
- Availability – sector & geography 9
- Loan maturity and ticket sizes 10
- About us & the report 11

**CONTACTS**

**James Wright**  
Head of Real Estate Finance  
t: +44 (0) 207 954 9619  
m: +44 (0) 7713 785 140  
e: james.wright@lgassetservices.co.uk

**Caroline Somers**  
Senior Analyst, Real Estate Finance  
t: +44 (0) 207 397 6292  
m: +44 (0) 7712 429 782  
e: caroline.somers@lgassetservices.co.uk
Market sentiment

Market sentiment as a whole is broadly unchanged from a year ago in respect of team size and origination intentions. The UK market has seen a pick-up in commercial real estate transactional volume following the general election result. This is similar to the recovery which was underway when last year’s data was collected, following the referendum result the previous summer. In each case, wider political uncertainty has continued.

72% of lenders confidently predict greater loan origination volumes in the next 12 months than the last, perhaps many not having been able to deploy as much capital as they wanted to over the past year. With a lower 53% seeking to increase origination headcount, plenty of lenders see capacity to do more with what they have; a trend which has continued from last year.

Deals are taking longer to complete. It takes, on average, just under 2 months (53 days) to take out a commercial real estate loan in the UK, from agreeing terms to drawdown of funds. This is an increase from 46 days in 2017.

72% of lenders confidently predict greater loan origination volumes in the next 12 months than the last.

The UK Base Rate rose to 0.5% in November 2017 and 10 year UK Treasury Gilts have risen by nearly 0.5% since June last year. There is a very clear consensus among respondents that we will see another rise in both the UK Base Rate (71%) and UK Treasury Gilts (65%) in the year ahead. Right now market expectations support this assertion implying an increase in the UK Base Rate to just over 1.0%. Interestingly the forward curve when our last report was published similarly implied a UK Base Rate increase in the next 12 months from 0.25% to nearly 0.50% when most lenders were predicting stability.

Lenders are still, by and large, expecting LTVs to remain stable on new loans but those respondents forecasting an increase has risen from 1 in 20 to almost 1 in 10 this time around. Pricing on new loans is also largely expected to remain stable, but nearly 1 in 5 predicts a pricing increase in the next 12 months.

Respondents say residential property values are at significantly more risk of value declines in the next year than commercial property.

This year we asked what the greatest risk to the UK commercial property market is in the next 12 months. An extraordinary 70% of respondents highlighted some form of political risk. Brexit (40%), a change in government and general political uncertainty all featured. Other frequent responses included an interest rate rise and a drop in foreign investment volumes.

Respondent Expectations

<table>
<thead>
<tr>
<th>Expectation</th>
<th>Decrease</th>
<th>Remain Similar</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size of Team</td>
<td>1%</td>
<td>46%</td>
<td>53%</td>
</tr>
<tr>
<td>New Loan Originations</td>
<td>2%</td>
<td>25%</td>
<td>72%</td>
</tr>
<tr>
<td>UK Base Rate</td>
<td>0%</td>
<td>29%</td>
<td>71%</td>
</tr>
<tr>
<td>UK Treasury Gilts</td>
<td>2%</td>
<td>33%</td>
<td>65%</td>
</tr>
<tr>
<td>LTV on New Loans</td>
<td>22%</td>
<td>68%</td>
<td>9%</td>
</tr>
<tr>
<td>Pricing on New Loans (Margin &amp; Fees)</td>
<td>14%</td>
<td>68%</td>
<td>18%</td>
</tr>
<tr>
<td>UK Residential Property Values</td>
<td>41%</td>
<td>48%</td>
<td>10%</td>
</tr>
<tr>
<td>UK Commercial Property Values</td>
<td>33%</td>
<td>60%</td>
<td>7%</td>
</tr>
</tbody>
</table>
For investment loans, the average maximum LTV available, across all debt types, has remained static (as correctly predicted by 77% of respondents last year). However, within individual lender categories we have witnessed significant change. Last year’s data showed a standard deviation of over 9% which has dropped to less than 6% this year, demonstrating that lenders have converged on leverage.

Debt Funds are able to offer the highest overall leverage for investment loans at 83% LTV, jumping ahead of Hedge Funds this year who have taken a notable step down on investment LTVs. Outside of Hedge Funds, there is very little variation from last year with no other lender category adjusting maximum leverage by more than 5%.

Mezzanine leverage is generally topping out at around 85% LTV with just four respondents able to go beyond that. However, Preferred Equity funding is available from nine further respondents. For Bridge Loans, average maximum leverage is 70%.

### Average Maximum LTV by Loan Type

![Average Maximum LTV by Loan Type](image_url)

### Average Margin

Taking broad averages across all lender types we can see that margins on the higher risk categories of debt have risen from last year, with only Senior Loans (-21 bps) now available at cheaper rates.

Mezzanine Loan costs have risen by a modest 45 bps but Bridge Loans (+223 bps) and Preferred Equity (+196 bps) are notably more expensive than a year ago.

![Average Margin](image_url)
Lenders have generally shown changes in their loan pricing corresponding to changes in their leverage offering. One notable exception to this rule is Peer to Peer Lenders who registered the largest increase in average margins but have dropped maximum leverage. Part of this can be attributed to more lenders in this category offering investment loans this year with many simply pricing those loans in at a similar level to their development loans.

**UK Banks feature as the cheapest source of Mezzanine and Bridging Loans.**

Pfandbrief Banks are able to offer the lowest cost of senior debt with an average margin of 170 bps and an average arrangement fee of 82 bps.

This is a reduction from 2017 (200 bps and 88 bps respectively). Insurance Companies and Pension Funds are not far off, on average offering senior loans at or just over 200 bps margin, in line with their 2017 pricing. These lenders usually charge their margin on top of a UK Treasury Gilt reference rate rather than Libor or Swap rates. On the basis of a fixed interest rate, this would reflect a 15 to 25 bps saving to the borrower based on recent rates making their overall interest costs broadly comparable despite the higher margin. Average arrangement fees are also low for these lender categories at 88 bps and 75 bps respectively.

UK Banks feature as the cheapest source of Mezzanine and Bridging Loans. Interestingly, for Mezzanine Loans, they are closely followed by Pension Funds, who did not offer this type of debt in 2017. Middle Eastern Banks have been responsible for much of the pricing increase in Mezzanine Loans (1100 bps margin in 2018 versus 917 bps in 2017) and Bridge Loans (1800 bps versus 1100 bps a year ago).

**Pfandbrief Banks are able to offer the lowest cost of senior debt with an average margin of 170 bps and an average arrangement fee of 82 bps.**

For investment Whole Loans, the European Banks, Pension Funds and North American Banks offer the best rates.
Income Covenants

Compared to last year income covenant requirements have been relaxed. For example, Insurers were the most income focused in their underwriting in 2017, requiring an ICR in excess of 200%. For 2018, however, they only require, on average, an ICR of 185%. European Banks are the notable exception to this trend, requiring an ICR of nearly 220% on average which is 40% up on last year. Much of this rapid change may be down to the agreed implementation of a tightening of Basel III rules which was endorsed in December 2017 (widely referred to as Basel IV).

The implementation of these rules will disproportionately impact the regulatory capital requirements of European Banks over other lender categories.

Pension Funds have the greatest DSCR requirement (165%, up from 130% in 2017).

Debt Funds represent the best ‘relative value’ for senior investment loans.

In respect of ‘relative value’, we notice two significant changes from 2017. Firstly the trend line is significantly flatter, reflecting the considerable convergence on leverage. Secondly, where we saw three fairly distinct lender groups last year, in 2018 Hedge Funds have reduced margins to join the lender group between 475 and 625 bps, leaving Peer to Peer Lenders as a sole outlier at an average of 950 bps. Lending on ‘prime’ transactions (priced at less than 350 bps margin) is by far the most competitive segment of the market with eight of our 12 lender categories competing in this space. Debt Funds represent the best ‘relative value’ for senior investment loans.
Despite a slight reduction in their leverage from last year, Peer to Peer Lenders offer the highest LTC in the market (87%). Interestingly, however, at 69% their LTGDV is bettered by Hedge Funds and Debt Funds, which indicates that they cannot offer the highest leverage except for the most profitable schemes. Hedge Funds and Debt Funds, at 71%, offer the joint highest maximum LTGDV on average.

**Average Leverage Year on Year**

![Average Leverage Year on Year chart](chart)

**Overall Finance Cost Comparison**

<table>
<thead>
<tr>
<th>Project type</th>
<th>Cheapest overall finance cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Development 100% Pre-let</td>
<td>Pfandbrief Bank</td>
</tr>
<tr>
<td>Commercial Development Part Pre-let</td>
<td>Asian Bank</td>
</tr>
<tr>
<td>Commercial Development Speculative</td>
<td>Middle Eastern Bank</td>
</tr>
<tr>
<td>Residential Development for Sale</td>
<td>Asian Bank</td>
</tr>
<tr>
<td>Residential Development for Hold &amp; Rent</td>
<td>Pfandbrief Bank</td>
</tr>
<tr>
<td>Land Loan with Planning</td>
<td>UK Bank</td>
</tr>
<tr>
<td>Land Loan without Planning</td>
<td>UK Bank</td>
</tr>
</tbody>
</table>

Based on a 2 year development at average LTC for the relevant debt type and run on a standard S-curve schedule with full repayment at PC.

Overall cost comparisons on development are significantly complicated by the different additional fee structures of different lender groups. For example, Debt Funds and Hedge Funds will charge combined arrangement and exit fees of around 300 bps and non-utilisation fees of nearly 150 bps. That is in comparison to Pfandbrief Banks who generally charge less than 150 bps in arrangement and exit fees and under 90 bps non-utilisation fees, Peer to Peer Lenders who charge no non-utilisation fees at all and Asian Banks who charge no exit or non-utilisation fees at all. Combining margin and all fees, we can see which lenders are best overall value for different project types under the assumptions outlined. We can see Pfandbrief, Asian, Middle Eastern and UK Banks all feature as the cheapest overall debt on particular project types.

Margin is the most useful direct measure of cost which can be accurately compared across lender categories. When we chart it against LTC we can see a very clear relationship between the type of project and the average debt available in the market. Unsurprisingly, land without planning is the highest cost at the lowest level of leverage. 100% pre-let commercial development is the lowest cost but residential development, particularly for sale, can attract notably higher leverage making the debt more accretive to equity returns.

**‘Relative Value’ by Loan Type**

![‘Relative Value’ by Loan Type chart](chart)
Looking at the ‘relative value’ by lender type, we can see that lenders to development projects have a higher pricing sensitivity to leverage than those lending investment loans.

Whereas Peer to Peer Lenders were a relatively poor value outlier for investment loans, for development loans they clearly represent the best ‘relative value’ to borrowers.

It is worth noting that, despite Middle Eastern and UK Banks offering poor ‘relative value’ against the trend line, they occupy a comparatively undersupplied area of the market, offering maximum LTCs of around 70% at margins of between 575 and 675 bps.

Availability: Development Loan Types

This chart shows the proportion of responding lenders who can fund various development loan types. We observe that Pfandbrief and European Banks have pulled out of the land finance sector in the UK since 2017.
All locations in the UK increased in popularity this year with two exceptions. The first is London, which has remained the most popular region but has been caught up by most of the UK’s other regions. The second is Scotland which has declined in attractiveness to lenders. Northern Ireland is the least favoured region and the only one in which more than half of respondents will not do business.

When it comes to real estate sectors, lenders are increasingly specific with their capital deployment, highlighting six sectors on average they will lend in compared to seven in 2017.

The most significant changes in lenders’ preference is a strong shift away from the residential and retail sectors and into industrial/logistics assets and hotels. Office remains the most sought after asset class for investment loans and is now just 7% behind residential in development preference (16% lower in 2017). Healthcare and leisure sectors, which were added to the survey options this year, are the least popular asset types.

The most significant changes in lenders’ preference is a strong shift away from the residential and retail sectors and into industrial/logistics assets and hotels.

### Sector Preference Year on Year

#### Investment

<table>
<thead>
<tr>
<th>Sector</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Office</td>
<td>80</td>
<td>85</td>
</tr>
<tr>
<td>Retail</td>
<td>70</td>
<td>75</td>
</tr>
<tr>
<td>Student Housing</td>
<td>60</td>
<td>65</td>
</tr>
<tr>
<td>Industrial / Logistics</td>
<td>65</td>
<td>70</td>
</tr>
<tr>
<td>Hotel</td>
<td>70</td>
<td>75</td>
</tr>
<tr>
<td>Residential</td>
<td>50</td>
<td>55</td>
</tr>
<tr>
<td>Healthcare</td>
<td>40</td>
<td>45</td>
</tr>
<tr>
<td>Leisure</td>
<td>30</td>
<td>35</td>
</tr>
</tbody>
</table>

#### Development

<table>
<thead>
<tr>
<th>Sector</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential Build to Hold to Sell</td>
<td>90</td>
<td>95</td>
</tr>
<tr>
<td>Residential Build to Sell</td>
<td>80</td>
<td>85</td>
</tr>
<tr>
<td>Office</td>
<td>70</td>
<td>75</td>
</tr>
<tr>
<td>Student Housing</td>
<td>60</td>
<td>65</td>
</tr>
<tr>
<td>Industrial / Logistics</td>
<td>65</td>
<td>70</td>
</tr>
<tr>
<td>Retail</td>
<td>50</td>
<td>55</td>
</tr>
<tr>
<td>Hotel</td>
<td>40</td>
<td>45</td>
</tr>
<tr>
<td>Healthcare</td>
<td>30</td>
<td>35</td>
</tr>
<tr>
<td>Leisure</td>
<td>20</td>
<td>25</td>
</tr>
</tbody>
</table>
Loan maturity and ticket sizes

For investment loans, we have seen a definite shift in availability from short term debt to longer term debt. In addition to the number of lenders able to lend at longer terms we also saw the number of lender categories participating in longer term debt increase. For example, we now see seven different lender types able to provide 10+ years funding, up from five a year ago.

Very large ticket sizes should be easier to fund this year than they were last year with an increase in the number of lenders able to lend £500m or more on investment loans (8 up from 5) and £250m or more on development deals (7 up from 3).

Another very clear relationship we noticed this year was the correlation between ticket size and pricing in both investment and development loans. Below we chart all individual lender responses on ticket size and average margin, showing the maximum and minimum responses, along with the mean trend lines. Larger ticket sizes generally come at a cheaper margin and the most expensive loans are being written at the smaller end of the market. This is due to the higher relative cost base for lenders in the small ticket space.
ABOUT US

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.

ABOUT THIS REPORT

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 2018. The anonymous open market survey was sent out publicly, resulting in a data set of 125 respondents from 87 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.
CONTACTS

James Wright
Head of Real Estate Finance
t: +44 (0) 207 954 9619
m: +44 (0) 7713 785 140
e: james.wright@lgassetsexervices.co.uk

Caroline Somers
Senior Analyst, Real Estate Finance
t: +44 (0) 207 397 6292
m: +44 (0) 7712 429 782
e: caroline.somers@lgassetsexervices.co.uk