DTZ Insight
Net Debt Funding Gap
Shrinking gap means safe to lend against grade C

25 November 2013

Contents

- Based on repeated requests from our clients and the press, we have for the first time analysed the UK's debt funding gap by property grade. Contrary to the prevailing consensus, our analysis shows that on an individual loan basis grade C properties are impacted just as much (but, NOT more) as grade A properties. However, given the lower absolute aggregate value of grade C relative to the overall stock, the grade C refinancing gap of GBP1.1bn is less than one third of the GBP3.6bn grade A gap for the 2013-14 period (Figure 1).

- This lower absolute gap on secondary properties should allow more bank and non-bank lenders to move into lending secured by lower quality properties, as the downside risk for this smaller stock of lower quality buildings is not significantly different than on higher quality properties.

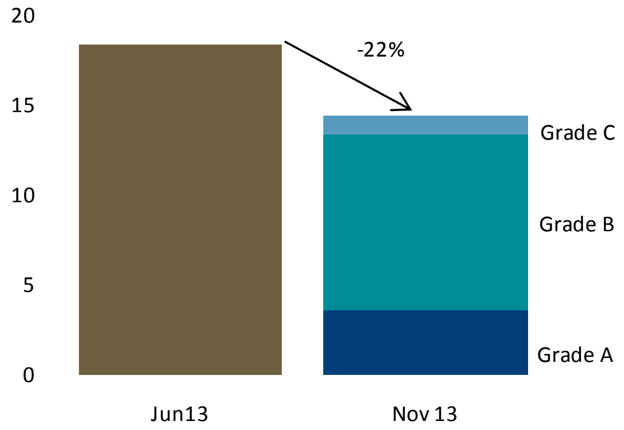
- An improving outlook for capital values and new non-bank lending across Europe is helping to shrink Europe's refinancing gap. Over the last six months the gap in Europe has fallen by 14% to USD74bn. However, progress in deleveraging remains slow in a number of markets, leaving Europe's gross debt funding gap to USD140bn, a 14% reduction from USD163bn in May-13.

- Lending capacity from non-bank lenders remains strong at USD180bn over the three years 2013-15. Non-bank institutional lenders remain the most active in the near term, but we expect strong activity from funds during 2014-15.

- The strength of non-bank lending and a reduction in the gross debt funding gap has further increased the surplus across Europe as a whole. This surplus remains concentrated on the UK, France, Germany and Sweden. But, net gaps still remain in a number of markets, including Spain, Italy, the Netherlands and Ireland. Although small on an absolute basis, relative to the total domestic outstanding debt, Ireland continues to show the biggest relative net gap.

Figure 1

UK refinancing gap by grade 2013-14, GBP bn



Source: DTZ Research

Authors

Nigel Almond
Head of Strategy Research
+44 (0)20 3296 2328
nigel.almond@dtz.com

Hans Vrensen
Global Head of Research
+44 (0)20 3296 2159
hans.vrensen@dtz.com

Net Debt Funding Gap

Introduction

This is seventh issue of our Debt Funding Gap report series provides an update on our previous analysis released in June 2013[1].

In estimating the net debt funding gap, we adopt the same four step approach as summarised below:

1. Estimate the ***refinancing gap*** based on refinancing of maturing debt vintages.
2. Add the impact of bank regulations to provide the ***gross debt funding gap.***
3. Estimate the amount of lending capacity from new non-bank lenders
4. Subtract the positive impact of ***non-bank lending sources debt*** from the gross gap to estimate the ***net debt funding gap.***

Our methodology for estimating the base refinancing gap remains unchanged from our previous reports. It involves a detailed analysis which takes into account:

- Vintage of outstanding loans
- Duration of loans by vintage
- Loan-to-value ratios by vintage
- Historic and future changes in collateral values, and
- Impact of loan extensions

Our analysis remains focussed on the near term refinancing gap as we have greater oversight on the likely trends in future capital values and refinancing LTVs. Both these inputs have a significant impact on the gap. Our model does extend out over future years, which we present, though there is greater uncertainty over the sizing of this gap.

Since our last report we have made adjustments to some of the inputs based on discussions with our local research and deal teams, and also updated information provided in the De Montfort University survey on UK commercial property lending[2].

For the first time, in the UK, we have analysed the refinancing gap across different grades of property (classes A, B and C). A summary of our approach is outlined in the report and in Appendix 1.

Our starting point this year is the outstanding debt to commercial real estate (CRE) as at the end of 2012. This includes lending by banks, covered bonds and CMBS. In reflecting the evolution of the market we also account for non-bank lenders. We exclude property company bonds as these are not secured against direct properties. These inputs are unchanged from our June report.

[1] Net Debt Funding Gap, Non-banks trigger surplus in core Europe, 6 June 2013
[2] The UK Commercial Property Lending Market Research Findings 2012

Net Debt Funding Gap

Gross debt funding gap

Refinancing gap continues to shrink

The global refinancing gap continues to shrink. Based on our latest analysis the global refinancing gap has shrunk 28% to USD78bn. Much of the reduction has occurred in Asia Pacific where the gap has fallen from USD23bn to USD4bn. This mostly reflects improvements in capital values in Japan, where accounted for the majority of the gap.

Across Europe as a whole we have also seen further reductions, with the gap 14% lower at USD74bn. The fall reflects an improved outlook for capital values as the economic outlook and market sentiment continue to improve.

Reductions were observed in many markets. The UK's gap fell 21% to USD23bn. This partly reflects a more detailed approach to our analysis in the UK where we now estimate gaps by grade of property (see Box1). Both Spain and Ireland, whose gaps have also been elevated, fell 10% and 20% respectively over the last six months. Of the major markets, France registered an increase in its gap from USD1.3bn to USD2.3bn.

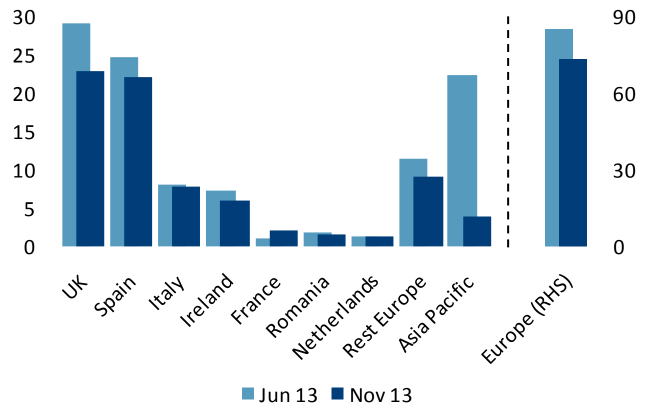
Regulatory pressures demand further deleveraging

We have updated our analysis of the regulatory impacts across different markets in line with our previous studies[1]. We continue to focus on the impact of the European Banking Authority rules given the complexity of assessing rules at a local level. In updating our analysis we assessed the level of deleveraging undertaken in the main European markets since the beginning of 2012. Based on this analysis we still see a significant impact, with regulation adding a further USD65bn (Figure 3).

As we have previously reported, markets with large absolute funding gaps such as the UK, Spain and Ireland see no regulatory impact given the scale of deleveraging already seen in these markets. In contrast other core markets do see some impact. France now stands out with a gross gap of close to USD24bn. With no evidence of any clear deleveraging in the French market since the outset of the financial crisis we believe action is required. In both Germany and the Netherlands we see significant regulatory impacts, although in both these markets we have seen some evidence of modest deleveraging.

Figure 2

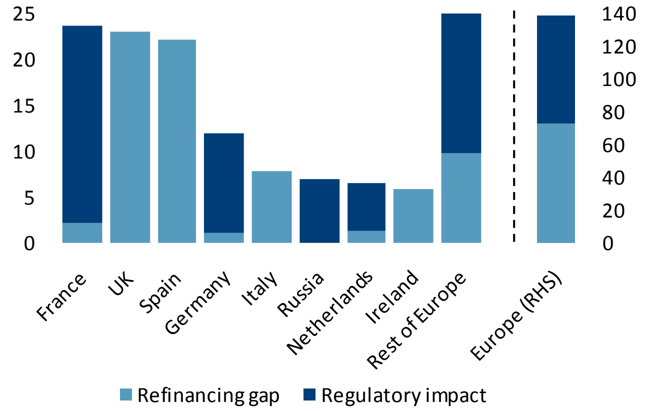
Global refinancing gap 2013-14, USD bn



Source: DTZ Research

Figure 3

Refinancing gap 2013-14, USD bn



Source: DTZ Research

[1] See DTZ Insight Net Debt Funding Gap European gap to be bridged by 2015, with UK ahead, 14 November 2015

Net Debt Funding Gap

Box 1. UK refinancing gap by grade

Lower property value of grade C means lower originations

In estimating the refinancing gap in the UK grade of property we have continued to follow the same methodology as in previous reports. The difference in this study is that we have run separate models for grade A, B and C properties. In each case we have adjusted the origination LTVs (Figure 4) and changes in capital value growth by grade based on historic and forecast of the IPD index quartiles[2]. We have also estimated originations by grade through detailed quartile analysis of actual transactions since 2005 (see Appendix).

Relative impact the same on grade A and C

We have run a hypothetical example for a grade A and C property where a loan was originated in 2007 and due for refinance in 2013. We have assumed the same property value of GBP100m. The LTVs at origination were 87% and 67% respectively for grade A and C. By 2013 values were around 30% and 40% lower. Based on current refinancing LTVs of 70% and 50% we have estimated the debt available at refinance. This leaves a refinancing gap of GBP38bn for grade A and GBP36bn for grade C (Figure 5). So on this relative basis the impacts are similar.

On absolute basis, grade A and B show biggest gaps

Based on our quartile analysis, the value of properties in the lower quartile (grade A) are higher than the value of properties in the upper quartile basket (grade C) for each year. Therefore, there is a higher volume of debt secured against grade A. The proportions vary through time, but in each vintage grade A typically represents 20-25% of originations by value, and grade C around 10%.

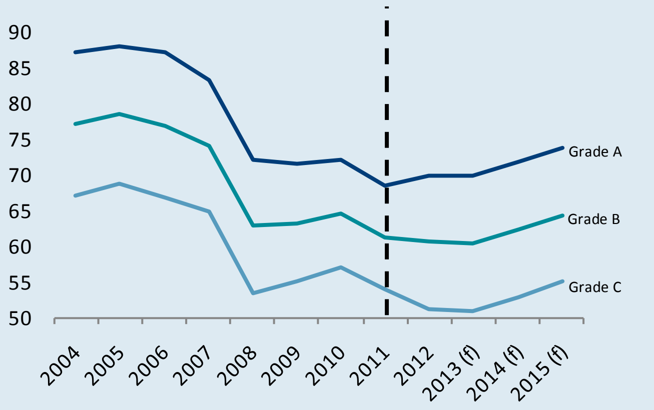
On an absolute basis we see a higher absolute gap for both grade A and B properties. Over the period 2013-14 the refinancing gap on grade C is just GBP1.1bn. This contrasts with a gap for grade A of GBP3.6bn and GBP9.8bn on grade B. The larger gap on grade B is understandable given it represents 50% (by number of deals) of the inputs.

Overall the UKs refinancing gap for 2013-14 is GBP14bn. This is 22% lower than the GBP18bn reported in our June report.

[2] See DTZ Insight Secondary Market Pricing – secondary to outperform from 2014, 23 October 2013

Figure 4

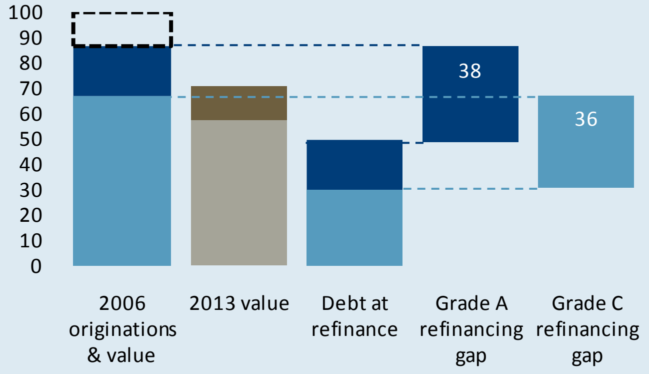
Trends in origination LTVs by grade



Source: DTZ Research

Figure 5

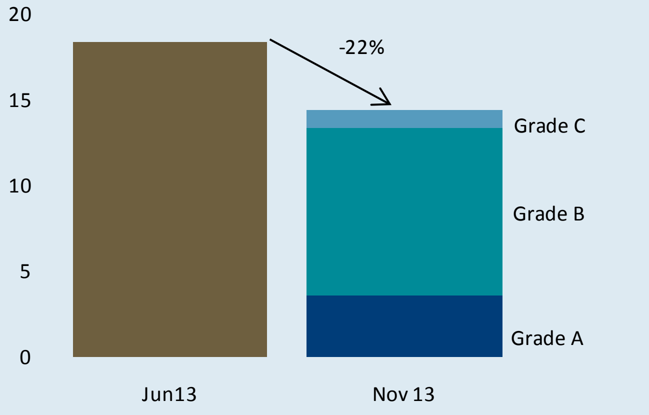
Estimating the refinancing gap by grade



Source: DTZ Research

Figure 6

UK refinancing gap by grade 2013-14, GBP bn



Source: DTZ Research

Net Debt Funding Gap

Bridging the gap

Swaps delay work-out

Delays in bank deleveraging are partially hampering the recovery in the market. Improved market sentiment and capital value growth will go some way to resolving the gap. Banks also need to deleverage further through crystallising losses on non-performing loans. This is being hampered by swap positions associated with these loans which have impacted private investors and more seasoned property companies and funds (see Box 2).

Non-bank lending remains strong

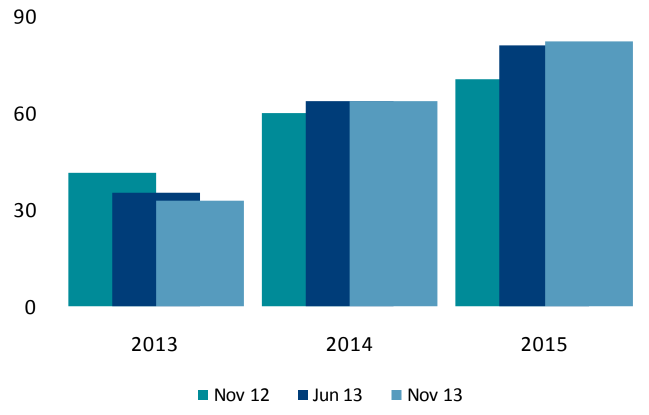
We have updated our analysis for non-bank lenders. Over the past six months we have continued to see growing interest from both institutional and new funds seeking to invest. Of note has been the decision by Norges Bank to lend against commercial real estate for up to EUR600m in partnership with AXA. We have also been able to update some of our figures based on fund closings.

Overall the amount of new lending capacity has remained unchanged at USD180bn over 2013-15 (Figure 7). We do see some differences in the available capacity across the years. We have marginally reduced the expected capacity this year, but there are some modest increases in 2014 and 2015.

As in our previous reports, we continue to see lending dominated by insurance companies and other institutions representing around two-thirds of current activity, although expectations of funds gearing up their lending programmes should see their share grow to half of lending capacity by 2015.

Figure 7

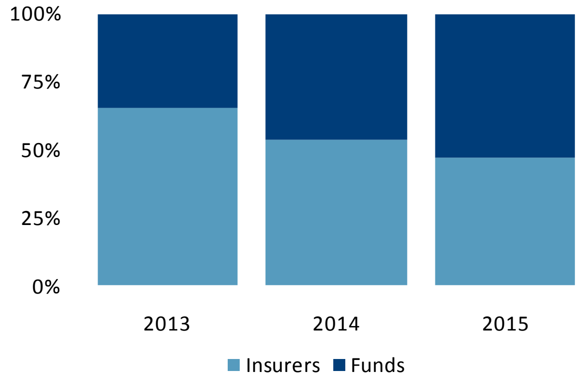
Lending capacity from non-bank lenders, USD bn



Source: DTZ Research

Figure 8

Lending capacity by lender types



Source: DTZ Research

Net Debt Funding Gap

Box 2. Swap debate requires more data to inform the market

Our recent report on swaps[2] highlighted new external data from Collyer Bristow solicitors and Vedanta Hedging Ltd. This data supports our view that many borrowers who used interest rate hedge products (IRHP) could successfully contest these with their providers. This could allow borrowers to claim back between GBP 5-10bn in loan concessions and financial redress over the next few years.

Some[3] have publicly questioned our assumptions without offering new information or evidence, perhaps basing their views on a limited client base. Our data was not simply based upon extrapolating the redress programme for SMEs to larger borrowers, but also upon information provided to us on actual legal cases that have settled and are active. *The Times*[4] recently reported a settlement which (unusually) was not made confidential by the Bank. In this case a borrower was compensated in full the cost of their complex, callable swap. The principal reason was a significant mis-match in the term of the borrowing versus the duration of the callable swap. In fact, the callable swap was one which the bank could cancel if rates rose, but if rates were low, the bank would not cancel. Working with large, publicly listed property companies with a sophisticated treasury function might support this type of perspective and the choice of complex products. We welcome a more meaningful debate, based on hard actual case data. As always, we are happy to change our view, if the facts change.

But, based on our own work with clients so far, there are many more companies without a separate treasury function, like developers, entrepreneurs, high net-worth individuals, private equity fund managers and property-based businesses. Many of these will have borrowings and IRHP's outside the scope of the FCA SME review. In fact, these companies make up a much larger share of the UK property market than REITs. Even though these businesses are considered to be 'sophisticated' for the purposes of the FCA Review, a large number of medium sized businesses still only had a basic book-keeping type finance function. Therefore, most were not able to seek independent FCA authorised advice. This is because there were no FCA authorised advisory firms authorised to deal with Retail Clients during the key period of 2005-2008.

Most non-REIT borrowers had little or no understanding of the implications of long term hedging products. Based on the cases we have reviewed, entry into a long term swap was rarely proposed by or driven by the borrower. In fact, Collyer Bristow claims that they have never seen a case of a customer "pleading" for a long term product. On the contrary, it was often pushed by the bank.

Long term IRHPs were sold in many cases without proper or any explanation of the potential downside risks compared with shorter term IRHPs. There is nothing unsuitable about long-term swaps per se, but that Vedanta rarely see evidence of banks providing sufficient information about the risks of entering into such long-term swaps versus shorter-term swaps. Many borrowers are finding these long term IRHPs now very problematic for a range of reasons. Many are refused further lending for new acquisitions and refinancing of existing properties. In some cases, this has lead to enforcement of collateral and forced sale of the building to repay the loan. Debt for equity swaps have also diluted equity investors, if they were unable to refinance due to the swap breakage. Finally, many borrowers are forced to cash trap any cash flow from the property to bring down the LTV ratio and improve their credit profile leaving no return for equity or capital expenditures.

[2] DTZ Insight, UK lending market, "Swap review to unlock legacy loans", Hans Vrensen, 9 September 2013.

[3] Viewpoint, Real Estate Capital, "Uninformed exchanges mar debate over swaps", John Rathbone, October 2013

[4] "Lloyds swap case settlement revealed" by Katherine Griffiths, The Times, 14th October 2013

Net Debt Funding Gap

Net debt funding gap

Gap eroding, but issues remain in many markets

In analysing the impact of non-bank lenders on the gross debt funding gap, we have considered their impact at the country level in line with our approach in our June report. We continue to see the focus on new lending capacity towards core markets, notably the UK, France and Germany. In these markets lending capacity from non-bank lenders is greater than the gross debt funding gap, leading to a surplus capacity (Figure 9). We also see a modest surplus in other markets including Sweden.

Net gaps remain in many markets

We continue to see net gaps in a number of core markets. The biggest gap remains in Spain at USD14bn, although this is 17% lower than in June. This highlights the progress that is being made in Spain, where we have seen a number of loan sales complete over the past few months. We continue to see gaps in Ireland, Italy and the Netherlands.

When placed relatively, the amount of debt outstanding Ireland and Russia stand out as being most exposed, with the net gaps at 11% and 8% relative to their debt (Figure 10). Spain is much lower at 5% and the Netherlands and Italy at 3%.

Net gaps remain in many markets

Overall we continue to see a net gap across Europe of USD42bn (Figure 11), although this is 16% lower compared to the USD50bn gap six months ago. This highlights the progress of deleveraging and improving market conditions in shrinking the gap and is supported by continued strength in non-bank lending.

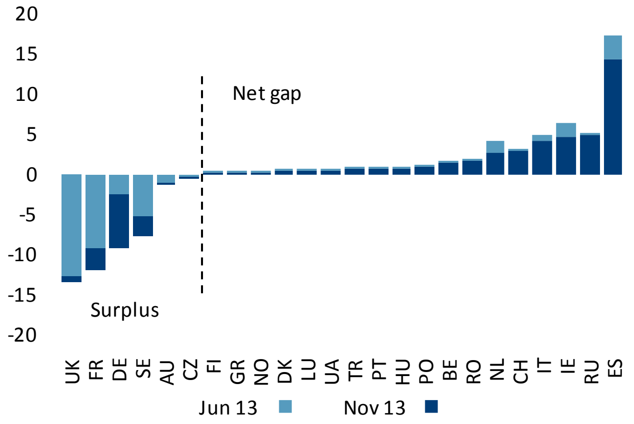
In addition, we continue to see strong levels of equity chasing commercial real estate across Europe, totalling around EUR130bn. With around two-thirds of this capital raised by value-add and opportunistic funds, this capital should be well placed in helping to bridge the gap, especially the better quality secondary properties.

Growth in lending to secondary

Our analysis for the UK does highlight a lower absolute gap on secondary property. This should allow more bank and non-bank lenders to move into lending secured by lower quality properties, as the downside risk for this smaller stock of lower quality buildings is not significantly different than on higher quality properties. The only issue that may arise on secondary is for legacy loans where the number of properties may be greater and require more active and intense management.

Figure 9

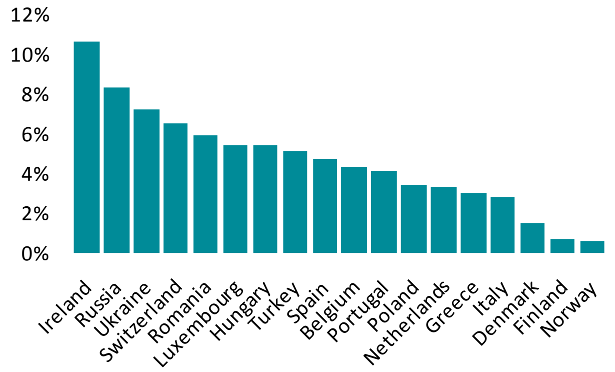
Surplus and net debt funding gap, USD bn, 2013-14



Source: DTZ Research

Figure 10

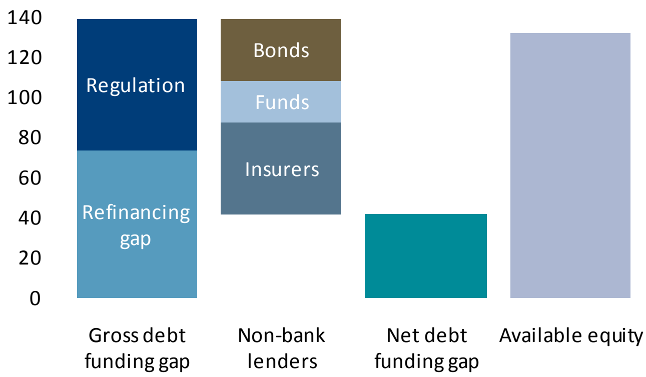
Net debt funding gap 2013-14 as proportion of outstanding debt, USD bn



Source: DTZ Research

Figure 11

European gross and net debt funding gap 2013-14, USD bn



Source: DTZ Research

Net Debt Funding Gap

Growth in loan sales across the continent

Both banks and bad banks have been active in selling loan portfolios during the year, with a clearer focus towards sales across continental Europe. In the past six months we have seen sales with a face value of over EUR7bn concluded, including a growing number in Spain, where SAREB (the Spanish bad bank) has been increasingly active over recent months (Table 1).

There also remain a high number of further sales in the pipeline, notably four portfolios from the Irish Bank Resolution Corporation (IBRC) along with a further portfolio on the market from the Spanish bad bank (SAREB). We expect further loan sales on the market, especially from the bad banks as they accelerate their workout.

Improving market efficiency

Since we started publishing debt funding gap analysis back in 2010 we have made a number of recommendations to improve market efficiency both in the short and long term. Recently, in the UK, a cross-industry working party has released what it calls a vision for Real Estate Finance in the UK[4]. The paper is focussed on the UK, and it makes sense initially to focus on the UK lending market. However, the paper does have wider implications for other European markets where we see similar issues.

We are supportive of the need for a granular CRE loan data base (Recommendation 1). It is imperative that this is undertaken by a truly independent organisation or indeed held in-house by the regulator. Having details that are more widely available to the market would help improve transparency and reporting.

The paper also argues for an expert advisory committee (Recommendation 2). We support this, but any senior expert committee should not be a substitute for a permanent and properly trained internal team at the relevant regulator, who are independent from any particular commercial interests in the market. Expert committees in the past have not prevented any crises, partly due to entrenched commercial interests and group thinking.

We would also support the need for education and qualifications (Recommendation 3). But, in our view any professional lender qualification would only work if it would be made mandatory for certain roles and require continuing accreditation, like the CFA designation.

As we have highlighted previously it is important for regulators across Europe to increase their oversight of CRE lending activities. Given the prevalence of cross border lending it is important that there is clear reporting of cross border lending activities.

The market could also benefit from changes to lending terms. Longer, ten year fixed rate loans such as those in the US could provide for greater stability in the market, especially from short term falls in values. The issues arising from the mis-selling of swap contracts underscores the need to greater education for investors and appropriate structuring, especially where the term of the swap exceeds the term of the loan

[4] A vision for Real Estate Finance in the UK, see www.ipf.org.uk

Table 1

Recent and pending loan sales

Lender	Size	Comment
Commerzbank	GBP4bn	Sale of performing and non performing loans
SAREB (Colonial)	EUR245m	Sale of former Colonial portfolio
Lloyds Banking Group	EUR440m/ EUR215m	Sale of German/ Spanish loan portfolios
SAREB	EUR323m	Sale of two loan portfolios
Lloyds Banking Group	EUR1.25bn	Two pending loan portfolios in Germany, France and Scandinavia
IBRC	EUR22bn	Four portfolios of UK and Irish loans being brought to market
SAREB	EUR340m	Former Bankia portfolio due to close shortly

Source: DTZ Research

Net Debt Funding Gap

Appendix

To estimate originations by grade we have used our investment transaction database for the UK.

Our starting point is to split the loans by grade using a quartile analysis for each vintage. In the case of the 2006 vintage, shown in Table 2, we have yield information for 345 properties. Therefore we take the bottom 86 properties as grade A and the top 86 for grade C.

For each band we then sum the value of the transactions. So the aggregate value of the 86 properties in the grade A bucket traded for a value of GBP7.1bn. The grade C bucket totalled GBP2.6bn and the middle 50% in grade B represented GBP21.8bn. We then calculate the proportion of the total value to create the weights for each vintage. In this case grade A is 25% and grade C is 8%.

We replicate this process each year to generate the weights. Typically they do not move significantly for the 2005-08 vintages, although more recently the slice for grade A has grown, whilst grade c has narrowed. This is reflective of trading in the market where we have seen a flight to quality.

Table 2

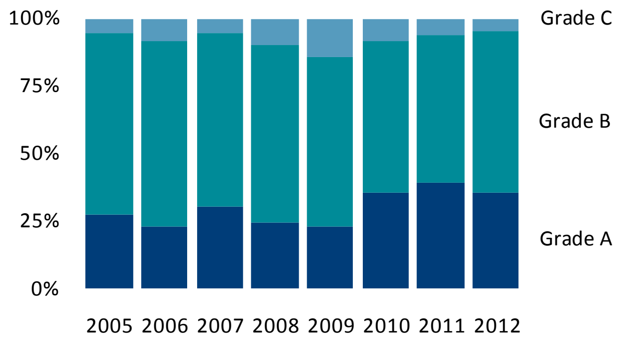
Estimating loan originations by grade

	Grade A	Grade B	Grade C
# of properties	86	173	86
Value (GBPbn)	7.1	21.8	2.6
% total	23%	69%	8%

Source: DTZ Research

Figure 12

Loan origination by grade and vintage



Source: DTZ Research

Net Debt Funding Gap

Other DTZ Research Reports

Other research reports can be downloaded from www.dtz.com/research. These include:

Occupier Perspective

Updates on occupational markets from an occupier perspective, with commentary, analysis, charts and data.
Global Occupancy Costs Offices
Global Occupancy Costs Logistics
Obligations of Occupation Americas
Obligations of Occupation Asia Pacific
Obligations of Occupation EMEA
Global Office Review
India Office Demand and Trends Survey 2012-13
Poland Banking Sector - January 2013
Motorways of the Sea - January 2013
The TMT Sector - October 2012
The European Insurance Sector - June 2012

Property Times

Regular updates on occupational markets from a landlord perspective, with commentary, charts, data and forecasts. Coverage includes Asia Pacific, Bangkok, Beijing, Berlin, Brisbane, Bristol, Brussels, Budapest, Central London, Chengdu, Chongqing, Dalian, Edinburgh, Europe, Frankfurt, Glasgow, Guangzhou, Hangzhou, Ho Chi Minh City, Hong Kong, India, Jakarta, Japan, Kuala Lumpur, Luxembourg, Madrid, Manchester, Melbourne, Milan, Nanjing, Newcastle, Paris, Poland, Prague, Qingdao, Rome, Seoul, Shanghai, Shenyang, Shenzhen, Singapore, Stockholm, Sydney, Taipei, Tianjin, Ukraine, Warsaw, Wuhan, Xian.

Investment Market Update

Regular updates on investment market activity, with commentary, significant deals, charts, data and forecasts. Coverage includes Asia Pacific, Australia, Belgium, Czech Republic, Europe, France, Germany, Italy, Japan, Mainland China, South East Asia, Spain, Sweden, UK.

Money into Property

For more than 35 years, this has been **DTZ's flagship research report, analysing invested stock and capital flows into real estate markets across the world.** It measures the development and structure of the global investment market. **Available for** Global, Asia Pacific, Europe, North America and UK.

Foresight

Quarterly commentary, analysis and insight into our in-house data forecasts, including the DTZ Fair Value Index™. Available for Global, Asia Pacific, Europe and UK. In addition we publish an annual outlook report.

Insight

Thematic, ad hoc, topical and thought leading reports on areas and issues of specific interest and relevance to real estate markets.
Great Wall of Money - October 2013
German Open Ended Funds – October 2013
Quantitative Easing - UK Regions - September 2013
Singapore Government Land Sales - September 2013
UK lending market -September 2013
Quantitative Easing - August 2013
Property Investment Guide Asia Pacific 2013-2014
Singapore Insight – Residential – July 2013
China Insight - The Healthcare Sector - April 2013
City of London occupier demand - April 2013
European Sustainability Guide - April 2013

DTZ Research Data Services

The following data is available for subscription. Please contact graham.bruty@dtz.com for more information.

- **Property Market Indicators**
  Time series of commercial property market data in Asia Pacific and Europe.
- **Real Estate Forecasts, including the DTZ Fair Value Index™**
  Five-year rolling forecasts of over 200 commercial property markets in Asia Pacific, Europe and the USA.
- **Investment Transaction Database**
  Aggregated overview of investment activity in Asia Pacific and Europe.
- **Money into Property**
  Data covering capital flows, size, structure, ownership, developments and findings of annual investor and lender surveys.

DTZ Research

DTZ Research Contacts

Global Head of Research
Hans Vrensen
Phone: +44 (0)20 3296 2159
Email: hans.vrensen@dtz.com

Head of Strategy Research
Nigel Almond
Phone: +44 (0)20 3296 2328
Email: nigel.almond@dtz.com

Global Head of Forecasting
Fergus Hicks
Phone: +44 (0)20 3296 2307
Email: fergus.hicks@dtz.com

Head of Asia Pacific Forecasting
Dennis Fung
Phone: +852 2250 8864
Email: dennis.kk.fung@dtz.com

Head of Research Information Management
Graham Bruty
Phone: +44 (0)20 3296 2297
Email: graham.bruty@dtz.com

Head of CEMEA Research
Magali Marton
Phone: + 33 1 49 64 49 54
Email: magali.marton@dtz.com

Head of SEA & ANZ Research
Dominic Brown
Phone: +61 (0)2 8243 9999
Email: dominic.brown@dtz.com

Head of Americas Research
John Wickes
Phone: +1 312 424 8087
Email: john.wickes@na.ugllimited.com

DTZ Business Contacts

Head of Valuation EMEA
Bryn Williams
Phone: +44 (0)20 3296 4474
Email: bryn.williams@dtz.com

Head of Valuation UK
Charles Smith
Phone: +44 (0)20 3296 4411
Email: charles.smith@dtz.com

Head of Valuation Netherlands
Jacques Boeve
Phone: +31 (0)20 8 407 262
Email: jacques.boeve@dtz.com

Head of Valuation Germany
Klaus Dallafina
Phone: +49 (0)69 92 100 400
Email: klaus.dallafina@dtz.com

Head of Valuation France
Jean-Philippe Carmarans
Phone: + 33 1 47 48 77 24
Email: jean-philippe.carmarans@dtz.com

Debt Solutions Coordinator
Tom Nuttall
Phone: +44 (0)20 3296 4571
Email: tom.nuttall@dtz.com

Debt Solutions London
Fergus Jack
Phone: +44 (0)20 3296 4494
Email: fergus.jack@dtz.com

Debt Solutions UK Regions
Richard Murphy
Phone: +44 (0)29 2026 2235
Email: richard.murphy@dtz.com

Debt Solutions Ireland
Margo Grogan
Phone: +353 1 6399290
Email: margo.grogan@dtz.ie

Debt Solutions Netherlands
Patrick Steenstra Toussaint
Phone: +31 20 571 1427
Email: patrick.steenstratoussaint@dtz.com

DTZ a UGL company