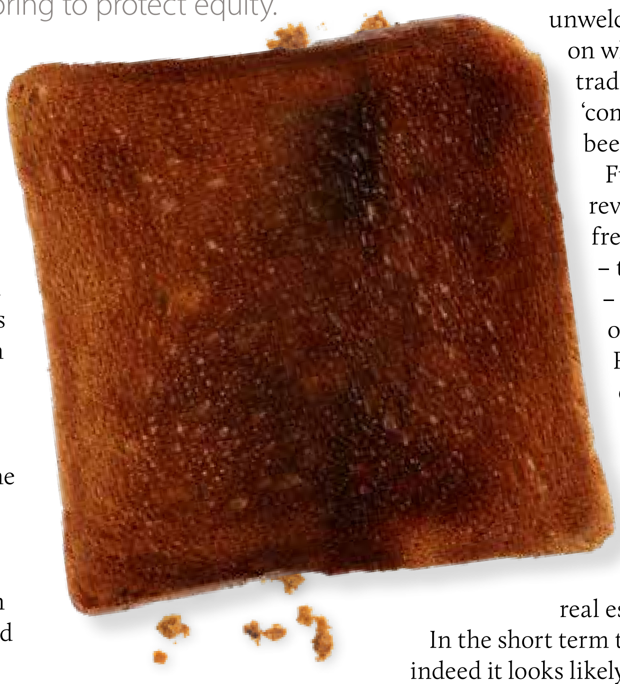
How equity became toast

The UK property market has been grappling with depreciating asset values over recent years due to a rare confluence of extreme events.

Arab Banker asked Raed Hanna, Managing Director of Mutual Finance, one of the UK's largest property finance companies, to analyse the impact this has had on the sector and the way both lenders and borrowers are endeavoring to protect equity.



The UK property market has been buffeted by a series of 'black swan events' over recent years. Today, lenders and investors alike are taking a more cautious approach, as they seek to adjust to often unwelcome new realities. Collectively, the impact of the Covid pandemic, Russia's invasion of Ukraine and the infamous budget from former UK prime minister Liz Truss, have had a significant impact on valuation, sales velocity and yield expectation.

Lenders and borrowers are being forced to confront the fact that property values are decreasing, that the equity in many properties is dwindling, and in some cases, may have vanished totally. For many investors, regardless of the value of their property, the question they are asking is 'has my equity become toast?'

While this is certainly bad news for borrowers, it is also placing a strain on lenders. Many are finding that the loan-to-value covenants they had originally imposed are now underwater, or at least under significant pressure, since in many cases the outstanding mortgage or loan on a property exceeds its value.

This has prompted a number of lenders to re-examine their real estate exposure and review loan and legal documents in a bid to enforce revaluation clauses. This is done with a view to asking clients to inject additional equity from their own resources, or via a consensual asset sales programme.

We have seen a number of lenders pull back from certain sectors such as offices and retail assets, while others have altered their lending criteria, embracing a more prudent and cautious approach. Based on our knowledge of the lending markets, we estimate that the LTV ratio for both offices and retail has respectively fallen by at least 10% since Covid, while interest coverage ratios are significantly more stressed than in the past. The sudden, sharp reduction in leverage of real-estate debt has had a major impact on refinancing opportunities, leaving many borrowers with no options and lenders with little chance of a provision-free exit via refinance. A number of lenders will no longer even consider office or retail assets.

This in turn has hit sales prices and caused a significant yield shift, prompting, on some occasions, the hasty sale of assets.

Valuers who may once have been robust and optimistic in their 'Red Book' reporting, in line with mandatory valuation practices issued by global professional real estate body RICS, are suddenly in a very different place.

Valuation figures have been squeezed from both sides. Just as lenders are demanding updated valuations to reflect changes in market conditions, increasing levels of distressed or forced sale transactions have provided an unwelcome new set of market comparables on which to base them. Valuations are traditionally based on an assessment of 'comparable sales' of similar assets and have been severely depressed as a result.

Furthermore, while banks are calling for revaluations of their current assets more frequently, there is concern that valuations – traditionally based on 'comparable sales' – are being further depressed by the lack of 'willing seller' data from the market. Rather, many sales are now being "forced or encouraged" by lenders.

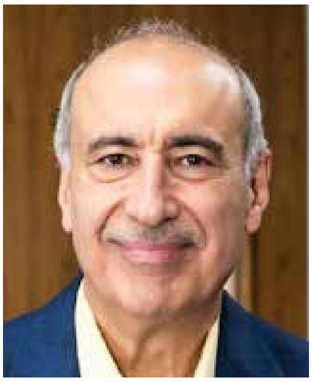
The pace of forced sales, transforming paper losses into actual ones, is accelerating as lenders double down on reviewing documents and covenants and continue enforcing default scenarios across the lending books of real estate-backed loans.

In the short term there seems little grounds for optimism, indeed it looks likely that lending facilities will reduce still further as UK banks limber up in readiness for the new, more stringent requirements of Basel III. Many have already drawn up plans for a re-allocation of capital in mid-2025, in response to the worldwide demands contained in Basel III, which will require them to increase capital requirements significantly.

These new standards also include new rules for calculating risk-weighted assets – a metric used to determine the minimum amount of capital a bank must hold in relation to the risk profile of its lending activities and other assets. Under the new rules banks will be required to set aside more capital in order to reduce an asset's risk weighting. It will take time before their full impact will be felt, since they will be phased in gradually over four and a half years.

Nevertheless, we are already seeing banks preparing for these toughened rules when considering longer term facilities. Ultimately Basel III will lead to different assets classes being appraised in more stringent ways, resulting in increased lending margins, thus compounding the cost of borrowing further.

This will be most clearly marked in the different treatment of commercial versus residential property owing to the fact that the Basel III rules will require banks to risk adjust



Raed Hanna

Raed Hanna established Mutual Finance in London in 1998 and since then the firm has become one of the largest property finance intermediaries in the sector. During 2023 the company arranged over £800m of debt and has been consistently involved in financing some of the most high-profile assets in the UK.

their lending downwards against commercial real estate assets. In turn, this will force many commercial property lenders to allocate more capital, thereby restricting their overall lending.

The lending industry has been hit hard since the global financial crisis, of 2008–9, when historic levels of government intervention were required to bail out and rescue lenders with large exposures to commercial real estate. In my opinion, this assistance will not be provided again.

Quite often we see that the challenge lies with individuals within a department rather than the bank itself. Some less experienced teams or departments may panic, taking quick decisions to protect themselves, without considering and acting with the long-term benefit of the property lender or client in mind. Others have asked for unreasonable equity injections at inappropriate times.

The sudden transfer of some loans into 'restructuring teams' within banks, often as a result of technical rather than actual covenant breaches, can also severely affect relationships. Many clients who had been highly respected borrowers suddenly find themselves confronted by lenders and bank officials with whom they had no relationship history or track record.

Of course, the disappearance of 'cheap money' as a result of the Bank of England's steep hike in interest rates over the last couple of years has impacted many clients. Those who had stretched themselves by obtaining high LTV ratios and low-end covenants have been the most exposed. However, this does not necessarily mean they would be the first targets. With a loan already at close to 100% LTV, lenders will often be more patient and seek a way to secure an exit without losses.

Lenders may also take a more favourable view of those clients who can provide a full repayment most swiftly. Banks will also be more considered in cases where there is junior debt and personal guarantees. This additional layer of equity can be used as a lever to reduce facilities. Traditionally, private banks had relied upon a client's asset base to support personal guarantees, but readjusted property values and other market disruptions have been eroding the net asset value of high net-worth clients. This has unfortunately led to many conflicts between clients and banks as they seek to remedy the situation.

We continue to see disagreements between clients and lenders regarding the best way to deal with LTV breaches. Typically, lenders will want to sell assets and clients will want to hold onto them, assuming that there will be a better time to sell in the future.

Although most facilities are agreed on a bi-lateral basis, disagreements can intensify when the debt layers of banks in syndicated larger deals are ranked in a capital stack. Those further down the stack can face a total loss on their investment and consequently their attitude toward loan restructuring may differ significantly from those at the top of the stack, for whom exiting may involve no – or significantly smaller – financial loss.

Many methods have been tried and tested with a view to restoring equity in a transaction. However, given it is often not possible to know how long this process will take, or indeed if it will ever be achieved, it can be a dangerous waiting game that lenders are not always prepared to play.

There are also many instances where the fundamentals are so bad that investing new equity is simply an economically unviable option for a borrower. Sometimes cutting your losses is the only option. Even large companies with long arms and deep pockets have had to let go of some deals.

As we become accustomed to a higher interest rate environment, the banking market is stabilising. However, lenders have become much more prudent, seeking to lend mainly against best-in-class assets, or to secure income streams with financially robust tenants.

This now poses a significant challenge, in that there are substantial proportions of the property market deemed 'off-limits' by lenders, especially outside major cities and well-performing sectors.

Commercial real estate has been particularly affected.

According to the latest bi-annual report from Bayes (formerly Cass) Business School in London, published in May this year, new lending for commercial real estate fell 33% last year to its lowest level since 2013.

The report also found, in terms of specific asset classes, that fewer than ten lenders, from a total of 71 surveyed, were willing to finance secondary retail assets or shopping centres. By contrast, 45 and 43 lenders were prepared to finance prime logistics assets and student housing assets respectively, ranking them among the most attractive asset types today,

We continue to work hand in hand with lenders and borrowers to reach consensual and mutually beneficial solutions. Once paper losses are quantified and the lender recognises its worst-case position (potentially with a debt-for-equity swap), it is often agreed that the client is the best placed asset manager to maximise potential recoveries. With a share in the equity position, the bank can hopefully take a more sympathetic view, in accordance with a long-term business plan.

I would like to think that some lessons have been learned over recent decades, with a number of clients now very focused on interest rate hedging. Having long term fixed rates in place help increase the predictability of cashflows. Others are seeking (where cashflow permits) to amortise their loans, reducing the debt over the term of a facility and therefore mitigating the refinance risk at the end of the loan.

Additionally, on occasion, we see some lenders reducing margins and increasing fees so as to increase the income available to service debt.

We are starting to see some light at the end of the tunnel. New lenders are entering the marketplace with no legacy of 'doubtful debt' – an account receivable that might become a bad debt at some point in the future – and others are looking forward positively as interest rates look likely to continue to fall. However, we don't expect this to be a quick fix and it is likely to be some time before wider positive market sentiment returns and we see transaction levels increase significantly. ■