Cass Commercial Real Estate Lending Survey

Mid-year 2018 Update Report

October 2018

The Cass CRE Lending Survey is sponsored by:
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The Cass CRE Lending Survey:

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Disclaimer

Acknowledgements

The authors are grateful for the on-going financial report for this work provided by the sponsor firms listed on the front cover. The analysis relies on the commitment of time and effort in providing information from the staff of 82 lenders, listed in Appendix 4.

The CRE Lending Survey was originated in 1999 by Bill Maxted and Trudy Porter of De Montfort University who continued the work up to 2015. We are indebted to the original authors for the historic data, analysis and insights underpinning the current results.

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Summary

This summary first states of the headline results from the 2018 mid-year update of the Cass Commercial Real Estate (CRE) Lending Survey, then summaries the main points from the more detailed breakdowns and time-series analysis in the main body of the text.

The Survey Sample

For June 2018, Survey responses were received from a total of 82 lending organisations, comprising 42 Banks and Buildings Societies, 11 Insurance Companies and 29 Other Lenders. A full list of lenders covered by the survey is in Appendix 4.

Outstanding Loans

Over the first half of the year total lender books shrank marginally, the net result of a large gain in for North American banks, the smallest lender category, and a fall in the books of UK Banks (the category includes building societies).

Outstanding loans and commitments, £ million

	Outstanding Loans	Undrawn Commitments	Total book June 2018	*Total book Dec 2017*	% change H1 2018
UK Banks	70,416	17,077	87,493	*96,409*	-9.2%
German Banks	18,979	742	19,720	*19,914*	-1.0%
Other Banks	22,096	2,068	24,164	*25,139*	-3.9%
North American Banks	10,337	5,077	15,414	*8,686*	77.5%
Insurers	23,263	754	24,017	*24,628*	-2.5%
Other Lenders	18,353	4,904	23,257	*24,244*	-4.1%
All Lenders	**163,444**	**30,622**	**194,066**	***199,020***	**-2.5%**

Source: Cass CRE Lending Survey

Undrawn commitments, which in total changed little through the first half, are mainly made up of the early stage of residential development loans. Unless specified otherwise, all the analysis in this report applies to the outstanding loans total of £163.4 bn, excluding the undrawn commitments.

Loan Origination

The £22.5 bn in new loans originated (excluding undrawn commitments) in the first half of the year were close to half the total recorded for the whole of 2017, but registered a substantial gain over activity in the first half of that year. Since lending activity normally steps up toward the year end, total origination for 2018 is likely to fall in the £45 to £55 bn range seen in the last four years.

Loan originations, £ million

	Full Year 2017	*First Half 2017*	First Half 2018	First Half % change
UK Banks	*21,424*	*8,118*	10,121	25%
German Banks	*5,740*	*2,050*	2,667	30%
Other Banks	*3,751*	*2,395*	2,121	-11%
N American Banks	*3,247*	*652*	1,898	191%
Insurers	*4,225*	*1,582*	2,210	40%
Other Lenders	*6,063*	*2,863*	3,476	21%
All Lenders	**44,450**	**17,659**	**22,492**	**27%**

Source: Cass CRE Lending Survey

With the exception of "Other Banks" – ie excluding UK, Germany, US and Canada - all lender categories significantly increased their origination through the first half of 2018 compared to the same period 12 months earlier. At the same time the syndication market also saw a high volume of activity with £6.3bn of syndication, against £8.9bn recorded in the whole of 2017.

Debt and the market cycle

The twenty-year history of the CRE Lending Survey tracks the leverage cycle through the long boom of the early 2000s, followed by the marked collapse and deleveraging after 2007.

- Measured by outstanding loans, CRE lending has had only three states in 20 years: rising from 1999 to 2008, falling from 2008 to 2014 and since then, flat.
- Neither the volume of or direction in loan books have had any enduring connection with the health of the market, measured by movements in capital value or by trading volumes.
- Loan origination is, however, linked to values and trading in the underlying real estate market: both before and after the market crisis for example there was a persistent tendency for every £1 in real estate transactions to generate £0.5 in loan origination.
- However, that relationship broke down from 2004 to 2008: loan originations stood far above the level indicated by market activity, and ran on after strong market signals such as peak rates in capital growth, and even falling capital values.
- Which resulted in the wave of loan defaults and losses which peaked in 2012, and fully subsided only in 2016, a full ten years on from the peak in real estate capital values.

Lenders – loan books and origination

The CRE Lending Survey has tracked 9 years of continuous growth in loan books up to 2008 (at an average 20% per year) followed by six years of continuous contraction (at 7% per year) to 2014. Against a turbulent history, we are now in the fifth year of what looks like extraordinary stability in both loan volumes and market structure.

- Since 2014 total outstanding CRE loans have stuck between £160 bn and £170 bn, and annual loan originations have run in a tight band from £45 bn to £55 bn: the first half of 2018 falls in with this stability on both measures.
- From 2008 to 2014 a decline in market share of previously dominant lenders among UK Banks, and the entry new lenders such as form of debt funds run by asset managers, created a new, more diverse, lending marketplace with more providers plus a wider range in lender sizes and business models.
- That new structure also appears to have stabilised since 2014, with shares of outstanding loans settling around 60% for the traditional lenders – UK Banks, and Insurers – 30% for non-UK Banks, and 10% for Other - generally new – Lenders.
- While there is still a tilt in recent origination shares toward newer and smaller lenders, the new broad division of the market looks set to remain unchanged.

Collateral – loan types and market exposures

The Survey provides unique insights into the assets underlying lender loan books and originations, categorised by type of project, form of loan and asset location. At the aggregate level, loan books are dominated by senior debt secured by existing investment properties, with small fractions in riskier development project or subordinated loans. The split across lender types and sizes, however, shows strong differentiation in business models and risk exposure.

- Standing investment properties are collateral for 86% of outstanding loan value; development loans have edged up from a 2014 low of 9% to 13%, but stand well below their peak share of 21% in 2007.
- Senior loans – with first claim on underlying collateral – dominate loan books, with only 2.4% out outstanding debt, and 1.8% of origination in the first half of 2018, in the form of subordinated loans.
- Development exposure – currently mainly in the form of residential schemes - is highly concentrated into UK Banks (16% of outstanding loans) and newer Other Lenders (24%).
- Subordinated debt is highly concentrated among Other Lenders, who have accounted for 70% - 80% of origination since 2014, supplanting the bank lenders who previously dominated this segment of the market.

Underwriting – interest rates and lending terms

The current terms applied to lenders have adapted to the changes in regulatory frameworks and persistent low interest rates of the last decade. As in many other aspects, the June 2018 survey results suggest underwriting criteria have settled around a new normal.

- Typical borrowing costs have edged up from late 2016 with Swap margin and LIBOR increases and marginal falls in prime lending margins – although secondary lending margins have shown a distinct upward shift over the last eighteen months.
- The spread between average property yields and debt costs has narrowed to 150 bps; senior debt yield, calculated on the basis of the LTVs offered by lenders, stands around 8%, close to its long run average and 200 bps above its 2006 level.
- The upper bound for LTV ratios has settled at 55%-60% across primary and secondary assets across all sectors, showing the smallest range across asset types on record.
- Lending margins on senior loans and prime property, at 194 for office bps to 220 bps for industrial have changed only fractionally since 2016; margins for secondary retail and office loans have, however risen over the period, with close to 300 bps prevailing across all three sectors.
- In contrast to investments lending, margins on development loans have risen sharply since 2015 and, despite a dip through the first half of the year, remain close to previous peaks.

Loan book quality

On standard underwriting metrics, the status of loan books has improved enormously from the low points of 2010-2012, with LTVs suggesting good coverage against any dip in capital values, and very high levels of income cover now the standard – no doubt due to a tilt toward income-based lending criteria and away from simple LTV.

- The mid-2018 results, nonetheless, suggest the long trend toward stronger loan book quality reached an end-point at the end of 2017, with a small uptick in higher LTV and lower IRC loans, and the first rise in the incidence of defaults since 2011.
- And the risk metrics do vary across lender types: for banks of all origins, for example, 80% of outstanding loans by value are at 60% LTV or lower, while that proportion is under 40% for the new Other Lenders, who are more inclined to take on subordinated debt and development funding.

Appendix 4: Respondents to the mid-2018 Survey

Aberdeen Standard Investments
Aalto Invest LLP
Aareal Bank AG
Aeriance Investments S.A.R.L
AgFe
AIG Asset Management (Europe) Limited
Allied Irish Bank (GB)
Aldermore
Al Rayan Bank
Aviva Investors Real Estate Finance
Axa Real Estate
Bank of America Merrill Lynch
Bank of Ireland Group
Barclays
Bayern LB London Branch
Blackstone Real Estate Debt Strategies
BNP Paribas
Cain Hoy Enterprises (UK) Limited
Cambridge and Counties Bank
Canada Life Ltd
Chenavari Investment Managers
Cheyne Capital Management (UK) LLP
Citi Group
Close Brothers Property Finance
Contour Capital
Coutts and Company
Credit Agricole Corporate & IB
Clydsdale Bank
DekaBank
Deutsche Bank AG
DRC Capital LLP
Europa Capital Mezzanine Ltd
GAM International Management Limited
GreenOak Real Estate
Hermes Investment Management
Helaba Landesbank Hessen-Thüringen
HSBC Bank plc
ICG-Longbow
ING Real Estate
Investec Bank (UK) Ltd
J P Morgan Securities
Laxfield Capital
Landesbank Baden-Wüerttemberg
LaSalle Investment Management
Legal & General
Lloyds Banking Group
M & G Investment Management Ltd
Maslow Capital
Man Group
Metropolitan Life Insurance Company
Morgan Stanley
Münchener Hypo Bank EG
N M Rothschild and sons
Och Ziff Capital Management
Oversea-Chinese Banking Corporation Ltd
Pacific Life
Partners Group (UK) Ltd
Partnership Life Assurance Company
pbb Deutsche Pfandbriefbank
Pluto Finance
Pramerica Real Estate Investors (Europe)
PGIM
Principality Building Society
Royal Bank of Canada
RateSetter
Santander Corporate & Commercial Banking
Starwood Capital Europe Advisers LLP
Société Generale
Sumitomo Mitsui Trust Bank Limited
TH Real Estate
The Royal Bank of Scotland
UBS Asset Management
Urban Exposure Limited
Wells Fargo Bank International
Zorin Finance

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Cass Business School
In 2002, the School was renamed Sir John Cass Business School following a generous donation towards the development of its new Bunhill Row premises.

Sir John Cass's Foundation
Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.

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