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Real Estate Finance – Debt Advisory

How COVID-19 has affected different UK real estate asset classes

Navigating the UK Real Estate Debt Market in the COVID-19 crisis – Part 2

June 2020

INTRODUCTION

Ashley Marks
Head of Real Estate, Excellion Capital

Excellion Capital prides itself on having its finger on the pulse of UK lenders. Never has this been more import than it is today, when uncertainty abounds.

We were delighted to note how positively our first report was received. Last month, we looked at how different types of UK Property lenders have responded to COVID-19. As a follow-up, we are today sharing with you Part 2 of our insight into how the UK real estate lending sector is reacting to the crisis, where we assess how different real estate asset classes are affected. Like Part 1, Part 2 also features insights obtained through our proprietary market analysis which includes in-depth conversations with more than fifty lenders.

For those of you who have not had a chance to review Part 1, you can access it on our website under www.excellioncapital.com/our-firm/publications. Please refer to the appendix for a summary of key trends from the report.

Since our last report, lender appetite continues to evolve as the Government begins to ease the lockdown restrictions and the effect of COVID-19 on the wider economy is better understood.

We expect COVID-19 will have a profound and long-term impact on several verticals of the UK real estate market. The way we work and live has changed dramatically; and we believe some of the changes are here to stay in one form or another.

As discussed in Part 1, the introduction of emergency legislation aimed at protecting tenants in commercial property has led to significant non-payment of rent at the March quarter. This has had a direct impact on landlords and their ability to meet interest payments. The knock-on effect was a surge in borrower requests for interest holidays. Although this is supported by the Government, only high street banks and other certain lender types benefit from Government support.

The lenders we have spoken to expect rent receipts by their commercial real estate borrowers from their respective tenants to fall significantly further for the June quarter, where rent received could be as low as 25%, meaning 75% non-payment.

Expectations vary from lender to lender as large differences apply across real estate sectors. This is severely affecting lender appetite for new loans in relation to commercial real estate in general. Meanwhile, certain commercial property types remain fundable. This is typically the case where the property is let to strong tenants who continue to pay rent and whose business and occupation are less impacted by the crisis, such as supermarkets.

As lockdown continues to be eased and businesses reopen, lenders will be concerned about the longer-term impacts on tenants and occupier demand on landlords across different real estate classes.

INTRODUCTION continued

When we published Part 1 of this series, a number of lenders struggled to assess the impact of COVID-19 on their existing book.

At the time, many lenders were inundated with borrower requests for covenant waivers and interest holidays and they were working through their books to determine how to adjust their lending policies in light of the new risks they face. From our discussions it would appear that the majority of high street lenders remain focused on their existing book and assisting existing customers, and most of them remain closed to new-to-bank customers. Meanwhile, the wider lending market has now reopened, but significant variances remain from sector to sector. It is with this in mind that I believe this publication is timely.

> *"The majority of high street lenders remain focused on their existing book and assisting existing customers, whereas most of them remain closed to new-to-bank customers."*

Removal of restrictions on physical valuations has played a role in reinjecting some life into the lending market as valuations continue to be a critical component for lending. Valuers being able to access properties means valuations can now be obtained again. However, valuation still remains a key risk with the lack of comparable transactions during or since lockdown making it difficult for any valuer or property buyer to assess the value of property on a post COVID-19 basis.

INTRODUCTION continued

RICS has provided guidance as to how valuers should apply or amend the suggested COVID-19 language to valuations and the associated impact this will have on the reliability of valuations and the insurance and PI cover offered.

Whilst it would go beyond the scope of this report to discuss all valuation-related aspects in adequate detail, our team is trained and available to discuss the key aspects with you as they apply to your situation.

Excellion Capital has seen activity pick up over the past 4 weeks, with approvals and funding taking place specifically in Residential property, across investment assets, development assets and within the bridge space. We have also seen active lender engagement in relation to supermarkets and industrial units.

We are pleased to share with you here our analysis, sector by sector. For your convenience, we also include below the key trends we have been seeing in the market. Should you wish to discuss the market or your own lending requirements, we would be happy to assist.

Ashley Marks

KEY TRENDS

- **Development finance**
  - **Commercial:** Development finance is only available with a suitable pre-let in place at lower leverage.
  - **Residential:** Lender appetite is returning. Finance is available for well located schemes at an LTGDV of c. 50% – 57.5%
- **Office –** COVID-19 has long-term significant and arguably permanent impact on office demand and the utilisation of space. Lender appetite remains for core locations with long term strong tenants. Appetite for Co-working, short-term and flexible leases is more restricted.
- **Retail –** Non-food retail was already a struggling sector. This has been further intensified during the crisis, with limited appetite from lenders. Food retail (e.g. supermarkets) has been bolstered and good appetite remains from lenders.
- **Logistics/warehousing –** Arguably the one sector which has benefited from the crisis, with lender demand remaining robust for multi-let units and large boxes.
- **Hotels –** Severely impacted during lockdown and beyond with travel restrictions and social distancing. Lenders are looking to support existing customers, with some limited appetite for new developments/investments at low leverage.
- **Healthcare –** Remains a robust sector, with lender focus on income multiples and strength of operator as opposed to asset values.
- **Co-living –** Direct impact due to high density and shared services. Lender appetite focused on schemes with limited shared services.
- **Student Accommodation –** Long-term robust sector, however it has been impacted by international travel restrictions. Appetite remains at conservative leverage where there is not much reliance on overseas students. In some cases an interest reserve is required for additional downside protection.
- **Residential and PRS Investment –** Direct short-term impact, which should now ease as the market opens up. Long-term demand / supply imbalances underpin lender appetite. Lenders remain supportive at lower leverage due to the uncertainty associated with valuations.

LENDER ANALYSIS

Appetite varies considerably across sectors

by Gareth Taylor
Real Estate Director, Excellion Capital

COVID-19 has had an impact on every sector of the UK real estate market — from offices, leisure and industrial through to residential property. Whilst certain sectors have been impacted more than others, all sectors are impacted in some way.

Savills recently reported the results of a survey of the impact COVID-19 has had on occupier demand after the pandemic has passed, by sector. Although the data is not UK specific but rather global, this provides a useful insight into differences between property types.

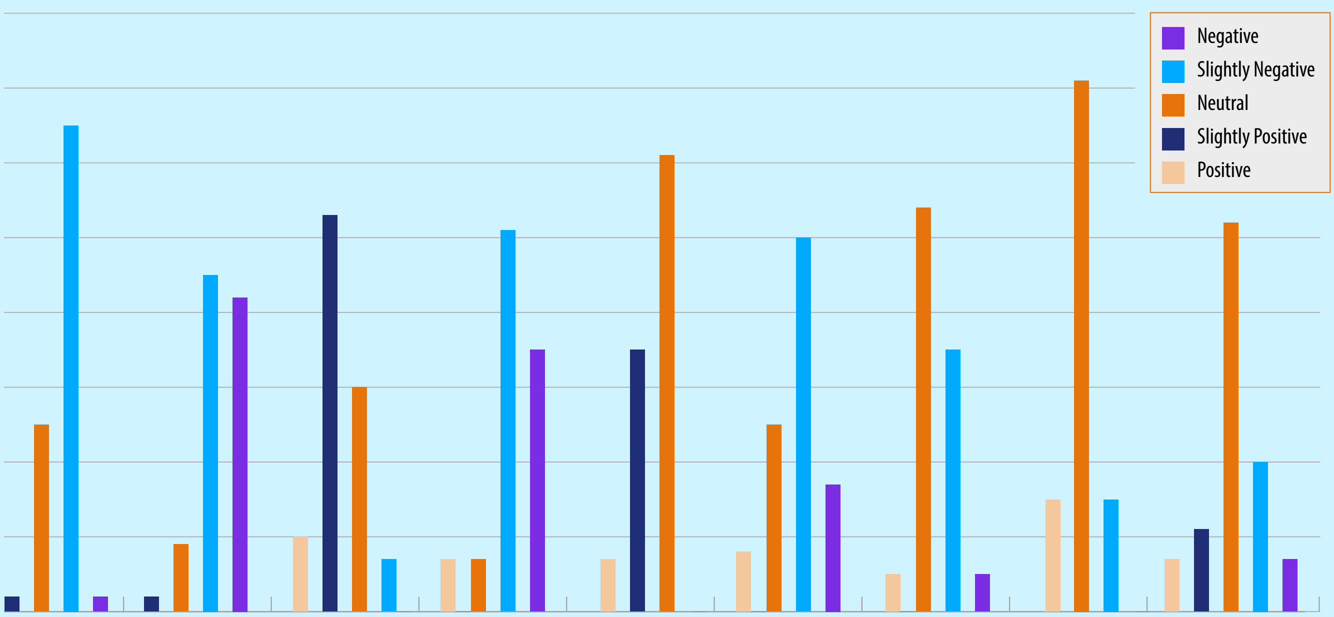
We explore the investment outlook for each sector in more detail below.

Offices

Given the intense exposure and an overall more-favourable-than-expected experience of remote working for most office occupiers during COVID-19, Coronavirus will have a significant impact on the office market.

According to the Savills Global Sentiment Survey, 84% of respondents expected home working to increase somewhat, whereas the remaining 16% expect it to greatly increase. More than half expect the use of video conferencing to greatly increase after the pandemic.

Impact Of COVID-19 On Occupier Demand After Pandemic Has Passed



Source: Savills Research

LENDER ANALYSIS continued

We note recent corporate announcements, for example from Twitter and Square, Inc, that virtually all their employees will have the option to work from home permanently, which sent shock waves through property investors already grappling with the difficulties of how and when office occupation will resume. On the heels of surprisingly successful work from home (WFH) experiences, there is momentum in favour of expanded WFH policies going forward.

> *“Facebook said they expect 50% of their workforce to work from home over the next decade.”*

Whilst longer-term policy questions as to how much WFH can be tolerated remain, we note that Google and Facebook also announced plans to permit employees to work from home after 2020, with Facebook stating that they expect 50% of the work force to work from home over the next decade.

Aside from public health questions, which arise in particular in relation to public transport and dense lifts in high rise towers, part of the equation is also the collateral benefits such as reduced commute times, lower pollution levels, reduced operational costs, and arguably an increase in morale at the level of the individual.

Whilst we accept that there is a world of a difference between making WFH work temporary where there is no choice and choosing WFH as a permanent solution, there is no denying that WFH is less painful for many office-based businesses than many of us would have thought.

With this in mind, we expect demand for office space to reduce as a result of social distancing requirements and changing work habits. At the same time, we also expect we will see less densely packed offices which would offset some of the space that will not be needed as a result of people working remotely.

It should also be noted that vacancy levels in the UK’s key office markets were at very low levels; this should also help mitigate some of the risks associated with the office sector.

We are seeing a significant impact on offices with short term tenancies (or licenses), especially in the co-working space where a large part of the benefit of being in such an office will no longer be deemed relevant by many occupiers.

These occupiers are not bound by long contracts and as such the COVID-19 impact on co-working is a immediate. Bearing in mind how dramatically the share of co-working spaces has grown within the country’s key office markets between 2012 and 2020, the knock-on effect on the wider UK office market must not be underestimated.

Office demand will change, but a core demand will remain for centrally-located, good quality office space. The impact on offices with strong tenants and longer leases should be less marked and lending appetite is likely to remain stable where lenders can be confident rents will be paid. We expect senior leverage will contract slightly, e.g. from 60% LTV towards levels closer to 50% as lenders become generally more conservative.

LENDER ANALYSIS continued

Retail

Retail as a sector was already struggling before the stay at home orders began, with consumers moving towards online shopping in greater numbers, requiring many retailers to reposition their offering.

With all physical stores closed at the beginning of lockdown and most stores having re-opened only in mid-June, the COVID crisis has had a major impact on non-food retail, and a direct impact on revenue. Retailers with online offerings have been able to partially mitigate this. However, this has had a direct knock-on effect on landlords with tenants not being able to pay their rent. The impact on non-food retail is likely to continue as lockdown restrictions are slowly lifted with strict social distancing policies in place.

On the flip side, food retail has performed well as demand increased significantly. Food retailers have been able to take up the slack from restaurants, cafés and coffee shops, and according to Knight Frank, demand has spiked by 21% over the last month alone.

The impact on non-food retailers is having a significant impact on lenders' appetite. Many lending businesses already have large exposures to retailers and many retailers have already invested a significant amount of time over the past years working with landlords to get through a tough trading environment that existed before. The crisis has only exacerbated this. Whilst appetite for assets with strong food retail tenants with longer leases will remain resilient, retail is not a popular word in most credit committees.

> *"Food retailers have been able to take up the slack from restaurants, cafés and coffee shops, and according to Knight Frank, demand has spiked by 21% over the last month."*

Logistics/warehousing

We believe logistics and warehousing is a sector which may actually benefit from the Coronavirus crisis, with a significant increase in demand from online purchases.

A number of online retailers have temporarily experienced problems with meeting the surge in demand, particularly supermarkets, and this is likely to impact demand for additional warehouse space.

Transactions are happening and lender appetite remains robust, particularly for diversified portfolios of multi-let industrial and for large big boxes with long leases to strong tenants.

Healthcare

Due to the nature of the crisis, healthcare is seen as a robust sector.

There is obvious uncertainty about care homes specifically given the issues faced, but in general lenders are open to providing funding for the sector. Often lenders are considering the leverage multiple rather than asset valuation as a suitable funding metric to ensure sustainable debt is provided.

LENDER ANALYSIS continued

Hotels

Travel restrictions (both domestic and international) as well as social distancing requirements have had a very clear impact on the hotel industry, with hotels temporarily shut. With the travel sector also still heavily restricted, uncertainty remains around the exit strategy for the hotel sector.

We expect the significant impact on debt financings of operating hotels to prevail throughout 2020 and 2021 as many commentators believe it could take up to 18 months before tourism and business travel statistics return to pre-COVID levels. As lockdown restrictions are lifted in the UK and internationally, we also expect a shift from international travel to domestic demand.

We further expect London to recover before the other regions, and central London locations to fare significantly better than more marginal locations. That said, sector analysts forecast that revenue per average room will not reach 2018 / 2019 levels until the latter half of 2022. Lenders will look to support existing customers with covenant holidays of up to 12 months, but only very few hotel financing proposals are being considered at this point in time. For existing properties and development sites in central London, a select few lenders are considering selected proposals provided the request involves modest levels of leverage and higher-than-usual downside protection.

"Many commentators believe it could take up to 18 months before tourism and business travel statistics return to pre-COVID levels"

Student accommodation

The impact on student accommodation will also vary from project to project. The long-term prognosis has not changed and it should be noted that Student Housing typically performs well during a recession. There is a short-term impact which will be mitigated to some extent by students paying upfront. However, for landlords who receive rents at the start of each term or quarterly, there will be a significant amount of non-payment for the summer term and no income from short term lets during the summer holidays.

Lenders are also concerned as to what university campus life will look like in the 2020/21 academic year and whether demand will drop from new students who either defer a year or do not come to campus if lectures are not taking place. In certain cases, student accommodation developments have been delayed due to sites being shut which could mean developments not being completed in time for the 2020/21 academic year. Where this is the case, lenders are trying to work with borrowers to provide a longer interest period to deal with the potential void period. This will impact existing development projects, but is less of a factor for new projects seeking development funding as the expectation is that these concerns will have passed by the time the development is completed.

During the last financial crisis this sector showed resilience and quickly bounced back. What remains to be seen in the current crisis is the impact on demand from foreign students as international travel may be limited for some time. Nearly 20% of the UK's student population — around 460,000 students — come from abroad so the loss of these students will have an obvious impact on this sector.

LENDER ANALYSIS continued

> *"Nearly 20% of the UK's student population — around 460,000 students — comes from abroad so the loss of these students will have an obvious impact."*

Lenders assessing any new loans will focus on underlying fundamentals based on the strength of the universities, supply and demand imbalances and reliance on foreign students which are expected to play a more subordinated role as compared to other years.

We have new loans being agreed for strong borrowers in key locations on existing assets but with up to 12 months interest reserve, in order to mitigate any impact from occupation levels in the 2020/21 academic year.

We are aware of development lenders who are active and believe a more normal market will have returned by the time any development is completed.

> *"Buyer demand across England spiked up by 88% after the market reopened, exceeding pre-lockdown levels in the week to 19th May; this jump in demand in England is temporary and expected to moderate in the coming weeks."*

Co-Living

Due to the desire for shared services and the high density of offering this is a sector that will be challenged as a result of COVID-19.

We are aware of specific projects where development funding has been pulled for Co-Living projects specifically designed with community use in mind. However, where the offering provides limited services and merely involves multiple residential units in the same building, the proposal will be perceived as more residential in nature, and defensive residential property continues to see funding support throughout the crisis, with funding for certain Co-Living assets already available today.

Since lockdown started, we have closed a couple of loans in the Private Rented Sectors (PRS), with some funding for 10 years at exceptionally low rates.

Residential and PRS

Given the size and diversity of the residential property market including the Private Rented Sector (PRS), we will comment separately on lending activity within (a.) residential investment assets and (b.) residential developments.

a. Residential Investments

Following the government's advice not to move homes, there was an obvious impact on transactional activity in the residential sector. This resulted in the housing market coming to a standstill, with the Bank of England reporting a 79% drop in mortgage approvals in April. However, as lockdown is eased and now that estate agents have reopened and valuers can access properties again following the Government's updated advice, the market is returning with surprisingly high levels of activity. Hometrack reported that "Buyer demand across England spiked up by 88% after the market reopened, exceeding pre-lockdown levels in the week to 19th May; this jump in demand in England is temporary and expected to moderate in the coming weeks".

LENDER ANALYSIS continued

Although it is too early to assess transaction volumes, we have received positive reports from estate agents as regards post lockdown viewing levels and also sales agreed.

Despite the crisis, the fundamental and acute demand-supply-imbalance in the UK housing market is still in place. What remains to be seen, however, is whether the economic impact of the crisis on consumers will significantly reduce borrowers' ability to purchase property which requires not only lender appetite but also consumer equity, and consumer confidence.

The rental market has and will be impacted in the short-to-medium term, as meaningful parts of the population struggle to pay rent. At the same time, we are seeing a reasonable level of activity among lenders in this arena.

In light of these underlying demand fundamentals, we note Hometrack (Zoopla) said: "the impact of coronavirus saw a 57% fall in demand for rental housing in the two weeks to 30 March; the fall in demand has since bottomed out and rebounded 30%, off a low base, in the two weeks to 14 April". In addition, Rightmove also registered a huge 22% increase in demand for lettings in the w/c 25th May compared to the same point in 2019.

Given the uncertainty it is likely that a number of occupiers may wish to rent before buying in the market and

> *"The Impact of coronavirus saw 57% fall in demand for rental housing in the two weeks to 30 March; the fall in demand has since bottomed out and rebounded 30%, off a low base, in the two weeks to 14 April."*

as such the number of people renting will likely increase providing support to residential rental values.

Overall, the residential sector has certainly been the most active among lenders. Excellion Capital closed three residential investment loans since lockdown began and we continue to see demand from lenders for both traditional residential and PRS units.

b. Residential Developments

Property development has been directly affected by the crisis, with many sites closed and some issues with supply chains. Following the Government's announcement supporting the reopening of constructions sites and the supply chain, most sites are open again and major suppliers have reopened. All the major housebuilders have also announced that all their sites are now open.

Uncertainty over how the crisis will impact housing prices remains unknown and this will prevent some site purchases until there is more clarity and this has led to a fall in support for loans secured on sites with planning.

Whilst some lenders are still on pause or seeking to fund higher quality projects than they might normally support at lower leverage points, the majority of other lenders remain supportive of residential developments in core markets and locations.

We have obtained credit approval for 4 development facilities over the past 4 weeks. These have been funded at a similar margin to what we would have expected pre COVID-19, however lenders have trimmed the available leverage which has been reduced across the board with most funders now lending 50% – 57.5% LTGDV.

TAKE AWAYS

How borrowers can navigate successfully in this ever-changing market

To succeed in this market, borrowers will need to understand the risks and uncertainties that lenders face — and address those pre-emptively. Borrowers must set out a comprehensive and realistic strategy in writing, i.e. articulate how exactly they will mitigate risks. Think: Plan A, Plan B and, if possible, Plan C.

Articulating their strategy in adequate detail will illustrate to the borrowers the questions the lenders and their respective credit committees will be asking and clarify the hurdles which will they will face during the underwriting process. This preparatory process must not be underestimated, especially in markets like these, when it is difficult to get a lenders' attention.

In today's challenging market, to get a deal over the line, it is more important than ever to present the opportunity in the best possible light, to anticipate a lender's challenges and to reach out to the most relevant capital providers. Who that is and how active they actually are is less obvious today than it seems.

> *"In today's market, it is very important to present loan and asset in their best possible light, to anticipate a lender's challenge and to reach out to the most relevant players. In a market like this borrowers require more assistance than ever before."*

It is our view that in a market like this, borrowers require more assistance and advice than in ordinary times now more than ever.

Excellion Capital builds long-term relationships with borrowers and lenders. We can help devise suitable strategies and structures together with the borrowers and ensure the asset and the lending opportunity will be framed to relevant lenders in a relevant manner.

The strong ties we have with a wide variety of lenders benefits from the regular dialogue we maintain with them, which helps us understand the overall market as well as their individual responses as it evolves. We know who is genuinely active and how they are responding to this crisis. As such, we are well placed to be of genuine relevance to our customers at this time.

If you have any questions or wish to speak about a specific property or sector please feel free to contact one of the team listed on the back.

0.1%
Bank of England Base Rate

0.2%
3 month UK LIBOR

-0.018%
UK 5 year GILT rate

0.38%
UK 5 year LIBOR SWAP rate

Figures accurate as at 16 June 2020

APPENDIX

Summary: Part 1 of this Series

Last month, Excellion Capital published a report entitled 'How UK property lenders are responding to COVID-19'. The May Report was the first in this Series; it analysed how different types of lenders had responded to the crisis. The May Report contained a summary of the Key Trends our team at Excellion Capital had been witnessing as the Coronavirus Crisis unfolded. For your convenience, these Key Trends have been reproduced here, given that they remain relevant and relate to the contents of this report.

KEY TRENDS

- **Lender appetite: severely reduced** — due to economic uncertainty and practical issues around valuation and reliance
- **Priority:** existing customers over new business
  - — **Priority 1:** Lenders are assessing current book and COVID-19 impact
  - — **Priority 2:** Existing loans and new loans to existing customers
  - — **Priority 3:** New opportunities are of lower priority, esp. within high street banks
- **Several pockets of activity exist** — specifically for residential assets (investment and development loans)
- **Open for business?** Challenger banks, alternative lenders and debt funds are more active for new business
- **Keen to be seen as a support to society**
  - — All lenders work closely with existing borrowers
  - — Banks are keen to avoid the backlash they faced in the GFC
- **Terms:** Where funding is available, the following conditions typically apply
  - — **Lower leverage:** LTVs are 5–10% lower than pre-crisis
  - — **Higher margins:** Margins can be 15–200bps wider (not uniform; see below)
  - — **Robust security package:** requirements on corporate / personal guarantees are rising
- **Pricing has not widened across the board**
  - — For strong assets in good locations with sustainable leverage, finance remains available
  - — at rates in line with pre-crisis levels
- **Greater scrutiny** on borrower strength, business plan, repayment plans, track record

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