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Real Estate Finance – Debt Advisory

How UK property lenders are responding to COVID-19

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

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Introduction

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Excellion Capital prides itself on having its finger on the pulse of UK lenders. Never has this been more important than it is today, when uncertainty abounds. UK real estate investors are facing new and truly extraordinary challenges as lenders are forced to adapt to a changed world and a new set of assumptions.

In this paper, we are pleased to share with you our insights into how UK lenders are reacting to the coronavirus crisis. We are highly active in this market and have obtained our insights through live market activity and in-depth conversations with more than 50 lenders. We have also completed several transactions since the crisis has hit the UK and received credit committee approvals on others from a variety of lenders.

Of course, lending volumes are massively reduced. Unlike the crisis of 2008, it's not that lenders don't want to lend. Lenders today are working closely with borrowers wanting to avoid the backlash they faced in the GFC.

Today, lenders wish to be seen as a support to society. That said, lenders are, understandably, concerned.

The introduction of emergency legislation aimed at protecting tenants led to significant non-payment of rent at the March quarter end. Some lenders informed us that rent received by their commercial real estate borrowers from their respective tenants has only been as high as 50% across the portfolio; this is expected to decrease significantly further for the June quarter, where rent received could be as low as 25%, meaning 75% non-payment. Expectations obviously vary from lender to lender and large differences apply across real estate sectors.

One major lender concern is therefore how will tenant payment behaviour affect interest payments from their borrowers, and how this will look in the future and where will the income for debt service come from? This, however, is not the only question on lenders' minds, as concerns over property values in the present and future also abound.

> *"Some lenders informed us that rent received by their borrowers across their commercial property book was merely c. 50% across their portfolio; this could decrease significantly further for the June quarter. Rents collected could be as low as 25%. 75% non-payment would be completely unprecedented."*

This concern is supported by data from the British Property Federation. It said that retailers had only paid a third of their estimated £2.5 billion rent bill at the March quarter payday. The BPF further expects rental payments to 'hit rock bottom' in June. Office tenants had paid about two thirds of their £2.1 billion rent bill and that sum was expected to halve to one third in June.

Pockets of lender appetite for new transactions are now narrowly focussed on situations where lenders have confidence that tenants will pay thus enabling borrowers to perform.

Introduction continued

Amounts lent are now at lower leverage levels, where debt can still be serviced in the event of partial non-payment of rent and loans are less exposed to falls in property values. We have also witnessed lenders requiring cash reserves to cover interest in the event of non-payment by tenants.

New lending is also heavily affected by a tighter lender focus as well as human resource limitations. COVID-19's sudden arrival shifted lenders' focus to support first and foremost existing clients with their cash flow needs and loan requirements. Most lenders are still busy reassessing existing loans for their credit integrity and supporting existing borrowers who may require liquidity or covenant waivers to get through.

Thus many consider new proposals not a priority and these are pushed further down the road. Some high street lenders have gone as far as to inform customers that they will not look at new lending opportunities until e.g. September, while others have decided to focus exclusively on existing borrowers and their needs.

New loans now face meaningful challenges with regards to valuers being able to provide a meaningful valuation report that lenders can rely upon. Valuation challenges apply irrespective of whether the loan's purpose is an asset acquisition or a refinancing. There are multiple aspects to this — they range from the valuers' difficulties in accessing properties in

> *“Today close to 40% of the outstanding loans reflect LTV ratios of less than 50%. This leaves lenders in a more prudent place than in 2008. Overall, this will lead to less radical lender action being taken than during the Financial Crisis.”*

times of lockdown and social distancing, to the lack of relevant comparables and to associated reliance and insurance-related questions. 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. Suffice to say, property valuations are a major obstacle to any new loan application in this market and navigating this minefield successfully will be a key determinant to successfully completing a transaction in today's market environment.

So... you might ask: is this ‘2008 all over again'? Not really. A key difference between COVID-19 and the 2008 Financial Crisis is that today close to 40% of the outstanding loans are understood to reflect LTV ratios of less than 50%. This leaves lenders in a far more prudent place than at the start of the Global Financial Crisis (“GFC”). We believe this will mitigate lender responses and bring about less radical action than that taken by many lenders during the GFC and its immediate aftermath.

In addition to leverage being, on average, much lower now than in 2008, the scene for borrowers is also markedly different. Since the GFC, the UK real estate debt market has diversified dramatically. We have witnessed a major influx of alternative and non-bank lenders who have changed the landscape significantly. The products offered, the lending process and loan delivery have all changed meaningfully. This leads to a market that is less uniform and which offers more diversity.

Lastly, let's talk about pricing. Some market commentators have said that interest rates have increased. This is not what we are seeing. Based on the transactions we have seen now, it would not be correct to say that pricing has widened across the board.

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Introduction continued

For strong assets in good locations with modest leverage, we have seen genuine evidence that finance not only remains available, but rather that it remains at the same or very similar pricing to the levels that prevailed before COVID-19 hit the UK.

We are delighted to note that since lockdown began, the Excellion team successfully completed 3 transactions; these are summarised on page 10. We work closely with a variety of trusted lenders that truly remain open for business and the transactions we closed with them during lockdown bear witness to this.

For these 3 loans, we had obtained credit approval before lockdown. Perhaps even more notable is therefore that we also managed to progress 4 completely new applications into legals, successfully obtaining credit committee approvals from 4 different lenders in the past couple of weeks. This, in our view, bears testimony to our team's operating experience and our ability to navigate successfully in difficult markets. These credit approvals are encouraging signs of life in a market in which relevant deals continue to be doable — albeit with significant difficulty.

For your convenience, I have included below the key trends we are seeing in the market today. Should you wish to discuss the market or your own lending requirements, we would be happy to spend time with you.

Ashley Marks

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

LENDER ANALYSIS

Different lenders are reacting in different ways

by Gareth Taylor
Real Estate Director, Excellion Capital

There have never been as many UK real estate lenders as there are today. The combination of a more diversified property debt market and COVID-19 means the list of active lenders — those genuinely writing new business today — is still very limited and the best lender is not always easy to find.

To understand how different lender types are responding to the COVID-19 crisis, we have spoken to more than 50 active lenders. Here are our findings.

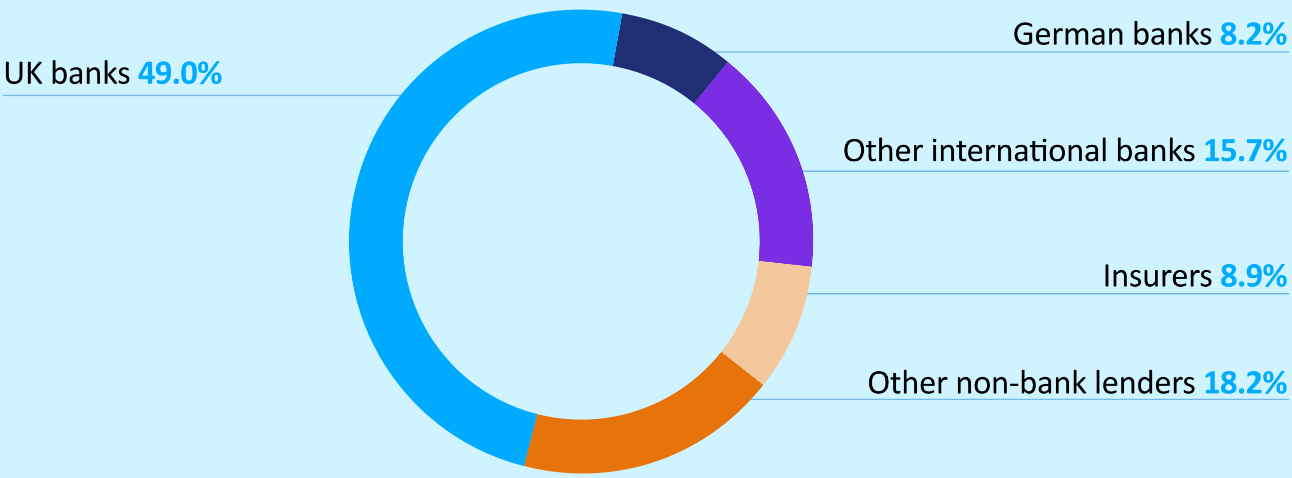
1. General observations — commonalities across lender types

The lenders we spoke with are fully assessing their lending book and the potential impact COVID-19 may have on value, on borrower's ability to pay interest and service the debt, and on the borrower's and the underlying assets' ability to sustain the capital sum due at maturity.

Although many lenders have stated they are still open for business, the reality is many are unlikely to complete new transactions or grant credit committee approvals until they have a clearer picture of what the market will look like after the crisis.

Outside of the high street banking market, strategy and appetite is also often driven by the lenders' own funders, many of which are based overseas. Some lenders are taking a pragmatic approach to new loans (and valuations), understandably with caution.

Market shares of different lender types *(by H2 2019 lending volumes)*



Source: CASS Business School Report on Commercial Real Estate Lending, April 2020

LENDER ANALYSIS continued

Generally, interest for some CRE asset types exists at lower loan to value ratios (e.g. 55% and lower) and lenders are looking to support strong and experienced borrowers with a solid track record only. Even higher risk lenders no longer look at the asset alone and also require a comprehensive strategy for repayment.

> *"Whilst lending is much more subdued, transactions are still closing."*

Invariably, the current crisis has also affected pricing across the spectrum of lenders, from high street banks to challenger banks, debt funds and insurers. Generally speaking, margins are widening. In some cases, it is not the interest rate that has seen upward pressure, but rather the leverage available was reduced at the same price point.

Despite these challenging times, lenders are generally looking to support existing borrowers on existing loans to find solutions, such as covenant waivers, repayment holidays and extensions. This is partially driven by lenders not wanting to compound issues or losses for what may be a temporary dip. In part this is also a result of the blow back that lenders suffered in public perception during the last financial crisis. As such, from a reputational perspective, no lender wishes to be seen to be making a bad situation worse at this time.

2. Crisis responses are not the same across the different lenders types

We have analysed how each of the different types of lenders we spoke to is responding to the crisis.

High street banks

The main focus of high street banks is on existing customers as they are keen to be seen as focusing on relationships. Their heavy exposure to the UK real estate market means a substantial amount of resource is focused on managing existing loans and providing flexibility to borrowers in the form of covenant waivers, restructuring loans or providing payment holidays.

Due to their role in the various government schemes (specifically CBILS), aimed at helping struggling businesses across the board (particularly SMEs), the sheer volume of requests has meant that new applications are not a priority. Indeed, one of these lenders has told our team that they will not consider any new-to-bank loans until September 2020.

Challenger banks

Among challenger banks, appetite and risk perception changes from week to week. Most challenger banks are now formalising their overall strategies to sensibly protect their existing book and provide new finance against the backdrop of a lack of physical valuations and the general economic impact of the lockdown.

Only some of the challenger banks benefit from government support, and many will feel the pain of repayment holidays and other concessions they need to make to their customers.

Whilst most challenger banks claim to be open to new lending opportunities, many are not providing terms or credit approvals to new loans until restrictions are lifted to allow physical inspections. Only a few challenger banks are genuinely progressing new loans on a case-by-case basis.

LENDER ANALYSIS continued

As such, within the challenger bank market, we have seen a limited number of new approvals going through. These have typically been in either in the bridging space or in residential property (investment as well as development assets).

Buy-to-let lenders

A variety of lenders issue Buy-To-Let (BTL) mortgages. This includes high street banks as well as building societies, challenger banks and alternative Buy-To-Let lenders.

Research from Knight Frank estimates that c. 500,000 home sales will be cancelled by the end of 2020 and predicted 350,000 fewer mortgages will be approved in England and Wales, even if lockdown restrictions start to be lifted in Q2 2020. Interestingly, property portal Rightmove put its monthly house price survey on hold noting there is insufficient fresh data of how prices are affected by the crisis.

This sector is now more cautious with regards to new loans, principally due to the inability of obtaining physical valuations and the government's advice to people not to move homes at this time. The majority of lenders have therefore suspended issuing new offers until further notice, and only a few are still active on the basis of desktop valuations, at times with LTVs reduced by c. 5% from pre-crisis levels.

Notwithstanding, the BTL sector has been open and willing to complete on pre-existing offers which had been issued prior to the crisis; at times with more modest leverage based on updated desktop valuations.

Debt funds

Debt funds' appetite for lending will largely be driven by their own funding. Those with short maturities will have limited appetite, whilst those with longer maturities and greater investment discretion will view this crisis as an opportunity.

Those with capital to deploy will be keen to invest in new opportunities to the extent this can drive returns. Prior to the crisis, the increase in market competition had made it more difficult for some debt funds to deploy the capital available to them, as their own cost of capital meant they could not always compete with deposit-taking banks and other low-cost capital lenders. With credit markets dislocated and less competition than before, they will look at new deals on a highly selective basis, with additional scrutiny of business plans and due diligence. Core fundamentals and longer-term business plans will be imperative, and borrowers can expect margins to increase.

Debt funds do not benefit from government support and will feel the pain of repayment holidays and/or borrower inability to pay interest where their underlying tenants are unable to pay rent. As such, they are also dedicating some — if not significant — resources to managing their existing books.

Our discussions with these lenders have demonstrated some debt funds are actively pausing their activities while others look to try and take advantage of the situation to write loans that they previously would not have been able to compete effectively on.

LENDER ANALYSIS continued

Alternative finance providers and bridging companies

Alternative providers are more flexible as they do not have the same cumbersome processes and structures as many of the other lender types.

Their desire to issue new loans will vary from lender to lender depending on the strength of their capital sources (or balance sheet). That said, most have curtailed their risk appetite reducing leverage and focusing on less risky loans.

This category can pick up meaningful slack that results from the lack of activity among high street lenders and challenger banks. With less competition than they normally face, solid bridging firms and alternative debt providers are today lending at lower leverage levels than they normally would, yet at a similar price point as before.

Whilst they are also selective, it should be noted that this segment of the market is used to completing transactions faster. As such their mindset is generally more adaptable which is a key asset in times like these where elements of the loan process that are normally taken for granted — such as physical property access for valuers — is subject to significant challenges.

> *“Although appetite for new loans is limited, some lenders are taking a proactive risk-based approach to bringing in new business.”*

Insurance companies

Traditionally, insurance companies are the most conservative in terms of risk. This is reflected in their lower pricing. Annuity funds focus on long term, stable, low risk assets. In the current environment, insurers appetite is diminished, however they will look at properties in core locations at modest LTV’s.

Many insures have private mandates with debt funds which allows them to continue to be exposed to slightly higher risk and shorter-term loans as compared to their annuity books.

International banks and branches of overseas banks

We are seeing a mixed bag of appetite depending on how banks are dealing with their own domestic challenges during the current global crisis. There is some appetite from some Middle Eastern and European lenders who remain keen to support existing customers and some have provided terms and obtained credit approval on new deals to new-to-bank customers as well.

CASE STUDIES

Positive signs: Times are tough but certain deals are getting done

Three deals done in lockdown — Relevant case studies

Excellion Advisors has been busy since the beginning of the crisis. We have a number of trusted lenders that are truly open for business and this has been reflected by the completion of three transactions during the crisis.

Since lockdown began, the Excellion team successfully completed the following three transactions.

Obtaining Credit Approval in this crisis is not easy

For the below three loans, Excellion had secured credit approval before lockdown started. Arguably, this makes closing less of an achievement. Perhaps then more notable is the fact that, since lockdown, we also managed to progress 4 new applications into legals, successfully securing credit committee approvals from 4 different lenders in the second half of April. This, in our view, bears testimony to our team's operating experience and our ability to navigate successfully in difficult markets. These credit approvals are also encouraging signs of life in a market in which relevant transactions continue to be doable — albeit with significant difficulty.

Freehold Portfolio Investment Loan

- £4m investment loan
- Secured on a portfolio of freeholds
- 5 year term

Residential Investment Loan

- £4m residential investment loan
- Secured on 16 flats in Kent
- 70% LTV
- 5 year term

Residential Investment Loan

- £11m residential investment loan
- Secured on a residential block
- 54 units in Surrey
- 65% LTV
- 10 year term
- Cost of capital: c. 2.5%
- No amortisation

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.

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.

> *"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."*

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.

0.1%	0.46%	0.09%	0.29%
Bank of England Base Rate	3 month UK LIBOR	UK 5 year GILT rate	UK 5 year LIBOR SWAP rate

Figures accurate as at 7th May

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