

# UK lenders continue pursuit of new business through turbulent start to 2022

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The latest Bayes UK Commercial Real Estate Mid-year 2022 report shows a new lending volume of £23.7 billion, indicating strong appetite for new business up until June 2022 before deal flow started to dry up.

In a dramatically different interest rate environment, lenders are prepared to pass on new opportunities for the second half of the year if it is not a good opportunity.

Findings by Dr. Nicole Lux, lead author and Senior Research Fellow at Bayes Business School (formerly Cass), show that the alternative lender segment has now experienced twelve years of continuous growth, growing on average 15 percent per year.

The report uses data collected from 79 major UK lenders, and indicates a new increase in commercial development finance, with lenders confirming their financing support for transitioning assets, carbon zero assets and assets with clear improved Environmental, Social and Governance (ESG) credentials.

Key highlights from the report, which covers data up to June 2022, also show:

- Development lending made up 22 percent of new origination in 2022, showing a new increase in commercial development finance, which for the first time, post-pandemic, includes speculative development finance.
- Debt funds have taken on larger scale asset transitioning projects, and supplied 72 percent of commercial development finance.
- Margins for prime office loans compressed by five basis points (bps) across six months, showing the high market competition during the first half of 2022. However, for other property types margins for 60 percent loan-to-value (LTV) increased by between five and ten basis points.
- Small to mid-size lenders concentrated 89 percent of their lending in residential development finance, with 'Other Lenders (debt funds)' supplying 25 percent of new residential development loans and UK Banks supplying 58 percent.

- Generally, smaller lenders have been less likely to refinance existing borrowers and hence, have the lowest client retention rate, generating most of their business from new acquisition lending.
- Underperforming and defaulted loans remained stable for now, with an average default rate of three percent.

With the announcement of interest rate increases in January 2022 followed by the start of the energy crisis related to the outbreak of the war in Ukraine, UK public bond issuance dropped to a low of £4 billion during the first half of 2022, according to the Bayes Bond Monitor.

The high incremental cost of debt is forcing developers and property companies to change their business models from a debt-funded acquisition model to a capital-light owner/investor model. Some developers are considering funding new construction with 100 percent equity.

British banks have been dominating their own market, providing 35 percent of new financing, followed by debt funds which held a share of 24 percent. Alternative lenders together (debt funds and insurance companies) have been responsible for 38 percent of new loan origination. On the other hand, International Banks have seen their [market share](#) gradually decline from 34 percent to 28 percent over the last 10 years. Overall, the largest 12 originators were responsible for 58 percent of new loans, of which five were UK Banks.

A large pricing gap also remains between the largest and smallest balance sheet lenders, resulting in a price differential of 0.8 percent for prime office. For example, prime office loan margins for the largest lenders stand at an average of 1.98 percent while borrowers can expect to pay an average loan margin of 2.77 percent when borrowing from smaller lenders.

When asked generally about lending appetite for 2022, prime office and prime industrial are the two property sectors that most lenders are willing to finance (93 percent and 85 percent respectively), followed by prime residential investments (81 percent).

Dr. Lux says that "interest payments and property income were approaching a 1:1 ratio by June 2022, and with the five-year Sonia swap reaching 5.2 percent by the end of September 2022, property income will not be sufficient to refinance some properties at these rates, leaving a potential funding gap."

"Our analysis shows that property net income yields need to increase to over 6 percent across different property types, or property values need to adjust downwards by between 25 and 35 percent to reach a new market balance."

Peter Cosmetatos, Chief Executive of CREFC Europe, says that "economic and political conditions have changed very rapidly since the end of the period covered by this research, but it is valuable to have this detailed picture of the state of the market at what may prove the end of one era and the beginning of another. It depicts a stable, diversely funded market, with debt funds and insurers together accounting for 38 percent of new origination and surpassing UK banks and building societies for the first time."

"It remains to be seen whether the market will be as resilient to the consequences of geopolitical turmoil and higher interest rates as they were to Brexit and COVID, and who is best placed to finance the repurposing and decarbonization that so much of the nation's real estate needs."

Paul Coates, Head of Debt and Structured Finance, CBRE Capital Advisors Ltd, says that "the Bayes report continues to demonstrate the

diversity and depth of liquidity in the UK lending market, which should give cause for confidence in the future."

"At the date of the report some of the macroeconomic and geo political challenges were evident, and have accelerated in the past few weeks, which the lending market (and wider Real Estate market) is evaluating."

"In the short term we are seeing some flight to quality, whether that be sponsor strength and/or asset quality, some moderation in leverage to maintain debt service ratios, and some margin increases reflecting the broader environment."

"In the higher interest rate environment credit strategies provide a strong risk adjusted return investment for many institutions. We know of increased allocations happening, so I expect we will continue to see lender liquidity available across the market, from all lender types, with variation at the micro level as individual institutions setting their own strategy relating to their back book and risk/return appetite."

"With that backdrop, I would expect to see competitive bidding for the strongest transactions, and the continuing trend of lender focus on sustainability (across the Environmental, Social and Governance metrics)."

Neil Odom-Haslett, President, Association of Property Lenders, says that "At the beginning of the year there were already a number of signs that the real estate market was getting a bit over-heated and the Russian invasion of Ukraine certainly accelerated this (rising [inflation](#) and increasing interest rates to name just two of the head winds)."

"In Q1 there was a cross over when the all-in cost of debt exceeded property net initial yield in many asset classes, which usually suggests this cannot be maintained indefinitely (unless there is strong rental

growth), and that there is likely to be a valuation correction at some point in the future."

"The report suggests that a number of lenders continued to lend despite this and just as we were reaching the peak of the market (consensus view is that the valuation peak was in June)." "

However, the report does indicate they did maintain their underwriting discipline (in the main) with max LTVs for senior debt at 60 percent (therefore unlikely to see the distress of previous cycles). I'm slightly surprised however that there was not more stress and distress in development lending with cost inflation and supply chain issues—perhaps this will follow in H2 2022 and into 2023."

"It is really pleasing to see that lenders are taking ESG and net carbon zero targets seriously and incentivizing borrowers to improve their properties. We all have our part to play and it seems we are all doing so. Looking ahead to H2, my sense is that it will be very different from H1."

Euan Gatfield, Head of EMEA CMBS and Loan Ratings, Fitch Ratings, says that "Elevated inflation, sharp increases in term bond yields and sustained caution over senior loan-to-value ratios all make this leg of the interest rate cycle different from 2005/06, the last time rates rose. Then, pressure on interest cover saw many lenders pivot towards high-yielding, low-quality collateral of the kind that caused almost all the losses sustained in the Global Financial Crisis."

"This time round, credit rationing administered in the capital markets is dampening risk-taking much more quickly. In spite or maybe because of this, properties with rental yields that did not normalize through the pandemic—and in the case of industrials, actually dipped to record lows—will face a meaningful value correction as debt finance becomes markedly dearer."

Aparna Sehgal, Partner, Dechert LLP, says that "the results of the Bayes data indicate the strength of lender and investor confidence in UK real estate. The amount of capital deployed, and the ongoing focus on development, as the economy emerged from COVID-era distortions was a welcome indicator of appetite for the asset class across the capital stack. While data from H2 2022 will likely look quite different, what we see in these results shows a resilience of, and commitment to, investment in the UK real estate sector which is reassuring."

**More information:** Report: [www.bayes.city.ac.uk/faculties...s-cre-lending-report](http://www.bayes.city.ac.uk/faculties...s-cre-lending-report)

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