Report: UK lenders entered 2023 on a high, after high refinancing activity in Q4 2022

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The latest Bayes UK Commercial Real Estate Year-end 2022 report shows that despite the increase in interest rates in Q3 2022 and the decline in real estate market transactions, lenders continued to close new loans.

It does not come as a surprise that 65% was the result of refinancing. The strong business activity was also supported by an active secondary market, 24% of new lending was syndicated or concluded as a participation, hence overall average loan size was also larger than in previous years, with £70m average loan size.

Findings by Dr. Nicole Lux, lead author and Senior Research Fellow at Bayes Business School (formerly Cass), show that the alternative lender segment including insurance companies now provide 31% of new loans.

Debt funds dedicated 55% of their new lending to development projects, 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 December 2022, also show:

- Development lending made up 23% 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 61% of commercial development finance.
- Margins for prime office loans have moved out by 0.16%, to 2.7%, but loan margins for secondary offices moved by 0.46%, to 3.87%. The largest movement was seen for secondary industrial property which moved by 0.69%to 3.58%.
- Small to mid-size lenders price loans more expensively, 3.05%, than larger lenders, 2.31%. The pricing gap is even larger for secondary assets, such as secondary office, 5.17%versus 2.75%.

- 42% of lenders have reported breaches and 47% have reported defaults across their loan book. In total, the average amount of loans in defaults reported was 3.5%, showing an increase again since 2021 (2.9%).

The second half of 2022 was dominated by the increase in interest rates, which has left many real estate investors worried about the incremental cost of financing. This resulted in increased refinancing activity in Q4 2022 and borrowers refinanced early rather than waiting longer in 2023, or extended loans in to 2024.

In addition to increasing lending margins, lenders also notably lowered the loan amounts on new loans. The average loan-to-value for a prime office loan is now 54.8%, while in 2021 it was still 56.8%. Similar movements were observed for all other property types.

Dr. Lux said, "We are definitely seeing that large institutional borrowers are rushing to negotiate the best debt deals. As long as the income remains stable, new asset valuations are holding up and borrowers are negotiating their refinancing as early as possible."

Mark Manson-Bahr, Global Head of Real Estate Finance, Allen & Overy LLP, said, "2022 was a year of two halves with greater stress in the market due to macroeconomic risks, inflation and realignment of global supply chains affecting deal volumes in H2. It is pleasing to see from the Bayes 2022 report that real estate finance lenders are responding to this challenging environment to offer flexible credit solutions and certainty of execution, which continue to be prized by borrowers. Despite the retrenchment of some traditional lenders, increased activity from alternative credit providers looking to deploy capital will provide a competitive environment for borrowers seeking new financing or refinancing options in 2023."

"Lenders are demonstrating greater selectivity when granting loans. ESG and stewardship remain a core part of lenders' activities, notwithstanding market challenges, and this is a trend we expect to continue to gain momentum in 2023."

Chris Gow, Head of Debt & Structured Finance, CBRE said, "The Report helps highlight similarities and differences between the UK and US debt markets. In both markets Logistics and Living remain the most favored assets classes, smaller lenders have a greater percentage of loans in default and the significant year-on-year increase in the all-in-cost of debt has mainly been driven by higher reference rates. But there is no sign of a credit crunch in the UK. Banks are well capitalized, their liquidity remains strong and most continue to support borrowers and look for new origination opportunities, albeit at more conservative levels that before. We are also fortunate to have a very active and continually growing roster of Non-Bank Lenders who are eager to step into any further dislocation."

Neil Odom-Haslett, President, Association of Property Lenders, said, "2022 turned out to be a year with a number of challenges, with unexpected events both nationally and internationally. As the Bayes report highlights, the world of real estate started the year strongly but as the year moved forward the impact of these events caused the market to react with valuation corrections and increased interest rates—it really was a year of contrasting halves. For the lenders it was a case of 'battening down the hatches' in H2 2022 and, as the report highlights, a number of lenders had an increase in loan covenant breaches and defaults. With lending liquidity reduced, of the lenders that were still actively lending, LTVs were reduced and spreads increased. The report also notes that certain asset classes are proving tricky to finance (e.g., secondary retail)."

"The lending market has shown in the last few months it is able to pivot and adjust—however the era of cheap (and easy) lending does seem to be over, certainly in the near term."

Peter Cosmetatos, Chief Executive of CREFC Europe, said, "At a time when financial regulators show renewed interest in both banking sector stability and real estate risk, we are fortunate to have this rich resource to provide insights into the intersection between the two."

"Unsurprisingly, given the rapid change in the interest rate environment, the research reveals rising stress, particularly in the parts of the lending market—like smaller challenger banks and especially debt funds—that serve higher risk real estate. However, there is little to suggest widespread real estate-related problems in the financial sector. The market is diversely funded and has not experienced excessive exuberance this cycle, and leverage has remained at sensible levels."

Euan Gatfield, Head of EMEA CMBS and Loan Ratings, Fitch Ratings, said, "2022 lending volumes held up remarkably well given LTVs were reined in and loan interest rates spiked. However, acquisition financing accounted for a lower share of lending than in any of the previous 15 years, and was largely the preserve of insurance companies, debt funds and overseas banks."

"Also noteworthy is that around half of refinancing involved a change of lender, well above the norm. How much this reshuffling reflected divergence in lender risk appetite or balance sheet costs remains to be seen. An interesting parallel is the question of how much the repricing of CMBS in 2022 reflected divergence in credit risk versus funding pressures facing some bond investors."

"Whatever lay behind those reallocations, we believe that for this and next year credit risk will be the dominant theme for lenders. Property values have already fallen quite a bit, banks are facing renewed scrutiny, office markets especially present considerable uncertainty, while typical five-year loans reaching maturity will have been shaped by looser standards of 2018 and 2019 origination."

More information: Bayes CRE Lending Report: www.bayes.city.ac.uk/faculties … s-cre-lending-report

Provided by City University London

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