Mortgage log-jam could stifle the market

Recently, The Business Magazine and Pitmans gathered a group of local experts to consider the property investment market. Below John Burbedge reproduces selected observations from the roundtable discussion

The Roundtable message came loud and clear: Mortgages need to be made more readily available, particularly for first-time-buyers (FTBs), to get the residential market moving, and with it the property sector in general.

The lack of lending was risking a 'stifling' of the market, claimed developer **Mark Clayton**. "There is a danger that people just won't move – and therefore the estate agents will not be paid, the lawyers will not be paid, the removal men will not be paid, the home furnishers on the high street will not be paid ... and even the Government will not receive stamp duty (SDLT) or VAT on any other associated service, damaging the public purse. People will stop spending on certain items and there will be casualties in the market place."

In addition to higher deposits being required within costly mortgage funding and legal and moving costs, a stamp duty increase in April 2011 was adding to the financial difficulties of buying a home. For many, without the Bank of Mum & Dad, it would be virtually impossible to move.

Mark Stuckey revealed: "The age of the average FTB without a deposit is 37."

Anthony Henry-Lyons agreed: "The log-jam in UK property, and devolving from that incidental commercial and retail development, is not being able to get mortgages.

"The market is all about the circle. First-time buyers get on it, then they upgrade and they move on, and on again and the circle keeps moving on. But if you can't get on the circle..."

With irony, he noted that FSA chairman Lord Turner is recommending greater mortgage and credit controls. "How will we get mortgages to work?"

Philip Davies called for mortgage indemnity so that FTBs can borrow 80-90%. "If we can get the institutions to provide some insurance, and the Government stands behind it, then we might move the FTB market."

Currently, the main residential market was probably £250,000 up to a £1m, said **Davies**. Buy-to-Let acquisitions had priced out FTBs pre-recession, and now they are priced out by the need for larger deposits and difficult mortgage terms.

Another problem will be shortage of HCA money for affordable housing. "We haven't got people walking on the streets yet through lack of housing but you can see within 5-10 years that there could be a shambles. Someone needs to take the initiative," **Davies** added.

From left: John Burbedge, Anthony Henry-Lyons, Jim Meechan, Rory Carson, Nick Coote, Philip Davies, Mark Clayton, David Murray, Mark Stuckey

Banking overview: 'We do want to lend, but....

"Most banks, and that includes Barclays, do want to lend money, and we certainly have the capacity to as one of Europe's best capitalized banks, despite the negativity that there may appear to be in certain sectors of the market," said **Stuckey** of Barclays Corporate.

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Glossary

Basel III – is the latest stage in the continuing G20 response to the international financial crisis. The G20 supported Basel Committee on Banking Supervision, is requiring banks to make very major improvements in their capital and liquidity. In September the BCBS proposed that banks must hold minimum common Tier 1 equity capital of 4.5% by January 2015, and a further 2.5% as a counter-cyclical buffer.

NAMA – the National Asset Management Agency – is a key part of the Irish government's solution to current banking difficulties. With its €80 billion NAMA aims to acquire around 15,000 good and bad property loans from the riskiest portfolios of Irish banks, thus allowing them lend more confidently into the main national economy. NAMA is a workout not liquidation vehicle. Property lending will continue where viable, but borrower default is likely to see NAMA place assets on the open market.

Participants

Rory Carson:
Asset manager, south of England
PRUPIM

Mark Clayton:
CEO
Chelsminster Group, residential developers

Nick Coote:
Head of Thames Valley operations
Lambert Smith Hampton

Philip Davies:
Founder of Linden Homes
Chairman of Ashill Developments

Anthony Henry-Lyons:
Commercial developer
Madford Developments

Jim Meechan:
Banking and finance specialist, Thames Valley
Pitmans

Mark Stuckey:
Head of southern region property team
Barclays Bank

David Murray:
Managing editor and publisher of *The Business Magazine* chaired the discussion.

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"However, we do have to make lending decisions in a very different risk environment than pre-recession, with pricing directly impacted by the cost to the banks of seeking funding in the wholesale market.

There are also demand issues, with a real reluctance from many businesses and households to take on more debt, with many of our commercial clients actively paying down debt."

Anthony Henry-Jones

"Even when we are approached with refinancing requests it's often not a straightforward transaction procedure. Funding is available, but because of changing risk profiles, it could be on very different terms from 2-3 years ago."

Banks considering loans to property developers would now look at a range of variables:

- the strength and quality of a management team
- type and location of asset
- quality of underlying income stream
- development opportunities, especially high-quality housing
- level of return on capital
- the opportunity to reduce and spread any risk.

"All those things will drive debt quantum, availability of funds, tenure of facilities and the price."

Banks will focus on developing client relationships, said **Stuckey**– for Barclays multi-transactional relationships. "It won't be a case of John Smith coming to us to buy money off the shelf, and we lend it, and don't talk to him again. It will be about growing a relationship and extending our ancillary sales, that's with existing and new-to-bank clients."

David Murray queried whether credit availability would be higher in 2011.

"Barclays willingness and flexibility around the assets we have looked to fund this year is stronger than last year, and I think it will remain constant going into next year, but that may not be the view of other banks," said **Stuckey**.

Cost of debt

Henry-Lyons: The fundamental problem is not the willingness of people to lend money, it is the pricing of it for the borrower. It's the cost of debt and the increased equity requirement. We all know the 120% loan-to-value scenario did occur, but nowadays the average lending criteria is 50-60% and they need to see the colour of your money before they'll go to credit committee."

Henry-Lyons said despite competition between individual UK banks, their terms were still not competitive. He exampled a Canary Wharf deal where a German bank was offering "substantially cheaper money".

Davies said banking aversion to high gearing also made quick deals difficult, further stagnating the market. "Going forward we have a need for some form of mezzanine financing."

Rory Carson explained that PRUPIM's access to funds was proving advantageous. "On some recent deals, we have found that tenants have been prepared to accept long-term leases because we can release capital to them from Day One."

The impacts of Basel III and NAMA

Jim Meechan warned that the "fairly gloomy outlook" might get worse before it got better. Basel III's "significant impact" on Tier I capital ratios would effectively reduce banks' lending abilities.

Quoting Bank of England statistics, **Meechan** revealed that 2010 Q2 real estate lending contracted at its fastest rate since 1998.

Henry-Lyons: "In fairness, the banks concern is getting their money back. To a degree the banks have 'played the game' and instead of foreclosing on a facility they have tried to work with the borrower. But there is a point of no return arriving very soon."

Property-laden banks, regretting not having sold during "the four months bubble last year when the investment market perked up", would be less accommodating this time round.

Nick Coote pointed out that several investment deals had failed during 'the bubble' because banks were loathe to lose large fixed money debt redemptions linked to properties. Hedge fund involvement had also not helped dealmaking.

Henry-Lyons: "The biggest pressure coming on banks is Basel III but I think the problem will be compounded by NAMA whereby a huge weight of property is going to hit the market and we haven't got a lot of purchasers out there at the moment."

While NAMA property offloading would provide bargain-purchasing opportunities, it would also depress valuation rates, and pressurise existing loan facilities. "That will all have an impact on us being able to do any business."

Meechan wondered about future funding availability for property investors and developers. "How closely are the regulators talking to banks about the level of Tier 1 capital they need to retain? How will that translate to lending activity going forward? As far as I see the G60 (Basel III) is proposing a far stricter regime, which can't be good news."

Clayton welcomed international parity over banking regulation, but also called for a level playing field for UK funders in terms of tax incentives given to foreign investors.

Jim Meechan

Davies said another reason for the banking sector's frugality with mortgage loans was its commitment next year to start paying back "their huge amounts of wholesale debt refinanced by the bank of England."

Meechan agreed that banks were trying to reduce their exposure, and a significant number of tenures were coming up for reconsideration. While praising banks for adopting a pragmatic approach to debt during the downturn **Meechan** was concerned they may not adopt such a patient approach this time around. "With NAMA compounding the market situation we could be looking at a fairly rough period."

Don't believe all you read in the papers!

Red-top tabloids and national media coverage came in for Roundtable criticism for perpetuating a UK plc 'doom and gloom' scenario.

Clayton said when Chelsminster spotted the property market overheating it acted to consolidate its property position. "We sat and waited. It was a hard game because the market was still rising. But the downturn did come. Then we had quantitative easing and things started to come back and grow. But now, it seems everyone has lost confidence and the market has been coshed because of all the negative media talking of possible double-dips. This does not help."

Stuckey suggested the national media picture was also inaccurate. "There are some really positive things that can be said about the Thames Valley particularly, but also across the regions. We are actually in a stronger position here in the south east."

Davies agreed that media coverage was too broadly negative. "They don't pick up the regional plusses.

Nick Coote

For example, the residential market is very regional, but the Thames Valley is definitely holding its own."

Murray stressed that *The Business Magazine* aimed to present an accurate regional view - "and you are right, this region is much stronger than other parts of the country".

Carson: "In the Thames Valley there is a slight difference between market perception and reality. The tenants I am talking to seem to be saying that they are growing and things are improving. But, I think the perception is that because we are not back to where we were in early 2007, it doesn't yet feel like 'Business as Usual'."

The unspoken Roundtable question was: "But, are we ever going to get back to those heady times?"

Henry-Lyons noted that as yet NAMA and its possible consequences for the UK had gone largely unreported by the media.

Philip Davies

Davies: "You can always point to London for a commercial, residential or investment market, even if it is currently fuelled by foreign money, but I wouldn't want to be doing anything outside the south-east at the moment, particularly with public sector cuts coming."

Be confident: recovery is coming

Coote pointed out that the Thames Valley traditionally followed London trends. "The positive activity we have been seeing in the West End, will probably be seen in the Thames Valley Q3 2011. Actually, we're already seeing the first signs with enquiries coming through."

Clayton: "Confidence is much more valuable than gold or any currency in the market. What can we do to take away this doubt? As people tighten up, it will stranglehold the market and people will be afraid to do business, especially the banks."

Coote said the importance of confidence was illustrated by the lack of market decision-making. "The whole of the commercial market today is actually driven by scheduled lease events."

Some corporates were opting for pre-let deals to offset tricky decision-making in a changing market. Pre-lets allow the company to secure their future move, then live within the existing lease and let it run-down, so the move impact is minimized, explained **Coote**. Yell's pre-let had even helped them come out of the recession feeling 'chipper'. With the economy seemingly improving and staff adopting a new building with a fresh working culture "it's like a whole company relaunch for them," said **Coote**.

Developers' dilemmas

Davies: "Most housing developers are storing away their strategic land because it needs huge upfront infrastructure money. Currently they have an appetite for 12-18 month production sites, but the problem is getting any volume through.

"As a rule of thumb, a good average was selling two-thirds of a sale per site per week. At recent low points we were below a third. Now we are around half a sale, but it doesn't give enough confidence to commit to further work in progress, because people can't get the mortgages at the other end.

"If house prices fall, as most indices predict, pockets like the Thames Valley will hold their own. You may see a problem at the bottom end though, partly through lack of demand and partly because the housing stock is tired."

Coote said that with foreign money making London's West End a very competitive prime property market, he had high-worth clients with £40-50m to invest now considering regional locations instead.

If this largely cheaper foreign money started to move out of London it was going to make it even more difficult for people in the UK to compete, he added.

Foreign investment could be a big benefit to the Thames Valley, **Murray** suggested. Only if the foreign investor understood the Thames Valley and its big regional towns, **Coote** countered.

"There are all sorts of complicated issues in the investment world that will impact on how properties are delivered and occupied going forward," added **Coote**.

He mentioned as examples, lease accounting changes, the amortising of fit-out costs, and the market mismatch of tenants wanting shorter leases; investors wanting longer leases.

Carson said such mismatches would be highlighted with only new stock being able to command long leases, while leases on secondary stock would continue to get shorter. This would push values further apart towards a layer-differentiated market between prime and other properties.

Henry-Lyons wasn't so concerned about lease length. "The American and European real estate industry has in general survived on shorter leases."

Rory Carson

Office overload in the Thames Valley

Coote saw two big negative trends.

- Office space demand is reducing by 30-40% through modern working practices. Average corporate desk utilisation is now only 53%. The historical wedding of workers to desks is being replaced by work anywhere flexibility, less need for floorspace.
- Globalisation is causing consolidation – jobs going to India, for example - and changes in human resource requirements in the Thames Valley.

"Add-in the recession to these changes and that's why demand for offices is unhappy in the Thames Valley."

Henry-Lyons: "Thames Valley office take up in the past 18 months has been at a monumental negative compared even to the 1990s."

Coote said there was 12.5 million sq ft of available built office space in the greater Thames Valley area - Guildford, Woking, Blackwater Valley, Reading, Maidenhead, Slough, Heathrow and Oxford. Take-up in Q1 2010 was 165,000 sq ft. Annualised that is 25 years supply of office space. The underlying trend is around one million sq ft take-up per year.

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"So, is there no need for speculative building?" queried **Murray**

Henry-Lyons: "We are back to the appeal of new versus old."

Coote: "Not all that supply is Grade A. Reading town centre, near the station is bucking the Thames Valley trend. Rents are going up; rents everywhere else are down 30-40%. I think future office demand will be focused right on transport hubs, people will want to walk to work, and live within sophisticated areas, and will need town centre residential. And that experience is not limited only to Reading."

Mark Clayton

Will Reading's Station Hill go ahead?

The roundtable view was it might have looked like the right scheme in 2006 but that times and circumstances had now changed to its detriment. The funding scenario was radically different now from when the scheme was first mooted, the panel agreed.

Coote: "I don't think it will happen in the form it is now, because it's just indigestible. Can anyone imagine anyone funding one of those buildings, particularly when there's no evidence that there is demand for high-rise? Reading Central at 10 or 11 floors is about as big as you can expect, whereas some of the Station Hill plans are for 30 storeys."

The concept had changed from the original scheme, because of amendments suggested by local authority planners. The panel discussed whether the viability of the development would be improved if there were more offices and retail in the mix and less residential.

"I can't see the appetite for that amount of residential. I was interested in Nick's point about offices near a transport hub, but will people want to live right on top of the station?" asked **Henry-Lyons**.

Davies pointed out that government (John Prescott) directives at the time for higher density building had actually created a demand for flats. "We have now done 10 years of that and the only demand now is back to houses. It will be a long time before there is any equilibrium in the apartment market."

Clayton pondered the developer's choice: residential v. retail v office.

"There is a risk element in retail and commercial offices, so, supported at the time by the government's aim to build 2.2 million new homes and bulk buying of buy-to-lets, that's why they may have put in a larger residential element. After all, everyone needs a roof over their head."

What's the true property value?

Henry-Lyons said too many people were viewing development proposals on the basis of rates per sq ft, and comparing them either against out-of-date rates or against inappropriate comparative properties or areas. A dose of valuation reality would assist the market.

Clayton said it was frustrating when deals were virtually agreed and then real estate agents' valuations presented to the banks for funding purposes 'trashed' the deal.

Stuckey: "The lack of movement in the market hasn't really helped with comparables."

Coote: "Valuers are having to work harder than ever to reflect market circumstances, being aware of changing market conditions, but hampered by low transactional levels."

Clayton highlighted a new valuation difficulty: "How do you introduce an aspect such as NAMA into a valuation?"

Coote warned that sources of valuation might contract in the near future with an industry trend for companies to use valuers who meet the new, exacting RICS competency standards.

Clayton: "Then you are back with equity problems, because if your valuations are being hit, then banks will ask for more equity to be put in."

Refurbishment opportunities?

Coote raised concerns about commercial office development. "Nothing is being built speculatively and yet people want top quality, big floorplate modern buildings, by a transport hub. Existing stock is slowly being taken out, that will accelerate as confidence increases, and then we will have a real problem of supply. This could effect business efficiency through not being able to provide the required working environment."

Refurbishment of older buildings in good locations could be where the investment market might find future value, he suggested. Deloittes in Reading was given as a recent example.

Henry-Lyons said the costs and regulations involved in refurbishment could limit this market.

Murray questioned whether banks were reluctant to get involved with secondary property.

Stuckey: "If it is a well-placed secondary asset and part of a widespread portfolio where the banks can be comfortable that risks are mitigated, then there is appetite, particularly as the opportunities to fund prime assets are pretty limited."

Mark Stuckey

While creating the right product for the Thames Valley at the right quality and adding value was always key, that wasn't the only difficulty, said **Clayton**. He exampled a proposal to convert 20,000 sq ft of commercial office space in Mayfair to residential, which is set to return 52% profit on costs, but the problem was still in finding an investor to come in. "It's not just lack of capital, it's confidence and commitment."

Carson said that in the current economic climate, several tenants had been opting to negotiate rent-free periods with their landlords in return for taking out lease breaks thus staying in their buildings longer and avoiding expensive relocation costs. "The problem is that their offices are not getting any younger and the rate of obsolescence is getting faster and faster as people opt to occupy at increasingly high densities. This will lead to a certain level of 'pent-up' demand when the economic outlook is brighter."

Coote pointed out that several 25-year deals were beginning to 'wash through'. "We are going to see a wave of big office deals coming along, and these tenants won't stay in their buildings because the M&E is inadequate. They'll want better buildings."

The panel agreed that there were enough positive signs to indicate that the property investment glass was "half-full rather than half-empty". The Thames Valley was still the place to be.

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