Research Blast

UK Real Estate Market, October 2017, UBS Asset Management

10 years on from Northern Rock

Have the lessons been learnt?
September 2007. Just three months on from the release of the first iPhone queues were forming along UK high streets, but this time for a very different reason. Northern Rock was to become the first UK bank to have a run on it in 150 years. The bank had aggressively expanded in the decade previously, to become the UK's fourth largest lender and enter the FTSE 100. But the growth in lending had been fuelled by borrowing on international money markets to lend to, predominantly, UK homeowners. When the sub-prime crisis hit in the US lending to any borrower with a perceived over-exposure to the housing market dried up, and when the news broke that Northern Rock had sought support from the Bank of England to maintain liquidity, there were queues outside branches the following morning.

The UK commercial real estate market was not directly linked to the sub-prime market in the US, but as the localised crisis spread to global financial turmoil, the two became intertwined with one common cause – unsustainable leverage. Similar to the residential market in the UK, loan-to-value (LTV) levels and the assumptions behind income provisions for commercial real estate did not leave sufficient room to absorb either a correction in pricing, drop in rental values or a reduction in income levels. So when the financial crisis triggered all three at the same time, large volumes of the commercial real estate market fell into negative equity, triggering a fire sale at a time when no-one was buying and further inflaming the situation. The result was the sharpest correction in UK commercial property pricing ever recorded. European markets such as Dublin and Madrid, where over leverage was even more accentuated and focused towards development, saw peak- to - trough corrections of 75% and 58% respectively.

Increased scrutiny of real estate lending from the Bank of England has forced lenders to hold more equity against their loans, reducing the risk of a repeat of 2007

Chart 1 Proportion of UK loan books at LTV levels

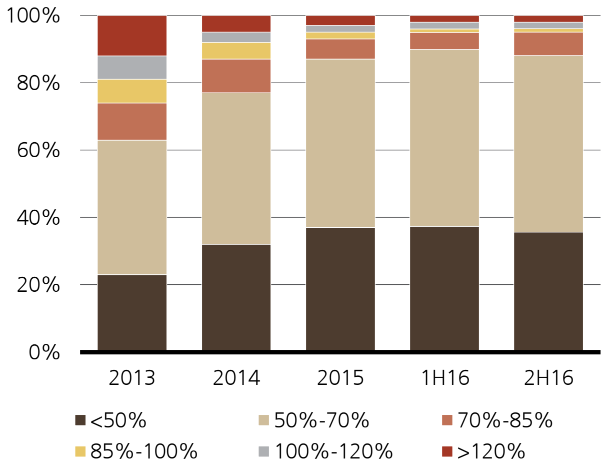
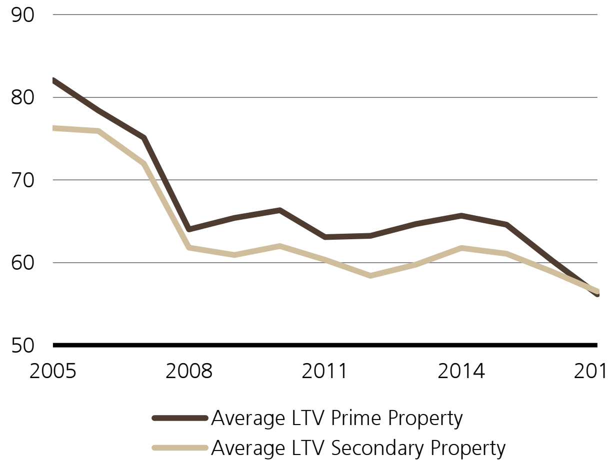


Chart 2 Average LTVs for prime and secondary UK Property (%)



Source: De Montfort Lending Survey 2016

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Current leverage
So as we assess whether lessons have been learnt over the past decade, the situation with bank lending to commercial property would seem a sensible place to start. And on the face of it, there have been significant steps taken to prevent a repeat of 2008. One of the first post global financial crisis (GFC) priorities was for UK banks to get their commercial loan books in order, assess what exactly they were holding and make arrangements for the non-performing assets. Helped by a recovery in market capital values, the proportion of loans in negative equity has fallen considerably and at end-year 2016 only 3% of loans were above 100% LTV and nearly 90% had LTVs of less than 70% as illustrated in chart 1.

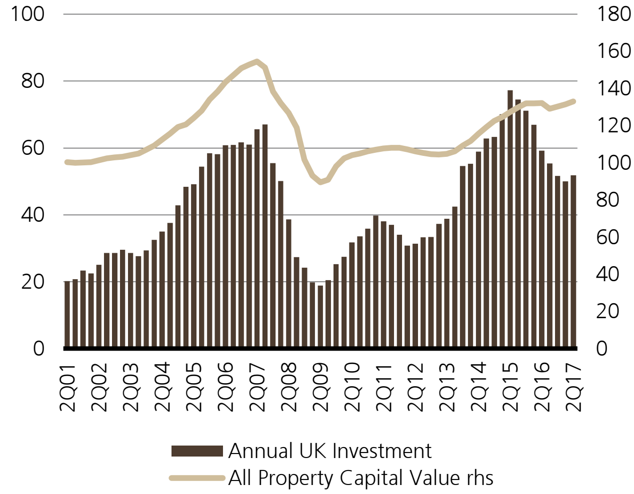
Banks have generally been retracting from the lending market, and have turned risk averse and increasingly selective in the loans which they offer. Large-scale development finance has been mostly limited to schemes with a significant pre-commitment for space, but perhaps most importantly loan to value requirements have moved in markedly in the post-GFC period as illustrated in chart 2. This has been partly driven by regulation from the Bank of England, which requires banks to stress test their loan portfolios under a severe economic scenario in which commercial property values fall by 40%, something which remains extremely unlikely barring a complete meltdown of the economy. With banks now holding sufficient equity on the loans they distribute to withstand a massive shock, the risk of another bank fuelled fire sale as assets turn into negative equity should not be a feature of the current cycle.

In the post-EU referendum period, the market has had an opportunity to demonstrate its robustness to shocks. In the immediate aftermath with the closures of the retail funds to redemptions, there were articles in the mainstream press suggesting that the commercial property market was on the brink of pulling the country back into a recession. Even though the fears were clearly overblown, the sentiment at the time triggered another risk that by investors pulling money out of the market, we would again be in a situation of forced sellers, this time led by the investors rather than lenders.

Fortunately, this was averted and although the retail funds had to close their doors to redemptions for a few months, the institutional funds were able to continue functioning without any major disruption to strategy. This was helped by changes to fund governance which were implemented after the financial crisis, with many improving governance and re-writing redemption terms to avoid the situation which retail funds faced. Many of them sacrificed liquidity in exchange for more stable exit mechanisms which reflected the timescales involved in selling large illiquid commercial real estate assets. This spread the redemptions over a period of time, limiting both the impact on fund strategy and contagion spreading to other investors wishing to remain within the fund. The structure of offering daily liquidity within the retail funds remains inherently flawed for an asset class as illiquid as real estate, however.

Interestingly as investment volumes have fallen after the referendum, pricing in the main UK markets has held up surprisingly well as illustrated in chart 3. Historically, there has been a very strong link between volumes and market pricing – between 2000-2015 the correlation was 0.85. But despite volumes falling away since the referendum pricing after a small correction has been strengthening, and since 2015 the correlation has completely reversed to -0.5.

Chart 3 UK Investment Volumes (billion GBP) **and MSCI Capital Value Index** (4Q00 = 100)



Source: Propertydata, MSCI September 2017

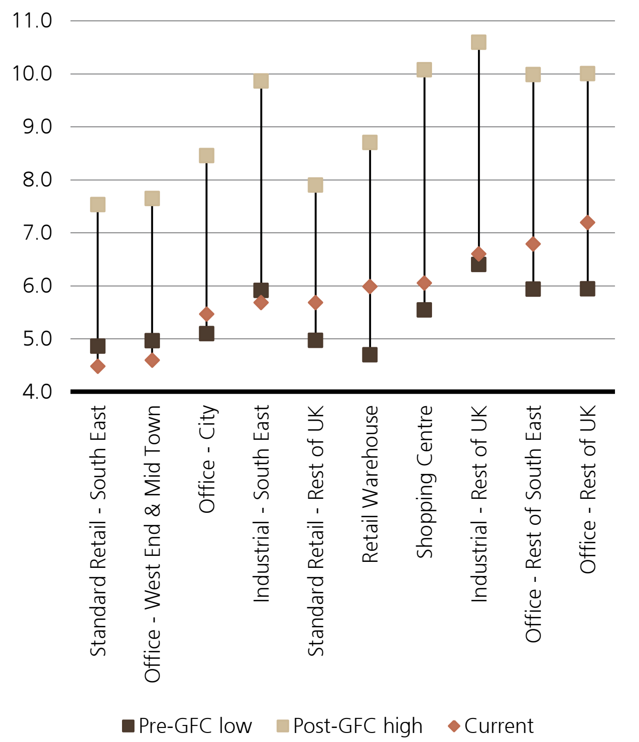
Ultimately, it requires forced sellers in the market to cause the type of pricing correction seen in previous cycles. Assets placed on the market which are not achieving the target price for the vendor are simply not transacting, whilst the deals which do complete are meeting or exceeding expectations and hence we now have a disconnect between transaction volumes and market pricing.

So what might make trigger a correction?
One potential cause frequently cited is that the global capital flows into the UK, and in particular London, could dry up. There are numerous external factors which could trigger this, such as a further tightening of capital controls for on/offshore Chinese capital, but with the current disconnect between transaction volumes and pricing there is no guarantee that a further reduction in liquidity would trigger this without sell side pressures emerging. It should also be noted that a significant volume of the foreign capital which is targeting the UK gets deployed in off-market deals for trophy assets which do not have an impact on the wider market.

A significant slowdown in the occupational market could be another trigger. Should occupational levels fall markedly, landlords would come under increasing pressure to maintain income streams through slashing rents which would reduce values and damage investor sentiment. But despite the uncertainty and weakened economic outlook in the post-referendum period, employment levels have remained at near record levels and in the short term, at least, it is difficult to see the level of job losses which would result in a large scale reduction in occupier levels which would be necessary to trigger forced sales. Furthermore, development levels outside of Central London remain relatively subdued so there is limited supply side pressure on rental values.

One area that we can draw parallels to 2007 however, is the relative level of property pricing in the UK. Across the UK, segments yield levels are around or below the levels recorded in 2007. In some prime markets yields are even further below pre-GFC level.

Chart 4 MSCI equivalent yields (%)



Source: MSCI 2Q17

Pricing at the current levels has been justified by the relative value of the property yields compared to fixed income, with the spread between property and gilt yields remaining at elevated levels compared to its history. But with weak or negative rental growth prospects across most sectors, property becomes increasingly dependent upon deriving its' relative value from the inflated values of other asset classes in the low yield environment. This makes property pricing increasingly exposed to changes within the interest rate environment.

With wage growth staying low and economic growth slowing, it appears that any rise in UK interest rates would be someway off, particularly as inflation is likely to drop below the 2% target next year once the base effects of the depreciation of sterling fall away. But recent rhetoric from the Bank of England has dramatically shifted expectations – markets are now pricing in two rate hikes in the next 12 months with the first coming in November 2017. Since the change in rhetoric, gilt yields have jumped by around 40 bps. At these levels, the risk premium for property remains at a comfortable level, but if the Bank of England is on the verge of taking a fresh approach towards monetary policy then the tightening of the spread could come forward much earlier than anticipated.

For property loans, variable repayments will start to move up in-line with the base rate after several years of very low all in costs of finance, particularly for core assets where the supply of debt has remained robust. And the increase in borrowing costs could occur at the same time as a correction in property yields driven by rising fixed income returns, and downward pressure on rents from the economic slowdown and Brexit uncertainty. Under this scenario, we are likely to see some pressure emerging on the sell side for the first time since 2007. But even under this scenario and with the increased discipline in lending, it remains highly unlikely to result in a correction on the scale of the previous downturns. So whilst we are still cautious on the impacts of a normalisation of monetary policy given where yields have fallen to, we are hopeful that some of the lessons learnt (taught by the regulator) will prevent the scale of the correction in the market this time around.

Data Sources: MSCI, Oxford Economics, Propertydata, De Montfort Lending Survey, UBS Asset Management Real Estate &Private Markets Research & Strategy

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