Legal & General Property

Recently, Sheila Hopkins, senior editor and managing director – Europe with Institutional Real Estate, Inc, spoke with ***Rob Martin*** *and* ***Gordon Aitchison*** *of Legal & General Property. The following is an excerpt of their conversation.*

Rob Martin is director of research at Legal & General Property (LGP) with responsibility for overseeing in-house forecasting and house-views, the investment process, performance analysis and bespoke in-depth research projects. Prior to joining LGP in October 2006, he worked for Hammerson Plc as head of research.

Gordon Aitchison is director of investment and development. He has responsibility for supporting all of LGP's funds' transaction activities both on and off market and its significant development pipeline. He sits on the board of LGP and is also a member of LGP's investment committee. Prior to joining LGP in July 2009, he was chief executive at Citygrove Developments.

People have been predicting distressed selling for some time and yet little of it has materialised. What is happening out there?

Rob Martin: There is something of a misconception here. There has actually been a lot of activity, particularly by the major UK clearing banks, but they have deliberately kept it very low profile. The distressed selling has also tended to be focused around sales of loan portfolios rather than direct real estate. And in many cases, the banks are not directly selling, but they are effectively compelling the current owners to sell. So there is this perception that not much is happening, but in reality actual volumes have been higher and if anything are picking up.

Has the way assets have trickled out from the banks been a planned strategy?

Martin: Some banks have taken time to gather portfolio data, and build in-house teams, which slowed early progress. In any event, the more experienced people who were around during the early 1990s recognised that the very rapid disposal of large volumes of stock depressed the prices for the rest of their portfolio. The early 1990s were characterised by a downward spiral from the banks' perspective — the term that was used a lot a few years ago was "fire sale" — and absolutely none of these people wanted to get back into that situation again. Additionally, the UK banks haven't had to sell large volumes of assets because the state bailed them out — the government is now the majority shareholder — and there have been a number of liquidity schemes that have given the banks breathing space.

Gordon Aitchison: One of the other issues that the banks face is that some of the loans that were written during the good times were drafted with limited lending covenants and were overly favourable to the borrowers. In these cases, the banks often cannot take action, even if the loan is technically in breach. This has also been a contributing factor to the reduced flow of distressed selling. The other barrier to activity has been the proliferation of long-dated, historic swaps, where breakage costs are now hindering vital bank restructurings.

How has the performance of the property market affected this?

Martin: In terms of the underlying market performance, rents are still under pressure in most parts of the UK. London is a separate case from the rest of the country in both economic and property investment terms; demand for stock in London is higher, and the occupancy markets are better. Outside of London, property markets are much more dependent on domestic capital flows.

Does this mean the banks are primarily selling London debt portfolios?

Aitchison: The banks have been selling geographically diverse debt portfolios and its fair to say that most of the assets are of a secondary nature with many located outside of London and the south-east. It is this higher yield profile that has attracted the private equity players that have recently acquired many of the high profile loan portfolios.

Martin: There are good reasons to be cautious about the areas outside of London and the south-east. The economy is much tougher outside of London, and the demand from tenants is much weaker in many locations. Because of this, investors need to be aware of the limited potential for tenant demand as well as potentially significant capex requirements. Sustainability legislation coming forward in the UK will make it impossible to sell certain very poor grades of assets unless their sustainability profile is improved, and that is going to require a structural degree of capex over the next five to 10 years.

I know you are focused on the UK, but what forecasts do you have for the Eurozone going forward?

Martin: Our economics team remains very concerned about the situation in the Eurozone, where they see a huge polarisation. On one hand, the economies of Germany, France and the stronger Eurozone members could expand marginally this year. On the other hand, Italy and Spain remain increasingly challenged and substantial contractions in activity are expected there. The fiscal situation is absolutely dire. The difficulty in the Eurozone thus far has in many ways been positive for the UK and the appetite for UK assets. Investors have a European allocation, but see lots of problems in the Eurozone so they look to invest in the UK. While the economic situation in the UK is not easy, we do have our own currency, an independent monetary policy and we continue to be a stronghold of the financial services industry. These factors continue to prove a major strength in this environment.

Aitchison: The UK is also a lot more transparent than other markets. In terms of valuation, we mark to market more than any other country in Europe. The funds that hold the majority of UK commercial property are valued quarterly, if not monthly, so the market is able to respond to changes in valuation quickly.

What are the upcoming regulatory changes in Europe, and how major an impact do you see them having?

Martin: So far as banks are concerned, the European banking authority is now becoming much more assertive in how it imposes regulation, which is really increasing the pressure on them. That is certainly causing some of the big European banks to look pretty hard at their commercial real estate lending businesses, and many are also considering non core activities as being target sales.

Will Solvency II's treatment of real estate affect investment by insurers?

Martin: Solvency II is critically important, and is something that we've become very familiar with as it has evolved. In many respects we expect it to be quite painful, but it does create a very clear price for taking risk and if you are going to take risk you have to have the return to match against it. One of the improvements in the Solvency II regime that was introduced toward the back-end of last year was a more thoughtful approach to how real estate leverage is handled. Previously, the way the rules were written, if there was any leverage in a vehicle it automatically was treated in the same way as private equity, which attracts a very high capital charge. Now there is a mechanism that takes into account the level of leverage. So if it is a high level of leverage, you get a high capital charge, but if it is a low level of leverage, which is true for many funds that use it as an operational tool, that is not so much of a problem.

What will be the impact of regulations in the UK?

Martin: The big UK banks are already ahead of the European Banking Authority target for 9% core Tier 1 capital, so they are less affected by that initiative. However, UK banks are under pressure from the Financial Services Authority (FSA), which is focusing on how banks treat their real estate exposures from a regulatory capital perspective. There are proposals out there to compel banks to use a slotting approach to determining the level of regulatory capital to be held against real estate loans. Some estimate that this could result in a doubling of regulatory capital requirements for the major UK banks. That is just going to make the situation more difficult for the banks. So, it's a major pressure and one of the key reasons why we expect the pace of real estate deleveraging in the UK to pick up .

Is there an estimate how much will come out?

Martin: There are two numbers that I think are relevant. There is £68 billion of loans which are up for refinancing over the next 24 months and there is staggering £50 billion of loans where the loan exceeds the value of the underlying real estate. The solution will need to consist of a combination of new debt, new equity and further writedowns from the current owners of loan portfolios. Whilst the provision of debt capital from alternative providers is growing, there will need to be a very significant contribution from equity, which is the space that we are in. The scale of the problem is such that this is likely to be a defining theme of real estate capital markets in Europe for the next five to seven years.

How are you going to take advantage of that?

Aitchison: The banks are in a difficult position. They can generally take control of a distressed loan in one of three ways: firstly they can agree to a consensual sale of the property with the borrower, secondly by placing the property in receivership, and thirdly by selling the loan. We are having most success by working with the borrower to jointly approach the bank to acquire the property. We have also acquired from receivers, but for the bank this is generally the option of last resort. More recently L&G has set up a lending team, which will be able to consider acquiring distressed loan books. In our opinion there has never been a better time to provide finance because values have fallen, rents are down, risk levels are low and the margins are good.

What other opportunities are you finding?

Aitchison: Banks are also teaming up with specialist property operators to manage the assets through to exit. We are having similar discussions with the banks but are offering an additional benefit in the form of fresh capital.

With little to no construction finance available, what are the opportunities for those that have the capital to remain active in the development sector?

Aitchison: Construction finance is an interesting area for us because banks have all but withdrawn from this sector in the UK, even for pre-let property. As a house we have been one of the most active funders of development and, with significant equity committed to our funds, this is very much an opportunity for us to access new sources of investment product, whether it is through forward funding agreements or tenant-driven initiatives.

Do you tend to develop to hold and manage afterward? Or do you develop to sell?

Aitchison: We develop to hold, generally. There is nothing to stop us from selling on completion, and we will look at every opportunity based on market conditions at the time, but typically we are looking to create product long term for our investor clients.

Finally, what are the implications of banks deleveraging going forward?

Martin: Deleveraging is a headwind, no doubt about it, in terms of the performance of real estate. Real estate is an asset class that benefits from leverage and thus withdrawal of leverage is a challenge. Frankly the economy is not going anywhere fast, so that is not helpful either. That said, this transition from a very high volume of debt capital to a much greater emphasis on equity is a very exciting transition and lays the foundations for some really strong performance for equity investors on a five- to 10-year view.

Aitchison: Above all, we are excited by the opportunities that we see coming out of the sector, particularly the mispricing created by a proliferation of reluctant owners of real estate. Those, like L&G, with the right know-how, resources and capital to restructure complex portfolios and provide solutions to the banks and distressed vendors, should be best placed to take advantage of this unique set of circumstances.

CORPORATE OVERVIEW

Legal & General Property (LGP) is a wholly-owned subsidiary of Legal & General Investment Management (LGIM), one of Europe's largest institutional asset managers and a major global investor. LGIM manages approximately £371 billion of assets on behalf of more than 3,300 clients (31 December 2011) and provides products and solutions spanning all asset classes. LGP is the third largest institutional property fund manager in the UK, managing or co-managing 16 separate funds or vehicles and two segregated mandates with an aggregate asset value of £10.6 billion as at 31 December 2011.

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