UK Debt Prospects, Q3 2015

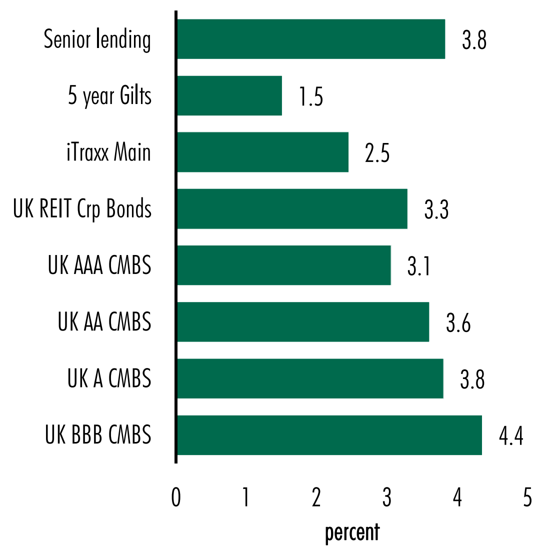
Lending returns diverge and relative value narrows as competition tightens margins

Figure 1: Senior CRE lending returns

	Q1 2015/20	Q2 2015/20
Absolute basis		
Gross return, %	3.6	3.8
Risk-adjusted return, %	3.5	3.7
Return on RWA basis - Strong		
Gross return, %	3.3	3.0
Risk-adjusted return, %	3.0	2.6
Return on RWA basis - Good		
Gross return, %	2.5	2.4
Risk-adjusted return, %	2.3	2.0
Return on RWA basis - Satisfactory		
Gross return, %	2.0	1.8
Risk-adjusted return, %	1.8	1.6

Source: CBRE.

Figure 2: Senior CRE lending returns in context, Q2 2015/20



Source: Bank of England, BofAML, CBRE, Macrobond

For Q2 2015 originations, **Senior CRE lending returns are forecast to be 3.8%pa (gross) and 3.7%pa on a risk-adjusted basis**. This is a modest rise on Q1 returns which were 3.6%pa and 3.5%pa respectively.

The improvement in performance on an absolute basis is entirely a product of a 36bps increase in the five year swap rate; **margins have actually compressed by an estimated 15bps** over the quarter.

Thus, when measured **on a Return on RWA (RoRWA) basis, gross returns have fallen from 3.3%pa to 3.0%pa, and risk-adjusted returns from 3.0%pa to 2.6%pa,** assuming Strong slotting treatment. This is because RoRWA is calculated here as a function of margin and fee alone.

Senior CRE lending continues to offer a healthy premium to the risk-free rate; 2.3%pa on a gross basis and 2.2%pa on a risk-adjusted basis.

However, **the premium offered by senior CRE debt against other forms of fixed income has narrowed over the quarter** – making senior CRE lending look a little less attractive on a relative basis versus corporate debt, REIT debt and CMBS.

We have previously released separate versions of *UK Debt Prospects*, in which we estimated the broad, average level of return likely to be achieved by lenders to the UK commercial real estate market on either an absolute basis or a Return on RWA (RoRWA) basis. In this edition, we combine both forms of return assessment, while continuing to set the findings of our analysis in an historical context and in the context of competing asset classes. As before, this exercise is a combination of debt side inputs, such as margins, real estate market forecasts and our proprietary forecasts of Default and Loss. It is worth stating that RoRWA calculations vary and accordingly we have had to make some assumptions, chief among which is that we assume returns are only generated by margin and fee components – we do not assume that lenders receive LIBOR (or any part thereof) or any cross-selling income.

PRESSURE ON MARGIN, INTEREST RATE UP

We estimate that senior lending margins across the broad mix of UK real estate fell by 15bps to around 1.9% by the end of Q2 2015. This was more than compensated for by a 36bps rise in the five year swap rate (though one should note the continued likelihood of highly volatility interest rates with the growing threat of GREXIT).

PROBABILITY OF DEFAULT, EXPECTED LOSS

Even in a rising market the idiosyncratic nature of individual CRE assets means value decline and hence default may still occur. Our latest forecasts indicate a gradual slowing in the rate of future capital growth; as a result, predictions of default and loss increase. We estimate that Q2 2015/20 senior 65% LTV originations have a Probability of Default (PD) of 2% (up from 1% in Q1) and annualised Expected Loss (EL) of 0.2% (up from 0.1%). Although rising, both PD and EL are still well below historic long-term average levels.

ABSOLUTE RETURN RISES OVER QUARTER

Given the above, gross returns on senior CRE lending are estimated to have risen to 3.8%pa at Q2 2015 – up from the 3.6%pa seen in Q1, but down on the 4.4%pa at the end of 2014. Taking into account PD and EL, risk-adjusted returns also improved to 3.7%pa at the end of Q2, versus 3.5%pa in Q1 and 4.3% at Q4 2014.

PREMIUM TO OTHER FIXED INCOME DOWN

Although rising in absolute terms, senior CRE lending returns have narrowed relative to other forms of fixed income. Against the five year Gilt, the premium offered by senior CRE lending has fallen from 2.4% to 2.3% over the quarter, while against corporate debt (as represented by the iTraxx Main series), the premium has narrowed more significantly, from 1.7% to 1.4%. There has similarly been a narrowing in the premium against REIT Corporate Bonds and CMBS.

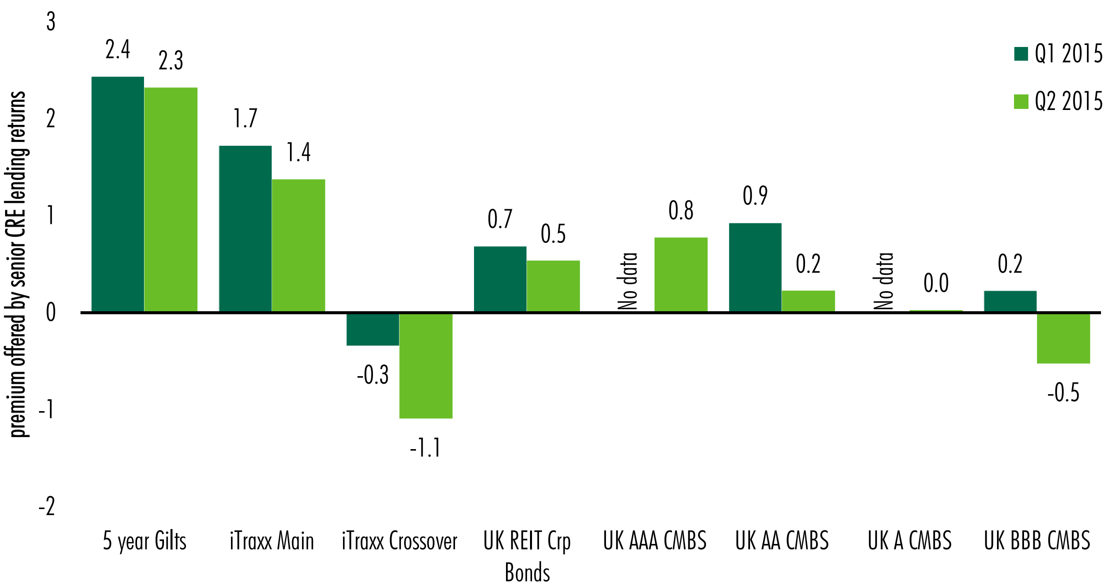
COMPETITION IMPACTING RETURNS

The above analysis shows how senior CRE lending returns have weakened over the quarter, as margins have contracted – even as margins have widened for other competing asset classes. This is doubtless the impact of heightened levels of competition in the senior CRE debt market, as evidenced by the De Montfort University *UK Commercial Property Lending Report* showing that in 2014 non-UK bank and building society lenders accounted for their greatest ever share of new lending, at 57%.

MEZZANINE

We estimate Mezzanine returns to be 9.0%pa on a gross basis and 7.3%pa on a risk-adjusted basis at the end of Q2, slightly down on Q1 2015 and Q4 2014.

Figure 3: Senior CRE lending returns, premium versus other forms of fixed income, Q1 and Q2 2015



Source: Bank of England, BofAML, CBRE, Macrobond.

ANALYSIS ON AN ABSOLUTE RETURN BASIS

Figure 4: Senior CRE lending returns, Q2 2015/20

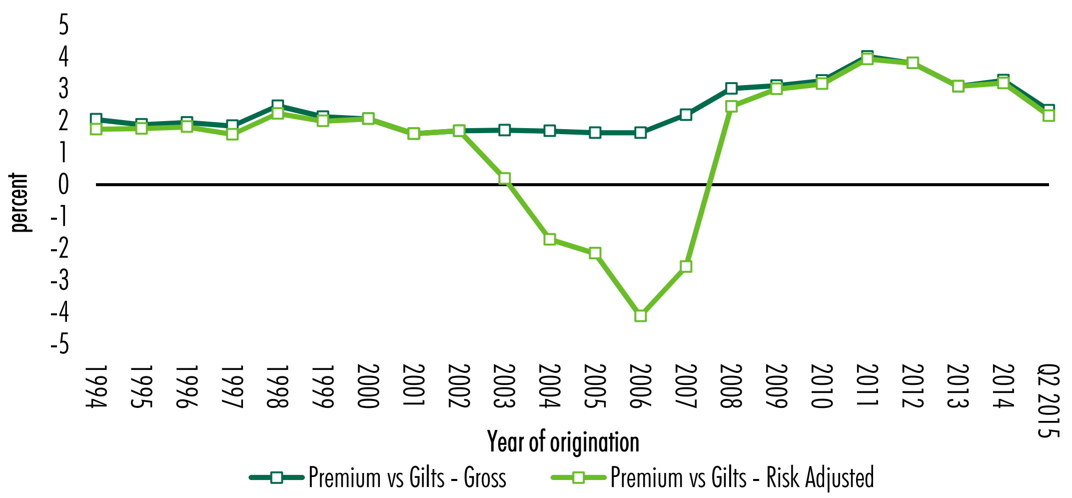
Source: Bank of England, BofAML, CBRE, Macrobond

Figure 5: Breakdown of Senior and Mezzanine CRE lending returns

	Senior lending (65% LTV)				Mezzanine (65-80%)			
	Base			Stress	Base			Stress
	2014/19	Q1 2015/20	Q2 2015/20	Q2 2015/20	2014/19	Q1 2015/20	Q2 2015/20	Q2 2015/20
Expected interest rate, %	1.4	1.3	1.7	1.7	1.4	1.3	1.7	1.7
Margin, %	2.8	2.1	1.9	1.9	8.2	7.8	7.3	7.3
Arrangement fee, %	1.1	1.0	1.0	1.0	0.0	0.0	0.0	0.0
Gross return, %	**4.4**	**3.6**	**3.8**	**3.8**	**9.6**	**9.1**	**9.0**	**9.0**
IPD all property capital growth, %pa	4.5	4.1	3.6	-5.6	4.5	4.1	3.6	-5.6
Probability of Default, %	1.0	1.0	2.0	35.0	4.0	5.0	6.0	58.0
Annualised Expected Loss, %	0.1	0.1	0.2	3.9	1.2	1.5	1.7	16.8
Risk adjusted return, %	**4.3**	**3.5**	**3.7**	**-0.1**	**8.5**	**7.6**	**7.3**	**-7.8**
Gilts	1.2	1.2	1.5	1.5	1.2	1.2	1.5	1.5
Gross premium versus Gilts, %	3.3	2.4	2.3	2.3	8.5	7.9	7.5	7.5
Risk-adjusted premium versus Gilts, %	3.2	2.4	2.2	-1.6	7.3	6.5	5.8	-9.3

Source: Bank of England, CBRE.

Figure 6: Senior CRE lending returns in historic context



Source: CBRE

SLOTTING CATEGORIES AND RWA

The level of RWA assigned to a loan depends on the Slotting category to which it is assigned. We consider three: Strong (70% RWA), Good (90%) and Satisfactory (115%). These figures are effectively the denominator of the calculation.

LENDING TERMS AND DEFAULT ESTIMATES

Margins, fees and estimates of PD and EL arrived at in the preceding examination of lending returns on an absolute basis apply equally when considering RoRWA. The focus is still on estimating broad market average senior CRE lending returns; the loan terms and LTV are thus identical, all that is different is the method of calculating return.

GROSS RETURN ON RWA

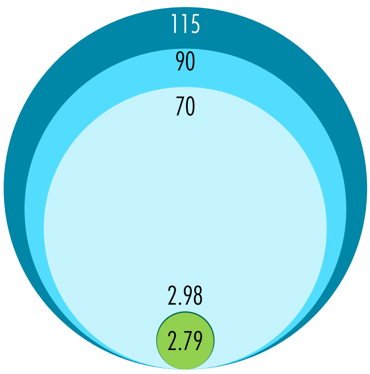
We estimate that were UK senior lending categorised as Strong for Slotting purposes, gross RoRWA would be 3.0% for originations at Q2 2015. Higher RWA requirements on Good and Satisfactory categories produce lower gross RoRWA returns of 2.4% and 1.8% respectively.

RISK-ADJUSTED RETURN ON RWA

Taking into account the impact of Expected Loss, risk-adjusted returns for Q2 2015 lending are forecast to be 2.6% (assuming a Strong categorisation), 2.0% (Good) and 1.6% (Satisfactory). The tightening in RoRWA over 2015 has been considerable, though returns on offer still remain well above historic averages.

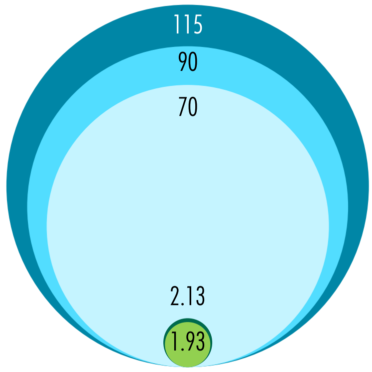
ANALYSIS ON A RETURN ON RISK WEIGHTED ASSETS RWA BASIS

Figure 7: Senior CRE lending returns, Q4 2014/19



Slotting treatment	Gross RoRWA	Risk-adjusted RoRWA
Strong	4.3	4.0
Good	3.3	3.1
Satisfactory	2.6	2.4

Figure 8: Senior CRE lending returns, Q2 2015/20



Slotting treatment	Gross RoRWA	Risk-adjusted RoRWA
Strong	3.0	2.6
Good	2.4	2.0
Satisfactory	1.8	1.6

RWA, £ – Strong (70%)
RWA, £ – Good (90%)
RWA, £ – Satisfactory (115%)
Interest and fees, £ gross
Interest and fees, £ risk-adjusted
Gross Return on RWA, %
Risk-adjusted Return on RWA, %

Source: CBRE.

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