UK Debt Prospects, Q1 2015

CRE debt offers 2.5% risk-adjusted premium to Gilts

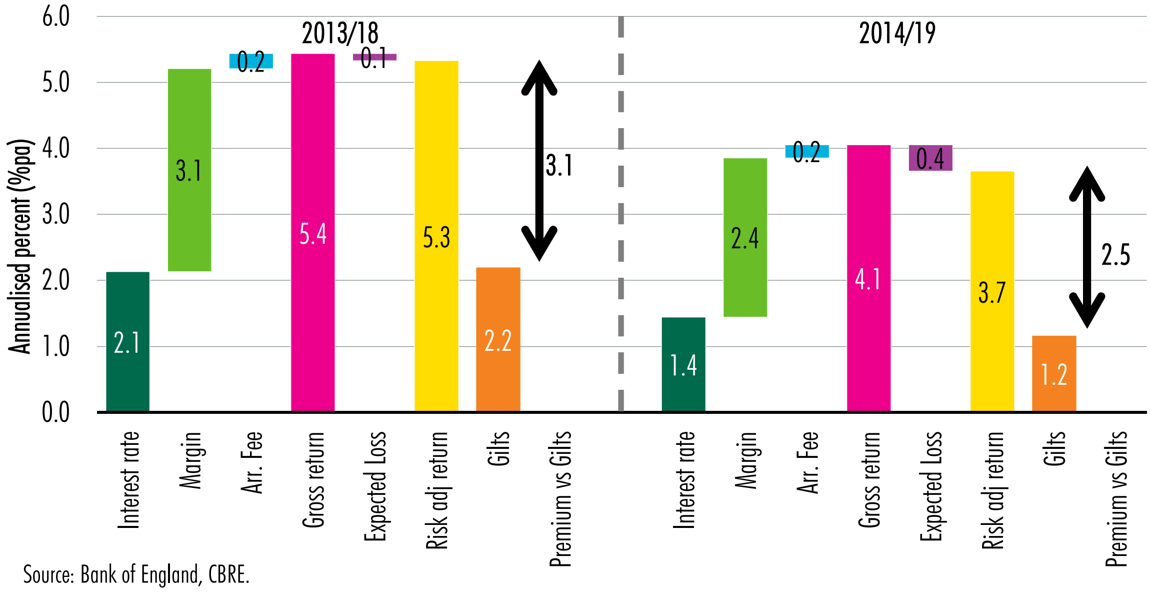
Probability of Default 4% 14/19 vs 1% 13/18

Annualised Expected Loss 0.4% 14/19 vs 0.1% 13/18

Senior Margin 2.4% in 2014

Risk-Adjusted Lending Return 3.7% 14/19 vs 5.1% 13/18

Figure 1 Senior Lending returns



Source: Bank of England, CBRE.

Senior debt returns against UK commercial real estate are forecast to be 4.1%pa (gross) and 3.7%pa on a risk adjusted basis (net of Expected Loss) over the next five years.

This compares favourably with the five year Gilt yield of 1.2%, offering a premium of 2.9%pa on a gross basis and 2.5%pa on a net basis.

In both instances, this is significantly above our estimate of the long-term premium to Gilts, showing that senior CRE lending remains attractive.

Applying an illustrative Stress scenario of a 25% fall in CRE capital values would see senior CRE lending returns fall to -0.5%pa.

Forecast returns to mezzanine lending have reduced to an estimated 8.3%pa and 5.2%pa on a gross and risk adjusted basis respectively; this still offers a premium to returns on senior lending, though a narrower one relative to the last couple of years.

In this first edition of *UK Debt Prospects*, we set out our estimates of average returns likely to be achieved by lenders to the UK commercial real estate market. We use a combination of internal and external data on market pricing and our own calculations of likely Default and Loss, given the predicted change in underlying individual asset valuations implicitly assumed by forecasts of average real estate market performance. Forecasts are for five year periods.

Forecast gross returns to UK real estate lenders have fallen over the last 12 months, from 5.4%pa for the 2013/18 period to 4.1%pa for the 2014/19 period. A 69bps fall in the interest rate over the term (note: we have used the five year swap rate), a 66bps fall in margin and a 15bps fall (or 3bps per year) in arrangement fees, have combined to put significant downward pressure on returns to lenders.

There has been a greater decline in forecast risk adjusted returns over the same period. Of course, all of the weakening in interest rate and lending terms outlined above has fed through to the risk adjusted level, but in addition returns have been hit by an increase in Probability of Default (PD) and Expected Loss (EL). With the forecast for all property capital growth declining from 5.8%pa in 2013/18 to 3.3%pa in 2014/19 – as 2014's forecast 12.2% is replaced by 2019's -0.4% – PD rises from 1% to 4% and annualised EL from 0.1% to 0.4%. Thus, a tempering of underlying collateral performance is responsible for the fall in forecast risk adjusted return to 3.7%pa in 2014/19, from 5.3% pa in 2013/18.

Despite the above, risk adjusted returns continue to offer a healthy premium to five year Gilts of 2.5% for 2014/19. While lower than that seen in 2013/18, this remains well above our estimate of this premium over the long-term, which should continue to attract new lenders to the sector.

The changes in forecast returns to UK lenders for senior debt are generally exaggerated for mezzanine debt lenders (here assumed to be a vanilla 65-80% LTV junior tranche). A 167bps decline in margins explains a fall in gross returns from 10.6%pa in 2013/18 to 8.3%pa in 2014/19, while an increase in PD from 4% to 11% further impacts risk adjusted returns, which fall from 9.4%pa to 5.2%pa. The gap between risk adjusted returns on senior and mezzanine debt has thus shrunk to 1.5%, from 4.1% in 2013/18.

In an indicative Stress scenario (-25% fall in capital values) forecast risk adjusted returns fall to -0.5%pa.

For further insight into how historic and future returns vary by market segment, duration, LTV, and under different economic scenarios, please contact us.

Figure 2 Breakdown of Senior and Mezzanine lending returns

	Central scenario				Stress scenario			
	Senior (65% LTV)		Mezzanine (65-80%)		Senior (65% LTV)		Mezzanine (65-80%)	
	2013/18	2014/19	2013/18	2014/19	2013/18	2014/19	2013/18	2014/19
Interest rate, %	2.1	1.4	2.1	1.4	2.1	1.4	2.1	1.4
Margin, %	3.1	2.4	8.5	6.8	3.1	2.4	8.5	6.8
Arrangement fee, %	1.1	1.0	0.0	0.0	1.1	1.0	0.0	0.0
Gross return, %	**5.4**	**4.1**	**10.6**	**8.3**	**5.4**	**4.1**	**10.6**	**8.3**
IPD all property capital growth, %pa	5.8	3.3	5.8	3.3	-3.4	-5.6	-3.4	-5.6
Probability of Default, %	1.0	4.0	4.0	11.0	26.0	37.0	45.0	57.0
Annualised Expected Loss, %	0.1	0.4	1.2	3.1	3.4	4.6	13.8	16.1
Risk adjusted return, %	**5.3**	**3.7**	**9.4**	**5.2**	**2.0**	**-0.5**	**-3.2**	**-7.8**
Premium versus Gilts, %	**3.1**	**2.5**	**7.2**	**4.0**	**-0.2**	**-1.7**	**-5.4**	**-9.0**

Source: Bank of England, CBRE.

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