GUIDE TO RECOVERY AND RESTRUCTURING

Secondary property remains an area of concern for the market, but banks and borrowers can be proactive and improve assets, regardless of the climate

Three years on from Lehman Brothers' collapse into bankruptcy and the property market has yet to return to normality.

Bank finance remains scarce, with regulation such as Basel III and the legacy of loans made during the boom meaning that banks are incredibly choosy about how and where they deploy their capital.

Macro-economic weakness also presents a challenge for tenants and property owners alike. Outside prime office markets including London's City and West End or dominant regional shopping centres, if a tenant vacates, finding a replacement is not simple. In these scenarios, where income as well as capital values come under threat, an issue is created for both banks and borrowers.

New research from CBRE draws attention to the issues facing investors and lenders in how to manage their portfolios. As David Wylie, head of economics and forecasting in the UK research team at CBRE, highlights in a paper entitled "Secondary market recovery...?", the prime sector of the market has recovered strongly, but secondary property has not benefited to the same extent.

In terms of the dichotomy of the market recovery, central London offices values have risen to only 22.4% below their 2007 peak, while regional offices are still 43.4% below their highpoint – the upturn has been incredibly London-centric. "The underlying performance data for individual properties reveal some degree of catch-up for the average and good secondary assets represented by the broader CBRE Monthly Index (see Chart 1)," says Wylie. The yield compression for prime assets appears to have largely run its course during 2009-10, and the capital appreciation of secondary assets remains almost identical to last year, with values experiencing no overall movement. "For secondary property, this

has meant two successive years of no overall growth at the All Property level (see Charts 2 and 3), with capital values unchanged from their post-recession lows," he adds.

"Despite the possible limits to prime performance in the short term, the risks in secondary markets remain substantial," says Wylie. "Aside from the question of income security and reletting risk, the weak pace of the economic recovery is likely to delay any improvement in occupier demand, at the same time as reducing the availability of debt finance and tightening lending standards. Under such conditions, yields could see further correction.

"Taken together, these factors point to a more than usually prolonged secondary market weakness."

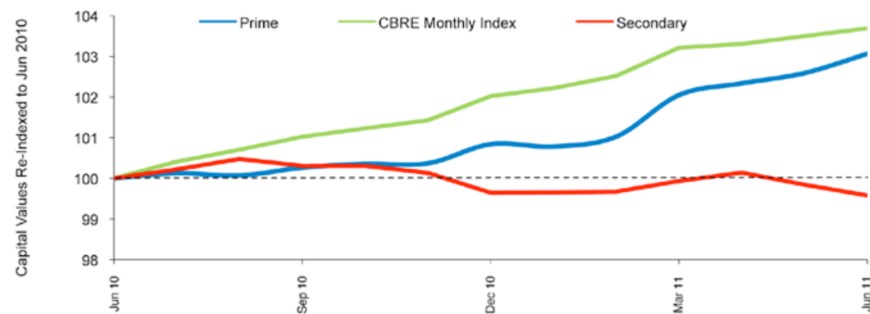
A further factor to consider is that property value indices generally only measure assets held by institutions such as life and pension funds, many of whom do not use debt, and only buy prime or good quality secondary assets. The vast proportion of the assets lent against by banks fall outside of this category and the problems in this area are likely to be even more pronounced than the data suggests.

This may not mean that recovery is forestalled indefinitely in all cases. Banks and borrowers are beginning to recognise that through being proactive, and undertaking asset management or loan restructuring, properties can be improved and income bolstered. By accepting that values are unlikely to rise or be maintained without proactive measures being taken, all might not be lost in terms of crystallising losses.

Banks can sometimes act independently, through loan sales or debt restructurings. But in general, co-operation has been the key to success. Engagement between banks, borrowers, new equity and asset managers is the single most important factor to address these issues, alongside proactivity, recognising the challenges ahead and putting in place the right structure to overcome them.

Secondary property values are unlikely to recover on their own for the foreseeable future, but that does not mean prospects can't be improved. Here are five solutions for consideration.

Chart 1. CBRE Monthly Index Prime & Secondary - Capital growth to June 2011



SOLUTIONS ON WHICH BANKS AND BORROWERS CAN FOCUS

New equity can aid debt restructurings – at the right price

Realism and flexibility on the part of new investors and existing borrowers is the key to bringing in fresh capital. "A lot of opportunistic money has been raised targeting restructuring and recapitalisation strategies, seeking returns of 20% or higher," says Nick Harvey-Jones, director in CBRE's real estate finance team, who works on bringing new equity into distressed or overleveraged situations.

There needs to be more flexibility in return targets. In the case of most investment situations so far, interest is still being paid and banks don't need to sell. The private equity or opportunity funds that have been successful in executing deals of a distress-led nature seem to have more realistic return requirements where the bid offer spread is not so damaging to the lenders and the borrowers concerned.

"If all parties are willing to be flexible and work together, then a positive result for all can be achieved," says Harvey-Jones. "This even extends to tenants: if they can be brought into negotiations alongside banks and new equity, then perhaps rental incentives can be offered to ensure they don't vacate a scheme, and the potential for a hole in the rent roll is avoided." Banks, existing borrowers and new equity can work together to find the right solution, if all are realistic.

Asset management: the key to maintaining income

"With little yield compression or rental growth coming through for a lot of property, the only way to truly drive performance is through active asset management," says Tim Perkin, senior director in the loan and corporate recovery team at CBRE. His team works with banks and asset managers to look for ways to improve cashflow and value, either through consensual appointments and the overview of a borrower's plans, or in the capacity of receivers, if the relationship between the bank and borrower has broken down.

In properties with unoccupied areas; there

Chart 2. CBRE Monthly Index Capital Value Changes

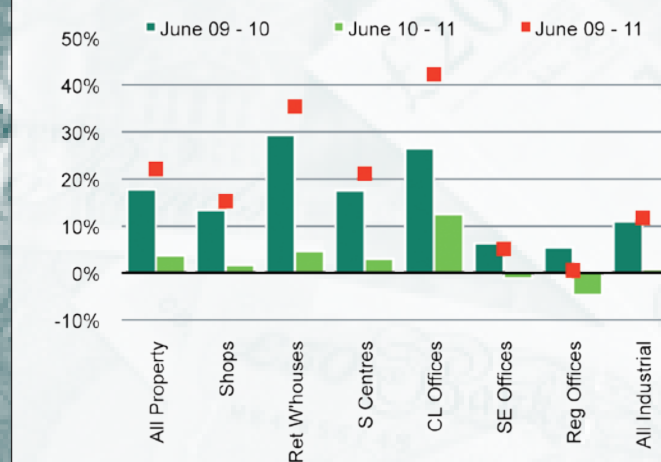
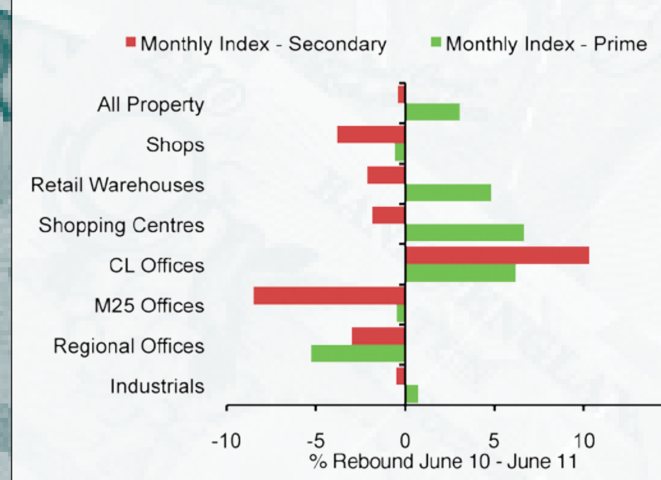


Chart 3. CBRE Monthly Index, annual sub-sector capital growth



are often "black holes" in service charge accounts, where the borrower has been unable to fund both the void service charges and their repayments to the bank from income received. Any shortfall in the accounts can lead to a deterioration in the maintenance of the property and relationships with remaining tenants, compounding the issues faced. "It is important to ensure that these problems do not develop, leading to increased vacancy rates," says Perkin. "Often we have found that borrowers may be unwilling to inject additional equity to fund shortfalls, or may lack suitable experience or incentive to provide their lender with confidence in their ability to improve the position with the asset." The appointment of appropriate asset managers can deal with these issues and ensure that asset values are not allowed to deteriorate through inaction.

> *"If all parties are willing to be flexible and work together, then a positive result for all can be achieved"*

In terms of insolvency, one of the key benefits is that receivers aren't responsible for rates liabilities. This can significantly reduce holding costs for properties with high vacancy rates and improve the net cashflow position while action is taken to improve occupancy levels. "But whatever type of appointment, we try to engage with tenants to improve cashflow and improve the recovery prospects for all involved," adds Perkin.

Banks will compete to offer new debt on the right opportunities

When the credit crunch was at its most savage, in early 2009, the expectation was that after a couple of years, the property debt markets would be changed by the experience, but that a normal level of liquidity would eventually return. However, a combination of increased regulation, bank deleveraging and continued uncertainty created by factors such as the Eurozone debt crisis means that new debt is almost as scarce as it was in 2009.

For this reason, CBRE has a specialist debt advisory team that sources new debt for clients to provide the best funding package possible. "We undertake significant due diligence on each to make sure the deal is fundable and to have the greatest idea of what will work best for our clients," says Natale Giostra, head of UK and EMEA debt advisory at CBRE.

Competition for lending to the right deals has increased, but sources of debt have become far more disparate than before the crunch. On secondary property loans, the quantum of debt available is small, and borrowers must work hard to put themselves in the best position possible to lift themselves above the pack.

"Whether it is for assets in regional or prime central London locations, lenders are continuing to closely analyse the fundamentals of each property on a case-by-case basis," says Giostra. "Competition for debt finance among borrowers is still high, and only the best-structured propositions are being accepted. So borrowers must build and present their financing proposals carefully, if they want to be successful.

"Using advisors to generate a pre-credit analysis for the lenders to assist in structuring a loan appropriately is one avenue, as they can address lenders' queries and questions, to facilitate their credit process-supporting negotiations."

While there is debt available, some borrowers will be unable to refinance assets in the current market, meaning alternative solutions must be

explored by lenders to recover value from their investments.

Loan sales bring liquidity and put debt in the right hands

One aspect that has been curiously lacking during the recent market downturn has been the sale of large portfolios of distressed loans by banks. In previous cycles, and particularly in the US; this has been a key part of their deleveraging process, and a way for private equity to access large pools of assets quickly. But until now, the bid-offer spread between buyer and seller has just been too large, and the motivations for sale reduced by the level of sovereign intervention in the banking system.

So reports that Lloyds Banking Group is selling a portfolio of £1bn worth of distressed property loans, coming on the back of other similar sales in the UK and Europe, is a big boost. "Loan sales are very important in terms of bringing new liquidity to the market and repatriating risk from those that don't want it to those that do," says Paul Lewis, director of special servicing at CBRE. There are benefits from a deleveraging perspective as well as from a workout perspective, as the loans are in new hands and proactive decisions can be made, easing the pressures on bank balance sheets. It should all hasten the reignition of the commercial real estate finance market. In all of this, the structuring of the loan sale is key.

Joint ventures need all of the partners aligned

Joint ventures are increasingly common as a way in which banks can work out distressed loans. They allow the banks to bring in what is lacking in a recapitalisation situation – sometimes this will be specialist asset management, while on other occasions will be fresh capital.

For Mark Evans, head of equity placement at CBRE, the key to setting up a joint venture between a bank and a new investor – possibly including the existing borrower – is an alignment of interest. "Everybody has to be aligned and it has to be organised in the right way, so that the economics are right," he says. "This can be structured so that the bank is paid out first and the new party gets paid out if certain performance targets are exceeded. Otherwise the bank might have to subordinate some of its own return behind that of the new equity investor, to entice them in. Either way, the bank is likely to have to leave the original debt in place, and even put in some new debt."

> *"The only way to truly drive performance is through active asset management"*

Evans says getting the right mix of skills and cash is also vital if banks are to minimise losses through setting up joint ventures. "You are either looking for new equity or new expertise," he says. "If the original borrower is a skilled property manager but lacks the cash to complete a business plan, then you might bring in new equity and keep the original borrower in, working on a fee basis with a profit share at the end. But if the original borrower was just a financial engineer who cannot add any value to a property, then you would not want to keep them involved."

CASE STUDY

PREVENTING ASSET depreciation is a major challenge within legacy loan positions, particularly where the borrower may not have equity left in the capital structure.

If borrowers are not able to demonstrate that they have adequate resources to implement asset business plans, limit non recoverable costs and maintain NOI, assets are likely to experience a sustained reduction in values.

Borrowers also need to constantly evaluate and refine these plans to reflect market conditions and show determination and innovation in their leasing and sales strategy. Unrealistic approaches or borrower inertia are increasingly likely to result in enforcement action by lenders.

CBRE was recently instructed on a portfolio of over 80 UK office buildings, which was approximately 60% vacant. The assets were situated in markets where there was a significant oversupply of accommodation and gross income from the portfolio had fallen to the extent that NOI had become negative. Having been unable to agree a consensual workout with the borrower, CBRE's LPA team and its asset manager, REAM Capital Partners, were mandated to asset manage the portfolio and maximise disposal proceeds for the lender.

On appointment, CBRE undertook a full assessment of the portfolio including a pricing review and examination of the asset management and marketing strategy. This focussed on how to work proactively to differentiate the properties in a market where there was competition and vacancy risk.

Subsequently, new agents were appointed to re-invigorate the asset management strategy. In tandem, the marketing of the portfolio was repositioned as it was apparent that these assets would be more attractive to owner occupiers in a vacant state than to investors, where the building was let on standard terms.

Above: Typical of the portfolio, this asset was 60% vacant

The base case strategy was to sell the buildings individually to owner occupiers rather than lease and sell to investors. In addition to potentially achieving higher disposal proceeds this also saved on the legal and agents fees associated with leasing.

Overall CBRE successfully worked out the entire portfolio for the client in a short space of time (under 18 months).The key to maximising proceeds in this case was the focus on proactivity in identifying alternative disposal strategies and getting incentivised teams in place to execute them.