

# EUROPEAN PROPERTY FINANCE TRENDS: THE BANKER'S PERSPECTIVE

Our third annual European Property Finance Trends report, conveys the trends and opinions of bankers across Europe. We interviewed 22 different banks from across the region to seek their opinion on the appetite for project investment, the preferred asset type and the outlook for the future of property finance.

CONFIDENCE CRISIS  
EURO ZONE  
EUROPEAN BANKS  
SPECULATIVE DEVELOPMENTS  
PRE-LET PROJECTS  
BOOST ACTIVITY  
FUTURE OUTLOOK  
PROPERTY LOANS  
JV PARTNERSHIPS  
ALTERNATIVE FINANCE  
EXIT STRATEGIES  
WORK OUT SOLUTIONS  
RISK ADVERSE  
DEFAULT ASSETS  
OFFICE ASSETS  
RETAIL ASSETS  
PRIME DEVELOPMENTS  
ECONOMIC STABILITY  
RECOVERY  
ECONOMIC IMPROVEMENT  
GOVERNMENT STABILITY  
ASSET PRICE INCREASE  
INVESTOR MARKET  
DISPOSAL OF ASSETS  
EQUITY  
SECURITY  
CASH FLOW  
RELATIONSHIPS  
MARGINS  
ANTICIPATIONS  
STATISTICS  
INCREASE IN DEMAND

EC HARRIS  
BUILT ASSET  
CONSULTANCY

The findings highlight the crisis of confidence we are currently witnessing amongst the European banks. Very few are lending speculatively and this is leaving many projects unable to get off the ground. Lenders are waiting until the euro zone situation improves, but with this likely to take some time, lenders and developers need to work together and find new ways of convincing credit committees to accept management project risk.

### Executive Summary

- 85% of lenders have been lending less or about the same amount as last year to speculative investment
  - Pre-let office and retail developments are the most preferred asset types for lending
  - 45% of European bankers believe that the banks are unlikely to increase lending to speculative property developments over the next five years
  - Property loans in default still remain a challenge for lenders and the fear of adding to this distressed asset burden makes riskier projects less attractive
  - A continued trend of lenders expect developers to inject more equity into their projects, often through JV partnerships and/or mezzanine finance
  - Increasing reliance of alternative funding models. We have noticed a 100% increase in the number of developers forming JV partnerships over the past year
  - Lenders are linking an increase in their confidence to an improvement in the euro zone situation
  - To avoid lending hiatus, lenders and developers need to work together to find ways to demonstrate that the exit strategy is fail safe and all risk is minimised when developments are not pre-let or in the right location.
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## The appetite for project investment

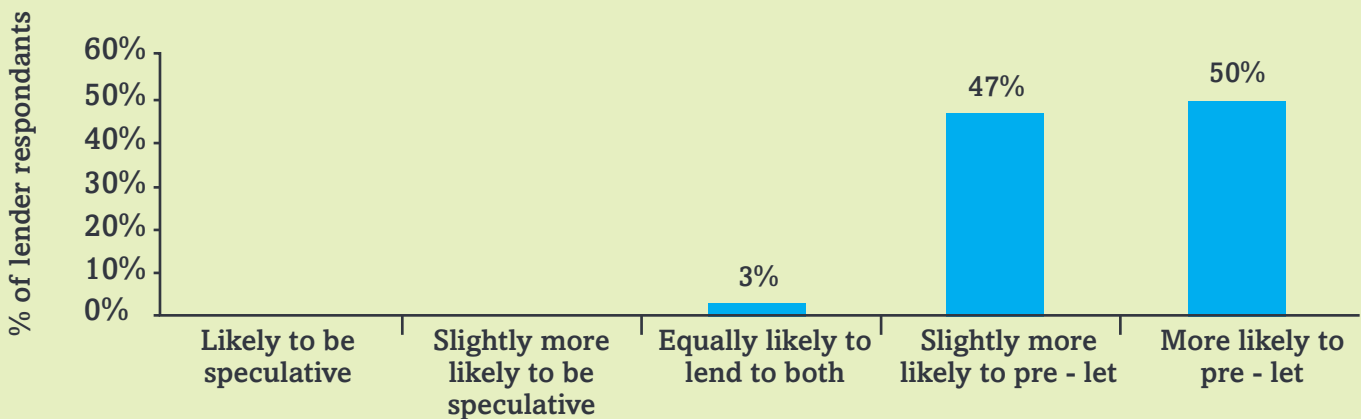
### Lenders are more likely to lend to pre-let projects

The positive lending sentiment has peaked this past year. 85% of lenders have been lending less or about the same amount as last year to speculative investment. However, pre-let projects seeking finance still seem to be the preferred option for lenders. Pre-let projects are one of the lenders' top priorities when making a decision to lend, along with the right asset type in a prime location being the most attractive to them. 97% of respondents

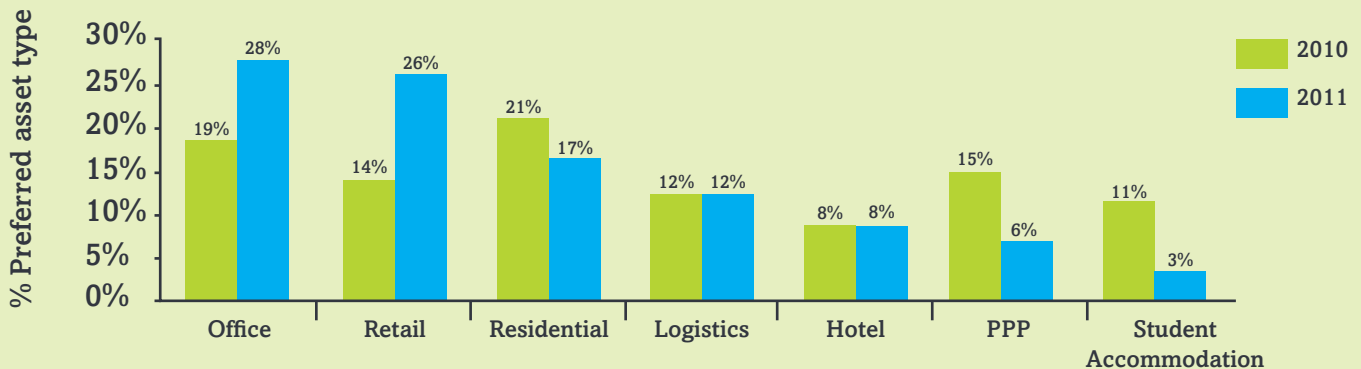
stated that they were more likely to lend to pre-let projects over speculative projects.

Currently, lenders are risk adverse meaning that secured cash flow is always preferential to underpin the lending books. Alongside this, many lenders declared that they still have default assets on their books and they cannot afford to take more risk.

### Likelihood to lend to speculative or pre-let projects over the next five years



## The preferred asset type



### Lenders prefer to lend to Office and Retail projects

With public spending slowly declining, an expected recovery in the commercial market is driving demand. The public sector has very little available funding for PPP and student accommodation projects. This is in stark contrast to this time last year, thus these classes are in great decline.

Steady economic recovery throughout 2010 and early 2011 has boosted demand for office properties across Europe, especially in the economic powerhouse tier one cities; London, Frankfurt and Paris. Over 50% of lenders prefer Office and Retail projects; 28% prefer Office projects and 26% prefer Retail projects.

The tier two cities are demonstrating healthy economic growth, such as the Polish cities of Poznan and Wroclaw and the French cities of Lyon and Lille. They are attracting increased volumes of lending to Retail projects.

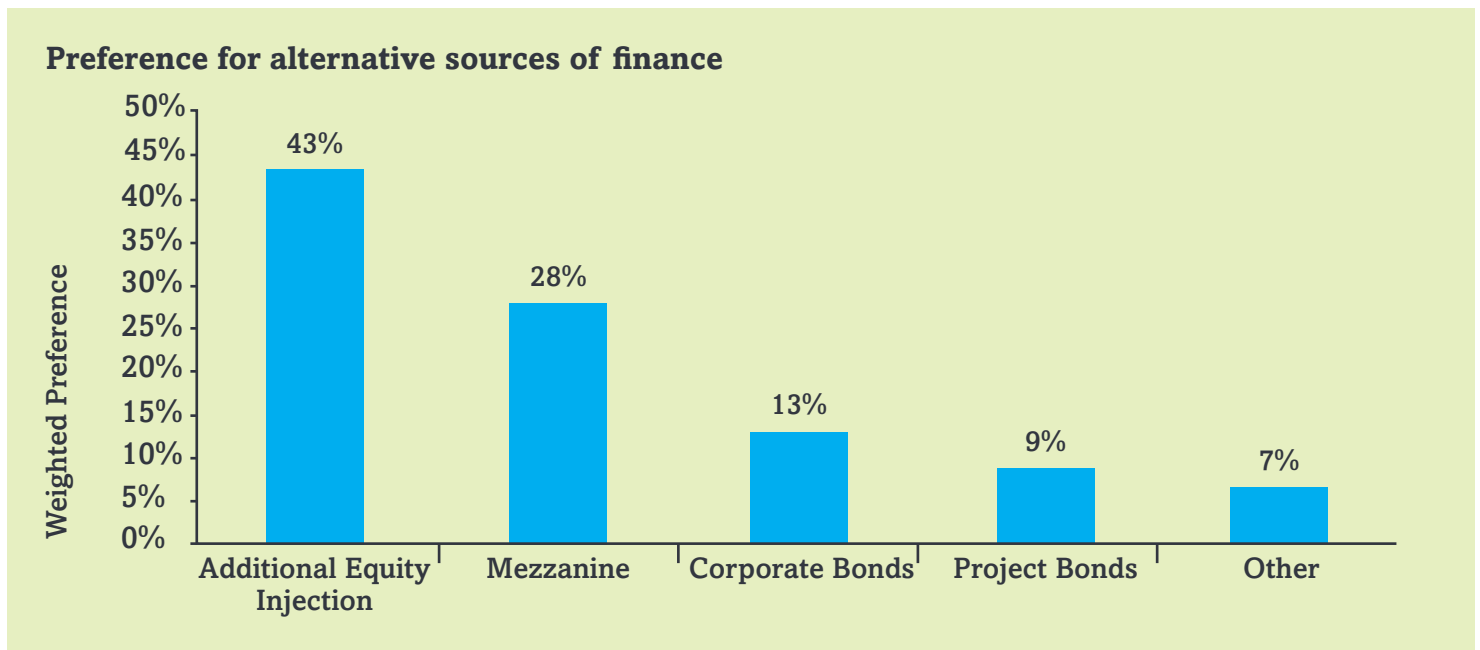
We are seeing an increase in lending in Poland in particular. For example, we are currently providing monitoring services to Aareal Bank, that are supplying finance for a Polish shopping centre based in Gliwice, in South West Poland. The scheme is 31,500 square metres and is due to complete in autumn 2012.

Lenders, especially in London and Paris, have been more active in high-end residential specifications. In London we are seeing an excess of development for this asset class. Our recent London Prime Residential Development Pipeline Report in July 2011, showed that a potential 9000 new prime residential development units are due to be delivered in London over the next 9 years, with a value in excess of £21 billion. However, the lending against mainstream residential projects is in decline.

Lending for hotel projects is stable though localised to specific regions such as tourism hubs and one off major deals. This is a volatile segment based on occasional projects. Distribution projects are also very localised, concentrated in Germany, France and Poland; Europe’s leading logistics and industrial centres.

Of all those we surveyed it was evident that the most optimistic lenders came from Poland, France and the UK.

## Alternative sources of finance



### There is high expectation on developers to establish JVs to raise the necessary equity funds.

Almost all lenders reported that they are currently using additional equity to cover project costs, often via a JV and 43% of those surveyed stated that they preferred an additional equity injection.

Corporate and project bonds have been noted by some West European lenders as being ‘on the rise’; 22% of lenders felt they were the most prevalent form of alternative finance. A few years ago such bonds were almost unheard of.

We are seeing a significant rise in alternative sources of finance currently being used to fund developments. However, these can create different governance challenges and in some instances form potential barriers to the optimum solution, unless communication and control is dealt with early on.

## Property loans in default remain a challenge for lenders

Almost a quarter of lenders hold a pessimistic view of the future and expect to spend less on speculative development over the next five years. This is in comparison to just 3% last year. Lenders believe the crisis is not over and uncertainty of the euro zone may lead to higher costs of borrowing and less liquidity, therefore reducing their ability to lend at higher volumes.

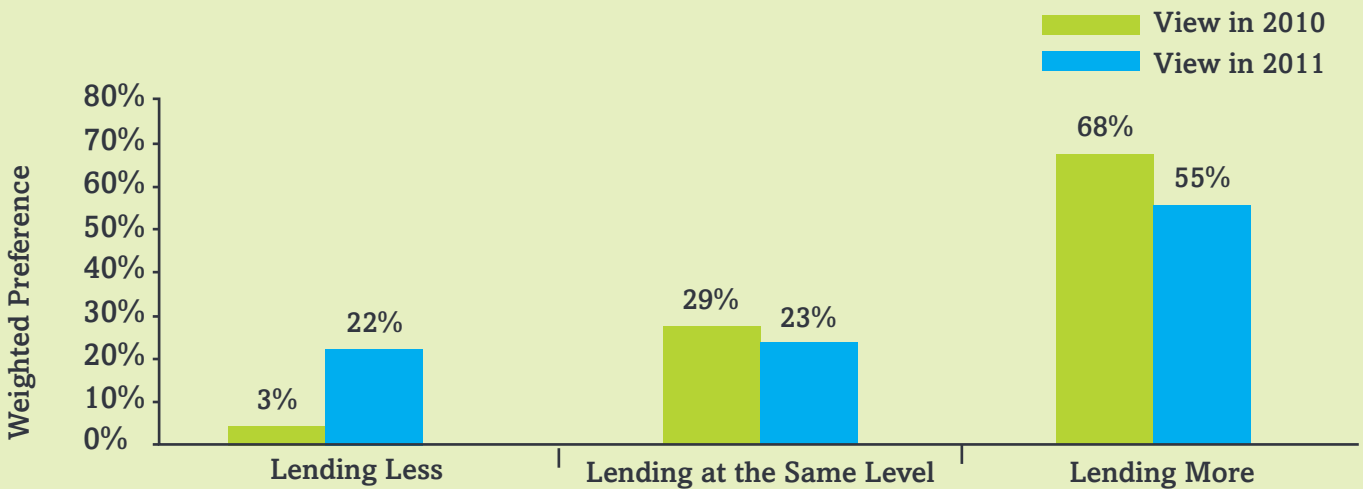
Over 40% of respondents stated that they still hold a high proportion of property assets linked to loans in default. We expect that post 2012 there will be a real risk that mature loans in need of refinancing will not be able to access leverage through traditional Commercial Mortgage Backed Securities (CMBS) and this may lead to more debt pile ups.

Lenders report that the implementation of Basel III, progressively from 2014, will require them to retain more equity for hold, introduce capital buffers and liquidity and leverage ratios. This will result in a constraint to future lending activity. This should encourage lenders to start to develop an effective work out

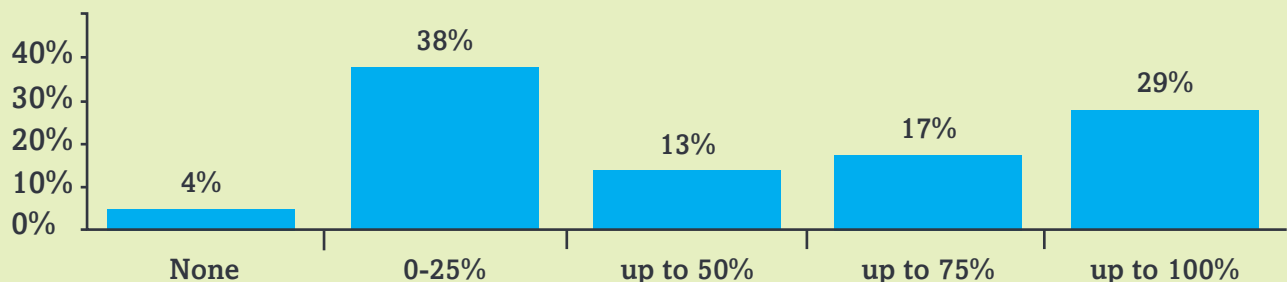
strategy, so as to dispose of debt in default before Basel III comes into force. Currently, many German banks are disposing of debt in default, before Basel III equity requirements are introduced. This is a good work out strategy to ensure their lending abilities are not constricted by both existing debt and new regulations.

A comprehensive disposal strategy for distressed assets is clearly very important, as the continuing presence of loans in default and property assets awaiting disposal is a burden on the appetite for banks to lend into developments. Alongside this, the optimisation of the asset and maintaining asset value is vital to ensure fast and lucrative disposal.

### Likelihood to lend to speculative projects over next five years



### % of total debt in default that has been removed from your Balance Sheet



## What will boost lenders confidence?

### Economic stability and recovery

All lenders stated that a more stable euro zone is vital to unlocking higher volumes of lending. This will boost investor confidence and occupier demand for property as well as provide a more conducive environment for the disposal of debt in default and potentially increase interbank lending.

### An increase in demand

All lenders believe that the occupiers are vital. They determine developers' pipelines for large projects and ensure a secured cash flow, which is one of the main requirements for securing lending.

### Western Europe market

In Western Europe, lenders state that they need a solution to the supply of finance. Negative issuance of CMBS since 2007 is causing them to fear further defaults in 2012 as they do not feel there will be enough CMBS to ensure financing of all mature loans that need it. Alongside this, they need to see an increase in the availability of funding, especially after Basel III comes into effect.

### Central and Eastern Europe market

Central and Eastern European lenders stated that they needed to see clear trends that the real estate market is improving. They would like to see asset prices increase and more lending by peers. In addition, government stability and policy is crucial for these regions, especially in Serbia where the EU candidacy has boosted interest and confidence in the property market of Belgrade.

## What will enable lenders to become more active?

### Create new solutions to convince credit committees

The crisis of confidence amongst the European banks at the moment means that very few are lending speculatively. Lenders say they are waiting until the euro zone situation improves. We believe the underlying issue is that lenders and developers need to find new ways of convincing credit committees to accept and measure development risk.

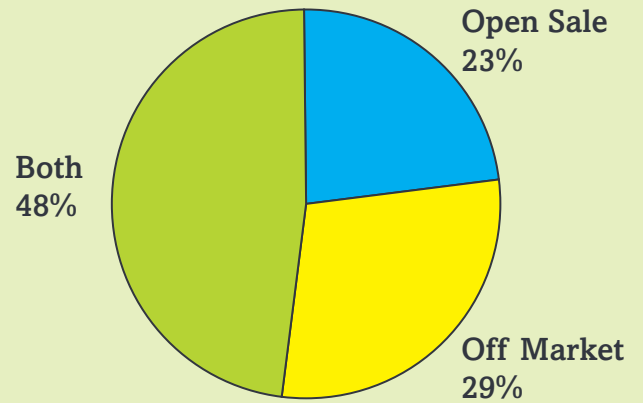
Our clients are requiring more statistical analysis and the use of insurance products. The deployment of risk control techniques and measures from other industries will help to convince credit committees and bankers that development risks are under control.

### Use alternative sources of finance as a gateway

As reported earlier, almost all lenders stated that they prefer to use additional equity to cover project costs, often via a JV and 43% of those surveyed stating that they preferred an additional equity injection.

A trusted JV partner can inject the equity developers need to meet strict debt to equity lending criteria. Although this will mean lower margins for developers as they will have to share the profit and often this type of finance is a lot more expensive, for example mezzanine finance. It is clear that developers will have to change their pre-finance strategy as well as their profit expectations to meet the needs of lenders.

## The preferred method to dispose of assets



### Accelerate a work out strategy for distressed assets

Getting appropriate advice on the best strategy for assets in default may provide the best opportunity to dispose of them quickly. 48% of lenders stated that they are still using both open sale and off market to dispose of assets. 29% prefer to dispose of assets off market, however this may increase in the future as it is seen as a viable means for some of our clients. It is a lot quicker, it means that they are less exposed and they usually get the best price, that is right for them.

As an example, one of our clients, a major Spanish bank has recently requested that the work-out solution includes preparing and managing a full exit strategy but within a closed investor market. This avoids the time consuming process of running bidder auctions which highlights the banks non-performing assets.

## What does this mean for developers?

### Be expected to bring equity to the project

Alternative sources of finance can help developers to meet the strict lending criteria. Many of the lenders surveyed stated that when seeking finance, developers must be prepared to provide more equity, along with a robust business plan.

There are a host of alternative finance examples and we are currently engaged on many schemes where the nature of the client is varied. Examples of this are:

- Off balance sheet led development by a volume player
- 'Active' JV where the equity provider also has development expertise alongside the lead developer partner
- 'Passive' JV where the equity provider relies solely on partner's development expertise
- Conventional leveraged project finance led development by small / medium developers
- Sovereign wealth with in house or outsourced development expertise
- Institutional equity combined with niche development expertise.

With all of these options it is vital that communication and control is dealt with early on to prevent all potential risks associated with your return on investment. It is interesting to note that we are seeing more Private Equity investor clients undertake direct developments without the use of developer partners to protect their returns.

### Secure the cash flow

Developers must minimise risk to secure finance. It is vital to adopt a robust approach to the development process from inception and land acquisition through to handover. Having a pre-let agreement in place with a reputable client is preferable, or a pre-contract with the future buyer of the asset, to ensure there is a great deal of pre-let. A full analysis of cost, value, the end client, programme and associated risks, can enable access to finance and should be a basis of sound development in any market.

### Build long term relationships with banks and lenders

Lenders surveyed stated that trust, communication and long term relationships with developers are important to them. In this volatile and constantly changing market this comes as no surprise; one lender said that building a strong relationship over time is better for the developer in the long run, rather than looking for the cheapest available finance.

An independent review of the business plan, for what are often multiple stakeholder vehicles or external funding bodies, is crucial to building confidence with lenders and gaining finance.

### Do not fixate on your margins

In order for projects to happen the developer and the lender need to be flexible. By showing the lender that you are flexible on margins can help to ensure the project progresses and help to secure the finance. One lender suggests making a fair risk split between the equity partner and the bank.

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**CLICK HERE** to see the video from Matthew Cutts, where he provides his view of the report

### The methodology

Interviews were carried out by experts from EC Harris' Lenders & Investors team with property lenders throughout Europe, including tier 1 global banks to local regional banks.

All property lending professionals are personal contacts of our experts with whom they have a working relationship. The relationships ensure we always have access to lenders' insights and anticipations, allowing us to correctly judge the market and assist our investment and development clients to plan for the future.

31 property lenders from 22 Banks were interviewed from the European markets including the UK, France, Spain, Italy, Germany, Austria, Serbia, Hungary and Poland.

The interviews comprised of a survey of multiple choice, ranking and open ended questions. Multiple choice and ranking questions have been compiled into the statistics in this report while the open ended conversations have provided the explanations and commentary behind the numbers.

