DE MONTFORT®

MID-YEAR 2017 SUMMARY REPORT

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Executive summary

Important Issues and Conclusion

- Despite lending activity during the first half of 2017 being subdued the overall amount of debt on lenders' balance sheet has remaind stable at £191.4bn with outstanding loan books value at £166bn (+0.8 from year-end 2016). At mid-year 2017, this total outstanding debt was £211bn consisting of £166bn retained on balance sheet and reported to the survey, £16.4bn of outstanding CMBS and £28.6bn identified from financial statements. This included £3.6bn lending undertaken by PWLB (Public Works loan book, the body of financing Council's acquisitions of commercial property) and £3bn of peer-to-peer lending.
- The loan books of German Banks increased by 12.2%, for Other Non-bank Lenders by 12.6% while the property loan exposure of UK Banks & BS grew by 0.2% between year-end 2016 and 30 June 2017. For all other lenders loan books were shrinking.
- During the first half of 2017, £17.6bn of new loan originations were completed. This compares with £21.4bn in H1 2016 and £23bn in H2 2016, representing a y-o-y decline of 18% and a 24% decline from H2 2016. This indicates a general slowdown in purchasing activity of new properties requiring debt during 2017, however there is a significant pipeline of deals under completion for H2 2017 which can still turn annual numbers around.
- Despite a slowdown in new origination volume, market liquidity did not suffer in terms of competitive pricing and lending terms.This is especially the case in the core and prime markets. In particular for the London market, there is a new super prime segment.
- 42% of new loan origination was allocated to Central London and another 11% to "Rest of Southeast". A total of 47% was targeting other regions, mainly in key centres Manchester, Birmingham, Glasgow, Leeds, and to a lesser extend Bristol.
- LTV ratios for newly originated loans have remained low and stable. While 12 months ago lenders were still comfortable lendng at 60-65% LTV, there is more caution regarding property values especially for prime property in London. Average LTV's were 58% at mid-year 2017. There is general willingness from lenders to improve on other terms and structure loans around business plans and improve speed of transaction closing.
- Origination volume for UK Banks & BS has declined less than for other lenders, when comparing with volumes 12 months ago; UK Banks & BS originated £8.1bn compared to £9.4bn H1 2016. It is generally confirmed by market participants that the regulation has effectively changed the lending ability and appetite of UK Banks & BS for the long term with regards to lending LTV, pricing and deal selection.
- All lenders are searching for extra margin income and shifting their lending strategies. 23% of all new origination went into development finance, and considering an undrawn amount of £25.3bn of debt,

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the number of development finance committed is even greater. Overall UK Banks & BS are the key suppliers of development funding providing 64% of residential development funding and 44% of commercial development finance. The second largest group for development finance was Other Non-bank Lender, supplying 25% of residential development finance and 35% of commercial development finance.

Responses to Research

- At mid-year 2017, data was received from a total of 78 lending organisations. The lending organisations comprised 43 Banks & BS, 11 Insurance Companies and 24 Other Non-bank Lenders. In comparison in 2007 58 lending organisations were reporting to the survey of which all of them were banks except for 5 Insurance Companies. In 2015 49 lenders were Banks & BS. The number of bank lenders has be steadily declining over the last 10 years
- Out of 78 organisations 6 lenders are not active in the market, and are deleveraging their portfolio, but still have significant amounts of loans under management. One lending organisation could no longer supply data, while one new organisation was added to the survey.
- Other Non-bank Lenders have been identified as a category of lender in this research since their recent entry into the market during 2012. Data trends prior to year-end 2012 do not, therefore, include this category. This category includes debt funds, asset managers and other organisations that are prepared to provide junior debt, mezzanine finance and more recently senior debt.
- Due to the increasing number of Insurance Companies that entered the market during 2011 and 2012, Insurance Companies have also been identified as a separate category of lender. Their inclusion as a separate category is restricted to guard against identification of individual companies within the aggregated data.

Loan Book and Market Size

- A total value of £191.4bn of committed debt (including both drawn and undrawn amounts) was recorded by the survey as at 30th June 2017, was equal to year-end 2016. However, the amount of underdrawn facilities is noticeably high with £25.3bn.
- The aggregated value of outstanding drawn debt recorded in loan books and secured only by UK commercial property was lower with £166bn in mid-year 2017 compared to mid-year 2016 with £173.4bn but higher compared to £164.8bn at year-end 2016.

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Table 1: Total loan book value (£m)

Total book	Total outstanding loans 2016	Senior	Junior & Mezzanine	Undrawn amounts	Total book size MY 2017
UK Banks & BS	76,826	76,790	36	19,205	96,031
German Banks	20,042	20,042	-	1,094	21,135
Other International Banks	24,036	24,036	-	772	24,807
North American Banks	7,620	7,620	-	1,460	9,080
Insurance Companies	22,707	22,005	702	1,750	24,458
Other Non-bank Lenders	14,782	12,463	2,319	1,080	15,862
All Lenders	166,013	162,956	3,057	25,361	191,374

- The outstanding loan book value of £166bn at mid-year 2017 was allocated as follows; £128.4bn held by Banks & BS (77%), £22bn (14%) by Insurance Companies and £12.4bn (9%) by Other Non-bank Lenders.
- It is extremely difficult to ascertain the total size of the commercial property lending market in the UK. As part of the process of widening the scope of this research to make it as comprehensive as possible, in addition to £166bn collected by the research the following amounts of outstanding debt have been identified:
    - Approximately £28.6bn of debt has been identified from the published financial statements of non-contributing organisations. This included approximately £3bn debt by peer-to-peer lenders and £3.6bn recorded for PWLB lending (Public Works loan book, the body of financing Council's acquisitions of commercial property)
    - At mid-year 2017 Trepp provided data on the total outstanding balance of UK CMBS, which was approximately £16.4bn. The amount of outstanding CMBS has been constantly reducing since the Global Financial Crisis (GFC) 2008/09.
- Thus, at mid-year 2017, an estimated approximate total value of 211bn of outstanding debt secured by commercial property has been identified by this research. This compares with £211.6bn recorded at year-end 2015 and £209bn recorded at year-end 2016. A moderate increase in six months by 0.9%
- In addition, a further £25.3bn of loans were committed but not drawn at mid-year 2017.
- UK Banks & BS held 46% of outstanding debt retained on balance sheet and secured by commercial property, German Banks 12%, Other International Banks 14%, North American Lenders 5%, Insurance Companies 14% and Other Non-bank Lenders 9%.

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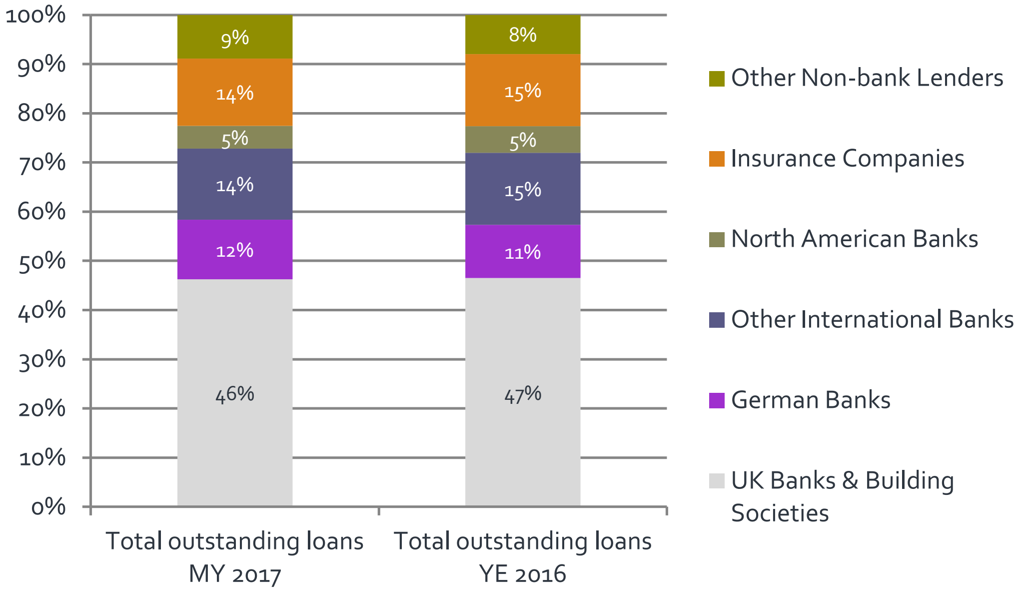
Figure 1: Debt allocation by lender category (% of outstanding loans)



Source: DMU 2017

Loan Originations

- During H1 2017 £17.6bn of new loan origination including refinancing on commercial terms was recorded as having been undertaken. This compares with £21.4bn undertaken H1 2016 and £24.7bn for the first half of 2015. This represents a y-o-y decline of 18%.
- During H1 2017, of the new loan originations of £17.6bn, £13bn was originated by Banks & BS, £1.6bn Insurance Companies and £2.5bn by Other Non-bank Lenders. However an additional amount of insurance money has been invested via Other Non-bank Lenders adjusting the total debt originated on behalf of insurance & pension funds to £3.5bn reducing the share of Other Non-bank Lenders to £0.8m origination.
- The 12 most active lenders undertook 61% of new loan originations; this is out of a total of 60 active lenders during H1 2017, who have originated loans, while 12 lenders were willing to lend but failed to close new deals during H1 2017.
- The total of 61% of new loan origination volume was undertaken by 5 UK Banks & BS, 2 German Banks, 2 Insurance Companies and 2 Other Non-bank Lenders. This was the first time Other Non-bank Lenders were in the top 12 lenders.

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Table 2: Total origination volume (£m)

	H1 2016	H2 2016	H1 2017	% change
UK Banks & BS	9,452	11,261	8,118	-28%
German Banks	3,580	2,130	2,050	-4%
Other International Banks	3,060	2,591	2,395	-8%
North American Banks	1,536	1,806	652	-64%
Insurance Companies	2,043	2,603	1,582	-39%
Other Non-bank Lenders	1,805	2,616	2,863	9%
All Lenders	21,476	23,007	17,659	-23%

- Overall it is worth noting that 51% of the total origination volume was refinancing of loans and 49% was for new acquisitions. While 2016 was dominated by refinancing activity (61%), in H1 2017 origination volumes were much more a result of new acquisitions. In 2015 the majority of 55.6% of new financing was provided for acquisitions. In 2014 this was 51.7% and in 2013, 61%. North American Banks (72%) and Insurance Companies (68%) derived a large amount of their H1 2017 activity through refinancing of their own loans or loans from other lenders. In contrast Other Non-bank Lenders sourced 51% of their new origination volume from new acquisitions.
- The market share of new loan originations shows a sharp decline y-o-y for all lender groups except Other Non-bank Lenders which increased their volume by 59% in 12 months and 9% over six months. Sharpest decline was recorded for North American Banks with 58% drop in origination volume, followed by German Banks with 43% decline y-o-y and 64% for six months.
- At mid-year 2017 2.5% of total newly originated loans was mezzanine finance. Considering the high amount of liquidity, there is little demand for mezzinane finance.

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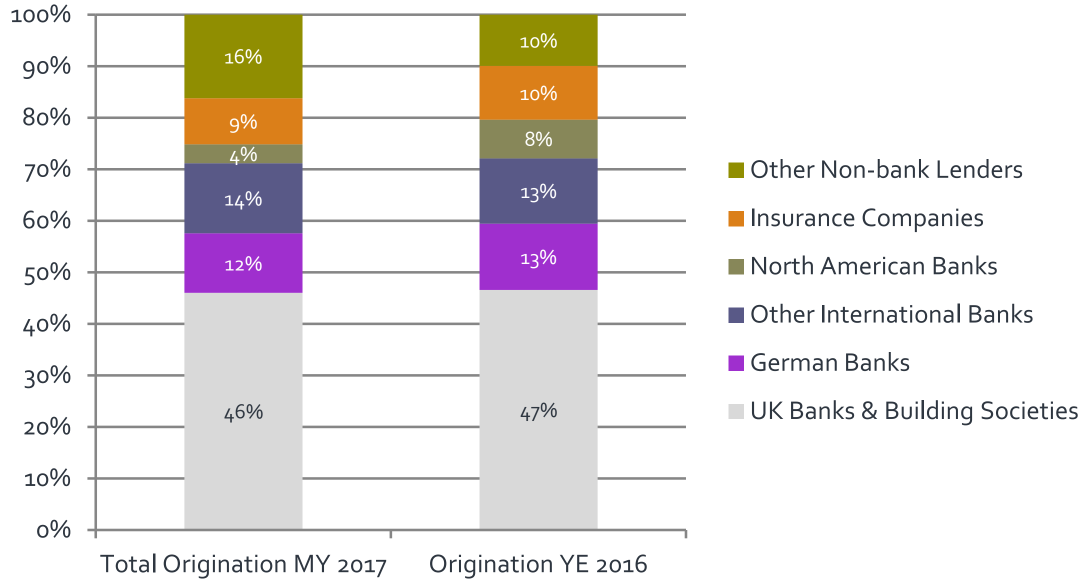
Figure 2: Allocation of new origination by type of lender (% of total origination)



Source: DMU 2017

Securitisations, Syndications and Club Deals

- No new CMBS issuance was reported to the research during H1 2017; however there have been synthetic CMBS, which have been mentioned by market participants.
- During H1 2017, approximately £0.874bn of debt was reported as being syndicated by 11 organisations. In addition, approximately £2.4bn was reported as the value of participations in club deals by 17 organisations that contribute to this research. This reflects a decline of the syndication market in terms of syndication volumes, which was also confirmed by Dealogic in June 2017. While the amount of club deal activity appears to be more healthy.

Structure of Loan Books

- During H1 2017, the large majority (93%) of loan exposure was held in loans up to 70% LTV. The proportion at year-end 2015 was 87.5% having steadily increased since 2012. This is 10-year low. With 37% of loan books below 50% LTV. This compares to an average leverage for property companies of 30-35% LTV.
- 87% of the exposure of total loan books was secured by investment property at 30th June 2017. At year-end 2016 this was 83%.
- The value of loans in breach of financial covenants and those in default at mid-year 2017 reported to

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the research was approximately £2.1 and represented 3.6% of the total aggregated loan book. This compares with £10.4bn and 7% reported to the research at year-end 2015 and £2.5bn at year-end 2016.

Senior Debt: Loan terms for Investment Property offered by All Lenders

- The decline in interest rate margins observed since 2012 reversed in H1 2017. At mid-year 2017, the average senior margin for loans secured by a prime office was recorded at 209bps for All Lenders, compared to 198bps year-end 2016. This represents an increase of 11bps. An increase was noted for all loans secured by prime property. For senior loans secured by secondary offices, average interest rate margins increased even further by 38bps from 263bps recorded at year-end 2016 to 301bps at mid-year 2017.
- However, deals considered super prime can still attract a margin of below 200bps. A bigger distinction was made between prime and secondary property loans, with fewer lenders willing to quote margins for secondary property and significantly higher pricing. The average senior margin ranged from 213 – 365bps for loans secured by secondary office, retail and industrial. Compared to loans secured by prime property with a range of 170bps to 266bps.
- The most competitive pricing was offered on senior loans secured by prime office property by German Banks with 170bps, which is an increase of 162bps compared to year-end 2016. This was followed by North American Banks with a margin of 189bps and Insurance Companies with an average margin of 216bps.

Table 3: Key financing terms H1 2017

Senior margins (bps)	Total average (bps)	60% LTV (bps)	Arrangement fee (average, bps)
Prime office	209	194	89
Prime retail	217	198	90
Prime Industrial	234	213	91
Secondary office	301	292	107
Secondary retail	289	269	108
Secondary industrial	287	259	104
Residential investment	252	277	100
Hotel	265	258	98
Student Housing	264	242	98

- The overall average LTV ratio recorded for deals during H1 2017 was stable at 58% for senior prime office loans. The noticeable decline of LTV ratio occurred during the first six months of 2016, when the average LTV provided by UK Banks & BS was 59% LTV compared to 65.6% LTV at year-end 2015. Over the last 18-20 months senior LTV ratios have remained well below 60% with an overall average of 58% LTV across property types.

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- Average arrangement fees have largely remained stable with the lowest fees offered by German Banks with an average of 80bps followed by Insurance Companies with 81bps for prime office property loans. The majority of lenders charge an upfront fee of 100bps on a 5-year investment loan with an LTV of 50% - 65%.

Mezzanine Finance loan terms

- At mid-year 2017 mezzanine terms were provided by UK Banks & BS, American Banks as well as Insurance Companies and Other Non-bank Lenders. Overall the risk appetite for junior – subordinate lending was very limited.
- At mid-year 2017 the average maximum LTV ratio increased slightly from 77% for loans secured by prime office property, indicating an increase from 73% LTV quoted at year-end 2016. Mezzanine loans of up to 80% LTV can be obtained from Insurance Companies (albeit lower than at year-end 2016 with 85% LTV) and Other Non-bank Lenders. One explanation is the continued search for extra yield.
- For mezzanine finance margins for loans against prime office property were 761bps followed by loan against retail property with 801bps. For loan against secondary properties margins were 830bps and 807bps respectively. A distinctions is made for loans with LTV ratios up to 75% vs loans with higher LTV ratios. For a loan against a prime office property mezzanine finance at 75% LTV can be obtained at a margin of 740bps compared to 85% LTV at 950bps.
- Overall mezzanine loans against prime property achieved IRR's of 8-9% while loan on secondary property deliver an IRR of 10-11% with niche lenders quoting up to 16%.

Other Investment Finance terms by All Lenders

- Finance terms for residential investment were offered by 25 lenders, compared to 17 at year-end 2016. This shows an increased interest in this asset class, especially with the expansion of PRS. The average loan margin for a senior loan was 274bps with an arrangement fee of 95bps at an average LTV of 61%. For this category Other Non-bank Lenders offered the highest margins of 500bps, compared to 180bps offered by Insurance Companies. There was no interest from German and Other International Banks mainly due to lack of suitable product.
- Mezzanine terms for residential investment loans were offered at an average of 805bps margin and an average LTV of 77%.
- 27 lenders also provided terms for hotel investment loans (22 at year-end 2016). For senior loans the average margin was 265bps at an average LTV of 57%. Margins ranged from the lowest offered by German Banks of 221bps to the highest by Other Non-bank Lenders with 313bps.
- Another 26 lenders also provided terms for student housing (23 at year-end 2016). The average margin was 264bps with an average LTV of 58%. The lowest margins were quoted by German Banks and Insurance Companies with 235bps. UK Banks & BS priced these loans at 253bps with an

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average LTV of up to 59%. Other Non-bank Lenders priced student housing at 277bps with an average LTV of 58%.

- The average mezzanine margin for loans against hotel property was quoted at 821bps with an average LTV of 78% and for student housing 819bps with an average LTV of 76%. IRR's ranged from 9 – 12%

Commercial Development Finance: Loan terms offered by All Lenders

- At mid-year 2017, 21 organisations provided data for finance of fully pre-let development. The average interest rate margin was 449bps, which was an increase from 401bps reported at year-end 2016 and an even higher increase from 336bps at year-end 2015. The average LTC (loan-to-cost based on GDV) ratio was 69% and the average arrangement fee 134bps at mid-year 2017.
- 15 organisations provided data for loans for 50% pre-let: 50% speculative development schemes at mid-year 2017. The average interest rate margin was 526bps with an LTC ratio of only up to 68% and an average arrangement fee of 148bps. In comparison the average margin year-end 2015 was 351bps and 480bps at year-end 2016.
- Only 10 organisations provided terms for speculative developments with an average margin of 602bps, 163bps arrangement fee and an average LTC ratio of 64%. In comparison, the average margin year-end 2015 was 384bps and 556bps by year-end 2016 with an arrangement fee of 150bps. This demonstrates the increasing cost of development finance for borrowers
- Few lenders provided mezzanine terms for development finance ranging from 70% - 85% LTC, 9.70% - 14% margin, arrangement fees of 150 – 200bps and exit fees ranging from 200 – 500bps.

Loan Terms for Residential Development offered by All Lenders

- At mid-year 2017 a total of 19 lenders provided terms for residential development. For senior loans the average LTV ratio for All Lenders was 59% LTV and 71% LTC ratio. The average interest rate margins was 497bps with an average arrangement fee of 128bps. This represents a decline from 528bps and year-end 2016.
- Margins from Norther American Banks were lowest at 300bps, followe by Insurance Companies with 380bps. Highest pricing was provided by Other Non-bank Lenders with 679bps for up yo 78% LTC.
- Mezzanine finance for residential developments was offered by 8 lenders with a LTC ratio up to 90% at an average margin of 11%, with a range of 9% - 18%. The average arrangement fee was 169bps and an additional exit fee of 146bps.

Future Lending Intentions

- 78% of All Lenders intend to increase loan originations for the second half of 2017, and are positive about the second half of 2017. A further 14% are trying at least to maintain their origination volume

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recognising the competition in the lending market.

- Equally 10 Insurance Companies and 21 Other Non-bank Lenders expressed an intention to increase origination volumes over the next six months.
- When asked about what lenders are most concerned about in the current market, 51 responded that they were concerned about property market fundamentals. Many expect property values to fall over the next 12 -18 months.
- Of all lenders North American Banks were the most concerned about the market situation considering all aspects from property market fundamentals, Brexit and a potential interest rate rise.

2007 – 2017: 10-years from the last boom cycle

- The composition of the lending market has changed dramatically. In 2007 debt financing was provided by 65 lending teams (58 organisations) vs 77 in 2017. UK Banks & BS held a total share of 69% of the total outstanding loan book. In 2017 it was 46% with only 1 BS actively lending (8 in 2007). In 2007 five lenders were insurers while all others were banks (43 in 2017).
- By mid-year 2007 the maximum LTV offered for senior loans secured by prime property reached 75%, while mezzanine terms extended to 91% LTV. Senior lending margins on prime property were quoted as low as 85bps, with 170bps for junior loans (up to 86%LTV) and 202bps for mezzanine loans (up to 91% LTV). The lowest margin was recorded for residential investments with 35bps at year-end 2007.
- In 2007 development finance was available at low margins of 157bps for pre-let developments, 180bps for part pre-let/part spec developments and 210bps for speculative development.
- Of the 58 banks lending in 2007 only 24 remain in the survey in 2017. Since 2007 UK banks and BS have provided 50% of total market loan financing, German banks 16% followed by 15% by Other International Banks. Since their establishment debt funds have provided a total of 6% of financing.

Challenge/Risk	2007	2017
increasing investment interest by property investors in local markets– focusing on submarket dynamics and asset specific characteristics – in the search for yield,.	Lending across UK (portfolios), strong believe in tenant and property diverisifcation to mitigate risk	Very selective on local submarkets, avoid concentration risks, Bank lenders might be less interested in following the investors' steps, due to regulatory pressures
Extending the definition of the Real Estate Investable Universe, increasing to so-called niche property types (e.g. hotels, self-storage, senior housing, and student housing),	Across a wide range such as healthcare, pubs, casinos	Focus on income sustainability, absence of riskier and more unstable assets like restaurants, pubs, casinos, petrol stations or trailer parks, which were popular alternative assets during the previous cycle peak 2006/07
Lending at higher LTV – extending senior LTV and additional mezzanine	Max senior LTV 75% Max mezz LTV 91%	restricted Max senior LTV 58% Max mezz LTV 78%
Move into development finance and non stabilised properties	Development finance cycle peaked in 2006/07, high amount of speculative development	Development finance cycle rising, but with less speculative development

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