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London Business School event says it will take 10 years to clean balance sheets, writes *Lauren Parr*

Banks lose appetite for all but most prime property morsels

Banks may no longer have the desire or the capacity to come back into the real estate lending market on the same scale they were in it before, but they aren't flat out refusing customers at the door. That was one of the messages from the London Business School's (LBS) annual real estate conference on 6 May, chaired by Dominic Wilson, former head of debt at AEW Europe.

In a keynote interview at the conference, held at Lord's Cricket Ground in north west London, Ric Lewis, chief executive and chairman of Tristan Capital Partners, quipped that in reality, it's a case of "death by term sheet. Banks won't say no, but they're building everything in there – they want spread and flexibility and they don't want prepayment".

Susan Geddes, managing director and head of real estate finance at Santander, delivered a sharp wake-up call in a session on real estate finance and legacy issues, by reminding the 250 delegates (22% of whom were LBS students) that banks' appetite for real estate is only part of their portfolios.

"People forget this," she said. "It's not what government wants either – it's desperately trying to address funding for housebuilders."

The build-to-rent model will be particularly encouraged, said Ian Marcus, managing director in Credit Suisse's investment banking division and a member of the Bank of England Property Committee.

"Emerging asset classes are interesting, supported by demographics," he said. "There is a significant amount of institutional capital out there that wants to invest in residential, for example, which has been the best performing asset class since the 1950s."

Back on the ground in the real estate sector, Lewis said that securing property finance requires "one or two conversations [with banks] that have to be well timed and well argued". He claimed he had never failed to find debt for a transaction – an experience not shared by all investors.

"It's a case of death by term sheet. Banks won't say no, but they're building everything in there – they want spread and flexibility and they don't want prepayment"
Ric Lewis, Tristan Capital Partners

Robert Balick, head of European real estate at alternative investment fund manager CarVal Investors, said his company, which focuses on distressed UK and French assets, typically talks to about 20 banks before finding debt – but in France, it is always the same two banks that finance its deals. "Relationship banking isn't dead," he insisted during a panel on European real estate investment challenges.

Lending focused on prime 'sliver'

In a keynote presentation, Liz Peace, chief executive of the British Property Federation, pointed out that loan-to value ratios are under pressure and new lending is focused on a small sliver of prime property. She estimated that there is £291bn of outstanding debt on commercial property, including £48bn of CMBS.

"Distressed debt sales are starting to come through gradually," she added, citing Lloyds' recent activity, "but assets are still priced too highly".

Marcus said he had seen one or two trophy assets sold or recapitalised by the likes of Lloyds and RBS. However, there are still tens of thousands of properties in the UK that have to be dealt with.

"Banks don't want to manage assets so they will seek partners that can inject equity and take the asset forward, where possible."

He added that some secondary stock could be overhauled using the right skill sets, but asked: "What about tertiary assets and what comes after tertiary?"

Geddes agreed that banks are starting to 'get real' in terms of putting distressed stock on the market, with more appearing this year, but it will be difficult for investors to finance purchases without stapled debt, as no bank wants exposure to another on its balance sheet.

She said one bank was looking at a capital markets structure to tackle its legacy assets and was discussing the possibility of floating assets off in a REIT structure.

A property company such as British Land or another external party could potentially be hired to manage such a REIT, suggested fellow panellist Marcus.

British Land chief executive Chris Grigg raised the problem of establishing pricing as "most assets banks hold do not fall within the sliver that's recovered".

Geddes also aired concerns about the quality and value of banks' assets: "These assets haven't been looked after well by the banks – there has been no capital expenditure, for example – so they are devaluing the assets they're holding." It will take 10 years for the banks to clear away these assets, she predicted.

With banks tied up with legacy issues and regulatory pressure among other things, institutional investors have stepped in to fill part of the funding gap, although alternative sources of debt are merely "a drop in the ocean", acknowledged Richard James, Cordea Savills' chief financial officer.

"Insurance companies all want to lend on prime," Marcus observed. "[Their lending operations] are run by their fixed-income divisions – do they have the knowledge and the infrastructure in place to do anything other than plain vanilla lending?

"We need to create a new CMBS product, call it something else, improve disclosure and, above all, simplify it. We also need to establish a reliable investor base in Europe by convincing insurance companies, pension funds and endowment funds that this is a product that fits into their portfolios."

But Grigg did not agree that structural innovations are the solution. "We've got to reprice the underlying kit so real estate offers the same returns as [investors] can get from other asset classes," he argued.

Consolidation needed

"This is a game for big players," added James. "We need more consolidation in the real estate fund investment industry to get things through."

Tristan's Lewis believes the market has been through the first wave of consolidation, whereby companies went out of business, and it is undergoing a less visible second wave, with companies struggling to raise capital. Besides high-profile takeovers, such as Blackstone's purchase of Valad, a raft of smaller approaches is taking place behind the scenes, he asserted.

"Some are [the product of] managers not getting bonuses; it's become difficult to retain good people."

A cyclical trend has also emerged of institutional investors favouring boutique investment managers, according to Lewis, who is in the middle of a road show for a new €500m core-plus fund.

"We need to create a new CMBS product, call it something else, improve disclosure and, above all, simplify it. We also need to establish a reliable investor base in Europe"
Ian Marcus, Credit Suisse

"Some LPs are saying: 'I'm angry, not just with poor returns, but because communication hasn't been open and honest'. They want people they can look in the eye and know who they're dealing with. They want to know how well the team gets along, how it is motivated – they're saying 'I want to know this actually works'."

Investors also want a breakdown of the rationale behind fee structures and if a manager cannot demonstrate this they will push for lower fees. "At the same time they want to make sure there's enough fee income to pay for the team," added Lewis.

Investors are also moving down the risk spectrum as they look for certainty of execution. Lewis reasoned that "a 95% chance of getting a 12% return is better than a 50% chance of getting a 15% return; investors have to accept that returns will be lower".

Cordea Savills' James said managers should be more flexible and open to what investors want – and increasingly, that is not heavy leverage or pooled fund structures.

"We've moved to a market that requires experience and judgement again – you've got to be nimble," Lewis told delegates. Core property has repriced very quickly, but with return to growth over the next few years, albeit modest, "active asset management strategies will start to make sense".

Yet there is no "basket of gold" to be found in this cycle. Certain assets remain a 'no-go' area and will struggle to attract widespread institutional interest, Lewis insisted. "Some assets in the middle piece [between core and opportunistic] have economic potential but others are a write-off. It can be dangerous to look at the middle piece in a shifting economy; be careful not to make the wrong move," he warned.

Among the markets Tristan is focused on are the UK, France and Germany, but Lewis expressed concern that these are markets every investor has on its shopping list.

No obvious 'buys'

Moderating a panel on European investment challenges, Richard White, KPMG's head of real estate tax, agreed that "no market is an obvious buy. You can't afford to dip into a market and do a deal; you've got to have people on the ground so you see fresh deals and understand the market, let people know you're there. Local partners help you get access to clients."

Tishman Speyer, which is about to take on an LBS student in its London office, also works hard to "blend with the fabric of a local market" by staffing its developing market offices with local professionals.

"We raise capital for each geographic area individually," said Rob Speyer, the group's president and co-chief executive, in another of the conference's keynote speeches. "We don't co-mingle capital."

While managers are wising up to what investors want, fund raising is still a challenge. There are no easy targets in real estate investment, but there could be further consolidation among smaller businesses.

Meanwhile, banks say other priorities rank above real estate, and will need to adjust their pricing to shift some of their legacy assets. "We're not seeing the clearing mechanism we had hoped for because no bank can be a lender of last resort to make that happen," said Lewis.

Even more of a worry are the tens of thousands of non-prime UK properties banks are holding that could be losing value each passing day.

"We've got to reprice the underlying kit so real estate offers the same returns as [investors] can get from other asset classes"
Chris Grigg, British Land