London Borough of Croydon Pension Fund

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The case for investing in UK Property Debt

Summary

As a result of the global banking crisis and ongoing regulatory changes (with banks needing to set aside increasing amounts of capital against their existing loan books) the availability of conventional commercial property mortgages from banks has become more restrictive. At the same time there is an imminent need for existing property owners to raise new capital, with approximately £150bn of loans maturing between 2012 and 2014 in the UK alone (source: IPD, UK Commercial Property Lending Market Research Findings 2011 Year End (De Montfort University research)).

The current situation is that existing lenders have a low appetite for refinancing on maturity and new lending. In particular, it is currently difficult to secure finance on properties with existing high loan to value ratios or on projects that look to add value through asset management. Accordingly, there is an opportunity for equity investors such as pension funds to provide lending on property at attractive yields.

The difficult refinancing environment, coupled with a major fall in property values since late 2007, has created an opportunity for institutional investors to access this asset class on a basis which we believe can deliver attractive risk-adjusted returns. A major component of the return is provided by contractual income "coupon" payments backed by underlying rental cashflows paid by a tenant to a landlord. This has elements of traditional bond investing and also property investing. As such, it is important that pension funds are aware of the fundamentals of property debt markets, the options available, and how to participate if they so choose.

Our preference is to invest in opportunities where the loan is specific to an asset or portfolio as opposed to providing a more general loan arrangement to a borrower such as a property company. We have also focused this paper on the UK market since this reflects its lender-friendly legal framework compared to other countries.

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Background

We believe that property debt products can deliver attractive risk-adjusted returns. The pricing of this debt together with liquidity considerations and the risks that would impair income and capital returns means that it is more closely aligned with commercial property investing than bonds.

Most pension funds will be aware of debt as a mechanism for gearing-up (potentially increasing) property returns, particularly in pooled vehicles. The impact of gearing in recent years, with falling asset values has been a stark reminder of the reality that leveraged returns can be extreme in either direction.

However, circumstances such as the banking crisis which contributed to a major fall in property values have in themselves created an opportunity for institutional investors to participate in the market as lenders of property debt. Raising property debt from conventional sources has all but dried up, leaving an opportunity in the market which can be filled in part by debt provided by pension funds.

Of the £150bn of UK property debt requiring refinancing in 2012-2014, approximately only one-third may come from conventional banking sources, although this is likely to be secured on only the most prime properties. Another one-third may come from new sources of senior debt and the remainder will have to be found from harder to acquire mezzanine loans. These are likely to be expensive for property investors seeking finance given the current lending environment. This means that over the next few years there is a refinancing investment opportunity worth approximately £70bn for equity-backed investors such as pension schemes to exploit. In addition there will be demand for debt in respect of new property transactions.

Key opportunities include provision of new senior debt/ whole loan origination and new mezzanine debt (together with acquisitions of existing loans via the secondary market). The different types of debt are discussed in more detail below.

Understanding debt investment

Investment in property debt is essentially lending a proportion of the value of a property, or portfolio, secured on the underlying asset value by way of a charge. The charge on the property allows the senior lender (or lenders of whole loans) to take possession of the property should the borrow default on the terms of the loan, for example failing to pay interest. Debt is usually divided up into different offerings which have different levels of security - the more secure your investment the lower the return you are expected to receive.

- **Senior debt** is structured to be the least risky layer and will normally extend to a maximum of 60% of the property value. Senior debt has first charge security and is paid in priority to other layers in the event of borrower default.
- **Mezzanine debt** is provided to augment senior debt with a second ranking charge, and may take the total debt “stack” (or whole loan package) up to 75%-80%. Mezzanine debt often comes with a profit participation feature on any capital value uplift achieved at exit.
- **Whole loans** are a combination of senior debt and mezzanine debt.

At the height of the UK property market in mid-2007, a typical senior debt arrangement would have been circa 80% of the property value with mezzanine debt taking the total debt stack to 90-95%, the balance being the equity contribution from the investor. Consequently, there was significantly less downside risk protection to debt provider(s) then than there is today.

The investors that will lose their money first if the value of the property falls are the equity investors. As such, a senior debt investor can accommodate a value fall of at least 40% without any loss of capital, while a mezzanine investor is protected from the first 20% or more of any value fall.

Since its peak, the property market has undergone c.35% downwards correction in underlying property values making property valuations look more attractive on a long term basis.

Loan structures and anticipated returns

The table below sets out the three main types of loan, what the characteristics are for each and the anticipated lifetime net return.

Type of loan	Loan structure characteristics	Anticipated lifetime net return (per annum)
Senior debt	Most secure debt layer with coupon payments driving return. The borrower will also likely pay an arrangement fee and may be penalised in the event of an early exit. Coupon of circa 6-7% per annum.	5%-6%.
Mezzanine debt	High coupon yield of c14-15% and can provide profit participation on exit/re-financing.	12-13%.
Whole loans	Combined senior and mezzanine debt, coupon yield of c10-11% and can provide profit participation on exit/re-financing.	c9%.

How does it actually work?

A property buyer, or existing owner wishing to refinance, will seek to borrow from debt markets to add to the equity they have available. This debt will normally be for a fixed period of between three to five years and the lender(s) will have either a first or second ranking charge over the underlying asset.

Traditionally this debt would come from banking markets but borrowers are now forced to look to less conventional debt providers for this facility, with demand for issuing debt greatly outstripping the supply available from lenders. This imbalance allows the lenders to dictate the terms of the loan whilst preserving attractive returns.

A pension fund wishing to invest would normally achieve exposure to property debt through a **pooled vehicle**, with specific return, risk and income objectives and managed by a specialist team with experience of real estate and debt markets. The vehicle will target an agreed income return (which will be determined by the fund's risk profile). In all cases, capital preservation will be an absolute priority.

What to look for in a property debt strategy

We would expect there to be significant focus on the following:

- The manager should ensure that there is appropriate diversification in terms of borrowers, underlying assets and occupational tenants.
- The coupon should be paid regularly (quarterly).
- There will usually be equity participation structures in place for whole loans and mezzanine loans.
- Loan covenants should take account of business plan delivery and be based on rental income multiples so that there is extra protection in terms of servicing/covering the loan repayments.
- Underlying assets should be in established or improving locations and not 'diminishing' assets such as properties let to a single tenant (especially those where there is potential covenant risk).
- Underlying assets should have clear scope for value/income creation so that the loan will potentially become even more secure over time.
- Scope to generate additional income to the fund from ancillary fees such as loan covenant variation fees (where in effect a one-off payment or change in the debt finance cost will be triggered in the event of the borrower seeking a change to the terms of the loan).

What are the risks?

Clearly for investors more familiar with investing in property equity, property debt strategies could be perceived to be more aligned with fixed income portfolios than property portfolios. However, an assessment of the underlying property's value and its ability to generate income to service the loan is the key consideration. Another key issue is the ongoing valuation of the underlying debt positions which will often need to rely on a mark to model approach.

Property debt strategies can be inherently less risky than equity investment, and in today's market be compensated for by a higher yield. For example, in an equity strategy, the property owner will suffer loss from any fall in value. In a debt strategy, the loss would have to erode the borrower's equity before the lender will be in a loss position. In circumstances where there are loan to value restrictions in the loan agreement, the lender may be able to take possession of the asset before this loss position is reached.

To mitigate the risk of borrower default on payments due under the loan agreement, for example, non-payment of interest, it is common to use a blocked account for rent receipts that only allow the borrower to make withdrawals with the lender's consent.

However, different debt strategies do have a wide range of risk and return profiles. The key risk with any property debt strategy is that on borrower default the asset or assets that the loan is secured against have fallen below the value of the outstanding loan. The risk of a complete loss of the loan advance is significantly higher where another lender has a more senior claim on the security.

How to invest

For most pension funds this is likely to be by way of a pooled fund, typically a close ended limited partnership-style structure. The pension fund will have a range of options offering different returns and risks. The precise choice of investment will depend on the appetite of the investor, and their investment objectives.

Key issues for the pension fund to consider will include:

1. Fund strategy and risk characteristics.
2. Fund size and fellow investors.
3. Manager track record in property lending.
4. Fund governance.
5. Fees and other costs.

The skill of the management team will be instrumental in assessing the credentials of potential borrowers and their business plan, evaluating the underlying assets, negotiating optimum terms and monitoring the loan until maturity.

The pension fund should expect to pay an annual management fee together with a performance fee above a threshold which will depend on the return aspirations of the vehicle. The investment should be regarded as being for the life of the fund, usually a period of seven to eight years. Investors will be drawn down over typically a two year period during which any coupon payments will be subsequently re-invested to avoid dilution of yield. The management fee will typically be in the order of 1.5% per annum of invested equity (with a fee of c.0.75% per annum based on investor commitments during the investment period) together with a performance fee of 20% of the excess cash flow above a pre-determined internal rate of return (IRR).

Conclusions

- We believe that whole loans and mezzanine debt provide an interesting opportunity for our clients with potential for attractive risk adjusted returns. A significant element of this return will come from an attractive coupon underpinned by the property cash flow (in other words, the contractual net income payable by the underlying tenants).
- Compared to the above (and other types of fixed income investments), senior loans are not as attractive from our perspective as potential returns do not provide a sufficiently high enough premium to reward investors for locking away capital on a long term basis.
- Whilst there is downside risk, the loans are protected by market value changes equivalent to the percentage of investor equity. The level of investor equity required today is typically fixed at a significantly higher level than before the financial crisis.
- We believe that clients should therefore actively consider property debt as part of their overall asset allocation. Clients, in conjunction with their investment consultant, may of course have different views on where property debt should be funded from and how it is treated within their specific strategy.

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