The Deleveraging of Global Real Estate

The global picture in real estate debt varies considerably.

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A CAPITAL-INTENSIVE asset class such as real estate depends on diverse sources of financing to function effectively. An abundance of cheap debt causes unsustainably high asset pricing and stimulates overbuilding. Too little debt leads to bankruptcies and under-investment in the building stock needed to serve a modern economy. In the last four years, commercial real estate debt has moved from one extreme to the other, which has been highly detrimental to the performance of real estate as an asset class.

Real estate is certainly not the only industry or asset class affected by the bursting of the "credit bubble." A global review of commercial real estate debt markets reveals that commercial real estate has many peculiar features in each market. Each country has its own story to tell. And like the aftermath of a natural disaster, courageous tales of debt "survivors" can be found among the death and destruction of global loan portfolios.

Despite the idiosyncratic nature of commercial real estate debt in different countries, common patterns can be observed. First, to mix a metaphor, the bursting of the commercial real estate debt bubble has a very long tail. Second, unsecured real estate debt is recovering well ahead of secured, mortgage finance. Third, highly structured debt creates the most difficulties to resolve. Fourth, national governments, central banks and regulators are having a major impact on the future re-alignment of commercial real estate debt markets.

GLOBAL DEBT MARKETS

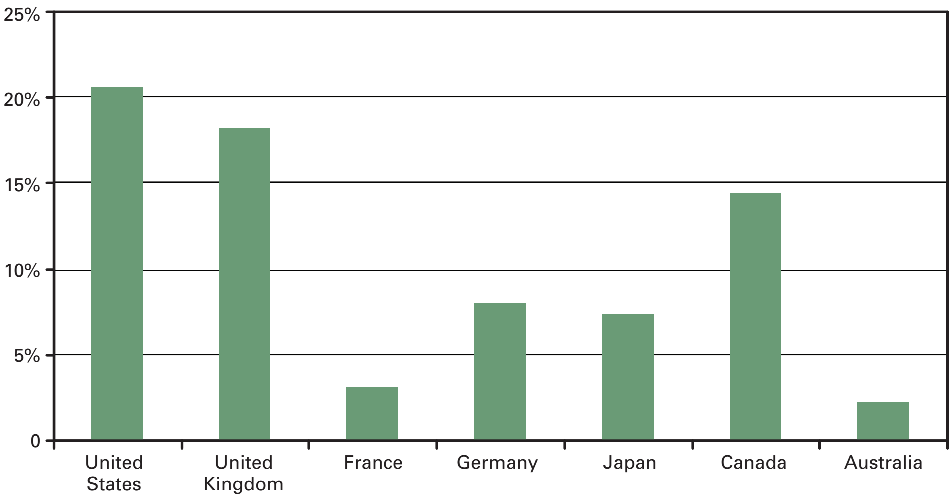
The resolution of legacy commercial real estate debt and the return of a normally functioning commercial mortgage market will be two of the biggest issues facing investors (as both a challenge and an opportunity) for years to come in the G-20 countries. Our analysis is based on a country-by-country survey of when and how the debt markets might recover.

There is relative certainty that fundamentals in many western countries will remain weak for the next two to five years. However, there is great uncertainty about what might happen in the debt markets over this same time frame. The three major categories of uncertainty are: the impact of legacy loans on the market and the degree to which this will lead to distressed sales; the timing of a return to a "normal" lending environment and what those "normal" conditions might look like; and the future of base rates and credit spreads in both the secured and the unsecured markets.

We find that transparency on historic lending patterns and the status of commercial real estate debt portfolios vary greatly. Ironically, the two most transparent markets, the United States and the U.K., are the two with the biggest legacy debt issues. In reviewing debt markets around the world, we observe major structural differences. At one end are the United States and the U.K., where institutional real estate lending has been supported by a deep, securitized debt market that included many cross-border lenders (Figure 1). Even if most commercial real estate loans were not securitized in the Anglo-American markets, lenders thought that securitization of their mortgage portfolios would always be a possibility. At the other end is Canada, where most lending was, and still is, dominated by large, domestic financial institutions using conservative underwriting standards. Canadian banks did engage in securitization, but they also tended to hold a majority of the loans they originated. Each bank also had a strong deposit base and capital reserve ratios were high. Continental Europe and the developed Asia-Pacific countries fall somewhere between the Canadian and the Anglo-American markets in terms of legacy debt risks. Securitization levels were lower in these regions and lending was done more cautiously in Asia because of the relatively recent memory of financial crises there. Lending by Chinese banks falls into a category of its own; data on lending volumes and non-performing loans is closely guarded. In 2009, state-owned banks were encouraged to lend to real estate to help protect home prices and the construction industry during the global recession. In 2010, the government announced that it will tighten up on lending to real estate to keep real estate prices from rising in both the residential and commercial sectors.

With the notable exception of China, lending in all G-20 countries was severely affected by the credit crisis in 2009. In Continental Europe, the traditional dominance of commercial banks started to be challenged by the securitized market over the last five years. In Asia, the commercial banking sector is the primary source of lending but loans are typically short-term (three to five years) and during 2006-2008 underwriting became relatively aggressive. All this changed in the second quarter of 2008, as the global financial system froze

Figure 1: Market dependence on securitized debt varies



Source: LaSalle Investment Management

up, securitization came to a halt, and bank balance sheets were put in danger of collapse. Going forward, the recovery of the banking system and of the commercial real estate credit markets is likely to be quite different in each country. Where a market lands on the "legacy debt risk" spectrum is likely to be a key driver that determines how rapidly the debt markets recover. The other major driver is the regulatory environment and what actions governments are taking with respect to both legacy and new loans.

In many countries, credit was abundantly available between 2005 and 2007, leading to the creation of a cohort of loans with high loan to values (LTVs), limited amortization, low debt service coverage ratios (DSCRs), and few restrictive covenants. The performance of these legacy loans and how troubled loans are dealt with will affect both the transaction market and existing portfolio performance. The primary risk is that these loans will not be able to be refinanced without significant additional equity investment, and that this will cause a wave of foreclosures resulting in properties trading well below current pricing for an extended period of time. Investors with capital to invest may find this scenario will provide opportunities to acquire property at very attractive pricing. However, for investors currently holding a portfolio of stabilized assets, it could mean poor pricing on planned sales at the end of a fund's life, lower rental rates due to competition from properties recently acquired at low prices by new buyers, or depressed valuations based on fire-sale comparables. The risk that this scenario will materialize varies by market. In many countries, regulators are giving lenders flexibility to renegotiate loans, so our baseline expectation is that we will not see a global flood of foreclosed properties in 2010, if ever.

The highest risk is in markets where significant value declines coincide with lenders who are not in a position to work through issues with borrowers. Foremost on this list is the United States, where steep value declines have put many loans at LTVs not sufficient for refinancing and many large loans were securitized into a bond structure not conducive to loan modifications or refinancing. It remains to be seen in the United States whether recent government changes to the legal structure associated with commercial mortgage-backed securities will increase the flexibility to restructure these loans, but even if restructuring is permitted, refinancing will be a challenge. The U.K. is in a similar situation, but due to less debt overall, a smaller portion of loans being securitized, and most significantly a rebound in pricing, the risk associated is less than in the United States.

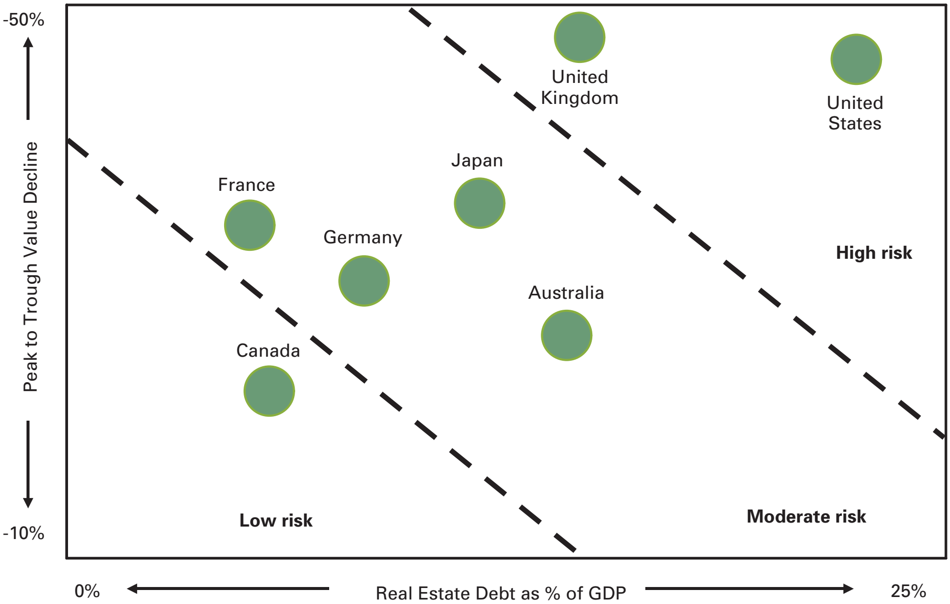
Asian markets have some risk because the short-term loans common in the region mean a large portion of properties have debt coming due over the next one to three years and many have experienced steep value declines. However, debt risks are mitigated by Asian financial institutions, which tended to hold rather than securitize their loans and are thus more willing to work with borrowers, especially as values start to rebound. This is especially true in mainland China where the government responded to the crisis by encouraging new lending. Singapore and Hong Kong have seen less government intervention and refinancing risks are higher compared to China. However, the risk in these developed Asian markets is gradually easing as capital value declines are slowing; in some cases, prices have rebounded, making banks more confident to roll over loans. In France, Japan, Australia, and Germany most loans are held by financial institutions that are reluctant to enforce their rights in the event of a technical default and push a borrower into foreclosure. Instead, they typically allow the borrower to refinance at a higher interest rate, require an infusion of equity and impose a "cash sweep" on all rental income. This type of forced "refinancing" improves the banks' balance sheets and creates fees. It also keeps the borrowers' hopes alive that they can re-establish a firm equity position in the property, maybe not today, but at some point in the future. While the phrase "pretend and extend" is often used in a pejorative sense, it is a viable strategy that provides borrowers with the option to pay down debt and the flexibility to get within normal loan covenants. It also allows banks time to improve the quality of their loan portfolios, which affects their capital reserve ratios and better positions them to sell loans into a secondary market at some point in the future.

Figure 2 summarizes the risk associated with legacy loans in major markets (Hong Kong, Singapore and China are not shown on the chart due to lack of data availability. The state-supported lending environment in China is creating the highest levels of debt-related risks in Asia, even though a degree of tightening is now under way). Risk is shown as a function of value declines and commercial real estate debt as a share of GDP, which is a proxy for a country's dependence on debt as a means of financing commercial real estate.

THE FUTURE LENDING ENVIRONMENT

During 2010 to 2012, we expect a measured return to a lending environment similar to the first half of the decade before real estate lending became extremely aggressive. During 2002 to 2004 spreads were typically 100 to 150 bps over the base rate and LTVs were limited to 60 percent to 75 percent,

Figure 2: Legacy debt risks are higher where plentiful debt coincides with value loss



Note: Real estate debt from government and private sources. GDP is 2009 nominal GDP estimate from Global Insight.
Source: LaSalle Investment Management

depending on the market. This new "normal" will also mean much lower lending volume than we saw during the 2006 to 2008 peak. This lending environment will be based on in-place income, limits to total loan size, and a significant spread premium charged for interest-only loans.

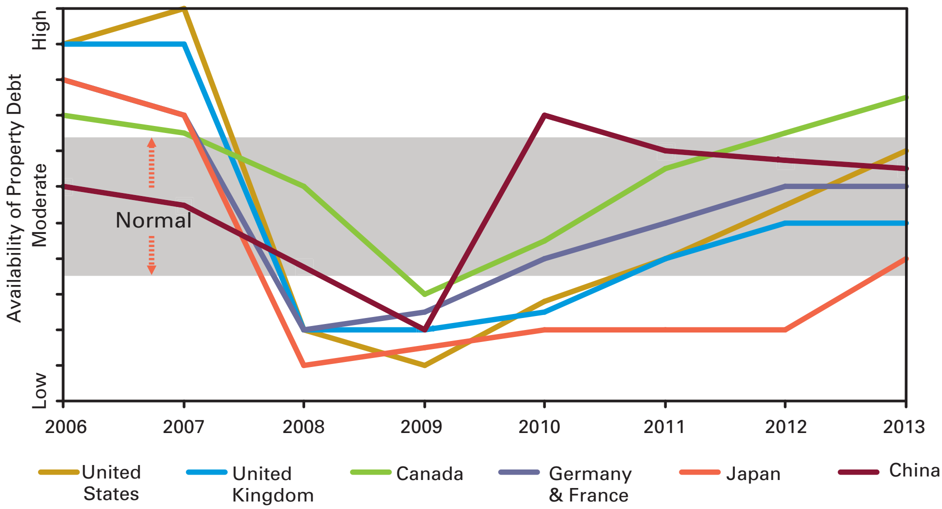
In the United States, we expect the debt securitization markets to open up again for new issuance very slowly. The recent re-opening of the unsecured lending market for REITs provides evidence of the credit market's willingness to forgive and forget, provided that stringent underwriting is used. The first three U.S. CMBS deals in over a year were launched toward the end of 2009. As securitization begins again, bonds backed by commercial mortgages will have more subordination, and originators will hold on to more risk associated with the loans. The appeal of these lower risk securities to investors will return as the economy picks up and as spreads on alternative investment fixed-income instruments move in. In the U.K. and Continental Europe, lenders are not likely to drastically reduce their exposure to the sector, but will lend at a slower pace with lower LTV levels and higher fees.

The markets that will take the longest to return to normal conditions are those in which the entire structure of commercial real estate lending needs to be re-examined and re-created. One example is the United States, where in recent years a significant share of the debt has been securitized. For securitization to resume, CMBS spreads need to narrow and investors need to trust that the ratings on the debt accurately reflect the risk associated with the deal. Another market that will take longer to return to normal is France, where financial institutions will remain cautious because their capital will be dedicated to securing loan extensions and supporting their existing real estate clients.

Markets such as the U.K. are seeing some improvement in lending, with an increasing number of active lenders and rising loan amounts. Loan availability, however, is still limited, with rates relatively expensive, and lending levels are unlikely to increase significantly in the near-term. Financial institutions in Germany are increasing loan availability to the domestic market, and are also starting to provide loans in other countries, supporting the debt markets in Continental Europe and even participating in some U.S. deals. This lending environment is possible due to German institutions' access to longer term funding via Pfandbriefs, which are covered bond vehicles collateralized by long-term assets such as property mortgages or public sector loans, as stipulated in the Pfandbrief Act.

In Asia, the timing of normalization of financial conditions will vary. Hong Kong, Singapore and Australia are already starting to see improvements. In the first quarter of 2010, there are now many more active lenders offering slightly higher LTVs than during the peak of the credit crunch (4Q08 to 1Q09). In Japan, legacy loan issues are constraining the availability of credit. However, Japan's Central Bank is encouraging lenders to make real estate financing available, which has increased the loan volume from balance sheet lenders. The CMBS market is still closed and is not expected to be a major source of debt capital for many years to come. In contrast to almost every other market, China has not been severely affected by the credit crisis. Bank lending has always been closely monitored by the state regulators. The tightening of the debt market during 2006 to 2008 was mostly a tool by the government to curb the overheating property market. Earlier in 2009, the government encouraged domestic banks to lend, resulting in a sharp surge of loan growth. Non-performing loans in China are often held by banks for long periods and rarely lead to foreclosures. However, government-ordered tightening of real estate lending in 2010 will raise refinancing risks for loans coming due. Figure 3 shows LaSalle's estimates and forecasts of debt

Figure 3: Lending conditions by country



Source: LaSalle Investment Management

availability in major markets over time. Debt availability was based on our finance team's assessment of the ease of obtaining a loan, the amount of lending, and the terms attached to a typical loan.

THE REGULATORY ENVIRONMENT

Changes in the regulation of financial institutions will also play a major role in the recovery of the credit markets for commercial real estate. In the United States, Japan and Europe, regulatory agencies and central banks have taken the view that new lending is critical to addressing overall systemic issues in the economy. While they have launched incentives to facilitate lending, thus far they are not generating much activity. Both the Bank of England and the U.S. Federal Reserve have quantitative easing programs aimed at providing financial institutions ready access to capital. The largest banks in both countries have issued new equity to strengthen their balance sheets. Smaller, regional banks are still capital-constrained and lending for commercial real estate still remains far below historic, pre-credit bubble levels. Lending terms are now much more stringent than even the pre-credit bubble era, and many borrowers are turned down when they apply for large, secured loans.

The gradual repair of bank balance sheets is a necessary first step on the way to normalized lending practices. We view the government incentives for commercial real estate lending so far as a collection of short-term fixes that are not enough to fully support the real estate lending market. Looking ahead, regulators will be focused on insuring that new lending is safer and treated more conservatively on bank balance sheets than it has been in the past. There is a possibility regulatory actions may limit lending and delay a return to a “new” normal. In Europe, this will be heavily influenced by the tougher Basel II rules, which will be set by the end of 2010 and take effect by the end of 2012 or when the economic recovery is assured.

There are also examples of direct programs that are designed to help the market for legacy loans. In the U.K. the government has set up the Asset Protection Scheme (APS). This is a five-year program guaranteeing losses on assets selected by the participating banks—now just the Royal Bank of Scotland (RBS), after the Lloyds Group found a cheaper solution following successfully raising additional equity. RBS will take the first loss, at around 10 percent, on all assets protected by the APS, and the government will cover the remaining 90 percent. Under these arrangements, assets are likely to remain managed by RBS rather than transferred to the government. The intention is that RBS will improve the assets’ value during these five years, instead of being forced to sell today. This process will probably lead to RBS holding more assets and working with borrowers, thus avoiding a flood of forced sales.

An example of a less direct program is Japan’s Real Estate Market Stabilization Fund. This fund is designed to support JREIT debt financing in order to avoid JREITs becoming forced sellers and setting off an asset deflationary spiral. The fund will be dedicated to helping refinance the circa JPY 330 billions of bonds that will reach maturity by March 2012. Lending criteria are stringent regarding both the financial strength of the eligible JREIT and the use of the capital. This action has helped restore confidence in JREIT balance sheets, but has not increased lending to the private equity sector.

IMPLICATIONS FOR EQUITY INVESTORS

For equity investors, a functioning debt market is critical to a liquid real estate market. The longer it takes for debt markets to stabilize, the greater the likelihood a lack of debt will collide with a surplus of properties being forced onto the transaction market. If this occurs, we would see a repeat of the 1990s, where transactions occurred at a fraction of their fair market value. While we do not expect this scenario to unfold in any country, the risk of this situation is greatest in the United States, where high risks are associated with legacy loans and strong incentives are needed to facilitate new lending.

The on-going multi-year challenge of legacy loans will create a steady supply of foreclosed properties to be marketed over an extended period of time (three to five years). The steady erosion of net operating income, as leases roll, will accelerate the process. The largest of these transactions are not likely to be at steep discounts to fair value, but they will present opportunities to acquire high-quality properties at attractive prices. Many banks are unwilling to take huge losses on their commercial loan books and force properties into foreclosure. Their resolve to "wait it out" means that investors will have to reach deeply into their banking relationships to get a controlling interest in defaulting loans. In Europe and the U.K., for example, equity investors may be invited to help banks with their problem loans through joint ventures. However, banks are moving very cautiously and are suspicious of vulture buyers who are looking to make huge profits by buying non-performing loans at steep discounts to par values. In the United States, loan portfolios are being auctioned off by the FDIC as part of the disposal of assets of failed financial institutions. However, the loan quality is highly variable and is dominated by smaller, construction loans.

In contrast, Canada and China are experiencing little hangover from the bubble; the ripple effects that might create interesting buying opportunities are few. We see more opportunities opening up in the United States, the U.K., Australia and Germany, where lenders are willing to bring in fresh equity to re-stabilize loans and to keep underlying properties functioning at the highest level allowed by the market.

Globally the reversion to the "new normal" will mean significantly higher borrowing costs compared to the 2006-2008 period and more restrictive covenants. We believe this will enable a more disciplined real estate market and for the foreseeable future will limit the risk of another property bubble developing. The final note of warning is that if debt conditions improve much more rapidly than we expect, investors will have to watch for signs of an "echo" bubble. In fact, Asia, the most rapidly improving region, is already seeing some signs of a potential asset bubble emerging in the residential sector in the Greater China markets.

CONCLUSION

The innovation of mortgage securitization (created to deal with the loans of failed banks in the 1990s) eventually destabilized the long-term health of the debt markets in many parts of the world. Portfolio lenders were caught up in the same "credit bubble" because they had to compete with the securitization market or stop making loans. The bursting of the credit bubble brings back needed discipline to the asset class. The re-emergence of unsecured lending to listed property companies in Australia, Europe and the United States shows that the credit markets are ready to begin lending to real estate again. In the second half of 2009 and the first half of 2010, underwriters are more comfortable operating in the unsecured market, because the corporate bond market is much stronger than the ABS (asset backed securities) market. This means that large, listed real estate companies have an advantage in the debt markets over private equity funds. We view this as a temporary situation and that the debt costs of borrowing in the secured, mortgage market will eventually equilibrate with the listed corporate debt market within one to two years.