Putting secondary property first

Exploring the challenges and opportunities of non-prime property assets

- What is secondary property?
- What are the main issues?
- What does the future hold?
- Finding solutions

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Overview

Secondary property can be a huge problem. It has not benefitted from the recovery in values seen in the prime market over the last two years and a vast amount of outstanding debt is still secured against such assets, many of which have breached their financial covenants or are in a default position.

With a slow recovery expected in the occupational markets, investors will continue to view secondary assets as risky.

Recent coverage in the media reflects the significance of secondary property and includes the recent Southern Cross position, proposed asset sales by NAMA and Lloyds Banking Group's Project Flagstaff portfolio sale.

But secondary property is also an opportunity. This bulletin explores the topic and addresses the following key questions:

- What is secondary property?
- How bad is the current situation?
- What is the outlook for this part of the market?
- What are the solutions?

At GVA we understand the intricacies surrounding secondary property, particularly its impact on banks, as well as on the wider market that holds secondary property interests.

Our extensive track record in this market has developed from our end-to-end approach: taking an advisory role to assess the opportunity, before exploring all avenues, and elevating the asset prior to going to the market for disposal.

How can GVA help?

We can provide tailored solutions on all elements of secondary property including:

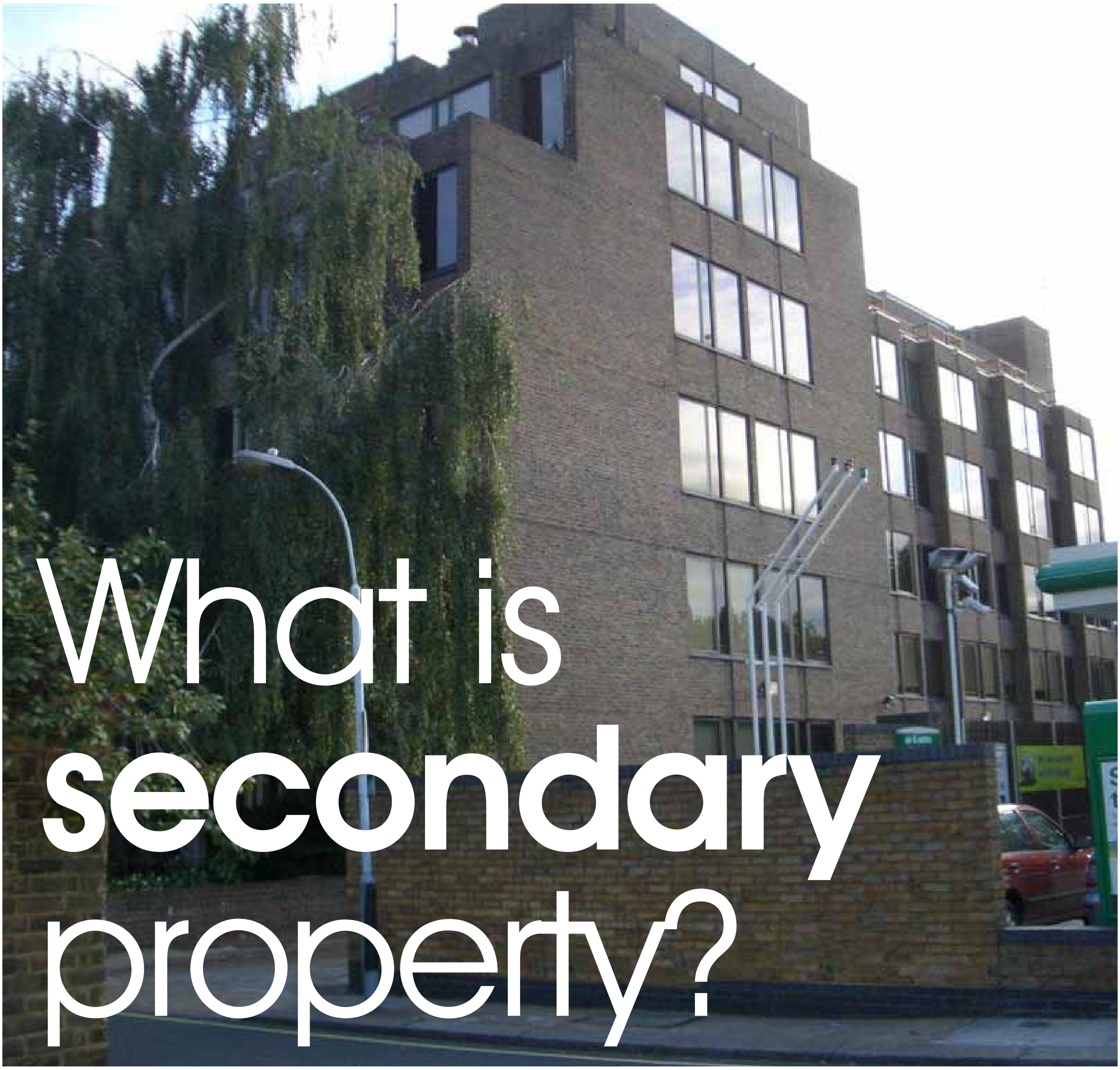
- Transactional advice
- Planning
- Business rates
- Sustainability
- Building

Our impressive experience in secondary property spans such sectors as:

- Offices
- Industrial estates
- Shopping centres
- Hotels and Leisure
- Care homes
- Residential land and development
- Automotive and roadside

If you would like to discuss how GVA can help you regarding any aspect of secondary property, please contact any of the members of the GVA team. Contact details are on the last page of this bulletin.

What is secondary property?



Secondary property is hard to define as it covers a large and diverse range of properties. What's more, the boundary between prime and secondary property fluctuates with the market.

Despite this, it is a vital area to explore, particularly for funding institutions in the light of the recession: a large proportion of outstanding debt is secured against secondary property.

This bulletin takes a broad view of secondary property, looking at the current and likely risks and opportunities for those holding such properties.

The current view

Secondary property has not benefitted from the recovery in values enjoyed by the prime market over the last two years.

A vast amount of outstanding debt is still secured against such assets, and many have breached their financial covenants or are in a default position.

Investors consider secondary assets as risky because:

- they are management intensive, capital intensive and potentially obsolete
- they are also more prone to voids and loss of income, covenant strength is weaker
- they are often over-rented with rental values still falling
- due to ever shorter leases it can be a challenge to re-let buildings when leases expire or break clauses take effect
- it is particularly hard to secure bank debt against

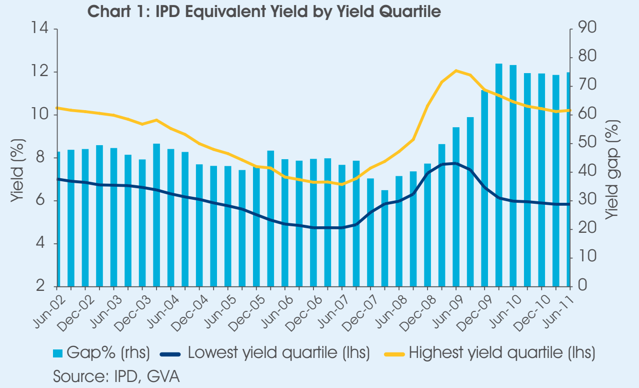
What are the main issues?

1. Scale

Investors paid little heed to the difference between prime and secondary assets during the last decade's property boom and capital value performance (as measured by IPD) showed little differentiation. But when the market turned, the gap between prime and secondary yields widened to create a two-tier property market.

The market as a whole bottomed out in mid-2009, having seen capital values fall by 44% (IPD Monthly Index). Prime property has since seen a fall in yields and a rise in capital values. Secondary yields did not respond to the same extent, and the yield gap between prime and secondary yields is still wide.

Chart 1: IPD Equivalent Yield by Yield Quartile

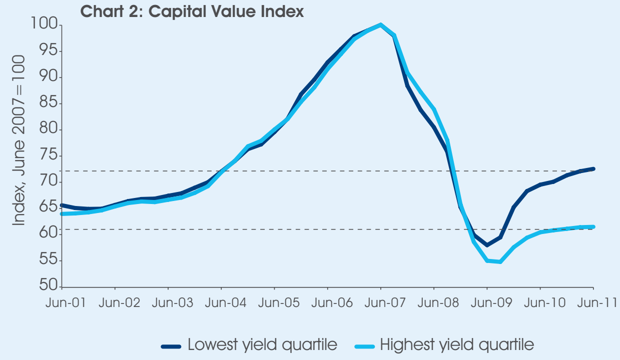


Source: IPD, GVA

At the height of the property boom, the yield gap (based on the IPD Quarterly Index first and fourth yield quartiles) was just 200 basis points. At Q2 2011, the gap was 440 basis points (chart 1).

Although this reversed the exceptional yield compression that occurred in the late 1990s-mid 2000s investment boom, it also reflects the current market uncertainty, lack of available debt, and a flight to quality, income security and risk aversion.

Chart 2: Capital Value Index



Source: IPD, GVA

IPD data shows that prime capital values increased by 25% from the bottom of the market in Q2 2009 to Q2 2011, while secondary values have risen by only 12%. So while prime values are 27% below their 2007 peak, secondary values are still nearly 40% below (see chart 2). IPD data measures mainly institutional-grade stock, and does not reflect very poor quality secondary properties (where the loss in value is likely to be significantly greater).

2. Debt finance

The last decade's property investment boom was fuelled by a large amount of readily available cheap credit, and the scale of bank lending to commercial property was massive. The lion's share of lending was used to purchase existing properties rather than speculative development.

As at Q1 2011, £190 billion of UK bank debt was secured against UK commercial property (ONS/Bank of England). Although this is down from the peak of £247 billion recorded in Q1 2010, it is still a huge figure compared with around £40bn in 1990.

However, this figure does not include CMBS, overseas lending or NAMA, important sources of commercial property lending. The De Montfort University survey of bank lending estimated the size of the total debt from all these sources including CMBS and NAMA at nearly £300 billion at the end of 2010. The estimated breakdown is shown in chart 3.

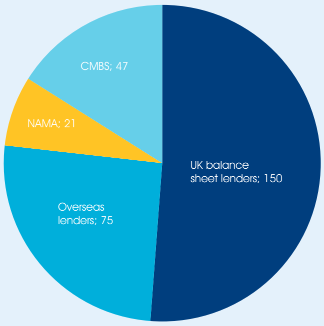
Putting this in context

At the end of 2010 the total value of commercial property within the IPD UK Annual Index (estimated at about half of the 'investable' market) was £133 billion. The total property debt is 2.25 times greater than this.

There is some good news on transactions… trading volumes have been trending upwards, increasing from to £23.7 billion in 2009 to £35 billion in 2010 and there is evidence of an increase in secondary property transactions.

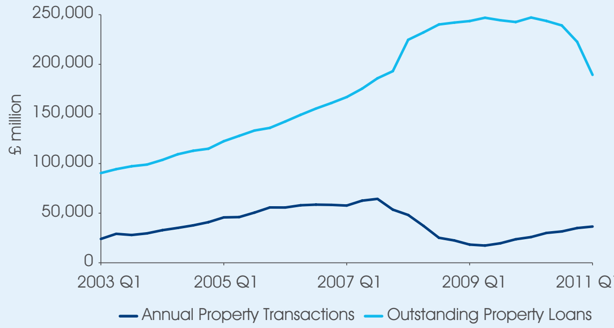
But the outstanding debt is still seven times the volume traded in 2010 (see chart 4).

Chart 3: Total lending to commercial property, end 2010, by loan origin (£bn)



Source: De Montfort University, GUA

Chart 4: Outstanding Loan Volumes and Transaction Volumes



Source: Property Data, ONS

What is this debt against?

Some 25% of outstanding bank debt on UK commercial property is against central London property, where values have held up well and assets are more towards the prime end of the spectrum. However, the rush by investors to purchase secondary property during the property boom, means that a large proportion - the De Montfort survey suggests a figure of around 62%, or £128 billion - is secured against secondary property, much of it at high loan-to-value ratios.

The problem of problem loans

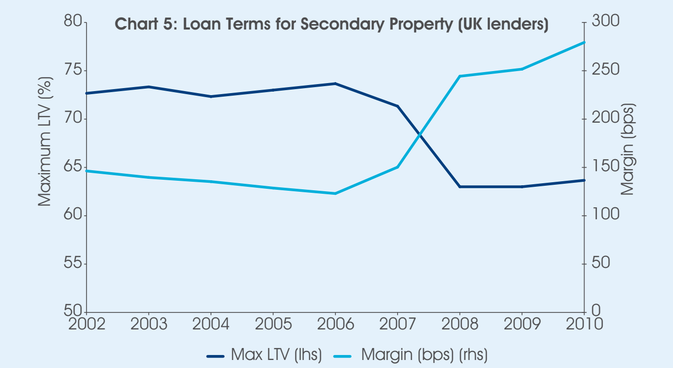
Whilst respondents to the De Montfort survey reported more than £15 billion of loan defaults in 2010 estimates vary for the total value of loans in breach of covenant. We believe the figure including CMBS and NAMA is likely to be well in excess of £80 billion.

As a result:

- Finance remains restricted. The overall level of new loans was less than £20 billion in 2010 though up on the £15 billion lent in 2009.
- The CMBS market is almost non-existent, but with continued limited availability of debt from balance sheet lenders it is likely that it may re-emerge in the medium term.
- Debt finance is almost entirely restricted to the prime end of the market, with LTV covenants limited to 60-65% and restrictions on individual loan amounts without syndication/clubbing.

Chart 5 shows the post-recession fall in typical LTV ratios for secondary property and the increase in the lending margin.

What next for loan refinancing?



Source: De Montfort University, GVA

£105 billion is due to mature 2011-2013 (excluding CMBS), as a result of the large volume of loans originating from the boom years of 2005-2007. What's more, some 70% of outstanding debt is due to be repayed by the end of 2015.

All of this presents a huge refinancing requirement, and with lenders looking to reduce their overall property exposure, it's likely that more asset disposals with occur.

Another factor hindering enforced sales is the significant cost of breaking the interest rate hedging arrangements, a problem exacerbated by the current low interest rates. As these positions mature and interest rates return to trend levels this will be less of an issue.

3. Legislative changes

To business rates rules…

In April 2011 the Government removed the £18,000 rateable value threshold under which properties would be exempt from empty rates. Now only those with a rateable value below £2,600 are exempt.

Secondary properties have been hit hardest by these changes due to their greater exposure to vacancy levels. Rental levels are being affected as landlords offer attractive terms to find a tenant.

Where there is simply no market for the existing use, allowing a building to fall into disrepair is not an option to avoid empty rates. Tightening legislation means that the Valuation Office is committed to assessing buildings assuming a reasonable state of repair unless the use is no longer economic.

To sustainability regulations…

Organisations participating in the CRC Energy Efficiency Scheme will see their building's energy costs rise by around 10% over the next three years, on top of predicted rises in energy prices.

Part L Building Regulations also dictate the minimum standards for fuel and power conservation during refurbishment/ extension work. This can result in upgrade work needed on older properties, which may render a higher proportion of secondary property, particularly offices, obsolete for their existing use.

4. Planning challenges

Planning can be a useful tool for enhancing values and making developments more viable and deliverable, yet the system can be difficult to navigate.

In secondary locations, local planning authorities may protect existing land uses in order to take a longer term view, making changes difficult.

Planning applications demand extensive support material, which can be costly and lengthy to produce, even before permission is forthcoming. Timescales are also dependent on having sufficient access to the right people in a local authority.

What does **the future** hold?

For banks

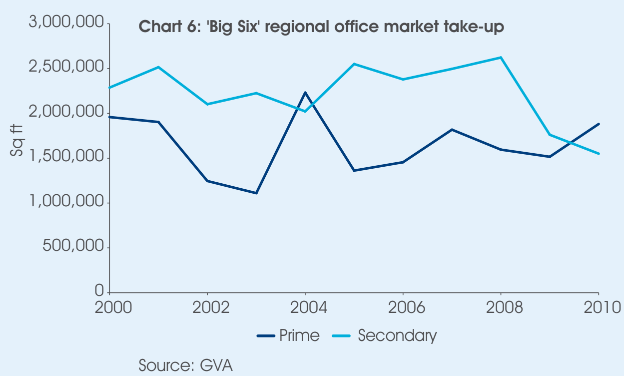
Their approach to secondary property is influenced by multiple issues, including:

- borrower relationships and ability
- the quality of the properties held and the scope for improving performance through asset management
- the availability of working capital
- their view on the recovery path for the secondary occupier market and of the outlook for capital values
- the maturity profile of the loan book
- their policy regarding future exposure to the commercial property sector

So far properties have been released to the market in a controlled way. However, with the banks establishing their strategies, there has been a noticeable increase in secondary property entering the market, and the rate of disposals is likely to accelerate.

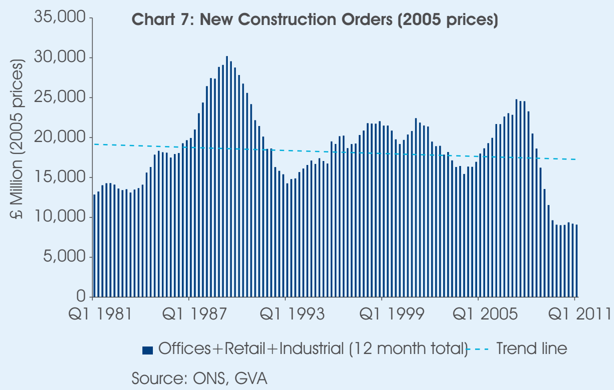
Figures from Property Data suggest that receivership sales in 2010 totalled more than £2.5 billion, a 45% increase on the £1.7 billion recorded in 2009 (there was a negligible amount in 2008). But the 2010 figure still only accounted for 7% of the total volume of transactions.

Lenders have adopted a very active policy of working with borrowers on consensual disposals and the receivership sales data shows the significant levels of sales that have taken place without a formal insolvency process. This trend will continue.



Supply: The restrained level of speculative development before the recession means that supply shortages are already beginning to emerge for prime stock in some markets, notably central London offices.

The weak occupational market and withdrawal of funding over the last three years has caused a dramatic reduction in development activity. The current low level of new starts (weaker than at any point over the last 30 years) will see supply shortages begin to feed through over the next couple of years. The lack of bank finance is limiting the new development that can be undertaken and this will restrict new supply for some years to come, reducing vacancies and causing stronger rental growth.



For occupiers

Demand: Chart 6 illustrates the impact of the recession on the secondary markets using the UK's six largest regional city centre office markets. Here prime take-up has held up well (although with considerable variation between the 'big six'), but secondary take-up has fallen significantly.

Bank lending is likely to be restricted for many years as the banks rebuild their capital base, so the economic upturn is likely to be slow, with occupier demand remaining weak for some time. Add to this the public spending cuts and rise in taxes and we are likely to see well below trend economic growth this year and next.

Employment, a key driver of the office sector, is not expected to rise this year, and see only sluggish growth in 2012. The retail sector also faces severe challenges: the cuts and tax rises mentioned above, plus rising inflation and low wage increases. This will mean a fall in household incomes this year and very modest growth in 2012, all of which will affect retail sales, and add to the increased competition high streets are facing from online trading. All this will mean weak occupier demand and rental growth for the commercial property market as a whole, and particularly so for secondary property.

So the prime market will see increasing shortages, but the story is quite different for secondary property where there is now a significant oversupply across almost all parts of the market, leading to falling rental values.

What's more, 25-year leases on potentially obsolete buildings dating from the late 1980s development boom are now approaching expiry.

The public sector will be reducing its properties, by selling them or not renewing leases. Many of these are secondary properties in age and location, and this increase will impact the market in terms of rental values and capital values. Many properties may only be suitable for re-development.

So the supply of secondary property is likely to increase in the short/medium term, and as overall occupier demand rises, it will take time – beyond 2-3 years – to percolate through to this part of the market, reducing supply.

For funding

- **Bank finance:** As yields for secondary property continue to diverge further from prime, opportunities for attractive long term returns from investing in secondary properties will improve. However, the lack of bank finance will remain a problem, with continued limitations on LTV levels, maximum loan amounts and associated terms.
- **Equity:** There is no shortage of equity, however, with opportunity funds, the better-financed property companies and some higher-risk institutional funds targeting secondary property. Yet with their cost of capital generally 15% on a leveraged basis, entry price and the availability of debt are key.
- **Mezzanine loans:** There is a further growth market of providers looking to capitalise on the funding gap between senior debt and equity, which offers a more attractive risk/return profile.
- **CMBS:** We believe the CMBS market will re-emerge (seen by Deutsche Bank marketing the £300 million Chiswick Park CMBS) and the institutional market could fill the funding gap left by the retrenchment of the traditional senior debt lenders, particularly as prime values continue to increase and supply reduces.

For sustainability

Regulations to improve the environmental performance of the existing building stock are set to increase and strengthen over the next few years (e.g. EU Environmental Performance of Buildings Directive, the Government's draft Carbon Plan, the Energy Bill). We also expect the costs surrounding energy and carbon to rise substantially. The CRC net is likely to pull in more secondary properties. By 2019 all new public and commercial buildings are to be zero-carbon.

Energy Performance Certificates (EPCs) and Display Energy Certificates (DECs): The prevalence and importance of these energy ratings are set to rise, with DECs becoming mandatory for commercial buildings by October 2012. By 2018 EPC ratings are likely to be used as thresholds for minimum energy efficiency, and commercial property landlords could be made to bring their properties up to this standard before they can be rented or sold.

Carbon reporting: Under the Climate Change Act the Government has to introduce mandatory carbon reporting for listed companies by April 2012. Despite this, an increasing number of companies are already undertaking various forms of environmental reporting and this trend is set to continue as issues of sustainability grow in importance for clients, staff and investors.

Secondary property owners will need to find cost effective ways to improve their environmental performance to satisfy occupier demands and compete with the newer, more energy efficient building stock. The other alternative is to become obsolete.

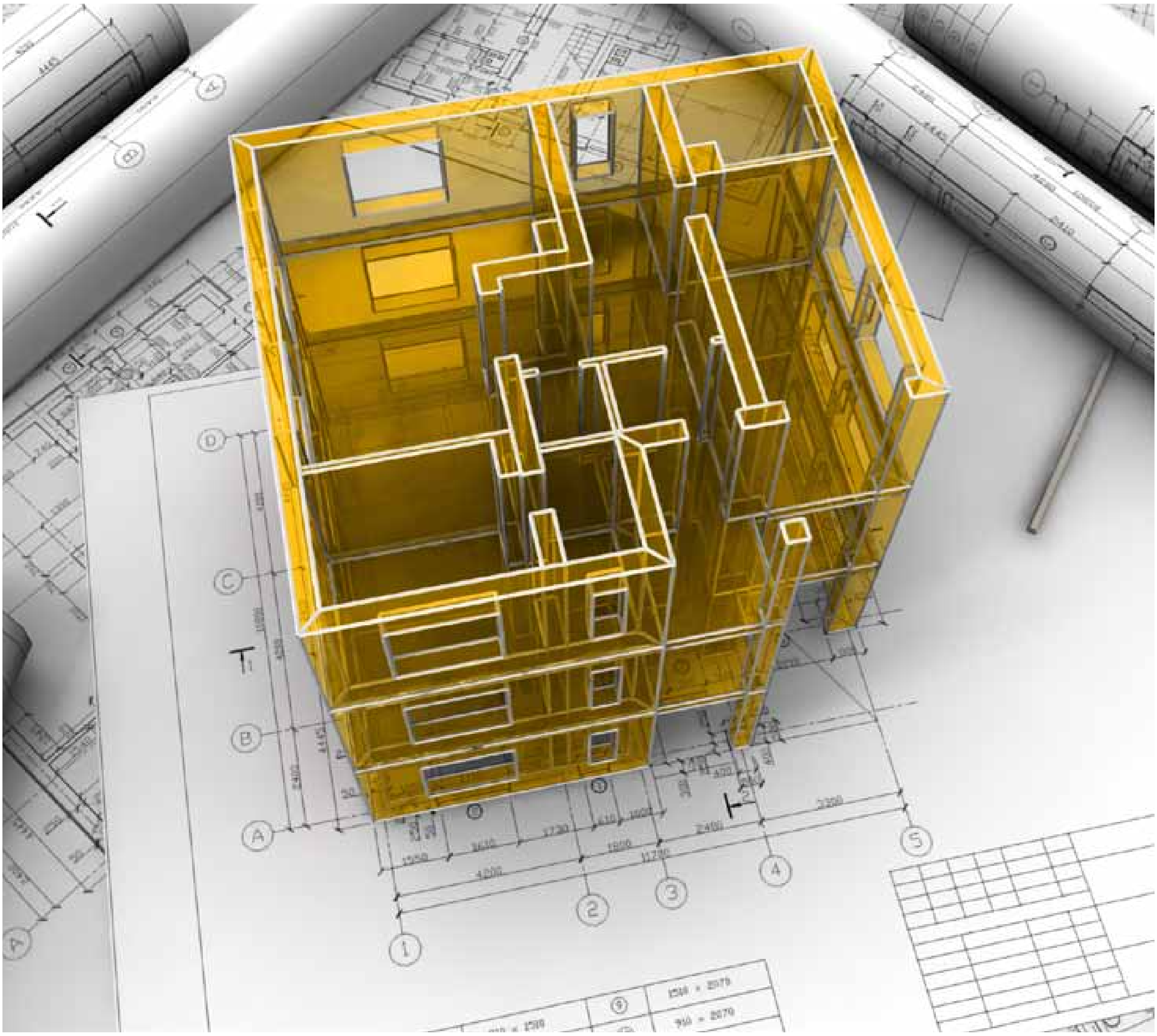
For planning

The Localism Bill has put the planning system into a period of transition as the Government looks at ways to reduce bureaucracy, speed up procedures and give greater certainty to applicants.

At the same time, it wants to get more local people involved in the planning process and offer incentives to communities (such as through the New Homes Bonus) to encourage them to support new development.

The Bill consolidates policy and may facilitate easier change of use, creating more flexibility. Streamlining applications should speed up the process of obtaining permissions and reduce costs.

The suggested changes depend on there being appropriate resourcing within local authorities to make them happen. It's unclear how this will work given the major cuts being made by most authorities.



Finding solutions

GVA is working with a host of clients to solve the challenges of their secondary properties. Often our work incorporates a multi-disciplinary approach to answer a client's complex needs.

Using a full service approach

GVA's multi-disciplinary abilities enable us to see a project through from beginning to end. The following examples demonstrate how we take a range of approaches to produce tailored, successful outcomes.

Various shopping centres – Asset Management

We acted as fixed charge receivers on five shopping centres totalling some 800,000 sq ft and producing an annual rent of £16.5m. All had suffered from a lack of routine management and were experiencing a high level of voids, poor maintenance, poor landlord and tenant relationships – and major rent arrears.

- We stabilised the income and performed a forensic audit of the management and service charge functions to obtain transparency.
- We achieved an average 20% saving on service charge levels through efficiency savings. This led to significantly improved tenant relations/ retention.
- We have collected over £500k of arrears previously thought uncollectable.
- Each centre has a planned preventative maintenance programme to deal with repairs. Efficient works programming and service charge budget management have enabled significant physical improvements to be made to the centres.
- We appointed quality letting agents and agreed new letting strategies, relaunching each scheme to work towards reducing voids.
- Each centre has an asset plan to exploit major asset management opportunities. This has highlighted the potential for foodstore development in two schemes. One is at agreement for lease stage with a major food operator and will enhance the scheme's value by some £25m, creating a development profit of some £12m.

Shopping centre in Trowbridge

The centre had a high vacancy rate with short leases let to predominantly sole traders and the anchor store was subject to a short term break. There was an adjoining development site with no planning consent.

Our retail agency team added value by:

- reducing vacancy levels
- attracting national multiple occupiers
- reconfiguring and increasing the demise of the anchor store
- agreeing a new 15-year lease to the anchor store

Our Management team regularised the service charge and our planning team obtained retail planning consent on the development site.

Through active management we enhanced the value of the centre by more than 100%. Our investment team then achieved a successful sale to a pension fund through a competitive bidding process.

Project West

A portfolio of 15 secondary commercial assets providing security to a loan within a CMBS which was in default. We were appointed as fixed charge receivers, acted as property managers and investment consultants to stabilise the income stream, and created/implemented an exit strategy. We set, and implemented, business plans on an asset-by-asset basis to drive value at a micro level and make the most of market conditions.

Temple Quay Central, Bristol

Temple Quay Central is a 13-storey mixed use tower on the waterfront in Bristol's business district. GVA and GVA Second London Wall were initially engaged by the lender to provide property and construction insolvency advice and to devise a strategy for the development. When an Administrator was appointed over the developer, GVA and GVA Second London Wall acted as a single source of development-related services to see the project through to completion.

We added value by:

- Providing an innovative mechanism for completing the development in accordance with the Agreement for Lease.
- Achieving completion within pre-agreed budget and funding allowances.
- Completing the development in March 2010 – just weeks after the original completion date – despite the Administration process.

Using business rates

There are many innovative ways to help landlords, developers and investors to mitigate the cost of empty rates, and GVA's Business Rates team has saved over £50 million in rates arising directly from the April 2008 changes. Initiatives include:

- using temporary and part occupation to extend relief periods
- reaching agreement that rateable values of vacant newly-constructed properties should be deleted from the Rating List through challenging Completion Notice procedure
- maximising empty rates on part listed buildings
- the receivership/administration process is protecting from empty business rates liability.

N.B. Taking a proactive approach is vital, as retrospective action is far more difficult.

Secondary office building in Croydon

GVA were instructed to review a long term empty rates charge on a vacant secondary office with an annual rates bill of £140,000 pa. The property was refurbished in order to assist marketing, the three month rate relief had already been taken and the Valuation Officer would not delete the property during the refurbishment scheme (insufficient works).

GVA added value by identifying grounds to have the property treated as exempt from rates for the period of the refurbishment. The approach made directly to the billing authority reduced the liability to £0 for the period of the works creating substantial savings.

Using property management

Credit control ensures that arrears are controlled and kept at a minimum, so that full estate expenditure can be recovered from tenants. Service charge budgeting ensures that funds are in place to improve the marketability of a property. Advice with contract tendering and monitoring, and health & safety, helps to maintain and improve occupancy.

Bridgend Industrial Estate, Bridgend

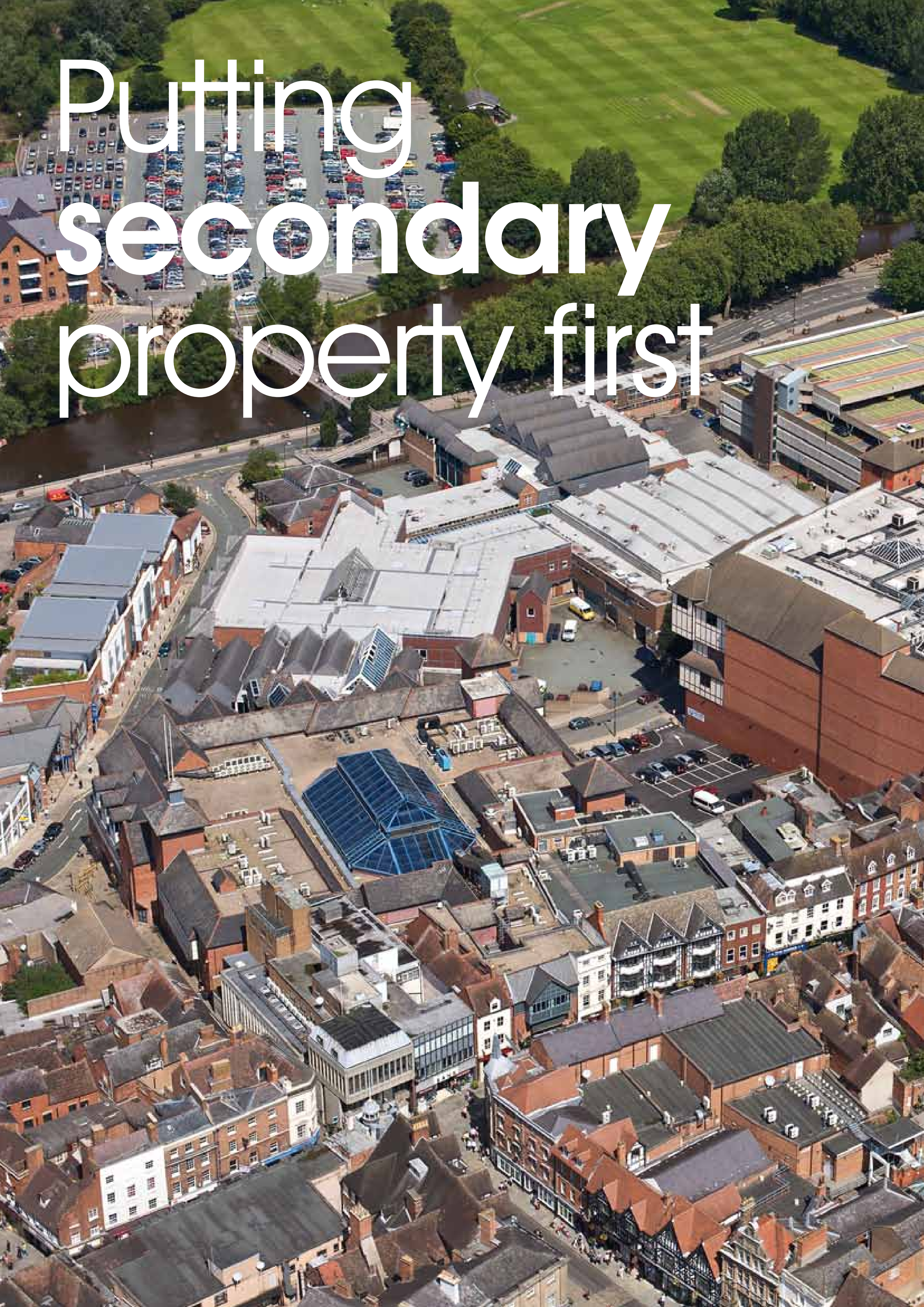
We have added value by:

- keeping rent and service charge arrears to a minimum
- seizing opportunities to increase rental and service charge income (widening user clauses or relaxing alienation provisions etc)
- achieving and often exceeding rental values at rent reviews and lease renewals
- ensuring that this complex multi-let asset is managed efficiently and proactively, enhancing its marketability and its value.

Using sustainability

Owners of secondary property will need to use methods such as carbon abatement cost curves and feasibility surveys to avoid obsolescence. Current incentives, such as enhanced capital allowances (ECAs), the Feed-in Tariff scheme, and the Green Deal, can help to improve the energy efficiency/reduce carbon intensity of buildings.

Putting **secondary** property first



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