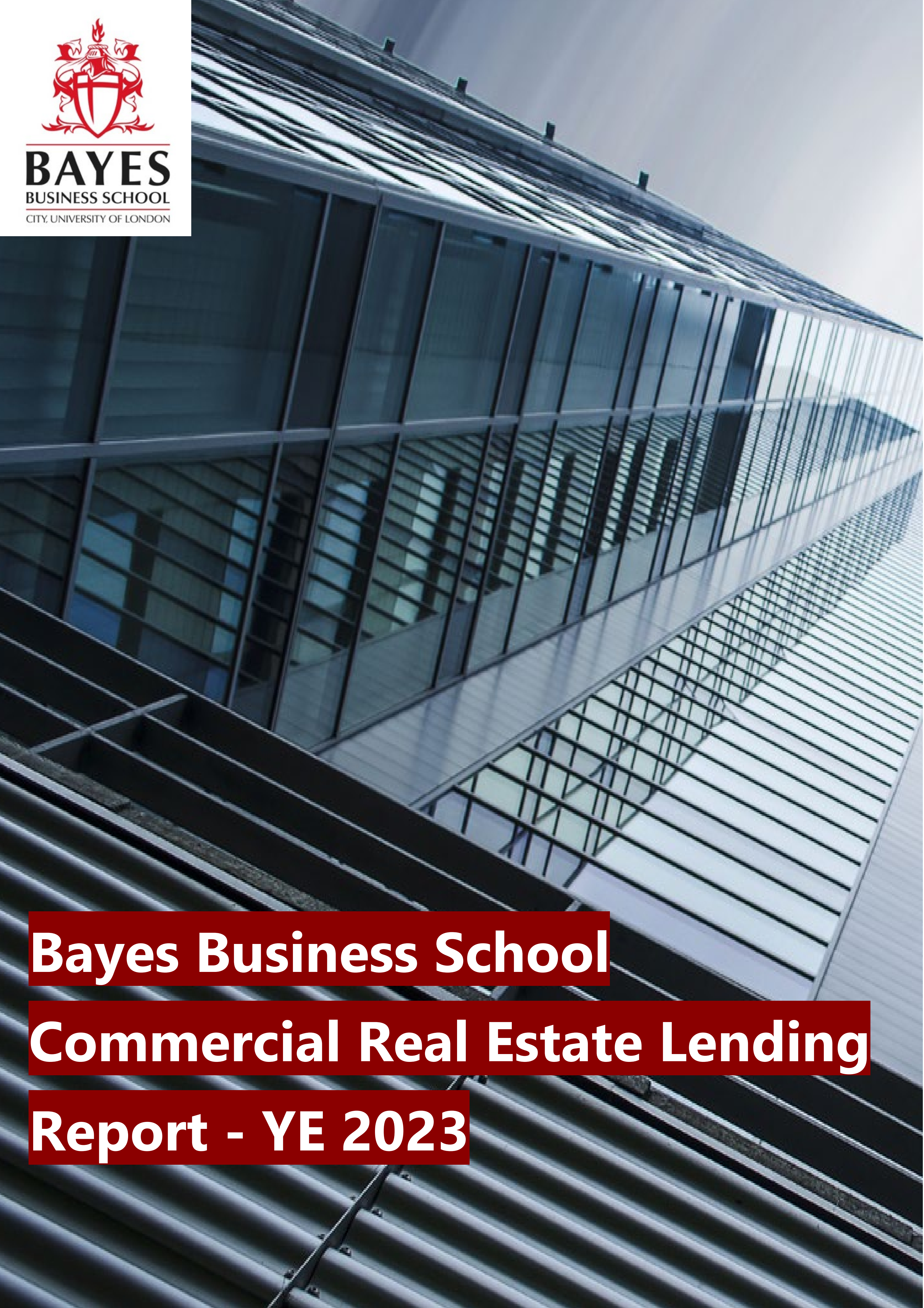


BAYES BUSINESS SCHOOL
CITY, UNIVERSITY OF LONDON

Bayes Business School Commercial Real Estate Lending Report - YE 2023

The authors thank all sponsors for the making this research possible.

Bayes Business School Commercial Real Estate (CRE) Lending Report

Survey and analysis by Dr. Nicole Lux, Project Director.

Report designed and written by Dr. Nicole Lux

Acknowledgements

The authors are grateful for the on-going financial support for this work provided by the firms listed on this page. The analysis relies on the commitment of time and effort in providing information from the staff of 71 lenders, listed in Appendix 4.

The CRE Lending Survey was commenced in 1999 by Bill Maxted and Trudy Porter of De Montfort University, who continued the work until 2015. We are indebted to the original authors for the historic data, analysis and insights underpinning the current results.

Contents

Charts

Tables

Summary

This summary provides the headline results from the year-end 2023 update of the Bayes CRE Lending Survey. It summarises the main points derived from the detailed breakdowns and time series analyses available in the main report. The survey sample consists of 72 lending organisations responded, comprising 37 banks and building societies, 11 insurers, 34 other lenders.

- **Outstanding loans:** These amounted to £170bn, a 4% decline in the 12-month period (£177bn, year-end 2022). Especially German Banks have reduced their overall UK loan books by 17%. Together with other European banks they have been affected by higher lending costs due to Basel IV and higher sterling funding costs making the UK less attractive. German Banks also commented on the importance of satisfying the criteria relating to Pfandbrief, which are no longer included UK property. International Banks have reduced their activities in the UK and only account for 25% of the market, compared with 32 – 34% prior to Brexit (2005 – 2019), especially the regions (excluding London/M25/rest of Southeast) are served by mainly UK banks and debt funds.

- **Origination:** 2023 has been the most difficult year for lenders since the GFC, with total origination dropping by 33% y-o-y. Especially the second half of the year the market remained quiet, with very little origination activity. Lenders were focused on refinancing their own loans where possible, which accounted for 42% of total lending activity and refinancing of other lenders with 20%. The market share of the largest 6 and 12 lenders has been declining since 2009 from 82% to 55% in 2023 together with their share of origination which reaches only 63% from previously 82%.

- **Development finance:** Development funding pipeline reduced during 2023 with £22.8bn at year-end. New development lending accounted only accounted for 16% in 2023 compared to 23% of in 2022. In 2023 debt funds for the largest provider of development finance in the market for the first time (57%). Residential and commercial development finance have both reduced over the last twelve months. The development finance market has become very binary with Other Lenders (debt funds) being the largest single source followed by UK Banks. A total of 30% of residential development finance came from small lenders (balance sheets <£1bn), while 57% commercial development finance came from lenders with balance sheets of >£1bn - <£2.5bn.

- **Loan book quality:** 60% of lenders have reported breaches and 61% have reported defaults across their loan book. In total, the average amount of loans in defaults reported was 3.9%, showing an increase again since 2022 (3.5%). ICR cover ratios over 2x have now been significantly reducing as expected and account for 51%, which is a similar level as last observed in 2012/2013. There is a significant difference in loan book quality between lenders with smaller loan books (<£1bn) vs larger ones (>£5bn). The weighted average default rate of portfolios of larger lenders (>£5bn) is 1.5% compared with smaller lenders (<1bn) of 7.5%. There is also a noticeable difference in outstanding loan book LTV ranges. 46% of loans in loan books of smaller lenders have an LTV >60%, compared to 20% in larger lenders. The same is valid for ICR range of loan books, large lenders record 61% of their loans with an ICR coverage of >2x compared to smaller landers with only report 24% of their loans with an ICR coverage of >2x.

- **Lending terms:** Loan to value ratios have a historic trough with the lowest LTV being offered for secondary logistics at 52%. The overall reduction in day-one loan to value for new lending is also due to uncertain market conditions, and further declining property values. Valuers have found little comparable market pricing evidence to provide the necessary comfort to lenders when determining the loan amounts. Hence, lenders have been overly cautious in how much they lend. Interest rate hedging has changed significantly with the introduction of debt funds, with fixed rate loans accounting for 36%, a category that previously did not exist. Up to 2014 the market was 72% hedged with fixed/floating swap, now hedging only accounts for 34%.

- **Sector appetite:** There are still only 9 lenders quoting terms for secondary retail, of which 7 are banks. In comparison 39 lenders quoted terms for prime office. The interest in non-prime hotels remains also limited. Development finance appetite remained constrained amongst lenders in 2023, only 10 lenders offered speculative development finance, and 19 offered terms for pre-let developments. Generally, lenders are showing some increased interest in niche asset classes such as data centre & life science, but not senior living.

- **Borrowing costs (investment):** Generally lending margins across all asset types have been increasing since 2016. Prime office margins have changed to 275bps in 2023 from 198bps in 2016, and they increased by 5bps between 2022 and 2023. Margins have been more or less remained stable across most property types in 2023 except for secondary retail properties (-22pbs), which was due to do lenders also reducing their total loan amount against these assets. Overall, while some lenders have kept loan margins stable 8 lenders clearly increased their margins by an average of 20-25bps. Only 3 lenders lowered their margins. Junior loan tranches start from c60% LTV to 75% LTV, two lenders offer up to 80% LTV. Junior loan pricing starts from 600bps – 1100bps with IRRs from 12 – 18%.

- **Margin trends by lender type**: With an appetite for very prime assets, German Banks may offer the most competitive margins (189bps: Prime Office) followed by Insurance Companies (229bps), but the level of day one LTV can be a deciding factor for borrowers. When it comes to alternative asset classes, Insurance Companies offer some of the most competitive margins against hotel assets (315bps), as well as for student housing (239bps). All lenders offer competitive terms for residential assets.

- **Margins trend by book size:** A large pricing gap remains between the larger balance sheet lenders and smaller lenders. The smallest lenders charge on average 366bps for a prime office loan, while larger lender offer terms below 283bps.

- **Borrowing costs (development):** Borrower demand for development finance remained strong in 2023 but was only met by less supply from lenders. Despite low availability of development finance, pricing terms remained very competitive. The average margin for a pre-let development scheme is now 424bps with potentially upfront and exit fees on top of 100 – 200bps. Bank margins range from 325 – 417bps, Other Lenders charge 470bps on average. Speculative development margins are on average 515bps. Day-1 LTCs are on average 47-56%. Residential development schemes can be financed at average LTC's of 61% and a cost of 538bps, excluding fees.

1. Introduction

This report brings the results from the Bayes Commercial Real Estate (CRE) Lending Survey up to December 2023, extending into its 24nd year the continuous series from the study started at De Montfort University with the support of a group of firms engaged in real estate lending.

All results in this report are based on responses from the real estate teams of lenders active in the UK market. Up to 2011, 50 to 60 lenders – dominated by large UK Banks and Buildings Societies, International Banks and Insurance Companies – provided information to the survey each year. Since then, the entry of new lender types from 2013/14 onwards – principally debt funds run by large asset management businesses – have increased the survey sample to 70-80 lenders. A total of 71 lenders contributed to the year-end 2023 data. Between 2022 and 2023 three lenders stopped lending, 4 lenders merged portfolios and three no longer contribute to the survey.

The rate and detail of response to individual questions varies between organisations due to reasons of confidentiality and data availability. Thus, a 100% response rate may refer to a different total from one question to another. Throughout the research complete anonymity is maintained. No lending organisations are named within this report other than in the list of Acknowledgements.

1.1. Survey methodology.

Information is collected for the Survey primarily via an extensive data form, in spreadsheet format, completed by the participating lenders. Data on loans focus on key aggregates– outstanding loan books, new originations – collected either in that form or from loan-by-loan records which are subsequently broken down into sub-totals by type of loan, type of collateral, and underwriting metrics such as Loan- to- Value (LTV) ratio and income cover. This record of loan books is supplemented by questions on current lending terms for different types of loans and collateral. More qualitative insights into lending policies and practices are added through free-form sections of the questionnaire and a round of face-to-face interviews with senior executives among lenders and other market participants.

Therefore, the report's analysis is limited to the categories and sub-categories for loans and lending terms prescribed by the data collection. It does not have the flexibility that would come from more granular data on individual loans. Over time, the data specification questions have evolved with the lending market structure, so a continuous time series is available only for the main aggregates. In this report and the accompanying full data spreadsheet all series are traced back as far as information is held consistently.

The CRE Lending Survey has gathered information at each year-end since 1998. Since 2002, an interim update Survey has gathered information in June each year using an abbreviated form of the full year-end data specification. This update report shows, accordingly, analyses to the extent possible given the data collected. For December 2023, responses were received from 71 CRE lenders who held a total outstanding loan book of £170bn and originated £32.6bn in new loans. The lenders held a further £23.3bn in loans committed on their books but not yet drawn down by borrowers which were excluded from the forthcoming analysis. Throughout the report commercial real estate lending is defined as loans secured by real estate investments or developments (further definitions see Appendix 3).

The analysis is based on Survey data collected from institutions we might term “mainstream lenders”. These provide loans secured against real estate assets, advanced by businesses with dedicated lending terms, which are recurrently in the lending market. In common with previous reports, it is extremely difficult to ascertain the total size of the secured commercial property lending market in the UK. There are a number of reasons for this. The definition of ‘commercial property’ is not uniform across the lending industry in the UK. From 2005 this research included loans to large scale residential investment and development projects as ‘commercial property’. This was because of advice from commercial property lending teams responding to the research who explained that they had become involved in lending secured by residential projects because of the large value of the loans involved. During the investigations and preparation of this report some organisations that are not detailed contributors of data to this research but whose financial statements have been examined, simply classified all their lending to real estate as ‘property lending’, others classified non-residential lending as ‘commercial’. However, commercial could include loans secured by commercial property, loans secured by land, overdrafts for businesses and unsecured lending backed by other (and often) personal guarantees on.

Thus, in estimating the total size of the specialist commercial property lending market, the following factors are considered: This research has always targeted those organisations that have specialist commercial property lending teams. Consequently, lending to commercial property on a smaller scale undertaken at branch or regional level by UK Clearing Banks is not necessarily captured in its entirety by this research; It is recognised that some lending into the UK commercial property market is by organisations neither located nor domiciled in the UK and thus is not captured by the research.

While the Survey provides the most comprehensive and detailed picture of those lenders, we recognise it does not capture the totality of debt finance for the UK CRE sector. These include for example:

- Unsecured lending to real estate firms – in the form of corporate debt or bonds – is beyond the scope of the survey.

- Some loans originated by mainstream lenders have escaped the survey sample by passing into "bad banks" such as Ireland's National Asset Management Agency or via sales of distressed debt to private equity firms (mainly relevant for the period 2008 – 2015)
- Loans provided under "corporate lending facilities" to real estate debt funds.
- Loans that have been taken outside conventional lenders' books through Commercial Mortgage-Backed Securities (CMBS).

While we do not undertake a comprehensive review of those other pools of real estate leverage, £8.5bn outstanding debt remains against UK real estate in CMBS bonds, £93bn have been issued as bonds and £15bn from small building societies and other debt holders which, added to the £170 covered by the Survey, gives a total outstanding real estate debt of approximately £293.5bn and £319.3bn including undrawn development debt.

1.2. Report structure

The Report is divided into seven main sections:

- Section 2 begins the analysis of the current Survey results with headline figures on the lending market – mainly new originations –, which split across the type and size of lender to profile the lending market's current structure.
- Section 3 provides an overview of lenders' loan books and the current market structure.
- Section 4 turns to the form that loans take and the collateral against which they are secured, highlighting lenders' overall exposure, lender types, risks of different underlying project types, level of loan security and real estate markets.
- Section 5 looks in detail at the terms achieved on new lending over time with key indicators, such as LTV, income cover and how they vary in the current market across types of projects and underlying property assets.
- Section 6 concludes with an overview of lending risk by analysing current loan books against underwriting metrics, default rates and loss provisions against a background of default and loss exposure over time.
- Section 7 provides a commentary on a decade since the Global Financial Crisis (GFC), uses the long time series of Survey data to outline trends and cycles in real estate leverage against the background of values and trading in the underlying market.

For consistency with earlier reports full sets of tables and graphics with more detailed results are provided in Appendix 1. For Survey sponsors and data providers and purchasers of this Report, the full historic and current data sets are also available in an Excel spreadsheet.

1.3. Main classifications and labelling

The main definitions and classifications used in this report can be found in Appendix 3.

2. Lenders loan originations

Market liquidity is an important indicator of financial stability and determines the future returns and performance of the CRE loan market. Lending cycles have been subject to changes in the liquidity in the underlying property transaction and investment market or changes in the banking and credit supply market. After a small recovery in Q4 2022, H12023 saw another tsunami of bad news for the sector as inflation refused to come down and Central Banks continued their single blunt instrument approach of raising interest ates to combat inflationary pressures. Inflation and interest rates have peaked during summer 2023, slowing down the overall transaction market during the second half of the year.

The lending market has followed the real estate transaction market, resulting in new loan activity being down by 33% y-o-y compared to 2022.

Investment volumes in 2023 reached approximately £40 billion (Costar), a 22% decline y-o-y. During the second half of the year as weaker economic sentiment and the unstable political climate plagued UK activity, investment volumes in the second half of 2023 dropped as a result.

As a reminder, YE 2022 origination volumes hit £48.6bn. Similar levels have only been seen in 2021, 2018 and 2015 before that. Followed by YE 2023 with only £32.3million, which is the worst year since 2013.

Table 1. Loan originations by lender group (£millions)

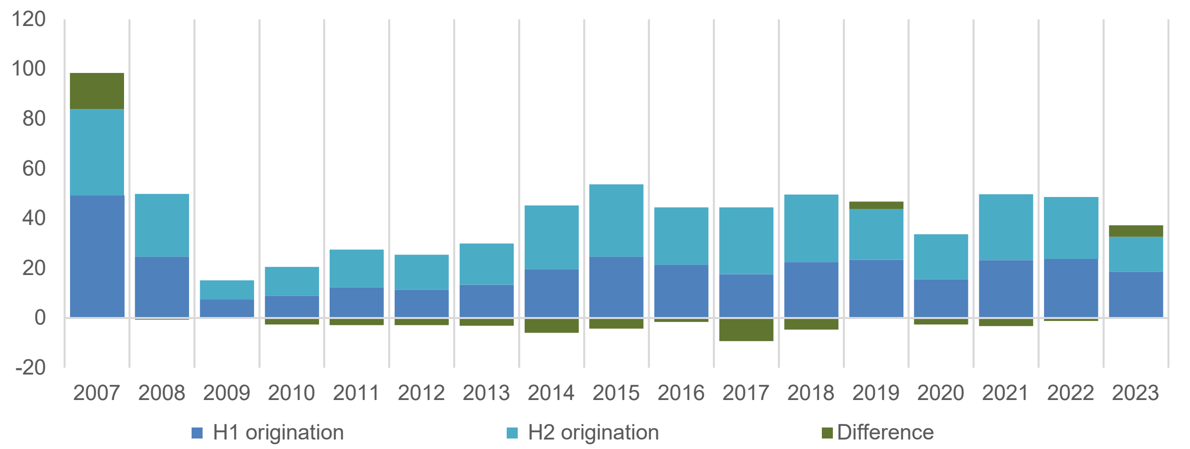
	YE 2022	**YE 2023**	**MY 2023**	**12-month % change**
UK Banks	20,001	17,264	8,594	-14%
German Banks	3,332	2,084	1,477	-37%
Other Intern. Banks	10,051	5,146	2,882	-49%
Insurers	4,911	3,029	2,074	-38%
Other Lenders	10,326	5,154	3,584	-50%
All Lenders	**48,621**	**32,677**	**18,611**	**-33%**

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Except for UK Banks, which only experienced a 14% decline to 2022 volumes, all other lenders have suffered declines of more than 35%. Other Non-Bank Lenders (debt funds) have seen a 50% reduction in new lending. With constantly moving interest rates, loan syndication has been difficult. The syndication market during 2023 reached £7.1bn compared to the full year of 2022 with £11.7bn, which is a surprisingly high amount given the loan pricing difficulties in the market. Some syndications and club financings were also the result of splitting large debt amounts between several banks, at times when their underwritten loan amounts have been restraint by their credit policy.

The composition of active lenders has shifted over the last two years with 53% of the new loans being provided by UK Banks followed by International Banks and Other Lenders with 16% each. German Banks only accounted for 6%, and 9% was attributed to Insurance Companies. Although since the first inclusion of Other Lenders (debt funds) in 2012, they have grown their share in origination by 10x to £10.3bn from originally £1.3bn, 2023 was the worst year for debt funds since 2012 with only £5bn of new lending, and a market share of 16%.

Figure 1. Loan originations during half-year periods (£bn)



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Note: Insurers were not identified as a separate lender type before 2012.

- Origination volume since 2000 has a range of £15bn to £85bn; it increased continuously from 1999 to 2007 with the rise fairly equally shared across lender types apart from a growing proportion from US and Canadian banks.
- Loan originations have been massively pro-cyclical: For example, the £165bn in new loans for 2006 and 2007, equivalent to 70% of outstanding loans at the end of 2007, came after the market signal of a peak rate in capital growth in 2005.
- The origination cycle has been recovering since 2010 and peaked in 2015 with £53.7bn. Since then, there has been a decline in volumes. 2020 has been the weakest half-year since 2013 and the fourth lowest number in a 10-year cycle as a result of the economic shutdown related to the health pandemic.

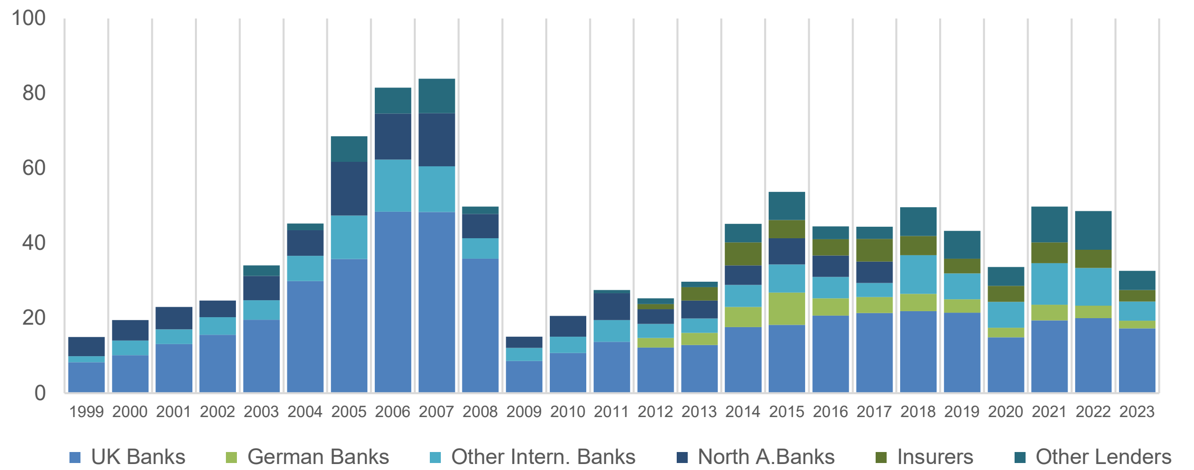
Most recent cycle:

- YE 2021 has marked a new turning point of the downward cycle post pandemic 2019/2020 with a 48% increase in loan origination y-o-y and outstanding loan books flat to declining by 3%.
- It now looks like 2021 was a short-lived peak. Interest rates and cost inflation in 2022 have started adding pressure on highly priced real estate assets, leaving little hope that the full year 2023 will see strong performance overall.
- By H1 2023 the difficulties of refinancing and new loan origination are becoming more visible and by YE 2023 origination volumes were down by 33% y-o-y.

The co-joint crisis of lenders and borrowers slashed origination in 2009 to £15bn, a refresh rate at only 6% of outstanding loan books. Nevertheless, from that point onwards there was a nearly continuous annual rise in volume to the new plateau of around £53bn by 2015 in loan originations. From 2015 onwards, a new cycle has become visible with the low point in 2020 caused by multiple business shutdowns due to the pandemic. Since then, lending volumes have recovered, despite economic headwinds for the sector, while the different active lender groups have been shifting their interests, with banks lowering their overall exposure to the sector and alternative lenders expanding their lending book.

- The origination shares of the long-standing bank lenders versus non-banks reached a split of 70% (banks) – versus 30% non-bank lenders, while the split between outstanding loan books is 60% vs 40%, banks vs non-banks.
- For all non-UK banks, combined shares in origination have been more volatile, running from a quarter to a half of the total but settling in a range of 30% to 40% over the last six years. Over the recent year this share has fallen from 27% to 22% by YE2023, showing the growing differences between the UK and the European common monetary market. The divergence in currency markets and approaches to banking regulation have made the UK real estate debt market less profitable for European banks. German Banks also mentioned that UK properties no longer qualify for the inclusion into Pfandbrief loan pools making funding more expensive.
- Other International Banks have increased their market share from 2017 to 2021 from 15% to 22%. At YE 2022 this share was 21%, but during YE 2023 International Banks have been very selective with new lending and are concentrating on maintaining their books contributing only 16% to origination.
- The biggest market share for new lending falls to UK Banks with 53%, another 16% are provided by Other Lenders and 9% by Insurance Companies.

Figure 2. Loan originations by lender type, £bn and % of total 1999 – 2023

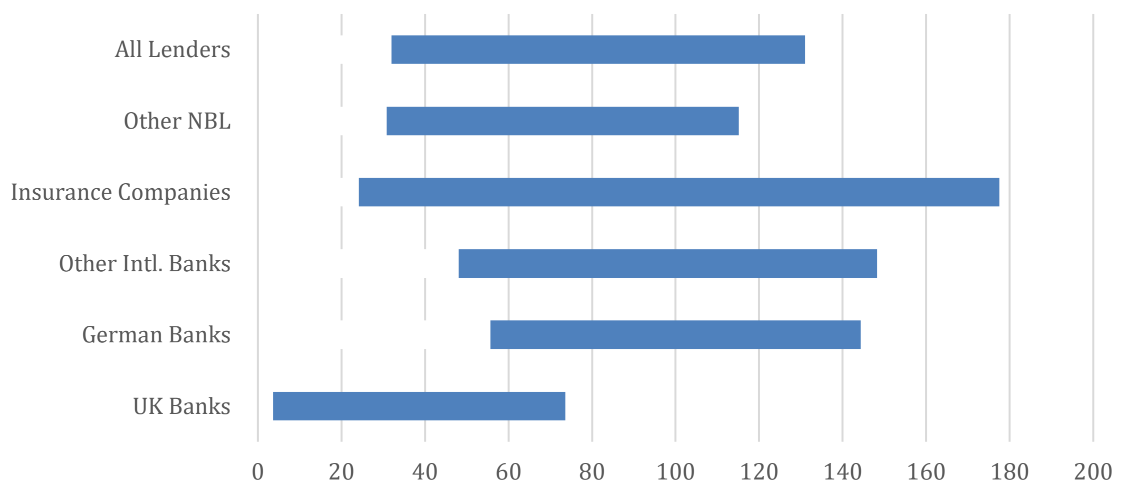


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report.

Note: Insurers were not identified as a separate lender type before 2012. North A. Banks were merged with Other International Banks from 2018.

- In 2023, 9% of all new lending was dedicated to residential finance, 6.8% to other commercial development projects and 84.2% to investment financing for commercial properties. This indicates a slowdown in the commercial development sector compared to 2022. While residential development finance dropped from 10.7% to 9%, commercial development finance dropped from 11.8% to 6.8%.
- In total £5.1bn of new lending was allocated to finance development projects, which represents a 50% decline from 2022, and is only 15.8% of total new lending.
- Foreign banks operating in the UK are focused on originating loans over £100m as a matter of efficiency and prime property asset sizes mostly found in London. Their minimum loan size starts typically at £40million and more. Als Other Lenders achieve an average loan size of £60m, there are now many which are looking to originate loans over £100m. Their minimum loan size starts at £31million. In fact, lenders have systematically turned down lending which does not reach their minimum size requirements, in order to optimise resources spent.
- Only for UK banks the largest loan size does not exceed £100m and is around £70 -80m. There is a large range from high street banks, clearing banks and regional banks, which provide small real estate loans to local businesses.

Figure 3. Average loan size range



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

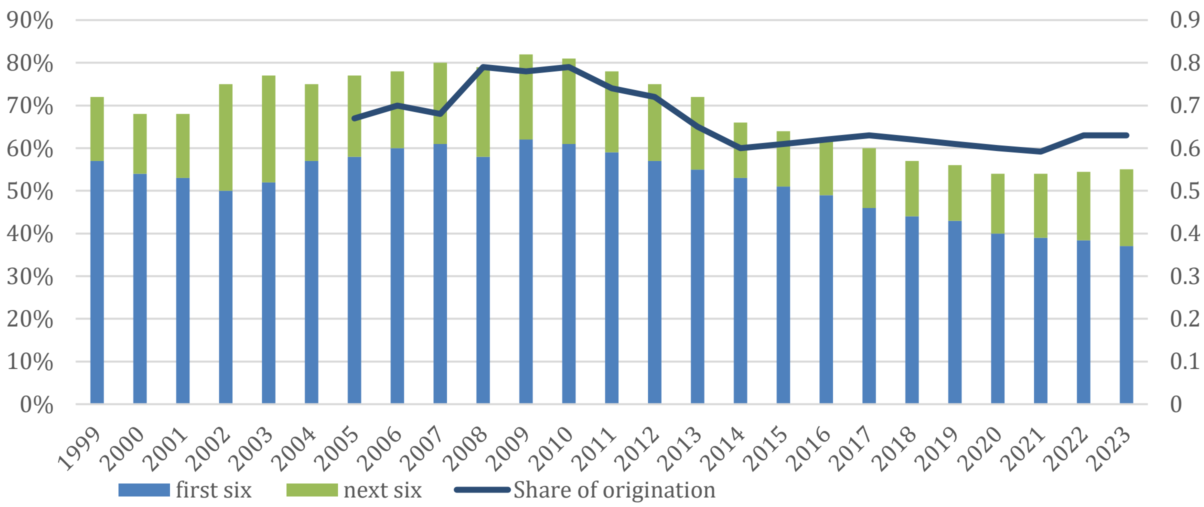
Figure 3 shows that International Banks are typically the source of large loan origination, followed by Insurance Companies, which have a capacity to underwrite large loans without the need for further syndication or participation partners. In 2023, they have also shown flexibility to originate small loans which are below their usual lending size.

With regards to loan length, the shortest investment loans are written for three years, with two times one year extension options to bring the total to five years. The longest loans are written for 10 years mostly by Insurance Companies. Selected regional UK Banks also offer fully amortising loans of 25 years for commercial property. A total of 42% development loans were written for a period of three years or less.

In 2023, the largest 12 originators were four UK Banks, three International Banks, two Insurance Companies, two German Banks and one Other Lender (debt fund). They originated 63% of total origination and held 55% of the total outstanding debt.

Over the long-term it becomes clear that the largest 6 and 12 lenders have lost market share in total debt and share of origination since 2009 and more rapidly since Brexit.

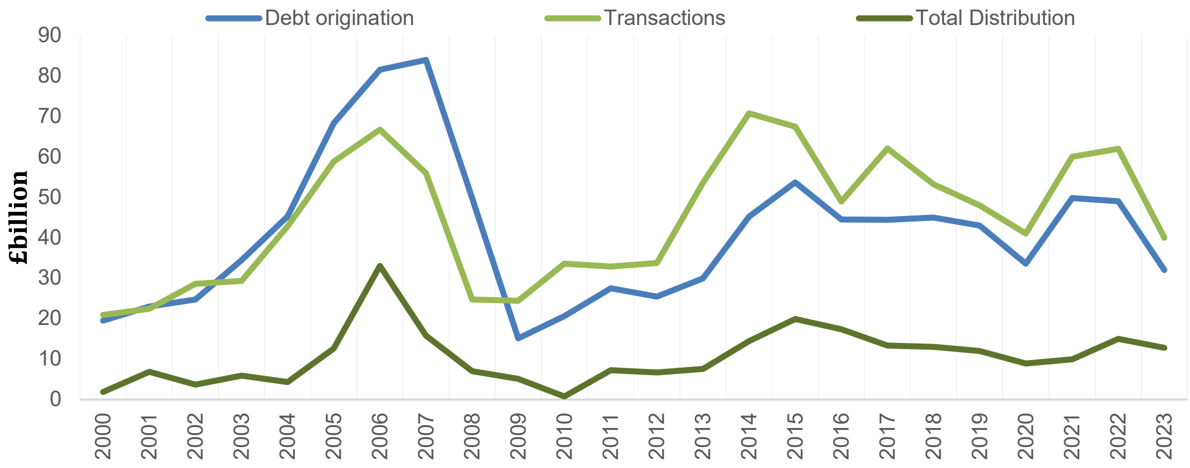
Figure 4. Market share of 12 largest lenders & originators



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Secondary market activity is another important indicator of the health of the real estate finance market. Over the longer term, 25% - 30% of loans are not held on a balance sheet but distributed into the secondary market. This level of secondary loan distribution is considered a healthy, liquid market. Secondary loan distribution accounts for syndications and securitisation of loans. After the collapse of the securitisation market, the syndication market stabilised over the last five years. Insurance Companies typically syndicate 30 - 40%, International Banks 40 – 50%, and UK Banks 20 - 25%.

Figure 5. Loan origination & market indicators, 1999 – 2023

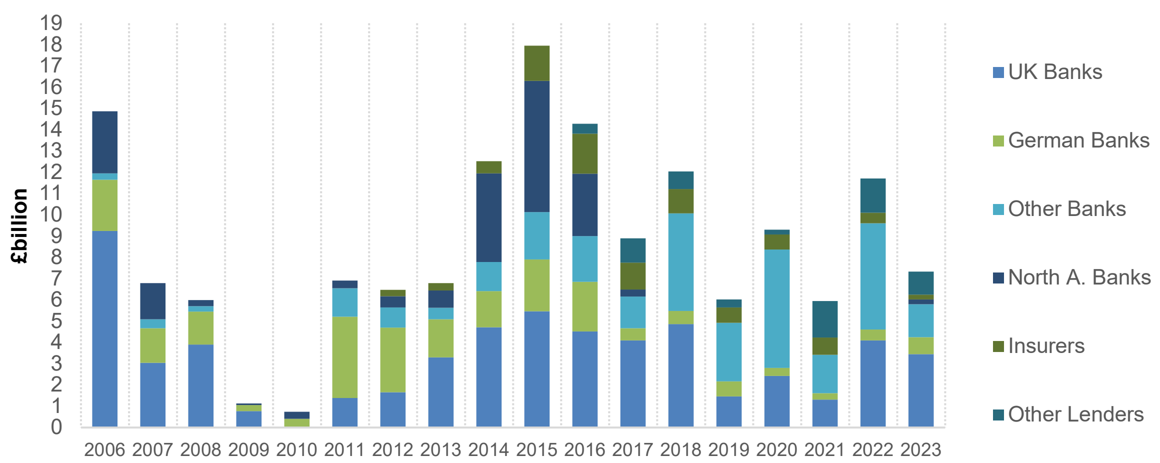


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report, Costar

YE2022 was a strong year for syndication & participation, which reached £11.7bn in total, compared to only £5.7bn in YE2021. Despite pricing difficulties and changing interest rates, the syndication market generated £7.1bn of activity in 2023, still more than in 2021. In total 11 lenders were active in syndication (14 in 2022) and 15 lenders (11 in 2022) recorded club deals and participations. For Insurance Companies 8% of newly originated loans were part of syndications or participations, which is the lowest amount in 20 years. The main active groups were International and German Banks amongst their peers to share large refinancings.

There was a pickup in loan sales of £0.8bn, however, this figure potentially understates the real activity. Some of this debt was obtained at discounts of 92 – 98%.

Figure 6. Syndication volume by lender origin, £bn, 2006 – 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

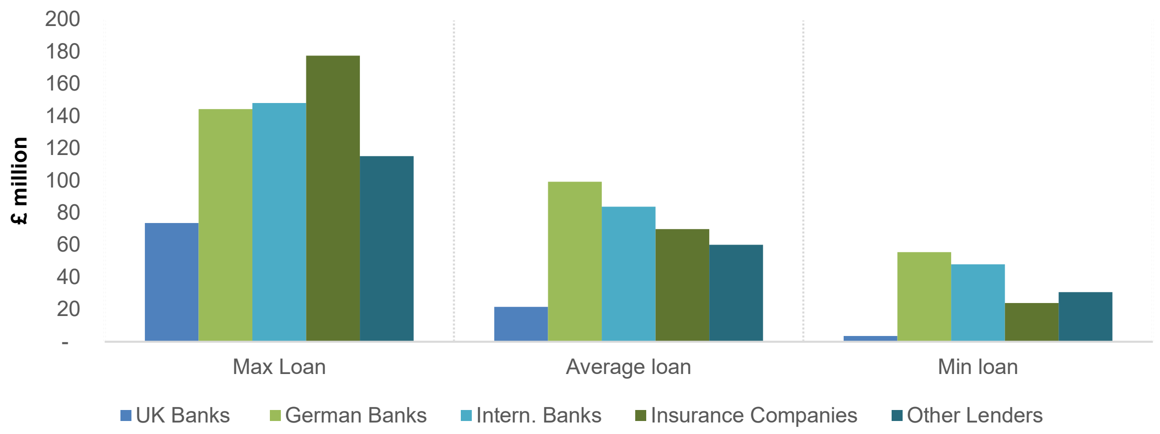
2.1. Lenders and loan sizes & lending policies

Typical loan sizes are a feature of loan books, which differentiates strongly between types of lenders. Leading up to the GFC 2008/09, the maximum loan size had reached more than £1bn for a large portfolio financing while during the crisis it was difficult for lenders to write loans larger than £50m.

- Between 2015 and 2020, the average loan size had decreased. In 2015, a total of 27 reportedly lent a single loan larger than £100 while in 2020 only 23 managed to lend above £100m ticket size. In 2023 a total of 34 lenders declared their lending intentions are above £100m.
- In 2023, the average maximum loan size was above £100m with £132m, which is still lower than in 2022 with £155m. The overall average loan was around £67m, which is 5.7% lower than 2022.
- For 8 lenders the typical average loan was above £100m, whereas for 15 lenders was less than £20m. Larger loans have been more often subject to club deals, thereby splitting exposures and risks across several lenders. Most lenders have a hurdle rate of >20m or >30m for their minimum acceptable loan size.
- Figure 7 shows the loan size average originated in 2023 for minimum and maximum loans size between different lender groups. Insurance companies are typically the source of large loan origination, since which have a capacity to underwrite large loans without the need for further syndication or participation partners.
- Overall, there is a large amount of liquidity across lenders for loan sizes between £20m to £100m available. Fewer lenders wanted to look at loans from £1 – 20 million. UK Banks are less likely to originate loan sizes above £100m.

Overall, there is a large amount of liquidity across lenders for loan sizes between £20m to £100m available. Fewer lenders wanted to look at loans from £1 – 20 million.

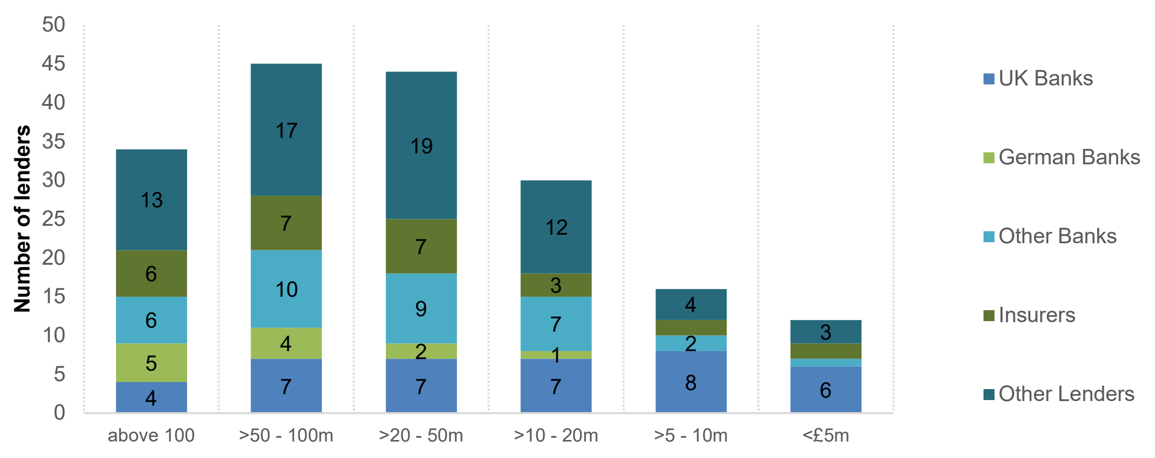
Figure 7. Average loan sizes by type of lender



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figure 7 shows the loan size average originated in 2023 for minimum and maximum loans size between different lender groups. The average loan size of UK Banks is just £22m. driven by smaller banks. The largest loans can be expected from German, International Banks and Insurance Companies.

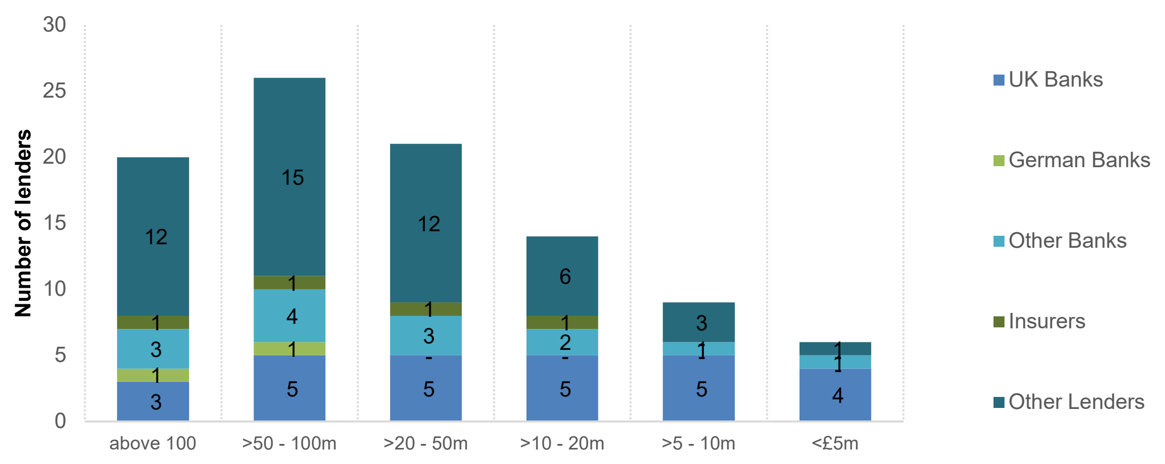
Figure 8. Loan size preferences for investment finance for 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

The survey also asked lenders about their latest lending policies for 2023. During 2009, many lenders stopped lending or reduced their loan size significantly. In the YE 2023 survey responses, 34 lenders were looking to provide investment finance above £100m (2022, 43 lenders) and only 20 are willing to finance developments above £100m. The smaller the loan size, the less attractive to lenders and only 12 lenders are willing to lend on small loans <£5m. As expected, UK Banks are present across all loan sizes, whereas German Banks are only interested in larger loans in prime assets. The most attractive loan sizes are between £50 – 100m, which attracts 45 lenders in this segment.

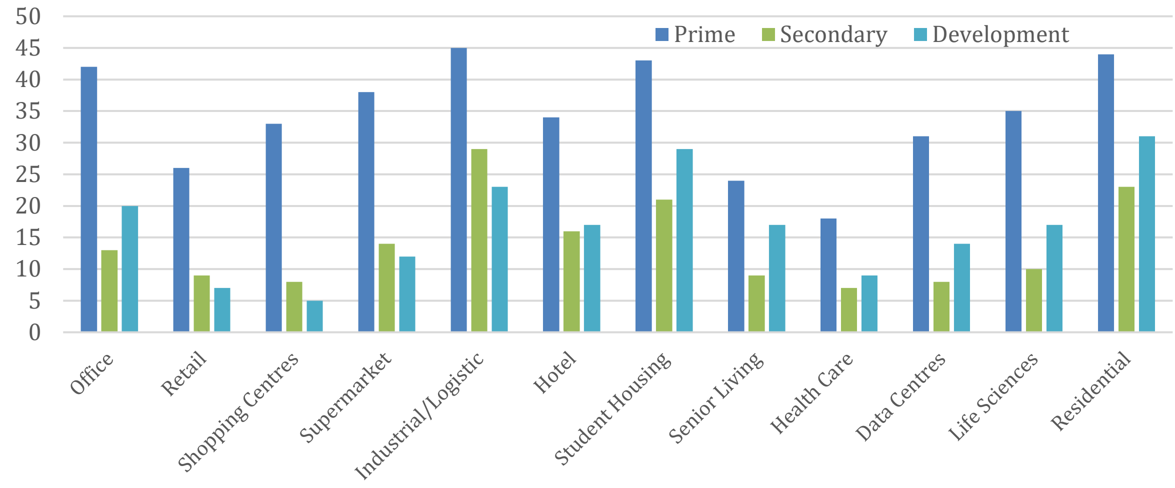
Figure 9. Loan size preferences development finance for 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

For development lending, the lending universe reduced noticeably, in 2023 only 20 lenders offered development finance above £100m compared with 24 in 2022. However, this is more than in 2020, when it was only 5 lenders. More lenders offer development finance from £50 – 100m, with 26 lenders active. For small development projects, which are mostly residential up to £5m, there is limited appetite of only 6 lenders offering financing.

Figure 10. Number of lenders active, by asset type



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Lenders were also asked about which types of assets and sectors they are still lending to in 2023. A total of 53 responded to these survey questions compared to 49 in YE 2022. There has been a further decline in lenders interested in lending to Prime Office (79% in 2023 from 94% in 2022) and industrial/logistics (85% in 2023 from 92% in 2022). Willingness to lend has also further declined for secondary offices (25% in 2023 from 47% in 2022) and office development (38% in 2023 from 43% in 2022).

Retail assets still attract the lower lender interest, with the exception of prime supermarket chains, which 72% of lenders are happy to lend to. The least lender interest is seen in secondary retail with only 9 lenders willing to lend and retail developments with only 7 lenders.

In 2023 lenders were more optimistic about the hotel market and 64% (2022: 59%) of the responders are willing to finance prime hotel. For secondary hotels, it is more difficult to find financing and 16 lenders are offering financing.

The most attractive types of assets for lenders over the past 3 years with increasing interest are residential assets, with 83% of lenders are providing finance for, prime student housing with 81% of lenders covering the sector. Also niche sectors such as life science assets and data centres have seen an increase in lender interest with 66% and 58% of lender providing financing for prime assets.

2.2. Securitisation market YE 2023

In the UK CMBS issuance has been on hold since the interest rate rise by BoE in 2022. Some internal securitisations were noted within UK Banks reaching £1bn. The UK expects its first CMBS Last Mile Logistics CMBS 2023-1 UK DAC, CMBS a single-borrower transaction arranged by Citibank in two years. The collateral for the transaction is a £289.8 million limited recourse, first lien floating rate loan with s a five-year term against 37 industrial assets across six UK regions. The leased space earns only 75% of estimated rental value, reflecting the sharp growth in UK industrial rents recorded in recent years, which also accounts for the 4.6% initial yield being below rack-rented comparables.

2.3. Summary

- The UK lending market is slowly changing to a more domestic market. While London commercial properties are still the target for international lenders, the rest of the UK market is dominated by UK banks and debt funds (57%).
- Lenders have been very selective in accepting any new borrowers. Lending appetite for prime and secondary office assets is declining, while lenders are focusing on lending to logistic assets, student housing and residential property.
- There is a significant difference in lenders offering financing against prime versus secondary properties, for example, 86% are willing to finance prime office, but only 32% offer loans for secondary office properties.
- Access to development finance is most easily provided for residential, industrial, office and student housing. However, there are also an increasing number of lenders financing developments in alternative properties such as senior living, data centres or life sciences.

2.4. Summary

- Despite concerns over carbon zero targets and other cost implications affecting office properties, logistics and office assets remain the most popular asset class to finance.
- When look for financing niche asset classes such as senior living, health care there is only a much more limited number of lenders interested (20 – 25 lenders)
- Debt liquidity drops significantly for small loans below £5m, lenders were focus on originating large loan tickets to sustain their balance sheets.

3. Lenders – loan books and segmentation

The following section provides a comprehensive analysis of lenders' outstanding loan books broken down by categories of lender groups, types of assets, types of lending and lender size. Table 2 provides a more complete picture, including undrawn commitments. These are to development loans, which have not been fully drawn yet and could still be withdrawn.

Table 2. Outstanding loans and commitments, £ million

	Outstanding Loans	Undrawn Commitments	Total book Dec 2022	Total book Dec 2022	% change
UK Banks	59,158	17,059	76,216	80,299	-5%
German Banks	11,937	169	12,107	14,745	-18%
International Banks	30,092	2,842	32,933	36,439	-10%
Insurers	32,683	1,299	33,982	33,417	2%
Other Lenders	36,690	1,959	38,648	37,913	1%
All Lenders	**170,559**	**23,327**	**193,887**	**202,813**	**-4%**

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

In 2022, the total loan books have reached an overall balance of £202bn, which is slightly above YE2021. However, by end of 2023, total debt on lenders loan books has declined to £193bn, this is due to lower origination, more repayments but also due to some lenders exiting the UK lending market. As a result, also total outstanding loans have increased declined from £177bn to only £170bn.

Table 3. Outstanding loans 2022/2023, £ million

	Outstanding Loans 2022	Origination 2022	Outstanding loans 2023	Origination 2023	Outstanding loans % change
UK Banks	63,315	20,001	59,158	17,264	-1%
German Banks	14,483	3,332	11,937	2,084	-25%
International Banks	32,730	10,051	30,092	5,146	4%
Insurers	31,923	4,911	32,683	3,029	-1%
Other Lenders	34,647	10,326	36,690	5,154	25%
All Lenders	**177,098**	**48,621**	**170,559**	**32,677**	**1%**

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

3.1. The lending market concentration

Over time and especially since the GFC, the UK CRE lending market has seen a rising number and wider range of lenders with new small debt funds launched by asset management firms and less conventional lending channels such as peer-to-peer lending by pension funds and to an as-yet limited extent, crowd-funding platforms for both investment and development loans.

The focus of the CRE Lending Survey remains on mainstream lenders. For instance, those with teams dedicated to the origination and management of loans as secured against commercial assets, excluding those for whom loans are likely to be very short-term (bridging finance) or occasional bespoke arrangements (peer-to-peer lending). Aside from the regional classification of lenders the report also considers lenders categorised by the size of their loan book (Table 4). Lenders have been sorted into four different groups by loan book size.

Table 4. Categorisation of lenders by size of loan book

Firm size	**Number of firms**	**Category**	**Category name**
<500m	15	24	Small
500m – 999m	19		
1bn - <2.5bn	30	30	Medium
2.5bn - <5bn	9	9	Big
5bn - <10bn	6		Large
>10bn	3	9	
Total	**72**	**72**	

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

In December 2023 a total of 72 lenders reported to the survey. Despite the increased fragmentation of the market, lending remains primarily centred among the largest, long-standing lenders (Table 6 showing total loans and originations for lenders ranked 1-5 in terms of outstanding loans and so on).

Table 5. Lender concentration – December 2023

Size Rank #	**Outstanding Loans £m**	**% Total Outstanding Loans**	**Loan Origination £m**	**Origination % Outstanding Loans**	**% origination of total origination**
1 – 5	57	34%	11.6	20%	36%
6 – 10	26.8	16%	6.9	36%	21%
11 – 20	29.2	17%	3.6	12%	11%
21 – 30	19.3	11%	3.0	16%	9%
31 – 40	14.8	9%	3.2	22%	10%
41 – 50	10.6	6%	2.9	26%	9%
51 – 60	7.2	4%	0.8	11%	2%
61 – 70	3.9	3%	0.5	13%	2%
71 –80	1.2	1%	0.1	10%	0%
Total	170	100%	32.6	19%	100%

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

In 2023, the largest 10 lenders held 50% of the outstanding loans and originated 56%. On average, lenders turn around 24-29% of their loan book. In 2022 especially the largest 10 lenders demonstrated their strength in origination, replacing ca. 30% of their total book with new loans, while smaller lenders have missed out. Overall market turnaround was strong with 27% of loans being renewed. The sharp slowdown in 2023 is visible also in the turnaround of new loans, lenders only replaced 19% of loans with new lending, of which the majority was refinancing.

- The five largest lenders, all long-standing market leaders, still account for 34% of total outstanding loans; they have written £11.6 new loans representing 36% of their loan book.
- In 2023 the top 20 lenders accounted for 67% of the total; the top 50 – 100 lenders gained market share increasing to 8% , but only contributed 4% of total new origination.
- Smaller lenders focused on originating larger loans resulting in an average loan size of £70m, 22 of these lenders fall into the category of Other Lenders (debt funds).

Table 6. Change of outstanding loan books by lender group

	Large	Big	Medium	Small	Average loan size
UK Banks	4	0	5	5	22m
German Banks			4	2	99m
Intern. Banks	1	2	5	5	84m
Insurance Companies	2	4	3	1	70m
Other NBL	1	3	10	15	58m
Total	8	9	27	28	67m
Average loan size	75m	91m	73m	24m	

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Table 7 shows the loan book distribution by lender group. Most Other Lenders still have loan books below £1bn of total loans, however 4 Other Lenders (debt funds) increased their loan books to the critical size of >£1bn in 2023.

By total loan book, the 12 largest lenders are, 4 UK Banks, 3 International Banks, and 3 insurance companies and two debt funds. A total of 45 lenders have increased their balance sheet loans versus 31 for which total loan exposure has declined.

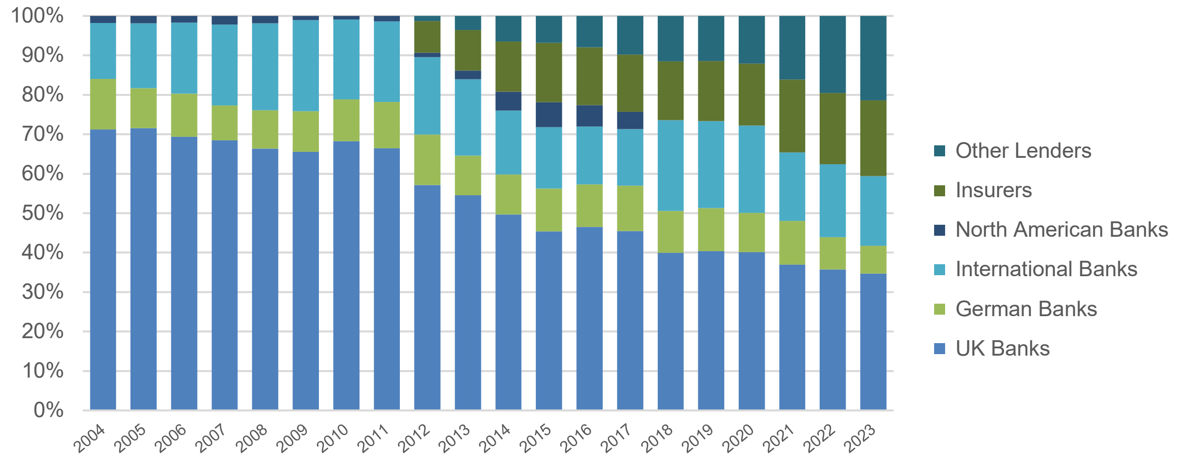
3.2. Outstanding loans

On the latest Survey figures the outstanding loans total decline of 4% to £170bn from December 2022 to December 2023. In addition, £23.3bn of loans were undrawn commitments, resulting in a total loan book value of £197bn. Overall development and investment lending has remained at similar strong levels as in 2023.

- From 2014 onwards, outstanding loans have run between £160 and £170bn with the current figure of £177bn.

- In 2023 lending books declined for 27 lenders, for three the decline with more than 30%, for 6 it was between 20 – 30%. For 28 lenders the overall loan book increased, while for 22 lenders loan books remained stable. Amongst the 10 lenders with the largest growth in loan books, were two banks, one insurer and the remainder were Other Lenders (debt funds).
- UK Banks have maintained their market share with 35%, while Other Lenders have increased their share to 21%. Insurance Companies accounted for 19% and International Bank for 18%.
- Historically, the market share of UK Banks has dropped by 14bp since 2012 and the combined share of bank lenders has continued to drop since the introduction of debt funds from 91% in 2012 to 65% in 2021 (72% in 2020).

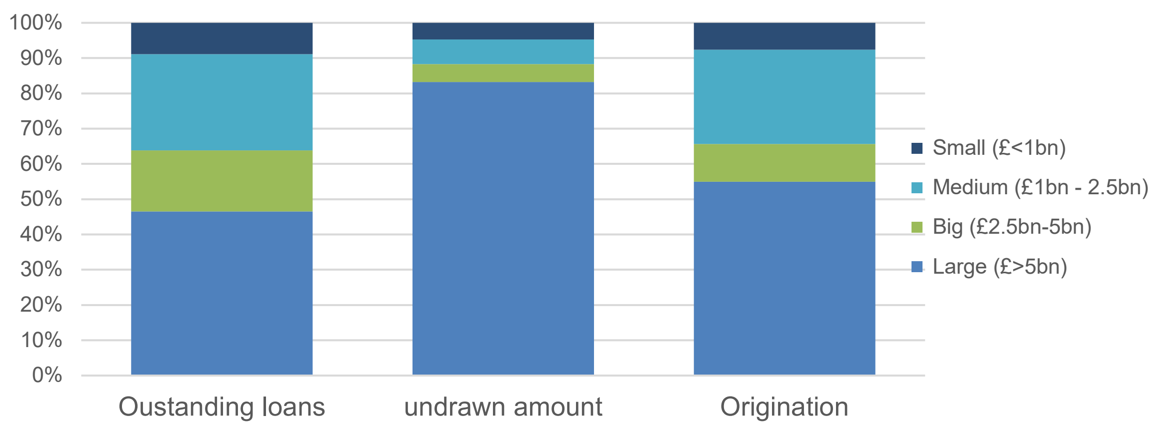
Figure 11. Outstanding loans by lender size, % of total



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figure 12 shows the market segmentation by loan book size. The largest lenders have approx. 46% of market share in outstanding loan books and 50% of origination share. They also hold the largest number of undrawn commitments for development.

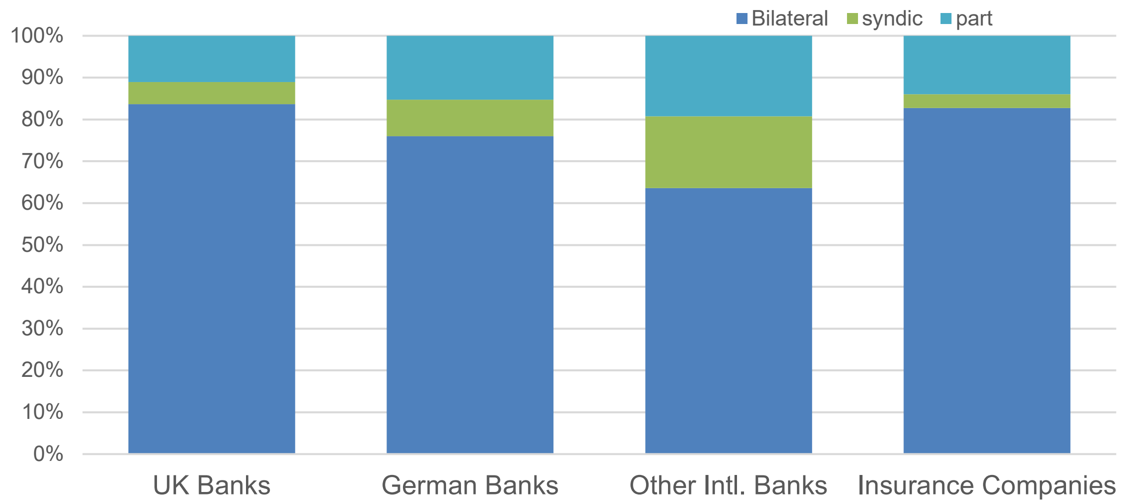
Figure 12. Share of loans and origination



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

In addition, lenders reported that 69% of total loans books are bilateral loans. The lender groups with the highest share of club deals and syndicated loans were Other International Banks, followed by German Banks.

Figure 13. Share of bilateral lending 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

3.3. Summary

The CRE Lending Survey has tracked nine years of continuous growth in loan books up to 2008 (at an average of 20% per year) followed by six years of continuous contraction (at 7% per year) to 2014. Since 2015 loan books have remained stable till 2018, when they started expanding again up to the pandemic, over 2022 to 2023 there has been a decline in total outstanding debt due to low origination volumes, higher repayment rates and some lender exiting the market.

- Lenders continued with new business early in H1 2023, until the market has reached a closing point in June 2023. Thereafter lending activity remained at its lowest since 2010. Lenders have been supporting good borrowers with business plans or good quality assets which could be either office, logistics, residential, student housing assets. There also been some activity in lending to transitioning assets.
- Historic re-cap: Since 2014 total outstanding CRE loans have remained between £160bn and £170bn. Annual loan originations have run in a tight band from £45bn to £55bn: The lending cycle has turned in 2019 with a decline of originations and expanding loan books, continuing this trend in 2020. Finally, 2021 seems another turning point after two years of decline with a peak in loan originations, the positive trend has continued in the first half of 2023 despite increasing interest rates.
- Since Brexit international market diversification has declined slightly by 3%. Overall International lenders (including German and Other International Banks) have lost 7% of market share between 2018 and 2023.

- UK Banks have lost nearly 20% of market share to Other Lenders (debt funds) and some to Insurance Companies.

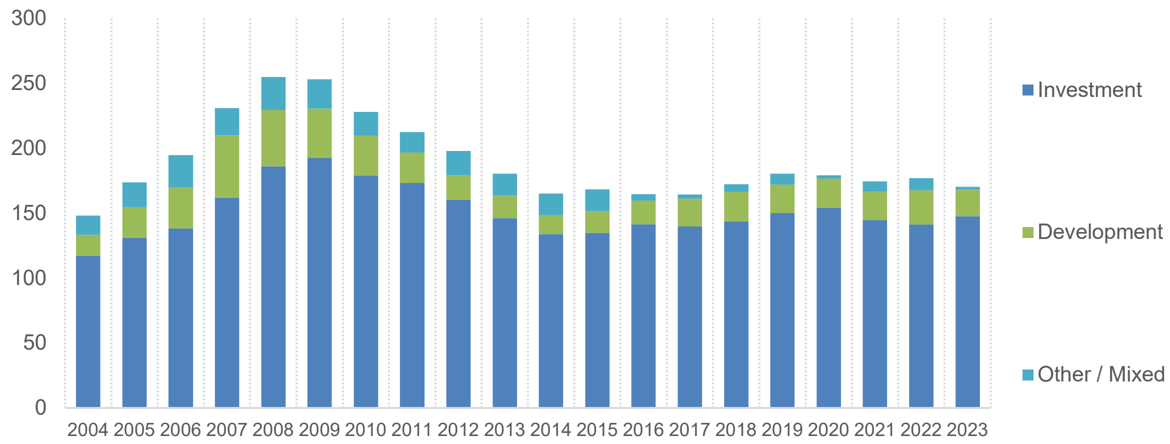
4. Collateral – loan types and market exposures

This section looks at collateral, that is, security for the £170bn of outstanding loans and £32.3bn of new loan origination in 2023. It shows a mix between the type of collateral, the form of loan and how these characteristics vary across lender type and size in the market.

4.1. Purpose of loans

The Survey identifies several primary purposes of borrowing. Loans secured against existing investment properties are split between refinancing existing loans, either by the same lender or other lenders and new acquisitions. Loans advanced against development are split between 100% pre-let or partly speculative commercial projects and residential development for either sale or rent. Figure 14 shows the broadest split of loan books.

Figure 14. Outstanding loans by type of collateral, £bn 2007–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

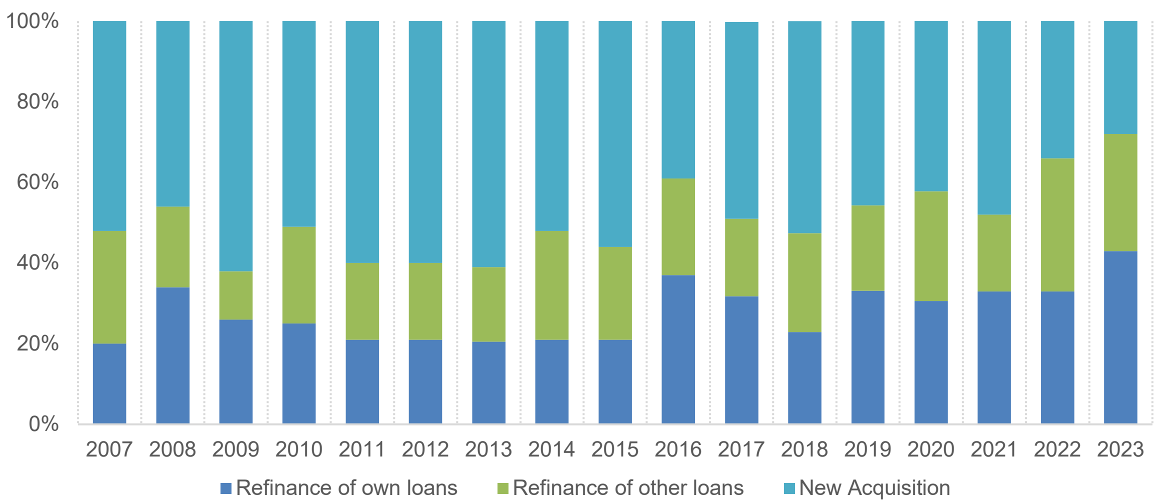
The Survey provides unique insights into the assets underlying lenders' loan books and originations, categorised by type of project, loan form and asset location. At the aggregate level, loan books are dominated by senior debt secured by existing investment properties with small fractions in riskier development projects or subordinated loans. However, the split across lender types and sizes shows strong differentiation in business models and risk exposure.

- Loans for investment dominate outstanding books, at an average 80% of the total each year, ranging from a low of 70% to a maximum of 87% that share investment loans have held since 2015.
- At YE 2023 standing investment properties are collateral for 87% of the outstanding loan value; out of which 1% is allocated to other investments. These are investment which could not be classified into the standard asset types and may include healthcare assets, data centres, life science parks etc.

- The share of development lending has increased to 13%. Development lending splits further into residential development lending 7% (£11.5bn) a decline in lenders books by c£4bn and 6% commercial development lending (£12bn).
- Development exposure is highly concentrated in UK Banks (8% of their total outstanding loans) and newer Other Lenders (35% of their outstanding loans). For all other lenders development finance represents less than 5%.
- As of 2022, UK Banks supply 46% of all residential development finance and 34% of all other commercial development finance in the market. However, in 2023 it was only 26%. The majority for residential development finance came from Other Lenders (debt funds) supplying 58%.
- Other Lenders (debt funds) also provided 54% of commercial development finance (pre-let) and 71% of all speculative development finance.

Figures 15 to 16 show the split origination between refinancing of loans already on the books of the originating lender, refinancing of loans from other lenders, or new loans, and the origination of new loans, which would typically occur for borrowers buying new assets. The splits are available in this form only from 2007.

Figure 15. Origination of loans by purpose, £bn 2007–2023

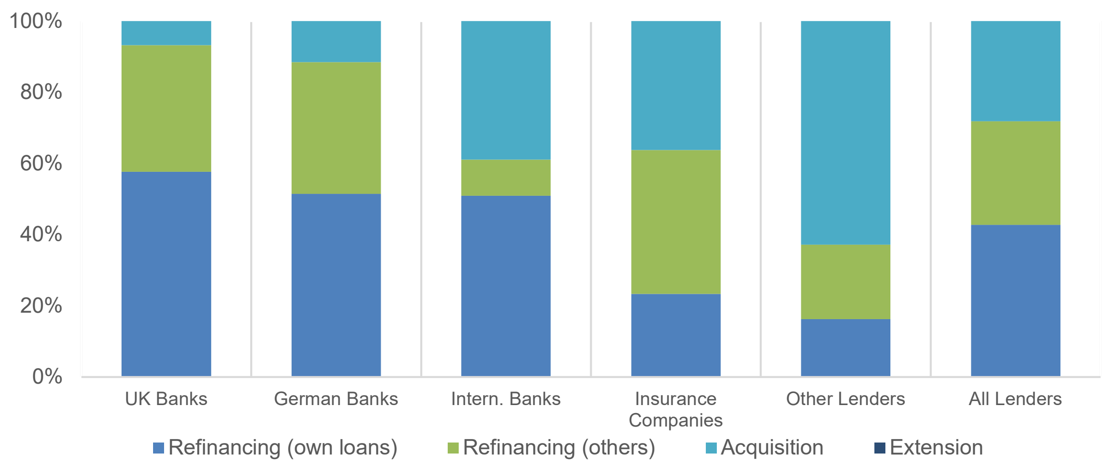


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

- New acquisition lending is experiencing a 20-year historic trough with only 28% in 2023. Only 2016 shows similarly low levels with 39%. Overall, since 2018 new acquisition lending has been on a decline, while refinancing has grown to account for the majority of lending activity.
- The decline in new acquisition lending stands in a contrast to the overall low lending volumes in 2009-2012, where lenders had to deleverage, and did not want to refinance loans, but engaged in new lending, while overall volumes remained low. In 2023, lenders are refinancing, but do are not open to look at new loans.

- Refinancing activity of mostly concentrated on internal loans (43%) of total financing activity. Especially UK Banks obtain most of their financing activity from refinancing their own loans, borrowers (58%). All other groups of lenders take a larger share of acquisition financing.
- Only Other Lenders (debt funds) still achieve a new origination share from acquisition financing of 63%.

Figure 16. Origination of loans by purpose & lender type, % by value

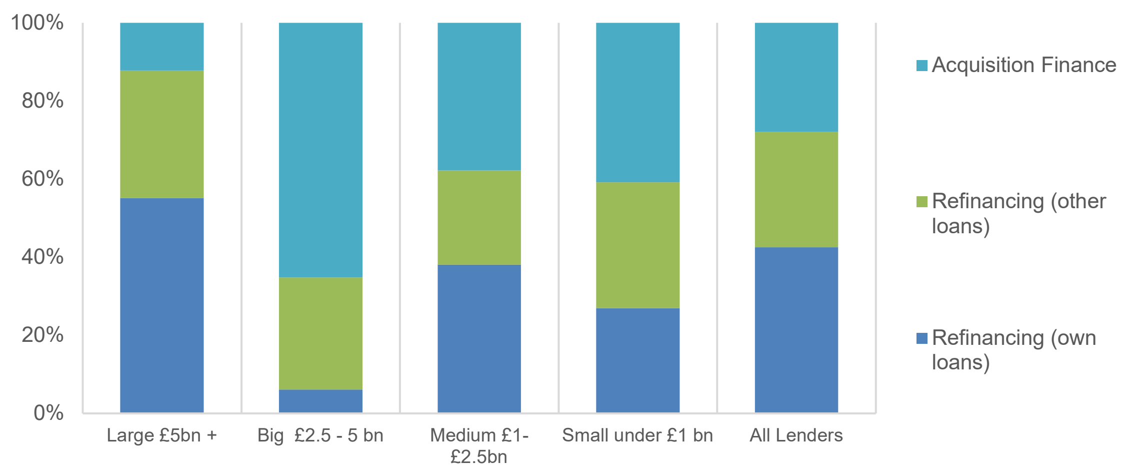


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

There are, however, substantial differences in the mix of origination business across types and sizes of lenders:

- Except lenders with loan books between £2.5 – 5bn, which were the most active group to provide acquisition finance (65%) all other lenders were primary concentrating in refinancing their own loans.

Figure 17. Origination of loans by purpose & lender size of loan book, % by value, 2023



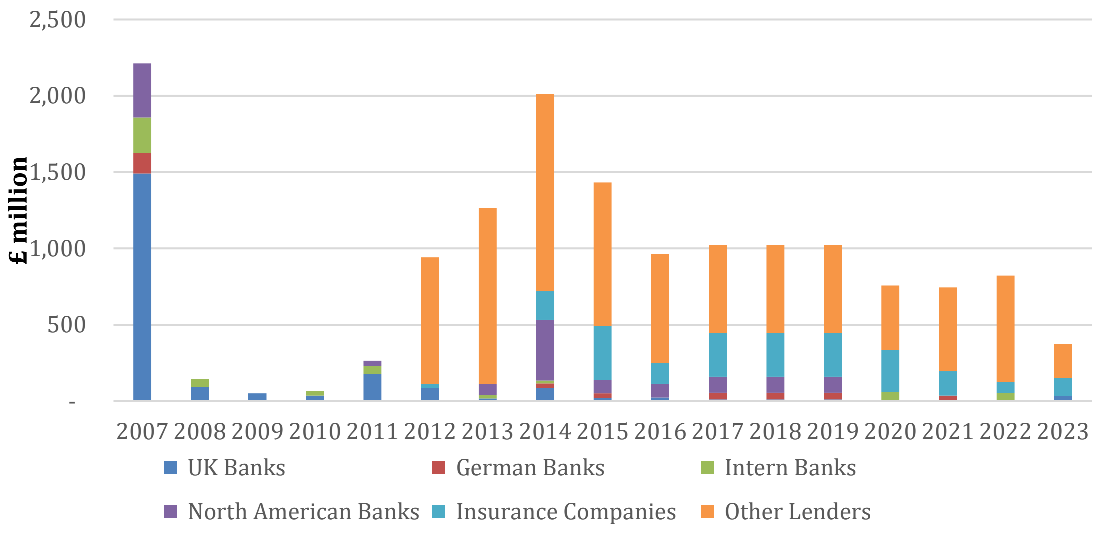
Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

4.2. Loans and the capital stack

The survey distinguishes two levels of collateralisation in lending: senior debt, following the standard definition of a first loan secured by a prior claim on the asset and subordinated debt defined as all forms of lending not secured by a first claim. Splits using terms such as stretched senior, junior and mezzanine debt have proved impossible to collect from lenders due to the lack of common definitions.

Over time, subordinated debt has accounted for only 2% to 5% of outstanding loans covered by the Survey with a slightly pro-cyclical variation within that range and currently stands slightly below its long-run average at 2% of books or just £3.5bn. Junior debt might also not get captured in the outstanding loan book, because it can be very short term.

Figure 18. Originated subordinated loans by lender type, £m 2005–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

The share of subordinated debt appears, at first sight, surprisingly low but should be considered against the relatively small proportion of the capital stack made up by junior and mezzanine loans. As Figure 18 shows, there has been a significant shift in the mix of lenders providing subordinated loans:

- Senior loans – with first claim on underlying collateral – dominate loan books; subordinated loans have a share of only 2.1% of outstanding debt and 1.1% of origination at YE 2023.
- Subordinated debt is highly concentrated among Other Lenders who have accounted for 70%-80% of origination since 2014, supplanting the bank lenders who previously dominated this market segment.
- Despite some junior funds being launched, the overall amount of junior or mezzanine debt is at historically low levels within banking institutions and other financial institutions and debt funds largely financed by institutional investors. Some bridging and mezzanine funding might be appearing in the C2C and B2C markets.

4.3. Development lending

The successful years for project developers are over at the current interest rate level, but financing is still urgently needed. There are still projects that need to be brought to a sensible conclusion. When it comes to short-term and bridge financing, costs are constantly increasing.

The price finding phase for real estate debt is still not over. Admittedly, the market is gradually starting to get used to this state of affairs. The good news is that the Construction Leadership Council (CLC) has released a statement revealing that the supply of most building materials — such as bricks, blocks, boilers, plaster, and timber — has returned to pre-Covid levels.

Overall, developers are much more confronted with an equity crunch than with a credit crunch. If they succeed in raising additional "real" equity, their chances of obtaining debt capital increase considerably. By contrast, "purchased" equity in the form of mezzanine is hardly accepted.

Both equity and debt capital are granted by lenders only for projects that have a chance of generating profits even in today's market situation. For lenders, the decisive factor is the current rent level, not the expectation of a possible rent increase. Projects that disregard sustainability criteria are now no longer financeable.

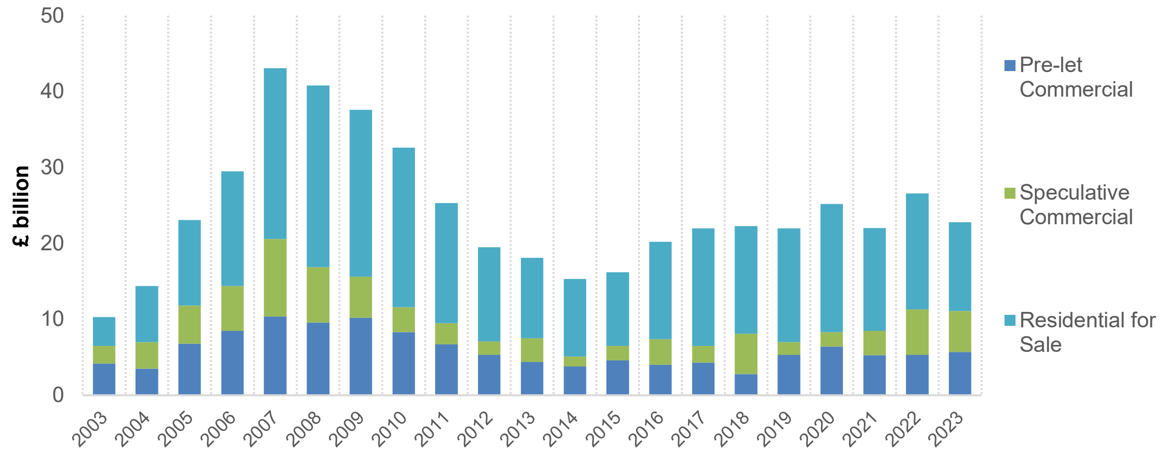
The overall construction pipeline is down, which means it is a good time for developers starting to look for new sites. The best way through the crisis is for equity-strong developers, especially small and medium-sized regional players who know the market inside out and who have established business relationships with local construction companies. In the residential space, private enterprises deliver 60% of new development stock.

For these local developers, regional banks are showing a willingness to provide financing. However, there will be a few more insolvencies on top of those that have already occurred, while costs continue to increase, and investors pause to wait for the bottom of the market.

Total outstanding loans secured against development projects (Figure 18) has followed the general cyclical pattern, peaking at close to £40bn in 2007 and increasing since 2014, reaching a new peak in H1 2023 with £26.7bn. London development market sees transactions more than double to £1.8 billion in H1 2023 (Savills), however, with the sharp slowdown in the second half of 2023, development loans have dropped sharply, leaving only £22.8bn of outstanding loan facilities by YE 2023.

- From 2016 onward, exposure to development has settled at 13%, a shade over its long-run average; residential development (including development for sale or rent) accounted for most recovery in total development loans.
- Residential development stood at £11.7bn at YE2023, or 7% of outstanding loan books. When accounting for undrawn amounts, there is still a very strong financing pipeline to residential projects going forward.
- Commercial development lending stood at £11.1bn (6% of total outstanding loan book), showing in increase in both pre-let development schemes as well as speculative development finance.

Figure 19. Development – outstanding loans, £bn 2003–2023, £bn

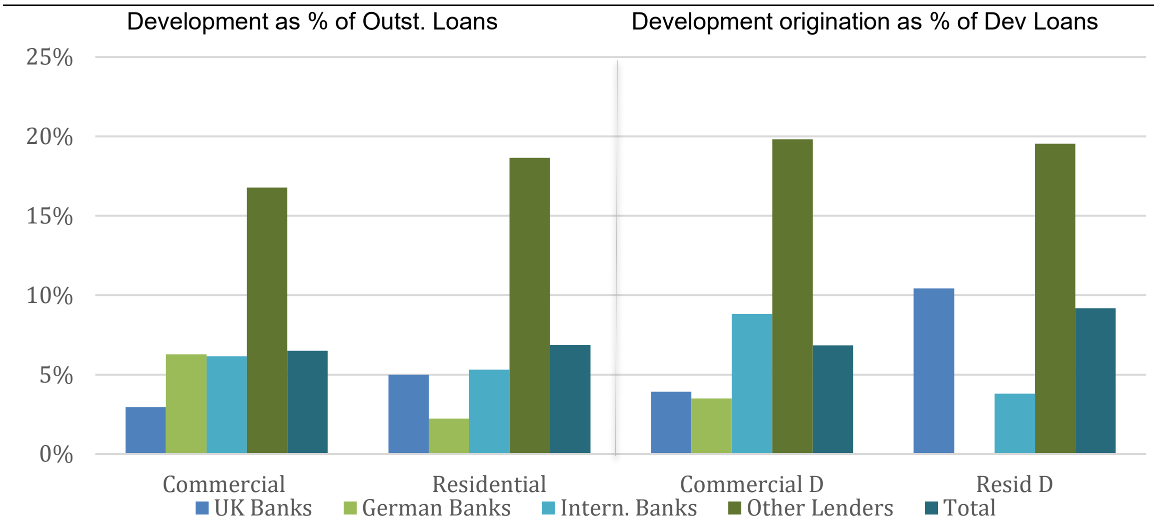


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Lenders vary widely in their appetite for development lending (Figure 23): as a fraction of total outstanding loans, commercial development is under 5% of books German Banks and International Banks but over 15% for Other Lenders.

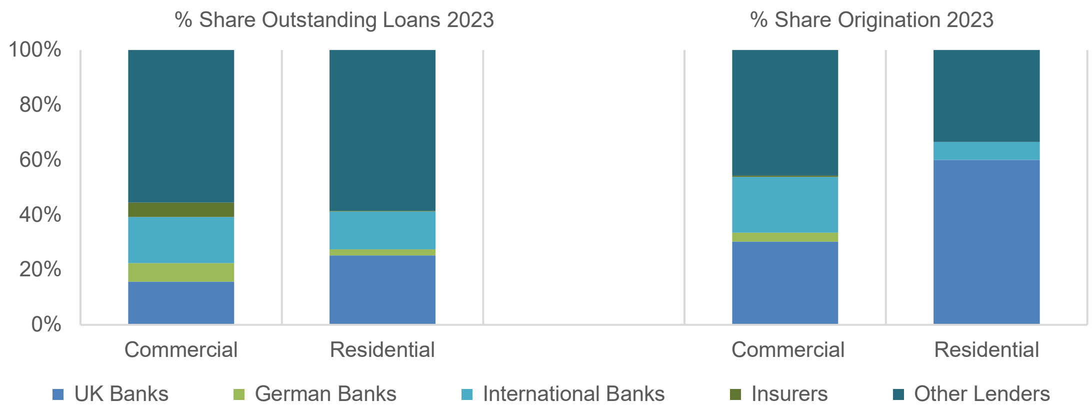
Origination of development lending as percent of outstanding development loans decreased to 33% in 2018 from 50% in 2015 but recovered in 2019 at 44%. In 2022, the market share was 41%. New residential development loans accounted for 19% of outstanding development loans and commercial development lending for 21%. In 2023 there it is harder for borrowers to obtain development finance, and development finance accounted only for 16% of new lending of which 9.1% was for residential development and 6.9% was for commercial development.

Figure 20. Development exposure and origination rate by lender type, 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figure 21. Share in total development loans by lender type, 2023

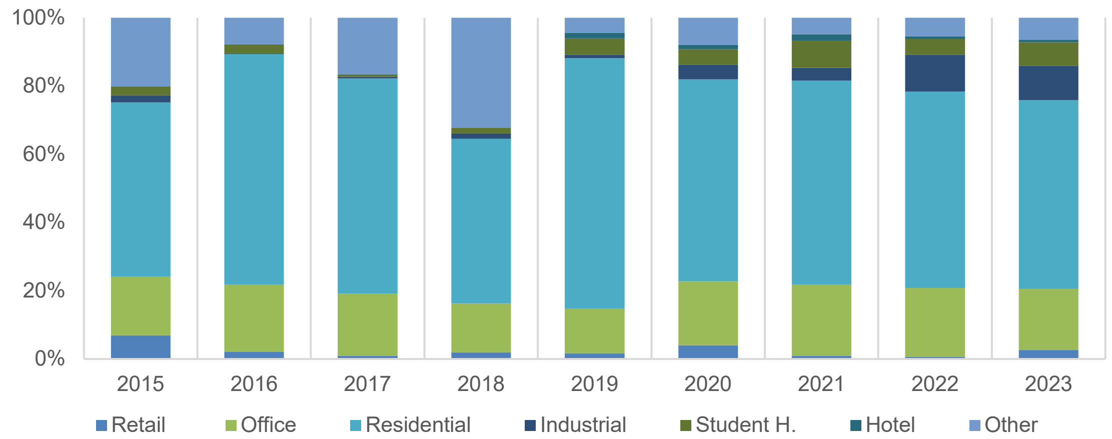


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

- UK Banks are providing 25% of the residential development finance in the market, and 20% of pre-let commercial development. They are also providing 42% of development for alternative asset classes, including student housing, healthcare or data centres.
- 71% of speculative development finance has been supplied by Other Lenders, followed by Other International Banks (15%).
- Other lenders were the largest lender group offering development finance in 2023, supplying 59% of residential development finance and 54% of pre-let commercial development finance. In comparison, in 2015 Other Non-bank Lenders were financing 70% investment projects and 30% development projects.

Respondents also provided a breakdown by property type for £25bn of development finance on their loan books. The largest proportion of outstanding development loans is allocated to residential development (55%). In comparison, the second-largest share, £4.4bn, goes to financing office developments (18%) followed by logistics with 10%. This leaves student housing development as the 4th strongest sector with a share of 6.9% followed by "other development" funding which includes care homes, GP Practices and other alternative sectors accounted for 6.4%.

Figure 22. Outstanding, drawn development exposure by property type, 2015–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

4.4. Asset type exposure

This section analyses the outstanding loan books by diversity of loans secured by different property types. The historic overview shows the changes in the types of underlying property secured by loans. The data excludes loans to Social Housing from 2016 onwards.

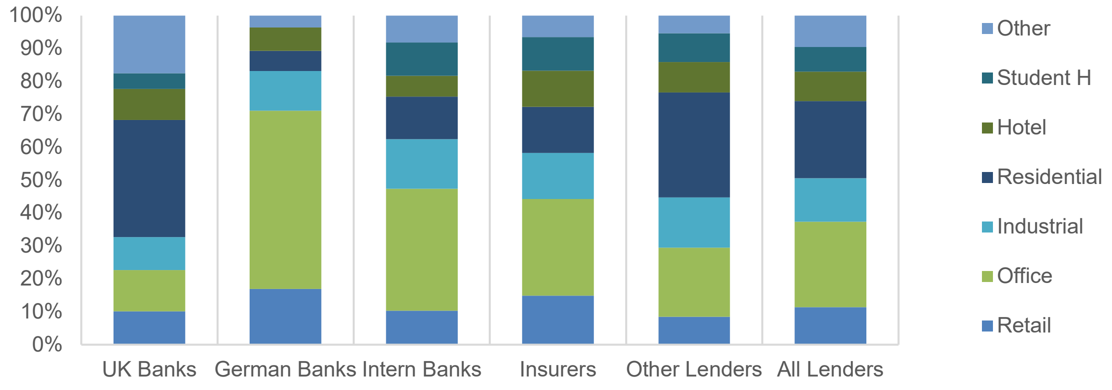
In 2023, lenders continue to specialise in different areas of lending. German and International Banks still concentrate most of their loan exposure in the traditional property types (retail, office, industrial) with 83% and 63%. Within the more alternative segments German lenders hold 7% of loan exposure in hotels. UK Banks recorded the highest exposure to residential loans with 36%. Lenders with loan exposure of less than 60% in traditional property types are UK Banks (33%) and Other Lenders (45%).

Insurers also financed a large amounts of student housing, accounting for 10% of their loan exposure, as well as hotels accounting for 11%. Other Lenders followed UK Banks and financed a large volume of residential loans (32%).

Over time the office sector's exposure has remained relatively stable with 26% in 2023. The outstanding loans to the retail sector have started declining to 11%, logistics exposure has increased to 13%. Loans to residential property have grown to 23% from just 14% in 2018 and are now the second strongest sector after offices. Residential loans have always had a substantial share on lenders loan books, but they have reached a 20-year peak.

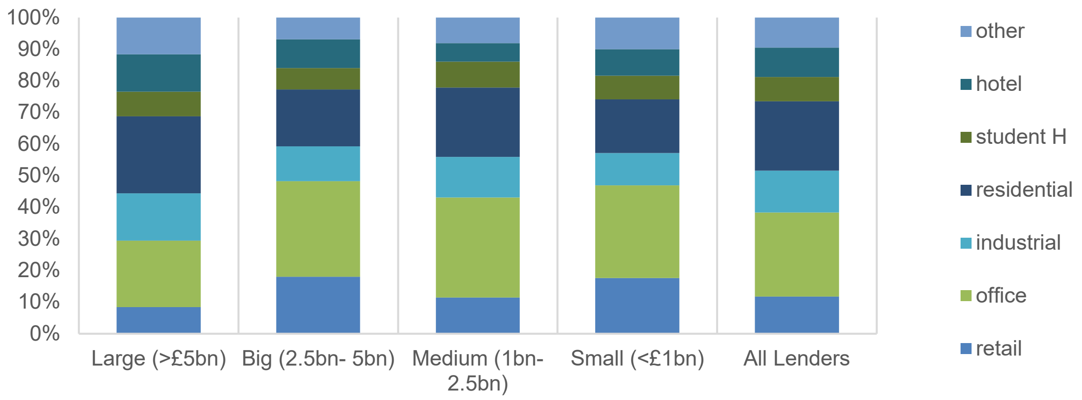
All lenders still hold retail property loans with German Banks having the highest average exposure of 17% of their outstanding loan book.

Figure 23. Outstanding loans by lender and asset type, % by value 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

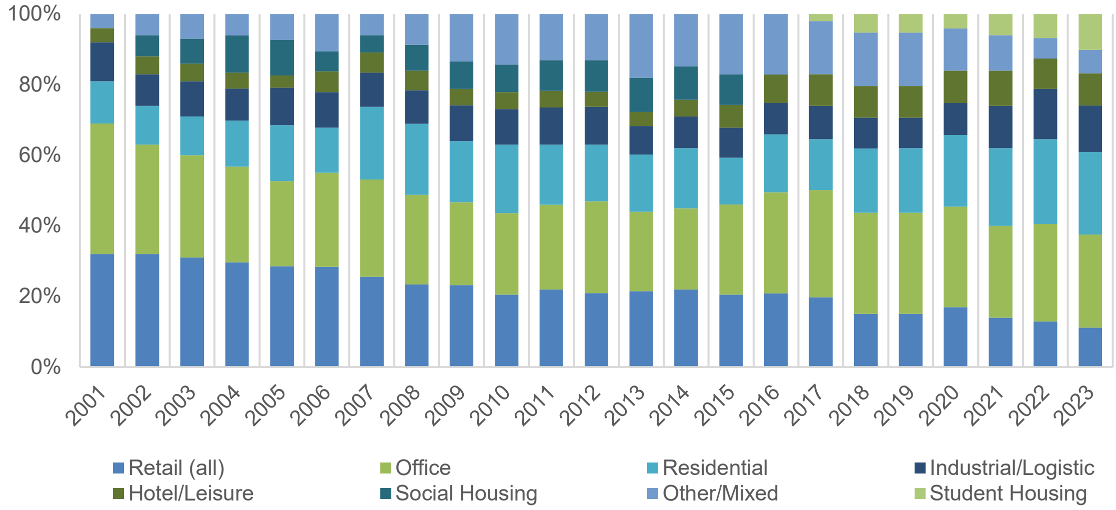
Figure 24. Outstanding loans by loan size and asset type, % by value 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

A cross-section analysis of different lenders by size of their loan books reveals that the smallest lenders are slightly more exposed to other asset classes but office. However, there is no particular lender group which is exempt from any specific asset type exposures. Overall, the loan exposure to traditional property types, in proportion to outstanding loan books has been declining in favour of alternative property types and residential loans.

Figure 25. Outstanding loans by asset type, % of book value 2001–2023

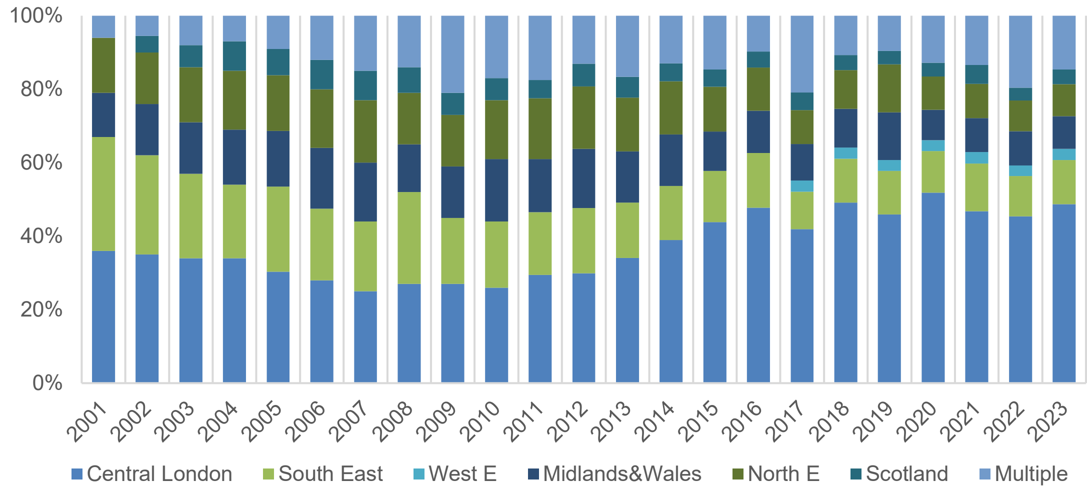


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

4.5. Regional market exposure

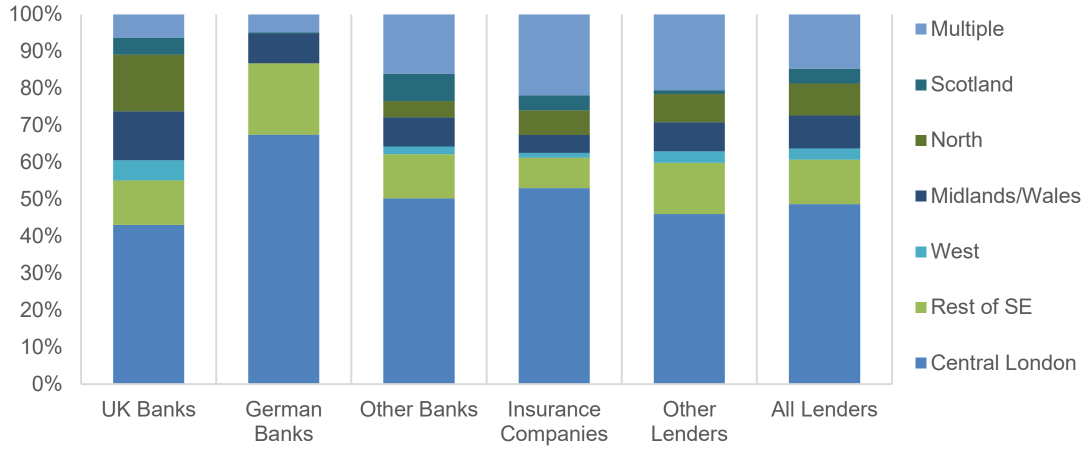
Loan exposures are still heavily concentrated on Central London and Rest of Southeast England totalling 60.7%. Historically, the weighting of loans toward Central London over time has varied with the cycle in the Central London office market, but up to 2013 ranged between 25% and 35%. North England is covered with 8.6% of loans and Scotland with 4%.

Figure 26. Outstanding loans by geography, 2001 - 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figure 27. Outstanding loans by lender type and geography, % by value 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

- Except for UK Banks and Other Lenders (debt funds) which have 43% and 46% of their loan exposure in London, other lender groups have over 50% of their loans allocated to Central London.
- UK Banks are the strongest lenders in the Midlands (13.3%) and North England (15.3%).

The exposure to the Central London market, at first glance, looks high and seems to have risen in the last five years. However, though it is not possible to precisely match the geographies used in other data sources, the Central London weighting of debt is not massively out of line with a weighting in UK investment market capital value of around 30%-35% , for example 27% in Central London offices alone as suggested by the Investment Property Forum's 2016 *Size and Structure of the UK Property Market.*

4.6. Summary

The Survey provides unique insights into the assets underlying lenders' loan books and originations, categorised by type of project, form of loan and asset location. At the aggregate level, loan books are dominated by senior debt secured by existing investment properties with small fractions in riskier development project or subordinated loans. However, the split across lender types and sizes shows strong differentiation in business models and risk exposure.

- At YE 2023, standing investment properties are collateral for 87% of outstanding loan value; development loans have edged up from a 2014 low of 9% to 13% but stand well below their peak share of 21% in 2007.
- Senior loans – with first claim on underlying collateral – dominate loan books, junior loans account for only 2.1% of outstanding debt and 1.1% of origination.

- Subordinated debt is highly concentrated among Other Lenders, which accounted for 70% - 80% of origination since 2014, supplanting the bank lenders, which previously dominated this market segment.

- Despite the continuing economic difficulties of retail properties lenders have not managed to downsize their loan books significantly over the last 24 months. Alternative asset classes such as student housing and hotels have become mainstream assets with all lender groups showing exposures.

- Residential investment assets have become the second largest asset class lenders finance after offices.

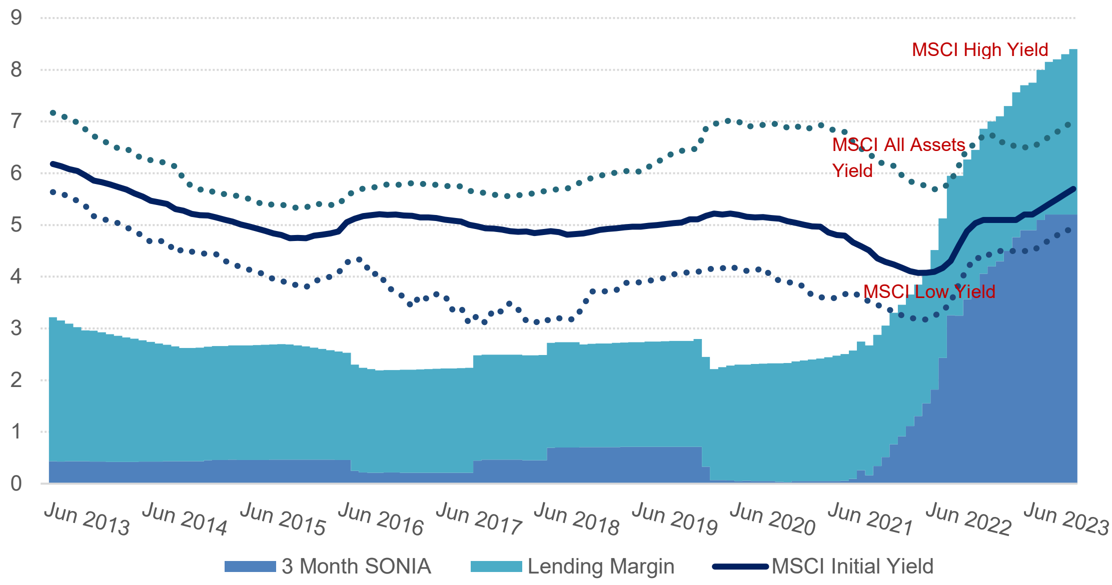
5. Underwriting – interest rates and lending terms

This section sets a framework of general trends in debt pricing followed by a detailed consideration of key lending terms and pricing margins currently sought by lenders. These are split by type of collateral.

5.1. Debt costs and property yields

Figure 26 shows borrowing costs (the total of the stacked area) for senior debt, on three months floating rate basis, based on three months SONIA plus margin. The components of that cost are the prevailing overnight rate, the Swap margin, plus the target lending margin for prime offices averaged across the respondents to the Survey at six-month intervals (the intervening months have interpolated values). The cost is set against the average current net operating income yields for investment-grade property from the MSCI Real Estate UK monthly Index. The dotted lines show MSCI yields for highest and lowest quartile-point yields in any market segment. The top yield quartile at 6.5% was in retail and the top of the low yield quartile at 4.5% for industrial properties up by 0.1% compared to YE 2023.

Figure 28. Borrowers' costs and property yields, % Dec 2013–Dec 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report; MSCI UK Quarterly Digest, Bloomberg

The reference base for hedged loans has varied over five years with:

- Flat or falling LIBOR rates from 2012 through to mid-2017.
- Between December 2021 to 2022, the BoE has increased the base rate from 0.1% to 3.5%.
- In the first half of 2023, Bank of England increased the interest rate further to 5%, the key reference rate for lenders, the 3-months Sonia remained at 5.2% at December 2023.

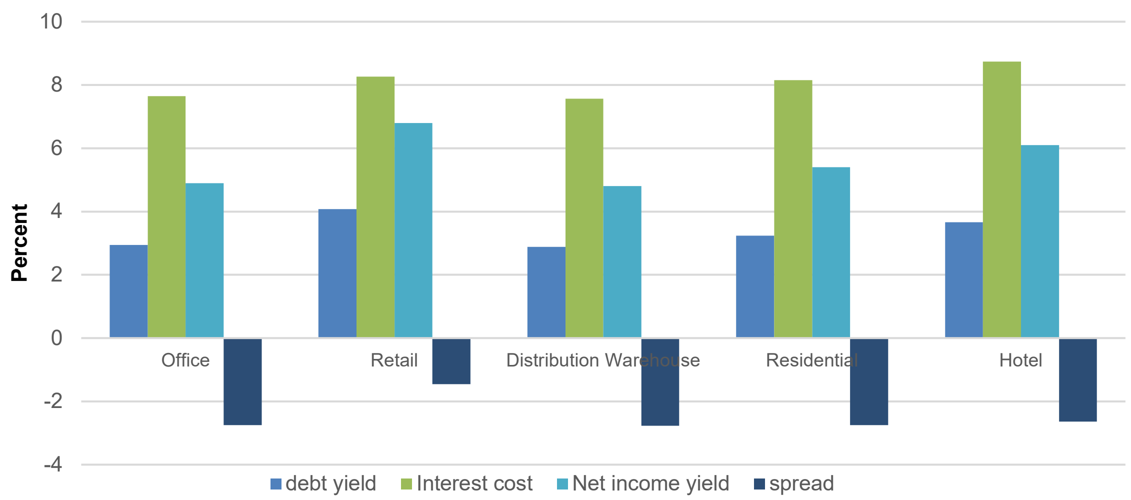
5.2. Debt yield & sustainable LTV

The Debt Yield – defined as property net income divided by the loan advance – provides an alternative to the conventional setting loans relative to capital value and the comparison of borrowing costs against property yield. The Debt Yield stands as an income-based measure of loan underwriting which avoids the potential inflation of debt with artificially low property yields or lending margins. Historically, lower debt yields (4–7%) indicate higher leverage and therefore, higher risk. Conversely, higher debt yields indicate lower leverage and thus, lower risk (8–12%). The debt yield is used to ensure a loan amount is not inflated due to low market cap rates, low interest rates, or high amortisation periods. The debt yield is also used as a common metric to compare risk relative to other loans. Given the low income yields over the past years on properties, debt yields are at overall low levels, leading to levels 40-45% below previous levels.

Figure 32 shows a generic example using real estate income returns represented by the MSCI Initial Yield. The calculation of Debt Yield is derived from:

Debt Yield = MSCI Average Initial Yield / 100 x CRE Loan LTV.

Figure 29. Debt yield by property type at 50% LTV, & MSCI yields



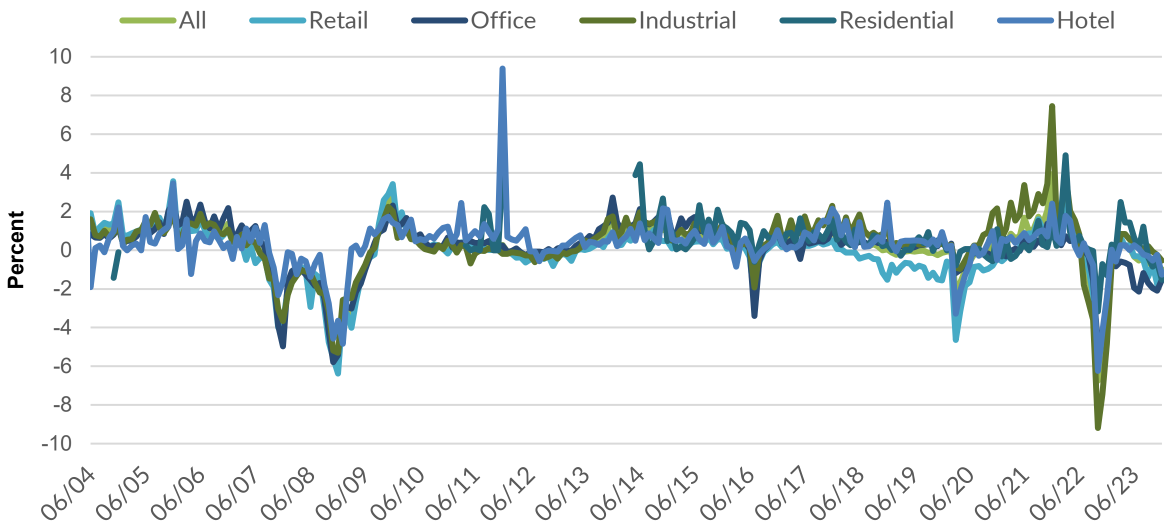
Source: Bayes Business School Commercial Real Estate (CRE) Lending Report, MSCI

Figure 29 also shows current assumed debt yield for different property types at 50% LTV.

- There is still a negative yield gap between property net income yields and loan pricing for the average property. However, for the very prime assets in each segment, debt pricing can be improved significantly and is on average 150bps cheaper than average pricing.

- Although retail assets have large repriced and now show very attractive yields including good debt yield and sufficient cash flow to pay a higher interest rate, lenders are still not looking at retail assets for lending.

Figure 30. MSCI Capital value growth by sector, Dec 2012 – Dec 2023



Source: MSCI UK index

- According to the MSCI capital growth declined between 2019 – 2020 by -3% and -6% respectively, but it recovered in 2021 with 14.2% growth.

- With rising interest rates and high inflation, the recover in 2021 was only temporary, and capital values declined in 2022 by -14.3% and a further -5.9% in 2023.

- Office property values declined for the second year in a row by -17.4% 2023 (14.6%, 2022). Value decline in industrial/logistics properties seemed to have stopped in 2023, with 0 growth or decline. Residential assets are the only sector which saw values grow by 2%.

While the latest property value growth means that LTV breaches have recovered in many cases, the rising interest rate costs are putting a new kind of pressure on the loans. Current ICR levels are now between 1.3 – 1.6x across different asset classes. After assuming another 50bps increase in interest rates, this will drop to critical levels of 1.2 – 1.5x, resulting in many covenant breaches.

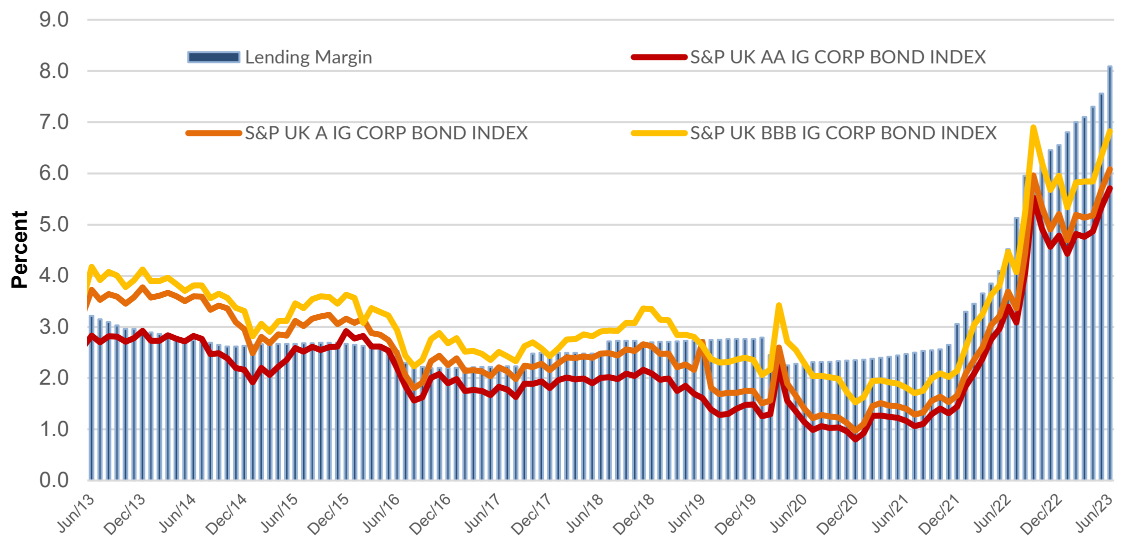
Table 7. Idealised interest rate scenario – ICRs, @50% LTV

	Total interest	Margin	Income yield	spread	ICR
Prime office	6.7%	2.7%	4.5%	-2.2%	1.3
Secondary office	8.8%	3.8%	5.6%	-3.2%	1.3
Residential	5.2%	3.2%	3.8%	-1.4%	1.5
Hotel	8.8%	3.8%	4.1%	-4.6%	1.0

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report, MSCI

The scenario assumes a 5-year loan at 50% LTV based on 5-year Sonia +margin. While property yields have already adjusted, day one ICR's still suggest to be very low at only 50% LTV loan amounts, hence further price corrections in the property market are to be expected.

Figure 31. Borrowers' cost and corporate bond yields %, 2013–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report; Bloomberg

A final point of comparison for CRE lending rates is lenders' interest income –lending margin + 3month Libor/Sonia– representing the income received by lender against BBB and A non-financial corporate bonds, as shown in Figure 35.

Up until June 2020 real estate loan pricing was below BBB corporate bonds but above AA and A rated bonds, which can be considered very tight given that most REITS only achieve ratings between A – BBB. The relationship changed again by the end of 2020 and throughout 2021 loan pricing increased, while corporate bond pricing declined. This had fuelled a new issuance of corporate property bonds especially for well rated property companies. The market changed suddenly in Q1 2022, when bond pricing increased, and bond markets remained almost shut for the remainder of 2022. In 2023, property companies have been assessing their options between issuing debt or borrowing on specific portfolios.

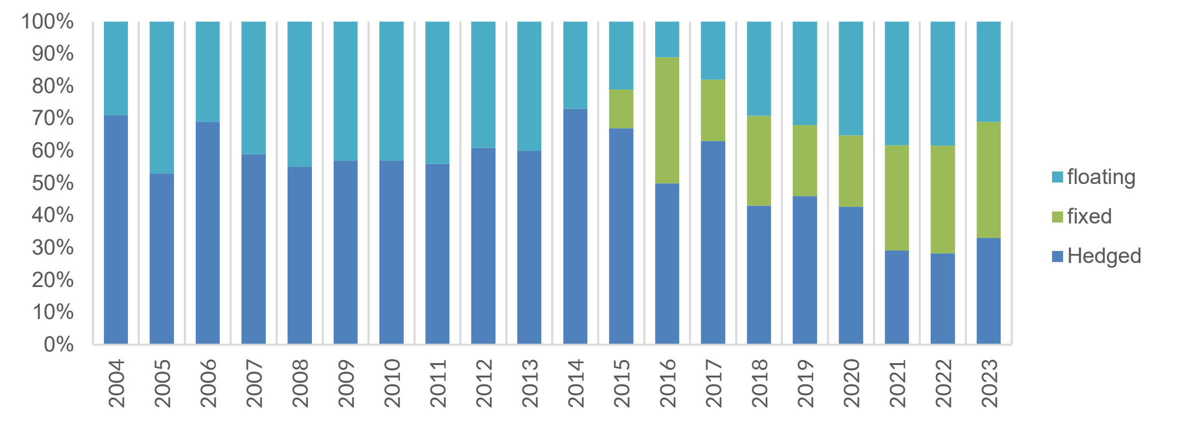
5.3. Interest rate policy & hedging

The global economy has moved from a period of long-term low Interest rate cycle to a period of consecutive interest rate increases. Over the last twelve months the BoE has increased its base rate by 400bps and to tame inflation, however its contractionary policy has dramatically increase lending costs. Since the interest rate shocks of the early 1990s which trapped many floating-rate real borrowers between rising debt costs and falling real estate asset values, it has been common for lenders to make interest rate hedging a condition of loans, or less often, to set fixed interest rates on their loans. In the post- GFC economic and interest rate market much of this had been neglected. Previous CRE Lending Surveys have shown that up to 2013 around 60% of outstanding loans were hedged with an interest rate swap or set at fixed interest to the lender but that proportion has run at a higher rate 70%-80% from 2014 on with a peak in 2016 (89%). Since 2021 more lenders have provided fixed term finance, when at the same time, hedging become less common.

Further 33% of outstanding loans are subject to interest rate swaps or some form of interest rate cap, compared to 46% in 2019. Since 2021, this shift to fixed rates loans and the decline of hedged loans using swaps has several reasons:

- Long-term low interest rate environment and market expectations on the Bank of England's monetary policy.
- Banks were being sued for miss-selling interest rate swaps, which means fixed rate loans have a lower reputational risk for them now.
- German Banks and Other International Banks typically mostly use fixed loans in their home markets, and the UK with the use of interest rate swaps was already an exception for them.

Figure 32. Interest rate basis, % by value of outstanding loans by loan book size, 2023



Source: Bayes Business School Commercial Real Estate CRE Lending Survey

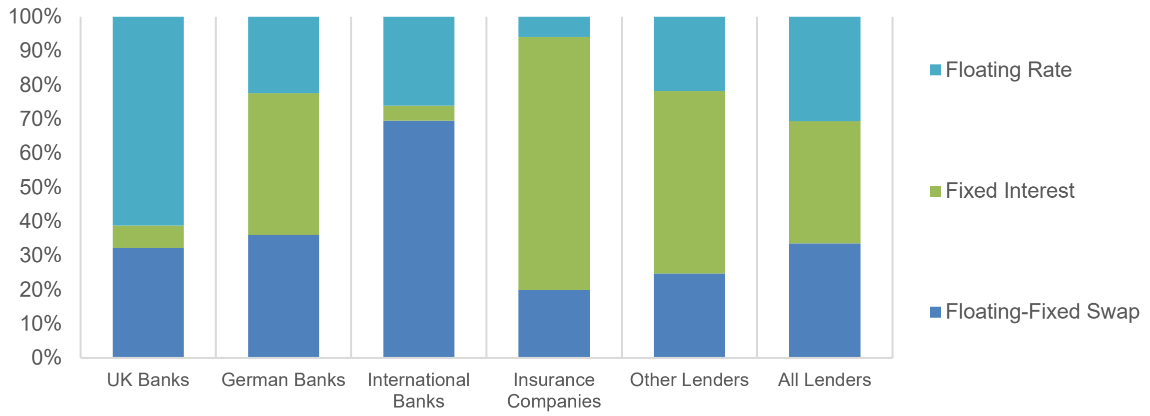
The December 2023 survey shows, overall, 33% of loans are again subject to interest rate swaps or some form of interest rate cap, compared to 27% in 2022. This is an increase for the first time after dropping sharply in 2021 from 42% in 2020 to 29%. In addition, 36% are at fixed lender interest and leaving 31% at fully floating rates to the borrower. This shift to fixed rates loans and the decline of hedged loans using swaps has several reasons:

- Long-term low interest rate environment and market expectations on the Bank of England's monetary policy.
- Banks were being sued for miss-selling interest rate swaps, which means fixed rate loans have a lower reputational risk for them now.
- German Banks and Other International Banks typically mostly use fixed loans in their home markets, and the UK with the use of interest rate swaps was already an exception for them.
- Having two sides of a deal – fixed swap (for the borrower) and a floating rate leg was an advantage for CMBS issuances, where the bonds were mirroring the floating rate leg. With less CMBS transactions, there is less need.
- Loan pricing since 2020 is based on three months Sonia rate as a reference rate or the corresponding 5-year Sonia swap rate for hedged loans. Most of the fixed rate loans have been agreed before 2022 since the fixed rate loan market is currently on hold as constantly increasing interest rates and changes in monetary policy make it difficult for lenders to price new loans.

As shown in Figures 36 and 37 interest rate policies vary widely across lenders of different types and sizes. Figure 37 shows the percentage of loans in the three categories for the period 2004 up until December 2023. Low interest rates encouraged borrowers to use floating rates and not to use any hedging. The market expectations about inflation and interest rate resulted in an increase in use of fixed rates, which now is one third of the total book.

- Bank lenders with an in-house capability to arrange swaps are most inclined to apply Swap hedging but there has been a shift in bank behaviour. Since 2019 the use of swaps by German Banks has declined from 80% of the sample to 36% in 2023. Instead, German Banks have increasingly been offering fixed loans as well, which is standard in Germany. These now account for 42%.
- UK Banks have also changed from 52% of loans with swaps in 2020 to 32% in 2022 remaining stable in 2023. Instead, they have been increasing their lending to floating rate loans. (61%).
- Insurers and Other Lenders rely mostly on fixed interest lending terms 74% and 53% respectively. Other Lenders have shifted from fixed rate to floating rate loans, reporting now 22% of their exposure as floating rate. For insurers, only 6% are floating rate loans.
- Overall, borrower have been asking for 5-year fixed or swap rates again, since shorter rates are currently more expensive (3-month Sonia = 5.2% versus 5 year Sonia swap 4.9%).

Figure 33. Interest rate basis, % by value of outstanding loans by lender type, 2023



Source: Bayes Business School Commercial Real Estate CRE Lending Survey

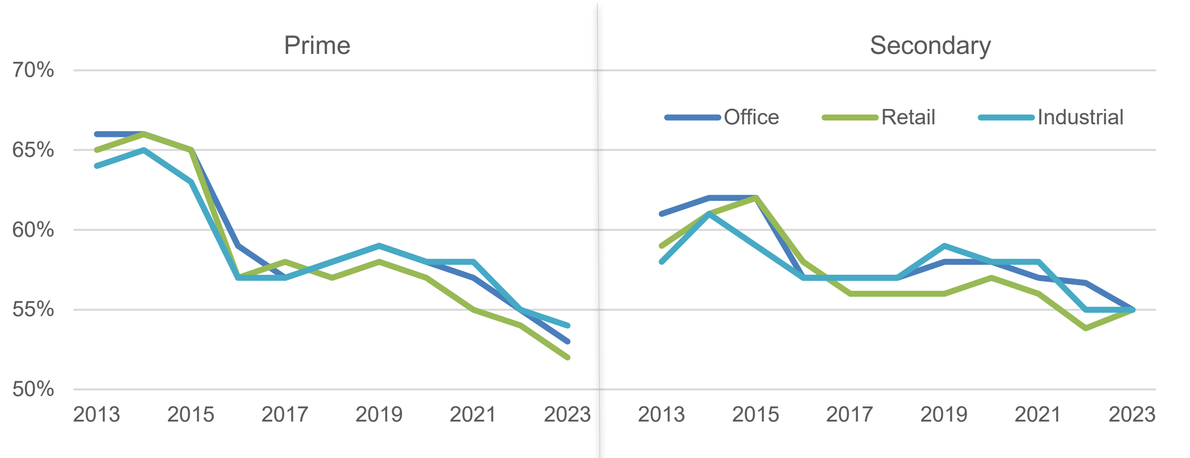
5.4. Target LTV and lending margins

This section details lending terms over time across types of projects, property type and quality. Respondents are asked the maximum Loan-to-Value ratio they currently set on new loans (and Loan-to-Cost for development projects) together with their target lending margins over Libor and fees. From July 2020, the basis of lending margins has also been changed to 3-months Sonia. Quoted margins are provided over Sonia. Not all respondents are prepared to quote pricing terms.

For December 2023, the analysis is based on returns from 53 lenders who provided terms across a range of the categories requested. As would be expected, more lenders state terms for prime property, while responses on secondary property and development lending come from the smaller numbers who lend in those segments of the market. It should be borne in mind that the terms quoted are general lender targets and not the finally agreed terms, which will vary loan by loan with the borrower and asset-specific circumstances.

Regarding Loan-to-Value ratios across property types, there has been little differentiation between sectors since 2010. The overall cut in prime LTVs post-GFC and convergence across sectors may be the outcome of several factors pushing in the same direction. Perhaps foremost is regulatory pressures on bank lenders through international Basel standards and the somewhat more stringent UK Slotting rules, which broadly require higher capital reserves against loans above 60% LTV. Only non-bank lenders in the market are free from this restriction and may more often offer higher LTV's. Figures 38 and 39 plot the headline LTV and margin terms since 2012.

Figure 34. Average of maximum senior loan to value ratio by property sector, % 2011–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

- Across property sectors and grades, the average LTV ranges from 53%-56%, which for prime property especially represents a reduction from the levels prior to 2015, and of course, a more radical change from the 80% senior prime LTVs, which were the norm before the GFC.
- Since 2019 LTV ratios have reduced by 4 – 5% ppts depending on property type. This represents a structural change in lending behaviour across all lenders. In comparison there was a brief period of stability between 2016 – 2019.
- Especially prime office and retail properties have reached historic minimums with regard to day one approved LTV ratios, with only 53% and 52%.
- The highest loan amounts of 56% LTV are available against residential investment properties followed by student housing properties with 55% LTV. However, there are lenders in the market lending generally providing whole loans up to 75% against any property type.

Loan Margins: When turning to target lending margins there is a principal point of contrast between grades of underlying assets:

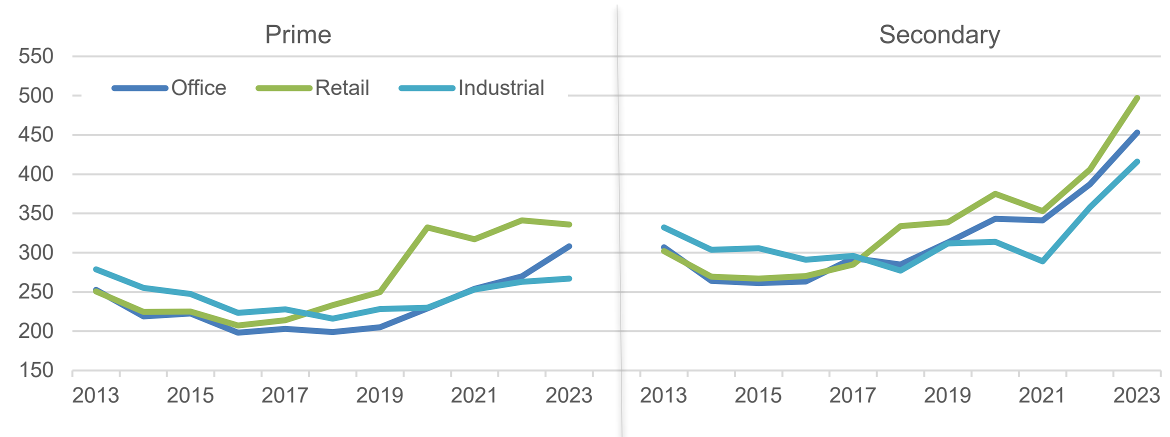
- Across property types, the previous cycle peak was reached in 2012 (prime office 324bps). Between 2013–2016 margins declined, reaching a new low in 2016 (prime office 198bps).
- Generally lending margins across all asset types have been increasing since 2016. Prime office margins have changed to 275bps in 2023 from 198bps in 2016, and they increased by 5bps between 2022 and 2023.Typical borrowing costs have edged upby 105bps for prime office since 2016, which is an increase of 63%. Pricing on prime retail loans increased by 59% (122bps). The least increases were noted for prime logistics where the loan price increase was only 39bps.
- By the end of 2023 prime office pricing reached 275bps and prime retail pricing was 336bps. For the first time prime logistics loan pricing was lower at 267bps. Lenders overall pricing terms show the clear preference of logistics properties over other property types such as office or retail. Especially office properties have lost attractiveness and lenders no longer believe that they provide a stable value and income basis.

- Loan pricing against secondary property types is generally 100bps wider than against prime. Also, amongst secondary property loan pricing, logistic assets attract the lowest loan terms.

- After three consecutive annual increase in loan pricing for residential properties of 241bps in 2020 to 292bps in 2021 and 324bps in 2022 (+11%), in 2023 pricing finally remained stable. Residential property loan pricing is generally wider reflecting the wide quality range of residential investments as well as lender diversity in this segment.

- Average margins for hotel property had further increased from 368bps to 393bps between December 2021 and 2022, but due to the positive economic results for the hospitality sector, lenders have renewed their interest in hotel property lending and loan pricing has reduced by 9pbs y-o-y.

Figure 35. Average senior lending margins by property type bps, 2021–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

- There is an increased dispersion of loan pricing amongst different lender groups, with German lenders offering the most competitive pricing terms for prime office and logistic properties with 189bps and 187bps, however their interest in secondary property drops significantly and their lending appetite is generally low.

- German lending margins are followed by insurance companies, which price only 30 – 40bps higher, however, they appetite in secondary properties is equally low and better pricing terms are offered by Other International Banks, when it comes to secondary properties.

- Non-bank Lenders (debt funds) typically still price their property loans 100 – 120bps higher across all property types than banks.

- Amongst UK Banks, lending terms are the most diverse, due to the differentiation between local/regional banks and large commercial banks. When considering large commercial UK Banks only, their loan pricing for prime property with 224bps is competitive across other bank lenders, however, regional banks on average show a pricing of 309bps. Hence, regional UK Banks pricing terms are on average 120bps above other bank lenders.

Amortisation: despite low LTV levels, depending on the property type amortisation will be included in the financing terms.

- Only 13 lenders require amortisation as part of their loan terms. Other lenders offer interest only loans. Typically, amortisation is between 1% - 2% p.a.
- Regional UK Banks often require 15 – 25yr full loan amortisation.

For prime property in particular, low initial yields and income returns mean that lenders setting terms primarily with an eye to debt service coverage ratios and debt yields. While loans against secondary property with higher yields providing more headroom than prime assets for lending to maintain strong levels of interest cover.

A total of 39 lenders have quoted margins for prime office compared to 28 for prime retail. There was especially further reduced appetite for financing secondary properties from non-bank lenders as well as bank lenders.

Table 8. Margin quotes received by type of asset

	Lenders YE 2022	Banks	Other Lenders	Lenders quoting YE 2023
Prime office	40	23	16	39
Prime retail	26	14	14	28
Secondary office	24	12	7	19
Secondary retail	11	9	2	11

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Borrowers, who wanted to find financing for secondary retail property loans still find very low availability with only 11 lenders still quoting margins in 2023, up from 9 in 2021. On existing loans, many lenders would structure the available cash flow to accommodate a rate of interest that left a surplus that could be taken in a full cash sweep to amortise the outstanding debt. A fee would be charged for the process of extending or restructuring a loan which would vary considerably between deals. Above 55% LTV lenders generally apply some form of amortisation which leaves them with an exit at 50–55% LTV. However, the increase in interest rates have left many loans breaching ICR/DSCR covenants, with no extra cash.

Table 9 provides additional detail on senior lending terms and Table 10 the same metrics for junior loans. Especially margins for logistics/industrial property continue to be very competitive. ‘Last mile’ logistics assets have been highly sought after by investors as a result of the structural shift towards ecommerce and constrained supply as assets in infill locations are taken offline for higher value alternative uses. Cultural factors such as high credit card usage and a highly digitally literate consumer base will continue to support a growing UK logistics infrastructure, making it an attractive asset class for investors as well as lenders.

Table 9. Senior debt – target lending terms by property type, December 2023

Property type	Average LTV %	Average Margin bps	Diff from 10 Year Avg bps	Arrangement fee bps
		Prime		
Office	53%	275	+45	121
Retail	52%	336	+70	127
Industrial	54%	267	+22	116
		Secondary		
Office	55%	380	+67	141
Retail	53%	383	+58	155
Industrial	55%	365	+52	129
Residential	56%	325	+62	116
Hotel	54%	384	+35	124
Student Housing	54%	279	+49	101

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

In 2023 the industrial/logistics sector continues to be seen as one of the most resilient real estate assets in the context of positive underlying market fundamentals, underpinned by limited supply and strong occupier demand. The other resilient property class has been residential property followed by student housing. Here inflow of debt is especially present in the residential development lending segment.

- Due to many new market entrants in the alternative lending sector, the range of available junior loan financing has been extended. The average LTV for prime office loans is at 64%. The lower cut-off for senior lending allows lenders to price whole loans and junior loans not only higher but also increase the loan portion of the junior loan.
- Especially pricing for junior loans against secondary office and logistic assets remain high with 12% and 11% respectively. In the case of offices this seems to reflect the concerns of lenders about the quality and sustainability of many office properties and the need for additional capex required. For logistics properties, it reflects the higher risk portion of the junior loan with higher LTV against an already overpriced asset class hence, very low debt yield.
- Starting LTV ranges for loans against secondary property types are also amongst the lowest starting from 52% LTV for secondary retail and 59% for secondary logistics, showing the low debt capacity of the prior ranking senior loans.
- Many lenders have also increased their arrangement fees to increase their overall returns.

Table 10. Junior debt – target lending terms by property type, December 2023

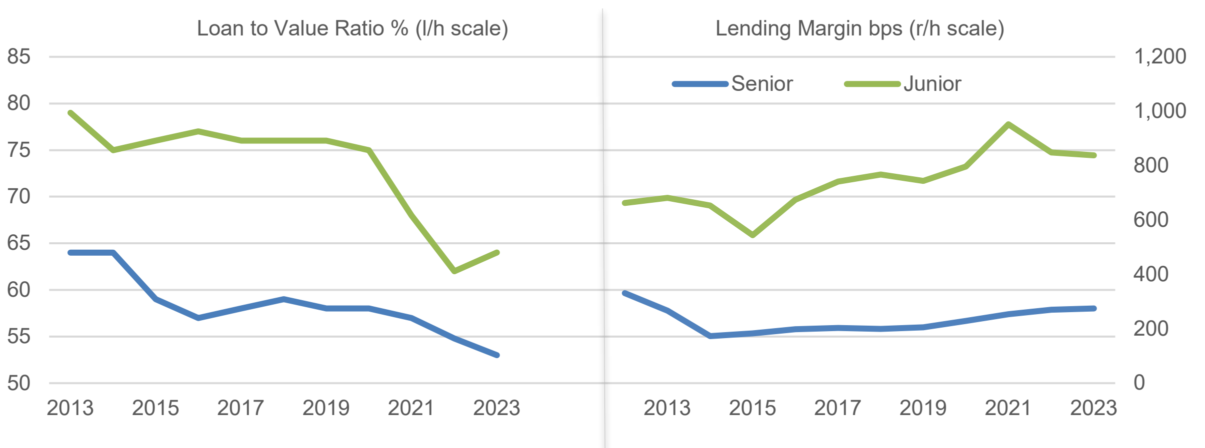
Property type	Average LTV %	Average Margin bps	Diff from 2022	Arrangement fee bps
		Prime		
Office	64%	838	+69	138
Retail	63%	826	-21	137
Industrial	66%	735	+12	134
		Secondary		
Office	60%	1212	+53	140
Retail	52%	750	-79	133
Industrial	59%	1102	-54	128
Residential	64%	988	-17	138
Hotel	60%	853	-23	116
Student Housing	60%	846	-6	116

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figures 40 and 41 track prime and secondary, senior, and junior loan terms back to 2012.

- For junior lending, target LTVs for prime and secondary assets have settled at around 76% since 2010. They reached a low point in 2016 but slowly increased again after that. There is a clear drop in junior LTV levels to allow lenders to increase the junior portion and reflect higher risk pricing.
- Due to the current macroeconomic uncertainty LTVs in junior loans have continued to decline from 2019 to 2023 following the same trend as senior loan LTVs.

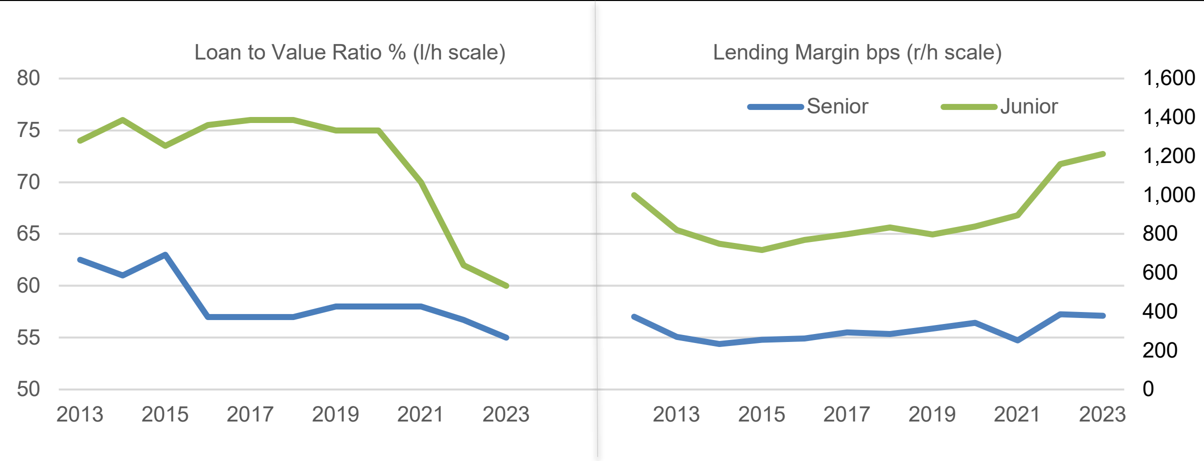
Figure 36. Prime office - target lending terms for senior and junior loans, 2011–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

More significant differences have been detected in loan pricing between different lenders depending on the size of their loan books and type of lender origin.

Figure 37. Secondary office – target lending terms for senior and junior loans, 2011–2023

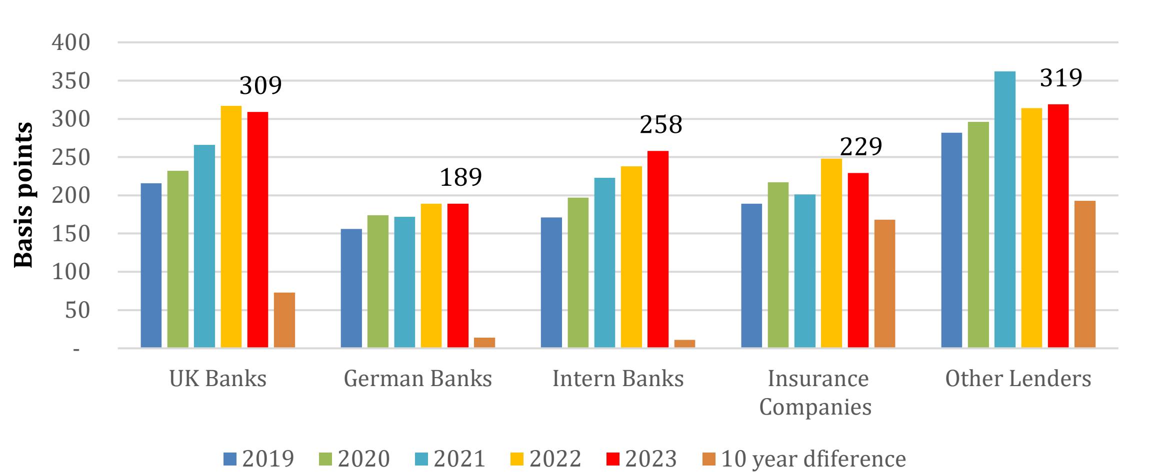


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Over the past two years all lender groups have been increasing their lending margins, however German Banks and Insurance Companies remain the most competitive in the market. The sample of non-bank lenders has experienced large turnover of participants and new debt funds being raised.

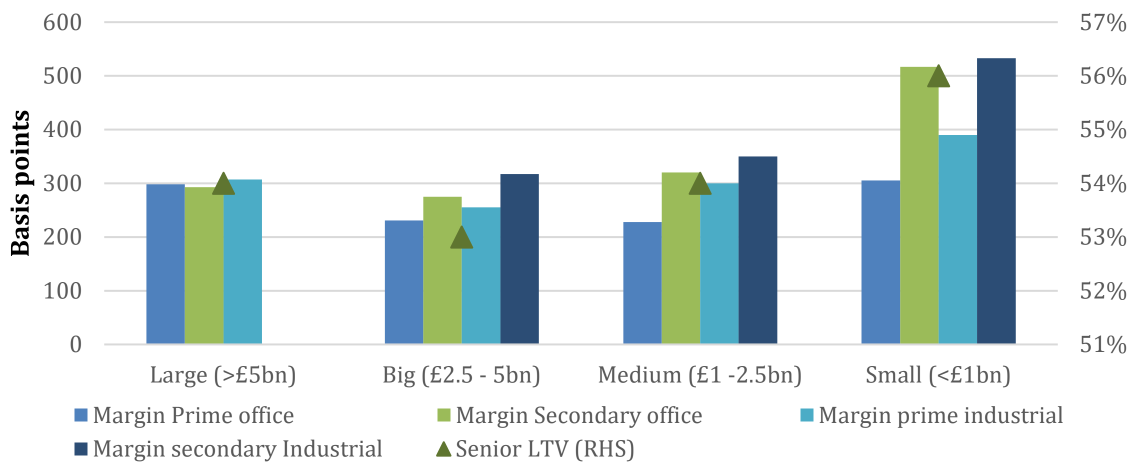
When considering the size of lenders loan books, loan pricing of lenders with loan books >£5bn used is amongst the highest with 377bps for senior office properties. In comparison the larger commercial banks offer the same for 22bps and the same LTV level. With regards, to secondary assets, lenders with total book above £2.5bn offer financing between 250 and 330bps, whereas small lenders' margins above 500bps.

Figure 38. Prime office lending margin by lender (basis points)



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figure 39. Prime office lending margin by lender loan book size (basis points)

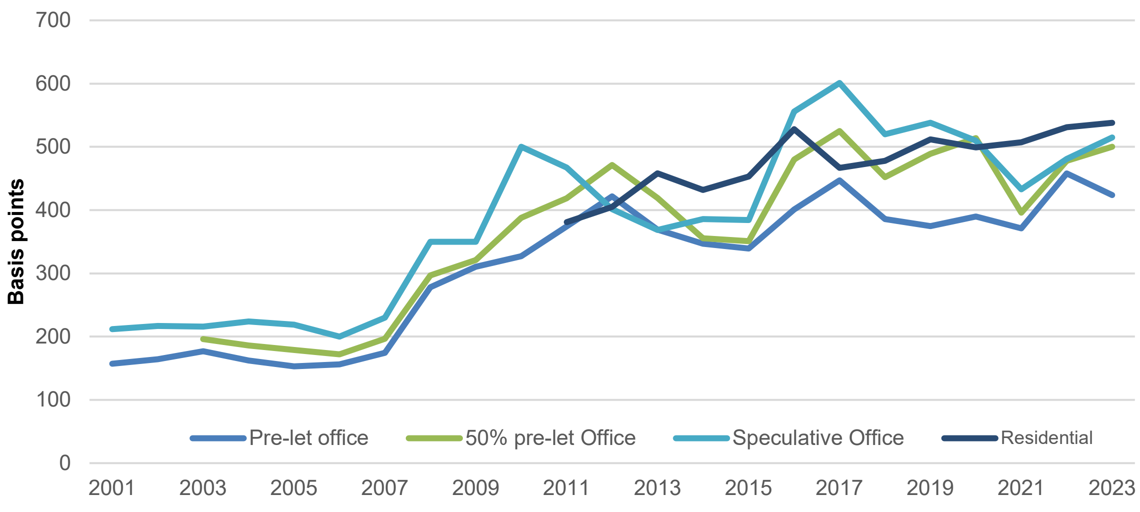


Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

5.5. Development loans

Only a minority of lenders are active in or targeting development lending, even fewer in speculative schemes. Therefore the 2023 quotations on terms in this section are based on 19 (22 in 2022) lenders providing pricing for commercial developments and 36 (29 in 2022) lenders providing terms for residential development.

Figure 40. Target senior lending margins for development loans bps, 2001–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Development lending, expressed in terms of lending margins, has followed a different path from the investment lending described in the last section:

- Over the last years, target margins for any type of development finance remain high, not only against the 150-225bps margins prevailing before 2008 but also against the low point reached in

2015/16. At year-end 2023 margins development finance pricing increased slightly over 12 months, but development pricing appears to be more stable than investment financing. Margins for residential developments and pre-let commercial development remain at a 20-year peak.

- For pre-let commercial development was on average 424bps, slightly lower than end of 2022 with 458bps and partially pre-let was available and an average of 500bps (a 22bps increase).
- Speculative development remains more expensive at 515bps compared to 481bps in 2022.
- Residential development finance has been offered by a changing range of market players. Only half of the lenders active in 2023 were banks, the rest were Insurance Companies and non-bank lenders. The average margin provided was 538bps, with banks starting from 350bps and Other Non-Bank Lenders at 607bps.

Table 11 gives a broad view of current development lending terms.

- Judged by the number of lenders providing information, there was no change in lenders willingness to contemplate development finance in 2023.
- There is more liquidity again in pre-let commercial development lending and also even for speculative schemes.
- Arrangement fees range from 100bps to 150bps upfront, with another 100bps – 200bps exit fee.

Table 11. Average senior lending terms for development loans, December 2023

	Lending margin bps	Arrangement Fee bps	Loan to Cost Ratio %	Lenders quoting Dec 2022	Lenders quoting Dec 2023
Commercial pre-let	424	128	58%	22	19
Commercial 50% Pre-let	500	129	61%	12	12
Commercial Speculative	515	136	57%	12	10
Residential	538	112	62%	29	33

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Tables 12 and 13 offer additional details about terms for senior and junior lending across different lender groups. Any development finance from Other Lenders (Debt funds) is priced above 500bps, while bank financing is available from 300 – 460bps depending on the status of pre-let vs spec. development.

Junior finance can almost only be sourced from debt funds. Banks may occasionally provide higher LTC financing in the form of whole loans and additional drawdowns if the borrower already has a development loan from the same bank.

Table 12. Senior lending terms for development loans, December 2023

	Pre-let dev LTC	Margin bps	50/50spec LTC	Margin bps	Spec LTC	Margin bps	Resi dev LTC	Margin bps
UK Banks	69%	417	63%	438	N/a	N/a	69%	508
German Banks	60%	325	50%	350	50%	350	55%	350
Intl. Banks	50%	385	45%	425	45%	575	52%	362
Insurance Companies	48%	355	45%	300	47%	385	50%	388
Other Lenders	59%	470	57%	556	56%	572	63%	607
All Lenders	57%	424	55%	500	53%	515	61%	538

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Loan packages for development schemes, especially those from debt funds, are typically more complex and bespoke than for investment properties, making terms difficult to summarise and compare. On junior loans, lenders will use a combination of lending margin, arrangement fees, exit fees and perhaps some form of conditional participation in profit to arrive at target returns. For this reason, terms are also expressed as IRR, where sufficient responses were given. For senior development finance, target IRRs on pre-let commercial schemes stand at 9%-18% and for residential development at 10-18%.

Table 13. Junior lending terms for development loans, December 2023

	pre let dev LTC	Margin bps	50/50spec LTC	Margin bps	Spec LTC	Margin bps	Resi dev LTC	Margin bps
Banks	58%	739	58%	731	58%	731	58%	769
Other lenders	62%	644	68%	725	68%	775	65%	747
All Lenders	60%	765	60%	730	60%	740	63%	756

Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

5.6. Summary

The current terms applied by lenders have adapted to the changes in regulatory frameworks and persistently low interest rates of the last decade. Actual loan margins have started increasing slowly since 2015/16 due to several economic and political conditions and the increase of interest rates after a long sustain low interest rate cycle.

- Typical lending margins have reached a turning point in December 2016 (trough) and have been rising over the past six years, with increases of 18% - 64%. The sector with the least loan price increase has been prime and secondary logistics.

- 2023 was marked by low new debt volumes, uncertainty of property valuation, falling property values, and increasing interest rates, which has made lender very cautious about new loans, hence in the sectors lender have been able to demand relatively high loan pricing.
- Coupled with increasing loan margins, lenders have also been increasing arrangement fees, and further lowered their loan amounts, day one LTVs.

6. Loan book quality

This section reviews the long-term cycle and process of normalisation in loan books and summarises current lenders' risk exposure indicators in December 2023.

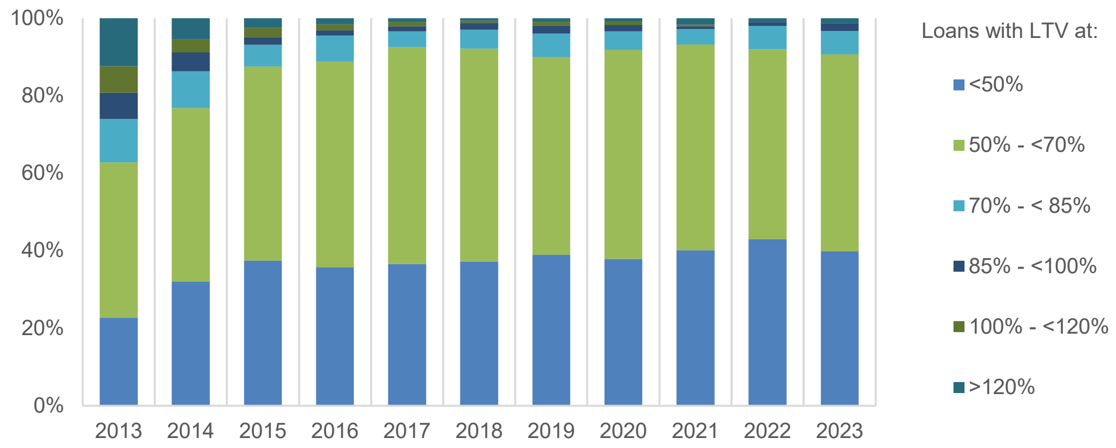
6.1. Loan book risk

On standard underwriting metrics, the status of loan books has improved enormously from the low points of 2010-2012, with LTVs suggesting good coverage against any dip in capital values. However, many covenant breaches have been recorded over the last 6-12 months, but as valuations are being delayed, lenders take no further actions so far.

- Since the previous GFC, banks have been writing loans with maximum LTV ratios of 50–60%, so their risk is considerably lower than in 2007/08. However, some financing structures have used higher leverage.
- In 2023 property values declined by another 5.9% on average across asset classes. While LTVs are always slow to change, new valuations will reflect adjusted LTV levels going forward.
- UK Banks have the largest share of loans (86%) below 60% LTV due to their strict capital requirements. A total of 54% of their total book is below 50% LTV compared to German banks which are more likely to lend up to 60% LTV. They have reported 34% of loans with an LTV above 60%.
- Other Lenders reported more loans above 60% LTV (54%). Insurance Companies have remained very conservative with 71% of loans below 60% LTV.

Figures 41 and 42 track the two key indicators of loan quality – current LTV and Interest Rate Cover (net income from asset divided by debt interest due).

Figure 41. Outstanding loans by LTV band, % of book value 2013–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

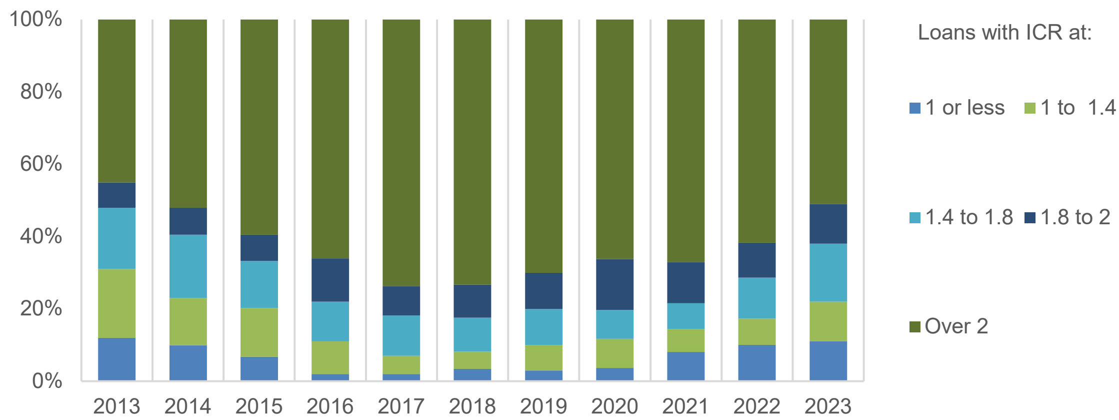
- On both LTV and ICR indicators, loan book security rose steadily from 2013 to 2021 with the proportion of loans standing above 70% LTV falling from 37% to only 6.7%. However, at YE 2023 this proportion reached 9%.

- ICRs have started falling for the first time since the GFC in 2021 and the percentage below 1.4x was 14% and rose further to 17% in 2022 and reached 22% in 2023. Lenders have noted that the times of >2x ICR levels are a feature of the past given the level of interest rates and hence, covenant levels are quickly becoming more important again.

- Only 51% if all loans held on lenders balance sheets are now reporting an ICR level of >2x at the end of YE 2023, from previously 66% in 2022. UK Banks and Insurance Companies are reporting levels above this average, with 75% of 70% of outstanding loans.

- Other lenders reported 52% of their loans have ICR levels of 1.1 – 1.4x only.

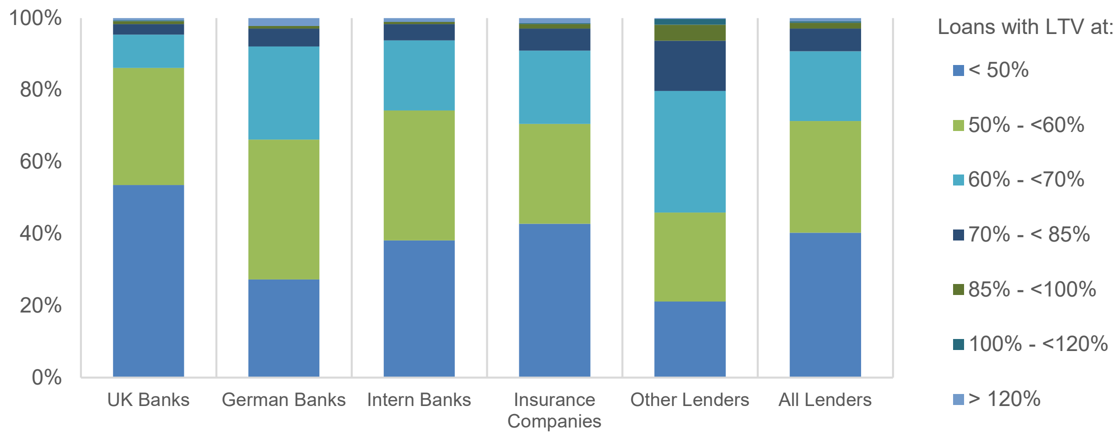
Figure 42. Outstanding loan by ICR band, % of book value 2013–2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

- German Banks reported 38% of their loans have an ICR level of 1.4 – 2x and another 55% are above >2x. Hence, they have little concerns about interest coverage.

Figure 43. Outstanding loan % of value by loan LTV band and lender type, 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

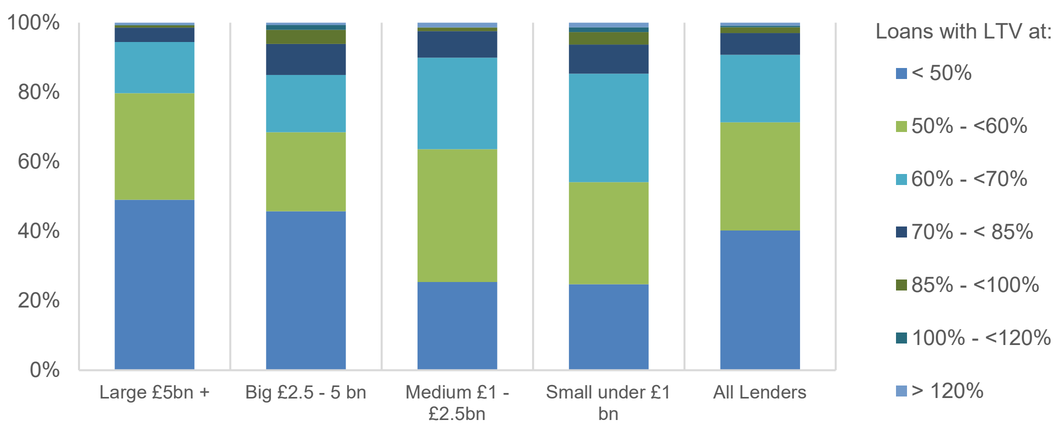
- The largest lenders in the market show the lowest risk profiles in terms of LTV ratios of their outstanding loan book. In 2022, 86% of their loan book was below 60% LTV. This share drops for big and medium sized lenders to 71% and 73%.

- In comparison smaller lenders hold 41% in 2022 (48% in 2020) of their exposure in loans above 60% LTV. Hence, overall, they have a now a slightly higher proportion of loans below 60% LTV accounting for the majority of their book (59%). However, they are the lender group with the lowest share of loans below 50% LTV (27%).

- Because smaller lenders are the ones with higher LTV lending on average, their proportion of loans above 2x ICR is also the lowest with 41%, compared with large lenders which have 75% of loans above 2x ICR.

- Small lenders reported 30% of their loans have a performance of below 1.4x ICR.

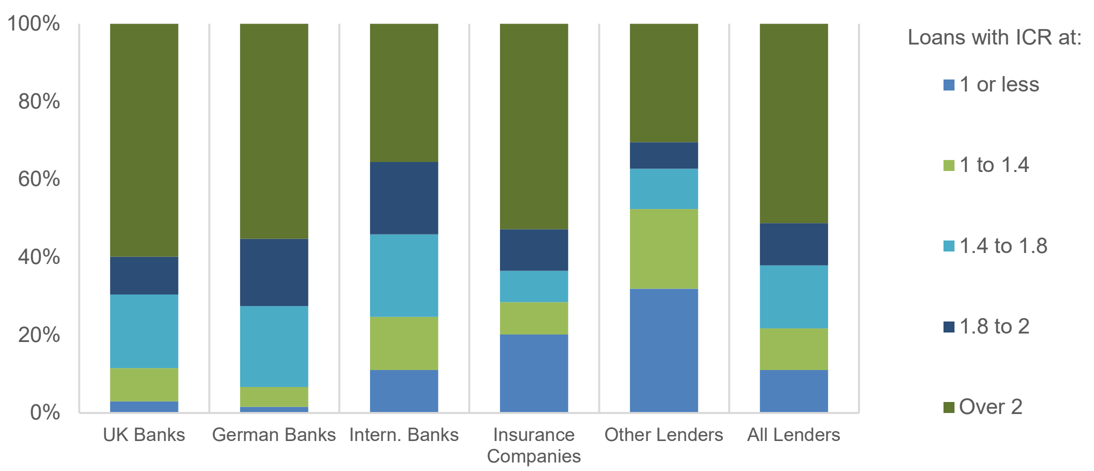
Figure 44. Outstanding loan % of value by loan LTV band and lender size, 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

These differences in loan book security are, to an extent, matched with current lending policies. Given their freedom from the regulatory constraints applied to bank, and in some cases higher target returns to investors, the debt funds classed as Other Lenders have a higher tolerance for subordinated and development loans at higher LTV's.

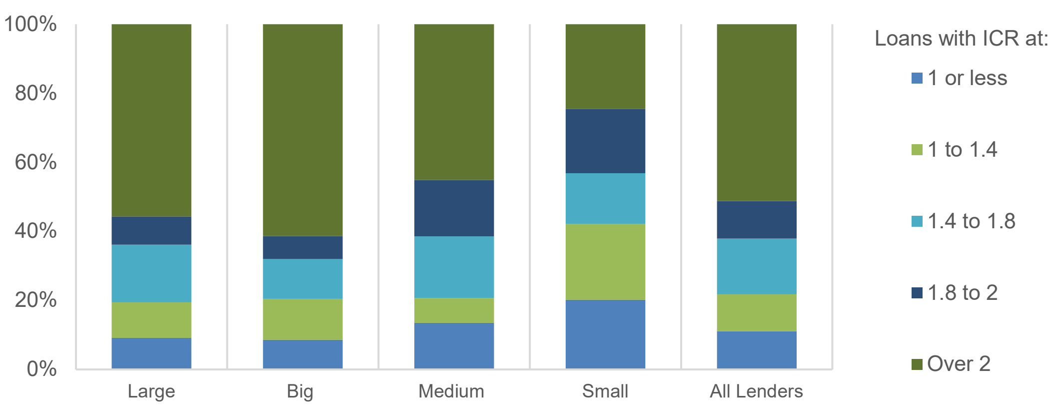
Figure 45. Outstanding loan % of value by loan ICR band and lender type, 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

The 2023 figures also show substantial variation in loan book security across lender types and size (Figures 49 and 50). By lender size, lenders with largest loan books report most of the loans with ICRs above 2.0x.

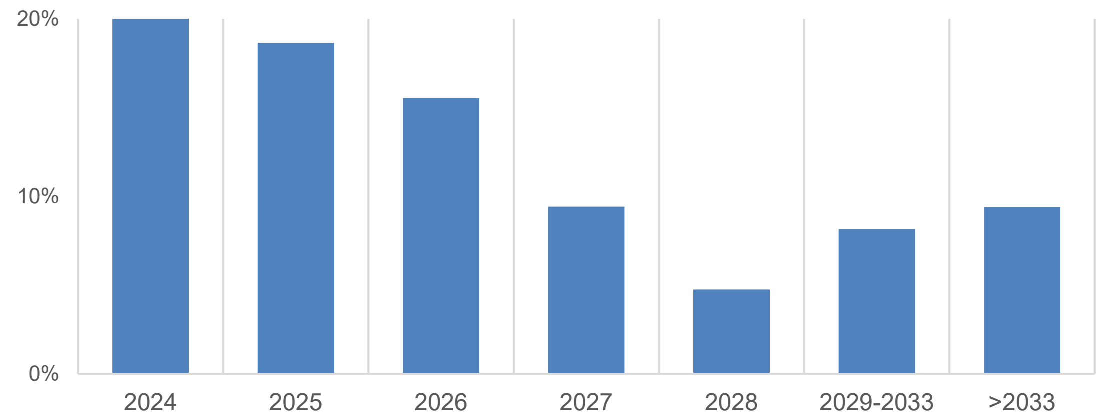
Figure 46. Outstanding loan % of value by loan ICR band and lender size, 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Report

Figure 51 gives the maturity profile of outstanding loan books as of 31 December 2023. A small number of respondents were not able to provide a breakdown however, the information provided is based on data covering 54% of survey participants.

Figure 47. Maturity profile of outstanding loan books



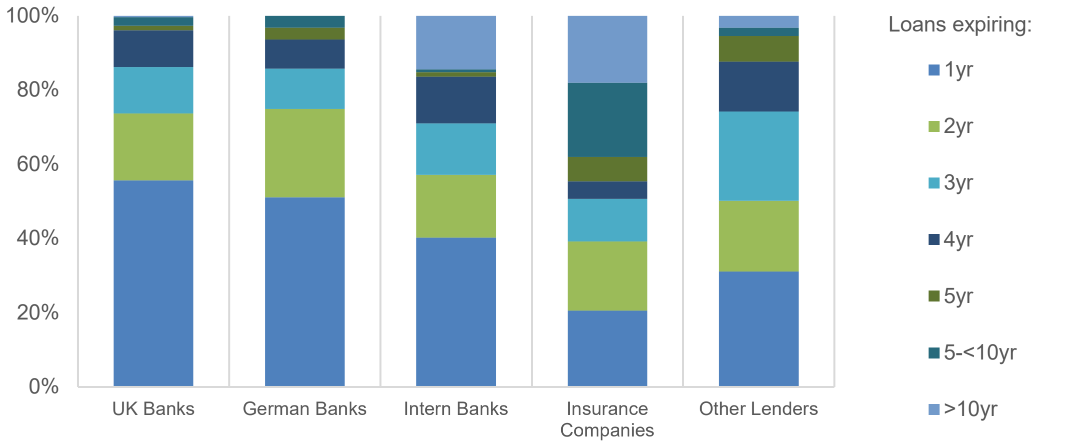
Source: Bayes Business School Commercial Real Estate (CRE) Lending Survey

During the next five years between 2024 and 2028 inclusive, approximately 82% of all outstanding debt is due for repayment. In comparison in 2018 approximately 78% of all outstanding debt was due for repayment during five-years. This trend has been growing of the last three years and is significantly higher than the proportions recorded by this research in previous years and before the GFC, for example, at year-ends 2006 and 2007; the proportion of debt due to mature within the following five years was 61% and 60% respectively and shows the short-term nature of the real estate finance market. The weighted average maturity (WAM) of most lenders' loan books is less than three to four years.

Results have already addressed the high amount of refinancing activity during 2023, however the high amount of maturing in 2024 (34%) is the result of some short-term extensions in 2022-2023 combined with maturing loans which were originated in 2019/2020. Overall, about 68% of outstanding debt has to be refinanced in the next three years.

The cross-section analysis by type of lender provides more detail of the maturity profile of specific loan portfolios. The only lenders with significantly longer dated loans are insurers with 38% of the loan book to have maturities over 5 years. UK and German Banks have 86% of their loans mature within the next 3 years (2026). Other Lenders have 74% of their loan book coming up for refinancing.

Figure 49. Maturity profile of outstanding loan book by lender type, YE 2023



Source: Bayes Business School Commercial Real Estate (CRE) Lending Survey

7. Conclusion

Lending activity in 2023 has declined -33% year on year and was one of the post difficult years post the GFC.

- The quality of loan books shows a divide between lenders with large loan books and those with smaller loans book. Smaller lenders are writing loans with higher LTV's and are more at risk of upcoming loan defaults due to increased interest payments. In fact, smaller lenders show on average default rates 3x as high as larger balance sheet lenders.

- The key reason for the slow movements of default rates, overall loan book LTV, interest cover ratios is primarily due to loan hedging arrangements, this will always lead to a time delay to what is observed current refinancing problems. Every year approx. 20% of loans on lenders' books tend to mature, but not all will go to term, some are financed early, while others might be able to postpone refinancing for another 12 months.

- Smaller lenders are also less likely to refinance existing borrowers, they typically receive most of their lending from new acquisition financing. In general, it is no longer sufficient for a borrower to work with their 10 – 15 lender contacts. All lenders are now highly specialised, some lending to transitioning assets and higher LTV with capex loans, other are specialised in hotel lending, residential development or other. The type of lender also varies with the life cycle and holding period of the borrower.

- Current lending margins imply interest costs are now resulting in tighter ICRs coverage ratios across different asset types (based on 60% LTV and a 5-year loan). Assuming a 5-year Sonia swap + loan margin now results in below 1x ICR's, hence a scenario of 50% LTV is more realistic, which provides a minimum ICR coverage of 1.2 – 1.4x.

Bayes Business School
106 Bunhill Row
London
EC1Y 8TZ
Tel + 44 (0)20 7040 8600
www.bayes.city.ac.uk