



Theme: Navigating through the turmoil

FINANCING PROPERTY 2008

Our 20th annual series of presentations

Theme: “Navigating through the turmoil”

Presentation contents



- Introduction
- Three Speakers:
 - Jim Ward UK Residential Markets
 - the key to so many things
 - Mat Oakley UK Commercial Markets
 - William Newsom UK Property Finance Market
- Conclusions Mat Oakley

Brief macro-economic view

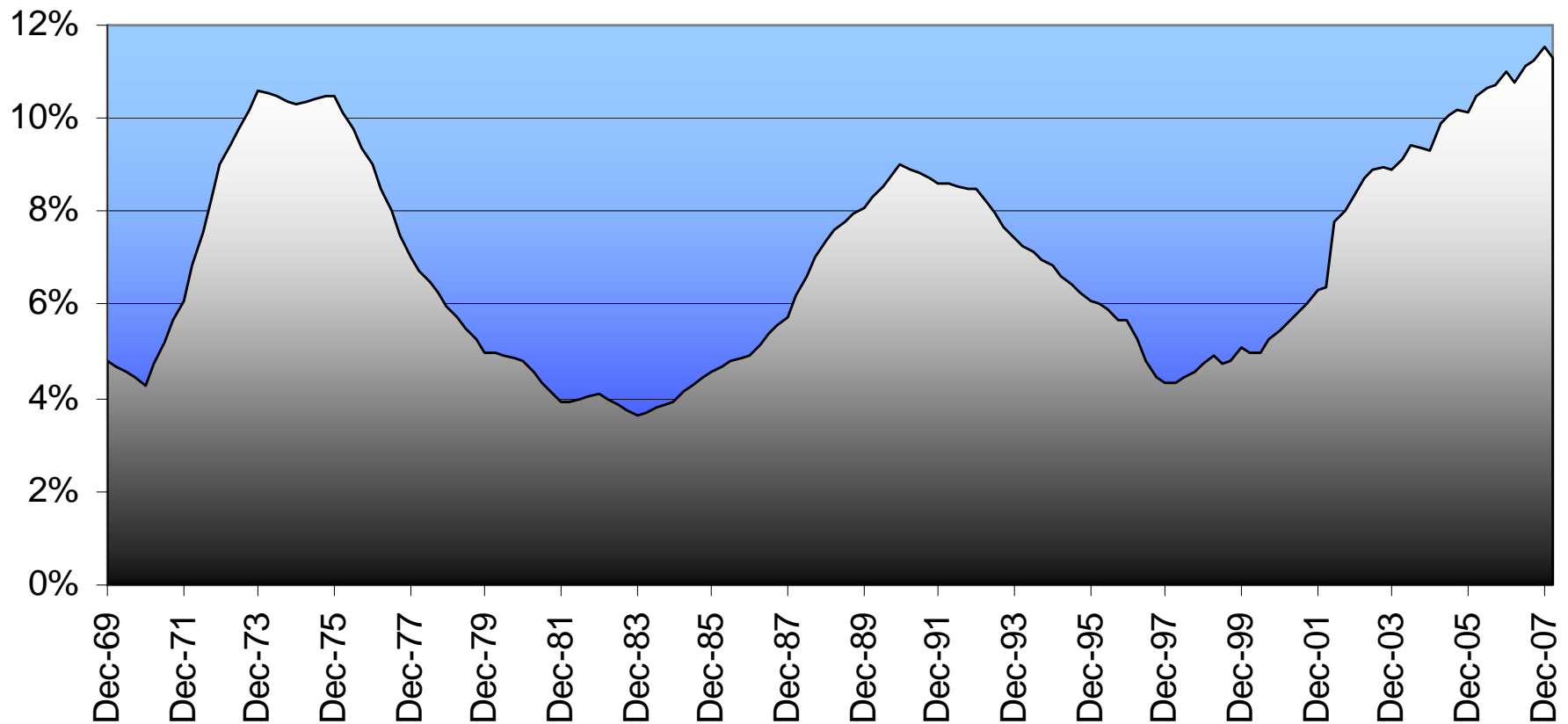


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- Without doubt, the UK property market is in a downturn
 - Arguably, the US economy is in recession, and there are concerns that the UK economy may be heading in a similar direction
 - What can we learn from previous downturns?

What are the similarities with previous cycles?

The debt mountains of the mid '70s, the early '90s and the mid 2000s

Property lending as a % of total lending



- Some commentators are pointing to similarities with the mid 1970s downturn

Similarities with the mid 1970s downturn



- Oil crisis. Steep oil price increases (+400% over '73/'74)
- Banking crisis. Secondary banks, BoE lifeboat
- Strong inflationary pressure (RPI reached 26% in mid 1975)
- Sharp increase in investment yields (prime office: 1973 @ 5.0%, 1974 @ 7.5%)
- The dying days of an unpopular government
- Then, most development schemes became unviable. Damaging business confidence

Leading to:

- A 4 year lag (1973/74 through to 1977/78) before the markets were restored to normal trading activity (prime office 1977 @ 5.75%, 1978 @ 4.5%)

But it is different this time



-
- Today, a much stronger UK economy (remember the ‘sick man of Europe’ prior to Margaret Thatcher)
 - Today, a much lower Base Rate environment (1973-1976 @ 10.5%+)
 - Today, very much more active markets (occupational and investment markets)
 - Today, better quality product (offices, retail, industrials). More resilient?
 - Today, markets are very much better researched and understood

Leading to, I believe:

- Markets will recover more quickly (than 4 years) – but how long?
- Over to Jim and Mat to help on that

UK Residential Markets

Jim Ward

Head of Residential Research

How far will the residential market fall?

Jim Ward

Director - Residential Research

How long and deep will the slowdown be?

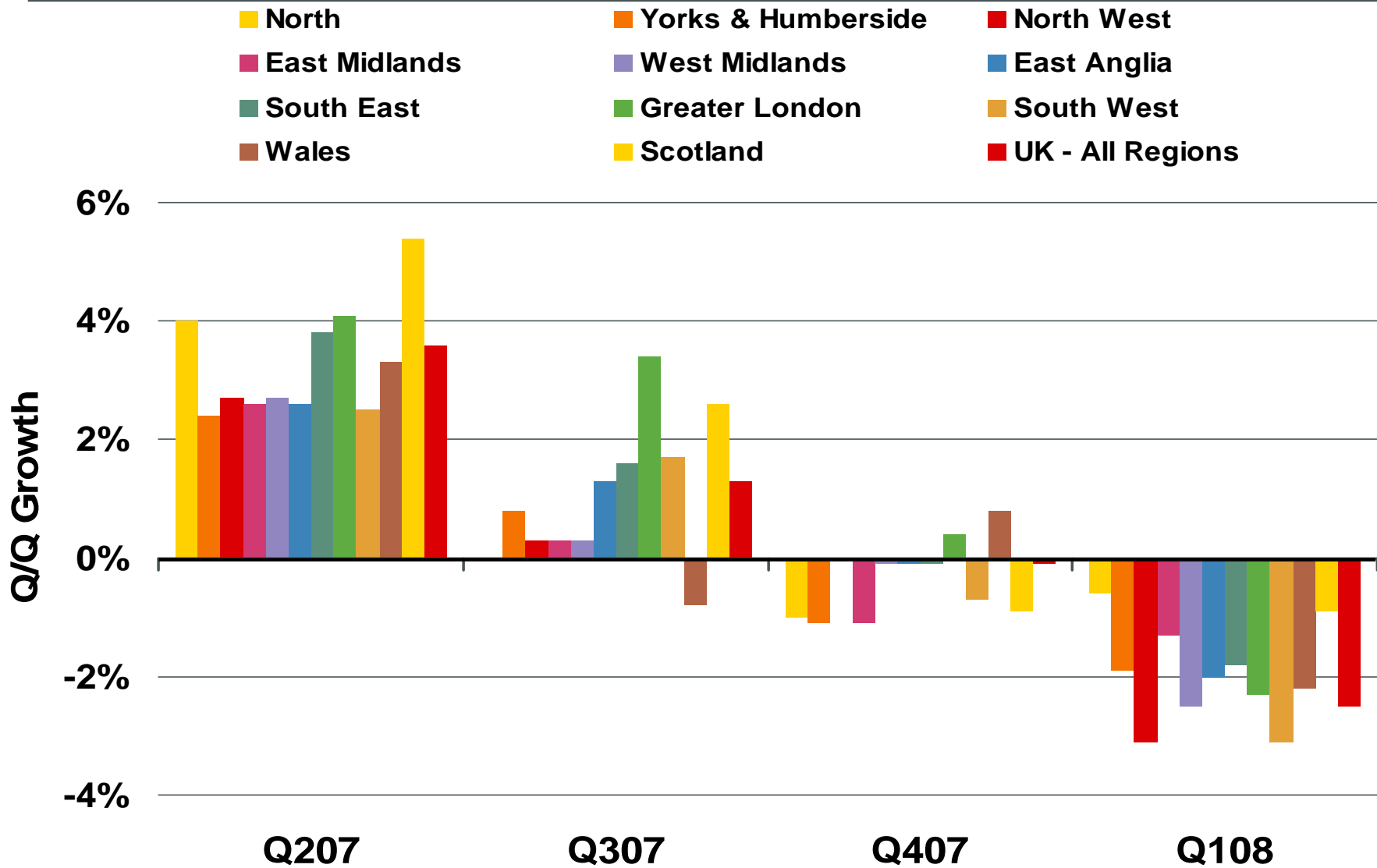
savills

~~Recovery H2 2008?~~

Slower market into 2009?

Deep house price falls?

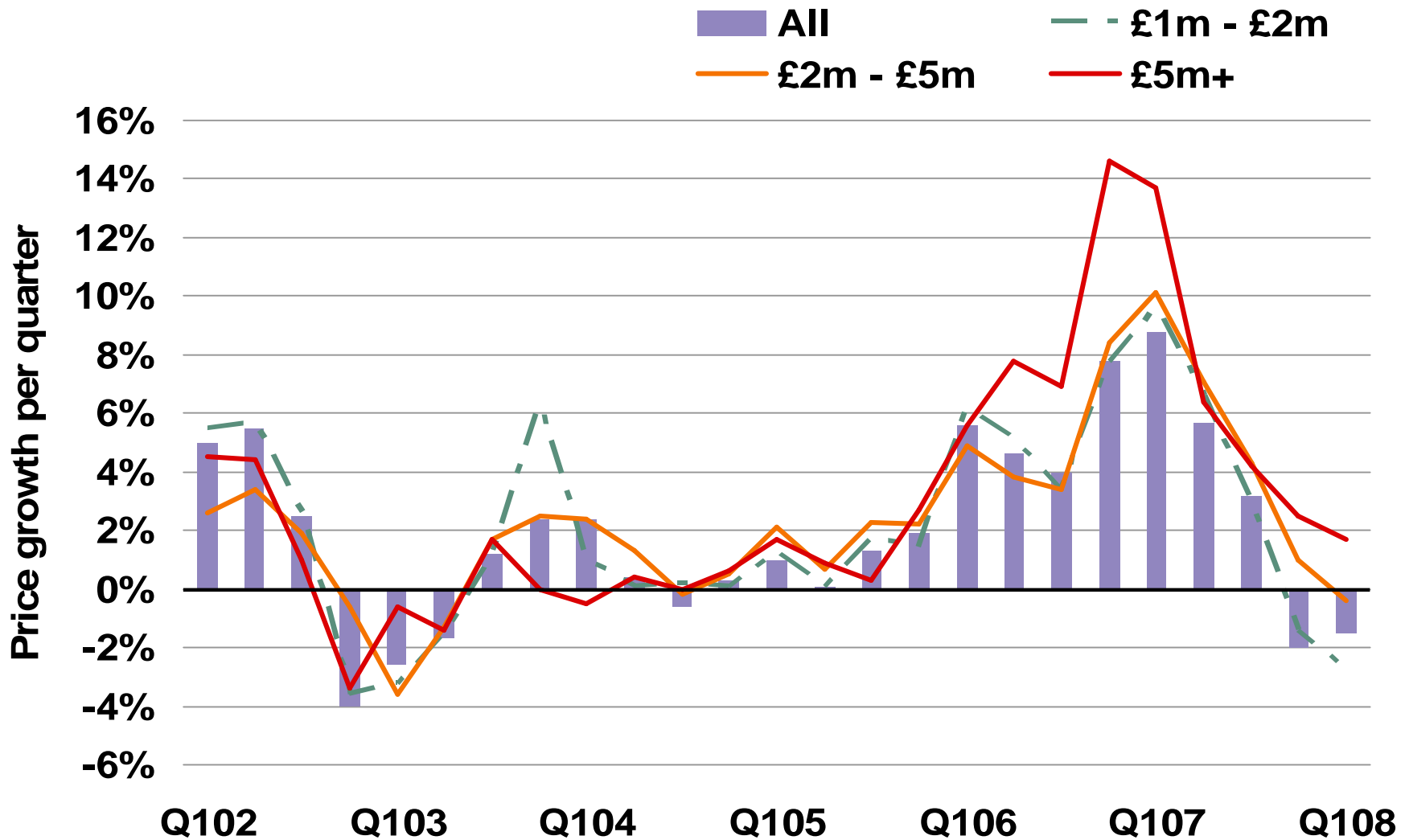
across all GB regions



Source: Nationwide

including prime central London

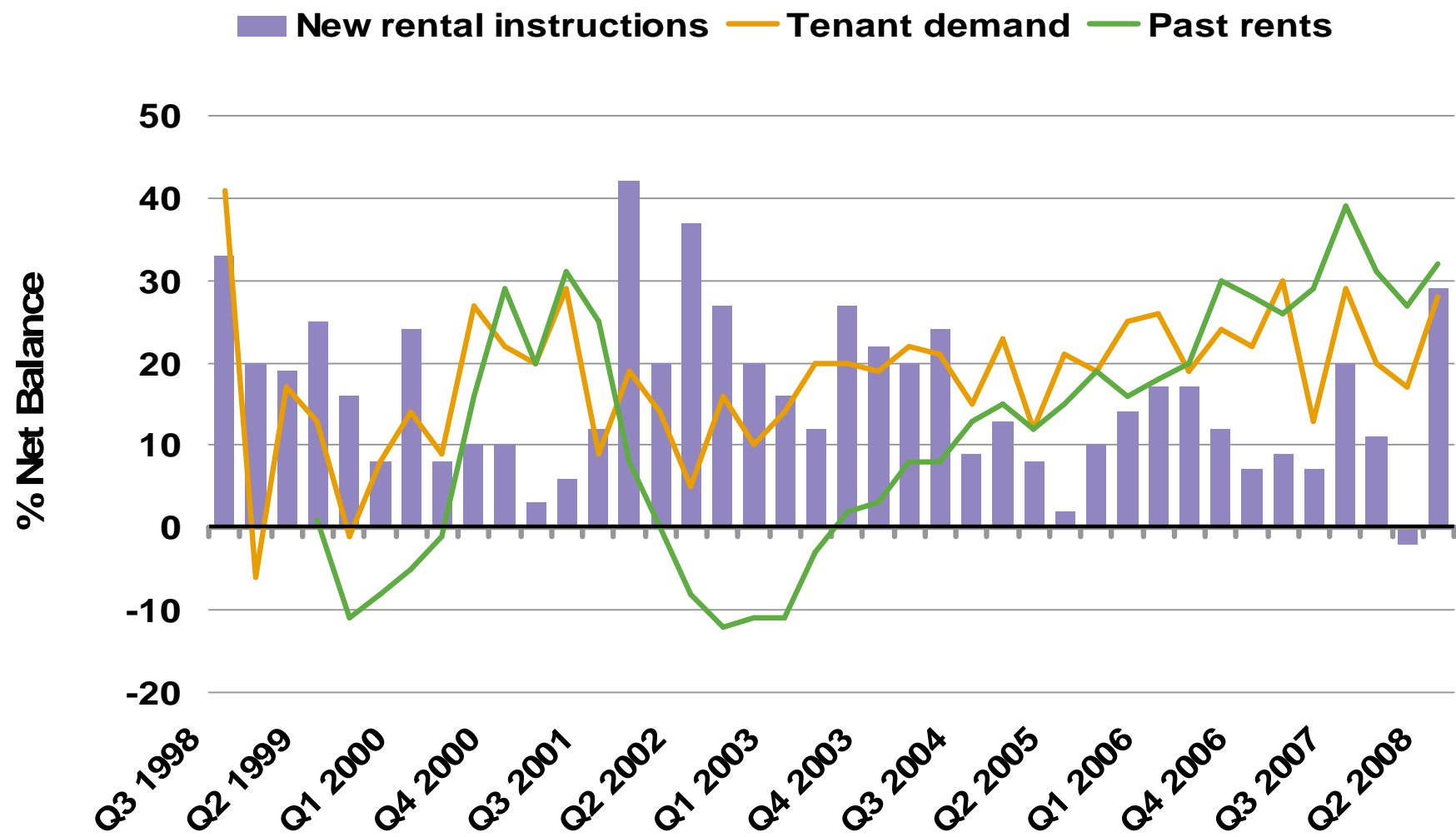
although very top end holding up better



Source: Savills Research

The rental market is strong nationally

potential buyers staying in rented accommodation



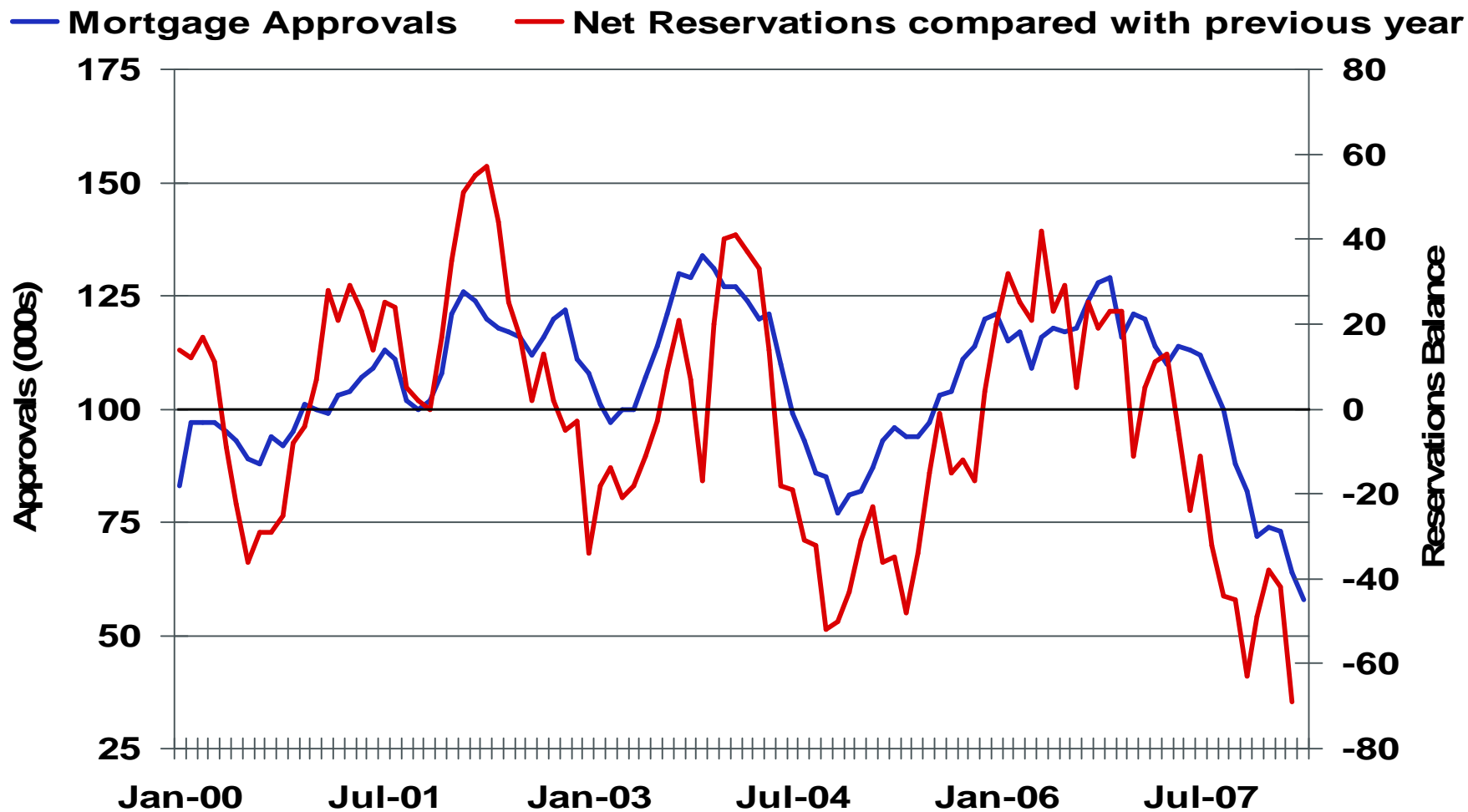
Source: RICS

Overall market turnover and take up of new homes are down

and are set to be the biggest fallers

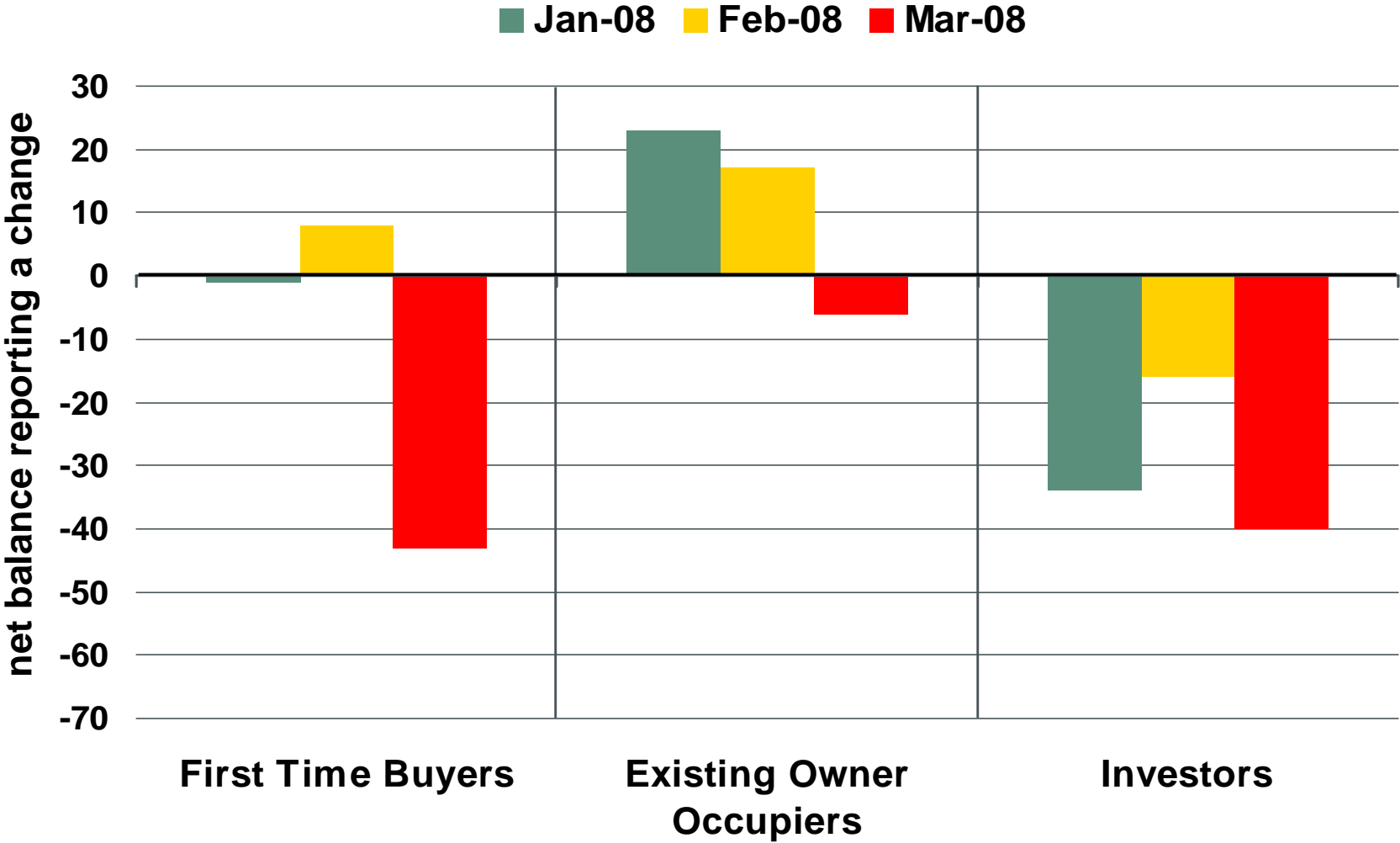


March 08 approvals 40%+ down on 2007 average



Source: HBF and Bank of England

most notably amongst investor buyers of new build property



Source: Net Reservations, HBF

who account for the majority of take up of high density schemes



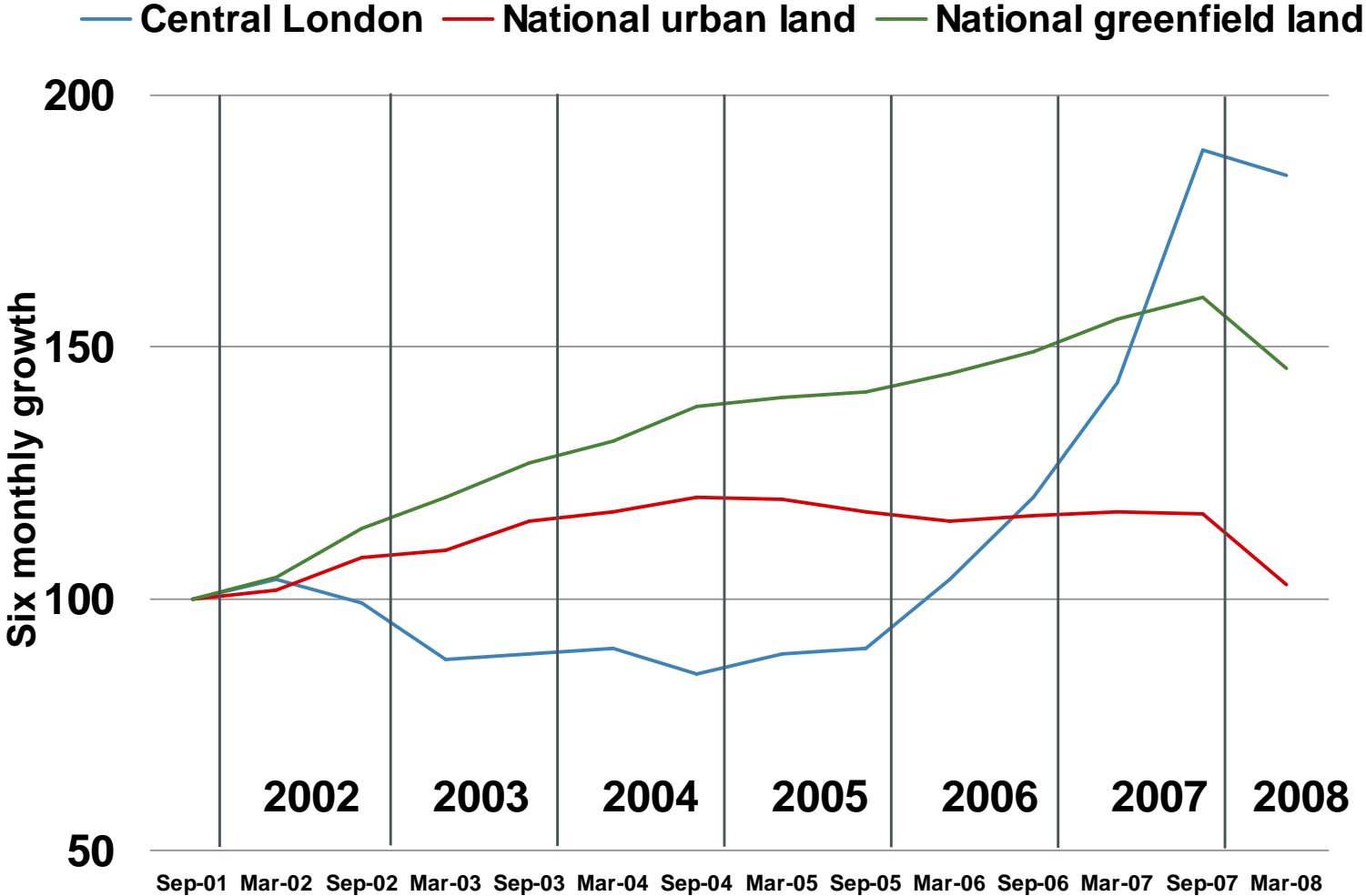
v 13% of all mortgage lending



Source: Savills Research

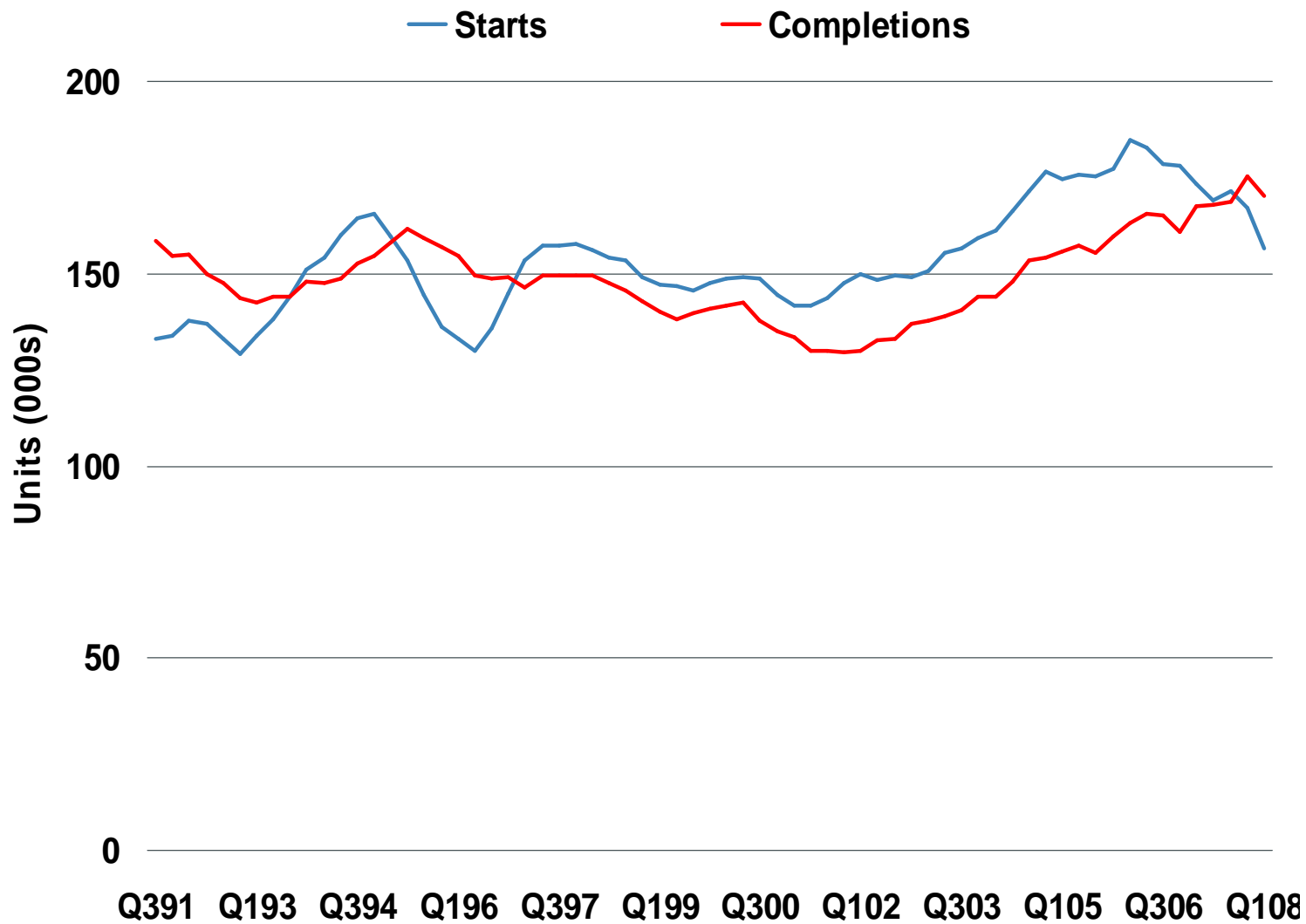
Land value is heading down

but less so in central London



Source: Savills Research

Housing starts have been heading down for some time and completions will follow



Source: DCLG

Possible triggers of a crash?



Repossessions

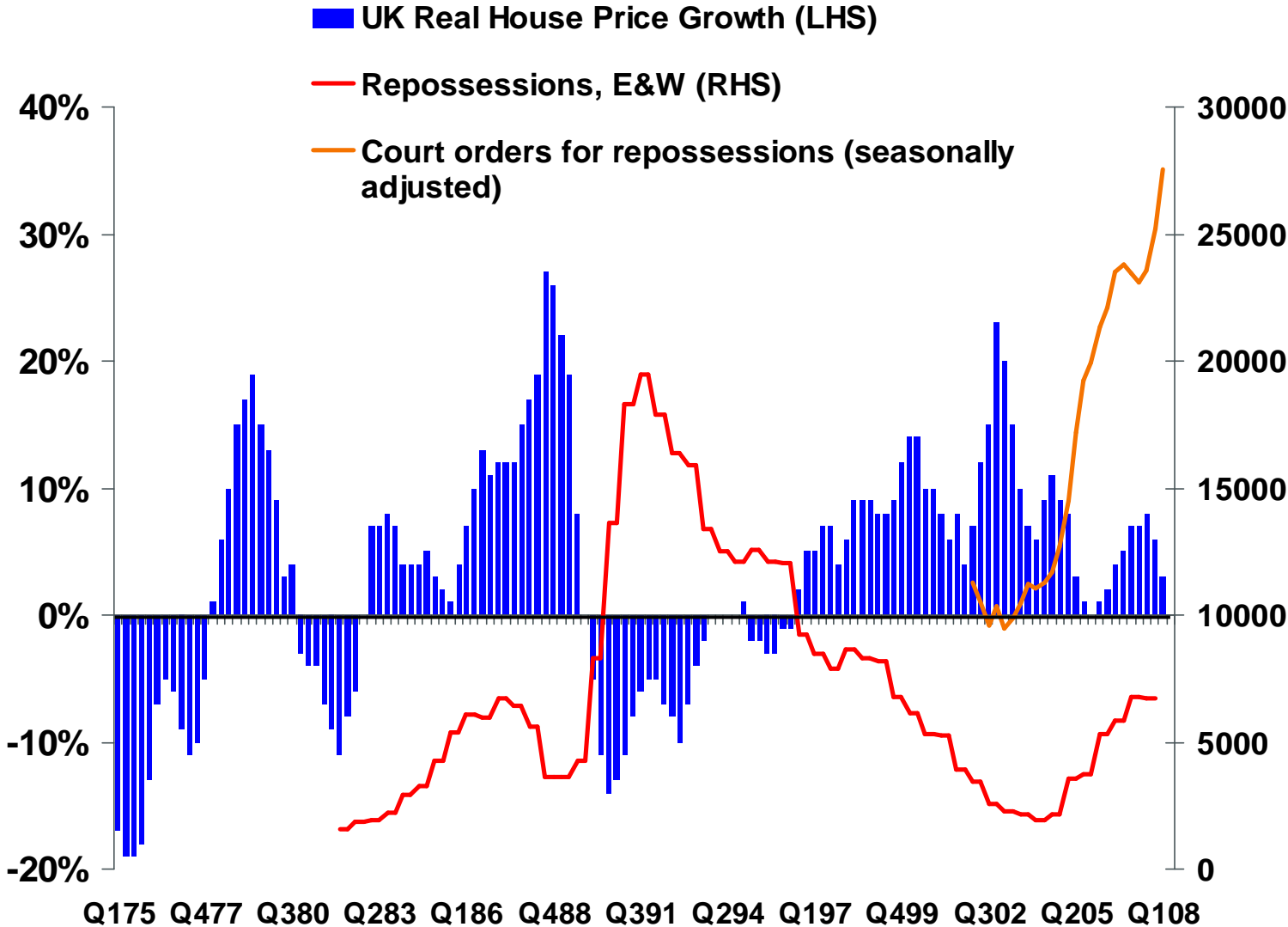
Affordability

Employment

Re-financing

New standing stock

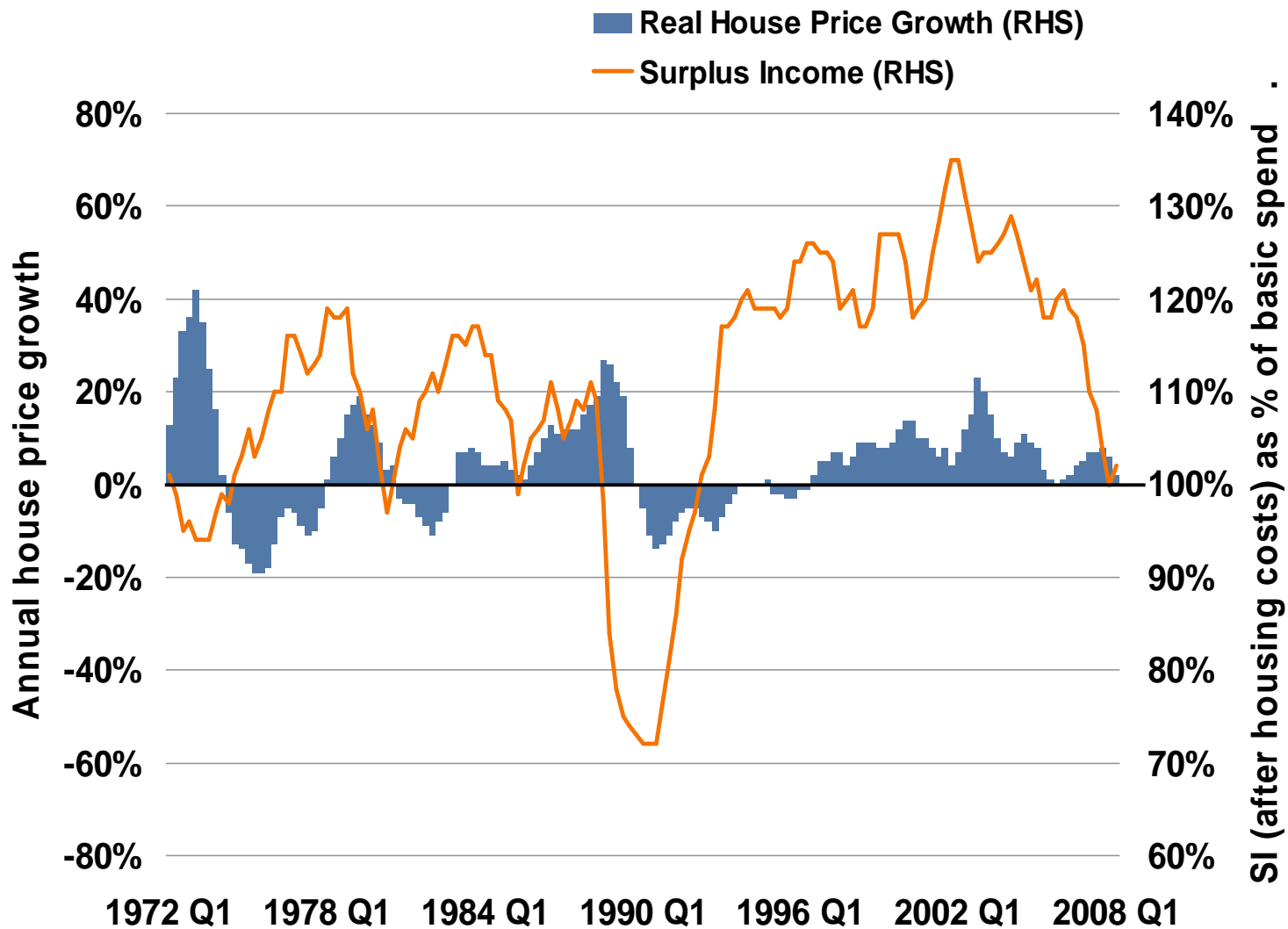
More repossessions - similar to levels pre 1990 crash



Source: Savills Research, DCLG and CML

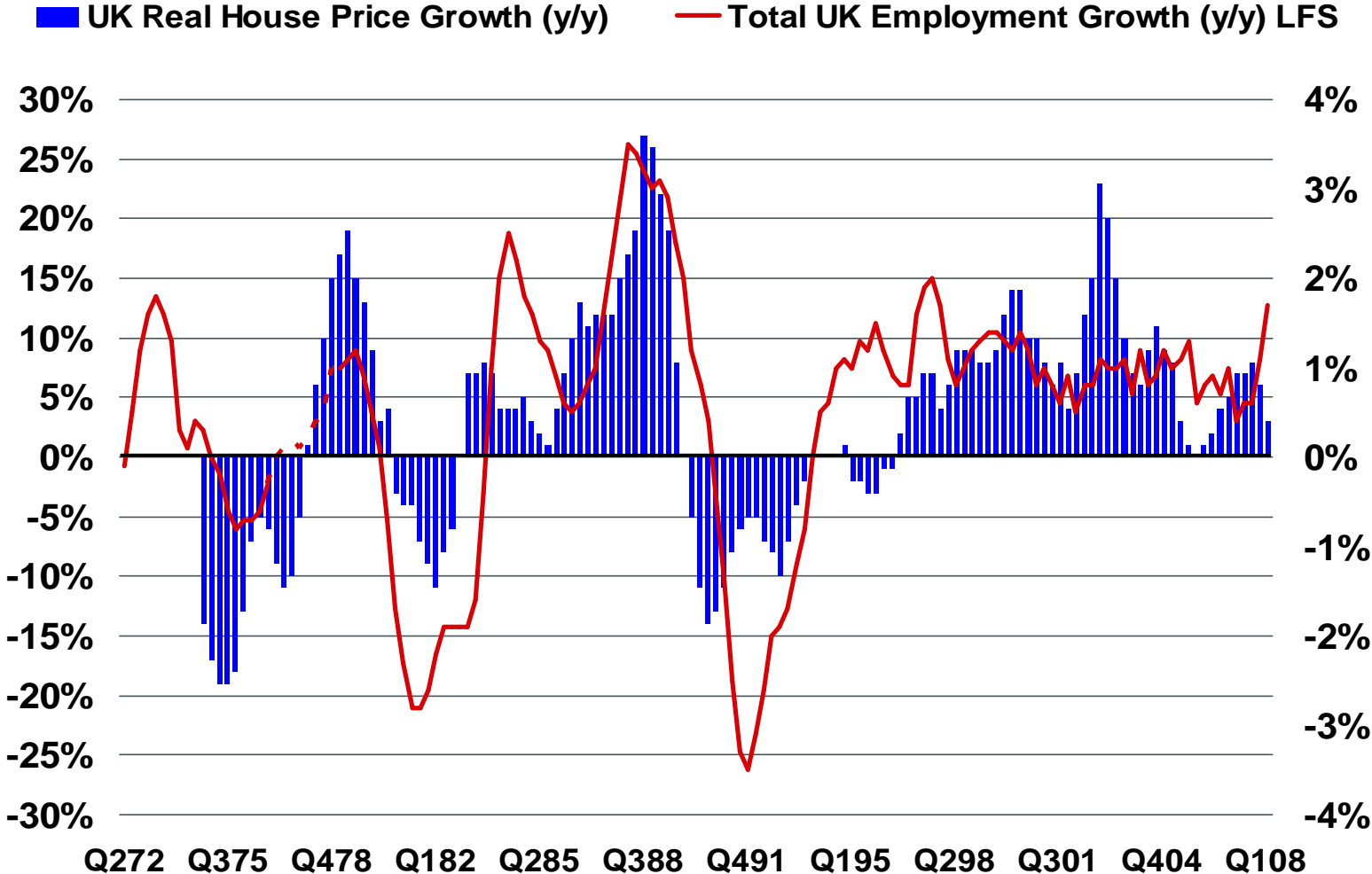
Affordability pressure not at 1990 levels

Price growth recovery once affordability pressures ease IF mortgage markets ease AND no job losses



Employment underpins housing demand

credit crunch impact on jobs is an issue in London

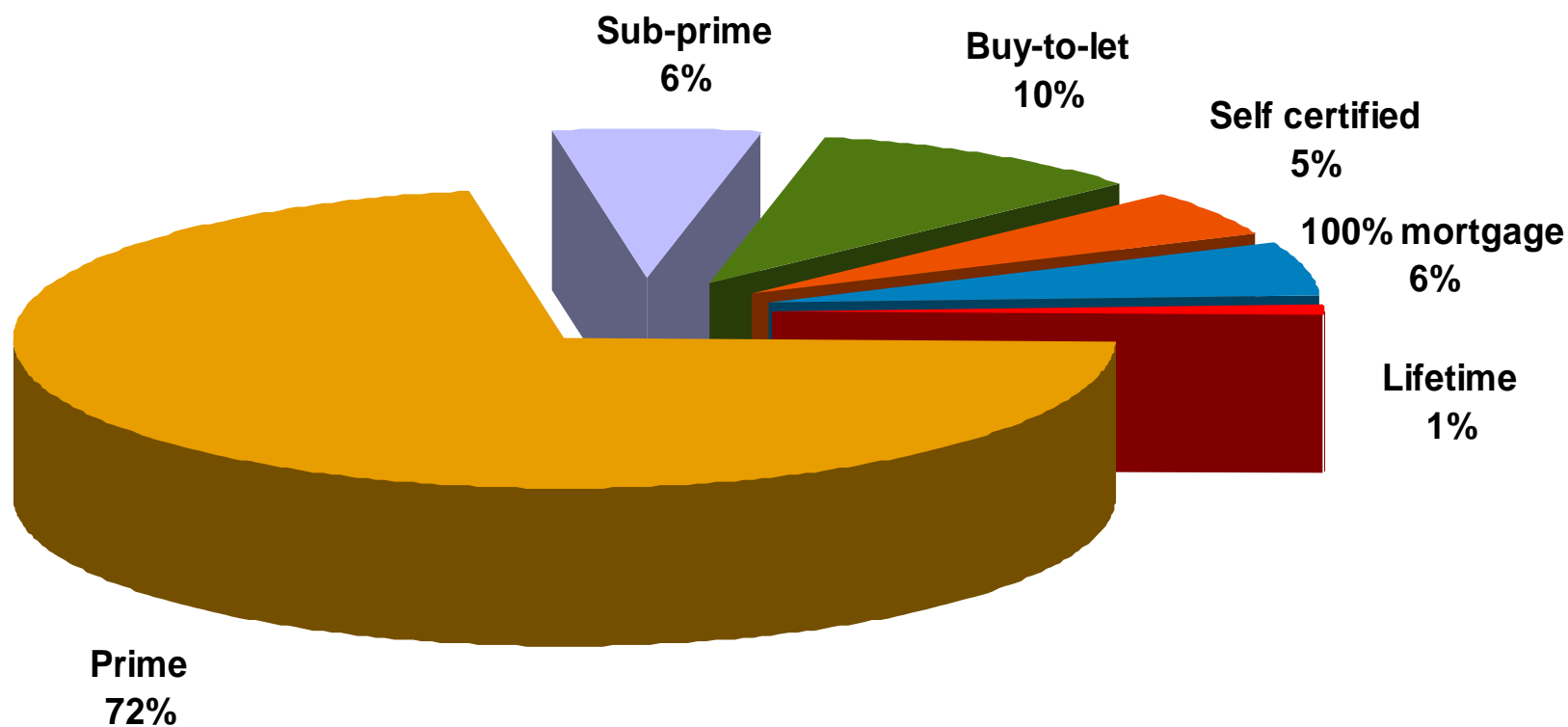


Source: CLG and ONS and Experian BSL

How many owners are too highly geared to re-mortgage affordably?

savills

28% of UK mortgages are not prime mortgages to owner occupiers



Source: Morgan Stanley Research

What is the risk of standing stock?

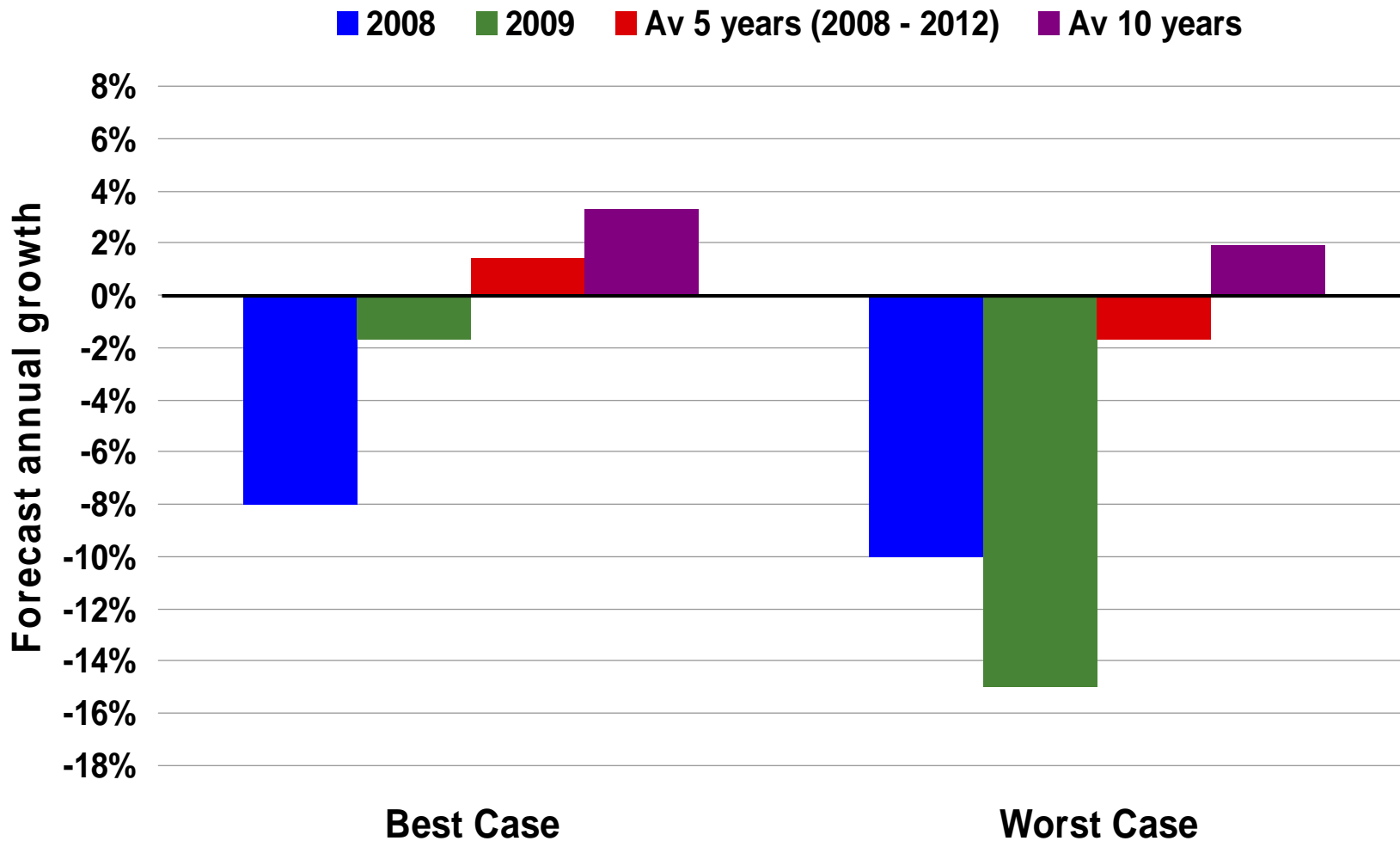
Central London supply pipeline



Source: Savills Research

We have downgraded our best case scenario

with increasing likelihood of worst case
easing of mortgage markets is pivotal



Source: Savills Research

Where will activity be?



STRATEGIC SITES

Bigger sites – long term demand

Up front investment

No HPI cushion v costs

Investor cashflow?

Affordable housing – short term loss v long term gain

Mixed use complexity + value

Long term development and management

UK Commercial Markets

Mat Oakley

Head of Commercial Research

Prospects for the UK commercial property markets

Outline



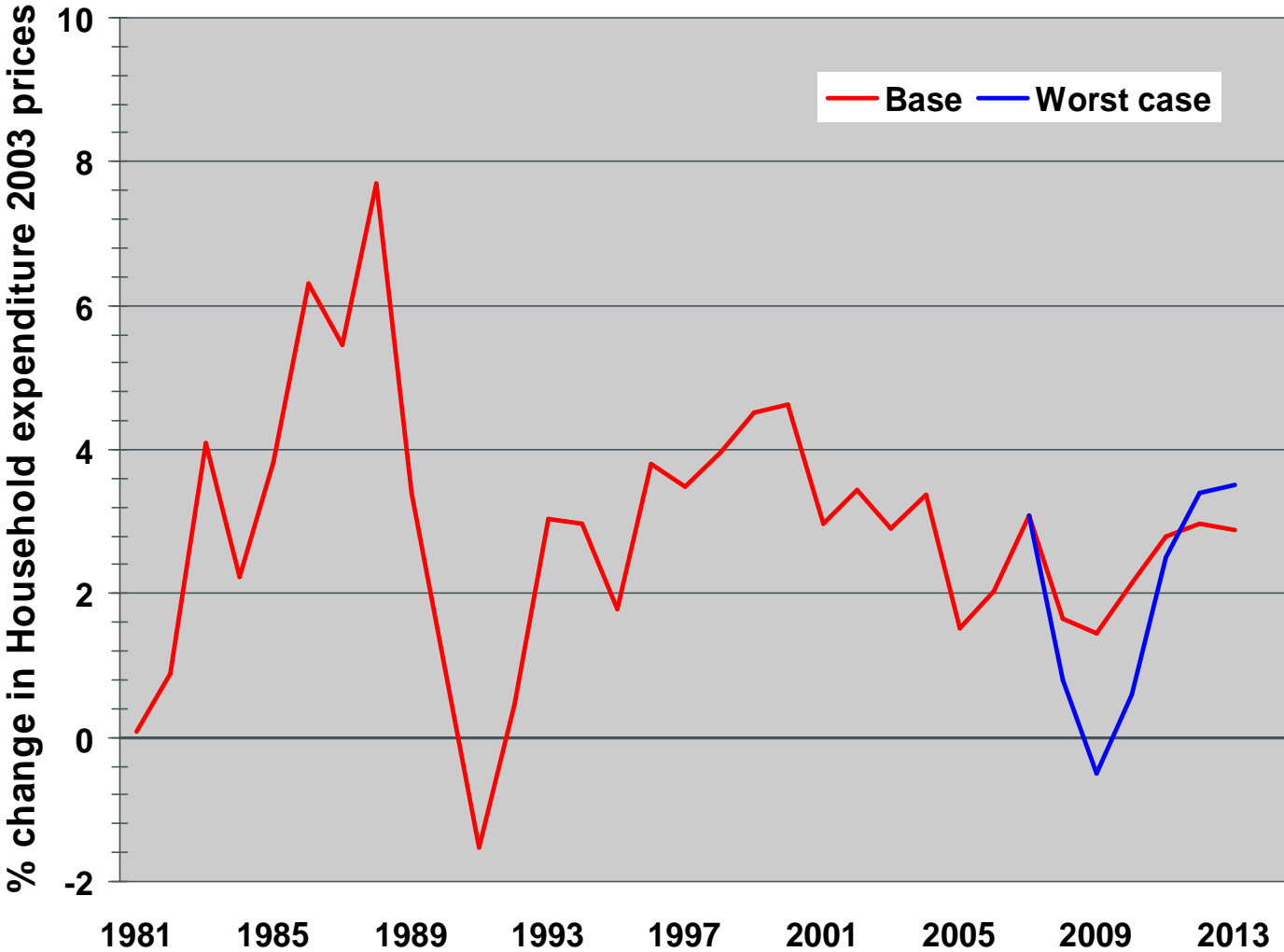
-
- What would a residential crash mean for commercial property?
 - Our base case for tenant demand
 - Investment market prospects – have we hit the bottom?

House price crash would hit demand for commercial property



-
- Lower discretionary spend impacts retailers
 - Low housing turnover impacts bulky goods retailers particularly hard
 - UK GDP sub 1% in 2008, lower in 2009 – technical recession?
 - Manufacturing output suffers more than services..
 - .. However total employment would fall in both areas in 2008 and 2009, implying lower demand for offices and industrials
 - Strong bounce back in 2010

Biggest impact of house price crash would be on household spending



However, we believe that the foundations are solid



-
- GDP growth to be below trend in 2008/2009, but in the 1.5% to 2.0% range, return to trend from 2010
 - Earnings growth to stay stable
 - Inflationary pressures will limit base rate cuts, but cost of money to drift down
 - Job losses limited at a national level

**Tenant demand to be selective, but
there will be demand**

Retailer focus will be on cost savings & profit per sq ft



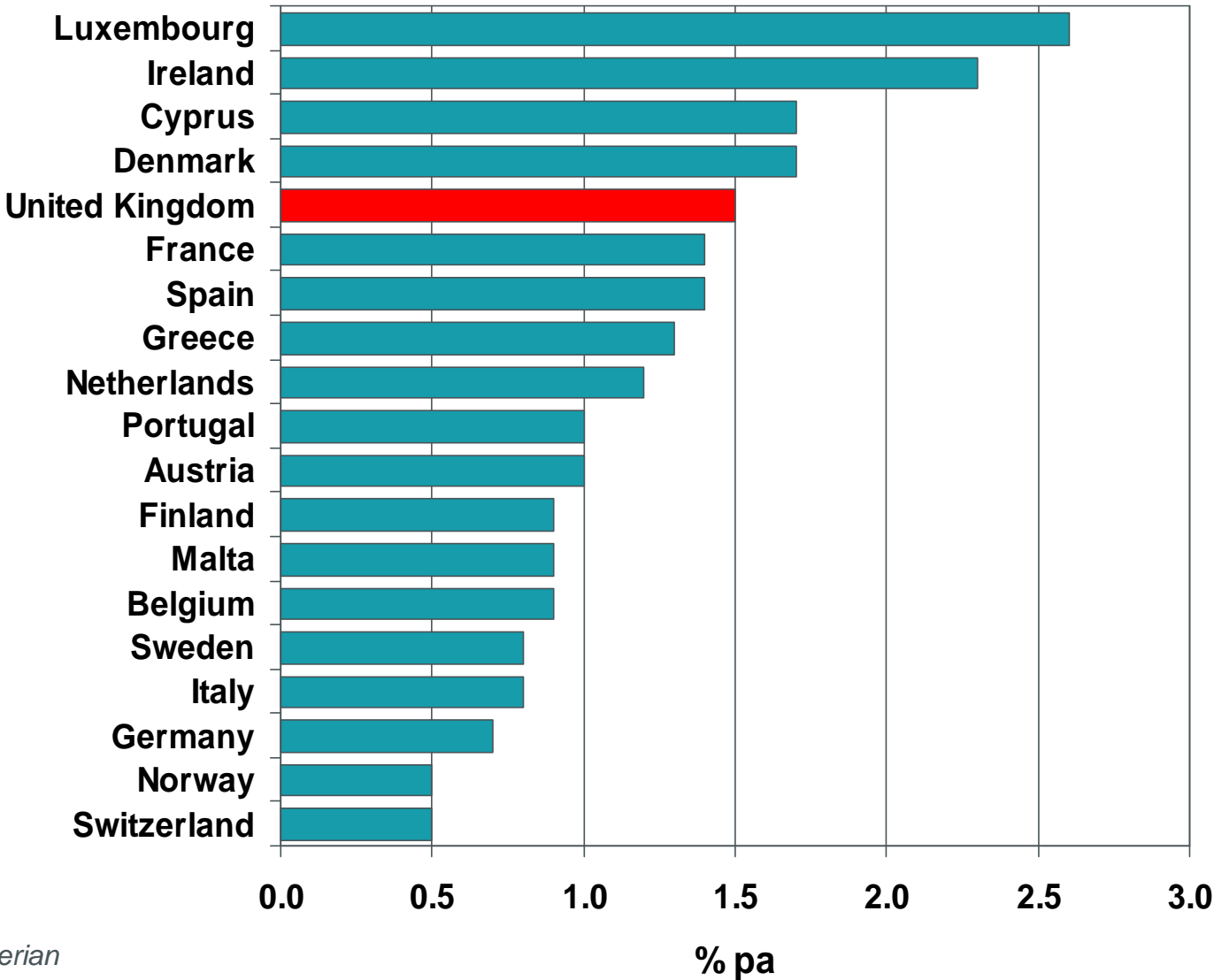
- Consumers will be more cautious about discretionary spend
- ... and retailers will be more selective on location
- Mid market retailers most at risk
- Food retailers look strong (food and non-food sales)
- Products linked to house moves look weak

Investor focus - Retail



-
- Top 25 high streets
 - Best shopping centres limit risks of tenant default
 - Shopping parks adjacent to strong/constrained town centres
 - Affordable bulky goods parks in strong catchments

Financial & Business Service employment growth in the UK to remain above the European average over the next decade



Source: Experian

Regional City office markets



-
- Manchester, Birmingham, Edinburgh and Glasgow are much less cyclical than London
 - Less exposed to international trends than London
 - All seeing rejuvenation of the City centre, and short term supply increases
 - Benefiting from relocations from London & SE due to high staff and property costs

Central London offices most exposed to downturn, but prospects are less bad than in 2003/4



-
- Development pipeline is swelling, but past its peak
 - West End less exposed to financial markets malaise, except at very high rent end of the market
 - City will see job cuts in 2008/9, perhaps as much as in 2003/4
 - But less space to rationalise this time around, so vacancy rates will not go as high as in 2003
 - Vacancy rates will rise in 2008/9, with rental falls in the City, but both will remain in single digit territory

Investor focus - Offices



-
- Long term secure income streams
 - Grade A to reflect tenant demand
 - Development opportunities post 2012?

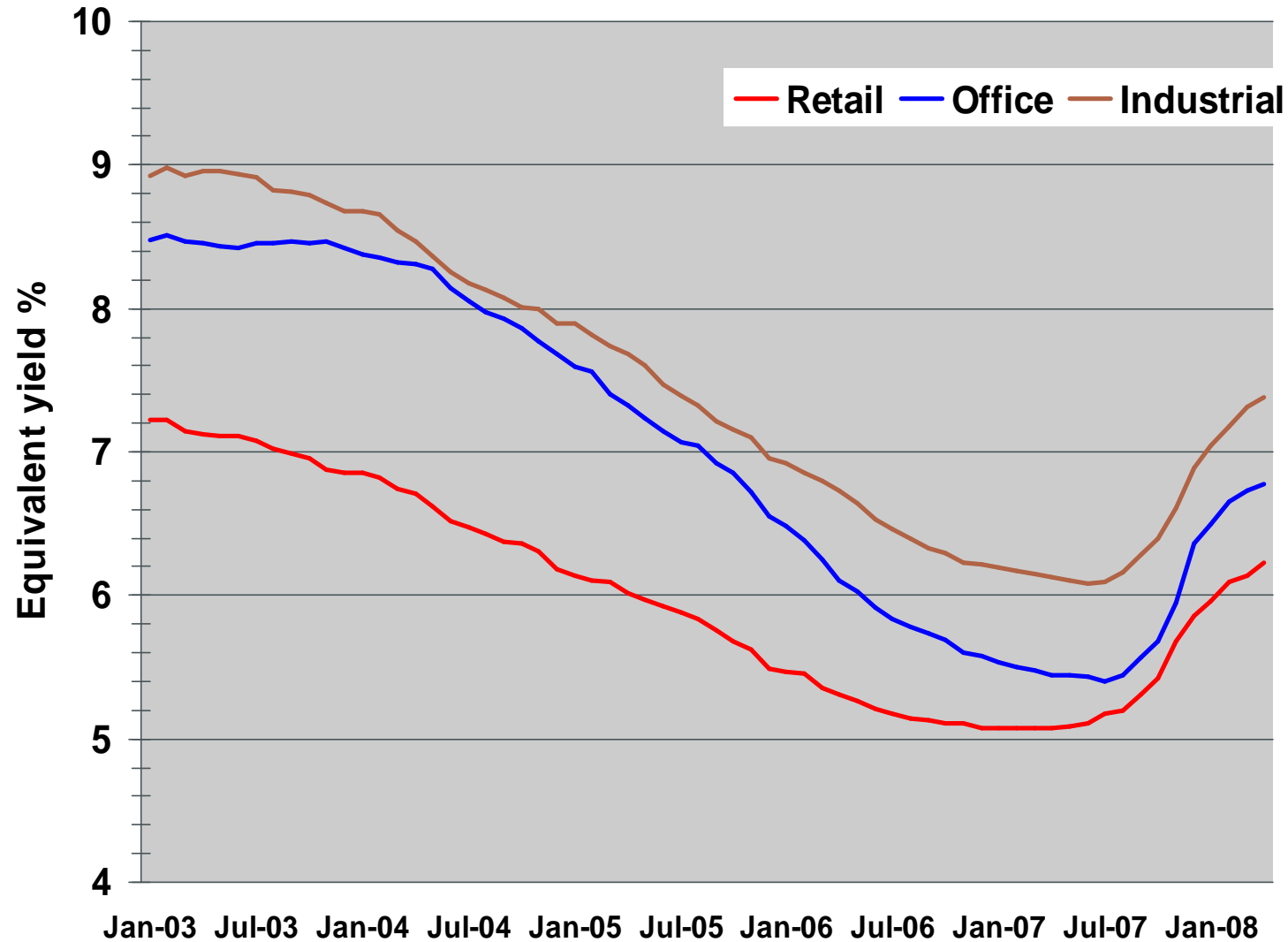
Logistics sector remains a safety play



-
- Tenant demand stable, though some drift from higher cost locations
 - Linkage to retail increasing
 - Development pipeline swelling in some locations but design & build limits speculative oversupply
 - Rental growth to remain low, but positive

**The investment market – is the bottom
in sight?**

According to IPD average yields are still softening



The market view is different



-
- Prime equivalent yields are similar to IPD averages (5.00% to 6.25%)
 - This implies some further correction to come in IPD yields
 - Still little evidence of secondary transactions
 - Investment volume in 2008 around 50% of same period in 2007
 - When will investor demand return, and what will happen then?

Expect further widening in gap between prime and secondary yields



- Investor demand is very focused on an increasingly narrow definition of prime
- September 2008 will be a key review date
- 2009 will see more sales both voluntary and involuntary...
- ... but this will bring a revaluation of secondary assets
- Double dip likely for average yields, prime to stay around its current level

Conclusions



-
- There are downside risks to tenant demand
 - We expect demand for prime and cost-effective locations to stay stable
 - Vacancies and tenant default to remain tolerable
 - Investor inactivity to be sustained in 2008
 - Widening of prime/secondary yield gap to continue in 2008/9
 - Prime investments starting to look correctly priced
 - Even the worst case is relatively short term!

UK Property Finance Market

William Newsom

Head of UK Valuation

Presentation Contents



-
- I have observed property lenders today fall into two camps:
 - Those that are joyous – able to lend
 - Those that are as depressed as hell – having difficulty lending new money
 - Catering for each, I will cover:
 1. The CMBS market
 2. Existing loan books
 3. Banks' liability side
 4. Why is now a good time to be lending?
 5. My forecasts of property lending terms
 6. Who is lending – and what is the key to successful property lending?
 7. Advice to those with existing loan books to manage

1. The CMBS market (one slide only)



- You all know what has happened
- The market is closed. No new issuance since 9 August 2007
- AAA spreads were 15-30 bps; now 200-250 bps. BBB have been up to 1,000 bps
- Previously, CMBS lenders consistently were able to offer higher LTVs and lower margins. But no longer
- I believe CMBS, a relatively new product, was a major contributor to the overheating of the property lending market – but that's a story for another time
- When the CMBS market returns, it will be in a different form (regulators, rating agencies, loss of confidence by investors, etc.) – and it could be some time and repriced

2. So, who is joyous and who is depressed? – there has been a significant change in lending ambitions



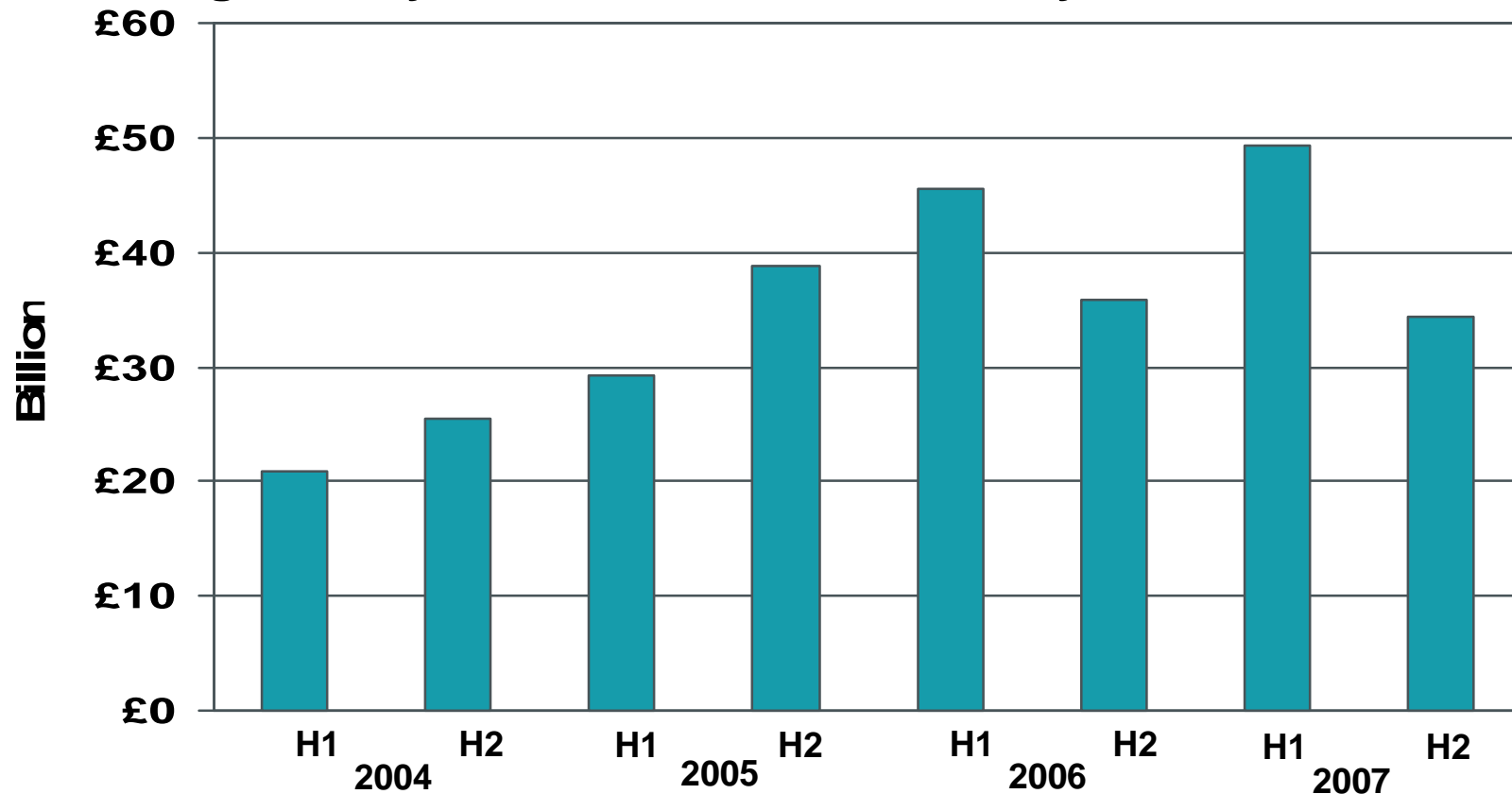
Proportion of lenders seeking to increase loan originations

	Dec-06	Dec-07	Comment
UK Lenders	80%	56%	30% down
German Lenders	86%	80%	7% down
Other International Lenders	91%	45%	50% down
North American Lenders	100%	60%	40% down
Building Societies	<u>100%</u>	<u>14%</u>	<u>86% down</u>
All	89%	55%	38% down

H2 2007 was still busy for lending



Lending activity undertaken in each half year 2004 to 2007



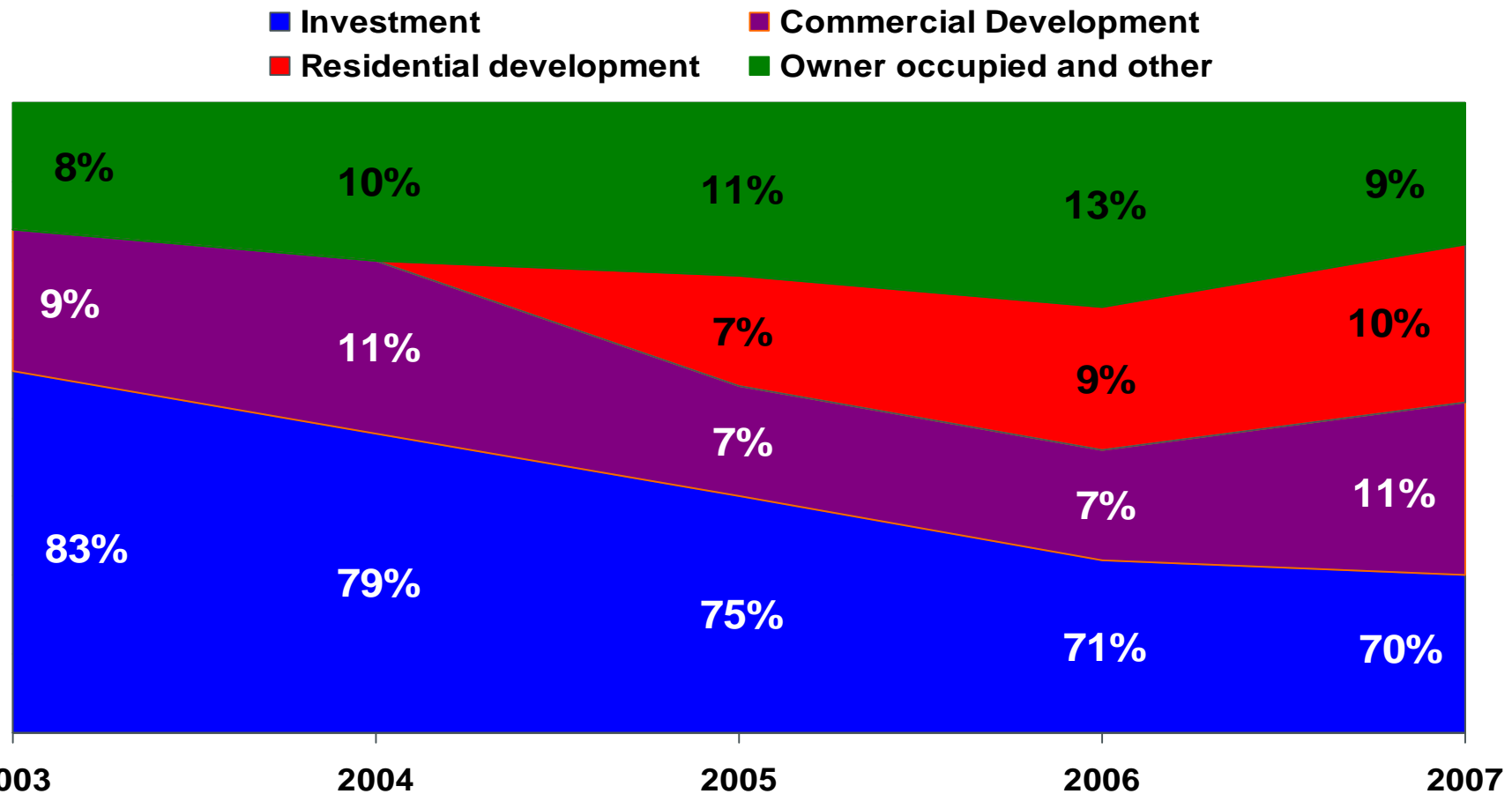
- UK Lenders continued to write nearly half (49%) of all business done in 2007
- Offices and retail continued to be 25% - 30% of that business. But residential increased strongly from 13% - 20% over 2006/07

Source: De Montfort University

Development lending has become an increasing part of lenders' activities



Allocation of aggregate loan books secured by different types of project



- Development lending grew from 9% in 2003 to 21% in 2007 (2.3 fold over 4 years)

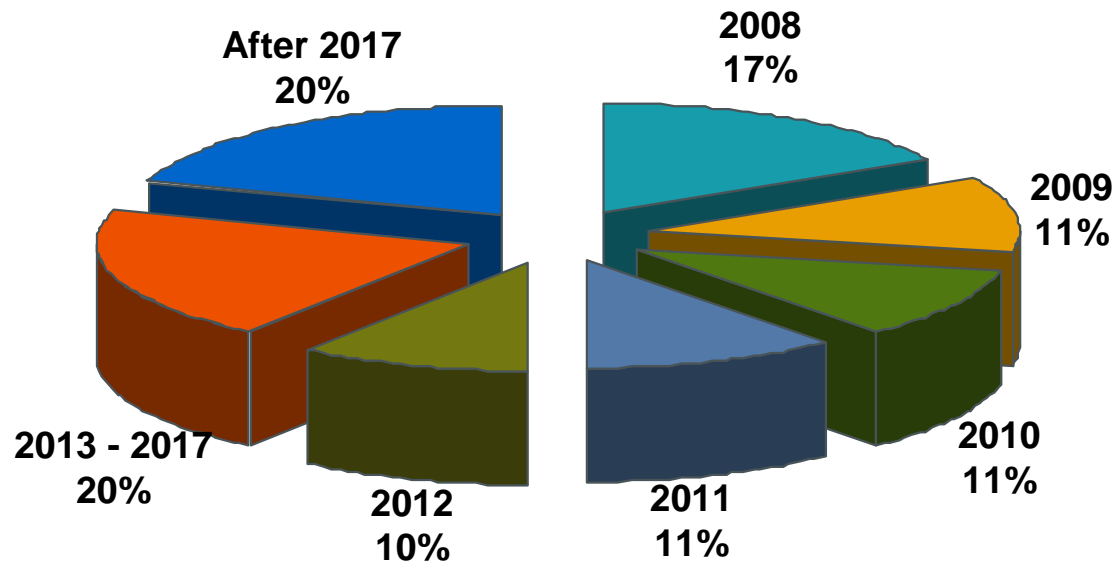
Source: De Montfort University

Senior debt maturities over 2008/09/10 – 39% of aggregate loan books (c£80bn). A lot, but ...



Proportion of debt due for repayment: All lenders

As reported now

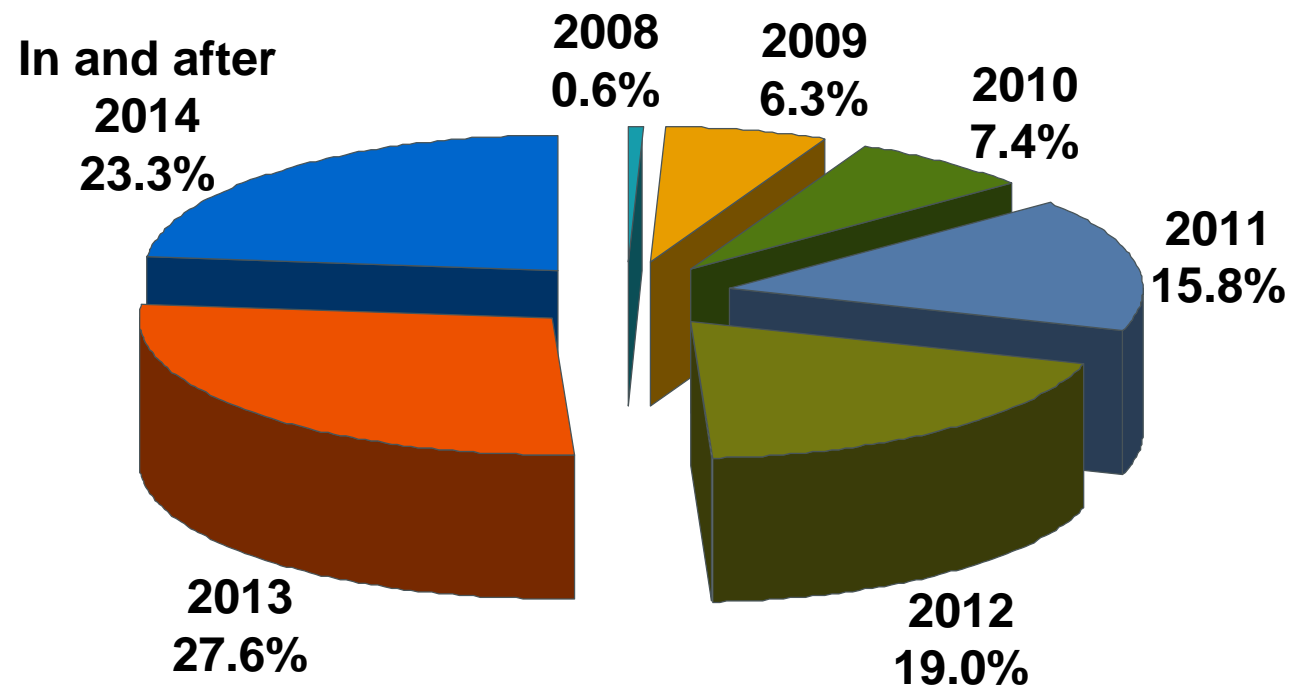


- Five year loans maturing in 2008 were granted in 2003. Yields are not back to 2003 levels and we have had rental growth in between. No worries
- However, concern arises where short term finance (1 yr/2 yrs) was provided. Many loans granted over 2006 and 2007 will now be in technical breach of the LTV covenant

CMBS loan maturities over 2008/09/10 – limited refinance exposure (14% of issuance)



EMEA CMBS Refinancing Exposure



3. Focus on banks' liability side of the equation

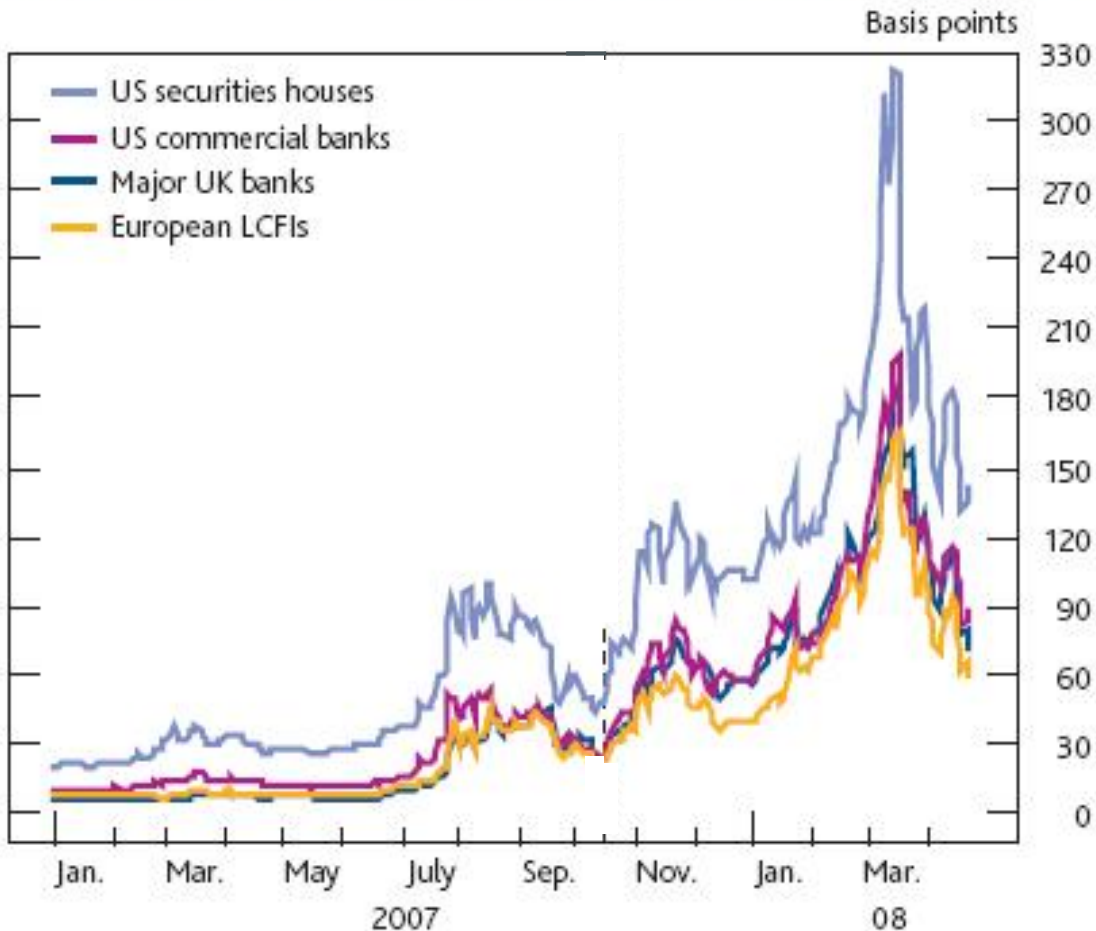


-
- What is the source of funds, at what cost?
 - The interbank market – volatile and expensive
 - Retail deposits
 - The covered bond market, eg German Pfandbrief – sound
 - The ABS market – closed
 - Existing balance sheet liquidity
 - Tier 1 Capital. Basle II
 - Not everyone is in the same boat, and therefore whilst publicity is focused on banks with problems, there remain many lenders with a healthy appetite for property lending (on the right terms)

Banks' risk of default is much reduced – credit default swap 'health scan'

savills

Major UK banks' and LCFIs' credit default swap premia



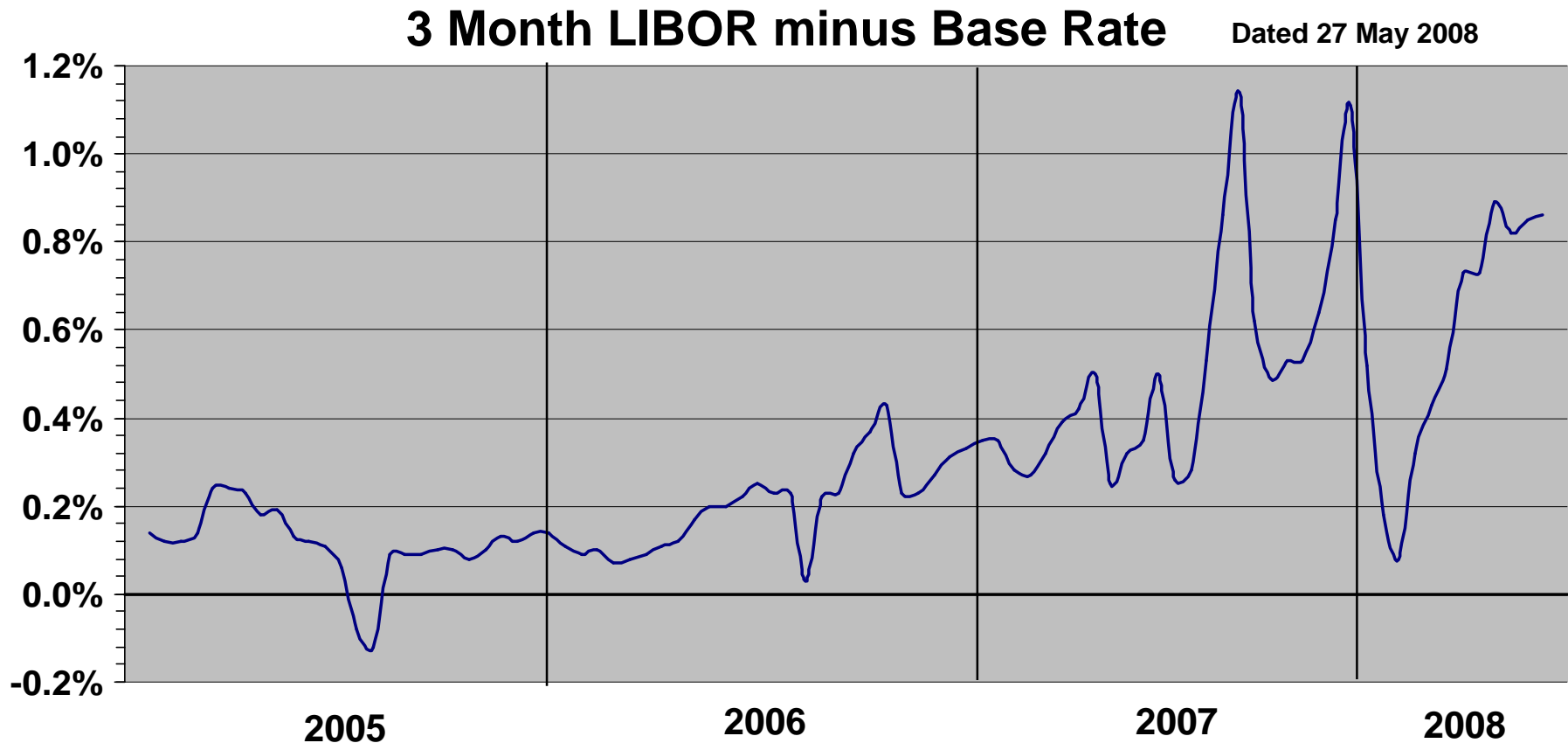
- However, CDS levels are still 3 to 10 times higher than prior to 9 August 2007

Sources: Markit Group Limited, Thomson Datastream, published accounts and Bank calculations. UK banks' and LCFIs' credit default swap premia (asset-weighted average five-year premia).

Source: Bank of England Financial Stability Review April 2008

... but, Libor continues to be volatile

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- 60% of respondents said yes, the worst is over
- But, “many saw plenty more bad news to come from worsening fundamentals”

Source: IPD, FT and Barclays Capital (Survey of European ABS Market, May 2008)

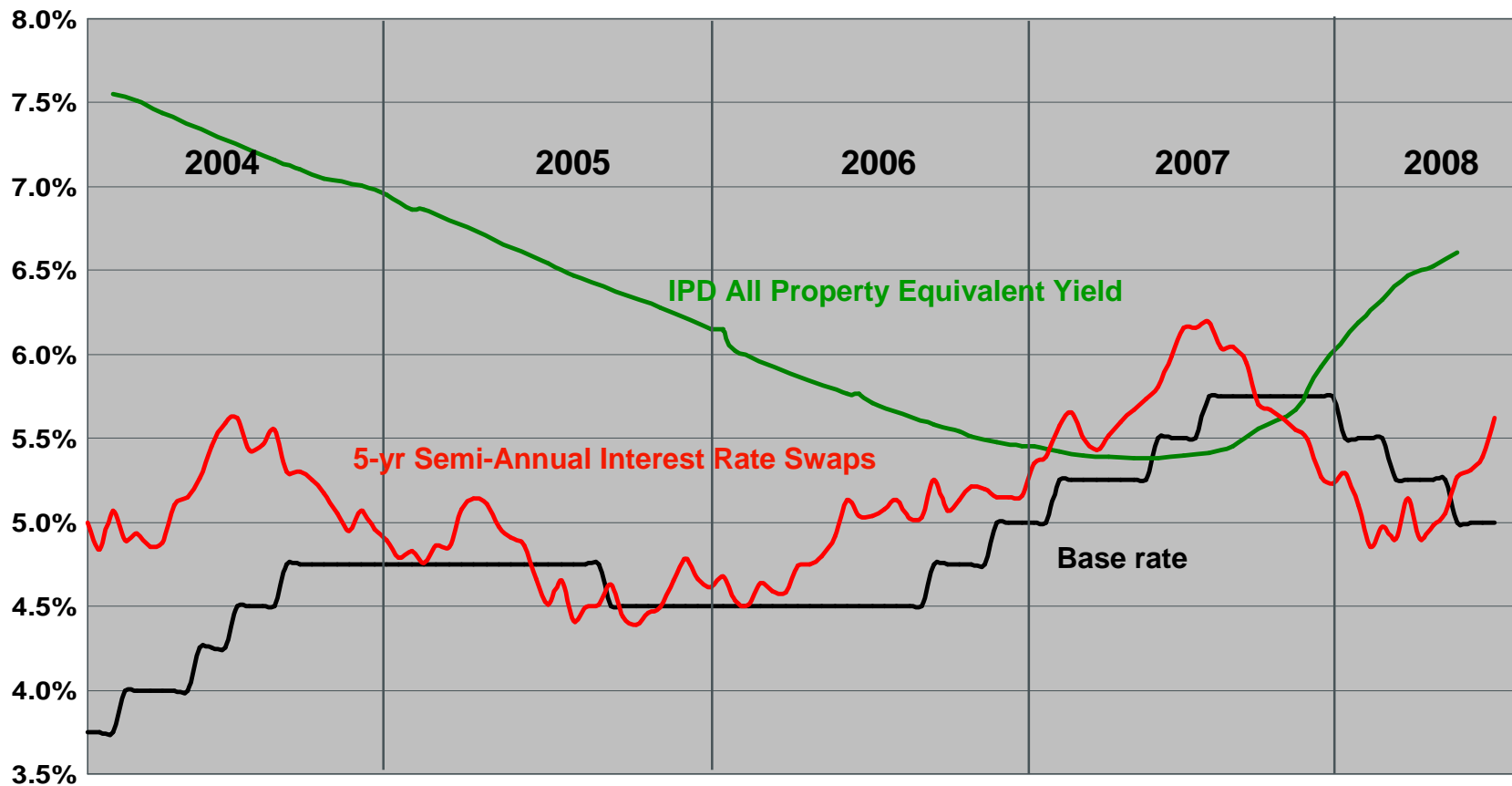
4. So, if you have the liquidity, now is a good time to be lending – firstly, because of a favourable macro-economic background



- GDP growth remains strong
- High employment/low unemployment
- Retail sales continue to grow
- The UK economy has been stable over a 16 year period. Build up of prosperity
- Corporate profitability remains healthy; tenants are not going bust; cashflows remain solid – important when lending against commercial investment property

... secondly, because property is more financeable

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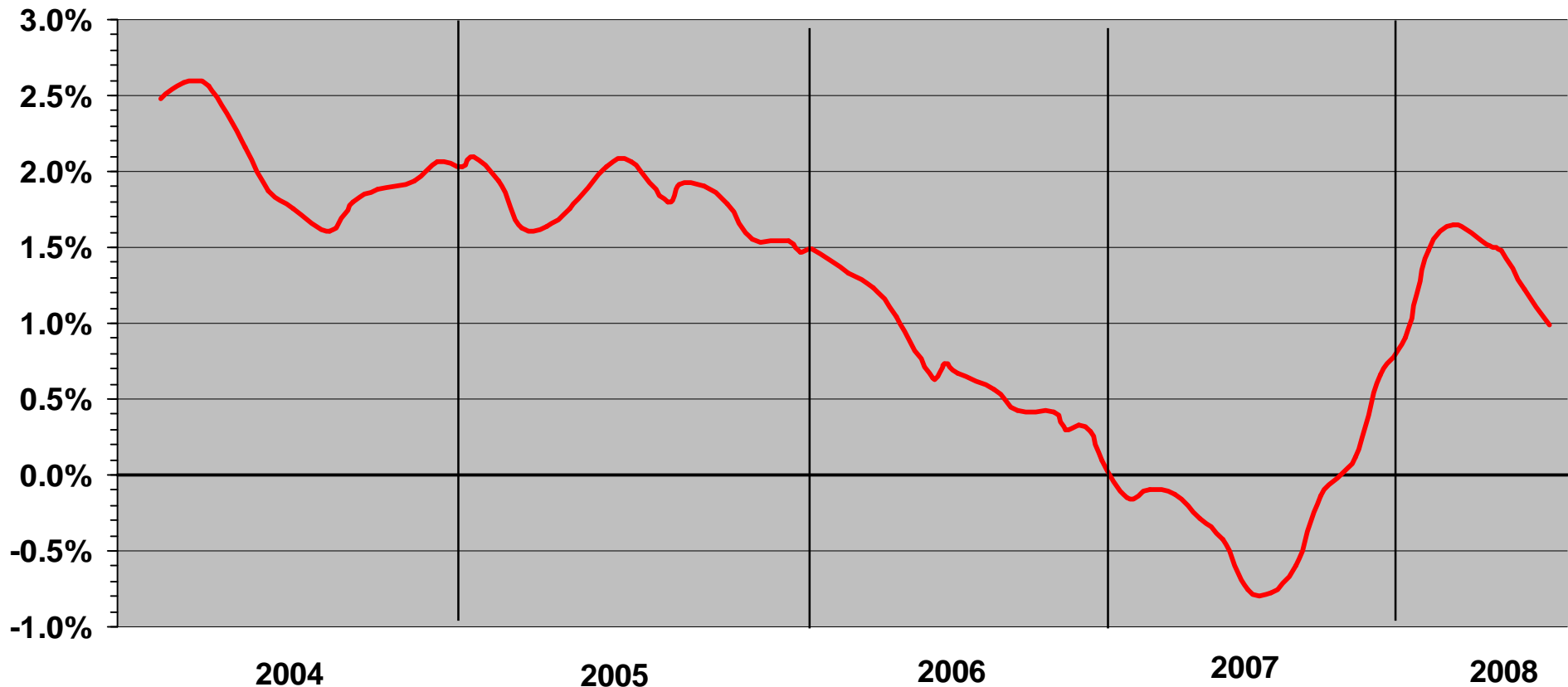
- Investment yields are back to summer 2005 levels (and still moving higher)
- The negative financing gap has closed – again back to 2005 levels (see next slide)

Source: IPD & FT

The negative financing gap has closed

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IPD All Property Equivalent Yield minus the 5 Year Swap Rate



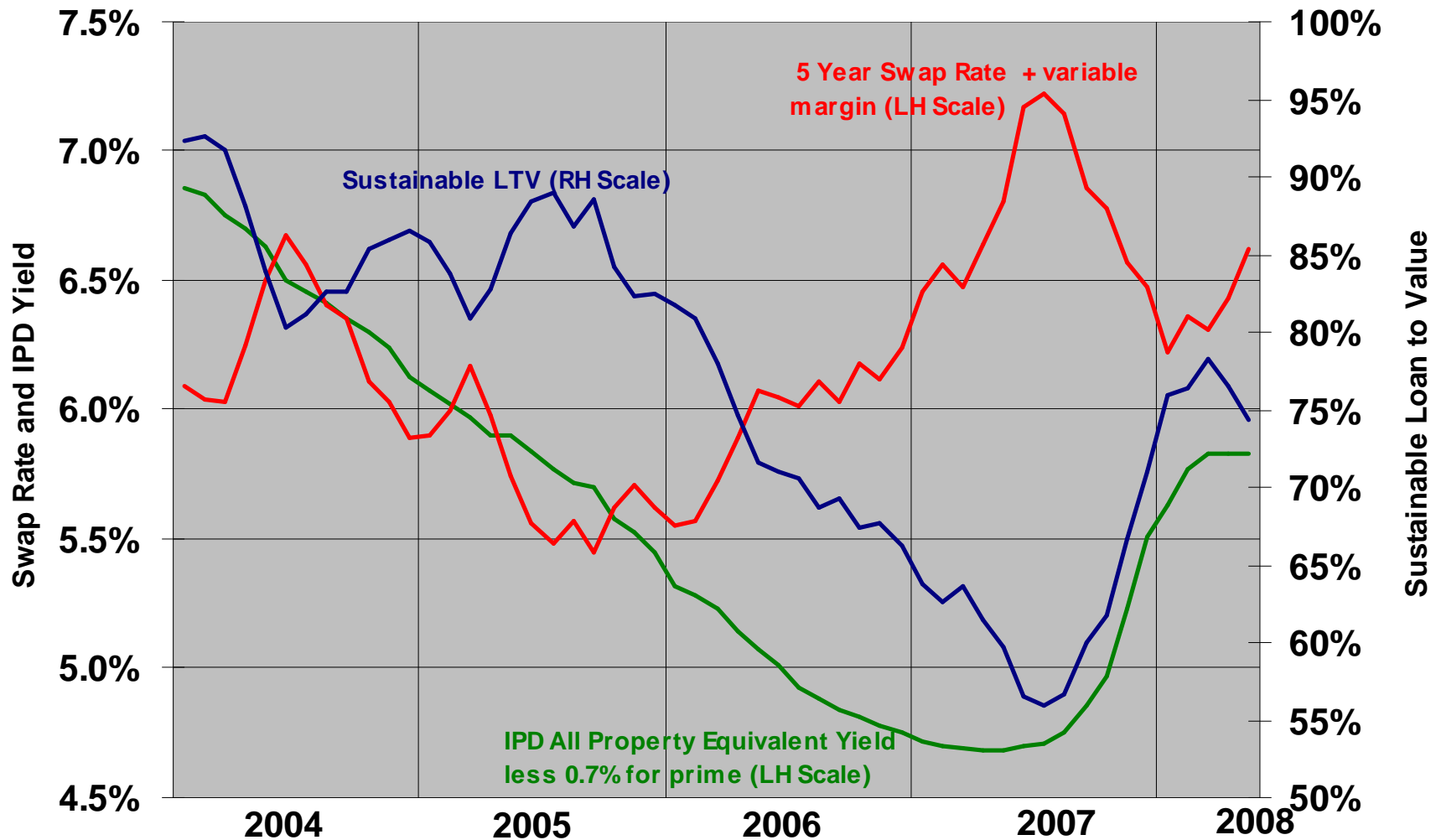
- Obviously, loan to value ratios are more sustainable. But, by how much – given today's increased interest rate margins?

Source: IPD and Financial Times

Over the last 12 months the sustainability of LTVs has increased from 55% to 75% - back to 2006 levels, even after allowing for increased margins and increased ITI cover



Sustainable loan to value ratio for prime investment



Data from FT & IPD
 Inspiration from Dominic Reilly – King Sturge LLP:

Now is a good time to be lending - thirdly, because of reduced competition between lenders



-
- Up to summer 2007 it was a borrowers' market
 - But many banks have withdrawn from property lending
 - Conduit lenders
 - Lenders with problems in their existing loan books
 - Lenders with problems raising finance on the interbank market
 - Lenders who state: "Lending strictly to existing customers only"
 - Now is a lenders' market – they can choose the business they do

... fourthly, because profitable business can be achieved



-
- § Margins up – highest for 8 years
 - § LTVs down – lowest for 8 years
 - § ITI cover up – back to 2003/4 levels
 - § Arrangement fees up – “highest on record”
 - § Exit yields - up

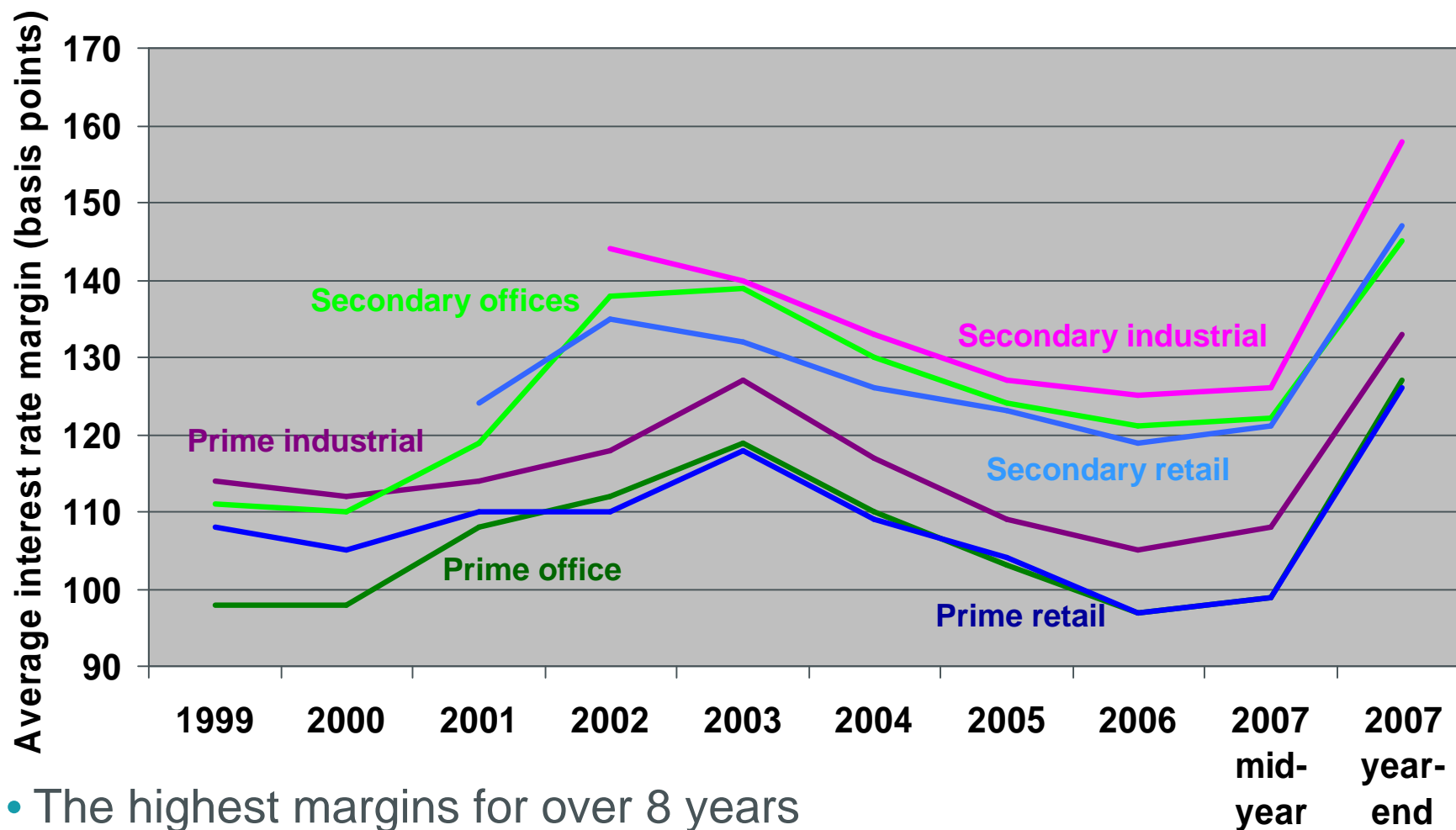
- What a magic combination for lenders!
- Lenders with capacity to lend are now able to do so on terms that 12 months ago they could only have dreamt of
- Debt has been repriced

Note:

- The email pack will include charts on all of these (now enclosed) – but Dec '07 is already ancient history.
- More interesting is where are they going?

The repricing of debt: higher interest rate margins

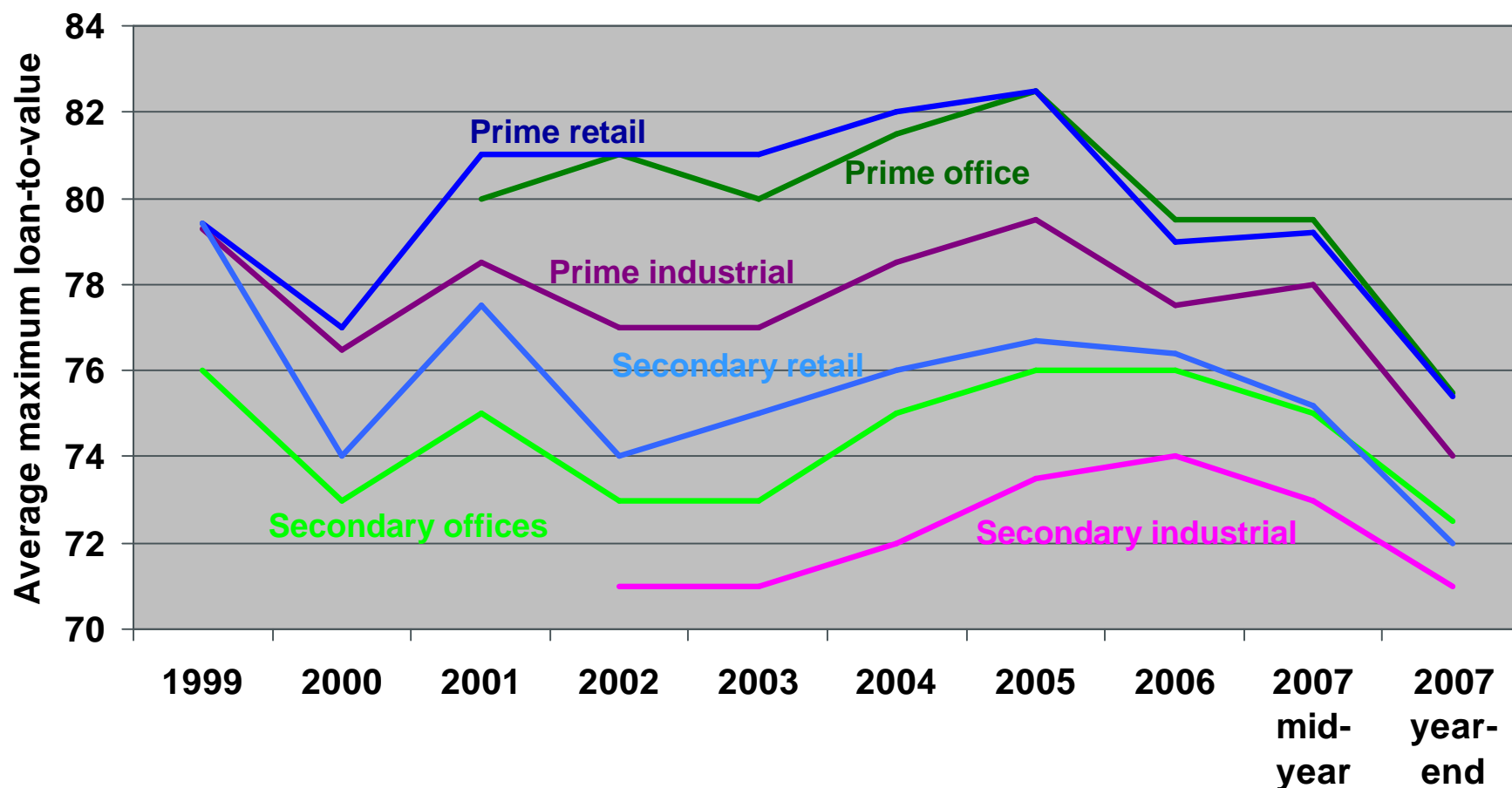
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- The highest margins for over 8 years
- Margins have increased further over H1 2008

... and lower loan to values

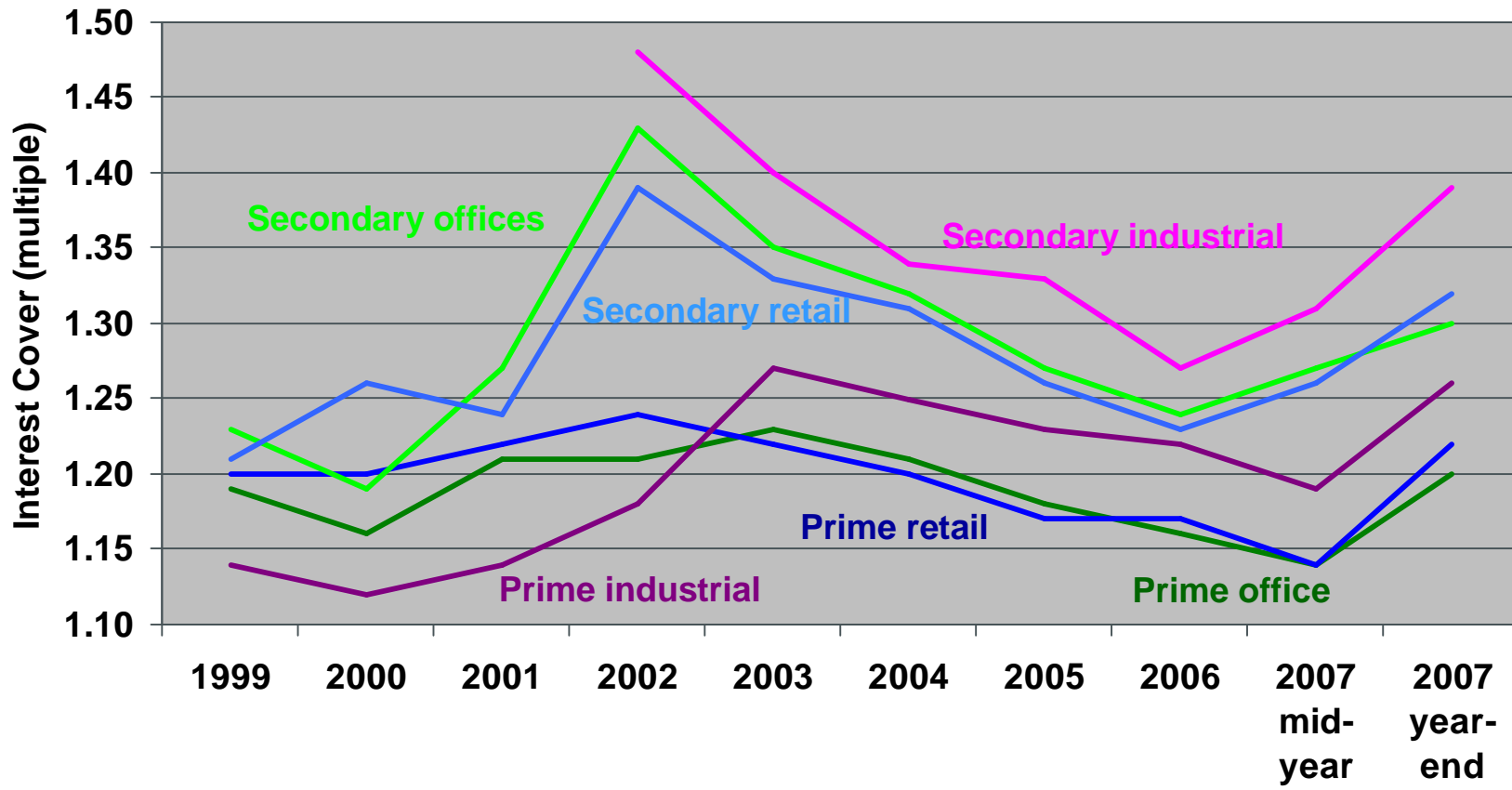
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- The lowest LTVs for over 8 years (except secondary industrial)
- Lower LTVs for prime in 2006 reflected reduced income cover due to downward yield shift

Source: De Montfort University

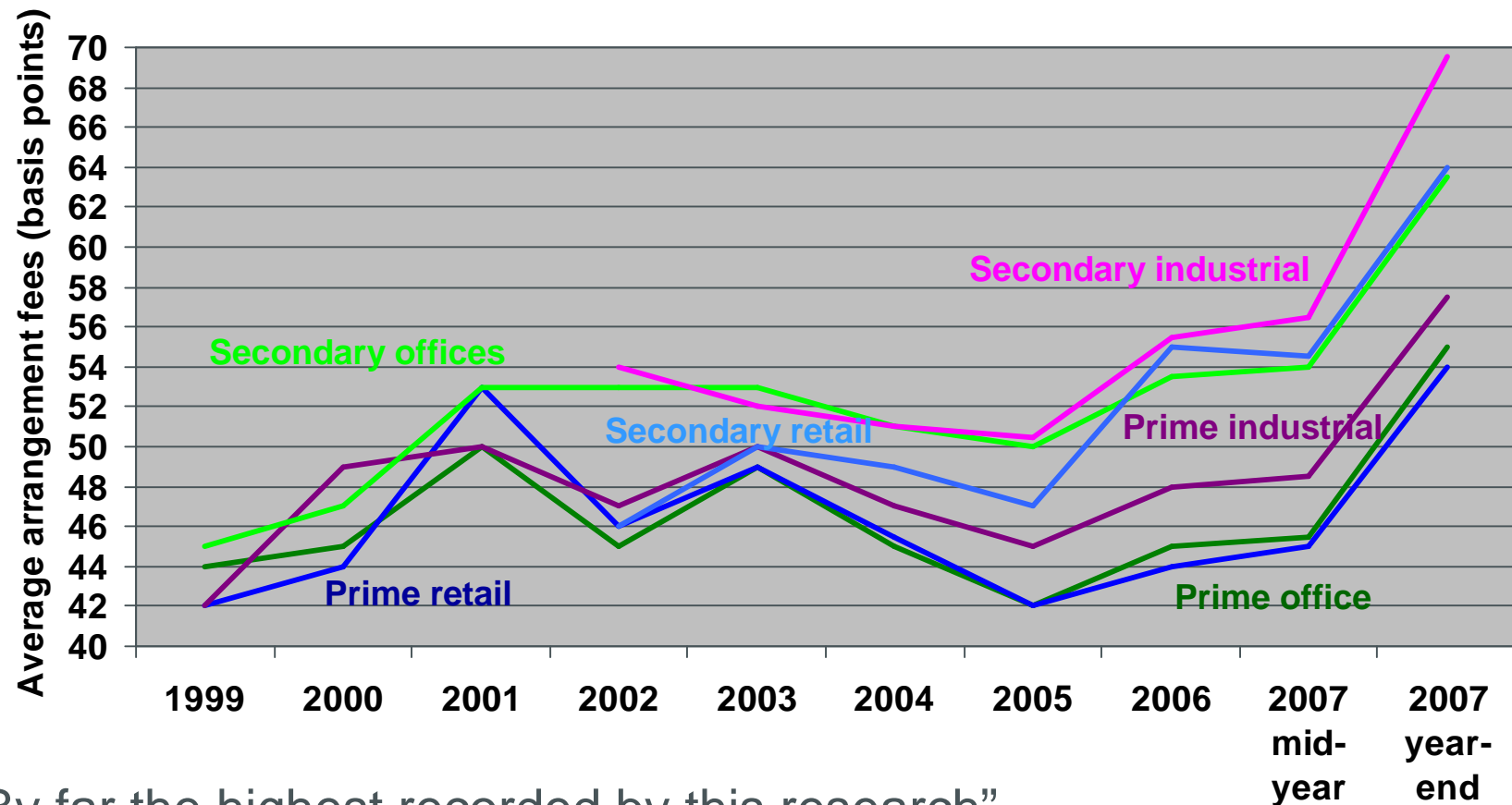
... and higher income to interest cover



- Back to 2003/4 levels or before

Source: De Montfort University

... and higher arrangement fees

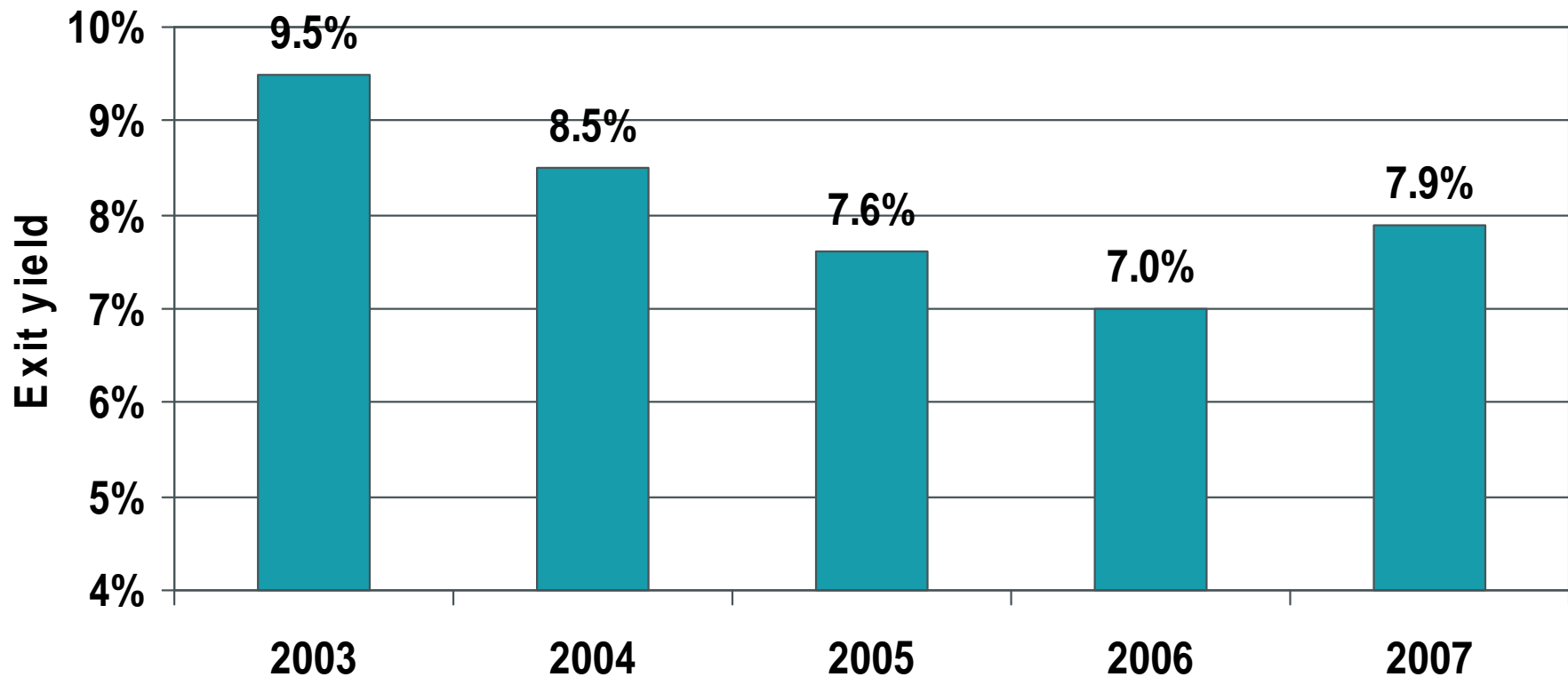


- “By far the highest recorded by this research”
- Greater allowance for risk of aborted deals (and generally)

... and higher exit yields



**Average exit yield for a 5 year loan secured
on a prime office investment**



5. My forecasts of property lending terms



- LTVs: may have fallen further since Dec 2007 (DMU research date)
 - I am not expecting them to fall much further; but to remain low
 - Interest rate margins: have continued to increase
 - I am not expecting them to increase much further; **indeed, may reduce** (40% ROC?)
 - Income to interest cover
 - Arrangement fees
 - Exit yields / residual debt amortisation requirements
- May have increased further since Dec '07
 - I am expecting them to continue increasing
 - Most are still short of previous levels (2003 and before)

The dramatic changes in lending terms have led to a higher equity requirement (or have they?)



	June '07	June '08	June '08
Transaction	Purchase	Refi of short term finance	Purchase
Prime Office/Prime Retail: Market Value	£100.00	£80.00	£80.00
LTV (average maximum)	79.5%*	72.5%	72.5%
Loan amount	£79.50	£58.00	£58.00
Equity required	£20.50	£42.00	£22.00
Increase in equity required	-	+ £21.50	+ £1.50
		+105%	+7.3%
Margin (average)	99 bps*	150 bps	150 bps
Amortisation	Limited	Full cash sweep	Full cash sweep

Source: De Montfort University (*) and Savills

... which are leading to changes in the market



-
- Absence of heavily debt-backed purchasers. As higher % of equity is required
 - Emergence of specialists to provide equity/JV finance
 - Re-emergence of mezzanine providers – definition: “the provision of additional debt using surplus rental income” (not ‘stretched senior’)
 - Lots of funds have been / are being set up for this purpose
 - The proper pricing of those additional layers of finance (300 bps to 1,000 bps)
 - The repricing of risk

6. Who is lending today? – Savills' view



-
- We monitor 120 different lending organisations (past, present, future)
 - 60 of them we saw at MIPIM
 - 74 of them we valued for in 2007
 - 2,700 individuals we email research documents to every month
 - 78 lenders claim they are still lending in the UK
 - And 42 lending in continental Europe
 - 16 new lenders identified since June 2007
 - But, how enthusiastically and on what terms?
 - But importantly, who will lend to new customers? ...
 - William, please name them ...

Active lenders who will lend to new customers above £50M (22, was 15 on 4 June 2008!)



-
- § Aareal
 - § Abbey/Santander
 - § AIB Capital Markets
 - § Bank of Ireland
 - § Barclays Bank
 - § Bayern LB
 - § Deka Bank
 - § Deutsche Postbank
 - § Eurohypo
 - § Helaba
 - § HSBC Plc
 - § HSH Nordbank
 - § Hypo REBI – more in Europe
 - § ING Real Estate Finance
 - § Lloyds TSB
 - § Morgan, JP
 - § Munich Hyp
 - § Nord LB/Deutsche Hypo – recently merged
 - § Royal Bank of Scotland
 - § Unicredit
 - § Wachovia
 - § West Immo

Active lenders who will lend to new customers typically £10M - £50M (15)



-
- § Bank of London and the Middle East
 - § Bristol and West Property Finance
 - § Close Property Finance – more equity positions
 - § Dunbar Bank
 - § Fortis Bank
 - § Investec Bank (UK) Plc
 - § Kaupthing
 - § Landesbank Berlin
 - § Macquarie Bank Ltd – more equity positions
 - § Met Life Investments
 - § Mitre Capital – more equity positions
 - § Norwich Union Mortgage Finance
 - § RBSI
 - § Société Générale
 - § UBS – more in Europe
 - § And others ...

... plus many others actively doing business, albeit on their own terms



Private banks are prepared to lend to new customers, provided they bring a wider banking relationship:

- § Allied Irish
- § Bank of Ireland PB
- § Barclays Wealth
- § Citigroup Private Banking
- § Clydesdale
- § Coutts & Co.
- § Credit Suisse PB
- § E.F.G.
- § HSBC PB
- § Schroders PB

Note: Banks whose business is predominantly driven by HNWIs

Major lenders are actively working with their existing customers:

- § Anglo Irish
- § Barclays
- § HBOS
- § RBS

They are seeing many “new best friends” (or so the borrowers think)

Smaller ticket lenders

I am told this area of the market continues to be busy

16 new lenders since June 2007 – some looking, some participating, some already active



-
- § Al-Salaam Bank – Bahrain?
 - § BNP
 - § BBVA?
 - § Deka Bank (Mark Titcomb)
 - § ING Real Estate Finance
 - § Intesa Sanpaolo?
 - § La Caixa
 - § Landesbank Saar?
 - § Mitre Capital
 - § Munich Hyp
 - § National Bank of Abu Dhabi
 - § Piraeus Bank?
 - § Qatar National Bank
 - § RZB (Austrian)?
 - § Unicredit
 - § Wachovia

Not on the lists?



-
- The lists are based on actual letters of instruction to value received
 - Or the promise of instructions to come
 - Or dialogue
 - If you are not on the lists
 - Get in touch with Savills!

The key to successful property lending today – “Navigating through the turmoil”



- Carefully examine the property fundamentals
- Not just quality of investment
 - Length of lease
 - Strength of covenant of the tenants
- But occupational desirability ...

A return to property fundamentals



-
- Where does value come from? It is the desire to occupy, whether as tenants or owners
 - Thus, occupational desirability is fundamental. Location, specification, floorplate layout, configuration, presence, quality, etc. Lettability
 - Occupational markets dynamics: supply, demand, development pipeline
 - Prospects of rental growth
 - Value at exit: lease expiry; loan expiry;
 - Obsolescence

Carefully examine other fundamentals



-
- Quality of your customer – proven track record – for investing, active management, developing etc
 - Work closely with your professional advisers – lawyers and valuers – only use the best
 - Likewise with your own staff. Loan officers need the full backing of their masters (Board, Credit Committee, etc.)
 - You must be seen to be serious players
 - “No slow nos.” No late pull-outs
 - Speed of decision making remains essential, even in this market

7. Turning to those with existing loan books ...

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Theme: Navigating through the turmoil

Values have fallen 15% - 20% (or more). Consider reviewing your loan books



Focus on:

- Viability of development projects in progress. In particular, some new build apartment blocks
- Investment properties with: early lease expiries; weak tenants; other challenges
- Non-income producing property, e.g. sites, vacant buildings, unsold resi
- Empty buildings represent a negative cashflow – empty rates, repairs/services, security, etc.
- Locations of oversupply, whether offices, retail, industrial, residential
- Secondary (and tertiary) properties
- Focus of cashflow, less so on LTV

Options available to distressed lenders - technical breach of the LTV covenant



- Seek more collateral
- Seek more income
- Amend (or delete) the LTV covenant
- Swap debt for mezzanine (properly priced)
- Swap debt for equity
- Hand the keys back/receivership/repossession

But my advice is:

- Hang on. It will come back

When faced with workout take a 5 year view



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- Don't be hasty. Keep a cool head
 - Don't squabble with your partners, the other syndicate members
 - I saw factions develop in the mid 1990s. Priorities? Cashflow, grow value, get rid quickly?
 - Take a five year view. Why?
 - Avoids a flood of property being released onto the market. Helps market stability
 - Is consistent with the view you took when the loan was initially granted
 - Should take you comfortably through to the other side of the downturn

Workout strategies



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- Work with the borrower. Prepare a business plan. Test the credibility of it. Prepare cashflows with growth. Run scenarios
 - Appoint a receiver only as a last resort
 - Usually, the borrower will be the best person to manage the process. Bankers are not property professionals
 - PGs are not a waste of time. They are an expression of confidence to work with you
 - If, after trying, you lose confidence in the borrower, consider transferring the asset to a bank-owned workout subsidiary (at arm's length). Why allow vultures to enjoy the fruits of the recovery when it comes?
 - In any event, work with Savills. Our recoveries teams. Project consultancy

UK Property Finance Market - Conclusions



- For both commercial and residential lenders, this is a brilliant time to be lending on well secured and profitable terms
- There is no shortage of organisations prepared to lend. However, like the property markets, it is about pricing. Risk has been repriced
- Higher levels of equity are required. Re-emergence of mezzanine.
- There are lots of funds waiting to pounce when the market reaches the perceived bottom
- As and when the CMBS market returns, it will do so in a different form
- When faced with loan workout, keep a cool head. Take a five year view
- There are still a lot of uncertainties in the markets. Therefore, lenders should continue to focus on the fundamentals, in particular occupational desirability

Overall conclusions – Mat Oakley



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- There is macro economic risk, but even the worse case scenario will be short lived
 - Focusing on areas of undersupply and/or areas of strong demand is the way to achieve above average returns
 - It is a great time to be lending

