September 2020

Knight Frank

COVID-19

What we know, what we expect, what we question.

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Executive Summary

The influence of the pandemic continues to be felt throughout financial markets, economies, and society in the broadest sense.

Optimists can highlight the unwinding of lockdowns, the reopening of trade, and with it a return to a degree of 'normality'. High-frequency indicators report a sharp rise in economic activity, as people return to work, and some of the worst predictions for output reductions have not come to pass. Pessimists might point to the long road to recovery for GDP levels, the risk of a second wave of infections, and an intangible disruption to previously accepted norms in almost all walks of life.

Those charged with making real estate decisions will be familiar with the difficulties of weighing both perspectives. Yet perhaps the most fundamental challenge is that of rising complexity: navigating real estate markets has become more complicated since the onset of the pandemic, and requires a greater depth of analysis than ever.

Our fourth edition of this research aims to shed light on some of these complexities. This time, we have undertaken interviews with several of our experts, focusing on a few specific topics in detail: the return to work, bright spots in the investment markets, and the influence and impact of leverage in real estate.

As always, space constraints mean that we can only scratch the surface of these debates here, but we would be delighted to discuss any of the issues raised with you direct, and in more detail.

William Matthews
Head of Commercial Research
william.matthews@knightfrank.com

Content

MARKET SNAPSHOT

Our latest take on key market sectors.

Real estate investment is steadily becoming easier. In Europe, economies continue to open up and intra-EU travel restrictions are easing. Resuming some level of travel is important, given that cross-border real estate investment is a major source of activity.

For now, we expect investors to target structural trends and safe haven locations. Based on provisional Q2 volumes, the US, Germany and the UK remain the top three investment locations, globally. Despite the US remaining number one for investment, indications are that Q2 volumes are significantly lower than last year, reflecting that the pandemic reached North America later than Asia or Europe.

In Europe, the logistics sector has held up well and by the end of H1, year to date volumes were above where they were for the same period last year. Germany also shows relative resilience, with Q2 transactions not far off investment levels seen in Q2 2019. In the UK, the acquisition of IQ by Blackstone, boosted H1 2020 volumes for Alternative / Mixed assets to almost 60% above where they were for H1 2019.

The road back to the office is uneven across the UK. With the cautious re-opening of offices beginning across the UK, the move toward some sort of normality is far from simple. The immediate term will see admittance for employees on a permission-only basis, physical distancing inherent and human transit routes governing movement within the office building. In short, a situation far removed from the working world most would recognise.

For businesses, travel to the office via public transport is also a major consideration and a clear area of vulnerability. This means that firms located in markets of least reliance on public transport, such as many of the UK regional cities and business parks, could encounter a smoother return. Moreover, office design is proving a factor in enabling office re-occupancy. Why? Fewer floors mean staircase access is a viable option for reducing human traffic congestion at lifts. In the UK regional cities, 90% of offices are below 10 storeys. This fact could prove conducive to permitting and encouraging quicker re-occupancy.

What will happen longer-term? The experiences of the pandemic will clearly have a lasting impact on the way we work and how our workplaces function. Working for home has proved an effective stand-in for the office and will be a component of businesses' operational structures moving forward. It is not though, a wholesale replacement. A hybrid model whereby some employees are working from home and some are working from the office is likely to prevail. Will this mean less demand for office space? Yes, in some instances, but most firms recognise that business culture is built and reliant on the interaction and collaboration that offices provide. Firms will also give greater attention to operational risk in the aftermath of the pandemic. This could ultimately drive additional demand into the UK Cities, as business strategies may conclude that spreading workforces across a greater number of smaller regional offices could improve resilience.

Positive signs for UK Industrial. Although the pandemic has had a profound impact on all businesses without exception, recent data supports the case for the UK warehousing market weathering the COVID storm comparatively well.

Foremost, the pandemic has served to accelerate the pace of the consumer shift to online retail, particularly for food. Online sales as a proportion of all retailing was 33.4% in May, it has dipped slightly to 31.8% in June. Compare this to the February percentage of 19.9% and the influence of the behavioural changes created by the virus become starkly clear. In the grocery market, online sales have risen from 5.4% of sales in February to 11.3% in May and remained at this level in June. Significantly, estimates suggest that around 25% of first time online shoppers will also continue using the method beyond the pandemic. To service this growth, demand for largescale fulfilment and 'near-urban' warehousing will continue. The pre-let of 2.3m sq ft at Dartford to a global online retailer is confirmation of these growth projections.

Importantly, the UK's manufacturing sector is also showing signs of recovering. The UK PMI (Purchaser Manufacturing Index) climbed to 60.3 in August, indicating expansion, and far above the record low of 32.6 seen in April. World PMI climbed above 50 in July, for the first time since January. Although sustained growth is questionable due to decreases in new orders, this improvement indicates that operations are gradually resuming in a number of sectors from almost a complete cessation.

Retail: lockdown = ground zero. The lockdown on "non-essential" retail stores was lifted on 15 June in England (12 June in N Ireland, 22 June in Wales and 29 June in Scotland). The retail re-opening has been very phased, with only around 40-50% of stores re-commencing trading in the first week that lockdown was lifted. Retailers are weighing up the financial viability of operating stores with drastically reduced trade (ca. 30% initially) against higher operating costs as strict social-distancing disciplines are enforced.

Many retail and leisure operators remain in a battle for survival and this will significantly depress quarterly retail rent collection rates in June and indeed September (to a projected 10%-20%). The wave of CVAs and administrations will accelerate in the second half of the year, as cost holidays lapse. Against this occupier uncertainty, rents will continue to rebase rapidly, with capital values following suit (by ca. 30%-50%).

Despite an improving monthly trend, retail trade levels will be significantly below "normalised" levels for some time to come. Christmas 2020 will be the first meaningful temperature check for most retailers, but realistically, any sustainable recovery in the retail sector is unlikely to take root until H2 2021, at the earliest.

Care homes: emerging from challenging times. After a difficult period, the number of COVID-19 deaths among care home residents has thankfully normalised to pre-pandemic levels. Challenges remain, but operators have been remarkable in their efforts to control the death toll, protect their residents, and their businesses. There will inevitably be an impact on occupancy and income streams, but the aggregate effect across the UK has been moderate compared to other property sectors. We will report the results of our annual Care Home Trading Performance Survey as usual in Q3 2020, but this year the research will be all the more important as we seek to measure the full financial impact of the pandemic.

Despite the challenges, the long-term drivers for healthcare property remain robust with demand expected to outstrip supply in the approaching decades. The development of new care homes and other healthcare facilities is a necessity looking forward and will provide vital access to the prime end of the market for investors seeking long-term fixed income. As shown by Figure 8, specialist developers are already adding new homes across much of the UK.

Build to rent: increasingly attractive
As lockdown lifts, thoughts inevitably turn to the future. Longer-term, as tenant priorities change as a result of COVID-19, the service-driven model adopted by operators may well emerge as offering clear advantages over the offering in the traditional buy-to-let sector. Purpose-built, affordable accommodation with a range of value-added features such as 24-hour security, all-inclusive bills and on-site support is likely to be attractive. High-quality internet connectivity will be even more of a priority following lockdown.

Elsewhere, shifts in working patterns and behaviours will lead to discussions about how to maximise 'work from home' options, possibly through an increased provision of working space in amenity areas, and the knock-on impact this will have on income, capital and operating costs. The nascent nature of the sector is likely to be one of its biggest strengths in this regard, allowing operators and investors to react and adapt quickly.

What is more certain however is that, despite near-term uncertainties, the need for good quality well-managed rental accommodation to support growing cities remains. This will continue to drive investors to the sector and, as such, investment volumes should continue to grow solidly over the medium-term.

Firms will give greater attention to operational risk in the aftermath of the pandemic. This could ultimately drive additional demand into the UK Cities.

TOWARDS PHASE 3 OF THE GREAT GLOBAL WORKPLACE EXPERIMENT: RE-IMAGINING THE OFFICE

Lee Elliott, Head of Global Occupier Research, talks to Neil McLocklin, EMEA Head of Consulting, about the process and practicalities of transforming the workplace in the post-COVID-19 world.

Office occupation

We are now firmly in Phase 2 of the greatest global workplace experiment: the phase whereby some workers are returning to offices of reduced capacity while many others are continuing to work remotely. This diverse and distributed work style will have a greater influence on the longer-term re-imagining of the workplace than the enforced working from home seen during Phase 1.

As companies adapt and rework their policies for more flexible work styles, for many, the office will become a personal choice rather than a professional obligation. This has strong implications for the office of the future.

Firstly, it heightens the flight to quality office space that has been evident in major global markets for the last few years. The office must be a compelling proposition.

Secondly, that proposition is founded on the delivery of a strong and alluring workplace experience – supported by greater services and amenities. The office of the future is much more than just the physical environment it presents.

Thirdly, the creation, curation and sustenance of this more compelling workplace environment and experience will derive from a greater partnership between occupier and landlord. The former will act to retain staff. The latter will act to retain income.

The future is about migrating from a 'One Size Fits Nobody' world, where the choice was limited to the office and occasional remote working, to a 'Workplace as a Service' offering that provides real choice

Lee Elliott (LE): Neil, the workplace has been through some significant transformations in the decade since the Global Financial Crisis. Is the workplace transformation post-COVID-19 really any different?

Neil McLocklin (NM): The fundamental difference between the Great Financial Crisis and COVID-19 from a workplace transformation perspective is that in 2008 company clients and employees largely read about it, whilst in 2020 everybody has experienced it. This means that as well as the fundamental driver of cost-saving for many businesses (which took precedence post-GFC), workplace transformation is also driven by a deep desire from employees to see change.

LE: What lessons from COVID-19 do you think will be most influential in shaping the future transformation of the workplace?

NM: We have learnt that people are able to work effectively from home on a mass scale, and indeed this has brought productivity improvements and work-life balance benefits for many. But for others, it has also brought a sense of isolation and/or issues related to not having the appropriate space to work effectively from home.

As we emerge from this crisis, we should not be asking whether people can work from home, but rather who should work from home and for how long. The debate will extend beyond distinctions of work and home too, as other options and workplace settings will become equally important. Just because a person does not have the physical space to work from home, why should they be precluded from enjoying the benefits of less commuting and a better work-life balance? We are already seeing clients developing strategies to explore how they could provide options for people to work closer to home (WC2H).

LE: What about the actual workplace itself?

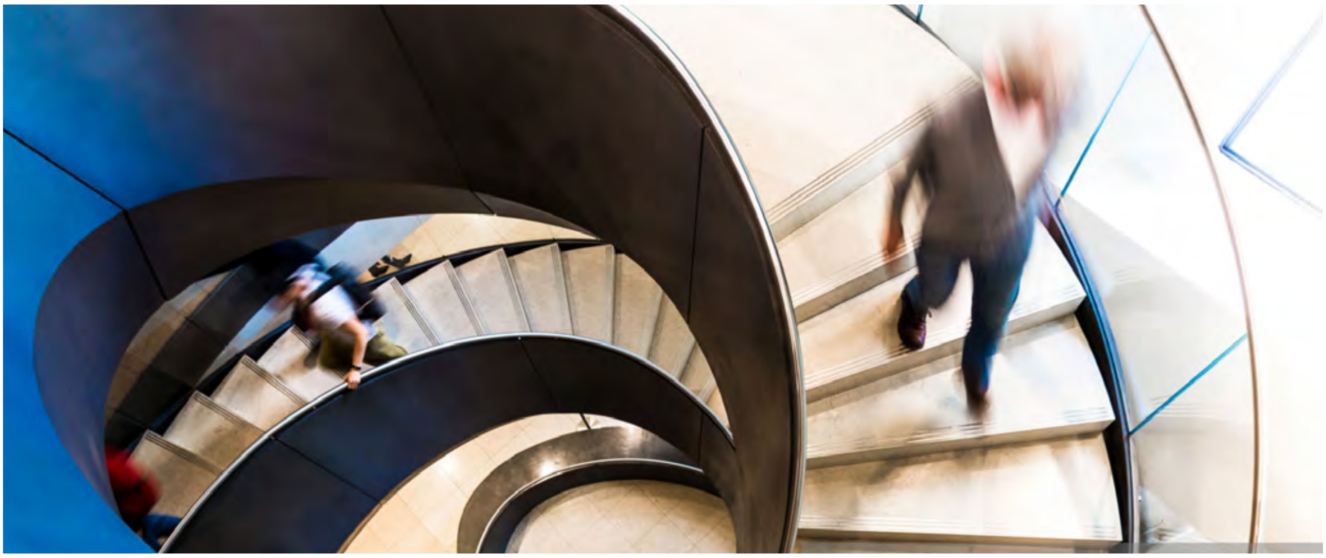
NM: Within the workplace itself, we will also see a greater variety of spaces to cope with the changing wants and needs of the employees. This will be necessary to address the fundamental question – why should I invest in my commute? It will certainly not be to do e-mail or attend virtual meetings. Rather it will be to socialise, collaborate, learn and develop. The workplace will, therefore, evolve to bring significantly less focus on workstations and much more emphasis on a variety of work settings that facilitate these types of activity.

LE: What factors or features do you think are most likely to advance rapidly in the post-COVID-19 workplace?

NM: There are two drivers that will be turbo-charged in importance from their already high BC (Before COVID-19) status. These are wellbeing and sustainability. There is a sense globally and across society that these two issues are what people want governments and businesses to focus on as the change they want to see coming out of the pain and anxiety that they have endured due to the pandemic. This will result in a lot less travel, both commuting and business, more sustainable buildings and a focus on the physical, mental, spiritual and social needs of employees.

LE: How would you distinguish between the workplace BC (before COVID) and AC (after COVID)?

NM: The future is about migrating from a 'One Size Fits Nobody' world, where the choice was limited to the office and occasional remote working, to a 'Workplace as a Service' offering that provides real choice to staff and results in a more dispersed, localised, accessible and sustainable real estate platform.



LE: Finally, what practical steps can business and real estate leaders take to deliver effective workplace transformation?

NM: Businesses need to develop transformational programmes that leverage this desire for change and realise the benefits as quickly as possible. There are a number of specific elements to focus on.

First, profiling. It is essential to develop a much more customer-centric perspective view on your workforce. This means profiling based upon insight into how they are working and what their workplace preferences are.

Second, having profiled the business, create the scenarios that can underpin a workplace as a service strategy and integrate HR, ICT and Real Estate / Workplace functions in order to deliver against that strategy.

Third, it would be a mistake to conclude that because we have worked from home for a while that we do not need to manage the change. There will be multiple changes in terms of how we use and behave in the office, management style, team dynamics and collaboration and different people start working in different ways. Change management is an essential consideration.

Finally, once the business case for workplace transformation is approved the programme needs to be delivered and the benefits realised. This is likely to mean multiple buildings being impacted in different geographies as well as many work streams, whether workplace design and delivery, real estate disposition and/or acquisition, technology and change management. The economies of scale and delivery effectiveness of this at programme level rather than project level are undoubted. Designing and managing the programme accordingly will be critical to its success, driving its performance, managing the risk and integrating the component parts, whether within the business or externally. Crucially, the programme itself needs to be a process of continuous challenge and process improvement resulting in enhanced outcomes beyond the original business case aspirations and incorporating the changing needs of the business.

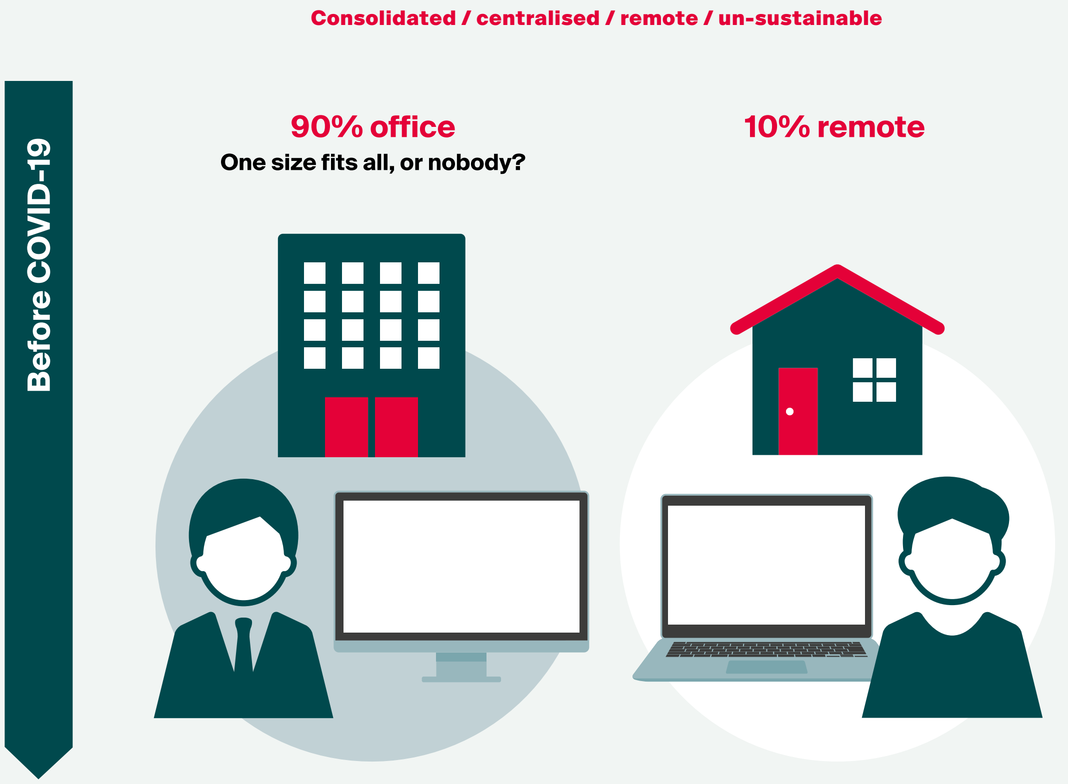
The fundamental difference between the Great Financial Crisis and COVID-19 from a workplace transformation perspective is that in 2008 company clients and employees largely read about it, whilst in 2020 everybody has experienced it.

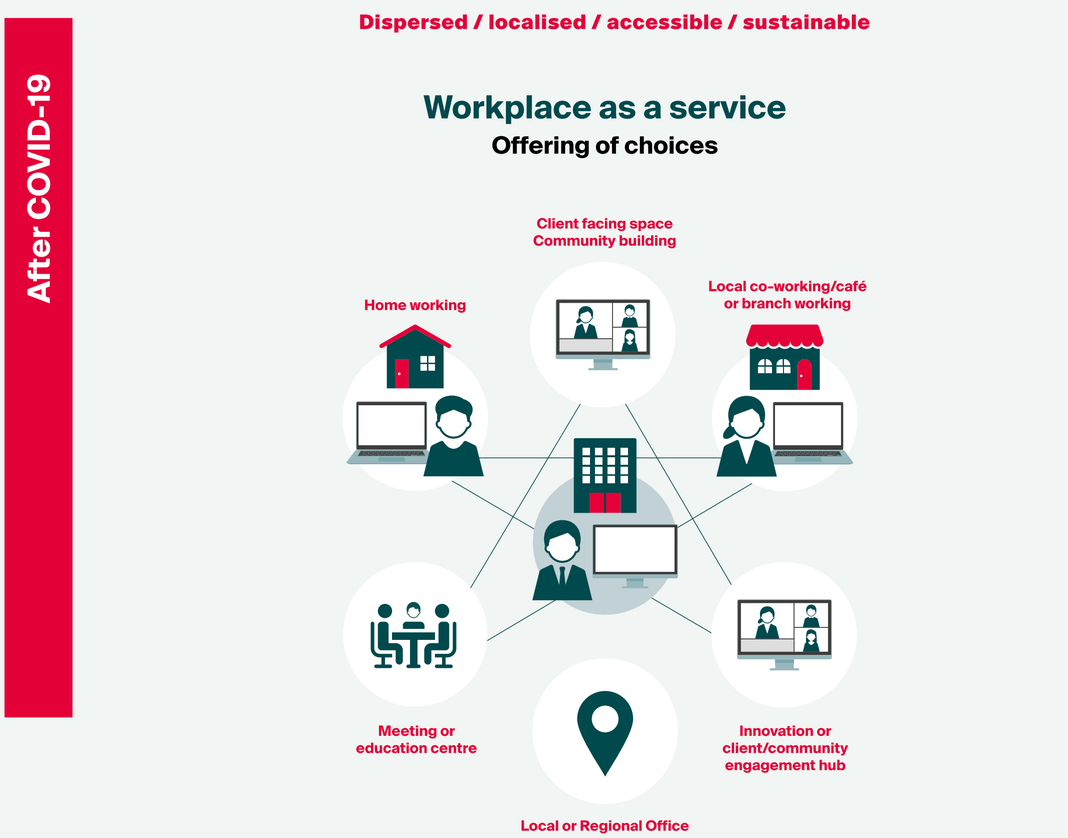
Dr. Lee Elliott
Partner, Global Head of Occupier Research
lee.elliott@knightfrank.com

A thought-leader with more than 20 years' experience analysing trends in Corporate Real Estate, Lee leads Knight Frank's dedicated Global Occupier Research programme. His passion is to develop market insight and foresight that supports the growth of both occupier and landlord / investor clients.

Neil McLocklin
Head of Strategic Consultancy EMEA
neil.mcLocklint@knightfrank.com

Neil McLocklin heads up our EMEA Strategic Consulting service line with over 20 years' experience leading strategic consultancy practices across Europe and working for a multitude of corporates as well as the public sector clients.





Source: Knight Frank, August 2020

SALE AND LEASEBACKS: AN INVESTMENT BRIGHT SPOT

Amidst a general slowdown in real estate investment activity this year, sale and leaseback transactions have been one notable outlier. Antonia Haralambous, an analyst in Knight Frank's research team, speaks to Tom Vaughan-Fowler, a Partner in Knight Frank's Capital Markets team, about the appeal for investors and occupiers alike.

Antonia Haralambous (AH): Sale and leasebacks aren't a new concept, or unique to real estate. What do they involve?

Tom Vaughan-Fowler (TVF): Simply put, an owner-occupier sells their property to a purchaser and then immediately takes a lease on the same property. They move from owner to tenant with minimal disruption to their operations.

AH: Would you say they're a feature of the current pandemic, or was there an increased interest in sale and leasebacks beforehand?

TVF: The recent rise in activity is definitely linked to the pandemic, with £867 million or 83% of total sale and leaseback investment in the UK occurring between March and July this year, according to Real Capital Analytics. However, this is not a new phenomenon: sale and leasebacks accounted for 9% of total commercial investment in 2009 during the GFC, above the long-term average of 5%. This trend will likely continue in 2020, as corporate debt is not currently readily available and was even less accessible at the beginning of lockdown, meaning some businesses will have to resort to other means to raise capital.

AH: So now is a good time for sale and leasebacks?

TVF: Definitely. You are effectively creating new investment product in a market that is still starved of stock. Cyclically, yields are very low, pricing has remained relatively robust over the last quarter and the demand for long, index-linked income has become stronger as a result of the pandemic. By way of returns, you don't currently get much for your money elsewhere, so real estate is still a very busy asset class. One thing vendors should consider is the scrutiny that their business will come under as part of a sale and leaseback obligation. The due diligence completed by a buyer will be forensic, both in terms of historic performance and future forecasts. Buyers will need to understand the tenant's business and their motivation for the sale and leaseback, but these are considerations that would be undertaken during any part of the cycle.

AH: Why have they become so popular? What are the main advantages of these types of transactions?

TVF: Many of the recent sale and leasebacks have been driven by occupiers seeking to inject cash into their business at a critical time. There are a lot of attractions to sale and leasebacks for owner-occupiers, not least that they can unlock equity that would have effectively been sitting dormant as an owned property. This equity can be used for investment, expansion or simply to bolster balance sheets. It's also worth remembering that through a sale and leaseback the vendor can unlock 100% of the value of the asset, as opposed to, say, the 60% they might get through a commercial mortgage. And unlike a bank loan, the capital generated doesn't have to be repaid. It's also tax efficient. Normally the rental costs are offset as an operating expense and can be deducted in full. This is another difference to a normal loan where only the interest payments are tax-deductible.

AH: What types of properties lend themselves to sale and leasebacks?

TVF: Realistically any property can lend itself to a sale and leaseback. The variance in investment appetite will come from the asking price, the tenant covenant and the lease structure. Of the sale and leasebacks completed thus far in 2020, 64% were in Industrial assets, 23% in Offices and 14% in Retail, according to Real Capital Analytics.

AH: Is there a sweet spot in terms of deal size or asset type?

TVF: A good way to look at it is to consider three main variables: the value of the tenant's credit, the vacant possession (VP) value of the building and the difference between the two. If the tenant's covenant is considered high risk, then a buyer is going to expect the overall pricing of the deal to be linked to the VP value of the asset, because there is a high risk of the tenant not being there in the future. With stronger covenants, you will see the delta between asking price and VP value expand significantly, particularly if there is a long, index-linked lease attached, which is often the case. Some investors will put very little standing on the VP value of the building because they are comfortable with the credit position and they consider the building to be "mission-critical" to the tenant's operations. In this scenario, if the building does end up becoming vacant, then something has gone very wrong during the underwriting process. Consequently, you get a range of values and a range of product types, but there is a home for all of them if they're sensibly priced. In the last few weeks, we have seen a couple of short-term sale and leasebacks trade successfully as well as the more traditional +20-year leases with indexation, the appetite for which remains strong amongst investors. These are still the most common type of sale and leaseback, partly because a long lease and fixed uplift mean a higher asking price and more receipts for the vendor, providing they have the covenant to support the obligations.

AH: What types of buyers are interested in sale and leasebacks? Where are you seeing demand emanating from?

TVF: Predominantly it is buyers with their own coupon obligations, often in the form of listed vehicles. The typical sale and leaseback (i.e long lease and either index-linked review or fixed uplift) suits those with their own outgoings. From a REIT's point of view, for example, who typically raise money from a variety of investors by promising them a minimum dividend, being able to secure a product with guaranteed income increases and long term lease obligations makes your life as an investment manager much easier. Sale and leasebacks do not typically suit the value-add investor for exactly that reason. Sale and leasebacks with weaker covenants and more downside risk are the ones most likely to suit an opportunistic investor, as long as they can purchase the asset at a price where they can still make money if the tenant defaults and they get the property back.

AH: What about the occupiers? How do you ensure that they receive a fair deal?

TVF: As a selling agent, it's an important balance to strike. You have to help create an investment opportunity that will be well received by the market, but you also have to remember that your client is about to become the tenant. While it may be tempting to ensure that the lease is drawn up in the most landlord-friendly manner, with the rent reviewed upwards by 5% every year, you wouldn't really be doing your client much service. The sale and leasebacks we have found to be most straightforward are the ones where both the vendor and the purchaser are completely clear of the tenant's future obligations before bidding begins.
You can do sale and leasebacks by negotiation, where the lease is effectively written at the same time as the SPA (sale and purchase agreement). However, these tend to become incredibly protracted because the value proposition is essentially changing during the legal process and you quickly end up with a different deal to the one that was originally agreed.

Sale and leasebacks effectively create new investment product in a market that is still starved of stock.

AH: Are there any accountancy considerations that need to be factored in?

TVF: Accounting practises and obligations change depending on the type of vendor. Public companies may need shareholder approval to sell their assets, for example, depending on the transaction size. New accounting rules also mean that leases normally have to be declared in the accounts as a liability, whereas previously it could be an off-balance sheet source of fundraising. One of the key points is that most sale and leasebacks can't be treated as a TOGC (transfer of business as a going concern) so VAT is payable on both the purchase price and the SDLT (stamp duty land tax). This can be dealt with by careful timing of the cashflow but it's a very important consideration. Ultimately, the accounting position will be different on each deal and we make sure any vendors we are acting for take the requisite specialist advice.

Antonia Haralambous
Analyst, Commercial Research
antonia.haralambous@knightfrank.com

Antonia is an Analyst in Knight Frank's commercial research team, focusing on capital markets. Her work covers both the UK and Europe, with a focus on investment market analysis. Previously Antonia was a member of Knight Frank's residential research team.

Tom Vaughan-Fowler
Partner, Capital Markets
tom.vaughan-fowler@knightfrank.com

Tom is a Partner in Knight Frank's Capital Markets team with ten years' experience focussing on the sales and acquisitions of commercial assets throughout the UK. Tom's specialities include portfolio transactions as well as the analysis and delivery of sale and leaseback transactions for both owner occupiers and investors.

SALE AND LEASEBACK TRANSACTIONS

Knight Frank's Guide
for Owner Occupiers

A sale and leaseback transaction is a way of releasing capital that has previously been tied up in your commercial real estate. The released capital can be injected directly back into your company for the benefit of the business.

Through a sale and leaseback, the owner of a property sells the asset to an investor who immediately leases the premises back to the vendor (the vendor, in turn, becomes the tenant).

Advantages of Sale & Leasebacks

- **Release capital for the wider benefit of your business** – capital that has previously been tied up in the value of your real estate can be released and injected back into your operations, used for wider investment or simply held as working capital.

- **Unlock the full value of the asset** – availability of commercial credit is currently at low levels and mortgage-backed financing typically only unlocks c.60% of the value of the underlying asset. A sale and leaseback enables a company to receive 100% of the value of its property (subject to transaction and tax costs).

- **Cash without debt** – unlike a bank loan, the capital generated does not have to be paid back and would not create or increase any indebtedness. Under accounting principle IFRS 16, most companies are required to recognise leases as liabilities on their balance sheets.

- **Lease terms to suit you** – the lease can be negotiated to suit the organisational needs of your business. The structure of the lease is inextricably linked to the realisable value of the asset.

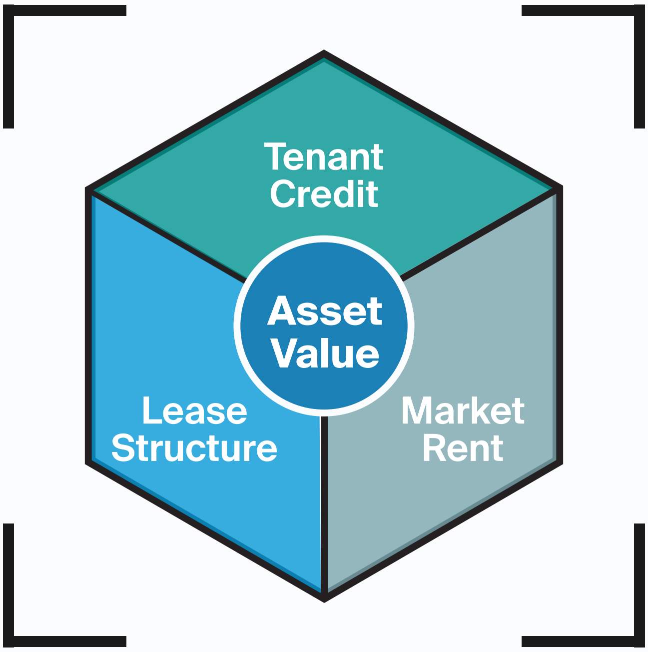
- **Fixed, forecasted outgoings** – under the lease, rental payments and other outgoings are clearly determined. This allows for clearer and more accurate business forecasts for the vendor.

- **Tax-efficient** – a sale and leaseback transaction can create tax benefits as the rental costs are offset as an operating expense. This means that usually they can be deducted in full, unlike a conventional loan where only the interest payments are tax-deductible.

Unlocking the Full Asset Value

Tenant Credit – the covenant strength of the tenant is closely linked to the value of the asset. The sale and leaseback is effectively a bond issued by the tenant and underpinned by the real estate. Investors will want to know what the proceeds of the sale will be used for.

Lease Structure – this should be negotiated to suit both parties but the strongest prices are paid for long leases, with full tenant repairing liability and fixed rental increases.



Market Rent – investments let at market rent give the buyer comfort that they can re-let the asset at the same level if the need arises.

For more information contact
Tom Vaughan-Fowler
tom.vaughan-fowler@knightfrank.com

REAL ESTATE DEBT: OUR PERSPECTIVES

Will Matthews, Head of Commercial Research, speaks to Victoria Ormond, Partner in Knight Frank's commercial research team, Lisa Attenborough, Partner and Head of Knight Frank's Debt Advisory team, and Marc Nardini, Partner and Head of Knight Frank's Restructuring and Recovery team.

The view from research

The provision and management of debt is a fundamental component of developed real estate markets, and understanding its implications can offer valuable insights into future market trends.

Will Matthews (WM): Victoria, can you provide some background to the current lending environment? What did the market look like prior to the onset of COVID-19?

Victoria Ormond (VO): To answer that, first, we need to look back a bit further in history. Pre-global financial crisis (GFC), we had a predominately bank-led lending environment. However, banks were already starting to rethink their lending, catalysed in 2007 by new Basel regulatory capital rules which more closely aligned the amount of regulatory capital banks had to set aside with the riskiness of the loan.

During the GFC, commercial real estate bank loan performance declined and become more capital intensive. This, combined with the new regulatory capital rules, meant that coming out of the GFC, banks generally lent less risky, lower loan-to-value (LTV) senior loans, creating space for new, non-bank lenders to enter the market. Nevertheless, this didn't happen straight away, leading to a dearth of lending, particularly against development financing, in the early years post-GFC.

Bringing us up to before the pandemic, banks had broadly continued to focus on senior debt and some international banks were already indicating an intention to moderate their lending. Non-bank lenders, ranging from debt funds to insurance funds, were an increasing share of the real estate lending market, in part because they are not subject to the same regulatory capital rules as banks, albeit other rules may apply for some types of lenders, such as insurers.

Non-performing loans (NPLs) from the GFC and later Eurozone crisis had continued to be sold down and in Europe, NPLs were down to about 3.2% of bank's balance sheets. Specifically, within the UK, the banks were well capitalised. At the end of 2019, according to the Bank of England (BoE), bank's risk-weighted assets (RWAs) had declined to just under £2.7 trillion, their lowest level since current records began in 2014. Total regulatory capital (Tier 1 & Tier 2), as a percentage of RWAs, was at its second-highest level, at 21.3%. As a result, the lending environment prior to the onset of COVID-19 was in a relatively robust state – capitalised better than it was previously – and the banks were operating at a lower risk level than pre-GFC. Some non-bank lenders were lending at higher LTVs, but these were generally overall smaller sized loans than the banks were originating pre-GFC.

WM: How has this situation changed since the onset of the pandemic?

VO: In the first quarter of the year, bank RWAs increased by 8.8% on the previous quarter, to just over £3 trillion, the highest since Q1 2017. These are likely to have increased further since then. Total capital reduced to 20.4% of bank RWAs, however, considering this ratio was 16.2% at the start of 2014, this is still robust. The Prudential Regulatory Authority (PRA) has also issued post-pandemic amendments to certain bank capital requirements, changing these from a percentage of these RWAs to an absolute amount. These RWAs and regulatory capital influence banks abilities to lend.

The BoE has also increased quantitative easing (QE) by £310 billion over the period of the pandemic. For context, £200 billion of QE was deployed in 2009. UK gilt yields have dropped significantly and the Bank of England (BoE) cut the base rate from 75 bps to 10bps over two successive cuts in March.

Bank's five-year credit default swaps (CDS) initially spiked to 2018 levels and beyond over March and April, although they are now towards more 'normal' levels. A spike in LIBOR largely offset the cuts in interest rates, applying upward pressure on funding costs. As a result, we saw some banks increasing loan margins on real estate debt and/or enhancing fees, particularly in those sectors most impacted by the resulting COVID-19 lockdown, such as retail and hotels.

At the onset of COVID-19, many bank and non-bank lenders around the world were focused on getting a sense of their potential risk exposure, rather than lending. In the UK, we remain somewhat in a period of stasis; quite early on into the pandemic, the PRA wrote to banks, essentially asking them to be lenient where loans are breaching covenants, or otherwise non-performing, where this is due to general market conditions, rather than specific issues related to the loan.

As time goes on and supportive measures by the government unwind, for example, the furlough scheme, the balance between loans triggering covenants due to general conditions and due to considerations specific to the loan is likely to change to the latter. This could prompt a shift away from banks simply waiving covenant breaches and could prompt asset sales. However, we may not see this in the real estate sphere until towards the end of this year, or even 2021 and beyond.

WM: What impact could COVID-19 have on banks and their capacity or inclination to lend?

VO: Banks are generally in a better position than during the GFC. There has been extensive fiscal, monetary and regulatory support, ranging from government underwritten loans to the temporary removal of Countercyclical Capital Buffers (CCB), which has the effect of increasing lending capacity for banks by more than ten times what was lent in 2019. The health of loans are likely to become impacted as borrower support unwinds, interest becomes due on COVID-19 related emergency loans and businesses face squeezed operating margins, for example, as restaurants and shops welcome lower density customer with higher costs.

At the onset of COVID-19, many bank and non-bank lenders around the world were focused on getting a sense of their potential risk exposure, rather than lending.

This means that moving forwards, we'll likely see more distress which is actually due to the individual corporate entity or property, rather than as general a condition. Previously, as these loans worsen in performance, increasing risk-weighted assets (RWAs) banks need to set aside more regulatory capital, which will impede their ability to lend. However, the PRA's changes to the relationship between RWAs and regulatory capital could mitigate this, which overlaid with the reductions in the CCB, could help support lending and bank health.
It is too early to tell quite what the impact on banks will be, but it is likely to be a 'slower burn'. I would expect to see an increase in non-performing loans over time and many banks have already announced significant provisions. However, again, the waters are muddied when it comes to comparing these provisions to other times in history, as the introduction of IFRS 9 impacts the required timing of when such provisions are made.

WM: What are the implications for non-bank lenders?

VO: For non-bank lenders, it's even harder to say because it is a largely untested market. These lenders generally came into existence on the back of the last crisis, so we haven't really been able to see what they look like through stressed conditions.

On the one hand, they're not subject to the same regulatory capital rules (albeit some are subject to other rules), so are they are less impeded in terms of lending. On the other hand, as they are not subject to the same regulatory capital rules many debt funds have higher LTV exposures. Additionally, those debt funds, which had previously purchased NPLs from the traditional banks, may need to reassess their business plans in light of COVID-19, potentially impeding their performance.

However, we could see the entry of new non-bank lenders to the commercial real estate market over the coming 18-24 months, to fill both the lending gap, to the extent that banks and existing debt funds retrench, but also to hunt in the NPL market as these increase.

WM: What does this all mean for commercial real estate?

VO: Traditionally, commercial real estate assets are large, lumpy, heterogeneous and heavily reliant on debt, although more recently there has been an increase in equity-backed investment. Looking back to the GFC, when lending become squeezed, particularly development finance, it did create an issue for real estate. To the extent that riskier development finance is squeezed again, the current lack of supply in many markets could be exacerbated, which is likely to support pricing for those in-demand assets.

For commercial real estate investment, it's probably going to be the more core, better-performing real estate which will be more attractive to lend against. In a retrenched lending market, this could actually create a split between the performance of core, well-located real estate, which is still attractive to lenders and the rest, which might struggle to source debt. Without means of financing, this could impact on demand for such assets.

It is likely we will see an increase in new debt funds coming to the market to provide leverage, however, to the extent that operating margins of borrowers are squeezed, regardless of rent adjustments, it could be harder to support the often wider margins that debt funds require to meet their own business plans.

We've seen a huge weight of demand for investment into property, so we could also see growth in demand from equity-backed investors, should sources of lending reduce.

Once we start to see lending distress, to the extent we see any, this may not appear in a significant way until 2021 or even beyond. We could see poorer performing real estate that struggles to be refinanced coming to market alongside better quality assets, increasing market supply and creating the additional impetus for transactional activity in the direct real estate markets, which we're to an extent, missing at the moment.

Overall there are a lot of moving parts to think about. How much will a reduction in CCB be successful in offsetting the increase in bad loans to enable traditional bank lenders to continue lending? What will the fate be of existing debt funds and how quickly will we see new non-bank lenders enter the market? How will international lenders fare compared to domestic ones? To what extent will the move by central banks and regulators to incorporate climate change assessments into financial stability reporting or to target green bonds, change the type of real estate assets being financed?

These are just some of the many questions which for now remain unanswered. Nevertheless, in an uncertain environment with low yielding bonds and volatile equity markets, direct real estate continues to have a story for demand and lending against direct real estate will continue to be an alternative way to access exposure to this market, in a way which is lower down the capital stack than direct equity.

It is likely we will see an increase in new debt funds coming to the market to provide leverage.

Will Matthews
Head of UK Commercial Research
william.matthews@knightfrank.com

Will is a Partner and head of the commercial research team at Knight Frank, which is responsible for producing a wide range of thoughtful and innovative real estate research.

Victoria Ormond
Partner, Capital Markets Research
victoria.ormond@knightfrank.com

Victoria is a Partner in the capital markets research team at Knight Frank. Drawing on over fifteen years of real estate experience across origination, restructuring, training, academia and commercial research, Victoria develops market leading insight, thought leadership, commentary and analysis, including for the flagship publication, Active Capital.

The view from our Debt Advisory team

Will Matthews (WM): Lisa, you are in direct contact with lenders every day. What is your view on how their appetite to lend has been impacted since onset of the pandemic?

Lisa Attenborough (LA): Initially lenders paused on most if not all new lending opportunities whilst they took time to assess the risk on their loan books. Following this review period, lenders began to open up to consider new lending opportunities albeit rebasing pricing and leverage to reflect the higher risk environment we are operating in.

Different lender types have been impacted in different ways. The following two examples show these differences on a spectrum:

- Clearing banks across the UK and Europe – initially focussed (and still to a degree) on existing client base. Clearing banks also have to consider their wider loan book outside of commercial real estate. For example, they may have exposure to the retail sector at a corporate level, which means they will need to carefully manage their balance sheet in the coming months.
- Debt funds financed by private capital and not constrained by PRA regulatory capital requirements don't have the same restrictions and considerations and in fact, are busier than ever.

WM: Are there specific property types that they are more willing to lend against, and has changed in recent months? Do you see it changing?

LA: Commercial real estate types that facilitate logistical operations and residential investment opportunities are underpinned by solid underlying demand, so continue to attract lender interest.

There are some property types that aren't faring too well in the short-term, however. Student accommodation, for example, has seen lenders pull back from the sector initially, but this may well change as university applications are converted into PBSA (purpose built student accommodation) occupancy.

The traditional office space sector is subject to similar conjecture, with some saying lenders are unsure about investing in it, but we haven't seen that yet. Lender demand is still there for offices both in London and regionally.

WM: How has pricing been impacted, and how much of this is additional risk premium applied by lenders to real estate, and how much a function of market interest rates?

LA: Different lenders are following different pricing strategies

Insurance lenders are pricing on the basis of relative value, with corporate bond spreads initially spiking upon lockdown. As a result, insurers increased their real estate debt pricing. Corporate bond spreads have now returned to more 'normal' levels, so debt pricing has come down (albeit not to pre COVID levels).

Several investment banks have introduced pricing floors. Loan syndication (the process by which investment banks distribute and manage their exposure) slowed significantly during Q2 of this year. This led to congestion in the market and consequently, we are seeing investment banks managing their balance sheet cautiously.

For debt funds, target returns remain the same, but leverage has reduced therefore achieving the same level of return for lower risk transactions.

Commercial real estate types that facilitate logistical operations and residential investment opportunities are underpinned by solid underlying demand, and continue to attract lender interest.

WM: What about future appetite for lending? How do you expect the pool of lenders to evolve over the next year?

LA: A lot depends on what happens with a second-wave and the shape of the economic recovery, and how both of those impact the amount of bad debts that banks will have to deal with in the coming year.

We are already hearing of clearing banks provisioning for losses which will impact future lending appetite. Barclays has set aside a higher than expected £1.6 billion to cover a possible rise in loan losses in the second quarter and Lloyds has announced recently an impairment charge of £2.4 billion for the three months to June 30 – a significant increase from the £1.4 billion in the first three months of the year.

In Europe, Banco Santander reported the highest provisions by a bank in continental Europe so far. The bank is holding back €1.6 billion specifically for losses linked to the virus. This provisioning will undoubtedly impact the lenders appetite for commercial real estate lending in the coming months and even years.

WM: Do you envisage a more competitive environment as debt funds raise more capital?

LA: Not immediately. One lender told us recently that "we have money to invest but we're in no hurry to invest it". For the short-term there will be a flight to quality both in terms of deals and sponsors who are being backed.

That said we have seen a number of new debt funds being set up, which eventually will drive competition, but I don't expect to see that to result in more competitive terms until the economy begins to show signs of recovery.

Lisa Attenborough
Partner, Debt Advisory
lisa.attenborough@knightfrank.com

Lisa joined Knight Frank in 2017 to set up and lead the Debt Advisory team. She joined from CBRE where as a Director in the Debt & Structured Finance team she focused on advising and arranging finance for clients within the alternatives sector. Lisa's background is in banking and finance, having spent over ten years originating and structuring development and investment finance in the UK student accommodation, higher education, and healthcare markets. During her time at Knight Frank Lisa has advised on over £1bn of debt transactions across the UK and Europe.

The view from our Restructuring and Recovery team

Will Matthews (WM): Marc, to what extent has the pandemic resulted in client distress so far?

Marc Nardini (MN): To set the scene – lenders pre-pandemic had some stress in their portfolios, particularly in the well-publicised sectors such as retail, and to an extent, residential developers, and the pandemic has proven itself to be a catalyst to speed that up. For example, retail has recently gone through a cycle that normally would have taken a number of years in the space of 14-15 weeks.

The same applies for developments with both residential and commercial, and also now for hotels, which as a result of the pandemic have really come under pressure. So, lenders are really in a tough environment at the moment, one where they're all taking stock and having to look at their risk and exposures, and having to mitigate that.

I wouldn't really say that lenders are seeing distress per se at the moment, because of all the support due to the economic scenario we're in, as well as the moratoriums against enforcement acts, I don't think there's actually distress out there in the marketplace. There is certainly stress where lenders are looking at their exposure to risk, but until we wean off the support that we've got out there at the moment, I don't think we're actually going to be able to address how much distress there is. But certainly what we're seeing across the market are lenders really drilling down into their portfolios to look at their risk exposure as a whole.

WM: Are there any sectors which have fared particularly well/badly?

MN: Again, to set the scene, it's very different from what we saw in 2007. There is very much a split market space at the moment where there are asset sectors that are trading and performing quite poorly against a backdrop of those that are trading very well. Sectors such as logistics and industrial are obviously thriving in the current environment, whereas retail, food and beverages, hotel and some residential developments – as I touched on before – they're the ones that have fared the worst because of their reliance on the consumer, and the stability of economic conditions.

I would add, though, that despite many assets being covered by the ones that are performing poorly, just because they fall into that asset sector class doesn't mean that they're distressed. Lenders and their borrowers who are well-stabilised and relatively low-leverage against the assets – they're all typically fairly secure, and those are able to pursue alternative strategies and options with those particular assets will fare well from this.

WM: What has been the stance of lenders to date when it comes to non-performing loans? How long are they likely to show leniency?

MN: I would say typically lenders have been providing support and they want to be perceived as providing support. I think in terms of being able to progress enforcement, they're holding off from doing so at the moment because of various regulations and also the risk of the negative PR and press criticisms that we saw in the aftermath of 2007.

I'd say as a whole, lenders have been pretty supportive. A lot of restrictions are going to be lifted come end of October, and I think that's when we'll really see how much stress is in particular lenders portfolios and we'll start to see a lot of them taking a more proactive approach when it comes to dealing with that.

WM: What is the appetite for lenders to take on ownership of distressed assets? Will this be a source of stock to the market?

MN: Lenders normally don't want to enforce, in most instances they won't take the ownership on themselves, they'll typically use a recovery mechanism, whether that be a receiver or an insolvency process, but, they don't want that. Lenders are in the business of lending and having a performing cycle from the start of the loan until the end of the term. Therefore, anything that does deviate away from that isn't really desirable for them, therefore lenders will be working very hard with their borrowers, providing there are open lines of communication there, to stabilise the loan performance over the period of that loan.

So, very different to 2007, but typically lenders will try to make their loans perform and be stabilised. There is no doubt though that there will be a lot of stock brought to market by loans that have failed to perform and where enforcement action has been taken. We're starting to see quite a significant increase in contact from lenders who do have concerns, so there is no doubt that there will be a market that will effectively be dominated by that restructuring angle.

WM: What are the key things to watch for in H2 and into 2021?

MN: I think we're still a little bit further out than that. I'd say H2 will be watching to see if there are enforcement actions taking place and if the government regulations allow that. 2021 I think will be the opening of the market, where there will be a lot of opportunities for the debt funds and private capital who effectively enter into an investment market at the bottom with the hope that future market conditions will begin to flourish and over a long-term period, the value of those assets will come good. So, I think 2021 will be the start of an investment market with a bit more buoyancy.

2021 I think will be the opening of the market, where there will be a lot of opportunities for the debt funds and private capital who effectively enter into an investment market at the bottom

Marc Nardini
Partner, Restructuring & Recovery
marc.nardini@knightfrank.com

Marc Nardini (BSc Hons MRICS FNARA) joined the Knight Frank Restructuring & Recovery team in 2014 as a Registered Property Receiver and Member of the Royal Institution of Chartered Surveyors. Marc is responsible for providing property restructuring and turnaround advice to a range of clientele, both in the UK and Europe, and has taken Receivership appointments in excess of £870 million worth of assets over the last five years.

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