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Julien Holmes, managing director of Crown Mortgage Management, believes that there are major challenges for lenders in the face of a faltering commercial property market

## Commercial market tumbles

There is little good news coming out of the commercial property sector at present. Capital values continue to tumble, with the latest figures from the IPD indicating falls of circa 15%. Tenant demand for commercial property has fallen at the fastest pace in six years and it looks as if this trend may soon be mirrored in the residential market.

However, we must retain some perspective. There is no doubt that the market prior to 2007 was overvalued. In the wake of the dotcom boom many investors sought alternative assets and property with strong and secure income streams and the commercial property market was particularly appealing. At the time, property yields (defined as income relative to capital values) compared well with those offered by other asset classes, such as gilts and cash, and all this attracted capital to the sector.

A strong demand for property as an investment, but only a finite supply of investment grade property assets,

reprice, compared with two years in the early 1990s.

The fall in capital values and the sudden rise in yields, combined with the continued high profile interest of some Middle Eastern investors in prime London property, has resulted in some commentators calling the bottom of the market. However, I still believe there are a number causes for concern.

As mentioned, a driver behind the growth of the market in the early 2000s was the reallocation of assets towards property. However, this trend is now reversed. Investment demand for property is patchy and, according to Mercer's latest European survey of pension fund asset allocation, pension funds anticipate that allocations to UK property will continue to decline.

Secondly, commercial property is undeniably affected by the prevailing economic climate. As I touched on a couple of months back, looking at the last economic slowdown, some business types were particularly vulnerable to failure, notably the provision of business services, which saw a threefold increase in liquidations. Given the 30% increase of office space in the West End of London anticipated during 2008 and 2009, this indicates that capital values may have further to fall.

The latest CBI retail survey must also be of concern. It showed retail sales in the UK falling for the first time in two years in March, affecting all types of goods. With wholesale and retail contributing between 11% and 13% of gross value added to the economy across all UK regions, retail properties still look vulnerable.

All this is exacerbated by faltering house prices. The UK consumer, the driver behind much economic growth of the last few years, is losing confidence. The stagnation in the housing market will inevitably affect household retailers and beyond



Julien Holmes

— demand for retail property is at its weakest since the RICS survey began, more than nine years ago.

So what does this mean for commercial lenders? On the one hand the faltering economy is bound to hit some businesses and, subsequently, landlords. Lenders are therefore likely to face increasing arrears on commercial properties. In order to minimise the impact of this lenders must consider their portfolios and the properties, both by type and location, at risk.

Furthermore, the significant falls in values in commercial properties present lenders with an additional challenge. This correction has occurred as a result of the credit crunch and consequently prior to the economic slowdown many are predicting. Some lenders may well face, for the first time, the spectre of negative equity in the commercial market.

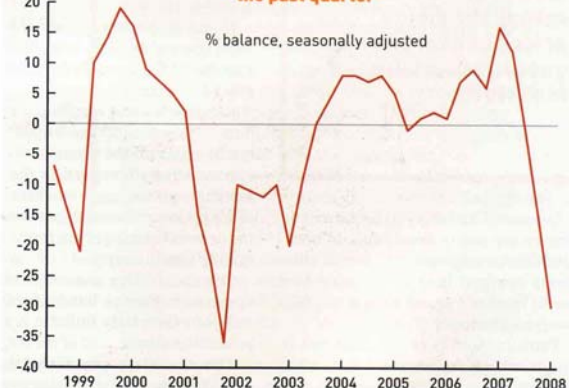
Perhaps the lending market has something to learn from the investment funds. It is worth noting that AREF member funds follow a code of practice that includes the external valuation of all underlying property holdings at least quarterly. Lenders would be well advised to take heed and, given the current state of the market, consider regular re-valuations across their portfolio, to best manage the risks now faced.

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resulted in rising property prices. Capital values rose by 41% during 2004-2006, creating the potential for an upward correction in property yields. This was then triggered by the credit crunch and yields rose from their low of 4.6% in June 2007 to 6.5% in February 2008 (source: Investment Property Databank).

At the same time, investors benefited from increased transparency in the sector, through data made available by the IPD and the Association of Real Estate Funds. Indeed, the AREF attributes the swift repricing of the commercial property market over the last few months to this increased transparency. It has taken only six months for the market to

Change in sales and lettings of commercial space to occupiers over the past quarter



Source: RICS Commercial Market Survey Q1 2008