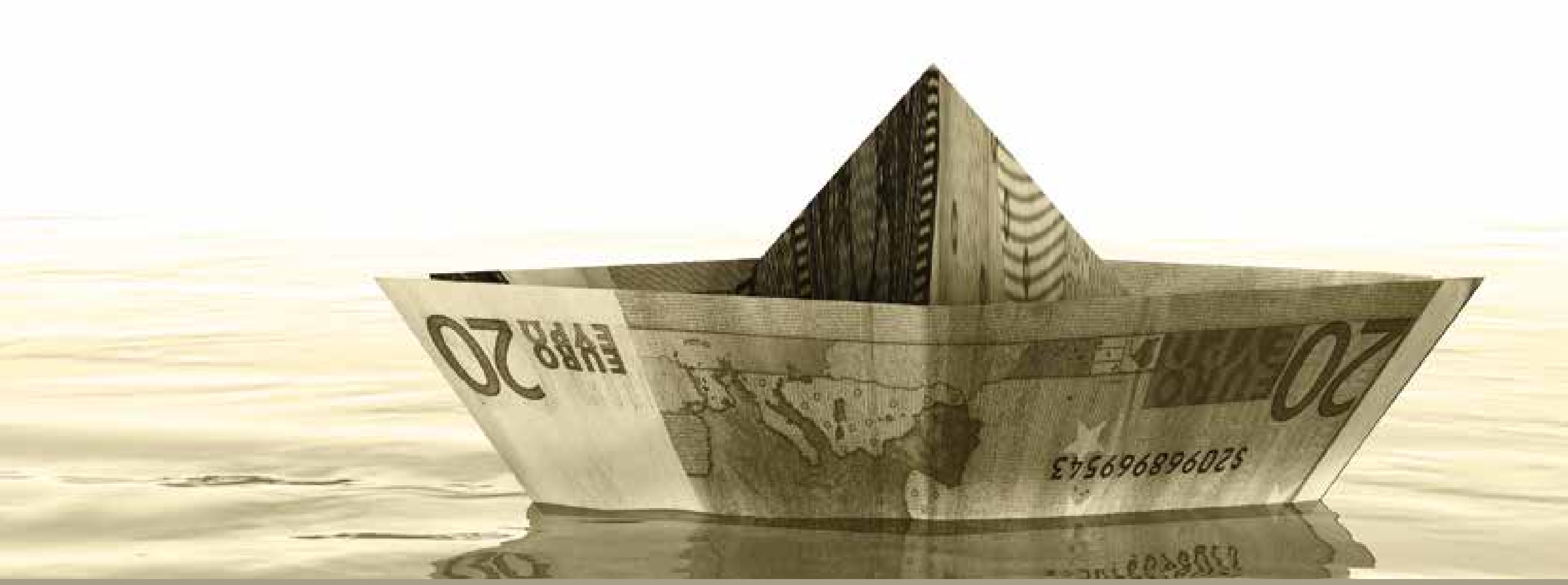

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The International Comparative Legal Guide to:

Lending & Secured Finance 2015

3rd Edition

A practical cross-border insight into lending and secured finance

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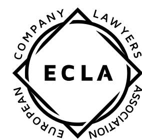

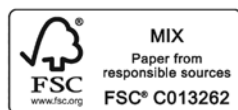

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Real Estate Finance: Trends Around the Globe and the Outlook for 2015 and Beyond

Reed Smith LLP

Matthew Heaton

According to Walt Disney, “it’s a small, small world”. Hillary Clinton took over 350 pages to espouse the existence of the global village and, according to the century-old adage, if X location sneezes, [*insert place with which you need to make a tangential link*] catches a cold. Economies around the world are inextricably linked, and financial contagion from one financial centre quickly spreads across the globe: one only has to look at the domino effect of the collapse of Lehman Brothers for a very recent and very relevant demonstration of this interconnectivity.

Real estate, however, is literally and figuratively anchored to the realities of local economies. Whilst global events can shape the overall state of economies, and even mask or compensate for structural imbalances, regional real estate is a sound barometer of local financial conditions. The media is full of coverage of the global recovery, focusing on rising employment and industrial output, oil and gas consumption, wage levels and other indicators of growth, but how does this play out on real estate around the world?

It is instructive to review the state of the real estate finance markets around the world to identify common themes and trends but equally to see the fundamental differences in conditions and prospects for real estate through 2015 and beyond.

The United States

As with so many things in the US generally, the real estate finance market is one of contrasts and contradictions. Whilst the entire market suffered terribly in 2008/9, the recovery of property values over the past 18 to 24 months has been less consistent.

Prices and sales volumes on both seaboards are now at around pre-crisis levels, with the major cities (Los Angeles and San Francisco on the West Coast and New York and Boston on the East) booming. In these cities asset prices are far exceeding predictions and, in certain cases, seeming to bear little connection to the yields which those assets can generate. There are several reasons for this. First, it is a consequence of the flight to quality that was witnessed during the financial crisis. Investors retreated to the major cities where asset prices remained robust, underpinned by fundamentally sound local economies. In addition, spiralling prices in the major cities is a reflection of the huge influx of overseas money from sovereign wealth funds and other foreign investors into the US. As has happened in Europe, cash-rich Middle Eastern and Asian investors have shown huge appetite for real estate in the US, snapping up many landmark buildings: for example the Waldorf Astoria in New York was purchased by China’s Anbang Insurance Group in 2014. In all markets, including where Western investors invest in China or Asia Pacific or the Gulf, the tendency is for overseas investors to put money into well-established, mature cities. This has had the effect of accelerating the recovery on both US seaboards.

The position in in-land America is less consistent. As a knock-on effect of the runaway prices in the coastal cities and the resultant downward impact on returns, the search for yield has prompted, mainly US, investors to again look at secondary US cities and regions. Prices are being pushed up, and in the Northeastern and Western US, are within touching distance of pre-crisis highs. The South and Midwest are still languishing in the doldrums, with anaemic growth and prospects not especially appealing even to the boldest investor.

Real estate values are therefore broadly reflective of the US economic recovery: strong headline growth masking some profound regional differences. This is likely to continue for 2015 and the foreseeable future.

A further trend in the US over the past few years has been the emergence of non-bank lenders (NBLs). Immediately following the financial crisis, bank liquidity dried up almost instantly. Banks, many of which were brought to their knees or beyond by exposure to residential and commercial real estate, stopped or severely restricted lending, even to strong borrowers. NBLs stepped in to exploit this liquidity gap, providing much-needed funds to prevent the spluttering US real estate machine coming to a complete halt. NBLs have remained, taking advantage of a lighter-touch regulatory regime and far more streamlined internal approval systems to provide an agile and proactive alternative to the mainstream lenders. Whilst banks are now lending again, in many cases aggressively, NBLs are exploiting niches such as development finance where traditional banks are less keen to lend. NBLs will continue to be of importance (funds raised by NBLs for investment are running at record levels) but a challenge for them will be increasing regulation. So-called ‘shadow banking’ is being reviewed by regulators on both sides of the Atlantic, and it is inevitable that regulation will increase, eroding NBL’s competitive advantage to some extent.

A further significant trend in the US is the increased level of equity circulating in the market, much of it from overseas. The property boom of 2004 to 2008 was debt-fuelled, with colossal amounts of cheap debt acting like gasoline on an already incendiary market, where investors themselves had comparatively little or nothing at risk. This time around, or so the optimists hope, the increase in asset values is equity-driven, with investors having much more ‘skin in the game’. Much more of the liquidity that is sloshing around the US real estate market is equity-derived, with huge amounts of money being injected from external sources such as Middle Eastern sovereign wealth funds and China. Banks are lending lower percentages of values, meaning that investors need to contribute more equity. This increased investor exposure should

lead to more prudence and responsibility in both borrowing and lending and the general improvement in the US economy should also help bring stability. Employment is rising, as are wages, and the general sentiment is increasingly positive. This has an influence on investors' appetite.

Several of the economic fundamentals required for sustainable growth in any market seem to be in place in 2015 in the US real estate market. There is (relative) macro-economic stability, plentiful availability of cheap finance and improving consumer and investor sentiment. Deloitte, in its 2015 Commercial Real Estate Industry Outlook states:

> *"In many ways, the commercial real estate industry is on more solid footing than it has been for quite some time. The US economy continues to progress and investors are generally seeing robust performance across most property types and markets. Could 2015 be the year for growth for the industry?"*

This, it is argued, provides a more sustainable platform for rising asset values which will help avoid a 2000s-style boom and bust. The question of whether the recovery in real estate values is embedded and sustainable is undoubtedly the key area to watch in the US in 2015.

Europe

Otto von Bismarck, the 'Iron Chancellor' of Prussia, famously stated: "whoever speaks of Europe is wrong: it is a geographical expression". If that was true in a nineteenth century geopolitical context, it is just as accurate in describing the contemporary real estate finance market. Whilst there is a common market, the status of real estate in Europe is fractured, ranging from cities and regions where values are increasing at breakneck speed to whole countries where prices are still falling.

United Kingdom

Real estate in many parts of the UK is booming. Buoyed by huge amounts of overseas equity, property prices in 2015 in many cities are already at or above pre-crisis levels. Trophy assets such as the Canary Wharf estate are being sold, often to sovereign wealth funds, at eye-watering prices with the ripple effect marked on prices in secondary cities such as Birmingham and Manchester. Reflecting investors' desire for safety in the US during the financial crisis, prime London was seen as a haven for real estate post-2008. However, as prices in London started to accelerate and yields fall, investors started looking outside of London and the South East of England. This has continued, and prices for all commercial asset classes across the UK have increased strongly and are, on the whole, at or about pre-crisis levels.

There is now a perceived lack of value in the UK real estate finance market, but unlike the US where the sheer size of the country provides secondary investment opportunities, UK investors have looked outside of the UK for yield. Initially this was to Western European countries such as Portugal, Spain, Ireland, The Netherlands and Italy, where the economic shock had created opportunities for investment. Latterly, investors have been looking further afield to Central and Eastern Europe in the search for better yields. This trend looks like continuing.

NBLs, as in the US, have had a significant impact in the UK and have helped provide liquidity to deal types which traditional bank lenders have shied away from. Whilst many of the banks badly affected by the credit crunch have repaired their balance sheets, jettisoned huge amounts of loans secured against real estate and are again actively lending, NBLs have retained a significant and growing portion of the market for lending. NBLs appeal to investors in the UK for the same reasons as in the US: perceived flexibility and appetite to share risk and quicker decision-making processes. They will remain a fixture. The tightened banking regulatory regime has also had the effect of capping LTVs of senior bank debt at somewhere around the 70% mark – NBLs are able to push this up into the 85%+ mark in the right circumstances.

Germany

Germany is Europe's economic heavyweight, and predictably its real estate market is robust. The 7 main cities (Berlin, Frankfurt, Munich, Hamburg, Dusseldorf, Cologne and Stuttgart) are still seeing greater price increases than other cities, but with the market becoming more diversified. In a bid to increase returns, investors are increasingly buying shopping centres, retirement homes and hotels. However, as with the UK and US, in the hunt for yield investors in Germany are also looking at riskier asset classes and/or outside of the main cities. The strong overall economic condition of Germany – good growth, low unemployment, low interest rates – has led to a construction boom, with year-on-year increases in construction permits granted since 2009.

It is generally accepted that the 2008 crash was largely caused by over-exuberant bank lending, and regulators the world over have spent the intervening time in tightening (or over-tightening) banking regulations. Increased capital adequacy requirements have in Germany seen the level of debt senior banks are prepared to lend fall from 85% loan to value to closer to 60%. In Germany at least, investors have been used to contributing up to 20% of overall costs, so a financing gap has arisen. NBLs have moved to exploit this opportunity. To date, these have primarily been US-originated specialised debt investment vehicles, though Asian, and in particular Chinese, investors are also being seen. These NBLs avoid the need for a German banking licence and other regulatory consents by partnering with local banks or structuring lending to originatesoutside of Germany. Bafin, the German banking regulator, is renowned for its vigorous approach, so these NBLs have to take particular care to remain within the regulations.

In addition, German insurance and pension funds are increasingly lending into the real estate market, attracted by longer term returns better than government bonds. Allianz AG, one of Germany's biggest insurance companies, has a stated investment strategy of lending and holding debt for periods of up to 10 years. These debt providers compete at the higher end of traditional senior debt / lower end of mezzanine debt in terms of loan to value levels.

A final indication of the direction of travel in the German real estate market is the negotiating strength of borrowers and investors. Whilst covenant-lite structures have yet to enter the market, the power of borrowers to influence pricing, structure and loan conditions is palpable and likely to become even more apparent over the next 18 to 24 months.

Real estate in Germany and, to a lesser extent the UK, is therefore in a purple patch. By contrast, Europe is physically book-ended by two very different propositions: France and Greece.

France

Due to a combination of economic and political factors, France's real estate market has had a torrid time. The state of domestic real estate is for the most part turgid. Residential property in a few, key cities – Paris, Toulouse, Bordeaux or Lyon, for example – has

remained stable, with new housing having shown some modest price increases since pre-crisis. Elsewhere, volumes and prices remain depressed.

In commercial property, there is a binary contrast across the country. Paris remains the stand-out location for investment: in 2014 around two-thirds of investment volume in France was within the central Paris region. This statistic puts into context other figures regarding increasing overall investment volumes in 2014. Whilst in other markets investors moved out of the capital city in the search for better returns, in France they have remained in Paris. This has resulted in stable or increasing prices in Paris whilst other cities and regions remain subdued.

Demand for trophy assets in Paris has had the effect of driving prices up and yields down. Foreign investment in France accounts for about 60% of overall investment, with over half of this money coming from outside of Europe. Paris is one of the top four cities in the world for direct real estate investment, but this status does not seem to be benefitting other parts of France in the way that booming assets values on the US seaboards are feeding through to real estate prices in other less desirable American regions. There is nothing to suggest this is going to change in 2015.

Political elements have had an impact on the real estate market, with investors skittish at the prospect of changes to the tax regime and occasional quasi-jingoism from the government. Deliberate legislative action has also had an impact, with strict regulations on environmental and security issues making commercial property built before 2005 extremely difficult to sell. In addition, the costs and protracted time frames for doing deals in France, allied with the very debtor-friendly banking and insolvency regimes, deter new entrants from the French market.

France's banking system is closed when compared to the US or UK, so there is less opportunity for new market entrants, equity investment funds and NBLs. That said, insurance companies are making inroads into the lending markets, and US private equity funds are making a splash: Lone Star acquired Coeur Defense for a headline €1.3 billion in what was the second largest real estate finance transaction in 2014.

France's real estate market, then, is enjoying a recovery of sorts but it is very localised in nature, focused as it is on Paris. The residential market remains weak and the outlook for the non-Parisian parts of France seems muted. Many of the trends from the US, UK and Germany are simply not visible here, and 2015 appears to be a year of at best consolidation for the majority of the country with increasing activity in the capital.

Greece

And then we have Greece. Real estate prices in Greece during the period 1994 to 2007 increased by a whopping 238%, buoyed by Euro membership, an influx of foreign capital and a surge in GDP. The ongoing financial crisis in Greece ravaged asset values and led to huge drops in the value of property, with a 52% peak to trough fall in the retail sector and 40% in the office sector. Construction activity has been decimated and demand for property, both commercial and residential, has collapsed with a 90% decrease in residential building work. Further uncertainty is added by the nature of parts of the Greek economy: the Bank of Greece acknowledges it is difficult to accurately track property values because the actual prices paid for real estate are impossible to verify.

One would like to continue with a 'but...' and explain how the outlook is stabilising with an upward trajectory predicted. However, the massive uncertainty surrounding the political and economic situation in Greece makes predictions exceedingly difficult. Foreign investors returned to Greece during 2013 and 2014, buying distressed and other assets with a value in excess of US$1.5 billion. A liberal visa programme, which effectively allows someone to purchase European residency in return for retaining an investment in Greece of €250,000, was introduced in 2013. This, combined with planned changes to the tax regime, is predicted to help stabilise the real estate market in 2015 and encourage growth after that. The Bank of Greece stated in a recent report that: "*as a whole, the real estate market is projected to start recovering gradually in 2015, provided that the present trend is not reversed by exogenous factors*". It is these exogenous factors which make calling the direction of the Greek market impossible. The new government, elected in early 2015, continues to play brinkmanship with the European Central Bank, the EU and the IMF over its bail-out. Will Greece leave the Euro (the feared 'Grexit' scenario)? Will investors, who were becoming attracted to prospects of enhanced value in Greece, be spooked and divert their money to less volatile areas? Will the huge back book of non-performing loans, which amounts in aggregate to €77 billion, simply prove too much for the banking system and suffocate any recovery? 2015 is a crucial year for Greece and what is clear is that few of the factors and trends impacting other European and Western economies in 2015 are going to be as significant here. The position of Euro membership would appear to trump all other considerations in the Greek real estate market.

United Arab Emirates

The story of the UAE property market over the past decade is a little like that of Greece, though in the UAE's case we are able to add, after the statistics of cataclysmic falls in property values: 'but since then...'. Peak to trough UAE real estate shed around 40% of its value, culminating in the well-documented US$10 billion+ bailout of Dubai World. Frenzied speculation, price increases that did not mirror the underlying realities of the local economy and the availability of cheap and plentiful financing all contributed to a bubble that ended in a nasty burst. But since then prices have rebounded to around their pre-crash levels and steps have been taken to prevent another bubble. These have included caps on mortgage lending, fewer off-plan developments, reduced debt as a percentage of overall deal costs (UAE investors now need to take a greater share of deal risk) and a marked decrease in foreign investment leading to investors with a far superior understanding of the region. Whether these things do actually prevent another crash or whether everyone is being naively optimistic, only time will tell. However, the Central Bank is alive to the possibility of a bubble and has stated that "*the UAE real estate markets and the banks' exposure to it remains a core financial stability priority*". This resulted in the capping of banks' exposure to real estate lending.

That said, a significant regional risk factor is the price of oil. Whilst the UAE economy is more diversified and robust than it was in 2008, the current slump in oil prices could have knock-on consequences for the economy generally and real estate values in particular. The oil industry still accounts for about 25% of UAE GDP and with economists forecasting that oil prices will remain low for the medium term, 2015 will be the year that its impact will become clearer.

Hong Kong

Q3 2008 saw a drop of 18% in the value of real estate in Hong Kong, but subsequent to that prices have rocketed, increasing strongly year-on-year. The headline issue of real estate in Hong

Kong is of the struggle of the authorities to moderate price inflation. Several measures have been introduced since late 2010 to support this, including tightening of mortgage policy and increased property taxes. Although these have led to temporary slowdowns in price rises, overall the trajectory has been firmly upwards. Prices are at record highs and certain parts of the residential sector experienced 15% price increases from June to December 2014, which by any normal criteria must be unsustainable.

The main driver of price acceleration is lack of land combined with consistently strong demand resulting from strong economic growth. The government has pledged to make additional land available for development (including 29 residential sites during 2015), but the basic lack of supply is clearly geographical. There are genuine fears of a bubble, and Hong Kong is now the most unaffordable place in the world to live: average property prices have reached 17 times the gross annual median household income. High prices and rentals have restrained industrial and commercial growth.

The Hong Kong dollar is pegged to the US dollar, so monetary policy is dictated indirectly by Washington. With the Federal Reserve expected to increase interest rates in 2015, Hong Kong's interest rates will likely follow suit. This could have a dampening impact on real estate values.

In relation to the finance market, a series of steps have been taken to help cool the market. Caps on loan to values for self-use residential and second properties have been introduced, and the Hong Kong Monetary Authority now has the power to introduce countercyclical capital buffer rates if excessive credit growth gives rise to systemic risks. Banks' exposure to real estate will undoubtedly be factored in to these considerations. However, despite the high cost of property and the fact that nearly every purchase is funded by a mortgage, the Hong Kong property market remains one of the most under-leveraged markets in the world compared to those markets with laxer banking controls.

For Hong Kong, 2015 is going to be a year of trying to keep a lid on the bubbling cauldron of property prices whilst having an eye on developments in the US to see what impact changes in monetary policy there have locally.

China

China, as one might expect, has taken more overt control of its real estate markets during the period since the credit crunch. In response to the global economic crisis in 2008, the government introduced a RMB4 trillion (*circa* US$588 billion) stimulus programme, a significant proportion of which went into the real estate sector. As a direct consequence of this, the real estate finance market in mainland China soared from 2008 to 2013. Since 2014 a combination of specific economic policy and a general softening of GDP growth led to a slow down in the real estate finance market.

However, reflecting the position in the US and other Western economies, China's market is polarising into robust, popular destinations for investment (Beijing, Shanghai, Guangzhou and Shenzhen) with the remainder of the country left trailing. Local policies and other factors also impact investor appetite, but the expectation is that it is the key industrial and commercial hubs that will attract the most investment and drive-up prices.

As mentioned in the context of other countries, another key trend in China is the increasingly outward-looking nature of investors, whether state-owned or not. Chinese investors are deploying huge amounts of capital in real estate and other assets around the world, having a marked influence on many of these markets. Outward-bound real estate investment grew more than 200-fold to nearly US$34 billion between 2008 and 2014. It is expected that this trend will continue and is a key factor for the global real estate market.

In relation to the financing of real estate, bank lending has traditionally been the main channel of funding. However, recently imposed tightening of lending regulations have forced banks to become more cautious in real estate lending. Banks are focusing more on larger developers and investors which are able to satisfy more demanding credit standards. Property trusts, funds and bonds are becoming more visible, providing an alternative to bank lending, but these types of financing are very much in their infancy. There would appear little chance of foreign investment becoming a major source of funding, but the government is supportive of these alternative lenders. How these new funders develop in China will be interesting to observe during 2015.

The global village

In the context of real estate at least, it would seem that Hillary Clinton was partially correct: it is a global village to an extent. Certain common trends do bind the international real estate market. The sustainability of the global economic recovery frames prospects for growth in real estate everywhere, whilst overall economic conditions heavily influence the countries like Greece that are being buffeted by 'exogenous factors'. In addition, events in Syria, Ukraine and Russia and the price of oil and gas have the capacity to impact economies around the world and shift real estate values. Additional factors such as the consequences of the ending of quantitative easing programmes in the US and UK, whilst the EU simultaneously commences one, all throw up challenges and risks, the effects of which should start to become apparent over the next 12 to 18 months. Throw in an unexpected military conflict here, a surprise financial catastrophe there (the media is awash with rumours of the return of subprime mortgages and its attendant risks of excess), and there is the potential for the global recovery to be derailed.

The economies which seem to be recovering best from the crash of 2008/9 seem to have the closest similarities. The US, Germany and the UK have increasing real estate prices supported by local and overseas demand, competitive debt markets with new market entrants and regulatory regimes which seem alive to the risk of another bubble. The UAE and China broadly fall into this category, though with domestic investment more locally based and an enormous amount of outwards investment being undertaken.

In the middle there are countries like France which, whilst more or less recovering from their recessions, appear to be walking a tightrope where a tiny amount of over-regulation or political interference could put the economy into reverse. At the far end are countries like Greece which have got so many political, economic and social factors to contend with that the coming year could mark a brilliant dawn or be the period in which their political leaders reverse decades of relative stability and diplomacy and undermine the nascent recoveries in their real estate markets.

2015 is therefore a crucial year for real estate the world over. It will show whether the world is experiencing a sustained recovery or just a temporary uptick, and political events in Greece, Ukraine and elsewhere will come to a head, for better or worst. It will also show whether the recent general upwards movement in real estate values will continue. Alternatively, regionalised factors could cause contrasting fortunes for real estate, with some cities and countries racing away, whilst others lag behind. Or, to put it another way, less Walt Disney and more Fleetwood Mac, who firmly believed "you can go your own way".

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