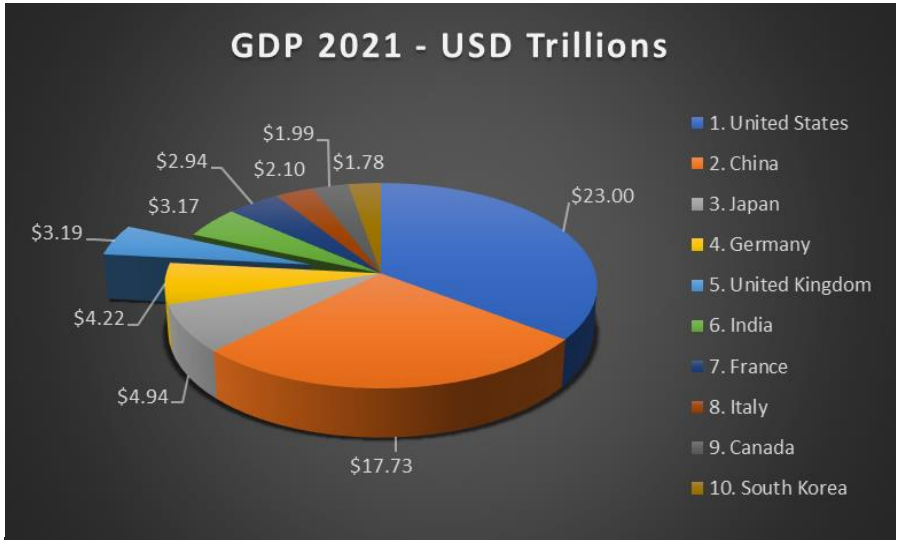
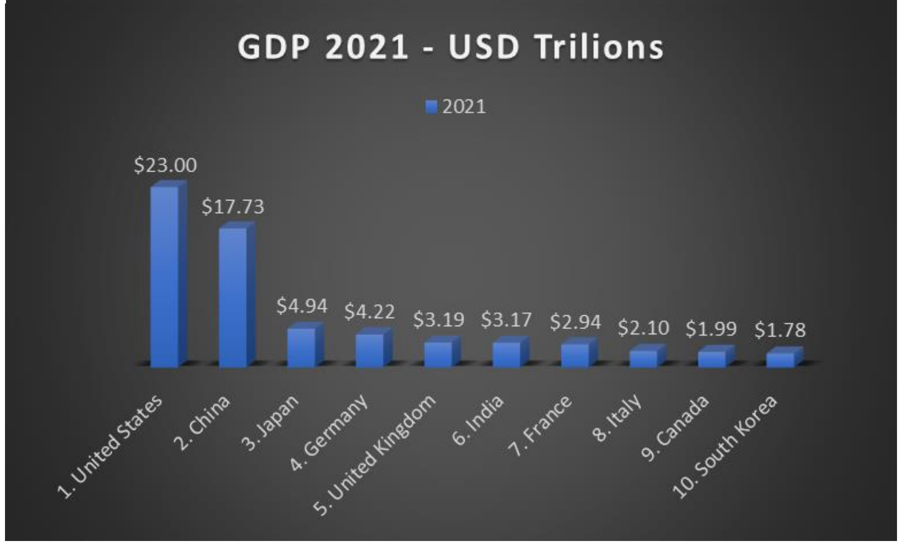
The road to real estate restructuring

UK – November 2022

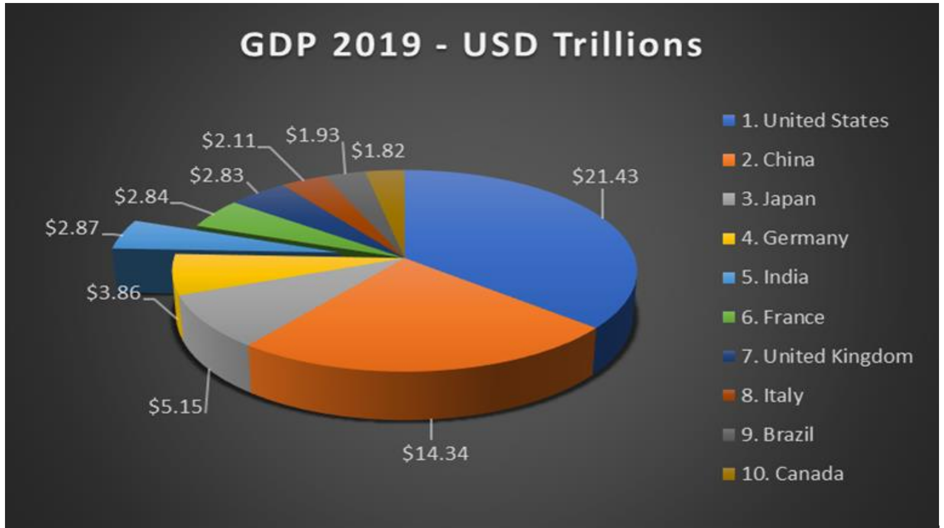
THE UK'S CURRENT GDP RANKING

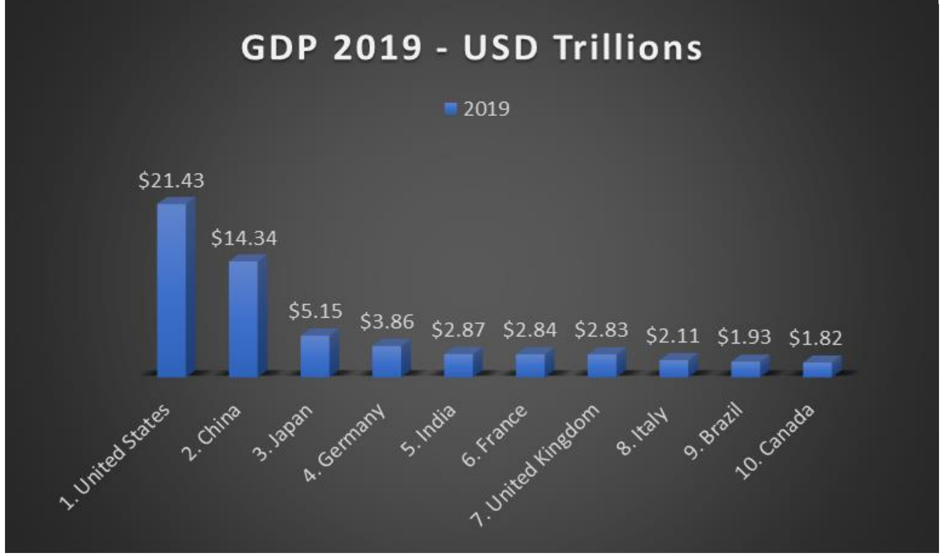




The UK moved from 7th to 5th place in terms of GDP during the pandemic (5th place in 2020 & 2021)

The World Bank predicts that the UK will likely remain in 5th place in terms of GDP in 2022 although it will be closely run.





Source: World economic forum, Statistics Times, OECD - Charts developed by Martell Real Estate Ltd using government data

PROPERTY MARKET OVERVIEW 2020 - 2022

- After a slowdown in the market due to the pandemic, 2021 became a record breaking year in Europe with a total of €359bn invested in commercial property, up 25% on 2020 and up 8% on 2019, which was the previous record year.*

- The UK commercial sales market grew by 49% between 2020 and 2021, with the office sector showing the largest amount of growth.*

- The growth in 2021, which continued in H1 2022, can be partly explained due to strong demand in the market following limited supply in 2020: this would have not been possible without a low interest rate environment.

- Despite overall investment growth, there have been signs of some shakiness in the market in 2022 due, in part, to inflation.

- In Q2 2022, a somewhat over-heated industrial market showed signs of a slight cool off, with prime yields pushing out by 0.5% (to 4.5%). Yields in the office sector also pushed out by 0.4% (to 5.6%). This is against an environment of rising rents across all property sectors.*

- Inflationary challenges, in relation to building materials, have created pressure for secondary building contractors who have been unable to adhere to fixed price contracts creating mothballing of some projects.

*Source: CBRE European Research, CBRE website – Jan 2022

Current Market **FORCES**

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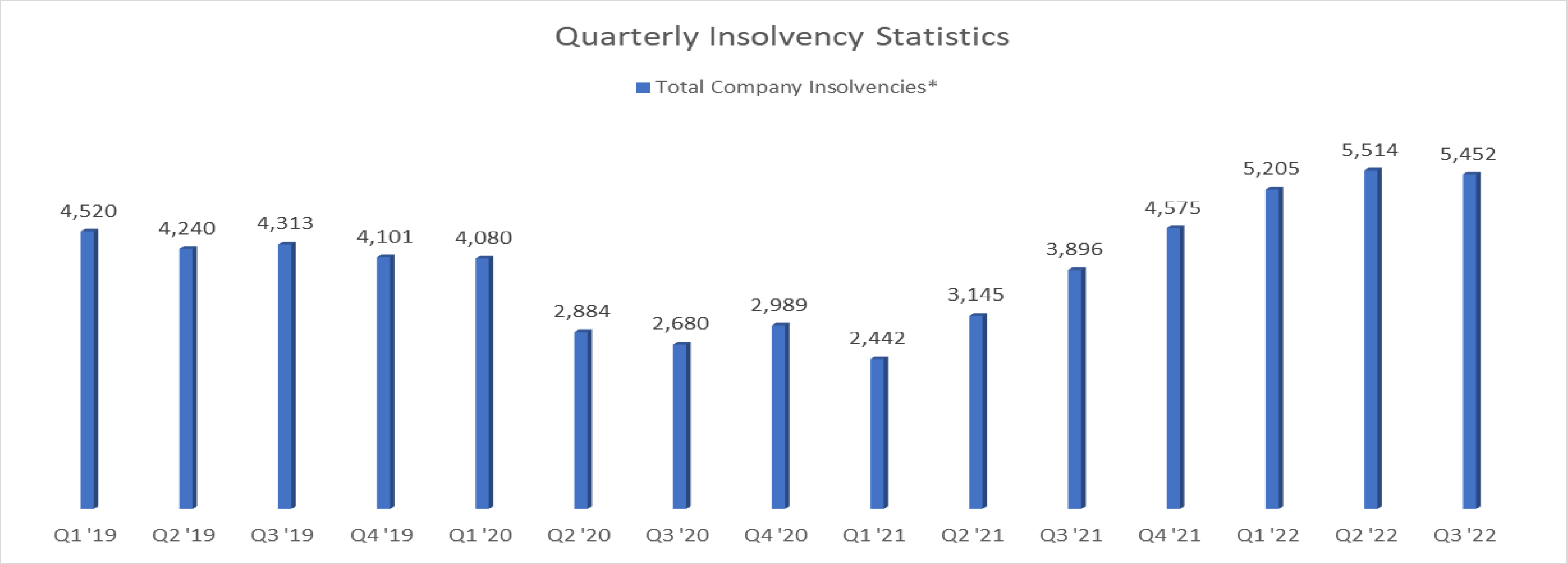
INSOLVENCY MARKET

- Although insolvency levels have been historically low throughout 2020 and 2021 (due to government protection measures), there has been a marked increase in 2022.

- The graph below shows insolvency statistics for CVAs, Liquidations, administrations and receiverships (both fixed and floating) for England, Wales & Northern Ireland between 2019 and 2022.

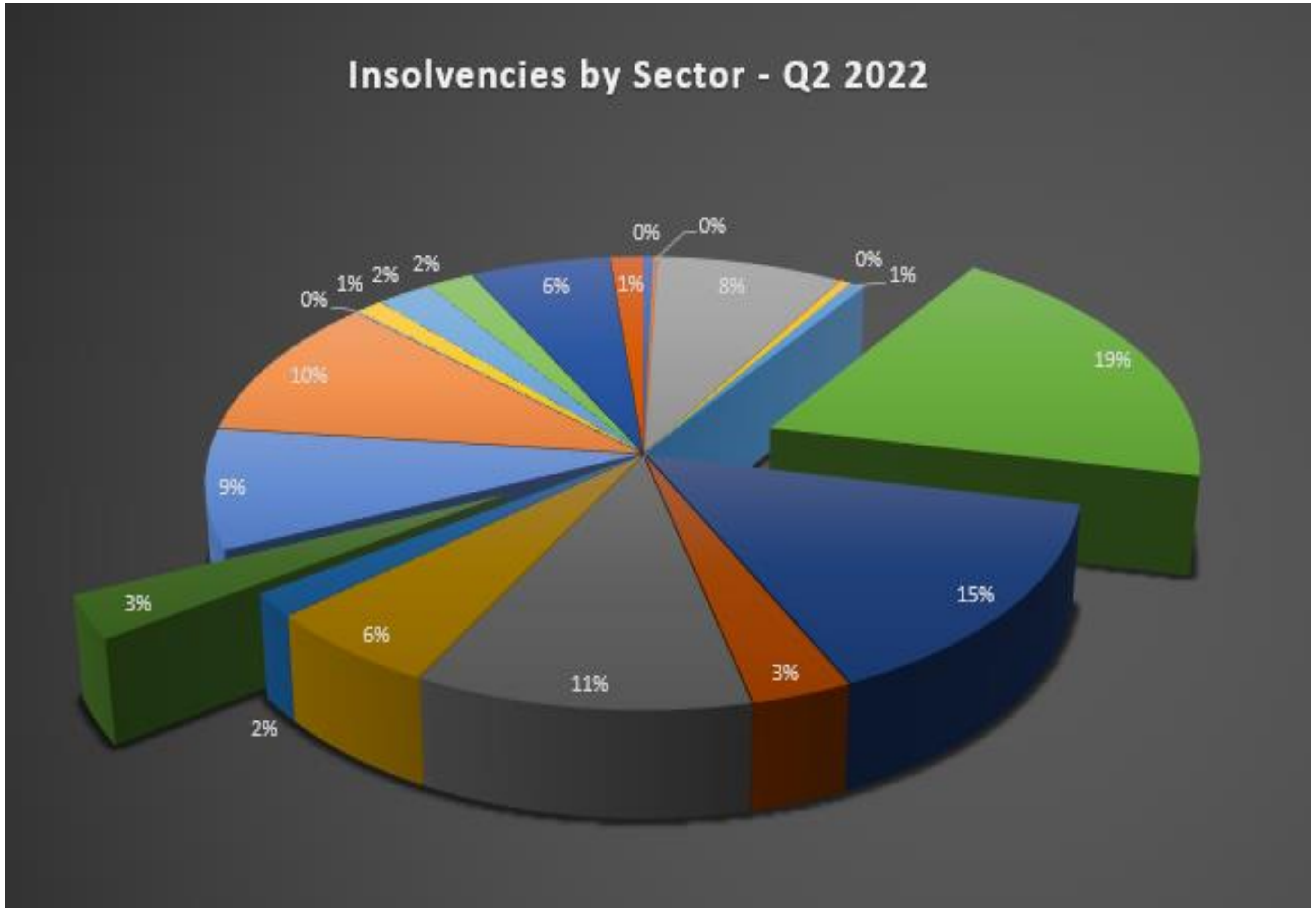


*This graph details company insolvency registrations at Companies House rather than insolvency procedure start dates.

Source: Gov.uk monthly insolvency statistics – chart developed by Martell Real Estate Ltd using government data

INSOLVENCY BY SECTOR

Construction is the leading sector in Q2 2022 insolvencies



*The sectors listed are a snapshot – not all sectors are represented in the key but all sectors are represented on the pie chart

Source: Gov.uk monthly insolvency statistics – chart developed by Martell Real Estate Ltd using government data

DOOM & GLOOM

5 different Chancellors of the Exchequer & 3 Prime Ministers in 3 years has created an unstable political environment in the UK.

…. But does that explain why we are where we are economically and, by extension, in the property market?

Yes

- The UK experienced the lowest GBP to USD ratio for 40 years following the mini-budget in September 2022.

No

- UK Interest rates are broadly in line with the US (with similar hikes, albeit at different times). The US has also experienced a low interest environment and similar inflationary pressures post covid. GDP positions remained "as is" in the US and UK in 2021 partly as a result of a quick re-opening post covid.

Maybe

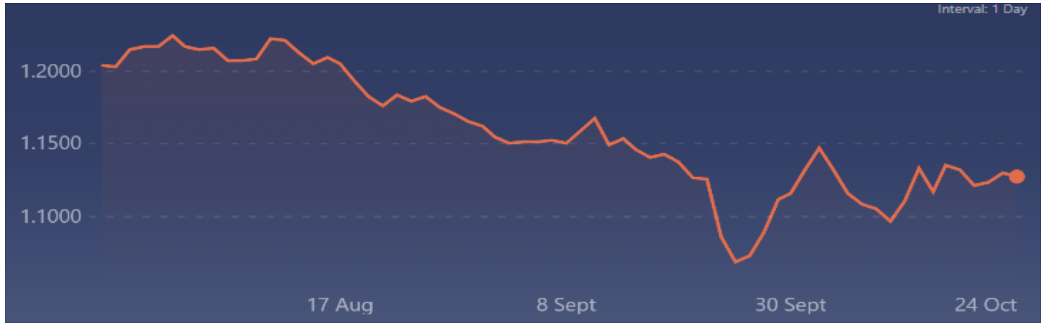
- That depends on whether the current PM and Chancellor create stability, where we sit in comparison to other countries and how we react to the current market uncertainty.

Base rate hits 3% as Bank warns of longest recession on record

British Prime Minister Liz Truss resigns after disastrous economic plan

Having been formally appointed by Queen Elizabeth II on Sept. 6, Truss is now the shortest-serving prime minister in British history.

GPB to USD



Bank of England raises interest rates by 0.75 percentage points

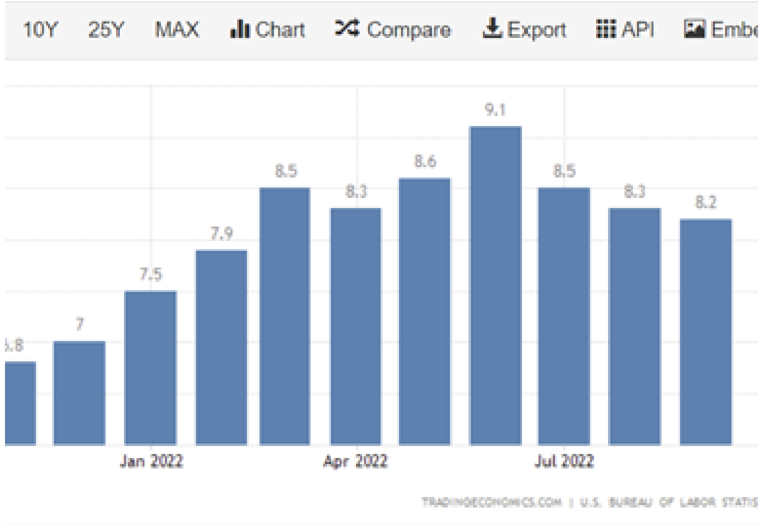
Largest increase in 30 years but central bank says rates may not have to rise much further

*Source: The Independent, The Times, Financial Times, xe.com

INFLATION

- **The US** Fed raised their interest rates by 75bps in July 2022. Another 75bps rate increase occurred in November. Current interest rate is 3.25%. US Fed and Bank of England have similar predictions on interest rate levels in 2023 at 4-5%
- **The UK** has been experiencing the highest inflation in the G7, but only marginally (10.1%) when compared to economies such as Germany, which are sitting at c10%. Italy jumped to 11.9% in October according to Moody's. UK's current interest rate is 3%.
- **Eurozone** inflation is sitting at 10% with interest rates of 2%. With inflation ranging from 6.2% (in France) to 24.2% (in Estonia), how will the Eurozone (comprising 19 countries) deal with interest rates changes politically?

US

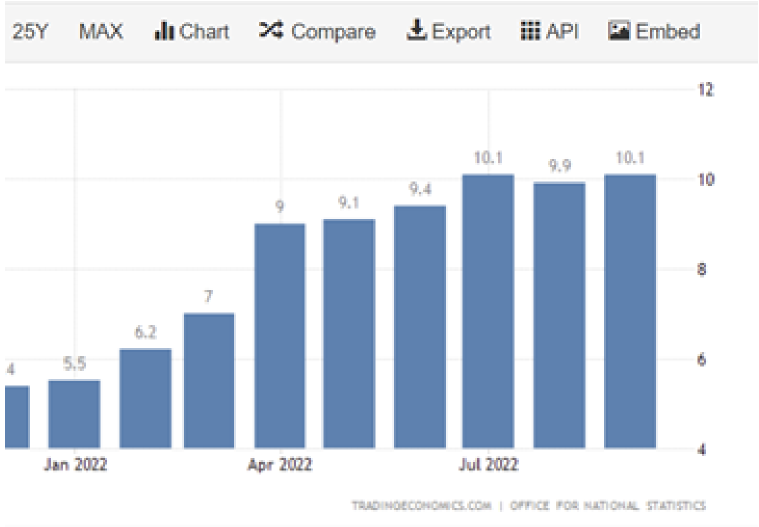


GMT	Reference	Actual	Previous	Consensus	TEF
12:30 PM	Aug	8.3%	8.5%	8.1%	
12:30 PM	Sep	8.2%	8.3%	8.1%	

EUROZONE

Reference		Actual	Previous	Consensus	TEForeca
Inflation Rate YoY Flash	Sep	10%	9.1%	9.7%	9.7%
Inflation Rate YoY Final	Sep	9.9%	9.1%	10%	10%

UK



	Reference	Actual	Previous	Consensus	TEForecast
AM	Aug	9.9%	10.1%	10.2%	10.6%
AM	Sep	10.1%	9.9%	10%	9.9%

*Source: tradingeconomics.com

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HISTORY DOESN'T REPEAT BUT IT RHYMES

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- In 2008, 5 banks were responsible for circa 71.5% of all commercial property lending in the UK and in 2007 total British mortgage lending was £372 billion.

- In 2021, the top 5 banks accounted for circa c 62.5% market share (9% decrease over a 14 year period). The total value of British mortgage lending reached £316 billion, the highest rate since 2007: partly due to house price increases but mainly as a result of stamp duty reductions.

- The reason for comparing these two markets is not because the events of 2007/2008 and 2021/2022 are directly comparable; but because they are two big market shocks in a market that has some similarities as well as differences.

- A key difference, apart from the obvious, is the emergence of the challenger banks (hence the loss of market share in the top 5 banks) and LTV ratios, which were averaging 50% - 60% in 2021 on prime assets, a marked decrease from 2007 when 100% residential mortgages were being offered and LTVs on prime commercial were 80% - 90%.

- In addition to the above, lenders had limited options in 2007 in the event of default and tended to favour fixed charge receivership or administration. NPL sales between UK banks and US hedge funds traded at record levels between 2009 and 2013. Stronger policies, including treating customers fairly, also came into play in recent years.

- The biggest difference between then and now is that interest rates were 5.75% in July 2007. By March 2009, interest rates had fallen to 0.5%, the same year that quantative easing was launched. In 2022, we are in the reverse position and will need to experience some pain in the market in order to recover …. but so will everyone else.

*Source: www.mortgagestrategy.co.uk; www.statista.com

MARTELL'S PREDICTIONS

1. MACRO ECONOMY

- The Bank of England will be keeping a close eye on the US federal reserve. US inflation has dropped by 0.9% between June and September following their 75 bps rate increase in July. The US have delivered another 75 bps increase in November. ***Martell predicts similar rises will continue in the UK in 2023 (small rises with 50 - 75 bps rises every so often to ensure rates are moving fast enough to challenge inflation). Bank of England predictions are that the UK will experience interest rates between 4% and 5% in 2023***

- The Bank of England has stated that the UK is facing a 2 year recession. Some economists are arguing that based on the recent interest rate increases, inflation will reduce below 2% before 2 years and that the rate increase is too aggressive. ***Martell believe that the truth lies somewhere between and are predicting a yo-yo economy over the next 24 – 36 months. After a period of recession in Q1 2023, there will be a yo-yo effect between small growth periods and mild recession as the market grows and contracts (AKA stabilises) post covid. The first countries to reduce inflation should be the first to recover.***

- Where inflation is data driven, it could be argued that foreign exchange is sentiment driven. As a country that imports more than it exports, a weak pound will lead to increased import costs in the UK economy and could further affect the construction sector. In relation to the wider UK property investment market, a weak pound could be advantageous. If it looks like the US and UK are getting out in front of inflation before the Eurozone, these real estate safe havens will be appealing to investors. ***Martell predicts that foreign cash investors (especially those pegged to the dollar) will see Q2 2023 onwards as a good time to invest in the UK presuming inflation has decreased and exchange rates are still in their favour. Saying this, investors will be picky about the type of stock they invest in.***

MARTELL'S PREDICTIONS

2. REAL ESTATE INVESTMENT VOLUMES

A softening of prime yields will continue across the commercial property sector.

UP

- **Commercial and mixed use** investment and development in well-located sites in cities **outside London** with a lack of Grade A space and capital growth opportunities, e.g. Leeds, Newcastle, Bristol, Oxford, Reading.
- **Residential development (especially BTR) commuting distance from London -** Secondary towns around the periphery with good planning opportunities and infrastructure will see market growth opportunities.
- **West End office** market to outstrip expectations. Smaller floorplates available in the West End will be appealing for businesses who want to locate in the capital.

DOWN

- **The London residential market** Increased mortgage and rental payments are likely to lead to something akin to the "mushroom effect" in the 1970's where a number of households move out of London into the periphery for more affordable property. Heat to come off London residential market.
- **Leisure** market outside tourist hotspots is likely to struggle whilst cost of living remains high.
- ***City of London office market*** Will employees seek to maintain a hybrid work model due to renters moving out of London, creating a further weaking of covenant / softening of yields than we've already seen in 2022? Watch this space.

MARTELL'S PREDICTIONS

3. RESTRUCTURING

- Construction sector will continue to see a volume of insolvencies in 2023. Although some build cost inflation areas appear to be settling and interest rate increases should lead to some price deflation, the weak pound will mean that import costs of materials will remain high. Labour costs are also high. It will be a market of two halves. The smaller housebuilders and contractors who have signed up to fixed price contracts and racier finance deals (mainly bridging and mezzanine) that are coming up to expiry / refinance will be the first to collapse. Larger development companies that are well capitalised and have moved away from fixed price contracts will continue to deliver projects. ESG requirements are coming under pressure due to cost considerations.

- Martell have been predicting secondary retail decline since 2018. Following the pandemic, some shopping centres with vacancies, "zombie tenants" and service charge shortfalls were selling at better levels than anticipated. Others were being discretely sold off at discount. Martell still believe this sector has not had its day of reckoning. Foreign investment, low interest rates and government protection measures for tenants during the pandemic have delayed the inevitable. Martell believe that lenders left "holding the baby", in locations where re-purposing is not an option, will need to sell at large discounts over the next two years.

- "Extend and amend" lending will come to an end in 2023. LTVs are much lower than previous market contractions this century; however new Basel III regulations, coming into effect in 2023, will give lenders less room for manoeuvre when LTVs increase. Those who can warehouse will but those who can't, twinned with a weakened appetite for the usual "white knight" lenders to come in and refinance assets bought at the peak in 2018/2019, will need to undertake forced sales.

- Complex restructurings will increase across all sectors including real estate. Sophisticated lenders will work with good borrowers to achieve better outcomes, where possible. Distressed portfolios more likely to be brought to market than we have seen in last few years.


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What are your Options?

A DIFFERENT APPROACH

Usual options – In times of distress, lenders try to work with borrowers then apply increased pressure. Parties have different drivers and speak a different language, resulting in communication breakdown. Lender brings in advisors at last minute and enforce by way of administration, receivership or NPL sale at discount.

A better way – Landlord and / or Lender brings in independent restructuring specialist who speaks language of both lender and borrower. Specialist will need to understand **Real Estate and Restructuring** to add value and assist the process. Specialist gives market advice in the context of the Landlord's programme and the Lender's timeframe and constraints.

Mediation - Once both parties are on board with over-arching strategy, independent expert works with both parties, subject to a standstill agreement, and delivers the programme, whether that be restructuring, a programme of sales, the appointment of turnaround directors or all the above.

Restructuring - A number of accountants advise Landlords and Lenders on Real Estate restructuring. Some are well connected to the property market but many are not. It is not enough to understand the top-down economics, legal structures and options. Ground up knowledge of property performance is essential in hands-on real estate restructuring.

Partnering – Large real estate companies are under pressure to use their own investment, agency and management teams, which only adds value when these teams are "best in class". An advisor who is well-connected in the industry and can pick the right team with no bias (at preferential rates) is invaluable.

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Bridging The gap

BRIDGING THE GAP BETWEEN REAL ESTATE FINANCE AND REAL ESTATE PERFORMANCE

MARTELL REAL ESTATE WAS FOUNDED BY CHARLOTTE COATES IN MAY 2021 TO ASSIST CLIENTS

(BOTH LANDLORDS AND LENDERS)

WITH HANDS-ON ASSET MANAGEMENT, RESTRUCTURING & SALES SUPPORT FOR PORTFOLIOS & LARGE SINGLE ASSETS WHERE THERE IS AN ELEMENT OF DISTRESS.

EXPERIENCE

17 YEARS OF FIXED CHARGE RECEIVERSHIP, NPL, ASSET MANAGEMENT AND RESTRUCTURING EXPERIENCE ACROSS ALL ASSET CLASSES IN 13 DIFFERENT JURISDICTIONS.

AT JLL & DTZ, PROJECT MANAGED & APPOINTED OVER 400 FCR ASSETS OVER £1BN IN VALUE. £3BN IN NPL WITH £8BN OF ASSET MANAGEMENT

SOLUTIONS

DIFFERENT APPROACH TO A RECURRING CHALLENGE IN AN EVER-CHANGING MARKET

REAL ESTATE RESTRUCTURING ADVISORY IS DOMINATED BY COMPANIES WHO ALSO TAKE ON INSOLVENCY APPOINTMENTS. ALTHOUGH QUALIFIED, MARTELL DO NOT TAKE ON FCR APPOINTMENTS

MARTELL PROVIDE TRULY INDEPENDENT ADVICE AND WORK WITH "BEST IN CLASS" AGENTS AND OTHER PROPERTY SPECIALISTS ACROSS THE ENTIRE MARKET.

For further information please see our website: www.martell-realestate.com or email us at charlotte@martell-realestate.com

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