

# European Development Lending

APRIL 2008

“Conditions in the credit markets are producing widespread changes in the terms for commercial development lending across Europe. The specifics vary greatly from one market to another, but are generally reflected in increased lender caution and likely to result in extended delivery periods ”

## KEY FINDINGS

Since July 2007:

- Bank margins have risen in the majority of countries
- Loan-to-value ratios have tightened in many markets
- Banks are now requiring a higher level of pre-lets as a condition of lending
- The likelihood of development delays has increased because scheme viability is being assessed more rigorously and arrangement of funding structures is taking longer
- Tighter terms will both reduce the number of development schemes brought forward and increasingly confine lending to the better schemes in the best locations

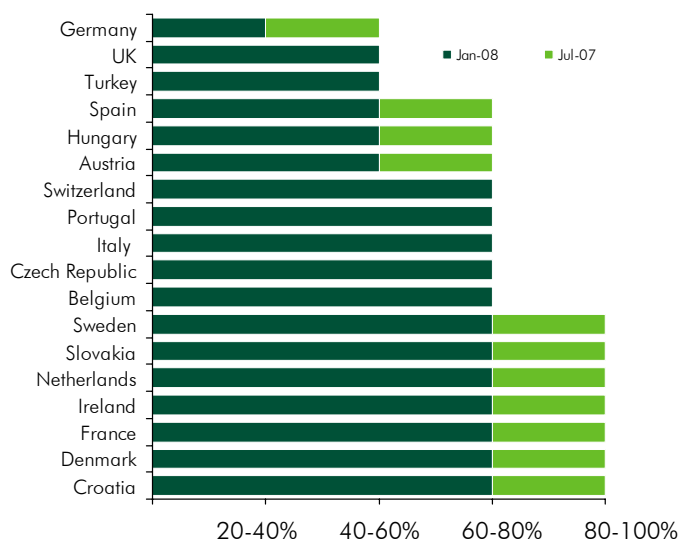
## INTRODUCTION

The global credit squeeze has the potential for a variety of impacts on commercial property markets in Europe, one of which relates to the availability and terms of development finance. There have already been significant changes in the development finance landscape over the past year: this time last year debt was relatively easy to secure on acceptable terms and it was the availability (or not) of equity that determined viability. Now the position is reversed, with plentiful equity (and equity margins coming under downward pressure as a result) and debt availability holding the key to development funding. This is happening at a time when build costs are rising faster than values in many markets, which is squeezing development margins and providing a further deterrent to would-be lenders. The better news for developers is that aggressive terms are still available for the right borrower in the right location, but lenders are clearly becoming more discerning on these and other criteria.

Official data on bank exposure to commercial development is, in many cases, not recent enough to be conclusive, but such data as is available suggests the lending market is changing. Statistics for some countries, including Germany and the Czech Republic, indicate that there has been a slowdown in the volume of construction loans granted in the second half of 2007. In others, such as France and Spain, there is little indication yet of such a change, although concerns over the volume of doubtful loans in the sector appear to be rising.

The lack of recent data, and the possibility that these statistics still fail to capture fundamental changes in attitudes to development finance, prompted this survey of CB Richard Ellis investment and development teams around Europe. In it, we analyzed bank lending attitudes and practices towards development finance in 19 countries across Europe. It is evident that, while almost all banks are more cautious about development finance following the sub-prime crisis, the extent of this shift and the way in which it is reflected in lending terms varies widely across markets.

Movement in LTV ratios from July 2007 to January 2008

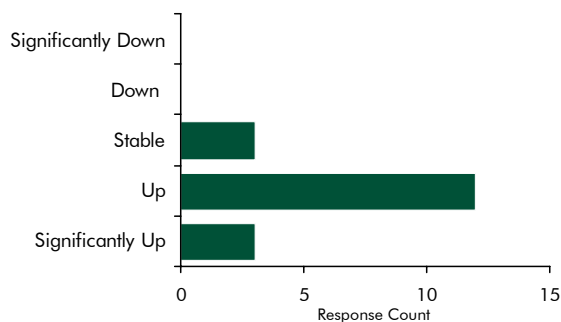


### Attitudes to Lending

The vast majority of survey respondents reported that current attitudes towards development finance are more cautious than in mid-2007. All but two of the respondents reported some degree of increased caution, with only Poland and Germany reporting no change in sentiment at all.

Attitudes within the UK, Irish and French markets are reportedly very cautious and show the most significant shift in attitude to lending. This is likely to reflect an adjustment from previously liberal lending policies, the likelihood of these markets entering a period of weaker value growth, and their high exposure to international financial services. These factors have heightened perceptions of risk and necessitated a bigger shift in attitudes and lending policy. By contrast, some other markets were already more discerning about lending prior to mid-2007 and have seen relatively minor changes since. This reflects various factors, including local market conditions (such as high vacancy in Amsterdam), limited bank exposure to highly-structured positions and inherent caution stemming from the memory of losses incurred in the early 1990s, as in the case of some of the Nordic banks. In general, the Central & Eastern European markets are among those seeing less of a shift in attitudes to development lending. Interestingly, where increased caution is evident such as in Slovakia, this is less to do with concern over local market conditions than with the fact many of the lenders are international banks in which lending policy is set elsewhere.

What has happened to margins for bank lending on development finance relative to mid-2007?



### Lending Margins

Bank margins have increased in the majority of countries covered by the survey. France, Spain and Austria all report significant increases in their lending margins, and only Switzerland, Slovakia and the Czech Republic report no change.

The remaining respondents indicated that bank margins were up over the period and, in general, margins across Europe are

now in the region of 150 – 200 basis points above base. They are typically higher in Eastern Europe than Western markets, and higher for longer term facilities. This is itself encouraging some lenders to focus more of their activities in emerging markets such as Russia and Turkey, where both lending margins and expectations of value uplift are higher. This is taking some lenders further up the risk-reward scale in response to losses incurred and a softer value outlook in core markets. This also mirrors the approach of certain equity providers whose forays into emerging markets have been driven by the possibility of returns (35-40%) that can be twice those available in mature Western markets.

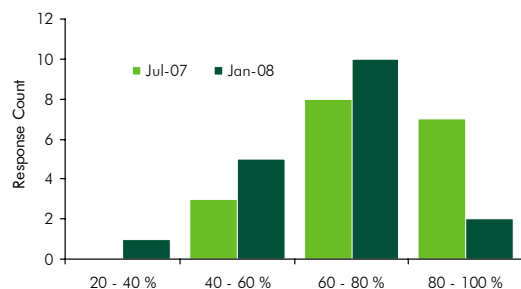
Whilst banks have increased margins to reflect the additional risks of development lending in the current market, there is no doubt that increases in inter-bank rates following the sub-prime crisis are also acting as a brake on development finance. Banks generally have to pass increased costs onto borrowers. It is noted in Ireland, for instance, that “the inter-bank rate is now prohibitive” for debt players.

### Loan to Value Ratios

Loan to development value (LTV) ratios were found to have fallen by an average of around 5 – 10% in most countries participating in the survey, and in others by up to 20%. In mid-2007, a significant proportion of lenders had been willing to provide between 80 – 100% of end development value. However, over the six months to January 2008, lenders have become less willing to provide credit facilities at these sorts of levels.

The survey results show a definite shift towards a lower level of LTV ratio. Indeed, over 50% of respondents reported that typical ratios had fallen to between 60 – 80% of the total end-value.

Typical Loan to Value Ratios for Developers



In four of the countries surveyed namely France, Ireland, Denmark and Sweden, LTV's shifted considerably moving from the 80 – 100% bracket to the 60 – 80% bracket. Those now typically offering the lowest LTV's of between 40 – 60% include the UK, Turkey, Austria, Spain and Hungary of which the last three have moved down from the 60 – 80% bracket. Germany, however, has seen lending conditions tighten furthest with lenders offering only 20 – 40 % loan to value.

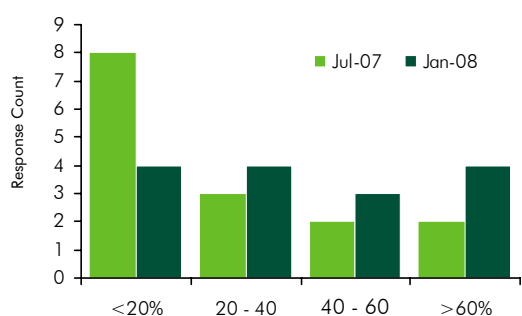
Alongside reductions in LTV's for new loans, falling values in some markets (notably the UK) have caused some technical breaches of LTV covenants on existing loans. One response has been the creation of an increased number of mezzanine "top-up" funds to support existing positions, and hence prevent foreclosure and possible distressed asset sales. This introduces further shifts in the structure of development finance and the profile of rewards for different players.

### Requirement for Pre-lets

The ability to secure tenants in advance of construction has generally been a condition of bank lending in most markets, but this can vary from country to country depending on local market conditions and practices.

Over 40% of respondents reported that, in July 2007, banks were prepared to lend on schemes with less than 20% pre-lets. In January 2008 the proportion prepared to lend on these terms was half this, with a much-increased proportion requiring more than 60% pre-let as a condition of loan.

What % pre-let is typically needed to secure bank finance?



Those countries willing to lend with less than 20% pre-let in the middle of last year included Ireland, Spain, Turkey, France, Belgium, Hungary and the UK.

Of these, France and the UK had seen the commencement of a significant number of totally speculative schemes, mostly in their capital cities.

The strongly rising markets that encouraged this practice have softened, at least in the short-term, with adverse impacts on the letting prospects of some schemes. It is this change that explains the reduced willingness to support further expansion in the supply of speculative schemes. Therefore it is these previously-buoyant markets that have seen the most marked adjustment in the requirement for pre-lets as a condition of funding.

Conversely some countries, such as Denmark and the Netherlands, were already operating a requirement for at least 60% pre-let for development schemes. These were followed by Switzerland and Turkey who also exercised more caution and fell into the 40 – 60% requirement for pre-let bracket.

Factors such as high levels of supply and muted rental growth prospects when lending prior to mid-2007 are arguably key to the practices of previously more cautious lenders. This is particularly relevant in the Amsterdam market where the vacancy rate has been running at 17% and where, as a result, the flow of finance into development had been relatively restrained. Banks in some markets, such as Austria and the Netherlands, were also more conservative regarding the calibre of their borrowers prior to the credit squeeze and have therefore not needed to adjust lending criteria to the same extent.

### Comment

It is clear not only that the attitude of lending banks towards development finance has become generally more cautious, but also that this caution is manifested in different ways in different markets. For instance, in markets such as Austria, bank attitudes to real estate lending were already relatively cautious, to the extent of excluding speculative development lending. In such markets the survey revealed little change in the requirement for pre-lets as a condition of lending. In others, notably France, the main response of lenders has been to focus lending much more tightly on the best developers and the best locations - not necessarily on more demanding terms - and to impose much more stringent conditions, or refuse facilities outright, on smaller developers of marginal schemes.

Some of this is part of a wider pattern whereby lenders in most mature markets are increasingly favouring long-standing existing customers with good track records, over prospective new borrowers of unproven standing. In this respect, the changes highlighted by the survey can be regarded as a further manifestation of the "flight to quality" that has become evident in other areas of real estate markets since the onset of the credit squeeze.

Other variations are emerging. For instance, it is clear that there is increasing divergence in the lending appetite and terms of different lenders in the same market. US and UK lenders are generally more cautious than others but, even in markets characterised by strong caution, there is no blanket moratorium so long as the status of the borrower and attributes of the scheme are robust. This heightens developers' need for high quality debt brokerage to keep up with shifts in the position of individual lenders in particular markets.

As with the survey's other findings, this is significant for markets as well as for individual developers. One possible consequence of a reduction in the supply of development finance, and therefore new buildings, is that any softening in tenant demand is partially offset by lower supply growth, thereby limiting any rental downside. If a tighter lending focus on the "best" schemes in the "best" locations becomes more widely embedded, this could well accentuate this impact by cutting off the flow of finance to marginal schemes or sponsors, of the type that might otherwise introduce a "bubble" element to new supply. One indication of the scale of adjustment is in the City of London, where development completions in the 2009-11 period are likely to run at less than half the level expected a year ago.

The survey also highlighted elements of the process (as opposed to the criteria) of assessing development loans that may also have market-level impacts. For instance, appetite for lending on very large lot sizes is diminishing (with the market for facilities over £100m particularly tight), and development size thresholds for syndication are falling as a further means of controlling risk. This increases the number of parties involved and therefore tends to prolong the process of loan assessment. Along with the need for borrowers to source higher equity contributions and the greater scope for loan terms to alter late in the process, this all points towards longer gestation periods particularly for schemes with complex financial structures or multiple sponsors.

### Market impacts

In terms of market impact, this will tend to extend typical time periods for development delivery. While the survey revealed no evidence of consented schemes being withdrawn completely, there are some instances of developments being delayed. This is partly through more time-consuming processes and partly by conscious decisions to phase or downscale developments, or restrict activity to initial ground works. This is to enable developers to time completions to coincide with stronger market conditions. Such tactics may be easier to deploy in markets where planning consents can be "mothballed" for periods of several years before lapsing.

Finally - and tempting as it may be - the changes highlighted should not be attributed entirely to the credit squeeze. Some are reflections of differences in local norms and practices, or of changes that were already in train and have merely been accelerated by the credit squeeze. However, the changes may well remain in place for some time or even tighten further, particularly if falls in asset values expose any previously-hidden rashness in European property lending. What is clear is that the changes highlighted have great potential to alter the flow, and terms, of development finance and therefore to influence the balance of European office markets.

**This paper has been compiled by EMEA Research and Consulting with input from our investment teams around the EMEA region, and assistance from CB Richard Ellis Real Estate Finance**

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