Guest Column: Alexander Fischbaum, CEO, AF Advisory Ltd, London

When can I have my money, please?

Alexander Fischbaum is the founder and CEO of AF Advisory, a London-based independent real estate advisory firm focusing on the UK and continental Europe. The company specialises in sourcing and structuring senior and mezzanine debt, equity and joint ventures, and marketing and disposal of not-super-prime assets. *The views expressed here are his own.*

Late cycle

After a great 10-year run for real estate all over Europe, we are in late cycle territory and most astute developers, investors and lenders are adjusting to that. Part of this is that credit committees look more closely and well-advised investors are prepared for that, to ensure they receive their money quickly, predictably and relatively painlessly….

Equity is abundant

Bad news? It depends; Yes, competition for assets remains very strong but at the same time we receive almost daily approaches from investors wishing to deploy equity on a JV basis in almost every sector and every country in Europe. The UK remains as popular as ever, and Continental Europe, with a particular interest in Germany, Spain and even smaller markets like Netherlands and Portugal also remains in focus. Thanks to this very significant demand, we are able to source equity for investments, development and even partially completed projects, where one equity partner wishes to exit prior to the pre-agreed term, or prior to all of the value creation opportunities having been crystallised.

While admittedly the abundance of equity makes the market more competitive, it opens up opportunities to exit or raise equity for long-term strategies, changes of plan and business partners etc. which previously would have not been possible.

And some investors have decided to obtain the income element of real estate with a significant reduced exposure to the capital exposure/risk by providing real estate debt.

Financing is abundant

Therefore debt is abundant in every form. Every deal we took on in 2017 got several, very attractive debt offers with record low margins and wide covenants; no matter how large, complex or difficult, be it development, refurbishment or investment.

This was the result of us creating competition for the financing and our advisory approach, but the enormous liquidity in real estate debt markets fuelled by banks increasing their lending targets and new entrants coming to the market, definitely played a huge role. Not only did lenders like the pitch, they were able and keen to deploy.

Changing requests: “We have bought this asset for more than we had planned, please help us find the best financing, so we can hit our targets!”

In line with the maturing property cycle, our clients’ requests continue to evolve. In the early phase of the cycle clients typically asked us “Can you find us finance for this?” Now, typical for late cycle stages, more investors and developers approach us requesting “We have bought this asset for more than we had planned, can you please help us get the best possible finance, so we can hit our distribution/return target?”

Be it investment or development our answer in most cases is: “Yes, we can!” But more than ever we need to convince the relevant credit officers of the merit of the proposal and that means: preparation, preparation, preparation!

So what has changed for credit committees?

As the cycle developed some factors moved against a typical risk officer’s / credit officer’s preferences and can get in the way of getting the money quickly if the proposal is not explained well enough.

Construction capacity constraints and cost inflation

These issues are of course causally related and currently

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present a very significant issue. Interestingly, both issues are prevalent in all jurisdictions we cover (Germany, UK, Netherlands and Spain) with effects rippling up from labourer to sub-contractor, contractor and ultimately the investor, even with fixed price contracts.

This increases overall cost and risk.

Key questions

The key questions developers need to ask themselves, even when a fixed-price contract is in place:

a) How well have you, your contractor and their sub-contractors calculated their proposals?

b) Are those that must be strong enough to absorb cost-overruns?

c) Can you make them absorb the cost overruns?

d) What is the plan if the answer to b) or c) is NO?

These questions exercise quite a few credit officers we have the privilege to speak to and are equally on the mind of our experienced development clients.

High land prices, requiring strong future rental growth

Land prices have reached levels that often make significant rental growth essential for underwriting. Of course, there are quite a few supply constrained markets, where rental growth is not unlikely and investors hope to time their delivery and exit accordingly. In addition, many German markets have seen slow rental growth, which lagged behind general economic development, so a catch-up is likely, while Spanish and Dutch markets have reversed their GFC declines and UK regional markets had a very good run. But this growth is often already reflected in the price and the overall country level development says very little about the prospects for a specific city or site.

Increased total cost

Increased land- and construction cost increase total cost, i.e. a high C in terms of LTC and need commensurate rents to achieve a high value (V) to return to an acceptable LTV. Some developments rely on the continuation of the strong rent inflation of previous years.

High LTC's / LTV's

The higher LTC's and LTV's achievable today combined with the higher cost / value has increased the bank's exposure significantly.

A 2009 City of London office investment

For a previous employer the author bought a high-quality, well-let City of London office building in June 2009 for ca. £600/sqft. The only reasonably priced bank finance available then was 50% LTV.

Therefore, the bank's exposure / sqft of high quality City of London real estate was ca. £600/sqft x 50% = £300. Add to this the WAULT of 8 years and the fact it was leased to a great covenant at £50 p.a. and one can see that the credit officer should not have lost too much sleep over that exposure.

A 2018 City of London office investment

Due to the higher rent levels and lower yields prevalent today a comparable asset would today trade at around £1,400/sqft and the bank would conceivably provide a senior loan of around 70% on it. Therefore the lender's exposure / sqft would be £980/sqft. That is 3.3 x the exposure of 2009 and prices in the City are softening!

Of course, lenders don't predominantly think in £/sqft but it is a convenient way of illustrating the issue.

I hope the above explanations have shone a light on some of the real issues credit officers face and that the answer to the increased scrutiny by the credit committees is preparation, preparation, preparation and the ability to create a convincing dialogue with the right lender. in the absence of this, the issues above will delay or scupper the unprepared or ill-advised borrower and their proposals.

But if the above approach is followed carefully, the answer to the question – "Can I have my money soon?" surely is "Yes, you can!"

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