

# lendingstrategy

20

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Julien Holmes, managing director of Crown Mortgage Management, warns that the sectors in the commercial lending market that are both suffering most and are likely to have been overvalued are the ones that make up the greater part of the UK property market

## Commercial data now sensitive

The commercial property market is hurting. The much reported falling prices of commercial property has had a disproportionate impact on the investment sector.

In the face of falling property values, many leading fund management houses have had to revalue their funds downwards. The investment trust sector has suffered even more, with the average open-ended commercial property fund falling 22% over the last 12 months.

The fall in fund values, a good indicator of investor confidence, is more extreme than the fall we are seeing in property values.

According to the Royal Institution of Chartered Surveyors, office capital values fell by 9.9% year-on-year, the fastest pace of decline since June 2003. And this is the best performing sector of the market. The retail market suffered even greater falls – dropping 13.8% year-on-year, with rental growth also falling back to 1.8%.

**It is impossible for lenders to have a clear understanding of the risks they face without accurate data**

RICS also believes (RICS Economic Brief, March 2008) the market has not yet bottomed out and it anticipates that capital values will continue to fall. Similarly, with rents increasing at their slowest monthly pace since April 2005, landlords will find little compensation from this side.

At the same time as the market is turning down, recent announcements by the Association of Chief Police Officers and the Financial Services Authority give cause for concern.

They estimate that mortgage fraud, particularly in the commercial sector, adds up to around £700m, which can often include the ramping up of com-

mercial property values.

This combination of circumstances raises some important considerations for lenders. As the chart below highlights, the sectors which are both suffering most and also are likely to have been overvalued are those which make up the greater part of the UK property market.

Some lenders are already taking action. According to a leading property analyst, one large UK bank is no longer issuing loans on commercial real estate or, indeed, rolling over existing ones.

In the face of these developments, combined with the fall in confidence and the underlying asset values, all other lenders with exposure to the commercial property market should re-examine their portfolios.

At a very minimum, properties should be re-evaluated in line with sector-specific movements in the market – as already mentioned, the divergence in the performance of different sectors and property types means that a tailored approach is advisable.

This should be combined with sector-specific risk analysis. Last month we looked at which types of businesses are most likely to be affected by an economic downturn.

And with the US now widely perceived as being in recession, with the continued fallout from the financial markets recently claiming its latest victim, Bear Stearns, these developments are beginning to have an impact on stock markets worldwide.

Lenders must therefore look closely at their portfolios to identify the key risk areas and to ensure that the appropriate risk management mechanisms are in place to actively manage these properties through any problems and minimise potential losses.

ACPO's concerns give rise to a further area of concern to lenders. It is impossible for lenders to



Julien Holmes

have a clear understanding of the risks they face without accurate data.

They would be advised to look again at many of their recent lending decisions to ensure that the valuations were fair and accurate and take appropriate action where they are not.

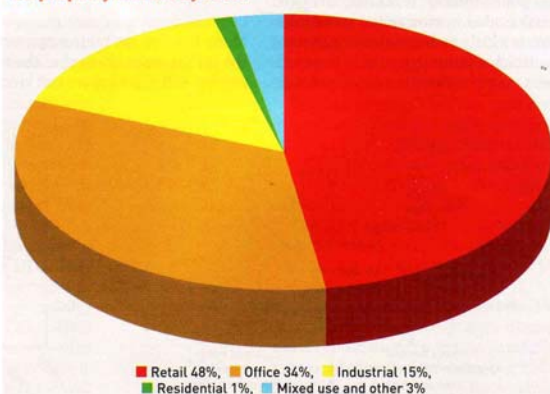
Indeed, in the more general mortgage market this is already happening with research from lawyers Moore Blatch revealing a 31% increase in negligence claims against surveyors.

The accumulation and management of all this data will not only enable lenders to understand the risks their commercial books face, but will also facilitate their sale at a later date.

What is becoming clearer as the months pass is that the credit crunch is not a temporary blip, but a major realignment of the financial markets and of their assessment and understanding of risk.

Given the outflows from property investment funds and the ongoing write-downs of mortgaged backed securities, it will be a long time before investors regain confidence in property as an asset class. When they do so, they will be choosy, and those lenders that have accurate and comprehensive performance data will be those best placed to securitise or sell-on their portfolios.

UK property market by sector



Source: Schroders/Investment Property Databank 31.12.06