

McKinsey: property financing is unprofitable

BANKS WHICH ENGAGE IN COMMERCIAL REAL ESTATE FINANCING SHOULD STICK TO MARKETS AND SEGMENTS THEY KNOW WELL

BY JUDI SEEBUS

The commercial real estate (CRE) financing industry is fundamentally unprofitable. That is the grim conclusion of a confidential report obtained by PropertyEU. It gets worse: even in the 'golden years' of 2006-07, the industry as a whole does not return its cost of capital, let alone over the business cycle. 'Put another way, the "profits" recorded in good times are in fact economic losses to equity holders; worse, they fail to provide a cushion for the significant losses that come in industry downturns.'

Entitled 'Commercial Real Estate Lending: Finding economic profit in a difficult industry,' the report is a damning indictment of bankers who were only interested in boosting market share, without any consideration for returns or profit and unhindered by any knowledge of their products or markets. The inevitable recommendation is: banks should focus on markets and segments that they know well.

The survey is the second in a series focused exclusively on commercial real estate. The findings are based on responses from eight large, primarily European banks and supplementary interviews with other players. Collectively the two groups comprise about 40% of CRE loans outstanding on balance sheets across Europe, McKinsey claims. The survey spanned 2006 and 2007, the final two years of the property boom.

POOR DEAL SELECTION

McKinsey attributes the widespread unprofitability of the CRE lending business to poor deal selection and, more specifically, a failure to adequately price the underlying risks. Other factors include a lack of revenue diversifica-

tion and cost inefficiency. 'Because of these dynamics, we expect that even after the current crisis has faded the CRE industry will continue to destroy value.'

At the root of the problem is the ease with which any large pool of capital can enter the CRE financing business. 'CRE lending can generally be conducted using the support groups and systems that almost any commercial or investment bank already has in place,' the authors of the survey continue. 'And the business is essentially based on one, easy-to-deliver core product.'

Because there are few barriers to entry, excess capital is often deployed in CRE finance, distorting the economics of the business. During the period of 'loose capital' that started in late 2001 and ended in 2008, CRE lenders accepted ever lower margins and even higher loan-to-values (LTVs), the survey points out. 'By the end, pricing on CRE loans reached historic lows at a time that the underlying riskiness of such loans reached unprecedented heights.' While some lenders grew concerned and starting pulling out of deals back in early 2007, most did not. Those that stayed in the market included investment banks which were able to offer cheap funding via their commercial mortgage-backed securities (CMBS) business. These lenders placed their trust in the seeming perpetual rise in commercial property prices, but were left with a razor-thin margin for error, even as their borrowers became increasingly vulnerable to vacancies and other cash-flows. These optimistic lenders consistently fail to price the rising risk of default and property market declines into their loans, McKinsey claims. 'And even those banks that, spotting the risks, try to charge more for them often find themselves well off the market, as

others undercut their offers. The result is that, in aggregate, CRE lenders do not return their cost of capital – even in good years.’

But the news is not all bad. Another key finding of the survey is that some CRE lenders generate returns exceeding their cost of capital. ‘Top-performing lenders have developed a thoughtful approach to their business, choosing their customers with care, concentrating on the markets they know best, and taking a deliberate view of the many risks inherent in property markets. Furthermore, they have kept their businesses at a manageable size, moving counter-cyclically to reduce volumes.’

Top CRE lenders generate higher risk-adjusted margins, the survey found. ‘They achieve this because they manage risk differently. They monitor it more precisely, considering it across geography, property type, client segment, and deal type (ie investment or development). Lower-performing institutions on the other hand, tend to take a uniform “one-size-fits-all” approach to risk. Top CRE lenders also have unique loan approval processes for each of these categories while the laggards tend to use one process throughout. And at top institutions, risk professionals are full-fledged members of deal teams.’

In its conclusion, McKinsey provides a profile of a top

performer. Successful CRE lenders a) target only established, close-to-home markets; b) build a narrow portfolio featuring only a few property types, client segments, deal types and ticket sizes; c) counter-cyclically manage the size and growth of the loan book; d) generate healthy

cross-sell margins with a lean infrastructure; and e) invest significantly in risk management.

Indeed, the handful of lenders that fit this profile and have capacity to write new business find themselves in a new ‘golden age’, the consultant claims. ‘Top players that exercised prudent restraint in those boom times can today easily write profitable low-risk business, while taking the necessary steps to limit loan losses in their current book of business.’

‘We expect that even after the current crisis has faded, the real estate financing industry will continue to destroy value’

WestImmo stays on course in financial storm

BY CORMAC MAC RUAIRI

At a time when many of the biggest names in property financing have been forced to take a breather from lending and re-assess their strategies to cope with the fall-out of the ‘credit crunch’, Westdeutsche Immobilienbank (Westimmo) has been conspicuously active. The real estate financing arm of WestLB has written loans totalling €3.1 bn up to the end of June, 3% more than last year. Westimmo expects its total new lending volume for 2009 will roughly match the €6 bn total for last year. This is not to suggest the global financial crisis and slow-down in real estate investment has passed Westimmo by: the bank wrote €9.6 bn of loans in 2007. However, Claus-Jürgen Cohausz, Chief Origination Officer of Westimmo, emphasized in an interview with PropertyEU that the bank

has a healthy equity base. At end-2008, the bank’s Tier 1 ratio stood at 8.4%, up from 6.1% in 2007, and well above the minimum ratio of 4%. This means Westimmo is very much open for business, Cohausz said. For instance, Westimmo was one of a group of five banks that took part in the \$1.28 bn refinancing of Bank of America and the Durst Organization’s New York tower in June.

CLUB DEALS

Closer to home, Westimmo took part in a €140 mln club financing with landesbank Helaba and Germany’s Postbank of MGPA’s office and retail property at Place de Madeleine in Paris in July. Westimmo noted that it has this year increased its loan syndication with German Spar-



CLAUS-JÜRGEN COHAUSZ,
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OFFICER WESTIMMO

kassen, or savings banks. Up to July this year, Westimmo syndicated €130 mln of commercial property loans to savings banks, compared to €90 mln for all of 2008. Cohausz stressed that club deals are one of the pillars of Westimmo's approach to commercial property lending. 'Up until the outbreak of the credit crunch, securitisation (CMBS) was trendy, but sharing risk has become popular again. All banks want to avoid taking on too large an exposure on their balance sheets'.

Westimmo will continue to be the largest single lender in most of the club deals it takes part in with other German banks, he added. However, the German financier also participates on a reciprocal basis in deals organised by

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savings banks. Cohausz said that while Westimmo is active, capturing market share from peers which have halted or slowed their activities is not a key driver. 'We haven't changed our strategy. What is important is that we have a balanced portfolio, with acceptable risk levels combined with a good risk/return ratio.' Noting that Westimmo had not been one of the banks to embrace financial engineering wholesale, Cohausz said mortgage-type lending plus the support of WestLB's depositor base would remain the bedrock of the business.

PFANDBRIEF MARKET

The German covered mortgage bond, or Pfandbrief, provides the bank with a means of re-financing. The Pfandbrief market was stilled temporarily in 2008 but it took off again in the first half of this year. Westimmo has issued €1.3 bn worth of the covered bonds so far this year, including a €500 mln issue in June. This marks the return of Westimmo to the ranks of major issuers after a five-year period when smaller coupons were placed on the market on a regular basis. Unlike peers such as Hypo Real Estate who have sought German federal government support through the bank stabilisation fund Soffin, Westimmo does not face any government restrictions on its activities. One potential stumbling block, a requirement that new business qualify for the Pfandbrief system, came into force in late 2008. But this was rescinded in January this year. Westimmo is active in the main European markets, the US and the Asia-Pacific region. Cohausz said the bank will not be retreating from any regions in response to the global financial crisis. He noted, however, that further expansion

in terms of offices is not on the cards. Germany and Europe currently account for about 60% of Westimmo's business. Cohausz said the target would be to split this figure equally for Germany and Europe, with the US and the APAC region accounting for the remaining 40%.

RUSSIA OFF-LIMITS

The Asia-Pacific region is showing a mixed performance. Japan, according to Cohausz, is writing new business, while Singapore is 'difficult'. Westimmo is not currently active in Australia. In Europe, Westimmo is active in Germany, the UK, France, Spain, Benelux, parts of Sweden and in Central and Eastern Europe. Cohausz said the bank has not been active in Russia – and won't be – due to ongoing political and legal concerns. But, he said the major CEE markets of Poland, the Czech Republic and Romania should not be seen as a higher potential risk than Spain, where the collapse of a housing bubble has damaged the economy. 'We recently closed two financial deals in Poland, plus one for a development project,' he said. Pre-conditions for loans have been tightened, including a higher pre-let ratio for developments and a higher equity commitment by the lender.

While other commentators are divided on whether the UK market is characterized by green shoots or growing gloom, Cohausz is cautiously optimistic. 'Values have fallen very sharply in the UK, and when that process was ongoing, 50-55 Loan-To-Value was the correct approach by lenders, he said. 'Now, we believe the decrease in values has slowed – and maybe found a bottom – in the UK, so 65-70% LTV (up to 75% in certain cases) could be possible. Stability of cash flow is the most important issue.' Westimmo has had a branch in London since the bank was formed by a merger in 1995. Traditionally, the UK capital has accounted for over 80% of Westimmo's loan book in the country. However, the real estate market in the UK is undergoing fundamental changes as decentralisation boosts the importance of cities like Manchester, Cardiff and Bristol, Cohausz noted. Rising yields and a weaker Sterling have drawn international investors back to the UK. Major office deals in London have captured the headlines, but Cohausz said foreign investors are also looking at retail and logistics. 'We are not concentrating on London only; we are pitching for deals where there is a clear demand.'

Asked about the much anticipated real estate recovery in Europe, Cohausz looks ahead to a near future when real estate will once again be more profitable than investing in government bonds, reflecting a spread of 300-400 basis points. But Cohausz said no one can be sure the property markets will be in a better position soon, as much depends on whether the recession continues, causing more bankruptcies than seen to date. ■