

Where is the Distress?

Considering Bank Led Sales and the Buyer Pool



One of the few advantages of being a certain age is that it allows you to experience market cycles, including those where capital values were drastically repriced, and to reflect on how each cycle has different attributes.

Between June 2007 to July 2009 (a period which encapsulated the Global Financial Crisis ("GFC")), commercial property witnessed a 44% capital value decline (source: MSCI) and residential values a 20% fall (source: Halifax). This was a consequence of global credit becoming less available and deleveraging by businesses as liquidity dried up.

This led to real estate asset values decreasing, as the cost of finance was higher or just unavailable. Together with falling occupier demand, causing higher vacancy rates, the market experienced a true double whammy. Asset values were impaired to such an extent that borrowers' equity was wiped out leading to lenders enforcing their rights, taking back assets and selling them to recover their debt and realise any losses.

This push to dispose of assets, between 2010 and 2013, repriced the market in a very transparent way from which, in the environment of lower interest rates, enabled the real estate market to enjoy capital value growth for the decade that followed.

Closer to today, during H2 2022, the commercial real estate market faced another dramatic repricing following the Liz Truss mini-budget, with all-property capital values reducing by around 16% over the period. The industrial sector bore the brunt of this, with a near 30% decline (source: MSCI). However, the banks have not, as yet, repeated the tactics adopted post-2009, largely leaving borrowers alone.

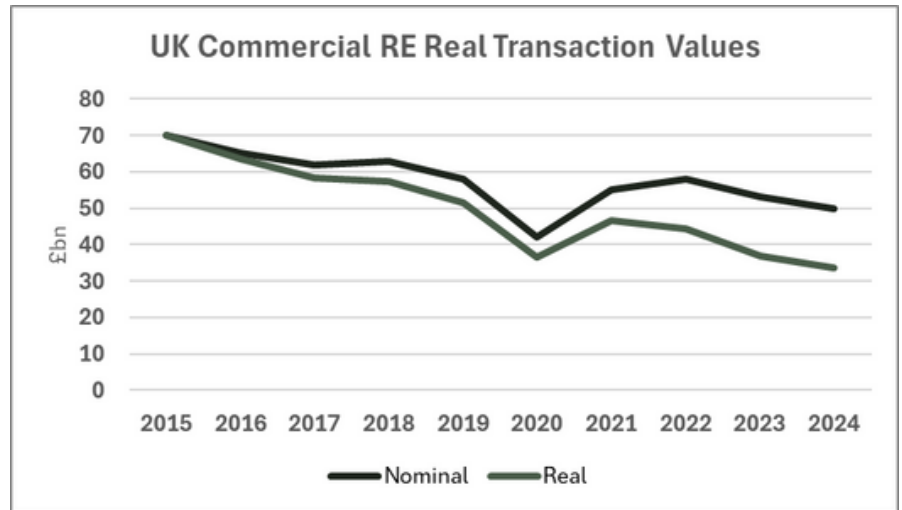
Why is this and does this mean that we are about to see more enforcement activity to recover loans?

At Ashen Capital we believe that asset pricing is, in general, at the bottom of the cycle for the better-quality stock, with the impact of outward yield movement being countered by occupier demand and the growth in rental values. This has allowed borrowers who maintained equity to refinance and keep control over their projects.

Borrowers have had to deal with increased interest rates, which has made debt more expensive and reduced income returns, but they have been willing to do so while they wait for an anticipated market recovery.

However, any recovery in values will not be a quick process because higher interest rates will continue to limit the benefit of leverage and the lack of UK domestic investor demand will limit investor appetite for core plus returns.

In addition, as UK pension funds switch to become Defined Contribution schemes or sell themselves to insurers, they are exiting illiquid assets such as Real Estate. This trend has resulted in reduced transaction volumes which are down nearly 30% over 10 years in nominal terms - but more like 50% in real terms.



SOURCE: MSCI, ONS

The net result is that a more selective buyer pool will likely either want to buy the best or worst assets, with the latter being where attractive returns can be made through transforming those assets into the best assets.

This means that the rest of the market is left stranded, able to service interest but with a shallow buyer pool providing competition on sale. Without the post-GFC push by lenders to realise their losses (and thus providing valuers with comparable evidence), borrowers will be able to continue to hold assets meaning that the unwinding of legacy positions will take time.

In response to this Ashen Capital is adopting the following strategies:

1. Investing in debt, where the capital is protected through being senior or preferential ranking and/or income producing assets. This creates liquidity for existing debt positions whilst delivering a quasi-equity return for debt risk;
2. Investing in equity positions where capital is created through the planning or development process, where the buyer or occupiers pools are deep and sustainable;
3. Finding sources of capital outside the UK traditional pension funds, which is able to take an increased income return whilst accepting reduced liquidity, at least for now.



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