GERALD EVE

DEBT MARKET COMMENTARY

We have seen continued volatility in the costs of SWAP rates with rates up c.1.5% since 30th August with 2- and 3-year swaps both pricing over 5%.

The Bank of England have continued to increase the Base Rate with a base of 2.25% and expectations of further rises with some commentators suggesting a base of 6%.

Interest rates are currently at a 14 year high and show no sign of decreasing in the short to medium term.

Following the 'Mini-Budget' on 23rd September, the market reacted badly due to unfunded tax-cuts and increased Government borrowing. This led to a sharp decline in the value of the Pound vs its major trading partners. For a while, the prospect of parity with the dollar looked like an option albeit the Pound has recovered a little since its record low. This depreciation in the value of Sterling will mean that foreign buyers (especially America) will see the UK as 'cheap' despite the rising cost of debt.

SONIA swaps

	Current	29/9/22	30/8/22	30/9/21
1 Year	4.757%	4.912%	3.508%	0.305%
2 Year	5.125%	5.267%	3.758%	0.511%
3 Year	5.107%	5.211%	3.605%	0.626%
5 Year	4.849%	4.880%	3.271%	0.753%
7 Year	4.563%	4.581%	3.048%	0.835%
10 Year	4.312%	4.339%	2.889%	0.927%

Rates correct as of 03/10/22 . Source: Chatham Financial www.chathamfinancial.com

The Refinance Gap

With interest rates at their highest point for 14 years, many property owners who purchased assets between 3-5 years ago will likely have an upcoming refinance event at interest rates far higher than when they purchased the property. As an example:

If you bought a prime logistics asset back in 2017 for, say £10m at 60% LTV when yields were c5.25% borrowing 60% LTV and have benefitted from not only yield compression but also from rental growth, then your current debt metrics may not look too stressed even as yields move out.

If, however you had purchased the same asset in 2020 at a yield of say c3.75% and if we assume the SONIA curve is correct, when a refinance on the £6m is due in 2025, you will be seeing an all-in debt cost (at today's rates) of c7% (c.5% swap rate and c.2% margin) so will need strong rental growth to provide a lender not just with interest cover but to offset yield shift and keep senior debt LTV metrics.

Leverage is, to a much greater extent than 12 months ago, being driven by the income and the interest cover ratios a lender requires (typically 1.5x as a minimum). The increased interest cost is putting pressure on these ratios and whereas year you might have seen 60% interest only on prime assets 55% is the new normal. Several lenders have already indicated that they won't consider facilities beyond 50% as a general rule. If you can operate within lower leverage then we have seen attractive margin pricing for core assets e.g 160bps on a logistics portfolio at sub 40% LTV.

Purchase Date	Loan Expiry	NIY	Current Yield	60% interest only debt on acquisition	Rental Income on acquisition	Interest cost on refinance (7%)	Opinion
2017	2022	5.25%	4.75%	£6m	£525k (gross)	£420k	Could refinance
2020	2025	3.75%	4.75%	£6m	£375k (gross)	£420k	Unable to refinance

The Gilt Market

With Sterling falling in value, the value of Gilts also fell as the markets raised concern over the UK's increased borrowing and its ability to service its debt.

The Bank of England stepped in to undertake a round of quantitative easing of c£65bn (buying back long dated gilts) to show market support and to help keep gilt pricing stable.

Gilt yields have fallen in response to the BoE intervention but yields compressed at the longer end of the market (10 year plus) rather that at the shorter end.

	Current	29/9/22	30/8/22	30/9/21
1 Year	3.424%	3.596%	2.642%	0.230%
2 Year	4.231%	4.342%	2.893%	0.405%
3 Year	4.382%	4.461%	2.719%	0.503%
4 Year	4.481%	4.610%	2.745%	0.550%
5 Year	4.381%	4.454%	2.659%	0.632%
6 Year	4.314%	4.455%	2.607%	0.654%
7 Year	4.314%	4.545%	2.663%	0.735%
8 Year	4.148%	4.263%	2.618%	0.854%
9 Year	4.155%	4.289%	2.699%	0.950%
10 Year	4.081%	4.212%	2.700%	1.021%

Rates correct as of 03/10/22 . Source: Chatham Financial www.chathamfinancial.com

Conclusion

There remains uncertainty around interest rates, gilts and the strength of the pound and these issues coupled with continued high inflation have led to a slowdown in market transactions with concerns also raised on the strength of the residential housing market which is also seeing reduced transaction volumes as borrowers struggle with increased interest rates and increasing utility costs.

Our view is that the real estate debt market will remain open for business for the remainder of the year but with lower LTVs and focus on sectors such as core Big 6 offices, prime industrial and BTR residential Those needing finance should seek professional advice as early engagement with Lenders and providing a working solution which is flexed for current market conditions will be essential to maintaining strong working relationships with lenders and borrowers alike.

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