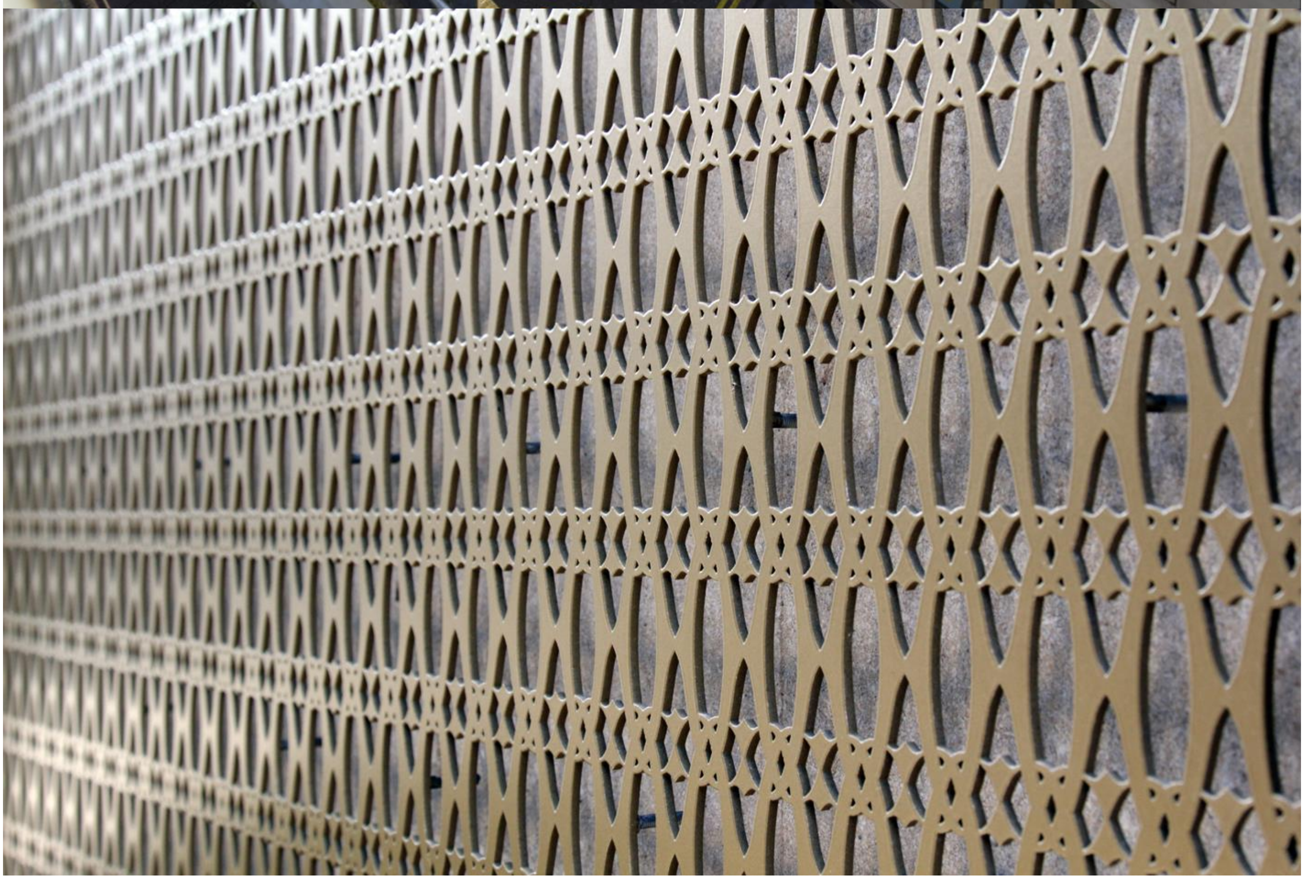
Debt and Gearing

Changes, Opportunities and Benefits

Riverside CAPITAL

THE PROPERTY INVESTMENT PEOPLE



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The Debt Market – A Brief History

The availability of debt in the commercial real estate market has gone through significant changes over the past 10 years. In the years running up to the financial crisis, real estate debt grew to record volumes. According to a banking survey compiled by Capital Economics, outstanding commercial mortgage debt rose from just under £50 billion in the year 2000 to roughly £250 billion during the peak of the market in early 2008.

This growth was driven by an increase in loan-to-value (LTV) ratios and a relaxation of underwriting standards resulting in some very poor quality loans.

The problems started with Subprime lending in the US but soon became a global problem. As investors started to realise that many borrowers would default, credit markets dried up and real estate was one of the first segments to feel the negative impact of this. Bank credit evaporated and banks called in their loans where they could; leading swiftly to a collapse in property prices.

Prior to 2008, lending was dominated by banks offering high levels of leverage at relatively cheap interest rates. The global financial crisis, however, has resulted in significant structural changes to the real estate market. Post 2008, banks are less willing to lend money and, in some cases, have stopped lending altogether, having been compelled to shrink their balance sheets under various legislations such as Basel III.

The Debt Market Today

Since the turn of the year there has been a significant change in market perception thanks to the continuing improvement in the economic outlook for the UK. With UK commercial-property values rising for the first time since 2011 we have started to see an improvement in bank lending conditions.

According to Savills, a new lender has entered the market almost every week in the past year in search of higher returns as gilt yields neared record lows. Greater competition on commercial-property loans has narrowed lending margins by as much as 2 percentage points over the past year.

British lenders have shown an increased willingness to provide commercial property debt for the fourth straight quarter during the three months through September, and this is expected to continue through to the end of the year, according to the Bank of England's quarterly credit conditions survey.

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Gearing – What can we Expect?

Gearing may be used to accelerate the process of wealth creation by allowing an investor to make a larger investment than would otherwise be possible.

The introduction of debt means that your equity carries more weight – referred to as the Multiplier Effect.

Debt is offered to investors based on a number of different criteria with differing rates of return dependent on: the length of lease; the quality of the underlying property assets; the strength of the borrower; the level of collateral available and willingness or otherwise to be exposed to default.

Gearing can be an effective strategy if the capital gain and income return of the geared investment exceeds the costs of funding the investment.

As long as the net gains from your investments over the long term outweigh the costs of borrowing, gearing will magnify those gains. Gearing is considered to be an effective long term strategy because experience has shown that over the long term, growth based investments can deliver the higher potential returns required.

Gearing should be viewed as a medium to long-term strategy; the ability to retain the investment and maintain the loan repayments during potential short-term market declines is essential in order to obtain the benefits of long term growth.

The Impact of Gearing

Fig.1	Fig.2
LTV 75:25 5% increase in the value of the property **20% Increase in Equity Value**	**LTV 75:25** 5% Decrease in the value of the property **20% Decrease in Equity Value**

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Gearing has the potential to significantly enhance income returns.

Fig.3

100% Equity		**25% Equity, 75% Gearing**	
		Debt (@5.5%)	£0.75m
Total Purchase Price	£1m	Total Purchase Price	£1m
Rental Income	£80,000	Rental Income	£80,000
		Debt Cost	£41,250
		Net Rental Income	£38,750
Ungeared Income Return p.a.	**8.0%**	**Geared Income Return p.a.**	**15.5%**

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