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UK real estate debt: distortions create opportunities

Investors in commercial real estate debt continue to focus heavily on the perceived 'high-quality' end of the UK market, typically Central London, according to Chris Taylor, CEO of Hermes Real Estate. This is having two distinct effects.

The first is that this market segment is now looking increasingly expensive. Spreads have continued to compress with sub 200bps margins increasingly common. We don't believe this to be an overly attractive risk/return profile, given capital values in Central London are at an all-time high, and tenant occupational demand appearing to thin.

Banking groups continue to adjust their real estate lending balance sheets towards perceived lower risk, higher quality assets, compelled by Basel III and 'slotting'. Whilst amplifying demand in an already richly-valued area of the market, it creates regional market distortion and significant opportunity in markets outside of Central London.

Banks still dominate commercial real estate lending in the UK, with an 89% market share. Insurers account for about 9% and alternative lenders – of which Hermes is one – make up only about 2%.

While the top end of the market may be showing signs of oversupply, we believe there to be a continuing net lending shortfall, as we've previously outlined. The Hermes Real Estate Senior Debt fund is currently assessing pipeline transactions of more than £1bn, with a weighted average margin of 275bps. This is a combination of tighter margins on well located, strong cashflow-producing assets in Central London but also lending opportunities against select regional properties, characterised by good location, strong demand, long leases (or the ability to reposition) with acceptable tenant credit quality.

The understanding of real estate fundamentals is key in our lending decision-making process and this plays to Hermes' real estate strengths. The asset security is core to our assessment of a lending opportunity and we have deep experience and resource to undertake the necessary assessment and due diligence to determine those areas of the market offering the most attractive investor risk/return profile.

The Hermes Real Estate Senior Debt fund was launched on 30 December 2013 with cornerstone capital investment.

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Notes to Editors:

Hermes Fund Managers

Hermes is a unique fund manager – we have been an industry leader in Responsible Investing for over thirty years and offer clients the unparalleled combination of:

- Our **Multi-Boutique Structure** gives institutional and pension fund clients globally the benefit of access to a broad range of specialist, high conviction investment teams operating within an established and robust operating platform.
- Our **Investment Office** is a crucial function, acting as a performance risk 'radar' for all boutiques' investment activity and is central to our mission to deliver Sustainable Risk-Adjusted Alpha to all our clients.
- Our commitment to behaving as a **Responsible Asset Manager**, not merely by being a 'Responsible Investor' in quoted companies but also by applying these principles across all asset classes and by behaving as a 'good fiduciary' on behalf of our clients.

Hermes' investment solutions include:

- **Bonds**: Inflation-Linked, Government Bonds, Investment Grade, High Yield
- **Alternatives**: Commodities, Hedge Fund Solutions, Real Estate, Private Equity, Infrastructure
- **Equities**: Global, Emerging Markets, Small & Mid Cap, Europe, Japan

Hermes manages assets on behalf of more than 170 clients* across these investment areas with £26.3 billion* assets under management. Additionally, we support pension funds and other global institutional investors worldwide in meeting their ESG responsibilities through our market leading Hermes Equity Ownership Services, which takes on a stewardship role engaging globally on more than £98 billion* of assets.

*Please note the total AuM figure includes £3.4bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"), a joint venture between Hermes Fund Managers ("HFM") and GPE Partner Limited. HGPE is an independent entity and not part of the Hermes group. £0.4bn of total group AuM figure represents HFM mandates under advice. Source: Hermes as at 31 December 2013.