OAK INVESTMENT MANAGEMENT GROUP

JANUARY (2) 2012: Hedges in real estate

To fix or 'hedge' LIBOR or EURIBOR exposure was the great lesson from the boom and bust of the late eighties and the early nineties. Then, interest rates that reached as high as 15% exposed real estate investors to a risk that they had not embedded into their calculations. Since then a combination of factors has meant that hedges have become ubiquitous and often 100% of the mortgage amount of an asset or a portfolio.

In the current economic environment and because many banks mandated hedges as part of their principal loans, many real estate operators have been denied the support afforded to the rest of the economy by the Bank of England's unprecedentedly low base rate. This means that even if a portfolio of real estate is doing relatively well, a disproportionate amount of cash flow is going towards an insurance policy against a scenario that is very unlikely to happen.

A hedged instrument has legal and financial characteristics that are well worth understanding. First and foremost a hedged instrument is super-senior, and ranks above any form of mortgage or first lien on any real estate asset. The instrument has been designed to be bullet proof in terms of legal / administrative challenge. These characteristics have allowed these instruments to be sold easily into the market, making them into a well priced commodity with all of the benefits (principally liquidity) and challenges (tight spread) that that presents for the banks.

Banks have mitigated the tight spread of hedges by selling them out wholesale, or by mirroring their qualities and selling them out, to the capital markets. There are two benefits from doing this, first they can take riskless arbitrage from the spread between the level at which their customers fix and the price at which the capital markets fix and secondly, they can take the full future benefit of the swap immediately. There is only one problem with this in practice: if the underlying real estate runs into trouble they have to inform the market, and acknowledge the mark-to-market liability as their own. Banks are understandably very loathe to do this. So even in while they might have taken a provision or be willing to discuss a 'haircut' on principal they are not willing to continence such a thing on their swaps. This is one of the important elements that has decreased transactional activity in the commercial real estate market.

So where does that leave the real estate investors? For perspective purchasers of assets with inappropriate LIBOR / EURIBOR hedges they can 1) synthetically neutralise (use counter-veiling instruments to mitigate the worst going forward) or 2) buy out (cost the buyout of the MTM position as part of the purchase price). For perspective purchasers of assets with no hedged legacy issues, they must 1) conduct a disciplined sensitivity analysis on their prospective underlying cash flow, 2) ensure that the hedged principal matches their inelastic cash flow and 3) gauge the current hedged proportions in the capital market as an indicator of future interest rate volatility.

Hedges in the market will slowly become less of an issue as 1) they naturally burn off, 2) they are re-set at a lower level or 3) this extraordinary fiscal environment comes to an end. In the meantime real estate investors should always match their hedge level to the risk that they are prepared to tolerate, and not by the level that their banks have prescribed.

Nicholas Frankopan is Managing Director of Oak Investment Management Group pan-European real estate investment manager. To contact the author please email nfrankopan@oakadvisors.co.uk or learn more about the group at www.oakimg.com.