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Leverage beyond 70 per cent loan to value "destroys value"

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The cost of debt in respect of property companies starts to increase significantly at a loan to value of 45 per cent, according to the 'options theory' contained in a report by Eurohypo.

Philippe Tannenbaum, director of research, London Branch at Eurohypo, says there is a statistically significant correlation between the value of the equity of a property company and its loan to value ratios.

This can also be demonstrated by a model based on the theory of options. According to this theory, there is a point where equity holders in a property company and the company's bankers are linked by an option.

Key to this theory is the idea that the banker has a 'put option' on the assets: if the value of the assets falls below the value of the debt, the banker has a right to sell the assets and recover his/her money.

Tannenbaum says that by applying this theory, the value of a property company's equity may be calculated in the same way as the value of an option. The value will be linked to the loan to value; to the volatility of the prices of the assets; and to the maturity of the debt.

Having calculated the value of a property company's equity, the market value of the debt of the company can then be calculated. This value will begin to increase as equity values fall due to the impact of increased gearing risk.

The report shows that beyond 70 per cent loan to value, leverage does not create any additional value and in fact begins to destroy value.

The model also gives an indication of implied values. In London, the implicit pricing resulting from the actual cost of the debt (around five per cent) seems to indicate a further fall in values of approximately ten per cent.

The cost of the debt starts to increase significantly at a loan to value of 45 per cent.

'Lowering the cost of funding for the banks is a first step and only a part of the solution to re-open the financing market,' the report states. 'The second step will consist of raising margins up to the level where bankers will consider they have an appropriate protection against their risk.'

Tannenbaum says the model may be used to draw some conclusions about the UK property market: 'The dramatic increase in yields combined with the decline of the cost of money has created room for margins to return to attractive levels for banks. More precisely, it is understood that the current level of margins required by those willing to lend is around 200bps, leading to an all-in-all cost of debt in London of around five per cent.'

According to the report, the implied loan to value whereby equilibrium is reached at this cost level is 60 per cent.

With a current average loan to value of 55 per cent for UK property companies, the implicit market view is that values have still to tumble ten per cent more for the option theory to be satisfied.

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