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Observations on the Current State of the European Real Estate Finance Markets

Dear friends, colleagues and market participants,

I very much hope that you are bearing up and keeping safe in these challenging and disruptive times. We at Brookland have been receiving a number of calls from clients and market participants on what we are seeing in the European real estate finance markets and I thought it may be helpful to share our experience more widely and I hope you find it useful.

My thoughts below are based on the current state of the market before the full extent of the duration and severity of the impact are known. The situation will certainly evolve over time.

There are currently no liquidity issues in relation to the providers of debt finance. Banks remain well capitalised and the larger debt funds have raised significant institutional capital in recent years. The market also benefits from a very diverse range of lenders and capital sources (e.g. debt funds of various kinds, insurers, P2P).

Leverage in the real estate markets has been well controlled. Losses on loans secured on structurally weak sectors like secondary retail shopping centres are inevitable but these can be absorbed without creating any systemic issues. There will be some cross-contamination for banks through significant exposures to corporate credit but these have tended to be more conservatively structured than the more aggressive HYB or 2nd lien loan markets where the exposures predominantly sit with funds.

There are, however, expected to be **significant liquidity issues for consumers and corporates in key industries** (and related asset classes) such as retail, F&B, hospitality in its widest forms (from hotels to caravan parks to hostels), leisure including cinemas, gyms and amusement parks, serviced offices, pubs, arenas/stadiums and over the longer-term potentially student accommodation. This will initially feed through as shortfalls in rent and depending on the duration of the current crisis will result in increased vacancies, reduced rents and a drop in capital values.

For real estate lenders, the key issues right now are the inability to fully (i) **assess risk**, in particular, future income and future values on the asset classes most at risk or (ii) **price that risk.**

This means that **the majority of lenders are now in pause mode for new lending opportunities.** If a transaction has already been credit committee approved there is a much higher chance of it progressing to completion albeit with the risk of adjusted terms. Transactions which have not been formally credit approved and where the borrower is not a core relationship are at much greater risk of lender withdrawal.

The priority of most lenders at times like this is to:

(i) Manage existing exposures on their books especially in the asset classes identified above that are considered to be the highest risk. In particular, the focus is on the impact of potential shortfalls of income in the next 6 months and to have discussions with borrowers and discuss potential waivers, where necessary.

(ii) Manage exposures that have been funded, but, were required to be distributed through the loan syndication market or the capital markets via CMBS. Neither of these markets are now providing any meaningful liquidity although we hear of some syndications being partially executed.

(iii) Manage ongoing commitments to lend e.g. further drawdowns on development facilities.

(iv) For debt funds investing on an international basis, manage FX risk as the cross-currency rates have been far more volatile than expected.

Investment banks required to distribute the vast majority of their debt exposures through syndication or the capital markets will be hampered by the very limited liquidity in these markets unless they have enhanced capacity to hold loans on their balance sheet.

Certain **debt funds and listed vehicles who have used "repo" funding** which are subject to mark-to-market provisions or are dependent on funding through commercial paper conduits or the securitisation markets face additional challenges as has been seen by the Mortgage REITS in the US.

Bridge lenders are likely to see a sharp increase in defaults due to the failure of borrowers to repay loans on maturity in the next few months and although in practice these loans may be extended any external funders may place restrictions on new loans until the crisis has passed.

Debt funds that do not have a discretionary mandate or are backed by 1 or 2 large influential investors have been some of the quickest to withdraw from the market.

There are also key logistical issues with restrictions on movement and the vast majority of the market will be working from home for the foreseeable future. Valuations, other types of due diligence, searches, notarisations etc are difficult to get done. The "material uncertainty" qualification now incorporated into valuation reports by most valuers is creating delays for some lenders and is proving to be insurmountable for others. On development transactions, there are issues getting materials to site and the availability of contractors. For traditional lenders with more structured and involved credit committee processes, there have been delays in committee meetings actually occurring due to logistical and technological issues. These are predominantly short-term issues.

Notwithstanding the above there are transactions still being executed which are expected to complete. We have also seen more opportunistic lenders step-in and replace lenders who have withdrawn from transactions.

There is a **flight to quality**. Lenders will prioritise their core relationships, domestic markets and asset classes and submarkets they view to be the most stable. Loans will be structured more conservatively, and financial covenants will be scrutinised more heavily.

Lenders may seek among other things to decrease leverage (in anticipation of values potentially falling), increase margins based on their perceptions of the level of increased risk, build in additional cash reserves as buffers and undertake valuations more frequently in the near term.

The flight to quality is very apparent in the **corporate sector** where we are seeing **record levels of debt issuance for "investment grade" corporates** with over €70bn of issuance in Europe in a single day as they bolster their cash reserves - although this sector does benefit from the ECB's pandemic emergency purchase programme. In the real estate space, Bloomberg reports that Vonovia, the German multi-family operator, appears to have successfully issued €1bn of corporate debt yesterday which was 3 times oversubscribed. By way of comparison, there has not been a single European HYB issuance since the current crisis started but we may not be too far off as the US market re-opened last week with its first issuance.

In terms of **real estate loan pricing** the limited number of transactions and the lack of transparency in the private debt markets means it is difficult to assess the extent by which pricing has shifted. This will become clearer in the next few months. In the European CMBS markets AAA spreads have risen from circa 100bps to circa 250bps but the capital markets have always been more volatile than private debt markets and AAA spreads remain significantly lower than in the depths of the global financial crisis or the sovereign debt crisis a few years later.

This current economic shock like others will pass. Our lending institutions are far better capitalised and are not burdened by large legacy NPL portfolios as they did in the GFC. Low interest rates and government support will also assist to manage the extent of the crisis. We expect most lenders and borrowers will collaborate and agree waivers for covenant defaults and payment defaults for 1-2 quarters although certain insurers may be more restricted in their flexibility to do so. **However, "we are all in this together" until we aren't:** if the current issues go beyond 6 months (or 2 interest payment dates) then the outcome, unfortunately, is much harder to predict.

For **lenders**, there will be new underwriting measures and stress testing introduced to certain asset classes to ensure debt service in the future can withstand similar events but, on the whole, our current view is that the market as a whole will continue unscathed. For borrowers, it is important that any adjustments introduced into loans currently being executed to reflect recent circumstances are not retained for the entire loan term and can potentially be reversed when the market outlook improves.

This is the first in a series of posts. Potential future posts we intend to look at include "**Real estate debt restructuring techniques**" and "**Opportunities in dislocated real estate credit markets**" but we would value your opinions so please do let us know.

Please stay well, keep safe and feel free to reach out to me or any of the Brookland team for a chat at any time.

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