**New options?**
**CRE loan refinancing opportunities scrutinised**

Recent restructurings of a number of CRE loans (SCI passim) alongside the launch of the first post-crisis CMBS would suggest that the European refinancing environment is improving – at least where prime assets are concerned. However, market participants warn that while there is increasing optimism for the future, the ability to find new debt capital for refinancing in today's market remains tough.

The launch of DECO 2011-CSPK last month has boosted hopes that CMBS may once again become a viable refinancing option. The transaction, sized at £302m and backed by a single loan on Chiswick Park in West London, is deemed to be the first true CMBS to be launched in the European market since 2007 (see separate deal profile).

"The new Deco deal was important for the market for people to believe that CMBS can work again. It will be interesting to see if the market agrees," says Stewart Hotston, director at Hatfield Philips. "It may transpire that it is easier to find banks that can provide the financing directly, such as in the case of Project Isobel at RBS."

Nassar Hussain, managing partner at Brookland Partners, explains that investment banks tend not to hold loans on their balance sheets for long, so will only make new loans if they feel comfortable that a viable distribution market exists. "That's through loan syndication or CMBS and, for investment banks, the most profitable exit route is through CMBS," he says.

He adds: "There are two or three more CMBS planned before the end of this year, but it won't really be until next year that you start to see a market re-emerging more properly. At that point, investment banks will be more comfortable originating loans that they can then securitise."

Darren Davey, md of Solutus Advisors, argues that CMBS, in principle, has always remained viable and will certainly ease – though certainly not carry the burden – of the real estate funding gap. "It's all about balance: so long as the pricing is attractive for all involved, demand will drive the re-emergence of CMBS," he says.

Any loan that has proved problematic in the past will be unlikely to be refinanced in the CMBS market, however. "It's going to take a lot of convincing to get investors to look at anything where we know there are already problems," says Hotston. "I could envisage refinancing where certain loans are refinanced and make up part of the pool in a new CMBS, but I don't see CMBS being used as a refinancing tool in its own right."

It is estimated that around half of the loans coming up to maturity are currently being refinanced, with the majority of those being low-risk and conservatively-underwritten loans. In many cases, borrowers are – where possible – giving up a large amount of equity in order to facilitate the refinancing.

Loan extensions are also popular, while other options include obtaining loans from a traditional balance sheet lender or – when required leverage surpasses 65% - from a

mezzanine loan fund. The size of the loan required, the quality and location of loan are all limiting factors, however.

"Location is critical for refinancing. If your property is in central London, you are going to get a more serious hearing than if you are elsewhere," says Hotston. "That applies across Europe: for example, nobody wants to refinance multifamily housing in the East of Germany and the same applies in the south of France or central Spain."

At the same time, Hussein notes that some institutions are having difficulty buying prime real estate assets and are therefore moving into the 'good' secondary sector. "Banks are also struggling to deploy as much capital as they were hoping to – in order to increase their business flows, they may have to become more competitive on financing terms and perhaps be prepared to increase their risk profile a little," he says.

Loan size is also critical. While a €50m-€100m loan is deemed manageable for lenders at present, anything larger presents more of a challenge.

"Even if you can find someone willing to take it on, you then have the challenge of putting multiple lenders together to refinance a loan rather than the single lender, single loan scenario," says Hotston.

A recent example of this is the GSW loan – a €1bn multifamily portfolio – that was refinanced by five different lenders. "None of them wanted to – or could – take on the whole amount alone," explains Hotston. "That changes the dynamics. Those needing to refinance small loans are generally OK, but for the big loans there are a handful of lenders that could consider it but as it stands, it's very difficult to refinance the big loans as they are."

While many balance sheet lenders face the overhang of legacy issues, they also have to contend with Basel 2 and 3 requirements that will push up the cost of riskier lending. Firms such as Pramerica, Duet, LongBow, Lasalle, M&G and Axa have – or are understood to be in the process of – establishing commercial real estate mezzanine platforms to offer financing no longer available from traditional balance sheet lenders.

"Mezzanine finance has, and will continue to, play an important role in filling the funding gap between CMBS and equity, as seen with the loan provided by GIC in the Deco deal and the ever-increasing list of mezz providers in the market," says Davey.

Hotston suggests, however, that the new mezzanine funds appearing in this space will not have a huge amount of influence in refinancings. "For any public deal, there's not a lot that can be done due to the documentation prohibiting unilateral deals with someone that essentially walks in off the street," he says. "You have to run a process to show that you've recovered the greatest amount that could be recovered. A lot of these funds feel they have an angle, but that quite often results in a loss for the borrower and that is a hard sell for a servicer, even if it results in an exit from the loan."

He adds: "In some cases, it might be easier for the big balance sheet lenders to keep the loans on their balance sheet because the cost of the funds is lower than the cost of a loss. Right now, nobody is incentivised to give these mezz funds access."

Insurance and life insurance companies are also looking to step into the space vacated by senior lenders. A number of teams have been set up for this purpose; for example, at Prudential M&G and Aviva. While these firms haven't been as quick off the mark as first anticipated, they are expected to make up a much larger proportion of the market in the coming years.

"On a relative return basis, senior real estate loans offer far stronger returns from a risk/reward basis, especially when compared with corporate loans/bonds. Also, due to Solvency II, the capital requirements for holding hard real estate will increase – thereby incentivising them to get exposure to real estate through debt," explains Hussain.

Opinion is divided on loan extensions in the current market environment. According to Hotston, borrowers often see extending their loans as a route to cheaper funding than a full refinancing.

"Our argument [is] that that is not necessarily the case now," he says. "Where loans are performing adequately, we frequently take the view that it's about the will of borrowers to go and find the refinancing and make the necessary sacrifices."

A significant number of loan extensions are nonetheless going ahead, although – depending on the nature of the underlying assets – banks and servicers are also looking at enforcement, particularly for prime offices in London. For example, the Aviva Tower, Leadenhall Triangle and St Katherine Dock properties were all sold at a price higher than their valuation – thereby encouraging other lenders and servicers to look at this option.

"Loan extensions shouldn't be dismissed completely – and the blanket 'extend-and-pretend' label is not always justified," concludes Davey. "While the requirements on the borrower – debt pay-down, increased amortisation, tighter controls, viable exit metrics – often prove unachievable, there are certain instances where such a route clearly provides the best route to maximum recoveries."