December 2014

Real estate finance – identifying common pitfalls and solutions

As the real estate finance market has returned to strength over the last two years, the London property market has boomed and spreads have continued to tighten, it is easy to lose sight of the protections needed should things go wrong. Here, Clifford Chance experts provide an overview of the current market, examine whether some of the important lessons of downturn risk have been forgotten, and provide reminders on best practice structuring and documentation points.

With the benefit of hindsight, it is now clear that 2013 was a transformational year for the real estate finance industry. Real estate lending really came back, and the taps were turned on in terms of new lending, both in the UK and across Europe.

In many ways the pace of the recovery has been quite surprising, driven by a steady influx of lenders, only some of whom were previously active. A recent study from Cushman & Wakefield puts the global flow of real estate capital in the year up to the end of Q2 2014 at US$788bn, up 17.2% on the previous year, and highlights New York as the world's largest real estate investment market, closely followed by London. London closed the gap on the Big Apple last year, with a 40.5% increase in investment activity, and is now the largest global market for cross-border investors, according to the research.

Investment is also increasing in the UK regions and many European jurisdictions that have been off the agenda for some time. The other key trend is for new types of lenders. In the UK market the banks and building societies continue to dominate, but are increasingly joined by the German banks and other international banks, including those from North America. There is also growing activity by insurance companies and other non-bank lenders, such as debt funds.

Emma Matebalavu, a partner in the Clifford Chance real estate finance group, says: "We are seeing a lot of debt funds active in the mezzanine space and pushing into senior debt. Some of the mezzanine funds are finding opportunities and bringing senior lenders into those, which is a reversal of how things used to work. The dynamics between the mezzanine and the senior lenders have often changed in terms of relationships with the borrowers."

Impact on loan terms

With these market shifts have come the inevitable impact on senior loan terms.

There are signs of an increase in leverage, although there remain a number of conservative borrower groups. The REITs and private property companies tend not to borrow above 55% loan-to-value, even if debt becomes more available, for example, while other borrowers are embracing leverage and doing deals at 80% LTV.

There has been a tightening in interest rate margins across sectors and geographies, again with some significant variations, and lenders are seeing some decline in average arrangement fees and in interest coverage ratios.

"Often if there is a strong sponsor with a good property, they have the pick of lenders."

Emma Matebalavu, Partner, London

The result is that more capital is now available outside the core markets, in European jurisdictions such as Spain, Italy and the Netherlands. There is demand for distressed debt portfolios and lending opportunities to finance portfolio acquisitions, and a gradual return of the CMBS market.

When it comes to structuring, key sponsors and borrowers are in a pretty good position on negotiations: "Often if there is a strong sponsor with a good property, they have the pick of lenders," says Emma. "Lenders compete for mandates, which means that borrowers can flex their muscles at the term sheet phase, both in terms of covenants and pricing, but also in terms of delivery and speed of execution." Aggressive timetables can cause some lenders to miss out, sometimes favouring the nimble mezzanine funds who will subsequently arrange syndicates of senior lenders.

Perhaps the most important lesson post-crisis is that no one size fits all. While borrowers may be keen to refer back to terms accepted on other deals with other lenders, the market has moved significantly in the last two years. Emma says: "We are seeing massive variation in terms of LTV, tenant quality, property quality and so on. It is important not to rely on what the borrower says has worked for other lenders in previous deals."

Best practice structuring

Control rights

When analysing today's real estate finance market, structuring challenges remain which should not be overlooked. One key aspect of this is control and the dynamics existing between creditors.

For deals involving senior and mezzanine financing, over the last year or so (partly driven by increased competition) there has been some movement away from the more typical structural subordination of the mezzanine debt back to the A/B intercreditor structures common prior to 2007/2008. Under an A/B structure, the A and B lenders lend under the same loan agreement, share in the same security package and the loan is bifurcated between the creditors behind the scenes (without the knowledge of the borrower). The rights of the mezzanine lenders in those A/B intercreditor agreements need to be carefully drafted (with due consideration given to the potentially different rights of those lenders under the loan agreement), otherwise the ability of the mezzanine lenders to frustrate a restructuring or enforcement may be significantly increased.

Valuation tests in intercreditor agreements have also started to re-emerge. For example, mezzanine lenders may be able to block amendments to the property covenants where the value breaks in the mezzanine loan. Where these tests are included, senior lenders should consider whether they fully control the valuation process and when, how often and how quickly they can call for a valuation.

The final interested party in terms of control is the hedging counterparty, although the extent of that control depends on the type of hedging arrangement.

If a cap is entered into or the hedging is taken out at the lender level, the hedging counterparty is not a party to the facility agreement and so has no ability to influence an enforcement or restructuring.

With borrower level swaps, the hedging counterparty now typically has the ability to terminate the hedge in certain circumstances even where the lenders have not accelerated or enforced the loan. Claire Fawcett, senior associate in the real estate finance practice, says: "Previously we have seen the hedging counterparties as silent participants in swaps, with no voting rights and limited say in enforcement and workout scenarios. Over the last year there has been a growing resistance on the part of hedging desks to allow that."

A further challenge arises around the control rights of sponsors and borrowers themselves, who are getting tougher in negotiating the terms of the loans, for example, making demands for greater consultation rights and longer (or more frequent) grace periods. There are also moves towards relaxation of change of control provisions, with sponsors arguing that change of control to affiliates should be permitted. Lenders need to be mindful of know-your-client rules when considering these requests (and the importance of their relationship with the sponsor to the deal).

Affiliates of the borrower or sponsor may also have multiple roles on transactions, giving rise to further issues of control. For example, an affiliate might also be the property manager or asset manager. The ability of a lender to enforce a share charge may have limited value in practice, if that lender does not have a corresponding right to kick out an affiliated manager which has no incentive to manage a property at a time when value may be eroding.

On a similar note, it is important to remember that security over intercompany loans is essential. It may prove impossible to enforce any share security taken over

"Remember that taking security over real estate in England is very different from taking security over real estate in Spain or Italy, for example."

Claire Fawcett, Senior Associate, London

© Clifford Chance, December 2014

the borrower and sell those shares without having the corresponding right to enforce (or otherwise deal with) the subordinate debt advanced to that borrower.

Security limitations
There has been some pressure from borrowers to move away from the typical real estate financing structures, whether for legal, regulatory or cost reasons. In addition, in certain jurisdictions the security available may be more limited than in England. For example, the amount recoverable under the mortgage may be a capped figure in certain jurisdictions. Other jurisdictions may have limitations on the effectiveness of cross-stream guarantees meaning that even where one borrower has surplus rental income, another borrower in the same structure may be insolvent.

With renewed interest in investment throughout Europe, Claire says: "Remember that taking security over real estate in England is very different from taking security over real estate in Spain or Italy, for example."

Lenders should be asking questions about things like insolvency regimes, priority periods, how long it takes and how much it costs to enforce security.

Tax pitfalls

Following the financial crisis, a swathe of real estate restructurings highlighted the significance of tax in these transactions. Dan Neidle is a tax partner at Clifford Chance. He says: "In a lot of these restructurings, tax was a major impediment to lenders doing what they thought they could do. In some cases it worked out, but in others lenders couldn't do what they had hoped, or it was a lot more expensive."

> "In a lot of these restructurings, tax was a major impediment to lenders doing what they thought they could do."
>
> Dan Neidle, Partner, London

He points to four tax pitfalls that lenders should be mindful of. The first is what to do about debt that will not go away, if you do not have enforcement over it and cannot get rid of it. In the UK a lender can enforce over the underlying real estate, but not without incurring a stamp duty charge. Structural subordination eliminates the problem, and a simple exercise of share security can take out the mezzanine debt.

Another common pitfall is degrouping charges, where the borrower moves a property into a different company within a group and does not pay stamp duty, only for that duty to be clawed back if the lender tries to enforce at any point in the next three years. The solution is to keep the old propco within the security net, under new propco, thereby keeping the companies together so that in an enforcement event there is no breaking of the group.

Debt pushdowns raise further issues around degrouping charges, where it is sometimes convenient to novate debt around a group. UK loan relationship rules mean novated debt can be subject to a deemed market value release upon a subsequent enforcement.

Another common problem is where a business has a difficult tax history, with assets perhaps over time having moved intragroup, been subject to securitisations, takeovers, and so on. Dan says: "The only way to be sure what will happen if you exercise security in this instance is to know at the point of lending into the group. As a lender you need to make sure the structure diagram from the borrower covers the consequences of enforcement."

Finally, there are the challenges presented by real estate partnerships, which are still quite common in legacy structures. An issue arises if the real estate falls in value, the lender enforces, and the buyer acquires the partnership interest. Stamp duty is payable on the value of the real estate, rather than on the value of the equity interest of the partnership. The lesson for lenders then is to make sure they have security over the partners in the partnership.

Dan concludes: "The bottom line is that borrowers should be telling lenders what the consequences for enforcement are, and if they are changing things in the structure in a way that benefits their tax position, it is only reasonable that lenders should know how that is going to affect them if they end up in an enforcement scenario."

© Clifford Chance, December 2014

Read our other publications…

CMBS and Real Estate Finance – responding to new investor demand (February 2014)

Please visit our website for further insights:
http://www.cliffordchance.com/expertise/practice_area/finance/real_estate_finance.html

Clifford Chance Contacts:

To discuss any of the issues in this publication, please contact one of our market experts below:

Emma Matebalavu
Partner, London
T: +44 20 7006 4828
E: emma.matebalavu@
cliffordchance.com

Dan Neidle
Partner, London
T: +44 20 7006 8811
E: dan.neidle@
cliffordchance.com

Claire Fawcett
Senior Associate, London
T: +44 20 7006 8737
E: claire.fawcett@
cliffordchance.com

© Clifford Chance, December 2014

Clifford Chance LLP is a limited liability partnership registered in England and Wales under number OC323571.

Registered office: 10 Upper Bank Street, London, E14 5JJ.

We use the word 'partner' to refer to a member of Clifford Chance LLP, or an employee or consultant with equivalent standing and qualifications.

This publication does not necessarily deal with every important topic nor cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

If you do not wish to receive further information from Clifford Chance about events or legal developments which we believe may be of interest to you, please either send an email to nomorecontact@cliffordchance.com or contact our database administrator by post at Clifford Chance LLP, 10 Upper Bank Street, Canary Wharf, London E14 5JJ.