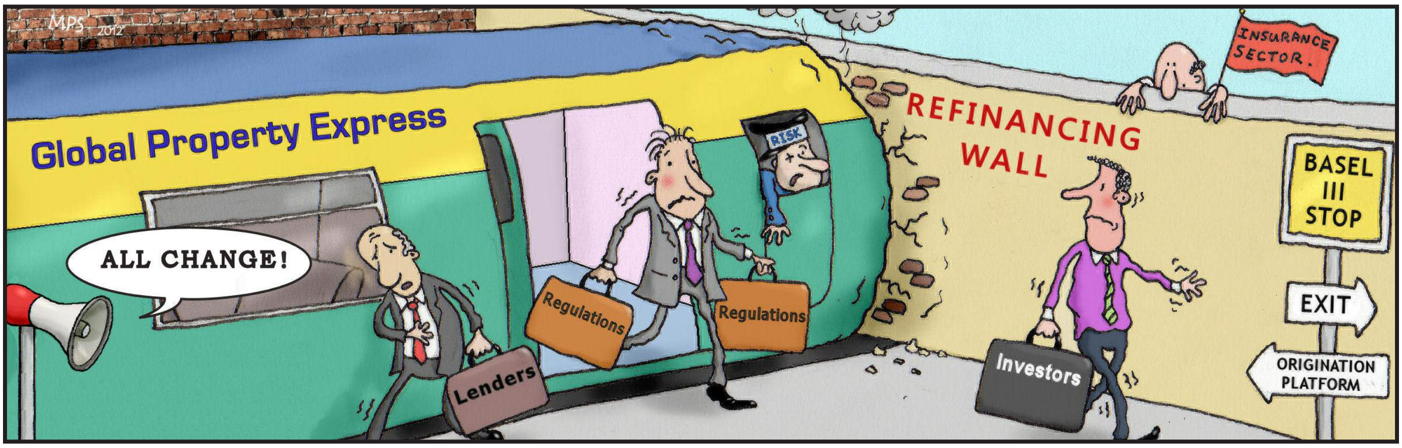

Real estate – all change?

Market and regulatory factors are driving significant change in the real estate sector. What lessons can we learn? And what can we expect in the future? In our first Real Estate webinar, Clifford Chance specialists examine the latest developments and consider what lies ahead.

Before looking at current market trends it is worth noting that these continue to take place within a landscape shaped by the global financial crisis. As the banking crisis hit, real estate lending became severely constrained, which in turn led to a strong reduction in transactions. This lack of depth in the market created pricing uncertainty, further undermining transaction volume.

The story since has, in many ways, been about dealing with these new realities, a process complicated by the other great consequence of the global financial crisis: a sea of regulation that is only now finally reaching the shore.

Current market trends

The first trend could be described as geographical, with evidence of lenders and investors either retrenching to their domestic markets, or limiting their interest to those countries with the most stable economic conditions.

This careful selection process can also be seen in the assets that investors are choosing. These are increasingly concentrated on "super core", where tenant covenants are strong in prime locations with long term leases.

With capital appreciation severely constrained by current market conditions, there has been a greater focus on creating and preserving value in existing assets. In response, some real estate companies have been able to add value by utilising their asset management experience on behalf of clients.

The main driver could, however, be summed up in one word: risk. Performance is no longer key. Instead, strategies that reduce risk, whether by market or tenant selection, or through transaction terms that give comfort to the investor or lender, are likely to win the day.

Lenders – new and old

There is a sense of 'the changing of the guard' as some banks, busy rebuilding their balance sheets and allocating capital in accordance with Basel III, take a step back from real estate loan origination. What will take their place is still evolving, but it is likely to include sovereign wealth funds, pension funds and insurance companies; the latter being encouraged by regulatory changes proposed in Solvency II (of which more later). It is important to remember, however, that banks and other market participants like NAMA will remain critical to the real estate market through their existing loan portfolios, although these may be wound down when the opportunity presents itself.

If loan origination is constrained, development debt is particularly scarce. Instead, many of the larger developments are being pre-funded by strong equity with a view to limited debt finance being put in place once good pre-lets are in position.

With regulators in some EU jurisdictions encouraging banks to scale back their non-domestic exposure, the trend towards domestic retrenchment may deepen.

Impact on transactions

In general, patchy, uncertain markets are leading to an increased focus on due diligence, contractual protection and greater use of insurance products.

Caution is key. Lenders are less willing to accept the risks associated with complex deal structuring and, because syndicating and securitising debt can be challenging in current market conditions, they will need to see a clear exit strategy. The ability to use commercial mortgage-backed securities (CMBS) is also being impacted by developments in the EU Capital Requirements Directive that create new disincentives to elements of securitisation.

Market conditions are also driving the increased use of strategic alliances, which aim to bring together multiple investors to share risk, and to marry passive cash with active managers.

Transaction terms

Where shallow markets are creating wide buyer/seller valuation gaps, deferred consideration and vendor financing are among the options being deployed. Similarly, JV transaction terms are changing to reflect market concerns. For example, investment policies are becoming more prescriptive and there is evidence of greater control by participants over the identity of fellow JV investors. Other factors Clifford Chance is encountering include requirements for greater liquidity and information rights, closer alignment between management and investor, and tighter termination rights.

An increased focus on counterparty risk, means that some borrowers are wanting more 'relationship' banking and are demanding concepts such as 'defaulting lender' provision in documents. Inter-creditor terms have also become a lot tougher for mezzanine lenders. Structural subordination of mezzanine debt is becoming commonplace, with Clifford Chance seeing several big deals in the London market done on these terms in the last year. More generally, there is a stricter approach by lenders to underwriting risk and a desire for good quality documentation.

Navigating the regulatory and economic 'sea of change' ahead

As touched upon earlier, the increased capital requirements set out in Basel III will almost certainly lead to a reduced supply of new credit from banks, as well as disposal of some existing portfolios. While this looks to be a negative, Solvency II looks more promising. Once finalised, its capital treatment of real estate and senior real estate debt may encourage insurance companies to invest in the asset class. But any hope that the insurance sector will simply step into the bank lenders' shoes is likely to be wishful thinking. Even when the regulatory framework is finalised, insurers will need to develop an origination platform or team up with existing origination platforms before they could be seen as a meaningful force. We are already starting to see a number of players in the market raising real estate debt funds targeting insurance companies, pension funds and sovereign wealth funds as investors.

On the plus side, any gap between the capital treatment of banks' and insurers' real estate lending could lead to arbitrage opportunities, with bank-assurance groups moving and arranging assets within the group to achieve capital efficiency.

The Alternative Investment Fund Managers Directive (AIFMD) will present real estate fund managers with significant challenges. It imposes administrative burdens (disclosure to investors), higher costs (depositary appointment) and added restrictions (for example, limits on what a manager can do). Its significant extra-territorial effect means that its impact will be felt beyond the EU.

New regulations on OTC derivatives, both in Europe and the US, look set to add costs to real estate deals too. Under new clearing arrangements, collateral provisions are likely to rise, making hedging more expensive to end users such as the real estate funds or borrowers.

While regulatory change is, in most cases, leading to uncertainty and higher costs, it is important to remember that it will also create opportunities. Just as traditional models and participants are put under increasing pressure, new strategies, alliances and players will emerge to take advantage of changing conditions.

The refinancing wall and the macroeconomic picture

This 'all change' mentality is likely to be further fuelled by the refinancing wall. There remains a significant amount of real estate debt that is due to mature in the short term. While extensions have generally been allowed, tail periods are coming to an end with no clarity on refinancing routes. As a result, more product may be released onto the market by both banks and investors.

The macro-economic picture may also be a key driver, with the state of the eurozone a major concern to market participants. Banking sector weakness, falling business confidence and the spectre of sovereign default will all impact the real estate market. More specifically, if the German open-ended funds are required to offload huge portfolios of assets it could have a significant effect on the real estate market in much of Europe. On the plus side, government action to support the real estate market, particularly in the light of a growing call in Europe for a 'plan B' growth agenda, may also be a feature in 2012/13.

Outlook

With many of the smaller, over-leveraged players out of the game, the market will belong to those who focus on good assets, have strong lender relationships and tested asset management skills. While a broader range of financing will emerge, banks' expertise in areas such as credit risk and structuring will ensure they have an enduring role. With securitisation off the menu, the focus will instead be on the long term and alternative ways for investors to access liquidity. But the overriding message seems to be one of caution and risk aversion as participants look to build deals that are strong enough to withstand regulatory and market change.

Clifford Chance contacts

Clifford Chance's international Real Estate Sector acts for the industry's leading players advising on the full range of real estate-related transactions and is a leading specialist in real estate investment banking and private equity transactions. With local and cross-border expertise it focuses on high-end businesses, notably corporate real estate, real estate finance, real estate M&A, large-scale development and regeneration, construction, hotels and high-value leasing, environment, planning and litigation. Clifford Chance is strongly positioned to support your real estate ambitions. If you would like to discuss any of the issues discussed, please contact our webinar panel.

Alfonso Benavides
Global Head of Real Estate Practice
Real Estate partner
T: +34 91590 7519
E: alfonso.benavides@cliffordchance.com

Simon Crown
Regulatory partner
T: +44 207006 2944
E: simon.crown@cliffordchance.com

Jane Cheong Tung Sing
Real Estate Finance partner
T: +44 207006 4371
E: jane.cheongtungsing@cliffordchance.com

Adrian Levy
Global Head of Real Estate Sector
Corporate partner
T: +44 207006 1536
E: adrian.levy@cliffordchance.com

Click here to view the webinar