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In The Know

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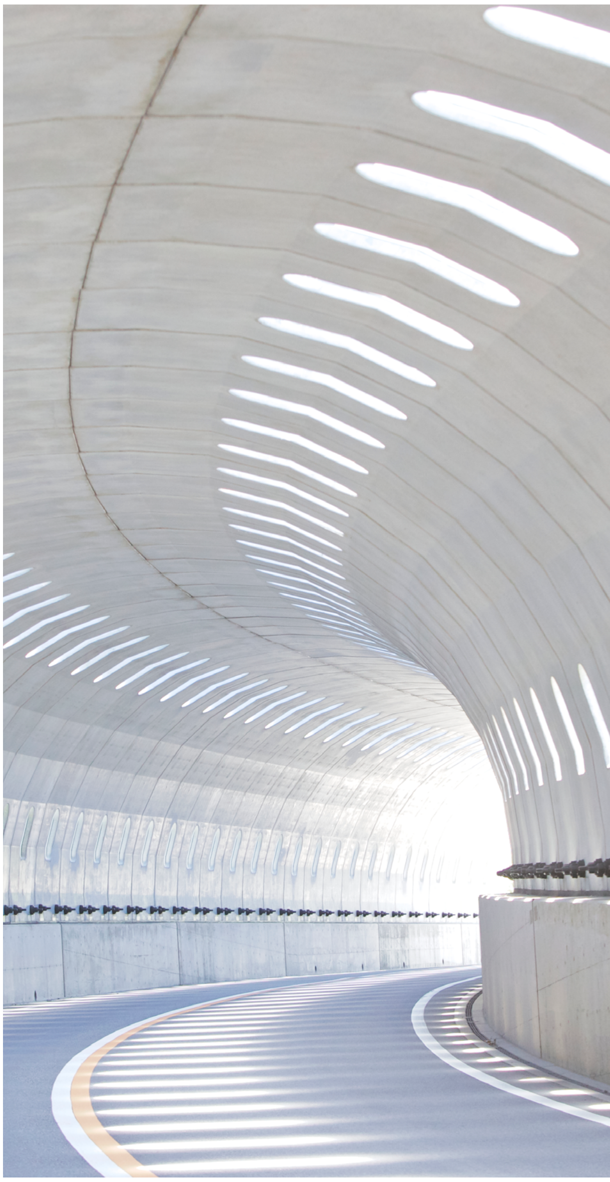
Spotlight on real estate - the hedge against inflation? Financing considerations in the real estate market



History would tell us that real estate investments are a good hedge against high inflationary environments as hard assets tend to appreciate during periods of high inflation, with the real-estate sector in particular traditionally providing increased rental growth and the ability to pass on increased input costs through rents.

While we have seen a consistent expansion in the real-estate sector since the bottom of the financial crisis and very accommodating capital markets environment with a prolonged period of very low interest rates, investors are once again looking at this asset class in the context of the current high inflationary environment which is new reality to a generation of investors. However, like all lessons from history, applying them to the present is notoriously difficult. The present market is incredibly complex and volatile as economies and the real-estate sector are still emerging from the pandemic and facing headwinds of tightening financial conditions which typically don't bode well for real-estate valuations.

Notwithstanding this complexity, there seems to be a general consensus among commentators that real-estate assets should form an increasing part of a balanced investment portfolio in high inflationary market albeit that investors will need to be selective with their investments in the real-estate sector as the ability to pass on inflationary costs and withstand the risk of a recession does not apply equally to all real-estate assets. Given this spotlight on real estate, in this Edition of 'In the Know' we look at how real-estate assets are financed in the bond market, in particular, we delve into certain key structuring and execution challenges and considerations in high yield bond transactions.

In particular, we propose to explore the following:

- What credit support, including a security package, can be offered up?
- What type of debt financing is most appropriate for the corporate group? A New York law high yield bond or English law governed covenanted Eurobond?
- What covenant flexibility is required in terms of (i) running the business (cash flow versus asset lending), (ii) further debt incurrence, and (iii) payments/value leakage outside of the restricted group?

These are some of the key questions and considerations that we have encountered in recent transactional work that we have undertaken, but they are not meant to be a full roadmap of all potential issues that may arise in the transactions in this industry. Each transaction and business will be unique and will have key considerations due to local law constraints, the corporate structure and the operational needs of the corporation/sponsor contemplating the financing and they should carefully be considered on a case-by-case basis.

Structure and Credit Support

Effective structuring of an international debt capital markets transaction in the real estate industry, including credit support and where the bonds sit within the corporate structure is critical in any transaction and may have a significant impact on the interest rate (or "pricing") that can be obtained. In the real estate industry, due to the nature of the business, the group will need to assess how best to optimize its capital structure for its business needs, utilizing a mix of international and/or local debt products available in each case, at either the asset level or corporate level. Broadly, this debt would fall into these categories:

	Asset-level debt	Corporate level debt
Local	Mortgages or development financing	Bank facilities
International	Asset-based financing	Capital markets debt

By virtue of their nature, international capital markets allow access to a broader pool of investors. For instance, whether the group decides to raise debt by way of a New York law governed high yield bond or an English law governed Eurobond, the amount of debt raised will generally be around or above EUR 300 million, especially for first time (or "debut") issuers.

Once the group has set out the optimal debt product mix in the capital structure, it can then turn to structuring the international bonds. The two main structures that we see in the real estate market are the bonds sitting at one of the following levels:

1. **The HoldCo level**: one of the companies higher up in the corporate structure that generally does not have any/many operations and will (due to its holding-company nature) be further away from the assets of the group; or
2. **The OpCo level**: one of the operating companies lower down in the corporate structure that will (due to its operational nature) be closer to the assets of the group.

The key consideration from the investors' perspective here is that recovery in the context of default or other distressed situations is usually more likely the closer the debt is to the underlying group assets.

In parallel to deciding where the debt will sit, the group must decide what security package will be offered (if the debt is to be secured) and what entities will guarantee the debt. Key considerations in putting together the security package are (i) the complexity, and in some jurisdictions, significant cost of real estate based security for local law reasons, (ii) asset-level intercreditor issues due to development financing and/or other asset-level financing, which, by its nature, would be first ranking and/or prohibit other security packages being put in place, and (iii) possibility of providing a "single point of enforcement"[1]. The guarantor package and what percentage of the group they represent in terms of the overall EBITDA and Assets of the group is also critical and may have significant pricing implications, and it will be heavily dependent on local law issues such as corporate benefit, thin capitalization, etc.

In practice and for best execution, due to the complexity of the issues emanating from asset-level security and local law constraints, security packages for capital markets debt are often limited to security over shares (usually a single point of enforcement), bank accounts and intragroup loans.

A key consideration with this form of security package is that the value in a real estate group/company is usually in the real estate asset at the operational level and bondholders would therefore only receive residual value after asset-level financing (such as mortgage debt and local facilities) is paid out first.

Therefore, as we will discuss below, the loan-to-value ratio of senior mortgage debt that ranks ahead of any bond financing but also additional pari passu debt ranking equally with the bond financing is of critical importance to investors.

High yield (New York law) or Eurobond (English law)

The structure of the transaction discussed above, is highly dependent on what type of debt the group decides to raise, and vice versa, the type of debt may be dictated by the structure of the transaction.

For sub-investment grade groups that wish to raise debt in the international capital markets, there are two main options: (i) New York law governed high yield bonds or (ii) English law governed Eurobonds. These products are tailored to industry considerations that provide issuers with flexibility to run their business and each has its own pros and cons. Key differences are the investor base (that may have a pricing impact) and the covenant package (usually incurrence versus maintenance based (although we have recently been observing a merging of the products)).

1 A "single point of enforcement" is a share pledge, which, upon enforcement, would allow the creditors to take ownership and control of the group below such point. Creditors favor this structure as this facilitates enforcement rather than requiring them to go to multiple jurisdictions or courts particularly for junior (or holdco) creditors as it gives them a seat at the table in a distressed situation.

Below is a high level summary of certain key terms of high yield bonds compared to Eurobonds in recent transactions observed in the real estate industry:

	High yield bond	Eurobond
Governing law	New York	English
Issuer	HoldCo or OpCo	Generally HoldCo
Security	Secured / Unsecured	Typically Unsecured
Covenants	Incurrence based	Maintenance based
Debt incurrence	Debt permissible based on fixed charge coverage ratio plus tailored baskets. May be secured based on leverage ratio or loan-to-value ("LTV") ratio and tailored baskets	Negative pledge, LTV, unencumbered assets ratio and/or interest coverage ratio
Restricted payments	CNI build-up plus tailored baskets	No restrictions

Although Eurobonds only include a few restrictions, the maintenance based covenants may have a significant impact on the operations of the business (or even cause a default) in the event of a downturn. On the other hand, high yield bonds generally include a full suite of restrictive, incurrence based, covenants and tailored exceptions to these in order to allow businesses to operate. Ultimately, the borrower group, with help from advisors, will need to carefully consider each option and the potential operational implications of each product on the business.

Key covenant considerations

One key particularity of the real estate industry is the distinction between businesses who (i) buy, develop and/or rent real estate (such as developers) or (ii) are real-estate heavy (such as hotels or infrastructure).

Often there is also a spectrum between cash flow and asset basis with some businesses, in which case the distinction is made on a case-by-case basis and some businesses will have a mix, in which case the covenant package will need to be specifically tailored to the group's needs. Management and investors alike will also run their credit analysis on a cash flow/EBITDA or asset/ LTV basis depending on where the business lands on this spectrum.

Specific carve-outs, especially in the context of incurrence based covenant packages, will then need to be carefully considered and tailored to the underlying business needs of the group. The key distinctions and considerations here generally revolve around (i) leverage versus LTV, (ii) securitization requirements, (iii) other recourse/non-recourse financing and (iv) joint-venture or other investment requirements.

Likewise, in the context of restrictions on payments made outside of the group (by way of dividends or investments), there is usually an overarching restriction that is then subject to certain specific carve-outs (or "baskets"). The suite of baskets and additional permitted investment capacity will depend heavily on the way the business is run and how projects are approached. Does the group regularly take on projects in joint-ventures or other investment structures for instance? Investors will be focused on these, as there is always a fine balance between not restricting ordinary course business of the group and avoiding significant value leakage outside of the group.

Conclusion

Real estate assets traditionally play a key role in balanced investment portfolios during high inflationary environments. While that still rings true, certain sectors of the real-estate market are emerging from the pandemic and the sector generally is facing significant headwinds in the form of tightening financial conditions not seen for a generation. Accordingly, we expect investors will be increasingly selective when assessing their real-estate investments focusing on sub-sectors that are best placed to pass on inflationary costs and deliver returns to their investors and shareholders in a rising rate environment.

As we touched on in this article, international debt capital markets transactions in the real estate industry involve industry-specific structuring and execution challenges and require careful consideration on a case-by-case basis. While this article focuses on the key questions encountered on international capital markets transactions, syndicated capital markets have themselves been adversely impacted by the current market volatility and consequently we have seen a notable proliferation in direct lending/private credit transactions in the real estate industry. However, the key structuring points discussed in this article are in most cases equally important to private credit transactions. For any debt product, effective structuring is more critical than ever and the appropriate structure, credit support and covenant package is key to providing a company the flexibility it needs to run its business and protect investors' capital in volatile markets.

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