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Financial distress: special situations opportunities and real estate debt

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Key Themes

The following key themes were discussed during a lively debate among the panellists at Baker McKenzie's seminar on **Financial distress: opportunities for corporate and real estate debt,** held at The Connaught hotel on 17 May.

Panellists included **Chris Holmes,** Partner at Deloitte Real Estate Debt and Capital Advisory and **Chris Zlatarev,** Managing Director at H.I.G. Capital, alongside **Sebastien Marcelin-Rice** and **Oliver Jefferies,** Partners in Baker McKenzie Real Estate Finance team.

Valuations and Rising Interest Rates

- As has been well-signalled in the commercial real estate market, valuing commercial real estate remains challenging, particularly for office buildings throughout the UK, Europe and the United States. An example was given of valuations of some offices in central London falling by 50%, although valuations have held up better in the West End than in the City. For the UK at least, the sense is that valuations in the retail sector have stabilised after suffering significant falls since the outbreak of COVID-19, but there have not been enough deals in this sector to identify or confirm a trend.
- Rising interest rates continue to present a challenge. The jury is out on whether we have hit peak interest rates in the UK or in the EU; there are some who take the (perhaps rosy) view that interest rates will start to fall later this year, but all seem to agree that we have seen an interest rate reset, and will not see rates returning to the rates witnessed over the last decade. Higher interest rates - or the necessity of addressing higher interest rates when refinancing existing debt - are creating challenges for debt service across the commercial real estate sector, although there are signs of rental growth in some sectors in the UK, partially mitigating the higher cost of debt.
- Drilling down on the current opportunities, the panellists indicated that rental yields are difficult to predict; office buildings, especially older buildings and B-grade or C-grade buildings which will require significant capex in order to meet ESG requirements, are in trouble but hospitality and hotel developments as well as other alternative asset classes still seem attractive for new originations.
- There is a lot of private capital "dry powder" in funds available to be lent against or used for equity (or quasi-equity) investment in UK and European commercial real estate, but uncertainty around valuations and high interest rates are, at the moment, limiting deal activity across the board.

More On Offices

- A combination of working from home, falling valuations and ever-increasing, but also evolving, requirements for environmental and energy credentials, has seen a large shift away from investing in office assets from both lenders and sponsors.
- These challenges will, though, bring opportunity, particularly where office buildings can be repurposed into other uses, for example by conversion into residential flats or mixed commercial/residential buildings. This activity has already started, including in the US, but is subject to the difficulties presented by buildings with larger floor plates which would require much more significant capital expenditure, and therefore will need to fall in value to a greater extent to be commercially viable.
- Repurposing an office building will require potentially significant capital expenditure. This is reflected in an increasing divergence between those offices which are seen as 'prime', with relatively little capex investment needed for conversion, and those seen as 'secondary', such as older buildings which need to be upgraded, anyway, to fulfil ESG requirements, and buildings whose footplates are less accommodating to residential use.
- There are, therefore, a number of options for investment in office buildings, depending on the age, size and location of the buildings, likely rental yields if used as offices, likely capex requirements if not already ESG-compliant, and the likely cost of conversion, if that route is chosen. The analysis of each opportunity will be more complex than pre-COVID, as there are many more factors to be considered.

Deal Terms Are Changing

- Generally across the UK and Europe, CRE financing transactions seem to be taking longer to progress from term sheet stage to closing, with more effort spent on structuring and early diligence phases. In addition, lenders are frequently devoting more time to considering their enforcement and exit options (especially in less creditor-friendly jurisdictions) at the origination stage and requiring additional structuring at the outset; previously, although transactions were structured with the necessity of enforcement in mind, close consideration of enforcement options typically occurred only if lenders or sponsors were concerned that a loan may become delinquent.
- Lenders are generally focusing on lower LTVs as well as on cash-flow and cash management in deal structures. There will be far fewer "covenant-lite" deals and these will remain the preserve of the very strongest institutional sponsors only.
- Banks and other lenders subject to regulatory capital requirements are becoming more cautious in response to, among other factors, the impending changes to the Capital Requirements Regulation in the UK and the EU and concerns around provisioning requirements should CRE loans become delinquent or default. There may be opportunities for others to acquire or finance distressed CRE exposures currently held in covered bond pools and selectively withdrawn by the covered bond banks as their performance deteriorates, although the panel thought that it was unlikely, at this point, that pools of NPLs would be created for divestment, activity being more likely to be on a single name basis for the time being. German banks holding CRE assets in pfandbriefe pools are an example of banks which may start to release individual assets.
- Alternative lenders are seeing unprecedented opportunities to lend as traditional banks stay on a cautious footing and funding gaps arise where borrowers/sponsors are unable to extend or inject new capital themselves. More innovative solutions to overcome debt service issues and/or interest rate hedging costs are being seen.
- Debt structures are becoming more complex, and there is an increase in senior/mezzanine deals, holdco financing, A-note and B-note tranching and loan-on-loan structures, as well as preferred equity financings. Equity kicker-type features allowing lenders to share in the upside as well as strong minimum returns and/or exit fees are becoming more common.

Opportunities for Equity Investors

- The panellists are seeing a fair bit of 'amend and extend' activity across the UK and Europe, with lenders and borrowers buying a bit more time to wait and see what appears on the horizon. Where possible, traditional lenders are certainly more likely to focus on this type of solution in the first instance given the difficulties and risks of enforcing in an uncertain valuation environment.
- The panellists noted that debt funds are bringing in what is essentially equity into the top end of structures to act as a bridge/a form of holdco financing to enable borrowers/sponsors to tide over for activities like working capital and capex improvements work until the wider traditional lending market opens up. Equity investors are, subject to structuring considerations, increasingly structuring some of the required additional capital as secured debt, to provide additional downside protection.
- Assets requiring significant capex or time to facilitate a repurposing are expected to come to market at a discount. Lenders are also more prepared to finance assets with good credit fundamentals but where the asset is not yet stabilised.

Distress

- Many banks engaged in large portfolio sales of their loan assets, including CRE loans, during and after the global financial crisis a decade or so ago. At the moment, the panellists identified a greater interest in the existing lenders working out CRE loan assets, and engaging in loan-on-loan financing arrangements. Where some of the more traditional bank lenders may not have the appetite or ability to engage in work-outs, for the reasons stated above, real opportunities may arise for funds who are looking for distressed opportunities to acquire debt or equity positions in consensual work-out situations. Strong relationships with sponsors where parties can come together to work out creative solutions will be key.

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