Property finance : what the coming year ?

The transactional real estate sector slowly recovers from the credit crisis. Banks are lending again: this is a fact, but they do so on fairly restrictive terms. They force borrowers to be more rigorous when they prepare a transaction and require more securities for their loans.

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It's true, banks are lending again to the real estate sector. Everybody is saying it. So things have changed since last year. At the time, everybody was complaining about the absence of credit and the impossibility which resulted for many leveraged investors to make any real estate deal. Equity buyers were the kings of the market because they had sufficient own resources and did not need external financing to carry out their acquisitions. They were essentially the German funds, the SICAFIs and other institutional investors.

Quality and transparency have become essential criteria

So the situation is different today. However, we can certainly not claim that we have returned to the practices that developed in the market before the crisis, and it is certainly so much better ! On the basis of a survey carried out inside the CMS network, we note that about everywhere in Europe, the points of view strongly converge on the current evolution of the market. While caricaturing a little, we can say that banks agree to only look at those files that bear on high-quality buildings (in particular environmental), located in prime places and occupied by first-class tenants (public institutions, etc) under the long-term lease agreements. Obviously, these transactions are not numerous…

Beyond this stampede toward quality – that doesn't surprise us because a number of investors have the exact same approach today –, other features of the approach of the "banks that are lending again" are worth noting. First of all, they look with mistrust complicated structures and see an additional risk there. A good file today is a file assembled on the basis of a structure as simple and easy to apprehend as possible. We can however wonder whether the possible complexity of the corporate structure set up by the borrower to carry out his investment is relevant for the assessment of the lender. Above all, one would indeed assume that the important element for the lender is to adequately control the underlying asset and the cash flows it generates. We also see that the banks have somewhat stiffened their approach regarding the content of the contractual documentation. We note less flexibility on certain clauses. The argument according to which it is "the standard documentation of the bank" is more frequently used than before. Securities are also dealt with in a less flexible way than before, more particularly mortgages. Mortgages securing only a small portion of the loan are less frequent than before: the banks often require a mortgage for a very substantial part of the loan amount. This evolution is explained in particular by the constraints of refinancing. We think on the one hand of the constraints depending on the coming into effect of Basle III and its consequences on certain classes of real estate assets, or on the other hand at the German pfandbriefs market which imposes mortgages equal to 60 percent of the mortgage lending value of the property. We also note that certain transaction which in earlier times would have been genuine without recourse financings, now no longer qualify as such because the guarantee of the parent company is required to a certain extent, etc. The banks also seek to better control their cash flows and, for this reason, are much more restrictive on the concept of excess cash flow and how to deal with it.

A more rigorous review of credit applications

As far as the financial ratios are concerned, we also see a rather significant evolution, in particular the level of the LTV which has gone down to around 65 percent. Any real estate investment thus requires a more important equity contribution, which could force certain investors to look for partners. Certain joint ventures that took place over the

outlook for

past year were in no doubt partly motivated by considerations related to the credit squeeze.

The banks are also much more rigorous in assessing the merits of credit applications: everything is checked, reviewed and scrutinized in every detail. This feeling of somewhat nit-picking slowness is still accentuated in club deals which we often find when the financing exceeds 50/70 million Euros. Indeed, in a club deal, each bank separately reviews the file and the associated risks. The borrower must often arm himself with patience and deploy treasures of persuasion to arrive at his goal. This evolution is however – but in a certain measure only – just a return to normality after years of great flexibility and sometimes excessive indulgence. All this makes that a financing today takes much more time to close than before, which can prove in certain cases to be a real handicap. Much more time to prepare a financing granted for a much shorter term, is one of the paradoxes of the current environment: in fact it is now fairly unusual for a loan to be granted for periods longer than 5 years.

Last remark on which it is not necessary to spend to much time: banks are certainly lending again, but the margins aren't what they used to be anymore ! Borrowing today approximately costs 100 extra basis points of margin compared to the period before the crisis. The precise level of the margin today, mainly depends on the quality of the underlying asset whereas before the margins were fixed in a fairly uniform way.

Creative solutions to fill the gap

Is this trend durable? We believe it is since the rules of Basle III will do nothing but impose even more constraints on banks. In addition, the needs of the real estate sector as regards refinancing will be very significant during the coming years: many loans, sometimes of considerable importance, will come to maturity soon. We speak about hundreds of billion Euros within three years. Under these conditions, it is not surprising to see various actors being interested in alternative financing solutions, such aws debentures that some of them, in particular Belgian, launched successfully since the crisis, or mezzanine loans. We read recently that the English Duet Group - and it is probably not the only one - are on the point of raising more than 120 million Euros in order to create funds specialized in mezzanine financing. The idea is to fill the gap between the share of real investments that banks are today ready to finance and that which they used to finance before the crisis, that is to say approximately 20 percent. Beside mezzanine lending, we can note that certain non-banking actors also have appetite for traditional senior loans: the insurer Axa recently raised several hundreds of million Euros in the context of the creation of funds intended to act as lenders alongside commercial banks in syndicated loans. Finally, the recourse to securitization could also become more frequent again. In Belgium, the Finance Tower could be refinanced in this way. Other operations of the same type could follow.

Case to be followed… but it will be necessary to be innovative, because meanwhile the regulatory landscape has just substantially been adapted in favor of the SICAFIs. The competition is therefore likely to be ferocious !

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