European distressed real estate

Current market conditions, and projections, for European distressed real estate were under the microscope at a seminar in June hosted by Berwin Leighton Paisner (BLP) for European real estate investors, lawyers, and other professionals. A review and update of the issues discussed was carried out recently amongst BLP's European preferred firms' network.

The seminar and subsequent review confirmed that loan to value ratios are still under water as capital values have fallen, putting more loans at risk of default. Banks are not selling non-performing loans/underlying real estate to any great degree. Coupled with this the lack of available debt has reduced the number of buyers. Sellers (including forced sellers) do not want to bring property to market where there is no market, and lack of sales means accurate pricing to sell/buy has been more difficult. Debt and valuation have therefore been the key causes of transactional paralysis to date.

Market activity

The market correction in the UK, following the fourth quarter of 2008, was far more dramatic and severe than elsewhere in Europe.

Across Europe there has been, until relatively recently, little transactional activity over £50m lot sizes. This is due to illiquidity – specifically, the lack of debt. In such a thin market, sellers, even on a forced basis, are reluctant to bring property to market. Interest rates are at historic lows and there is a lack of attractive return from asset classes into which to put realisations.

The disconnect between what buyers are willing to pay and the price at which sellers are prepared to sell has paralysed the market. However, things appear to be changing. In the UK, buyers are looking for debt finance from the (forced) selling bank and there is a more pro-active approach to packaging up assets for sale (to protect capital value and reduce transaction times), whether by buying in title insurance, or looking for ways to improve the improve the asset. Market sentiment suggests that the market for UK prime property has bottomed out and that the banks still in the real estate market are willing to assume higher debt exposure, which in turn is unlocking transactional activity in Europe.

What are banks doing with defaulting real estate loans?

Formal enforcement has not occurred to the extent expected. It seems most European countries are seeing more informal management of problem loans, keeping down the amount of distressed real estate that might otherwise be traded.

In the UK, banks have avoided calling defaults and enforcing security – crystallising losses could deter investors and fuel demands from regulators to raise fresh capital. Loan defaults such as those relating to interest cover ratio (ICR) or loan to value (LTV), where the debt is still being serviced, are largely being managed through renegotiation or extension of facilities for a fee. Where enforcement is happening:

- Lower value stock is being sold, whether by public auction (mainly tertiary stock) or privately.
- Banks are thinking differently than in the last recession where they exited at any price at the bottom of the market and then saw buyers taking the upside when the market recovered. If restructuring is not deemed to be an option, a 'hold' strategy may be appropriate, whether by the bank or a joint venture, to protect future upside. Banks buying in distressed real estate assets (directly or using a subsidiary) are reducing the number of assets that would otherwise be traded. This is happening not just in the UK, although elsewhere in Europe the process generally takes longer and may be less attractive for balance sheet reasons, for example in Germany.

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In France, ICR/LTV breaches are occurring but again formal enforcement has not been common. This is due partly to the perceptions around the (relatively inflexible) enforcement regime, and also the lack of market for the assets. A similar perceived lack of formal loan enforcement has also been seen in Germany and the Netherlands. However, this may be set to change given the positive signs of recovery in Germany, as in other stronger eurozone economies.

The UK has a flexible insolvency regime, relatively benign to senior lenders. The Netherlands also has a flexible regime, though the official dealing will (the case with most European jurisdictions) have its costs paid in priority to the senior lender (not the case in the UK).

Other European jurisdictions are generally court-based and more rigid, and offer little control, as a result, to the senior lender, over the official/disposal proceeds: a further disincentive to selling out. France's relatively recently introduced Sauvegard procedure (similar to Chapter 11) affects enforcement – the process can last anything from 6 to 18 months.

More property groups have expanded, around Europe, so there is now a multi-jurisdictional element to enforcement. Whether enforcement results in 'forum shopping' for the most beneficial insolvency regime remains to be seen. It may be possible, following the relatively recent introduction of the European concept of COMI (Centre of Main Interest), since the COMI is established at the time of enforcement. There are tactics in play here; senior lenders will benefit from a COMI in the UK, junior lenders may not.

Are things changing?

Across Europe, falling rents and a weakening leasing market equals reduced rental growth, with the resultant impact on capital values. This trend is set to continue in those European countries not yet seeing positive economic growth. Here, pressure on occupiers is expected to increase; continuing to service loans where rental income drops may accelerate problem

loans, forcing more assets to market. By contrast, some of the stronger eurozone economies, such as Germany, are beginning to see signs of increased rental growth (on prime property), and positive economic growth. In prime office markets, tighter supply conditions and a better economic outlook have led to the bottoming out of prime rents.

European corporates, requiring liquidity in an illiquid market, are now looking to sale and leasebacks of real estate assets, to unlock capital. This is made easier when many real estate assets are currently held on a depreciated historic cost for accounting purposes.

Currency shifts mean that the UK is now more attractive to investors, despite falling capital values, so it seems inevitable that investment activity will pick up more quickly here than elsewhere in Europe. There are signs of increased transactional activity, though the lack of debt funding fuels fears that, in the UK market at least, it may lead to a 'W' rather than 'V' shaped recovery. September's eurozone figures, released by the European Central Bank, saw the first year-on-year fall in bank lending to the private sector.

We are now seeing investors looking to buy into senior parts of capital structures in CMBS at a discount, where the underlying cash flow remains strong - offering investors good risk-adjusted returns. For more experienced investors, there may be opportunities to acquire junior pieces in the CMBS capital structure, if priced on an interest-only basis, though careful due diligence here is essential.

Behind the scenes activity between Government and the banks on assets qualifying for the Asset Protection Scheme may also impact on the volume brought to market. Affected banks with Irish subsidiaries may be able to use the National Asset Management Agency (NAMA), set up by the Irish Government, for distressed Irish property loans. It is thought around 27% of the portfolio potentially within NAMA comprises around 27% of UK-based assets.

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