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German real estate corporates enter the leveraged debt and high yield bond scene

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Sub-investment grade rated property companies in the German market are increasingly supplementing conventional real-estate senior secured bank financing with corporate-style loans and capital markets debt – we examine this trend and highlight certain structural considerations.

The conventional real estate investment capital stack

The traditional composition of the capital stack used to finance real estate investments in the German market (similar to many other European and US markets) consists (in the order of increasing potential risk and return) of:

- senior third party (often bank) debt, secured not only by an insolvency-remote, first-ranking land charge (*Grundschuld*) over the financed property or properties, but additionally, among others, through (a) *in rem* pledges over the entirety of operated bank accounts of the property holding SPV (the "**PropCo**"), (b) the security assignment of certain of the PropCo's claims, in particular in respect of its rental income and insurance claims and (c) an *in rem* pledge over the shares in the PropCo itself;
- (optional) mezzanine third party debt (sometimes combined with profit participation arrangements), either unsecured or secured only by a second-ranking land charge over the financed property or properties;
- (optional) unsecured preferred equity; and
- common equity.

As in most other European markets, real estate senior secured (bank) debt is a comparatively inexpensive form of financing in Germany, with current interest rates for "core" rated real estate assets averaging around 1.0 – 1.5 per cent. p.a. above EURIBOR. This lower cost debt is balanced against stricter lender access to the underlying real estate collateral, by the imposition of considerable operational constraints to the letting activities of the PropCo and an ongoing duty to maintain financial covenants throughout the lifetime of the financing.

Operational limitations typically include an extensive lockdown on the handling of liquidity within the PropCo (in the form of restricted operating rights for bank accounts and a detailed payment waterfall providing for the order of priority of settlement of operating and financing costs). Additionally, a number of specific covenants will typically be included which relate to the operation of the property itself (such as restrictions around changes to existing and the conclusion of new leases). Finally, senior lenders may require the implementation

of potentially complex capital expenditure programmes, with more or less onerous budgeting, approval and reporting processes.

Typical financial covenants include the periodic testing of the maintenance of specific loan-to-value ratios (LTV) calculated on the basis of usually yearly property valuations usually conducted by third party valuation experts. Additionally, lenders will often also require the testing of cashflow based metrics relating to rental income. These are expressed as ratios between net operating income (either backward-looking or projected forward) and (i) debt or interest service (DSCR/ISCR) or (ii) indebtedness under the respective facility (Debt Yield).

Under current market conditions, senior secured lenders in the German real estate market will usually offer to finance no more than 60 – 70 per cent. of the nominal value of a property or portfolio of properties. Investors may sometimes attempt to bridge a portion of the remaining 30 – 40 per cent. of the nominal value with mezzanine third party debt. This type of debt is usually comparatively expensive, with current German market interest rates (depending on the type of real estate asset) fluctuating around 7 – 20 per cent. p.a. Mezzanine debt in the German market may contain some property-related restrictions, but will tend to be considerably less restrictive than the typical provisos contained in senior secured financings.

The past and current role of corporate-style loans and capital markets debt

The addition of corporate-style bank and capital markets debt to the overall capital stack of real estate companies has been a feature in the German market for some time, but was almost exclusively restricted to listed borrowers/issuers with existing investment-grade ratings. Coinciding with the current continued high availability of market liquidity, lender/investor appetite for extending these kinds of financing opportunities to sub-investment grade and unrated real estate companies has significantly increased in the past two years.

Structures and features of real estate corporate-style leveraged loans and high yield capital markets debt

Cutting financing costs

Previously, achieving a higher return on equity through further leveraging of real estate companies and real estate investment structures was mostly only possible through the incurrence of mezzanine debt. Mezzanine lenders made use of the fact that marginally higher returns on equity were possible for companies seeking to increase leverage by bridging the funding gap between the initial LTV levels (that senior secured lenders were willing to finance) and the purchase price of real estate investments. Maximizing this circumstance meant that mezzanine interest rates would tend to move towards convergence with typical expected real estate equity return rates (but stay just below them to incentivize equity holders).

Being able to access comparatively cheaper corporate loan offerings and tap into capital markets means that real estate corporates are able to expand their options in respect of further leveraging considerably and need no longer only rely on the incurrence of mezzanine debt. Depending on maturity profiles and specific individual ratings, sub-investment grade real estate corporates are now partially able to raise debt that is priced below typical mezzanine debt.

Individual real estate investment independence and operational flexibility

The close interlink between senior secured bank debt and the underlying financed real estate asset not only causes numerous operational restrictions to the day-to-day letting business of the specific borrowing PropCo, it also means that the fate of the individual financing is inseparable from the investment cycle of the financed property. This will cause borrowers to often attempt to align debt maturity profiles with expected investment horizons. Senior secured real estate financings will almost always provide for the sale of the financed property or the shares in the borrowing PropCo to trigger an immediate and full mandatory prepayment. Additionally, senior secured loan documentation may sometimes also stipulate yield maintenance or at least some form of prepayment penalty payable upon any prepayment. Multi-asset property financings will often also set minimum release pricing for individual financed assets, thus imposing limitations upon the possibility of asset liquidation.

In contrast, the holistic structural view taken by corporate-style leveraged bank debt and high yield capital markets debt as a financing form for the entirety of the corporate structure (including values not expressed in the real estate asset base such as corporate goodwill) allows a degree of decoupling of these financing forms from the underlying asset base. As such, borrowers/issuers are afforded a far greater deal of independence regarding individual asset acquisitions and sales and thus, the further development of their business.

From an operational perspective, and in further contrast with the extensive constraints imposed by senior secured financing, corporate-style leveraged bank debt will typically contain far less comparable property-specific restrictions. Covenants are usually limited to generic negative pledges and undertakings (for example, the continuation of business or the entry into arms' length transactions with affiliates). High yield indentures will usually not contain any specific property operations restrictions.

Securing low interest rates and bullet amortization upon maturity

Capital markets debt is currently particularly attractive for real estate issuers (as for others), as they are able to secure coupon levels based upon the currently historically low interest rates with comparatively long maturities. As the debt so raised is not linked to specific real estate assets, issuers are able to finance a portion of their (rolling) asset base at stable and predictable long-term interest costs.

Issuing capital markets debt further permits additional long-term sustained leverage levels by allowing bullet amortization upon maturity. This is also in contrast with senior secured real estate financings, which may require deleveraging throughout the lifetime of the financing by way of regular amortization payments.

Structural subordination

As typically issued at holding level, real estate corporate leveraged loans and high yield capital markets debt will be (potentially several) levels structurally separated from the underlying real estate asset pool held at the PropCo levels and the cashflows generated by them. Collateral provided will – if at all – take the form of share pledges in intermediate holding companies and of the security assignment of proceeds/intercompany debt issued by the issuer to its affiliates. Providing share security over the PropCos will – in most cases – be prohibited by negative pledge provisions commonly included in land charge/senior secured debt documentation.

In lieu of documented intercreditor agreements, *i.e.*, contractual ranking arrangements which are often entered into between the senior and mezzanine financing parties, real estate leveraged corporate loans and high yield capital markets debt is structurally subordinated. This structural subordination ensures the primary and secondary access of the senior and mezzanine third party debt situated in the PropCos to the real estate assets and cashflows and thus effectively ranks real estate corporate loans and high yield capital markets debt just prior to equity.

The asset vs. cashflow paradigm and incurrence covenants

A distinguishing underlying structuring paradigm of financing real estate corporates – in comparison with other corporates – hinges on the perceived relatively higher value stability of the real estate asset base. In addition to this value stability, providing financing against the real estate asset class also carries the advantage of a traditionally perceived higher degree of cashflow stability. Whereas, for example, industrial corporates may have seasonal EBITDA fluctuations and are more often exposed to sales and supplier market instabilities, real estate letting produces comparatively far less cashflow volatility once lease agreements are in place (with the principal risk lying in the insolvency risk of the tenants). Increasing real estate portfolio sizes further immunizes against cash-generating fluctuations, as an individual tenant defaults and vacancies are compensated by a large tenant base.

Echoing this shift in structuring paradigms, high yield indentures for real estate issuers will base incurrence leverage tests (such as for the incurrence of ratio debt) on an LTV test rather than on a EBITDA/debt test. While the reliance on an LTV incurrence test is thus a highly recognizable distinguishing feature of real estate high yield issuances, a detailed review of the test itself reveals a few differences vis-à-vis the LTV test employed in the context of senior secured debt. As noted above, determining values in senior secured debt financings usually occurs by employing third party valuers. These valuations occur on the basis of pre-determined valuation standards like RICS Red Book and may include site visits, market assessments, etc. Determining "value" in the context of high yield indentures has mostly taken the form of fair value

assessments by management or by referencing issuer balance sheet values. While these will be usually generally based on existing (mostly yearly) surveyor valuations, management fair value assessments and balance sheet references will allow a certain degree of (reasonable) adjustments.

Additional leveraging

Senior secured bank debt on the level of the PropCos is generally not impacted by a sub-investment grade issuer rating on the level of a holding company and will continue to be an irreplaceable feature in the overall capital stack of real estate holding companies.

Recognizing its continued necessity, a few high yield bond indentures recently observed in the market have permitted the continued issuance of non- or limited recourse asset-level senior secured debt outside of ratio debt and permitted debt baskets, thus effectively allowing the growth of the asset base alongside asset-level debt so raised. In such cases, protection from over-leveraging the entirety of the structure hinges on the assumption that market LTV levels for the incurrence of this kind of debt will remain stable. Increasing LTV levels would – in such cases – not restrict incurrence of additional debt and would de facto further prime holding company creditors.

Additionally, this also means that the incurrence of ratio debt on the basis of LTV-based tests would not be expected to play a role in determining the permissibility of additional leveraging of the entire investment structure by way of raising additional debt in the PropCos, but will effectively only limit the issuance of pari passu debt on the holding company level.

Deciding between corporate leveraged and high yield capital markets debt

Deciding between pursuing corporate leveraged and high yield capital markets debt will depend on a number of circumstances, including maturity profiles, appetite for meeting capital markets disclosure requirements, perceived capital markets interest and many others. Rendering such a decision will require a case-by-case analysis of the individual financing needs of the potential borrower/issuer in question.

Conclusion

Formerly inaccessible leveraged loan and debt capital markets becoming accessible to sub-investment grade rated real estate companies represents a significant opportunity for the enhancement of their existing financing structures. White & Case is at the forefront of this development, having advised on the majority of transactions in this relatively new market.

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