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Changing face of the real estate market

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The market in real estate is in a state of evolution, with the rapid growth of quasi operational assets such as data centres and logistics centres, as well as the occupation of more conventional assets, such as offices, on more flexible terms. The varying nature of those business models means that a bespoke approach to underwriting a loan on those assets is often required. New structures are emerging which are a hybrid between "classic" real estate finance and leveraged loans.

Evolution of the real estate market

Technology and disruption have affected a number of industries in recent years. However, it is only very recently that they are having a marked impact on the real estate sector (and, by extension, the financing of real estate).

The ever-increasing need for data centres and logistics centres are the most obvious tip of the technological iceberg, but are only part of the story. Demand for real estate is increasingly moving to a shorter-term, more flexible and adaptive model in other areas. Mixed-use developments are on the rise. In the residential space, the WeLive model provides accommodation with communal mailrooms and laundry rooms that double as bars and event spaces, as well as communal kitchens, roof decks, and hot tubs. The turnover of tenants is far quicker than the industry is used to, with the flexibility to stay for just a few nights (the Airbnb model), or a much longer period.

Equally, the lines between residential and commercial space are becoming more blurred. The exponential growth of wireless connectivity continues to result in an increase in flexible working, and serviced office providers; this is now also feeding into developments combining living and working sectors. One example is the Barratt London and SEGRO collaboration on the former Nestlé factory at Hayes in West London, which envisages a two-fold development of the site; urban logistics warehouses and modern industrial space on one hand, and homes and communal spaces on the other.

In all cases, the demand is for more flexible spaces, both in terms of the need to accommodate mixed use, and more versatile (often shorter) tenancies which typically results in less predictable income flows. All parties investing in, or funding the acquisition of, real estate, will need to adapt to this new model.

Impact on market participants

The systemic change in the real estate market gives rise to some key issues for borrowers, in optimising the debt component of the capital structures used to finance such businesses. For lenders, the key is ensuring adequate protection when advancing funds into a non-traditional business model. The change also impacts on sponsors, who need to consider differing approaches, to fund their acquisition of real estate assets.

We have set out below some of the key issues that we have seen arising in recent deals, that all parties should be considering at an early stage, to ensure that the acquisition and financing of these non-traditional assets, can proceed quickly and efficiently.

Key issues – and some potential solutions

Rental income

As explained above, one of the main changes arising from the current market trends is the requirement for flexibility. The knock-on effect of that flexibility is, of course, the lack of reliable long term rental income.

The absence of a long term contracted income flow has a consequential impact on the underwriting value that can be attributed to these assets. In order to ascribe value, lenders will need to look to the track record of a business and consider covenants based on its historic EBITDA; an approach which is more common in hotel deals. Additionally, lenders will need to consider whether there is any value outside of the contracts the business currently has with its tenants/users. For instance, a lender may need to take into account whether it can have some degree of confidence that alternate tenants could be easily found (for example, based on the asset's location) or whether there are viable, alternative uses for the space.

Owner and operator

One of the other key themes to emerge is the rise in the range of real estate assets which require active management and are owned and managed by the same entity. Historically, owned assets were managed by an independent 3rd party operator, giving the lender comfort that a reputable, qualified and economically stable external party was managing the asset which the lender was financing. However, the growth of logistics businesses, serviced office providers and similar market participants results in a more complex business model. As such, the health of the assets is increasingly dependent on the quality of the operator.

Where the identity of the operator is considered critical, lenders may wish to deal with this issue by incorporating key man provisions or adapting the change of control provisions in their finance documents. In more conventional real estate financings, change of control provisions focus on the identity of the sponsor. In some parts of the market, sponsors are seeking to agree deals on the basis that a change of ownership will not trigger a mandatory prepayment as long as the incoming sponsor is deemed to be acceptable. Where the quality of the operator can have a material impact on the economics of a deal, change of control provisions may instead state that a change of ownership is permitted provided that the operator remains the same. Additionally, key man provisions requiring that particular individuals remain involved in the operation and management of the business are likely to become a feature of financings of these sorts of assets.

Flexibility

For assets where active management is crucial to performance, such as flexible workplaces and mixed use residential spaces, owners and operators will require finance arrangements that allow flexibility in relation to management of the asset. Operators will be keen to ensure greater scope than is available in more traditional real estate financings. This is relevant both to the types of actions that can be taken in relation to the underlying property and how cashflows are managed. Key issues for borrowers will include ensuring their ability to undertake a wide range of leasing activities or development works, to keep up with client demand and remain attractive in their markets. Borrowers will also need to focus on their ability to utilise a sufficient amount of their cash flows to meet the costs of such activities.

These types of businesses will therefore have a need for working capital expenditure in a way that is not required in relation to traditional real estate assets. Lenders will need to be cognisant of these working capital requirements, and the associated costs. They should therefore consider having provisions regarding the use of cashflow by an owner or operator, and the determination of excess cashflow amounts, which are less restrictive than would be expected in more traditional real estate financings.

Recourse

Another consideration for lenders will be whether or not loans advanced in relation to these quasi operational assets will be made on a non-recourse basis. Conventionally, real estate loans were advanced on a non-recourse basis because a lender is able to take a view on the value of the underlying real estate, as well as its ability to generate cash flows. However, loans made in relation to alternative assets such as data centres are often advanced on the basis of the credit of a corporate group and its business as a whole, rather than in relation to a single real estate asset. This approach is often taken because it enables lenders to mitigate their risks by lending against the wider performance and assets of a business and consequently, having claims against a greater pool of assets.

Access to funding

Securing debt facilities for the acquisition of more non-traditional real estate assets may prove challenging for private equity investors, because of a lack of lenders willing to fund against this newer asset class. In particular, it may be difficult where there is insufficient data or performance history to allow more conservative lenders to underwrite these loans. However, as a result, there are also opportunities for alternative capital providers to finance these assets, as they will have more flexibility to consider structures and assets which high street banks will be constrained from funding and for which investment banks may not have the appetite.

“Hybrid” financing structures

We are seeing a growing prevalence of “hybrid” loans, which take many of the asset value preservation features from a real estate loan, and combine them with the protection – and flexibility – afforded by a leveraged finance model.

In conventional real estate finance transactions, preservation of the value of the underlying asset is typically monitored by way of LTV and forward looking, lease contract based, financial covenants together with regulation of the maintenance of the property and conduct of business activities. Conversely, leveraged finance transactions focus on profit generating business activity and rely on covenants that measure a business’ earnings and cashflow, in order to provide adequate protection for lenders.

Market participants will need to carefully consider how their financing arrangements deal with issues such as appropriate methodology and thresholds for establishing financial covenants, what constitutes permitted distributions, the determination of excess cash flow and whether cash sweeps or cash traps will apply. Ultimately, these loans will need to strike a balance to give lenders the protection they require whilst allowing borrowers to access the money needed to finance acquisitions and ongoing working capital requirements, as well as the flexibility needed to operate their business model.

Our recent experience with “hybrid” loan agreements has seen a number of new trends emerging. Some features that have hitherto been seen less frequently in the European market, such as sponsor level guarantees, are being introduced to give comfort to a lender, where rental income generation is less predictable. Cashflow flexibility is crucial, with borrowers receiving far more control over accounts generally than would be the case in a more traditional real estate financing. Lender control over disposal of assets is also reduced, with borrowers more frequently having the ability to reinvest the proceeds rather than applying such proceeds in repayment of their loans. A more flexible approach to taking security (both in terms of timing and the proportion of assets to be secured) is also a trend that we have seen, again more typical of a leveraged finance transaction.

We are also seeing borrowers achieving greater flexibility in terms of what constitutes permitted activities. Provided that excess cash (after debt service) is used, lender consent may not be required for asset acquisition and capital expenditure, as long as certain financial metrics are satisfied. Occupational letting activity might also be permitted, provided leases are granted on arms’ length terms and subject to the effect on rental income.

The evolution of the real estate market continues apace, and we therefore expect to see an ever-increasing number of these “hybrid” real estate finance loans in the future.

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