Client Alert | Real Estate Finance

Americanisation: The influence of US deal terms on the European real estate finance market

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European real estate finance transactions are increasingly incorporating deal terms that, whilst often seen in US real estate finance deals, are less common in European deals. The popularity of real estate as an asset class with US-based investors who deploy capital on a global basis provides these investors with practical insights into the nuances between different markets. This exposure to accepted commercial positions in other jurisdictions, coupled with the current abundance of capital in the European real estate market has enabled such sponsors to become increasingly demanding in relation to deal terms. Similarly, US debt funds who are active in the European real estate market, are also referencing commercial positions that are commonplace in the US when negotiating terms on European transactions. Set out below is an analysis of the various trends we are currently seeing in the market which reflect the influence of US deal terms.

Financial covenants

A typical European real estate finance loan will require the borrower to comply with both a loan to value covenant and an interest cover covenant, although additional or alternative covenants may be included from time to time (*e.g.* debt yield). In the US however, it is common for real estate financings to be implemented on the basis of covenant-loose or covenant-lite provisions, with the former usually referring to the inclusion of one or a limited number of maintenance financial covenants and the latter seeing no financial covenants included at all.

Whilst covenant-lite is now the norm in the European large cap leveraged market, the real estate finance market has traditionally been more resilient to financial covenant abrogation. This may be a reflection of the different nature of the real estate finance market, which traditionally enables sponsors to borrow more at a cheaper cost than in the leveraged finance market, having regard to the collateral value of the real estate asset and the perceived stability of that asset. As such, real estate finance lenders tend to focus on preserving the value of the real estate asset (being the primary collateral in a non-recourse financing to an SPV borrower), are more sensitive to any fluctuations in value and are keen to be able to act following any perceived erosion in asset value. In comparison, in the leveraged finance market the emphasis is on ensuring the business remains profitable and there is generally considered to be more latitude for tolerating fluctuations in the financial performance of the business as a whole. The extremely competitive market for leveraged finance, both among traditional lenders and alternative capital providers, has resulted in lenders in the leverage finance space being willing to forego the requirement for financial covenants to ensure deal flow.

We have recently seen a relaxation of the requirements for financial covenants in European real estate finance deals. Given the relatively low leverage on current deals (particularly when compared to the historically highly leveraged deals seen some years ago) lenders have become more comfortable setting covenant levels with substantial headroom prior to triggering a default, with a relatively lower level as a trigger for a cash trap or sweep. The current resurgence of CMBS in Europe has seen deals where this has gone a step further. The Blackstone Sponda and Onyx transactions do not include any default financial covenants. However, as Blackstone had also negotiated to ensure portability of the underlying debt (see discussion below), following a permitted change of control maintenance financial covenants will apply.

The acceptance of deal terms where there are no maintenance financial covenants may be a function of the flexibility of CMBS investors and their requirements, the ability of the strongest sponsors to demand more relaxed terms or a combination of the two. We would anticipate that other sponsors, having seen the terms achieved on recent deals, will seek to convince lenders to forego maintenance financial covenants where new loans are destined for distribution by CMBS transactions. However, it is less likely that such terms will be seen on deals that are intended to be syndicated as the bank market does not appear willing to accept these terms.

Cash trap

Another common feature of European real estate finance deals is the cash management system adopted through a process of controlled accounts, whereby cashflow is paid into accounts operated by the security agent. On each interest payment date, the cash flows through a waterfall, with funds used to pay amounts due under the loan (*e.g.* costs, interest, amortisation or mandatory prepayments), with the remainder available for use by the borrower (including for distribution of cash to the sponsor). Typically, if certain financial covenant levels are not met, a cash trap would come into effect, whereby monies which would otherwise have been available for the borrower's use are trapped into a blocked account for a specified period. If, during that period, the relevant financial covenant is not satisfied, those funds would be swept in mandatory prepayment of the loan.

Strong sponsors are seeking greater latitude from lenders to have the opportunity to weather a downturn in the value or performance of their underlying assets (in circumstances where the loan is otherwise performing). This is one of the arguments used to support the request for relaxation of financial covenants discussed above. Similarly, to the extent that addressing any downturn in the value of the underlying assets may require further investment in the asset, sponsors are seeking alternatives to the cash trap to enable them to use cash that would otherwise be trapped following the occurrence of such a downturn. Recent deals have seen lenders agreeing to the cash trap being replaced by a distribution blocker. Where there is a distribution blocker, those funds that would ordinarily have been subject to the cash trap are instead restricted from being distributed by the borrower to the sponsor until the relevant covenant is again satisfied. However, prior to such time, those funds may still be used by the borrower towards costs or expenses directly related to the ownership or operation of the underlying real estate assets. As such, absent an event of default, those funds will not be applied in mandatory prepayment of the loan.

Change of control

It has long been the market position in European real estate facility agreements that they contain change of control provisions, whereby a change of the controlling interest (howsoever defined) in the borrower results in the lenders being entitled to demand a mandatory prepayment of the loan.

In the US, by contrast, there has been a rise in the inclusion of "portability" clauses. With its genesis in the high yield bond market, the portability clause provides for an exception to the change of control provision allowing, under certain circumstances, control of the parent company (or borrower) to be transferred without triggering a change of control. Given the additional flexibility this allows sponsors, it is not surprising that portability is now also being seen in European real estate finance transactions.

In Sponda, for example, the sponsor is permitted to transfer to an entity which is, or is advised or managed by, an entity that owns, controls and/or manages not less than €2 billion of European commercial real estate assets (or €5 billion of commercial real estate assets outside of Europe), provided also that certain LTV covenants are met and the properties are managed by a property or asset manager whose operations exceed a critical mass; with the reference to specific size thresholds used as a proxy for competence.

This approach reflects a more dynamic methodology for regulating the capability of those managing the underlying assets, as well as the identity of the owners of those assets. It is also clear that it is possible to include a formulation that, by referencing a manager or sponsor's market position, allows lenders to take a view in advance that entities meeting those minimum requirements will be acceptable substitutes for the original parties, provided that they can satisfy the lenders' KYC requirements.

Recourse

Conventionally, in Europe, real estate loans are advanced on a non-recourse basis. An SPV structure is created for the sole-purpose of holding the relevant property with recourse limited to the property itself and the shares of the property-owning vehicle.

In the US, lenders expect to have recourse to the sponsor (whether such recourse is limited or not). Lenders typically require a 'bad boy' guarantee that gives recourse to sponsors in certain circumstances. Traditionally these guarantees were intended to discourage certain "bad acts" such as fraud or misappropriating funds, with recourse to the borrower and the guarantors (who typically included the sponsor) for the losses suffered by the lender as a result of such acts. Today, the list of these bad acts has grown. The once limited list now seems to cover every possible eventuality (including every event of default). Whilst we are not yet seeing guarantees with similarly broad application in European deals, it is becoming increasingly common in European transactions, particularly where US debt funds are involved, for lenders to seek 'bad boy' guarantees or other sponsor level guarantees that guarantee specific obligations of the borrower.

The different approaches to recourse between jurisdictions are even more pronounced in the context of development financing. Lenders under a US development finance facility will typically require a completion guarantee whereby the guarantor guarantees the prompt and complete performance by the borrower of the design, construction and completion of the improvements that are the subject of the loan (i.e. the actual construction). By contrast, in the European market, the LMA recommended form of development facility provides for a cost-overrun guarantee only, and this is customarily the limit of what is requested by lenders.

Title

A feature of US deals that is not commonplace in European transactions is the requirement to obtain title insurance. Title registries in the US are not maintained on a national basis, but instead on a county and state basis, with the process differing between each county and state. The public register is not liable to pay compensation for errors made in relation to title registration and unlike the system in England and Wales, there is no state guarantee of title. Instead, it is customary in the US to obtain title insurance. Title insurance will be purchased by the buyer of the property to ensure good title is obtained; as well as by the lenders to ensure they have received first-ranking security over the property. Given the complexity of the title registration system and the lack of state guarantee, title insurance provides a welcome and necessary substitute.

In most European jurisdictions, a robust system is in place for giving lenders comfort as to title in the property they are financing and perfecting their right of recourse to it. In civil law jurisdictions, a notary will oversee the granting of a mortgage and is able to confirm the validity of the document and that there is no issue with title. In the UK, it is customary for properties to be sold with full title guarantee and a buyer will obtain the benefit of certain implied covenants under the Law of Property (Miscellaneous Provisions) Act 1994. More fundamentally though, in England and Wales, anyone buying or selling land or property, or taking out a mortgage, must apply to HM Land Registry to register any purchases or any mortgages over the property. The land registry then provides owners with land title that is guaranteed by the government. That being said, where specific title defects are highlighted in a title review in a European transaction, title insurance is increasingly being deployed on an exceptional basis as a risk mitigation strategy.

Conclusion

The terms of real estate finance deals transacted in Europe are increasingly adopting positions that have developed over time in the world's largest real estate market. The global flow of financial and human capital means that both the money and the people who deploy it are regularly transferring their experience to new markets. In particular, the experience of US based investors and debt funds of negotiating commercial terms in their home market, equips them with the tools necessary to make an assessment as to whether differences in deal terms are justified by local market issues, or if, as appears to be the case in many instances, they are simply a function of the time it takes for markets to evolve and converge. Whilst the different legal frameworks in particular jurisdictions may require alternative approaches to be taken in relation to certain issues, we would expect the overall trend of European real estate finance deal terms being influenced by the market position in the US to continue.

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