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Insights

EUROPEAN DISTRESSED REAL ESTATE – HOW WILL IT PLAY OUT THIS TIME?

Mar 22, 2024

BCLP's Pan-European Real Estate team hosted a round-table event on 27 February 2024 with several Managing Directors at Alvarez & Marsal to discuss the European commercial real estate market, including the latest developments on distressed real estate.

This article summarises some of the topics discussed, including the real estate debt market and refinancing pressures that characterised 2023, the outlook for European commercial real estate in 2024, the challenges facing the German real estate market and trends in cross-border restructuring processes, particularly following the decision involving German real estate group, Adler (*AGPS Bondco PLC* [2024] EWCA Civ 24), being the first Part 26A restructuring plan to come before the Court of Appeal[1].

2023 – A YEAR OF TWIN PRESSURES

The pressure points for European commercial real estate in 2023 were twofold – debt pressures and market pressures.

Interest cover ratios (ICRs)

ICRs came into sharp focus for lenders, particularly banks and regulated lenders. Sponsors seeking debt for new deals, or to refinance, suddenly faced not only higher interest payments but also increases in OpEx, such as energy and construction costs, that competed for cash flow and put ICRs under pressure. *"Traditional investment real estate debt has averaged around 7%"* meaning that *"for a lot of would-be investors the figures no longer stacked up"*, said **William Clark, Senior Advisor with A&M's Portfolio Advisory Group**.

Loan-to-value ratios (LTVs)

A symptom of the higher interest rate environment has been the dampening of investor demand. This has contributed towards significantly depressed valuations across most commercial real estate sectors. "*Some debt funds have greater flexibility with the ICR coverage, but the LTV is a key metric for them, because they're looking at the overall route to recovery"*, added William.

Refinance walls

Impending debt maturities across Europe, particularly in the office and retail sectors, combined with falling valuations threatened a wave of insolvencies, or at least an increase in more expensive mezzanine lending. Instead, 2023 saw a great many loan extensions. The purpose has been to give borrowers a bit of time - either to find a new funding solution (such as an injection of further equity or, where that is not possible, to secure mezzanine finance or PIK loans) or to seek to sell the asset.

Valuation uncertainties

Lower transaction volumes compounded valuation uncertainties. Those transactions that did complete showed significant variances in pricing, often informed by bespoke factors, unique to the assets. "*Whilst valuers used those transactions as the benchmark to price the rest of the market, the depth of liquidity at that pricing level was not necessarily there*", noted **Adam Paxton, Managing Director and Co-Head of A&M's UK Real Estate Restructuring team**.

Cost inflation

Cost inflation caused development and CapEx projects to be put on hold and many development-led business plans were no longer financially viable due to the joint impact of higher costs and lower forecast exit values. *"Changing occupier demand and ESG requirements are also driving higher CapEx requirements which are also arising significantly earlier than originally planned. This is leading to difficult conversations between sponsors and lenders*", added Adam.

Difficult equity raising market

The difficult equity raising market has been another significant factor, as evidenced by several traditional property funds having experienced challenging equity raises. For example, some funds, particularly in the UK where DB pension money has started to dry up, have been unable to fully replenish capital as real estate struggles to compete against the bond market in a higher interest rate environment.

WHAT DOES 2024 HAVE IN STORE?

This year promises increased activity, likely in the second half of the year and not across all asset classes. However, prior pressures remain (and may intensify with the passage of time), whilst the UK and US elections present new uncertainties.

Increased activity in 'hot' sectors

The second half of 2024 is expected to see increased transaction volumes, although views on market trajectory differ. However, *"beds, sheds, meds, breads [supermarkets] and bytes [data centres]"* are the asset classes that top the list of investor demand, justified by rental growth.

Increased distress

With a significant number of frustrated sales in 2023, borrowers will likely come under increased pressure in 2024, and the patience of lenders may become thinner. *"As UK PLC starts to stomach the high cost of debt and, as corporate bonds expire, I think we're going to see more tenant failures, compounding the problem for those investors with tight ICRs",* added Adam.

Political uncertainty

The upcoming UK and US elections are creeping into conversations. In the UK, the polls are predicting a Labour victory, and some are anticipating an increase in regulation as a result, particularly in areas such as tax and sustainability (ESG). For example, one international investor recently expressed nervousness in the living sectors regarding the introduction of rental caps, as seen across parts of Europe.

Increased lender scrutiny

Some European banks have low provisioning for non-performing loans on their commercial real estate books meaning they have very little scope for surprises. However, since the GFC, there is at least a more diverse lender pool comprising debt funds, insurers and challenger banks. Some of the challenges they face include back leverage and fund expiries, but one common theme across several lenders is a lack of internal work out resource.

Increased lender action

There is some evidence that lenders are becoming more proactive in enforcing non-performing loans. A&M has seen not only assets with structural issues such as offices facing difficulty, but also prime real estate which is low yielding because there is not the debt coverage meaning that, in some instances, ICR ratios are falling below 1. Shifts in cap rates can also lead to significant falls in capital value (which would currently apply to both German offices and UK prime logistics). For example, a reduction in cap rates from 3% to 5% can result in a 40% fall in capital value and "*in many cases that's the borrower's equity*", William noted. Challenges will persist in such sectors until there is yield compression.

CHALLENGES IN THE GERMAN REAL ESTATE MARKET

Germany is currently, perhaps, the most distressed real estate market in Europe, with transaction volumes down by more than 50% between 2022 and 2023, insolvencies up by more than 23% over the same period, and a 16.5% drop in commercial property prices[2]. *"Most of the underlying macro-drivers [in Germany] are similar to the UK and indeed other large European jurisdictions, such as the Nordics – it's not the first rate-driven bubble we have seen",* said **Munich-based Christian Ebner, Managing Director – Restructuring at A&M**. However, what *"makes Germany different is the*

pressure on company directors to comply with the still exceptionally strict German insolvency regime".

German insolvency restrictions

There are two key peculiarities of the German regime that stand out. First, directors in Germany found by a court to have been negligent in their filing obligations could face personal consequences – including penal law consequences. Second, German insolvency restrictions include a 12-month look-ahead test regarding solvency and over-indebtedness – in volatile macroeconomic times that can become a challenging exercise. These considerations put pressure on management teams and introduce a level of conservatism independent of any external KPIs, such as covenants. *"Ultimately, if you get a new management team appointed to a sponsor asset, and they look at a business plan and suddenly think, 'I'm no longer so sure I can refinance this in 18 months,' then people will agitate for action something like 18 months before maturity. That I do think is a German peculiarity, and the reason why you will have seen a lot more activity – starting with the unsustainable developers but also now affecting more mainstream real estate".*

Outlook for the German market

Ongoing hope for a gradual recovery from mid-2024 means that German administrators and insolvency practitioners will likely take their time, said Christian. On average, there is a sense that valuations might improve, that rate cuts *"might be in the offing before too long",* and that, from a valuation perspective, if you hold your breath for 12-18 months, better value will be realised. This may cause appointment takers to sit on assets for longer, causing others to do the same and which could ultimately lead to a glut, depressing values further. *"In Germany, it's those management teams, those directors, driving situations sometimes over and above the wishes and incentives of sponsors and sometimes forcing the hand of creditor groups as well. I think that will continue until such time as there's a genuine sense that values are re-stabilising and that external refinancability is being restored."*

Cross-border restructuring trends

The recent Court of Appeal decision in Adler demonstrates the willingness of German real estate owners to use the English Courts to implement a restructuring of their debt liabilities. They are availing themselves of the cross-class cram down under Part 26A of the Companies Act 2006 to 'force' a desired outcome against a dissenting class of creditors – in the case of Adler, a class of 2029 noteholders. Whilst the High Court sanctioned Adler's plan in April 2023, the Court of Appeal set aside the first instance sanction order. In doing so, the Court of Appeal primarily agreed with the arguments raised by the 2029 noteholders, namely that the plan diverged, without proper justification, from the pari passu treatment the 2029 noteholders would have received in the relevant alternative, being a formal insolvency proceeding. In so doing, the so-called 'rationality test'

in Part 26 schemes of arrangement was not considered to be appropriate when the Court considers the fairness of cramming down a dissenting class of creditor.

The decision in Adler demonstrates the changing mindset in Part 26A restructuring plans - they are becoming far more 'litigious' in nature, involving extensive cross-examination of multiple witnesses and expensive expert evidence and valuations. So, whilst a flexible tool, they are not an inexpensive process. This was further evidenced in the recent McDermott Restructuring Plan which was heavily contested but was ultimately approved by the High Court (CB&I UK Ltd [2024] EWHC 398 (Ch)) ("**McDermott**"). Whilst this trend towards ever more 'contentious' restructuring plans is therefore anticipated to continue, what has not yet been seen is whether the increasing process costs and court scrutiny will result in stakeholders pursuing alternative restructuring options, such as enforcement, if a consensual, out-of-court solution cannot be reached.

FINAL THOUGHTS

In summing up, whilst this year promises increased activity in European commercial real estate, ongoing pressures and new uncertainties mean we will likely witness further challenges over the remainder of 2024, particularly for those operating in the most affected sub-sectors, such as offices and retail. Indeed, increasing transaction volumes and the associated price discovery may provide more confidence to lenders to exert their rights and protect their positions as debt maturities approach, driving increased restructuring activity.

Where distress arises, we will also likely continue to see an increasing preparedness amongst real estate owners, at least for those able to afford it, to avail themselves of the Part 26A restructuring plan to 'force' through restructurings in order to restore liquidity and operational performance for the benefit of 'in the money' creditors. That said, it will not be plain sailing for those advising corporate debtors, as shown in *Adler* and *McDermott*. The English courts have shown themselves more than able to intervene and to ensure that there is 'fairness' in the process when it comes to exercising their discretion to cram down dissenting parties. Those advising such corporates also need to ensure that the restructuring process is 'proper' in terms of timetabling and disclosure – indeed, the whole process is looking increasingly like full blown commercial litigation. More hard fought cases are expected – debtors, in partnership with their legal and other advisers, will need to take the judgments in these cases into account when structuring their proposals in order to achieve the desired outcome.

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[1] At the time of writing, (1) the judgment sanctioning the Part 26A restructuring plan in CB&I UK Ltd [2024] EWHC 398 (Ch) ("**McDermott**") had only been handed down the same day; and (2) the judgment sanctioning (or otherwise refusing sanction of the original plan but sanctioning the amended plan) the Part 26A restructuring plan in Project Lietzenburger Strasse Holdco S.A.R.L [2024] EWHC 468 (Ch) was still awaited.

[2] Source: JLL Investment market overview Q4-23.

MEET THE HOSTS

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BCLP's Pan-European Real Estate team combine restructuring, insolvency, debt, equity and tax experts with deep real estate experience across core and alternative asset types.

For details of the core BCLP team, see 'Meet the Team' below.

A&M

Alvarez and Marsal is an independent global professional services firm which has set the standard for helping organisations tackle complex business issues, boost operating performance and maximise stakeholder value.

- Adam Paxton, Managing Director, Co-Lead Restructuring Real Estate
- William Clark, Senior Advisor, Portfolio Advisory Group
- Jo Hewitt, Managing Director, Cross Border Restructuring
- Christian Ebner, Managing Director, Restructuring Head of Germany
- Rob Croxen, Managing Director, Co-lead Restructuring Real Estate

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