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CMBS and Real Estate Finance – responding to new investor demand

The European commercial mortgage market has seen a resurgence over the last two years, at least for prime properties and strong sponsors in the UK and Germany. The need to refinance large CMBS transactions has led to a series of new financings through bank syndicates, bond restructurings, new CMBS, high yield or secured bonds. Here Clifford Chance experts consider the shape of real estate finance today, including the shifting investor base, product mix and borrower demand.

The year 2013, after a few years of tentative growth, has proved to be the year when real estate finance came back with a bang, and the market now finds itself responding to genuine investor demand for real estate debt both through direct lending and via the capital markets.

In Europe we have witnessed the steady re-emergence of CMBS transactions, primarily involving single loan deals with strong sponsors, and often refinancings, but in some cases being new deals with less granular underlying properties.

Increasingly European real estate finance is attracting a new and more diverse lender base, given that the market was so dominated by bank lenders pre-crisis. The US real estate lending market has always involved a significant amount of insurance money, while debt funds and CMBS funds have also recovered well stateside. On this side of the Atlantic the investor base is gradually shifting now with UK clearing banks, US universal banks, investment banks from both the US and Europe, insurers, corporate lenders, debt funds, investment managers and hedge funds all moving into the space. We are even seeing some, albeit limited, interest from Chinese banks.

Each of these new investor bases comes to the asset class with a distinct exit strategy and different priorities. The debt funds, investment managers and insurers, for example, typically aim to hold loans until maturity, and so are more focused on fixed

interest rates for the life of the deal and long-term yield maintenance. By contrast, senior relationship lenders are often part of a club with no plans to syndicate the loan, and as such may be more focused on their lender and counterparty rights as opposed to exit strategies.

We are also seeing the return of senior lenders who are focused on documentation points that allow for exit by way of syndication post-origination, or through a CMBS or loan re-packaging.

Today's real estate investors are seeking much more information about the deals they are entering. Christopher Walsh, a partner in Clifford Chance's structured finance practice, says: "investors are clearly seeking greater levels of detail and greater levels of underlying involvement in the structuring of deals, but some care needs

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Christopher Walsh, Partner, Clifford Chance to be attached to that. We are looking at a much more savvy investor pack, asking much more pertinent questions, because people have learnt a lot over the last few years and understand how these structures can operate under stress."

Getting the details right at the loan documentation stage, from a swaps and a securitisation point of view, will help ensure options are kept open further down the line.

Getting the structure right

On syndicated transactions, the key derivatives points that need to be considered at the outset are the identity of the hedge counterparty, the creditworthiness of the hedge counterparty, and the hedge counterparty's rights, in terms of access to information, hedge termination and voting.

Emma Matebalavu, partner in the firm's real estate finance team, says: "the point at which the hedge provider can crystallise its position and close out becomes extremely important. Historically in the real estate market there were very limited rights, but as more people are coming into the market, we are seeing the hedge counterparties asking for more. It is crucial that the lending and the hedging desks within institutions speak to each other."

As a general strategic point we see people backing away from complicated hedging structures and instead moving towards interest rate caps. Christopher says, "people need to be cognisant of hedging mechanisms, which are an important feature to get right, both at loan level and allowing for syndication or securitisation."

When we look at some of the capital markets structures being employed, we find the US CMBS market is now very active and back to pre-crash activity levels, being used as a fundamental financing tool. In Europe, CMBS is slowly returning, and has been seen on a variety of deal types, ranging from whole business securitisations of operating businesses with real estate assets through to single large trophy asset financings and single loan multi property financings.

These transactions include both agency capital market financings, and true sale securitisations, but we have yet to see European CMBS backed by multiple loans which may re-emerge in 2014.

Documentation

Across the loan market there is a move to simplify documentation. At the peak of the boom, each law firm used its own template, but working out loans during the financial crisis proved complex as a result. Getting the lending markets moving again has proved too slow, expensive and complicated, and sponsors have complained of the costs and time being taken to do deals.

The market-wide consensus on a need for standard forms to increase efficiency and stability led the Loan Market Association to draft its own Investment Property Facility Agreement, Development Property Facility Agreement, and, coming soon, an Intercreditor Agreement.

Barry O'Shea, a senior associate in the banking and finance practice, says, "when these documents first came out, a lot of us thought they were essentially for the plain vanilla part of the market, so the straightforward investment property position with a bank lender. But the forms have proved more successful than we expected, and that's more efficient."

Nevertheless, the forms are nothing more than templates, and so will not work for every type of transaction. They are falling short in senior/mezzanine transactions, where debt funds or lenders are looking for yield protection, in addressing the lender/counterparty balance of rights, and for certain types of assets, such as hotels or loan portfolios.

The loan documentation is typically designed to allow for a CMBS exit, but there are still a number of loan-level documentation points that lenders should look to cover off if planning a CMBS exit. These include:

- Cooperation by the borrower group of future disclosure requirements of the lender (Reg S standard and Rule 144a);
- Day one and ongoing reporting requirements that may be needed by the capital markets, and regulators;
- Reliance on representation given to the lender, also able to be relied on by future arrangers and dealers;
- Reliance for future investors/SPVs on legal opinions and valuations and other third-party reports; and,
- Rating agency considerations.

Emma says "the disclosure point is key because, particularly in the current markets, and especially for single-loan deals, the level of disclosure is quite high. Not all borrowers will be anticipating that their loan agreement may be made public, which is what the Bank of England recommends for new CMBS transactions."

Future-proofing loan documentation is challenging when it comes to swap points, with rating agencies able to update their criteria with little or no notice. It is also important to look at the interaction between the collateral movements under the swap and the payments under the loan upfront, and also the scope of legal

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opinions. We are seeing the inclusion of provisions that permit amendments that may be required in the future to facilitate a securitisation, and also permitted amendments for regulatory reasons.

Regulating for the future

There are a number of key structural features that investors are looking for in the next generation of CMBS, most notably much simpler capital structures with simple pro rata and pari passu cash flow triggers. Class X Notes still survive, but investors are wary of them. We are seeing high ranking profit extraction mechanics but no reserve or liquidity support for such profit extraction securities, and it remains to be seen whether or not subordination on loan default or loan maturity will be required by investors on all deals.

We are certainly seeing greater control by noteholders of the special servicer and primary servicer, and enhanced reporting requirements both from day one and on an ongoing basis. The role of investors has changed, and cornerstone investors demand additional information upfront in pre-marketing, for example, which creates its own legal difficulties. The level of investor control over post-closing amendments, including rating agency criteria changes, is one area where there remain different schools of thought.

Against this backdrop, swaps regulatory requirements, which have always been an issue in the CMBS market, are now much more invasive and all-encompassing. The applicable requirements vary depending on the location of the swap provider, but the advent of The Dodd-Frank Act in the US and the European Market Infrastructure Regulation (EMIR) in the UK and EU raises new challenges.

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The rules causing us most concern under EMIR include representations as to the status of the borrower, which is an issue in terms of timing more than anything else. The need for a written agreement covering dispute resolution, portfolio reconciliation and portfolio compression is another new consideration, as is the need for timely confirmation and the new reporting requirement. Anne Drakeford, partner in banking and finance, says: "in practical terms we need to work out who it is in the structure that is actually going to do the reporting, because the sanction for not complying is a fine and most structures are not set up to deal with fines. And contrary to popular belief, there is no SPV exemption."

Another question is the impact that EMIR is going to have on the hedging strategies of hedging providers, because of the obligation to clear swaps on a hedge counterparty's own hedge. And finally there are risk retention issues – governed under Article 122a previously, which from January has been replaced by Article 405 of the Capital Requirements Regulation. We see the risk retention issues as solvable for CMBS, albeit probably not with a one size fits all approach.

Despite these uncertainties, there are clear signs of an uptick in real estate finance, and the return of CMBS looks much more encouraging than 12 months ago, driven by its pricing versus syndication.

Emma says, "lenders are beginning to be able to distribute real estate debt through syndication, portfolio sales that are ongoing, and CMBS. We have new regulatory constraints, and quite fast-moving documentation standards that are evolving as people get used to the market as it sits today. The return of tight timetables and execution constraints means there's a lot to think about from a legal perspective."

We are optimistic for a busy 2014.

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