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European real estate debt: Protection across market cycles

February 2019

For Investment Professionals only

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested.

At M&G, where we typically originate the majority of our real estate loans directly with borrowers, our underwriting process enables us to include tailored covenant packages that provide downside protection for our investors. Here we offer some insight into this process.

Investors in senior real estate debt benefit from a range of downside protections. The first is seniority, in the form of a first-ranking charge; the second is security over the underlying real estate asset, which includes a substantial equity cushion and also protects against potential falls in real estate values.

Covenants add further structural protections, which are incorporated in the contractual terms of each loan and can typically be customised to protect investor capital. These are bespoke and are determined as part of a rigorous investment process, where the debt is underwritten in a way that the investor benefits from safeguards which act as early warning signs in the event of any deterioration in cashflow, the credit status of the borrower or in the value of the property.

In the current market environment, with central bank interest rate rises being experienced or under consideration in many markets, the physical asset security backing European real estate debt can offer important protection and value for fixed income investors. The floating rate interest also available on a range of real estate loans can protect against a rising rate environment and offer valuable downside protection relative to corporate bonds.

Underwriting: testing cashflow durability

To assess new loans and the risks we as the lender are willing to accept, we undertake extensive due diligence as part of our underwriting process. This process contributes to determining the interest rate on the loan given the underlying risks associated with the asset. Analysis of the real estate asset's cashflow sustainability has two distinct elements: the capacity of the tenants to meet their rental obligations, which support the interest payments on the loan; and the capacity of the borrower to repay or refinance the principal at the end of the loan term. The former focuses on the quality of tenants, their income stability and the terms and length of their leases; while the latter focuses on the credit quality of the borrower for the debt, since in many real estate assets the tenants are not typically the borrowers of the loan.

We use scenario modelling to develop a projected cashflow profile for each real estate asset. For example, in an office building, the expected rent for each tenant in a building is forecast and modelled to create a total expected rental profile for each quarter of the prospective loan term. The model incorporates factors such as tenant entry and exit dates, void periods, rent reviews and projected rental and rent-free levels based on factors such as demand for floor space and pricing of comparable lettings nearby. We have extensive specialist resources that cover the real estate market and it is their job to understand the details around how particular industries work in certain localities, and these factors can also be incorporated when modelling cashflows.

Scenario analysis can be carried out to model the potential performance of the loan under a variety of macroeconomic and asset-specific scenarios to assess the impact of these stresses. The process stresses the asset's cashflow profile to establish the debt levels and interest rate shifts that it can sustain without a loan becoming impaired.

We understand the importance of stress testing assets to help our insurance clients evidence to the regulator how these assets perform in a variety of different market scenarios. This can involve testing changes in multiple factors such as estimated rental levels, void rates, tenant incentives, yield shift, changes in interest rates, and refinancing risk to name a few. Such assumptions are used to inform the credit rating process of the loan. This modelling factors feeds into the decision-making process to set appropriate covenant levels on the debt facilities, to ensure the lender is protected from declining rental income or value deterioration in stressed environments.

The real estate assets associated with a particular loan are typically held in a 'special purpose vehicle' (SPV) to ensure that the property assets are legally separated from other assets and liabilities of the borrower. There is recourse to the assets ringfenced within the SPV, therefore providing direct access to the lenders to the property, the tangible collateral which protects investors in the event of a downside scenario.

Building in covenant protection

When originating real estate loans, setting bespoke covenants on an asset by asset basis is a key risk management tool. Covenants enable a lender to closely monitor the performance of loans, provide early signals of deterioration, and obtain better recoveries from assets in the case of a default.

At M&G, we work with real estate borrowers to agree bespoke covenants for each transaction. These typically include value-related metrics such as loan to value (LTV), income-related metrics such as interest coverage ratios (ICRs), as well as property specific covenants. Credit metrics such as debt yield, debt per square foot and EBITDA are analysed upfront, continuously monitored throughout the loan term and are tested for compliance, typically by annual revaluations of the properties and quarterly cashflow statements.

LTV covenants protect investors from property value deterioration. This is particularly significant at times when property markets may be volatile, as the LTV of an asset may drop significantly if the market value of a property falls. They enable a lender to act in cases where real estate value declines to a point where the senior loan balance is higher than a pre-set percentage of the asset value.

For example, if the senior debt has a starting LTV of 55% and the covenant is set at a level that allows headroom above that, such as 65% LTV, a 15% fall in the property price would push the senior debt to 65% of the property value and trigger the covenant, allowing the lender to step in and enforce action. The goal is to ensure senior lenders' principal is not threatened by falls in real estate values whilst the borrower is still incentivised to find a cure to protect their equity investment.

Many lenders in this market focus solely on the LTV ratio of an asset. However, the LTV associated with a property can be relatively volatile, making this an unstable metric to base an investment decision on. We therefore believe it is important to complement LTV covenants with additional forms of protection, as well as considering the credit rating of an asset when deciding to invest.

Interest coverage covenants (how many times the interest due on the loan is covered by the rental payments made by tenants) can also be used for protection against rental income risk. They are based on the modelled projected rent and set with a degree of headroom.
They enable a lender to act should the income from the real estate asset fall below the prescribed percentage, such as in the event of a tenant breaking their lease obligations.

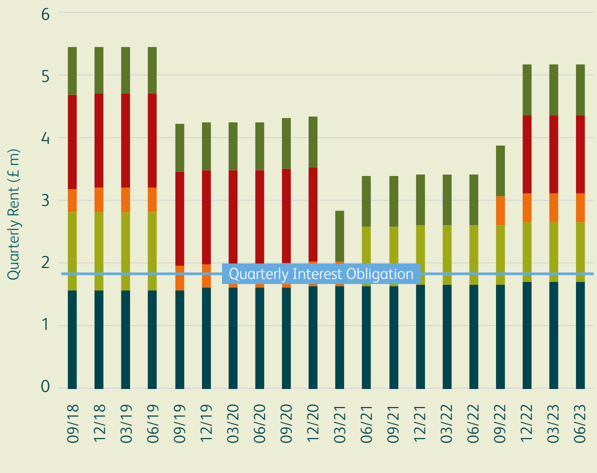
A **cash sweep** can be built in should there be a modest deterioration in the property value or income, forcing the borrower to use any excess cashflow from the property to pay down the loan principal.

Default covenants are set at a level below the modelled base case scenario, with a breach occurring after a greater deterioration in property value or rental income. This would typically breach following a cash sweep trigger, and serves as a sign of distress. The borrower usually has the right to repay enough of the loan to cure the covenant breach, but if they are unable to do this, the lender has the right to assert more control over the property's operations or even force a sale for repayment.

Scenario modelling example: interest coverage covenant

In this example, we consider a hypothetical financing request for a five-year senior loan at 55% LTV secured against a London city office valued at £500 million, which equates to a senior loan (notional) of £275 million. The property has five tenants so we have undertaken scenario modelling on these to build a projected rent schedule for the asset over the five years of the loan. The projected rental income from the total asset therefore looks like this:

Projected rent schedule



Tenant 1

- No lease events assumed during our loan term
- Rents increase annually with RPI
- RPI is modelled by taking a conservative view relative to quoted 5-year GBP RPI swaps: in this case at 1.50% pa

Tenant 2

- Assume tenant breaks lease and vacates in September 2019
- It is assumed the space is then void for nine months, at which time it is relet
- The new tenant is granted 12 months' rent-free incentives at the start of the new lease in June 2021, so the first rental payment is received in September 2021
- It is assumed the space relets at ERV of £50 psf, which is 33% below the current rental level

Tenant 3

- Rents increase annually with RPI
- Assume tenant breaks lease and vacates in June 2021
- New tenant enters lease in September 2021, with a 12-month rent-free period, so begins paying rent in September 2022
- The new rent is at ERV of £50 psf, which is 19% higher than day-one rent

Tenant 4

- Assumed that tenant vacates at lease maturity in March 2020
- Assume nine-month rent-free and 12-month void period, so new tenant begins paying rent in December 2022
- Current lease is 20% over-rented, so new lease is below day-one rental level

Tenant 5

- Has rent review in September 2020, at which time rent reverts to ERV of £50 psf, which is 8% above the current rental level
- No lease events during loan term, therefore cashflows are projected to be stable

Source: M&G, illustrative (ERV: estimated rental value; psf: per square foot)

This loan has an annual interest of £7.6 million, which as the projected cashflow profile above shows, can be paid throughout the loan term from the rent roll with headroom.

The day one interest coverage ratio[1] would be 2.9x, but it falls to a low of 1.5x in March 2021, when tenants two and four have both exited their tenancies and there is some vacancy in the property.

To protect investors against the risk of interest non-payment, we would seek to insert a cash sweep covenant set at 1.7x, which would be activated before rental income declines to the lowest projected point. This would allow lenders to divert all excess cashflow generated by the property above this level towards covering upcoming interest payments and repayment of principal. The cash sweep ensures that lenders can deleverage the loan whilst there is still meaningful excess cash being produced.

We would also insert a default covenant, set at 1.4x, which would be breached if interest coverage fell below the base case illustrated above. A breach would give lenders the right to accelerate the loan by requesting repayment of the loan in full and ultimately take enforcement action to sell the property should this be necessary.

[1] For ease of illustration, ICR has been calculated based on headline rent rather than NOI (net operating income). In reality, consideration would have to be taken of void costs and other deductions.

Credit ratings and impairment situations

M&G has been assigning internal credit ratings to public and private assets for over 20 years. For all assets, this rating is approved by a credit committee, which analyses the credit risks and categorises the credit within a rating structure consistently across all asset classes. The process for each area of fixed income is slightly different, especially in the case of private assets where the existence of structural protections may give a lender greater visibility and control if there are any warning signs, and seniority, security and covenants are all considered.

Credit quality is continuously monitored and any investments that are 'on watch' are referred to the Minor Problem Credit Committee, in a situation where a borrower looks like they may be close to hitting any of their covenants or if there is credit deterioration but no near-term expectation of default.

If a company faces a potential default, significant risk of loss or an imminent restructuring, it is then referred to the Major Problem Credit Committee whilst further action is taken to ascertain what is necessary to protect the investment and maximise investor value. We typically set the levels of financial covenants relatively tightly to ensure that if a breach occurs, it is likely to occur at an early stage of deterioration, so the borrower engages early when they still have a significant amount of equity at risk. This means borrowers are more likely to work with the lender to cure the issues by, for example, injecting more equity in the transaction.

At M&G, there is a dedicated restructuring team on the investment floor that can step in early to remedy such issues by working with the company where they may take a majority share of the company to work with them in order to enhance recoveries and minimise any potential negative impact on our client portfolios.

Collateral and Solvency II considerations

Real estate debt offers stable cashflows, backed by the security of the underlying real estate, which is attractive for insurers looking for high quality income streams. To add to this security, bespoke covenants for each asset aim to give additional protection by acting as early warning signs in the event of borrowers struggling to repay and/or there is deterioration in the value of the property.

Bespoke analysis can be carried out to understand economic risks and assist insurers with their Own Risk and Solvency Assessment (ORSA) under the standard model. The capital treatment of real estate debt investments can also be favourable for investors due to the existence of tangible collateral backing the debt and can offer a lower spread risk charge under the standard model, relative to a similar-rated corporate bond.

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The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. Where past performance is included, please note that this is not a guide to future performance.