

The Way Forward: A European Perspective

December 30, 2021

In this the final edition of *REF News and Views* for 2021, we attempt to summarise the key movements and market activities we have seen within the European real estate finance sector – how this both impacted 2021 and how it is likely to continue/change in 2022 and moving forward in the short/medium term. This article also introduces a number of topics on which we intend to focus further legal commercial analysis in 2022 as liquidity continues to drive competitiveness and climate change continues to impact commercial decisions and the legal/regulatory environment.

Anyone who has attended, either physically or remotely, some of the keynote speeches at flagship Real Estate conferences around Europe in 2021 (such as the INREV conference in Stockholm) will have heard a lot of information about the “bounce back” we have seen both in Europe and internationally further afield in our sector – a bounce-back fueled by unprecedented liquidity and capital investment chasing product. At every level, whether it is consumer spending on the High Street or capital deployment of savings funds, the activity has been frenetic. Sale of durable retail goods (essentially, people spending on their homes) rose on average around 25% in 2021, an increase that has not been seen since 1946, as people have started to spend again. As the High Street reopened, spending came back quickly in certain areas. A lot of analysts have been quick to say that this was not a “recovery” because there was no true recession in 2020 but rather the world economy simply went on a European-style “grande vacance” during 2020, shut down by the fear of COVID, and simply re-opened.

High Street spending will undoubtedly help our ailing retail sector. The question is whether the spend on durable retail goods will further cascade into general retail spend. We have seen a lot of retail park loans being placed within commercial lenders’ special servicing teams, and whilst there has been a recovery within the sector, there is a need for Funds to look at repurposing assets. After all, there are only a certain amount of shopping centres that can be converted into residential. We believe Borrowers and Lenders will need to work together in consensual exit strategies to maximise recoveries and performance.

The good news is that, from the new lending perspective, there is a lot of capital being deployed into strongly performing Real Estate, including significant specialist sectors like Life Science, Data Centres, and Specialist Healthcare, as well as certain undervalued/oversold Retail, with new Funds coming from around the world. Bond issuance has been strong also. The coupon attached to unsecured corporate Bonds (working off slightly lower leverages and higher income covenants) is often more attractive than traditional Senior Lending mortgage finance. It may seem counter-intuitive and, in many cases, too good to be true, but these deals are out there. The cost to Funds/Borrowers in issuing these Bonds is not only lower, but often results in a lot less internal reporting and maintenance, as the covenant packages attaching to Bond finance are essentially more “covenant light,” with financial covenants and negative pledges being relied upon and less Lender involvement at the individual property asset level. Given the majority of traditional senior debt mortgage lending into European deals is still done on a limited recourse “special purpose” basis, it is often quite straightforward to issue bonds to refinance existing structures without substantial costs in creating new standalone structures. We would be delighted to discuss with our clients ways in which this can be achieved.

It would be remiss to sign off on 2021 from a REF perspective without touching on climate change. Legal requirements/regulation will undoubtedly increase and must shape part of our decision-making processes in the REF sector. De-carbonisation will have an impact on yield. More stringent regulation on de-carbonisation is inevitable given that Real Estate accounts for roughly 40% of global greenhouse emissions. Relying on carbon taxes is short term. It is fair to say that the overwhelming consensus is that carbon taxing will just slow down the same destruction of our climate, so essentially the time for these measures is over. There has been much talk about the 2020s being the period for effecting sustainable investment strategies now. Essentially, the message seems to be that the time for talk is over – we must act. Importantly, this seems likely to have an impact on valuations in the near future, since few buildings are

currently valued on a basis that includes de-carbonisation costs. Another trend we expect to see is an increased focus on repurposing existing buildings rather than new build.

In particular, we believe that Lenders and Borrowers need to look at the cost of transition so that they are not left behind with stranded assets due to climate change. This means diversifying risk within portfolios, looking at ameliorating insurance obstacles, etc. and looking at ESG plans. Funds are likely to have more stringent action plans demanded by their investors/government and regulation, and failure to comply could have very damaging impacts. European funds and investors in particular are reallocating capital towards climate- and ESG-friendly funds and strategies at a significant pace, and the EU's sustainable finance regulations and taxonomy are already making their impact felt.

Finally, we would like to wish our readers a happy and prosperous 2022 and look forward to continuing to work with you.