DISTRESSED SELLERS WISE UP

A new realism among vendors is one of the forces helping to unlock distressed real estate opportunities in Europe

BY **JUDI SEEBUS**

'A big wave of American investors is looking at distressed opportunities in Europe'

Jos Short, chairman Internos Global Investors

1. ARI DANIELSSON, MANAGING DIRECTOR REVIVA CAPITAL 2. BEN CAIRNS, PARTNER RESTRUCTURING ERNST & YOUNG 3. MATHIEU ROLAND-BILLECART, PARTNER REAL ESTATE CORPORATE FINANCE ERNST & YOUNG 4. AUDIENCE PARTICIPATION 5. TASSOS KOTZANASTASSIS, FOUNDER AND MANAGING DIRECTOR 8G CAPITAL PARTNERS 6. DAVID RYLAND, PARTNER SJ BERWIN (LEFT) AND JOS SHORT, EXECUTIVE CHAIRMAN INTERNOS GLOBAL INVESTORS

PHOTOS: KARLA GOWLETT

A number of factors are helping to create a better environment for unlocking distressed real estate opportunities in Europe, according to Mathieu Roland-Billecart, partner real estate corporate finance Ernst & Young. Speaking at the PropertyEU Distressed Investment & Workout Briefing hosted in London at end-May by law firm SJ Berwin, Roland-Billecart said a steady flow has so far failed to materialise as swap structures have blocked transactions in some cases. 'There has been a lot of noise out there but there are also a lot of good properties locked into bad capital structures. The forces are now pushing in the right direction and prospects are improving.'

A key change that has taken place in the last 12 to 24 months is that vendors have become more realistic and sales conditions are improving, agreed David Ryland, partner funds & indirect real estate at SJ Berwin. Just two years ago, German bank Westimmo tried to sell a big loan book but there was virtually no interest and ultimately the deal with Apollo fell through. At the time, Westimmo was not willing to accept a hefty discount, but that is now changing, Ryland noted. 'The performing loan market is becoming quite important as well. The joint venture looking at Eurohypo's UK loan book is trying to acquire both performing and non-performing loans.' Indeed, media reports suggest Eurohypo has received five fully funded bids for its performing and non-performing UK loans. In another sign that appetite for larger loan books is increasing, Deutsche Bank has also put its UK loan book on the market and more are rumoured to follow. A new realism is also becoming visible among vendors of sub-performing loans, Roland-Billecart said. 'At least they are now willing to enter into discussion. It's an interesting part of the market.'

WAVE OF AMERICANS

During his introductory presentation, Roland-Billecart singled out four key pools of potential opportunities for distressed real estate: banks loans, maturing CMBS structures, overleveraged borrowers and corporate insolvency. In terms of opportunities, Jos Short, executive chairman of Internos Global Investors, has his sights firmly fixed on the European hotel sector. His company,

TOP INVESTMENT PICKS

Asked how they would spend a theoretical €500 mln, the panellists made the following choices:

JOS SHORT (INTERNOS) would look for operating businesses 'stuck in banks', particularly in the hotel and healthcare sectors. The consolidation of the real estate investment management arena also offers potential. 'The real estate investment management sector is oversupplied...I would use some of the money to buy up other REIM companies and squeeze the synergies out of that.'

DAVID RYLAND (SJ BERWIN) would not invest in loan portfolios, but added that distress was not limited to the bank market. German open-ended fund managers are in distress as well, he pointed out. 'Focusing on the opportunity area offers the most upside, it's a very good time for that strategy. The time for core has come and gone.'

MATHIEU ROLAND-BILLECART (ERNST & YOUNG) would buy a loan book. 'Not non-performing loans, that's too much hard work. I would go for sub-performing loans with a 70-90% LTV with potential returns in the high single digits. I know vendors are thinking about it.'

SOURCES OF DISTRESSED PROPERTY

BANKS
- Loan sale
- Asset sale
- 'Lenders led solutions' with new capital

CMBS
- Influencer in asset sale at maturity or insolvency
- Recapitalisation

OVER-LEVERED BORROWERS
- Recapitalisation
- Discounted Pay off
- Asset sale

INSOLVENCY SITUATIONS
- Asset sale

SOURCE: ERNST & YOUNG

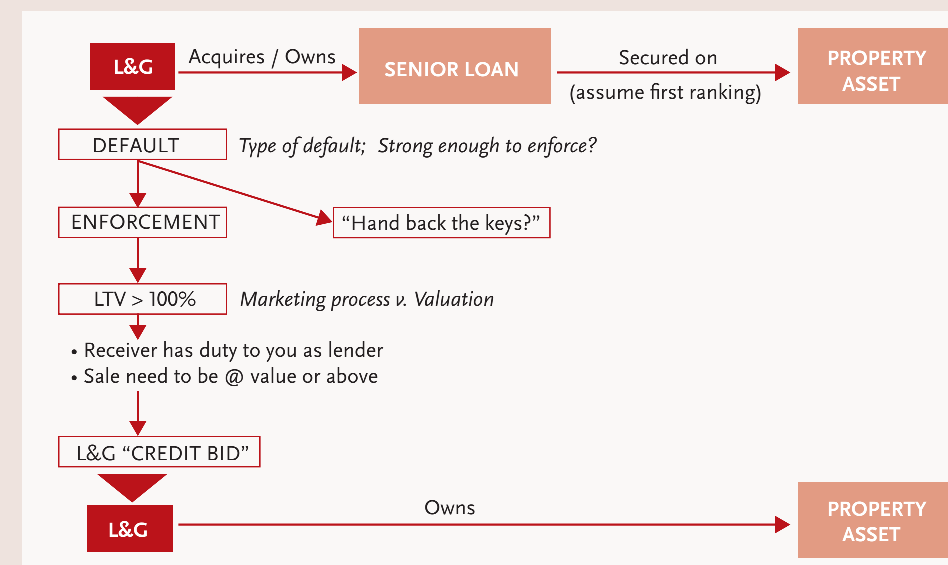
FROM EMERGENCY ROOM TO VALUE RESURRECTION

Key lessons on operations:
1. Banks (staff & infrastructure) not normally well-equipped for workout
2. Retain key staff and recruit new staff with hard asset and transactional experience
3. Incentivise and align team – maximise value, not minimise losses. Align commitment time of staff to expected workout timeline
4. Invest in infrastructure and get organised
5. Streamline decision-making

Key lessons on workout strategy:
1. Be proactive – be first on site, but carefully prioritise your focus and time
2. Get facts straight – dig deep
3. Focus on the underlying asset – get control of cashflow ASAP
4. Explore voluntary arrangement before legal routes
5. Think like equity, not debt
6. Senior debt is king – make friends, not enemies. Solve their situation to solve our clients situation.
7. Don't throw good money after bad – know when to stop.

SOURCE: REVIVA CAPITAL

REAL ESTATE 'LOAN TO OWN' CASE STUDY



KEY DEAL CONSIDERATIONS
- **Default:** Type & Timing
- **LTV:** Does the value clearly break in the debt?
- **Security package & Jurisdiction:** Impact on whether and where you can enforce & on enforcement plan
- **Hedging & impact on waterfall**
- **Tax:** Risk of value leakage

OTHER CONSIDERATIONS
- **Reputation**
- **Resources to convert loan**
- **acquisition into asset-owning position**
- **Partnering**
- **Identifying opportunities**

SOURCE: ERNST & YOUNG

which was formed in 2008 and bought GPT Halverton for €2 in 2009, now has 80 staff managing €2 bn in assets. Internos also manages portfolios on behalf of American investors: 'A big wave of American investors is looking at distressed opportunities in Europe. Some of them are names you've never heard of.' The wave of American investors includes players like Oaktree and Varde but also Blackstone, Short added. 'Blackstone has said that Europe is where it's going to play. For vendors of loan books this is good news.'

ASIAN APPETITE

Besides Americans, Asian investors are also showing more appetite, Roland-Billecart said. 'Asia is coming in quite strongly. For Japanese investors who can get only 1% yields on bonds in Japan, 6% returns sound quite sexy. Even pension funds are looking at some single-asset situations. The market is getting deeper and broader.'

In terms of sources, Roland-Billecart believes the UK and Ireland will generate 80% of the NPL deals coming through in 2013. NPL opportunities will not feed through in Spain until 2014, he predicted. 'It is taking so long for Sareb (Spain's bad bank, ed.) to set up. There will be opportunities before then, but it will be another 12 to 18 months before it starts going in a big way.'

But while the NPL sector does offer some attractive opportunities, investors need to proceed with caution, Short warned. 'A health warning comes with the NPL sector. The question investors need to ask is: how are the early deals performing for the buyers? Good assets tend to trade out pretty quickly and there's a lot of secondary and tertiary product that has been starved of capex. The structures are typically distressed, so the issues are in the structures, particularly in Europe. But that makes it difficult to get out of them. For some of the earlier buyers, it's not going as well as they had hoped.'

Valuation of the assets underlying secondary and tertiary loans is also a thorny issue, Short warned. Since the early sales, discounts have increased, he pointed out. 'You have to work the graphs and find the crossover points. It's not all a bed of roses. Some investors are suing the valuers.' Pointing to Portugal, Short cited an example of a loan sale in an asset class where no single transaction had taken place in 2012. As a result, the valuation included a clause citing the 'market conditions' – which freely translated means the asset cannot really be valued, he pointed out. 'A lot of people are putting teams in Iberia, in Spain and Portugal, but it's scary.'

Secondary and tertiary assets are inherently difficult to value, agreed SJ Berwin's Ryland. 'There's a big difference in what you might get from a particular auction and the sale of individual assets. Returns from wholesale to retail are much harder to realise. There are some easy gains initially, but often a big tail.' Often it is also very difficult to predict how the other members in a highly structured vehicle will behave, he added. 'Syndications are like the hedge market, it's often difficult to know how they will work out.' While the underwriting of many distressed loans is not perfect – 'it never is' – there is a lot of good news for distressed real estate investors, the panellists agreed. 'There are some very interesting deals,' Short noted, pointing to 'very aggressive' US hedge fund buyers. 'Some have made a tonne of money. What you need are decent operating businesses that are in the wrong structure, for example healthcare and hotels. If you play the Harry Potter card, you will make money. But the risk on those sorts of deals is way higher. If you get it right, you can make a tonne of money, but if you get it wrong, you can lose your shirt. It's very binary.'

TIGHTER PRICING

While vendors are becoming more realistic about their pricing expectations, the increased competition from US investors and other players is also oiling the sector, Roland-Billecart noted. 'The pricing is getting tighter. There are some big auctions on the cards and new names coming through. The competition is working wonders for bank loans. I don't know to what extent it's affecting pricing, but it works great for the vendors. Investors are becoming more picky, but it's not a vendor problem. There are more names to replace them.'

Rising servicing costs are also forcing banks to take action, Ryland noted. Loan servicing entails significant overheads, he pointed out. 'I can't see them holding stuff on a long-term basis.' Echoing Internos' Short, Ryland said he sees opportunities in the hotel sector in particular. 'That's a big activity, banks can't put up the capex and are more inclined to seek a resolution by writing off the equity and re-incentivising the management.' Banks are also getting a bit more 'ballsy' in their discussions with owners or incumbents, Short noted. 'They're having some tough discussions and replacing the egos. That wasn't happening for the last three years.'

In terms of sources, some bigger non-core loan pools and portfolios are feeding into the market in the UK. And with some fund vehicles reaching the end of their life, Germany, the Netherlands, Spain and France are also offering opportunities, Short noted. 'Spain and the Netherlands is where you would start.' Hotels and leisure are key areas, he added. 'We're definitely looking at that.'

Health warnings should be in place, however, for some markets, Short said. 'A lot of Dutch real estate is commanding net initial yields of 12-15%. But the Dutch market is structurally under-demolished. In northern Europe the most challenging market is the Netherlands.' The industrial and office sectors are particularly challenging, he added. 'You may be able to do a sale-and-lease back with an occupier or local heroes for assets of up to €10 mln, but beyond €10 mln, there is very little bank debt. Dutch banks were badly damaged in the crisis and the German banks have decided that the Netherlands is non-core. But the German open-ended funds are leaving so there are opportunities.' ■

SIGN UP NOW FOR 2013 INVESTMENT BRIEFINGS

4 June | UK
4 June | Germany
4 June | European residential
5 June | Netherlands

For more information, go to www.propertyeu.info