ROUNDTABLE

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Alternative lenders eye a greater slice of Spain's property debt market

Participants in Real Estate Capital's virtual roundtable on the Spanish market expect the pandemic to reshape the profile of the country's real estate lending market. Eugenia Jiménez reports

The government of Spain, one of the European countries hardest hit by the first wave of the coronavirus, announced sweeping measures on 25 October aimed at combating a new surge in the number of cases. It imposed a nationwide curfew and triggered emergency powers after the country's infection rate jumped by almost a third over the previous week.

Economists have warned that the restrictions are likely to undermine Spain's economic recovery. According to the Spanish Statistical Office, gross domestic product was up 16.7 percent in Q3 but output was down 8.7 percent overall at the end of Q3, compared with the same point in 2019. From being one of the eurozone's fastest growing economies before the pandemic, Spain's economic outlook is now highly uncertain.

Its real estate sector was also experiencing healthy levels of activity before the pandemic. Investment volumes in the first quarter of the year reached €4.2 billion, 54 percent up on the same period in 2019, according to consultancy CBRE. In contrast, the Q3 volumes of €1.4 billion were down 65 percent year-on-year.

A year like no other

Real Estate Capital's 2020 Spain roundtable, conducted virtually with four market specialists, revolves around how deeply the pandemic has affected the liquidity of real estate finance and how covid-19 will ultimately reshape the country's property lending market.

Alberto López, managing partner and co-founder of Urbania International, who is responsible for the Spanish investor, developer and asset manager's equity and borrowing activities, says covid's impact on the availability of debt has been huge.

Most domestic banks are focusing on refinancing existing loans, he explains. "For people who want to develop or invest in new schemes there is limited traditional financing available, and it is non-existent in cases," he says. "The number of active banks in the market has narrowed, with a couple of domestic banks doing most of the lending. Smaller banks that were active pre-pandemic are barely lending now."

José García, managing director at London-based Aexx Capital, an alternative lending platform launched last year, says covid has triggered a change in the country's real estate cycle. A reduction in banks' appetite to lend to the sector, he argues, is creating opportunities for alternative debt providers.

"We have witnessed situations in which banks have either walked away

José García
Managing director, Aexx Capital

García took on the role of managing director at the London-based alternative investment platform in 2020. Aexx Capital, founded in 2019, focuses on real estate debt opportunities across Western Europe and has provided around €100 million in loans. It offers whole loans, mezzanine and preferred equity. Prior to joining Aexx, García was a director at Chenavari Investment Managers, a European credit-focused asset manager.

Alberto López
Co-founder and managing partner, Urbania International

López has overall responsibility for alternative investments at the multi-asset real estate investor, developer and asset manager, which focuses on southern Europe. He is involved in the execution of deals, including origination, underwriting, financing and asset management. He previously owned a real estate investment company in Brazil.

Álvaro Otero
Head of real estate and construction, CMS Spain

Otero specialises in advising the national and international clients of law firm CMS's Spanish branch on the acquisition and sale of real estate companies and assets. He has extensive experience in sale and leaseback operations, leases of commercial premises, hotel and office transactions, development and construction contracts, as well as the financing and refinancing of real estate companies.

Paloma González
Director, real assets and alternative assets, Sanne Group

González is based in the Madrid office of Sanne, a UK-headquartered provider of alternative asset and corporate administration services. She is responsible for driving the company's European offering – including fund, corporate and loan agency services – to a variety of clients that invest directly or indirectly in real estate and alternative assets. She joined Sanne in 2019 from financial services firm CITCO, where she led the Madrid office for 12 years.

from or changed the terms of deals that were agreed before the pandemic struck," he says. "Going forward, banks will be more focused on other businesses such as corporate transactions. They need to be more efficient and will focus on existing clients, meaning they will give up even some low-risk real estate lending opportunities, offering alternative lenders like us the potential to position ourselves on transactions that we would have been unable to source two years ago."

Accepting alternatives

Alternative debt providers, including credit funds, insurance companies, and private equity investors, were already expanding their footprint in Spain before the pandemic. The roundtable participants agree that the dislocation in the Spanish lending market will create more opportunities for non-bank lenders to establish themselves as vital sources of real estate credit.

Álvaro Otero, partner and head of real estate and construction at law firm CMS Spain, advises clients on financing options including private debt and traditional bank finance. He says that the growth of non-bank lenders in Spain in recent years has been made possible, in part, by a reduction in the stigma that was once attached to them.

"There was a general feeling in the market that you just looked outside traditional banks for financing if you were in trouble," he says. "People are realising now that alternative capital is a funding source with no more catches than bank financing."

However, he says banks remain active in Spain, to a degree: "I am currently dealing with a transaction where the asset is being backed by a Spanish bank, another by a German bank, and another by an alternative lender."

Paloma González is a director at the Spanish arm of alternative asset and corporate services provider Sanne Group, with a focus on real assets. She predicts an increase in activity from the sort of private lending funds that her

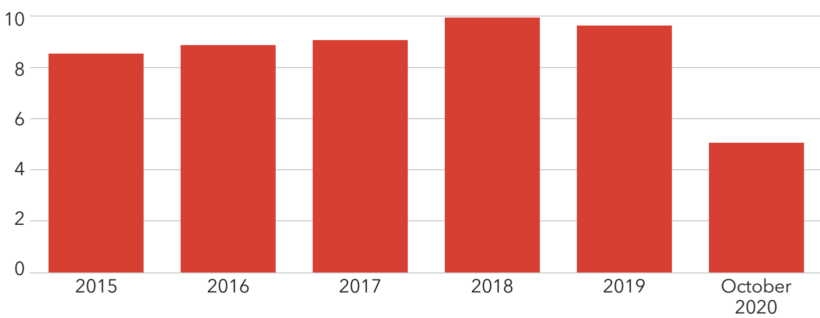
"I am now seeking distressed assets to deploy opportunistic capital, but the market is not there yet on a big scale"

ALBERTO LÓPEZ
Aexx Capital

"We foresee an interesting period for alternative players and opportunistic funds, which entered the market in the aftermath of the global financial crisis but left it some years later once it became expensive for them"

PALOMA GONZÁLEZ
Sanne Group

Investment volumes have declined significantly as a result of the pandemic and lockdowns (€bn)



Figures include only direct investment activity, excluding corporate deals, plots of land, debt, asset transfers and acquisitions for own use (except hotels)
Source: Savills Aguirre Newman Research

company provides services to, including the return of those that made high gains in the early years of the Spanish market's recovery during the last decade.

"We foresee an interesting period for alternative players and opportunistic funds, some of which entered the market in the aftermath of the global financial crisis, but left it some years later once it became expensive for them," she says. "Now could be a good opportunity for them to invest, for example, in the troubled hotel industry."

However, Urbania's López believes Spanish sponsors and foreign non-bank lenders are still in the process of learning how to deal with each other.

"I see lots of lenders, targeting double-digit returns, which are not very flexible in the product they offer, and others seeking single digit returns, which are not flexible at all," he says. "Everybody plays by their books with a similar structure for all the different markets. The ongoing educational process means sponsors need to better understand lenders' requirements. But lenders also need to better understand sponsors if they want transactions to go through."

The roundtable participants expect banks to further retrench to more conservative transactions over the next 12 to 18 months. García says domestic banks already have limits as to what they will finance and are unlikely to provide debt to properties such as hotels, assets in transition or land purchases. "All Spanish banks have the same school of thought and tend to compete for the same transactions. We have seen a few low-risk profile deals that banks simply do not want to provide finance to."

Distress is looming

The discussion turns to how Spanish borrowers are coping with the impact of the pandemic. Unprecedented levels of government intervention and support for businesses mean a clear view on how many borrowers are in genuine distress and have defaulted on their debts is unlikely to be possible until 2021.

González expects Sanne's real estate investor clients on the equity side of the market to come under pressure. "We expect some tough months ahead," she says. "So far, our clients have been focusing on refinancing their loans, but we have some clients that will not be able to repay their debt obligations or fulfil loan covenants. We are seeing a lot of waiver requests. Uncertainty around the extension of social restrictions in Spain just adds to this."

Across Spain's banking system, distress is likely to start becoming apparent at the end of Q1, the participants noted. Banks are currently supporting small businesses and self-employed people through credit lines guaranteed by the public sector. At the time of publication, it was unclear when this support would be discontinued.

"When the grace period on Spanish government-backed loans expires, borrowers will have to start paying their debt, so we are likely to see the first wave of distress coming to the market. We might, though, wait a bit longer to see this happening," says García.

Until that happens, banks will not be able to start working out the scale of the assets on their books that have defaulted and that can therefore be sold on to investors as non-performing-loans. "Banks will need to provision all these NPLs before they bring them for sale to the market," says García. "They need to have a high level of provision, otherwise they would be selling at a loss."

In recent years, Spain's banks made progress in offloading their legacy NPLs through large-scale loan sales. Data from investment banking advisory firm Evercore show €49 billion of loans and lender-owned real estate was sold during 2018 and 2019. However, only €2.2 billion of legacy Spanish assets changed hands during the first half of 2020.

CMS's Otero argues that although it is still early in the cycle to see a new

Compelling sectors

The participants in our Spain roundtable tell us which property sectors look like good business, despite covid

José García, Aexx Capital: "Alternative residential assets, such as student accommodation, senior living or build-to-rent apartments, are offering stable cashflows, which is what lenders want to see in order to finance them"

Paloma González, Sanne: "The logistics sector is a clear winner of the pandemic. If a sponsor wants to sell an asset rented to Amazon, for example, it will have plenty of financing options to choose from"

Alberto López, Urbania: "Student housing will continue to provide yield for real estate investors. Assets are yielding 4-5 percent, which is solid and attractive. Also, the level of occupancy is just 5-8 percent down despite the crisis"

Álvaro Otero, CMS Spain: "Logistics is in the spotlight and it is expected to remain so in the near future. Alternative asset classes, such as nursing homes and student accommodation, have also been resilient to the crisis and are attracting interest" wave of Spanish NPL transactions, potential buyers such as opportunistic private equity funds are already looking for opportunities. "The underlying real estate in some hotel-backed debt transactions, for example, is probably good," he says. "Occupancy might just be temporarily affected, meaning some investors see this type of NPL as a good opportunity. But banks will not be ready to sell NPLs until the end of 2021."

New lending terms

Despite covid's impact on liquidity in Spain's real estate lending market, some loan deals have closed in the country since the end of March. In such cases, the roundtable participants report, the lending terms on offer were highly dependent on the property sector of the underlying asset.

López says that during the pandemic Urbania has closed two loans from Spanish banks secured by student accommodation properties. "The pricing increased by 100 basis points across both loans, to reach 300bps," he says. "But beyond that, they did not touch the structure of the deals."

He adds that the loan-to-value and loan-to-cost ratios on offer have been reduced, although not dramatically: "I would say lenders are trying to charge more money than pre-crisis on the same assets but have not touched loan terms. But on the development side, they have not increased spreads much, or touched loan conditions. Going forward, they will be more conservative because of pressures on their balance sheets, meaning higher margins are likely."

In González's view, the loan conditions offered by Spain's banks remain largely unchanged, although the profiles of the deals they are willing to finance have narrowed. "Lending terms have not dramatically changed because, among other reasons, some banks do not even consider certain asset classes," she says. "They are offering similar terms to pre-crisis in those sectors that grab their attention."

García argues that the banks' conservative approach to new loan origination means there is demand from borrowers for bespoke and flexible loan structures, which firms like his are aiming to provide. "We consider whether there is a sound business plan behind the deal, and whether we can be aggressive on LTV or LTC," he says. "We are not very aggressive on the amount of money we advance, but we are flexible on the terms."

Looking forward, the participants expect the availability of finance to vary by sector. Most agree logistics and subsets of the residential market such as student housing will remain popular among lenders.

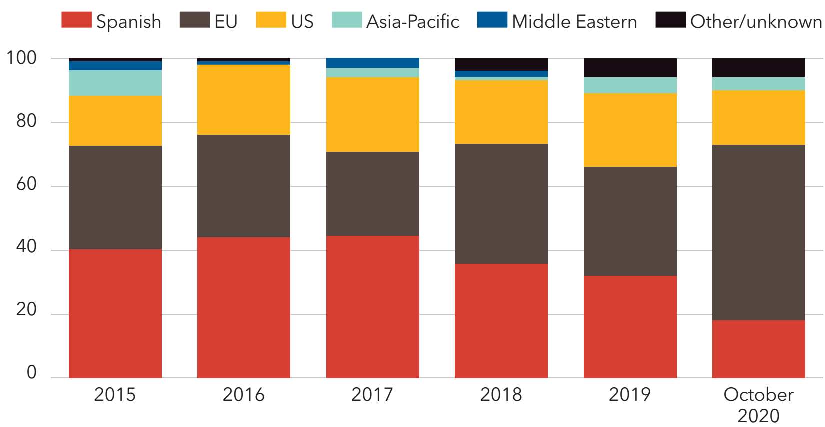
No place like homes

However, López says it may become more challenging to source residential development finance as banks focus more keenly on location while demanding a higher percentage of pre-sales before backing any scheme: "Despite ultra-low interest rates, the economic crisis will have a significant impact on the capacity of people to apply for new mortgages and buy new homes, which will definitively change their buying appetite towards the rental market." He says there has been a drop in sales for the residential development projects in Urbania's portfolio.

"Banks will demand more pre-sales going forward," he says. "Before they were lending with a 50 percent level of pre-sale in a building, but this will increase."

According to Otero, the supply of debt to office properties will also be highly dependent on the location of the assets. "Transactions are happening in the office sector for properties with a good rate of occupancy," he says. "The owners of such offices are securing finance, although on core locations."

The proportion of domestic investors in Spanish real estate has decreased since 2017 (%)



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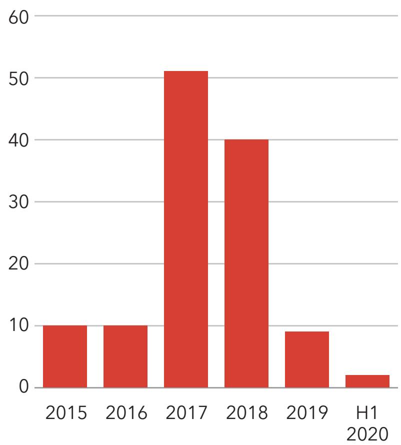
Source: Savills Aguirre Newman Research

Sales of Spanish real estate loans and lender-owned property had already declined from before the onset of the pandemic (outstanding principal balance, €bn)



Source: Evercore

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CMS Spain

Otero believes the office sector will emerge from the crisis in good shape: "The working-from-home trend will be compensated by the need for tenants to continue to rent pre-pandemic volumes of floorspace due to the needs of social distancing."

García admits he is concerned about the office sector's future performance: "The key will be to really know the operating partner that manages the office space, and having confidence that it is capable of keeping occupancy levels high with a sustainable rental level to ensure buildings' tenants are able to pay their rents."

Retail, by contrast, is a sector the participants are wary of. They agree that as more goods change hands online, bricks-and-mortar shops will carry less appeal and therefore attract less investor interest. Yet although retail assets, as well as hospitality, will be the sectors hardest hit by the pandemic, some higher-risk investors will also see them as an opportunity.

López says Urbania is actively looking to buy hotels. "I am now seeking distressed assets to deploy opportunistic capital, but the market is not there yet on a big scale," he says. "Capital values have fallen, so we want to take advantage. Hospitality is a sector we are looking at because we understand its operational side, thanks to our expertise and experience in other asset types that also have that operational element."

Overall, Spain remains on property investors' radar, but CBRE predicts investment volumes in the country will drop by around 30 percent this year to approximately €8 billion.

"There is so much equity looking for yield, which should put Spain's real estate sector in a better position in the aftermath of this crisis than during the previous one," says Otero.

According to López, there is a dislocation between the capital markets and the real economy, with investors sitting on huge volumes of dry powder, despite the uncertainty in European economies. "Rather than a crash in the market, I expect a price correction and some distress," he says. "The need for investors to chase yield, and the large amount of equity capital, will keep the market in a better position than it was in 2008."

But García says International Monetary Fund forecasts that Spain's GDP will shrink by 12.8 percent in 2020 mean those aiming to buy property there will be looking to do so at bargain prices in order to counter the risk.

"Spain's GDP forecasts will lead investors to assume they will buy at higher discounts than in other countries," he says. "The potential for a divergence in buyer and seller pricing expectations could delay the recovery of transaction volumes. We will see a spike in dealflow if sellers are willing to lower prices."

He adds that the actions of lenders will determine dealflow: "This will all depend on the pressure that existing lenders put on sponsors forcing them to sell. If that happens, we will see a rebound in transaction volumes next year but, if banks continue being patient, we won't see this rebound until 2022." ■