REPORT

RE DISTRESS & FINANCING OPPORTUNITIES

Exclusive insights from Europe's leading real estate market voices: When will distress materialise and where are the opportunities in the meantime?

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INTRODUCTION

For more than 25 years, GRI Club's exclusive networking events have been providing unique opportunities for the industry's decision makers to exchange valuable insights and experiences, igniting deal flow and potentialising the real estate market.

GRI Club reports present the key takeaways from these events, including the most valuable insights, the most ardent discussions, and the most intriguing strategies.

This report was compiled following the **GRI Club RE Distress & Financing Opportunities Forum** in London. The forum saw three closed-door roundtable discussion sessions pooling sentiment from the real estate industry's leading figures, as well as recent transaction experiences, providing an invaluable outlook into the current market scenario.

Photos: GRI Club

CURRENT EUROPEAN REAL ESTATE MARKET PANORAMA: WHEN WILL DISTRESS MATERIALISE?

Discussions described the European real estate market over the past two years as sticky, slow, and grinding, contrasted against a thirst for asset repricing, distress, and transaction volume.

Two years ago, the market began to forecast a wave of distress, similar to that of the Global Financial Crisis (GFC) when large-scale restructuring of real estate portfolios occurred, largely made up of NPLs and M&As.

Two years on, this wave of distress is yet to materialise. Loans may be reaching maturity, but both sponsors and lenders are agreeing to waivers and extensions, and NPL transactions on the scale that was expected are simply not emerging.

Overall, consensus was that increased activity is on the horizon and there will be a turning point in the market. The question remains whether this will be triggered by distress surfacing at a more significant level, or by the lowering of rates and the return of core money into the market.

Sponsor-Lender Relations

Discussions revealed very low rates of restructuring occurring in the market at present - different to the GFC - and rather refinancing being the preferred solution for struggling assets.

When it comes to refinancing, however, the market is experiencing a number of consensual stand-stills between lenders and sponsors. Often, lenders refrain from enforcing the sale of an asset or taking ownership for lack of a better plan than the sponsor. This leads to a waiting game, with the hope that either a third party will step in or that an extension will lead to more attractive exit options by the new maturity date.

One participant shared the experience of lender negotiations in fact being more complex when there is equity still left in the deal, as the lender still holds leverage over the sponsor. In cases with no equity left in the deal, lenders are broadly reluctant to take action against the asset due to current lack of liquidity.

Catalysts for Distress

Discussions addressed a number of theories around what is inhibiting full scale distress in the European real estate market. Perhaps the maturity wall is yet to hit in its entirety and it's a simple matter of time, or perhaps the bid-ask spread is just too large. One participant reported that the few attempted transaction experiences felt more like a price discovery process than anything else.

It was also suggested that more activity will come as values start to settle. Following the global disruption caused by the COVID-19 pandemic, it was an almost impossible task to value real estate assets - a situation that continues until now for office assets.

However, as fundamentals begin to settle, the possibility of non-consensual activity and forced sales will arise, consequently driving more consensual activity and bringing market momentum back.

The amend and pretend strategy while waiting for lower interest rates in the near future is not adequate for those assets shy on time, and pragmatism is required to make tough decisions and carefully consider whether to put more money into certain assets.

Certain asset classes are proving resilient, such as student living and hotels, whereas others - suburban offices, for example - are simply too leveraged, and with such drastic increase in interest rates, the asset must be de-leveraged and losses will be incurred. A deep leveraging exercise is needed to assess the situation of assets on a case by case basis. From this exercise, transactions will begin to flow.

Occupier Fundamentals

Vacancy rates remain low across European real assets in a number of sectors. These strong occupier fundamentals were highlighted as a significant difference between the current real estate scenario and that during the GFC.

Operationally, assets are generally performing well and demonstrating dependable cash flow and income, helping to compensate for the shock to the capital stack and coverage ratios caused by soaring interest rates. Where lenders have confidence in the operational strength of an asset, sponsors can buy time - a tool being used in abundance in the market at the moment.

During the GFC, it was an entirely different picture, as tenants were continuously defaulting payments and in many cases ending in bankruptcy.

Interest Rates Speculation

When will interest rates come down? This question remains at the top of everyone's mind, with hopes that the ECB will lower them sooner rather than later, triggering a flurry of new deals and increased activity.

When comparing the present scenario with last year's incessant fear of increasing interest rates, it was suggested that the simple reassurance that rates will no longer increase has instilled confidence in buyers, slightly encouraging deal flow.

Europe vs. US

The US may have seen slightly more asset repricing - especially in the office sector - and transaction volume, however there is certainly no evidence of wide-scale NPL portfolio disposals.

Common belief says that market trends seen in the US are followed suit by Europe shortly after. However, meeting discussions emphasised specific differences between the two regions, particularly the acuteness of the destruction of the US office sector.

In major US cities, prime offices are suffering very low occupancy rates, whereas the situation is far better in Europe's main cities, where the return to the office has been more prominent.

Although it is impossible to assess Europe as one homogenous place as trends and complexities vary so dramatically from country to country, office vacancy rates in Europe's major cities are around 8%, while the US is suffering from rates of around 22%.

The saving grace for Europe was suggested to be the halting of speculative development of new office space by banking regulations, helping to keep vacancy rates down.

CAPITAL DEPLOYMENT: WHERE ARE THE OPPORTUNITIES IN THE CURRENT CLIMATE?

Although there are a number of opportunities in the market at present, they are simply not deliverable at an interesting enough price. “One of the biggest challenges we have is sourcing enough truly distressed investments,” shared one participant.

A certain level of distress is materialising within development projects, however. Many development projects that have been underwritten to yield low returns are increasingly facing distress due to the precarious high-leverage situation they now find themselves in.

These developers that are “running short on time” offer an interesting angle for investors searching for distress.

Elsewhere, when it comes to investors appraising for both equity and credit, naturally, credit is coming out on top, with one participant revealing that 75% of their time is focused on credit situations.

Emphasis was also placed on the preference in projects with operational strength. As balance sheets are increasingly tight under the macroeconomic mayhem, operational performance is a saving grace in making projects viable.

Core Money

Lower returning core strategy fundraising is a tough environment, and the absence of core money in the market is contributing to the lack of transaction volume, participants agreed.

Buying assets unleveraged, without debt finance, would be very well placed in the current scenario, however there is clear a lack of core capital, while value-add and distressed funds are in abundance. Similarly, from the other side, sellers wish to sell at core pricing but those buyers are far and few between.

Regional Opportunities

"Europe has flipped on its head."

The Northern European markets are experiencing the most acute capital destruction, with incredibly high leverage, and massive bond redemptions approaching in the coming years. The Southern European markets, on the other hand, are experiencing some of Europe's highest levels of economic growth and becoming increasingly attractive markets for real estate investors. This economic power balance is the polar opposite to that of the GFC.

With this in mind, on more than one occasion participants referred to opportunities within various sectors in both Italy and Spain. These are most certainly not distressed opportunities, however, as Spain in particular was reported to be entirely void of distress.

Germany, meanwhile, is experiencing a slow deflation of its real estate bubble, with hopes a more normalised market is to follow. Local institutions and institutional investors in Germany are starting to adjust to pricing norms seen in other markets. However, this adjustment is slower than expected, causing frustration among investors. While there's a lot of capital available, transaction volumes remain low.

France was reported to be presenting a number of Built-to-Sell developments which are stuck in the pipeline, with balance sheets which need to be freed up.

CEE's PBSA (Purpose-Built Student Accommodation) sector, although in its infancy, is showing tremendous opportunity in some of the key regional cities, particularly Poland, and further east for the more adventurous investors.

REINCARNATION & PLACEMAKING: HOW CAN THE RE INDUSTRY SUSTAINABLY REGENERATE DISTRESSED ASSETS/AREAS?

Creating Value Through Placemaking

The value of an asset is inherently related to the amount a tenant will pay for it, and this is what ultimately drives long term value. With fast-evolving society, and thus fast-changing tenant demands from real estate, placemaking has gained prominence, and it is becoming increasingly crucial to address the surroundings of an asset or a collection of assets, and not just a lone single asset.

Placemaking encompasses a lot more than the traditional real estate investment strategy of a single asset with a long term tenant, generating stable returns. It requires vision of the wider 'place', and at times even involves financial expenses applied not directly to the asset, but contributing to enhance the surroundings which will ultimately benefit the asset(s).

Participants explained that, on occasion, this may even take the form of adjusting rents to below the market value of that space in order to attract specific tenants that will aggregate value and enhance the place.

It was highlighted, however, that this level of placemaking can be complex to carry out in smaller cities, where the cost of a building may be comparable, but the rents will never reach those of major capitals in order to see equivalent returns.

Lender Perspective

Pre-GFC, exposure to development in the UK was at an all time high of around GBP 40 billion. By late 2023, annual exposure sat at a meagre GBP 27 million.

Historically, UK lenders have had an appetite for development and heavy refurbishment projects, but the impact of the macroeconomic situation on real estate in recent years has unfortunately not supported this appetite. The optimists' expectation, however, is for appetite to grow in the coming years.

One participant explained that lenders are, naturally, favouring opportunities with macro tailwinds, a potential for growth, and resistance against inflation, listing residential, logistics, student living, and self storage, among others.

The challenge for lenders is to underwrite the softer, less quantitative elements of placemaking.

One participant reminded the room that, at the end of the day, these projects have to answer to the private markets, and provide clear answers to questions regarding returns, debt yields, and risk spread. Quantifying the qualitative aspects of a project with this in mind is extremely challenging.

These forward-looking placemaking projects which leverage innovation often involve mixed use or entirely new asset classes, often without a clear proof of concept. Lacking proof of concept, or even an asset class to classify the project, substantially limits available capital and also demands higher returns.

Furthermore, the timespan for these projects is generally far longer than for a single asset. Simply accumulating the assets and working with local authorities on zoning and planning can take up to five years or more before development even begins. Finding long term capital for this type of scheme is another major obstacle that was highlighted by participants.

To overcome certain challenges involved, one participant shared an example of a recent placemaking scheme in which a large part of the space involved residential development, providing more solid and dependable numbers when underwriting the scheme. This ultimately instilled more confidence in lenders, allowing them to be part of wider placemaking but at a safer, more comfortable level.

It was noted, however, that this is more achievable with large placemaking schemes, and the bigger challenge is in attracting capital to smaller projects.

Innovators in real estate and placemaking are tasked with demonstrating the potential value to be extracted from innovation in the sector - ROI becoming 'return on innovation' rather than simply the typical 'return on investment'. This will require substantial evolution in the real estate industry and a considerable change of mindset.

Sustainability & Community

A clear common theme among discussions around sustainable placemaking was the importance of a long-term view, and the mindset of future-proofing assets.

This may be in the form of incorporating flexibility into the design and repositioning of assets - especially in reconversions of offices to residential. Having flexibility with floor space that can be converted into other uses when needed is becoming increasingly important in the fast-changing society that we live in.

It is important to address the story being told about an asset repositioning. There is an abundance of assets that are underutilised, shared one participant, referring specifically to London. These assets also include various building types, including offices, town halls, churches, etc., and many are in prime locations.

It must be asked how value can be extracted from these assets and their presence in the local community, which leads to the matter of redevelopment versus retrofit.

One participant drew attention to the carbon implications of redevelopment preventing the revitalisation of areas and resulting in a number of buildings which are not fit for purpose.

“Water finds its way, capital does the same thing,” the same participant continued to explain. If such buildings are unattainable for redevelopment and retrofit simply doesn’t provide sufficient returns, the capital will find its way to a development which does, leaving these areas underutilised and, in the worst cases, abandoned. To avoid these scenarios, it is necessary to see more buy-in from local authorities and city planning bodies.

One participant emphasised the need for central government incentives for both the private real estate industry and the local governments, to encourage investment and revitalisation of more critical areas.

The revitalisation of these areas brings gains for not just the private sector, but also the local authorities where huge value can be brought to the area through culture, local economy, health and well-being of the community, and climate resilience.

Public-Private Collaboration

Twenty years ago, the gap between the public and private sector was substantial. Real estate developers viewed public city planners as a mere obstacle in the development process, and in return, developers were believed to prioritise profits at the expense of everything else. This simplistic overview is far less prominent within city planning and real estate development today.

The two parties need each other more than ever, and collaboration is crucial in the pursuit of innovation in order to tackle the staggering level of carbon emissions generated by the real estate industry. This collaboration is taking form slowly, as each side becomes more enlightened about each other's end game.

In the UK, the council planning process takes the blame for a number of difficulties in the real estate development process, and is viewed by many as "long-winded". Discussions highlighted the political aspects which contribute to this, such as the mayoral elections and general elections which put a lot of development on hold, as well as the recurrent changes in planning policies.

Furthermore, in London developers must navigate the specifics and variations of each of the 33 London boroughs' local planning regulations and policies.

On the other hand, it was recognised that, ultimately, local authorities are accountable to their electorate, meaning planning committees must be scrupulous with regards to local planning to ensure the development is beneficial to the local community and the bigger picture.

Taking into account the pains and gains to be had on both the public and private side, neither can face the enormous task of regeneration in London alone. With public budgets squeezed and the regulatory environment around planning and carbon increasingly stringent, collaboration is the only answer.

GRI CLUB MEMBERS WILL ALSO ATTEND

EUROPE GRI 2024

Founded in 1998 in London, GRI Club currently brings together more than 16,000 senior executives spread across 100 countries, operating in both real estate and infrastructure markets.

GRI Club's innovative discussion model allows free participation of all executives, encouraging the exchange of experiences and knowledge, networking and business generation.

GRI Club Members also have access to our exclusive online platform to learn more about other members and their companies, correspond and schedule meetings, and receive unrestricted access to all GRI Club content.

Find out more about GRI Club Europe

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