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Spain's lending market adjusts to tough times

The country's real estate financing market is much better positioned to weather this economic crisis than the last one, argue the participants in Real Estate Capital Europe's Spain roundtable. By Daniel Cunningham

The problems facing Spain's real estate financing sector are depressingly familiar across European markets. Rising interest rates due to inflation are pushing up the cost of debt, causing buyers to put transactions on pause. Meanwhile, asset values are widely expected to decline, although to what extent remains anybody's guess.

The uncertainty is making it difficult for the wide array of lenders active in the Spanish market to close deals. Domestic banks, the stalwarts of the sector, are far more selective about what they will finance and are more conservative on deal terms. International banks, including German and French lenders, are said to be biding their time before committing to new deals.

Against this backdrop, sponsors are understood to be turning to the growing number of non-bank lenders that have entered the market in recent years, including homegrown firms and large-scale managers often headquartered in London, Paris or New York.

The participants in *Real Estate Capital Europe*'s Spain roundtable, held in October in Madrid, argue their market has come a long way since the aftermath of the global financial crisis. Back then, domestic banks, many of which were bruised by the impact of the GFC, held most of the market share. Alternative finance was largely limited to expensive debt provided by opportunistic platforms with an eye on recapitalising distressed situations.

Spain is entering this latest economic crisis with a stronger banking sector, and a flourishing alternative lending market, the participants agree. However, they concede it is a challenging time for any type of organisation to underwrite property deals.

Fátima Tagle, business development director at alternative asset and corporate administration services firm Sanne, which was acquired by fund administration firm Apex Group in August and hosted the roundtable, sees three effects of the economic situation on the lending market so far.

"First, even though we come from a leverage-adjusted environment already, leverage levels are being analysed a little harder. Second, lending margins are very important to banks, but alternative lenders are also aiming to reprice, or at least they are putting the possibility on the table. Third, covenants are becoming stricter, with more of a focus on the security package, so a lender can act in case there is a default."

A decline in investment activity is also noticeable, the participants agree. "The market is lagging after the summer," says Alejandro Moya, partner at Incus Capital, one of Spain's most prominent non-bank lenders. "The transactions that were discussed before summer are not closing because buyers are thinking they may not be the best

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Alejandro Moya

Founding partner,
Incus Capital

Moya co-founded Incus Capital in 2012 and is a member of its investment team and investment committee. Since its launch, the Madrid-based real assets specialist investment advisory firm has advised on more than €2.2 billion of invested capital across credit and equity funds in more than 100 transactions. Moya is responsible for overseeing all real estate-related investments across the firm's target markets of Spain, Portugal, Italy and France.

Fátima Tagle

Business development
director, Sanne

Tagle is based in the Spain office of alternative asset and corporate services group Sanne, an Apex Group company. She has more than 17 years of experience in risk analysis, financial modelling and high-level reporting. At Sanne, she focuses on loan agency services, including deal closing and originations. She oversees the company's interactions with law firms, debt funds and private equity firms. Before joining Sanne, Tagle worked in the risk and governance team at Barclays.

Javier Beltrán

Chief executive officer and
founder, CG Capital Europe

Beltrán founded and launched Madrid-based CG Capital Europe, a real estate and infrastructure investment banking firm. CG Capital Europe provides advisory services to its investor and lender clients for sale and purchase transactions, financing structures (debt and equity), and investment and asset management. Beltrán has 27 years of experience in investment banking, real estate and capital markets in Europe.

Alberto López

Chief executive officer,
AEXX Capital

López is the founder and chief executive of AEXX Capital, a Madrid/London-based investment firm. The company specialises in providing flexible credit solutions across the capital structure focusing on Western Europe. He has been involved in more than €2 billion of opportunistic, value-add and debt investments across Spain and Latin America. He is also co-founder of development and investment company Urbania International.

deal, given the uncertainty. The market is somewhat frozen from an institutional investment point of view, partly because of the impact of the higher cost of financing. We hear family offices are still active, but for smaller deals."

Moya believes a fall in asset values is inevitable, with markets such as Spain, Portugal and Italy usually taking longer to adjust than the UK or Germany.

"Sponsors used to get financing at 2 percent and now it has increased by roughly 300 basis points," he explains. "There needs to be an adjustment to reflect that. The big question is what the impact will be on yields. As a lender, when analysing a deal, you need to be very cautious about the exit assumptions, and there is huge uncertainty around them now."

"The market is somewhat frozen from an institutional investment point of view, partly because of the impact of the higher cost of financing"

ALEJANDRO MOYA
Incus Capital

The senior debt and equity adviser at the table, Javier Beltrán, chief executive of Madrid-based investment banking firm CG Capital Europe, has already seen a 10 to 15 percent decrease in asset prices in the limited number of deals closing. "We are seeing some deals moving and there has been an adjustment in pricing. I disagree that we will see more covenants, as sponsors are looking for more flexibility due to the market uncertainty. People have money. There has been a lot of equity raised that managers need to deploy, so deals are still closing if sellers flex down prices."

A major positive for the availability of finance, argues Beltrán, is that alternative lenders still view it as a place they can find attractive risk-adjusted returns. "Every month there is a new debt fund getting into the market, of which 80 to 90 percent are international. They are bringing many types of capital. For instance, we are seeing stretch senior financing coming in, priced at a 4.5 to 5.5 percent on an all-in basis," he says.

Alberto López represents another homegrown non-bank lender at the discussion. The chief executive of Madrid-based lending platform AEXX Capital describes a "choppy" lending market, in which pricing deals is challenging. "It is very difficult to price a deal or do accurate underwriting because everything is so volatile and it's hard to predict where cap rates will be two years down the line. So there is a direct impact on the leverage that can be provided to the market."

One impact of rising rates has been lenders stepping away from writing fixed-rate loans to focus purely on floating-rate facilities, López says. "The lenders need to protect themselves from the risk of Euribor fluctuation. I think everybody has taken a more defensive approach to lending. If you only want to close a deal and deploy capital you could opt to go covenant-lite. However, if you want to play a defensive and more cautious role you

> *"I've seen delays, because of the uncertainty, but I still see deals closing and movement in the market"*
>
> **FÁTIMA TAGLE**
> **Sanne**

need to put in some hurdles so you can take control of the deal while helping the sponsor to be more disciplined in an uncertain market. I think this is the market consensus."

Tagle has observed a keener focus by lenders on the quality of an asset, its location and the track record of the sponsor. Lenders are also prioritising their existing client relationships, she says. But she does not see sponsors walking away from transactions as the cost of debt becomes more burdensome. "I've seen delays, because of the uncertainty, but I still see deals closing and movement in the market."

More institutional

Beltrán notes that his advisory work at CG Capital Europe is now more evenly split between investment transactions and financings, whereas not long ago, a higher percentage of his mandates were focused on investment deals. He suggests this is partially due to an increase in enquiries from property owners seeking to recapitalise their assets as they resolve to hold them rather than sell in the current market. The need for additional financing for capital expenditure, as sponsors aim to modernise their properties, is another explanation, he suggests.

Moya offers his own theory as to why Spanish advisory firms like CG Capital Europe are spending more time on debt deals: the prevalence of more complex, non-bank financing transactions in the market.

"I believe the market has become more institutionalised," he says. "It has become normal to source alternative financing. At one point, the only options were bank finance or high cost opportunistic capital. Now, investors are supporting a range of debt funds which managers are seeking to deploy in Spain. It is a growing trend here to have different sources of capital for every type of risk."

López also makes the case for alternative lending in the Spanish market.

Assessing distress

Will there be a repeat of life after the GFC?

After the global financial crisis, Spain endured years of distress, including in real estate, with non-performing loans soaring. However, the roundtable participants do not expect a repeat in these troubled economic times.

Incus's Moya points to the industry's relative stability through the pandemic. "During covid we thought there would be some distressed deals, but everything comes back to the fact that the system is not highly leveraged. Unless sponsors are really forced by liquidity constraints, there should not be many distressed transactions."

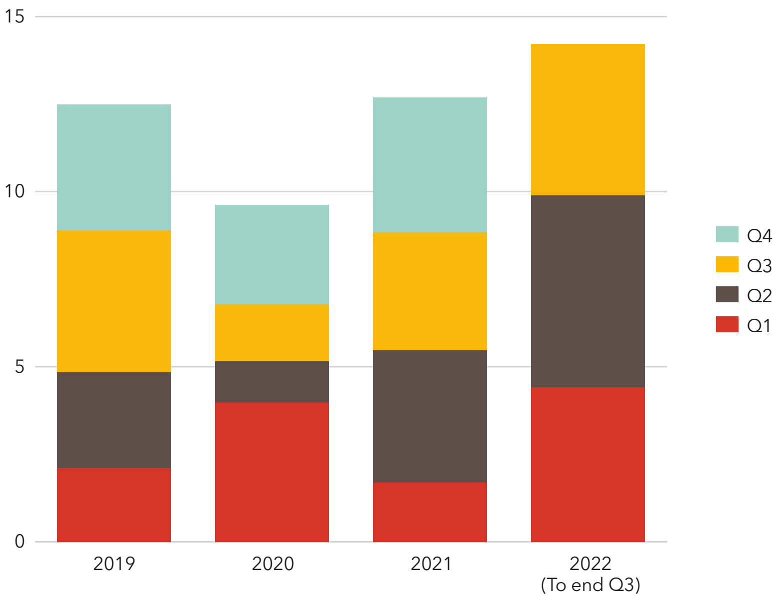
Among AEXX's suite of funds, López runs opportunistic vehicles. "I am starting to see some level of stress turn to distress, but it is very few deals and we are not going to see many more," he says.

"If rates hit 6-7 percent as some economists predict, real estate will not be the main economic problem," predicts CG Capital's Beltrán. "Other sectors, such as corporate lending, will be more severely impacted. In real estate, banks will still be here in the coming years, and although the pricing of the capital stack may get more complex, the wide provision of debt to this sector will outlast this crisis."

López adds that the level of distress will be determined by how long high inflation lasts. "If it is short-term, sponsors will hold assets to protect their equity. If it is long-term, they will be under pressure to sell."

Sanne's Tagle believes lenders learned lessons during the GFC. "Lenders' portfolios are far higher quality and more resilient. There is a wider spread of loan structures in the market. Also, debt advisers have been very active and are playing a necessary role in bringing new ideas to help sponsors structure deals."

Despite roundtable participants reporting a slowdown in dealflow, three large portfolio and platform transactions resulted in a higher volume in the first three quarters of 2022 than the whole of 2021 (€bn)



Source: CBRE Research

"We've seen the transition from Spanish equity investors borrowing from banks, to doing joint ventures with private equity firms after the GFC, to now realising an alternative lender is a good option, which allows them to capture the full amount of their return. Equity investors in Spain have become more sophisticated and they understand the alternative financing structure."

According to Beltrán, there are more than 60 active real estate debt fund lenders in Spain today. "CG Capital Europe is super active in this field, so there are many different layers of capital available, depending on the risk."

Debt is available at a range of price points, the participants agree. Beltrán sees increased pricing for debt secured by core assets, at around 150 to 200 basis points above Euribor, translating into a total cost of debt in the order of 4 percent, which can be expensive for sponsors given core property yields are 4 percent, in some cases. A solution for sponsors is to reduce the amount of leverage they request and complete a refinancing in future years, he says. At the other end of the spectrum, he sees loan pricing at up to 10 to 12 percent, for value-add investments in secondary and tertiary markets, and up to 17 percent in opportunistic situations.

Sanne regularly works with the many Spanish lending platforms which are focused on small- to mid-sized sponsors, says Tagle. "They tend to close smaller loan deals, with more frequency. They focus on €10 million to €50 million loans, often taking the upfront risk in financing the purchase of land and taking administrative risk. They look to their sponsors to refinance out in two years when construction is ready to begin."

López says the segment of the market described by Tagle has become a focus for AEXX, which initially targeted larger loans. "I first set up with a minimum ticket size of €25 million, then realised there was a big market from €10 million to €25 million, so I set up a second fund to cover that part of the

market." The larger the deal, the more likely it is to be financed by a foreign debt fund manager, the participants agree. Moya says Incus's minimum ticket size is €10 million, but adds that the firm competes with foreign lenders for far larger tickets.

However, Beltrán argues that foreign debt fund managers, including some of Europe's largest platforms, are willing to go as low as €20 million to find deals in the Spanish market, despite typically focusing on €50 million-plus transactions in markets such as the UK.

Dominant force

While the participants see the continued growth of Spain's alternative financing sector as a potential saving grace during a difficult period, they agree the country's banks remain a critical supply of liquidity. Banks' maximum loan size in bilateral deals is said to be around €40 million, with larger financing deals requiring a club structure.

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> **JAVIER BELTRÁN**
> **CG Capital Europe**

"They are still the dominant force in the market," comments López. "They haven't retrenched. They are still lending. Obviously, their spreads have increased a bit and they are being more defensive on LTV. For banks, it is becoming a more sponsor-driven market. They want to find good quality sponsors, with assets that have performed well over several years, so they are looking to protect stable partnerships.

"On the other hand, banks have disregarded lower-quality deals and they are not in the mood for assets in a secondary or tertiary location, or with less reliable tenants. Some are also reluctant to lend on hotels, because their balance sheets are full of such loans."

As well as leading AEXX, López has experience as a borrower through his role as co-founder of development company Urbania International. From that perspective, he is quick to give credit to the banks' continued role in the Spanish market. "From the equity play that we have, we are still pretty active with the banks, and they provide very good terms."

Beltrán's take is the market is large enough to accommodate banks and non-banks. The former group are active, but after the bruising impact of the GFC, risk departments are "very powerful". He says: "Banks have very conservative levels, around 50 percent loan-to-value, with 55 percent as maximum. They have the option to refinance their sponsors or extend existing maturities. But they do not have much appetite to grow their balance sheets."

Across European real estate markets, there is an expectation of a refinancing gap as incumbent lenders reduce the amount of leverage they are prepared to provide in new deals. Around the table, this prospect is considered a factor that can be managed in the market.

"We strongly believe debt funds will play a very important role in the coming months, because the banks will reach a limit on how much they can lend and a limit to exposure to certain sectors and sponsors," says López. "So there will be step-in situations where credit funds will be more flexible than a bank can be and can adjust the loan terms to fit the reality of the sponsor."

Moya believes the volume of equity in the market will cushion it from the impact of rising rates. "The difference between the GFC and this crisis is there is much more equity in the system now. There will be refinancing situations where there is a correction in the asset value, but there is still headroom for values to fall due to the amount of equity in deals. Most deals also look strong from a cashflow perspective because rents have generally increased substantially."

Beltrán agrees. "This sector, and infrastructure, are the two most protected against inflation. It is true that 8 percent inflation cannot be passed on to tenants for three years, but most lease agreements are inflation-linked and that is helping the market already this year."

López concedes not all tenants will be able to pay higher rents. "There are good tenants that can cope with that increase and those, for instance in secondary offices, that will suffer a

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ALBERTO LÓPEZ
AEXX Capital

lot and not be able to afford the inflation-linked increase. So the situation is not straightforward. Also, in the BTR sector, it will be difficult to pass the full impact of inflation on through rents. Sector by sector, lenders need to dig deeper and understand the impact."

Talk turns to the impact of inflation on construction. Participants agree that construction costs increased significantly to June but have since plateaued, meaning development in Madrid remains cheaper than in some other European capitals such as Paris.

López remains willing to finance development deals, albeit with fresh scrutiny on the terms. "We need to revise every single aspect of the costing plan to price deals correctly. We are seeing some sponsors put projects on hold and sit on land. We are also seeing – where there are forward purchase agreements – the buyer request a guarantee there will be financing, so they either require stapled finance from the vendor or they require the sponsor to negotiate with its banks to rollover existing financing to the buyer."

Moya sees a huge opportunity in development finance as banks become more reluctant, apply more covenants, or demand more pre-sales. "We have an opportunity to provide flexible money during the development cycle. As a lender, you need to get super specialised to understand the borrower's business and the potential risks. If it is well rewarded risk, we can do it."

Banks are reluctant to finance land purchases, urbanisation costs and more speculative deals adds López, which he says creates opportunities for alternative lenders to back sponsors at the beginning of their development projects. "These are very far away from being cookie-cutter deals, so you need to put more brains into the transaction and be more flexible," he says.

Tagle says many of her clients have experience of working with non-bank lenders in such situations. "This is not new. Sponsors have integrated the availability of alternative financing into their financial projections, particularly at the early stages of their schemes, or when there is administrative risk."

How far?

While confident in the ability of Spain's real estate financing sector to remain liquid through tough economic times, participants are faced with the uncertainty of how far the country's commercial property prices will fall.

The 10 to 15 percent price reduction Beltrán has already witnessed is the best indication the participants currently have of the impact of current economic conditions, though he is quick to urge market observers not to look too negatively on the market's prospects and argues there are plenty of quality assets which so far have maintained their cashflow.

Moya expects some clarity on values in the New Year, as valuers get to grips with the impact of inflation on yields. "In upcoming valuations, we should see the effect of rents increasing wherever they can, and that may balance out the impact of inflation. For the time being though, this is theoretical because there have not been many transactions."

In the coming months, the participants' argument that Spain's evolving real estate lending industry will continue to function will be tested as the impact of inflation and rising rates becomes apparent across the market. ■

Spain's 'beds' sectors draw lender attention

What is catching the eyes of debt providers?

Current sector preference varies by lender type, according to the roundtable participants.

Sanne's Tagle has seen lending activity in the hospitality sector this year, particularly from non-bank lenders. "At the start of the year, we saw a lot of hospitality financing from medium-sized debt funds and we are still seeing financing activity in luxury small developments in key leisure destinations such as the Costa del Sol," she says.

For Incus's Moya, the distinction between prime and secondary assets is becoming more important than sector choice as tenants in the secondary sector struggle to maintain cashflow. However, sector-wise, he expects leisure and tourism-focused real estate to hold up, as people continue to socialise and travel following the covid crisis.

AEXX's López believes build-to-rent residential and the living sector in general – a major area of investment in Spain in recent years – will prove resilient. "Demographic shifts and lifestyle changes have created new opportunities in the living sector. There is the trend of people wanting to rent instead of buying or needing to rent because they don't want to save because they are focused on enjoying their leisure time."

CG Capital's Beltrán sees newer forms of tourism-related real estate, including modern hostels and touristic apartments, as steady parts of the market. He also mentions a more traditional sector: "Offices are being much more resilient than people thought in March 2020. There is a need for new, green offices. On the other hand, shopping centres are now very hard to finance."

López says traditional banks have focused on mainstream residential and logistics, leaving limited space for alternative lenders. "But the newer type of real estate coming through has not been on the agenda of the banks, so alternative lenders have had the chance to finance things like purpose-built student accommodation, senior housing and co-living."