KEYNOTE INTERVIEW

More lending, but expect more distress in 2024

Paul Lloyd, CEO of loan servicer Mount Street, appraises the faltering performance of the European real estate finance market in 2023 and predicts a mixed picture next year

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Founded 10 years ago, loan servicing firm Mount Street manages around €130 billion of loan facilities, a figure that is set to rise to €150 billion by the end of the year, some 60 percent of which is in the real estate sector. The business employs 210 people, operating out of 10 offices in Europe, the US and Australia. As such, it has visibility of a significant slice of the real estate lending market.

"We have a broad understanding of the various real estate sectors and jurisdictions, both from a borrower and lender perspective," says chief executive officer Paul Lloyd. "We are a partner for our clients, an arms-length version of themselves, managing problems for them as they arise, which puts us in a position to appreciate the risks that real estate lenders face in an uncertain market environment."

Lloyd shared his assessment of the performance of the European lending market in 2023, and its prospects for recovery in the coming year.

Q How has the European real estate lending market performed in 2023?

At the start of 2023, origination activity was fairly healthy. But that has slowly petered out as interest rates and inflation have rocketed, with both lenders and borrowers uncertain when that would end. We have now reached the point when the market has become more comfortable that rates have stabilised – not comfortable enough for lots of new lending or borrowing, but enough to start making decisions about what to do next.

A big challenge facing the market in this period has been dealing with a spike in maturities of four and five-year vintage loans. Of the loans on our book that matured in the first half of this year, 75 percent have been extended for 6-18 months, with the average extension being around a year. Next year we expect 55-60 percent of maturing loans on our book to be extended.

Banks still like to lend against assets that produce consistent income, and they want to maintain their relationships with good-quality sponsors, particularly if they are prepared to inject a little extra equity to pay down part of the loan. Other sponsors have had to sell assets to pay down a larger amount of their loans to meet their covenants. As of the end of September 2023, the annual percentage of loan extensions had reduced to 67 from 75 at mid-year. Therefore we are seeing the number of maturing loan extensions decrease as the year progresses.

We are seeing fewer refinancings and a pickup in originations as 2023 draws to a close. However, falling asset values are causing lenders to seek to renegotiate terms after producing their initial term sheets, so deals are taking longer to close, which is dampening new financing activity. And it remains to be seen how much of that revival in originations is because lenders want to reach their deployment targets before the end of the year.

Q Which lender groups have you seen as active so far this year?

We are not seeing much bank lending, the majority is being done by alternative lenders – debt funds, pension funds and insurance companies. Debt funds account for around 60 percent of our book, and at the moment alternative lenders account for 90-95 percent of new loans.

We have seen some of the nimbler debt funds, with sign-off from their investors, pivot from whole loans to mezzanine. That is where the demand is right now because senior lenders are offering lower loan-to-values, and because as loans come up for renewal, lower asset values mean that a facility that would have been 60 percent LTV has become 65 percent, for example.

Q With interest rates possibly at or near their peak, are borrowers more accepting of the terms lenders are offering today?

We are seeing LTVs being driven down. A lot of deals being done at 45-55 percent. Pricing has gone up regardless of whether it is a CMBS deal, a balance sheet loan, or a syndicated loan. Spreads are typically 2.5-2.6 percent over EURIBOR or SONIA to finance a good-quality office asset. In the past, German banks might have lent at a margin of 1.1 percent or less.

There is also a lot more scrutiny on underwriting now. Lenders want to ensure that cashflows are supportive of the underlying debt service. Borrowers have accepted that higher pricing will persist for some time. However, that is unlikely to open the floodgates and result in lots of new activity in the short term.

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Q Do you anticipate an increase in lending activity in 2024, and what will drive it?

We expect lending volumes in 2024 to be higher than this year, but still 20-25 percent below 2022 levels. It will not be until central banks believe they have inflation under control, and we start seeing reductions in interest rates, that a strong appetite for new deals will return.

In 2024 the main driver of activity will be debt funds doing business with borrowers that have to refinance existing loans. For lenders, sitting on an asset for too long and trying to ride out the market cycle can be damaging. Often it is investors' money in those

Q How is technology helping servicers stay aware of potential distress in loan portfolios?

Having access to a specialist loan servicing tech solution allows lenders to swiftly assess their book for potential problems. For example, in November WeWork filed for bankruptcy in the US. Mount Street can look for exposure to WeWork across our clients' portfolios and create a report almost immediately to inform them of any issues that may arise. If they are made aware there will be an imminent default, lenders can take steps like getting cash deposits from sponsors, or quickly entering negotiations that can lead to a better outcome.

Our system is a one-stop shop that does all the invoicing and payment, telling the lenders and the borrowers what is due and what has been collected, plus calculating covenants, as well as incorporating asset-level information. We do assessments and produce reports so that clients know what the effect will be if a sponsor or tenant gets into difficulty. We also give them access to that system, so they can conduct that analysis themselves and generate reports for their credit committees or investors if they want to.

> *"We increasingly see that if sponsors threaten to walk away, lenders are reluctant to have those assets on their books, so they enter into negotiations to find a mutually agreeable solution"*

loans, and they need to see that capital being put to work. With interest rates at their current level, those investors could be getting a better return on the cash in their bank accounts.

Q How much distress do you see in the market?

Of the loans we manage that have matured in 2023 in our non-CMBS book, around 8 percent are in some kind of restructuring situation because they have been unable to meet their terms and lenders have been unwilling to extend. In addition, we have some CMBS transactions that are in special servicing. That is a much higher proportion than we have seen in the post-global financial crisis period, when defaults were minimal.

There will be loans coming up for refinancing where nobody wants to lend against the assets because they are obsolete offices, for example, or they are in a jurisdiction out of favour with investors, or when the pricing on the finance available is too high for the asset to sustain.

In those situations, the only option will be to default. Generally, the better outcome for any of these assets is a consensual workout process involving the sponsor and the lender. More often than not, that results is a higher principle recovery rate than enforcement litigation and the lender taking back the keys.

We increasingly see that if sponsors threaten to walk away, lenders are reluctant to have those assets on their books, so they enter into negotiations to find a mutually agreeable solution. If the process is confrontational, the market starts expecting a fire sale, and that reduces the amount the lender can recover.

Next year, the proportion of loans in distress could rise to 12, 15 or perhaps even 20 percent. The next 12 months will see not only the next tranche of refinancings, but also the loans that were extended in 2023 coming up for renewal again. Credit departments will want to see this money repaid so that they can lend it again at a more favourable margin, particularly in situations where the asset is likely to deteriorate further, so that they are not faced with a worse situation another year down the road.

Q Is the current market leading to lenders outsourcing their loan portfolios?

We will see increasing use of loan servicers. Our lender clients are asking us to undertake a lot more surveillance, oversight, and assessment of their portfolios. That helps them to understand what problems could arise and prevent some of them from happening. And if things do go wrong, we roll our sleeves up and work with them to do the recovery, restructuring and the workout if needed.

Banks and institutions frequently lack the capacity for that work. Some are scaling down and reducing their workforce. In 2022 Aviva Investors outsourced its £30 billion (€34 billion) commercial real estate, private corporate debt and infrastructure book to us, and its team of 23 joined Mount Street. That team is now 38 strong and benefits from access to Mount Street's specialist technology platform to manage those loans.

They have also gained experience working with a full spectrum of lenders and loan types, and together those things have created a better loan servicing experience for the client. We expect to do more outsourcing, whether that is by seconding people to institutions, or taking on their teams within our business. ■