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Market Views: Are U.S. Deal Terms Filtering into the European Real Estate Market?

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Senior finance documentation is increasingly reflecting the demand from international private equity funds for softening of covenants in return for more corporatised lending terms. This trend is resulting in the following:

- the emergence of increasingly looser financial covenants/cov-loose on the basis of "bad-boy" guarantees being provided by Sponsors (essentially guarantees from the Sponsor against certain bad behaviours such as fraud/misconduct);

- covenant levels are set with ample headroom – most likely due to the fact that current deals are on slightly lower leverage ratios;

- alternatives to cash trap or cash sweep (*e.g.*, rather than having a cash trap, sponsors are seeking this to be replaced with a distribution blocker instead, the reason being they will need to use the cash on the property); and

- portability clauses with respect to change of control – certain sponsors in particular are demanding this so that any subsequent sale, provided the buyer and asset manager meets certain pre-agreed criteria, would not trigger change of control.

These deal terms are traditionally more common in the leveraged finance market. Real estate financing transactions are traditionally slow to adopt the trends developed in the leveraged finance space due to the fact that the lender's primary route to recourse (*i.e.*, the property) very heavily relies on the underlying value of the property, whereas leveraged finance places very different emphasis on many other factors, such as cash flows, quality of management, the business as a going concern, and its outlook, etc. However, we have seen the emergence of lighter covenants and more sponsor-friendly deal terms of late, which may be driven in part by the presence of U.S. debt funds that are active in the European market and therefore increasingly questioning the entrenched European market positions, and in part relating to the large supply of capital. The resurgence of CMBS in Europe has also assisted this trend, as sponsors ask lenders to give up certain maintenance covenants for transactions that are to be included in CMBS portfolios.