A review of loan terms and covenant use in the European Real Estate Sector

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Introduction

This study reviews loan terms and covenants used within private commercial real estate credit agreements, secured against European real estate collateral. This sector is heavily leveraged and has been strongly impacted by the recent financial crisis, but to date has been under-researched due to opacity of this market.

Methodology

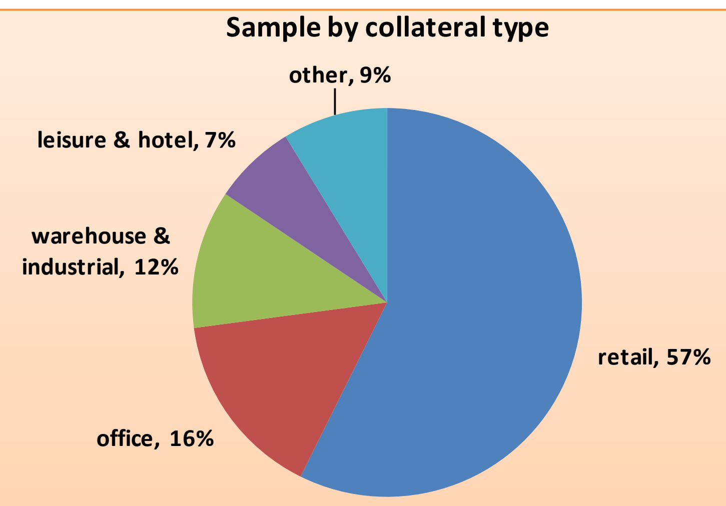
The results are collated directly from primary loan agreements and supporting documentation. These are sourced directly from the borrowers, who were selected to be a representative sample of the type of borrower within the commercial real estate sector.

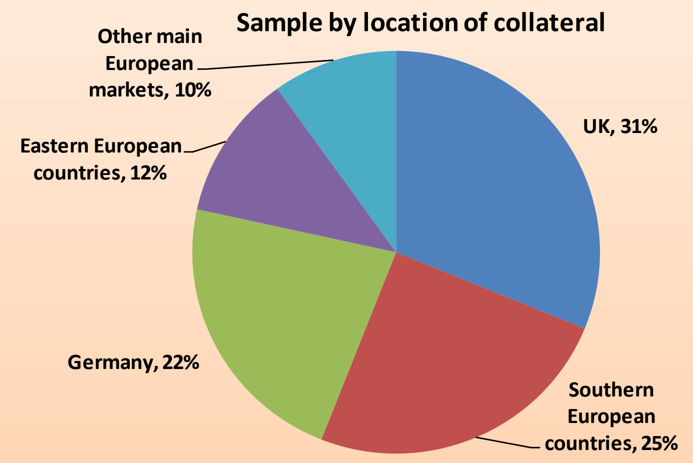
Motivation

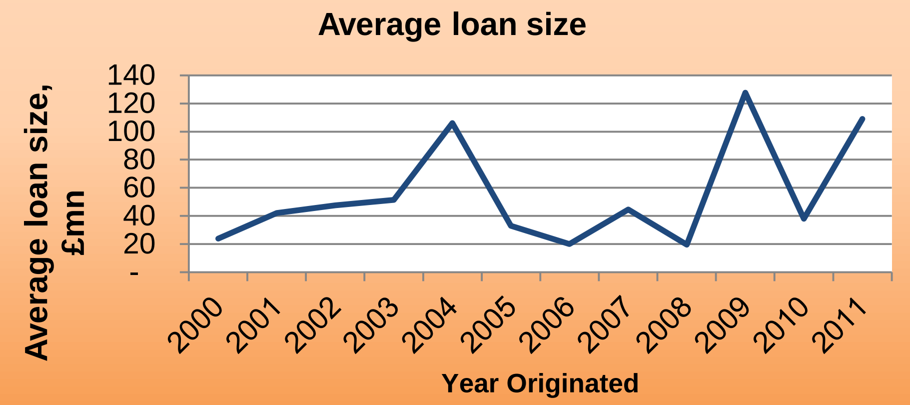
- To our knowledge, this is the first study using actual loan documentation to research the loan terms and covenants of private commercial lending in the European real estate sector
- This sector is heavily debt dependent, which provides a strong motivation to undertake this research to increase transparency of lending terms and covenant use
- Mather and Peirson (2006)[1] find covenants are the most heavily negotiated component of a loan contract, further making research into covenant levels important
- The majority of covenant studies to date are based in the US and exclude real estate due to the unique use of property as security. The results below confirm that the real estate market uses different covenants to other sectors, with the ICR and LTV being key. Therefore conclusions from existing studies cannot necessarily be applied to the real estate sector
- The data presented here can be used to fill this gap by undertaking future research into the drivers and determinants of covenant use

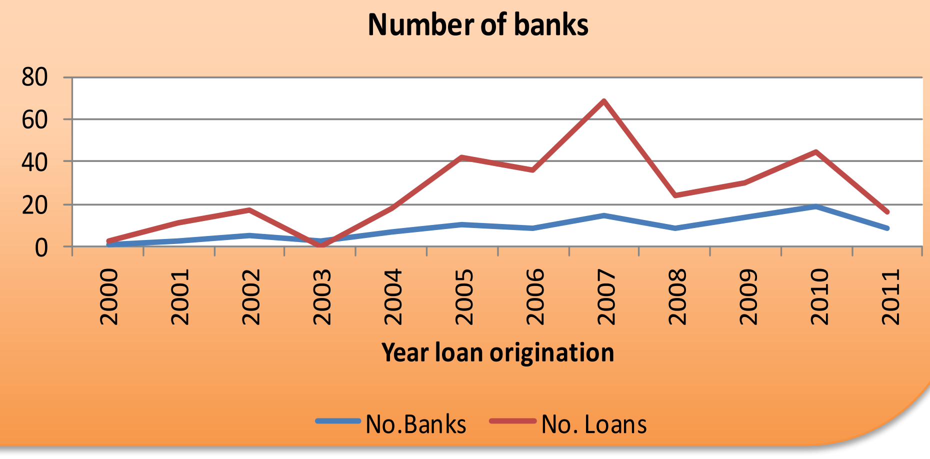
Data

- 338 loans originated between 2000 and 2011
- 214 are EUR, 105 GBP and 17 other (SEK, CHF, USD)
- Loan sample ~ £17bn
- 62% loans <£25mn, 27% £25mn - £100mn, 11% >£100mn
- Average loan size £50mn
- 23 different borrowing entities
- 53 lending banks



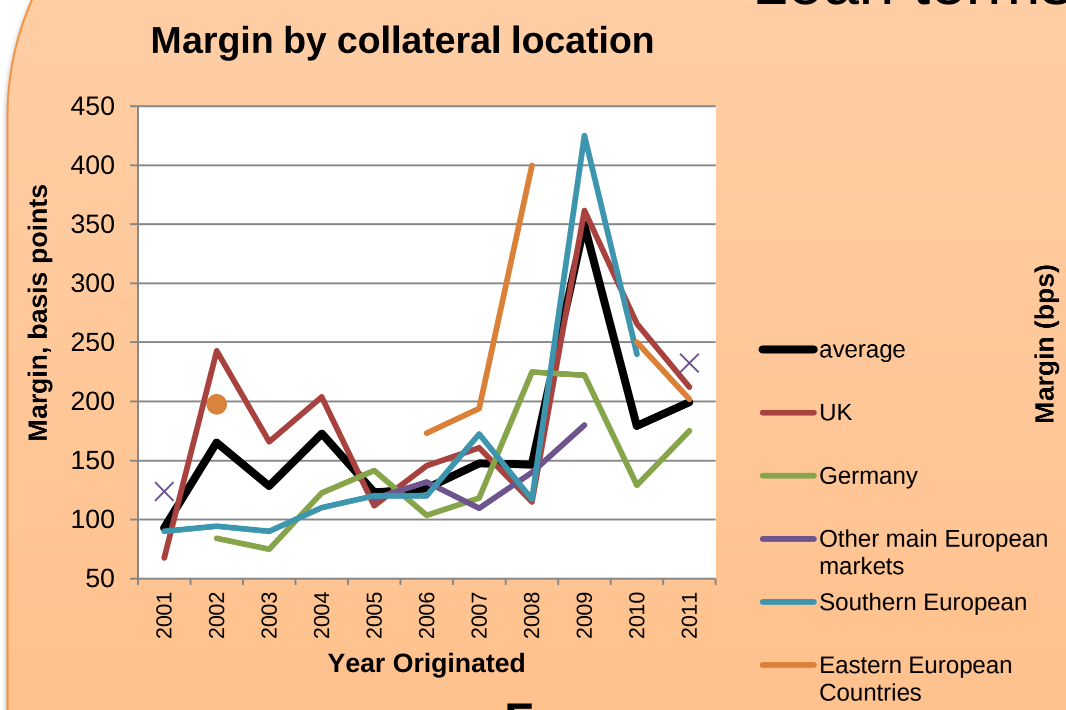


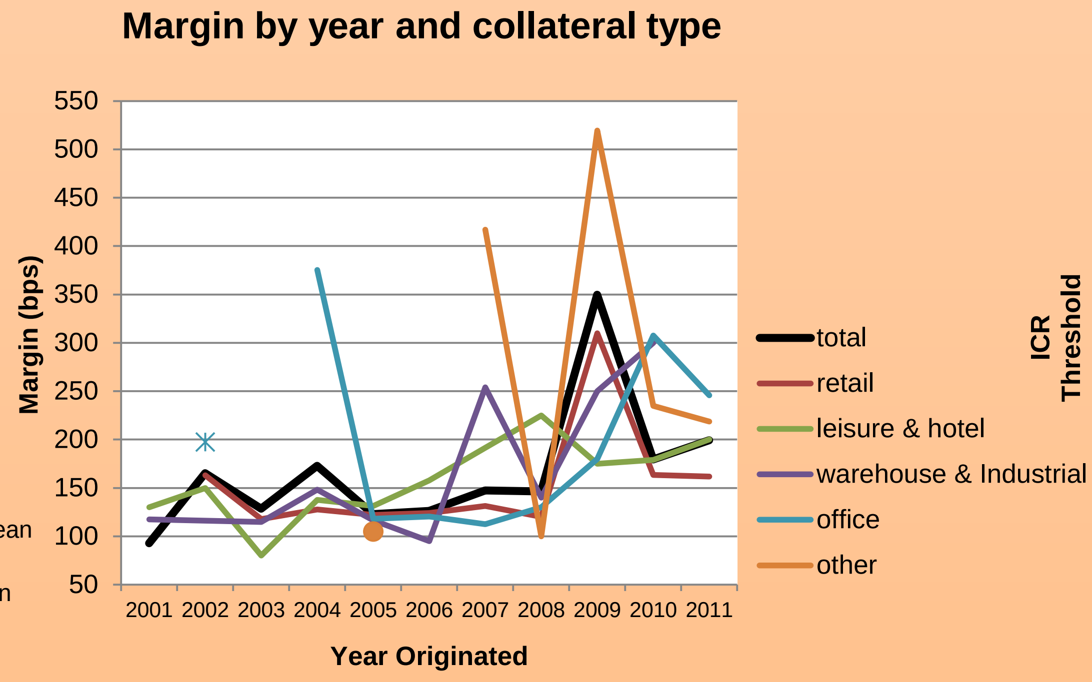


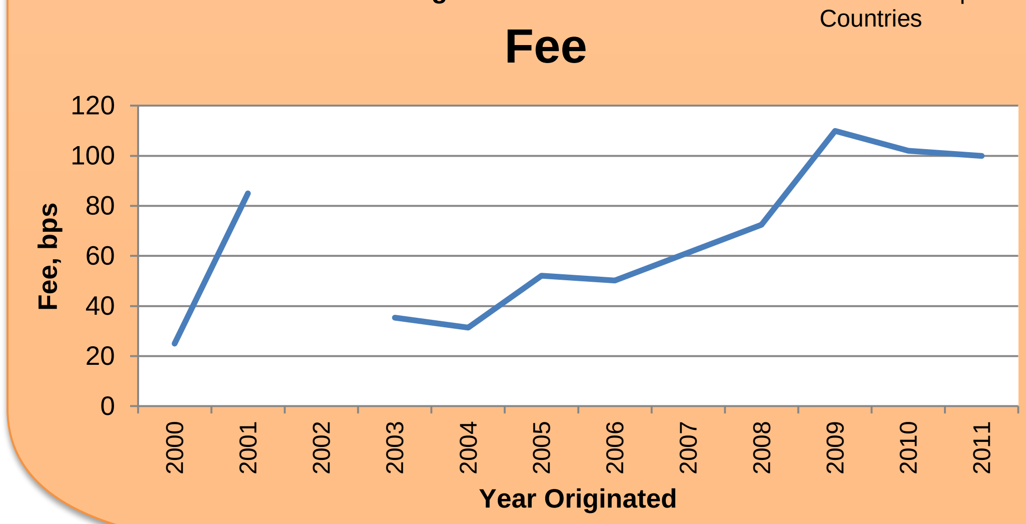


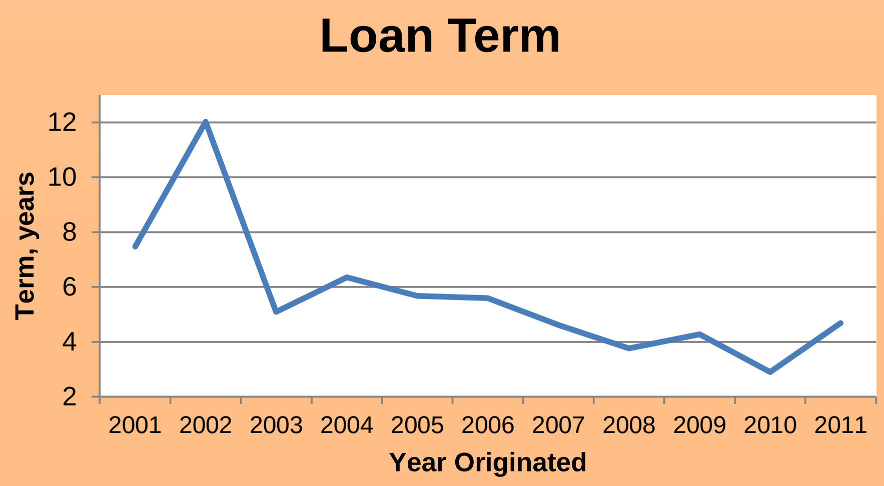
Results

Loan terms

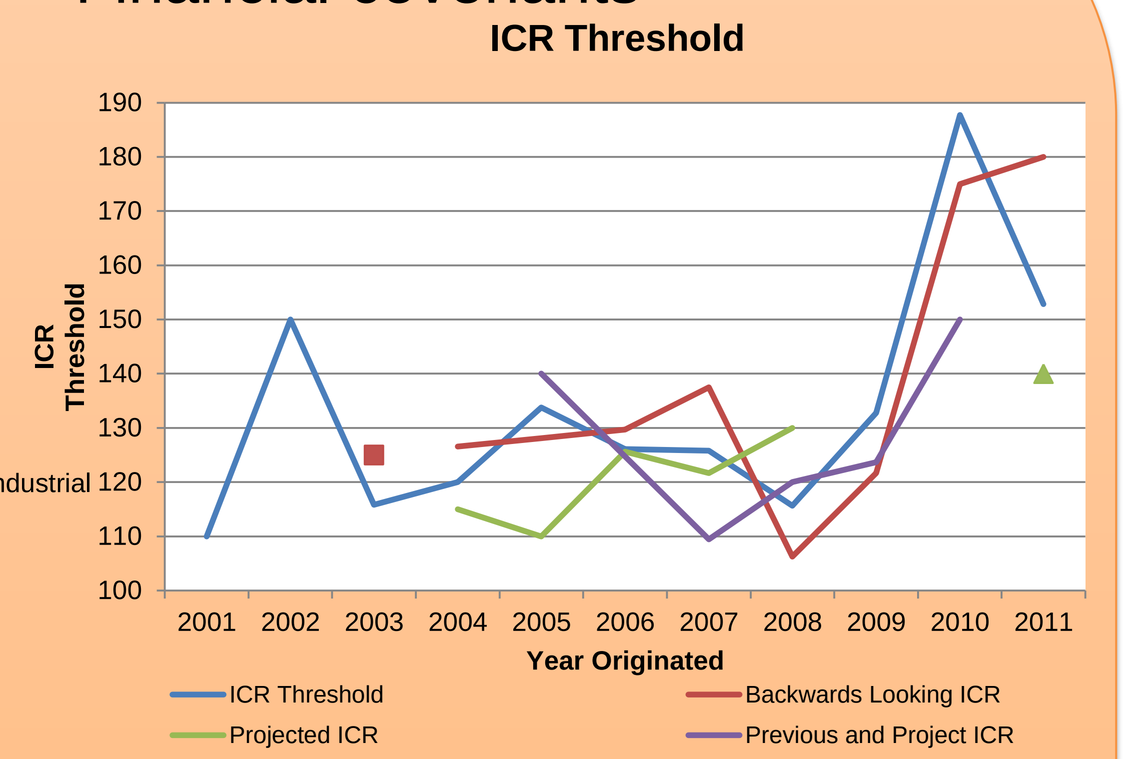


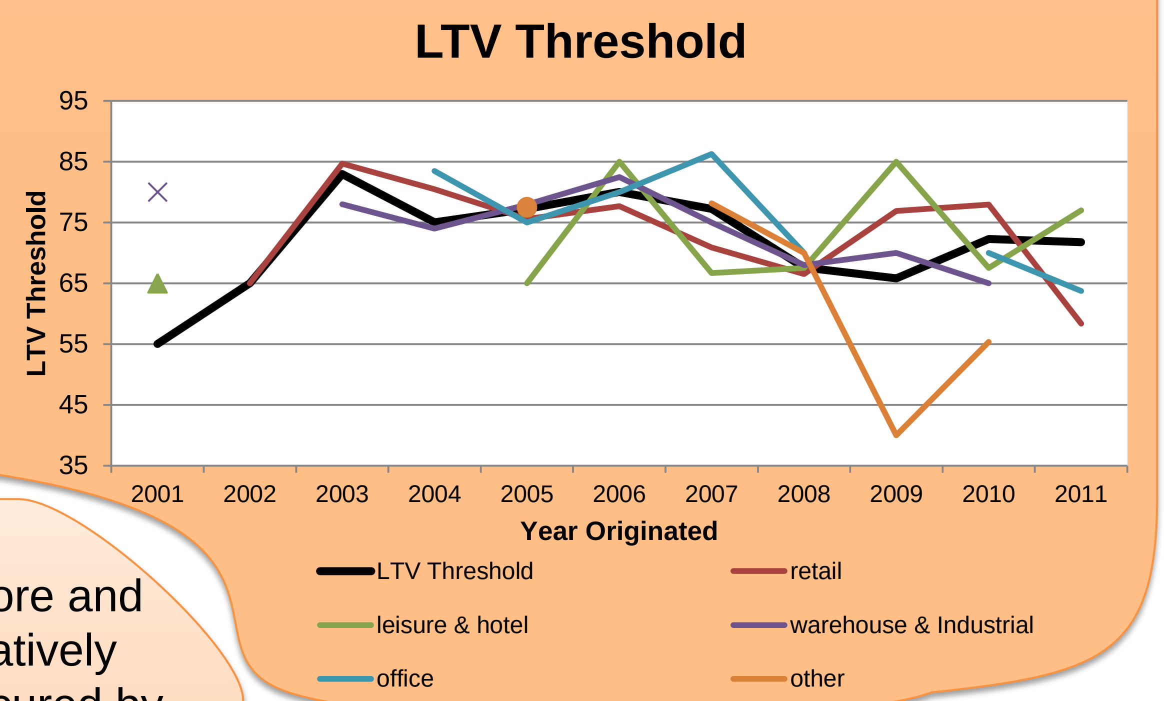






Financial covenants





Conclusion

The results show a bifurcation of the components of commercial real estate loan contracts before and after the onset of the recent financial crisis. While the average length of the loan has had a relatively mild reduction, the cost of loans in terms of margin and fee has markedly increased. Loans secured by real estate capital in more risky locations or of more risky type have witnessed a greater spike in cost for the borrower. In terms of hedging requirements, both the number of loans and proportion of loan which must be hedged has declined following the crisis.

The most commonly used financial covenants, ICR and LTV have become stricter for newly originated loans following the crisis. The DSCR threshold (not shown here) has a more muted response, possibly due to the more heavy use of amortisation necessitating a lower threshold.

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1 Mather, P., Peirson, G., 2006. Financial covenants in the markets for public and private debt. Accounting and Finance, Accounting and Finance 46, 285–307.