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January 2013

Annington PIK Notes
Hybrid High Yield/CMBS Bonds Help Fill Europe's Real Estate Funding Gap

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Introduction

As Europe's commercial real estate debt market enters its sixth year of "credit crunch" disruption, it is increasingly clear that traditional bank lending will not be able to meet the demand for new finance.

The bank debt available at present is largely provided by German banks with funds raised in the *Pfandbriefe* market. The reliance of these banks on *Pfandbriefe* restricts them to providing low LTV debt on prime properties in amounts typically below £100 million. The insurance and private equity/fund sectors have yet to make an impact in direct real estate lending. European CMBS has shown the first signs of recovery with three publicly offered deals since 2011[1], but it will be some years before it reaches the volumes previously seen in the market. Other than CMBS (which has just begun to re-emerge), none of these sources of debt are expected to be available for secondary assets, peripheral locations, distressed borrowers or anything but the most simple property types to any significant extent, at least in the short-term.

Over the same period that the market for real estate debt has shrunk, the market for high yield debt has seen considerable growth with annual European issuance volumes varying between €30 and €50 billion and global annual issuance volumes averaging at over $300 billion driven, *inter alia*, by investor demand in a low interest rates environment.

Development of the High Yield/CMBS Hybrid Market

A. Centre Parcs

In early 2012, a £1.01 billion investment grade issue by UK holiday park operator Centre Parcs sowed the seed for what now seems an obvious move to bridge Europe's real estate funding gap in the high yield markets. This transaction, although not a high yield in itself, was notable for issuing long-dated fixed rate bonds which are rare in the traditionally five-year floating rate European real estate debt market. The make-whole and early redemption premiums included in the Centre Parcs deal and typical in the market for fixed rate debt have historically not been widely accepted by European real estate borrowers who expect to be able to sell or refinance their assets without restriction or penalty. The terms of this transaction were seen as showing that European real estate owners were finally ready to change their traditional models and accept new terms to secure finance in a changing market.

B. Four Seasons

The next step came in June 2012 with a £525 million (£350 million senior secured and £175 million senior notes) issue by vehicles[2] established by Terra Firma to secure the financing for the acquisition of the UK Four Seasons nursing home business. Similar to the Centre Parcs transaction, this deal formed part of the refinancing of a CMBS which previously financed the assets. Unlike Centre Parcs which can be seen as an unusual form of a CMBS deal with certain high yield features, the Four Seasons deal was a classic New York law-governed high yield issuance on standard high yield terms.

C. Annington

The most important development to date is the issue in November 2012 by the Annington Homes Group[3] of £550 million of PIK notes backed by the equity interest in a large portfolio of residential property occupied by UK defence services personnel and leased to the Ministry of Defence[4]. The notes were issued to partly finance the acquisition by Terra Firma of the portion of the Annington business held by Nomura. This transaction, too, is associated with CMBS transactions. Here, the PIK note issuer receives cashflow primarily from the holding company of two CMBS bond issuers with significant outstanding transactions.

The Annington indenture contains a number of innovative terms introduced to the otherwise standard high yield covenant package. These deviations from the standard largely reflect (i) the relatively passive nature of real estate businesses compared to the more complex operating businesses of traditional high yield bond issuers and (ii) techniques and structures commonly seen in real estate financing. The most important of these changes include:

- No ratio debt in the Limitation on Indebtedness Covenant. In a typical high yield bond, the amount of permitted additional indebtedness increases in line with the financial performance of the Restricted Group (so called ratio debt). In the Annington deal, however, the amount of permitted additional indebtedness is confined to a few limited situations and baskets (the “permitted debt”), but is otherwise static. Only for the Rentals and Developments Business of the Annington Portfolio, the concept of ratio debt was introduced, based, however, on Loan-to-Value and Loan-to-Cost ratios, respectively, rather than a ratio of Adjusted EBITDA to Interest Expense or of Consolidated Net Debt to Adjusted EBITDA as would be typical for high yield.

- No Consolidated Net Income based Restricted Payments or Build-up in the Restricted Payments Covenant. In a typical high yield bond, the Restricted Group may make Restricted Payments, i.e. pay dividends or make Investments, in an amount of 50% of the group’s Consolidated Net Income[5]. Both the Consolidated Net Income and the Restricted Payments under this exemption are calculated on an aggregate basis from the issue date. This means that the ability to make Restricted Payments is flexible and changes in line with the group’s financial performance (the so called CNI Build-up). In the Annington deal, however, there are only very limited exceptions to the Restricted Payments Covenant which is otherwise static and does not “breathe” as a result of changes to the Consolidated Net Income.

- Introduction of a cash sweep and trustee controlled accounts at issuer-level for certain proceeds available exclusively for repayment of the notes. Both the concept of a cash sweep and trustee controlled accounts are foreign to traditional high yield bonds.

- Creation of an order of priority of payment (waterfall) for the use of certain funds by the issuer/the Restricted Group. Other than in the context of intercreditor agreements, waterfalls, too, are foreign to high yield bonds where investors rely on the covenant package to protect their interests.

- Addition of real estate typical reporting to bondholders. Typical high yield reporting includes annual and quarterly financials as well as an updated MD&A. In the Annington deal, investors additionally get the reports made available to the CMBS investors, including information on the properties and their valuation.

- Elimination of some baskets and other provisions not relevant to a real estate business.

Comfort as to other standard requirements of real estate debt investors (including limitations on operating costs and capital expenditure and ensuring that the group acts appropriately to refinance its debt) was provided through the covenant packages in the underlying CMBS transactions which apply to a large part of the asset pool and indirectly also benefit the high yield investors as they constrain the sponsor with respect to those assets as long as the CMBS transactions are outstanding.

Outlook

As the first high yield transaction with clear real estate finance features, the extent to which the Annington deal will be a precedent for future similar transactions is not clear at this stage. Going forward, it may be possible to further strengthen some of the typical real estate provisions. This, however, has to be weighed against the need of the issuer to retain sufficient flexibility to maximise the returns from the business. In addition, while some high yield bond issuers, like the Annington Group, will be able to point to covenants in outstanding CMBS or other financings to address (at least to some degree) the needs of investors, many others will not and will have to devise different solutions to these issues.

Much will depend on the investors in future transactions and whether these are offered exclusively to traditional high yield bond investors or whether real estate debt investors continue to be attracted to these investment opportunities. It also remains to be seen whether high yield investors will see any advantages in adopting real estate debt techniques.

What is clear, however, is that high yield bond issues will be an interesting and attractive source of funding to the debt-starved European real estate industry. This seems likely to be particularly the case with sophisticated owners in the hospitality, healthcare and retail real estate sectors as well as owners of secondary assets and owners of very large portfolios, all of whom face significant challenges in raising new financing in the traditional markets.

A version of this article was first published in Real Estate Capital.

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[1] Paul Hastings (Europe) LLP advised the arrangers of all three of these transactions.

[2] Elli Finance (UK) Plc and Elli Investments Limited.

[3] Annington Finance No. 5 plc.

[4] Paul Hastings (Europe) LLP advised investors in the transaction.

[5] Note that in PIK bonds such Permitted Payments are sometimes confined to Investments.

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