Investment in Real estate distressed debt

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PRICEWATERHOUSECOOPERS

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As discussed elsewhere in this edition of UK real estate insights, the continuing real estate crisis is entering a new phase of distress. This is creating new opportunities for distressed debt investors.

Typical strategies of distressed debt investors

Once distressed debt investors identify a real estate backed loan either as a suitable asset in itself or as a means of securing ownership of the underlying real estate asset and/or as an opportunity to take an equity stake in the borrower, they will most likely implement one of the following strategies:

Outright acquisition of the loan

In this case, distressed debt investors acquire the loan from the originator at a discount to face value. The level of discount will be the subject of negotiation between the two parties and will be influenced by a number of factors. The acquisition cost may be financed solely through equity or via debt financing (less likely in the current market). It is not uncommon in today's 'buyer's market' for potential sellers to consider providing vendor financing and deferred payment schemes to investors as a means of improving price through a lower cost of funds.

Through servicing of the loan, investors may be able to achieve their target return via:

- seeking to restructure the loan on more favourable terms to the borrower, with a view to achieving a refinancing or discounted settlement payment in excess of their required return;
- repossession of the collateral (i.e. property asset) via legal or out-of-court means, after which they will manage the asset prior to sale.

Acquisition or conversion of the loan into an equity stake in the borrower

In certain cases, distressed debt investors will either seek to acquire an

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equity stake in the real estate backed borrower or convert the acquired loan into an equity holding. The overall aim would be to influence the management of the company and collateral assets (for example seek liquidation of the company if it is considered that the forecast recovery will achieve the investor's target return).

The type of loans/borrowers spans residential, small and medium sized enterprises (SME) and corporate borrowers. The options available, servicing methods, expertise required and underlying collateral will differ for each loan/borrower type.

Acquisition of the security backed by the asset

In this scenario, investors will acquire the security backed by mortgages on commercial or residential properties (commercial/residential mortgage-backed securities) at a discount to face value.

Commercial or residential mortgage-backed securities are, in most cases, collateralised by fixed or floating rate mortgages and have multi-class structures, ranging from AAA to junior unrated bonds. As with the outright acquisition, the level of discount is negotiated between the seller and the investor. In determining the best approach to realise their target rate of return; investors will consider either:

(i) holding the note with the expectation that property prices or the performance of the mortgages will improve and hence the investor will be able to resell the security at a higher price and realise its internal rate of return; or

(ii) seeking to influence the servicing of the assets, as per the terms of the structure and in conjunction with the other noteholders. In certain cases, investors might seek to collapse the note structure and force early liquidation of the collateral if they are of the opinion that this helps them achieve their target return earlier.

Market challenges

While financial institutions and lenders are coming under pressure across the UK and Europe as defaults increase and collateral values fall, in some markets few sales of distressed real estate secured loan portfolios have taken place, predominantly due to:

i) current provisioning levels versus the perceived market value of the loans and underlying collateral;

ii) government intervention, which has created uncertainty among sellers and buyers regarding the saleability of affected loans and the associated accounting and legal issues;

iii) a lack of debt financing and scarcity of investor capital, meaning internal rates of returns ('IRR') have risen and pricing has decreased in a market where more sellers are emerging;

iv) certain previously active distressed debt investors have exited the market (e.g. Lehman Brothers);

v) lack of specialised servicing capacity, especially in the UK market, due to:

- the more benign credit conditions of the last 10 years;
- the deterioration of the current credit conditions has challenged the profitability and operational structure of existing servicers that are finding current collection levels much harder to maintain in a relatively illiquid market for property sales. This is forcing them to re-examine staff levels and cost structure.
- the difficulties encountered by financial institutions that were significant players in the UK and European servicing market, has created uncertainty over the going concern status of some servicing entities.

The factors above should, however, be temporary and as evidenced by recent regional financial crises in Asia, Latin America and more recently in the United States, financial institutions and lenders are likely to ultimately embrace the loan sale solution, as a fundamental solution to the capital, liquidity, operational and strategic problems they currently face.

The UK is considered to be the largest emerging market for real estate backed distressed debt transactions in Europe, although activity to date has centred primarily on nonconforming loans and more liquid corporate bonds. The expectation is that, like Germany, Italy, Poland and, more recently, Spain, the sale of portfolios of secured defaulted and non-core loan portfolios in the UK will soon become commonplace. This can be attributed to the following reasons:

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- as financial institutions complete their mergers or internal restructuring, they will be focusing more on future strategy and looking to exit non-core markets or operations;
- the UK Asset Protection Scheme only covers approximately 23% for the Lloyds Banking Group and 15% for Royal Bank of Scotland's[1] assets. Taking into account the significant size of the Lloyds and RBS balance sheets (in excess of £1trn for Lloyds and £2trn for RBS), significant downside risk still exists for the participating banks;
- as the levels of distress and capital pressure points increase, management will have to readjust its expectations regarding the intrinsic value of the assets and hence narrow the current price expectation gap;
- investors gradually gain more transparency regarding the bottom of the market and the likely impact that government initiatives (such as the Mortgage Protection Scheme) will have on their pricing and recovery strategy, along with the representations and warranties that they are willing to accept in the sale and purchase agreements;

Tax considerations

When acquiring distressed debt, tax structuring is mainly driven by investor (purchaser) tax considerations; although sellers of distressed debt should be mindful of the potential VAT issues on sale and should seek to ensure that they preserve their corporate tax losses, where possible. There are a number of complexities that arise that make the considerations different from investment in direct property. Investors' return on acquiring distressed debt effectively comprises two components: interest and discount, and the key tax issues that arise in relation to these are:

(i) taxation of the vehicle used to acquire the distressed debt portfolio;

(ii) withholding taxes;

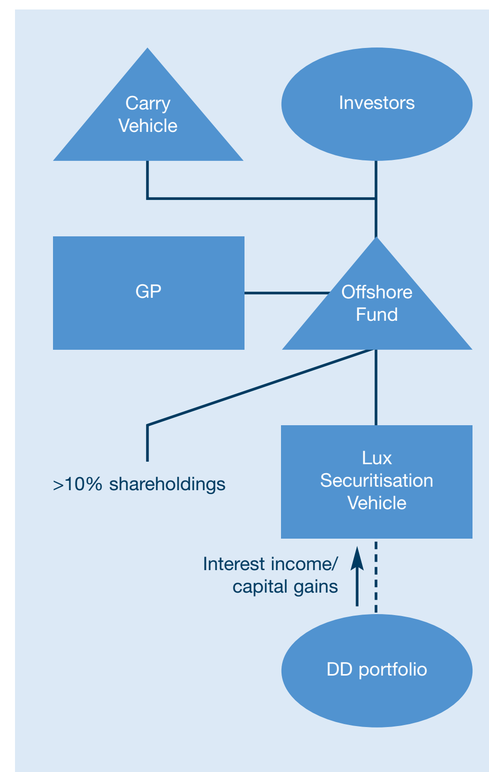
(iii) VAT; and

(iv) carry planning.

In order to mitigate taxation on the debt collection profits and the interest, the investment vehicle is typically located in a low-tax jurisdiction. However, if the debt is not a 'gross paying' instrument such as a quoted Eurobond, then withholding taxes may arise in relation to cross-border interest flows, particular where the debt vehicle is resident in a jurisdiction without the benefit of adequate treaty protection.

The nature of the debt portfolio being acquired and whether withholding taxes are in point will therefore be key tax drivers in choosing the jurisdiction of the acquisition vehicle. Suitable offshore locations without significant treaty networks include Jersey, Barbados and Cayman. Suitable treaty jurisdictions include Luxembourg, the Netherlands, Ireland and Singapore.

Example 1: Typical debt fund structure



Beneficial ownership

Under most tax treaties, reduced interest withholding tax rates are only available if the recipient in the treaty jurisdiction is considered the 'beneficial owner' of the interest and not merely a conduit with very narrow powers. Therefore, investment funds need to take appropriate care in establishing a debt acquisition vehicle in a treaty jurisdiction to mitigate withholding taxes.

Two court cases that have drawn attention to beneficial ownership from tax authorities and tax professionals worldwide are the UK Indofood[2] case and the Canadian Prevost[3] case.
In Indofood it was proposed that a Netherlands company be interposed to receive interest and thereby seek to benefit from the Netherlands–Indonesian tax treaty and reduced Indonesian withholding tax. Although the UK court did not ultimately decide on the beneficial ownership question, it was clear that the UK court did not consider the Netherlands company to be the beneficial owner of the interest received as it was merely a conduit and did not have any powers in relation to the

1 Lloyds Banking Group and Royal Bank of Scotland presentations.

2 Indofood International Finance Ltd v JP Morgan Chase Bank NA [2006] EWCA.

3 The Queen v Prevost Car Inc, 2009 FCA.

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interest received; all the interest had to be on-paid in short order to the ultimate beneficiaries who, apart from the proposed interposition of the Netherlands company, would not have been entitled to the reduced withholding tax rates.

Prevost concerned another Netherlands company, interposed this time to gain access to the favourable dividend withholding tax rates under the Netherlands–Canadian tax treaty. In this case the Netherlands company was considered to be the beneficial owner by the Canadian court as the dividends received were at the free disposal of the Netherlands company. The on-payment of dividends received by the Netherlands company to its shareholders was subject to a final decision by the Netherlands company's board.

VAT

Careful structuring is also required to prevent irrecoverable VAT on the debt collection services provided to the investment vehicle, especially where the investment vehicle is located in the EU.

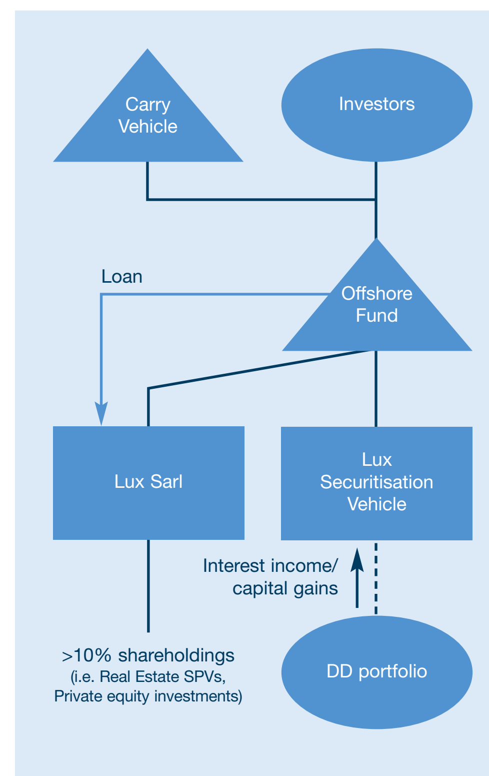
Carry planning

When considering management incentives/carry planning, the tax treatment of capital gains in the UK (taxed at 18%) is significantly more beneficial than current income tax rates; therefore, structuring these incentives in a manner that gives rise to a gain should be advantageous, if this can be achieved. The UK anti-avoidance provisions need to be considered carefully, however, in the context of a debt fund where a significant element of the overall return is likely to be derived from interest, as this is generally categorised as an income rather than a capital profit.

Tax issues on default

Investors in distressed real estate debt need to be mindful of the issues that may arise if they are required to take possession of the underlying properties on which the debt is secured, in the event of a default of the borrower. These issues may include (but are not limited to) transfer taxes, access to capital allowances and/or depreciation and structuring issues. Some widely used distressed debt investment vehicles, such as the Luxembourg securitisation vehicle, are not suitable to hold real estate or real estate companies and additional structuring may be required when taking possession of the properties.

Example 2: Modified debt fund structure to accommodate default



As mentioned above, this is a complex area, and the comments on tax are of a general nature only. Readers should seek advice specific to their circumstances before seeking to establish a debt fund or investing in distressed debt.

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