# Compelling case needed to access non-traditional funding

Although alternative lenders offer valuable flexibility in restructuring situations, they are often quicker to enforce their security, says **Stephen Jacobs**

Since the global financial crisis (GFC), debt funding of operational real estate (going concern business funding, which takes into account the property and business) has seen increased demand for alternative lending. Traditional banks however, have become more risk averse and have sought to manage their balance sheets, avoid weaker sectors and shift to lower-risk property deals. More recent crises such as the Covid-19 pandemic, rising inflation and worries over the strength of the economy have escalated this trend.

These factors have resulted in access to traditional finance becoming more challenging for many, particularly for those looking to restructure debt where there is a greater level of distress.

For example, last year less than half of the debt-funded deals brokered by our sister company for the purchase of operational real estate in the SME and small corporate space were through mainstream traditional lenders, compared with over 80% before the GFC. This increased appetite and growth in funding for higher-risk debt has created more opportunities for restructuring professionals when assisting clients, as they can leverage alternative funding sources to address complex financial situations.

Moreover, higher-risk lending inherently carries a higher probability of default, which also presents opportunities for restructuring professionals.

## Rapid access to funding

Alternative funders have a greater risk appetite, more flexibility around interest coverage and loan-to-value (LTV) covenants and can approve loans in a quicker timeframe than many of their peers. They offer tailored financing options, including whole loans, bridge loans and mezzanine financing. This has afforded flexibility and rapid access to funding, which is crucial in turnaround and restructuring scenarios, particularly when a business is on the brink of insolvency.

Their evolution has widened the pool of funders who can offer debt solutions outside of traditional risk parameters. However, practitioners will need to make a compelling case in order to access such funding, with a comprehensive business plan outlining the strategy for achieving financial stability, including detailed budgets, a line of sight as to how the funds will be used, and evidence that management is capable of delivering the change.

> **Loans not being repaid at maturity was the most common reason for default. The knock-on effect is likely to see increasing demand for restructuring and insolvency services from both debt funders and directors**

Lending against operational real estate where there is distress has been predicated by steeper pricing to reflect risk, with some borrowers holding assets financed through alternative lenders at higher LTV ratios than traditional lenders.

An era of ultra-low interest rates from mid-2009 saw the proliferation of fixed-rate loans that enabled businesses to lock in and enjoy the benefits of cheap money. According to M&G Investments' Global Real Estate Outlook 2024, nearly 40% of outstanding UK commercial property loans would mature in 2024 and 2025. Many of the loans that have matured were agreed at much lower interest rates than were available at expiry, and the outlook is that refinance rates will continue to be higher for loans maturing during 2025.

The maturity of fixed-rate loans has created challenges for businesses needing to refinance or restructure. Higher interest rates and inflationary pressures have eroded operating margins for many businesses and impacted profitability. This in turn has had an impact on the value of operational real estate whereby a decline in EBITDA has effectively pushed LTV ratios higher, making it harder for borrowers to meet the criteria of some lenders. This has created a funding gap between refinancing requirements and the availability of debt funding, limiting how much debt a borrower's underlying trading assets can support. For a funder to accept a level of risk with the upside of an equity stake in supporting the business, it is crucial for the restructuring professional to be able to demonstrate that there is a viable plan for the business to overcome its problems and restore financial stability.

For a restructuring professional, this could mean walking into a situation where if a refinance is not viable then an asset sale may be the only option. However, the erosion of EBITDA will have an impact on the value of a trading business. The practitioner will need to establish what the business will achieve if it is sold to ascertain if the debt can be repaid. Consideration may need to be given to the closing value of the asset after trading. The cost of running the business, if it is loss-making until a sale is completed, may return a lower recovery for creditors than if it is sold closed.

## Kick the can down the road

According to the Bayes Real Estate Research Centre, the debt funding gap in the UK commercial real estate sector between 2022-2026 is estimated to be £27-37 billion. The report further states that the debt funding gap represents approximately the annual new lending capacity of UK debt funds.

Where trading property values have declined, we have seen less appetite from lenders to crystalise their losses through forced sales or foreclosure. One solution to bridging the gap is to extend existing loan facilities with the aim of resolving the situation later. At a time when the cost of capital is still relatively high, despite interest rates starting to come down from a 16-year high of 5.25%, an extension to pay off burdensome debt will kick the can down the road, particularly if the cost of servicing it does not reduce materially in the short to medium term. The speed and pace of anticipated interest rate reductions will be critical for the survival of the most heavily indebted borrowers.

According to the Bayes Business School's Mid-Year 2024 Commercial Real Estate Lending Report, the volume of UK real estate loans in default or breach of covenants reached £7.3 billion at the start of the second half of 2024, of which £3.7 billion of loans were in default and a further £3.6 billion in breach, as elevated interest rates continued to put pressure on borrowers. The total default figure represented 4.9% of all outstanding UK real estate loans, up from 4% at the end of 2023, but is still significantly lower than the 2010 peak of 25%. Moreover, the report said that loans not being repaid at maturity was the most common reason for default. The knock-on effect is likely to be increasing demand for restructuring and insolvency services from both debt funders and directors. This will drive an increase in both turnaround and restructuring assignments, and company insolvency processes where rescue is not viable.

High cost of capital: the speed and pace of interest rate reductions will be critical for the survival of the most heavily indebted borrowers

## Large runway for borrowers

Loan facility extensions are often subject to valuation to ascertain whether trade and LTV will support an extension, and we have seen a rise in the number of valuations that we have undertaken in this scenario. In instances where funders will not lend due to a valuation not stacking up because of the level of borrower stress or distress, the only option may be to sell assets to repay debt.

> **2025 is likely to be particularly challenging for a swathe of SMEs already operating on the thinnest of margins as a hangover from inflationary pressures and the higher cost of servicing debt**

Notably, we saw an increase in the number of consensual sale mandates in 2024 where directors were actively attempting to refinance while marketing their businesses for sale. In some cases, the decision to sell was driven by the incumbent lender offering forbearance as leverage over a borrower to ensure the potential for more than one route to exit the relationship. This behaviour was most prevalent when confidence in the ability of a borrower to refinance was low.

We have seen different behaviours towards borrowers across the debt funding scene, with traditional lenders generally affording greater forbearance by providing a longer runway for borrowers to restructure or refinance compared to alternative lenders who have been quicker to appoint administrators or receivers to enforce their security and sell assets to recover their loans.

Despite enduring operational and cost challenges, SME and small corporate operators have shown resilience in recent years and looking forward, there are some good fundamental conditions to be positive about. The UK debt market is more diverse than it was during the GFC, with a much wider array of investor types and alternative funders offering creative solutions to adapt to market conditions and needs. The expectation is that interest rates will continue to fall during 2025, and inflation will stabilise, which has the prospect of boosting levels of activity. Although mainstream traditional lenders are still relatively cautious, it is hoped they will improve their lending appetite, and that alternative lenders and new entrants will continue to focus on niche areas of lending.

## Double the liability

Looking at the macroeconomic landscape, 2025 is likely to be particularly challenging for a swathe of SMEs already operating on the thinnest of margins as a hangover from inflationary pressures and the higher cost of servicing debt. Any relief from interest rate cuts is likely to be afforded through reductions in small increments over a prolonged period and will therefore be burdensome to them in the short to medium term.

Businesses will be further challenged by the tax measures imposed in the Labour Party's November 2024 budget. These include, from April 2025, an increase in employers' national insurance contributions and the national living wage and minimum wage, and a reduction of business rates relief from 75 to 40%, which will effectively double the liability for retail and leisure operators.

These cost challenges will impact the operational viability of the weakest businesses leading to decreasing loan serviceability, business distress and failure. While the alternative funding market will be able to take up some of the refinancing slack, we will see more non-performing operational real estate coming to the market both consensually and through insolvency, as exit-by-asset sales will be the only viable option. This will create opportunities for well-funded and experienced operators, speculative investors and private equity waiting for distressed opportunities to emerge, driving both restructuring and deal activity.

**Stephen Jacobs** is director of bank support and business recovery at Christie & Co