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Opportunities are slow to unfold in European real estate debt

A golden era for alternative real estate lenders has so far failed to get underway. But there are signs the machinery is becoming unclogged, writes Judi Seebus

A year ago, alternative real estate lenders in Europe were convinced they were on the cusp of a golden age. During *PERE*'s European debt roundtable discussion in March 2023, participants spoke of a "huge" opportunity ahead to take advantage of a potential shortfall in refinancing funds for maturing loans amid a potential retrenchment from traditional lending sources. "I have seldom been this excited to be investing in debt," said one participant.

It is a storyline that global investors have continued to buy into. In a January survey by INREV, the European Association for Investors in Non-Listed Real Estate, 84 percent of respondents said they intended to increase their allocations to European non-listed real estate debt funds. This marks the third consecutive year in which debt has been singled out by global investors as their preferred route of entry into European real estate.

Despite these great expectations, the four managers taking part in this year's *PERE* European debt roundtable say demand for new lending has so far failed to emerge on a significant scale. Indeed, borrowers spent most of 2023 digesting the rapid repricing of real estate after interest rates began to rise midway through the previous year. The resultant large bid-ask spread between sellers and buyers led to a record-low volume of commercial real estate transactions in Europe last year at €166 billion, roughly half the previous year's total, according to MSCI data.

The expected wave of opportunities generated by a wall of maturing debt has also yet to surface to a meaningful degree for alternative lenders, while signs of distress in the system are virtually absent as traditional lenders play the waiting game and extend existing loans, particularly for well-collateralized debt with strong sponsors. However, at the close of the first quarter of the year, the roundtable participants see transaction activity starting to normalize, which will drive more opportunities for acquisition financing.

Indeed, sellers that have been holding on to assets to find value are now starting to accept the reset in asset values, while buyers looking for rock-bottom prices are becoming more realistic, says David White, head of real estate debt strategies, Europe at

PHOTOGRAPHY: **JON CARDWELL**

Hans Vrensen

Head of research & strategy Europe, AEW

Hans Vrensen is a managing director heading AEW's award-winning European Research & Strategy team and a member of the European executive committee and investment committees. He has 30 years of international commercial real estate capital markets experience and previously worked at Green Street, DTZ/C&W, Barclays, Moody's, LaSalle IM and C&L/PwC.

Christian Janssen

Managing director & head of real estate debt Europe, Nuveen

Christian Janssen is a managing director and head of real estate debt for Europe at Nuveen Real Estate. He has over 30 years of experience in structured finance, real estate debt and investment management and previously worked at Renshaw Bay, Barclays Capital, Morgan Stanley and First Boston's Mortgage Financial Engineering and Project Finance Groups.

Matteo Milan

Managing director real estate debt, Cain International

Matteo Milan is a managing director at Cain International and is focused on the management and expansion of its debt strategies across the UK and Europe. In 2023, Cain arranged approximately $2 billion in commercial real estate financing opportunities globally and is targeting greater levels of activity for 2024.

David White

Head of real estate debt strategies, Europe, LaSalle Investment Management

David White is the head of LaSalle Real Estate Debt Strategies in Europe and has an extensive track record of working in real estate private equity and investing throughout the capital structure. Prior to joining LaSalle, David started his career at Deutsche Bank, before co-founding a pan-European alternative lending business.

manager LaSalle Investment Management. "There has been a delay in transaction activity, but we have seen an increase in acquisition financing within our pipeline," he says. "For refinancing opportunities, we continue to see good borrowers lean into assets that they want to continue to support, and in certain cases, they require financing solutions that may be bespoke to their business plans. That is an area where we have a competitive edge as an alternative lender."

Banks still open for business

With regards to refinancing opportunities, however, a larger number of sponsors than expected have been propping up maturing loans with new equity, reflecting a level of confidence in their investments and the underlying market fundamentals. Banks have largely stayed open for business and managers like LaSalle IM are collaborating with them to resolve issues for borrowers, adds White. "We are working alongside senior banks in many instances to find capital solutions, whether that is senior or mezz financing. We are often not there to compete – in many instances it is quite the opposite."

Matteo Milan, managing director for real estate debt at manager Cain International, likewise sees the debt refinancing market opening up as both borrowers and lenders come to grips with potential losses. "The banks have been slow to react and have been giving borrowers a year or two years' extension. The lack of valuation evidence, which can vary by jurisdiction, has been exacerbating the problem," he says.

Many borrowers are still reeling from the shock of having moved from a near-zero interest rate environment to more normalized market conditions, adds Christian Janssen, managing director and head of real estate debt for Europe at manager Nuveen. "It is not that rates are so high now; it is that they were so low for so long, and investors assumed that was the new normal. But once we start seeing some transactional evidence, the market will unclog itself pretty quickly."

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>
> **CHRISTIAN JANSSEN**
> **Nuveen**

All four participants agree the opportunity in the real estate debt space remains "phenomenal" and that transaction volumes will surprise on the upside in the next few years. The return potential of debt is attractive relative to equity, says Janssen. While senior debt for a prime Class A office may generate a return of between seven and nine percent at a comfortable 60-65 percent loan to value, an unlevered acquisition of the same asset may yield no more than five percent, he points out.

Nevertheless, some institutional investors are currently overallocated to real estate due to the denominator effect, meaning they are hesitant to invest in debt, Janssen notes. They may be in danger of missing the bottom if they wait too long, he adds. "That is something that niggles at the back of my mind, but it does not look to me that this opportunity will be short

"A rate cut would be a great boost for equity investors and once they go in, debt transaction volumes will increase"

MATTEO MILAN
Cain International

lived. I think we are on a higher-for-longer interest rate trajectory, and we should have three to five years where debt investments will be very interesting. There is still a significant funding gap and a fair amount of pent-up demand for debt from borrowers."

Lessons from the past

Research from manager AEW indicates the debt funding gap for commercial real estate loans due to mature in Europe between 2024 and 2026 is approximately €100 billion, which is not as big as it was during the global financial crisis. Meanwhile, regulations introduced since then have also spurred traditional lenders to become more prudent and allocate higher reserves against non-performing loans.

The risks will likely be concentrated in certain vintages, as they were in the commercial mortgage-backed securities market post-GFC, says Hans Vrensen, head of research & strategy Europe at AEW. "Ultimately, the returns on credit are largely about loan origination vintages as well as careful due diligence, and to a lesser extent about real estate fundamentals. Some NPL portfolio sales may be expected to come out of the 2018-23 vintages, but I have not yet heard of any – perhaps because more adequate reserves have already been built in to absorb potential losses."

Banks, borrowers and alternative lenders alike have drawn lessons from the GFC, and high LTV levels of 85-90 percent are now a thing of the past, White points out. In the case of a breach of covenant, many borrowers have been plugging the holes themselves, he adds: "As a lender you may need to be a little more creative if the borrower does not have any more capital to deliver alone. But broadly speaking, we have been seeing a bit of a virtuous circle. The European lending market typically includes financial covenants, which is a big difference with a lot of the US market, and that allows a

lender to get ahead of problematic situations, often before it is too late."

Most central banks across Europe have put more stringent banking regulations in place over the past decade, leaving more space for alternative and private fund lenders. This is particularly true of the UK, where the introduction of slotting rules in 2014 requires banks to review their real estate lending and has significantly reduced the risks they have been able to take.

The UK and Spain were the two biggest real estate markets impacted by the GFC in terms of distressed loans, but AEW estimates the debt funding gaps in both these countries – as a proportion of loans originated between 2018 and 2021 that will be subject to a funding shortfall upon maturity – are now among the lowest in Europe, at 9 percent and 14 percent, respectively.

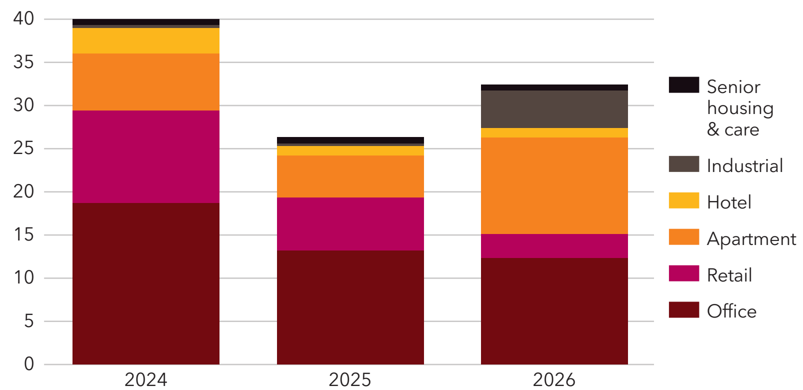
Germany, on the other hand, had a much less bruising experience in the GFC due to its efficient bank funding channel with covered bonds. But it now has the highest relative debt funding gap in Europe, Vrensen notes. He singles out German residential as a potential source of problematic debt exposures, adding that most refinancing challenges will stem from a combination of debt service coverage and LTV issues. "Mezzanine loans could add an additional layer of complexity," he notes.

Janssen agrees: "Some investors are facing debt service issues, but at this stage the indications are that this is not an endemic problem, even with the (European Central Bank) saying lenders should be looking very carefully at their commercial real estate loan books."

Investors crave stability

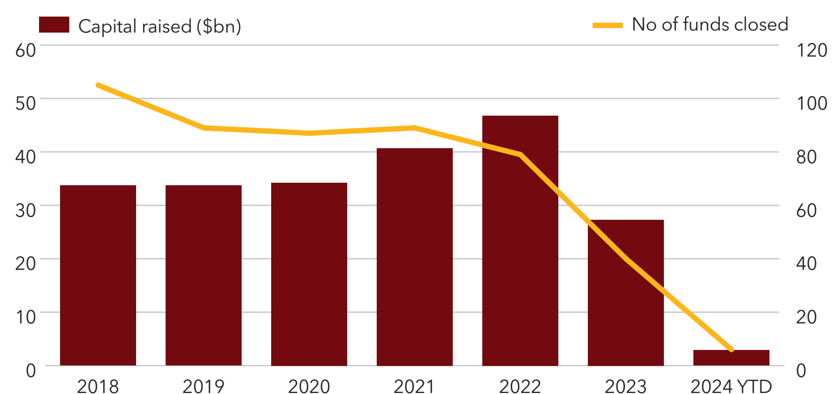
The looming wave of maturing loans will trigger more refinancing activity, either through debt or partial equity solutions, Janssen adds. "Last year there was a lot of uncertainty and fear in the market, but market participants now seem to be more convinced there

Volume of commercial real estate loans due to mature in Europe in 2024-26 by sector (€bn)



Source: AEW Europe

Capital raised for closed-end private real estate debt funds globally since 2018



Source: PERE

"The ECB and the Bank of England have done a great job in stabilizing the banking system post-GFC, but European central banks are not providing anywhere close to the transparency we see in the US"

HANS VRENSEN
AEW

Green milestones

Lenders have traditionally followed landlords on the pathway toward a carbon-neutral future, but are increasingly taking the lead

One of the bright spots in the current real estate cycle is that demand for green loans has been rising, and is not expected to diminish any time soon. LaSalle Investment Management is more active in green lending now than it was 12 months ago, says David White, who is convinced the firm will be even more active in this segment over the next 12 months.

Indeed, lenders have a clear role to play in the energy transition of buildings and retrofitting existing ones to improve energy efficiency and performance, says AEW's Hans Vrensen. "Lenders want to avoid the risk of non-compliant buildings – those that do not meet legal minimum standards – becoming stranded, as that would leave little or no collateral value for the lender to fall back on."

To reach the decarbonization targets agreed in the Paris Climate Accord, more governments are setting minimum Energy Performance Certificates for buildings, while lenders are quantifying the costs of the capital expenditure required to bring existing assets up to scratch. Some developers on the journey toward environmentally friendly or even carbon-neutral buildings are being spurred by incentives such as lower debt costs.

Lenders can justify a lower cost of debt if it means the asset will enjoy greater liquidity and demand from a capital value perspective, which in turn means lower risk, says White. "Borrowers are starting to recognize they may need to provide additional reporting and data for a green loan, but that is something they were already starting to sign up for."

The ESG bar is continuously being raised in both new developments and refurbishments, adds Cain International's Matteo Milan. "That is the way to attract tenants and drive rental growth. If I look at our lending book and what we were financing five or six years ago, I see that our borrowers are continuing to develop an even better state-of-the-art asset in terms of green credentials. We incentivize that and are proud to be part of that journey."

One of the obstacles for both borrowers and lenders as well as the LPs backing debt vehicles is the huge variation in energy and carbon data points, says Nuveen's Christian Janssen. "It would be beneficial if there were greater standardization and clear guidelines on what data and reporting formats are needed. But it is still early days and as this industry matures, the market will move in that direction because it will enhance transparency."

Meanwhile, the European Loan Market Association has introduced a framework for green real estate loans and an ESG due diligence questionnaire, which encourages managers to assess and report carbon emissions for the underlying loans. LaSalle's lending criteria are based around green pathway goals with economic terms linked to achieving these, and verification by third-party advisers. A growing number of borrowers are also willing to report on energy consumption, whether they are required to or not, says White. "Almost all of our borrowers have started sharing consumption data. We are on a good pathway, but there is still lots to achieve between now and 2050."

may be two or three rate cuts this year and not six. What investors really crave is stability, and the expectation of the [interest rate] curve is moderately downward sloping."

Meanwhile, debt funds that have been raised over the past 12-24 months are coming under greater pressure to deploy capital and are also competing with banks for good assets, says Milan. "A borrower may see only three term sheets for a property in a less favored segment of the market, but the number could rise to as much as 15 for an asset that ticks all the boxes in terms of quality, location and sector."

Lenders may offer lower margins and more flexible covenants for alternative assets such as student accommodation, build-to-rent properties and well-located logistics facilities. This approach can also extend to traditional asset classes like offices, especially those in prime locations, with sustainable designs and backed by high-quality sponsors, he adds. "There is always a trade-off between discipline and the relationship with the investor. A rate cut would be a great boost for equity investors and once they go in, debt transaction volumes will increase."

The refinancing pain in the current cycle is being felt most acutely in the commercial office sector, while logistics assets and living subsegments such as build-to-rent and student housing remain popular among equity and debt investors alike. Many investors have put offices in the penalty box, but the weak sentiment around this asset class in Europe is overblown, says Vrensen. While average office vacancy rates across the US are 22 percent, they are only 8 percent in Europe, he notes.

Given the ongoing flight to quality by office tenants, well-located, ESG-compliant assets represent an excellent opportunity, the participants agreed. "We are a great believer in the office space, particularly now with the right sponsor," says Milan. "But you need to go back to the basics and look at the location and the cashflow that is coming in."

Looking for a niche

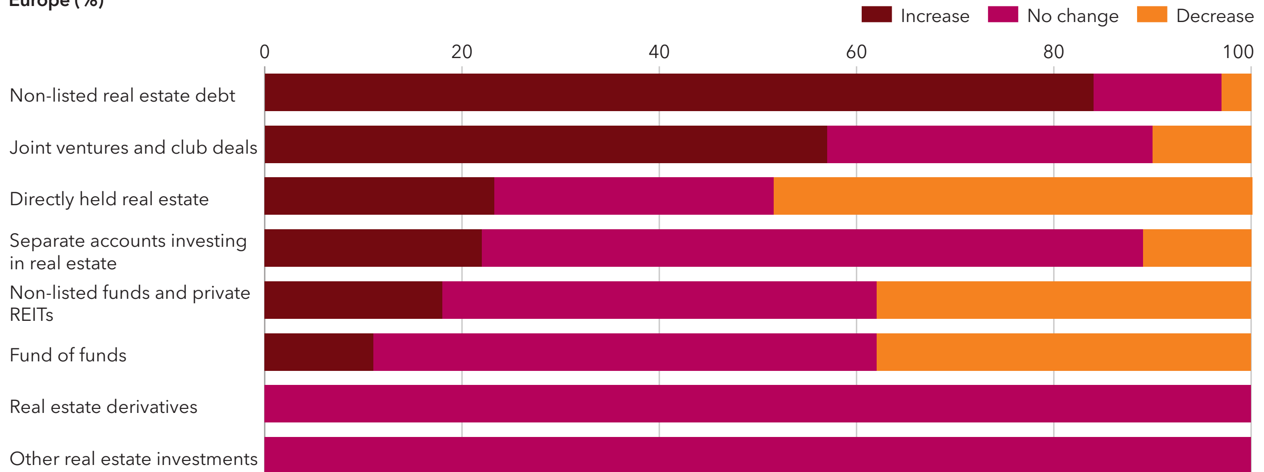
PERE data shows $150 billion has been raised for closed-end private real estate debt funds globally since 2020. That said, none of the participants think there will be an indiscriminate rush to flood the market on poorly underwritten loans just to get this capital out the door.

Instead, conversations between borrowers and lenders are focusing increasingly on risk versus returns and potential value drivers in the period ahead, for example what the underlying business plan is and whether it is progressing according to schedule. A lender's job is to stress-test models and think about where value is, White says. "Our role is to find a comfortable fixed-income credit profile and return capital for our investors as opposed to creating alpha through equity-type risk."

As lending against real estate becomes less attractive for traditional lenders due to higher capital requirements, banks are becoming more selective and focusing primarily on the assets that make sense for them and where they can add ancillary services or products, Janssen notes.

While banks have not withdrawn en masse from the syndication market, they are now taking a smaller piece on their balance sheets, he adds. "The market segment that works for banks is very efficient and pricing for core assets with low LTVs and a stable cashflow is very competitive. Alternative lenders do not want to compete against banks there; they do not get covered bond treatment, nor do they get to borrow at Euribor plus a small spread. Alternative lenders must find a space where they have a competitive advantage, either

The majority of respondents to INREV's investor survey (weighted by real estate AUM) expect to increase near-term real estate debt allocations to Europe (%)



Source: INREV, Investment Intentions Survey 2024

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>
> **DAVID WHITE**
> **LaSalle Investment Management**

mezzanine or development or brown-to-green financing or longer durations – that means loans that do not fit into what the banks do."

Some banks may still originate a whole loan and sell off the mezzanine and/or senior debt, but the reverse is also occurring with alternative lenders stepping in as originators. The rise of advisory brokers, meanwhile, is facilitating greater competition between different types of lenders and oiling the further development of multiple channels of debt financing.

While banks remain a formidable participant in the European market relative to the US, where the division between traditional and alternative lenders is more balanced, Janssen is optimistic Europe will move towards a 60:40 split within the next five years. "It is a process of evolution, not revolution," he says.

The move towards a more differentiated offering of liquidity options is not cyclical either, White says. "Borrowers need various solutions across a variety of situations. Where a bank says 'not for us,' we might be able to find the right solution because we are not constrained by regulatory capital requirements or balance sheet pressures that the bank may have. The European market, particularly on the continent, is shifting more towards the US model, with additional solutions for capital and borrowers via the growing alternative lending landscape."

Transparency in Europe lags US

Another area where the more mature US lending market still has a big advantage over Europe is enforcement procedures, which are fairly standard across the country. With rules differing across jurisdictions in Europe, lenders are forced to spend huge amounts of time researching risks and ensuring low-probability scenarios are fully covered.

Janssen points out that loan documents may number up to 200 or 250 pages. Given the challenge of enforcement in some jurisdictions, the most obvious targets for alternative lenders are the larger markets that are more liquid and transparent, the participants agreed.

Transparency on real estate lending is an area with much room for improvement, says Vrensen. "The ECB and the Bank of England have done a great job in stabilizing the banking system post-GFC, but European central banks are not providing anywhere close to the transparency we see in the US. European CMBS was the only market segment that was truly transparent, but unfortunately this product was blamed for much of the GFC, and regulators have not allowed it to return as a funding channel in Europe.

"Post-GFC regulation has not improved transparency in the European real estate lending market. Two steps forward, three steps back is how I would describe it."

Lenders also have a role to play in promoting transparency, says Janssen, as well as in ensuring the assets they finance or refinance retain their value long-term. "Overall, I think the industry is moving in the right direction," he adds. ■