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Europe Debt roundtable

ROUNDTABLE

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A historic opportunity for European real estate debt

Alternative lenders are strongly positioned to make up the continent's funding shortfall. But raising capital is a major issue, say participants in PERE's roundtable discussion. Stuart Watson reports

As the participants meet in late March for *PERE*'s European debt roundtable, finance is making headlines around the world, and not just on the business pages. A little more than two weeks earlier, the news of tech lender Silicon Valley Bank's collapse triggered a minor banking crisis. Another US lender, Signature Bank, also folded soon after, forcing regulators to step in to calm the sector. Nonetheless, contagion subsequently spread to Europe, where UBS stepped in to take over stricken fellow Swiss bank Credit Suisse, and a sell-off of shares caused jitters about the future of Germany's Deutsche Bank.

The precarious condition of the global financial sector is thus the backdrop to a meditation on the position of real estate debt as a strategy for institutional capital in Europe – its impact being an obvious jumping-off point for the five alternative lenders at the table. One of them, 30-year industry veteran John Cole, global head of real estate debt at London-based investment firm Cain International, has just returned from a business trip to the US, where he took the temperature of the lending market.

Cole observes that the Federal Reserve's rescue plan appears to have calmed markets to a degree. But the Fed has continued to raise interest rates – albeit more slowly than previously anticipated – in the hope of targeting inflation, and there are still concerns over liquidity.

"We are at a pivot point. Has the rate peaked? The Fed needs to ensure confidence in the financial system, and further interest rate hikes of any significance will clearly impact that, so the room for maneuver is very tight. Everyone is looking for where the next pinch point will be, and because the market is global, that is not just a US problem. It is a European one too."

Could the banking sector be headed for a 2008-style meltdown? David White, head of European real estate debt strategies at Chicago-headquartered manager LaSalle Investment Management, believes it is unlikely: "Things are moving very quickly, but I think there will be more wobbles rather than major failures. We have seen from previous downturns that it is hard to predict which institutions will get into difficulty."

Nervousness in the financial markets is prompting caution on behalf of lenders and causing a contraction in credit provision, says Christian Janssen, head of real estate debt for Europe at London-headquartered manager Nuveen Real Estate.

The squeeze on debt is having a knock-on effect on asset prices, and meanwhile the anticipation that values will fall is prompting lenders to take an

PHOTOGRAPHY: RICHARD DAWSON

David White

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

White, who has more than 16 years' experience in real estate private debt, oversees LaSalle's Real Estate Debt Strategies business in Europe. The European Debt Investments' team of 25 people covers higher-yielding debt investments and senior-secured lending strategies. LaSalle has made over €6 billion of debt investments in Europe since 2010.

Ellis Sher

Co-founder and chief executive officer, Maslow Capital

Sher co-founded Maslow capital with Marc Rose in 2009. The firm has hitherto focused on loans in the UK living market, but is now expanding into other European jurisdictions following the January 2022 acquisition of a significant minority stake in the business by Arrow Global. Maslow's 30-strong team oversees a £1.5 billion book consisting of loans of £10 million to £300 million.

Christian Janssen

Head of real estate debt, Europe, Nuveen Real Estate

Janssen joined Nuveen Real Estate in 2013 to launch its European debt platform. The 14-strong team manages two principal strategies, consisting of core and core-plus financing, plus some segregated accounts and discretionary funds. The firm manages around $45 billion of real estate debt globally, including more than $5 billion in Europe.

Natalie Howard

Head of real estate debt, Schroders Capital

Howard joined Schroders Capital in January 2021, tasked with building the global investment manager's European debt platform. She leads a 10-strong team offering loans across the whole of the debt capital stack. The business aims to grow its loan book to €5 billion over the next three years.

John Cole

Global head of real estate debt, Cain International

Cole joined Cain International in 2014, where he leads a team of 22 people. The London-headquartered private equity real estate firm provides development finance tickets of $50 million-plus in the UK, US and continental Europe, as well as smaller loans through its Fortwell Capital business. The firm's loan book since inception totals $6 billion, and currently stands at $2.9 billion.

even more cautious stance, creating a "feedback loop."

Real estate capital values have adjusted quickly in the UK, but cap rates in the US and continental European markets have not yet moved out as much, he observes. "There will be some stresses over the next six, 12 or 24 months. Not everyone will lose money, but in aggregate, real estate valuations will come under pressure. At this stage, people are still processing where value will end up. What is happening in the banking sector may be another domino to fall, exacerbating the value adjustment we have seen over the past 12 months."

Some form of recession is coming, predicts Natalie Howard, head of real estate debt at London-based manager Schroders Capital. Increased default levels are being seen across banks' SME lending portfolios. "We are seeing less liquidity in all aspects of credit, which is starting to affect businesses. It is those companies which pay the rents that determine the value of buildings. If you overlay the fact that real estate has to command a premium to the risk-free rate, then that must impact asset values."

Huge opportunity

With the attention of the banking sector focused on staving off its own liquidity crisis, rather than meeting the lending needs of property investors, that opens a clear opportunity for alternative lenders. "In our business you want to be going long when the dominance of the banks is giving way," says Ellis Sher, chief executive officer at London-headquartered development finance provider Maslow Capital. "Whether in a bull or bear market, real estate debt always offers good risk-adjusted returns. Our job has always been to get a near-mezzanine return for a senior debt risk, and this is a market that tends to favor that."

Howard says: "The opportunity in real estate debt is huge, especially if you consider the size of the funding gap that there is now. Europe is a trillion-euro market, 7-8 percent of which is currently served by alternative lenders. The banks have retrenched significantly. Somebody has to fund that."

The latest research by investment manager AEW on the European debt funding gap, published in January, puts the shortfall between the UK, German and French real estate loans due to mature in 2023-25, and the amount of new financing available to repay them, at €51 billion. "Because of the Basel IV regulations, the banks are no longer allowed to extend and pretend on their loans, so that is going to build up a wall of refinancings," she adds.

"Risk is at the forefront of investors' minds, now more so than ever," says White, a trend that he believes will favor allocation to debt strategies over equity. "We used to show how you could get a very attractive risk-adjusted

"Whether in a bull or bear market, real estate debt always offers good risk-adjusted returns"

ELLIS SHER
Maslow Capital

return for debt next to the assumptions you would need for your equity to produce a higher return. Historically, the answer was often, 'Yes, but we want the higher return.' Today, this situation has changed, and more investors than ever are favoring the risk-adjusted income yield that debt investments offer."

Risk-adjusted returns for real estate debt have always been attractive, says Janssen. The difference today is that the asset class offers nominal returns that are exciting, too. "Base rates have gone up 300 basis points, credit spreads have widened somewhat, and there is less liquidity. In the past, a borrower might agree to 10 percent on a bridge basis. Now they will accept 10 percent for five years as standard. Of course, nobody wants to be borrowing at double-digit returns for a long period of time. But there is no other option.

"There is so much liquidity out there. But only a tiny percentage of it is being allocated to commercial real estate debt"

JOHN COLE
Cain International

"Not only is the nominal return really interesting, but so is the relative value because returns are similar in equity and debt, but for equity there is potential downside that is not priced in yet. So some investors in both real estate equity and debt are making a tactical shift in their allocation from equity to debt for the next two or three years until they feel bullish about equity again."

The current climate also favors the reallocation of other capital streams to real estate debt, suggests Howard. "We are seeing a lot of institutional money going into the 6-8 percent-yielding strategies. A significant proportion is coming out of corporate direct lending. Risk levels in that market have quadrupled and loss rates are much higher than in secured lending, while returns have broadly stayed the same, so those investors are looking at real estate and infrastructure debt as diversifiers in their credit bucket. What we need to do is continue to educate investors that there is a strong relative value case right now for real estate debt, which can provide the income and downside protection that they need in challenging markets."

Education process

Real estate debt offers attractive risk-adjusted returns in the current market climate, and borrowers willing to sign up to attractive terms are plentiful. But tapping into the apparently ample supply of investor capital is proving more difficult.

PERE research shows fundraising for European real estate debt strategies fell from $10.9 billion in 2021 to $5.8 billion last year. Raising money is the biggest challenge, admits Howard: "There isn't a single fund manager I have spoken to who said fundraising was easy last year. I think everyone raised much less than they thought."

Arrow Global, a shareholder in Maslow Capital, was an exception to that rule, holding a final close for its

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Schroders Capital

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CHRISTIAN JANSSEN
Nuveen Real Estate

second credit opportunities fund, ACO II, on a hard-cap of €2.75 billion in March.

"They raised that in eight months, with a 100 percent re-up, and it was oversubscribed, which is unheard of in the current environment," says Sher. "That is really a non-performing loan fund, which gives you some idea of where investor sentiment is heading."

Participants concur that, in Europe, the mission to educate the market about the scale of opportunity and relative value available in the real estate debt space, which grew out of the global financial crisis, remains incomplete.

Cole says: "There is so much liquidity out there. But only a tiny percentage of it is being allocated to commercial real estate debt. In a lot of ways, it is better, because there are more of us making the argument; however, that educational process which began more than 10 years ago is still really just scratching the surface."

Attracting fixed-income money into the space is agreed to be particularly problematic, often because managers whose primary focus is real estate equity lack contacts within that corner of the investor universe.

"A lot of equity investment managers who are looking to broaden into debt are not tapping into that fixed-income market. It depends on who you are plugged into, because you can sometimes walk into a room to meet investors interested in real estate debt and then [be] told you should be two rooms over to meet someone else in the same organization," says White. "That's where it really helps to have an investor relations team which understands debt as a product, and also knows where the demand lies."

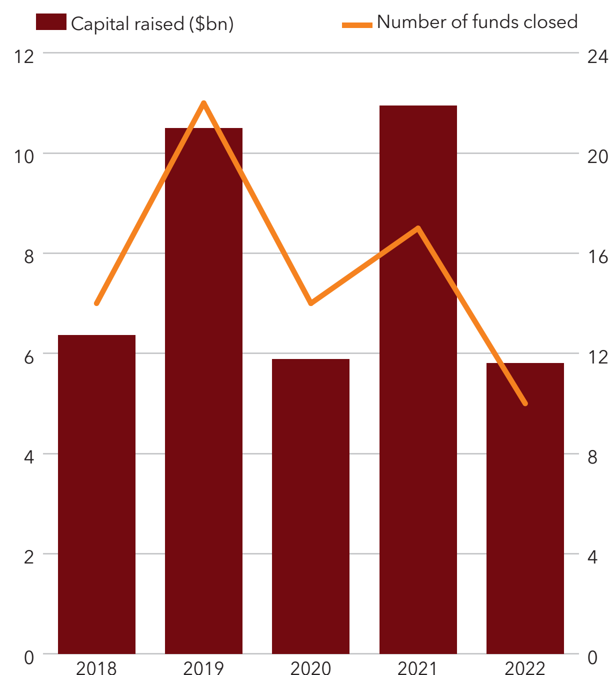
Thematic lanes

As more managers have identified the market's potential in recent years, Europe has seen a proliferation of debt funds, each looking for points to distinguish themselves as they try to corral some of the available pool of capital. Janssen lists the common differentiators: return profile, jurisdiction and currency, how high the manager is willing to go in the capital stack, whether they undertake development or specialize in a particular asset class.

"We are all doing different things," says Cole. "We are financing construction, then when it's built, somebody else will take it on by lending for a sale or a refinancing. Depending on the complexity of what you do in your different piece, that either opens your pool of investors up to a very small part of the overall pool of capital, or narrows it even further."

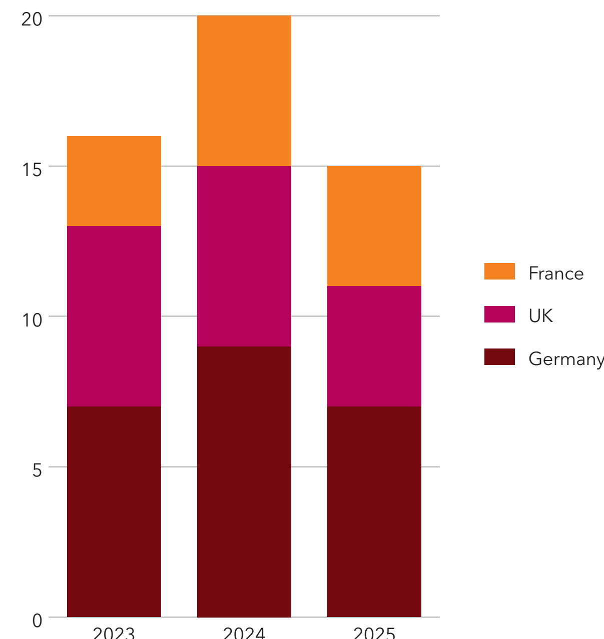
Howard says: "A nuance of the market is that every alternative lender has a slightly different focus and strategy, so very few of us come up against each other. And the amount of money that is potentially available to allocate to

Capital commitments and the number of funds closed for European real estate debt fell sharply year-on-year in 2022



Source: PERE

The refinancing shortfall could reach €51bn across the UK, France and Germany for 2023-25, creating an opportunity for alternative lenders (€bn)



Source: AEW

European lending goes green

Sustainable finance is becoming normalized in the continent's real estate markets, say participants

Over the past five years, ESG-focused financing in Europe has advanced far more quickly than in the US, reaching a point where almost all debt providers have a green lending framework, says Nuveen Real Estate's Christian Janssen. "And in three to five years' time, all loans will be 'green,'" he adds.

Natalie Howard says that all of Schroders Capital's debt strategies qualify for Article 8 status under the EU Sustainable Finance Disclosure Regulation. Article 8 funds are defined as having environmental or social characteristics and good governance practices.

The firm has also recently launched an Article 9 lending strategy in response to demands from three investors. Such vehicles are subject to stricter criteria, requiring a non-financial objective positively impacting society or the environment at their core. "That cuts out around 80 percent of the market," she observes. "To meet the criteria, the key is to be able to robustly prove positive social impact. BlueOrchard, which has been an impact investment manager for 20 years, is part of Schroders Group, and we have 110 ESG professionals, which has allowed us to get out ahead of the market and launch an Article 9 fund."

Having access to dedicated ESG support is increasingly vital, says David White. "LaSalle has ESG specialists in every jurisdiction and product group, as well as an overarching global ESG team of 30 people. That is where we believe the market is moving, and it requires a lot of expertise and understanding."

The participants agree that an increasing proportion of European real estate risks becoming obsolete as sustainability standards rise. Howard says that around 20 percent of commercial assets are already too outdated to lend against. "It's good that more people are moving towards sustainable lending now because it means they are avoiding lending on assets that will be obsolete in five, 10 or 15 years' time."

For some asset owners, obsolescence will have a serious impact on their ability to refinance, adds Cain International's John Cole. "For some of the loans that were written four or five years ago, when you combine that with the lack of cash available for refinancing, it will be tough."

"Risk is at the forefront of investors' minds, now more so than ever"

DAVID WHITE
LaSalle Investment Management

private debt is huge, so we often don't even have similar investors that we talk to." Few debt funds are specific to any one real estate sector, she adds. "In debt, we are not there for the upside, so we are not making sector and jurisdictional selections, we are looking for the best risk-adjusted returns."

For debt investors, asset selection is not the sole key to performance, says Janssen. "In equity, you either like the purchase price for that asset or you don't. But in debt there can be an asset you would never want to own, but you might be comfortable lending at a 50 percent LTV because you believe at that level it is perfectly defensible. That is one of the key distinctions between debt and equity. Are we all-in for retail? No. Would we do it selectively? Absolutely."

"We are not in-the-box thematic investors, but select thematic lanes alongside the evolution of the market," says LaSalle's White. "In the last 12 months, we have deployed about €1.3 billion and much of it has been across living sectors, with a big component of that student housing. Logistics has also been a huge sector for us, and then hospitality, followed by a very selective allocation to office."

Cain International's sector preference has also been shaped by the market climate. "Our focus has turned around 180 degrees from three or four years ago when it was majority offices. It is now predominantly the living sector, whether it be student or multifamily, or houses for sale. But we are always opportunistic and will look at any sector with a strong sponsor," says Cole.

Of the managers participating in the discussion, Maslow is the only one with a firm sector focus, concentrating mainly on the sub-£500,000 per unit residential sector in the UK. "We like to look for markets where there is good affordability, and the pipeline is quite dry in terms of new supply," says Sher.

Maslow is constructing a strategy around funding the refurbishment of properties to meet with the new UK energy performance requirements due to be introduced in 2025. "The UK has Europe's oldest and leakiest housing stock, so a lot of capital is needed at relatively small ticket sizes. That probably requires a granular, bridging-based approach."

There is a strong sense among the participants of a rare opportunity waiting to be seized. "I have seldom been this excited to be investing in debt," says Janssen. Meanwhile, Howard believes that if she had €3 billion of capital at her disposal she could deploy it in six months, "easy."

If the European real estate debt gap is to be bridged, however, the space will require a great deal more capital from a more diverse group of investors. And, as noted at the outset of the discussion, these are challenging times for liquidity. ■