FEATURE

ANALYSIS

REAL-ESTATE FINANCING

The evolution of commercial real estate debt

UK real estate debt is attracting attention from new forms of capital including private debt funds as the market adapts to a changing economic environment, writes Laxfield Capital's **Emma Huepfl**

A diverse range of international investors is examining the opportunity created by the need for banks to deleverage from a market they dominated since the early 1980s. The process is taking place throughout Europe, but is most apparent in the UK, where a combination of higher margins, greater transaction volume and ease of execution, make it a natural first step for new commercial real estate mortgage investors.

The market offers an opening, but not an obvious answer to whether the new capital suits its needs and whether the market is adapting to the shape of the funding offered. There are signs, however, that the commercial real estate (CRE) trading dynamic is changing and adapting along with the type and duration of its debt providers.

The opportunities for private debt investors start with core real estate lending where loan assets are backed by large real estate investments with predictable, often rated income streams. Since 2009 European banks have rarely been seen competing for the very large financing requirements of these sorts of assets.

Mortgage providers who can fund amounts of £100 million ($152 million; €119 million) or more and have an appetite to hold these investments, thus reducing the borrower's risk of dealing with different entities over the life of the loan, tend to be better positioned to take this business. All-in yields for these core loans, (margin priced over 5 or 10 year gilts or swaps) currently trade at 3 percent – 4 percent maximum.

It is notable however that the pool of available assets to back mortgage investments is reducing, as prime and core assets are removed from the financing pool by cash investors from overseas buying in the major European markets, particularly London.

Some of the active international buyers have used banks from their own domicile (as seen with several large Asian buyers in the last 12 months) to obtain funding at preferential rates.

Investors suited to these sorts of mortgage assets often view these as fixed income proxies, and require an appropriate illiquidity premium over corporate or government bonds.

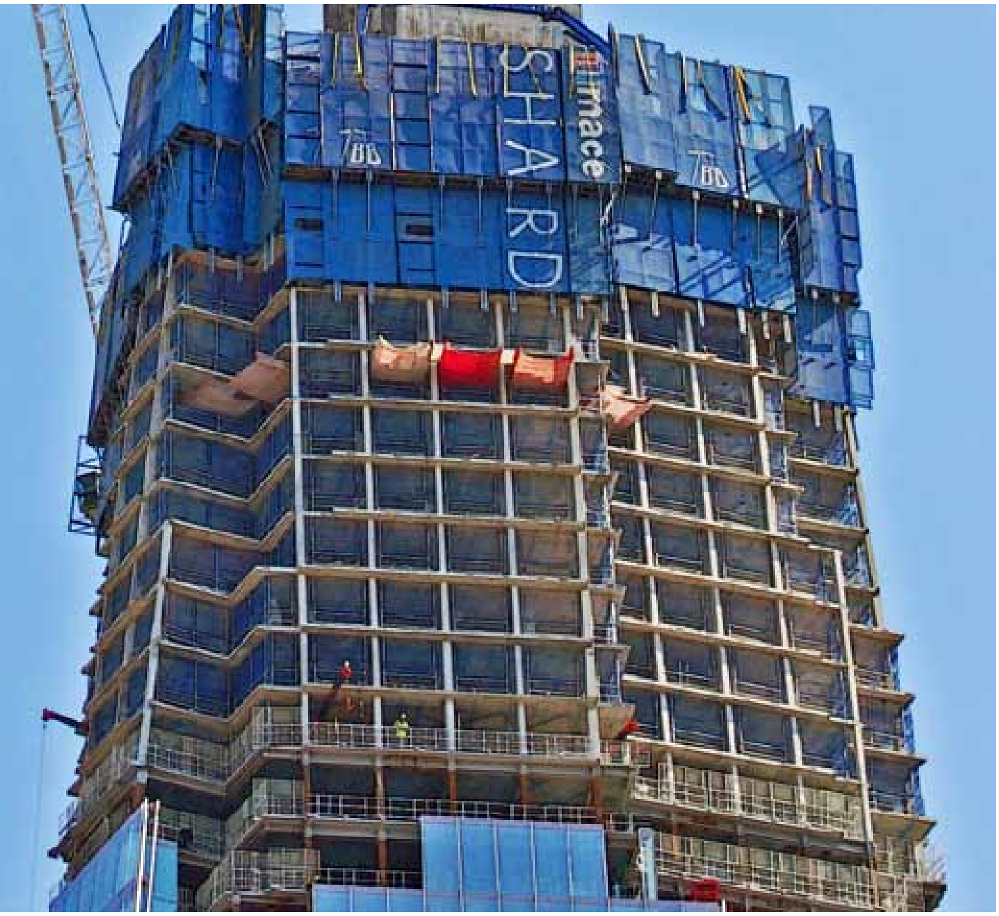
For investors with more modest appetite, there is a middle ground of funding where individual loans vary from £10 million to £75 million and banks still form a substantial part of the market. Risk positions top out in the senior market at 55-65 percent in contrast to the market pre-2007 where senior loans were regularly provided at 75-80 percent LTV. Gaining market share in this area depends as much on deliverability as price competitiveness, and those with a straight forward decision making structure have much to gain.

A WIDENING GULF

Returns in the mid-market reflect the divided nature of the commercial real estate sector, where the gap between prime and secondary has spread to exceptionally wide levels. Funding for London offices in good locations, is widely available even where the assets are transitional or short-leased.

By contrast, apart from a small pool of the best assets in other markets, lenders are avoiding regional offices or retail, and trading volumes would indicate that a margin

"COMMERCIAL REAL ESTATE PRIVATE DEBT IS IN AN EXTRAORDINARY PHASE OF CHANGE"



premium of 100-200 bps does not offset the negative sentiment and refinancing risk around these sorts of assets.

Yields on these mortgages also vary markedly depending on the sponsor quality (despite most loans being funded via non-recourse SPVs, the lending market currently takes a very strong view of the owner and manager of the loan security, which gives certain equity investors a strong advantage in availing themselves of a range of flexible loan products).

For investors seeking opportunistic returns, the mezzanine, distressed and secondary loan markets offer higher yield, but require specialised knowledge and risk appetite. Large portfolio sales from banks are heavily bid, and suit only specialised investors with large resources for analysis and the intensive management teams required to sort documentation and asset strategies.

In the higher-yield mezzanine market, a disparate range of funding has targeted the sector, raised through funds, public issues and via direct allocations. Target returns in excess of 10 percent do not make this natural funding for a well-capitalised investor buying secure, well-let assets, so investors need to be positioned to deal with exit risk and have a strategy for working with, or replacing the existing management if the equity position is heavily eroded. To date, there has not been widespread investment in this market.

A SHIFT IN REFINANCING TRENDS

Despite the huge global interest in the UK debt market, it is fair to say that conversion to active investing has been relatively low to date, even for those who have made a move towards capability. Bank finance, when it was widely available, was distributed through a large regional network and came with great flexibility. Most finance directors saw the standard market product as a five year floating rate market with interest rate risk hedged via swaps. Refinancing was generally only considered in the year a loan was due to mature.

Finance directors are now thinking much earlier about the need to protect their liquidity, and constantly considering their refinancing positions. Conversations with lenders thus start much earlier, and will be gauged from a much larger group as new funding needs to be assessed and tested. Time taken to close transactions is thus much longer, and from a mortgage investor's perspective the "hit rate" is low.

BARRIERS TO ENTRY

Much of the new capital targeting the UK market has fixed rate and longer duration requirements, (5 – 20 years vs bank finance with 3-7 year availability). One reason the market take-up has been slow is that many borrowers consider fixed rate, with yield maintenance provisions, and lacking swap profit potential an encumbrance on their business. The US market is provided mostly on a fixed rate basis, which would indicate that acceptance may come with availability, or at least a lack of ready alternative.

Aside from whether the market will start to absorb the fixed-rate capital, another barrier for new investors is route to entry.

The most successful new lenders in the past five years have been established overseas investors such as US life companies, with a specific allocation to private debt, transferring proven lending skills from an existing platform, often with the help of local intermediaries or by hiring an experienced team.

Slower to capitalise on the opportunity have been institutions with separate real estate and fixed income divisions who do not have an immediate allocation to the sector. Setting up a team, a strategy, a credit process and gaining credibility in the market is a time consuming, expensive process.

Allocating capital to a professional investor is an alternative route which has seen the creation of various debt vehicles and existing institutional investors setting up third party management vehicles.

The investor must then satisfy itself on the alignment, specialised capabilities and allocation and diversification strategies of the partner it chooses. These are not straightforward in a market which is at the early stages of development, and where rating, benchmarking and performance analysis is lacking and market data on lending is limited and difficult to prove for accuracy.

SOURCES OF NEW CAPITAL

Whilst the conversion rate as stated above is still relatively low, there has been a reasonable impact on the market from new lending sources, and this is expected to accelerate this year. Fixed rate lenders numbered two in 2007, but now there are more than ten. We expect more of these investors to make an entry, either directly, partnering, or through intermediaries.

US investors, driven to seek investments in the UK by yield compression in their own mortgage market are likely to continue to increase their presence, subject to deal opportunities and continued yield uplift. European institutions who have expressed an interest may well convert to an investment strategy and a further pool of liquidity may be created.

There is a bottleneck around the entry point for new investors seeking conservative prime assets to gain traction and experience. Margin compression has been significant as new entrants price first deals to win business. This is slowing down the move of some new lenders into the market, as they must compete with lenders who

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have proven execution skills and are targeting well capitalised investors with access to a wide range of financing relationships.

We do expect other types of investors to follow the US Life Companies into the market, and the range of interest is strikingly wide. The London market brings equity investors from all over the globe, which often have fixed income allocations within the same organisation. If the flow of capital into equity investments continues, we believe it is likely that some of those investors will see value in debt secured on similar assets and seek a route to market, or respond favourably to opportunities presented.

"THE LENDING MARKET CURRENTLY TAKES A VERY STRONG VIEW OF THE OWNER AND MANAGER OF THE LOAN SECURITY, WHICH GIVES CERTAIN EQUITY INVESTORS A STRONG ADVANTAGE IN AVAILING THEMSELVES OF A RANGE OF FLEXIBLE PRODUCTS"

THE KEYS TO SUCCESS

Successful investment strategies require a realistic and patient approach to the market. Deals are not falling off trees, the need for finance and the space created by retreating banks is there but the market is adjusting carefully and investments are slow to book.

Investors must expect a certain level of caution from borrowers jaded by dealing with retreating lenders and the inadequacy of CMBS structures to deal decisively with problem loans and the conflicting interests of bondholders.

New finance must expect scrutiny from the market before take-up, and needs to ensure that the combination of new skills required, - a detailed knowledge of real estate, lending, and fiduciary capability are satisfactorily represented in their platform, as well as moving away from pay structures which reward origination over long term performance.

In summary, commercial real estate private debt is in an extraordinary phase of change, and the market is working to adapt to a very sudden re-shaping of its capital. Evolution will continue.

Those who will benefit will be well capitalised investors, who seek out a specialised, capable management platform. They will also need flexibility to shift strategy as pricing changes and opportunities develop differently within the space. Above all, this needs to be a multi-year approach, with the ability to be flexible in a thin market, and move quickly when transaction levels rise. ■

Emma Huepfl is a director and co-founder of real estate financing group Laxfield Capital, and focuses on deal origination and lender relationships.

For more in-depth analysis of the real estate debt markets, read the special supplement published alongside the July / August issue of Private Debt Investor.