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## Opportunity tempered by complexity

*Conditions in European real estate debt markets favour alternative lenders. But sluggish investment activity is picking up only slowly, and underwriting remains challenging, say roundtable participants. By Stuart Watson*

This should be a great time to be an alternative lender in the European real estate market. And the participants in *Real Estate Capital Europe's* roundtable agree that, in some respects, it is. Banks are no longer the dominant force they once were, creating more scope for debt funds to operate. Interest rates remain high and borrowers no longer expect cheap finance.

However, they also acknowledge the current opportunity comes with complexity. Deal volumes remain subdued. Capital markets are recovering from the shock of higher interest rates, so fundraising is tough. Meanwhile, determining how far property values have adjusted, and how much further they could still fall, complicates loan underwriting.

This is an “exceptionally good time” for alternative lenders, says Aparna

Sehgal, partner and head of structured finance and real estate finance for the UK and Europe at law firm Dechert, host for the discussion.

She notes that of the loan originations on which her team is currently advising, around 70 percent involve non-bank lenders against approximately 30 percent where the lender is a bank. Over five years, those proportions have reversed. “Also, in the past, alternative capital providers would often provide mezzanine debt or a portion of the loan. They were in the deal, but not leading it. That has changed very substantially.”

While banks are still lending, it is within more limited parameters than previously, says Graham Fasham, head of European origination at real estate debt platform DRC Savills Investment Management. “They are focused on their own books, their own existing clients, and the scope of the assets they

will lend against has also narrowed.”

While stabilised logistics and living sector assets are still in favour with bank underwriters, that leaves room for alternative lenders to secure deals and generate returns by embracing more complex situations, for which liquidity is limited. “We don’t want to lend at the peak of value, we want to lend on the journey to that higher value. Whether that is a cashflow-based journey or refurbishment or full development, there is more opportunity out there,” Fasham says.

Private debt providers can take development or letting risk on good quality assets in strong markets while enjoying the comfort of deploying at lower loan-to-values (LTVs) into a market that has largely repriced, argues Alexander Oswatitsch, head of real estate debt for Europe at Frankfurt-based manager DWS. “That space has opened up for alternative lenders at

PHOTOGRAPHY: JON CARDWELL



## Aparna Sehgal

Partner, Dechert

Sehgal is head of structured finance and real estate finance in Europe at law firm Dechert, advising on the financing of complex real estate-backed transactions, often highly structured and/or involving back-leverage arrangements.

## Graham Fasham

Head of origination, Europe, DRC Savills Investment Management

Fasham heads European debt origination for DRC Savills Investment Management, which has assets under management of £2.9 billion across a range of senior debt, high-yield and whole loan products.

## Andrew Gordon

Head of European real estate debt, Invesco Real Estate

Gordon manages Invesco Real Estate's debt business in Europe. The firm has just over \$90 billion of real estate debt and equity globally. Its open-end European direct lending strategy focuses on high-quality, sustainable property, distributable current income and a 'credit-over-yield' approach to prioritise capital preservation.

## James Mathias

Senior portfolio manager, PGIM Real Estate

Mathias is responsible for European and global mandates for core and core-plus debt. PGIM Real Estate's integrated European real estate debt platform has raised and invested €14 billion since 2010, offering investors a range of investment strategies with returns ranging from senior debt through to high yield.

## Alexander Oswatitsch

Head of real estate debt, Europe, DWS

Oswatitsch is responsible for European real estate debt investments at DWS, leading a pan-European debt fund business that manages six senior and junior strategies in the form of client mandates, and as open-end or closed-end funds. The firm manages around €76 billion in real estate assets across equity, debt and securities.

*“Lenders with different risk appetites are providing capital in different ways”*

**APARNA SEHGAL**  
Dechert



a revised base with improved economics and at a lower level of risk.”

The principal driver of alternative lenders’ strategies is increased opportunity to provide senior debt and whole loans, he says. But there is also scope for providing mezzanine finance to bridge the gap in the capital stack created by traditional senior lenders offering lower LTVs. “A combination strategy makes sense with a main focus on whole loans together with a 20 or 25 percent mix of mezzanine to take advantage of that opportunity,” Oswatitsch adds.

“Any time the banks are retreating there is more space for us, so it’s a great time. But it’s not necessarily an easy time,” says Andrew Gordon, head of European real estate debt at US

manager Invesco Real Estate. “Investment volumes have dipped, so there are fewer transactions and less opportunity to lend today.”

### **Debt funding gap**

Hopes have been raised that the looming debt funding gap could provide a flood of transactions for alternative lenders as a wave of European real estate loans becomes due for refinancing at a time when incumbent lenders have reduced the LTVs they are willing to provide. Investment manager AEW’s analysis shows a \$40 billion shortfall between debt due and the amount available to replace it in 2024, and \$100 billion over the 2023-26 period.

James Mathias, senior portfolio manager for European debt at manager

PGIM Real Estate, suggests the funding gap opens two attractive pools of opportunity. Alternative lenders can fill the gap created by traditional lenders seeking to reduce their exposure by refinancing at lower LTVs, and they can take advantage of a situation in which overall bank liquidity is reduced. “Banks are constrained in terms of the size of tickets they can write, the volume of capital they can deploy or the ability to finance the transition to enduring core asset profiles, almost irrespective of where the LTV sits,” he says.

The refinancing opportunity may be smaller than anticipated because some of the liquidity gap likely will be filled with equity rather than debt, argues Gordon. “If it comes to the crunch and

there isn't a debt provider able to lend, the sponsor will take the hit by writing off existing equity or putting in new equity to fill the gap."

Another source of new business is encroachment into previously bank-dominated geographies. "We tend to think of our sector as mature, but actually it's near the start. There are large parts of the market that alternative lenders haven't got into yet," says Fasham.

Germany offers a compelling opportunity, while the participants also identify Spain and France as markets offering potential for expansion. Regulation, particularly around enforcement of defaulted loans, is a complicating factor for debt funds seeking to operate in those jurisdictions, however.

Many potential new entrants to the private credit market are US investors, says Sehgal. She believes new private credit platforms may be more comfortable backing strategies focused on markets with more easily accessible and creditor-friendly legal frameworks, such as the UK, the Nordics, the Netherlands and Ireland. "More mature platforms may look to service liquidity demands in jurisdictions like Germany and Spain, for example, although recent changes to legislation in both jurisdictions have been welcomed by lenders."

### Back leverage

The participants agree banks have significantly reduced their new lending, particularly outside their existing

client bases. But they have not pulled back completely, says Sehgal. Instead, their role within the lending ecosystem has evolved, so they are increasingly providing back leverage to alternative lenders rather than lending directly to sponsors. "North American banks are already well established in the back leverage space, and UK and European banks are also now interested in providing repo and loan-on-loan facilities. It is healthy because lenders with different risk appetites are providing capital in different ways, which leads to greater liquidity across the market."

Used correctly, back leverage can increase the market's debt capacity, but it has a potential downside, says Fasham. "There is a temptation to overuse it. It puts banks in a great risk position,



*"We don't want to lend at the peak of value"*

**GRAHAM FASHAM**  
DRC Savills Investment  
Management

## Alternative Lenders

especially if used widely across a portfolio. But debt funds need to focus on how much leverage they are willing to put on their book, and what that might mean at a time of stress.”

To date, back leverage has not been used as extensively in the European market as in the US, says Mathias. “That’s a good thing in terms of avoiding market risk from overuse at this stage. There are still a broad range of different alternative lenders targeting different strategies, and many of them are completely unlevered.”

Investors’ views differ widely on the desirability of committing capital to levered debt funds, says Gordon. “It doesn’t work for insurance companies because of regulation, and for some European investors, back leverage is

still taboo. But if they don’t invest solely in Europe, and are accustomed to investing in the US, for example, they will be aware of the pros and cons of back leverage.”

### Funding is improving

Back leverage or no, securing investor commitments has not been easy for debt funds in recent times, but the participants note the fundraising environment is beginning to improve. “Last year was difficult until Q4, when the tone of the conversation started changing and investors started gearing up to make commitments,” says Gordon.

DRC Savills IM had a first close on a pan-European whole loans strategy in early 2024. Fasham notes that while several commitments came

from existing investors, there were new sources of capital as well. “We have turned a bit of a corner,” he says. “Fundraising is still not easy, but we are having more conversations that are progressing to a later stage. We are finding the whole loan product is most attractive to investors, although there is demand for high-yield strategies as well.”

“Core capital is not back,” says Oswatitsch. “Investors who want to be in the real estate debt space have more flexible capital, and they are not looking for single-digit returns. Apart from certain pockets like insurance companies, interest is coming from higher-return investors.”

Real estate debt offers attractive risk-adjusted returns with downside

*“There are fewer transactions and less opportunity to lend today”*

**ANDREW GORDON**  
Invesco Real Estate





*“It is understandably taking investors longer to make decisions”*

**JAMES MATHIAS**  
PGIM Real Estate

protection not just for investors seeking an alternative to private real estate equity, but also for fixed income investors seeking a more stable alternative to public or private corporate bonds, says Mathias. Because institutional capital typically looks to “play through” market cycles, the manager’s track record becomes critical in attracting commitments, making this a challenging environment for first-time managers seeking to raise funds.

“We are continuing to see meaningful investor demand for core strategies alongside our high yield ones. But it is understandably taking investors longer to make decisions. They are still constrained by the denominator effect on their portfolios. As managers, we need to work with them through that

process and make sure that we can support them to achieve the outcomes they are looking for,” he says.

The participants agree that the complexity and volatility of today’s market makes structuring and underwriting loans even more crucial for alternative lenders. Loan structures will incorporate an array of risk mitigants, says Sehgal. “Those include cash traps, interest reserves, guarantees for certain risks, bespoke cash waterfalls. Much of the focus in commercial discussions is on income.”

However, she observes that borrowers’ bargaining power is returning in circumstances where the transaction involves an in-demand asset and a proven sponsor with a compelling business case. “Borrowers are starting to ask for

more flexibility. It doesn’t mean that the debt is cheaper, but there is more conversation around some of the covenants and earnout triggers.”

Discussion turns to the relative merits and pitfalls associated with underwriting transitional strategies. Borrowing remains expensive, so sponsors’ returns must be sufficiently high for debt to be accretive. In the current market, that often means lending to private equity sponsors pursuing transitional strategies such as reletting, repositioning and development, aimed at securing double-digit returns, says Gordon.

“There is a need to look at assets that aren’t just nice and simple standing, fully let buildings,” he argues. “That coincides with the fact that lease

*“Investors... are not looking for single-digit returns”*

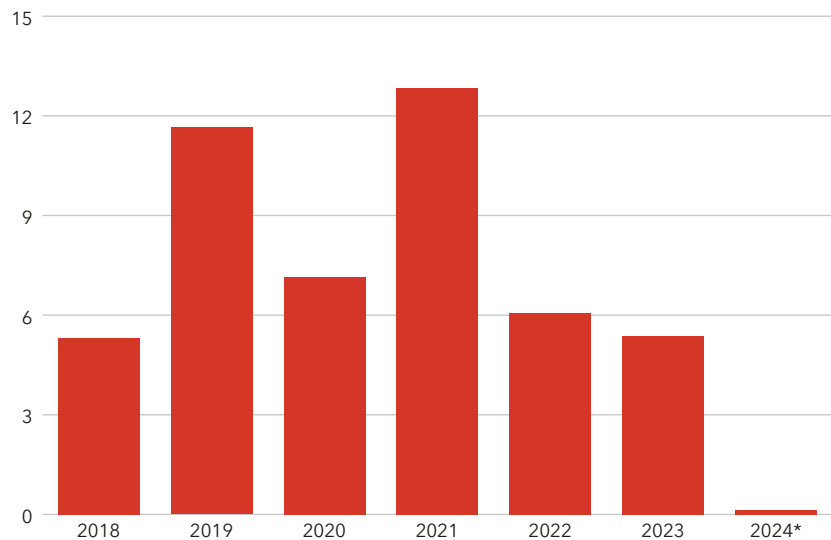
**ALEXANDER OSWATITSCH**  
DWS



terms are getting shorter, and in operational asset classes like self-storage or serviced apartments tenants commit for months, not years. As a lender, that means you need to understand the asset you’re lending against. The lender must underwrite like a sponsor. It makes our job harder, but it makes it more interesting.”

The difficulty of servicing debt in a higher interest rate environment is continuing to shape lenders’ views of the appropriate leverage point for transactions, adds Mathias. But the pressure on underwriting is easing somewhat as volatility has reduced and the expectation that rates will fall has led to reduced pricing for fixed-rate loans alongside easing hedging costs for floating, making debt more

Investor commitments to European debt strategies remained subdued in 2023 (\$bn)



\*Data through 7 May 2024

Source: Real Estate Capital Europe

accretive to investments. “That gives us more certainty, and more conviction when coming to underwrite a deal.”

“Because of that serviceability piece, standing buildings are tough to underwrite just now, especially when we haven’t seen the value of certain assets or asset types tested in the market,” says Fasham.

Regardless of whether a lender is underwriting a transitional business plan or a portfolio of core stabilised assets, the quality of the income is the critical factor, argues Mathias. “Lenders must still focus on the same underlying principle: underwriting positive credit migration. Financing assets which will benefit from occupier and investor demand in the long term is essential to mitigating exit risk, so the focus must be on identifying income streams that can grow and withstand potential stresses over the life of the loan.”

### Interest rate cuts

Lending activity remains subdued across European real estate markets, particularly for new acquisitions. Banks are still concentrating on their existing loan portfolios, says Mathias. “When you look underneath the origination numbers, you see a lot more extensions and refinances of existing bank loans.”

Could hoped-for cuts in central bank interest rates, or the conviction that cuts are likely later in the year, prompt a renewal of activity?

In recent months, the market for office upgrades and office-to-residential conversions in London has begun to take off, as market participants gain confidence in values in parts of the market, notes Fasham. “The bid-ask spread between buyers and sellers is getting to the right place. It feels like it’s moving in a more positive direction. But it’s still relatively slow and it is taking the continent a little bit longer to catch up.”

Lower bank rates could help stimulate activity in the mezzanine market, says Oswatitsch. “Debt is still very

## The German opportunity

### Alternative lenders see a chance to break into one of Europe’s largest markets

The low-cost capital available to domestic banks has made Germany a difficult market for alternative lenders backed by international money to play in. But regulation, particularly Basel IV, which will overhaul global bank capital requirements, could be a game changer. “It will make development lending very expensive for banks,” predicts Oswatitsch.

Meanwhile, some local debt funds are over-extended, creating opportunities for incoming alternative lenders to provide recapitalisations. “Because the banking market was so competitive, most German alternative lenders went into mezzanine and development at high LTVs and loan-to-costs up to 90 percent,” says Oswatitsch.

Transactions in popular sectors still prompt a few local lenders to offer highly competitive terms on senior loans. However, they are increasingly outliers in a market where foreign lenders are becoming more competitive, says Oswatitsch. “We could be seeing the kind of transformation that might really make German markets interesting for alternative lenders on a risk-adjusted return basis.”

Structural factors related to regulation, and cyclical ones generated by stress in the domestic lending market could generate “exciting” opportunities, suggests PGIM’s Mathias. “There is a flow of deals coming through from very strong sponsors which are still low-levered and are seeking to finance high-quality assets.”

The altered competitive landscape has allowed DRC Savills IM to access opportunities not previously available, says Fasham. “We have seen a lot of transactions recently with sponsors we wouldn’t have got close to normally in sectors like logistics where there was previously a whole raft of German lenders out ahead of us before we got close.”

Invesco Real Estate’s Gordon sees parallels with the UK banking sector after the global financial crisis, when regulation led to retrenchment in the banking sector. “That regulation hasn’t been there for Germany. If it comes in, along with some of the overexposure issues the market has today, hopefully those things will conspire to create some space for debt funds.”

expensive right now, so mezzanine lenders are competing with equity solutions. Unless there is a rate reduction, it will probably take more time to reach the right equilibrium.”

Lenders also need investment market volumes to recover, says Gordon. “That will happen when people become confident that we’ve reached the bottom of the market, and interest rates coming down will help to give people confidence that we have reached that point.”

It is difficult to predict when rate cuts will come. When they do, the stimulus for debt markets, and alternative lenders, could be significant. “There will be pent-up demand to put money out there. People will look for signals and respond,” says Sehgal. “But you can’t write a business plan on hope, and in the meantime, it has been encouraging to see how creative lenders have been. They are finding ways to work with each other, and with the banks, to underwrite and to deploy capital.” ■