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A time of opportunity and challenge

For the alternative lenders participating in Real Estate Capital Europe's roundtable, market conditions seem conducive to grow their loan books. But the apparent opening is not without complications. Stuart Watson reports

Alternative lenders have become firmly established within European real estate markets over recent years, putting down deep roots in ground that was once the sole domain of banks. Currently, the territory should be fertile for their businesses to grow. Banks on both sides of the Atlantic are more selective in their lending and will likely be a diminished force for a time, while uncertainty over capital values has made debt a more secure position to occupy within the capital stack. Moreover, higher interest rates offer an opportunity for more aggressive loan pricing and higher returns.

But while the participants in *Real Estate Capital Europe's* alternative

lenders roundtable confirm that it is indeed a time of opportunity, that story is complicated by a set of challenges facing managers, capital providers and borrowers.

At the forefront of the participants' minds is the precarious macroeconomic situation. "We have seen a fairly strong recovery in real estate fundamentals since 2021, but there are indicators that a recession is coming," says Dan Pottorff, who has led manager Tristan

Capital Partners' real estate debt business since its inception in 2021. "The big question we do not yet know the answer to is whether it will be a hard or a soft landing. We are all thinking about how we can manage our loan books to minimise the risk."

Ciaran Singh, a principal at debt investment business DRC Savills Investment Management, says his firm has been cautious in its originations over the past 18 months in a market that has looked "toppy", in anticipation that a downturn was imminent.

"As lenders we don't benefit from the upside risk in the same way as equity investors, so we focus heavily on downside protection through the cycle," Singh says. "There is still the focus that you would expect on beds and sheds, which have strong fundamental

\$5.8bn

The amount of capital raised by European real estate debt funds in 2022

PHOTOGRAPHY: PETER SEARLE



Matteo Milan

Managing director,
real estate finance,
Cain International

Matteo Milan joined Cain International in 2014 and plays a key role in the origination and development of its UK debt portfolio, as well as driving its European expansion. The London-based privately owned real estate firm manages \$15 billion of assets, including more than \$2.9 billion in real estate development and construction loans.

Alexander Oswatitsch

Head of real estate
debt, Europe, DWS

Based in Frankfurt, Alexander 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, with a total volume of €2.5 billion.

Dan Pottorff

Head of debt
investment, Tristan
Capital Partners

Tristan hired real estate finance specialist Dan Pottorff to establish a European lending business in 2021, launching its TIPS One debt fund the same year. The real estate investment management firm, which has its head office in London, manages more than €16 billion of assets for institutional and private investors.

Ciaran Singh

Principal, DRC
Savills Investment
Management

Ciaran Singh is a principal at London-based European commercial real estate debt investor DRC Savills IM. Vehicles advised by the firm provide senior debt, whole loans and mezzanine finance across all major asset classes. It has executed more than 150 investments, deploying in excess of €3 billion (€3.4 billion).

Matthew Phillips

Partner, head
of finance and
operations, Valor Real
Estate Partners

Matthew Phillips joined Valor in January 2017, shortly after it was established. The London-headquartered manager, which specialises in the urban logistics sector, has amassed a pan-European portfolio of more than 175 properties valued at over €3 billion.

“Debt coverage is more important now than leverage. A few years ago, that was probably the other way around”

MATTEO MILAN
Cain International



drivers, certainly in the UK, where prices have rebased meaningfully. We are also looking at financing assets with operating cashflows and higher margins where inflation can be accretive rather than NOI-dilutive, like self-storage and limited-service hospitality.”

The failure of US lenders Silicon Valley Bank and Signature Bank in March, followed by the forced takeover of Credit Suisse by UBS, prompted fears of a full-scale banking meltdown. However, not only has that been avoided, but there has yet to be a significant negative impact on European banks’ appetite for real estate or the pricing of their loans, says Alexander Oswatitsch, head of real estate debt for Europe at German asset manager DWS.

“For example, at [real estate market event] MIPIM, it was interesting to see that the German banks had reduced but healthy lending volumes, although everyone was focusing on the same types of low-risk deals,” says Oswatitsch. “And I would have expected more margin movement on the senior side than has materialised.”

Matteo Milan – managing director, real estate finance, at private investment firm Cain International – notes that the banks’ approach to development financing is also unchanged. “Banks have always been ultra-conservative in development. They are playing specific asset classes and supporting existing clients. I have not experienced them changing their appetite or pricing significantly.”

The borrower at the table, Matthew Phillips, a partner at last-mile logistics platform Valor Real Estate Partners, says there is no “credit crunch” yet. “We still regularly get debt terms from banks, and they’re just as competitive. Margins haven’t really moved that much, if at all. It’s in the news that there are issues in the US commercial real estate lending market, and, while Europe is very different, with a smaller proportion of loans from regional bank lenders, there could be a contagion effect. If that happens, the latter part of this year could be more difficult from a financing perspective.”

Uncertainty in the sector could see banks’ cost of capital increase, pushing

up lending margins. “Combined with a reduced appetite for risk, that could open the door for alternative lenders to be more directly competitive with traditional bank lenders,” suggests Singh. “Will that happen in the very short term? Probably not. But it is an opportunity that could evolve over the course of this year and into next.”

In the interim, alternative lenders’ ability to commit quickly gives them the edge over banks in some circumstances, says Phillips. “We took a loan from a debt fund at the beginning of the year in Germany, where we have typically used bank debt. That was a question of execution speed. We had term sheets from German banks at slightly lower leverage and lower margin, but we expected Euribor would increase and we wanted to complete the financing and move on.”

Window of opportunity

Oswatitsch argues that, at this point in the cycle, alternative lenders have a strong fundraising pitch to make to core investors. Provided their underwriting accounts for potential repricing, by

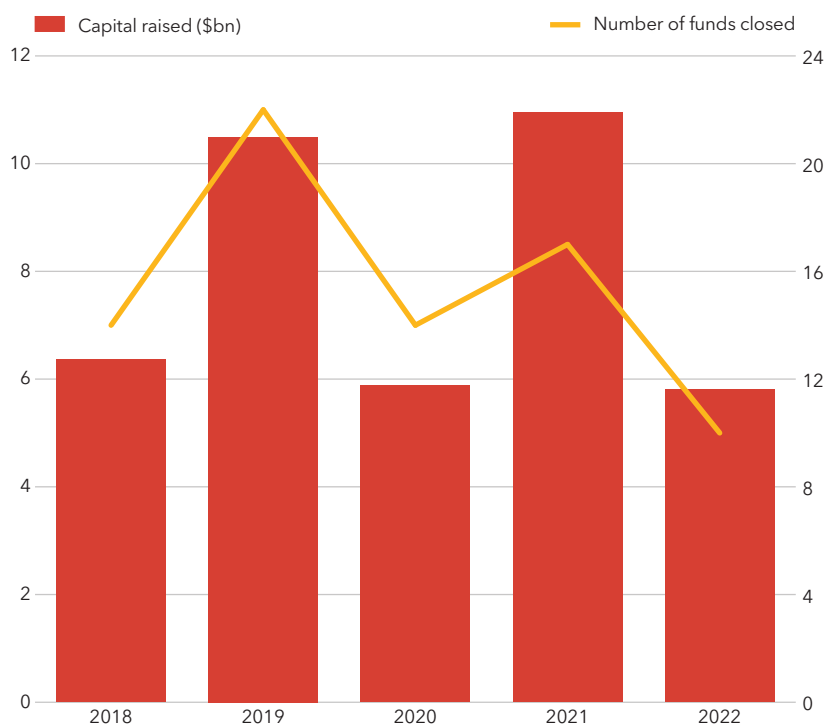
placing their money in the debt part of the capital stack they will make more attractive risk-adjusted returns, he says: “If they take the equity risk, they typically make a 4 percent return.

“In traditional senior real estate debt, at a margin of 2 or 3 percent over Euribor, they are making more return at a significantly reduced risk position. That makes debt a pretty good product, particularly if it is combined with the opportunity created by traditional banks lowering LTVs and reducing lending targets.”

However, he also notes that as risk-free rates increase, there is pressure on real estate debt funds to increase their target returns to maintain a premium over less complex and more liquid asset classes. And while they may be able to ask higher prices for debt now, the window of opportunity will eventually close as interest rates fall again. “Then the question becomes whether you can create a product and deploy within that window of opportunity.”

Meanwhile, the scope for increasing margins is constrained because if

Total debt fundraising by managers and number of funds raised both fell sharply in 2022 compared with the previous year



Source: PEI Group



“We see situations... where the senior bank lender might be open to refinancing, but at a lower leverage. Not every borrower has the equity to bridge that gap, so that opens up a stretched senior opportunity”

ALEXANDER OSWATITSCH
DWS

borrowing is too expensive, well-capitalised managers will revert to using equity. Both equity and debt transaction volumes are materially lower than in 2022, but lenders have similar deployment targets so there needs to be a balance between debt and equity returns for both sides to meet their goals, says Phillips.

“If debt becomes more expensive than equity, well-capitalised sponsors will want to hold assets unlevered,” says Phillips. “In that situation, the debt increases the overall deployment capacity of a fund but is not accretive for returns. An all-in borrowing cost of 8-percent-plus works for certain deals but it is not sustainable in the medium term if property yields are still middle-single digits.”

While debt fund managers can make a powerful case right now when marketing their products to investors, other factors are limiting the pool of capital available to them. Liquid asset classes have been revalued more quickly than real estate, creating a denominator effect that has left many

investors overallocated to illiquid assets, and needing to rebalance their portfolios.

“There is a lot of engagement,” says Pottorff. “Intellectually, a lot of investors get it, and debt has risen to the top of what they would do in the real estate space. But they must have the capital to allocate. We take a lot of meetings, and a lot of people say, ‘Oh, this is really interesting. But we might need three or six months to sort out our denominator effect.’”

Established managers are more likely to be successful in attracting capital, argues Singh. “In a turbulent period, track record is what should set you apart. There is a clear direction of travel towards investing with managers with broader-based product offerings – for example, providing distinct senior and stretched senior products – and who can demonstrate that they have a track record in different geographies across different parts of the capital stack.”

Having deep real estate expertise within a platform is also a crucial

selling point for managers, says Pottorff: “That should distinguish us from the banks. We don’t have to sell if something goes wrong. We can take it over and manage it ourselves.”

Borrowers under stress

In the current economic climate, many borrowers’ business plans are under stress, which places further limits on how far lenders can increase their margins without risking provoking a default.

The development sector in particular has been battered by headwinds of late, says Milan. “Construction inflation has been a big problem, the cost of debt has gone up, cap rates are moving out, and the price of land has only just started to adjust.

“Viability works in the living and student accommodation space, and even in carbon-neutral offices and hospitality, if you assume rental growth. But we are entering a recession, which immediately creates a worry around whether continuing to increase rents will be affordable for tenants.”

“There are indicators that a recession is coming. The big question we do not yet know the answer to is whether it will be a hard or a soft landing”

DAN POTTORFF
Tristan Capital Partners





“We are seeing more confidence from sponsors that yields are stabilising. We are starting to see clearing prices and trades are beginning to happen”

CIARAN SINGH
DRC Savills Investment Management

Close scrutiny of borrowers’ business plans is essential to make sure that a loan still works for them at a higher interest rate, and lenders are increasingly focused on cashflow and debt yield. “Debt coverage is more important now than leverage,” says Milan. “A few years ago, that was probably the other way around.

“With banks offering lower LTVs, there is an opportunity for alternative lenders to bridge that gap. But because the interest coverage ratio is tighter than it was before, you need to consider whether the solution is to load the structure with more expensive debt. Will you just be storing up a problem for later?”

If a borrower’s leverage is too high and they fail to deliver an element of their business plan, it is easy to wind up in trouble, says Phillips. “ICR coverage needs to be stress-tested more now, particularly on vacant assets, given the likelihood of a prolonged period of economic volatility. For us that leads to a mindset of sticking with the senior or stretched senior space, rather than

leveraging at 70 percent or above and putting more pressure on loan covenants.”

Whole loan renaissance

The transition from an era of low-interest rates to a period in which rates and asset prices are both more volatile has bolstered demand for more straightforward structuring, and as a result, whole loan products are enjoying a renaissance, suggests Pottorff.

“We have seen a number of players announce whole-loan products, and it feels like the market is increasingly going in that direction. It is a simpler product that investors get, and with base rates where they are now, it produces returns which are pretty attractive.”

Offering a simpler product reduces execution risk on large development loans, says Milan. “Going to several different banks and mezzanine providers can be time consuming, and we have seen that sort of deal fail because one lender cannot perform. When there is uncertainty in the market, increased

certainty of execution is a plus for an alternative lender.”

Phillips suggest that there is a gap in the market for debt funds able to offer senior debt and execute quickly. “A significant number of alternative lenders are active in the whole-loan space, which is understandable. But it doesn’t suit everyone, and well-capitalised managers would probably like the option to borrow from debt funds at lower leverage and lower margin than whole loans, if they could still have the same execution speed. However, senior debt, particularly in Europe, is still mainly bank-driven.”

With banks cautious on LTVs, there is more opportunity for junior debt provision, argues Oswatitsch. “For us, that product is more focused on cashflow and conservative, high-quality assets, not so much chasing a double-digit mezzanine return. You can make a good return on the junior side for what used to be senior risk. If the senior has gone down to 55 percent LTV and you bridge the gap between 55 to 65 percent, you can still get 6.5 to 7 percent

Back in the game

The roundtable participants note that the use of back leverage by alternative lenders in the European market is evolving against the context of changing market conditions.

In recent years, big US private equity funds have been able to boost their lending returns by employing a form of structural credit known as a repo line.

“They were blowing us out of the water a year ago, because they had structuring advantages through FX hedging pickup and repo line loan pricing,” says Tristan’s Dan Pottorff. “That US repo market became big and sophisticated, and frankly cheaper than what you could get from a balance-sheet style lender.”

Those advantages are diminishing, however. In many cases, repo lines have a daily mark-to-market feature, which can be problematic during a period of shifting values. Pricing is also becoming less attractive. “There are still people offering repo lines,” adds Pottorff. “It is just a lot more expensive. And so the relative pricing has shifted in favour of a more conservative approach to using back leverage.”

European institutional capital providers have in any case historically been suspicious of the use of back leverage, says Alexander Oswatitsch of DWS. “They don’t like it, especially continental European

investors. It is typically the first thing they strike out of the prospectus. And in more uncertain times, when you might have some workout situations in your loan book, it is better not to have back leverage.”

Higher interest rates mean that back finance is less impactful for alternative lenders, says DRC’s Ciaran Singh. “It was a big part of the whole loan story in a low-rate environment. But where you don’t need to use it to deliver returns, why would you put your cashflow from those underlying loans at risk?”

Nonetheless, the likes of Tristan and DRC are using back leverage, albeit in a form that is more acceptable to the local market.

Pottorff says: “We have European investors who are comfortable with it. But the important distinction is we don’t use anything that looks like repo lines, and it is not a warehouse facility. It is loan-on-loan, and we are also doing it at a lower leverage point.”

The prospect of providing back finance as an alternative to traditional senior lending might also appeal to European banks, suggests Singh.

“If they attach in the low to mid 30s or 40s percent and have another chunk of equity above them in the capital stack that seeks to protect itself before the bank is left owning the assets, it’s a better risk-adjusted investment for them to make. But there is still a nascent market in Europe and arrangements tend to be bespoke.”



“ICR coverage needs to be stress-tested more now, particularly on vacant assets, given the likelihood of a prolonged period of economic volatility”

MATTHEW PHILLIPS
Valor Real Estate Partners



IRR – or more depending on the asset class – at a decent credit risk.”

Dealflow down

Yet another challenge for alternative lenders has been to secure a steady flow of deals through which to deploy. “The lack of certainty meant there was less transaction volume, particularly in the second half of 2022,” says Singh. “Where there was opportunity, it was highly competitive because the investable universe was narrowing. Retail was hard to underwrite, office was becoming more challenging, and logistics was still repricing. At that point, we didn’t feel there was a lot of value in many transactions.”

The other participants relate similar experiences. “We have seen volumes coming down,” says Milan, “as you would expect, because it is more difficult to find an opportunity that makes sense from the borrower side.”

However, there is also some optimism that activity will soon ramp up once more. “At the start of this year, people have started to realise that there

is a new norm, and that things will stay this way for the medium term,” Milan adds.

“They need to start reappraising viability, assuming higher debt and construction costs will persist, and the cycle will restart. What we are still missing is maybe that bit of distress that we haven’t seen yet, but people are waiting for, and which could be the trigger for starting again.”

Regulation has made it harder for banks to “extend and pretend” loans past their agreed terms than it was during the phase following the 2008 global financial crisis, says Oswatitsch. “It now impacts their capital costs much more quickly, and that drives refinancing discussions. We see situations coming up where the senior bank lender might be open to refinancing, but at a lower leverage. Not every borrower has the equity to bridge that gap, so that opens up a stretched senior opportunity, for example.”

Having fewer equity players in the market creates space for managers with strong deployment capabilities, claims

Phillips. “Historically, when there is a dislocated cycle, you are going to find better deals, particularly as a sector specialist. You need to be very disciplined, but at the same time hunt for off-market opportunities in those areas of dislocation where someone needs to sell.”

Conviction is growing that interest rates will soon peak, notes Singh. “We are seeing more confidence from sponsors that yields are stabilising. We are starting to see clearing prices and trades are beginning to happen. That confluence of factors drives more confidence to lean into loans that you want to make in the sectors that you want exposure to, particularly in the senior and whole-loan space.”

Pottorff is optimistic, with caveats: “You perhaps couldn’t say that this is a time to make hay while the sun shines, but you can risk-adjust for the macro backdrop. This is an opportune moment for alternative lenders, although whether they can take advantage will depend on their ability to raise capital.” ■