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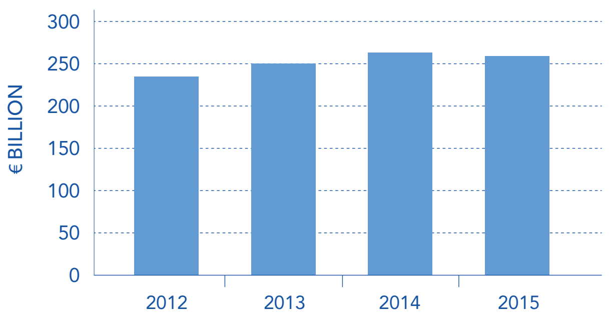
Challenging lending environment gives rise to European real estate debt funds

- The European commercial real estate lending market is undergoing structural changes opening the door for alternative sources of lending
- Investors are demonstrating a growing appetite to invest in debt whether that is through debt funds or directly
- Debt funds have been launched with strategies from senior or subordinated debt to a mix of tranches
- Despite the opportunity, raising capital and finding attractive deals can prove challenging for debt funds

The European real estate lending market is undergoing significant structural changes as a consequence of the credit and financial crisis and the regulatory changes that are being imposed on banks, its traditional source of debt. At the same time at least €1 trillion of real estate loans needs to be refinanced in the next four years.

FIGURE 1: EUROPEAN LOAN MATURITY PROFILE



Source: DTZ, May 2012

With fund managers and institutional investors believing that banks may not return to the market in the medium term and that the industry is in a period of structural deleveraging, this situation presents a good opportunity for more investors to consider debt investing.

This is particularly the case as commercial real estate lending pricing and conditions have changed since the start of the financial crisis. Senior loan pricing has increased substantially during the last five years with loans now priced at 250-400 basis points over LIBOR/EURIBOR, depending on the country, loan-to-value (LTV) levels and the type of real estate.

Banks that currently provide senior loans are not prepared to lend higher than 50%-60% LTV for good quality buildings with stable cash flows. This means that borrowers either need to provide more equity or find other types of debt capital to bridge the gap.

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This has created opportunities for other market players to enter the commercial real estate lending market. In the last three years at least 19 real estate debt funds have been launched with an estimate target size of €9-10 billion.

Large investors, particularly insurance companies are also establishing their own loan desks to provide senior loans.

Debt funds being launched now are the second wave of this type of product. In the 2009-2010 period, the first generation successfully raised and deployed capital that focused almost exclusively on mezzanine loans. Now, a broad mix of strategies has appeared, particularly as providing only mezzanine loans proved to be challenging due to the lack of senior lenders to lend alongside.

A number of distinct real estate debt fund strategies have been identified that fund managers are currently offering. These are based on the various tranches of debt being sought in the market.

Senior debt funds invest in senior ranking and conservatively structured real estate loans with leverage of up to 60% LTV.

Funds that have a subordinated debt strategy tend to offer a mix of stretched senior, junior and mezzanine loans. This tranche of finance sits in the space between lower risk senior lending and the equity.

Subordinated debt consists of a number of loan types that sit within the capital stack: stretched senior (typically 40%-60% LTV), junior (typically 60%-70% LTV) and mezzanine (typically 70%-80% LTV). Pricing on these loans depends on risk level and ranges from 6% on stretched senior to 12% on higher risk mezzanine.

The following table provides some characteristics of debt funds' strategies:

Strategy	LTV range %	Target gross return %
Senior	0-60	4-6
Subordinated	60-80	8-15
Whole loans	0-75	6-8
Mixed debt	0-80	8-10
Distressed loans	50-100	15-20

A whole loan strategy is a combination of senior and mezzanine debt for which borrowers are prepared to pay a higher price as it offers them a one stop-shop solution rather than needing to look for separate lenders.

Some fund managers have also adopted a mixed strategy and provide a mix of loans within the whole capital stack.

A distressed debt strategy is usually associated with opportunity funds that bought portfolios of loans from banks, governments and defaulted CMBS issues at significant discounts.

The majority of debt funds have a strategy to focus on providing newly originated loans secured by good-quality, well-located real estate, mainly in the UK and stable western European countries such as Germany, the Nordics, the Netherlands and France.

The main sectors that senior debt funds focus on are retail, offices, industrial/logistics and residential.

Although the increasing number of funds and the growing appetite from investors appear to reflect a growing market, both fund managers and investors have indicated that the capital raising environment remains very challenging, particularly for small and independent fund managers. Larger fund managers have been better able to raise capital but often because they have been supported from internal sponsors.

OTHER KEY HIGHLIGHTS

- ▶ Competition from other sources of lending such as direct lending from insurance companies and the Pfandbriefe market in Germany
- ▶ Real estate debt fund returns vary depending on strategy and fund risk profile
- ▶ Specific risks relevant to investing in real estate debt funds
- ▶ Most important areas of due diligence process relevant to real estate debt funds
- ▶ Senior debt funds target fixed income investors and subordinated debt funds target real estate investors

The full report is available to members at www.inrev.org
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