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Welcome newcomers breathe life into lending markets

16 August 2013 | By Nassar Hussain

After a tumultuous few years in the real estate debt markets, the recent improvements in the availability of debt have been warmly welcomed.

The main story of 2013 has been the return of senior debt and CMBS (commercial mortgage-backed securities), resulting in increasing levels of liquidity. Although it will take time for the liquidity to work its way into increased transaction flows, across a broader spectrum of property sectors it is already starting to have a positive impact on real estate values and the rate of loan defaults.

Some of the increased liquidity is clearly short term and opportunistic. However, the vast majority represents a fundamental and longer-term shift towards a more diverse and robust source of real estate debt capital.

Historically, European corporate real estate markets relied primarily on banks, which lent up to 90% of debt capital, while CMBS contributed less than 10%. This differed significantly from the US market, which benefited from far more diverse sources of funding: bank lending accounted for around 60% of the market, CMBS for about 22% and non-bank lenders — predominantly insurance companies — 18%.

This diversification of funding combined with the longer duration of loans were key factors in the US real estate lending market rebounding far more quickly than here in Europe.

The range of lenders now willing to provide finance for European commercial real estate has grown significantly compared with 2006/7, but it is highly fragmented. Among the range of lenders that provide debt across the capital structure to the European real estate markets are sovereign wealth funds, international, domestic and regional commercial banks, insurers, pension funds, CMBS and other capital markets investors, investment banks, private equity, hedge and debt funds and family offices.

The lending criteria for these lenders is even more varied and disparate. They can offer senior, stretched senior, mezzanine, whole-loan debt, on a range of margin and return profiles with a variety of prepayment penalties, maturities, jurisdictions, within real estate asset classes or other sectors, on fixed or floating rates, and with hedging, amortisation, concentration limits, investment or development or operating assets, and so on. Some providers have also invested indirectly.

With an estimated €2.4 trillion of loans on their books and continued pressure to deleverage and increase their capital reserves, many European banks remain constrained in new real estate lending, while others have diverted their focus to areas such as SME (small and medium-sized enterprise) lending.

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For many others, however, the relative risk/reward on real estate debt compared with alternative forms of debt — for example, high-yield or infrastructure lending — has made real estate a core asset class again. When combined with government initiatives such as Funding for Lending, which offers cheaper sources of capital, the attractiveness of real estate debt has led to significantly increased lending targets.

Insurance companies and pension funds have been among the main beneficiaries of this opportunity. This is in addition to the increased activity prompted by European Union regulatory changes such as Solvency II, which has prompted several mainstream and big-ticket insurance lenders — among them MetLife — to establish a meaningful position in the market.

Some US insurance companies are also taking advantage of the higher yields European real estate debt offers over lending in their domestic market.

The growth in alternative lenders is also linked to the myriad debt funds that have been raised and continue to be raised. The main focus of these funds has been mezzanine debt, however, we are now seeing a number of senior, whole-loan and specialist strategies being employed by Starwood, ICG Longbow and LaSalle Investment Management.

For established names raising capital has now become far easier than the difficult period between 2009 and 2011, when many first entered the market. The latest De Montfort University study of property debt (Property Week, 17.05.13) indicated that 15% of lending in 2012 was written by insurance companies and other alternative lenders. Although this is not a significant amount, it does represent a transition in the market that is likely to continue. Larger players such as insurers and sovereign wealth funds have also benefited from being able to employ a variety of strategies — be they direct lending or indirect lending through managed accounts or debt funds. In certain cases — Aviva, for example — they have even established their own debt funds.

Secure network

The market changes that are occurring in 2013 are not confined to the rise in alternative lenders. This year, we have also seen the return of the CMBS markets, with nearly €6bn of issuance so far — more than the three previous years combined — and expectations that it may reach €10bn by the year-end.

Although the return of multi-borrower or multi-jurisdictional conduit transactions is not expected in the short term, the role of the capital markets — including retail and corporate bonds — will continue to increase and play a more significant role in property finance.

There are already signs that some investment banks have started to rebuild their lending and securitisation teams — undoubtedly inspired by the success of Bank of America Merrill Lynch's Taurus German multi-family CMBS in April this year.

The increased competition in real estate debt has already resulted in significant margin compression for core lending areas. Greater numbers of lenders are returning to specialist areas, such as development finance, healthcare and hospitality.

The next significant change will be the broadening of lending criteria to secondary real estate and, while this process has already started, it will only gain true momentum when a wider economic recovery sets in and increases occupational demand.

Source:
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