REAL ESTATE CAPITAL

Lenders learn to love alternative real estate

Publication Date: 9th September 2019 | By: **Alicia Viilegas**

When asset manager Legal & General Investment Management bought the Hampton by Hilton hotel at London's Stansted Airport for £48.3 million (€53.3 million) in October 2017, it decided it could earn the highest risk-adjusted return by taking direct exposure to the asset's cashflow.

For the first time, LGIM decided to appoint the hotel operator as its agent, rather than agree to a long-term lease with it. It meant the hotel would be run directly on the investor's behalf: if the hotel had a bad six months, so would LGIM, and vice versa.

"At the time, we were not only underwriting the hotel itself but also effectively establishing processes and procedures for investments like this, which would follow a management-intensive route to secure higher returns," says Rob Martin, research director at LGIM Real Assets.

The firm is a prime example of a conservative institutional investor that has recognised the need to diversify its property portfolio outside the traditional core segments – offices, industrial and retail – to include alternative assets, which are often operational by nature. And as investors have warmed to alternatives, lenders have gradually followed.

"Lenders are clearly interested in understanding alternatives better, which is a good lead indicator that there will be debt liquidity in this space," Martin says, highlighting conversations with financiers at events organised by the Commercial Real Estate Finance Council Europe to educate them about the specific dynamics of alternative properties.

Recent deals show lenders are also becoming more comfortable with alternatives. US bank Goldman Sachs entered the UK build-to-rent residential sector in April, for instance, with a £118 million loan for a scheme in Birmingham. In September, Dutch banks ING and NIBC provided €52 million to support the acquisition of two data centres by Dutch investor The DataCenter Group in the Netherlands.

Investment into alternatives is not a new phenomenon. As a proportion of total European property investment, the share of alternatives has grown from 27 percent in 2009 to 36 percent in 2018, according to Savills. However, absolute investment volumes have increased significantly in the last year – up 43.4 percent year-on-year to €125.6 billion in 2018. Low yields in traditional asset classes have encouraged some to look elsewhere for higher returns. The lack of available product in the core space across Europe has also been a driving factor.

"Alternative asset classes tend to offer higher cashflow returns than traditional property types," says Amal Del Monaco, head of sector specialists at AXA Investment Managers – Real Assets, the investment arm of French insurer AXA, which last year invested almost €2 billion in alternatives. "This space is less mature, has lower investment volumes and less data available than offices, for instance. You have to build your conviction when investing in this space.

"Student accommodation, for example, can generate returns of between 5 and 6 percent depending on the geography, which compares to a return of between 3.5 and 3.75 percent for a core office building."

Portfolio diversification is also a motivating factor for investors at this late stage of the real estate cycle, as several emerging non-mainstream asset classes are perceived to have countercyclical benefits. Douglas Edwards, head of equity raising at Frankfurt-based property fund manager Corestate, says alternative assets reflect changing patterns of demand in western societies, which require new uses for real estate: "I look at alternatives as a new world based on the living cycle. Younger generations are now looking for real estate such as student accommodation, co-living and aparthotels. Baby boomers demand new senior living concepts and the silent generation needs assisted living and care housing."

What is alternative real estate?

Commercial real estate has traditionally been categorised as offices, industrial and retail, with anything else branded 'alternative'.

Hotels and apartment buildings have long been identified as two popular *types of alternative property, with properties such as data centres and storage facilities considered fringe assets. Recent years have seen the emergence of concepts such as purpose-built student housing schemes and high-end retirement facilities. A common facet of alternative properties is that they are run by operators, rather than directly leased to tenants, as tends to be the case in the core segments.*

Lenders Follow

Lenders have not woken up to alternative assets overnight. Some, including banks, have written large hotel loans through this cycle, for instance. In more niche parts of the alternative property market, landlords have often needed to turn to debt funds with the risk appetite to provide finance. The recent buzz around lending to alternatives is driven by the growth in investment activity in these sectors, and by the fact that emerging segments, such as build-to-rent apartment schemes, are expected to grow massively.

The volume of lending in Europe's alternative space is difficult to quantify. However, an analysis of all UK real estate debt transactions on which consultancy firm JCRA advised last year demonstrates the trend: in 2018, debt deals for operating assets – which included student accommodation, hotels, healthcare, leisure and marinas – surged by 20.2 percent to more than £2 billion year on year.

"An increasing number of lenders have more appetite for alternatives," says Simon Marshall, director of real estate debt advisory at JCRA. "This segment still provides higher loan margins compared to traditional asset classes, as less track record in this space means less visibility on historic trends and how these assets perform in different market conditions.

The pricing premium over loans against mainstream assets highlights the relative lack of debt liquidity in some parts of the alternative property market. Neil Odom-Haslett, head of commercial real estate lending at UK-based manager Aberdeen Standard Investments, says there is not yet "competitive tension" among real estate lenders in some alternative sectors, as some remain wary of underwriting operational properties.

"As a manager of debt funds, we need to ensure we achieve a certain return hurdle for our investors," he says. "We are comfortable to lend against those less traditional asset classes because of the margin pick up they offer. At the moment, in central London, we are seeing margins at circa 110 basis points for super prime properties at LTVs lower than 50 percent. We just can't compete on that"

Nassar Hussain, principal at debt advisory firm Brookland Partners, says lenders typically charge higher margins for properties with an operational element, to reflect the increased risk: "Traditional prime assets would typically be in the 150-250bps range, hotels would be 250bps plus, whilst more esoteric operating assets would be priced even higher."

Lending terms in key European markets

Co-living

The UK saw loans with a 65-70% LTV priced at 3.25-5.5%

Data centres

Pricing for loans at 50-60% LTV in the UK can range from 2.25-2.75%

Build to rent

Developments in Spain at 75% LTV can offer margins of 6% while those in the UK with LTVs up to 70% offer margins of 3-5%

Senior living

Loans at 60-65% LTV in the UK have been priced at 3.5%

Student housing

In Spain, loans at 50% LTV in existing assets have been priced at 2-2.5%

Hotels

Loans at 55-60% LTV in the UK have been priced at 2.25-2.75%, while in Spain loans at 50% LTV have been priced at 2%

Data provided by CBRE based on deals closed in the UK and Spain in H1 2019

Lowdown on alternatives

When structuring loans against alternative assets, lenders usually provide lower leverage, as a defensive measure, with the maximum loan-to-value ratio being 10 to 15 percent lower when compared with financings against traditional properties. "Debt funds have traditionally been more flexible than banks and have more risk appetite," says **Hussain**. "But if a borrower wants higher leverage this comes at a price."

Corestate's Edwards says non-bank lenders are more flexible when providing debt for alternative asset classes, while the banking segment has not yet adapted its metrics to understand the source and nature of income from this type of asset: "Many bankers want to move to alternatives, but there are inherent rules and regulations of the banking organisations creating an impediment to allow them to be flexible enough to provide debt into this space.

"But I believe it is a question of time, education and managing processes well. Then banks will be able to take advantage of lending into alternatives and get more attractive interest rates – like debt funds, for example, already do – whilst staying in line with their internal regulations," he notes. Some in the real estate industry argue that the term 'alternative property' is fast becoming meaningless. They say a customer-focused, operational model is becoming the norm across all real estate segments, and that even offices are shifting towards that model with the rise of co-working. Those who continue to use the term argue its definition is changing, with many now viewing real estate such as hotels and student housing as staples of equity and debt portfolios. Savills' data show that investors poured €26.6 billion into these two asset classes across Europe in 2018, which represented an increase of 73.9 percent from 2013.

The distinction lenders should consider, one debt advisor argues, is not whether a property is 'mainstream' or 'alternative', but whether it is leased on a traditional fixed lease or on an operational basis, as is happening across many types of real estate. Some offices, the advisor adds, are now leased to operators, meaning lenders need to take a similar underwriting approach as they would to a hotel. As the operational model, which is most prevalent in the alternative sectors, becomes the norm across a more service-oriented commercial real estate industry, the distinction between financing an office block or a hotel becomes less obvious.

Lenders report that loan structures need to be carefully considered when financing operating assets, across myriad sectors. Speaking in private, one banker says loan covenants are typically tighter when financing an asset with a potentially volatile cashflow: “There needs to be a safety net, so lenders consider options such as cash traps.”

Lenders’ view of student housing and hotels

Although they still fit many organisations’ alternative label, few lenders now see student accommodation or hotels as exotic.

Hotels and apartment buildings have long been identified as two popular types of alternative property, with properties such as data centres and storage facilities considered fringe assets. Recent years have seen the emergence of concepts such as purpose-built student housing schemes and high-end retirement facilities. A common facet of alternative properties is that they are run by operators, rather than directly leased to tenants, as tends to be the case in the core segments.

“We see student accommodation and hotels as fairly mainstream,” says Gregor Bamert, head of real estate finance at Aviva Investors, the asset management arm of UK insurer Aviva. “In some cases, having rental income from hundreds of different rooms, in different locations, might be a much more stable source of rental income than that received from one large retailer.” In the UK, consultancy Knight Frank predicts 29,000 new student beds will be delivered in 2019, boosting the sector’s market value to £53 billion and offering a stable income stream. Yields have compressed to 4 percent in London and 5.25 percent elsewhere.

Mark Bladon, co-head of origination at Investec Structured Property Finance, says: “Whilst headline yields in student accommodation, which is seen as a defensive asset class in case an economic downturn is triggered by Brexit, have compressed 25-50bps in the last two years according to Knight Frank, this could be as much as 50-100bps for portfolio sales in certain locations over the last 12 months, reflecting new entrants coming to the market with appetite to quickly acquire scale. For lenders, margins have also tightened, but not significantly.”

Amy Aznar, head of debt investments and special situations at investor LaSalle Investment Management, says loan pricing for ground-up developments is more attractive for lenders: “Banks aren’t particularly active in development finance for student accommodation, especially at slightly higher leverage points.”

Property investors and lenders see growth opportunities for student accommodation in continental Europe, where market sources say there remains a premium of 50-100bps on student development loan margins compared with the

UK. “Spain and France, which are increasingly offering English-language courses that are tailored to international students, and of course the UK and Ireland are markets where we continue to see strong potential,” Aznar says.

Property investors and lenders see growth opportunities for student accommodation in continental Europe, where market sources say there remains a premium of 50-100bps on student development loan margins compared with the *UK. “Spain and France, which are increasingly offering English-language courses that are tailored to international students, and of course the UK and Ireland are markets where we continue to see strong potential,” Aznar says.*

Hotels also benefit from a liquid supply of debt, provided by consistent appetite from banks and growing interest among debt funds. “Hotels have an attractive yield profile compared to other sectors,” says Chris Gow, head of debt advisory EMEA at consultancy JLL’s hotels and hospitality group. “I don’t even consider hotels to be an alternative because so many lenders are very comfortable with this asset class.”

Bettina Graef-Parker, responsible for hotel financing at Germany’s Aareal Bank, stresses the importance of understanding the operational nature of hotels: “Underwriting debt for a hotel is more like financing a business rather than a fixed-income property. We do deep analysis into the individual properties that we finance.”

Emerging sectors

One debt fund lender says loans written against alternative assets tend to be bespoke, given the esoteric nature of many such properties. They say the most important factor when financing a property that is likely to have a volatile income is to calculate the sustainable cashflow, from which leverage is then appropriately calculated. The lender adds that the operational nature of some properties gives rise to measures to acknowledge potential deleveraging of the sponsor’s EBITDA through growth in company profits: “This might mean a more flexible amortisation regime, which rewards the sponsor for generating income through growth.”

Another market participant notes that across operating asset classes, lenders usually use the debt-to-EBITDA ratio as an equivalent to debt yield, which measures the amount of income generated and available to pay down debt before covering interest, taxes, depreciation and amortisation expenses. Lenders might also calculate covenants slightly differently. Interest coverage for hotels, for instance, is typically calculated on a rolling 12-month basis, rather than quarterly, to avoid seasonal bias.

The composition of the alternatives space is changing, with sectors such as hotels and student housing no longer seen as off-piste by most lenders. New real estate concepts are emerging, such as build-to-rent housing in the UK or co-living schemes across major cities. Other sectors are experiencing an evolution: developers are aiming to provide higher-quality retirement living, and experiential leisure uses are becoming more popular. UK BTR is a sector that most agree has huge growth potential. So far, however, the banks have been cautious because such schemes cannot be de-risked via pre-sales – as is the case in the build-to-sell sector, where banks are more active.

“Banks like ourselves, which do not generally back speculative developments, need to find ways to innovatively structure around the natural lack of pre-lets to get new PRS […] off the ground,” says Madeleine McDougall, global co-head of real estate and housing at UK lender Lloyds Bank. “The way these deals are structured under the bonnet can be quite different to those of a more traditional asset class, but the fundamentals don’t change: a strong sponsor with a good track record and an asset with a solid pre-let or appropriate structuring are a must.”

Co-living is less mature still. Those behind such schemes aim to extend the student housing concept to the wider housing market, in the context of a lack of affordable housing in large cities. Specialist co-living provider The Collective, which has two projects in London, first attracted development finance from Singapore-based United Overseas Bank for its 546-bedroom Old Oak scheme in west London, which has maintained 98 percent occupancy since it was completed in 2016. Once stabilised, the asset was refinanced by German lender Deutsche Bank.

“We are now looking to fund more co-living schemes, as we see increasing demand from occupiers and the product is becoming widely accepted by the investment market,” says Nicholas McNair, a managing director in commercial real estate at Deutsche Bank. “Co-living has the potential to be more volatile than traditional leased investment product, but the fundamentals are very strong. People are demanding this product partly because of the pressure on housing, affordability and mobility.”

The Collective is now developing a 705-room co-living scheme in London’s Canary Wharf, having secured development finance from Lloyds and mezzanine debt from UK non-bank lender Cheyne Capital. Jill Xiaozhou Ju, investment director at The Collective, says it was “easier” to source finance for its second scheme, once the firm had a proven track record in London. Although she did not disclose the terms of the financings, she said loan pricing for co-living projects is similar to that for student housing or build-to-rent schemes. According to data from consultancy CBRE, margins for UK co-living investment loans range from 2-3.5 percent for deals up to 70 percent LTV.

Despite the oft-made observation that so-called alternative sectors are those that are backed by the clearest structural and demographic drivers, there remain limits to debt liquidity in some parts of the market. Senior living is a segment with a clear demographic benefit – Europe's ageing population – but equity players have specifically mentioned a lack of lender support as a factor holding back the sector's growth. Some lenders point out that many care homes across Europe are dependent on local authorities paying patients' fees, thus making owners and operators vulnerable to changes in public spending. There is also the reputational risk of being associated with the failure of a care home provider, should a loan default.

The wider healthcare sector, including nursing homes, is an area some remain wary of. "We finance every alternative sector except healthcare," says one debt fund manager, who did not want to be named. "It's impossible to mitigate the political risk in that sector." Bank of Ireland's Hilary Coates, who leads the Irish lender's healthcare team, is one proponent of the sector within the banking community. She says the lender has a strong appetite to lend against the healthcare sector due to rising demand for care and housing.

"When financing this sector, we look at operators whose business model is care-focused, thereby ensuring full alignment of interest between residents, owners and lenders," she says. "In Ireland, as the state provides funding of circa €962 million to circa 23,000 people in residential long-term care, with 80 percent of these receiving care in private nursing homes, we assess cashflows and the repayment capacity based on the income."

Although alternative property sectors are at different stages of their evolution, and are typically intensive assets to lend against, opportunities in less-established parts of the market are becoming more capitalised than ever by lenders seeking premium margins at this late stage in the cycle.

Investors will keep pouring capital into this space on the back of predictable demographic trends, the growing importance of real estate as a service and the desire for long-term income. Lenders, therefore, are likely to continue to be comfortable with providing finance outside commercial real estate's mainstream.

5G and the future of data centres

There is 63.4 million square feet of data centre space globally, and another 4.3 million under construction, according to JLL

However, with the roll-out of 5G, the fifth-generation cellular network technology that will allow quicker downloads and greater efficiencies, the pipeline for new data centres is expected to soar.

“Demand to upgrade data centres for 5G technology will spur new developments and strategies, including the need for new infrastructure and topology such as edge data centres – using micro facilities in multiple locations to send and receive data rather than use just one data centre in one location,” says Kirsty Barnes, head of banking and finance with an expertise on data centres at law firm Gowling WLG. “This will drive a huge amount of investment that will need funding.”

Despite the growing opportunity to finance the development of data centres and operators generally, some banks are still cautious in this space as they struggle to understand an asset class that does not fit neatly into a traditional property loan scenario, Barnes says.

“Financing data centres is particularly difficult, because it generally involves both a real estate asset and an operating business,” she says.

Since 2010, an increasing number of lenders, however, have shown more appetite to back data centres. These lenders are more willing to provide a hybrid facility between a real estate and a corporate loan, Barnes says. “Rather than just looking to the value of the underlying asset, they also look to the value of the underlying business. The lending, therefore, is not just predicated on the valuation of the asset, but on understanding the customer contracts in place, the growth potential and the income streams more generally.”