No shortage of debt capital

Lenders are keeping Europe's property market financially liquid, despite Brexit and the extended nature of the current real estate cycle, argues Nassar Hussain of Brookland Partners

With myriad capital sources competing to provide debt, the European commercial real estate financing market is as complex as it has ever been. Against that backdrop, a community of property debt advisors has emerged this cycle, to help sponsors navigate the sector. London-based independent advisory firm Brookland Partners is among them.

Nassar Hussain, former real estate investment banker and founder of the firm, shares his thoughts on liquidity in the age of Brexit, lender adaptability and why there is still some way to go for the current cycle.

Real Estate Capital: *How is Brexit affecting the liquidity of debt capital in the UK commercial real estate market?*

Nassar Hussain: Investment volumes have steadily recovered since the referendum in 2016. However, as a result of the extreme uncertainty as Brexit approaches, we are seeing some bidders decide to hold off.

It has had more of an impact on equity investor appetite than lender appetite. There are some investors from certain jurisdictions – such as the US – who appear to be more concerned about Brexit than others such as those from Asia-Pacific and the Middle East. It is quite a mixed market. We see some deals where investors are completely unfazed and pushing ahead and others where they are delaying and having second thoughts in case a deal may become difficult to explain if a bad Brexit were to take place. Lending appetite generally remains strong.

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Nassar Hussain

We occasionally see lenders raise Brexit as an issue, but it is typically one of many factors including the leverage request which, when aggregated together, causes them to decline the transaction. This is especially the case for lenders based outside the UK.

REC: *Do you see Europe as a liquid real estate debt market?*

NH: Western Europe is now generally quite a liquid market. This certainly was not the case several years ago.

Each country went through its own cycle and its own particular issues over different timeframes. It was difficult to source local debt in Spain, the Netherlands and Ireland a few years ago and these markets were dependent on a limited number of overseas lenders. Other jurisdictions have recovered more slowly, such as Greece and Portugal, and it is interesting that banks in these jurisdictions were much slower in selling their non-performing loan portfolios.

Europe is now greatly helped by the fact we have more diverse funding sources, which is the key difference between today and where we were at the peak of the last cycle. In 2006, 90 percent of all lending was done by banks, with the other 10 percent coming from CMBS and insurers. Today, banks account for 70 percent, the remaining 30 percent coming from debts funds and insurers, and a small element of CMBS.

REC: *What role will CMBS play in the European property debt market in the coming few years?*

NH: 2018 was a good year for CMBS, with around 15 deals, but it is still less than 10 percent of where the market was in 2006. It gained positive momentum last year, but it is still a relatively small component of the overall debt market.

There are three key reasons why CMBS has not made a big comeback since the crisis. First is that the non-CMBS market – the banks, insurers and debt funds – have provided a lot of liquidity and senior loan pricing has been very competitive. It is hard for CMBS issuers to compete with that. Second, the regulatory capital treatment of CMBS for investors is much harsher than it is for other structured finance asset classes, which can hurt returns on a relative basis. Third, there are fewer investors than during the last cycle.

Ultimately, CMBS is a relative value play for investors and borrowers will only turn to the CMBS market if it offers pricing below that available from the wider real estate lending market. For a very long time, that was not the case, so there was a dearth of issuance. However, last year, pricing tightened across asset-backed securities and CMBS suddenly became an attractive proposition again.

The issuance we saw last year is positive for the market. I expect that to continue steadily this year, with increased CMBS demand from investors.

REC: *What is your outlook for this real estate cycle?*

NH: When I was at Merrill Lynch back in 2006, I exited all the positions I had on our balance sheet and I resigned in early 2007 because I felt very uncomfortable with the level of leverage and how aggressive both the lending markets and the valuation markets were. It just didn't feel sustainable.

In 2019 we don't have those same factors at play. Leverage in the system is moderate and is manageable. Real risk is not held by the banks, so there is no real systemic risk as there was last time around. Mezzanine loans are generally being written by debt funds, and while there are some riskier loans being done by debt funds and challenger banks and small specialised lenders; it is a small part of the overall market.

This has been something of an artificial cycle due to very low interest rates and quantitative easing. So, taking those factors into account, it cannot be assumed this will be a similar cycle to previous examples.

For the market as a whole, values are 10-15 percent higher than the last cycle, which could be a sign that the market is too hot, but values have now largely stabilised, and some have fallen, so it is a healthy position to be in. There are structural issues in specific markets such as secondary retail and prime residential, but the overall market can absorb these. Some pain will certainly be felt by investors and lenders in these sectors.

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Data from the last cycle show the biggest single factor in loan defaults was the vintage of the loan. The vast majority of all losses were made on loans written between 2005 and 2007, so lenders have become far more aware of the impact of the cycle than in the past. It is very difficult for lenders to completely halt lending, but they can temper their lending activity. Overall, lenders are managing risk appropriately.

There is always a risk, but extraneous factors aside – such as geopolitical issues including a hard Brexit or contamination from other more aggressive sectors such as private corporate debt or high-yield bonds – it is hard to see this cycle coming to an end in the very near future.

REC: *This cycle is also more complex, with the growth of operational property such as co-working. How are lenders adapting to the changing fundamentals of the market?*

NH: Co-working is here to stay. You only need to look at WeWork, which in just under a decade has become the largest corporate office occupier in central London.

The issue is the limited guarantees provided by serviced office operators or their opaque financials, so lenders cannot underwrite the covenant and therefore the loan in the same way as with traditional real estate. Many co-working buildings should be treated like operating assets. There have always been specialised teams within lenders for operating assets such as hotels and healthcare, but lenders to traditional asset classes such as offices are now shifting their approach and learning to underwrite co-working properties.

REC: *How can debt advisors add value in the European market?*

NH: In the past, borrowers had a few relationship banks and they would typically use the same banks for most of their transactions. But because today's market is much more diverse and fragmented, debt advisers play a role in sourcing the right type of lender and debt.

Brokers and debt advisors have always been a part of the US market, and borrowers have generally appreciated the value that they add. That role has now become more accepted within the European market, hence there is now quite an active debt advisory market we now have over here. It is still small in comparison.

It is also important to differentiate between debt advisors and brokers. It is about more than just introducing a lender to a client; it is about being able to manage the entire execution process, from due diligence to documentation, structuring and hedging – as well as offering more bespoke and sophisticated debt solutions, such as CMBS and high-yield bonds. ■