Unrated deals slow down in face of volatile markets

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Bespoke notes suit some investors but pricing has become challenging, reports Lauren Parr in a special report on Europe's debt capital markets.

Bank's preference for higher-quality deals, combined with a 'hands on' approach to loan structuring by investors and borrowers has promoted a move towards unrated and privately placed deals as an alternative to mainstream CMBS over the past five years. The opportunity set has diminished of late however, with banks prepared to lend into more markets and the widening of capital markets spreads.

In the lead up to last summer, there was a pick up in companies raising debt through the issuance of notes to a single or small, bespoke group of investors which was partly driven by a need for niche financing options given banks' heavy focus on the best assets in safe markets.

These typically unrated bonds tend to be more obscure in some way than banks are prepared to finance or rating agencies to rate.

"It may be an esoteric asset class or a challenging jurisdiction that might not suit rating agency methodology or where an agent might not give a good rating resulting in considerably wider pricing," explains Gareck Wilson, a partner at Brookland Partners. "It might be quicker and easier to identify a small number of investors that like the product."

An example of such a deal is Italian property company Gruppo Statuto's placing of a €59 million bond to finance the conversion of a Rome office building into a luxury W Hotel with one London-based institutional investor in January.

"Had a traditional bank been prepared to finance this it would have been done with a bilateral loan and cheaper, but it wasn't possible at the LTV level the borrower required and on this type of development project. Structuring the deal in this way incurred limited costs relative to CMBS, which was out of the question," says Francesca Galante of First Growth Real Estate Finance, which advised the group on the debt raising.

Deals that are not big enough to make the higher setup costs of a full securitisation stack up are some of the best suited to the private market. These costs include rating agency fees in the region of £500,000 "just to have a look" according to an investor.

In Galante's view: "CMBS doesn't make sense under a €100 million debt quantum."

Another disincentive is the requirement of a liquidity facility as part of a rated CMBS. "These are difficult to come by and if you do get one it's likely to be expensive," Wilson says.

Around the time CMBS investor M&G Investments was being shown a greater number of deals, last July, "things were falling between the loan space, being outside the absolute prime market, and the CMBS market, being too small to warrant securitisation," recalls Matthew O'Sullivan, head of commercial securitisation credit research – ABS at M&G.

Lately, calls from arrangers have been infrequent, pointing to fewer opportunities than last year. "A major factor is that general capital markets spreads across the corporate and ABS asset classes have widened since the start of the year, but loan spreads haven't, with more traditional bank lenders in Europe having come back into the market. That means doing private or unrated CMBS is less attractive," O'Sullivan says.

Debt brokers have also noted less activity on the private placement front than they had anticipated. "Looking at pricing there's not an obvious case to do it; the arbitrage isn't there," says Don Belanger, who heads Situs's Capital Markets Solutions division.

The various types of capital markets transactions Situs CMS has pursued on behalf of large investors or sponsors since the platform's launch in April 2015 have mostly been put on hold largely owing to "investor and issuer concerns about capital markets exits since last June/July. Everyone is affected by the same thing: perceived global macro problems and uncertainty".

Its core business remains matching borrowers and lenders on bilateral situations, with the syndication route an easier one to go down.

However "the concept is still important as having a loan in bond form means you have financing options that you wouldn't have had otherwise," Belanger says.

Crucially, some investors can only invest in bond format. "There is far more capital to invest in real estate debt if you can access the capital markets; some of that is dedicated capital, some is flexible, but there are investors that cannot invest in anything but capital markets instruments," highlights Charles Roberts, a partner at Paul Hastings.

“Seized up capital markets mean it’s more difficult to find standard issuance. It’s likely unrated product is more expensive than rated product from a borrowers’ perspective but given where the market is, syndicating large loans is a cheaper method of distribution for banks than capital markets,” he says.

Furthermore, unrated bond issuances without multiple classes of notes do not constitute securitisations from a regulatory point of view, therefore attract milder capital treatment than rated CMBS bonds and could fare better than underlying loans.

One of the biggest plus points associated with private ‘club’ deals is the certainty of execution they provide, particularly in a volatile environment. “Look at how many CMBS deals have been aired in the market that haven’t happened from a lender and borrower perspective,” Cairn Capital’s Peter Hansell says.

“If you put a club together of fixed income investors rather than going out and doing a widely marketed deal you know these guys are working with you until the end. Conversely, if you go down the CMBS route i.e. making a loan and then going to talk to people, you don’t have the certainty that investors will support the deal at the time you go to market.”

Lessons learned from the financial crisis have fuelled other motivations for private deals, such as the desire for investors and borrowers to communicate directly and to structure deals which are specific to their requirements.

“Quite a lot of investors and borrowers would rather have a discussion to agree terms and structure directly,” says Hansell.

“One of the big issues historically with CMBS was the feeling that it is a faceless process where the only participant that knew everybody was the bank in the middle. When it comes down to it there is value for both the borrower and the lender in having direct discussions, understanding the precise business plan strategy of the borrower and agreeing potential structural features.”

Continues Hansell: “Investors want to be able to guarantee themselves a certain allocation within a transaction so they are working from an early stage to get the deal they want, knowing they’ll get the amount of a deal they want at the end of it.”

With a great deal of uncertainty in the market currently, especially with a potential Brexit on the horizon, it is unclear how much activity will be seen over the next few months across capital markets from a commercial real estate perspective.

“It will be interesting to see if and how Brexit will affect structures used for UK assets. Given that UK transactions already have a smaller investor base, if this shrinks we could see more private style deals,” notes O’Sullivan.

Large, low leverage agency deals on trophy assets backed by prime sponsors like the Westfield Stratford transaction may still get done as banks that got hurt through CMBS last year look to take on less risk.

“There continues to be a source of demand from investors and borrowers for unrated, privately placed deals,” to Wilson’s mind. The success of Amicus Mortgage Finance, the £100 million securitisation of a portfolio of bridge loans on which Brookland acted as lead arranger and bookrunner last August, “shows originators there are alternative sources of financing available” while from investors’ perspective “being able to pick up bonds that have the same credit quality as a rated deal but are priced based on illiquidity makes for a pretty good investment”.

Cairn CRE debt fund targets private club deals

The advisory business behind transactions such as the £260 million securitisation of the Toys R Us portfolio, has launched a European commercial real estate debt fund to capitalise on a rise in club deals, hoping to pump up to €750 million into the market for real estate structured bonds.

Cairn Capital’s open-ended European Commercial Mortgage Fund, with €50 million of seed capital from Cairn’s majority owner Mediobanca, will invest across the debt capital structure in listed or unlisted and rated or unrated commercial mortgage securities, of either investment or non-investment grade.

It can also make or participate in short- term bridge and warehousing financing, typically to facilitate longer-term debt structures in which it can be a cornerstone investor. Cairn aims to hit net returns of between 7-8 percent per annum. The fund will be managed by a team led by Cairn’s head of real estate, Peter Hansell.

A major focus of the fund is to provide capital on private club deals, where Cairn sees a lot of activity going forward. The firm has been active on this front on both the advisory and investment side over the last few years, structuring and placing circa €1.2 billion of CRE debt since 2013.

Demand has come from borrowers who have been looking to diversify their investment base and satisfy a financing requirement that has not been addressed by the banking market.

On the other hand, fixed income investors are looking to deploy significant capital into CRE debt in bond form. Cairn’s offering marries together those two interests in a co-mingled fund format.