REPORT

FUNDING FOR THE FUTURE

SENIOR DEBT, ALTERNATIVE LENDERS, AND CLOSING THE DEBT FUNDING GAP IN EUROPEAN REAL ESTATE

OCTOBER 2023

Notes by: ESSEC Business School & GRI Club
Editor: Rory Hickman
Designer: Douglas Junqueira
Image: Wirestock / Freepik

WELCOME TO EUROPE GRI

Leverage is a fundamental instrument to make real estate projects viable and get residential buildings, offices, hotels, shopping centres, hospitals and many other projects vital to society off the ground.

At a time when the world needs to learn to deal with atypical macroeconomic indicators, the environment provided by GRI Club gains even more relevance to gather opinions, strategies, and perspectives from real estate market leaders across the world.

The following material seeks to summarise the considerations of these executives and provide a catalyst for the deeper discussions ahead on the subject of credit and debt markets in real estate.

If you are interested in the topic, you can find more about the **GRI Credit Opportunities & RE Debt 2023** meeting, which will be held on November 30th, in London.

Enjoy reading!

GUSTAVO FAVARON
CEO & Managing Partner, GRI Club

CONTENTS

INTERACTIVE TITLES

INTRODUCTION

GRI Club is changing the game for networking and providing key market insights with its event coverage that transforms the intimate discussions of C-level executives into digestible reports.

This report was compiled from the outlooks shared during sessions covering opportunities and challenges in the **Credit & Debt** space at **Europe GRI 2023** in Paris. The largest GRI Club event to date gathered more than 700 of the most senior leaders in the real estate market for 45+ investor-led roundtable discussions on a range of industry topics.

Taking place behind closed doors, with no press and no presentations, GRI Club events feature a unique format that is crafted to facilitate **free-flowing discussions among top industry decision makers**, enabling the executives to share their insights into the latest trends, developments, and challenges coming to the market.

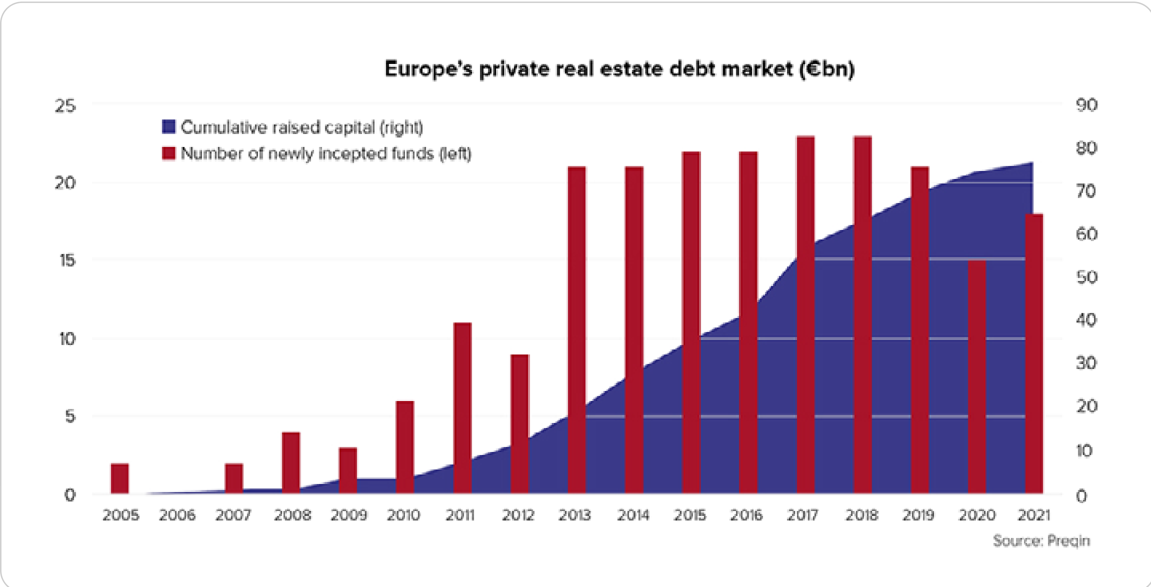
Photos: GRI Club

PRIVATE REAL ESTATE DEBT RISING

Europe has seen a significant rise in the real estate private debt sector over the past decade, driven by various factors. The financial crisis caused traditional lenders to step back, creating opportunities for alternative lenders and experienced real estate equity investors to enter the private debt realm.

As interest rates have climbed, real estate debt has become more attractive to investors, offering returns that were previously found in equity investments. Real estate debt also provides a layer of protection during market corrections, making it appealing in today's uncertain environment.

Private debt funds are now estimated to have reached €80 billion in total volume as traditional banks struggle to meet the high demand for financing.



However, competition in the sector is fierce. Despite the interest in private debt, fundraising has been slower than expected, although experts are optimistic that this trend is here to stay and will continue to grow.

Success in the real estate debt market requires a deep understanding of its unique dynamics. Transitioning between equity and debt investments demands different skills and strategies. Professionals experienced in private debt from other industries also need to grasp the intricacies of the real estate market, particularly in higher-risk segments.

Real estate debt investments require a comprehensive analysis of risk-return dynamics, focusing on metrics like interest cover ratios and loan default risks, rather than just valuation projections. Senior debt investors prioritise loan default risks and refinancing uncertainties at the end of the loan term, with the quality of the underlying real estate asset playing a significant role in their assessments.

DISSECTING DISTRESS

Investors are attracted to discounted distressed real estate debt opportunities, particularly in a changing market marked by defaults and uncertainty.

It's crucial to understand that real estate, even in a debt context, is intricately connected to the underlying properties. Each property's unique dynamics are vital, and performance can vary significantly, with top-performing assets differing greatly from the worst.

The impact of losing tenants or income can rapidly affect property valuations, even in senior debt scenarios. Weaker markets can witness substantial property value swings of 10%, 20%, or even 30%, raising questions about loan viability and the ability to repay it.

For investors interested in distressed debt opportunities, it's advisable to focus on income quality and the cash flow supporting the loan. Scrutinising tenant agreements and evaluating default and business failure risks are essential. Different sectors should be considered due to varying performance across industries.

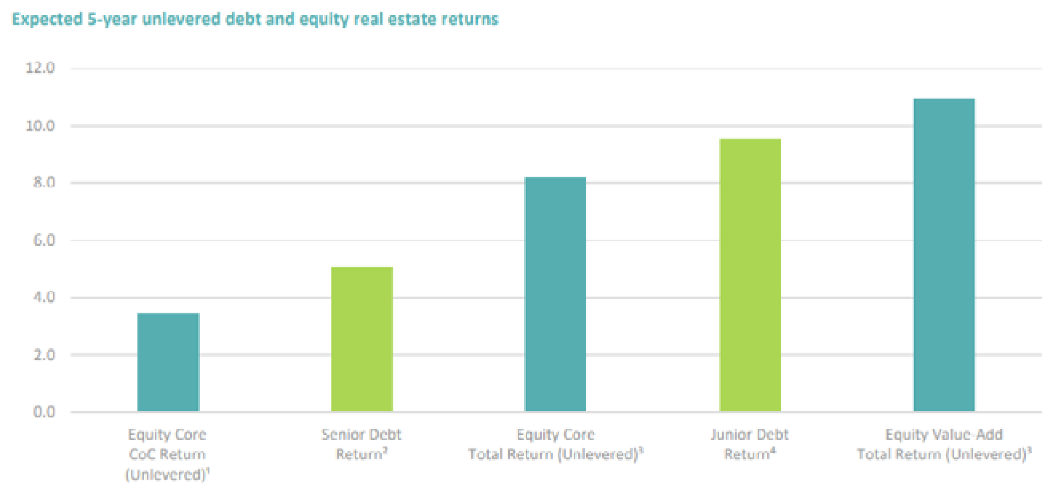
Residential properties and logistics spaces are currently viewed positively for their high-quality income potential. However, caution is needed in sectors like offices, where vacancies are rising, especially for weaker secondary assets.

The retail sector, although relatively stable in recent quarters, faces challenges, particularly in light of a cost-of-living crisis, as exemplified by the recent bankruptcy of UK retailer Wilkos.

Image: Rawf8.com / Freepik

THE SENIOR DEBT SOLUTION

Senior debt has long been the linchpin that connects risk assessment and pricing. But as the industry navigates through a tumultuous landscape, it begs the question: Is senior debt the solution to the growing chasm between supply and demand?



1) Average all-property (ex. retail) net initial yield minus capex and maintenance. 2) 6-month EURIBOR Swap Rate (5-yrs) + 200 bps margin + arrangement fee. 3) Average all-property (ex. retail) unlevered return minus estimated capital costs, but before taxes and fees. 4) 6-month EURIBOR Swap Rate (5-yrs) + 650 bps margin + arrangement fee.
Source: Real Capital News, CREFC, May 2023

STABILISING RATES AMID A WIDENING GAP

Interest rates are showing signs of stabilisation, offering a glimmer of hope for the real estate market. Yet, the debt funding gap continues to widen, prompting industry experts to scrutinise the situation. The UK stands out as a relatively stable market, providing a beacon of hope.

Data on margins indicates a slow but steady stabilisation taking place. These insights are vital in understanding where refinancing challenges lurk, taking into account transaction volumes and lending commitments.

While funding gap values offer crucial insight, industry players are increasingly relying on a daily cash-flow approach to assess investment eligibility. In such turbulent times, having the cash in hand is often more reassuring than the theoretical valuations.

A NEW CHALLENGER?

Although asset values have plummeted while interest rates remain elevated, these rates do not necessarily serve as a barrier to debt accumulation, given the continued growth in rental rates.

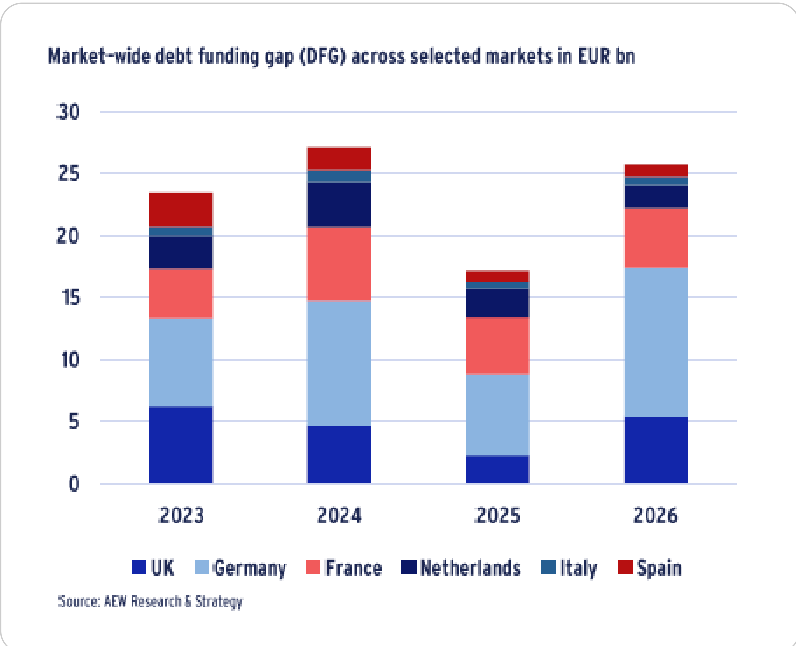
Senior debt, traditionally the highest-ranking security in real estate financing, is now facing competition. High-yield corporate bonds have emerged as a high-yield sub-asset class, although they function differently from loans. While loans come with variable rates, these bonds offer fixed-rate stability.

DEBT FUNDING GAP DILEMMA

The debt funding gap presents a critical challenge for the industry, prompting banks to adopt a more conservative stance. Investors are eager to secure core assets, but the current market dynamics leave their value in question.

Office deals, for instance, are influenced by a multitude of factors unique to the current situation. The values ascribed to these assets are contingent upon the present environment and can't be compared with the past.

Thin margins are not solely attributed to financing terms; they also result from income capitalization rates that limit the ability to raise rents. As a result, debt funding remains a viable strategy, but it must be driven by a cash flow-centric approach, which isn't universally applicable to all asset classes.



LEERY LENDERS

Lenders, especially banks, are exercising caution when it comes to financing retail and office spaces. Their primary focus is on senior debt, which they view as the less risky option in the current climate.

The approach to lending varies significantly based on their geographical location. Whether in the USA, the UK, or Germany, the underlying asset's performance is not the crux of the issue; it's the ever-fluctuating value.

Property appraisals have become a source of uncertainty, as the true value of an asset remains elusive, subject to constant change and external factors. The scarcity of transaction volume adds further stress to asset valuations, amplifying the challenges posed by this market condition.

WEATHERING THE STORM

The real estate industry is no stranger to adversity. Although valuations have taken a hit, they still hold relevance. While assets may be available, it will take time to realise their potential, with timelines extending to one or two years.

Deals, however, remain possible in all seasons - it's a matter of finding the right opportunity in this crisis period. Lenders and borrowers have faced darker times and have emerged stronger, ready to overcome the current challenges.

In these testing times, unlocking value in assets requires creativity and resilience. Regularly reporting to lenders for negotiations, seeking longer loan terms, refinancing with different lenders, and exploring legal protection are all potential avenues.

Image: Reflex-ajans / Freepik

DEBT FUNDS & ALTERNATIVES

The real estate financing landscape is in a state of flux as traditional banks rethink their lending strategies and shift towards the capital-efficient back leverage model. This change is particularly advantageous in the real estate sector, where distributing loans effectively expands balance sheets.

THE ASCENT OF ALTERNATIVE LENDERS

Driven by regulatory and risk-related factors, the lending industry is transitioning from direct lending to back leverage. This shift is creating opportunities for emerging players like alternative lenders and debt funds, who are better equipped to meet the growing demand for higher returns.

Securing construction financing remains a challenge, and alternative lenders are stepping into the spotlight due to their flexibility and ability to cater to specific market needs. Their adaptability and unique solutions have made them prominent players in the evolving lending landscape.

Various financing options, such as bank refinancing and mezzanine financing for project completion, are gaining traction. Local and global banks' retreat from certain markets has opened doors for alternative lenders.

ADAPTABLE ALTERNATIVES

Alternative lenders are known for their adaptability, higher loan-to-value ratios, and the provision of unique solutions compared to traditional banks. While the market is currently stable, there is anticipation of potential distress opportunities in the future.

Borrowers need to understand the advantages of working with alternative lenders and how their financial structures differ from traditional banks. The significance of permanent capital and the role of insurance companies within the industry are also noteworthy.

Image: Lemonsoup14 / Freepik

DEBT DILEMMAS AND THE QUEST FOR LIQUIDITY

The real estate market is at a crossroads, as players in the industry grapple with the decision between debt and equity investments. The first half of 2023 has seen sluggish transaction volumes, leaving sponsors with ample capital but few investment opportunities.

The key question facing real estate professionals now is whether the price discovery process will accelerate or fall into stagnation.

DEBT'S EXPENSIVE DILEMMA

Debt, while historically a cornerstone of real estate financing, has become an expensive and cumbersome avenue for investors. Raising capital is challenging, and this scarcity of funds has made real estate deals harder to come by.

With property prices and values trending downward, property owners often prefer to retain their assets rather than sell at a loss. This trend has shifted focus away from acquisitions and towards development, as the market grapples with a shortage of available properties for purchase.

While waiting for equity to reprice, funding gaps have become more pronounced in the market, creating obstacles for capital deployment. Lenders have responded by looking for multi-use assets with strong fundamentals and future flexibility. They are increasingly open to bridging these funding gaps with their own equity, provided that convincing business plans are presented.

Lenders are now reassessing the status of borrowers, extending terms for assets demonstrating strong underlying performance but gearing up for potential defaults in certain cases. Additionally, regulatory environments in different regions may influence lenders' willingness to grant term extensions.

In the residential sector, there are promising signs of transaction volume growth. Developers continue to sell properties, creating liquidity fundamentals that stand in contrast to other sectors where values and cap rates are likely to remain stagnant. In these sectors, lenders are content to maintain their capital deployment, particularly in hospitality and logistics.

INSTITUTIONAL VS. LP RISK APPETITE

The readiness to invest in the real estate market varies depending on the strategy. Deals are available, but they demand substantial dry powder.

For some commercial banks, despite reduced cap rates in certain sectors, the appeal of taking the lead remains. There's a noticeable shift towards smaller and mid-sized portfolios due to concerns about liquidity in larger portfolio deals.

Alternative lenders have entered the scene, targeting assets with higher exit yields to address the funding gap. Over the next 18-24 months, distressed assets may serve as a catalyst for market movement. Other potential catalysts include fund refinancing needs and targets, as well as the decreasing purchasing power of tenants.

Owners, in the meantime, are willing to wait for price discovery, as they lack immediate capital requirements. This patience contributes to the ongoing slowdown in transactions.

LENDING LIQUIDITY

Liquidity remains a significant concern for lending appetite, leading LPs to explore the credit and alternative lending side. While this trend is more of a near-term phenomenon, LPs are generally positive about the market and are biding their time for the deployment of their dry powder. Credit lenders are now receiving considerable attention.

The real estate market is experiencing a dynamic shift in its approach to debt and equity. Interest in dry powder lending exists, but it is contingent on price corrections. An appetite for opportunistic investments is growing, but the market remains in a "wait and see" mode, anticipating who will take the leap first.

Image: ro9drigo / Freepik

NPLS NEARING AND CAPITALIZATION CONCERNS

The real estate finance landscape in Europe is undergoing notable shifts, with a focus on addressing NPLs and the evolving challenges facing borrowers and lenders.

One key consideration is the need for adaptation to regional nuances and market conditions. In Germany, for instance, the traditional banking sector is facing challenges from alternative lenders, driven by increased intermediation.

Within the EU, there's a challenge in importing capital, mainly due to higher origination costs. This makes it increasingly difficult for borrowers to negotiate favourable terms with lenders.

In response to these changes, alternative lenders are emerging as a viable option for borrowers. However, these opportunities often require higher quality, such as strong sponsors, prime locations, and alignment with ESG standards.

In addition to traditional sources of debt, structures involved in equity crowdfunding are gaining prominence. These platforms cater to both small and professional investors. Nevertheless, managing discretionary capital while maintaining investor engagement remains a challenge, especially for larger projects.

ONCOMING WAVE OF NPLS?

NPLs have attracted attention with aggressive valuations, but underwriting remains challenging. While asset rentals and occupancy rates are relatively clear, underwriting cap rates presents difficulties, particularly in living sectors and logistics, where margins are slim, and increased interest rates further complicate matters.

NPL figures for Europe paint a picture of impending change rather than an immediate crisis. Europe is estimated to hold 343 billion euros in NPLs as of the second quarter of 2023, with a substantial portion of 110 billion euros residing in France, followed closely by Spain at 80 billion euros.

However, these numbers do not signify a current wave of NPL issues. Instead, they serve as a precursor to what's expected to come. On the balance sheets of banks, the NPL-to-loan ratio may appear disconcerting, but European banks have bolstered their capital reserves, rendering them less vulnerable and reducing the urgency to offload NPLs.

Nonetheless, there remains an expectation that NPLs will eventually make their way to the market. It's important to note that not all NPLs are the same. In Spain, a new trend is emerging: portfolios of unlikely-to-perform loans. This development signifies a shift in the NPL landscape, with potential implications for the broader European financial sector.

CONSOLIDATING CHALLENGES

In Southern Europe, the NPL market may be undergoing consolidation, as the number of market participants created during the financial crisis appears excessive. Challenges related to securing financing for distressed assets and difficulties faced by buyers are notable in the current market.

The rise in NPLs could be attributed to the presence of non-institutional or unregulated alternative lenders. This trend may impact the quality of underwriting and credit processes.

In terms of the lending market, there's relative stability, but concerns revolve around changes in capitalization rates and their potential influence on income streams. The health of the lending market varies by location and the origin of lenders.

Looking ahead, a significant amount of euro debt is due for refinancing in the next three years. These refinancing activities are likely to be handled by domestic lenders in key European countries.

Interest rate margins differ across Europe, with some countries experiencing low margins and correspondingly low borrowing costs, while others, such as Italy, have higher margins. Particular concern is directed at interest rate fluctuations in the UK market.

Image: Nespix / Freepik

FINANCING FRANCE'S FUTURE

Access to financing has become a precious commodity in the current French market. The quest for capital has intensified across the board, with the office sector facing particularly arduous challenges.

The sensitivity of banks is no longer solely tied to the nature of the asset. Instead, it's increasingly driven by the quality of the bank's client relationships. However, the office sector has proven more susceptible to the constraints of the financing market, especially for U.S. investors.

The current situation differs significantly from the challenges faced during the 2008 financial crisis. This time, higher LTVs and stricter covenants have come into play. Additionally, investors are placing a growing emphasis on Environmental, Social, and Governance (ESG) criteria.

BACK TO BASICS

In the face of market volatility, one strategy being touted is to "go back to basics." This means prioritising factors like location, tenants, and sponsors, even if it means accepting slightly lower returns. In a tumultuous market, stability can be found in the fundamentals.

Those who wisely hedged their positions are now navigating the financial storm with less turmoil. Hedging strategies have proven to be a valuable safeguard in the current economic climate.

Alternative lenders, who once played a substantial role in the French real estate financing landscape, have recently displayed some reluctance. Their reluctance stems from the limited flexibility they have when dealing with certain property legislations.

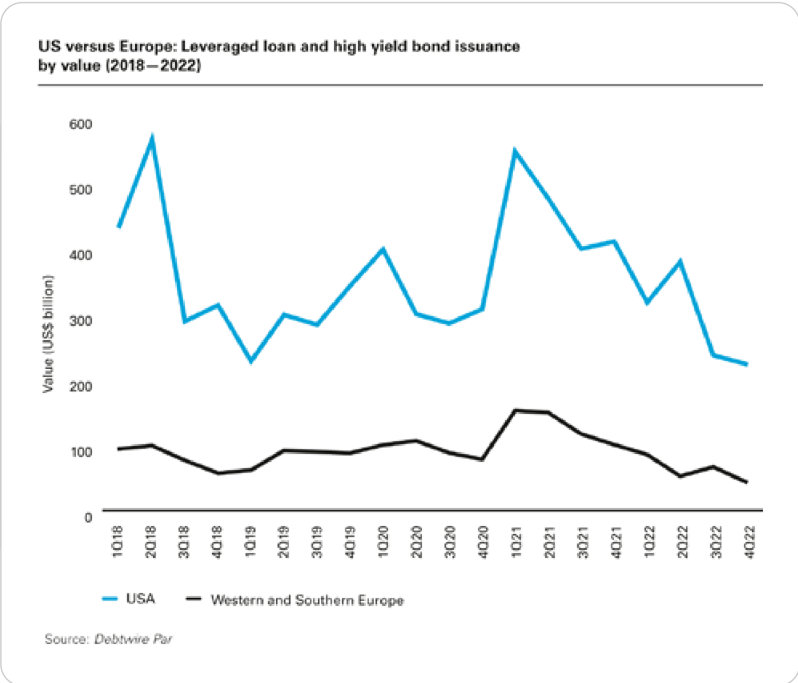
FINANCING AND REFINANCING DYNAMICS

Participants in the industry have expressed surprise at the figures involved in recent financing and refinancing deals orchestrated by investment funds in France. This has opened the door to discussions about power dynamics between sponsors and banks, highlighting how banks' attitudes can shift depending on the sponsor.

US VS EUROPE - LENDING, LEVERAGE, AND REFINANCING

The landscape of real estate investment in the United States and Europe reveals striking differences in leverage, lending structures, and emerging opportunities. As we explore these distinctions, we gain insights into the challenges, strategies, and potential areas of growth within these markets.

US VS. EUROPE LEVERAGE LEVELS



One of the most prominent disparities between the US and European real estate markets is the level of leverage. The US market exhibits a higher degree of leverage, partly attributed to the presence of non-bank lending entities. This environment has given rise to an early resurgence of value-add and opportunistic deals, despite the ongoing challenges.

Image: DanaCS / Freepik

Conversely, Europe lags a bit behind, with traditional banks continuing to dominate the lending landscape. This results in a more conservative approach, characterised by a preference for lower LTVs.

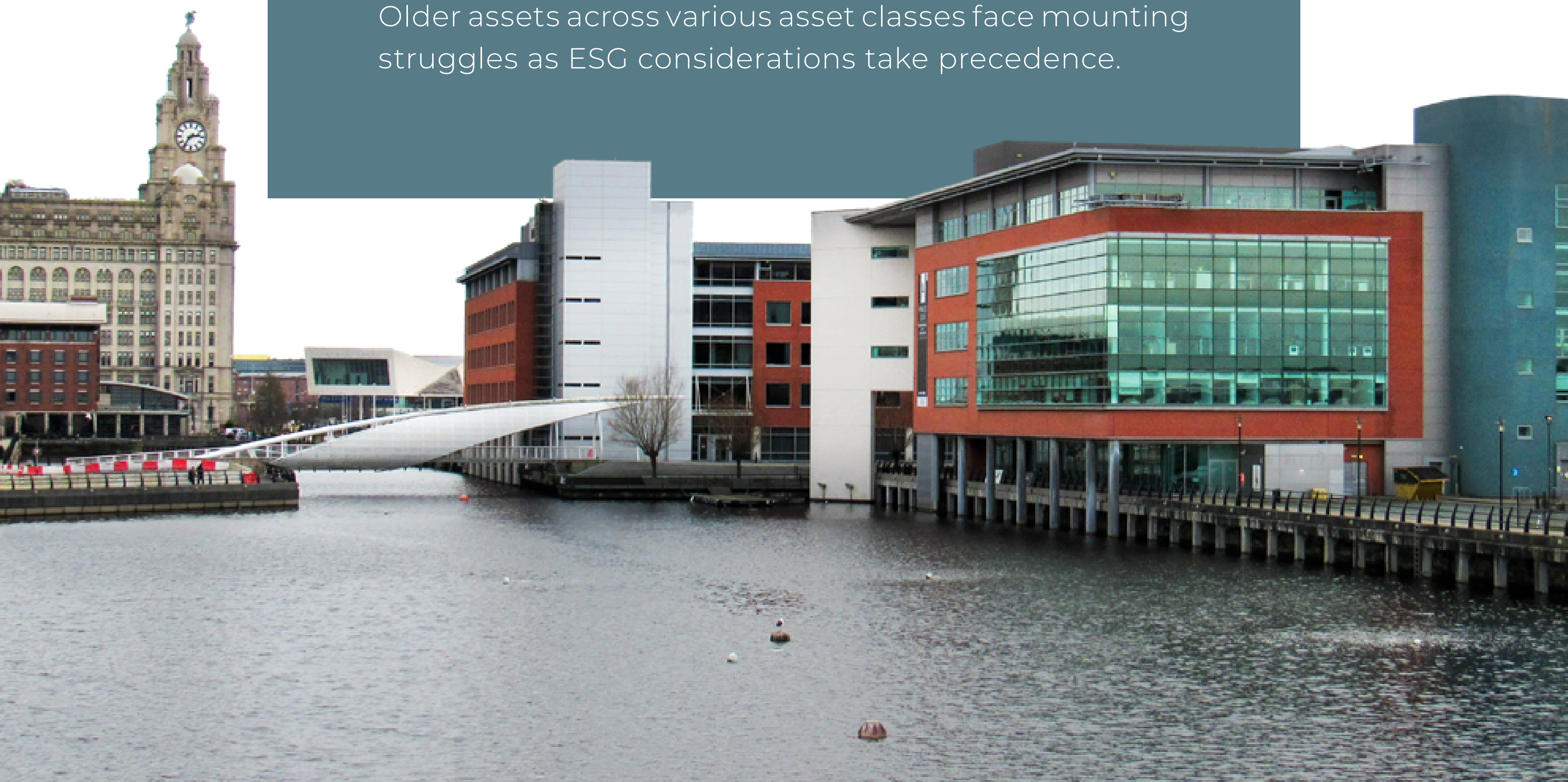
The UK stands as a notable exception, with debt funds emerging as key players in recent times. London, in particular, attracts international value-add investors, thanks to favourable demand and supply fundamentals. However, the market remains clouded by the uncertainty of property values.

RUSH TO REFINANCE

The current real estate market grapples with several critical issues, chief among them being the impending challenge of refinancing. Most deals financed in 2020 are set to require refinancing in 2025, setting the stage for a complex financial juggling act.

Historically low transaction volumes are signalling potential distress on the horizon due to a lack of available discretionary capital, while impending repayments amplify the urgency to intelligently reallocate capital. Older assets across various asset classes face mounting struggles as ESG considerations take precedence.

Image: frimufilms / Freepik








GRI Club


GRI CLUB MEMBERS WILL ALSO ATTEND

GRI CREDIT OPPORTUNITIES AND RE DEBT 2023

Founded in 1998 in London, GRI Club currently brings together more than 10,000 senior executives spread across 100 countries, operating in both real estate and infrastructure markets.

GRI Club's innovative discussion model allows free participation of all executives, encouraging the exchange of experiences and knowledge, networking and business generation.

GRI Club Members also have access to our exclusive online platform to learn more about other members and their companies, correspond and schedule meetings, and receive unrestricted access to all GRI Club content.

CONTACT

Diego Tavares
Managing Director & Senior Partner
diego.tavares@griclub.org

Kirsty Stevens
UK & Pan-Europe Director
kirsty.stevens@griclub.org

GRI Club

GRI Club Europe

GRI Club

@griclub.europe

griclub.org