REPORT

Middle Market Funds

Assessment of the opportunities and challenges in the mid-market space by senior European RE leaders.

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SUMMARY

INTERACTIVE TITLES

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INTRODUCTION

For more than 25 years, GRI Club's exclusive networking events have been providing unique opportunities for the industry's decision makers to exchange valuable insights and experiences, igniting deal flow and potentialising the real estate market.

GRI Club reports present the key takeaways from these events, including the most valuable insights, the most ardent discussions, and the most intriguing strategies.

This report was compiled following an intimate GRI Club Meeting in London, which gathered leading real estate players to discuss opportunities and challenges in the middle market space, as well as exchange sentiments regarding the current market climate.

Photos: GRI Club

TRANSACTION VOLUMES

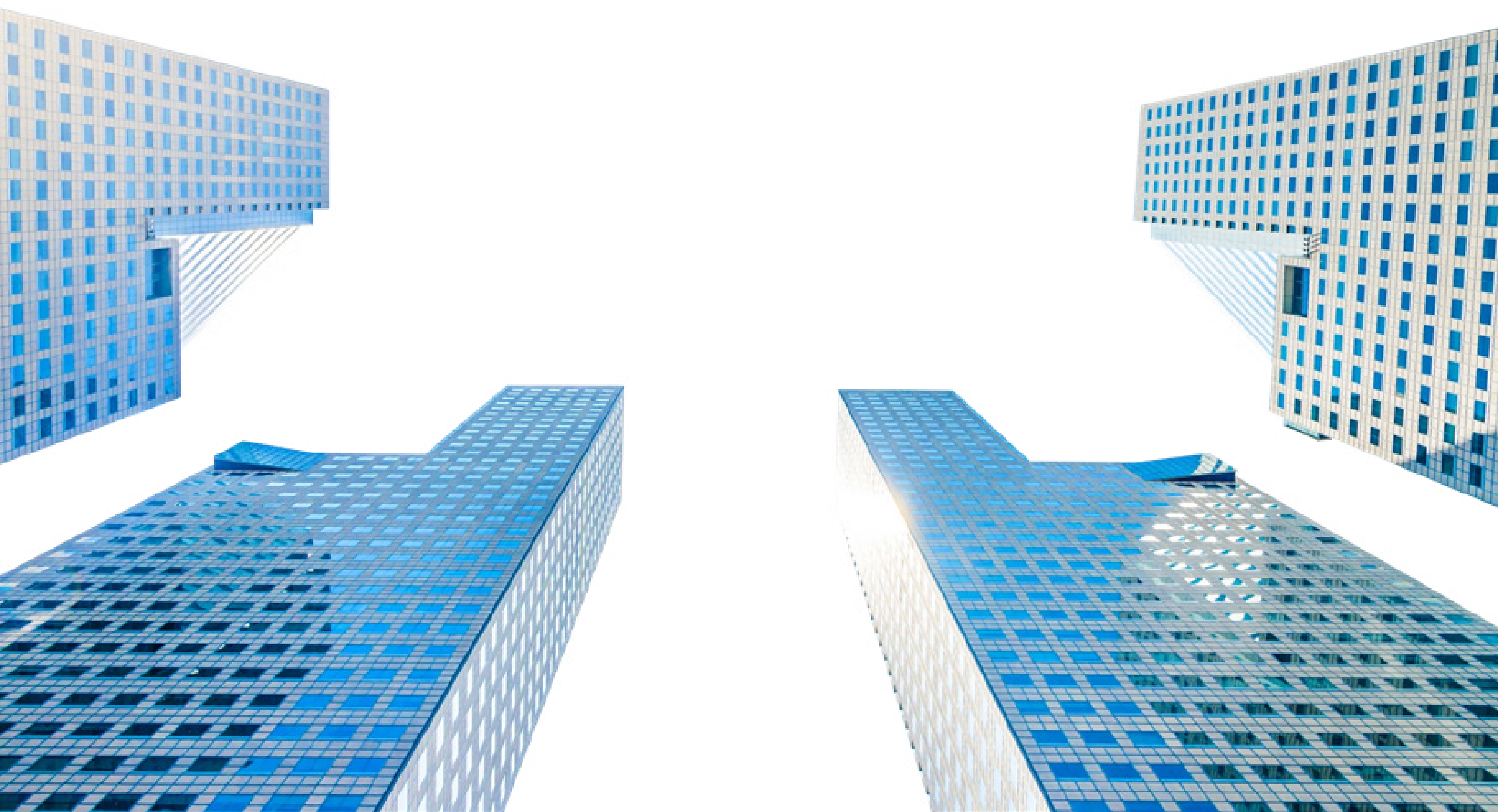
After an extremely poor level of real estate transaction volumes in Q4 2023, the first weeks of 2024 saw optimism and confidence among market players for increased transaction volumes and a drop in interest rates sooner rather than later. By February, however, reality struck.

Expectations were for distress, and equity platforms set up gap funding and distress platforms in anticipation. However, real estate distress in the UK seems to be hitting far slower, and meeting participants suggested it may not reach the initially projected severity.

In general, sellers still aren't ready, and banks continue to hold out and "play nice". Consensus during discussions indicated that this scenario will continue for a while longer, as banks lack sufficiently robust workout strategies to play differently.

More specifically, participants indicated that traditional lenders are reluctant to pursue foreclosure unless absolutely necessary. Foreclosures among debt funds - which many expect to be more stringent - were also noted to be exceedingly rare at present.

Optimism remains for the second half of 2024 and 2025, when volumes will supposedly pick up, as well as anticipation for the wave of distress as loans mature in the coming year.



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HYPER-CAUTION

"There's a difference between people that are saying we're open for business, and people that are doing business." Meeting participants seemed to agree that there is a large amount of capital, but whether that capital is accessible is another matter.

Caution has swamped the real estate market for the past two years, and any hope that 2024 would see this lift seems to be drifting away.

The lack of transaction volume is creating a fake market in which it is difficult for players to be confident in their deals, instilling a wait-and-see attitude and leading to extremely selective lenders.

The situation was referred to as "painful" by one participant, as players grapple with the potential of a double dip versus suffering the hindsight of recognising this as the "best time ever to invest".

Considering this hyper-cautious environment, even with capital ready to deploy, many continue to focus on small deals which could be salvaged by the markets in the event of a worst-case scenario.

"SOMETHING NEEDS TO GIVE FOR THE BIG GUYS TO COME BACK."

Discussions suggested that for transaction volumes to return to normality, one of two things must happen:

1. **LENDERS PULL THE PLUG.**
   Lenders forcing foreclosure will prompt assets to enter the market, attracting opportunistic buyers and a restart of the market.

2. **CAPITAL ACCEPTS THE NEW NORM.**
   The market accepting current rates and pricing as the new norm, will see the ceiling adjust and a resurgence in market volume.

FUNDRAISING

According to a representative from a large and prominent private equity firm, investors remain steadfast in their support for larger funds at the high end of the market, and raising capital has not faced significant challenges. This sentiment was echoed by peers in comparable or larger firms in the industry. However, it was observed that capital deployment hasn't matched the pace seen in previous stages of the cycle.

Meanwhile, mid-market firms reported a far more challenging fundraising environment. There's a notable issue with exits and capital recycling, resulting in a lack of returns for investors. This creates a cycle where firms struggle to secure commitments for new funds, hindering market activity. Breaking this cycle is essential for injecting equity back into the market and revitalising activity.

Participants also reported an increased interest in strategies involving early fundraising and gradually raising debt as needed. This approach allows firms to demonstrate capital deployment to LPs as they go along, addressing investor concerns about missed opportunities elsewhere. It also helps mitigate the risk of committing capital upfront without visible progress, ultimately fostering confidence.

The real estate market is a confidence-driven business, and until that confidence is restored it will be difficult to see volumes return in any significant way.

Image: EyeEm / Freepik

DEVELOPMENT FINANCING

Insights brought from developers in the UK, and more precisely London, revealed that availability of money has improved in the past six months - largely from banks - with inventory loans fairing easier than construction finance.

However, the cost of capital is an issue. Funding development with 10-12% cost of debt requires considerable examination of viability. Schemes started in the past 18-24 months operated under the assumption of significant interest rate drops, a scenario that hasn't materialised.

In such circumstances, developers who have heavily invested in land amidst a high-interest environment cannot afford to adopt a wait-and-see approach. They must proceed with development, initially prioritising less capital-intensive activities.

The advantage of having a stable manager with ready access to capital was highlighted, as this ensures survival through the capability to secure additional funds during particularly turbulent or critical periods.

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STUDENT HOUSING & CO-LIVING

» STUDENT HOUSING

Student accommodation has shown resilience throughout the previous years, while other asset classes have been more reactive to the macroeconomic turbulence. The sector has therefore proved far easier for financing from banks due to superior liquidity. Adjustments in covenants have occurred, however, reflecting an acknowledgment that market conditions have shifted alongside margin changes.

One participant attributed student accommodation's success to "pure demand mismatch". Student populations are constantly increasing, and London boasts more universities in the European top 20 than any other city, contributing to the ever-growing number of international students.

This demand for student accommodation is not expected to subside any time soon, and with development confined due to planning restrictions, cost of construction, and other factors, the dynamics of student accommodation is less linked to macro-environments, and more to the embedded supply and demand dynamics of individual markets.

» CO-LIVING

During the discussion, co-living was also singled out as a particularly interesting sector. It was clarified that there is no direct correlation between student accommodation and co-living, and they are separate markets. Co-living competes in the more traditional BTR market, while student living is a sector of its own.

The demographic of co-living tenants has changed since the conception of the sector. While it was previously mostly postgraduate students, it now encompasses a range of ages and situations, attracting those looking for a living concept interlinked with lifestyle. In simple terms, one participant suggested, it is residential with extra square footage for communal space to innovate lifestyle.

The occupier in today's real estate wants more. Whether that is exceptional communal space, ESG certification, or grade A office space, the occupier is winning due to the real estate's most recent reality: *the best versus the rest*.

ESG

Discussions indicated that while ESG considerations in real estate were once viewed as optional, they are now essential. In the past six months, increasingly more lenders and investors have started to question and consider ESG, climate risk, and possible failures in their investments.

» STAKEHOLDER INTEREST

We have turned a corner with ESG, one participant reported, and there is increasing recognition of the benefits of ESG among stakeholders beyond asset owners, as well as increasing appetite to understand the regulatory landscape.

A short while ago, real estate firms would have just one responsible sustainability leader, nowadays the concern reaches far higher levels of the company hierarchy, and senior management takes part in the decision making process regarding ESG.

Capital is the primary driving force behind this momentum, discussions revealed. The regulators are pushing the banks, and consequently the banks are asking more questions and demanding a more structured ESG approach. Participants noted an uptick in ESG considerations within new facility agreements, including detailed mid-term ESG plans for assets and associated capital expenditures.

Although this has encouraged more consideration - and in some cases action - from investors and developers, participants reported that those who were previously leading the way in ESG, have in many cases slowed down and begun “soft-pedalling”.

They are asking how to conserve cash, and assessing their commercial business model - ultimately profit is priority. Certainly from an investor standpoint, there is scrutiny regarding the return on equity and payback period associated with ESG investments.

» WHO WILL PAY FOR IT?

For more institutionalised assets, the pressure to bear the costs of implementing ESG arises from the necessity of ensuring market activity when holding assets for extended periods, up to five years or even longer. While some leading entities actively respond to this pressure, they represent only a small fraction of the market, and for mid-market schemes this imperative isn’t as prevalent.

From an office occupier perspective, ESG is crucial. Participants reported seeing a small willingness from these occupiers to pay for ESG premiums, but considering record low office vacancy rates, the sector cannot afford to place these costs entirely on the occupier.

Meanwhile, in the residential space, participants reported occupier prioritisation of ESG as extremely low, and their willingness to pay even lower, despite incentives such as energy savings.

In general, consensus during the discussion revealed that occupiers will not bear the costs of ESG in the long term, and at times even contribute further to the problem. While redevelopment of existing buildings is often the most carbon-friendly option, occupiers often resist other characteristics associated with older structures, consequently forcing the demolition and development of a new building, resulting in a significantly larger carbon footprint.

Discussion participants thus defended the importance of both government regulations and lenders to apply pressure on the implementation of ESG.

» FURTHER CHALLENGES

The challenge of implementing ESG measures goes beyond financial considerations, to *how* to effectively implement these measures, particularly relating to the environmental aspect. Real estate professionals often lack expertise in assessing the carbon footprint of buildings, and many regulations are criticised for being unproductive. For instance, the energy performance certificate (EPC) rating scheme was dismissed as entirely ineffective by some participants.

Furthermore, there is a lack of regulations overseeing the demolition of existing assets for redevelopment. Development activities contribute significantly to the real estate sector's carbon emissions, and destroying structures that could be renovated is counterproductive to achieving carbon reduction goals. Meanwhile, the industry's focus on minor contributors, such as lighting and building automation, fail to address the primary sources of carbon emissions.

However, other participants noted an increasing knowledge base around ESG and sustainability of assets. The reporting and measuring of the environmental impact during the development stage has increased significantly, as well as consideration around how carbon can be reduced during the design process, which is often a more economically viable method of implementing ESG in real estate.

» LONG-TERM ESG

Real estate is a fast evolving industry and market players are typically focused on short-term gains rather than long-term considerations. ESG initiatives, however, require a long-term perspective.

One participant presented the example of the logistics sector, where ten years ago investment was focused on simple sheds, while nowadays logistics investment involves complex structures equipped with EV panels and energy storage to feed back to the grid.

Balancing the immediate financial interests of investors with the long-term sustainability goals poses a challenge, and highlights a fundamental imbalance between the desire for immediate returns and the need for sustainable, forward-thinking strategies.

GRI CLUB MEMBERS WILL ALSO ATTEND

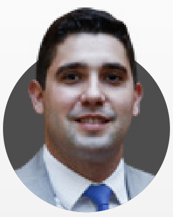
GRI BEDS EUROPE 2024

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



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