REPORT

Q1 2024

Real Estate Credit & Debt Outlook 2024

Key takeaways from discussions among the top 100 leaders in the debt space

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GRI Club

WELCOME TO GRI EUROPE

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.

Enjoy reading!

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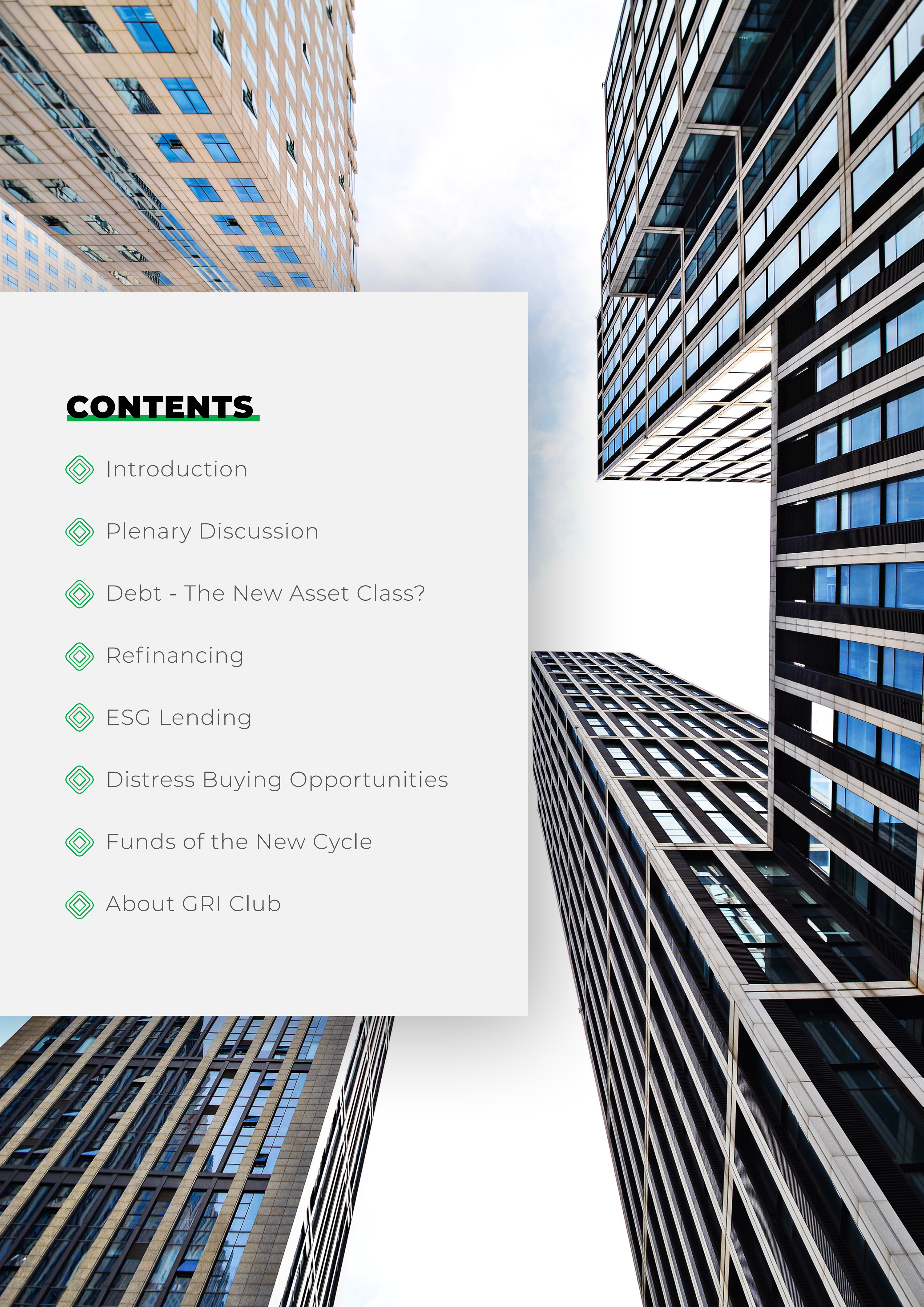
CEO & Managing Partner, GRI Club



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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 GRI Credit Opportunities & Real Estate Debt in London. Featuring the top 100 leaders in the debt space, the event provided a forum for valuable discussions on the growth of private real estate debt.

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.

PLENARY DISCUSSION

In the opening session, Simon Wallace, Global Head of Real Estate Research and Strategy at DWS, reflected on fundraising challenges for debt strategies, highlighting that despite positive sentiments, actual fundraising hasn't met expectations.

Three key reasons were identified:

First, some limited partners (LPs) struggle to categorise debt investments, debating whether they belong in real estate or fixed income. Additionally, a lack of data, research, and expertise in the sector hinders fundraising efforts.

The second point revolves around the observation that the real estate industry isn't facing a shortage of debt; rather, available debt encounters fewer opportunities, especially in challenging segments like secondary office spaces.

Lastly, some LPs opt to handle debt investments directly, by passing fund structures, contributing to slower fundraising.

Despite challenges, Simon anticipates a future shift, citing factors such as an easier origination environment, the end of grace periods for existing loans, and the continued appeal of debt for investors seeking decent cash returns in a low-interest-rate environment.

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SUPERIOR STRATEGIES

In the broader discussion on capital raising and real estate credit strategies, members explored market challenges and opportunities. The conversation covered the geographic makeup of strategies, investor bases, and the difficulty of raising funds for dedicated European strategies. Back leverage was discussed as a tool for meeting target returns, highlighting the importance of diverse capital pools and the freedom they provide to find value in transactions.

Challenges in the European market were also considered due to the region's relative lack of knowledge and comfort with private credit strategies. The discussion delved into the current market landscape, including the impact of liquidity, benefits of having both direct lending and back-leverage capabilities, and the role of different capital sources.

REFIS & RECAPS

Insights were shared into deployment opportunities, the shift in underwriting matrices, and dynamics of the refinancing model.

The increase in refinancing opportunities, potential challenges in the refinancing world, and evolving structures and pricing levels were also discussed, along with perspectives on distress in the market, with members anticipating increased transaction activity due to various catalysts, including the cost of carrying assets and potential equity write-offs.

Addressing current market conditions, members focused on potential recapitalization opportunities and their impact on sales activity. The consensus was that recaps might occur, but sales activity is expected to increase due to the prevailing market situation.

Emphasis was placed on the importance of having both capital and mental preparedness for asset management, suggesting that sales may be a more attractive option than recaps.

EUROPEAN ENVIRONMENT

The conversation touched on adjustments in valuations, particularly in Europe, where there's a realisation that certain markets won't sustain historically low cap rates. Motivated sellers, particularly in German and French open-ended funds, are emerging, willing to accept asset haircuts to facilitate transactions.

The discussion extended to interest rates, anticipating a lower environment in the next 12 to 18 months, potentially boosting buyer confidence and narrowing bid-offer gaps. Considerations on construction finance were also addressed, noting challenges in finding suitable sites and expressing caution despite stabilised cost inflation.

Overall, the conversation reflected cautious optimism about the market's future, anticipating increased activity, improved liquidity, and potential opportunities for both equity and lending in the coming years.

DEBT - THE NEW ASSET CLASS?

While discussing debt as a new asset class, members examined the dynamics of real estate transaction volumes and expected interest rates in 2024, the shift from banks to private credit providers - especially in the UK and the US - emphasising origination opportunities and market forces.

Participants discussed the impact of inflation on asset prices, noting variations across different sectors. Panellists expressed optimism about a potential increase in capital for real estate debt in 2024, citing a more stable interest rate environment and opportunities arising from partnerships with banks.

However, concerns were raised about the lingering effects of the 2019 market, with indications that investors, including mom-and-pop entities, might allocate less to real estate due to perceived complexities and the opportunity cost of other investments.

BALANCING ACT

The discussion also touched on the role of stability in the interest rate curve as a catalyst for stimulating transaction volumes. Overall, members anticipated a balancing act in determining the accretiveness of debt, managing return expectations, and navigating potential changes in interest rates. The conversation acknowledged the need for confidence in the market and highlighted the evolving landscape of real estate finance.

One participant expressed scepticism about investing in debt funds, citing concerns about their competitiveness, structure, and high fees. They argued that the long investment period and high expenses associated with debt funds made them less attractive compared to alternative investments, such as AA ABS (asset-backed securities) or equity.

Questions were asked about the value proposition of debt funds, especially in a market where interest rates were lower and liquid bond funds offered similar returns without the illiquidity and high fees.

The response from the group highlighted the unique benefits of debt funds, including downside protection, control, and the ability to fill the gap left by retreating banks in real estate credit. They emphasised the importance of net returns and risk-adjusted performance, acknowledging the challenges posed by evolving market dynamics and fee structures.

DEBT DOUBTS

Doubts were also brought up in regards to the catch-up clause in debt funds with a suggestion that many investors might not fully understand it. The clause is a mechanism to incentivise fund managers to perform well and achieve returns above the hurdle rate by allowing them to participate more significantly in the profits once that threshold has been surpassed.

Concerns about the relative returns in the debt fund asset class were expressed too, particularly for funds with high deployment speeds and extended investment periods.

One participant questioned the sustainability of high returns in the current market environment and highlighted potential issues with the total profit and multiple, especially in the context of rising interest rates.

Another member responded by addressing the relevance of investment periods, explaining that longer periods may be driven by the desire to keep capital deployed for reinvestment and generating returns over an extended time.

The discussion expanded to include considerations about the challenges faced by smaller banks, potential changes in market dynamics, and the impact of regulatory developments such as Basel IV.

The sustainability of credit pricing was also considered, with some members expressing agreement that extremely high pricing might not be sustainable in the long run, especially for transitional transactions.

REFINANCING

On the subject of refinancing, the discussion revolved around the changing landscape of real estate financing, particularly in Europe, with a focus on the role of alternative lenders and the shift away from traditional bank liquidity. Members highlighted the influx of new players into the market, transforming the capital composition in the industry.

There is speculation on whether bank liquidity will diminish, creating an opportunity for alternative liquidity sources. One participant from a well-known company explained their strategy of filling the gap left by traditional banks, focusing on opportunities with lower LTV hurdles.

FUNDAMENTAL FACTORS

The conversation touched on refinancing dynamics, the challenges of different asset classes, and the importance of assessing underlying fundamentals. The speakers also discussed the various approaches lenders are taking, such as amending and extending deals, considering equity release, and the role of back leverage in the current market conditions.

A relationship-oriented approach was emphasised, highlighting the need for rationality and flexibility in negotiations between lenders and borrowers. Members then shared insights into the evolving back leverage market, emphasising its importance and potential expansion with new entrants.

LENDER OUTLOOK

Lending and distress scenarios were also considered, with the conversation covering topics such as back leverage, the role of lenders in driving transactions, the potential for distressed loan sales, and the impact of property values on market opportunities.

Members expressed varying views on the enforcement of loans, with considerations for regulatory reasons and the quality of sponsorships. They also touched upon different asset classes, highlighting the challenges and opportunities in sectors such as office, multifamily, logistics, and operating assets.

The overall takeaway from the session suggests a cautious approach among lenders, considering the uncertainty in the market and the need for strategic decision-making based on property values and sponsorship quality.

ESG LENDING

On the evolving landscape of green finance within the real estate sector, industry experts shed light on the challenges and opportunities associated with the shift towards sustainable lending and investment practices. The conversation delved into the complexities of aligning financial strategies with ESG goals.

One senior lender in attendance emphasised the two broad categories of green lending - formal and informal. Formal methods include sustainability-linked loans and pricing mechanisms, while informal strategies focus on the overarching goal of integrating sustainability into all financial activities.

The challenge lies in finding a balance between incentivising borrowers and addressing concerns related to the enforceability of ESG commitments.

GLACIAL GREEN ADOPTION

The slow adoption of green lending despite the global emphasis on sustainability was observed as a key issue. The industry has struggled to see widespread demand for green loans, with borrowers expressing reservations about the tangible benefits and potential risks associated with adopting ESG initiatives. The timeline for ESG lending, set against the backdrop of long-term financial commitments, has raised concerns among both lenders and borrowers.

The conversation then shifted to the definition of green lending and the lack of a standardised framework. The need for a consolidated understanding of what constitutes green finance was noted, emphasising the importance of measurable criteria like carbon emissions reduction rather than relying solely on certifications or green building labels.

SUSTAINABILITY STRUGGLES

The challenges of aligning diverse perspectives on sustainability were also addressed, with one participant sharing the efforts made by his team to assess and categorise their portfolio based on CO2 emissions, aiming to adhere to a decarbonisation plan committed to 2050.

The struggle arises from the varied interpretations of sustainability, making it crucial to establish a common language and metrics for the industry.

The discussion turned towards the role of lenders in supporting the transition to a low-carbon economy. Lenders acknowledged the need to move beyond greenwashing and focus on tangible actions, including incentivising transitionary plans and providing support for projects with long-term environmental benefits.

CLIMATE OF COOPERATION

As the real estate sector grapples with the challenges of retrofitting existing buildings and meeting ambitious decarbonisation targets, the panellists discussed the potential role of financial institutions in driving positive change.

The conversation highlighted the need for a collective effort to overcome hurdles, create standardised frameworks, and foster a financial ecosystem where green finance becomes the default rather than the exception.

The industry experts concluded that the next five years would be crucial in determining the trajectory of green finance, with the potential for a tipping point where sustainable practices become integral to all financial transactions.

DISTRESS BUYING OPPORTUNITIES

The Distress Buying Opportunities session opened with an anecdote about Sir Isaac Newton. Although renowned for his groundbreaking contributions to physics and mathematics, Newton also left an indelible mark on 17th century finances.

While serving as a valuer, Newton crafted one of the earliest sets of valuation tables. These tables, applied to Oxford College and church properties, served as the commercial real estate benchmarks of his era. Calculating interest compounding over years, Newton's tables challenged prevailing notions of risk-free rates, with cap rates of 3-5%.

DYNAMICS OF DISTRESS

Back in the present day, industry experts engaged in a discussion exploring the contemporary dynamics of the real estate market. Addressing topics ranging from credit and interest rates to the evolving risk-adjusted return profile, the discourse underscored the crucial role of distress in resolving stagnant assets.

The conversation delved into diverse perspectives on distressed opportunities, encompassing secondary market transactions, community involvement by GPs, and broader issues like government interventions impacting residential and office markets.

VARIABLE VALUATIONS

At the heart of the discussion were the challenges and opportunities within the real estate market, with a specific focus on recapitalisation strategies. Members acknowledged declining property values and dissected the intricacies of recap opportunities, discerning between assets worth retaining and those to relinquish.

While consensus prevailed on the abundance of recap opportunities, the spotlight was on seeking sponsors with unwavering conviction and well-defined business plans.

Amidst predictions of heightened distressed assets due to rising debt costs, participants explored the shifting market sentiment. Despite the anticipation of a potential increase in distressed assets, optimism lingered for a soft landing, positioning credit as a viable alternative to equity.

The conversation also touched upon the maturation of investors in the credit space and the ripple effects of market distress on realistic pricing.

FUNDS OF THE NEXT CYCLE

Covering a spectrum of asset classes, including offices, senior housing, and residential properties, the Funds of the Next Cycle conversation explored challenges and opportunities in an ever-evolving market.

COVID-19 emerged as a pivotal factor shaping investment decisions, with speakers expressing regret over initially avoiding offices. The spotlight then shifted to senior housing, acknowledged as a niche asset class with robust demographic support and stable operating models. Discussions also delved into the intricacies of leverage, financing costs, and the significance of forming partnerships with local banks.

REGIONAL RANGES

The conversation expanded to encompass insights into the real estate market in Poland, revealing surprising trends where German banks are increasingly financing projects compared to their home turf. Factors like the Euro-denominated basis, cost considerations, and adherence to ESG criteria were highlighted as crucial influencers in investment decisions.

Geographical preferences within Italy, especially in major cities, were explored, emphasising the development of high-quality properties for accelerated returns. The dialogue also delved into the origin of capital, with a keen examination of the merits of separately managed accounts (SMAs) over pooled investment vehicles.

SOURCING STRATEGIES

Zooming in on investment strategies, participants shared views on capital sources, focusing on the challenges associated with managing individual and high net worth capital. Convincing investors about more efficient and less risky real estate investment methods took centre stage. Residential and hospitality sectors garnered particular interest, with a focus on value-added and opportunistic strategies.

The discussion took an intriguing turn towards riskier, higher-return components such as junior debt and mezzanine financing, with a notable emphasis on the burgeoning life sciences sector. Insights into borrowing behaviour related to operational assets were discussed, revealing counterintuitive trends where high-interest rates didn’t deter borrowers.

The increasing focus on integrating ESG criteria into financial structures was underscored, navigating regulatory pressures, investor expectations, and the evolving landscape of green finance.

REPORT

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.

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