Private real estate: opportunity in Europe's real estate debt markets

Partners Group Research Flash March 2014

Partners Group
Passion for Private Markets

Chris Lydiker
Private Real Estate

Pieter Nelissen
Private Real Estate Research

Private real estate: opportunity in Europe’s real estate debt markets

EXECUTIVE SUMMARY

Financing real estate investments in European markets remains a challenging endeavor. The retrenchment of bank lending as a result of the financial crisis, stricter lending requirements and the subsequent enactment of regulatory reforms has made financing unavailable to all but the most secure borrowers. Yet the market has simultaneously created new demand for non-traditional debt lenders to fill the gap. Europe’s bank deleveraging activity is estimated to create a USD 163 billion gross funding gap where alternative lenders are currently finding opportunity.[1] These real estate debt opportunities can provide investors with attractive core-like returns while providing an attractive position in the capital structure with adequate downside protection provided by equity cushions. In this research flash, we seek to identify opportunities of the European real estate debt markets and where investors should be focused on in order to benefit most from this window of opportunity.

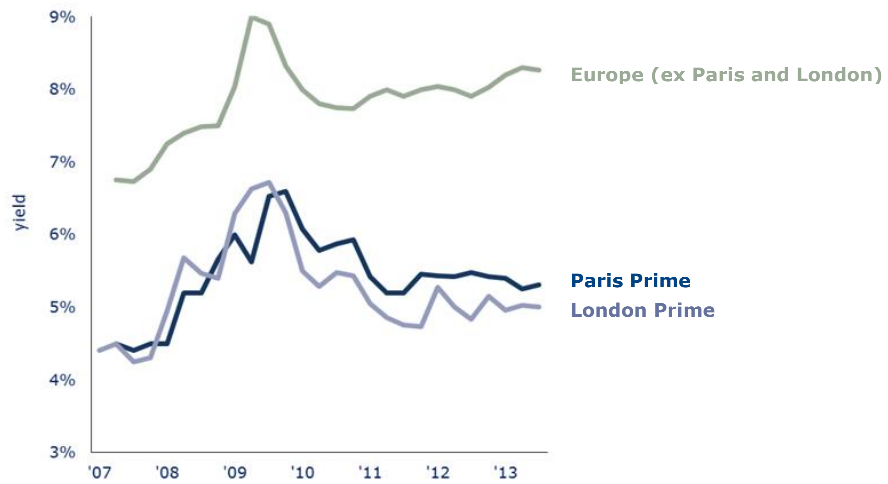
[1] DTZ, Net Debt Funding Gap (June 2013)

Private real estate: opportunity in Europe's real estate debt markets

THE CONUNDRUM

European real estate fundamentals have improved, both on the public and private side. Investor optimism and liquidity in European commercial real estate markets continues to rise as institutional investors seek bond-like cash flows backed by strong covenants in core "safe haven" markets. However, as demonstrated in Exhibit 1, yields on core properties have compressed significantly since 2010 and are currently close to pre-crisis levels. The flight to the "perceived" quality of core markets has driven yields near historic lows, tightening 100 to 150 basis points since the trough. For example, 431 Oxford Street recently sold in London for a reported 2.9% net initial yield. Another example is a Paris office property in 1 Rue de Ventadour, which sold for a reported 3.8% net initial yield. The increased competition is likely to put prime returns under pressure trending towards the long term averages of 6-8% per annum.

Exhibit 1: Average property yields



Source: Real Capital Analytics (December 2013)

Simultaneously, outside of Europe's core markets, yields have remained flat or experienced yield expansion since the financial downturn. In addition, the likelihood of a rise in interest rates over the medium term should give investors pause in pursuing prime assets whose yields are highly correlated to interest rate movements, and may be most affected when interest rates increase. Conversely, the historically wide gap between prime and secondary markets suggests there may be overlooked opportunities for private debt investors to exploit in the current environment.

A SHIFT IN LENDING

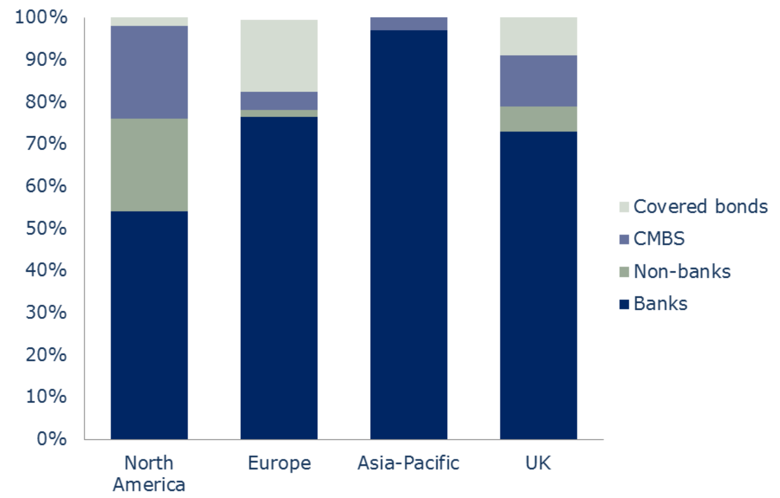
The structural shift in the composition of European lenders has led to a significant decline in the total capital available for investment and a lack of alternative capital funding. European banks have imposed stricter lending standards and are largely retracting from real estate lending markets due to the impact of stricter capital requirements. Banks currently represent 94% of the commercial real estate debt outstanding in Europe. However, that number is

Private real estate: opportunity in Europe's real estate debt markets

shrinking as some of the largest players are reducing the scope of their activity, shifting to domestic markets exclusively or withdrawing completely, including banks such as Hypothekenbank Frankfurt in Germany, Societe Generale in France or Yorkshire bank and Clydesdale in the UK. As a result, insurance and pension funds have recognized the opportunity to step in and subsequently increased their footprint in real estate lending, including US insurers TIAA CREF and Mass Mutual (Cornerstone), with traditional European insurers such as AXA, Allianz and Aviva also increasing lending activity. However, these players eventually will face limitations in their real estate lending capabilities by forthcoming regulatory requirements mandated by Solvency II.

In the UK, it is anticipated that non-traditional lenders will increase their market share from 7% to 15% over the next three years and in broader Europe from 2% to 7%.[2] By way of comparison, alternative lenders currently comprise 23% of the North American commercial real estate loan market, as illustrated in Exhibit 2. Yet even with the anticipated increase in non-traditional lending in Europe, market segments targeted by equity (predominantly core) do not necessarily line up with the segments where there is the most need for capital. This has also been reflected in value trends, where core values have largely recovered or remain stable, while non-core properties still remain in distress.

Exhibit 2: Outstanding debt by lender type



Source: DTZ (June 2013)

While banks in the Eurozone generally remain highly levered, there are significant differences in European banks by country. UK and Irish banks have generally proven to be in more advanced stages of deleveraging, while in Germany and Italy banks continue to take a "wait and see" approach, dampening growth. In addition, high loan spreads are being driven by two main factors (i) increased regulatory costs and (ii) high bank funding costs. Funding costs are extremely divergent, largely based on the country in which the bank is based, how well the bank is capitalized as well as size and diversification. For example, the cost of buying credit-default swaps (a proxy for borrowing costs) on the debt of Intesa, Italy's largest bank, is 150 basis points while insuring debt issued by Monte dei Paschi di Siena, a smaller Italian bank, is

[2] DTZ, Net Debt Funding Gap (June 2013)

Private real estate: opportunity in Europe's real estate debt markets

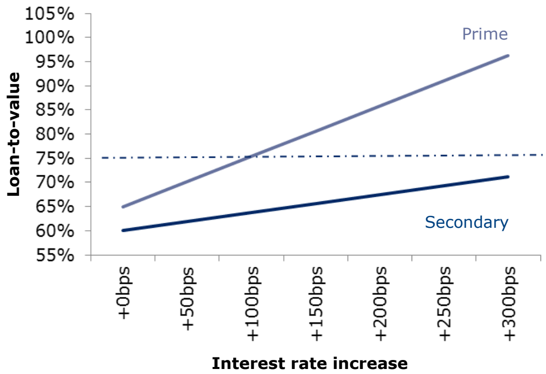
360 basis points.[3] Concurrently, regulatory impacts may well increase funding costs by an additional 50 basis points or more over the long term. While banks are forced to pass on these costs to borrowers, which are likely to remain high over the medium term, non-traditional lenders are provided with an attractive opportunity as an alternative source of capital at lower overall costs.

Stricter Basel III capital requirements, higher funding costs, and pressure from government to lend to corporates and small- to mid-sized enterprises are forcing Eurozone banks to dramatically reduce commercial real estate lending. Total real estate loans outstanding in the Eurozone are down an estimated EUR 40 billion for 2013. Over the medium term, bank reductions in commercial real estate exposure will lead to an estimated debt shortfall of EUR 350-600 billion in Eurozone bank funding to commercial real estate and changes in commercial lender composition in UK and Europe will continue to provide attractive opportunities.

CORE LENDING MAY NOT BE AS SAFE AS IT APPEARS

The overall lending environment in Europe is set to improve once the flow of funds into the sector increases, but today's lending criteria remains very selective. Lenders continue to focus almost exclusively on prime properties and/or properties backed by strong sponsors. As far as sectors, lenders have solely targeted office, retail and industrial properties with very limited appetite for construction loans.
Anecdotally, reported margins for core properties have started to tighten due to increased competition, to 150 to 250 basis points. Maximum loan-to-values for core Western European markets have typically fallen between 60-65%, with few lenders willing to go to 75% on core properties. Simultaneously, security packages are significantly stronger and covenants are set tighter than before the financial crisis, although some lenders are starting to loosen covenants on loans backed by prime properties and/or leading sponsors.

Exhibit 3: Senior loan with a 75% LTV covenant test



Senior loan assumptions	Prime	Secondary
NOI (GBPm)	5	5
NOI growth p.a.	2.00%	2.00%
Cap rate	5.00%	8.00%
Term (yrs)	5	5
Senior terms		
LTV	65.00%	60.00%
Margin	2.50%	4.00%
Swap rates	1.50%	1.50%
All-in rate	4.00%	5.50%

Source: Partners Group Research (September 2013)

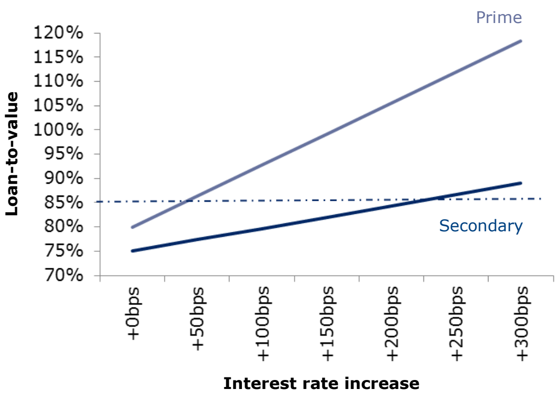
Ironically, private lenders' focus on prime properties in the "safe havens" of Europe may not be as "safe" as they appear at first glance. Senior lenders are currently willing to lend at a maximum loan-to-value for Western European markets within the 60-65% range. However, as

[3] Bloomberg, 5-year senior CDS (17 December 2013)

illustrated in Exhibit 3, prime property yields are highly correlated to movements in interest rates (approximately 80% correlated[4]), whereas properties located in secondary markets are markedly less sensitive (approximately 50% correlated[4]). A meaningful shift in interest rates could therefore quickly result in a covenant breach as interest rates rise and yields expand. As Exhibit 3 illustrates, typical senior loans with a loan-to-value covenant of 75% on a prime asset would breach its loan-to-value covenant with just a 100 basis point rise in the interest rate. Conversely, a senior loan on a secondary asset does not breach the same covenant even well after a 300 basis point expansion in the interest rate.

Given these results, we were curious what the implications of a rise in interest rates meant for more subordinated mezzanine-debt focused investors. In the current environment, mezzanine lenders are willing to lend at a maximum loan-to-value for Western European markets within the 75-80% range. Again, prime property yields were much more correlated to changes in interest rates (approximately 80% correlated) as opposed to secondary properties (approximately 50% correlated). The typical mezzanine loan today has a loan-to-value covenant of 85%. Exhibit 4 illustrates our findings. Our analysis indicates that mezzanine financing on prime and secondary assets are more sensitive to changes in interest rates than what we found in our senior loan test, but with a similar strength among secondary properties.

Exhibit 4: Mezzanine loan with a 85% LTV covenant test



Mezzanine loan assumptions	Prime	Secondary
NOI (GBPm)	5	5
NOI growth p.a.	2.00%	2.00%
Cap rate	5.00%	8.00%
Term (yrs)	5	5
Mezzanine terms		
LTV	80.00%	75.00%
Margin	7.00%	10.00%
Swap rates	1.50%	1.50%
All-in rate	8.50%	11.50%

Source: Partners Group Research (September 2013)

A mezzanine loan on a prime asset breaches a loan-to-value covenant of 85% with only a 50 basis point increase in interest rates, while a mezzanine loan on an asset in secondary locations does not breach the same covenant until after a 225 basis point expansion.

Perhaps somewhat counter intuitively, our findings suggest that the current lending targets of "safe haven" prime assets may be somewhat of a misnomer. Given today's low interest rate environment, the likelihood of increased rates is not a question of "if interest rates will rise," but "when will interest rates rise?" Based on our analysis, our belief is that when interest rates eventually do rise, investors will be best positioned in those assets that are not readily susceptible to rate increases. For example Partners Group recently funded a 65% LTV senior loan secured on a portfolio of secondary retail properties in the U.K., with a debt yield of 14%

[4] Based on UK data only, correlation measured across the last cycle (2006 to date)

which allows the portfolio to absorb very significant increases in yields before the debt is impaired.

CONCLUSION: CAPITALIZING ON THE CHANGING DYNAMICS OF DEBT FINANCING

Today, we believe private lenders have the ability to fill the void that traditional banks have stepped away from. In today’s environment, debt principally offers a safer part of capital structure which can be acquired at lower loan-to-values determined on a lower value base. Income can be secured through higher spreads available for both senior and mezzanine debt. Based on our analysis, we believe strategies that are capable of capitalizing on this opportunity through investments in floating-rate senior secured debt with strong covenants as well as mezzanine debt financing for secondary markets in Europe will be capable of achieving core-like returns for investors, albeit in more secure positions in the capital structure.

Private real estate: opportunity in Europe's real estate debt markets

Client contact:
Kathrin Schulthess
Investment Solutions
Phone: +41 41 784 65 81
Email: kathrin.schulthess@partnersgroup.com

Media relations contact:
Alexander von Wolffradt
Phone: +41 41 784 66 45
E-mail: alexander.wolffradt@partnersgroup.com

www.partnersgroup.com

Disclaimer

This material has been prepared solely for purposes of illustration and discussion. Under no circumstances should the information contained herein be used or considered as an offer to sell, or solicitation of an offer to buy any security. Any security offering is subject to certain investor eligibility criteria as detailed in the applicable offering documents. The information contained herein is confidential and may not be reproduced or circulated in whole or in part. The information is in summary form for convenience of presentation, it is not complete and it should not be relied upon as such.

All information, including performance information, has been prepared in good faith; however Partners Group makes no representation or warranty express or implied, as to the accuracy or completeness of the information, and nothing herein shall be relied upon as a promise or representation as to past or future performance. This material may include information that is based, in part or in full, on hypothetical assumptions, models and/or other analysis of Partners Group (which may not necessarily be described herein), no representation or warranty is made as to the reasonableness of any such assumptions, models or analysis. Any charts which represent the composition of a portfolio of private markets investments serve as guidance only and are not intended to be an assurance of the actual allocation of private markets investments. The information set forth herein was gathered from various sources which Partners Group believes, but does not guarantee, to be reliable. Unless stated otherwise, any opinions expressed herein are current as of the date hereof and are subject to change at any time. All sources which have not been otherwise credited have derived from Partners Group.