Real estate debt funds still at 'embryonic' stage

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23 May 2013

Property debt funds are stepping in to replace banks as a source of lending, but real estate experts say the process is still at a very early stage of development.

Real-estate bankers and property specialists participating in a panel discussion in London yesterday said it will be years before these debt funds are a major component of the European property finance market and can fill the hole left by banks that have reduced lending since the financial crisis.

Figures from data provider Preqin, published earlier this month, show there are 19 Europe-focused real estate debt funds in the market that are targeting investor commitments of €10bn. That is up from seven funds targeting €2.3bn in May 2012.

In the latest example of investor interest, the property arm of debt specialist Intermediate Capital Group said on Wednesday that it was approaching a final close on its third real estate debt fund with the fund expected to be oversubscribed at its £700m hard cap.

But Steve Eighteen, the former global head of non-core real estate at RBS, said during the discussion that while debt funds were key to helping to fill some of the gap left by banks retrenching, the money raised by such funds so far was still small -- less than €5bn, according to his estimates.

“I think we should keep in perspective that the development of property debt funds is still pretty embryonic,” he said.

“They all need to get bigger but in particular to increase their individual loan size.”

While the amount those funds are seeking to raise has grown sharply, real estate experts on the panel said the new funds require strong technical skills from fund managers and still have to prove their staying power.

Dale Lattanzio, managing partner at DRC Capital, which specialises in European property debt, said: “What the right number is – what will eventually be raised – I don’t know…In the context of not only the UK market but the broader pan-European market, it’s quite low relative to the size of the historic markets which were dominated 95% or so by banks.

“There will be things that work, things that don’t work, but we’re in that period of market testing.”

DRC invests largely in mezzanine debt, targeting returns in the low- to mid-teens.

Lattanzio said that even over the last three years, the real estate debt fund market had evolved and now includes increasingly specialised types of funds. For example, some target senior debt, others make hybrid debt and equity investments and still others target higher loan-to-value ratios and specialise in mezzanine debt.

Nassar Hussain, managing partner and founder of Brookland Partners, which hosted the panel, said the new funds offered new opportunities: “Debt markets are in significant transition and that transition is positive in nature.”

The new ICG fund will invest in mezzanine debt and loans that combine mezzanine and senior debt, targeting an internal rate of return of 10% to 12%.

Christophe Evain, chief executive of ICG, said that while banks were lending more now than in recent years, they were still cautious. He said: "In particular, banks are lending to prime assets but they're not lending to the smaller assets which are mainly outside of London, and there are very good opportunities in that part of the market right now."