Duet's three voices: l-r Rob Clayton, Dale Lattanzio, Cyrus Korat

Duet tunes into funding gap with latest offering

Duet's new mezzanine fund is hoping to tap into the huge market between senior debt and equity. Paul Norman meets the team from Duet. Portraits by Marcus Rose

This month, Duet Private Equity, part of the $2.3bn (£1.4bn) asset manager Duet Group, floated the UK's first listed real estate mezzanine finance fund, targeting a much-talked-about real estate funding gap.

Trading in Duet Real Estate Finance is due to begin on Monday, 14 March. It is one of a growing number of mezzanine debt platforms proposing to step in as a cushion between senior debt and equity, plugging the slot of between 60% and 80% of the value of properties that senior debt has effectively walked away from in the wake of the property crash.

Cyrus Korat, Duet's 38-year-old senior investment manager, explains the rationale: "The asset market has stabilised and there is a realisation that the situation people find themselves in is what it is and they are not going to be rescued by asset prices going up anymore.

"When a loan needs to be refinanced, we can fill that gap in the middle between bank and borrower. We are the linchpin in getting the deal done, balancing the requirements between senior debt and equity."

And there is a huge market up for grabs.

Dale Lattanzio, Duet's 46-year-old Pennsylvania-born managing director, says there is around €1,000bn (£860bn) of debt outstanding in Europe, mostly in the UK and Germany, with half of this due for refinancing in the next three years.

For investors, the appeal is clear. The predicted returns on mezzanine refinancing are typically seen as starting at 12-15% to reflect the cost of higher risk. The IRR for Duet's master fund is "15%-plus".

Unsurprisingly, INREV's January annual investor intentions survey revealed that of the 33 investors who responded, 39% considered mezzanine to be within their investment process, up from 23% last year.

Lattanzio is clearly upbeat after Duet's recent investor roadshow, as the group looks to raise £100m at a price of 100p a share: "Generically, the type of investors we have been seeing are equity income funds, private banks with high-net-worth clients, some pension funds and real estate investors, particularly real estate securities investors. It is mostly UK and some from continental Europe."

Cost of refinancing

On the other side of the deal, as Rob Clayton, Duet's 50-year-old senior investment manager, says, the cost of refinancing with a mezzanine debt fund involved is often surprisingly palatable.

"What is interesting is that a lot of the loans we are seeing are falling due after having been booked five years ago when interest rates were much higher. So, actually, re-organising the capital stack doing a new senior loan at today's interest rates, then adding in a slice of mezz, is not costing the sponsor any more money," says Clayton.

Of course, it is not good news for the rump of property. The new wave of mezzanine funds are focused almost exclusively on lower-risk prime real estate, and Duet is no exception.

"There is so much need that we can focus on deals that can make sense from a risk-adjusted return standpoint, where the cash flow and the quality of the asset meet our underwriting criteria," says Lattanzio. "Generally, the regions we focus on are the UK and Germany and then Western Europe."

Within this, Duet is targeting a balanced portfolio, but principally looking at offices and retail.

Lattanzio adds: "This strategy, which is a high-income strategy backed by good, high-quality real estate assets, is very understandable to investors and interesting to them because they are beginning to read about the issues in the real estate debt market and the situation that the banks are in. They find it interesting that they can participate in a market that, otherwise, they wouldn't have access to."

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>
> Rob Clayton

The first two deals for the fund, which is entirely equity financed, have already been completed, highlighting the type of high-quality, well-let assets Duet is in the market for.

In January, Irish investment company Vico Capital secured a £107m refinancing of 17 Columbus Courtyard in Canary Wharf.

The restructuring of the debt on the property, which is the European headquarters of Credit Suisse, was arranged by Duet through the mezzanine platform, with funding from US life insurance giant MetLife and Swiss-based private equity company The Partners Group. Lattanzio says: "It is a good example of what we can do. MetLife provided the senior debt and then we provided the mezzanine and brought in a partner as the preferred equity part of the capital structure.

"It was a Morgan Stanley securitised loan. The senior banks were trying to facilitate some refinancing and also the sponsors had heard that we had this kind of capital available, so we came at it through multiple levels."

It has also completed a €14.5m mezzanine financing secured by a portfolio of hotels in Germany owned by Blackstone Real Estate Partners.

While Duet is the first mezzanine fund to list in the UK, it is by no means alone in targeting the so-called 60-80% LTV gap.

Pramerica Real Estate Investors has launched a £150m European mezzanine vehicle, while M&G, the fund management arm of Prudential, has raised €40m from European institutions for a fund, and Topland has launched a £200m mezzanine debt and preferred equity venture.

Duet, says Lattanzio, is differentiated by its "debt focus in terms of the profile of our strategy".

He adds: "We go to 80% LTV ratio and we are reasonably flexible on the size of the investment we will make because we can invest not only through our fund but through our co-investors who have expressed appetite for direct yield alongside the fund."

Clayton, formerly director of structured finance at Topland and a manager at both CIT and Industrial Bank of Japan, says that the strength of its relationships and experience of dealing with banks and sponsors is key.

"The banks have issues we are all aware of and they are keen to deal with people they have known for a while. We offer a wealth of experience with the banks, having both worked as bankers and with bankers, as well as having borrowed from and invested with them," says Clayton.

Significant opportunity

Lattanzio thinks that the opportunity that has arisen for the mezzanine debt providers will remain for a significant period of time.

"We don't think senior lenders will come back into high LTV lending in the future. Over time, there will be more senior lenders participating in the senior part of the capital structure and that will involve more bank participation as well as the participation of some other institutions, like insurance companies. But we don't see that there will be a medium-term move into the part of the capital structure that we are focused on."

Lattanzio believes the market is helping itself by thinking about refinancing strategies far earlier than previously, and working hard to secure good terms from mezzanine funders while they exist.

"A phenomenon is that the banks and sponsors have realised it takes longer to complete a transaction. And it is more well understood that there is a lack of capital out there, so they are giving themselves much more time in getting in front of the refinancing dates than last year."

While Lattanzio expects greater movement this year from banks looking to sell assets owned through the foreclosure process, the situation with regards to loans is different.

"We believe that is just a more difficult process for the banks because there is very little, if any, leverage in the market for buyers of loans."

Unlocking deals will come down to Duet's relationships and experience. Lattanzio says: "Loan sales will happen in certain situations where the banks, for strategic reasons, might want to get out of certain portfolios."

DUET'S THREE VOICES

Rob Clayton

Senior investment manager Clayton has just turned 50 and is married with children. A self-confessed sports fanatic, he joined Duet from Topland in 2008 where he was director of structured finance. Before that, Clayton was at CIT, where he helped to fund the development of More London on the South Bank as well as the acquisition of 11 shopping centres from Charterhouse. Through the 1990s, he worked at Industrial Bank of Japan.

Cyrus Korat

The 38-year-old senior investment manager is recently married and joined Duet from Merrill Lynch. "My background is on the trading side across credit, mortgages and the mortgage-backed securities world. I set up Merrill's property derivatives business, did a number of structured trades at Merrill – both financing and derivatives – and some work-out stuff with regards to Merrill's mortgage business in UK."

Dale Lattanzio

Duet's 46-year-old managing director lives in London with his wife and four children. Born in Pittsburgh, Pennsylvania, Lattanzio grew up in the Boston area. He joined Duet in 2008, like Korat, from Merrill Lynch, where he had been co-head of global commercial real estate. "I have spent half my career in the UK in the real estate and debt markets. My background is in real estate and non-performing loans transactions. What we do requires experience across a host of things and we have been investors, lenders, borrowers and non-performing loan investors."