

European real estate debt finance moving towards American model

Upheavals in European real estate credit, particularly the entry of non-banks to debt investment, are creating more of a US-style market that may eventually include mortgage REITs, says Dale Lattanzio, Managing Partner of London-based DRC Capital.

With diversification of property credit sources now under way in Europe, the role of banks will gradually be reduced in volume - but not in importance - boosting capital provision from pension funds and, in particular, insurers, he told PIE in an interview recently in his London-West

End office. "It's definitely a new and emerging asset class in Europe. The European market will in the future look much more like the US market with respect to sources of finance for commercial property. If today it's 85% to 95% bank-financed, at some point in the future - and we think this is going to take some time - banks will have a market share of about 50% or 60%, the rest coming from the capital markets or from funds or REITs. There are mortgage REITs in the States; there may well be mortgage REITs here someday."

Lattanzio, a former managing director of commercial real estate at Merrill Lynch, launched DRC Capital LLP earlier this year with partners Rob Clayton and Cyrus Korat, focused on the mezzanine debt market. The investment team provides investment advisory and asset management for the £300m European Real Estate Debt Fund LP and Duet Real Estate Finance, a London Stock Exchange listed company, that raised £76m in 2011. The first fund was launched two years ago and finished its capital raise last summer. It won seed capital from Fo-

rum Partners, a similar private equity group founded and run by an American, Russell Platt. A second fund is already on the drawing board.

"Fund 1 has a stated life that it will invest and then the harvest period after that; these vehicles tend to just have a fixed start and stop date," Lattanzio told PIE. Fund 1 is a five year vehicle, with two one-year extensions so that it can run for seven years in total. It is more private equity in style because commitments are in illiquid assets. "With Fund 1 we're approaching 75% invested and expect to be there within the next month or so," Lattanzio says. Investment started slowly partly because the capital raise, begun in January 2010, was generally ahead of the non-bank debt investment trend. "We didn't really see any deals happening in the market because it was stuck really until the summertime of 2010 when there was a little bit of liquidity; some assets moving, some new bank lending activity... In order for us to make an investment we have to have something happening; there have to be buyers and sellers and banks lending or restructuring debt because we're providing a piece of the capital structure."

DRC is focused exclusively on the mezzanine part of the capital stack above senior debt. "Banks were still lending, up to 60% and in some cases 65% loan to value ratio so it was really the opportunity to top up that bank debt or help de-leverage that refinancing that we saw... There was also still a lot of high leverage - 80%, 85%, 90% LTV lending - so our idea was to help de-leverage banks back down to 60 or 65. But what has happened since last summer with the sovereign debt crisis is that the size of the mezzanine function has grown in width because banks really only want to lend to 50, maybe 55 LTV."

For its investors, DRC targets returns in the mid-teens. "We think mezz offers great risk-adjusted returns, particularly for property investors, because if you can get current cash-flow and that kind of return and yet have a debt risk profile, that's quite a nice thing to have alongside a property investment that is very equity dominated." DRC is also clear in its geographical focus: "70% of what we do has to be between UK and Germany; that's the mandate of the

fund. The rest we've split between France and Scandinavia. UK and Germany account for about half of all the debt outstanding in Western Europe and interestingly, it's roughly equally split between the two. In round numbers, about €1tr of debt is backed by western European commercial property. Roughly €250bn of this sits in Germany and €250bn in the UK. Those are also the biggest and most developed markets, and the most transparent - also from a legal perspective - and understandable from a lender's perspective." DRC investors are typically insurance companies and pension funds from UK, continental Europe and North America but the strategy is also of interest to investors from other regions.

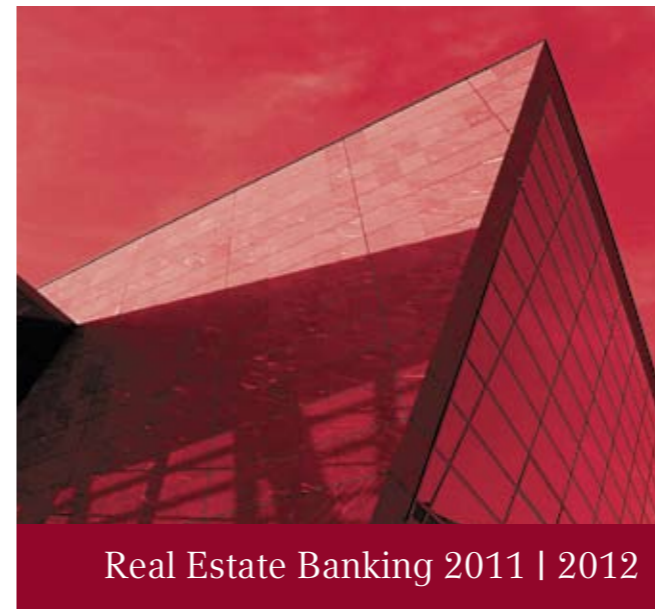
From a borrower standpoint, mezzanine debt can offer attractive leverage considered alongside senior debt, he says. "One of the main reasons it can be attractive for borrowers today is because interest rates are low. If you take senior debt these days at LIBOR

plus 250bp or 350bp - up to 50% or maybe 55% LTV - and then you add on our piece of debt - you're taking about an all-in cost of debt somewhere between 6% and 6.5% depending on how much mezzanine is in there. So mezzanine can play a role across a lot of different property types. Sometimes it is just used as an equity replacement; the borrower needs something to fill that capital stack beyond senior debt."

Lattanzio says that the opportunity continues to widen in parallel with the expanding debt financing gap as old financings come due and banks are no longer willing to extend - or wish to cut back commitments. "In terms of jurisdictions, we see a lot of activity in the UK; we've seen increasing activity in France over the last six months as the French banks definitely retrenched after last summer, particularly in commercial property," he says. "Netherlands is another place with increasing activity now." ■ pie



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