DRC CAPITAL

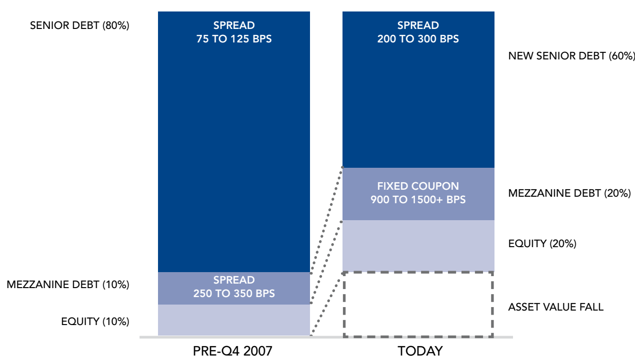
Commercial Real Estate Debt In Europe: From "One-Size Fits All" to "Pick 'n' Mix"

With a change in the financing landscape and the growth in real estate debt funds in Europe, investors considering real estate investment strategies now have alternative sources for European real estate exposure.

Pre-2007, European commercial real estate ('CRE') debt grew to record volumes. Financing was predominantly provided by banks that were prepared to provide high leverage at very low margins. The availability of cheap funding combined with relaxed capital standards fuelled the growth in debt volumes with low margins and higher loan-to-value ratios. When the credit markets started to tighten in mid-2007, commercial real estate was one of the first segments to feel the impact.

Since the global financial crisis, there have been significant structural changes to the real estate market; a fall in property values and returns, overexposure of key lenders and the introduction of Basel III banking legislation. These structural changes have opened an opportunity for alternative lenders and in particular mezzanine debt funds, which fill the gap between senior loans and equity in the capital structure. Figure 1 shows how the typical capital structure for commercial real estate pre-2007 was primarily bank funded. Post-2007, this bank-funded "one-size fits all" financing model has become more diversified with mezzanine debt becoming more prevalent in the capital stack.

Figure 1: **Typical Commercial Real Estate Capital Structure**



This shift in the traditional financing model presents an opportunity for investors looking for exposure to commercial real estate in Europe. Previously restricted broadly to investing in equity funds, investors can now choose from a greater choice of products covering a wider risk-return spectrum, allowing them to "pick 'n mix" products to suit their investment strategies. These options include a mix of senior debt, mezzanine debt, whole loan and equity products with varying risk and return characteristics, as demonstrated by Figure 2 and Table 1 below.

Figure2: **Investments with Exposure to Real Estate**

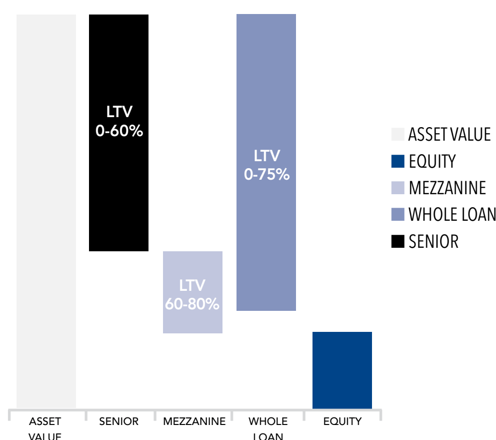


Table 1: **Options for Investing in Real Estate**

	INVESTMENT TYPE	LEVERAGE	LIQUIDITY	RUNNING YIELD	EXPOSURES TO CHANGE IN PROPERTY VALUE	TARGET IRR
Core Property	Direct	Low	Medium	Medium	Medium/High	8 - 10%
Opportunistic Property	Direct	High	Low	Low	High	15%+
Senior Debt backed by Property	Debt	Low	Low	Low	Low	3 - 4%
Whole Loan backed by Property	Debt	Medium	Low	Medium	Low/Medium	6 - 7%
Mezzanine Debt backed by Property	Debt	Medium/High	Low	Medium/High	Medium	12 - 15%

RISK AND RETURN PROFILE FOR DIFFERENT INVESTMENT PRODUCTS

Using an example of a prime London office property with an initial market value of £100 million and annual rent of £5.5 million, the return characteristics for the most common real estate investment options are compared below. The way in which the returns vary given a change in the exit value of the property is also assessed. Table 2 sets out the financing assumptions for the London property example.

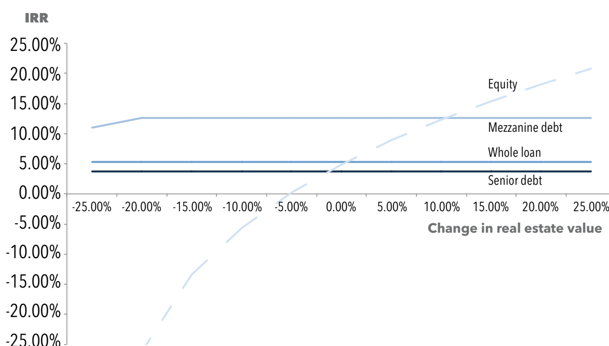
Table 2: **Financing Assumptions**

	SENIOR	MEZZANINE	WHOLE LOAN	EQUITY
LOAN AMOUNT	£60m	£20m	£75m	£20m
LTV ATTACHMENT POINT	0.00%	60.00%	0.00%	80.00%
LTV DETACHMENT POINT	60.00%	80.00%	75.00%	100.00%
UPFRONT FEE	1.00%	2.00%	1.25%	N/A
MARGIN	L+ 2.50%	12.00%	L+ 4.00%	N/A
AMORTISATION	1.00%	N/A	1.00%	N/A
TERM	5 YRS	5 YRS	5 YRS	N/A

Assumes LIBOR at 100bps and repayment upon maturity

The leveraged equity investment has the most volatility, as demonstrated in Figure 3 below, as it is highly sensitive to changes in the underlying asset value. In this example, a 25% increase in asset values will give the equity investor an IRR of 20.7 percent on their investment. However, if prices fall, the equity investor will take an immediate loss as their investment is the riskiest part of the capital structure. The return for an equity investor will come from income in the form of rents and increases in asset values, and in a high-growth environment the latter will be the main factor driving the returns.

Figure 3: **Investment IRR vs Change in Asset Value**



The investment with the least volatility is the senior debt, which is only affected if the property value falls by more than 40 percent. In addition the senior lender will have seniority with regards to rental income, and likely amortisation which will reduce the risk profile over the life of the loan. If any loan covenants are breached, the senior lender will be able to enforce its mortgage on the property and sell it in order to protect its loan.

Mezzanine debt sits between senior debt and equity in the capital structure. It offers a defensive strategy for investors

Table 3: **The Volatility of Returns for Real Estate Investments to Changes in the Underlying Property Value over 5 years**

PROPERTY VALUE		SENIOR DEBT	WHOLE LOAN	MEZZANINE	EQUITY
% CHANGE	£	IRR	IRR	IRR	IRR
25.0%	125m	3.7%	5.3%	12.6%	20.7%
20.0%	120m	3.7%	5.3%	12.6%	18.2%
15.0%	115m	3.7%	5.3%	12.6%	15.4%
10.0%	110m	3.7%	5.3%	12.6%	12.3%
5.0%	105m	3.7%	5.3%	12.6%	8.9%
0.0%	100m	3.7%	5.3%	12.6%	4.9%
-5.0%	95m	3.7%	5.3%	12.6%	0.2%
-10.0%	90m	3.7%	5.3%	12.6%	-5.6%
-15.0%	85m	3.7%	5.3%	12.6%	-13.4%
-20.0%	80m	3.7%	5.3%	12.6%	-26.3%
-25.0%	75M	3.7%	5.3%	10.9%	-45.4%

who are seeking higher returns while at the same time being downside-protected with respect to a fall in property values. Although the mezzanine debt ranks behind the senior debt it will usually have a second ranking security package and often a first ranking share pledge over an independent borrowing entity, and benefit from the equity buffer which has to erode before any capital is lost. In any event, the mezzanine lender will have a preferred claim ranking after the senior lender.

Whole loans offer an alternative to the senior plus mezzanine financing solution, providing financing at a LTV level greater than senior debt but typically lower than mezzanine debt. Investors can expect moderate returns for the commensurate level of risk from a whole loan investment. The security package offered to the whole loan lender will generally be similar to that offered to the senior lender.

CONCLUSION

With senior banks continuing to reduce their exposure to real estate and tightening their lending criteria, a significant funding gap remains in Europe. DTZ research suggests that although the gross funding gap in Europe is shrinking as banks de-lever and alternative financing sources emerge, the gap is still substantial at approximately £104 billion. In the UK alone, the value of loans secured by real estate maturing between the end of 2012 and 2017 is estimated at £143 billion by De Montfort University. This volume of maturing debt in combination with deleveraging by senior banks and their reluctance to lend above 60 percent LTV, offers a significant opportunity for debt investments.

Investing in debt backed by commercial real estate provides the investor with attractive risk adjusted returns. Generating relatively high income returns and being second loss in nature means that debt investments outperform equity investments in flat or negative asset value environments. With the reduction in asset values since 2007 and the supply/demand imbalance in the provision of credit to commercial real estate, the next few years should provide the ideal conditions for debt investing in Europe.

In summary, a debt strategy can and should play a very important role in any real estate investment portfolio. ■