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A focus on income

As banks unwind their real estate loan portfolios, DRC Capital puts an emphasis on the income story behind such opportunities – with an eye towards future appreciation.

By Gregory Morris

Formed more than four years ago to take advantage of what appeared at the time to be a fleeting opportunity in European real estate debt, DRC Capital now looks like it will be in the game for the long run.

"When we first started the business in 2008, it wasn't clear how long the debt opportunity in Europe was going to be around," says Dale Lattanzio, managing partner. "Now, this looks like a business that is going to last well into the future. That is why it makes sense to have an investment management business completely dedicated to it."

Spun out of Duet Private Equity in March, DRC has developed a compelling proposition. "Many investors believe in the income story from real estate," Lattanzio says, "but they don't necessarily believe in the capital increase story." Therefore, that is precisely the angle of attack that Lattanzio and his partners, Rob Clayton and Cyrus Korat (the "R" and "C" in DRC), have taken for the past four years.

Duet and DRC will continue to collaborate, capitalising on their success raising £300.5 million (€360 million; $478 million) for the European Real Estate Debt Fund, which held a final close in the summer of 2011. Part of the equity, about £76 million, was raised by Duet Real Estate Finance, a London Stock Exchange-listed investment company, with Evercore Private Funds Group as the placement agent. Forum Partners, the London-based private equity real estate firm, was a seed investor and strategic partner in the fund.

"The debt opportunity in European real estate is structural and not cyclical," Lattanzio states emphatically. "We are a very focused investment management business, and the opportunity for us is to grow our business in the different aspects of the real estate debt space. The point of the spinout was that we believe in our investment philosophy and it was important for the market to be able to recognize that and differentiate us."

That approach has been validated by the market in a way that puts a wry smile on the partners' faces. About 12 months after DRC's public offering, three other similar public vehicles entered the market – Starwood Capital Group, Cheyne Capital Management and ICG-Longbow Real Estate Capital, part of the Intermediate Capital Group. To paraphrase the old adage, imitation is the most sincere form of flattery.

Of course, it remains to be seen if having a few similar vehicles brings more attention to the segment and thereby more investors and opportunities, or if it just muddles the picture.

Lattanzio: bullish on the size of the opportunity presented by Europe's debt market

Filling the funding gap

Lattanzio remains sanguine about the overall size of the potential investment arena for him and his partners. As evidence, he refers back to the way DRC included a listed feeder vehicle in the initial fundraise. "It was certainly a different set of investors and disciplines to create a fund that is listed on the London Stock Exchange," he says, "but the extra effort definitely seems worthwhile for us in order to grow interest in the market."

Further growth came just about the same time that the other three competitor funds were being launched, as DRC launched a second £400

million fund in October. The success of that round of financing for DRC, even though it was no longer the only horse in the race, further confirmed that the partners are onto something.

Wherever DRC goes from here, the firm's intermediate term intentions are clear. "We have a target of more than £1 billion in the high-yield or mezzanine space," says Lattanzio. "We see continued interest in debt strategies and therefore expect other moves, including senior or stretched senior debt vehicles. We also may work on debt acquisition. Such strategies would be structured in separate pools as they have different risk and return objectives."

Clayton: European pensions were a key backer of DRC

Reviewing the genesis of the strategy, Lattanzio recalls that "the nature of the real estate market in Europe was in such a position that debt lending had to change under the terms of the Basel II and Basel III accords. The market at that time was dominated by a few big banks, but participants and regulators knew that those institutions had to reduce their exposure—and quite dramatically."

Whether or not those directives and the resulting tectonic shifts in the sector have achieved their intended goals is open to discussion. What is not up for debate is that the moves opened a funding gap – more like a chasm – that is estimated at $200 billion to $300 billion. "We were one of the few private vehicles that were in a position to move into that space," Lattanzio recalls. That is partly because European regulations do not allow real estate investment trusts to hold debt. In contrast, that is allowed in the US, where he notes there are more than 130 vehicles including focused mortgage REITs.

Undeterred, Lattanzio is optimistic. "We expect that the European market will become more diversified over time and will come to be more like the sector in the US," he says. "There are likely to be more players and more different types of vehicles and structures."

Still, Lattanzio is cautious about too many predictions characterising how the market might evolve or what the population of competitors might look like. "We are still in very early days," he adds.

Korat: sees accelerated participation among investors

The need for risk-adjusted returns

If these are early days, then it stands to reason that DRC would have the eagerly sought first-mover advantage. And, indeed, Lattanzio reckons his outfit has just that – even more so considering the nature of the business in Europe.

"This market is still composed of bilateral deals," Lattanzio says. "In comparison, the US market is much more variable and transparent. Here, counterparty is very important. A good track record is essential, and experience doing business with this or that party or partner is essential. The market will open over time, but for now those interpersonal relationships we have and are forming now are very important."

Clayton notes that the same could be said upstream of the people who back DRC. "The European institutional investor class that we felt would have the greatest interest have invested," he says. "Pension plans, in particular, had a need for this type of high risk-adjusted return. That also is one of the reasons that, for our first fund, the opportunity was a European one."

Korat concurs. "The opportunity we brought to the market had not existed or been accessible to institutional investors before," he says. Even so, the novelty did not bring an immediate rush of participation.

"It took some time for investors to understand what we were doing," Korat adds. "They have, and now we are seeing that accelerated participation." The strongest evidence of that acceleration is the simultaneous launch and first close of DRC's second fund.

While Lattanzio says he finds that acceptance and acceleration rewarding, there is still some convincing to be done. "Many investors believe in the income story in our sector, but they do not yet believe in the capital increase story. The other big picture theme is that we are in a position to take advantage of the banks reducing their leverage. For many potential investors, that is a market where there are only a few advisors. It is very different from the fixed-income bond market, where there are many players."

Investment parameters

Korat stresses that "we are lenders, so we are aware of all of the factors that affect real estate – the macroeconomic factors and the local and regional factors as well." Regionally, he says DRC is focused on northern Europe, the United Kingdom, France and Germany, where the immediate currency risks are less than they are in southern Europe. Lattanzio is quick to add that DRC is not focused on distressed assets.

Korat notes that, in all the major countries, as well as the smaller national market, the focus is on the bigger cities in those nations. "In the UK, Germany and France, we are in the big cities. In Denmark, we are right in central Copenhagen."

By asset type, the portfolio is backed by office, retail, some hospitality and some industrial and light logistics. "We can look at anything, and our job is to work out the appropriate lending for that property or asset," Korat says. "An office building with a 25-year lease gets a different treatment than does a hotel due to the nature of the risk." ◻