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# Future of private debt: The new face of real estate lending

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*Alternative lenders have muscled into traditional banking territory in the real estate sector. But will they stand up to scrutiny when a downturn comes?*

Alternative lenders have been steadily growing their market share in European private debt since the financial crisis. At first they filled a debt gap created by dislocation; today they are a structurally persistent feature of the lending market.

The EU referendum has created more business for non-banks in the UK, while increased turnover and a continued recovery in fundamentals across Europe is opening up opportunities on the continent. In the US, non-bank lending (including capital markets) is approaching 50 percent of the loan origination market.

Alternative lenders see no reason why they shouldn't continue to be a growing part of the lending landscape in Europe. Non-bank lenders have established a strong foothold in the real estate debt market, writing circa 25 percent of the £53.7 billion ($69 billion; €62 billion) of loans that were issued in the UK last year, according to De Montfort University's Commercial Property Lending Report for 2015. That marks "a powerful move in a big market” in the view of Dale Lattanzio, managing partner of property debt fund DRC Capital.

Banks and building societies still dominate the UK market, but their market share continued to fall in 2015. They represented 34 percent of new loan originations at year-end – the lowest level recorded by the research in the 19 years since it began – compared with 39 percent in 2014.

For the first time, insurance companies were the second-largest category of new loan originators, representing 16 percent of the 2015 total.

Until the financial crisis, the market was dominated by banks with the exception of a couple of insurance companies. Then, in 2010, US life insurance companies led a slew of foreign capital, including Asian sovereign wealth money, into a European market seen as bottoming out. Other non-bank capital followed and there is now “a very diverse pool of capital, particularly in real estate lending, with UK banks’ diminishing market share forecast to continue for the time being”, says Emma Huepfl, Laxfield Capital co-founder.

The principal driver behind this shift is the increasing regulatory pressure on banks and the amount of capital they have versus what they require, which means alternative sources of capital will continue to be necessary.

“European banks, which are nearly twice as levered as US banks, are essentially managing down their balance sheets,” says Jon Rickert, investor director of GAM’s real estate finance team, which provides mezzanine and whole loans in the UK and Europe.

Insurers have made a big impact in the senior debt market, motivated by the yield on offer compared with other forms of fixed income. Their investment portfolios, on balance, are made up of single A corporate bonds, yet real estate senior loans pay a premium of 50-100 basis points. “For insurers that don’t need liquidity, real estate debt is an attractive place to be, on that basis,” says Rickert.

Peter Cosmetatos, chief executive of CREFC Europe, the commercial real estate trade association, adds: “There’s enormous scope for insurers and pension funds to pick up slack.”

Some insurers lend directly, although it’s common for them to buy into syndicated loans. “It’s not just competition that has taken market share away from banks; their appetite has shrunk a bit,” says Paul Wilson, head of MetLife’s London office.

Generally insurers play at the conservative end of the spectrum, providing fixed-rate longer term debt typically against larger deals. These have dwindled of late and tight pricing last year caused some to step back, redirecting capital towards the US.

Where debt funds have made their mark has principally been in the place that banks or insurers don’t want to be, whether type of loan or higher leverage point. “A lot of clients are now looking for people that can provide debt on opportunities that banks no longer deem attractive," says Lattanzio.

## BREXIT DRIVES BUSINESS

Alternative lenders have stepped up activity in recent weeks, picking up more deals and able to be more selective as a result of banks' reticence in the wake of the Brexit vote.

According to one observer: "The banks have been a lot slower to make decisions since the referendum. They have not stopped, but a lot of deals have come into the alternative lending programme that would have been bank-type deals. Borrowers have been prepared to pay a premium for somebody that can execute to a tight acquisition timetable with discounted assets available in the market."

Since June, bank pricing has widened by 25-50 basis points and loan-to-values have reduced from the mid-60s to the low-60s. "That creates opportunities for asset managers like us," says Rickert.

Over the past eight years debt funds have established a stream of repeat custom and their institutional investor base has become increasingly sophisticated. They continue to target capital at market gaps, evolving their offering to keep growing market share. M&G Investments, for example, is looking at launching a development finance fund, as well as specialist vehicles based around geography or length of loan term.

There is more room for debt funds to grow on the continent as the underlying recovery in fundamentals continues to progress. The UK has been the first port of call, being most advanced in the cycle and with an attractive foreclosure regime.

"The need for alternative sources of capital showed itself earlier in the UK than on the continent. Therefore, there was more willingness to embrace debt funds as part of the solution," Lattanzio says.

The reach of alternative lenders differs vastly from one country to another, influenced by local banking environments. The German market is largely driven by a functioning pfandbrief market and local savings banks prepared to lend at high LTV ratios, making it hard for international lenders to compete. France is also competitively banked, domestically.

According to Lattanzio, for some time there wasn't enough activity for debt funds to participate more heavily in European markets, but an opportunity is now arising to refinance "digestable chunks" of debt held by private equity firms which invested in large distressed portfolios.

Debt funds are also playing a role in unlocking situations for new equity and some existing situations that require refinancing in Ireland, such as the Blanchardstown shopping centre near Dublin.

"Now senior lending partners are starting to expand into the Dutch market it's natural that we should go along with them as well as our borrowers, increasing our own share there," says Amy Aznar, head of debt investments and special situations at LaSalle Investment Management.

Alternative lenders' grip on the continent "is really just starting", Lattanzio adds. Banks will remain an important part of the system, but the balance of lending is expected to continue tipping towards non-bank sources of capital over the next five to seven years in order for the real estate market to continue to function, he believes.

Insurers are on their way to 20 percent of the UK CRE lending market, while Rickert estimates debt funds and asset managers could end up with a market share of around 15-20 percent of the core European market in the long term. "I don't see banks piling in in the way they did prior to the crisis, consistent with where regulators seem to be pushing banks," he says.

## WHAT GOES UP

The big concern is if a 10 percent value drop were compounded by a real deterioration in the economy. Alternative capital came into a rising market and hasn't had to deal with a downturn to date, and until then it is unclear how well loans have been covenanted and protected.

"Things could change if there were a real question mark around economic and political stability as negotiations with the EU unfold. The general perception of the UK matters for investors far away when there is a choice of markets to invest in," Huepfl says. However, real estate debt still offers a good risk-adjusted return for investors in the low interest rate environment.

Non-bank capital currently has an advantage in being less regulated than bank debt, and has proven its value in helping to maintain liquidity post-referendum through quicker approvals.

"A more diversified lender base in Europe, which has been traditionally dominated by the banking sector, provides a good foundation for a healthier capital markets environment," says Cosmetatos.

## GROWING SHARE OF INFRASTRUCTURE DEBT

One area of the private debt market seeing a big emergence of non-bank lenders is infrastructure debt. "The appeal is excess margin relative to fixed income alternatives, as well as the term available; these are long-dated, cashflow-producing assets," says Kit Hamilton, head of investment for Macquarie Infrastructure Debt Investment Solutions.

Pre-crisis, banks were comfortable lending over 25-30 years, but changes in capital treatment have triggered a shift. Banks' increasing cost of liquidity has steered them towards an originate-to-distribute model, while improved equity requirements for institutional investors' real asset investments opened the door for their role in the financing of roads and power plants, for example.

A reasonable estimation of institutions' market share would be a third of all loans written for UK infrastructure in the past 12 months. Macquarie deployed over £1 billion in this space during that time.

“You need to be in the flow of conversation as opportunity areas ebb and flow,” Hamilton says. “The PPP space [building roads, schools and hospitals] was relatively quiet in the early days, because the risk-return didn’t add up. That changed over the past 12 months as some swaps have received different capital treatment, meaning banks are pricing higher.

“The potential for non-banks is enormous. From a geopolitical perspective there is a continued need for institutional spending and the numbers are vast, so there’s a huge amount of capital investment required. Over the longer term, a lot of infrastructure investment sits more comfortably in capital markets and private markets than it does with banks.”

Across real estate, infrastructure and corporate debt, institutional investors have grown their market share to around 20 percent over four years, says Laurent Belouze, head of Natixis Asset Management’s new real asset private debt division.

The firm is targeting aircraft debt as a new asset class for investors. “We’re at the stage of explaining the way it works,” he says. “The structure is always the same in terms of financing maturity and it’s easier to underwrite than infrastructure, which has various different sectors. It’s a big market with capacity to find transactions and the quality of, and access to, collateral is very good.”