The changing landscape of real estate finance in Europe

A large refinancing hurdle looms over European real estate markets with limited debt availability and potentially adverse implications for future financing costs. Against this background, real estate companies and funds are considering how they can best manage their funding requirements going forward.

New regulations set out in Basel III and funding issues caused by the ongoing economic uncertainties are resulting in the shrinking of bank balance sheets. In particular, over-exposure by banks and the impact of the new regulations imply increased costs for real estate lending and reduced risk taking in future.

The uncertainties around the financial system are unlikely to be resolved in the short term. Furthermore, the nature of the changes occurring in the banking system imply a structural shift is taking place.

Therefore, as well as strengthening their existing relationships, it is wise for borrowers to seek access to additional sources of funding in addition to traditional bank financing. The largest borrowers have access to unsecured bond markets, but for the remainder of the market there are fewer options.

New sources of debt are therefore being sought to fill the gap being left by the banking market. In addition to the favourable regulatory environment laid down by Solvency II for the insurance industry, the changes detailed above represent an opportunity for institutions who are seeking investments which provide a low risk and stable return profile.

Borrower options for funding diversification depend on size and leverage

Figure 1 shows the potential financing routes for a real estate borrower in today’s market. The available options for a borrower largely depend on its size and risk profile. For those at the larger end (greater than $2bn in assets, LTV 40% or below) and with an unsecured funding profile, bond markets are a viable option. There are two primary markets that are currently available, corporate bonds and US Private Placement (“USPP”).

Of these options, the corporate bond market is better established in Europe, although it is still much smaller than in the US where bond financing is more common. It is viewed as an attractive option for borrowers that are predominately publicly listed or are a dominant international player. We are seeing a steady trend in the number of European property companies who are developing a strategy to move from secured to unsecured debt in order to gain access to this market, and it is expected that the number of issuers will increase in future years. The key drivers for this change are as follows:

• Large debt quantum available: corporates typically issue a benchmark bond of €500m although smaller amounts are also achievable. The bond market is currently by far the easiest way to access large amounts of capital within a short time period
• Diversification of funding from banks: this is a strategic target for many listed corporates
• Longer tenors: manage maturity profile and provide certainty of funding
• Flexible covenant structure: unsecured nature allows freedom to trade and manage assets as desired
• Speed/ease of execution: once the first deal has closed it is relatively simple to tap the market via repeat issuance
• Pricing: the overall yield paid is low given the current interest rate environment.

The USPP market can be seen as an alternative option to the corporate bond market. No external rating is required from the rating agencies although investment grade metrics are typically required to attract investor demand. There is
strong demand for issuers who have the appropriate credit metrics and this has resulted in a growing number of borrowers tapping the market for amounts up to €400m with maturities ranging from five to 12 years, with much longer potentially available for very strong credits. This sector is often seen as attractive by borrowers who have no strategic rationale to gain a formal investment grade rating. It can also be used as a stepping stone towards a full investment grade rating and potential Eurobond issue in future years.

In addition to those who already have access to these markets, some borrowers are in a position to grow into investment grade territory. However, for the majority of the sector this is not a viable option. The majority of real estate debt is non-recourse in nature and secured against specific assets. Unsecured lending is not the sole solution to the broader real estate funding gap and as such, additional sources of finance will be required to meet demand.

An alternative financing source is required for borrowers who cannot access the bond markets directly.

For those borrowers who do not have portfolios large enough to issue unsecured bonds, there are currently limited financing options. Listed property companies can issue convertible bonds, but this can only act as an incremental source of finance in what is a capital intensive sector.

The primary alternative to bank debt for smaller real estate players before the 2008 credit crunch was CMBS, but this market is still closed. Strong headwinds still exist despite a number of attempts to encourage buyers to emerge, not least the pre-crunch legacy deals which are currently at or approaching maturity.

The other well-established and popular route is via the German Pfandbrief market. While the lower funding costs of the capital markets can be passed through to borrowers, the underlying loan remains on the bank’s balance sheet. Therefore the same regulatory pressures apply as for the wider banking market.

The majority of borrowers will remain reliant on secured lending but will still require finance on commercial terms. Larger players will also seek to diversify their funding base and this is where the biggest opportunities arise for alternative debt providers.

A strong business case exists for institutions to lend against real estate.

In the next two years alone, DTZ projects €500bn of debt will mature across Europe. This gap will partially be filled by crystallisation of losses and re-equitisation. A large senior debt requirement will remain however.

Due to the external factors driving bank behaviour mentioned above, the availability of secured funding is expected to remain constrained. This will result in lending terms remaining conservative with a focus on well located marketable assets that can generate strong cash flows. Borrowers are aware of the problem and are actively seeking funding diversification away from banks. These drivers create strong incentives for new lenders to establish a position in the market.

As insurers and pension funds like stable, predictable cash flows and are hungry for assets that offer higher yields than bonds, a number are starting to explore the opportunity provided by investing in direct property loans. Driven by Solvency II, insurers see investing in direct property loans as a compelling investment story. If this trend continues then we could well see this market growing and following the US example where around 20% of real estate transactions are underwritten by long-term investors such as insurance companies and pension funds. Recent research by INREV showed that 41% of their interviewed members considered investing in debt in the year ahead.

For insurance companies, real estate debt offers a higher return on capital than investing in direct real estate. One of the drivers for this higher return is a lower Solvency Capital Ratio. Aside from the regulatory benefits, the economic return profile is also attractive. Loans typically have a lower loss given default than bonds due to the presence of maintenance covenants, resulting in a better negotiating position if problems arise.

Another positive feature of investing in real estate debt is the fact that loan returns are insulated from asset level volatility. Asset level volatility is expressed in the equity buffer, and accounting rules allow accrual accounting, removing the need for mark to market and associated volatility.

Debt can also provide the same diversification benefits as direct real estate investment. Portfolios can be diversified over different geographies, asset types, borrowers and tenants. As with direct real estate investing via equity, real estate debt also provides low correlation to other asset classes.
Institutions are not, however, expected to replace banks overnight. While some lack the expertise and infrastructure, the insurers’ own investment criteria may also make their loans less attractive to borrowers as they may seek longer-dated fixed rate paper that more closely matches their liabilities. This goes against the majority of borrower’s requirements for shorter-dated loans that provide them with the flexibility to refinance and to manage debt maturities.

What are the options for entering the market?
There are a number of different ways of providing finance against real estate that are currently available to a new entrant into the market. Figure 2 shows the various finance types which can be broadly classified into the following:
- Secured senior debt
- Secured mezzanine debt
- Unsecured debt
- Purchase or financing of loan portfolios

The majority of new entrants are expected to enter the market by providing senior secured debt against strong assets with good income potential. However, it is notable that entrants to date all have slightly different approaches, often driven by funding/return requirements and their existing approach to real estate analysis.

Banks can play an active role in bridging between borrowers and institutional lenders
Banks can play an important role in assisting new lenders to enter the market. Those real estate teams that have survived the previous few years in good health retain a strong level of market knowledge and client relationships. Borrower relationships are a critical aspect of the European market and should not be overlooked by a prospective new entrant. For institutions seeking to establish a lending platform, it might not be appropriate to build a large origination platform in the first instance, and lending alongside banks which have established platforms can provide additional comfort over lending decisions. Small teams also often have to allocate their resources carefully and it can make sense to let a bank undertake a lot of the legwork involved in the origination process. Banks can help institutions with limited resources to achieve scale.

For example, at ING Real Estate Finance, we have a global origination platform with experience in more than 15 countries, and a real estate lending portfolio of €35bn focused on Europe. This gives us the local knowledge required to make decisions based on fundamental real estate analysis. Furthermore we can help institutions access loan deals as part of syndications or via club deals.

Future developments
It is still too early to say whether the above description will be a solution for the debt gap that currently exists within European real estate. The facts are that there is structural change occurring in the European real estate debt market and that an opportunity exists for new lenders to fill the gap. Although there is potential for CMBS to make a comeback at some point, the future for this product in Europe is still very uncertain.

It is not impossible that the future shape of the European real estate finance market could tend towards the US market, where insurers make up 20% of the lending base and banks take a leading role in acting as intermediaries for the bond markets. On this basis, the opportunity for alternative capital providers to get a foothold on the real estate debt market is clear.
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