Lending trends for European real estate investors and funds 2013

[The experts' view in 12 questions]

REAL ESTATE FINANCE

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Introduction

We are pleased to present to you the results of the 2013 Nyenrode Survey that was conducted amongst ING Real Estate Finance's clients in the European Listed & Institutional Real Estate sector. As is the case with qualitative research, findings are general in nature, yet they provide useful food for thought for the sector and its stakeholders.

The main themes that can be identified from the survey include:
1. Diversified Portfolio Lending: the recognition by borrowers that single asset lending without recourse to a holding company is often not an optimal funding strategy;
2. Syndication: the need for banks that provide access to other lenders (including non-bank lenders such as insurers) to diversify their funding sources, and
3. Country-by-Country Approach: clients increasingly value the local knowledge and relationship with a specialist real estate lender in their country.

Interestingly these themes can be matched to certain lessons learned in the recent past when analysing why performing real estate loans turned into non-performing real estate loans. The obvious lessons learned include providing too high Loan to Value's (LTVs), or accepting only limited rights to modify contracts earlier in the process when risks are foreseen. But in addition to these obvious lessons, one also has to conclude that a variety of sound principles were underserved in the real estate sector. And these principles bear an interesting similarity to the themes listed by the respondents in the underlying 2013 Nyenrode survey:

Lending into a diversified pool of cash-generating assets

Lower costs and looser structures were sought opportunistically in order to obtain the 'optimal' conditions for each single asset transaction. But when certain transactions defaulted and a single asset was no longer worth fighting for because equity had often evaporated, the lending relationship with the bank became strained, and management often lost credibility with a wider group of lenders. In theory one must sympathise with the principle of having all lending stakeholders looking at an identical credit risk profile for a borrower.

Having access to a variety of funding sources

In hindsight, many real estate companies had a high dependency on only a small number of banks, which went hand-in-hand with a widespread willingness by banks to take on large single lending exposure per transaction on a bilateral basis. As in any other business, the dependency on a limited number of suppliers is a threat in the real estate sector as well. So when banks implemented a strategy to decrease exposure to the real estate sector, or even decided to retreat entirely to their home markets as their own liquidity had dried up, borrowers faced tremendous challenges in obtaining refinancing with other parties. Clearly a broader group of lenders offers more opportunities to replace banks that decide to 'run for the hills'.

The importance of proper business due diligence

Spreadsheets packed with assumptions (which appeared realistic at the time) were often preferred over a professional review of the quality of the borrower's (local) management. True business due diligence, including a good understanding of the business model on the ground, was hard to find. As lending is about the predictability of future cashflows, analysing the main risk and value drivers in a borrower's business model is key. This includes management's track record in deploying strategies to optimise value and minimise risks. Few will dispute that this is best served by banks having a local presence with real estate specialists, as it is in essence a local business.

Whilst it is encouraging to note that there appears to be a common insight amongst both borrowers and lenders on funding strategies these days, there is more to take into account.

The European banking landscape has been changing as most banks have cut down on real estate lending and also often retreated back to their home countries. In addition to the losses incurred on real estate loans and the lessons that can be drawn from this as mentioned above, capital markets in general have not proved to be an economically attractive funding source for the banks since the start of the crisis. As a consequence, many banks have retreated to their home markets, or at least focus on geographies where they have ample access to liquidity. A further effect has been that local regulators typically limit the banks' activities outside their national market in order to protect the domestic depositors. In a way one could say that since the financial crisis started, new walls have been erected around national boundaries, despite the 'free flow of capital' doctrine that the EU stands for.

As a consequence, real estate borrowers in the listed and institutional segment have felt that funding is becoming more and more a country-by-country exercise, which makes their lives less efficient than it was 5 to 10 years ago. These borrowers are starting to select banks on the basis of their access to liquidity, in order to remain relevant and predictable as a partner. In most European countries one will find only a handful of players with large liquidity positions on the ground. Arguably, these are the ones that are futureproof.

So what is the conclusion to be drawn from the 2013 Nyenrode Survey, at a time when banks struggle to meet their own liquidity needs for their lending portfolios? It is probably that in the

European real estate sector we can expect to see:
- more country-by-country portfolio transactions, which
- because of the transaction size, require lending syndicates including banks and non-banking institutions, and
- where the syndicate leaders have a locally-based relationship with the borrower, based on trust, reliability in execution, and on-the-ground real estate knowledge.

If these expectations become reality, it will also help the European real estate sector in another way: more use of syndicated transactions will increase the transparency of real estate lending, helping market participants to better compare lending conditions. In fact this looks like a brighter future.

On that positive note I wish you pleasant reading.

Jan-Evert Post
Member of the global management team of
ING Real Estate Finance

Summary

Goal and research methodology

The goal of this qualitative research is to identify lending trends for European real estate investors and real estate funds by interviewing selected ING Real Estate Finance ('ING REF') clients as experts. 31 clients responded. Data was collected partly by selfreporting and partly through additional interviews.

Main results and conclusions

Diversification of funding sources is currently an important strategic issue in the boardroom of my company/fund.

Diversification within reliable providers of equity and loans is seen as an important issue. Scarcity of banks and delocalisation of banks is seen as problematic. Some respondents say that the real estate industry is too dependent on a few banks, since banks are reducing their real estate lending business.

By 2015-2017 real estate companies/funds will be willing to pay more for their funding to diversify away from banks.

Paying more for funding to diversify away from banks is not an obvious option, because pricing is not always crucial. Yet pricing can be the decisive factor for funding opportunities. Past bank behaviour could motivate some real estate investors to diversify into slightly more expensive funding sources. The respondents warn that increasing margins too much is out of the question. Collaboration by real estate investors with multiple banks instead of one will become more common. This is likely to result in higher costs.

By 2015-2017 real estate companies/funds will be using different strategies to obtain funding from different sources.

We found three main paths for strategic intentions:

1. Continuation of the current strategy with no significant changes;
2. A multiple product approach, looking for more balance sheet financing combined with asset-based financing instead of one product approach;
3. A strategy of looking for alternatives, such as a joint venture partnership possibly with equity sponsors, insurers, debt funds, mezzanine finance providers and bonds.

To what extent is availability and pricing of financing a prerequisite for the implementation of your real estate strategy?

We see variation in answers to the question as to the extent to which availability and pricing of financing is a prerequisite for the implementation of real estate strategy. The type of answer is strongly influenced by the respondents' situation.
Three perspectives could be identified:

1. Equilibrium perspective: respondents who consider the extent to be low seem to fund largely with equity;
2. Operational perspective: respondents who consider it to have a medium impact agree that availability is more important than pricing;
3. Systemic perspective: respondents who rate availability and pricing of financing as having a major impact on their real estate strategy.

By 2015-2017 far more liquidity will become available for secondary real estate compared to 2013.

Respondents offered no identical or unanimous answers to this question. On the one hand it was mentioned that opportunistic funding is and will always be there and they believe financiers will remain reluctant to finance secondary assets.
On the other hand, a correction towards secondary assets is inevitable, especially now when the market is overfocused on prime and because of the imbalance between demand and supply for prime. In some countries this trend is already visible: banks are more open and have more liquidity. Local banks are more likely to be willing to look at such assets, but pricing will be higher.

By 2015-2017 the main debt funding sources for the international real estate industry will be …

In spite of various trends the dominant position of banks will continue, with only a small degree of product innovation. Some respondents see Pfandbriefe as an important way for banks to raise funds. The rise of local banks is an important trend. No other funding alternatives will play a significant role. There are trends in syndicated loans including institutional investors such as insurance companies and corporate bonds for companies which have direct access to capital markets.

Respondents differ in identifying sources of debt funding, but we can group three main sources in order of importance:

1. secured bank funding;
2. insurance companies and securitised products;
3. unsecured lending and other alternatives.

Real estate companies/funds are currently focusing more on bank relationships that demonstrate reliability/certainty of funding.

We see a variety of answers which can be translated into fundamental, critical and pragmatic views. By phrasing this question in this manner we discover that reliability is readily perceived as trust. Interestingly, our respondents emphasise that reliability and certainty have to be seen as a mutual process and are key to the relationship, in contrast to a principal-agent relationship. This is also because there is a reciprocal interest which is based on the same information. Respondents see reliability as dynamic and not as a permanent position, but in a constant state of flux.

By 2015-2017 banks will increasingly be teaming up with insurers, pension funds, sovereign wealth funds and other investors.

The majority of our respondents believe that teaming up by banks is indeed a trend. Banks have knowledge about real estate financing and are expected to play more of an intermediary or coordinating role in the field instead of being the sole lender. Banks are seen as core players in facilitating a more joint platform for institutional lending within Europe. There are interesting parties and constructions which could team up with banks such as investor funds, lower cost capital providers, insurance companies and pension funds. Respondents expect that this will create more liquidity.

What should banks do to get liquidity back into the real estate market?

The banking and real estate industry both live in a kind of 'iron cage' within which they are sustaining one another. This cage is created by regulators, by financiers themselves, and by real estate professionals. In the respondents' view, both financiers and the real estate industry are mainly conservative and much the same. Respondents stress that real estate is - in essence - a good asset class with an acceptable risk and profitability. Innovative products and services seem to be limited. Respondents could not suggest many new innovations, and fell back on easy solutions. They emphasise that much greater liquidity could be made possible by financiers teaming up.

Will CMBS (Commercial Mortgage Backed Securities) re-emerge as a significant source of funding for real estate assets? Will real estate companies/funds standardise their loans/funding more, so that the lending provider can raise money more easily and more cheaply?

Most of the respondents say that real estate CMBS could return to the market, but not on the same scale as before. CMBS are still perceived as 'toxic' instruments by the public. If they do re-emerge, it will be within certain boundaries. Our respondents suggest: simpler; fewer tranches, very small number of transactions/new issues; only for low leveraged and single tranche deals; control on costs of securitisation; not for primary, but for secondary topics; standardisation of documents, security and administrative elements. They state that banks will have to tailor this product, bearing part of the downside risk themselves.

By 2015-2017 real estate lenders will increasingly be focused on the ability of assets to generate sustainable income over the long term rather than day 1 leverage.

For some this is simply a non-question: their response is that prudent lenders always focus on sustainable income. The banks' assessment must be based on more parameters than just cashflow, such as business plans, strategy, quality and marketability of assets and quality of the real estate managers. More pragmatically, they state that a proven track record with sustainable cashflow generating capabilities make banks more willing to lend.

What metrics do you think are likely to apply for each of the following products?

We asked about the different metrics and costs associated with various funding sources. These included secured and unsecured bank lending, corporate bonds, CMBS, debt funds and institutional loans. The respondents report only marginal differences between the various sources.
When asked about costs, for example, only unsecured bank lending is associated with high costs. All other sources are associated with low to medium costs. Another example: Loan to Value ratios are all perceived to be around 50 - 60% on average for all funding sources.

However, when we differentiate between respondents who have experience with one of the funding sources and respondents who have not, differences are noticeable.
The expected minimum portfolio size in particular shows big differences between those two groups. Perceived portfolio sizes tend to be smaller for respondents without experience than for those who use the product.

Chapter 1 Introduction and methodology

Research objectives

The goal of this research is to identify lending trends amongst European real estate investors. What strategies are currently used? What are the developments in attracting debt? And what are the trends for future funding strategies?

Methodology

The survey sample of 55 clients was selected based on the institutional client population of ING Real Estate Finance (ING REF) in Europe. Out of 55 selected clients, 31 responded. Relationship managers conducted personal interviews based on a semi-structured questionnaire. The questionnaire offered room for explanation and elucidation of the answers given. The answers were subsequently entered in a confidential, secure and encrypted database.

The qualitative survey asked for the respondents' view of the financial markets, sources and conditions of available funding and to what extent this matches current real estate investment strategies. Hence this survey can be characterised as a self-reporting survey. This means that all answers and views are the respondents' own and no checks based on ING information were carried out or added. The consequence of this method is that consistency and data quality fluctuate.

Population and case selection

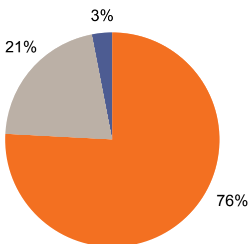
Because there is no insight into the total population of real estate investors in Europe, a representative sample cannot be established from a statistical perspective. The sample was therefore selected strategically for this survey and based on ING REF clients' population. All respondents are institutional investors. Respondents in this research are from real estate companies with real estate in Austria, Germany, Poland, the Czech Republic, Slovakia, Hungary, the Netherlands, Spain, the United Kingdom, Italy and France.

Data collection and data analysis

The duration of the interviews was 30 to 60 minutes between April and June 2013. During these interviews notes were made to be put into an electronic encrypted database for further analysis. Excel was used for quantitative data analysis; qualitative analysis was done in Atlas.ti (thematic analysis).

Chapter 2 Results

1. Diversification of funding sources is currently an important strategic issue in the boardroom of my company/fund



Yes, 76%
No, 21%
No answer, 3%

Diversification of funding sources is seen as an important strategy to reduce risks in a funding portfolio. As one of the respondents told us: 'Investors are more risk-averse so for investments it is much better to have a few sources of funding rather than rely only on one type.' Depending on the underlying real estate market, traditional lending sources have sometimes proved to be too risky. As one respondent says: 'We are using different banks … to achieve the best market rates as well as to avoid overexposure to just one specific bank.'
Diversification of funding sources is a strategic issue for most respondents. In general the current limited availability of debt drives the need for diversification. By doing this they want to control their dependency on banks.

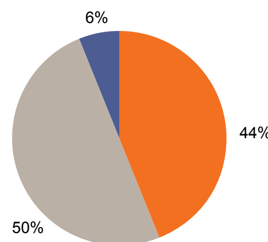
Banks' disengagement from real estate lending and the return of international banks to their home country are regarded as a major problem. This leaves few banks active in the lending landscape. There seems to be a clear trend of banks reducing their exposure to lending and real estate finance in particular. This creates greater dependency on fewer banks. However, one respondent has the opposite view, as he states: 'We have a broad choice of competitive banking partners that satisfy our diversification needs,' or - as another respondent says - 'since we have low leverage on prime assets, there is still funding available.'

Some justify their search for diversification as an attempt to establish lender diversification i.e. a mixed lender portfolio. Others mentioned diversification as a tool for growing the share of non-bank debt in their portfolio. But they are aware that diversification with products such as bonds or US Private Placements (USPP) depends on the size of the assets or portfolio.

On the other hand, in countries like Poland with a reasonable current market situation and a liquid financing market, diversification in terms of type of funding is not the top priority. In those countries companies carefully choose their financing partners and are looking for diversification of lenders with the most reliable (credible) local relationship.

A minority of respondents said that they don't see benefits in diversification. As one says: '...diversification of funding has been a criterion in the funding policy for many years, and look at the effect it has had ...'

2. By 2015-2017 real estate companies/funds will be willing to pay more for their funding to diversify away from banks



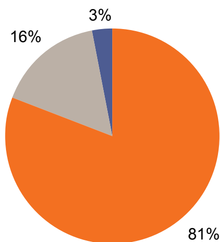
Yes, 44%
No, 50%
No answer, 6%

Half of the respondents believe that real estate investors are not willing to pay more for their funding to diversify away from banks. Pricing is not always the crucial factor for diversifying away from banks.
Some investors are somewhat scared off by the banks' behaviour after 2008. This makes them more willing to diversify into slightly more expensive funding sources. However, paying too much margin is out of the question, as a further rise on top of the costs of secured bank lending is not considered feasible.
Diversification of risk can also come from working with multiple banks instead of just one.
On the other hand, diversifying the funding portfolio can lower the real estate company's risk profile overall, resulting in opportunities to lower total funding costs.

Finally, as a few indicate, pricing can be the most important factor for differentiating between funding opportunities, since this is also expected from underlying investors: 'we are not prepared to pay more if we don't need to.'
If bank lending is more expensive than alternative lending and if a real estate company is constantly looking for the cheapest opportunities, this might be decisive in prompting them to diversify

away from bank lending. But many respondents remain risk-aversive in appreciating lending qualities of banks that other providers cannot easily provide.
Loyalty can also be achieved on the basis of reputation. As one respondent states clearly: ‘operating with other people’s savings, we have to act diligently and can only work with financial institutions of excellent standing.’

3. By 2015-2017 real estate companies/funds will be using different strategies to obtain funding from different sources.



Yes, 81%
No, 16%
No answer, 3%

The question whether real estate companies/funds will be using different strategies to obtain funding from different sources gives rise to a variety in answers. Generally speaking it is undoubtedly a ‘Yes’ (25 out of 31 answers). As one respondent says: ‘the global credit crisis has made it clear that banks are not the source to rely on and not the source for the future.’

We divided the answers into two categories: measures and strategic intentions. Measures are reactions to the current situation without substantial changes in strategy. Strategic intentions can have a substantial impact on the real estate company’s business model.

Measures

‘We are open to using different sources of financing. But we will not use different strategies,’ is how one respondent illustrates this category.

Measures might be standby facilities to react very quickly to market opportunities. The respondents want to attract different sources, depending on current leverage or market circumstances. This can be regarded as opportunistic behaviour. A few respondents talk about becoming more creative in order to attract different sources of money at reasonable price, but with the same strategy.
The main response in this category can be expressed as follows: managing real estate remains the main activity, with long term financing on low LTVs. The likelihood of other sources being more competitive based on robustness is difficult for the respondents to verify. Answers in the category ‘measures’ predominantly suggest that the majority of real estate companies will continue to use the traditional path to obtain funding. The number of different sources will stay small and differentiation will only take place in individual cases.

Strategic intentions

Lack of flexibility from the banking sector and new Basel III regulation will create niches for other (non-bank) lending providers. As one respondent states: ‘we think that with the banks reducing their exposure, other sources will develop.’
One respondent expresses his concern clearly: ‘Other strategies outside the regular lenders are required in order to safeguard the funds’ future…’
For some respondents market practice has shown that working with lower leverage and more capital calls (i.e. a greater proportion of investors’ money) is also an option. We also note comments that compared to the US, the EU bond market is still geared towards high volume bonds and hardly any retail bonds.

Since bank funding is currently dominant, it must be the banks who lead the churn. And not just the bigger banks - even smaller regional banks can jump in.
International financial institutions/lenders are reducing their loan book and refocusing on their home markets or on specific regions and asset classes. The expectation for the coming years is that European institutional entities will develop alternative funding products which might be of interest to real estate companies. It is not just banks that are in the position to create changes. Pension funds and insurance companies will be natural beneficiaries of the market change. But expansion of funding sources will be possible only when insurers or pension funds can solve current operational limitations.

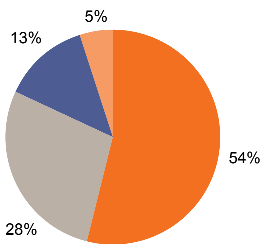
We divided answers on strategic intentions into three categories, as shown in the table below:

Continuation of current strategy	• consistent with current business model, no significant changes in the current sources (i.e. bank financing) in the next 2-4 years. • limited size means limited choice of sources, effectively only secured financing available. ‘More size means more choice’.
Multiple product approach	• more balance sheet financing combined with asset-based financing instead of one product approach
Looking for alternatives	• joint venture partnership possibly with equity sponsor • insurers (not easy due to asset specifics) • debt funds • mezzanine (but not well developed yet) • projects of a more speculative nature where debt funding is more expensive or not easy obtainable • bonds (will be more important)

To conclude, if the picture of the current situation given on the previous page is correct, the question arises: are there many strategic choices at all? The answer is not that clear. We might even conclude that the difference between measures and strategic intentions is wafer thin.

4. To what extent is availability and pricing of financing a prerequisite for the implementation of your real estate strategy?

The question was to what extent the availability and pricing of funding is a prerequisite for the implementation of your real estate strategy. The graph shows the responses to this question: 13% of respondents gave a low score, 28% medium, 54% consider it to be high.



High, 54%
Medium, 28%
Low, 13%
No answer, 5%

Respondents who consider the impact to be low argue that good commercial real estate will always find financing. They have profited from the shortage of liquidity in the past and have good clients with equity available. Someone reports 'we are looking mainly for revolving credit facilities.' Mezzanine or junior loans are also mentioned as means of financing the real estate strategy.

Respondents who propose a medium impact agree that availability of financing has a high importance for capital-intensive real estate funds, while the impact of pricing can be rated medium to low. Availability of capital in a wider context is also dependent on the improvement of stock markets which will change the influence of financing and LTV. The discount to NAV currently blocks the intended growth strategy for some parties that are listed on a stock exchange.

Pricing is always important with regard to competitive advantage, but can be factored into the purchase price of the product. We hear different opinions: one respondent states they will, if required, leverage up their own total investment portfolio outside the fund, another respondent states that this is a driver for further deleveraging through asset disposals. Financing as an issue is strongly differentiated and influenced by local and national specifics.

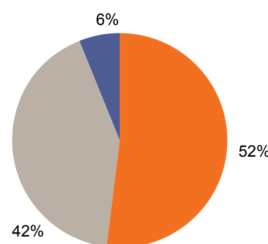
It is obvious that respondents who rate the impact of the availability and pricing of financing on implementation of their real estate strategy as high emphasise the capitalintensive character of real estate 'since financing represents between 40-75% of the capital to be employed.' If there is only limited funding available, asset disposals instead of asset acquisitions will become more important.

A few respondents gave combinations of importance to express extra information. We see combinations like high on availability/ medium on pricing. Retaining a high level of flexibility for business decisions (i.e. without having to involve lenders) is important. Some are even willing to pay more to generate new income.

The variation in answers is strongly influenced by the situation in which the respondents find themselves. Respondents who consider the impact to be low seem to have a good investor base and no equity issues. We would call this a sort of equilibrium perspective. Respondents who suggest a medium impact state that availability is more important than pricing in view of the influence of financing, LTV, competitive advantage, and differences in local and national specifics. This type of reasoning suggests an operational perspective. A somewhat more strategic perspective can be found in the answers from respondents who rated the impact of availability and pricing of financing as high. The few respondents who combined their rating stressed three prerequisites: collaboration with local professionals, flexibility from banks, and tax optimisation. This might be deemed a more systemic perspective.

5. By 2015-2017 far more liquidity will become available for secondary real estate compared to 2013.

Answers to this question are very interesting. They range across all the options: (probably) yes, yes/but, no and yes/no (e.g.: for debt: no / for equity: yes). The score is: Yes - 17, No - 14 and No answer - 2 (multiple answers possible).



Yes, 52%
No, 42%
No answer, 6%

Some respondents with 'some form of yes' think that more liquidity will become available, especially if institutional entities other than banks develop new funding products. Will this influence the funding of secondary real estate? Some state that those entities will probably have a conservative approach and focus (certainly at the start) on prime real estate. The available funding will then spill over to secondary real estate.
Other underpin their 'yes' by pointing to changes to a greater appetite for risk amongst banks and cite specific French and German banks, as we see in this quote: 'Those banks are more and more open.'

Those who responded with 'no' differentiated their 'no' with arguments relating to asset types and the capital position of the banks.

With regard to asset types: liquidity is currently available for secondary assets but it is from equity-only investors who purchase without leverage. Due to capital scarcity at the banks, funding is available for low-leveraged/low risk assets but for higher leveraged/non-prime assets there will hardly be any funding. Funding is only available for prime deals. Some respondents do not expect more liquidity, either for prime or secondary real estate investments.

We also asked our respondents if only opportunistic capital is looking for very high IRRs.
Again we see a variety of answers: yes, no, probably or even 'opportunistic capital is already entering the market.' Some added comments like: it depends mainly on real estate growth, or too great a concentration on core which increases the difference between core and value add.

In analysing the reasons given for the answer as to whether opportunistic capital is looking for very high IRRs, we can group them into four categories:

To summarise these widely varying answers on the question of whether far more liquidity will become available for secondary real estate by 2015-2017 compared to 2013, and whether opportunistic capital is looking for very high IRRs, one might conclude:

- Opportunistic funding is and will be always there, financiers will remain reluctant to finance
- The market is now over-focused on prime. Because of an imbalance between demand and supply for prime, a correction toward for secondary assets is inevitable
- In some countries this correction is visible, banks are more open (and have more liquidity)
- Real estate growth could be a main driver
- Local banks are more often willing to finance such assets.

6. By 2015-2017 the main debt funding sources for the international real estate industry will be …

6.1 Main debt funding sources for the international real estate industry in the near future

What will be the main debt funding sources for the international real estate industry? In other words, what do our respondents feel are the upcoming trends/sources by 2015-2017? They mainly refer to the type of financiers and products.

Financiers: the dominance of traditional banks

The most common answers don't point to a trend as such, but suggest business as usual.
Banks will remain banks and will continue to be the most important source for debt funding, albeit at lower LTVs with a better risk profile. The majority of respondents will continue to obtain funding via the traditional secured bank lending path.
The respondents do identify some minor trends, such as the rise of local banks and a very modest entry of insurance companies, pension funds, debt funds and mezzanine funds. Under Solvency

Conservatism	The gist of these answers mainly suggests that real estate will remain a conservative asset with more conservative IRRs. Opportunistic funding is currently available and will be available in the future. But as one respondent states: 'opportunistic buyers will come to the market but financiers will remain reluctant to finance these assets.' Or with more nuance: 'there will be opportunistic buyers, but probably equity buyers.' Opportunities will rather be sought in prime real estate in exotic markets or in core assets with management issues.
Secondary asset	The market is now over-focused on prime. A correction is inevitable. According to the respondents this will strongly influence the secondary market segment with higher capital availability, both from equity as well as debt. Some respondents argue that banks are now more liquid and they anticipate a move towards secondary real estate only if the overall liquidity for these type of assets improves (i.e. there is demand on the buying side). Some state that liquidity will become available for secondary assets if real estate growth is to be expected. Others argue that there is very limited trading of secondary real estate which makes funding more difficult. And even while banks are currently still willing to provide financing on non-prime assets, the financing spectrum for such assets is more limited (local banks are more often willing to look at such assets). Pricing is higher, structures in terms of leverage and amortisation are more restrictive.
Economy and regulation	Basel III risk costs raise the margin, which kills many deals. One respondent forecasts that if more liquidity is to be available, it will be more towards 2017 than 2015.
Bank behaviour	It all comes down to the banks' capital position/requirements. For low-leveraged/low risk assets there is funding available, but for higher leveraged/non-prime assets there will hardly any funding. Furthermore, banks have trouble finding deals that comply with their risk parameters even if banks are more open to providing financing and the risk appetite is increasing in terms of leverage, structure and asset types including value-added assets.

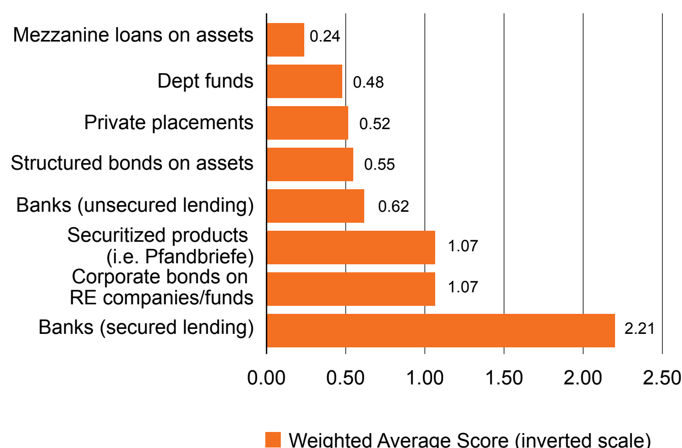
II insurance funds will increasingly add funds to the business. Whereas they now only take large single volumes in the main countries, this will widen to include other types of real estate. One respondent specifically mentioned corporate bonds for companies which have direct access to capital markets, qualifying it immediately by saying that this will only contribute a relatively small portion in total. Others question the dominant position of banks in the future, as we learn from answers like: 'Less banks but more private placements, more DCM, less funding from banks,' and 'Portfolio solutions will become more important than piecemeal transactions.' With all the new regulations, some respondents expect secured financing to become more important, especially for smaller entities. Institutional investors and debt funds as niche players may become more important in the light of significant refinancing requirements.

Products: more of the same, or a little bit of product innovation
The answers mostly relate to existing products such as corporate bonds, Pfandbriefe, private placements, debt funds. The respondents identify some trends. Corporate bond deals are growing in number, so liquidity is increasing. Others emphasise that a long ownership tenor with long funding availability will result in lower leverage, enabling more long capital into the real estate loan market. More Pfandbriefe funding is also mentioned. DCM products will be available but only for those with investment grade rating. Mezzanine combined with bank debt can be a substitute for higher leveraged deals. Retail bonds can serve a small part of the market. Only a small proportion of the respondents believe that the Private Placement market will develop further.

6.2 Top 3 trends for main debt funding sources in the international real estate industry

Respondents do not always seem to be on the same page when it comes to predicting upcoming trends for debt funding sources. Whilst a few indicate that the role of bank financing will diminish, the majority of respondents believe that secured bank funding will remain the most important source of funding. Even though there might be more regulation of this source, secured bank funding is predicted to remain available and affordable and underlines the importance of local market knowledge. Insurance companies and securitised products are seen as interesting growth categories.

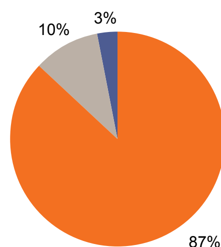
Top 3 trends for main debt funding sources 2013[1]



Alongside secured bank lending, corporate bonds on real estate companies/funds and securitised products are expected to play a significant role in providing debt in the real estate industry by 2015-2017. Mezzanine loans on assets are expected to contribute least.
Two respondents added two other possible categories not included in the question: convertibles and joint ventures.

7. Real estate companies/funds are currently relying more on bank relationships that demonstrate reliability/certainty of funding.

The answer to the question of whether reliability/certainty of funding by banks is seen as the most important driver for relationships is clear. Yes, agree 27 respondents, whilst only 3 feel otherwise (no) and 1 did not respond to this question.



Most of our respondents express views about reliability and certainty as a driver for relationships and position their answers in today's context. Some point to lessons learned from past experience and mention that the latest crisis has shown that with the right partners one can survive a crisis. Regulations are

1 How to read this graph: 29 valid responses were given to indicate the top 3 main debt funding sources for the international real estate industry. These scores have been weighted as follows: no. 1 trends are scored 3, no. 2 trends are scored 2, no. 3 trends are scored 1. For example; out of all 29 responses 'banks (secured lending)' was cited as the no. 1 trend 17 times, as the no. 2 trend 5 times, as the no. 3 trend 3 times. This adds up to a total score of (17 x 3 + 5 x 2 + 3 x 3=) 64, giving an average weighted score of 64 divided by 29 resulting in 2.21.

seen not just as constraints but also as assurance because the counterparty risks of banks are monitored more closely compared to a few years ago. 'Certainty of performance is more important, and that is what bank relationships mean to us,' expresses this well.

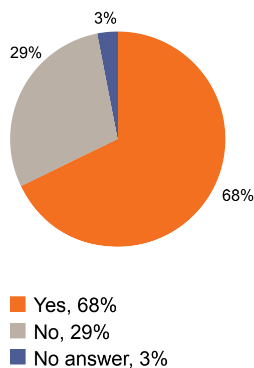
We see this reflected in quotes like: 'building good relationships has always been important, but today it has become even more important' and 'it has always been the case, but recent years have proved that relationships are key.' As we dig deeper into the answers we see that reliability/certainty of funding can unintentionally translate into 'trust' in banks or even into 'mutual trust'. Some respondents even define this as a key focus of their business. Some mention that a strong relationship is useful in order to demonstrate management ability, expressing the view that: 'alongside the pure commercial terms this is the most important factor in choosing our financing partners.' The most explicit comment in this regard is: 'Two-way reliability prevails over pricing, leading to a concentration in banking relationships.'

Our respondents wonder how much choice they have, since the group of banks that have these capabilities has become smaller and consists mostly of continental banks. Relationships are seen as most important, communication is key and this is also the commonly cited disadvantage of DCM/CMBS-type funding: you can't contact your counterparty. And what does reliability mean 'when priority is given to those with the highest exposure or when the conditions of the indicative term sheets usually do not match to the final credit contract?'
The importance of reliability applies to both lenders and borrowers. There is always an open financial market where banks are competing with each other. Reliability is dynamic, not a permanent position, to summarise one of the respondents. The banking market has changed drastically. Not all banks are too big to fail. Counterparty risk is therefore present on both sides.

The pragmatic view

Alongside the fundamental and critical views on this issue, there is also a pragmatic view. Respondents keep it simple and just remark that banks' ability to engage with the fund if issues arise is almost more important, and in case of a defaulting loan it is essential that you can call someone within a bank, as compared to a default situation with a loan from an unknown investor.
And, one respondent argues, borrowers with a long business relationship with a bank do get financing approvals faster. The role of the exchange of information is important according to this respondent: 'Corporates (REITS) aim to use bank's balance sheets for lending and necessary back-up facilities. In return banks are pitching for fee-driven cross-selling. In that respect relationships are becoming more important, although real estate companies only have limited cross-selling to offer their banks.'
It all comes down to the fact that banks like their familiar customers and familiar funds; their business policy is to stick to business ties established in recent years/decades.

8. By 2015-2017 banks will be teaming up more and more with insurers, pension funds, sovereign wealth funds and other investors.



- Yes, 68%
- No, 29%
- No answer, 3%

The majority of our respondents believe that this is indeed the case. As banks currently have most of the know-how about real estate financing and are expected to change into a more intermediary player in this field instead of being the sole lender, banks are seen as core players in facilitating joint platforms for institutional lending within Europe.
This is apparently lacking at the moment, but could provide great competitive advantages to consortia and their clients. Banks could team up with lower cost capital providers who lack the necessary expertise and relationships that banks have. Combining the two could therefore provide a fruitful and ideal combination.

Insurance companies and pension funds are often identified as capital-rich investors to team up with banks, especially in the context of current restrictions and specialisation of the financial sector. Working together will allow greater liquidity. Banks are able to satisfy their lower risk appetite, while more liquid insurance/pension funds can find adequate ways to achieve higher returns on their investments such as in real estate.
Finally many respondents, particularly French specialists, indicate that banks are already moving to an originate-to-distribute business model, making it more logical for them to team up with insurers, pension funds and other investors.

9. What should banks do to get liquidity back into the real estate market?

To classify answers to this question we use a concept called 'organisational isomorphism'. This is based on the view that the biggest factor that organisations must take into account is other organisations. In this view, organisations compete not only for resources and customers, but also for political power and institutional legitimacy, for social as well as organisational fitness. This struggle for survival (always) gives rise to a process of homogenisation, and one way to describe this concept is isomorphism. As a result of this homogenisation survival process, everybody or everything survives, but survives in an iron cage. Three forms of isomorphism are identified: 1) coercive isomorphism that stems from political influence and the problem of legitimacy; 2) mimetic isomorphism resulting from standard responses to uncertainty; and 3) normative isomorphism, associated with professionalism [2].
In the banking industry Basel regulation can easily be identified as coercive isomorphism. It has become a coercive factor by providing the basis for the actions of regulators such as central banks. Surprisingly only two respondents mention Basel III as having an influence on the real estate industry. 'First step,' says one respondent, 'they (the banks) need to finish their 'homework', i.e. stick to stricter BASEL rules as the political/commercial necessity from the outside.' According to another respondent, banks also need to continue to get their house in order before stability can be restored.

Almost in contradiction to this coercive isomorphism we also hear survival responses from respondents. These can be almost described as mimetic isomorphism with minor variations. We can see the beginning of a paradox between these mimetic reactions and the coercive rules. A good example is this answer: 'Reduce the power of risk departments when new rules & restrictions are implemented and managed.' It appears that while Basel III forces one into a Basel III iron cage, respondents are trying to build a parallel - but iron - case for avoiding the Basel III cage.

Some answers in this respect have to do with bank behaviour or bank strategy i.e. 'stop financing only brand new real estate which is 100% leased for 15 years, and where the tenant is a government institute with no break options'. Some blame the banks' mimetic isomorphy, as we see in this quote: 'Banks have similar strategies: top 5 cities, core, no developments. Allocation of liquidity is key, and so is stable equity. They are all pursuing the same financing.'
Many answers on lending policies reflect a recognition that real estate financing benefits from mortgage security and better margins. Increased liquidity could be achieved by banks expanding their allocations to real estate that meets threshold criteria, rather than having fixed allocations each year.
We see comments about how banks should be more flexible when granting loans, show an understanding of economical requirements, be more flexible depending on the type of assets, i.e. increase the leverage a bit to say 70%, be more flexible on secondary or opportunistic projects.
Overall the message is: real estate is a good asset class with an acceptable risk and return.

Some answers could be linked to increasing professionalism (normative isomorphism) at banks, as we see in this brief summary: 'Stable, reliable bank strategy is also important factor.' These answers are mainly concentrated around themes like:

1. Broaden the scope and knowledge
   Realise that real estate financing represents lower risk as it benefits from mortgage security; analyse each and every operation and value it on its merits; finance if and only if the quality of property can be properly assessed; specialisation will matter more; more specialist knowledge in order to be in a better position to assess the various real estate investments so that banks are better able to finance projects that don't appear to be prime at first sight, but are still sound opportunities.

2. Product/service innovation
   Bring new liquidity to the market, leveraging their underwriting and execution skills and commercial network.

3. Teaming up
   Cooperation by competing banks with new lender types to leverage their head start with regard to knowledge of property finance transactions as well as loan operations and market capabilities; a more pragmatic approach towards the current financing market would be one aspect of creating a more stable environment in which liquidity can come back into the market. As one respondent says: '… an environment has to be created in which bottom fishing is not a business objective anymore.' In this respect some respondents identify parties with which to team up: unsurprisingly these are insurers and pension funds. Create a platform that allows all institutional lenders to participate with banks taking the lead because they have the skill, the knowledge and the systems to cater for this; to share funding and provide Pfandbriefe-compatible financing structures, cooperate with new players pushing into the market.

We see a cluster of straightforward answers like: lend more money, take (their) losses and look forward ('but in some countries liquidity has returned to the market') or create trust.

Outliers: do we need more liquidity?
Some respondents question whether more liquidity is an answer at all. Some point to the locked risks of credit contracts. Others refer to granting loans on the basis of proven financial criteria or express the change they would like to see as a solution: grant more loans more in niches of the real estate market instead of going abroad.
They also ask that profit should be stressed over risk. Some respondents state explicitly that there is no inside knowledge about real estate within bank regulators. But that is crucial for detailed monitoring of risk & pricing.

2 DiMaggio, P. J., & Powell, W.W. (1983). The iron cage revisited: institutional isomorphism and collective rationality in organizational fields. American Sociological Review, Vol. 48 (2), pp 147-160.

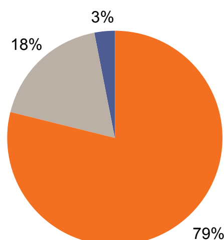
10. Will CMBS re-emerge as a material source of funding for real estate assets? Will real estate companies/funds standardise their loans/funding more, so the lending provider can raise money more easily and more cheaply?

There does not seem to be much of conceptual problem with this product returning, even if it was abused before; its return is still at an early stage, but CMBS as a product is important. Some respondents expect CMBS to return to the market but not on the same scale as it was before the financial crisis and probably only in selected markets. History has shown the disadvantages of this product, such as limited flexibility for asset managers with an impact on liquidity, the inability to communicate with the investors in a direct dialogue, and a mostly complex and diffuse structure.

If CMBS re-emerges, marketing will be difficult due to the public perception of CMBS as toxic instruments which contributed to the financial crisis. Many market participants want to avoid this instrument. If CMBS re-emerges, the respondents expect greater simplicity, fewer tranches, very small number of transactions/new issues, lower run-offs, control on costs of securitisation, not for primary, but for secondary topics and only for low-leveraged and single tranche deals.

Although standardisation is not a new concept, some respondents believe that CMBS could provide an efficient platform for private placements if the documentation, security and administrative elements are structured in a standardised way. One respondent adds that retention rules and originations should remain in-house, servicing rules should be outsourced. Banks will have to tailor/diversify this product.
Some respondents have seen landlords who have started to conclude lease agreements more suitable for Pfandbriefe-financing in order to enhance the liquidity of the property assets and thus support the valuation.

11. By 2015-2017 real estate lenders will increasingly be focused on the ability of assets to generate sustainable income over the long term rather than day 1 leverage.



- Yes, 79%
- No, 18%
- No answer, 3%

The vast majority agree with the statement that by 2015-2017 real estate lenders will increasingly be focused on the ability of assets to generate sustainable income over the long term rather than day 1 leverage. They reason that real estate is a long-term asset that needs to be financed with long-term capital. Sustainable income is therefore also needed to secure debt servicing. One respondent puts this in a broader context by saying that this is true not only for financiers but also for equity investors.

Some respondents tend to see this as a non-question and say: 'has this been different over the past years, this is a natural way of thinking - long and sustainable cashflow has always been a key element for the banks, prudent lenders already do so …' The quality of the asset will be assessed more thoroughly. However, it should not be the only element of the banks' assessment. Asset levels, business plan, proposed strategy, the quality of the asset, the marketability of the asset and the quality of the asset managers are of key importance nowadays. Yet a track record in managing properties should be leading. If there is a proven track record with sustainable cashflow-generating capabilities, banks will be more willing to lend, argue the pragmatic respondents.

The general view is that this is already the case. Cashflow was, is and will be important. LTV will become less important in the future. Even investors want it to fall to lower levels. One respondent argues that both scenarios are realistic: 'Day 1 leverage might help banks to consolidate their current position while long-term exposure will be very important to safeguard their sustained stability.' One of those who responded negatively questions whether a majority of lenders will get to this point and maintain their behaviour in this way.

12. What metrics do you think are likely to apply for each of the following products?

We asked the respondents what they believed would be the minimal required real estate portfolio size in order to be able to apply for various funding sources. These included secured and unsecured bank lending, corporate bonds, CMBS, debt funds and institutional loans.
We also asked about various credit metrics such as LTV, ICR and DSCR associated with these sources. Finally we asked about associated costs.

Overall respondents don't see a big difference in the requirements when applying for the various funding sources. They report only marginal differences between the various sources. When asked about costs, for example, only unsecured bank lending is associated with high costs. All other sources are associated with low to medium costs. Another example: Loan to Value ratios are all perceived to be around 50- 60% on average for all sources.

However, when we differentiate between respondents who have experience with one of the funding sources and respondents who have not, differences are noticeable. The expected minimum portfolio size in particular shows big differences between those two groups. Respondents without experience tend to perceive portfolio sizes as smaller than those who use the product.

Chapter 3 Conclusion

Availability of equity and loans is seen as an important driver for diversification. Scarcity of bank funding and delocalisation by banks is seen as problematic by our respondents. But paying more for funding to diversify away from banks is not an obvious solution because pricing is not always crucial. Past bank behaviour can motivate some real estate investors to diversify into slightly more expensive funding sources. Collaboration by real estate investors with multiple banks instead of one will become more common.

Other ways to diversify and lower the risks are a multiple product approach, looking for more balance sheet financing combined with asset-based financing instead of a single product approach; a strategy of looking for alternatives, such as a joint venture partnership possibly with equity sponsors, insurers, debt funds, mezzanine finance providers and bonds.

In spite of various trends, the dominant position of banks will continue, with the added factor that the rise of local banks is a serious trend. No other funding alternatives will be substantial. There are moves involving syndicated loans including institutional investors such as insurance companies and corporate bonds for companies which have direct access to capital markets.

Respondents differ in identifying debt funding sources, but we can group three main sources:

1. Secured bank funding
2. Insurance companies and securitised products
3. Unsecured lending and other alternatives.

Reliability is readily perceived as trust. Our respondents emphasise that reliability and certainty have to be seen as a mutual process and are key for the relationship, in contrast to a principal-agent relationship. This is also because there is a reciprocal interest which is based on the same information. The majority of our respondents believe that teaming up by banks is the way forward. Banks have know-how about real estate financing, and are expected play more of an intermediary role in the field instead of being the sole lender. Banks are seen as core players in facilitating a more joint platform for institutional lending within Europe. The banks' assessment must be based on more parameters than just cashflow, such as business plans, strategy, quality and marketability of assets and quality of the asset managers. More pragmatically they state that a proven track record with sustainable cashflow-generating capabilities make banks more willing to lend.

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