Real estate senior debt funds

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The global financial crisis has its roots in several interlinked events. The first phase began with the bursting of the subprime bubble and the collapse of Lehman Brothers in 2008-2009, and has led to a loss of trust in the 'too big to fail' view that previously prevailed in the markets.

Financial institutions, unsure about the quality of their counterparties, stopped lending to each other, massively disrupting the interbank lending market. In the second phase, countries had to bail out their banking systems, which led rating agencies to reassess their ratings on sovereign risk. This was a particular issue in the Eurozone, where Greece soon appeared to be close to default with a risk of contagion to other over-indebted countries, which became known as the PIIGS (Portugal, Ireland, Italy, Greece and Spain). The third phase was a 'flight to quality', with a complete decoupling of the cost of debt of Southern European countries from that of countries in Northern Europe. The 10-year German federal bond yield has now fallen to 1.2% (with short maturities offering negative coupons), while the cost of debt for Italy and Spain is unsustainable.

Regulatory response

While the Eurozone countries were struggling with the sovereign debt crisis, regulators were asked to address the failures in the previous supervisory systems. The result is the forthcoming Basel III and Solvency II regulations. Basel III essentially doubles banks' Core Tier 1 capital requirements, and imposes liquidity ratios (Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)) that will profoundly transform their Asset and Liability Management (ALM) models. This will have an even bigger impact on Corporate and Investment Banks (CIB), which largely relied on market funding.

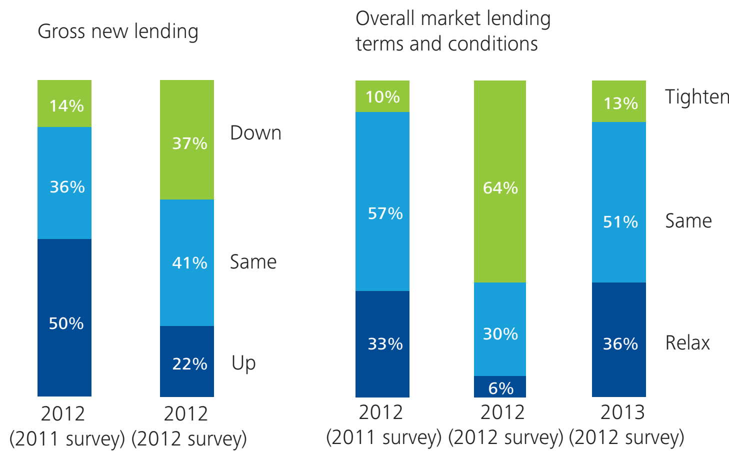
Lending was faced with both the need to hold more regulatory capital and to absorb market funding costs through more effective matching of ALM maturities. Banks are therefore being forced to reduce their balance sheets to meet the regulatory capital hurdle, and to increase their margins to combat increased liquidity costs. Solvency II essentially reassesses insurers' regulatory capital consumption according to risk, thus obliging them to shift their investments away from equity (either listed or unlisted) and towards best-rated debt instruments.

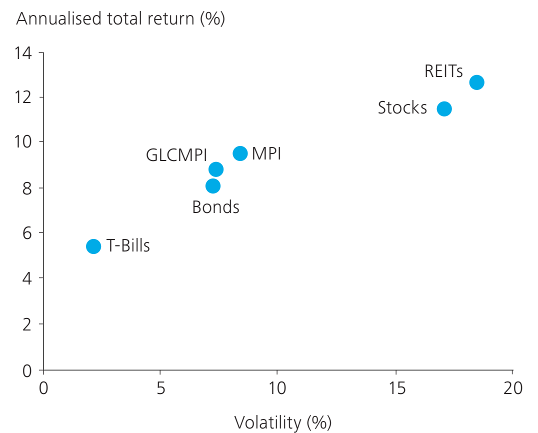
Consequences

Hard-pressed banks have had to reconsider some of their activities, cutting down their exposure to riskier or longer-term lending segments. Real estate lending has been particularly hard hit, with very significant players completely withdrawing from the market, and others refocusing their activity on historical clients, with the aim of bringing in additional fee-generating business (M&A, equity and bond issuance, etc.). All the same, bank liquidity is still available for risk-free investments in central business districts, albeit at a 4-5% cost. The biggest listed real estate investment trusts have massively reduced their leverage and turned to the bond market, where longer maturities are offered at a cheaper cost. Nevertheless, this leaves smaller or leveraged investors out in the cold, facing a stretched funding market. At the same time, Solvency II presents insurers with the challenge of reducing their risk profile while generating decent returns, e.g. to meet obligations to life insurance policy holders.

Filling the void

Equity investment in real estate is capital-consuming as a volatile first loss exposure. Bond investments are unsecured and register lower recovery rates than traditional bank lending. Banks are engaging in massive deleveraging despite reasonably attractive returns. This situation led insurers to start filling the gap, beginning with those already active in this field in the U.S. (e.g. Axa, Aviva, Allianz, Prudential). However, investing in mortgage loans is not as simple as it would seem at first sight: (i) loans are not traded on regulated markets and suffer a disadvantage due to their illiquidity; (ii) loan monitoring needs real portfolio management organisation, and (iii) fund flow settlements are specific (e.g. early repayments). In other words, while global insurers can invest time and money in setting up their own business, smaller players are still weighing up the pros and cons.





Source: DTZ research

Senior loan debt funds

Meanwhile, real estate asset managers, facing institutional client base issues and used to monitoring debt from a borrower perspective, soon proposed to reduce their clients' costs by setting up funds specialised in loan investment. As compared to insurers, they had to overcome one more hurdle: contrary to mezzanine funds, regulatory approval with regard to banks' lending monopoly had to be addressed. This was largely managed by using same-group fronting banks. The banks' loans are then sold to a securitisation vehicle, directly funded by participating investors. It may seem ironic that financial techniques largely responsible for the financial crisis are part of the solution to it.

Although this article has focused on real estate, debt funds are being organised on many fronts to address the challenges in other sectors, e.g. infrastructure, SMEs, LBOs, local authorities. These initiatives obviously need to be undertaken using a highly professional approach, but there is no doubt that this could represent an excellent opportunity for well-advised investors.

To the **Point**:

- Sovereign yields are at all-time lows in safe haven Northern European countries
- Solvency II pushes insurers down the risk curve, but risk-free yields cannot feed their balance sheets
- Basel III leads to bank deleveraging, especially on long-term financing
- Asset managers respond to this context by setting up debt funds:
  - Filling the bank funding gap
  - Responding to insurers' quest for long-term secure yields
- This context creates opportunities for well advised borrowers and investors

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