Focus on real estate debt

Pierre Masset, Partner at Deloitte Luxembourg, interviewed Anthony Shayle, Head of Real Estate Debt EMEA within UBS Asset Management's Real Estate & Private Markets (REPM) business, where they explored market trends, distressed debt and market regulation in the context of debt leveraging.

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Anthony Shayle
With over 22 years of experience in real estate debt, as the Head of Real Estate Debt EMEA, Anthony Shayle is focused on growing the European real estate debt fund business within UBS Asset Management. Prior to joining UBS, Anthony held various senior investment, asset management, debt structuring, finance and accounting positions in the areas of private equity and real estate at Curzon Global Partners, AXA REIM, RODAMCO, BZW and Bankers Trust. Anthony is both a fellow of the Association of the Chartered Certified Accountants and the Royal Institution of Chartered Surveyors.

1. At various occasions in the last few years, we have talked about the "wall of money" coming into alternative investments. Could you please give us a sense of where the market is today, both in terms of supply and demand and how this "wall of money" affects the way in which investments are made?
This is a very interesting question because the so-called "wall of money" has, at varying times, been quantified differently and its source has shifted globally. So if we were to go back far enough, we could say that the money initially came from the US, then it came from the Middle East, and now it is coming from Asia. We could thus say that the "wall" is somewhat of a global tsunami moving around the world according to the wider economic cycle across our planet.

That said, where is the money coming from now? It is clearly coming from Asia at this moment in time. It is hard to go anywhere without seeing the mention of Korean, Chinese (which dominate today's market), and more recently, Japanese money. This proves the substantial growth of these economies. In addition, what characterizes them is the fact that they are moving more and more into pension-planned economies. Therefore, this is a case of global demographics as much as it is about global economics. We also have to recognize that the investment industry, in which we are all working, is based around the source of the money coming out of varying types of institutional investment pockets. We could thus say that it is this demographic shift into pension fund-based economies that is fueling the so-called "wall of money".

In terms of the supply and demand, we see a direct correlation between the volume of transactions in the real estate market and the opportunities for debt financing (if the first one falls, the second must, by definition, fall as well, because real estate transactions are predominantly leveraged). We have observed a trend shift from very highly-leveraged transactions pre-GFC (global financial crisis) to lower-leveraged ones.

To put that in context, the market has gone from 75–80 percent senior debt leverage, pre-GFC levels, down to 60–65 percent. This means that while there is still demand for debt, it may be marginally smaller. The debt market follows the trend of the investment transaction market – if the latter falls away, the former will follow suit. This implies that loans will run to term. This point is crucial because, as the market continues to grow,

one would expect debt transactions to repay earlier than the stated maturity points. However, as the market turns over from growth to contraction, people who own real estate may choose not to sell it, which means they do not repay early, and consequently loans run to maturity.
To this end, one of the key indicators for the state of the market is whether or not loan maturities are shorter than stated or are actually running to term. Of course, we are all so familiar with the consequences of loans running beyond term; we have seen that over the last 10 years. To sum up, one of the things to bear in mind is that the choice between an equity only investment and a leveraged equity investment (ie. with debt) is driving banking markets worldwide.

2. How does this change the way you allocate capital? On a day-to-day basis, as a fund manager, how does this change the way you look at things, given that we could potentially be near to a top-of-the-cycle moment?
Indeed, there is a high probability that you could be lending or investing at the top of the cycle. I think it is very difficult to judge the exact point at which the cycles will turn over. It is very evident that when you are close to the top of the cycle, you do change your investment strategy. Therefore, as early as 2013, we started raising a lending product linked to part of the upside on real estate. Our view as advised to our team, as well as the investors coming into our fund, was not to focus on central London as a target for deploying capital. By doing so, we have carefully avoided substantial exposure to central London. Instead, the focus has been on a) anywhere outside of prime central London and b) alternative sectors that could offer the possibility to generate yield on the equity investment made, in other words, sectors where there is likely to be cap rate compression, and where there are prospects of further income growth.

3. In the debt space, in the last year we have seen a large portion of loans coming from banks' de-leveraging; where do you think we are in that process?
It is fair to say that the UK market has probably done most of the clearing out of distressed debt and non-performing loans (NPLs). Many people seem to be fond of NPLs now, but as a traditional lender, the preference is to originate debt with our own due diligence. Hence, from my perspective, the sooner the market is clear, the more likely you are to find stable lending opportunities. As mentioned previously, it is believed the UK has pretty much cleared itself. Spain has completed a large part of its work and Germany and France have clearly done theirs. There is one country remaining – Italy. This presents a great deal of opportunity though, as the one thing that really matters in the NPL business is the ability to assume control of your asset. In my view, one of the things having held back the Italian market from international lenders is the enforceability of its charges and, in this respect, the NPL process in Italy must address this problem and find a solution to it.

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4. Do you think a rising interest rate environment is likely to change the current picture when it comes to real estate debt?
This is an interesting question. No, it should not, but in practical terms, it can be. The issue is the cost of capital. So, in the case of rising interest rates, is the rise driven by central bank policy or by the risk push resulting from investor appetite? If it is caused by central bank policy, everybody's interest rate should be rising, and so investors should be on a level playing field. On the other hand, if it is caused by risk profiling, ie. investors taking a different perspective, then that creates opportunities in the market, and, ultimately, one person's risk is another person's opportunity.

5. Could you please share with us your views on leveraged debt funds?
This is a phenomenon that has been seen in the US and is now "coming to a theater near you". There is a very early indication that debt funds across Europe are now starting to look at leveraging themselves. Let's start with the basic principles.
Is leverage a bad thing? A subsequent question would be, why put it there? There are two main reasons:

- The first one is that leverage may be used as a subscription line in order to manage draw-downs, in order to avoid taking huge chances with equity in the balance sheet and dragging down performance, which can be considered perfectly legitimate
- The second reason is to boost returns

If we look back historically, 2013–2014 real estate lending returns were great; they were potentially outstripping traditional equity, which many investors became accustomed to seeing. Nevertheless, that could not last, and today the returns we see are much more constrained. Therefore, some fund managers find it perfectly legitimate to add some leverage to lift the return base, because investors seek superior levels of yield. It is of course perfectly fair to do that, but what everybody has to remember is that leverage brings volatility to equity level returns. So the question then becomes, would it be acceptable to leverage a debt fund? And the immediate reaction I always receive from investors is "no, you are not putting debt on debt". However, a distinction should be made between the debt taken on board (which is a liability in the balance sheet) and the debt leveraged upon debt (which is an asset in the balance sheet). To this end, leverage, in a debt fund, is not unlike that in a real estate fund. The only real difference is that for debt, it is leveraging contractual assets as such the related liabilities, interest rates and maturity exposures should be monitored and matched and, of course, the debt level should be kept within reasonable debt targets.

6. So you think that if we stay within those reasonable debt targets, regulation is not really required?
The more you leverage your debt portfolio, the more you look like a bank. Need I say more?