22 September 2015

European Real Estate Debt Funds - Full Armories Facing a Changing Battlefield

Special Report

www.scoperatings.com

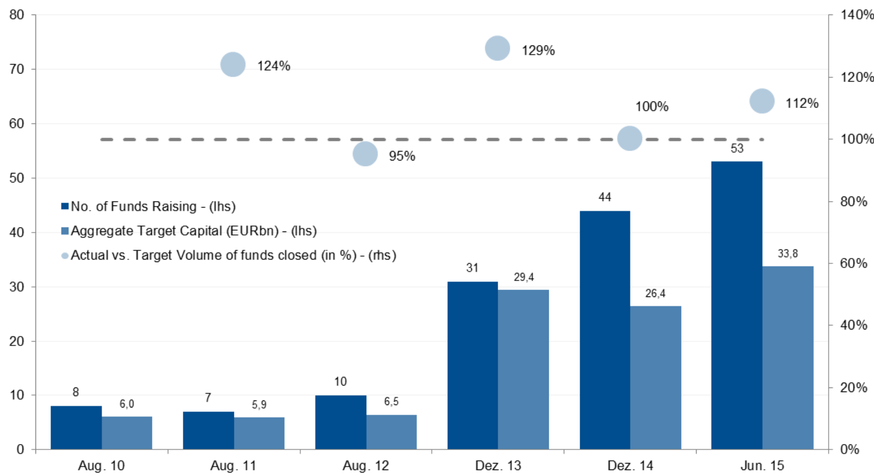
Overview

European real estate debt funds have gone from strength to strength over recent years with growth driven by both the asset and liability sides in funds. However, Scope predicts this to be a slowing trend. While demand for real estate debt funds is expected to remain high or even increase further, increased liquidity in Europe's commercial real estate (CRE) lending markets will intensify competition for assets, making it harder to source assets suitable for meeting investor's risk-return profiles. To stay ahead of the curve, real estate debt fund managers need to demonstrate flexible and innovative lending strategies, as well as operational strength, to put available money to work efficiently.

European real estate debt funds continue to grow

2015 is on track to be record-breaking for European real estate debt funds ('debt funds') with the number of funds and target capital raising by mid-year 2015 already above the 2013 full-year record. With 53 funds and an aggregate target capital of EUR 33.6bn as of June 2015, growth of European real estate debt funds has kept its momentum since late 2012. The positive market reception of real estate debt funds is also reflected in strong placement volumes for funds since 2011, with most vintages showing actual placement volumes exceeding target levels.

Figure 1: Trend in funds placed



Sources: INREV, Bloomberg, Capital Watch, SEC, PEI, Scope Ratings

Debt funds own pools of financial assets in the form of financial claims or debt issuances. They issue capital in either fixed or variable amounts. Common asset classes include secured/unsecured bonds and loans exposed to corporates, real estate, project finance and infrastructure.

Analyst

Harald Berlinicke, CFA
Director
+49 (0)30 27891-226
h.berlinicke@scoperatings.com

Philipp Wass
Associate Director
+49 (0)30 27891-253
p.wass@scoperatings.com

Press

André Fischer
+49 (0)30 27891-150
a.fischer@scoperatings.com

Business Development

Stephan Geiger
+49 (0)30 27891-143
s.geiger@scoperatings.com

Scope Ratings AG
Lennéstraße 5
D-10785 Berlin

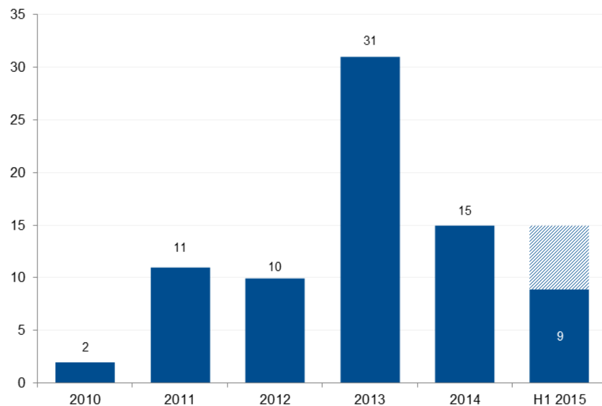
Phone +49 (0)30 27891-0
Fax +49(0)30 27891-100
Service +49(0)30 27891-300

info@scoperatings.com
www.scoperatings.com

No increase in fund inceptions but larger volume expected

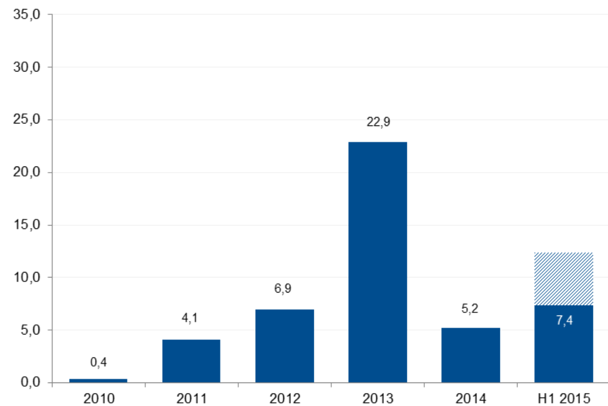
Ongoing demand for alternative lenders and adjustments of debt funds targeted loans will help outpace the drop in 2014 fund issuances (Figure 2) and targeted capital (Figure 3). Scope expects the number of vehicles this year to be similar to 2014 levels but with significantly larger target capital volumes.

Figure 2: Trend in funds by vintage



Sources: INREV, Bloomberg, Capital Watch, SEC, PEI, Scope Ratings

Figure 3: Trend in targeted fund size by vintage (EUR bn)



Sources: INREV, Bloomberg, Capital Watch, SEC, PEI, Scope Ratings

Demand boosted by search for yield and new regulatory framework

The two most prominent reasons for strong demand are: i) institutional investors' ongoing hunt for yield in a painfully low interest rate environment; and ii) a favourable amendment in the regulatory framework for institutional investors in Europe. In particular, the currently strong demand for debt funds among German insurance companies and pension funds can be explained by changes in the German insurance supervision law (Versicherungsaufsichts-gesetz - VAG).

New regulatory framework very supportive

VAG differentiates between pension funds and smaller insurance companies on one hand, and large insurance companies on the other. While the former will still be governed by the German investment regulations (Anlageverordnung), even after Solvency II, the latter will be subject to Solvency II as of January 2016.

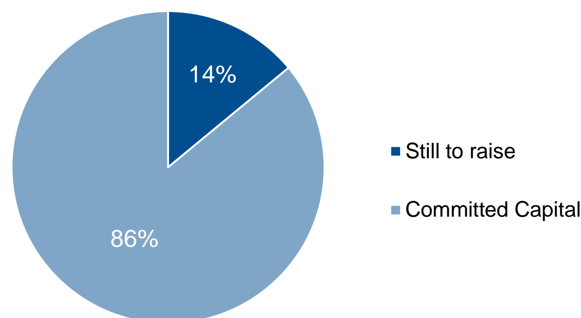
The expected treatment of debt funds under the two different regimes can be summarised as follows:

- Anlageverordnung: 'Transparent' debt funds with look-through reporting on underlying assets qualify for quotas of up to 50% depending on LTV and ranking of the assets; 'untransparent' debt funds qualify for the 7.5% AIF bucket or the 7.5% ABS bucket (if the investment format is structured/note participation).
- Solvency II: Risk-based capital requirements based on 'look through' for the rating, duration and currency of the debt fund's underlying assets. The higher the assets' credit quality, the more headroom exists to include debt funds in a large insurer's investment portfolio.

Accelerating funding ratios…

Furthermore debt funds continue to attract investors who are hunting for yield in the low-interest environment caused by the ECB's monetary policy. Both aspects – regulatory change and monetary policy – have accelerated funding ratios in European debt funds to 86% in June 2015 from 47% in February 2014.

Figure 4: Funding ratio of funds (Vintages 2010-15)



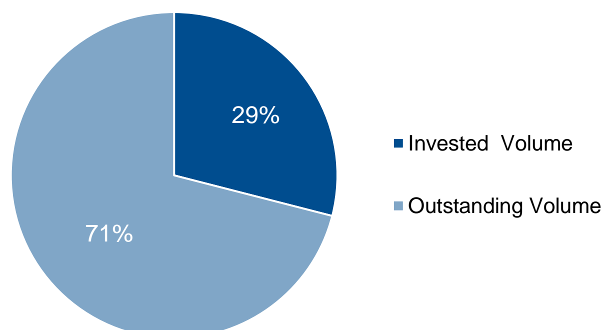
Sources: INREV, Bloomberg, Capital Watch, SEC, PEI, Scope Ratings

Relatively low minimum investment thresholds and the ability to delegate portfolio management to specialised real estate asset managers further increases this asset class's attractiveness for institutional investors, allowing them to supplement and diversify their investment portfolios at little marginal cost.

…meets low invested volumes

However, the persistently low invested volume of 29% as at June 2015 (February 2014: 19%) reflects the difficult market in which debt funds operate. Scope believes this is due directly to increased competition from commercial and mortgage banks as well as large insurers with inhouse asset specialists, which compete with the funds amid a scarcity of compelling assets.

Figure 5: Investment ratio of funds (Vintages 2010-15)



Sources: INREV, Bloomberg, Capital Watch, SEC, PEI, Scope Ratings

QE brings banks back into play

European real estate markets no longer lack funds

A reason for the persistently low investment ratios among debt funds – banks are back in the game. According to DTZ[1], most of Europe's real estate markets no longer suffer from a lack of funds. Nowadays markets are confronted with the 'Great Wall of Money' illustrated by GBP 60bn of capital available to fund commercial real estate in the United Kingdom (UK), compared to just GBP 37bn of lending opportunities this year[2].

Banks competitive again – turning up the heat on debt funds

The flood of liquidity has led to reduced target spreads among banks (see Appendix II), increasing their competitiveness vis-à-vis debt funds and leading to an increase in their commercial real estate lending (see Appendix III). In return this has put more pressure on debt funds to lower target returns or change their targeted risk profile, confirming Scope's prediction of stretched risk-return expectations published in March 2014.

Debt funds forced to review strategies

Since debt funds typically market fixed absolute returns to investors, they are now forced to review their strategies to respond to increased competition among lenders.

Watch out for real estate debt's track record

Disappointing long-term annual returns on property debt of -0.5%

The demand for real estate financing comes against a backdrop of new research by CBRE[3], showing that long-term returns on commercial real estate debt have struggled to break even. Gains from long periods of stable returns averaged 2% to 5% p.a. over the past three decades, but were wiped out by periodic crises in which returns fell to as low as -20%. As a result, the average annual return on risk-weighted assets was -0.5% over the past 27 years.

This contrasts greatly with returns achieved by equity investors in commercial real estate. According to a study by the Research Foundation of the CFA Institute, investing in CRE equity has provided investors with healthy through-the-cycle returns of 7.0% for the period of 1984-2009[4], mainly because they benefit from significant property value increases in bullish markets. This more than compensates for losses during downturns, unlike debt investors who have limited upside potential on property price.

Debt fund managers: between a rock and a hard place

Debt funds: number of options stay competitive

Under pressure to produce long-term debt yields, as well as competition from banks and the biggest insurance companies, how can debt funds compete and what should investors look out for? Scope believes that i) lower target returns, ii) higher leverage or iii) a broader range of assets are the main adjustments available to debt funds to stay competitive.

For debt funds, Scope sees the potential in subordinated financing with loan-to-values (LTV) above 60%, or for stretched senior financing (LTV up to 75%). These are areas, as an example, where only few German mortgage banks get involved as most banks still exhibit pronounced risk aversion.

---

[1] DTZ Insight "Available capital reaches new peak record level", April 2015
[2] PEI Alternative Insight, Private Debt Investor – Annual Review 2014, March 2015
[3] Financial Times, "Lenders pour cash into UK property market", 22 May 2015
[4] Research Foundation of CFA Institute, June 2012

Figure 6: Distribution of tranches and interests outside banking sector

Financing Tranche	LTV-category approx., in %	Financiers	Yield approx., in % p.a.
Senior loans (real estate lending)	0 to 50	Insurers, pension funds	above Bunds / Pfandbriefe
Senior loans	0 to 75	Insurers, **debt funds** (senior debt strategy)	4-6
Junior mezzanine loans	60 to 85	**Debt funds** (subordinated debt strategy)	5-15
Equity (capital substitution preferred equity	80 to 95	Private equity funds, specialised institutional investors / familiy offices	15-30

Increased focus on Spain and Italy

Another option is a dedicated regional strategy. With investors persistently focusing on the UK, France and Germany, Spain and Italy are somewhat neglected – though they may be the next centre of attention. In fact, as secondary targets, Spain and Italy attract investor interest similar to the UK and Germany, highlighting the increased attractiveness of these two markets today. This is due mainly to:

i. valuations rising from troughs reached in Q4 2013[5];
ii. a strong year-on-year increase in CRE investment activity of 131% in Spain and 58% in Italy as at Q2 2015[6]. Growth of investment activity also fuels growth in new lending opportunities; and
iii. high margins of 180 bps (Spain) and 250 bps (Italy)[2] compared to the top 10 CRE markets by investment activity.

Both banks and debt funds have role to play, on specific deals too

Scope believes there is plenty of room for banks and debt funds to come together and team up on transactions: banks would take the senior part of the capital structure and debt funds, the mezzanine part of the financing.

Operationally strong debt funds compete for pole position

Debt funds remain an attractive financing partner and investment provider

Along with debt funds' ability to source and secure attractive assets, their success will also be driven by their flexibility in adjusting to borrowers' demands. Debt funds – with their generally faster decision-making processes, fewer covenant requests, and more headroom or ability to offer tailored facilities – will be a choice for borrowers searching for different financing sources. This would allow them to become the lender of choice, even if they might not be the cheapest kid on the block, allowing them to generate a valuable yield pick for institutional investors.

Assisting institutional investors with regulatory look-through requirements a key differentiator

Operational strengths will play a part too. With the apparent benefit provided by investors' ability to have look-through assessments on all debt fund assets, the debt funds' risk assessment tools or its ability to provide regulatory accepted credit assessment on a name-by-name basis will become a key differentiator among debt funds.

[5] IPD September 2014
[6] CBRE Q2 2015

Outlook

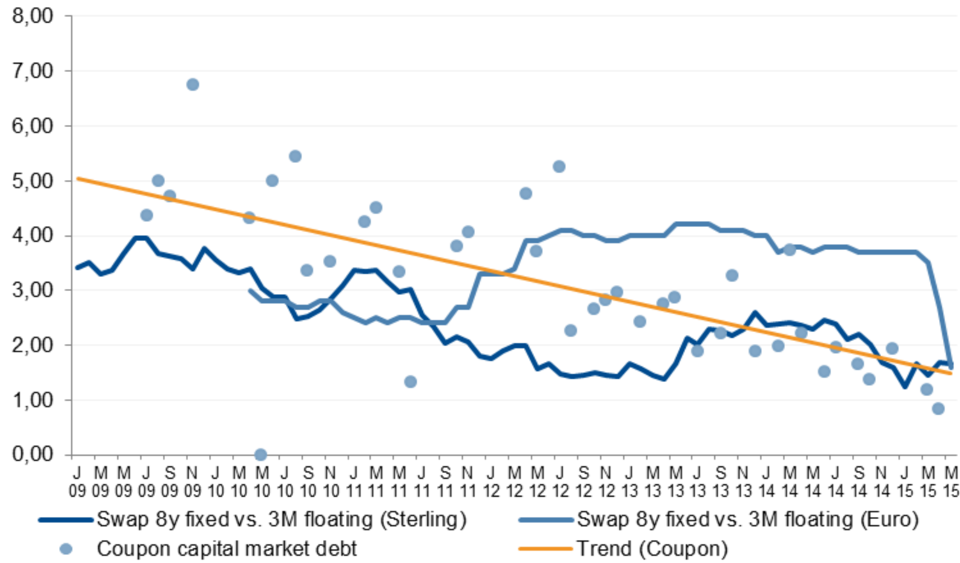
Without a doubt, CRE financing in Europe will have a larger and more diverse pool of credit providers, in which banks will continue to be the bedrock. Scope believes borrowers will profit from the larger range of potential financing sources, which will have a favourable impact on default rates in European CRE debt and maturing CMBS transactions in the short-to-medium term. Nonetheless, Scope expects consolidation in the European CRE debt fund market and sees risk of negative returns for investors in the long run.

Appendix I: Funds focused on European Real Estate Debt

Fund	Vintage	First Close	Size (USDm)	Target (USDm)
Aalto Commercial Real Estate Loan Programme	2013	--	629	1.945
Aeriance Mezzanine RE Debt Fund (AMREF3)	2013	--	--	555
AgFe Senior Debt Fund II	2014	2014	857	857
Agora Invest REM 2 SICAV SIF - Residential	2014	--	--	111
Algebris NPL Fund 1	2014	2015	444	444
Amplus Finance (Cairn Capital + CBRE)	2013	--	--	1.572
ASSET BANCARI IV	2013	--	--	277
Aviva Investors UK Commercial Real Estate Senior Debt Fund	2013	2013	512	786
Blackstone Real Estate Debt Strategies II LP	2013	--	3.500	3.000
Caerus Real Estate Debt Lux. S.C.S, SICAV-SIF, Fund I	2013	2014	133	333
Cerberus Institutional Real Estate Partners LP Series Two	2008	--	493	4.000
Chenavari Real Estate Debt Strategy (Sub Fund 2)	2011	--	222	1.110
Chenavari Real Estate Debt Strategy (Sub Fund 1)	2011	--	100	166
Cheyne Real Estate Credit Holdings III	2014	--	--	666
Colony Distressed Credit and Special Situations Fund IV LP	2015	--	--	2.000
Commercial Real Estate Debt Fund	2014	--	213	213
DAWM CRE senior loan fund	*2015*	2015	832	832
Deka Realkredit Klassik	2009	--	652	2.219
European Real Estate Debt Fund II	2013	2014	765	629
German Real Estate Debt Fund (BNP)	2015	--	133	333
Greenoak UK Secured Lending Fund	2014	--	--	472
Henderson Senior Secured Real Estate Debt Fund	2012	--	779	1.572
Hermes Real Estate Senior Debt Fund	2013	--	629	1.572
ICG-Longbow Senior Secured UK Property Debt Investments Ltd	2013	2013	163	163
iii-investments Real Estate Debt Fund II	2013	--	222	277
La Banque Postale Asset Management Hybrid Fund	2013	2014	666	1.110
LaSalle Residential Finance Fund I	2013	--	--	377
LaSalle UK Special Situations Fund I	2012	--	236	126
Leimdörfer Real Estate Capital I	2015	--	--	555
Leimdörfer Real Estate Capital II	2015	--	--	555
LFP Creances Immobilieres	2013	--	255	444
LFP Property Senior Bonds	2013	2013	284	444
LFP Senior Loan Club	2014	--	--	333
Matrix Commercial Mortgage Fund	2010	--	--	314
Omni Secured Lending Fund I	2014	--	0	100
Omni Secured Lending Fund II	2015	--	45	250
Opportunities Real Estate Fund 1	2013	2013	377	377
Opportunities Real Estate Fund 2	2014	--	102	786
Origin Capital	2015	--	--	111
Palmer Vinci Construction Fund	2011	--	--	--
Partners Group Real Estate Income 2014	2014	--	110	314
Pluto Finance	2013	2013	305	566
PMRP Preferred LLC	2010	--	106	125
Pramerica Real Estate Capital V L.P.	2014	--	294	294
Predirec Immo 2019 Fund	2012	2012	311	444
Prime London Residential Development Fund II	2014	2014	--	236
Score Real Estate Loans	2013	--	113	444
Senior Debt Fund	2012	--	--	472
Senior European Loan Fund	2012	--	359	555
Standard Life Property Debt Fund	2014	--	164	393
TIAA Henderson Real Estatet Enhanced Debt Fund	2015	2015	217	786
UBS Participating Real Estate Mortgage Fund (UBS-PREM)	2013	--	220	786
Venn Partners Commercial Real Estate	2013	--	--	786
Zencap Asset Managment Real Estate Debt Fund I	2013	--	--	111

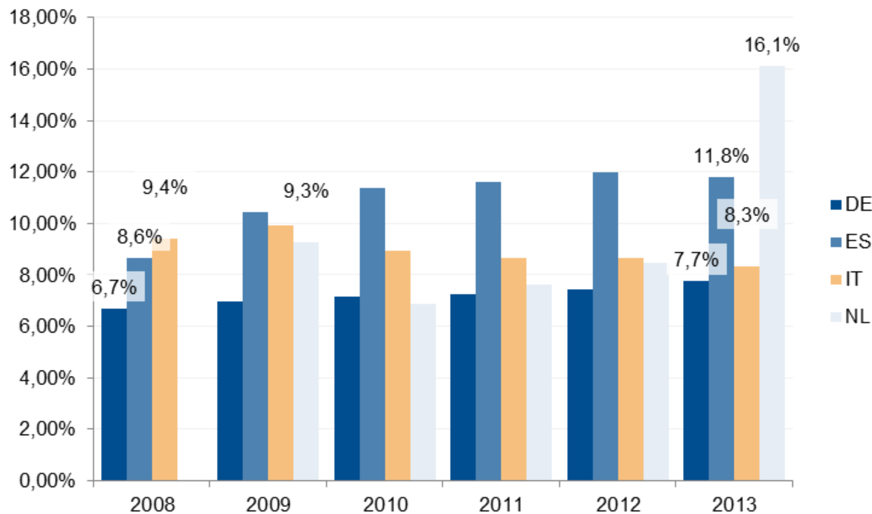
Sources: INREV, Bloomberg, Capital Watch, SEC, PEI, Scope Ratings

Appendix II: Coupons of CRE related capital market debt vs interest rate swaps (same duration)



Source: Bloomberg (26.06.2015)

Appendix III: CRE exposure as a percentage of risk-weighted assets



Sources: EBA, Scope Ratings

Scope Ratings AG

Headquarters
Lennéstraße 5
10785 Berlin
T: +49 (0)30 27891-0
F: +49 (0)30 27891-100
Service: +49 (0)30 27891-300

London
The Gridiron Building
8th floor
One Pancras Square,
London, N1C 4AG
T: +44 207 554 8638 / +44 207 554 8615

Frankfurt am Main
Rüsterstraße 1
D-60325 Frankfurt
T: +49 69 97 944 754

Paris
21, boulevard Haussmann
F-75009 Paris
T: +33 1 53 43 29 89

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid
Phone +34 914 186 973

info@scoperatings.com
www.scoperatings.com

Disclaimer

© 2015 Scope Corporation AG and all its subsidiaries including Scope Ratings AG, Scope Analysis GmbH, Scope Capital Services GmbH (collectively, Scope). All rights reserved. The information and data supporting Scope's ratings, rating reports, rating opinions and related research and credit opinions originate from sources Scope considers to be reliable and accurate. Scope cannot however independently verify the reliability and accuracy of the information and data. Scope's ratings, rating reports, rating opinions, or related research and credit opinions are provided "as is" without any representation or warranty of any kind. In no circumstance shall Scope or its directors, officers, employees and other representatives be liable to any party for any direct, indirect, incidental or otherwise damages, expenses of any kind, or losses arising from any use of Scope's ratings, rating reports, rating opinions, related research or credit opinions. Ratings and other related credit opinions issued by Scope are, and have to be viewed by any party, as opinions on relative credit risk and not as a statement of fact or recommendation to purchase, hold or sell securities. Past performance does not necessarily predict future results. Any report issued by Scope is not a prospectus or similar document related to a debt security or issuing entity. Scope issues credit ratings and related research and opinions with the understanding and expectation that parties using them will assess independently the suitability of each security for investment or transaction purposes. Scope's credit ratings address relative credit risk, they do not address other risks such as market, liquidity, legal, or volatility. The information and data included herein is protected by copyright and other laws. To reproduce, transmit, transfer, disseminate, translate, resell, or store for subsequent use for any such purpose the information and data contained herein, contact Scope Ratings AG at Lennéstraße 5 D-10785 Berlin.