

Debt goes slow and steady



Guest comment by **Paul House**

Banks are playing it safe in CRE and that discipline is reaping rewards, writes a managing partner at Venn Partners

While ‘past performance is not an indicator of future success’, there is merit in reflecting on the trends from the previous year to help guide market players as to what the future holds. In the commercial real estate loan market, the trends of the last 12 months indicate, at least from the vantage point that Venn occupies, a debt market that is in a ‘slow and steady’ environment.

Debt is currently in its rightful place; it follows the commercial real estate market and does not lead it as was the case in the previous 2007-2009 cycle.

Critical to evaluating the past year is a review of the activities of the market leaders who dominate the CRE lending market in Europe: the national and international banks. Across the EU, with the possible exception of Germany, bank lenders have predominately focused on the lower risk core markets with modest incursion into the core plus and value-add sectors.

Whilst credit pricing has decreased over the past year, this is not a unique feature of the CRE debt market and follows lower credit spreads in the broader fixed income markets.

Importantly, the continued regulatory focus on bank balance sheet strength combined with the shared memory of the 2007-2009 near-death experience have meant that banks have focused on the less risky core real estate markets; this has also kept leverage levels low and interest coverage ratios relatively high.

The corollary to this is that it has enabled the well-publicized growth of non-bank, alternative lenders, such as Venn Partners.

The growth of the number of these firms, and the capital available to them, has created a deeper, more varied CRE market. Alternative lenders have grown market share and focused on attractive markets where the banks are less able to, offering investors interesting returns as a result.

Examples include loans secured by value-add properties that offer attractive investment returns, or longer term loans which works well for insurance companies that seek investments to match their long-term liabilities.

The result of this slow and steady upturn is a market where leverage has been, for the most part, in check.

As an example, the retail property market has witnessed sharp value and cashflow declines brought about by the changes to the occupational market and the impact this has had on the investment market.

Whilst the retail asset class has illustrated volatility, the debt markets slow and steady backdrop has meant that, whilst volatile, the impact has not resulted in severe market disruption. In the UK, we have witnessed 60 to 65 percent LTV senior loans from the 2014-2015 financing vintage becoming 95-plus percent LTV loans in 2019. Here, the discipline of the new CRE debt markets has had some benefit – the distress of the underlying real estate did not extend into creating distressed lenders.

Lower going in leverage has mostly spared senior losses or mitigated the size of the loss. Those alternative lenders that did deploy capital into this area came from a broad base and whilst impacting fund IRR performance, a diversified and wide range of lenders served to disperse the impact on the industry.

Vigilance is always warranted, but the CRE debt market that exhibited a slow and steady pace during 2019 has the benefit of a market where leverage is in check, and the benefits of a deeper market help insulate any credit events that do occur. Perhaps a bit dull, but that is just the market the debt world likes. ■

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