KEYNOTE INTERVIEW

Alternatives filling the financing gap


The aversion to risk among traditional lenders is creating notable opportunities for alternative debt financing instruments, say Curth-C. Flatow and Kim Jana Hesse of German real estate debt advisory FAP Finance

The pandemic's grip on European real estate markets may have started to recede, but now the industry faces rising inflation, hiked interest rates and surging commodity prices, triggered by the war in Ukraine. These maladies, combined with wary banks offering stricter loan terms, are proving a boon to alternative lenders, argues Curth-C. Flatow, founder of German debt brokerage firm FAP Finance, and Kim Jana Hesse, FAP's head of capital partners.

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Q How has the German debt market developed over recent years?

Curth-C. Flatow: I think you have to divide the market into two phases: before Ukraine and then afterwards. Of course, we also saw significant changes during the pandemic, but that has improved. Since the outbreak of the war, there is a lot of uncertainty in the market, whether for German lenders or non-German lenders.

Lenders, especially the mortgage and savings banks, are becoming very selective about doing business. They are very cautious because from their perspective this is a very uncertain market, whether we are talking about cashflows, LTVs, pre-leasing quotes or pre-sales quotes. If there is one word that characterises the German market right now, it would be 'uncertainty'.

Kim Jana Hesse: While the classic bank lenders are stepping back and being more cautious, alternative lenders are seeing more opportunities, particularly in this rising interest rate environment. Even then, it is getting more challenging to find the right lenders, even to find the right alternative lenders. However, I do think there is still enough capital in the market for each deal if you have the right network.

Meanwhile, there is definitely a preference to finance existing buildings rather than new developments. Most lenders say they would prefer existing buildings if they have a choice.

Q How are wider factors such as the war in Ukraine, rising commodity prices and high inflation influencing real estate financing?

CCF: I would say it is causing a lot of restrictions and leading to people being cautious. Classic lenders are saying the better deal is no deal, even if the leverage is low. This is largely because of uncertainty on how prices and values will develop over the next 12 to 18 months.

The banks have already been pretty restrictive in the past, calculating debt yields, which are already far above real interest and amortisation – so that in itself is not a new development. Where you are now seeing existing buildings preferred, instead of new developments, that is driven by inflation.

KJH: Factors such as rising commodity prices and supply chain disruptions have an impact on the underwriting process of lenders. The lenders have an even bigger focus on risk buffers and the sponsor's equity capitalisation in order to compensate possible building cost increases.

Q How are investors thinking about real estate as a hedge against rising inflation?

CCF: We are currently having a discussion with some investors who want to buy existing portfolios of multifamily buildings and wanted to split it up and sell the single units to capital investors. They are seeing significant demand as private investors view real estate as protection against inflation.

I cannot confirm the investment interest from institutional investors at the moment, as what we are hearing and seeing from them – that is, not the asset managers but the direct insurance companies and pension funds – is that some are very cautious. This is because the significant fall on the stock market has changed their asset allocation in a significant manner and some of them simply had to stop business because they needed to relocate their asset allocation.

Q Against the economic headwinds, what are the advantages of lending strategies becoming more specialised?

CCF: The bottom line for lenders at the moment is that they have a more interesting risk-return profile because they can ask for higher margins or higher interest but can offer a lower leverage because the banks are being more cautious. That is definitely offering opportunities for the non-bank sector.

We have investors who believe in the market in the mid- and long-term basis, not in the short-term basis, who are buying and who are profiting from the non-bank market.

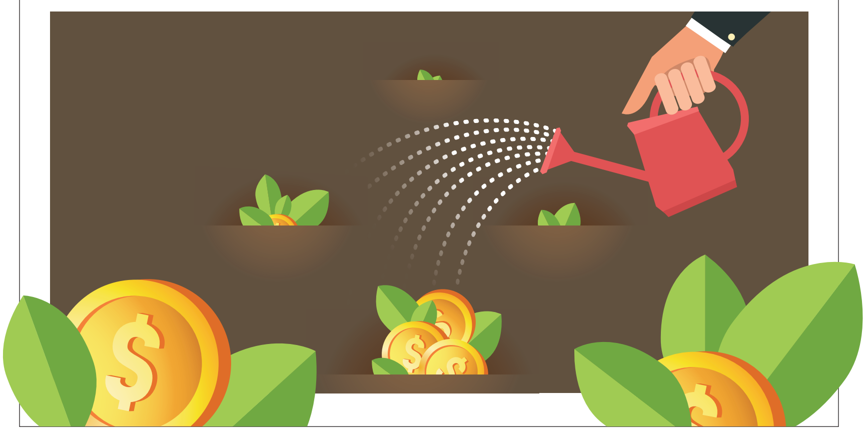
Mezzanine debt funds and insurance companies may be more restricted. But, if the banks are also restricted, you need whole loan funds, and alternative

Q In recent years, German banks have raised capital for environmentally sustainable real estate lending through the green Pfandbriefe. How do you see this trend developing in the private debt lending space?

KJH: It is definitely a big topic for all kinds of lenders. However, we have to look separately at the institutional lenders (pensions funds and insurance companies) and the other alternative lenders (like debt funds).

Most debt funds are not willing to reject a project or give up margins yet due to ESG. But, usually, ESG criteria is a subject for their underwriting and they are raising questions about it. ESG criteria have an impact at the end when the lenders are considering their exit risk. For example, most lenders are not willing to finance new developments without a good ESG concept, as they do not want to have a refinancing risk after their loan term.

We would say the difference for institutional lenders is that they are already partly selecting their projects according to ESG standards. We also see in the market that institutional lenders are coming back with new funds, for example Article 8 and 9 funds, which are really focused on this ESG issue.



lending has definitely profited from that.

This helps on the other end too, as the borrowers can then do deals. We recently closed a €200 million non-food retail transaction with a whole loan fund, which would have been impossible with a classic bank.

KJH: The majority of alternative lenders expect more financing opportunities in the next few years. In addition to compensating the lower leverages of the banks, they also expect to have access to more deals in general. Many lenders are already seeing an increase of financing requests.

That means that opportunities are back for alternative lenders. What we also see is that those lenders often set themselves apart from banks due to short timelines and because most of the examination processes of banks are getting longer and longer.

But there may also be more financing opportunities for banks if they are willing to leave their usual financing profile. During the last year we have seen more willingness from banks to provide club deals with debt funds. This gives them access to more or new deals. A few years ago, this was not really common.

Q How do you see financial market volatility impacting property debt costs?

CCF: The main question is whether those property debt costs are net margins or whether they include liquidity spreads. In these uncertain times, what we are seeing is liquidity costs increasing and banks increasing their gross margins.

KJH: Unlike banks, we do not see an increase in interest rates for most alternative lenders yet.

A few of the alternative lenders are already increasing their interest rates, but most are saying that, by the end of this year or the beginning of next year, they will do so.

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> **CURTH-C. FLATOW**

Q What are the risks that higher base rates, rising margins and the costs of interest rate caps and swaps might slow financing deals?

KJH: We do not think that the financing business in general will be slowed down. Rather, there will be a shift from less classical bank loans to more financing with alternative lenders. And maybe the LTV and LTC levels will shift a bit.

It is becoming more challenging for borrowers to find the right lender, but we definitely think that it is still possible to find lenders for each deal, as there is enough capital in the market. Access to a broad network of lenders is getting more important. We think that the number of alternative lenders will continue to increase and that the number of deals financed with whole loans rather than the classic senior/junior structure will increase.

Q Where do you see some of the best opportunities for real estate lenders?

CCF: The lenders who are active and doing business can cherry pick, and that is a valuable opportunity. That is the real story now and what we are seeing taking place in the market.

There are people out there lending. However, once the deal is made more complex – maybe there are some structural issues, or it requires higher leverage, or in some other way the deal is not plain vanilla – these lenders who are active and can provide financing are able to pick and choose, and that can present a significant opportunity depending on the asset class.

KJH: In addition, speed and flexibility can set you apart from other lenders. If lenders can ensure a short timeline from signing of a term sheet to disbursement, this often helps, especially when debt is needed quickly for a purchase. But also, the ability to be flexible to the collateral structure can help, especially in mezzanine capital.

Q How do you see demand for debt advisory?

KJH: We see an increased demand for debt advisory. Whenever the market situation gets more difficult, an adviser can help because of their unique network of capital partners.

In addition to the current market situation, the deals are becoming more complex in terms of general structure or know-your-customer structure. This often makes an adviser necessary. We already see an increase in the number of requests, so it is a good market for advisory businesses.

CCF: It is difficult when there is a lot of uncertainty in the market. Usually, borrowers come to an adviser because the banks are not doing business, so you might otherwise not have an opportunity to do a deal.

On the other hand, with a debt adviser you have access to a broader network so you can get those deals done, which fortunately for us is boosting business. ■