Alternative Real Estate Finance
An Investment Opportunity for Institutional Investors

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Abstract

Since the credit crisis, the supply of commercial real estate lending by the traditional financiers has fallen substantially. Intensifying regulatory pressure has contributed to the current deleveraging process. This paper investigates the opportunities that this development has created for institutional investors.

1 The transformation of the European real estate lending market

In reaction to the high level of economic uncertainty and regulatory changes, the European real estate lending market[1] structure is in a state of transformation. Economic uncertainty has reached unusual high levels since the summer of 2007. The forced acquisition by the American universal bank JP Morgan of the troubled US investment bank Bear Stearns and the subsequent bankruptcy of Lehman Brothers have sent the real estate driven speculative cycle in mortgage backed securities into an abrupt reverse. It has not recovered since then despite governments' and central banks' measures taken to avoid an economic depression that was feared as a result of the increased uncertainty about the strength of the financial system.

Almost relentlessly, this heightened economic uncertainty has been stuck at dangerously high levels since then. The measures taken by governments resulted in inflated and unsustainable government debt and weakened central bank balance sheets, further adding to the heighted levels of economic uncertainty. The related Euro crisis, where government debt costs cannot realistically be borne by a number of EU states and in which many banks that overextended themselves in extending real estate finance, has further added to the economic malaise. The negative economic outlook in general and the weakening state of the real estate market in particular has made banks very reluctant to provide real estate finance.

As the banking system turned out to be less robust than previously thought, the Bank of International Settlements (BIS), felt it needed to sharpen regulatory oversight. This culminated in the Basel III accord[2]. The new regulation demands better bank funding and liquidity management as well as higher equity capital reserves to offset risks. Under Basel III, real estate loans were assigned to the highest risk category for which banks would have to allocate a substantial part of their scarce equity capital.

This leads to retrenchment behavior. Most banks prefer not commit to new real estate loans. Most credit committees will "delay and pray" by not exercising their right in case of covenant breach. As long as interest is being paid, banks avoid repossession of depressed real estate assets in the hope that real estate prices will recover in the future. Some banks, however are forced to reduce real estate lending in order to comply with Basel III regulation.

Cushman and Wakefield (2012) conclude that: "A new financing landscape is beginning to emerge however, incorporating a greater diversity of lenders such as non-bank financial institutions (pension funds, insurance companies) - which are likely to adopt a more conservative approach to lending - and specialist managed debt funds targeting higher returns by encompassing both senior and stretch senior lending." Interestingly, the regulatory changes that affect institutional investors, such as Solvency II in the case

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[1] For the purposes of this study, the European real estate lending market is defined as the supply and demand for senior loans to finance commercial real estate located in Europe.

[2] BIS (2011)

of insurance companies, give these investors a comparative advantage in the European real estate lending market[3]. The penalty in terms of risk capital requirement for extending real estate loans is significantly more favorable under Solvency II than under Basel III.

[3] EC of European Parliament (2009)

2 The supply side of the European real estate lending market

Cushman & Wakefield (2012) interviewed 78 leading real estate finance providers to determine their willingness to lend and to identify in which direction the European real estate lending market is likely to evolve.

Chart 1. Market participants in the European real estate lending market

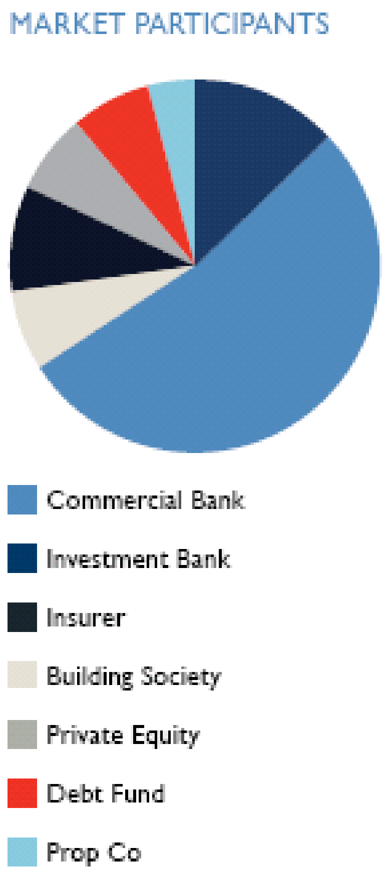
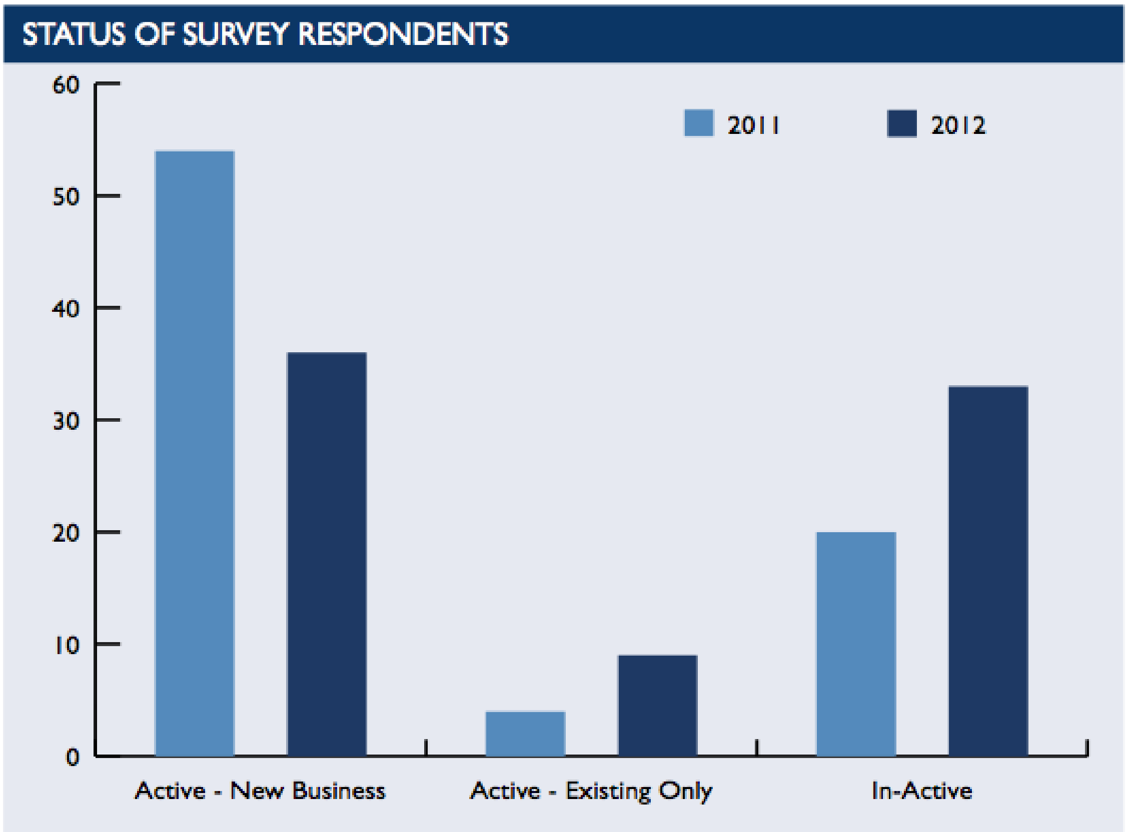


Chart 1. shows that the majority of lenders are banks. Alternative financiers have expanded their market share on the European lending market slightly more than 25%.

The number of financiers that was willing to extend credit fell by 33% from 2011 to 2012. Only half of these active lenders would consider lending to applicants with whom they had no previous relationship (categorized as Active – New Business in Chart 2).

Chart 2.Status of Survey Respondents

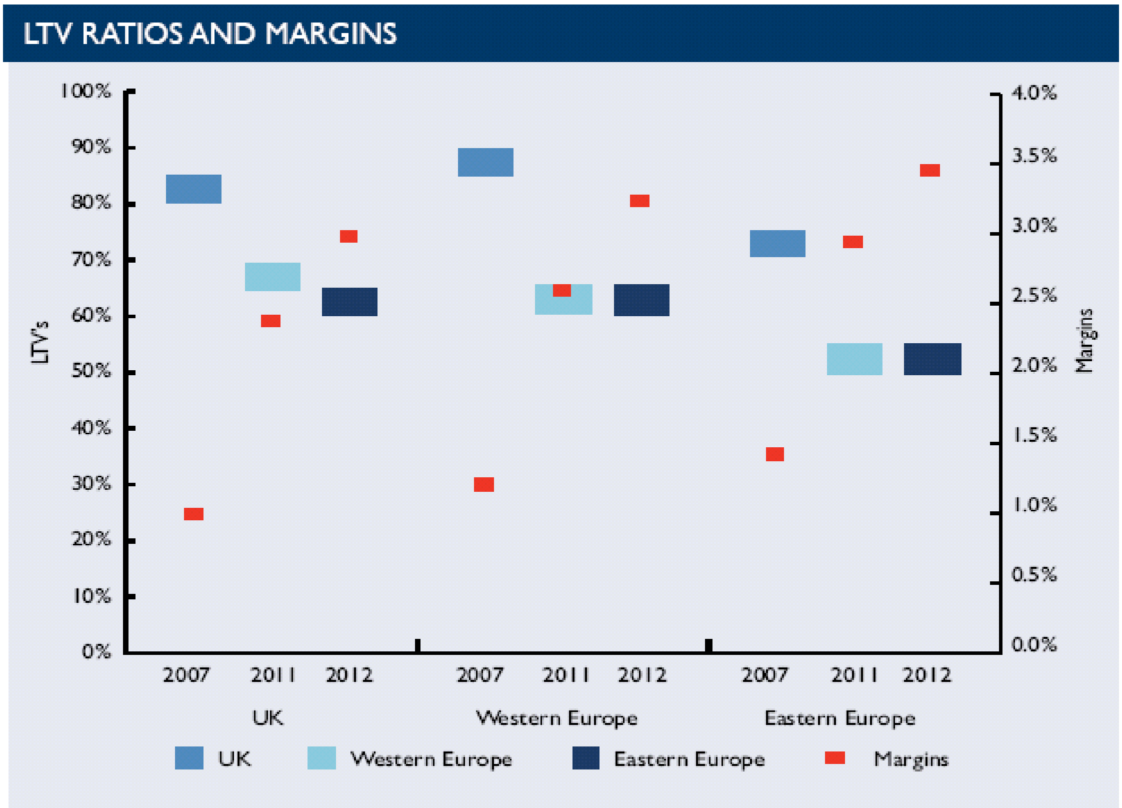


In that case the lending criteria tend to be highly restrictive in terms of loan-to-value (LTV) allowance and cash flow security requirements. The number of lenders that are either inactive or only willing to consider credit applications of existing customers has risen significantly.

The traditional syndication market has fallen into a dormant state. Those lenders that are still active prefer to form “club deals”, whereby a limited number of lenders negotiate and jointly underwrite prior to the deal closing as opposed to syndicating the loan after closing.

The tolerance for high LTV on real estate loans is falling. The maximum LTV on senior loans has decreased from 65% in 2011 to the current level of 60%.

Chart 3. LTV ratios and margins on European real estate lending



While the funding cost of the lenders has been falling as a result of the monetary stimulus provided by central banks, the interest rates on European real estate loans have not fallen to the same extent. This results in a significant increase in margins earned by the financiers. In Western Europe this margin increased from about 1% at the start of the credit crisis to a level of 3.4% today. Margins have also increased in the Eastern Europe and the UK albeit from a slightly higher and lower level for these two geographies respectively.

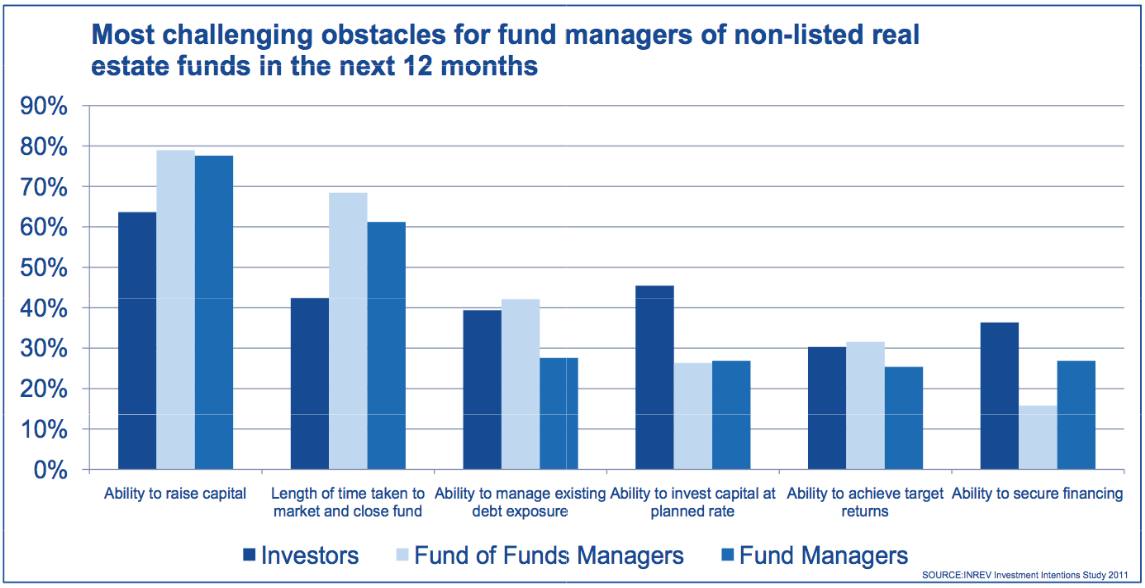
Michael Lindsay, Head of Corporate Finance EMEA at Cushman & Wakefield concludes: “The findings of our lender survey show the severity of bank withdrawal from the European commercial real estate debt market over the past year. Looking ahead, the bright star is the increased lending activity and intentions of non-bank financial institutions and the potential arrival of senior debt funds this year which will provide some welcome new sources of liquidity.”

3 The demand side of the European real estate lending market

The results of INREV (2011) indicate that obtaining funds in the European real estate lending market is a key concern for the dominant demanding party in this market, unlisted real estate funds. The top three key concerns were:

- Ability to raise capital (identified by 80 percent of the respondents);
- length of time taken to market and close fund (identified by 50 percent of the respondents);
- ability to manage existing debt exposure (identified by 40 percent of the respondents).

Chart 4. Obstacles for fund managers of non-listed real estate funds



As a result of dearth of finance, the number of fund launched collapsed from a peak level of 71 in 2005 to only a few per year after 2008.
According to the INREV (2012), in total fund managers secured only €5.5 billion of new loans in 2011 compared to almost €30 billion in peak year 2007. Most of this funding came from banks, but insurance companies (and pension funds) are increasingly seen as an alternative source of finance.

4 Opportunity for alternative supply of real estate lending

According to INREV (2011), there is a significant funding gap as demand for real estate (re)financing remains elevated while lending from traditional providers of credit is reduced as a result of the financial crisis and more stringent regulation. Approximately 10% of fund managers have failed to secure refinancing in the last twelve months due to the withdrawal of bank lenders from the market.
“Like investors, lenders have lost their appetite for risk. In rationalizing their loan books they are focusing not merely on reducing the size of their real estate exposure, but on increasing the quality of it by focusing on high quality underlying assets, in prime capital cities and core markets. We’re seeing an understandable flight to quality and safety. This is challenging the non-listed real estate sector, but it also presents opportunities,” said Brenna O’Roarty, owner of RHL Strategic Solutions, who carried out the research on behalf of INREV.

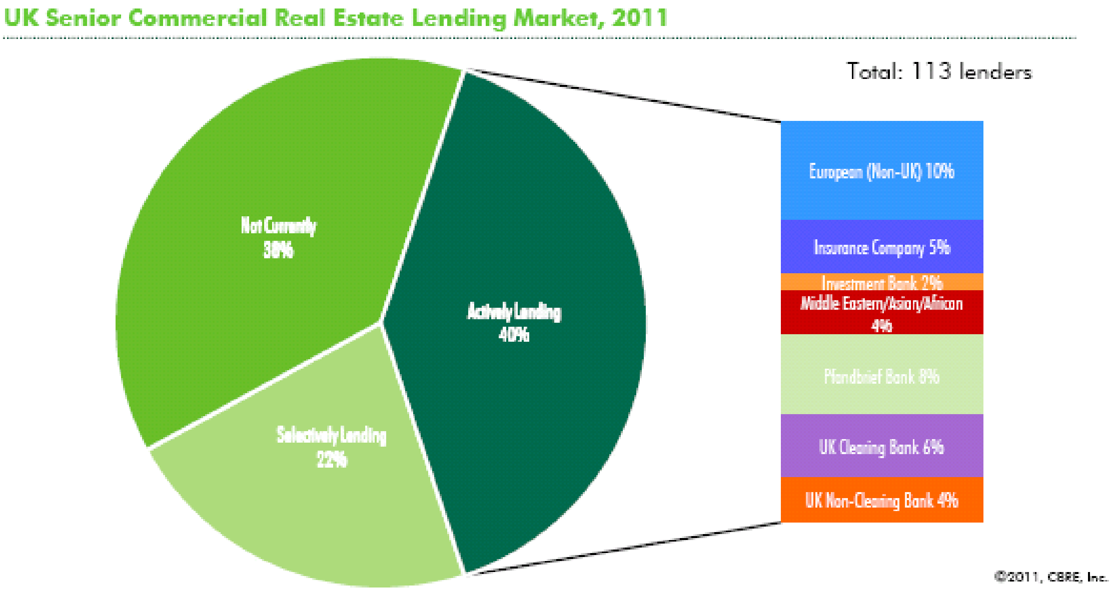
The funding gap invites supply from alternative sources of supply such as insurance companies and pension funds have emerged. Insurers are growing more interested in the European real estate lending market, given the attractive margins and the advantageous capital treatment under Solvency II. Insurers are typically more interested in the lower risk spectrum and prefer to supply senior real estate loans. Pension funds are also becoming increasingly keener in investing in real estate loans as the returns are attractive relative to the expected returns from traditional fixed-income investment opportunities.

This leads to the following question: what opportunities have developed for institutional investors to profitably increase their supply on the European real estate lending market in general and in the U.K. and the Netherlands in particular? From a more forward-looking perspective, a related question is raised. How have the institutional investors reacted to this opportunity and what can be expected in the future from this alternative source of real estate lending?

5 The UK real estate lending market

The UK is the leading property market in Europe and developments in the UK tends to set trends for continental European markets. It scores highly on liquidity, transparency, lending opportunities and profitability. Therefore, the UK offers a good starting point in the analysis of likely development of alternative real estate finance. Out off the 356 institutions with a UK banking license, 113 have a commercial real estate loans on their books.

Chart 5. UK senior commercial real estate lending market participants



Due to economic volatile circumstance in combination with stringent regulation, UK lenders are increasingly risk-averse. Over the course of 2011, 11 of the 54 lenders decided to withdraw from the UK lending market. The number of lenders in the actively lending category has fallen to 43. German banks traditionally take a prominent position in the UK real estate lending market. German banks earn higher returns in the UK, as competition is less fierce than in their home market. In total German banks have over £29 billion of UK commercial real estate loans on their books. Due to Basel III and the state aid that, for instance, Commerzbank had to ask for in order to survive the raging credit crisis, however, the German banks are retreating from the UK real estate lending market. The exits of EuroHypo (part of Commerzbank) and Société Générale are illustrative of the negative stance of bank towards real estate lending.

At the other side of the spectrum, CBRE (2011) notes the growing interest of insurance companies to expand their real estate loan book. The share of insurance companies has grown to the present level 14.3% of the UK real estate lending market.

Table 1. UK senior lending market by lender type

UK Senior Lending Market by Lender Type, 2011

LENDER TYPE	ACTIVELY LENDING	SELECTIVELY LENDING	TOTAL LENDING	AS %	MARKET SHARE v 2010
Building Society	-	5	5	7.1%	▼
European (Non-UK)	11	1	12	17.1%	▲
Insurance Company	6	4	10	14.3%	▲
Investment Bank	2	5	7	10.0%	▼
Middle Eastern/Asian/African	5	2	7	10.0%	▼
Pfandbrief Bank	9	2	11	15.7%	▼
UK Clearing Bank	7	-	7	10.0%	▼
UK Non-Clearing Bank	5	6	11	15.7%	▲
Total	**45**	**25**	**70**	**100.0%**	

The number of insurance companies actively lending in the UK real estate market has increased by the entry of a new insurance company in 2011. That brings the total of insurers in the UK market to ten. Insurers are successfully gaining market share on banks due to the less stringent capital requirement under the Solvency II regime compared to the capital requirement for banks under Basel III. Insurers are offering more attractive terms than banks both in terms of LTV ratios as well as margin.

Table 2. Lending conditions for UK senior real estate loans

Overall Market: LTVs and Margins, 2011

LENDER TYPE	AV MAX LTV	TREND	TYPICAL MARGIN	TREND
European (Non-UK)	61.9%	▼	2.8%	▲
Insurance Company	69.0%	▲	2.4%	▲
Investment Bank	77.1%	▼	4.0%	=
Middle Eastern/Asian/African	65.0%	▼	3.1%	▲
Pfandbrief Bank	67.0%	▼	2.4%	▲
UK Clearing Bank	66.5%	▼	2.5%	▲
UK Non-Clearing Bank	64.2%	▼	3.6%	▲

CBRE (2011) expects this momentum to continue and insurers to obtain a share up to 20%, in line with the share of insurers in the US real estate lending market.

IPF and APB (2011) concludes that: "insurers are also anticipating growing demand for their lending, given the amount of debt that is needed to refinance bank loans and CMBS. With the limited competition and liquidity that banks can provide, insurers see a golden opportunity to scale up their lending, especially on the bigger-ticket assets and portfolios that banks find difficult to finance. Borrowers' attitudes have also changed. They now see benefits in diversifying the maturities of their debt and forging relationships with lenders who are long-term players…Respondents stressed that new sources of capital are essential…"

6 The Dutch real estate lending market

Traditionally, three banks have dominated the Dutch real estate lending market: ING Real Estate Finance (ING), FGH Bank (FGH) and SNS Property Finance (SNS). Due to the devastating credit crisis, SNS was forced to implement a strategic re-positioning in the market. The role of SNS is increasingly taken over by ABN Real Estate Finance (ABN). The market share of ABN expanded not only organically but also due to the integration of the Fortis Real Estate Finance activities. As a result of this development, four players set the tone in the Dutch real estate lending market: ING, FGH, SNS and ABN with ABN gradually taking over the role of SNS.

Table 3. Volumes development on the Dutch real estate lending market

Tabel 4 Leningproductie per jaar en waarde totaal uitstaande leningen in 2009 (in miljoenen euro's)

	Productie					Totaal uitstaand
Aanbieder	**2005**	**2006**	**2007**	**2008**	**2009**	**2009**
ING Ref	4.000	4.200	9.731	10.750	5.948	18.400
FGH Bank	2.700	4.100	6.300	4.800	2.780	17.220
NIBC	1.577*	2.000	2.300	500	1.000	2.289
SNS PF	2.250	3.800	5.600	4.684	761	13.400
ABN Amro	-	-	1.200	883	728	4.000
van Lanschot Bankiers	400	330	585	525	500*	
Berlin Hypo	-	-	100	130	217	453
Deutsche Hypo	61*	77*	100	130	212	780
Syntrus Achmea Vastgoed	531	730	750	710	100	2.300
WestImmo	-	-	100	100	100*	
Bank voor de Bouwnijverheid	24	19	61	35	22	
Pfandbriefbank	631*	800	490	-	-	
Aareal	600	600	600*	-	-	
Fortis REF NL	728*	923*	1.200	700	-	
Euro Hypo	400	500	250	110	-	
HSH Nordbank	395	956	961	100	-	
HBOS	552*	700*	-	-	-	
Landsbanki	-	-	p.m.	p.m.	-	
KBC Bank	p.m.	p.m.	p.m.	-	-	
Lips Finance	-	-	p.m.	-	-	
Friesland Bank	p.m.	p.m.	p.m.	-	-	
Essen Hyp	-	-	p.m.	-	-	
Totale leningproductie (in miljoenen)	14.849	19.735	30.328	24.157	12.368	

Bron: SEO Economisch Onderzoek, gebaseerd op (PropertyNL, 2007, 2008, 2009, 2010); '-' aanbieder was dat jaar niet actief in Nederland; * schattingen SEO; ** de leningproductie van Fortis REF is voor 2009 meegenomen in ABN AMRO, per juli 2009 zijn deze samengegaan; zie Box 3 voor een toelichting op de beperkingen van de weergegeven data

Besides the dominance of the top four banks, chart 3. illustrates two developments on the Dutch real estate lending market. First, the foreign (mostly German) banks have withdrawn from the Dutch market. The driver behind this development is the pressure that the newly introduced Basel III regulations put on these over-extended German banks. In some cases these banks had received government support in order to ensure continuity and consequently had to retrench in order to be able to pay back state aid.

Second, a striking difference between the UK and the Dutch real estate lending market is the modest role that non-banks play in the Dutch market. The only non-bank is investment manager of pension fund assets Syntrus Achmea Vastgoed that – both in terms of loan production and loan book – clearly falls outside the top four of the Dutch real estate lending market. The market share of non-banks on the Dutch real estate lending market is significantly lower than on the UK market. This raises the key question:

Why is the market share of non-banks on the Dutch real estate lending market relatively modest given the attractive returns?

The answer to this question lies mostly in the idiosyncratic structure of the Dutch real estate lending market. A recent study commissioned by the Dutch anti-trust authority NMA into the competitive structure of the Dutch real estate lending market by Kerste et al. (2011) concludes that there are indications of an oligopoly. The oligopolistic traits of the Dutch market are definitely more pronounced than in the more balanced UK (and European) real estate lending market.

Table 4. Concentration indices of the Dutch real estate lending market

Tabel 6 Vastgoedfinancieringsector kenmerkt zich door lage concurrentie

	2005	2006	2007	2008	2009	*Gemiddeld*
C3	60,3%	61,3%	71,3%	83,8%	78,7%	71,1%
C4	70,9%	71,4%	78,9%	87,4%	84,8%	78,7%
C6	80%	81,0%	86,8%	93,3%	94,7%	87,2%
HHI	1505,5	1464,7	1918,2	2791,6	2979,6	2131,9

Bron: SEO Economische Onderzoek, gebaseerd op (PropertyNL, 2007, 2008, 2009, 2010) ; zie Box 3 voor een toelichting op (de beperkingen van) de weergegeven data

Before the credit crisis started, the three largest suppliers of real estate lending on the Dutch market had a collective market share of 71.3%. Four the largest four players, this number is almost 79%. The widely used indicator for market concentration Herfindahl-Hirschman Index (HHI)[4], stood at a remarkably elevated level of 1918.2 in 2007. A HHI that surpasses the threshold of 1800 is an indication of a market with an unusual level of concentration of power. From this disturbingly high level, the HHI managed to creep up further to a level of 2979.6. Kerste et al. (2011) conclude that the effective competition to the dominant parties (referred to as the competitive fringe) is limited. The dominant parties are seen to compete on the limited quantity of credit that is available rather than price[5]. Credit rationing seems to be the name of the game on the Dutch real estate lending market.

[4] Martin,S, (1994)

[5] This type of competition is referred to as Cournot competition. See Tirole (1988).

Will this development go into reverse, as the credit crisis is gradually resolved? Based on quantitative and qualitative analysis, Kerste et al (2011) present multiple factors that this is unlikely to happen.

First, they stress the increased role of local expertise in order to successfully operate in real estate lending. Recent years have proven that risk management of real estate lending has proven to be less straightforward than previously thought. Fundamental oversupply in different segments of the real estate market, multiple layers of regulations affecting the heterogeneous group of market participants and an environment where deleveraging will take multiple years to reach sustainable levels, make risk management a more precarious activity than it has been for a long time.

Second, they claim that alternative sources of real estate finance are mostly conservative parties that are concerned that entering the real estate lending market may lead to reputational risks. Kerste et al. (2011) refer to this concern as an “image problem”. They emphasize, however, that required investments in knowledge and developing an effective local network are the main obstacles for alternative finance in the Dutch real estate lending market.

Third, Kerste et al. (2011) observe that the terms and conditions for real estate lending in the Netherlands are “dictated more by supply than demand”. This is due to the imbalance between supply and demand. Many parties are desperate to get (re)financing arrangements. This is often referred to as the funding gap. Kerste et al. (2011) conclude that price elasticity of demand is consequently quite low, further contributing to the market power of the dominant suppliers of credit on the Dutch real estate lending market.

Fourth, the authors point out that the cost of switching from supplier of real estate lending to another are often prohibitive due to so-called break-up fees[6]. Even if the lender is willing to switch, he is often confronted with substantially worse lending conditions (e.g. in terms of LTV and required margin) as lenders are very reluctant to extend credit to new clients. An additional obstacle for entry is that lenders often find it difficult to effectively switch suppliers as Kerste et al. (2011) claim that the lending conditions are not easily comparable due to lack of transparency on the part of suppliers and their willingness to negotiate the lending terms.

As a result of the idiosyncratic structure of the Dutch real estate lending market and in contrast to other leading segments of the European real estate lending market, it is unlikely that non-banks will gain substantial market share at the expense of traditional suppliers. While in the leading UK real estate lending market, the share of non-banks is tending to the US level of around 20%, this is unlikely to happen any time soon on the Dutch market.

[6] These fees are governed by the so-called boeteclausules in Dutch lending contracts.

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