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# What part do debt funds play in today's real estate finance arena?

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Real estate debt funds have traditionally had a much lower profile in European real estate lending than in the US market. The global financial crisis changed this, however, and following the crisis, the downturn in the commercial real estate markets created a credit drought as banks, previously responsible for around 90% of European commercial real estate debt, dramatically reduced their lending. This left a gap in the market, which created an opportunity for a range of new lenders – chief among them were non-listed debt funds.

Since then, the market has seen a proliferation in the number and size of real estate debt funds, culminating in a record year in 2017 when, according to INREV data, fundraising levels hit a high of €10.6bn. However, investment fell more than 40% during 2018. Is this a reflection of waning interest in the asset class or something else?

Looking at who is lending in the market, while it is clear that traditional lenders are firmly back in a dominant position, they do not have pre-crisis levels of liquidity, allowing the real estate debt funds to cement their position in the market. So with space for debt funds available in the real estate finance arena, what other factors may influence how big a piece of the lending pie can be taken by the debt funds in the short to medium term?

## Tight controls

Other than liquidity issues, lending criteria also remain more tightly controlled than in the heady days when the relationship with the borrower trumped any restrictions credit may have wanted to place on the deal. The borrower community has since found that assets which do not neatly fall within set parameters are more challenging to finance with traditional lenders. Step forward the debt funds, some of which have been established specifically to lend against assets and asset classes that are outside the core business of other lenders.

Debt funds can also lend higher up the capital stack than many traditional lenders would be willing to do and regulation has played its part in driving the market here, given that banks are subject to capital adequacy requirements, which makes higher leverage more expensive to provide. Again, debt funds are not constrained in the same way, with many pursuing whole loan strategies to highly remunerative effect.While it is widely recognised that there is a huge weight of capital on the equity side looking for a real estate home (which could result in lower required leverage), the effect of higher gearing on returns continues to drive the appetite for higher leverage.

It is worth considering what challenges the debt funds will face in the real estate space. While it is true that, in general, debt funds may have more flexibility in terms of risk and leverage, there appears to be limited appetite, given where we are in the cycle, to venture too far up the risk curve. The ability to deploy capital continues to be an issue across the market (both debt and equity) and given current uncertainty, fund managers must be all too aware of making promises to investors they will not be able to keep or worse, losing investments if property prices fall.

It remains to be seen how far fund managers will push the barriers to get their investors' cash out the door. Will we see more debt funds venturing into development finance? Will leverage creep up? Will we see echoes of the real estate finance deals of 2006/2007, which saw secondary or tertiary assets being treated as financial instruments rather than bricks-and-mortar propositions that had to stack up in their own right?

One thing is certain, real estate debt funds are here to stay. There continue to be organisations with their roots firmly embedded in the real estate market recognising that a useful diversification is to take debt positions as well as equity. There are also those looking to broaden their appeal to investors by offering a wider variety of real estate products, be that primary or secondary via debt and on an even more granular level, being able to offer a choice of debt profile depending on the risk appetite of the individual investors.

Whichever way one looks at it, real estate debt funds continue to be an important resource for borrowers and investors alike.

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# Contacts

## Jo Solomon

Partner

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