KEYNOTE INTERVIEW

How to achieve safety in a tough market

Real estate direct lending can offer stable returns without the fluctuations of the public markets – a quality valued by investors today, says Ellis Sher, managing director, Arrow Lending Opportunities

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Q Should investors be increasing allocations to direct lending over the long term?
We have been investing in this asset class since 2009. Over that period, we have funded in excess of £5 billion ($6.4 billion; €5.8 billion) of developments, delivering more than 17,800 units across 258 projects with zero credit losses of capital, interest and fees. In our experience it has proved to be a very reliable asset class and we have been happy to reinvest our gains back into it.

Real estate direct lending makes sense to us in all market cycles. We see

It is primarily driven by safety. People have common responses to uncertainty, and one of those is a flight to quality. Investors have had a tough time in public market fixed-income, which has been responding violently to changes in interest rates, and some investors are reacting to that.

Private credit was historically difficult to access. What investors are now discovering is that done correctly, it can be a source of stable returns without the fluctuations of public markets.

It is an instrument that can offer a viable hedge against interest rate rises, with the majority of loans linked to base rates – and it comes with security. If you mark it at a sufficiently modest loan-to-value and have deep origination capabilities, thorough underwriting and asset monitoring, it can offer attractive downside protection.

We have seen private credit increasing its market share and enjoying growing investor demand since the financial crisis. Direct lending in the form of real estate lending is just a more secured form of private debt that is particularly attractive today.

Q What defines a successful deal in real estate debt?

A typical deal for us will involve funding a sponsor that is credible – it all starts with who you are lending to. I have seen really good assets destroyed by incompetent people and I have seen some tricky situations monetised by very good people. In times like this, those situations become more evident – upward movements in values are a great disguise for a lack of talent.

So, the search is for a sponsor whose past work you can see and who can talk openly about the successes and failures they have had.

It is then important to dig into the contractor. Are they capable? Can they point to past schemes of a similar size and complexity? How robust is their balance sheet and cashflow to withstand bumps in the road?

Then the third element is what is being built – is it appropriate to meet demand in the area? And of course, you look very carefully at the core KPIs of loan-to-cost, loan-to-value, profit on construction, and so on.

it as an all-weather asset class because we have seen its response to low interest rates, high interest rates, stable inflation and unstable inflation.

We have seen its robust performance through Brexit and other domestic and international geopolitical challenges. Of course, it is not without its challenges but if you can find a manager that has an experienced team, diverse origination sources, fastidious underwriting and portfolio management, then this is an asset class that investors should consider.

Q How does real estate debt currently fit into portfolio construction strategies?

These are secured asset-backed loans. How they fit into portfolios is really a function of what exposure and diversification investors wish to have in the context of their overall fixed income allocation. These are not profit participation loans and we are not party to a project's profits – that belongs to the equity. So, the question is how happy you are as an investor with a certain spread above base rate and how that compares with other asset classes on a risk-adjusted basis.

Historically, there have been much bigger allocations to other forms of private credit, but that has all been held up to scrutiny with the 14 successive interest rate rises since December 2021. Today, equity is likely finding it harder to justify targeted risk-adjusted returns versus secured real estate credit.

Q Which sectors within real estate remain attractive, and which are out of favour?

Non-ESG compliant commercial office blocks are falling out of favour. But when you look at office buildings that are being transformed to modern ways of working and have high green credentials, that market is still active. Retail is difficult, while build-to-rent and private rented sector remain attractive.

Elsewhere, co-living continues to be an emerging asset class. Student accommodation in certain towns and cities also keeps attracting huge interest – both consolidation plays and new developments – and hotels are back.

So thematically, the beds business is as hot today as it was a few years ago. UK net migration for the year to December 2022 stood at 745,000, which is more than 1 percent of the UK population. That is simply not sustainable from a housing perspective.

There are still huge drivers for real estate investment. Planning is such a convoluted and complex process, and we see no improvement in the length of time it takes to get consent; it remains as bureaucratic and expensive as ever. That means it requires a lot more courage today to be an equity investor and our sector needs confident equity to build more homes.

Q How have the US regional banking challenges impacted the real estate debt market?

That is another reason for people to be cautious. We have had situations where

investors have chosen not to focus on the UK because they are looking to those US regional banks disposing of assets and seeing better risk-adjusted returns, so there was a little bit of redirected capital.

If you're the chief executive officer of a bank here and you see what's happened in the US, you wouldn't be alone in being in a risk-off frame of mind. You are going to be looking hard at your own ability to withstand similar challenges, which usually causes you to be conservative and to hoard liquidity.

Q Given the current environment, what should investors prioritise when picking managers to target real estate lending opportunities?

In any environment, you have to be partnering with experienced and seasoned managers who can evidentially demonstrate an ability to source, underwrite and manage loans that have delivered above market returns on a risk-adjusted basis. You need to be satisfied with the manager's ability to control risk and be proactive about risk management.

Do I believe investors are more conservative in this environment? Sure. Do I think there is a flight to more established managers? Yes. Will you have to be able to convince investors you know what to do when things don't go well? Absolutely.

Investors should be looking at the depth of the team, how long it has been together and whether or not there are any gaps in expertise, with a focus on the downside. We are in a period where things will get tested and distinctions can really be made between managers.

Q Real estate debt investment is significantly transforming urban landscapes and building repurposing. Can you elaborate on how your firm is involved in this area?

Transformation is happening slowly, but not for the lack of good intentions.

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Planning regimes across Europe are difficult, cumbersome, bureaucratic, expensive and uncertain. There is a lot of capital that wants to support transformation, but it is hard.

The biggest movements are in conversions of old offices to deliver more ESG-friendly outcomes, and the same in residential. We recently supported a project where we had to use local tradesman based within two or three postcodes of the site, as set out in Section 106.

So, we are contributing that way, and through our focus on housing that is affordable to a large pool of end buyers. Our lending strategy has always prioritised the lower end of the value chain, so one-bed, two-bed and three-bed, multifamily apartment blocks.

Our biggest role in transformation has been our support for Manchester, where we have invested nearly £1 billion and helped our borrowers transform the skyline. High-rise residential was not a thing in Manchester a decade ago but very much is today. This change is helping to define Manchester as the go-to destination outside the Southeast to study, work, shop and live.

Q Finally, do you see an opportunity for investors in the impending maturity of outstanding bonds and loans?

Yes, we do in theory, especially with impending refinancings where there is absolutely a gap between historical refinance levels and where we are today in a higher rate and lower value environment. That opportunity comes down to whether investors and banks are prepared to crystallise losses and whether investors are brave enough to transact.

That said, we haven't seen much distress, and our current view is that will prevail as there seems to be enough equity, pragmatism and patience in the system to avoid mass distress. ■