How private debt lending will take centre stage in real estate

18 Jan 2024 08:18 GMT | by Mark Posniak

Alternative lenders are filling the void left by traditional banks

Mark Posniak

GUEST WRITER

European lending director, Arrow Global

In recent years the European real estate sector has witnessed a significant transformation in its financing landscape. The rise of private debt, particularly in the housing sector, has emerged as a pivotal development. This shift reflects a broader trend in the financial world, where non-bank lenders are increasingly taking centre stage, offering more adaptable and flexible funding solutions compared to traditional bank syndicated lending, which can be complex in its structure.

Traditionally, the real estate sector has relied heavily on favourable financing terms from banks. However, since the global financial crisis, there has been a gradual reduction in the number of European banks as they retrench from capital-intensive activities such as bridging, development and other speciality credit in favour of lending activities that attract lower capital charges.

The number of European Banks reduced by 36% from 8,162 in 2008 to 5,263 in 2021. Over the same period, eurozone bank assets fell from over €40tr in 2008 to €27tr in 2013, before recovering to €31tr by June 2023. This decrease can be explained by several factors including the deteriorating macro-economic outlook, geopolitical tensions, elevated base rates and tightening regulatory environment.

The finalisation of Basel III regulation is estimated to remove an additional €125bn of real estate bank financing from the European market as banks focus on lower leverage on stabilised assets for larger clients to mitigate the impact of

adverse capital treatment for higher LTVs under the new regulatory rules.

Turning to alternative sources

The real estate sector has turned to alternative sources of capital including private credit providers. Arrow believes that the penetration of private credit in the €2tr European commercial real estate lending market has far to go from its current level of 15% to the US level of closer to 50%.

Since the GFC, there has been a steady increase in allocations to private debt. Pere's LP Perspectives 2023 revealed that 25% of real estate investors surveyed aim to commit more capital to real estate debt funds. Additionally, 27% of the respondents intend to maintain their current allocations towards real estate debt in 2023. This trend is attributable to the asset-backed nature of the loans, their yield certainty, and their lack of correlation with more liquid fixed income alternatives.

The supply of new homes is systematically curtailed by inefficient planning systems

The role of private debt in the housing sector across Europe is heavily influenced by broader macroeconomic factors. Despite the availability of debt, the supply of new homes is systematically curtailed by inefficient planning systems. These systems, in dire need of modernisation, slow down the development process and increase costs, hindering the ability to meet new homes targets. To illustrate this, in England, between 2019 and 2022, only 687,390 additional homes were built, falling well short of the 300,000 annual net additional dwelling target. This challenge is exacerbated by demographic

This publication is intended for use by Nick Jones at Arrow Global
It may not be copied or disseminated to others without written permission.

changes, such as an ageing population, longer life expectancy and the trend towards smaller households.

Furthermore, a significant portion of the European housing stock, particularly properties built before the 1980s, are deficient in quality and volume. These properties require major refurbishments and energy efficiency enhancements to meet new government-imposed standards. This scenario presents a substantial opportunity for developers and non-bank lenders alike. However, the realisation of this potential is contingent upon governmental facilitation in terms of increasing the number of homes and improving the energy efficiency of existing properties.

Value creation

The current state of the lending market is characterised by an oversupply of debt capital relative to demand. This imbalance, however, is subject to fluctuations. Recent trends indicate a rebalancing as liquidity withdrawals from the market and the pace of interest rate increases by central banks begins to moderate. Despite these challenges, there is a noticeable uptick in new-build enquiries, signalling a market belief that the worst of the interest rate rises may be over and a growing comfort among sponsors in their ability to transact with more certainty.

In terms of performance and value creation, non-bank lenders continue to focus on delivering competitive risk-adjusted returns relative to traditional fixed income assets. The key to value creation lies in a broad origination funnel, allowing lenders to identify investments which offer the most favourable risk-adjusted returns. This approach involves meticulous discipline in their origination, diligent underwriting, and ongoing loan management, supported by competent personnel and intelligent systems.

This publication is intended for use by Nick Jones at Arrow Global
It may not be copied or disseminated to others without written permission.

There has been a gradual reduction in the number of European banks as they retrench from certain lending

From a borrower’s perspective, private credit offers distinct advantages over the syndicated loan market. Non-bank lending is increasingly becoming the norm in Europe due to its speed, ease, and flexibility. In contrast, the syndicated market is less flexible and cost-effective only for larger deals over €150 million. The direct lending approach, often characterised by a more personalised, non-tick-box methodology, aligns better with the needs of borrowers seeking funding for projects that may not fit the traditional banking mould.

Increasing ESG intergration

ESG considerations are also becoming increasingly integral to lending. Lenders are incorporating ESG factors into their product design and lending programmes, focusing on aspects like energy efficiency, contributions to local communities, affordability, and the sustainability practices of borrowers. The trend towards green and sustainability-linked loans, where the cost of credit is tied to a development’s environmental credentials, is gaining momentum. This shift reflects a broader recognition that a robust and measurable ESG policy is not only beneficial for societal and environmental outcomes but is also becoming a prerequisite for raising capital from third party investors.

This publication is intended for use by Nick Jones at Arrow Global
It may not be copied or disseminated to others without written permission.

> *“Non-bank lenders are filling the gaps left by traditional banks, offering more flexible and innovative financing solutions”*

The landscape of private debt in the European real estate sector is undergoing a significant transformation. This shift is driven by a combination of regulatory changes, macroeconomic factors and evolving investor preferences. Non-bank lenders are filling the gaps left by traditional banks, offering more flexible and innovative financing solutions. As the market adapts to recessionary pressures and changing demographic needs, the role of private debt in financing housing and development projects will become increasingly vital.

The future of this sector will likely be shaped by continued focus on risk-adjusted returns, the growing importance of ESG considerations, and the ability of non-bank lenders to adapt to the changing needs of borrowers.

As Europe grapples with housing shortages and the need for energy-efficient refurbishments, brownfield regeneration and urban repurposing, the alternative lending market stands ready to play a key role in addressing these challenges, offering a blend of agility, innovation, and responsiveness that traditional financing channels may not be able to match.

This publication is intended for use by Nick Jones at Arrow Global
It may not be copied or disseminated to others without written permission.