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Investing in the future

How institutional capital is addressing the global housing shortage

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KEYNOTE INTERVIEW

Meeting demand from the living sectors

Demographics and aging stock support residential private lending across Europe, says Arrow Global's Ellis Sher

Cities throughout Europe are facing a shortage of homes, particularly affordable housing. This is the case across a range of subsectors and tenures – from student housing to senior living and buy-to-let to shared ownership.

Furthermore, the banking sector's caution toward operationally intensive real estate lending means a growing role for non-bank lenders in supporting this delivery.

The developers creating new stock in the living sector are looking for support from knowledgeable and flexible lenders, says Ellis Sher, managing director of Arrow Lending Opportunities, which operates across continental Europe.

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Q Why is investor interest in residential private debt rising?

There are a number of reasons this is happening now. Firstly, the pandemic demonstrated the resilience of the sector and also the commitment of governments to support homeowners and renters in difficult times. Also, contrary to what many people expected, the data from residential real estate investment trusts showed that people kept paying their rent through the pandemic.

Secondly, the residential sector is supported by demographic change, with substantial immigration into the UK continuing to drive demand.

Finally, the shorter length of residential leases means rents can dynamically adjust to inflation more quickly than other real estate asset classes. This, coupled with the downside protection offered by investing in senior secured private debt, has fueled interest in this investment category.

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Q What is the opportunity for residential private debt in continental Europe?

The thesis remains the same, the trends that we see in the UK are prevalent in Europe, too. In certain European countries you see population growth and ageing stock which needs replacement or upgrading. We see a lot of commonalities across the countries in which we operate.

Of course, there are differences, too, which is why it is important to have a high-quality local team on the ground wherever you operate. For example, Portugal has certain nuances which currently make direct, non-bank lending challenging, while Italy has certain limitations on pricing. In other jurisdictions like Spain, you cannot take personal guarantees.

Local knowledge and local sourcing are critical to building high-quality and sizeable loan books in different jurisdictions, and this is why we invest heavily to create local footprints that have the expertise, skills and relationships to operate successfully.

Q What types of residential project are lenders preferring?

We have a mixed portfolio of UK residential developers that are focused on delivering single- and multifamily housing, co-living, build to rent, build to sell, retirement home and student accommodation.

Within this, we see particularly strong opportunities to lend against in the built-to-rent sector, from studios to two-bedroom units, where the developer is looking to retain the asset. There is a lot of equity being allocated to these projects and to housing more generally.

Q What are the typical loan sizes and terms for these assets in particular? And where are the best opportunities?

These are typically two- to four-year loans ranging from £10 million ($12.55 million; €11.65 million) all the way up to £300 million. If I looked across our book, I would say the weighted average loan duration, excluding any extensions, is about 30 months.

We have never had a location agenda. There are opportunities all over the UK, but certain capital only wishes to allocate to London. There are good reasons for investing in London, which is a market with long-term resilience.

However, we have found you can find good value with good sponsors across the country. We have supported a number of successful projects across regions, in areas such as Salford, Manchester, Liverpool, Leeds and Birmingham, which have enjoyed superior price growth compared to many of the London boroughs.

Q What types of structure and strategy are performing best at the moment?

We prefer fully funded schemes. Although we have been presented with peak debt facilities numerous times, these arrangements heavily depend on the business plan remaining on schedule as cash is recycled from sales. Consequently, we tend to pass on these opportunities because they place both the lender and the sponsor in a difficult position if things go wrong.

We also provide loans for strategies where the equity is invested on an in pari passu basis with the debt. However, this approach is heavily dependent on the covenant strength of the sponsor.

Q What is the competition for residential private debt players?

There is no shortage of liquidity in the market. The challenger banks have taken market share from the high street, across a number of specialist areas of credit, while the high street still participates in the larger end of the market. And then there are a range of debt funds and family office sponsored direct lending ventures.

Size of loans is the primary difference. Challenger banks tend to cap out at £35 million and the larger debt funds only want to start at £100 million. Other specialist lenders like Maslow, part of Arrow Lending Opportunities, cover a wide range from £10 million up to £300 million, so are competing with different players depending on the size of the loan and asset class.

Competition on terms is vibrant. However, it is a big market and there is no shortage of opportunity, especially if you can offer a range of products in the lending cycle, acting as a one-stop-shop for borrowers' lending requirements. In some European markets, non-bank finance is not as well established, which means there is less competition as a consequence.

Q What are borrowers looking for from lenders, and why might they choose private debt?

The non-bank sector tends to offer quicker response times as well as more flexibility on equity, gearing and asset classes than the traditional banks can.

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"We see particularly strong opportunities to lend against in the built-to-rent sector where the developer is looking to retain the asset"

There is also a feeling that relationship banking ended with the global financial crisis, and there are people who are still licking some of their wounds from the GFC. However, private debt providers offer personal levels of service and invest in those relationships.

What a lot of borrowers look for is somebody who they can call, who can respond quickly and who thinks entrepreneurially. They are prepared to pay for the service and for the extra gearing. Borrowers aspire to do business with people they enjoy working with. However, it is not just relationship at any price; you need to remain competitive.

Q What is needed for success in the field of residential private debt?

Borrowers like to speak to people who can relate to what they are doing and who offer a suite of products to help them. It is advantageous if a lender can offer breadth and depth of product, which might be development, bridging, buy to let, term mortgages, stabilization mortgages and perhaps also have the capability of funding more off-piste special situations. And if they can do these things in as many jurisdictions as is feasible, with agile decision making and seamless process, then that would be a very compelling proposition.

In order to interact well with borrowers, you really have to have systems in place which allow you to give a quick yes or no. Being entrepreneurial really resonates with brokers and borrowers as well.

Given the sustained demand and demographic trends we are seeing, along with the strategic advantages of investing in residential private debt, this asset class presents a compelling opportunity for investors seeking to diversify their portfolios and capitalize on the growth and stability of the European housing market. ■