EXPERT Q&A

Lending at scale in Europe's granular residential market requires a careful balance of operational efficiency and local knowledge, says Adam Baghdadi, head of lending solutions at Arrow Global

Unlocking scale with local residential expertise

Q Which countries in Europe are providing the most interesting granular residential real estate opportunities?
We have historically made considerable investments in the UK, and that continues to be the case, but we have seen a meaningful uptick in Southern Europe in more recent months, particularly on the prime hospitality side, which is experiencing strong tailwinds.

The EU accounts for 60 percent of global tourists, and 45 percent of those tourists end up in Southern Europe, according to data from the European Travel Commission. As such, it is a very attractive time to be lending across prime hospitality real estate in the region. That said, we continue to see a nice balance of opportunities across the eight markets in which we operate.

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Q How do differences in residential property law, enforcement and planning frameworks shape your lending strategy country by country?
Those factors certainly affect risk tolerance and the way we draft documents. In the UK, for example, enforcement regimes for property lending are well established. Enforcement is not particularly time-consuming, and there are few legal barriers or ways in which borrowers can obstruct the process. As a result, we are generally able to rely on a comprehensive security package without worrying about obfuscation or delays in the courts system. In fact, we are usually able to proceed without recourse to the courts, simply by appointing an administrator.

In Italy, by contrast, anything that becomes a court-driven process is likely to last for a significant period of time. We therefore typically design our documents so that they include incremental protections outside of a simple mortgage security, such as a sales mandate that is triggered in the event of default. That approach would be off-market in the UK; it just isn't something we would need to do. But in markets where legal challenges from an enforcement perspective are more complex, it is possible to structure around that.

Q Are you seeing early signs of borrower distress in granular residential portfolios, or is the 'extend and pretend' mindset still dominating?

I would say that the situation varies. In general, we are seeing the most distress in those countries where capital structures were pushed to the maximum when rates were relatively low. One relevant case study for this trend is Germany, where pockets of distress are starting to emerge.

That is a market where banks were generally happy to lend more than 90 percent of a developer's capital structure, with a developer only putting in a very thin slice of equity. That equity was often coming from pre-sales, which have dried up as a result of higher interest rates, making it more expensive for pre-sale buyers to get mortgages.

There are other features of the German market, particularly involving director liabilities and the short-term nature of administration processes, that have led to its default rates spiking faster than those in other countries. But in general, I would say that in markets where capital structures were pushed to their limits, we have seen things go 'pop' relatively quickly.

By contrast, there is less distress immediately apparent in countries where capital structures have been created more thoughtfully. That said, we are certainly seeing an increase in defaults across most geographies. The interest rate environment is making it unsustainable for certain capital structures to continue as they are – in many cases, a restructuring or refinancing is required. This is particularly apparent on the construction side, where we are finding opportunities to step in as a provider of rescue finance.

Q How important is data to sourcing and underwriting, and is technology playing a role?

Data is incredibly important, and there is certainly a role for technology to play in this market. On the servicing side of our business, across 24 platforms and 4,000 employees, we manage around €110 billion of assets across 35 million individual credits and assets. That means there is an enormous set of data we can utilise to evaluate liquidity and support our underwriting and valuation processes.

Artificial intelligence also helps us to review legal documents. Work that would have taken a team of five people two weeks to complete can now be done by a good analyst in a single morning. If you have sufficiently high-quality data to feed into an AI system, there are huge advantages to embracing this technology. It can be an incredibly powerful tool if handled carefully.

Q What are the key underwriting considerations when dealing with highly granular portfolios across different asset classes and geographies?

It is vital to have a local approach. If you are underwriting a granular set of residential properties in Portugal, for example, you need an experienced team on the ground, including local valuers with market knowledge and insights into the liquidity of those assets.

We own 24 local platforms across our network, employing more than 4,000 people that are involved not just in origination but in underwriting every deal we do.

You also need specialised product and asset type expertise. For example, in the UK, we are a major development financier of residential real estate and student accommodation via Maslow Capital, and we have a panel of valuers to assist us on related matters. We have developed more than 24,000 units, which creates a lot of data, and so if we are underwriting a scheme in Manchester, Leeds or Liverpool, we are able to not only get third-party market corroboration to support our due diligence but also analyse how schemes we have previously funded have performed.

By contrast, in Southern Europe, where we do more lending related to hospitality and tourism, we are able to turn to one of our hospitality-based platforms for relevant guidance. For example, we own Details, a hotel management business active across Iberia, and our in-house portfolio management team previously ran a major investor's entire portfolio of hotel assets.

Not every underwriting process is the same or even similar. You need different pockets of expertise depending on the country and the asset class in which you are operating. The first step on this journey, therefore, is identifying the right people to speak to, those people who really understand how these assets trade and what the liquidity is. This applies to both internal teams and third-party professional partners.

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Q How can you balance the scalability of residential asset-backed deals with the operational complexity involved in managing lots of small tickets?

One of the advantages of looking at these highly granular portfolios is that we are often either already servicing those assets through our in-house servicing capability or are at least in a position to do so. Those local servicing platforms are critical to accurately underwriting granular portfolios of residential assets, wherever they may be.

For example, through Norfin, our development management partner in Portugal, we have delivered a significant volume of tourist, residential and hospitality real estate projects in the market. They can help us form a bottom-up view of what those assets are worth. We also own Whitestar, which is the largest non-performing loan servicer in Portugal. Again, it is a case of having boots on the ground to help with the heavy lifting. This isn't a business that can be run out of a central office location.

Q How would you describe the competitive dynamics between banks and non-bank lenders in the granular residential lending market?

Every country has a slightly different mix of bank and non-bank institutions playing in this space. Banks are certainly active, particularly in continental Europe, but they generally have pretty hard limits on what they will and won't do. Those limits may include things like loan-to-value (LTV) and loan-to-cost (LTC) caps.

For example, a bank may be unwilling to lend more than 60 or 70 percent LTC, while the developer may require 80-85 percent. The bank market simply won't stretch that high in terms of the leverage on offer.

Banks may also require a significant number of pre-sales, while the developer may be looking for financing before it has been able to sell anything off-plan. Banks may also require all of the collateral to reside in one country. Many of the deals where we have been able to secure attractively low LTVs at higher chargeable rates have involved borrowers with assets in multiple countries.

They may have assets in Spain and assets in the UK, for example, and they may want to combine those collateral pools. A Spanish bank typically wouldn't be interested in the UK collateral, while a UK private credit lender won't be in a position to take security over the Spanish collateral.

"There are very few pan-European players willing to commit to the space as a whole"

Of course, enforcing a registry of Spanish mortgages is very different from registering a UK mortgage. You need local expertise in order to do both. In these situations, we often find there are local players interested in the local aspects of the deal, but there are very few pan-European players willing to commit to the space as a whole, as we are. ■