In Conversation with Industry Experts: Recap of Mount Street's CRE Roundtable

Recently, Mount Street was pleased to host our inaugural Investor Round Table event at our Wood Street office. The event was the first in a series of three designed to take the temperature of the Real Estate market from a range of market participants. First up were Investors and we were delighted to welcome the following attendees:

HELEN SHELLABEAR (HS) - SHELLWIN PLC

Helen's career began in the Restructuring & Insolvency division of GVA Grimley, and she undertook secondments to the Global Restructuring Group at RBS and the Solutions Group at LBG. She subsequently held senior roles at Hudson Advisors and Addington Capital before taking over as CEO at Shellwin Plc in 2019. Helen is the third generation to lead her Family Office specializing in the investment and development of office and industrial assets in the Southeast of England.

DALE HARTLESS (DH) – LEFTFIELD

Dale is COO of Leftfield with over 20 years of experience across a range of disciplines. He joined LNR Partners in 2009 working in structured finance/CMBS and moved to a senior role at Hudson Advisors/Lone Star working on NPL deals before joining Leftfield in 2017. Leftfield are specialist investors in UK Industrial and Logistics property, who are currently aggregating Fund III, having sold Fund II to Kennedy Wilson/GIC in May 2022.

SAM HARRIS (SH) – KITTI & SADES

Sam is a versatile interim CFO with extensive experience in complex project management, across various industries, including real estate development. As a Value Enhancement Partner to PE investee businesses, Sam improves outcomes and returns for his clients, with a proven record of accomplishment of helping them finance, restructure, transform, and grow towards higher exit valuations. Sam is a Chartered Accountant. He is currently engaged by a real estate investment fund for their self-storage platform.

GORDON ROWAN (GR) – ALPHA REAL CAPITAL

Gordon brings 22 years of experience in structured finance spanning real estate and infrastructure debt in public bond (US/European) and private markets. He has worked across origination and restructuring, predominantly at monoline insurer Ambac Assurance UK, where he was also a member of the Investment Committee. He started his career in Corporate Finance Advisory at Deloitte in London. Today, Gordon is part of the Long Income Real Estate origination and the Alternative Credit Strategies teams at Alpha Real Capital – and has an interest in decarbonisation of the economy.

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MATTHEW GAMBLES (MG) – MIKARE

Matthew started his career with Price water house Coopers in Jersey in 1992 as an Accountant and entered the field of banking in 1996 with Union Bank of Switzerland, as a Portfolio Manager. Senior roles at Deutsche Bank, Ermitage Wealth Management, and RBC followed before joining Stanhope Capital (Jersey) Limited where he worked particularly closely with Trustees and Ultra High Net Worth Families, advising on investment strategies for their trust and wider personal assets. Matthew now runs a single-Family Office in Monaco.

The external attendees were joined by Mount Street employees Jim Gott (JG) and Matt Murray (MM) from our Asset Surveillance desk, and Sam Larking (SL) from the Primary Servicing team. The discussion was moderated by MM.

Jim Gott (JG) – Senior Director, Head of EMEA Asset Diligence and Asset Surveillance

Jim has over 25 years' experience in the real estate, engineering, environmental and power and energy markets. Over the last ten years Jim has managed hundreds of CRE debt and equity projects amounting to many billions of £'s / €'s / $'s of loans, acquisitions and divestitures. Jim's experience includes assisting clients with managing risk, negotiating acquisition and divestiture price adjustments, ESG, technical and environmental due diligence and brownfield development.

Matthew Murray (MM) – Director, Asset Surveillance

Matt re-joined Mount Street in 2022 as a Director in Asset Surveillance having previously led the Primary Servicing Team. Matt has 20 years' experience in Real Estate Finance and Corporate Credit including roles at Hudson Advisors, Deutsche Bank, Mizuho Corporate Bank and Puma Property Finance as a Development Finance originator. Prior to joining Mount Street, Matt was Head of Loan Servicing at CBRE.

Sam Larking (SL) - EMEA Primary Servicing

After graduating from university with a degree in Economics, Sam joined the Commercial Real Estate Restructuring Team at Nationwide focusing on non-performing loans, before moving into the Transaction and Execution Team working with Originators to onboard new UK Commercial Real Estate transactions. Sam has also held roles at Metro Bank as a Relationship Manager and as an Asset Manager at CBRE Loan Services before moving to Mount Street in 2020. Since joining Mount Street Sam's focus has been client delivery for several key clients, team management and managing a diverse portfolio of Commercial Real Estate facilities in the UK and across Europe. Sam has over 9 years of experience in the Commercial Real estate sector.

We enjoyed a vibrant conversation covering a range of topics and as expected, at times veered off on interesting tangents. We have condensed the conversation below and hope you enjoy reading as much as we did hosting.

(MM) 'Welcome everyone to our inaugural Mount Street Roundtable event and many thanks for joining us today. We are obviously at a fascinating point in the cycle right now so we're really looking forward to hearing your views on a range of topics. So, let's get straight into it with point 1:

DEVELOPMENT APPRAISAL AND PROJECT DELIVERY

What changes and challenges are Investors seeing in terms of both appraising new opportunities and delivering projects?

(MM) 'Because they are both so interlinked these days, maybe we can also look at this within the context of ESG. Standards and approaches to ESG are still widely variable so what are attendees doing themselves and what are they seeing from their counter parties concerning ESG plans and requirements?'

(HS) 'The main issue is cost, which will not be a surprise to anyone. At Shellwin we are fortunate in that we have a long investment horizon and want to own these buildings for the next 20 years. My personal view is that for a five-year business plan, you can forget it because the money you need to invest in these buildings is way over and above what it was in the past.'

> *"Gone are the days when you can create a nice Cat A fit-out, get a tenant, and walk away. You need to put a lot of money to make assets fit for purpose from an energy perspective for the next 20 years'"*

'You've got to be looking at air quality monitoring, cycle storage, showers... You have got to be putting a lot of money into the bit that is difficult to price a return on; the value of amenity service to occupiers.'

'But in addition to the costs issue you have also got a skills shortage. I am talking to a lot of contractors about smart building tech and they look at me blankly. I am talking to them about the circular economy and recycled materials, they just aren't there yet. And it makes me question how we can all get moving, particularly on Scope 3 carbon emissions, which is the big issue for real estate businesses'.

(DH) 'On the industrial side, we are not necessarily seeing that 'a certain asset comes with green premium', but what we are seeing is that you maximize the buying pool for assets if you have got something that is green, that has got BREAAM very good or better for example. I think that this will create a green premium, in that it will become prime.

So, you are going to start to see a bifurcation between prime and secondary. This was supposed to happen about five years ago, then three years ago, but still it never happened. Now you are starting to see it. You are starting to see a clear distinction between prime and secondary and the market is thinner for secondary assets.'

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> "You maximize your buying pool if you've got something that's green, that's got BREAAM very good or better."

(HS) to (DH) 'To what standard do you have to build for an institutional buyer to come and buy your estates?'

(DH) 'For us at Leftfield, holding something for the period we look to hold for – five years plus, which may or may not happen, you need to future proof it. So, you are looking at EPC A, you are looking at BREAAM very good, you're looking for something that appeals to the largest possible buyer pool'

(HS) 'Are you putting that mechanism in your Leases where the tenant must bring it back to EPC A at the end of the term?'

(DH) ' We usually have a Clause that a tenant cannot do anything which brings the EPC below A'.

(HS) 'There are going to be a lot of people that will benefit from the 'green premium' in the short term. And I think if you are going to benefit from it, you need to be on that train now because at some point soon it will become the norm, and then there will be no such thing as green premium because we should all be at that level'.

(SH) 'The problem is that you move into a lovely office ,that smells like a new car, and in five years it is going to feel dated. So that Green premium is itself a depreciating asset. You have got to keep refreshing it to give the occupier that experience; and maintain something that can be monetised. I think for us it is a little easier with the warehouse space. Usually, you just need to hit an ESG or BREEAM requirement, which is a technical consideration rather than an experiential one'.

(DH) 'A key differential in the industrial space is that the fit outs are tenant spend. If a tenant wants a certain fit out, then they are installing it at their own cost. Whereas in the office market now it is still very much on the landlord's shoulders, and it is not being clearly rentalised.

You could maybe argue that it is being rentalised because you demand a higher rent. But this is very subjective, it would be much easier if you could say - if you want XY&Z above a standard fit-out then we as landlord can rentalise this and you can have it'.

(GR) 'What is considered Prime these days? The old trophy assets like the towers at Canary Wharf no longer tick the right boxes.'

(HS) 'A building such as 22 Bishopsgate. It utilises smart building tech to optimize management & operations, it's got 1,500 bike spaces, you do not even have a reception – just a QR code and assistants walking around with iPads, it even has a code of conduct for dogs.

A lot of people are following that as the blueprint for where you must get to. And it is not going to be relevant for everyone because not everyone wants those kinds of amenities or critically not every business wants to pay the resultant service charge for those types of amenities.

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But we've put on free pilates classes in some of our buildings for example. Curating an occupier community is incredibly difficult, but it is the way it is going. So, for each individual landlord you have got to be looking very closely at potential occupier base I think to work out which amenities are going to be the most valuable'.

(JG) 'Some of the office buildings, which would have been considered trophy assets for a long time, are now looking distinctly dated versus the new generation of smart offices and that makes them problematic, it makes you ask, 'What can we do with these assets?'. Do you go Residential? Is it an option, personally I think that you will see a lot of areas having to go more residential.

(HS) 'Local authorities will resist those changes at the moment because they arguably went too far on the office to resist conversions permitted development in some areas. We have had Article 4 directions placed on many of our officers to prevent conversion to residential which for us is fine because we are seeing an undersupply of good quality offices'.

(MM) 'I think the whole office market is at an interesting point right now. I knew we would end up going off on tangents so let us just touch on that quickly, Jim, I know you have a line about office'.

(JG) 'Yes, the new sub-prime'. I think, at the moment it is like everything is being treated the same by investors as opposed to being split into jurisdiction, asset class, and risk categories.

> *"There's a lot of people appearing to drive the car whilst looking in the rearview mirror".*

From a debt point of view I don't think it's particularly debt funds that are at risk, it feels as though it is likely more Banks and Insurers, but I'm sure that there are people sitting with assets that are going to become, and I'm not going to use the term stranded as that seems transient, I think that they will be obsolete. And it is going to remain obsolete unless you spend a lot of money, and it may be that not enough people are taking that into account. So are Lenders really valuing the ESG piece because I think it is just risk reduction'.

(MM) 'And we have lenders who will simply not lend to the sector. They have zero allocation to Office for new lending, some of which may be driven by their experiences in the US which has some of the most difficult markets in the world now – places like San Francisco are over 30% vacancy rates.

(SH) 'My comment on ESG is very simple in that to achieve something of some real value, you have to put some dollars into it and bring it up to a great standard that creates benefits and value in use'.

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(HS) 'Absolutely. I think CBRE said that they estimated 25% of the value of a building was what it would cost to bring it up to the right standard. And that certainly is my experience so far’.

(JG) 'You're seeing a real spread in how Lenders are approaching ESG considerations. Some are screening out non-compliant deals before they even reach the Term Sheet stage and others are saying it is high on the agenda, but when you look at the detail it's something like a 5-basis downward ratchet on your margin if you stick a solar panel on'.

(MM) 'Outside of sustainability considerations, how else can investors and developers look to differentiate their products?'

(HS) ‘At the moment, you have coworking and then you have traditional offices and you've got all these other models in between such as traditional serviced, plug and play or managed plus and it is working out - What do I want to provide? What can I feasibly do? At the moment offices are all about creating a point of difference, then working out how you monetize that'.

(MG) 'It is back to being brave, being different. Putting a Pilates class out there – people may not take it up, but they want to know its there'.

(HS) 'We’re also looking at solar PV projects on a lot of our buildings because we think it's the next long-term income strip product, it's really exciting'.

(GR) 'It is already happening. If you have enough building, you can do rooftop solar but also storage via batteries at the back and side'.

(MG) 'I have done it at home. I think it is just the right thing to do and some of these things will eventually become core requirements, maybe an element of solar within your mix even just on residential, never mind commercia, may well be you need to have that in there'.

(JG) 'The Energy and solar piece is interesting because it is much easier to value than other amenity spaces. It is an income strip so you slap a yield on it, but you cannot really do that with a Pilates space.

For any development, assuming a 4 or 5-year development phase, how do you keep up with where things are on the technology side because you need to make those decisions on day one? You need to think of the ESG piece before you have started your design because if you try and retrofit it is very difficult'.

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(SH) "Are you always going to have to accept that sometimes you are going to be out of date? You cannot crystal-ball what tomorrow's technology will be. If so, it strikes me that careful consideration of the costs and economic value is required to find the right balance".

(DH) "Just on the solar panel point, before we go off it, Tritax for one, are putting in solar panels on the roofs of their developments and storing the energy in battery stores on site. This is then sold to tenants at below market rates. So that is a complete income strip that's not part of your rent that is being charged'.

FINANCING

What are you seeing from your lenders in terms of their approach to existing facilities and new lending? Has the growth of debt funds and alternative Lenders been successful at plugging funding gaps and what are the benefits and downsides to that approach?

(MM) 'Gordon given you sit across the Equity and Debt desks, maybe you could start us off on this one.'

(GR) 'We have seen a very fast uptick in base rates across the West, the Western world, particularly and unsurprisingly the commercial real estate market has reacted to that. And what we do not know is what is coming next and whether this is a game of chicken between the Fed and the markets and who believes who and whether it is going to be hard or soft landing'.

> *"There is a lot of uncertainty. There is a wall of CMBS deals coming to refi in the next few years and the question is how is that dealt with?"*

I think that a lot is hanging on what comes out of base rates and whether the FED pivots and whether rates go down and a lot of that will be driven by inflation. So, I think they are the corners of the jigsaw.'

(MM) 'Matthew, what are you seeing in your discussions with Lenders?'

(MG) 'We have a large mixed-use project under development in Berlin and my problem is it's mixed-use - primarily Resi, but I've also got a fairly large office in the basement, and two towers – one for sale apartments and one serviced apartment and then some retail space In this kind of current environment, I'm finding a lot of the banks won't even look if it's not vanilla.

Banks are saying - I'll just stick to this because I understand it and I can do it.'

> *"People are very vanilla in the deals they want to do. And everything takes longer"*

(MM) 'There has been a lot of new money coming into the market over the last 12-18 months, in particular US money, especially when they had the built-in 20%-dollar premium, and Mount Street has been appointed to act for several of those funds.

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The dollar has fallen back a bit now, but they are generally sophisticated lenders who understand risk, often because they have also got significant equity operations'.

(GR) 'Capital structure is also key. Loans that are 5 or 7 years long create this natural cycle of looking over your shoulder and maybe having longer-term financing in place for a good part of the capital structure is one way to handle that'.

(HS) 'I have an internal debt limit that I will not reach because I have seen what happens when you do. It means I will grow slower, but it means I can sleep at night'.

(DH) 'We're seeing quite a bit of appetite from our lenders. Although admittedly we are in a strong financing position, having sold our Fund II portfolio last year and buying our current assets at new repriced levels. Our lawyers and professional advisors are often helpful in selecting a lender as they are seeing who is doing deals. They can give insight such as ' X Lender say they are lending, but 9 of 10 are getting turned down at credit', which is invaluable in a volatile market'

(MM) 'Well I think we could keep this going for hours but sadly we have already gone over time so we'd better call a halt to proceedings there. Many thanks again to everyone for attending and I think we held a really useful and interesting conversation. We did not get to cover everything on the schedule, but the conversation took some very interesting tangents and I hope we can all get together and do it again next year!'

Here is our quick summary of takeaways from the meeting:

- There is a growing bifurcation between prime and secondary properties, especially in the office sector.

- Investors need to work hard to differentiate their offerings not just in terms of Real Estate, but also branding and awareness. As Helen Shellabear said:

> *"Know your market, know your customer, know your buildings and be proactive in terms of what you're doing."*

- ESG considerations are only getting stronger and are not something Investors can realistically ignore. Cost, but also skill shortages remain a major barrier to delivery for projects that want increased focus on long-term sustainability.

- Lenders are being very selective around deals and the process is generally taking longer than it has done. Approaches to ESG criteria are varying but it will feature in some way for most Lenders in the current market.

Thanks again to the attendees and we look forward to the second in our three-part series of Roundtable events which will focus on the debt markets and be held at our Wood Street offices over the summer (Dates TBC).

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About Mount Street:

Mount Street manages over €130bn in CRE, Infrastructure, Shipping, Aviation, Structured Finance and Corporate loans with a team of over 200 professionals across 10 offices in EMEA, the USA, and Australia. We offer expertise across the debt life cycle with our core loan servicing business, Mount Street Mortgage Servicing, Europe's largest 3rd party servicer with €78bn under management and a further $26.5bn under management in the USA. Our regulated portfolio management and advisory business, Mount Street Portfolio Advisers manages €24.8bn of debt instruments across EMEA and the USA for institutional investors. Our business is powered by our proprietary loan management platform, CreditHub.

If you are a Real Estate Lender and would like to attend the next Roundtable, please contact Matt Murray at matt.murray@mountstreet.com for more info.

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