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

Building on the success of our previous Roundtable focussing on Real Estate Investors, we were delighted to host our second event, this time focussed on Real Estate Lenders. We had the opportunity to glean insights on a wide range of topics ranging from current market conditions to the interplay of development versus investment risk, the role of AI in real estate, and identifying the most promising sector opportunities as we move into 2024 and beyond.

PETER CLAYTON

With almost 20 years of working in the UK real estate finance market, Peter has worked on over £5bn of investment and development debt facilities, predominantly structuring senior and junior debt, across almost all sub-sectors, and with a wide variety of types of clients from small private property companies to REITs to global institutional capital.

KRISTINA FOSTER - SCHRODERS CAPITAL

Kristina joined Schroders in December 2020 as a founding member of the Schroders Real Estate Debt Team. Prior to joining the firm, Kristina was a Managing Director of Real Estate Debt Europe at Barings Alternative Investments, a global real estate private equity and real assets platform, and was responsible for originating, structuring, and executing core, value add and opportunistic real estate lending strategies both in the UK and in mainland Europe.

Kristina began her career in the real estate industry at DTZ Debenham Thorpe, where she qualified as a Chartered Surveyor and became a founding member of European Valuation & Advisory and has experience across the capital structure. Kristina then joined RBS, where she held several senior positions. Kristina holds a BSc (Hons) from Nottingham Trent University and is a member of the Royal Institution of Chartered Surveyors. (RICS)

Website: schroderscapital.com

MARCO RAMPIN - CERBERUS

Marco is a Managing Director on the Real Estate Private Credit team. Based in London, he leads Cerberus' origination and execution of real estate debt investments across Europe. Prior to joining Cerberus, Mr. Rampin held roles at CBRE Global Investors and CBRE Capital Advisors, and from 2007 to 2015, he was Head of European Real Estate Finance within the Fixed Income division of BNP Paribas Corporate and Institutional Banking. Mr. Rampin has 30 years of real estate experience in roles spanning from advisory to principal investing and debt financing. He began his real estate career at JLL in Italy, France, and the United Kingdom and later held roles at Lend Lease Real Estate Investments and AIG Global Real Estate, before moving to the banking sector in 2004.

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ANTHONY RAUD - MASLOW CAPITAL

Anthony is a key member of the Origination Team at Maslow Capital. Maslow is a leading provider of real estate finance, offering funding solutions across all living sector assets, from £10m to £300m. Anthony has extensive experience in real estate development and investment finance, having worked across Deal Origination, Credit Analysis, Deal Execution, and Portfolio Management. Prior to joining Maslow in 2019, Anthony held various roles at a major Australian bank, ANZ, within the Institutional Property Group.

Website: maslowcapital.com

JOHN BIGLEY - EXPERIENCED LENDER

John has over 25 years of real estate and debt capital markets experience. He has spent the past 9 years as Principal at DRC Capital working as a senior transactor involved in origination, structuring, execution, asset management and investor relationship management. Prior to DRC, John was a Director at Westimmo and has also held positions at Merrill Lynch & Co. and JP Morgan Asset Management. John started his career in direct property consultancy and asset management and has been a Chartered Surveyor since 1997. John holds a BSc joint (Hons) from the University of St. Andrews.

The external attendees were joined by Mount Street employees Jim Gott and Matt Murray from our Asset Surveillance desk. The discussion was moderated by Matt Murray.

JIM GOTT – 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.

Website: mountstreet.com

MATTHEW MURRAY – 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.

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QUESTION - LENDING CONDITIONS

What are the key drivers determining how, when, and where Real Estate collateralised credit should be deployed in today's environment?

As expected, interest rates dominated the conversation with all attendees agreeing monetary policy is the biggest single factor driving investment decisions today. But as the market faces up to 'higher for longer', market participants are reacting in different ways as Marco Rampin, Managing Director of the Real Estate Private Credit team at Cerberus points out:

> *" Every time there's a shock in the market, re-pricing takes place starting with a bid/ask gap that gradually closes down. This time, however, it looks like the bid/ask gap is going on forever because half the industry believes that interest rates will come down and is not prepared to accept the adjustments."*

He continues "15 years ago liquidity was wiped out, but this time, due to covid, etc, people kept a lot of dry powder to keep chipping in to de-leverage, so no-one is selling at prices they think will negatively impact their returns, because they think sooner or later values will go back." The result is a kind of market paralysis that's seen thin trading across the board and a lack of price discovery in certain sectors, especially office (more on that later), that makes it very difficult for market participants to get a feel as to where we are in the cycle. But it's not all doom and gloom. The combination of rising rates and lowering LTVs has also provided the sort of risk-adjusted return opportunities not seen since the aftermath of the GFC as Kristina Foster, Fund Manager at Schroders explains "It's clearly a Lenders market if you're doing new transactions. Returns in Investment grade lending are multiples better than they were".

This begs the question, where does a senior loan sit on the leverage curve in today's market? 60% LTV with anything above in the stretch senior/junior lending space used to be a commonly agreed market metric, Peter Clayton, offers an alternative view "I don't think it's dictated by LTV, I think it's dictated by income on the senior side. Everything we look at is now driven by income". Foster agrees "We sit alongside a very large real estate team so we're looking at RE more as an operational business and making sure you get the gross to net right, rather than just looking at LTV".

John Bigley feels:

> *"Senior lending used to be lending that you could do at any point, and it would always be ok. It was a through-the-cycle approach to lending. I guess it should still be like that, but you have some overlays that have been pretty challenging".*

Ultimately investment committees will still only sign off on certain LTVs, no matter how strong net income is, and with reductions across the board in available leverage. How are Borrowers reacting to the new normal? Peter Claytons' view is, after a period of denial, the market has now shifted "Any kickback [from Borrowers] there may have been has now left, as we're facing a new reality. As a senior lender, you can only structure to a certain point if you are cashflow led".

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So where are lenders focussing most of their efforts now? "It's almost strangely competitive for the right deals. Anything with a good debt yield and solid cash flow" says Bigley. Anthony Raud, Deal Origination at Maslow Capital agrees:

"There's less transactions in the market than 12-18 months ago, but at the same time there remains a lot of liquidity which needs to be deployed across the board, so you've got a situation where it's very competitive, especially for the quality transactions".

Maintaining compliance with debt yields and interest cover ratios in a rising rate environment is a challenge for a lot of investors and those assets that are strongly yielding are often doing so for a reason, as Peter Clayton says "If something has a good debt yield and you're at 55%, what is the risk on that underlying asset because the yield should be priced in. Retail has given pretty good income cover as interest rates have risen and therefore been a relatively resilient sector, but how happy are we with the underlying performance of the tenants in retail?". John Bigley feels "Retail has been kicked quite hard since 2017. If you find an asset where rents have re-based and the tenant base is focused on the value and convenience end of the spectrum, they're actually quite resilient at this point". Peter Clayton expands further:

"We funded three [shopping centers] that were all that I could call community-led. All off high double-digit yields. A) all the income was resilient and B) it had been re-based. Occupancy in all of them is over 90%. From a risk-reward perspective, we are making better returns off those loans than some of the other loans we've done in the last couple of years".

So with a clear preference amongst our panel for income-producing resilient cashflows, how does that feed into our second discussion topic:

"Are we at the start of an office apocalypse? Or is there hope for the sector?"

It seems every day leads to darker headlines for the office market, what are the views of our attendees – do they even have an allocation in their mandate for new office deals now? For John Bigley it's a case of "For new deals yes, but it's very narrow". Marco at Cerberus feels "It's not excluded but pretty unlikely" with Kristina Foster adding "As a business, Schroders is on the equity side, so we see the long-term market for office, but for our market information, for capital raising purposes, it's completely off the table". There are also pressures on the capital raising side as Bigley explains "Non-bank lenders have to sit in front of investors who are not always specialists and you don't necessarily want to have a conversation get hijacked about why you just did an office loan".

Jim Gott, Head of Loan Surveillance at Mount Street asks if the general sentiment toward the sector is at least partially a result of what we're seeing in the US "Markets like San Francisco are being talked about as being in a death spiral. And the US in general has low unemployment allowing employees to call the shots regarding WFH". John Bigley agrees "There's a lot of things in the US experience which are not a very easy read across to Europe, therefore, the US private equity led sentiment to offices in Europe, maybe a bit overcooked. But it's there. There's not a lot we can do about it".

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And how about Valuations, did the attendees think we were seeing conditions on the ground in the office market translate fully into valuation numbers? Peter Clayton believes:

> *"Anyone selling office right now is a forced seller. It's almost impossible for valuers to come up with the right number…the market tends to overreact to interest rates, well the same thing happens in Valuations, Valuers tend to go one way too far then it will settle at a slightly better place. But it's almost impossible for them to value right now".*

Jim Gott adds "We have seen assets that have gone to market and offers are coming in at half the [recent] valuation. We're also seeing a large disconnect between Borrower and Lender valuations – we recently had a deal where we had a 27% difference between valuations on the same asset and it's because everything, especially in the office, is so thinly traded".

"In defense of the valuers", says Marco Rampin, "It's very difficult and I feel for them. It's also difficult for investors, particularly those who are long-office, to digest that their offices are no longer in the 4 or 5 maximum rates but they are in 6+. There's a lot of capital that's being burned".

Whilst there are obviously numerous challenges, assets with the right credentials in certain locations are hitting record rental levels, as Jim explains:

> *"If you look around the City you're seeing the super prime rents come up. Those assets are doing well there's a lot of demand for them. It's fine if you're in the right location and have top sustainability credentials, but if you don't, what can you do with that space?".*

John Bigley feels "It's got to find an equilibrium. Many B-grade buildings are still going to have a life, some people are still going to want this space, they don't need a particular ESG badge, it'll have to settle out".

Marco Rampin raised an interesting point "Conversion costs are expensive, but maybe at some point we'll see some [state] subsidies, just to avoid the collapse of entire districts."

DEVELOPMENT

What are the key underwriting decisions when looking at development transactions and how do they differ from pre-covid?

Pre and post-Covid worlds are very different, and that change is particularly pronounced in the construction and development sector which has experienced the challenge of rapidly escalating build and labour costs and now record rate increases. How are Lenders handling these challenges? Anthony Raud of Maslow kicks us off: "You've got construction prices that have gone up exponentially. We've found in some cases that we've had to work with borrowers and/or developers who have been hit by 10-15/20% plus increases over the life of the build. We're very focused on good sponsors and forming relationships with the right parties.

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It's more important than ever that you need liquid sponsors, who have a solution-based approach and the relevant experience of having been through life cycles before". What about build costs, have they generally settled now? "I'd say they've stabilised over the last six months and if anything come back very slightly. Certainly, not to the levels they were two years ago, but definitely leveled out".

And what about on the sales or exit side, what's different now? "It's not necessarily different from pre-covid, but location and amenities continue to be crucially important across the board, especially when assessing PRS/BTR transactions. We've funded a couple of co-living schemes, which has a big focus around community feel and amenity space – it's a sector which is still in the discovery phase, but we feel will continue gathering momentum". Peter Clayton adds "We fund one co-living asset at the moment In the right location, in the right cities then we buy into the concept because there is a cohort of people leaving university that want to maintain that kind of lifestyle".

Jim Gott feels as a sector, development lending finds itself at an unusual point in the market "I have a view that the heavy Capex/Development piece is probably lower risk than Investment Grade at the moment, despite debt pricing being the other way around. Sometimes it's easier to justify investing in an asset where you're taking it from something that's a bit sub-standard, a bit functionally obsolete in some way, and turning it into something else in a decent sector". Kristina agrees "For development lending, you're paying your interest on your own loan, and you never hit the LTV until you get to the end of the development".

"I dislike the term, but Brown to Green is a space that makes sense at the moment" says John Bigley "I've seen recently a debt deal at 60% LTC, prime west end location, moderate refurb to bring it up to a good B+ standard, and I can make 11% IRR. Also doing refurbishment works over the next year or two and then coming into the market is a sensible story".

PRS is in the news a lot at the moment and at the peak of the market these schemes were often aggressively underwritten with low yields and plenty of rental growth priced in, how has that played out in practice? "PRS or BTR schemes are beneficiaries of rates and mortgages becoming harder to access" says Anthony, "A pool of buyers that had their deposit set aside and were ready to come into the market have been hit by the continuous rate hikes. An example is a young professional or a couple who were ready to buy but are unable to for now. They however still want to have a higher level of living and access to amenities, be near restaurants, train stations and so forth. Newer stock being delivered in the PRS or BTR space has been the beneficiary of that".

"Single-family housing is an interesting story for us" states Peter Clayton "There's a real shortage of good quality housing stock to rent across the country. We see that as a possibly bigger opportunity in terms of the development side. We're starting to see more opportunities feed through to certain operators from the big housebuilders. Sitting on sites where they might not be able to get the sale prices or velocity that they were doing previously."

TECHNOLOGY

Two-fold question, how do you see technology such as AI disrupting the Real Estate sector and are you deploying new tech and data analysis techniques in your platforms?

'AI' seems to have replaced 'ESG' as this year's favoured acronym and there are multiple thought pieces about the potential impact of Generative AI on the workplace and our lifestyles in general. We asked the attendees how they felt this might affect the property sector and how they were using technology and data in general versus a few years ago. "We're starting to use data science," says Kristina Foster, increasingly so in our underwriting, especially when addressing climate risks".

Is there a possibility as AI develops you won't need the analyst and as a knock-on, does that mean you don't need as much space as an occupier? "I can't map in my head how AI disrupts real estate? How do you train an analyst if they aren't seeing lots of deals.".

> *"This also goes back to being back to being in the office; people have a duty of care to the next generation to help them work together and share our knowledge and experiences. You can't go to university and suddenly know what we've learned after 20-odd years in the sector. I feel quite strongly about that and about going back to the office. I don't really see where AI fits in and unless it is part of an initial screening tool, I don't think it's there yet".*

"In our case, we have data, and we mine data, but we do our own interpretations of the data analysis," says Marco Rampin, "but there is no AI involvement. On the equity side, we've employed a CTO to really think about how you can make a better model for managing assets and provide better outputs and accurate data and returns. So in that sense, we're using our own proprietary data to make things better". Anthony Raud adds, "We have tools behind the scenes where you click a button, and it tells you what HPI growth is, what it's been over time, affordability in certain boroughs, etc. As a firm, we've been ahead of the curve on this for some time. However, in terms of using AI tools, we are currently looking into the integration of GPT within a secure, enclosed environment to enhance our operational efficiency on basic tasks, however, the majority of the heavy lifting will remain with the team who draw on many years of experience." Peter feels "AI is more powerful for a homogenised product as opposed to something that had multiple risk variables however we must be alive to the opportunity AI presents".

> *"At the end of the day real estate is a people business, so the impact of AI is naturally limited".*

OPPORTUNITIES

Where do attendees expect to see, or are already seeing, opportunities given the market dislocation?

Market conditions are obviously incredibly challenging, but periods of dislocation always lead to opportunities, so to round off the conversation we wanted to get views from all attendees on where 'they see the best market opportunities at the moment. Peter Clayton started us off:

" I like the concept of doing things counter cyclically. Pricing in sectors like office might get to a point where deals start to look interesting. Also brown to green makes sense as a concept but judging the risk-reward in that space is tricky and ensuring stock selection is critical. BTR in the form of both multi-family and single-family housing we continue to see as an opportunity for us going forward".

In John Bigley's view, it's "Residential because occupier demand continues to be unsatisfied. I see non-bank lenders continuing to play wherever they have relevant capital, which tends to be in more transitional situations. Some of the alternatives are interesting such as student and self-storage. Being slightly counter-cyclical in very core locations and on well-performing assets does make some sense that would apply to retail and to offices; some of the traditional assets that have been battered hardest over the last few years".

Marco Rampin feels "Prime locations carry less risk and it's the prudent stance to take not knowing where rates are going to go. Returns seem to have changed. The market is pricing similar detachment points at least twice the levels seen in a zero-rate environment. This partly reflects increased volatility and lack of liquidity in the real estate market. Considering how traditional banks are retracting, with or without price corrections, it's expected there will be some form of de-levering so someone else can step in. The securitisation market is very small in Europe and CRE public debt we see in the US doesn't seem to have taken hold in Europe, so perhaps private credit has a chance to offer an alternative to these instruments".

Kristina Foster - "Agree totally with the sectors. Maybe not quite there yet but bridging the debt funding gap with interesting junior or mezz-type loans but at a lower attachment point than people have in the past is an opportunity. I think values need to stabilise a bit and it will be an opportunity".

Anthony Raud - "We're seeing more enquires or opportunities to assist built part-built schemes which need liquidity in getting to completion or sites where we may want to step in to assist the Borrower. We feel this will be a continued focus and we have a credit solutions fund for these types of scenarios. We also feel that income-producing assets remain an attractive proposition for debt and equity players, in the residential space such as BTR/PRS, or student accommodation. Our view is that they'll be resilient moving forward – especially in the right locations".

Here is our quick summary of takeaways from the meeting:

- Interest Rates continue to be by far the most important part of the market mix with a growing acceptance amongst both Lenders and Borrowers that higher rates are here to stay;
- Cashflow is king and a through understanding of gross to net and the resiliency of income is key in underwriting new transactions;
- Development finance, particularly in the brown-to-green space is providing interesting risk adjusted opportunities, often presenting better than Investment Grade opportunities;
- The office sector is extremely challenged, and thin trading is making valuation difficult;
- Retail is benefiting from re-based rents and valuations with yields often high enough to well cover increased interest costs.

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Thanks again to the attendees and we look forward to the third in our three-part series of Roundtable events which will focus on Real Estate Advisors and be held at our Wood Street offices in the first quarter of 2024. If you are a Valuer, Broker, Lawyer, or other advisor and would like to attend please contact Matt Murray at matt.murray@mountstreet.com for more info.

About Mount Street:

Mount Street manages over €130 billion of assets, including €95 billion in commercial property, with a team of over 200 professionals in 10 offices across EMEA, the US and Australia. We offer expertise across the debt life cycle through our core loan management business, Europe's largest third-party manager, Mount Street Mortgage Servicing. Our regulated portfolio management and advisory business, Mount Street Portfolio Advisers, manages €22.7 billion of debt instruments across EMEA and the US on behalf of institutional investors. Our business is powered by our proprietary loan management platform, CreditHub.

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