# Heading towards the highest risk-adjusted returns in real estate debt

Alternative real estate debt lending is on the rise, providing the private debt market with more liquidity and diversification of lenders. Dale Lattanzio, Managing Partner at DRC Savills IM, and Mohamed Ali, Senior Analyst Global Real Estate Debt, discuss the alternative lending market and the opportunities real estate debt presents.

By *Harry Geels*

**What global trends do you see in the real estate debt markets?**

**Dale Lattanzio:** 'It is interesting that with rising inflation and interest rates real estate prices fell pretty much with the same speed, maybe quicker and more than the markets anticipated, with differences among sectors and regions, of course. For the three main regions, Asia-Pacific, Europe and the US, we forecast challenges for bank lending and other non-bank lenders refinancing the real estate loans due over the next couple of years, because LTV ratios have increased and interest coverage ratios have gone down. The US is the most diverse, balanced, and transparent market, followed by Europe, where non-bank lending only began in 2009 and now makes up about 25% of the market. Banks still dominate the market here, especially in the bigger deals. In Australia, regulators have taken a stricter view on real estate bank lending during the last decade, which has led to an increasing role for non-bank lenders.'

'Alternative lenders need to prove themselves twice over, for their own investors, and for the borrowers.'

**Mohamed Ali:** 'It is good for the markets that non-bank lending has grown considerably. The markets have become – from a cyclicality point of view – less dependent on a single participant's behaviour. Globally, non-bank financing has grown at an average of 25% CAGR since 2015. The appeal for the borrowers is that non-bank lending offers more flexibility, for example with 'combination deals' where private equity also does a part of the financing. In my opinion private equity and private debt will continue to drive the growth of this asset class.'

**Is there a risk that the alternative lending market will grow too fast?**

**Ali:** 'There are certainly challenges in the market, such as maturity walls, across all regions. The volume of bank loans doesn't match current requirements, which provides an opportunity and a need for alternative lenders to provide capital to the market. We also see differences in risk appetite. Banks prefer the top tier of the investment grade market. Borrowers that don't meet the requirements of the bank, usually stricter in uncertain market environments, will require the flexibility of alternative lenders. This has been the case in the US for quite some time, with Australia and Europe providing further growth opportunities for alternative lending.'

**Lattanzio:** 'Essentially, banks are leveraged institutions, whereas most alternative lenders, like Savills Investment Management, supply capital that is most often unleveraged through closed-ended funds, which isn't subject to market moves, and that is there for the duration of that loan. Again, this is a nice supplement to banks. Now that banks take a smaller part of the market, many bank credit analysts have moved to alternative lenders. Yes, growth in the alternative market has been fast, but reasonable. The talent pool has been able to keep pace with the expansion of the market. However, there are differences between how banks and alternative lenders manage their loan portfolios. For example, we manage both the equity and the debt sides of real estate investments, with resources from a parent with vast, global capabilities, which provides added value.

## ‘The markets have become – from a cyclicality point of view – less dependent on a single participant’s behaviour.’

Alternative lenders also need to prove themselves twice over, for their own investors, and for the borrowers.’

### Is there a cycle in alternative credit? And is this a good time to invest in real estate debt?

**Ali:** ‘There is a cycle and we are currently in the better part of it. It’s a good time to invest in real estate debt. Property values have dropped considerably after interest rates increased. Perhaps more devaluations are coming, but most of the correction is likely behind us. New loans will be issued to rebased property values, with circa 30-40% equity cushion. In order for this equity cushion to erode completely, property values will need to drop more than in any past downturn. Of course, there are regional and sector differences. And that calls for an active approach: find the best opportunities, which are increasingly becoming available, and structure the transaction to achieve the best risk-adjusted returns for investors. While there will certainly be preferred sectors in this climate, it is important to judge each investment on its own merits to uncover a broad range of opportunities.’

**Lattanzio:** ‘As a lender, we want an environment that offers a bottoming of real estate prices while there isn’t a lot of capital available for borrowers. Then we can find the highest risk-adjusted returns. We are now heading towards that environment. Because we still have a nice equity cushion, real estate debt currently offers a good risk-return. In general, we prefer sectors that have demonstrated lower volatility. Residential-for-let and the industrial and logistics sectors have proved resilient. For investment grade loans, which in Europe are mostly floating, the spread would typically be between 150 to 200 basis points. If we move up in the risk spectrum and look at higher LTVs, spreads can go up to 300 to 400 basis points. For construction and development, we are in the 400 to 500 basis points range. These spreads have been reasonably consistent throughout cycles.’

### Where is real estate debt positioned within investor portfolios?

**Lattanzio:** ‘During the emergence of the asset class, we launched mostly higher yielding or mezzanine strategies to appeal to real estate investors, who wanted downside protection while still having double digit returns. When interest rates went lower and lower, and in some cases negative, investors expressed an appetite for higher quality alternative credit strategies, such as real estate and infrastructure debt. That appetite has recently grown because of relatively high risk-adjusted returns.’

### How important is ESG to you and your investors?

**Lattanzio:** ‘ESG is extremely important, because it is increasingly being incorporated into the investment processes of our clients, and because the future value of real estate will reflect the sustainability of the asset. We only lend to sponsors and owners who incorporate ESG into their business plans and upgrade to a higher quality asset over the term of the loan. We will also include obligations to adhere to specific ESG improvements over the term of the loan.’

**Ali:** ‘An additional dimension is the new regulations that will demand much more from investors regarding sustainability. You simply don’t want to have property below standard when these regulations come into effect. Institutional investors have been focusing on sustainability earlier than private investors, and European investors before American, but everybody is catching up fast now, which is a good thing. It’s a clear and undeniable trend, especially in real estate with its relatively large environmental footprint.’ ■



**Dale Lattanzio**

Managing Partner, DRC Savills Investment Management

**Mohamed Ali**

Senior Analyst Global Real Estate Debt, DRC Savills Investment Management

## SUMMARY

The volume of real estate bank loans doesn’t match current requirements. This provides an opportunity and a need for alternative lenders.

The appeal for the borrowers is that non-bank lending offers more flexibility.

New loans will be issued to rebased property values, with a healthy equity cushion.

Real estate debt currently offers a good risk-return.

We lend to sponsors and owners who incorporate ESG into their business plans and upgrade to a higher quality asset over the term of the loan.

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