KEYNOTE INTERVIEW

# Meeting investors' needs in the mid-market



*A mid-market focus makes sense for investors in the current economic environment, says Ralf Kind, head of real estate debt at Edmond de Rothschild REIM*

In February, Edmond de Rothschild Real Estate Investment Management announced it was seeking €600 million of capital for the next vintage of its real estate lending strategy. If successful, the fund will be significantly larger than its first vehicle, which was launched in 2020, and for which it managed to amass €350 million split across a fund and a separate account. Like its predecessor, the new fund will be focused on providing loans in the mid-market segment. *Real Estate Capital Europe* asked the privately-owned manager's head of real estate debt, Ralf Kind, why a focus on mid-size loans is likely to appeal to real estate debt investors at this moment in time.

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**Q What do you consider to be the 'mid-market' when it comes to real estate financing in Europe?**

At the lower end, it is a €20 million ticket, and at the upper end, €60 million to €70 million. If we look at the available data, most real estate lending transactions have happened in that market segment. Because there is a lot of activity, that makes it quite a liquid market. Buildings valued at €50 million to €100 million are more easily tradeable than the big trophy assets because the market is deeper.

**Q EDR REIM is currently raising for its second real estate lending strategy. Why are you focusing on mid-market loans?**

If you look at the sources of finance available to commercial real estate borrowers in Europe, there are the international banks and the big debt funds, which tend to focus on tickets over €100 million. Some of them lend on double-digit tickets of €70 million to €90 million, but they are the exception. Most of them pitch for larger

transactions. Then at the lower end there are the local banks and smaller debt funds, which focus on loans of up to €20 million.

In the medium-sized segment there is less competition, which helps generate an attractive price premium, particularly if you focus on value-add transactions, and if you are flexible enough to do deals across Europe, and across a variety of asset classes.

On a senior secured whole loan of up to 60 percent loan-to-value you can get a return of 9-10 percent. A sponsor would struggle to get that kind of refinancing done with a bank, because banks are generally looking to provide up to 40-50 percent LTV with ICRs often being the limiting factor in the debt sizing. The borrower could opt to source a senior debt piece from a bank and then add a mezzanine loan on top. But then they have a more complex structure. If you can provide a single tranche whole loan that reduces complexity, and combine that with fast execution, then you can command an attractive price premium from the borrower.

In the mid-sized market, you can also take a stretched senior position, a junior piece behind the banks' super-senior tranche, at around 40-60 percent LTV, which can generate double-digit returns.

Investors can achieve attractive returns for senior secured debt right now, which are higher than managers are making for real estate equity strategies. However, an equity transaction should generate a higher return than debt because it involves higher risk, so that situation cannot continue forever. But the dislocations we are experiencing in Europe at the moment mean that as a debt investor you can currently generate a better return than you could for an equity investment.

Another reason why we choose to invest in the mid-market is that we have a 120-strong real estate asset management team located across all the major European countries. Having those boots on the ground assists us in identifying origination opportunities and assessing where we should deploy capital.



**Q Why is a mid-market strategy timely at this point in the real estate cycle?**

A wave of maturing loans will hit the market in the second half of 2023 and next year. Many of those transactions will be within the mid-market segment, which will generate a lot of demand for whole loans.

If an existing lender, perhaps a bank, is unwilling to continue providing the same level of debt, the borrower has two options. Either they take a single tranche loan at higher leverage from a debt fund at higher pricing, or if the bank stays in the deal at a lower LTV point, then alternative lenders can fill the funding gap with a stretched senior piece. That creates plenty of deal opportunities with good assets and sponsors.

Currently, debt prices equity, so as a lender you are in a very strong position to negotiate good deals for your investors. The repricing of European real estate is not yet done. During this year and next, debt will often continue to lead the discussion. At some point interest rates will fall and a new real estate cycle will begin. But right now, it is a fantastic moment to invest into real estate debt.

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**Q How do you convince investors a mid-market lending strategy makes sense in today's market?**

Fundraising is tough. A lot of investors' allocations to real estate are being scaled back due to the denominator effect. Some of them are saying they are closed for the year – they will see what happens and maybe come back to the market in 2024. On the other hand, in times of crisis, managers can write the best real estate credit deals provided they have the unspent capital

to do them. The most important objective for new investors these days is security and stability in a very volatile market environment. Naturally, many will prefer credit over equity strategies because debt is a safer place to be. And when you can also generate a good cash return at a premium over what is available in the liquid market, then that is a very interesting proposition.

In that context, the key attraction for investors is a manager's ability to generate cashflow that is protected by secure structures and backed up with operating capabilities in case something goes wrong. And in this environment, you can also demand defensive credit enhancements from the borrower in the form of additional guarantees or interest reserve accounts. If you sit at 60-65 percent LTV on a repriced asset basis with additonal protection it is a quite comfortable position to be in.

In addition, many investors are currently cautious when it comes to single-sector or single-country strategies. They prefer a more diversified pan-European lending strategy. By focusing on the mid-market, a lender can achieve good pricing and a high return for the risk that they underwrite, while having a diversified loan book. For a large-ticket loan you might be able to achieve a price premium. But if anything goes wrong you have an issue because it is a very lumpy exposure no matter how defensive your loan structuring. With smaller assets you can offset losses elsewhere in your portfolio.

**Q You are aiming to provide whole loans in the mid-market range. Why is that product well-suited to today's environment?**

Some Middle Eastern and Asian investors are comfortable higher up the capital stack at 80 or 85 percent LTV on repriced asset values where you can write high double-digit returns. But more conservative institutional investors, for example, from Germany and France tend to prefer less risky senior whole loan strategies. If you do a lot of mezzanine lending, you probably exclude those investors.

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As a debt fund, your target audience of capital providers ultimately drives the strategy. It is currently difficult to raise and deploy €600 million just on mezzanine transactions without taking substantial risk. Our strategy is focused mainly on whole loans with the option to do selective junior and mezzanine financing, because in two years, the market may be different. Assets will have gone through repricing, banks may lower their interest coverage requirements and start to do more lending, so as a manager you need the flexibility to move a little further up the capital stack and continue to deploy.

In our new fund we are also considering providing a sleeve using fund-level leverage to enhance returns. That would not appeal to conservative European investors. But it might attract US and Middle Eastern investors which are accustomed to using loan-on-loan finance.

**Q What are the current risks inherent in mid-market lending?**

Always, where there is return, there is risk. First and foremost, you need to look at the quality of the sponsor. Who is the equity partner that you are lending to? Are they well-capitalised enough to support the asset if the business plan is delayed? Then you assess the asset quality and location.

For example, office has replaced retail as the asset class that nobody seems to like. But if you have a strong sponsor with an asset in a good location and a sound value-add brown-to-green business plan, you can lend at 50-60 percent LTV, with good interest coverage, and generate a high single or even double-digit return. Meanwhile, in some ways value-add is more defensive than core product because the income and value created can offset any further negative yield shift.

However, in times like these you must also ask if the borrower's business plan is realistic. Execution will tend to take longer than expected, and costs will go up. Whenever we lend, we do a full equity-style, bottom-up underwrite and stress test using our own network of asset managers across Europe which have detailed knowledge of their local markets. ■