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ULI Transatlantic Capital Markets Forum

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Fundamental shifts are occurring in the capital markets in response to the unprecedented recent changes in the macroeconomic environment. Forum discussions focused on the contrast between the U.S. and European markets; the reasons for the differences and the risks/opportunities created for those operating in debt and equity markets.

The forum debated the extent to which changes were a permanent paradigm shift in the market landscape or a response to temporary external influences. There were differing opinions on the current downside risks in the market and whether "this time it will be different". However all agreed that the operating strategy in this environment was being affected by the lack of yield in traditional financing as a result of monetary policy.

The following highlights are taken from a roundtable forum of 28 leading real estate capital market professionals from both Europe and the U.S., held on 8th October 2014 in the Munich offices of Hogan Lovells, which generously sponsored the event. The objective of the Forum was to discuss, explore, and compare the current state and outlook for the real estate capital markets in Europe and the U.S.

Debt Markets

The discussion opened with an analysis of the current state of the U.S. and E.U. financial markets.

U.S. - A Search For Yield

In the U.S., market participants were faced with *"significant and very flexible capital markets looking for yield" and a "tremendous amount of capital flowing into real estate as a proxy for that fixed income yield"*. A proliferation of new players has been forming in this ever more crowded marketplace, including debt funds, private equity funds and REITs - and all are looking at the lending space. The U.S. market was described by one participant as *"very much 'Times-Squared' - wherever you go"* (a reference to the ultra-competitive, efficiently priced, low yields in the centre of New York City). There was a general consensus on the status of the U.S. market with one participant describing it as being *"infinitely more competitive than it was years ago"*.

Paradigm shift or passing trend?

For one participant, who described their business as a 'relationship lender', the observation was that the *"potential lender universe is radically different today"*. For the relationship lenders, who work with investors who are in the market for the long term, and where *"10 basic points not going to make or break the deal"*, a key question was whether the new universe of lenders was a passing trend, caused by central bank monetary policy, or a paradigm shift. Will these lenders providing Asian capital or U.S. insurance companies be here for good, or is there merit in sticking with the *"same guys that they've been working with for the last 20 years"?*

One participant stated that although investors learnt from the crisis and have been decreasing leverage, there was a concern that refinancing is currently so cheap and covenants are once again being relaxed. The extent of refinancing activity means more volatility in transactions and a split in the market between long-term holders (who are not very interested in debt) and shorter term, value-add businesses using debt and chasing a 10-20% return - *"a completely new dynamic between the borrower and the lender"*.

U.S. Downside Risks?

On the downside risk in the current U.S. market, there were differing views among the participants. Although there was general agreement that *"éventually rates will have to rise"* and that the U.S. economy is in better shape than the E.U. economy, some questioned whether the current status *"was as good as it gets"* and identified the key question of the underlying reason for an interest rate rise, and whether it is realised as *"gradual or a shock to the system"*.

Although there was some disagreement on the downside risks in the U.S. market, the consensus was that the above factors, coupled with a flush of capital as a result of an accommodating U.S. Federal Reserve keeping interest rates low, have resulted in an increased flow of capital looking at alternative risk profiles in an attempt to access increased yield. This has included going into structured lending, exploring alternative aset classes or going offshore.

Europe - still a fragmented, debt dominated market

As one of those offshore markets, the E.U. was described as *"still a debt reliant market",* which is currently less competitive and features some pockets that are much less crowded and offer more opportunities.

Nevertheless, many agreed that the dominance of the bank debt looked poised to continue, with banks already coming back strongly into the market place. For some, this raised alarm bells with banks *"lending on things they wouldn't have touched a couple of years ago"*.

For other Forum attendees, it was hard to see how participants in this market can remain profitable in a scenario with banks continuing to drop margins. One participant cited a senior debt fund that promised its investors just 1.75%.

New E.U. regulatory environment, new lenders

For one of the lenders, the smaller lending sizes are still less competitive so margins were similar to a few years ago, but U.K. lending on larger facilities has experienced *"more intense competition, with significant erosion in margins, fees and covenants"*. Loan to Value (LTVs) have not increased, meaning that regulation has largely achieved what the regulatory authorities had wanted. The challenge for lenders is how to achieve a capital return in this environment.

In addition to the wave of capital coming to the E.U. lending space as a result of U.S. lenders looking for yield (which participants expected to continue), the group discussed other key investor groups including the insurance companies looking for more yield in their fixed income portfolios and pension funds.

Insurance companies considering private debt look at the product relative to other asset classes and real estate has less liquidity but a wider spread. Insurance companies are therefore moving into senior lending out of fixed income portfolios. Bigger insurance companies are doing this directly and smaller insurance companies are doing intermediate debt capital through managers. Forum participants questioned the financial viability of this approach given the management fees involved. However, one participant noted that insurers are generally happy to pay these fees in a similar way to other fixed income products and in fact, the returns look very similar to other fixed income products after paying these fees.

Passing trend or Paradigm shift?

Similar to the U.S. discussion, the question arose as to whether this capital would be around for long, or was just a passing trend. It was noted that pension funds are largely asset allocators and as such are likely to be providers of capital for longer time periods, whereas the fixed income allocations from the insurance companies could disappear much quicker.




European vs U.S. CMBS Market

The discussion then turned to the CMBS markets and their potential to return as a force in Europe. Despite the early comments that Europe is still a market dominated by bank debt, some participants thought the potential for growth in European CMBS exists. One participant close to the markets noted that 10-12 deals could take place this year and next year could see around €25bn ($30bn) of securitised deals in Europe. This compares to $80bn in the U.S. last year, and a prediction of $100bn in 2014. There are two types of products that this participant thought would be competitive in this market: granular portfolios with a defined selling programme and investment grade stabilised assets. Anything that is 'value-add' would not be a good fit with the CMBS market.

The U.S. has more conduit lending, whereas Europe is a much thinner, bespoke market which is why deals are lower. Europe is still a floating rate market but going forward, if there is more fixed rate, we could see the conduit market increase in size.

According to one participant, the European CMBS market developed very differently to the market in the U.S.. The U.S. market was developed by those who wanted the interesting 'B' tranches of debt and who developed the skills to service these effectively. The European market, on the other hand, was a market that started by those looking at the AAA tranche and was never developed where the more risky pieces were being bought by those capable of servicing it most effectively. There *"wasn't a framework that made the product shine"*. The same participant expressed the view that the European CMBS market would not take off without this infrastructure framework - i.e. organisations that want to own the higher risk tranches.

One participant also made that point that the U.S. CMBS market grew dramatically because there were points in the cycle when it was cost effective in comparison to the debt market: *"People were prepared to give up some of the actual or perceived flexibility of the debt markets in order to get the benefits of the cost differential."* The participant's conclusion was that we could *"develop a market that had sufficient cost differential then that market would flow"*.

One of the challenges for the E.U. CMBS market was that sponsors have had a very negative experience with the first generation CMBS in Europe: *"Poorly structured deals…so that a lot of investors in CMBS look on European CMBS with a very jaundiced eye"*.

Downside Risks?

The group considered the political and regulatory risks facing the E.U. market with some expressing concern with the lack of time dedicated to discussion of these risks in lending decisions. There was again generally less consensus amongst the group on the risk side.

One participant held the view that this was *"no longer a debt story"*. Whilst the concern in the U.S. might be the existence of a possible credit/liquidity bubble, in the E.U. it was less about a build-up of liquidity and was more an *"equity capital story"*.

One forum participant cited the *"huge erosion"* in covenants that was occurring in the E.U. markets referring to *"covenant-lite"* practices that had started 18 months ago in the U.S. and had started to be adopted in the E.U. - where the weaker underlying economic prospects gave more cause for concern.

Equity Markets

One participant stated that while questionable covenant practices have transferred across to Europe from the U.S. in the CMBS markets, the opposite is true in the case of unsecured real estate bonds - where U.S. best practice has not been adopted by European firms. The example was given of REIT bonds in the U.S., which feature four financial covenants that everyone has to agree on, compared to French REIT bonds which will typically only feature one financial covenant.

The group discussed the ECB Asset Quality Review with results due a week or so after the Forum. The view was generally that, whilst there will surely be a number of banks that are affected very significantly by the review, the overall impact should not be too significant on the operation of the market. Perhaps the greatest concern was the knock-on impact of banks that fail the tests, on those banks that pass but have business relationships with the failed banks.

U.S.: Economic Growth with Caveats

The U.S. reached an inflexion point in 2009. Although companies' top lines have not been growing much, productivity has improved and higher profits have generally arisen through cost reductions. Wages have remained stagnant and the U.S. has become more competitive on a global basis because of this. Wage pressure is therefore a concern for CEOs, as recent economic growth has largely benefited those that are already wealthy and *"if you are living off your salary, this has not been a very good recovery for most people in the U.S."*.

Three industries in particular have been driving growth: energy, healthcare and technology. According to one participant, typically U.S. expansions have lasted 30-100 months, with an average of 60 months and we are currently in month 64 of this expansion. The conventional wisdom is that we are *"the seventh inning of a nine inning game… if you are making an investment today that has a three to five year horizon, most investors think we will have a problem."*

In spite of this expectation of some disruption in the market within the next three to five years, *"capital markets are extraordinarily robust"*, including many foreign buyers from Canada, Asia, and the Middle East. The top markets were cited as NYC, San Francisco and to a lesser extent Washington D.C, Chicago and Dallas.

Cap rates were noted as being generally in mid-4s; these are around 25 basis points less than a year ago despite interest rates increasing. The best core assets were attracting unleveraged IRRs of 5.75% -6.25%. Initially, secondary markets had a huge spread to the core markets and *"many investors had a thesis that it would narrow and it has."*

It was agreed that the capital markets were ahead of the real estate fundamentals, but as one participant noted *"if you wait for fundamentals to be good, it's too late on the capital side."* Many funds are thinking that the returns that the U.S. exhibited in 2008-10 will be exhibited in 2012-15 in Europe: *"Global capital allocations and these new capital shifts are creating new ways to talk and think about long term pricing."*

Housing / residential - huge issues led to the credit crunch but then construction stopped. Since then, there has been a huge pent up demand and 1% population growth a year (c. 3m people). Around 64% of people own homes (which has decreased in recent years from 69-70%) and thus multi-family apartments are an interesting asset class. The housing sector is recovering although it is still plagued by *"structural issues in getting a mortgage."*

Retail - While trophy malls are doing exceptionally well and largely immune from threats like the Internet, they are nearly impossible to access at a competitive price. At the other end of the spectrum, one participant noted that *"most retail is likely to go away".*

Offices - Certain cities doing better than others. NYC / San Francisco are doing very well with lots of young people who want to live there. Office design is changing: more open plan/ more density.

Development: is just starting again, as many investors have complained that they are not able to find deals with the correct risk return.

2009-11 was seen as a great time to invest in the U.S., as fundamentals gradually caught up. The main perception in the U.S. is now that *"Europe will recover and the money that was made in 2009-11 in the U.S. will hopefully be made in 2013-5 vintages in Europe."*

Europe – not just about the capital markets

In Europe, it is not just the capital markets that are ahead of fundamentals. Pricing of assets is now much more about global capital distribution, including the shift from fixed income to alternatives. The questions were whether this would continue and whether it would affect long term pricing.

It was generally agreed that the large capital inflows into Europe could not necessarily be attributed to strong fundamentals; rather that the European market, when contrasted with other investment opportunities, has started to look more attractive. Many markets, such as Brazil, China and Australia, are beginning to lose lustre and investors look at Europe and see *"developed countries, decent property rights, and as you look at it globally the European story is compelling for people"*.

The tax environment was also mooted as a reason for the U.K. real estate market's relative strength. By comparison with most countries, and especially the U.S., the tax regime encourages investment. By contrast, in the U.S., the existence of Foreign Investment into Real Property Tax Act (FIRPTA), leads to an onerous taxation, which has implications on the market. These forces have had an impact on relative Sovereign Wealth Funds (SWF) capital flows into the two regions where *"London is two and a half times all of the U.S., including NYC."*

Two to three years ago, there was more of a trading environment with only private equity organisations in the market; now the market has shifted to longer-term investments. Deflation was cited as the key risk for the European real estate sector. It was noted that some European markets such as Spain and Ireland are improving and therefore if you are an early deployer of capital in then you can access better returns.

European REITs

One participant described the current situation in the European public equity real estate markets: *"There are enough deals in the pipeline that we will be back to the historical peak in 2014."*

Some public companies are trading at historic highs, with significant premiums to net asset values. Unibail Rodamco was cited as an example. The company is trading at around a 30% premium to net asset value - a clear signal of close to full value in the markets. It was argued that the reason for these premiums was due to market dislocation and macro-play: many hedge funds are backing management teams and countries' economies, rather than closely analysing the underlying assets.

One participant noted that while real estate is typically between 5-7% of a country's index listed market by value, in recent times real estate has constituted 18-20% of the overall issuance. In the U.S. at least, major corporations do not need to issue equity frequently, whereas the typical European REIT model pays out a lot of dividends and therefore has to raise more equity.

The group discussed whether the European market might become like the U.S. and be more public. One participant mentioned that it was surprising that the real estate public equity market was not *"twice, or three times bigger than it is".* A reason for this was that historically *"IPOs that create new companies are very entrepreneur driven."* In Germany, unfavourable legislation, combined with strong competition for assets from open-ended funds, also restricts growth of the listed sector. Additionally, the general lack of product in terms of both quantity and variety limits the relevance and growth of the asset class. This was contrasted with the U.S., where the market features the like of Healthcare REITs, multi-family housing REITs, multi-family housing REITs and many other sub-sectors.

A significant amount of the demand is a macro play, with hedge funds as major investors. Some funds are backing management teams, as this is one way of getting quick exposure rather than having their own people on the ground.

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