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ULI Transantlantic Capital Markets Forum

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The following highlights are taken from a roundtable forum of 30 leading real estate capital market players from both Europe and the U.S., held on 25th June 2013 in the Paris offices of Hogan Lovells, which generously sponsored and hosted 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.

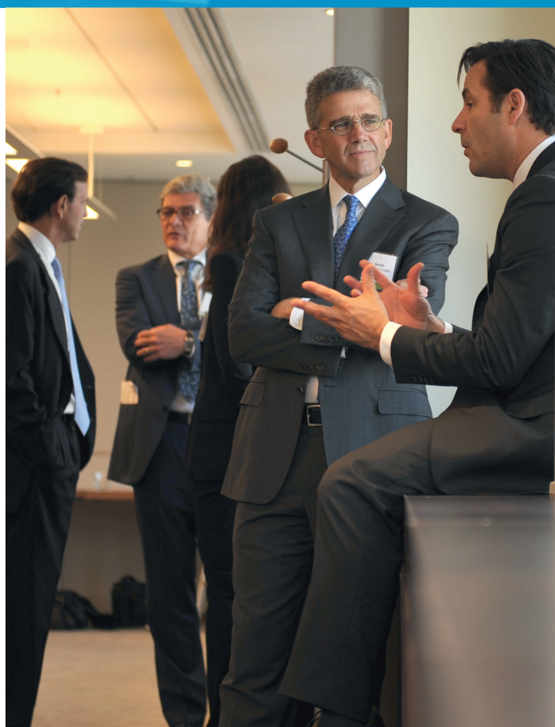
Hogan Lovells

U.S. AND EUROPEAN REAL ESTATE CAPITAL MARKETS REMAIN IN VERY DIFFERENT CYCLES, WITH THE U.S. WELL AHEAD OF EUROPE IN ITS ECONOMIC AND CAPITAL MARKETS RECOVERY. *"IF WE COMPARE THE U.S. AND EUROPE, THE U.S. IS PERHAPS TWO YEARS AHEAD IN THE CYCLE,"* NOTED ONE FORUM PARTICIPANT. HOWEVER, EUROPE IS STABILISING AND BEGINNING TO RECOVER. ANOTHER PARTICIPANT OBSERVED, *"THERE ARE FEWER FEARS THAN A YEAR AGO ABOUT EUROPEAN REAL ESTATE, BUT ALL IS NOT RIGHT."*

In Europe, as is also true in the U.S., there is a significant gap between prime and secondary markets and between stable and recovering markets. There is also a great deal of refinancing that is needed and abundant distressed debt. Debt capital is more available than nine months ago, but there is a lack of senior debt available, particularly for secondary assets, even though there is a lot of equity chasing real estate. However, many institutional investors, especially U.S. investors, that were only interested in the U.S. two years ago now view Europe as a region of opportunity. European debt funds are now especially attractive for institutional investors because of the yield they offer.

In general, institutional investors in the U.S. are quite optimistic and there is no absence of capital for debt or equity. The capital market environment is less robust in Europe, but the European economy and capital markets have stabilised somewhat over the past year, and investors are now seeing new opportunities in Europe.

Globally, the spectre of rising interest rates has further complicated matters for investors and lenders. Interest rates have been on a downward trend for many years, but now that trend is poised to reverse direction and rates are poised to rise for the foreseeable future.



Debt Capital

Everyone is expecting increasing interest rates over the near and long term, and we have already seen a substantial increase in 10-year rates in the U.S., Europe, and elsewhere around the world in recent months. Strong additional spikes going forward would be disruptive to financial markets, but if rates move up gradually, the effect could be offset by growth in the economy and in rents. Notes one participant, *"If rates spike, then there could be serious negative impacts for real estate investors"*.

In the U.S., the overall debt markets are remarkably healthy. The only segment that is constrained is construction lending, where considerable equity is required. In Europe there is hardly any development financing available.

Insurance companies have been very well positioned for several years, with strong appetites to invest in a market with attractive spreads, and the only constraint has been the amount of money they have been allocated to lend. However, the markets have become more competitive in 2013 with the re-emergence of CMBS lenders.
Banks in the U.S. are also doing well today, but there may be a credit bubble developing. Spreads have declined and lenders have become more aggressive across the board in the U.S.. Banks in Europe are not quite so healthy, and more time will be needed to reach a level of normalisation. Notes one participant, *"The U.K. banks have, in effect, been nationalised."*

In Europe there is significant appetite on the investor side for debt, including quite a lot of interest in senior debt from fixed-income institutional investors. German lenders are also active, making loans at LTVs of around 60%; at 65% lending becomes more difficult. There is also considerable appetite for mezzanine and junior debt. Some investors who are not active mezzanine lenders in the U.S. are finding attractive mezzanine lending opportunities in Europe. One investor notes, *"We could have raised twice as much capital as we actually did for our mezzanine fund in the U.S."*

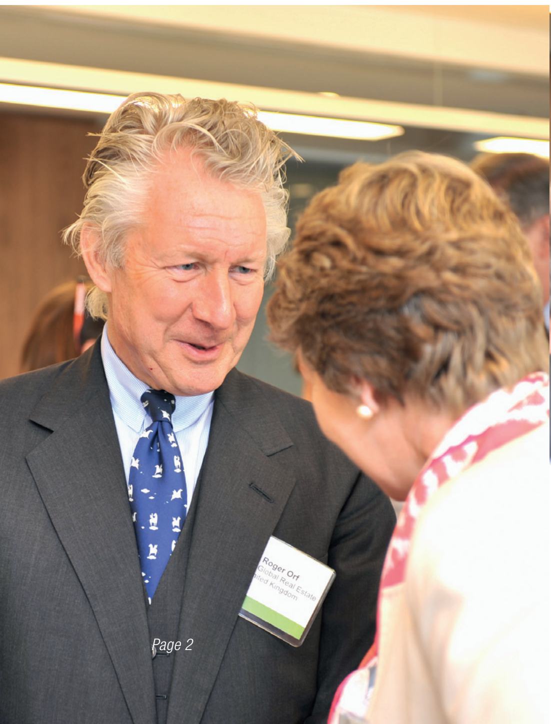
Development finance is happening in Germany and London, but not much elsewhere, with 300+ point margins on development finance. Lending can be found on refurbishments in London, but debt capital is hard to find for core assets in Madrid or Milan. It is generally hard to get loans in southern Europe. French and German banks are lending, but in France it can take as long as six months between signing and closing.

The CMBS sector in Europe has not come back strongly as it has in the U.S. CMBS is not back to a conduit style in Europe; all CMBS deals are currently single borrower deals. CMBS documentation is still not where it needs to be, and inter-creditor issues have not been worked out sufficiently in Europe. Banks have been so competitive that CMBS cannot get traction. German Pfandbriefs are also very competitive. However, German banks have been pulling back from the U.K.

Subordinated debt, which has been an issue for some senior lenders in the past, is not a problem today in Europe because it is viewed as more normal, the market is more competitive, and senior lenders need to get deals done.
Also, non-bank banks are active in the European market today, and are starting to become a force in the European real estate capital markets.

With all of the distress and debt problems that remain in Europe, there will need to be more equity in the European real estate capital markets over the next few years. Notes one participant, *"In three years there will be less debt capital in the European market than there is today. Higher interest rates will cause a pullback."*

In the European real estate debt capital markets, the liquidity issue is largely solved, but not the solvency issues. In the U.S., debt is now readily available from banks, insurance companies, the CMBS sector, and non-traditional lenders.



Equity Capital

With high levels of distress and the need to recapitalise many properties, equity is replacing debt in the European real estate market. Notes one participant, *"We are seeing 40% or more equity in some deals. Some investors have done deals with 100% equity."*

In Europe values in secondary markets are still down 20% to 40%. Some secondary markets in the U.K., France, and Germany are attracting European investors, but this is not generally the case in Spain and Italy and other southern markets. Portugal is in a worse position than Spain. There is no debt available in either country. Yields on secondary markets in Europe are going up while yields in prime markets are going down.

Nevertheless, some U.S. opportunistic investors are starting to look at Spain. Private equity firms are moving into Spain, some with a U.S. housing type play in mind. Some Saudi money is also going to Spain to establish residency for those investors that are nervous about instabilities in the Middle East. Investors are also seeing some opportunities outside major urban conurbations in some countries in northern Europe.

Non-listed real estate investment vehicles have raised more capital in 2012 than in any year since 2008, but the level is still less than half of what was raised in 2007. The U.K., Germany, and the Nordics were the preferred destinations for this capital. These funds are attracting capital from North America, Asia, Latin America, Europe, and the Middle East. Capital flows are especially strong from the Middle East.

With pricing very rich in the U.S., many U.S. real estate investors now see Europe as an attractive option. U.S. capital is coming back to Europe, as investors think the timing is right. Comparisons between two recently raised European real estate funds shows that the more recent of the two has a much higher ratio of U.S. investors, further indication that U.S. investors are back in the Europe real estate investment business. The recent purchase of Henderson by TIAA is an example of this trend as well.
Globally, investors have greater comfort with developed markets; e.g., in Asia some investors are moving from China to Japan. However, less developed regions such as Africa remain an intriguing long term option for some investors. All private equity shops are now in Africa, especially Kenya, Ghana, Nigeria, and Tanzania.

In the U.S., there are now over 60 mezzanine funds, according to one source. These funds represent the quest for yield, the need for deleveraging, and the search for distressed opportunities. Core is overpriced, but allocation to core continues. Competition for properties is very intensive. Competition on price is one item, but now there is competition on terms as well.

Apartments are favoured in the U.S., including investments in apartment development. Office buildings in tech and energy markets are also in favour. Retail has recovered the least. Niche strategies such as self-storage are also in favour. *"Self-storage tends to perform well on the upside and the downside."* Senior housing and student housing are also attractive, as are data centres.

Fundraising is still very difficult in Europe. Side car investments and special deals are favoured

by investors. Larger investors will invest in a fund but will also want a sidecar investment special to them, where they have more rights to turn off the flow. In Europe, there is an oversupply of real estate investment management firms and funds leading to pressure on margins, and there will likely be a consolidation in the future.

German funds are seeing structural changes due to regulatory change. The new rules will mean that closed end and open end funds will operate under the same rules. Nearly all money in German open bend funds is retail money, and there are few dominant players. Start-ups and boutique firms are gaining traction. The ongoing issue is finding new investors to pay out the old investors. Canadian and Qatar investors have stepped in on the recap deals. The implication of the new law is that there will be daily liquidity for open end funds and the distribution system has changed completely.

In France the fundamentals are not good. Unemployment is going up and will continue to go up. But there is an influx of money to Paris. France is not creating jobs. Many large French companies are still cutting jobs. The Dutch market also has problems and is not drawing investors, according to one participant.

In general, equity investor strategies are changing as the markets continue to slowly stabilise and recover. Notes one investor, *"What we did 12 months ago is not what we are doing today. We are buyers in Spain and Italy today, but last year we were buyers in Germany."*

Currently the European real estate capital markets have reached a bit of equilibrium, but it will be two more years to recover from the current recession in Europe. The big issue for Europe remains growth. There is no growth, and it will take some time before there is growth again. In the U.S., growth has returned and the real estate capital markets are generally healthy again. The principal U.S. concern going forward is the trajectory of interest rates and the policy decisions of the Federal Reserve.

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About the Author

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Dean Schwanke is a Senior Vice President of ULI and Executive Director of the newly formed ULI Center for Capital Markets and Real Estate. In this role he oversees and coordinates ULI work on real estate finance and capital markets issues, including books, Emerging Trends reports, the ULI Real Estate Business Barometer, online content, continuing education programs, and sessions at ULI meetings and conferences.

Over the past 28 years, he has directed the development of over 70 books and reports for ULI, and has personally authored or coauthored numerous books and reports, including the ULI Real Estate Forecast report from 1996 to 2003; the Mixed-Use Development Handbook in 2003; and the Resort Development Handbook in 1997.

He has directed the Emerging Trends in Real Estate program at ULI since 2003, and he has made over 60 presentations at conferences and other events on emerging trends as well as many other topics, including real estate capital markets, place making, and mixed-use development.

He holds a BA degree from the University of Wisconsin-Madison and a master of planning degree from the University of Virginia.

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