TH Real Estate

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Q&A

Based in London, **Christian Janssen** is the Head of Debt, Europe, and oversees the origination, portfolio management and business development activities for TH Real Estate in Europe. Here, Christian gives his view on why now is the right time for investors to engage in commercial real estate (CRE) debt in the UK.

What is CRE debt?
CRE debt is typically structured as a loan secured on commercial real estate. It offers income-focused returns through periodic interest (and principal) payments, culminating with the repayment of the remaining principal at maturity.

Why could investing in CRE debt be a good investment strategy?
Well-managed CRE debt provides performance protection through diversified, stable income streams. CRE debt benefits from a substantial degree of downside protection provided by the 'buffer' of the sponsor's equity. While there is typically no additional upside to debt returns in a rising market, the sponsor's equity will absorb the first loss in a falling market. In addition, contractually-agreed interest payments insulate the lender from the volatility of a changing rental income profile. As real estate market cycles become shorter and harder to predict, this insulation and degree of certainty is increasingly regarded as highly attractive by investors.

UK CRE loans usually include substantial covenants, put in place to protect the lender in the event of capital value or income declines. These typically include a 'cash trap', where any surplus income not required for debt service can be retained by the lender and used to reduce the loan, and a default clause, which allows the lender to sell the property if the default LTV is breached. These covenants are typically triggered at thresholds long before the deterioration of income or capital value would leave the lender at risk of first loss.

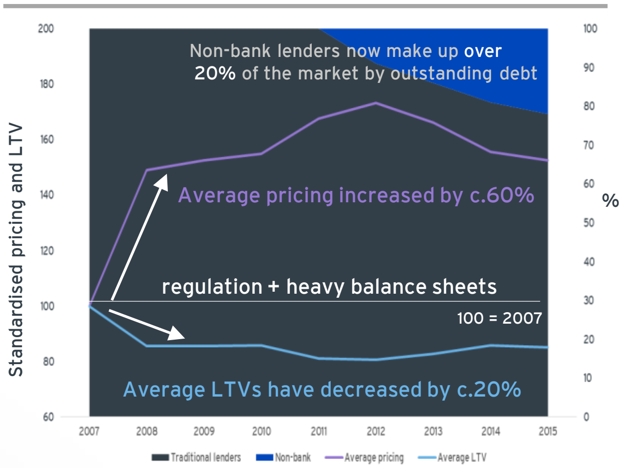
Why is now a good time to invest in CRE debt?
Real estate equity markets are currently experiencing significant volatility, elevated valuations, and heightened uncertainty. An investor focus on income, given the low interest rate environment, is now paramount.

As such, the downside protection investment attributes of CRE debt are becoming increasingly sought after; alongside stability, diversification and contracted income. CRE debt presents very competitive relative value, compared to fixed income and direct real estate.

Who are the main players in the CRE debt space?
Although CRE debt has always been a fundamental part of the UK real estate market, the dominance of banks, until the global financial crisis (GFC), heavily restricted investment opportunities for traditional investors. Since the GFC, stricter regulatory, capital and liquidity requirements have increased the burden on banks' balance sheets, which has led to a tightening of underwriting standards, significant reductions in the leverage of loans, and substantial increases in loan pricing.

The resulting retrenchment of traditional lenders, as well as the reduction and repricing of available capital, has created a permanent, attractive and executable investment opportunity for non-bank lenders and debt funds to provide a meaningful share of future CRE debt finance in the UK.

The rise of non-bank CRE lending in the UK



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Q&A (continued)

How has Brexit impacted the sector?

Since the UK announced its decision to leave the European Union, real estate market performance has proven far more resilient than consensus projected. However, given the political and economic complexities of any European negotiation, market forecasts vary significantly, and largely still imply a degree of pricing correction as markets begin to gradually 'normalise'. Tellingly, most anticipated valuation declines would remain well within the buffer offered by the borrower's equity in a sensibly structured loan.

> The investment attributes of CRE debt are becoming increasingly sought after; offering stability, diversification and contracted income.

Brexit has reinforced the bank retrenchment away from commercial real estate, with a slower, more selective transactional approach. This has opened up further opportunities for non-bank lenders to achieve higher returns on the same quality of asset, with speed of execution increasingly held at a premium. Direct investor activity has been buoyed by the prolonged low-yield capital market environment, but with parts of the UK real estate market looking late cycle, and well-documented geo-political uncertainties, CRE debt's future returns look very compelling. A CRE debt strategy offering downside protection and income-focused returns is well positioned to offer investors competitive relative value.

What are the current opportunities in the sector?

In the context of retrenching traditional lenders and the persistent narrow focus on prime assets, increased opportunities for well-capitalised, specialist, alternative finance providers exists. Investment opportunities can be found in those assets currently 'off the radar', particularly core-plus assets in established markets. With robust underwriting, ideally informed by direct real estate expertise, these underserved markets present the most appealing prospect for the selective 'cherry-picking' of transactions, backed by strong fundamentals and robust return characteristics.

Contact us

For information on our CRE debt capabilities, please visit: threalestate.com/debt

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Important Information:

Past performance is not a guide to future returns. The value of investments and any income will fluctuate (this may be partly be the result of exchange rate fluctuation) and investors may not get back the full amount invested. Where opinions have been expressed, they are based on current market conditions and are subject to change without notice.

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