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Global Perspective – Spotlight on Real Estate Debt and Fund Finance

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Introduction

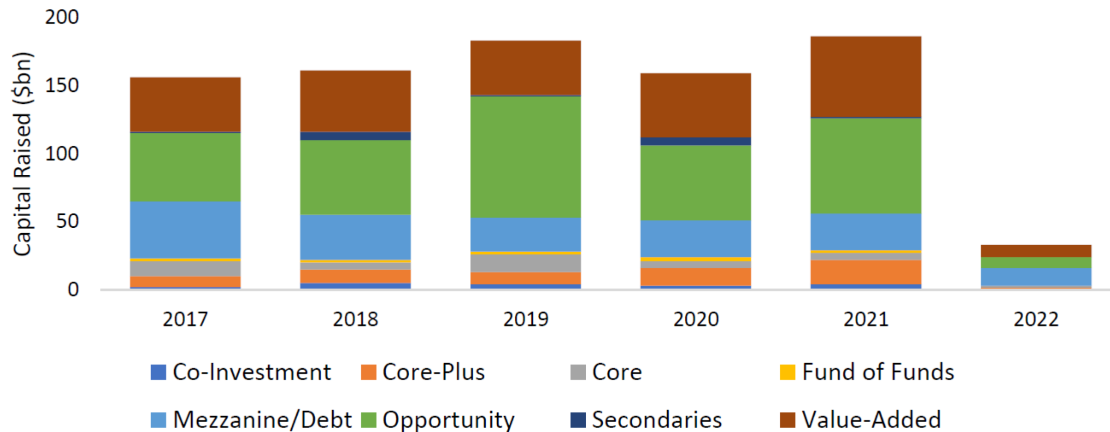
Based on the latest quarterly data from PERE, a leading publication for the world's private real estate markets, there seems to be a major shift underway in private real estate fundraising, as real estate debt has recently prevailed as the most popular strategy amongst real estate asset classes since PERE began tracking the data in 2008. This shift served as the impetus for a recent panel discussion at this year's PERE Global Investor Forum, held in May 2022, in San, Francisco, California. Moderated by Albert Tan, a Partner and Co-Head of Fund Finance at Haynes and Boone, LLP, the panel, titled "Global Perspective – Spotlight on Real Estate Debt and Fund Finance," brought together the expertise of panelists Roshan Chagan, Partner at Ares Management Corporation, Vicky Du, Managing Director and Global Head of Fund Finance at Standard Chartered Bank, and Simon Uiterwijk, Head of Commercial Real Estate Debt, US, at NN Investment Partners, who addressed the recent ascension of real estate debt as a favored strategy within real estate fundraising, situating the trend within the broader economic shifts of recent years, and discussed the role of subscription-secured lines of credit within this context.

Following is a high-level summary of the discussions from that panel.

Global Perspective – The Rise of Real Estate Debt

According to PERE's Q1 2022 Fundraising Report published in early May, out of total capital raised of $33.2 billion during the first quarter, debt prevailed as the most popular strategy for the first time since PERE began tracking the data in 2008—raising approximately $11.5 billion. Significantly, debt accounted for more than 34% of total capital raised during the quarter—easily the largest-ever percentage for the strategy since PERE started tracking the data.

Notably, based on the report, four of the top five private real estate funds closed in the first quarter of 2022 were focused on mezzanine debt investments, and all four debt funds exceeded $1.5 billion—with the highest topping $3.2 billion.



Source: PERE

Debt's fundraising triumph consequently knocked the reigning champion strategy— opportunistic—out of the top spot, a position the latter strategy has held, according to PERE, for all but one of the last 12 years. Apart from 2020, opportunistic has prevailed every year as the most favored strategy, accounting for at least 30% of total capital raised since 2017. This time, however, opportunistic dropped to its smallest-ever share of 25.18% and fell to third place behind value-add, which accounted for 33.03% of the capital raised.

The panelists discussed several factors that are driving the shift to real estate debt as opposed to other strategies within the asset class, continuing a trend that has developed over the last couple of years. Specifically, the panelists largely agreed that market volatility, rising interest rates, and inflation have all contributed to push investors toward safer investment opportunities, including real estate debt funds. Investors view real estate debt as a safer option in this environment since the floating rate nature of real estate loans provides a natural hedge against inflation. Moreover, as Mr. Chagan highlighted, since debt is higher in the capital structure, such an investment provides investors with confidence as there is security for the investment.

Following the global financial crisis of 2008-09, the real estate debt market faced significant reputational hurdles, and in the last couple of years, the COVID pandemic and the apparent cultural shifts occurring in its wake, including a push for greater flexibility and remote work arrangements, have spurred discussion on the risks of commercial real estate as an investment strategy. The panelists largely agreed that, despite these challenges, real estate debt has performed well and will remain an attractive strategy for many investors. As a general matter, diversification across different sectors and geographies within a real estate debt portfolio can serve well in managing concentrations and avoiding idiosyncratic risks. Moreover, an investment in real estate debt offers investors the prospect of consistent income and cash flow to help balance a portfolio, and it can offer investors a back door to acquiring discounted assets in sectors or at times when an equity investment may be seen as too risky or expensive. The panelists were generally skeptical of claims of the death of the office, arguing that the human need for personal interaction and relationship building in a business context means businesses will largely continue to make use of commercial office space for the foreseeable future. Furthermore, commercial real estate is a real asset that can be repurposed or retooled to become something else. From her vantage as a member of

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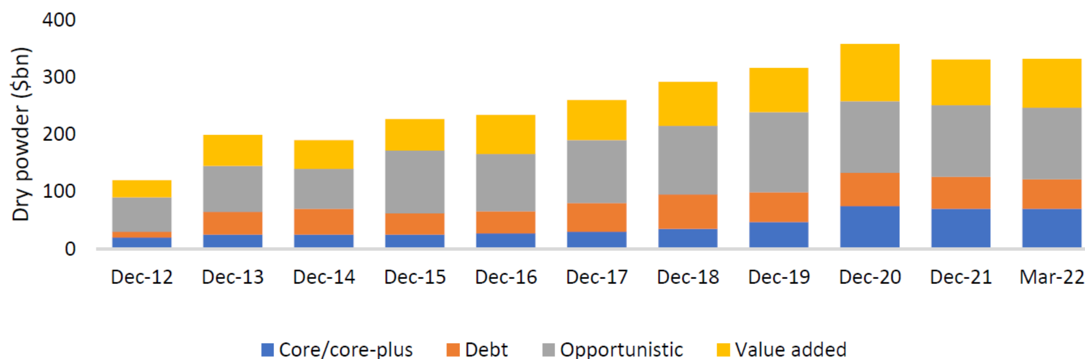
Standard Chartered Bank's Capital Allocation Committee, Ms. Du corroborated that, from her perspective, the pipeline of commercial real estate loans remains robust.

Global Perspective – Fund Finance

Similarly, despite the continuing challenges presented by COVID, the demand for subscription financing has remained incredibly strong, and the market generally has seen no material distress, including no material defaults of capital calls on institutional investors within the fund finance industry. In fact, the fund finance market has continued to experience robust growth, with the global fund finance industry more than doubling over the past four to five years, growing from approximately $300 billion to approximately $700 billion according to fund finance market participants.

This explosive growth—notwithstanding the challenges of the last few years—should not come as a surprise to those who understand the benefits of subscription facilities, the flagship product within the industry. As the panelists discussed, subscription facilities are typically primarily used as liquidity management tools, and the benefits of their use accrue to both sponsors and investors. For instance, access to a subscription facility alleviates administrative burdens from the constant capital calls that might otherwise be necessary, allows sponsors to deploy capital more quickly, and helps institutional investors manage their cash pipeline and liquidity management. Also, during times of liquidity crunches or economic volatility, it takes time for institutional investors to figure out their cash needs; subscription facilities help them better assess future cash needs. From a lender's perspective, subscription facilities remain attractive assets given the historical performance of these facilities and the growth of the industry. The panelists discussed one particular area of growing trend—lending to separately managed accounts ("SMAs") with a single investment-grade investor, which is generally a sovereign wealth fund or a public pension plan, as opposed to larger comingled funds featuring a number of investors—with Ms. Du highlighting the distinct challenges of underwriting SMAs. Ultimately, lenders tend to get comfortable lending to SMAs on the basis of higher fees, the overall diversification within the lender's portfolio, and the strength of the lender's relationship and/or familiarity with the investor.

Closed-End Private Real Estate: Dry Powder by Primary Strategy, 2012 -2022



Source: Preqin

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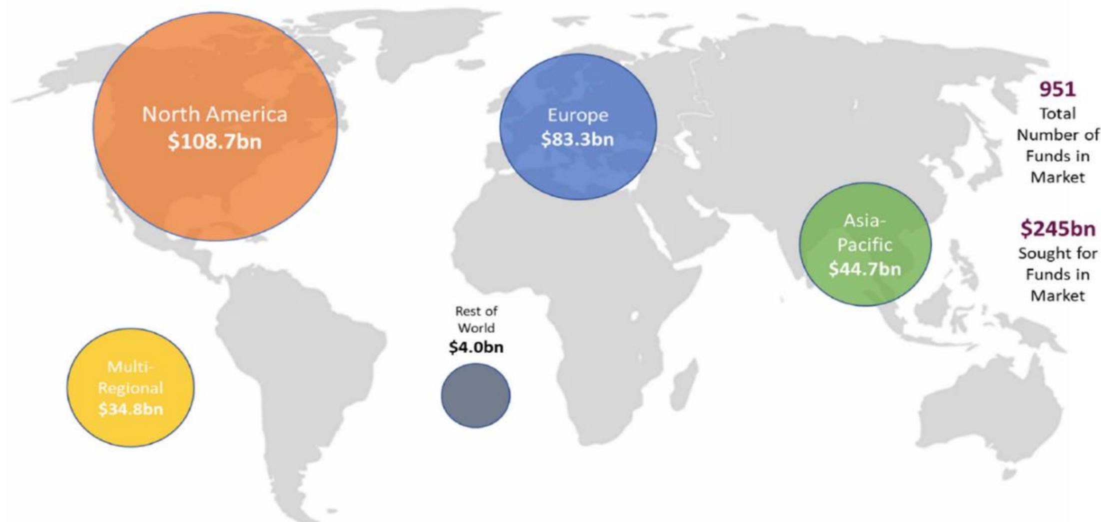

Source: PERE

As fund sponsors and investors have come to a greater understanding of the utility of subscription facilities, investors have come to expect (and even require) their use. This greater familiarity has also spurred an expansion of innovative and unique uses of subscription facilities and related products to address the differing needs funds encounter at different life stages. With allocations to alternative investments continuing and private capital fundraising continuing to grow, the continued growth of the fund finance market seems assured. According to Preqin, over the last three years, there has been, on average—within the real estate private equity sector alone—between approximately $300 billion to $350 billion of dry powder. Furthermore, according to PERE, in the first quarter of 2022, there are 951 new funds in the market targeting to raise approximately $245 billion in new capital— with 44% targeting North America, 34% targeting Europe, 18% targeting Asia Pacific, with rest allocated among multi-regional strategies and rest of world. While this represents only the private equity real estate market, Preqin forecasts that total private capital fundraising across all private capital asset classes—inclusive of private equity, venture capital, private debt, real estate, infrastructure, and natural resource—will be well over $1.6 trillion by 2026.

Looking Forward – Real Estate Debt and Fund Finance

The panel closed with a discussion of panelists' perspectives on the current market cycle and outlook for the future. With respect to real estate, panelists predicted that outcomes will likely depend on the specific sector and geography. While some sectors may be in decline, the residential side may continue to experience upside in certain areas. Similarly, logistics assets may continue to perform well, but some areas may have assets that are overvalued. The debt market overall has performed better than during the global financial crisis—compared to the financial crisis, the market is currently characterized by lower loan to value ratios, higher cash flow ratios, higher spreads, and more protective covenant structures. Simon Uiterwijk further emphasized that there is still a good amount of liquidity in the debt market, as evidenced by the fundraising statistics.

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Some panelists think that there is a probability of a recession by next year, and investors could mitigate negative effects of such a recession by maintaining floating rate debt assets and staying in a favorable position within the capital structure. In terms of fund finance, the market is expected to grow as facilities have proven to be a useful liquidity management tool for both sponsors and investors. Borrowers of fund finance facilities also tend to have a longer-term horizon in terms of market views and more patient capital; therefore, they may be well positioned to withstand shocks in the market, with access to subscription facilities themselves further buoying their position. The panelists fully expect continued growth in the fund finance market.

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