REACT news

FINANCE CONTINENTAL EUROPE UK & IRELAND

Why leading private equity firms are breaking into Europe's debt market – and what they'll lend against

29 Jul 2021 | by James Riding, Guy Montague-Jones

Private equity giants see room to grow in the European lending market

What Top private equity firms on both sides of the Atlantic including Ares, Kennedy Wilson, Tristan, and Delancey are becoming lenders in Europe

Why Moving into European debt is a natural evolution for growing private equity firms and current market dynamics are favourable

What next Biggest private equity firms will be able to draw on different pools of capital to lend on a broader range of assets

The list of big-name private equity firms moving into real estate lending in Europe is growing ever longer.

This month, *React News* revealed that both Ares Management and KKR were looking to build platforms, joining Tristan Capital Partners, which hired Dan Pottorff from LaSalle Investment Management last summer to make its first foray into lending, and Delancey, which is also preparing to begin lending for the first time.

They follow hot on the heels of Kennedy Wilson, which entered Europe's lending market last year by launching a $2bn platform with Fairfax before striking a new $700m lending partnership earlier this month with GIC. And having first started lending in Europe in 2017, Brookfield signalled its intention to step up a gear last year by hiring Martin Farinola from GAM.

There is no single reason why these investment giants are targeting the European debt market. Both market dynamics and internal factors come into play.

Replicating success in the US

For the North American private equity firms, building European lending arms is in many ways a natural evolution. Ares, KKR, Kennedy Wilson and Brookfield had all built successful real estate lending platforms back home before starting to explore opportunities this side of the Atlantic.

Martin Farinola, head of Brookfield's European real estate debt business, says: "Aside from the attractive risk/return osition that Europe offers, given our circa $40bn real e platform in Europe, it was natural for us to expand our debt presence and replicate the successful business we have built in North America."

As their businesses grow in scale and sophistication, it becomes easier for these firms to establish successful and competitive lending arms. The growth of Apollo Global Management's European lending platform, for example, has been aided by the success of its US-listed mortgage REIT and the growth of its Athene insurance business. Both provide capital to fuel the growth of the European lending business and help it become a more flexible lender.

> *"It was natural for us to expand our debt presence and replicate the successful business we have built in North America"*
>
> MARTIN FARINOLA, BROOKFIELD

Similarly, KKR's recent acquisition of insurance company Global Atlantic is expected to help drive the growth of its lending activities. At a recent investor day, KKR's co-chief operating officer Joseph Bae said: "One of the most exciting things about our real estate credit business is the synergistic impact with Global Atlantic."

There are also synergies to exploit between the debt and equity businesses within firms, particularly when it comes to understanding market trends and underwriting deals.

"If you're in equity, and you've got a debt business, while there are going to be certain walls you can't cross, at a general holistic level you're going to understand the debt markets very well," says Chris Holmes, who recently joined Deloitte to head up its real estate debt advisory practice.

uch as internal factors are important, the market itions have to be right for the new entrants to be successful. In this regard, there are a number of reasons why private equity firms have chosen to make their move now.

Room to grow

For starters, there is plenty of scope for growth as the non-bank lending market is far less developed than it is in North America.

"The European market is still, I would say, 80% dependent on bank lending so there are a lot of opportunities available, especially in France and Spain, but even in Germany," says Nicole Lux, who authors the Cass Business School's UK Commercial Property Lending report and is co-founder of proptech start-up FinLoop.

Fiona D'Silva, head of investment for Europe at Kennedy Wilson, agrees that there is room for new entrants.

"It does feel like there are a lot of alternative lenders in the space right now but the reality is that relative to the US, it [the non-bank lending market] is tiny," she says.

A good case can also be made that the market timing is right. With property values at historically high levels and the outlook still highly uncertain in the wake of the pandemic, many investors are likely to look favourably on real estate debt.

"There is a lot of global capital looking for a return and real estate debt offers a different risk return profile to equity. At a time when markets are volatile, debt can start to look more attractive to some investors," says Paul Coates, CBRE's head of EMEA debt and structured finance.

Market dynamics favour alternative lenders

The case has become all the more compelling as a result of [illegible]ced competition. Since the onset of the pandemic, traditional bank lenders have become more cautious and less eager to pursue new business as they tackle issues with existing loans.

"Due to the pandemic, traditional lenders have retreated from certain segments of the market, and this has allowed debt funds to access more or alternative attractive opportunities such as development," says Farinola.

This dynamic is unlikely to endure because more normal market conditions will return as the economic outlook improves.

Non-bank lenders have been able to grow market share during the pandemic as banks have retreated

However, the pandemic has accelerated a shift towards more operational real estate, which is harder to finance because it requires that lenders underwrite both real estate and operational risks. This could open up more opportunities for alternative lenders who find it easier to provide finance for operational assets than banks due to regulatory constraints.

"Those deals are becoming more and more prevalent, allowing alternative lenders to play a bigger role," argues D'Silva.

Growing range of deals

Naturally, the new market entrants will struggle to compete with banks on the most straightforward senior loans and will gravitate towards market segments where returns are somewhat higher.

However, this encompasses a broad range of deals.

Outlining Brookfield's lending sweet spot, for example, Farinola says: "We typically seek whole loans of above €50m and across all asset types on a pan-European basis. We also offer both mezzanine and select development loans."

As the new market entrants build out their European lending platforms, they are likely to be able to lend on an ever-growing range of deals as they draw on more pools of capital.

Kennedy Wilson, for example, started off last year by focusing mainly on senior loans through its partnership with Fairfax, and its new partnership announced this month will allow it to compete more in the market for higher leverage loans.

After expanding rapidly in the wake of the financial crisis, non-bank lenders' market share growth has slowed in recent years as banks have fought back. The pandemic will have given them a chance to accelerate once more, and the arrival into the market of some of the biggest names in real estate private equity looks set to extend those gains.