KEYNOTE INTERVIEW

Closing the debt funding gap

Recent fundraising success underlines confidence in alternative lenders, say PGIM Real Estate's global head of private debt strategy and investor solutions, Andrew Radkiewicz, and Andrew Macland, managing director and head of European debt

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Q How was the experience of raising last year's fund, PRECap VII, during a period in which the pandemic continued to impact travel and investor decision-making?

Andrew Radkiewicz: Just before the pandemic, we started discussions predominantly with our existing investors. We felt there was clearly momentum in the strategy. Then, during the pandemic period, there were stops and starts. A lot of meetings moved online, which was very time efficient in terms of not having to get on a lot of aeroplanes and travel around the world.

These hybrid environments were great to introduce the strategy and cover a lot of initial meetings. But this was a blind discretionary fund that relies enormously on trust and building relationships. As lockdowns eased, it was critical that we met face to face with the investors and particularly new investors.

PGIM Real Estate Capital VII (PRECap VII), which closed to investors in early 2022 is our most cross-border fund and has UK, continental Europe, Asian, Middle East and US investors. The most challenging market getting face to face was Asia, but we actually welcomed our first Japanese client.

Q You raised around 50 percent of the €1.82 billion from new investors. How did you achieve this, and does this reflect a wider trend in the market?

AR: As an established investment house, we have seen a change in the investors we speak to over the last 13 years. Back in 2011, it was entirely real estate allocations and real estate orientated teams within investors. But we have seen a progression over the years and, particularly with PRECap VII, with interest from alternative fixed income allocations and private credit allocations coming into the RE debt space. We were widening the scope of allocations within investor books.

Even before covid and the war in Ukraine, investors were looking for downside protection and more income focus. Those factors that come with a debt fund probably went up the scale of importance for investors.

Q Fundraising was completed in 2022 before economic uncertainty kicked in. But have you seen investor attitudes to real estate debt change since?

AR: Ironically, all those factors suit debt strategies. If we take risk, the higher the risk in the market then the more investors are likely to swing towards credit strategies because of the downside protection. If you look at the market environment, credit factors tend to suit alternative lenders.

We have high interest rates coming through the system and that clearly impacts what traditional lenders can offer. Debt service covers get tighter, leverage levels get lower and generally a funding gap appears.

Similarly, we have bank regulations overlapping. Since the financial crisis, we have seen bank regulations impacting real estate finance like Basel II, Basel III and now Basel III finalisation, each of which has materially increased capital charges for banks, particularly as risk increases on the loan books. At a time when higher interest rates are increasing risk, regulators are charging more capital as well.

Q How did deployment conditions change in 2022?

Andrew Macland: We are a value-add fund seeking mid-teen returns, so that dictates the type of deals we look out for. You could argue that the refinancing difficulties that borrowers are going to be facing over the course of this year will open up funding gap opportunities. We have seen loan-to-value ratios reduce quite significantly, through a combination of increased interest rates and retrenched traditional retail lenders, and there is not enough cashflow to service high levels of senior debt.

But the way we invest, which can be through whole loans or loan on loan financing, recapitalisations or buying out of partner equity, will continue to focus on common themes. We look at the underlying business plan at the real estate level.

We are always looking to underwrite and exit to make sure it has an improved position from when we entered. That is reliant on the partners, the borrowers and active management to enhance value through the term of our investment.

Going into the end of last year, it was very difficult to underwrite value. Average ticket size has probably increased slightly. It was between $25 million-$50 million and that has continued to be the sweet spot for us. I would not expect that to change much over the course of this year, but having a larger fund and the ability to recapitalise some of the distress in the market probably means we have averaged up our ticket size slightly over the last 18 months.

Q In deploying capital, how can debt fund managers mitigate the additional risk in the market today?

AM: The real focus is on the underlying real estate and what is the borrower's sectoral or jurisdictional expertise. It is about backing good partners.

As we have grown, we have formulated framework agreements. We have some sponsors in continental Europe and have a framework to finance shovel-ready development schemes. That is where the borrower is using their equity to secure sites, obtain planning, go through a fully tendered construction process and, in some cases, secure prelets.

While the funding might have some speculative element to it, we are comfortable with where the rental values and exit yield assumptions are.

We can use the size of the fund to access larger schemes and jurisdictions where we have conviction. And our lending is against the gross development value, which provides us with a capital buffer.

AR: Things have changed an awful lot over the last 10 years when we think about risk. Today, we recognise three macro structural trends driving growth in real estate: decarbonisation, digitalisation and demographics. Occupier demand at the end of the day is going to be driving liquidity of assets.

When we look at digitalisation, there are sectors that are linked to the supply chain like logistics and data centres. In demographics, it is the changing quality requirements from student living to co-living and later living. And decarbonisation is critical because when you think about major companies already signed up to a climate commitment, the type of property a tenant is going to occupy is probably likely to be sustainable.

Q What is your outlook for the fundraising market in 2023?

AR: We are looking at the next strategy, in terms of both investor demand and broadening our horizons. Real estate debt might often seem like a bit of a niche but take a step back globally and there is about $250 billion sitting in funds across the world, which compares well against other private alternative strategies.

Probably around 90-95 percent of that is in the US. The real estate lending market is also twice the size of the European. We believe Europe has an awful lot of catching up to do from the perspective of market share, but there is also a big opportunity from the investor side and a lot of growth across the risk-return spectrum. ■