ROUNDTABLE

SPONSOR
• SHIFT CAPITAL •
SUPPORTERS
• CAIN INTERNATIONAL • DRC CAPITAL •

Alternative lenders hunt for France's opportunities

Retrenchment among the big domestic banks that dominate the French market has created opportunities for debt funds – when sponsors are willing to pay the price. Stuart Watson reports

There can be no doubt that the pandemic has stifled real estate investment activity in France. CBRE figures show commercial investment volumes fell by 32 percent year-on-year in 2020, with all three major asset classes – offices, retail and industrial – showing a reduction of 30 percent or more.

However, that decline needs to be placed in the context of an all-time record performance in 2019, when more than €40 billion was traded. Meanwhile 2020's figure of €27 billion was still €3 billion higher than the 10-year average.

France is still a popular destination for real estate investors. But, as the participants in *Real Estate Capital*'s 2021 France roundtable discussion acknowledge, it has become difficult to find good deals in the equity or debt spheres in the country, particularly at the higher end of the risk-return spectrum.

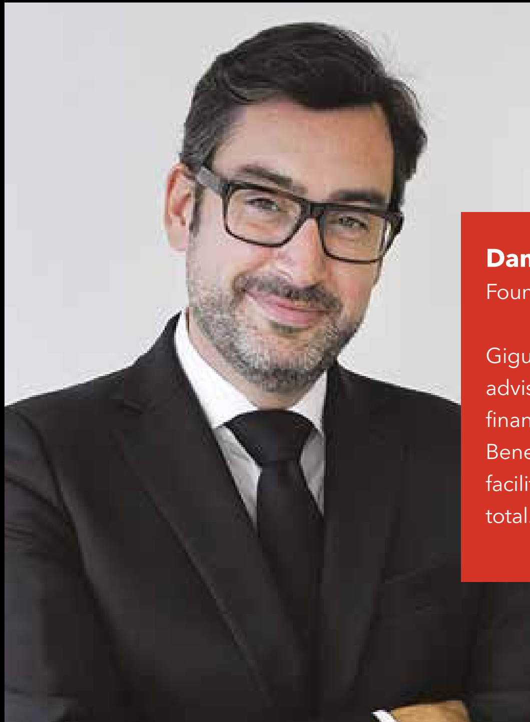
CBRE's research shows a healthy trade in core assets has continued, and accounted for 62 percent of the market in 2020. The participants agree that the relatively slow progress of the French covid vaccination programme and the fear of a further wave of infections when the warmth of summer has faded have contributed to uncertainty over the timing and strength of the country's economic recovery. These factors have also reinforced the generally risk-off sentiment among investors and lenders.

Pandemic pause

"Decisions around lending and investing are more challenged in continental Europe than in the UK or US," says the borrower at the virtual table, Daniel Harris, head of European investment at privately held real estate investment firm Cain International. "People are understandably nervous about the winter. Sentiment is improving. But Europe lost the first quarter to covid, and that makes all investing decisions slightly more challenged. In mid-June, continental Europe should be where the UK is now."

"The crisis has lasted longer than expected, and we are not getting out of this situation yet," agrees Damien Giguet, founder of Paris-based advisory firm Shift Capital.

French real estate lending is dominated by a handful of large domestic banks, which have responded to the market's cautious tone. Since the onset of the pandemic their willingness to lend has been highly dependent on the type of asset and associated risk, says Giguet. "Asset classes that have proved their resilience during the crisis are very sought-after. If you want to finance residential, logistics or core to core-plus offices that are well located, with good tenants and good sponsors – sponsorship is getting more important – it is still quite doable. For retail, value-add offices and assets in non-core locations



Damien Giguet
Founder, Shift Capital

Giguet created Paris-headquartered Shift Capital in 2012. The capital advisory firm aims to connect real estate investors with providers of finance across European markets including France, Germany, the Benelux countries, Italy and Spain. To date, it has been instrumental in facilitating 80 deals on real estate assets valued at around €2 billion in total.

Daniel Harris
Head of European investment, Cain International

Harris joined Cain International in 2017 and leads the firm's investment origination and execution activities across continental Europe. Owned by chief executive Jonathan Goldstein, and US private equity house Eldridge, the company operates in both Europe and the US. Since 2014, it has invested more than $6.4 billion in real estate debt, equity and experiential lifestyle and leisure businesses.

John Bigley
Principal, DRC Capital

Bigley has more than 25 years' experience in real estate and was recruited as a principal by DRC Capital from German lender Westimmo in 2014. London-based DRC is an independent investment advisor focusing on commercial real estate debt in Europe. It operates debt funds denominated in both euros and sterling across a range of risk profiles, with total assets under management of around €4 billion.

> *"For retail, value-add offices and assets in non-core locations or with non-core sponsors, it is very challenging to get bank debt"*
>
> **DAMIEN GIGUET**
> **Shift Capital**

or with non-core sponsors, it is very challenging to get bank debt, and there will be almost no liquidity at all for hospitality until everything reopens."

John Bigley, a principal at London-headquartered debt fund manager DRC Capital, notes that dealflow, which seemed to be recovering in the second half of 2020, has slowed once again in the first quarter of this year.

"France is a great place to do business," he says. "But it is behind the UK and US in terms of its covid response. We financed a core-plus to value-add office transaction in a Paris suburb in October. But right now, we talk to frustrated operating partners and private equity investors, who say they cannot find value-add deals. There is not much being marketed, or available off-market, because there is a mismatch in price expectations between buyers and sellers. Would-be investors are mostly pinning their hopes on the second half of the year. What limited dealflow we have seen at year end, and in the first quarter, has been from very motivated sellers. Otherwise, the mindset is to wait a year or so."

Uncertainty over offices

French value-add office space was a hot market pre-pandemic, says Harris. "In France, there is a lot of relatively old stock, so there was plenty of opportunity to upgrade that and lease it into a strong occupational market where a lot of tenants are state and state-associated organisations, and then sell it on. You got relatively well paid for that risk."

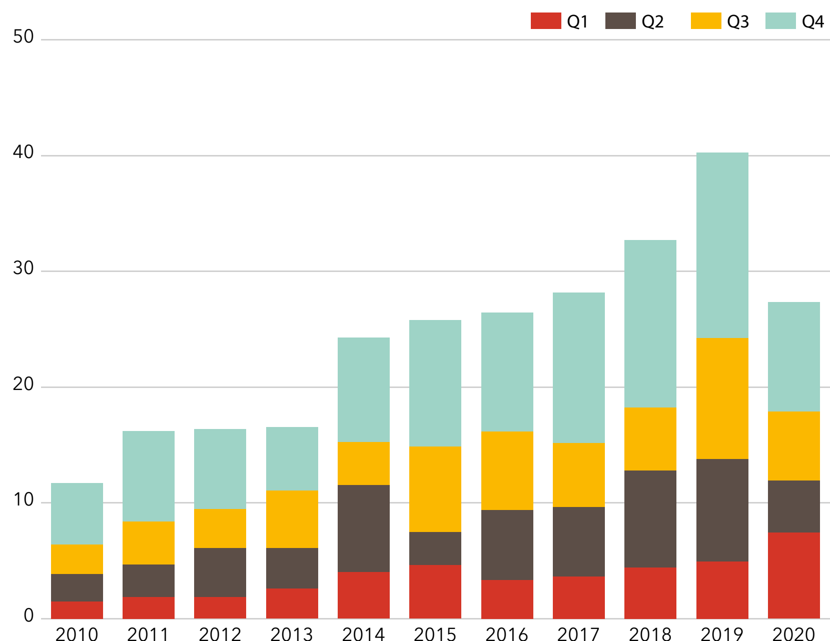
Activity has been dampened by ongoing uncertainty over the course the pandemic will take. "When everyone is slightly more fearful around the return to offices, it is a bit hard to make investment decisions until they actually see it happen," adds Harris.

Meanwhile, the cost of debt is also playing a major role in restricting dealflow. "Why are there fewer transactions at the moment? Because debt for value-add product costs double what it did before covid, and that is feeding through to the equity pricing," argues Harris.

"If I am borrowing at a percentage interest rate in the mid-sixes, instead of the mid-threes, and I have money with a set return target, I cannot do the same deal with less margin, so that has to be cut from the price of the asset. Sellers would rather wait for 18 months or two years until the cost of debt reduces, and their buyers are able to pay a higher price."

For lower-risk deals on which bank finance is available at almost the same pricing as it was pre-pandemic, the market is recovering, observes Giguet. "There was a bit of a hole in the pipeline of origination in February and March,"

French commercial real estate transaction volumes fell sharply in 2020 (€bn)



Source: CBRE Research, Immostat, Q4 2020

he says. "Now, we are seeing deals coming through again. I think this year will be more of a core and core-plus market rather than a value-add market because the lack of traditional finance is resulting in a very significant repricing of value-add assets. But there are big core and core-plus deals happening."

Bigley says DRC is trying to line up value-add office financings, but closings have been delayed as prices have been continually adjusted downward over several months. However, he is confident that the asset class will emerge strongly from the pandemic in spite of increased remote working: "Paris is the biggest office market in Europe by square metres, and office attendance rates have been among the highest on the continent throughout the crisis."

Liquidity for real estate lending has declined over the course of the pandemic, partly as a result of bankers' reluctance to take on new business, says Harris: "Most banks have retreated, and not just from real estate lending. They are primarily focused on working with their existing customer base across all their business lines."

New relationships

Giguet says he has engineered some new borrower-lender link-ups involving French banks, though he admits those cases tend to be "either special ventures with very institutional capital, or where the fund is new to the lender, but where the team is very well-known. Most of the time initiating new relationships is more challenging than before".

"It is not a credit crunch, but there has been a shrinking of liquidity," he says. "That provides a good opportunity for alternative lenders to finance assets which would have been financed by traditional banks in the past. Any value-add asset located outside a very established location, like central Paris, now has to find liquidity outside the traditional lending market. I do not know if that will be a long-term trend. However, we expect banks' balance sheets to be impacted by the crisis for at least this year and next."

That is a boon to debt funds like DRC, which have hitherto struggled to compete. "The French lending market has a strongly domestic flavour to it and is very competitive," says Bigley. "While it has always been on our radar, when we have looked at it in the three or four years prior to covid, on a risk-adjusted basis the pricing was not compelling for us. Conditions have certainly changed for debt funds."

He recalls that the sponsors in DRC's recent core-plus Paris office transaction felt they had exhausted all possible options in the banking sector before concluding that they would have to seek an alternative source of finance. "We did that deal at the standard pricing for our whole loan fund at around 65 percent loan-to-value, which is significantly higher leverage than you would have got from a French bank, on an asset that would probably have been bankable pre-covid.

"The debt is more expensive than a lower leverage bank facility but it is deliverable and accretive to returns for the sponsor. Typically, the banks would have stepped up for that at a lower LTV than they do for more core lending. But sponsors are now running out of patience and turning to alternative lenders."

Bigley notes that most of DRC's competitors that are also looking to step in to seize market share in the banks'

Higher loan pricing for value-add offices

Segment remains attractive to alternative lenders, but finance is more expensive, says Cain's Harris

Value-add office transactions have been comparatively rare in the Paris office market since the pandemic began. Nevertheless, in November 2020, Cain International completed one of the most notable recent deals when it purchased Colisée II in the Clichy district (pictured), with the intention of refurbishing and extending the 124,000-square-foot building.

The French lending platform of London-headquartered alternative investment fund manager Cheyne Capital provided a €96 million senior loan to fund the deal.

Because the planned works are extensive, the financier was always likely to be a debt fund rather than a bank, says Cain International's Harris. He notes that interest from alternative lenders was strong both before the pandemic, when the purchase was first mooted, and after it, when it was finally concluded. The pricing, however, had changed. "We had debt funds chasing us on that transaction, and the pricing was very keen" he says. "Then, once covid happened, everything stalled.

"When we eventually chose our lender in early summer 2020, there was quite a lot of competition again. We got roughly the same LTV and the terms were pretty much the same as pre-covid. The only difference was the interest rate was higher."

Mixed fortunes for French retail

There is still liquidity for the right assets, suggest roundtable participants

Bigley: Retail in France is different from the UK, in that it is on a perhaps less extreme, albeit similar, downward trajectory as a result of the growth of online sales. It takes a brave investor to go into shopping centres. But in France there is a hybrid model somewhere between a shopping centre and a retail park. Those have done comparatively well, and we have contemplated financing them.

Harris: All retail is tarred with one brush. But for the right price who wouldn't buy irreplaceable high street shops in a location like the Champs Élysées in Paris? Internet penetration is generally much lower in France than in the US or the UK, and so covid has not had such a big impact, and my feeling is that it will have less impact in the longer term.

Giguet: France has strong administrative barriers to building new retail park or shopping centre space in locations where provision already exists. That will help to protect the sector and support investor interest. Well-located retail parks can still find lending liquidity. But it will be challenging for pure shopping centres, especially out of town. We do not know how their rent roll will evolve after the crisis. A lot of small retailers might get into difficulty when government support is withdrawn, causing significant vacancy, so lenders are very reluctant to look at those situations.

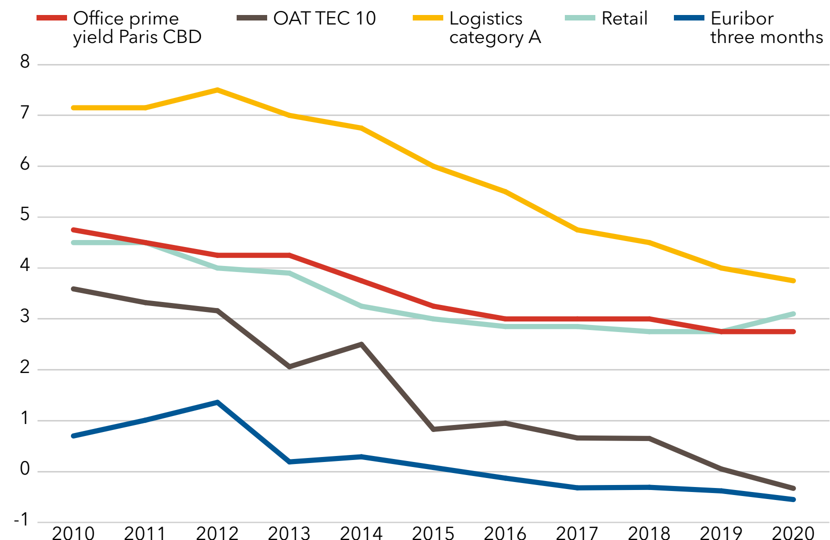
absence are vehicles managed by UK or US private equity firms and investment managers. The participants agree that this is because Anglo-Saxon debt funds typically target opportunistic or value-add returns and therefore lend at a higher risk profile than French debt funds. The latter tend to be subsidiaries of the banks and insurance companies that dominate the French real estate market, which are more comfortable providing senior debt against core or core-plus assets.

"The French debt fund market is very narrow," says Giguet. "Most of them are substitutes for traditional senior lending, and they are all positioned on the lower end of the pricing spectrum, at around 200 basis points over EURIBOR.

"There is appetite from UK-based debt funds for higher risk loans. But because they are targeting IRRs of 8 percent, they are pricing loans at 650 basis points, plus fees. Institutional real estate investors are often reluctant to take those terms, however, because at high interest rates any delay to their business plan can quickly impact their return on equity. We have seen deals not happen for these reasons, or they are executed with full equity for one year while sponsors wait for bank finance to be available again."

The window of opportunity for most alternative lenders is limited because loan pricing will be cheaper in 12

Prime office yields moved out slightly in 2020, while logistics values continued to increase

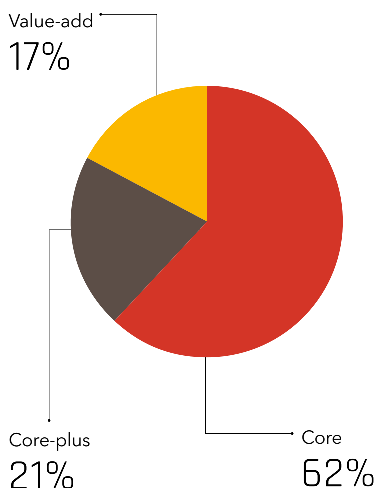


Source: CBRE Research

> *"Right now, we talk to frustrated operating partners and private equity investors, who say they cannot find value-add deals"*
>
> **JOHN BIGLEY**
> **DRC Capital**

months, predicts Harris. "It is a good market for debt funds willing to take a risk and bet on a market recovery, particularly in the French office market," he says. "If you are confident that we are not all going to spend the rest of our lives working from our bedrooms, it is a very opportune time for the debt funds to be lending money."

Almost two-thirds of deal activity in 2020 was at the lower end of the risk spectrum



Source: CBRE Research

The roundtablers seek to quantify changes to LTVs and loan pricing since the onset of the pandemic. Giguet kicks off: "Before covid, on core-plus deals we could source finance with bullet loan structures up to 65 percent LTV on five-year maturities. Now it is more like 60 percent. On value-add deals we could finance 60 percent LTV or more before covid. Now, every traditional banking finance deal is capped at 50 percent. For a shiny asset in the heart of Paris you could raise a little more.

"The pricing for core loans has hardly moved, maybe by 10 basis points at most. But the further you go up the risk spectrum, the wider the difference is. With bank financing, a typical value-add office deal in greater Paris could be financed at 60 percent LTV and 250 basis points pre-covid. Now it is 50 percent at 300-350."

LTVs in the alternative lending segment have not altered much, but pricing has, says Harris. "For value-add transactions you can still get 60-65 percent LTV without too much of a problem," he says. "However, debt funds that were looking for a 6-7 percent IRR are now targeting 8-10 percent. That means margins have gone from around 3.5 percent to 6.5 percent."

Bigley concurs with Harris's figures on margins and debt fund IRR targets. "LTVs are in the 60-65 percent range," he says. "At 60 percent LTV with a domestic French lender prior to covid, pricing was at 300 basis points, or sometimes even tighter in the high-200s. That has probably increased by 40-60 percent."

For vendors of value-add assets, the increase in loan pricing presents a dilemma, adds Harris. "Generally, the pricing of today is a moment in time," he says. "It will not be the pricing of the future. But a buyer cannot take one of these loans in the short term, and in a year's time refinance their way out of it when everyone is vaccinated and the central banks have flooded the market with cheap money. If a seller wants to sell today, they need to accept the pricing levels of today."

Zombie situations

As the roundtable draws to a close, the conversation turns to the potential for opportunities to buy non-performing loans in the aftermath of the pandemic. It is agreed that there has hitherto been little evidence of that kind of activity because of the comprehensive state assistance provided to French businesses.

Giguet observes: "While there are a lot of zombie situations, there is no pure distress on lenders' books. After the reopening of the economy, and the end of government support, it will become clear what those businesses' accounts look like. And after that we will see whether the banks are willing to sell NPLs or will prefer to manage them on their books. We hope that there will be a few more portfolios on the market as a result."

"There is bound to be some distress," says Bigley. "But I question how much and how quickly it will come. Distressed opportunities will probably be more evident in the near term in corporate credit and SME corporate credit than in our space."

Distressed buyers will have to exercise patience, cautions Harris: "When do lenders get more aggressive in the view they take about repossession? When the market is stronger. When they feel they can enforce, force a sale, achieve a reasonable price, and get their loan back. If you have a tricky position today on a half-built value-add asset with no tenants, it is hard to get out of, so why would you force the exit? I expect to see more distressed deals coming through in 2022-23 when the market has really recovered and lenders can get out of their positions." ■