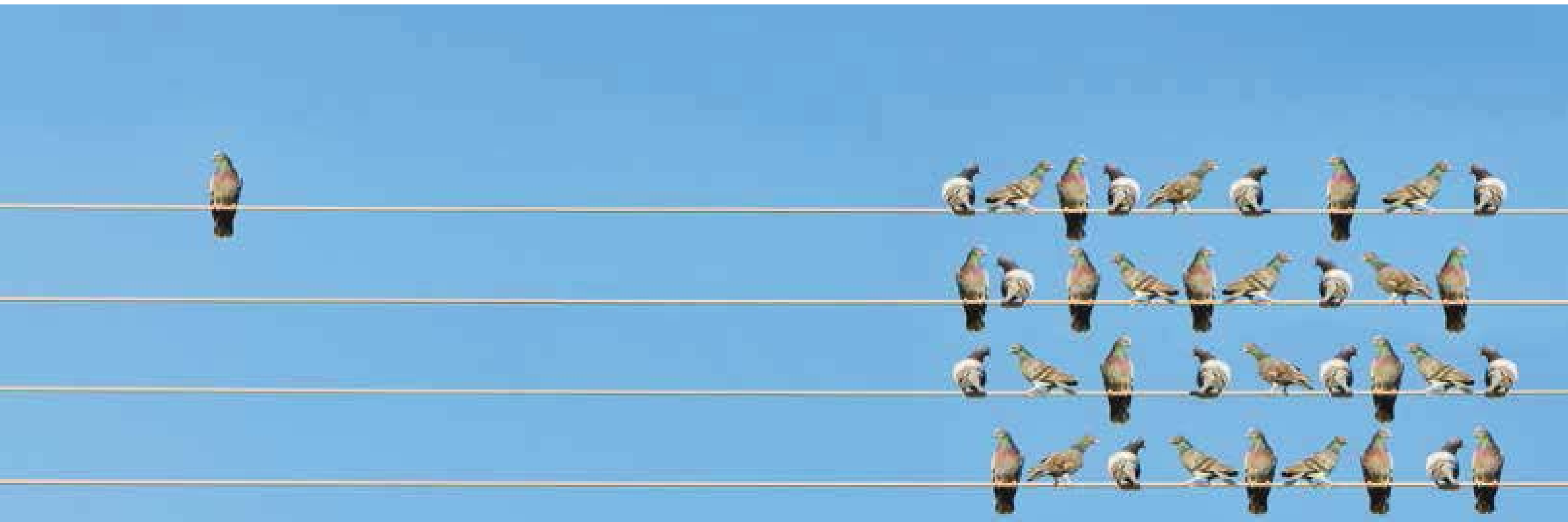


# Why Germany is a lonely place for debt funds

**Lauren Parr speaks to those alternative lenders managing to carve out a niche in the country's uber-competitive lending market**

Life is not easy for non-bank lenders aiming to provide debt capital in Germany's real estate market, given the exceptionally competitive banking sector in the country.

"There's not much juice in the German market for alternative lenders – it's too liquid," says Markus Kreuter, JLL's head of debt advisory in the country.

However, there are a few debt funds focused on German real estate, though those that do exist have struggled to source deals or have set return expectations too high in a market in which loan margins are notoriously low. Last year's *German Debt Project* report by Bavaria's University of Regensburg said that debt funds in the country primarily focus on mezzanine tranches. "The banks frequently tend to class them as providers of quasi-equity and not as competitors," the report stated.

With Pfandbrief banks dominant in the senior debt market up to 60-65 percent loan-to-value, alternative debt provision only makes sense higher up the capital stack. "If you're willing to go up the risk curve then it makes sense to be an alternative lender in Germany; if you're just aiming to finance the same core risk as banks, there is no chance to earn money," says Kreuter.

Banks are able to finance up to a maximum of 80 percent LTV on a non-recourse basis, but rarely go higher than 70-75 percent.

Düsseldorf-based Caerus Debt Investments is a rare example of a Germany-focused debt fund. Michael Morgenroth, partner with the firm, explains the opportunities he sees relate to mezzanine debt that is akin to preferred equity, for which borrowers are willing to pay between 7 and 15 percent. Since it entered the market in mid-2014, Caerus has raised more than €1.2 billion of capital from institutional investors and invested close to €1 billion in mezzanine and whole loan financing.

Morgenroth argues that firms like Caerus, which can also originate whole loans up to 80 percent LTV, can compete with banks by acting as one-stop shops, simplifying the process of sourcing higher leverage for borrowers.

## WHOLE LOANS

Whole loan financing is becoming more established in Germany, comments Curth Flatow, founder of Flatow Advisory Partners, which is among those planning to launch a debt fund. "It wasn't necessary in the past as banks were more aggressive in terms of LTV. Now bank capital has been reined in and more parties, from insurance companies, superannuation schemes and debt funds, are willing to provide unitranche debt as the overall asset class has become better understood," he says.

Debt funds are also willing to finance parts of the market banks may avoid – for example, secondary cities and part-vacant properties. "In Germany, you have a very competitive banking market thanks to Pfandbriefe but banks are still not financing everything, everywhere. They have their typical roster and they have strict rules about what they won't finance," says Morgenroth.

He cites one example of a deal won by Caerus, in which it financed a B&B that fell short of a bank's rigid criteria to finance hotels with no fewer than 80 rooms. "You just need to identify the risk and price it," he says.

## RESIDENTIAL DEVELOPMENT

A particular opportunity surrounds the provision of mezzanine particularly for residential development, argues Flatow, pointing to the high volume of ongoing development to address the undersupply of housing in metropolitan areas such as Berlin, Hamburg, Stuttgart and Munich. Alternative lenders are drawn to the higher returns on offer through development lending, with a number of participants active in the market for small-ticket finance below €10 million – namely private wealth and some 'Versorgungswerke'; pension funds for professional groups.

RiverRock European Capital Partners, which has offices in London, Paris and Milan, also has a mezzanine fund aimed at Germany. "Traditional lenders are seldom willing or able to complete a deal in three to four weeks, so if there is an enormous amount of time pressure to get something done because an opportunity has arisen, we are able to get outsized pricing by virtue of being quick to complete and flexible in terms and structure," says Nicolaus Harnack, head of real estate at the firm, which targets double-digit returns.

Another gap alternative lenders are aiming to fill is refinancing borrowers seeking to release part of the equity produced through a rise in market values. "Banks are reluctant to lend in these situations, whereas funds are looking from an LTV perspective and not how much equity a sponsor originally invested and are therefore more open to the prospect," says Flatow.

Pan-European debt funds often find yields too aggressive in Germany's main cities and have limited appetite for financing small-ticket regional deals. Dale Lattanzio, managing partner of London-based debt fund manager DRC Capital, has experience in funding German deals. He admits that the challenge lies in sourcing opportunities given liquidity created by the Pfandbrief market: "Alternative lenders spend more time elsewhere," he says.

Some argue that increasing regulatory pressure on Germany's banks could create additional opportunities for alternative debt providers, if banks were forced to retrench from certain parts of the market. "Basel IV will limit the ability of banks to finance higher risk so there will be a fair market share for participants that are able to finance 60 percent LTV and above," says Morgenroth.

The *German Debt Project* also noted the potential for regulation to increase the alternative market: "The more stringently higher LTVs are penalised by regulations, the more debt funds could force their way into the gap that emerges."

### INSTITUTIONAL INVESTORS

Despite the prevalence of the banks in the German sector, there is a growing demand for real estate debt from the country's institutional investors – indirectly in many cases. "Historically low interest rates and a squeeze on opportunities in the real estate market mean the prospect of investing in alternative asset classes such as real estate debt is becoming more interesting for pension funds and insurers," comments Flatow. "Some pension fund managers have already invested, while others are still in the process of assessing what might be possible for them and what kind of risk profile they would like."

German pension fund giant Bayerische Versorgungskammer (BVK) last year ploughed €750 million into a stretch senior lending mandate awarded to Deutsche Asset Management. The fund is opportunity driven, with the bulk of capital deployed in the US, followed by the UK, France and, to an extent, Germany.

There is also a significant appetite from insurers to finance real estate, partly driven by favourable treatment under Solvency II regulation. Talanx, Germany's third-largest insurance group, has invested in the sector, albeit only representing a fraction of its current portfolio.

German insurer Allianz is one of the few German insurers with a direct lending business. The Munich-based firm is sidestepping the banks by offering financing on core risk at longer terms than those at which banks are most competitive in pricing. "We like the German real estate market from a fundamental perspective, both for equity and debt investments. Nevertheless, as a decent risk/return profile must be granted for our investors and given the heavily banked environment, we currently put our focus on terms of seven-years plus," says Roland Fuchs, head of European real estate finance.

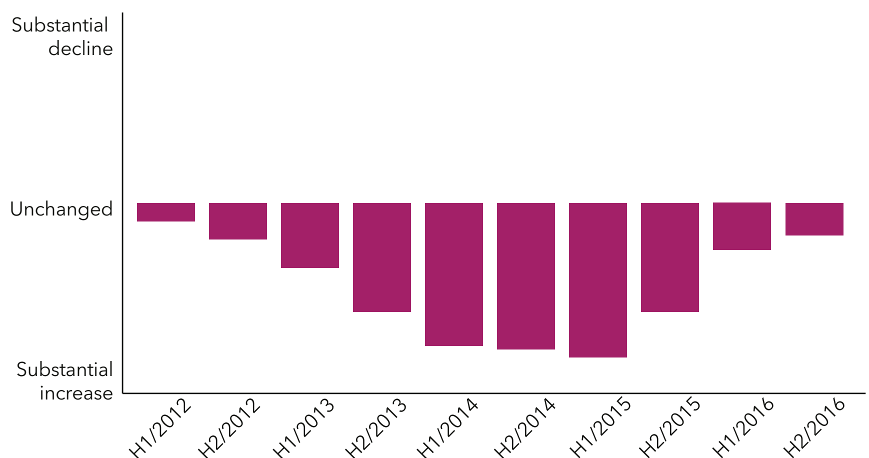
While Germany's institutional investors are increasingly seeking to access real estate debt as an asset class, they are unlikely to limit themselves to their domestic market. In the independent debt fund management world, there are opportunities to lend, but they look likely to remain limited.

DRC's Lattanzio argues that it does not make sense to build a business model solely around the German sector. "The construct of the market is such that a number of domestic investors don't use higher leverage," he says, explaining that many open-ended funds in the country do not look for geared returns. "There is definitely a place for alternative lenders in Germany, but Germany is not the biggest element within our investment portfolio."

There are prospects for alternative lenders in Germany, but they are unlikely to make anywhere near the same impact they have on the UK market. "Debt funds and, more especially, insurance companies will increasingly find their niche in the market," according to the *German Debt Report*, "however, based on the interviews we conducted, this will be a gradual progression." ■

**STRONG COMPETITION**

Lenders polled by the *German Debt Project* continued to report increased competition during 2016




Source: *The German Debt Project: IRE/BS, University of Regensburg*