ESO CAPITAL

A world away from mezzanine

David Christie of ESO Capital explains how private debt can offer close alignment between management and capital in selected areas of real estate

The opportunities for private debt investing in real estate for mid-market funds, such as ESO Capital, would seem to be very different from what we see in the corporate world. Mention private debt among the swarms of real estate brokers and advisors at conferences such as MIPIM, and their immediate response is "do you mean mezzanine?"

Private debt in the corporate arena is often defined as the first-lien transitional, or growth capital, to asset-backed entities wishing to retain longer-term equity control. Private debt in the real estate arena however has very different characteristics, often filling the gap left by a combination of relatively more conservative lenders and sponsors running short of equity.

The mezzanine lending strategy might prove to be an attractive risk-return within a conservative 'core plus' or even 'value add' investment strategy, but in the world of more opportunistic themes, this can sometimes feel like being a rear passenger in a car being driven at immense speed.

ESO is often approached for mezzanine financing by residential developers who have secured senior lending, often through private debt funds, at pricing between eight to ten percent. The issue we see is that this tranche represents 60 to 70 percent of the capital required for the project. Often in these instances, the borrower has limited monetary capital itself but emotional capital runs high, with a strong desire to retain equity control. The answer tends to be the introduction of mezzanine finance.

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The pricing for mezzanine development financing varies enormously; in Germany, where institutional lenders seem comfortable with stretched senior to developers, mezzanine lending can be sub 10 percent. In the UK, we have been approached by established developers seeking to refinance mezzanine loans for London projects priced as high as 20 percent.

The common theme is that mezzanine financing very often extends up to 90 percent loan to cost. At this point in the capital stack, the effective risk for the mezzanine lender is akin to equity, yet the control is very limited indeed. In ESO's experience, if the opportunity looks like equity and smells like equity, it very likely is just that, and therefore the governance should reflect this.

These types of loans are partly a result of the real estate market becoming increasingly bifurcated, especially at the opportunistic end. Opportunistic property companies with mid-market capitalisation and skilled management have been largely replaced by relatively small asset management platforms that often seek capital backing on a 'deal per deal' basis.

At the same time, there is growing pressure on managers raising increasingly large funds to invest that capital efficiently. Many are now having to turn to specialised asset management platforms (AMPs) both for their deal sourcing and asset management capabilities.

This can however become a somewhat challenging relationship with question marks regarding alignment of interest. The AMPs are motivated to grow the number of deals 'under the belt', and it is in their interest to do so with a variety of different capital providers to avoid cross-collateralisation of promotes. Monogamy, more formally referred to as 'exclusivity', is not an easy point of negotiation between funds and AMPs and a subject that probably does not suit either party.

While there are some very skilled platforms indeed, the economic structure opens the door to a diverse range in ability. Temptations for misalignment are numerous, and perhaps one key danger is where we see skilled asset management teams being dragged out of their core skill set in the pursuit of management fees. As the market has now steamed up, asset management teams are cognisant of the immense competition of other investors and the difficulty of securing similar opportunities.

Alternatively, what options are open to the asset manager which has demonstrated an ability to source, build and manage in sectors such as healthcare, student housing and the residential private rental sector? These are evolving sectors in real estate where there are strong merits for management specialisation.

Investor interest in the space is not only for the finished product - a relatively high-yielding income-producing stabilised asset – but now recognises the value of the team that builds a strong platform for future growth. Many fund managers have demonstrated the premium value over and above Net Asset Value (NAV) for a platform that has chosen to specialise. Very often these AMPs have entered the market with a limited balance sheet.

These are exciting sectors of growth where there are increasingly private debt funding options offering the potential for closer alignment between management and capital. This is a format often adopted in the corporate arena, and ESO Capital is now applying this successfully in real estate.

Our corporate team was recently approached with a similar dynamic in the UK's largest asset-backed peer-to-business lending platform. In this instance, the target was to provide a balance sheet to enable the platform to initially underwrite its own loan book, while at the same time supporting management in evolving the infrastructure within the company in the knowledge that our capital will facilitate a significant growth in lending volumes and loan book under management.

Following on from this experience, ESO's real estate team recently finalised a credit investment into a company active in the fast-growing and evolving residential Private Rental Sector (PRS). The management team was initially seeking an equity injection at a project level, believing that this was their only option. The business focuses on acquiring sites for private rental housing in the north of England. They had used limited in-house capital to deliver the first project and having secured exclusivity on numerous other projects, were seeking additional funding.

In this instance, an equity deal would have provided piecemeal funding of individual development projects, not security on funding for pipeline opportunities. There was also an added challenge: the company targets a specific area within the fast-evolving PRS market - notably housing rather than large city centre apartment schemes. As a result, the size of each project is significantly smaller, generally with a gross development cost of between £5 million to £10 million.

Large private equity funds have recently provided significant capital to large city centre PRS programmes costing hundreds of millions. However, raising capital for relatively smaller projects can in many instances prove to be a significantly greater challenge. According to *PERE*, the top ten managers raised $149 billion for opportunistic or value-added strategies; to invest this, they no doubt need to put sizeable tickets to work.

Applying our experiences and skillset from corporate deals in the real estate arena has been predicated on recognising the abilities of management teams and the value of specialisation. In addition, it was closely associated with confidence in their ability to secure a strong pipeline of new projects. The real value to both management and investor has been driven by recognising the merits of building a portfolio of stabilised end product within the balance sheet of the company.

As the company progresses with existing development projects, a debt facility is made available to secure and finance additional projects. As these reach completion and the investment becomes income producing, each project can be refinanced with stable senior debt from traditional lenders.

Upon completion of the project, there is a wider, and admittedly cheaper source of capital to finance the investment. This in turn facilitates the recycling of the capital within the corporate entity to fund subsequent new projects. Our debt investment is first lien against new projects (pre-completion) and the profile of loan to value is maintained within a sensible threshold of not more than 75 percent.

The key component is consistency in the profile of the project. Private debt, at its corporate roots, is growth or transitional capital, and this is how it is being applied in this instance. Upon hitting a certain critical mass in the portfolio, the company will be in a position to attract longer-term institutional capital but only if the management team maintains focus on its strategy and quality of product.

At the same time, a key risk of investing in some of these real estate sectors is securing an exit. By structuring the investment as debt, the investor is safeguarding a further exit option – refinancing! The longer term benefits are there for all, and what we see here is closer alignment between management and the private debt capital solution. ■

David Christie is managing director, real estate, at ESO. He oversees all real estate-related transactions, targeting off-market niche opportunities in the UK and Northern European countries. He has over 20 years' real estate experience across multiple sectors throughout Europe with prominent private equity real estate investors including ARES and Doughty Hanson.