EXPERT Q&A

Private debt has a key role to play in alleviating property shortfalls in Europe, say Arrow Global's Mark Posniak and Maslow Capital's Ellis Sher

Direct lenders stand ready to address housing issues

While deal activity may seem muted, there are good reasons to believe that demand for private debt across Europe remains resilient, especially in the real estate sector, say Mark Posniak, European lending development director at Arrow Global Group, and Ellis Sher, CEO and co-founder of Maslow Capital. Arrow Global announced the full acquisition of Maslow Capital in August after buying a minority stake in the real estate lender in December 2021, forming part of Arrow Lending Opportunities (ALO) investment strategy.

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Q How has the direct lending market evolved in the past 24 months, and what does the European lending landscape look like today?

Mark Posniak: Over the last 24 months, the direct lending market across Europe has experienced something of a transformation. The non-bank lenders are growing in prominence due to their agility and ability to offer far more flexible funding solutions than the banks. The increased regulatory and solvency pressures on the banks mean they are retreating from certain areas of the credit market and leaving substantial gaps for private debt funds to fill.

Ellis Sher: Since we came into this space in 2009, specialist non-bank lenders have been taking market share from the banks. Banks have been far more disciplined and focused on their core banking capabilities, allowing space for the non-banking sector to expand. European regulators have focused on weeding out poorly run or undercapitalised banks, resulting in a 35 percent reduction in banks between 2008 and 2021.

Q Why are investors excited about the future of the

direct lending private debt strategy?

ES: Since the GFC, allocations to private debt have been steadily increasing. That is because in many cases the loans are asset-backed, yield-certain and non-correlated compared with some of the more liquid fixed-income alternatives.

More recently, that interest has really accelerated due to the numerous rates rises, pushing rates to pre-GFC levels. Most non-bank lenders provide floating rate loans, which has significantly increased both IRRs and money multiples. In absolute terms, these instruments have become more numerically interesting.

A number of investors have also started to see this type of private debt as an all-weather asset class, so while the underlying property sector is cyclical, done correctly there should not be as much volatility on the secured debt side as there might be with equity.

Q How will lending change as we head into a recessionary period and what sort of opportunities will be created?

MP: Specialist lenders have historically done well in recessionary periods, filling the gap left by the banks as they get to grips with their legacy positions. The non-bank lenders can really come into their own if they have efficient capital to deploy, as they can create products to deliver solutions without having to push the boundaries in terms of leverage, borrower solvency and asset quality.

We do anticipate non-bank lenders getting slightly more selective, but they will still be able to create high-quality loan books via their flexibility and accessibility during these uncertain times.

ES: Everyone speaks about the refinancing gap that this higher interest environment will bring. That gap is estimated at about $93 billion, but we are yet to see it coming through in refinancing requests, nor have we been presented secondary books to acquire. I do wonder whether the opportunities that everyone anticipates will materialise. I am beginning to think that with sufficient pragmatism, flexibility, patience and liquidity in the system, the refinancing cliff may not materialise to the extent anticipated.

Q How have broader macroeconomic factors influenced the role of private debt in the housing sector?

ES: We continue to play our role in the provision of debt for new-build housing developments. A lot of private debt is focusing on the living sector – it seems that multifamily residential is the new industrial. There is unfortunately only so much the lending market can deliver because the planning systems are inefficient.

Despite best intentions, we are seeing a continuous slowdown in the time it takes to achieve planning along with heightened costs of doing so. Governments across Europe are missing their new homes targets, while need is heightened by an ageing population, longer life expectancy and smaller households.

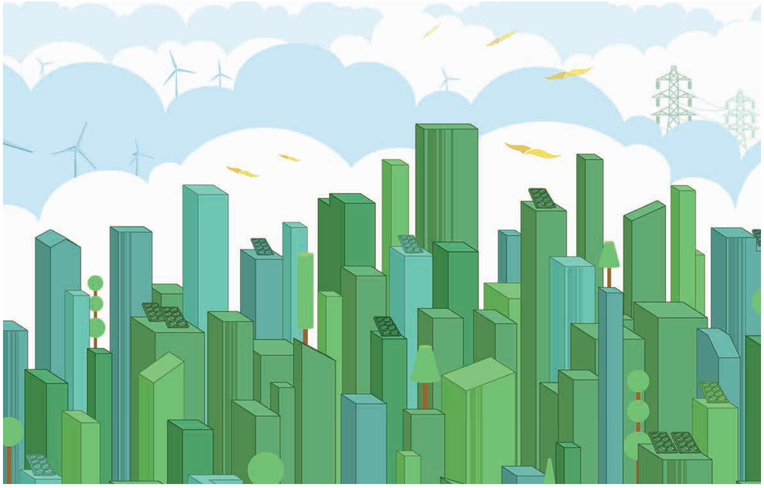
Private debt is available, as is equity, but the issue is that supply is systematically curtailed by planning systems that are deeply flawed and in need of modernisation, across many parts of Europe.

MP: Housing supply is not keeping pace with demographic changes, creating a substantial opportunity for developers and non-bankers alike. Much

Q How can ESG play a role in direct lending?

MP: ESG is built into the framework for our product design and lending programmes, with a core focus on energy efficiency, financial contributions to the local council, end-unit price points, affordability and developer procurement, reputation and governance of the business.

ES: We have seen the market attempt green-linked loans where the cost of credit is attached to the development's green credentials. That is yet to have a significant impact but is certainly the direction of travel. There is no question that in Europe, failure to have a positive and measurable ESG policy that delivers in the real world will make institutional fundraising particularly challenging.



of the European housing stock is deficient in quality and volume – major refurbishment and energy efficiency enhancements are required for more than 50 percent of housing stock across the UK, Ireland, Germany, Spain, Italy, Holland, etc.

In fact, looking at the UK, most of the properties were built in or before the 1980s and are going to struggle to meet the government-imposed new energy efficiency standards, so there is a huge opportunity to help buy-to-let landlords to upgrade their properties to achieve the required Energy Performance Certificate ratings.

Across the rest of Europe, there are going to be improvements required to rental properties to make them energy compliant and better places to live. So, while non-bank lenders can fill the funding gap left by the banks, we need governments to facilitate that by increasing the number of homes and the energy efficiency of existing properties to meet legislative changes being proposed.

Q What are the supply and demand dynamics in the direct lending space? How are loans being structured to get deals done?

MP: Borrowers need quick and certain decisions, with funding packages that provide them with the flexibility required to meet their business plans, rather than trying to fit a banks' credit mandate. Non-bank lenders can be flexible around how they structure a facility across duration, leverage, serviceability and composition of pricing, making capital much easier to access.

ES: While deal activity is currently muted, there is an oversupply of debt capital versus demand; however, that ebbs and flows. We are starting to see a rebalancing as some liquidity withdrawals from the market and the rate at which central banks have been increasing rates begins to moderate.

> *"Specialist lenders have historically done well in recessionary periods"*
>
> **MARK POSNIAK**

> *"Multifamily residential is the new industrial"*
>
> **ELLIS SHER**

The fundamentals of the sector have not changed: populations are growing; existing housing stocks require extensive improvements; and planning laws remain complex, hindering new supply. Despite the challenges we have witnessed, we are seeing a notable pick-up in new-build enquiries.

There is a way to go but that pick-up is an indication of two things. First, the market believes we are through the worst of interest rate rises and sponsors are slowly becoming more comfortable that they can transact with more certainty. Secondly, there is no question that inflation across construction is moderating, albeit more so across Europe than in the UK.

Q What can we expect to see when it comes to performance, risk-adjusted returns and value creation?

MP: Non-bank lenders will continue to focus on delivering competitive risk-adjusted returns relative to traditional fixed-income assets. Value creation will come from expertise in credit selection, proactive risk management and seizing opportunities that emerge during market dislocation.

ES: On value creation, nothing has changed. It is best to have a large origination funnel, allowing one to understand which deals offer the most favourable risk-adjusted returns. Deal selection is key, along with diligent underwriting and ongoing management of the loan, all performed by highly competent people supported by intelligent systems. Those are the fundamentals.

Q From a borrower's perspective, what are the advantages of private credit vs the syndicated market?

MP: Direct lending is quickly becoming the norm across Europe because it is quicker, easier and much more flexible. Furthermore, a lot of the specialist lenders take that old-school lending approach, where it is not a tick-box exercise.

ES: The syndicated market is much less flexible, and everyone will tell you that the cost of putting a syndicated deal together is considerable. The truth is the syndication market only works for large deals, and if you are looking for anything less than €150 million then it is not a cost-efficient funding source. Maslow Capital, part of Arrow Lending Opportunities (ALO), has funded €5.9 billion of developments across 257 loans. Only one of those was syndicated, and I promised I would never go through that pain again! ■