EXPERT Q&A

The hardest thing for investors is to gauge where they should be on the risk spectrum, say Paul House, managing partner, and Beatrice Dupont, partner, at Venn Partners

Seizing opportunities in commercial real estate debt

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Q What is the immediate outlook for private commercial real estate in Europe?

Paul House: We are cautiously optimistic. If you look at transaction volumes, there is a healthy interest in commercial real estate. The driver of cashflow is the occupational market, which is in pretty good shape, with the exception of the retail sector. Recent months have shown continued positive GDP growth in Europe, with July's figures confirming that the UK posted growth after data from the country's Office for National Statistics had suggested a contraction in the second quarter. Earnings multiples are not overheated against historic metrics and we don't have an overleveraged market.

That said, we are certainly cautious because these are uncertain times. The political situation concerns us and one has to consider the impact of rising trade barriers on the underlying economies and the commercial real estate sector. Against this backdrop, investing in real estate private debt has the advantage of predictable income while also benefiting from downside protection against potential property value declines.

Q What impact will the current political environment have on private commercial real estate lending in both the UK and Europe as a whole?

PH: Political volatility should have a negative impact on bank funding that still dominates CRE lending. This will mean the supply of credit will be in check. On the demand side, the key is the impact on the underlying economy and on the underlying CRE equity market returns. Real estate is the infrastructure of society, so we naturally follow the stats on white collar job growth, business confidence, manufacturing, consumer confidence and anything which shows the demand for wider business services. Thus far, these figures are holding up.

Beatrice Dupont: One of the benefits of CRE lending, particularly in the more value-add space in which Venn Partners operates, is that we can adapt our portfolio to changing market conditions. Our loans are typically repaid over a two- to three-year period as we lend against assets that are repositioned from value-add to core, and therefore we recycle capital at least once in our funds. This means we can react to macro events and vary our exposure accordingly. As an example, our investments were initially more weighted towards the UK as this was the most attractive market in Europe. But with Brexit and an increasing demand for alternative lending in continental Europe, that dynamic has shifted and we have now rebalanced our portfolio accordingly.

Q How do you characterise the differences between sectors, such as business parks, offices, logistics hubs and retail?

PH: There are some marked differences both between the sectors and between geographies. Venn Partners' mandate is to identify the best place to deploy capital in sectors with high relative performance while avoiding those that underperform, and we have to date managed to do just that.

Take UK retail. Until 18 months ago, it wasn't necessarily the dirty word it is today. Properties that traded in 2014 and 2015 are now trading at prices that are up to 50 percent below those levels – and this has happened quickly due to the repricing of retail rents and substantial changes to the occupational market. For investors that went long on retail, that is going to impact them significantly. We avoided pure retail loans that were most exposed to these downward trends.

Retail is the bad press story, but the broad brush the industry applies to it hides areas of potential value. The transactions we review and track illustrate some important anomalies, such as retail properties that have sometimes been hit so hard on value that they are close to residential or last-mile industrial land values. Furthermore, rent is repricing inside those two asset classes in select sub-markets. This presents a unique opportunity to benefit from the change from pure retail to mixed-use properties.

As another example, Venn Partners focused on alternative asset classes, such as hotels and pubs, before it became more mainstream, and we were able to capture superior returns as a result.

Looking to differences across geographies, the benefit of being exposed to both the UK and continental Europe is that although the occupational market impacts can differ across jurisdictions, they can follow the same trend. This is something we follow closely for our investments. Student accommodation, for instance, is only emerging in Spain but is a very established asset class in the UK.

Q What do you consider to be the main issues for clients weighing up the opportunities in private commercial real estate lending?

PH: Commercial real estate debt is no longer a new asset class, as was the case when we started the real estate lending platform at Venn in 2013. Today, investors are well versed with the benefits of investing in real estate debt and like the predictability of the income and the protection that comes from having security over a tangible asset. That said, real estate debt is not a ubiquitous asset class and it can be difficult for investors to compare investment opportunities as presented to them. One of the hardest things for investors to gauge is where they should be on the risk spectrum, as the market and the risks within it are difficult to compare given its fragmented nature.

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PAUL HOUSE

"If things go wrong, we need to have the necessary measures to protect the capital of our investors"

BEATRICE DUPONT

Q How is the growing investor interest in sustainability manifested in the commercial real estate lending market?

BD: The equity sponsors we lend to increasingly understand that they have a responsibility to take on the sustainability challenge, and many are doing so. As a lender, Venn Partners is one step removed from this. However, there is a natural sustainability impact from our investments because a large part of the lending Venn does supports borrowers that are transforming older unproductive buildings into state-of-the-art, environmentally efficient assets.

Q How important is depth of knowledge in the investment team and what happens if we enter a period of defaults?

BD: One cannot underestimate the importance of experience in a team, particularly in the private lending space. We are creating bespoke loans which are tailored to each client's business plan. Obviously, we want our clients to make money. However, if things go wrong, we need to have the necessary measures to protect the capital of our investors. We do this by underwriting our loans against scenarios which may turn out to be worse than predicted but still result in capital preservation, thus mitigating the risk of things not going according to plan.

PH: Venn Partners has the benefit of having experienced three different real estate cycles in three different global markets. While history can never be the guide to the future, the experience of the team plays a critical role in avoiding trouble in the first place, but also in enabling us to emerge from difficult positions that inevitably happen during more economically challenging environments. ■