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KEYNOTE INTERVIEW

Debt opportunities, risk premia and market momentum


Growing investor interest and increasing market momentum in real estate debt have prompted a new partnership, say ARA Venn's Paul House and ARA Asset Management's Mark Ebbinghaus

Global expansion is on the menu for ARA Asset Management, which is active in 100 cities in 28 countries and has been investing in European real estate equity for some time. However, the Singapore-based group has been looking for product line expansion, which led it to join forces with Venn Partners, a London-based European real estate credit specialist to create ARA Venn.

ARA has taken a majority stake in Venn and will work closely with ARA Venn to grow the scale and scope of its operations. Mark Ebbinghaus, ARA Asset Management's European chief executive, and Paul House, managing partner and head of the CRE business at ARA Venn, discuss the opportunities on offer in European real estate debt.

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Q What were the drivers behind this partnership?

Mark Ebbinghaus: Our move into Europe was very much investor-led and we have seen significant quantities of capital progressively deployed, not only to the UK but continental Europe over the last five years. We have seen a lot of interest in Europe and the UK from our Asian investors and a lot of demand on the credit side. Some of our investors actually prefer to invest in debt, but we had never really been able to cover that. So, we have broadened out our expertise within the wider platform, bringing people on that have a deep experience in credit, and this new partnership is a significant step forward.

Paul House: Our business commenced in 2009 and our investment management efforts began in 2012. Since then, we have built a business with about £5 billion ($6.4 billion; €5.8 billion) of assets under management and committed capital, purely focused on real estate credit in both commercial and consumer residential areas.

What we noted in our own capital raising is that firms like us have been in an increasingly competitive market for capital as investors look to rationalize the number of managers they deal with while still wanting to access a choice of different products, so we were looking to align ourselves with a partner who would help us expand and with whom we would have a good cultural fit. As ARA looks to grow in Europe, we think we are in a good position to help foster that growth.

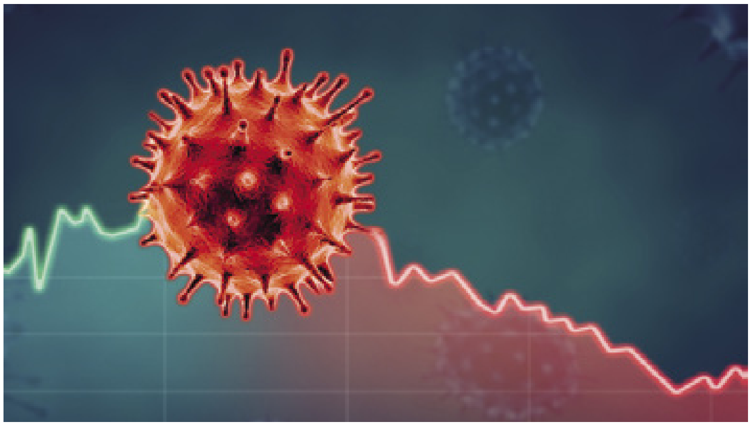
ME: I've known the Venn team for over five years and we have developed a close relationship and understand each other well. We tend to think about things quite deeply and for us the culture, alignment and really wanting to work together is critical. It's not just a numbers game.

Q What characterizes the transactions you are targeting?

PH: On the CRE debt side, we are raising capital for our latest fund for deployment in the UK and Europe, supported by ARA. We are looking for mid to upper single digit total returns, predominantly from whole loans but with the ability to take some junior positions as well.

We are targeting mid-sized private equity or institutional-sized family offices who are investing in value-add real estate opportunities. We are able to go higher in loan to value than bank lenders, as we typically try not to compete with banks given their pricing advantage at lower LTV loans. The types of deals we would look to do are often with some form of value-add aspects.

We are looking at a building in Spain right now, located in the CBD of Madrid. It has an existing tenant but the building could use some improvements. Some capital expenditure will improve its sustainability rating as well as its aesthetic quality and add



Q How will investors respond to the increasingly volatile environment driven by the reaction to covid-19?

ME: We think at least in the near term there is going to be relative polarization between those investors that are proactive and those that are reactive, it is likely that there are going to be few leaders and more followers in these uncertain times, decision making is also likely to be pushed out for many.

It is in our view likely that the market will continually evaluate and eventually 'come to a landing' on the competing impacts of, on the one hand, as to whether we are in a near term (temporary), medium term or more permanent change in risk premia environment, requiring a higher rate of return for a given level of risk, leading to asset pricing contraction pressures, and on the other hand, the impact of what is likely to be an unprecedented level of monetary and fiscal expansion leading to asset pricing stimulus and lower required rates of return pressures.

We feel that participating in the markets via debt is likely to receive strong levels of support, particularly as bank appetite contracts and those with firepower are likely to be well positioned to optimize performance. Investors are likely to support trusted managers with strong sponsorship and deep market insight that have scale and scope to capture market opportunities.

PH: On a more lasting note, the extreme volatility that investors are experiencing in the global capital markets – in both the equity and the debt capital markets, is happening post a long stretch of relatively low volatility and consistent moves higher in asset prices. The sharp volatility experience from the global pandemic can lead to investors seeking lower risk strategies that are available in the private debt markets of which CRE debt is part of.

In addition, the public policy reaction that is currently underway – being a decline in central bank interest rates plus higher fiscal spend – is a trend that spells of continued low interest rates in sovereign debt is likely to spill over to corporate debt. With the backdrop of high volatility, the opportunities that emerge from the dislocation plays to the benefit of private funds that we manage as we retain the ability to pivot to capture the best investments as they emerge. Investors with the memory of the 2008 crisis will recall that post that event, significant opportunities were captured in the years that followed.

value for the client, either through increased rent or a new tenant. The loan size also fits neatly into the fund target of between €10 million to €50 million, where we see less competition from low cost capital providers.

We also have a residential lending business in the UK private rented sector, which would be called multifamily residential in other markets, where we originate and manage a £3.5 billion PRS lending scheme for the UK government. To date, we have lent a little over a billion in this mandate and we are looking to deploy another £2.5 billion over the next few years. For this type of assets, we would lend on an LTV of say 60-65 percent. We get a government guarantee on the bonds that we issue and then we go into the institutional marketplace and fund those positions. So, there is a policy angle, which is to support a nascent industry.

We see potential to develop non-government investment mandates in this asset class given its growth prospects and the deep technical expertise and market knowledge that we have gained through our work with the Government program.

ME: We see three or four strong product lines at ARA Venn and we are reviewing broader opportunities. In addition to the products Paul mentioned, ARA Venn is very strong in the RMBS market through their Dutch residential program, so we will naturally look at the commercial mortgage-backed securities market too and look at other government programs outside UK PRS.

Following this transaction and our current contracted dealflow, we will have some S$90 billion ($63 billion; €58 billion) of real estate AUM worldwide, with some half that figure in the public markets. We are reviewing a whole host of opportunities and we will take them one at a time, but we think public credit funds are quite an exciting space.

> *"The covid-19 crisis is such a major and unique event that it is difficult to predict timing"*
>
> **PAUL HOUSE**

Over the next couple of years, we can broaden out the offer in the platform, augmented by our capital partners and our public market experience. For example, ARA Dunedin, which was set up in July 2019 to invest in and manage real estate assets in the UK, will be able to co-operate with ARA Venn to the benefit of both organizations.

Given the size of ARA, scale is critical and, as we all have limited bandwidth, we have to focus our energies on scalable opportunities, whether they are platforms or products. We believe ARA Venn and the debt arena is absolutely something which is scalable. I think we have the right ingredients to really leverage a platform which has had a great start in life, towards bigger and broader initiatives.

Q What do you think will be the impact of the current global pandemic on the European debt market?

PH: Right now, the news flow and market hope is for a return to a functioning market by summer 2020 – the covid-19 crisis is such a major and unique event that it is difficult to predict timing as this is more in the hands of the medical profession and in the public policy arena. What is happening economically is that the functioning of the market is being severely disrupted and we are witnessing a sharp decline in economic activity levels.

Whilst we were late cycle before this event, this unprecedented interruption in economic activity will indeed have an impact, and in our view, it will be correlated to how long the market is disrupted. The longer the stagnation period, the deeper the economic impact is likely to be.

If we are able to commence trading again in the summer this sharp correction will reset economic points (for example, rental rates in the occupational market, or capitalization rates for the transactional market) however with the short closing we would not foresee a massive move on pre-closing levels as the market re-opens. The drag of three or four months of inactivity will have time impact, but occupational markets should resume where they left off and the markets that were already under pressure, retail for instance, will be more impacted than those that were trading well before the crisis.

However, if the market close period extends or the return is muted by way of continued policy moves to suppress the virus transmission (which has a drag effect on the economy), then the financial cost of this crisis will deepen, and there will be a reset in asset values and the risk premium required by capital. In this case, we could see some distress in the system.

It is in these times of heighted volatility, firms such as ARA Venn are well positioned to use our skill set to re-enter the market in a timely way and have the double benefit of prudent but high return investments for our investor clients and be part of a market that will be re-establishing itself. ■