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Commercial property debt to steer away from major banks in 2017

According to Stuart Chait, executive chairman of Land Equity Group, commercial real estate debt has been forecast to move away from major commercial banks, with 2017 expected to see a boom of new ‘alternative' senior debt, mezzanine and debt equity funds.

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Chait believes that the new offering in commercial property financing packages will result in a more diverse, aggressive and competitive commercial real estate lending sector. "The alternative offerings will span across sub-Saharan Africa rather than be solely focused on South Africa, due to the fact that it is in this region where the most growth is being seen," says Chait.

Stable income returns

Commercial real estate debt (CRE debt) has a long history as an investment category in international investment portfolios and Chait says the trend is already visible in developed international markets such as the United Kingdom, Western and Eastern Europe, Australia, Japan and the United States. “CRE debt offers stable income returns, with flexibility which means it can be perceived as a defensive and conservative investment. Investments can be tailored to match the risk-return profile of a specific investor,” Chait says.

“This trend will become even more evident during the year ahead. A variety of factors including rating agencies’, investment analysts’ and investors’ requirements have resulted in banks reducing the size and leverage of loans on offer, tightened underwriting standards, and increased loan pricing for certain segments of the market. South African banks are now highly regulated due to the practice of Basel 3 regulations and are busy increasing their capital ratios up to the required limits for implementation in 2019. As the result of an extended turnaround time required for compliance issues relating to loans, banks have become sluggish and clients are losing opportunities.”

Chait believes that the market demands another option, and for there to be much more competitiveness. "We anticipate that during 2017 many of the debt packages will come from investors seeking alternative investments, rather than the traditional banks."

Demand high for fixed-income investments

“South Africa has a strong institutional and pension fund industry with a huge demand for fixed-income investments. Good quality, investment-grade senior debt is therefore an attractive investment to the fixed-income market, and as the senior debt has the highest level of security, it provides a conservative interest coupon. Senior debt comprises up to 60% of the banks’ loan-to-value of an asset or an asset portfolio.”

Chait said that mezzanine debt was usually the next 20-30% slice, with pricing ranging from 15 to 25% per coupon, depending on risk. “The last slice of funding falls under equity or debt equity and is usually 10-20% of the total funding required. This has the lowest security but the highest return – a targeted internal rate of return from 40% upwards. In developing countries, as little as 5% equity is often required."

Since the credit crisis in 2007/8, there has been little debt available in the market and property owners have been forced to list their commercial portfolios. “Typically, a listed property real estate investment trust has anything from 30-50% debt, and the balance is held by shareholders who are mostly institutional. The length of debt is also generally short, and this is where the problem lies."

New banking regulations necessitate for more capital to be put up against its property loans than what was required before the credit crisis. “Banks have therefore become short-term holders of property debt, and usually sell or securitise the debt to the institutions who are looking for safe and secure coupons to pair with their policies or investments.”

Boom expected in creation of property debt funds, products

Chait feels that there will be a boom in the creation of property debt funds and products, as many institutional investors now have cross-border mandates and the ability to hedge their income for policyholders and members.

“Fund managers are also regulated, but because they do not have the compliance factors associated with holding banking licenses, our experience is that they are able to perform much faster than commercial banks."

The alternative commercial property finance industry is lucrative because the debt is well-secured, the returns are excellent and the turn-around time is fast, making it entrepreneurial in its appearance. The decision-making ability from engagement to execution can sometimes be done within a few days, whereas banks are hamstrung and can take months.

“Cash-strapped property investors or developers are often forced to seek funding from the alternative finance market. This particular hedge fund money is very expensive, at up to 30% interest per annum, and there is not enough competition in the market because international funds have still not been approached and this money has not been raised aggressively by local fund managers. After the credit crisis, we saw a wave of investment bankers leaving to start up hedge funds and private equity funds. I believe South Africa (and covering sub-Saharan Africa) will see a new and robust industry start to gather momentum, and what is most important for investors and managers is that these funds are cheaper and more efficient to run than commercial banks or listed property funds.”

Quality loans

Land Equity Group plans to invest in this space by backing the debt fund management teams to set up funds, and who will then go and raise money for capitalising the funds on an ongoing basis from the local and international markets. “We already have an indicative anchor investor on the senior debt fund for $50m, and another Middle Eastern investor for $100m, but the success of this venture will not only be the amount of money raised, but rather be based on the quality of the loans, and the experience and performance of the management team that runs it. There is extensive administration, legal work and risk assessment that comes with managing loan books such as these, and that is why the people and experience are our focus. We have already had approaches from both local and international CRE debt teams wanting to get onboard. We want to back the people, and to let them manage and build the business across the continent and in their own management styles."

"The real issue in sub-Saharan Africa is not that there's not enough opportunities, but rather that the 'ticket size' per investment isn't big enough. Real estate, being a big capital investment item, will now fall into the same category of longer-term investments such as resources and infrastructure, and this is what big investors look for in developing markets. Alternative real estate debt funds will help catapult this sector into a serious growth phase."

Chait and his Swiss and UK partners plan to set the first new team up in early 2017 to initially raise $1bn in senior, mezzanine and equity finance, and international advisors are currently being selected and appointed to run the initial capital raising process. The company is targeting sovereign wealth funds, life institutions, pension fund and empowerment fund money from Canada, the US, Germany, Singapore, the Middle East, China and Japan, as well as South Africa. “I feel that the timing is perfect. Sub-Saharan Africa, with its 1.1-billion population, is on the cusp of catching a 20- to 30-year wave of capital investment, similar to what we saw with the BRIC countries two decades ago."