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"WE'RE ABOUT TO STIR UP POSITIVE TENSION"

Outlet pioneer Scott Malkin on the future for Value Retail and the sector

REAL DEAL CHASERS
EXPO REAL crowds reflect big pack now vying for assets

US DEVELOPERS' FOREIGN POLICY
EB-5 vehicle carries overseas investment into US market

MARGINS SHOW CONTINENTAL DRIFT
Widening debt spreads are key REC Europe Forum topic

GREEN SHEEN ON THE BIG APPLE
How native New Yorker SL Green built its property empire

SOLD ON SYNDICATION
Macro economic jitters fail to dent loan buyers' appetite

GETTING AHEAD IN THE MED
Southern Europe roundtable panel eyes the opportunities

All photographs: Marcus Rose

KEVIN GRUNDY
Senior director, structured investments, Invesco Real Estate

JOSE BORREGON
Managing director, Spain and Portugal, CBRE Global Investors

GREGG GILBERT
Head of Iberia, Benson Elliott

GENNARO GIORDANO
Managing partner, GWM Capital Advisors

Roundtable

SUPPORTED BY:
Benson Elliott | CBRE Global Investors | GWM Capital Advisors | Invesco Real Estate

SOUTHERN EUROPE

Catching a rising tide in the Med

Our panel of investors in Southern European property still see Iberian opportunities and a chance to get in early on Italy's real estate recovery, but say bank debt for anything other than vanilla deals remains scarce. Paul Yandall reports

With Spain's GDP growth one of the strongest in Europe, forecast to be over 3% this year, and Italian 10-year government bonds back down to under 2%, Europe's largest southern markets are in recovery mode.

Spain attracted €10bn of investment in the first half of 2015, the highest for years and more than the €7.5bn for the whole of 2014. Debt is more widely available for core assets and margins have halved in the past two years. Italy, hampered by its sovereign debt crisis of 2012, is making its way back, albeit at a slower pace, with Milan leading the way.

Both countries are starting to attract investment from as far afield as Asia, with Chinese investors Fosun and Dalian Wanda making large acquisitions.

Demand for finance across the region is rising but lending is still tricky in smaller markets and for development, with local banks becoming more active in Spain than in Italy and alternative lenders still struggling to make an impact.

Our roundtable panel of property investors gave their views on how Southern European markets have evolved since the financial crisis and, with an election in Spain in December and lending rules recently relaxed in Italy, where they might be headed.

Specialising in Portugal and Spain was Jose Borregon, managing director overseeing those two regions for CBRE Global Investors and also active in Italy, and Gregg Gilbert, head of Iberia for opportunistic investor Benson Elliott.

Focusing on Italy was Gennaro Giordano, managing partner of GWM Capital Advisors, which advises institutional and family office capital. Having a foot in both regions was Kevin Grundy, senior director at Invesco's structured investments for Europe team, with a focus on value-added opportunities.

The roundtable gathered at CBRE Global Investors' offices at One New Change, St Paul's, in London.

JOSE BORREGON: Spain today is probably one of the most popular markets – potential money to be invested there is huge. In the first six months of the year it was €10bn. This is around equal to the investment done in 2007. The difficulty now is doing proper underwriting for the different asset classes.

The market has corrected very quickly, so we have had strong yield appreciation, linked to growth prospects that look very good. ▶



"ITALY IS STILL LACKING THE CLEAN-UP OF BANKS' BALANCE SHEETS THAT HAS HAPPENED IN SPAIN... IT'S FRUSTRATING INVESTORS SEEKING DEALS"
Gennaro Giordano, GWM

"THE REAL OPPORTUNITY IN ITALY IS CREATING CORE PRODUCT, AS CORE CAPITAL IS COMING IN... THAT'S EXACTLY WHAT WE'RE DOING"
Kevin Grundy, Invesco

"ON THE CONTINENT WE'RE SEEING THE START OF A LONG RECOVERY PHASE OF MAYBE FIVE YEARS OF LOW GROWTH, INFLATION AND INTEREST RATES"
Jose Borregon, CBRE GI

GREGG GILBERT: Spain is in a good position because growth is clear now you've had numerous successive quarters of positive GDP growth and the signs are pretty clear in the general economy. In the real estate markets, which tend to lag, you're starting to feel the impacts: office rents are beginning to rise, good shopping centres are experiencing significant sales increases, hotels are doing really well and financing is coming back. What's nice is, compared to London, we're just starting to move up the curve, so there's a lot more to come.

GENNARO GIORDANO: Italy reopened in 2013. In 2011 and 2012 we were in the middle of a sovereign debt crisis, so Italian bonds were trading at a 7% yield and nobody, not even us, was really buying direct real estate. There was almost no capital and no debt as Italian banks were, and still are, stuck with a large amount of non-performing loans. Italy is still lacking the clean-up of banks' balance sheets, which to some extent has happened already in Spain, but it's frustrating investors seeking deals in Italy.

KEVIN GRUNDY: I do think Italy is a year or two behind Spain in its activity, which is great if you're looking into Italy right now. Generally speaking we're on the uptick; it's a slow recovery and for the people on the ground that's a great environment to operate in.

JB: Portugal has been a closed market, and in terms of the perception of country risk, very little has been acceptable there because of the low level of liquidity in the market. Spain has been more effective from a country risk point of view but suffered more on the price side during the crisis.

Depending on markets and timing, first we had the opportunity investors, US hedge and private equity funds, looking for very high returns at big discounts on platforms or loan portfolios. Now, in Spain, there's more interest from core investors as the country risk is more stable and because of the growth prospects.

KG: On the core side, people are very selective about location and in both Spain and Italy that's a very narrow definition now. In Madrid, you can point to the street people want to be on. In Italy you point more to the city, or Milan and the various submarkets of Milan, that are the main engine.

GENNARO GIORDANO: Many international investors disappointed with Spain are moving to Italy, but are a bit disappointed there too, because there are not many deals yet and they are not easy to get your hands on without a local presence. GWM manages a main fund in excess of €1bn of equity with around a €500m allocation to European real estate, plus other joint-venture mandates with prominent investors, but the reality today is not lack of money, it's lack of deals.

There's not much coming out of NPLs, while a lot is expected from big Italian funds selling assets as they approach final maturity. The challenge today for an asset manager like us willing to stay in Italy is finding the right product at the right risk-adjusted return, avoiding the new overseas money crowd.

Core capital is coming, but it is still very selective and Italy does not yet have a market of core investors to provide a reliable exit for the private equity and opportunistic investors that have been investing in the country over the past two years. There's not a deep pool of money and there's still not a deep debt market.

KG: The real opportunity in Italy now is creating core product, because core capital is coming in. So, on the value-added and opportunistic side, that's exactly what we're doing. We're viewing core money as our exit ultimately and trying to be a step ahead of it. If you're a tenant in central Milan needing a floorplate of 1,000m² in a modern building, this is exceptionally difficult to find. The modern buildings a core client may want aren't currently there to buy.

By the end of this year we will have done three Milan office deals. The first was a 6,000m² property in the Porta Nuova district. We bought it empty to refurbish so it was not core to begin with, but tenant interest has been just exceptional. If we had it finished today it would be fully occupied and the building's value is probably up 20% since we bought it before we even started work, just because of investor appetite and the location.

The great thing about Milan – and this has been true for a long time – is that if you can unlock or create quality space at good value, then you will lease it; that's the whole trick. You shouldn't throw Milan in with every other Italian city, it behaves a lot more like a Northern European city.

"THE CHALLENGE WITH SPAIN... IS THAT WHEREAS THE FUNDAMENTALS ARE 'DOWN HERE', PEOPLE ARE BUYING 'UP HERE'"
Gregg Gilbert, Benson Elliott

MARKET EVOLUTION

KG: Milan has gone from traditional CBD to developments and business park deals in the northern ring to Porta Nuova and you've got the CityLife commercial and residential development, with big towers, going up. The Italian story is not identical to Spain, but core capital is expected to come to Italy and if you're higher up the risk curve there's an opportunity to be ahead of that and to potentially feed that market.

GREGG GILBERT: [Italy] sounds like Spain two years ago. In 2013 in Spain there was very, very little product available and five other opportunistic investors were bidding probably on every asset. Everyone had about the same price but the vendor expectation was significantly more and nothing traded.

In 2013, banks weren't doing anything, there was no ability to take a loss, there was very little movement in the market. Now, in the past month, I've probably had three deals in my email inbox a day. Huge portfolios from banks and the bad bank, everybody's got an off-market transaction that's not really off market – there's just a lot more product coming through.

JB: One common element between the Southern European markets is that they're peripheral and, especially in Spain and Portugal, the investment market is dominated by international players.

So, the 'sense of opportunity' needs to be there because, if not, investors are not going to operate. 'Sense of opportunity' means a differential opportunity in terms of return or asset quality. They are always looking at what they cannot get in their own markets.

GREGG GILBERT: I think investor interest in Spain is largely driven by a dramatic decline in rental values and pricing during the crisis. If you look at the Spanish rental values chart, the peak to trough is pretty dramatic and everybody is expecting a dramatic rebound.

When we're looking at Portugal, for instance, one thing that makes us less interested is that the peak to trough is

A VOTE TO DELAY DECISIONS IN SPAIN?

Spain's forthcoming general election, on December 20, and to a lesser extent Catalonia's recent election, in which pro-secessionist parties won a majority of seats, have made some investors nervous. Goldman Sachs and Cerberus are reported to have delayed investments because of the rise of anti-austerity parties such as Podemos, which has promised to stop evictions of people behind on their mortgages.

KEVIN GRUNDY: I don't know if people share a view on what happened in Catalonia and what will happen at Spain's general election at the end of the year, but this is something that is not unfamiliar to locals in the market. We just have to ride it out.

JOSE BORREGON: I think international markets have a very different interpretation to how locals interpret elections. They value risk in different ways, but there is a degree of uncertainty and that's delaying some international investment, which is waiting and seeing. Not so much what has happened in Catalonia, but maybe more about the result of the election for the central government at the end of the year.

The question is to what extent central government will be able to maintain control over nationalistic parties and what is the weight of influence of the new parties going to be? We have seen investors delay activity in Greece, we have seen that in Portugal, in Ireland and in Spain to a certain extent.

much flatter than Spain, so if you expect things to return to the peak – which would be quite bullish – you're talking about 15% rental growth in Portugal, but more like 50% in Spain. So you can see buyers who have competed and lost out to others expecting 50% growth.

KG: We'd probably unanimously say there will be rental growth in Spain, but when you talk about rental growth of the magnitude some people expect, whether it's 30% in five years or longer, where that plays out will have a big impact on returns.

In Madrid, vacancy rates are not really falling much despite rents rising, so that may be a sign that the best buildings are going to be the best buys. We've just got to be sure we're avoiding the crowd, whether that's international funds or SOCIMIs in Spain, who make it very hard to compete. As long as we have a different way to approach it, then we believe there's a lot of opportunity.

GREGG GILBERT: We think the office opportunity in Spain is very compelling. So do the new REITs (SOCIMIs) that don't pay taxes and have a lower cost of capital. We cannot compete with those guys buying existing office buildings.

We were fortunate to buy something earlier this year when we thought 'let's buy smaller for opportunities other people don't see'. But we've had a very difficult time getting more to build a portfolio, so I'm not sure we'll buy cash-flowing, existing assets. We'll be looking more at projects with significant leasing to be done or capex to be invested, such as development opportunities.

We committed to buy a new, vacant office building in 2011 [Cornerstone, in Poblenou, Barcelona] and acquired it in 2013. When we sold it this July, a significant amount of institutional capital was interested and we were very happy with the price achieved. It was four-fifths let and there was significant competitive interest from international buyers for core prime assets, because those assets in Spain don't trade very much, as they often get bought by local institutions that never trade or other long-term holders.

When we marketed Cornerstone, a new, quality building with large floorplates, we were almost alone in the Barcelona leasing market and had the biggest leasings in two successive quarters. We saw that and bought another piece of land in the Glòries district and we're developing another office building.

ASIAN WAVE HAS YET TO BREAK

JOSE BORREGON: Chinese investors have done big merger and acquisition deals in the past two years. China has invested more than €870m in Spanish hotels and chains, €420m of it funds from HNA to become NH Hotel Group's major shareholder, with around a 30% stake.

Likewise, Singapore wealth fund GIC acquired around a 30% stake, worth €200m, in real estate group GMP.

GENNARO GIORDANO: Fosun is probably the first Chinese investor to buy a big, institutional property in Italy: Piazza Cordusio, Unicredit's former HQ in central Milan, from Omicron fund, managed by Idea Fimit SGR. But I can't say if it's really a good sign of whether the Chinese are stepping up.

Occasionally we see them seeking businesses or seeking generally, but in terms of institutional buyers, I can't tell you if anything has changed or if that one was an exception.

GREGG GILBERT: A specific Chinese investor has bought a couple of notable opportunity projects, big refurbishments in Barcelona and Madrid. We've seen a good amount of similar cases where all of a sudden there's a Chinese or Asian buyer behind it. In Portugal I hear a lot in the residential space, but I think it's driven by visa laws more than an interest in investing.

Lisbon resi seems even hotter than Madrid and I get the sense that it's driven by Chinese investors. It's anecdotal, but a lot of Lisbon projects are at peak Madrid prices, which is not what you'd expect.

FINANCING AVAILABLE

GREGG GILBERT: Financing is available, but it will be from our peers: other value-added and opportunistic type investors, basically mezzanine funds. They're going to charge more than we want to pay so we're evaluating other structural alternatives. We would love it if a bank financed it at 200bps over, but that's not realistic. We're talking to banks and a range of different capital sources.

We have the ability to do it all-equity, which was our assumption, but I think the markets have recovered faster than we anticipated so we will find some other interesting opportunities to develop it. For development, it's pretty safe to say, unless it's residential, you're not going to have traditional bank financing in Spain yet.

JB: Financing core investments in Spain has moved very quickly; pricing has changed dramatically, as has the number of players. Before you had mainly debt funds operating, but now they are almost out, because banks are coming back.

When the financial system collapsed, debt funds or equity investors were the only ones providing funding. Funding for core investments had very low loan-to-value ratios and very high spreads: maybe 30% LTV and 400bps spreads. Now, we're at 150bps spreads with local banks, and a few international ones, lending. Development is more difficult. You have to go to mezzanine lenders or other types of funding sources.

Portugal is recovering some liquidity but there's still a 100bps differential and it's only for super core with very low LTV levels. So, funding is coming back, banks are starting to be more active, but on the development side they are very cautious about risk, LTV levels and security of the cashflow.

GENNARO GIORDANO: Italy's banking system has suffered over the past few years.

Gennaro Giordano
Giordano is managing partner at Global Wealth Management (GWM) Capital Advisors, which is based in Luxembourg and London. Founded in 2000, its real estate investments division has a mandate of about €1bn to target real estate across Europe, but mainly in Italy. It also manages separate individual accounts from international investors, which it co-invests with.

Jose Borregon
Borregon is MD of the Spain and Portugal markets for CBRE Global Investors. The firm is investing in southern Europe for at least five funds and five separate accounts and has targeted offices, logistics, retail and value-added opportunities there since 2000. A particular interest is Spain's retail market, as marked by its €153m purchase of El Boulevard Shopping Centre in Vitoria last year.

Kevin Grundy
Grundy is a senior director for structured investments for Europe at Invesco Real Estate. He specialises in value-added investments, joining Invesco after the manager took over Doughty Hanson's real estate business last year. In Europe, Invesco operates across the spectrum, from core to value-added and opportunistic deals, via four funds. It manages about €6.5bn in European assets.

Gregg Gilbert
Gilbert is head of Iberia, operating across all asset classes, in Portugal, Spain and Italy for London-based pan-European value-added and opportunistic investor Benson Elliott Capital Management. The firm closed its second fund in 2009 with €500m in commitments. It sold its Cornerstone office development in Barcelona to UBS in July for €80m.

The largest banks are helping their biggest clients, the big borrowers, so are putting in a lot of money, getting a project finished say. So in Italy it would be very hard for any bank committee to approve spec development.

Only recently has there been interest in lending from local banks; international banks like the French and Germans are starting again, but are very selective. Spreads are in the 200bps range, but lenders are still looking for core assets to finance, such as retail, because the fundamentals are good and the assets more institutional.

There's still very little finance that's not 100% conventional, or that requires banks to do a little extra work to understand the risk. Alternative lenders cannot really access the market. Mezzanine lenders can do a little, but lending in Italy is still a business for banks.

There's been a change of law that allows you to set up special-purpose vehicles for lending, but that still has the involvement of a bank and retention of a stake.

KG: These financing constraints are not automatically bad news for an investor. All of us around the table and a large number of other investors aren't really capital constrained for most deals we want to do. The real impact is that it excludes smaller investors that would otherwise be competitors, because they can't do all-equity deals.

GLOBAL RISKS, LOCAL IMPACTS

JB: In Continental Europe we're seeing the beginning of a long recovery phase of maybe five years of low growth, low inflation and low interest rates. It's happening at different speeds in different countries, with the main southern economies growing fastest.

The one big risk is what will be the global influence on the European economy of, say, oil prices, or interest rates in the US and the effect of being an increasingly global, interdependent economy? At what point are global elements going to affect Europe?

GREGG GILBERT: The challenge with Spain is that a lot of people priced growth in a long time ago in the capital markets. So, whereas the fundamentals are down 'here', people are buying 'up here'. The question is, how much more [growth] is there left to go?

All those positive things about Spanish real estate markets don't necessarily mean you buy everything in sight, because pricing has recovered long before the fundamentals. You need to be creative about the types of deals you do and the structures you adopt to capture future growth.

KG: One thing that would be good for the markets is if the wave of capital making short-term bets cools off a little bit. The Spanish national elections coming up may, even if they have no impact on real estate in the medium to long-term, be something that cools it down a little.

For all of us who have been in the market for a long time, it's challenging now to find the product and to compete with capital that is looking at it totally differently as a macro play – we're real estate people at the end of the day. ■