



Prudential Real Estate Investors

Recently, Geoffrey Dohrmann, publisher and editor-in-chief of *The Institutional Real Estate Letter – North America*, spoke with Andrew Macland and Andrew Radkiewicz of PREI. The following is an excerpt of that conversation.

Dohrmann: *PREI has not focused on debt in Europe before now. What was the strategic thinking of bringing in a specialist debt team?*

Macland: PREI has an established mezzanine investment capability in the United States that has deployed more than \$3 billion in the mezzanine sector. In 2008, the company began looking at the European debt market with an eye to expanding its mezzanine business abroad. They soon came to the realization that debt is a much more immature sector in Europe than in the U.S., and to access it correctly, a specialist debt team would be required. Coincidentally, on the strength of the market opportunity, we had both recently left N.M Rothschild & Sons to specifically launch a debt platform. Our platform turned out to be a very good fit with PREI, and we joined their London office in January.

Dohrmann: *What made you a good fit?*

Radkiewicz: We both came from investment banking and principal investing backgrounds and worked together as a team at Rothschild. We were responsible for all aspects of the real estate and finance activity, which included balance sheet deployment of the bank into mezzanine in Europe, as well as running a number of off-balance-sheet debt vehicles. Independent banks like Rothschild have a very different structure than the majority of lenders. In the U.K. and Europe, the mezzanine sector has been dominated

by major commercial banks. These banks tend to silo each division, so there is little interaction among the departments. At Rothschild, we had a cradle-to-grave structure, where the same people who originated a loan were also in charge of structuring and management. So, our background of investing as principals and of having a multi-disciplined approach in lending was fairly unique in the real estate investment world. This fit perfectly with what PREI was looking for to complement its real estate equity origination, underwriting and funds management platform in Europe. We're one of the few specialist-dedicated teams operating in Europe over the past few years. So it's combining the experience we've got with taking advantage of the opportunities available in the market. But it is centered on our core competency, which is real estate finance.



Andrew Radkiewicz, Managing Director, Prudential Real Estate Investors, has worked in real estate finance since 1990. He spent his last 12 years in banking at N M Rothschild & Sons, and as a managing director was responsible for the bank's on- and off balance sheet real estate funding activities. He was a member of the banking and investment banking boards and a member of the Credit Committee. Andrew was responsible for establishing Real Estate Capital, which went on to fund multiple loan portfolios as well as single transactions for clients such as British Land and Invista.



Andrew Macland, Managing Director, Prudential Real Estate Investors, qualified as a Chartered Surveyor and has more than 12 years of real estate experience. He has had a wide range of responsibilities, including distressed loans and recoveries, senior debt origination and syndication, as well as growing and managing successful mezzanine portfolios. As a director at Rothschild, Andrew was responsible for executing the on-balance sheet mezzanine strategy, resulting in significant growth in the bank's position and reputation in this sector.

Dohrmann: *Why is a cradle-to-grave approach important in managing the new mezzanine investment strategy?*

Radkiewicz: When we look around, we see opportunities being created because of regulatory change, as well as because of the dislocation in the credit market and the relative volatility in commercial real estate markets. Taking advantage of these opportunities requires an established real estate fund platform, such as PREI's, combined with the specialist knowledge and skills that we possess. We are not going to simply buy portfolios of distressed debt, we are going to focus on originating, structuring, and managing mezzanine loans that we have control over.

Dohrmann: *Is your strategy primarily aimed at taking advantage of one-of-a-kind, short-term opportunities*

that are being created through regulatory and other market changes?

Radkiewicz: Not at all. While we won't shy away from the one-of-a-kind opportunity, our goal is to have the right platform to take advantage of this area for the long-term. Because of what is going on in the marketplace, mezzanine and distressed debt are very much at the forefront of institutional investors' thinking. But this is a strategy that we believe will work well in this market, and will work just as well when the markets stabilise.

Macland: The core lending fundamentals have not changed — we are ensuring that we have the right platform, with the core skill sets in place to properly underwrite and document the deals available. And the opportunities we are currently seeing offer historically low leverage positions with equity-type returns.

Dohrmann: *Will the two of you also be involved in the U.S. debt market?*

Radkiewicz: No, there is an existing U.S. mezzanine fund and a mezzanine business. We are purely focusing on the European business. However, although we are a specialist team, we're fully integrated into the existing direct real estate business. So we can take advantage of the transactions personnel and, in particular, the asset managers on the ground in Europe.

Dohrmann: *Why the focus on Europe?*

Radkiewicz: It is a newer market for debt investment. It isn't mature, and thus offers much less competition between fund managers for the best investment opportunities. But also it's very much a market that offers the ability to take the primary approach, whereas most U.S. mezzanine funds and mortgage REITs are focused on buying assets in the secondary market. So it's that ability to be hands-on. And the level of return and the level of income fit well when compared to the type of returns offered elsewhere.

Dohrmann: *How is your team going to be integrated into the organization?*

Macland: We came as a team of four people, which included our colleagues Matthew Crowther and Brian Scally. We will be working as part of PREI's fund management group in the London office, and will also work closely with PREI's transaction teams in Munich and Paris to originate and underwrite investments, and with all of the European

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offices to properly monitor the loans, borrowers and underlying properties. So it's not a standalone silo. We're very much bringing complementary skill sets to what is not a straightforward sector. PREI is very much focused on having all the skill sets required to manage a long-term business in this area.

Dohrmann: *How does being part of PREI help your mezzanine business?*

Radkiewicz: PREI is providing the vital on-the-ground underwriting capability for when we're initially analyzing a deal. In addition, PREI's investment committee brings a wealth of experience to the process of underwriting potential deals. We also benefit from the consistency and quality of systems, operations and reporting drawn from the network of PREI funds.

Macland: We bring the debt skills and have been working with real estate finance for many years. That overlaps neatly with PREI's platform in Europe, where it has over \$7.7 billion of assets under management. So it's a good complementary fit as you go into what is a new market in Europe for fund managers.

Dohrmann: *What has created the opportunities you are looking at?*

Radkiewicz: There are two main drivers — regulatory changes and market dislocation. On the regulatory front, banks now need to put aside more capital against commercial real estate loans. Prior to January 2008, banks could put aside the same amount of capital irrespective of gearing levels. After January '08, the Basel II accord came into being, which effectively requires a risk quotient to be applied. This means that lower-risk, low-leverage lending will require less capital than before, but higher-risk or mezzanine lending would require much more capital.

More recently, the dislocation of banking markets has significantly widened those opportunities by limiting the availability of senior debt for new transactions to around 50 to 65 percent loan-to-value, where previously those limits were as high as the 85 to 90 percent range. These huge funding gaps need to be filled, which provides the opportunity to fill that gap predominantly with mezzanine finance.

Dohrmann: *Who will you be lending to?*

Radkiewicz: The main focus is on high-quality property companies and real estate investors who are acquiring property in the distressed market. These are the types of borrowers with whom we have had relationships for many years. We will look to structure mezzanine debt, secured ahead of their capital to assist them in acquiring those properties.

Dohrmann: *What other areas will you be focusing on?*

Radkiewicz: We also are going to focus attention on distressed but performing loans. We will source distressed debt through banks and work with them on individual facilities to inject new capital into the structure in order to alleviate the relevant stresses and be able to take a good income and capital return. We're not looking at buying existing CMBS or distressed loan books from banks. We see a much stron-

ger risk-reward from actually being in control of what assets go into our fund.

Macland: This area is interesting because we can look at restructuring individual performing deals where the current value is causing the stress, but the bank, borrower, and we can see future potential value recovery. This means the bank does not need to write off as much of the loan and all parties have a co-aligned interest going forward.

Radkiewicz: We will also look at distressed property funds. Some closed-end funds, for example, were originally lowly geared, but now, because of falling values, are breaching or will breach loan-to-value covenants. In those cases, we can inject new mezzanine at the property level, and work with the fund managers, as well as the banks, in order to alleviate the distress in those facilities.

Macland: It's fairly easy to buy loan books, whether they be part senior loans, part B-notes, or buying into CMBS structures. It's far more difficult to individually build up a portfolio of loans. It takes longer. It takes a lot more due diligence. And you have to have the capability to do it. But by doing that, you end up with a lot more control and a much better ability to cherry-pick the right deals, working with the best clients and achieving the best risk-adjusted returns in today's market.

Dohrmann: *How do you cherry-pick the best deals?*

Macland: We do not just cherry-pick the best deals, we cherry-pick the best borrowers. Our borrowers are predominantly medium-sized real estate companies run and managed by skilled property entrepreneurs and asset managers. They have the skill sets to source, identify and undertake the asset management of the property. These are the guys that are putting in the equity, which, more often than not, equals, or is more than the mezzanine that we are putting in. It all comes back down to the property fundamentals and the borrower's

track record. That's the key thing that we look for.

Radkiewicz: I think it shouldn't be forgotten that even when you're talking about senior debt, but in particular mezzanine, that you don't get away from the fact that all risk-return relates to the underlying real estate. So it's hugely important that when looking at mezzanine, you

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don't move away from the fundamentals: What are the assets? What's the income and the strength of that income? What's the asset management plan for that property in order to improve it? What's the track record and expertise of the sponsor and the borrower? The only way you can really govern and control that is by being involved in the structuring at the source, be that primary mezzanine into new acquisitions or restructuring distressed debt. We feel it's very important that in managing the risk of the investments that we don't step away from the core fundamentals of real estate.

Macland: There's been quite a lot of chat about people buying portfolios of debt at deep discounts. But to us it's not really about what you can buy the debt for; it's about what the underlying value of the real estate is today, and whether that real estate value supports the debt. If you're buying large portfolios, that's very difficult to ascertain. When you're

doing direct origination on a deal-by-deal basis, the market value is clear, so you have a real feel of where you are in the capital structure today.

Dohrmann: *As a new concept in Europe, how is a mezzanine lending strategy being received?*

Radkiewicz: Mezzanine is a relatively nascent concept in Europe as contrasted to the U.S. So, we have talked to quite a few investors in Europe and the U.S. in part to educate the market and in part to ensure that the strategy we're looking at is the correct one. Investor response is strong in terms of interest in mezzanine and a preference, from a risk-rewards basis, to be closer to the deal, closer to the control, and closer to the structuring, and not second-guessing legacy and historic pricing and risk, but being able to directly do diligence and structure the individual transactions today.

Dohrmann: *Is there any fear that the borrowers who use mezzanine will end up overleveraged the way they did in the past with too much debt and too little equity?*

Macland: The availability of debt over the past five years has had a big impact on the market and chased down yields. Structured financing vehicles and aggressive bank lending fuelled this. We don't see ever repeating the cycle in the course of our careers. Going forward, even utilizing mezzanine, a borrower will need to inject at least 20 to 30 percent cash equity into a transaction. This is as much of an equity requirement if not more than has been required for the last several years.

Radkiewicz: In the past, 85 to 90 percent of senior debt leverage was commonplace, with mezzanine being on top of that. Looking at the market now, senior debt is really only available at 50 to 65 percent leverage. And when you're looking at mezzanine, there's a completely different tranche. It goes from 50 or 65 percent maybe up to 75 or 80 percent. So it's a very, very different average weighted gearing position. And for the right deals, mezzanine, alongside an equity “buffer” or “first loss,” makes sense. In the next few

years, there'll be a net delevering of the market as a whole. We're focused on cherry-picking the best properties and the best managers to partner with, and taking advantage of this fundamental change and shift in the marketplace.

Dohrmann: *Where do you see the best opportunities for this cherry-picking?*

Macland: For the time being, we're seeing more opportunities in the U.K. because it has experienced the largest correction. Investors that sold out of the market over the last five years are now re-entering and our focus is on these cash rich investors.

Radkiewicz: Our borrowers are finding prime properties at attractive cap rates. Any fund or company selling real estate into this market has some level of distress; it's the good and prime assets that are appearing on the market and actually selling. So it's a great opportunity for our borrowers, and for us, to get involved in good quality properties at historically attractive yields.

Macland: We're seeing some prime assets, particularly in the West End, where yields have been pushed out so far, that on a capital value-per-square-foot basis, you're getting to levels that we haven't seen for a long, long time.

Radkiewicz: Continental opportunities — particularly in Germany, France and the Nordics — focus on the restructuring of distressed debt, particularly with fund managers that historically have had conservative gearing levels and now find themselves breaching loan-to-value covenants with the banks. We will help those funds and fund managers de-gear the senior debt by replacing some of it with mezzanine without having to wholesale restructure funds or sell assets.

Dohrmann: *What makes mezzanine attractive to investors?*

Macland: Mezzanine ranks ahead of equity and provides positive returns from day one. There are no upfront costs such as stamp duty or other transactions costs as for

a direct equity investment. At the moment, we're seeing double-digit

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coupon returns in the market. You also have, in all cases, arrangement fees and minimum exit fees, often linked to minimum IRR returns. We are also able to negotiate profit shares, on the lower-levels of mezzanine, in the 55 to 75 percent range so you're also getting a percentage of the upside. It makes it a very attractive hedge against future volatility in the real estate market because you have a buffer above you, but you also do benefit from future capital upside.

Radkiewicz: And that is key. Mezzanine is a complementary form of

investment to equity real estate. It has a different risk-reward profile. It's very much an income-driven initial return, with fees and coupon paid in priority to any returns to equity. There is also the potential for upside through the profit participation in the underlying real estate. But that is provided with downside protection of the borrower equity ahead of you, as well as the priority income return. So the profile is an income-driven return, with potential for participating in capital upside, overlaid with downside protection.

Macland: Mezzanine is receiving a good amount of interest because it is income-driven, and given where we are in the market, our investments will be targeting gross returns in excess of 15 percent.* A substantial proportion of that, well over half, will be in the form of current paid income. So it's a good income play for a lot of investors, who will not have to wait years for IRR accrual because the substantial portion of returns are current and in cash. This is a very good opportunity for investors to get the income return they need, while complementing their equity investments and mitigating the volatility in the market. ❖

*Targeted returns are not guaranteed

CORPORATE OVERVIEW

Prudential Real Estate Investors is a leader in the global real estate investment management business. PREI has been managing real estate investments for institutional clients since 1970, when it introduced the industry's first commingled, open-end equity real estate fund to U.S. pension plans. Today, PREI offers its clients a broad range of real estate investment strategies in the United States, Europe, Asia and Latin America. As of Dec. 31, 2008, PREI globally managed more than \$44.0 billion in gross assets (\$28.6 billion net) on behalf of over 400 clients and is ranked among the largest real estate investment managers.

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