What is the future of the CRE market?

Despite the fluctuations in the capital markets this year, European warehouse funding for granular, small and medium balance commercial real estate mortgage loans remains stable, explains ***Sabah Nawaz, partner, Cadwalader, Wickersham & Taft LLP.***

This is particularly the case in the "loan on loan" warehouse space. "Loan on loan" funding typically involves an institutional lender advancing loans to a SPV established by a sponsor being, in this scenario, an alternative provider of commercial real estate debt. The SPV on-lends the loan proceeds to a range of commercial borrowers, and such borrowers grant security over diverse commercial real estate assets.

The structures of such warehouses can vary. For example, a warehouse may or may not include mark to market or margin call features and various forms and degrees of recourse to the sponsor. These features originated in the U.S. market and, to some extent, these may be included in European structures.

Currently, warehouses are funding assets such as office, multifamily and light industrial, located in the UK and the rest of Europe.

Certain warehouses are matched to the maturity of the underlying assets. Where a warehouse is not match term funded to the underlying assets, there is a need for either a refinancing of the warehouse, either via another private financing route or a publicly offered take-out. Last year, we saw the first CRE CLO in Europe in over 15 years (following the established success of the product in the U.S). This European CRE CLO refinanced warehouse funding of medium balance commercial real estate loans.

At its core, a CRE CLO is similar to a CMBS as it is dependent on the performance of commercial real estate mortgage loans.

One of the advantages of a CRE CLO is that it is a funding tool for sponsors holding medium ticket loans that are secured against "transitional" commercial real estate. "Transitional" in this context means the commercial real estate asset is located in a strong sub-market or is of a stable property type class but could benefit from some asset management or capital expenditure initiatives to realise its full potential.

Another key advantage of a CRE CLO is that the sponsor retains a significant degree of control (subject to conditionality, agreed at the outset of the CRE CLO, to give protection to noteholders) over requests from underlying borrowers for loan modification requests. This is suited to transitional assets, since by their changing nature, the associated financing may need to be modified. In addition, the noteholders in a CRE CLO typically benefit from the sponsor holding a significant percentage of the junior notes.

A CRE CLO can be structured according to the requirements of a sponsor. A CRE CLO may be structured as a static transaction or, to give flexibility, the transaction may incorporate replenishment features. Replenishment allows the CRE CLO (subject to the satisfaction of conditions) to reinvest principal proceeds. Providing further flexibility, CRE CLOs may permit the disposition of defaulted or credit risk assets, again, subject to certain parameters.

In addition to the recent European CRE CLO discussed above, setting aside current pricing considerations, from a medium- to long-term capital markets perspective, there is a gradual trend towards public issuance backed by portfolios of small balance and granular commercial real estate loans.

There are other recent European public issuances which are not marketed or structured as CRE CLOs but have been backed by pools of granular and smaller commercial real estate loans. Subject to the usual pricing considerations, this landscape presents an opportunity for investors in respect of the diversity of underlying assets. It is also an opportunity for sponsors, which are active recipients of private lending, to become debut capital markets issuers.

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