EXPERT Q&A

Despite broader headwinds for the sector, secured lending into niche areas of the European residential real estate market offers compelling risk-adjusted returns, says Adrian Cloake, chief investment officer at LCM Partners

Mining niche seams brings rich returns

Q What areas of the European speciality finance market does LCM focus on?

We launched our asset-backed specialty finance strategy ("SOLO") in 2018, which focuses on smaller ticket loans and leases secured against equipment and real estate. We have an exclusive partnership model where SOLO provides financing to SME borrowers via established originators or OEMs at their point of sale, helping them sell more of their goods. A developing theme has been a focus on investments with real environmental or social benefits; for instance, we've been funding more granular renewable assets and service equipment rather than the larger ticket infrastructure itself.

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Q Real estate is a crowded space. How does LCM fit?

First and foremost, we are credit investors. Our work is about finding the right originators and partnering with them in the right way. There have to be shared values; alignment in terms of approach to risk and governance, plus a desire to build a long-term working relationship.

Our real estate focus so far has been on supporting new residential builds and conversions, plus originating social housing leases. But our credit-led investment approach differs from a typical real estate fund. We're looking to lend into areas where our partners have identified products that offer granularity, high quality underlying credits and a clear demand for financing that isn't satisfied by traditional banking sources.

In Ireland we have a groundbreaking partnership with a business called

"Home for Life" that converts distressed mortgages into social housing leases, allowing families to stay in their homes. As well as the obvious social purpose, the end credit is effectively government backed.

For us, development financing means funding SME developers building affordable housing to help solve the shortages common across our European markets. The risk may be spread across a large number of fairly small lends but that doesn't mean we are any less cautious or thorough when it comes to our diligence and underwriting.

Q So, what do you look for in your origination partners?

We've operated at the granular end of the European consumer and SME lending market for over two decades. It's a point of differentiation that we're willing and able to embrace the challenges that come with the managing of hundreds of thousands of underlying borrower relationships and the huge quantities of data that come with it.

Within the SOLO strategy we identify origination partners that operate in niches that are scalable, deep and play to our operating and investing strengths. Our partners need to have multi-year track records that can survive diligence; we're not only evaluating them as a potential partner but also thinking about the lending parameters and controls that we'll need to protect our downside. We also want them incentivised to make it work. We have a preference for businesses where the founders remain active managers and are prepared to accept a meaningful level of risk-sharing through first loss or deferral of fees.

We're celebrating our 25th anniversary, and it is fair to say we have kissed a lot of frogs. We know what asset types we like, and what we don't like. What an ideal partner should look like, and what to avoid. While constantly evaluating new investment ideas, we are also looking to replicate our existing partnerships in new markets across the 10 European countries where we have a local presence. With real estate development, we began in the Netherlands, then added the UK and Sweden, and will soon board two more partners in Spain and Ireland.

Q Why development finance in particular?

In short, we like the market dynamics. We are operating in countries or regions where there is a housing shortage and a desire by politicians to improve the housing stock. If we take the UK for example, the government has a target to build 300,000 homes annually but we've never got anywhere close to that level and the shortfall is currently about 100,000 units every year.

The BRE Trust, a charity dedicated to improving the built environment, has concluded that the UK has some of oldest housing stock in the developed world, which is having massive societal costs in terms of ill-health, lost education and lost employment opportunities, as well as wasted energy consumption. So any improvement to that stock delivers a clearly positive ESG impact.

The small ticket nature of the SME market means there's usually a lack of alternative financing from banks or real estate funds, and we can achieve good double digit returns while spreading our risk over a large number of locations. We take comfort from the fact these are relatively liquid assets and have been able to build a fairly large, diversified real estate credit portfolio without compromising our approach to risk.

Q What does LCM bring to the table?

We're experienced, flexible and can provide certainty of funding over a multi-year period. Our team has worked together for a long time, acquiring and originating asset finance and mortgage loans. Our sister company, Link Financial, offers SOLO's origination partners its market-leading technology and servicing capabilities across its European platform. We can provide a cradle-to-grave operating solution for managing loans as well as our capital and underwriting expertise. Our strategic partner and shareholder, Brookfield Asset Management, is one of the world's largest real estate investors.

Q It's been a tough period for real estate. Where do you see the risks?

Parts of the commercial real estate market have had a hard time of late and the residential sector isn't immune either. House prices are falling, input costs are rising, supply chains have been stretched and rising mortgage rates are impacting the ability to refinance. We're well aware of these stresses in our credit analysis but also know that there's now a decent opportunity to provide funding for high-quality developments and at improved yields.

We partner with experienced originators with track records of loss rates that can be as low as 10 basis points. They carry out regular physical monitoring of progress and step in to resolve any issues. We've generated well-diversified portfolios with relative short duration and high turnover in terms of numbers of projects being funded or exited in any given month. That helps to protect against both one-off events, such as sudden moves in the mortgage market, and longer-term trends such as declining real estate values.

Q So, what's next?

We'll continue to expand SOLO's real estate lending alongside what we're doing in small equipment leasing and renewables asset finance. It's going to be a core part of the SOLO strategy over the next few years. We're already looking at adding one further residential property partner and a social housing originator during the next quarter. Beyond that, at the rate things are progressing, it could well be that we end up offering dedicated real estate credit and asset finance as large-scale European credit strategies in their own right. ■