

STRUCTURED FINANCE INSIGHT: Starz to guide Europe's property-backed CLO market into growth in 2022.

Europe's market for commercial real estate CLOs (CRE CLOs) is poised for growth in 2022 as the fledgling sector builds on the foundations of last year's first post-GFC deal.

At least one new deal is expected to emerge by the end of the first half, and last year's debut issuer Starz Real Estate is lining up its second deal, slated to launch in second half of 2022.

"We're seeing interest in the asset class from both investors and issuers, and would expect to see at least a couple of deals this year," said Gordon Kerr, head of European research at ratings firm KBRA.

"The development of this market will take some time. There's a certain amount of education involved," he noted.

CRE CLOs are already an established asset class in the US, typically based on a portfolio of floating-rate loans to transitional CRE assets, such as properties being developed for a different use. Last year, deals worth €45bn priced, according to Moody's Analytics.

These US deals often carry features that mimic corporate CLOs rather than traditional CMBS; for instance, by having many more loans in the portfolio, and allowing the manager to trade loans in and out of the asset pool.

Further, CRE CLOs have to pass certain tests designed to give investors extra protection, such as interest coverage tests and overcollateralisation tests. Also, the manager typically holds a large chunk of the deal to keep manager and investor interests aligned.

But despite carrying the CLO label and some of that market's technology, CRE CLOs are typically sold to CMBS investment or real-estate teams in the US, rather than

corporate CLO investors. In line with this, Starz Real Estate's deal was primarily placed with traditional CMBS investors in Europe, according to market sources.

Static to managed

Starz Real Estate's debut transaction **Starz Mortgage Securities 2021**, which priced in October last year, references a static pool of European and UK assets, meaning that the deal does not have reinvestment flexibility.

In Europe's nascent market, static deals are expected to form the bulk of issuance, before deal-flow transitions towards the managed deals that now dominate US supply.

Europe's predicted course would follow that of the US market, which gradually developed post-GFC with a very slow start before accelerating in the last couple of years.

"In the US, the CRE CLO asset class began with static and lightly-managed deals," said Yee Cent Wong, senior managing director at KBRA. "It took a couple of years before evolving into the primarily managed market that we see today."

Property search

One of the challenges for proponents of European CRE CLOs is finding enough properties to support the potential growth, as well as finding the right audience to invest.

"Growth may be tempered by the depth of the investor base for these types of products - primarily the European CMBS investor base - as well as the stock of suitable underlying loans," said Georghios Anker Parson, partner at Brookland. "There are not many non-bank lenders in Europe with sizeable loan pools suitable for securitising at present."

In the interim, hybrid structures may start to appear that blend traditional CMBS with some aspects of CRE CLOs.

Mr. Anker Parson points to Irish lender Finance Ireland, which has completed two European transactions under the **Pembroke Property Finance** brand. These deals are supported by a granular portfolio of mortgages secured against small-value

commercial real estate, and share many - but not all - attributes of the CRE CLO asset class.

Starz CEO David Arzi says his firm intends to be a repeat issuer in the European CRE CLO market, with a focus on smaller-sized loans.

“The middle market is fairly under-served,” he said. “We feel it offers the best risk/return. We like that risk dynamic.”

Property search

Another hurdle facing those with ambitions around this market is the plethora of rules and regulations governing commercial real estate and its tenants across different European jurisdictions.

KBRA highlights difficult and lengthy planning regulations and requirements, depending on the country and locality, as well as the need to understand and navigate the various country and EU laws in place with regards to each individual property and loan.

But Reed Smith partner Iain Balkwill, who worked on the Starz transaction, is positive about the potential for the asset class in Europe and highlights the rapid growth in US CRE CLOs since 2012 as an indicator of European promise.

“Anybody active in financing commercial real estate in Europe is a candidate [to bring out the next CRE CLO] ... I’d be surprised if they are not looking at it,” he said.

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