Cheyne’s key links in property debt: Ravi Stickney (left), Graham Emmett (centre) and Arron Taggart
Debt funds step up in Cheyne reaction

The hedge fund’s property investment team responded to post-crash real estate debt market changes by ramping up loan origination via an expanded funds series, in addition to its original bond-buying strategy, Jane Roberts discovers.

Hedge fund manager Cheyne Capital Management’s very modern business is based in a reassuringly tasteful conversion of a historic mansion overlooking London’s Green Park. Established in 2000 by ex-Morgan Stanley colleagues Jonathan Lourie and Stuart Fiertz, the evolution of its real estate investment business mirrors the fast-paced changes that have overtaken Europe’s property debt markets in recent years.

The firm, which since 2008 has increased its property debt funds from one to six (see table, p21), accounting for $2.5bn of Cheyne’s total $6bn under management, was originally known in real estate circles as a buyer of debt securities: CMBS and RMBS. However, lately Cheyne has steadily increased its investment in high-yield loan origination, taking advantage of dislocation in the lending market and growing demand for property finance as investment markets improve, especially from mid-market sized borrowers. These days, the breakdown of its portfolio of investments is more like 50:50 bonds to loans.

Having a now 11-strong team with the expertise to invest via a range of debt instruments and flexibly across the capital stack has been key to wringing consistently good risk-adjusted returns from real estate debt as markets have changed, say head of real estate debt Ravi Stickney and investment partner Graham Emmett.

“Because we’re a combined loans and bonds platform, when we draw down capital, we can buy bonds, which yield more than cash, typically 4-5%, and that stops cash drag [on fund performance],” says Emmett, who joined Cheyne in mid 2013 to head new origination. “We can rotate out of bonds when we see the loan opportunities coming and they usually return 10%-plus.”

“We still carry a big bond book of high-grade CMBS,” adds Stickney, Cheyne’s real estate bond-buying tactician, recruited from ING in 2009 to work with Shamez Alibhai, then Cheyne’s head of real estate and still a senior member of Cheyne’s partnership.

“CMBS 2.0 [new issuance] is a pure relative-value proposition that won’t generate the same returns as secondary CMBS, but it’s liquid and liquidity has its costs, and it’s still compelling. Although returns of 12% have fallen to 6%, compared to other high-grade bonds, that is still good and a lot of investors like that ‘high’ yield.”

Photography: Marcus Rose
Cheyne has a small UCITS fund that only invests and trades low-risk, liquid bonds. But the opportunity lay elsewhere when Stickney joined back in 2009 to implement a new strategy for Cheyne’s UK listed vehicle, now called Real Estate Credit Investments (RECI), and to be fund manager for the private launch of the Cheyne Real Estate Debt Fund (REDF).

“In 2009, after Lehman Brothers’ collapse, real estate debt was like a landscape of tumbleweed: the markets were closed,” Stickney says. Cheyne bought investment-grade CMBS secured on good real estate at deep discounts to par along with many controlling bond positions, “understanding that you can rehabilitate the values if you can buy certain positions to establish control and effect your own strategy”.

Most investments Stickney picked came good, in deals such as Four Seasons, secured against nursing homes; and securitised loans backed by London offices, such as the White Tower portfolio, Woolgate Exchange, Canonbridge House and Devonshire Square.

Others deals, such as its investment in CityPoint, are on the way. Brookfield recently bought the junior loan, ranking behind the Ulysses CMBS, from Mount Kellet in a ‘loan-to-own’ strategy for the City tower, and Cheyne’s class E notes now look almost certain to be repaid at par.

But Stickney admits that one “went bad and we got bruised – a CMBS deal on a loan in Birmingham, which just shows you should be very wary of non-core locations”.

RECI GETS RESCUED

RECI has had a rollercoaster history. Listed in 2005 as Queens Walk at €10 a share, it bought US and European unrated and sub-prime debt, and like many pre-crisis credit funds, was heavily-gearred. In 2008 it crashed and almost burned, with the shares collapsing to €0.40.

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In 2009, Cheyne sold assets at deep discounts to net asset value and in 2010 raised capital through a dilutive, €2-per-share issue and a preference share issue with an 8% coupon, which remains a legacy of those times, maturing in 2017.

This allowed the fund to start buying again, and the remaining legacy investments were transferred to a separate cell. The last ones were sold in November and the proceeds returned to its shareholders.

“RECI has almost an entirely different shareholder register now,” says Emmett. “The leverage is very low and we had a successful capital raising in 2013, so it has reinvented itself.”

The fund’s December 2014 factsheet shows total loan commitments of £105.3m and an investment portfolio worth £158m. Trading at a small premium to the estimated December NAV of 157.5p puts its market cap at £114.7m and suggests RECI could continue to grow by raising further capital for investment to supplement cash from repaid loans.

As well as the team’s experience and RECI’s rehabilitation, Stickney attributes Cheyne’s capital raising success to the team’s good track record and REDF’s performance. REDF raised an initial $35m in 2009 and eventually closed at $900m, with 15-20 mainly institutional investors from Europe and the US. It was fully invested by 2011 and has since been recycling capital, averaging a 12.3% net return since launch.

“We’ve showed that we’ve raised and closed and invested and got our money back,” he says.

In 2011, many of the investors re-upped in the first Cheyne Real Estate Credit Holdings fund (CRECH). With $625m of assets under management, CRECH 1 is also closed to new investors and fully invested.

CRECH 2 followed, launched for a single, institutional investor, and last year Cheyne raised an initial $250m for CRECH 3, and will continue raising capital until the fund reaches a similar size to the first fund. The business’s 35 or so investor clients now also include Asian investors, sovereign wealth funds and family offices.

Stickney highlights origination capability as the third skill investors look for. “We’ll have originated £500m of new investment in 2014 and invested all of the money people have given us,” he says. “We don’t over-raise; we’ve always raised incrementally.”

Adds Emmett: “Having that mentality means you don’t feel pressured to invest and can wait for the right deals.”

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The team decided to move more heavily into mezzanine lending in 2011, originally targeting mezzanine deals, though the funds’ investment criteria allow for generic debt.

RECI made its first, very profitable, loan in December 2012, on the Great Northern Hotel at Kings Cross, alongside Santander, and now has more loans than bonds for the first time: £74.8m compared with £61.2m, as of 31 December.

“The decision was made, rightly, to focus on sub-£100m, mid-market deals where mid-market banks, building societies and others had withdrawn, leaving clients high and dry,” Emmett says. Arron Taggart joined in 2012 from Clydesdale Bank and works with Emmett on origination and structuring.

**POOLING INVESTORS’ CAPITAL**

Cheyne doesn’t operate separate senior, mezzanine or preferred equity-style funds, enabling investors’ capital to be pooled on deals where the risk-return profile suits them all, without potential conflicts of interest should they sour.

With preference and ordinary dividends to pay, RECI limits its preferred equity deals and has no special situations ‘bucket’. But by investing alongside the private funds, usually taking 15-20%, public market investors in RECI get a diversified slice of a bigger fund.

“Our investment thesis is we sit in the mezzanine and either look down and do some senior loans or look up and do equity,” Emmett says. “We’ve done seven or eight deals where we’ve underwritten the whole loan and then sold the senior down.”

For whole loans they seek a 6-7% blended margin, so that if the senior isn’t sold, it doesn’t kill the fund returns. Average net returns are in the low to mid teens and the average loan-to-value ratio is 67%.

“The way the debt market is evolving, we are likely to do more whole loans,” Taggart says. “Senior and mezzanine lenders are getting more used to each other and we have agreed intercreditor agreements with many senior lenders.” One was backing Mercer Real Estate Partners’ £64m acquisition of City building Mitre House, from special servicer Capita. Cheyne sold on a £40m senior loan to Deutsche Bank.

The majority of deals have an intercreditor agreement, including step-in rights, but Cheyne may negotiate control in other ways if it takes a preferred equity interest. “It goes back to how senior lenders are starting to see us; in this case as an exit route from a deal should it go wrong,” Taggart says.

All Cheyne’s loans are in some way value-added deals based on “a value-driving event, such as repositioning an asset, a rent review or a planning play”, Emmett says. “We’re a flexible solutions provider but not the asset manager.”

For example, Cheyne backed retail specialist Vixcroft, set up by former managers at Arrowcroft, in its acquisition of the Octagon shopping centre in Burton-on-Trent last year; Cheyne will deleverage its position as value-added initiatives are completed.

In a special situations deal, Procession House, which was sold for a healthy gain last year, Greycoat invested alongside Cheyne and was development manager. Cheyne bought the debt secured on the EC4 asset at a deep discount to par.

The majority of its loans are in the UK, but last year the team wrote two German loans and a facility for Dutch warehousing.

**HALF A DOZEN DEALS CLOSED**

In its March–September 2014 first half, RECI did six new deals and restructured two loans (on a UK retail park and German multi-family housing), passing up two more that were more equity driven and were closed by Cheyne’s private investors.

Emmett and Taggart say Q4 2014 was particularly busy. Competition increased, but so did deal flow. “An unbelievable number of deals came across our desks,” Taggart says. But with the UK now in a general election year, the flow might moderate.

In the medium term, they see loan origination as a continuing opportunity for Cheyne and its clients, because banks are still constrained by stringent lending criteria and relatively lower-LTV-ratio senior loans; meanwhile, they think their direct competitors may shake-down to six to eight players.

“There is no way the regulators will allow what happened before to commercial banks to happen again,” says Taggart. Emmett adds: “It’s not a hit-and-run for Cheyne. This opportunity is going to be around for the medium term.”

**CHEYNE’S SIX DEBT FUNDS**

<table>
<thead>
<tr>
<th>Name</th>
<th>Vintage</th>
<th>Structure</th>
<th>Market cap/ capital drawn</th>
<th>Investment strategy/returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate Credit Investments</td>
<td>2005*</td>
<td>Listed investment company</td>
<td>£115m</td>
<td>Originates high-yield loans and buys CMBS. Targets 7% distribution yield</td>
</tr>
<tr>
<td>Cheyne Real Estate Debt Fund</td>
<td>2009</td>
<td>Private fund, closed to new investment</td>
<td>£900m</td>
<td>European senior CMBS and RMBS: 12.8% annualised return since inception</td>
</tr>
<tr>
<td>Cheyne Real Estate Credit Holdings 1</td>
<td>2011</td>
<td>Private fund, closed to new investment</td>
<td>£625m</td>
<td>CMBS, high-yield loans, equity &amp; special situations. Returned 12.7% net in 2013 and c11% in 2014**</td>
</tr>
<tr>
<td>Cheyne European Real Estate Bond Fund</td>
<td>2012</td>
<td>UCITS IV</td>
<td>c£100m</td>
<td>Senior investment-grade CMBS/RMBS</td>
</tr>
<tr>
<td>Cheyne Real Estate Credit Holdings 2</td>
<td>N/A</td>
<td>Single institutional investor</td>
<td>c£200m</td>
<td>N/A</td>
</tr>
<tr>
<td>Cheyne Real Estate Credit Holdings 3</td>
<td>2014</td>
<td>Private fund, capital raising</td>
<td>£250m</td>
<td>CMBS, high-yield loans, equity and special situations</td>
</tr>
</tbody>
</table>

Source: Real Estate Capital/Cheyne  * Restructured in 2010  ** Provisional