

# Duet Group

## Profile

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M&G Real Estate Finance's new property debt fund has strong backing from its parent company

The private equity arm of hedge fund Duet Group found rare success in reaching a first closing for its debut real estate debt fund, which will target Germany and the UK, writes *Jane Roberts*

# Duet proves to be in tune with tough real estate debt market

Last year was an extraordinarily tough time for fund managers trying to raise capital to buy property – and for funds investing in property debt it was tougher still, as Duet Group's Dale Lattanzio readily admits.

While Lattanzio was wearing out the shoe leather month after month, a line of rivals and their strategies went down, one by one. Not only were many pension funds and other institutional investors still nursing losses and undecided about fresh allocations, they didn't believe in the property debt story.

In particular, they didn't have faith in the returns some investment managers were promising, or that there were sufficient distressed deals from banks, or demand for costly subordinated debt from borrowers, to generate them.

"Real estate investors spent most of 2009 trying to understand what their positions were and future allocations were dependent on the answer to that question," Duet Private Equity's managing director explains.

"Only now are they starting to think about future allocations. The other issue was understanding a debt strategy and how it played a role in a portfolio. Again, only now are they starting to consider new strategies."

In this context, last month's successful first closing of the Duet European Real Estate Debt Fund by the hedge fund's private equity arm was remarkable. Lattanzio and his team raised just over €100m for a closed-ended, five-year fund focusing on Germany and the UK, which will underwrite subordinated loans for new deals and loan refinancings,



Photo: Marcus Rose

Duet's (l-r) Lattanzio, Korat and Clayton hope to raise the debt fund's total equity to €300m

as well as buying existing loans.

Natalie Howard, who knows the Duet team and was a European managing director for Lehman Brothers' Real Estate Mezzanine Partners, says: "When you consider that most people have raised no money at all, they have done terrifically well to have a first closing of €100m plus – it's a real feather in their cap."

#### Tough fund-raising market

One source adds: "Considering that M&G, which has a good front person and relationships with investors across Europe and the US, raised €40m [plus €100m from Prudential Assurance, a subsidiary of M&G's parent, Prudential Group], it says a huge amount about the fund-raising market."

Central to getting Duet's vehicle off the

ground was Forum Partners' decision to seed the Duet fund with £40m from its third European real estate fund. The rest of the capital came from four European third-party investors and funds managed by Duet Group.

Forum specialises in convertible bond and debt investing. Russell Platt, managing director, Europe, says: "We knew Duet as we invested with them in India [see box] and have a long-standing regard for Dale.

"We thought there was an obvious gap in the bank and debt capital markets, because the sums needed to refinance the industry are enormous. We thought it would be interesting to put together a joint effort to tackle this, which would need some scale. So we pooled some capital, and importantly, got some third-party investors."

Duet will continue fund raising this year, targeting the Middle East, Asia and the US, and Lattanzio hopes to pull in another €200m-€300m by the final closing. Senior investment managers Rob Clayton and Cyrus Korat are working on the first deals, kicking off what they expect to be a 30-month investment period.

Clayton joined Duet from Topland, where he was director of structured finance. Before that he worked at CIT, which is back in the market buying distressed assets, such as Hull's Princes Quay and Kings Reach Tower in London, former HQ of IPC publishing.

"We are looking at a couple of new situations where some senior debt is available, but not as much debt as the sponsors need," says Clayton. In one, smaller, deal, the Duet fund could provide about £5m of subordinated debt to take loan-to-value ratios from just 50% to 75%.

The second deal is much larger, at around £400m, and would involve the Duet fund providing £20m of mezzanine debt to top up the debt from 65% to 70%.

"We are starting to see good deals," says Clayton. "The way banks are regulated [in terms of their more conservative capital requirements] means this gap isn't going to disappear for a while. We are speaking to potential borrowers, funders and people who want to sell. We are providing something we believe can help raise transaction volumes."

Lattanzio adds: "Last year the European investment market was dominated by foreign buyers using mostly equity for a different kind of return profile. Now buyers who like a bit more leverage for a more opportunistic return are coming in, so we expect activity to pick up. Last year, if you wanted senior debt, you could only get it for prime assets. That is changing slowly."

Lattanzio says the fund's target is an unleveraged, blended net return "in the mid teens", which will rely on repriced subordinated debt continuing to be expensive.

The cost to sponsors varies hugely from deal to deal. "It's a big range because it's so asset specific," Lattanzio says, but it is typically at least three to four times the cost of senior debt, at around 600-1,000 basis points over Libor. Some deals also offer the potential for a preferred equity return linked to profits when the investor exits.

Duet would also like to underwrite subordinated debt in refinanced capital structures, as banks tackle the billions of pounds of loans due to mature every year.

"We have seen existing debt where what was once senior might provide a return that

## Developed markets are second string to Duet's bow

London-based hedge fund Duet Group was founded in 2002 by former Credit Suisse investment banker Henry Gabay and Swiss bank UBP trader Alain Schibl.

The group made its name in emerging markets, especially Africa and India, where it has a number of funds and joint ventures. Its assets under management total \$2.1bn, with just over half in hedge funds, or hedge funds of funds, and the rest in private equity, including real estate.

In April 2008 the founders hired Osman Semerci, former global head of fixed income at Merrill Lynch, as chief executive officer.

Semerci brought in a stream of former Merrill colleagues and set about further building up the private equity side. Korat and Lattanzio joined in September 2008.

Duet began adding products that would

capitalise on distress in developed markets. The European debt fund and a Japanese special situations fund are the first two such funds to focus on developed markets.

One of Duet's biggest punts is in backing Indian property firm SARE (South Asian Real Estate), which failed to float in 2007, when it planned to build 40,000 homes in India. SARE raised \$200m of equity with Duet and UK private property company Topland, plus a number of wealthy individuals and funds. These included funds managed by Forum Partners, which is now the main investor in the European property debt fund.

Duet also owns an Indian business hotel developer that acquired Dawnay Day's platform last year, as well as a newer infrastructure business. In Brazil, it co-manages residential developer Itacare.

is acceptable to us," says Lattanzio. "We've had talks about refinancing situations where we would play a role where there is a deficit – typically between new equity coming in from the existing borrower or a new one and the bank keeping a restructured senior loan.

### Opportunistic approach

"We can choose to be opportunistic about the structure, because we understand how to underwrite debt structures, as well as to focus on the underlying real estate."

Korat, who used to trade debt at Merrill Lynch, looks at buying existing loans for the fund. He says: "We are reviewing a couple of small banks' loan books, but it is very much smaller, non-core disposals, rather than wholesale selling by banks of big, core positions."

He does not believe there will be huge, wholesale sales of discounted loans. "Banks have a three- or four-year view on trying to get rid of non-core assets and only in the second half of last year did they decide what

was core and what was non-core. We are talking about the fundamental business models of a lot of large lenders, so decisions were never going to happen overnight."

Lattanzio adds: "Banks are going through decision-making in every business area on what clients, segments and regions they are going to be in. That takes time. But we feel they have got to the point where some of these decisions are being made and there is more direction about how they are going to manage their businesses and portfolios.

"There won't be one theme to the way this will happen in Europe, because they will employ many solutions. One situation we are seeing is a bank that decided to withdraw from a particular geographic area."

One reason why Lattanzio expects more activity is the bulge in maturing loans: De Montfort University's last estimate was that £150bn is due for refinancing by 2012 in the UK alone. "In those situations there tends to be activity," Lattanzio says.

Despite investors' initial scepticism, he sees "credible entrants" appearing this year, including private equity real estate funds adding debt expertise or partnering up – such as Orion and Colony Capital – or insurance companies, credit fund managers and other hedge funds, although the illiquidity of real estate debt doesn't suit all hedge fund capital.

"Our general belief is there will be a place for non-bank lending in Europe's commercial property markets for quite some time," Lattanzio concludes.

**"Last year was dominated by equity. Now buyers who like a bit more leverage for a more opportunistic return are coming in, so we expect activity to pick up"**

Dale Lattanzio, Duet