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REAL ESTATE

The Case for European Real Estate Debt

BARINGS INSIGHTS

The supportive pricing fundamentals in the European real estate market, and low leverage relative to previous property cycles, suggest the asset class is well-positioned to withstand the impact of the pandemic.

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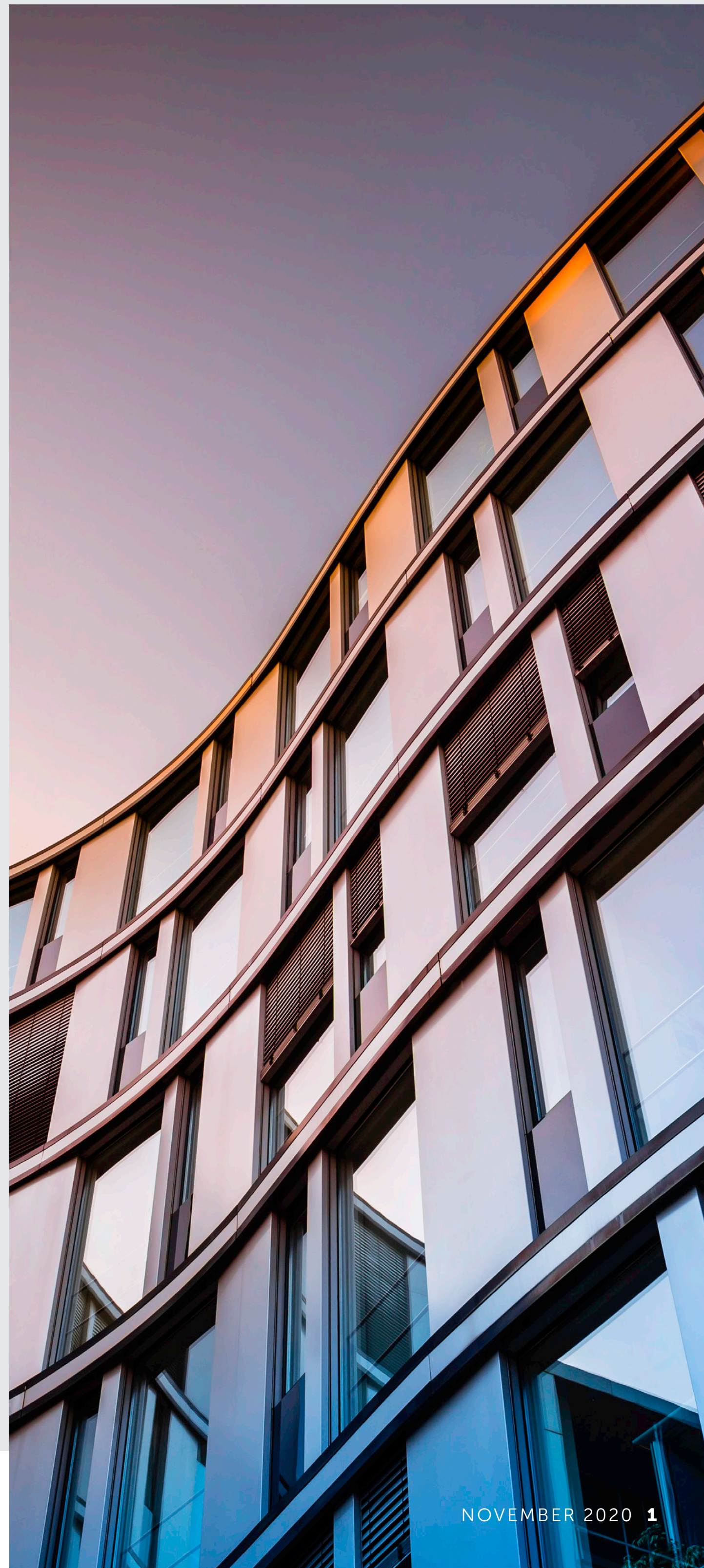


Highlights

- European real estate debt can offer a stable income return and exposure to loans that are secured by fully diversified 'hard' collateral—both providing considerable downside protection.
- Rising capital requirements for banks are reducing the appetite for real estate lending and opening up the market for non-bank lenders over the mid to long term.
- When compared to other asset types, property default risk is broadly similar to investment grade bonds and infrastructure, and below high yield corporate bonds.
- Supportive property pricing fundamentals due to long-term low interest rates, coupled with low leverage relative to previous property cycles, suggests the European real estate market is in a position of strength to endure the impact of COVID-19.

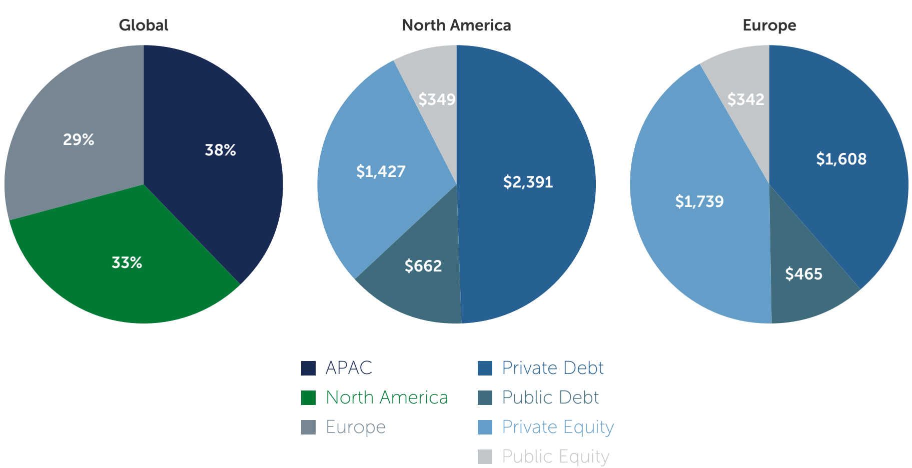
Why Invest in European Real Estate Debt?

Three primary reasons underpin the case for investing in European real estate debt:

1. CONSIDERABLE EXPANSION POTENTIAL

- With just under a third of the total global commercial real estate (CRE) invested universe in Europe, an investor who excludes an overseas allocation significantly limits their opportunity set.
- While the U.S. has a mature CRE debt market, the European property debt market is less developed with fewer capital sources.
- In many parts of Europe, there is considerable expansion potential from emerging real estate investment sectors such as student accommodation, multi-family and logistics.
- European private CRE debt markets total $1.6 trillion, but lower leverage levels imply scope for growth.

FIGURE 1: Global Commercial Real Estate Invested Universe ($14.6 Trillion)



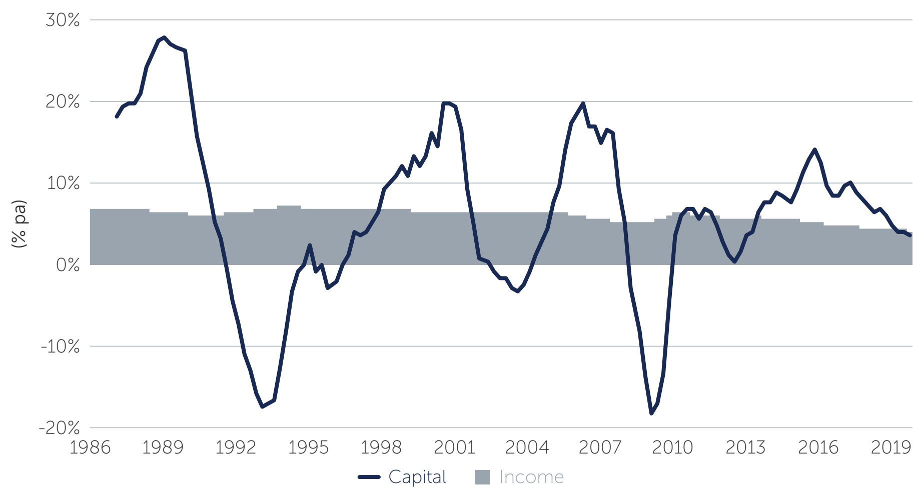
SOURCE: Cushman & Wakefield, Money into Property. As of January 2018. (US$ Billions).

"European real estate debt can offer a stable income return and exposure to loans that are secured by fully diversified 'hard' collateral—both providing considerable downside protection."

2. ACCESS TO STABLE AND ENHANCED RETURN POTENTIAL

- CRE debt provides a fixed income, delivering stable cash flows through a pre-determined schedule of interest and principal payments.
- This stable income return makes property highly financeable, while providing a hedge against market volatility **(FIGURE 2)**.

FIGURE 2: European CRE Equity—Income Return Stability

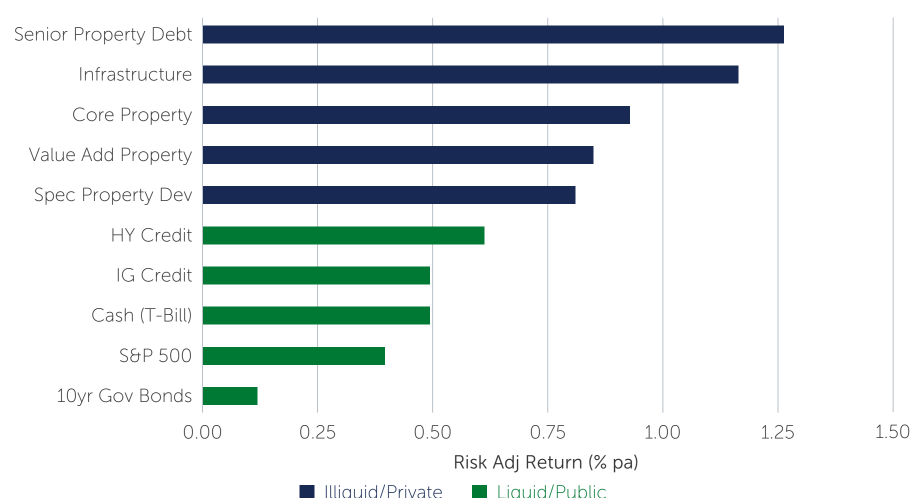


SOURCES: CBRE; Cushman & Wakefield; Barings. As of March 2020.

"CRE debt instruments include a potential 'illiquidity premium', which compensates investors for the absence of an established secondary market."

- While corporate bonds are typically unsecured, real estate loans are secured by collateral, which helps mitigate downside risk for the lender.
- On a risk-adjusted basis, senior property debt returns tend to outperform their real estate equity counterpart and other publicly traded asset types.

FIGURE 3: Long-Run Risk Adjusted Investment Return Expectations



SOURCE: Barings. As of April 2020. Risk-adjusted returns are calculated by: total return (per annum)/risk (per unit of volatility).

- CRE debt instruments include a potential 'illiquidity premium', which compensates investors for the absence of an established secondary market.

3. RISK REDUCTION THROUGH PORTFOLIO DIVERSIFICATION

- European CRE is lowly correlated to equities, bonds and other real estate markets, so its inclusion in a diversified investment portfolio should reduce specific risk.
- The low correlation between European property markets themselves facilitates the construction of a fully diversified loan portfolio **(FIGURE 4)**.
- Real estate loans are secured by hard collateral, providing additional downside protection **(FIGURE 5)**.
- Investing in CRE debt allows indirect access to the CRE market, but without the operational challenges experienced by CRE equity investors.
- The lack of uniformity in European CRE markets, which results from different underlying market conditions and cycle maturities, is a source of considerable diversification but also adds a layer of complexity.
- On the upside, these country differences can allow the exploitation of pricing inefficiencies, when local pricing anomalies emerge.
- On the downside, navigating the nuances of each market—such as differing regulatory and legal frameworks, lender covenants, security and enforcement rights and property valuation practices—requires the skills of a competent manager with a comprehensive and genuinely local network.

FIGURE 4: Global Real Estate Returns (2005–2019 % PA)

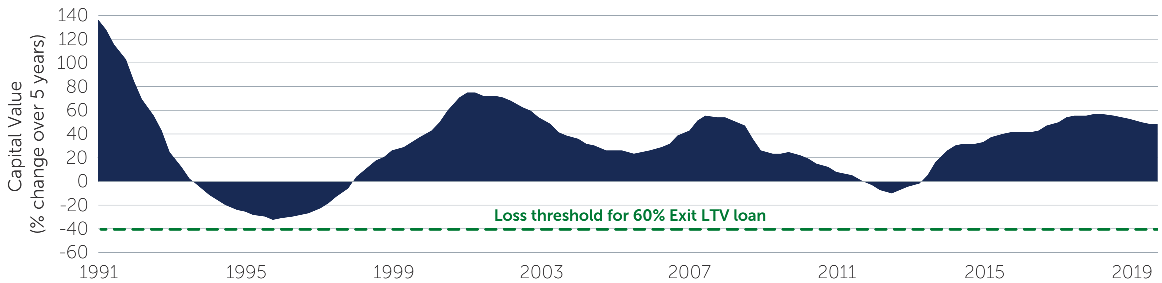
	Americas		Europe																		APAC				Other Assets	
	U.S.	Can	Austria	Belg	Czech	Den	Finland	France	Germ	Hung	Italy	N'lands	Norway	Poland	Port	SA	Spain	Swd	Switz	U.K.	Auz	Japan	Korea	New Z	S&P 500	U.S. Treas. (10yr)
Total Return	7.7	9.8	6.1	5.5	7.7	7.3	6.7	8.4	5.7	7.0	4.9	7.1	8.9	8.0	6.5	15.2	7.0	9.4	6.2	6.4	10.2	5.7	8.5	10.5	8.9	4.2
Volatility (SD)	9.7	5.6	1.1	1.9	5.9	4.6	2.0	6.2	3.3	9.4	2.3	4.9	5.4	6.1	4.7	7.3	8.1	5.2	0.7	10.4	5.7	5.3	4.7	6.0	16.9	8.4
Risk Adjust.	0.80	1.75	5.37	3.00	1.31	1.59	3.33	1.37	1.72	0.74	2.15	1.44	1.66	1.32	1.39	2.09	0.86	1.81	8.56	0.62	1.79	1.08	1.82	1.75	0.53	0.50

FIGURE 5: 15-Year Correlation Matrix

	Americas		Europe																		APAC				Other Assets	
	U.S.	Can	Austria	Belg	Czech	Den	Finland	France	Germ	Hung	Italy	N'lands	Norway	Poland	Port	SA	Spain	Swd	Switz	U.K.	Auz	Japan	Korea	New Z	S&P 500	U.S. Treas. (10yr)
U.S.	1.00																									
Can	0.83	1.00																								
Austria	0.51	0.33	1.00																							
Belg	0.48	0.48	0.23	1.00																						
Czech	0.70	0.63	0.67	0.80	1.00																					
Den	0.50	0.65	0.28	0.67	0.74	1.00																				
Finland	0.49	0.59	0.48	0.84	0.76	0.67	1.00																			
France	0.77	0.82	0.46	0.82	0.86	0.84	0.85	1.00																		
Germ	0.04	-0.38	0.57	0.00	0.25	-0.33	-0.04	-0.17	1.00																	
Hung	0.60	0.46	0.71	0.60	0.91	0.69	0.59	0.67	0.36	1.00																
Italy	0.53	0.59	0.37	0.81	0.80	0.84	0.86	0.85	-0.08	0.77	1.00															
N'lands	0.37	0.23	0.60	0.67	0.86	0.64	0.65	0.61	0.44	0.90	0.77	1.00														
Norway	0.65	0.63	0.36	0.83	0.81	0.78	0.74	0.91	-0.06	0.63	0.81	0.63	1.00													
Poland	0.70	0.86	0.29	0.67	0.74	0.85	0.72	0.85	-0.34	0.66	0.83	0.51	0.66	1.00												
Port	0.43	0.23	0.35	0.81	0.79	0.67	0.66	0.68	0.28	0.72	0.75	0.87	0.76	0.50	1.00											
SA	0.52	0.78	-0.04	0.65	0.52	0.80	0.63	0.78	-0.61	0.36	0.70	0.27	0.69	0.83	0.44	1.00										
Spain	0.68	0.45	0.45	0.77	0.87	0.72	0.63	0.78	0.26	0.80	0.76	0.83	0.81	0.65	0.93	0.47	1.00									
Swd	0.76	0.58	0.60	0.68	0.85	0.64	0.65	0.85	0.23	0.72	0.70	0.70	0.90	0.56	0.75	0.43	0.87	1.00								
Switz	0.23	0.32	0.26	-0.02	0.10	-0.26	0.19	0.09	0.15	-0.04	-0.03	-0.10	-0.01	0.09	-0.25	-0.11	-0.14	0.13	1.00							
U.K.	0.60	0.42	0.22	0.25	0.36	0.43	0.07	0.49	-0.07	0.30	0.23	0.13	0.58	0.26	0.26	0.28	0.47	0.61	-0.30	1.00						
Auz	0.87	0.76	0.49	0.78	0.89	0.68	0.70	0.92	0.06	0.71	0.71	0.63	0.89	0.73	0.73	0.65	0.86	0.91	0.15	0.54	1.00					
Japan	0.76	0.64	0.52	0.76	0.91	0.73	0.65	0.83	0.13	0.79	0.70	0.69	0.80	0.73	0.79	0.63	0.89	0.81	-0.04	0.44	0.92	1.00				
Korea	0.32	0.49	0.11	0.80	0.55	0.42	0.78	0.66	-0.17	0.30	0.63	0.35	0.68	0.50	0.46	0.64	0.38	0.47	0.28	-0.02	0.60	0.53	1.00			
New Z	0.77	0.78	0.41	0.75	0.87	0.83	0.66	0.91	-0.14	0.71	0.72	0.59	0.85	0.81	0.70	0.79	0.81	0.79	-0.06	0.52	0.93	0.95	0.57	1.00		
S&P 500	0.12	0.02	0.36	-0.01	0.08	0.01	0.05	0.15	0.18	-0.04	-0.06	-0.05	0.31	-0.23	-0.01	-0.08	0.03	0.30	-0.14	0.54	0.13	0.09	0.05	0.09	1.00	
U.S. Treas. (10yr)	0.20	0.19	0.04	0.21	0.11	-0.05	0.31	0.09	0.03	0.10	0.22	0.11	-0.16	0.36	0.02	0.01	0.09	-0.09	0.36	-0.39	0.05	0.03	0.15	-0.05	-0.60	1.00

FIGURE 4 AND 5 SOURCES: MSCI; S&P. As of July 2020.

FIGURE 6: Loan Collateral—No Losses at 60% LTV (5-Year Exit)



SOURCES: CBRE; Cushman & Wakefield; Barings Research. As of March 2020.

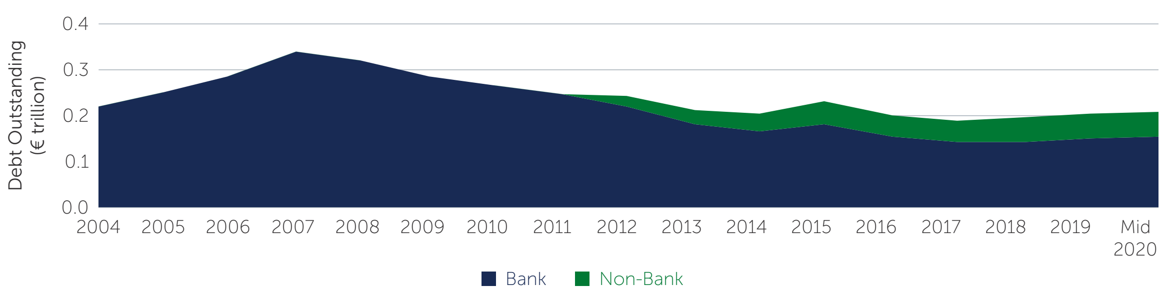
Is Now an Appropriate Time?

IMPENDING DEBT FUNDING GAP

Banks continue to dominate the European CRE debt market. In the aftermath of the 2007/2008 financial crisis, tighter regulatory standards, increased bank capital requirements and the introduction of measures such as slotting—where financial institutions assign each of their performing specialized lending exposures with one of four risk categories such as strong, good, satisfactory or weak—have put mounting pressures on banks to retreat from real estate lending. The demise of traditional CRE bank lending has opened up market opportunities for non-bank lenders. In the U.K., non-bank lenders have been steadily increasing market share and now account for roughly 25%[1] of the total outstanding loan book. In Europe, non-bank lender market share is much lower at roughly 9%[2], and banks are still focused on working through their existing loan books to try and improve overall quality and meet statutory regulatory requirements.

The introduction of higher capital charges for bank CRE lending has been a key driver in opening up the CRE debt market to alternative lenders in recent years. Today, banks are being increasingly deterred from 'higher-risk lending', with capital charges rising as the lender moves up the risk curve. This means schemes such as speculative development are now far less attractive for banks compared to the past.

FIGURE 7: U.K. Private CRE Debt



SOURCE: Business School (formerly Cass) Commercial Real Estate (CRE) Lending Report. As of October 2020.

The COVID-19 crisis will likely make senior/core debt harder and more expensive to source from banks—even into 2021—because of competition from general corporate lending. While CRE transaction volumes will inevitably decline over the short-term, with £43 billion[3] of CRE debt maturing in 2020/21 in the U.K. alone, there will be plenty of refinance opportunities. New refinancing deals will require the asset to be re-valued and loan terms will need adjusting in line with the market. These revisions, alongside higher capital costs, could force some borrowers to look beyond traditional lenders for a more competitive deal.

1. Source: Business School (formerly Cass) Mid-Year U.K. CRE Lending Report. As of October 2020.
2. Source: Cushman & Wakefield Money into Property 2017.
3. Source: Business School (formerly Cass) U.K. CRE Lending Report. As of May 2020.

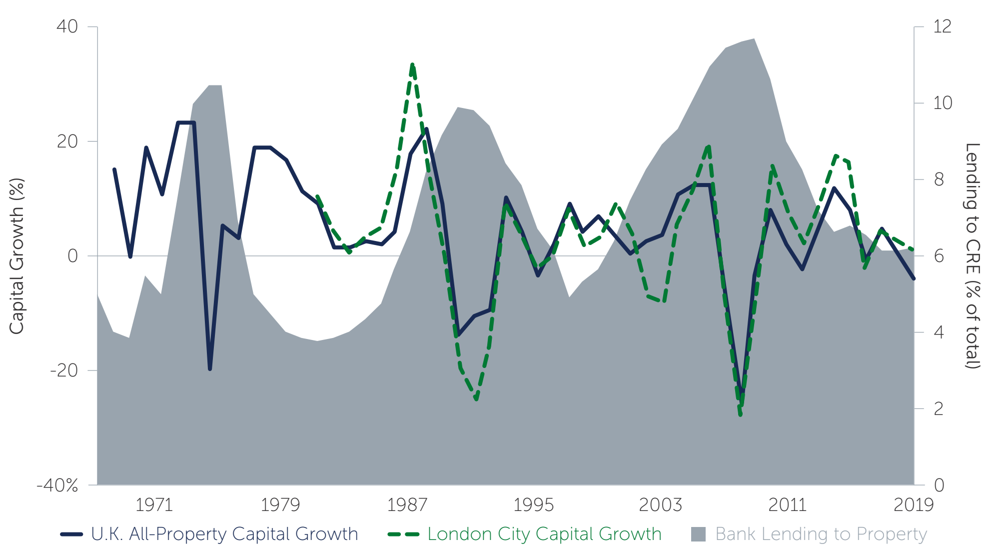
For high yield/value-add borrowers, sourcing bank financing for non-100% income producing assets may be particularly challenging. We foresee the emergence of opportunities to lend to equity investors typically engaged in 'manage-to-core' strategies; albeit these deals will only be viable in locations where local market structural supports remain intact. Longer term, rising bank capital requirements with the implementation of Basel IV, which introduces a new output floor (initially set at 50% from 2023, rising year-on-year to 72.5% in 2028)[4], could potentially reduce bank lending flexibility and competitiveness, allowing alternative lenders to grow market share. This anticipated broadening in the capital sources available to investors in European property is already underway, and in our view will continue to create opportunities mid to longer term.

SUPPORTIVE PRICING

The potential for a generous CRE risk premium exists, despite prime property yields being at record lows. This is underpinned by highly accommodative monetary policy from the European Central Bank and Bank of England, with ultra-low interest rates boosting the real estate and risk-free rate spread. Given the significant economic impact of COVID-19, and provided inflationary pressures remain subdued, interest rates are expected to remain low for the foreseeable.

Ultra-low interest rates will likely provide significant support for core real estate pricing. In locations and property sectors where the structural drivers (demographics and technology) are still favorable, the outlook for long-term capital appreciation is also positive. This also explains why a highly divergent pricing outlook across the property sub-sectors has emerged. Whereas secondary retail and business hotels are being negatively impacted, prime offices, logistics and residential are arguably mid-term beneficiaries of the conditions brought about by the pandemic. Furthermore, should inflation/interest rates unexpectedly spike, or if there is a currency event, given the low leverage levels in this current property cycle, only a relatively modest pricing correction would be expected in these favored sectors of the market. This is a crucial difference from the three significant U.K. CRE pricing corrections over the last 50 years, where increased leverage usage was the amplifier for each CRE pricing collapse.

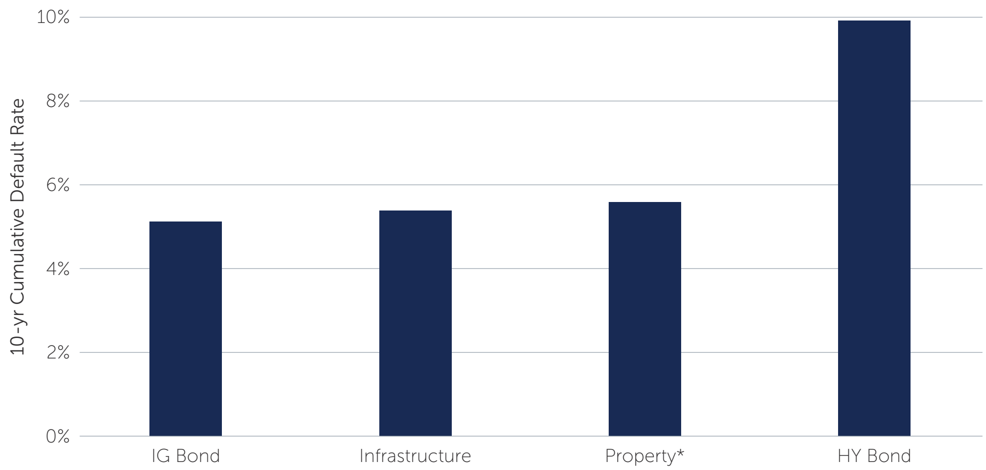
FIGURE 8: U.K. Property Lending vs. Capital Growth



SOURCE: Bank of England, MSCI. As of November 2020.

4. Source: Business School (formerly Cass) CRE Lending Report. As of May 2020.

FIGURE 9: Default Rates By Asset Class (1983–2019)



SOURCES: Moody's; Business School (formerly Cass) CRE Lending Report. As of May 2020.
*Property: Project finance loans are defined as senior secured loan facilities, which are comparable to senior secure real estate finance loans.

The downside of low prime yields is that capital value risks are elevated, which is why our senior/core lending strategy focuses on wholly stabilized assets with strong income stability and underlying tenant credit ratings. Pricing will be determined by the relative value in the spread to corporate bonds and loans structured to accommodate temporary cash flow disruption—avoiding structural features such as cash traps and rent reserves. While the strategy's lower inherent risk means returns will look low relative to investment grade equivalents, we believe they will look more attractive on a risk-adjusted basis. For investors with greater risk tolerance looking for higher returns, we foresee opportunities in the value-add/ high yield space. Here, the focus will be on prospects where there is the potential for both positive credit migration and value creation through the life of the loan. Lending will be subject to borrowers demonstrating their capability to execute a strong business plan, aligned with invested capex.

LOW DEFAULT RISK

At the end of 2019, the weighted default rate in the U.K. CRE lending market remained low at 3.2%, despite a rise in the absolute value of defaulting loans[5]. This stability was also reflected in Bank of America's[6] analysis of over 1,000 European and U.K. CRE loans (totaling €181 billion) between 2000 and early 2020. While the aggregate default rate of almost 16% (by amount) looks high over the period, it can be explained by a high concentration of loans in 2005 to 2007 vintages. Prior to 2007, average LTVs were much higher compared to today and there was greater use of leverage to increase the debt quanta, leaving some loans heavily exposed to the sharp property pricing corrections in the aftermath of the financial crisis. Since then, of the €49 billion of new loans securitized, only three loans (1%) have defaulted, all of which have been in the retail sector, which is in the midst of wholesale structural reforms.

Moody's[7] analysis of 10-year cumulative default rates by asset type shows that high yield corporate bonds carry the highest default risk over the long term, while property, investment grade bonds and infrastructure are all broadly similar. In the event of a loan defaulting, project finance loans (similar to secured real estate loans) have historically had the highest recovery rates at roughly 78%, ahead of infrastructure at roughly 70% and distressed sales at roughly 50%.

The widespread economic impacts of COVID-19 will certainly lead to a rise in CRE loan default rates and write-offs over the near-term, but given the tight regulatory controls now in place and much lower leverage levels in the current property cycle, it should prevent a sharp spike and in turn, limit the number of distressed sales.

Key Takeaway

While COVID-19 has cyclically weakened the major real estate sectors, to varying degrees, the European real estate market looks well positioned to endure its impact. Pricing fundamentals of the asset class are supported by lower-for-longer rates, while leverage levels remain low relative to previous property cycles—which in turn should limit a sharp rise in defaults going through and coming out of the pandemic.

However, several uncertainties remain, and market volatility is likely going forward. For real estate investors seeking downside protection, European real estate debt can potentially meet those needs—through the potential offering of a stable income return and exposure to loans which are secured by diversified 'hard' collateral.

5. Source: Business School (formerly Cass) CRE Lending Report. As of May 2020.
6. Source: BofA Global Research—Which European CRE loans suffered losses and why? As of March 2020.
7. Source: Business School (formerly Cass) CRE Lending Report. As of May 2020.

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