REAL ESTATE

European Real Estate Debt: Why Now?

INSIGHTS

Against a backdrop of decades-high inflation and rising rates, real estate debt is worth considering—especially given the potential for attractive returns, duration risk mitigation and diversification.

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Highlights

- While real estate debt is not a substitute for real estate equity investments, it is highly complementary.
- There are a number of reasons to increase an allocation to real estate debt, including the potential for attractive returns.
- Floating-rate real estate loans mitigate duration risk—a perennial challenge for fixed income investors.
- On a risk-adjusted basis, real estate debt and equity assets have historically outperformed the major publicly traded asset classes.
- European property debt, in particular, offers powerful diversification benefits for investors.
- Increasing regulation and a pandemic-induced property-refinancing backlog have created a considerable opportunity for non-bank lenders.

Real Estate Debt & Equity: A Complementary Mix

Strategic property investors—those looking to maximize risk-adjusted returns in the long term—can benefit from an allocation to both debt and equity real estate through the cycle. In particular, fine-tuning investors' preferred blend, depending on the phase of the property cycle, might be worth considering. For instance, real estate debt exposure can be built up through the top of the cycle, forgoing frothy peak equity returns but limiting the inevitable downside to come. Meanwhile, exposure to real estate equity can be increased during the recovery phase at the bottom of the cycle, when return expectations are rising.

The optimal property debt allocation will depend on the individual investor's investment objectives including target returns and risk tolerance. The basic principles of investment diversification suggest a minimum and therefore meaningful property debt allocation for the "average" investor to begin at around 15%–20%. That could rise to over 50% for the most risk intolerant long-term capital sources. Real estate debt is not a substitute for real estate equity investments—rather, it is highly complementary.

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The Inflationary Environment

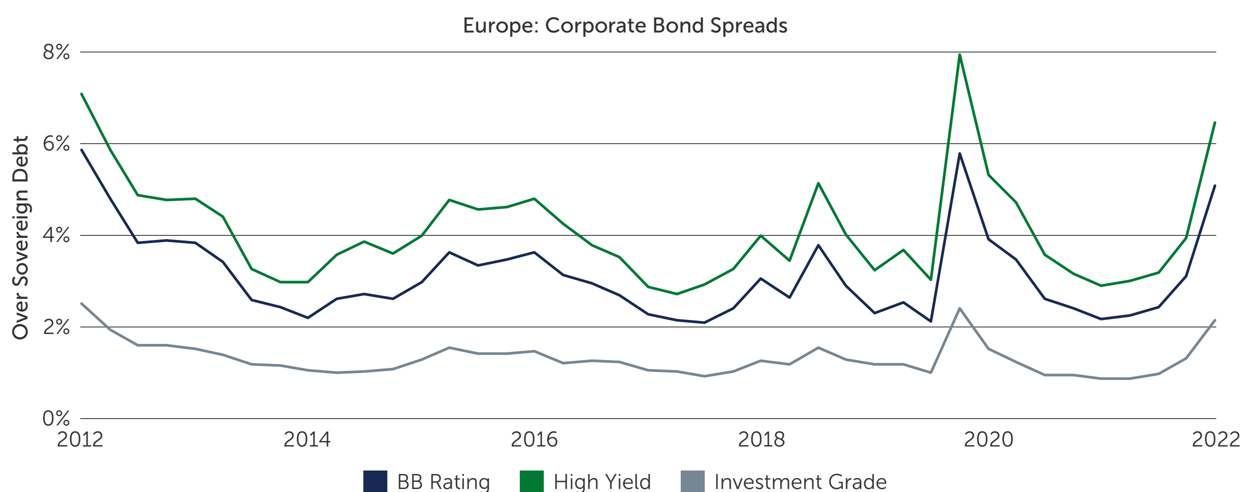
High inflation will likely continue in the coming months. Against this backdrop, the U.S. Federal Reserve (Fed), which has set the global interest rate climate for capital markets, is currently in an aggressive tightening phase to attempt to wrestle inflation back under control—almost irrespective of the consequences for growth, in our view. Risks of a global recession are therefore rising, but especially in Europe because of the continent's additional high dependency on energy from Russia. While the European Central Bank's (ECB) monetary tightening has lagged behind the Fed, the central bank recently ended an eight-year era of negative interest rates at their July 2022 meeting, hiking for the first time in over a decade and increasing their deposit rate by 50 basis points (bps) to 0 bps.

While still remarkably low, a higher cost of debt and, just as importantly, the drop in economic sentiment, are combining, resulting in European property yields beginning to rise. While external macro risks remain high, the internal risks to the property market are actually still relatively low. Factors that could potentially mitigate the European property market's likely slowdown include a benign occupational supply side—given low existing vacancy, modest development, and chronic shortages of modern accommodation (especially buildings with strong ESG credentials). Total property market leverage levels are also much reduced compared to previous property cycles. And given that loan-to-values (LTVs) are more modest in this current cycle, we believe the sensitivity of property values to a wider macro slowdown and rising property debt costs suggest that there is far greater market resilience.

Buoyed by a Floating Rate

Central bank policy actions and ongoing macro headwinds have resulted in a significant and sustained widening between credit spreads on liquid public corporate bonds and risk-free rates (sovereign debt).

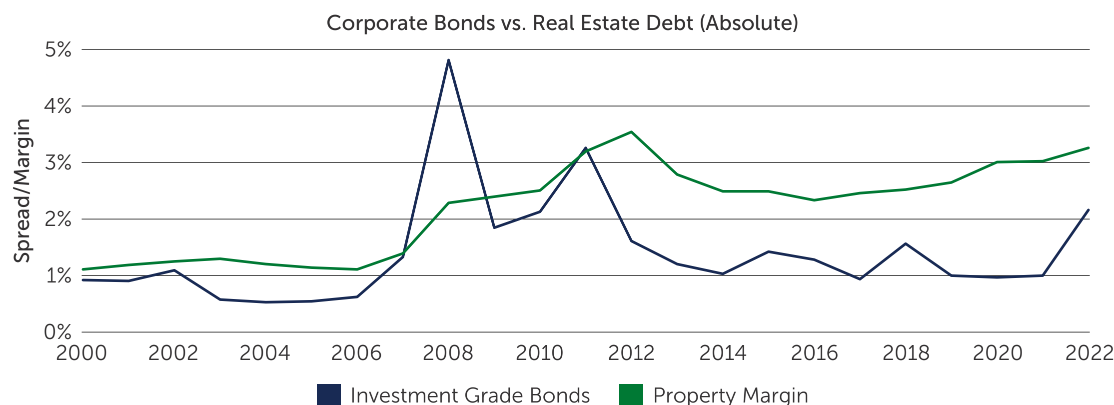
Figure 1: Rising Risk Perception Around Corporate Lending



Source: Bloomberg. As of Q2 2022.

While the relationship between corporate bond spreads and property debt margins is positive, it is fairly weak at +0.4 correlation over the past 20 years.

Figure 2: The Relationship Between Corporate Bond and Real Estate Spreads is Not Direct

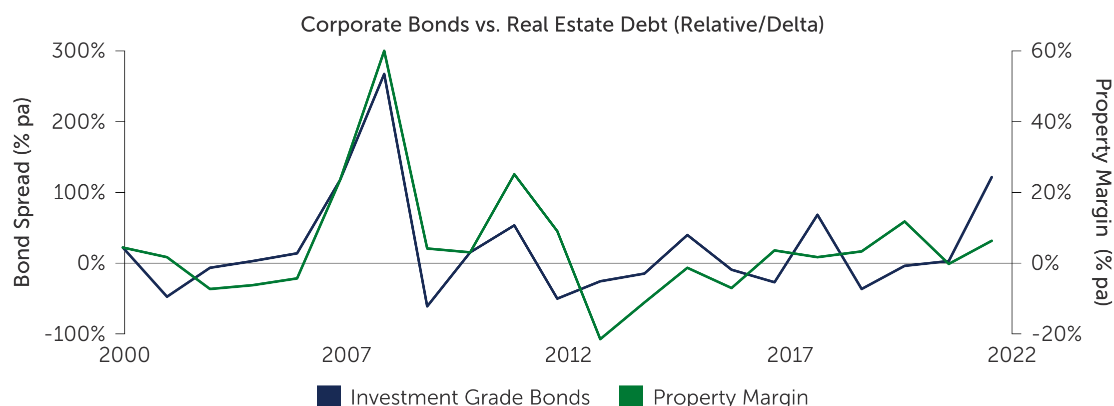


Sources: Bloomberg; Bayes Business School. As of August 2022.

But there is a stronger correlation (+0.7 over the past 20 years) between the rate of change in corporate bond spreads and property margins. And the relationship rises close to perfect correlation (+0.95) if the European Commission's Economic Sentiment Index is also factored in via a simple regression analysis. This suggests that with corporate bond spreads rising and economic sentiment falling, the relative value between property debt and corporate bonds has deteriorated. This dynamic explains why property debt margins have needed to increase **(Figure 3)**.

While rising margins are a negative for real estate equity values and returns, they are a boon for real estate debt investors. Further, European property debt is typically structured on a five-year variable or floating-rate basis—this helps mitigate duration risk, a perennial challenge for fixed income investors.

Figure 3: Change in Corporate Bond Spreads Readily Filter Through to Property Debt Margins



Sources: Bloomberg; Bayes Business School. As of August 2022.

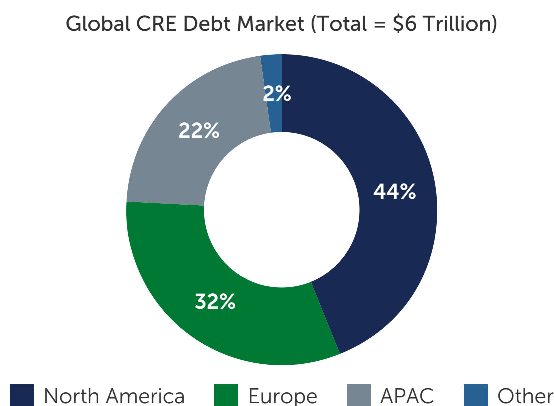
In addition to these potential benefits, there are a number of other less cyclical, but equally highly compelling, long-term reasons to build a meaningful allocation to European real estate debt.

An Expansive Opportunity

The size of the global real estate debt market is estimated at around $6 trillion, with North America the largest market ($2.6 trillion), followed by Europe ($1.9 trillion), and APAC ($1.3 trillion) **(Figure 4)**. The U.S. is the deepest and most mature property debt market. This is evident in Europe, where there are fewer types of lenders and a heavy over reliance on banks (which make up over 90%)—and therein lies the considerable opportunity.

For instance, rising capital requirements under the evolving Basel banking regulatory framework are designed to restrict bank lending appetite for higher credit risk exposures, including real estate. While senior loans on lower loan-to-values (LTVs) are less affected, mid to higher LTV whole loans, mezzanine debt and any value-add or opportunistic property investment activities—such as speculative development—are now less attractive to banks. This is because of the regulatory need to build up larger capital reserve buffers for such types of loans. And given the pandemic-induced real estate refinancing backlog, we believe the opportunity for non-bank lenders to expand and plug a looming property debt-funding gap, while earning potentially increasingly attractive returns, is going to be considerable over the next few years.

Figure 4: European CRE Debt Market Has Catch-Up Potential

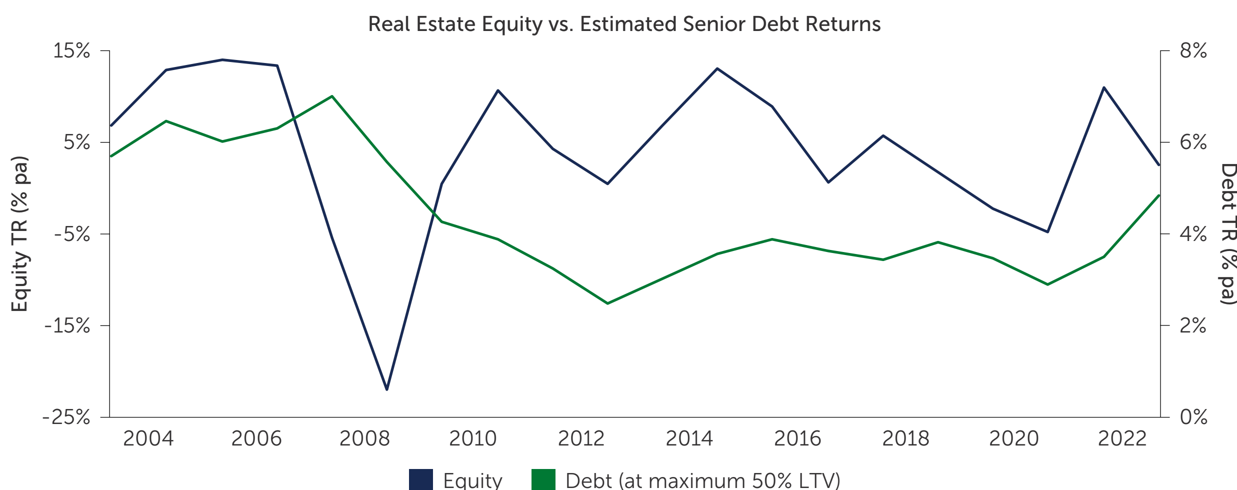


Sources: PGIM, Barings. As of July 2022.

Tapping the 'Illiquidity Premium'

Low-risk senior property debt investment provides a fixed income, underpinned by stable property cash flows, with a pre-determined schedule of interest and principal payments. These stable senior debt income returns also provide a hedge against market volatility, which is particularly attractive through the property cycle. A careful selection of assets in property sectors and markets that are supported by positive structural tailwinds—such as demographics, technological trends, and ESG—is also important. In our view, the future cash flows of such assets have long-term income growth potential. This helps generate higher exit liquidity for the borrower (the property equity investor) be they core or those with more short-term value-add business plans looking for mezzanine, or even development, financing.

Figure 5: European Real Estate Debt is Highly Complementary to Real Estate Equity



Sources: Bayes Business School; Oxford Economics; MSCI; Bank of America; Barings' calculations. As of August 2022.

With real estate loans also secured by 'hard' collateral, these assets offer considerable downside protection in the event of delinquency or even default. And, on a risk-adjusted basis, both debt and equity property have historically outperformed the major publicly traded asset classes over the long term. This is effectively an illiquidity premium inherent in commercial real estate (CRE) debt loans, which compensates investors for the absence of an established secondary market. At the same time, the looming dearth of debt capital and reduced appetite from banks suggests that property debt margins will also rise—boosting return expectations for the asset class. The current backdrop of rising rates supports the case for these floating-rate loans, further paving the way for potentially attractive returns.

Figure 6: Real Estate Debt and Equity Have Outpeformed Over Longer-term Time Horizons

20 Year (% pa)	U.K. Property Senior Debt	U.K. Property Equity	European Equities	German Bonds	European IG Corp Bonds
Total Return (TR)	4.3	7.2	7.5	4.1	2.9
Risk (SD 03–22)	1.3	9.7	17.7	6.6	6.1
Risk Adjusted Ratio	3.2	0.7	0.4	0.6	0.5

Sources: Bayes Business School; Oxford Economics; MSCI; Bank of America; Barings' calculations. As of August 2022.

While external macro economic risks are elevated, the inherent internal property market risks are largely unchanged. That points to potentially higher returns for the same risk, which we believe increases the appeal of an allocation to real estate debt. The funding opportunity will likely be the greatest for non-senior property debt strategies—with the potential for significantly more generous margins and thus attractive returns for whole loans, mezzanine, and the financing of new construction activity.

Diversification Potential

Another benefit of the asset class is that in a mixed asset or a multi-strategy investment portfolio, European property debt returns offer the potential for powerful diversification. The lack of uniformity between individual European property markets adds the opportunity for extra diversity and the potential to exploit pricing anomalies. The source of this diversity is simply a reflection of the fragmented nature of the different national European economies—specifically, their varying property market practices, regulations and legal frameworks. While a debt allocation avoids the full operational challenges and extra costs incurred by equity property investors, the diversity does add a layer of complexity—however, investors and asset managers that have local property market presence and expertise are well-positioned to navigate the challenges and identify pricing anomalies.

Figure 7: Correlation Across Asset Classes

Correlation	U.K. Property Senior Debt	U.K. Property Equity	European Equities	German Bonds	European IG Corp Bonds
U.K. Property Senior Debt	1.00	0.03	-0.08	-0.04	-0.20
U.K. Property Equity	0.03	1.00	0.64	-0.18	0.15
European Equities	-0.08	0.64	1.00	-0.32	0.56
German Bunds	-0.04	-0.18	-0.32	1.00	0.41
European IG Corp Bonds	-0.20	0.15	0.56	0.41	1.00

Sources: Bayes Business School; Oxford Economics; MSCI; Bank of America; Barings' calculations. As of August 2022.

Key Takeaway

2022 likely marks the end of several decades of benign inflation and falling interest rate expectations. As a result, investors and asset managers need to adjust strategies and find alternative ways to achieve attractive returns.

Against this backdrop, real estate debt is an asset class worth considering, for a number of reasons:

- Prospects for property debt returns are rising, while at the same time near-term property equity return expectations are ratcheting down.
- The floating-rate nature of European real estate loans also mitigates duration risk, which is beneficial in the current rising rate environment.
- Increasing regulation and the pandemic-induced property refinancing backlog have created a considerable and attractively priced opportunity for non-bank lenders to bridge a looming European property debt gap.

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