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REAL ESTATE

The Evolving Opportunity in Real Estate Debt

INSIGHTS

While the current landscape may be challenging to navigate, it is also shaping a compelling opportunity in real estate debt—from core to opportunistic lending.

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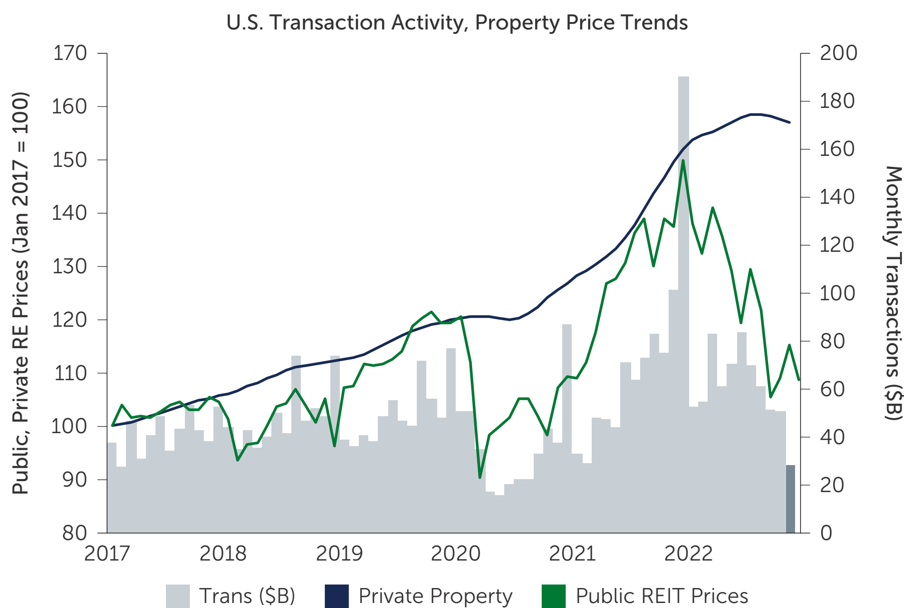
There are a number of risks facing real estate today—from a macro environment characterized by higher rates and persistent inflation, to structural changes in investor demand, particularly for sectors like office. However, the significant increase in base rates over the last six to nine months, combined with wider spreads in the market, has also resulted in a more attractive risk-return profile for real estate debt. This suggests that while the current landscape may be difficult to navigate, it is also presenting select compelling opportunities across the asset class.

A Murky Picture on Valuations

Against the challenging backdrop, transaction volumes in the U.S. real estate market have fallen precipitously **(Figure 1)**, and it is a similar case in Europe. Given the expectations for lower interest rates in the future, there is less refinancing activity in the market. At the same time, financing for new acquisitions—which can make up around 40–60% of the pipeline—has all but disappeared. With fewer transactional data points, the picture on underlying real estate valuations is murky—and depending on how the macro picture evolves, there could be continued pressure on capitalization rates and property level cash flows. This uncertain environment has led to a pull back from traditional lenders such as banks and insurers who are facing potential challenges with their existing portfolios. That said, it appears to be a great time to be a lender if you have dry powder and can structure around the current risks.

Figure 1: U.S. Transactions Have Fallen Back to Pandemic Lows



Source: Bloomberg; Federal Reserve; NAREIT; NCREIF. As of December 31, 2022.

Areas of Relative Value

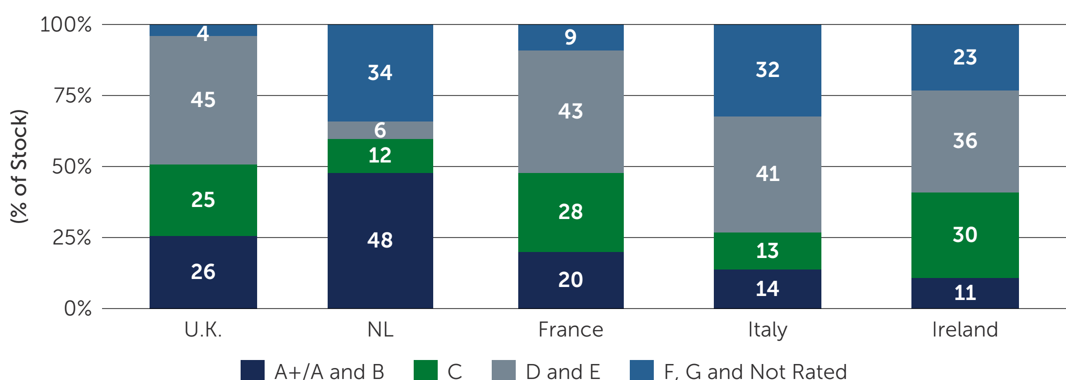
Looking across the market, we continue to see a number of attractive places to deploy capital, from core to opportunistic lending. In particular, attractive opportunities are emerging in pro-cyclical areas such as construction. While this may be somewhat of a contrarian view heading into a potential recession, the easing of some of the supply chain and input cost pressures over the last several months is a tailwind for the sector. In addition, construction assets have historically performed very well coming out of difficult periods. This is largely because most construction projects take around 18 to 36 months to deliver, while the average duration of a recession is less than two years. As a result, it seems reasonable to assume that the macro environment will be in better shape by the time the final product is delivered.

One sector in particular that does require vigilance is office. While the sector indeed rapidly deteriorated during the pandemic (much like many others), demand for office space continues to decline today. In particular, vacancy rates edged up to 7.7% in Europe's major office markets in the third quarter, and to 17.3% in the U.S. office sector by year-end.[1] Given the cultural shift toward remote working, we are seeing a structural change in demand for office in the wake of the pandemic—not dissimilar to what has been seen in retail over the last decade. We believe that there is a strong case to be made that appraised values for offices are not accounting for the challenges facing the sector, especially given the gap between the price trends of public and private office prices. As a result, and akin to what has been taking place in retail, the office sector is likely to see a significant reset in valuations in the next 12 to 24 months, in our view.

While the structural shift in office demand is likely to result in ongoing challenges for the sector—especially for those spaces that are non-differentiated and less ESG-friendly—we do believe that certain bright spots remain. For instance, we see opportunities in more specialized office assets including life sciences, content creation and ESG-forward, well-located space, which is currently in undersupply **(Figure 2)**. In our view, office assets that are modern, green compliant and offer the right amenities to attract talent—which we refer to as the "haves", versus the "have nots"—have the potential to achieve attractive rent levels.

We also see opportunities across the full risk-return spectrum for real estate debt. In terms of value, core plus loans look particularly attractive today, given the lower business plan risk relative to value-add assets. As we get toward the end of 2023 and into 2024, depending on how the economy develops and how central banks react in terms of a policy pivot, one area we expect to see more opportunities emerge is in distressed loans. More specifically, there are $70 billion of office loans maturing this year in the U.S., and $60 billion maturing in 2024—and given the structural challenges facing the sector, much of this may not have a refinancing exit or an investment sales exit.[2]

Figure 2: EPC Ratings Across European Offices



Source: Savills. As of November 2022.

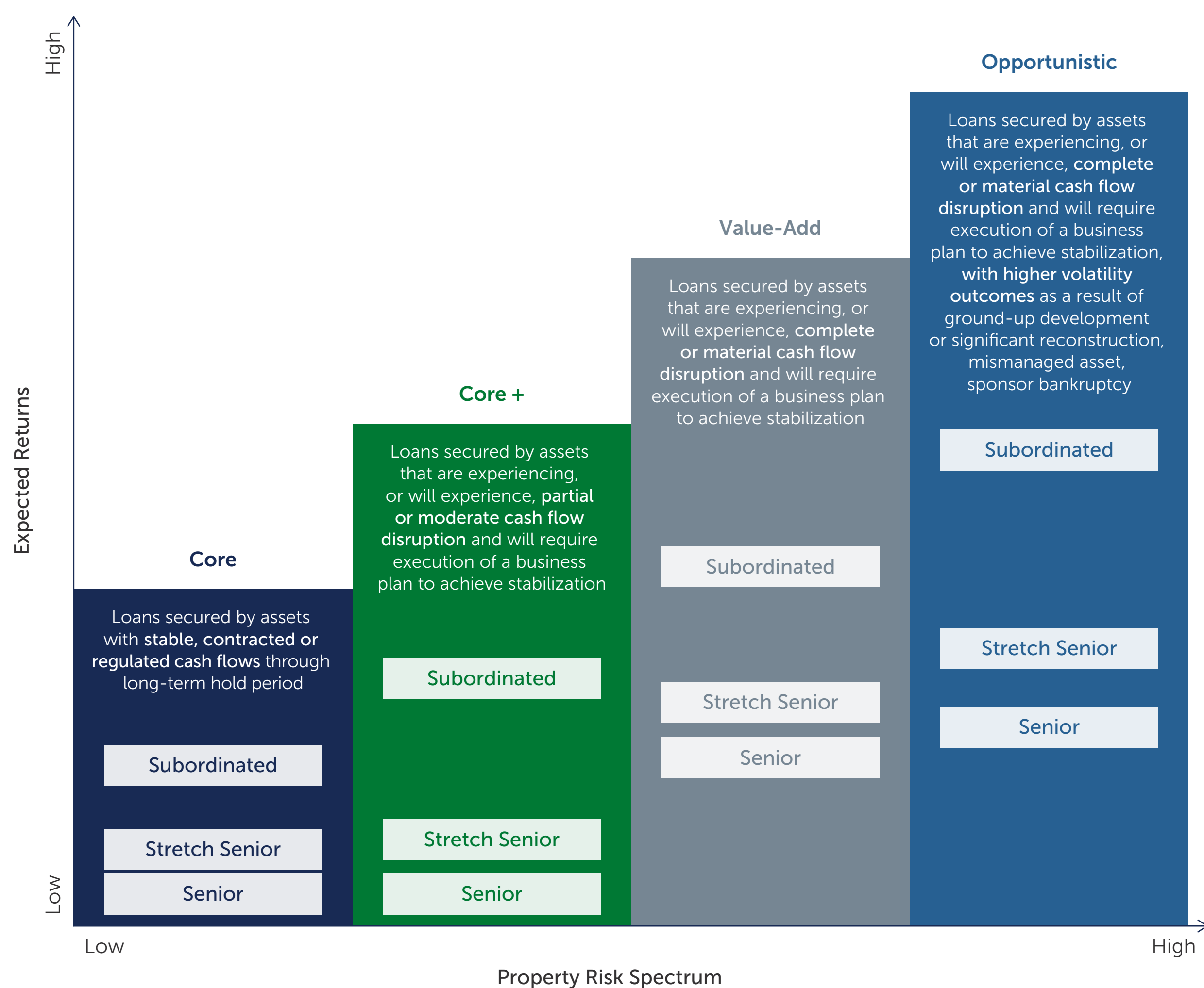
1. Source: Cushman & Wakefield; CBRE-EA. European data as of September 30, 2022. U.S. data as of December 31, 2022.
2. Source: Mortgage Bankers Association. As of December 31, 2022.

Who's Buying Real Estate Debt?

The range of opportunities available today is truly reflective of the evolution of the real estate debt universe. A decade ago, the asset class offered largely distressed opportunities, but today, there is the potential to build a well-diversified portfolio with exposure to both core and value-add assets, and to opportunistic and distressed opportunities. This is largely due to post-GFC regulations, which have resulted in banks retreating from the market, creating an opportunity for alternative lenders to fill the gaps across the capital spectrum.

As a result of the expanding opportunity set, portfolio exposure to risk today can be tailored to meet investors' individual needs **(Figure 3)**. For example, for investors seeking long-term, fixed rates assets to match long-term, fixed rate liabilities, core real estate loans may be a suitable option to consider. Alternatively, for investors that require a higher-yielding risk/return profile, floating-rate core plus construction value-add loans may be more relevant.

Figure 3: A Diverse Risk-Return Spectrum Across Real Estate Debt



Source: Bloomberg; Federal Reserve; NAREIT; NCREIF. As of December 31, 2022.

This diverse risk-return offering is a key factor driving growth in the non-bank investor base for commercial real estate debt—with insurance companies, domestic and international pension funds, and traditional sovereign wealth funds increasing their market share over the years. In the insurance segment, more specifically, traditional insurance companies have historically considered investment grade rated core assets to match their long-term liabilities. But in the past decade of low interest rates, reinsurers have increasingly been attracted to higher yielding sectors, from core plus to opportunistic—and these sectors offer some of the most compelling relative value opportunities today. In addition to the diverse opportunity set, real estate debt offers insurance companies limited correlation to, and lower volatility than, traditional asset classes, as well as an illiquidity premium relative to certain corporate bonds with a similar risk profile.

Key Takeaway

While the current environment is certainly challenging, the impact of higher spreads, coupled with lower leverage and loan-to-value ratios, are creating some compelling opportunities across U.S. and European real estate debt. In particular, past periods of economic slowdown have resulted in some of the most attractive vintages of real estate debt, and we expect this cycle to be similar.

That said, valuations across the asset class are harder to discern, and a number of headwinds remain on the horizon—from a potential recession, to ongoing inflationary pressures, to a possible policy pivot from central banks. As a result, in this environment, having experience through cycles, as well as the resources to manage tricky situations that may unfold, are paramount.

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