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Investment perspectives

The attractiveness of real estate debt

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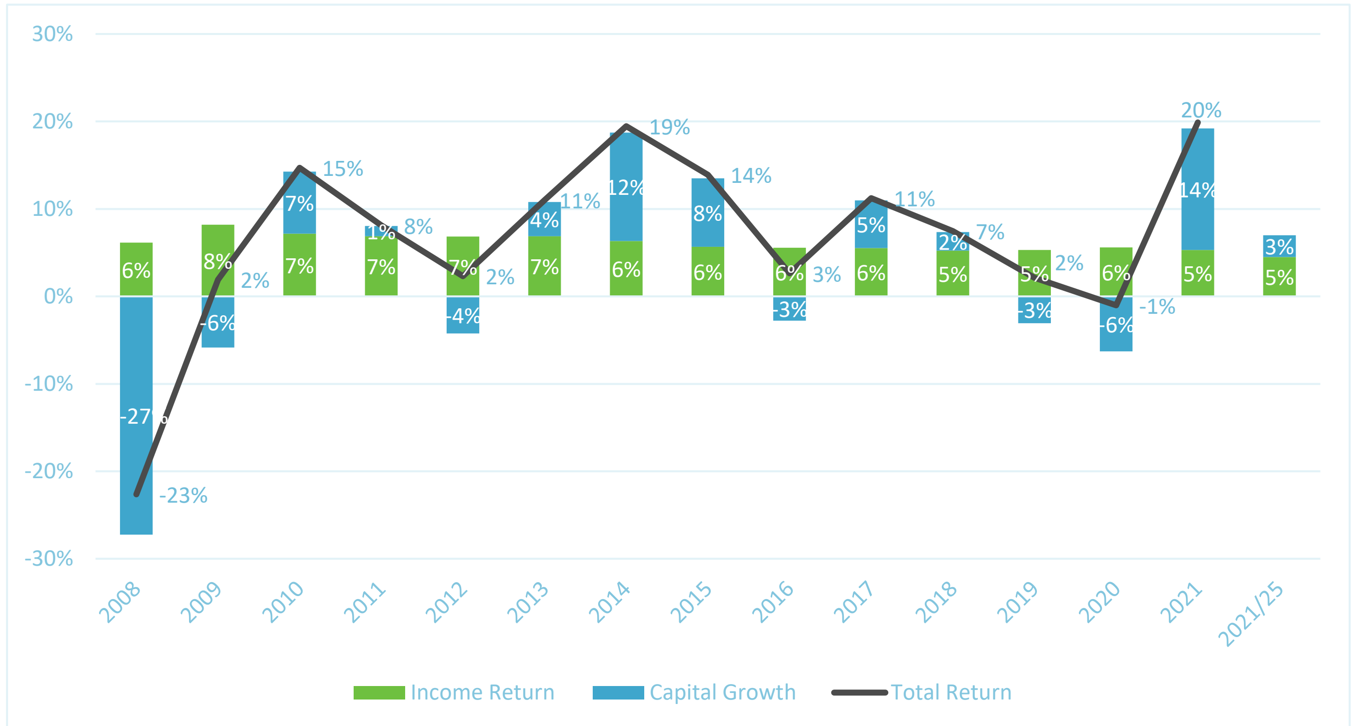
Commercial real estate debt refers to loans backed by real estate. A large proportion of investment in real estate is financed by a combination of equity and debt. Unlike equity owners, debt holders generally intend to be passive investors, earning an agreed interest rate throughout the life of the investment and repaid at maturity of the loan.

This article looks at why investors should consider an investment in real estate debt as part of a well-diversified portfolio, and how the asset class stacks up relative to equivalent rated corporate bonds and to equity investment in property. We also touch on how the market has evolved over recent years, what is driving the investment opportunity and potential considerations for investors.

Why consider real estate debt?

Core UK property is a long-established asset class for institutional pension fund investors. Investors are attracted to the asset class as it provides a relatively consistent income as well as potential capital appreciation and some inflation protection over the long term. The extent and direction of capital growth are variable, depending on the market cycle and on asset specifics, such as location and quality. After a strong 2021, with the Morgan Stanley Capital International (MSCI) UK Monthly Index returning 19.9%, the outlook for capital appreciation over the next three years has moderated considerably. Chart 1 below shows historic returns and the consensus capital appreciation forecast of 2.5% p.a. for the period 2021–2025, which is mostly attributed to the bounce-back last year in 2021.

Chart 1: Historic UK property (equity) returns and outlook



Source: MSCI UK Monthly Property Index to December 2021, IPF Research, UK Consensus Forecasts: Autumn 2021

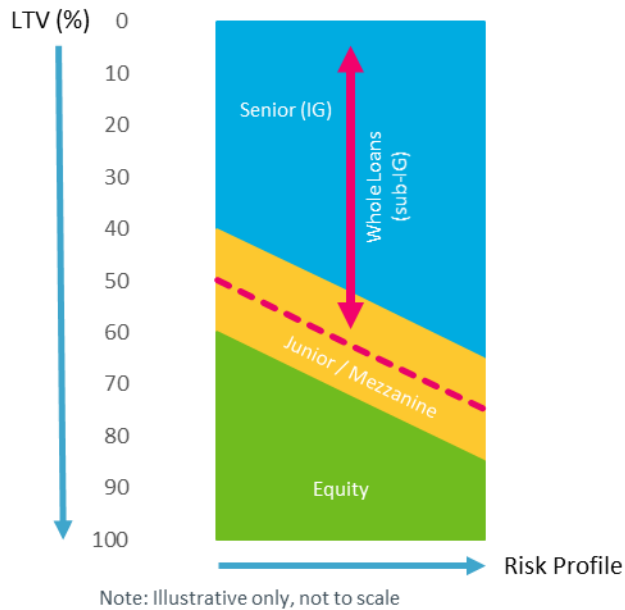
Real estate debt is a relatively new asset class to many institutional investors, but it can offer attractive risk adjusted returns when compared to both real estate equity and corporate bonds.

Returns can vary considerably depending on a number of factors:

- Stability of income depending on whether refurbishment or development is required;
- Where you are lending in the capital structure; and
- How deep a position you take.

Typically, whole loans (a combination of senior and junior debt) or subordinated loans generate a higher return from taking a higher level of risk than senior loans (Chart 2). The main measure of risk is typically loan to value (LTV), which is the ratio of the loan relative to the value of the property.

Chart 2: Example capital structure of an investment



What is driving the investment opportunity?

There are several factors driving the investment opportunity for real estate debt, which we'll consider in turn. These are:

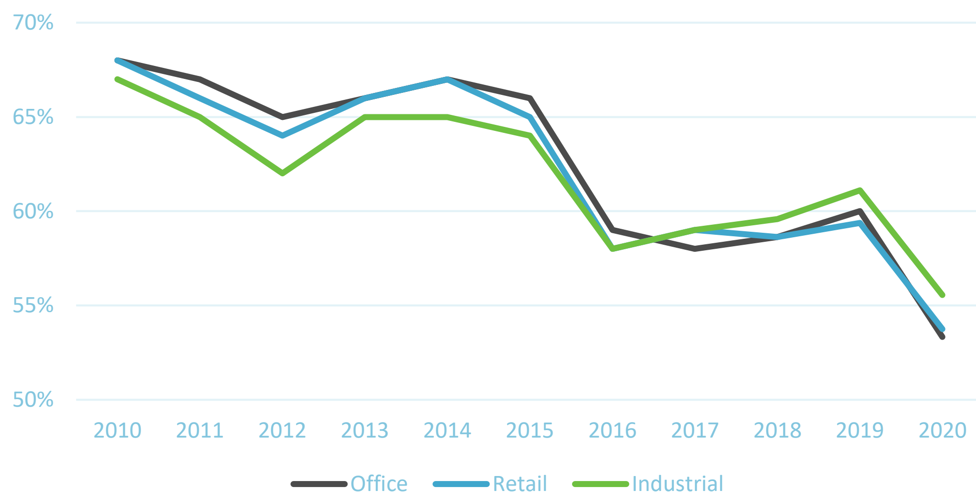
- Shortfall in debt capital
- Maturity profile of outstanding loan books
- Attractive yields in a low yielding environment.

Debt capital shortfall

In the years following the global financial crisis, banks significantly pared back lending due to changes in regulations, which forced them to hold more capital against their debt issuance. The resulting financing gap was particularly marked in the UK and European real estate market.

Following the Covid-19 pandemic, banks have retrenched further, focusing solely on key relationships and on properties with low LTV ratios. The average LTV across bank lenders is now below 60%, a radical change from the LTVs of around that we saw before the financial crisis. This demonstrates the marked conservative nature of most bank lenders (Chart 3). This leaves an opportunity for alternative lenders to invest in higher LTV loans.

Chart 3: Average of maximum senior loan to value ratio (%) by property sector, 2010–2020



Source: Business School (formerly Cass) Commercial Real Estate (CRE) Lending Report YE 2020

Loan maturity profile

A large wave of loan maturities is due for refinancing in the next five years, which we expect to lead to high demand for real estate debt. According to Cass Business School's Commercial Real Estate (CRE) Lending Report 2020, approximately 80% of all outstanding loans in the UK are due for repayment between 2021 and 2025. With many banks unable to refinance the loans on their book at similar terms, their borrowers will seek alternative lenders.

Attractive yields

Real estate debt vs equity

Equity investors in real estate are exposed to variable capital appreciation/depreciation and accept the first loss (or all losses if there is no debt finance). While this can generate significant returns in certain market environments, e.g. returning close to 20% last year, forward-looking forecasts show more normalised expected returns.

With real estate debt, the LTV will be approximately 50–85% and investors can earn returns of 3–8%+ with the additional benefit of no stamp duty on transactions. This means that asset valuations need to drop by more than 15% before debtholders take a principal loss. This has only happened during the global financial crisis in 2008, and it's worth highlighting that income returns remained stable throughout.

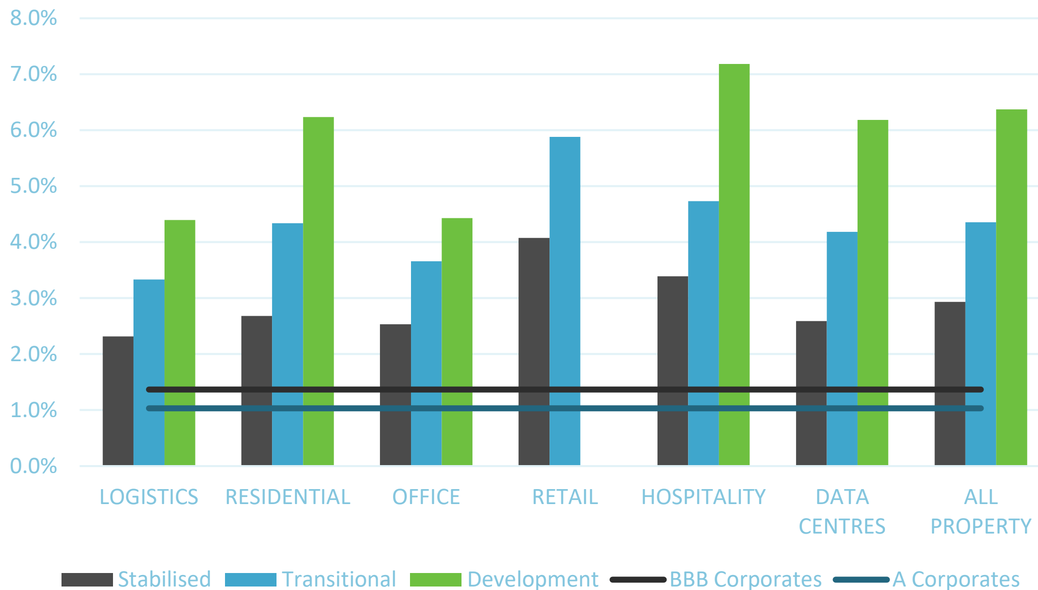
Given the favourable position in the capital structure over equity, we believe that real estate debt returns offer an attractive risk-adjusted return for investors who can withstand the illiquidity.

Real estate debt vs corporate bonds

Real estate debt typically falls into the income-focused part of investors' asset allocations. Compared to corporate bonds, real estate debt provides a significant pick-up in yield (Chart 4) even given recent spread movements in public credit. This is due to the illiquidity premium, as loans tend to have 3–7 years' tenor and there is no established secondary market meaning the debt is held to maturity.

On a risk-adjusted basis, the case for real estate debt is further supported by typically higher recovery rates versus corporate credit since the debt is secured on a physical asset.

Chart 4: Real estate lending returns versus competing fixed income investments, low LTV and varied levels of asset maturity, September 2021



Source: CBRE Investment Management, Refinitiv, BofAML. CBRE Investment Management define Low LTV lending as 50%.

Conclusion

An allocation to real estate debt has the potential to form an integral part of a well-diversified portfolio. It can serve as a good diversifier from other forms of private debt, such as direct lending, and also from real estate equity. Expected returns are lower than equity returns, but lenders are better protected as they are higher in the capital structure, earning more certain income from an asset that will repay its debt prior to paying equity owners. There are structural factors that should support debt pricing, namely bank retrenchment and a wave of upcoming loan maturities.

Real estate debt is an illiquid asset class with typical fund terms of around 10 years. More open-ended funds are being launched, which may allow a shorter lock-up period, but the underlying liquidity could still be challenging. A lock-up of capital may not be appropriate for some pension schemes with improved funding levels who are expecting to reach their end-game sooner.

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