Market Insights

Bricks, mortar and loans

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Real estate debt is gathering momentum among bond investors.

Key takeaways:

- Senior secured real estate loans feature bond-like cash flow profiles with predictable returns equivalent to that of investment grade bonds, virtually zero sensitivity to interest rates and low volatility.
- They provide sizeable diversification benefits and are secured by top-ranking securities including mortgages). Senior debt investors are the first to be paid in the event of a default.
- The asset class fits with the aims of many insurance portfolios thanks to favorable treatment under the EU's Solvency II Directive.

Real estate debt is not yet a mainstream investment and is not found in all institutional investor portfolios, but the concept is nevertheless quite simple: it's an investment in bricks and mortar. The main difference with direct real estate investment is the level of comfort that its debt investment provides to investors. Whereas direct real estate investing can be volatile and capital values are at risk, **real estate debt – and senior secured loans particularly – have predictable returns and low volatility**. And, importantly, senior debt investors are the first to be paid if something goes awry.

Returning the equivalent of investment grade bonds, senior real estate loans are secured by first ranking securities, such as mortgages, on all kinds of properties. In short, they have a **bond-like cash flow profile, while being fully collateralised byreal estate assets**.

Deep market provides downside protection potential

Senior commercial real estate loan investing may not yet be mainstream, but there is a substantial market for them, similar in size and issuance to high yield. With c. €100bn of new issuance last year in Europe alone[1], **senior real estate loans permit considerable diversification**, allowing loan investors to choose the assets best suited to their strategy's target returns and their clients' needs.

The loans themselves are backed by a huge range of real estate assets, including office buildings, retail properties, residential properties, multi-family housing, student housing, senior housing, hotels,light industrial assets and logistics assets.

This allows good diversification, which is one way of protecting capital. By limiting the average loan-to-value (LTV) of a portfolio to 70% investors can obtain further downside protection. Put another way, a building would have to lose about 30% of its value before a real estate senior loan strategy would suffer anyloss.

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What lies behind the emergence of the real estate loans market?

The loans market is closely linked to the real estate investment market, in which transactions are at historical highs, leading to high demand for leverage. The leverage is provided by a combination of banks, insurers and debt funds, with the need for alternative sources of capital rising fast as banks' capacity to hold loans on balance sheet is declining.

Banks provided around 90% of real estate financing before the global downturn – there was €2.4 trillion of commercial real estate loans on banks' balance sheets in 2007[2]. With the European CMBS market virtually closed and the need for financial institutions to become "asset light", there is a **need for alternative partners in order to distributeloans**.

Low defaults, low losses, solid yields

Senior secured real estate debt does what it says on the tin. That is, **it has a full security package**. It benefits from first ranking security interests over the real estate assets, and over various receivables such as rents, insurance claims and hedging agreements.

The default rate has been zero on issuance since 2012. But should default rates rise, investors would benefit from a lower than average losses given default compared with other debt instruments. **Recovery rates are high** driven by the quality of the securities and the control provided to creditors under the loans documentation.

Real estate debt generally compares well with other asset classes in terms of risk profile and expected yields. Recent market conditions across the debt markets spectrum have produced compressing margins while transactions have been structured more aggressively in terms of covenants, gearing, LTV and so on. But returns remain up to 100bps higher than corporate debt with similar levels of credit risk (i.e. investment grade or crossover senior secured facilities)[3]. Moreover, although transaction gearing is rising, borrowers remain well capitalised and markets are not showing signs of overheating.

Diverse return sources

The depth of the asset class means that a number of different strategies can be deployed across the senior real estate loan risk spectrum. We think a combination of four strategies can deliver most value to investors.

- The first is investment in **core real estate in the most developed European property markets** – the UK, France, Belgium, the Nordics and Germany. This core strategy should be more than 60% of the portfolio.
- The second strategy is **investment in loans backed by a pan-European portfolio**. This may provide slightly higher margins than the core strategy. It is an opportunistic trade which typically occurs when a real estate equity sponsor decides to sell a geographically-diversified portfolio. Such portfolios tend to be sizeable, so only lenders able to draw on considerable capital and manage multi jurisdictions are given access to and are able to participate in these deals.
- The third is **"country premium",** or allocating to peripheral European countries. These loans are usually backed by prime buildings in countries such as the Netherlands, Spain, Italy, Austria and Ireland. Because these markets have less depth and the economies are more vulnerable, debt investment should total no more than 20%-40% of the total portfolio.
- **The final strategy is what we call "value add",** which can provide significant yield pick-up. This strategy is about lending in core countries on real estate projects which are backed by assets which could be turned into core properties with proper asset management. The assets may be well located, but perhaps need repositioning or renovating. Or they may be desirable for their high technical specification, but have a temporarily high vacancy rate due to a large tenant moving out.

Picking a way between the markets

Viewed from outside, Europe is a single market. **From a vantage point within Europe itself, the differences between the states are considerable**. This applies no less to the real estate market than to the broader economies. While the UK real estate market and particularly the central London market, is relatively expensive, for instance, with rents still rising, in France prime rents in Paris CBD are significantly lower than central London (€800 & €1.475/sqm as of Q4 2015)[4]. This clearly makes the French market comparatively attractive and investment opportunities easier to find. In a more expensive - and potentially volatile - market like the UK, it makes sense to lower the LTV to provide a higher cushion in case of a decline in rental prices and capital values. Recent transactions on Core assets in France and UK are providing margin in the range of 130/185.

Meanwhile, in **Germany**, margins are much lower than in other core markets due to the widespread use of Pfandbrief, or AAA-rated covered bonds, for financing real estate transactions. The low margins make Germany, for the time being, a competitive place to source loans.

Matching needs of long-term investors

The risk-return profile of senior commercial real estate loans is compatible with the expectations of long-term investors with substantial fixed income portfolios. In addition, the asset class has virtually zero sensitivity to interest rates and exhibits low volatility.

In particular, **the asset class fits with the aims of many insurance portfolios thanks to the favourable treatment of loans under the EU's Solvency II Directive**. The Solvency Capital Requirement (SCR), under Solvency II, stipulates the capital that insurance companies are required to hold and is based on a formula that is designed to take all quantifiable risks into account.

To illustrate this, the SCR on real estate equity is considerably higher than investing in real estate debt, which can severely penalise any returns on equity investments by insurers. In fact, the SCR on equity investments are up to five times higher than for debt investments[5] .

Branding, resources and fund size open doors

The success of a senior commercial real estate loans strategy depends on experience, contacts and old-fashioned research. Knowledge and experience of both financing techniques and real estate is a prerequisite, as are sufficient financial resources to put people on the ground in a large number of locations.

Sourcing the loans relies on direct contact with individuals at borrowers, sponsors, brokers, lenders, banks and even other debt providers, right across Europe. **A sizeable fund and a strong brand name** is often necessary to be visible in the marketplace and to get an early seat at the table, which is key to obtaining decision-making power over key issues that will be incorporated in the loan documentation.

Did we mention the search for a maximum control over loss risk? Here it is again

The obsession of a senior loan strategy is to reduce the risk to bear losses to a minimum. Long-term institutional investors representing the needs and ambitions of savers need to be sure those needs are met. The definition of a successful portfolio of senior secured real estate loans is not just about margins, but **ensuring that the loans are fully paid back at maturity**. Why else invest in senior loans?

The underlying risk of real estate loans will never be fully mitigated. RE senior secured loans are providing with tangible guarantee where lenders investment are protected through first rank lien on mortgages.

[1] Source: Natixis Asset Management Research
[2] Source : AEW Research
[3] Source: Natixis AM analysis
[4] Source: AEW Research
[5] Source: Natixis AM analysis

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ADDITIONAL NOTES

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