European Commercial Real Estate Financing: An increased appetite to invest through debt funds

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Investment funds targeting Commercial Real Estate (CRE) Debt are experiencing strong interest from investors. The origins of CRE Debt fund growth trace back to the global financial crisis of 2008-9. Consequent of the financial crisis, stringent new capital requirements were imposed upon banks, resulting in a more conservative approach to origination. With this regulatory burden, CRE Debt funds experienced continuous growth over the past decade since the financial crisis, with overall industry assets-under-management reaching record levels, especially as banks were invited to distribute more. While funds and insurance companies represented less than 3% of the CRE lending landscape in 2010, they now represent over 20% of the market. This growth trend is indicative of the robustness of CRE debt, with investors drawn to the asset class for its diversification, its risk-adjusted returns in a low interest rate environment, its regular income stream and favourable treatment under Solvency II.

Notably, there have been concerns arising about a potential market correction, stemming from the recent geopolitical uncertainty and elevated market volatility levels, particularly following nine consecutive years of growth in AUMs until 2018. However, the CRE Debt market has entered 2019 with sustained albeit more modest growth. Moreover, the real estate lending market continues to emit positive signals, remaining a stable and secure realm of the fixed-income alternative investment universe.

Strong fundamentals of the European property market

Although the European economy has generally been growing, inflation has remained below the 2% hurdle rate defined by European Central Bank (ECB). The ECB appears to have adopted a passive stance from a monetary policy perspective, therefore interest rates will likely remain steady at least through the first half of 2020. Conversely, in response to slowing growth rates amongst a number of Eurozone economies, the ECB has implemented fiscal measures, reactivating long-term refinancing operation lending to banks in March 2019 to alleviate credit liquidity shortages. Subsequently, the level of capital availability remains relatively high. According to a 2019 INREV survey, investors plan to place an estimated €33bn of new capital into real estate assets this year. Thus, the fundamentals for sustained investment are supportive while the demand for CRE debt remains strong.

On the other hand, substantial market uncertainty caused by geopolitical instability (i.e. US-China trade-wars, Italian elections and Brexit) has been a major concern. While these market uncertainties are adding pressure on the wider real estate sector, CRE debt performance experienced a particularly strong finish to 2018, with the positive momentum persisting throughout H1 2019 and expected to continue for the remainder of the year.

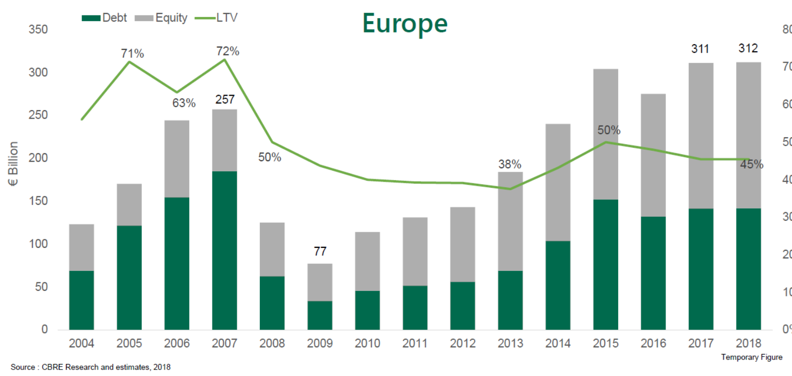
Although the real estate market is in the late stage of the cycle, the turning point is not imminent due to the weight of money targeting real estate, which still offers a significant premium to Government bonds (an average of 300/350 bps). Real estate market fundamentals are healthy with strong rental growth across the European markets in 2018 (+4%, source: BNPP RE, July 2019), which is expected to continue on average in most European cities from 2019 to 2023, given the low vacancy rates observed in most locations albeit with a wide variation across markets.

Fulfilling investor requirements

A key attractive aspect of CRE Debt investment is risk mitigation. More investors have been recognising the stable and defensive attributes CRE Debt. Despite uncertainty surrounding a potential market correction, 2018 witnessed €21 billion of global capital raised for senior, junior and whole loans; marking the fifth time in the past six years that capital raised for debt strategies surpassed €15bn (Source: REC, January 2019). In 2018, non-listed debt products attracted 13.8% of global capital raised for real estate investments, which is a notable increase from 6.9% and 8.2% seen in 2016 and 2017 respectively (source: Capital Raising Survey 2019, INREV).

Furthermore, CRE Debt strategies exhibit attractive risk-adjusted returns, with a floating rate feature that supports performance as interest rate rise. CRE Debt also sits at the top of the capital structure, providing investors with additional security and lower price volatility in the event of a price shift, particularly when compared to low-yield equity investments. Thus, the combination of strong asset class fundamentals, coupled with a long-term structure of investment delivering stable cash flows from inception makes investing in CRE debt an attractive opportunity.

Record in investment volumes with reasonable LTV levels



Finally, a more disciplined approach to debt origination contributes to providing further comfort to investors. Although real estate investment volumes have reached record figures in Europe, above 2007 levels, total loan amounts have remained lower than pre-crisis and Loan To Values (LTVs) have decreased from a peak of 72% to 45% on average.

Lending practices

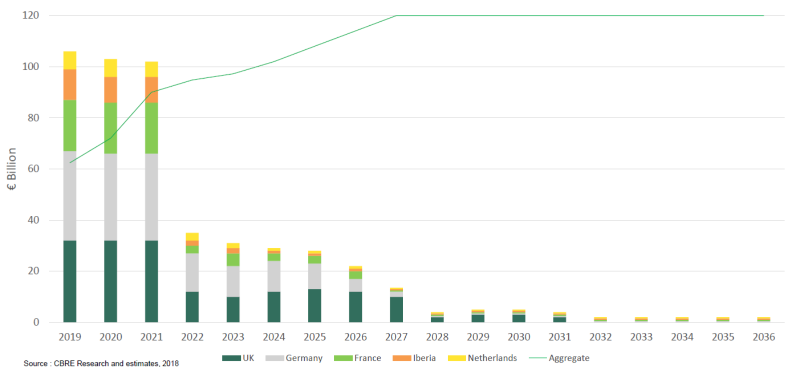
From a lending perspective, European debt markets continue to exhibit positive trends. With 75% of the European debt maturing by 2022 (Source: CBRE Research estimates, December 2018), the CRE debt market should benefit from a strong refinancing need to supplement new transaction volumes. Moreover, a deep and diverse pool of lenders are competing for opportunities to lend across a wide spectrum of sectors, from core to opportunistic strategies, and from traditional to alternative assets.

With the continuous search of yield and income, investors plan to diversify their portfolios through an increased allocation to non-traditional assets. Alternative sectors such as student accommodation, data centres, mixed-use properties and new business models with flexible leases have recently been sought-after, despite requiring specific expertise. Notably, in light of the revised Basel regime shifting from III to IV by 2022, lenders follow a high level of discipline in the structuring of real estate credit risk.

Final thoughts

As CRE Debt is benefiting from a favourable macroeconomic environment and tailwinds in the form of low vacancy rates and continuing growth, it is gaining recognition as an established component of institutional investor portfolios. Attractive characteristics of the asset class itself, such as the defensive attributes coupled with stable income, combined with a more conservative approach to financing than in previous cycles, lead to a continuous development in the European CRE Debt market.

CRE Debt maturity in Europe



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