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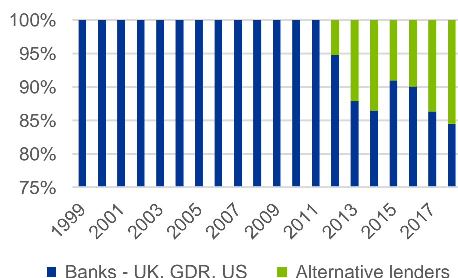
Uncertain times = Real estate debt?

Chart 1: **The 4 quadrants of real estate investment or the real estate cycle?**

Public Equity Listed markets	**Private Equity** Unlisted real estate
Public Debt CMBS	**Private Debt** Unlisted debt

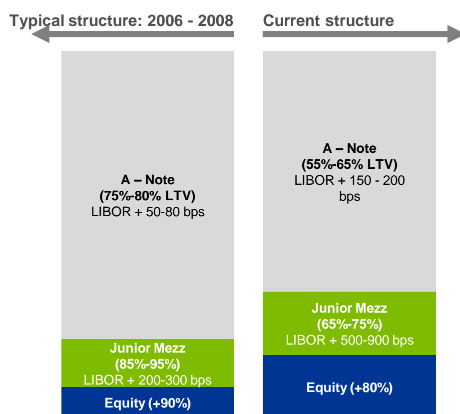
Source: BlackRock

Chart 2: **Share of UK lending by provider type or components of returns**



Source: Cass CRE Lending Survey 2018

Chart 3: **Typical financing Structure**



For illustrative purposes only

Source: BlackRock Real Assets Research

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Introduction

European real estate has a number of characteristics that make it an attractive choice for increased allocations in 2019, according to the recent INREV investor Intentions Survey.

The reasons cited for increasing allocations include: 1) A transparent and relatively liquid alternatives market, 2) the diversification benefits within a multi asset portfolio, 3) ability to add management to enhance returns, 4) the potential for a positive income return, long term risk adjusted performance and 5) the ability of real estate to provide a hedging proxy to inflation.

Over the long term, real estate has historically exhibited a low to moderate return correlation with other asset classes and therefore, we believe, can provide diversification within a multi-asset portfolio. The performance of European real estate has shown negative correlation with bonds and moderate correlation with equities over the 18-year period to December 2018 as measured by MSCI. The risk/return profile of European real estate lies between equities and bonds with performance exhibiting both equity and bond like characteristics[1].

Real estate performance can be accessed through public/private debt and equity, the relative attractiveness of each varies as we move through the real estate cycle. We believe that a combination of structural and cyclical developments have led to an interesting risk/return profile for real estate debt in Europe today.

European real estate

BlackRock's 2019 Global Rebalancing Survey indicates that 54% of investors intend to increase their real assets allocations in 2019. This is the highest for all asset classes, as investors are increasingly seeking exposure to real assets' stable yields, diversification benefits, and earnings growth potential. The survey suggests that rising allocations to real assets (and real estate) may come at the expense of reduced allocations to equity markets, as investors become more concerned with the economic cycle.

European real estate markets are diverse, composed of local trends, idiosyncratic risks, and unique opportunities. As a result, market performance across Europe is not synchronised and the market therefore offers a wide range of risk/return opportunities for investors. The size of the professionally managed, invested real estate market in Europe is estimated at USD2.8 trillion and represents around one third of the global universe. The remainder is split almost equally between North America and Asia Pacific[2].

European markets occupy 12 of the top 20 largest invested markets globally with liquidity being a feature of many European markets. Capital liquidity scores developed by Real Capital Analytics (RCA) measure property market liquidity by assessing the depth and breadth of investment capital in real estate markets globally. London, Paris and Berlin rank second, fifth and sixth respectively with several other markets like Frankfurt, Munich, Hamburg and Stockholm in the top 30 globally.

[1,2] BlackRock Real Assets: European Real Estate – Balancing Risks and Opportunities, October 2018

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A changing landscape for real estate debt

Increasing regulation has reduced bank dominance …

The European debt market remains relatively opaque compared to the established direct market. Opportunities in the real estate debt market have evolved out of the regulatory change imposed following the global financial crisis (GFC) to mitigate against future bank and sovereign failures. Consequently, alternative lenders have started replacing in part traditional bank lending as seen in Chart 2. The resulting structure of real estate lending has increased the opportunities for investors seeking access to real estate performance whilst closely managing their downside risk in the event of a market downturn or rising interest rate environment.

Prior to the GFC the real estate debt market was dominated by banks (UK and overseas) as shown by Chart 2. In 2007, banks originated 95% of new loan originations in the UK, Europe's most transparent market. The change was driven by banks refocussing on repairing their balance sheets and increasing regulation (including Basel III) that increased the capital requirement for banks' lending against real estate.

… paving the way for alternative lenders.

Whilst traditional banks currently remain dominant in the market, by mid-2018 they had reduced their share of new originations to 85%, with new debt sources, including debt funds, stepping in where banks have retrenched. We believe that incoming regulation, including Basel IV and rules that require higher capital reserves to be held against real estate loans will continue to drive banks towards mainstream vanilla real estate lending. Ultimately this will benefit alternative lenders poised to move into the resulting void in the market.

Real estate = real asset = downside mitigation

European real estate markets are entering a mature stage in the cycle …

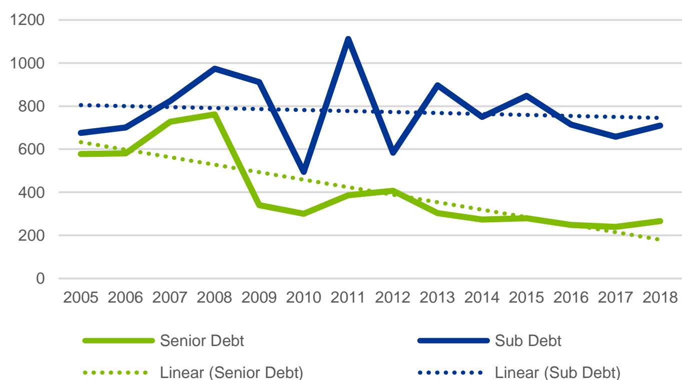
The return generated by an equity investment in estate comprises both contracted income and capital growth as seen in Chart 6 overleaf. The capital growth component of total return represents the changing value of the asset as assessed by external valuers, and introduces significant volatility into the total return. Equity investors experience this volatility as values fluctuate in response to the market and valuer sentiment. To a certain degree, real estate debt returns are protected against value volatility, and an investment in real estate debt will likely deliver more stable returns for a longer period of time even in an environment of falling values.

… however debt investors are relatively protected from capital declines.

Although protected by a significant equity buffer, investors in real estate debt are not completely protected against a falling market as a deteriorating economic environment will increase the likelihood of corporate failure and tenant default. In this case, lenders are able to protect their investment by enforcing their security and liquidating the underlying collateral. This is generally a relatively simple exercise as the borrower is typically an SPV, that only owns property, has no employees, or moveable assets.

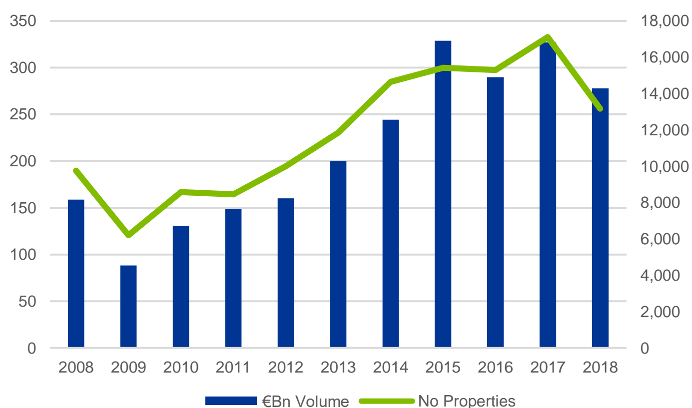
As UK & European real estate markets enter a more mature stage in the cycle, real estate debt investment provides an interesting strategy that can mitigate downside risk. The increased equity cushion and security ranking ahead of equity in the capital stack can all contribute to delivering attractive risk adjusted returns at this stage in the cycle.

Chart 4:
Senior and subordinated debt returns



Source: BlackRock December 2018; Returns are defined as the average annual 3 month Libor rate + Margin. Margin is reported by Cass CRE Lending Survey Mid-2018, based on UK Prime Office lending.

Chart 5:
European transaction volumes and number of properties



Source: RCA – European Capital Trends Q1 2019

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It's all about the income!

Income is the principal driver of real estate performance ...

Over the past 15 years, European real estate has delivered a strong income and predictable cashflow as shown in the chart below, income has provided in excess of 70% of the total return. Furthermore, the current dynamic in the European office market is characterised by vacancy rates significantly below average in most markets, driven by below average deliveries of new stock in a buoyant occupier environment.

As discussed in BlackRock's paper titled "European Real Estate – Balancing Risks and Opportunities", Europe is a region comprising diverse real estate markets and economies, and the unsynchronised nature of growth across the region leads to an attractive landscape for both equity and debt investors. The equity and bond like characteristics of real estate performance is further attractive to investors looking to capture capital growth cycles whilst also benefitting from a strong income component.

Following a period of strong total returns driven by both income and capital growth, the upcoming real estate cycle will be less focused on capital growth but more on income. Therefore testing the resilience of in-place income and ensuring appropriate senior interest hedging will be key to ensure healthy interest coverage for commercial real estate loans.

… and is attractive to investors seeking to match their liabilities.

The nature of senior and mezzanine real estate debt cashflows (interest and principal repayments) are attractive to fixed income investors such as pension funds or insurance companies seeking to match their anticipated liabilities with relatively secure and predictable investment returns. Unpredictability of cashflows resulting from loan prepayments is often mitigated by penalties attached to such early redemptions

Conservative lending

LTV's are now lower post GFC …

Real estate markets were not immune to the impact of the GFC with real estate capital values falling by in excess of 15% (as measured by MSCI Pan European Real Estate Index) peak to trough across the cycle, fundamentally changing financiers view of real estate risk. Pre GFC it was typical for senior loans to prime commercial real estate to be agreed in excess of 75% LTV, however, following the GFC, senior LTV ratios of 50-60% are now more commonplace, increasing the opportunity for specialist providers.

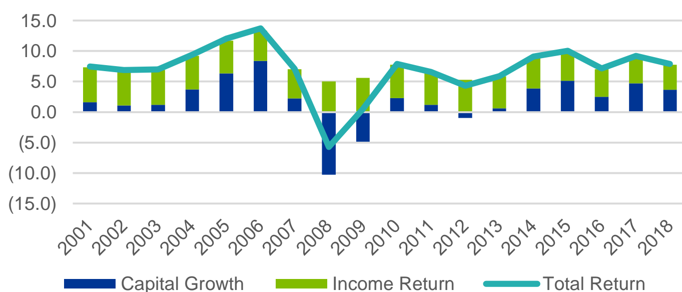
… increasing the opportunity for mezzanine lenders.

A simplified capital stack can be seen in Chart 3 where we compare a typical structure in 2007 with 2018 and highlights the increased equity cushion provided by investors today, a more conservative approach taken by senior lenders, and therefore corresponding growth in the market opportunity for alternative lenders.

Expecting LTV's to remain low.

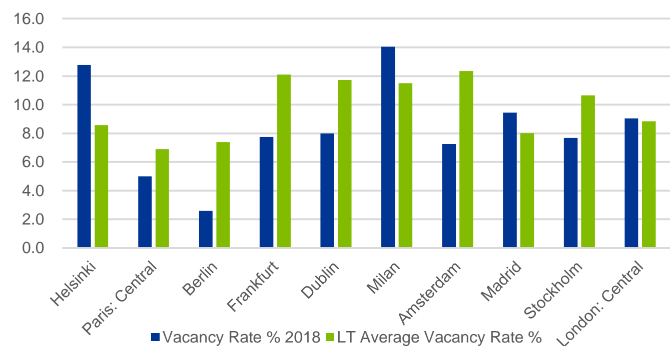
In the face of increasing regulation we expect senior LTVs to remain low compared with the previous cycle, increasing the attractiveness of real estate debt for alternative lenders. Despite disciplined LTV ratios and historically low interest rates, returns from senior debt have been volatile whilst subordinated debt returns have remained relatively stable as shown in Chart 4.

Chart 6:
European real estate - total return components % pa



The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.
Source: MSCI Multinational Digest, Pan European Index, December 2018

Chart 7:
European office vacancy as % stock



Source: PMA European Office Market Forecasts Winter 2018

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Real estate is a debt driven asset …

Among alternative lenders there is a wide range of acceptable LTV's with which lenders are comfortable. However, whilst the property sector has a strong influence on the decision of an equity investor, a debt investor is less influenced by sector, as they focus on the term, income coverage and sponsor to mitigate risk. The lower risk profile of real estate debt allows investors to create portfolios diverse in terms of asset type and jurisdiction, much more easily than direct property investment

Even for most core investors, real estate is still a debt driven asset class and in the context of increasing transaction volumes and increased competition for assets driven by growing globalisation of capital, we expect demand to continue to increase for loan facilities across Europe. Demand for European real estate has grown steadily over the past 10 years as has the actual number of actual transactions, as shown in Chart 5

... and demand will also be driven by refinancing.

Furthermore, according to the latest INREV Fund Termination Study, there is a wave of fund terminations between 2018 and 2022, and, in excess of 90% of funds have provisions to extend or rollover. Current market conditions (as we enter a downcycle) will likely dictate that extension clauses are exercised therefore driving further demand for debt refinancing and recapitalisation.

Market selection. What do we like and why?

The idiosyncratic nature of direct real estate markets is reflected in the diverse range of opportunities for real estate debt lenders across Europe. As such some jurisdictions are more attractive to a real estate lender than others through a combination of real estate market dynamics, the economic cycle and regulatory environment. In the following table we summarise the pros and cons of the main European markets alongside the two main categories of real estate debt.

Senior

+
- Senior position in the capital stack.
- Predictable and stable income.

-
- Competing with banks and other regulated lenders.
- Low volatility, low returns.

Junior

+
- Downside mitigation
- Returns have held up well versus senior debt, therefore offers better value as LTV's have fallen.
- Avoids competing with banks and other regulated lenders.

-
- Subordinated.
- Higher leverage than senior.

Market views

Market	Views
France	• Large and diverse economy. • Size/scale of Paris as a global city. • Strong banking sector. • Increasingly business-friendly environment. • Low unemployment.
Germany	• Consistently performing economy. • Solid domestic fundamentals with diverse export base. • Good public finances. • A liquid real estate market. • Ageing population. • Lack of global city. • Very low yields. • Competitive lending environment
Netherlands	• Strong economy. • Business friendly tax regime. • Liquid and transparent real estate market. • Brexit-based interest?
Belgium	• Relatively stable market. • Continued demand from national and European administrative users. • Political instability.
Spain	• Strong forecasted economic growth. • Employment market positive trend. • Political instability.
UK	• Landlord and lender friendly regulatory environment. • Strong economy. • Attractive relative yield spread. • Uncertainty created by EU departure. • Constrained banking sector? • Liquid and transparent real estate market.

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Risk Warnings

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Risks associated with ownership and operation of real estate assets: Real estate funds may be exposed to risk of loss arising from, or relating, to the ownership, operation or management of any real estate in which it has an interest.

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