For Investment Professionals only

Seeking risk mitigation and return potential

The investment case for European commercial real estate debt

February 2023

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance.

Commercial real estate (CRE) debt can offer attractive risk-adjusted returns with the benefit of hard asset security and structural protections, minimising the impact of potential real estate value falls. The asset class reflects a defensive investment opportunity that can be accessed by institutional investors across the risk/return spectrum, through strategies targeting senior debt, mezzanine debt or a blended approach.

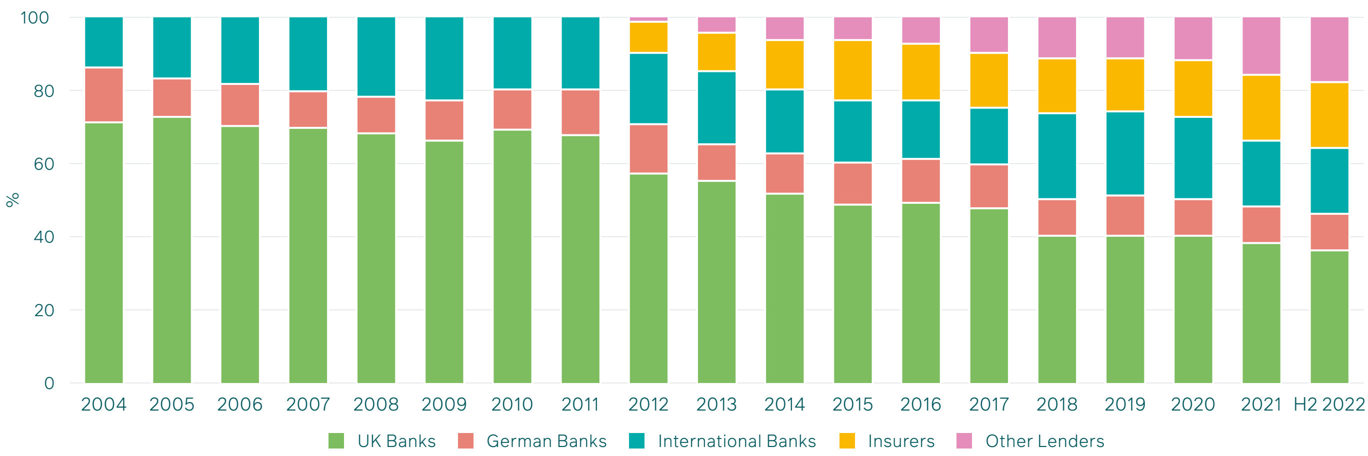
The European CRE debt landscape

Investing in European CRE debt provides an opportunity to deploy capital at scale and benefit from attractive dynamics. Today's market is estimated to total more than €1.8 trillion[1] and non-bank lenders are an established source of finance for borrowers, particularly in the UK and increasingly in Continental Europe.

In the UK, non-bank lenders represented around 36% of the overall market at the H1 2022[2], having been gradually increasing since 2012. In Europe, non-bank lenders' market share is still much lower, at around 6-7%[3]. Both the UK and Europe lag the US, where non-bank lenders represent 35-40% of the market[4].

Traditional bank lenders remain constrained in their ability to hold higher leveraged loans secured against real estate as a proportion of their overall lending book, owing to greater regulatory capital requirements. Further, evolving regulation could impact some European banks' appetite for lower risk loans by introducing a minimum capital requirement on their internal risk weighting models. As a consequence, LTV ratios are likely to remain conservative and loan margins have the potential to offer attractive returns on an absolute and relative value basis.

Figure 1. Outstanding loans by lender type



Source: M&G, Bayes Commercial Property Lending Report, H1 2022.

[1] PGIM Real Estate, September 2021.
[2] Bayes Commercial Property Lending report, H1 2022.
[3] Schroders, July 2021.
[4] Schroders, July 2021.

Capital structure seniority: senior CRE debt

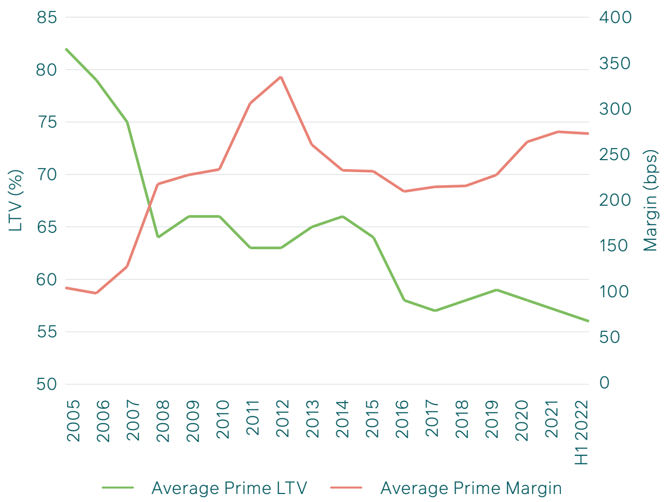
Senior CRE lending offers investors access to the least risky part of the capital structure. Senior loans are made at conservative loan to value (LTV) levels, having stabilised at between 50% and 60% following a substantial drop post-Global Financial Crisis.

Conservative LTV levels mean that significant falls in the value of underlying real estate assets can be withstood before principal is exposed, supporting capital and return potential. Senior lenders also benefit from first-ranking security over the underlying real estate and priority access to cashflow from the property.

Loans can be structured to achieve an investment grade style risk profile and typically require interest to be paid in cash on an ongoing basis, providing investors an ongoing cashflow stream.

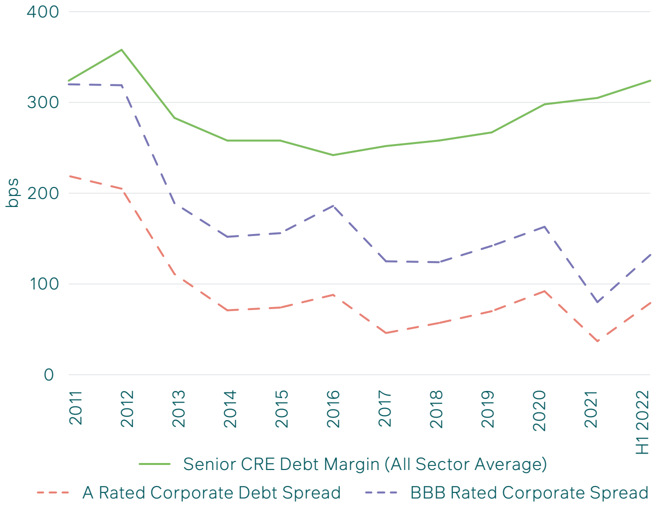
The significant pull back of traditional banking capital post-Global Financial Crisis has also resulted in an increase in achievable returns. Consequently, senior CRE debt secured against typical income producing assets can offer investors a spread premium relative to similarly rated corporate bonds, as demonstrated by Figure 3. These returns can be further enhanced by investing in transitional and development loans, where financing is less prevalent, interest is typically capitalised and specialist skills are required to underwrite, structure and monitor transactions.

Figure 2. Senior UK CRE debt margin and LTV



Note: Based on office, retail and industrial sectors.
Source: Bayes Commercial Property Lending Report, H1 2022.

Figure 3. UK senior CRE debt margin vs corporates



Note: BBB and A rated corporate 3-5 year asset swap spread.
Source: Bayes Commercial Property Lending Report, H1 2022.
BofA Merrill Lynch, as at June 2022.

Embedded protection against real estate value volatility: mezzanine CRE debt

Mezzanine CRE debt occupies an intermediate part of the capital structure, ranking ahead of equity but behind senior debt. Returns are higher than for senior debt on an absolute basis to reflect this subordinated position.

Given that mezzanine occupies a debt position in the capital structure – with LTV levels typically ranging from 60% to 80% – returns also benefit from an equity cushion. The equity owner bears the first loss in the event of real estate value deterioration, whereas mezzanine debt returns can remain stable in an environment of falling real estate values.

A blended approach

Investors are not constrained to a senior or mezzanine real estate debt strategy. Those looking to generate returns ahead of senior CRE debt at a risk level below mezzanine debt on a portfolio basis can invest in strategies that are able to invest in both areas of the capital stack, enabling investors to achieve a blended risk and return profile, similar to a whole loan offering.

Managing risk in CRE debt

Risk mitigation is relevant for all types of CRE lending and can be implemented through a number of measures.

Prudent underwriting

An important part of prudent loan underwriting involves extensive due diligence to establish the sustainability of a property's cashflow and its ability to service interest and support debt repayments. This includes an assessment of the credit quality of tenants; the terms and length of leases; any current, contracted income; and the ability to replace income on an ongoing basis. For instance, property level data can be explored to analyse historical volatility of rents and yields, enabling the lender to assess debt recoverability in a range of market environments.

Whilst scheduled loan interest payments can make cashflows predictable, borrowers' right to repay their loan at any time has the potential to affect return on principal. This risk can be mitigated by a prepayment penalty within the loan term in the event a borrower decides to repay early.

Bespoke documentation and covenants

M&G believes bespoke loan underwriting and structuring are a prerequisite to achieving target returns. Incorporating investor protections like financial covenants upfront can help to protect against the risk of capital loss. The key contractual terms of each deal are customised and scrutinised to ensure the investment reflects the specific risks of the underlying property and the business plan of the borrower.

The role of financial covenants is to provide an alert to lenders in the event of any potential deterioration in a borrower's ability to service debt and/or a lender's ability to recover principal. By setting these stringently, lenders are able to take early action, take greater control around any workout and ensure borrowers remain financially incentivised to take remedial action. Typically, these covenants include cash sweep triggers which allow control of the cashflow to be taken and default covenants which, in the extreme, allow enforcement action to be taken.

Managing interest rate risks

Rising interest rates can impact the ability of the underlying borrower to meet its interest and debt service obligations, particularly if income from the property does not increase in line with rate rises. Cashflow underwriting can help to project a level of rate rise that may be tolerable. Negotiation of an interest rate hedge with the borrower can further mitigate risks from a rising rate environment.

Managing inflationary risks

Inflationary risks can manifest in a number of ways in CRE lending. For example, rising costs can reduce net operating income generated by the underlying property and impact the ability for interest to be serviced. In the context of a development loan, rising construction costs may mean that a development scheme no longer has sufficient funding to reach completion.

Income from the underlying real estate may have some inflation linkage (for example RPI or CPI-linked leases) which can help to offset rising costs, though it would be unlikely for the inflationary impact on income and costs to perfectly align.

Risk mitigation techniques can include negotiating cash reserves with a borrower to provide support if operating margins were squeezed, and ensuring that fixed price building contracts and appropriate contingencies are in place to mitigate against construction cost rises.

Loan monitoring

Loan monitoring is vital in order to track the performance of investments and seek to deliver on target returns. M&G advocates the continuous monitoring of covenants throughout the term of a loan and testing against ongoing performance. Key Performance Indicators (KPIs), which measure pre-agreed targets over the course of a loan should also be tracked as part of active risk management.

Manager selection

Investment in CRE debt requires sufficient scale and property market expertise. Investment managers with full-scale capability and specialist real estate and restructuring expertise are able to leverage their market insight to help source deals, underwrite risk and manage potential workouts.

Managers with a unique financing proposition, strong deal sourcing capabilities and long-term relationships are often best placed to source attractive risk-adjusted opportunities across geographies and sectors. In M&G's case, this constitutes a focus on self-origination with senior and mezzanine investment capabilities, held to maturity, with the ability to provide large-scale debt financings.

Increasing focus on ESG considerations in CRE debt

Environmental, social and governance (ESG) issues are becoming an increasing area of focus for property owners and lenders, and the landscape continues to develop at a significant pace in the CRE lending market.

To ensure lenders are capturing these issues, the creation of an ESG framework can help to embed ESG principles in the investment process. This may incorporate minimum levels of green- or sustainability-linked loans within investor portfolios; stringent exclusions relating to occupiers' activities; and KPIs designed to track improvements in the energy metrics and green credentials of underlying assets during the term of a loan.

Data sharing between occupiers and property owners continues to increase and collaboration among industry groups and lenders is likely to improve this further. M&G has taken a leading role in this area by seeking to create a unified standard for data that should be collected by landlords on behalf of lenders. The development of third-party carbon estimation technology should also help lenders gauge the carbon impact of occupiers and assets where this information is not readily available.

M&G: Taking a unique investment approach to drive value

M&G has grown to become one of Europe's largest non-bank debt providers[5], having been an early mover in CRE lending. As part of M&G's £76.7 billion Private & Alternative Assets business[6], the Real Estate Finance team has committed over £13.2 billion in commercial real estate loans[7] across more than 130 transactions in the UK, Europe and the US. M&G has raised and invested capital across both senior and mezzanine CRE debt strategies on behalf of more than 100 global institutional investors.

M&G has a track record of more than a decade in deploying significant volumes of capital to achieve attractive target returns for investors. Working in close collaboration with M&G's breadth of real estate equity and restructuring experts, the Real Estate Debt team continues to source a deep pipeline of opportunities and evolve its proposition to meet both investor and borrower demands, including in the rapidly developing ESG space.

[5] Real Estate Capital, Europe's Top 50 Lenders 2022: The Alternative Lenders, December 2022.
[6] M&G, as of September 2022.
[7] M&G, as of January 2023.

M&G Investments

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