Product development

November 2023

The growth of real estate debt

Since the beginning of 2023, the number of managers adding real estate debt to their product arsenal has increased significantly. The current market environment, characterised by diminishing credit supply, rising interest rates, and higher margins, has led to what many managers believe to be a unique opportunity in real estate debt, not seen in the last decade.

This article looks to demonstrate the recent growth in funds dedicated to real estate debt, analysing the key drivers and investor demand.

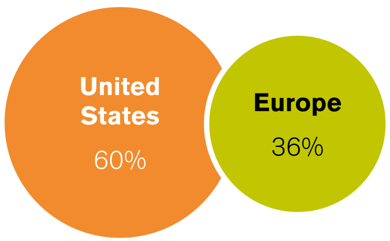
Read on

A growing number of managers are launching real estate debt funds

Real estate debt funds became more popular after the global financial crash (GFC) as traditional sources of financing dwindled due to a combination of increased regulatory scrutiny and a crash in property values. At the time, several real estate managers expanded into debt, particularly in the US as property values suffered more compared to Europe. From 2007 to 2009 US commercial property prices declined by almost 40% compared to 20% in Europe[1]. During this three-year period, at least 13 new US real estate debt managers emerged including Blackstone, Apollo, and CBRE, compared to only three in Europe[2]. Since then, the percentage of real estate managers that have a debt strategy has steadily increased and currently 60 of the top 100 US real estate managers have a real estate debt fund verses 36 in Europe (including the UK).

The expansion from real estate into real estate debt appears to have been more natural than the expansion of private debt into real estate debt – out of the top 100 US private debt managers only 25 have a real estate debt fund. Additionally, only eight of those 25 managers did not have a real estate equity fund prior to launching into real estate debt.

Percentage of top 100 real estate managers with a real estate debt fund

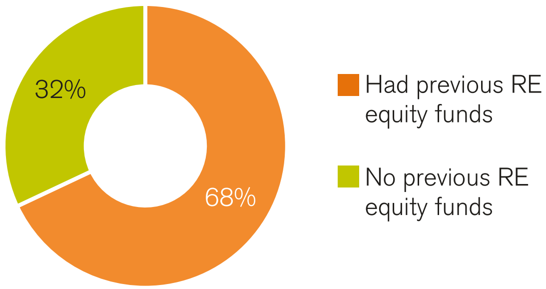


Source: Preqin Ltd.

This can be attributed to the specialisation that is required when underwriting real estate loans – managers with real estate equity practices can benefit from in-house valuation and asset management expertise, which may allow them to better appraise assets and manage downside scenarios if they need to take control of the assets. The pace of regulatory change in real estate also adds significant risk to the asset class, managers without sufficient expertise may underestimate the potential impact this has on the underlying asset.

Additionally, most pure-play private debt managers operate diversified strategies and do not have sufficient in-house resources to create a dedicated real estate debt fund. Still, there are some examples of private debt managers expanding into this strategy.

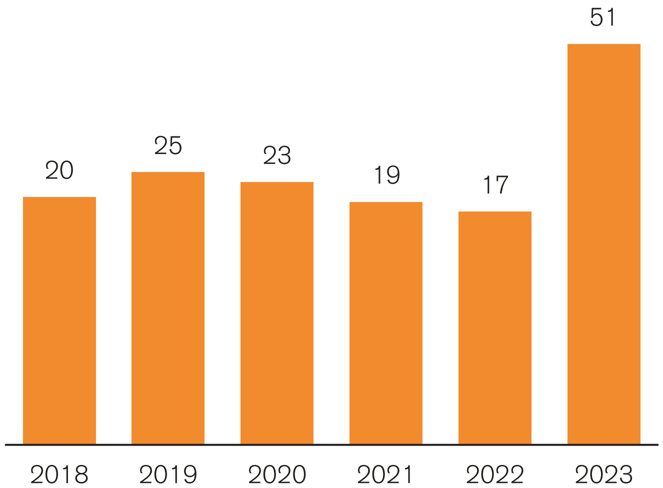
Background of US private debt managers that have expanded into real estate debt



Note: Macfarlanes analysis of Preqin data, based on the top 100 private debt managers in the US by funds raised in the asset class.
Source: Preqin Ltd.

Currently, we are seeing a resurgence in real estate debt funds to take advantage of favourable market conditions that have not been experienced in the last 10 years. In 2023 so far, at least 10 fund managers have launched their first real estate debt fund including Bain Capital, Tikehau and TPG. Existing managers are also contributing to this growth with several announcing new fund launches in 2023. In fact, the number of real estate debt fund launches grew three times from 2022 to 2023.

Number of real estate debt funds launched per vintage



Note: For closed end comingled funds.
Source: Preqin Ltd.

However, AUM data does not yet reflect the growth in this strategy. When looking at the past five years, the AUM growth for real estate debt funds pales in comparison to that of real estate equity or private debt funds.

A possible explanation is that several funds are still currently fundraising – fundraising in 2023 has been challenging across asset classes, leading to fundraising periods becoming more prolonged.

Still, several sources expect debt strategies to play an increasingly larger role in real estate – according to PERE's fundraising data, in Q1 2023 debt represented 24% of capital raised across real estate strategies, up from 15% in Q1 2021.

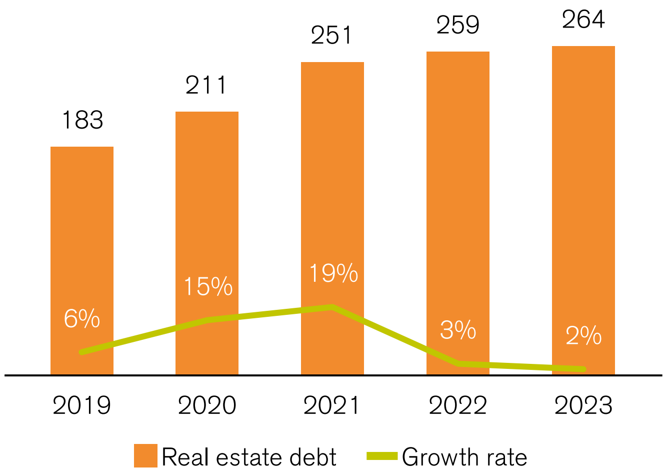
Managers launching their first real estate debt fund in 2023

- TPG
- Fiera Capital
- Fundrise
- Northwood Investors
- Castlelake
- Warburg
- Northcap Partners
- Tikehau Capital & Altarea (in partnership)
- Silverton Group
- Bain Capital
- Hilco Real Estate Finance

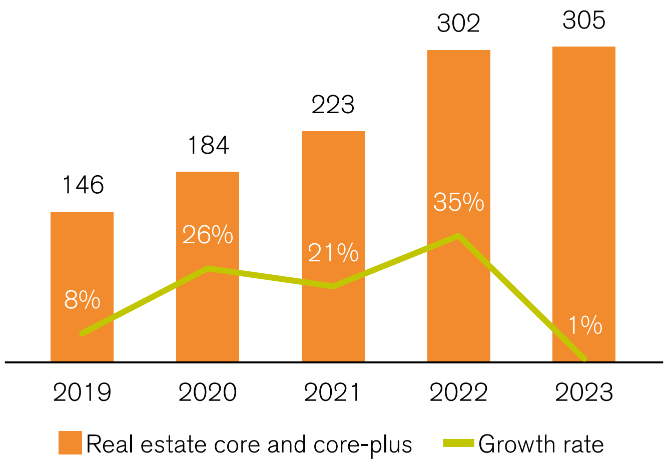
Note: This list is not exhaustive.
Source: Company announcements.

Comparison of AUM growth across asset classes ($bn)

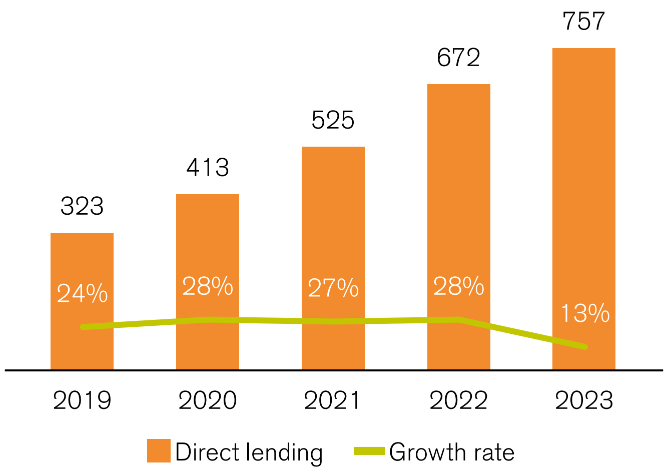
Real estate debt funds



Real estate equity funds



Corporate direct lending funds



Source: Preqin Ltd.

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Real estate debt as part of existing private debt funds

Although many managers, particularly in Europe, have not yet created dedicated real estate debt funds, that does not mean they are not still able to take advantage of opportunities in the space. Tikehau for example, prior to launching its first real estate debt fund in 2023, already had a track record in this strategy of €500m[3] through its special opportunities strategy.

As mentioned previously, private debt funds tend to be diversified with little concentration restrictions on sectors. This means that most funds have flexibility in their mandates to invest in real estate. Given the returns currently achievable within real estate debt, more deals are becoming suitable for the return profile of private debt funds, particularly for more opportunistic funds where managers have the flexibility to move around the capital stack in pursuit of opportunities.

Fund managers opting to invest through existing vehicles should be cautious about investor sentiment as some investors may not wish to increase their exposure to real estate through a private debt fund, given the impact on their portfolio-level target allocations and diversification goals. Some investors may have included concentration limits in their side letters and therefore may be excluded from investments that surpass that limit, but the majority typically do not have this protection.

What is driving this growth?

In the past year, great emphasis has been put on the size of the "maturity wall" that will hit the US and Europe by 2025 i.e. the value of existing debt that will mature by that date, most of which will look to be refinanced. For commercial real estate (CRE) this is estimated as €150bn in Europe[4] and $1.5tn in the US[5].

High interest rates and supply-side retrenchment have transferred more power to remaining lenders. This is leading to a tightening of terms and superior risk-adjusted returns.

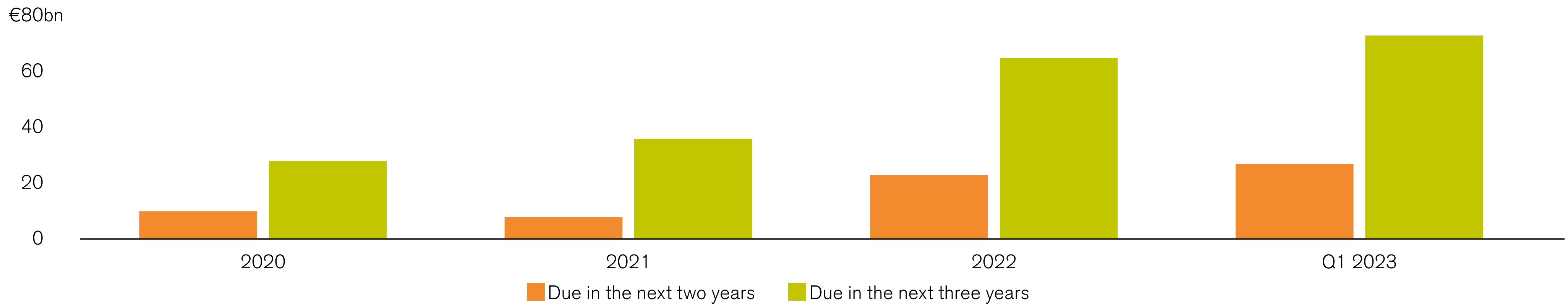
Supply-side retrenchment

- Banking caution and regulation.
- The worsening of key metrics for existing loans – LTVs and ICRs.

Opportunities for alternative lenders

- Higher returns as a result of higher base rates and widening credit spread.
- Increased negotiating power.

European leveraged loan maturity wall (€bn)



Source: Pitchbook LCD – Morningstar European Leveraged Loan Index.

Banking caution and regulation

The banking sector has become more cautious due to the current market environment and the failure of four US banks since March this year[6], one of them a major global player. Although US banks have been more impacted, these events have also led the UK and Europe to increase their focus on banking vulnerabilities. In the UK for example, regulators are taking a more hands-on approach to stress testing and will be conducting tests themselves based on banks' balance sheets rather than leaving it to banks to self-report.

Increased caution by banks will further drive the market share of non-bank lenders in real estate financing, this has been compared by some managers to the trend seen in private debt, with some stating that real estate debt is approximately five years behind direct lending. In the UK, non-bank lenders already make up 30% of CRE origination, but this is still some way behind the US where this figure stands at 55%. If the UK evolves in the same way, this will represent an additional annual debt origination value of over £10bn for non-bank lenders.

The implementation of Basel IV could prove to be an important catalyst for the growth of European non-bank lenders. Basel IV introduces "output floors" that limit the minimum risk-weighting a bank can attribute to a loan, therefore requiring banks to increase their capital reserves. Previously, sophisticated banks, mainly in Germany and Scandinavia, could benefit from using internal models that ultimately attributed a lower risk-weighting to specialised loans, which include real estate.

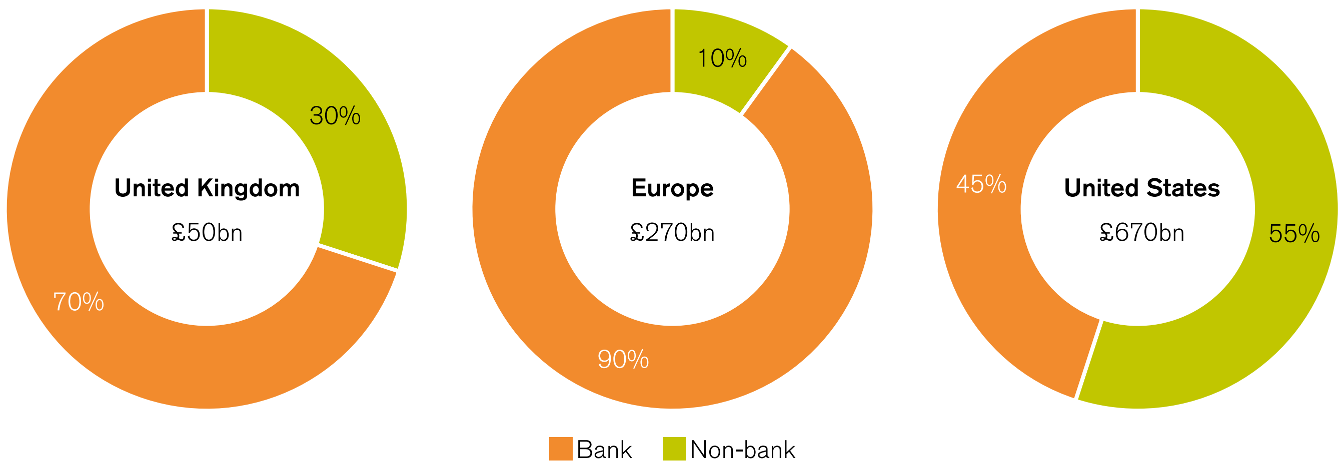
Basel IV will have limited impact on UK banks. When first implementing the Basel reforms, the UK decided not to allow the use of internal models for calculating capital requirements, instead, the stricter "slotting approach" was implemented across the sector leading to, on average, higher risk weights on specialised loans. However, the UK real estate debt market is impacted given the presence of foreign lenders actively lending into the UK, particularly from Germany.

These output floors will gradually increase until 2027 thus continuing to move the dial on banks' capital levels and limiting banks' origination in real estate debt.

Note

Basel IV is an informal name given to the final implementation of Basel III and is a set of international banking reforms that began implementation in January 2023, and are expected to take five years to fully implement.

CRE loans origination sources and annual debt origination values



Source: Bayes Business School, Cohen and Steers.

Loan-to-value ratios (LTVs)

LTVs are derived at the time of loan origination by dividing the total committed credit amount by the total value of the property (plus any other collateral). Generally, the lower the LTV, the less risky the loan. The willingness to lend at different LTVs is a key differentiator between banks and non-bank lenders, with the latter accepting on average higher LTVs (although also charging a corresponding higher margin to recognise the increased risk). Initial LTVs above 60% make up less than 15% of UK banks' loan books, whilst for debt funds they represent more than 55%[7].

Since the GFC there has been a trend for CRE to become less leveraged. In 2019, the average initial LTV in the UK ranged between 55% and 60% across sectors, down from 75% pre-GFC. Currently, LTVs on new transactions are at their historic low ranging from 53% to 56% across property types indicating that lenders are on average more risk averse. Borrowers are currently faced with two difficult and opposing issues on LTVs:

- falling property prices have caused current LTVs (the LTV if the same loan amount was refinanced today) to increase; and
- lenders are on average looking for lower LTVs than when loans were first originated.

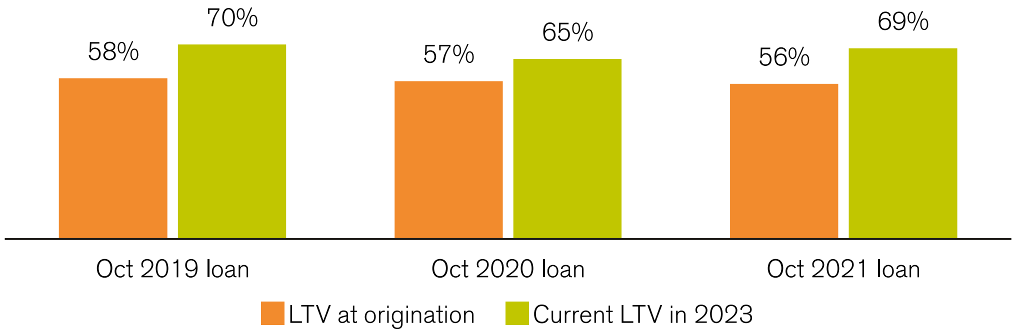
According to Green Street's commercial property index, property prices have declined 10% in Europe in the past 12 months and 28% from their peak in May 2022[8]. Debt issued at peak values could be greatly impacted when refinancing in 2025/2026 if property values do not recover. The bar chart on the right illustrates the impact that the decline of property prices has on LTV ratios. For example, a loan issued in Europe in 2019 with an LTV at origination of 58% would now have an LTV of 70%, based on the average decline in CRE prices. At this level, supply from banks is much more reduced leaving borrowers to look for more flexible lenders and/or finding different ways to increase capital for example through preferred equity. For lenders, this means that they can achieve higher returns at lower leverage points.

Note

Trends in CRE prices vary significantly based on sector. Prices in the office sector for example have experienced a more significant decline in the last 12 months than stronger sectors such as industrial.

Evolution of LTV ratios for loans originated between 2019 and 2021

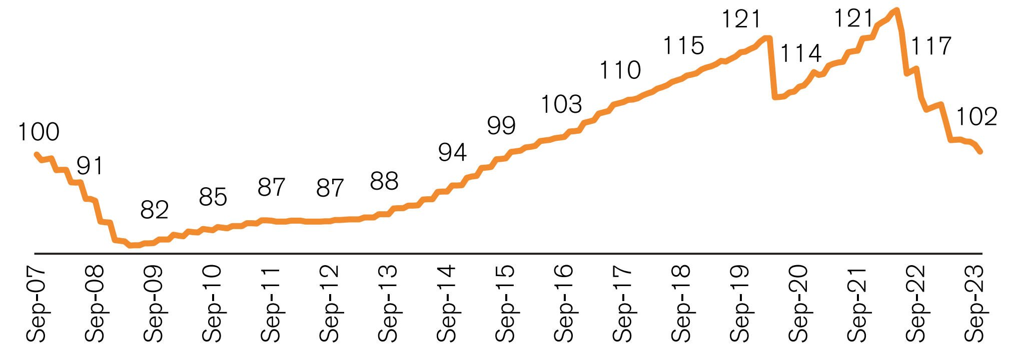
Based on average LTVs at time of origination and average decline of property values across sectors.



Source: Based on Bayes Business School data.

Pan-European Commercial Property Price Index (CPPI)

Indexed to 100 in September 2007



Source: Green Street's Pan-European CPPI.

Interest coverage ratios (ICRs)

ICRs show a borrower's ability to service the interest on their debt from the income received from the underlying property/ies. The figure is derived by dividing a property's net rental income[9], by the interest expense. Generally, the higher the ICR the less risky the loan.

Although ICRs have always been included in loan documentation, in the last 10 years, due to the low interest rate environment, LTV was often the key metric analysed. ICRs are now at the forefront of loan structuring considerations because LTV ratios do not convey the impact of interest rates or margin increases.

In 2023, there has been a deterioration of ICRs which has been more significant than the changes seen to LTV ratios. To illustrate the impact, we look at the ICR evolution of a CRE loan issued in 2020 in the UK, assuming a 2x ICR at origination, as it corresponds to 50% of net rental income being allocated for interest payment, and a 3%[10] margin over the reference rate[11].

During the period from October 2020 to October 2023, the rise in interest rates has caused an increase of 166% in interest costs, while rents grew over that period by only 21%, thus explaining the sharp decline in this ratio. With base rates forecasted to decline in 2024 and 2025, some recovery is expected.

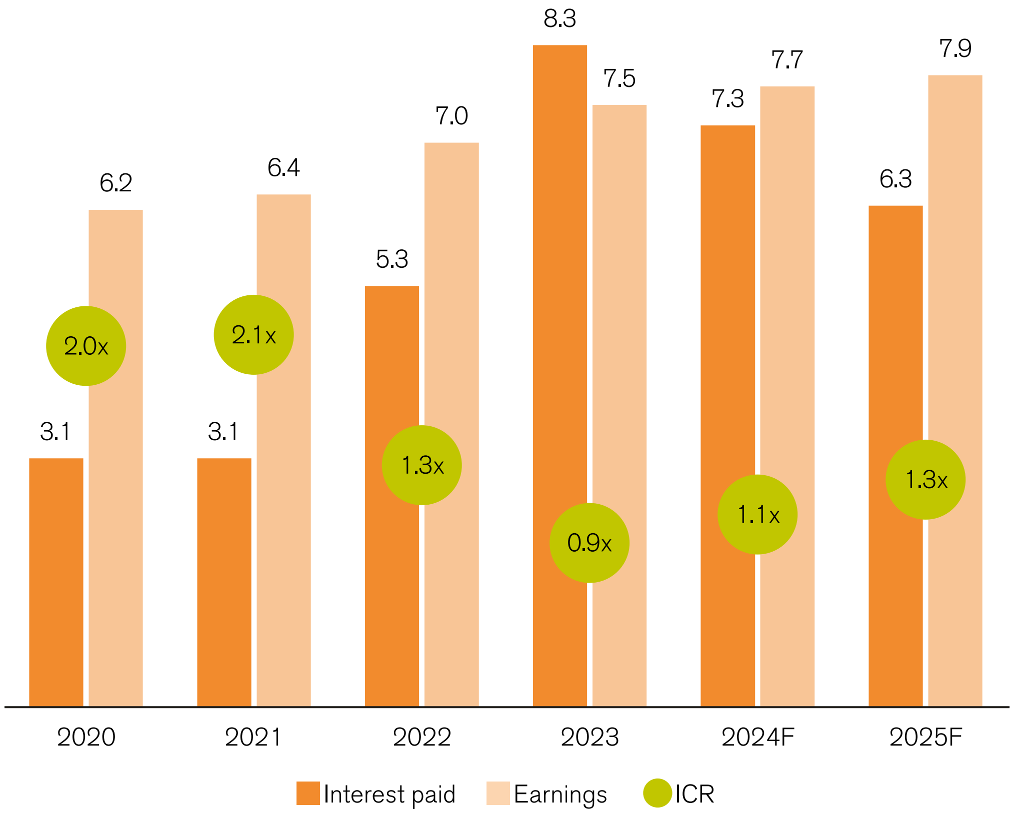
Note

At current interest rate levels, many borrowers will struggle to refinance at an affordable cost. Banks will often not lend at lower ICRs creating opportunities for debt funds – ICRs below 1.4x make up over 50% of debt funds' loan books compared to less than 10% for UK banks[12]. Similarly to LTVs, borrowers are facing pressure from both sides, ICRs are decreasing but lenders want to move towards safer assets and demand higher ICRs.

The decline in ICR also emphasises the importance of hedging, a standard feature in loans that has become more lax in recent years. It is expected that lenders will look to insist that borrowers hedge in new loans, which can add an additional cost for borrowers. This is also renewing interest in fixed rates, which are now being provided by more debt funds.

ICR evolution for a loan originated in 2020 with a 2x ICR at origination, if rates are unhedged

Loan size 100mn, 3% fixed margin, growth in earnings is matched to inflation[13]

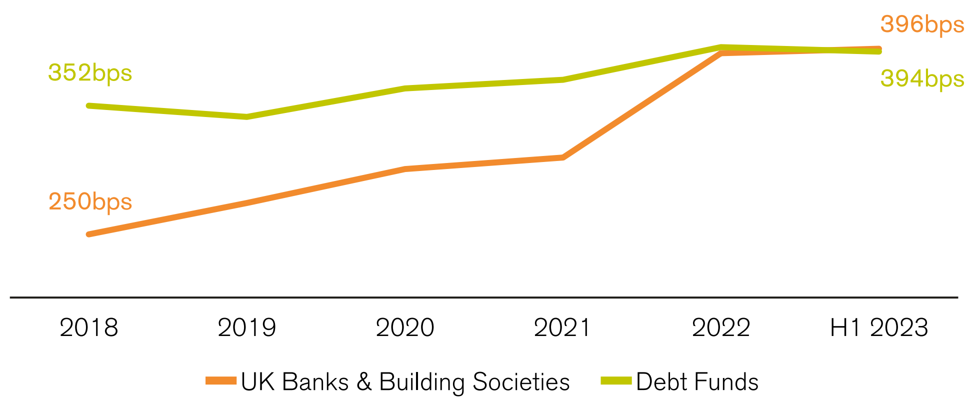


Opportunities for alternative lenders

The initial real estate debt funds set up after the GFC were almost exclusively focused on mezzanine or other subordinated debt. As bank lending falls, fund managers are seeing opportunities further up the payment priority and are in theory able to negotiate better terms. Whilst previously more senior loans in real estate did not often meet the target returns of alternative lenders, the growth mainly in base rates but also in margins has made these safer loans more attractive. In 2018, the difference between the margins offered by banks and debt funds was on average 100 basis points across sectors, since then there has been a significant convergence.

Fund managers are now providing a similar price and more flexibility than banks, improving their competitive position. By way of a simple example, senior loans provided by a bank in 2019 would be priced at LIBOR (0.5–1%) plus a margin of 2–3%. Now with SONIA rates in excess of 5%, plus margins increasing to almost 4% for similar assets, funds can be competitive if they offer a fixed rate of 8% on their loan. Overall, several managers believe this has resulted in favourable risk-adjusted returns which, as mentioned previously, has led to a rapid increase in funds dedicated to this opportunity.

Margin evolution for UK banks and debt funds across property sectors in the UK



Source: Bayes Business School.

Barriers

Although there is clear growth in real estate debt strategies, it is not without its challenges. Fund managers must navigate a fragmented and highly regulated sector where data can quickly feel out of date. Some of the key barriers include:

Fragmentation

- The significant differences by sector and by jurisdiction create complexity for fund managers looking to map the market and identify investment opportunities, particularly as investors increasingly require more granular analysis and more specialised funds.

Valuation uncertainty

- The slowdown in deals in the core and core plus markets has made price discovery particularly challenging.

Change in laws and regulation

- Real estate is a heavily regulated industry; fund managers must keep up to date with new regulations and their impact on investments.
- The Building Safety Act is a recent example of a law that has the potential to impact the value of real estate. For example, projects that had been submitted for planning based on the previous standard may need altering to comply, which in some cases may result in a reduction of the number of units available for rent.

Restructuring and defaults

- So far, distress and defaults have been slower than anticipated, but several market participants expect distress to become much more visible in the coming year.
- Some managers see this as an opportunity, others may struggle with the increased operational burden and the uncertain means of exit.

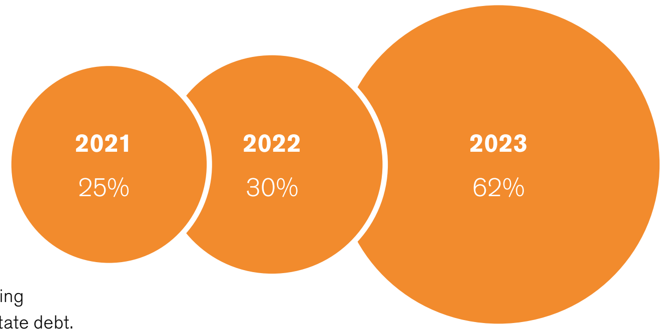
Investor demand

Similarly to other alternative asset classes, fundraising for real estate debt is down as investors across the world take a step back on allocations. According to INREV's investment survey[14], 62% of European investors surveyed are looking to increase allocations to non-listed real estate debt[15]. This is a significant evolution from previous years when less than a third of investors reported an expected increase in allocations.

In Europe, according to INREV, insurers are the largest investors into non-listed real estate debt funds (40%), followed closely by pension funds (37%)[16]. One of the drivers behind insurers' allocations may be the treatment of CRE debt under Solvency II. As with private debt, the solvency capital calculation for CRE falls under the spread risk module of Solvency II, however, because real estate debt loans are usually collateralised this can lead to a reduction in the solvency capital required (if certain criteria are met). Currently, the higher returns available in real estate debt at lower leverage points, paired with a potentially more favourable Solvency II treatment, make this strategy more efficient from a solvency perspective.

Several large investors in the US allocate to the asset class from their private debt programs, but some are investing through their real estate/real assets strategies, which is also more common in Europe. CalPERS and CalSTRS, the two largest investors in real estate debt in 2023, are a good example as the former allocates from its private credit program and the latter from real estate. This makes it more difficult to estimate how much headroom investors may have to allocate to the strategy, but it may also afford greater flexibility for investors looking to commit, depending on the return profile of the product and how it aligns to the different programs.

Percentage of investors increasing allocations to non-listed real estate debt in the following years



Note: Investment intentions survey: comparing year-on-year answers for non-listed real estate debt.
Source: INREV's investment intentions survey.

Top 5 North American allocators in real estate debt funds in 2023

Investors	Commitments to RE debt in 2023, USD m	Investing from	Managers
California Public Employees' Retirement System	1,850	Private credit	Blackstone, Mesa West Capital
California State Teachers' Retirement System	797	Real estate	PCCP
Canada Pension Plan Investments	585	Unknown	Harbor Group International
Pennsylvania Public School Employees' Retirement System	400	Private credit	TCI Fund Management Limited, PIMCO
New York State Common Retirement Fund	265	Private credit	Raith Capital Partners, KSL Capital Partners

Note

From a portfolio construction perspective, real estate debt is more aligned to a private credit program than a real estate one. A possible explanation for those allocating through real estate/real assets is the lack of a dedicated private debt program – until August this year CalSTRS did not have a dedicated private credit allocation. This may also explain why in Europe this is more common, as US investors have been generally quicker to implement dedicated private credit allocations.

Key takeaways

- Although in terms of AUM we do not yet see a significant growth in real estate debt, the number of fund launches and fund managers debuting their first funds dedicated to this product in 2023 clearly shows that fund managers see a significant opportunity in this strategy.
- In the short term, opportunity in this space is mostly driven by current market conditions that make it attractive for private managers to bridge the lending gap as banks pull back. We expect to see a peak in the number of funds dedicated to this strategy followed by some cooldown as it remains to be seen whether these preferential conditions will persist. In the long term, the presence of non-bank lenders in real estate in Europe and in the UK is likely to continue an upward trajectory following both the trend seen in the US and the trend seen generally in corporate direct lending.
- Although fundraising is down, there are some positive signs in investor sentiment. Almost two-thirds of investors in Europe are looking to increase their exposure to real estate debt and some US investors are making sizeable allocations.

How we can help

This note was prepared by our private capital advisory team who provide holistic advice on how to shape products, terms, structures and marketing strategies to support fundraising efforts and fund level transactions and deals.

Learn more about our expertise

For more information, please contact one of the listed contacts, or your usual Macfarlanes contact.

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Endnotes

1 Green Street Commercial Property Price Index; **2** Considers Cheyne, M&G and Grosvenor. Based on Preqin Ltd data, may exclude small managers or managers that have since discontinued operations; **3** According to Tikehau; **4** According to Lazard writing for PERE; **5** According to Bloomberg; **6** Silicon Valley Bank, Signature Bank, First Republic Bank and Heartland Tri-State Bank. According to the Federal Deposit Insurance Corporation; **7** According to Bayes Business School H1 2023 report; **8** According to Green Street's Pan-European Commercial Property Price Index. Aggregated data may underestimate/overestimate price corrections in specific sectors; **9** Net rental income is calculated on a historical or projected basis over the same period as the interest expense; **10** The 3% margin is used based on the average margin in 2020 for senior real estate loans across sectors, according to Bayes Business School; **11** The reference rate used for illustration purposes is the BoE interest rate. Potentially relevant reference rates vary by currency and market, and include the following (and rates derived from them): EURIBOR, SOFR and SONIA; **12** According to Bayes Business School H1 2023 data; **13** For illustrative purposes only. Based on ING's forecasted figures for UK base rates for 2024 and 2025; **14** INREV's 2023 survey was based on a sample of 75 institutional investors and seven funds of funds with aggregate real estate assets under management (AUM) of close to €800bn, the survey has global reach although the majority of this year's respondents were domiciled in Europe; **15** When weighting responses by investors' real estate AUM, this number is even higher at 79%; **16** According to INREV's Capital Raising Survey 2022.

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