EXPERT Q&A

The bottom of the market has been reached and now there are potentially compelling upside opportunities, says Rupert Gill of Barings

A unique window for real estate debt investors

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Q How would you describe the current state of the European real estate cycle?

The market is in a much better state today than it was 12 months ago. Valuations have significantly repriced downwards, and this is now being reflected in both new acquisitions and refinancings. Real estate investment volumes picked up across the market in the fourth quarter of last year and, from a lending perspective, our volumes were up dramatically in the second half and continue to gather pace.

Real estate does get impacted by interest rate rises and the market took a little time to accept those. The office sector was also impacted by a structural shift that has led to a large correction in values.

But a lot of property types continue to see strong occupier demand and despite yield shifts, the lack of supply in Europe is driving increased rents and cashflows. That is true in logistics and in residential, where a shortage of housing is an issue in many European markets. Even in office, we see a shortage of good-quality stock in good locations which means that, despite remote working trends, there is huge demand for not just new developments, but also renovated properties that offer very good amenities and have good ESG credentials.

On the credit side, there is more liquidity than prior periods coming from real estate private credit funds and insurance companies. Banks are also lending again, albeit with more constraints and more focus on their core borrowers and core assets in the best locations.

Q Why does real estate credit present a compelling investment opportunity?

Real estate credit is compelling right now because the underlying hard asset collateral has been significantly revalued downwards. As we move forward in a growth cycle, rents are likely to continue to grow due to a lack of supply, and valuations are likely to improve. As a result, the credit quality of loans written today should improve.

Lenders can further amplify this credit improvement by writing loans where the business plans of borrowers involve improving the quality of the underlying assets. This will increase occupier demand and subsequently increase rents, which means the value of the collateral should continue to improve.

A big influence on investment outcome is timing – and getting that right is critical. At this point in the cycle, real estate private credit offers investors the potential for significant downside protection because of this sharp correction in values.

Returns are relatively high right now for lenders, interest rates are off the peak, but remain elevated compared to recent periods, and margins are relatively high as well. This backdrop means credit investors are getting returns that are the best they have been for a decade. Returns are also relatively stable because of the real estate repricing that has happened and because the underlying collateral cashflows are moving upwards.

What is new for credit investors in this asset class is the option of multiple investment strategies, allowing them to pick a strategy that suits their own risk-return requirements.

There is a range available from vanilla senior core debt all the way through to complex development lending and even levered strategies, which are becoming a bigger feature of the European market. Investors can get returns potentially ranging from the mid-single digits up to mid-teens. Given the regulatory headwinds that banks are facing, we believe this is an opportunity that is likely to endure for many years to come.

Q How does the asset class provide investors exposure to global structural trends?

The other reason investors like this asset class is because of its ability to provide exposure to a number of global structural trends, namely increasing e-commerce and digitalisation, deglobalisation and rewiring of trade routes, changing demographics and decarbonisation.

Essentially, real estate is about getting the basic building blocks of society right. For example, what is often overlooked is the impact that a lack of quality housing can have on a workforce. Poor living conditions could severely impact people's ability to get work or contribute to the economy with maximum effectiveness.

Increasing numbers of smaller households, along with urbanisation trends, are also driving demand for housing. In addition, in most major European gateway cities, it is more affordable to rent than it is to buy.

In terms of education, the availability of good-quality student accommodation is low in a number of countries and this could have a potential impact on future economic growth. In logistics, we see global supply chains rewiring from 'just in time' to 'just in case', driving new demand.

Decarbonisation and ESG are also priorities for some investors and less so for others, but in Europe, tenants are typically looking to minimise their occupancy costs through lower energy costs and/or occupy modern premises. For assets to be liquid for landlords and lenders, they need to be fit for purpose.

Q What about default and exit concerns?

The downside is a lot lower for lenders right now than it has been for some time. There are still pitfalls to be avoided – we are still trying to figure out how we use offices, for example – but generally a lender's basis is much better today than it was four or five years ago.

European real estate loans are typically structured with multiple lender protections and strong covenant packages that act as triggers in the event of significant cashflow or valuation deterioration. That gives credit investors good downside protection and, if things do go wrong, the enforcement process is also a relatively simple exercise, with borrowers structured as property owning SPVs.

In terms of exits, we are seeing the return of liquidity and the return of the banks, who are no longer a one-stop-shop, but will provide finance into core stabilised properties. With many private credit funds focused on value-add lending strategies, banks represent a very good option for refinancing at the end of a value-add business plan; or give confidence that a borrower will be able to sell onto core real estate investors seeking typical core bank finance.

Q Finally, which sectors do you expect to offer the most lending opportunities in the next few years, and why?

Everyone is focused on 'beds and sheds' or living and logistics. Within residential, we also see opportunities in student accommodation, affordable housing and hotels, which are making a comeback. We also see opportunities in logistics and warehousing, and the derivatives of warehousing like open storage, self-storage units and cold storage.

We believe these sectors should continue to offer most of the lending opportunities because of the sheer demand and wide-scale lack of supply that encourages capital into the sectors.

Where we see more relative value is in putting capital to work with borrowers who are adding value to real estate through asset management and capex strategies, including core-plus, value-add and development-lending strategies. Lenders will need strong real estate underwriting skills for these types of lending strategies and this is also where banks are stepping back from. Although we see this as a structural change in the European real estate lending market, we believe the time for credit investors to access the asset class has never been better. ■

Rupert Gill is head of portfolio management in the European real estate debt team at Barings