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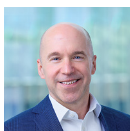
REAL ESTATE

Three Reasons to Consider European Real Estate Debt

INSIGHTS

The European real estate market is at the beginning of a new property cycle. Although the landscape is not devoid of risks, there are three key reasons why real estate debt presents a compelling investment opportunity—but a selective approach across sectors is crucial.



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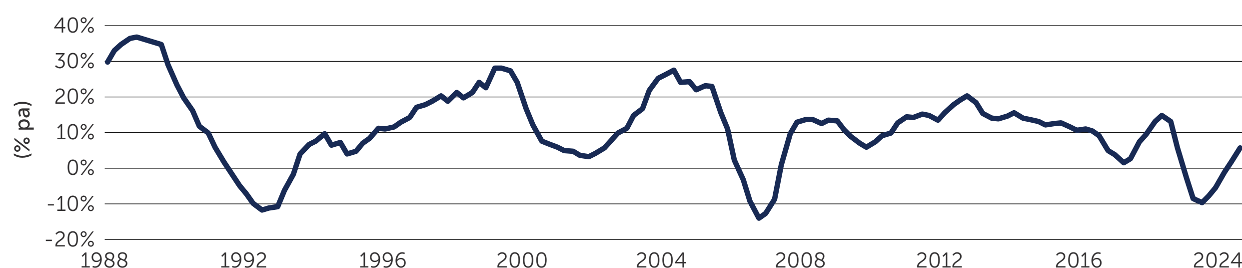
The recovery phase of the European real estate cycle has begun, with stabilizing prices paving the way for continued momentum in the coming years. Underpinning this positive backdrop, borrowing costs have eased and credit conditions continue to improve. Investor confidence has accordingly increased, resulting in more capital being deployed in the market. For commercial real estate (CRE) debt, these dynamics are giving rise to new loan origination opportunities that paint a bright picture for the asset class—especially when coupled with the ample refinancing opportunities ahead, given that €450 billion of debt matures over the next four years.[1]

Although the landscape is not devoid of risks, particularly as economic momentum cools in Europe and geopolitical risks rise around the globe, there are three reasons in particular that real estate debt presents a compelling opportunity:

1. Significant downside protection potential
2. Stable income profile and attractive return prospects relative to broader fixed income markets
3. Exposure to structural themes such as changing demographics, e-commerce and ESG

Figure 1: European All-Property Prime Total Returns

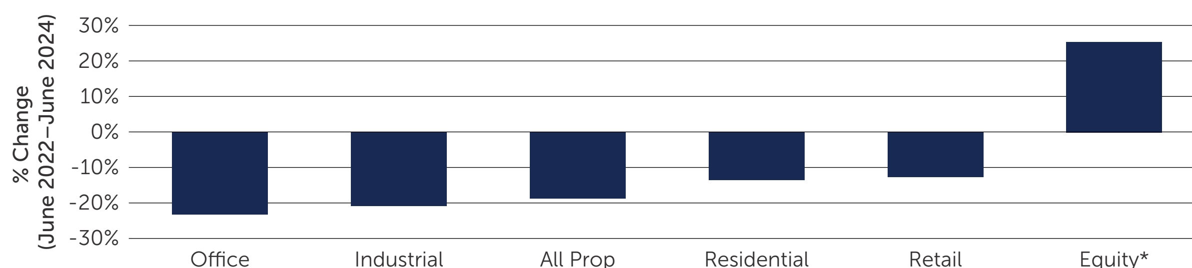


Source: CBRE, Cushman & Wakefield. As of Q3 2024.

1. Significant Downside Protection Potential

Over the past few years, the European CRE market has undergone a significant re-valuation against a backdrop of rising interest rates. Specifically, since June 2022, All-Property European capital values have declined by 19%, with even bigger declines occurring across specific property sectors—even those where occupational demand has remained strong **(Figure 2)**. To put this into context, valuations across equities, for example, have increased during the same period.

Figure 2: European Pricing: Real Estate Capital Values vs. Equities



Source: MSCI, Marketwatch. As of Q2 2024. *Equity = STOXX Europe 600 Price Index

1. Source: Barings Research, MSCI. As of April 2024.

In addition, given the increase in banking regulation over the past 15 years, there have been low levels of property development across several sectors including residential and logistics. As a result, modern stock shortages are prevalent across most of Europe's key cities, and vacancy rates remain low.[2] This explains why top-end rents continued to rise through the recent interest rate-induced economic slowdown—and it also suggests that cashflows should remain secure in the coming years, or potentially even increase.[3]

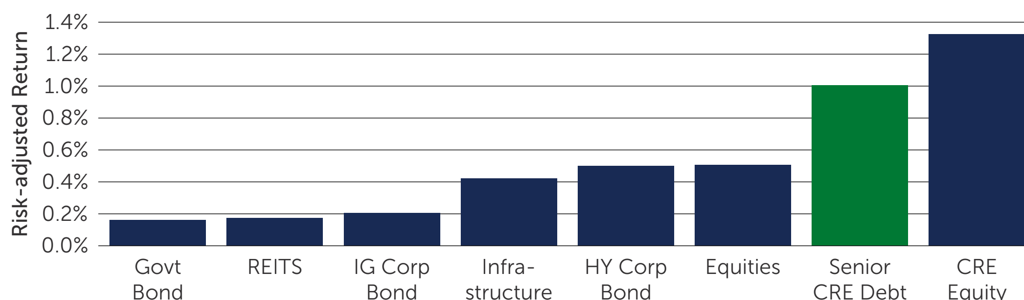
This combination of a sharp downward adjustment in property capital values and the likelihood of secure cashflows creates the potential for downside protection for CRE debt investors—which is beneficial given the macroeconomic uncertainties that remain on the horizon.

2. Stable Income Profile & Attractive Return Prospects

A key attraction of CRE debt is the income stability it offers investors. In many ways, CRE debt behaves like corporate fixed income, given that it is underpinned by stable property cashflows with a pre-determined schedule of interest and principal payments. The loans are also secured by hard collateral, which provides considerable downside protection in the event of delinquency or default. The asset class also offers investors exposure to a range of higher risk/reward strategies, such as mezzanine debt, whole loans and construction finance. While these strategies tend to generate higher returns, they can come with a lower repayment probability in the event of default.

Another benefit of CRE debt is that it offers investors exposure to property without the operational challenges that can come with allocating to real estate equity. While returns typically aren't as high relative to peak equity, downside is limited, and the asset class has historically provided income stability through the property investment cycle **(Figure 3)**. Looking at returns over the past decade, real estate debt has outperformed fixed income and equities on a risk-adjusted basis. This outperformance stems largely from the lower volatility and illiquidity premium inherent in CRE loans given the absence of a secondary market—albeit this is less of a concern for strategic, long-term investors.

Figure 3: European Risk-Adjusted Returns (2014–2023)

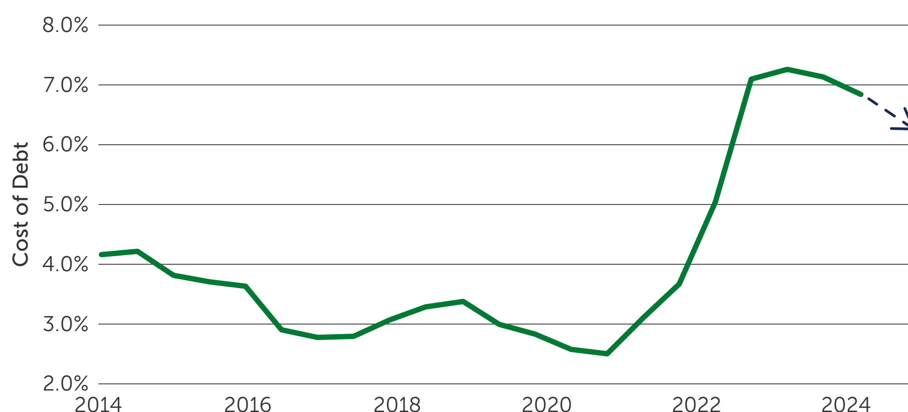


Source: MSCI, FTSE/EPRA, Bayes Business School, Barings Research. As of October 2024.

2. Source: Cushman & Wakefield, Barings Research. As of November 2024.
3. Source: Cushman & Wakefield, Barings Research. As of November 2024.

Looking across the market today, still-elevated interest rates and property debt margins have pushed up the total cost of debt, which helps explain why direct property market liquidity slowed so sharply over the past few years **(Figure 4)**. Although interest rates are set to continue their decline in Europe, property debt return prospects are likely to remain attractive relative to the near-zero interest rate period that followed the financial crisis. A moderating cost of property debt should also facilitate transactions and create opportunities to originate new real estate loans.

Figure 4: U.K. Total Cost of Debt



Source: Bayes Business School, OEF, Barings Research. As of October 2024.

3. Exposure to Structural Themes

Property markets constantly evolve, shifting to accommodate long-term demographic trends, technological tailwinds, changes to global supply chains and other societal trends like ESG. As such, constructing a diversified loan portfolio in carefully selected property sectors and markets where these long-term structural drivers align should help ensure the delivery of stable income returns and reduce the risk of borrower default. Given the long-term growth potential of these assets, they can also help mitigate asset obsolescence and, accordingly, help generate higher borrower exit liquidity.

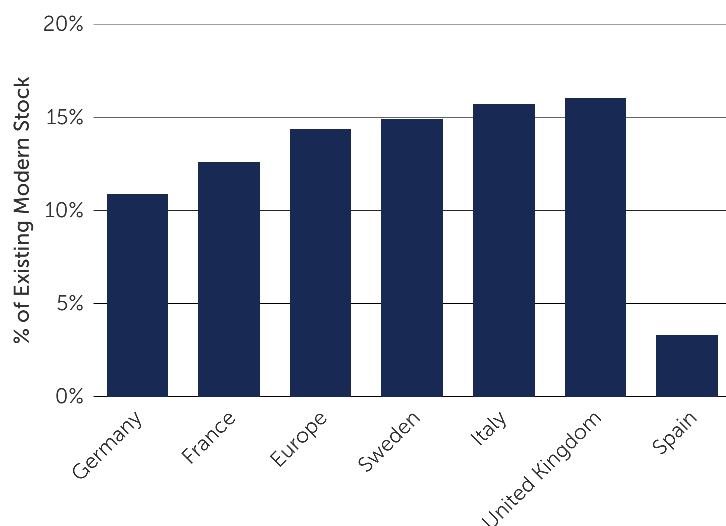
Looking at ESG as an example, there is an acute demand/supply imbalance of living properties in many European cities. This shortage is presenting opportunities for CRE debt investors to contribute capital to the delivery of what is quickly becoming critical social infrastructure. Further supported by a backdrop of increasing ESG regulation in Europe, capital from CRE debt investments can be used to refurbish and renovate properties to improve certain ESG credentials—such as energy efficiency—and subsequently help in the transition from 'brown' to 'green' properties. These strategies aim to upgrade assets in order to meet tenants' ESG requirements and can help in selectively avoiding energy-intensive assets, which helps ensure continued tenant demand and can improve investor liquidity.

Compelling Opportunities via Sector Selection

LOGISTICS

The logistics sector appears attractive today given the favorable occupational outlook, widespread modern stock shortages and significant discount in prices. Demand, too, likely has further room to run given the multi-speed rollout of e-commerce across Europe and likelihood of supply chain consolidation in response to growing geopolitical pressures. By our estimates, an additional 33 million sq m of logistics space will be required over the next five years **(Figure 5)**.

Figure 5: Projected E-commerce Logistics Demand (2024–2028)



Source: CBRE, Oxford Economics, Euromonitor, Barings' calculations. As of December 2023.

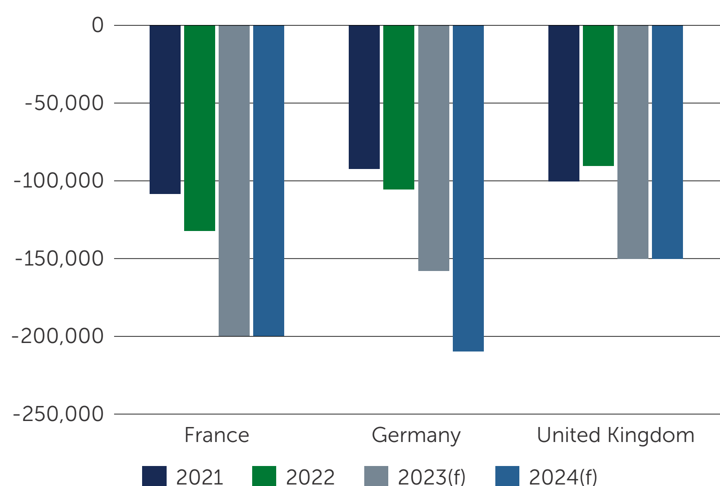
Robust fundamentals further support the case for logistics, paving the way for strong long-term rental growth—in fact, logistics rental income growth is forecast to exceed that in both the retail and office sectors over the next five years.[4] Despite the strength of the sector's fundamentals, yields also remain attractive after rising considerably during the recent downturn, a result of tight sector pricing at the outset of the rate-hiking cycle.

Lending Opportunity: With equity investment volumes in the sector set to sharply rise, new origination opportunities are likely to be considerable. In particular, limited supply means occupancy levels are high, and cash flows should be stable. Renovation, refurbishment and development capital will be required to maintain and upgrade energy efficiency.

RESIDENTIAL

The structural undersupply of housing in many European cities underscores the case for residential assets. Development has lagged both the obsolescence rate and government housebuilding targets, compounding unaffordability for first-time buyers **(Figure 6)**. With housebuilding expected to remain weak, housing shortages in Europe's growing cities will inevitably worsen. This is likely to drive long-term capital appreciation across the sector and protect the value of the loan's underlying asset.

Figure 6: Shortfall in Housebuilding Compared to Government Target



Source: JLL, ONS, Destatis, Cour des comptes. As of November 2023.

Rising rental demand and reliable rental flows have made residential assets a mainstream investment option for core institutional investors in Europe, often as an alternative to the much-reduced investable universe in the retail sector.

Lending Opportunity: The significant sector expansion potential and reliable income stream make the sector highly financeable. In addition, the potential for higher yields and the lack of development capital have opened the sector up to alternative lenders.

4. Capital Economics. As of Q3 2024.

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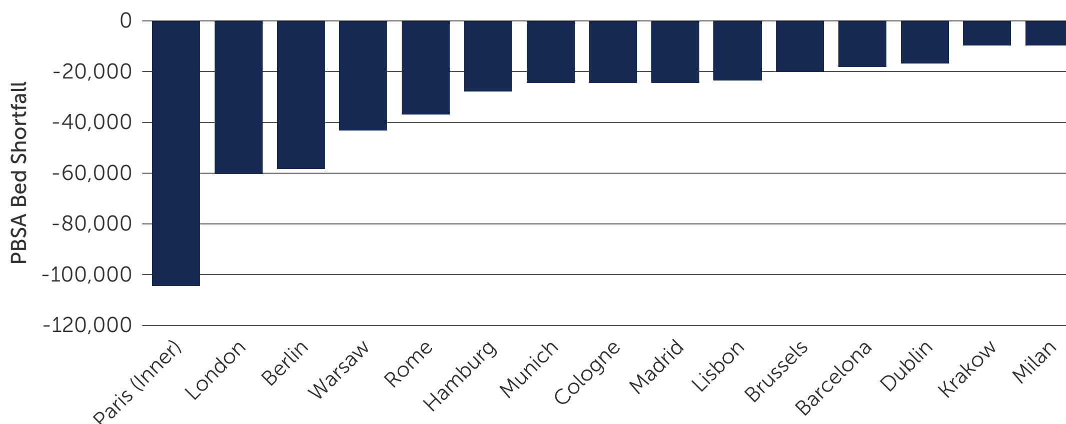
> *"In the PBSA sector, there is an opportunity in the top-ranking university cities where increasing demand and a lack of modern student housing stock should lead to rising cashflows to service higher debt costs."*

PURPOSE-BUILT STUDENT ACCOMMODATION

Europe is uniquely placed to benefit from the rise in global demand for higher education. Its higher education sector is internationally renowned for its quality, with around half of the top-rated institutions across the globe located in the region.[5] The emerging global middle class is the "megatrend" driving overseas student demand against a stock base that is either undersupplied or becoming obsolete **(Figure 7)**. While risks exist from government policies that restrict international student numbers, university funding pressures, and the rise of e-learning, the top-rated institutions are likely to be resilient to these factors. Conversely, assets servicing institutions at the other end of the spectrum could face challenges.

Lending Opportunity: In the PBSA sector, there is an opportunity in the top-ranking university cities where increasing demand and a lack of modern student housing stock should lead to rising cashflows to service higher debt costs.

Figure 7: PBSA Bed Shortfall



Source: JLL. As of June 2024. *Shortfall = Total PBSA Beds - Unmet Demand

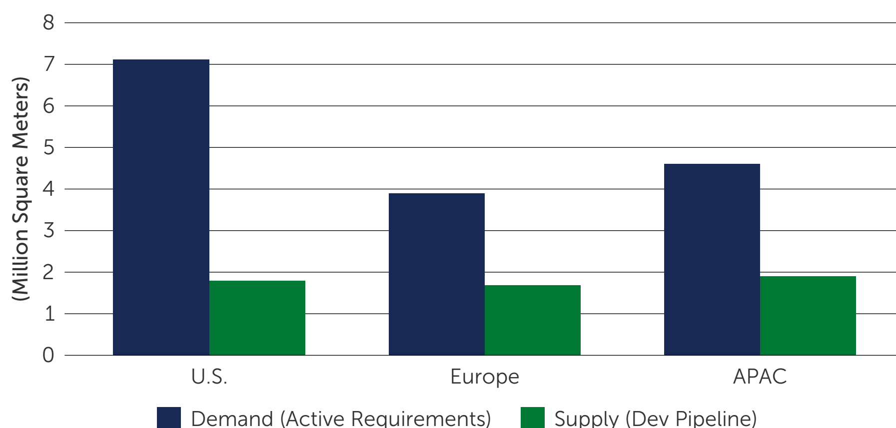
5. Source: Times Higher Education World University Rankings. As of 2024.

SUSTAINABLE CBD OFFICES

The post-pandemic shift to hybrid working has lowered aggregate demand for office space, with tenants taking less overall space. While the U.S. is at the more extreme end of this, there are particular dynamics that soften this trend in Europe. For instance, smaller cities in Europe that are well serviced by public transport systems, as well as the smaller sized European homes that are less conducive to working-from-home, boost the case for offices.

For these reasons, we believe that tenant (and investor) demand for office space will persist, but that it will disproportionately focus on the highest-standard, sustainable CBD office space. Notably, modern office stock is in chronic undersupply after post-GFC regulation significantly curtained new project development. In-demand buildings with green credentials are even more lacking **(Figure 8)**.

Figure 8: Net Zero Offices (to 2030)



Source: JLL. As of January 2024.

Lending Opportunity: Select assets in this sector offer diversification benefits to a broader loan portfolio. Specifically, there is potential value in modern, centrally located buildings that are able to command "green premiums" and attract the best corporate occupiers—which should lower cashflow risks.

> *"We believe that tenant (and investor) demand for office space will persist, but it will disproportionately focus on the highest-standard, sustainable CBD office space."*

RETAIL

Investor interest in retail continues to rise, reflecting the sector's potential for modest income growth, namely in locations where rents have appropriately rebased. The inflation spike has driven up nominal turnover and therefore the effort rate (the rent to turnover ratio) has plunged. Given the online retail sales growth potential and structural changes facing the sector, we remain cautious about its long-term prospects. We see value in retail schemes where there is a heavy tenant weighting toward grocery, as well as in online-resilient categories such as hardware (DIY), homeware, and garden.

Lending Opportunity: Highly selective financing of retail schemes dominated by internet resilient tenants can provide some diversification benefits and potentially boost debt returns through higher margins.

ALTERNATIVES

Alternative property sectors are growing rapidly, providing investors with an opportunity to align with different and emerging economic growth drivers and societal trends. Self-storage is one example, which stands to benefit from stronger demand as housing shortages and unaffordability drive residential unit sizes smaller. Senior and healthcare facilities to accommodate Europe's aging population is another.

Lending Opportunity: Selective financing of alternative property sectors can offer diversification benefits to a broader loan portfolio and potentially boost debt returns through higher margins. That said, we believe stock selection is crucial in this sector, and we remain cautious on energy-intensive alternative properties.

Key Takeaway

The European real estate market is at the beginning of a new property cycle, with a number of select opportunities on the horizon despite a shifting macroeconomic, political and geopolitical landscape. In this environment, European CRE debt looks compelling given its potential for downside protection, stable income and attractive return potential. The asset class also offers investors exposure to structural and societal trends such as changing demographics and ESG. While tapping into these themes can reduce both default and exit concerns, we believe a selective approach across sectors is paramount to navigating both the opportunities and challenges that lie ahead.

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