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REAL ESTATE

Is now the right time to invest in commercial real estate (CRE) debt in the U.K.?

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WHAT IS CRE DEBT?

CRE debt is typically structured as a loan secured on commercial real estate. Three features make debt attractive for investors: income-focused returns with the payment of periodic interest on a current basis (typically quarterly); the repayment of the remaining principal at loan maturity; and downside capital protection as a result of its structural and payment priority relative to equity.

WHY COULD INVESTING IN CRE DEBT BE A GOOD INVESTMENT STRATEGY?

Well-managed CRE debt aims to provide performance protection through two principal means:

First of all, CRE debt benefits from a substantial degree of downside protection provided by the 'buffer' of the sponsor's equity contribution. While there is typically no additional upside to debt returns in a rising property market, in a falling market, the sponsor's equity will absorb the first loss. As a result of this buffer, loans are typically valued at par throughout their life unless a severe downside event occurs, and a possible loan impairment occurs.

The second is that contractually agreed periodic interest payments, commonly secured on a diversified and stable income stream in a well-constructed portfolio, insulates the lender from the volatility of a changing rental income profile at an asset level.

As a result of these principles, income returns and valuations of loan portfolios are very stable and have a low correlation with CRE returns from direct investment. As real estate market cycles become more difficult to predict, this insulation, diversification and higher degree of certainty are increasingly regarded as highly attractive by investors.

U.K. CRE loans usually include substantive performance covenants, put in place to protect the lender in the event of capital value or income declines. These typically include loan-to-value (LTV) ratio and interest coverage ratio (ICR) covenants structured to include both ‘cash trap clauses’, where surplus income not required for debt service or property management can be retained by the lender and used to reduce the loan, and default clauses, which allow the lender to enforce its security if a default covenant is breached. These covenants are typically triggered at thresholds long before the deterioration of income or capital value would expose the lender to a risk of loss.

U.K. CRE loans also typically benefit from a full security package that in combination with the default covenants ultimately permit the lender to step into the role of asset owner to ensure loan recovery where agreement cannot be reached with the initial equity sponsor. This ensures that while a CRE lender is typically a largely passive participant in a CRE transaction, they have the recourse to become more active to protect their position including the power to sell the property.

WHY IS NOW A GOOD TIME TO INVEST IN CRE DEBT?

Real estate markets are currently experiencing significant volatility and heightened uncertainty. Investors’ focus on income returns, given the low, but increasing interest rate environment, is now paramount.

Why invest in U.K. commercial real estate debt now?

Market opportunity
Structural and regulatory changes in U.K. CRE lending marketplace have created **a long-term opportunity** for alternative lenders

Relative value
Attractive risk-adjusted returns relative to fixed income investments and direct real estate on a current income and total return basis

Diversification
CRE debt acts as a **diversifier and stabiliser** in a well-constructed portfolio

Capital protection
Debt benefits from an equity buffer, which we believe can provide **performance protection** particularly in times of increased uncertainty (e.g.Brexit/COVID-19) and late real estate cycle

Stable income
Stable, income-focused returns with low correlation to wider property and investment markets, especially in a low interest rate environment

Source: Nuveen Real Estate, 2022.

As such, the relatively high current income return combined with potential downside protection characteristics of CRE debt alongside stability, diversification and contracted income is becoming increasingly sought after by investors. CRE debt presents very competitive relative value, compared to fixed income and direct real estate investments.

These structural benefits are now open to CRE lenders beyond the traditional banking sector as a result of the significant regulatory and market changes which have occurred since the global financial crisis (GFC).

WHO ARE THE MAIN PLAYERS IN THE CRE DEBT SPACE?

Although CRE debt has traditionally been a fundamental part of the U.K. real estate market, the dominance of banks, until the GFC, heavily restricted investment opportunities in CRE debt for alternative investors/lenders. Since the GFC and, more recently, the COVID-19 pandemic stricter regulatory, capital and liquidity requirements have increased the burden on banks' balance sheets, which has led them to tighten underwriting standards, significantly reduce loan leverage, substantially increase loan pricing and even ration credit in some sectors.

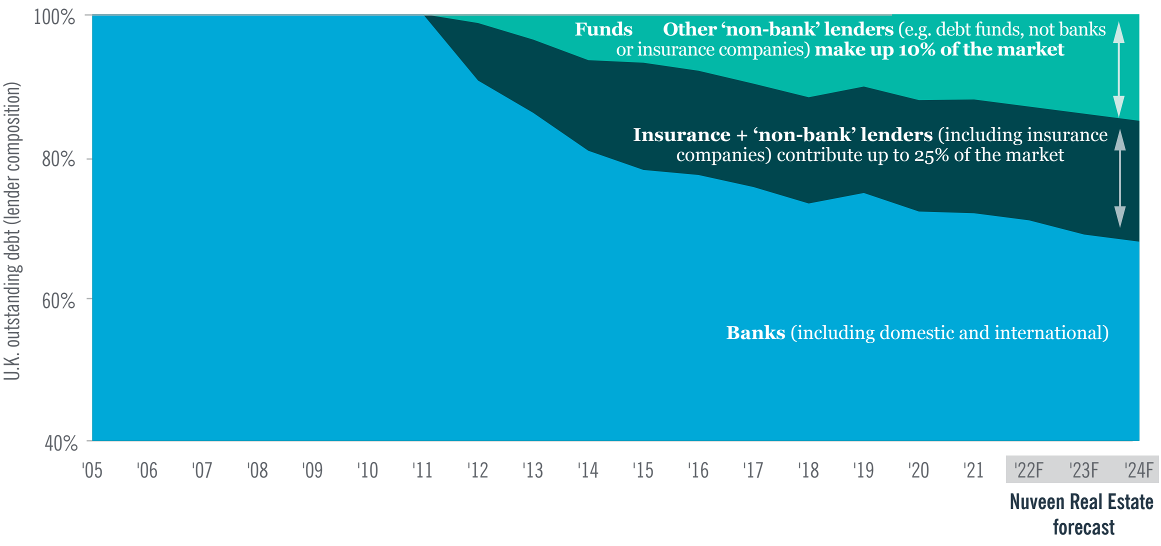
The resulting retrenchment of traditional lenders, as well as the reduction and repricing of available debt capital, has created a permanent, attractive and executable investment opportunity for non-bank lenders and debt funds to provide a meaningful share of future CRE debt finance requirements in the U.K.

HOW HAS BREXIT, COVID-19 AND GEOPOLITICAL UNCERTAINTY IMPACTED THE SECTOR?

The immediate impacts of the U.K. leaving the European Union include labour shortages in certain sectors, trade friction and challenges to supply chains. The COVID-19 pandemic, however, has had a much more significant impact on the economy than Brexit and with new variants of the virus emerging and continued infections, the uncertainty seems far from over. The current conflict in Ukraine could have a severe impact on interest rates, inflation and valuations of financial assets. While it is too early to assess what this impact is likely to be in detail, an expectation of continuing volatility seems prudent.

The rise of non-bank CRE lending in the U.K.

The retrenchment of traditional lenders through Global Financial Crisis and COVID-19



Source: Nuveen Real Estate, 2022, Cass Business School, Mid-Year 2021.

Against this backdrop, real estate markets face ongoing volatility in the short-term. Given the political and economic complexities of the post-Brexit transition, inflationary pressures, the uncertain path of the post-COVID-19 recovery and geopolitical turmoil, market forecasts vary significantly and incorporate a degree of pricing correction as markets are expected to move towards normalisation. Tellingly, however, the most anticipated valuation declines in downside forecast scenarios would remain well within the buffer offered by the borrower's equity in a sensibly structured loan.

The factors mentioned above have reinforced the bank retrenchment away from commercial real estate, with a slower, more selective approach to origination of new lending transactions. This has opened up further opportunities for non-bank lenders to achieve higher returns on the same quality of asset, with speed of execution increasingly held at a premium. Direct investor activity has been buoyed by the prolonged low-yield capital market environment and abundance of capital but uncertainty over future values is now unusually high due to the disruptive headwinds that have been exacerbated by the pandemic, together with the risk of a rising interest rate cycle and because parts of the U.K. real estate market are firmly late cycle. In this context, we believe that CRE debt's future returns look very compelling. A CRE debt strategy offering potential downside protection and income-focused returns is well positioned to offer investors competitive relative value.

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The investment attributes of CRE debt are becoming increasingly sought after, offering stability, diversification and contracted income.

WHAT ARE THE CURRENT OPPORTUNITIES IN THE SECTOR?

In the context of retrenching traditional lenders and the persistent narrow focus on prime assets, increased opportunities for well-capitalised, specialist, alternative finance providers exist. Investment opportunities can be found in those assets currently 'off the radar', particularly core-plus assets in established markets and including refurbishment, capital expenditure (CapEx), 'greening' and construction lending. With robust underwriting, ideally informed by direct real estate expertise, these underserved markets present the most appealing prospect for selective cherry-picking of transactions, backed by strong fundamentals and robust return characteristics.

Capital value resilience is present in core sectors, such as U.K. logistics, and in less obvious areas. Emerging CRE formats that have benefitted from the pandemic also offer lower risk lending opportunities, including science parks, multi-family housing and data warehouses but also single-family housing, grocery retail and new urban agriculture formats. Retail warehouses have been the first format to recover after suffering from the retail crisis and offer a path for lenders back into the retail sector. While in the office sector, net zero carbon (NZC) goals and ambitions highlight assets with stronger efficiency standards that reduce the risk of value loss during the race to NZC adoption, both in London and in the key regional cities where fewer office workers have adopted working-from-home practises.

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