Commercial Real Estate Debt – a not-so-little wonder?

There are few go-to investments in public markets today. About 20% of bonds globally are yielding negative rates; the MSCI World Index is trading on a P/E above 211 and the Buffett Indicator for the US is over 200%.2
Little wonder that more and more institutional investors are looking to private markets for better value.

Here we offer some compelling reasons for considering an allocation to Commercial Real Estate (CRE) debt ahead of other opportunities. CRE debt funds offer indirect inflation-linked income streams typically 100-160 basis points higher than public-market debt with a similar credit worthiness. The span of a CRE debt fund investment is typically ten years, which suits long-term investors such as pension funds. Rising interest rates are not a danger as loans are set and adjusted in line with changes to the base rate. As with other mortgage-type products, there is a 0% floor on interest payable, which means that negative yields are not a possibility.

Negative yields are a reality for a lot of publicly traded paper so we can say there is extra value these days in the illiquidity premium. What then are the risks to the principal in these strategies? CRE debt is fully collateralised. That is one strength of investing in bricks and mortar. Senior debtholders have first-ranking mortgages. Second, Loan-to-Value (LTV) ratios have been falling in recent times, which is another source of comfort because it means the equity borrower has more 'skin in the game'. BNP Paribas AM's tolerance range in European CRE debt is for LTVs of between 55%-65%, which gives a generous equity cushion.

Then there is diversification by ultimate revenue. No worthwhile CRE debt strategy puts all its eggs in one basket. It is common for funds to have exposure to over two thousand tenants, situated in hundreds of properties in different jurisdictions. So investors can take comfort that their income - typically distributed quarterly - comes from a greater variety of underlying sources than many other forms of debt.

Some of CRE debt's characteristics are available from other asset classes but few offer them all. Most publicly traded mortgage-backed securities, for example, are concentrated in the residential sector, whereas CRE debt is broader (NB it does include exposure to residential). Commercial mortgage-backed securities in Europe are more diversified than RMBS but even put together, both markets are far shallower than CRE debt, which stands at €1.2trillion in Europe, with €200bn in annual financing (the average loan maturity in this market is six years).3

Another interesting comparison is with commercial real estate itself, i.e. owning the property. Current sale prices are high but they are not rising much. This suggests that holding senior debt in the capital stack is preferable to holding the building itself. Capital appreciation rates in Europe are approximately 3.0% while senior debt is offering approximately 2.5%.4 Subtract the greater fees and risks involved in realising equity value; and right now the senior debt seems a more efficient form of return.

Of course, the equity holder has some leverage to boost its return, but we have already spoken about leverage ratios, i.e. Loan-to-Value, falling. As ever, the choice depends on an investor's target risk-adjusted return.

For the shrewd investor, we not only see LTVs altering in favour of lenders but also other attractive elements to deals. One office block we have backed in Munich ticks all the boxes for a workplace ready for a post-COVID world: close to urban amenities, including public transport hubs, with twenty-six different tenants, many of whom are state-owned. The workers get a convivial, flexible environment but the current owner benefits from rents today below market rates, which ensures low vacancy rates.

Of course, not all deals are the same: some offer more value than others. So sourcing matters. There is a general trend under the Basel rules for banks to hold fewer 'riskier' assets on their own books. But asset managers still need to have deep and broad relationships in order to access the right mix of opportunities for our clients. BNP Paribas Asset Management is very fortunate that our parent is the number one operator in Continental Europe of real estate services. It is a top ten player in real estate mergers and acquisitions. So although we talk to all the relevant banks and sponsors, we happen to be in a privileged position as part of the wider BNP Paribas family.

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No discussion of an asset class is complete without discussing ESG. Aside from being SFDR article 8 compliant, specifically for real estate investments we assess all potential projects in terms of their Net Environmental Contribution (NEC). This evaluates properties based on their construction and operations, providing guidance to ESG-minded investors. For new-builds, we can influence both elements. For existing properties, it is just operations, although this can still be significant. For example, as part of a broader portfolio, BNPP AM has financed the acquisition of one landmark headquarters of a TV broadcaster in the centre of Paris. The building's NEC score on purchase was -4% but we were attracted by the acquirer's plans for refurbishment. The basic concrete structure will remain the same but energy-efficiency savings will take the NEC score to +43%.

NEC data is commonplace in the European real estate market and we expect scores in general to shift to the right in line with decarbonisation and energy efficiency. BNPP AM's portfolios, however, are already top-quartile and expect to remain so. In terms of sectoral exposure, we currently favour city-centre offices, logistics and residential. Logistics is very fashionable: last year amounts invested in logistics increased by 53% versus just 8%5 for offices. But we see this as justified as retail businesses of all kinds continue to restructure their distribution and goods of kinds have to be moved more rapidly from point to point.

The meteoric rise in value of logistics is a good reminder of the asset manager's responsibility to be prudent when choosing which acquisitions to fund. To interested asset owners, BNPP AM emphasises that we are financing portfolios of businesses. Our risk assessment and due diligence is also on the equity owner and underlying tenants than the buildings in which they sit. We have a suite of covenants to mitigate income impairment from borrowers or, indirectly, tenants. Ultimately, prospective clients should view CRE debt strategies as reliable, defensive elements of their total fixed income allocation. They obtain regular, inflation-linked income from a wide variety of European private and public-sector revenues with the collateral security of real estate in the background for reassurance and peace of mind.

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FOOTNOTES:
1 End Jan 2022, source MSCI
2 Market cap of the Wilshire5000 index of stocks divided by the country's GDP. At 10th Feb, 2022, USD48.5trn/USD24.1trn.
3 Source: CBRE
4,5 Source: BNPP AM & BNPP RE Research

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