European market volatility provides real estate debt opportunity

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Market conditions remain volatile amid higher interest rates, inflation and the threat of looming recession. In such an environment, investors are struggling to meet return requirements. However, asset classes such as commercial real estate (CRE) debt could offer the potential for value across short, medium and long-term timeframes, while adding effective portfolio diversification.

Shifting market conditions set stage for CRE debt

Economies throughout Europe are feeling the strain with the continued fallout from the COVID-19 pandemic, Russia's invasion of Ukraine, substantial energy and food cost increases and the resultant cost of living crisis.

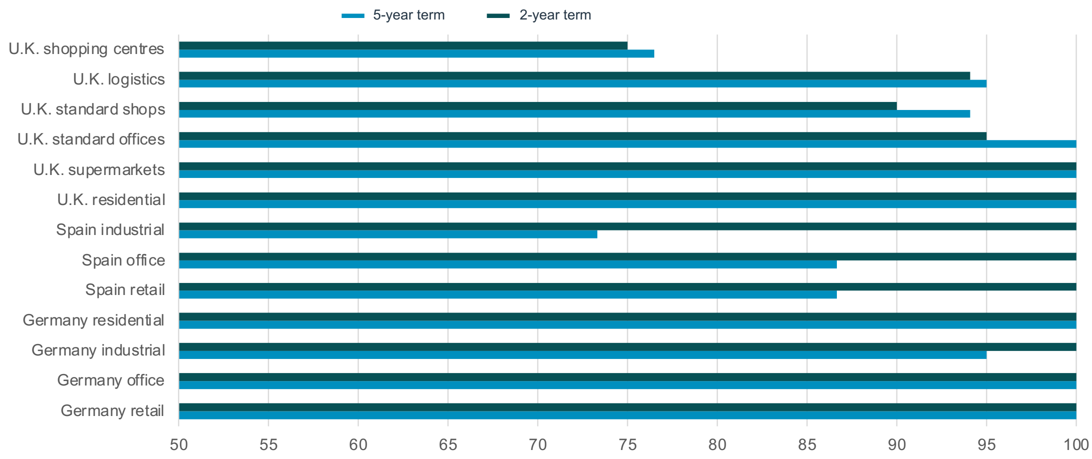
Figure 1 shows that 2023 economic activity in European countries, as measured by gross domestic profit (GDP), is projected to fall compared with 2022 growth. Rapid and substantial interest rates increases mixed with higher inflation is causing GDP to fall. These interest rate increases have also resulted in the cost of borrowing against CRE debt now being higher than the equivalent yield available from direct investment in the same property. While this rapid change is proving troublesome for borrowers, the growing cost of borrowing offers increased returns for debt holders.

These current challenges in the CRE debt market, however, are potentially outweighed by a positive outlook. Rising interest rates, which are unlikely to soften in the short-term, the lower supply of debt and increased lender pricing power have created a strong platform for debt investment opportunities. Weaker currencies have also created an environment that invites foreign investment, particularly US-dollar investors, as currency correction over the medium term could boost returns. With economic growth expected to improve in 2024 (see figure 1), the current debt environment is attractive for European-based investors as well, with the sector offering effective diversification to direct investment portfolios

Real estate debt is a historically low volatility asset class which offers a strong fixed income, cash pay return, and inflation-hedging characteristics from which debt investors can benefit. Furthermore, analysis by Nuveen Real Estate finds a strong probability of European real estate debt being paid back in full across two and five-year timescales, underlining the low volatility aspect of such investments (figure 2).

Figure 2: Probability of valuation at expiry being greater than 75% of start value

(i.e. debt investment repaid in full)



Source: MSCI, 1995-2020

Barriers to entry

Current conditions could be positive for not only short to medium, but also, long-term returns for debt investors, given diminished sources of lending and attractive lending rates for in-demand asset classes.

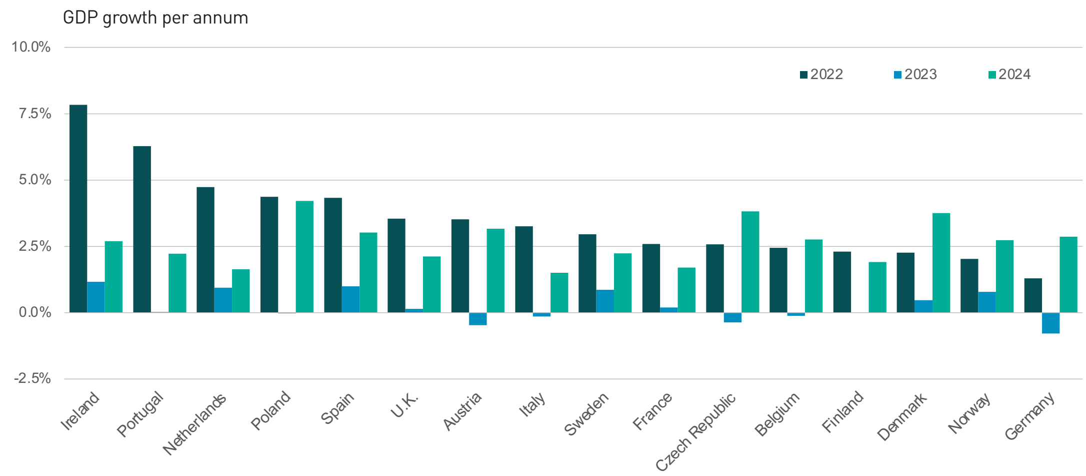
Historically traditional banks have made up the majority of CRE lending in Europe, with issues around available capital and its deployment, and a lack of depth of resource to originate lending opportunities directly being two of the main obstacles for alternative lenders entering the market.

The experience and knowledge of local real estate markets on a sector-by-sector basis as well as an understanding of the dynamics of the local lending environment required when investing in real estate assets are also hurdles. Identifying the demand of specific borrower groups and the need for different types of debt capital are all aspects which require local expertise. With Europe an attractive proposition given current macro and market conditions, understanding the culture, demand and process of location-specific investments is increasingly important.

Non-bank lenders such as Nuveen Real Estate with extensive experience of real estate investment across Europe have been able to penetrate specific target markets across Europe, especially where a more conservative lending approach from banks has created a short supply of debt and increased purchasing power alternative lenders have in this space.

Figure1: Economy faces a sharp slowdown over the coming winter

Occupier markets across sectors may start to see some turbulence from end 2022



Source: Oxford Economics, September 2022.

Partnering with experience

While these barriers exist, partnering with an experienced asset manager provides solutions to these obstacles.

With over 85 years of commercial real estate and CRE debt investing experience and $156 billion in assets under management as of June 2022 ($44.8 billion of which is devoted to CRE debt investments), Nuveen Real Estate offers investors a strong platform, an experienced team and superior track record.

Having invested across the U.S., Asia-Pacific and Europe, we offer local expertise combined with a global perspective. We are able to identify areas for growth, address market demands for real estate and help investors diversify their portfolios to achieve long-term investment success.

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