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a.s.r. real assets investment partners

Investing in commerical real estate loans as an alternative to property investment

Many investors in private real estate invest chiefly in real estate assets, whether directly or indirectly. However, investing in the financing of loans on real estate assets can also be an interesting way to build real estate exposure. Commercial real estate lending has recently become more interesting for alternative lenders because the traditional banks are being put under increasing pressure by changing regulations to reduce the real estate loans they are allowed to have on their books. At the same time, a large portion of the outstanding real estate loans will expire in the coming years and will have to be (partially) refinanced. This threatens to create a funding gap over the coming years, which will significantly increase the demand for real estate loans from alternative lenders. According to a.s.r. real assets investment partners, this offers an interesting opportunity for alternative lenders, such as institutional investors, to invest in real estate loans over the coming years. Especially as we expect interest rates to remain structurally at higher levels than we have seen in recent years.

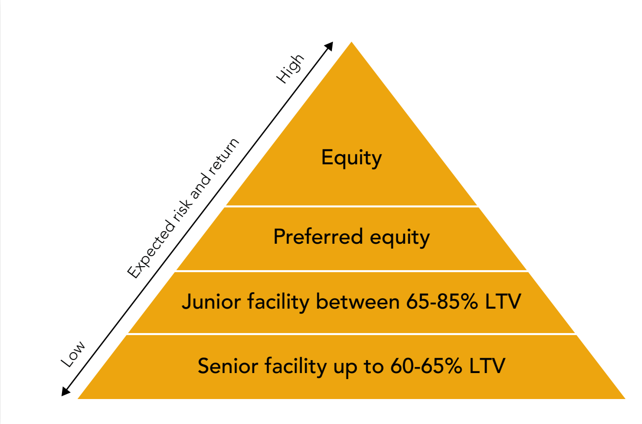
Commercial real estate loans

Real estate loans from lenders such as banks and institutional investors provide loans to real estate owners to (partially) finance real estate assets. Real estate owners use loans to purchase real estate, but they also use it for such things as refinancing and making additional investments in the area of sustainability. In general, there are three types of facility:

1. Investment facility: these are real estate loans to partially finance existing real estate assets that get a rental income from one or more tenants.
2. Transition facility: these are real estate loans to finance the renovation or redevelopment of real estate assets. This type of loan enables an investor to make an (indirect) impact, especially in the financing of sustainability programmes.
3. Development/construction facility: these are real estate loans to finance the development of real estate.

Real estate financing can be further divided into various tranches, each with its own risk-return profile:

1. Senior facility: this is the most senior tranche within the capital structure and often has a first right of mortgage. The loan-to-value ratio is a maximum of 60-65%. The interest rate can be either fixed or variable.
2. Junior facility: a junior facility, or mezzanine loan, is a subordinate type of loan that often has a higher loan-to-value ratio of 60-85%. Due to the higher risk profile, providers of junior facilities get a higher interest payment to compensate. The interest rates for these loans can also be either fixed or variable.
3. Preferred equity: this is a hybrid form of loan capital and equity.



Characteristics of a commercial real estate loan

For most investors, real estate loans are part of their fixed-income portfolios. However, there are also investors who see them as part of a private real estate portfolio. Aside from that, investors generally invest in real estate loans for the following characteristics:

- Real estate loans have a low correlation with traditional investment categories, which can enhance the risk-return profile of a portfolio.
- Real estate loans offer an attractive premium compared to other fixed-income securities with a comparable credit risk profile. This risk premium is to compensate for the relative illiquidity and complexity of the investment category.
- It is an interesting supplement to a mortgage portfolio. Mortgages often have long maturities and the interest rate is usually fixed. The term of real estate loans are often shorter and usually have a floating interest rate.
- The direct returns on real estate loans are attractive and predictable because the vast majority of the returns are cash flow driven with the interest payments on the outstanding loan amounts.

- Investing in real estate loans fits well within an ESG and impact strategy. For example, the loans can be made with the aim of reducing energy emissions from existing real estate assets or to enable the construction of new energy-efficient real estate assets.
- Within the investment category for fixed-income value investing, real estate loans are notable for their low default rates and high recovery rates. This is partly due to the equity that the owner of the real estate object brings to the capital structure. In addition, real estate is a physical investment, which means that the loan provider can take ownership of the property in the event of a default. Furthermore, various mitigation measures are often included in the loan documentation to monitor the risk of a default. Examples of such measures are the loan-to-value ratio, interest coverage ratio, and the debt service coverage ratio.

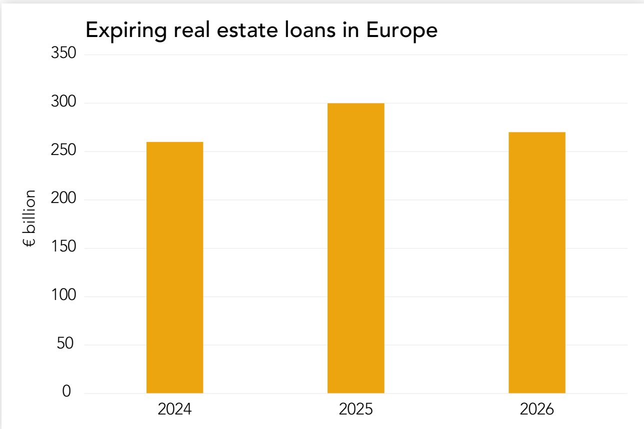
Market Composition and Opportunity

There is a lot of money in the real estate loan market worldwide. The United States has the largest real estate loan market, with an estimated size of $4.4 trillion (source: J.P. Morgan North America Credit Research, March 2023). The size of the European real estate loan market is approximately €1.5 trillion (source: Bayes Business School, European CRE lending, 2022). In the coming years, between €200 and €300 billion of European real estate loans will have to be refinanced every year[1]. The vast majority of outstanding loans in Europe are, unlike in the United Kingdom and the United States, still with the banks. However, under the influence of changing regulations, banks are increasingly reducing their existing real estate loan exposure.

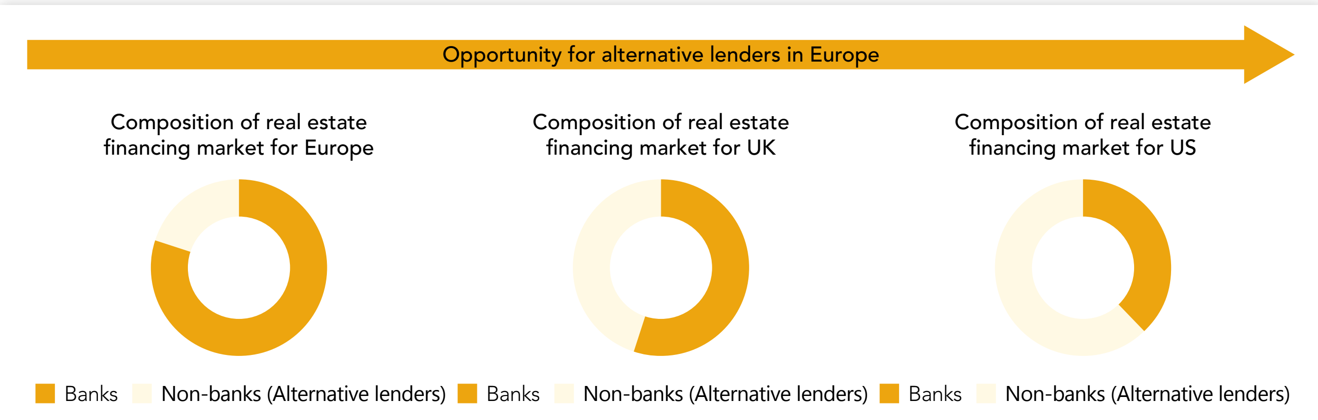
1 source: Bayes, Bloomberg and AllianceBernstein Real Estate

This threatens to create a mismatch between the demand for and the availability of loan capital for the financing of real estate. This impending funding gap offers alternative lenders, such as institutional investors, an attractive opportunity to invest in real estate loans under interesting conditions (lender friendly) over the coming years. As a result, the share of alternative lenders in the real estate financing market is also expected to increase further in Europe.

For example, the average loan-to-value at which a loan is made has further decreased in recent times. While, in theory, senior facilities often go up to a loan-to-value of 60-65%, today they are often originated at a loan-to-value of up to 50%. At the same time, the values of European real estate have fallen sharply over the past two years and these lower loan-to-values apply to the corrected values. In addition, interest rates have increased recently, making the returns on real estate loans currently very attractive. The combination of these factors increases the market momentum for investments in real estate loans. As far as a.s.r. real assets investment partners is concerned, this makes it relatively interesting at the moment.



Source: Bayes, Bloomberg, and AllianceBernstein Real Estate



Source: Bank of America and J.P. Morgan

Many managers are responding to this opportunity for alternative real estate lenders, increasing the range of available investment strategies. There is now a wide range of choice for investors who want to build up exposure in this area. This means that every investor has a strategy available that matches the intended risk-return profile. Depending on the available investment amount, investors can opt for a direct strategy via a separate account solution, or an indirect strategy via a closed-end or open-end real estate loan fund. Just as with regular real estate investments, it is essential to have sufficient risk mitigation in place through diversification when choosing to invest in real estate loans. In addition, investors should also ensure that the sectoral and regional distribution is properly aligned with your broader investment strategy. Based on its house view, a.s.r. real assets investment partners prefer real estate loan strategies which consider the fundamentally stronger sectors such as logistics and residential, but also attractive niches. With regard to the financing of offices and retail real estate, a.s.r. real assets investment partners would be more selective and opt to underweight these sectors.

For investors, investing in real estate loans can be an interesting addition to their existing investment portfolios. Due to the expected demand for real estate loans, the higher interest rate levels, and the recent price correction of commercial real estate, there appears to be an attractive entry point for new investors in the near future.

a.s.r. real assets investment partners would be happy to talk to you about the possibilities in this area.

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