

# View from Private Markets:

**Reappraising the value  
of real estate debt**

A key diversifier amid rising  
rates and soaring inflation

**Vincent Nobel**

Head of Asset Based Lending

**Angela Sheahan**

Strategy Analyst,  
Real Estate Debt

October 2022

**Federated  
Hermes**   
Limited

[www.hermes-investment.com](http://www.hermes-investment.com)  
For professional investors only

In our latest newsletter we explore the impact of high inflation on property values and look at how real estate lending strategies can provide real estate investors with a valuable diversifier.

- In the years following the global financial crisis, low rates reduced absolute returns for real estate lenders, but that is set to change now that rates are rising.
- Defensive real estate debt strategies should be largely protected from short-term property value declines, and may actually benefit from the rising rates environment.
- An allocation to real estate debt as part of a wider property investment strategy can help reduce the impact of real estate yield widening on overall portfolio return, while at the same time still maintaining exposure to the income that real estate assets generate.



For lack of a better metaphor, real estate investors have been drunk on low rates over the last decade. Leverage has been cheap, and this has made defensive debt strategies relatively unappealing. When investors think there isn't much risk in the system, there is little to defend against.

Real estate debt returns are a combination of the risk-free rate (either in fixed rate form or floating) and a credit margin. Yet with central bank rates at or near zero the risk-free rate component has been negligible; and in a stable environment loan margins are modest. Therefore, compared to long-term averages, real estate loan absolute returns have been low over the course of the last decade.

However, in 2022 the business environment radically changed: inflation is at a four-decade high and soaring prices have forced central banks to raise rates, creating upward yield pressure for real estate assets. How much of a concern do widening yields represent?

In this newsletter we explore the possible impact of high inflation on property values and look at how real estate lending strategies can provide real estate investors with a valuable diversifier.

### Inflation and the required risk premium

The current environment of high inflation and rising interest rates is set to have a profound effect on the pricing of real estate and real estate debt.

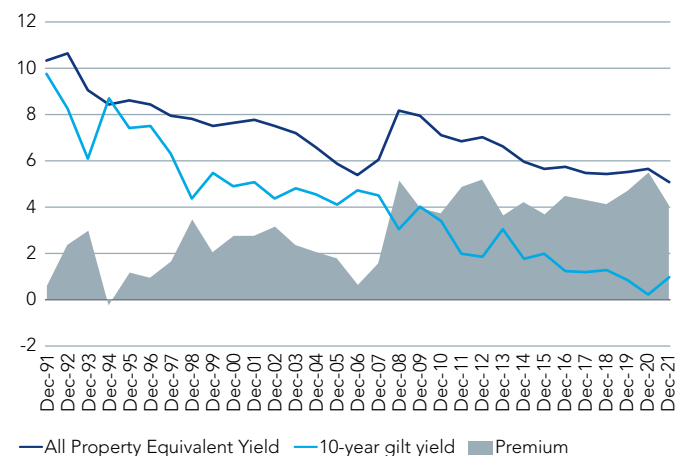
Investors traditionally value real estate in comparison with the risk-free rate: with a premium applied to allow for the risk associated with holding real assets, the illiquidity of these assets and the depreciation of physical buildings. Although real estate loans are typically agreed for periods of three to five years, it is the 10-year government bond yield that is used as the risk-free rate benchmark in fair value analysis, because it has a similar maturity profile to prevailing lease lengths of prime property.

### The current environment of high inflation and rising interest rates is set to have a profound effect on the pricing of real estate and real estate debt.

During the 2008-09 global financial crisis (GFC) property values fell across the world. Moreover, real estate looked attractively priced in the aftermath of the GFC as monetary policy put significant downward pressure on bond yields. As ongoing monetary tightening pushed bond yields lower than ever before – despite significant property yield tightening in the years following the crisis – real estate has remained a relatively attractive proposition for an entire property cycle (around the last 15 years).

Figure 1 shows that the average premium for holding real estate rose from approximately 190 bps to 440bps in the post GFC years. However, on an absolute basis, returns have been low, which has made cheap leverage an attractive option for many investors.

Figure 1: Real estate yield premium



Source: MSCI Real Estate / UK Office for National Statistics.

**Past performance is not a reliable indicator of future performance.**

The relative value of real estate debt also changed since the GFC. Pre-GFC, typical leverage on real estate assets could amount to 80% or more of the property value, while credit margins were tight. This leverage ratio fell sharply after 2007 and margins increased. For the last 10 years, typical leverage has been closer to 55-60% across all property types. Despite the fact that margins rose significantly immediately after the GFC, they have come down since their highs in 2012. Along with falling central bank rates, the absolute return of real estate debt decreased. Even if credit margins remained somewhat attractive, for many investors senior real estate loans were simply not worthy of attention in an environment where levered real estate equity strategies could achieve double digit returns with ease.

At average leverage levels of

**60%** the underlying real estate assets can lose  
**40%** of value during the life of the loan before the lender suffers a capital loss.

Today, however, we find ourselves in a rapidly changing rate environment. In a bid to fight inflation, central banks are aggressively pushing up rates, and governments are trying to find ways to stimulate growth. We have seen inverted yield curves. So, if low rates reduced absolute returns for real estate lenders, what can we expect now that rates are rising?

### Relative value in real estate debt

We certainly believe that the relative value of real estate debt looks attractive in the current environment. Rising rates puts upward pressure on real estate yields. As can be seen in Figure 1, the real estate market may lag a little (as it did in 2007) but in the end, investors will require a premium for holding real estate assets compared to government bonds. In times of low growth (and certainly in a recessionary environment), rental growth will be harder to achieve, and therefore upward yield pressure should result in capital value decline for real estate owners. The possibility of (modest) capital value decline is a compelling argument for allocations to real estate debt.



**Industrial property, such as distribution warehouses, has historically been a high yielding, low growth investment.**

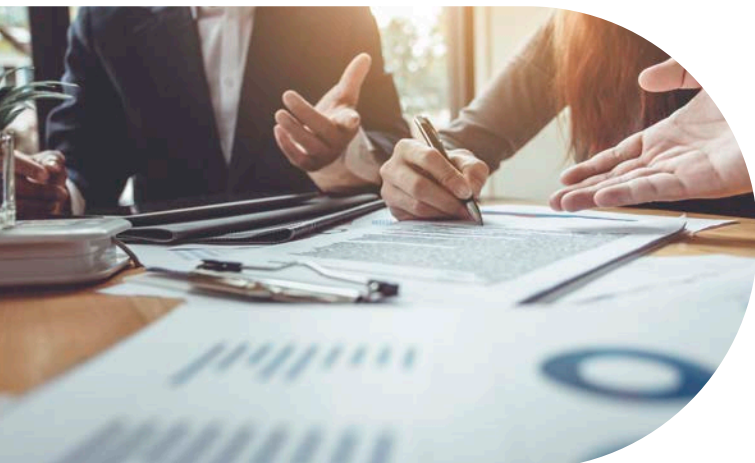
For allocators of capital, this changing investment environment should move real estate debt from not worthy to noteworthy. By making an allocation to real estate debt as part of a wider real estate strategy investors can reduce the impact of real estate yield widening on their overall portfolio return, while at the same time still maintaining exposure to the income that real estate assets generate.

At average leverage levels of 60%, the underlying real estate assets can lose 40% of value during the life of the loan before the lender suffers a capital loss. Provided the property income is maintained at levels that allow borrowers to pay interest, real estate debt strategies continue to deliver stable income without much (if any) correlation to the real estate market that serves as its collateral. As part of a wider real estate portfolio, an allocation to real estate debt can help stabilise overall portfolio returns during a downturn.

### Focus on UK distribution warehouses

Over the last property cycle, the segment that has witnessed the most significant transformation is the industrial real estate sector. Industrial property, such as distribution warehouses, has historically been a high yielding, low growth investment. But the rapid uptake of online retail over the last 15 years – culminating in many people's dependence on it during the pandemic – has transformed the economics of this sector.

In the UK, for example, yields have fallen significantly over the last cycle (see Figure 2). Meanwhile, as interest rates fell, the indicative pricing for real estate deals against industrial and distribution warehouses also became cheaper (see Figure 3). As seen across the real estate sector, however, leverage has remained significantly lower since the GFC. As a result, investment in distribution warehouses has been attractive for both equity investors and lenders alike.



With interest rate increases putting pressure on both the low yields in industrial property, as well as the cost of debt, it is likely to be a sector at significant risk in the current environment. However, with prevailing loan-to-value ratios at less than 60%, the values of the underlying real estate assets would need to fall by more than 40% before the loans suffer a capital loss. Outperforming parts of the distribution sector could continue to deliver stable returns for equity investors whereas underperforming assets in this sector could be at risk of losses. For lenders to this sector, positions are likely to be a lot more protected apart from exceptionally underperforming assets or overleveraged loans.

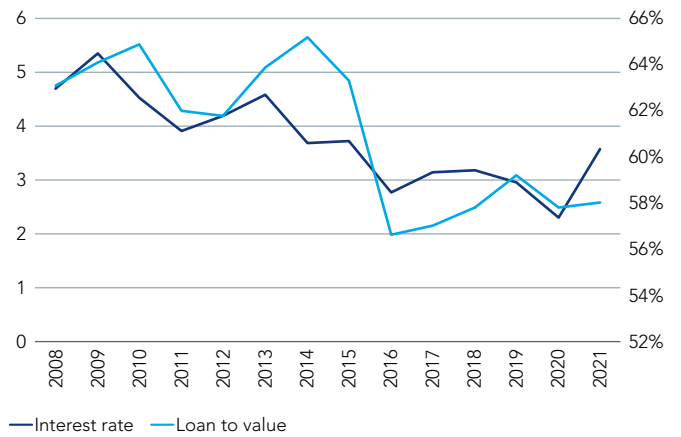
**Figure 2:** Equivalent yields for UK industrial assets



Source: MSCI Real Estate as at August 2022.

**Past performance is not a reliable indicator of future performance.**

**Figure 3:** Cost of debt on industrial property (swap rate + lending margin) and loan-to-value ratios



Source: Bayes Business School, Bloomberg.

**Past performance is not a reliable indicator of future performance.**

### Ensuring stable returns

Defensive real estate debt strategies should be largely protected from short-term property value declines, and may actually benefit from the rising rates environment. We continue to hold the view, therefore, that allocating to real estate debt, as part of a wider private markets real estate strategy can be a very valuable contributor to long-term stable income returns from the property sector.



**This portfolio contains illiquid assets. Due to the nature of these assets, being typically private, unique and bespoke, these portfolio investments will not be as easily sold in the market as publicly traded securities. Ability to redeem from this investment is limited and may be significantly deferred.**

**The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Past performance is not a reliable indicator of future results.**

**For professional investors only.** This is a marketing communication. The views and opinions contained herein are those of Vincent Nobel, Head of Asset Based Lending and Angela Sheahan, Strategy Analyst Real Estate Debt, and may not necessarily represent views expressed or reflected in other communications, strategies or products. The information herein is believed to be reliable, but Federated Hermes does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Figures, unless otherwise indicated, are sourced from Federated Hermes. This document is not investment research and is available to any investment firm wishing to receive it. The distribution of the information contained in this document in certain jurisdictions may be restricted and, accordingly, persons into whose possession this document comes are required to make themselves aware of and to observe such restrictions.

Issued and approved by Hermes Investment Management Limited ("HIML") which is authorised and regulated by the Financial Conduct Authority. Registered address: Sixth Floor, 150 Cheapside, London EC2V 6ET. HIML is a registered investment adviser with the United States Securities and Exchange Commission ("SEC"). Distributed in the EU by Hermes Fund Managers Ireland Limited which is authorised and regulated by the Central Bank of Ireland. Registered address: 7/8 Upper Mount Street, Dublin 2, Ireland, DO2 FT59.

**In Australia:** This Strategy Document relates to potential offer of financial products or investment opportunities in Australia (Investment opportunities). Both Hermes Investment Management Ltd (HIML) and Federated Investors Australia Services Ltd. ACN 161 230 637 (FIAS) are the distributors of the Investment opportunities. HIML does not hold an Australian financial services licence (AFS licence) under the Corporations Act 2001 (Cth) ("Corporations Act"). HIML operates under the relevant class order relief from the Australian Securities and Investments Commission (ASIC) while FIAS holds an AFS licence (Licence Number - 433831).

The offer of Investment opportunities only made in circumstances under which no disclosure is required under Chapter 6D and Part 7.9 of the Corporations Act. Nothing in this Strategy Document is, or purports to be, an offer to a person to whom disclosure would be required under Chapter 6D or Part 7.9 of the Corporations Act.

This Strategy Document is not a disclosure document under Chapter 6D of the Corporations Act or a product disclosure statement for the purposes of Part 7.9 of the Corporations Act. This Strategy Document has not been and will not be lodged with ASIC and does not contain all the information that a disclosure document or a product disclosure statement is required to contain. The distribution of this Strategy Document in Australia has not been authorised by ASIC or any other regulatory authority in Australia. In addition, the Fund is not a registered managed investment scheme, as defined in the Corporations Act.

This Strategy Document is provided for general information purposes only and is not intended to constitute, and does not constitute, the provision of any financial product advice or recommendation and must not be relied upon as such. This Strategy Document is not intended to influence a person in making a decision in relation to a particular financial product or class of financial products, or an interest in a particular financial product or class of financial products.

This Strategy Document has been prepared without taking account of your objectives, financial situation or needs and you should obtain independent professional financial advice that considers your circumstances before making any financial or investment decisions.

**In Hong Kong:** The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. The strategies are not authorised under Section 104 of the Securities and Futures Ordinance of Hong Kong by the Securities and Futures Commission of Hong Kong. Accordingly, the distribution of this document, and the placement of interests in Hong Kong, is restricted. This document may only be distributed, circulated or issued to persons who are professional investors under the Securities and Futures Ordinance and any rules made under that Ordinance or as otherwise permitted by the Securities and Futures Ordinance.

**In South Korea:** Hermes Investment Management Limited is not making any representation with respect to the eligibility of any recipients of this document to acquire the strategies therein under the laws of Korea, including but without limitation the Foreign Exchange Transaction Act and Regulations thereunder. The strategies have not been registered under the Financial Investment Services and Capital Markets Act of Korea, and none of the strategies may be offered, sold or delivered, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to applicable laws and regulations of Korea.

**In Spain:** This document is issued by Hermes Fund Managers Ireland Limited, Branch in Spain, with Fiscal Identity Number W0074815B, registered in the Mercantile Registry of Madrid, - Volume 40448, Book 0, Sheet 16, Section 8, Page M-718259, first registration, with domicile at Paseo de la Castellana 18, 7º planta, 28046 Madrid - Spain, and registered in the Comisión Nacional del Mercado de Valores with official registration number 36.

**Benchmark source: MSCI.** The MSCI data is for internal use only and may not be redistributed or used in connection with creating or offering any securities, financial products or indices. Neither MSCI nor any other third party involved in or related to compiling, computing or creating the MSCI data (the "MSCI Parties") makes any express or implied warranties or representations with respect to such data (or the results to be obtained by the use thereof), and the MSCI Parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to such data. Without limiting any of the foregoing, in no event shall any of the MSCI Parties have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

## Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

## Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit [www.hermes-investment.com](http://www.hermes-investment.com) or connect with us on social media:

