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

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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.

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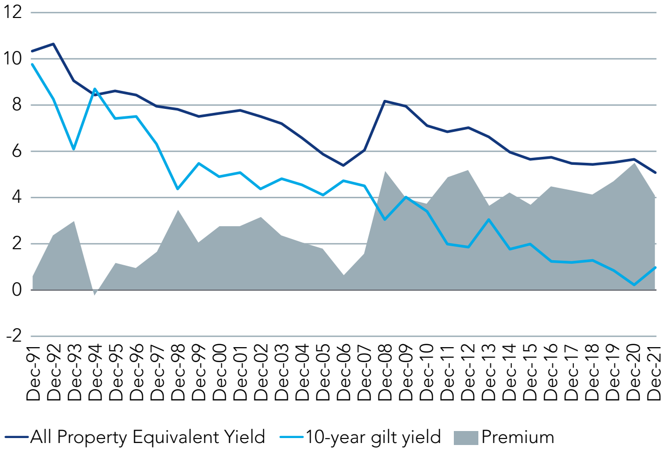
During the 2008-09 global financial crisis (GFC) property values fell across the world. Moreover, real estate looked attractively priced in the aftermath of the GFC as monetary policy put significant downward pressure on bond yields. As ongoing monetary tightening pushed bond yields lower than ever before – 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.

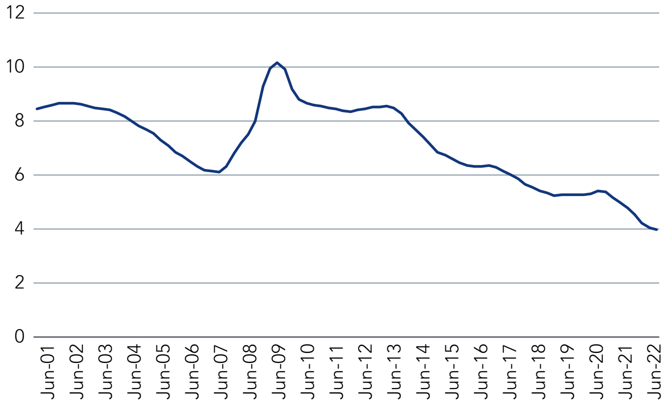
Focus on UK distribution warehouses

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.

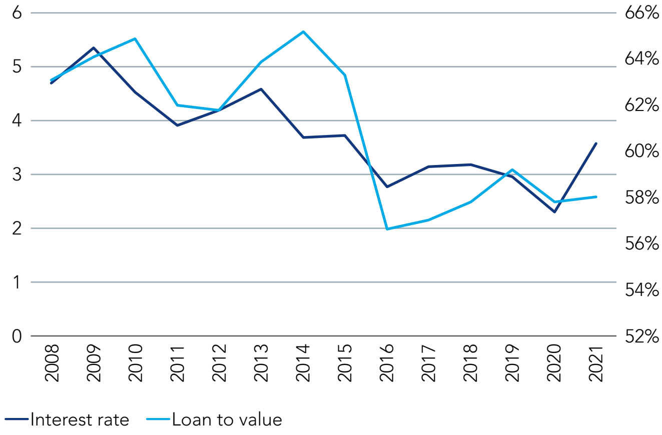
With interest rate increases putting pressure on both the low yields in industrial property, as well as the cost of debt, it is likely to be a sector at significant risk in the current environment. However, with prevailing loan-to-value ratios at less than 60%, the values of the underlying real estate 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.

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