Private Markets Insight

Alternatives for institutional investors:

a non-bank lender approach to commercial real estate

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Alternatives for institutional investors

A non-bank investment approach to commercial real estate debt can help institutional investors better deliver on their medium- to long-term investment targets and drive attractive returns.

- Banks remain the dominant providers of capital in the European commercial real estate (CRE) finance market. However, banks' lending approach is largely informed by their role as systemic providers of credit and by the short-term nature of their balance sheet liabilities.
- Non-bank lenders – such as asset managers – do not face the same pressures to minimise portfolio loan maturities or build highly granular, representative portfolios.
- A CRE lending approach that takes a relative value, bottom-up approach to evaluating opportunities can potentially be better suited to meeting the investment objectives of institutional investors.

Senior real estate debt has the potential to be a tremendously useful, across-the-cycle component of any institutional investment portfolio. The appeal of the asset class can be particularly evident during periods of market correction, when senior real estate debt portfolios can expect to continue to distribute income-driven returns every quarter, while real estate equity allocations struggle to deliver positive returns.

The considerable equity buffer between the loan amount and the value of the property at the outset of the loan should allow for significant market deterioration before senior real estate debt strategies begin to suffer losses. Furthermore, loans made in the aftermath of market corrections typically provide excellent risk-adjusted returns for lenders able to increase their allocations.

Yet, despite its apparent usefulness – particularly for institutional portfolios with existing allocations to real estate equity and other private markets equity strategies – the financing of real estate remains largely led by traditional banks across Europe. Banks remain the dominant providers of capital in the European commercial real estate (CRE) finance market, despite losing some market share in the aftermath of the 2008-09 global financial crisis.

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One consequence of commercial banks leading the finance of CRE is that, from the perspective of some institutional investors, it has become the accepted norm. However, banks' lending approach is largely informed by their role as systemic providers of credit and by the short-term nature of their balance sheet liabilities. It is also heavily influenced by regulatory constraints. We believe these considerations should not define institutional investors' approach to the asset class.

Institutional investors can find the stability and predictability that private markets investments generate rewarding – however, for traditional banks, CRE loans' relative illiquidity can pose a significant challenge. It is one of the reasons why we argue that institutional investors should not limit themselves to the banks' approach to gain exposure to the asset class. It's also why we believe they should consider other approaches potentially better suited to their medium- to long-term investment objectives.

Banks' approach to CRE lending

Banks' vital systemic role as providers of credit and liquidity for the economy – as well as keepers of customers' deposits – brings with it stringent regulatory requirements that largely inform both the portfolio of loans they hold and the process that underpins how credit decisions are made.

Traditional banks' preference for shorter-dated loans, for example, provides a useful illustration of this role. Across much of Europe, customers' deposits – essentially overnight funding – account for the majority of banks' liabilities. As a result, the longer the term of a loan made by a bank, the greater the duration mismatch it will cause to their balance sheets.

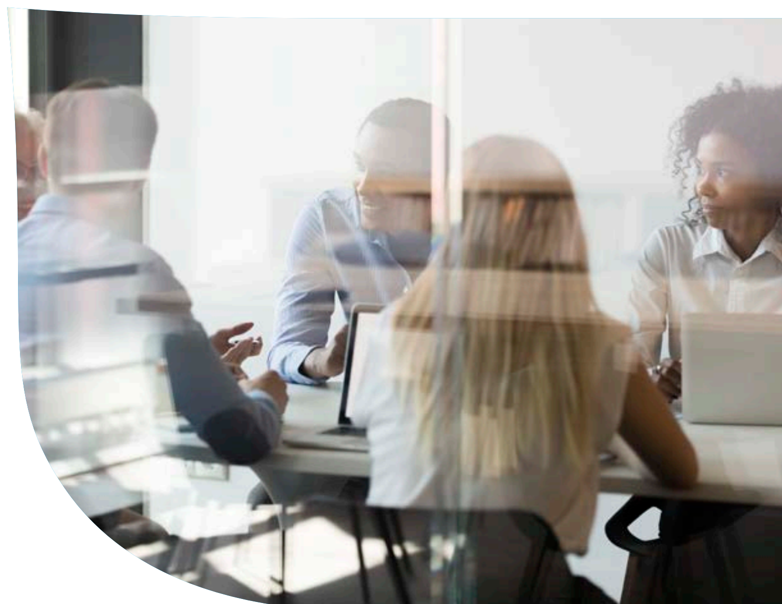
In addition, the European CRE secondary loan market's limited liquidity compels banks across Europe to lean towards financing shorter-term loans as a way of reducing the extent of this asset-liability mismatch. On top of this, the more frequently the loans come up for refinancing, the more a bank can require repayment of the loan balance – shorter maturities are, therefore, a proxy for liquidity.

The longer-term capital behind non-bank lenders allows their CRE strategies to place a greater emphasis on providing loan structures best suited to both the borrower and their business plan for the collateral property.

Similarly, banks' systemic role encourages a top-down approach to CRE lending. The lending restrictions imposed on bankers by their credit teams orient them towards creating highly granular loan portfolios that cover assets in all sectors and geographies within their jurisdictions. The results are highly diversified portfolios of modest loan-to-value (LTV) senior CRE loans, secured by assets that are a representative cross-section of their real estate market. However, contrary to popular belief, such representative portfolios do not always result in lower overall risk profiles. Crucially, this exposure to every part of the market can result in over-diversification and high beta.

Episodes such as the recent Covid-19 pandemic help to illustrate this point. During the lockdowns, low-LTV loan portfolios exposed to all parts of the market experienced difficulties achieving 100% interest collections on their loans. In contrast, some non-bank CRE loan portfolios – typically much less diversified as they target sub-sets of the market – were able to achieve 100% collections comfortably and weathered the pandemic without any payment defaults.

Commercial banks' CRE loan portfolios are constructed to be representative of their underlying markets. The goal, in crude terms, is to earn a premium over the savings rates needed to pay customers; and to maintain as short a portfolio maturity as is reasonable. However, such objectives do not necessarily tally with the investment aims of institutional investors, who may use CRE debt to support medium- to longer-term investment targets.



The choice for institutional investors

Non-bank lenders – such as asset managers – do not face the same pressures to minimise portfolio loan maturities or build highly granular, representative portfolios. As a result, they may be able to provide institutional investors with CRE debt portfolios better suited to their medium- to long-term investment goals.

Senior CRE debt strategies that seek to deliver predictable, income-driven returns from loans secured against assets selected for their likelihood to withstand downturns can provide just such an alternative.

By taking a bottom-up approach to asset selection, such strategies typically place greater emphasis on the underlying properties as determinants of credit risk than on the traditional credit metrics that drive bank portfolios' risk models, such as LTV and interest cover ratio (ICR). Properties that are less likely to suffer heavily during downturns are more inclined to support delivery of continuous income over the life of the loan.

Additionally, providing lower-LTV loans on weaker properties does not necessarily reduce the loan risks in all material respects. A primary focus is, therefore, on appraising the collateral asset; and then assessing the sponsor and the business plan for the asset in order to establish the merit of the lending opportunity at that particular point in the economic cycle.

The design of an appropriate loan structure – considering loan metrics and covenants – is very much secondary in the sequence, though, of course, it remains important. In other words, such an approach first seeks to determine whether or not to invest in a property at all, and, only *after* that, moves on to establish the most appropriate credit structure for the loan.

The longer-term capital behind non-bank lenders also allows such strategies to place a greater emphasis on providing loan structures best suited to both the borrower and their business plan for the property.

In the event that such considerations result in shorter-term loan structures, non-bank lenders will inevitably compete against traditional banks for the business. However, banks' highly layered decision-making processes can prove burdensome. The comparatively swift and more decisive deal execution available at non-bank lenders also provide an opportunity to win business.

Finally, such strategies can also aim to deliver returns that outstrip those that banks can achieve by introducing a relative value overlay to their search for lending opportunities. Non-bank strategies often seek attractive lending opportunities in areas of the market where loan pricing dislocations exist – for example where pricing is less efficient – and, as a result, can deliver attractive across-the-cycle returns that have the potential to significantly outperform real estate equity portfolios during downturns.

This less-common relative value approach to CRE lending should result in portfolios that – in addition to displaying a low correlation to direct real estate allocations – also offer investors an opportunity to make counter-cyclical investment allocations.

Indeed, this conservative approach – which focuses on low risk to generate relatively attractive returns – is directly responsible for some senior CRE lending strategies' current outperformance of corresponding equity allocations[1].

In contrast, banks are unable to actively pursue counter-cyclical investment lending strategies because of their regulatory framework and systemic role in the economy. As a result, despite banks' low-risk appetite, segments of their portfolios can be expected to suffer during downturn periods.

While some loans can comfortably sit in both bank and non-bank portfolios, many do not.

In fact, banks' credit risk models, often dominated by traditional metrics, can ultimately promote pro-cyclical lending behaviour, particularly in market segments that they dominate – such as CRE lending. In turn, this can lead to significantly lower lending appetites, and the need for regulatory capital trades to free up their balance sheets.

Conclusion: a real estate discipline

Institutional investors looking to make an allocation to CRE debt need not feel restricted to following the norms set by the commercial banks. Alternative approaches exist that may better align to institutional portfolios' investment goals and horizons; particularly since these aims are typically different to those of the banks.

We believe that a CRE lending approach that takes a relative value, bottom-up approach to evaluating opportunities – rather than focusing on building highly-diversified portfolios from the top-down – is potentially better suited to meeting the investment objectives of institutional investors.

By first and foremost emphasising CRE lending as a real estate discipline, a non-bank investment approach can not only help institutional investors better deliver on their medium- to long-term investment targets; it also allows for the coverage of parts of the market where banks might be less active, and where the relative lack of capital may well drive attractive relative returns.

While some loans can comfortably sit in both bank and non-bank portfolios, many do not. Ultimately, different motives underpin banks and non-banks processes for making senior CRE loans and this variation in approach can sometimes result in disparate financial outcomes.

[1] Federated Hermes' real estate debt portfolio posted a total return of 3.7% for the first three quarters of 2022 compared to 2% for the corresponding international real estate equity portfolio over the same period. **Past performance is not a reliable indicator of future performance.**

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