ISA | Insights Strategy Analysis
by LaSalle

FOCUS

Investing in real estate debt

July 2024

The three-part case for investing in real estate debt

1

Debt in the portfolio

Private debt may offer portfolio diversification, attractive risk-adjusted returns, and stable cashflow with downside protection.

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The role of non-bank lending

Non-bank lenders are playing a growing role in the commercial real estate debt markets as other lenders have pulled back due to regulatory changes.

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The debt opportunity today

Current pricing dynamics are favorable for real estate debt as a wall of debt maturities is meeting lower appetite for lending from existing sources.

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1

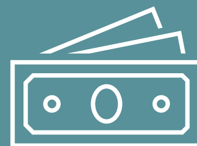
Debt in the portfolio

What does real estate debt do for the portfolio?

Portfolio **diversification** via low-to-moderate correlation to other real estate quadrants and other asset classes broadly

Potential for **higher returns** compared to other fixed income assets

Contractual interest payments provide **cashflow** and focus on income return **lowers volatility** compared to equity investments



Downside protection, depending on priority position in capital stack[1], repayment priority and recourse to underlying collateral with durable value

Variety of risk/return profiles based on the profile of the underlying real estate and loan structure

Exposure to **one of the largest segments** of the real estate market

(1) Different styles of debt investing (e.g., senior mortgages vs mezzanine) have different positions within the capital stack and thus benefit from downside protection to differing degrees.

Real estate debt 101

Debt investors enjoy downside protection in the event of a value decline; however, it does mean that they do not (under most structures) participate in the upside from value increases.

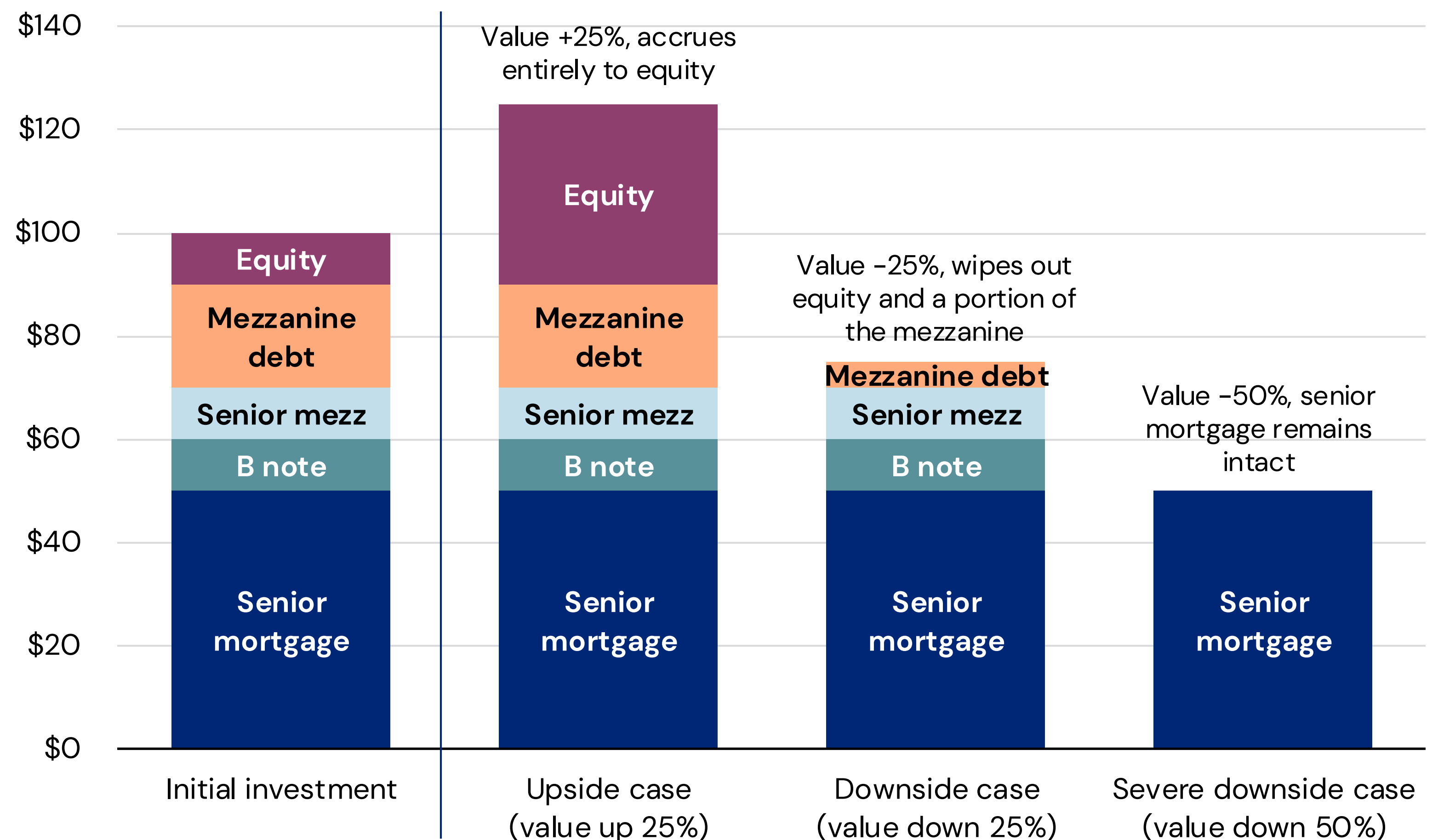
Contractual interest payments also provide stable cash flow to debt investors regardless of net operating income (NOI), unless it is insufficient to service the debt *and* the borrower does not have equity left to protect and/or lacks the liquidity to do so.

The risk of investing real estate debt is influenced by:

- The profile of the underlying real estate and business plan (core, value-add, opportunistic)
- The debt tranche's position within the capital stack (senior mortgage, B note, mezzanine)
- Whether the loan is structured relative to a fixed or floating rate
- The presence of interest rate floors and caps
- The structural protections and covenants included in loan documentation and the nature of the local foreclosure process

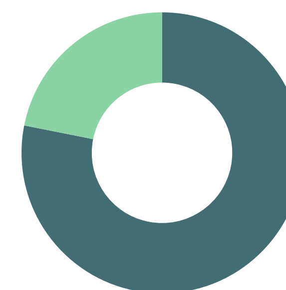
To learn more...
Read our paper "An introduction to real estate debt"

Indicative capital stack conditions under various value scenarios



Indicative representation of income return share by investment style

The return to **senior debt** comes entirely from **income**



Unlevered equity relies on **capital growth** for a portion of the return, but a majority coming from **income**

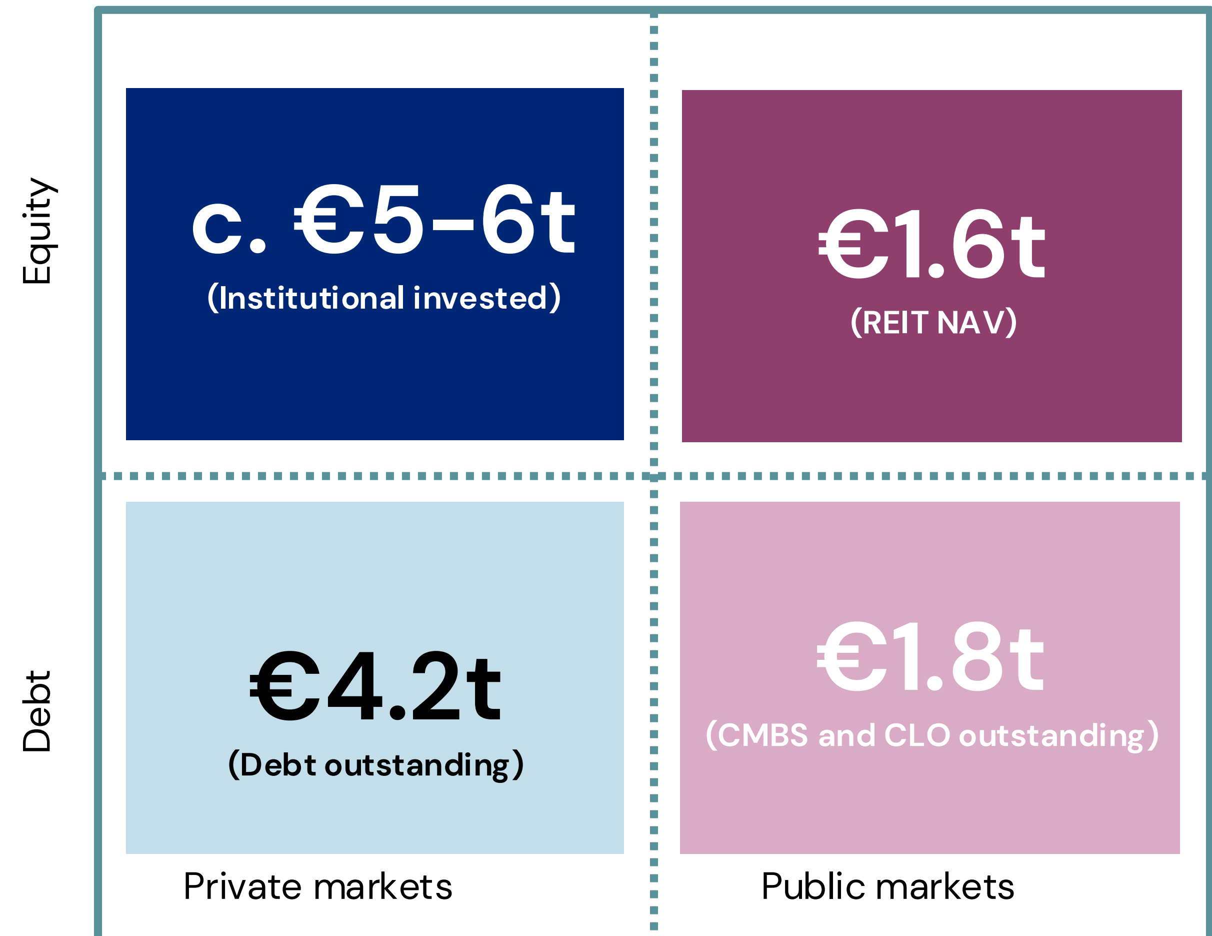
Levered, **value-add style equity** may depend upon **capital growth** for the majority of return

All illustrations on this page indicative illustrations based on LaSalle experience and industry standards.

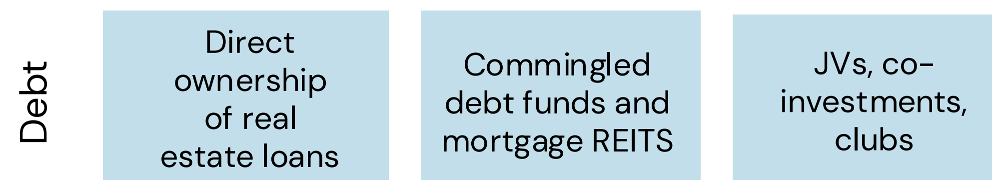
Debt strategies a key quadrant of real estate

Historically, institutional portfolios under-weight to debt strategies

- Non-public debt is easily the **second largest of the four quadrants of real estate.**
- Because banks have dominated private debt markets, especially in Europe, **debt strategies have historically comprised a smaller portion of institutional portfolios** relative to their weight in the quadrant diagram.
- **This is changing** as increased regulation makes direct real estate lending less efficient for banks (see next section), and the gap is increasingly being filled by alternative lenders. As investors continue to seek attractive risk-adjusted returns and stable income, these credit funds are expected to facilitate greater allocations by institutional investors to the private debt quadrant.



Channels for accessing private debt markets



Source: LaSalle analysis of data from MSCI, JP Morgan, Bayes, EPRA NAREIT. Latest as of February 2024.
No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Mortgages have low correlation to other assets

Real estate debt return correlations vs. other asset classes

United States
(Q2 2004 – Q1 2024)[1]

Asset class	Senior RE mortgages (1)	Non-agency CMBS	Corporate bonds	Public RE equity	Stocks	T-bills	Core private RE equity
Senior RE mortgages (1)	1	-	-	-	-	-	-
Non-agency CMBS	0.68	1	-	-	-	-	-
Corporate bonds	0.62	0.65	1	-	-	-	-
Public RE equity	0.50	0.70	0.48	1	-	-	-
Stocks	0.33	0.58	0.44	0.76	1	-	-
T-bills	(0.02)	(0.04)	(0.02)	(0.03)	0.01	1	-
Core private RE equity	(0.06)	(0.06)	(0.31)	0.14	0.02	(0.08)	1

Europe and the UK
(Q2 2014 – Q1 2024)[1]

Asset class	Private RE debt – subordinated & mezzanine (1)	Listed RE equity	Core private RE equity	Stocks	Public RE bonds	Corporate bonds	G'ovt bonds
Private RE debt - subordinated & mezzanine (1)	1	-	-	-	-	-	-
Listed RE equity	0.61	1	-	-	-	-	-
Core private RE equity	0.58	0.59	1	-	-	-	-
Stocks	0.08	0.66	0.25	1	-	-	-
Public RE bonds	0.46	0.67	0.13	0.53	1	-	-
Corporate bonds	0.41	0.61	0.05	0.46	0.97	1	-
Government bonds	0.36	(0.19)	(0.27)	(0.24)	0.17	0.23	1

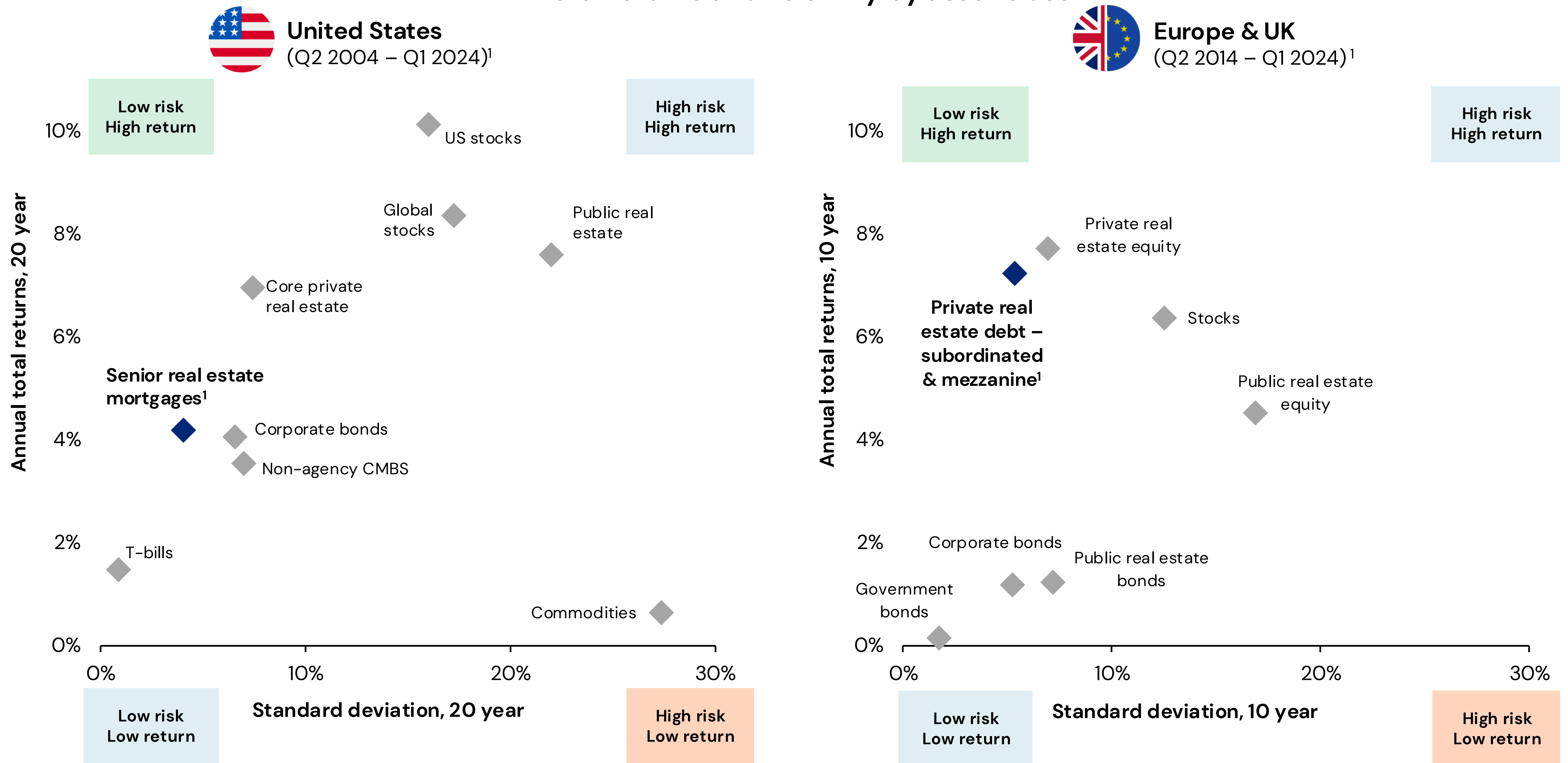
Note that private real estate values are generally based on quarterly appraisals.

(1) A note on cross-regional comparability: Time periods selected based on data availability (matched to longest period of available data in which we have confidence in the integrity of the mortgage data. Additionally, US senior mortgage data and European subordinate and mezzanine data not directly comparable as they represent different segments of the capital stack (selected based on data availability for each region). **For this reason and the differing time periods, we would emphasize comparison within rather than across regions.**

Sources for US: Giliberto-Levy Senior Mortgage Index, FTSE NAREIT, NCREIF ODCE, Citigroup, Standard & Poor's, HFRI, and the Federal Reserve. Senior RE Mortgages is represented by the Giliberto-Levy total returns. Public Real Estate is represented by FTSE NAREIT US Real Estate Index. Core Private Real Estate is represented by the NCREIF ODCE gross total returns. NCREIF ODCE data reflects the returns of diversified, core, open-end funds including leverage and fund expenses, but excluding management and advisory fees. Corporate Bonds are represented by the Citigroup Broad Investment Grade Corporate Bond Index. Stocks are represented by the S&P 500 Index. T-bills are represented by the US Government 90-day T-bill. Commodities are represented by the S&P GSCI Total Return index. Data as of Q1 2024. Most recent as of May 2024.

Sources for Europe: LSEG Eikon, MSCI, FTSE EPRA, ICE. Private Real Estate Equity represented by the MSCI PEPFI. Private Real Estate Debt represented by the MSCI European Debt Funds Subordinated / Mezzanine index. Public Real Estate Equity represented by the FTSE EPRA NAREIT Developed Europe index. Public Real Estate Bonds represented by the ICE BofA Euro RE bond index. Corporate bonds represented by the ICE BofA Euro Corporate index. Stocks represented by the FTSE All Share Index. Government Bonds represented by the UK Government 2-year benchmark. Data up to Q1 2024, most recent as of July 2024.

Debt can offer higher returns, lower volatility vs fixed income



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Note: Past performance is not indicative of future results. There is no guarantee that any trends shown herein will continue.

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The role of non-bank lending

What is the role of non-bank lenders?

Banks remain a primary source of debt capital for commercial real estate, but that **landscape is changing**

Non-bank lenders are increasing their share in the UK and the US, in part due to regulatory changes

Basel III rules constrain bank lending; US implementation (a.k.a. “Basel III Endgame”) not yet final but likely to have impact

Insurers covered by policies such as **Solvency II** enjoy advantageous capital treatment when investing in CRE debt and thus have been a key pillar of the credit market

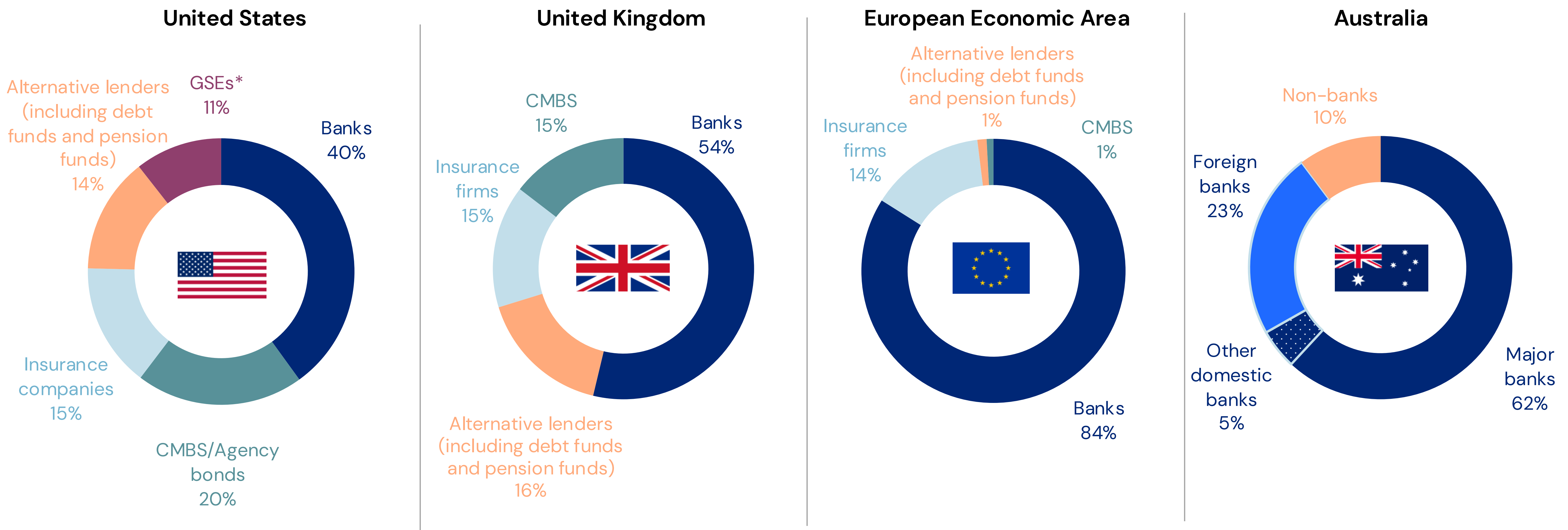
Non-bank lenders can **fill a niche** in the market; for example, as a key provider of large loans and financing development in the UK

Borrowers seek lenders who understand the underlying real estate and intend to hold the loan to maturity

Banks are still an important source of real estate debt capital, but not the only one

Different landscapes offer diverse opportunities: US market offers depth and alternative lender market maturity, whereas Europe is maturing with alternative credit growing market share

Sources of debt market capital by geography



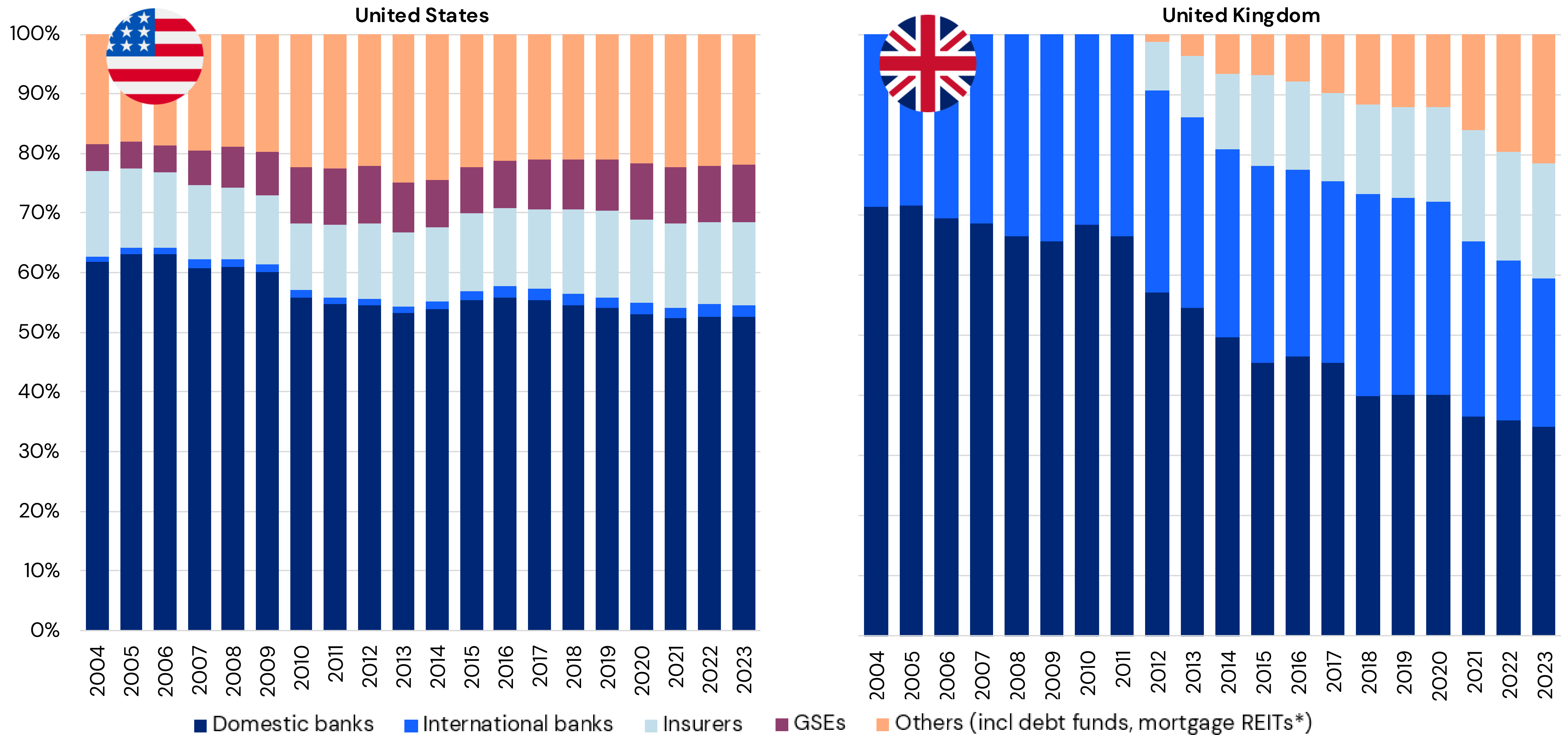
More diversified providers of debt
More mature private credit landscape

More bank-dependent debt capital markets
More opportunity for disruption by private credit

Source: Federal Reserve Flow of Funds, Bank of England, Refinitiv, Bayes Business School, European Banking Authority, European Insurance and Occupational Pensions Authority, Real Estate Capital, LaSalle (June 2023), Australian Prudential Regulation Authority, CLI Group Research (August 2023). * GSEs = Government-sponsored enterprises such as Fannie Mae and Freddie Mac.
Note: No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Banks: Alternative lenders are growing share in the UK

In the US, where private credit market is more mature, their share has been more stable



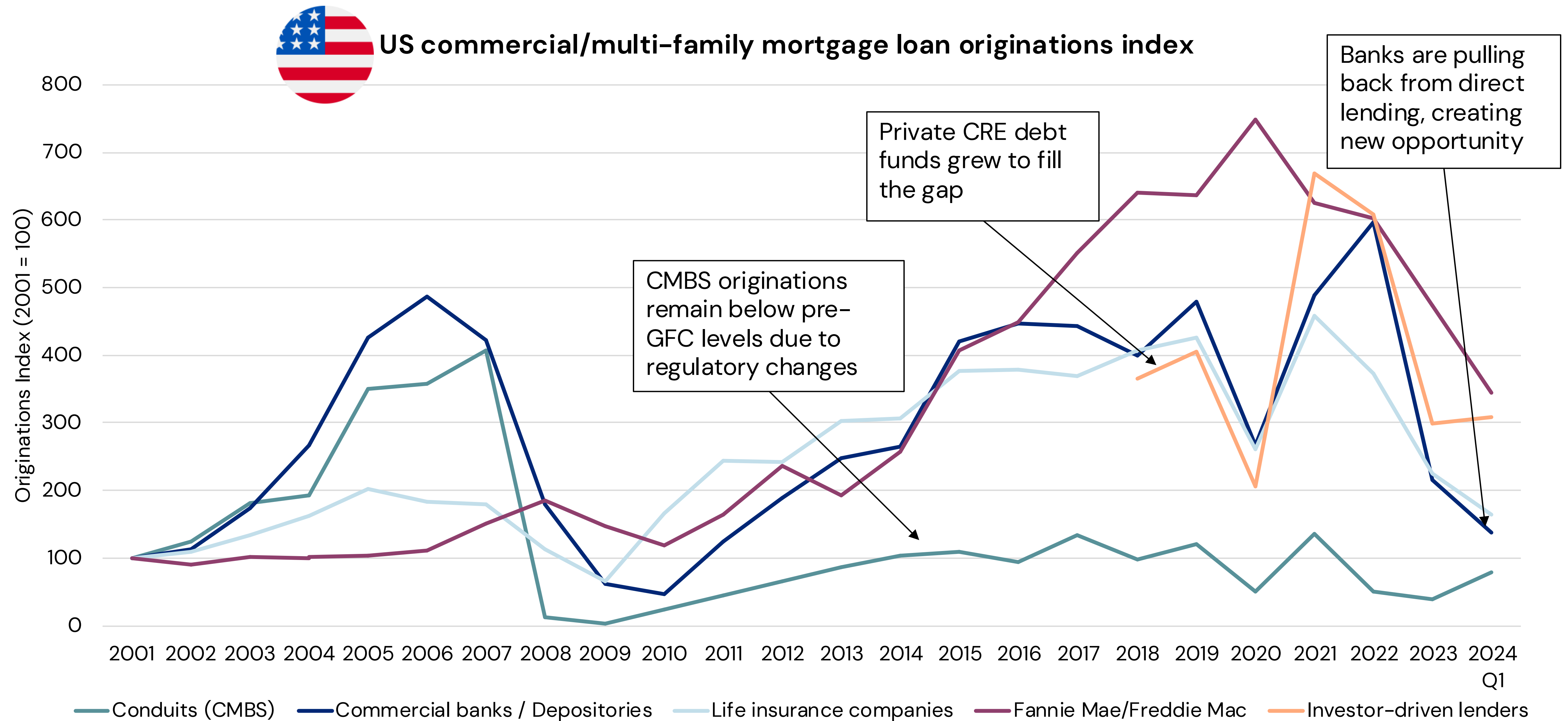
Using data drawn from the Federal Reserve's Flow of Funds dataset, the share of the CRE loan book accounted for by domestic banks is stable at around 50% in the US, having grown in the last decade.

The UK's long-running Bayes Commercial Real Estate Lending Report has only tracked alternative lenders since 2012 – and in the ten years since, their share of outstanding loans has surpassed that of domestic banks.

*The UK data does not include mortgage REITs. Note: CMBS has been excluded from both charts due to data availability issues. GSEs = Government Sponsored Entities – e.g., Fannie and Freddie.
Source: Bayes Business School (April 2023), Federal Reserve (July 2024), LaSalle (July 2023). No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

Shifting lender landscape

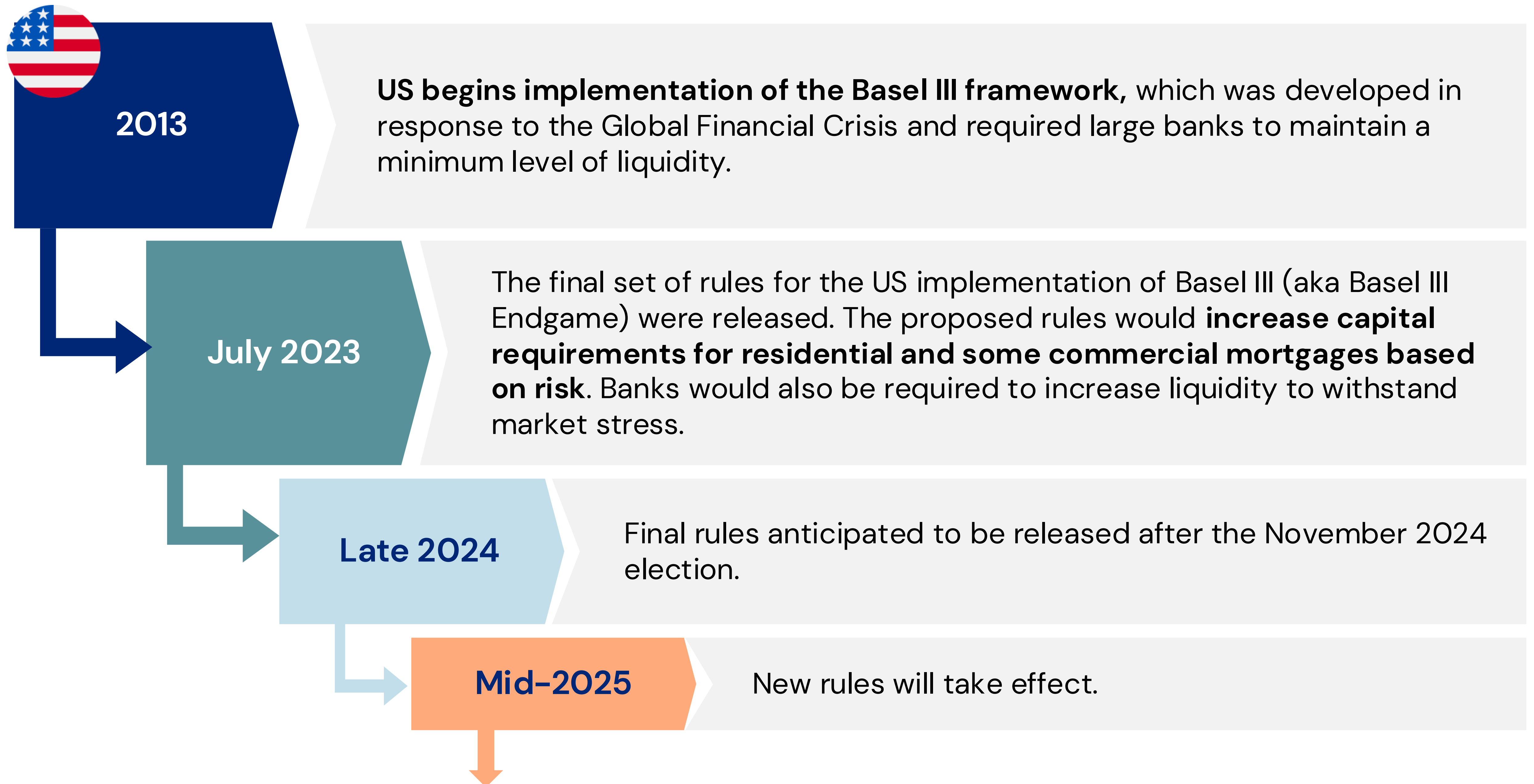
Regulatory changes can create opportunity for private lenders



- The 2010 Dodd-Frank Act increased risk retention requirements and limited banks' ability to use securitization, which caused a permanent reduction in CMBS issuance in the US and left a gap in the market.
- Banks have slowed direct originations in favor of providing debt fund-level financing, which receives less regulatory scrutiny. This is opening the door for non-bank lenders to increase their share of direct lending.
- US insurance companies are subject to risk-based capital requirements on commercial mortgages, which have been in place since the 1990s and are periodically updated. They remain a key source of debt capital.

Source: Mortgage Bankers Association, LaSalle Research. Data as of May 2024. No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

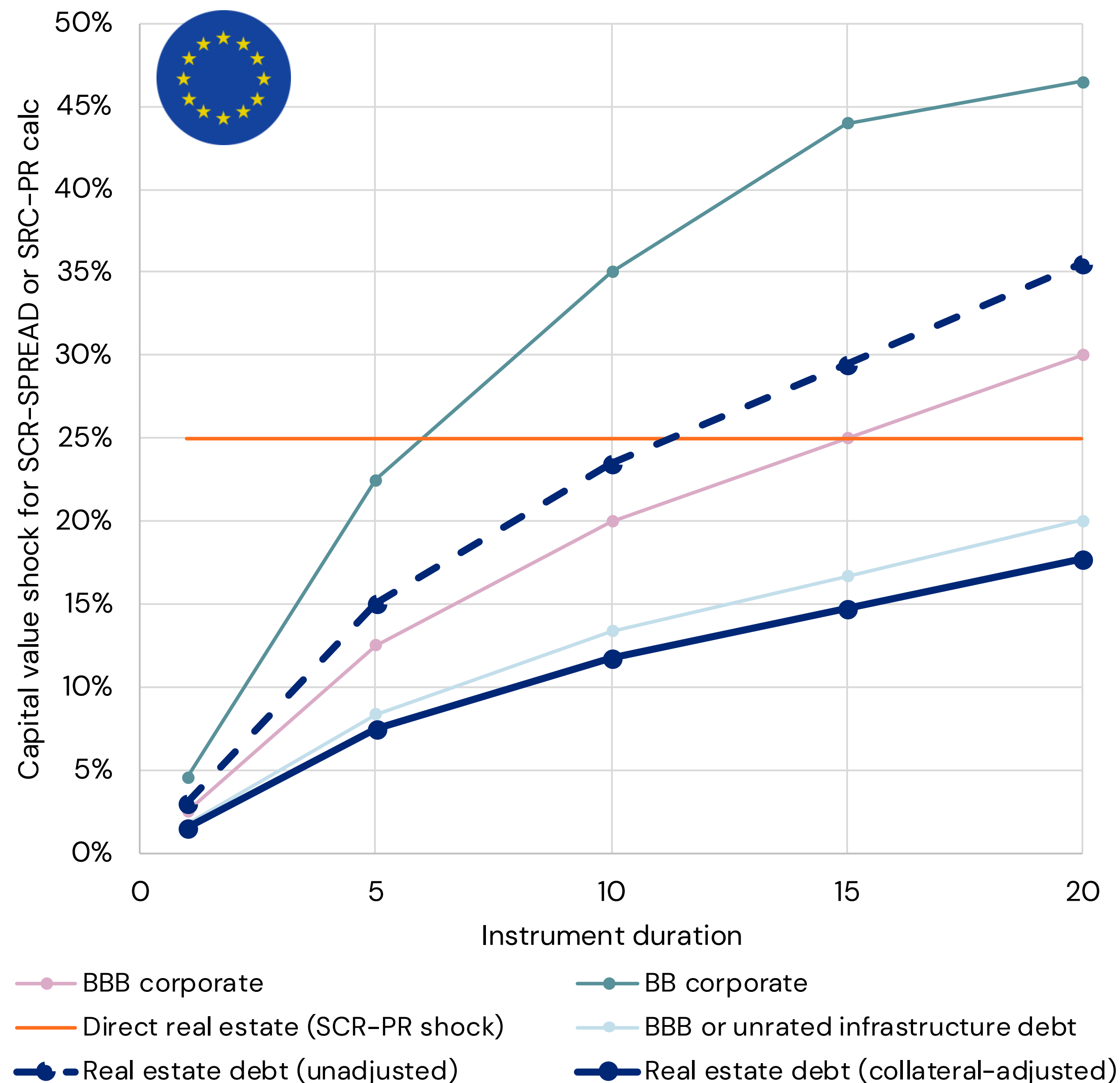
Implementing Basel III in the US ("Endgame") could further reduce banks' share of market



If the rules are implemented as proposed, **the impact on commercial real estate investors is likely reduced bank lending capacity, increased borrowing costs, and less long-term capital availability from banks** with greater rates of CMBS securitizations as banks look to move long-term loans off their balance sheets. The negative impacts would be most acute for high-leverage investment strategies, while low-leverage borrowers may benefit. However, the final rules are expected to be pared back.[1]

(1) Source: Green Street report, "Too much 'Basel' in the debt sauce", March 12, 2024.

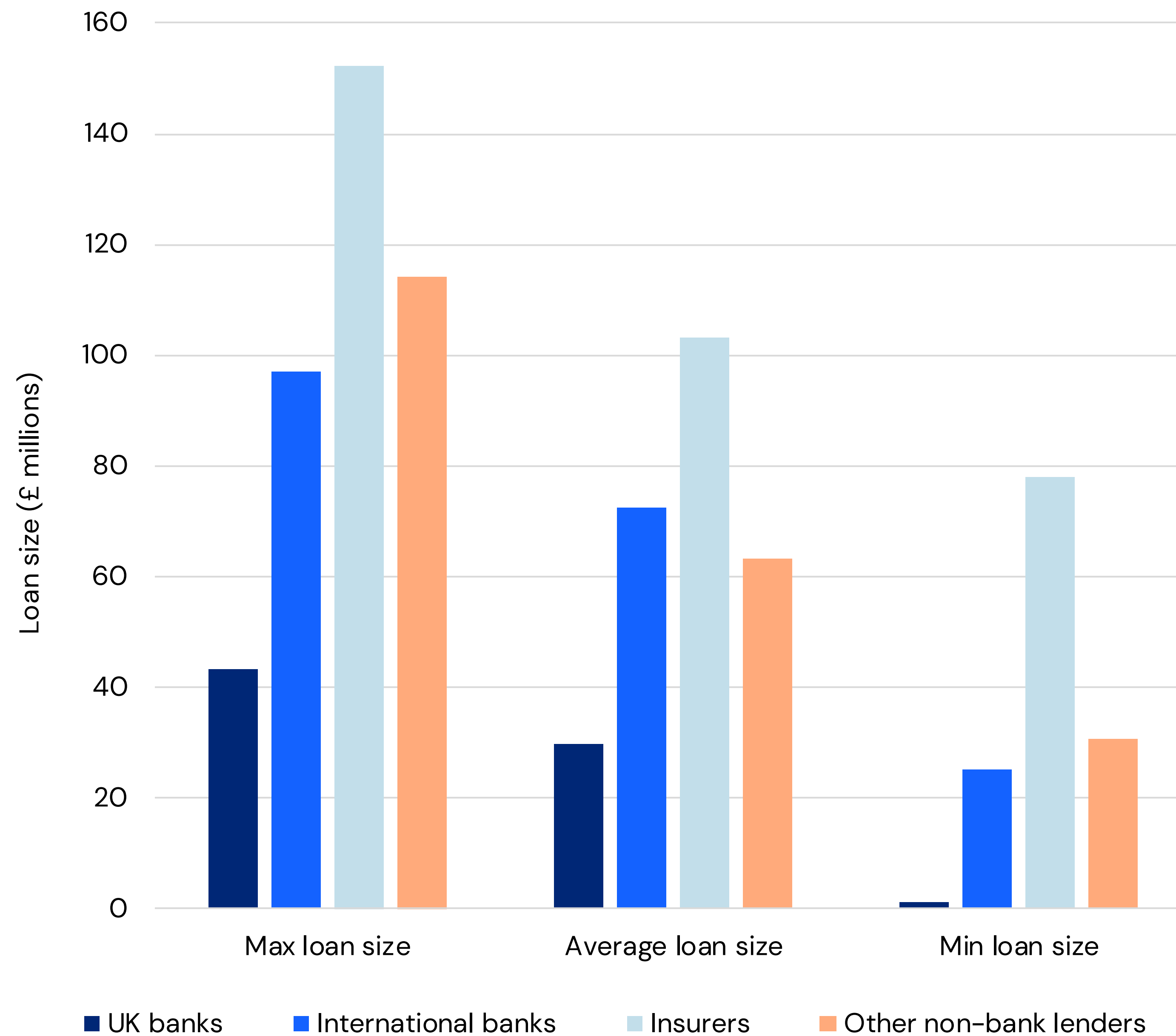
Collateral adjustment can make RE debt highly capital-efficient for insurers

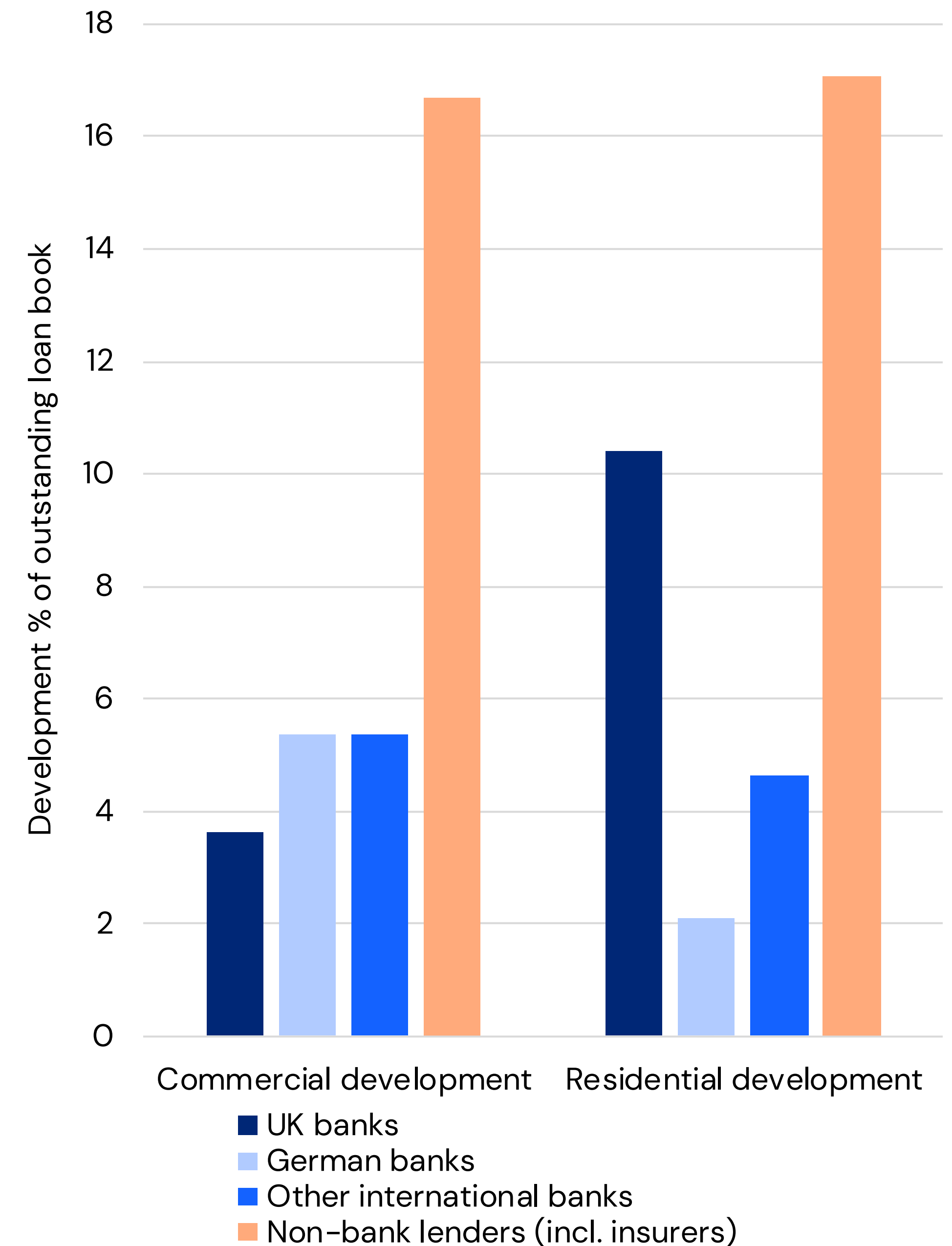


- The comprehensive Solvency II regulations for European insurers mandate levels of regulatory capital as a function of credit rating, duration and collateral type.
- While real estate equity carries a flat charge of 25% of capital value, and fixed-income instruments are also assessed against shifts in interest-rate curves, floating-rate real estate debt can be highly capital efficient.
- Unrated private real estate lending is initially assessed at a credit quality between BBB-rated and BB-rated corporate bonds, but this regulatory capital requirement can be reduced by 50% for collateralised lending at an LTV below 75%.
- Other regions, such as the US, have similar policies – e.g., National Association of Insurance Commissioners (NAIC) risk ratings.
- This treatment has established insurers as a key pillar of credit provision to real estate, especially as compared to banks.

Source: European Commission, LaSalle as of July 2023.

UK non-bank lenders provide larger loans, finance higher-risk developments, filling a market need





Source: Bayes Business School as of October 2023. No assurances are given that these trends will continue or materialize as expected. Nothing herein constitutes a guarantee or prediction of future events or results and accordingly the information is subject to a high degree of uncertainty.

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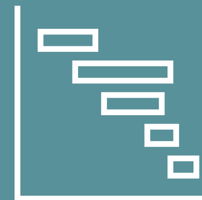
The debt opportunity today

Why invest in debt today?

Ample lending opportunities via the **debt funding gap** left by lower LTVs and elevated near-term maturities



Commercial real estate loans offer a yield **premium to other fixed income** assets

Prospective debt **returns compare favorably** with equity returns, and LTVs reflect rebased, defensible basis

Europe faces large financing funding gap

Est. €300 billion+ gap over forthcoming 5-year period due to lower LTV ratios and valuation declines

Estimated debt funding gap through 2027 – UK and Europe

We expect that this funding gap, shown for Europe but also extant in the US, will likely be **closed through a combination of equity injections and new financing sources.**

While the gaps tend to be largest for office assets, they still have an **impact of lending capacity across the entire market**, as a bank that lends against an office has less capacity to lend in other areas.

Source: LaSalle analysis of data from MSCI Real Capital Analytics, Bayes Business School, CBRE, JLL. Data as of February 2024

*Our estimates are based on historic value change since 2018 (which impacts debt originated over the last five years) as well as our capital value forecast. Historic LTV is per market as reported by CBRE, differentiated by property type. 2027 LTV estimates are based on LTVs available as of end-2023, typically around 10 percentage points lower than LTVs at origination, but also differentiated by property type.

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US loan maturities elevated in the near-term

Debt refinancing challenges has the potential to create investment opportunities

Loan maturities by lender type ($ billions)

	2024	2025	2026	2027	2028
GSE's	$28	$38	$53	$55	$104
CMBS/CDO/ABS	$234	$106	$69	$65	$62
Credit Cos/Warehouse	$168	$112	$56	$24	$23
Life Cos	$59	$65	$75	$68	$77
Depositories	$441	$253	$205	$129	$69

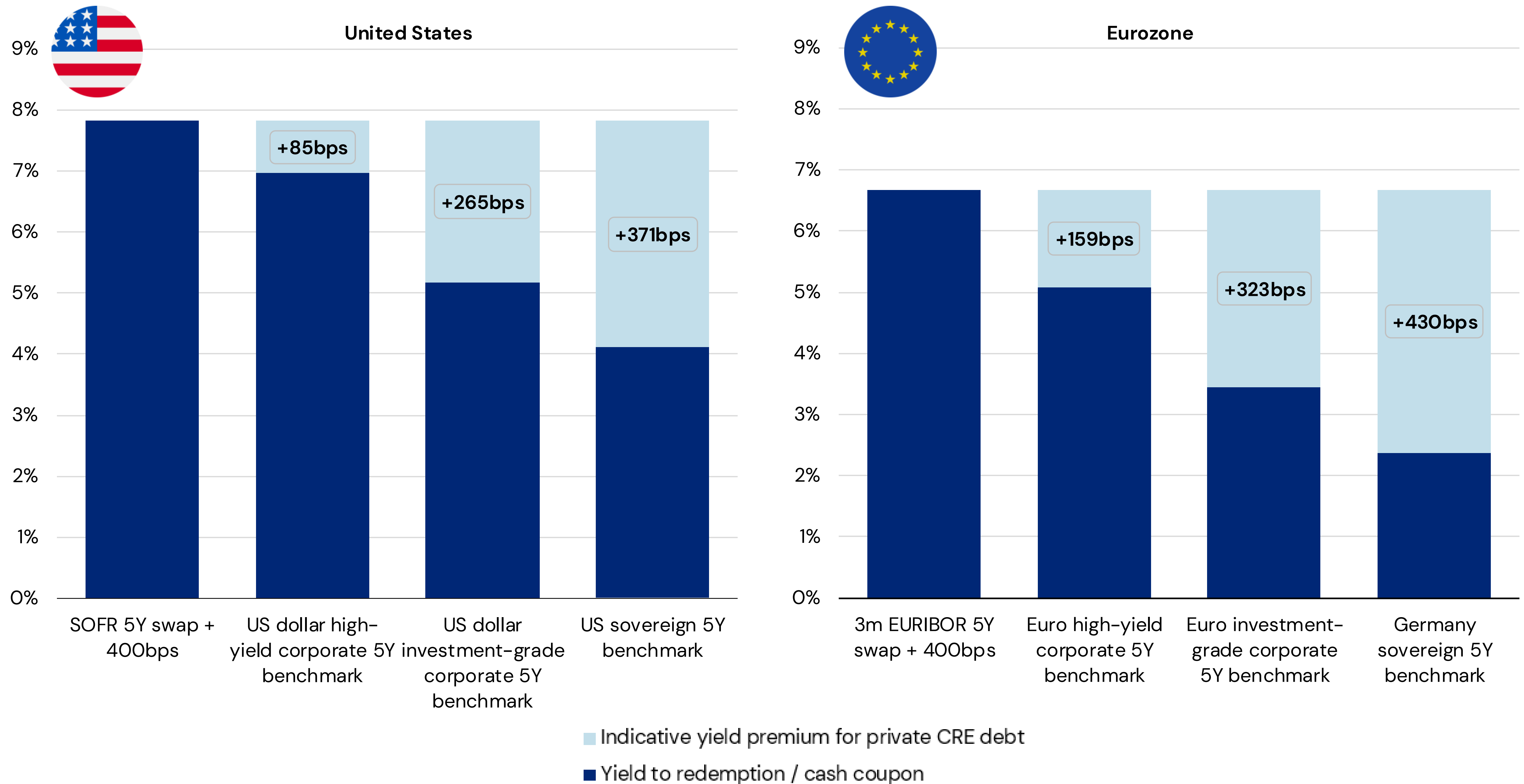
Loan maturities by property type ($ billions)

	2024	2025	2026	2027	2028
Healthcare	$19	$9	$6	$6	$4
Other	$160	$90	$61	$40	$30
Hotel/Motel	$105	$54	$36	$19	$12
Retail	$71	$59	$48	$38	$45
Industrial	$110	$46	$54	$32	$30
Office	$206	$102	$77	$70	$47
Multi-family	$257	$213	$175	$138	$167

Data pertains to all lender types
Source: Mortgage Bankers Association, LaSalle Research. Data for this chart is released once per year (in Q1) and does not reflect extensions that have taken place.

Real estate lending offers a potentially significant yield premium

Strategy offers incremental returns compared to corporate fixed income



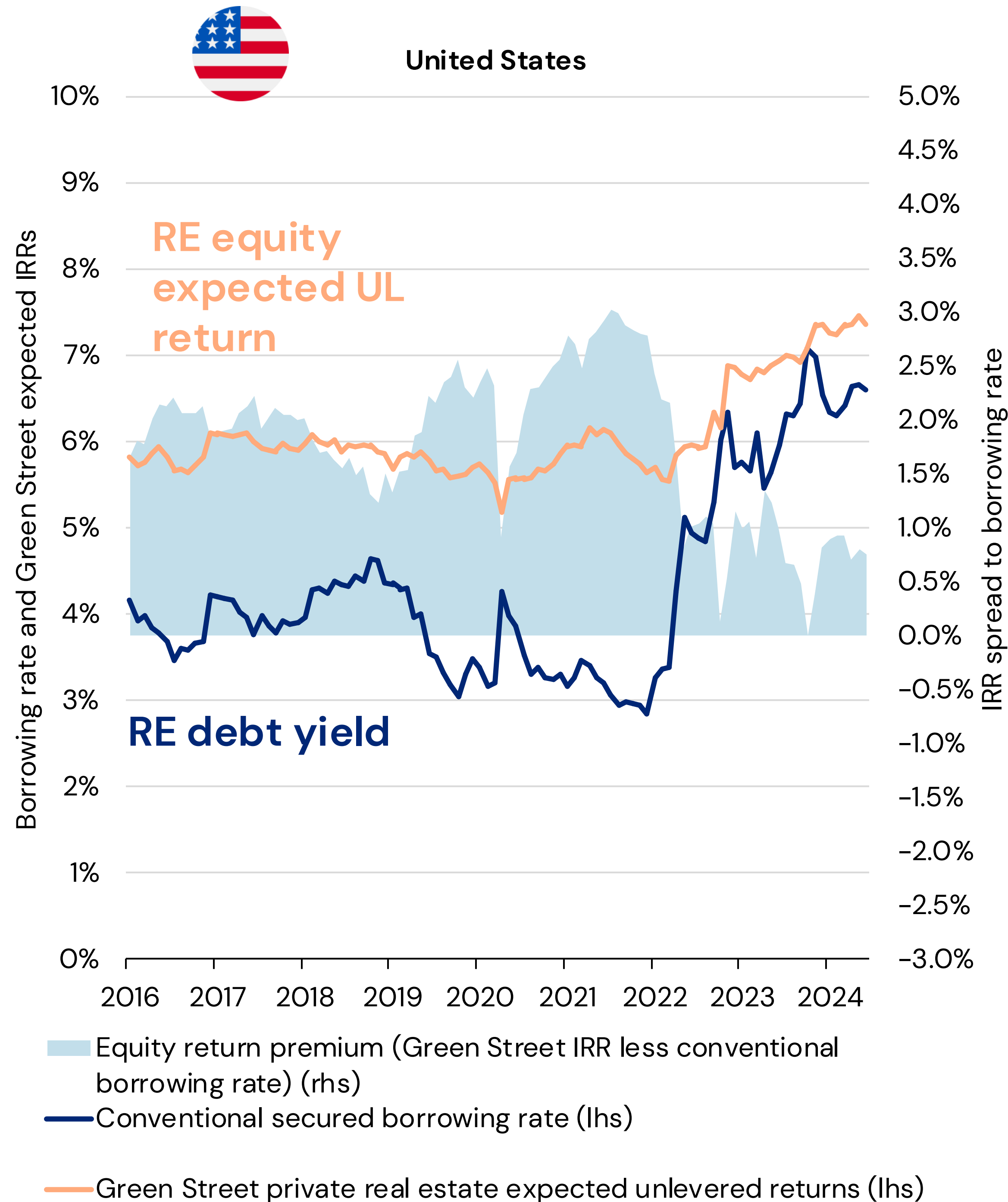
Source: Refinitiv, LaSalle (07/24).

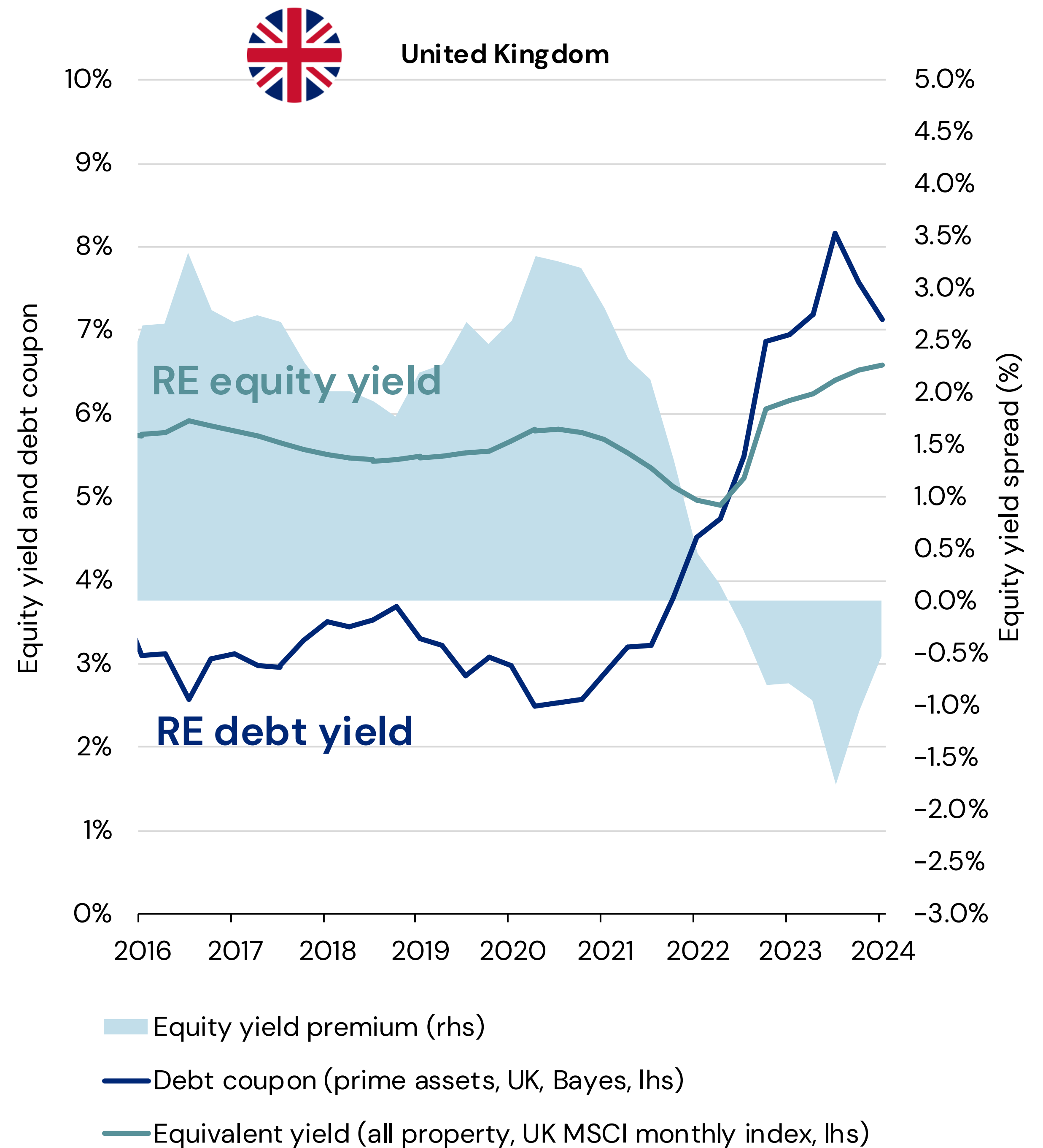
Yield to redemption of listed fixed income indices includes coupon and principal repayments and as such is analogous to IRR.

Real estate debt attractively priced today

Spread between expected equity and expected debt returns has narrowed

Comparison of debt vs. equity pricing (2016-2024)





Note that the data series used in the UK and the US above are not directly comparable across countries due to different data source definitions available.
Source: LaSalle, MSCI, Bayes Business School. Data as of June 2024.

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Other real estate debt content from LaSalle

An introduction to European real estate debt at LaSalle

The outlook for European real estate debt

An introduction to real estate debt

PERE roundtable: European real estate debt

A historic opportunity: real estate debt in 2024

Contributors

Dominic Silman

Head of Research and Strategy, Debt and Value-Add Capital, Europe

dominic.silman@lasalle.com

Jen Wichmann

Senior Vice President, North America

jen.wichmann@lasalle.com

Hina Yamada

Senior Analyst, Europe

hina.yamada@lasalle.com

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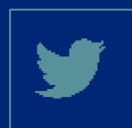

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