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Real Estate Debt

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The office conundrum

Investors grapple with the changing environment

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EXPERT Q&A

What opportunities are there for real estate debt investors in the US and Europe? LaSalle's David White and Craig Oram talk through the tailwinds set to impact the sector

Keeping pace with evolving markets

Q How do real estate debt investments compare with equity in terms of risk-adjusted returns and portfolio composition?

David White: Debt offers attractive risk-adjusted returns and will continue to be an important part of any portfolio. It is complementary to a range of other options in real estate alongside equity or value-add, and our role is to support equity participants by providing an important element of the capital structure.

Underwriting real estate debt is not always straightforward but our resources on the equity side, in research and strategy and in capital markets, help us to do it in the most informed way possible.

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Craig Oram: When analysing real estate equity and real estate debt returns over a 20-year period, debt offers more consistent and steady returns. The current pay component of debt is also attractive to investors.

Q How have recent market changes created opportunities in real estate debt investing?

CO: Now is a great time to raise money in an open-end fund structure, with asset pricing having adjusted approximately 20 percent in the US, even in the multifamily sector – and, with a reduction in leverage, new loans are being originated at very attractive levels.

As a floating rate lender that prices loans over one-month SOFR terms, the interest rate environment has shifted in our favour. The current 10-year forecast for one-month term SOFR averages approximately 2 percent higher than the 10-year average leading up to 2022. The increase in base rates translates into a one-for-one increase in returns to our investors.

DW: Asset values have certainly started to adjust, and we are seeing a lot more transaction volume and a lot less volatility in bid-ask spreads. The increased flow of capital back to investors is also

allowing LPs to think about reallocating their portfolio mixes across debt and equity and allowing for more fresh capital to be allocated to real estate.

Q What are the key differences in your investment strategies for the US and European real estate debt markets?

CO: The for-rent residential sector forms a significant part of the commercial real estate market in the US. As a result, LaSalle Americas has a strong residential focus in this unique area of the market, with about 60-70 percent of our debt fund series allocated to for-rent residential loans.

We stopped investing in office loans from our US debt fund series in 2019 and there are still many headwinds in that sector. Our open-end debt fund strategy does not involve niche or speciality sectors – rather, we underwrite transitional properties in traditional sectors, taking newly constructed or underperforming assets and bringing them up to market levels.

DW: In Europe, our approach is wider. We are in many ways led by our borrowers, and there is not that same volume in any one sector, so we take a very research-driven approach across a number of property types. The fundamental question we ask ourselves is: which real estate sectors are lagging behind the evolution of modern lifestyles? There is a massive supply shortage in the face of strong demand in student housing, for example, though sectors such as leisure, hospitality and logistics present equally compelling supply-demand dynamics.

Q How has the recent volatility in US real estate valuations influenced your debt investment approach?

CO: The 10-year US Treasury rate has changed significantly over the past year and has driven fluctuations in value. Our investors benefit from higher base interest rates, but we are mindful of how rates affect valuations. Operating conditions remain difficult, with heightened pressure on property profitability as revenues are affected by new supply and continued inflation in areas such as property taxes and insurance. The good news is increasing interest rates have put a damper on new construction starts since mid-2022, so there is an end in sight to the new supply pipeline.

In the near term, migration and job growth continue to drive underlying demand, with much of the new multifamily product being absorbed. We expect demand to outstrip supply in the long term despite greater cost of living pressures in the US. The great aspect about investing in debt is you don't have to time the exact bottom of the market – you can take an informed view of current and projected values and lend at a basis inside of that.

Q What role do sustainability considerations play in your debt investment strategies across different markets?

DW: We account for sustainability targets among European borrowers and investors by ensuring all our debt products have a green focus. We also have a green lending pocket of capital set aside for investors with additional needs.

We are always looking for opportunities to drive the improvement of assets from a sustainability perspective. We ultimately see improved liquidity, stronger valuations and improved yield metrics where buildings are delivered based on higher sustainability standards.

CO: Sustainability initiatives are not to be overlooked in the US. Many of our investors express concern over these initiatives' potential impact on fund performance. Our fiduciary duty to investors is our top priority – as such, our approach is to embrace sustainability initiatives that drive performance and maximise value over the long term, while keeping risk to a minimum. This might include enabling properties to benefit from more favourable permanent financing options, or driving property profitability or lower tenancy costs that enable rental rate increases to be absorbed.

Q How are you adapting your debt products and strategies to meet current market challenges and investor demands?

DW: We are focused on finding thematic, scalable opportunities that support underutilised assets with strong paths to cashflow and value. We have been very active in the levered whole loan market, for example. In Europe, the historic model consisted of senior bank lending sitting alongside alternative lenders that offered mezzanine debt to create a leveraged capital structure.

Funds later started trying to compete with banks, but now we work closely with our banking relationships to underwrite deals and ultimately offer whole-loan solutions to our borrowers with more flexibility, speed and certainty of execution.

CO: As an alternative lender, we can offer sponsors a flexible loan product, certainty of execution, in-house asset management and, thanks to the current interest rate environment, a loan product that is not priced materially above those of permanent financing options.

When you go through down cycles, sponsors are reminded of the value of relationships with a lender that conducts its asset management in-house and thinks like an equity owner. For sponsors, lending from a real estate specialist like LaSalle has a lot of advantages in more challenging market conditions. ■

David White is the head of LaSalle Real Estate Debt Strategies in Europe, and Craig Oram is a portfolio manager and the president of LaSalle Debt Investors in the US