WHY DEBT, WHY NOW?

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Debt funds remain a comparatively small part of the real estate investment market, but they have been gaining in prominence in recent years. The share of debt funds in total capital raised globally by real estate investors has risen steadily, growing from 7% in 2016 to about 12% in 2020.[1] Funds investing in North America continue to lead the pack in the real estate debt world. Capital raised for debt funds shows the depth of the market in the US as compared with Europe. For non-US-based investors looking for exposure to commercial real estate (CRE) debt, the US market offers numerous attractions.

Broadly, the COVID-19 pandemic created an economic setback that led traditional sources of debt capital to retrench during the early stages of the pandemic, and while most have returned to nearly normal activity, there remain constraints on proceeds, as compared to pre-COVID.

CRE debt markets are also at different levels of maturity. Since 2008 the US has raised about 2.5 times more capital for debt funds compared to Europe.[2] As such, CRE debt presents an attractive proposition, at a time when returns from fixed income investments have been pushed to all-time lows. In the current low interest rate environment, the CRE lending sector should remain attractive on a relative basis given the decline in bond yields.

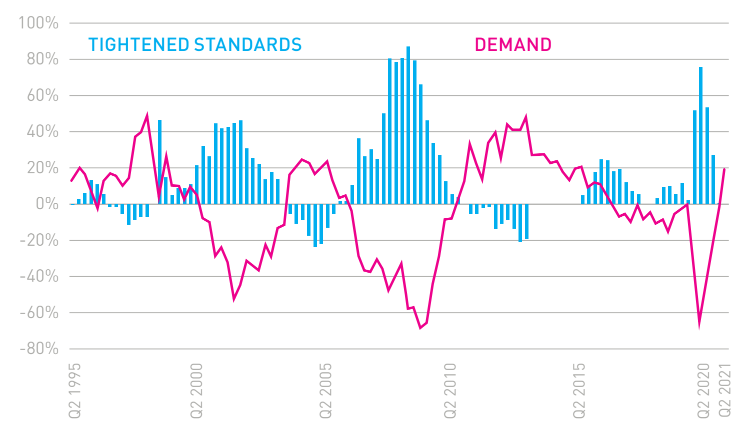
FUNDING GAP

CRE debt has long been considered attractive for its ability to combine stable income returns with a level of downside protection from real asset exposure. However, the lure has intensified as regulatory requirements have constrained traditional capital sources, creating opportunities for non-traditional lenders to fill the resulting gap.

- Recent economic uncertainty has exacerbated the capital gap that resulted from regulation during the last expansion, creating further opportunity for non-traditional lenders.
- Lending standards tightened dramatically in 2020 as banks responded to the uncertain economic outlook. As demonstrated by the Federal Reserve Senior Loan Officer Survey *(Exhibit 1)*, the percentage of banks tightening lending standards reached levels not seen since the GFC. Lending standards have started to loosen in recent quarters but remain constrained.[3]
- Reduced appetite amongst traditional lenders for certain types of real estate lending—particularly transitional properties or assets which are typically higher risk—creates further opportunity for alternative lenders to respond to unmet demand.
- Nontraditional capital providers are well positioned to take advantage of this funding gap by originating and acquiring loans to produce attractive risk-adjusted returns, while potentially taking materially less risk due to having seniority in the capital stack in relation to the equity position.

EXHIBIT 1: STRICTER BANK LENDING STANDARDS

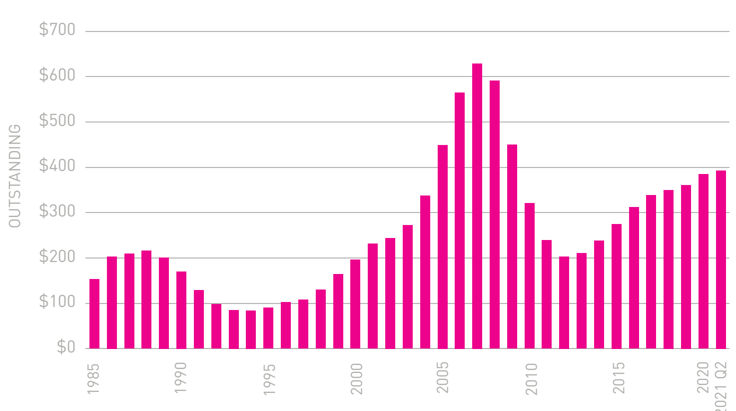
Source: Federal Reserve Senior Loan Officer Survey, USAA Real Estate Research



- Banks are the primary source of construction loan capital in the US, though bank construction loans outstanding remain 39% below pre-GFC levels, even though development activity is above 2007 levels *(Exhibit 2)*.
- This demonstrates that for construction deals, the market is seeing a mix of more equity capital required and non-traditional lenders increasingly being relied upon to meet the borrowing needs of developers.

EXHIBIT 2: CAPITAL GAP—BANK CONSTRUCTION LOANS OUTSTANDING (US$ BILLIONS)

Source: FDIC; USAA Real Estate Research



US CRE DEBT IS A SIZEABLE MARKET

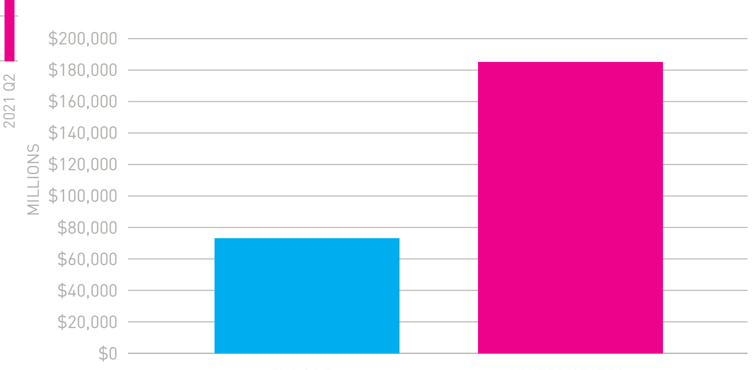
These market dynamics suggest an attractive investment environment for private debt. According to the 2021 ANREV/INREV/NCREIF Capital Raising Survey, non-listed debt products were the only type of vehicle for which the number that raised capital increased from 48 in 2019 to 76 in 2020, growing their share in the total number of vehicles fromt 5% to 11%.[4]

US CRE debt makes up a large market, with over US$5.0 trillion in US mortgage debt outstanding as of Q2 2021, via traditional sources.[5] The size of the market offers institutional investors depth, liquidity as well as potentially strong risk-adjusted returns. Capital raised for debt funds shows the depth of the market in the US, especially as compared with Europe. Since 2008, the US has raised about 2.5 times more capital for debt funds as compared to Europe *(Exhibit 3)*. However, appetite for CRE debt vehicles amongst European-domiciled investors is growing. European investors account for 51% of the global capital raised for non-listed debt vehicles in 2020. This is a notable change compared to 2019 when European-domiciled investors accounted for only 13% of the capital raised for non-listed debt products.[6]

The CRE debt market in Europe continues to lag the strong growth in investor appetite. Outside the US, real estate finance continues to primarily be a bank-led market, although European non-bank lending activity has grown in recent years. Real estate debt funds remain comparatively new in Europe as the market is evolving, but vehicles have been gaining in momentum.

EXHIBIT 3: CAPITAL RAISE FOR CRE DEBT FUNDS, 2008–2021 (US$ MILLIONS)

Source: IREI; USAA Real Estate Research



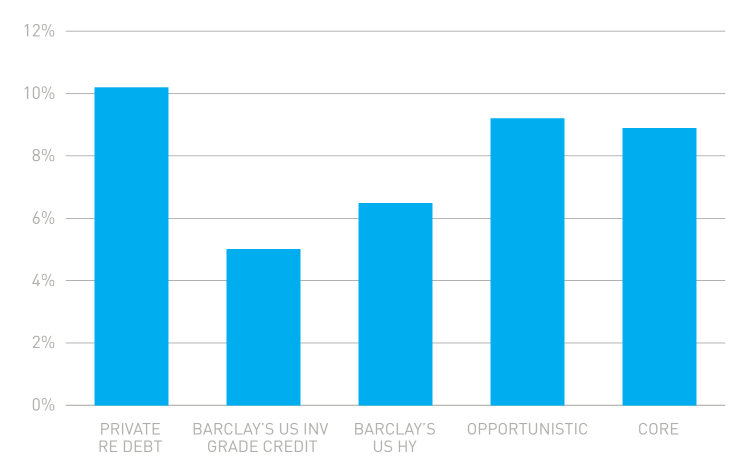
STRONG RELATIVE PERFORMANCE

Institutional investors have increased their appetites for CRE debt funds in recent years. The reasons for this are familiar; the hunt for yield and diversification arguments are well-known—though low volatility and strong relative performance have also played key roles. Expectations of traditional fixed income securities have been driven extremely low. Demand for yield has become more pronounced and the relative risk-reward profile of CRE debt has become even more compelling.

- CRE debt funds have outperformed investment-grade corporate bonds by 540 BPS annually, on average, over the past ten years, and outperformed high-yield corporate bonds by 370 BPS *(Exhibit 4)*.[7]
- CRE debt fund total returns have also compared favorably to other real assets. Private equity real estate returns, as captured by Preqin. Have delivered returns of 9.3% and 8.9% for opportunistic and core strategies, compared to 10.4% for CRE debt funds over a ten-year period.[8]
- Looking at the available returns data for CRE debt funds across geographies, the relative outperformance of the US compared to Europe is also clear. Most vintages where we have data suggest North American debt funds have outperformed Europe across seven out of nine vintages.

EXHIBIT 4: TEN-YEAR RETURNS THROUGH Q1 2021

Source: Bloomberg US Corporate High Yield Bond Index (LF98TRUU:IND), Bloomberg US Aggregate Bond Index (LBUSTRUU:IND); Preqin Private Capital Benchmarks (note captured funds are global); USAA Real Estate Research



BEYOND THE CURRENT ENVIRONMENT

In the current environment, investors have become very selective, choosing certain asset classes over others and focusing on quality assets in terms of location, tenant covenants, and ESG criteria. US CRE debt has been increasingly sought after by pension funds and other institutional investors, and the arguments for including real estate in private-debt allocations appear to be strong.

Currently, there is an opportunity for institutional investors to fill the funding gap and capitalize on the robust demand in the commercial lending sector while providing investors with strong risk-adjusted returns. CRE debt strategies are attractive because they rival core equity strategies from a total return perspective and provide substantially more return than traditional fixed income in the current environment, while potentially taking materially less risk due to seniority in the capital stack in relation to the equity position.

As with most investment opportunities, real estate lending has a certain level of embedded risk. Even with such a strong CRE debt outlook, it is important to ensure sponsor alignment. It is critical to invest with a qualified and experienced investment manager that can navigate the risks and challenges within this sector.

ABOUT THE AUTHORS

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NOTES

This article represents the opinions and recommendations of the authors and are subject to change without notice. Past performance is no guarantee of future results.

[1] Asian Association for Investors in Non-Listed Real Estate Vehicles, European Association for Investors in Non-Listed Real Estate Vehicles, and National Council of Real Estate Investment Fiduciaries, Capital Raising Survey 2021, INREV, April 13, 2021, https://www.inrev.org/research/capital-raising-survey.

[2] IREI (website), Institutional Real Estate, Inc., https://irei.com/.

[3] "Senior Loan Officer Opinion Survey on Bank Lending Practices," Federal Reserve, Accessed October 25, 2021, https://www.federalreserve.gov/data/sloos/sloos-202004.htm.

[4] ANREV, INREV, and NCREIF, Capital Raising Survey 2021.

[5] "Financial Accounts of the United States," Federal Reserve, September 23, 2021, https://www.federalreserve.gov/releases/z1/.

[6] ANREV, INREV, and NCREIF, Capital Raising Survey 2021.

[7] Preqin, Private Capital Performance Data Guide, Preqin, Accessed October 25, 2021, https://docs.preqin.com/pro/Private-Capital-Performance-Guide.pdf; Bloomberg and Barclays Indices, US Corporate High Yield Bond Index, Accessed October 25, 2021, https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/rSbjXhPAtPbI/v0; Bloomberg and Barclays Indices, US Aggregate Bond Index, Bloomberg, September 30, 2021, https://www.ssga.com/library-content/products/factsheets/etfs/emea/factsheet-emea-en_gb-sybu-gy.pdf.

[8] Preqin, Private Capital Performance Data Guide.