GUEST COLUMN

Real estate debt investment offers advantages after steady value gains

By Michael Morgenroth, CEO of Caerus Debt Investments

After the steady climb in real estate asset prices of recent years, investors are looking increasingly at property debt, where stability, low capital requirements, stable income and defensive qualities offer distinct advantages.

For decades, government securities were considered unconditionally secure, yielding good and profitable returns. But the world has changed; German sovereigns have for some time now even yielded negative returns. The result: many institutions have brought new asset classes onto their radar screens. Many find that property debt shows a favourable risk-return ratio, low volatility and is treated separately from real estate allocations, which may already have reached permitted limits.

Because, by early 2017, prices have risen in almost all asset classes for several years, the probability of further upside is declining. Now may be the right moment to consider investing more defensively. If growth prospects diminish or the risk of a setback rises, investment in real estate debt offers an excellent opportunity.

As a lender or debt investor, the institution takes a creditor position: this means that even with a loan-to-value of 80%-85% it retains a security buffer of 15%-20% due to the externally held 'first-loss-piece' of the borrower's equity. If cap rates rise, any value declines thus first impact the equity. Also, while in real estate equity side ancillary costs can be as high as 10% annually, creditors begin to be rewarded at entry, receiving regular annual income in interest payments over the life of the investment.

Real estate loans are also very stable for institutional balance sheets. Generally, a system of annual impairment tests determines whether loans require value adjustments. As long as this is not the case, the market value remains stable – making low investment volatility real estate loans additionally attractive.

Benefits also accrue on the regulatory side. By comparison to equity-side investment, property loans are privileged as regards solvency capital required (SCR) under the EU's Solvency II rules. While equity-side allocations are subject to 25% SCR, those for commercial real estate loans are much lower. Standard duration expirations of five to seven years attract an equity SCR for the spread risk of 7.5%-9.2%. This element is particularly potent for insurance groups and, no other asset class provides a higher return on required equity under EU capital adequacy rules.

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What about returns? For mezzanine capital investments, these can be 8%-15%, depending on the risk situation. But for whole loans, 3%-4% are more realistic as long as the portfolio is not completely limited to A-cities. Compared to classic capital market products, real estate loans can also benefit investors by delivering yield pickup derived from the collection of liquidity, market access and complexity premia.

Because of its nature, real estate debt is often priced against standard fixed income investment. But here, too, it shows attractive comparative spreads – providing a high degree of security through first-class collateralisation, actually a creditor position comparable to covered bonds. Further advantages are low value correlation with other asset classes, as well as a steady, attractive cash-flow.

And the main challenges? There are several elements to consider when investing in real estate loans. The asset class poses complexity in risk identification and the translation of identified risks into a creditable and credible credit agreement – as well as the ability to hedge credit risk. But investors have met these challenges in diverse ways. Many larger institutions have built their own teams. But for the majority of smaller institutions it makes more sense to buy market access and expertise externally, hiring a specialised advisor or fund manager.

If the decision has been made to involve an external adviser, the latter should have an established and resilient network to be able to provide almost a real-time, detailed overview of the real estate investment universe as well as market conditions for equity and borrowed capital. And he should certainly demonstrate the ability to invest the capital in a timely manner. The advisor should be able to meet institutional needs, especially from a regulatory perspective, while ensuring best practice in allocation, reporting and risk management. Fees should also only apply to invested capital to ensure alignment of interest.

Nowadays, control options for commissioning external managers, which many institutions require, should always depend on the size of the investment. While in an individual mandate, veto rights and early involvement in investment decisions are the norm, in a pool fund they are unusual, simply in the interest of a rapid investment process. In short, many investors have discovered the advantages of investment in real estate loans as opposed to the direct, equity side. Further growth of the asset class is pre-programmed. ■ **mm**