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The outlook for European real estate debt

A Q&A with Edward Boots, head of origination for continental Europe with M&G Real Estate

What are the benefits of real estate debt investing?

Commercial real estate debt reflects a defensive investment opportunity that can be accessed by institutional investors across the risk/return spectrum, through strategies targeting different parts of the capital structure – from senior to junior debt, or a blend of both.

The nature of the sector can offer both significant downside protection and attractive return potential. An investment in real estate debt can deliver stable cashflows due to its fixed-income nature, as well as providing the benefit of hard asset security. The ability to match liabilities to these cashflows can be beneficial, along with favourable capital treatment of commercial real estate debt investments for insurers.

The benefits of the sector stand out in the current economic environment, in our opinion, with the potential for equity-like returns for credit investing like we've never seen before. Real estate debt, therefore, is attracting increasing attention from investors globally, as well as new market entrants.

What is the current landscape in European debt markets?

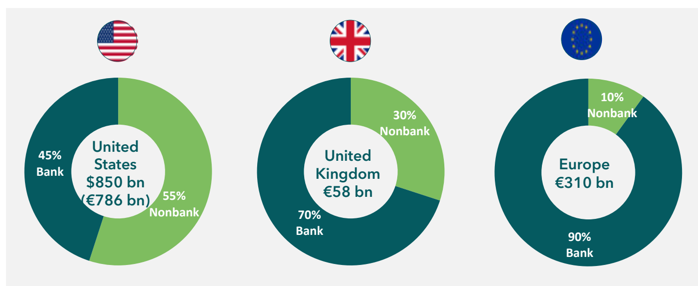
Regulatory scrutiny on European banks has been increasing, with implications for capital treatment of real estate loans, which may impact banks' risk appetite and cost of financing.

The loan-to-value (LTV) level at which banks are prepared to finance loans has reduced, such that borrowers are still able to meet debt-servicing requirements in the current environment. At the same time, we continue to see valuation declines in certain parts of the real estate market, meaning loan books remain under pressure.

Some lenders' focus is turning, therefore, towards the performance and exposure of their existing loan books, and away from writing new business. As such, we believe the opportunity for alternative lenders continues to grow.

Figure 1: Opportunity for nonbank lenders to grow market share as banks reduce exposure

Annual loan origination volumes and sources of capital



Sources: Bayes Business School Commercial Real Estate European Lending Report, H1 2023, and Macfarlanes, "The growth of real estate debt," November 2023

Currently, transaction volumes remain subdued amid economic uncertainty, persistent lender caution and higher borrowing costs. In many cases, refinancing requirements are being met by short-term loan extensions. Banks' retreat from some parts of the market, however, coupled with downward property valuations, is likely to create a debt funding gap in certain parts of the market.

Are there signs of distress in the banking sector?

So far, we have not seen widespread distress, largely owing to a shift in lenders' mindset and behaviour after the global financial crisis. Lower LTVs and higher underwriting standards have created a more stable lending environment.

However, as equity cushions within loans have eroded due to corrections in valuations, focus is moving towards stability of cashflow.

In certain parts of the market – for example, secondary offices – question marks remain around the sustainability of future cashflows. We know the office sector has been the dominant sector in which banks have been active lenders, across Europe and across the quality spectrum. It is not clear where these exposures currently sit, and whether they are being valued accurately, in the absence of comparable transactions.

We think, however, credit risks remain localised and sector specific. Across the real estate industry as a whole, there is enough diversification in the lending market for different lenders to push into gaps in the financing landscape, should it become necessary.

Where are alternative lenders able to gain traction?

Broadly speaking, this is the case in parts of the market where banks show reduced ability or appetite to lend. Points of differentiation for alternative lenders include, for example, the ability to provide large loans without the need to syndicate debt to other lenders.

The pool of active bank lenders is also shrinking for development financing, given the less favourable balance-sheet treatment associated with these loans. We see this as a compelling opportunity to lend against refurbishments and new developments at moderate leverage and potentially attractive returns, financing tomorrow's best-in-class real estate.

The way alternative lenders are able to approach deals can also help drive increases in market share. Discretion over capital, paired with lean decision-making processes, can compare favourably in some cases with banks' processes – specifically where more than one bank is required to provide financing. We find borrowers appreciate the greater certainty and speed of execution, particularly in the current market, where volatility and event risk are high. A lender's ability to provide whole loans – loans at a higher leverage point – and hold them to maturity can also be a key differentiator, as borrowers want to know upfront who they will be dealing with throughout the term of a loan.

In the same way, the ability to structure cross-border portfolios has the potential to unlock opportunities for alternative lenders who are able to navigate multiple property markets and legal regimes. Not all lenders are willing or able to consider such transactions; local lenders may not necessarily have appetite for multi-jurisdiction exposure.

From where we stand, structuring expertise and flexibility of capital allows us to uncover interesting opportunities. Business-plan-execution risk is, for example, something other lenders might shy away from. We believe, with the right sponsorship and the right structure in place, these transactions — such as manage-to-core strategies — can offer very good relative value, while also offering potential ESG benefits.

Where do you identify opportunities in the lending market currently?

We see interesting pockets of opportunity in markets and sectors across Europe, where our unique positioning overlays wider trends.

Alleviating Europe's housing backlog will require substantial capital flows, which is creating significant financing opportunities. We believe alternative lenders should be well positioned in multiple markets, as many existing lenders reach exposure limits. Though margins can be tight in the residential sector, alternative lenders are still able to add value compared with local lenders and lenders that are less keen to take development risk.

Here, we see particular opportunities in the mid-size space: loans of up to €100 million. In the Netherlands, this is being driven by portfolio sales by large investors, in response to a changed yield and regulatory environment. On the flip side, local high-net-worth investors, well immersed in the market, now see an opportunity to tap into the market at favourable pricing.

Equally, the development of Europe's purpose-built student accommodation (PBSA) and build-to-rent sectors could create another notable source of opportunities for alternative lenders. Given they are at an earlier stage in their evolution than the equivalent markets in the United Kingdom, lenders with experience in these sectors could be well positioned relative to local banks, which may only be prepared to provide smaller loans or lower leverage. Larger cities in Spain, Portugal and Italy stand out as markets that could offer attractive financing opportunities, with increasing investor interest underpinned by low PBSA provision rates currently. (See Figure 2.)

What is the outlook for real estate debt markets?

Notwithstanding political and regulatory risks, the outlook is largely positive, in our view. Given that real estate is a cyclical market, as interest rates normalise, investment volumes should rise, along with financing opportunities for lenders.

We also expect increased central bank scrutiny on banks to be a continued theme, with the potential to impact the composition of the lending landscape. This is likely to increase the scope for alternative lenders, particularly those with the ability to allocate larger amounts in single transactions, we believe.

Figure 2: Potential financing opportunities could arise in Europe's PBSA sector

PBSA provision rates in Europe

Country	Beds	Students	Prov rate (total)
Denmark	68,667	262,706	26.1%
United Kingdom	754,000	2,934,390	25.7%
Sweden	112,444	438,466	25.6%
Netherlands	144,861	821,124	17.6%
Ireland	41,850	256,785	16.3%
France	408,556	2,818,695	14.5%
Germany	331,065	2,920,263	11.3%
Poland	126,800	1,223,629	10.4%
Spain	102,707	1,722,247	6.0%
Portugal	23,600	446,028	5.3%
Italy	62,100	1,909,360	3.3%

Sources: Bayes Business School Commercial Real Estate European Lending Report, H1 2023, and Macfarlanes, "The growth of real estate debt," November 2023

This is an environment, however, in which lenders need to be selective in where they invest in debt, and how they structure it. Having seen high capital flows into sectors such as PBSA and hotels, some valuations have started to look elevated, in our view. With transaction evidence hard to come by currently, we are cautious around paper valuations and lean heavily on our local real estate expertise to underwrite robust loans with sustainable credit structures and LTV levels.

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The views expressed in this document should not be taken as a recommendation, advice or forecast.

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