Relative value in European real estate debt

December 2017
Real estate debt provides compelling relative value opportunity

Real estate debt finance, an asset class that has attracted significant institutional capital over the past ten years, in senior debt is currently offering some of the most significant value relative to similarly rated corporate bonds since 2011. Nonetheless, real estate debt is an illiquid investment class suited to long-term investors happy to accept illiquidity as well as capital at risk.

Real estate debt offers:

- Attractive spreads over corporate bonds of similar credit risk
- A high proportion of current income return
- The capacity to make significant capital allocations
- Security against physical underlying assets
- Defensive characteristics via high underwriting standards and tailored financial covenants
- Significant downside protection against potential falls in property values when compared to investing in direct property.

The value of investments will fluctuate, which will cause fund prices to fall as well as rise and you may not get back the original amount you invested.

Risks associated with these strategies:

Credit Risk: The strategy may be exposed to the possibility that a debtor will not meet their repayment obligations.

Liquidity Risk: The strategy investments may be illiquid, as a result it may be difficult for the strategy to realise, sell or dispose of an investment at an attractive price or at the appropriate time or in response to changing market conditions.

Concentration Risk: due to a limited number of investments, the strategy may be affected adversely by the unfavourable performance of a single issuer.

Interest Rate Risk: changes in interest rates may adversely affect the market value of some of the strategy investments.

Derivative Risk: the use of derivatives for non-hedging purposes may expose the strategy to a higher degree of risk and may cause larger than average price fluctuations.

Currency Risk: the strategy may be exposed to currency rate movements.

Please note this is not an exhaustive list, you should ensure you understand the risk profile of the products or services you plan to purchase.
Long term trends

Over the past two to three years, corporate bond spreads have been generally trending downward, while loan-to-value (LTV) levels and commercial real estate debt spreads have continued to offer attractive relative value. Following the global financial crisis, real estate equity investors have become more conservative in their LTV requirements and an increased regulatory environment has seen a reduction in bank lending. As a result, the lending gap and subsequent opportunity for non-bank lenders to lend against real estate has become structural rather than a specific reaction to the crisis, with the potential for beneficial capital treatment also available for some investors within the Solvency II framework.

Corporate credit spreads have narrowed significantly over recent years as investors have tried to combat the monetary policy effects, particularly in the Eurozone, by buying into higher yielding assets. Similarly, ABS spreads have been distorted by the effects of the European Central Bank ABS purchase programme which has driven even tighter spreads. At the same time, whilst there has been some yield compression in real estate debt, the pace of decline has been slower boosting the spread premium on offer.

UK senior real estate debt margin vs corporate bonds

![Graph showing UK senior real estate debt margin vs corporate bonds]

UK senior real estate debt spread premium*

![Graph showing UK senior real estate debt spread premium]

Source: De Montfort Mid-Year 2017 Commercial Property Lending Report (CRE Debt margins), BofA Merrill Lynch (BBB and A rated corporate 3-5 year asset swap spread). *UK Senior CRE Debt Spread Premium calculated as the difference between the equally weighted average of CRE debt margins from the De Montfort University report and the BofA Merrill Lynch 3-5 year BBB and A rated GBP corporate asset swap spreads.
Recent developments

Whilst the trend of tightening corporate spreads has been evident over a number of years, in the last 12-18 months this downward trend has been pronounced and the relative value of real estate debt is more evident and more attractive than it has been since 2011. Whilst investors expect to be paid an illiquidity premium, the relatively short loan terms of three to five years, coupled with income from quarterly interest coupons ensures that investors are being more than fairly compensated for the perceived illiquidity of the asset class.

**UK senior real estate debt margin vs corporate bonds**

**UK senior real estate debt spread premium**

Source: DeMontfort, Bank of America 2017
Current opportunities

We see a compelling opportunity in today’s market to take advantage of the low corporate bond spreads and significant premium that real estate debt offers. Average senior real estate debt discount margins have stabilised at around 200–250bps, almost double their pre-crisis levels, making senior debt an attractive investment opportunity in an environment of low interest rates and tight credit spreads.

In order to access these opportunities, M&G Real Estate Finance is currently offering two strategies which provide attractive return profiles and access to investment grade loans, as follows:

<table>
<thead>
<tr>
<th>Whole loans</th>
<th>Description</th>
<th>Gross Discount Margin*</th>
<th>Gross IRR*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate Debt</td>
<td>Senior real estate debt</td>
<td>200–250bps</td>
<td>2.75–3.25%</td>
</tr>
<tr>
<td>Finance IV</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate Debt</td>
<td>Strategic real estate</td>
<td>400–550bps</td>
<td>4.75–6.25%</td>
</tr>
<tr>
<td>Finance VI</td>
<td>debt allocation</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: M&G 2017 *Target returns assume an average Libor rate of 0.75% throughout the term of the strategies. The value of investments can fall as well as rise.

Expected target returns are not guaranteed and depend on a number of factors and assumptions.

Indicative portfolio credit ratings of REDF IV & REDF VI**

Source: M&G 2017 **M&G internal credit ratings, indicative only.

![Indicative portfolio credit ratings](image-url)
Real Estate Debt Finance IV (REDF IV)

For investors seeking attractive returns whilst ensuring their risk profile remains conservative, REDF IV offers an investment route to access a portfolio of senior real estate loans across the UK and Europe with 100% exposure to investment grade ratings, with an average rating of BBB. The charts below demonstrate the target discount margin relative to corporate bond spreads in both the UK and Europe. Assuming a 25bps hedging cost from sterling to euro, these spreads present an even more compelling opportunity for euro based investors.

REDF IV target discount margin vs corporate bond spread

Source: Bank of America, M&G 2017
Real Estate Debt Finance VI (REDF VI)

For investors with a slightly higher appetite for risk, our strategic allocation vehicle, REDF VI, targets gross discount margins of 400-550bps with a minimum 60% exposure to investment grade loans and an expected average rating across the portfolio of BBB-/BB+. As the charts below demonstrate, not only is this opportunity extremely compelling relative to corporate bonds. In addition, it also offers gross returns which are similar to unlevered core real estate equity investments, whilst providing a significant buffer to falls in real estate values before returns are impacted, thus providing a good defensive diversifier in a broader real estate portfolio, especially late cycle.

REDF VI target discount margin vs corporate bond spread

Source: Bank of America, M&G 2017
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