The inherent stability of European real estate lending

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In today's current investment landscape, I have witnessed first hand how real estate lending has emerged as a stabilising force, offering investors a safe haven from the volatility of public markets. At Arrow Lending Opportunities, we've honed our focus on this private debt investment strategy, particularly within the European real estate credit sector, and I'm keen to share insights into its increasing appeal.

My experience in real estate lending has shown me the inherent safety and stability it brings, which is especially valuable in a market characterised by shifting rates and uncertainties in public markets. As a result, investors are increasingly gravitating towards private credit. This shift is motivated by the desire for stable returns and protection against fluctuating interest rates. Once perceived as elusive, private credit is now acknowledged for its potential to offer steady gains amidst the instability of public markets.

The resilience of real estate debt is evident from its consistent growth since the global financial crisis. Its attractiveness stems from its ability to weather various market conditions, whether fluctuating interest rates or geopolitical upheavals. This asset class's robust performance, even amidst challenges like Brexit and international geopolitical crises, underscores its reliability.

For investors, selecting a seasoned real estate debt manager, known for diverse origination sources, meticulous underwriting including conservative loan-to-value ratios, and effective portfolio management, is crucial for successfully navigating this investment strategy.

Since 2009, we have been investing in this asset class, funding in excess of £5 billion of developments and delivering more than 17,800 units across 258 projects without any credit losses of capital, interest, and fees. Our experience has proven this to be a highly reliable asset class, leading us to confidently reinvest our gains.

In portfolio construction, real estate debt occupies a unique and vital space. These secured, asset-backed loans offer a stable alternative within the fixed income allocation. Investors must balance their comfort with the spread above base rate against other asset classes, especially considering the increases in interest rates.

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Over the last 18 months, my attention has been focused on the evolving landscape of attractive real estate sectors. Office buildings that comply with ESG standards and boast high green credentials, while adapting to modern working styles, are increasingly in demand, especially in supply-constrained central business districts like The City of London, Amsterdam's Zuidas, or Porta Nuova in Milan. This trend contrasts sharply with the declining interest in older, hard to remodel office units and poorly situated retail and leisure space.

The 'beds' business, encompassing build-to-rent, private rented sectors, co-living, part-buy-part-rent, student accommodation, and hotels, continues to thrive, a trend that is significantly bolstered by the current state of net migration and the ongoing challenges in housing and planning processes. The Office for National Statistics (ONS) recently predicted that net migration will see the UK population reach 70 million by 2026, 11 years earlier than predicted.

In the realm of student accommodation, I'm particularly excited about the new opportunities this sector presents. The globalisation of post-secondary education, with Europe as a major beneficiary, contrasts starkly with the mid-2000s when few English-taught undergraduate programmes were available for foreign students in Europe. Now, with over 3,000 such programmes, there's a pressing need for safe and accessible student housing. Arrow is ready to capitalise on this opportunity by sourcing, acquiring, repositioning, and developing new purpose-built student accommodations through our local real estate platforms.

As mentioned, the UK's housing market remains under considerable pressure, as evidenced by the net migration figures for the year to December 2022, standing at 745,000, which is more than 1 percent of the UK population. This level of migration highlights the persistent and growing need for housing, a demand that is not being met due to the convoluted and expensive planning processes which show no signs of improvement. The demand/supply imbalance has been further exacerbated by a reduction in rental supply since the pandemic. This is largely due to a widespread retreat of Buy-to-Let investors, driven by tax and regulatory changes, particularly the requirement to upgrade properties to meet net zero carbon targets. This situation underscores the need to build more homes, seizing the opportunities that these moving real estate trends present for astute investors.

The recent challenges faced by US regional banks have also impacted the real estate debt market with the retreat of bank lending further opening up the opportunity for non-bank lenders as traditional banks look to remain better capitalised as measured by Tier 1 capital ratios.

Today a successful deal in real estate debt relies on several factors: a credible sponsor, a competent contractor, and a project aligned with market demands, with a keen focus on key performance indicators like loan-to-cost and loan-to-value. Moreover, real estate debt investment is not just about financial returns; it's also about urban transformation and repurposing to bolster its appeal. Whilst Europe's cumbersome planning regimes present challenges, significant capital is available to support transformation, especially in ESG-friendly residential and office spaces. Arrow Lending Opportunities has played a pivotal role in this regard, particularly in Manchester, where our investment of nearly £1 billion since 2009 has transformed the city's skyline and established it as a prime destination outside the Southeast. High-rise residential, once uncommon in Manchester, is now a defining feature of the city and a sign of the city's wider confident regeneration.

Looking ahead, the upcoming maturity of bonds and loans presents a potential opportunity for investors. In the US alone, $22.5 trillion of CRE debt is set to mature by 2027, over half on bank balance sheets.[1] The gap between historical refinance levels and the current environment of higher rates and lower values offers a unique prospect. However, realising this opportunity depends on the willingness of investors and banks to engage in transactions.

In conclusion, real estate lending stands as a robust and resilient investment strategy, capable of delivering stable returns amidst market fluctuations. Its role in urban transformation and creating a positive social change through helping to alleviate the housing crisis, as well as adaptation to various market cycles positions it as a vital component in any well-rounded investment portfolio. As investors navigate a changing economic landscape, real estate debt, underpinned by experienced managers and grounded in thorough analysis, offers a safe haven of stability and growth.

FOOTNOTE

1 Source: M&G Real Estate based on Trepp Quarterly Data Review 1Q 2023 (2023)

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