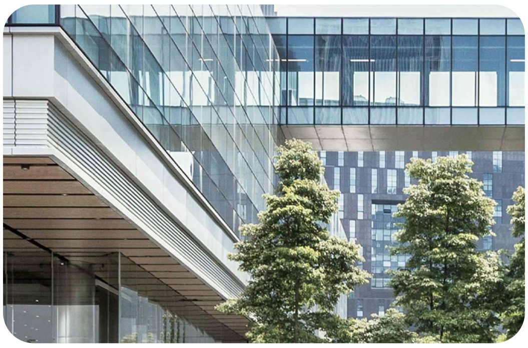


Transforming the Real Estate Horizon

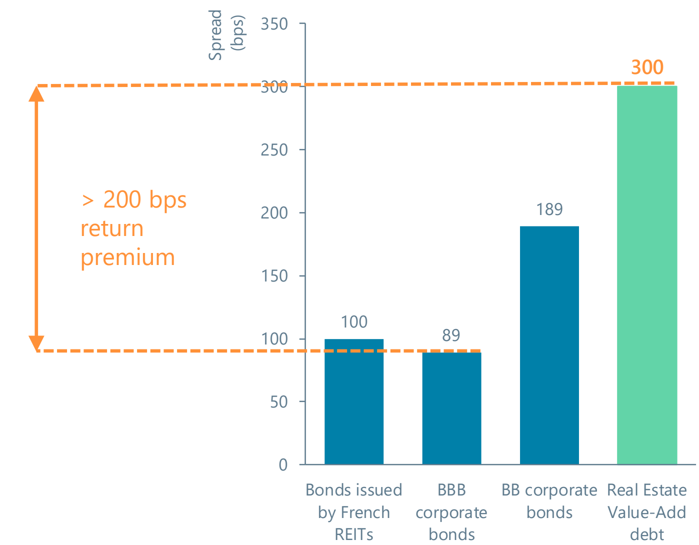
Value-add strategy provides access to the innovating and evolving real estate market

By Pierre SAELI, Head of Real Estate Loans, July 2024

Real estate debt market, a compelling investment opportunity

Despite the negative news flow surrounding the real estate market, we believe that the current market offers a favorable environment for investing in real estate debt. Although the year 2022 was marked by a rapid rise in interest rates, which led to a downward recalibration in asset values, the current real estate debt market presents a compelling investment opportunity. Compared to a few years ago, a shift to a healthier, more sustainable market environment for investors has been observed thanks to leverage levels (Loan to Value-LTV) declining approximately 5 to 10 %, coupled with the decline of real estate values. In addition, spreads on real estate loans, at historically high levels (+300bps), enable this asset class to regain its attractiveness in comparison to Investment Grade and BB-rated bonds. These credit spreads are further supported by a context of reduced competition amongst lenders, leading to a decrease in the supply of available financing.

Spread comparison excluding financial issuers [1]

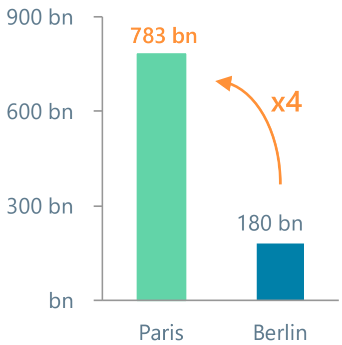


Moreover, the end of the tightening monetary cycle is also playing a pivotal role in fostering a more favorable perspective for real estate values. A stabilization, or even an increase, in real estate values offers a positive background for investments in real estate debt. An additional noteworthy element in the current conditions is the inverted yield curve, contributing to a progressive performance of floating rate loans, which make up the bulk of the real estate debt market. Investors in the area can benefit from the enhanced returns.

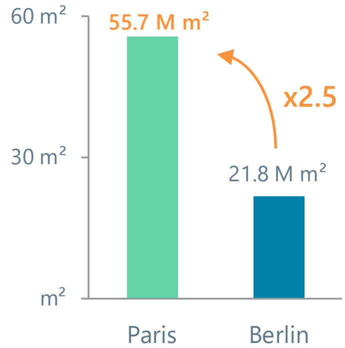
Paris, a destination attracting investors

The GDP of the Paris region is four times bigger than that of Berlin, with its population matching those of Berlin, Munich and Hamburg combined. In addition, the French capital city holds the distinction of having the largest office market in Europe at 55,7m sqm, which is 2.5 times the size of Berlin's, with the lowest vacancy rate in its Central Business District (CBD), at around 2%. The attractiveness of this city is not limited to its office sector; it is a broad and diversified real estate market that encompasses all asset classes, from office and retail to high-end hotels and logistics, etc.

GDP comparison (EUR)[2]



Office market size comparison[2]



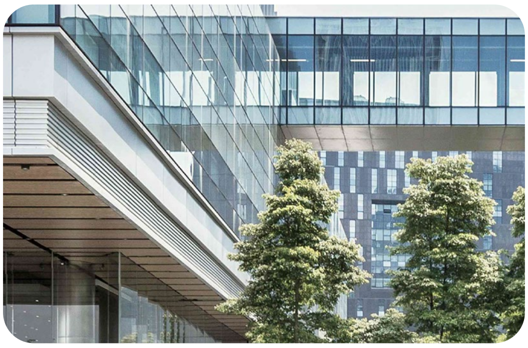
Furthermore, it is the largest investment market in Europe providing liquidity for properties, an appealing point from a risk perspective, especially during periods of market correction. These factors reinforce the city's robust economic activity and vibrant market dynamics, offering a wide range of opportunities to suit various investment strategies.

It is essential to note that geographic diversification remains a key element of a sound investment approach. Several underlying trends, such as the demand of centrality for offices, the growth of the living sector and urban logistics, are common across all major European gateway cities. Therefore, even with a significant weighting towards the Paris market, investors should consider a diversified portfolio to capitalize on these pan-European trends.

Value-add debt, a strategy shaping the future of real estate market

A value-add debt strategy, where an asset is transformed to a superior level characterized by higher industry standards or functionalities with substantial capital injection, anticipates the future needs of the real estate market.

[1] Source: Barclays Live and SCOR Investment Partners, as at 30.04.2024 | For BB corporate bonds: ICE BofA BB Euro High Yield Non-Financial Constrained Index; average duration 2.9 years; For BBB corporate bonds: ICE BofA BBB Euro Non-Financial Index; average duration 4.6 years; French REITS sample include: SFL, Gecina, Covivio, Inli, URW, Klépierre (average bond maturity is 4.2 years) | [2] Source: Paris Region Facts & Figures 2024, JLL



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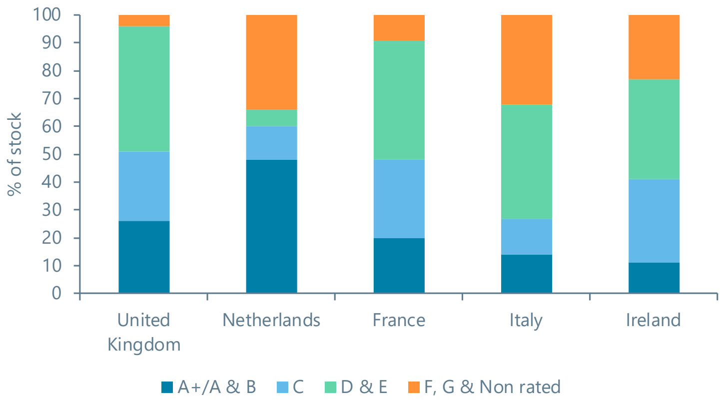
Value-add and real estate debt: the sweet spot

To illustrate, an ambitious goal of achieving carbon neutrality by the year 2050 set by the European Union is being transmuted into increasingly tighter laws and regulations across Europe, associated with the energy efficiency of buildings. EPC (Energy Performance Certificate) is a typical example under this regulatory framework applied in office buildings in Netherlands or in residential buildings in France. Projects seeking energy efficiency pave the way for direct results in terms of reduction of GHG (Greenhouse Gas) emissions.

Energy Performance Certificates (EPC)[1]

Break down by countries



There is also a growing demand for restructured and certified assets from investor's perspective. Properties aligned with ESG policies translating into lower operational costs attract tenants willing to pay higher rents, and therefore resulting in lower vacancy rate. Ultimately, the need of investment to ensure the building's continued functionality in light of its aging process existence and utilization is crucial. This underlines the critical function that value-add debt plays in shaping the trajectory of the real estate market in the forthcoming times.

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[1] Source: European Commission, Barings Real Estate

Value-add investment allows to benefit from market cyclicality

Real estate debt being fundamentally floating-rate it has reaped the full benefits of interest rates increase since 2022. In addition, the current synergetic combination of real estate values downturn, leverage levels decline and spreads at historic peaks offers a unique opportunity of investment in value-add debt.

Using whole loans as part of a value-added debt strategy

Whole loans benefit from 1st-rank security, with a higher leverage level than a senior debt. For example, on a transaction where the LTV of senior debt would be 55%, the LTV of a whole loan could be as high as 65 or 70%, for a higher spread. Over the past 2 years, with the rise in interest rates, we have seen a downward adjustment in real estate values, and consequently lower LTV levels in financing transactions. This process is nearing completion providing a sweet spot in the investment market cycle to increase exposure to whole loan.

Whole loan benefits from a less complex structure than an alternative (senior debt combined with mezzanine debt). Setting up a structured whole loan by a single creditor is easier and has greater certainty of execution. A service for which a borrower will be ready to offer additional remuneration.

Value-add investment approach, aligning with the sustainability

Our future senior real estate debt strategy is meticulously designed to finance refurbishment initiatives. For building renovations, the work program is designed to achieve a minimum reduction of 30% in primary energy demand. As for new constructions, predominantly residential, the performance mandate calls for a 10% reduction relative to the NZEB (Nearly Zero-Energy Buildings) benchmark.

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