KEYNOTE INTERVIEW

The drivers underpinning demand for RE debt

New investors are coming into real estate debt as an alternative to direct investment, finds Andrew Macland, head of European debt at PGIM Real Estate

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In January, investment manager PGIM Real Estate closed its PGIM Real Estate Capital VII fund, one of Europe's largest recent property debt funds, on €1.82 billion. The vehicle is the seventh in PGIM's flagship European high-yield debt fund series. A significant fundraising at any time, it was even more pertinent being achieved as the market continued to emerge from the pandemic, which curtailed face-to-face meetings, a cornerstone of sealing investor commitments.

Andrew Macland, head of European debt at PGIM Real Estate, spoke with Real Estate Capital Europe about what it takes to successfully raise a fund in this market and which strategies are gaining traction with investors.

Q How challenging was fundraising during a pandemic?

Being in a pandemic, with travel restricted, meant there were challenges to capital raising, especially as it was more difficult to meet investors face-to-face.

We launched PRECAP VII as covid-19 was starting to bite. While fundraising was difficult, the advantage of having a series of funds was that we already had a good following of investors. However, each of those investors were also undergoing their own issues at the time. It meant some were willing to commit to a new fund, while others were not.

When investors cannot meet in person, they are more likely to invest with their existing managers. The lack of travel and meetings meant investors were less likely to meet with other managers that had come to the market, to see what they might be offering – and we benefitted from being a trusted partner with a long-standing track record.

Q Did you see new investors come into the real estate debt market?

Yes, we were pleased with the number of new investors that came into the fund. In the past, we were more heavily weighted towards pension funds, but we attracted insurance companies, Asian investors and sovereign wealth funds into PRECAP VII.

Historically, real estate focused investors looked to add real estate debt as a diversifier to their direct real estate portfolio. But increasingly during the fundraise, we saw private credit investors expanding from traditional corporate debt investments into real estate debt, due to the material benefit of having tangible real estate as security to protect repayment of the loan. On the other hand, our senior debt strategy was much more a focus of traditional fixed income investors looking to expand into the real estate debt asset class.

Q What type of strategies are popular with investors?

We have two pillars to our debt strategy in Europe, both driven by investor demand. We have our high-yield, value-add-style strategy – most recently PRECAP VII, which is an absolute return, closed-end fund. We also have our senior debt strategy, which appeals to investors seeking conservative, fixed income-type investments. Investors in the latter are looking to match their long-term liabilities in an alternative asset to traditional fixed income. They see senior real estate debt as an attractive through-the-cycle investment to hold to maturity.

We raised €1.6 billion for our senior debt strategy last year. The retrenchment of traditional senior debt lenders in Europe, plus banking and insurance industry regulation, has led to significant growth in alternative senior debt strategies since the Global Financial Crisis.

Value-add strategies, including mezzanine and preferred equity, have also seen significant growth in Europe since the GFC. They are partly driven by the same retrenchment of the banks. But that type of strategy is much more about a co-alignment of capital with the borrower's equity to achieve equity-style returns.

Q What sort of returns can investors earn from these strategies?

Across Europe, senior real estate debt is seeing typically low single-digits return, whereas the high-yielding, value-add strategies, are seeing high single-digit, low double-digit returns. In times of heightened market volatility, such as during covid-19 or as a result of the current conflict in Ukraine, we see a retrenchment of liquidity available in the market, and thus an additional risk premium can be charged by those remaining active – with loans priced higher, but often at reduced loan-to-value or risk levels in response to the perceived market risk.

Q With a greater diversity of strategies, how has the profile of investors changed?

Early in the cycle, the people we would speak to within the investor market would typically be real estate

Top of mind

Managers seeking to raise funds need to be ESG ready

With uncertainties in the current economic and geopolitical situation, environmental concerns could have taken a back seat for investors diligencing funds. But ESG remains a focus for institutional investors, as PGIM Real Estate found during its PRECAP VII fundraise.

"A few years ago, ESG would only have been a part of an array of questions you might have received from investors as they were considering coming into a fund. Today it is on top of the list," says Andrew Macland, highlighting investors' interest in company-wide targets to make their portfolios sustainable.

"We closed PRECAP VII last year, before inflation and interest rates became immediate concerns. Even then, there had been a noticeable increase in questions on ESG matters from investors during the fundraising."

ESG creates opportunities for investors into real estate debt: managers are increasingly making green or sustainable loans. But they are also being more selective about what investments they will make. "Managers have to consider that, to fund an asset, they need to think about how it will look in in three, five, 10 years' time," says Macland.

The evolution in the quality of space is going to be dramatic over the next few years, he believes, as anything constructed today must tick every environmental box because of concerns about how liquid will that asset be. Lenders can accommodate that by making stipulations in loan deals around the quality of the building.

Macland adds: "If your sponsor set out to achieve, say a BREEM 'excellent' accreditation, and they achieve it, then you can have a margin adjustment to reflect that. Loan structures can help to promote sustainability, meaning investors gain exposure to the best product in the sector."

specialists. Investors' real estate teams would be considering how to invest in core-plus or value-add real estate, for instance, and those teams would then consider real estate debt as an option.

In the past five years, that has changed. Within the investor universe, managers are now as likely to speak to people who cover infrastructure investment or fixed income, as they are with real estate specialists.

Investors are looking, from a holistic standpoint, to solve the issues they have. The type of investors we are speaking to include private credit teams that would now look at real estate lending as an alternative to some of those fixed income corporate strategies.

We are getting more traction with private credit-focused investors as they weigh up their allocation options. So real estate debt feels like it is more of a component of the private credit world, particularly the senior debt strategies.

Q Is real estate debt now considered a distinct asset class?

Real estate debt has become a more established asset class as alternative lenders have grown. Certainly, because of Solvency II, for insurance companies and pension schemes fixed income has become a much bigger pool than traditional real estate in terms of investor allocations.

Investment-grade real estate debt is being seen by investors as a more established asset class, and as an alternative to corporate debt. There are more managers and strategies for them to allocate to, and it is becoming a recognised area in which they can invest.

Because investors are making commitments to funds, they can adjust to the rates in the market as they change, so it is a very good way for investors to match their underlying liabilities.

On the value-add side of the industry, investors recognise that debt offers some capital protection, meaning reduced volatility. There is a growing understanding among investors that, at any point during the cycle, debt is an attractive way of investing into real estate as an alternative to direct investment.

Q Which sectors are investors keen to gain exposure to through debt strategies?

Real estate debt investors tend to be agnostic on the sectors. However, as a house, we have a view on where we see the best value. We concentrate on investment themes, whether that is logistics, living sectors, or alternatives like data centres. We follow those themes through our equity and debt strategies as a house.

> *"Debt offers capital protection from changes in the value of the underlying real estate"*

As a lender, the liquidity of our exit position is obviously highly important, and so it is important to concentrate on where the best value is and which are the most liquid markets. For example, since 2015 our equity business stopped investing into retail, and our debt business followed that. This meant when there was a major correction in that sector, we had very little exposure.

Q How are investors allocating to funds thinking about inflation?

Traditionally, inflation has been good for real estate insomuch as many rental contracts are index-linked or the rising cost of construction restricts supply of new stock, leading to rental growth. Inflation was coming through during late 2021 and early 2022. But there is now greater scarcity of product because the Ukraine crisis is exacerbating supply problems and materially accelerating the cost of some materials such as steel and concrete.

From an investor demand standpoint, we are not worried investors will be overly concerned about debt investments in the current market. On the senior side, where investment is focused on stabilised properties, there is minimal construction risk. But we remain highly vigilant towards long-term income risk, and we remain focused on the granularity of income and the strength of the quality of the covenant.

On the value-add side, which can be more construction-led, we are building in more contingency for future inflation. For example, contractors are putting in contingency sums on tender prices. It is very hard to cost-analyse anything now, which is going to have an impact on the market in terms of reducing future supply of real estate even further, which should again be supportive of rental growth in the longer term.

Q What is your outlook for real estate debt?

In times of volatility, debt remains an attractive investment class that offers capital protection from changes in the value of the underlying real estate with the opportunity for positive credit migration. Returns are focused on income, providing broad appeal to institutional investors targeting either real estate or fixed income allocations.

Our lending strategies are backed up by structural trends. On a firmwide basis, we are highly focused on digitisation, demographic and decarbonisation trends, and how they affect tenant and borrower demand at the asset level. The interest rate environment is a concern, but income growth should continue to provide support values – and therefore potential to improve the loan position in the capital stack – over time. ■