INVESTING IN COMMERCIAL REAL ESTATE: THE BENEFITS OF DEBT VS EQUITY

With the emergence of real estate debt funds, investors considering real estate investment strategies now have alternative sources for real estate exposure. This article discusses some of the main characteristics of mezzanine and senior debt in comparison to equity.

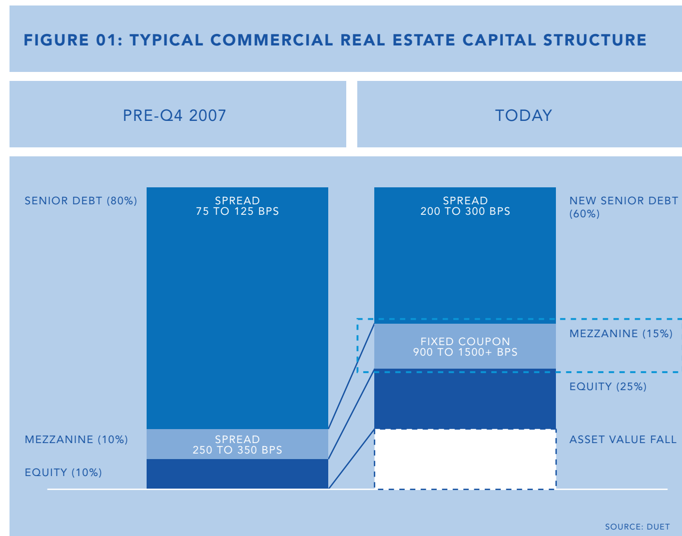
Over the past decade commercial real estate debt grew to record volumes. This growth was accompanied by an increase in loan-to-value (LTV) ratios and a relaxation of underwriting standards, with many senior banks providing high leverage with very low margins of 75 – 125 basis points. When the credit markets started to tighten in mid-2007, commercial real estate was one of the first segments to feel the negative impact.

The vast availability of credit pre-2007, and more stringent lending since, has resulted in a significant supply and demand imbalance between the amount of debt that needs to be refinanced over the coming years and today's supply of credit. This imbalance is often referred to as the "funding gap", which is seen as the biggest challenge to many international property markets. For Europe alone the gap is estimated to be $122 billion (€92.1 billion), according to DTZ Research.

The global financial crisis has resulted in significant structural changes to the global real estate market; a fall in property values and returns; overexposure of key senior lenders; and the introduction of Basel III banking legislation.

These structural changes have opened an opportunity for mezzanine debt funds, which fill the gap between new senior loans and equity in the capital structure. Figure 01 shows how the typical capital structure for commercial real estate has changed from 2007 to present.

FIGURE 01: TYPICAL COMMERCIAL REAL ESTATE CAPITAL STRUCTURE



OPTIONS FOR INVESTING IN REAL ESTATE

Investments in real estate can be made through different instruments with varying risk and return characteristics. This article focuses on senior debt, mezzanine debt and equity, which generally sits between value add and opportunity real estate. Table 01 shows the targeted returns and the associated risk for the most common real estate investment.

TABLE 01: OPTIONS FOR INVESTING IN REAL ESTATE

	LIQUIDITY	RUNNING YIELD	EXPOSURE TO CHANGE IN PROPERTY VALUES	TARGET IRR
CORE PROPERTY (LOW LEVERAGE, DIRECT PROPERTY)	MEDIUM	MEDIUM	MEDIUM/HIGH	8 – 10%
OPPORTUNISTIC PROPERTY (HIGH LEVERAGE, DIRECT PROPERTY)	LOW	LOW	HIGH	20% +
MEZZANINE DEBT BACKED BY PROPERTY (DEBT INVESTMENTS)	LOW	MEDIUM/HIGH	LOW/MEDIUM	15% +

SOURCE: DUET

RISK AND RETURN PROFILE

The table below illustrates the volatility of returns for real estate investments to changes in the underlying property. This simplified example assumes a property acquisition of €100 million financed with €50 million (50% LTV) senior debt, €20 million (70% LTV) mezzanine debt, and €30 million of equity over the course of one year.

TABLE 02: THE VOLATILITY OF RETURNS FOR REAL ESTATE INVESTMENTS TO CHANGES IN THE UNDERLYING PROPERTY

PROPERTY VALUE		EQUITY		MEZZANINE DEBT		SENIOR DEBT	
% CHANGE	€	% CHANGE	€	% CHANGE	€	% CHANGE	€
+20%	120M	+67%	50M	0%	20M	0%	50M
+10%	110M	+33%	40M	0%	20M	0%	50M
0%	100M	0%	30M	0%	20M	0%	50M
-10%	90M	-33%	20M	0%	20M	0%	50M
-20%	80M	-67%	10M	0%	20M	0%	50M

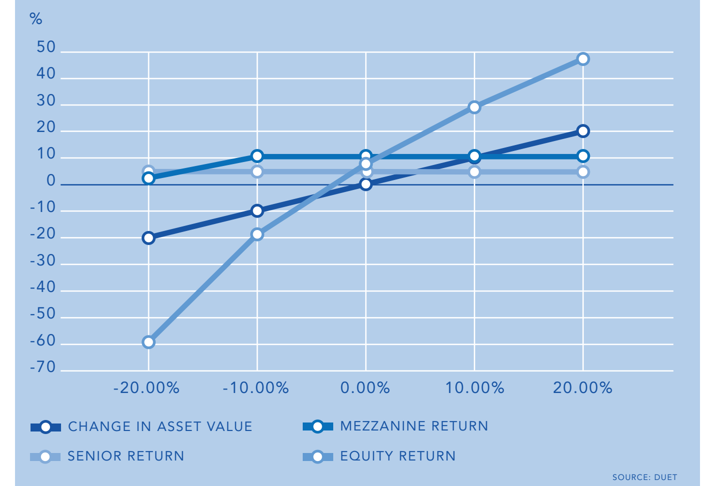
SOURCE: DUET

The leveraged equity investment has the most volatility, as it is highly sensitive to changes in the underlying asset value. A 20% increase in asset values will give the equity investor a 67% upside on their investment. However, if prices fall the equity investor will take an immediate loss as their investment is subordinated in the capital structure. The return for an equity investor will come from income in form of rents and increases in asset values, where in a high growth environment the latter will be the main factor impacting the returns.

The investment with the least volatility is the senior debt, which is only affected if the property value falls by more than 50%. In addition the senior lender will have seniority with regards to rental income, and likely amortisation which will reduce the risk profile over the life of the loan. If any loan covenants are breached, the senior lender will be able to enforce its mortgage on the property and sell it in order to protect their investment.

Figure 02 shows the internal rates of return (IRRs) for senior debt, mezzanine debt and equity, given a change in value of the underlying real estate for a range from -20% to +20%. In this assumption, we have assumed a two year holding period for an asset with a net yield of 8% p.a., senior debt cost of 5% p.a. and mezzanine debt cost of 11% p.a. The most steeply sloped line shows the leveraged equity return and, as indicated by the previous table, these returns are highly volatile and are the most sensitive with regards to price movements of the underlying value of the real estate. The mezzanine debt takes the next loss after the equity. However, as the LTV of the mezzanine was 80%, the value of the underlying real estate can fall by more than 20% before the mezzanine debt makes a loss of the principal amount invested. In this particular example the senior debt is being preserved over the whole range of price shocks. But note that the return profile for mezzanine is above the senior debt return profile for most of the price range, as the mezzanine investment offers a higher IRR than the senior debt, for the increased risk that it assumes.

FIGURE 02: INVESTMENT IRR VS. CHANGE IN ASSET VALUE



Mezzanine debt sits between senior debt and equity in the capital structure. It offers a defensive strategy for investors who are seeking higher returns while at the same time being downside protected with respect to a fall in property values. Although the mezzanine debt ranks behind the senior debt it will often have a second ranking security package, and benefit from the equity buffer which has to erode before any capital is lost.

The security package offered to the mezzanine lender varies from deal-to-deal, however, the mezzanine lender will have a preferred claim ranking after the senior lender.

With senior banks reducing their exposure to real estate and tightening their lending criteria, a significant funding gap has emerged in Europe. Research suggests that the funding gap in Europe is as big as $122 billion (€92.1 billion). The amount of loans maturing over the coming years, in combination with the reluctance to lend amongst senior banks offers a significant opportunity for debt investments.

Investing in debt backed by commercial real estate provides the investor with attractive risk adjusted returns. Being high income generative and second loss in nature means that debt investments outperform in flat or negative asset value environments. Therefore, a debt strategy can play a very important role in any real estate investment portfolio ■

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