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The effect of Covid-19 on Private Real Estate Debt

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Real estate debt is an attractive asset class for insurers due to the premium to public debt (illiquidity premium), favourable risk profile given collateral and protective covenants, and its potential positive contribution to ESG metrics. According to the industry level data, insurers held real estate assets in excess of EUR 134bn¹, representing just under 2% of non-unit linked assets.

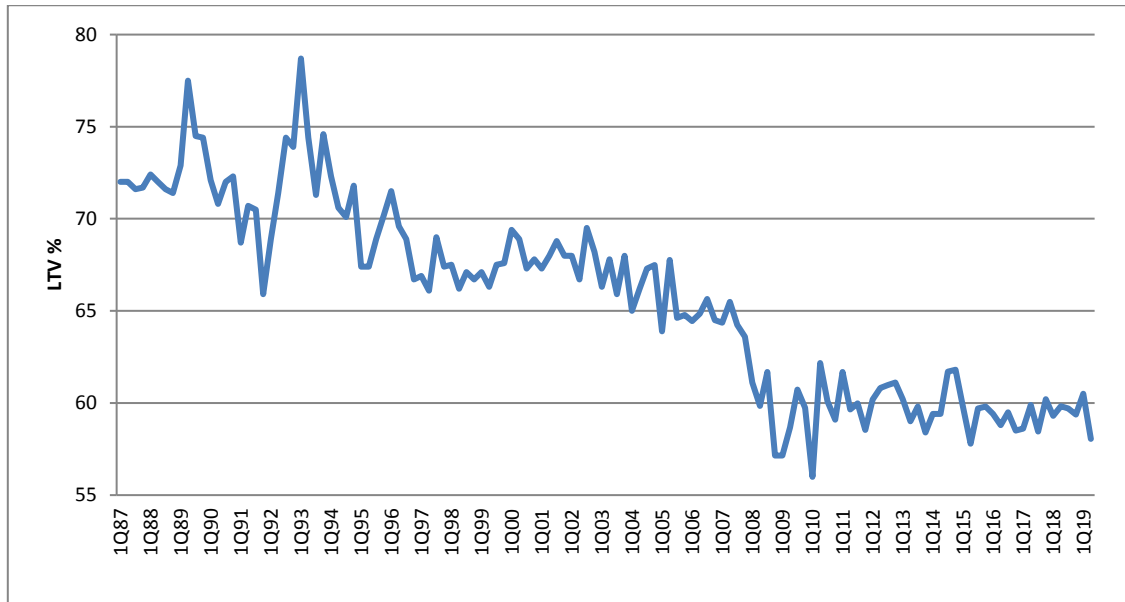
In late Q1 2020 the Covid-19 pandemic brought the world to a standstill and caused major disruption to the global economy. In this article we discuss, from the perspective of an insurer, how the virus has impacted private real estate debt investment and the outlook for the future of the sector.

Comparison with the Global Financial Crisis (GFC)

The shock to markets seen in March and April 2020 as a result of the Covid crisis has inevitably drawn comparisons with the GFC of 2007-2008. However, in reality, it is a completely different crisis. The GFC was a structural crisis, driven by (amongst other things) overly benign credit conditions, excessive risk taking by poorly capitalised banks and the subsequent liquidity shocks that froze the real economy. The effects were catastrophic, widespread and prolonged.

The Covid crisis was driven by an identifiable cause, the Covid-19 virus. The stimulus packages were swift and robust and financial markets snapped back almost immediately. Private debt markets also bounced back quickly because banks were better capitalised and had learnt their lesson about credit cycles, which meant they were able to resume lending in the months following the turmoil of March and April. Post-GFC (but pre Covid -19) loans generally had lower Loan-to-Value (LTV) ratios, higher cash flow coverage ratios and better margins than pre-GFC loans. This meant that lenders were less concerned about defaults in the aftermath. The result was a large divergence in attractiveness within sectors rather than a broad-based eschewing of real-estate debt.

AVERAGE LTV AT ORIGINATION OF US LIFE INSURERS



Source: ACLI

Spreads

The start of the pandemic saw public corporate debt spreads widen significantly and rapidly. However the avalanche of fiscal and monetary policy support for corporate balance sheets and orderly markets

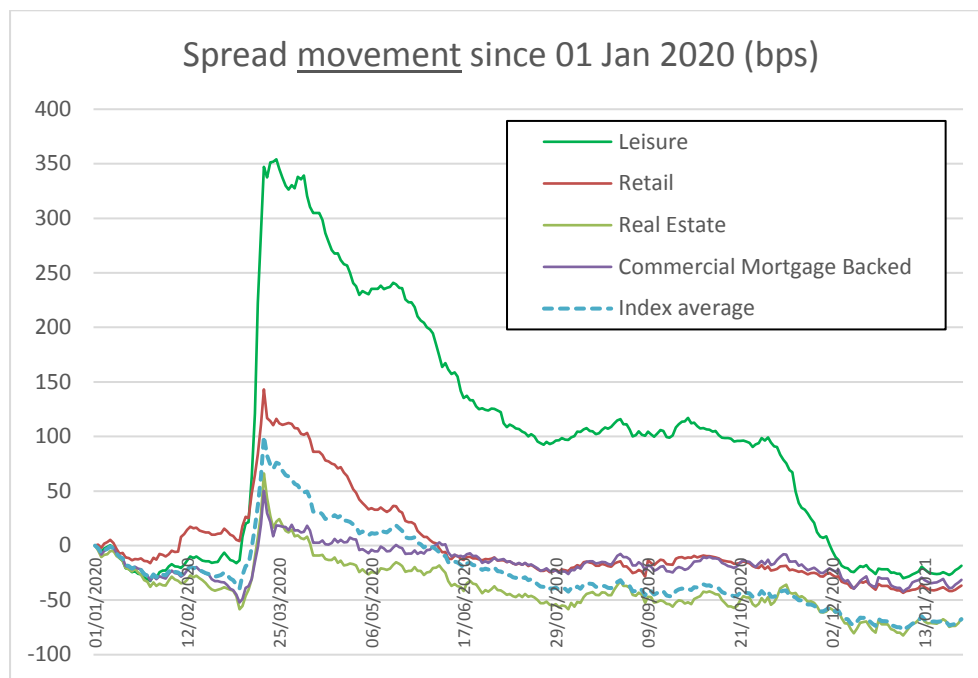
¹ EIOPA Insurance Statistics, YE19

helped them to quickly return to pre-pandemic levels and in some cases, better than pre-pandemic levels.

Public spreads are important for private markets as they are a rich source of data for benchmarking pricing, valuations and liquidity spreads. Private market spreads typically lag public markets due to the time it takes to originate transactions, with spreads agreed weeks or months in advance, as with homeowner mortgages. Anecdotal observations of private markets show that although there has been some widening post-pandemic, these were significantly less pronounced than public markets.

Generally speaking, spreads in the Commercial Real Estate (CRE) retail sector remain c. 40-50bps wider, while residential and logistics are now originated at levels below the pandemic². This sector divergence is discussed later in this article.

PUBLIC BOND SPREAD CHANGE IN BPS SINCE JANUARY 2020



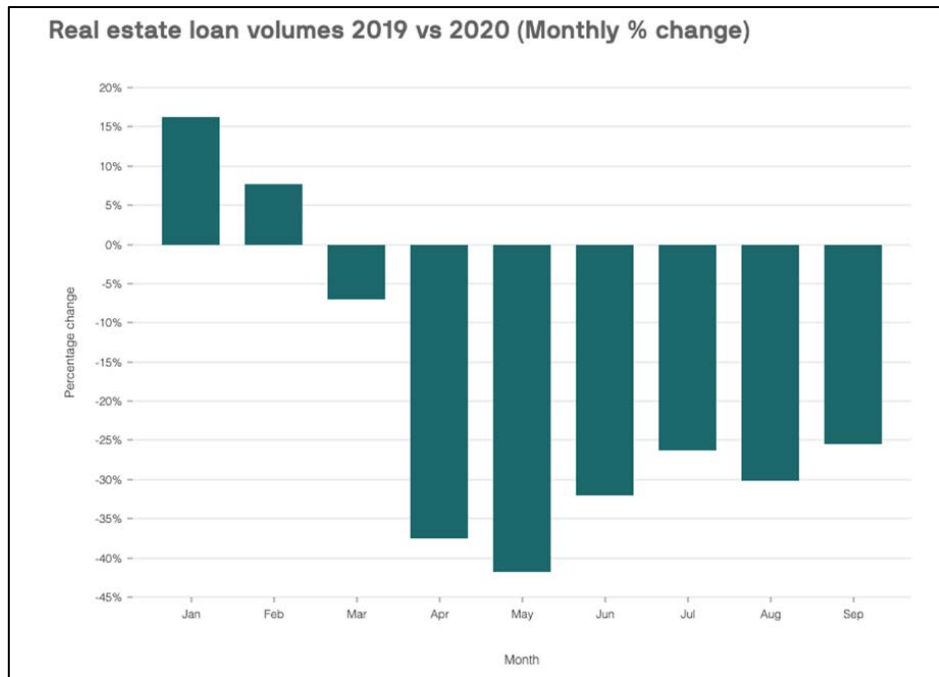
At the start of the pandemic, spreads of publicly issued bonds in the leisure sector (inc. hotels) widened by 350bps from the start of 2020. With high vaccine efficacy and a successful UK roll out, these spreads have retreated to pre-pandemic levels.

Source: Bloomberg, Working Party research

Volume

As is evident from the graph below, prior to the Covid 19 outbreak, real estate private debt issuance volumes in Q1 2020 were slightly in excess of Q1 2019. Across Europe and the UK, March and April 2020 saw a complete standstill in issuance, while Q2 and Q3 saw volumes significantly down on the same period in 2019.

² Working Party research



Source: Native Finance

Bank originators needed to assess the impact on their funding costs and institutional lenders saw their illiquidity premium (assessed relative to proxy public bond benchmarks) turn negative. Both had to evaluate the longer-term impact on market segments and digest the elevated uncertainty during the pandemic. In addition, real estate purchases were stymied due to difficulties in having properties valued (due to physical distancing) and general ambiguity around property values.

Late in 2020 and the beginning of 2021, the market appears to have returned to some semblance of normality.

Perhaps the biggest impact on volumes was best seen in the way the market segmented, with core transactions backed by prime investors remaining executable, but secondary and tertiary quality transactions becoming much more difficult to finance due to a decline in risk appetite amongst lenders. The return to relative normality did not, therefore, benefit everyone.

New origination and covenants

Despite 6-8 weeks of standstill during March and April 2020, investors and originators were typically motivated to fulfil their commitments. Many transactions were completed with limited pricing revision or the insertion of material adverse change (MAC) clauses. Once the pipeline cleared, for new transactions, terms such as LTV's were tightened by 5-10 percentage points, to take into account ambiguity around valuations. Existing transactions came under pressure and many borrowers requested waivers for principal and interest payments or to avoid technical breaches. Some countries enacted mortgage or rental holidays on a national level, which created pressure on insurance lender's consent. These holidays were sometimes "paid-for" with additional covenants such as blocking dividends, cash-trapping or increasing the pace of amortisation after the holiday.

Real estate debt approaching maturity, during these crisis-hit months, was often extended by a year or two as it was in the interest of both lenders and borrowers to avoid unnecessary defaults.

Downgrades

Private debt assets are typically rated internally by insurers, however the rating methodology is often similar to public assets exposed to the same risk factors. Working Party research has found that, at the beginning of the pandemic, real estate debt experienced more severe credit rating downgrades

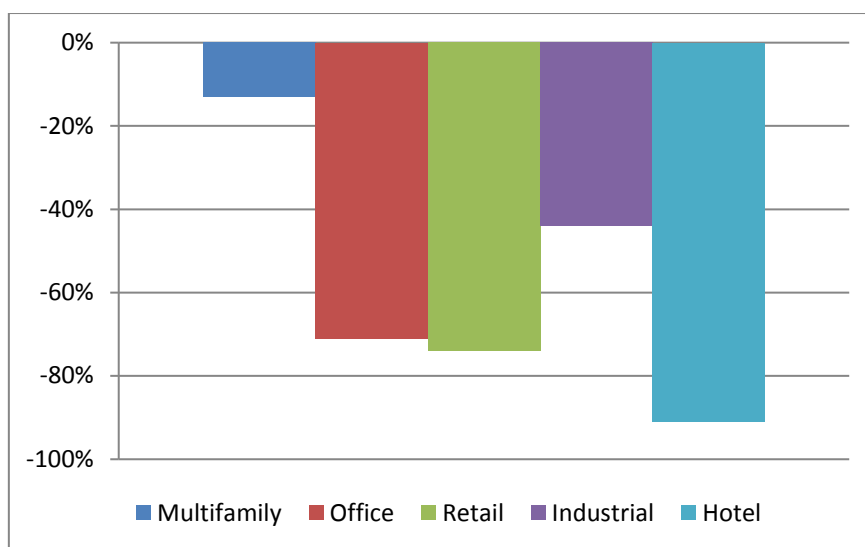
than an average bond portfolio but that this began to level out through the year. Some sub-sectors were relatively insulated from these downgrades, for example, affordable housing.

Given the uncertain outlook for asset valuations and difficulty in physically valuing the properties, there is potential for further downgrades across the sector. Insurers should be thoughtful about the impact on their balance sheet from future downgrades of both new and existing assets as it can negatively impact solvency capital ratios, have accounting impairment implications, and potentially cause breaches of asset allocation parameters.

Impact on sub-sectors

Real estate debt is not a homogeneous asset class, with very different drivers of value between sectors and across borders. While overall CRE volumes fell by 40% over 2020, some sectors were more heavily impacted than others as shown in the chart below.

2Q20 YOY CHANGE IN ORIGINATIONS – PROPERTY TYPE



Source: Mortgage Bankers Association

Differentiation has become more pronounced within sub-sectors. Investors must rapidly adjust to the “new normal”, which means reassessing the value drivers underpinning each property and loan in the wake of behavioural changes by tenants and the public.

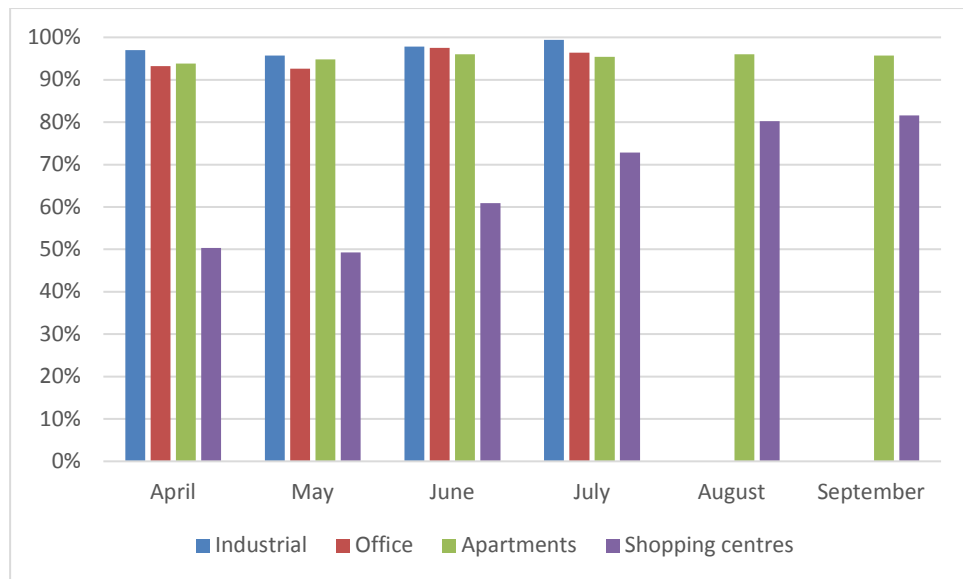
It is clear that there is value to be had in picking less-loved sub-sectors that could bounce back quickly, but risks remain as the full downside on valuations may not be realised until longer term leases roll off in the coming years. Due-diligence becomes ever more critical.

Offices

Increased social distancing will require more space per employee, cause logistical challenges for office towers and push up the trend in home working. That said, land remaining expensive means that office towers offer efficient land use and opportunities for connectivity. We expect larger corporations to rationalise property holdings to ‘trophy’ head offices at the expense of satellite or out of town offices (e.g., the Gherkin in London may be better placed than La Defense in Paris).

In the short term, we expect premium tenants to see out existing leases. In the medium to long term, we expect that companies may eschew signing high value, long-tenor contracts (with long tenors typical in the office sub-sector) until we are safely in a post-pandemic world. The full impact on office debt may not be felt until a year or two in the future as existing high-value leases need to be replaced. As far as rent collections are concerned, these remain robust for now, as the graph below demonstrates.

RENT COLLECTIONS ESTIMATES



Source: Nareit

“Covid-clauses” may be a feature as tenants try to shift some of the risk to landlords upon the occurrence of certain defined restrictions such as government-imposed work-from-home rules, thereby increasing due-diligence requirements.

Retail

Covid-19 sharply accelerated the trend away from bricks-and-mortar retail to online shopping. Within bricks-and-mortar retail, the reduction in footfall was more pronounced in outlets considered ‘non-essential’ (such as those containing leisure activities such as bowling or cinemas) than ‘essential’ (such as supermarkets).

In the short term, we expect ongoing pressure on rent collection for landlords letting to ‘non-essential’ retailers, potential for Covid clauses in lease contracts as well as increasing pressure on traditional retail business models. This is reflected in widening spreads for loans backed by retail assets. In the longer term, lenders must consider whether the shopping mall and High Street will reassume its place for leisure activity, or whether those larger multi-use complexes will need to downsize, with capacity reallocated to other uses such as offices, distribution points or residential.

Large retail chains will be able to reallocate resources more efficiently and diversify income between loss making and profitable locations and invest in online presence. Smaller retailers will likely remain reliant on government subsidies and landlord largesse until Covid-19 restrictions ease.

Looking at the data below, we can see how retail footfall has suffered more significantly in shopping centres and high streets compared with retail parks. This is predominantly down to retail parks offering larger stores and open spaces compared with the High Street.



Source: Springboard and the Department for Business, Energy & Industrial Strategy

Industrial / logistics:

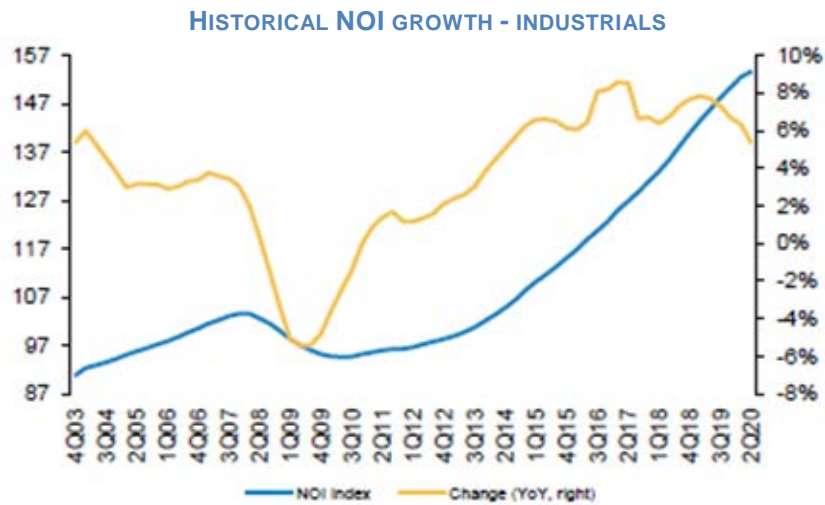
While a lack of footfall caused well-documented problems for bricks and mortar retail, the logistics sector benefited from a significant and accelerated shift to e-commerce. Warehouses and other industrials remain the preferred property type for lenders and at present it is the most competitive sector in the CRE space together with residential. The increased investor demand has put downward pressure on spreads in this sub sector, relative to other CRE sub-sectors. There were still some losers in the sector, for example freezing centres for flowers, for industries impacted by reduced demand.

Logistics deals had already been increasing in volume prior to Covid-19, especially warehousing for supermarkets, facilities near airports and other connection hubs, and distribution centres for deliveries and online shopping and we expect this to continue in the short term.

For high quality logistics transactions, pricing³ is now tighter than pre-Covid.

Net Operating Income (NOI) continued to grow in the sector, clearing benefitting from the pandemic.

³ Working Party research



Source: Morgan Stanley research

Hotels

Despite a widespread vaccine rollout being implemented, international travel restrictions continue. That said, it is expected that hotels servicing international tourists should see a rebound in demand before those dependent on business travellers. With video conferencing becoming the norm, the path back to normality for the latter category is less than clear.

As with retail, larger hotel chains may be naturally insulated with the combination of profitable and loss-making locations. We have seen some hotels take the opportunity of low guest numbers to make major refurbishments and upgrades which can increase asset appeal and property value or at least offset sector wide declines.

One unexpected relative beneficiary are hotels servicing domestic travel, with wealthier countries keeping their tourist dollars (or euros) at home.

Residential

Multifamily sectors, excluding downtown luxury properties, still benefit from a general lack of affordable housing in Europe and the US, and have been somewhat of a safe-haven asset.

Anecdotally, rent collections been stronger than expected except for lower quality affordable apartments. This is likely to be a function of the job losses - typically unemployment hits people with lower paid jobs harder. The move towards working from home exacerbates this strong performance with minimal spread widening compared to the broader market.

Consequences for insurers

Real estate debt has been an attractive and growing asset class for insurers. Covid-19 put a dent into origination flows for most of 2020, but by Q4 things had broadly returned to normal.

The most significant impact for insurers is the increased due-diligence requirements given the evolving economic landscape, as Covid-19 continues longer than most had anticipated. Restrictions on physical movement and the working environment have had direct effects on all real estate sub-sectors. Although vaccinations are being urgently applied, it is yet to be seen whether there will be a timely reversal of these controls, or whether they will act as a catalyst to accelerate trends which will ultimately reduce the value of rented floor space; trends such as flexible working, online shopping, and video-conferencing.

With most insurers typically investing in investment grade debt, the focus will be on whether all potential risk factors have been sufficiently incorporated. As long-term leases roll off there may be

significant knock-on effects on property valuations. Increased demand for safer assets has already seen prime logistics and residential debt being financed at cheaper rates than pre-crisis.

For investors with a more liberal approach to risk it is clear that there are ample opportunities to achieve returns greater than those available pre-Covid. That said, the many uncertainties that face the global economy would seem to justify a premium over prime sectors and countries.

The aftermath of the global financial crisis left banks better regulated and capitalised; the consequence being they were in a better position to open their balance sheets again once the Covid-19 turmoil declined. Originators and lenders also learned the lessons of the GFC, keeping covenants and LTVs tighter, which resulted in less stress on existing portfolios and proving the robustness of the asset class.

Finally, the Covid-19 pandemic crisis may alter portfolio allocations, with some investors preferring the safety of primary quality assets and others seeking opportunities in under-appreciated sectors, borrower and regions. In general we expect demand for investment grade CRE debt to continue to be a cornerstone of fixed income portfolios for insurers.



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