Strategic opportunities in private credit: Real estate and infrastructure debt

November 2024

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Since the onset of the Global Financial Crisis (GFC), demand for private credit has grown significantly, driven largely by three major factors: regulatory changes, structural shifts in the banking sector, and investor demand for yield.

1. **Regulatory changes:** In response to the GFC, regulators have introduced stricter capital and lending requirements for banks. These reforms have significantly curtailed banks' capacity to extend credit, initially to middle-market companies often perceived as riskier borrowers, and later to other spaces such as commercial real estate(CRE). This has created a substantial credit gap, which private lenders have been quick to fill.

2. **Bank disintermediation:** With banks retreating from certain types of lending, private capital has emerged to meet the demand for business loans. Unlike banks, private credit providers can creatively structure transactions, providing lenders and borrowers with more flexible, tailored solutions.

3. **Increased need for yield:** As we've written about in earlier pieces, both institutional and wealth investors have a growing need for portfolio yield as a source of returns, given the volatility in public equity markets and demographic shifts increasing the need for current income.

As a result of these factors, we've seen a rise direct lending, which refers to non-bank lenders providing loans typically to private equity sponsor-backed companies. This has led to the rapid expansion of the private credit opportunity set, which is becoming a staple in institutional portfolios, with additional growth coming from the global wealth management space.

If we fast forward to 2024, these conditions remain in place and have been largely exacerbated by additional stresses on the financial system, such as the US regional bank crisis in 2023, which led to the insolvency of a handful of mid-sized financial institutions. In recent years have seen an increasing number of investors allocate to direct lending strategies. Although these allocations have improved portfolios, they are also beginning to create additional risks around diversification. We argue that while direct lending is a necessary part of investors' private credit allocations, it shouldn't be the only exposure. This is where additional private credit asset classes can be considered, particularly real estate and infrastructure debt.

The results of our latest Global Sovereign Asset Management Study (IGSAMS)[1] indicate that sovereign wealth funds are most interested in infrastructure debt (51%), real estate debt (50%), and corporate direct lending (29%) among the various private credit sectors available in the market (Figure 1). The attractiveness of these sectors reflects their potential for stable, long-term cash flows and the opportunity to capitalize on the growing demand for infrastructure and real estate financing globally.

1. Sample size of sovereign wealth funds: 2024 – 73, 2023 – 80.

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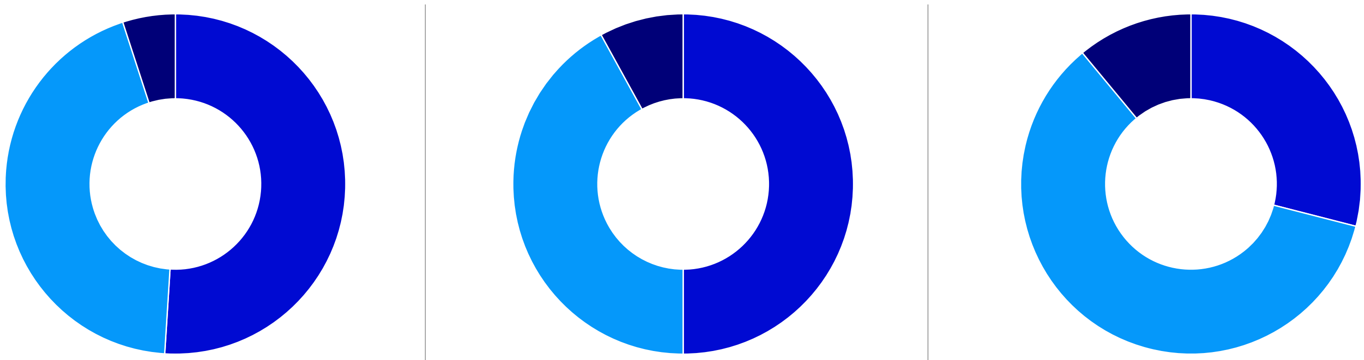
Figure 1 – Attractiveness of private credit sectors (% citations, SWFs only)

Infrastruture debt | **Real estate debt** | **Corporate direct lending**



Infrastruture debt

	%
Very attractive	51
Moderately attractive	44
Not attractive	5

Real estate debt

	%
Very attractive	50
Moderately attractive	42
Not attractive	8

Corporate direct lending

	%
Very attractive	29
Moderately attractive	60
Not attractive	11

Source: Invesco Global Sovereign Asset Management Study 2024. Note - Question: How attractive are the following private credit sectors? Private credit sectors covered: Infrastructure debt, Real estate debt, Corporate direct lending, Distressed debt & special situations, Structured credit, Asset-based lending, Venture debt; Sample size: 37.

Additionally, we see similar results from the ANREV (Asian Association for Investors in Non-listed Real Estate Vehicles) 2024 survey on investment intentions, where 88% of investors who currently utilize debt exposure in their real estate portfolio state that they plan on increasing their allocations over the next two years.[2]

We discuss how opportunities in real estate and infrastructure debt are being propelled by similar factors that drove the exponential growth of direct lending post-GFC, and how allocating to these investments at this current juncture can help investors maintain a high level of income at a low to moderate level of risk, increase diversification, and capitalize on long-term structural tailwinds.

Opportunities for private capital in real estate debt

Private investment is becoming a vital source of capital for real estate financing, offering an attractive alternative to traditional banks. In the US, real estate has historically been heavily financed by regional banks. As regulatory tightening and overall consolidation of the banking sector continues, the volume of loans being supplied by this channel as a percentage of overall lending has been declining. Exogenous shocks such as Covid-19 have also created large structural shifts in traditional real estate sectors such as retail, hospitality, and office. This has impacted the risk appetite of traditional banks and led to a sharp decline in the issuance of commercial mortgage-backed securities (CMBS), falling from almost $100 billion in 2019 to $40 billion in 2023.[3] Currently, regional banks supply almost a fifth of US real estate credit (Figure 2). With this ecosystem being subject to greater constraints, new sources of capital will be needed to finance emerging projects in growth areas.

2. ANREV Investment Intentions Survey 2024, January 2024.
3. S&P Global

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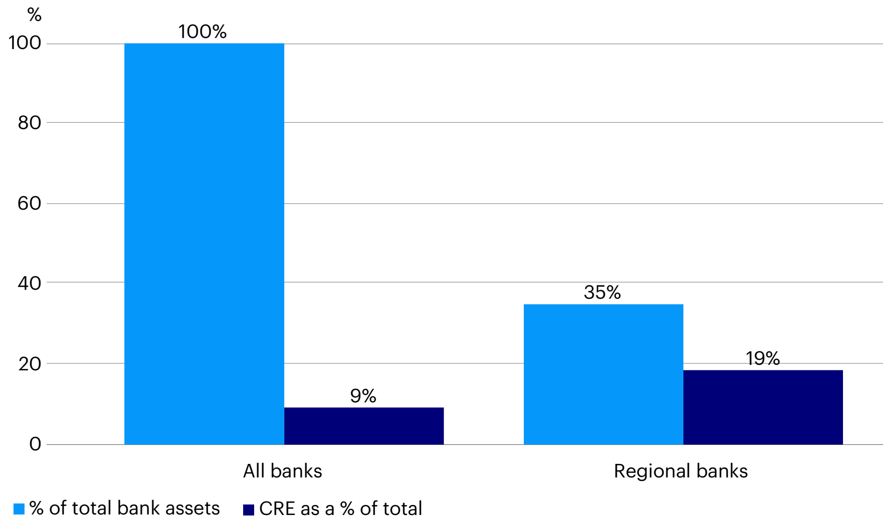
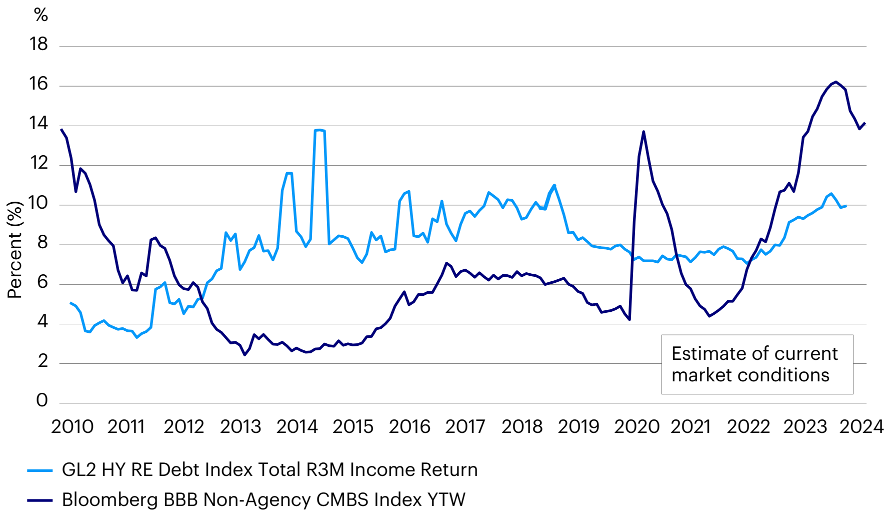
Figure 2 – Regional banks as a percentage of commercial real estate(CRE) loans



Source: Invesco, Gilberto-Levy, FDIC, 30 June 2024.
Note: CRE - Commercial Real Estate.

The decline in CMBS issuance has also caused yields to rise to the mid-teens, as the weak quality of assets resulted in increased risk premiums (Figure 3). In the current market conditions, other real estate debt maintains healthy yields of around 10%, without the risk posed by CMBS exposure (which is heavily supported by office and retail properties).

Figure 3 - Real estate credit yields compared to proxy CMBS yield to worst



Source: Bloomberg LP, 30 June 2024

Overall, we still believe the opportunity set in real estate is very robust. Demand is growing for different real estate sectors such as industrial properties and data center assets, as e-commerce, digitalization, and artificial intelligence continue to drive the global economy.

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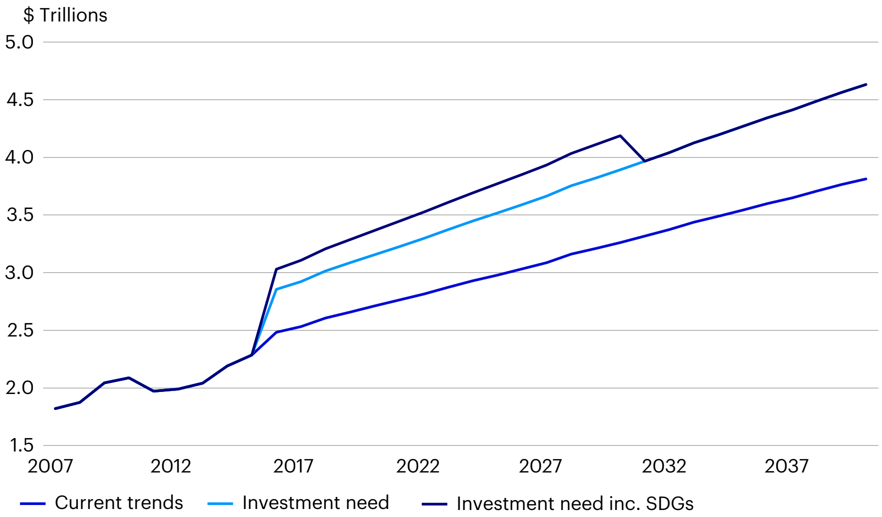
Financing real estate growth sectors: Industrial and data center assets
Private real estate debt strategies are increasingly financing non-traditional sectors such as industrial real estate and data centers. These sectors offer investors exposure to growing real estate assets with stable income-generating properties and low volatility.

Industrial real estate, such as warehouses and logistics centers, has benefited from the growing demand for efficient supply chains. The Covid-19 pandemic and additional demographic factors have further accelerated the shift to online shopping, which has led to a surge in the need for storage and distribution facilities. According to CBRE Group, the global industrial real estate sector had a record-low vacancy rate of just 3.1% in 2023.

Data centers, on the other hand, sit at the heart of the digital economy, supporting cloud computing, big data, and AI applications. As AI technology becomes more widespread, demand for data processing, storage, and transmission infrastructure is growing exponentially. Investments in data centers are critical for enabling AI advancements, as AI algorithms require immense computing power and real-time data access. In the US alone, the data center market is projected to grow from $59.83 billion in 2021 to $143.1 billion by 2030, according to Allied Market Research.

Infrastructure debt as a mechanism to capture global tailwinds
Another key structural trend which is augmenting the opportunity for private credit is need for global infrastructure buildout, which is forecasted to reach $4 trillion by 2023. This is supported by growth in emerging economies, global efforts to decarbonize energy production and distribution, and replacement of aged infrastructure assets in developed economies. Infrastructure investments, such as transportation networks, energy production, and telecommunications, are crucial to the functioning of modern economies.

Figure 4 – Investment need in infrastructure



Source: Global Infrastructure Hub, 31 December 2023.
Note: SDGs – Sustainable Development Goals.

The key benefits of infrastructure debt include stable, long-term cash flows, often tied to inflation, high barriers to entry, and support from public institutions.

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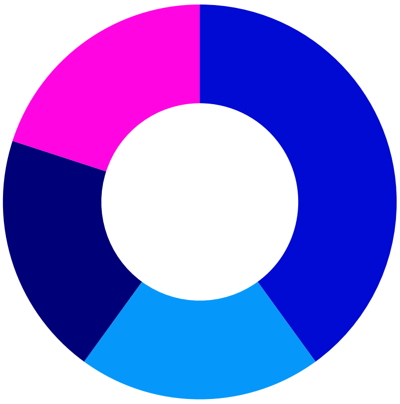
Increasing stability for infrastructure debt opportunities: Wind farms and solar projects
One key subsector of infrastructure debt, high yield exposure, has the ability for projects to de-risk over time as they near completion and contracting, which can allow for meaningful spread compression. We prefer high yield infrastructure exposure in our portfolios, as this allows us to achieve high spreads and double-digit yields with reasonable upside potential.

Renewable energy projects for example, particularly wind farms and solar installations, often start with high-yield debt due to the risks associated with construction, technology, and regulatory approvals. However, once these projects are operational and have proven their ability to generate electricity under long-term Power Purchase Agreements (PPAs), the debt associated with these projects can be upgraded to investment grade. These PPAs lock in electricity prices for 20 to 25 years, providing predictable cash flows and reducing revenue risk.

Putting it all together: Building a diversified private markets income portfolio
A key inquiry we receive from investors is not only which private credit asset classes to deploy into, but how to think about weighting the various exposures. We spend a considerable amount of time thinking through asset allocation within private markets, aiming to triangulate returns, risk, and diversification. The chart below shows one example of how we currently construct private credit portfolios, with real estate and infrastructure debt serving as key building blocks. I will note direct lending is still the anchor position at roughly 40%, but this is lower than most private credit allocations we analyze in client portfolios. In aggregate, the combined exposure from real estate and infrastructure debt balances the direct lending allocation.

Figure 5 - Sample private credit portfolio



	%
Senior direct lending	40
Real estate debt	20
Infrastructure debt	20
Alternatives credit	20

Source: Invesco Solutions

Conclusion: Expanding the private credit opportunity set
Private credit continues to expand rapidly, with Preqin forecasting that the global private debt market will reach $2.7 trillion by 2026. As bank lending remains constrained and demand for alternative financing sources grows, real estate and infrastructure debt are likely to play an increasingly important role in private credit portfolios, complementing current exposures to direct lending. The global transition to sustainable energy, digital transformation, and AI adoption are all trends that require significant capital investment. Real estate and infrastructure debt provide investors with an opportunity to finance the physical and digital infrastructure necessary for these global trends, whilst also offering attractive returns, portfolio stability, and inflation-protected income. As the private credit landscape continues to grow, infrastructure and real estate debt will remain essential components in the construction of diversified, resilient private market portfolios.

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202412-4063769-GLR