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As the old saying goes, every activity has its own time and season. From an investment perspective, today is a time and season when credit offers attractive relative return potential. Interest rate escalation has raised yields on a broad range of credit investments, including real estate credit. And investment opportunities within real estate credit are anticipated to expand because of evolving regulatory guardrails for banks who have traditionally been the largest providers of credit to commercial real estate around the globe.

This note focuses on three reasons for investing in real estate credit today (Figure 1):

## Figure 1: Three reasons for investing today in real estate credit

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### Higher interest rates

1

Central bank policy rates today are multiples higher than their pre-COVID averages. Policy rates are expected to remain meaningfully above pre-COVID levels over the longer run, thereby supporting yields.

### Reduced basis

2

Real estate equity prices are in the process of resetting, providing an reduced basis relative to pricing of 12-18 months ago.

### Tighter bank regulation

3

Proposed intensification of bank capital requirements could result in diminished bank lending activity, leaving a gap for non-bank lenders to fill.

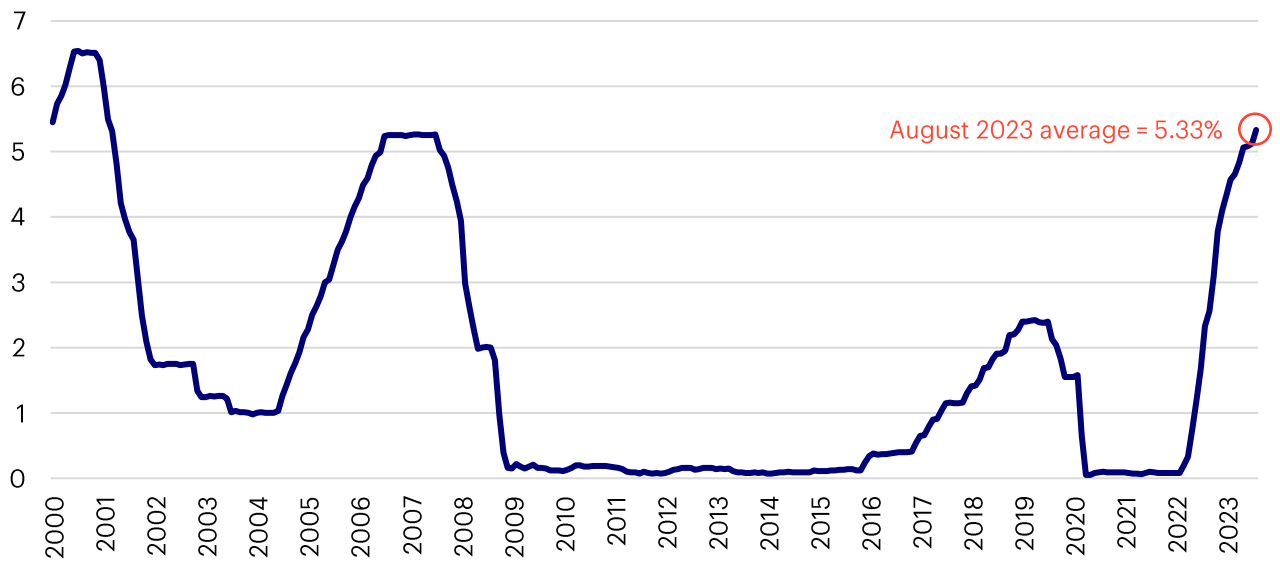
Source: Invesco Real Estate as of September 2023. Past performance is not a guarantee of future results.

**Higher interest rates.** The Federal Reserve's 525-basis-point increase of the Fed Funds rate since March 2022 represents one of the most aggressive periods of rate escalation in US history. Additionally, the Fed's moves are matched by similar increases in other key global markets, for example in the Eurozone (450 basis points), UK (515 basis points), Australia (400 basis points) and South Korea (300 basis points). This escalation follows several years of record-low central bank policy rates following the 2008-09 Global Financial Crisis (GFC) and the more recent 2020-21 COVID-crisis period (see Fed data as an example on Figure 2). Near-zero policy rates were adopted in these periods in response to severe threats to global economies, and those policies were part of broader initiatives by central banks to provide liquidity and calm anxieties. These policies have largely accomplished their intended effect.

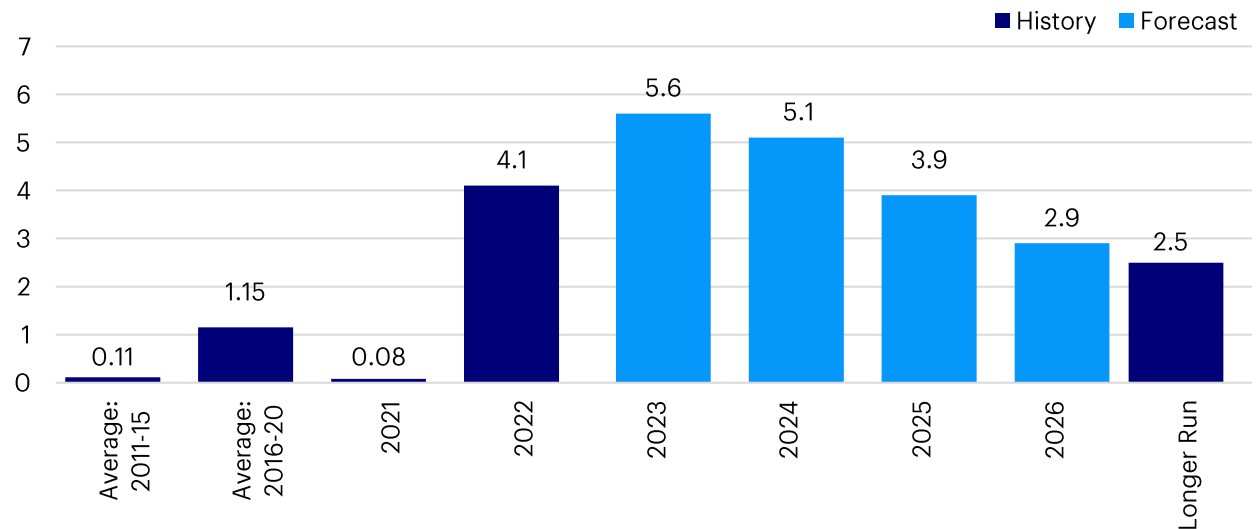
Going forward, while policy rates are likely to moderate from currently elevated levels over the next few years, guidance from central banks makes clear that the likelihood of policy rates returning to near-zero levels is extremely low (see Fed data, as an example, on Figure 2). This means that policy rates going forward are highly likely to remain meaningfully above where levels were prior to the commencement of global rate escalation in early 2022, thus supporting higher real estate debt yields going forward.

**Figure 2: Fed Funds rate, historical and FOMC median forecast**

**Fed Funds rate (2000-August 2023) (%)**



**Fed Funds rate (Recent history and FOMC median forecast) (%)**



Sources: Invesco Real Estate, utilizing historical data from Moody's Analytics as of September 2023 and the Federal Open Market Committee (FOMC) median forecast as of September 20, 2023 (most current available). Single-year estimates and forecasts are for the end of calendar years. Past performance is not a guarantee of future results. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions, there can be no assurance that actual results will not differ materially from expectations.

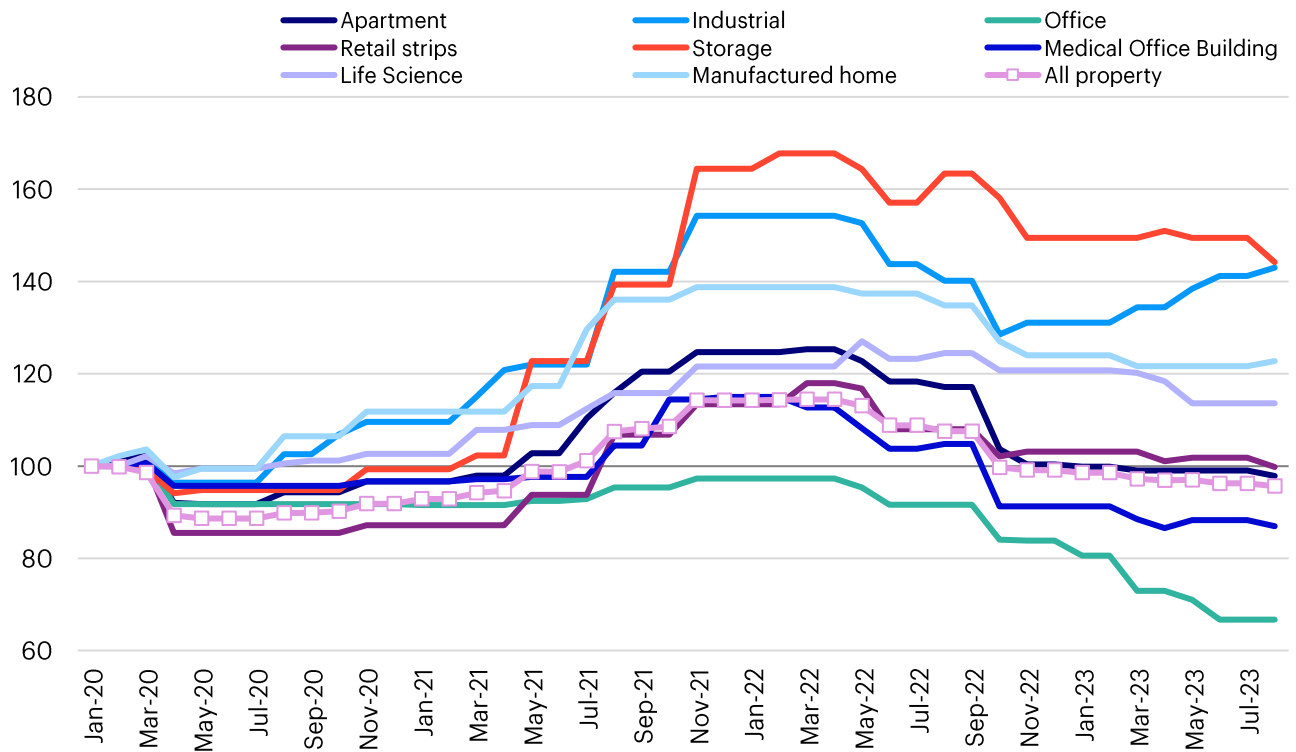
**Reduced basis.** As a result of elevated interest rates and expectations of slowing global economic growth, real estate asset values have fallen in almost all key global markets since early 2022. As an example, in the US, Green Street data show that commercial real estate prices held in private markets peaked in March of last year and have since fallen on average by 16%, with variation by property type. A similar magnitude of correction has been seen across European markets, with slightly less change in the Asia Pacific region. For those investing in real estate debt today, this means that new vintage loans will be sized against collateral values that are lower than peak values of early 2022, which results in less risk within the capital stack.

Property prices may decline further in the short term if interest rates remain elevated and short-term economic conditions soften before eventually recovering. This possibility highlights the importance of the quality of a loan's underlying collateral, tenant credit, and sponsorship strength, as well avoiding vulnerable sector exposures (e.g., office) and developing an appropriate view of current market value in the underwriting process. It also highlights the attractiveness of the credit slice of the real estate capital stack. New loan amounts at 50% to 65%<sup>1</sup> of reset values provide a sizable cushion for potential short-term price declines.

<sup>1</sup>A loan-to-value ratio range of 50% to 65%, is common knowledge within the real estate credit industry with respect to the typical loan-to-value ratio of senior loan positions.

**Figure 3: US commercial property prices, indexed, pre-COVID to present**

**Green Street Commercial Property Price Index: Jan 2020 = 100 (%)**



Source: Invesco Real Estate using data from Green Street as of September 2023.

**Cumulative price gain/loss**

	Since Jan-20	Since Mar-22 (Peak)
Storage	49%	-14%
Industrial	41%	-7%
Manufactured homes	22%	-12%
Life science	14%	-7%
Retail strips	2%	-15%
Apartment	-1%	-22%
Medical Office Building (MOB)	-12%	-23%
Office	-31%	-31%
Single Family Rental (SFR)		+5%
Data centers		-12%
<b>All property</b>	<b>-3%</b>	<b>-16%</b>

Green Street's Commercial Property Price Index (CPPI) data for Single family residential (SFR) and data centers starts after Jan 2020; data as of September 15, 2023. **Past performance does not guarantee future results.**

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**Tighter bank regulation.** Since the GFC, successive iterations of the Basel guidelines have increasingly strengthened the lending practices for all internationally active banks, which has removed some of the more aggressive real estate financing activity seen prior to the GFC. Furthermore, in response to bank failures that occurred earlier this year, Federal bank regulatory agencies issued a proposal in July that would require large US banks with total assets of \$100 billion or more to:

- Maintain a layer of long-term debt amounting to a 16% aggregate increase in common equity tier 1 capital to increase institution resiliency and resolvability of potential future bank failures;
- Standardize aspects of the capital framework related to credit risk, market risk, operational risk, and financial derivative risk, reducing subjectivity related to assessing such risks; and
- Require banks to include unrealized gains and losses from certain securities in their capital ratios.<sup>1</sup> The exclusion of unrealized gains represented a key aspect of hidden risk among bank failures occurring earlier this year.

If the contents of this proposal are ultimately adopted, the enhancements to bank resiliency will likely come at a cost to banks that could result in dampened lending activity. Given that bank lending accounts for roughly half of US real estate loan volume outstanding<sup>2</sup>, and a higher proportion in the AsiaPac and EMEA regions, a pullback by banks would open opportunities for non-bank lenders to fill the gap.

**Summary.** Taken together, the potential for higher yields at an reduced basis are attracting attention to private real estate credit investing. And access to opportunities could expand as the escalation of currently proposed bank regulations could dampen bank lending activity in commercial real estate, leaving a gap for alternative lenders to fill.

<sup>1</sup> See Federal Reserve Board - Agencies request comment on proposed rules to strengthen capital requirements for large banks, July 23, 2023.

<sup>2</sup> Source: Federal Reserve Flow of Funds as of June 2023.

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## Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested. Property and land can be difficult to sell, so investors may not be able to sell such investments when they want to. The value of property is generally a matter of an independent valuer's opinion and may not be realised.

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Generally, real estate assets are illiquid in nature. Although certain kinds of investments are expected to generate current income, the return of capital and the realization of gains, if any, from an investment will often occur upon the partial or complete disposition of such investment.

Investing in real estate typically involves a moderate to high degree of risk. The possibility of partial or total loss of capital will exist.

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