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Property Whitepaper: Debt trumps equity in a world of higher rates

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Property Whitepaper: Debt trumps equity in a world of higher rates

The era of cheap money is over. That matters when choosing between debt and equity in real estate. Unless a fund has a strong strategy for growing the value of its owned buildings, then in today's market debt might be the more prudent choice for institutional investors.

The 2025 cio investment club roundtable on property kicked off with asset owners airing some of their biggest concerns. Pension Insurance Corporation's Head of the Built Environment, Tanmay Desai, said its key risks as an insurer with property asset liabilities out as far as 60 years were climate change and impacts such as overheating and flooding of the asset. Shorter term, he saw stress in the UK construction industry among developers and sub-contractors.

Phoenix is another long-term insurer active in the pension buy-out market. Simon Blowes, head of real estate debt at Phoenix, said its biggest challenge for funding DB deals is duration – finding suitable lending opportunities with organisations who are comfortable borrowing for longer.

At the shorter end, in the lending market for living and logistics, Blowes' challenge was competing for deals against banks.

The Metropolitan Police Friendly Society (MPFS) is a with-profits offering voluntary savings funds to police staff and their families across the UK. The property challenge for MPFS is whether to stick with its current four UK commercial real estate funds. Returns have been varied in recent times for a number of reasons: the shock of COVID; changing habits in office work and shopping; the withdrawal of DB pension capital as it translates to buy-out with the likes of PIC and Phoenix; have all played a part. Paul Grimshare, CFO for MPFS, noted that its effective costs for exiting a property fund could be in the order of 6-7%.

Paul Amer, CIO of MS Amlin, a global reinsurer with numerous affiliates said that after 2022, his team had been waiting for liquidity to return to the property market. "It hasn't fully returned yet although things are improving and we are looking to increase exposures where possible," he said. "Our reinsurance clients have very diverse responses to this. Having expected returns of 0% on property for the last two years, some have asked: Why am I holding this? One is contemplating transferring out of an existing fund of funds to a pooled property fund with a three-year lock-in and higher fees in order to achieve slightly better liquidity."

Chris Palmer, senior adviser to AlphaReal, divided the needs of asset owners at the cio investment club based on the duration of their liabilities. For pension insurers looking for securing long-term income streams, he noted the appeal of lending against contracted rental income from a strong, credit-worthy tenant rather than lending to the property per se. "Just as infrastructure is a concession from a government-related entity or involves a licence or concession from a licencing quango, so you can make long-term, inflation-linked deals with the likes of housing associations where the credit risk is with the organisation, but where that organisation's revenues are backed by a government licence or against social housing rentals from a local authority. In agreements such as Credit Tenant Leases, in effect you don't care about the property."

For the likes of friendly societies and reinsurers, on the other hand, Palmer saw value in much shorter-dated real estate debt, whose credit rating was at the lower levels of or just below IG. He sketched out a typical loan: 3-5 years in term with 2-2.5 years non-call; up to 60% Loan-to-Value, earning 500bps over base rates with fees upfront. "You get attractive credit spreads as a reward for taking on the crossover credit quality. If you are in Value-Add transactions, then development or refurbishment cashflows are all over the place," said Palmer. "These deals are not suitable for Solvency II driven liability-matching but are good for those like MPFS and MS Amlin without Matching Adjustments to worry about."

MPFS, however, is currently in conservative ('Core') real estate equity rather than debt. So Clark Coffee, head of European CRE debt at asset manager AllianceBernstein, made the strategic case for debt over equity; and answered Amer's question as to why capital has not returned to the property market. "When rates were rock bottom, leveraging real estate produced attractive income and capital appreciation was a bonus," said Coffee. "You could succeed by financial engineering. That chapter is closed for now."

Just because equity is now far more dependent on capital appreciation does not however mean lending is an easy alternative. Coffee saw real work for lenders to do assessing what the long-term potential of any building was; and whether the borrower has a credible business plan to enhance value. "It's so much more important in today's world where capital rates are not moving in line with interest rates. Borrowing is no longer accretive making a borrower's property-level capabilities much more important."

There is a longer trend to note in addition. AllianceBernstein research finds that c.75% of returns from core property over the past 20 years came from active distributions rather than capital appreciation. This will not be the case in a higher rate environment. Cash flow is being diverted from equity to debt. "In today's environment we can earn like owners but sleep like lenders," said Coffee.

Palmer agreed: "This year and next, I think I want to be a lender, not an owner. It's too early to be a buyer just yet."

"European real estate values are down on average c 25%," said Coffee. "There are few new buildings happening. Regulation and planning costs are considerable. That should translate to meaningful rental growth in the future because there is limited new supply. For institutional investors, debt is a lot safer [than equity] in terms of getting it right."

"As a non-bank lender, our thesis is where a borrower has headaches, we bring the paracetamol," said Coffee. "We earn a premium for helping to cure the headache, which sometimes can be as simple as providing the borrower more flexibility than banks are willing offer."

Grimshare asked whether AllianceBernstein sees real estate differently across European countries.

Coffee replied that you can earn a premium in Europe - if you have the access. "Let's say there are seven or eight markets in Europe we focus on, each with unique features. For lenders, there are different enforcement rights in those different jurisdictions. For equity investors, there are different commercial and lease structures. All in all, there are more attractive returns available in Europe as it's a less efficient market compared to the US."

Coffee explained that in the US, you also don't get the same covenant structures as in Europe. "If there is a hiccough with asset performance in Europe, the lender typically has strong covenants to protect its capital."

LTV covenants are another form of protection. If the market moves, then a property gets revalued. If the denominator has changed sufficiently, then the borrower either has to pay down the loan or face the risk of default. This is a very effective protection for lenders.

CRE lenders in the US do not have LTV covenants to fall back on. Coffee noted that in the US, it is borrowers who have greater optionality to the extent a loan underperforms.

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Battling the Banks

Blowes said: "I spend the majority of my time sourcing CRE debt; our approach is sector-agnostic in that we believe any sector can offer opportunities if you are willing to do the work on the underlying assets. Where we have struggled recently is competing with banks at the short end of the duration curve, especially in the Build-to-Rent and logistics sectors.

These are deemed to be defensive plays that are relatively easy to underwrite, so there is a lot of capital chasing a limited amount of debt transactions in the market. We would add exposure to these sectors. However, margins are squeezed to the point where the return profile looks challenging." In consequence, Phoenix avoids where the banks are playing and instead offers more bespoke, long-term funding solutions.

Coffee said there was no point competing against the banks. "There's a risk of adverse selection; lending for the wrong reasons to capture yield." Instead, the CRE debt team at AllianceBernstein maps out market segments where banks are not as active, and extracts additional yield by lending into these areas.

Desai then outlined the PIC approach, which includes long-term asset ownership. "The way we have done it is to really understand the structure, project constraints and product design," he said. "We ask developers to fill in a 50-point questionnaire which captures the key metrics and principles of the building and deal. We review those answers and these highlight very quickly for both parties where an issue needs further consideration before the deal progresses. This reduces the likelihood of abortive costs and time spent for both parties.

"For one high-rise 40-storey tower, we realised there was a sizeable gap between floor and slab height. We wanted to know why the developer was spending on all that concrete if the extra height was not providing a benefit and lost to tenants."

> *The way we have done it is to really understand the structure, project constraints and product design…*

Another example was a huge hotel portfolio which was stabilized and in great locations. There was no flood risk and opportunities for some properties to be repurposed. But 28 of the 40 hotels had combustible cladding. Desai pointed out that currently hotels are exempt from the UK's Building Safety Act of 2022 [introduced following the fire at Grenfell Tower]. "But PIC takes the view that despite not being in breach of regulation, cladding is still a material building-safety risk and one that we are not comfortable with as a long-term asset holder."

Palmer said "Technicals matter. It's a good property because PIC get it built."

"You have to have good knowledge sources," continued Desai. "We avoid overheating in buildings by situating meshed ventilation next to windows to regulate natural airflow. We make housing that is energy efficient to reduce energy price impacts to our residents. This is derisking."

With regard to Energy Performance Certificates (EPCs), Palmer said that unless an office building now is an 'A', it is not rentable. "The situation is binary: the lower graded buildings no one will want to rent."

Blowes noted, however, that you can't push every asset up to an EPC 'A' rating. "Costs of retrofitting are continuing to rise. In some cases, particularly in secondary offices, the potential upside doesn't warrant the capex outlay, so conversion to alternate uses has to be considered or else the asset becomes stranded," he said.

Grimshare asked where the money is coming from to fund these upgrades; was it ever uneconomical? Palmer replied that for some buildings it was existential: "The price plummets from £10m to £2m. It's a known unknown."

At the other end of the range, Coffee observed that grade-A-rated offices are now 75% leased prior to practical completion in central London. "That kind of take-up used to happen six to twelve months post completion."


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What Forms the Letters

Desai pointed out that EPC ratings are just a single letter whereas the underlying metrics which inform that letter are numerous. "These Standard Assessment Procedure (SAP) points deserve to be understood," he said. Otherwise, the risk is that contractors will adopt a tick-box approach rather than focusing on the metrics that can have the biggest impact in achieving the desired rating. "The devil is in the detail," said Desai.

"Real Estate is becoming more operational in nature," observed Coffee.

He noted that the likes of WeWork had made office leases across the board more flexible. Coffee said that when spaces were only occupied by micro-businesses, that didn't bother institutional investors. But now bigger enterprises are actively using serviced offices, and even standard office leases are trending toward greater flexibility in favour of the tenant. "You now have to underwrite much higher costs to manage office assets than previously. Tenants are becoming more demanding, and landlords are having to be more flexible and more hands-on" said Blowes. "It's no longer a case of lease and forget."

"And that is why gilts and public-market bonds are becoming more attractive," concluded Desai.

The cio investment club property roundtable moved on to the set-up of individual asset owners. Amer explained that one-third of surplus assets for MS Amlin are in medium and long-term holdings; and the bulk of illiquids are in real estate. MS Amlin uses one fund of property funds, which may access 25 different managers. The number of underlying properties can be anywhere from 50 to 1,000. Liquidity can thus vary from three months to seven years. "We ourselves are asset allocators," said Amer.

Current targets include convenience orientated retail and a tilt towards logistics. Datacentres since 2018 have been an absolutely star performer but the focus there is changing from owning buildings to electrifying them. MS Amlin continues to sell office assets.

Amer continued: "The fund of funds has very strong convictions in the subsets. Timing is not always spot on but these are three to five-year convictions with the aim of selling towards the top of the cycle."

Historically, MS Amlin's strategic allocation to real assets was 8%. That was reduced in 2022 but is now likely to increase perhaps as high as 10%.

Amer did note that there was regional variance in terms of opportunities and optimism. He put Europe more attractive than US "because Europe is repricing faster."

For MPFS, Grimshare said that three of the four UK property funds it uses are Core equity. One has a big focus on prime London office. Another emphasizes the merits of out-of-town retail developments. One challenge for Grimshare is that "it can be hard explaining underperformance succinctly when strategies are so varied, and if the broader market has not suffered as much in a downturn."

Moreover, some MPFS products such as its ISAs allow rapid withdrawals. The four property funds, on the other hand, are quite illiquid, creating a partial mismatch. In the overall scheme, that should not matter as the strategic asset allocation to property is only up to 10%. But given the mixed returns from the funds, Grimshare is pondering changes. In doing so, he remains pragmatic that MPFS would never be a big player and probably have to take similar terms in any other property fund vehicle.

"This is a fundamentally illiquid asset class," noted Coffee. He pointed to the US, where innovative semi-liquid vehicles have been established but subsequently put brakes on redemptions.

Addressing Homelessness Over Forty Years

For the pension insurers seeking multi-decade income streams, quarterly withdrawals are not a problem. Blowes gave an example of a satisfying illiquid deal Phoenix had struck with a UK local authority. The asset manager lent £234m to Westminster City Council in the heart of London to buy suitable accommodation for those who are homeless.

"We have a housing crisis in the UK," remarked Blowes. "One in 50 Londoners is homeless. Across the UK, local authorities are spending £4m a day on temporary accommodation. That figure is a 70% increase year-on-year. These numbers are well beyond local authorities' budgets."

When under financial pressure, local authorities have a tendency to seek support from central government. Blowes said that they do not naturally turn to private finance. "Phoenix is trying to create solutions to this problem. In this case, Westminster were able to use our funding to acquire houses and flats to be repurposed for temporary accommodation, reducing the strain on the Council's balance sheet."

Westminster is AA-rated; the term of the deal is 40 years and will be fully amortized. After four decades the Council will own a greater stock of housing outright. Servicing the debt costs the council less than paying their annual bill for temporary accommodation. "It's a win-win situation for the council," said Blowes. With deals of this nature, Phoenix is structuring these deals as 'hell or high

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> *These assets will take longer to originate and the competency of counterparties we work with will have to go up to get through these new rules.*

water' leases or with debt guarantees, which in effect means that the insurer is primarily focused on the creditworthiness of the borrower rather than the underlying assets. "Full mortgage security over the properties is an added bonus; our initial recourse is with the council," said Blowes.

The Bulk Pension Annuity market is hot right now – an estimated £40bn will transfer from pension funds to insurers such as Phoenix and Pensions Insurance Corporation this year. Blowes noted that as the market has become more competitive, insurers are more focused than ever on seeking the best possible risk-adjusted returns and maximising portfolio efficiencies in order to make bids for the pension deals more competitive.

"We are innovating new funding solutions in order to fulfil our durations needs; offering bespoke funding solutions that fits our borrowers' requirements whilst tackling environmental and social challenges," he said.

Desai returned to the Building Safety Act (BSA). "We know anything over 18m high is going to have to go through the gateways regime regulations," he said. "These assets will take longer to originate and the competency of counterparties we work with will have to go up to get through these new rules."

And so, PIC is cautious on high-rises. Desai is adamant that the UK needs more of them, especially in city centres with great transport and infrastructure connections. But while the BSA beds in, there are alternatives. "When buildings are lower than 18 metres, investors want to deploy capital quickly," he said.

Habiko, a long-term partnership between PIC, Muse and Homes England was launched earlier this year. The objective is simple: to deliver 3,000 low-carbon, low-energy affordable homes for rent. PIC's registered provider will then manage the assets created going forward. "This demonstrates we are there for the very long duration and provide long-term stewardship," said Desai.

Palmer observed that while these are equity investments, PIC has a variety of means subsequently to achieve steady income streams, including strips and leasebacks.

Although Desai reiterated that challenges for the construction industry remain – insolvencies are up 40% since COVID and ongoing geopolitics continue to put strain on supply chains – at least pension insurers are clear on what kind of properties they want to build. "We know what good looks like," concluded Desai.

Participants

Paul Grimshare

Chief Investment Officer, Metropolitan Police Friendly Society

Paul is a qualified Chartered Accountant (ICAEW) with significant experience across the insurance sector and as a non-executive director in the UK and overseas.

He has been the Chief Financial Officer and a director of the Metropolitan Police Friendly Society Limited since 2022. The Society is a mutual that has been supporting and providing savings, investment and protection products to serving and former members of the UK police services and their families for over 130 years. Paul is responsible for the Society's investments and oversight of its external investment managers. He recently led a review of the Society's investment strategy and investment managers that resulted in the appointment of Schroders Investment Management as its principal manager. Paul is also responsible for Society's financial operations, financial and regulatory reporting, and capital management.

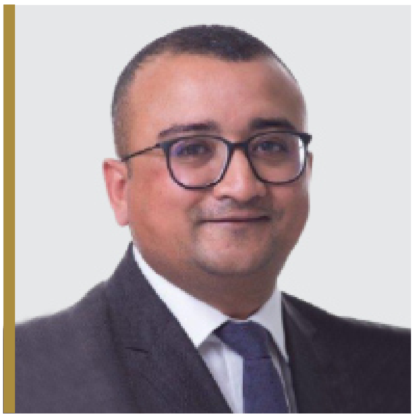
Paul Amer

Chief Investment Officer, MS Amlin

Paul has been MS Amlin's Chief Investment Officer since 2019 having joined the firm in 2015. As CIO, he is responsible for the development and implementation of the firm's strategic asset allocation and external manager monitoring.

Prior to joining MS Amlin, Paul fulfilled numerous senior portfolio management roles at Insight Investment and Barings Asset Management with a focus on multi-asset investing. He started his career at State Street Global Advisors.

He holds a degree in Economics and Statistics from Birmingham University and is a CFA Charterholder.



Tanmay Desai

Head of Built Environment, Pension Insurance Corporation

Tanmay Desai is the Head of Built Environment at Pension Insurance Corporation, where he leads a multidisciplinary team overseeing technical due diligence and construction monitoring across a £2.5 billion development portfolio.

With over two decades of experience spanning consultancy, client-side, development, and funding roles, Tanmay brings a 360-degree perspective to risk management in real estate investments. His expertise spans a wide range of asset classes including affordable housing, senior living, build-to-rent, PBSA and commercial ground rents. He is known for his strategic leadership, ability to challenge norms, and commitment to sustainable, high-quality development practices.

PIC

Chris Palmer

Consultant, Independent Consultant

Chris is a senior advisor to Alpha Real Capital, the secure income asset manager and also a consultant to a number of UK infrastructure and social housing investors.

He was previously Head of Illiquid Assets Origination at Phoenix Group plc, before that Head of Market Risk, Credit at Swiss Reinsurance and a credit portfolio manager at Legal & General, Old Mutual Asset Managers and Allied Irish Banks.

Chris is a graduate of the University of Cambridge and a fellow of the London Institute of Banking & Finance. He is Chair of Sporting Wellness, a charity that supports young sportsmen and sportswomen across the UK.

Simon Blowes

Senior Investment Manager, Phoenix Group

Simon is a Senior Investment Manager at The Phoenix Group where he leads on real estate debt origination and portfolio management.

Simon has 15 years' market experience covering lending, transaction structuring, investment strategy, risk management and workouts.

He has previously held roles at ReAssure, Swiss Re & Jefferies.

Clark Coffee

CIO and Head-European Commercial Real Estate Debt, AllianceBernstein

Clark Coffee is the Chief Investment Officer and Head of European Commercial Real Estate Debt.

His previous business, Lacarne Capital, was acquired by AB in 2020 to establish the firm's real estate debt business in Europe.

Previously, Coffee was head of Tyndaris Real Estate, where he was responsible for building the business into a top-10 real estate debt fund in Europe. Prior to that, he co-headed origination for Deutsche Bank's European commercial real estate credit business and oversaw the risk management and restructuring of more than €2 billion of troubled loans during the global financial crisis.

Coffee holds a BA in economics from Lake Forest College and an MBA from the University of Michigan. Location: London/Frankfurt

In attendance

Brendan Maton (Moderator)

Director, Crayford Ash

Brendan Maton has been covering pensions and investments as a journalist for almost thirty years. He began his career at FT Business before going independent in 2003. Since then, he has chaired roundtables, moderated investor conferences and hosted the IPE channel of sponsored webcasts. He still writes on pensions and investments for IPE as well as freelancing for a host of organisations.

Ian Coulman

Ian is an experienced investment professional with international experience and strong leadership and management skills. He has a strong investment knowledge of major asset classes and a wide variety of investment products and styles in fixed income, equities and alternative asset classes. His most recent role was Pool Re's Chief Investment Officer, where he was responsible for the development and implementation of investment strategy, strategic asset allocation and the monitoring of the investment managers through whom Pool Re invested. Since leaving Pool Re Ian is now exploring opportunities where he can use his experience and knowledge.

Prior to joining Pool Re as CIO, Ian fulfilled several senior investment roles with Butterfield Bank in Bermuda and AIG in London, Boston and Tokyo. Ian began his investment career with the private Swiss bank Lombard Odier.

Bob Sharma

MD, Head of Insurance EMEA & APAC

Bob Sharma is a Senior Vice President, Managing Director, and Head of EMEA and APAC Insurance for AB, where he is responsible for leading the insurance initiative across Europe, the Middle East and Africa (EMEA) and Asia-Pacific (APAC). In this role Sharma advises insurance clients on portfolio strategy, strategic asset-allocation topics, developments in the investment market and insurance industry dynamics.

He joined AB in 2024 and has been working in the investment industry since 1999. Previously, Sharma held the role of managing director and head of EMEA Insurance at Wellington Management, where he led the insurance business for many years. Sharma holds a BSC (Hons) in economics from the University of Manchester.

He is a CFA charterholder and holds the Sustainability and Climate Risk (SCR) Certificate from the Global Association of Risk Professionals.

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Chloe Irapah

Administrator, cio investment club

Chloe joined the cio investment club in June 2025 to assist with the coordination of marketing, events, and administration of the club.

Chloe is a Marketing and Management professional with over six years of industry experience, starting in luxury fashion and progressing into roles focused on partnerships and project management.

She holds a First Class Honours Bachelor's degree in Marketing and Management and is known for aligning brand vision with innovative marketing strategies and impactful partnerships.

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