OAK INVESTMENT MANAGEMENT GROUP

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Real Estate and Debt are inseparable. Because real estate is so expensive in absolute and relative terms there are very few investors that can grow to scale without the help of judiciously chosen and deployed debt packages. This presents opportunities as well as challenges to a real estate investor that must understand the nature of real estate financing.

Senior debt can be an excellent way to accrue benefit to the owner of equity if, first, the cost of debt is containable within the operational performance of the underlying asset and, secondly, there is a realistic upside for which equity is working actively. Both of these factors have downside risks. In the former it might well be that the cost of financing goes up or its availability evaporates altogether. In the latter the best case scenario might not materialise, or worse the un-thought of downside scenario might occur. In either extreme case equity is lost and debt recuperates what it can from any residual value of the underlying asset.

In non-extreme scenarios senior debt generally does well from real estate. First, senior debt gets paid a regular coupon on rental income, which is by itself a regular event. Secondly, investment in real estate debt as well as equity tends to be lower risk than investment in the debt or the equity of corporates as cash flow is less volatile. Finally, real estate debt touches every sector of the economy so is a diversified, universal cost on the economy – an ideal banking target sector. Of course there are extremes, both in terms of value generation (such as planning gain for example), or, value destruction (such as investment grade income that disappears and leaves no residual value), but these are relatively less prevalent than with corporates.

As a result it could be argued that real estate is in itself a junior form of banking. Measuring riskiness of cashflows against obligations; judging the quality and durability of creditors and debitors; squaring off tenors of assets and liabilities; ensuring adequate funding lines; assessing internal and external risks are all fundamental to banking as well as real estate operations. Therefore, issues that affect banking also affect real estate. The current scarcity of excess capital is weighing heavily on both sectors, just as much as (retrospectively judged) the abundance of capital before 2007 overwhelmed both sectors.

Yet help comes from an unlikely corner: Taxation policy. Usually, debt is given a subsidy by the tax payer in the form of tax deductibility of interest payments (as opposed to dividends). Attempts to correct this balance in real estate through real estate investment trusts (REITs) have not completely levelled the playing field. This means two things; first, discounting the risk of default debt will always trump equity in terms of capital efficiency for the provider and the user (at the expense of the tax authorities). Secondly, the higher the rate of tax the more valuable will be this 'tax shield' will be especially for durable income producing assets. With tax rates going up around Europe one can expect increased marginal investment in real estate, even if the wider economy performs worse. This may not be driven by fundamentals but it is a system-wide stabiliser that may help two important sectors back to functioning normally again.

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