Martin Barnewell

Episode 207: UK Commercial Real Estate – Lending into the Recovery

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. Hi, I'm Stewart Foley. I'll be your host. Welcome back. It's nice to have you, and thanks for joining us. I got a little bit of an unusual opening this morning. I just came back from Minneapolis where I had dinner with avid podcast listener, Tim Hunter at Allianz, senior portfolio manager at Allianz. And I want to give a shout-out there to Michael Demuth and the entire team, the entire investment team at Allianz Life in Minneapolis. I know that several of those folks listen to our podcast. And the reason I bring it up is that one of the topics that Tim and I were talking about at dinner with our team is commercial real estate lending. And it was very timely because it was a great background for this podcast which is on commercial real estate lending. And we're joined by Martin Barnewell, who's the investment director on the commercial real estate lending team at abrdn. Martin, thanks for joining us. Thanks for taking the time. This is a great topic, and your timing is impeccable.

Martin: Well, thanks for having me.

Stewart: We are thrilled, and I want to start them off like we start them all. So where did you grow up, the town? What was your first job? Not the fancy one. And what do you think makes insurance asset management cool?

Martin: Excellent. Well, yeah, great question. I grew up in Dublin, in Ireland. That's where I'm from originally. I spent the first 26 years of my life there. Fantastic place to grow up and be educated, but I wanted to spread my wings a little bit so I spent a little bit of time in Chicago, working there in real estate debts. And then for the last 12 years of my life, I've been in London, in the UK, again working in real estate debt.

But my first job, not the fancy one, definitely was I was 16 years old and I worked in a factory making copper bracelets which were supposed to help with arthritis and rheumatism. And aside from all the things, the wonderful things that you get from your first job, the experience, the first pay package, it was actually a company that employed members of Ireland's traveling community, which is like a gypsy community. And actually working with a very marginalized and often misunderstood minority group from Ireland was just a fantastic experience for me, a huge eye-opener. And to sit alongside these people as colleagues and friends was a really unique insight for me. So yeah, that was an amazing experience for my first job.

And then why do I think working in insurance is so cool? Well, what I would say is I'm still young, relatively speaking, so I've got a few years before I can retire. But what I love about insurance is a lot of what it does is about providing for certain outcomes, known and unknown in people's lives, like retirement, et cetera. And I love to dream about a comfortable retirement and traveling the world with my wife and seeing all these wonderful places. And for our investments can play a small part in insurance companies delivering in these outcomes and making people's lives a bit more comfortable and better, then that's a really, really cool thing to do. So yeah, something I'm really proud to play a part in.

Stewart: That's terrific. Yeah, I think a lot of times insurance industry gets a bad rap. And what I used to say to my students is when the wind blows and all of that and people are picking their belongings up out of the front yard, it's the people in those cars that have insurance company names on them that are writing checks and putting people's lives back together in no uncertain terms. And it can also be the loss of a family member that has a negative financial impact, and I think insurance does an awful lot of good. And so I always try to take the opportunity to ring the bell for insurance, the insurance industry, which I love dearly. I'm very happy to be a small part of it. So speaking of which, abrdn has a very rich insurance history itself or insurance heritage. What can you tell us about that to frame the conversation for your specialty which is commercial lending?

Martin: Yeah, definitely. abrdn's got a really long heritage. It's going to celebrate its 200-year-old birthday next year, so happy birthday to abrdn. But yeah, and it goes back really very much to 1825 when it started life as a life company in the insurance space. And insurance has been at the heart of the business until very, very recently. Now, we're a pure play investment manager, works across three distinct areas with traditional investments, a platform business, and an advisory business. But when insurance is very much in our DNA and we manage over $230 billion of capital for insurance clients, and that's over 150 clients, we've got specialists across the business who live and breathe insurance and someone who worked previously in a bank and at first joins abrdn. This whole world of insurance was very new to me 10 years ago. But it's been a phenomenal journey and my understanding has grown and evolved as I worked alongside some great colleagues and then some fantastic external clients that we've helped navigate the markets.

So within abrdn, where I work is within private credit. And we're private credit. As you'll know from some of your podcasts and your guests, is a very broad and diverse business which spans many different asset classes with very different risk and return profiles. Within abrdn, where we work is very much insurance-focused, investment grade, conservative end of the business, do that across infrastructure debt, corporate debt, fund financing, and real estate debt. And that's where I spend most of my time, in the commercial real estate part of the business.

Stewart: That's extremely helpful. And so in particular, it's not only real estate lending but your focus is you're fairly focused in the UK, and there's some important differences in the UK market versus the US. So can you talk to us a little bit about the UK as an investable market and what the characteristics are?

Martin: Yeah, absolutely. And having spent some time in the US, I have a little bit of an understanding of the market there and how it operates. And what I would say about the UK is that the key difference is if you go back to the GFC, 99% of the lending was done by banks in the UK. So it was completely bank-dominated. And if you look at the US market, there's much more diverse and granular sources of capital that support the commercial mortgage lending business. So your debt funds, insurance companies, CNBS, banks, et cetera, and the government agencies that are active in the market. Whereas UK, completely bank-dominated. In 2008, you had that extreme global financial crisis. The banks turn off the taps and the source of capital for real estate debt just disappears overnight, and that exacerbates, accentuates to the clients and capital values that were already happening in that market.

So what you've seen since then in the UK is a real shift from a completely bank-dominated market to a lot of new entrants into that space, and particularly in the insurance space. And now non-bank lenders of which insurance capital is a very sizable part, is about 30% to 35% of the UK lending markets. So a huge amount more of diversity in terms of sources of capital and types of institutions that are now playing in the commercial estate debt market, and that's brought a change in the types of deals that are done. So where we work with insurance lenders who are looking very much at the investment grade, liability matching part of the market, they obviously want fixed rate. They want prepayment protection, and that's the sort of things we help structure and put in place for them.

But it was relatively new or limited in its use in the market so there's a bit of an education when it comes to working with borrowers to give them access and understanding to these slightly different products. And they'd be used to that more traditional, shorter-dated floating rate bank debt that they would've always relied on an underwrote in their business plans. But what I would say about the UK market is it's very large. It is very liquid in terms of the real estate equity market over US, a trillion dollars in size. It's a very transparent market that attracts huge amounts of overseas capital from the US, from the Middle East and Asia. And it's a very lender-friendly jurisdiction from a debt point of view.

So it's got very robust and well-established legal frameworks. It's very easy to lend from a regulatory point of view. And the protections for lenders are really, really strong in terms of enforcement and foreclosure. If there's a default, you can be able to step in and take control of an asset within a matter of days. So it is a really robust, well-governed, and well-established lending market and a real estate investment market as well.

Stewart: That's really helpful. And I don't want to... This is my opinion only, but I always feel like the insurance industry is better positioned to be the lender on those kinds of projects than a bank. Banks have overnight deposits and then there's this government enterprise that's basically set up to back up the bank in case there's a run on it. And it's like when in the insurance world, it's like our assets and our liabilities match up very well and it's highly unlikely that there's going to be a run on. It just seems like a natural fit as far as the insurance industry playing a big role in this market. And further, it seems like there's no end in sight to that trend given where the banks are. So just one person's opinion.

Martin: Yeah. It's a great point and I think insurance has a really important part to play in the landscape of real estate debt in UK. It's already playing a big part, and I think that's just going to grow and increase as we see more insurers seek to access the market. And I think it creates a fantastic opportunity as well in many different types of markets because banks will think and understand risk and price risk in a very different way sometimes to an insurer. So our clients very much look at it through the lens of an external credit rating agency. Banks look at it through their own rating metrics and price deals very differently.

So as an insurance investor, you can at times in the market really exploit those opportunities where there's certain deals that banks don't like or they're not competitive on, where if you think of it through the lens of a fixed income investor is transitioning from public credit and corporate bonds and is taking on a CML that's an A-rated deal for 5 years, you can trap an incredibly attractive illiquidity pickup of 100 to 200 basis points in doing so and exploit those disconnects and dynamics of the real estate debt market in the UK because of that bank influence.

Stewart: Thanks, that's super helpful. So the market dislocation in 2022 in the UK, can you talk a little bit about the impact that it had on the commercial mortgage lending market?

Martin: Yeah, absolutely. What we saw in Q4 2022 was an incredibly sharp spike in interest rates in the UK. And we were obviously seeing that globally from pressures and inflation, but the UK had some very specific dynamics and at the time which caused a huge spike and a very sharp spike in interest rates. And obviously, the value of real estate assets are often correlated with that premium that they need to achieve over the risk-free rate. And as a result of that rapid spike, you saw the fastest and sharpest correction in capital values in the history of the UK commercial real estate markets. So incredibly sharp and fast correction, really down to up to 30%, 35% capital value declines on assets overnight almost. So it was incredibly fast, very different even to the GFC where yes, there was very deep cuts but that was over a prolonged two-year period.

Here, the bandage was ripped off rapidly. It was very painful for investors, not so much lenders who'd remain quite disciplined throughout the cycle. That regulation is clearly working. It's creating a better market to lend in. And certainly lenders will have experienced some challenges and pain and defaults, but we would describe what we're seen as more stress rather than distress. But equity owners have obviously been impacted quite significantly. And if you look at the experience across Europe and in the US, those declines were less severe in those markets, and therefore we think they probably have a bit more to go. Whereas the UK, having such a sharp and fast correction, meant that as we entered 2023 and reached the midpoint of 2023, we'd taken the pain, the market had stabilized, and the outlook was turning more and more promising.

So we've got a situation where from a debt perspective, it becomes incredibly interesting because as you know as a lender, rather than equity on it, there is no upside for me. It's only my upside is getting my money back. So we're not going to have a party about that, get the streamers out. And therefore we look at things quite negatively and quite conservatively. So as a lender, if I've seen a rapid correction in capital values of up to a third of those asset values and then a long period of stabilization, that gives me incredible confidence to lend into those markets.

Because how I describe it to a client the other day is if we had an asset that's $100 million and the market was doing 60% loan to value, so that $100 million asset, 60 LTV, what's happened now is that that asset's fallen into $70 million in value because of the slight stress and some distress in the markets. Lenders have pulled back a bit, so leverage is more conservative now. So that's 60 LTV is more like 50, maybe 55, and all of a sudden instead of lending $60 million against $100 million dollars asset, I'm lending maybe $35 million against an asset that's worth $70 with a much more positive outlook. So I'm going in my hands, covering my head. I'm not going to get hit as hard. I'm in a defensive position, and as a lender that's exactly where I want to be. So there's a huge tick in the box for me from a lending perspective. Sharp decline, the market's less competitive so leverage is lower, and interest rates are higher which is going to constrain the amount of debt you can lend anyway to ensure you've got those nice interest cover levels.

And because of that pullback from the market, margins and spreads increased nicely. They come in a little bit this year, but they're still incredibly attractive. And as I mentioned earlier, when you look at it through the eyes of an insurance investor rather than a bank and how they price and rate risk, it creates a real aligning of those stars and a once in a decade maybe opportunity from a lending perspective where you're lending into a recovery cycle in a really defensive position, market's less competitive so you can dictate terms a bit more, and the spreads are really attractive. And then you've got corporate bond spreads on the other side if that's how you think about your capital and your returns. And if they've tightened, all of a sudden we can deliver for our insurance clients high quality investment grade debt, exactly structured as they want and need to match those liabilities that they have, and it can deliver. And some recent deals, we've managed to deliver illiquidity pickups of 180, 200 basis points, which is very much at the upper end of our experience over the last number of years.

Stewart: Thanks so much. This is very helpful. So talk to me a little bit about how the UK commercial mortgage loan market is different from the US.

Martin: Yeah. One of the key things is the source of capital. There is some CMBS, but it's an awful lot less than you would see in the US markets. It's still bank-dominated so they're still 65% of the market. It's traditionally a 5-year floating rate market. Sensibly structured 60% LTV spreads from 150 basis points to 250 points for traditional senior lending. And that's the vanilla part of the market. But what is unique now is that opportunity for insurance lenders that we think is so interesting right now. Insurance clients, some of them, want obviously very long-dated fixed rates loans to match those longer-dated liabilities in the balance sheet. That's a difficult dynamic right now because we're at the peak of the interest rate cycle.

Globally, the US is looking at rate cuts. The UK is very much looking at rate cuts. So borrowers either want floating rate or they want shorter-dated debt to get them through this cycle, get them into a lower interest rate environment, and then perhaps consider longer term. So the opportunity is a little bit shorter than some insurance clients would like, but if you're looking at shorter liabilities on your balance sheet, that three to five-year space, then there's huge amounts of flow and opportunity in those sectors.

The one elephant in the room I haven't mentioned, which is on the minds of I'd imagine many of your listeners in the US if they've got a real estate focus, is obviously the office sector. And that is a part of the market where I talked about the stabilization and the bottoming out of capital values. That's true for a very small subset of offices, but we do think offices have a lot more pain to face and there's going to be a lot more structural change rather than cyclical in that sector, and it's something we're very, very cautious of.

Stewart: Thank you. There's at least in the US considerable concern about the office sector, and I think my sense is that the jury is still out on what ultimately return to work looks like. But other sectors of commercial real estate look terrific. So can you talk to me about how you view the various sectors in commercial lending or commercial real estate?

Martin: Yeah, definitely. It's something we think about every quarter. We have a huge real estate equity franchise. We work very closely with our research colleagues there in interpreting and understanding the house view. So it's a core part of our job and something we're always talking about as a team. If I look across the kind of sectors, maybe taking the office one last but a bit of a look at where we really like right now, so what we call over here, the living sector which would be multifamily in the US, so private rental sector, really positive. It's got a supply-demand imbalance as a real lack of high-quality rental accommodation in key cities. And we think that that sector is going to be particularly resilient. Student accommodation as well in a number of key cities in the UK, there's a real supply-demand imbalance. You've got situations where your students are going to university in a city, Manchester, and they have to live in a city that's an hour away in Liverpool. So there's a real lack of supply of high-quality student accommodation in certain locations. We really like that as a lending opportunity.

What I talked about that really sharp correction of capital values. So logistics and industrial is a part of the market where we've very good confidence in its outlook. We couldn't lend on those assets for the last five or six years because when we look at it through the lens of an external credit rating agency, those yields were too hot against their long-term averages and it keeps us away from that sector. That really rapid correction in capital values happened first in logistics. So they went 30%, 35% down overnight, and that brought us back, able to look at deals in that sector again. So we've been quite active in the logistics space for the last 12 months, having not been able to play in that market for the last number of years despite really liking the fundamentals and that shift from retail to multichannel retail and the logistics requirements that go with that. So really positive there.

Selectively, we really liked luxury hotels. Our kind of thumb is if I can't afford to stay there, I'm going to look at it because my only option and ability to get into these lovely hotels is on a site inspection rather than as a paying customer. But joking aside, we really like some of those opportunities in the prime five-star, ultra-luxury hotels. And they often lend themselves particularly well for insurance clients because they're often owned by private individuals. High net worth sovereign wealth funds want to hold the asset for 10, 15, 20 years. So looking at very conservative, insurance-friendly, fixed rate, long-term debt really works in those deals. So that's been a great part for the market for us to play in.

Retail has gone through a number of structural changes in the UK. And again, it's probably a bit further ahead in its journey than some other jurisdictions. So what we've seen is a huge decline over the last 10 years really in capital values for retail assets. Some retail assets will continue to struggle like strip malls, shopping centers. Some of them are poor quality, don't have the right tenant mix, lots of vacancy CapEx requirements, so we're very cautious on those. But there are out-of-town retail parks which are really popular, which trade well, which have convenience retailers, supermarkets foods, bulky goods, DIY and discount retailers, really defensive, performed exceptionally well. And selectively we really like those.

Which brings me to the sort of naughty, naughty child on the outside, which is offices. And you're absolutely right, the return to office has not yet played out. I don't think anyone can say with the highest level of confidence that they know exactly what it's going to look like, but I think we have a decent idea of what's going to happen and a very clear conviction on the parts of the market which we think will do well. There's the truly best-in-class offices that have the highest level of fit out and amenities in great locations, in prime cities like obviously London. But there are a number of other cities in the UK where we're seeing rents grow in those markets, where we're seeing tenants really want to occupy this space. And everyone is chasing their 5% of the market that looks like what I've described, but then you've got a real polarization where the rest of the market is going to really, really struggle.

The CapEx requirements to bring these assets up to a level that's attractive to prospective tenants is huge. And if you go outside of the cities to these business parks out of 10 locations, that really does just spook me because we see some really on the face of an interesting opportunities come across our desks, a borrower will say, "Look, I'm buying this asset. It's fallen by 75% in value. I'm going to spend X million on it. Just lend me 40%, 50% of its value today. You'll get all your money back. Surely that's a great idea." The problem for us when we look at those deals is yes, they're buying it at a massive discount. Yes, they're going to spend that money, but is there a tenant in that location in two, three years time when we've finished refurbishing it? I really don't know. And as a lender, I've just got so many other options in other places, the market I could put our money in, and therefore I've got to be really, really cautious on those kinds of deals.

Stewart: That's super helpful too. I guess my last question here just to wrap up is what about mezzanine? You had mentioned your conservative approach and outlook, but I think it's worth just exploring. Is that a sector that you're involved in? And if so, in what way?

Martin: Yeah. So we've always focused on the more conservative senior lending parts of the market, but we have had strategies which could have looked at mezzanine opportunities in the past, but we're not a core mezzanine lender. That's not our core business. And there are others who do it very well in the UK and in Europe. But what I would say right now, all the things we love about the market from a senior lending perspective are true from a mezzanine point of view. So as long as the return stacks up and it's the right assets, if we're happy to lend 40%, 50% LTV for senior capital and get 200, 300 basis points and a 200 bits of liquidity pick up, then for mezzanine structured in the right way and those assets, the right assets facing into what we think is increasingly going to be an upswing in capital values over the next three years, then if I was going to be a mezzanine lender, today is the time and we're selectively speaking to a small number of clients around that opportunity right now and why we think we've never had the highest conviction.

But right now, if we were going to do mezz, it is the time to do it. And the fundamentals of real estate are so important when you're taking that higher risk position, but the rewards are absolutely there. It's double-digit return territory and you can be really selective given there's refinancing pressure out there. You can pick and choose the assets that you want to lend against in the sectors that you like. And I think it could be a really, really exciting opportunity for the next 12, 18 months.

Stewart: I have really enjoyed getting this education on commercial real estate lending from you. Martin, thank you so much for being on. And I've got a couple of fun ones for you out the door if you'll indulge me. You can take either of these or both. Most of our guests take both, no pressure. What's the best piece of advice that you've gotten that you'd care to pass along and who would you most like to have lunch with, alive or dead?

Martin: Yeah. Look, I've had the opportunity to listen to a number of your podcasts, so A, thank you so much for having me on and being... Oh, absolutely answering these two questions, they're the things I prepared for the most.

Stewart: That's awesome. That's great. That's exactly what we need. That's exactly what we need. That's what keeps people coming back, man. I'm telling you.

Martin: I love the format. I really love that, you're the personal thing at the start and the end. I think it just bookmarks your shows brilliantly. So I really like the format and I'm a listener now. I'm signed up, so I'm ready to go for all the next episodes, but yeah.

Stewart: That's true. Thank you.

Martin: To answer the questions, the first one, I remember a colleague of mine, very senior person in our human resources team, involved in the hiring and firing of the execs and everything else. We were having dinner once after a course we're on together and she said to me, "There's one thing, one piece of advice I've got in my life. It's the single best piece of advice I've ever got when it comes to a job interview and the questions you want to ask a potential employer at the end." And she had my full attention, obviously with that intro. And the question she always asks at the end of every interview, and she does it to try and get the sense of an organization and take the temperature of its culture is, "What gets punished here and what gets rewarded?"

And I thought that was a brilliant question because the answer that the individual gives you will give you a fantastic insight into that culture of that company. And how they deal, particularly with the first part of punishments versus rewards is a really great insight. So it's something I've always remembered and something I always ask whenever I'm in front of a prospective employer.

Stewart: That's fantastic. That's great advice.

Martin: Yeah. No, I really like it. And then the last thing is, who would I like to have lunch with, sadly no longer with us but if you'll indulge me for a minute, I'm a big, big soccer fan, as you would call it in the US. So my team is Glasgow Celtic. They're a very romantic football club. They were founded in 1888 by Irish immigrants to Scotland who were escaping famine and hunger and lack of opportunity. They all moved to Glasgow, and Celtic was created to feed the impoverished Irish in Glasgow. So it was created with really noble and charitable aims, but it grew into a global football club as it is today.

But in 1967, its manager was a man called Jostein who sadly passed away, but he took a group of 11 men from the outskirts of Glasgow, formed a team that won the greatest prize in world football, which was the European Cup in 1967. And he did it by beating the glory team at the time, which was into Milan from Italy. And they were the red-hot favorites. And he beat them playing beautiful, inventive, attacking football against all the odds, a real David and Goliath story. And just to spend and break bread and spend some time with a man like that to understand how he shaped teams, the leadership involved, and the vision would just be the ultimate privilege. So that would be who living or dead I would love to have lunch with.

Stewart: Wow. I love that. What a great answer, and thanks for the history too. That is super cool. Yeah, well done. So listen, thanks for joining us. We've been joined today by Martin Barnewell, who's investment director on the commercial real estate lending team at abrdn, and we'd like to thank abrdn for making Martin available to us. So thanks so much to you and abrdn as well.

Martin: Thank you very much. Real pleasure.

Stewart: Thanks for listening. I learned recently that the average podcast lasts 21 episodes, and this is episode 207 or something like that for us, and we're approaching 70,000 downloads. And that would not be possible without a really terrific listener base that has really nice things to say to us. So I just want to say thank you so much to everyone who listens to our podcast. If you have ideas, please shoot me a note at stewart@insuranceaum.com. My name's Stewart Foley and this is the InsuranceAUM.com podcast.