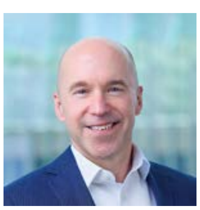
INSURANCE SOLUTIONS

Three Reasons Insurers Should Consider Real Estate Debt

Early 2025 saw property investors shift to risk-on, but uncertainty has led to a risk-off stance. U.S. policy ambiguity adds volatility, likely delaying recovery. Despite this, European real estate debt remains a compelling opportunity for insurers for three key reasons.



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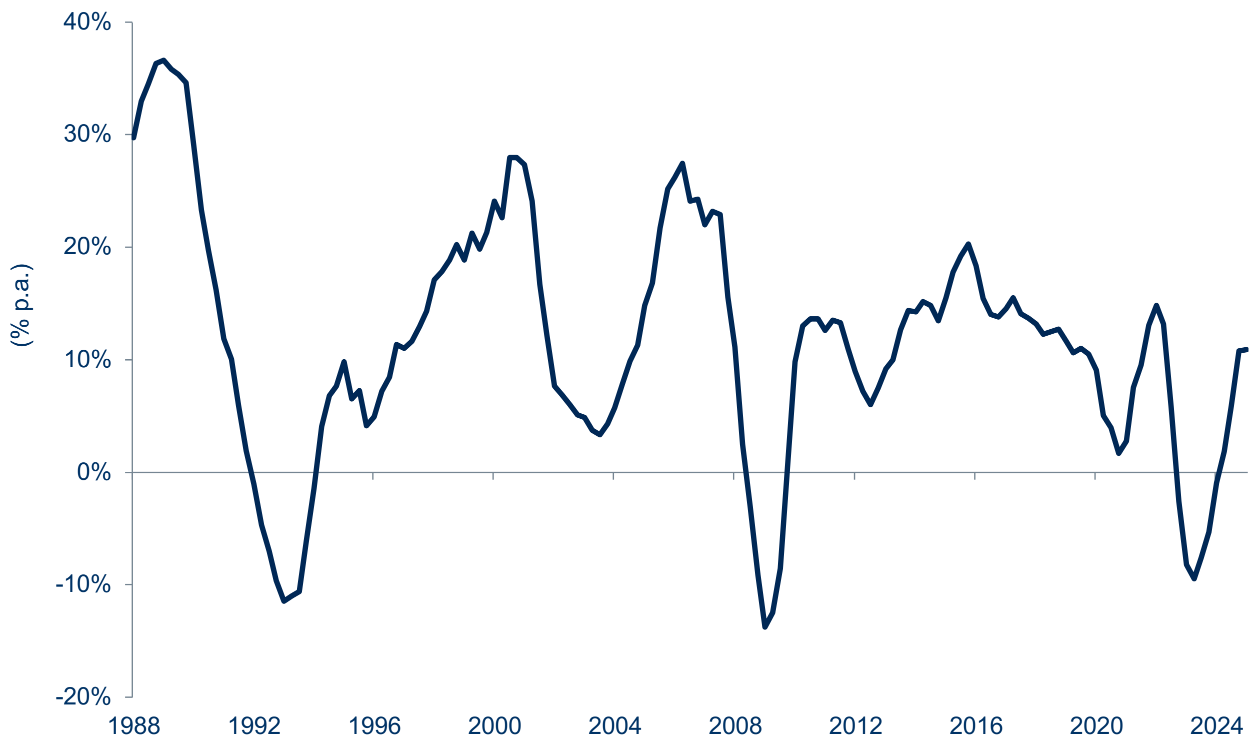
The start of 2025 marked a shift in investor sentiment within the European property market. Investors initially leaned towards a risk-on approach, but have since taken a risk-off stance in response to heightened uncertainty. Volatility surrounding U.S. policy clouds the outlook for the European economy and European CRE market, and this uncertainty is expected to prolong the recovery in transaction volumes. Increased risks to growth also mean further rate cuts are likely, with lower interest rates supportive for real estate pricing and values. Having already undergone a significant repricing, European real estate debt appears reasonably well-protected against further property value volatility. When coupled with ample refinancing opportunities—driven by an expected €450 billion of debt maturities over the next four years—it paints a bright picture for the asset class.[1]

In particular, despite a less certain landscape in 2025, there are three key reasons that real estate debt presents a compelling opportunity for insurers:

1. **Significant downside protection potential.**
2. **Suitability for insurance balance sheets from a fundamental and Solvency II perspective.**
3. **Exposure to structural themes such as changing demographics, e-commerce and ESG.**

Figure 1: European All-Property Prime Total Returns



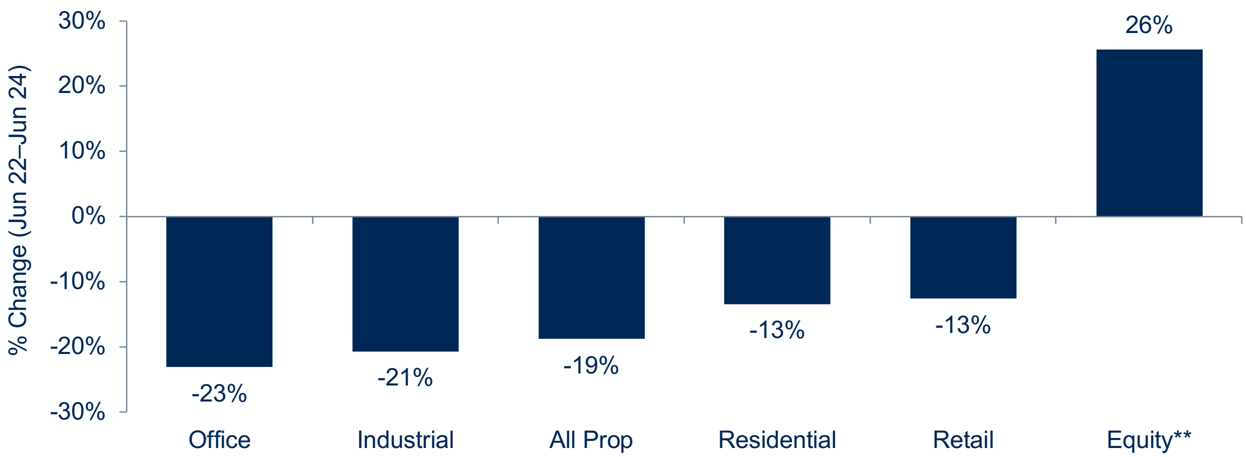
Source: CBRE, Cushman & Wakefield. As of Q1 2025.

[1] Source: Barings Research, MSCI. As of April 2024.

1. Significant Downside Protection Potential

The European CRE market has already undergone a significant re-valuation against a backdrop of rising interest rates over the last few years. Specifically, since June 2022, All-Property European capital values have declined by 19%, with even bigger declines occurring across specific property sectors—even those where occupational demand has remained strong **(Figure 2)**. To put this into context, valuations across equities, for example, have increased during the same period.

Figure 2: European Pricing—Real Estate Capital Values vs. Equities



Source: MSCI, Marketwatch. As of Q2 2024. **Equity = STOXX Europe 600 Price Index.

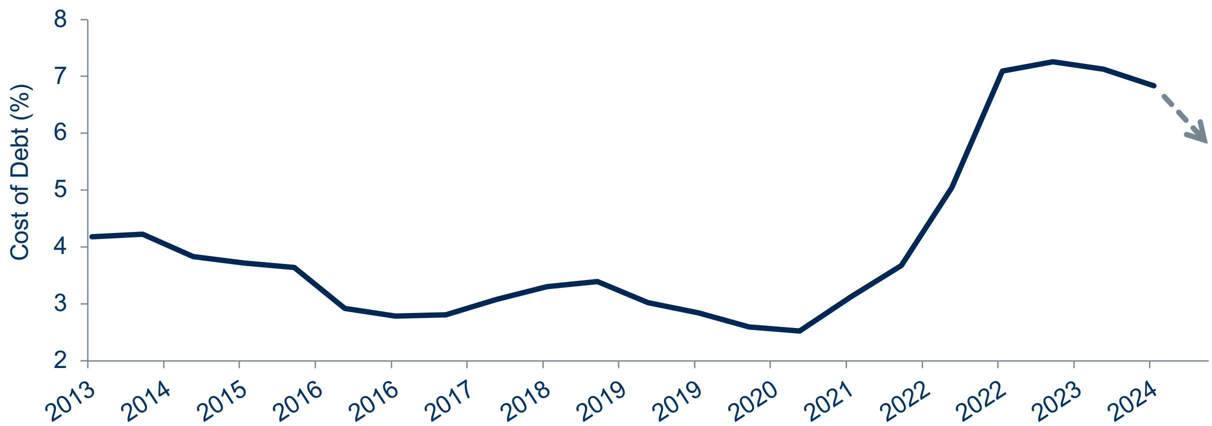
In addition, given the increase in banking regulation over the past 15 years, there have been low levels of property development across several sectors including residential and logistics. As a result, modern stock shortages are prevalent across most of Europe's key cities, and vacancy rates remain low.[2] This explains why, despite the recent significant fall in property valuations, occupier demand remained strong and top-end rents continued to rise through the recent interest rate-induced economic slowdown—and it also suggests that cashflows should remain secure in the coming years, or potentially even increase.[3]

Real estate debt exposure can provide investors with income stability through the property cycle, and loans secured by "hard" collateral can provide considerable downside protection for CRE debt investors particularly following the recent sharp correction—which is beneficial given the macroeconomic uncertainties that remain on the horizon.

Looking across the market today, still-elevated interest rates and property debt margins have pushed up the total cost of debt, which helps explain why direct property market liquidity has slowed over the past few years **(Figure 3)**. Although interest rates are set to continue their decline in Europe, property debt return prospects are likely to remain attractive relative to the near-zero interest rate period that followed the financial crisis. A moderating cost of property debt should also facilitate transactions and create opportunities to originate new real estate loans.

[2] Source: Cushman & Wakefield, Barings Research. As of November 2024.
[3] Source: Cushman & Wakefield, Barings Research. As of November 2024.

Figure 3: U.K. Total Cost of Debt



Source: Bayes Business School, OEF, Barings Research. As of October 2024.

2. An Efficient Asset Class for Insurance Balance Sheets

CRE debt offers investors with diverse exposure in terms of sector, geography, and sources of risk premium. Broadly, CRE debt can be viewed as "core" and "non-core" loans, which serve different purposes for lenders and therefore have different risk/return characteristics.

Core CRE lending refers to lending against real estate assets with high occupancy rates. These assets generate stable, contracted, or regulated cashflows over a long holding period. Debt is typically structured with conservative Loan-to-Value (LTV) of c. 50–60% and is used by equity owners (the borrowers) to access leverage and increase return.

Although fixed-rate and long-dated core loans exist, these are more common in the U.S. By contrast, the majority of core loans in the European market (including the U.K.) are floating-rate, with typically between five to seven years' maturity. Spreads are currently 150–200 bps over swaps on core loans, offering a significant illiquidity premium over comparable corporate bonds.[4]

For insurers seeking higher returns, the asset class also offers exposure to a range of higher risk/reward, "non-core" strategies. These are loans against assets which require the execution of a business plan to achieve stabilization, ranging from leasing and light refurbishment to ground-up construction. Higher returns can also be achieved through mezzanine loans. While these strategies take on construction and/or business plan risk and can come with a lower repayment probability in the event of default, they have the potential to generate higher returns even on a default-adjusted basis.

Non-core loans can be particularly capital-efficient from a Solvency II perspective. Non-core loans are designed to finance clearly defined, short-term projects, as they typically mature within two to five years. The shorter maturities, and corresponding lower spread durations, help reduce Spread SCR, enhancing their appeal from a regulatory capital perspective.

[4] Source: Barings. As of As of May 31, 2025.

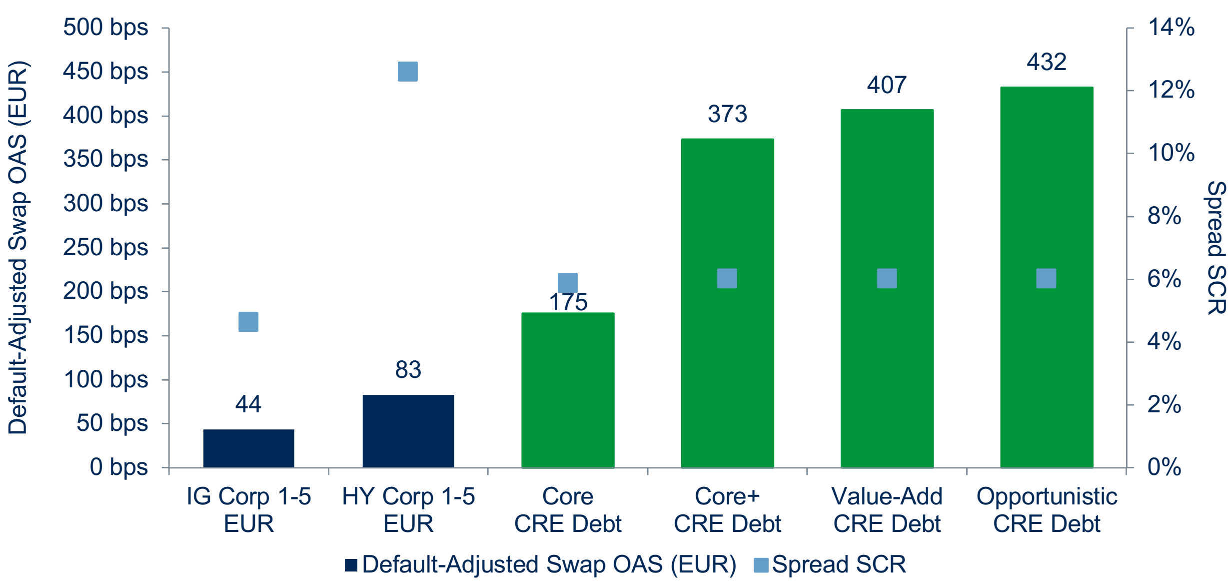
Given these characteristics, what roles could CRE loans play on insurers' balance sheets?

European CRE loans are Solvency II efficient assets for backing short-dated liabilities and surplus assets due to their excess return over corporates, floating rate nature and capital efficiency. If used to back liabilities, the floating-rate cashflows can be swapped back to fixed through an interest rate swap overlay.

Non-core loans are particularly suitable in insurers' surplus portfolios, as they offer a higher return potential and attract lower SCRs due to their shorter maturities (and therefore lower spread duration). As floating-rate assets, CRE debt does not attract excess interest rate risk, or Interest Rate SCR. On opportunistic loans with construction risk, for example, spreads are currently in the 450–500 bps range.[5] With the fundamentals of fixed income, and return potential comparable to equities over the long-term, CRE debt can be an efficient surplus asset class from both a risk/return and a capital-return perspective.

For those insurers looking for greater duration—for example using CRE loans to back life liabilities—the supply is much greater in the U.S. market. This is because in the U.S., the lender base is highly diversified between banks and other sources of capital, with insurance capital in particular playing a significant role. As a result, we see a steady supply of long-dated, investment grade quality and fixed-rate U.S. CRE loans with strong prepayment protection, which are ideal for backing long-dated insurance liabilities, including in Matching Adjustment portfolios. These can be held in conjunction with an FX overlay to hedge back to liability currency.

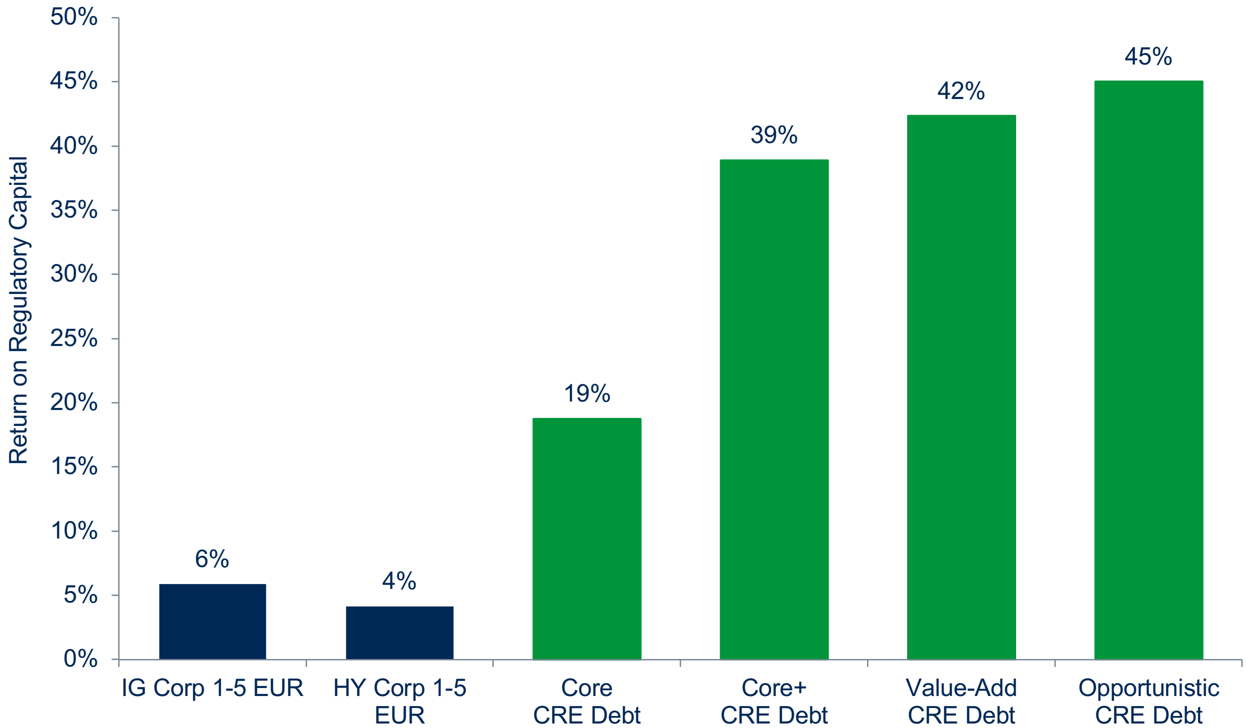
Figure 4A: CRE Debt Allows Insurers to Capture an Illiquidity Premium (Left Axis) Over Corporate Bonds While Attracting a Low Level of Spread SCR



Source: Barings, Aladdin, Moody's, European Insurance and Occupational Pensions Authority (EIOPA). As of May 31, 2025. Barings' interpretation of Solvency II. Investment Grade Corporates based on 1–5 year BBG Euro Aggregate Index. High Yield Corporates based on 1–5 year ICE BofA Euro High Yield Index (BB & B). Investment returns are not guaranteed.

[5] Source: Barings. As of May 31, 2025.

Figure 4B: As a Result, CRE Debt can Significantly Outperform Public Assets in Terms of Return on Regulatory Capital



Source: Barings, Aladdin, Moody's, EIOPA. As of May 31, 2025. Barings' interpretation of Solvency II. Investment Grade Corporates based on 1–5 year BBG Euro Aggregate Index. High Yield Corporates based on 1–5 year ICE BofA Euro High Yield Index (BB & B). Return on regulatory capital is calculated as return over regulatory capital held, where (1) return is default-adjusted spread over swaps (EUR); (2) regulatory capital held is Spread SCR adjusted for diversification benefit (assumed to be 20%) and target solvency ratio (assumed to be 200%). Investment returns are not guaranteed.

3. Exposure to ESG & Other Structural Themes

Property markets constantly evolve, shifting to accommodate long-term demographic trends, technological tailwinds, changes to global supply chains and other societal trends like ESG. As such, constructing a diversified loan portfolio in carefully selected property sectors and markets where these long-term structural drivers align should help ensure the delivery of stable income returns and reduce the risk of borrower default. Given the long-term growth potential of these assets, they can also help mitigate asset obsolescence and, accordingly, help generate higher borrower exit liquidity.

Looking at ESG as an example, many European cities face a significant supply-demand imbalance in living properties. This shortage presents opportunities for CRE debt investors to contribute capital towards the delivery of what is quickly becoming critical social infrastructure. Further supported by a backdrop of increasing ESG regulation in Europe, capital from CRE debt investments can be used to refurbish and renovate properties to improve certain ESG credentials—such as energy efficiency—and support the transition from 'brown' to 'green' properties. These strategies aim to upgrade assets to meet tenants' ESG requirements and can help in selectively avoiding energy-intensive assets, which helps ensure continued tenant demand and can improve investor liquidity.

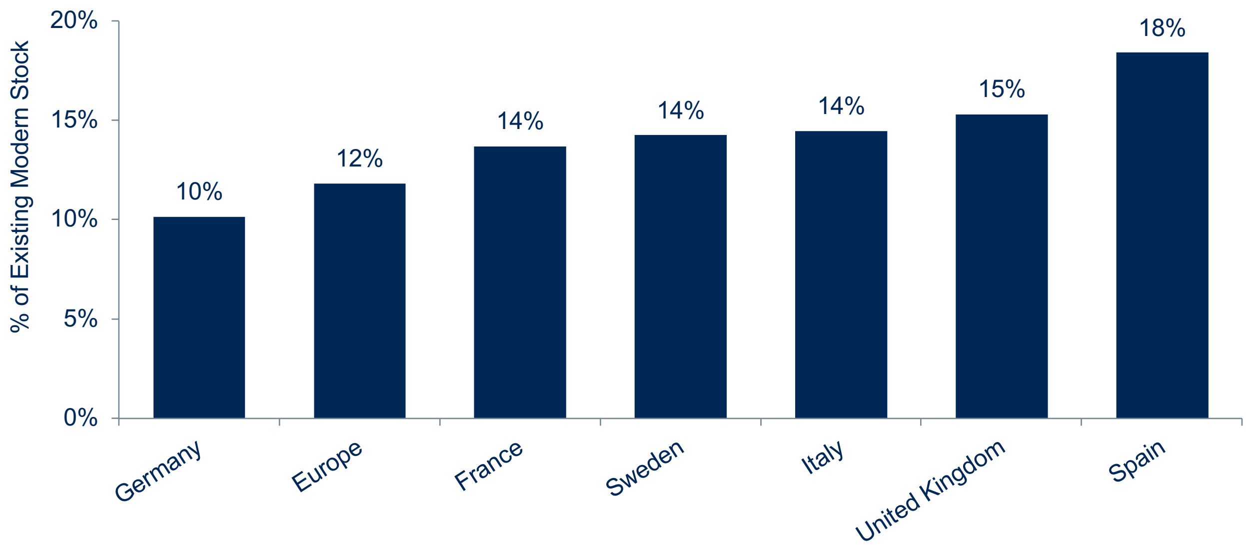
Compelling Opportunities via Sector Selection

Transportation-related strategic assets such as toll roads, seaports, airports, railroad rolling stock

Logistics

The logistics sector appears attractive today given the favorable occupational outlook, widespread modern stock shortages and significant discount in valuations. Demand, too, likely has further room to grow given the multi-speed rollout of e-commerce across Europe, the limited new construction activity, and the likelihood of further supply chain consolidation in response to growing geopolitical pressures and trade tariffs. By our estimates, an additional 33 million square meters of logistics space will be required over the next five years **(Figure 5)**.

Figure 5: Projected E-commerce Logistics Demand (2025–2029)



Source: CBRE, Oxford Economics, Euromonitor, Barings Calculations. As of February 2025.

Robust fundamentals further support the case for logistics, paving the way for strong long-term rental growth. In fact, logistics rental income growth is forecast to exceed both the retail and office sectors over the next five years.[6] Despite the strength of the sector's fundamentals, yields also remain attractive after rising considerably during the recent downturn, a result of tight sector pricing at the outset of the rate-hiking cycle.

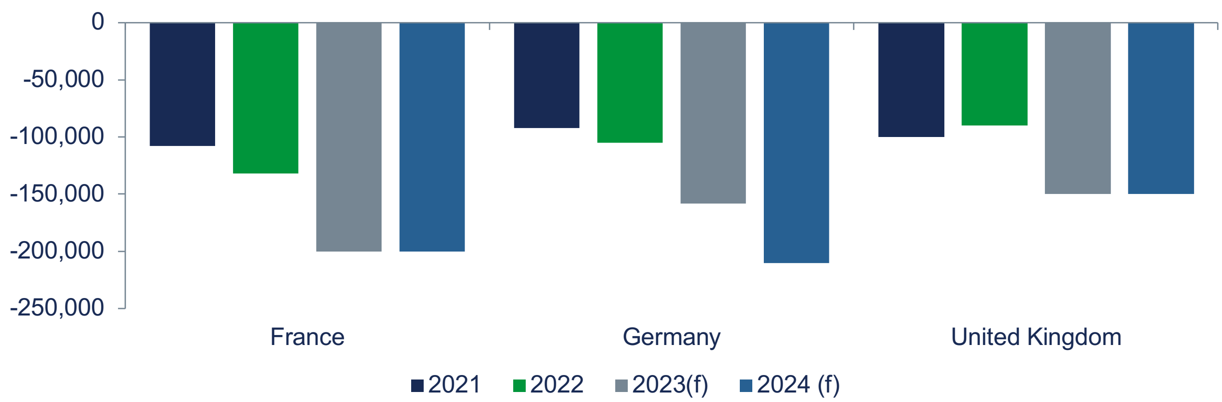
Lending Opportunity: With equity investment volumes in the sector set to rise, new origination opportunities are likely to be considerable. Limited supply is keeping occupancy levels high, and supporting stable cash flows. Renovation, refurbishment and development capital will be required to maintain and upgrade energy efficiency.

[6] Capital Economics. As of Q1 2025.

Residential

The structural undersupply of housing in many European cities underscores the case for residential assets. Development has lagged both the obsolescence rate and government housebuilding targets, compounding unaffordability for first-time buyers **(Figure 6)**. With housebuilding expected to remain weak, housing shortages in Europe's growing cities will inevitably worsen. This is likely to drive long-term capital appreciation across the sector and protect the value of the loan's underlying asset.

Figure 6: Shortfall in Housebuilding Compared to Government Target



Source: JLL, ONS, Destatis, Cour des comptes. As of November 2023.

Rising rental demand and reliable rental flows have made residential assets a mainstream investment option for core institutional investors in Europe, often as an alternative to the much-reduced investable universe in the retail sector.

Lending Opportunity: The significant sector expansion potential and reliable income stream make the sector highly financeable. In addition, the potential for higher yields and the lack of development capital have opened the sector up to alternative lenders.

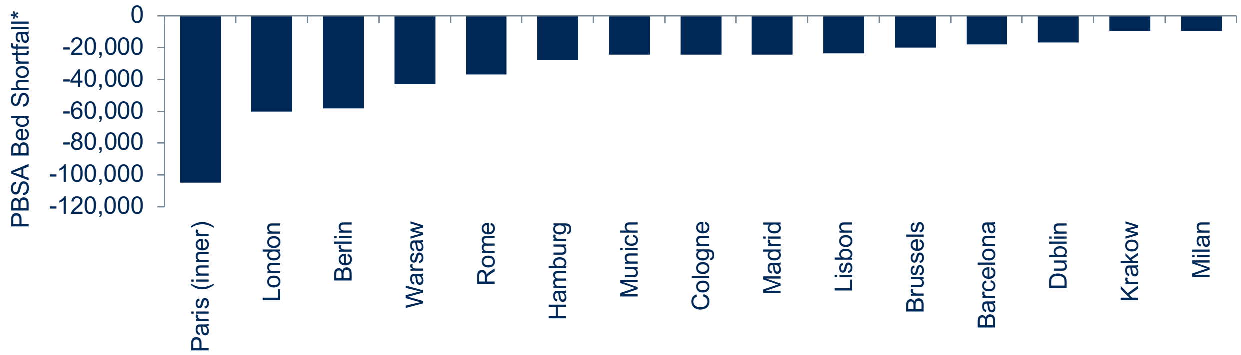
Purpose-Built Student Accommodation

Europe is uniquely placed to benefit from the rise in global demand for higher education. Its higher education sector is internationally renowned for its quality, with around half of the top-rated institutions across the globe located in the region.[7] The emerging global middle class is the "megatrend" driving overseas student demand against a stock base that is either undersupplied or becoming obsolete **(Figure 7)**. While risks exist from government policies that restrict international student numbers, university funding pressures, and the rise of e-learning, the top-rated institutions are likely to be resilient to these factors. Conversely, assets servicing institutions at the other end of the spectrum could face challenges.

Lending Opportunity: In this sector, there is an opportunity to finance the supply of student housing in the top-ranking universitiy cities that lack modern student housing stock.

[7] Source: Times Higher Education World University Rankings. As of 2024.

Figure 7: PBSA Bed Shortfall



Source: JLL. As of June 2024. *Shortfall = Total PBSA Beds - Unmet Demand.

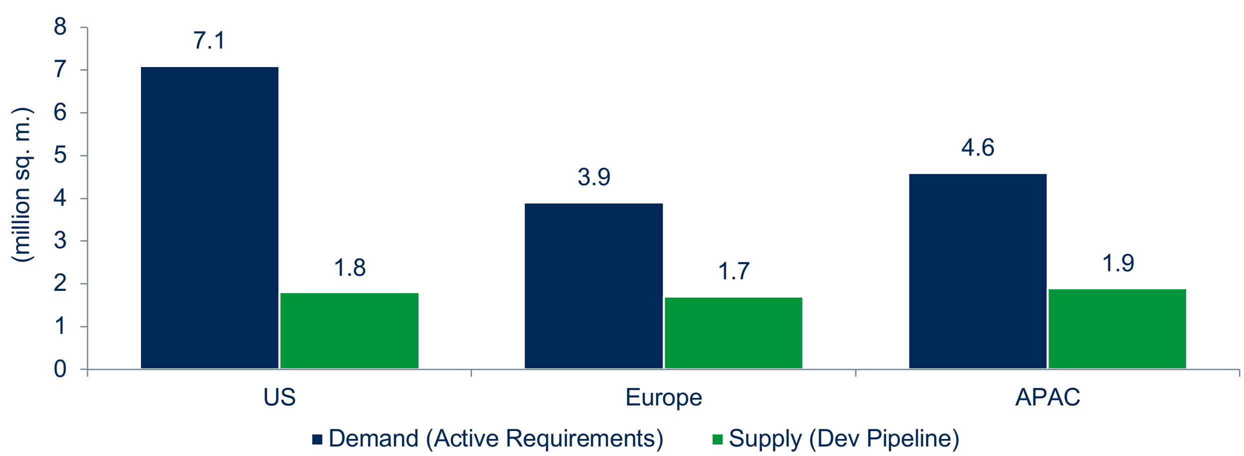
Sustainable CBD Offices

The post-pandemic shift to hybrid working has lowered aggregate demand for office space, with tenants taking less overall space. While the U.S. is at the more extreme end of this, there are particular dynamics that soften this trend in Europe. For instance, smaller cities in Europe that are well serviced by public transport systems, as well as the smaller sized European homes that are less conducive to working-from-home, boost the case for offices.

For these reasons, we believe that tenant (and investor) demand for office space will persist, but that it will disproportionately focus on the highest-standard, sustainable CBD office space. Notably, modern office stock is in chronic undersupply, following post-GFC regulation that significantly curtained new project development. Buildings with in-demand green credentials are even scarcer. **(Figure 8)**.

Specialist office sectors such as life sciences have received attention from property investors and lenders over recent years. If research grants in the U.S. diminish, the life sciences sector in Europe may be set to benefit from increased occupier and investor demand.

Figure 8: Net Zero Offices (to 2030)



Source: JLL. As of January 2024.

Lending Opportunity: Select assets in this sector offer diversification benefits to a broader loan portfolio. Specifically, there is potential value in modern, centrally located buildings that can command “green premiums” and attract the best corporate occupiers—which should lower cashflow risks.

Retail

Investor interest in retail continues to rise, reflecting the sector’s potential for modest income growth, namely in locations where rents have appropriately rebased. The inflation spike has driven up nominal turnover and therefore the effort rate (the rent to turnover ratio) has plunged. Given the online retail sales growth potential and structural changes facing the sector, we remain cautious about its long-term prospects. We see value in retail schemes where there is a heavy tenant weighting toward grocery, as well as in online-resilient categories such as hardware (DIY), homeware, and garden.

Lending Opportunity: Highly selective financing of retail schemes dominated by internet resilient tenants can provide some diversification benefits and potentially boost debt returns through higher margins.

Alternatives

Alternative property sectors are growing rapidly, providing investors with an opportunity to align with different and emerging economic growth drivers and societal trends. Self-storage is one example, which stands to benefit from stronger demand as housing shortages and unaffordability drive residential unit sizes smaller. Another example is senior and health care facilities, accommodating Europe’s aging population.

Lending Opportunity: Selective financing of alternative property sectors can offer diversification benefits to a broader loan portfolio and potentially boost debt returns through higher margins. That said, we believe stock selection is crucial in this sector, and we remain cautious on energy-intensive alternative properties.

Key Takeaway

The European real estate market is at the beginning of a new property cycle, with a number of select opportunities on the horizon despite a shifting macroeconomic, and geopolitical landscape. In this environment, European CRE debt looks particularly compelling for insurers given its ability to generate attractive returns for both reserving and surplus portfolios in a capital-efficient way, and with built-in downside protection.

The asset class also offers investors exposure to structural and societal trends such as changing demographics and ESG. While tapping into these themes can reduce both default and exit concerns, we believe a selective approach across sectors is paramount to navigating both the opportunities and challenges that lie ahead.

Barings' Global Real Estate Platform Overview

$46.4 B/$3.7 B
AUM/AUA[8]

246
Dedicated Investment Professionals

17/9
Local Offices in Countries

756
Active Investments

190+
Institutional Investors

Barings Real Estate Debt

$24.9 B/$3.7 B
AUM/AUA

$28.8 B
Dedicated Real Estate Debt AUM[9]

$75 B+
Loans Closed Since 2004

$160 B+
Deals Reviewed Each Year

Aligned Interest: Investing alongside our parent company

Insurance Solutions: Working to insurance clients' specific ALM, rating and regulatory requirements

Reporting: Customized reporting to meet insurers' needs

[8] As of June 30, 2024.
[9] Includes $3.8 billion of AUA related to co-lending agreements. Does not include affiliated real estate debt assets that are not managed directly by the Real Estate Debt team.

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