

## Europe Real Estate Debt Strategic Outlook

March 2024

### IN A NUTSHELL

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- Financing conditions in the European real estate market remain challenging, but this presents interesting opportunities for investors in private debt. CRE debt returns continue to look attractive across the capital stack, both within the wider real estate market and in a multi-asset context.
  - Investors remain positive on the sector and we expect a pick-up in fundraising activity this year. The large debt funding gap should create significant refinancing opportunities, with a fading denominator effect also leading investors to restart investment in their real estate portfolios.
  - The prevalence of non-performing loans is likely to increase in the coming years, presenting alternative lenders with a potential opportunity to offer workout and restructuring solutions to institutional clients.
  - With the underlying real estate market correction now all but complete, we believe a whole loan strategy, which can offer a notable return premium on the senior part, looks attractive on a risk-adjusted basis.
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### Current conditions

#### Inflation is on the way down and interest rates have likely peaked

The last two years have been characterised by high inflation and rising interest rates across Europe. At the same time, commercial property values have declined to an extent not seen since the GFC. However, inflation is now down sharply on recent peaks and continues to edge lower, while interest rates are widely expected to have peaked, with talk turning to the likely timing of rate cuts. And with the real estate correction now all but complete, it does appear that we may now be at a turning point. We expect the underlying property market to enter a recovery phase in 2024, and already we see evidence of this in certain segments. That said, there will still be headwinds this year, as increasing numbers of business failures and job losses are likely to put upward pressure on vacancy.

The refinancing situation is likely to remain challenging, as existing loans taken out in the previous ultra-low interest rate setting continue to mature in an environment of significantly higher rates. As such, borrowers may face LTV breaches as a result of the recent repricing, and could be required to inject fresh equity or take on additional debt. However, our experience would suggest that despite market risks remaining elevated, there is certainly no widespread shortage of debt finance. Traditional lenders are likely to continue to focus their lending on certain preferred sectors, and provided assets are of a high quality and especially if there is a clear ESG transformation plan in place, they are still willing to finance. As the banks seek to limit their overall exposure to real estate, existing loans may not be extended repeatedly if the overall market outlook hasn't improved significantly this year, but the potential pool of alternative lenders that are ready to plug the gap left by the banks continues to grow.

### Market sentiment

#### European debt market sentiment remains subdued overall, but certain sectors are in demand

Overall sentiment in the European CRE debt market remains below par, although the mood did improve slightly in the fourth quarter of 2023. In particular, respondents in the latest CREFC quarterly sentiment survey were more optimistic about the availability of debt, as well as the economic environment and what that means for real estate fundamentals. Overall market conditions were still seen as negative on balance, although did see a notable improvement since the third quarter, which was largely driven by an uplift from UK-based investors.

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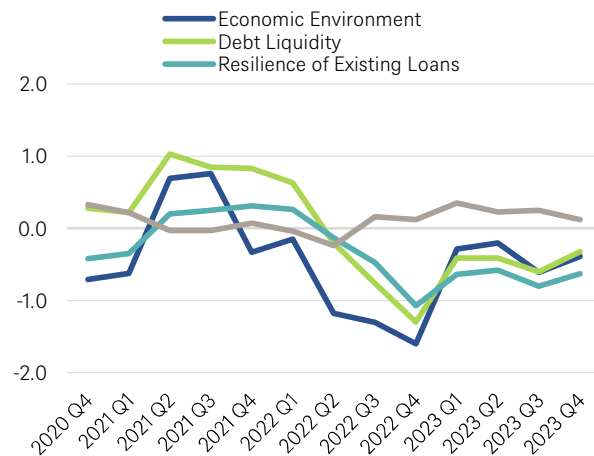
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By sector, all parts of the residential market, including multifamily residential, student accommodation and senior living, continue to be viewed positively, with expectations of higher rental growth, while hotels and industrial are also well regarded. Conversely, offices remain unpopular, with a widening gap in sentiment to the other sectors.<sup>1</sup>

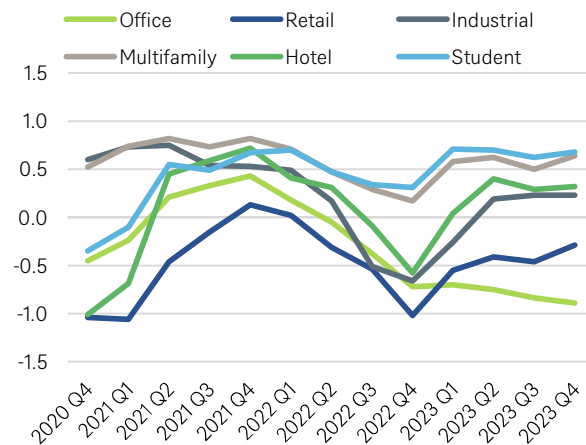
These trends are also mirrored in the German market, where a falling trend in both the inflation rate and market swap rates led to a slight uptick in sentiment in the fourth quarter, having reached a three-year low in the previous quarter. However, credit conditions are also reported to be tightening, with appetite for new lending volumes being dulled by the desire to minimize risk.<sup>2</sup>

### European Commercial Real Estate Debt Market Sentiment

Selected Sentiment Indicators



Sentiment by Sector



Source: CREFC, December 2023

### Tighter credit conditions

Margins are still edging higher as lenders remain cautious

The latest ECB Bank Lending Survey suggests that lending conditions in both the commercial and residential real estate sectors already saw a significant tightening in the fourth quarter of last year, and are expected to tighten further in the first half of this year. In the wider credit market, margins on new loans to enterprises continued to rise in three of the four largest Euro Area members. Other tightening factors such as stricter loan covenants, greater collateral requirements and smaller loan sizes also suggest that the banks are seeking an additional buffer against potential future losses given the current environment of a weaker economy and increased borrowing costs.<sup>3</sup>

In the real estate market, we estimate that senior lending margins across Europe have risen by around 50-75 basis points over the last two years for prime property, with around half of that increase coming through in the last 12 months. However, in some cases the increase has likely been even higher, particularly for secondary assets. In line with the wider ECB survey, we also see smaller loan sizes in the real estate market, with most lenders capping senior LTVs at around 50%, and sometimes even lower.

Sector preferences continue to be reflected in loan pricing trends as well, with office margins generally having risen by more than logistics or residential. In fact, the proportion of lenders actively financing office investments has fallen, with only around 70% of lenders currently doing so in Germany, compared to almost 100% just a few years ago.<sup>4</sup> Meanwhile, anecdotal evidence suggests that for the strongest assets in the logistics sector, for example, margins may even have started to see downward pressure, such is the level of competition between lenders.

<sup>1</sup> Real Capital News, CREFC, December 2023

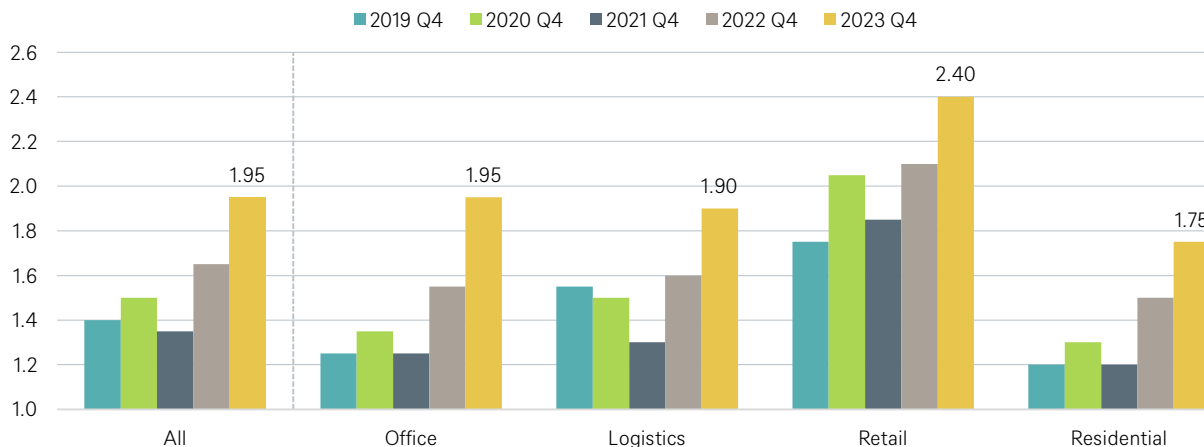
<sup>2</sup> BF.Quartalsbarometer, January 2024

<sup>3</sup> ECB Bank Lending Survey, January 2024

<sup>4</sup> BF.Quartalsbarometer January 2024

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**Weighted Average European Prime Senior Lending Margins by Sector (%)**



Source: CBRE, DWS, February 2024

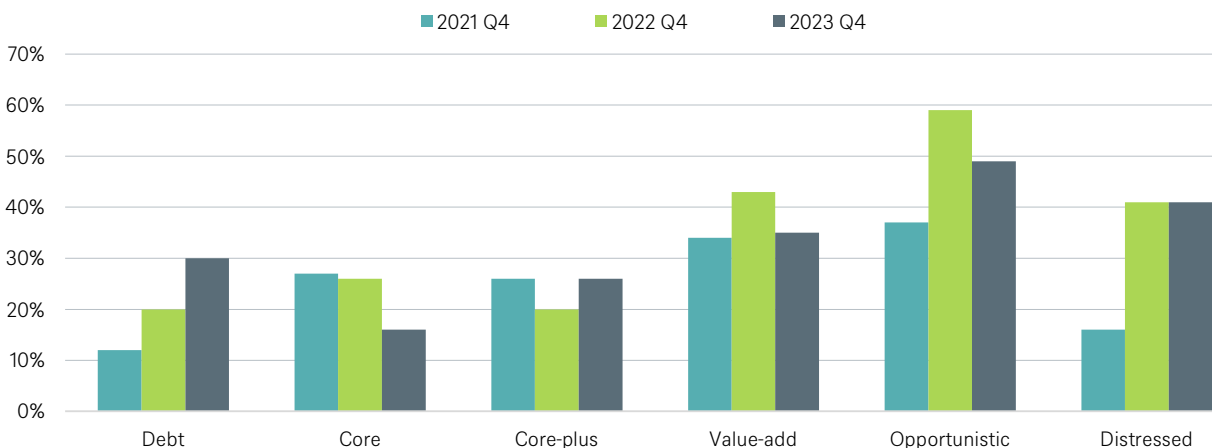
**Elevated return premium**

Strong risk-adjusted returns compared to other fixed income investments

Despite swap rates ticking upwards slightly in the first two months of 2024, they are still down significantly from their peak late last year. As such, all-in debt costs have seen a slight fall; however, we expect senior margins to remain elevated as ongoing macro risks and increased regulatory burden are likely to dampen appetite for new lending among the banks in particular. There are one or two rays of light in the economic outlook, not least surrounding inflation, yet the overall picture is still somewhat gloomy and lender caution is likely to remain a feature of the market in 2024.

Nevertheless, the returns from real estate debt continue to look attractive, both within the wider real estate market and in a multi-asset context. Recent survey evidence also shows that increasing numbers of investors are expecting attractive opportunities within the sector this year.

**Investor Views on Where the Best Opportunities Lie Over the Next 12 Months (% of Respondents)**



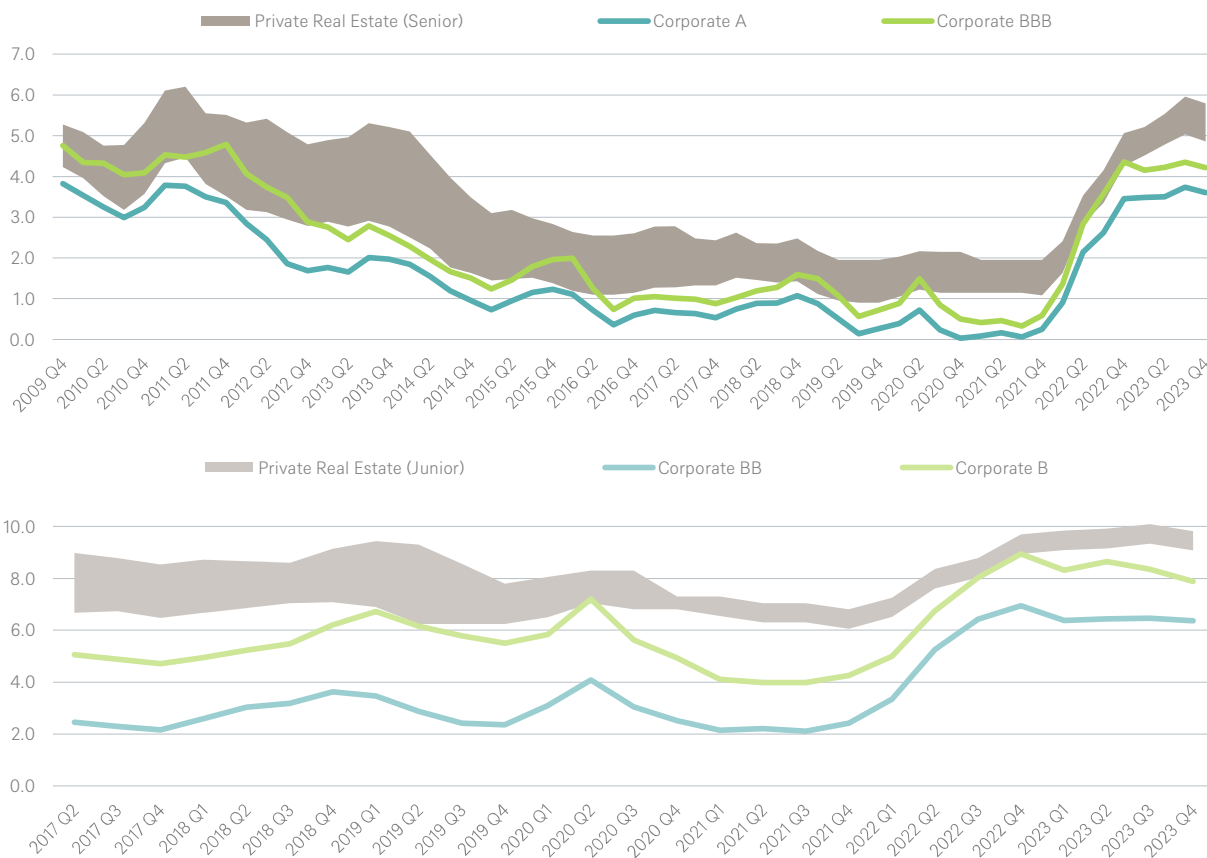
Source: Preqin, December 2023

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From a cash-on-cash perspective, our forecasts would suggest that a core real estate equity investment would yield a return of 4-5% over the next five years.<sup>5</sup> Based on current pricing a senior loan would achieve a similar cash return,<sup>6</sup> with a greater degree of downside protection. The return spread over corporate bonds has also picked up again over the last 12 months as well and now sits comfortably above its historical average. Since 2009, senior real estate debt has typically offered a premium of 50-100 basis points over equivalent-rated bonds, but that spread currently sits at 100-150 basis points – the highest for the past decade.

The historical bond spread for junior debt has been even higher at around 200-400 basis points, yet unlike the senior lending market, strong competition among alternative lenders further up the capital stack, as well as limitations on the ability of assets to generate enough income to service even higher junior rates, has kept margins in check over the past year. Nevertheless, with current returns of 9-10% for junior lending against prime property, this segment remains attractive. This is particularly the case for new lending, where valuations reflect current pricing, giving additional downside protection.

**Euro Area Real Estate Debt (Offices) vs. Corporate Credit Yield to Maturity (% , Quarterly avg.)**



Source: DWS, CBRE, S&P, February 2024. Data are quarterly averages. Private Real Estate: Total cost of debt (margin + swap + arrangement fee) for a five-year office loan in Germany, France, Netherlands, Italy and Spain. Corporate A: iBoxx € Non-Financials A 5-7; Corporate BBB: iBoxx € Non-Financials BBB 5-7; Corporate BB: Markit iBoxx EUR HY Non-Financials BB 5-7; Corporate B: Markit iBoxx EUR HY Non-Financials B 5-7.

<sup>5</sup> Net of fees; assuming 50% leverage.

<sup>6</sup> Net of fees

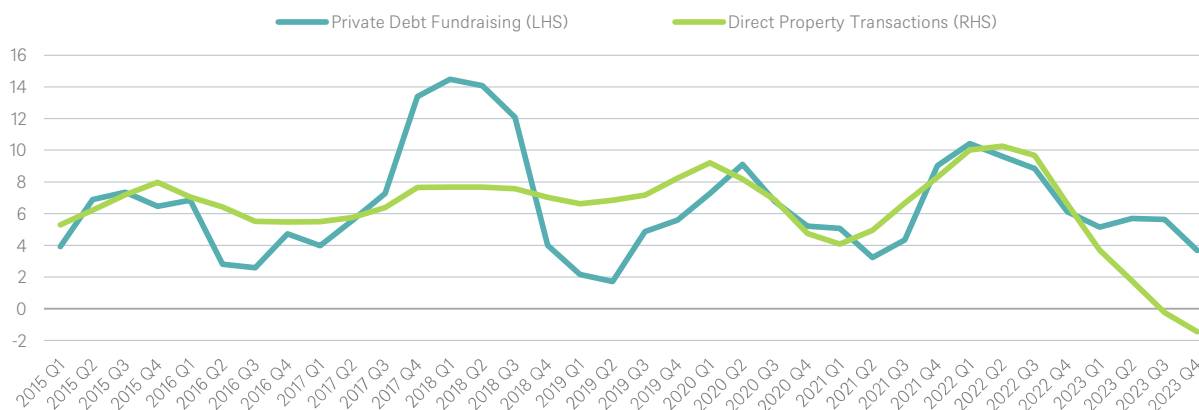
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## Debt market liquidity

Investment lending volumes remain weak, but there are a large number of refinancings on the horizon

The large jump in financing costs was a significant factor behind the real estate market recording its weakest year for direct investment in more than a decade last year. Transaction volumes in 2023 were around half the level achieved in the previous year, creating a dearth of new financing opportunities, and with a large amount of uncertainty also hitting wider market confidence, lenders have been more selective within the remaining pool of opportunities. Unsurprisingly, with a marked drop in market activity, fundraising for European real estate debt was challenging last year. Just eight funds reached a final close for a total of €3.7 billion, some 40% lower than the year before and around 60% lower than in 2021.<sup>7</sup>

### CRE Private Debt Fundraising & Direct Property Transactions (12 month rolling, €bn)



Source: Preqin, Real Capital Analytics, February 2024.

However, there are several reasons why we might expect the market to pick up during the remainder of this year and beyond. First, despite a shortfall in new investment lending, there will be a large number of refinancing opportunities coming through over the next couple of years.

CBRE estimate that that around €640 billion of private real estate debt was issued between 2019 and 2022. But given the recent sharp fall in property values and a decline in senior LTVs for new loans, a gap of more than €100 billion may need to be bridged as these loans mature over the next four years, even assuming a recovery in underlying property values over this period.<sup>8</sup>

Among this shortfall, there will undoubtedly be properties where the refinancing numbers simply won't stack up, leaving few options but to plug the gap with additional equity or to initiate an asset sale. But there should also be a sizeable number of opportunities to apply junior debt in addition to a new or extended senior loan, or to use a whole loan structure from a single lender.

A similar situation also exists within the public credit markets, where more than €150 billion in bond financing is due to mature within the next four years. Green Street have calculated that that the debt funding gap for the listed sector over this period could be as much as €30 billion.<sup>9</sup> Some of this will be refinanced at much higher rates on the public market, but some may also have to be replaced with secured bank lending or subordinated debt from alternative lenders.<sup>10</sup>

Second, the denominator effect is likely to have played a significant role in the lack of fundraising for real estate debt last year. While there are investors who specialize in real estate debt, a large proportion of investors' real estate allocations will consist of both debt and equity. And with equities and bonds underperforming during the post-pandemic period, investors

<sup>7</sup> Preqin, February 2024

<sup>8</sup> CBRE, December 2023

<sup>9</sup> Green Street, February 2024

<sup>10</sup> Scope Ratings, October 2023

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have been left overallocated to real estate, meaning a pause in new investments. But the denominator effect is ebbing now, as equities have seen a strong recovery and bonds have come back to some extent as well. This means that a growing number of investors may begin to restart investment in their real estate portfolios, and given the attractive risk-adjusted return, we believe that real estate debt offers a compelling story.

And finally, survey evidence suggests that non-listed real estate debt remains high up on many investors' lists of preferred investments. The latest INREV Investment Intentions survey shows that 84% of respondents are planning to increase their real estate debt allocations over the next two years, making it by far the most favoured route into the real estate market. The amount of capital being targeted by real estate debt funds currently in the market has also grown significantly, rising from less than €6 billion in 2019 to around €18 billion in 2023.<sup>11</sup>

## Rising distress

### An increase in non-performing loans could present opportunities for restructuring and workout solutions

With additional tightening having been widely perceived in the lending market, and with a growing number of existing loans likely to come under increased stress at renewal, this does suggest that defaults are likely to increase during the early stages of the recovery phase this year and next. ECB statistics for the third quarter of 2023 suggest that non-performing loans (NPLs) as a proportion of total gross loans in the wider banking sector remained low at just 1.8%, down from over 7% in 2015, although they have also cautioned over a potential increase in stress within the real estate sector due to rising refinancing and repayment risk.<sup>12</sup> Rating agencies have also issued similar warnings on the public side, highlighting interest-rate sensitive sectors such as real estate as being likely to see higher default rates this year.<sup>13</sup>

Following the Global Financial Crisis (GFC), non-performing loans ratios didn't peak until around five years after pricing bottomed out in the real estate market.<sup>14</sup> The situation was of course somewhat different at that time, with looser lending criteria and much higher LTVs being the norm, and much has been done in terms of financial regulation since then to shore up the finances of lenders and prevent a re-run of the same situation. Nevertheless, with rising bankruptcies in the wider economy and a still-significant funding gap in the real estate market, the prevalence of NPLs is very likely to increase in the coming years.

And with some of the NPL expertise built up by the banks following the GFC now having been eroded, this could present an opportunity for alternative lenders to step in, offering workout and restructuring solutions to institutional clients who are significantly exposed to defaulted loans but may lack the expertise to manage the exposure themselves.

## Investment strategy

### Sectors with strong underlying fundamentals offer strong risk-adjusted return potential

Given our view that underlying property values have now just about reached the bottom, we believe that on a risk-adjusted basis, a whole loan strategy looks particularly attractive. Whole loans, which typically offers debt at up to 65-70% LTV, can provide significant benefits for both the lender and the borrower. For borrowers, they provide access to higher leverage than a pure senior loan – which may become increasingly important as sponsors face upcoming refinancing shortfalls – with a single lender, thus reducing the complexity of the debt financing structure. The lender, meanwhile, can achieve a notable return premium over the senior part, while also retaining the senior position in the capital stack, allowing for greater control and providing more flexibility to manage the loan over its life.

Likewise, we still believe that junior real estate debt offers an appealing proposition, while the attractiveness of senior lending has also grown due to a significant rise in achievable returns. More generally, we continue to see the best opportunities for lending in the logistics and residential sectors. Office and retail remain more nuanced, with secondary assets generally undesirable due to the current weak demand environment for both sectors.

### Logistics

In the past, margins for logistics loans were usually higher than for the office sector, yet this is no longer the case as the recent strength and growing size of the logistics sector has proved attractive to lenders. Even so, we still see attractive risk-

<sup>11</sup> Preqin, February 2024

<sup>12</sup> ECB, January 2024

<sup>13</sup> Fitch Ratings, February 2024

<sup>14</sup> World Bank, February 2024

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adjusted returns for logistics lending. Despite some reduction in demand and an increase in vacancy over the past 12 months or so, the occupier market remains in a strong position. Development activity has also fallen away, meaning the market balance should improve quite quickly as demand picks up again over the medium term. Meanwhile, longer-term prospects should be buoyed by structural change, and a major repricing over the past two years should significantly reduce the risk of a further major fall in values, providing additional downside protection. We especially like urban logistics due to the compelling demand story, and given the potential shortfall in logistics supply in the short-to-medium term, development also continues to look attractive.

### Residential

The living sector remains a key focus, both for direct property investment and for debt. Margins for lending in the private rented sector (PRS) tend to be among the lowest of any sector, although with reference rates now at significantly higher levels, this part of the market still looks attractive from a return perspective. However, underlying property yields for this segment have increased less than other sectors, meaning that interest coverage can still be low. Other parts of the living sector, such as student housing, can offer a margin premium of 50-60 basis points over PRS,<sup>15</sup> while the income return also tends to be higher due to the smaller market size and greater element of operational risk. Multi-family residential, co-living and student housing all benefit from strong long-term demand drivers, and the supply outlook is also supportive.

### Office

Investing in the office sector, whether through debt or equity, is more challenging in the post-pandemic world, but we shouldn't write the sector off. For well-located prime assets, the underlying market fundamentals are still positive, and the generally poor sentiment towards the sector could open up opportunities to achieve higher lending returns for limited additional risk.

Weaker assets without green credentials and in non-central locations carry a markedly higher risk than they may have done five years ago, and this is reflected in a rising margin differential between prime and secondary offices. Higher borrowing costs for secondary assets add yet more risk to an already difficult market where occupancy and rents are both under pressure, and we do not currently see value in this part of the market. The exception here could be troubled assets where there is a clear path to improvement. This could be through significant refurbishment and improvements to green credentials or through change of use to sectors such as residential or hotel; however, location would play a vital role in determining whether such value-add strategies would be viable.

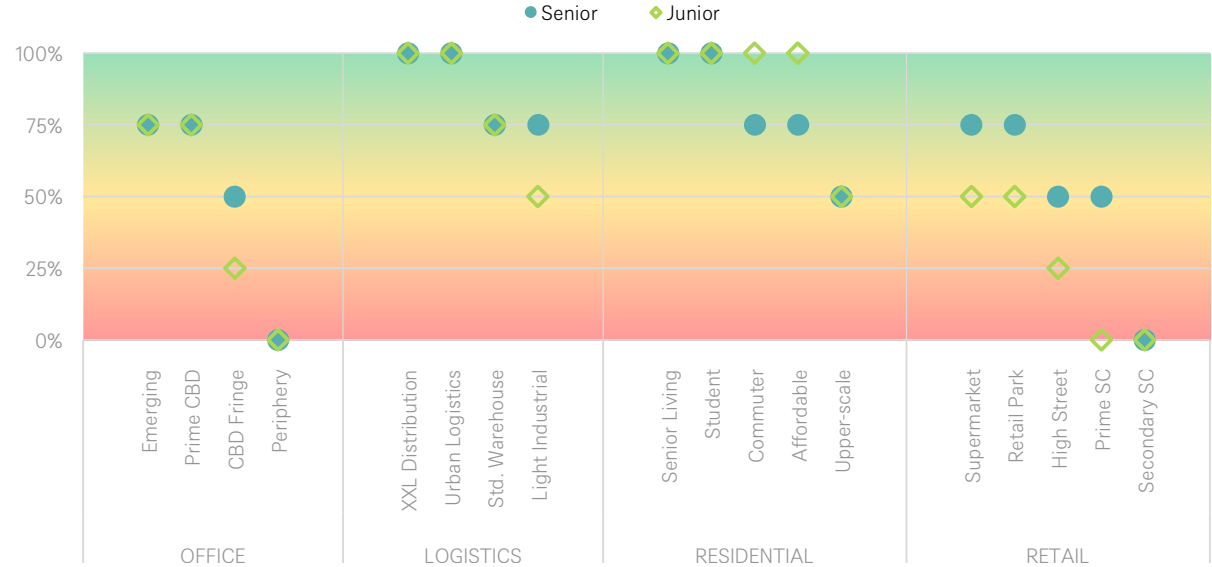
### Retail

Our view on retail remains negative on balance, as the structural headwinds impacting the sector look unlikely to abate in the near future. The high property yields currently achievable in the sector offer more headroom around servicing debt costs, although this assumes strong occupancy and a stabilised income. Shopping centres in particular remain challenging, as all but the very best centres continue to battle against rising vacancy, and the demand outlook is negative. The UK market is further along in its structural correction than Continental Europe, and there is perhaps less downside risk here as prices have already adjusted and rents have rebased. For the European market as a whole, we are moderately positive on supermarkets and retail parks due to the lower impact of e-commerce, although in both cases we would still tend towards lending at lower LTVs as the return is attractive enough without taking on additional downside risk.

<sup>15</sup> Bayes Business School, October 2023

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Private Debt Strategies by Subsector (Level of Conviction, %)



Source: DWS, March 2024

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