Europe Real Estate Debt Market Update

November 2024

IN A NUTSHELL

- After two years of restrictive lending conditions, falling inflation rates and weaker business indicators have led to a significant drop in interest rates and a gradual easing of financing conditions.
- Underlying real estate prices appear to have stabilised and we see the early signs of a market recovery, while the real estate debt sentiment reached its highest levels since the end of 2021.
- Recently, lending margins in the high-quality segment have eased due to increased competition, driven by subdued transaction volumes and the partial return of traditional bank lenders. Also, we estimate that the refinancing gap has narrowed due to improved refinancing conditions on the bond market. But all-in rates are still attractive and lending conditions remain favourable from lender perspective.
- European debt strategies marked a turning point, accounting for 40% of total fundraising for non-listed vehicles in 2023. We see opportunities for private vehicles to step in as traditional banks have tightened their portfolios, given higher risk provisions and regulation.
- We currently see the best opportunities in whole loan strategies across the UK, Germany, France, Spain and the Nordics, offering higher LTVs compared to traditional bank loans. But junior and senior loans also offer potentially attractive returns in the current market environment.
- We still prefer logistics and residential assets but strong price corrections in the office and retail segment offer selective opportunities, while hotels and niche sectors are becoming more attractive.

Current Market Conditions

Falling long-term rates support real estate and debt market conditions

We have seen significant falls in long-term rates and financing costs over the past months, while yield curves have steepened. The main drivers have been falling inflation rates and upcoming recession fears in the US due to a weakening labour market and the larger-than-expected rate hike in Japan (the first since 2007) that triggered a stock market sell off in early August and a partial unwinding of the yen carry trade. Lower growth and inflation expectations also raised market expectations of future rate cuts.

Euro five-year swap rates dropped from 3% in June to 2.2% in September, while five-year GBP swaps eased from 4.5% to almost 3.6%. Government bonds also saw a strong uptick as 10-year gilt yields came down by 80 basis points to 3.6%. The first-rate cuts in the Eurozone and UK also provided some easing for short-term or floating debtors like project developers. The BoE cut the base rate by 25 bps to 5.00% in August for the first time since 2020 while the ECB cut rates by 25 bps in June and September. Both swaps & bonds have moved out by 40-50 bps since mid-September as stronger than expected data releases and geopolitical uncertainty increased financial market volatility.

Easing inflation pressures across Europe and the UK should also set the path for further rate cuts. In September, headline inflation reached 1.7% in both the euro area and the UK, although inflation in the services sector and wage growth remained somewhat sticky. Inflation expectations also eased significantly with market based break-even rates at 1.4% in Germany and 1.6% in France. In the UK, survey-based consumer inflation expectations fell from 3.9% in January to 2.6% in June 2024. Lower inflation rates and worsening business indicators fueled rate cut expectations.[1]

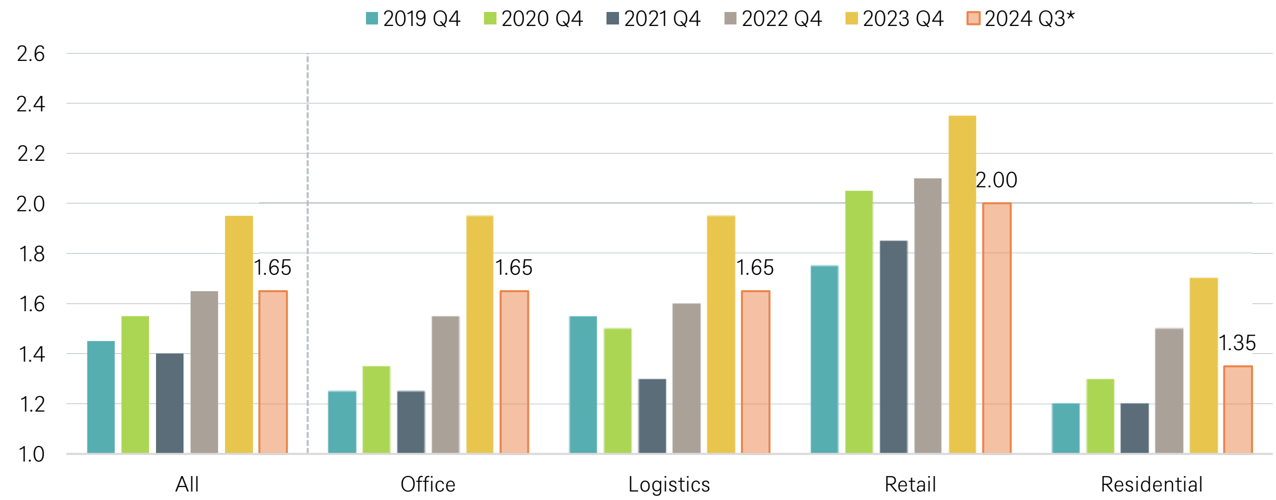
Underlying real estate pricing has stabilized and a handful of markets are even showing early signs of recovery as transaction activity is on the rise from a low level. It may probably take some time for the valuations to adjust, but transaction-based market prices, especially in the logistics and residential segments, are on the cusp of an upturn. Asset-level total returns in the European real estate market recorded the highest quarterly return in two years at +1.2% in the second quarter of 2024.[2] From a geographic perspective, the strongest quarterly returns were witnessed in Sweden, Portugal and the Netherlands, with the UK not far behind. On an annual level, year-on-year returns from the Real Estate Debt Fund Index significantly outperformed the wider Pan-European Quarterly Property Fund Index at 5.6% compared to -7.4%, respectively.[3]

The interest rate environment is still elevated compared to previous years and investment volume remain low as property owners wait for better exit prices. But real estate fundamentals are improving and with a narrowing price gap between buyers and sellers, an increasing willingness of lenders to deploy money can be observed. Lower benchmark rates should support the investment market and loan volumes are already showing some signs of strength. With volume of new debt being just half of 2022 levels across Europe, it rebounded to €15bn in the first half year of 2024, about double compared to the same period last year.[4] Restricted capital markets and high levels of loan extensions and restructurings by existing lenders have prevented higher volumes.

Also, increasing ESG requirements and the scarcity of quality projects eligible for financing have resulted in relatively low financing volumes. While core deals continue to be rare, there is growing demand for capex financings in order to meet rising sustainability standards. Moreover, we see increasing demand for niche segments like self-storage and data centres. The attractiveness of real estate debt has also improved significantly for borrowers over recent months thanks to the return of a positive leverage effect, as lower long-term rates and higher property yields have pushed the spread between prime yields and debt costs positive again. This should support the underlying transaction market as well as loan volumes looking forward.

[1] Macrobond, September 2024
[2] DWS, Property Performance Monitor Q2 2024
[3] MSCI Europe Quarterly Private Real Estate Debt Fund Index (Unfrozen) - EUR
[4] Dealogic, September 2024.

Senior debt margins by sector



*DWS estimate.
Source: CBRE, DWS. As of October 2024.

Signs of a real estate market recovery and stabilized prices increased the competition across lenders given the low transaction volume and the attractive returns for commercial real estate loans. We estimate that senior margins for European prime real estate debt peaked earlier this year and have since eased by around 25 basis points compared to the fourth quarter of 2023. Certain segments of the market may have experienced greater declines, while margins for lower quality assets remained stable due to limited liquidity. The strongest competition is seen among smaller loan tickets well below €100m where there is more pressure on margins. Lenders' focus is still on residential and logistics rather than office and retail.

Sustainability-linked loans continue to attract attention in the European real estate debt market as ESG credentials remain important for both lenders and borrowers. While activity has focused on corporate debt and investment grade loans, sustainability features are increasingly being incorporated into real estate debt. It is difficult to quantify the discount for ESG linked loans as an average margin premium, but we expect that non-energy efficient or obsolete buildings could find it even more difficult to get any financing at all.

Refinancing accounts for a major part of the overall real estate debt volume, driving demand for both senior and junior financing needs. JLL projects that US$3.1 trillion of real estate assets globally have maturing debt over 2024 and 2025, with US$2.1 trillion of debt which will need refinancing – approximately 30% of which has been completed over the first six months of 2024.[5] CBRE estimates that 27.5% of the loans issued in the EU between 2019 and 2022 cannot be refinanced, resulting in a gap of approximately €176 billion. In Germany, a financing gap of around €77 bn is expected between 2024 and 2027, which by now is likely to have significantly diminished. Providers of private debt have the potential to close the financing gap, as the LTV (loan-to-value) limits for a whole loan are higher than those for traditional bank loans. However, positioning is crucial, as not all business plans are worth supporting.

[5] JLL Research, October 2023.

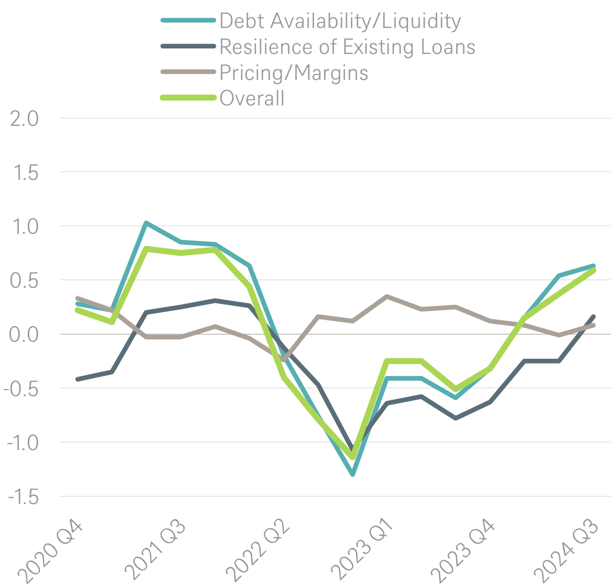
High refinancing needs due to the funding gap and an overall higher risk aversion of traditional bank lenders support the position of private lenders. In 2021, banks financed approximately 80% of CRE financing in Europe, compared to only 38% in the USA.[6] Due to tighter regulatory requirements, higher risks from falling capital values and rising numbers of non-performing loans, banks are becoming more restrictive in lending. Thus, we expect a medium-term shift in favour of private credit providers in Europe. Offices still represent the largest share of the total lending volume due to high refinancing needs in the sector.[7] But improving capital markets and the fall in swap rates and credit spreads may have lowered the funding gap most recently. Many real estate corporates used the improved conditions of tighter credit spreads and margins for refinancing via the bond market.

Debt sentiment has reached a trough

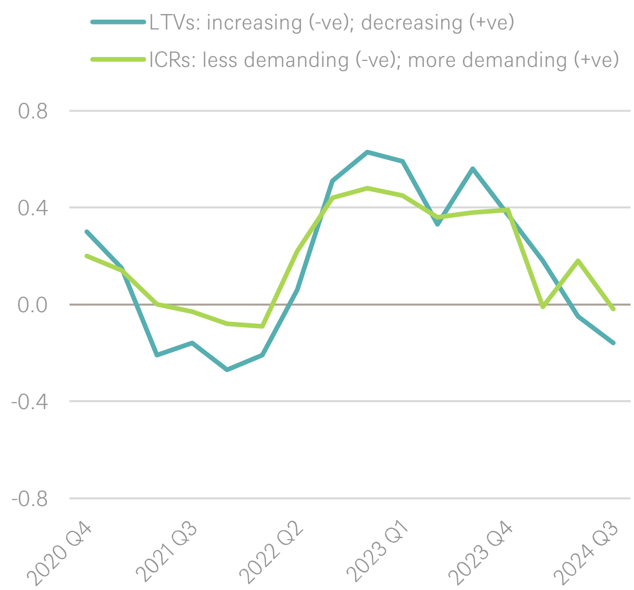
Sentiment on the verge of a turnaround after two years of deterioration

European Commercial Real Estate Debt Market Sentiment

Selected Sentiment Indicators



Financial Covenant Sentiment (New Loans)



Source: Real Capital News, CREFC, September 2024

After two years of deterioration, overall debt market conditions reached their highest levels since 2021 Q4. Less restrictive monetary policy, lower financing rates and the improved economic outlook were the main drivers of the enhancement. Debt sentiment has improved across all subsegments, and we expect a further recovery. The growing optimism was most pronounced in the UK compared to Ireland and Continental Europe, as it is the most liquid and institutionalized market (and therefore, was the first to correct). In continental Europe, debt sentiment for volume of new business saw the strongest uptick. Debt availability as well as resilience of existing loans also saw improvements as rising investment activity increased lenders willingness to deploy money.

[6] Candriam, World Economic Outlook Database (IMF)
[7] Real Estate Capital Europe, September 2024

While most lenders remain reluctant to lower their expectations regarding equity and covenant requirements, falling interest rates are enhancing borrowers' debt-service coverage. ICRs have stabilized after two years of tightening. Improving overall credit conditions and a contraction in loan margins resulted in higher loan-to-value ratios, up from about 55% to 60% on average in the UK. Shrinking all-in debt costs by about 100 basis points to 5.5% in the UK helped to stop further tightening of covenants.

Real Estate Debt Fund Raising

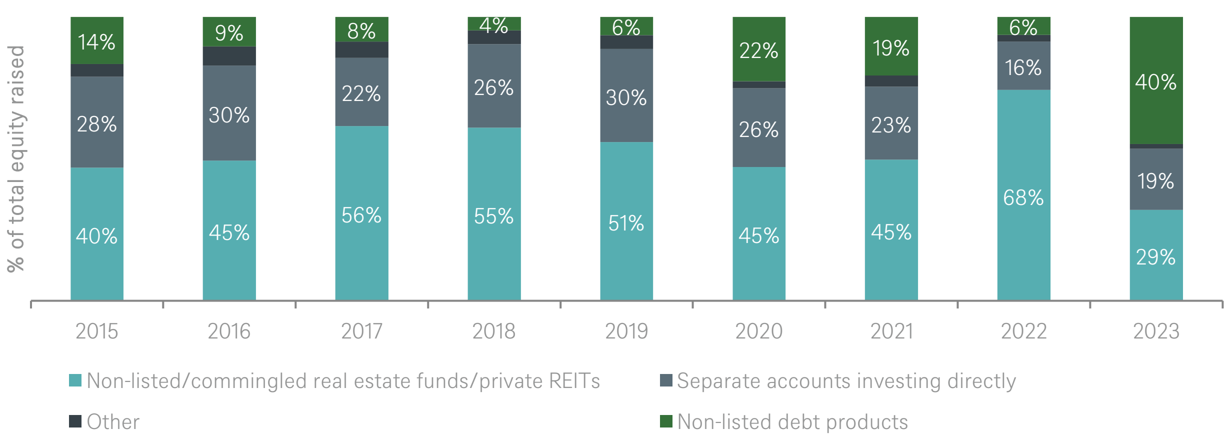
European debt vehicles show impressive performance with strong focus on residential

Globally, non-listed equity funds attracted the lion's share of capital raised in 2023 with 39%, followed by non-listed debt products with 24%. This is one of the highest shares for debt products since the inception of the survey, reflecting investors' continued appetite for the attractive risk-return profile of this slice of the non-listed asset class. European investors showed a particularly strong preference for non-listed debt products during 2023. However, with volumes on a very low level.[8]

With 40% of total equity raised, European non-listed debt strategies marked a turning point, leaving non-listed equity funds in second place with just 29%. Debt vehicles were particularly favoured in relation to alternative sectors. The residential sector stands out, with 81% of the capital raised for the European residential strategies in 2023 targeting private debt. Non-listed funds and debt funds showed the most diversified investor base, both by investor type and origin.

The substantial amount of dry powder accumulated over the last few years should be ready for deployment as market participants feel the end of the cycle is nearing. With a significant number of investors pivoting to debt strategies, combined with the lack of debt origination in the last year, lender liquidity is strong. Nevertheless, it should also be noted that the total volume of raised capital was significantly below previous years. However, given the refinancing needs as well as more restrictive capital requirements for banks, we expect the set of opportunities for alternative lenders to widen, in particular in Continental Europe.

Europe: Capital raised by Vehicle Type



Source: INREV, Capital Raising Survey 2024

[8] INREV, Capital Raising Survey 2024

Investment strategy

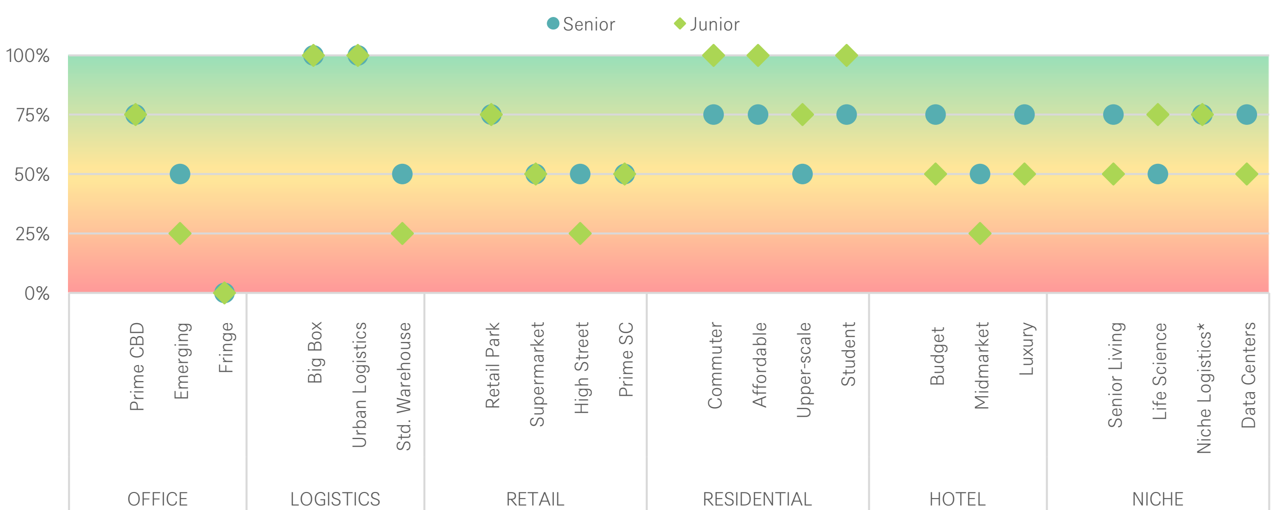
UK in focus given positive credit spread; niche sectors like self-storage and data centres look attractive

Major European economies are still heavily reliant on traditional bank finance where, for the most part, banks are in risk-off mode and are unwilling to countenance new or non-sponsor borrowers. Rising risk provisions and stricter lending standards have seen traditional banks tighten their portfolios, focusing on preserving capital and steering clear of risk-heavy deals. We expect this trend to continue as banks are switching from internal based calculation models to more standardised approaches and the number of delinquencies on CRE loans picked up. As a result, private debt funds are stepping in as the source of capital for many developers and property owners which in turn often use loans from traditional banks as back leverage.

Germany saw a particularly strong increase in delinquencies, with commercial real estate NPL (Non-performing Loans) ratios rising from 2.2% to 5.0% between March 2023 and March 2024.[9] With traditional banks tending to retreat from real estate financing, alternative lenders–especially private debt funds–are rapidly stepping in to fill the void. For Germany, which has traditionally been undercapitalized and heavily reliant on traditional banks as capital providers, this offers opportunities in the current market environment. We see strong demand for capital injections into development projects when the lender and/or sponsor ran out of money or bridging loans when there are LTV covenant breaches. Also, there is still a huge refinancing need for prolongations when capital values are down, and traditional lenders would not provide the same amount of leverage.

The UK seems ahead of continental Europe in terms of transaction activity. While some lenders focus more on their current exposures and prolongations, other are actively seeking new funding opportunities to make up for reduced lending over past two years. The market for average loan volumes of around €100m is highly competitive delivering deep liquidity for borrowers but mainly for the high-quality part of the market which ticks all / most boxes. The larger end also remains well capitalised with non-bank lenders increasingly able to support significant underwriting previously reserved for the banking community. The segment of the market with loans under €40m still remains less crowded and seems attractive.

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



*Cold Storage, Self-Storage, Airport Logistics

Source: DWS, October 2024

[9] European Banking Authority, EBA Dashboard Q1 2024

Overall market focus is still skewed towards defensive sectors, with residential assets garnering the most attention. Due to relatively low margins and a positive sector outlook, we favor junior loans and operational segments such as student housing and co-living. With relatively stable yields, a significant supply gap across Europe, and strong rent growth prospects, residential assets are our top choice. Affordable housing and ESG-compliant refurbishments are also highly attractive from a lender's perspective.

Logistics continues to be in high demand, benefiting from increased transaction activity in the sector. We maintain our positive view on the sector as reduced development activity and robust occupier demand support solid long-term fundamentals. However, recent high completion rates and a moderate industrial outlook necessitate a more selective approach in certain parts of the market. We remain focused on urban and last-mile logistics properties in central locations and we favor both senior and junior loans due to their appealingly high margins compared to other sectors.

While office remains out of favour, the large volume of refinancing needs and attractive margins may offer good returns for significantly corrected capital values. Here, we would focus on best-in-class offices with strong ESG credentials in good locations via both senior and junior loans. Mezzanine financing and bridge loans are increasingly in demand for restructuring projects. We also see more refurbishment and redevelopment projects involving conversion to other uses offering attractive debt returns.

We have also seen strong activity in the hotel sector where where KPIs have improved. Luxury products in prime locations are in focus, where higher leverage and reducing margins can be delivered, although we also see strong demand for Core+ and Value Add assets with refurbishment potential and higher avilable margins in the budget segment.

Additionally, we are increasingly favoring niche segments such as data centers, life sciences and niche logistics given significantly lower LTVs, better covenants, and and higher credit spreads over the risk-free rate compared to the traditional beds and sheds sectors.

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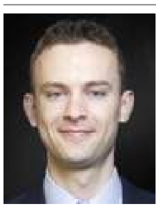

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Counterparty risk – A financial institution or other counterparty that underwrites, distributes, or guarantees any private credit investments or contracts that the strategy owns or is otherwise exposed to, may decline in financial health, and become unable to honor its commitments. This could cause losses or could delay the return or delivery of collateral or other assets.

Prepayment and extension risk – When interest rates fall, issuers of high interest debt obligations may pay off the debts earlier than expected (prepayment risk), and the strategy may have to reinvest the proceeds at lower yields. When interest rates rise, issuers of lower interest debt obligations may pay off the debts later than expected (extension risk), thus keeping the strategy's assets tied up in lower interest debt obligations. Ultimately, any unexpected behavior in interest rates could increase the volatility of the strategy's yield and could hurt performance. Prepayments could also create capital gains tax liability in some instances.

Debt securities risk – Debt securities are subject to the risk of the issuer's or a guarantor's inability to meet principal and interest payments on its obligations and to price volatility.

Default risk – The issuers or guarantors of debt securities may fail to make payments or fulfil other contractual obligations.

Secured debt risk – Although secured debt generally will be secured by specific collateral, there can be no assurance that liquidation of such collateral would satisfy the borrower's obligation in the event of non-payment of scheduled interest or principal or that such collateral could be readily liquidated.

Second lien and subordinated loans risk– Second lien loans generally are subject to similar risks as those associated with investments in senior loans, and, because they are subordinated or unsecured and lower in priority of payment to senior loans, they are subject to additional risks, including the risk that the borrower may be unable to meet scheduled payments, price volatility, illiquidity, and the inability of the originators to sell participations in such loans.

Private investment risk – Private investments are highly competitive, less transparent, and illiquid.

PIK interest risk – Loans with a payment in kind ("PIK") interest component generally represent a significantly higher credit risk than coupon loans; may have unreliable valuations requiring continuing judgments about collectability and the value of any associated collateral; and the borrower could still default when the actual payment is due at maturity.

Direct Lending risk – The lender in privately offered debt is responsible for the expense of servicing that debt, including, taking legal actions to foreclose on any security instrument securing the debt. This may increase the risk and expense compared to syndicated or publicly offered debt.

Interest rate risk – In general, rising interest rates in the market will negatively affect the price of the direct lending investments. Sensitivity to a change in interest rates is more pronounced and less predictable in instruments with uncertain payment (or prepayment) schedules. Central bank monetary policy, rising inflation rates, and general economic conditions may cause interest rates to rise.

Illiquid portfolio investments risk – Private credit investments generally will be long-term and highly illiquid.

Valuation risk – There is no central place or exchange for private credit investments to trade. Uncertainties in financial market conditions, unreliable reference data, lack of transparency and inconsistency of valuation models and processes may lead to inaccurate pricing and other market participants may value direct lending investments differently.

High yield debt risk – High yield debt securities have historically experienced greater default rates than investment grade securities and are subject to additional liquidity and volatility risk.

Reinvestment risk – During periods of declining interest rates, an issuer of debt obligations may exercise an option to redeem prior to maturity, which could result in new investments with lower-yields.

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