Alternatives Research
Real Estate

May 2021

Marketing Material*

EUROPE REAL ESTATE DEBT STRATEGIC OUTLOOK

Second Quarter 2021

IN A NUTSHELL

_ Lenders have adopted a cautious approach over the last 12 months, especially around sectors such as retail and hotels. Pricing in certain parts of the market has already returned near to pre-crisis levels, but we expect further divergence between sectors given the rapid changes to shopping and working patterns.

_ A wider market recovery is expected to take hold over the next 6-12 months, and this is where the risks should start to diminish somewhat. With lending margins currently elevated, we could start to see junior debt in particular perform well on a risk-adjusted basis.

_ Logistics and residential would seem to offer the most attractive proposition, both for senior and junior lending. Retail as a whole looks challenging, and in many cases the higher return on offer is unlikely to justify the significant additional risk; however, we still see certain opportunities within the sector.

Current Market Conditions

European private real estate debt continues to grow in importance for investors. Last year represented a sharp slowdown in Europe-focused debt fundraising – with a general increase in risk aversion and a rapid drop in overall real estate transaction volumes – while the time taken to reach a final close also remained well above historical levels.[1] However, there is still a large amount of dry powder waiting to be deployed, and of those investors who currently invest in debt, over 40% surveyed recently said they planned to increase allocations to the sector over the next two years, with none of the remainder indicating that they plan to reduce allocations.[2] And as overall real estate transactions pick up this year, we expect debt fundraising activity to gather pace again.

Measuring market-wide loan terms through the course of last year was difficult due to fewer transactions taking place. In the United Kingdom, loan originations were down by 23% year-on-year and average loan sizes were down slightly. Almost a quarter of lenders surveyed didn’t lend at all over the first half of the year, although this figure dropped to just 11% in the second half.[3]

In both the United Kingdom and Germany, lenders are currently tending to focus their attention on offices, logistics and residential.[4] Retail and hotel financing is much more selective, with few lenders offering any sort of terms on shopping

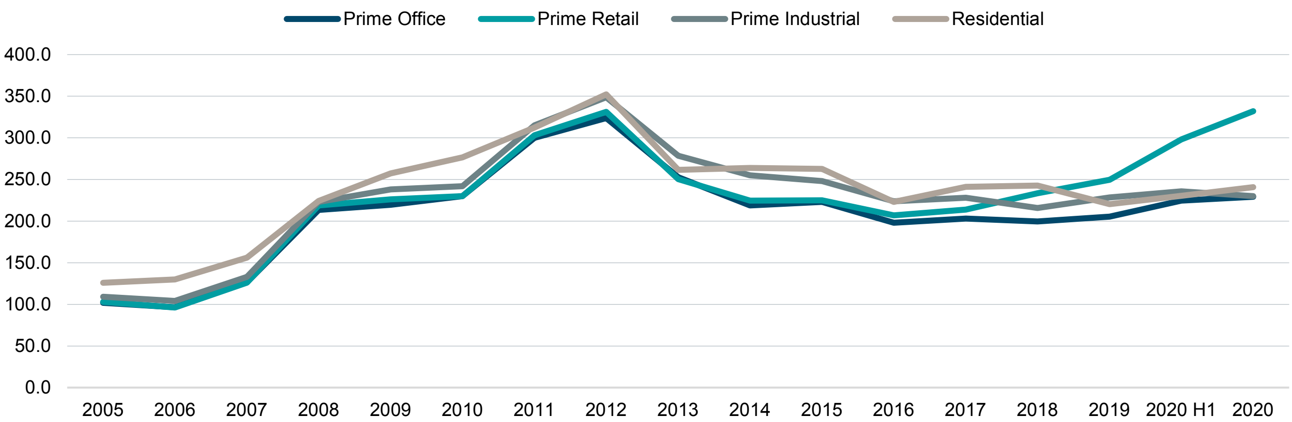
[1] Preqin, April 2021
[2] INREV, January 2021
[3] Cass Business School, April 2021
[4] Cass Business School, April 2021; IREBS, September 2020

centres or secondary hotels. So far, defaults on existing loans have been increasing, but have been minimised due to loans being extended or short-term refinancing. The full effect of Covid-19 is likely to show through further this year though. Europe's largest banks all increased loan loss provisions significantly in the first half of last year, which is an indicator of expected stress.[5] And as government support schemes for tenants and businesses are wound down and covenant testing holidays come to an end, more lenders are likely to trigger defaults and move to foreclose on properties not expected to recover.

Lending is likely to pick up this year, but accelerated changes to shopping and working patterns mean greater differences are likely to persist between sectors. Non-bank lenders in the United Kingdom increased their share of total new originations from 15% in 2012 to 25% in 2020, at the expense of the traditional lenders, although the ratio seems to have stabilised. But declining credit quality for certain riskier assets (e.g. retail) could mean that banks need to increase margins significantly (due to a higher risk weighting) so it is likely that exposure of such assets may be shifted to other lenders, with the banks unable to refinance them.[6]

Alternative lenders remain active on the junior side, accounting for the lion's share of junior originations in recent years – around 70%-80% of total junior lending in the United Kingdom since 2014, for example. But non-bank lenders would also need to plug the wider gap left by the withdrawal of traditional lenders, particularly from sectors such as retail.

U.K. SENIOR LENDING MARGINS BY SECTOR



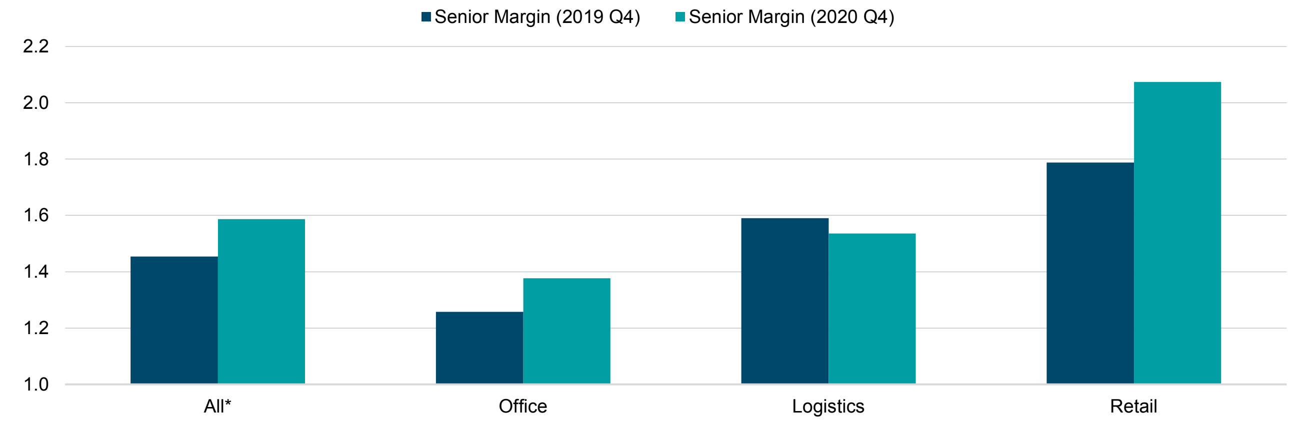
Source: Cass Business School, October 2020

Senior: Our experience suggests that on average, senior margins across Europe rose by somewhere in the region of 25-50 basis points after the onset of Covid-19 last year, yet moving into this year, terms in some markets and sectors were beginning to return towards pre-Covid levels again, and in some cases may have even dropped below.

Overall, margins on senior debt remain slightly higher than a year ago, before the pandemic took hold, while LTVs are down.[7] However, with swaps in negative territory at the end of 2020, the total return on offer to lenders actually fell slightly compared to early last year – and the fall would have been greater without the assumed zero floor on rates. That said, swap rates have come off their all-time lows early in 2021. In the first three months of the year, euro swap rates increased by 20 basis points, although were still firmly negative at -0.30%, while rates in the United Kingdom were up by as much as 50 basis points to reach their highest level since before the pandemic.[8]

[5] Knight Frank, February 2021
[6] Cass Business School, October 2020
[7] CBRE, March 2021
[8] Macrobond, April 2021

CHANGE IN EUROPEAN LENDING MARGINS (2020 Q4 VS. 2019 Q4)



Source: CBRE, DWS, March 2021
Note: *Excluding residential

Looking at the main commercial property sectors in more detail, there are clear differences in trends. The notable premium on offer outside the Core European markets remains in place. Excluding the retail sector, Germany, France and the Benelux countries are all trading at margins of 1.00%-1.20%, while Southern Europe, the United Kingdom and Ireland are at 1.70%-2.10%.

For both retail and offices, lenders still appear cautious, but particularly so for retail. Margins in the retail sector are up fairly universally and LTVs were typically around 5%-10% lower, with the exception of Germany, which was adjudged to remain unchanged. In most cases margins were also slightly higher for offices. London and Frankfurt continued to trade at pre-crisis levels, but margins in other markets including the Nordics, Benelux and Southern Europe remained 25-50 basis points higher, with LTVs slightly lower on average.

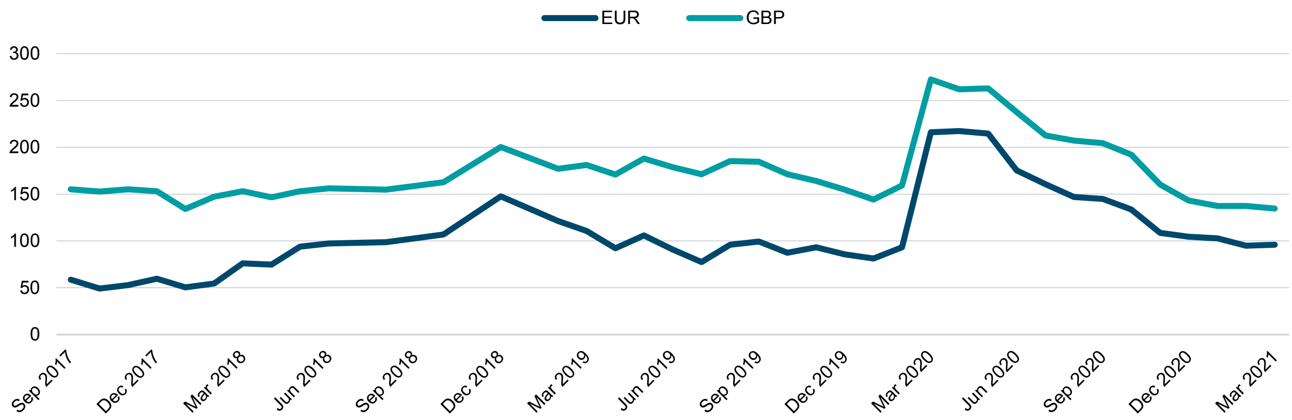
However, logistics margins are already largely back close to their pre-Covid levels, with one or two markets already undercutting their 2019 rates, while LTVs were largely speaking unchanged year-on-year, indicating that lenders are more confident here. Logistics margins in the Central European markets were up by around 25 basis points on average, Germany was unchanged, but all other regions saw fractional declines.

For residential, although data is more limited, anecdotally we see a similar situation to the logistics market. Continental European pricing remains generally lower than in the United Kingdom, with Germany in particular a tight market. In the United Kingdom, residential margins have actually widened a touch, moving out by around 20 basis points year-on-year.[9] This is perhaps due to increased home working and a desire for more space meaning people have been more inclined to move out of major cities during the lengthy periods of lockdown.

At the all property level, the public debt markets can also give us some insight into European senior debt pricing. Swap margins on both EUR and GBP bonds saw an initial spike of 100 basis points or more in March 2020. While this may not have been replicated in the private market – or at least there is little data to back up a trend on this scale – swap spreads on real estate bonds are now back to pre-crisis levels. In the CMBS market, spreads have also come back in some way. As of mid-April, euro CMBS spreads were sitting around 30 basis points above pre-crisis levels, having first spiked up to 150 basis points above.[10] The fact that CMBS spreads remain slightly higher in relative terms is likely to be reflective of the type of asset involved, but the general trend supports the view that pricing is not too far off where it was at the beginning of 2020.

[9] Cass Business School, April 2021
[10] JP Morgan, April 2021

EUR REAL ESTATE SWAP SPREADS (BPS, END OF MONTH)



Source: Markit iBoxx, April 2021

Junior: A higher level of caution among bank lenders during the pandemic has created potential opportunities for subordinated lenders. In Germany, the number of lenders offering mezzanine finance increased by 9 last year to reach 155, and those surveyed provided a total of €6.9 billion of mezzanine finance, up by almost 20% year-on-year. But even here lenders are being more selective on what type of property they will lend to at the moment. Almost all subordinated lenders in Germany continue to offer finance for both office and residential properties; however, retail and smaller niche sectors saw notable falls in the number of willing debt providers.[11]

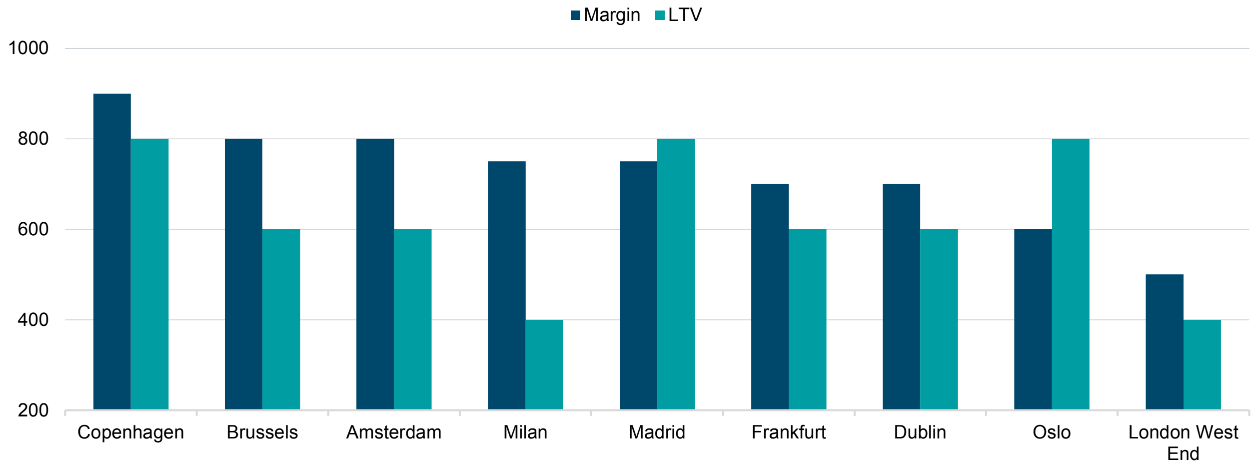
While mezzanine capital accounts for a relatively small proportion of overall financing – around 2%-5% of total outstanding loans in the United Kingdom, for example – within the European non-listed debt fund universe, almost 20% of the funds focused on subordinated lending, with a further 30% engaging in strategies including both senior and junior lending.[12]

In the United Kingdom, junior margins were reported to have risen by around 25 basis points for logistics, 50 basis points for offices and 75 basis points for retail during 2020.[13] In Germany, returns also appear to have increased, as a majority of mezzanine lenders achieved returns in the 10%-12% range, up from 9%-11% in the previous year.[14]

Elsewhere in Europe, upward pricing movement and a slight drop in LTVs were also suggested in one or two locations.[15] However, with fewer overall real estate transactions taking place, and lenders generally more risk averse, pricing movements for junior debt have generally been harder to ascertain. Our own experience suggests that pricing on the junior side has generally moved further than for senior over the past year, with sector trends mirroring those for senior lending.

[11] FAP, October 2020
[12] INREV, November 2020
[13] Cass Business School, April 2021
[14] FAP, October 2020
[15] CBRE, March 2021

EUROPEAN JUNIOR PRIME OFFICE LENDING MARGINS BY COUNTRY (2020 Q4)



Sources: CBRE, DWS, March 2021

Risk Analysis

Methodology: The basis for analysis in this paper is to compare the total cost of debt (i.e. the return for a lender) across markets and sectors. However, it is vital that we also consider risk. This should always be done at the asset level, although we can also make observations based on wider market conditions. Here, we use our historical, current and forecast direct real estate data to assess risk on the debt side. While we may also consider other elements that are harder to capture within the available data, the main risk factors we consider directly are:

_ **Occupancy risk**: measured by the current vacancy rate, as well as the short-term and long-term trends in occupancy.

_ **Interest Coverage Ratio**: a measure of the ability of a property's NOI (or rent in this case) to cover interest costs. We use ICR rather than DSCR as loans are assumed to be interest only for the purpose of this analysis.

_ **Debt yield premium**: a gauge of the lender's cushion vs. the property owner. The debt yield premium increases as LTV falls and also increases as property yields rise.

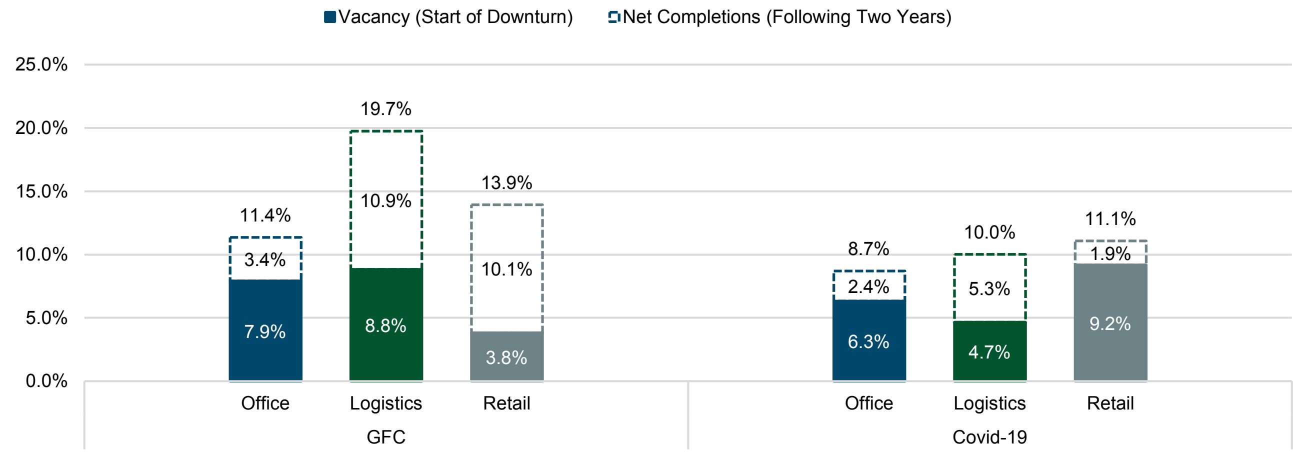
_ **Historical covenant stress test**: We look at the maximum historical peak-to-trough falls in rents and values in any rolling five-year period and assess how this would affect the current ICR and LTV covenants if repeated.

_ **Forecast covenant stress test**: We apply our maximum forecast fall in rents and values to the current ICR and LTV to assess whether any breach of covenant is expected. As retail is currently the only sector where we expect any notable fall in either rents or values, the other sectors are largely unaffected by this factor.

These risk factors are combined into an overall rating, and then compared against the lender's expected return to assess returns on a risk-adjusted basis.

Occupancy risk is clearly an important factor here, and in recent years European vacancy has generally been on a downward trend (with the exception of retail). Yet some markets are now seeing rising vacancy as demand is held back by the pandemic. However, compared to the previous downturn, the outlook does appear more positive. Going into the current downturn, vacancy was somewhat lower for both offices and logistics, and while we do expect some further rise in vacancy, there has been much less space under construction this cycle, taking away the element of oversupply that was present during the GFC.

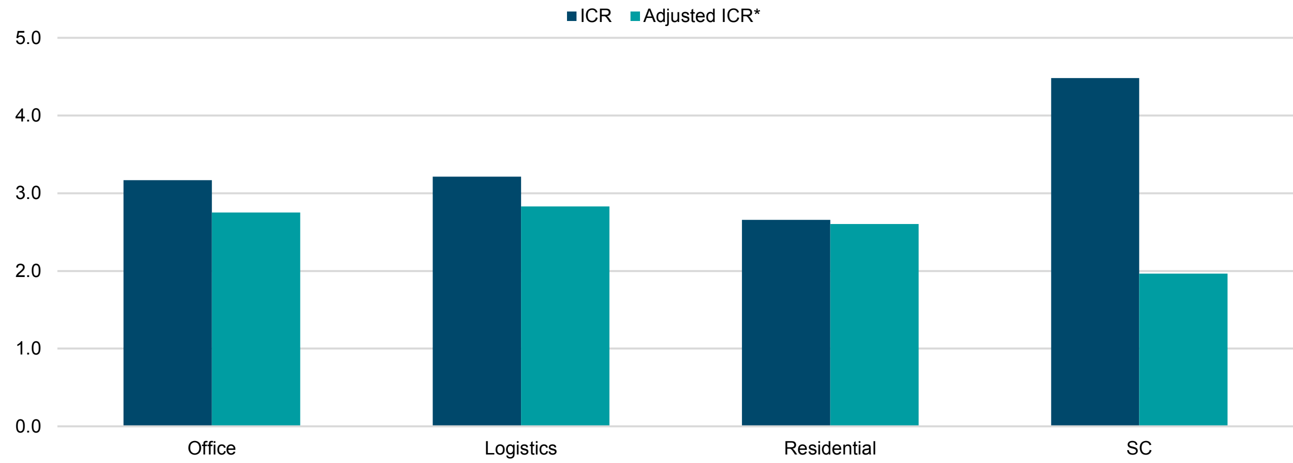
EUROPEAN VACANCY IN DOWNTURNS



Sources: DWS, JLL, PMA, April 2021
Note: Xxx…

One factor not included directly, but also relevant, is the ability for landlords to collect the rent as it becomes due. Retail rent collection in particular has been far lower since the onset of Covid-19, typically ranging anywhere from 40% to 90% across Europe during the past year.[16] On an absolute basis, retail lending returns in some markets could appear attractive, even accounting for some of the risk factors mentioned above. However, there are still significant risks on the occupier side. Prime shopping centre ICRs based on a fully occupied property paying all its rent in the United Kingdom would be over 4.0, and even accounting for an increase in vacancy, the ICR would be fairly comfortable. But with rent collection rates at 50% or less, this could push the ICR below 2.0.

INCOME RISK (UNITED KINGDOM)



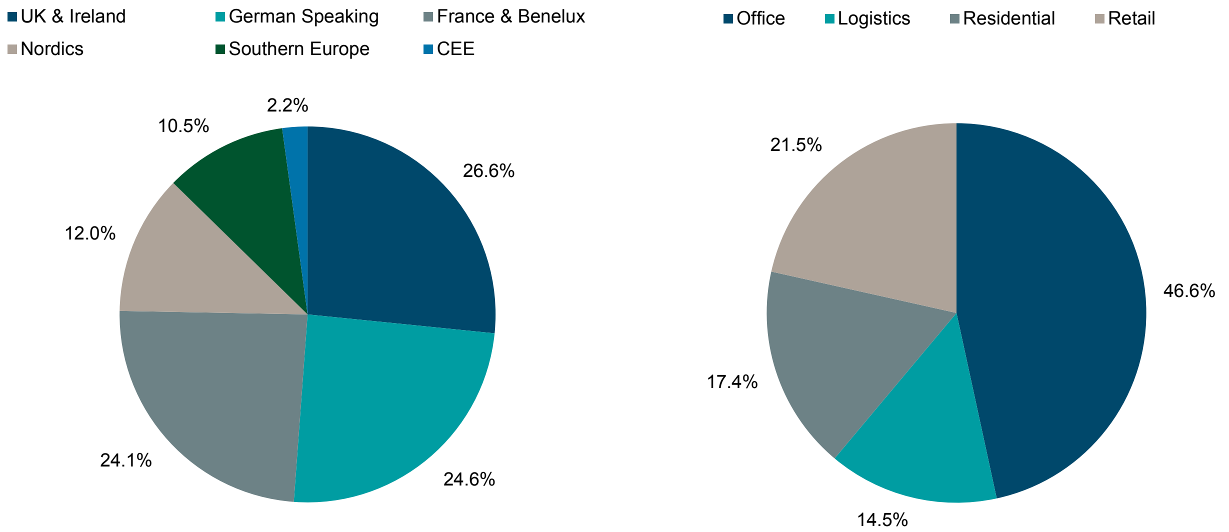
Sources: DWS, CBRE, PMA, April 2021
Note: *ICR adjusted for rent collection rate 2020 Q4

[16] Morgan Stanley, PMA, April 2021

Market Size and Portfolio Allocation

Private debt market: There remain few estimates of the size of the European real estate private debt opportunity by country or sector. In order to assess what a pan-European real estate debt portfolio could look like, the overall real estate market size (i.e. value of total market stock) therefore forms a useful starting point. Without comprehensive information on lending across all countries, drilling down further into the debt side is difficult, but the overall real estate market size represents a reasonable proxy for debt market size, given similar LTVs on recent originations and relatively similar trends in property values (between countries) over the last five years.

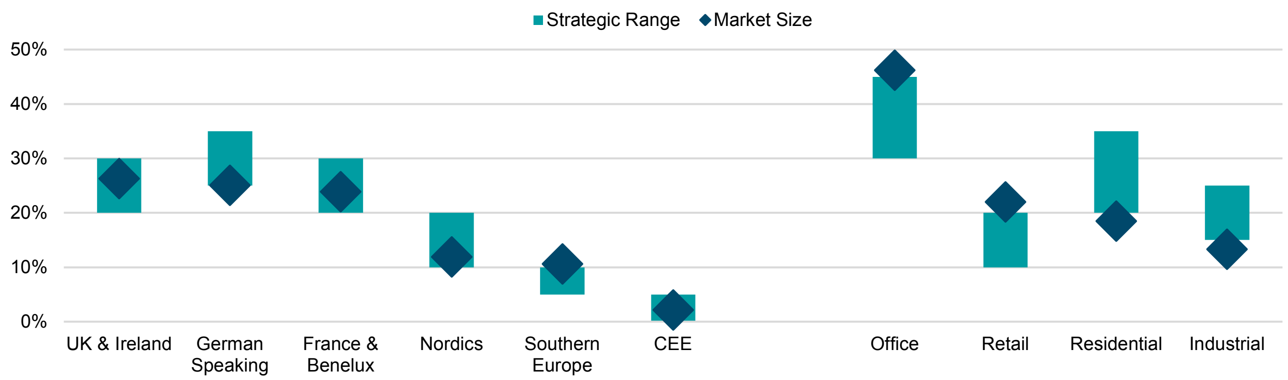
EUROPEAN REAL ESTATE MARKET SIZE BY REGION & SECTOR IN 2020 (USD TERMS)



Sources: DWS, MSCI, Real Capital Analytics, April 2021

Neutral portfolio: However, there are structural factors, relating both to the overall real estate market and specifically to the debt market, which might influence how much capital an investor wishes to allocate to a country or sector. Factors we take into account include volatility of capital values; investment momentum; transparency of the real estate market; country risk; institutional risk; general ease of doing business; ease of enforcement for lenders; investment sentiment and a forward looking measure of expected change in overall market value.

NEUTRAL PORTFOLIO WEIGHTING



Sources: DWS, MSCI, Real Capital Analytics, April 2021

After adjusting market size for these structural and longer-term cyclical factors, the resulting strategic allocation gives an indicative target range for a pan-European portfolio. It should be noted that this analysis is targeted at the whole debt market – the portfolio may look somewhat different for junior debt, with the United Kingdom, Germany, Southern Europe and the Benelux countries seeing more activity in this part of the spectrum.

Outlook & Investment Strategies

Here, we consider the risk and return on offer across countries, sectors and lending strategies, and examine where the best opportunities might lie. The return on offer from both senior and junior lending has increased compared to the beginning of 2020, however, the risks have also increased, for some sectors in particular. The real estate cycle has been disrupted by the Covid-19 pandemic, with all parts of the market seeing a reduction in direct property returns over the past 12 months. And despite vaccination programmes being well underway across the continent, the economy is not yet out of the woods.

Yet we see 2021 as the start of the recovery phase for large parts of the market. And it is at this point in the cycle that we could start to see junior debt in particular perform well on a risk-adjusted basis. The pandemic has brought with it significant economic decline, financial difficulty for (some) tenants, negative or weaker value growth across all sectors, and rising numbers of loan defaults. Being at the upper end of the capital stack, junior lenders are most at risk during this phase of the cycle. But with the recovery expected to take hold over the next 6-12 months, this is where the risks should start to diminish somewhat, and with margins currently elevated, junior debt begins to look attractive on a risk-adjusted basis.

Within the junior lending market, we feel that retail carries too much risk for the most part. However, there are still attractive opportunities elsewhere. Overall, logistics would be our top pick on a risk-adjusted basis, and we feel that Germany, the Benelux countries and Italy offer an attractive mix of risk and return in this part of the capital stack. Within the office sector, the Benelux countries would again seem to present the best risk-adjusted opportunities, benefiting from positive long-term occupancy trends and relatively stable values.

For senior lending, logistics again tops the table overall, and while the risks appear higher for offices in general, Italy, Portugal and Finland are offering stronger returns within both sectors without climbing too far up the risk curve. Absolute returns are lowest in the residential sector, but we feel this is justified to some extent by the lower risk. In the retail sector, we expect significant further capital value decline, but lending against prime assets at prevailing market LTVs of circa 50% should offer a buffer against potential value loss. Retail lending has the potential to increase portfolio returns, but we would remain highly cautious given the elevated risk of tenant failure or inability to meet rent payments.

Return outlook: At the all property level, for both senior and junior debt, our analysis largely confirms the expected risk-return relationship (i.e. higher return = higher risk) at the pan-European level, but drilling down to the country or sector level suggests where some of the opportunities may lie.

Senior:

_ At the all property level, the Core European countries are fairly tightly clustered in terms of risk and return at the low end of the return spectrum. The Nordics and France appear to offer marginally higher returns than Germany, without notable additional risk.

_ The United Kingdom offers a hedged return premium of around 50 basis points over Core Europe, although with some extra risk. There is also still some additional risk around the consequences of Brexit. The CEE countries and Southern Europe offer comfortably the highest returns, although with the exception of retail, risk is also generally the highest.

_ Overall, European retail is offering a notable return premium over the other sectors, but this comes at the cost of much greater risk. Within the sector, Southern and Central Europe look most attractive – low e-commerce penetration is a positive, although online sales are accelerating rapidly and will eventually begin to catch up with Core Europe. The United Kingdom offers the highest retail returns at similar levels of overall risk to Core Europe, but occupancy risks are significant and rent collection remains weak.

_ At the subsector level, there may be a limited number of opportunities within retail, such as supermarkets and to some extent factory outlet centres, which we would consider as potential higher-risk tactical plays. However, shopping centres and high street look more challenging. The best centres and retail destinations still have the potential to perform moderately well over the longer term, but the differential in performance between prime and secondary retail continues to grow. We would approach secondary retail with a great deal of caution, even for senior lending at lower LTVs.

_ Returns are generally similar for offices and logistics, but lower volatility and lower occupancy risk mean logistics tends to look more attractive from a risk perspective. Within each of the two sectors, there is not a great deal to choose between regions, as the risk-return relationship holds fairly well. Risks for U.K. logistics appear marginally higher, without being compensated by additional return, although it still looks relatively attractive in an all property context.

_ Within the office sector we would favour lending to assets in emerging and CBD locations over fringe and peripheral locations, as we expect a reduction in long-term office demand, with the majority of remaining demand to be focused on a smaller number of key locations. In the logistics sector, we are positive on most types of asset, although lending to last mile and last hour assets would be our top picks, given supply constraints and the accelerated trend in online sales spurred on by the pandemic.

_ Residential is tending to offer the lowest returns, but with a slight advantage over logistics in terms of risk (and a bigger advantage over offices). The United Kingdom looks slightly more attractive overall, offering higher returns than Core Europe, but at similar levels of risk. Within Core Europe, France and Germany are slightly behind the Nordics on a risk basis. For senior, we have a positive view on most strategies within the residential market, although we would be slightly more cautious on high end residential due to greater volatility in pricing.

SENIOR RISK & RETURN OUTLOOK

Senior Risk Profile / Return to Lender	75-125 bps	125-175 bps	175-225 bps	225+ bps
High		German Speaking Retail France & Benelux Retail	Nordics Retail	UK & Ireland Retail CEE Offices
Medium-high	German Speaking Office	UK & Ireland Office Nordics Office France & Benelux Office	Southern Europe Offices	CEE Retail Southern Europe Retail CEE Logistics
Medium-low	France & Benelux Residential	Nordics Logistics UK & Ireland Logistics	Southern Europe Logistics Southern Europe Residential	
Low	German Speaking Residential Nordics Residential	UK & Ireland Residential France & Benelux Logistics German Speaking Logistics		

Sources: DWS, CBRE, April 2021
Note: Return includes estimated hedging costs into euros where applicable

Junior:

_ With few lenders offering junior terms for retail at the moment, estimating market-wide pricing is more difficult. Retail margins are likely to be at least 100 basis points higher than offices for most markets – for some countries the spread is estimated to be as high as 400 basis points. But the risk rating is also significantly higher. Of all retail markets, Southern Europe appears to be the most attractive on a risk-adjusted return basis, although our analysis could easily underestimate the risks and even here we would be very cautious due to the longer-term challenges for the sector.

_ Logistics and offices are generally offering similar returns, but the risk rating for logistics is considerably lower. For offices we would be even more focused on CBD and emerging locations, and would exercise caution for secondary locations, where we see the greatest risk around occupancy and value decline. Logistics represents our top pick on the junior side, as we see strong ongoing demand from both occupiers and investors across the different parts of the sector.

_ In terms of region, Benelux logistics and offices look relatively attractive, offering similar hedged returns to other parts of Core Europe at lower levels of risk. Southern Europe doesn't appear to offer much of a return premium, yet levels of risk are higher.

_ At a return of less than 5.0%, junior U.K. offices and logistics don't look particularly attractive on a risk-adjusted basis relative to Continental Europe, although in reality many junior lenders are likely to lend at rates closer to those in Germany or the Benelux countries,[17] which starts to make the U.K. look more attractive.

JUNIOR RISK & RETURN OUTLOOK

Junior Risk Profile	400-600 bps	600-800 bps	800-1000 bps	1000+ bps
High			UK & Ireland Retail Nordics Retail	France & Benelux Retail
Medium-high		German Speaking Retail Southern European Offices	Southern Europe Retail	
Medium-low	UK & Ireland Offices	German Speaking Offices	Nordics Offices Southern Europe Logistics	
Low	UK & Ireland Logistics	German Speaking Logistics	France & Benelux Offices France & Benelux Logistics	
	Return to Lender			

Sources: DWS, CBRE, April 2021
Note: Return includes estimated hedging costs into euros where applicable

[17] Cass Business School, April 2021

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Investment in real estate may be or become nonperforming after acquisition for a wide variety of reasons. Non-performing real estate investment may require substantial workout negotiations and/ or restructuring. Environmental liabilities may pose a risk such that the owner or operator of real property may become liable for the costs of removal or remediation of certain hazardous substances released on, about, under, or in its property. Additionally, to the extent real estate investments are made in foreign countries, such countries may prove to be politically or economically unstable. Finally, exposure to fluctuations in currency exchange rates may affect the value of a real estate investment.

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_ Adverse changes in economic conditions including changes in the financial conditions of tenants, buyer and sellers, changes in the availability of debt financing, changes in interest rates, real estate tax rates and other operating expenses;
_ Adverse changes in law and regulation including environmental laws and regulations, zoning laws and other governmental rules and fiscal policies;
_ Environmental claims arising in respect of real estate acquired with undisclosed or unknown environmental problems or as to which inadequate reserves have been established;
_ Changes in the relative popularity of property types and locations;
_ Risks and operating problems arising out of the presence of certain construction materials; and
_ Currency / exchange rate risks where the investments are denominated in a currency other than the investor's home currency.

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