Europe Real Estate Debt Strategic Outlook

May 2023

IN A NUTSHELL

— Surging interest rates have slowed commercial real estate investment and lending activity. The recent banking turmoil has increased the risk aversion of traditional lenders and further tightened financing conditions, resulting in higher margins and lower required loan-to-values (LTVs).
— The reduced credit availability from traditional lenders and higher margins creates an attractive opportunity for private debt strategies as underlying real estate fundamentals remain robust. Looking ahead, we expect institutional investors to increase capital allocations to private real estate debt.
— Increased benchmark rates and lending margins for real estate senior and junior debt provides attractive risk-adjusted returns relative to investment-grade corporate bonds and real estate equity investments, especially from a cash-on-cash perspective.
— Reduced debt availability in the market allows for a more selective approach as we see higher risks compared to a year ago, including borrower and tenant default risks, and valuation write-downs. We prefer residential and logistics but are more cautious on secondary office properties given the demand polarisation. We also see opportunities in lending for manage-to-green and repositioning strategies across all sectors, with sustainability factors lowering vacancy, raising rents, sustaining values and supporting the servicing of debt.

Current Market Conditions

Commercial real estate lenders face higher risks but also find attractive opportunities

The cost of debt has risen sharply over the past twelve months. Despite this, traditional lenders have become increasingly selective in their approach to the real estate sector, reflecting the weakening economic outlook, falling values and concerns over interest coverage. Senior margins continue to rise and average LTV ratios have declined across all sectors, trends that have only been exacerbated by the recent turmoil in the banking sector.

The current slump in investment volumes may be limiting the origination of new financing opportunities, but there is certainly no shortage of refinancing requirements. It is estimated that up to €150 billion of commercial real estate loans are set to mature across Europe in the coming two years.[1] This could create some challenges for the real estate industry as a whole, particularly as commercial banks continue to reduce their exposure, while according to Scope Ratings, a third of European commercial mortgage-backed securities maturing in the coming two years are subject to “very high” refinancing risks.[2]

[1] Evercore, Greenstreet January 2023
[2] Scope Ratings, March 2023

This backdrop should create opportunities for private debt, particularly junior facilities as LTV ratios are cut. Given the recent increase in return from private debt, as well as the downside protection from further value decline, the strategy has certainly grown in attraction for many institutional investors. This was most evident in the latest INREV investor intentions survey, with 79% of respondents expecting to increase their allocation to non-listed real estate debt over the next two years – more than any other route into the market.[3]

Surging interest rates affecting commercial real estate investment volume and pricing

The environment of higher inflation and interest rates, together with slowing economic growth, has finally taken its toll on real estate performance. Prime yields have risen sharply across all markets and sectors. No part of the market has escaped unscathed, with even previously strongly performing sectors such as residential and logistics recording large falls in value in response to rising yields.

Although valuations are still lagging where assets would likely trade today, we expect that the full extent of this correction will be realised by the middle of this year. By this point, we anticipate that European values will on average have fallen by around 20%, with much greater falls recorded across weaker quality, secondary assets, particularly in the office sector. Complicating the refinancing of existing loans, debt yields and ICRs for new loans could benefit.

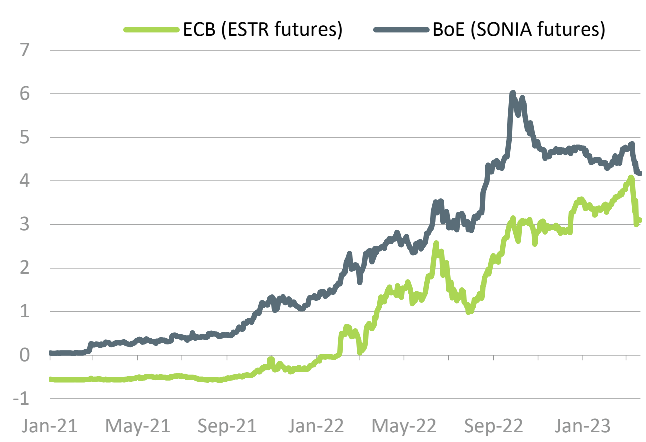
The hiking cycle nearing its peak

Tightening financial conditions from banking turmoil could help to bring down inflation

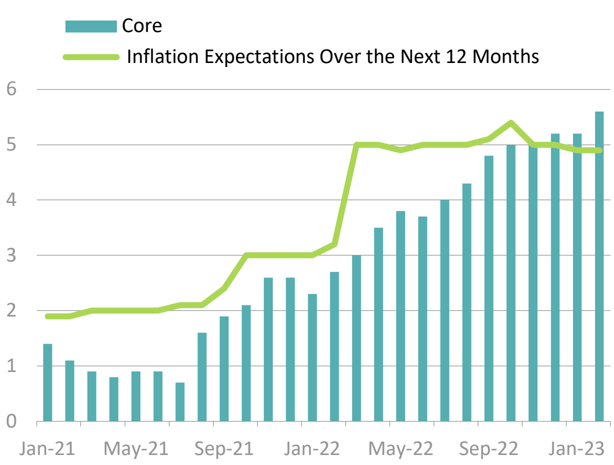
Eurozone inflation is now falling. Having peaked at close to 11% at the end of last year, the latest estimates are now close to 7%. It's still however too early for central banks to declare victory. Price growth remains well above target, while core inflation remains sticky. With labour markets also showing few signs of weakness, we don't believe we've seen the last of the ECB rate rises, with the deposit rate projected to rise another 75 basis points to 4% this year.[4]

The recent stress in the banking sector has led some to question whether central banks will continue to raise rates by as much as previously expected, with market-implied rates falling back since the middle of March. On balance, we believe central banks still see greater risk in "de-anchoring inflation" than in "overtightening", nonetheless this does suggest we may well see the peak in central bank tightening over the coming 6-12 months, with borrowing costs moderating over the medium term.

Market Implied Central Banks Target Rates



Euro Area Core Inflation, YOY Change in %



Source: Macrobond, Eurostat, March 2023

[3] INREV, January 2023
[4] DWS CIO View, May 2023

Market Sentiment

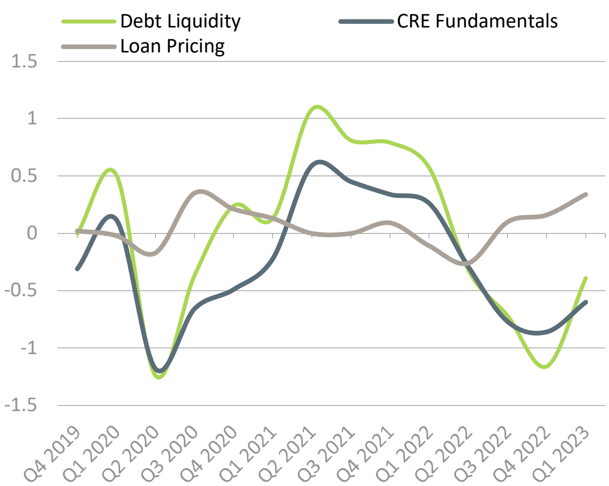
European sentiment recovered from a low in the fourth quarter except for office and Germany

The sentiment among European real estate financing professionals saw an uptick in the first quarter of 2023 compared to the end of last year. However, debt liquidity and real estate fundamentals indicators continued to screen negative.

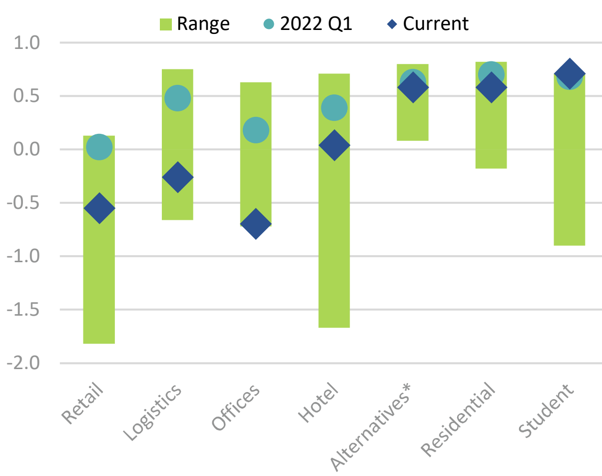
Overall financing sentiment dropped to a particularly low level in the United Kingdom, driven by the bond market turmoil from the mini budget and related market volatility: 51% of respondents viewed overall market conditions as “significantly worse” compared to 19% for continental Europe. German real estate lenders’ sentiment has fallen to a record low for the second consecutive quarter. Sentiment dropped to -19.44 points in the first quarter of this year, driven by low lending volumes and rising liquidity costs.[5]

European Commercial Real Estate Debt Market Sentiment

Overall Sentiment (change from the previous quarter)



Sector Sentiment Q1 2023



Source: Real Capital News, CREFC, March 2023

The improved first quarter results came on the back of an improved economic outlook and higher interest rates, although the survey was conducted at end of January and doesn’t reflect the stress of recent developments in the banking sector. The office market was exception, where weakening sentiment towards secondary stock further weighed upon sentiment, while student housing and residential have held up well given expectations for strong rental growth.

Traditional banks may increase the (re)financing gap

Banks are more risk averse and scaled down their order books while REITS increase financing outside the bond market

The fastest rate hike cycle in three decades in the United Kingdom and the strongest ever since the euro area was established has not only pushed up interest rates but also led to a significant tightening of credit conditions. The ECB bank lending survey in the fourth quarter of 2022 reported a substantial tightening in credit standards for all loan categories and a further move in margins. The net tightening of loans to enterprises was the largest reported since the euro area sovereign debt crisis in 2011, driven by higher margins and collateral requirements.

Bank expectations of further tightening of credit standards and terms and conditions over the coming six months were strongest for commercial and residential real estate. Risk aversion in the banking sector could further increase the refinancing gap for commercial real

[5] BF Quartalsbarometer Q1 2023

* e.g. healthcare and senior living

estate, further reducing bank lending to the sector. The share of traditional bank lenders in the United Kingdom has already dropped from nearly 100% in 2012 to just about 60% in the second half of 2022.[6]

Refinancing on the bond market has become relatively more expensive. The yield spread on publicly traded real estate increased on average to circa 185 bps over the risk-free rate[7], an increase of circa 90 basis points compared to January 2022.[8] This may drive listed companies to seek alternative financing outside the bond market, especially for unsecured debt.

Higher margins, liquidity costs and lending requirements

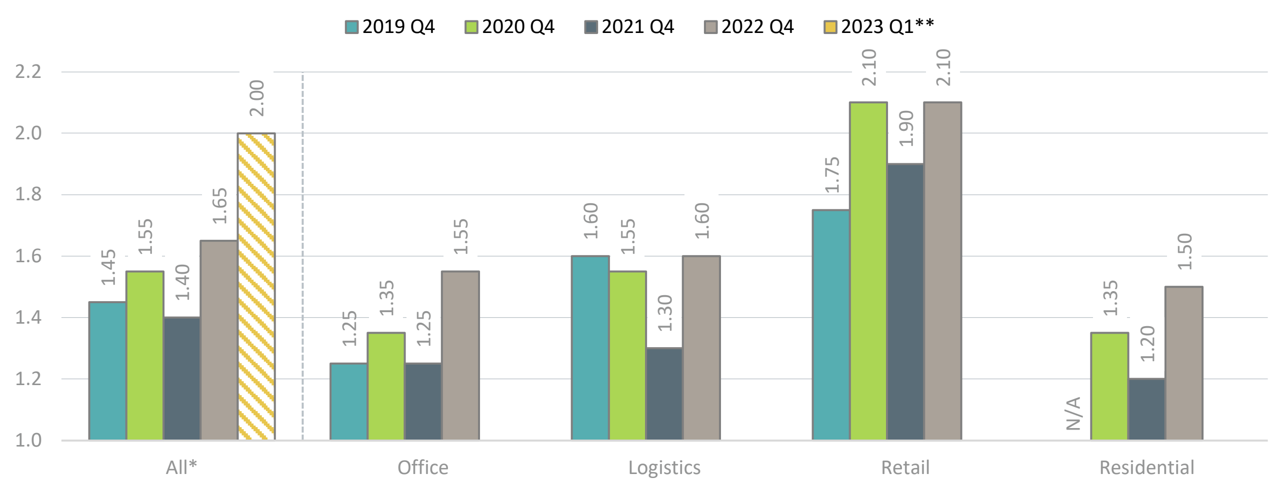
Valuation write-downs and financial market spill over result in tightening credit conditions and financing ratios

Senior lending margins across Europe rose by 20-30 basis points in the fourth quarter of 2022 compared to the same quarter a year ago. In the first quarter of 2023, margins are estimated to have risen strongly given the further tightening of financial conditions, widening credit/swap spreads, and the overall increase in market uncertainty.

A significant widening in the spread between lenders offer rates can also be observed, especially in the junior segment. Margins for weaker assets, and higher risk investments rose more sharply, as access to riskier loans became scarcer. In Germany, the average financing rate rose by around 45 basis points compared to the fourth quarter of 2022, while margins for project development added almost 100 basis points compared to a year earlier.[9]

Slowing transaction volume and higher risk aversion from lenders led to higher equity requirements and decreasing LTVs. We estimate average LTVs dropped by 5 to 10 bps on average across all segments. Project developments and secondary assets saw even stronger movements and the availability of financing is increasingly linked to debt service ratios. The banking events of mid-March has further widened execution and credit spreads as well as liquidity costs and may further tighten lending requirements.

Weighted Average European Senior Lending Margins By Sector (%)



Source: CBRE, DWS, January 2023; Note: *Excluding residential **DWS estimate

[6] Bayes Commercial Property Lending Report, H1 2022.
[7] Greenstreet, European Market Monitor, April 2023.
[8] Greenstreet, Real Estate Debt Markets, 1Q 2022.
[9] BF Quartalsbarometer Q1 2023

Attractive risk-adjusted returns

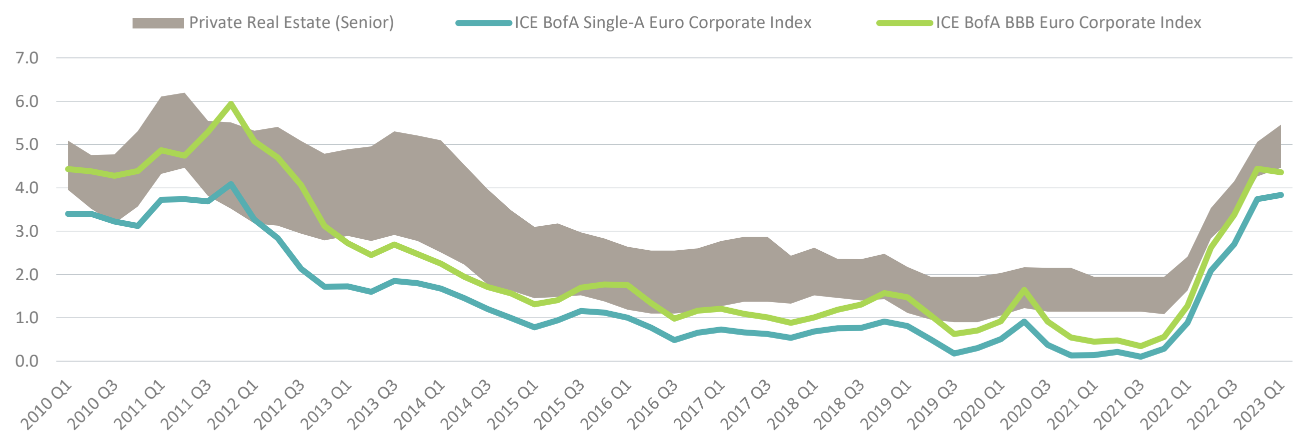
Illiquidity premium, higher income returns and less mark-to-market price risks for CRE loans

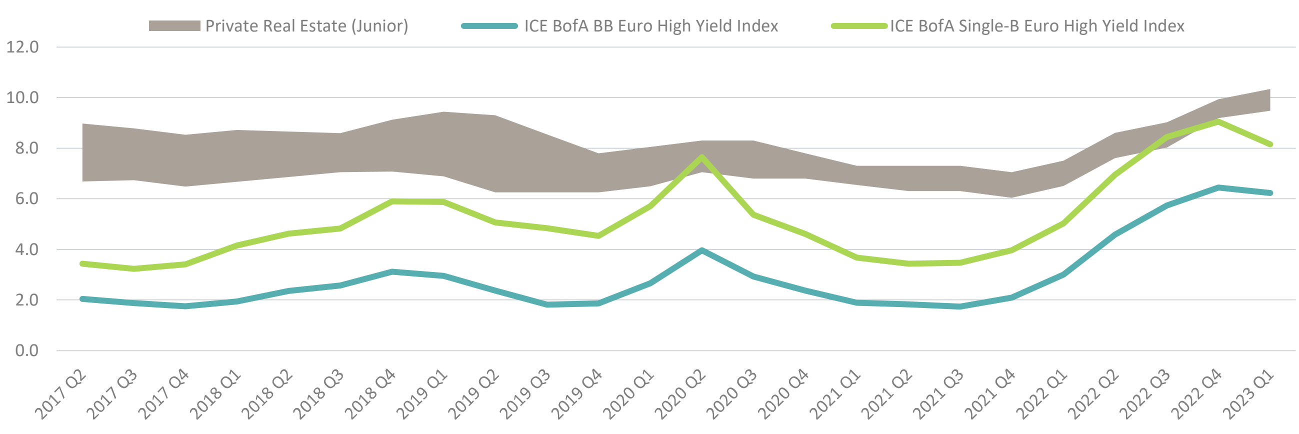
Real estate debt typically offers a yield premium over corporate bonds in the region of 100-150 basis points for senior and 200-400 basis points for junior loans. While the spread had been somewhat eroded over the past twelve months, since the start of this year, higher real estate margins have re-established much of this premium.

At the sector level, the all-in debt cost for offices has risen sharply. Senior loans rose from 1-2% during the negative interest rate environment to around 5% today. Not only have swap rates increased, but margins have also increased more than other sectors reflecting an increased perception of risk.

With junior returns coming in at 9-10%, there has been no shortage of investor willing to lend into this part of the market. Helping to keep margins relatively stable, returns over senior have narrowed. Nonetheless, this segment continues to screen well, providing higher cash payments relative to corporate bonds, with still considerable downside protection, particularly where real estate valuations are reflecting the latest market pricing.

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





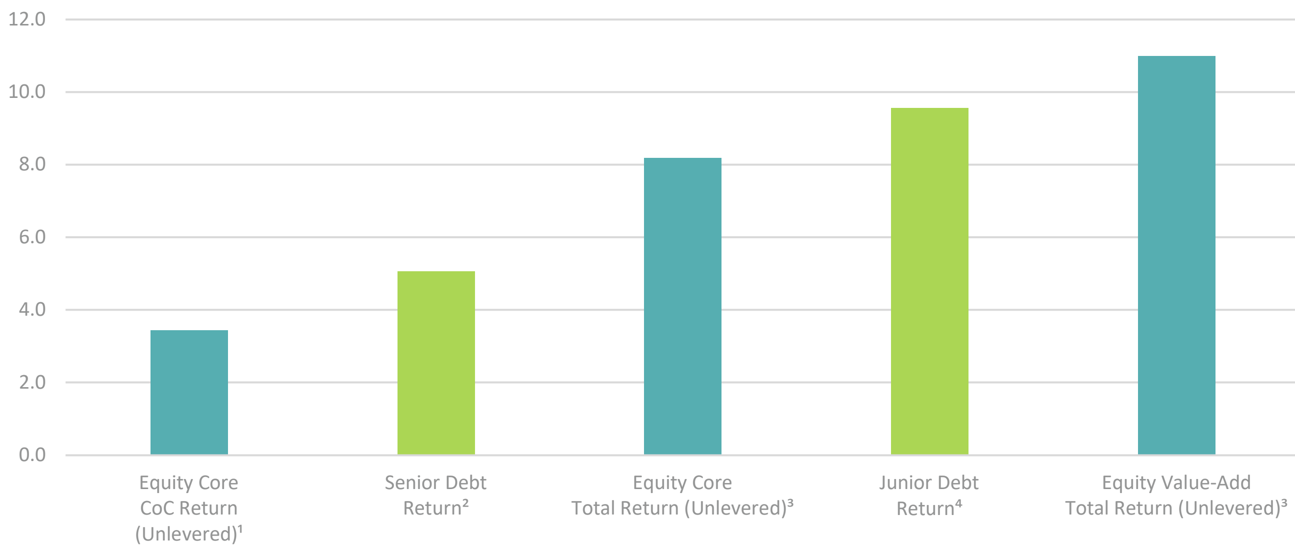
Source: DWS, CBRE, Refinitiv, March 2023. Data are quarterly averages. Private Real Estate: Total cost of debt for senior office loan in Germany, France, Netherlands, Italy and Spain; Corporate bonds: ICE BofAML Index.

Attractive cash return from real estate debt

Strong fundamentals, reduced credit availability and diversification make the case for debt

Real estate senior and junior debt provides an excellent alternative to real estate equity investments based on current pricing, especially from a cash-on-cash perspective. As shown in the chart below, an investment in senior debt could be expected to provide almost 150 basis point additional cash return over the coming five years, compared to a core equity investment. The cash return from real estate debt also screens attractive relative to the average coupon for the ICE BofA Euro High Yield Index (3.8% coupon) and ICE BofA Euro Corporate Index (1.8% coupon)[10]. Whilst the overall return from both senior and junior may be lower than equity, for those investors worried about downside risks, debt could provide an attractive addition to a portfolio.

Expected 5-year unlevered debt and equity real estate returns



1) Average all-property (ex. retail) net initial yield minus capex and maintenance. 2) 6-month EURIBOR Swap Rate (5-yrs) + 200 bps margin + arrangement fee. 3) Average all-property (ex. retail) unlevered return minus estimated capital costs, but before taxes and fees. 4) 6-month EURIBOR Swap Rate (5-yrs) + 650 bps margin + arrangement fee.
Source: Real Capital News, CREFC, May 2023

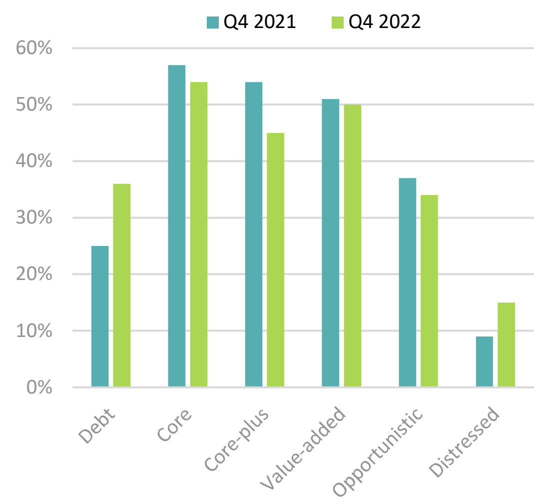
Investment Strategy

Investors increasingly focused on debt investment

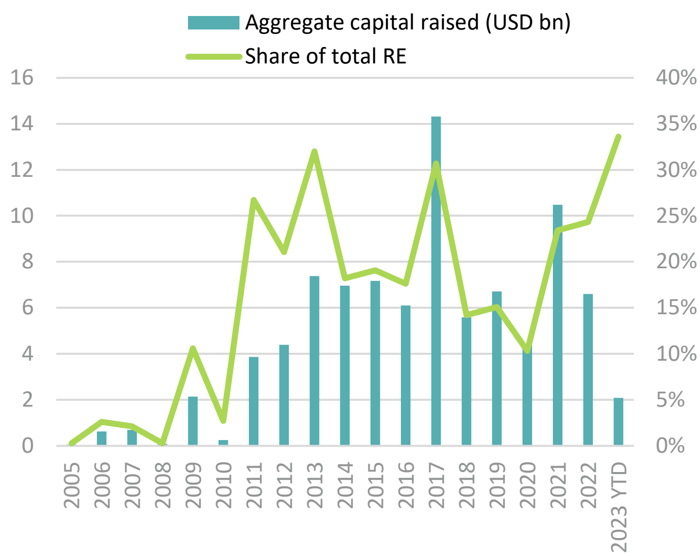
Right now, just 12% of closed-ended real estate funds are focused on debt investment. However, this is rapidly changing. As shown by the INREV Investor Intentions Survey, and when looking at current fundraising, there is a huge amount of interest in this part of the real estate market. According to Preqin, one third of all capital closed-ended capital raised at the start of this year, was targeted towards debt strategies.

[10] Refinitiv, March 2023

Strategies targeted over the next 12 months



Fundraising Real Estate Debt Focus Europe



Source: Preqin, Q4 2022

Office

We continue to see a divergence between best-in-class office buildings with green certifications and old, lower-quality grade B stock. Grade B office assets without green credentials are out of favour with both investors and occupiers. While we have seen rising debt margins on this type of stock, we see considerable downside risks in terms of both income and pricing, and therefore would exercise extreme caution towards this part of the office market.

In contrast, best-in-class continues to perform well, with high levels of occupancy and often rising rents. Given the general level of caution towards office in general, this may provide opportunities to achieve an attractive risk adjusted return within this segment of the market.

Logistics

Logistics is appealing on a risk-adjusted basis. Occupier fundamentals look strong, with record-low vacancy across most logistics markets, while the sector has undergone a major repricing over the past six months. This could create some issues / opportunities where borrowers are looking to refinance, and in all cases, it will be important to get an accurate picture of the true market pricing.

Given the extent of repricing, the United Kingdom could provide attractive opportunities. Urban logistics remains a top pick, given the strength of long-term fundamentals, but corridor locations are also increasingly in scope given the repricing, while development financing could also prove attractive.

Residential

The residential sector tends to offer the lowest margins, while low yields on traditional PRS has historically created some difficulties in achieving sufficient interest cover rations.

Student housing, senior living and co-living tend to offer both a higher income return, and a lending premium compared to traditional multi-family residential, reflecting both operational risk as well as a less market maturity. Nonetheless, given the strength of the long-term demand drivers for these segments, as well as today's low levels of vacancy and rising rents, we consider them a particularly attractive option. An ageing population in Europe clearly supports the story around senior housing, while growing numbers of international students and a limited stock of existing supply also support a positive outlook for student housing.

Retail

We continue to have a broadly negative view on shopping centres in terms of rent growth and vacancy outlook. However, in some cases we do see attractive lending options, particularly in markets such as the UK where we believe the structural price correction has almost run its course. In addition to an elevated margin, for those assets where income is sustainable, even without substantial rental growth today's high yield should be more than sufficient to allow borrows to service debt costs, with the option for amortisation.

Conclusion

Overall, we see higher default risks and valuation write-downs. We are more selective in borrower and tenant analysis, and debt metrics and focus on centrally located, high-quality assets or transitional properties with upside potential. We prefer residential and logistics but are more cautious on secondary office properties given the demand polarisation and economic uncertainty. We see increasing opportunities in lending for manage-to-green and repositioning strategies across all sectors, with sustainability factors lowering vacancy, raising rents, sustaining values and supporting the servicing of debt.

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

Source: DWS, May 2023

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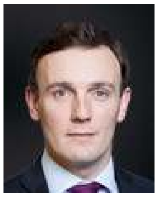

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