Marketing Material

November 2020



Opinion

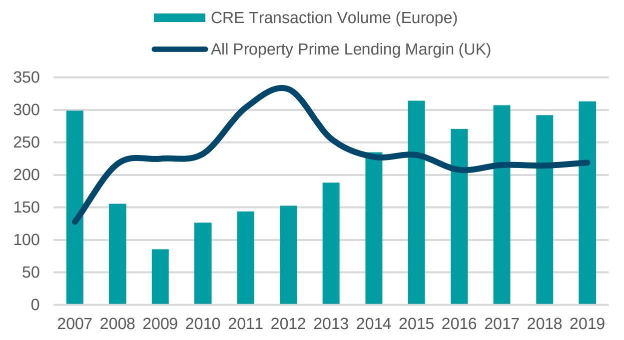
# European Private Real Estate Debt
## November 2020

This year, we expect direct property returns to be markedly lower for the best performing parts of the European property market, and negative for the remainder. At the same time, the return on offer from private debt has grown since the start of the year. However, current market conditions have also increased the risk attached to real estate lending, as well as leading to a widening differential between sectors. While we believe that every opportunity should be assessed on its own merits, an understanding of the size of the investable universe and the risks associated with each market and sector also forms an important part of the portfolio allocation process. With careful selection, we feel that private real estate debt could offer an attractive risk-adjusted return profile looking ahead.

## Current market conditions

Following the Global Financial Crisis (GFC), margins on senior debt rose sharply, remaining elevated for several years thereafter. Then as transaction volumes picked up[1] and alternative lenders became more active,[2] the middle part of the decade saw lending terms begin to move back in favour of the borrower. But for the last five years, the market has remained remarkably steady.

**TRANSACTION VOL. (€ BN) & LENDING MARGIN (BPS)**




Sources: Cass, RCA, DWS, October 2020.

Early in 2020, a typical Continental European prime office could expect to achieve a margin of 100-150 basis points, with something closer to 200 basis points in the United Kingdom. The maximum LTV most lenders offered was typically in the region of 60%. Junior loans were available at 600-800 basis points at LTVs of up to 80%.[3]

In a wider fixed income context, private real estate debt continued to look attractive. At the beginning of this year, euro-denominated BBB corporate bonds were yielding less than 1.0% for maturities of up to 10 years.[4] At the same time, based on a proprietary database of deals, DWS estimates that senior private CRE debt was offering an illiquidity premium in the region of 80-100 basis points over similarly rated non-financial corporate bonds.[5]

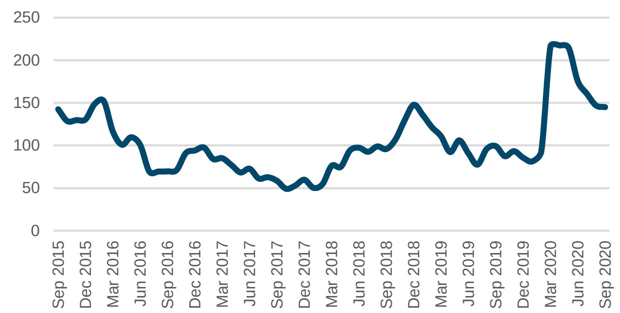
Since the onset of the Covid-19 pandemic in March 2020, there has been a change in conditions. Increased caution among lenders has seen some pull back from new lending and others offering more conservative terms or requiring higher returns. With fewer real estate transactions and greater uncertainty over valuations, assessing current loan pricing is more challenging.

A look at fixed income yields provides some insight. Corporate yields saw an initial spike across the spectrum, with average yields for both A and BBB rated bonds jumping by more than 150 basis points between early and late March.

[1] Real Capital Analytics, October 2020
[2] Cass, May 2020
[3] CBRE, March 2020
[4] IHS Markit, iBoxx € Non-Financials BBB, March 2020
[5] DWS, October 2020

This was significantly less than during the GFC though, and yields have since fallen back close to their February levels.[6] Swap spreads for euro-denominated real estate bonds have also followed a similar path, and remain around 40 basis points above pre-Covid levels, as of mid-October.[7]

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




Source: Markit iBoxx, September 2020.

While pinpointing marketwide private loan terms at any point in time is difficult, our own experience suggests that for senior loans secured against prime property during the third quarter, a rise in the region of 25-50 basis points since the beginning of the year would be broadly reflective of overall market movements.[8]

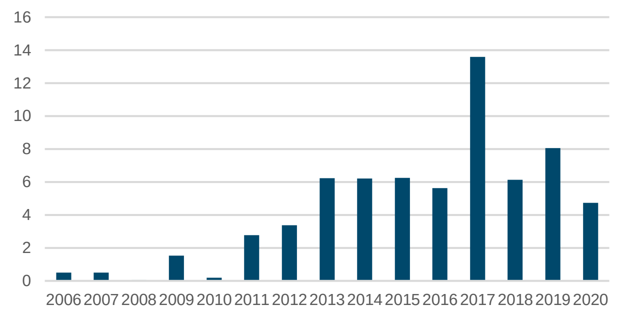
However, some sectors have moved more than others. Those considered more resilient to current market stress, such as residential and logistics, are proving more in demand among lenders, which may limit the extent of changes to typical loan terms. And with greater numbers of lenders potentially willing to step up lending again to these sectors, it is possible margins will come back down again towards the end of the year or in 2021.

On the other hand, those lenders who are still prepared to finance retail and hotel assets, where the occupier market has been more severely affected this year, are attaching a greater risk to such deals. For retail in particular, a widening margin spread over other sectors was already underway before this year. In the United Kingdom, for example, the spread over offices had opened up to around 50 basis points in 2019, having been priced similarly just a few years earlier.[9] However, the current situation means that an additional layer of risk is now likely to be reflected in the loan terms offered, with an increased chance of seeing loan write-offs.

At the junior end of the capital stack, we estimate that margins have risen more sharply as lenders become more cautious on the potential for asset value declines.

So far this year, the private debt fundraising space has continued to see activity, despite the slower market for transactions. As of the beginning of September, Europe-focused real estate debt funds had raised a total of €4.7 billion. Excluding separate account mandates, this was broadly in line with fundraising over the same period in both 2018 and 2019.[10]

**EUROPEAN CRE PRIVATE DEBT FUNDRAISING (€ BN)**




Sources: Preqin, Oxford Economics September 2020. Excludes separate account mandates. Data for 2020 is for January-August inclusive.

The European CMBS market, on the other hand, remains slow. CMBS financing can often be used for non-prime assets, weaker collateral or special situations, meaning the market may not be seen as directly comparable to senior private debt. Additionally, daily pricing often gives the impression of liquidity, although this is not necessarily the case. Nevertheless, pricing can still offer some additional insight into wider market trends.

After a promising start to the year, just one CMBS transaction completed in Europe during the second and third quarters, since the Covid-19 pandemic took hold in early March.

[6] Macrobond, October 2020
[7] iBoxx, October 2020
[8] DWS, October 2020
[9] Cass, May 2020
[10] Preqin, September 2020

Reported spreads have largely mirrored other fixed income products, down some way from their early-April peak, but remaining around 70 basis points higher than at the beginning of the year.[11]

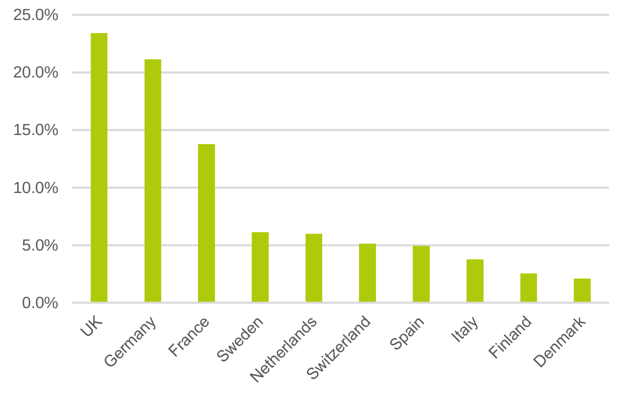
## Market Size & Risk Factors

Assessing the size of the European commercial real estate private debt market presents challenges. While market transparency is gradually improving, there are still relatively few estimates of the size of the total opportunity by country or sector.

The size of the broader real estate market forms a basis for analysis. Market size estimates produced by MSCI are useful in this respect. Additionally, historical transaction volumes can be used as a tool to measure relative size between markets and sectors, under the assumption that trading frequency doesn't vary significantly by location or asset type.

From here, estimating the size of the debt portion of the market would require reliable estimates of LTV ratios and average terms for outstanding loans within each market. While our own experience provides valuable insight, this type of data is generally not readily available at the market level. However, looking at typical LTVs on new originations earlier in the year, there was in fact relatively little difference between markets.[12]

**LARGEST CRE MARKETS (% OF EUROPEAN TOTAL)**




Sources: MSCI, RCA, DWS, September 2020.

At the beginning of this year, maximum senior LTVs for the majority of large markets and sectors sat close to 60%.[13] Where available, historical data also suggests relatively little change in ratios for new lending over recent years. For example, LTVs in Germany have sat slightly above 60% for the last four years, with the United Kingdom remaining just below 60% over the same period.[14]

At the sector level, it's possible we may see some divergence. Differences in the expected path for capital values across sectors mean that LTV ratios on existing debt could move apart. Meanwhile, a widening gap in risk profiles between sectors is also likely to be reflected in differing maximum LTVs on new loan originations. However, there appears to be relatively little difference between sectors historically.

When looking to build a pan-European debt portfolio, estimates of market size are clearly important when considering portfolio weightings. However, it is also important to look at the different risk factors affecting each market.

In our opinion, volatility of capital values would be among the most important of these, with big swings potentially impacting the ability to recover an investment in full in the event of default. While historical value movements are not necessarily an accurate indicator of future performance, amplified volatility can be related to the underlying structure of the occupier or investment market. Hence, markets which have seen large swings in pricing in the past could also be more prone to greater value movements in the future, assuming the same structural drivers remain in place.

Additionally, risks affecting the general security of the economic and political environment, the ability to conduct business, and the transparency of the real estate market could affect the general functioning of the debt market, and hence should have some influence on how much capital a fund or investor may wish to deploy to each market.

## Market Outlook

This year, with a significant fall in transaction volumes during the second and third quarters, new lending activity is also likely to have fallen. That said, there should still be a large

[11] JP Morgan, August 2020
[12] CBRE, March 2020
[13] CBRE, March 2020
[14] Cass, IREBS, August 2020

number of refinancing requirements, and we do expect transaction activity to pick up, although the Covid-19 situation in the coming months could affect how this plays out.

The current market still offers the opportunity to secure higher returns on even the most secure properties, compared to the beginning of the year. And while there is still an expectation that fixed income yields may remain low in the short term, we could also see a gradual upward trend in yields start to push real estate debt returns higher as we look beyond 2021 towards the middle of the decade. But in the current market, pricing risk appropriately could become even more important.

Private debt returns – typically consisting of a reference interest rate (often hedged by the borrower using an interest rate swap or rate cap) plus a margin and arrangement fee – are clearly a key component in deciding where to deploy capital. A lender looking to increase returns could do so in a number of ways. Rising up the capital stack would perhaps be the most obvious. Moving from senior to whole loan or junior, could take returns from sub 2% per annum to as much as 10% or more at the moment.

Equally, shifting between markets and sectors could allow differing return targets to be met. For example, a senior office loan in Central Europe would currently be likely to secure a notable margin premium over a major Core European market. Similarly, lending against U.K. retail assets is likely to offer markedly higher returns compared to U.K. logistics right now.

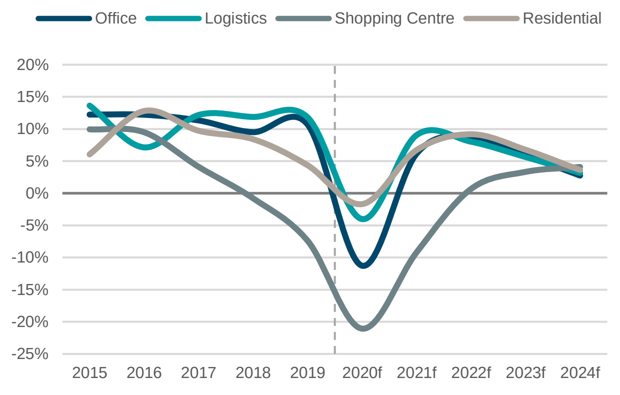
However, the other key component is risk. At a given point in time, higher margins are usually accompanied by a higher level of assessed risk. With regard to positioning within the capital stack, the risk comes from declining credit quality as the LTV increases. And for markets and sectors some of this risk is structural – i.e. related to the functioning of the economy, the real estate market and the debt market in general – as discussed above. But lenders should also assess forward looking risks.

Taking into account our outlook for capital values by sector, from a pure risk perspective we would favour logistics and residential, where we are forecasting less of a market correction this year and we expect positive long-term trends. As such, risk-adjusted returns for both senior and junior lending in these sectors could remain attractive.

Sectors such as student housing and certain parts of the hotel market could also be attractive, although it will be particularly important to consider operator risk here. Both of these sectors undoubtedly face short-term challenges related to Covid-19, but we still expect longer-terms trends to be broadly favourable. For this reason, we see good opportunities for senior lending at the prime end of the spectrum. A degree of additional caution may be required at the junior end of the capital stack, but with sufficient allowance for short-term volatility, lending to subsectors such as budget hotels could still prove attractive.

For retail, we would be generally be very cautious, as values are expected to come under significant downward pressure. Yet, with many lenders pulling back from retail lending altogether, we would expect a sizeable rise in margins over the remainder of this year and into next year.

**EUROPEAN PRIME CAPITAL GROWTH OUTLOOK (% P.A.)**




Source: DWS, September 2020. f = forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect. Past performance is not indicative of future returns.

Taking the example of a German shopping centre, our real estate market forecasts would suggest that prime capital values could fall by 30% over the two years from mid-2020. That would mean that a loan with a current LTV of 60% would increase to around 85% under this scenario, and would most likely be in breach of covenant.

It would be easy to write off lending into a market where you expect values to fall by 30% (or more for secondary retail). However, we believe there may still be room to include the sector in a diversified debt portfolio, particularly as lending at lower LTVs, together with careful asset selection, could enable lenders to take advantage of more favourable pricing while still reducing risk.

At the market level, higher returns can generally be found in the United Kingdom at the moment, although uncertainty around the Brexit trade negotiations and additional hedging costs mean that on a hedged and risk-adjusted basis, the premium over Core Europe is eroded somewhat. And while our base case forecast assumes a favourable outcome from the Brexit trade negotiations, we would still expect to see an increased level of due diligence at the junior end of the spectrum given the elevated level of risk.

For European junior lending in general, we believe a stronger focus on sectors showing a higher level of resilience, such as logistics and residential, and on markets seeing less short-term volatility, such as Germany and other parts of Core Europe, could lead to better risk-adjusted returns.

There is currently relatively little to choose between Core European markets in terms of senior lending returns, with the total cost of debt generally in the region of 150-200 basis points.[15] But considering our outlook for capital values, we would likely assign a lower risk of significant capital value decline in Germany compared to France or the Benelux countries, for example. Therefore, despite lower absolute returns, this could still lead to German outperformance on a risk-adjusted basis.

More generally, we would also expect a widening in spreads between core and core plus assets. As some lenders focus more on the lowest-risk opportunities, we could start to see lending returns pushed up for well-located assets that have an additional risk factor, such as a refurbishment element. And in an environment of reduced risk appetite, it’s possible that some of these risks will be mispriced.

[15] DWS, October 2020

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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
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