

Europe Real Estate Debt Update

October 2023

IN A NUTSHELL

- Near-term inflation expectations have fallen since the start of the year, and while core inflation remains somewhat sticky, the slowing European economy is likely to limit further interest rate hikes.
 - Nevertheless, all-in financing rates have reached their highest levels since the aftermath of the GFC. The majority of this increase has come from higher swap rates, although rising perceptions of risk, weakening sentiment and a reduction in the supply of willing lenders have also pushed margins higher.
 - Properties with strong ESG credentials remain in high demand, and we believe such assets may reduce risk from a lender's perspective. Conversely, buildings that fall below current environmental standards are at risk of obsolescence and could find it increasingly difficult to secure financing.
 - We believe the logistics and residential sectors still offer some of the best risk-adjusted returns for both senior and junior debt, although offices and retail could also offer interesting lending opportunities on a more selective basis.
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Current market conditions

Persistent inflation continues to put upward pressure on all-in financing costs

Inflation now looks to be on a steady downward path across most of Europe, leading to a decline in near-term inflation expectations. Consumers now anticipate Eurozone CPI inflation to be just 3.5% over the coming 12 months, a marked fall since the start of the year, yet core inflation remains elevated and headline inflation is set to remain above target until 2025.¹

Interest rates in the United Kingdom have risen by a staggering 515 basis points since the end of 2021, and by 450 basis points in the Eurozone, yet rates now appear to be reaching their peak. In line with the US Federal Reserve, the Bank of England narrowly voted to pause its rapid tightening cycle in September, and while at the same time the ECB decided to raise rates by a further 25 basis points, expectations are that the slowing European economy will put a lid on further increases.

Underlying real estate pricing has already moved quite a way, yet a lack of transactions-based evidence means reported values may still be lagging reality. Although some markets and sectors appear to be stabilising, property yields continue to expand across large parts of the market. Office yields saw the biggest increase in the third quarter, rising by 20-25 basis points on average, although logistics pricing was largely stable.² Sharp falls in property values, together with darkening clouds over the economy, have led to growing concerns among lenders, pushing margins higher. And as long as there is still doubt over whether values have reached a trough, the banks' appetite for refinancing is likely to remain muted.

We estimate that senior margins for European real estate debt were around 30 basis points higher in the third quarter compared to the start of the year, and around 50 basis points higher than their pre-pandemic nadir. Combined with a sharp rise in swap

¹ ECB, October 2023

² CBRE, September 2023

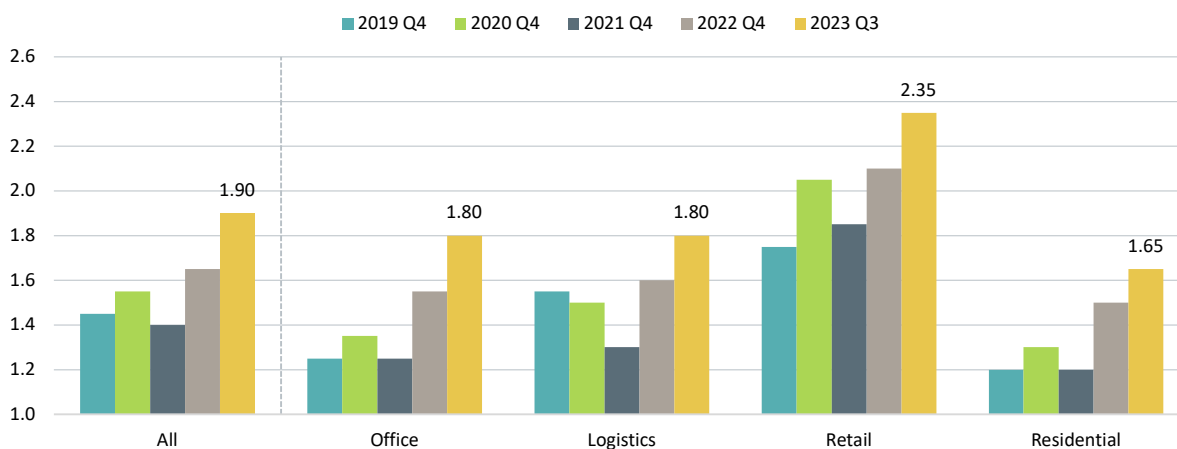
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rates, total borrowing costs are at their highest levels since the aftermath of Global Financial Crisis (GFC),³ and pressure on interest coverage ratios (ICR) means that senior loan-to-value (LTV) ratios are currently likely to be capped at around 50%. Junior loan pricing is also estimated to have increased slightly, although healthy competition among alternative lenders has had something of a balancing effect in this regard. Meanwhile, constrained capacity for the underlying assets to service debt at even higher rates may also limit further junior margin increases.

Senior debt margins by sector



Source: CBRE, DWS, September 2023

Direct property investment volumes remain very subdued, as current financing rates are often not accretive to returns and there have not yet been a significant number of forced sellers. However, as existing loans expire there is expected to be a large funding gap caused by falling property values, lower LTVs on new lending, and reduced bank lending volumes. In some cases, sponsors will be able to inject fresh equity to plug any refinancing shortfall, but often the situation will require the inclusion of preferred equity or junior debt. Yet with underlying prime values having already corrected by around 20%, a lot of the potential downside risk has already materialised. Significantly higher all-in rates could therefore make junior lending on new loans look quite attractive, opening up more opportunities for alternative lenders, who are typically more active than the banks in the junior and whole loan space.

Real estate debt also continues to look strong in a multi-asset setting, as rising margins have pushed up the premium over other fixed income investments. For senior debt, the return spread over similarly-rated corporate bonds currently sits close to its highest level for 10 years, while junior debt has also seen an increase in spreads since the start of the year, despite margins remaining relatively stable.⁴

Debt sentiment remains subdued

Lenders are cautious due to the impact of higher rates and a weaker economic environment

As loan pricing continues to trend upwards, this could offer attractive opportunities for lending at corrected values and with lender-friendly terms that provide downside protection while achieving strong returns looking forward. However, other factors are still subduing overall sentiment among lenders.

With sticky core inflation and robust labour markets pushing up rates higher than expected over recent quarters and market expectations remaining elevated, real estate debt sentiment deteriorated again in the third quarter, shaped by the financing market and economic environment. As capital values continue to be marked down across markets, refinancing risk and an

³ CBRE, DWS, September 2023

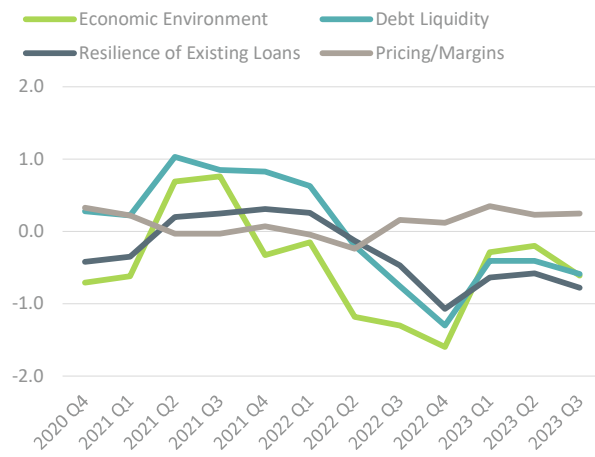
⁴ DWS, S&P, September 2023

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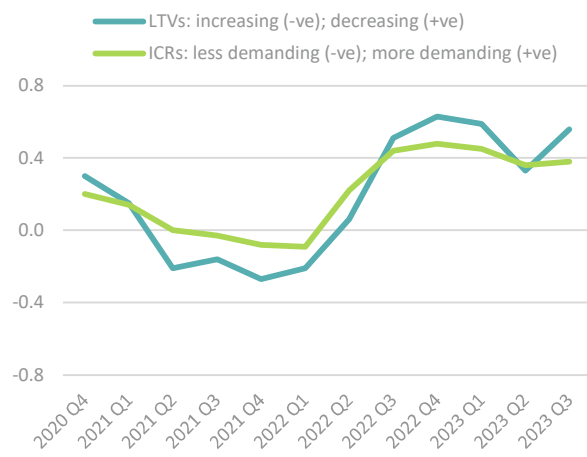
increase in the number of distressed loans are reflected in rising concerns about current loan books. Overall, the restrictive financing environment is also shown in current sentiment on covenants for new loans, with respondents observing significantly weaker sentiment towards LTVs in the third quarter, having seen a slight improvement in the previous period.⁵

Sentiment towards certain sectors has also deteriorated further, especially the office segment, where lender pessimism is now even greater than during the Covid pandemic. This could offer some possibilities in the sector as poor sentiment may lead to even higher margins as core lenders are more cautious, while underlying prices have already corrected to a large degree. In the retail sector, sentiment remains subdued, but is now comfortably above offices. The correction to retail property was already ahead of the curve, with values having fallen significantly before the pandemic, and lenders may now be comfortable that values are close to the bottom. Meanwhile, retail yields are high enough for sponsors to support a higher cost of debt for assets with strong occupancy.

European Commercial Real Estate Debt Market Sentiment
Selected Sentiment Indicators



Financial Covenant Sentiment (New Loans)



Source: Real Capital News, CREFC, September 2023

ESG credentials becoming increasingly important for lenders

Assets that fall below current environmental standards may struggle to get financing

Continued polarisation within the real estate market and a rising risk of obsolescence for non-energy-efficient properties have resulted in an increasing focus on the quality of underlying assets among sponsors, but also from lenders. The importance of strong ESG credentials has accelerated in recent years in line with decarbonisation efforts, as well as a growing focus on wellbeing – especially for offices.

In our view, buildings that meet the highest environmental standards are likely to achieve higher rental growth, maintain their value better, and offer greater liquidity upon selling, all of which may reduce risk from a lender’s perspective. Moreover, restrictive monetary policy and a weakening economic environment have led to an increase in risk aversion from lenders. Traditional lenders in particular are shying away from riskier lending such as developments and value-add investments, shifting the focus onto the quality of assets and covenants.

Tightening regulation across markets regarding Minimum Energy Efficiency Standards (MEES) and Energy Performance Certificates (EPC) has increased the risks of obsolescence and resulted in larger discounts for non-energy-efficient stock. Although it is still difficult to quantify a “premium” for ESG-compliant assets, lower quality buildings already have greater

⁵ CREFC, September 2023

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difficulty in securing financing, and we expect to see rising margins for such assets as well as more restrictive terms, including lower LTVs and higher ICRs.

European transformation of the building sector towards net zero presents huge capital requirements and offers great potential for private lenders. As such, refurbishment strategies to transform older stock into sustainable assets in line with regulation may offer attractive lender returns due to a developer risk premium. Green building certifications could be assessed from acquisition and over the term of the investment to show measurable improvement while also holding borrowers accountable.

Investment strategy

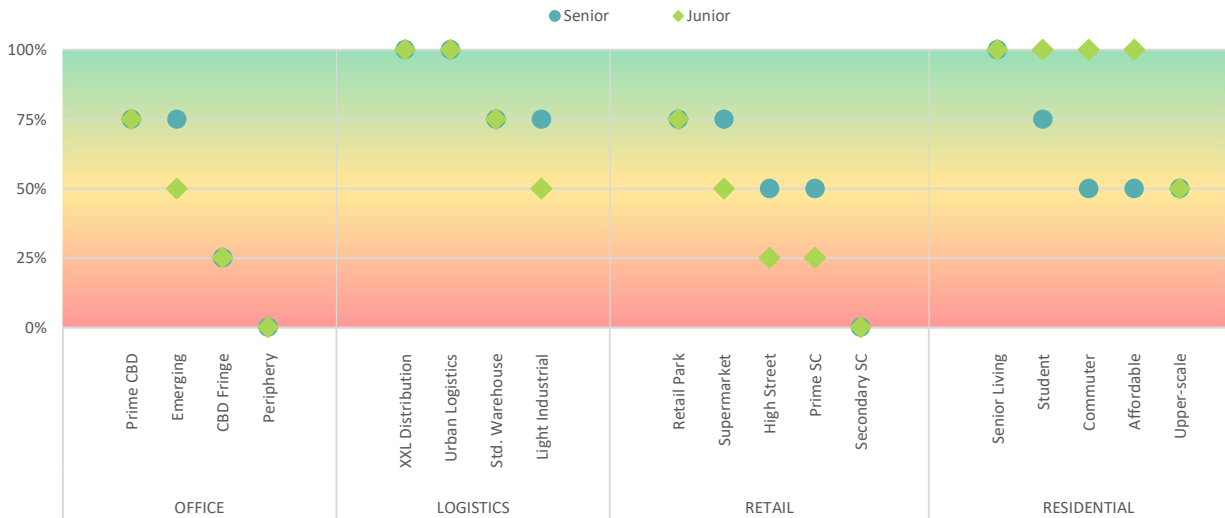
The UK offers strong risk-adjusted opportunities, while the European logistics sector retains significant appeal

Although property values have fallen some considerable way this year, the underlying market continues to show resilience, with rents increasing across the vast majority majority of markets and sectors. However, structural trends and economic pressures are still feeding through into occupier fundamentals, pushing up overall vacancy rates.

Logistics, as well as parts of the residential market, still look appealing from a lender perspective. Both sectors still benefit from low vacancy and strong demand, with positive long-term structural trends helping to counteract near-term economic weakness. Logistics in particular has repriced quickly this year, allowing lenders the opportunity to invest in a sector with strong underlying fundamentals at rebased values.

The low yield on private residential continues to present an additional risk, with ICRs being squeezed, even at lower LTVs. That said, as rising interest rates push even more prospective homeowners into renting, and with continued supply shortages, this presents a compelling case from an occupier risk perspective. Elsewhere within the living sector, student housing and senior living are both likely to offer a slight return premium while still benefitting from strong structural drivers for the underlying assets, leading to potentially attractive lending opportunities.

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



Source: DWS, October 2023

An overall fall in the availability of finance from traditional lenders is allowing still-active lenders to be more selective. Offices are suffering in this regard, with risk perceptions reflected in current loan pricing, as margins have risen further than the other major sectors this year. We feel this is fully justified for lower-quality and poorly located stock. However, with the sector out of favour and with lender returns having risen significantly, next generation office space with strong ESG credentials could still offer attractive opportunities for lenders.

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In terms of location, we believe that the United Kingdom and the Southern European region currently offer good risk-adjusted returns for both senior and junior lending. Absolute returns are typically highest in the UK market, even after taking euro hedging costs into account, while its risk profile does not look not significantly higher than in other parts of Europe. The UK retail market in particular could be one potential entry point to the sector, given how far values have corrected. Southern Europe also looks appealing, with a notable return premium over the likes of France or Germany, and little additional risk when we consider factors such as the strength of occupier fundamentals, debt covenant metrics, and volatility of rents or values.

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