European Real Estate Debt Opportunities

IN A NUTSHELL

- Financing gap and more restrictive lending from the traditional lenders is an potential opportunity for alternative lenders, in a de-risking environment with stabilising values and a recovering investment market.
- Basel IV has a tightening effect on banks credit standards, already visible in lending sentiment and surveys while overall debt margins in Europe seem to follow an opposite trend.
- This is most pronounced for higher leveraged debt, such as whole loans and development financing, which look increasingly attractive given elevated margins compared to senior loans.
- Supply shortage, falling development activity, construction sector insolvencies and the shift toward high-quality assets support development financings in particular.
- We favor residential including PBSA and co-living, logistics and selective prime offices offering attractive risk premiums.

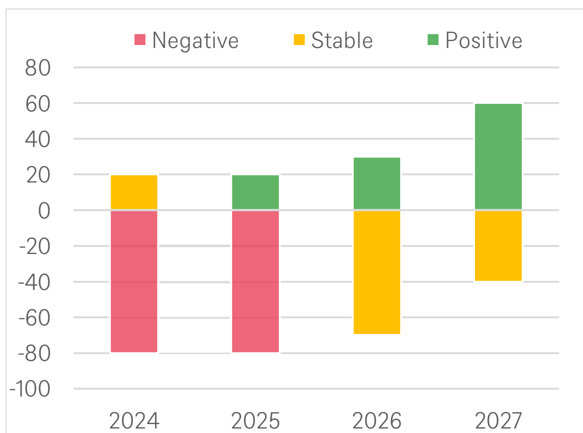
Restrictive Bank Lending Sentiment

Opportunities for private debt as market recovers

While the overall market sentiment in Europe is recovering, recent surveys of German credit institutions with exposure to the real estate market point to stricter lending conditions from banks. Banks reported more restrictive lending behaviour compared to pre-crisis levels. Quantitative criteria, such as debt yield, LTV and DSC have tightened, while pre-sale and pre-rental quotas are being enforced more rigorously, posing challenges in the current market.

Survey participants expect the crisis to persist throughout 2025, with both the real estate market and in-house real estate loan portfolios viewed as high-risk. Follow-up financing remains a key challenge amid elevated borrowing cost. In the case of office and retail properties, 90% of survey participants see a high or very high risk, while the level is significantly lower at 40% for hotel and logistics. Eventually, this most likely leads to a financing gap, which we see as an opportunity for private debt vehicles, as market fundamentals remain supportive as well. Prime yields have stabilized, and prime capital values turned positive given low supply and strong rental growth.

Real Estate Lending Market



Source: EY, September 2024.

Tactical View: Development Financing

Regulation, Supply and Returns

The new Basel III regulations (CRR III & CRD VI) also known as Basel IV, which are binding from January 2025, coming into full effect in 2030, significantly impacting real estate lending by commercial banks.

Higher capital requirements for real estate loans, especially for high LTV loans, may tighten lending conditions and increase financing costs. Banks are required to hold more common equity Tier1 (CET1) capital for riskier loans. Risk-weighted Assets (RWA) potentially will increase, particularly for CRE loans:

- with high LTVs (>80%)
- with weak borrower credit assessments
- project financing without long-term rental income.

Projects without stable income streams have higher risk weights at 150%, up from 100%, while speculative projects are now at 250%. This may result in overall tighter credit conditions and tighter lending standards. Additionally stricter funding requirements (NSFR) may limit short-term refinancing through the money market. Stricter credit assessments and lower LTV ratios may further increase lending margins and risk premiums for project financings, creating attractive opportunities for private debt. A one percentage point increase in required capital is estimated to increase loan rates by about 8.8 bps for construction lending.[1]

The impact from regulation is already evident. The EBC's January 2025 bank lending survey revealed a sharper-than expected tightening of credit standards, with banks increasing capital buffers and risk weighted assets in response to regulatory requirements.[2] These regulatory requirements were explicitly reported to have a net tightening impact on banks' credit standards across all loan categories in 2024. For loans to SMEs, the net tightening is the largest since the second half of 2012.

Falling Supply leads to stronger demand

Supply across Europe is declining, with development starts having plummeted in most market sectors and locations.

Europe Building Starts Trending down

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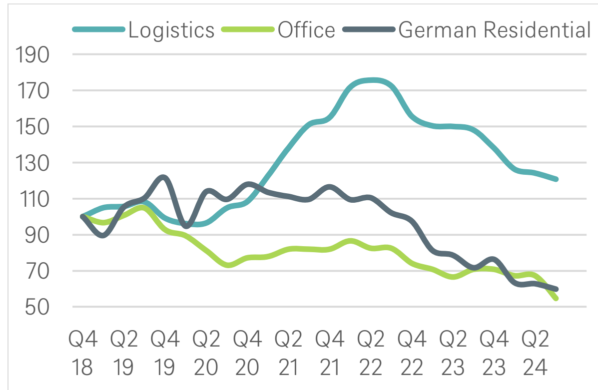

Source: Destatis, PMA, JLL, DWS, February 2025

In the office sector, building starts have continued to fall in most major markets. Two-thirds of European cities recorded a drop in new developments, and rolling annual building starts across 26 locations have dropped to their lowest level in over a decade.[3]

EU: Building Permits & Cost Expectations

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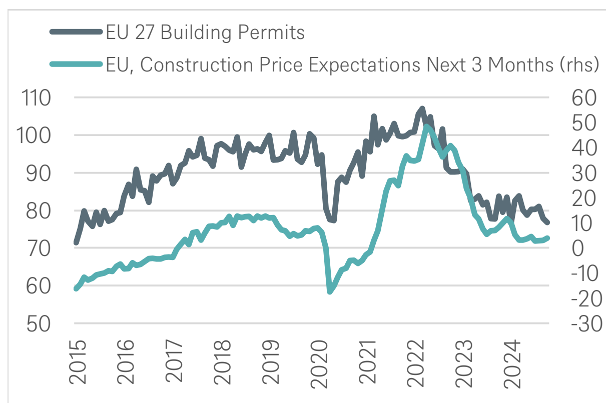


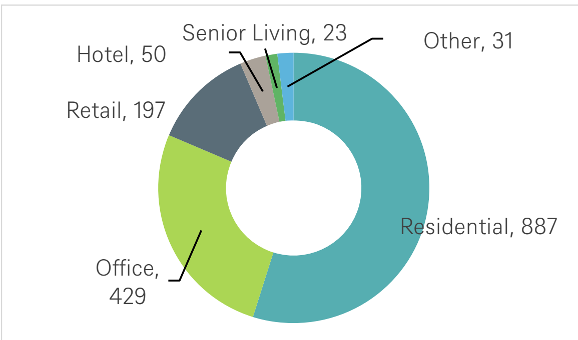
Source: Macrobond, Eurostat, February 2025.

Europe's housing sector remains the most supply-constrained, with the shortages expected to worsen as building permits decline sharply. An estimated 9.6 million new homes are needed to meet demand.[4]

[1] Glancy, D & Kurtzman, R. How do Capital Requirements Affect Loan Rates, August 2018.
[2] ECB, Bank Lending Survey Q4 2024.
[3] PMA, European Office Quarterly Data, Q4 2024.
[4] CBRE, European Real Estate Market Outlook 2025, January 2025

The housing crisis is particularly severe in Germany, where construction sector orders have hit record lows and 400 development projects, totalling over 1.4 million sqm, have been affected by insolvencies.[5] Building permits have plummeted by 19% in 2024. The construction industry remains in distress, fuelled by high interest rates, financing challenges, elevated material costs, and regulation. Insolvencies among property developers could further delay projects, exacerbating housing shortages. The number of bankruptcies of large companies in the German real estate sector has doubled to 66 cases in 2024.

Germany: Insolvencies by Sector ('000 sqm)



Source: Bulwiengesa AG, February 2025.

This leads to decreasing construction capacities, which is likely to fuel demand. The mismatch between supply and demand continues to push rents higher, particularly in smaller cities and rural areas. Well-planned and well-financed project developments are likely to benefit from high demand and rising capital values as more projects may become profitable again.

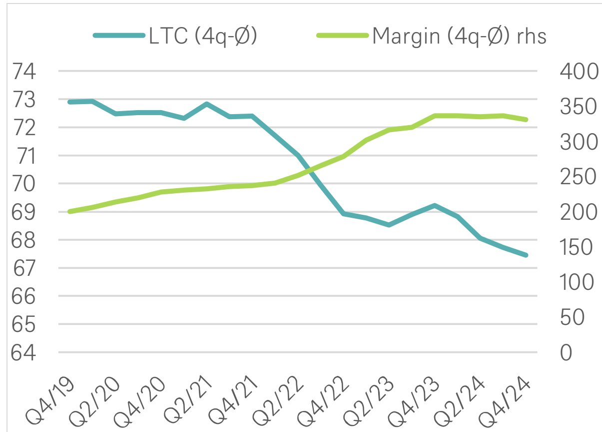
Development margins remain attractive

The wave of insolvencies in the construction sector could lead to higher risk premiums for project financing. Core senior margins across Europe have increased by around 70 bps over the past two years but are now beginning to compress.[6]

In Germany, development margins widened by up to 150 bps and remain elevated due to uncertainty and risks. While falling capital values pressure exit yields, increased construction costs and bankruptcies continue to push up the risk premium for development loans. We expect that the spread between senior core loans and project margins (150-200 bps) will persist, creating potentially attractive opportunities in project financing across Europe.

Germany: Development Financing Covenants

% (lhs) Basis points (rhs)



Source: Bf Direkt AG, Q4 2024.

Why development financing now?

Since mid-2024, capital values have stabilized and the first signs of yield compression have been evident in select markets. Fundamentals remain healthy with robust prime rent growth driven by low vacancy of modern stock. The investment market shows signs of recovery to potentially offer new opportunities and debt is accretive again with positive leverage. Higher entry yields, strong market fundamentals and significant price corrections are expected to create attractive opportunities for real estate debt investments.

Since commercial banks are likely to tighten lending conditions for loans with high level of debt, we consider project financing to be attractive in the current environment. The current margin premium over senior loans may be persistent.

We favour the residential sector as the most supply-constrained market including PBSA and co-living as well as refurbishment projects Logistic demand remains strong and we target modern assets in last-hour locations, especially in areas with low vacancy like southern Europe, Benelux and Northern Italy. Offices on a more selective basis in prime locations.

[5] Bulwiengesa AG

[6] DWS, Europe Real Estate Debt Market Update, November 2024.

Real Estate Research Team

Office Locations

Frankfurt
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: +49 69 71909 0

London
45 Cannon Street
London, EC4m 5SB
United Kingdom
Tel: +44 20 754 58000

New York
875 Third Avenue
26th Floor
New York
NY 10022-6225
United States
Tel: +1 212 454 3414

San Francisco
101 California Street
24th Floor
San Francisco
CA 94111
United States
Tel: +1 415 781 3300

Singapore
One Raffles Quay
South Tower
15th Floor
Singapore 048583
Tel: +65 6538 7011

Tokyo
Azabudai Hills Mori JP Tower
1-3-1 Azabudai
Minssato-ku
16th Floor
Tokyo
Japan
Tel: +81 3 6730 1300

Sydney
Level 16, Deutsche Bank Place
Corner of Hunter and Phillip Streets
Sydney NSW 2000
Australia
Tel: +61 2 8258 1234

Teams

Global

Kevin White, CFA
Global Co-Head of Real Estate Research

Simon Wallace
Global Co-Head of Real Estate Research

Americas

Brooks Wells
Head of Research, Americas

Liliana Diaconu, CFA
Office & Retail Research

Ross Adams
Industrial Research

Sharim Sohail
Self-Storage Research

Europe

Ruben Bos, CFA
Head of Real Estate Investment Strategy, Europe

Tom Francis
Property Market Research

Siena Golan
Property Market Research

Rosie Hunt
Property Market Research

Carsten Lieser
Property Market Research

Martin Lippmann
Head of Real Estate Research, Europe

Asia Pacific

Koichiro Obu
Head of Real Estate Research, Asia Pacific

Seng-Hong Teng
Property Market Research

Hyunwoo Kim
Property Market Research

Matthew Persson
Property Market Research

Authors

Carsten Lieser
Property Market Research
Carsten.lieser@dws.com

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