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There are many ways in which insurers invest into the real estate sector. Real estate has been a popular asset class among insurance companies for a long time. Today, insurers can access real estate markets in various ways, ranging from traditional direct real estate investments to mortgage loans or real estate investment trusts (REITs). As outlined in Figure 1, real estate capital markets can broadly be categorised into four segments.

Why private commercial real estate debt has become a popular asset class among insurance companies over the last decade

Until the subprime mortgage crisis of 2007/2008, commercial mortgage-backed securities (CMBS) were a popular way to gain access to the commercial real estate (CRE) debt market. This has changed with the CMBS market seeing less new issuance in the years since the crisis. At the same time, many banks have

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<th>Figure 1. Real Estate Capital Markets</th>
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<tr>
<td><strong>Equity</strong></td>
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<td>Private / Illiquid</td>
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<td>Public / Liquid</td>
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Source: DWS International GmbH. As of: July 2020
been forced to cut back on their leverage and boost their regulatory capital to comply with the regulatory reforms implemented in the wake of the financial crisis. This has created opportunities for insurance companies to engage in the private lending market.

Well-structured and underwritten CRE loans can offer a number of qualities to insurance companies. These include:

- **Illiquidity/complexity premium:** Compared to public debt instruments with similar risk profiles, CRE loans can offer higher spreads reflecting an illiquidity or complexity premium.
- **Backed by real assets:** The underlying property serves as collateral for the loan providing protection through security packages and financial covenants. In case of default, this can also result in higher recovery rates compared to unsecured loans. In some jurisdictions, this principal preservation feature is also reflected in lower solvency capital charges for CRE loans compared to unsecured loans.
- **Portfolio diversification:** Private real estate debt can provide low correlations to traditional asset classes.
- **Source of duration:** CRE loans may be an attractive source of duration to match both shorter and longer-dated insurance liabilities. This makes the asset class attractive for life and P&C insurers alike. However, due to their floating nature in general, interest rate overlays may be necessary.
- **Customisation:** As a private asset class, insurers may negotiate bespoke terms for each loan in order to meet specific duration and cash flow needs as well as regulatory requirements.
- **ESG investments:** In recent years, ESG disclosures in respect of real estate assets (such as energy certificates) have improved significantly. This makes it easier to identify potential ESG investments in the CRE debt space.

**The current commercial real estate lending market and the impact of COVID-19**

The commercial real estate debt market is currently in the classic late stage of its cycle, described in the upper right quadrant of Figure 2, but with some unique attributes.

From a credit perspective, delinquencies continue to be low. We have not seen excessive loan-to-value (LTV) creep or undisciplined underwriting standards, which is a very positive sign at this point in the cycle. We believe the cycle still has more time to run.

Historically, CRE debt was mainly provided in the form of whole loans. However, from the end of the 1990s more granular risk profiles started evolving and loans were broken down into senior and subordinated or junior loans (sometimes referred to as ‘mezzanine loans’), taking incremental risk behind the senior loan.

Moving into the early part of 2020, typical senior margins on European prime offices sat at around 100 to 150 basis points at LTVs of up to 60% to 65%, and junior margins at 600 to 800 basis points at LTVs of up to 80%. In the U.S., those ranges for comparable senior loans sat between 150 and 225, and trading in a wider range for junior debt in a range between 500 and 900.

Given that the effect of COVID-19 on the market has varied significantly by property type, the spread of lending terms between sectors is likely to have widened. Based on our experience, we would estimate that margins on senior lending have increased by 25 to 30 basis points on average since the beginning of the year in both regions. Equally, for junior loans, we would estimate that margins have risen by around 100 to 300 basis points on average, as the upper sections of the capital stack are now deemed to be more at risk.

However, for senior loans in areas such as retail and hotels, the increase is likely to be much greater. Even before the current crisis, underlying issues in the retail real estate market were already beginning to push up margins on retail debt.

This year, we would expect that with a significant drop in real estate transaction volumes, new lending activity will also fall. However, transaction activity has not stopped entirely, and there will continue to be a large number of refinancing requirements. With this in mind, there may be opportunities,
particularly for insurance companies, to take advantage of lower levels of competition and to capitalize on an increase in loan pricing.

Commercial real estate lending will likely remain attractive for insurance companies

Market dislocations caused by the COVID-19 crisis have enabled insurance companies to invest into plain vanilla asset classes such as investment grade credit at compelling spread levels for the first time in many years – at least for those that were able to benefit from the opportunity.

In the short term, the current market situation therefore represents an opportunity for insurers even if spreads have already tightened significantly again. Moreover, with the various measures put in place by monetary authorities the “lower for much longer” interest rate scenario will be the most likely outcome.

Given this outlook, in our view insurance companies necessarily will have to continue to evaluate private markets in search of higher yields. Hence, DWS believes that real estate debt, both senior and junior, will remain a highly compelling asset class for insurance investors.

Past performance is not a reliable indicator of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.