DWS

EUROPE REAL ESTATE DEBT STRATEGIC OUTLOOK

Second Quarter 2022

IN A NUTSHELL

- A notable pick up in direct real estate transactions and growing investor confidence during 2021 spurred increased levels of private debt fundraising. And with many investors intending to increase allocations to real estate debt, those trends show little sign of abating this year, despite increased macro risk.
- Lending margins were squeezed last year, while euro swap rates remained below zero. Competition remains strong among lenders, particularly for logistics and residential, but a significantly higher near-term inflation outlook has led to a sharp rise in lender returns early this year, despite low margins.
- On a risk-adjusted basis, we like the logistics and residential sectors, although there are other segments that are also of interest. For junior lending, we favour CBD offices and urban logistics, while for senior debt, emerging office locations, senior living and student housing look attractive.

Current Market Overview

The importance of private real estate debt for investors in Europe remains clear to see. European domiciled investors have a current allocation of around 9% to non-listed real estate debt within the real estate sector as a whole, and the proportion with allocations to non-listed debt has increased from 43% to 52% over the last three years. Of those who invest in private debt, almost 40% are expecting their European allocations to increase over the next two years, compared to just 5% who expect to see a decrease. This trend was particularly evident among certain larger investors, including sovereign wealth funds and insurance companies.[1]

In 2020, the pandemic saw Europe-focused fundraising for private real estate debt fall to its lowest level since 2012. Real estate transaction volumes dropped by 20% as investors became more risk averse across many parts of the market and completing deals became harder in practical terms due to travel restrictions. However, with wider activity rebounding sharply, private debt fundraising more than doubled in 2021, reaching the second highest total on record. As of April 2022, dry powder is down slightly since the start of the year, but according to Preqin there remains almost $14 billion awaiting deployment and a further 36 funds in the market with an aggregate fundraising total of $19 billion.[2]

Indications from early in 2022 suggest that direct real estate investment activity will remain strong this year. Despite the shadow cast by the Russian invasion of Ukraine, pan-European investment volumes for the first quarter were up by 5% year-on-year.[3] And with the current positive sentiment towards real estate debt, we would expect another strong year for fundraising activity.

[1] INREV Investment Intentions Survey, January 2022
[2] Preqin, April 2022
[3] Real Capital Analytics, March 2022

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Six months ago, we highlighted inflation as an area to watch for real estate lenders. Inflation was already on a steep upward path in the second half of 2021, although there was a general expectation that this would be relatively short lived, with a return to normality by the end of this year. The situation in Ukraine, however, has had a significant impact on the price of oil, gas and other commodities, and there remains significant uncertainty over the length of the conflict and its potential implications. Our view is that inflation will remain high in 2022, averaging somewhere close to 8.0% in the Eurozone, before falling back to a still-above-target 3.3% next year.[4] To some extent, index-linked leases should offer real income protection for property owners against these steep increases, although not all leases contain such a provision, and those that do sometimes contain caps on the rise each year.

CONSTRUCTION COMPANIES' BALANCE OF EXPECTATIONS FOR OUTPUT PRICES (% BALANCE, NEXT 3 MONTHS)

Source: European Commission, March 2022

Higher inflation will also have other effects on real estate. One area will be construction costs, which had already been rising rapidly before the conflict began. Producer prices for metal ores, timber and plastics all rose by between 25% and 47% over the two years to end-2021,[5] and the recent spike in gas prices could also start to feed through into cement production prices. Escalating costs are an area of concern for development lending, creating additional risk. However, if weaker developer profits also lead construction volumes to fall, this could provide a potential impetus for stronger rental growth, and therefore values, in the longer term.

Rising rates could also strain financing costs for floating rate borrowers. To some extent, increasing income through lease indexation could offset rising financing costs, albeit with a lag, while rate caps can also help to protect borrowers against significantly higher rates. Of course, for holders of such loans, a higher reference rate equates to a stronger return. And with lending practices typically remaining more conservative since the GFC, debt servicing costs generally have some room for manoeuvre. Although, with rates rising fast, Interest Coverage Ratio (ICR) and Debt Service Coverage Ratio (DSCR) covenants on existing loans could in some cases come under pressure, possibly requiring an injection of equity from the borrower.

European banks increased loss provisioning significantly during the early part of the pandemic, and by the start of this year some had already started to release those provisions. However, the ECB has urged caution, with the recent spike in inflation and removal of Covid-related government support, lenders are being asked to carefully consider sector exposure as well as individual borrowers' default risk.[6]

While our current view is that inflation will gradually return to target (2.0% p.a.), long-term interest rates have risen sharply in the early part of this year as concerns over longer-term effects are showing through. The German 10-year Bund increased by 80 basis points in the first three months of 2022, and the euro area five-year swap by 90 basis points. With current real

[4] DWS, March 2022
[5] Eurostat, March 2022
[6] S&P, February 2022

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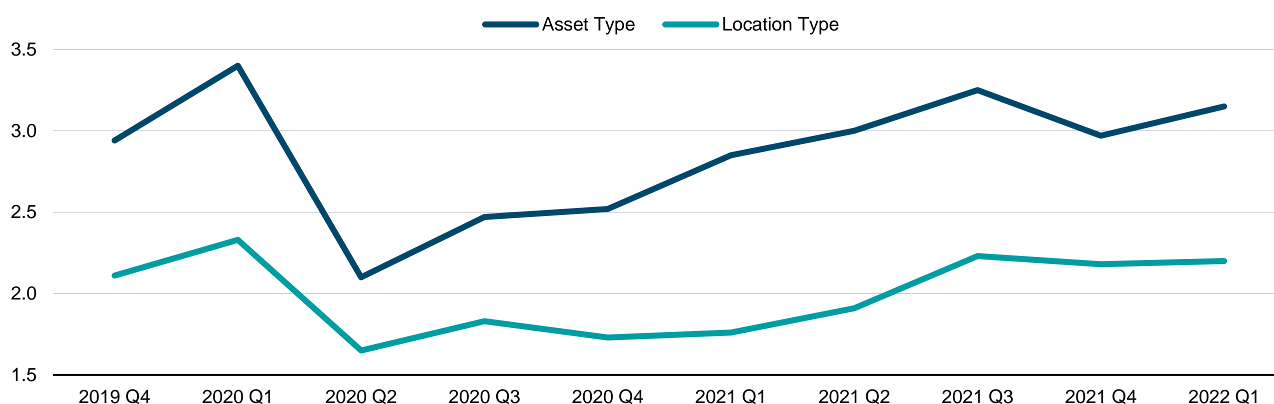
estate yield spreads being well above historical norms, this does leave some room for rising rates to be absorbed, but if long-term rates continue to climb, this makes further yield-led capital value growth less likely.

With regard to risk appetite, the initial onset of the pandemic led to a significant change in attitude, as finance professionals rapidly switched their attention to more core locations and assets. The year and a half since then has seen risk appetite pick up again, with better opportunities foreseen higher up the risk spectrum, particularly in terms of asset strategy. However, given the geopolitical events of the first quarter, an increased perception of risk in the underlying property market could see some tightening of underwriting standards again and a shift back towards core.

RISK OPPORTUNITY SCORE (WEIGHTED AVERAGE OF SURVEY RESPONDENTS, NEXT 3 MONTHS)



Source: Real Capital News, CREFC, March 2022
Note: *Asset categories run from 1 (core) to 5 (development/repositioning); location categories run from 1 (prime city centre) to 5 (developing markets).

Increasing levels of confidence in the European economic recovery and a significant pick-up in real estate investment led to strong activity within the real estate private debt market during 2021. The year started well, with loan originations in the United Kingdom reported to be up by 50% year-on-year during the first six months of the year.[7] European private debt fundraising during the second half of the year was more than double the first-half total, and CMBS activity continued apace in both the United Kingdom and Continental Europe, leading to the strongest year for European issuance since 2013.[8]

In Germany, following a brief hiatus in 2020, when some banks withdrew from the market and others focused on a narrower set of opportunities, competitive pressure began to build again during 2021. However, there has been a reluctance among the banks to take on more risk through a move into the value-add end of the spectrum, with concerns over potential for exaggerated underlying property values, given recent strong yield compression. This concern was evidenced by a decline in LTVs for new business during the pandemic in 2020.[9]

This was also seen elsewhere in Europe. However, the wider trend over the past year has been for LTVs to creep back up again in some segments of the prime market. This has particularly been the case for logistics, where exceptionally strong performance of the underlying assets throughout the pandemic, together with a positive outlook for occupier demand and rental growth,[10] has led to strong competition among lenders.

We estimate that average LTVs for loans secured against prime logistics properties are now around 60% on average across Europe, up from 57% before the pandemic. Margins were also estimated to be around 25 basis points lower at the end of 2021 compared to two years earlier, and the sector is now often priced similarly or even below offices. By way of comparison, office margins are only just back to their pre-pandemic levels and retail remains 15 basis points higher. Yet the retail sector

[7] Bayes Business School, October 2021
[8] Trepp, JP Morgan, March 2022
[9] IREBS, September 2021
[10] DWS, January 2022

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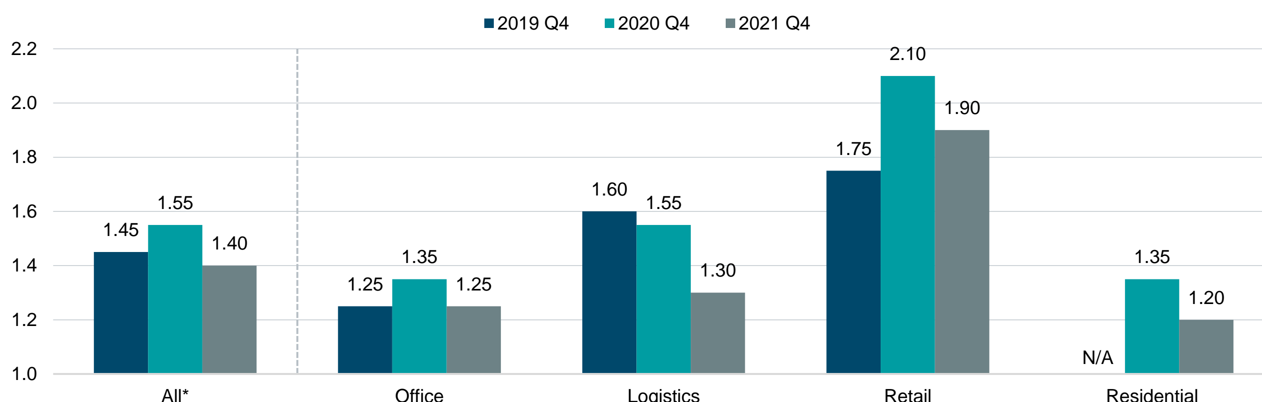
is perhaps the hardest to read due to a low volume of transactions, and the differential is likely to be considerably higher for some parts of the market, such as secondary shopping centres.

WEIGHTED AVERAGE EUROPEAN SENIOR LENDING MARGINS BY SECTOR (%)



Source: CBRE, DWS, April 2022
Note: *Excluding residential

While logistics and residential are attracting the most attention among senior lenders, willingness to lend in the retail sector is slowly returning, although with a preference for new acquisitions over refinancing, due to the value being set on the open market and therefore reducing future re-pricing risk.[11] What's more, there is significant disparity in sentiment towards different types of retail asset. We have seen this in recent performance data on the direct side, with assets such as retail parks comfortably outperforming smaller shopping centres.[12] This is certainly reflected in the availability of finance, with a greater number of lenders willing to finance supermarkets than shopping centres, for example. And even among alternative lenders – who are generally able to sit higher up the risk curve than the banks – appetite for secondary retail remains low.[13]

In the junior space, residential remains the most popular sector among lenders in Germany, and although major cities are still a preference or even a requirement for some, there has been more willingness to lend in strong locations within smaller cities, as well as in weaker locations within larger cities. Hotel and retail generally remain unpopular among junior lenders, although demand for offices – which had dropped off during the early part of the pandemic – has now returned for stronger assets.[14]

In the office market in general, lenders remain more cautious towards secondary stock. As well as concerns over the level of demand for secondary space, given changing working practices, the potential requirement for significant capital expenditure in order to meet certain ESG criteria is creating some hesitance. In fact, the topic of ESG is growing in importance for lenders, with many now having specific lending programmes for green financing, and others indicating that they would offer lower margins for assets that achieve high ESG standards.[15] The recent evolution in sustainability certification and moves towards other agreed standards in the field of ESG have been key factors in enabling this part of the market to grow.

In terms of geography, the lowest rates for senior lending are still to be found in Core European countries such as Germany, France, the Netherlands and Denmark, while the United Kingdom, Central and Southern Europe all attract a fairly sizeable premium. In the Euro Area, the rise in swap rates late last year was largely absorbed by the typical zero floor on CRE lending. Conversely, swap rates in the United Kingdom were already above zero and so the increase was transferred entirely into higher lending rates, leading to an increasing delta between the two regions.

[11] CBRE, March 2022
[12] MSCI PEPFI, March 2022
[13] Bayes Business School, October 2021
[14] FAP, October 2021
[15] Bayes Business School, October 2021

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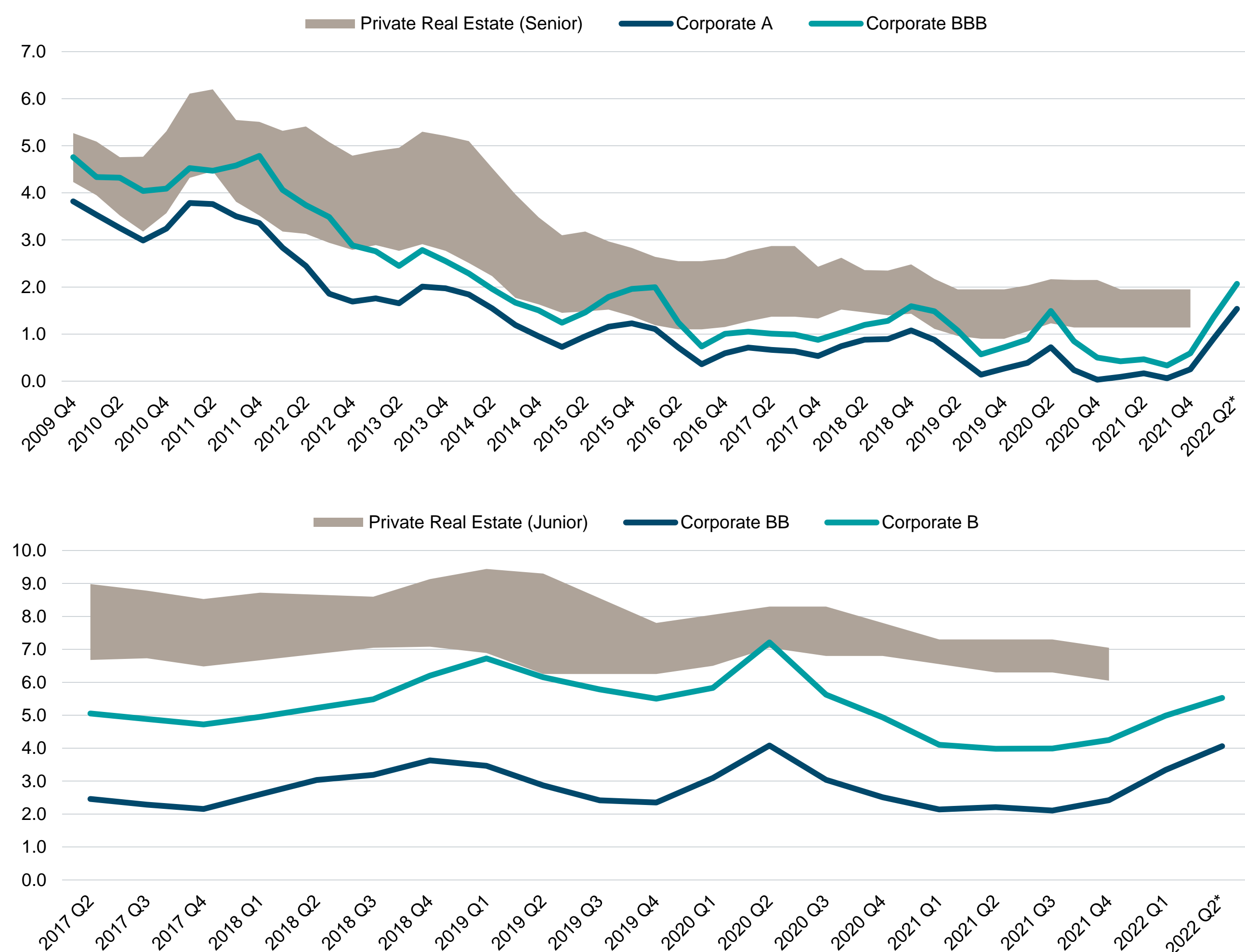
This year, with euro swaps now above zero, rising rates have meant that borrowing costs have risen universally. And with inflation already running at its highest level for a generation, a winding down of quantitative easing (QE) and expectations of central bank rate hikes, swaps are likely to remain elevated.

European senior lending rates for prime offices have typically offered an illiquidity premium of around 50-100 basis points over the equivalent-rated corporate bond yield. For junior debt, the spread rises to around 200-400 basis points. Despite some increase in wider market risk early in 2022, strong ongoing competition is likely to have kept margins under pressure. By mid-April, non-financial corporate bond yields sat 130-150 basis points higher than at the end of 2021, and while evidence from the private real estate debt market can be slow to emerge, a similar rise in the swap rate is likely to be reflected in loan pricing across the continent during the first half of this year.

EURO AREA REAL ESTATE DEBT (OFFICES) VS. CORPORATE CREDIT YIELDS (%, QUARTERLY AVG.)



Source: DWS, CBRE, Markit iBoxx, March 2022. Note: 2022 Q2* represents incomplete quarterly average. Data are quarterly averages. Private Real Estate: Total cost of debt for senior office loan in Germany, France, Netherlands, Italy and Spain; Corporate A: iBoxx € Non-Financials A 5-7; Corporate BBB: iBoxx € Non-Financials BBB 5-7; Corporate BB: Markit iBoxx EUR HY Financials BB 5-7; Corporate B: Markit iBoxx EUR HY Financials B 5-7.

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Market Outlook

Coming into 2022, the European economy and real estate market were on a relatively strong footing. However, a sharp rise in inflationary pressure has meant that five-year swap rates have turned positive for three years, reaching an eight-year high of 1.00% at the end of March and increasing further to 1.25% by mid-April.

Strong competition among lenders has been putting downward pressure on loan margins over the last 18 months, but with senior margins already at exceptionally low levels and risk perceived to have increased due to the Ukraine conflict, margins are unlikely to have compressed a great deal further in the early part of this year. The rise in swap rates means we expect a significant increase in yield to maturity. But at the same time, higher financing costs for both developers and property owners could have their own consequences in terms of risk.

Here, we compare risk and return between regions and sectors for both senior and junior lending. Lender returns are composed of the five-year swap rate, margin and arrangement fee spread over the term of the loan, while risk is assessed based on the following criteria:

- **Covenant stress test**: An assessment of the potential for financial covenant breaches based on our underlying property forecasts and on historical data from periods of stress.
- **Occupancy risk**: Measured by the current vacancy rate, as well as recent and long-term historical occupancy trends.
- **Interest Coverage Ratio**: A measure of the ability of the income generated by a property to cover interest costs. We use ICR rather than DSCR as loans are assumed to be interest only for the purpose of this analysis.
- **Debt yield premium**: A gauge of the lender’s cushion vs. the property owner.

Our analysis shows that senior debt tends to follow the expected pattern of increasing returns at the expense of greater risk. The relationship is less clear cut for junior lending, although availability of data in this space plays its part. However, across the capital stack, results suggest that it may be possible to improve risk-adjusted returns by prioritising lending opportunities in certain regions and sectors.

Senior:

- The United Kingdom, Ireland, Southern Europe and the CEE region currently offer a hedged return premium of 50-75 basis points over Core Europe, with only moderately higher risk. Within Core Europe, there is little to choose between countries in terms of lender returns, although the Netherlands, Belgium and Denmark offer similar returns to France or Germany, but with less risk.
- In the logistics sector, a larger weighting to the higher-yielding U.K. market keeps the pan-European average fractionally above offices, but in fact most markets are now seeing logistics priced at similar levels to offices and residential. The Polish market looks to be among the most attractive within the sector, although the Ukrainian conflict could pose greater short-term risks to the CEE region.
- Logistics and residential offer a weighted average senior lender return of 125-150 basis points, but with lower volatility and better occupancy metrics, overall risk for both sectors is notably lower than for offices, which is priced similarly. Within the office sector, Southern Europe looks to be among the more attractive regions on a risk-adjusted basis, offering a return premium of 50-60 basis points over Core Europe, but with only slightly greater risk.
- In the residential market, debt yields tend to be low, providing the lender with less of a cushion over the property owner. However, volatility has been considerably lower than other sectors in the past and our longer-term outlook for the underlying occupier market is positive. As such, overall levels of risk are adjudged to be considerably below the all-

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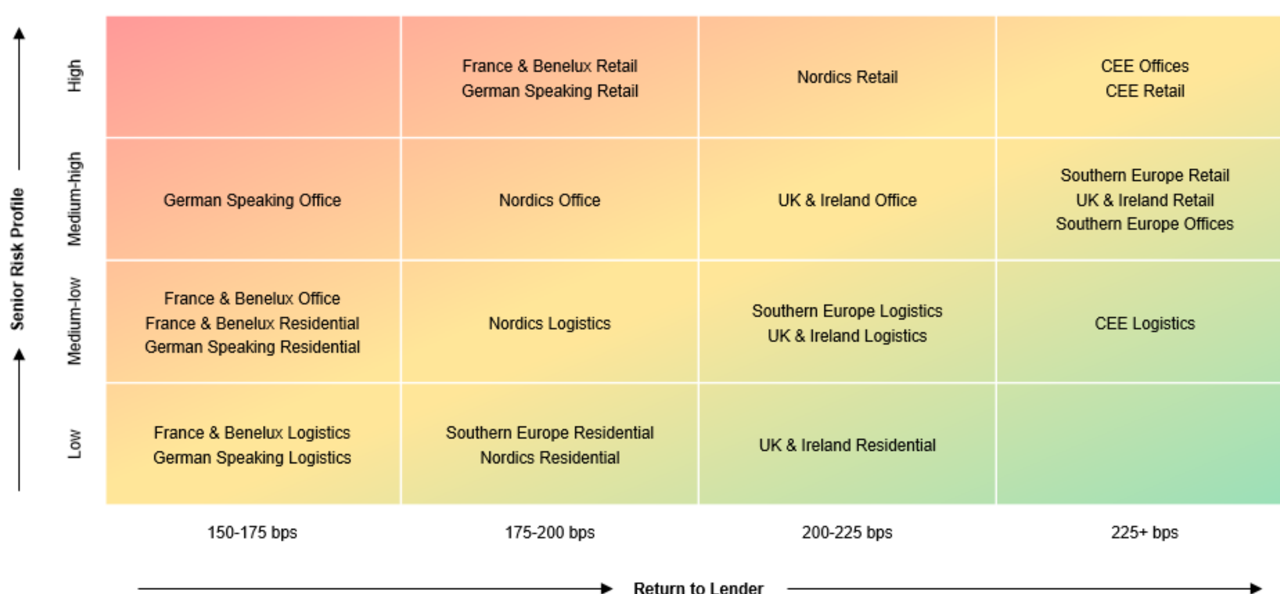
property average for the residential sector, and so those markets with the highest absolute returns – the United Kingdom, Ireland and Spain – also look the most attractive on a risk-adjusted basis.

_ Until about five years ago, retail was priced in line with offices. Since then, the return premium for lenders has grown considerably, with the recent pandemic only serving to widen the spread further. But with this comes significantly higher risk. On the face of it, higher interest coverage ratios, higher debt yields, and lower LTVs paint a somewhat positive picture for retail. However, these would only apply to new lending at current rates and would assume assets are marked to market and will remain tenanted and operational. With the occupier balance for European retail continuing to move in the wrong direction, further falls in both rents and values expected in the short-to-medium term, and a greater chance of tenant failures, this shifts the balance of risks well into negative territory.

_ That said, within the retail sector there are still markets that look more attractive on a relative basis. Here, the risk-return relationship holds less well, as markets with higher returns, such as the United Kingdom or Southern Europe, also score slightly better on risk than lower-yielding markets such as Germany and France. In the case of the United Kingdom, this is partly down to the fact that more of the correction to underlying values and rents has already occurred, meaning that we see less risk of covenant breach looking ahead (again, based on new lending at market values). Nevertheless, relative to the other main sectors, risks remain elevated, particularly for the shopping centre segment.

SENIOR RISK & RETURN OUTLOOK



Sources: DWS, CBRE, April 2022
Note: Return includes estimated hedging costs into euros where applicable

Junior:

_ The junior lending market remains somewhat opaque, although our own database provides useful guidance and has enabled us to estimate lending conditions across many of the main markets and sectors.

_ Pricing for logistics and offices continue to move in close step, although there are some markets where the evidence would suggest that logistics is now priced slightly lower. Given recent positive sentiment towards logistics and its strong longer-term outlook, this isn't hugely surprising, although lenders remain broadly positive on the outlook for prime offices as well, as pricing remains competitive, and margins have compressed over the past year and a half. That said, we still believe there is quite a gap in risk profile between the two sectors, with logistics continuing to look more attractive overall. In terms of region, France, Benelux and the Nordics look likely to offer some of the better opportunities, particularly for logistics.

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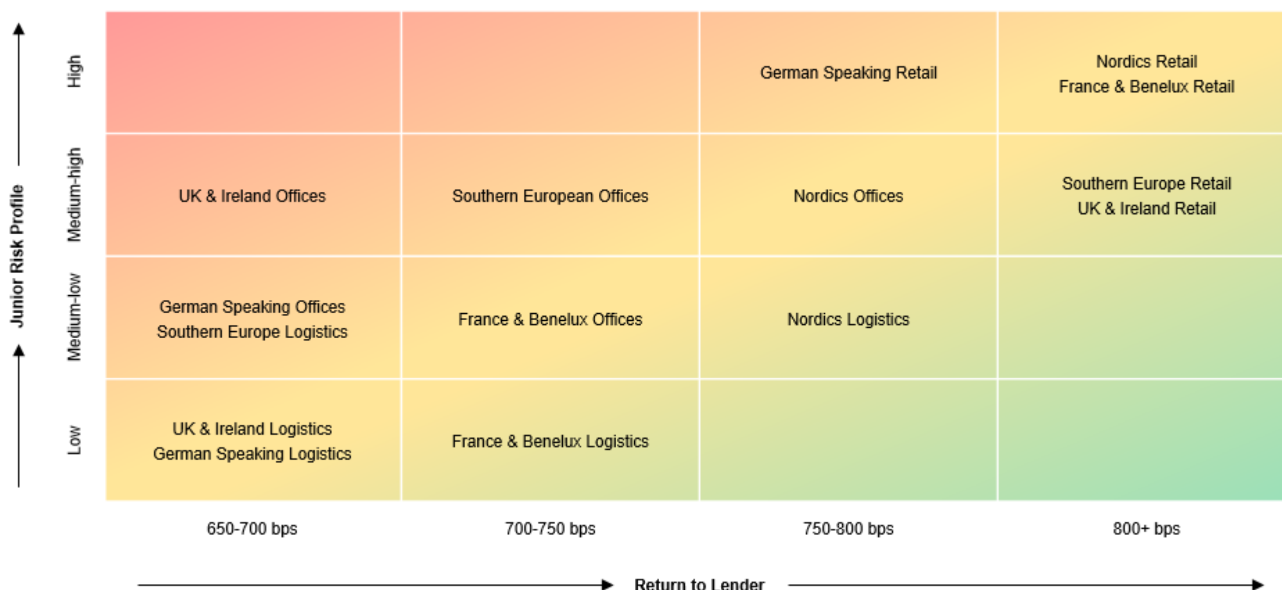
_ For retail, many lenders remain cautious towards even senior lending, with new junior lending remaining largely off the cards. For those lenders who are willing to lend within the sector, we estimate that junior margins could be between 100 and 200 basis points higher than both offices and logistics. While risk for junior retail lending is clearly significantly higher than for other property types, the United Kingdom and Southern Europe again look to be more attractive on a relative basis within the sector, offering hedged returns of 8-9%, but with lower risk compared to other markets. Still, there are a number of other risks not directly considered within this analysis, and we would remain cautious on junior lending for most parts of the retail sector.

JUNIOR RISK & RETURN OUTLOOK



Sources: DWS, CBRE, April 2022
Note: Return includes estimated hedging costs into euros where applicable

Investment Strategy

Despite elevated risk due to the Ukraine conflict and ongoing pandemic, our medium-to-long-term outlook for the underlying property market remains favourable. While high inflation and other near-term risks may temper the strong recovery seen during the second half of 2021, we still believe that junior debt in particular will perform well on a risk-adjusted basis. However, particularly with higher rates this year, some parts of the senior market may also start to look more attractive again.

Floating rate vs. fixed rate: The impacts of higher inflation and interest rates can be complex and should be considered carefully within underwriting. Intuitively, in a time of rising interest rates, lenders prefer floating rate loans over fixed rates, although in this environment an argument can be made both ways. Floating rates allow lenders to increase returns as interest rates rise. Additionally, fixed rate pricing strongly depends on expectations of where interest rates will move, meaning that if rates rise more than anticipated over the life of the loan, the variable rate will likely emerge as the winner from the lender's perspective.

However, rising rates could also increase financing costs for the borrower, leading to additional risk of covenant default or tenant distress, putting any potential additional return to the lender at risk. In the current environment we would ideally maintain a mix of floating and fixed rate loans, with a tilt towards a greater proportion of floating rates.

ESG: Buildings are increasingly influenced by ESG considerations, either through regulation or through tenant requirements. While investors are still working to fully quantify the financial benefits of ESG, and measurability is still evolving, we believe

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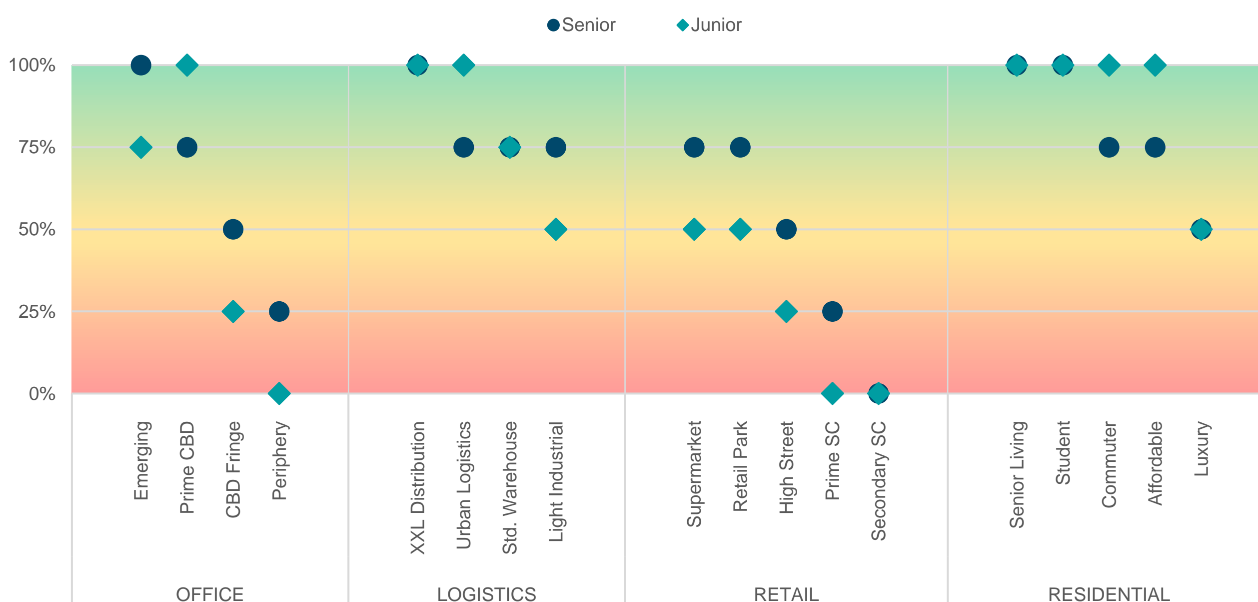
an increased focus in this area is likely to support assets to achieve higher rents, better maintain their value over time, and benefit from improved liquidity upon sale. For lenders, one of the key areas of risk is around refinancing, and so incorporating ESG evaluation within the underwriting process and targeting buildings with stronger credentials should be an important way of mitigating this risk.

Lenders can also work with borrowers to improve standards for weaker existing buildings by offering incentives to meet certain agreed measures within the terms of the loan. Taking a short-term view, accepting a slightly lower absolute return – either for a stronger asset initially or through improvement incentives for weaker assets – might not sound attractive for a lender, but taking a longer-term risk-adjusted view, strong ESG credentials could lead to return outperformance.

Urban logistics: Overall, logistics remains appealing on a risk-adjusted basis for both senior and junior lending. Our occupier market outlook is still positive for the sector in general, although urban logistics is expected to be a clear outperformer due to greater supply constraints and strongly positive demand trends.

Last-mile assets in particular could be well placed to counter higher inflation and fuel costs, with proximity to customers moving further up the agenda for occupiers. However, with senior logistics margins now at close to 100 basis points in Core Europe, we feel that junior looks slightly more attractive, with returns of 600-700 basis points, and typical maximum LTVs of 75-80% offering sufficient downside protection.

PRIVATE DEBT STRATEGIES BY SUBSECTOR (LEVEL OF CONVICTION, %)



Source: DWS, April 2022

Prime CBD and emerging office locations: Office occupancy has taken a hit thanks to the pandemic. Rapid changes to working practices have led many occupiers to reassess their space requirements, with some downsizing and switching to more flexible working arrangements. However, while the overall occupier base may have shrunk slightly, the demand for high-spec, well located offices remain as strong as ever.

Similarly, to urban logistics, senior pricing for prime CBD offices assets is tight, leading us to a preference towards junior lending in this space. On the other hand, in less established but emerging locations, senior could still be more attractive, assuming a slight margin premium over prime CBD assets.

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Commuter residential and life-long living: The residential sector tends to offer the lowest absolute lender returns, although segments such as student housing and senior living often still offer a slight margin premium compared to PRS. This could in part be down to increased operational risk in these segments but could also be partly down to the smaller and less mature market, which may deter some lenders from entering.

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 PBSA. Within the PRS segment, we would favour commuter and affordable schemes over luxury residential, with the latter tending to experience higher volatility in pricing.

Retail (selective): Our risk-return analysis for the retail sector largely focuses on the shopping centre segment, and here we maintain a negative view, despite the notable return premium. However, other parts of the sector – which is still shunned in its entirety by some lenders – may now be starting to offer certain opportunities.

Supermarkets and retail parks were among the better performers within the sector throughout the pandemic, and both have a moderately positive story looking ahead. We don't foresee strong value losses in either segment over the long run, but we would still favour senior over junior here due to the long-term risks around online sales diversion. Immediate risks around high inflation should also be considered, although the grocery segment tends to be better insulated in this regard. On a very selective basis, the prime high street could also start to look interesting, as we feel much of the total correction to values and rents has occurred already, and the likelihood of further decline has diminished.

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