

Europe Real Estate Debt Update

October 2022

IN A NUTSHELL

- With inflation at a 40-year high, rising interest rates have pushed up borrowing costs to their highest levels for more than 10 years.
 - Sentiment among lenders has turned, with concerns over liquidity, the economy and increased levels of risk within the underlying property market counteracting any increase in sentiment around higher returns.
 - Although our view on lending has softened in many parts of the market, those segments that offer a yield premium while still benefitting from solid long-term growth fundamentals could still offer strong risk-adjusted opportunities for junior lenders.
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Current Market Conditions

Rising interest rates have led to significantly higher lender returns – but also higher underlying risk

In the first nine months of this year, the European economy has gone from a position of relative strength to being on the verge of recession. The conflict in Ukraine has had significant and wide-ranging impacts, perhaps most notably in forcing up consumer price inflation to around 10% across the continent, its highest rate for 40 years. In an attempt to bring this under control, central banks have already increased policy rates, and the market expects significant further tightening in the coming months. As such, longer-term swap rates have spiked.

The underlying property market remains in relatively good shape right now; occupancy levels are at or below historical averages, and with European leases typically benefiting from some form of indexation, higher inflation should at least to some extent be passed through to in-place rents. The weakening economy does of course pose a threat to near-term occupier fundamentals, although with rising construction costs and high levels of market uncertainty limiting construction activity, lower levels of supply in the medium term may soon begin to offset any reduction in demand.

In our most recent direct real estate forecasts, we estimated that property yields would move out by 20-40 basis points this year,¹ driven by a rapid narrowing of the spread over long-term fixed income yields and a sharp rise in borrowing costs. The year-to-date numbers would broadly support that outlook, although a small handful of cities have already seen yields move out by as much as 50 basis points in the year to September. This trend is not limited to the more challenging sectors either; logistics and

¹ DWS, July 2022

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residential – both of which have seen strong occupier trends in recent years, even through the pandemic – have seen yields move out almost as fast as the weaker-performing office sector.²

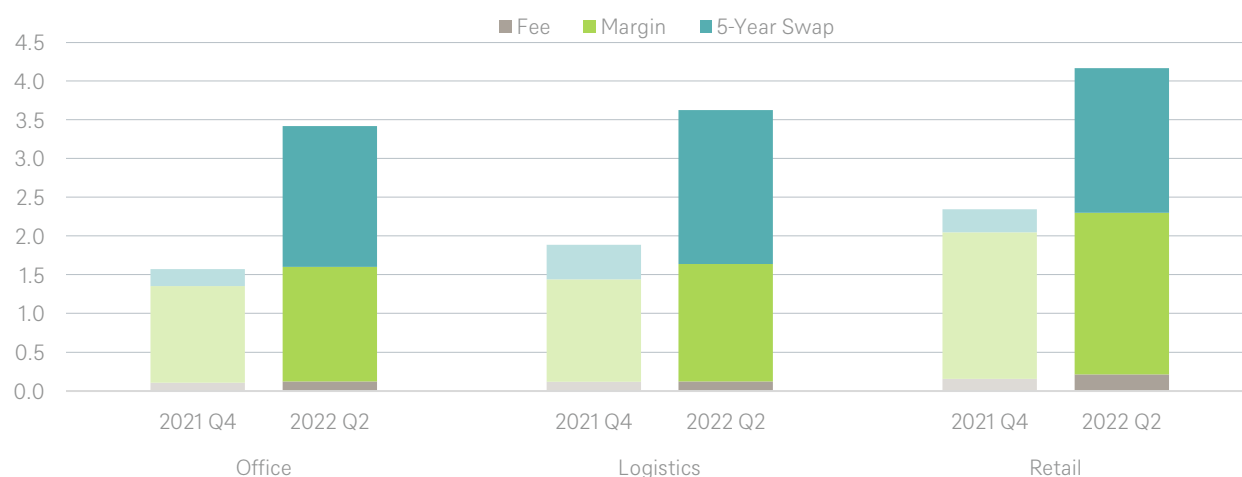
This short-term price correction, with a likelihood of more to come over the next 6-12 months, suggests a marked increase in risk for real estate lenders across the spectrum. But despite near-term volatility, our longer-term forecasts for property yields have not changed significantly. This means that for assets that are initially valued at a significant discount against recent pricing, the risk of further value decline over the lifetime of any new loan should be mitigated to some degree.

However, with all-in borrowing costs now approaching or even exceeding valuation yields in some cases, some financial covenants on existing loans could become stretched, while new loans will almost certainly be underwritten more cautiously. Investment activity has also slowed markedly. Our own experience suggests that pricing is often moving faster than the data suggests, but with fewer investment comparables, valuers have been slow to knock down values. This has implications for underwriting refinancings, where the property value is driven by valuer appraisals, as opposed to acquisition finance, where the price is determined by the open market.

In the first six months of the year, borrowing costs doubled, most of which was due to the strong rise in swap rates, which have since moved out further.³ The five-year euro rate averaged 2.0% in the third quarter, rising to more than 3.0% by the end of September – having started the year at zero. However, core senior lending is still somewhat dominated by the banks, and given recent and expected interest rate movements, increased funding costs mean that margins are also starting to get pushed out. This is likely leading to a narrowing of spreads between the banks and alternative lenders.

Additionally, some banks are either retrenching to home markets, moving away from certain risk profiles (e.g., development lending) or reducing available leverage on new loans. With less competition, this could put further upward pressure on margins at the core end of the market.

Senior Total Cost of Debt – European Weighted Average by Sector (%)



Source: CBRE, Macrobond, DWS October 2022

² CBRE, October 2022

³ CBRE, Macrobond, DWS, October 2022

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Sentiment has turned

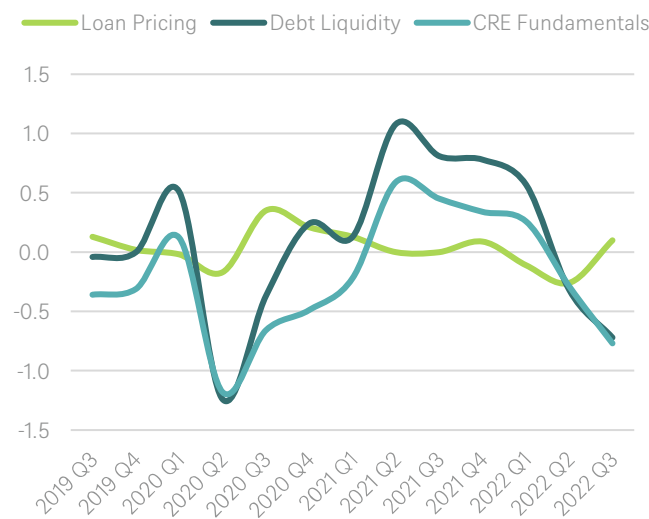
Growing lender caution and significantly fewer direct transactions are leading to a slowdown in lending activity.

Economic headwinds are starting to affect sentiment within the real estate debt market, with views on both the underlying property market and the availability of lending becoming more negative since the start of the year. On the other hand, higher pricing is – perhaps unsurprisingly – viewed positively by lenders, although the relatively modest uptick in pricing sentiment suggests that this is being viewed within the context of greater market uncertainty, with increased concern over borrowers’ ability to abide by existing financial covenants.⁴

Sentiment towards every sector has also diminished since the start of the year. While lenders remain moderately confident around the living sectors (residential, student and senior living), they have become significantly more pessimistic towards retail, offices and hotels. However, the largest drop in sentiment was seen within the logistics sector, a view that is likely down to a feeling that the sector has become overpriced. There are also potential worries around the ability of 3PLs to afford higher rent payments (given they are typically operating on tight margins), supply chain issues, and the potential for the cost-of-living crisis to weaken consumer demand. The counterargument would be that future demand drivers for logistics look solid, and the market remains heavily undersupplied – but pricing looks vulnerable right now.

European CRE Debt Market Sentiment

Overall Sentiment (change from previous quarter, net balance)



Sector Sentiment (change from previous quarter, net balance)



Note: *Includes senior living
Source: CREFC, August 2022

While there remains plenty of capital available for real estate lending, there is little doubt that the market has slowed. Fundraising activity for European real estate debt recovered well after the Covid pandemic, and direct transaction activity in the first half of this year was the highest for seven years. However, the third quarter paints a different picture, with direct investment volumes similar to those recorded in the same period of 2020 during initial phase of the pandemic. And with investors adopting a higher degree of caution, fundraising also appears to be slowing – in the second and third quarters, only one sizeable European

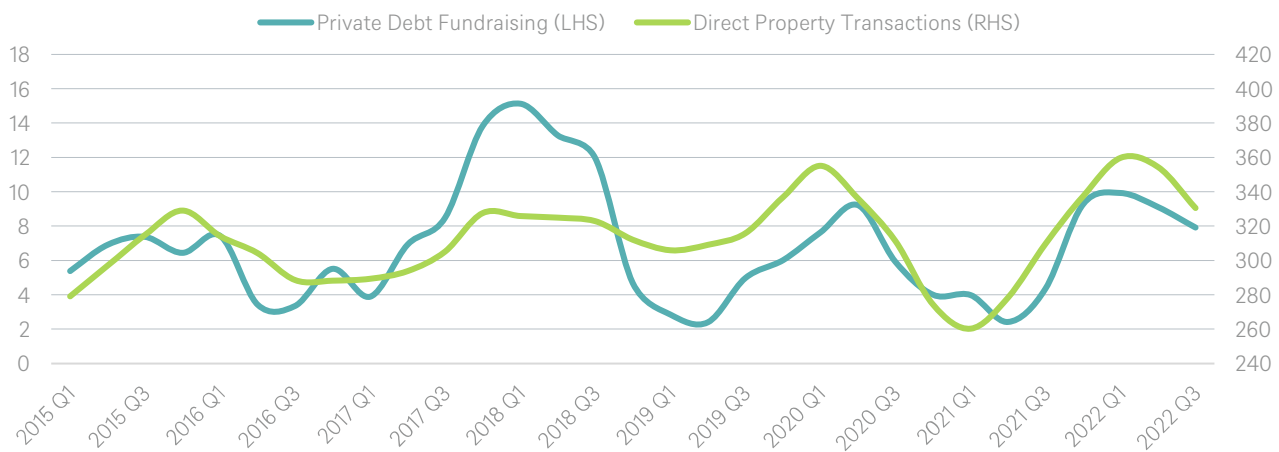
⁴ CREFC, August 2022

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real estate debt fund reached a close. As such, the amount of dry powder allocated to European CRE debt has fallen by almost 20% so far in 2022 as existing funds deploy capital.⁵

With the investment market expected to continue at a slower pace for the remainder of 2022, there are likely to be fewer opportunities for new acquisition lending in the short term. By no means does this mean that the lending market will grind to a halt, but heightened risks will likely necessitate extra caution – which could mean, for example, additional due diligence or stricter lending criteria. Furthermore, with senior lenders lending at lower LTVs, this could lead to funding gaps in upcoming refinancings, creating opportunities for junior lenders.

CRE Private Debt Fundraising & Direct Property Transactions (12 month rolling, €bn)



Source: Preqin, Real Capital Analytics, October 2022

Investment Strategy

Risks have increased, but savvy lenders could still benefit from higher risk-adjusted returns

Overall, the attractiveness and stability of the underlying real estate market has declined compared to six months ago, and our level of conviction towards lending in certain segments and sectors has been revised downwards accordingly, despite an increase in lender returns. Risks have certainly increased to some extent within the logistics sector due to the increased potential for a more significant value adjustment. Prime corridor logistics looks more at risk from rising costs, and here we are less optimistic than at the start of this year, particularly for junior lending. That said, for urban logistics, strong demand drivers and acute shortages of space are likely to offer more protection against falling property values, making both senior and junior lending continue to look attractive within the segment.

Retail, largely speaking, is off the radar for many lenders. Our view on the sector was perhaps beginning to soften earlier this year, but even retail parks, which have proven to offer some additional resilience to online migration and have been a recent outperformer within the sector, now face headwinds. Supermarkets look to offer the most resilience against rising prices and falling incomes, and this is perhaps the one retail segment that still looks attractive. Meanwhile, in the hotel sector, the budget

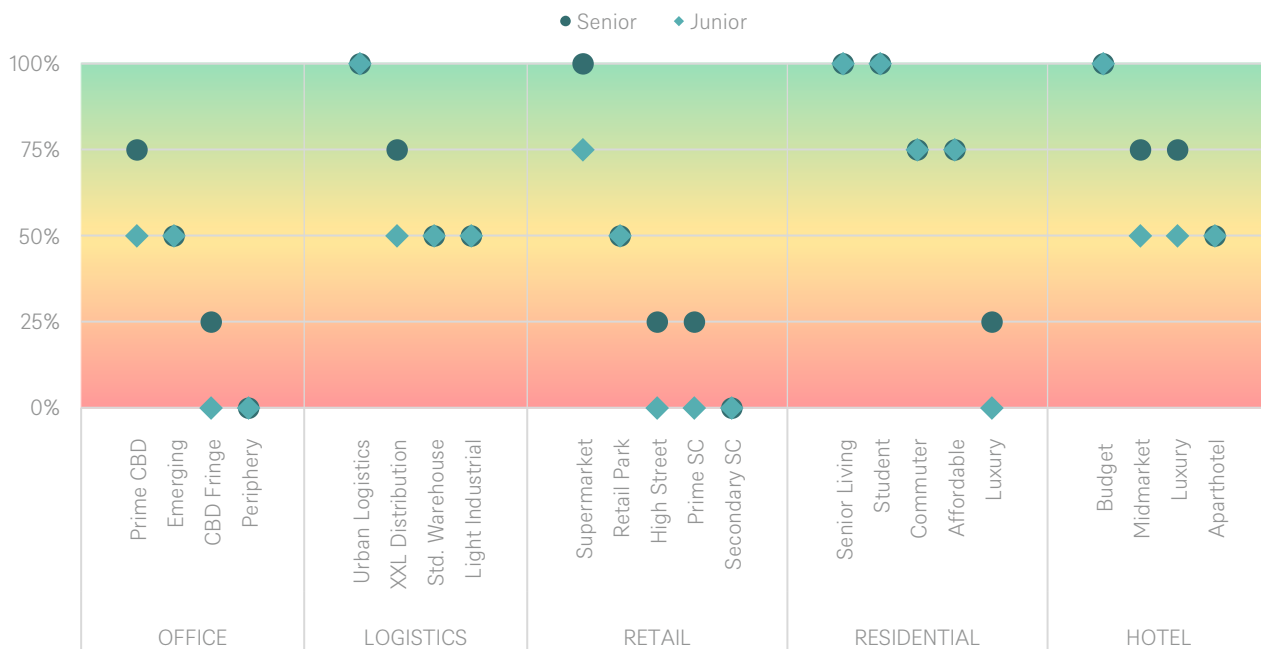
⁵ Preqin, October 2022

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segment looks best placed to weather the cost-of-living crisis, although midmarket and luxury hotels also look relatively secure for senior lending given very long lease lengths.

Residential is perhaps the most attractive sector overall, particularly senior and student, both of which tend to offer a margin premium over the private rented sector (PRS) while benefitting from strong long-term demand drivers. Falling disposable incomes are also likely to support demand in the commuter and affordable segments. Our view on offices has softened across all segments, as underlying fundamentals are likely to deteriorate over the next 12-18 months. Prime CBD offices still look relatively resilient from an occupier perspective, although even here there is an elevated chance of a notable price correction, meaning increased risk for junior lenders in particular.

Investment Strategies by Sector (level of conviction, %)



Source: DWS, October 2022

Furthermore, there may be a current disconnect between asset performance and what a junior lender is willing or able to lend against. For the lowest yielding sectors such as PRS or prime offices in major cities, all-in senior loan rates have increased far more than property yields this year. For junior lenders this may mean that the numbers no longer stack up, as the property simply won't generate enough income to service the junior loan. As such, lenders will need a further focus on income and stability of cashflow, in addition to location and asset type.

Higher yielding assets and sectors might pose less risk of a debt service covenant breach when interest rates rise significantly, as there will be more excess cash from the rental income to service higher loan payments. In the current environment, properties with more affordable rents could therefore look more attractive from a lender's risk perspective. This means that with today's market pricing, as well as a focus on niche or alternative segments such as senior living or student accommodation, lenders may also look towards prime offices or PRS in regional cities, where assets can often trade at a notable yield premium over key gateway cities such as London or Paris.

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