# EUROPE REAL ESTATE DEBT UPDATE

November 2021

**IN A NUTSHELL**

_ Debt market activity is picking up across the continent. Europe-focused private debt fundraising has recovered strongly this year, while UK originations in the first half of the year were up by 50%.

_ Overall lending terms remain conservative, with maximum LTVs drifting lower in some markets. However, there has been a clear shift in sector perceptions, while more generally, risk appetite has risen both in terms of location and asset strategy.

_ Fundamentally, private debt remains a key sector for investors, and regulatory change is opening up more opportunities for non-bank lenders. Selectively, junior debt looks attractive on a risk-adjusted basis, with an expected market recovery supporting underlying property fundamentals.

## Current Market Conditions

With a marked rise in confidence, both within the real estate investment market and in the wider economy, the last six-to-nine months have seen a significant pickup in real estate debt market activity. In the United Kingdom, loan originations during the first half of the year were up by 50% year-on-year. And given that originations between January and June typically account for a little less than half of the annual figure, full year volumes are likely to easily exceed last year's subdued total and should even surpass the ten-year average.

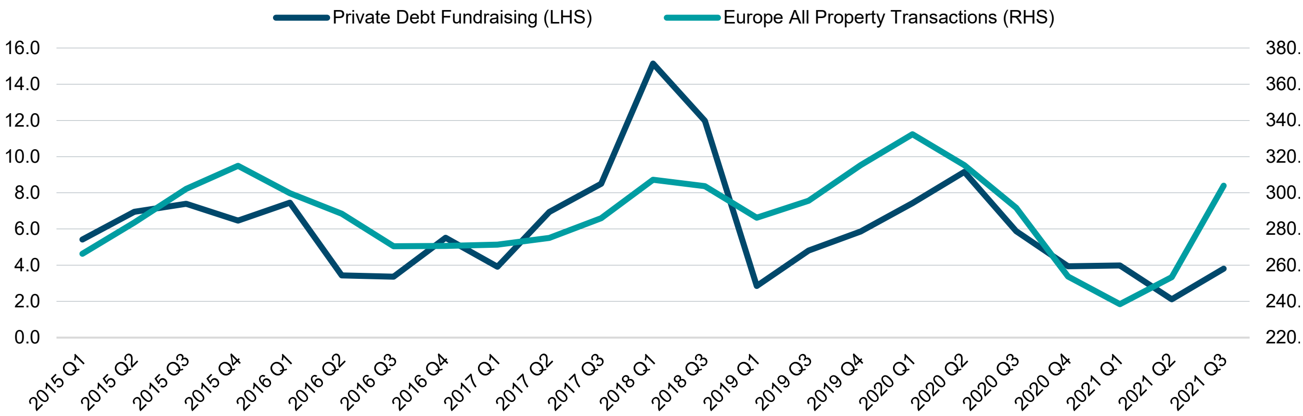
Over the last decade, we've seen a large rise in private debt issuance among non-bank lenders as the banks have retrenched due to increasing capital requirements and regulatory burden. But perhaps unsurprisingly, given the fall in direct real estate transaction volumes during the worst of the pandemic last year, activity on the debt side also took a hit during this period.

Private debt fundraising ground to a halt in the second half of 2020, but in the first three quarters of 2021, seven funds with a focus on Europe reached a final close with a total capital raise of $4.4bn. This is only slightly below the average for the first nine months of the year over the past eight years, in both size and number, and a sure sign that activity is picking up. As such, dry powder is down slightly, but as of early October there is still a significant $15.2bn waiting to deploy, while there are currently 44 funds in the market aiming to raise a total of $23bn.[1]

Looking at current investor opinions, there is also still a strong positive view towards commercial real estate debt, and as travel and the European economy continue to reopen, overall real estate transactions are set to pick up next year and we'd expect this to spur increased debt fundraising activity.

[1] Preqin, October 2021

**EUROPEAN REAL ESTATE PRIVATE DEBT FUNDRAISING & DIRECT TRANSACTIONS (12-MONTH ROLLING, EUR BN)**




Source: Preqin, RCA, October 2021

The pandemic has led to a general increase in caution with regard to lending terms, as evidenced by a slight decline in LTVs on new lending in some markets[2] and a general deleveraging of outstanding loan books[3]. With the banks becoming even more selective on new lending, this has most likely increased the funding gap further. Non-bank lenders have been particularly active this year, increasing their share of outstanding loan books in the United Kingdom to 30% for the first time during the first half of this year.[4] Anecdotally, among alternative lenders it's been more difficult for new debt fund managers to come in and raise capital, but experienced managers with strong track records have continued to be successful in this regard.

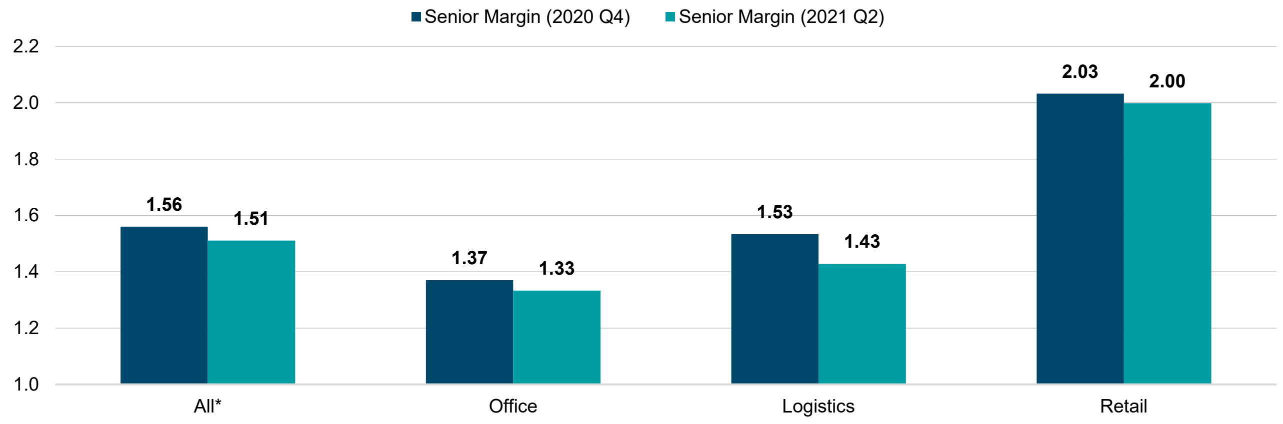
Limited transparency in the real estate private debt space makes measuring marketwide trends more difficult. Here, the public debt markets can give us some insight into senior debt pricing at the all-property level. Looking at the public real estate debt space, both EUR and GBP denominated bonds are now already back below pre-pandemic levels, having initially spiked upwards by more than 100 basis points.[5] Equally, the CMBS market would also suggest that pricing has returned close to its early-2020 level.[6]

In the private market, the overall trend during the first half of this year is perhaps less clear-cut, and on a pan-European basis there has actually been relatively little movement in senior loan margins. But when we break this down to the sector level, we can start to see some differentiation. Pricing trends have largely followed the same path as general investment sentiment so far, with investors marginally more positive about offices compared to the beginning of the year, but significantly more enthusiastic about logistics. In fact, most office markets have seen no movement in senior loan margins or LTVs this year. Yet more than half of major European logistics markets saw margins tighten, meaning on a weighted average pan-European basis, logistics margins fell by around 10 basis points in the first half of the year.[7]

The retail sector is more difficult to read. Aggregated European data doesn't tell a consistent story, but a lack of transactions is likely to be masking the underlying trends here. On an anecdotal basis, lenders are still very cautious on retail, with some pulling back from new lending altogether, instead focusing their attention on logistics and residential, as well as offices on a more selective basis.

[2] CBRE, September 2021
[3] Bayes Business School, October 2021
[4] Bayes Business School, October 2021
[5] Markit iBoxx, September 2021
[6] JP Morgan, September 2021
[7] CBRE, DWS, September 2021

**CHANGE IN EUROPEAN LENDING MARGINS (2021 Q2 VS. 2020 Q4)**




Source: CBRE, DWS, September 2021
Note: *Excluding residential

Across the continent, the lowest rates on a weighted all property basis are still to be found in the major Core European markets. Strong competition to lend in the likes of Germany, Denmark and the Netherlands in particular has pushed margins close to or even below 100 basis points for offices and logistics. The other Nordic countries still attract a premium of around 25-50 basis points.

The United Kingdom, on the other hand, remains at the higher end of the margin range, particularly for retail, where the underlying market has been hit harder than just about anywhere else. UK banks are subject to a strict slotting regime when calculating capital requirements, meaning that their capital costs are considerably higher than banks elsewhere. Due to cheap domestic pfandbrief funding, the German banks are typically able to offer the lowest margins against UK property although currency hedging generally puts a floor on the rate.

On the face of it, margins on UK lending appear to have risen across most sectors during the first half of the year.[8] Partly, this stems from the type of borrowers that are active in the market at the moment, with smaller local players not able to achieve the same loan terms as the larger international investors (who have been less active). But a rise in margins has not been recorded for all types of lender. In fact, the German and other international banks – who are currently very much focussed on London – have seen margins compress further. On the other hand, average reported margins among the UK banks – who are serving the regions, but on a more conservative basis – have risen. Equally, debt funds have been able to raise pricing for lending in areas where the banks are not currently lending.

In the UK market, we can also see just how far the sector spread has moved over the past year or two. In terms of level, there’s relatively little to choose between offices, logistics and residential at the moment. Logistics has traditionally sat above offices, although the spread has now narrowed to virtually nothing. The current attractiveness of residential is also visible here, and the strong demand we continue to see for logistics and residential suggests that both sectors could soon be priced below offices.

Retail is another matter. In fact, retail margins had already moved out some way before the pandemic – a reflection of the sector’s longer-term structural issues. On the direct side, UK shopping centre yields, for example, have almost doubled over the past five years. Right now, even a well-located prime shopping centre would do well to achieve a yield of 7.00%, with secondary centres well into double digits.[9]

[8] Bayes Business School, October 2021
[9] CBRE, September 2021

But the pandemic has put huge further strain on retailers. So far, lenders have often worked with borrowers to avoid defaults by extending or offering short-term refinancing. But as government support schemes are wound down, we could start to see more loans in default. This is particularly a risk for the retail sector, and lenders certainly appear to be pricing in this risk.

Looking ahead, inflation is another factor that is likely to influence lender decisions. In the underlying property market, index-linked leases are common across much of Continental Europe, offering property owners some protection against rising inflation. At the same time, higher inflation can act as a brake on construction activity, diluting future occupier competition, and in turn helping to preserve rent levels and property values.

But a longer period of above-target inflation could also lead interest rates to rise faster than expected. This, as well as making property yields look less attractive in relative terms and therefore dampening the potential for further value growth, would also start to erode the real value of income from fixed rate lending. Inflation expectations have certainly increased across Europe, although we still expect the current inflationary environment to be relatively short lived. Yet in a more prolonged inflationary scenario, we would expect to see an increase in the proportion of floating rate loans being issued, allowing lenders to benefit from rising rates.

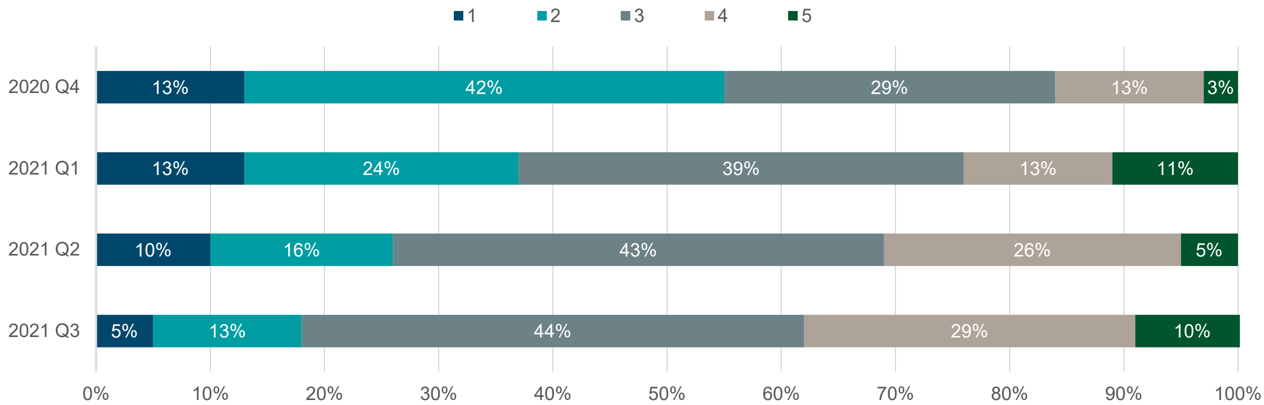
## Shifting Risk Appetite

Since the onset of the pandemic, there has been a clear change in perceptions of the risk profile across the different sectors. In line with sentiment towards the underlying assets, lenders looking to deploy new capital have shown a clear shift in appetite towards logistics and residential. Offices are still a focus for many, but the sector is seen to be more selective, while retail is generally more difficult or even off the cards for some.

But the general level of risk lenders are willing to take on within a particular market or sector is also evolving. In the underlying property cycle, we saw something of a correction – or at the very least a slowdown – across most sectors and locations last year and into the beginning of this year. But now the scene is set for recovery, and it’s at this point in the cycle that taking on more risk potentially starts to become more attractive.

Retail occupier fundamentals have worsened markedly, and there has been some increase in vacancy in the office sector, but generally occupancy levels across most markets remain high. And the strong economic growth that is now coming through, together with the fact that new supply remains fairly limited, should start to present more opportunities at the higher end of the risk spectrum.

**ASSET PREFERENCE AMONG REAL ESTATE DEBT PROFESSIONALS***




Source: CREFC Europe, August 2021
Note: *Asset categories run from 1 (core) to 5 (development/repositioning)

Surveys taken over the past year suggest this is already evident among debt professionals, where there's been a clear trend towards the middle and higher end of the asset risk scale. A similar trend can be seen with regard to location preference, where there is still relatively little appetite for poor secondary or tertiary locations, but a clear increase in sentiment around core-plus or good secondary locations.[10]

With long-term interest rates and direct property yields both at record lows, the return on offer from parts of the senior real estate private debt market still look attractive in relative terms. At the prime end of the spectrum, we estimate the senior lending spread to be 25-100 basis points over A-rated corporate bonds. However, moving up the risk curve this spread widens. For good quality junior debt with a margin of 500-700 basis points, the spread over similarly rated corporate credit increases to 225-425 basis points, and this grows even higher for secondary junior debt.[11]

This generous spread for junior debt partly stems from a lack of competition from the banks in this portion of the capital stack, with the majority of lending originated by debt funds and alternative lenders, which have their own investor return requirements. And as well as the typical liquidity premium offered by commercial real estate debt in general, junior lending can introduce an additional level of complexity, which requires a specialist team knowledgeable in valuation, sourcing, risk management and co-ordination of lifecycle events relating specifically to subordinated debt. Junior lenders must also have a particularly strong understanding of the underlying property market, given that they may end up taking control of the property in a foreclosure scenario, suggesting that experienced real estate managers can mitigate risk and even benefit from further upsides.

## Market Opportunity

While non-bank lenders now account for almost one third of the real estate private debt market in the United Kingdom, the Continental European market is still largely served by the banks. In Germany, for example, the senior end of the market in particular is dominated somewhat by Pfandbrief lenders, who are able to secure cheap funding through the covered bond market; however, there are opportunities for new lenders where the banks are less active – such as junior lending, whole loans, non-core locations or smaller cities.

But continuing regulatory change could open up even more new opportunities for alternative lenders on the Continent. With the finalisation of Basel III from 2023 onwards, the larger Continental European banks are likely to see increasing requirements on regulatory capital, particularly at the lower end of the credit risk spectrum where there is currently no minimum capital requirement.

So, while alternative lenders have generally been more active at the higher end of the risk scale, regulatory change could lead the banks to retrench from other parts of the market, opening up lower-risk opportunities where the non-bank lenders may have been less competitive previously.

At the same time, loan extensions or covenant waivers granted during the pandemic will need to come to an end, and this should present refinancing opportunities for alternative lenders where banks look to minimise exposure to sectors such as retail and hotels. And eventually, if the overall market lender composition were to move towards current UK levels, that would suggest a sizeable potential opportunity for non-bank lenders.

So, we expect there to be a range of opportunities at various points in the capital stack for private debt funds and insurers, but we believe that junior debt could perform particularly well on a risk-adjusted basis. While the real estate market correction has been relatively mild on average – all property prime capital values fell by around 5% last year – it will be particularly important to remain vigilant as government support is withdrawn, revealing the true economic impact on sectors that have been most reliant on it. Nevertheless, we expect a widespread recovery to take hold in 2022, and with occupier fundamentals in relatively good shape, the balance of risks looks far from unhealthy.

[10] CREFC, August 2021
[11] DWS, Thomson Reuters Datastream, S&P Global Ratings, August 2021

For sectors such as logistics and residential, where the underlying property market has proven most resilient and the outlook is the most positive, there is still a strong case for junior debt investment, even if margins may have compressed since last year. Retail continues to look challenging for the most part, as the pandemic has added significant additional stress to an already struggling market. But there will be parts of the sector that are less affected by the transition to online sales, such as retail parks, for example, and once a new post-pandemic equilibrium is found, there could be other areas that start to look attractive on a risk-adjusted basis, particularly given the recent increase in loan pricing.

Outside the main commercial sectors, hotels could also start to offer interesting opportunities soon. With the exception of the business-travel segment, the underlying drivers for hotel demand are still in place, and with junior pricing moving out some way since before the pandemic, the balance of risks could start to look attractive as travel picks up again.

# Research & Strategy—Alternatives

**OFFICE LOCATIONS:**


**Chicago**
222 South Riverside Plaza
34th Floor
Chicago
IL 60606-1901
United States
Tel: +1 312 537 7000

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

**London**
Winchester House
1 Great Winchester Street
London EC2N 2DB
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
20th Floor
Singapore 048583
Tel: +65 6538 7011

**Tokyo**
Sanno Park Tower
2-11-1 Nagata-cho
Chiyoda-Ku
18th Floor
Tokyo
Japan
Tel: +81 3 5156 6000


**TEAM:**


Global

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

**Simon Wallace**
Global Co-Head of Real Estate Research

**Gianluca Minella**
Head of Infrastructure Research

Americas

**Brooks Wells**
Head of Research, Americas

**Liliana Diaconu, CFA**
Office Research

**Ross Adams**
Industrial Research

**Joseph Pecora, CFA**
Apartment Research

**Ana Leon**
Retail Research

Europe

**Ruben Bos, CFA**
Property Market Research

**Tom Francis**
Property Market Research

**Siena Golan**
Property Market Research

**Rosie Hunt**
Property Market Research

**Martin Lippmann**
Property Market Research

**Aizhan Meldebek**
Infrastructure Research

Asia Pacific

**Koichiro Obu**
Head of Real Estate Research, Asia Pacific

**Natasha Lee**
Property Market Research

**Hyunwoo Kim**
Property Market Research

**Seng-Hong Teng**
Property Market Research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## The authors

**Simon Wallace**
**Global Co-Head of Real Estate Research**

**Tom Francis**
**Property Market Research**

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