IMMOBILIEN FONDSNEWS

Der Newsletter der institutionellen Immobilienwirtschaft

SPECIAL ISSUE 2023

REAL ESTATE DEBT INVESTMENTS **SPECIAL**

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Preamble to this edition

Dear Reader,

After a period of carefree, golden times, the real estate industry is now facing several challenges at once. Economic and energy crises, a rapid rise in inflation and the increase of interest rates by the central banks. The pronounced demands for sustainability are causing high pressure to act with related investment costs, or are increasingly leading to devaluations of many and existing property.

Additionally, banks have been increasingly withdrawing from the segment of commercial real estate financing for quite some time, not least due to the high regulatory requirements since the last global financial crisis. This has created a financing gap which, however, represents an opportunity for alternative providers.

A number of these topics are covered in the following professional publications, which we combined in our FondsNews Debt Special. We would like to thank the authors and companies for their co-operation and wish you a lot of fun while reading.

Yours

Ralph Dobbeck
Team FondsNews

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Quelle: © Jharna – stockadobe.com

Real estate debt lending: Is this the right time?

The last three years have been characterised by heightened global uncertainty as a result of the war in Ukraine, a rapid rise in inflation and subsequent increase in central bank policy rates. Unsurprisingly, commercial real estate has been impacted with significantly reduced transaction volumes and a wide bid-ask spread, driven by sellers' expectations being rooted to historic prices while buyers' expectations are tied to the rapid rise in the cost of debt, and the rising yield environment. Investors have been cautious to deploy capital, given the deteriorating macro environment and the uncertain outlook.

In recent months inflation has decelerated and visibility around the timing of peak interest rates has improved. Prospective investors are asking whether the time is right to deploy into real assets and the optimal route; debt, equity (direct real estate) or both.

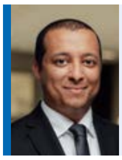
Real estate debt markets are experiencing a confluence of trends which create an attractive opportunity today. Declining availability of debt financing, real estate yield re-ratings and rising interest rates have created favourable return conditions. Senior loans, which typically represent 50-55% of property value, are structured to provide stable cash flows to investors. Downside protection is provided by the 1st mortgage structure (who gets paid first in times of distress), large equity cushion, strong covenants and cash traps that can be used to deleverage the loan. Returns depend on sector and location but in the current elevated interest rate environment, IRRs in senior loans are circa 6-7% over a 5-year loan maturity period. For cautious investors, this return will be attractive as the strong downside protection will help preserve their capital and income. For example, given the large equity cushion, property prices over the next 5 years would need to drop by a further circa 50% in order to erode away all the equity and start to impact the senior debt.

The risk adjusted returns from senior real estate lending look compelling.

Investors seeking more upside will either need to seek exposure in higher LTV debt strategies or selected real estate equity strategies, both requiring higher conviction and move up the risk curve. For real estate equity investors, the marked reduction in transaction volumes at -54% between January to August 2023 vs same period 2022 reflects the uncertainty of transaction price discovery and thus valuations. This is both a risk and an opportunity but reminds of the risk adjusted returns of senior lending.

It is noteworthy that there has always been a considerable range in returns within sectors. An analysis of MSCI data for European offices, for example, suggests that the average returns spread in offices have varied significantly - there has been an average annual dispersion between the 5th and 95th percentile of offices of some 35% over the last 20 years. Even in the office sector, that has to deal with several challenges, you can still outperform if you select the right assets at the right locations.

In times of heightened cyclical market uncertainties, real estate debt investments are in the spotlight on the basis of their attractive risk-return profile. For now, senior real estate lending protected by the cushion of high equity represents an appealing investment approach for institutional investors.



Mohamed Ali
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Europa, (k)ein fragmentierter Markt

Quelle: © Natasa Tatarin – stock.adobe.com

Vielen Marktteilnehmern erscheinen sowohl die Immobilien- als auch die Finanzierungsmärkte in Europa als stark fragmentiert. Tatsächlich fallen die sich aus erwarteten negativen Korrelationen resultierenden positiven Portfolioeffekte insbesondere in Zeiten sinkender Preise regelmäßig geringer aus als erwartet. In einer globalisierten Welt zeigt sich der Markt in seinen grundsätzlichen Dynamiken dann nicht fragmentiert, sondern vielmehr gleichgerichtet.

So betreffen Megatrends alle Länder in ähnlicher Weise. Wohnraum ist beispielhaft überall knapp – zumindest im Durchschnitt und speziell in Ballungsräumen. Hinzu treten globale Ereignisse, wie die Corona-Pandemie, deren Auswirkungen in einem gleichgerichteten Verhalten münde(t)en – zumindest innerhalb der Bevölkerungen der führenden Volkwirtschaften. Büromärkte stehen durch Home Office und ESG ebenfalls über Landesgrenzen hinweg unter Druck. Spitzenmieten sind weltweit vor allem durch die Nachfrage von einem überschaubaren Kreis multinational operierender Konzerne bestimmt.

Auch die Finanzierungsmärkte reagieren gleichgerichtet, Banken befinden sich überall auf dem Rückzug bzw. agieren defensiv. Selbst in Deutschland, bei sehr hoher Wettbewerbsintensität, sinkt die Aktivität von Finanzierern.

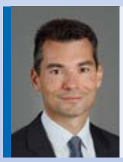
Unterschiedliche Situationen innerhalb Europas existieren aber dennoch a) hinsichtlich steuerlicher und rechtlicher Bedingungen wie bspw. der (vor allem zeitlichen) Durchsetzbarkeit von Gläubigerrechten und b), wenn sich Akteure (Investoren, Finanzierer) jenseits global angeglichener Prozesse nur in konkreten Regionen betätigen, in denen spezielle Regeln gelten oder sich das Spezielle daraus ergibt, dass dort Platzhirsche quasi die Regeln machen.

Aus der Sicht eines institutionellen Investors müssen Investmentopportunitäten daher immer individuell betrachtet werden, innerhalb ihres konkreten Umfeldes an ihrem Standort zwecks Einschätzung ihrer spezifischen Wettbewerbssituation. Strategien wie Bridge-to-Exit-Finanzierungen, Umnutzungen von „Stranded Assets" sowie Projektentwicklungen mit ausgeprägter ESG-Komponente vereint in allen Märkten Europas eine Win-Win-Situation zwischen Darlehensnehmer und -geber. Gemeinsames Ziel ist in zwei bis vier Jahren der Exit eines Produkts, welches das neue „jetzt", also die zukünftigen Ansprüche der markbestimmenden Mieter- und Käufergruppen abbildet und damit sowohl zukunftsfähig als auch tragfähig ist. Hier zeigt sich eine andere Art der Fragmentierung – zwischen zukunftsfähigen Objekten auf der einen und Stranded Assets auf der anderen Seite – erneut unabhängig von Regionen und Ländergrenzen.

Konkrete Investmentansätze bieten dann zum einen klassische konservative Seniorfinanzierungen innerhalb der oben genannten Objektstrategien. Aufgrund der geringen Verfügbarkeit von Finanzierungen bzw. des geringen Wettbewerbs ist zur Erzielung von attraktiven Überrenditen gegenüber Fixed-Income nur das Eingehen vergleichsweise niedriger Risiken notwendig. So gelingt bei geringer Komplexität und historisch sehr moderaten LTV/LTC die mittel-bis langfristige Sicherung hoher Coupons im Festzinsbereich.

Zum anderen bietet sich die Möglichkeit, pan-europäischen Top-Managern Kapital vorrangig zu deren Junior-Positionen, also im Senior Bereich zur Verfügung zu stellen. Hier können, ebenfalls aufgrund fehlender Liquidität im Markt, bei geringen Risiken und niedrigen Ausläufen attraktive Renditen im kurzfristigen, variabel verzinsten Bereich erzielt werden.

Das aktuelle Marktumfeld bietet in 2023 und 2024 auf breiter pan-europäischer Basis Investmentopportunitäten im Bereich Real Estate Debt. Aufgrund der eingeschränkten Liquidität und des geringen Wettbewerbs werden diese rückblickend risikoadjustiert voraussichtlich als außerordentlich attraktiv zu bewerten sein. Unabhängig von einer gegebenenfalls existierenden Fragmentierung wird deren Erfolg weiterhin von der nachhaltigen Analyse und Selektion sowie der passenden, möglichst simplen Strukturierung abhängen.



Dr. Patrick Züchner
CIO
Aukera Real Estate

European Private Real Estate Debt

Banks have been steadily withdrawing from commercial real estate lending in Europe since the Global Financial Crisis, partly due to stricter regulatory requirements. High inflation rates, rapid interest rate hikes and a fragile economic outlook are accelerating this trend as we go through a phase of asset repricing in Europe. The result is a materially widening funding gap in the commercial real estate market and hence a potentially much larger market share for real estate debt funds. For investors in private real estate debt there is a compelling opportunity to benefit from higher returns on new loans at lower leverage levels and tighter security structures.

Quelle: © eyetronic – stock.adobe.com

New market environment

The new interest rate environment is putting pressure on real estate valuations and creates a risk on upcoming re-financings of maturing loans from 2018/19. The all-in cost of debt has more than doubled since the beginning of the rate hikes in 2022[1] , and this has been impacting the availability and pricing of new real estate loans. Moreover, lenders are lowering the LTVs they are prepared to offer on new loans with the Interest Coverage Ratios often being the bottleneck in the debt sizing.

On the other hand, there are no signs of a systemic credit crunch, as seen in 2008/09 because leverage levels are generally lower and debt funds have provided borrowers with much more choice and flexibility than previously existed. However, the banks continued retrenchment from real estate lending is accelerating across Europe because of the impact of rate increases. For many borrowers, debt funds have now become a natural solution to the widening funding gap.

The case for private real estate debt

From a lenders perspective, the current market environment represents a compelling opportunity to move down the risk curve by providing loans at lower LTVs on a repriced asset basis, whilst achieving higher returns than before the rate hikes. Moreover, debt strategies are currently yielding higher returns than many equity strategies whilst being of course less risky. According to the INREV Investment Intention Survey 2023, private real estate debt has emerged as the preferred strategy for investors and will remain so for the next two years in Europe. Real estate debt investments provide attractive risk-adjusted returns with a high recurring income component, downside risk protection, and diversification benefits as investors can relatively easy gain exposure to a variety of real estate sectors and geographies across Europe.

In comparison to listed bonds issued by REITS or publicly traded property companies private real estate debt offers some key advantages. Private real estate debt investments are typically secured by the underlying real estate collateral. In contrast, listed bonds are typically unsecured. Additionally, private real estate loans may offer the potential for higher returns than listed bonds due to the illiquidity premium associated with the financed assets. In addition, as bonds are traded their market valuations involve a higher degree of volatility, whereas private real estate loans are typically valued on an amortised cost basis subject to impairment tests.

Esg considerations in lending

Despite the fact that lenders are not supposed to manage the assets provided the loan is performing, they are taking a more active role regarding ESG considerations. Direct origination of loans allows for thorough ESG assessment of the business plan of the sponsor of the transaction. In addition, it provides the lender the opportunity to negotiate specific ESG loan criteria and covenants that can be monitored consistently after funding. An obvious example is the target ESG certification of a property, as it will have a positive impact on the future liquidity and value of the asset. As such, the focus on environmental and social characteristics will improve the relative performance and value of the collateral and hence lowers the loan's risk position.

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[1] Edmond de Rothschild REIM, 15.08.2023

Ralf Kind
Managing Director,
Head of Real Estate Debt
Edmond de Rothschild

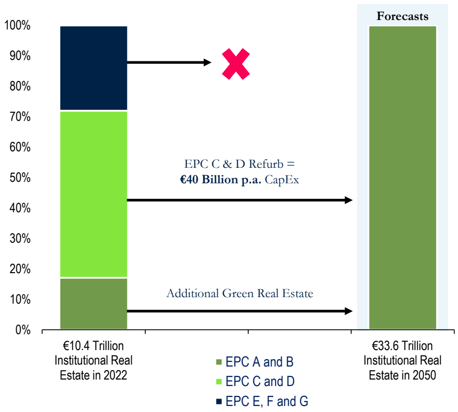
The Long-Term Funding Gap in European Real Estate

In Europe, there are a combination of market drivers that are collectively impacting the real estate market:

- European regulations are putting significant sustainability obligations on real estate developers, investors, and occupiers.
- Simultaneously, bank regulations are severely restricting banks' ability to provide development or refurbishment finance.
- Additionally, bank credit factors are being heavily influenced by the interest rate outlook, resulting in tighter debt service cover, lower loan-to-values, refinancing stress and limited advance rates.

In aggregate, these drivers are creating a widening gap between the growing demand for future-proofed properties, and the permanent reduction in bank debt to fund the supply of such real estate. This funding gap presents an opportunity for experienced alternative debt providers to finance the next generation of European property.

Exhibit 1: "Green" CapEx and New Building Requirements



Sources: PGIM Real Estate's Bird's Eye View 2021, Real Capital Analytics, PGIM Real Estate. As of December 2022.

Net Carbon-Neutral Policy Across Europe is Accelerating the Demand for Sustainable Buildings

Europe's net-zero commitments are driving demand for prime property that is aligned with 2030 and 2050 decarbonization trajectories. With real estate accounting for 39% of total emissions of CO_2 and 36% of energy use[1], real estate will be hugely impacted by these goals, particularly through occupier and investor demand.

From a European supply perspective, only about 17% of existing institutional real estate is rated EPC A and B, the minimum threshold needed to satisfy future sustainability requirements. An estimated € 40B per annum is required to upgrade lower-rated buildings, in addition to the new developments required to meet expected 2050 demand for compliant properties.

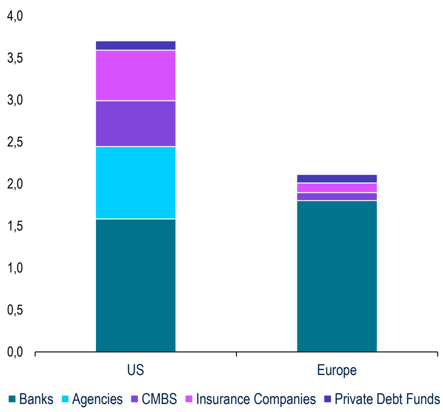
We expect financing opportunities to emerge across the capital stack. ESG considerations make refurbishment increasingly relevant, alongside re-development and new construction, due to the impact of embodied carbon within existing structures. However, much of the older, poor-quality stock (rated EPC E and below) will be obsolete.

Alternative Lenders Can Play an Increasing Role in Financing the Green Built Environment

Regulatory constraints on banks mean that financing solutions will increasingly have to come from other market participants.

Banks, who dominate European lending markets, hold over 85% of all real estate loans in Europe, compared with much more diversified sources of capital in the United States (Exhibit 2, LHS). However, those banks are more constrained than ever in their capacity to lend.

Exhibit 2: Estimated Market Size of the Commercial Real Estate Debt Market (€ Trillion)



Note: Estimates are based on historical debt stock and the investable universe of real estate stock. Source: Mortgage Bankers Association, Cushman & Wakefield, Bayes Business School, IEIF, IREBS, ECB, PGIM Real Estate. As of March 2023.

The funding gap that emerged in Europe after the financial crisis has been further exacerbated by regulatory and credit factors.

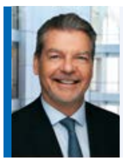
- Bank Regulation: Basel III Finalization is the latest in a cascade of regulatory changes that have consistently increased bank capital requirements against real estate loans, estimated to remove over €125B of lending capacity from the banking system.
- Credit Factors: Higher interest rates have resulted in tighter debt service coverage ratios. This has been the key driver of lower LTV loans and thus lower advance rates. Given long-term interest rates are forecast to be elevated in Europe, there will be less money in the system for acquisition and refinancing.

Alternative lenders entered European real estate credit markets after the GFC, and now form a key part of the funding market. However, significant growth is clearly needed in private debt to satisfy demand over the next decade and thereafter.

Conclusion

a significant investment is needed to tackle carbon emissions and the policies in place to combat it, real estate has an important role to play in achieving operational net-zero targets. A green built environment of the future will need new capital for development and refurbishment projects. These factors are all driving the underlying demand for European real estate debt and make the case for investing in solutions that are poised to meet the needs of the future of European commercial real estate.

[1] Source: INREV



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PGIM Real Estate

Reasons to invest in Private Real Estate Credit

Quelle: © xy – stock.adobe.com

Over time, the advantages of investing in Private Real Estate Credit (high-yield debt) have essentially remained the same: Attractive relative value, equity cushion to absorb unforeseen asset stress, real asset collateral to help hedge against inflation, floating rate/short duration to avoid major interest rate driven markdowns, and returns comprised primarily of income.

Private real estate debt funds have largely experienced steady growth, as these advantages have spurred increased allocations. Looking forward, debt investments made in the next couple of years should potentially benefit from underwriting post inflation valuations, higher yields, and better visibility on the post-COVID landscape. The equity buffer/cushion and high current return are gaining a renewed focus by investors during this period of uncertainty and market volatility.

The capital gap has returned

The banking sector is under pressure on several fronts. As a result, banks are still lending but are being selective and offering lower amounts of leverage. When banks tighten lending and offer lower loan-to-value (LTV) loans, borrowers will turn to other sources of capital, such as debt funds, and/or subordinate debt capital sources to fill the capital gap.

As observed during prior periods of stress, it appears the capital gap has once again emerged as an opportunity for debt funds to invest in assets banks would've generally executed on.

Reset values lead to better entry points and lower exposure levels

As interest rates have increased, the higher debt costs have put pressure on property valuations. This adjustment to a new rate environment will take some time to settle and the ultimate range of the 10-year Treasury will be a significant driver of these valuation adjustments. The classic bid ask stalemate will likely exist for non-forced sales until investors feel valuations have reset to a reasonable level. Still, the longer this volatility continues, the more the pressure begins to build. There has been some acquiescence in the market where sellers are beginning to accept new values.

Whether the post inflation valuation decline is 5% or 20%, new debt investment/loans will be sized to reset values generating a fresh equity buffer and lower exposure levels.

Private real estate credit remains a solid complement and hedge to core equity holdings

As highlighted, property values are in the process of adjusting to higher debt costs. Even the preferred property types are not immune to this dynamic. An allocation to credit with a current income focus is a logical complement to core equity where investors can achieve a higher return than recently observed in the debt arena while maintaining a more protective position in the capital stack.

Private real estate credit in the world of elevated inflation

A. Short duration
The majority of loans in the space are structured as floating rate debt. The accompanying low duration profile has been a positive for investors as interest rates have risen, resulting in losses in many fixed income portfolios in 2022 and into 2023. As the market anticipates short-term rates to stay above 2.5%, short-term yields will likely have a fairly solid floor at or near the Fed's inflation targets and the Fed will be reluctant to cut rates too far.

B. Real assets
Historically, commercial real estate has had a positive correlation with inflation. When inflation occurs, the resulting higher construction costs should slow the new supply benefiting existing properties. Interestingly, inflation is indirectly slowing supply by increasing debt costs and making it difficult to project returns on new developments.

With the tailwinds of reset valuations, higher yields, and improved property type information, 2023 and 2024 appear well-positioned to outperform most years. New investments should be underwritten to reset valuations and the conservative posture of the banks should allow for opportunities to enter the capitalization stack that did not exist previously. Private real estate credit investments offer a margin of safety via the equity buffer which is worth more during periods of volatility and the high current income typically generated by credit investments should help to stabilize portfolio returns in a period where there is uncertainty around the economy and future rental growth.

Kirloes Gerges
Managing Director,
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Principal Real Estate

Quelle: © whitehoune – stock.adobe.com

Mission Possible: Here's how to bring debt funds in line with ESG

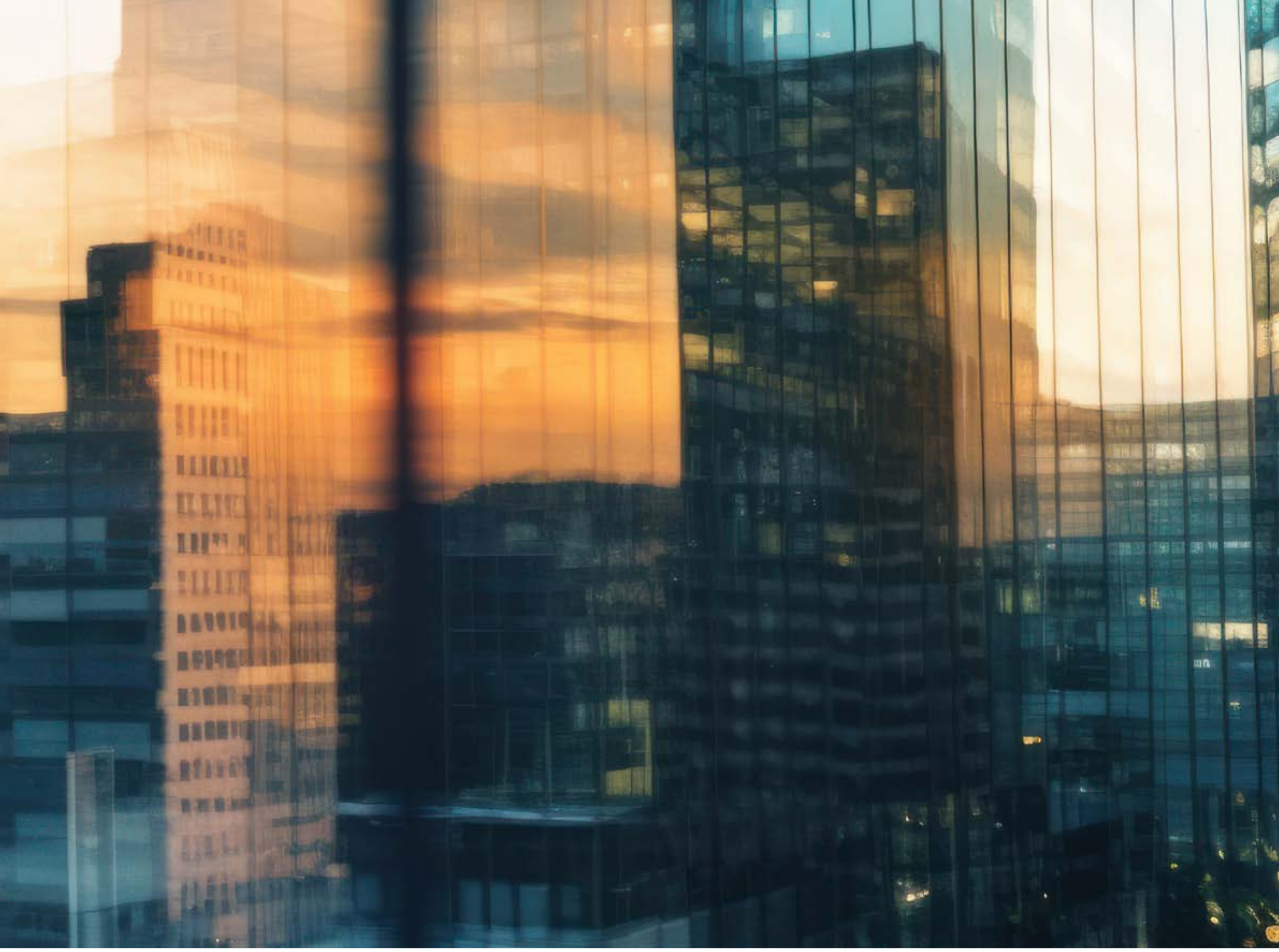
Until not so long ago, sustainability – or somewhat more broadly, ESG criteria – played only a minor role in the real estate debt fund industry. According to the annually published FAP Mezzanine Report, even just two years ago, very few investors were willing to seriously factor ESG into their lending decisions. To the contrary, the fear was that prioritising environmental or social or corporate governance objectives would be a drag on investment returns. But the market has been changing quickly and considerably. Many investors now only invest in projects that are expressly sustainable for a simple reason: to ensure that asset values are protected into the future. This includes real estate debt funds, despite their generally far shorter time horizons.

Despite this striking recent development, there are still many players in the market who prefer to wait and see while rationalising that the regulatory framework is not completely finalised, or that their reputations could be damaged by interim accusations of "greenwashing". This thinking, however, is based on a fallacy: There is, in fact, no point in waiting for these regulations to be ultimately enshrined in some sort of ultimate final state, based upon which the industry can then orient itself for the long term, because these regulations will, by necessity, continue to change and evolve. For example, carbon limits will undergo further adjustments as the process of global climate change continues, and building materials and components will be benchmarked against evolving environmental as well as social criteria. On the investment side, sustainability-related regulations and standards will therefore likewise continue this process of dynamic evolution.

But there's another good reason not to wait: Adapting a fund manager's business model, which is a prerequisite for offering sustainable investments, is challenging and involves a lot of hard work. The earlier you start this process, the better. Even if it's not possible to comply with, or even to predict, all of the nitty-gritty details of tomorrow's regulations when launching or converting a fund today, the fund will surely be far closer to the ultimate objective of ESG conformity than one that doesn't even attempt to start building these criteria into its investment processes. Even if the ultimate goal posts have yet to be precisely defined, these processes are undoubtedly moving in the right direction. And it's the experience factor as well: Managers can only learn to compete in this new and dynamically changing market environment by gaining concrete practical experiences with the ESG transformation process, even if only preliminary or transitional.

Bringing ESG standards down to the individual property level is a major challenge

While the regulatory framework establishes specific requirements and standards, the practical details are often perplexingly vague. To take the example



of Article 9 investments, the worthy goal is to promote specific actions to limit climate change and its impact and to make human habitats, especially urban agglomerations, more inclusive, safe, resilient and sustainable. Translating such ambitious standards – sometimes seemingly rather over-ambitious – to the investment holding and property level is the major challenge that debt fund managers must face and overcome.

Perhaps we might share our own experience: In converting our own debt fund from Article 6 to Article 9 of the EU Disclosure Regulation, we established new "green loan" criteria, and since the start of this year, we have been strictly limiting our financings to those transactions that fulfil these criteria. To do this, we worked over the past two years together with a specialised consultancy to create our own scoring model based on the criteria of the EU taxonomy, the Carbon Risk Real Estate Monitor (CRREM), and other relevant market standards.

In practice, the EU regulators can surprise with pragmatism

Another experience that has surprised us and others: When regulations actually have to be applied in practice, the EU regulators are often far more pragmatic than their fearsome reputation would lead one to believe. In fact, where details of regulations are subject to differing interpretations or ambiguities, or where there are other doubts or questions, these issues can often be clarified through open and candid dialogue with the regulators. In the case of existing investment holdings, for example, the regulations provide for transitional periods. We were able to reclassify our FAP Balanced Real Estate Financing I fund in accordance with article 2 para. 17 of the Sustainable Finance Disclosure Regulation (SFDR) with effect from 1 June 2023, even though only 65 per cent of the investment holdings were Article 9 compliant. That being said, we are working hard to steadily increase the percentage to 90 per cent, if possible by the beginning of 2024, and we have been also putting plans in place so that we can more efficiently react to future changes as they arise. That's important for everyone to think about – because more stringent criteria will definitely come!

Hanno Kowalski
Managing Partner
FAP Invest

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Embracing environmental sustainability in European real estate finance

It is widely accepted that sustainability considerations are now ever more important in European real estate markets. A rising regulatory focus and tightening legal standards, combined with the increasing trend of occupiers and buyers seeking assets providing best-in-class credentials, means environmental considerations are now a crucial aspect of delivering investment performance.

As a consequence, there is a significant opportunity for private real estate debt markets to help institutional investors deliver on their ESG ambitions and obligations, through driving an improvement in building quality and supporting a reduction in carbon emissions, while continuing to generate attractive risk-adjusted returns.

Over the last five years, both the market and regulatory environment have changed significantly. At property level, minimum energy performance standards have tightened across Europe (and will likely continue to do so) while in the financial markets the EU taxonomy regulations came into force in July 2020, and SFDR in March 2021.

At the same time, innovations have been developed in loan structures. The Loan Market Association, an industry body, first published its 'Green Loan Principles' in 2018; with guidance for sustainability-linked loans (where the interest rate is linked to agreed performance targets) following in 2019. Most banks and private

ICG finances the Nice Sheraton hotel, which consumes 38% less energy than equivalent buildings.

debt fund managers now account for environmental factors in their underwriting and loan structuring; some will offer green or sustainability-linked financing.

Undoubtedly this greater focus in the lending community is welcome, but undertaking a general review of sustainability credentials, or even offering modest incentives, is unlikely to be the most compelling way of helping drive change unless it is done in support of an action plan for delivery.

The environmental imperative applies to existing real estate as much as new build. Approximately 35% of European building stock is over 50 years old and almost 75% deemed energy inefficient.[1] However new developments alone will not mitigate climate change - in the UK, the RICS estimates that 35% of whole-life carbon is emitted in the build phase. Stock refresh rates are low and, as a consequence, there is a strong argument that renovation of existing assets offers the widest range of opportunities, and is where the greatest environmental gains can be realised. Often, it also avoids the need for planning and permitting, which in many countries is challenging and time consuming - even for those buildings with leading sustainability credentials.

A thoughtful way of supporting improvements in the built environment - and to allow investors to ensure their capital is being used actively to help drive change - is to support these renovations and upgrades of existing assets, rather than being passively invested in buildings that already comply with current standards.

Supporting this 'green transition' through backing business plans which improve assets over the loan term can also result in positive credit migration - the underlying property value is likely to increase through the completion of a renovation project, and the loan-to-value (LTV) ratio may reduce as a consequence. This may not be the case when financing brand-new buildings, where there is often limited opportunity to add further value during a typical loan term.

Happily for investors, these ESG ambitions can be realised while securing strong investment outcomes. As renovation projects will initially carry more risk than fully-leased properties, this typically allows lenders to charge higher interest rates or other fees. Yet when the project has completed, the lenders will benefit from an enhanced property (often with best-in-class sustainability credentials), at a lower LTV ratio but at the same high interest rate, and with potentially enhanced liquidity upon exiting the loan.

[1] In focus: Energy efficiency in buildings (europa.eu)

David Mortimer
Co-Head of Real Estate Debt
Intermediate Capital Group

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Social and environmental impact in the mid-market segment

Quelle: © anttoniart – stock.adobe.com

Demand for real estate credit in the mid-market space (€15-120m) is strong across all borrower types, assets and geographies. This is due firstly to a decline in lending appetite from banks, who were once dominant lenders in this space, given regulatory and capital constraints, and secondly due to fewer transactions taking place, given the increase in overall borrowing costs. As such, demand for loans within the mid-market segment is being generated by owners seeking to refinance assets, which is typically every 5 years.

In terms of sustainability, most real estate investors have to date focused on energy performance certificates (EPCs), with minimum EPCs embedded as business-as-usual. A rise in the focus of sustainability in the mid-market sector, has however more recently been driven by more stringent regulation and greater investment activity of the larger real estate investors in the mid-market space. Impact investing, where the delivery of impact objectives is primary, and financial returns secondary, is a newer but growing theme in the real estate industry, which is being driven by larger real estate investors who have employed experts in this field. Best practice to deliver sustainable objectives typically centres around a scorecard which is used to assess and score the environmental, social, and governance credentials of both the asset and borrower, with a minimum threshold for investment. To deliver impact, lenders also need to demonstrate pre-define sustainable performance targets, which will drive positive change through smarter design of terms and conditions of the loan agreement.

While reporting for impact loans is more onerous, impact investing generates improvements in assets and communities which are attractive to investors and sponsors alike. In our view, there is greater demand for assets which deliver strongly on either sustainability or impact metrics, and this is a trend we believe is set to continue.

The mid-market segment which was traditionally dominated by banks, has become more attractive to alternative lenders. Private equity funds, debt funds, and insurance companies have all increased their exposure to the mid-market space, attracted by the higher yields on offer and the ability to tailor loans to individual borrowers and assets.

The alternative lenders are also attractive to borrowers, as they can often get more flexible terms than they would with a bank loan. Private lenders are more willing to underwrite loans based on the specific characteristics of the asset and the borrower, rather than relying on a one-size-fits-all approach. This can be particularly beneficial for borrowers who have more complex financing needs, such as those looking to refinance existing debt or reposition an asset.

Despite the increased interest in the mid-market space, there are still challenges to be addressed. One of the biggest is the lack of standardization in loan documents and underwriting criteria. Unlike the large loan market, where there are standard documents and underwriting criteria that are widely accepted, the mid-market is much more fragmented. This can make it more difficult for lenders to compare different deals and for borrowers to understand ongoing deliverables and reporting requirements.

Another challenge is the lack of transparency in the mid-market. Unlike the public markets, where information is readily available and widely disseminated, the private mid-market space is much more opaque. This can make it more difficult for investors to get comfortable with a particular borrower or asset, and can therefore lead to a higher cost of capital. Lenders with large teams and proprietary information are best placed to serve this growing need. Despite these challenges, the mid-market space is likely to continue to grow as banks continue to retreat from this segment. Private lenders are well-positioned to fill the gap, and are likely to become an increasingly important source of financing for mid-market borrowers. As the market matures, it is likely that we will see more standardization and transparency, which should help to attract more investors and borrowers to the space.

In conclusion, the mid-market segment is a growing area of the real estate market, driven by a decline in lending appetite from banks and an increase in demand for loans from owners seeking to refinance. Within the mid-market, sustainable lending has grown sharply, and now Impact investing is also a growing theme. Despite challenges such as lack of standardization and transparency, private lenders are well-positioned to fill the gap left by banks and are likely to become an increasingly important source of financing for mid-market borrowers.

Kristina Foster
Fund Manager, Real Estate Debt
Schroders Capital

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The benefits of having a Service AIFM when managing real estate debt funds

Alternative investment strategies like real estate funds are currently experiencing a slowdown in investment transactions. The market struggles with occasional financial difficulties faced by construction companies, developers, and borrowers and requires intensive asset management and restructuring work. Additionally, fluctuating interest rates and general economic uncertainty have put alternative investment strategies into a challenging market environment. These restructuring obstacles on the underlying real estate assets significantly impact the management of these funds.

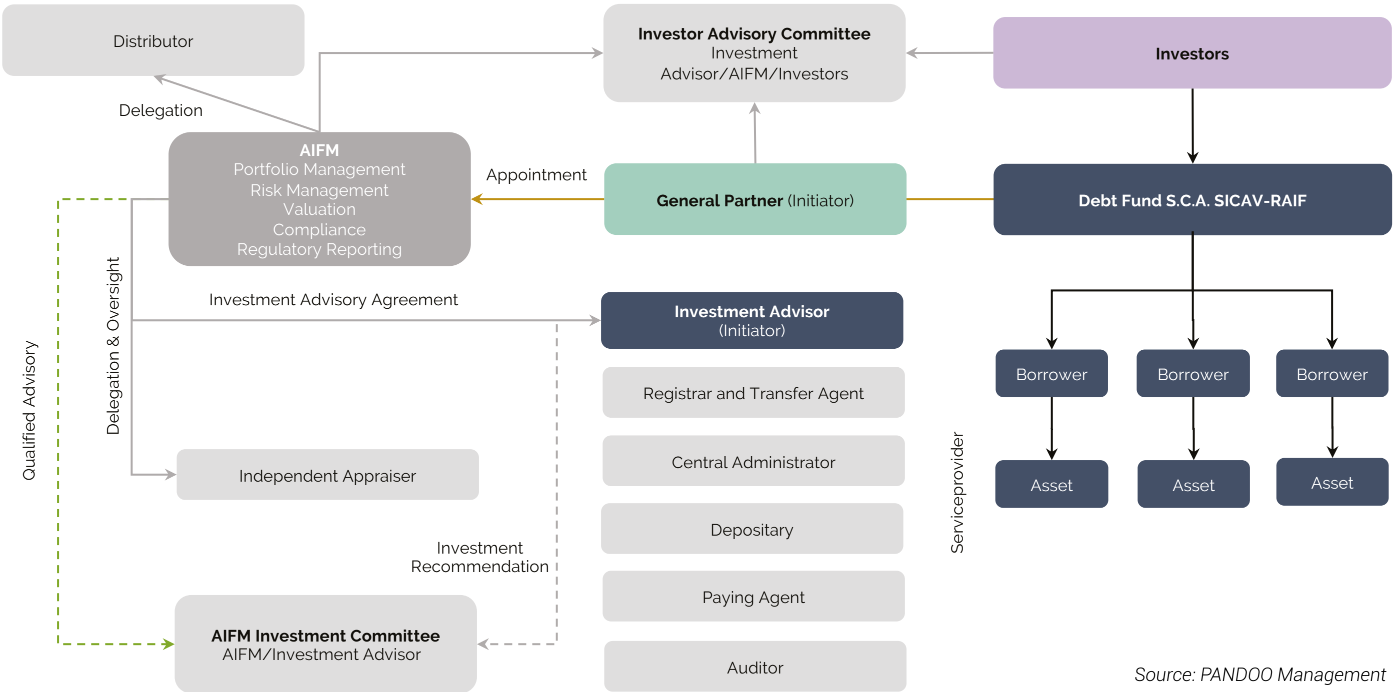
Opportunities in a challenging environment

Investment Advisors ("IA") and other service providers (graph 1) that can navigate these challenges could potentially unlock attractive opportunities for real estate debt funds in the future. The Alternative Investment Fund Manager ("AIFM") plays a critical role in the management of real estate debt funds. The core functions of the AIFM encompass Portfolio Management ("PM"), Risk Management ("RM"), and Valuation. Reliable, robust, and thorough governance processes in cooperation with the IA and the Governing Body ("GB") of the fund are crucial for successfully managing these funds in the current market. What are the key tasks of these core functions, and what governance elements are needed to manage the funds successfully amid current uncertainties?

The PM function acts as the main driver for governance elements, with the investment approval process as a pivotal task. The interaction between the IA, who recommends the investments to the AIFM, and the execution of the transaction by the GB of the fund are key elements for a successful investment process. The organization of this cooperation should be formalized via an AIFM Investment Committee ("IC") which analyzes and approves the investment transaction. Checking the investment eligibility, the investment restrictions, and the borrower's AML/KYC are some agenda items for the IC.

In addition to the AIFM IC, it is advisable to establish an Investor Advisory Committee to keep investors informed about current developments, investment opportunities, fund performance, and future outlook. It is important to note that this forum can only act as a consulting body to the IA and the AIFM, as the ultimate responsibility for the investment approval remains with the PM function of the AIFM.

Graph 1: Loan Structures, Setting up a new Debt Fund



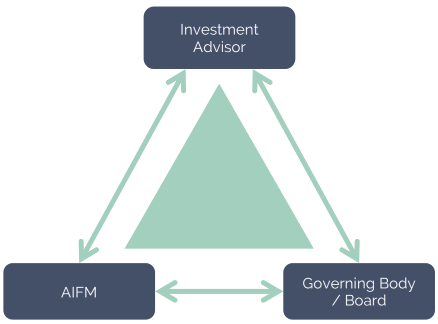
Source: PANDOO Management

In-depth analysis and risk assessment as a basis

When launching a real estate debt fund product, the RM function of the AIFM will perform an in-depth product analysis, develop a risk matrix, and create an RM policy. The operational workstream includes regular risk monitoring, oversight of service providers, and the production of regular RM reports. These reports should include the initial risk rating on all risk categories, the ongoing calculation of risk indicators, portfolio analysis, and investment compliance monitoring.

The Valuation function of the AIFM is responsible for ensuring a proper and independent valuation of the underlying real estate assets of each debt fund in accordance with legal and regulatory requirements and the fund's prospectus. It is also the obligation of the AIFM to ensure that appropriate and consistent valuation procedures are established. The selection of the independent appraisers and monitoring of their performance is also an important responsibility of the Valuation function.

Graph 2: Governance Triangle



Source: PANDOO Management

Choosing the right service providers is key to success

Success in launching a real estate debt fund product starts with an appropriate setup and selecting the right service providers who are experts in this specific asset class. It can be concluded that in analogy to the well-known concept of the "investment triangle", a similar cooperation concept, the "governance triangle" (graph 2), between the AIFM, the IA, and the GB of the fund is essential. The existence of such an appropriate governance concept is a key differentiator for real estate debt fund managers. These managers will be able to benefit from restructuring opportunities, which can provide sustainable and attractive risk-adjusted returns.

Johannes Reis
Partner
PANDOO Management

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U.S. Real Estate Debt Markets – Summer 2023

When Charles Dickens wrote in A Tale of Two Cities “it was the best of times, it was the worst of times…” he could have been writing about the current state of the real estate equity and debt markets in the U.S. The national office vacancy rate is approaching 20% and while the return to office (“RTO”) preference among the CEOs of major companies is steadily gaining momentum, the actual physical occupancy rate has yet to catch up to pre-Covid times. Nevertheless, the trend is a good one. Last week the White House Chief of Staff urged all federal workers to return to the office. In what may be the most ironic of positive RTO announcements, the founder of Zoom has asked the company’s employees to return to the office on a hybrid basis.

The Federal Reserve has raised short term interest rates by approximately 500 basis points in the past twelve months and property owners who borrowed funds when short rates were approximately 0% now are trying to negotiate loan extensions or forestall foreclosures because their assets are not able to cover today’s refinancing rates. Some U.S. cities that de-emphasized aggressive police work in their jurisdictions have experienced a surge in crime that has materially impaired the business environment in those markets. Major property owners have ‘handed back the keys’ to their lenders associated with prime office buildings located in downtown Los Angeles and hotels in what used to be prime submarkets such as Union Square in San Francisco. Tenants are abandoning markets such as Chicago and relocating to states such as Florida, Texas, Georgia, Arizona, and North Carolina. For investors who loaded up on Class B office buildings in secondary

markets, or lenders who aggressively pursued higher loan-to-value mezzanine loans and/or transitional loans, the next 24-36 months are likely going to be very challenging.

Overall transactional activity is substantially below historical levels. Owners cannot/will not sell properties based on today's implied cap rates, and on the retail investor side, large fund managers are facing long queues for redemptions. A similar trend is happening on the institutional side. We understand there are over $30 billion of outstanding redemption requests impacting the institutional open-end real estate equity fund market. Last year the major common stock indices (Dow Jones/S&P 500) declined by 10% to 20%, and the publicly traded REIT index lost almost 30% of its value, yet during the same period, private real estate funds reported total returns of 7% to 10%. Transactional activity cannot pick up until the bid/offer spread compresses, which, in our opinion, means that property values are likely to be declining in the next 12-24 months. This phenomenon will hold most true for office properties. The trend likely will not apply to industrial assets and life science properties and probably only modestly for multifamily assets. Retail property values already have begun to rise. The sector that will be most acutely impacted will be office buildings, particularly older properties, with mid-block locations, in less economically diversified locations and ones that do not have more up-to-date sustainability features.

The positive side of the real estate finance ledger is that with distress growing across the markets in an economy that is likely to become more challenging as the Fed contemplates additional interest rate increases, those with capital to invest have a terrific environment with which to deploy new funds. AAA rated SASB (single asset/single borrower) CMBS can be acquired with yields of 6+% and their BBB rated SASB counterparts can be purchased in the secondary market with yields of 8+%. While the secondary CMBS market remains very active, there is virtually no bid for bonds secured by most office buildings. The very best buildings may command a bid, but the price/yield available is indicative of the market's fears. Unleveraged yields in the 9% to 12+% range are readily available for the office bond buyer. The new issue market has been, and is likely to remain, quite slow. If real estate equities are not trading and loans are difficult to refinance (for the reasons noted above), then there is a much lower volume of new loans that can be fed into Wall Street's origination machine.

Through the first six months of this year, total new issue volume was approximately $16 billion. This sum represents approximately 30% of last year's total volume. Conduit issuance this year, for the first time in more than two years, has exceeded SASB issuance ($9+ billion vs. $6+ billion). The forward calendar for new securitizations is likely to remain relatively muted. Accordingly, the 'technicals' for CMBS trading are relatively good because of limited supply and modest demand.

The loan side of the business substantially parallels the securities component of the market. The largest life insurance companies remain active, albeit with smaller portfolio targets, as the rating agencies are carefully scrutinizing insurance company balance sheets. The largest banks also remain active, but they are subject to increasing pressure from their regulators and so their origination targets are materially lower than last year. The private debt funds are in mixed positions. Some funds, particularly those that focused on mezzanine loans, transitional loans, and construction loans, have materially curtailed their new business activities as they become more focused on loan extensions and workouts. The more prudent debt funds have been gathering capital to take advantage of today's excellent lending environment with less competition and higher yields.

In summary, for debt investors who for the past several years strategically managed away from the sugar highs of high yielding/highly leveraged mezzanine and transitional loans, the market opportunities in U.S. real estate debt have never been better!

Gregory White
CEO
Prima Capital Advisors

Review DebtConference 2023

2 DAYS
7 BLOCKS
33 SPEAKERS

Keynote by Dr. Gertrud R. Traud (Helaba)

Chairman of the conference: David Rückel (PIA Pontis)

Initiator of the conference and founder of the FondsForum platform: Oliver Strumpf

On 6/7 June 2023 the annual DebtConference took place. More than 110 international participants from Europe and overseas as well as institutional investors came to Kap Europa in Frankfurt to attend. The kick off of the event was the investor dinner the evening before in the O/C OPERNCAFÉ restaurant, which was also attended by the sponsor representatives.

On the 2 conference days 33 renowned investment experts and investors presented their experiences, insights and interesting facts on the current topics related to Real Estate Debt Investments. In between, a block per day with the now established face-to-face meetings, which were once again very popular. After the first filled day of the conference, the participants came together for the conference dinner in a nice atmosphere with good food and wine as well as interesting conversations at the restaurant MainNizza.

For the first time, a new program item was integrated to the event on the second day – the break-out sessions! Herefore, the participants were able to choose one of three topics in advance and work out results in small groups with a moderator and co-moderator. These conclusions were then presented to the audience for further discussions.

In addition to the many positive feedbacks, we also received valuable suggestions. Now, we are already looking forward to the next event in 2024, where the latter can be taken into account. Further information will be available at:

www.DebtConference.com

Expert contributions, among others by Richard Flohr (CrossHarbor)...

...as well as interesting panels.

For the DebtConference developed - now a permanent feature - the face-to-face meetings.

The new format at the conference - the break-out sessions were very popular.

Good mood and a great exchange...

...at the investor dinner the evening before the conference...

...and at the conference dinner on the evening of the first conference day.

Speakers


Trevor Castledine
bfinance


Christian Chaki
BVV Versicherungsverein des Bankgewerbes


Clark Coffee
AllianceBernstein


Richard Flohr
CrossHarbor


Andrew Gordon
Invesco Real Estate


Lorcain Egan
Starwood Capital


Paul House
ARA


Christian Janssen
Nuveen Real Estate


Christian Jopp
Württembergische Gemeinde-Versicherung


Indraneel Karlekar, Ph.D.
Principal RE


Tim Knapp CFA
DWS


Cyrus Korat
DRC Savills


Hanno Kowalski
FAP Invest


Rebecca Kunz
Helaba Invest


Michael Lavipour
Affinius Capital


Michael Leister, CFA
Commerzbank


Frederik Leser
PANDOO Management


Christophe Montcerisier
BNP Paribas Asset Management France


David Mortimer
ICG Real Estate Debt


Dan Pottorff
Tristan Capital Partners


Andrew Radkiewicz
PGIM Real Estate


Anja Ritchie
StepStone Group


David Rückel
PIA Pontis Institutional Advisors


Andrew Schwartz
Qualitas


Niraj Shah
Rockwood Capital LLC


Shrey Shah
PIMCO Europe Ltd.


Oliver Strumpf
FondsForum


Dr. Gertrud R. Traud
Helaba


David White
LaSalle Real Estate Debt Strategies


Greg White
Prima Capital Advisors


Daniel Younis
Schroders Capital


Dr. Patrick Züchner
Aukera Real Estate


Kasimir zu Eltz
Barings

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VideoStatements DebtConference 2023

No better time to be a Debt Investor
Richard Flohr, Managing Director, CrossHarbor Capital Partners

The situation of the Debt Market
Paul House, Co-Head of Commercial Real Estate Debt, ARA

Importance of governance
Frederik Leser MRICS, Partner, PANDOO Management

Was jetzt getan werden muss
Dr. Patrick Züchner, Chief Investment Officer, Aukera Real Estate

ESG in European Real Estate Markets
David Mortimer, Co-Head of Real Estate Debt, Intermediate Capital Group

Changes during the last months
Christophe Montcerisier, Head of Real Estate Debt, BNP Paribas Asset Management

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Upcoming conferences and events of the FondsForum platform

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All events at a glance

30 Nov 2023	ESG Praxistag	www.ESG-Praxistag.de	Frankfurt
07 Feb 2024	Forecast	www.Forecast2024.de	Frankfurt
07 Feb 2024	NeujahrsEmpfang	www.RealEstateReception.com	Frankfurt
08 Feb 2024	FondsRechtKonferenz	www.FondsRechtKonferenz.de	Frankfurt
27 Feb 2024	SupermarktInvest	www.SupermarktInvest.de	Frankfurt
7/8 Mar 2024	USA Conference	www.USA-Conference.com	Königstein
29/30 Apr 2024	HotelReturn	www.HotelReturn.de	Frankfurt
23/24 May 2024	ESG Konferenz	www.ESG-Konferenz.de	Frankfurt
18 Jun 2024	SommerEmpfang	www.SommerEmpfang.com	Königstein
19 Jun 2024	SommerKonferenz	www.SommerKonferenz.de	Königstein
12/13 Sep 2024	DebtConference	www.DebtConference.com	Frankfurt
17 Sep 2024	HealthCareDay	www.HealthCareDay.de	Frankfurt
07 Oct 2024	EXPO-Cocktail	www.EXPO-Cocktail.de	Munich
6/7 Nov 2024	FondsForum-Konferenz	www.FondsForum-Konferenz.de	Königstein
Nov 2024	JazzNight	www.JazzNight.de	Wiesbaden
28 Nov 2024	ESG Praxistag	www.ESG-Praxistag.de	Frankfurt

For your annual planning in 2024!

Our event overview in an interactive PDF file. Simply "click" on the QR code or scan it.

From sponsorship to participation, feel free to cross without obligation the positions on the events that are of interest to you. We'll get in touch with you shortly.

info@FondsForum.de

Dates/locations: subject to change

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