EDMOND DE ROTHSCHILD

EDMOND DE ROTHSCHILD REAL ESTATE INVESTMENT MANAGEMENT

THOUGHT PAPER ON EUROPEAN PRIVATE REAL ESTATE DEBT



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Banks have been steadily withdrawing from commercial real estate lending in Europe since the Global Financial Crisis ("GFC"), 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 of these structural and market changes 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 over the next few years. For investors in private real estate debt there is a compelling opportunity to benefit from higher coupons on new loans at lower LTVs and tighter lending structures. In our opinion, the next few years will provide an excellent vintage for real estate debt investments in Europe with an attractive risk-return proposition. However, maintaining strict investment discipline and focus on quality loans backed by strong sponsors and good assets is key.

In this brief paper we describe the current market environment for commercial real estate lending, its key growth drivers and our general investment beliefs for private real estate debt investments, considering the ongoing structural changes as well as the current dislocations in Europe.

NEW MARKET ENVIRONMENT

CURRENT CHALLENGES AND OPPORTUNITIES IN THE REAL ESTATE MARKET

The real estate market has been impacted by several key events, such as disruption created by the war in Ukraine, high inflation and the repricing of risk. All have contributed to a higher interest rate environment, fears of a recession in several countries and ongoing volatility in capital markets.

The new interest rate environment is putting pressure on real estate valuations and creates a risk on upcoming re-financings. Rising rates mean higher debt service costs for borrowers which then imply higher required equity ratios (i.e. lower LTVs) to keep lender-required debt service coverage ratios constant or raise these to even higher levels where lenders feel comfortable.

Furthermore, from a non-European perspective, the strength of the US Dollar ("USD") compared to Sterling and the Euro is making assets in the UK and Europe appear cheap to USD-based buyers. Therefore, European credit compares favourably in a global context and provides additional currency pickup from hedging for USD-denominated investors (circa +150bps)[1].

THE BANKS CONTINUED RETRENCHMENT FROM REAL ESTATE LENDING IS ACCELERATING ACROSS EUROPE BECAUSE OF THE IMPACT OF RATE INCREASES.

LENDERS ARE ADAPTING TO THE CHANGING MARKET CONDITIONS

The all-in cost of debt has risen by around 4% since the beginning of the rate hikes in 2022[2], and this has been impacting the pricing of all new real estate loans. Moreover, lenders are lowering the LTVs they are prepared to offer on new loans, to ensure there is sufficient cash flow available for debt service with the Interest Coverage Ratios (ICRs) often the bottleneck in the loan sizing. Depending on the asset class and location, we have seen LTVs offered by lenders fall by 5-10% LTV points.

IMPACT OF CAPITAL VALUE DECLINES ON DEBT INVESTMENTS

On the one hand, if a loan has been well structured with adequate guarantees and good covenants, and has been provided to a well-capitalised borrower with sufficient "skin in the game", then a value decline can be mitigated. Moreover, if the underlying asset has good asset management potential (e.g. lease up of vacant space, upgrading of asset through refurbishment, significant indexation of rents) then a yield shift can be offset by higher cash flows generated, or tangible value created. That being said, it implies that the equity investors/borrowers, in their first loss position, need to work harder to achieve their target returns and cannot rely on cap rate compression to produce underwritten returns.

On the other hand, a highly levered loan secured on an asset which was bought at low yield (high price) in 2018-20 and which was financed at cheap rates with little equity investment may become a restructuring case. We are seeing an increasing number of such deals coming to the market looking for refinancing/restructuring options.

THE EMERGENCE OF DEBT FUNDS IS FACILITATING THE AVAILABILITY OF CREDIT

Firstly, we do not observe any sign of a systemic credit crunch, as seen in 2008/09 because borrower LTV levels are around 20% below where we entered the GFC[3].

Over recent years, debt funds have provided borrowers with much more choice and flexibility than previously existed. In the UK, debt funds have around 30% market share across all asset classes. In Continental Europe, the market share is at 10% but rapidly growing[4].

The banks continued retrenchment from real estate lending is accelerating across Europe because of the impact of rate increases. These new conditions are pushing property valuations down and, in return LTV ratios up on existing loans, thus leading to higher Risk Weighted Assets (RWAs) and higher capital charges for banks.

From a lending perspective, private real estate debt has become a natural solution to this widening funding gap.

From an investment perspective, the current environment represents a compelling opportunity for debt funds with dry powder. Debt funds are taking advantage of the situation by moving down the risk curve whilst still achieving the same, or higher, returns than before. In general, returns from debt strategies are currently higher than from many equity strategies whilst being less risky given the equity cushion in the capital stack and the security provided.

1. Chatham Financial, 27.04.2023.

2. Edmond de Rothschild REIM, 27.04.2023.

3. Edmond de Rothschild REIM, 27.04.2023.

4. Edmond de Rothschild REIM, 27.04.2023.

SIGNIFICANT TAILWINDS FOR PRIVATE REAL ESTATE DEBT

THE CASE FOR REAL ESTATE DEBT IN THE CURRENT MACRO-ECONOMIC AND FINANCIAL ENVIRONMENT

Taking into account the market characteristics described in the previous section, real estate debt investments benefit from the current dislocations and provide an attractive investment proposition over the next few years:

1. Attractive risk-adjusted returns: Real estate debt investments can provide attractive risk-adjusted returns, in particular since base rates as well as margins are increasing and the quality of new loans is better with lower LTVs, and tighter lending structures.

2. Security packages: Compared to equity investments which are directly exposed to market changes, real estate debt investments generally have a lower level of risk since debt has priority over equity in the event of default or enforcement procedure. Debt funds may also invest in shorter-term projects, which reduces exposure to market volatility and provides increased liquidity for investors.

3. Income streams: Real estate debt funds can offer stable income streams to investors through interest payments with a high recurring component typically paid on a quarterly basis. When set in the new economic environment, they are also a good mitigant against inflation.

In comparison, real estate equity investments provide returns in the form of dividends (after all costs) and capital appreciation or capital gains at exit which are less predictable.

4. Excess demand: In recent years, there has been a trend towards increased regulation of traditional banks, leading to reduced availability of financing for real estate developers and owners. This has led to an acceleration in the transition from bank financing to alternative lenders. At the same time, a huge wave of loans originated in the very active years of 2018-19 will need to be refinanced in 2023-24[5].

5. Diversification and less volatility: Investing in private real estate debt can provide diversification benefits to investors as it is relatively easy to gain exposure to a variety of real estate sectors, geographies and typology of projects. Real estate debt investments are also typically less volatile than real estate equity investments as they are not "marked to market". In addition, they have a lower correlation to traditional asset classes such as equities and bonds.

THE CASE FOR PRIVATE REAL ESTATE DEBT IN COMPARISON TO FIXED INCOME

Real estate debt investments can be compared to fixed income or bond investments as both asset classes provide investors with a predictable income stream in the form of interest payments. Real estate debt investments typically involve lending capital to real estate owners in exchange for a fixed rate of interest and fees over a defined period of time.

Fixed income investments in Europe, such as government bonds, corporate bonds, and money market instruments, also involve providing capital to issuers in exchange for regular interest payments. Like private real estate debt investments, fixed income investments are generally considered less risky than equity investments, although they may offer lower potential returns.

However, there are some key differences between private real estate debt and fixed income investments in Europe. Real estate debt investments are typically secured by the underlying real estate asset, providing investors with a degree of collateral and protection in the event of default. In contrast, fixed income investments are typically unsecured as bonds are issued by listed holding entities, with unsecured investments offering no collateral or security for investors.

Additionally, real estate debt investments may offer the potential for higher returns than traditional fixed income investments due to the illiquidity premium associated with private real estate assets. This illiquidity premium reflects the fact that real estate assets are often more difficult to buy and sell compared to listed bonds, which may make them more attractive to investors seeking higher returns. In addition, with bonds being traded on stock exchanges their market valuations typically involve a higher degree of volatility, whereas private real estate debt investments are typically valued on an amortised cost basis subject to regular impairment tests.

ESG CONSIDERATIONS

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. This is achieved by monitoring projects and ESG measures during the due diligence process and in the loan agreements through certain covenants and/or margin reductions related to ESG considerations.

However, we still notice that, if equity sponsors decide to amend the asset management strategy or business plan, in particular in a changing market environment, then lenders cannot and should not call a default.

Overall, we believe that ESG and the focus on certain environmental and/or social characteristics will improve the relative performance and value of the collateral assets and hence lower the loan's risk position. For example, the target ESG certification of an asset is a key consideration when analysing value creation potential as it will have a positive impact on future liquidity and therefore on the ultimate value of an asset.

INVESTOR SENTIMENT ON DEBT FUNDS

Considering the above, we observe that many investors are favouring higher return debt strategies at lower risk positions and are anticipating an opportunity to take advantage of asset repricing and dislocations over the next few years.

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.

In the short term, real estate debt funds are expected to be an attractive investment for investors in 2023. According to an INREV market study, over 60% of investors are planning to

5. Edmond de Rothschild, 27.04.2023.

increase their allocation to European real estate debt funds in the next two years. When adjusted for size of the investors, this figure actually increases to close to 80%[6]. Investors are likely to be attracted to the asset class because of potential diversification benefits, expected stability of returns, and low anticipated correlation with other asset classes.

Overall, it appears that many investors have a positive outlook on real estate debt as an investment opportunity and it is noted that, historically, the best debt vintages are those launched in times of crisis.

OUR INVESTMENT BELIEFS

LENDING STRATEGIES AND THEIR FUTURE EVOLUTION

We see a great window of opportunity for debt investments over 2023 and 2024 and we expect the private real estate debt market to grow significantly over the next few years. It is therefore important to keep some degree of investment flexibility in any lending strategy as the market evolves.

Short term, the focus is on whole loans and some selective junior/mezzanine loans in the mid-sized lending market (average size of loans between €30-50m). The risk-adjusted returns are currently favourable.

In addition, we also see a lot of interesting investment opportunities in the so called "stretched senior" space which is embedded in a whole loan but structured as junior loan (e.g. between 40%-60% LTV). Banks are reluctant to underwrite the full whole loan and prefer the super senior tranches only (e.g. 0%-40% LTV) as they want to move down the risk curve whilst achieving the same or higher returns than before.

Over the coming quarters, it will be important to observe the dynamics of the refinancing market as an estimated €300bn of commercial real estate loans will mature annually[7]. These will have to be underwritten on lower valuations at much higher pricing. As a consequence, a higher equity injection from sponsors will be required to complete a refinancing. Although it will create challenging situations for many borrowers, it will also generate interesting opportunities in the context of the next real estate cycle.

Last but not least, for assets where there is still upside asset management potential or sufficient equity commitment from sponsors, there is a compelling case for new debt investments to realise a higher return at lower risk (i.e. lower LTV position, tighter security structure).

IMPORTANT INVESTMENT AND DIVERSIFICATION CRITERIA.

The cornerstone of our approach is the selection of strong sponsors and borrowers to ensure they are able to stand behind their equity investment and provide adequate security packages.

The geographical allocation will focus on Western European countries including the UK with appropriate level of liquidity in the real estate transaction market.

A wide approach will be adopted for the sector allocation with opportunities analysed in all major and alternative sectors (logistics, residential, retail, office, hospitality etc.).

In the context of the higher interest rate environment and the widening funding gap, we expect the returns of new deals to be around 10%-11% gross IRR and therefore the net return of the 2023 vintages of real estate debt strategies to be 100bps higher at c.9% IRR (unlevered)[8] compared to the previous vintages launched three years ago. The average LTV is expected be around 70%.

EDMOND DE ROTHSCHILD REIM AS A CREDIBLE SOLUTION TO ADDRESS THE PAN-EUROPEAN REAL ESTATE DEBT MARKET

With a long history of managing alternative investments, such as Real Estate, Infrastructure and Private Equity, Edmond de Rothschild has a dedicated Real Estate Debt team that focuses on originating and managing real estate debt investments across Europe. The team has a solid track record and significant experience in the banking, capital markets and real estate sectors. It is recognised for its disciplined underwriting approach and active portfolio management.

Over the past 3 years, six whole loans and mezzanine loans have been originated to high profile sponsors in several countries (Germany, Netherlands, France, Italy and UK) and several real estate sectors (Industrial, Logistics, Offices, Residential and Hospitality). Solid security packages have been specifically structured for each opportunity in order to address adequately the risks and the downside scenarios.

The Real Estate Debt team is part of Edmond de Rothschild's pan-European operating real estate platform, that has 120+ real estate professionals on the ground in the largest markets in Europe. This allows the Real Estate Debt team to take ownership of assets in case of default, providing a strong signal to borrowers.

6. INREV Investment Intentions Survey 2023, 17.01.2023. **7.** Edmond de Rothschild REIM, 27.04.2023. **8.** The expected return is based on projected cash flows for hypothetical portfolio investments that are consistent with the outlined investment strategy and takes into consideration (among other factors) assumptions with respect to projected valuations of hypothetical portfolio investments at future dates, market conditions, broad general macroeconomic factors, current investment opportunities, the availability of leverage and financing at expected times, amounts, costs and other terms, anticipated contingencies and portfolio investment concentrations in certain assets. All hypothetical portfolio investments were assumed to have returned invested capital and generated profits. In addition, the gross expected return does not take into account vintage vehicle expenses, management fees and/or performance compensation, or tax or other considerations specific to particular investors, all of which may impact returns. Net expected returns reflect the deduction of fees and expenses, which include vintage vehicle expenses, management fees and/or performance fees.

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