EDMOND DE ROTHSCHILD REAL ESTATE INVESTMENT MANAGEMENT

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THOUGHT PAPER ON EUROPEAN PRIVATE REAL ESTATE DEBT

More than a year has passed since we published our first *Thought Paper on the European Private Real Estate Debt Market* in June 2023. In that paper, we explained the general market environment for commercial real estate lending, its growth drivers and our investment beliefs for private real estate debt investments considering the structural changes and the dislocations in European property and financing markets. As we approach the last quarter of 2024, European real estate markets appear to have passed its cyclical trough after significant price corrections which resulted in increasing number of loan defaults and some (high-profile) insolvencies. We believe that the real estate repricing across Europe will be mostly completed by year-end. However, the market conditions for real estate lending are still complex and it is likely that new macro shocks or financial crises will happen again. We live in an environment with a high degree of volatility. The long-awaited first interest rate cuts by the ECB in June & September and the BOE in August respectively, however, had only marginal impact on the all-in financing costs for borrowers. Debt costs continue to remain elevated, driven on the demand side by the big investment and refinancing needs in European property markets in the next few years and on the supply side by regulatory capital requirements (Basel IV) limiting senior banks' appetite to extend new loans outside their existing, larger relationships.

In this updated Thought Paper we take a look at the current stage of European real estate debt markets, its challenges and opportunities following the repricing of real estate assets, as well as certain new trends in lending strategies and investor sentiment for the asset class. We conclude with our general investment beliefs for private real estate debt investments as we prepare for the next real estate cycle.

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STAGE OF THE MARKET

REPRICING (ALMOST) COMPLETED

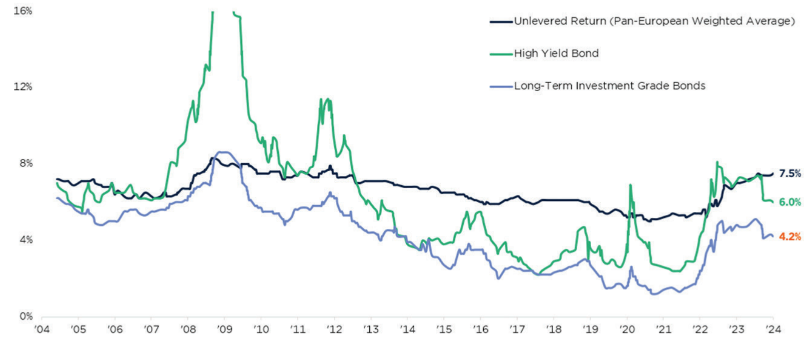
Commercial real estate in Europe has had a bumpy ride over the last two years to put it mildly. And let us not forget, this *ride* was even against a relatively modest weakening of the real economy and in particular without the severe recessions which many economists had predicted beforehand. Nevertheless, the rapid interest rate increase implemented by the ECB and BOE to tackle raging inflation rates has taken its toll on real estate valuations across Europe. Average prime yields in Europe have risen significantly to 5.30% (+130bps), up from 4.00% in 2022, reflecting the lingering effects of high inflation and cautious investor sentiment.[1] In our opinion, however, the full average-value decline capturing all different European sub-markets and risk profiles has been more in the 20% to 50% range, and for properties in distressed situations transaction prices fell to levels where even senior lenders had to accept write-downs on their loan positions. From a geographic perspective there were strong differences too. The German real estate market, for example, which traditionally had benefitted from a relatively low cost of financing has been over-proportionally hit by higher interest rates as can been seen by the high number of insolvency cases. Indeed, in many of those insolvency situations the underlying real estate projects are good ones but the capital structures which had been put in place before 2022 to finance those projects are now completely broken because of the value declines. In addition, in most situations which led to insolvency, the value decline is such that the current market value of the underlying asset does not enable a recovery of the invested equity in the deal, hence there is no economic incentive for sponsors to inject additional equity. In other countries, for example Switzerland, the impact on real estate values has been much more moderate with transaction prices decreasing 5% to 10% on average.[2] This "safe haven" market benefitted from strong fundamentals driven by a resilient economy, population growth and limited new supply as well as a lower (negative) interest rate base to start the cycle. But the glass is half full. We believe that many European real estate markets are bottoming out. In some sectors (e.g. core logistics) prices have already stabilized for a few quarters now. We believe that now is the right time to prepare to re-enter the European real estate market at discounted values.

A NEW CYCLE – GET SET

Smart money investors (incl. private equity, certain institutional investors especially from Asia and the Middle East, Family Offices) have already returned as buyers in the European real estate markets particularly in the value-add and opportunistic segment where cheap acquisition prices can be obtained. Whilst deal volumes still remain well below the average of the previous boom-years, due to the absence of mainly institutional investors, the massive repricing of the market and the sheer quantum of investable capital from investors may lead to a faster recovery process than many people anticipate. It is worth mentioning that the European commercial real estate market is highly sensitive to offshore investors who typically account for 50% of acquisitions in any given year.[3]

We expect to see increased investment activities in 2025. With inflation and (forward) interest rates on the decline, we believe that the trough of the market cycle has (almost) been reached. And from a buyer's perspective waiting for the absolute lowest capital value can be a tricky objective and becomes of marginal value if the (relatively) low purchase price is put into the context of replacement costs and positive demand drivers. Additionally, increasing valuations in the listed real estate sector and tightening credit spreads in capital markets also point to a market recovery. Pan-European private real estate unlevered return has outperformed both high-yield bonds and long-term investment grade bonds yield since beginning-2024.[4] In our opinion, investors should position themselves to re-enter the European real estate market. Obviously, timing has always been one of the most important success factors in real estate investing be it in debt or equity strategies.

Unleveraged Total Return Expectation on Real Estate vs. Corporate Bond Yields



IRRs, public market valuation metrics and bond pricing as of 1 May 2024. IG Bond Time Series is weighted 80% Eurozone, 20% GBP
Source: Bloomberg, BAML (High Yield), HIS Markit (Investment Grade), Green Street. Data as of 1 May 2024

DEBT COSTS REMAIN ELEVATED

The all-in cost of debt for commercial real estate in Europe increased significantly after the rate hikes in 2022-23. Currently, according to our data, senior loans price on average around 5%-6% p.a. unlevered Loan IRR ("LIRR"; coupon plus annualized fees) with a loan to value ("LTV"; against repriced asset basis) often below 50%. Whole loans, which typically go higher up the in capital stack to 60%-70% LTV, price between 8%-10% p.a. unlevered LIRR, subject to the underlying risk profile of the project.[5] To ensure there is sufficient cash flow available for debt service, with the Interest Coverage Ratios ("ICRs") often being the bottleneck, lenders have lowered the LTV they are prepared to accept significantly. Loans for value-add properties with heavy capex programmes or development projects are priced at low double digit unlevered LIRRs. Mezzanine loans which provide higher leverage and are subordinated to senior / whole loans are priced at low to mid-double digit unlevered LIRR area. If lenders use back-leverage in their financing structures (see further down for more details) those LIRRs can be increased by 1%-2% depending on the terms of the credit lines used. In any case, returns from debt strategies, even if unlevered, are still higher than from many (core+) equity strategies whilst being less risky given the equity cushion in the capital stack and the security provided as part of the financing.

1. Savills European Investment Market September 2024
2. Source: Edmond de Rotschild REIM Switzerland, as of mid september 2024
3. Savills Annual Global Capital Markets Report 2024
4. Green Street 2024 Pan-European Sector Outlooks
5. Source : Edmond de Rothschild REIM Germany as of mid September 2024

On the back of positive inflation data and some gentle pressure from capital markets, the ECB delivered its first 25bps interest rate cut in June 2024 and another 25bps rate cut in September 2024. The Bank of England followed by entering the rate cutting cycle in August 2024 with a (first) 25bps interest rate cut. However, those rate cuts have not really changed the outlook for debt costs or real estate pricing. In this early stage of the recovery the main focus of lenders and equity investors alike is on the income return rather than any capital appreciation from yield compression. Cash is king. Moreover, for the time being the headline inflation is likely to remain above the 2% target and new geopolitical or financial crises may happen quickly. We therefore believe that capital markets currently overestimate the speed and magnitude of further rate cuts. In addition, due to the value corrections from the previous cycle and the implementation of the "Basel IV" regulatory framework, banks encountered a steep increase in their Risk Weighted Assets or balance sheet risk capital in relation to their real estate lending books. We believe that for these reasons their lending appetite on the asset class will remain subdued for longer. Furthermore, interest rates on (floating rate) commercial real estate loans are comprised of a margin "spread" over base rate (e.g. EURIBOR). To put it simply, the spread is the risk premium the lender requires to make the loan and cover the regulatory capital requirement for the risk. We believe that pricing will remain high for a longer period than the curve suggests due to defensive lending policies from traditional banks on the asset class and lack of available capital to cover the financing need. It is important to remember that the price of any product is driven by demand and supply, and the current demand for commercial real estate loans is far greater than the available capital given the big investment and refinancing needs as a result of the decline in property values and the ongoing retrenchment of banks from commercial real estate lending. These factors combined have created the well-published *Funding Gap* which has been estimated to be around €100bn in the European real estate finance market over the next two years.[6] From a debt investors' point of view this is a perfect alternative lenders market where investors can achieve attractive returns from lower LTV loans combined with tighter security structures.

SHOW ME THE DEALS

The current conditions in the European real estate financing markets have put lenders into a favorable position to realize attractive risk-return parameters on new loans. However, the actual lending volume is still relatively small. In the UK, for example, loan origination in 2023 fell to its lowest volume in ten years. In total, only £32bn (€37bn) of new loans were originated which was a 33% drop from 2022. The reduced deal volume was provided across all types of lenders including debt funds.[7] On the continent we could see a similar pattern even though the statistical evidence is not as good as in the UK.

There are a couple of reasons to explain this. The first point is the speed of the repricing process following the interest rate increases which has taken some time to work its way through the different countries and market segments. Europe is not a homogeneous market; all countries have their own local requirements and ways to deal with such value adjustments. During the adjustment process many bidders have simply put their acquisition plans on hold in order to wait for further price corrections and the market to stabilize in general. As a consequence, investment volumes and therefore acquisition financing have been subdued. In fact, most of the new loans which were closed were refinancings of old loans. And those refinancings typically are getting done at lower LTVs which again resulted in smaller lending volumes. Although reliable figures are hard to come by, there is also anecdotal evidence that in some refinancing situations the existing lenders simply extended maturing loans. However, with the repricing process (almost) done, we believe that there will be an increasing need for new debt financing as we go into the new cycle and investors re-enter the market. We expect lending volumes to increase substantially in 2025.

Another aspect for the lower than expected lending volumes so far, were the challenging fundraising conditions over last two years. Many debt funds in Europe are structured as closed-ended funds and depend on new capital commitments coming in to grow their loan pipelines as their existing funds mature. As the debt funds' dry powder was getting smaller many managers have simply become more selective in their deal origination. But also on this side of the lending equation we are cautiously optimistic. The fundraising environment has started to improve. We are seeing more investors seriously considering investments in the European private real estate debt asset class given the attractive risk-adjusted returns which often exceed their target returns while at the same time providing a higher safety level compared to equity strategies. It is therefore no surprise that private real estate debt has maintained its status from last year as the preferred strategy for investors in Europe according to the INREV Investment Intention Survey 2024.[8]

HORSES FOR COURSES – THE RIGHT STRATEGY

In terms of actual lending strategies, whole loans are currently gaining most of the investor interest. Whole loans are senior secured loans but they provide for (slightly) higher leverage than traditional senior bank loans and therefore price at a premium. As mentioned before, whole loans currently yield around 8%-12% p.a.[9] unlevered LIRR depending on the underlying risk profile of the transaction (from core to development financing). But is not just the pull factor from LPs who have put whole loans into the limelight of European commercial real estate finance. The other driver is the ongoing retrenchment of banks from real estate lending which has been a structural trend in Europe since the Global Financial Crisis ("GFC") which in turn allowed debt funds to take market share by providing more flexible lending solutions to borrowers. This is not to say that banks have stopped lending to commercial real estate but they have become much more selective and prefer simple transactions ideally in their home markets. Moreover, some banks have adapted their business models and prefer to provide "back leverage" to the debt funds rather than the loan to the underlying borrower directly. These back leverage deals come in different shapes and formats and include, for example, Loan on Loan facilities or Asset Backed Lending structures but the logic is always the same: The bank takes the senior tranche at lower price and the debt fund lender as originator of the underlying transaction retains the junior tranche at a higher price. If properly structured the return from such levered fund strategies will be higher than for unlevered debt funds. However, levered fund strategies may not be acceptable for certain institutional investors due to regulatory requirements, for example certain insurance companies.

Likewise, there is also demand for junior or mezzanine loans if the senior or whole loan together with the (new) equity from the sponsor cannot fill the funding gap to refinance a transaction. Those subordinated loan products are priced at higher rates than whole loans to reflect the increased risk position in the capital stack. To mitigate the risks on those positions lenders are demanding much tighter structures in addition to standard security items including pre-funded reserve accounts, cash traps or amortization requirements linked to covenants, bespoke waterfalls or recourse to sponsors.

6. AEW Research Mid-Year Outlook 2024/ Real Estate Capital Europe, April 2024
7. Bayes Business School Commercial Real Estate Lending Report – YE 2023
8. INREV Investment Intention Survey 2024
9. Source : Edmond de Rothschild REIM Germany, as of mid September 2024

OUR INVESTMENT BELIEFS

On the basis of the overall market dynamics but also the underlying risks, our European Real Estate Debt strategy is based on strong convictions and the following principles.

LENDING STRATEGIES AND THEIR FUTURE EVOLUTION

We continue to see a great window of opportunity for debt investments over the next few years and we expect the private real estate debt market to grow significantly as the market has to deal with a huge refinancing wave from loans originated in 2018-2022. It is therefore important to keep some degree of investment flexibility in any lending strategy as the market evolves and we move into a new real estate cycle.

The focus on whole loans will continue to dominate the investor landscape for real estate debt in the short term. The risk-adjusted returns are compelling and in many cases higher than for (core+) style equity strategies. However, as interest rates begin to trend lower from their peak levels, a debt investment strategy which can combine whole loans and selective junior/mezzanine loans provides the necessary flexibility to generate attractive returns for investors over a longer time period.

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.[10] As explained before, new loans are underwritten on lower LTVs and at much higher pricing than before the interest rate hikes. 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 especially for value-add/opportunistic strategies.

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 pillars of our lending approach are the selection of strong sponsors and borrowers to ensure they are able to stand behind their equity investment, a thorough understanding of the real estate assets we are lending against, and careful and defensive structuring of the security structures.

The geographical focus remains 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, life science etc.).

In the context of the higher debt costs and the widening funding gap, we expect the returns of new loans, which will comprise mainly whole loans but also include a certain allocation to junior/mezzanine debt, to be around 10%-11% gross unlevered IRR and the net return from the real estate debt strategy to be around 9% IRR (unlevered).[11] The average LTV after a three-year investment period 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, seven whole loans and mezzanine loans have been originated to high profile sponsors in several countries (Germany, Netherlands, France, Italy, UK and Spain) and several real estate sectors (Industrial, Logistics, Offices, Residential, Hospitality and Life Science). 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 140+ 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.

10. Edmond de Rothschild REIM, 27.04.2023

11. 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.