INVESTMENT OPPORTUNITIES

IN EUROPEAN COMMERCIAL REAL ESTATE DEBT

December 2023

EXECUTIVE SUMMARY

We believe the European Commercial Real Estate (CRE) debt market currently offers an opportunity for non-traditional lenders (Alternative Lenders) to enter or expand their presence. Historically, as seen in previous credit cycles, what we believe are the most promising investment opportunities tend to emerge during challenging market conditions, because well-capitalized lenders have the power to negotiate more favorable terms. Reduced competition, especially for development loans and loans tied to value-add properties, provides Alternative Lenders with the opportunity to implement high yield strategies with improving downside protection.

Several market characteristics are shaping the current landscape, and in our opinion are expected to continue creating opportunities for Alternative Lenders in the future.

1 **Traditional Lenders Retreat, Alternatives Compete:** Regulatory constraints have led banks and other traditional lenders to become more selective when making loans. For example, they've reduced the amount they lend in comparison to the property's value (loan-to-value or LTV). They also underwrite properties more conservatively, i.e. require higher interest coverage requirements based on higher loan constants and more conservative cash flow underwriting. We believe newly implemented risk-based capital rules and a cyclical shift towards reduced risk-taking will make credit conservatism a lasting trait of traditional lenders. The result is a decrease in their market share, and smaller loans that are more senior in the capital stack.

2 **The Growing Funding Gap:** As traditional lenders reduce senior funding, borrowers are on the hunt for "gap capital" to bridge the space between senior loans and equity. Borrowers increasingly turn to additional debt options like mezzanine debt instead of common equity to retain control and upside. Meanwhile, Alternative Lenders exploit the evolving landscape to achieve superior credit quality and target higher returns. As banks recede, the funding gap expands, providing Alternative Lenders with the ability to capture market share, and set the stage for further growth.

3 **Intermediaries Make their Mark:** The rising influence of broker intermediaries is reshaping the market, particularly in the historically direct relationship between European banks and borrowers and now for North American headquartered lenders and property owners doing business in Europe. Intermediaries' broad network of capital sources, and strong vetting capabilities derived from transaction experience, may help borrowers find the best capital for their projects—and to engage in new lender relationships with confidence.

4 **Essential Infrastructure for Lending Excellence:** Speed, certainty, and creativity demand robust infrastructure. Leading Alternative Lenders use their equity operations to tap specialized knowledge in submarkets, sectors, and construction, enabling prudent loan underwriting and management. Lenders with scaled platforms have centralized functions (e.g., legal, credit, capital markets, asset management), enhancing the borrowing experience and lender responsiveness. This necessary infrastructure acts as a barrier to entry, and a competitive edge to lenders who invest in it.

5 **Strong Relative Value:** Illiquidity can result from imbalances between the supply and demand for debt capital. That same illiquidity can create the opportunity to achieve better risk-adjusted returns compared to alternative asset classes, and compared to CRE loans originated earlier in the economic cycle.

TRADITIONAL LENDERS RETREAT, ALTERNATIVES COMPETE

Types of Lenders and the Rise of Alternative Lenders

Three categories of CRE lenders exist in Europe:

1. Banks
2. Other Balance Sheet Lenders (e.g., insurance companies, pension funds, credit unions)
3. Alternative Lenders (e.g., debt funds, public and private mortgage REITs).

Banks and Other Balance Sheet Lenders (collectively, "Traditional Balance Sheet Lenders") typically provide the most competitive terms for senior loans. That's because their capital efficiency and low funding costs support strong profitability despite lower loan yields. Banks have traditionally dominated lending for development and properties with a value-add component because the short-term nature of their corporate funding matches up well with the short-term loans needed for such projects. In addition, banks underwrite credit support (e.g., recourse to the borrower) to offset perceived risks in these loans. Other Balance Sheet Lenders have traditionally dominated longer-term loans backed by stabilized properties. Here, longer-term loans match the longer-term hold strategies typical of stabilized property owners.

Alternative Lenders have an advantage because they're not subject to regulatory or formulaic risk-based capital regimes. This allows Alternative Lenders to pursue any strategy that matches the risk/return profile that their investors seek, including targeting higher returns by going deeper into the capital stack. In contrast to Traditional Balance Sheet Lenders, leading Alternative Lenders integrate real estate ownership and development experience from their equity businesses into their lending process. Leveraging this real estate expertise provides a deep and standing knowledge of submarkets, sectors, construction, and sponsor— and underpins an ability to deliver speed, certainty, and creativity to borrowers.

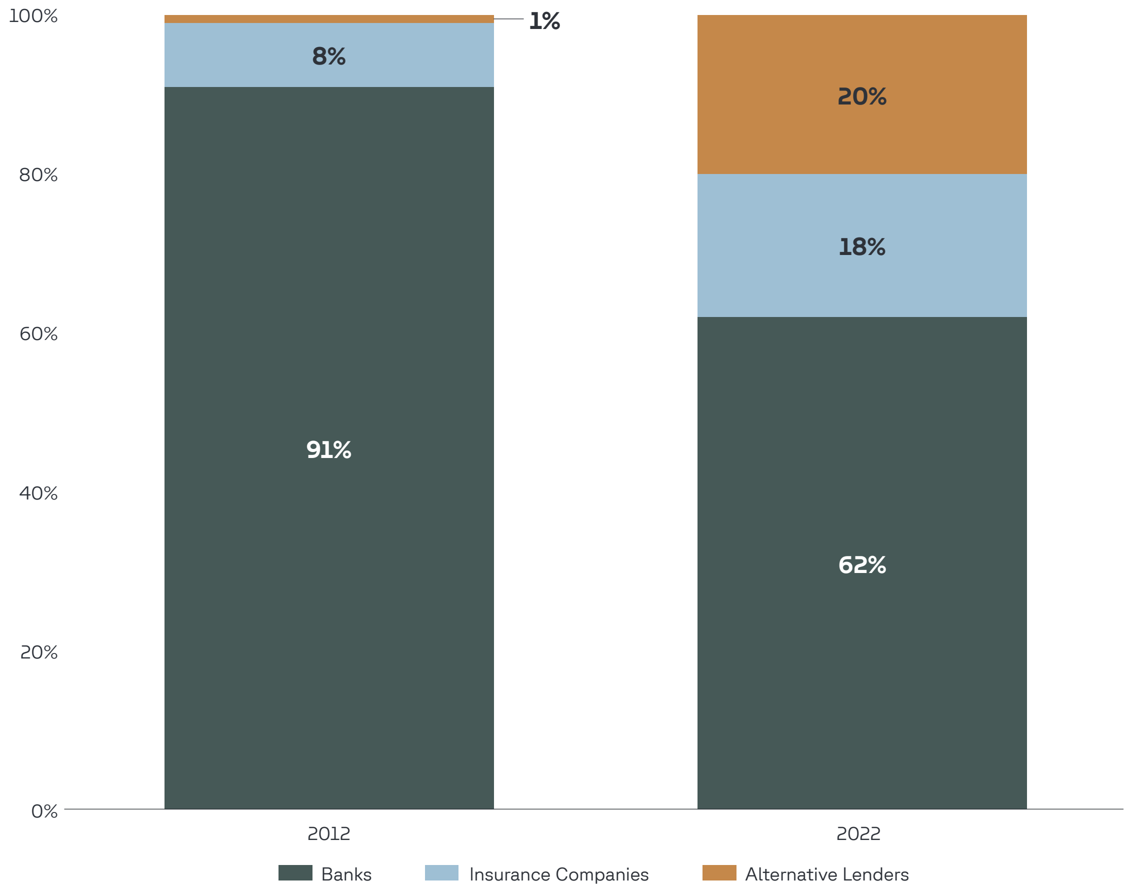
Being competent in both debt and equity also positions Alternative Lenders to prudently invest in "gap" capital, which bridges the debt and equity worlds. Alternative Lenders also have the ability to step into the shoes of the borrower in the case of credit stress. Lenders who are unable to assume ownership in the case of a loan default could be left with a wasting asset as collateral or accepting distressed liquidation proceeds levels—a suboptimal outcome in any case. Key to maximizing returns is the ability to pursue all resolution strategies, most importantly the ability to take ownership.

Banking on Change: The Market Share Shift

While triggered by a cyclical downturn, we believe that the traditional lenders' shift to a more secure position in real estate transactions will likely be permanent. Market changes like the rise of intermediaries, increased prominence of North American sponsors in Europe, Alternative Lenders' growth, and shifts in lender regulation and credit culture suggest changes are here to stay.

Historical changes in the competitive makeup of the lender market are clearly seen the chart below:

EXHIBIT 1: CHANGE IN COMPOSITION OF U.K. CRE LENDING, OUTSTANDING LOANS 2012–2022



Source: Bayes Business School

Over the past decade, banks have lost about 28% of their market share in the U.K., and Alternative Lenders jumped in to fill that void. Despite this, banks and Other Balance Sheet Lenders still account for 80% of outstanding loans in the U.K. market.[1] Equivalent data for the rest of Europe is scarce, but we estimate bank lenders hold 90% of outstanding loans.[2] This contrasts with the U.S., where banks and Other Balance Sheet Lenders account for 53% of outstanding loans.[3] Drawing on U.S. experience, we see significant potential for the transfer of debt market share to Alternative Lenders in the U.K. and Europe.

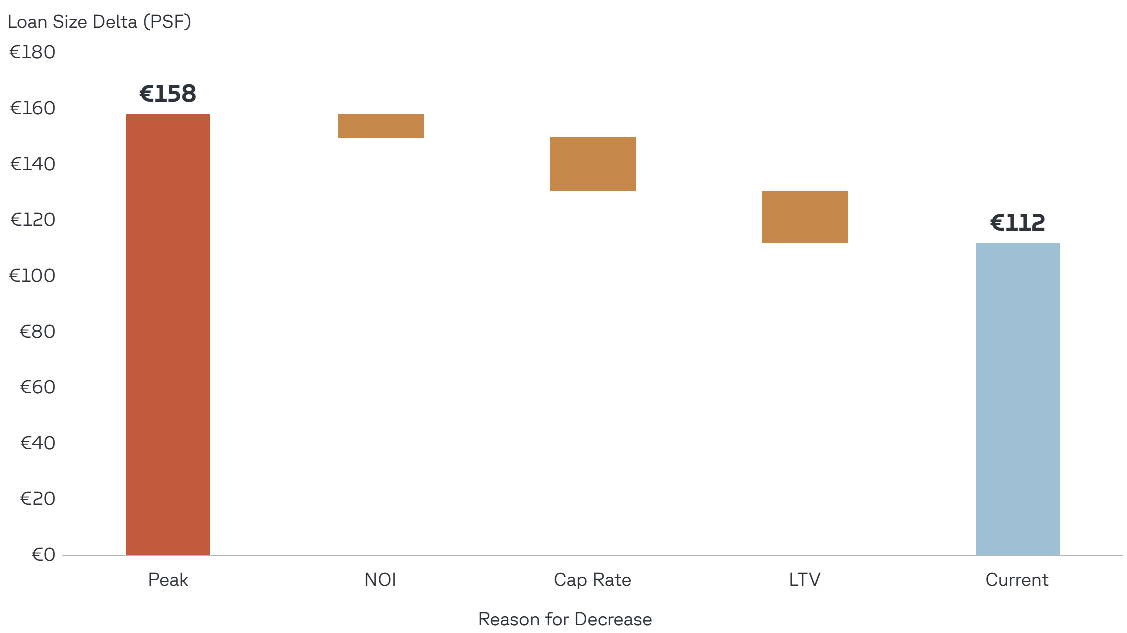
One aspect of the regulatory environment is the Basel Framework, which is designed to ensure banks hold adequate capital and liquid assets to meet expected outflows. In the U.K., bank regulators have introduced "slotting," a system categorizing loans by risk and setting capital requirements accordingly. Slotting has reduced traditional lenders' appetite, especially for value-add and development strategies. Basel III, with similar requirements to slotting, is expected to have a comparable impact on continental European banks. Recent banking sector stress, such as Silicon Valley Bank and Signature Bank's collapse in the U.S., and UBS's acquisition of Credit Suisse in Europe, could lead to additional government regulations.

1. Ibid. Note – includes U.K., German, and International Banks and Insurance Companies
2. PGIM. European Real Estate Debt: Where Next? September 2021
3. Mortgage Bankers Association. Commercial / Multifamily Mortgage Debt Outstanding. Q4 2022. Includes Banks & Life Insurance Companies

THE GROWING FUNDING GAP

Alternative Lenders have historically filled the void left by Traditional Balance Sheet Lenders, particularly banks, who have traditionally dominated the market for loans backed by development and value-add projects. Banks have the lowest funding costs, and where they choose not to lend quickly becomes the feasible domain for non-bank lenders. In Europe, we see a significant and potentially larger opportunity for Alternative Lenders compared to the U.S. This is due to Traditional Balance Sheet Lenders in Europe pulling back, coupled with their higher market share, which results in a comparatively larger gap in available capital. **Exhibit 2** (below) illustrates how changes in underwriting assumptions, compared to the most recent market peak in 2021, have reduced the last dollar amount from €158 to €112 PSF, on an indicative industrial/logistics project. These changes include a 5% lower assumed Underwritten Net Operating Income (NOI), higher vacancy allowances, lower effective rent, lower rent growth, and higher operating expense assumptions. The most significant adjustment is in underwritten values due to an increase in the cap rate assumption from 4.75% to 5.50%. Finally, lower advance rates associated with lower LTV requirements (from 75% to 65%) further reduce the basis. All other factors constant, **a reduced last Euro loan basis reduces risk for the same asset in the current market, but it also leads to higher demand for capital from property owners.**

EXHIBIT 2: REPRESENTATIVE STEPWISE REDUCTION IN LOAN PROCEEDS IN CURRENT MARKET VS. 2021



According to one estimate, the gap capital shortfall for European banks alone is €93 billion across all sectors.[4] We anticipate the current market dislocation to create opportunities for those who have both access to capital and the expertise to navigate this sector and backfill this portion of the capital stack. Property sale volumes in Europe have seen a 60% year-over-year decline, ending in Q2 2023.[5] Historically, acquisition financing drove most of the value-add lending volume. However, refinancing volume associated with loan maturities aggregating over €390 billion estimated in the U.K. and Europe in 2023 has helped offset the decline in acquisition financing.[6] This "wave of maturities", coupled with the inevitable capital requirements in the CRE sector, including those for ESG-related upgrades, generates substantial demand for gap capital. We're anticipating that banks will exercise a high degree of selectivity and, in any case, are likely to apply reduced advance rates targets for property recapitalizations.

4. AEW, CRE Lending Stabilises While Debt Funding Gap Remains, August 2023
5. Real Capital Analytics.
6. Bloomberg: Europe Is Bracing for a Sharp, Abrupt Real Estate Reversal; January 2023.

INTERMEDIARIES MAKE THEIR MARK

An increasing share of lending volume in Europe is now facilitated by mortgage brokerage firms. This is reshaping the market's traditional direct lending dynamics, particularly by banks, into a more fluid matching of capital to individual projects. Mortgage brokerage firms have extensive and global capital relationships, along with firsthand insights into the preferences and capabilities of various lenders gained through transactional experience. This combination makes the firms useful when playing matchmaker. Particularly in less liquid markets, they excel in identifying the best lender for a project, tailoring terms to suit the needs of both the borrower and lender. Perhaps more importantly, for value-add and development lending scenarios, a lender's ongoing performance, encompassing loan disbursements, covenant management, and occasionally, creative loan modifications, can significantly influence project success. This presents a unique opportunity for capable and creative Alternative Lenders to set themselves apart.

Borrowers, notably North American private equity firms doing business in Europe, know what they want. They seek a U.S. style of business approach known for its swifter and more reliable execution, globally standardized loan terms, and the capacity for creative solutions that benefit both borrower and lender over the term of a loan. Mortgage brokers play a pivotal role by gauging a lender's performance capabilities and offering endorsements for specific projects, thus catalyzing a more efficient and dynamic market. In this operating environment, the market share of Alternative Lenders is poised to expand, favoring those with the highest performance standards, because they're the ones who stand out to the brokers.

ESSENTIAL INFRASTRUCTURE FOR LENDING EXCELLENCE

To provide speed, certainty, and creativity as a lender, significant infrastructure is essential to support these capabilities. A solid understanding of markets and sectors, derived from an affiliated equity business, positions the lending function to quickly qualify new opportunities while considering all pertinent information during credit underwriting and loan structuring. While maintaining an equity footprint may entail substantial resource allocation, the economies of scale in leveraging it to bolster the lending function are substantial as well.

Additional credit-specific centralized functions are essential to support a scaled and responsive lending business. Maintaining a distinct credit function, separate from transaction teams, helps ensure consistent underwriting, adherence to appropriate diligence protocols, and impartial credit assessments. Meanwhile, a dedicated capital markets function is crucial for securing optimal senior funding. Effective loan servicing, encompassing covenant compliance, loan draw administration, and credit surveillance requires disciplined adherence to a robust process and seamless integration with third-party loan servicers to leverage economies of scale for routine tasks.

Additionally, asset management that taps equity expertise is pivotal in structuring sustainable workouts and maximizing returns from real estate-owned (REO) properties acquired through foreclosure. A dedicated legal function is important for documenting terms with consistency, creativity, and prudence during loan origination, but also for enforcing rights when necessary.

Other centralized roles include funds management, portfolio analytics, compliance, and various other critical functions. When viewed collectively, the resource commitment required to support a best-in-class lending business is substantial. This commitment may act as a barrier to entry for potential new players and a competitive advantage for those already established in the field.

STRONG RELATIVE VALUE

The opportunity within the European CRE debt market not only appears highly favorable in the current market environment, but also boasts an impressive decade-long track record of delivering strong returns relative to other asset classes. **Exhibit 3** (below) provides a comprehensive view of the risk-adjusted returns offered by real estate credit when compared to various asset sectors.

In the chart, we compare the performance of the Global Real Estate Debt Fund Index to stocks, bonds, and REITs in both the U.S. and Europe. Since the emergence of debt funds following the Global Financial Crisis, CRE debt has exhibited low volatility akin to that of fixed income investments. In addition, it has delivered the second highest return performance, trailing only U.S. stocks during this period. This performance results in a Sharpe Ratio of 1.82 over the period. In contrast, other asset classes in the chart displayed Sharpe Ratios ranging from a high of 0.77 (U.S. stocks) to a low of 0.06 (U.S. fixed income), clearly demonstrating strong risk-adjusted performance of European CRE debt.[7]

EXHIBIT 3: RETURN/RISK COMPARISON OF ASSET CLASSES, 2013–2022

Source: Bloomberg, Preqin, NAREIT,. Note: All returns are total returns. Real Estate Debt is based on global debt fund performance from Preqin, U.S. stocks is S&P 500, European stocks is S&P Europe 350, U.S. bonds is Bloomberg U.S. Aggregate, European bonds is Bloomberg EuroAgg Index, U.S. REITs is U.S. NAREIT All-Equity index, European REITs is FTSE EPRA NAREIT Europe REITs index.

The chart above draws from extensive datasets and, depending on market segments, there may be some overlap. However, the plotted points' coordinates provide valuable directional insights for understanding where strong relative value exists among asset classes.

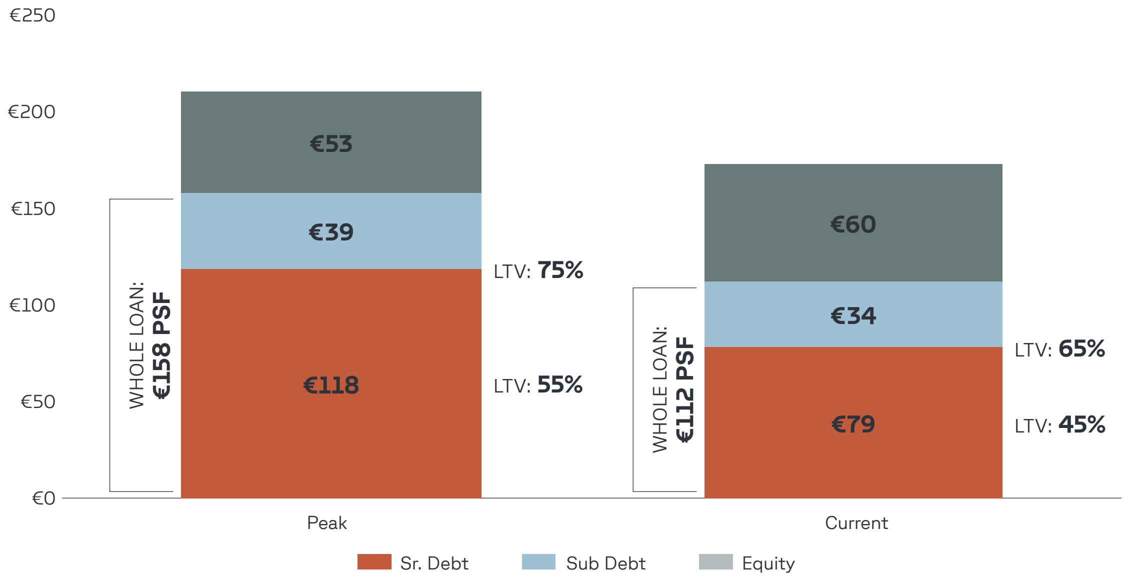
In the case of Real Estate Debt, factors such as loan-level financing, leverage levels, and stability are critical considerations for investors. Market observers often focus on the LTV ratio in relation to the investor's final euro invested. Yet in the case of leveraged investments, the debt multiple associated with senior leverage on the loan itself can significantly influence the severity of losses in case of credit defaults.

7. See Exhibit 3 footnote for indices used. Real estate debt fund index from Preqin can't be defined by country. All returns reported in home currency, and risk-free rate used Sharpe ratios for U.S. indices is 3-Month Treasury, for European indices is Eurozone 3-Month Government Bond, and a 50/50 combination of these two for debt funds.

For example, reducing the senior funding advance rate (senior funding as a percentage of the total loan) from 75% to 70% implies a reduction in debt multiple and a corresponding decrease in loss of severity on the retained interest in leveraged loans. In this scenario, a shift from 3.0x to 2.3x occurs in the event of a loss on the whole loan principal. It's important to note that there's interplay between the advance rate of the whole loan relative to the property value and the advance rate linked to senior financing on the loan itself. Conceptually, as the advance rate of the whole loan decreases, the likelihood of default decreases, consequently reducing the impact of senior financing on loss adjusted returns.

As illustrated in **Exhibit 4** (below) with the same assumptions as **Exhibit 2** (above), the final euro exposure of sub-debt is now lower than the last euro exposure of senior debt two years ago for the same property, signifying a substantial reduction in risk.

EXHIBIT 4: ILLUSTRATIVE CAPITALIZATION: PEAK VS. CURRENT (€PSF)



Source: Affinius Capital
These charts are for illustrative purposes only and no reliance should be placed on this data.

CONCLUSIONS

In the current phase of the economic cycle, we believe CRE debt strategies offer attractive risk-adjusted returns. As banks grapple with the complexities of the current lending environment, a gap exists between borrower requirements and credit availability. The regulatory environment, rapid rise in interest rates, and market value correction are expected to limit traditional lending and create compelling opportunities for Alternative Lenders in Europe. Consequently, an opportunity exists for Alternative Lenders to meet this demand, much as they have successfully done in the U.S. over the past two decades. For historically U.S.-centric real estate debt investors, it's time to cross the pond.

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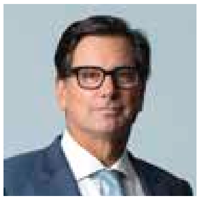

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