Investing in a low-interest-rate environment

Recently, **Jonathan A Schein,** senior vice president and managing director of global business development for Institutional Real Estate, Inc, spoke with **Clemens Schaefer,** head of real estate, Europe, for DWS. Following is an excerpt of that conversation.

What is DWS doing in Europe at this time?

We are active on the real estate equity and on the real estate debt side. The house is dominated by our real estate core investment capabilities on the equity side, where we have roughly €28 billion in assets under management*, predominantly in open-end vehicles and separate accounts, and then we have a debt business where we are offering real estate mezzanine separate accounts and senior loans in a commingled vehicle and in separate accounts, bringing us to almost €31 billion in total assets under management.*

What is your role?

I am head of the Europe real estate business and oversee all our real estate equity and debt investment management activities. A few months ago, I was fortunate to be appointed to this position as the successor to Georg Allendorf, after serving most recently as the CIO and following 21 years with DWS' real estate business. Georg and I have worked closely together to shape the platform over the recent years, so I will continue the growth path we have been working on, focused around three cornerstone growth initiatives to further diversify our platform.

What are those initiatives?

One is to push our real estate debt capabilities on the senior and the mezzanine side. Second, to grow our institutional flagship Pan-European, open-ended real estate fund. And third, to continue providing club-deal offers to our institutional client base.

What kinds of debt products is DWS offering, and how are they performing in this low-interest-rate environment?

The mezzanine space is yielding somewhere between 4 percent and 10 percent, depending on the risk profile of the transaction. The bulk of our investment activity is in the lower to mid-risk segment, somewhere in the 4 percent to 8 percent range. Those yields have compressed, as we have seen happen on the real estate equity side, but still they are providing good cash returns and low duration risk, since mezzanine loans often have terms of two to four or five years. For the foreseeable future, we see the market cycle holding, so mezzanine can be an attractive alternative for getting access to real estate — you give up upside, but you have substantial downside protection with good cash yield.

On the senior loan side, we are offering 50 percent to 60/65 percent loan-to-value products, which yield roughly 1.5 percent and also offer the advantage of having short duration. We see pension funds and insurance companies looking at this product as a replacement for their traditional fixed-income allocations.**

When yields are being compressed, there is risk. How do you manage risk within your debt investments?

One of our underwriting standards when we do mezzanine is to only invest in transactions where we like the underlying real estate — where we would also be an investor in the real estate, and where our equity real estate team would feel comfortable managing the asset. We basically do an equity underwrite of the transaction, and then analyse it in the context of covenants and legal framework of the mezzanine loan agreement, and conclude whether it is attractive on a risk-adjusted return basis. Our debt team has access to the underwriting capabilities within our research group and also our equity team. We would not finance on the mezzanine side something we would not buy or would be unable to manage on the equity side. If we are capable and willing to invest on the equity side, then it is an implicit statement that we can handle all the risk coming out of an unplanned/unexpected equity position.

So you wouldn't lend on something if you didn't believe in the value of the property.

Yes, at that value that we are financing. The senior side has much more cushion. There we focus on LTVs of 60 percent to 65 percent. We take assets we believe are attractively priced and generate value for our investors. Of course, the investment underwriting itself is very much the same — we still do an equity underwrite and reflect on what it means for a debt position in the capital stack — but, given that we are on average 60/65 percent LTV, we would sometimes invest in senior debt where we would shy away on the mezzanine side, because it is less likely that we would gain control.

Tell us a little more about your open-end fund.

Our first fund, is an €8 billion NAV fund here in Germany for German retail clients incepted in 1970 — so almost a 50-year track record in managing German and Pan-European investments on behalf of our retail clients. When we started out in 2017 to launch our new flagship, open-ended core strategy targeting institutional investors, one of the driving forces behind it was this track record for German retail investors. We have a similar track record with German institutions, so why are we not leveraging our capability and expertise in core investing to cater also to the needs of non-German institutional investors? Our Europe core

*Source: DWS as at 30 June 30 2019

** Past performance is not a reliable indicator of future returns.

strategy is really the answer to that, offering a diversified, Pan-European focus. It plays to the full strength of our platform, with local asset management and transactions offices across Europe, strong research capabilities, and a centralized portfolio management team run out of London. We are now three-quarters through the deployment of the initial capital commitments.

Do you attract investors from outside of Europe? Asian investors? Australian, US, Canadian?

The fund itself is structured to be able to absorb investors from all over the world, as we paid particular focus on creating a very accessible product, and the initial focus on fundraising was here in Europe. Most of the investors of the first close are coming from across Europe, including the Benelux region, as well as the US.

In a low-yield environment, is core real estate still attractive to investors? How is it really playing out today?

All the asset classes are competing for flows against each other and, therefore, real estate needs to provide an attractive risk/return profile. And I believe that core real estate in Europe can still deliver an attractive return over performance of the risk-free rate, which apparently is negative by now. With the German 10-YRS-Bund yield being compressed to negative 30 basis points per annum, real estate returns are likely to compress as well, but it will provide an attractive outperformance over credit fixed income and, therefore, it may continue to be an attractive asset class for investors seeking illiquidity premium.

Which markets offer the best investment returns today?

We spent a lot of time and effort with our research team answering that question, and that is also one of our advantages, if compared with other platforms. Our global research team includes more than 20 individuals, so we have a substantial cost and resource commitment to this function, and we made it the center of our investment process. Our chief investment officer for Europe is also our research chief strategist, which demonstrates the importance we place on this function. We spend time and effort finding undervalued sectors and geographies that we believe still offer very good value. We have just recently made a substantial investment in residential in the Nordics, and in the Netherlands we are looking at similar transactions, also in Spain and Germany. Although returns are often lower than in other asset classes, we believe that is actually very good value for money, with the trend of people continuing to move to the cities and driving demand for rent. We will continue to invest for our core funds into residential. On a different note, logistics and logistics development is something we rank quite highly. Land values have appreciated, construction costs have increased as well, but yields have so dramatically compressed that there is a lot of money to be made in the logistics space, while the absorption of newly produced space is at record levels and realisation times are very short. Between starting the construction and completion is usually less than one year, so you are faced with substantially less market-change risk than you are with other development projects. Beyond that, we still believe there is good value to be generated in the wider logistics sector. We see a lot of the trading volume moving from stores to the internet, with product that will need to be shipped and stored. We also see pockets in the hospitality space, hotels in particular, and we like student apartments, basically in strong geographies with strong student and university supply — The Netherlands, the UK, Ireland, and a little bit less so in Germany.

What other big trends are you seeing?

People moving to cities, living in smaller apartments, creating families later, wanting to be flexible — all of which support our growth strategy around the residential sector. But the biggest challenge for mature businesses in the real estate investment management space is going to be the technology push, and developments on the tech side that change how services are provided. Investors hire us to take their money, invest it into real estate, manage it well, report about what we are doing, help them to adhere to their regulatory requirements, and sell at some point to good success. The question is whether the technological change will actually split up this value-creation chain. There might be very strong competitors evolving who are very good at providing the regulatory services or the reporting services. Substantial investment into tech is required and it is expensive — many traditional players might not be large enough in size. So we may see a decoupling from the real estate–related services. Obviously, tech is not only a threat, but also a great opportunity if you find the right way to make the technology development your friend.

Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

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CORPORATE OVERVIEW

DWS Group
DWS Group (DWS) is one of the world's leading asset managers with €719 billion of assets under management (as of 30 June 2019). Building on more than 60 years of experience and a reputation for excellence in Germany and across Europe, we offer individuals and institutions access to our strong investment capabilities across all major asset classes including Active, Passive and Alternatives asset management.

DWS – Real Estate
DWS's real estate investment business has been investing in real estate assets for almost 50 years. As part of the Alternatives platform, the real estate business has more than 450 employees around the world and €60 billion in assets under management as of 30 June 2019. We offer a diverse range of strategies and solutions across the risk/return and geographic spectrums, including core and value-added real estate, real estate securities, real estate debt and opportunistic real estate.

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