Lending only on what we would buy as equity

Arno van Grondelle, Institutional Real Estate, Inc's managing director, *Institutional Real Estate Europe*, spoke with **Alexander Oswatitsch,** head of real estate debt, Europe, for DWS. Following is an excerpt of that conversation.

What investment structures is DWS offering in the current market for real estate debt investors?

When we look at the real estate financing market, we distinguish between the private side of the market and the public side, such as CMBS structures, which are effectively multi-tranche securitisation structures. The European market is much more dominated by private investment structures. That is where DWS is active, and within this universe we cover the entire capital stack, from senior to mezzanine strategies on the private debt side.

The private side is typically comprised of banks, insurance companies and alternative lenders, such as ourselves, being active with financing or lending strategies ranging from senior loans to whole loans to mezzanine loans. The senior loans are obviously the most conservative and, therefore, the lower-yielding structure, while mezzanine hits in the higher risk part of the structure. Depending upon risk/return profile, one of them is better suited to certain lenders or investors than the other.

Where do you see investor interest?

We see investor interest across the capital structure, with different investors focused on different parts of the capital stack. The senior side, for example, is attractive for insurance companies that have a lower tolerance for risk and, as a result, are willing to accept a lower return, while still looking for fixed-income substitutes in the current low-interest environment. Overall, we see a very much increased interest in private debt from the insurance side. A typical mezzanine investor, on the other hand, would be willing to take an additional risk, because they are looking for higher returns.

What could be the potential risk/reward profiles for investors who choose to invest in various debt structures?

The mezzanine space is providing higher yield potential for investors with a greater risk tolerance. With senior loans there are also historically less volatile solutions available for more conservative investors. We see insurance companies looking at this product as a replacement for traditional fixed-income allocations, while pension funds are looking at mezzanine as a substitute for real estate–equity investments.

What are the implications of today's low-interest-rate environment on real estate debt? What is the attractiveness of private real estate debt in such an environment?

The development of global monetary policy and slow economic growth indicates that bond yields are likely to remain lower for longer, as we see long-dated sovereign bonds across Europe yielding even negatively. This is the background for the relative attractiveness of private real estate debt, which provides an illiquidity premium compared with liquid bonds of similar credit risk and quality. It therefore makes an attractive case for substituting lower-yielding, fixed-income investments with private senior real estate debt. At the same time, a mezzanine strategy is an attractive alternative to investing into real estate equity.

Do any asset classes or lending strategies look particularly attractive?

We have been active across all asset classes, including office, logistics, residential, retail and hotel. We also like value-add and a certain level of development risk, as a function of the quality of the assets, the sponsor business plan and track record. This builds upon the real estate expertise we have within the wider platform, with the debt business integrated within the real estate–equity business. Building upon this strength and expertise, our value-add financing can be a good addition to both our senior and mezzanine strategies, with a mix of lending against core or cash-flowing assets and value-add assets. We have seen some good opportunities in residential financings in Spain, in student housing, which is, in part, a nice defensive play in the UK at the moment. We have seen some softening on the market for retail, particularly regarding noncore and less-dominant centres, but again, this can also create interesting opportunities at the right valuation and pricing levels. So some markets continue to be underserved as traditional lending pockets continue to be impacted by greater regulatory constraints on the banking side.

What types of funds and segregated accounts are you currently managing? What are your growth initiatives?

We are currently active in senior and mezzanine strategies for clients via segregated accounts and dedicated real estate funds. All combined, we have almost €2 billion of assets under management at the moment, with 44 percent in mezzanine strategies and 56 percent, senior strategies, and we are looking to expand on both. We are currently exploring other opportunities to expand upon our mezzanine strategy, and for senior strategies, our separate accounts offer a good solution for insurance companies, for example.

How is your approach to financing different from traditional bank financing?

Some banks tend to rely more on third-party valuations and are mainly driven by the relationship with a certain sponsor. For us, the first point is obviously the real estate. When we look at real estate, we look at the underlying collateral as if we were looking at it from an equity standpoint, and this gives us another perspective beyond purely a third-party evaluation exercise. We consider the price, the volatility and how the asset could perform in a downturn, as opposed to just what the market value is as of today. When we look at the sponsors, we look at their ability to perform the tasks required to maintain the value or increase the value of the real estate, and not just as an existing relationship.

How do you manage risk, particularly as you move down the capital structure?

This is a very important question for the mezzanine strategies. One of our underwriting standards when we do mezzanine is to only invest in a transaction where we like the underlying real estate — where we would also be an investor ourselves 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 the loan covenants, the legal framework of the mezzanine loan agreement, and come to an assessment whether this is an attractive risk-adjusted return at the debt level. We have access to the underwriting capabilities of our equity team, in combination with the input from our research team, so, in essence, we will not finance on the mezzanine side something we would not buy or would be unable to manage on the equity side at their proposed debt level. If we are capable and willing to invest in the equity side, then this is an implicit statement that we believe we can handle all the risk coming out of an unplanned equity position. We also only invest in markets where the overall DWS real estate debt and equity platforms have historically been investing and have a local network.

What else should investors know about the capabilities of your business? What differentiates DWS from other lenders?

The key for investors when selecting an asset manager is whether the debt manager knows the real estate and has the local teams of real estate professionals available to really assess and value the underlying collateral they are lending against. DWS is one of the largest global institutional asset managers with a long track record — almost 50 years investing in both real estate debt and equity, and as a debt asset manager with almost €2 billion of assets under management. We have a team of 10 debt investment professionals based in London, Frankfurt and Paris, integrated within the wider local offices of DWS on the real estate equity side. Finally, the experience and value created on the equity side of the business gives our real estate debt business additional support and additional advantage in how we assess our investment opportunities for our investors.

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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.