ARES

The Growing Investment Opportunity for Commercial Real Estate Debt

Introduction

The commercial real estate ("CRE") debt market today is experiencing a confluence of market dynamics that we believe have created attractive near-term investment opportunities. The market environment is characterized by a decreasing availability of debt financing, resetting property valuations, and rising interest rates, which we believe could collectively result in favorable risk-adjusted return opportunities.

In this thought piece, we explore how **directly originated CRE debt** in the U.S., U.K. and Europe present a compelling investment opportunity in the current environment, with a focus on the following drivers:

Increased base rates

which are expected to remain high for an extended period

Widening credit spreads

resulting from the retrenchment of traditional lenders

Increased equity subordination

due to lower loan-to-value ("LTV")[i] detachment points

A growing funding gap

driven by structural shifts in the banking industry.

With market volatility expected to persist for the foreseeable future, directly originated CRE debt with healthy equity subordination and floating-rate structures, can provide investors with lower volatility and steady returns primarily through high levels of current income.

Attractive Portfolio Attributes of Directly Originated CRE Debt[ii]

High current income

Shorter duration, floating-rate exposure

Diversification[iii]

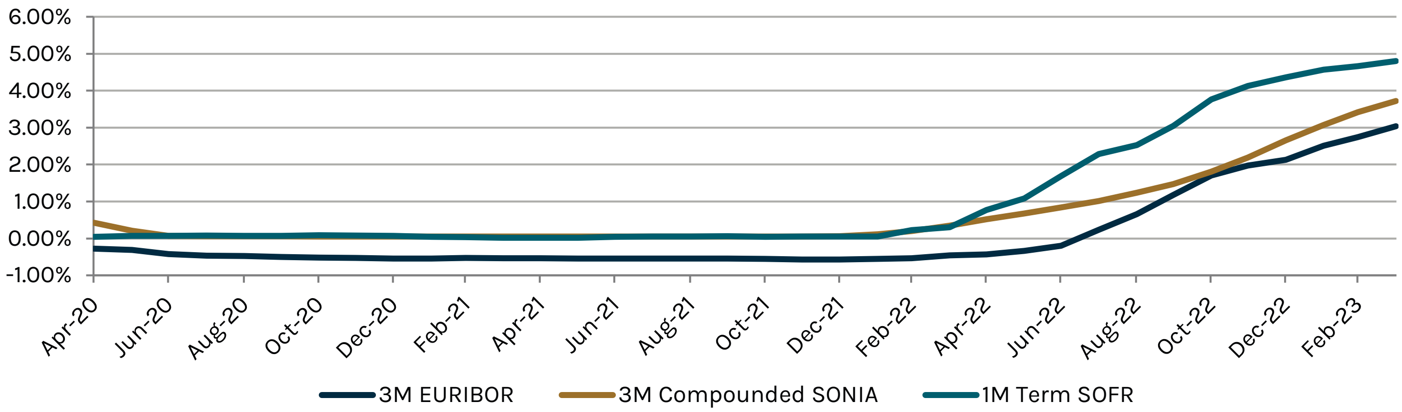
Complement or substitute to Investment Grade Fixed Income and Core Real Estate Equity

Higher for Longer Base Rates

To tame inflation, central banks have aggressively raised benchmark interest rates since March 2022. As a result, the 1-month term SOFR, which is the predominant index rate used to calculate the coupon on USD floating-rate loans in the U.S., increased from near zero in January 2022 to over 4.6% by March 31, 2023. GBP and EUR rates followed suit with increases of 4.1% and 2.7%, respectively, over the same period. This material increase in benchmark rates has benefited floating-rate CRE debt by increasing coupons, and consequently, absolute returns.

Understandably, increased coupons in excess of property cash flows reduce debt service coverage ratios ("DSCR"), which may impact the borrower's ability to pay interest. To mitigate this risk, a loan's structure generally includes interest rate protection, which is paid for by the borrower that effectively creates a minimum DSCR. We believe that this interest rate protection and enhanced principal protections, discussed below, allow lenders to benefit from rising rates while mitigating potential risk to property cash flows.

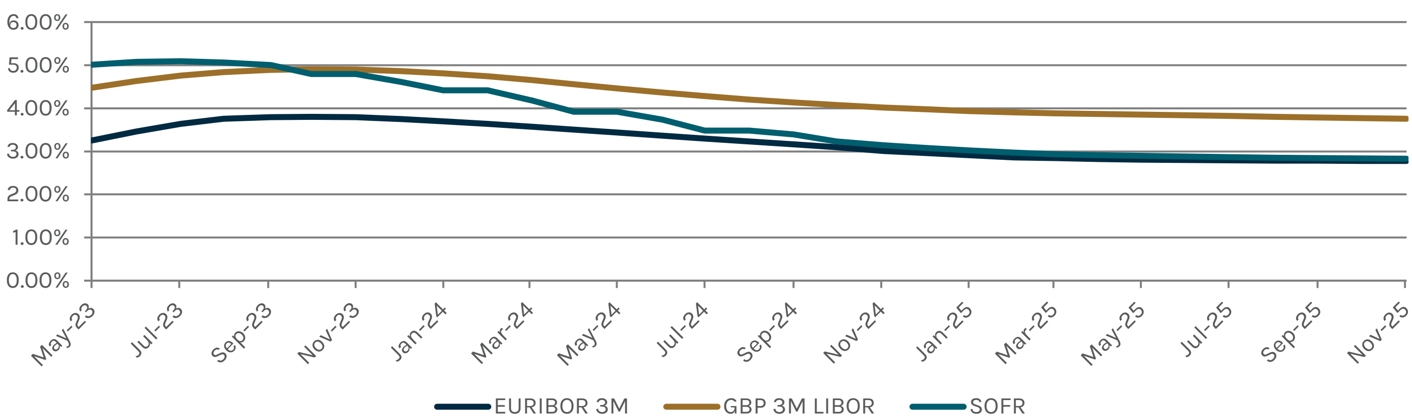
Historical Base Rate



Source: Validus-Horizon as of April 2023

Although it is understood that the direction of interest rates can change quickly and materially, looking ahead based on the forward curve[iv], base rates are forecasted to remain elevated in the near-term. As a result, forecasts indicate base rates will continue to provide a "tailwind" to commercial mortgage lending returns for the foreseeable future. Furthermore, with the ability to negotiate base rate "floors" that are set at or near the current base rate, lenders have the opportunity to structure CRE loans with effectively high minimum coupons. This would allow lenders to continue to benefit from the currently high base rate environment on new originations, even if base rates were to decrease.

Forward Base Rate Curves



Source: Validus-Horizon as of April 2023

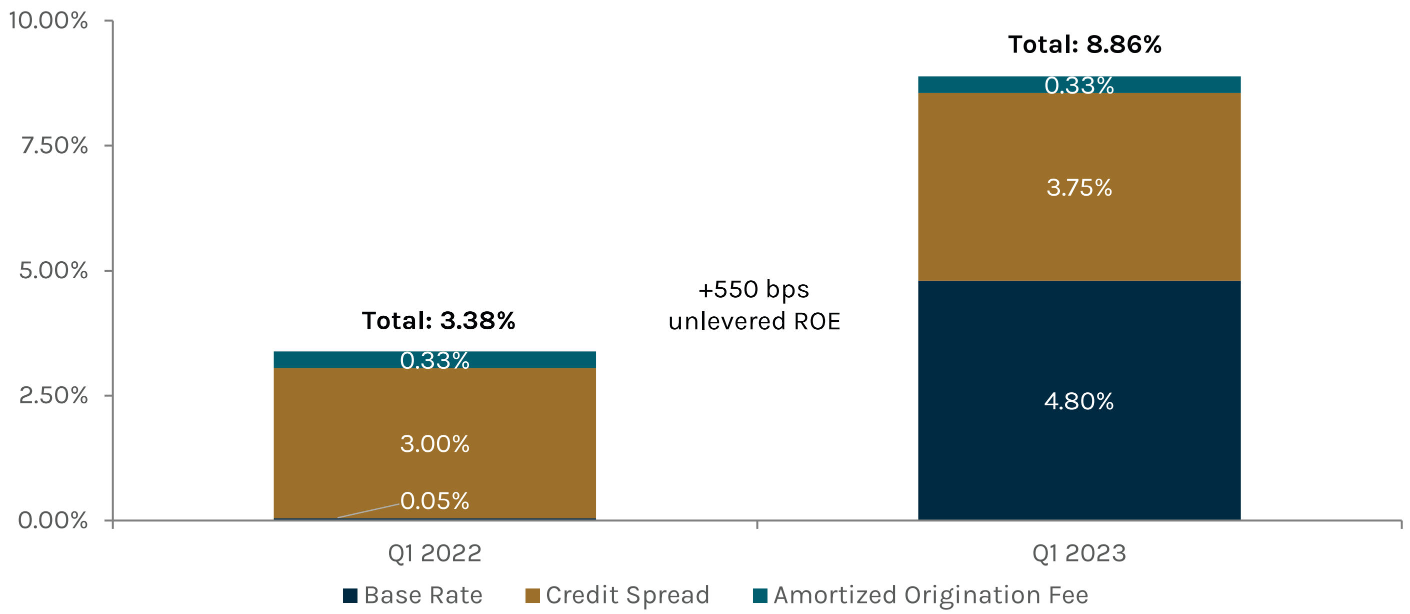
Widening Credit Spreads

In addition to increasing base rates, we have observed a widening in credit spreads as traditional lenders, such as banks, face pressure on their balance sheets. Stricter capital and liquidity requirements for banks, has created a funding gap in the market. This trend is likely to be further exacerbated by recent volatility in the banking sector, evidenced by the collapse of Silicon Valley Bank and Signature Bank in the U.S., as well as the emergency acquisition of Credit Suisse by UBS in Europe. To mitigate concerns around contagion, additional government regulations are anticipated, which will likely impose further strain on bank balance sheets. Given the dominant role the banking industry plays in the real estate finance market (particularly in Europe), any retrenchment of bank lenders is likely to lead to a decline in credit availability for CRE, which may result in an attractive investment environment for CRE lenders. We expect this dynamic to continue to unfold over the next 24-36 months.

Furthermore, given the short duration nature of CRE debt, we expect continued demand for financing as these loans reach maturity. In the U.S., it is estimated that ~$450 to $500 billion of CRE debt will mature annually from 2023 to 2026[v]. While in the U.K. and Europe, it is estimated that over €390 billion of real estate loans are due to mature in 2023 alone[vi]. This demand for financing, at a time of lower supply, is enabling CRE lenders to negotiate for higher credit spreads across all risk profiles when originating loans.

As reflected in the figure below, using light transitional first lien mortgage loans in the U.S. as an example, we have already seen credit spreads widen by 75 to 100 bps over the past year. When combined with the current 1-month term SOFR rate of 4.80%, the unlevered return on equity has increased by approximately 550 bps when compared to similar loans originated in 1Q 2022. Lenders in the U.K. and Europe are benefiting from similarly enhanced economics on new originations.

Enhanced Economics Resulting From Rising Rates and Widening Spreads



For illustrative purposes only. As of March 31, 2023. Based on Ares Real Estate's current market observations. As such, our views are subject to change at any time. January 2022 utilized 1-month LIBOR. Current Market utilizes 1-month term SOFR. Key assumptions include: 1.00% origination fee amortized over 3-year term.

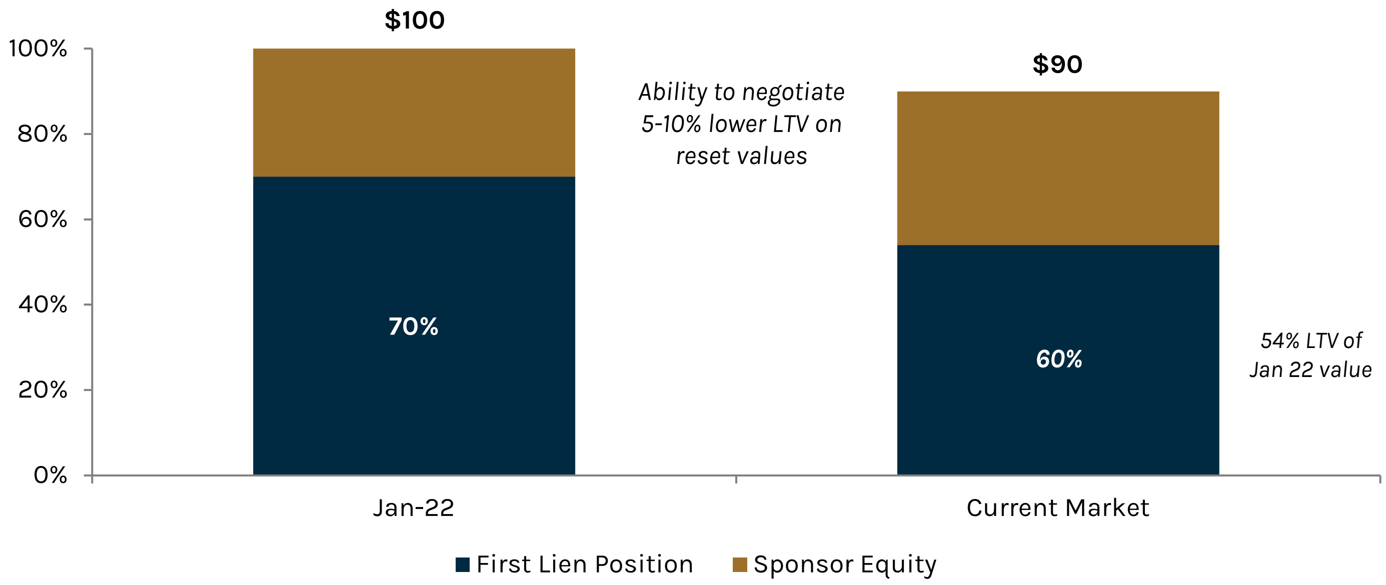
Enhanced Principal Protection[vii]

In addition to more attractive economics on newly originated loans today, CRE lenders can originate loans at a more secure position in the capital structure on higher quality collateral with values that are resetting to align with the current market.

Market value weighted capitalization rates ("Cap Rates") for the NCREIF Property Index, which represents 10,770 investment grade, income-producing properties with a market value of $933 billion, increased to 4.0% in 4Q 2022 compared to 3.8% in 3Q 2022. As a result of rising cap rates, we have started to see valuations of commercial property adjust downward, as reflected in the U.S. by a negative appreciation return of (4.5%) for the NCREIF Property Index in 4Q 2022. We expect this re-adjustment in valuation to continue throughout 2023.

As the funding gap grows amidst a retrenchment of traditional lenders, CRE lenders have an opportunity to negotiate better terms, which include offering lower proceeds such that their entry LTV is lower compared to similar loans originated in 1Q 2022. For collateral values that have not yet reset, the LTV ratio creates an equity buffer that can help mitigate potential downside risk. This is an important feature of CRE debt which allows it to deliver expected returns, even if capital values are falling. For example, at an LTV of 70%, a CRE debt position is unlikely to experience any losses until the underlying property loses 30% of its value. Today, lenders have the opportunity to originate loans at lower LTVs on collateral whose value has reset, resulting in an attractive detachment point compared to valuation in 1Q 2022. By providing stable capital returns and downside protection, CRE debt can generate attractive risk-adjusted returns during times of economic volatility, such as today.[viii]

Lower LTV Provides Additional Principal Protection



For illustrative purposes only. As of March 31, 2023. Based on Ares Real Estate's current market observations. As such, our views are subject to change at any time. January 2022 utilized 1-month LIBOR. Current Market utilizes 1-month term SOFR. Key assumptions include: 1.00% origination fee amortized over 3-year term.

Increasing Market Share for Non-Bank CRE Lenders

In addition to the near-term tailwinds mentioned above that favor CRE lenders, we observe longer term structural changes in the CRE lending market that serve to benefit non-bank CRE lenders in the U.S., the U.K. and especially Europe.

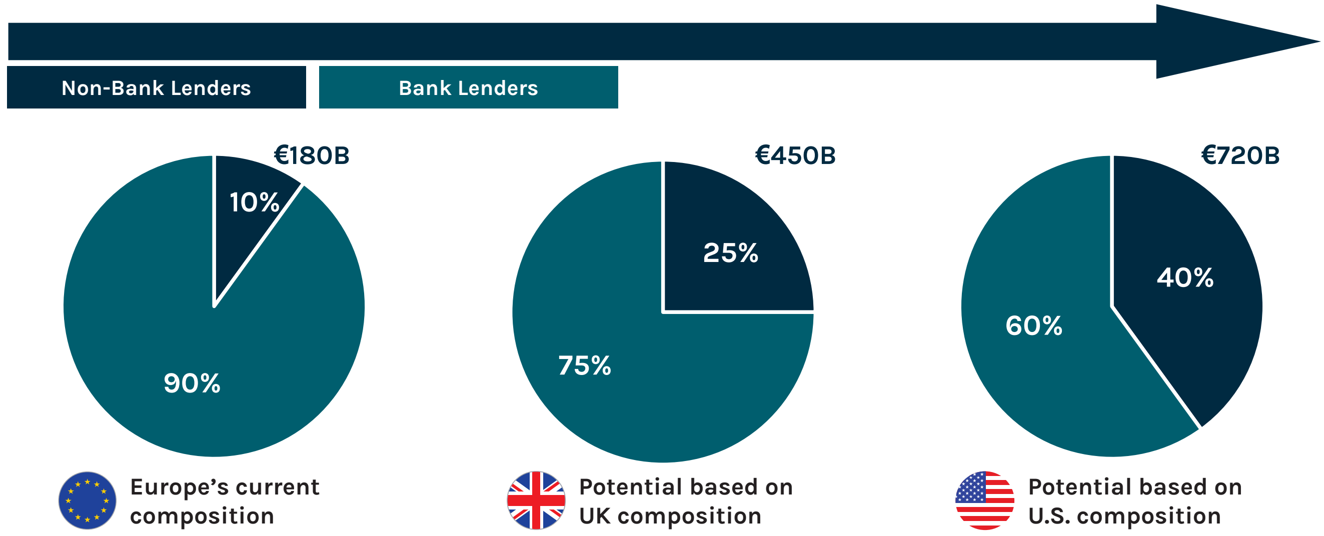
Since the Global Financial Crisis ("GFC"), increased banking regulation has resulted in the adoption of tighter underwriting standards which has led to bank retrenchment from new lending opportunities. This has driven demand for non-bank CRE lenders from institutional real estate borrowers. We expect this trend to continue in the medium term as traditional lenders continue to grapple with regulatory, capital and liquidity issues resulting from the GFC, COVID-19 pandemic, 2022 market volatility and recent bank failures.

Non-bank market share remains uneven between the key regions, which can be attributed to how different regulations affect the ability and risk appetite for traditional banks to participate in CRE lending. Non-bank CRE lenders currently account for 40% of the real estate debt market in the U.S., 25% in the U.K. and 10% in Europe. When compared to the U.S. and the U.K., Europe appears particularly behind the trend.

While the European real estate debt market remains dominated by banks, mounting regulatory pressures over the near-term could lead to a change. The difference between the U.K. and continental Europe bank participation rates is primarily driven by the prior implementation of the slotting regime in the U.K., which governs real estate lending by classifying loans into risk-based categories and determining capital requirements accordingly. In contrast, European banks have followed the internal ratings-based approach, which allows them to use internal models to calculate capital requirements. With the implementation of Basel III in 2023, which has very similar requirements to slotting, we expect the continental European market to trend towards U.K. levels over the next few years as banks have to increase the amount of capital they hold against their real estate positions. According to the European Banking Authority, the increase in minimum required capital could lead to a total capital shortfall of €125 billion. In response to that, banks are likely to reduce overall lending as well as further retrench from certain pockets of the markets as they seek to address this capital shortfall.

If non-bank CRE lenders in Europe could reach a similar penetration rate to that of the U.K., it would translate to approximately €270 billion of additional lending capacity available to non-bank CRE lenders.

Long-Term Opportunity for Alternative Lenders[ix]



Conclusion

In conclusion, CRE lenders should benefit from near term "tailwinds" provided by rising base rates and a combination of continuous demand for financing at a time when lower supply is expected. We believe that in the current environment, CRE lenders can negotiate higher credit spreads, lower LTV detachment points (and therefore higher equity subordination) and additional structuring terms that can further protect their principal position. However, given rapidly changing market dynamics, having access to large quantities of real-time property level data is important, as managers underwrite, structure and price loans. Additionally, we believe managers that can provide financing solutions to borrowers across the risk spectrum, property types and geographies, will benefit from a high degree of incumbency, which drives proprietary deal flow.

---

i Loan-to-Value is the ratio of a loan to the market value of the underlying property.

ii Ares Management. Core Commercial Real Estate Debt: An "All-Season" Strategic Investment Opportunity, October 2020.

iii Diversification does not assure profit or protect against market loss.

iv Chatham financial as of March 2023.

v Colliers Quick Hits | CRE Loan Maturities Present Opportunities; October 2022.

vi Bloomberg: Europe Is Bracing for a Sharp, Abrupt Real Estate Reversal; January 2023.

vii References to principal protection are not guarantees against loss of investment capital or value.

viii References to downside protection and risk-adjusted returns are not guarantees against loss of investment capital or value.

ix Based on UK and U.S. market compositions and estimate of €1.9 trillion European real estate debt market based on data from the sources listed below. Sources: Bloomberg, as of January 2023. Mortgage Bankers Association, Bayes Business School, IREBS, IEIF, PwC Strategy& Banque de France, AFME, PGIM Real Estate. As of September 2021.

ARES

Disclaimer

REF: RE-03412