

U.S. Private Commercial Real Estate Debt Opportunity

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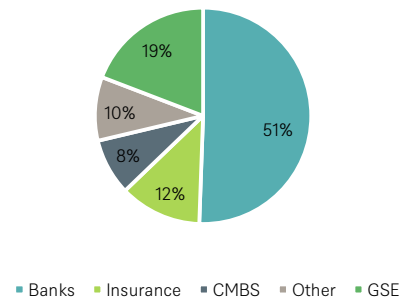
- U.S. private commercial real estate (CRE) debt is a large and growing asset class that we believe can add value to a multi-asset portfolio.
- The market has generated strong risk-adjusted total returns, driven by income, that display low correlations with equity investments. These attributes warrant a strategic allocation for many investors, in our view.
- From a tactical perspective, we believe that comparatively high yields and spreads, reduced cyclical risks, and an expanding opportunity set add to the market's attractiveness.

U.S. CRE Debt Market

The stock of outstanding U.S. CRE debt (including multifamily loans) totaled \$5.9 trillion in the second quarter of 2024 (a little more than half the size of the \$11 trillion corporate bond market), having increased 81% (6.1% annually) over the past decade.¹ Banks account for about half of the outstanding debt, with the balance spread across Government Sponsored Enterprises (GSE) like Fannie Mae and Freddie Mac, insurance companies, commercial mortgage-backed securities (CMBS), and others (see Exhibit 1).² Banks' share of the mortgage market has been stable since the 1970s, while the shares of other segments have fluctuated – notably with the rise and fall of the CMBS market before and after the Global Financial Crisis (GFC).³ line 13pts spacing. Body Private CRE debt occupies a unique space within the investment

landscape, with characteristics derived from each of its principal components:

Exhibit 1: U.S. CRE Debt Market (\$5.9 Trillion)



Source: Federal Reserve. As of June 2024.

¹ Federal Reserve (CRE debt); SIFMA (corporate bonds). As of June 2024.

² Federal Reserve. As of June 2024.

³ Federal Reserve. As of June 2024.

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- **Private:** Because it is not listed on an exchange, private CRE debt is more difficult to source and trade, a feature that has historically been rewarded with an illiquidity premium.
- **CRE:** Credit risks generally stem from CRE cash flows and collateral, rather than corporate or consumer finances.
- **Debt:** Over time, total returns are driven more by income than capital gains and are more sensitive to yields than earnings.

Private CRE lending is diverse, spanning core (e.g., backed by stable properties at low loan-to-value (LTV) ratios to opportunistic (e.g., high-LTV speculative construction), offered at floating or fixed interest rates. Various permutations can produce different risk and return profiles. In this paper, we will focus primarily on core, fixed-rate debt, with further discussion around other investment strategies to follow in future publications.

Strategic Considerations

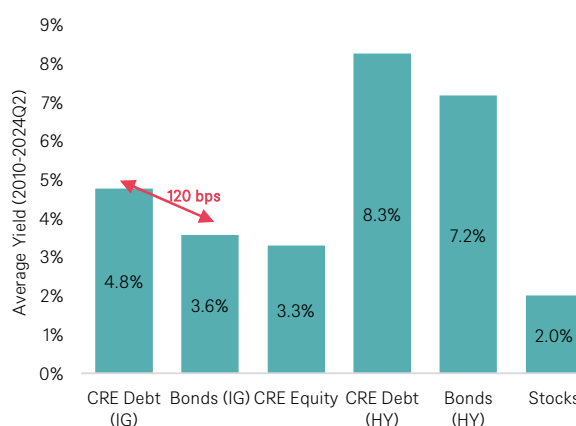
Private CRE debt has historically delivered notable portfolio benefits, namely income, competitive risk-adjusted returns, and diversification. In our view, these benefits justify a strategic allocation to the asset class, irrespective of cyclical considerations.

Income Returns: As a credit instrument, private CRE debt has perhaps unsurprisingly delivered stronger income returns than equity investments that offer the potential for earnings-driven capital gains – including stocks and private CRE – since 2010 (see Exhibit 2).⁴ More interesting is that its yields have compared favorably with those of corporate bonds, providing a premium of 120 bps for investment-grade assets. To be sure, the risks associated with CRE debt are different from those of corporate credit. However, we believe that much of the differential represents compensation for the relative complexity and illiquidity of private assets.

Risk-Adjusted Returns: Private CRE debt has generally delivered lower total returns than equity investments, but it has done so with less volatility (see Exhibit 3).⁵ Moreover, it has generally achieved higher returns, with lower volatility, than corporate bonds.⁶ Unlike equity, it is relatively insulated from the vagaries of earnings expectations (e.g., profit or rent).

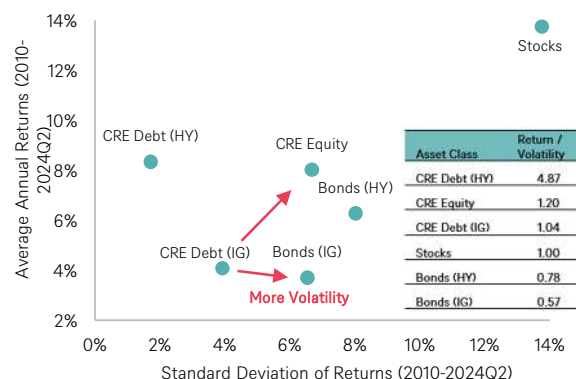
And as a private asset, we believe that it earns an illiquidity premium, supporting returns. The result: private CRE debt returns have scored well relative to other asset classes on a volatility-adjusted basis.

Exhibit 2: Income Return by Asset Class (2010 – 2024Q2)⁷



Sources: Giliberto-Levy Commercial Mortgage Performance Index (CRE debt); NCREIF Property Index (CRE Equity); ICE Corporate Bond Index (bonds); S&P 500 Total Return Index (stocks); DWS calculations. As of June 2024.

Exhibit 3: Asset Class Returns and Volatility (2010-2024Q2)



Sources: Giliberto-Levy Commercial Mortgage Performance Index (CRE debt); NCREIF Property Index (CRE Equity); ICE Corporate Bond Index (bonds); S&P 500 Total Return Index (stocks); DWS calculations. As of June 2024.

Return volatility aside, risks also appear modest from an underlying credit perspective. Over the past 30 years, credit losses have averaged 30 basis points annually within the Commercial Mortgage Performance Index, a fraction of its

⁴ For now, we assume debt is held to maturity, and ignore mark-to-market value shifts on fixed-rate debt.

⁵ Volatility accounts for mark-to-market value changes on fixed-rate debt.

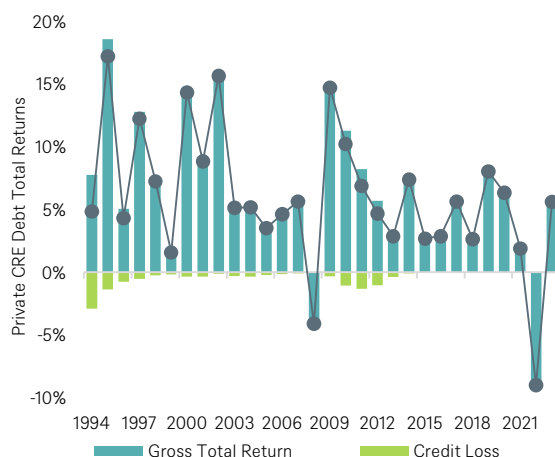
⁶ Giliberto-Levy Commercial Mortgage Performance Index (CRE debt); ICE Corporate Bond Index (bonds); S&P 500 Total Return Index (stocks); DWS calculations. As of June 2024.

⁷ The earliest data available for high-yield CRE debt is 2010.

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6.3% annualized (gross) return (see Exhibit 4). Banks' net charge-offs on CRE loans have averaged 20 basis points annually over the same period.⁸ Insurance companies, which have typically focused on lower-risk lending, have recorded much lower delinquency rates (averaging 0.4% annually) than banks (2.4%), suggesting, in our view, that credit losses on core loans have also been lower.⁹

Exhibit 4: Private CRE Debt Total Returns and Credit Loss



Source: Gilberto-Levy Commercial Mortgage Performance Index. As of June 2024.

Diversification: Like other fixed income assets, private real estate debt is more sensitive to interest rates than earnings, which creates diversification relative to listed and non-listed equity (see Exhibit 5). Yet unlike other debt, its credit risk is derived from CRE cash flows and collateral, rather than corporate or consumer finances. Coupled with its modest standalone volatility, this implies that private CRE debt may help to reduce overall risk within multi-asset portfolios.

Tactical Considerations

Income, favorable risk-adjusted returns, and diversification are features that justify a strategic allocation to private CRE debt, in our view. Yet we believe that there are also reasons to consider the asset class from a tactical perspective. These include potentially attractive yields and spreads; reduced cyclical risks; and an expanding opportunity set.

Yields and Spreads: Over the past 30 years, yields on private CRE debt have tracked those on long-term A-rated corporate

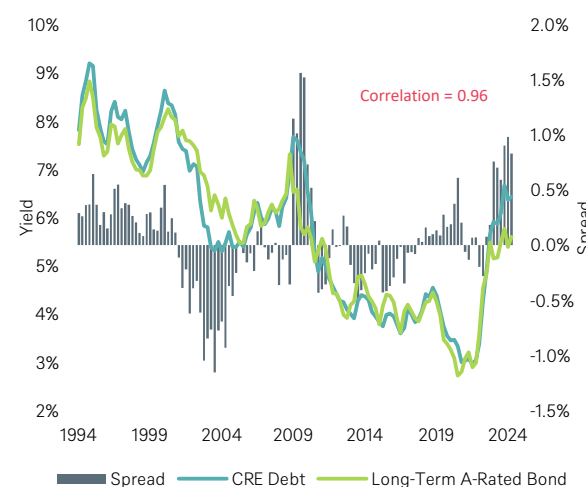
bonds (see Exhibit 6). In the wake of the Federal Reserve's 2022-23 tightening campaign, yields on both instruments rose to their highest levels since 2010. However, private CRE lending rates increased further, opening a spread only exceeded during the GFC. In our view, elevated yields and spreads buttress the absolute and relative case for private CRE credit as a source of income and total return.

Exhibit 5: Asset Class Correlations (2010-2024Q2)

	CRE Debt (IG)	CRE Debt (HY)	Stocks	CRE Equity	Bonds (IG)	Bonds (HY)
CRE Debt (IG)	1.00					
CRE Debt (HY)	0.05	1.00				
Stocks	0.39	0.00	1.00			
CRE Equity	-0.03	0.20	-0.23	1.00		
Bonds (IG)	0.91	-0.06	0.46	-0.20	1.00	
Bonds (HY)	0.54	0.05	0.82	-0.24	0.67	1.00

Sources: Gilberto-Levy (CRE Debt); ICE (bonds); NCREIF (CRE Equity); Standard & Poor's (stocks). As of June 2024.

In Exhibit 6: CRE Debt and A-rated Bond Yields



Sources: ACLI (CRE Debt); Moody's (A-rated Bonds); DWS (calculations). As of June 2024.

⁸ FDIC. As of June 2024.

⁹ ACLI (insurance); FDIC (banks). As of June 2024.

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Reduced Cyclical Risks: A post-COVID CRE correction has reduced values by 18% and construction starts by 68% (sector-weighted) from their mid-2022 peaks.¹⁰ In our view, stabilizing interest rates, coupled with reduced supply, have laid the foundation for a new real estate cycle, characterized by healthy fundamentals and moderate appreciation. Rising cash flows and values improve borrowers' capacity to service and repay debts, reducing default risks.

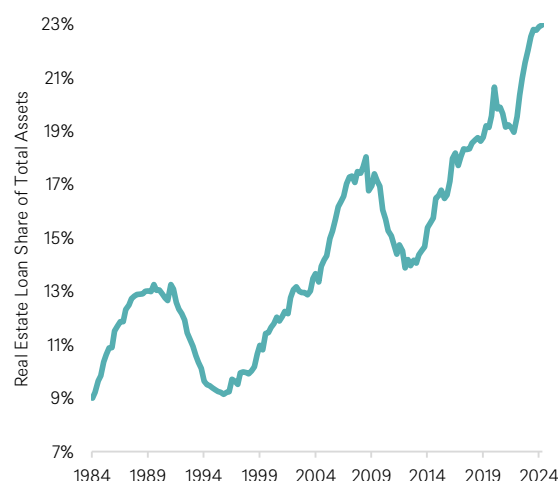
Expanding Opportunity Set: We believe that loan maturities and reviving property sales, amid a pullback from banks, will create lending opportunities over the next several years. Just under half of the \$5.9 trillion of outstanding mortgage debt is scheduled to mature through 2028.¹¹ In some cases, debt may be written off, extended, or replaced with equity, but much of it will require refinancing. Moreover, although property sales volumes were muted through the first half of 2024, we believe that they will pick up as real estate values recover, stimulating demand for new financing.¹²

This wall of demand may arrive at a time when banks (which hold 51% of outstanding mortgage debt) are under investor and regulatory pressure to curb their real estate exposure.¹³ In particular, small and medium-sized institutions (accounting for about 42% of the banking system but 74% of its CRE lending) hold record levels of CRE loans on their balance sheets (see Exhibit 7).¹⁴ We believe that any effort to pare this exposure could create considerable origination and acquisition opportunities for other lenders, on more favorable terms (including yield and credit protections).

Conclusion

From a long-term perspective, private CRE debt has exhibited qualities – income, risk-adjusted returns, and diversification potential – that may, for many investors, justify a strategic portfolio allocation. Moreover, current conditions reinforce the case for investing in the asset class, in our view. Yields are elevated, both on an absolute (compared with history) and a relative (compared with other debt instruments) basis.¹⁵ The prospect of healthy fundamentals and recovering asset values mitigate the credit risks that have already been relatively limited for core loans over the long-term.¹⁶ Finally, we believe that debt maturities and a rising pace of transactions, coupled with a pullback from banks, will create abundant opportunities to acquire and originate loans on terms that are favorable for investors.

Exhibit 7: CRE Loan Share of Total Assets, Small and Medium-Sized Banks



Sources: FDIC; DWS calculations. As of June 2024.

¹⁰ NCREIF ODCE Index (values); CoStar (construction starts); DWS calculations. As of June 2024.

¹¹ Federal Reserve (outstanding mortgage debt); Mortgage Bankers Association (maturities). As of June 2024.

¹² MSCI (transactions); Mortgage Bankers Association (originations). As of June 2024.

¹³ Federal Reserve. As of June 2024.

¹⁴ Small and medium-sized banks are defined as those with less than \$250 billion of total assets.

¹⁵ ACLI (CRE lending rates); Moody's (A-rated corporate bonds). As of June 2024.

¹⁶ ACLI (delinquencies); FDIC (bank net charge-offs); Gliberto-Levy Commercial Mortgage Performance Index (credit loss); DWS (CRE recovery). As of June 2024.

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Counterparty risk – A financial institution or other counterparty that underwrites, distributes, or guarantees any private credit investments or contracts that the strategy owns or is otherwise exposed to, may decline in financial health, and become unable to honor its commitments. This could cause losses or could delay the return or delivery of collateral or other assets.

Prepayment and extension risk – When interest rates fall, issuers of high interest debt obligations may pay off the debts earlier than expected (prepayment risk), and the strategy may have to reinvest the proceeds at lower yields. When interest rates rise, issuers of lower interest debt obligations may pay off the debts later than expected (extension risk), thus keeping the strategy’s assets tied up in lower interest debt obligations. Ultimately, any unexpected behavior in interest rates could increase the volatility of the strategy’s yield and could hurt performance. Prepayments could also create capital gains tax liability in some instances.

Debt securities risk – Debt securities are subject to the risk of the issuers or a guarantor’s inability to meet principal and interest payments on its obligations and to price volatility.

Default risk – The issuers or guarantors of debt securities may fail to make payments or fulfil other contractual obligations.

Secured debt risk – Although secured debt generally will be secured by specific collateral, there can be no assurance that liquidation of such collateral would satisfy the borrower’s obligation in the event of non-payment of scheduled interest or principal or that such collateral could be readily liquidated.

Second lien and subordinated loans risk – Second lien loans generally are subject to similar risks as those associated with investments in senior loans, and, because they are subordinated or unsecured and lower in priority of payment to senior loans, they are subject to additional risks, including the risk that the borrower may be unable to meet scheduled payments, price volatility, illiquidity, and the inability of the originators to sell participations in such loans.

Private investment risk – Private investments are highly competitive, less transparent, and illiquid.

PIK interest risk – Loans with a payment in kind (“PIK”) interest component generally represent a significantly higher credit risk than coupon loans; may have unreliable valuations requiring continuing judgments about collectability and the value of any associated collateral; and the borrower could still default when the actual payment is due at maturity.

Direct Lending risk – The lender in privately offered debt is responsible for the expense of servicing that debt, including, taking legal actions to foreclose on any security instrument securing the debt. This may increase the risk and expense compared to syndicated or publicly offered debt.

Interest rate risk – In general, rising interest rates in the market will negatively affect the price of the direct lending investments. Sensitivity to a change in interest rates is more pronounced and less predictable in instruments with uncertain payment (or prepayment) schedules. Central bank monetary policy, rising inflation rates, and general economic conditions may cause interest rates to rise.

Illiquid portfolio investments risk – Private credit investments generally will be long-term and highly illiquid.

Valuation risk – There is no central place or exchange for private credit investments to trade. Uncertainties in financial market conditions, unreliable reference data, lack of transparency and inconsistency of valuation models and processes may lead to inaccurate pricing and other market participants may value direct lending investments differently.

High yield debt risk – High yield debt securities have historically experienced greater default rates than investment grade securities and are subject to additional liquidity and volatility risk.

Reinvestment risk – During periods of declining interest rates, an issuer of debt obligations may exercise an option to redeem prior to maturity, which could result in new investments with lower-yields.

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