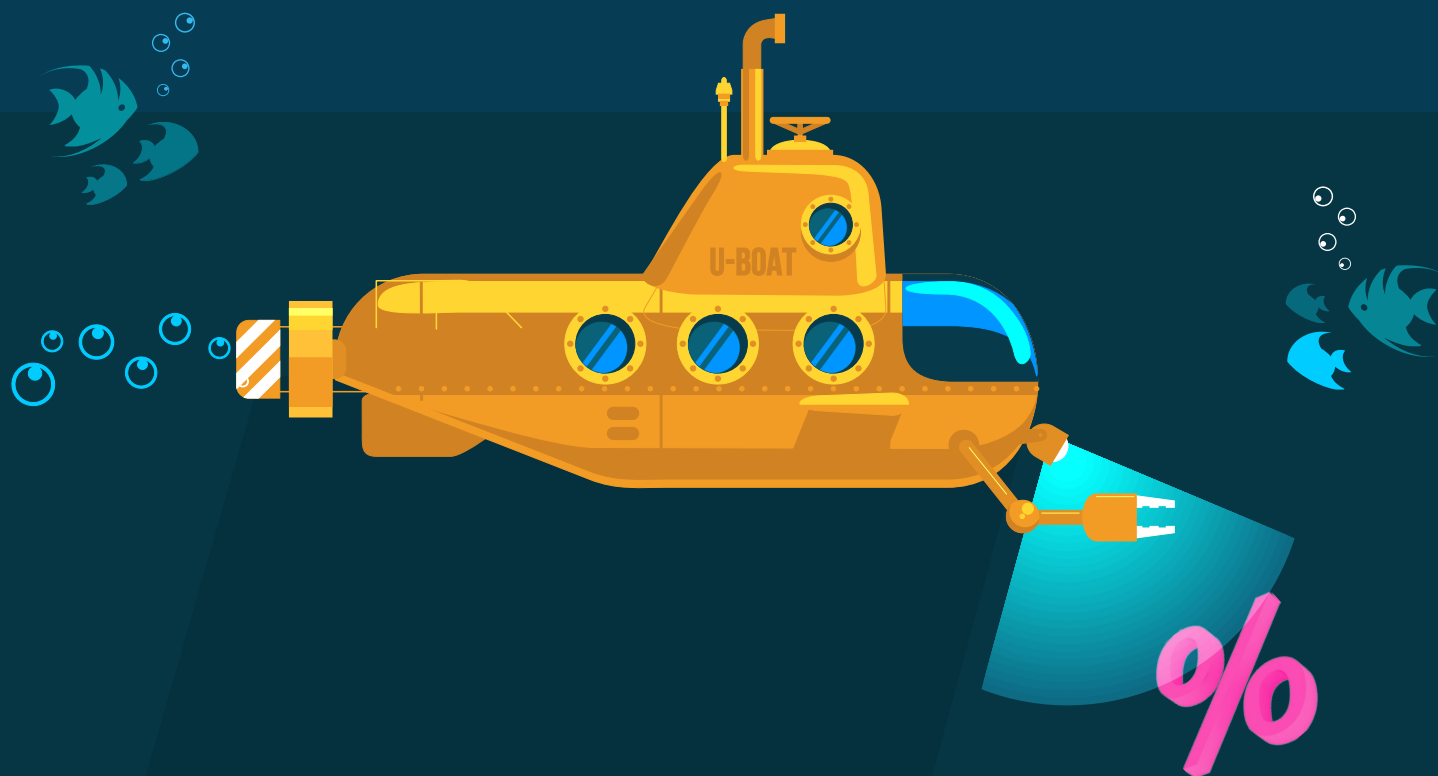




How **low** can we go?



INTERVIEW

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Thought Leadership for the Insurance Investment Community

Exploring The Various Uses of Private Real Estate Debt in an Insurance Portfolio

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DWS

The real estate debt asset class can provide debt investment options that may outperform traditional benchmarks while potentially offering attractive returns, downside protection, diversification benefits, and lower volatility.

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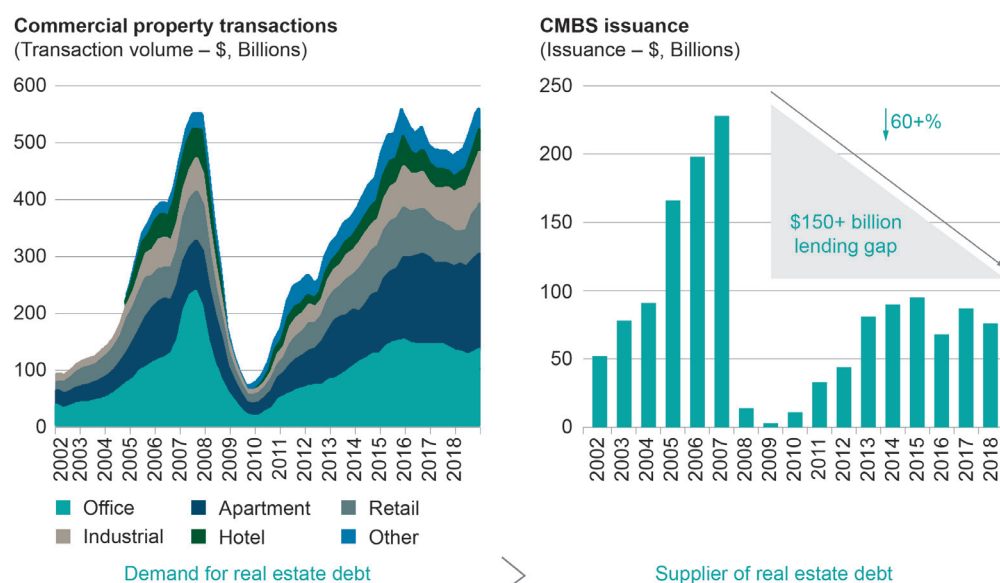
Executive Summary

- While the commercial real estate market cycle might be in its later stages, the fundamentals remain strong. Underwriting standards remain disciplined, delinquencies remain low, the economy is generally strong, and there is limited new supply with limited pockets of overbuilding. DWS believes this part of the cycle has further to run; it is prudent to adopt a more defensive posture in investment choices.
- Financial regulations implemented after the 2008 financial crisis caused banks to limit their investments in commercial mortgage-backed securities (CMBS) and commercial real estate (CRE) lending, giving other types of investors, such as insurance companies, an opportunity to increase their activity.
- The \$4 trillion CRE debt market is projected to see approximately \$1 trillion of debt maturities over the next several years and much of this will need to be refinanced. The pullback by traditional lenders, like banks, equates to significant demand from borrowers, and a continued opportunity for alternate investors, such as insurance companies, to increase their lending activity.
- The share of private real estate lending from alternate investors is now about 9% of the total, up over 57% since 2013, as non-bank lenders have come to understand the potential advantages of this asset class and become more active. Among the potential advantages of CRE debt are stable current income, low volatility, limited downside risk via the equity cushion, low correlation to most other traditional asset classes, structural flexibility, and potential downside protection/principal preservation as well as the possibility of higher recoveries in the event of a default.
- It is currently possible to execute strategies that generate an estimated 6% to 9% net investment return, depending on the investor's risk/reward appetite and preferred position in the capital stack.

THE EVOLVING MARKET

The debt secured by commercial real estate has been dominated historically by traditional lenders such as banks and institutional investors. However, banks have been forced to cut back on their leverage and boost their regulatory capital to comply with the regulatory reforms implemented in the wake of the financial crisis. Their demand for CMBS and CRE lending fell at a time of rising investment in the commercial real estate sector, causing a funding gap. (See Figure One.)

FIGURE 1: Transactions Volumes Versus CMBS Issuance



Source: Real Capital Analytics, Commercial Real Estate | Finance Council, and DWS, year-end 2018



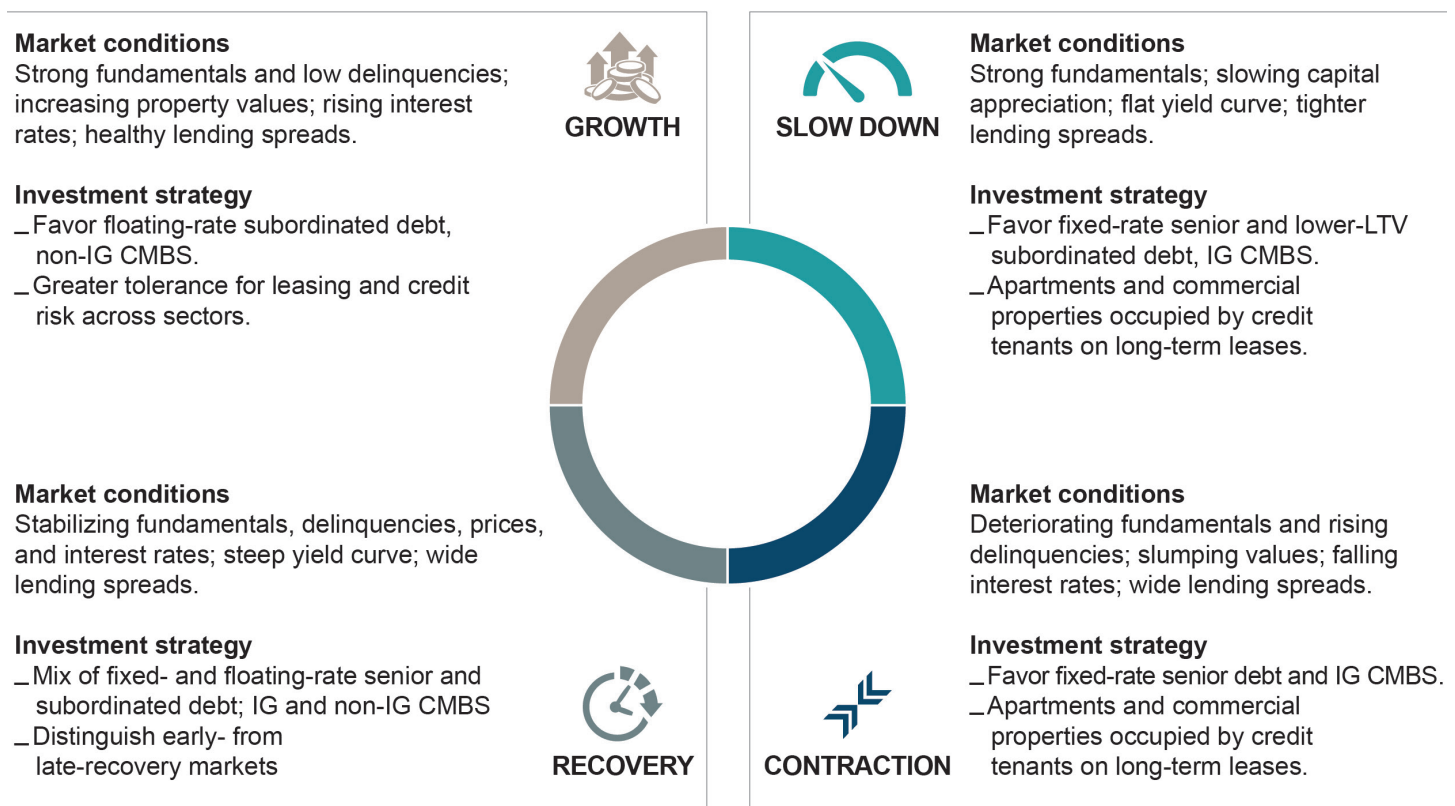
Since the financial crisis, annual CMBS issuance has remained less than half of 2006 and 2007. The current size of the commercial real estate debt market is about \$4 trillion, with around \$1 trillion of this maturing over the next several years, requiring refinancing or recapitalization (estimates from Board of Governors of Federal Reserve and Moody's Analytics, as of year-end 2018).

The potential mismatch of supply and demand for debt as these maturities approach should allow nontraditional private debt lenders, like insurance companies and others, to increase their debt activity and seek attractive returns.

Firms with developed real estate platforms can therefore help craft specific strategies that meet the needs of these investors with loans to institutional-quality borrowers and properties.

As noted earlier, the share of commercial real estate debt from alternative lenders is now about 9%, which is up over 57% from 2013. The trade publication Commercial Mortgage Alert estimated in early June that there were nearly 160 firms and funds providing subordinate debt, private debt, preferred equity and other types of commercial real estate financing. However, despite their interest in CRE assets, many of these are not consistent market participants. They may be active when conditions are favorable, but withdraw when the environment becomes more challenging. Consistent success requires a firm that is active in commercial real estate debt in all phases of the cycle, with deep relationships and a good reputation in the market with borrowers, co lenders, brokers, banks and other participants. This allows certainty of execution and a consistent discipline in underwriting through all market cycles.

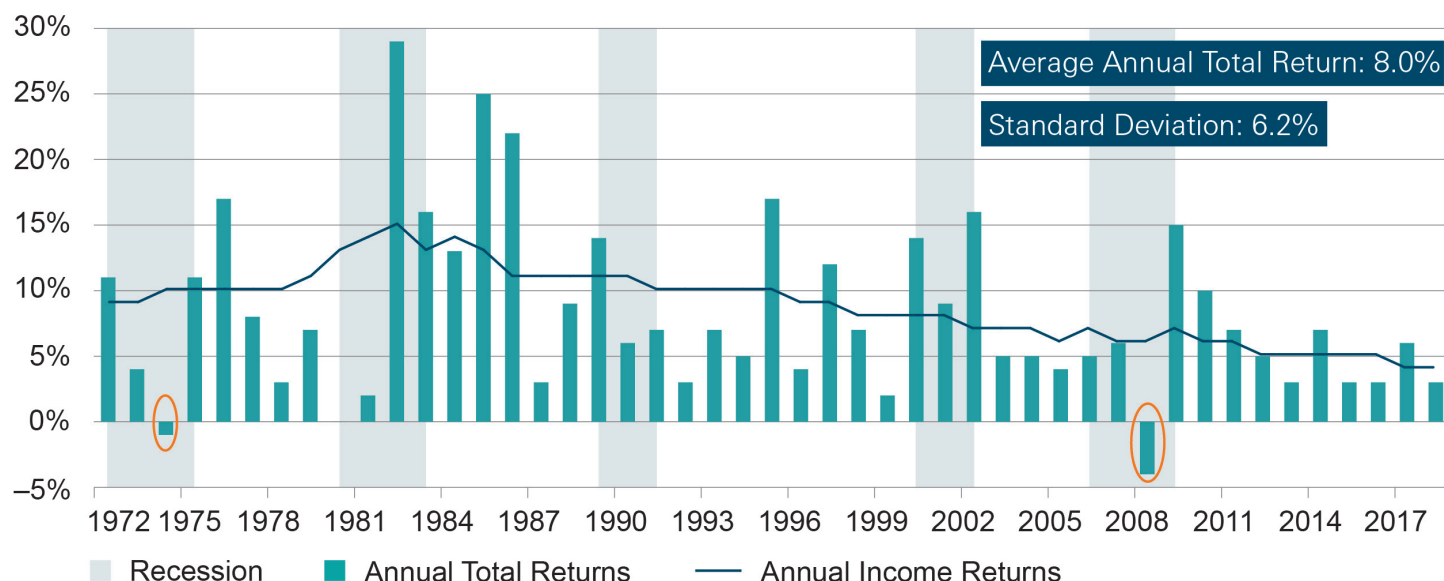
FIGURE 2: Stages of the Commercial Real Estate Economic Cycle



Note: "IG" refers to "Investment Grade"; LTV" refers to "loan-to-value". Source: DWS, Year-end 2018

THE CURRENT CYCLE

The commercial real estate debt market is currently in the classic late stage of its cycle, described in the upper right quadrant of Figure Two, but with some unique attributes. As shown below and described earlier, there are various opportunities within each stage of a cycle.

FIGURE 3: Long-Term Stable Income**Giliberto-Levy Commercial mortgage performance index annual return (1972–2018)**

Source: The Giliberto-Levy Commercial Mortgage Performance Index ("G-L Index" or "GLCMPI") measures the investment performance of select private-market investments in commercial real estate debt. Specifically, the Index tracks fixed-rate, fixed-term senior loans that are made by and held in the investment portfolios ("on balance sheet") of institutional lenders such as life insurance companies and pension funds. Past performance is not an indicator of future results. As of December 2018.

From a credit perspective, delinquencies continue to be low. We have not seen excessive loan-to-value creep or undisciplined underwriting standards, which is a very positive sign at this point in the cycle. We believe the cycle still has more time to run. Nonetheless, it has already been a very long cycle and DWS is taking a more defensive late-cycle approach in its commercial real estate lending. Even so, we believe there are still valuable opportunities. In fact, since 1974 there have only been two years, 1974 and 2008, where returns were negative. (See Figure Three.) That illustrates the long term stability of the asset class.

INVESTMENT VEHICLES

Investors often tend to think of the senior mortgage market when considering real estate debt. While that is the largest part of the market, and mostly dominated by banks and CMBS, the growing activity

of non-bank investors has created more access points to get exposure in ways that might offer better returns.

Generally speaking, the real estate debt space consists of any fixed income or credit structure that is ultimately backed by real property. For example, if you owned a mid rise multi family property worth \$100, someone might be willing to make you a senior loan on that property of up to \$60 in order to earn a reasonably low return that nonetheless represents a slight premium to corporate bonds (as of the end of June 2019). Alternatively, if a lender understood the risk of that property, market and sponsor really well, and wanted to achieve a higher return, it could make a mezzanine subordinate to the \$60 senior mortgage, which would receive a higher return for the incremental increase in exposure.

These subordinate positions require the same, and often even more, detailed analysis of the creditworthiness of the senior loan. The objective is to find the optimal structure and returns that make sense for investors with varying risk appetites.

REAL ESTATE DEBT ATTRIBUTES

Well-structured and underwritten commercial real estate deals offer a number of qualities. These include:

- Potentially attractive risk-adjusted returns versus other asset classes throughout the cycle*
- Historically stable income*
- Low historical volatility*
- Historically higher recoveries in the event of default*
- Portfolio diversification: low correlation to traditional asset classes*
- Flexibility in targeting short-, medium- or long-duration assets and loan structures



- Principal preservation: possible downside protection through the equity cushion
- Loans secured by well-located, high-quality properties
- Large market opportunity: \$4 trillion market with around one-quarter of that due for refinancing in coming years (estimates from Board of Governors of Federal Reserve and Moody's Analytics, as of year-end 2018).

One of the key advantages is stable and current, predictable income. The vast majority of these investments are structured with current pay of contractual income. For investors that are matching liabilities, such as insurance companies and certain others, this is obviously important. Or, if you think that the appreciation in your core equity portfolio is going to be weaker as the cycle extends, shifting to higher income strategies such as CRE debt is an option.

Another benefit of the sector is principal preservation. These investments are collateralized by real assets that carry significant cushion to the lender's exposure. In the earlier example, if you have a \$60 loan in a property that's worth \$100, you stand to achieve the returns you originally expected, unless the value deteriorates by 40% or more. If the loan is supplemented by a 15% mezzanine loan, the total loan basis would be 75%; still exhibiting a 25% cushion in the form of the first loss position of borrower's equity. Should the market experience a downturn at some point, the investor has insulation and the values can deteriorate somewhat before the investment is impaired. That is an advantage the owner of the property does not have, and a significant benefit to a real estate debt allocation.

A third noteworthy attribute is the ability of different investors to meet

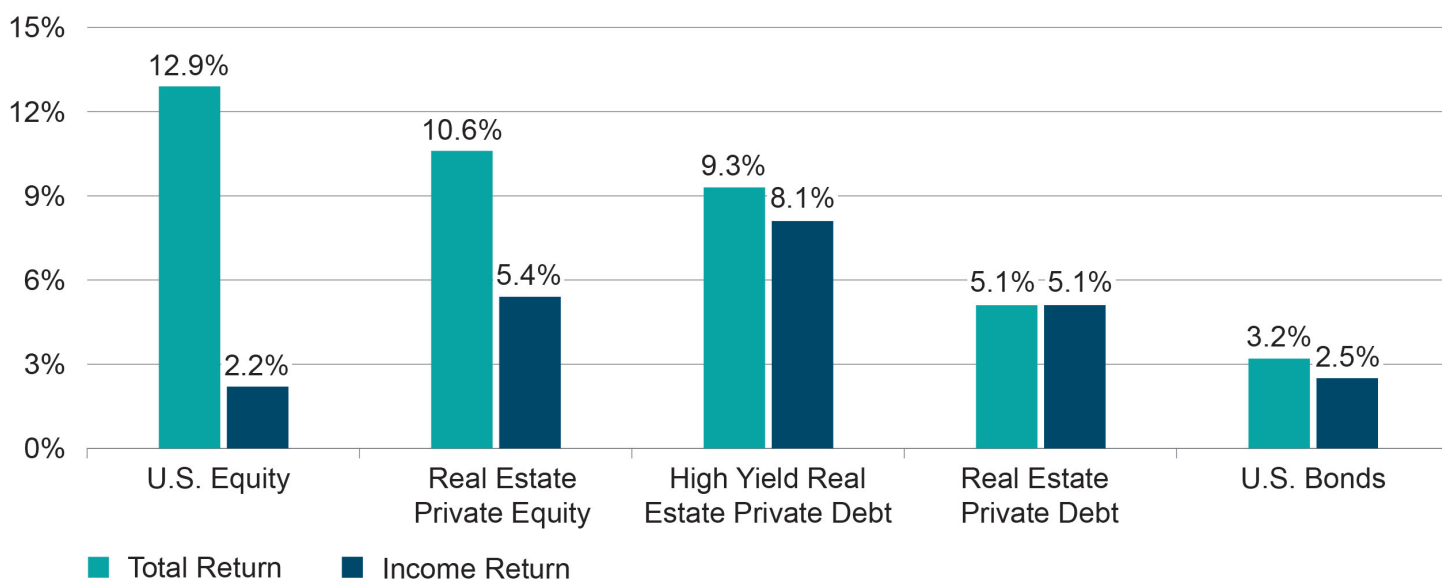
their specific risk appetites and sensitivities to duration. While one investor might want a real estate debt strategy that targets, for instance, a long term fixed rate investment grade portfolio that meets its risk appetite and balance sheet needs, another might seek a shorter term floating rate strategy with slightly higher spreads that matches its particular liabilities. A third investor shifting out of a strategy in core equity might be less sensitive to duration but still wants to outperform the NCREIF Property Index.

CURRENT RETURNS

Figure Four represents the composition of returns for various asset classes. Looking at the two primary real estate debt areas, high yield has posted post recession returns of 9.3% represented by the Giliberto-Levy High Yield Real Estate Debt Index, of which almost 90% are comprised of income, while higher-grade mortgage debt is in the 5% range

FIGURE 4: Private CRE Debt vs. Other Assets

Average annual returns: Total return vs. income return (2010 through 2018)



Sources: NCREIF Property Index (Real Estate Private Equity); Giliberto-Levy High Yield Real Estate Debt Index (High Yield Real Estate Private Debt); Giliberto-Levy Commercial Mortgage Performance Index (Real Estate Private Debt); Bloomberg/Barclays U.S. Aggregate Bond Total Return Index (U.S. Bonds); S&P 500 Total Return Index (U.S. Equity). Past performance is not an indicator of future results. As of December 2018.



as represented by the Giliberto-Levy Commercial Mortgage Performance Index. Compare that to the NCREIF Property Index, which is the column to the left. The returns are about 130 basis points higher but the income component is only about half, so it enjoys less of the benefit of having a strong income aspect. The forecast for NCREIF is in the low fives for the next five years (total return), so while the performance has been excellent since the great recession, on a forward looking basis, those returns are expected to moderate.

Turning to the groups on the right of Figure Four, both high yield and the mortgage index have significantly outperformed the broader bond index (Bloomberg/Barclays U.S. Aggregate Bond Index). As a complement to fixed income portfolios, history suggests that CRE debt can provide outperformance.

RETURN RANGES

As you can see from the chart in Figure Five, senior fixed-rate mortgage loans of up to approximately 60% LTV have rates between 4% and 5%. Senior “stretch” loans, or whole loans, increase the LTV somewhat, providing rates above this level by 50 to 75 basis points. Lower risk subordinate debt, such as mezzanine loans and B Notes up to 60% LTV have rates in the 5% to 6% range. A moderate risk subordinate loan of 60% to 75% LTV increases the rate to approximately 6% to 8%, and higher risk subordinate debt (greater than 75% LTV) can have rates from 7.5% to the mid-teens depending on structure and property. It is important to note that in each of these loan types, the lender still benefits from the first loss equity position of the sponsor/borrower, providing protection and principal preservation benefits to the lender. Figure Five shows the return ranges for various benchmarks.

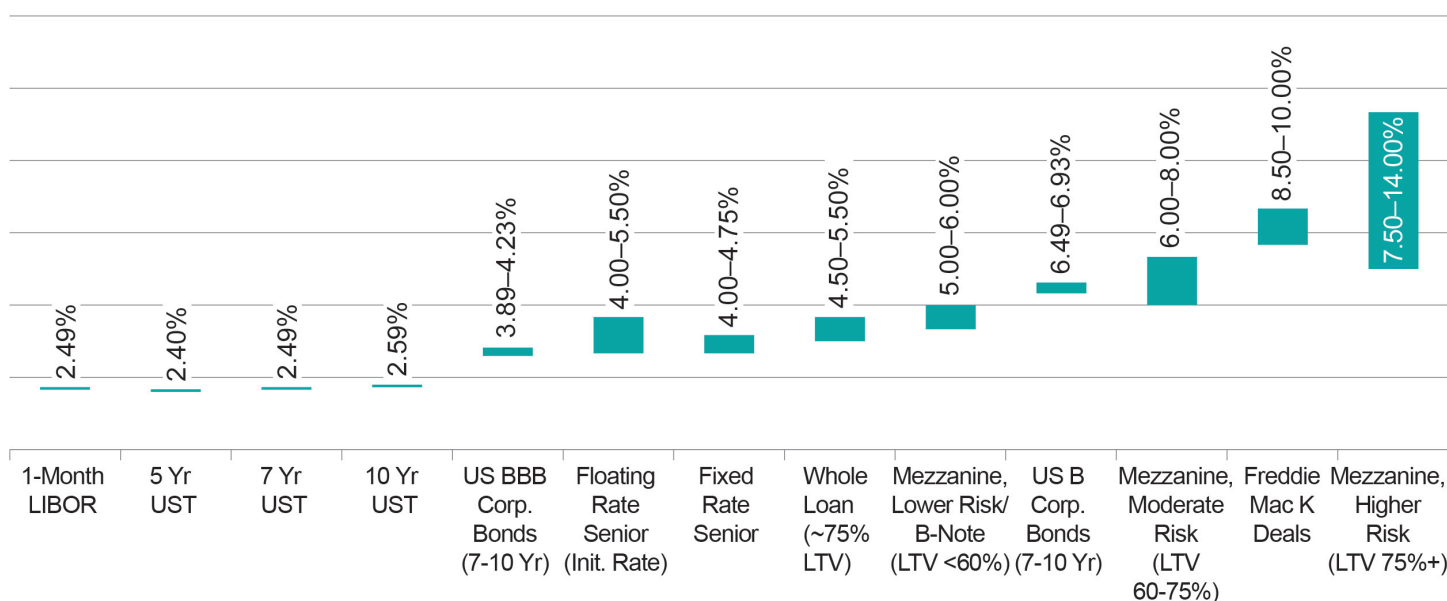
THOUGHTS ON AN APPROACH TO THE CURRENT MARKET

Given the point of the cycle, investors could look to utilize an approach which would involve a mix of private debt and public debt, such as CMBS or Freddie Mac K deals, to enhance liquidity. We feel that a combination of medium risk senior loans and low- to medium risk mezzanine loans secured by stable properties with experienced sponsors would create a highly-effective, late-cycle approach.

Also, being in this late stage of the cycle makes it sensible to focus on the most liquid markets. These do not necessarily have to be primary markets; they could be secondary or tertiary markets as long as there is a high level of understanding of that market and liquidity. This could include those with the best relative growth, including in population, rent and employment.

FIGURE 5: Current Yield & Returns

Real Estate Debt (Interest rate ranges)



Note: The above interest rate ranges are for illustrative purposes only and represent current market pricing. Actual interest rates for individual investments may be higher or lower. Interest rates are not warranted and past performance is not indicative of future results. Interest rate ranges cover the main real estate sectors across a range of quality levels and locations. Sources: Cushman & Wakefield, Markt, Bloomberg, Moody's, Chatham Financial and DWS. As of March 20, 2019.



In terms of property types, DWS's perspectives:

- Industrial is attractive, given its recent return performance and supported by strong fundamentals driven by e-commerce.
- We also favor some cyclically defensive property types. Multi family, for example, has historically held up well in this part of the cycle. While construction was very active for a while, it has now slowed down but rising home prices has kept demand strong.
- Favorable to certain Retail, which is also cyclically defensive, but on an individual basis. Selection would be very important with a property being a dominant center, with credit tenants on long term leases.
- Within Office, selection is paramount, requiring credit tenants on long term leases.

CONCLUSION

Commercial real estate debt offers a yield premium in many cases to certain other asset classes, with the benefits discussed herein. Given the movement of market participants, as well as the increased standards instituted over the past several years, private commercial real estate debt can be considered an "evergreen" allocation given the range of sub-sectors. With its range of opportunities, investors can look to the asset class for uncorrelated asset class exposure, differing levels of income generation, not to mention it being complementary to other real estate investments such as equity ownership.✿

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