Schroders capital

October 2022

IAPF INVESTMENT CONFERENCE

Finding secure income in today's market – the role that real estate debt can play within pension scheme portfolios

Sam Murphy
Product Manager

BIOGRAPHY

Sam Murphy

Product Manager, Real Estate Debt

- Sam is the product manager for the Schroders Capital real estate debt platform which consists of 5 private markets funds domiciled in Luxembourg
- He has spent 8 years at Schroders across private and public markets
- He has an MBA from Kelley Business School at Indiana University and from Manchester Business School
- Sam has an undergrad degree from the University of Sheffield

Schroders, 2022.

Schroders
capital

An investment business founded on performance, innovation and integrity

€65.9bn

assets under management in direct, primary, secondary, and co-investment capabilities

Real Estate **€24.6bn**
Operational excellence, hospitality and sustainability expertise driving performance across the value chain in Europe and Asia

Securitised Credit **€16.3bn**
Full spectrum of securitised assets and asset-related private debt in data-rich credit sectors across the US, Europe and APAC

Private Equity **€12.5bn**
Small and mid-sized buyout in Europe and US as well as Growth investment in Asia and Global venture capital

Infrastructure **€5bn**
Essential infrastructure in Europe across the capital structure

Insurance-linked **€3.9bn**
Uncorrelated long-term returns across life and non-life insurance risk globally

Impact **€3.6bn**
A global impact investment capability dedicated to generating lasting positive changes and attractive returns

250+

investment professionals

450+ employees directly dedicated to private assets globally with many more supporting the proposition across the group

Long and consistent track record of delivering strong risk-adjusted returns

Transparent ESG integration, sustainability and impact measurement capabilities

Flexible suite of tools and services for institutional and private investors

Dedicated Private Assets Solutions team

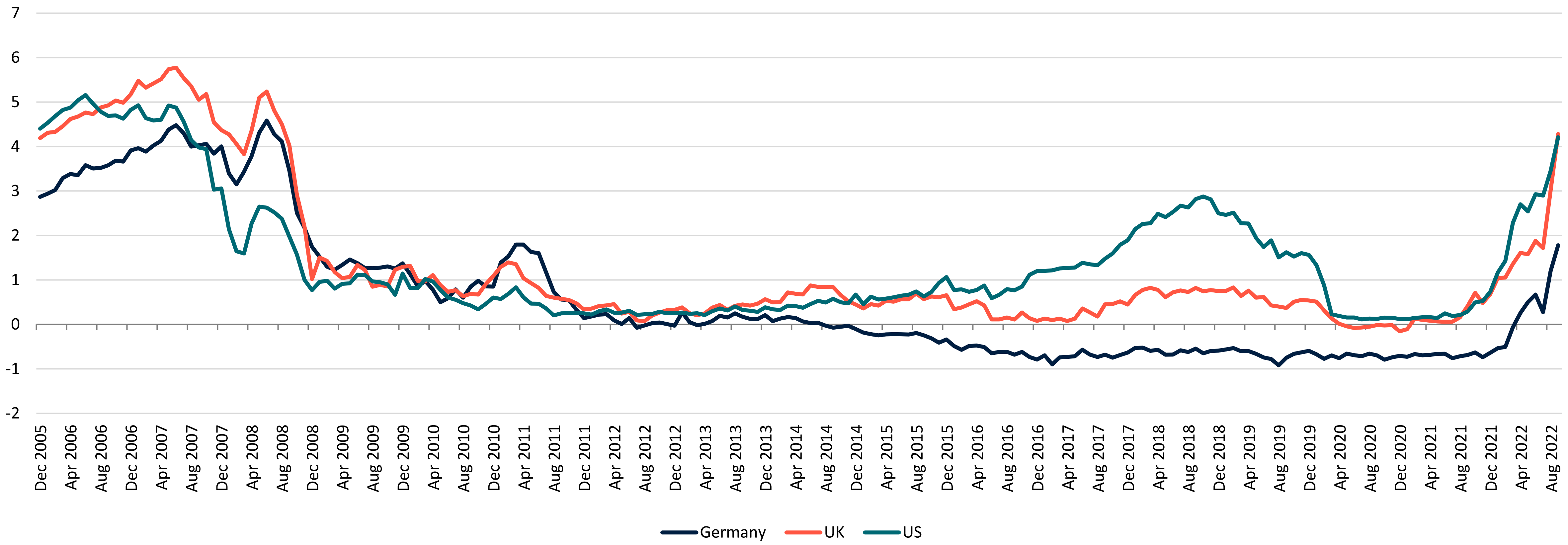
In-house data science team supporting our investment practice

Past performance is not a guide to future performance and may not be repeated.
Source: Schroders, 2022. AUM and performance as at December 2021 (includes non-fee earning dry powder).

MARKET CONTEXT

Returns have gone back to the future

The end of the low yield world

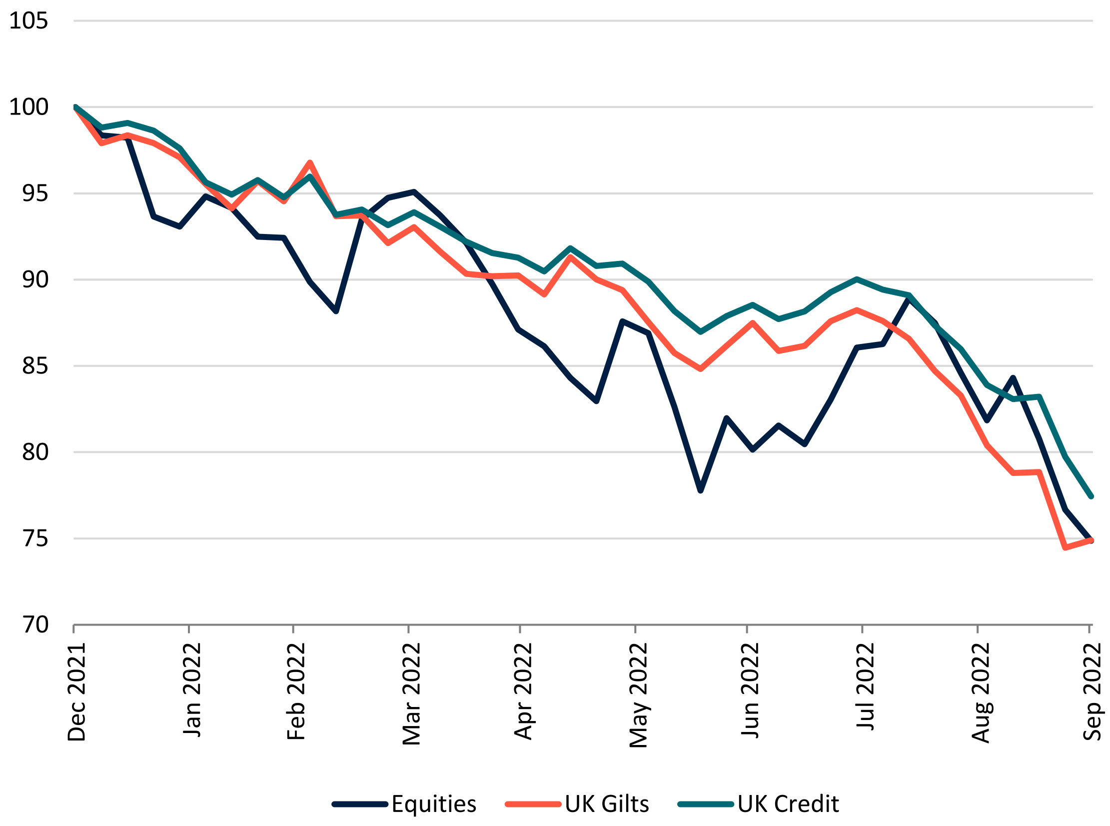


Schroders, Refinitiv, October 2022.

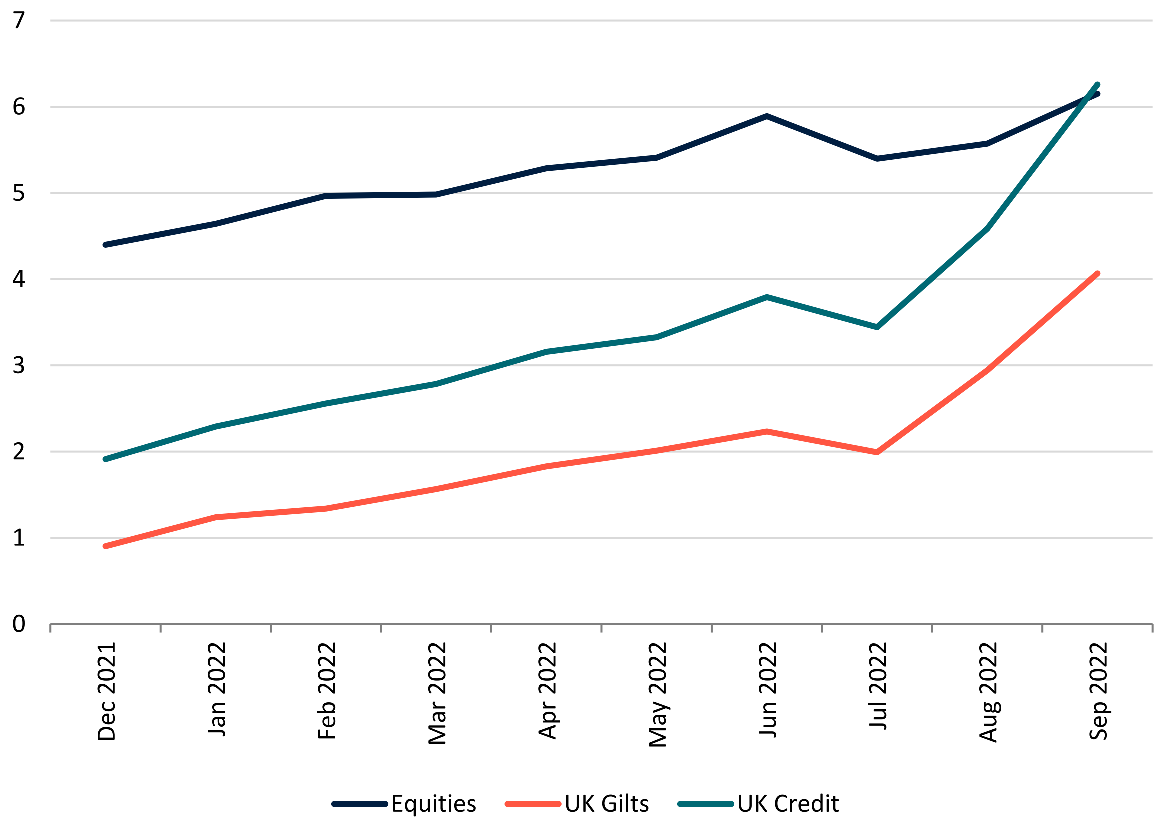
Perfect storm in 2022

Correlations high across asset classes

Market sell off over 2022



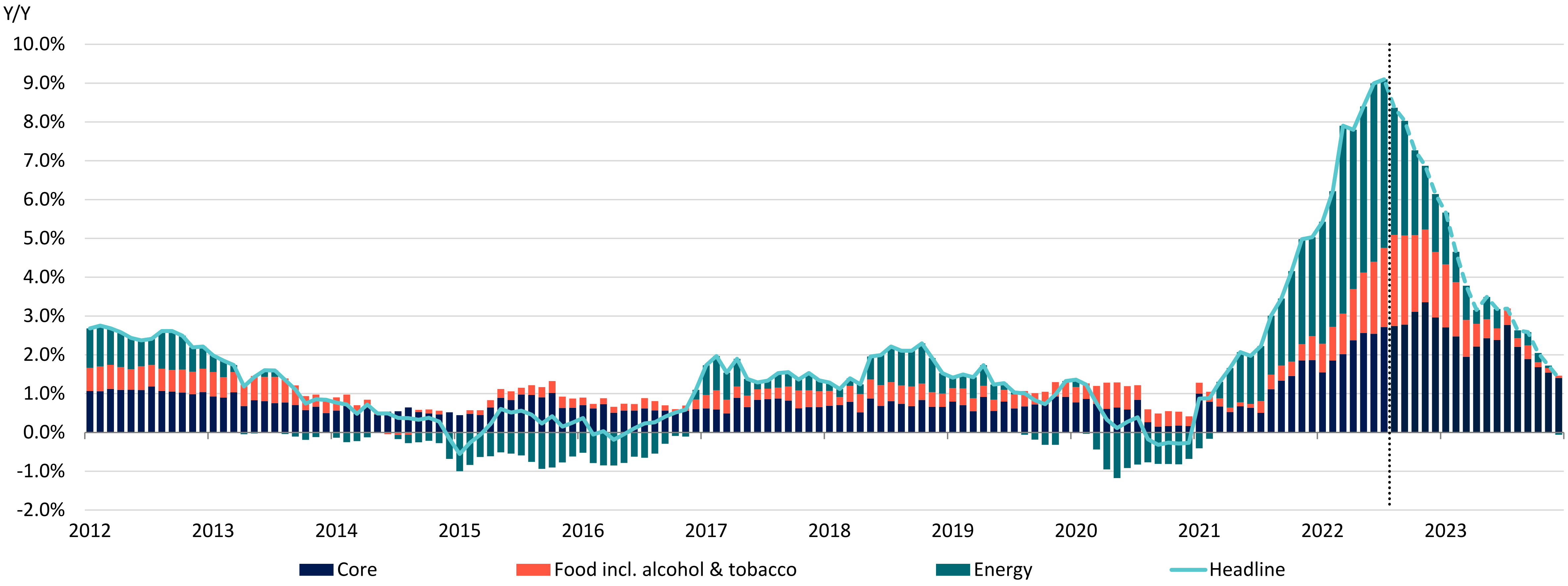
Asset yields up across asset classes



Source: Schroders. UK Gilts = ICE Bank Of America United Kingdom Gilts All Stocks Index. UK Credit = ICE Bank Of America Sterling Non-Gilt Index, Equities = MSCI World United States. Equities asset yield proxied by earnings/price.

Eurozone inflation

Jump in food and energy prices is now spilling over into wages and core inflation



Source: Schroders Economics Group, September 2022. Note forecasts should be regarded as illustrative of trends. Actual figures will differ from forecasts.

THE EUROPEAN REAL ESTATE DEBT MARKET

The European real estate debt market

Commercial mortgages secured against physical real estate assets

01 Growth of alternative lenders

€1tn market requiring €200bn+ new capital every year for the financing/re-financing of commercial real estate. Bank retrenchment leads to the creation of a new asset class.

02 Debt financing covering all real estate sectors

Main sectors are Industrial, Logistics, Office and Retail but increasing demand for Build to Rent and Data Centers as well as Hotels, Student Accommodation and Healthcare.

03 Supply/demand imbalance: Lender friendly terms

Full covenant packages remain market standard. Returns are attractive vs public/private alternatives. Returns can be dialed up/down to suit investor appetite..

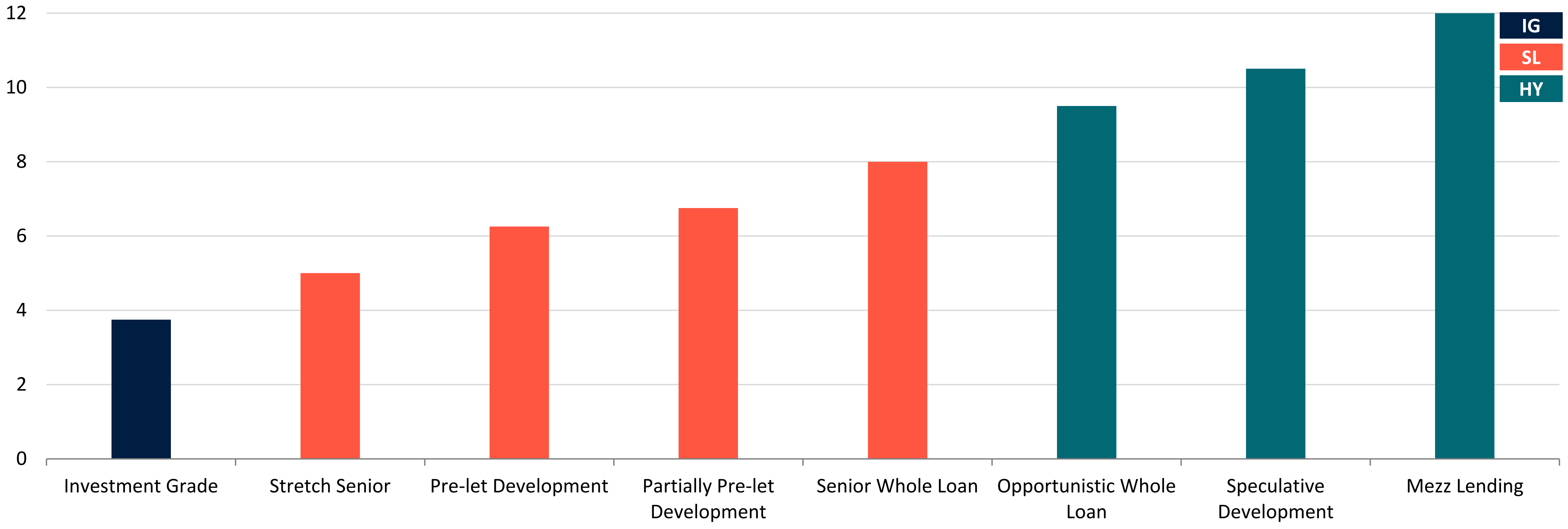
04 ESG central to Lending success

Tenants are increasingly conscious of their carbon footprint. The built environment will require significant capital investment to achieve the UK governments carbon targets. A robust, measurable and repeatable ESG process becomes key to reducing risk.

Schroders, 2022. Assets shown are part of Schroders Real Estate equity funds. Note: SCRED will not lend on Schroders RE equity assets.

Returns available today from private real estate lending

Returns available for real estate lending (all in rate, %)



Schroders, 2022.

THE REAL ESTATE DEBT MARKET TODAY

The real estate market today

Fundamental shift in the cost of capital changes European Real Estate market dynamic

Cost of capital ↑

Significant re-pricing of debt capital in Europe in 2022

Real estate valuations ↓

Valuations are falling and expected to fall 15% over 18 months

Lenders step back

Fewer lenders. Falling values meets with lower leverage availability

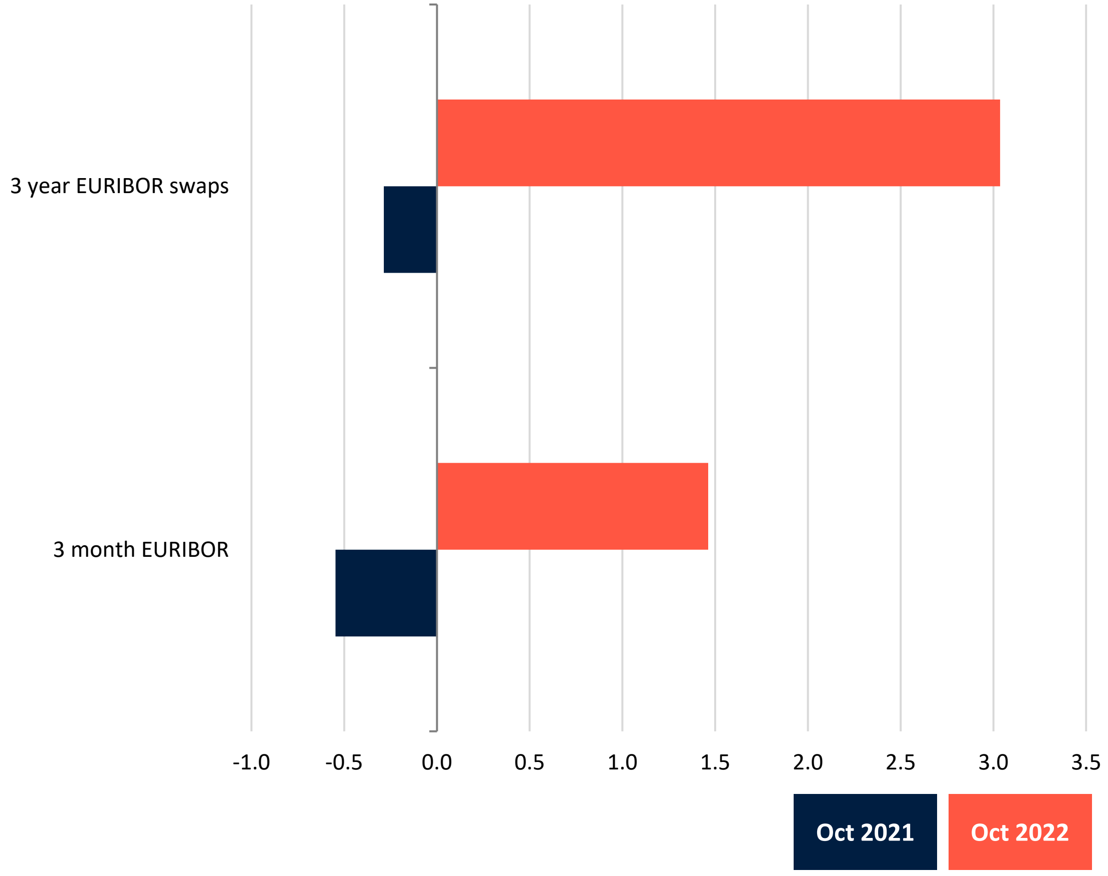
Schroders, 2022.

COST OF CAPITAL AND REAL ESTATE VALUATIONS

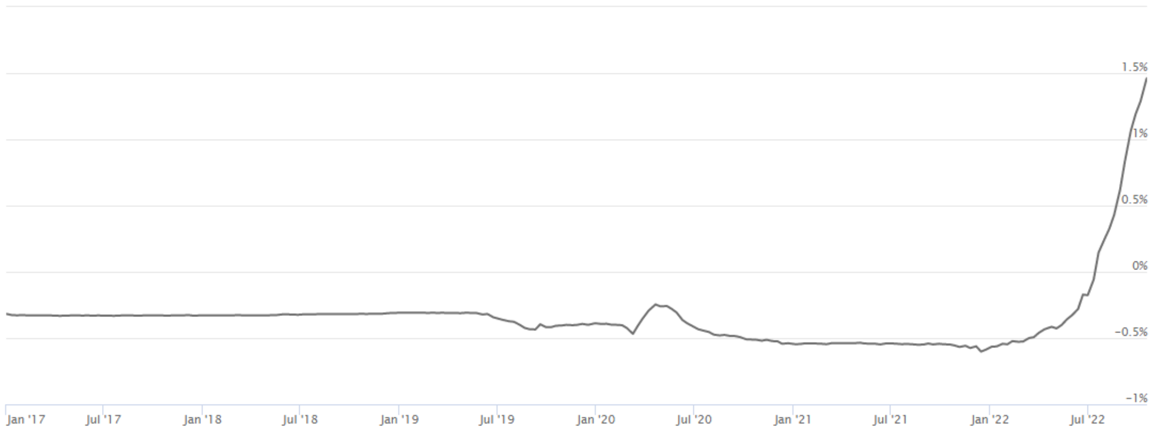
What a difference a year makes

Three year EURIBOR moves from -0.286% to 3.036% in 12 months

EURIBOR rates, 20th October 2021 to 2022



…after 5 years of negative rates

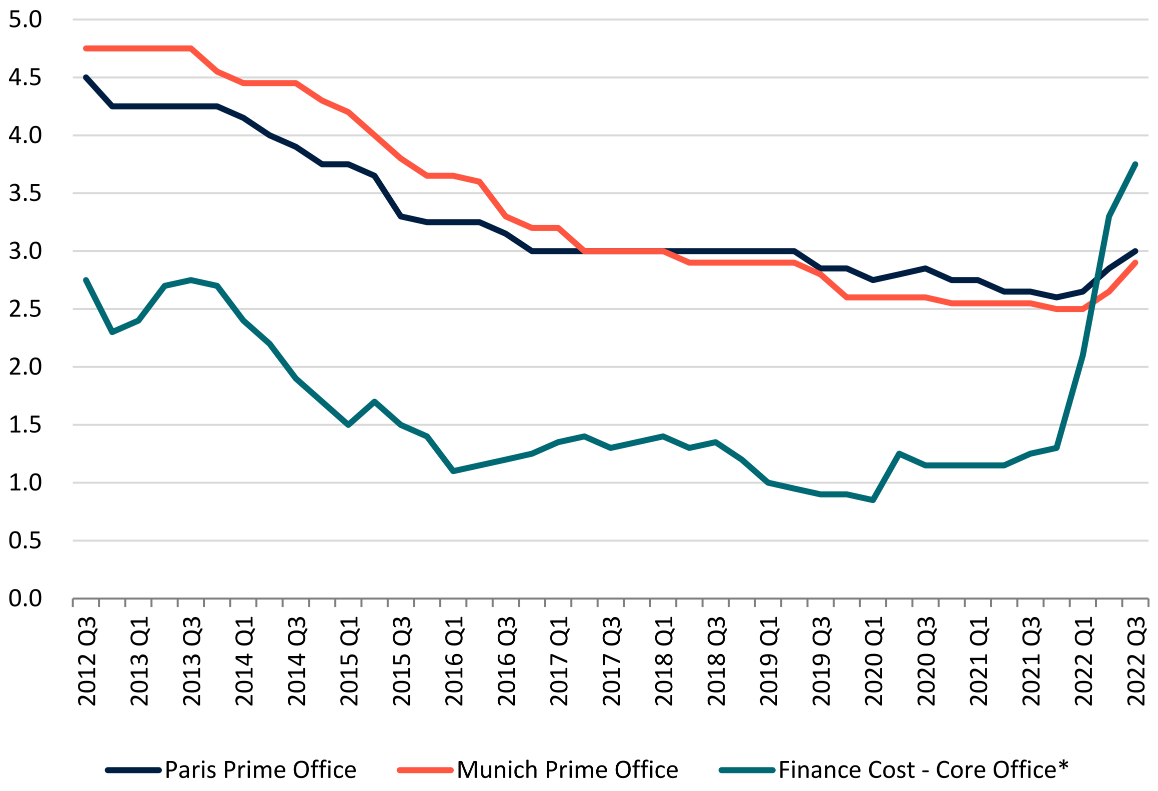


Schroders, Chatham Financial, October 2022.

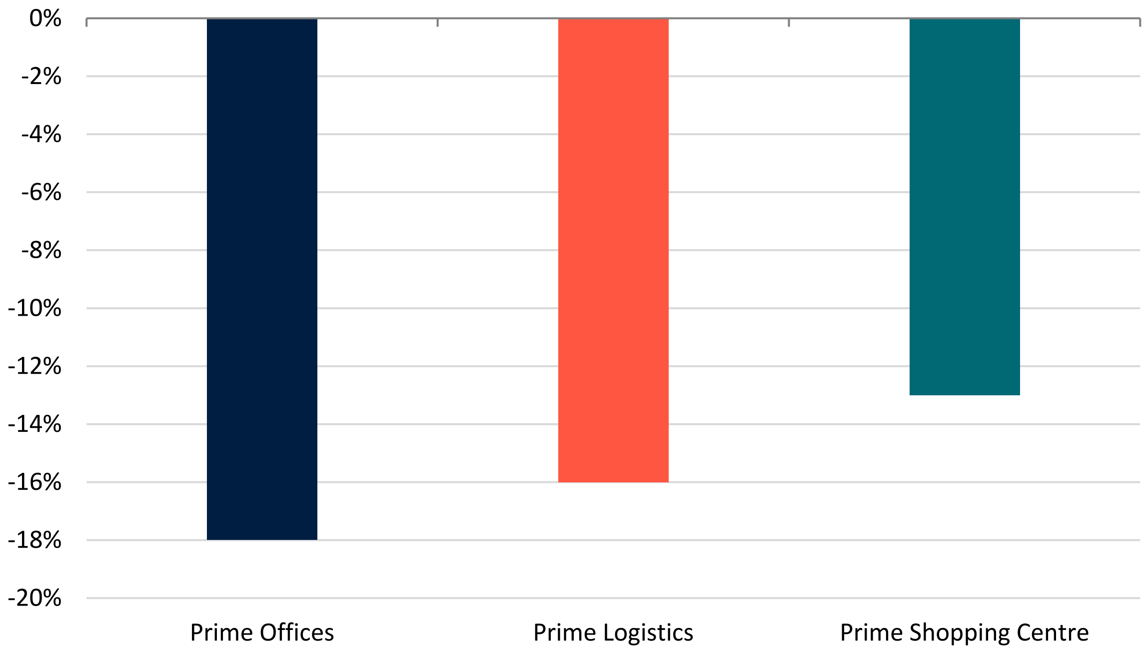
Increase in cost of capital impacts real estate valuations

Market declines starting to feed through and anticipated to continue through 2023

Prime Office Yields and Finance Costs



Schroders Capital Real Estate research – expectations for capital values to fall 15–20% between 2022–2023



Source: CBRE, Datastream, RCA, Schroders. September 2022.

IMPACT ON REAL ESTATE LENDING MARKETS

What is the impact on the real estate lending market?

Appetite for new loans has reduced, leverage has reduced and return hurdles have increased

Banks and alternative lenders are operating *very* cautiously


Real Estate Capital Europe

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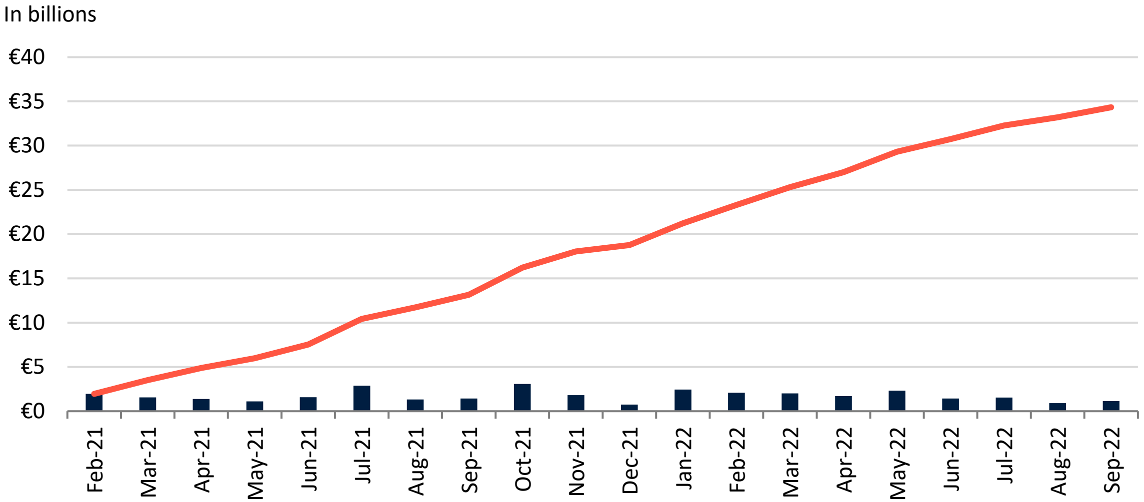
REFINANCING

AEW: Key markets face €24bn refinancing gap to end of 2025

Fewer lenders likely to result in higher deal flow



Those who will lend are doing so at lower LTV’s

- Finding debt capital will be a challenge for borrowers – both as loans mature (typically every 5 years) and for new acquisitions
- Lower asset values will make re-financing challenging – borrowers will in some cases need to inject fresh equity, but in others will need to find new financing arrangements or look for a junior lender given values have fallen
- Appetite which does exist from lenders (banks, alt. lenders) will be at lower leverage (LTV’s)

Regulatory changes are impacting banks re-financing capability

- Basel IV (coming January 23) will make it more difficult for banks to re-finance loans by simple ‘extend and pretend’
- The capital charge of holding loans with ‘forbearance’ will increase
- We expect the outcome here to be further deal flow and a desire for banks to offload these liabilities

Schroders, 2022. AEW. Deal flow shown is Schroders proprietary deal flow since 1st January 2021.

Lending appetite across market participants is low

Regulations and small number of players constrains the market

Banks

Very limited appetite for new loans in the current market

Focus only on large, existing relationships

Reduction in risk appetite resulting in lower LTV's for those transactions which do complete

Maximum leverage typically up to 60% – punitive risk capital charges there after

Insurers

Focus is on a specific market segment which is attractive from a risk weighting perspective

Typically look for low risk, investment grade deals with long terms (7+ years)

Small part of the market and no appetite to broaden lending scope

Debt funds

Limited appetite for lending in the current market environment

Focus will be on ensuring performance of existing loan book given covenants may be breached

LTV's will have come down and required rate of return will have increased

High costs to create a debt business deter new market participants

Conclusion

The 3 key market participants have each:

- Reduced their lending appetite
- Reduced their LTV's on loans they are prepared to provide
- Banks and insurers are constrained by regulations and are therefore unable to extend their loan franchise
- Debt funds are small in number and will have a higher return hurdle and require lower risk in the form of leverage and terms

Schroders, 2022.

THE CHALLENGE FOR BORROWERS

The challenge for borrowers

Falling asset values mean that re-financing (if available) is going to be difficult

Assumes values falling 20% and financing of 60% LTV

The challenge

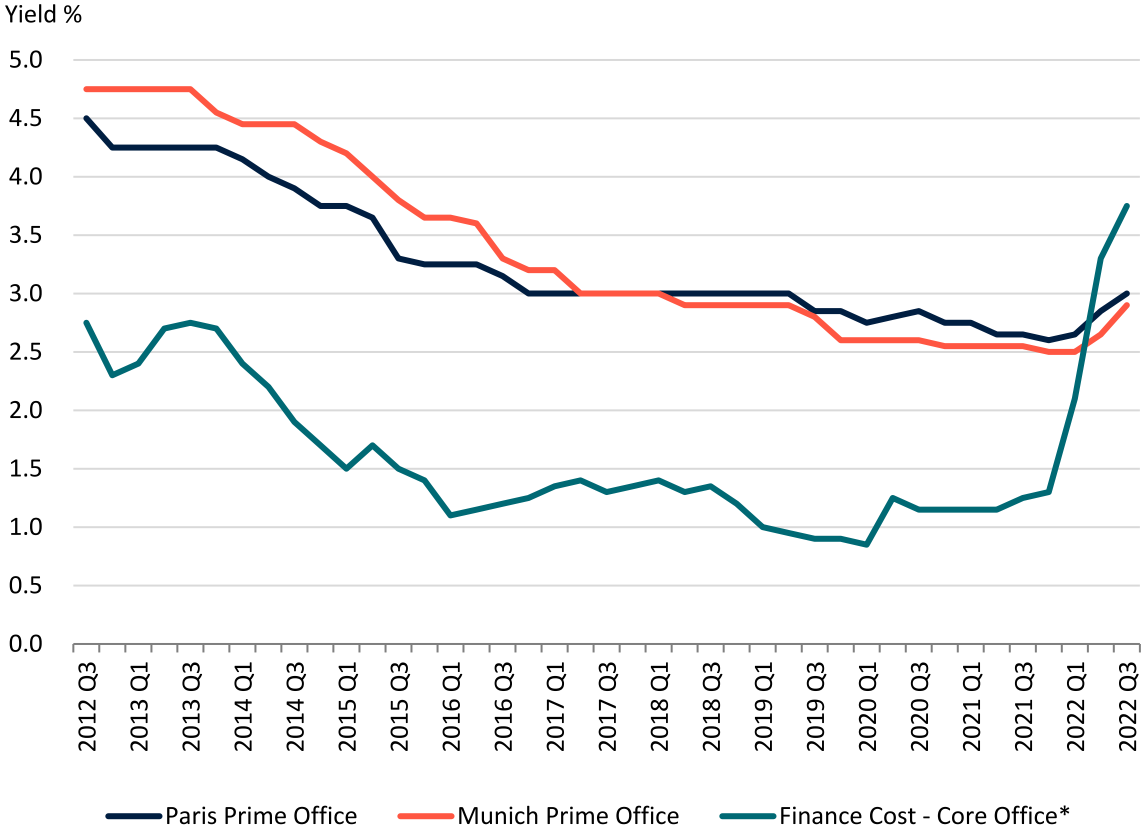
- Assume an asset financed in 2018 is now in need of re-financing
- Asset was valued at €100m – financed with 65% leverage and 35% equity
- Asset value has fallen from €100m to €80m due to increase in borrowing costs, market sentiment and challenging economic outlook
- Assuming the existing lender will extend the facility, the borrower will face a challenge
- 65% LTV of the new €80m value is €52m, resulting in a short fall for the borrower
- We believe existing lenders will be lowering LTV's so this would be a more acute challenge than the example
- In certain sectors, such as logistics and industrial, strong capital value grow post-2018 will enable borrowers to inject equity in to the deals. This will not always be possible or preferable for all real estate owners

Schroders, 2022.

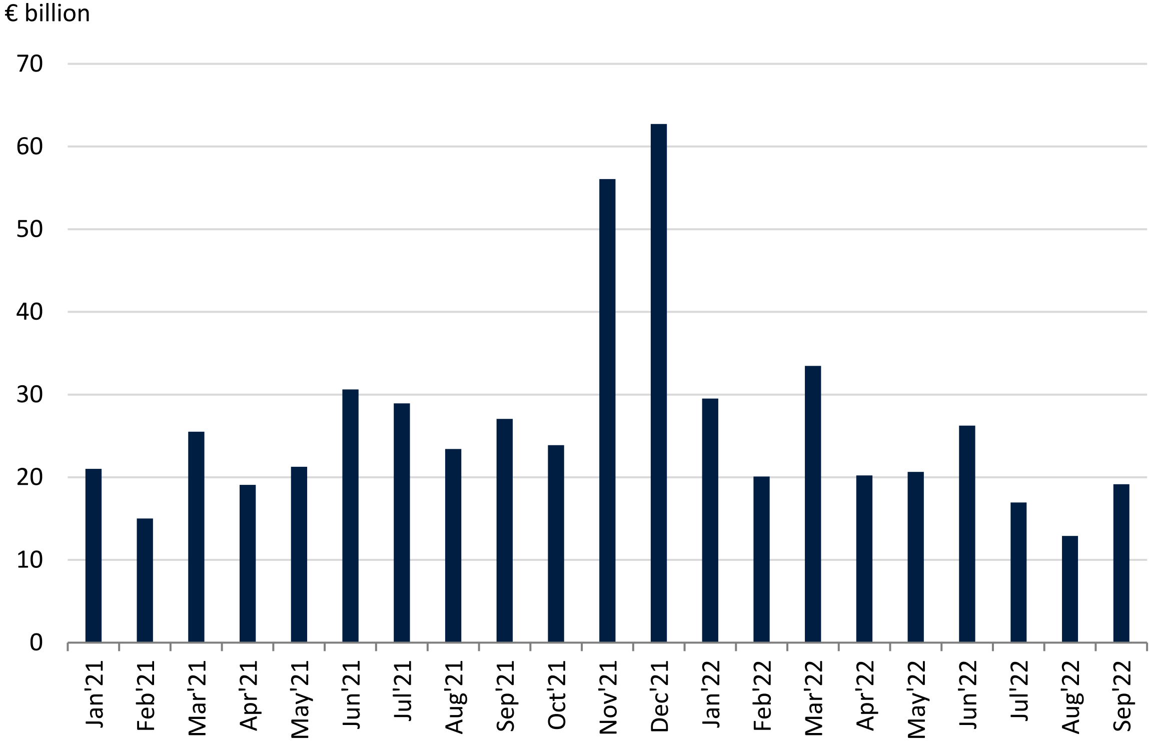
Finance costs and real estate investment transactions

Increase in finance costs has caused a sharp drop in investment transactions

Prime Office Yields and Finance Costs



European RE Investment Transactions



Source: CBRE, Datastream, RCA, Schroders. September 2022. *Average France and Germany. Note late reporting means that transaction figures for latest six months may be revised up.

THE OPPORTUNITY TODAY

The opportunity for investors

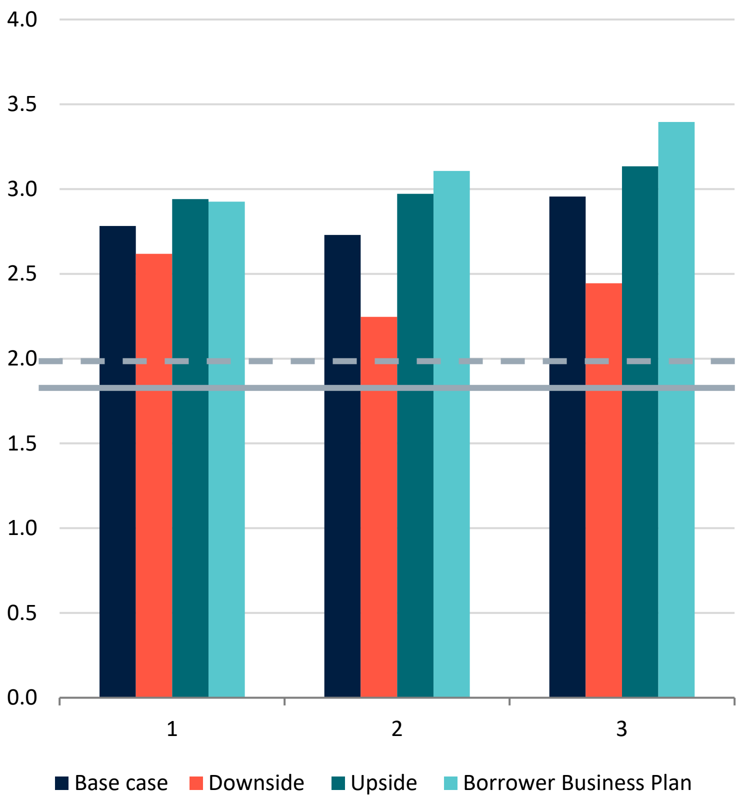
Provide capital in a constrained market

- Target returns can be achieved at lower leverage
- Remaining active and opportunistic in the market – using our internal RE expertise to get comfortable with valuations (not having to wait for 3rd party valuation reports)
- Provide capital where it is otherwise not available with full covenant packages and lender friendly terms as a result
- Provide capital above the stringent lending limits of the banks with outsized returns for the additional leverage being underwritten

Outsized returns now available

- Senior secured, first mortgage positions are now generating gross IRR's of 6–7% in Europe
- Senior secured loans are rated AA-B using S&P rating methodology (internal rating)
- Recovery rates in event of default very high given the equity cushion and conservative starting LTV's. In event of default the lender can take control of the asset

Covenant packages, including ICR



Schroders, 2022. Gross IRR is calculated by combining the margin, arrangement and exit fees. Gross IRR's are projected and not guaranteed

Transaction example

Senior secured loan against Dutch industrial assets to an institutional borrower with 25 year lease

2x Dutch Industrial assets

Key loan information

- EUR 17.2m, 5 year loan
- Gross IRR of 6.5%+
- 67% LTV (of a conservative asset value)
- Two assets in the Netherlands near the German border
- Senior secured first charge position
- Tenant has a 25 year lease on both assets
- Rental uplifts due to inflation indexation
- Sale and leaseback strategy by US sponsor – sponsor has been running the strategy for 16 years and never missed a payment or defaulted on a loan
- Bank guarantee of 12 months
- Loan is less than the vacant possession value of the assets, providing strong recovery position in a worst case scenario
- LTV and ICR covenants and prepayment fees
- Tenant has occupied the asset for 75 years and it is the global HQ. The second asset has been occupied by the tenant since 1964

Schroders, 2022. Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy.

Transaction example

Senior secured loan against newly refurbished asset in Milan

Low leverage whole loan with High Yield pricing

Key loan information

- EUR 27m loan
- Loan is at 55% LTV given the lack of funding available in the market today. Hotels in particular are struggling to attract debt capital
- Coupon is 8%, 1% arrangement fee and 1.5% exit fee giving a gross IRR of 10%
- We use the expertise of our internal hotel team to analyse hotel opportunities
- 3 year loan
- Newly refurbished hotel located North of Milan, close to San Siro Stadium. 310 keys operated on 20 year management contract with global multi-national. Hotel opened late 2019 and didn't ramp due to the pandemic
- First charge whole loan of to refinance existing debt and provide working capital line to cover any opex and interest service shortfalls during the first year of ramp up
- Cashflow projections underwritten at discount to the Competitive Set

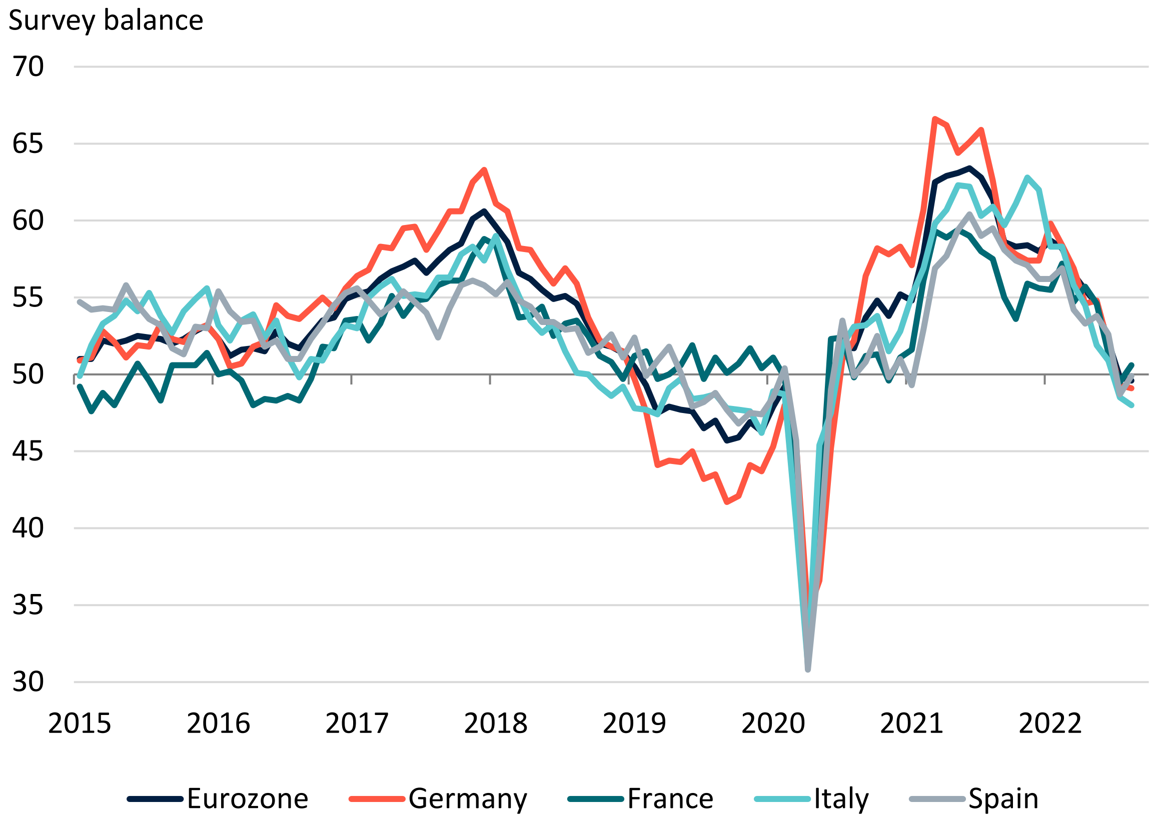
Schroders, 2022. Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy.

HOW TO LEND THROUGH CHALLENGING MARKETS

How to lend through challenging markets

1. Recession

Manufacturing PMI's



Key considerations and risk mitigants

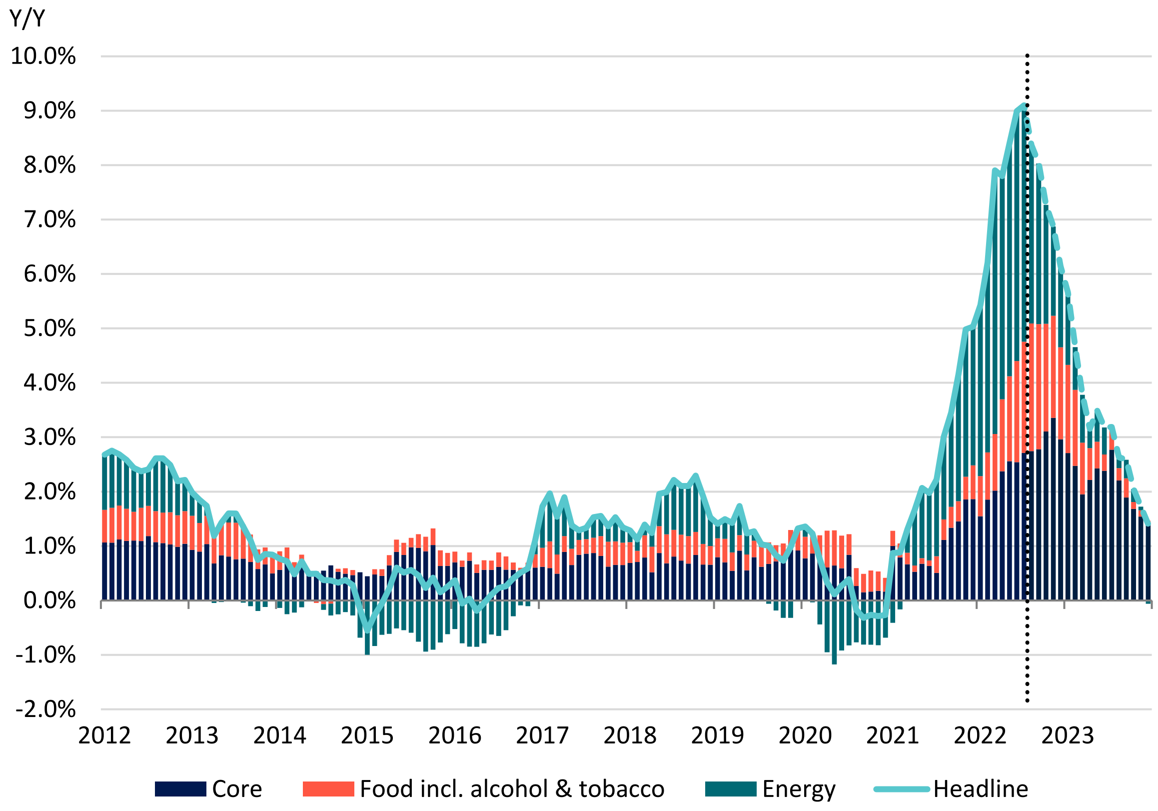
- Senior secured position in the capital stack
- Sole lender to provide control in a challenging market
- Higher quality assets, improved location, higher tenant quality (either through diversification of tenants or by number/sector)
- Lower leverage (LTV's) to protect loan exit-position to re-finance the loan and repay the principle
- Assets which will be improved during the life of the loan help to support asset value
- Full suite of covenants as standard – tight covenants which bring the lender to the table early
- Fewer development loans

Source: Markit, Refinitiv, Schroders Economics Group. September 2022.

How to lend through challenging markets

2. Inflation

European inflation



Key considerations/risk mitigants

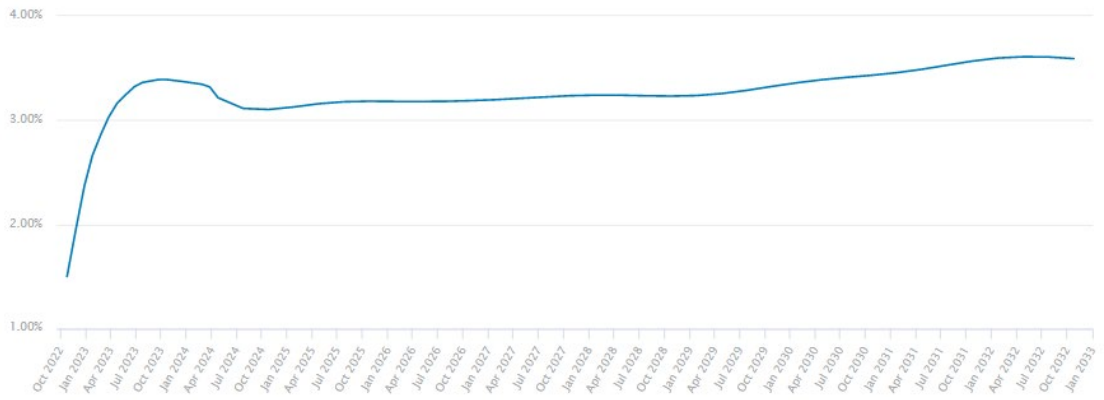
- Rents are correlated with inflation over time, albeit with a lag. 70% of European rental contracts have a contractual inflation adjustment
- Shorter rental contracts are able to be re-set more regularly – sectors such as purpose built student accommodation and single/multi-family assets are examples
- Growing income can help offset rising property yields to sustain values
- Private real estate lending transactions can be floating rate, providing investors with potential inflation protection

Schroders, 2022. RCA, Schroders. PMA, JLL June 2022.

How to lend through challenging markets

3. Rising interest rates

EURIBOR forward curve



Key considerations/risk mitigants

- Focus on tenant profile and the quality of the cashflows servicing the loan
- Structuring the right covenants to ensure there is tight control over debt serviceability
- Margins increasing to compensate for macro risks
- Focus on sectors where rental contracts are shorter and can therefore be re-based (student accommodation, build to rent) but also sectors where there is structural growth in rental payments, and this can be maintained even in a slowly economy (life science, healthcare)
- Increased swap rates result in higher absolute returns

Schroders, Chatham Financial, 21 October 2022.

How to lend through challenging markets

4. Falling asset values

Values expected to fall through 2022–2023

OXFORD ECONOMICS

17 October 2022

Research Briefing | Global

Soaring debt costs increase the risk of real estate distress

- Debt costs continue to soar across advanced economies, threatening to push commercial real estate markets into distress. We believe that the transmission mechanism for forced selling will be refinancing shortfalls, but interest coverage ratios are also looking dangerously low.

Key considerations/risk mitigants

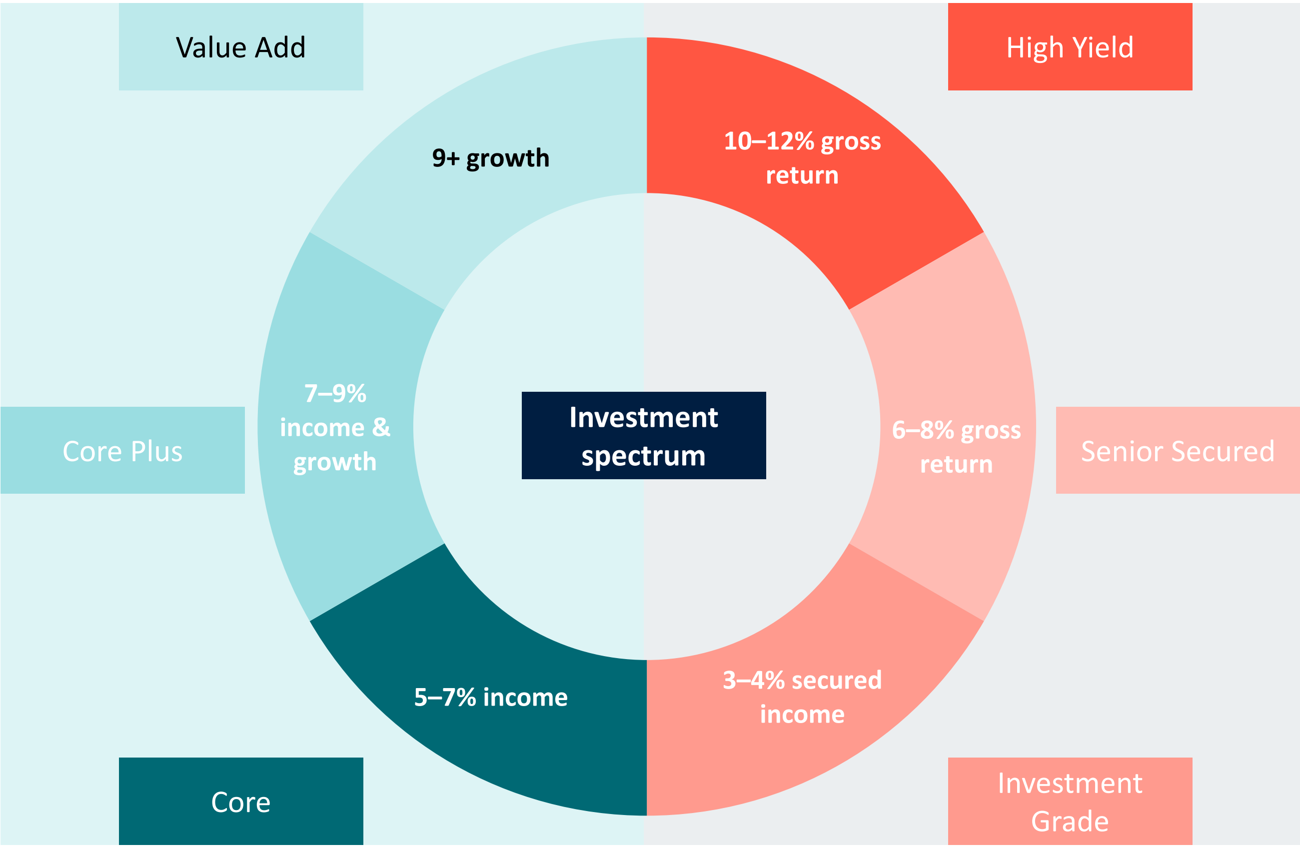
- Significant equity cushion behind a high quality sponsor
- Looking to lend up to 75% max LTV, giving a minimum of 25% cushion of further valuation falls
- Lend to sponsors who have deep pockets and can inject equity if needed to make-whole the loan at re-finance
- Borrowers who are larger/institutional and can inject more capital in to deals
- Better assets with alternative uses to underpin value

Source: Schroders, Refinitiv Datastream, ICE Data Indices, J.P. Morgan. Data as at 30 September 2022. Any reference to sectors/countries/stocks/securities are for illustrative purposes only and not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy.

RELATIVE VALUE ACROSS REAL ESTATE TODAY

Investing across real estate capital markets

Investors under allocated to real estate debt given the size of the market

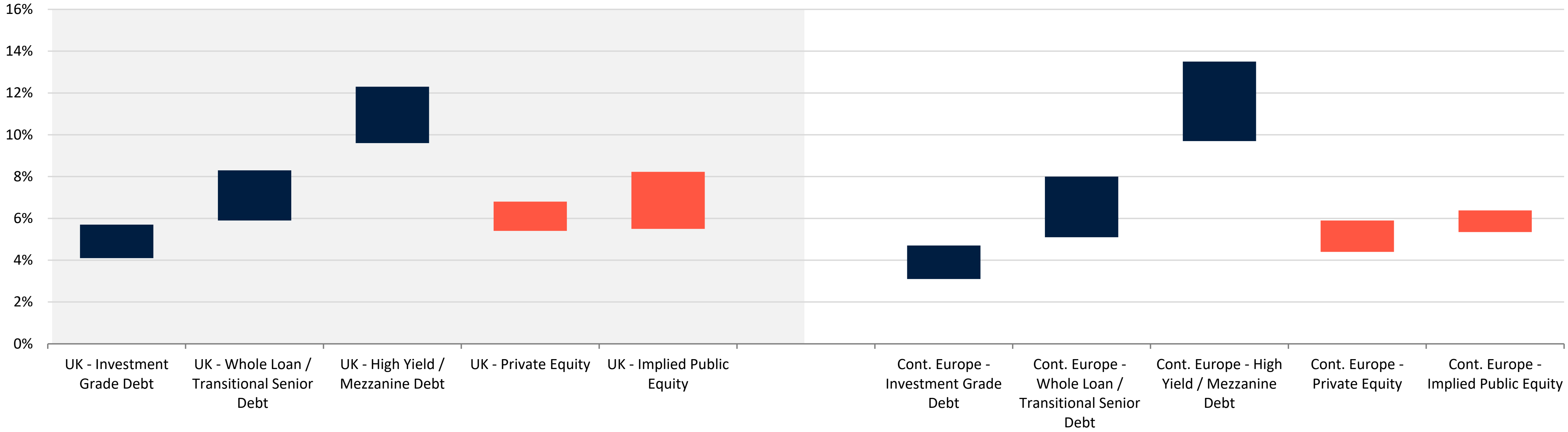


Schroders, 2022.

Relative value across real estate markets

Range of estimated prospective performance across the traditional property-types

Local currency prospective private real estate debt performance – YTM (five year view) – and unleveraged prospective equity returns for grade-A/prime real estate profiles



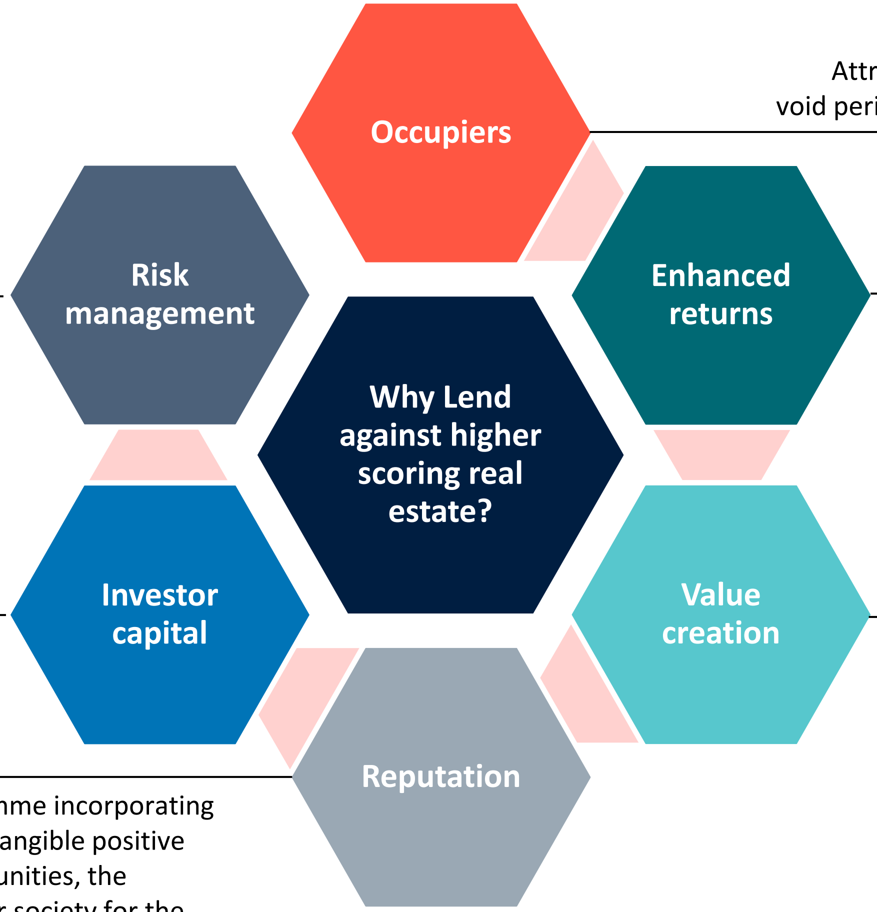
- Performance ranges are shown for the traditional property-types, namely the office, industrial, retail and multifamily sectors
- There is current relative value in private real estate debt and publicly traded real estate equity investment opportunities where these capital markets have seen pricing respond most evidently
- High yield private real estate debt offers a particularly compelling cyclical opportunity where yields have increased and providers are able to negotiate favourable terms including higher equity subordination levels

Source: Schroders Capital, October 2022. Note: The forecast should be regarded as illustrative of trends. Actual figures will differ from forecasts. Please note that this chart is a five year view.

ESG

Real Estate with stronger ESG credentials

Boosts rents, attracts tenants and safeguards future value



Attract best tenants, shorter void period, rental premium (JLL)

Reduced emissions and operating cost savings (Climate Change Committee)

Protecting future value and liquidity

85% of Institutional Investors are actively integrating sustainable investing approach (KPMG/AIMA/CAIA 2020)

Value premium though increased occupier attraction and retention, rental value and lower rate of depreciation (JLL)

An investment programme incorporating sustainability delivers tangible positive impacts to local communities, the environment and wider society for the long term

Source: Schroders, 2022, JLL 2021.

ESG in practice

Implementing tangible improvements such as EV charging points in to the loan agreement

Senior Whole Loan – Greater London Retail

Size:	£33m	**Coupon:**	5.80%
LTV:	55%	**Fee:**	upfront 1.25%
Term:	3 years	**IRR:**	6.45%
ESG:	3.25/5	**Loan Rating:**	AA

ESG – At our request the Borrower has commissioned and paid for an **ESG Report and Action Plan from JLL** to undertake primary and secondary research on the assets impact on the community and wider environment. The output of the report will be implemented through the capex programme.

Recommendations include:

Energy – lighting, energy use, heating and cooling, solar, EV charging, biodiversity

Social Value – local charities, wellbeing gardens/seating areas, biodiversity, skills and training, living wage, food bank/donation point, subsidised space for local business, shuttle busses for out of town retail workers

Source: Schroders. Assets shown for illustrative purposes only and is not a recommendation to buy or sell any financial instrument/securities or adopt any investment strategy.

CONCLUSION

The role of real estate debt in pension scheme portfolios

1 Secure income

- Contractual cash flows from quarterly rental payments
- Covenant packages as standard – lender friendly terms across the market due to capital constraints. Illiquidity offset by downside protection

2 Real asset lending

- Loans secured against real estate assets provides downside protection
- Recovery rates higher than public market equivalents given the senior secured nature of Investment Grade and Senior Loan
- Option to include as a real estate alternative

3 Floating rate

- Option to structure transactions as floating rate instruments, giving potential inflation hedging to investors

4 Complexity and illiquidity premium

- Opaque market requiring large origination team
- Investors benefit from the bi-lateral negotiation and structuring of the loans
- Single lender creates clarity and in stressed scenarios

Schroders, 2022.

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