PRIME CAPITAL

European Real Estate Debt

Newsletter Q2 2023

Summary

> In Q1 2023 European Real Estate investment volumes were with EUR 34.2bn (-63% YoY) on the lowest levels since 2012.

> IRRs for Whole Loan and Mezzanine financing are rising strongly to adapt to the changing interest-rate environment. LTVs / LTCs remain stable at lower levels.

> Uncertainties around the impact of interest rate changes on real estate prices are significant, while long-term fundamentals for developments and value-add projects remain strong. Real estate debt solutions allow to play this investment case with a nuanced approach that reduces downside risks.

> Prime Capital was able to close an attractive senior loan for a state-of-the art office development in Augsburg with an IRR of > 8%.

Real Estate Market Europe

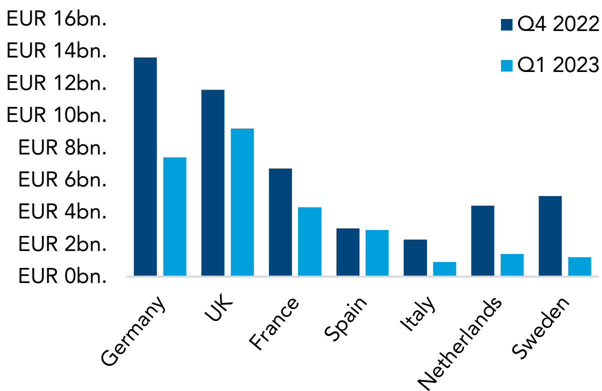

Figure 1: Transaction Volume by Quarter (Western Europe).

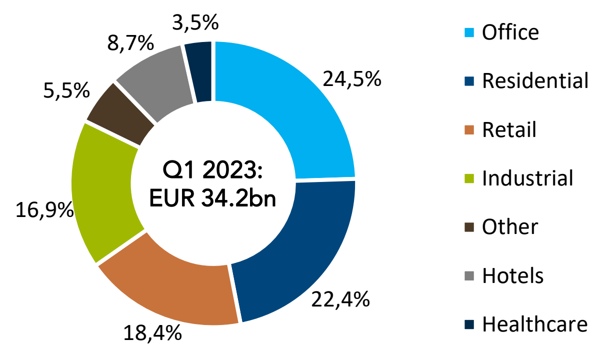

Figure 2: Transaction Volume by Asset Class (Western Europe).

In the first quarter of 2023, the European real estate transaction volume amounted to EUR 34.2bn, leading to a 63% YoY decline compared to EUR 79.6bn in Q1 2022.[1] These levels were not seen since 2012 and the weak years after the GFC. The reasons are the still insecure market environment and rising interest rates. Nevertheless, with decreasing core inflation rates, the prerequisite for a recovery of the market has been achieved. The first positive impacts on the transaction volume are expected to be visible in the second half of 2023, as investors are gradually overcoming the shock rigidity and increasingly coming to terms with the new market environment.

Country-wise, the investment volume decreased by over 60% in all of the leading European markets in Q1 2023 compared to Q1 2022. The only exceptions with a smaller

[1] Source: CBRE - European Real Estate Investment Volumes Q4 2022.

decline were Ireland (-12% YoY), Spain (-40% YoY), Switzerland (-40% YoY), and Portugal (-40% YoY).

In Germany, the last three quarters were all separately the weakest since 2012, showing impressively that the transaction boom has ended for now. Nevertheless, the decline in transaction volume to EUR 7.8bn (-67% YoY) shouldn't be exaggerated, as Q1 2022 was particularly strong. Compared to the 15-year average of EUR 17.3bn, the decline looks, with -45%, less dramatic.

The investment activity split up by sectors also aligns with the overall development. In each sector, a decline was noted for Q1 2023.

Retail, with a transaction volume of EUR 6.3bn, a decline of only -7% YoY, had in relative values the best quarter out of the different sectors. This is because one year ago the retail market was still heavily affected by the aftermath of Covid-19.

The residential sector recorded, with EUR 7.7bn (-55% YoY), the biggest decline in investment volume of all sectors. The simultaneously increasing debt- and construction costs show the biggest effect.

In absolute numbers, the office sector claimed, with a transaction volume of EUR 8.4bn (-41% YoY), once again, the first place. Especially prime office locations are still performing and in strong demand.

Large-volume deals and larger portfolio transactions remain the exception. Instead, smaller volumes are supporting the market to a certain extent and are gradually providing for a revival. Investors are much more selective about location, asset and space quality than during the boom phase, and ESG is acting as an additional factor. Equity-strong investors now have the chance to take advantage of opportunities in the investment market with little competition.

Mezzanine and Whole Loan Financing Market Overview[2]

During the first quarter of 2023, the trend of increasing returns for real estate debt investments accelerated. Responsible are mainly the continuing rise of the base rate, the higher risk premium due to the uncertain market environment paired with the overall underlying structural change due to the banks withdrawal from the market. In line with these market developments average returns (measured as IRR) for Whole Loans for existing properties rose by 100bps from 650bps to 750bps. The average returns for Whole Loan development financing rose even more strongly with +110bps to now 850bps (Figure 3 & 5). We observed the same trend on the Mezzanine side but in a more weakened form as the main adjustments have already taken place in the previous quarters. Mezzanine returns for existing properties rose by 50bps to 1250bps and for development financing by the same amount to 1325bps (Figure 4 & 6).

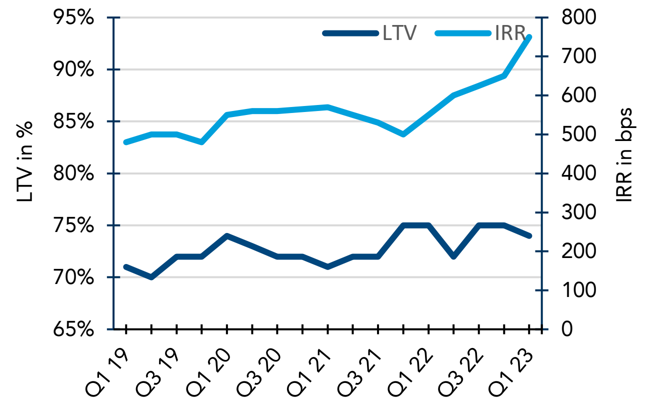

Figure 3: LTV and returns for existing properties Whole Loan financing in Europe.

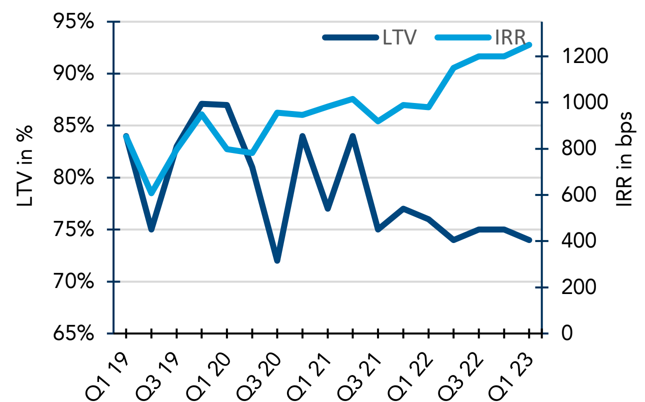

Figure 4: LTV and returns for existing properties Mezzanine financing in Germany.

In contrast to the development of the returns, LTVs and LTCs changed only moderately. For Whole Loan financing of existing properties, a slight decrease of 1% from 75% to 74% was observed, while LTVs for Mezzanine financing remained unchanged. The same is true for project developments. Whole Loan LTCs decreased by 1% to 74%, while the LTC for Mezzanine remained flat at 82%. But it must be noted that the valuations are very volatile due to the low investment volume at the moment. Therefore, LTVs and LTCs vary strongly.

[2] The aggregated data in this section is based on the transactions conducted by Prime Capital (closed-, pipeline- and rejected-deals).

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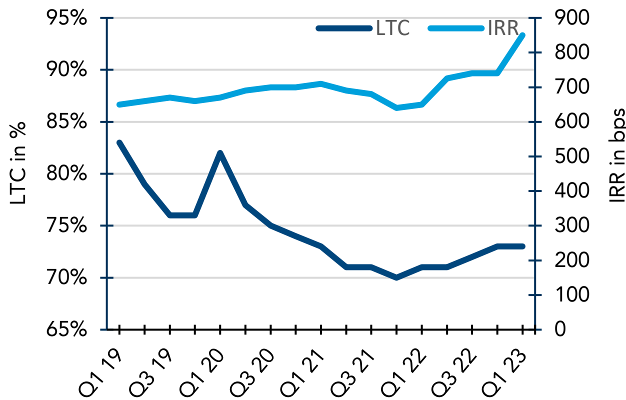

Figure 5: LTC and margins for Whole Loan project development financing in Europe.

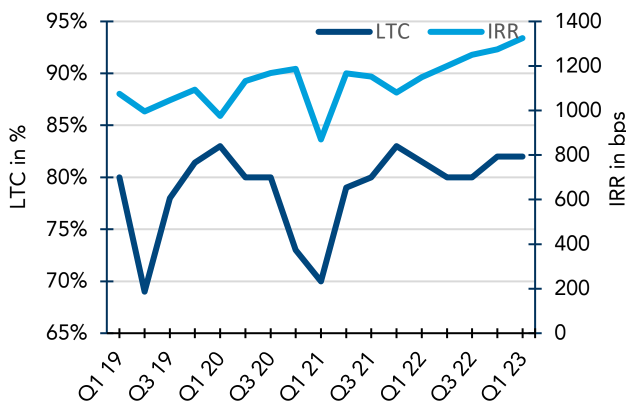

Figure 6: LTC and margins in Mezzanine project development financings in Germany.

Successfully manoeuvring through the current market environment – the time is now to invest in alternative real estate debt solutions

The steep increase of *nominal* interest rates was without doubt one of the most discussed topics among real estate market participants over the past 12 months. Interestingly, less has been written about the substantial changes in expected *real* interest rates (i.e. nominal rates after deducting inflation expectations). As can be seen in Figure 7, expected *real* interest rates have increased by about 2.0% since the beginning of 2022 and now – for the first time in more than 10 years – almost reached zero percent again. Put simply, by investing in a low-risk asset such as German government bonds, investors now expect to almost achieve a break-even return after incorporating inflation expectations. This stands in sharp contrast to the past decade where *real* returns of low-risk assets were highly negative.

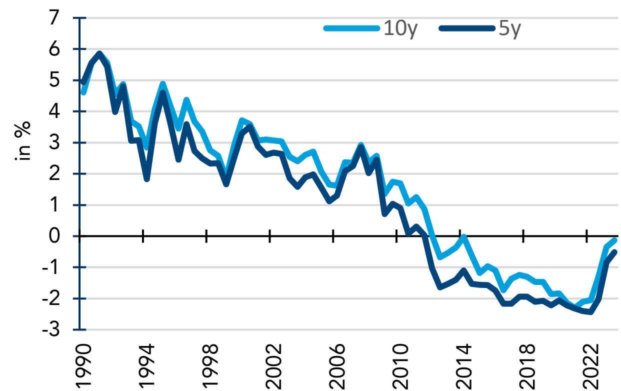

Figure 7: Expected real interest rates for German government bonds with 5y & 10y duration [3]

With respect to the real estate market, this change in return expectations of low-risk assets should be "passed through", leading to an increase in cap rates and, hence, resulting in a repricing of real estate assets. But there remain open questions in this respect. For example, it remains to be seen whether such a change in real interest rates is only temporary or whether it will be the "new normal" for the next few years. Consequently, it is open to debate to which extent such increase in real interest rates is already reflected in current real estate valuations. In addition, there might be other mitigating factors, e.g. increases in rental income exceeding current inflation expectations.

Unfortunately, none of us has the famous crystal ball that would allow us to make a firm forecast in this respect. Rather, the market will work this out over the next 12 to 24 months. For the time being, however, we believe that downside risks from real estate asset repricings and the resulting uncertainty will remain substantial, which needs to be carefully managed.

On the other hand, if we forget the recent interest rate movements for a second, the mid-to-long-term perspective especially for real estate developments and value-add projects, looks attractive from our point of view. In an increasing yield environment, the ability to create value and deliver projects that meet the expectations of occupiers is more important than ever. In this context, the ongoing tectonic shifts, such as the rethinking of office concepts or improving energy efficiency of existing buildings should clearly benefit those who focus on creating value and introduce high downside potential on "legacy" portfolios of long-term asset owners. For example, according to a recent survey by Knight Frank, 47% of the survey participants intend to move their headquarters in the next three years to new and modern offices – an increase of 40% compared to two years ago!

[3] Deutsche Bundesbank

Hence, from a fundamental perspective, the development and value-add segment of the real estate market continues to look attractive and remains a very interesting investment case.

The key question is how to play this investment case in the current market environment. For several reasons, we believe that real estate debt products by alternative lenders are particularly well suited, e.g.:

1. **Downside protection:** In contrast to equity investments, conservatively structured real estate debt investments have a substantial embedded downside protection as can be seen in Figure 8. This protection is particularly helpful in times of high uncertainty. By comparing various debt products, Senior Loans and Whole Loans offer the highest downside protection because they benefit from a strong security package and a preferred ranking in the waterfall with respect to any cash proceeds generated by the property. At the same time, a low levered and carefully structured mezzanine can offer an attractive risk-return profile for yield driven investors.

2. **Quick adaptation to the market environment:** Tenors for such debt financings are usually relatively short (on average less than three years) and, hence, changes in the interest rate environment and risk appetite (i.e. risk spreads) can be quickly reflected in new transactions or refinancings.

3. **Lower regulatory capital requirements:** The regulatory regime under Solvency-II works in favour of real estate debt investments provided by alternative lenders, especially if the duration is relatively short. For example, a non-rated real estate debt investment with a duration of 3 years leads to a capital requirement of 9% compared to 25% for real estate equity investments.

Figure 8: Relationship of changes in value of real estate debt and equity to changes in property values.

[4] Does not include other return elements, such interest income or running yields

[5] 25% price shock for real estate under Solvency II (value-at-risk with confidence level 99.5%)

In summary, the current market environment is driven by, on the one hand, high uncertainty (interest rates and therewith risks of repricing); but, on the other hand, attractive fundamentals for those projects with high value creation angle (i.e. real estate developments and value-add projects). From an investment perspective, we believe that real estate debt products offer the most compelling investment proposition in this context because their risk/return characteristics allow for a nuanced approach that reduces the impact of repricing risks while tapping fundamentally attractive projects.

Sample transaction in Augsburg

Attractive > 8% IRR senior secured CRE-debt deal for a sustainable office development project in Augsburg

Sector	Office	Prime Capital senior tranche	16m
City	Augsburg	Term	2.5y
Strategy	Development	LTC	< 70%
LEED	Gold	IRR	> 8%

In May, Prime Capital's Real Estate Debt team closed a financing transaction for a project development of one of Germany's most modern office buildings. Project "Aurum" is located in the CBD of Augsburg next to the central train station and will consist mainly of offices. Before construction, the sponsor CV Real Estate AG has already achieved a **pre-lease of more than 50%**. One of the anchor tenants is the SDax-listed PATRIZIA SE. The real estate company will use the building as its headquarters. The sponsor is aiming for **LEED Gold Core & Shell** certification for the property. The Whole Loan fund managed by Prime Capital participated in the multi-party financing structure by providing the Senior Tranche. Success factors for the closed construction financing included the high pre-letting rate to a **tenant with a strong credit rating**, cost security through a general contractor and the central location in an **economically strong region**. The transaction shows that despite the challenging market environment, there are still attractive opportunities for real estate debt investors.

Sample Q1 2023 transaction opportunities (pipeline)

Location	Sector	Asset Type	Financing Type	LTV	IRR	Size
Germany (South)	Mixed Use	Existing	Mezz-anine	79%	13.5%	18m
Nether-lands	Logistics	Existing	Whole Loan	84%	9%	40m
Germany (South)	Office	Development	Mezz-anine	80% (LTC)	14%	9m
Germany (West)	Logistics	Existing	Whole Loan	71%	10%	15m
Germany (Top 7)	Resi-dential	Development	Whole Loan	71% (LTC)	11%	12m

About Prime Capital's Private Debt Team

Our team has been active in the Real Estate Debt market for many years, with a particular expertise in Mezzanine and Whole-Loan transactions and has already carried out transactions of approximately EUR 1bn. In addition, our wider Private Debt Team invests into Transport Debt, Infrastructure Debt and Corporate Lending. We expect significant further growth in these areas, which provide attractive risk-adjusted returns to our investors.

Prime Capital's Private Debt Team manages assets in excess of EUR 2bn across private debt segments on behalf of institutional investors.

Further information about Prime Capital AG can be found on our website www.primecapital-ag.com.

Contact:

Dennis Davidoff
Executive Director
Real Estate Debt
dennis.davidoff@primecapital-ag.com

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