M&G Investments

Real Estate Debt Investing in 2022: Lessons Learnt, Opportunities and Key Risk Controls

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Introduction

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Duncan is the Co-Head of Real Estate Finance, M&G Investments with joint responsibility for all strategic and operational aspects of the business. He is a member of the Real Estate Finance Investment Committee and has over 15 years sector experience.

Duncan joined M&G Investments in 2011 with primary responsibilities being to originate, structure and execute real estate debt investments and to raise capital for dedicated real estate debt strategies. He has been heavily involved in the establishment and management of five commingled funds and nine segregated accounts, collectively constituting £5 billion of investor commitments.

TEAM	SCALE	TRACK RECORD	ACTIVE
17 Investment Professionals **7** strong Investment Team	**£5.1bn** Assets Under Management and **£12.0bn*** committed to investments since inception of the platform in 2009	**125+ Loans** On behalf of **100+ Institutional Investors** Committing to **£9.1bn of UK opportunities*** **€3.3bn of Cont. Europe opportunities***	**£1.7bn** Of capital committed in **2020**

Source: M&G *Information as at Q3 2021. Past performance is not a guide to future performance

Why Real Estate Debt

1. Traditional lenders have had to scale back lending activity due to new regulation following the global financial crisis, and have grown more conservative following the Covid-19 pandemic due to the instigation of a risk-off approach. Alternative lenders continue to grow their portion of the lending market, especially in underrepresented portions of the market.

2. Offers investors the ability to earn higher risk-adjusted returns than similarly rated corporate bonds via an illiquidity premium.

3. Downside protection for returns in volatile markets where underlying Real Estate Equity value is in decline. The Debt piece can remain 'In The Money' even when equity returns turn negative.

Source: M&G

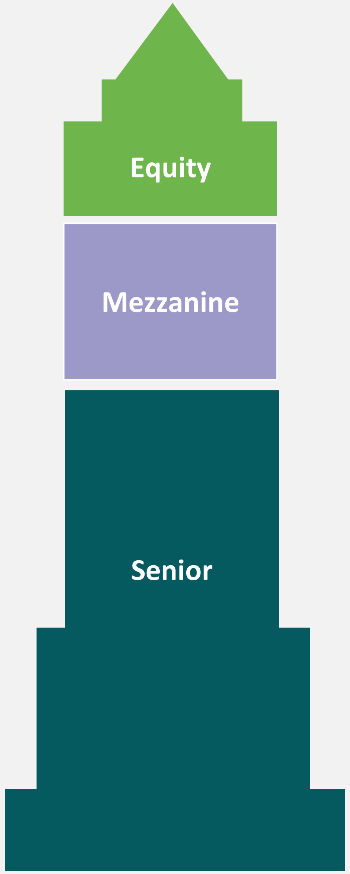
Typical Capital Structure

- **Equity**
  - First loss piece
  - Receives excess cash after payment of interest on debt

- **Mezzanine Loan**
  - Intermediate tranche of the capital structure
  - Payments are subordinated to senior debt
  - Second-ranking claim over the real estate

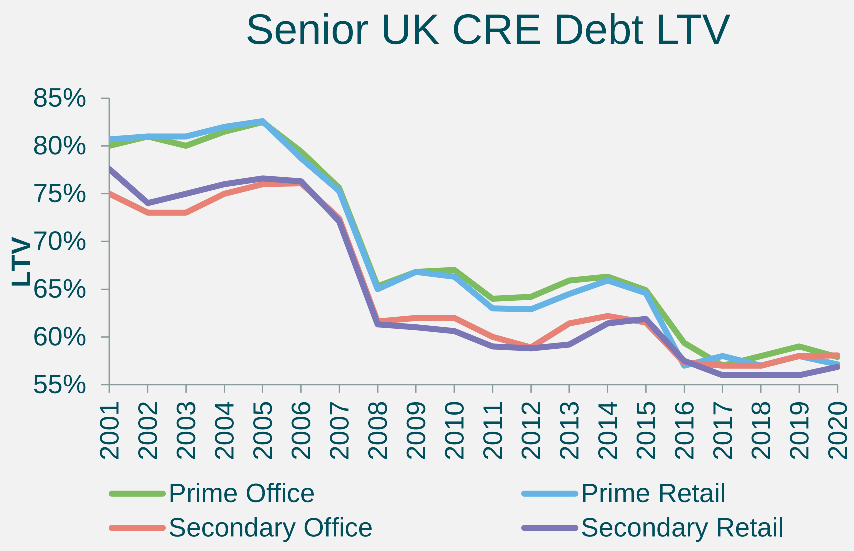
- **Senior Loan**
  - Lowest risk tranche of the capital structure
  - Payments received in priority to all others
  - First-ranking claim over the real estate
  - Receives payment first in the event of enforced sale or insolvency

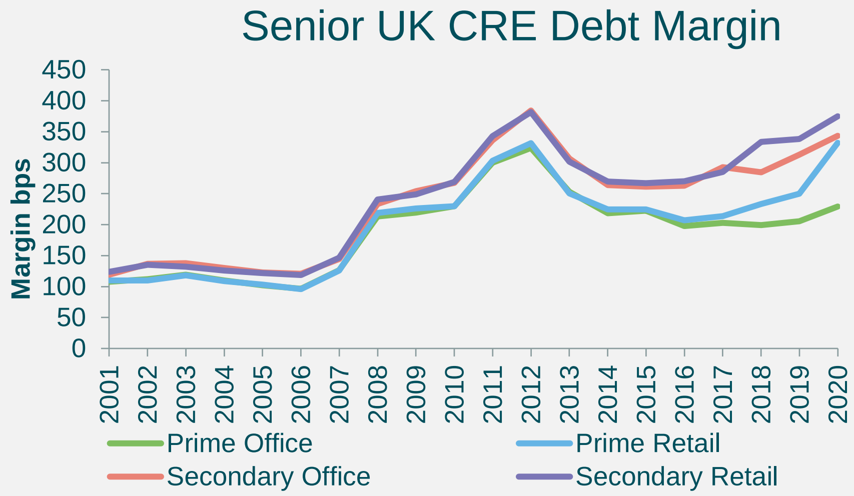
Capital Sources

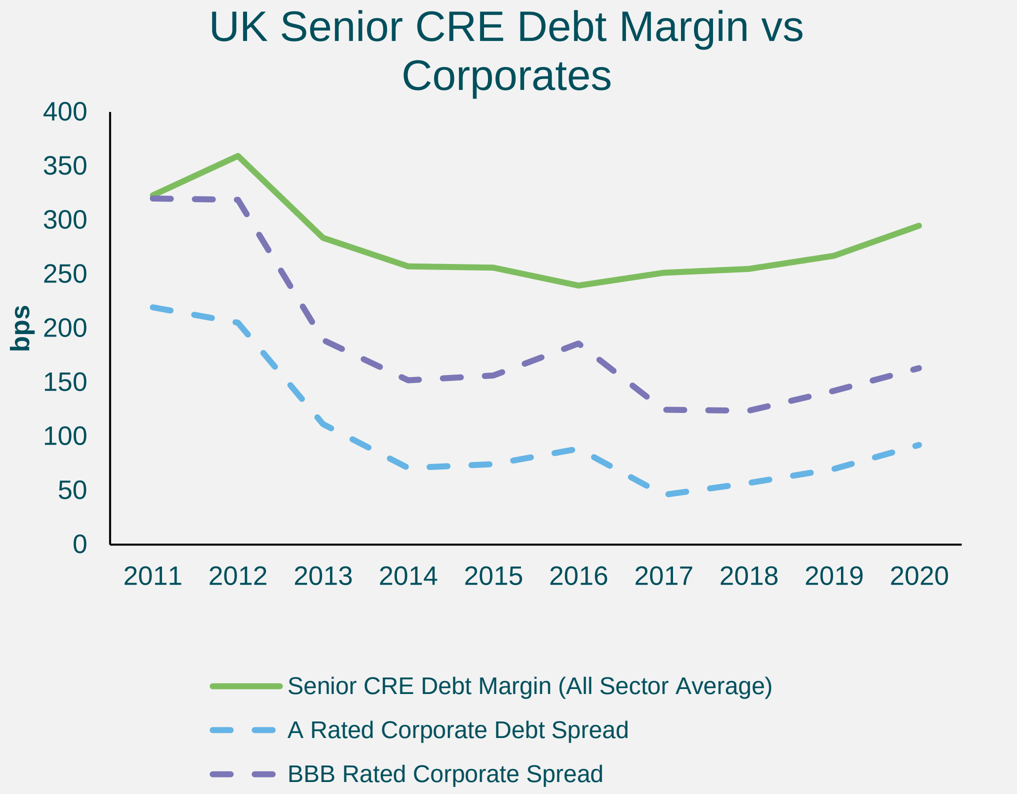


Source: M&G

Rebasing of Real Estate Debt Risk-Return and Attractive Relative Value





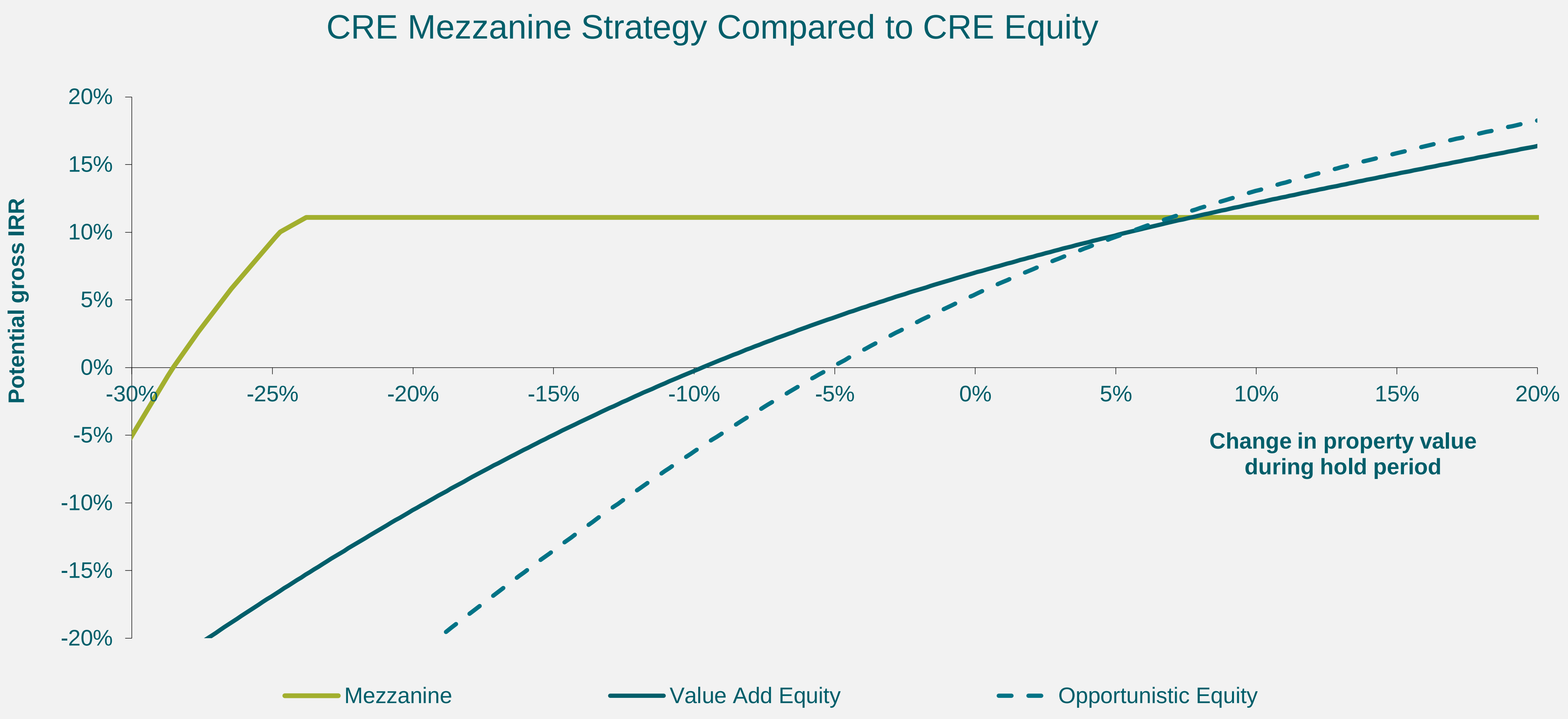


Source: As at 31 December 2020 - Cass Commercial Property Lending Report, YE 2020 (CRE Debt margins). As at 31 December 2020 - BofA Merrill Lynch (BBB and A rated corporate 3-5 year asset swap spread).

Source: The Cass Commercial Real Estate Lending Report YE 2020.

Attractive Returns with Downside Protection

CRE debt strategies can offer a stable level of returns compared to the potentially more volatile and unpredictable returns associated with commercial real estate equity investments, especially in markets where property values may fall.



Source: M&G, illustrative.

Key Observations

1

Market Opportunity Remains Significant:

- Partial dislocation in the market as a result of bank lender liquidity constraints.
- An average of €150 billion requires refinancing annually within the European CRED market, with further volume found in acquisition and development transactions.
- Non-bank lending within the UK and Europe accounts for 27% and 6% of overall lending volume respectively. Expectation that both will grow to align with the US figure of 40% over the next decade.

2

Specific Areas of Opportunity:

- Pending loan maturities present specific situations that can unlock enhanced value.
- Reduced liquidity in the transitional and development investment styles.
- UK and peripheral continental markets continue to provide enhanced premiums compared to core European Markets.
- Opportunities to selectively participate in secondary trades as banks look to reduce balance sheet exposure.

3

Increased divergence in Asset Performance:

- Focus on bottom-up analysis given increasingly divergent asset performance within individual sectors.
- Stock selection: a focus on reputable borrowers with robust business plans and strong track records.

4

Capital Preservation Remains the Priority:

- Direct origination provides opportunity to directly negotiate covenant measures with respective counterparties.
- Tight covenant protections enable lenders to engage with the equity whilst they still retain a significant stake within the Investment.
- Consideration given to valuation cyclicality and specific leverage requirements throughout the real estate cycle.
- Real Estate Workout and Restructuring experience.

Source: M&G

Attractive Market Returns on Offer

Geographic & Investment Style Considerations

Asset Class	Long term Considerations & Outlook
Logistics, residential and long income	Asset classes will continue to provide access to good quality defensive opportunities, with potential to access income reversion in some opportunities. Excess demand driving return down a potential concern.
Office	Structural shift in office demand may lead to more grey space and vacancy. However, we expect high quality office in prime locations to continue to perform well, with secondary locations and non prime stock expected to underperform.
Student Housing	We expect some level of normalisation in student numbers after this year. We continue to look to lend to experienced operators in sub-markets with attractive supply-demand dynamics.
Hotels	Some operators continue to require short term cash injections to address liquidity shortages. We remain optimistic on the long-term outlook of leisure offerings.
Retail	There is currently significant uncertainty as to the long term underwritable cashflows. Until the long-term picture becomes clearer, we remain very cautious and underweight retail, albeit we continue to find pockets of value in the Super Prime and Retail Warehouse space.

Source: M&G

Debt Structuring Considerations

The Tool Box

Loan Covenants	• Early warning / stop-loss triggers • Oblige borrower to do / not do something • May trigger default, cash traps and/or change in economics • Can be tied to any kind of financial metric • Contractual definitions are key
Security	• Mortgages (1st ranking or subordinated, active or passive) • Share pledges • Bank account pledges, receivables pledges, fixed and floating charges, subordination agreements etc. • Guarantees and other recourse
Other	• Funding sequence (sequential / equity first, pro-rata debt & equity) • Repayment sequence (incl. from sales, scheduled amortisation or cash sweeps) • Margin ratchets & profit share agreements • ESG targets • Prepayment fees

- In multi-tranche capital structures, the above needs to be considered vis-à-vis the borrower & the other creditors.
- Having a manager with in-house workout experience can be beneficial.

Source: M&G

Brief Case Study: Hotel Refinancing Loan

- Lending Opportunity: Whole Loan paying EURIBOR + 5.00% @ 60% loan to value
- Established and well reviewed 4* hotel portfolio on a franchise agreement

Loosely Structured Loan		More Firmly Structured Loan
• **LTV**: Loan Amount / Market Value • **ICR**: 12 month look-back	**Covenants**	• **LTV**: adjusted for employer liabilities and future capex obligations • **ICR**: 12 month look-back / 12 month look forward • **Increasing EBITDA thresholds**
• 1st ranking mortgage • PropCo share pledge	**Security**	• 1st ranking mortgage • PropCo share pledge + Lux HoldCo share pledge • Security over OpCo
• Interest accrual feature • Capex obligation on borrower tied to margin step-ups	**Structural Enhancements**	• Interest reserve • Opex reserve • Capex reserve + longstop dates for spending • Sponsor guarantee

Source: M&G

Risks associated with this fund

M&G Real Estate Debt Funds

The value of investments will fluctuate, which will cause prices to fall as well as rise and you may not get back the original amount you invested. There is no guarantee the objective will be achieved. Where past performance is referenced, please note that this is not a guide to future performance

- **Credit Risk**: the strategy may be exposed to the possibility that a debtor will not meet their repayment obligations.
- **Liquidity Risk**: the strategy investments may be illiquid, as a result it may be difficult for the strategy to realise, sell or dispose of an investment at an attractive price or at the appropriate time or in response to changing market conditions.
- **Concentration Risk**: due to a limited number of investments, the strategy may be affected adversely by the unfavourable performance of a single issuer.
- **Interest Rate Risk**: changes in interest rates may adversely affect the market value of some of the strategy investments.
- **Derivative Risk:** the use of derivatives for non-hedging purposes may expose the strategy to a higher degree of risk and may cause larger than average price fluctuations.
- **Currency Risk**: the strategy may be exposed to currency rate movements.

- Please note this is not an exhaustive list, you should ensure you understand the risk profile of the products or services you plan to purchase

* As required by Markets in Financial Instrument Directive II.

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