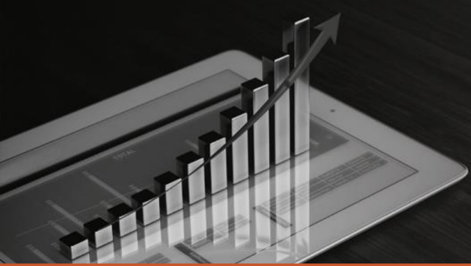

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The following publication is part of the Berenberg Funds and Solutions series:

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  - Bonds
  - Multi Asset
  - Risk-focused solutions
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*In **Insights,** we give you a better understanding of our investment philosophy and thinking*

REIT bonds: opportunities after the storm

Bonds issued by real estate operators have had an eventful journey over the last two decades. The bursting of the real estate bubble was followed by the Global Financial Crisis (GFC) in 2008, and the euro crisis in 2011. In the low-interest environment that followed, real estate companies issued increasingly high bond volumes. After a sell-off of real estate bonds during the COVID-19 crisis of 2020 and the subsequent recovery, risk premiums recently rose to their highest level since the GFC. Markets fear the consequences of rising financing costs, high inflation and a cooling of the economy. We believe that these fears are overblown and that favourably priced real estate investment trusts (REITs) – such as those operating in the logistics and data centre segments – are increasingly attractive.

Real estate operator for beginners

REITs allow investors to participate in the publicly listed real estate market - we focus on the bonds of these companies

Real Estate Investment Trusts (REITs) are publicly listed companies that own and lease real estate. They generate current rental income, interest income and distribute the majority of this as dividends. In addition, they have exposure to the increase in property values. Depending on national regulations, the maximum debt level of these companies is also limited. In return for complying with these and other restrictions, REITs are exempt from taxation at the corporate level.[1] Therefore, REITs are an exciting vehicle that enable investors to invest in real estate with built-in leverage. It is the bonds of precisely these companies that are the focus here.

Mortgage-REITs are not REIT bonds

REIT bonds differ from mortgage-REITs. The latter do not invest directly in real estate, but in securities that gain exposure to the real estate market both physically and synthetically. Synthetic means that the vehicle holds securitised packages of loans, such as mortgage-backed securities. This means that, in the event of a bankruptcy, these instruments bear the risk of a lower recovery rate than with REIT bonds. In addition, mortgage REITs are subject to fewer legal restrictions, so that – in combination with the increased complexity of the underlying assets – it is more difficult for investors to assess the actual risk profile of the assets.

REITs as real estate operators are to be distinguished from real estate developers with significantly different economic exposure

Furthermore, it is important to distinguish REITs as real estate operators from real estate developers, whose operational business consists of the construction of real estate and its profitable sale. Traditional REITs also sometimes develop real estate, but with the intention of subsequently leasing it out. Real estate developers generate high returns on capital in good times, but they also suffer more in an economic downturn. This is because they do not generate bridging and regular income in the form of leases and also have to grant high discounts on properties that have not yet been sold if demand for new buildings falls. Currently, they are also likely to suffer from rapidly rising building material prices and supply-chain bottlenecks.

REITs can be operationally specialised in one segment or be diversified across several real estate segments

REITs operate in different segments of the market (Fig. 1). The most common sectors include office, residential, retail, but also more specialised segments – such as data centres and wireless broadcast towers. REITs are either active in one sector only (so-called pure plays) or diversified across several asset classes. Different value

[1] Not all companies that own and operate real estate meet these conditions and are therefore REITs. We use the terms REITs and real estate operators as well as REIT bonds and real estate bonds synonymously.

drivers characterise the individual sectors. For example, while property location generally the most important factor for office REITs, the profitability of wireless broadcast towers REITs can be strongly attributed to the secular trend towards increasing mobile data transmission.

Fig. 1: Common REIT sectors

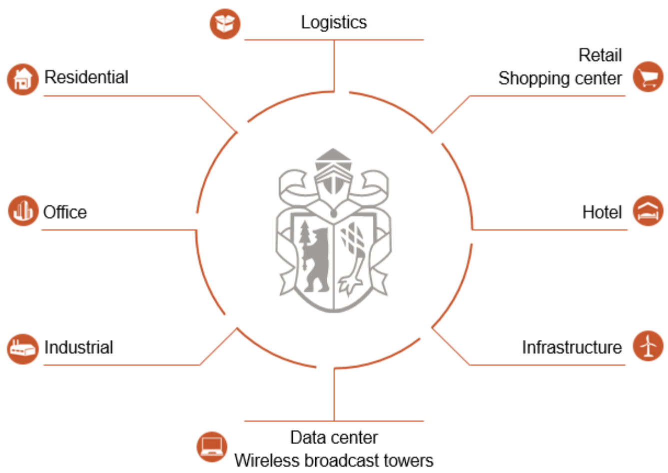
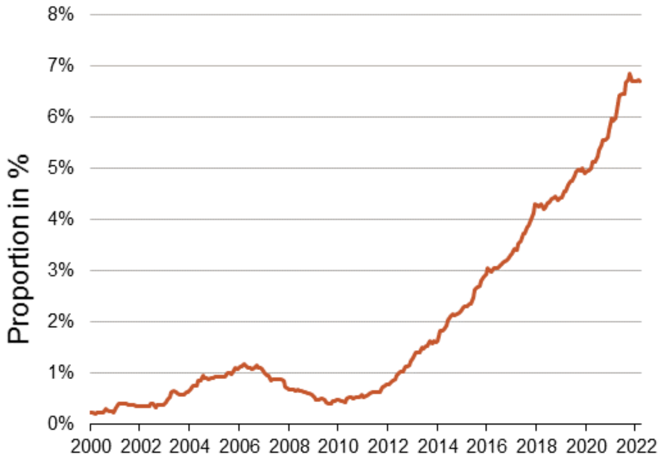


Fig. 2: Share of real estate bonds in the European corporate bond market has risen sharply

Share of the ICE BofA Euro Real Estate Index in the investment grade ICE BofA Euro Corporate Index (in %)



Data as of: 31.08.2022
Source: ICE, Berenberg

The rapid rise of the real estate bond segment

At the turn of the millennium, the European real estate market was much more fragmented than it is today and many real estate companies financed themselves through bank loans. The subsequent privatisation wave of municipal housing stocks and other publicly owned real estate led to a consolidation wave towards larger, capital market-ready companies that were both listed on the stock market and increasingly issued bonds. Between 2000 and 2006, investment grade real estate bonds increased six-fold in proportion to the total European investment grade corporate bond market. After the bursting of the global real estate bubble, this trend initially declined. From 2010 onwards, however, strong growth was delivered again (Fig. 2).

Bond investors saw an opportunity in the real estate sector to achieve a satisfactory return on their invested capital in the low interest rate environment

This is because the low interest rate environment sent investors hunting for yield. For institutional investors, such as insurers and pension funds, REIT bonds were an interesting asset class due to their good credit ratings, stable and visible cash flows, and the supposedly high recovery rate in the event of bankruptcy. In addition, the same investors often decided to invest directly in real estate in order to generate the required return on their invested capital via rental income. These investments were, in turn, also financed to a certain extent with debt capital, so that newly issued bonds from this segment flooded the market. Real estate companies are now the fourth-largest sector in the composite investment grade bond market, preceded only by financials, utilities and consumer goods.

Real estate bonds represent the fourth-largest sector within the corporate bond market

Table 1: Real estate bonds with relatively attractive yields

	Real estate-Bonds	Corporate Bonds
Effective yield	4.37%	3.23%
Effective duration	5.17	4.80
Average rating	BBB+	A-
Spread in basis points	305	197
Number of bonds in the index	339	3963

Data as of: 31.08.2022
Source: ICE

REITs already have to reward investors with a higher risk premium due to their complex organisational structure and increased interest-rate sensitivity. However, due to the steadily increasing debt issuance volume, investors demanded even higher risk premiums. Yields, nevertheless, represented historically favourable financing conditions for real estate operators. At the same time, the asset class became increasingly attractive for bond investors in view of the higher effective yields and improving risk metrics, such as a declining leverage ratio. This led to a self-reinforcing cycle.

The trend towards sustainable capital investment also favoured the growth of the real estate bond segment

In addition, there was the trend towards sustainable investment. Often, compliance with current construction standards – in regards to energy efficiency, energy sufficiency or the use of building materials – is sufficient for a property to be classified as sustainable. Therefore, even an existing property that meets current sustainability standards can be reclassified as sustainable according to a common green framework and then refinanced with a new green bond. Issuers who followed the sustainability trend enjoyed increased demand and, therefore, also achieved more favourable financing conditions for themselves. At the end of August of this year, real estate bonds were weighted twice as heavily in ESG indices as in broad corporate bond indices.

Real estate bonds are twice as heavily weighted in ESG indices than in broad corporate bond indices.

Risk premiums of real estate bonds currently at the highest level since the GFC – significantly higher than for other corporate bonds

Increased uncertainty in the early stages of the Corona pandemic led to only a temporary increase in REIT risk premiums

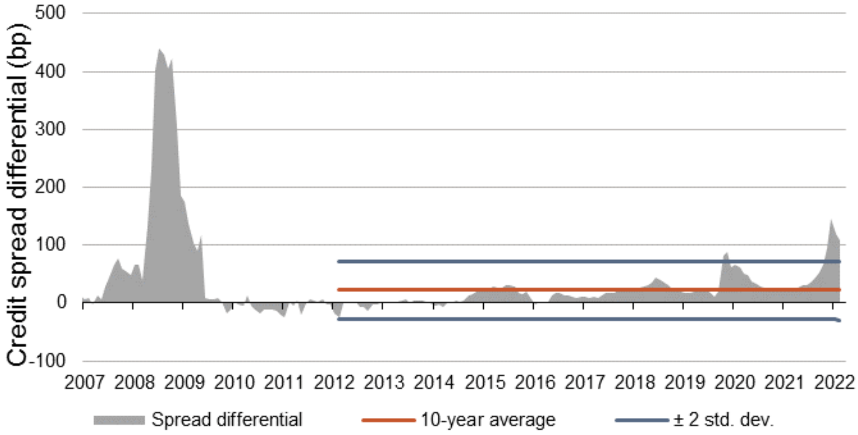
During COVID-19-afflicted 2020, lockdowns hit the retail and hotel industries particularly hard. With extensive opportunities for workers to work from home, office REITS also came under increased strain. Between January and April 2020, the risk premium of real estate bonds over government bonds jumped 80bp higher than that of corporate bonds (Fig. 3). However, the feared rent and payment defaults largely did not materialise despite months of lockdowns. Risk premiums, therefore, subsequently fell back to historically normal levels.

Risk premiums in the real estate sector are at their highest level since the global financial crisis in the current market phase

In the current year, real estate bonds again experienced a significant sell-off. A look at the spread differential between real estate bonds and the broad corporate market reflects investor pessimism: only during the GFC – which resulted from a real estate bubble – was the difference more pronounced. Currently, the spread between real estate bonds and the broad market is four standard deviations above the 10-year average (Fig. 3). Considering the fundamental factors, this situation seems exceptional to us and presents an opportunity for investors.

Fig. 3: Credit spreads of real estate bonds versus the broad corporate bond market

Differential between the spread over government bonds of the ICE BofA Euro Real Estate Index (EJRE) and the investment grade ICE BofA Euro Corporate Index (ER00) (in basis points)



Data as of: 31.08.2022
Source: ICE, Berenberg

The strong widening of spreads since the beginning of the year can be attributed to several factors.

- Recession concerns and rising interest rates could lead to declining market values of properties, causing credit metrics – such as the loan-to-value ratio – to deteriorate.
- With a recession looming, investors fear operational problems in the form of increased rent defaults and rising vacancy rates.
- The rise in interest rates associated with inflation could cause difficulties for REITs in refinancing their significant debt.
- Idiosyncratic events, such as those at Adler Group and the Swedish REIT Samhällsbyggnadsbolaget i Norden (SBB), have severely dampened investor sentiment towards the entire sector recently. Here, activist investors have voiced allegations of accounting irregularities, whereupon the bond prices of these issuers plummeted.

Property price outlook between inflation and recession

Depending on the investment segment, property prices are relatively more or less affected by a recession

The outlook for property price development is correspondingly important, as this drives the numerator of the leverage ratio of REITs and thus the risk premiums demanded by the market. These prices can be derived, on the one hand, from a summation of the expected rental income over the lifetime of a property and, on the other hand, from the market value that can be achieved in the event of a sale. According to a calculation by the asset manager Natixis, rents are quite sensitive to a change in GDP growth. If GDP growth were to deteriorate by one percentage point, the growth of prime rents for retail properties and shopping centres would historically fall by about 1.2 percentage points. Logistics and residential properties, on the other hand, react less sensitively and their prime rents would only fall by around 0.5 percentage points according to the calculation. The situation is similarly differentiated by geography, as prime rent growth in Spain and the UK, for example, is historically more sensitive than in the Netherlands and Germany. A possible decline in GDP growth in the eurozone is, therefore, likely to have an impact on property prices. We expect an energy crisis-induced recession for the eurozone in autumn and winter, followed by a strong recovery next year. The extent and duration of the recession should remain limited accordingly and not weigh on economic growth in the long term.

In recent years, the real estate market has experienced high levels of investment. In 2021, the investment volume in Europe alone amounted to €359bn. Rising financing costs and the threat of recession stand opposed to a new record first half-year of investment in European real estate in 2022. It is difficult to predict how the total investment volume will develop in the future, because higher interest rates and fears of recession will certainly prove to be a drag. However, unsurprisingly, both the type of property and its quality (e.g. location and age) play a decisive role for the two price drivers mentioned. Therefore, special attention should be paid to these characteristics when selecting an issuer.

REITs are well financed – no threat of a refinancing wave in the short term

The fear that REITs will find it more difficult to finance themselves when nominal interest rates rise is not entirely unfounded. If the fine balance between financing costs and operating business is upset, companies would have to spend proportionately more of their operating income to service interest costs. This reduces the companies' interest-coverage ratio, which is one of several risk indicators for investors. If this falls unexpectedly sharply, there is even the threat of a downgrading of the credit rating by the credit rating agencies, which could result in a further fall in bond prices.

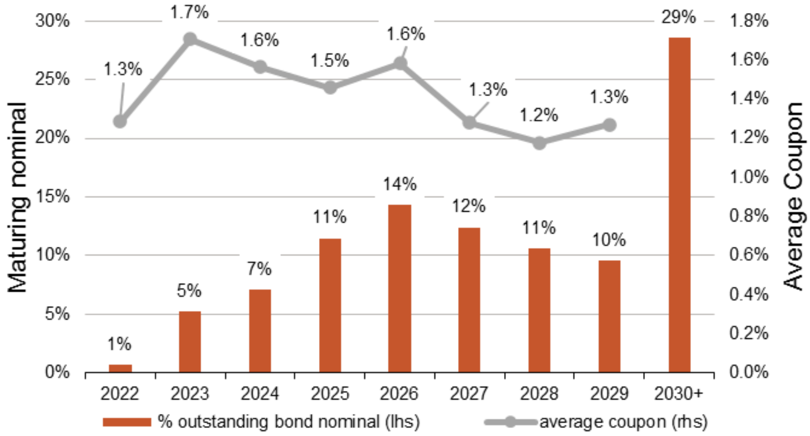
REITs have recently financed themselves on the capital market at favourable conditions and have therefore gained time to adjust to the new interest rate environment

However, REIT operators have used the last few years to bolster their financing structures on favourable terms in the negative interest rate environment, as well as to build up an equity cushion by issuing cheap hybrid bonds. Some market participants might be put off by the fact that real estate companies have to refinance almost €5.6bn of outstanding bonds in the next 12 months. However, this represents only around 3% of the total outstanding nominal bond volume. Overall, there is no threat of a refinancing wave in the short term (Fig. 4), so spreads in the secondary market should at least not widen further due to increased supply. Companies will have to gradually refinance maturing bonds and bank loans, but the higher interest costs for new issues will only be reflected in the P&L over time due to the staggered financing structure and long remaining maturities. In addition, the bonds with relatively higher interest rates are refinanced first. This means, on the one hand, that interest coverage ratios will fall more slowly than the market suggests and, on the other hand, that REITs will have time to adjust their operating business to the circumstances.

Higher coupons from newly issued bonds will only notably phase into the interest coverage ratio over several years

Fig. 4: Maturity structure of European real estate companies

Annual maturing bond nominal of the real estate bonds in the ICE BofA All Maturity Euro Broad Market Index in relation to total outstanding bond nominal (in %) and nominal-weighted average coupon (in %)



Data as of: 31.08.2022
Source: ICE, Berenberg

Burden of rent losses and vacancies remains manageable

REITs in commercial segments have often negotiated inflation-linked leases and can thus offset increased financing costs

In our view, fears about a dramatic operational deterioration of REITs are also exaggerated. On the one hand, REITs often have inflation-linked long-term leases with commercial clients. In this context, the rent adjustments take place only once a year, which means that there could be a temporary deterioration in the interest coverage ratio in the next quarterly financial results. However, if inflation settles back to a lower level in the medium term, REITs would jump to a significantly higher interest coverage ratio due to the time-delayed inflation adjustment. A temporarily lower interest coverage ratio is, therefore, more of a snapshot in time and not necessarily an indicator of persistent operational weakness.

Inflation-linked rents may increase tenants' credit risk to the REIT

On the other hand, one must also take into account that an inflation-linked adjustment increases the credit risk of the tenants – i.e. the counterparty risk for the REITs. Especially during an economic slowdown, it is conceivable that tenants will not be able to bear a mid-single-digit percentage increase in rental costs, as well as the sharp rise in energy costs, and will therefore run into financial difficulties. In this context, in particular, attention should be paid to a diversified tenant structure of the REITs, whereby tenants with a high credit rating would be an important prerequisite when purchasing the bonds. Even if this scenario does not occur, higher vacancy rates are conceivable in the medium term. Therefore, it is also important to pay attention to what the drivers of vacancy rates are and how to best position oneself here. For office REITs, it is ultimately the location, while other segments are less affected due to a secular demand overhang.

Scandals and technical factors overshadow solid fundamentals

Individual scandals have been weighing on investor sentiment for months

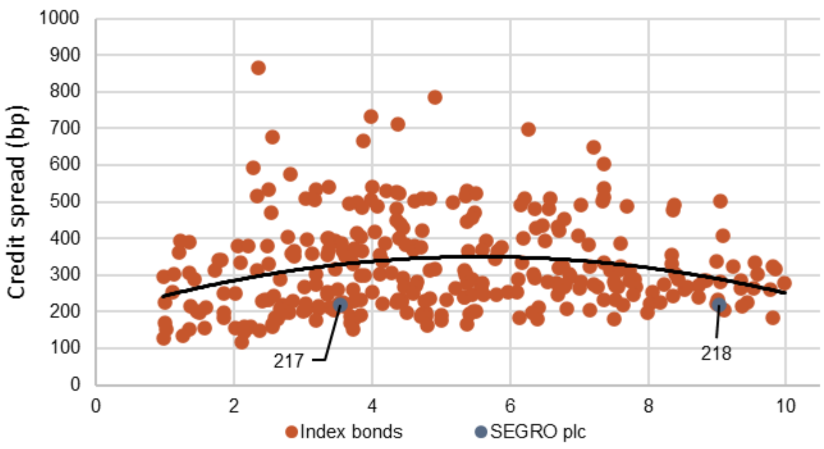
Another aspect that has weighed on European REITs for months is idiosyncratic scandals that have clouded investor sentiment. For example, when the British short-seller Fraser Perring accused the Adler Group of fraudulent actions and deceiving investors. The allegations were followed in April this year by the news that auditors KPMG were unable to issue an audit opinion for the 2021 financial year due to accounting inconsistencies. Since then, Adler Group's bonds have been falling almost unchecked. Similarly, Swedish REIT SBB was accused by financial analysts of unfair business practices and accounting irregularities earlier this year. We believe that these scandals have taken their toll on the entire sector – and unjustifiably so. It remains to be seen when this effect will subside and the broad investor community will again consider the segment independently of individual scandals. As the allegations against these and similar stressed names are still unclear, we do not want to try to "time" the market at the moment and do not consider their bonds in our own investments.

Technical factors in the market have led to a flattened credit spread curve and thus to attractive investment opportunities

Last, but not least, it seems to us that the magnitude of the sell-off in this segment is driven by technical factors. For example, asset managers have been forced to sell bonds at the short end of the maturity spectrum in the face of significant capital outflows this year because the market offered little liquidity at the longer end. This sometimes results in significant market distortions such as the flattening of the credit curve described below. While the current flattening of the curve is also a phenomenon in the broad corporate bond market, it is particularly pronounced in the real estate segment (Fig. 5). We believe that risk premiums have reached a temporary peak relative to those in the broad market and that buyers could benefit from a potential spread tightening. Even if this does not occur in the short term, investors can earn attractive yields.

Fig. 5: Flattening of the spread curve over the entire maturity spectrum

Risk premium of the 305 bonds in the ICE BofA Euro Real Estate Index over their remaining maturity (maximum 10 years)



Data as of: 31.08.2022
Source: ICE, Berenberg

For us, this results in attractive opportunities, especially for bonds with shorter remaining maturities. In normal market phases, spread curves show an upward sloping trend. With longer maturities, the issuer has to compensate the investor for the increased uncertainty regarding the future credit risk. Currently, however, this curve has flattened, so that in some cases one receives only a marginally higher risk premium for the longer dated, equally-rated bonds of an issuer (Fig. 5). For example, a bond of the UK REIT SEGRO plc, with a remaining maturity of 9.0 years, offers only one basis point greater credit spread than the equally ranked bond of the same issuer with a remaining maturity of 3.5 years. An investor, therefore, only receives a higher yield in the longer bond compared to the shorter one due to the risk-free interest rate. Across the entire bond and maturity spectrum, this offers the possibility of earning the same risk premium with a significantly lower interest rate risk from issuers with a strong credit rating.

Conclusion: buying opportunities in logistic and data centre REITs

Driven by factors such as a recession-related adjustment in consumer spending or the decline in demand for office space due to the hybrid work model, there is still a lot of uncertainty in the medium term in some segments such as retail and office REITs. Similarly, we are watching REITs in the logistics and data centre segments with interest as we expect a structural tailwind here.

Logistics REITs with properties in various Eastern European countries have been excessively punished since the Russian war of aggression

Logistics REITs operate both large standardised and specialised warehouses, as well as handling centres near major urban centres. The e-commerce market, which has grown strongly over the past few years, has been the driving factor here, with excess demand for available space driving up prices for logistics space. In view of the Russian war in Ukraine, REITs with properties in Russia and Ukraine have been hit particularly hard. But even where properties are located only in (NATO member) neighbouring countries, REITs have been slammed by the markets. In our baseline scenario, however, we do not currently assume that Russia would attack a NATO member. Accordingly, we consider some of these bonds to be oversold. In addition, we do not expect any significant increase in vacancy rates for logistics real estate in the event of a mild recession in Europe. Ultimately, it is important to pay attention to a broad diversification of both the tenant structure and the properties' location.

In the logistics segment, a large proportion of REITs have an inflation-linked rental portfolio, which should keep the interest coverage ratio stable in the medium term. We are particularly interested in bonds that have a shorter remaining term than the "weighted-average unexpired lease to first break" (WAULB) reported by the REIT – i.e. the weighted average remaining lease term until the first termination date on the part of the tenants. Provided there are no significant rent defaults, this means that the ability to repay interest and, in view of significant cash balances and access to free credit lines, the repayment of the nominal volume should be secured. The current flattening of the credit curve offers the opportunity to buy bonds with a shorter remaining term than the WAULB and thus to secure an attractive yield-to-maturity with low credit risk.

Attractive opportunities exist in bonds with a shorter residual maturity than the average weighted residual lease term of the REIT portfolio

Unlike logistic REITs, data centre REITs have recently been more resilient than the rest of the REIT market. On the one hand, this is because data centres are often located in internet cross-points – such as Germany, France and the Netherlands – and have, therefore, been little affected by the Russian war. On the other hand, the secular trend towards growing demand for data processing and, in general, cloud computing capacity and related specialised infrastructure is also the stabilising factor here. These REITs enjoy high pricing power and therefore prefer shorter lease terms in order to be able to raise prices more often. We expect rents in this segment to continue to grow disproportionately in the future, which provides a buffer for the interest coverage ratio from a lender perspective.

Data centre REITS benefit from secular trend towards ever-growing demand for cloud computing capacity

In addition, possible rent losses in the face of a recession in Europe are less of a burden on the business in relative terms. Compared to other real estate segments, data centres are largely modular. This means that, in the event of a tenant leaving, the time-consuming renovation/remodeling of the property can be avoided and the space can be re-let within a short timeframe. It is true that the returns in this segment are lower than, for example, in the logistics REIT segment, which is in line with the risk profile. However, data centre REITS offer a defensive opportunity to achieve yields of 3-4% at intermediate maturities.

Over the past few weeks, we have implemented these and similar opportunities in our flexible fixed income strategies, such as **Berenberg Euro Bonds** and **Berenberg Credit Opportunities.**

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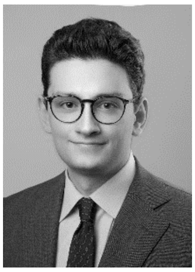

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