CORESTATE
Capital Group

Private debt and real estate financing –

a winning asset class in uncertain times

CORESTATE Group is a fully integrated investment manager with a leading role in the European Market in both real estate equity and debt. With a wealth of experience in investment and financing, we enjoy a strong standing in Europe where we have established in-depth real estate debt expertise. The aim of this study is to pass on this expertise to our customers.

Our research addresses the idiosyncrasies of the financing market in Germany and Europe and demonstrates why we think there is further growth ahead – and, for example, why English-speaking regions are ahead of Continental Europe. At times of uncertainty, private financing increases in importance compared to conventional bank financing, as COVID-19 has once again demonstrated.

Offering an attractive risk-adjusted yield and a high level of product and financing availability even in times of crisis, further strengthens its attractiveness for institutional and semi-institutional investors.

The quality and success of a financing transaction is, of course, hugely reliant on the underlying real estate. This study provides a brief summary of the short- to medium-term outlook for individual real estate sectors; always considering the financing environment.

Given that sustainability and ESG remain key pillars of the CORESTATE Group, we conclude the study with an overview of green financing opportunities, which we believe offer growth potential and the ability for financiers and investors to make an important contribution to society.

We hope you enjoy reading this study and that we can spark your interest in the topic of real estate financing.

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We are living in a disruptive era. Technical, social and ecological upheavals are changing the way we live and communicate, the economy and, last but not least, the investment market. And change is happening quicker than ever before.[1] The real estate market has also evolved against this backdrop, with private debt solutions becoming increasingly important over the past ten years. The number of newly created real estate debt funds has increased by a factor of between three and four since 2010, and private debt structures remained extremely popular among investors in the COVID years of 2020/21.

There are good reasons for this: Not only does the private debt market offer an attractive balance between risk and return, as this and other studies show,[2] it also offers defensive supply-demand characteristics that not only remained stable in a crisis such as COVID-19 but benefited in this challenging environment. The higher the risk aversion among banks, the more financing requests are received by private providers. This is the result of an internal analysis of CORESTATE Group's financing opportunities received over the past few years. While there was a bottleneck for investment opportunities in real estate equity, there have been plenty of opportunities in the private financing area and the market has remained highly liquid.

In this paper, we discuss the current real estate financing environment and shed some light on private debt as an attractive investment.

- We analyse the field of **private real estate financing,** outlining the market as well as recent trends, particularly the disproportionately high growth observed over the past few years.
- We address current trends and topics affecting the **European real estate markets** and relate these to the financing context, as the success of real estate financing continues to depend to a large extent on the quality of the underlying assets.
- We round off this paper with an analysis of sustainable financing opportunities, in which we pinpoint the potential and the challenges of **green real estate financing**.

1 Who would have imagined the advent of NFTs, rapid institutionalisation of crypto currencies and meme stock rollercoasters five years ago?
2 See also ARES: Core Commercial Real Estate Debt, 2020; DWS: Commercial Real Estate Debt – An Insurance Perspective, June 2020; Barings: The Case for European Real Estate Debt, April 2020

The real estate financing universe

Private real estate financing appeals to investors for a variety of reasons. Firstly, it is well suited as an income-generating asset class for portfolio diversification and broadening asset allocations. Private real estate financing provides access to a broad range of underlying real estate types and sectors. Through fund solutions and broad structuring options, it also offers access to large-volume flagship and landmark buildings such as the Fürst in Berlin.[3]

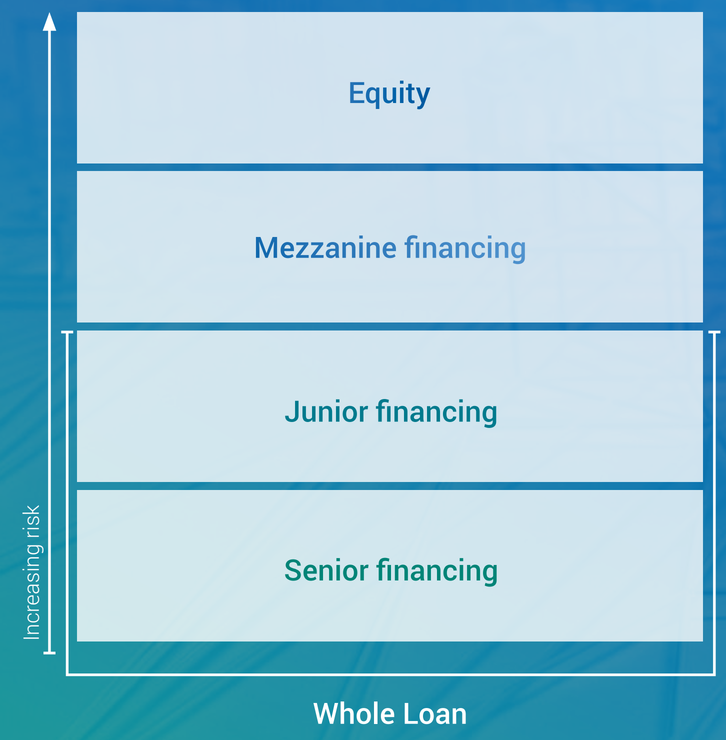
Given that most real estate investments and project developments are backed by financing, the overall real estate financing market is very large, and the share of private financing continues to rise. From an investor perspective, the market is broad, deep and multi-layered.

Most real estate financing provides constant cash flow through regular interest payments, which in the case of existing properties is covered by the underlying rental income. As a result, investors are offered attractive risk-adjusted return characteristics with yields that can vary greatly depending on the risk profile. Expected returns in the low-risk segment of senior financing start at 0.8% to 1.5% and can rise to 15% and more for mezzanine financing. Whole-loan structures, which are a hybrid of senior and junior tranches, achieve distributions of approximately 4% to 7%, depending on tranche structure, the total loan-to-value (LTV) ratio and the quality of the tenant.

3 Das Fürst ist eine Quartiers-Projektentwicklung am Kurfüstendamm mit ausgesprochener Nutzungsmischung auf einer projektierten Gesamtfläche von knapp 100.000 m^2. Das Projekt wurde 2021 von der CORESTATE Bank mit EUR 1 Mrd. finanziert.

Illustration of the financing landscape for real estate investments

Risk tends to rise in correlation with the LTV and decreasing debt service capacity, as the equity buffer shrinks and the risk of insolvency increases. At the same time, factors such as the existence of ongoing cash flows to service the debt, tenant creditworthiness and the average remaining lease terms are also significant. In the case of project developments, where rental income will only be generated in the future, there may be a somewhat higher level of risk, which is however also reflected in the expected return.



Mezzanine financing
Subordinated capital: typical LTV <90%; bridge financing; short to medium term maturity; higher risk

Junior financing
Junior collateral; typical LTV <80%; medium to long term maturity; moderate risk

Senior financing
Senior collateral; typical LTV <65%: medium to long term maturity; very low risk

Whole Loan
Usually with senior collateral; combination of senior and junior tranche; typical LTV <80%; low risk

Private debt real estate financing market with structural tailwinds

Over the past few years, the private real estate financing market has been experiencing a structural upturn and become increasingly professional and institutionalised. In 2019, demand from investors for private real estate debt strategies was at a record-breaking level with capital commitments of EUR 32bn, 50% higher than the previous year's level.[4] Although COVID-19 has had a significant impact on equity real estate investments, the impact on the real estate debt sector has been significantly lower – in fact, the share of assets under management (AUM) in global debt vehicles in 2020 climbed to 9.4% of all non-listed real estate products – 180 basis points above the 7.6% reported in 2019. In Europe, this trend was even more pronounced, with the share of private debt AUM rising from 3.6% to 8.1%[5]

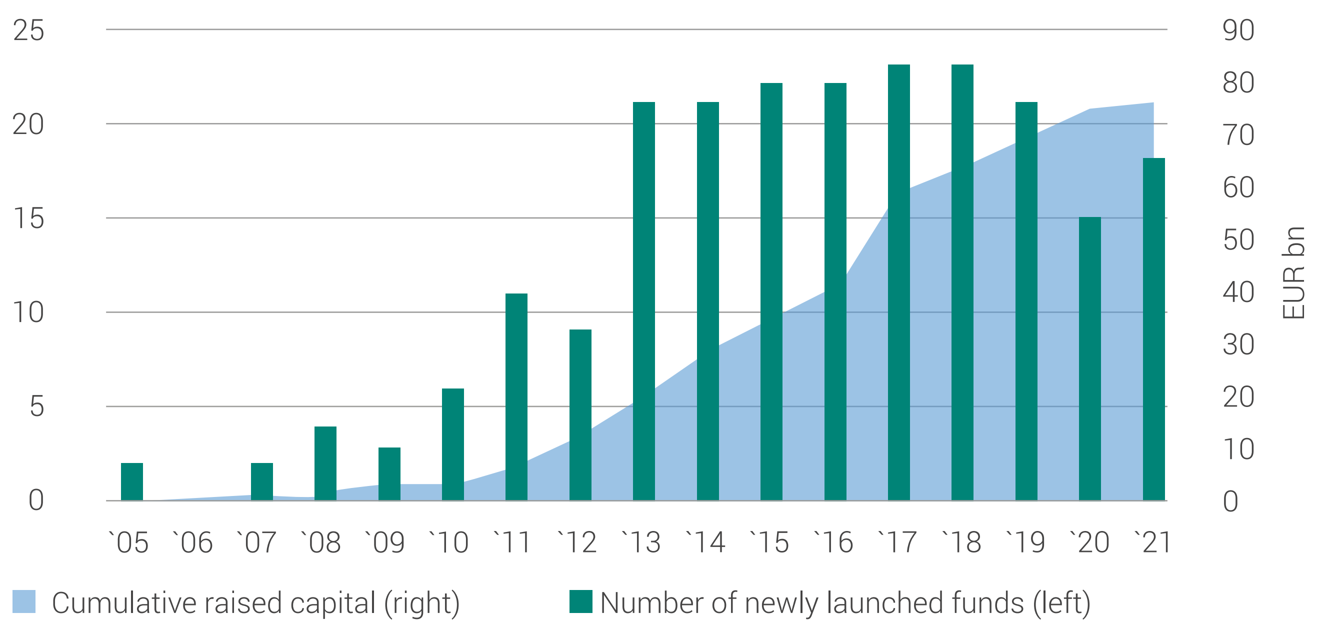
Structural and regulatory changes following the Great Financial Crisis (GFC) paved the way for private debt products

The impact of the 2008/09 financial crisis was immense and affected both real estate markets and financing markets around the world. Before the financial crisis, LTVs tended to be at very high levels – in some cases close to 100%. When the real estate markets crashed, many of these loans went down with them. This, coupled with the general risk aversion among banks, resulted in bank lending becoming significantly more restrictive and the average LTV declining from over 70% in 2007 to approximately 40% in 2009.

In the non-core segment, i.e. for value-add and opportunistic investments, it was generally difficult to obtain bank financing. As a consequence, the market environment became increasingly attractive for alternative and private financiers. In subsequent years, interest in private financing solutions and the supply of private debt funds that granted investors access to this market remained high.

4 Vgl. INREV: Debt Vehicle Universe, 2020
5 INREV: Fund Manager Survey 2021

Europe – market for real estate financing funds



The rising demand is primarily driven by institutional investors. For example, the share of capital commitments from pension funds has risen to 45% in 2020 and is therefore significantly higher than the values recorded in 2018 (13%) and 2019 (8%): a reflection of the institutionalisation of the sector.[6] This is also demonstrated in a recently published study that identified private debt solutions as an attractive alternative to hedge fund solutions.[7]

Source: Preqin, CORESTATE Research
6 INREV: Capital Raising Report 2021
7 SS&C Advent: Ist Private Debt der neue Hedgefonds? 2020

Latest developments in the COVID-19 environment

The current cycle is following a similar pattern to the financial crisis. In 2020, when the impact of COVID-19 on the economy and on the real estate markets was extremely difficult to predict, banks became extremely restrictive and risk-averse. In this environment, the relevance of private providers such as debt funds rose again significantly.

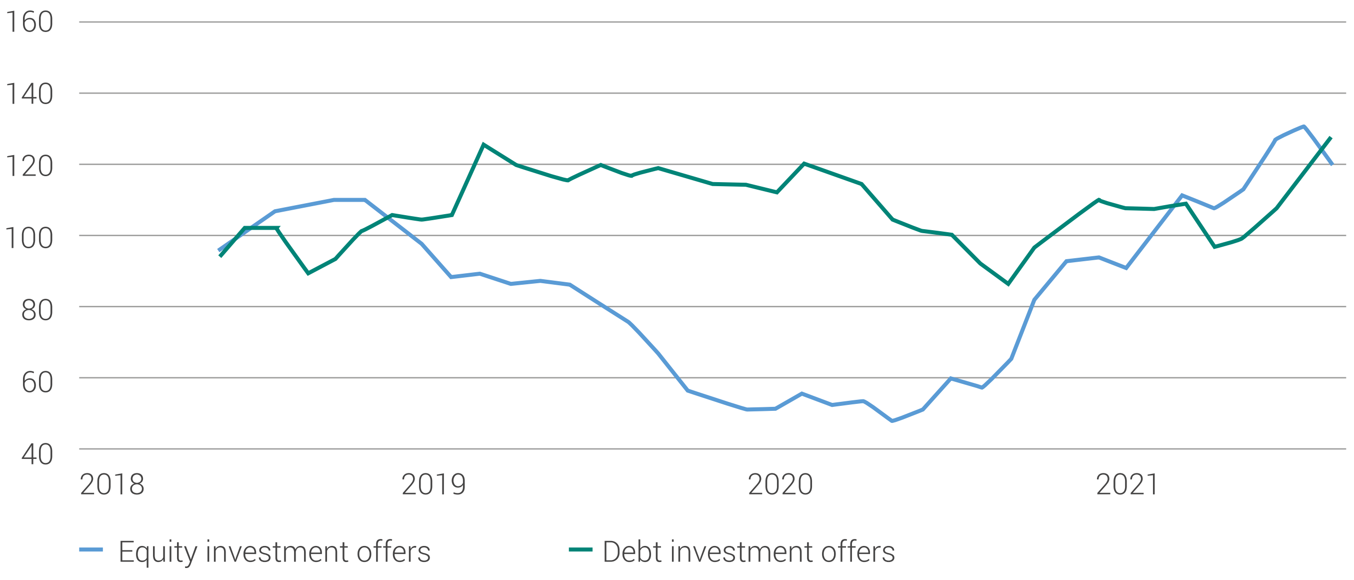
As an internal analysis of investment and financing opportunities recorded within the CORESTATE Group shows, there was a significant decline in the number of offers in the investment segment. This recovered again over the course of 2021.

At the same time, the number of financing opportunities has remained stable, and even increased for a time. As the last two crises have shown, the private debt market tends to be rather robust when it comes to capital allocation: investor funds can be drawn down, invested and "put to work".

However, the performance and success of a loan depends significantly on the underlying property.

We therefore discuss current market themes and challenges in the next chapter: *"The European real estate markets – structural and cyclical developments".*

Corestate Group: Recorded investment opportunities* Index, 2018 average = 100



* 6-Monats Durchschnitt; Die hier dargestellten Werte spiegeln nur eine Annäherung an den Gesamtmarkt wider, da es sich um eine CORESTATE Group interne Erfassung von Angeboten handelt.

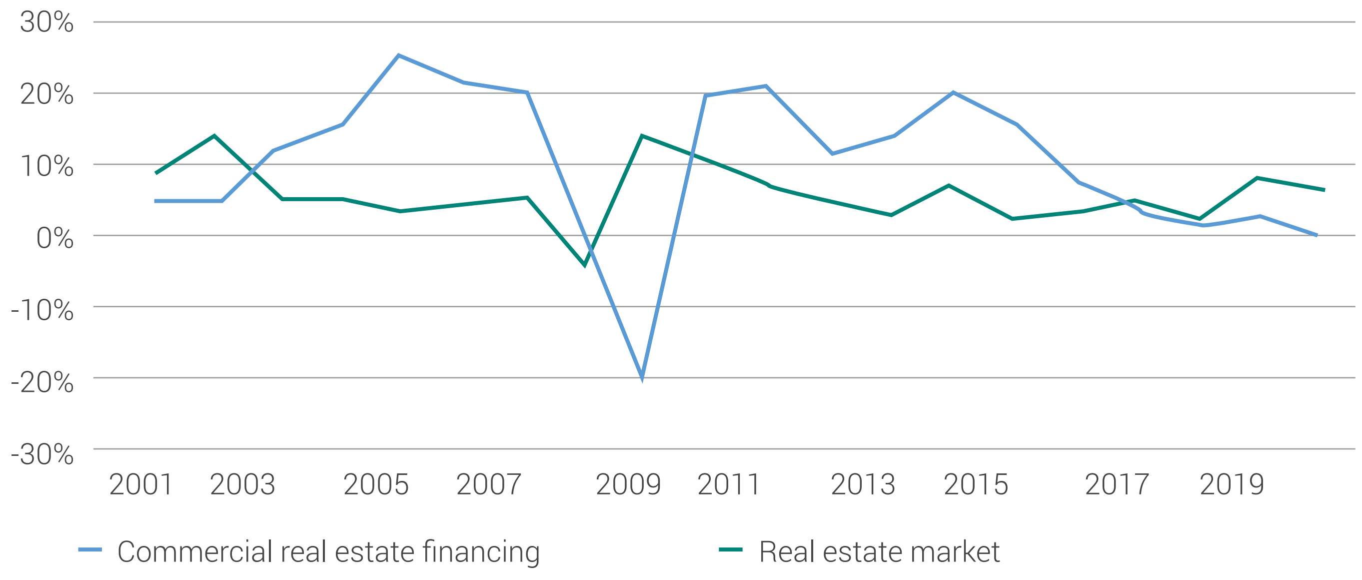
Expected returns in the private debt sector

The real estate financing sector is characterised by relatively high and stable risk-adjusted returns. Risk profiles differ depending on the type of financing – with lower risk in senior or whole loan transactions than in junior or mezzanine structures. In both cases, however, investments are backed by real assets that offer ongoing distribution. At the same time, the nominal values of the financing are lower than the value of the real estate – in senior financing by a significant margin. This has changed after the 2008/09 financial crisis, when LTVs on financing and project developments were much higher at over 70% and therefore ran into difficulties more quickly. Nowadays, the overall market remains more restrictive and, despite the boom, LTVs are not excessive.

There is no systematic evaluation of the performance of the European private real estate debt market yet. However, an analysis of the US market shows that risk-adjusted returns are attractive, and the asset class is significantly less volatile than the traditional real estate investment market. As such, the real estate financing market is particularly attractive for those investors, which are reliant on a stable and regular distribution, i.e. primarily institutional investors such as pension funds and insurance companies.

	Commercial real estate financing	Real estate market (all sectors)
Total return	5.9%	10.1%
Volatility (standard deviation)	4.0%	10.5%
Return per volatility (Sharpe ratio)	0.68	0.65

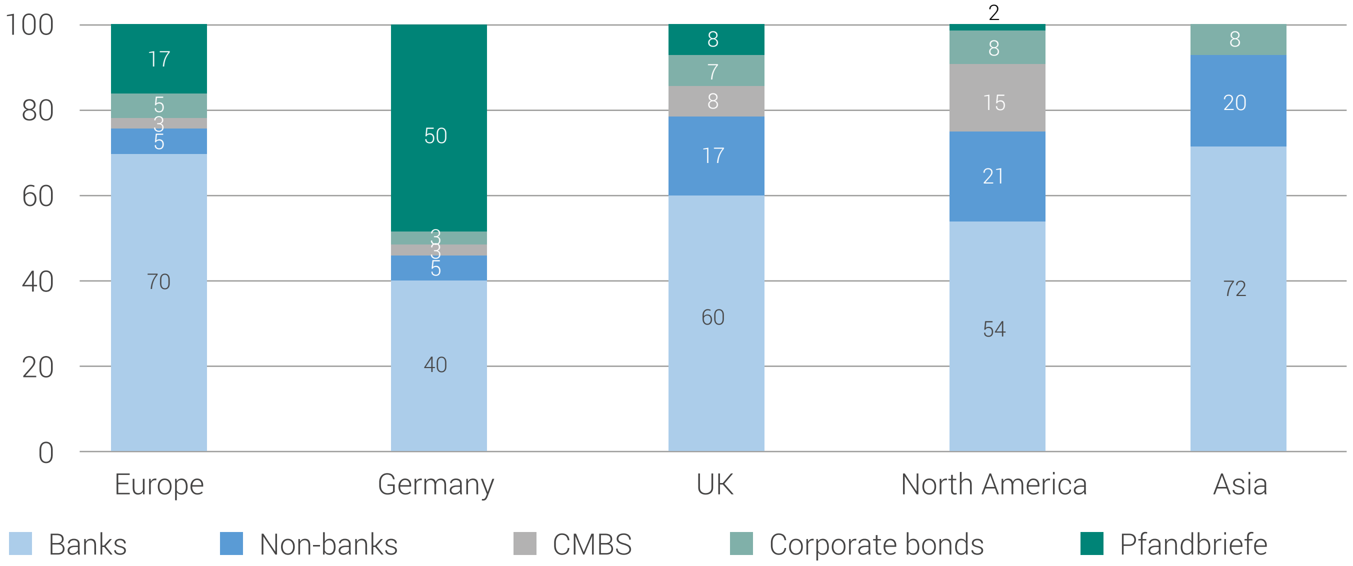
USA – total return comparison



Source: Giliberto-Levy Commercial Mortgage Performance Index, PMA, Federal Reserve St. Louis, CORESTATE Research

Outlook

Share of real estate financing lenders (in %)



The real estate financing market in Europe continues to be dominated by “traditional” creditors such as banks and insurers. However, private financing solutions, such as private debt funds, are on the rise and are benefiting from investor demand for stable and regular returns. Broad investment opportunities across various risk classes offer access to a variety of return profiles.

At the same time, demand from borrowers remains high, ensuring that investor funds are drawn down and “put to work”.

Therefore, there are very good prospects for further growth in the real estate financing asset class.

Source: Helaba

Europe’s real estate markets – structural and cyclical developments

In this chapter, we briefly analyse the current cyclical and structural trends on the European real estate markets. We will be forward-looking and focus on Germany, while always consider implications for the real estate financing market.

General environment

As is currently being demonstrated, predicting the future course of the pandemic is near impossible. After an increasingly optimistic outlook had developed in the past months until October/November 2021, Germany is currently facing difficult developments again. Due to a rapid increase in infection figures and critical levels of intensive care capacity, partial lockdowns are being discussed even though recently, the leading candidates for the German federal elections vowed that no further lockdowns would be imposed – a testimony to how unpredictable this virus is.

Consequently, Germany’s anticipated economic growth in 2021 has been lowered to 2.7%, with a significantly stronger growth rate of 4.6% expected for 2022. This should have a generally positive impact on the German economy and strengthen consumer spending, for example.

However, economic sentiment remains cautiously positive. The IFO index has declined significantly to 97.7 points from its three-year high of 101.8 back in June. Besides the pandemic, the main reason for the caution lies in rising inflation, partially coupled with a shortage of raw materials, as well as the possible development of the labour market once government support is reduced. The overall environment is improving, but challenges remain ahead.

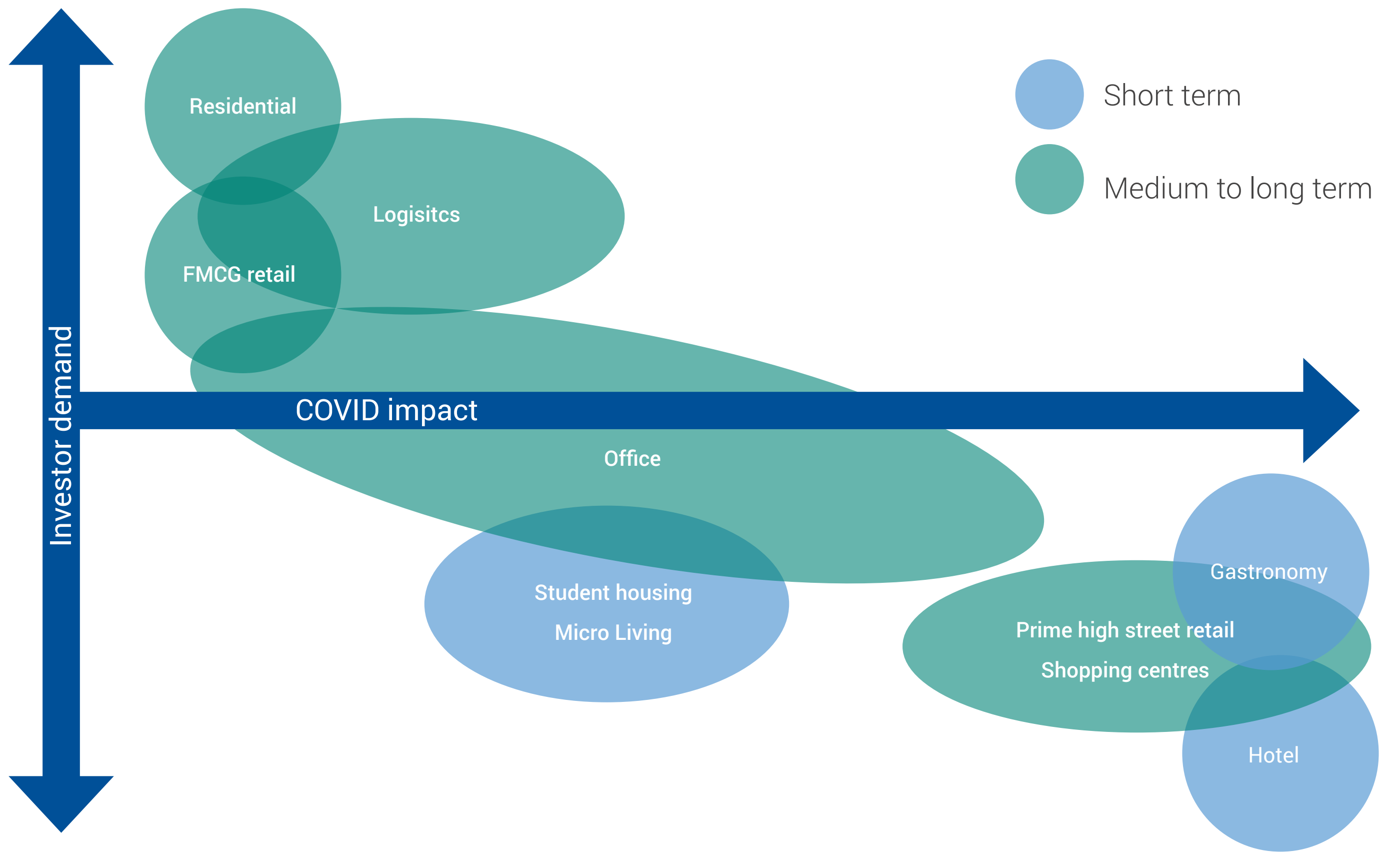
Expansive monetary policy as a critical driver of the real estate markets

Against this backdrop, it is likely that the ECB will maintain interest rates at a low level or at zero in the medium to long term. In the zero-interest rate environment, the real estate asset class remains very attractive for investors as a distributing investment with adequate returns. Demand for real estate investments should therefore remain high, bolstering not only property values but also demand for financing.

Risks currently tend to lie on the income and rental side, which can vary greatly depending on the sector and property type. There are both cyclical and structural aspects to consider here, which is why we will be looking into the individual sectors and providing an outlook for each one.

8 At least according to the statements made at the first TV debate broadcast on RTL on 29 August 2021.

COVID-19 impact on the real estate sectors Stylised illustration



Source: CORESTATE Research

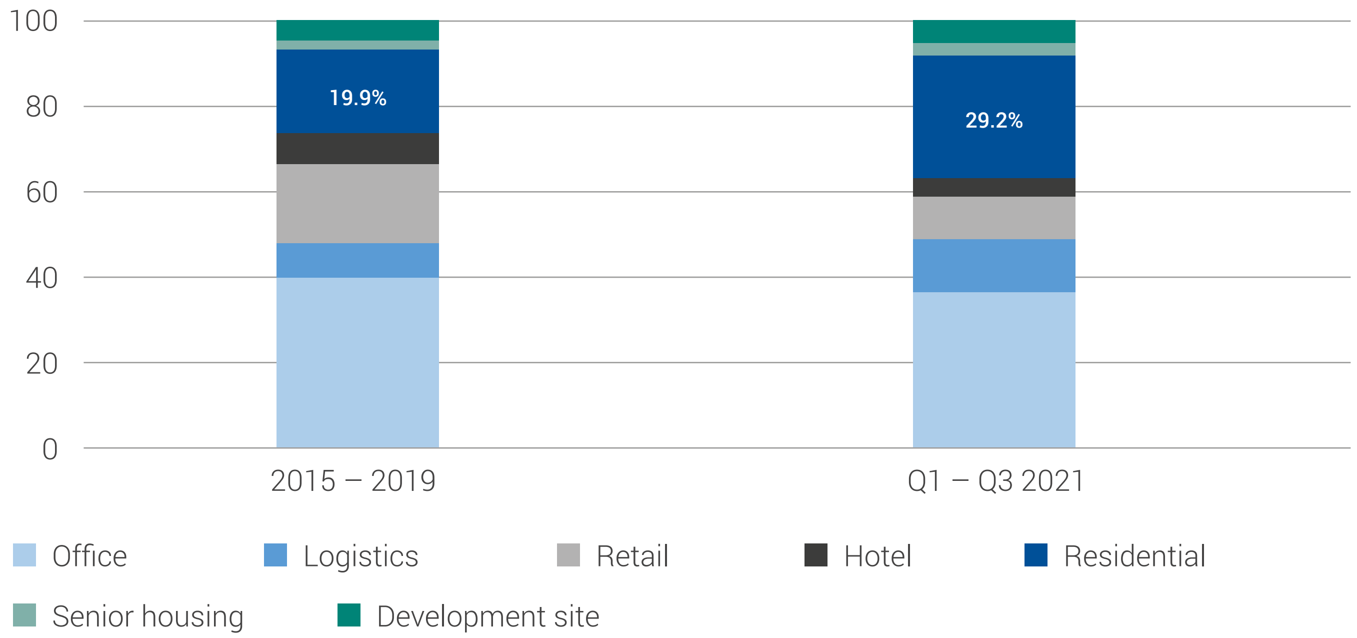
SECTOR OUTLOOK: RESIDENTIAL

Traditional residential

Due to the high **income stability** of this asset class, investor demand remains very high, which has caused property values to rise even in both COVID years, 2020 and 2021. The significant increase in the attractiveness of the residential real estate market can be seen in the distribution of transaction volume by sector. While the share of residential real estate stood at approximately 20% in each of the five years prior to COVID-19, this figure rose to 30% in the first three quarters of the current year, becoming the strongest sector after office real estate.

Germany is the largest investment market in Europe and offers many potential investment targets due to its polycentric structure. This opens up investment and financing opportunities in many second and third tier markets, where potential yields are higher than in the top markets. COVID-19 may boost the appeal of smaller locations, particularly those on the outskirts of major cities.

Germany – transaction volume by sector



Source: RCA

Micro Living

With its various sub-categories, such as student living, serviced apartments and assisted living, micro living meets the **zeitgeist and long-term megatrends**.

Student residences remained relatively stable on the operational side during the COVID-19 pandemic, with high occupancy rates. Looking ahead, student residences should be in an even better position in future, as good education, and thus universities, are gaining in importance and demand in difficult economic times. Also, against the backdrop of increasing automation[9], the situation on the labour market could remain tense in the longer term. In this environment, the best possible education should be the key to success in the labour market. In the medium and long term, demand for university education and student living should therefore remain high.

As a "hotel-like" asset class, **serviced apartments** were viewed critically by investors during the COVID-19 pandemic, which put pressure on investment demand -. In the meantime, sentiment has turned somewhat positive again, as serviced apartments were a more defensive category within the hotel industry with relatively high occupancy rates.

This is due to the higher share of long-term guests in serviced apartments, which stabilises the occupancy rates.

9 In future above all also by office workers. See also: McKinsey: Jobs lost jobs gained: Workforce transition in a time of automation, 2018

SECTOR OUTLOOK: CITY QUARTERS

Mixed-use city quarters, often developed to revitalise underused urban areas, are not only popular in urban planning, they also meet the requirements and tastes of different types of users and tenants. By creating synergies among different types of use within a city quarter, a positive overall concept can be implemented that appeals to and attracts both residents and commercial tenants.

Fundamentally, city quarters are subject to the same dynamics as the individual residential, office and retail sectors. However, in a coherent concept, they are more than the sum of their parts and benefit from the synergies that arise from the mix of uses.

At the moment, the market for city quarters in Germany is worth approximately EUR 200bn but is still relatively new from an institutional investor perspective. However, things are now changing, which increases the potential in terms of financing. As an asset class of the future10, which incorporates current megatrends such as new mobility, new work, sustainability, etc., city quarters should generate above-average demand from tenants in the long term – provided the overall concept and the location are the right fit. With plenty of development projects in the pipeline, including those that are still in the planning phase, there is high demand for financing.

10 Oxford Economics

SECTOR OUTLOOK: HOTELS

Prior to the COVID-19 pandemic, the hotel sector was a strongly growing segment. Tourism (leisure and business travel), and therefore also the hotel market, were bolstered in particular by the following factors:

a) **Increasing prosperity in the emerging markets, particularly in China, with a corresponding rise in travel**

b) **Changing consumer behaviour in industrialised nations, away from material consumption and more towards immaterial consumption (experiences instead of possessions)**

c) **Globalised business relationships**

In principle, these drivers should remain intact after COVID-19, which is why a marked recovery of the hotel industry is likely. However, particularly for business travel we expect that even in the medium term there will be fewer trips than before. Travelling for a single meeting may continue to be replaced by simple video calls. Alternatively, multiple meetings in one location may be pooled together, perhaps even involving an overnight stay. This means that there is definitely potential for recovery for the hotel industry in terms of business travel (providing the pandemic subsides).

Tourism Economics expects European tourism flows to recover and overnight stay figures to return to pre-COVID-19 levels from 2023.[11]

Some locations are likely to recover more quickly, particularly those less reliant on international and business travel. This means that countries with a strong and large national economy, such as Germany, should see a relatively rapid recovery.

This development is also strengthened by the increasing awareness for sustainability, a trend that already had an impact on the hotel industry before the COVID-19 pandemic. Again, this should have less of an impact on markets that are less reliant on air travel and instead can rely on national and regional guests.

In the long term, the key to the success of a product in the hotel industry, and therefore also of the underlying financing, will be a coherent overall idea combining **location, operator and concept.** We believe that hotel investments will experience a comeback in the next 12 to 18 months and also offer some potential in terms of financing. With banks remaining cautious, this is an area that should see an increase in activity from a private real estate debt perspective.

11 Tourism Economics: Travel and Tourism DACH Region

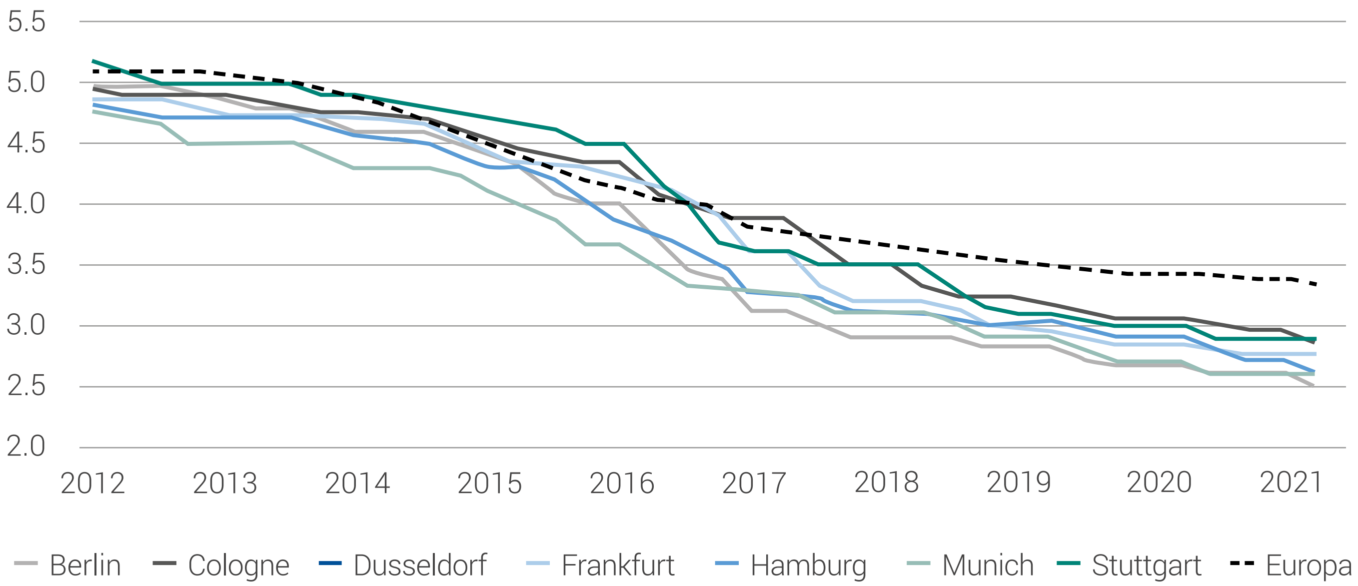
SECTOR OUTLOOK: OFFICE

The office sector is currently experiencing structurally and cyclically uncertain times. Therefore, selective acquisition strategies are crucial for the success of an investment.

In cyclical terms, the economic situation in 2021 and to some extent also in 2022 will have a dampening effect on the office rental market. The specific impact varies depending on the country, the individual market and on the dominant industries in that market. Banking, for example, poses a higher risk than the pharmaceutical and communications industries or the public sector.

Against this backdrop, investor interest focuses on long-term leases with secure tenants. Investor demand has remained high in this core part of the market, despite the risks, with initial yields for prime yields increasing even further over the course of the year and resulting in Germany offering the lowest yields in Europe.

Germany – office prime yields



Source: PMA

Beyond the cycle, the office market is currently undergoing a **comprehensive structural change.** The location, time, and format of office work has become much more flexible over the

past few years due to modern users (particularly from FAANG industries). This trend has been picked up and amplified by modern co-working providers. COVID-19 has placed many of these concepts at the heart of everyday office life. It can be assumed that office-based work will remain more flexible in the future and that demand for office space will likely decline rather than increase. However, due to ongoing rental agreements, this is a slow and long-term process.

Furthermore, this development is not likely to affect all office locations equally: With the use of the office set to become a conscious decision rather than an obligation, office buildings where companies and employees want to be will have the upper hand. This can be achieved through good and urban locations, which are easily accessible, additional services, flexible rental agreements, agglomeration synergies and the like.

Other trends that tend to point to a decline in demand for office space include the aforementioned automation of (office) work and demographic developments. Despite immigration, our ageing population means that there will be a decline in the number of workers in the medium to long term.

We therefore assume that the market will require **different office space rather than more office space** in the long term. The modern form of office-use is considerably more flexible, service-oriented, and communicative than in the past. Many existing buildings can no longer offer these features and are likely to require adaptation in the medium- to long-term.

Real estate financing in the office sector therefore makes the most sense in the long term in cases where modern office buildings are developed or where existing offices are modernised through conversion or refurbishment.

SECTOR OUTLOOK: RETAIL

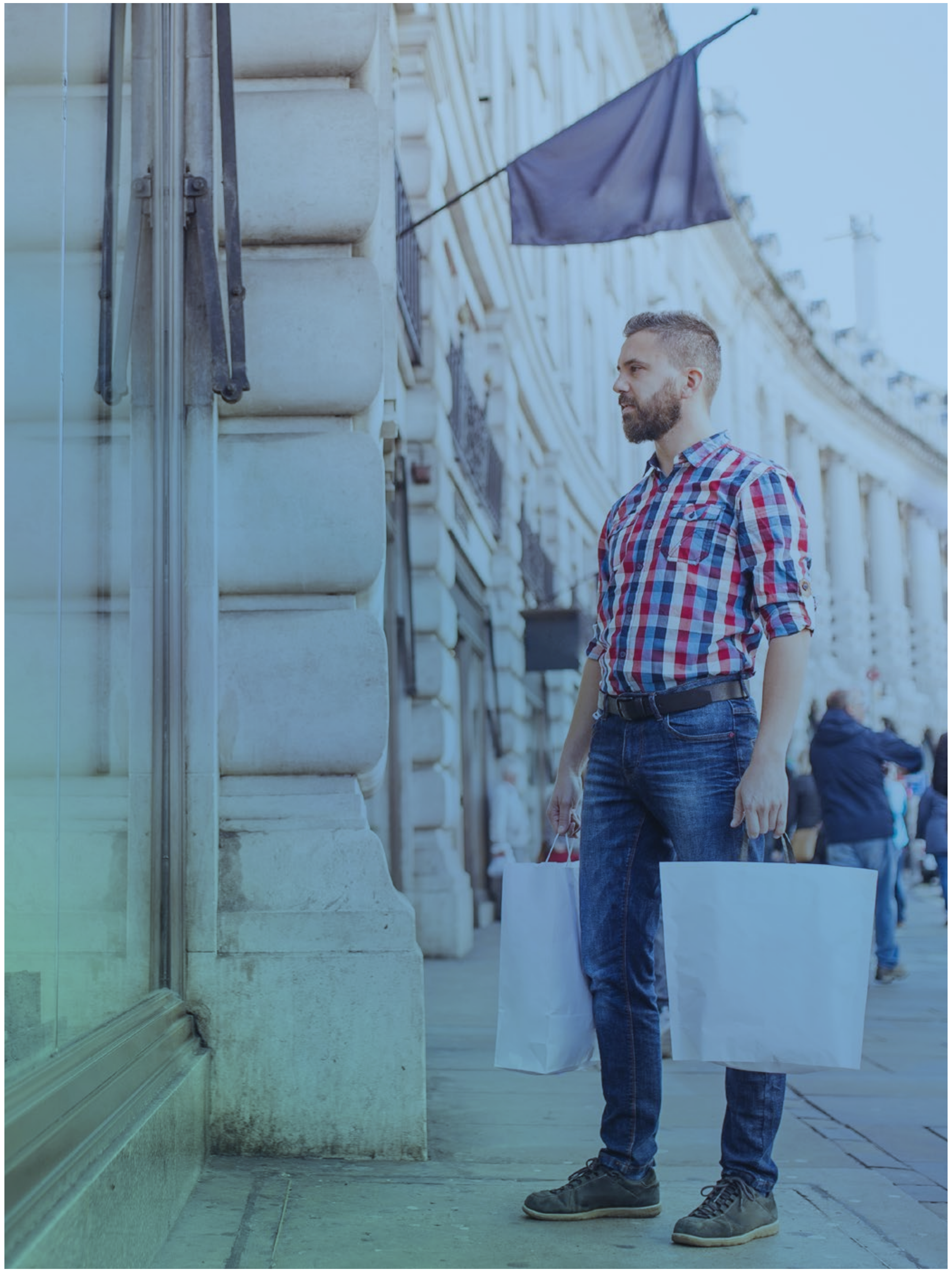
The retail sector has been primarily shaped by structural rather than cyclical factors over the past 15 years. For example, during and after the 2008/09 financial crisis, prime retail rents continued to rise because of increasing globalisation of the retail industry and the enormous amount of pressure on prime locations - despite the catastrophic impact of the financial crisis on the labour and consumer market in some cases.

During the economic boom phase between 2017 and 2019, however, prime rents stagnated because of the increasing dominance of e-commerce, particularly in the fashion segment. This put pressure on retailer margins, leading to stagnating or even declining rents. COVID-19 has accelerated this trend considerably, especially in the durable goods market.

On the consumables side, the impact of COVID-19 was much smaller, if not almost non-existent. This is reflected in the performance of the different types of retail properties. While the prime locations of large and small cities, and in particular, shopping centres have clearly seen a drop in investor demand, there has been an increase in demand for supermarkets and retail parks with long-term leases.

However, there remains a risk even in the classic Fast Moving Consumer Goods (FMCG, food, drugstore, etc) segment: no other retail segment has experienced a stronger growth in e-commerce during the COVID-19 lockdowns. If the past can teach us one thing, it is that consumers who have gone online once, rarely return to in-store shopping. Even though the share of online sales in food retail is still low, the potential for increasing online sales in the future remains high.

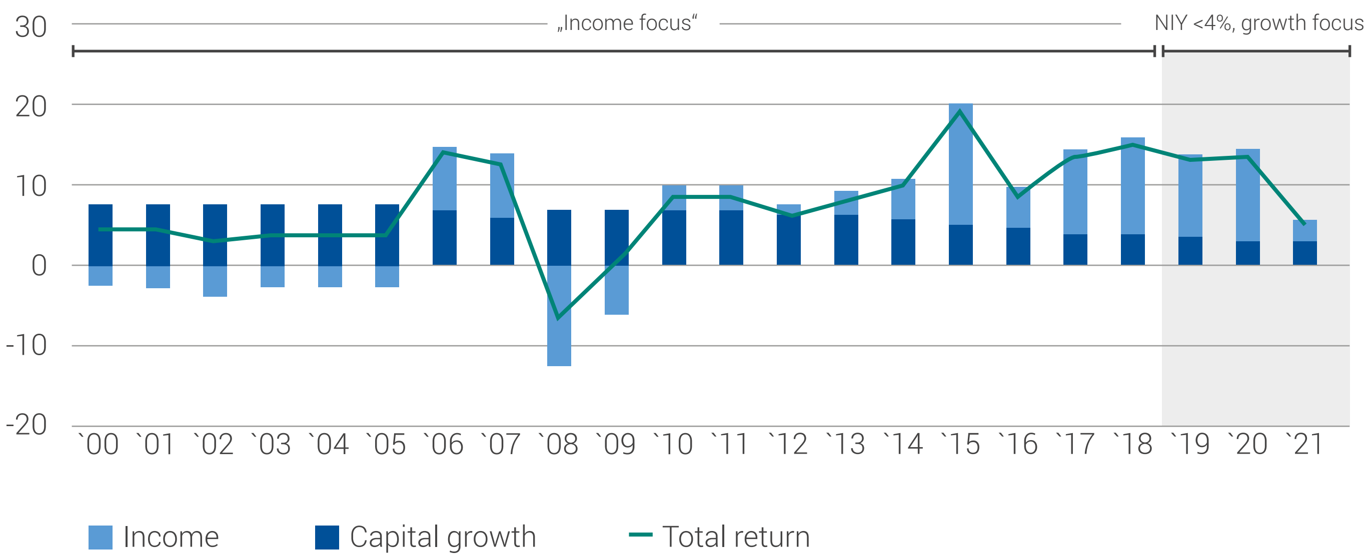
The retail market is likely to remain the most challenging market in the short to medium term. After all, the problems here were not caused by COVID-19 (as in the gastronomy or hotel industries), but rather simply exacerbated by the pandemic. This means that investments and financing in this sector should be extremely selective and depend above all on the individual property and letting situation.



SECTOR OUTLOOK: LOGISTICS

Historically, the logistics sector has been a "cash-flow" based sector that worked well as an asset class without any major growth dynamic. This meant that high initial yields, which ensure an above-average cash flow, were a key acquisition criterion. More recently, the sector has shifted towards more growth (strong decline in initial yields and rise in rents) and lower current yields. Which means that the investment rationale for logistics real estate has changed.

Germany – logistics investment parameters



Sources: PMA, CORESTATE Research

The logistics sector is one of the sectors benefiting from structural tailwinds, driven by the boom in e-commerce. This suggests that the sector will also be able to generate more sustainable growth than in the past. From a cyclical perspective, on the other hand, the dependence on more growth represents a risk. In the past, the logistics sector correlated strongly with economic development, which means that in a weak market this necessary growth could be missing.

The long-term outlook in the logistics sector, in terms of the technical development of distribution cycles, is relatively uncertain. These developments are often at an early stage of implementation (such as fully automated distribution warehouses) or are not yet ready for the market (such as autonomously driving HGVs), but have the potential to have a significant impact on location parameters and building-specific aspects. These developments are difficult to predict and therefore pose a certain risk.

On the investor side, demand in the logistics sector is currently very high, as the asset class proved very stable during COVID-19, or even increased in relevance, and its structural importance as an asset class came to the fore. Accordingly, the demand for financing was also high.

Considering the long-term uncertainties on the technical side and the high valuations in the sector at the moment, financing should be for a shorter term and with proven experts on the investment or project development side.

Green real estate financing

The COVID-19 pandemic and its impact on the economy and society has dominated the media coverage for the past two years, overshadowing other topics such as sustainability and climate change. However, severe flooding in Germany in July, which caused 180 deaths and billions of euros in damage, and the UN climate conference in Glasgow in November brought these issues back into the focus of a broader public.

Yet, climate experts from the worlds of politics, regulation, economics, and NGOs had continued to work on an ambitious EU programme for the period after COVID-—19, even during the pandemic, which they intend to be greener and more sustainable. The planned regulations affect all parts of the economy, but particularly the real estate and financial sector. Green real estate financing is therefore gaining more and more attention, even if the term is still used in many different ways. Only the EU Taxonomy Regulation (EU Taxonomy), adopted by the EU in June 2020, will solidify this term with a clear definition and content.

Political framework

The UN member states laid the foundations for global environmentally, economically, and socially sustainable development in the framework of their Agenda 2030 when they agreed on 17 global Sustainable Development Goals (SDGs). One of these key goals is climate action. The resolutions of the world climate conference in Paris in 2015 – and the associated objective to limit global warming to well below two degrees Celsius, compared to pre-industrial levels – are now gradually being translated into specific resolutions, initiatives, and goals at the European and national levels.

One lever identified by policymakers is the steering of global financial flows in line with climate goals. The UN Principles for Responsible Investment initiative, in which over 3,000 signatories have voluntarily committed to incorporate environmental, social and governance (ESG) aspects into their investment decision-making processes, serves as an example. At a European level, the "European Green Deal" is an ambitious programme to become the first continent to reduce its net greenhouse gas emissions to zero by 2050. The European Green Deal includes a range of measures to regulate the financial market. The centrepiece is the regulation on "EU Taxonomy" adopted in June 2020, which is set to be implemented as early as 2022. The regulation aims to establish an EU-wide system for classifying economic activities in terms of their sustainability, thereby creating more transparency in the still very heterogeneous market for green investments/financing.

In this context, the real estate sector is of particular importance, as, according to the EU, it is responsible for approximately 40% of European primary energy consumption and about 30% of CO_2 emissions. The EU Taxonomy Regulation is an important milestone to enable green (real estate) financing and

investment to make a breakthrough over the medium term. In Germany there are also several initiatives that are closely linked to this Europe-wide strategy. For example, the "Sustainable Finance Committee" is advising the German government on the development of a national strategy to position Germany as a sustainable finance centre for the long term. The German financial sector is already taking its own first steps, such as signing a collective commitment to climate action at the end of June 2020 with the aim of implementing methods to measure the climate impact of its loan and investment portfolios. There is quite a bit of movement in the green financing sector, even though not all initiatives are coordinated yet and there is still some uncertainty among stakeholders. One thing is certain: the topic of green financing will continue to gain relevance.

Green financing instruments at a glance

Fundamentally, real estate projects - and particularly new developments are well-suited for green financing.

Until the EU taxonomy is implemented, the threshold for classifying financing as "green" is still based on voluntary guidelines such as the Green Bond Principles of the International Capital Markets Association (ICMA) or the Green Loan Principles of the Loan Market Association. These guidelines are, in turn, based on accepted standards in the financing market, and extend them with a "green" component, such as a specified use of funds.

Financing instruments referred to as "green" are often geared to specific green projects (such as the construction of solar power plants or energy-efficient or energy-neutral buildings) and available funds are only permitted to be used for such projects. Examples of green capital market financing include green bonds and green Pfandbriefe (mortgage bonds). Outside of the capital market, green promissory notes and green loans are means of taking out loans to finance green buildings.

Green financing in the real estate sector

According to the taxonomy regulation, sustainable economic activities are classified on the basis of technical assessment criteria which have been defined for four different areas: for example, for a taxonomy-compliant new building (built as of 01.01.2021), the primary energy consumption must be at least 10% lower than the standards for nearly zero-energy buildings, NZEB.

When acquiring buildings constructed prior to 2021, an EPC (Energy Performance Certificate) of class A must be provided. Alternatively, evidence can also be provided that the building is among the top 15% of the national/regional stock. Renovations must result in a 30% reduction in primary energy consumption in order to be classified as sustainable. The taxonomy regulation also defines a range of specific individual measures, including for example the installation of energy-efficient appliances or photovoltaic systems.

In addition to these technical assessment criteria, a taxonomy-compliant investment must also adhere to the Do No Significant Harm (DNSH) criteria. These criteria stipulate that, even if an activity has a positive impact on one objective (for example climate protection), it cannot be considered sustainable if it has an adverse effect on any others (such as the sustainable use of water resources). Relevant requirements for buildings include specifications for the water supply or specific standards concerning construction materials.

Benefits of green financing

But why do borrowers take on the extra effort and costs of external certification? The advantages are on the one hand on a strategic level and can on the other hand also be measured in concrete figures. Aside from the strategic advantages, green real estate serves the demand from ESG-conscious investors and project developers who find a suitable partner with providers of sustainable financing solutions. One area where there is no consensus yet is whether borrowers of green financing achieve a “greenium” (green + premium), i.e., an excess return compared to “normal” financing. In the case of green financing, this can often be demonstrated by the fact that green bonds from some issuers are several basis points below “normal” bonds with matching maturities. With other issuers, however, there is no such evidence of a “greenium”.

However, some banks are already promising a margin reduction of between five and ten basis points for green real estate financing.

In addition, green financing already now serves as a type of insurance policy for future changes in regulatory requirements, thus preventing a possible malus that may impact us in the coming years.

In addition, real estate investments in green buildings offer the general advantage of comparatively lower operating costs and thus higher tenant satisfaction, which leads to lower tenant fluctuation and greater acceptance of higher rents.

Green subsidies

Another advantage is the possibility of combining financing with green subsidies. There are a number of programmes, offered by the KfW, for example, which, depending on the energy efficiency of the building, can play a key role in achieving an attractive financing structure through favourable interest rate conditions or repayment bonuses. This is particularly relevant to the construction, conversion, and refurbishment of energy-efficient housing in accordance with the KfW standards or the installation of systems to generate renewable energy.

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