



## EUROPEAN COMMERCIAL REAL ESTATE DEBT – A LONG, UNWINDING ROAD

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### HIGHLIGHTS

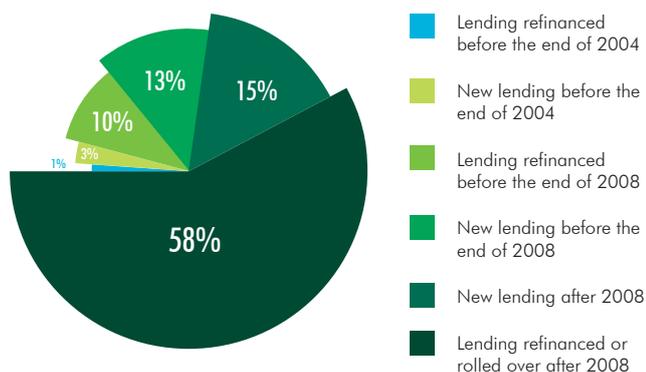
- Our research shows that across the European CRE debt universe there is circa €926 billion of outstanding debt, €101 billion below the total outstanding debt in 2008.
- Although the value of prime property has recovered strongly, the value of the majority of CRE in Europe is still a very long way below its 2007/08 peak.
- Lenders are now starting to deal with non-performing loans more aggressively after a period where extension and forbearance strategies dominated.
- The UK banks have been particularly active (especially in terms of loan sales), but many Eurozone banks still retain a large debt overhang.
- With most legacy CRE exposure in the Eurozone focussed in Northern Europe, and the weight of capital heading towards the peripheral countries, some Southern European countries such as Spain and Italy could surprise with a relatively fast reduction of CRE debt overhang if banking systems continue to stabilise.
- Loan sales will continue to be the most efficient deleveraging mechanism throughout Europe. NPL buyers acting as liquidity providers will be key to transitioning CRE exposure from legacy lenders to new capital sources.

### INTRODUCTION/OVERVIEW

With a recovery in the debt and real estate markets now appearing to have gained real traction, CBRE has updated its European commercial real estate debt model to gain an insight into how the European debt overhang is faring across continental Europe. In this report we have used our proprietary modelling of loan originations to analyse the European Commercial Real Estate ('CRE') Debt market, to analyse how the outstanding debt is made up and how it has changed since we last assessed the markets in 2010.

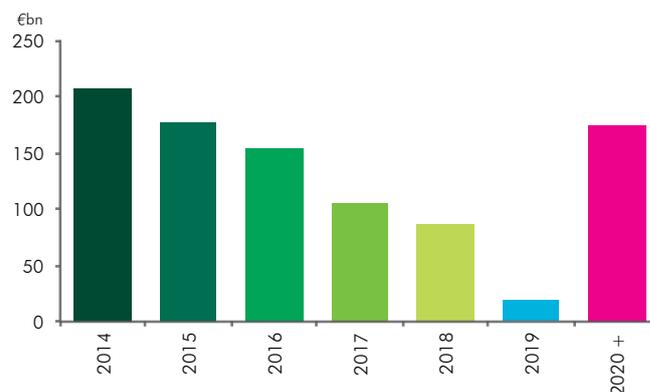
Since the end of 2008, legacy lenders have started to deleverage and address their issues with varying degrees of success. Our model suggests that there is currently €926 billion of CRE debt outstanding in Europe. It should be noted that there is also a very substantial amount of lending to investors that is secured against residential property or development land that is not covered by this analysis.

Chart 1 - Structure of Current CRE Debt Stock



Source: CBRE Research

Chart 2 - Maturity Profile of European CRE Debt



Source: CBRE Research

Compared to the position at the peak of the market (end 2008) this is a reduction of only a net €101 billion. However, this understates the progress that has been made as the €926 billion total includes around €140 billion of debt issued against new transactions since the end of 2008. In some instances – for example where vendor finance was provided – that debt might carry the legacy of the global financial crisis ('GFC'), but the majority of this debt will be untainted by the past.

As well as impacting on the 'quality' of Europe's CRE debt, the issue of roll-over loans and short-term extensions has had a significant impact on the maturity profile. Our model shows that the majority of the outstanding debt (79% - €731bn) is due to mature in the next 5 years. Although conditions in the lending market have eased considerably in the last 12 months, we still believe there is far more maturing debt to absorb than there is lending capacity in the near term. New lenders such as debt funds have not yet entered to the level required to make a significant impact and, with the CMBS market still only at the early stages of reopening, it is likely that the process of unwinding Europe's legacy real estate debt will continue to be a gradual one with a high reliance on opportunistic loan purchasers.

**SIZE OF THE ISSUE**

The CBRE European Commercial Real Estate Debt Model estimates that there is circa €926bn of European debt outstanding as at the end of 2013. It is worth repeating that this figure relates to lending secured against commercial real estate only. Across

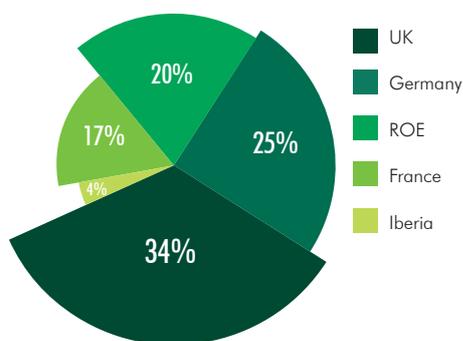
Europe there is also a very substantial amount of lending to investors and businesses (as opposed to personal mortgages) that is secured against residential property.

Of this total more than half (59%) relates to properties in the UK or Germany. This is a reflection of the relative size of the CRE investment markets in these two countries; over the last ten years the UK and Germany account for 53% of all CRE investment in Europe. The CRE debt stock is not, therefore, that different in its structure to the underlying market.

After the UK and Germany, the next largest category of CRE debt is that secured against property in France. This is again driven by the fact that, although the lending market in France was never quite as unrestrained as that in many other European countries, the underlying real estate market is the next largest in Europe by quite a large margin.

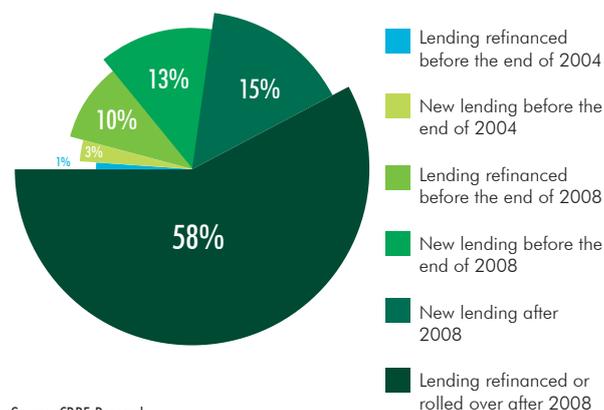
A perhaps surprising conclusion, given the well-publicised problems of the Spanish banking sector, is the relatively small amount of outstanding CRE lending in Spain and Portugal. However, the underlying investment markets in both countries are relatively small and were not dominated by the large portfolio trades that were prevalent in Germany and the UK during the mid 2000's. Additionally, banking regulations in Spain effectively curtailed the emergence of a widespread CMBS market, further dampening the growth of CRE lending. In Spain the property lending legacy of the GFC therefore mainly relates to the residential sector. This is made clear by the statistics relating to loans that have been placed in SAREB, the Spanish 'bad bank' vehicle. The

**Chart 3 - Structure Of Current CRE Debt Stock By Country**



Source: CBRE Research

**Chart 4 - Structure Of Current CRE Debt Stock By Origination**



Source: CBRE Research

200,000 assets to which these relate include 82,300 residential units, 14,900 land plots and 84,300 development loans leaving relatively few standing CRE investment loans.

A particular problem that is significant in describing the size of the CRE debt problem facing Europe is the extent to which the existing stock of CRE debt remains a function of the high levels of highly leveraged investment activity in 2005-2008. Although the initial term on much of that lending has since expired its legacy remains because subsequent market conditions mean that it has needed to be rolled over, or refinanced on a short-term basis. With the collapse in the value of commercial real estate in Europe in the aftermath of the GFC, and fall in turnover of the investment market in the majority of cases, borrowers have been unable to repay loans taken out in the boom years of 2005-2008 either by selling the underlying real estate, or refinancing the loan on commercial terms.

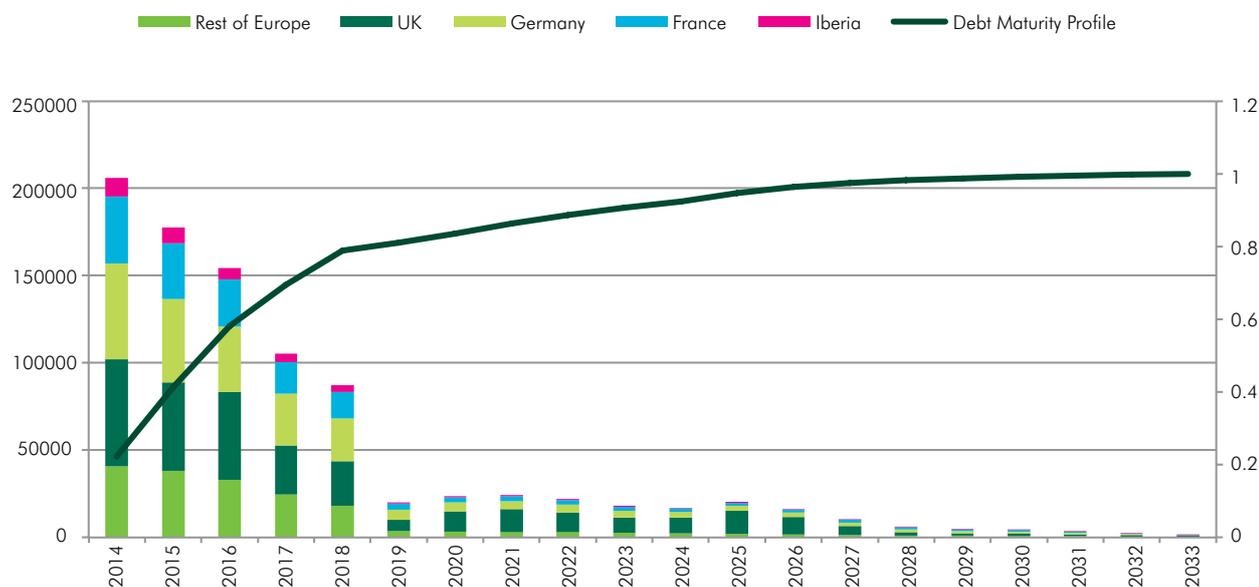
Whilst, we estimate that only around €208bn of the 2005-2008 vintage of debt remains outstanding, much of the rest of the total stock of debt is comprised of extended or restructured legacy loans rather than true newly originated debt. Given that 2005 to 2008 loans were often highly leveraged with looser lending terms secured against secondary and tertiary quality collateral, these loans still need to work their way through the lending system.

The other key structural issue surrounding the outstanding CRE debt in Europe is the very short-term nature of that debt. This is also a result of the preponderance of short-term extensions, debt roll-overs and renewals/refinancing on terms that would not have been available on the open market at the time. This has meant that over the last five years much of the debt that fell due was extended on to subsequent years, with the wall of financing slowly reducing, but mostly moving from one year to the next, as banks continued to defer the crystallisation of losses. As a consequence the majority of the outstanding CRE debt (79% - €731bn) falls due in the next five years (2014 to 2018). The longer-term debt mostly relates to assets located in Northern European countries, having been provided by insurers seeking longer term assets to match their liabilities.

Finally, it is not possible to get a complete picture of the size of the issue of outstanding CRE debt without also considering the behaviour of the underlying real estate market. In this respect both the total value of transactions being recorded and the pricing trends are relevant.

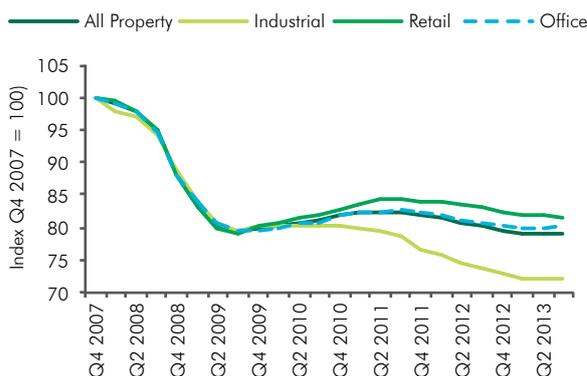
The total value of CRE investment transactions in Europe peaked at €256 billion in 2007. Over the four years that represent the peak of the market 2005 to 2008, over €780 billion of CRE investment transactions were recorded.

Chart 5 - Maturity Profile of European CRE Debt



Source: CBRE Research

Chart 6 - Evolution of Capital Values in Europe



Source: CBRE European Valuation Monitor

After the GFC the total value of transactions collapsed, with less than €75 billion of transactions completed in 2009 and although the total value of investment activity continues to improve it is still running at only about €140 billion per annum. Moreover, this investment is highly concentrated at the prime end of the market and there has been little improvement in the liquidity of secondary and tertiary property.

There is a similar polarization in terms of pricing. The value of prime property has recovered strongly over the last four years, in some cases getting back close to its pre-crisis peak. However, the value of secondary and tertiary properties is still well below 2008 levels (as shown by the movement of CBRE's European Valuation Monitor which tracks the value of 'average' properties rather than the prime end of the market). In addition, debt capital is scarce for this product. Coupled with a recovering, but fragile, occupier market, which is the main driver for a recovery in the secondary asset space, debt secured against such property will continue to roll over until provisioned appropriately. We also expect many of the assets to continue to underperform whilst they remain starved of capital under their current ownership. As a consequence, this 'zombie' element of the debt overhang could take some time to finally clear.

## DEALING WITH THE PROBLEMS

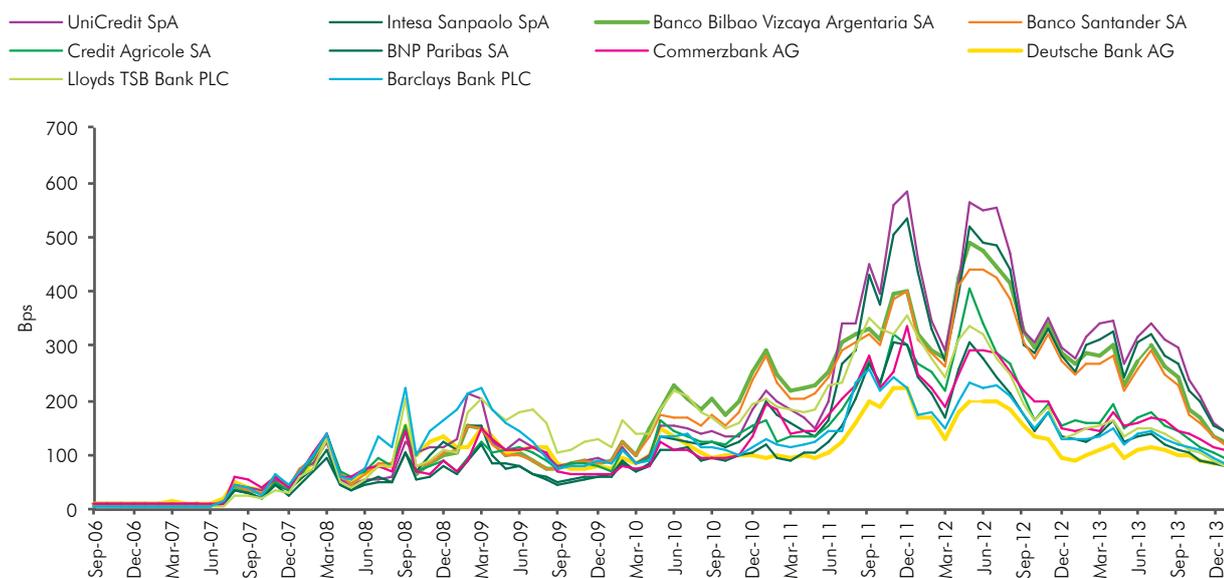
There is no doubt that with improving economic conditions some normality is starting to return to the European CRE investment and CRE debt markets. However, despite the contraction so far in the amount of outstanding CRE debt in Europe, few would say that legacy issues have been dealt with decisively. There is still a long way to go before we will see a return to the efficient allocation of capital and real estate loan books fully provisioned. As such we expect a continued net reduction in total outstanding debt over the coming years.

The speed with which lenders have accepted the right level of provisioning and write downs has been varied by country and by lender, but almost all lenders have sought to de-lever and reduce their exposure to the CRE market over the past five years. Certainly across Ireland and UK those provisions have been made more readily than in some other Eurozone countries. This has been evidenced through the level of asset and loan sales that have been undertaken by UK and Irish banks. Loan sales have been the tool of choice for many lenders looking to either reduce or completely exit from their loan books, capitalising on the high demand from opportunistic credit and real estate focussed investors. What is clear is that certain banks have seen loan sales as an important tool to deleverage quickly 'en-masse' rather than enforcing at the individual loan level, and we expect to see this strategy becoming more prevalent in mainland Europe where insolvency regimes in some jurisdictions can make loan by loan enforcement very slow.

The 'bad bank' structures in Ireland (NAMA) and Spain (SAREB) have also made a contribution to unwinding the CRE lending legacy. However, only a relatively small proportion of their activities have involved lending against standing CRE investments. Of the €32 billion paid out by NAMA, just €8 billion related to standing CRE investments in Ireland.

Much of the deleveraging in the UK has been driven by an improving underlying economy, increased investor demand and regulatory pressures. With better economic data coming out of Europe and the ECB driven Asset Quality Review being undertaken

Chart 7 - CDS Rates for Selected European Banks



Source: Bloomberg

to assess the strengths of Euro area banks, these pressures will, following the same pattern as the UK, see banks being able (and having to) to make provisions. With a variety of opportunistic investors seeing value in these markets, a 'healthy' NPL Portfolio market should be able to emerge throughout Europe as legacy lenders start to increase their absorption capacity to take write-downs.

## CHANGING LANDSCAPE

There are market trends in progress that could have a significant impact on how the issue of legacy CRE debt works itself out.

In some of the more distressed investment markets (particularly Ireland and Spain) interest from investors picked up strongly in 2013, as did the total value of transactions being completed. Coupled with the relatively small aggregate value of CRE debt in Spain, whilst there remains significant distress in the CRE market, we could see a clearing of the debt overhang faster than other parts of Europe as a result of a combination of activity in the direct market and an improved capacity for banks to sell on CRE loan books.

In Germany and the UK both liquidity and pricing have been improving in the markets for poorer

quality real estate. So far the volumes of transactions have been relatively small, but the trend is clearly for the number of transactions to increase. This should have a knock-on effect on the debt secured against such property – both in terms of borrowers' ability to repay such loans and banks' ability to sell them on to debt funds.

The key however remains the motivation of the legacy banking sector to release assets to the markets. The underlying issues behind this are well illustrated by viewing bank Credit Default Swap ('CDS') rates as a proxy for health and ability to deleverage quicker.

The previous graph (See chart 7) shows five-year CDS rates for a pool of banks across Europe since 2006. What is very clear is that looking back at 2006 credit default rates, rates across all the chosen banks were very similar and very low. Through the recent cycle there is a clear divergence between the Northern and Southern European banks, although spreads have reduced in the last quarter. This illustrates the risk differential between the regions, and that rates are still some way off 2006 levels. We have also looked at the average CDS rate of those chosen lenders above 2006 rates which shows – UK 76bps, Germany 85bps, France 81bps, Spain 113bps and Italy 134bps - higher today than 2006.

If we see a continued recovery in the Euro area's banking systems, combined with the relatively low debt overhang and influx of 'first wave' private equity capital into peripheral Southern European countries, the result could be an increased clearing of the European legacy debt issues in these countries - which may surprise many.

## CONCLUSIONS

With current levels of outstanding CRE debt of around €926bn the total CRE debt stock in Europe has fallen by some €101bn compared to its peak level at the end of 2008. In fact the progress has been better than this implies as the €926 billion total includes €143 billion of 'new' debt issued on transactions completed after the end of 2008. Therefore around €244 billion (or 24%) of the debt that existed at the end of 2008 has now been retired.

This indicates some progress to de-lever to more sustainable levels. That said with around 58% of the outstanding debt (€538 billion) maturing in the next three years, this deleveraging process is still in its infancy. Around €208bn of the debt originated at the peak of 2005-2008 has still to mature, much of which will comprise significant numbers of underperforming and over-levered secondary assets. However, more significant is the much larger value of extended/renewed/rolled-over lending of the same vintage that is also still working its way through the system.

There is no doubt that a considerable amount of write-downs and provisions have been made but the deleveraging cycle is still in varying stages across Europe. The considerable polarisation

that exists between different European banking systems is well illustrated by the comparable CDS rates (see chart 7). However many of the Southern European countries never experienced the huge CRE investment volumes at the peak of the market in 2005-2008 that the UK and German markets experienced. This is likely to ease the distress in the CRE market caused by continued deleveraging in these jurisdictions and could result in a relatively fast turnaround in the local investment markets.

The deleveraging process has now started in earnest with 2009 and 2010 being years that will be associated with 'extend and pretend'. UK legacy lenders have, or at least have started, to de-lever with a renewed sense of urgency and taken the write downs required to break legacy capital structures enabling assets to be sold.

The new capital sources, from debt funds, insurers, private equity and capital markets, have aided in the process of legacy banks to deleverage. However, they are still in their infancy and more new debt providers will be required to complete the full deleveraging process. In the meantime the opportunistic buyers of non-performing loans will remain the most influential participants in the deleveraging process for some time.



This report was prepared by the CBRE EMEA Research Team in conjunction with CBRE Capital Advisors.

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