VIEWPOINT EUROPE CAPITAL ADVISORS, 2017

CBRE Capital Advisors analysis of trends in Europe’s debt market

European Commercial Real Estate Finance
2017 Update

CBRE



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HIGHLIGHTS

In this year's debt report, we identify the trends underpinning the composition of Europe's debt market. We highlight principal features affecting the European loan sale market in 2016, while providing deeper 2016 reviews and 2017 outlooks for key jurisdictions across Europe.

KEY CONCLUSIONS:

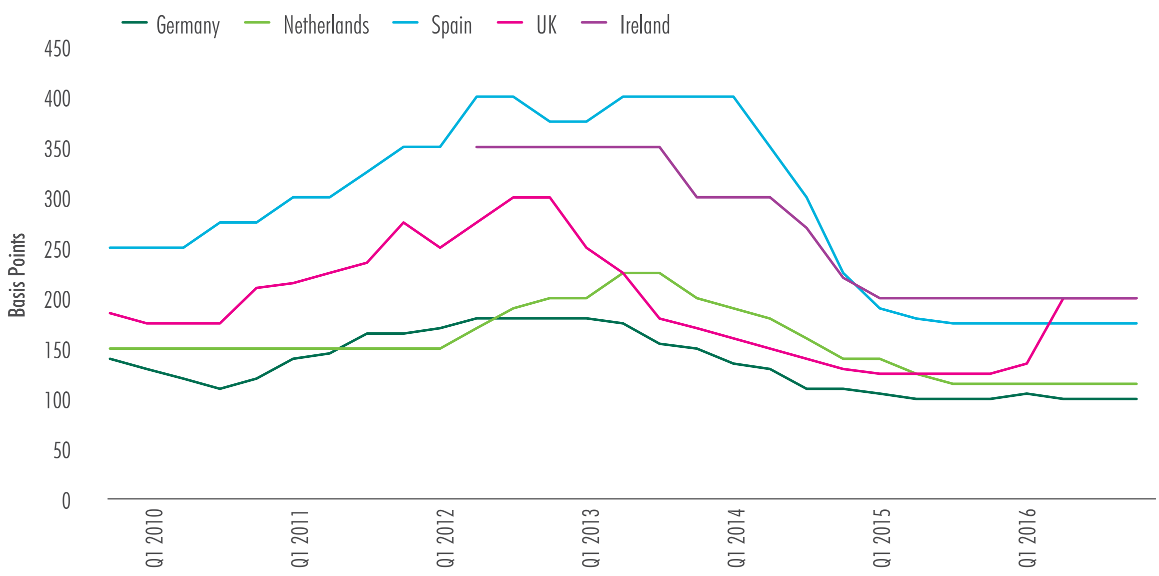
- Total nominal value of the European Commercial Real Estate (CRE) investment debt decreased slightly over the course of 2016 from €1.14 trillion to €1.06 trillion, which is largely attributed to reduced levels of investment transactions in 2016
- We estimate that new debt issued increased from €68 billion in 2013 to €125 billion in 2015, while maintaining at €116 billion in 2016
- Additionally, the amount of debt retired in 2016 is also in line with the new origination levels over the past year
- 2016 was the first year, since post-GFC loan sale activity commenced in Europe, that real estate secured loan sale activity fell
- In 2017, we expect loan sale activity to pick up from 2016, albeit the activity will be relatively concentrated across several key jurisdictions, for instance Italy and Spain

THE EUROPEAN DEBT LANDSCAPE

In a change from recent years, politics took over from economics as the main driver of the financial markets in 2016. At the top of the list were the EU referendum and the US presidential election. However, these were not alone as market moving political events. The Italian referendum on constitutional change and shifting polls for the upcoming elections in France and the Netherlands have also had an impact. As a consequence 2016 was a year of volatility, but one where on the whole there was no outright change in overall trends.

With the exception of a jump in the UK immediately after the referendum, senior lending margins for good quality property were stable in most countries throughout 2016. For secondary properties and/or higher LTVs there was some evidence that lending margins increased over the year. More importantly, from the perspective of the real estate debt market, the year finished with a strong upward trend in medium term interest rates. This increase was much smaller in Europe than in North America and Asia, but nonetheless may signal that the aggregate cost of fixed interest debt is on the increase for real estate investors.

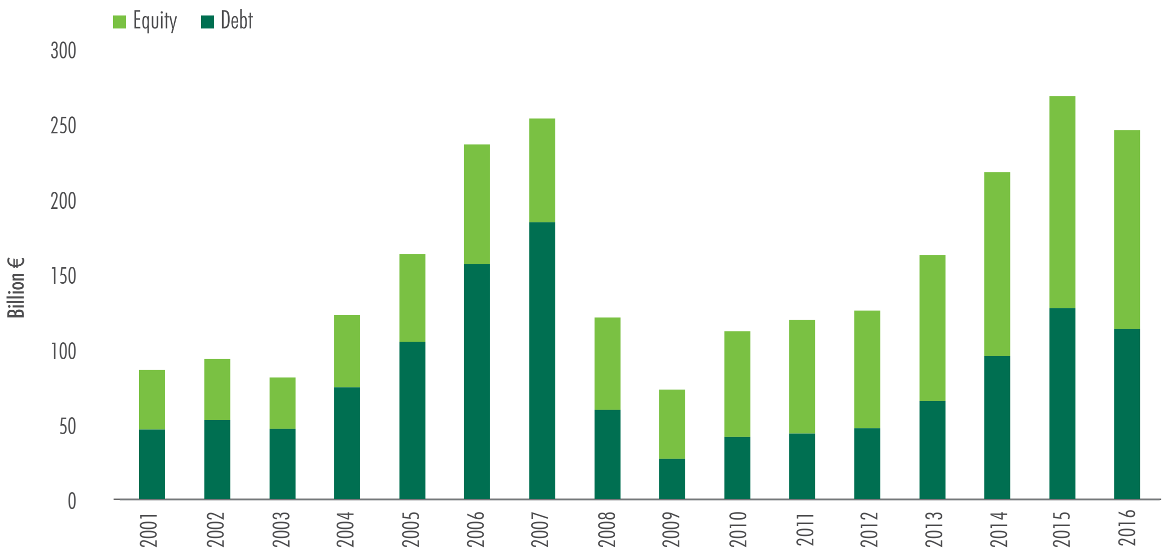
FIGURE 1: CRE SENIOR LENDING MARGINS (OVER LIBOR/EURIBOR)
Margins over Libor/Euribor for senior lending



Source: CBRE Research, 2017

Our analysis suggests that the total (nominal) value of European CRE investment debt decreased very slightly over the course of 2016 from €1.14 trillion to €1.06 trillion[1]. Although there was a slight dip in the total value of investment transactions in 2016, the market remained strong overall. This continued investment activity meant that the amount of new debt issued during the year essentially matched the amount of old debt being retired. We estimate that new debt issued increased from €68 billion in 2013 (40% out of €168 billion of CRE investment) to €125 billion in 2015. This was nearly maintained in 2016 with €116 billion of new debt being created against transactions totalling €255 billion (46%), while at the same time the European CMBS market remained effectively closed in 2016.

FIGURE 2: DEBT-EQUITY SPLIT IN CRE TRANSACTIONS
CBRE's estimates of the debt vs equity spilt in European CRE investment market



Source: CBRE Research, 2017

Looking ahead there are some interesting trends to look out for in 2017:

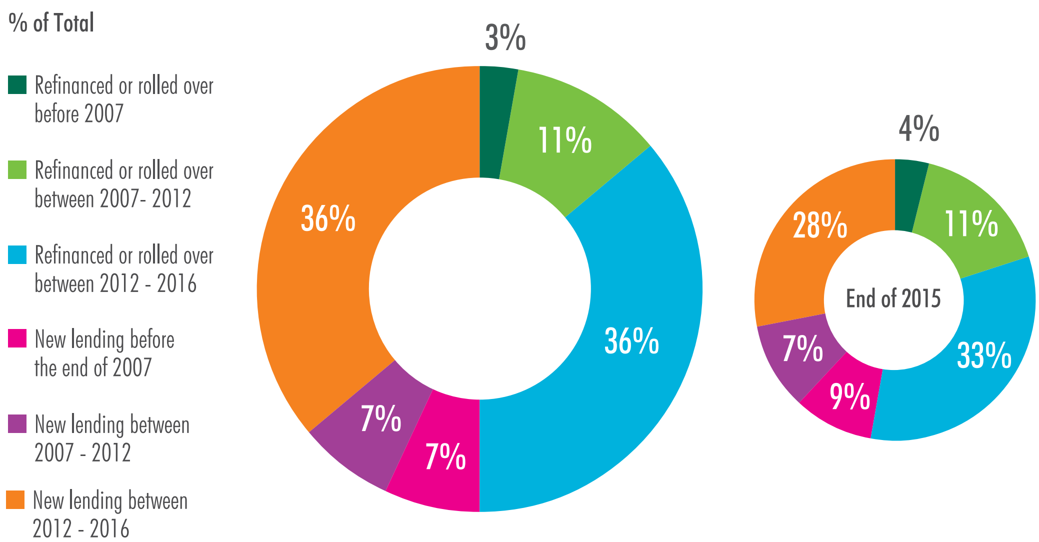
- Our forecasts suggest that despite the dip in 2016, the level of investment transactions will remain high in 2017, matching the 2016 level
- The upward trend in US interest rates in the last months of 2016 seems to have paused. However, our house view is that this was the start of a longer term trend and that the next few years will see further 'normalisation' of medium and long-term interest rates
- The interest rate trend in Europe is not likely to be as marked as that in the US and although borrowers will have to cope with an increasing trend in the overall cost of debt in 2017 the increase will be fairly small
- Higher interest rates will also impact on the direct market, reinforcing the view that (for prime property at least) yields are probably at their floor in this cycle

[1] The Euro value of the debt stock can be affected significantly by the Euro-Sterling exchange rate. In order to allow a like-for-like comparison in the value we have excluded any movements in the exchange rate over 2015 and 2016.

The upward trend in interest rates appears to be a function of a stronger global economic outlook itself driven by fiscal stimulus either already applied (or intended) by a number of governments globally (including China, Japan and the USA). This higher economic growth should be beneficial to real estate in terms of driving up demand and stimulating rental value growth.

The last few years have seen a very substantial change in the profile of the CRE investment debt stock. Historic (pre-GFC) debt now makes up relatively small proportion of the total, with new debt, the result of strong investment turnover in 2014-2016, now making the biggest contribution to the total stock. In most countries prices have returned to, or surpassed, the levels at the previous market peak. This means that most historic loans on investment property are capable of being refinanced on commercial terms and it is notable that in the UK at the end of 2014 the De Montfort Report[2] stopped reporting information on loans that had been extended because they were impossible to refinance.

FIGURE 3: BREAKDOWN OF EUROPEAN DEBT STOCK (AT END 2016)
Legacy debt is declining and 'new' debt, issued post crisis, is increasing



Source: CBRE Research, 2017

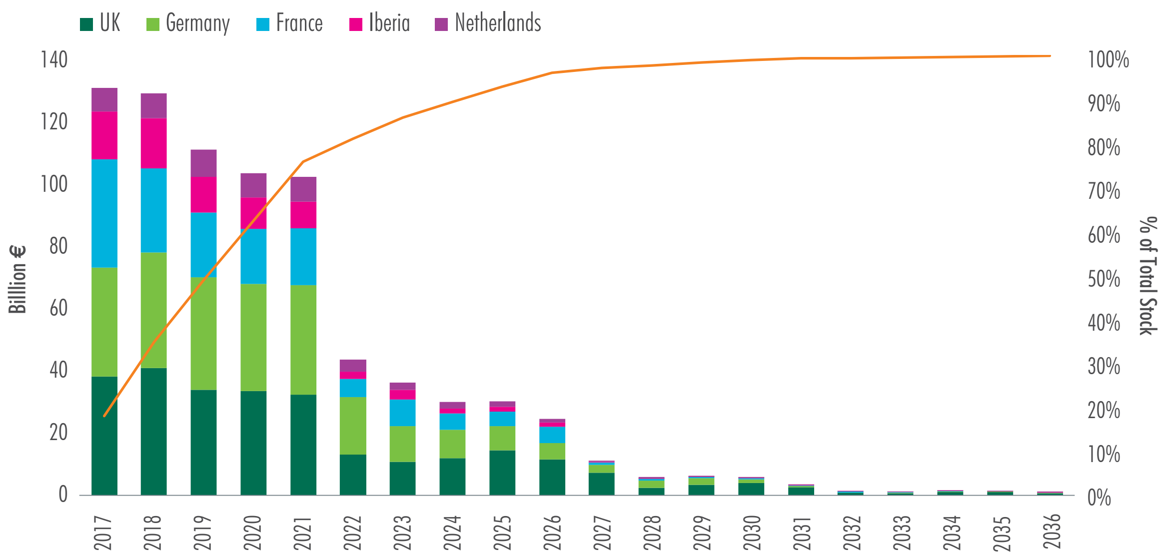
[2] The UK Commercial Property Lending Market Research Findings 2015 Year End, Maxted, Porter and Lux, May 2016.

There is still a substantial legacy of historic debt, but its influence on the market will continue to diminish going forward. Capital value growth in the last few years has improved the quality of some of this legacy debt, but that growth has been disproportionately in the prime segments of the market. For example, the CBRE Prime Office Yield index for the Euro area currently stands at 4.07% compared to a 2007 low of 4.75%. For secondary offices the equivalent figures are a current 5.45% against a 2007 low of 5.14%. The fact that in most of Europe the development cycle has not yet meaningfully restarted suggests that loans against development land (which lie outside the scope of this analysis, but were substantial in 2006/07) will still be out of the money in most cases. However, already a substantial amount of legacy debt is in the ownership of non-bank vehicles that will be more active in their management than the originating banks.

As the influence of legacy debt diminishes, the duration profile of the European debt stock is also normalising. According to our estimates, almost exactly half (49%) of European CRE debt is due to mature over the next three years. This is consistent with other estimates of the average duration of new loans being issued. The De Montfort Report[3], for example, found that the average length of new loans granted in the UK in 2015 was five years.

In 2017, the majority (57%) of debt due to mature will be the product of refinancing rather than new lending maturing for the first time. A high proportion of new debt is for 5-years duration and although the direct CRE market in 2012 was stronger than in the preceding years, it was not until 2013 that the level of transactions started to pick up strongly.

FIGURE 4: CRE DEBT MATURITY IN EUROPE (AT END OF 2016)



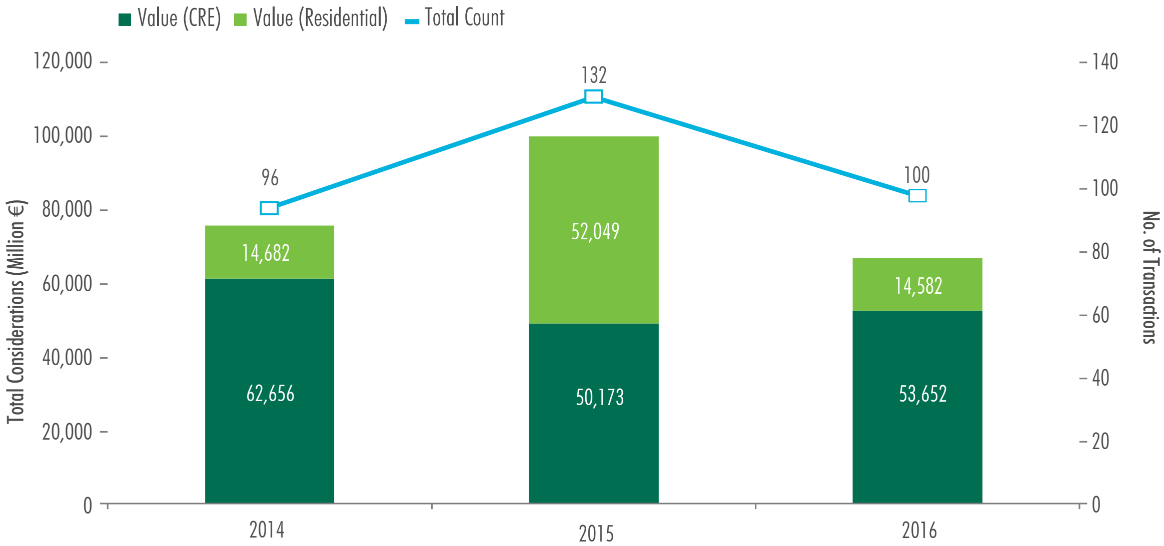
Source: CBRE Research, 2017

[3] The UK Commercial Property Lending Market Research Findings 2015 Year End, Maxted, Porter and Lux, May 2016

LOAN SALE ACTIVITY: 2016 MARKET REVIEW AND BEYOND

2016 was the first year since 2012 when real estate secured loan sale activity fell. Whilst on the face of it, this may look like a classic peak of the cycle decline, we are not so sure. To us, it seems like a mid-cycle pause that reflects some of the uncertainty in the wider market rather than a structural decline in the volume of European loan sales.

FIGURE 5: TRANSACTION CLOSED

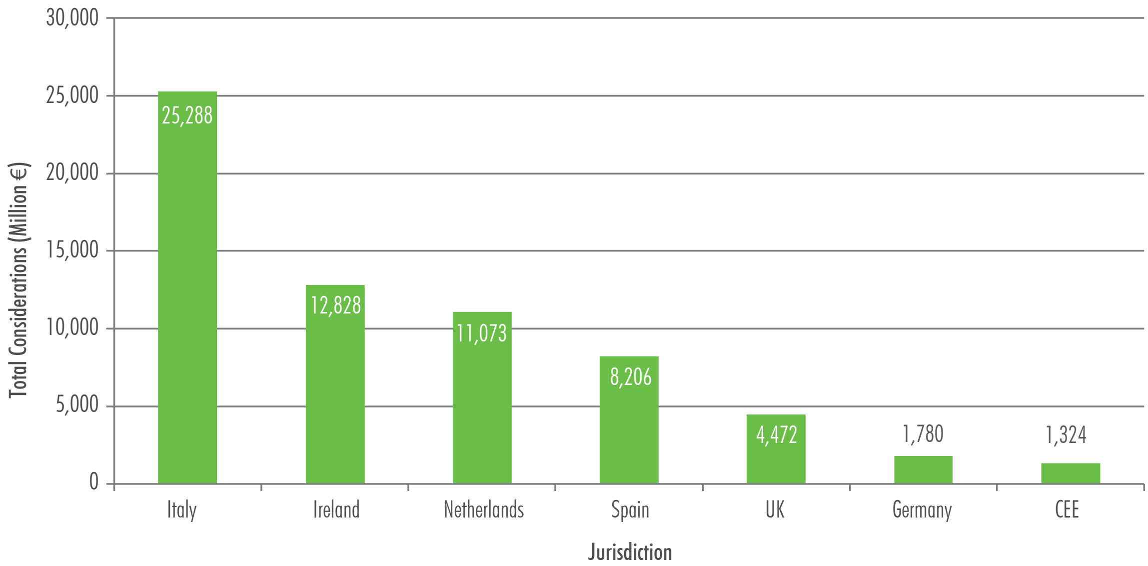


Source: CBRE Research, 2017

Overall there was a degree of hesitation by sellers in 2016. We witnessed more deals pulled or delayed, primarily as a result of wider macro-economic issues and political volatility. This pushed some deals we expected to close in 2016 into 2017.

As expected the picture is far more mixed on a region by region level. Some countries such as the UK are now genuinely ending their deleveraging cycle. Some, like Ireland have the finishing line in sight. Some countries such as Italy are really just starting to make a market, whilst others such as Portugal are still waiting for the starting gun to fire.

FIGURE 6: TRANSACTION CLOSED BY JURISDICTION, 2016



Source: CBRE Research, 2017

Despite the apparent slowdown in loan sales, we see the fundamental rationale for loan sales only increasing in 2017. Firstly, regulators have grown increasingly impatient with the pace of Non-Performing Loan ("NPL") reductions and are now applying far more pressure where they have leverage to do so. Secondly, the 'collateral damage' impact on banks from NPL Sales has been lessened by both the greater provisioning by the banks which has increased given the passage of time and greater opportunities to reinvest proceeds in more profitable and less capital intensive activities. Thirdly, the demand for NPLs remains very strong. Buyers believe they can deliver greater returns than the originating banks can through proactive strategies and sellers have the opportunity to benefit from this. Ultimately banks may be able to enhance total proceeds through a loan by loan wind-down strategy but after risk and opportunity cost is taken account of, this strategy often does not payoff.

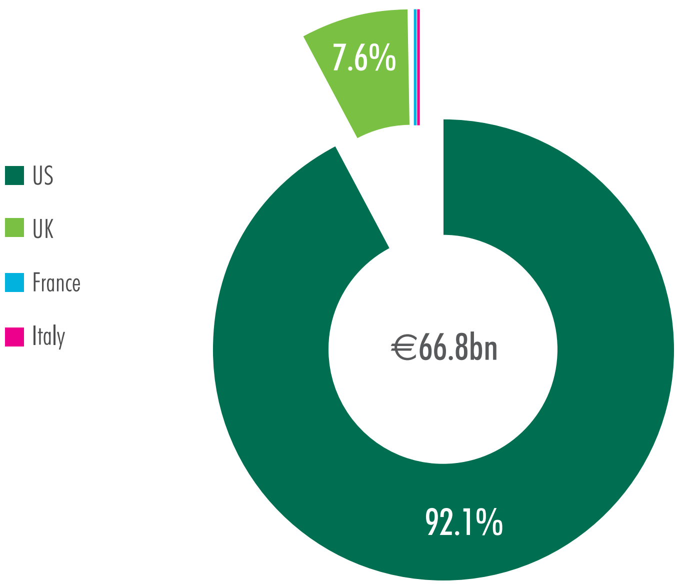
We think it is for these three reasons that there is still likely to be a solid loan sale market in 2017 and beyond. The one major impediment to this would be a failure to close the bid/ask spread that has created a level of inertia in some jurisdictions to date.

BUYER DEMAND

From a buyer perspective the market remains deep. 2016 saw resilient fundraising activity by both the larger funds and the mid-sized firms. CBRE Capital Advisors is currently tracking €66.8 billion of dry powder amongst loan purchasers across the globe, with a focus on European investments. As one would expect, a large majority (92%) of this capital is held by US-based investors, with the UK accounting for 7% and Italy and France accounting for the remainder. Additionally, the ultra-low interest rate environment is also a driver for the investment banks in play.

FIGURE 7: CURRENT DRY POWDER BY FUND MANAGER DOMICILE

€67 billion to invest in loans globally, mostly held by US-based investment managers



Source: CBRE Research, 2017

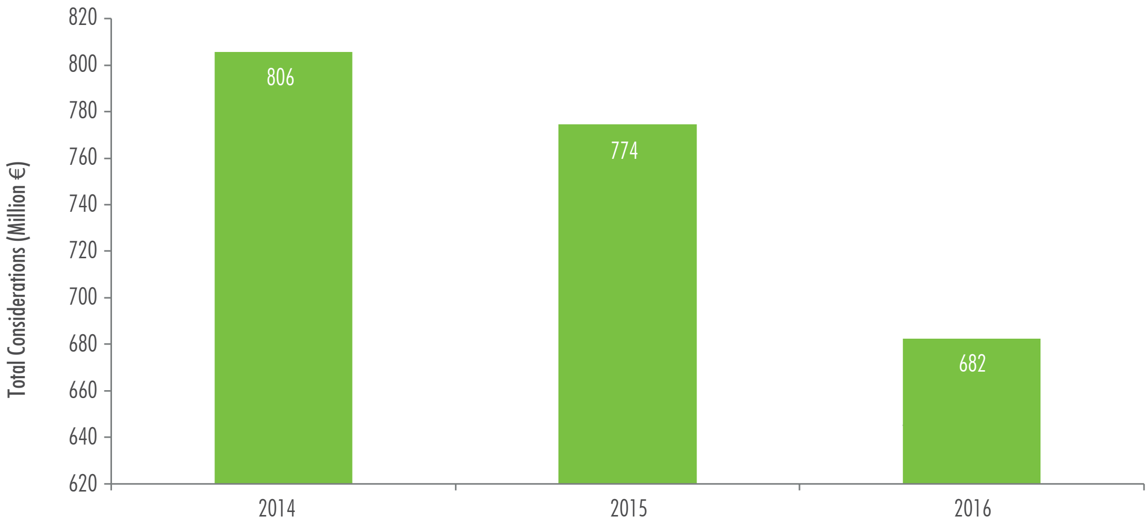
The volume of capital in the sector is pushing investors to diversify into new territories and alternative asset types. This, too, is benefiting the loan sale market, as often those buyers that want to make an impact on a new territory are also the buyers that are prepared to pay the highest price.

TRANSACTION SIZE

2016 saw a slight reduction in the average portfolio size, with fewer jumbo deals available for the handful of major private equity funds and consortia able to absorb them. We also noticed a rise in the number of smaller deals coming to the market, although many of these were ultimately pushed into 2017. In our view this also represents a broadening of the acceptability of loan sales to many of the smaller local banks with smaller distressed books throughout Europe.

These factors led to an increased willingness to participate in smaller loan sales, and compete with the mid-sized firms. Portfolios sized in this 'sweet spot' of €300-€500 million, where the major funds compete with both investment banks and mid-sized private equity funds, saw the best competitive tension and consequent pricing in our view.

FIGURE 8: AVERAGE TRANSACTION SIZE BY UNPAID PRINCIPAL BALANCE



Source: CBRE Research, 2017

LIQUIDITY AND PRICING

In the sub €100 million bracket, liquidity remains more challenging except for single connection opportunities which are appraised more like traditional real estate. There are now also an increasing number of new entrants in this space eager to take advantage of more granular opportunities. This is aiding liquidity in most markets.

Whilst return expectations of the private equity funds have not fallen, buyers are able to take more aggressive views on workout strategies and real estate asset management upside as often they are more financially driven than the seller banks. Therefore pre-sale vendor due diligence of value add asset management initiatives is often key to premium pricing. Clearly those loan pools that are benefiting the most are those jurisdictions where lenders have the highest level of control and a clear route to benefit from enhancements in the underlying real estate.

The loan-on-loan market is still strong, albeit lending margins have stabilised and, where available, LTC levels of up to 70% provide support to pricing. However, in the current low interest rate environment, an increasing number of buyers with balance sheet leverage are seeking yield from both unlevered performing and non-performing loan acquisitions, though a relatively strong sustainable income yield is key to this buyer segment.

OUTLOOK

In our view the outlook for loan sales in 2017 and beyond depends heavily on the jurisdiction. An increased need to deleverage will be partially offset by a natural reduction in the loan books brought about by a recovery in real estate values across Europe. We also see some banks shifting emphasis to other sectors such as consumer loans and shipping. Nevertheless, increased volume of activity will likely be seen particularly in Spain, Portugal and Italy maintaining and potentially increasing volumes in 2017, despite some reductions elsewhere.

COUNTRY BY COUNTRY REVIEW

GERMANY

Volume Outlook: ↑

FIGURE 9: GERMANY

Transactions Closed

	Transaction Closed (Million €)		
Year	2014	2015	2016
CRE	3,755	3,989	1,239
Residential	0	750	0
Total	3,755	4,739	1,239

2016 Top Buyers & Sellers

Purchaser Name	2016 Ranking
Apollo Global Management	1
Octane Capital	2
Cerberus Capital Management	3

Vendor Name	2016 Ranking
LBBW	1
FMS Wertmanagement	2

Source: CBRE Research, 2017

2016 Review

- Loan sale volumes were again relatively low compared to other European jurisdictions and the volume of NPLs held by banks, reflecting both the health of the German banking system and the reluctance of many of the Landesbanks to sell

2017 Outlook

- Regulatory pressure likely to increase on German banks
- Further loan sales are expected primarily to come from the non-core wind-down divisions of the German banks
- We don't see a particular rapid expansion of real estate secured loan sales with perhaps greater emphasis on other assets such as shipping

COUNTRY BY COUNTRY REVIEW

IRELAND

Volume Outlook: ↓

FIGURE 10: IRELAND

Transactions Closed

	Transaction Closed (Million €)		
Year	2014	2015	2016
CRE	21,186	18,322	11,355
Residential	2,816	3,397	1,473
Total	24,002	21,719	12,828

2016 Top Buyers & Sellers

Purchaser Name	2016 Ranking
Cerberus Capital Management	1
Oaktree Capital Management	2
Colony Capital	3

Vendor Name	2016 Ranking
NAMA	1
RBS	2
Danske Bank	3

Source: CBRE Research, 2017

2016 Review

- A very active year in the Irish market primarily driven by some large highly distressed NAMA trades, though the NPL sale cycle is clearly in its final years

2017 Outlook

- The Irish deleveraging story is not yet quite complete with further sales expected from a number of the banks
- We expect to see 2017 loan sales secured mostly on land and residential units
- Sales will come from a small number of banks and potentially NAMA

COUNTRY BY COUNTRY REVIEW

ITALY

Volume Outlook: ↑

FIGURE 11: ITALY

Transactions Closed

	Transaction Closed (Million €)		
Year	2014	2015	2016
CRE	536	4,635	24,713
Residential	0	628	575
Total	536	5,263	25,288

2016 Top Buyers & Sellers

Purchaser Name	2016 Ranking
Fortress	1
PIMCO	2
AnaCap	3

Vendor Name	2016 Ranking
UniCredit	1
HETA	2
BPER	3

Source: CBRE Research, 2017

2016 Review

- With most of the structural obstacles to private equity investment in Italy now removed through government legislation, the market finally opened up in 2016. The market has been less accessible however for many buyers with local servicing expertise being key to successful acquisitions and workouts

2017 Outlook

- Italy could finally be one of the most active loan sales markets in 2017
- Whilst Italy suffers from the lack of any 'Bad Banks', we still expect sellers' and buyers' pricing expectations to start to converge in 2017. As banks adopt more achievable provisioning levels allowing the market to open up, both to new entrants on the demand side and a wider pool of selling banks on the supply side

COUNTRY BY COUNTRY REVIEW

NETHERLANDS

Volume Outlook: →

FIGURE 12: NETHERLANDS

Transactions Closed

	Transaction Closed (Million €)		
Year	2014	2015	2016
CRE	896	1,518	7,645
Residential	530	693	4,628
Total	1,426	2,211	12,273

2016 Top Buyers & Sellers

Purchaser Name	2016 Ranking
Lone Star Funds	1
J.P. Morgan	1
CarVal	3

Vendor Name	2016 Ranking
Propertize	1
Rabobank	2
FMS Wertmanagement	3

Source: CBRE Research, 2017

2016 Review

- The Dutch NPL market finally came alive in 2016, with a number of key deals including Propertize's Project Swan
- With its creditor friendly insolvency regime and flourishing economy, the market was a key target for a wide range of buyers

2017 Outlook

- We expect continued activity throughout 2017 as sellers seek to capitalise on strong investor interest
- However we don't view the Dutch NPL cycle as a long one. A recovery in asset prices will lead to a natural paydown of distressed positions and the market is very concentrated in a small number of books

COUNTRY BY COUNTRY REVIEW

SPAIN

Volume Outlook: ↑

FIGURE 13: SPAIN

Transactions Closed

	Transaction Closed (Million €)		
Year	2014	2015	2016
CRE	5,936	6,459	5,743
Residential	7,307	3,952	2,463
Total	13,243	10,411	8,206

2016 Top Buyers & Sellers

Purchaser Name	2016 Ranking
Bain Capital	1
Deutsche Bank	2
Oaktree Capital Management	3

Vendor Name	2016 Ranking
Banco Sabadell	1
SAREB	2
Bankia	3

Source: CBRE Research, 2017

2016 Review

- 2016 saw a reduction in NPL volumes but we expect 2017 to make up for this
- NPL volumes are still high and changes to accounting treatment of distressed assets is likely to create further impetus over the coming years

2017 Outlook

- Spain (and indeed Portugal) is likely to be one of the most active markets in Europe in 2017 and potentially beyond
- We expect a number of large and small portfolios to come out in 2017 driven by both large national banks and smaller local players
- We are expecting both granular portfolios and single name trades

COUNTRY BY COUNTRY REVIEW

UNITED KINGDOM

Volume Outlook: ↓

FIGURE 14: UNITED KINGDOM

Transactions Closed

	Transaction Closed (Million €)		
Year	2014	2015	2016
CRE	21,006	8,803	1,669
Residential	3,843	42,199	2,803
Total	24,849	51,002	4,472

2016 Top Buyers & Sellers

Purchaser Name	2016 Ranking
Cerberus Capital Management	1
Deutsche Bank	2
Oaktree Capital Management	3

Vendor Name	2016 Ranking
Permanent TSB	1
RBS	2
Co-operative Bank	3

Source: CBRE Research, 2017

2016 Review

- The UK market was an early leader in the deleveraging cycle and so it is no surprise that the loan sale story is now tailing off, with a limited volume of NPLs now burdening the banks

2017 Outlook

- We see the potential for a handful of commercial and residential trades in 2017
- The performing loan market is likely to be the most active, with the majority of non-performing loans settled on a 'loan by loan' basis

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

CBRE CAPITAL ADVISORS

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Our Loan Advisory team advises on the sale, acquisition, valuation and workout of both performing and non-performing loans. The team has acted as loan sale advisor and buy side advisor on Europe's most high profile NPL portfolios.

Our experienced international experts offer a unique combination of real estate and debt advisory expertise. We have also managed many of Europe's most difficult CMBS and balance sheet loan workouts, with market leading restructuring techniques achieving premium returns for our clients.

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