European commercial real estate: credit outlook improves

Borderline investment-grade, high-yield issuers still face stiff financing challenge

Analyst

Philipp Wass

+49 30 278 91 253

p.wass@scoperatings.com

Media

Matthew Curtin

+33 7 88 89 78 09

m.curtin@scopegroup.com

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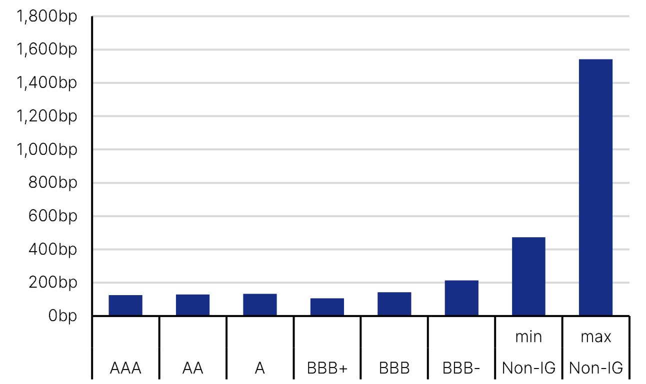
Debt markets are slowly reopening for Europe's commercial real estate companies, but investor confidence is yet to recover to pre-2022 levels given the prevalence of high leverage, heavy capital expenditure and questions over governance at some issuers.

Only solidly investment-grade companies rated BBB and above have access to the most liquid debt capital markets. Falling bond yields and tighter spreads can provide capital market-based financing which is competitive with secured bank borrowing. For these issuers, spreads for new issues ranging from 90bp to 150bp, close to the 25bp-145bp range in 2021 (**Figures 1, 2**), the year when capital market debt issuance for real estate companies peaked (**Figure 3**).

For borderline investment-grade companies rated BBB-, investors' fears of rating downgrades are visible in much wider spreads. Spreads on new issues running above 200bp, a sharp contrast with the 60bp-145bp range in 2021.

While we believe prices have reached bottom for some property classes, investor jitters also point to the risk of further drops in property values at the riskier end of the European commercial property market. Banks' appetite to fund weaker commercial real estate remains muted which exposes real estate managers to a doom loop. Distressed asset sales may challenge current valuations and can become a catalyst for balance-sheet restructuring. In addition, potential sales by open-ended real estate funds to offset cash outflows will test the market's resilience.

Figure 1: CRE risk aversion: Z-spreads by issuer rating



Source: Bloomberg, Scope Note: Data for Z-spreads (spreads across the yield curve) is from 14 August 2024

Figure 2: Yield spreads on new CRE corp. bond issuance

		2024	2021
AAA AA A BBB+ BBB		*90-150bp*	*25-145bp*
BBB-		*above 200bp*	*60-145bp*
Non-IG	min	*around 500bp*	*190bp*
Non-IG	max	*na*	*475bp*

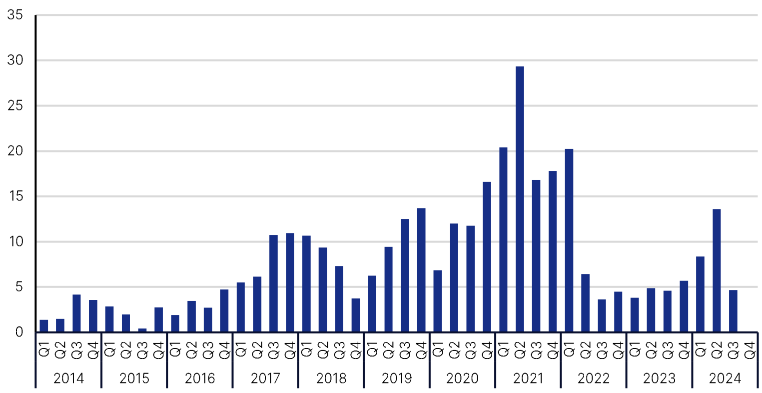
Source: Bloomberg, Scope

Non-investment grade issuers face still tough financing challenges

Spreads are even higher for non-investment grade rated issuers and companies where investors are concerned about governance. They are effectively priced out debt capital markets as a source of funding to avoid potential covenant breaches and support interest coverage ratios.

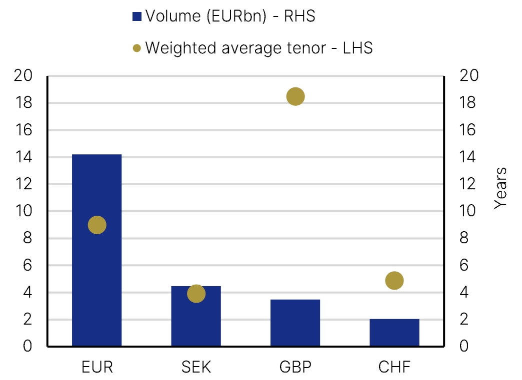
Europe's smaller capital markets, such as Sweden's, offer borrowers credit only at shorter maturities (**Figure 4**) and so provide little relief to a debt-laden industry.

Figure 3: Bond issuance from European real estate companies 2014-24
EUR bn



Source: Bloomberg, Scope Note: 2024 data is for year to date.

Figure 4: Bond issuance by selected markets
EUR bn



Source: Bloomberg, Scope. Note: markets are euro area, Sweden, UK and Switzerland; data is year to date

Risk of further declines in property valuations hangs over sector

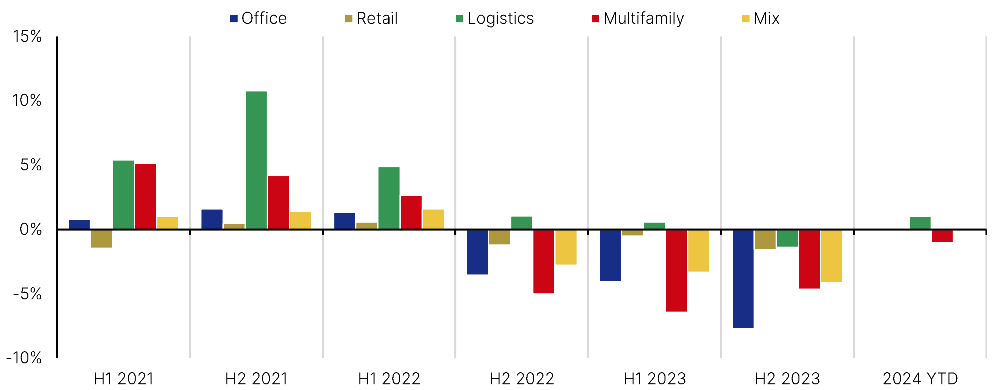
Danger of further declines in CRE valuations

Investor caution also reflects the considerable remaining risk of further devaluation in CRE assets. Corrections for prime real estate (retail and office) as well as residential and logistics properties in general are bottoming out (**Figure 5**). However, prices for non-prime assets and those requiring hefty investment – modernisation, compliance with environmental regulation, conversion to adapt to structural shifts in real estate demand – are still falling.

Questions over liquidity at some open-ended real estate funds

Some additional downward pressure on valuations could come if open-ended real estate funds, which are experiencing large cash outflows, start to dispose of weaker properties in their portfolios to raise liquidity. So far, the funds have avoided doing so to keep net asset values high. Should a substantial amount of the property –- such as some of the EUR 128bn in investments[1] held by German open-ended funds – come to market, we will see further devaluations of real estate assets.

Figure 5: Half-year fair value at sample of 53 property companies[2] (% change on previous H1)



Source: public information, Scope

[1] Investmentfondsstatistik (bundesbank.de) - August 2024
[2] Office: 13; Retail: 10; Logistics: 9; Multifamily: 12; Mix (mix of different commercial property classes): 9

Sharper turn in interest-rate cycle offers possibility of greater relief

Prospect of lower interest rates offers relief to indebted CRE firms

Europe's CRE companies would clearly benefit, like any indebted sector, by a sharper-than-expected turn in the interest-rate cycle if fears of recession and stagnant growth result in looser monetary policy in Europe and the US. We currently expect continued cautious reduction in policy rates with just one 0.25bp rate cut from the ECB and Federal Reserve during the second half of the year.

Underlying mid-swaps have turned sharply south on fears of a recession in the US. In case of a weaker growth outlook materialising, as well as sluggish economic growth in the UK and EU, faster interest rate cuts could provide a fund-raising window of opportunity for companies with structurally sound asset portfolios, low leverage and no governance issues.

In general, we expect little near-term issuance from smaller real estate peers (gross asset value of below EUR 2bn) in the Eurobond market. The benchmark bonds that that these companies issued to take advantage of cheap market funding costs in the decade before 2022 have left many with the headache of refinancing them at much steeper rates today – if at all.

Banks provide continue support to sector – up to a point

Bank finance ample for some, but not all, CRE borrowers

Banks have become more cautious and selective but continue to lend to the sector. They are willing to roll over existing financing for operationally sound properties/portfolios – are even willing to provide fresh credit if security packages are strong and covenants tight.

Margins on secured loans have increased to 60bp-230bp[3] reflecting property type, ultimate ownership, leverage and, most importantly, location. Bank funding can therefore be a more reasonable alternative for weaker creditors than capital markets-based funding.

Bank funding has its limits, however. Banks not only have tightened underwriting but have become more focussed on the composition of their loan books with regards to maximum exposure to a sector, individual issuers and/or properties without good EPC grades or other green-building certification. Secondly, highly leveraged transactions are no longer feasible, meaning that if a borrower runs into financing trouble, it might have to tap grey debt markets at a much higher cost.

Refinancing for high-yield issuers remains challenging

Secured bank lending can only cover a marginal part of the refinancing of maturing bonds, leaving lower investment-grade and non-investment grade issuers under pressure to restructure their assets or their liabilities – or both – to protect their creditworthiness, most likely at a high cost to both equity and debt holders.

Europe's CRE sector as a whole is over the worst of the recent financing crunch but the credit outlook for many companies remains highly uncertain.

[3] An increase of 50-70bp compared to 2021, mostly related to the *Beleihungsauslauf* of the underlying financings, which determines the portion of the financing that is not covered bond eligible and therefore exposed to market price risk

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin
scoperatings.com

Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scoperatings.com

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Bloomberg: RESP SCOP
Scope contacts

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