German commercial real estate - refinancing risk surging

Debt instruments secured by CRE exposed to property revaluation and repricing risk

German commercial property prices are above sustainable levels – by about 16% for the seven largest German cities and 9% for smaller cities and towns. Once interest rates normalise, debt instruments secured by commercial real estate (CRE) in Germany will be vulnerable at refinancing due to property revaluation and repricing risk.

German CRE prices have surged since 2008…

Over the last 10 years post crisis, German nominal commercial real estate property prices have grown at an average pace of 6.2% p.a. supported by an abundance of liquidity in the market, the low interest rate environment, the sound, stable national economy and investors' desperate search for yield.

…and twice as strongly in top seven cities…

This growth has not been spread evenly across Germany. In the top seven cities growth has been 11.6% p.a. since 2008, while in smaller cities and towns it was limited to 5.4% p.a.

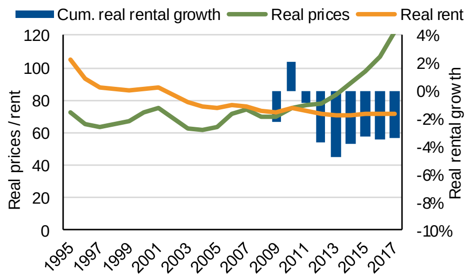
In real terms, using the regional German GDP index as a deflator, property price growth has been higher in Germany's top seven cities (7.5% p.a.) than in other German cities (2.5% p.a.). This dichotomy was also driven by the entrance onto the market of new international lenders and less experienced investors who were attracted to prime city locations and significant investment tickets rather than CRE in the surrounding areas.

…while decoupling from rental income growth…

While real commercial property prices were growing faster than GDP, real rental income dropped during the same period, pushing the property multiplier to unprecedented levels. Real rents decreased by 0.3% p.a. in the top seven cities and by 0.9% p.a. in the smaller cities.

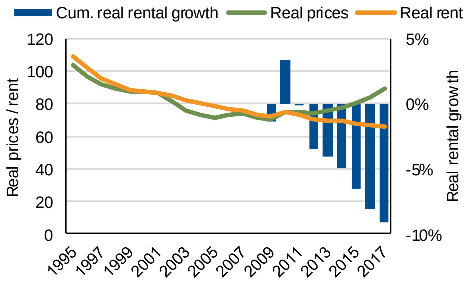
The sustainability gap widened, with real prices in big cities rising by 7.5% annually since 2008 but rents falling by 0.3%. This gap was less pronounced for smaller cities and towns in which the real rental decline was greater but, at the same time, market value increase was weaker.

Figure 1: Top seven cities – real price / rent levels



Sources: Scope, Bulwiengesa

Figure 2: Other cities – real price / rent levels



Sources: Scope, Bulwiengesa

…and exceeding sustainable levels.

Despite the higher increase in the top cities, prices in both larger cities and smaller cities seem to be above their sustainable mean. Prices are at levels that we deem to be above the sustainable mean by 16% for the top seven cities, and by 9% for the 120 secondary German cities.

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Related Research

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We have calculated the sustainable mean as a linear function of real property prices during a full economic cycle from 2007 to 2014.

Property prices have historically been more volatile than rent levels. Rent levels are kept relatively stable by 5-10-year lease terms and indexation clauses that protect them from potential shocks. At the same time, property prices are more volatile due to their high exposure to macroeconomic factors and investor demand. If demand falls as a result of rising interest rates, portfolio rebalancing strategies and/or a weakened economy, the German commercial real estate market may be subject to considerable price corrections.

Current property price levels will drive refinancing risks…

New market players and fiercer competition are changing the rules

Once the ECB starts to tighten its post-financial crisis expansionary monetary policy and increase interest rates, refinancing conditions will tighten both in terms of funding costs and tenor. The combination of higher lender competition and regulatory capital requirements has reduced the attractiveness of traditional CRE for numerous historic lenders, especially when such exposures remain on their balance sheets. In order to preserve their commercial relationships and remain competitive, banks have become more interested in non-conventional refinancing solutions, like securitisation, structured syndication and loan repackagings. New buyers, such as insurance companies, pension funds and direct lenders, are stimulating demand by broadening the scope of their investments in a bid to enhance their returns while managing their regulatory capital constraints. However, the normalisation of macroeconomic conditions will lead these buyers to rethink their portfolio allocation and dampen demand, putting even more pressure on refinancing.

Interest rate normalisation may also lead to a flight to quality. CRE assets with a low gross rent multiplier, below average property quality, or assets exposed to a mature or declining market, such as the retail sector, may become less attractive and harder to refinance at a sustainable cost of debt.

For riskier projects with high leverage, non-prime or esoteric illiquid assets, or with modest cash flows, borrowers will have to turn to more aggressive or opportunistic lenders like private equity firms which require higher margins for the risk taken.

Finally, unattractive refinancing conditions as well as reduced leverage incentives (e.g. BEPS and interest deductibility, Basel IV and capital requirements) could lead sponsors to choose equity financing solutions over debt financing solutions.

…which are reflected in Scope's CRE credit risk approach.

Scope focuses on sustainable cash flows and long-term security value

Scope's ratings reflect an investor's expected loss over an instrument's weighted average life accounting for the time value of money at the instrument's promised rate. Our approach considers the probability of default and the expected loss, both over the life of the transaction and at refinancing. We analyse sustainable cash flows, the security's long-term value and asset quality in order to assess the refinancing probability of default and expected loss.

Our bottom-up approach, starting with the assessment of a sustainable rental income, includes structural and regional differences in its cash flow projection. Our long-term credit ratings and comprehensive analytical approach incorporate asset-specific features and fundamental regional economic or sector trends into their assumptions.

In our view, German CRE transactions with limited interest rate protection, no amortisation, modest financial metrics or exposure to weaker regions are likely to be among those most undermined by a market regime shift caused by the normalisation of the ECB's monetary policy or investors' rebalancing strategies.

Breakdown of regional rent levels …

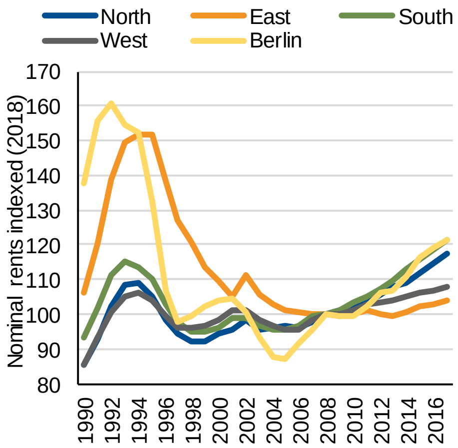
Significant rental trend disparities among regions

Rental growth is unevenly spread across Germany. In the last 10 years, the cumulative growth of nominal rents has ranged from 23% in Bavaria to -3% in Brandenburg. If we break the country down into the cardinal directions (plus Berlin), the southern and northern regions clearly outperform rental growth in the eastern and western regions during the same period.

Figure 3: Cum. rent increase since 2008

Sources: Scope, Bulwiengesa

Figure 4: Regional rent index (ind. = 2008)



Sources: Scope, Bulwiengesa

Rental growth in the eastern part of Germany as well as in Berlin was strongly impacted by German reunification in the 1990s, followed by a sudden correction lasting until 2005 (see Figure 4). Since then, and despite the global economic crisis (sub-prime and European sovereign crisis), rents have recovered and grown in most German regions.

… illustrates that regional specificities are driving the markets.

Top seven cities are not top rent growth performers

Although some regional trends are becoming apparent, aspects specific to the regions are playing an essential role. Not one of the seven big German cities is among the top 10 performers in terms of rental growth over the last 10 years. While this appears surprising at first glance, it reflects the growing attractiveness of secondary cities with a good infrastructure which are close to strong economic locations. Offenburg, ten kilometres away from Strasbourg and one hour away from Zurich, and Ulm, located in the middle of the German automotive 'golden triangle' of Nuremberg, Stuttgart and Munich, are good examples of two such cities.

Cities located in economically weak regions in both the eastern and western parts of Germany have experienced rental declines. Neubrandenburg has a weak economy and is far away from other major German cities, reflected in a 28% drop in its population since reunification. The picture in Recklinghausen or Hamm, where the economy suffered from the phasing-out of coal, is the same.

City	State	10y rental growth
Offenburg	BW	59%
Kempten	BY	41%
Aschaffenburg	BY	40%
Neumunster	SH	38%
Regensburg	BY	36%
Dresden	S	34%
Freiburg	BW	34%
Ulm	BW	33%
Konstanz	BW	29%
Hannover	NS	29%

City	State	10y rental growth
Neubrandenburg	MV	-17%
Cottbus	BB	-12%
Recklinghausen	NRW	-11%
Eisenach	TH	-11%
Hamm	NRW	-11%
Brandenburg adH	BB	-11%
Frankfurt (Oder)	BB	-10%
Gera	TH	-8%
Bottrop	NRW	-8%
Görlitz	S	-7%

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