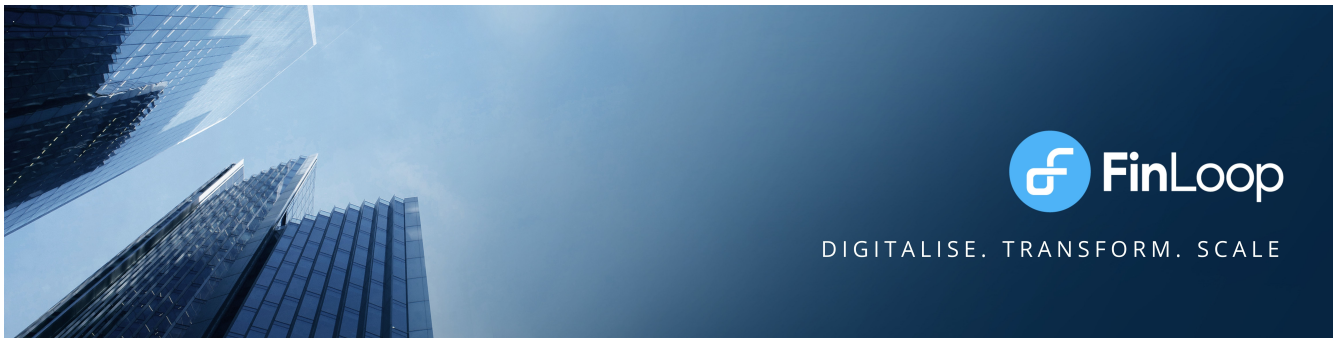

FinLoop Q3 2022: European Debt Liquidity Barometer

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Summary:
• Debt affordability has been further declining across European real estate markets with rising interest rates. 10yr BBB credit spread have increased another 80bps in Q3 2022.
• Loans on highly priced properties with 60% LTV are now stretched to cover interest payments when refinanced today, borrowers in Germany, Sweden, and the Netherlands are still slightly better off than in other markets.
• The listed real estate market is leading the market indicating the anticipated decline in property values, EPRA showing a Q3 2022 performance of -16% (previous -24%) leading to an expected decline in underlying property values of 30 – 40%. Q3 2022 showed €900million further deal volume across FinLoop platform, 33% of financing requests were for residential loans, 17% office..
• 17% of FinLoop listed transaction were seeking debt for transitioning assets, refurbishment and asset improvements.
• Most active lenders were alternative lenders, while banks were showing keen interest in residential transaction and stabilised assets with cash flows..

1 Market changes Q3 2022 - Q2 2022

This section looks the changes across all markets quarter-on-quarter and analyses the key differences and reasons for changes over the period. • Across Europe countries GDP growth is weak. Especially Germany is expecting close to 0% GDP growth, therefore negatively impacting the rest of Europe. The UK also is not expecting any GDP growth for 2022.

• Interest rates have increased for the 3rd quarter in a row. For Sweden and Germany 10yr rates just moved by another 80bps, less than in Q2 2022, while for other countries rates moved by 100 – 120bps. The UK has seen a sharp rise by 170bps over just 3 months.

• Overall Germany and the Netherlands improved their overall score to Q3 2022 from Q2 2022 due to relatively slower increase in interest rates compared to other markets.

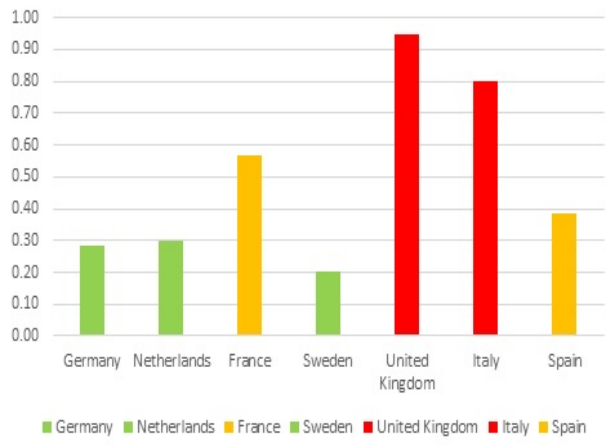
• When adding the iliquidity risk for CRE debt using the IBOXX BBB bond yield indices, debt affordability is declining further in all markets, especially affecting the ability to pay interest on the most expensive (prime) property. This makes refinancing difficult for borrower and lenders. No country shows a significant advantage over another.

The ECB has warned about the impact of the CRE sector on the economy. “Bank mortgage loan portfolios exceed 200% of banks’ CET1 capital in most euro area countries.”

High leverage and strong links with the economy shape the transmission of real estate boom-bust cycles to the financial system. About 58% of real estate investors are investment funds (RCA, 2022), collective investment vehicles backed by institutional investors such as insurance companies and pension funds, but also private investment funds (German open-ended funds), which are sold as retail products to private investors.

European real estate transactions are to 50% domestic and another 15% from other European markets. Hence, the domestic buying and selling activity is most important. The ECB further indicates that 68% of properties have remain stable in value, only 7.5% have seen a value adjustment of 10%, 4.4% declined by 5%. While for 18.2% the value has increased.

Figure 1: Q3 2022 individual market scores



Source: FinLoop

2 CRE debt availability Q3 2022

• While it has generally become more difficult to find financing, borrowers are very pro-active to refinance assets, especially with the additional angle of re-purposing or transitioning to improve the overall asset quality.

• Many financing requests now contain an extra element of capex or light refurbishment to upgrade the building quality. Most liquidity is still available for the €20 – 60million loan market. Regional lenders are also very active in the €10 – 20million loan market.

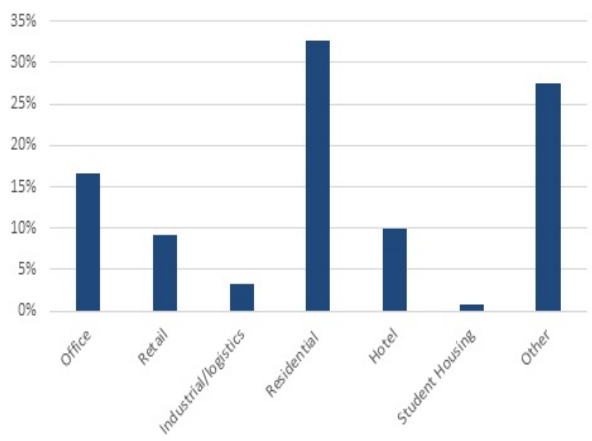
• In Q3 2022 €900million of new transaction were listed on FinLoop, the majority, 33% were residential, and 17% office.

• 41% of FinLoop transactions were for development finance, 20% straight acquisition loans, 22% refinancing, and 17% bridge finance seeking less than 12 months financing to either upgrade, transition assets with the view of long-term financing option after the initial period.

• The most active lenders were alternative lenders and for residential financing banks showed keen interest.

• Current interest cover ratios are expected to be 1.2x – 1.5x across Europe for loans not on fixed rates or those being refinanced, based on a 55% - 60% LTV. Hence, putting pressure on lenders to lower debt amounts, asking for deleveraging of existing loans or interest reserve accounts.

Figure 2: Q3 2022 FinLoop transactions by sector



Source: FinLoop

3 Long-term market movements

• Across other European markets, the interest rate increases have had a much larger effect on debt affordability combined with highly priced properties, which are still trading at high income multiples.

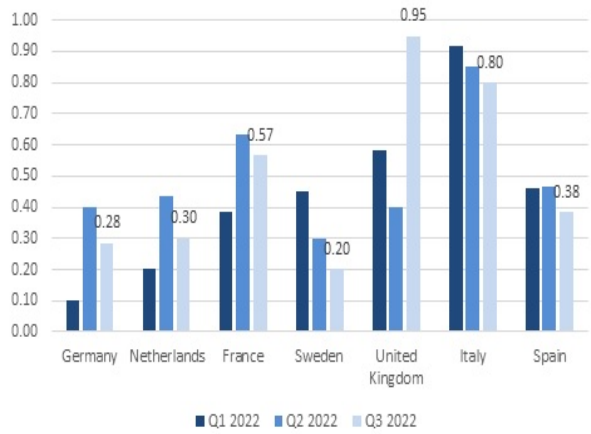
• The European EPRA index recorded a quarterly return of -16%. REITS exposed to office markets and key cities are trading at discounts of 17 – 30% to NAV suggesting a clear property value decline in the underlying market in the near term. This increases the pressure to revise property yields upwards over the coming quarters.

• The UK economic and financial markets have reacted very negatively to the latest government announcements and debt costs are now becoming a burden for many borrowers, hence the UK overall score has risen sharply indicating market distress.

• The Euro area is staying more closely together by the common interest rate policy and ECB control and appears less volatile.

• Property yields have started softening in Germany, Italy and Spain.

Figure 2: Q3 2022 FinLoop transactions by sector



Source: FinLoop

Table 1 Estimated European debt funding gap 2023

	Market Decline		
Total Transactions	10%	20%	30%
300€	270€	240€	210€
250€	225€	200€	175€
Total Debt	LTV 55%		
165€	149€	132€	116€
Difference	-17€	-33€	-50€
138€	124€	110€	96€
Difference	-14€	-28€	-40€

Source: FinLoop

4 Future outlook for the CRE debt market

• Based on historic transaction volume figures from RCA and CBRE, European refinancing volume for 2023 – 2024 of approximately affecting €250 – 300bn real estate assets per year. Assuming a conservative 55% LTV this means €140 – 165bn of debt to refinance. Gemany's market share alone is approx. 30%.

• In a potential decline of property values, this will lead to lower loan amounts, leaving a potential financing gap. The estimated European financing gap for a 10% property value decline is €14 – 17bn per year, of which €5bn is for Germany alone.

5 Caveats and Methodology

The new European credit liquidity barometer for real estate debt markets by FinLoop is based on relative market performance for 8 selected European markets, and is published on a quarterly basis. It tries to assess the credit environment and debt availability for real estate investors in each market based on economic, financial and property market indicators. The barometer consists of five variables

• Absolute 10yr government bond yields as indicator for interest rates in each market.

• Change of 10yr government bond yield as indicator of change in interest rate terms, showing how quickly interest rates are changing in each market.
• Quarterly GDP growth estimate as indicator of general market and economic health supporting real estate markets.
• Quarterly REIT performance by premium/discount of market cap as an early sentiment indicator of real estate pricing. REITS trading at a premium is an indicator of confidence of investors in the future of the underlying property market while REITS trading at a discount tend to indicate bearish sentiment on the outlook for the underlying real estate.
• Debt affordability ratio, income over cost of debt, calculated as the net income yield over the cost of debt for a 60% LTV loan, representing an estimated interest-cover ratio (ICR). The pricing is derived from the local risk-free government rate + BBB Iboxx bond yield to provide an indication of debt pricing versus potential income.

Each quarter all eight markets are ranked on all 5 indicators. The final score is weighted between the 5 indicators and normalised to a score from 0 to 1. Overall a score of 0 – 0.33 is regarded as a market with high debt affordability and positive overall economic stability (green), markets with a score 0.34 – 0.66 are regarded to be of good debt affordability on a selected basis with moderate economic performance expectations (yellow). Markets with a score of 0.67 – 100 are considered of low debt affordability with the risk of increasing lending rates, and below average economic performance (red). The author(s) note that, for each individual real estate market, unexpected trends or events could significantly disrupt everyone's outlooks and forecasts. Unforeseen and unforeseeable shifts could rapidly change current prospects. For example, the property market cycle is equally linked with the economy while the CRE lending market is correlated with other banking markets. Further, every market offers high and low risk opportunities representing properties of a large range in yields and quality. Each individual transaction has to be assessed on an individual basis. Further, FinLoop reports lender appetite on specific asset classes and types of loan to provide additional insight into each market in terms of debt availability.

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References

► How to optimise leverage on your assets in a rising interest rate environment
► FinLoop Q2 2022 debt liquidity barometer
► FinLoop Loan Management

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