Analysis - Growing pains hurting European CMBS revival

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By Sinead Cruise and Al Yoon

LONDON/NEW YORK (Reuters) - Recovery in Europe's sluggish market for commercial property bonds is lagging up to five years behind the United States, delaying a return to cheaper borrowing and putting the brakes on real estate prices.

Without radical reform, Europe's commercial mortgage-backed securities (CMBS) sector may never serve as a fruitful source of debt again, experts said, while in the U.S., demand for real estate bonds and the allure of distressed assets is sparking more lending from banks, private equity and hedge funds.

"The rules of the game have to change dramatically to give confidence to investors to embrace the European market again," said BNP Paribas real estate securitisation head Marco Rampin.

Commercial Real Estate Finance Council data shows about $2.4 billion (1.5 billion pounds) of U.S. CMBS were packaged and sold in first-half 2010, from $638.5 million a year ago, including the rebirth of multi-loan deals key to expanding credit to property buyers.

Europe, on the other hand, is still waiting for its first genuine post-crisis CMBS issue, even though average commercial property prices in key markets like Britain have gained about 15 percent in the past year.

The UK growth has slowed sharply since March, data from CB Richard Ellis shows, with the decline blamed on lack of credit.

Figures from Deutsche Bank show outstanding European CMBS total $195 billion, against $855 billion in the United States. Between now and end-2013, about $150 billion of U.S. CMBS falls due for refinance, against $30 billion in Europe.

Although five-times smaller, Europe's CMBS refinancing task may prove a bigger challenge due to inherent structural quirks.

"The European CMBS market is much younger and didn't have chance to develop many of the "strengths" of the U.S. product before the downturn," said Citigroup CMBS analyst Stav Gaon.

The 15-year-old U.S. market was deeper, and had greater experience of managing troubled loans, Gaon said.

Detailing a major flaw, experts said most European CMBS gave junior noteholders too much sway relative to their stake, which meant they could block asset liquidation if a bond defaulted.

This potential for conflict, combined with the lack of an empowered industry of bond troubleshooters, known as special servicers, has done more to repel prospective European CMBS buyers and issuers than most other factors, the experts said.

Meantime, underwriters on a recent U.S. issue gave AAA-rated investors majority control in special servicing to allay similar concerns, Deutsche Bank analyst Harris Trifon said in a note.

Until more logical rules on creditor relationships are set, credit flows to Europe's property market are likely to remain stunted, limiting potential growth in real estate values.

"Besides lack of clarity on who does what and how in case of defaults, it's also the lack of a special servicing 'culture' (in Europe) that hinders a speedier recovery," Rampin said.

OVER-COMPLICATED

Most analysts said the different structural make-up of U.S. and European CMBS explained the mixed recoveries and galvanised the case for major reforms of the product in Europe.

Until these happen, lenders will miss out on a key means of replenishing capital reserves from which to generate new loans.

In Europe, most CMBS have covenants linked to loan-to-value and income-to-interest ratios that tended to drive loans into special servicing much sooner than in the United States.

At 5-7 years, average deal terms were also much shorter, a characteristic that has bunched up maturities of debt issued during the boom, and overwhelmed shallow refinancing appetite.

Euro CMBS issues tend to contain 5-12 loans, against 100-200 loans for U.S. deals. Even today, last week's $788.5 million U.S. CMBS priced by Goldman Sachs and Citi was backed by 23 assets.

The larger volumes make the U.S. deals more homogenous in nature, enabling investors to quickly reprice risk against benchmark issues, a crucial first step to boosting liquidity and restoring a more affordable mortgage market, the experts said.

"The US account base is very active and enjoys wide participation from hedge funds, money managers, insurance companies and pension funds," Edward Chai, a portfolio manager at Henderson Global Investors, said.

The U.S. CMBS market recovery has been boosted by the Federal Reserve's Term Asset Backed Securities Loan Facility (TALF) emergency lending program.

This high-level backing reflects common understanding that the broader U.S. mortgage market cannot move forward without reviving CMBS as a financing method, a fact yet to dawn on most participants in the more disparate sister market in Europe.

"With CMBS being the dominant source of U.S. commercial real estate finance, the lack of issuance has had a huge impact and there is no real alternative," said Nassar Hussain, a principal at niche property investment bank Brookland Partners.

Although less than a tenth of the total commercial real estate finance market in Europe, securitisation gave Basel II-constrained European lenders vital means to recycle capital and manage exposure to higher-risk, higher-margin loans.

Experts said Europe would struggle to reduce the cost of borrowing without devising standard practice for managing problem CMBS, broadly seen as over-complex debt investments.

"It's hard to imagine the U.S. commercial real estate market without CMBS, while in Europe people might argue it's possible to live without it. That's unlikely in my opinion," Gaon said.

(Editing by Andrew Macdonald)