Analysis: Europe from above

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With 2017 well underway, Daniel Cunningham examines the key factors affecting the region's real estate lending.

Many in the real estate industry will take to the sky later this month to head to MIPIM, the annual property fair in Cannes on the French Riviera. The gathering is perhaps the best chance for property professionals from across Europe and beyond to swap notes on the state of the market.

It is an apt point in the calendar at which to take stock of the defining factors in the European real estate debt markets. While the underlying property markets seem relatively resolute, external factors could upset matters.

For an industry driven by global flows of capital and cross-border investment deals, the volatile state of European and global politics is the number one threat.

The UK's triggering of Article 50 of the Lisbon Treaty this month will begin the countdown to its new relationship with the European Union. We know it will not seek access to the single market, but little else about its eventual trading status with the outside world is clear at this stage.

The strength of the EU will be further tested at the ballot box this year. The Netherlands votes for a new government on 15 March, with far-right politician Geert Wilders, the would-be leader of a 'Nexit', in the running. The first round of the French presidential election is held on 23 April, in which Front National's Marine Le Pen is aiming to pull off France's version of the populist uprisings that saw the UK vote for Brexit and the US for Donald Trump. Then, on 24 September, Germany's federal election takes place. The

future of Angela Merkel – for so long a beacon of European stability – is far from assured. Her main rival, the former European Parliament president Martin Schulz, is a Europhile and arch-critic of Brexit.

For real estate financiers, underwriting Europe's elections is almost impossible. "People are vigilant around it, especially the French and German elections," says Riaz Azadi, managing director at real estate advisory firm Eastdil Secured. "But, when it comes to underwriting, lenders and investors continue to look at the CRE fundamentals. Transactional data in France and Germany can provide lenders with further conviction about the underlying market and investment thesis."

As well as the fight to save the EU, the impact of US President Donald Trump's policies on Europe will form the backdrop to the year. Trump's 'America first' message and scorning of globalism could have significant consequences for Europe.

"Trump's trade policies will have a longer-term impact," says Andrew Burrell, head of forecasting for JLL. "There's a lot of noise out there and unpredictability in the system, but still the same underlying themes in the economy."

Despite perceptions, economic growth in the eurozone has been relatively strong, with 14 consecutive quarters of growth now recorded.

"The global financial crisis seems to have had a permanent impact on how fast European economies can grow, but during the last two years, the UK and the eurozone have done well, relative to benchmarks. They will continue to grow at around 1.5 percent," predicts Burrell, "although there is potential for higher inflation to slow growth down."

Although inflation in Europe remains below the EU's 2 percent target, it has spiked in Germany, up 1.7 percent in December. German sensitivity to rising inflation could lead to pressure on the European Central Bank to ease off its monetary policy. 'Trumpflation', imported from corporate growth in the US could also be an issue for the eurozone.

The rock bottom interest rate environment has become a significant feature of the European property markets, with investors able to access cheap debt and banks competing on pricing. An interest rate rise would place upward pressure on pricing, force sponsors to rethink debt strategies and potentially hit property values.

However, this threat may prove unfounded, for now. "Higher inflation is expected this year, but monetary conditions will remain ultra-loose, so inflation will fall back to target

levels next year. I don't see interest rates going up until the end of the decade," says Burrell.

The sentiment is echoed by bankers who do not envisage a significant change in the economic landscape. "Monetary policy will be accommodative for a while, with low interest rates and continued QE," says Michael Shields, head of real estate finance for the US, UK and APAC at ING Real Estate Finance.

One economic situation to watch is Italy's banking crisis. Last December, the government approved a €20 billion bailout of the weakest banks and there are hopes that the crisis can be contained, although it highlights the continued struggle of some European lenders with their non-core legacy debt piles.

"The systemic weak capital position of banks in Italy and the political uncertainty following the Italian referendum are important issues, but they are not crippling the system," says Marco Rampin, head of debt and structured finance Europe at CBRE Capital Advisors. "People continue to invest."

Adapting to the cycle

Investors' and lenders' views on where we are in the cycle differ, but many agree that several European markets look fully-priced.

Speaking about the UK, Nassar Hussain, managing partner with advisory firm Brookland Partners, says: "Investors' returns are moving more towards income returns and more limited capital growth. Whilst the very large opportunistic funds still see significant demand, we are seeing more LPs move towards core-plus strategies as it becomes harder to source deals with opportunistic type returns.

"Core, core-plus works for mainstream lending, it's where the majority of the lending market is. Senior lenders are still risk-conscious. They compete on pricing but less so on risk. For additional risk the whole loan and mezzanine funds fill the gap."

"There has been a solid performance in prime rental growth for all European sectors, aside from UK offices," adds JLL's Burrell. "There is potential for prime yield compression in the near term, but outward movement from 2018 as market interest rates edge higher."

Elsewhere, there is a sense of potential for some growth in certain parts of the European markets. "Paris is one market where we'll probably still see some refurbishment and construction activity and there's potential for more construction to add supply in some

German cities. It’s not the end of the cycle yet,” says ING’s Shields. “What worries me though is that yields are so tight. If Mario Draghi took his foot off the gas and stopped QE, yields could back up. That’s the risk.”

Undoubtedly, several lenders dialled back their lending activity in 2016, with UK clearers especially risk-averse and many firms which seek higher returns having difficulty sourcing the deals that will generate them.

However, market watchers insist there is a strong line-up of organisations determined to provide liquidity to the European markets. “2015 was a big year of lending for a lot of banks and institutions and a lot set similar targets for 2016, but for many reasons there was not the same volume of dealflow, so lenders generally have appetite to put risk on their books,” says Gadi Jay from Blackstone’s real estate division, who is responsible for sourcing debt for the firm’s European investments.

For continental European banks, such as the Germans, the monetary policy backdrop makes continued lending imperative. Negative interest rates punish those who sit on their capital.

“There’s an increasing appetite from European lenders,” argues Azadi. “There was a blip in the UK last year, which spurred on some of the newer entrants to the market which felt they would not be crowded out.”

Others agree that liquidity remains plentiful. “Everyone seems quite open for business, including markets such as Central and Eastern Europe, almost as if everyone wants to make up for the ground lost following the pause in the wake of the Brexit result,” says CBRE’s Rampin. “But while appetite is there, prudence is paramount. Large underwrites or holding larger positions are becoming rarer, so syndicating the risk is popular. Alternative lenders are gaining ground in this space.”

Debt fund managers continue to attract capital into the sector. AXA recently closed its 10th senior property debt fund on €1.4 billion, with a further close to come. Mezzanine funds are less prevalent, with those seeking high-yielding business choosing instead to write whole loans.

But not all parts of the market are well-served, explains Shripal Shah of UK debt advisor JCRA: “There will be a miss-match of demand and supply for some types of debt, such as development finance and non-prime assets.

“Is real estate debt pro-cyclical? It has to be, as it follows transaction volumes. The current trend is for lenders who want to finance higher yielding asset classes such as student accommodation.”

Pricing remains tight

Market data gathered by JCRA shows that average UK lending margins were 255 basis points in Q3 2016 and almost 270 bps in Q4 2016. Many estimate that margins went up between 25 and 50 bps throughout the year. However, others note that in the early part of this year, there has been some renewed downward pressure on margins.

“Pricing across the board is tightening for core and core-plus assets, even in the UK,” says Azadi. “This is partly driven by increasing confidence in the syndication market for larger loans, growing the balance sheet and managing loan maturities in addition to factoring in a lenders’ own balance sheet funding sources.

“The combination supports a positive environment for borrowers on stabilised assets and also conversely highlights opportunities for alternative lenders where debt liquidity may be more scarce.”

Pricing is, of course, asset specific and a premium can be attained by lending to alternative sectors in good locations, including student housing or private rented sector residential in the UK market, with some noting a 20-25 bps premium on prime alternative assets in core locations.

“The key is income durability versus those assets with some need for capex or re-letting risk which can be disruptive to the income,” Azadi says. “There’s a pricing premium for that, putting regulatory constraints aside.”

The counter-pressure on market pricing is the threat of tightening regulation with the Basel Committee on Banking Supervision revising its latest regulations, known as Basel IV.

In a paper last July, KPMG predicted the ‘Basel IV’ revisions to Basel III to increase capital requirements of international banks by €350 billion, or reduce their balance sheet assets by around €7 trillion.

Tighter rules

Increased regulation has been the tone since the global financial crisis in which real estate debt played such a significant role. However, the regulatory trajectory looks set to change in the US, with Trump dismantling the Dodd-Frank Act of 2010. A potential result

is that US banks become more competitive lenders in relation to their European counterparts.

Aside from the market for new lending, there remains a huge opportunity within the European non-performing loan sector. Although the first wave of NPL markets, predominantly the UK and Ireland, have now largely played out, a mountain of untapped non-core debt, much secured on property, still sits on balance sheets across Europe.

According to Deloitte's latest *Deleveraging Europe* report, €2 trillion of non-core assets on European financial institutions' balance sheets. In January, Evercore reported tracking 28 live real estate-related deals across Europe with €27.8 billion of face value, up 49 percent from the volume tracked at the end of Q3.
Spain, and possibly Italy as its banks are forced to sell NPLs, will feature prominently this year, with the focus of the market shifting south.