CATELLA

Capital Market Tracker DEBT 2020

Introduction – diffuse messages

Margin pressure, risk provisioning and increased reports of "alleged overvaluations" currently describe the commercial real estate markets. The messages that financing institutions in Europe are currently sending out with regard to the real estate markets are complex. The ECB's quarterly lending survey published in October reports a broad-based tightening of credit standards, which banks attribute mainly to risks related to the macroeconomic environment and weaker creditworthiness of borrowers. The survey also shows that the main reason for the decline in corporate demand for credit is a postponement of investment plans. The survey sends a similar message on access to finance for businesses: Small businesses expect access to internal and external finance to deteriorate. Banks may interpret the drop in demand for credit as a sign of deteriorating economic conditions, while businesses find their negative expectations confirmed by tighter credit standards.

Facts and Statements

- Euro Area banks: A tightening of credit standards on loans to firms in the third quarter of 2020 indicates credit risk considerations due to the coronavirus.
- Non-performing loans (NPLs) are expected to increase in 2020/21, but banks have significantly improved their asset quality, built up larger capital buffers and strengthened their liquidity positions while the volume has decreased significantly.
- Real estate financing sentiment recovered from the worst shock in the second quarter as the expectations of the availability of real estate financing and loan margins collapsed to record negative levels.
- Higher risk provisioning and interest margins by real estate financiers and banks lead to lower LTCs and LTVs. Mezzanine and subordinated capital in overall financing is increasing and a rising share of non-banks as capital providers in the financing market can be observed in Germany.
- Financing terms for core buildings seem stable now, standing around 20 bps above the pre-covid level, after having risen by around 40-100 bps in the second quarter.
- Capital costs for opportunistic properties and developments have increased much more strongly.
- Demand for real estate debt is increasing with a record high of EUR 32 billion raised globally in 2019 (INREV) while non-bank credits account for about one third of the total external debt of companies in the euro area (ECB).
- The Covid-19 pandemic has led to a flood of regulatory measures in order to mitigate the impact of the crisis – e.g. the postponement of the Basel-III reforms (often dubbed as Basel IV) from January 2022 until January 2023 and the permission to exclude central bank exposures from the leverage ratio until 27 June 2021.
- ECB will announce further stimulus on Dec. 10; liquidity injections via APP, PEPP and TLTROs are most likely.
- Since interest-rate differentials between Europe and US have declined, USD hedging costs dropped sharply.
- Record low interest rates as well as fiscal and monetary stimulus continue to support real estate (debt) markets globally. The attractiveness of real estate in the investment market is likely to remain high.

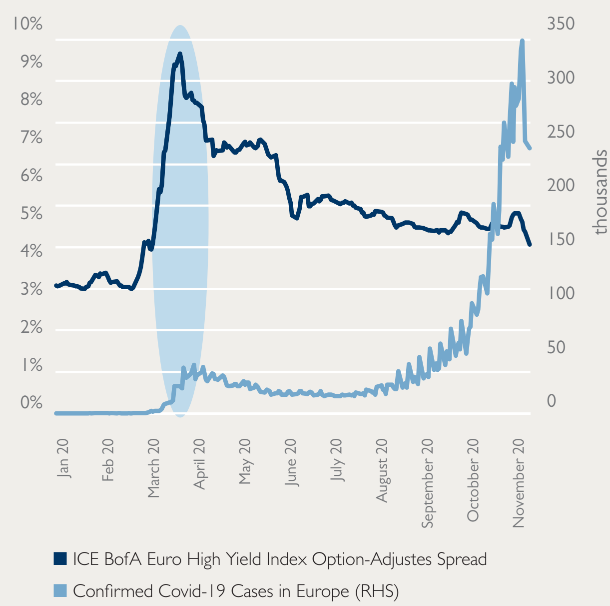
Second Covid-19 wave without volatility

The outbreak of the corona pandemic in Europe led to a massive widening of spreads for EUR corporates in Spring. Although the "second wave" of new infections led to a renewed increase in risk premiums, the widening was comparatively moderate.

Yields on investment grade corporate bonds fell at the end of October even almost to the annual low of February. The slight net increase in risk spreads since then has been offset by a similar decline in government bond yields. This allows favourable financing conditions, which can provide helpful relief for companies in the current crisis situation.

For bonds in the high-yield sector, the returns are still at a significantly higher level than at the beginning of the year, as the default risks have risen more strongly. Retailers in particular had problems to generate liquidity, as capital markets have been effectively closed or very expensive for them. But ECB measures also supported high yield markets, as fallen angel credits can be offered as collateral for lending. The default rates for European high-yield bonds are revised by Fitch to 4-5% in 2020 from initial 2.5% and are expected to increase towards 8.0% in 2021.

HIGH YIELD SPREAD VS. SECOND COVID WAVE



Source: Catella Research, Ice Data Indices, Federal Reserve Bank of St. Louis

Bank Lending Survey Q3 2020

Euro area banks reported a positive impact on their liquidity position and financing conditions regarding the impact of the ECB's asset purchase programmes in the October survey. Access to retail and wholesale funding as well as debt securities, securitisation and money market access has improved.

But overall terms and conditions for new loans to enterprises tightened in Q3 (a net percentage of 8%, after 2%), indicating credit risk considerations due to Covid-19. The rejection rate for loan applications increased across all loan categories. Margins on loans to firms (defined as the spread over relevant market reference rates) tightened slightly, while margins on riskier loans continued to tighten more strongly. Collateral requirements of banks for loans to firms increased significantly, reflecting concerns about firms business outlook.

Credit standards for loans or credit lines to enterprises tightened significantly in the third quarter of 2020 (19% of banks after 1% in the second quarter as net percentage). Banks reported a net tightening of credit standards for both loans to SMEs (18%) and large enterprises (16%). A further net tightening of credit standards is expected for the fourth quarter, reflecting concerns around the economic recovery (net percentage of 19%).

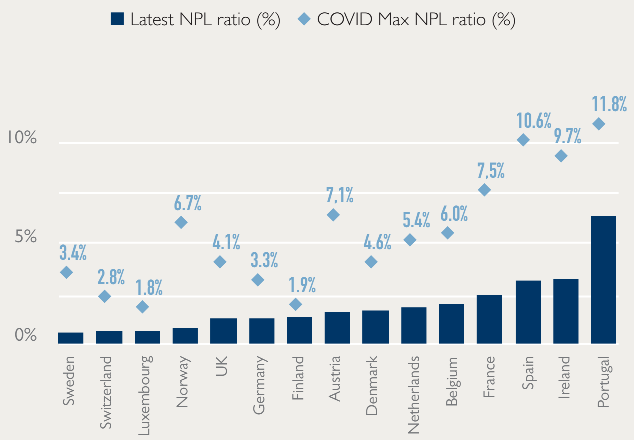
Risk perceptions (related to the deterioration in the general economic and firm-specific situation) is the main factor contributing to the tightening of credit standards.

Demand for loans to enterprises remain robust in Germany and Italy, while there was a significant decline in France and Spain in the third quarter of 2020. Overall, net demand to enterprises declined moderately, significant weakening for fixed investing, supported by debt refinancing and restructuring. A decline in short-term loans indicates lower emergency needs.

Non-Performing Loans in EU

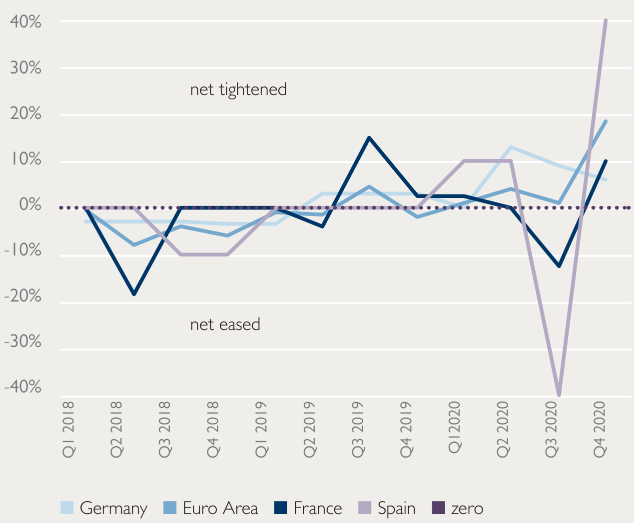
Banks have significantly improved their asset quality since the global financial crisis of 2008/09, built up larger capital buffers and strengthened their liquidity positions, therefore entering the economic slowdown in a better state than they did at the time of the previous financial crisis. The weighted average NPL ratio stood at 3% in June 2019 compared with 6% in June 2015 and total CRE volume decreased by 47% to €117 bn (18.4% of total) in the same time. On average, the NPL ratio has improved by 75 bps each year. NPLs ratios are higher for lending segments such as SMEs, CREs and consumer credit. As of June 2019, the average NPL ratio of banks for CRE lending stood at 8.1%, while the NPL ratio in Germany was comparatively low at 1.7%.

COVID-19 EFFECT ON NPL RATIO



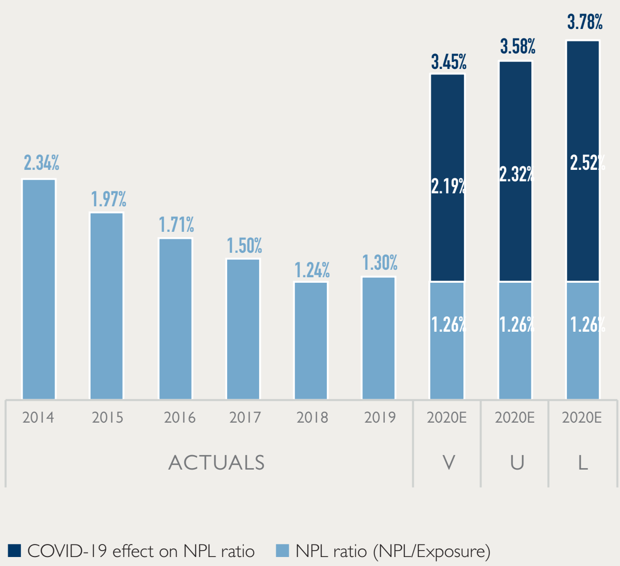
Source: Catella Research, NPL Markets, IMF

CREDIT STANDARDS (LOAN SUPPLY) TO ENTERPRISES NET PERCENTAGE
(frequency of tightened minus that of eased or reverse)



Source: Catella Research, ECB Statistical Data Warehouse

NPL PROJECTIONS FOR GERMAN BANKING SECTOR ACCORDING TO V-, U-, L- RECOVERY



Source: Catella Research, Strategy & analysis

Germany – Pandemic increases loss potential for CRE lenders

Covid-19 has hit the volatile and highly cyclical German CRE market at a late point in cycle. Shocks to the CRE sector could feed through to the financial system, considering the cyclicality and the interconnectedness of the CRE market with the financial sector and the real economy. A drop in commercial property prices would affect collateral values and loan-to-value (LTV) ratios in the banks' portfolios. Depending on crisis length, payment deferrals, defaults and declining collateral values, followed by increasing NPLs and provisioning needs, as well as reduced earnings are possible. Government support measures and strong solvency profiles mitigate these risks to some degree.

Most vulnerable sectors are hotel and non-food retail, due to the coronavirus-related lockdown whereas residential real estate has shown stronger resilience. The German Retail Foundation forecasts that 50,000 retail locations generating €40 billion of revenue are at risk of closing. Demand for office space could suffer from increased adoption of remote work and tenant insolvencies, leading to declining rental incomes and property values.

German banks are most exposed among European peers, holding 27% of total CRE lending in the EU which almost equals their capital (99% of CRE lending relative to equity). But German banks benefit from better asset quality (NPL ratio of 1.7%) than other European banks (8.1%) and price contractions have been less pronounced during recessions, compared with the European average. Specialised CRE lenders Aareal Bank AG, Berlin Hyp AG, Deutsche Hypo and Deutsche Pfandbriefbank AG (pbb) hold significant concentrations in CRE that represent more than nine times of their tangible common equity. The existence of real estate specialised lenders in Germany results from historical covered bond market.

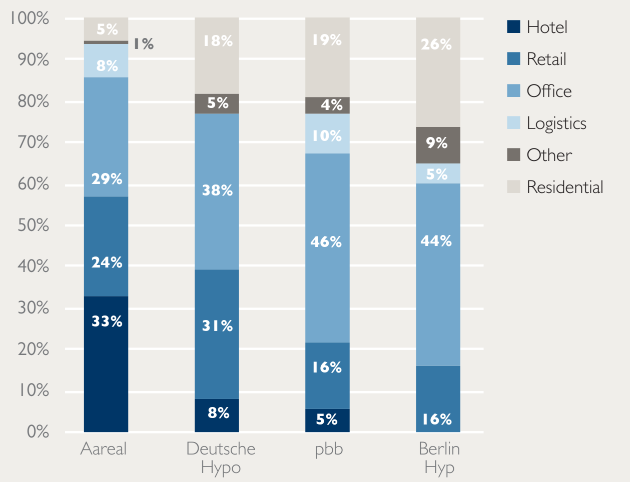
Aareal is most exposed to hotel and retail sectors and highly dependent on developments in international markets. In the first three quarters of 2020, they have significantly boosted loan loss provisions (Aareal €167m; pbb €84m; Berlin hyp €50.4m).

Mezzanine and private debt – Non-banks and international investors appear to be playing a larger role in CRE markets than they did before the crisis

The market for subordinated finance is growing in Germany, due to the low loan-to-value ratios being demanded on average by senior lenders. According to FAP, 155 investors are currently active in the subordinated financing market in Germany, nine more than last year. While in recent years, more and more providers from the Anglo-Saxon world have left the market, they are returning in the wake of the Corona crisis. They see an opportunity to re-establish themselves in the German market - despite their higher return expectations.

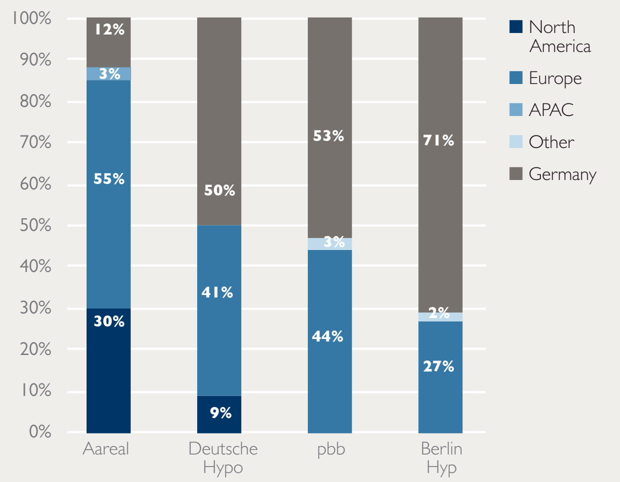
In this area, too, new financing was deferred and hotel and retail asset classes in particular suffered the most and financing of office properties also became more difficult in the course of the crisis. It is in this very reluctance that many subordinate financing providers have seen their opportunity, stepping in with attractive offers in situations where banks are either no longer providing any financing or are only offering low loan-to-value ratios. They are also frequently offering bridging finance at interest rates previously reserved for mezzanine capital. Both the spectrum of interest rates and the bandwidth of lending ratios have expanded significantly.

CRE EXPOSURE
BY TYPE OF PROPERTY AS OF YEAR-END 2019



Source: Catella Research, Moody's

CRE EXPOSURE
BY REGION AS OF YEAR-END 2019



Source: Catella Research, Moody's

Commercial Real Estate Financing

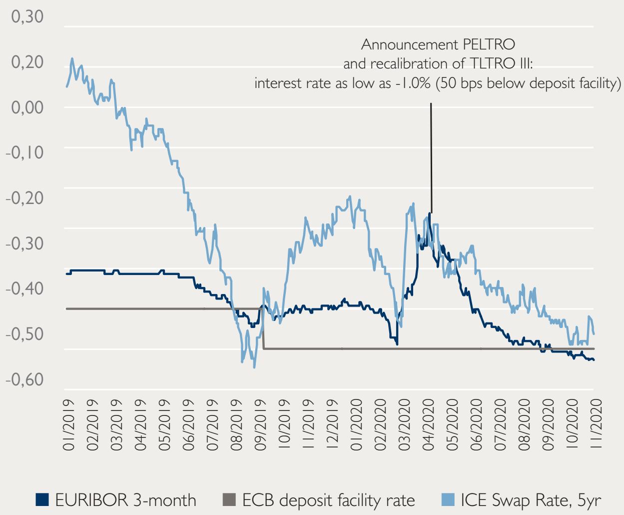
After a sharp drop of financing conditions over all real estate segments in the previous quarter, market sentiment started to rise again. Margins and financing terms jumped significantly in the second quarter, partly driven by increased liquidity costs, but fell again afterwards.

The current level of uncertainty highly depends on the asset class. The prospects for hotel and retail are still bleak while residential properties were the least affected. Financing terms for core buildings seems stable now, standing around 20 bps above the pre-covid level, after having risen by around 40-100 bps in the second quarter. Large-volume transactions only take place on a very limited basis and financing takes much longer than before the crisis with many banks taking a closer look at the solvency of tenants and increasing credit default risks. Margins on existing buildings currently range from 50 to 310 bps while the average margin across all real estate segments is around 150 bps (Q1/2020: 131 bps) according to BF direct. The average margins of the individual real estate segments are between 118 and 184 bps.

Capital costs for opportunistic properties and developments have increased much more strongly by up to 200 bps in the second quarter. New loans had hardly been available for developments and we observed increasing demand for whole loan bonds and bridge financing during the lockdown. Some developments had been postponed or weren't sold, both leading to longer financing periods than estimated and blocking new financings. In general, banks and insurance companies remain active as capital providers, even though many enterprises are using their credit lines by 100%, thereby reducing the banks liquidity situation.

The average margins in the individual real estate segments range between 223 and 261 bps and the average of all is up on the previous quarter at 234 bps (Q1/2020: 220 bps). Short-term money market rates as well as long-term bonds have decreased further, as ultra-loose monetary policy keeps dovish and provides further liquidity to the market.

INTEREST RATE COMPARISON (%)



Source: Catella Research, Bundesbank, Federal Reserve Bank of St. Louis

FINANCING COMMERCIAL PROPERTIES VS. DEVELOPMENTS

Germany	Commercial Core Properties *5-year EUR SWAP			Commercial Project Developments * 3-month EURIBOR		
	(pre-Covid) Q1	(lockdown) Q2	Q4	(pre-Covid) Q1	(lockdown) Q2	Q4
Ø Interest basis* (0% floor)	-0.25%	-0.28%	-0.46%	-0.41%	-0.3%	-0.52%
Ø LTV (existing) Ø LTC (dev.)	62-76	57-47	60-75	69-82	66-81	68-81
Ø Interest rate	1.31%	1.47%	1.50%	2.20%	2.31%	2.34%
Ø Margin % p.a.	99-167 bps	109-185 bps	118-184 bps	199-240 bps	203-258 bps	223-261 bps

Source: Catella Research, bulwiengesa AG, BF direkt AG

Contact:
Prof. Dr. Thomas Beyerle
thomas.beyerle@catella.de
+49 30 310 193-220

Carsten Lieser
carsten.lieser@catella.de
+49 30 310193-242