European CRE debt: Trends in transition

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Loans and asset portfolio sales from European banks present attractive investment opportunities, in our view, not just for private equity players but also for asset-backed securities (ABS) investors with flexible mandates.

CRE disposals from European banks have accelerated over the past 12-18 months

Loans and asset sales of just under €40bn have been completed in 2014 while another €38bn is in the sale pipeline. Therefore, 2014 transaction volumes may touch €75bn versus €30bn completed in 2013. In this chapter, we take a bottom-up look at the commercial real estate (CRE) deleveraging process based on publicly announced loan and portfolio disposals.

Spotlight now on Italian and Spanish NPL sales

While UK and Irish banks have been the main sellers to date, we expect loan (particularly non-performing loan (NPL)) disposals from Italy and Spain to gather momentum. The pipeline of Italian NPLs for sale is already on the rise and is beginning to attract a number of private equity investors.

Despite bank deleveraging, availability and cost of CRE financing has improved

Terms of CRE financing have improved significantly towards mid-2014 due to normalisation of bank funding markets and declining systemic risk premiums. This, in turn, has reduced the valuation gap between buyers and sellers in portfolio transactions. Alternative lenders and corporate bond markets have also become more important sources of CRE finance.
Role of securitisation likely to increase

Finally, we note that the shrinking securitisation market has been underutilised so far, but is likely to provide competitive financing for stabilised loan portfolios over the coming years.

CRE deleveraging has been a theme that Morgan Stanley has discussed in depth over the past two years. In a cross-asset Blue Paper, our equity colleagues and we argued that the CRE deleveraging process in Europe represents a structural change and not a cyclical one. Given the scale of the problem and synchronisation across several countries, we had initially expected the process to continue over a 7-10-year time-frame.

While the European Central Bank’s (ECB) longer-term refinancing operations (LTRO) and other funding initiatives slowed down the deleveraging process early on, asset disposals from European banks have accelerated over the past 12-18 months due to a combination of factors. First, stress tests in different countries and higher capital charges on restructured loans have forced banks to take mark-downs and encouraged asset sales. Second, improving real estate fundamentals have reduced provisioning requirements at banks, further improving the economics of disposals. Third, lower risk premiums across a variety of market assets have resulted in a significant increase in the number of investors looking for scalable ‘illiquid’ opportunities. Last but not least, improving terms of financing have also increased the purchasing power of buyers and reduced the valuation gap between buyers and sellers.

In this chapter, we take a bottom-up view of the deleveraging process based on publicly-announced portfolio disposals. We argue that the focal point of asset sales has shifted from core countries to the periphery. Countries where asset sales have been highest so far (UK and Ireland in particular) are not just the big lenders but also ones where bank stress tests came earlier. In other countries, the asset quality review (AQR) stress test is likely to be a catalyst for asset sales. We contrast this ongoing bank deleveraging with the improving backdrop for European CRE lending. We posit that while alternative lenders and corporate bond markets have started to play a more important role in financing real estate, bulk of the financing for portfolio acquisitions still comes from banks. Finally, we note that the shrinking securitisation market has been underutilised so far, but is likely to provide competitive financing for stabilised loan and asset portfolios over the coming years.

Different sellers, different motivations

According to estimates from Cushman & Wakefield, portfolio sales worth €29.9bn had been completed through April 2014 and, based on public newswires, we calculate that another €9bn of assets have been disposed since. Loans worth another €38bn are in the sale pipeline. This also means that, 2014 transaction volumes may exceed €75bn versus €30.3bn completed the year before. In terms of geography, transactions in UK and Irish assets have increased significantly year-on-year, even as sales of German assets have declined (Exhibit 1).

Thematically, we believe that asset sales related to CRE and NPL exposures can be grouped into the following categories:

1. UK banks disposing non-core loan books: UK banks were important contributors to transaction volumes in 2013, with early stress tests and slotting rules encouraging non-core asset sales. Of the €30bn of portfolios that traded in 2013, Lloyds alone was responsible for nearly €5bn. However, the pace of disposals from the UK has moderated in recent months, and we expect this trend to continue. UK banks have already scaled down their non-core portfolios materially; the core versus non-core categorisation has become more flexible; the capital and liquidity situation has improved and UK real estate is in recovery mode. Per our estimates, remaining non-core CRE exposure of major UK banks is £23bn (~€30bn) (see Exhibit 2), but we note that not all of it may eventually take the form of loan/asset sales.
2. **German banks selling lending businesses**: The CRE deleveraging process in Germany has been lumpy and sporadic. The main catalysts for sales have been strategic decisions to cut entire lending businesses. Prominent cases in point are Commerzbank’s decision to wind-down its Eurohypo unit and EAA’s (WestLB’s ‘bad bank’) renewed efforts to sell the WestImmo portfolio. As of Q1 2014, Eurohypo’s CRE-related assets stood at ~€32bn (€27bn performing and €5bn in default) while WestImmo’s portfolio is worth ~€11.8bn. Therefore, asset sales from these German banks are likely to sum up to ~€44bn over the medium term. We are unable to estimate the CRE holdings of smaller German banks due to data availability constraints, but we would expect the AQR/stress test to be a catalyst for sales from these entities too.

3. **Diversified portfolio sales from Irish ‘bad banks’**: Over the past year, there has been a noticeable shift in activity from individual banks deleveraging their balance sheets to ‘bad banks’ working out their pooled assets. Almost 65% of 2014’s volume is accounted for by ‘bad banks’, with IBRC and NAMA’s mega portfolio sales alone representing almost all this volume. With a majority of IBRC assets sold, we expect NAMA to be the main source of asset disposals over the remainder of the year. Based on most recent reports, we estimate the combined size of NAMA and IBRC portfolios to be nearly €20bn in carrying value (see Exhibit 3).

4. **NPL portfolios from Spanish and Italian banks**: Asset sales from the two southern European jurisdictions have so far been slow. More importantly, the problem in these countries is likely to be non-performing/sub-performing loans and not CRE exposure in general. In Spain, before...
Caixa Catalunya came to market with its €6.9bn portfolio of residential loans ("Project Hercules"), SAREB accounted for almost all the loan disposals. However, even sales from SAREB have been slower in 2014 versus 2013. Italian banks, for their part, have lagged further behind, with sizeable disposals beginning only in December 2013. However, the impulse at this stage of the deleveraging cycle is likely to come from Italian and Spanish banks, particularly in the context of non-performing assets. The pipeline of Italian NPLs up for sale is already on the rise. In April 2014, UniCredit and Intesa jointly signed a deal to transfer €2bn in NPLs to a special purpose vehicle (SPV) managed by KKR. The transferred assets are a small fraction of the total NPL/sub-performing portfolios held by Italian banks, which our bank analysts estimate to be of the order of €250bn. Additionally, in Spain, SAREB holds an estimated €49bn of loans and repossessed properties. This sizeable inventory of potential disposal assets is beginning to attract a number of private equity investors focused on peripheral opportunities.

5. Loan workouts in CMBS pools: Away from loan disposals by banks, asset sales from commercial mortgage-backed securities (CMBS) transactions have also been steady over the past 18 months. We estimate that the outstanding legacy CMBS market has shrunk by €26bn since the beginning of 2013, with asset sales accounting for ~€6bn of these volumes (see Exhibit 4).

In the past, disposals have been through individual asset sales, but as we approach the legal maturity of transactions, there has been a shift towards portfolio sales. We expect CMBS-related disposals to be strong heading into 2016 as €9.4bn of loans, representing 23% of the outstanding CMBS universe, mature over the next 18 months. Furthermore, €13bn of outstanding CMBS loans is already in default and in different stages of work-out. However, in the broader scheme of things CMBS disposals are likely to be significantly smaller than other sources of assets discussed earlier.

### Key transitions in the lender base

Despite the ongoing deleveraging by European banks, both...
availability and cost of CRE financing has improved materially over the past year. As shown in Exhibit 5, maximum loan-to-value (LTV) across most countries are now above 70% and typical margins have compressed across the board. Of particular note is the UK, where loan margins have come in by nearly 1% in the past year. Furthermore, European CRE lending volumes were up 30% in 2013, according to Cushman & Wakefield.

This recovery in lending appetite has in turn provided further impetus to transaction volumes with respect to both loan and asset purchases. Direct investment activity in CRE markets has been particularly strong in 2014, with a turnover of just under €40bn in the first quarter of the year according to CBRE. During 2013, investments in the CRE space aggregated €166bn – 31% more than in 2012 and 121% more than in 2009 when activity levels were at their lows.

**Indicative lending terms**

<table>
<thead>
<tr>
<th>Market</th>
<th>Q1 2014 Max loan (m)</th>
<th>Q1 2014 Max LTV</th>
<th>Q1 2013 Max loan (m)</th>
<th>Q1 2013 Max LTV</th>
<th>Margin (bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>€250</td>
<td>75%</td>
<td>€200</td>
<td>67%</td>
<td>135</td>
</tr>
<tr>
<td>Ireland</td>
<td>€150</td>
<td>70%</td>
<td>€50</td>
<td>70%</td>
<td>300</td>
</tr>
<tr>
<td>Netherlands</td>
<td>€200</td>
<td>75%</td>
<td>€60</td>
<td>65%</td>
<td>190</td>
</tr>
<tr>
<td>Spain</td>
<td>€50</td>
<td>60%</td>
<td>€30</td>
<td>55%</td>
<td>400</td>
</tr>
<tr>
<td>UK</td>
<td>£180</td>
<td>72%</td>
<td>£75</td>
<td>60%</td>
<td>160</td>
</tr>
</tbody>
</table>

Source: CBRE, Morgan Stanley research
Alternative providers of capital like insurance companies, public equity and debt markets, private equity, opportunistic debt funds, etc., have been important contributors to this defreeze in CRE financing. However, the contribution of non-bank lenders to outstanding stock of debt is still under 5% (see Exhibit 6). So, even though many European banks are in deleveraging mode, disintermediation of the banking system remains a slow process. Part of the transition in financing markets is simply the replacement of European banks in deleveraging mode with select foreign banks. Another dynamic at work is that, where alternative capital is focused on NPL/distressed loans, banks often provide financing for these acquisitions. The bank involved can be the seller of the portfolio, a bid partner, or a third party.

In this part of the chapter, we will discuss some of the key themes in financing markets:

1. Shift from domestic to international bank financing: A significant portion of acquisition finance still comes from banks – either legacy lenders returning to domestic lending or foreign banks increasing their presence in European CRE. This has been through a combination of direct lending and loan portfolio acquisitions, either alone or in partnership with private-equity funds. In mixed portfolio acquisitions, these banks also provide financing against the NPL portion of the portfolio. For instance, CoStar reports that when Commerzbank also sold its €4.4bn commercial lending business (‘Project Octopus’), the successful bid structure involved J.P. Morgan acquiring the performing loans and also financing Lone Star’s purchase of the NPL portfolio. Another dynamic related to banks is the return of investment banks to CRE lending, with a recent report from DTZ estimating their debt capacity to be ~€25bn over 2014 and 2015.

2. Loan-on-loan financing competing with direct asset financing: As noted earlier, the deleveraging process has primarily taken the form of loan portfolio sales rather than repossessed asset sales. In keeping with this trend, CRE financing has also shifted from asset financing to a ‘loan-on-loan’ format. As was the case in ‘Project Octopus’,

### Exhibit 6

**Non-bank lenders’ market share**

<table>
<thead>
<tr>
<th>Year</th>
<th>UK only</th>
<th>European total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source:** DTZ, Morgan Stanley Research
an increasing number of loan portfolio acquisitions are being financed by commercial and investment banks, insurers and specialist lenders. Recent cases in point include J.P. Morgan’s and AIG’s financing to Oaktree for acquiring Nationwide’s ‘Project Adelaide’, and GE Capital Real Estate’s €770m loan-on-loan facility against ‘Project Tower’ acquired by Blackstone from NAMA. GE Capital RE is also reported to have closed six UK financings in 2013 along with a £1.4bn loan portfolio acquisition (also called ‘Project Tower’) from Postbank late-2013. Moreover, while buyers have become less reliant on seller-financing in recent months, it is likely to remain a backstop strategy used by even ‘bad banks’. For instance, although NAMA’s guidelines allow for advances up to €2bn to facilitate sale of Irish assets, only €360m has been advanced so far.

3. The slow but steady rise of alternative capital: Data from Preqin highlights the growth of Europe-focused real estate funds. As of May 2014, there were 53 primarily debt-focused funds in the market with aggregate target capital of US$22bn (see Exhibit 7). Of these, nearly 60% of the target capital was being raised with a Europe-focused strategy versus 30% in 2013 and a mere 9% in 2012. This increase in fundraising has been driven by both domestic as well as international investor interest, with 34% of US investors and 45% of Asian investors targeting Europe. In all, Preqin estimates that real estate funds have nearly €40bn in dry capital to invest in Europe. Insurance companies are another class of lenders contributing to the diversification of the CRE lender base. In 2014, we count AXA (Coeur Defense), MetLife (Woolgate Exchange), Allianz and Canada Life among insurers extending loans to the sector.

4. Property bonds replacing bank loans and CMBS: Net issuance of €13bn in real estate investment trust (REIT)/property bonds in the past three years has taken the outstanding size of the sector to €25.6bn (see Exhibit 8). Furthermore, while much of the issuance in the past has been from larger IG-rated REITs, instances of smaller companies tapping into the sub-IG market are on the rise. As we have previously highlighted, this increase in property bond issuance is driven by a strategic

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**PE debt funds in the market by geographic focus**

*Exhibit 7*

![Graph showing PE debt funds in the market by geographic focus](image-url)

*Source: Preqin, Morgan Stanley Research*
emphasis by property companies to: (i) shift from secured to unsecured borrowing; and (ii) reduce reliance on bank borrowing. It is worth noting that capital-raising activity by REITs is also on the rise, particularly in the periphery. Two Irish REITs – IRES REIT and Green REIT – have recently raised €200m and €385m of capital, respectively. In Spain, Merlin Properties is planning a €1.5bn equity raise and the pipeline of other new listings is also growing.

In contrast to the growth in property bond issuance, European CMBS issuance has been anaemic over the past six years. In all, only €13.5bn of pure-play CMBS has been placed with investors since 2008 while bonds worth over €30bn have been redeemed over the past 18 months alone. No CMBS transactions have priced so far in 2014 but two small deals – a €355m Italian multi-asset deal from Deutsche Bank and BAML’s securitisation of its £211.5m loan to Apollo – are in the pipeline.

Parting thoughts

Loan and asset portfolio sales from European banks present attractive investment opportunities, in our view, not just for private equity players but also for ABS investors with flexible mandates. While UK and Irish banks have been the main sellers so far, we expect loan, particularly NPL, disposals from Italy and Spain to gather momentum. Meanwhile, the funding gap left by European banks is slowly but steadily being filled by international banks, debt funds and corporate bond markets. For now, CMBS-based activity remains muted, but we expect the role of securitisation markets in financing acquired portfolio to increase over the medium term.

Notes:
2 European Property Credit versus CMBS (May 20, 2014).

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