Highlights
A year on from our last review, we have updated our ‘European Debt Model’ to assess the scale of bank deleveraging across Europe. This year we are also including the results of our Loan Sales Monitor, which tracks all live and closed European commercial real estate (CRE) loan sales to provide more colour on the process of bank deleveraging.

KEY CONCLUSIONS ARE:
• The total volume of CRE debt across Europe actually increased by circa €23 billion
• Although the aggregate debt stock is virtually unchanged, there have been significant structural changes: much more of the stock is new (post crisis) lending and a significant amount of the legacy debt is now held outside the banks
• 2014 saw a 133% increase in loan sales with circa €49 billion traded, mostly in the UK and Ireland, but with a growing volume across the Eurozone
• Despite the level of legacy non-performing loans (NPLs) in Europe identified by the Asset Quality Review (AQR), we do not expect a rapid change in loan sales volume and expect the bank deleveraging cycle to be protracted
• Some banks are considering more structured alternatives to the straight NPL portfolio trade to reduce debt exposure whilst minimising the associated collateral damage to their balance sheets
• The combination of the slow pace of deleveraging, the rise of alternative lenders and leverage-hungry private equity buyers may lead to a further increase in European CRE debt levels in the short term
THE CHANGING EUROPEAN DEBT LANDSCAPE

2014 was the year in which the debt market in Europe changed materially. Seven years after the start of the global financial crisis (GFC) the amount of new lending on real estate transactions picked up strongly, the cost of that debt fell significantly and the progress made by banks in managing their legacy of historic loans accelerated.

Our analysis suggests the total volume of European CRE debt actually increased by €23 billion over the course of 2014. The main reason for this was a rise in the amount of new lending (it should be noted that our analysis still includes the circa €49 billion of debt sold in loan portfolio sales in 2014, so the total figure masks this bank deleveraging process). We estimate that the amount of new debt (backing investment transactions) issued in 2014 was up by 47% on the same figure in 2013. However, in absolute terms, the figure is still less than half that in 2007, the peak of the cycle before the financial crisis.

Total volume of European CRE debt actually increased by €23 billion over the course of 2014

There are several drivers of the increase in the amount of new debt. Partly it is simply the result of growth in the size of the CRE investment market: the total value of investment transactions in Europe increased by 29% in 2014, reaching over €216 billion. There was also a shift in the types of transaction being undertaken. Until late 2013 the market was dominated by institutional style investors buying prime buildings in central locations and using a very high proportion of equity. However, over the last year there has been an increase in activity by higher risk investors. This is exemplified through both the markets where investors have been active (Ireland and Spain are both seeing record levels of CRE investment) and the type of property that is being traded within the more established markets (in the UK the strongest yield shift is in secondary and tertiary property outside London). Such investors have traditionally made greater use of leverage both to increase their buying power and to enhance returns.
The debt market itself has also changed a great deal since mid-2013. Particularly notable has been the influx of new institutional lenders. The institutions have prioritised long-duration loans on high quality real estate and the margins on such lending have tumbled as a result. Coupled with the fall in underlying interest rates, the result has been a sharp drop in the total cost of borrowing for real estate investment.

The fall in margins for loans on core real estate has been such that many traditional lenders (banks) are no longer looking to compete in this part of the market, and are looking for higher margin business in riskier parts of the real estate market instead. This, in turn, has helped fuel the interest in secondary and tertiary property described above. In our view, regulatory capital considerations are likely to provide a floor on bank debt margins and we see rising loan to value (LTV) levels and increased appetite for more secondary lending as the major moving parts which banks will adjust to compete effectively.

Our model suggests that the increase in new lending against transactions has resulted in a small increase in the total stock of CRE real estate debt since the end of 2013 from €955 billion to €978 billion. However, this does not mean that the banks are not making progress in terms of addressing the legacy:

- Legacy loans make up a shrinking proportion of the total debt stock – loans on transactions completed since the end of 2007 now account for 24% of the total
- An increasing amount of legacy debt is no longer on the banks’ balance sheets, having been transferred or sold on to third parties who are actively managing it, (the sale of legacy loans by banks accelerated rapidly during 2014, reaching €49.2 billion over the year) i.e. banks are deleveraging without shrinking the total debt stock that our analysis captures
- As the market improves and the underlying assets are sold, some legacy loans are being repaid

Nevertheless, the greater availability and lower cost of debt is fuelling capital value growth in some parts of the real estate market and there is potential for this to accelerate valuations beyond what is justified by market fundamentals.

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1 The Euro value of the debt stock can be affected significantly by the euro-sterling exchange rate. In order to allow a like for like comparison the 2013 debt stock is calculated on the basis of the end-2014 exchange rate.
Despite the changes described above, the CRE debt stock remains dominated by loans that are the result – either directly or indirectly – of lending that took place prior to the GFC. The high leverage used at that time, and the fact that outside the prime segment of the market values remain a long way below those prior to the GFC, meaning that a lot of historic lending continues to be rolled over, extended or held against insolvent borrowers. As a result, although the average loan length has increased slightly over the last year, a very high proportion of the total is due to reach maturity within the next few years. Our model suggests that over 50% will mature by the end of 2017 – some €542 billion.

While this finding may sound dramatic, even in ‘normal’ market conditions the length of new loans is rarely more than seven years, and the average duration is close to five years. Thus we would normally expect to see just such a profile, with the majority of existing loans due within three or four years.
Loans secured against property in the UK and Germany represent the majority (57%) of Europe’s debt stock. This closely mirrors their proportion of underlying CRE investment activity in Europe and so is as expected. The comparative lack of stock in some jurisdictions, particularly Spain, has in part been responsible for a relatively fast turnaround in pricing levels, as private equity buyers have turned away from core markets in search of a value.

**BREAKDOWN OF EUROPEAN DEBT STOCK**  
As at end 2014

![Pie chart showing the breakdown of European debt stock as of end 2014.]

Source: CBRE Research

Many traditional lenders are no longer looking to compete in core markets
LOAN SALE PROGRESS

We have tracked all European loan sale activity during 2014 and can see that, over the past 12 months, the market experienced a surge in lenders’ deleveraging activity with approximately €49.2 billion of CRE loan sale transactions in 2014. This represents a significant increase from 2012 and 2013 levels at €9.3 billion and €21.1 billion, respectively. The €49.2 billion total is the equivalent of roughly 5% of aggregate CRE debt removed from bank balance sheets\(^4\).

Predictably, the average transaction size increased by 55% in 2014 to €683 million (UPB) from €441 million in 2013. Additionally, loan portfolios with Unpaid Principal Balances (“UPBs”) above €500 million are now becoming increasingly common. In 2013, there were nine transactions with UPB above €500 million, totalling more than €13.6 billion. In 2014, this number grew to 22 transactions, worth in aggregate more than €41.5 billion.

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\(^2\) Unless otherwise stated the value of loan sales is expressed in this report in terms of the Unpaid Principal Balance (UPB) or in other words the outstanding amount of the debt. In most cases loan transactions take place at a discount to UPB meaning that the consideration paid in respect of a loan sale will be below the UPB.

\(^3\) Although purely REO and residential loan portfolios are excluded from this total, some of the loan portfolios include debt secured on a mix of different property types.

\(^4\) These loans are not always completely removed from bank balance sheets as a result of the transaction. The use of loan-on-loan finance means that private equity buyers are not taking all of the risk associated with these sales.
Despite the entry of several property investment companies into the loan sale arena in recent years, distressed debt purchases continue to be dominated predominantly by US-based private equity funds. Private equity firms were involved in 81% of all transactions completed in 2014; property investment companies accounted for just 10% and the remainder can be attributed to a combination of lenders, asset management agencies and others. Private equity is particularly dominant in the largest transactions. Of the 22 transactions over €500 million in 2014, all involved private equity buyers.

**ANNUAL MARKET SHARE (TOP 4 PURCHASERS)**

By UPB, Top 4 Purchasers accounted for 28% in 2013 and 54% in 2014

Source: CBRE Capital Advisors
Typical discounts to UPB decreased slightly to 44% in 2014 from 47% in 2013. More significantly, achieved discounts to the underlying property value are now low or (depending on jurisdiction) non-existent, as competition for the right product has intensified amongst the leading players buying real estate loans. The top four purchasers in 2014 accounted for 54% (in UPB) of all transactions over the year, a significant increase from the 27% market share in 2013.

Together, UK and Ireland accounted for approximately 60% of total completed transactions in 2014, with lenders and investors taking advantage of the current high liquidity for UK and Irish assets. Since 2012, the UK has consistently accounted for about one third of total transactions, with closed transactions growing from €6.7 billion in 2013 to €16.5 billion in 2014. Ireland saw the second highest amount of activity over the past year, recording transactions totalling €12.6 billion.

There was a surge in activity in Spain in 2014, a year-on-year increase of 103% from €3.2 billion to €6.5 billion in 2014. The Spanish market was almost non-existent as recently as 2012, when just €520 million of loan sales were recorded.
Despite the widespread expectation of accelerating loan sale activity in Italy, transaction levels remained stubbornly low in 2014, despite the high volume of legacy CRE loans held by banks. Perhaps more notably, given the size of the market, activity in Germany also remained low, with loan sales totalling just €3.9 billion during 2014. On the other hand, private equity firms are beginning to branch out into higher-yielding peripheral markets, as evidenced by trades in Romania totalling circa €480 million in 2014.

Based on live transactions that CBRE is tracking, the proportion of UK deals is reducing. This reflects the proactive work of the UK banks over the last three years. In addition to continued supply of Irish and German portfolios, we are now seeing an increased supply of portfolios within peripheral markets such as Poland, Romania and Greece. Other notable markets with live deals include Spain, Netherlands, and France.
THE FUTURE OF THE DELEVERAGING CYCLE

As discussed above there have been major changes in the European CRE market with consequent effects on the debt market, and many of those changes will continue into 2015, but taking in more of Europe.

There has been a lot of focus on the supply side, with the European Central Bank’s AQR highlighting Italy as a big source of potential opportunities. This may seem a logical extension given the activity in Ireland and Spain over the last year or so. However, we believe this is too simplistic an analysis.

While loan sales release capital they also crystallise losses. Banks need to be effectively provisioned in order to take advantage of this opportunity, which will act as a dampener on loan sale volumes. In addition, although discounts to underlying real estate values in the UK have been exceptionally narrow, we expect them to remain significant in countries with less creditor friendly insolvency regimes and where the costs of enforcement (which include the time taken) will act as a brake on pricing.
Our expectation is that many of the critically impaired banks are more likely to rely on short term capital-raising than loan sales to restore capital ratios. However, deleveraging through loan sales remains a powerful tool to release capital for reinvestment and enhance return on equity. We believe it is those banks that are in this second phase of their recovery to profitability that are most likely to look to loan sales as a tool to release capital (CBRE has identified circa 16 European banks from the Comprehensive review that, whilst not impaired, have both relatively low Common Equity ratios and significant volumes of CRE secured NPLs on their books). This is urgently needed across Europe as many banks are simply not covering their cost of equity.

CBRE has identified circa 16 European banks from the Comprehensive review that, whilst not impaired, have both relatively low Common Equity ratios and significant volumes of CRE secured NPLs on their books.

Nevertheless, we expect the pace of loan sales to continue to be subdued in the short term. In our view, given a perceived shortfall in provisioning and lack of sustained inflation of underlying occupational markets (most of the recovery in European real estate values has been driven by yield compression only to date) we are still at an early stage in a bank deleveraging cycle. It may take many more years for some banks to become comfortable with the wholesale portfolio liquidations that the UK has witnessed.

![Adjusted CET1 Ratio to Corporate NPL Exposure](image-url)
There have also been big changes affecting the demand side, most significantly the growth in investment activity in secondary property which is also helping to drive price increases in this part of the property market. This impacts the debt stock in two ways:

- Transactions on the underlying real estate can result in historic loans attached to that property being paid off (in whole or in part). Many of the transactions in this part of the market are occurring with the lender ‘in the room’, accepting less than full repayment of the debt in order to unlock the transaction and resolve an NPL situation. From many jurisdictions this can be a more effective exit route, where banks’ carrying values do not reflect the discounts that buyers demand as compensation of the protracted time and cost that enforcement can entail.

- An improving secondary market also creates a demonstrable exit route for investors who are buying bank loan books. Foreclosure on the debt serves little purpose if the asset is unsaleable. Where the underlying market is improving (both in terms of price and level of activity) this becomes an increasingly viable option. Even in jurisdictions where foreclosure is a long, complex and expensive process an improving secondary market creates opportunities for negotiated solutions, with asset sales from which both lender and borrower benefit. This can help bridge the gap between price and value that prevents a wider loan sale market in some jurisdictions.

So far, the UK stands out as the market where secondary prices have improved significantly in 2014. Prime yields are continuing to fall, but the re-pricing in the secondary market has been much more significant.

**UK PRIME VS SECONDARY ALL PROPERTY YIELD**

*Excluding Central London*

Source: CBRE
The performance of secondary real estate is ultimately more dependent on economic growth than is the case for prime CBD assets. Therefore the next European markets to benefit from a significant improvement in investor demand (and increasing prices) for secondary property are those with the strongest economies.

The most likely markets to see improvement in secondary property over the near term are Sweden, Germany, Denmark and Norway, which combine growth rates that are at or near their trend level over 2014/2015 and where GDP is already above pre-crisis levels. Also worth mentioning are Ireland, which is currently seeing very strong economic growth, but where total GDP is still well below its pre-crisis level, and Spain, where the rate of economic growth is accelerating, but where total economic output is also still well below its pre-crisis level.
CONCLUSIONS

In summary, whilst we expect continued loan sale activity in 2015, with expansion into new jurisdictions, we also expect the rate of acceleration in loan sales to slow. This is due to the time the market will take to overcome a number of structural obstacles currently standing in the way of a liquid loan sale market throughout Europe.

We expect to see banks look to more structured, innovative deleveraging solutions beyond the simple loan sale. This could involve joint venture solutions, sale of servicing platforms or repackaging of existing NPL debt. Such solutions will offer those banks an exit strategy without crystallising significant balance sheet losses.

The combination of subdued loan sale activity, continued increases in the volume of debt being employed by alternative lenders, greater activity by leverage hungry private equity buyers and a potential re-emergence of the European CMBS market all provides the conditions for a further increase in total European CRE debt exposure in 2015, just at a point when many expected to see a reduction.

TECHNICAL NOTE

CBRE’s European CRE Debt Model is a bottom up estimation of the size and structure of the debt in Europe secured by commercial real estate investments. As such it does not intend to capture debt secured against residential property, development or lending to owner occupiers of commercial property. The outputs are driven by the underlying level of real estate investment transactions in the regions covered together with assumptions as to the amount and duration of lending that will have attached to those transactions. These assumptions are informed by debt market studies, such as those produced by DeMontfort University (UK) and IREBS (Germany) and our own experience of the operation of investors active in the European market. Over recent years assumptions relating to the refinancing (or roll over) of existing debt that matures is an increasingly important driver of the results of the model. Our model captures debt that is held by Private equity firms and other lenders and is not limited to the banking sector.

The bottom up (rather than top down) nature of the model means that debt is identified against the country where the collateral is based rather than the lender and remains in the model even if the debt is sold to private equity or other investors in the debt market. However, loan-on-loan financing used by investors in real estate debt is not treated as additional real estate debt.
This report was prepared by the CBRE EMEA Research Team in conjunction with CBRE Capital Advisors.

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