Intelligent Investment

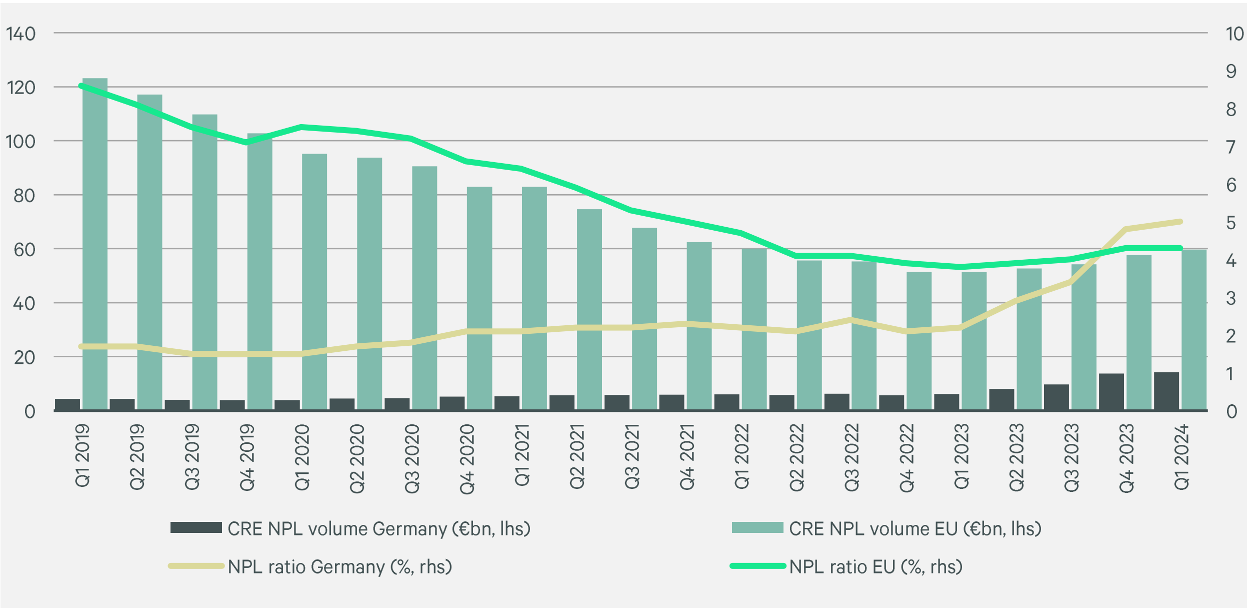
Distressed opportunities in Germany's commercial real estate market

Dr. Jan Linsin and Matthias Düsing
July 22, 2024

The German commercial real estate debt market is facing a wave of distressed assets and non-performing loans (NPLs). Despite challenges in the investment and letting markets, the debt market is adapting to the new realities to recapitalize one of Europe's largest real estate markets.

The changing financial market environment has caused major distress. The ratio and volume of commercial real estate NPL in Germany as reported by the European Banking Authority (EBA) has significantly increased from 2.2% (€6.2bn) in 2023 to 5.0% (€14.2bn) in 2024. With a further increase in the remainder of 2024, Germany is likely to become one of the most distressed markets across Europe (see figure 1).

FIGURE 1: Non-performing loan volume (€bn) and ratio (%) of commercial real estate in Germany and EU



Sources: European Banking Authority, CBRE Research July 2024

© 2024 CBRE GMBH

Market environment

During the last market upward cycle, lenders and borrowers were able to lever on favorable financing and market conditions in almost all German commercial real estate segments. Since 2022, the market fundamentals have changed, and the leverage effect has evaporated. Financings and valuations have come under severe stress, recalling memories of previous credit-driven asset price inflations.

All-in financing costs have increased, e.g. senior loans in the German office sector up to 5% in mid 2024 (from below 2% in mid 2019) and LTVs in the institutional sector went down from 60% to around 55%. The debt funding gap results from the decrease in (mark-to-market) asset values and opened-up an estimated funding gap for the German market amounts alone of around €77bn until 2027 based on current values (see figures 2). These estimations do not even include yet the current extensions of loans originating from 2017-2018 which will also expire in 2024 and 2025.

Major portfolio selloffs or 'fire sales' for German loan books have been absent so far. Headlines around recent acquisitions of loan portfolios are clear proof of the increase in transaction activities on the debt side. It could have been the starting point of a deleveraging phase comparable to the aftermath of the great financial crisis. The current share of distressed deals of total investment volume more than doubled compared to last the peak and reached almost 60% of the last cyclical high from 2012 already (see figure 3 on page 3).

Looking beyond the gloomy headlines, a differentiated view helps to understand the drivers and challenges. The identification of refinancing solutions is key for successfully navigating the recapitalization phase.

FIGURE 2: Debt gap maturities Germany per year based on current values by asset class (€bn)

Source: CBRE Research December 2023

© 2024 CBRE GMBH

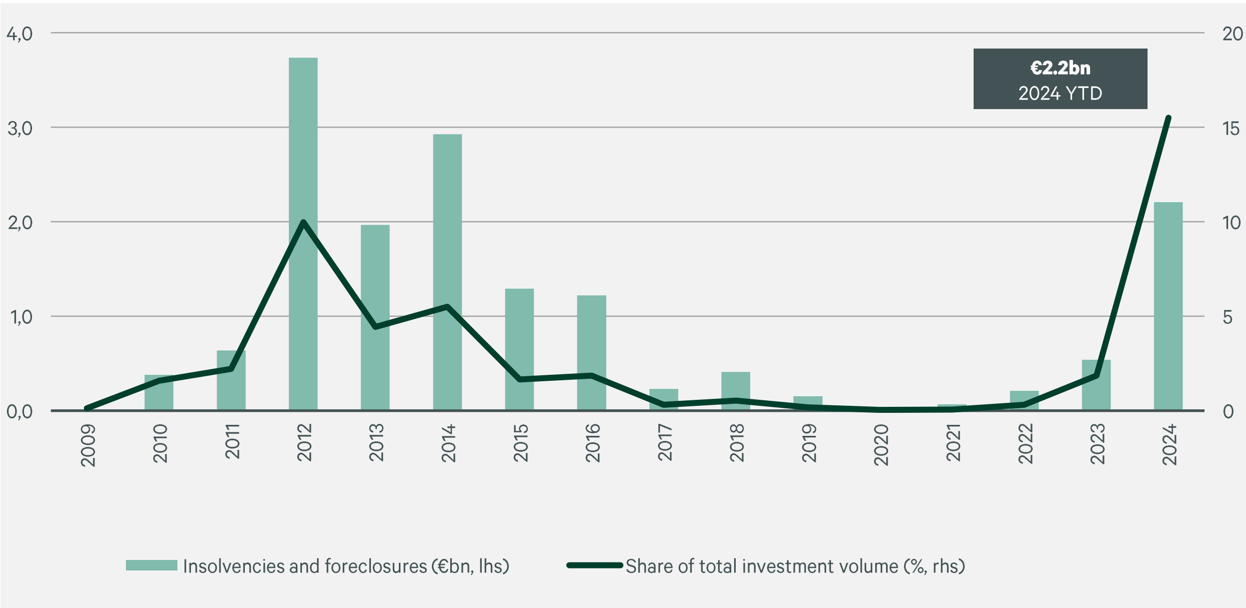
The financial system's and real estate market's responses to the changing market environment are based on the following key fundamental market drivers.

Germany's economy continues to be among the weakest growing in Europe. The slightly improved outlook in annual GDP growth with 0.1% in 2024 and 1.2% in 2025 respectively as well as some early indicators from the private sector and labor market are somewhat encouraging. It will only give some tailwinds for real estate occupier markets and underlying income fundamentals, nonetheless. The German economy is not just facing cyclical weaknesses, but structural challenges in its key industries and its overall competitiveness.

ECB's interest rate hike cycle between 2022 and September 2023 of more than 300 bps in short-term ECB policy rates is virtually unprecedented over the past decades. With historical low financing costs prior to this and the bulk of maturities coming in the next years, the effects have yet to fully materialize in real estate lending and transaction markets. Despite an anticipated further easing in consumer price inflation rates, current outlook for ECB policy rates is indicating a "higher-for-longer" scenario and only gradual changes in the mid-term with policy rates normalizing at around 2% at the mid of 2027. Consequently, the historically unprecedented zero-base rate environment will most likely not return and real estate market participants will have to adjust to the "new normal" as known from 2006 and the decades before.

Investment market liquidity has suffered during the repricing process on the German commercial real estate investment market. Transaction markets experienced heavy hits over the past 18-24 months that can be quantified with a decrease in total transaction volume of -57% year-on-year in 2023. However, the transaction market is showing signs of improvement in H1 2024 again with a transacted volume of €14.2bn and a plus of 15% year-on-year. The market has likely passed its cyclical trough. Year to date, over €2.2bn (16% of total) have been distressed sales and foreclosures, most prominently large single project developments in CBD locations.

FIGURE 3: Transaction volume insolvencies and foreclosures (€bn) and share of total volume (%)



Source: CBRE Research July 2024

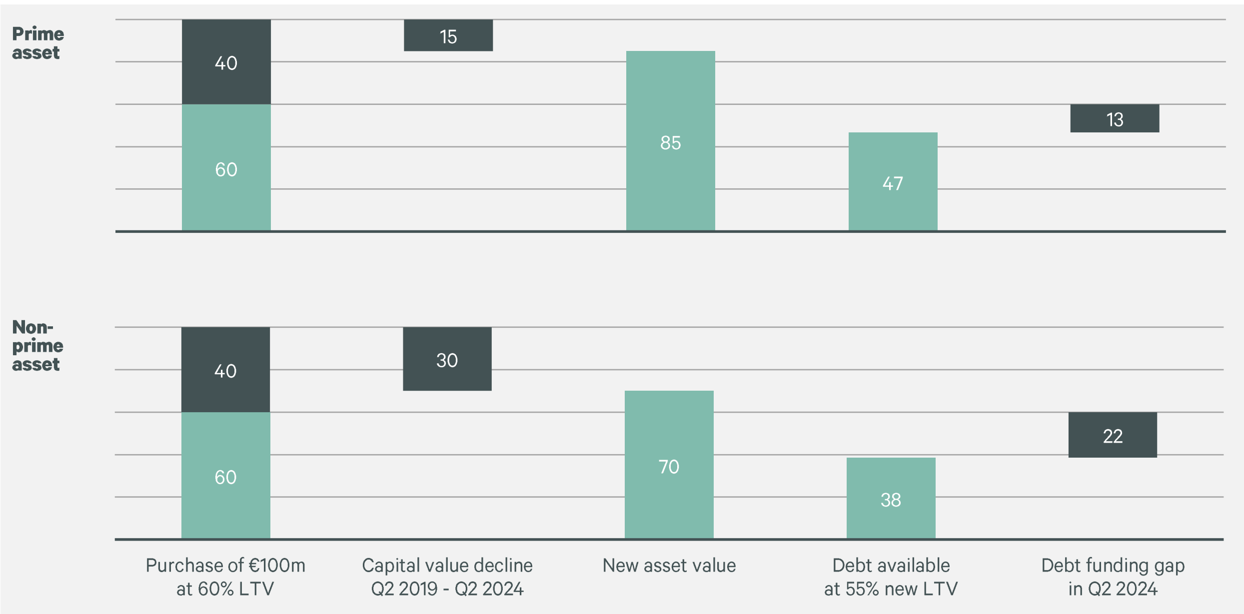
© 2024 CBRE GMBH

Property yields are showing signs of stabilization, at least for the prime end of the market. With still relatively weak sentiment during H1 2024, better yielding alternatives like corporate and government bonds and higher overall target returns, the yield expansion and capital value correction is not yet over. Long-term interest rates have continued to climb, but with the initiation of policy rate cuts may begin to stabilize. If long-term rates sustain a downward path, yields will have scope to level off and eventually fall and gradually closing the gap between expected and required returns. This should allow investment activity and underwriting assumptions to improve, albeit likely not until near the end of this year. The market has entered a phase of easing now with the bulk of the price correction behind and forward-looking indicators becoming more favorable again.

Specific asset classes and risk profiles are more exposed to distress. At their cyclical peak early 2022, German prime offices yielded at 2.50% (net initial) for CBD locations, at 3.00% in non-CBD locations and 3.10% for secondary assets in CBD locations. All these segments have experienced a strong correction in achievable returns, yields and financing costs recently. Prime offices in CBD locations corrected by 230 bps and yield at 4.80% currently. Asset values have declined in a range from 15% (prime) up to 30% and more (non-prime) in some cases leaving debt funding gaps on the asset level (see figure 4). Expectations around consumer price inflation and ECB's near-term rate policies have improved over the past months suggesting more stability and predictability of the further yield development for the equity and debt side alike.

Leasing market fundamentals are undergoing changes, offering new structural risks and opportunities driven by the demand side (e.g. Flight to Quality) and the supply side (e.g. ESG and increased CapEx). Risk perceptions of investors, developers and lenders are being adapted to this new reality, resulting in higher risk premia and growing numbers of distressed assets. For example, older non-ESG compliant buildings in less fungible submarkets and ongoing project developments in the CBD's are associated to more risks.

FIGURE 4: Stylized simulation of refinancing gaps for Munich office assets bought in Q2 2019 (€m)



Source: CBRE Research July 2024

© 2024 CBRE GMBH

Recapitalization strategies

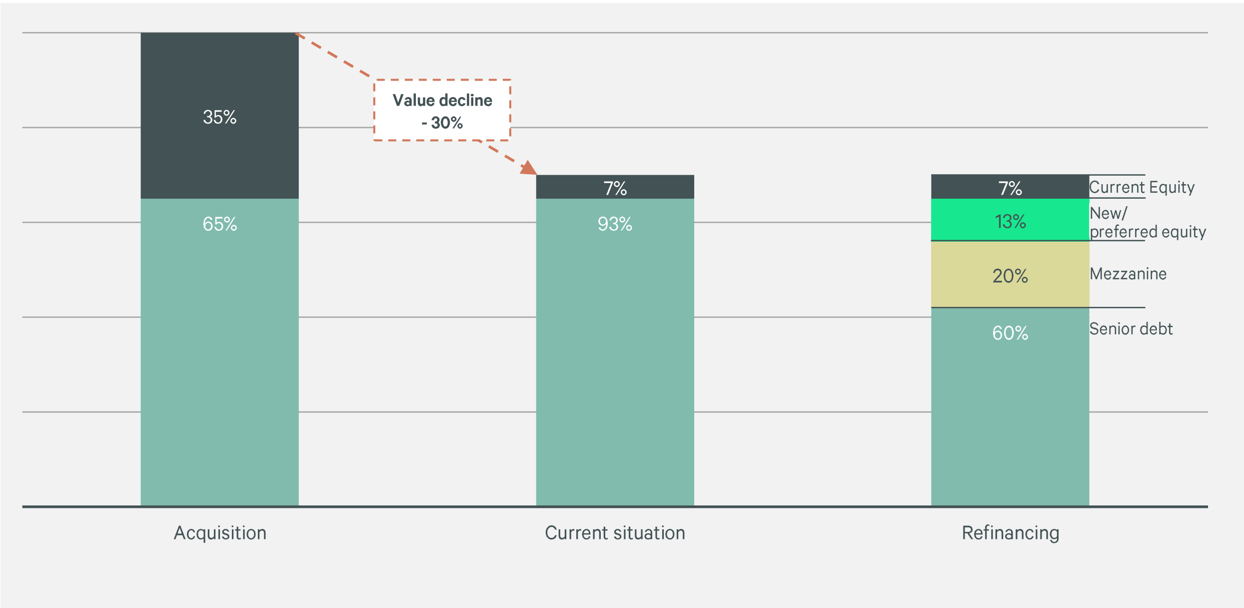
Lending markets have become more restrictive and selective. It comes with no surprise that lending standards continue to be tight resulting in higher financing costs and lower LTVs (loan-to-value ratios). For offices, all-in financing costs for new senior loans increased up to 5% in mid 2024 (from below 2% in mid 2019) and LTVs in the institutional sector went down from 60% to around 55%. Not only mezzanine lenders, but also senior lenders are facing higher risks of covenant and LTV breaches and subsequently, unrealized losses.

Yet, the market is in a wait-and-see stance (or "amend and extend") to avoid significant price depreciation. It is following the hope of a market recovery in the near-term. However, reduced debt availability and structurally higher construction and CapEx requirements (e.g. ESG and incentives) are complicating the situation further. Closing of the gap will be challenging as capacities of non-bank lenders could not be fully sufficient to bridge all cases.

The recent CBRE European Lender Intentions Survey 2024 suggests that the debt markets remain resilient, and lenders in Europe are willing to lend in current market conditions. More than 60% of lenders are planning to increase their activities and are prepared to lend at 60% or higher LTV.

Recapitalization strategies include multiple paths: negotiating loan extensions, fresh equity infusion, sourcing new equity from joint-venture partners, sourcing new senior, senior-stretched and whole loans as well as mezzanine capital and preferred equity (see figure 5). These instruments come at the cost of higher capacity requirements, increased opportunity costs and the need of much deeper understanding of commercial and technical asset fundamentals.

FIGURE 5: Stylized refinancing of an asset following a value decline



Source: CBRE Debt & Structured Finance July 2024

© 2024 CBRE GMBH

Outlook

Despite the challenges, there are also strong arguments to stay optimistic on the outlook for the German debt market and the office sector in particular.

German office letting markets are considered very stable. Occupation rates in the Top-7 office markets are still at 93% and recent Q2 2024 figures suggest a slight upward trend in occupier demand, stable and growing rents and a decreasing pipeline. Supply-side risks are relatively low compared to international peers. The debated effects of work-from-home are yet to be seen but will most likely have a lesser impact compared to other markets globally due to well-functioning urban structures and robust residential markets.

Demand-supply ratios are remaining healthy in the CBD and some non-CBD parts of the German office markets. Some parts of the market are still reporting strong real rental growth figures and inherent upside potentials for income-oriented strategies and value-add or even opportunistic plays. Forward looking return expectations are improving giving cause for improved underwriting assumptions. Not all geographies and segments will perform equal though. Yet, understanding letting market fundamentals and deploying rigorous market due diligence is key again to identify the best opportunities.

German lenders and equity sources are generally well situated to handle refinancing as their NPL ratios have increased but are still very low in historical comparison also due to rigorous regulation (Basel II+III e.g.). With forward indicators pointing towards a gradual recovery of the economy and occupier markets as well as an easing in interest rates and refinancing costs, there is certainly some light at the end of the tunnel.

Contacts

Dr. Jan Linsin
Managing Director
Head of Research
jan.linsin@cbre.com

Matthias Düsing
Associate Director
Research
matthias.duesing@cbre.com

Anja Scholz
Associate Director
Research
anja.scholz@cbre.com

Daniel Sander
Managing Director
Head of Debt Advisory
daniel.sander@cbre.com

© Copyright 2024. All rights reserved. This report has been prepared in good faith, based on CBRE's current anecdotal and evidence based views of the commercial real estate market. Although CBRE believes its views reflect market conditions on the date of this presentation, they are subject to significant uncertainties and contingencies, many of which are beyond CBRE's control. In addition, many of CBRE's views are opinion and/or projections based on CBRE's subjective analyses of current market circumstances. Other firms may have different opinions, projections and analyses, and actual market conditions in the future may cause CBRE's current views to later be incorrect. CBRE has no obligation to update its views herein if its opinions, projections, analyses or market circumstances later change.

Nothing in this report should be construed as an indicator of the future performance of CBRE's securities or of the performance of any other company's securities. You should not purchase or sell securities—of CBRE or any other company—based on the views herein. CBRE disclaims all liability for securities purchased or sold based on information herein, and by viewing this report, you waive all claims against CBRE as well as against CBRE's affiliates, officers, directors, employees, agents, advisers and representatives arising out of the accuracy, completeness, adequacy or your use of the information herein.