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## The Start of a New Recession in the Eurozone? What of the budding recovery in Commercial Real Estate?

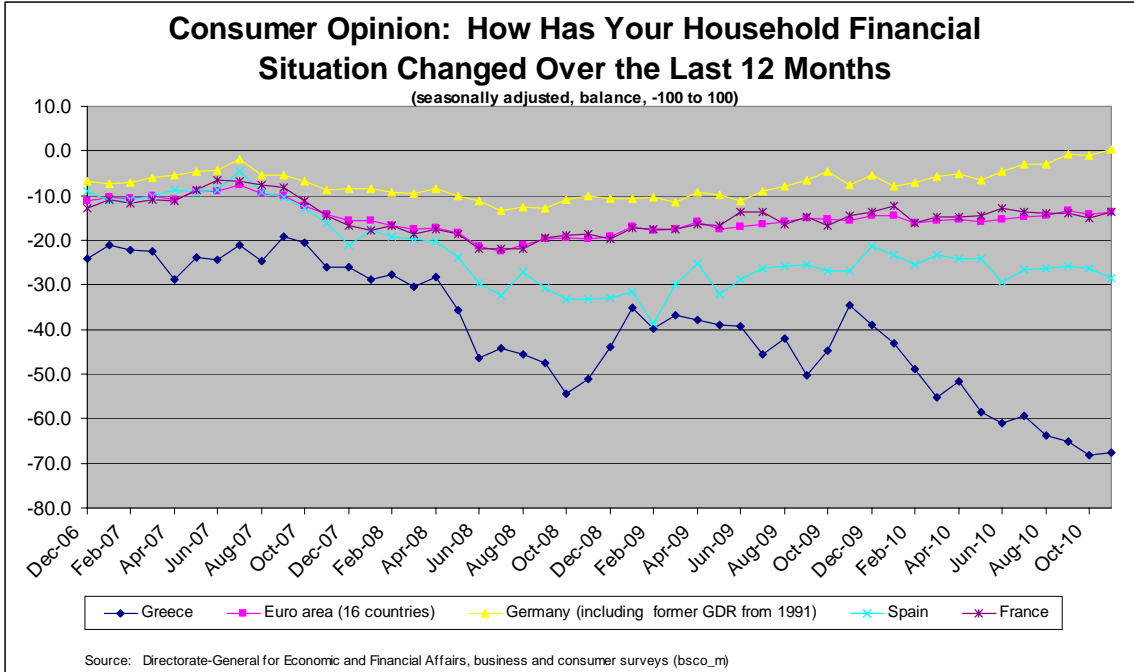
### EUROZONE ECONOMIC OUTLOOK

4<sup>th</sup> February 2011

**MIAC | Acadametrics** believes that the Eurozone is at a critical tipping point, with several major markets poised to move ahead strongly (the UK, and Norway) or continue improving (Germany, Sweden). However, even with recent good news, the recent sovereign debt crises continue to have negative impacts. If the situation is managed well, the results could be most fortunate for the Eurozone. If not, there is a dark cloud of returning uncertainty ahead. The memory of how first a spike in interbank lending rates and then freezes in interbank lending in mid-2007 presaged the market meltdown in the fall of 2008 is too recent not to take seriously analogous events in Europe.

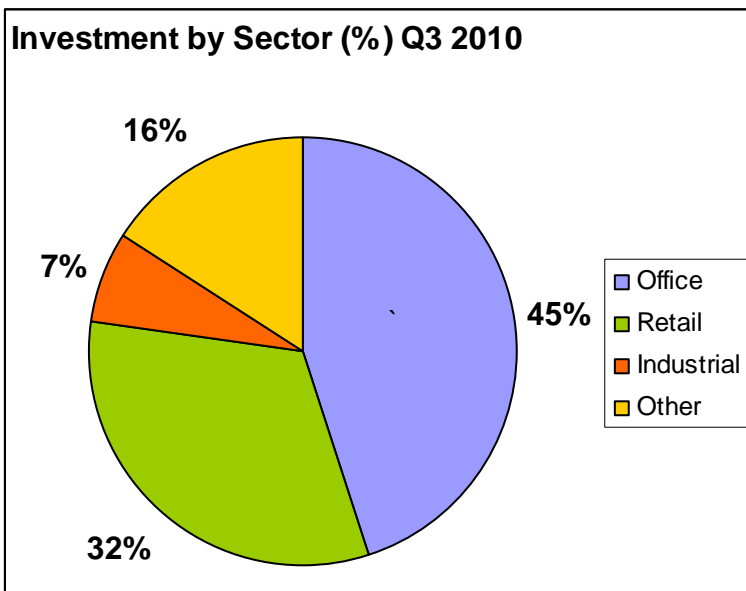
Recently, the Wall Street Journal ran an article (“As Europe Falters, Firms Feel Chill of Weak Economy” *Cari Tuna, Ellen Byron*. Wall Street Journal (Eastern edition). New York, N.Y.: Dec 7, 2010. pg. B.1) that makes a strong case for a return to the vicious cycle from the preferred virtuous cycle we all hope for. The driver? The expected government spending cuts and their impact on consumption and employment. That, we all know, will have the usual domino effect and drive down the demand for commercial real estate. Because government is the prime buyer of software and health care in Europe, those industries are under pressure to cut prices and therefore costs. (J.P. Morgan analyst John DiFucci states that 30% to 40% of software spending in Europe -- and roughly 10% to 15% globally -- is government purchased.)

The pressure to cut government spending is rising. This pressure will become acute in 2011 as the annual budget cycle kicks in. As the economies in Spain, Ireland and Greece have stagnated or stalled with the drop in business investment (signaling business lack of confidence), consumer spending has also dragged. Ireland and southern Europe will continue to lag behind the rest of Europe for the immediate future.



## EUROZONE COMMERCIAL REAL ESTATE MARKETS

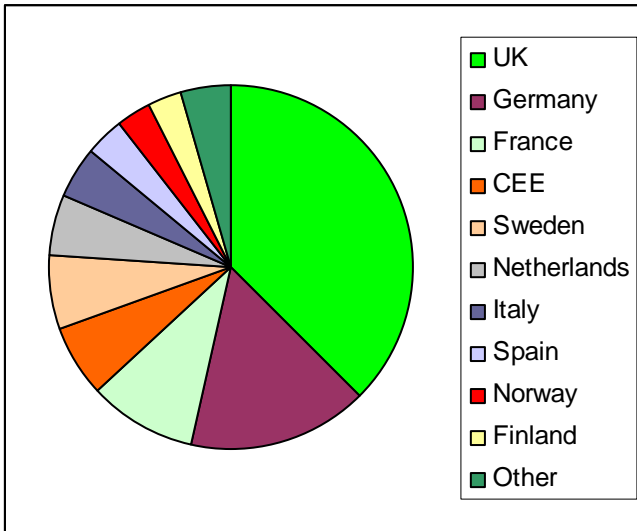
This means that many major commercial tenants will remain focused on consolidating operations to cut costs. The resultant weak leasing demand means that with lease expirations will come rising vacancies. Business investment is not driving occupancies upward – its lack is driving them downward. This pattern is true to form in all commercial real estate (CRE) markets, as CRE typically lags by significant times any general economic recovery.



The evidence indicates that investor demand is following the economic outlook in each local market. The highest demand by property investors is currently in Germany, central and eastern Europe (particularly Poland) and in the Nordic countries. Poland was the only major European country to essentially dodge the recession with only one quarter of negative growth. Germany is now posting strong economic growth, as are the Nordic countries. These regions and markets (particularly in Paris, Berlin, and Stockholm) are benefiting from uncertainty about government spending cuts elsewhere in Europe as investors are increasingly driven to them.

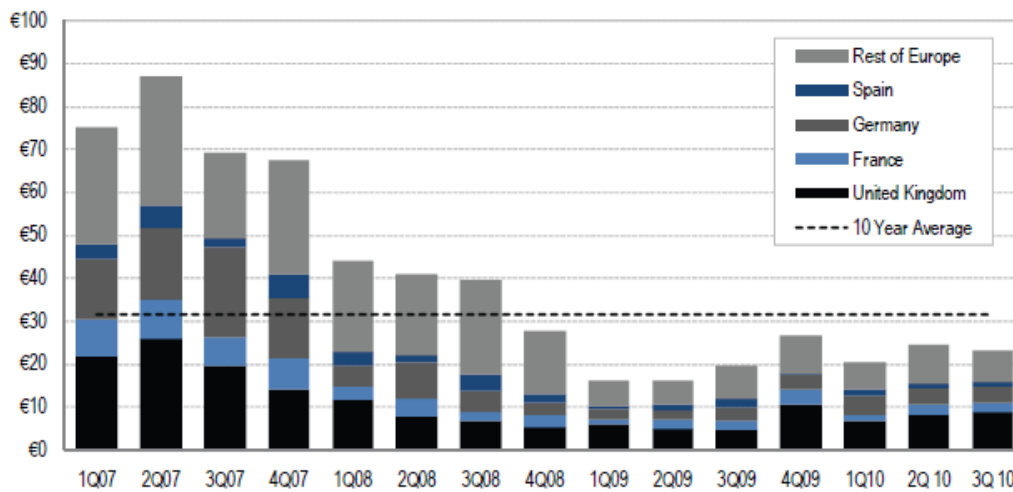
There are signs that UK investor interest is also falling off according to surveys by Lloyds Banking Group and Property Market Analysis (PMA), and less money has been flowing into UK real estate recently according to the Association of Real Estate Funds. This is in spite of the relatively tight office space market in Central London.

**Investment By Market (%) Q3 2010**



Source: CB Richard Ellis 3Q 2010 MarketView

**Quarterly Investment Transaction Volume, Private Markets, (bil)**



CBRE, DTZ, Pramerica Real Estate Investors Research

## NEW ORIGATION LOAN MARKETS

Proposed government spending cuts and the anticipated weaker economy have not had an immediate impact on the primary CRE markets. As in the US markets, there is a complete split in the conditions seen in the new originations market and the secondary loan markets.

In the new origination markets, differences in the key lending terms between the strong and weak markets have started to become more evident. In the hot markets, bankers are looking to make larger loans and at higher LTVs. The markets heating up most quickly are in Germany and France. In these markets, banks are again competing over prime deals (as they are in prime US markets) and are producing more aggressive lending terms (see the table below). CB Richard Ellis cites as an example of this increased competition the October closing of Hardstone's purchase of CB16 tower at La Défense in Paris, which Morgan Stanley, Aareal and Crédit Foncier de France jointly financed. The property was valued at approximately €220 million.

### Key Lending Terms\*:

#### Top Quality Real Estate and Tenant, September 2010

Market	Max Loan	Max LTV	Margin **
France	€100	70%	150
Germany	€150	75%	110
Italy	€50	65%	200
Netherlands	€70	70%	150
Spain	€35	65%	275
UK	€75	70%	175
Market Trend	MIXED	=>	MIXED

\* New 5-year loan based on the maximum underwriting ability of a single lender

\*\* Margin over Euribor / Libor swap

Source: CB Richard Ellis 3Q 2010 MarketView

The German bankers are the most active lenders today. Their access to low cost covered bond financing allows them to outbid competitors. According to Savills, German banks represent nine of the twelve banks lending in the UK. They cite new origination loan terms in the UK that are more conservative than the CBRE numbers given in the table above – 150 bp margins over Euribor; face amounts under €100 million; LTVs of 65% and five-year terms on stable properties. Development financing, if available at all, is priced at 350 margins over Euribor and includes terms requiring pre-leasing and solid financial guarantees. According to Pramerica, transactions outside of the top tier CBDs are being done by a number of smaller funds, which have cash remaining from before the financial crisis and/or have financing available from regional banks that do not have “legacy loans” on their books. These banks are willing to do sub €10 million loans with easier terms and conditions than larger banks demand: but at a price.

We have noted that insurance companies have begun moving into the new origination CRE debt markets in Europe. This has long been the case at the top end of the US CRE market, and this development brings the European markets more into line with US markets in this regard. In the US, life companies account for close to 20% of the market according to CB Richard Ellis. They cite AXA Real Estate Investment Managers, who have already made over €1 billion in new loans and have announced further commitments in their European senior debt lending capacity.

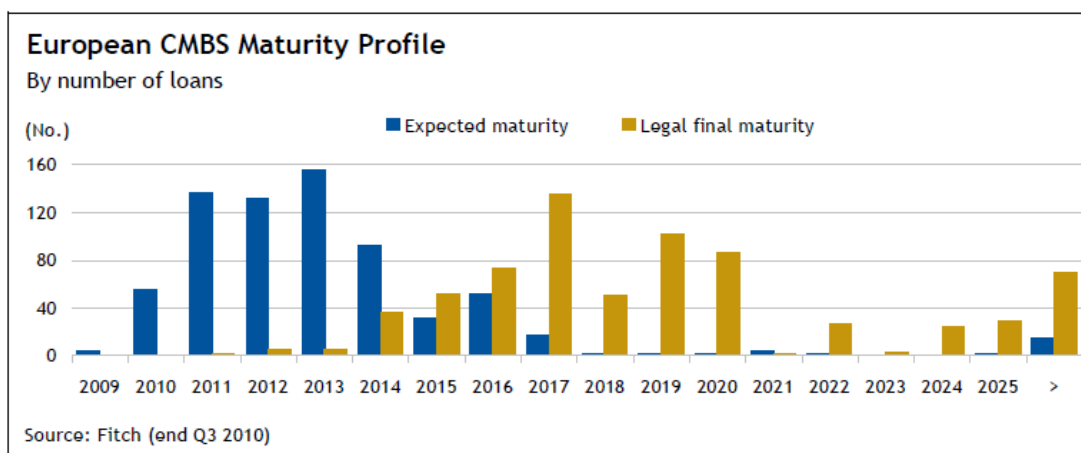
Many Eurozone markets continue to remain less developed than the US markets because of issues such as the lack of document standardization, limited market transparency and a limited ability to obtain early prepayment penalties. These issues continue to limit institutional investment levels in many European markets as compared to the development in the US markets.

## SEASONED CRE LOAN PERFORMANCE

Of course, nothing we've said should be taken to mean that existing commercial real estate loans are out of the woods. In spite of some encouraging news about commercial loan delinquencies and potential upturns in sectors like retail, the CMBS market data shows that significant risk remains in the Eurozone seasoned loan markets even if the Eurozone economies do not swoon in 2011. Fitch's "Quarterly European CMBS Performance Update Q310" makes the risks all too clear (quotes from their summary below).

- **Deteriorating performance measures:** The proportion of current loans decreased to 72.6% from 77.6% in Q310. This was driven by more loans breaching their loan-to-value ratio (LTV), interest coverage ratio (ICR) and/or debt service coverage ratio (DSCR) covenants, as well as a growing number of maturity defaults.
- **Continued balloon risk:** Loan maturities remain the key challenge, as many borrowers continue to be unable to repay their outstanding loan balance when due. At end-Q3, 58.8% of loans (by number) that had passed their scheduled maturity dates had not been redeemed.
- **Increased leverage:** The weighted-average (WA) Fitch LTV increased to 98% from 96% in Q3. This results from a combination of redemptions of low-LTV loans and further value falls for poor-quality collateral.
- **Stable collateral income:** Term defaults are roughly flat from last quarter at 4.1% as collateral income continues to hold up. Similarly, the WA ICR and DSCR remain high at 1.9x and 1.8x, respectively.
- **Varied loan performance:** Performance varies significantly across jurisdictions: 95.7% of Swiss loans are current, while only 12.5% of Irish loans are in the same situation. Similarly, performance varies by servicer, with the proportion of current loans ranging between 36.4% (CBRELS) and 83.3% (Eurohypo).

Fitch produces some of the best analysis of delinquency trends and maturity default risk in both the US and European markets. The tables and charts below neatly summarize the current situation, where considerable risks still remain.



Fitch - and others - have been telling market observers loud and clear that most of this loan product is not qualified for refinancing today (see the graph of expected loan maturities above). Therefore, the legal final maturities (mostly balloon maturities) are how long the borrowers have to obtain improvements in their NOI (presumably from an economic upturn) or to raise added capital (to pay down debt).

The tables below reflect the fact that The UK, Germany and France have the most developed markets. They also indicate where the exposures are largest. With the UK, and the office market in particular, showing nascent signs of a slowdown, this is mixed news indeed.

### Collateral Location Distribution

Country	% of loans
Germany	37.7%
UK	31.4%
France	10.8%
Netherlands	4.6%
Ireland	3.4%
Switzerland	3.3%
Italy	2.4%
Other	6.4%

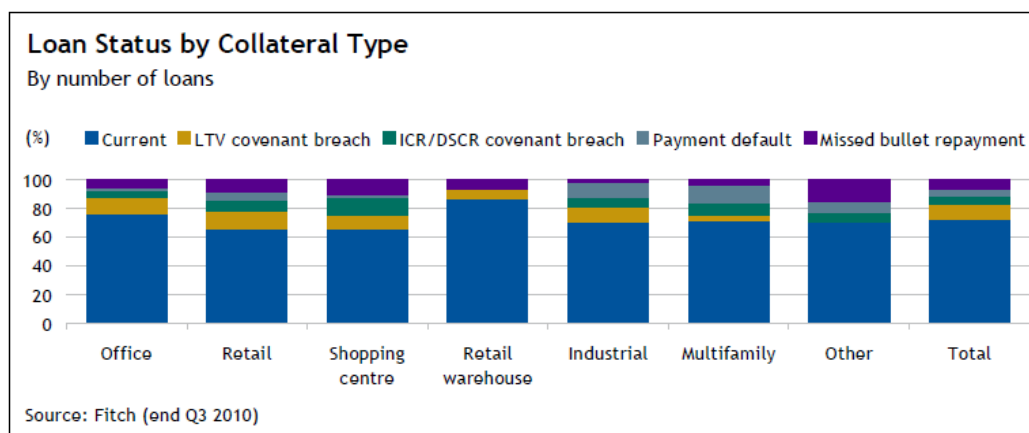
Source: Fitch

### Collateral Type Distribution

Type	% of loans
Office	45.2%
Retail	21.0%
Shopping centre	9.3%
Industrial	6.7%
Retail warehouse	4.1%
Multifamily	8.0%
Other	5.7%

Source: Fitch

As glum as the maturity chart above seems to be, the story overall is that most outright payment defaults are still the exception rather than the rule. Lenders will work with borrowers who have missed a balloon payment and who show signs of willingness to put up additional cash, or they will work out some form of pay down arrangement.



## SEASONED LOAN SECONDARY MARKETS

Regarding the secondary (seasoned) loan markets, the Eurozone banks are still digging out from under loans that have problems. CRE remains a significant portion of the problem assets, which remain over represented on bank balance sheets as compared to historical norms. The new Basel III capital requirements will make it more costly to continue holding these loans. That will put pressure on the banks to clean up these loans through refinancing rather than through extension and modification. Unfortunately, even with a recovery in property values, many of these loans cannot be refinanced without added borrower equity or bank write-downs. This problem is most evident in the UK, where bankers were more aggressive at the height of the market. The result of this continuing “overhang” is that bankers are less willing to lend in all but the strongest markets, allowing time for the building of capital, reductions in existing loan principal amounts and the recovery of property prices. This means that most European bankers today are cutting back on lending rather than increasing it.

Seasoned properties are of course the most vulnerable to being upstaged by newer properties in their markets. The net result of this situation is that the available bidders continue to discount loans traded in the secondary markets by haircutting the valuations (effectively capping NOI and putting a ceiling price based on an LTV on the loan) and placing increased yield requirements on properties lacking very strong leasing characteristics.

## POSSIBLE EFFECTS ON US CRE MARKETS

| MIAC | Acadametrics -recognizes that there is a risk of “contagion” to the still-weak US markets in a major Eurozone meltdown, but we feel that the likelihood of this occurring remains small. We were particularly encouraged by the ability of Spain to successfully tap the debt markets the second week in January 2011. Nevertheless, many commentators see these risks as significant, and a review of the thinking about the risks of contagion is in order.

The bottom line is about investor confidence and actual exposure to any possible contagion. During mid-2010, there was a distinct possibility that concerns over the deepening EU liquidity crisis were making some firms more risk-averse. It is widely remarked that the longer working Germans and French will not indefinitely subsidize Italians and Greeks (who have earlier retirement ages). While we see risks to the Euro as a common currency and even the possibility that one or more EU members could be forced to come off the Euro, we see the strong commitment of the EU as a whole to be a strong mitigant.

Still, the issue of relative debt-to-GDP cannot be entirely ignored. Eurozone politicians are in a very tight fix, with unpopular budget cuts provoking angry reactions from the populace and increasing the levels of national debt an equally difficult situation. In 2009, the average debt-to-GDP ratio for EU countries was 84%, with Greece having the highest ratio among the 16 members. More than half of these countries exceeded the required limit established by the EU of a 60% debt-to-GDP ratio. Several exceeded the goal by a large margin. By contrast, the current U.S. debt-to-GDP ratio is close to 90%. While the US economy has proven to be larger, stronger and more resilient, we still consider the comparison an alarming one because it means that even here in the land of the dollar bill, debts come due.

The good news is that by comparison, the sovereign debt crisis is small when compared to the subprime mortgage crisis. The credit exposure of U.S. financial institutions to the Euro sovereigns is relatively small, with only an estimated \$165.9 billion direct sovereign debt exposure in the implicated countries (primarily Portugal, Ireland, Italy, Greece and Spain). It has been estimated that there was approximately \$4.6 trillion in subprime and Alt-A mortgages outstanding in June 2008, mostly held by US institutions (per National Real Estate Investor; “Will Europe’s Sovereign Debt Crisis Derail the US Commercial Real Estate Recovery?”; David Lynn, Ph.D; Jul 6, 2010). A Wells Fargo analysis in their January 19, 2011 “Daily Forex Fundamentals” places the number at

far less – only \$19 billion of US exposure to the €3 trillion in European sovereign debt outstanding from the implicated countries, but Wells Fargo says Americans also own another \$70 billion of private securities from those countries. It is true that many of the European banks have operations in the US, but the most significant are Swiss, German, UK and French institutions with relatively solid balance sheets and whose countries of origin are not implicated in the sovereign debt crisis.

## **HOW MIAC | ACADAMETRICS CAN HELP**

MIAC | Acadametrics is continually monitoring the debt markets and loan collateral behavior in the Eurozone and the US. Our market knowledge makes us ideally suited to assist market participants with independent credit and valuation analysis in volatile markets. MIAC | Acadametrics also continues to monitor and evaluate the changing regulatory and legal climate financial institutions operate in within the major markets. MIAC | Acadametrics can assist you with time- and market-tested analytical solutions and valuation expertise.

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