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What impact will the banking crisis have on property companies?

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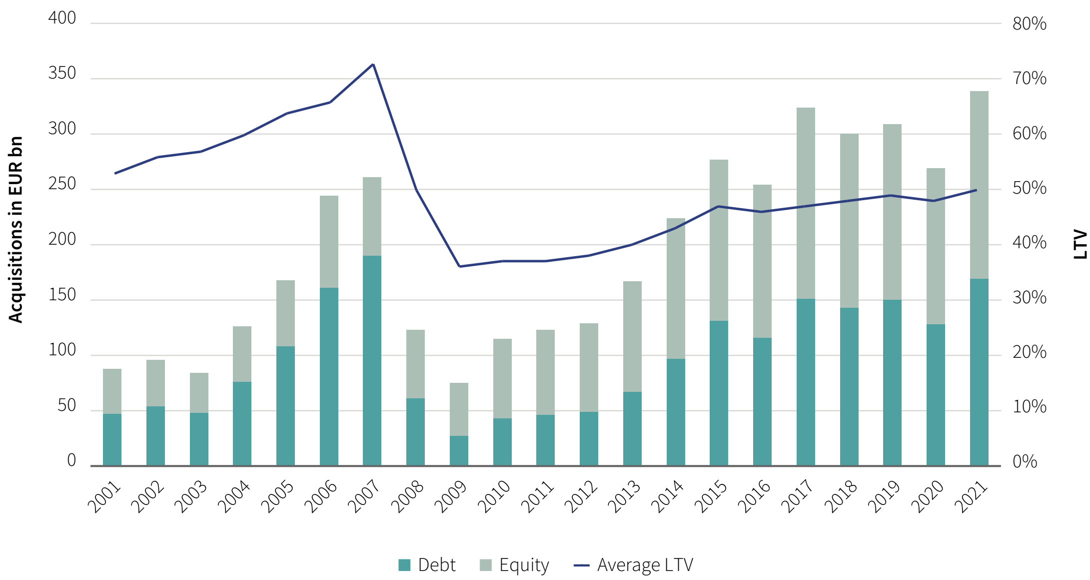
The failures of Silicon Valley Bank and Credit Suisse revived the spectre of a banking crisis, triggering a widening in spreads[1] on the credit markets and, in parallel, a decline in property companies' equity market valuations.

Although regulators did step in to quickly bring the crisis under control on both sides of the Atlantic, many uncertainties remain, notably the risks to future refinancing of commercial real estate loans against a backdrop of higher interest rates and slumping certain real-estate markets. This is even more the case in North America, where regional banks have accumulated exposure to commercial property loans that could exceed 30% (including direct and indirect exposure)[2].

In Europe, the situation is less dire, due to banks' more moderate exposure (9% of loans on average, according to the European Banking Authority). Moreover, terms on loans granted after 2015 carry prudential ratios that are far more conservative than during the Great Financial Crisis, with LTVs[3] below 50%[4], thus leaving a significant margin of safety in the event of a market downturn.

Leverage used for real estate investments in Europe since 2001



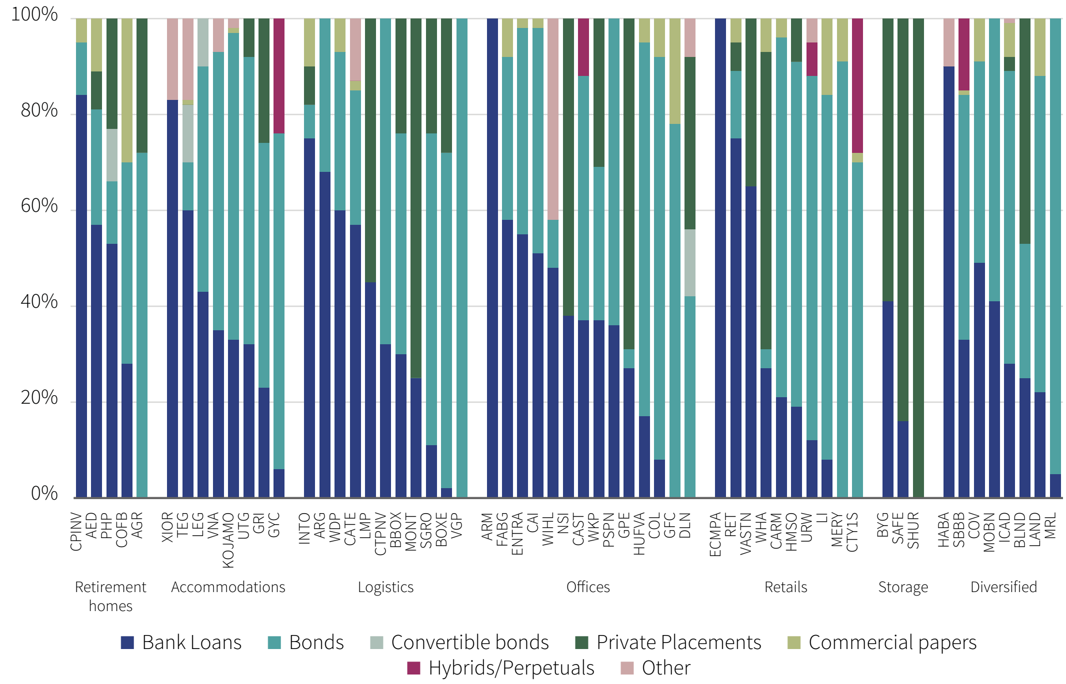
Source: ODDO BHF, May 2023.

(1) Difference in yields between one bond and another bond of equivalent maturity regarded as "risk-free".
(2) Source: Moody's, May 2023.
(3) Loan to Value: ratio between the amount of the loan and the property's value.
(4) Source: ODDO BHF, May 2023.
Past performance is not indicative of future performance.

Real-estate risk to the European banking system therefore looks to be well under control. Even so, banks will most likely reduce or limit the liquidity they provide to the sector, even as they remain the cornerstone of real-estate financing.

To take one example, direct financing has expanded exponentially in recent years to 200 billion euros but accounts for just one twentieth of banking financing[5]. Accordingly, as bank loans will probably have to be refinanced (i.e., constant exposure), the question will arise for new credit lines to replace, for example, the bond financing that has been widely used by property companies since 2015. Issuance accounted for 1% of the investment grade[6] market in euros in 2013 but rose to 6% in 2022[7]. As of the end of January, Bank of America estimates that a total of 27 billion euros in real estate bond pools will have to refinanced in the coming years. Bonds average a little more than 40% of property liabilities, followed by bank loans, at 35%[8].

Breakdown of property company liabilities based on the type of debt



Source: Kempen, Companies, May 2023.
X-axis: Bloomberg identifiers of the companies.

(5) Sources: Prequin, ECB, Goldman Sachs, May 2023.
(6) A debt security issued by a company or government that is rated between AAA and BBB- by Standard & Poor's.
(7) Source: Bank of America, May 2023.
(8) Source: Kempen, May 2023.
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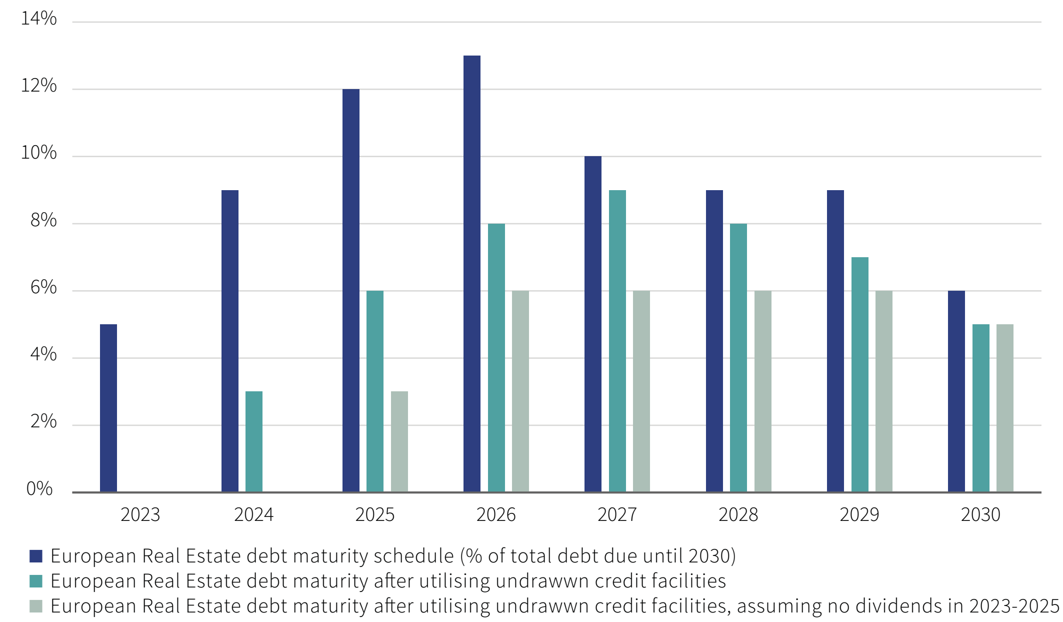
However, property companies do have time to get their refinancing in place. The peak of the “debt wall” is expected for 2024-2025, but when factoring in undrawn credit lines, it would be more like 2025-2026. In a stressed scenario, property companies can still reduce distributions and gain an additional year.

Maturity of European property debt



Source: Goldman Sachs, Companies, Rothschild & Co Asset Management, May 2023.

This should allow enough time for investment property markets to thaw out and allow property companies to make divestments, thus avoiding massively diluting shareholders via recapitalisations at current valuations (with discounts averaging more than 40%). There is still some buyer appetite for assets having solid fundamentals, appetite that should be whetted further by pivots in monetary policies and price declines of between 10% and 20% (from peak to trough). Vonovia’s recent announcement of two deals totalling 1.5 billion euros is a good example. This property company sold off a €560 million portfolio to CBRE, a business property consultant, for a gross yield slightly above 4%, or a 10% discount to the yearend appraised value, vs. an equity market discount to gross asset value of -30%(9). Vonovia’s second deal was the divestment of a minority stake (one third) of a €3 billion portfolio. In this case, the implied discount to gross asset value was, in face value terms, closer to the market discount. The way the deal was structured (including a buyback option, the difference between economic rights and the pro-rated stake, etc.) makes it hard to extrapolate to its other assets, according to real-estate appraisers. However, it does show investors, at a critical time, that the company can access equity financing remunerated at 8% vs. 12% on the financial markets(10).

It is mainly non-prime(11) assets facing structural changes (due to remote-working or e-commerce) that are proving to be a hard sell. When they do find buyers, it’s at steeply discounted valuations. This category includes obsolete offices (containing thermal bridges) in second-tier neighbourhoods hit by remote-working or shops with outmoded formats in declining catchment areas.

(9) Source: Rothschild & Co Asset Management, May 2023.
(10) Source: Companies, May 2023.
(11) Buildings that are not up to current standards or are not centrally located.
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Liquidity risk analysis of various property markets

Asset class	Real estate fundamentals	Yields		Value adjustment *(after pressure is relieved on yields, and rental income impact)*	Liquidity risk
		before correction	Estimated post-correction		
Offices					
Primes	++	< 3 %	[4 % ; 5 %]	[-10 % ; -15 %]	Low
No primes	-	Between 4 % and 5 %	>> 5 %	>> -20 %	High
Retail		Around de 5 %			
Primes	+	[4 % ; 5 %]	[5 % ; 6 %]	[0 % ; -5 %][1]	Low
No primes	-	>> 5 %	>> 6 %	>> -20 %	High
Logistics	+	< 3 %	[4 % ; 5 %]	[-15 % ; -20 %]	Low
Healthcare	+	Between 4 % and 5 %	[5 % ; 6 %]	[-5 % ; -10 %]	Low
Residential	+	< 3 %	[4 % ; 5 %]	[-15 % ; -20 %]	Low

(1) Adjustment already made during the Covid-19 crisis.
Source: Rothschild & Co Asset Management, May 2023.

Conclusion

Current discounts crystallise falling real-estate prices and, even more so, the risk of dilutive recapitalisations for overleveraged companies. However, Eurozone property companies'' maturities do give them a reasonable time horizon to pay off debts by making divestments. Sales already made in an investment property market that is at a standstill are encouraging, and the gradual return of deals should give financial markets a better grip on refinancing risk and, hence, limit discounts.

Completed writing on 12 May 2023

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Performance	Since the beginning for the year	2022	2021	2020	2019	2018	Volatility 1 year
R-co Thematic Real Estate C EUR	0.4 %	-23.5 %	6.6 %	-22.8 %	21.6 %	-7.5 %	24.6 %
IEIF Eurozone coupons nets réinvestis[1]	-1.0 %	-34.6 %	2.1 %	-10.7 %	21.5 %	-9.9 %	26.4 %

(1) Benchmark index
Sources: Rothschild & Co Asset Management, 28/04/2023.

Risque SRI : 5
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Share(s)	C EUR	I EUR	P EUR[1]	D EUR	ID EUR	I2 EUR	F EUR	CL EUR[1]
ISIN code	FR0007457890	FR0010680553	FR0013293925	FR0007474028	FR0011361062	FR0011885789	FR0011885797	FR0013293909
Dividend Policy	Capitalisation	Capitalisation	Capitalisation	Distribution	Distribution	Capitalisation	Capitalisation	Capitalisation
Subscribers	All subscribers	Institutionals	See below[1]	All subscribers	Institutionals	All subscribers	All subscribers	See below[1]
Minimum amount of initial subscription	5 shares	1 000 000 €	1 shares or 500 000€ for institutionals investors	5 shares	1 000 000 €	1 share	1 share	1 shares or 500 000€ for institutionals investors
Maximum Management fees	1.50 %	0.75 %	0.95 %	1.50 %	0.75 %	0.75 %	2.10 %	1.25 %
Subscription fees (max)	3.0 %	3.0 %	3.0 %	3.0 %	3.0 %	5.0 %	2.5 %	3.0 %
Redemption fees (max)	-	-	-	-	-	-	-	-
Transaction fee	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %	1.03 %
Performance fee	15 %	-	15 %	15 %	-	-	-	-
Country of registration	FR - AT - BE - DE - ES - IT - LU	FR - AT - BE - DE - LU - NL	FR - AT - BE - DE - ES - IT - LU - NL	FR - AT - DE - ES	FR	FR	FR - ES - IT	FR - NL

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