Press release

2018 Irebs study on the German Debt Project Rational steps to turning some increased risk into "micro-margins"

- Drop in the volume of new business in 2017 and 2018 for the first time despite rising prices. The cake is getting smaller as a result of high competitive pressure.
- Loan-to-value ratios (LTV) for industry continued to decline significantly in 2017 (59% down from 63%) and have stabilised at a similarly high level in the current year. However, LTVs are falling, particularly in low-risk business, and are holding at significantly higher levels in more complex financing.
- In price-adjusted terms, LTVs have risen significantly in recent years. If commercial property prices had not risen since e.g. 2013, the average LTV would currently be 80%.
- The proportion of financed project developments and financing for value-add and opportunistic investments is gradually increasing. In addition to price-adjusted higher LTVs, the financing mix is becoming more challenging.
- With risks rising, margins are now falling for the fifth year in a row, including 2018. At the same time, regulatory requirements are increasing, and the mix of new business is becoming more complex.
- The question of margin levels which adequately reflect risk is becoming increasingly important.

Eltville, 27 June 2018. The "German Debt Project" study conducted by the International Real Estate Business School (Irebs) is publishing detailed information about the market for commercial real estate finance in Germany for the fifth time with the support of the Verband deutscher Pfandbriefbanken (vdp), as well as six renowned representatives from the real estate sector.

We have reached a new market phase: In recent years, the central question in our study has been whether or not there has been another double-digit rise in the percentage volume of new business. Even as this "cake" has been growing, the competition among banks has been increasing steadily. In 2017, the banking portfolio which was analysed by us fell by 7% in new business and is expected to also decline this year. Taking into account savings banks and cooperative banks, which are under-represented, as well as some special effects within this portfolio, new business decreased by about 3–4% in 2017. The individual growth targets of the respondents for 2018 are even more different than in previous years; as a result, some banks continue to regard themselves as being on a growth course in Germany. However, other institutions are well below budget in the first half of the year. Thus, competitive pressure remains high.

Even more differentiation is needed than in previous years. More discussion about the different risk clusters: Discussions with the participating banks focused less about “the middle of the business”; primarily on the low-risk core segments, as well as the complex financing of opportunistic investments and project developments.

The core segment remains the most competitive, especially for large mortgage volumes. In the interview, some respondents spoke about "micro-margins", which can only pay off in terms of returns (RoE) for large finance volumes. In this segment, the continued high investment pressure on the part of investors in strong equity positions is leading to falling LTVs. In addition, the high price buoyancy of core assets is dampening the level of LTVs.

In order to increase the average margin as new business declines, many banks are striving to finance more risky assets with higher margins since margin pressure is not as pronounced there as in the core area. The financing institutions are thus following the strategy change of many investors who (are having to) look for risky assets due to a sharp decline in rental yields. "In order for this strategy to work, investors and financiers are dependent on stable tenant demand and rapid increases in construction costs, which are not unexpected at least. But both are inherently uncertain," says Prof. Dr Tobias Just of Irebs.

At the same time, former risky properties are priced like a low-risk core property. The main author of the study and managing director of the Irebs Immobilienakademie, Markus Hesse has summed this up as follows: "Investors are pursuing the goal of managing an object as the core property, and financiers are trying to factor in this expected success in advance. Consequently, *managed-to-core* is becoming *priced-like-core* at the same time. However, it remains to be seen whether all the risks are adequately taken into account." The differences in margins between the individual property types have also gone down, with the exception of retail, which has been increasingly valued cautiously by financiers over the past two years.

Overall, these developments are leading to a further decline in gross margins. While the gross margin in 2013 was still 161 basis points (bp), the level only reached 125 bp in 2017 and looks set to continue to fall slightly to 121 bp in 2018. Gross margins on core objects have even fallen mostly to 50–70 bp. At the same time, LTVs fell significantly from 65% in the previous year to 61% in 2017 (the expectation for 2018 is almost stable). This decline in LTV is welcome as a start, but it also partly reflects the price development in properties since 2013. Index-linked to the 2013 price level, LTVs for industry are around 80% and even higher for institutionally-held residential property. LTVs have fallen, especially for core properties; however, LTVs have remained virtually unchanged for opportunistic investments or project developments.

Opinions are increasingly at odds when it comes to assessing price risks. Some banks point out that debt servicing (interest and capital repayment) remains affordable even at higher interest rates, or at least within plausible interest rate scenarios. Our analyses show that this reasoning makes sense. However, our analysis also demonstrates that relatively small changes in terms of demand from users could place a considerable burden upon financiers. In that respect, the main risk may not be the turnaround in interest rates, but an economic turnaround. Over and beyond consideration for debt servicing, other institutions cite regulatory capital risks in the case of potential price corrections. Simon Mallison from Real Capital Analytics, the originating lead sponsor, notes that rental yields for core office properties, in particular, have fallen sharply in the last three years.

Banks are not blind to rising risks; they are adopting a rational approach to higher risks and paying great attention to their ability to service their loans; there are usually still sufficient buffers in place here, at least for scenarios where demand remains good. The regulatory system ensures that banks also keep an eye on price risks. This is a question of capital adequacy. However, equity can only be accrued at present by taking greater risks; banks are, therefore, continuing to take chances in a still booming real estate market. As stiff competition persists, banks are having to remain vigilant and act rationally in increasingly choppy waters owing to the lack of alternatives.

The German Debt Project study

The German Debt Project study was initiated by the market research and consultancy company Real Capital Analytics and has been supported by the Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken, vdp) from the start. Twenty-four German financial institutions took part in the survey. The credit volume analysed in the context of the study is € 185 billion. The objective of the study is to increase transparency for the German market in commercial real estate financing and to enable meaningful comparisons, in particular in risk analysis. The study was carried out for the first time in 2013.

The originating lead sponsor is Real Capital Analytics, and the co-sponsors are bulwiengesa and JLL; the trade association sponsors who have supported us are Commercial Real Estate Finance Council Europe (CREFC), INREV and the central real estate committee, Zentrale Immobilien Ausschuss (ZIA). The project management rests with Markus Hesse. The research in the study is led by Prof. Dr Tobias Just from Irebs. They are the co-authors of this study. The Association of German Pfandbrief Banks (Verband deutscher Pfandbriefbanken, vdp) supported the study.

German Debt Project website (www.german-debt-project.de)

The study can be purchased for € 450 exclusive of VAT from the www.german-debtproject.de website. It contains a collection of studies and commentaries by Irebs Real Estate Academy and its sponsors and supporters on the subject of commercial real estate financing. Other current issues relating to the subject of commercial real estate financing are also highlighted.

About the Irebs Real Estate Academy

The Irebs Real Estate Academy is the further training academy of the Irebs International Real Estate Business School and part of the Faculty of Economics of the University of Regensburg. The International Real Estate Business School comprises the Irebs Institute of Real Estate Economics and the Irebs Real Estate Academy. The Irebs Real Estate Academy offers professional development courses for management, junior management and specialist staff. In addition to real estate, construction and financial management companies, our clients include industrial, commercial and service companies and the public sector.

The Irebs Real Estate Academy is certified to ISO 29990 as a provider of education and further education. This seal guarantees students that the Irebs services are designed on the basis of employment market requirements and are continuously being improved.

The contact course on Real Estate Economics and the course of Excellence for the Executive MBA Real Estate at the Irebs Real Estate Academy are accredited by the renowned Royal Institution of Chartered Surveyors (RICS). Further information is available at www.irebs-immobilienakademie.de.

Press contact for the GDP research project

Markus Hesse
IREBS Immobilienakademie
Barocketage Kloster Eberbach | 65346 Eltville
Telephone: 06723 995099
E-mail: markus.hesse@irebs.de