European CMBS under pressure as refinancing risk intensifies concerns

CRE loans securitised in the benign lending environment of 2017-2018 have reached their final maturities but six loans securing four European CMBS have been forced to seek maturity extensions to prevent refinancing failures.

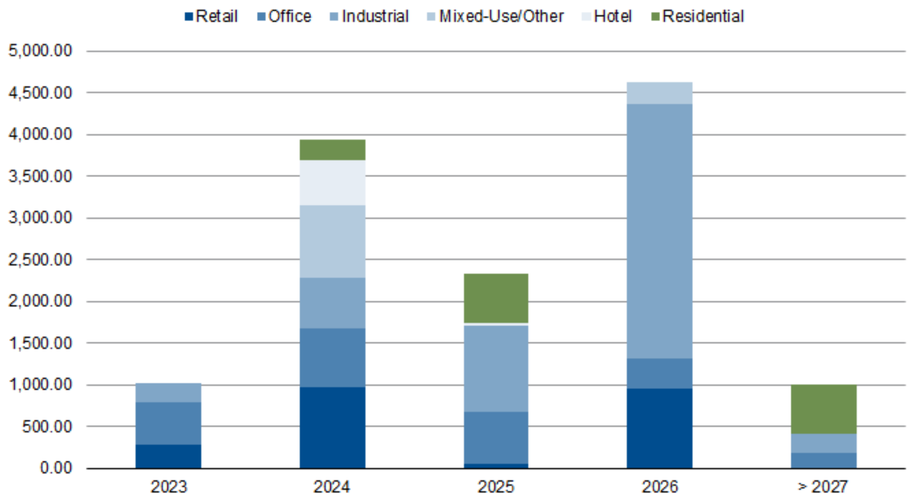
The same threats are also being felt in the EUR 300bn CRE debt market, amplified here by the sharp decrease in liquidity provided by banks in the wake of SVB's failure and pressure in the financial system culminating in UBS's negotiated takeover of Credit Suisse.

These developments demonstrate the powerful sector headwinds, which we highlighted in our most recent note (A third of commercial real estate loans in European CMBS face significant refinancing risk), as well as growing concern amongst CMBS noteholders about recent servicing decisions. We estimate refinancing risks to be high for retail and shopping centre loans[1] and certain single-office loans[2] maturing in 2023-2024 (Figure 1).

The loan securing Taurus 2017-1 IT S.r.l. reached its extended maturity in November 2022 but it has been unilaterally extended by the servicer to January 2024 with an option for another year. The same servicer also extended the three loans securing Pietra Nera Uno S.R.L for a year.

In return for better terms, Taurus 2018-1 IT S.r.l. noteholders approved a one-year extension on the last remaining loan with an option for another two years. Rejection by senior noteholders of FROSN 2018 DAC of the one-year extension plan advanced by the sponsor and servicer led to a loan event of default and transfer to special servicing.

Figure 1. Maturity profile of European securitised loans (in EUR m equivalent)



Source: Scope Ratings, Investor reports

[1] Elizabeth Finance 2018 DAC, Emerald Italy 2019 SRL, Deco 2019-RAM and Deco 2019-Vivaldi S.R.L.
[2] Salus - ELoC 33 DAC, Taurus 2018-2 UK, and Viridis - Eloc 38 DAC

Analysts

Florent Albert
+49 30 27891-164
f.albert@scoperatings.com

Benjamin Bouchet
+33 1 8626 1876
b.bouchet@scoperatings.com

Team leader

David Bergman
+39 02 30315 838
d.bergman@scoperatings.com

Investor Outreach

Michael John MacKenzie
+44 20 3714 4981
m.mackenzie@scopegroup.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related methodology

CRE Loan and CMBS rating methodology
October 2022

Related Research

See page 4.

Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

The European real estate playbook: triple threats

CRE borrowers face three key challenges

These extensions or extension attempts highlight the difficult underlying conditions facing European commercial real estate.

1. Deteriorating financing conditions. Interest rates have increased by more than three percentage points since February 2022[3]. Margin expectations have also increased as lenders' appetite to finance CRE assets wanes. Anecdotally, the coupon on the Bel Air (Taurus 2018-1 IT) loan almost doubled to 7.15% from 3.75%[4] after the maturity was extended.

2. Cautious underwriting. Lenders have become more cautious in their underwriting due to challenging cashflow and value projections after a decade of accommodating monetary and fiscal policy and ongoing structural changes affecting the real-estate sector.

3. Worse secondary market liquidity and overvalued assets. We don't believe retail and office yields have decompressed enough to reflect all the interest-rate increases[5] and ongoing structural changes. E-commerce and remote working challenges are exacerbated by the deteriorating credit quality of retailers, companies laying off employees, and the cost-of-living crisis impacting both consumer spending and companies' revenues.

   As an illustration, no properties have been sold in FROSN 2018 DAC since the second quarter of 2020 even though there is an asset disposal plan[6]. JLL, the broker engaged to sell Taurus 2017-1 IT assets, said it "didn't receive any acceptable offers" and adds that only one significant retail transaction closed in Italy in 2022. We expect continental European shopping centres to face increasing challenges similar to those faced by UK properties in recent years[7].

Early-stage conclusions for the CMBS market

Three key takeaways for CMBS investors

A number of early-stage conclusions can be drawn for the CMBS market from these developments.

1. Extensions come at the expense of senior noteholders. Servicers have been granted increased power to service stressed loans and maximise stakeholder value since the GFC, when the special servicing of some defaulted loans proved cumbersome and lengthy because of the lack of freedom in servicing. Consequently, most CMBS 2.0 documentation has embedded unilateral rights for servicers to extend loan terms to prevent a default if it is deemed to be in the interest of all noteholders.

   We generally view loan extensions without enhanced protective terms as credit negative for senior and mezzanine tranches, which represent the largest portion of CMBS investors. For example, the situations regarding Taurus 2017 1 IT and Pietra Nera Uno are unlikely to improve as both portfolios are already stabilised[8], no capital expenditure investments are planned and further rate hikes from central banks are expected, increasing hedging costs.

[3] 3-month compounded SONIA increased from 0.19% in Feb 2022 to 3.42% at the end of Feb 2023; 3-month Euribor rose from -0.55% to 2.48% over the same period.
[4] New loan margin of 3.83% and a cap strike of 3.25% compared to 2.50% and a cap strike of 1.25% prior to the extension.
[5] Valuers have been reacting more quickly than in previous cycles but not quickly enough in our view in assessing property valuations downwards following the interest-rate hikes.
[6] Two properties were released to the borrower in Q2-22.
[7] Maroon CRE loan: autopsy of a default UK retail gloomy environment and loan legacy weaknesses.
[8] Taurus 2017-1 IT occupancy is 87.1% while Pietra Nera Uno weighted average occupancy rate is 84.7% down from 91.0% and 95.9% respectively at closing but better than most other office and retail transactions.

2. Refinancing planning has once again become paramount. In recent years, accommodating financing conditions have enabled borrowers to draw up refinancing plans a few months or even just weeks before loan maturities. Reverting to longer refinancing planning periods and/or proactive deleveraging are necessary to ease refinancing discussions and avoid last minute “distressed exchanges”.
3. Shorter workout periods increase fire-sale risks for noteholders. The servicer sought a loan maturity extension with no note maturity extension in Pietra Nera Uno S.R.L and FROSN 2018 DAC. Shorter work-out periods mean shorter periods to implement business plans and ultimately maximise value for noteholders.

Noteholders’ concerns are growing

Noteholders’ have raised concerns about the latest developments in securitised CRE loans. Noteholders will certainly increase scrutiny over servicers’ standards as well as servicers’ rights to modify and waive consent to loan modification and standstill periods without the consent of all noteholders for both performing and defaulted loans[9].

Unilateral loan and maturity note extensions may impact the credit quality of the notes, especially in borrower-friendly jurisdictions in addition to directly impacting CMBS liquidity and pricing. Noteholders may also become more resistant to borrower-friendly structures – even those brought by strong sponsors – while favouring a return to tighter lender-friendly structures.

Same issues, higher risks for CRE loan holders

Finally, some CRE loan holders will be even more concerned than noteholders about recent developments. While misalignment of interests is not an issue in the CRE loan market because servicers act principally on behalf of pari-passu lenders (unlike CMBS, where senior, mezzanine and junior noteholders have divergent interests), holders of loans do not benefit from CMBS work-out periods, so fire-sale risks are higher. Pretend and extend is therefore lenders’ only solution to prevent refinancing defaults.

[9] Emerald Italy CMBS secured shopping mall loan defaulted in June 2020. A standstill agreement was approved, followed by a new standstill on acceleration and enforcement put in place in September 2022. No significant progress was made during this period while special servicer fees dragged free cashflows away from debt repayments.

Appendix II. Commercial real estate snapshot

Figure 1: Rated transactions

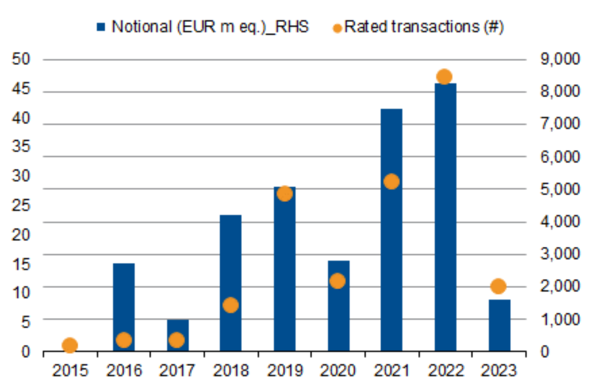


Figure 2: Financing type coverage

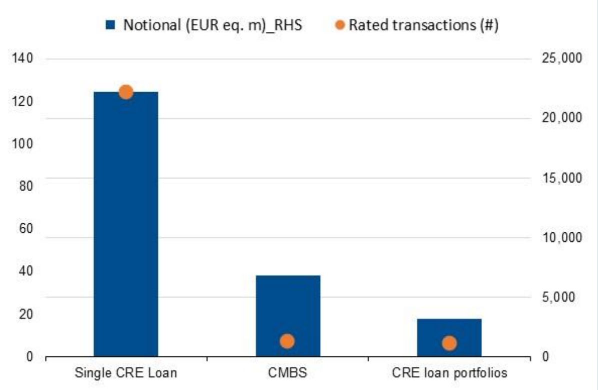


Figure 3: European geographic coverage

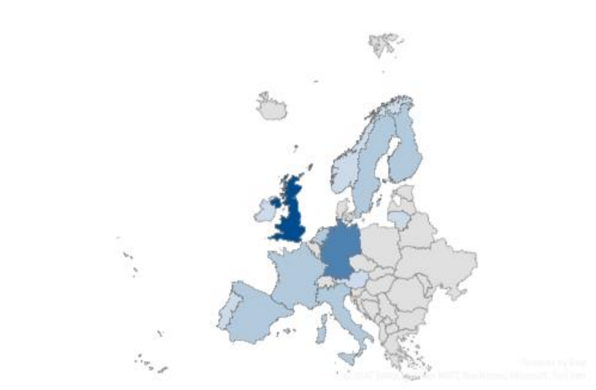


Figure 4: Asset type coverage

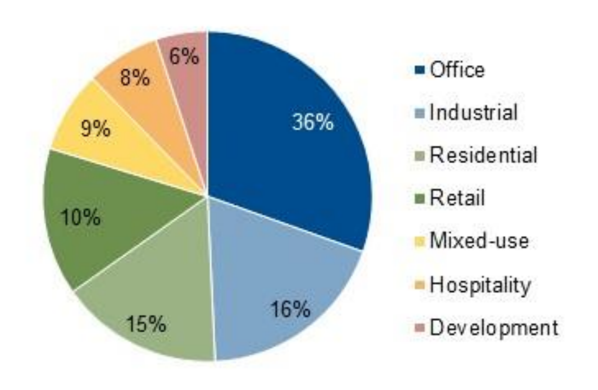


Figure 5: Scope recent real estate research

Franchise	Asset-type	Topic (link)	Geographic coverage
Structured Finance	CMBS	A third of commercial real estate loans in European CMBS face significant refinancing risk.	Europe
Structured Finance	CMBS	Scope assigns preliminary unsolicited ratings to notes issued by CASSIA 2022-1 S.R.L. – Italian CMBS.	Europe
Structured Finance	Cross	CRE loan and CMBS rating methodology	Europe
Structured Finance	CMBS	A primer on European CRE CLOs: same foundations as US CRE CLOs. Same success?	Europe
Structured Finance	CMBS	European CMBS: stellar valuations but mixed operating performance; refinancing risks lurk.	Europe
Structured Finance	CMBS	Outlook for European CMBS market: webinar	Europe
Structured Finance	CMBS	European CMBS: Part 2 -- wave of credit downgrades; tighter 2021 issuance	Europe
Structured Finance	CMBS	European CMBS: Part 1 – a bright future post Covid-19	Europe
Cross-franchise	Cross	Scope Real Estate Review, June 2021	Europe
Structured Finance	Residential	Financing the UK Build to Rent sector. Credit risks to consider for lenders	UK
Structured Finance	Cross	Investor should assess debt yield alongside traditional financial covenants to capture CRE risks	Europe
Structured Finance	Residential	UK affordable housing: public policy uncertainty vs assets in high demand	UK
Structured Finance	Residential	Residential real estate: Lisbon’s secure rental income initiative unlikely to stop gentrification	Portugal
Structured Finance	Cross	Covid-19: What will the European CRE sector look like when the dust settles?	Europe
Structured Finance	Logistics	European logistics CRE: outdated assets unlikely to ride the momentum	Europe
Structured Finance	Retail	Maroon Loan: autopsy of a default	UK
Structured Finance	Cross	Leasehold property: attractive investment opportunities with diverse risk drivers	Germany
Structured Finance	Healthcare	Healthcare: an attractive segment for alternative CRE investors	Europe

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR - 75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

Disclaimer