DTZ Research

DTZ Insight
Global Debt Funding Gap
Europe struggles despite positive trends

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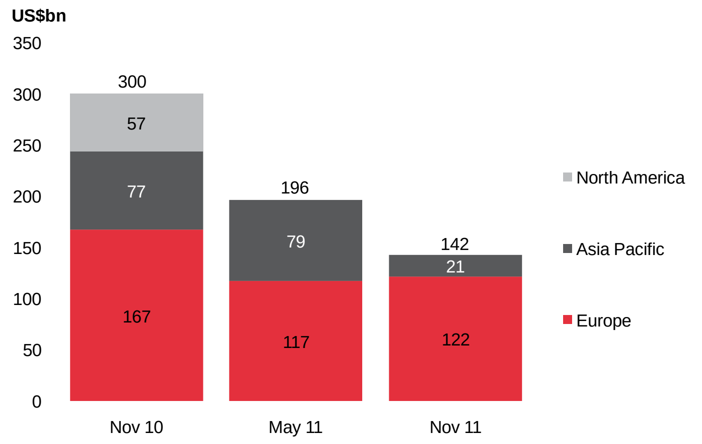
- The global debt funding gap has been cut by 27% over the past six months. It is now estimated at US$142bn down from US$196bn six months ago (Figure 1). More detailed data from our recent bank survey has triggered a 74% reduction of the Japanese debt funding gap in the last 6 months.
- Unfortunately, Europe continues to struggle, as downgrades to our capital value forecasts have led to a 4% increase in the funding gap. The UK, Spain and Ireland have all seen an increase in their gap on both an absolute and relative basis.
- Sufficient equity remains available to bridge the debt funding gap. Globally, there is nearly $400bn of equity available – nearly three times the current gap. Significant regional differences remain. The European ratio is less favourable as US$156bn of equity is available to bridge a US$122bn debt funding gap.
- Banks are taking steps to shrink and deleverage their balance sheets with a growing number of loan sales being brought to the market. Loan sales are likely to increase as regulatory authorities require banks to further bolster their capital reserve positions. We view the recent interest from SWF and other institutional buyers of such loan portfolios as a very positive sign. Discounts might come in, as return requirements become more realistic.
- Increased lending from insurers, institutions and other niche lenders has started to provide new capacity. Based on this, we have raised our estimate of new non-bank lending for the next three years by over 80%, from $80bn to $150bn.

Figure 1

Global debt funding gap by region 2012-14



Source: DTZ Research

Global Debt Funding Gap

Introduction

This is the third edition of our Global Debt Funding Gap report, which provides an update to our previous reports[1].

In this report we provide an update to our previous analysis incorporating new evidence previously unavailable. We have also undertaken a more detailed analysis of the lending market in Japan. Compared to our previous May 2011 report, the amount of debt outstanding in each market remains unchanged, based upon data reported by Central Banks at the end of 2010. The majority of debt is secured by properties located in North America and Europe (Figure 2).

In this update, we have also incorporated our latest forecasts for capital value growth. Also, we quantify the impact of a European downside scenario, which we launched in another research report last week.

Our methodology for estimating the debt funding gap remains unchanged. As before, it involves a detailed analysis which takes into account:

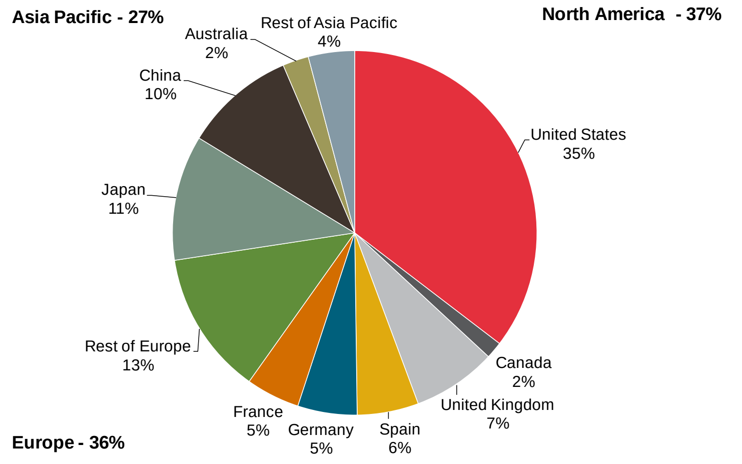
- Vintage of outstanding loans
- Duration of loans by vintage
- Loan to value ratios by vintage
- Historic and future changes in collateral values, and
- Impact of loan extensions

Where data permits, inputs vary for each individual country. A detailed step-by-step methodology is available in the appendix of our May 2011 report.

This report is divided into three key sections. In the first section we update our debt funding gap analysis and highlight those countries and regions most exposed. In section 2 we outline some of the solutions underway. Finally in section 3 we present our outlook in which we examine in more detail how some of these solutions and available equity will reduce the debt funding gap.

Figure 2

Outstanding debt to commercial real estate by market, YE 2010



Source: DTZ Research

[1] Global Debt Funding Gap – smaller but pressure remain, DTZ Research, 5 May 2011
Global Debt Funding Gap – new equity to plug into messy workout, DTZ Research, 24 November 2010;
European Debt Funding Gap – resolutions underway, DTZ Research, 29 March 2010

Global Debt Funding Gap

Section 1: Global debt funding gap

Global debt funding gap more than halves over year

Over the next three years (2012-2014) we estimate the global debt funding gap totals US$142bn, a 27% reduction on May 2011, and less than half the level a year ago (Figure 3). The dramatic fall reflects refinements to our methodology based on new information and highlights how the passing of time helps to heal some of the problems.

Asia Pacific's gap has improved significantly. This is in contrast with Europe where the debt funding gap remains elevated and has shown little improvement on six months ago. However, compared to our analysis in November 2010, Europe's debt funding gap has reduced by 27% from US$167bn.

Largest gaps in UK, Spain and Japan

At a country level, the UK has the largest absolute debt funding gap of US$44bn (Figure 4). Spain has the second largest debt funding gap at US$29bn, followed by Japan at US$21bn. The most striking change has been the reduction in Japan debt funding gap from US$78bn to US$21bn. This reduction mostly reflects changes to our assumptions, based on new data (see Box 1).

Ireland's debt funding gap remains elevated at US$14bn. France (US$8bn), Italy (US$7bn) and Germany (US$6bn) have the next biggest absolute debt funding gaps. The remaining US$15bn is in Europe. Overall, we have seen a small increase in the funding gap across Europe, including the UK, Spain and Ireland. This reflects a generally weaker outlook for capital values over the period 2011-14. The exceptions are France and Germany, where our outlook has shown a modest improvement.

Ireland remains most exposed on a relative basis

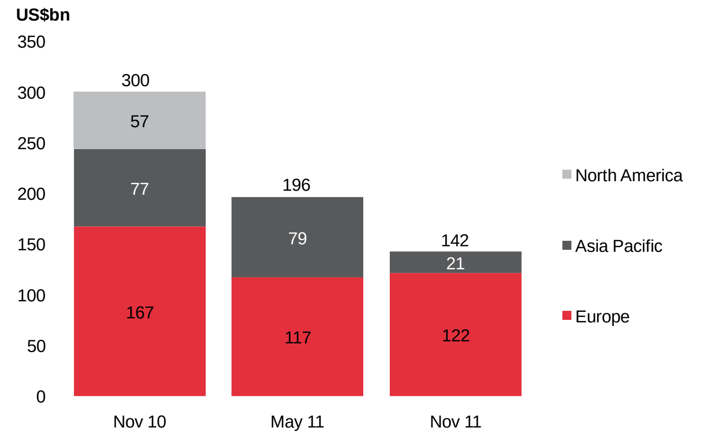
Comparing the debt funding gap relative to the size of the individual countries invested stock is a more reliable measure of its exposure.

On this basis Ireland remains the most exposed market with its debt funding gap equivalent to 21% of its invested stock. Despite having a relatively small absolute debt funding gap of US$2bn, Hungary has a relative debt funding gap of 8%. This is followed by Spain at 6% and Romania and the UK at 5% (Figure 5).

The reduction in Japan's debt funding gap means it is now less than 2% of its invested stock, and closer to core European markets such as France.

Figure 3

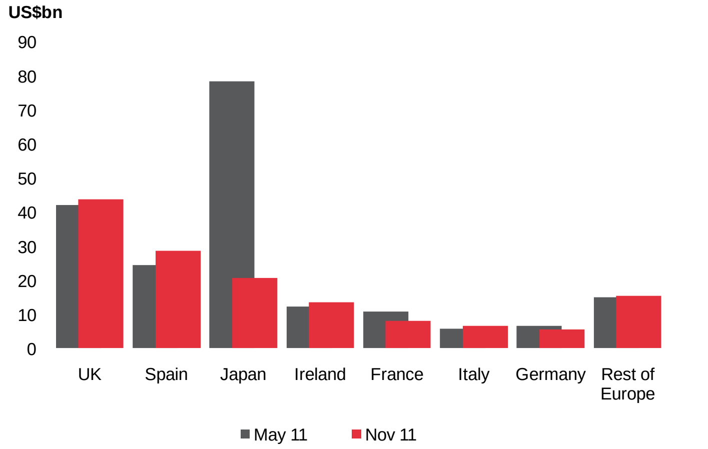
Global debt funding gap by region 2011-2014



Source: DTZ Research

Figure 4

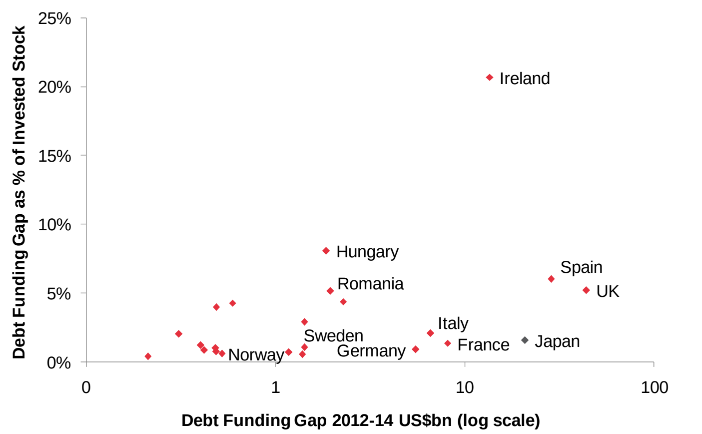
Debt funding gap by country 2012-14



Source: DTZ Research

Figure 5

Debt funding gap as a percentage of invested stock



Source: DTZ Research

Global Debt Funding Gap

Scenario analysis increasingly relevant, with continued uncertainty and sensitivity of gap estimates

The weakness in Europe's debt funding gap is not surprising given the wider sovereign debt issues and pressure on banks' balance sheets. Furthermore, our gap estimate is very sensitive to capital value movements. This makes scenario analysis relevant to consider.

We have recently published a downside property scenario forecast in which we assume a disorderly default by several European states leading to a double dip recession[2]. This downside scenario, which has a 20% probability, would have a negative impact on our capital value forecasts through lower rental growth and higher yields going forward.

Increased gap under the downside scenario, especially in markets with limited gaps in base case

We have run our debt funding gap models with this new set of lower capital value forecasts from the downside scenario. Based on this, we estimate that there would be a 78% increase in the debt funding gap in Europe from US$122bn to $217bn. However, the results vary widely among individual countries with some markets facing a debt funding gap up to 7 times higher in the downside scenario when compared to our base case (see Table 1). These are primarily markets with very small debt funding gap under our base case, for example Norway, Belgium, and the Netherlands.

France and Germany not spared under downside

France and Germany post significant increases in their absolute gap. France sees its debt funding gap rise from US$8bn to US$36bn and in Germany from US$6bn to US$17bn. This pushes the debt funding gap to 6% and 3% of their invested stock (Figure 6). The debt funding gap in Spain also escalates from US$29bn to US$47bn and equivalent to 10% of its invested stock. In contrast the UKs funding gap only increases by a smaller proportion to US$49bn to just 6% of its invested stock. Ireland is also relatively immune as the downside scenario with its debt funding gap up to US$15bn, equivalent to 23% of its invested stock.

Table 1

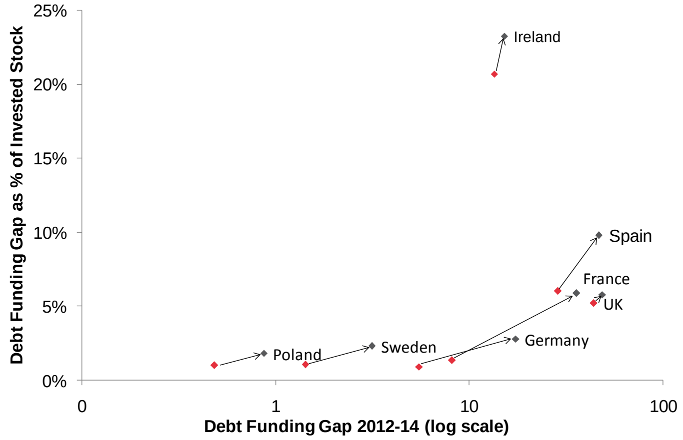
Impact of downside scenario for selected European markets

	Debt Funding Gap		
Country	**Base Case**	**Downside**	**Multiple**
Norway	0.5	4.0	7.6
Belgium	0.5	3.0	6.3
Netherlands	1.4	7.1	5.1
France	8.1	35.8	4.4
Germany	5.5	17.3	3.1
Sweden	1.4	3.2	2.2
Italy	6.6	14.5	2.2
Poland	0.5	0.9	1.8
Spain	28.7	46.7	1.6
Ireland	13.5	15.2	1.1
UK	43.8	48.6	1.1
All Europe	121.7	217.0	1.8

Source: DTZ Research

Figure 6

European debt funding gap as a percentage of invested stock under downside scenario



Source: DTZ Research

[2] See European scenario analysis – Non-eurozone office markets more resilient, DTZ Research 1 November 2011 for more detail on this scenario

Global Debt Funding Gap

Box 1: Japan's shrinking debt funding gap

In our previous reports, Japan had the largest absolute debt funding gap globally. Following discussions with a number of Japanese banks, in cooperation with our Japanese colleagues we revisited our model assumptions.

As data on lending is not freely available, we undertook a survey with a number of major banks based in Japan. The survey focussed on three key areas (a) loan originations, (b) loan durations, and (c) loan to value ratios (LTVs). In addition we also sought feedback on loan performance, loan extensions and other lending practices.

As a result of the survey we made changes to most of the inputs to our model. Whilst some minor adjustments were made to the loan origination profile, the most significant impact has been in respect of loan durations and LTVs.

Our previous loan duration profile was based on UK data. The survey results highlighted that durations were shorter than in the UK, as we expected (Figure 7).

In this graph we show our old inputs compared to our new inputs based on the survey work we undertook. We show this by different vintages aggregated into 2005/06 and 2007-10. The first thing to notice is the recent increase in shorter term loans (1-3 years) from 2007-10. At the same time there is also a much higher proportion of 4-6 year loans in excess of 60%. The survey also highlighted that longer term loans (over ten years) are not evident in the Japanese market.

The other key assumption change has been in respect of loan to value ratios, which according to the survey were relatively lower compared to our previous estimates (Figure 8).

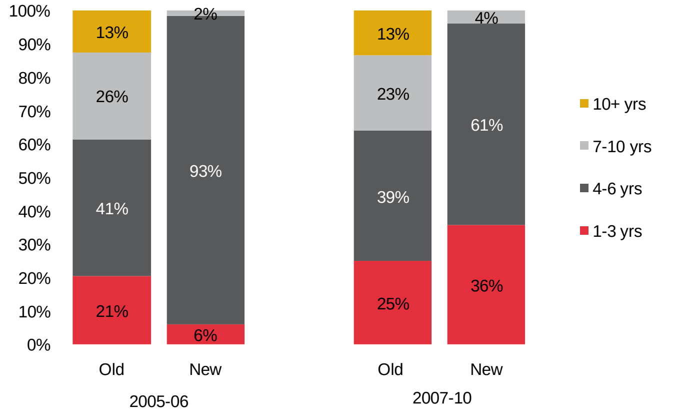
Beyond these specific adjustments, discussions with a number of banks also highlighted the practice of shorter term loan extensions, particularly recently, for loans which had relatively shorter loan durations. In our current analysis we therefore adjusted our loan duration profile for recent lending whereby half of loans have been extended for a period of three years.

A final issue raised in discussions has been the use of partially amortising loans. In our previous report, there was no allowance for amortisation in line with general practice in Europe. Feedback received by the banks highlighted that loans would amortise between 1-2% per annum depending on the origination. As rates varied by vintage and by lender our model assumes 1% pa for 2005-2008 vintages, 2% pa for 2009-2011 vintages and reverting to 1% pa thereafter.

The impact of these changes has been to reduce Japan's debt funding gap from US$78bn to $22bn over 2012-14. It is our view that Japanese borrowers and banks are dealing with their refinancing issues better than their European counterparts, as they extend and amend existing loans for a longer period of time. This might be partly due to lessons learned in the previous downturn in Japan.

Figure 7

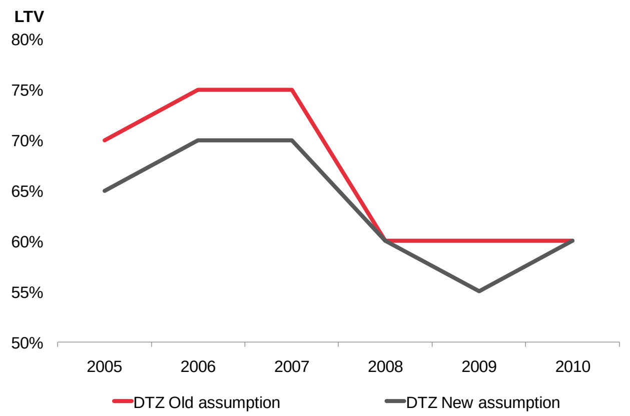
Old and revised assumptions on Japanese CRE loan durations



Source: DTZ Research

Figure 8

Old and revised assumptions on Japanese CRE LTVs



Source: DTZ Research

Section 2: Current market status

Loan sales prove effective in reducing the gap

With a number of banks committed to exiting their non-core commercial real estate loans, we are starting to see growing interest in loan sales. By packaging loans into a portfolio, banks are able to more effectively shrink their balance sheet than through working through individual assets. Both RBS and Lloyds in the UK are committed to loan sales, along with NAMA in Ireland and Santander in Spain (see Table 2).

With the European Banking Commission setting out requirements for Europe's banks to find an additional €106bn to bolster their capital position, we expect banks take a proactive approach to meet or further reduce their planned reduction in lending to commercial real estate.

Increasing interest from SWF and institutions

An interesting new development has been the announcement that China Investment Corporation will provide equity behind Blackstone's planned acquisition of RBS' £1.4bn UK loan sale. This is the first time we have seen sovereign wealth funds coming into the market. This could lead to interest from other similar buyers. Separately, the Bank of Ireland has recently announced the sale of a €1.1bn loan portfolio to Kennedy Wilson supported by institutional equity.

Discounts on loan sales are coming down

Successful loan sales depend largely on the price agreement between the selling and the buying parties. The importance of pricing is reflected in certain deals that fell through because of a price mismatch. In August, US private equity firm Apollo Global Management that has been an active loan buyer in Europe, quit negotiations to buy a £3.5bn loan book from Barclays Capital.

Loan sale discounts vary depending on the quality of the underlying loans and the need of the bank to raise equity. Evidence shows that they range between 20% and 60% and are usually either a collection of non-core, low quality loans or a combination of some low and some better quality loans. Usually banks group a large number of loans into portfolios and try to sell them collectively. In some rare cases banks sell individual or small portfolios of loans.

Whilst many funds who have raised capital for distressed loans are seeking huge discounts upwards of 60%, the reality is that more recent sales of loans or assets have attracted much smaller discounts to par on the original loan balance in the region of 20-30% (Table 3).

Table 3

Discounts on actual or planned asset/ loan sales

Seller/ portfolio	Target price	Sale price	Discount
Credit Suisse	€2.3bn	€0.9bn	60%
RBS, Spanish Loans	€290m	€160m	45%
Lloyds Banking Group, Project Flagstaff	£60m+	£45m	25-33%
Bank of Ireland	£1.3bn	£1.1bn	20%
RBS, Project Isobel	£1.4bn	£0.98bn	30%

Source: DTZ Research

Table 2

Notable market deals

Seller/ Buyer	Property/ Loan name	Country	Date	Loan amount	Solution implemented
NAMA/ Barclay Brothers	Hotel Portfolio	UK	Sep 2011	€800m	Sale of loans relating to Claridges, the Connaught and the Berkeley hotels.
Lloyds Banking Group/ Telereal Trillium	Project Flagstaff	UK	Oct 2011	£45m	Sale of 38 repossessed assets across the UK.
Bank of Ireland/ Kennedy Wilson	Mixed loan portfolio	Europe	Oct 2011	€1.3bn	Sale of loan portfolio of mixed commercial and multifamily assets.
RBS/ Blackstone	Project Isobel	UK	Ongoing	£1.4bn	Sale of loan portfolio.
Lloyds Banking Group	UK Loans	UK	Ongoing	£1bn	Portfolio of UK loans being brought to market.
Santander	Mixed portfolio	Europe	Ongoing	€8bn	Bringing €4bn portfolio of loans and €3bn portfolio of foreclosed assets to market.

Source: DTZ Research

Global Debt Funding Gap

Section 3: Outlook - Bridging the gap

Sufficient equity is available to bridge the debt funding gap

The gradual reduction in the global debt funding gap comes at a time of increased uncertainty in global financial markets, particularly across Europe where the authorities continue to grapple with high levels of sovereign debt.

Globally, we estimate there to be US$399bn of equity available, which is nearly three times the debt funding gap of US$142bn (Figure 9). But, there are variations at a regional level. In Europe the amount of available equity is just US$156bn, a mere 28% above Europe's debt funding gap of US$122bn.

In Asia Pacific available equity is more than four times higher than the debt funding gap. In North America, there remains no debt funding gap to be bridged.

Growth in equity targeting debt solutions

In our previous report we highlighted that over US$36bn of equity had been raised by funds to specifically target exiting loan positions or new loan originations. Based on our updated analysis, we now estimate this figure has more than doubled to US$73bn, with growth in available equity across all regions (Figure 10).

Half of the available equity is targeting the Americas, although a further US$24bn is seeking opportunities across multiple regions. A further US$8bn is targeting the EMEA region, which as we highlighted in the previous section, has seen growing levels of activity in loan sales.

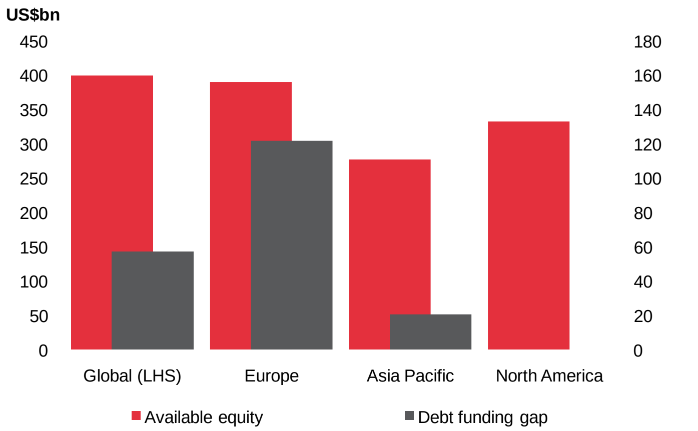
Opportunity funds under pressure to invest commitments

We know that some of the available equity is at risk of being returned to investors as many funds near the end of their commitment period. The majority of this available capital (56%) is through opportunity funds (Figure 11). This might trigger these funds to invest their commitments sooner rather than later

In addition, the need for many banks to continue to shrink their balance sheets further, we would expect to see more secondary and tertiary product coming to the market over the coming year. This will suit these opportunistic and some value-added funds where pricing levels are sufficiently attractive and timing of commitments allow.

Figure 9

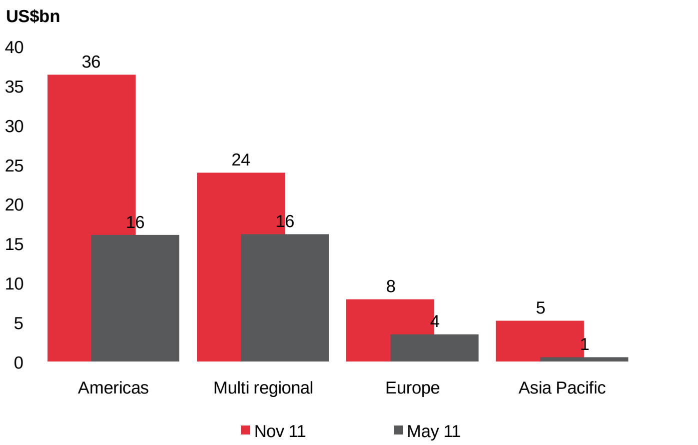
Debt funding gap and available equity



Source: DTZ Research

Figure 10

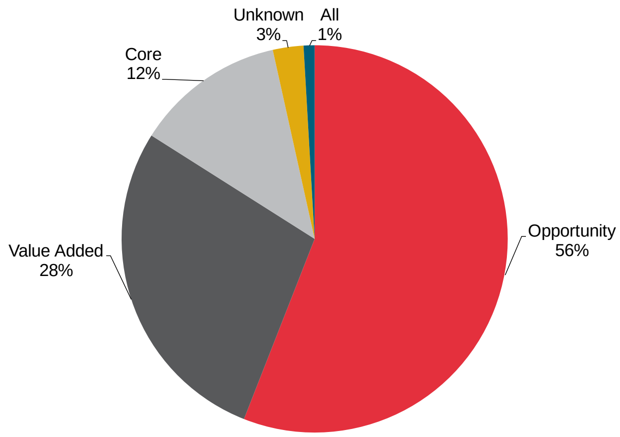
Equity available to target debt solutions



Source: DTZ Research

Figure 11

Funds at risk by style



Source: DTZ Research

Global Debt Funding Gap

Insurers to increase lending capacity

We have previously highlighted the growing interest of insurance companies entering the lending market. This growth reflects the opportunities and returns available at a time when banks, particularly across Europe, seek to reduce their exposures. As the full impact of the new Solvency II requirements are yet to be confirmed, there is the possibility of further growth in lending should lending receive a more favourable treatment compared to equity investment.

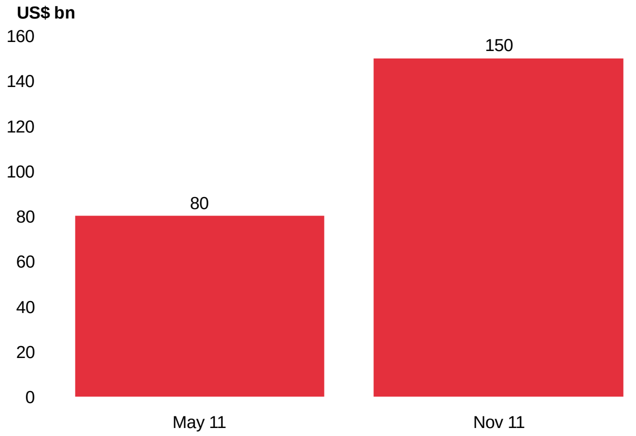
We previously estimated there to be upwards of US$80bn (€60bn) of funding from insurance companies. With more funds now entering this space and the potential for smaller insurance companies to co-invest with other insurers or banks, we expect to see an increase in lending capacity.

There are already ten life insurers active in the UK and continental Europe including AIG, Allianz, AXA, Aviva, Legal & General, MetLife, M&G and Canada Life.

On a pro-rata basis, with 30% of the funding gap in the UK, we could see the existing ten insurers growing increasing, with up to 25 new insurers directly or indirectly active in the next three years. On this basis we could see an additional US$150bn (€110bn) of new lending capacity over 2012-14 (Figure 12).

Figure 12

Lending capacity from Insurance companies



Source: DTZ Research

Additional capacity from alternative sources

As highlighted earlier, we have also started to see other institutional capital enter the market with China Investment Corporation (CIC) backing Blackstone in its investment in RBS' loan sale. If successful we could see further investments from CIC or other sovereign back funds.

Besides these new institutional players, we are also seeing the return of more niche lenders. Many of these have been active in the past but in a relatively limited capacity. With demand for new lenders and attractive returns, these niche players are starting to come back into the market.

Corporates are also cash-rich which could lead to an increase in the shadow banking sector. We have already seen examples of corporate lending in Asia Pacific.

Whilst lending from institutional investors, who have teams in place to meet regulations and underwrite new loans, we would caution against other corporate lending, where underwriting standards may not be as robust with other institutions, which could lead to further problems down the road.

Back to basics approach to new lending

We have previously argued for changes to lending practice, particularly in Europe. Fixed rate loans, without swaps, have been widely used for many years in the US markets, which despite its many other problems, has no debt funding gap. This is also partly due to the long maturities (10 years) and scheduled annual amortisation. In the current volume-restricted European market environment, emerging non-bank lenders now have a historical opportunity to change the basic lending terms in the market. Non-bank lenders might also find it easier to not offer swapped floating rate loans, as they are likely less motivated by the profitability of their swap desks.

New pending legislation that might force cash collateralisation of swap contracts with both counterparties is likely to make the floating-to-fixed rate swaps extinct. Neither party would be willing to cash reserve on a mark-to-market basis, as swap breakage costs can be very high relative to the loan amount. This would be a very helpful development in bringing the European commercial property lending markets back to basics with more fixed rate loans.

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