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The Commercial Property Elephant in the Room

By RICHARD BARLEY

Anyone searching for the next European banana skin may want to take a closer look at the commercial real-estate lending market. There are €2.5 trillion ($3.24 trillion) of commercial real-estate loans outstanding in Europe, but up to €700 billion of this was funded by banks that are pulling out of this market and by the now largely defunct commercial mortgage-backed securities market, according to Morgan Stanley . At the same time, prices in some markets have fallen to levels that may make them hard to refinance.

Until now, banks have taken advantage of ultra-low interest rates to extend and restructure existing loans. But with increasing amounts of pre-crisis era loans falling due, hard decisions cannot be postponed much longer. One indicator of the scale of the problem: Only 24 of the 122 CMBS loans totaling €10.7 billion that have matured in 2012 were repaid on time, ratings firm Fitch says; another 12 repaid late and many of the remainder are in workout, standstill or being extended. That bodes ill for the €31.9 billion of CMBS loans maturing in 2013 and 2014.

True, new sources of financing are emerging, including insurance companies, sovereign wealth funds and specialized debt funds. Property companies have been raising cheap cash in the corporate bond markets. Yields on commercial property—at 5.6% for prime European office property according to CBRE—look attractive compared with ultra-low bond yields, and margins on property loans are high. But new sources of funding may only plug €200 billion of the lending gap, Morgan Stanley says.

Meanwhile, a two-tier market is emerging. New investment is focusing on prime properties with stronger cash flows, such as central London offices, with other regions and second-tier properties with tenant vacancies shunned. That increases the risk these properties plummet in value and push up loan-to-value ratios to levels that may be too high for refinancing: In the U.K., half of commercial real-estate loans have an LTV of over 71% and 20% have an LTV over 100%, according to the Bank of England.

That means there is plenty of pain to come. Owners might be able to inject new equity to get access to new funding; others might not get refinancing on any terms. Banks are chipping away at the problem, selling loans at discounts, recognizing nonperforming loans and repossessing properties. But the process has a long way to run. European property values could fall on average by 10% over the next five years, with secondary-quality property falling by up to 50%, Morgan Stanley thinks.

For banks and property investors, there may be plenty of slip-ups ahead.

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