

Special Report

# EMEA Structured Finance CMBS Outlook - May 2009

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## Executive Summary

This report updates Fitch Ratings' outlook for the European CMBS sector, which was published on 18 February 2009. In this issue, Fitch extended its CMBS outlooks to include South African structured finance transactions.

In March 2009, the agency revised its forecasts for a number of economic and monetary variables in both the euro area and the UK as follows:

- Forecasts for GDP growth in the euro area were revised significantly from -0.6% in 2009 and 0.9% in 2010 to -3.2% in 2009 and 0.4% in 2010. Forecasts for UK GDP growth were reduced further from -1.4% in 2009 and 1% in 2010 to -3.4% in 2009 and 0.2% in 2010.
- Expectations for unemployment in the euro area, were increased from 8.8% in 2009 and 9.3% in 2010 to 9.4% in 2009 and 10.7% in 2010. In the UK, unemployment expectations were increased from 7.3% in 2009 and 7.9% in 2010 to 7.7% in 2009 and 9.0% in 2010.
- Inflation forecasts in the euro area were revised from 2.6% in 2009 and 1.9% in 2010 to 0.7% in 2009 and 0.9% in 2010. Forecasts for UK inflation were lowered from 2.3% in 2009 and 1.5% in 2010 to 2.0% in 2009 and 0.8% in 2010.

The impact of these changes and other factors on the agency's outlook for specific sub-sectors in Q2 is as follows:

### EMEA CMBS Outlook Table - May 2009

Asset class/ country	Outlook		Areas to watch
	Asset performance	Ratings	
UK	Declining	Negative	Rental value declines as vacancies rise and tenant administration risk remains elevated. This risk is already somewhat factored into estimated yields although for secondary assets further widening is expected.
Pan-European	Declining	Negative	Economic indicators are worsening in important CMBS regions such as Germany and France. Widespread value falls are expected throughout Europe.
South Africa	Declining	Stable	Commercial property market is under strain due to worsening economic situation. Rated transactions include quality portfolios and perform in line with expectations.

Source: Fitch

## European CMBS

Mounting credit risk in European CMBS is reflected in a spate of negative rating actions taken by Fitch in recent months, highlighting the agency's concerns about full repayment of various mortgage loans underlying these transactions. Even though the number of impaired loans remains modest, this masks a sharp rise in "balloon" risk. The length and strength of contracted rental income means that loan losses may not emerge for several years still. Technical events of default, such as loan-to-value ratio covenant breaches, are largely being managed without recourse to outright repossession or court action. Even loans remaining outstanding after their scheduled maturity dates may not be sufficient to trigger a property fire-sale, especially with hedging costs (currently) much reduced. Yet any reprieve

is not indefinite, and by legal final bond maturity - normally at least two years after the date the last loan matures - servicers will have had to sell the asset. Moreover, unexpected events such as a tenant defaulting may prompt servicers into liquidating collateral, although perhaps not before alternative avenues such as sponsor negotiation or re-letting have been exhausted.

Rating actions have been concentrated in the UK, located at the eye of the storm in European commercial property markets. Indeed, the trend of falling UK values that accelerated over 2008 as the banking crisis worsened has continued into 2009, with further declines expected for secondary assets in particular. Meanwhile, outside the UK, property markets are coming under the weight of intensifying recessionary forces, and in anticipation of declines in property values across much of Europe, the outlook for European CMBS ratings is negative across the board. This can be read as a sign of the increasing likelihood that non-UK CMBS bonds will also be downgraded during the remainder of the year.

## UK Property Update

### Asset Performance Outlook: Declining

#### *Ratings Outlook: Negative*

Peak values have already declined in the region of 35-40% in the UK, with many now expecting total peak-to-trough falls to exceed the 50% mark. Passing rental yields currently range from around 7%, for prime city centre retail pitches and “trophy” offices on institutional quality leases, to 12% for some secondary industrial units. This implies unusually-elevated risk premiums, signalling widespread uncertainty about market rents, tenant quality and absorption of commercial space. When an individual property is valued, these factors must be appraised on a micro-level, and often with binary outcomes; assuming a single lease defaults or breaks can have a severe effect on the appraised value. Only investors with high capacity for commercial real estate can afford to make assessments of binary risks on a macro level; yet these entities are typically contending with falling equity valuations and debt covenant breaches, and do not appear poised to acquire property on a large scale. As the pool of prospective purchasers has whittled down, there has been a marked increase in discrimination by property type, quality and location, as well as by the diversity, robustness and length of contracted income. Over time, Fitch expects risk premiums to fall and converge with longer term averages as rental income falls.

## European Property Update

### Asset Performance Outlook: Declining

#### *Ratings Outlook: Negative*

The eurozone economy as a whole is coming under recessionary pressures and is widely expected to register falls in occupational demand. An important contribution to European CMBS collateral is made from Germany, whose export-led economy is widely expected to suffer in the face of an intensifying global slowdown. The commercial property market is increasingly pricing in falling rents into current yields, causing values to fall - especially in cities such as Frankfurt where there is significant ongoing development activity and high vacancy rates. Moreover, the banking system remains under stress, with a key mortgage lender, Hypo Real Estate Group, currently being restructured as part of a state-led recapitalisation effort. A lack of bank finance means that even bonds secured on German multifamily housing - more remote from the occupational market downturn than many other property types - recently suffered negative rating action in light of the sheer volumes of debt involved.

France is another important source of CMBS property collateral, mainly in pan-European transactions. French yields have experienced greater outward movement than those for German assets, resulting in more significant value reductions;

however, France's occupational markets remain less affected, supported by concentrations of public sector occupancy in many centres. Paris's financial district, La Défense, will suffer falls in value as sentiment surrounding the banking sector remains weak; however, this district has experienced less development than in rival centres such as London or Frankfurt. Nonetheless, further value declines in France are expected to be considerable, although somewhat more muted than in the UK.

Elsewhere in Europe, the picture is much the same, although some countries are expected to fare worse than others. Within the eurozone, both Spain and Ireland are highly exposed to falling real estate values given their outsized construction sectors and deteriorating public finances. There is also growing concern about the impact of the slowdown on some countries in central and eastern Europe (CEE), especially those outside the eurozone with significant foreign currency-denominated private debt. None of Spain, Ireland or the CEE countries contributes significant collateral in European CMBS, however.

## South Africa

### Asset Performance Outlook: Declining

#### *Ratings Outlook: Stable*

Disposable household income in South Africa came under considerable pressure during 2008. The consumer price index (CPI) peaked at about 13.7% in August 2008, with the reserve bank's repo interest rate having risen to 12%. The global economic crisis also started to materially affect the South African economy, with GDP falling by an annualised 1.8% during Q408.

Although consumer debt had grown significantly in recent years, the introduction of the National Credit Act in June 2007 put a limit on excessive borrowing by consumers. More recently, South African banks have reduced the availability of types of consumer credit, such as mortgage loans, by requesting higher deposits.

CPI fell rapidly to 8.6% in February 2009, however, and moderate relief for consumers has come via the reserve bank cutting interest rates in recent months. Further interest rate cuts are expected in 2009, which should bring more relief for consumers. However, the slowdown in global growth has affected the economy. Job losses continue, mainly in the manufacturing and mining sectors, while, although in a better financial position than their European counterparts, South African banks have been experiencing rising bad debts. Company liquidations climbed significantly over the 12 months to January 2009.

The South African commercial property sector has recently come under strain. Rising unemployment and declining consumer spending will negatively affect the profit margins of retail commercial property owners. Demand in the office and industrial commercial property sector is falling. Large financial institutions have postponed expansion plans and export markets have weakened due to a sharp fall in global demand. In addition, banks are tightening their credit lines, making refinancing more difficult for lower quality commercial real estate portfolios. The South African commercial property sector is entering a challenging phase.

Fitch expects minimal rating actions on South African CMBS investment-grade rated notes in 2009.

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