CREDIT MARKETS SPECIAL | CORPORATE BONDS | REAL ESTATE

Real Estate EUR Corporate Bond Market

Liquidity on the real estate bond market has increased significantly in recent years. Around half of the outstanding bonds have IG ratings with benchmark qualities. The growth trend for green bonds is likely to continue

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Will the recovery come in 2024?

The market for EUR real estate corporate bonds has grown strongly in recent years. This has enabled real estate companies to extend their financial liabilities and diversify their financing portfolios. After peaking in 2021, the primary market has been overshadowed over the last two years by the war in Ukraine and the ECB's restrictive monetary policy. In our opinion, access to the capital market is likely to remain tight for real estate companies in 2024. This is because the attractiveness of the real estate sector is currently suffering from the economic slowdown as a result of global economic and political uncertainties and the still high level of interest rates.

The EU's sustainability efforts are shaping the real estate issuance market. The proportion of ESG placements has risen steadily since 2011, reaching around 40% of the total volume by 2024 (YTD), and the momentum remains upward. Green bonds are the most common form within the ESG categories.

Conditions on the real estate market have changed radically since 2022. The ECB's drastic and rapid increase in interest rates led to higher borrowing costs, while the sharp decline in transactions resulted in devaluations of real estate portfolios. The expected easing of the ECB's monetary policy should provide positive stimulus for the debt-intensive real estate economy. We expect the first interest rate cuts in June. Nevertheless, we consider the current low spreads to be excessive and expect slight upward pressure this year.

However, if sentiment continues to brighten, the investment grade real estate sector offers potential compared to the non-financial sectors. However, it remains to be seen whether 2024 will see the start of a recovery in the real estate sector. Many challenges still remain.

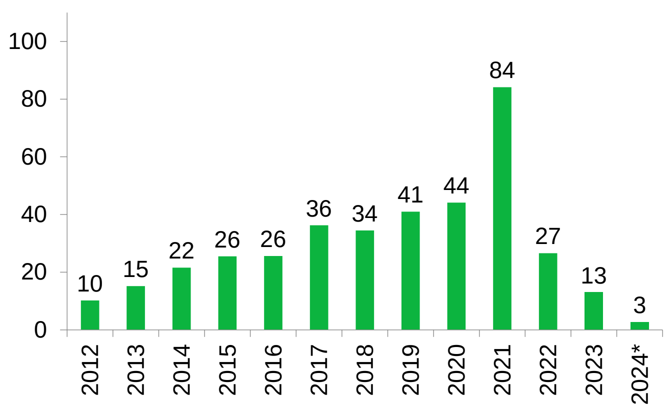
According to Moody's, the still relatively high (re)financing costs will pose the greatest risk to the credit quality of real estate issuers over the next 12-18 months, as the high interest rate level is not yet fully reflected in real estate valuations. Issuers' interest coverage ratios will remain under pressure and debt levels are likely to rise. However, the still relatively low refinancing requirements of real estate issuers in 2024 remain supportive.

Real Estate Corporate Bond Market

Rising issuing momentum was recently slowed by the war in Ukraine and the restrictive monetary policy

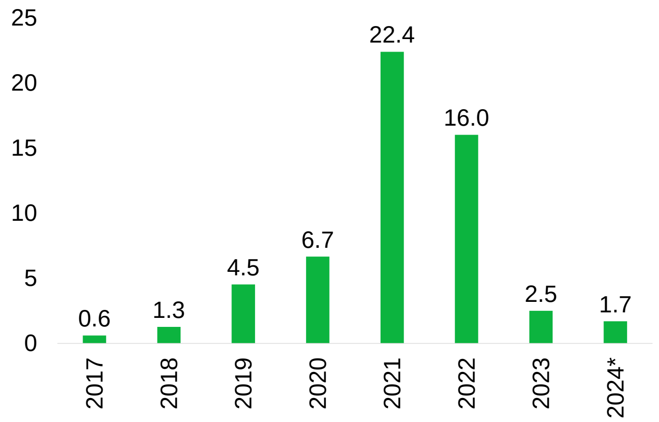
The EUR issue volume in the real estate sector, which is part of the financial segment, has risen significantly in recent years. While bonds worth just EUR 10bn were placed in 2012, the issue volume reached EUR 84bn in 2021. The low interest rate phase (2014-2021) undoubtedly contributed to this, which companies used to strengthen their liquidity and extend the maturity profiles of their financial liabilities. Issuance activity was overshadowed by the war in Ukraine and the restrictive monetary policy over the last two years, meaning that it was significantly below the long-term average in 2022 and especially in 2023.

Primary market reaches its peak in 2021
EUR issue volume in bn



** As of: 15.3.2024*
Source: Market data provider , Erste Group Research

ESG-bonds are gaining in importance
Issue volume of EUR ESG-Real Estate in bn



** As of: 15.3.2024*
Source: Market data provider , Erste Group Research

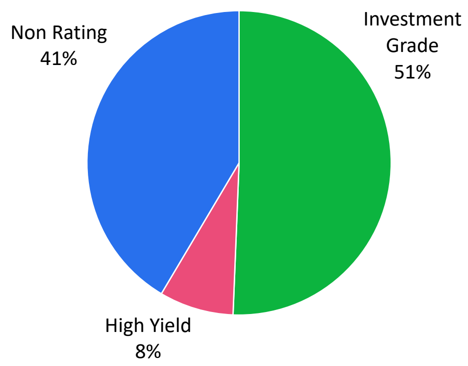
Growth trend in sustainability-related bonds likely to continue; green bonds remain the most common form

The EU's sustainability efforts are shaping the real estate market and thus the issuing market for sustainability-related bonds. This has successfully established itself in recent years. While only a single green bond with a volume of EUR 600mn was issued by French real estate group Icade (BBB+ stable) in 2017, real estate issuers have been able to enter the primary market on a larger scale in recent years in particular. In 2022, the proportion of sustainability-related bonds even exceeded that of conventional bonds for the first time. Within the ESG categories, green bonds, whose issue proceeds are used exclusively to (re)finance existing or new projects with environmental benefits, remain the most common form. This is also due to the fact that real estate groups are increasingly redeeming their conventional bonds if their existing real estate portfolios have already been renovated or modernized in terms of energy efficiency. Green bonds have now become the standard for new real estate projects that meet the green assets criteria. The average 5Y green bond ratio is around 27%. As demand for sustainable investment solutions from investors (including insurers, pension funds and banks) is increasing, the trend towards green real estate financing is also likely to remain high. By mid-March 2024, the green ratio had reached around 40%.

High number of benchmark issues increases liquidity on the real estate bond market

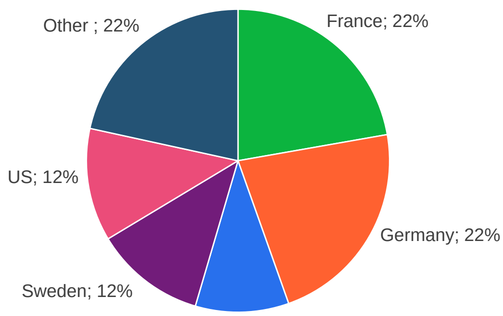
In total, the outstanding volume of EUR real estate bonds reached around EUR 370bn as at the end of February 2024. Broken down by rating category, around half of the bonds have investment grade (IG) ratings and only a small proportion (8%) have speculative ratings (High Yield, HY). Of the IG bonds, over 80% or EUR 158.2bn are currently benchmark-eligible (issue volumes of at least EUR 500mn), which significantly increases liquidity on the real estate bond market. The share of the top 5 issuers accounts for around 33% of the total IG benchmark volume. Unibail-Rodamco-Westfield and Vonovia are the most active issuers on the EUR real estate market with a share of 11% each.

Rated bonds dominate the overall EUR market
Share of outstanding volume by rating category



Source: Market data provider , Erste Group Research

FR and DE determine the overall EUR market
Share of outstanding volume by country



Source: Market data provider , Erste Group Research

Big 5 countries account for almost 80% of the total market

The overall market is currently concentrated in five countries, which together account for around 80% of the outstanding volume on the secondary market. France and Germany lead the overall market with a combined market share of 44%.

Austria: a small market with great ESG potential

In contrast, Austria represents a small issuance market with a share of around 1% of the total EUR volume or just under EUR 3,5bn. The major Austrian issuers include CA Immo (Baa3 neg, corporate bonds with a total value of around EUR 1bn, of which 35% green ratio), S Immo (no rating, corporate bonds with a total value of around EUR 570mn; green ratio 50%), UBM (no rating, corporate bonds with a total value of around EUR 440mn, green ratio 11%) and Immofinanz (no rating, corporate bonds with a total value of around EUR 238mn, green ratio 0%). For analyses of some of the major Austrian issuers included in our coverage list, please refer to our publication "Corporate Credit Monitor Austria" (only available in German).

CEE market concentrated on a few countries

Of the CEE countries, the Czech Republic, Poland and Romania are currently the main players in the EUR bond market, accounting for around 4% (just under EUR 8bn). For more information, please refer to our special report: "The CEE Corporate Bond Market: Facts & Figures".

Development of Risk Premiums

Significant increase in refinancing risk

Conditions on the real estate market have changed radically since 2022. The drastic and rapid increase in interest rates by the ECB has led to higher borrowing costs and a fall in property values. Since July 2022, the deposit rate has been raised ten times and is currently at 4.0% (base rate = 4.5%). The rapidly rising interest rates thus put pressure on the capitalization rates for property valuations, which can be interpreted as an indicator of the risk and profitability of a property investment or reflect an investor's return expectations.

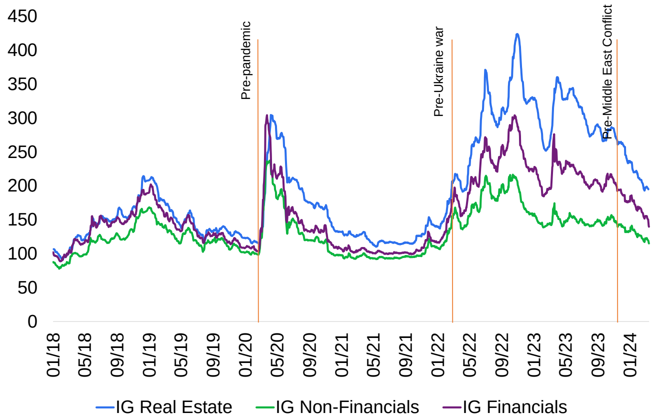
Perspective of falling key interest rates remains spread driver

After the increased volatility caused by the uncertainty surrounding the consequences of the war in Ukraine in 2022, sentiment brightened somewhat in 2023. This was mainly due to falling inflation and the associated hope that interest rates would soon fall. There were signs of an end to the interest rate hikes and the real estate sector closed 2023 with a positive performance of +9% (2022: -18.3%). Risk premiums remained under pressure for a short time due to the turbulence in the banking sector in mid-March 2023. Since around the beginning of April 2023, they have been on a downward trend, reaching levels seen before the outbreak of the war in Ukraine for the first time.

However, cautious economic outlook points to upward pressure on spreads

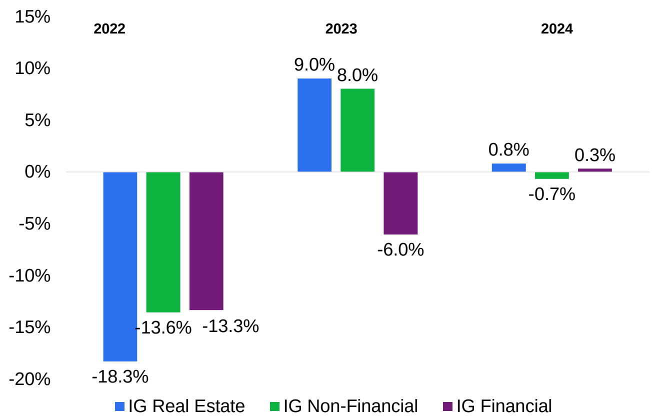
As the economy is likely to remain weak, we consider the low real estate spreads to be exaggerated and expect slight upward pressure this year. Important EZ sentiment indicators (EZ Purchasing Managers' Index, ifo Business Climate Index for Germany) have recently recovered slightly, but remain weak.

Downward spread trend from the beginning of 04/23
Development of benchmark spreads in bps



As of: 15.3.2024
Source: Market data provider , Erste Group Research

Real Estate bonds benefit from bet on falling interest rates, Performance in %



As of: 15.3.2024
Source: Market data provider , Erste Group Research

Financial challenges

Increased capital costs are reflected in the ratings

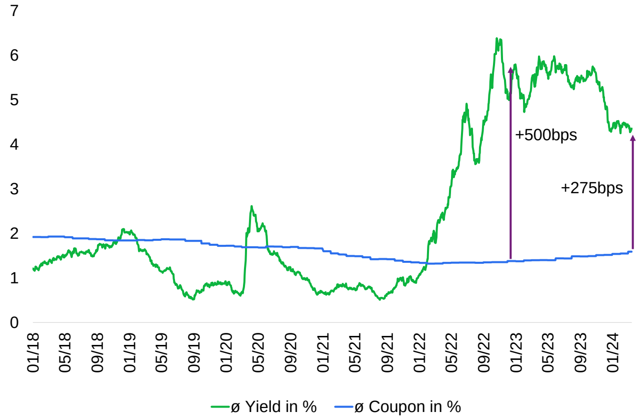
Financial conditions in the real estate market changed dramatically in 2022, due to the ECB's tighter monetary policy and a reassessment of real estate credit risk. The increased cost of capital has already led to a high number of negative rating adjustments since 4Q/22. The ratings of around 40 Real Estate companies, 20 in the Investment Grade segment and 22 in the High Yield segment, were downgraded. Including the changed outlooks, a total of 70 issuers were affected by negative rating actions. The highest number of rating adjustments took place in the first quarter of 2023.

Further rapid decline in financing costs remains limited

However, speculation about interest rate cuts in the near future after the ECB left key interest rates unchanged for the fourth time in a row in March has led to falling bond yields on the secondary market since the end of October 2023, which is currently making upcoming (re)financing somewhat easier. The average yield level on the secondary market is currently around 275bps (end of October/23: +500bps) above the average coupon of outstanding real estate benchmark corporate bonds. However, we believe that a further rapid fall in financing costs (difference between yields and coupons) is likely to be limited by the still challenging economic environment. The decline in yields has recently lost considerable momentum and has been moving sideways within a narrow corridor since the beginning of the year.

Fall in the cost of capital loses momentum

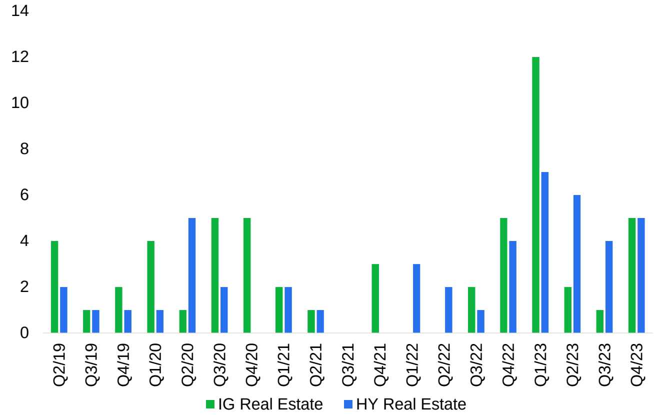
Development of Ø yield and Ø coupon, in %



As of: 15.3.2024
Source: Market data provider, Erste Group Research

Number of downgrades rose sharply in 2023

Rating adjustments, number



Source: Moody's, Erste Group Research

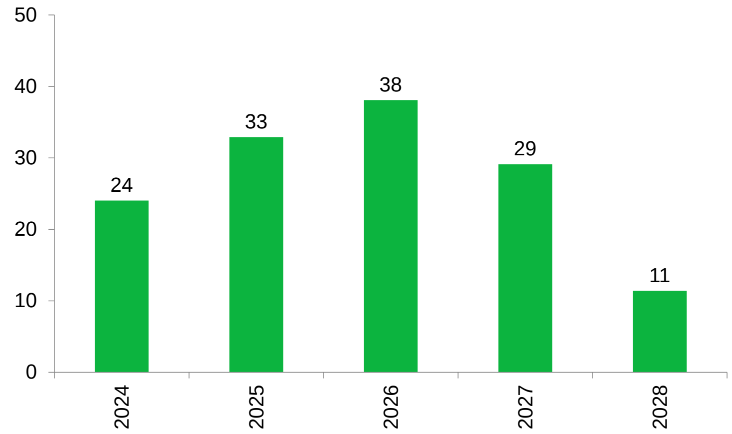
Credit quality will continue to suffer from the relatively high cost of capital

According to Moody's, the still relatively high (re)financing costs will pose the greatest risk to the credit quality of real estate issuers over the next 12-18 months, as the high level of interest rates is not yet fully reflected in real estate valuations. Issuers' interest coverage ratios will also remain under pressure and debt levels are likely to rise. The consensus for STOXX Real Estate companies expects a higher debt repayment period (= net debt to EBITDA) in the next two years, which at 10x is likely to be above the five-year average of 7x. However, the still relatively low refinancing requirements of real estate issuers in 2024 remain supportive, although these will gradually increase over the next few years, meaning that a cumulative volume of EUR 95bn will fall due between 2024 and 2026.

Financing structure optimized in recent years

On a positive note, the financing structure in the real estate sector has improved noticeably in the last decade through the issue of corporate bonds. However, a return to bank financing has been observed in recent months due to a lack of alternatives. In our opinion, this trend is likely to continue for some time. Secured bank financing is currently being negatively affected by the lower portfolio values, which in turn is having an impact on conditions. This is because the collateralization of real estate loans often depends on how much these properties or loan collateral are actually worth. According to Moody's, an increasing number of real estate groups are currently resorting to the sale of their minority interests in order to secure liquidity.

Refinancing requirements will increase continuously until 2026
EUR Outstanding volume in bn



Source: Market data provider , Erste Group Research

Access to the capital market remains tight

We believe that access to the capital market for real estate companies is likely to remain tight in 2024, as the attractiveness of the real estate sector is currently suffering from the economic slowdown as a result of global economic and political uncertainties and the still restrictive interest rate level. This is also clearly reflected in issuing activity. By mid-March 2024, for example, 17 bonds had been placed, many of them with a smaller volume. The average coupon for these issues was around 4.4%, compared with around 2% at the beginning of 2022. This means that real estate companies are gradually having to accept significantly higher financing costs on the capital market and actually be able to afford them.

Relative valuation

Monetary easing remains the driver

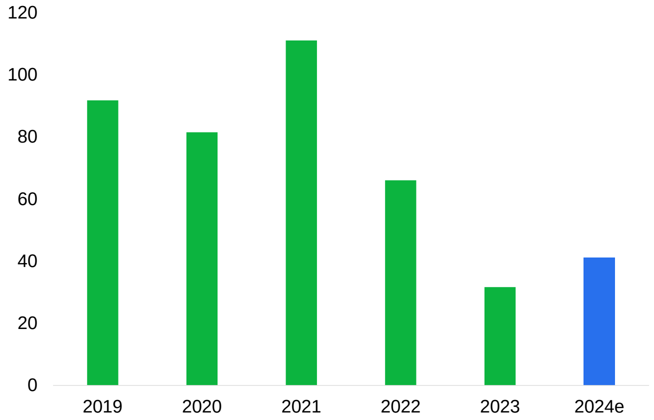
The expected easing of the ECB's monetary policy should provide positive impetus for the debt-intensive real estate industry. We expect the first interest rate cut in June and three more by a total of 100 basis points by the end of 2024.

Transaction market with slightly more momentum

After increasing confidence regarding interest rate cuts spread in the second half of the previous year, a slight increase in transaction volumes was also observed recently. For example, the German investment market for real estate saw a slight recovery in the second half of 2023, with transaction volumes showing a slight upward trend since the historic low in 2Q/23 (EUR 7.2bn). According to JLL[1], 2023 was the weakest investment year since 2011, with an investment volume of EUR 32bn or 52% below the previous year.

The transaction market has probably bottomed out

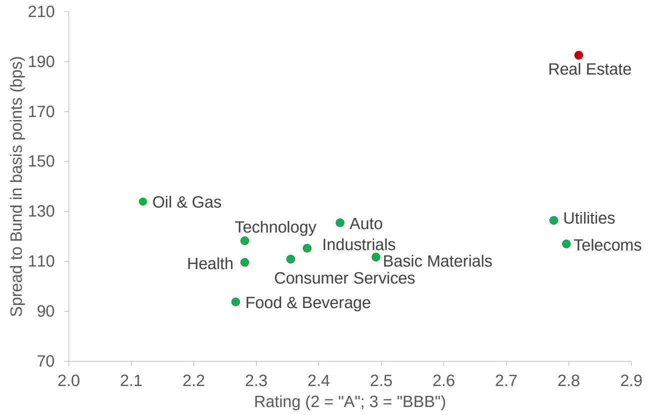
DE: Transaction volume in EUR bn



Source: JLL, Erste Group Research

IG Real Estate Sector currently offers potential returns

Ø Sector ratings and Spreads in comparison



Source: Market data provider , Erste Group Research

Austria fares better than the European average

The development of the transaction market shows a differentiated picture in a European comparison. In general, the investment volume in the Real Estate Sector fell in all European countries in 2023, although the extent of the decline varied. In the top 7 countries (Germany, Italy, Spain, France, the UK, the Netherlands and Sweden), the decline ranged between -30% and -55% y/y. The real estate investment volume in Austria was better than the European average with a minus of 37%. Expectations for 2024 are generally positive for Austria. CBRE expects the transaction market in Austria to pick up again in terms of volume and number of transactions.

Housing market: high construction costs and more restrictive lending are a burden

Within the Real Estate Sub-Sectors, the residential market, which has often been the strongest asset class in recent years, was hit the hardest in Austria in 2023. Rising construction costs and more restrictive lending by banks due to the sharp rise in interest rates played a major role here. In the meantime, the rising momentum of construction costs has slowed slightly month-on-

[1] Jones Lang Lasalle: service, consulting and investment management company in the Real Estate Sector

month, but they still remain at a high level. According to Statistics Austria, the construction cost index rose by 0.3% in February 2024 compared to January, but remained 3% above the February figure for the previous year. This is leading to a wait-and-see attitude on the part of many development companies and therefore to lower construction orders. Although the stricter lending guidelines[2] were relaxed somewhat in mid-March 2024, experts do not expect a sustained upturn in lending volumes. Housing completions are expected to decline in 2024, having risen steadily since 2020. Demand for housing is expected to grow steadily over the next few years due to the megatrends of urbanization and migration, but this could lead to bottlenecks due to the decline in completions.

Commercial Real Estate market more sensitive to economic cycles

Compared to the residential market, the commercial real estate market (office, retail, logistics and industrial properties) is more exposed to economic fluctuations. Following the slump in the transaction market in 2023, more activity is expected this year, which could lead to a slight stabilization of market prices. More transactions, particularly in the office segment, would also create more flexibility for companies to reduce debt through sales. However, the still high level of interest rates will continue to have a negative impact on real estate valuations. The rating agency S&P assumes an average decline in real estate valuations of between 10% and a maximum of 24% for European Real Estate companies. Although this decline will not be fully offset by the indexation of rents, it will be partially mitigated.

Will the real estate crisis bottom out in 2024?

Despite the negative rating adjustments in recent quarters, the issue volume-weighted rating in the investment grade real estate sector has only deteriorated marginally. On average, real estate issuers currently have a rating that is only slightly below that of utilities and telecoms in a sector comparison. The significantly higher risk premiums can be explained by the higher interest rate sensitivity of the real estate sector. There are currently slightly positive signals on the real estate market. If sentiment continues to brighten, the investment grade real estate sector offers potential compared to the non-financial sectors. However, it remains to be seen whether 2024 will see the start of a recovery in the real estate sector. Many challenges still remain.

[2] KIM V (FMA issues Regulation for sustainable lending standards for residential real estate financing (KIM-V) - FMA Austria)

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