Weekly Credit Brief Aug 08 - Aug 14 2023

High mortgage rates and property devaluation continue to threaten the credit outlook of the German real estate sector

by Amrita Parab

- **NUS-CRI Agg PD shows a worsening trend in the German real estate sector's credit profile, driven by higher borrowing costs and inflation-linked challenges**
- **NUS-CRI Forward PD suggests that the credit profile of the sector may witness further deterioration, driven by deteriorating financing channels and diminished demand of residential property owners and developers**

The German real estate market, which once thrived on inexpensive credit and economic growth, now contends with a sharp reversal attributed to elevated interest rates and surging inflation in the Euro area. Constituting roughly a fifth of Germany's economic output, the German real estate sector is Europe's largest real estate market. The sector's recent decline is highlighted by a decrease of 47% in new construction compared to an average of the past two years, a 27% YTD drop in building permits, and a record 6.8% decline in home prices in Q1 2023 as compared to the previous year. Concurrently, the NUS-CRI 1-year Aggregate (median) Probability of Default (Agg PD) also worsened since 2022, crossing over the BBB+ upper bound when proxied against the PDiR2.0 bounds[1] and highlighting the challenges pertaining to tighter credit availability, property devaluation, hindered profitability and, the uncertain macroeconomic environment faced by the industry. With the property price decline expected to continue into the next year, the NUS-CRI Aggregate (median) Forward 1-year PD (Forward PD[2]) as of Aug-2023 suggests further deterioration in the outlook of the industry's aggregate credit profile, with the Forward PD potentially moving into the non-investment grade territory.

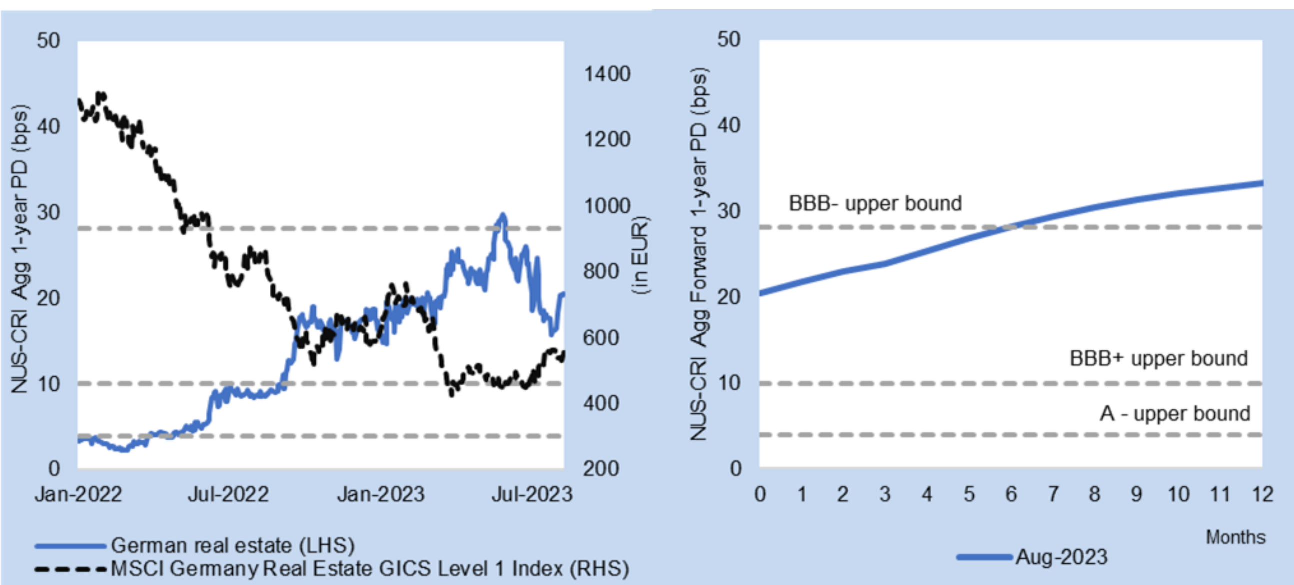

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for German real estate developers and the MSCI German Real Estate GICS Level 1 Index, with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for German real estate developers as of Aug-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

Germany's property sector is grappling with the significant impact of the series of interest rate hikes implemented by the European Central Bank since Jul-2022. These rate increases have precipitated a significant surge in

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.
[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months, conditional on the firm's survival in the next 6 months.

financing expenses for German households, leading to a sustained drop in demand for new homes. Resultantly, residential real estate prices in Germany experienced a substantial drop, registering an average year-on-year decline of 6.8%[3] during the initial quarter of 2023. Similar pain is being witnessed in the commercial property segment where, as interest rates have increased, the cost of borrowing money has increased, leading potential property investors to seek higher returns. This has led to lower asking prices, as property owners are reluctant to offer significant discounts on their book values due to concerns about potential spikes in debt (loan-to-value) ratios. As a result, the German commercial real estate segment witnessed a 50% decline in transaction volume in Q1 2023. The decline in residential demand and the drop in commercial property valuations have diminished the sector's revenue-generating capability. Additionally, surging building costs have added a hurdle to the sector's profitability, which has been exacerbated by the rising cost of concrete and other construction materials, as well as a shortage of skilled workers.

The real estate industry faces mounting challenges as rising borrowing costs complicate the refinancing of existing debt and the issuance of new debt. As property prices fall, the increase in loan-to-value ratios of property firms makes it harder for real estate firms to raise new capital due to a decline in collateral values. An increase in loan-to-value ratios could even force these firms to raise funds through equity financing in order to bring their loan-to-value ratios back within an acceptable range. With investors and lenders wary of the incumbent challenges faced by real estate firms in an era of high-interest rates and persistent inflation, financing channels for firms in the sector continue to narrow. Germany's financial supervisory authority, BaFin, has expressed concerns about domestic banks' substantial exposure to the property market and the potential negative consequences of swift declines in property values. A recent Bank Lending Survey of the Deutsche Bundesbank indicates that banks have continued to tighten lending standards in Q2 2023 for both enterprises and households. The higher scrutiny by regulators and tightening credit conditions further deprive the real estate sector of much-needed financing. Surging yields of bonds issued by Vonovia and LEG Immobilien, two major real estate firms in Germany, over the past year are also indicative of the higher borrowing costs faced by the sector in capital markets should they want to refinance (see Figure 2a).

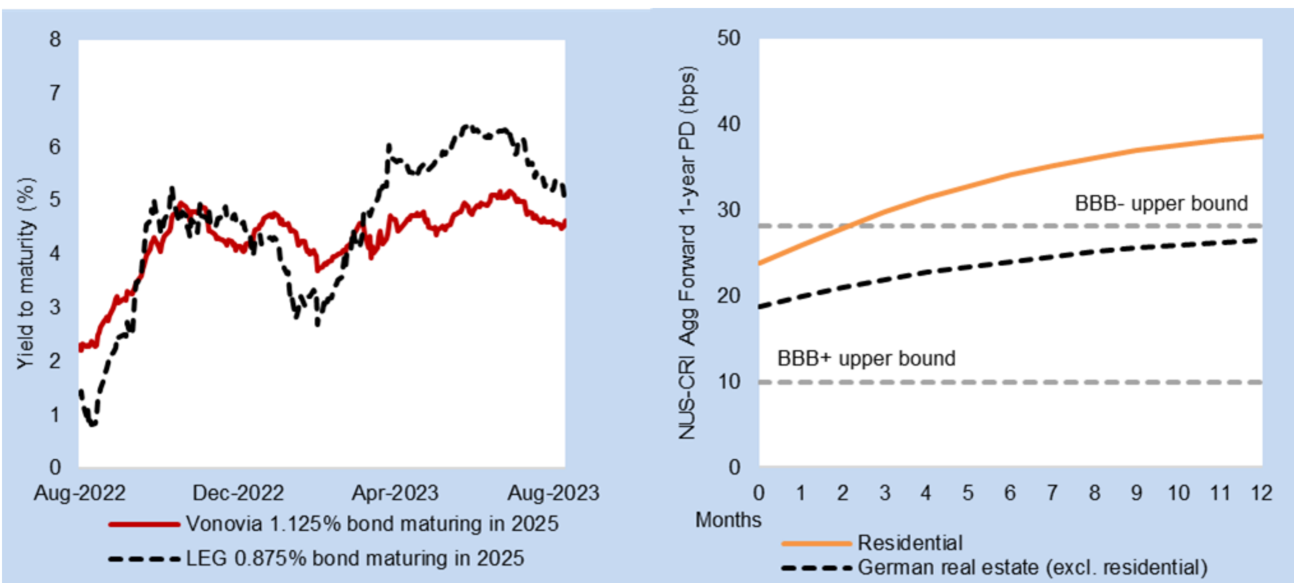

Figure 2a (LHS): Yield to maturity (%) of select bonds issued by Vonovia and LEG Immobilien. Figure 2b (RHS): NUS-CRI Agg (median) Forward 1-year PD for German real estate developers, split by residential developers and all German real estate developers (excluding residential) as of Aug-2023, with reference to PDiR2.0 bounds. *Source: Bloomberg, NUS-CRI*

A further breakdown into sub-sectors reveals that residential property firms potentially show a more rapid deterioration into non-investment grade territory as compared to non-residential firms involved in the ownership and development of commercial properties such as office, retail, and industrial properties (see Figure 2b). Residential property firms face a challenging environment as banks tighten lending standards, mortgage rates increase, and inflation eats into household disposable income. Slowing construction activity is yet a sign of the flagging demand. The average effective mortgage rate for residential properties jumped from around 1.35% in Jan-2022 to 3.88% in Mar-2023 which consequently negatively impacted demand for new homes. Devaluation of properties is another issue that has proven to be a drag on credit health. Major residential property firms such as Vonovia, LEG Immobilien, and TAG Immobilien all recorded losses in the second quarter of 2023 driven by

[3] This contraction marks the most significant decrease since the commencement of data collection back in 2000, as reported by the Federal Statistical Office (Destatis).

the devaluation of property portfolios. With around 17%[4] of their total outstanding debt maturing over the next two years, a persistent property devaluation may add pressure on their credit health as they may be forced to undertake remedial rights issues to maintain loan-to-value ratios. As such, going forward, a weak macroeconomic environment may continue to dampen real household incomes and lead to commercial property devaluations, which in concert with higher mortgage rates and hindered profitability, may continue to adversely impact the credit health of the German real estate sector, as suggested by the Forward PD in Figure 1b.

[4] Data from Bloomberg

Credit News

Country Garden crisis brings new pain to China's property sector

Aug 11. China's largest private homebuilder, Country Garden, is facing a liquidity crisis despite securing a RMB 50bn (USD 7bn) credit line from the state-backed Postal Savings Bank of China last year. The company confirmed missing payments of USD 22.5mn on two international bonds, reflecting the deepening property crisis in China's real estate sector. The slowdown in the sector, which contributes over a quarter of China's economic activity, presents a challenge for Chinese authorities as it grapples with trade headwinds and deflationary pressures. Country Garden's predicament also underscores the potential risks to the viability of private developers that have been key drivers of China's urbanization and economic growth. (FT)

US regulators try to consign emergency bank fire sales to history

Aug 14. US banking regulators are aiming to prevent emergency fire sales of large regional banks by requiring lenders to establish "living wills" to facilitate the orderly wind-down of a troubled institution. The Federal Deposit Insurance Corporation (FDIC) is responding to the recent failures of banks like Silicon Valley Bank, Signature Bank, and First Republic, which were seized and sold at a loss. Under the new rule, banks with over USD 100bn in assets would need to submit detailed resolution plans and raise new unsecured debt to recapitalize a failed bank. The goal is to avoid destabilizing the broader banking system during such failures. (FT)

Cat bond funds ranked among 2023's top-performing credit funds

Aug 10. Catastrophe bond funds have emerged among the top-performing credit funds this year, with their strong performance being driven by the absence of major insured events and the higher yields offered. These bonds, known as cat bonds, are issued by insurance companies to borrow money from capital markets. If a specific insured catastrophe event occurs, investors may lose their initial investment, but if the event doesn't happen, the bond retains its value. Notably, cat bonds have performed well due to the current attractive reinsurance rate environment and the absence of significant losses from insured events this year. (Reuters)

Banks' problems aren't over, according to the bond market

Aug 09. Moody's has taken action on 27 banks, including downgrading the credit ratings of 10 and placing others under review or assigning a negative outlook. This highlights the potential risks in the bond market for regional banks, even as their stocks have rallied. These ratings actions indicate that many of the core issues revealed by this year's crisis in Mar-2023, such as the risks posed by higher interest rates, are only beginning to be addressed. Moody's pointed out that while the Federal Reserve's proposed tougher capital requirements for banks with over USD 100bn in assets could be positive for their credit risk, there are still key issues unaddressed, particularly related to interest-rate risk and the complexities of valuing certain assets. This underscores the ongoing challenges faced by regional banks as they navigate changing market dynamics. (WSJ)

ICE's USD 12bn mortgage tech deal builds heft in US home loans

Aug 13. Intercontinental Exchange (ICE) is poised to complete USD 12bn acquisition of mortgage software specialist Black Knight after the US Federal Trade Commission ended its opposition to the deal. While ICE's move has the potential to transform the complex US home loan market, some players remain concerned about the company's growing control over technology that underpins the USD 12tn industry. With its prior acquisitions of mortgage data repository MERS and loan origination platform Ellie Mae, ICE is positioned to streamline and automate the mortgage process, but smaller lenders worry about being locked into ICE's technology and facing higher costs. (FT)

New lending by mortgage REITs has dried up (WSJ)

Bond market sees no end to tumult as fed casts a hawkish shadow (Bloomberg)

McDonald's kicks off bond sale ahead of upcoming maturities (Bloomberg)

Regulatory Updates

Russian central bank to hold emergency rate meeting as rouble flounders

Aug 14. Russia's central bank is holding an emergency interest rate meeting following the rouble's fall below RUB 100/USD, prompting disagreements among policymakers over handling the economic fallout from the Ukraine invasion. The rouble's decline has caused divisions among Russian officials, with some downplaying its impact while others, including Putin's economic adviser Maxim Oreshkin, indirectly criticizing the central bank's policy. The central bank has stated that the rouble's fall is influenced by various factors, including a drop in exports and rising internal demand for imports. Rising inflation and ballooning deficits from increased military spending are also contributing to the rouble's decline. (FT)

Australia central bank says worst over for inflation as policy enters 'calibration stage'

Aug 11. The head of Australia's central bank, Reserve Bank of Australia (RBA), Philip Lowe, stated that the worst is over for inflation and that policy is now in the "calibration stage". While inflation in Australia had peaked at over 7.8% last year, it trended down to 6% in Q2-2023 and is projected to return to the RBA's target band of 2-3% by late 2025. Lowe indicated that some further policy tightening might be necessary to ensure inflation returns to target within a reasonable time frame. The RBA has raised interest rates by 400 basis points since May last year, pushing the cash rate to a decade-high of 4.1%. (CNA)

India's RBI holds rates steady but eyes food price spike; signals tighter policy (Reuters)

Sri Lanka central bank cuts statutory reserve ratio by 200bps (Reuters)

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