Corona crisis meets financing –
an opinion from financiers

A new kind of crisis – framework conditions and development

The coronavirus pandemic has changed us and the business world that we were used to overnight. Disbelief and shock quickly gave way to concerns about employee health, quickly followed by what must surely be the largest scale field trial of business continuity planning. Maintaining the functionality of businesses for the short and medium-term was the objective. Now, countries and businesses are looking for a long-term way out of the coronavirus shutdown.

Balancing different fundamental rights, protecting life versus the right to participate and freedom are an essential part of the pandemic timeline and thus also a part of the burden on the German economy. Lockdowns are now loosened successively or are lifted completely. Regional conditions are taken into consideration in Germany, which is strongly characterized by the federal system. The relatively parallel loosening of individual restrictions however is at the expense of the quantifiability of individual protective measures. The pandemic is a global event, the specific effects of which are difficult to forecast in any case. In terms of the economy, we are expecting the worst recession since World War II. The specific dimensions of this recession are currently still unclear, in particular with regard to an economic recovery.

The crisis furthermore showed the interconnectedness of the global economy to us export-dependent Germans.

The 2008 financial crisis burdened the economic system for the long run. However, the real economy is now particularly affected, unlike during the financial crisis. Slumps in demand and supply bottlenecks are now battled with aid packages amounting to billions and comparably robust banking and economic systems.

Market participants must nevertheless expect delayed effects on the real estate industry and its financiers. Even if the economy restarts, the impaired outlook on rents and the more difficult financing environment will remain palpable at least until 2021. For private equity and debt capital investors in the real estate industry, the most recent developments therefore accompany a risk analysis of the loan books. This has been completed for the time being and will come to the foreground only once the economic effects have a more specific and enhanced effect on financiers, for example in the form of non-performing loans.

The real estate landscape

The development of the investment and rental markets is decisive in the evaluation of the sustainability of real estate as loan collateral, which is the mainstay of real estate financing.

The effects of the crisis will differ depending on the type of use. We are summarizing these as follows:

Asset type	Overview
Office	This asset category is irregular. While the pandemic accelerates digitization, only very few residences were found to be suitable work environments within the scope of the home-office regulation. Office properties are however always more susceptible to a recession, which from experience initially affects B-locations and properties with a short WALT, i.e. value-add and opportunistic product.
Flexible workspaces	The duration of the currently reduced capacity, in particular with regard to event spaces and short lease terms, remains to be seen. The implementation of hygienic measures will be decisive in the context of a possible concern about changing staff and businesses.
Retail	The closure of retail enhanced the trend toward online trade. The significant negative effects are now already apparent in the non-food sector. Many businesses will presumably not survive the crisis due to liquidity and will not be available as future tenants. Local suppliers, or retail properties with a high food or drugstore ratio, have proven themselves to be crisis-resistant. Retail parks as well as hardware stores and garden centers have also demonstrated themselves to be robust for now.
Residential	Residential properties are deemed to be relative winners and a resilient asset category that generates stable cash flow. They are gaining attractiveness for security-oriented investors and profit - in particular - from the interest rate development over the long-term. However, private clients will increasingly focus on job security and asset situation. Some investment decisions may be delayed or real estate may be preferred as a secure investment. In sum, this could indicate price stability in particular in good locations.
Healthcare	The underlying demographic development strongly supports this asset category. Based on the highly regulated environment, the staff bottlenecks, in connection with reputational risks, investors focus strongly on professionalism and creditworthiness of the operator.
Hotel sector	The effects of the coronavirus crisis on the overall hotel industry are enormous. Occupancy rates have dropped significantly in particular on trade fair locations with international traffic, and recovery seems unlikely for the short term in light of the prohibition of events. Furthermore, an increase of travel costs as well as digitization may result in a long-term drop in demand. Generally, we are therefore expecting an acceleration of the consolidation trend of operators because the existence of many businesses is threatened. Even financially sound operating chains will renegotiate terms. The significance of bank guarantees and deposits for rental security increases.
Logistics	This asset category continues to experience high demand despite the varied performance of users during the crisis. While they were affected by the interrupted supply chains, for example in the industrial and automotive sector, the demand for space from online and food retailers has increased. The susceptibility of the global supply chains may cause a medium and long-term review of the just-in-time model and thus increased space demand in some economic segments.
Data centers	The sharp increase of digitization due to web-based collaboration, online shopping, e-schooling, and electronic recreational activities drives data traffic and increases the significance of data centers.

The global investment pressure of investors and banks continues. Uncertainties however have a negative effect on the real estate market because decisions on leasing, purchasing, or selling a property are delayed or canceled. Therefore, we are expecting a significant drop in transaction volumes in all sectors for the short term. It is our opinion that core and core-plus properties will be less severely affected but value-add and opportunistic products will be very strongly affected. For the overall year 2020 we are expecting a decrease of approximately one third in comparison to 2019. Even if transactions are still conducted, they are very selective. Investors focus on existing properties, while real properties and developments are classified as more critical due to the inherent risk. Generally, a strong focus is placed on quality products, in particular in prime locations, unless palpable price reductions tempt toward opportunistic products or comparably less advantageous locations. Temporary rent arrears however are a significant factor in pricing, and investments are strained by more restrictive and more expensive lending. This uncertainty paralyzes the market. The stock market drop furthermore increased the real estate allocation in investor portfolios—in part beyond target values. Nevertheless, the relative attractivity of real estate increased because it has a lower volatility than many alternative forms of investments, e.g. stocks. This trend is supported by the low interest rates manifesting over a long time.

The diversity of industries generating rents based on different business models affects the value of real estate. User markets and user behavior will therefore be decisive for the further course of investment markets. Investors must question their business models. Ailing businesses without substantial reserves will presumably no longer be available as tenants after the crisis. Real estate with users in public administration, food, drugs, or health are, for example, assessed differently than small startups, travel agencies, or trade companies.

The financing landscape

The framework conditions for financing were already clouded in early 2020, as demonstrated in the most recent publication of the German Real Estate Finance Index (DIFI) by JLL and ZEW, the market sentiment index for commercial real estate financing in Germany. This affected the specific current financing situation and, even more significantly, future financing expectations. This outlook should by now have exacerbated.

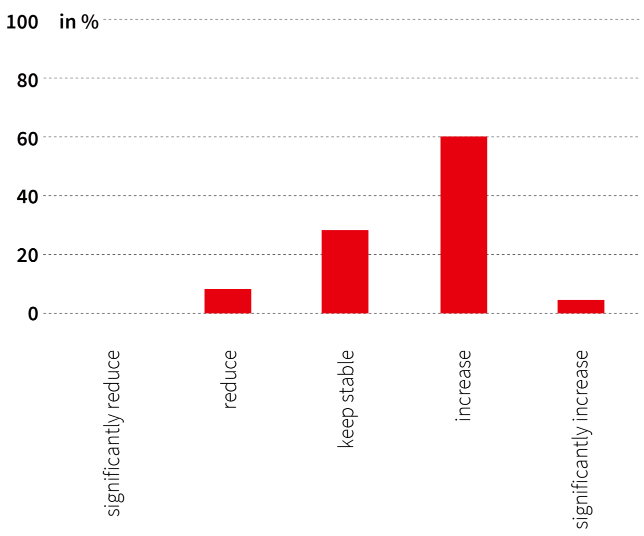
JLL surveyed 27 mortgage banks, savings banks, credit unions, insurers, and alternative financers about their handling of existing and new business in early May in order to capture the current situation in the financing sector.

New business of banks

Unlike the 2008 financial crisis, banks are generally open for new business despite the uncertainties, which are currently difficult to quantify. Of the respondents, not a single market participant rejected new business, at least pro forma. Just the opposite: approximately two thirds of respondents at least plan to expand or strongly expand loan books. It remains to be seen whether this is wishful thinking. Only one bank plans a slight reduction, which is a decision that is not based on the consequences of the coronavirus crisis.

Transactions will predominantly (67%) be handled within the scope of existing lending guidelines if these are found to be sustainable. This also explains why the negotiated financing that JLL will support during the crisis is contracted and disbursed within the scope of the agreed parameters.

How will the banks' loan book develop?



The following survey results should be emphasized in detail:

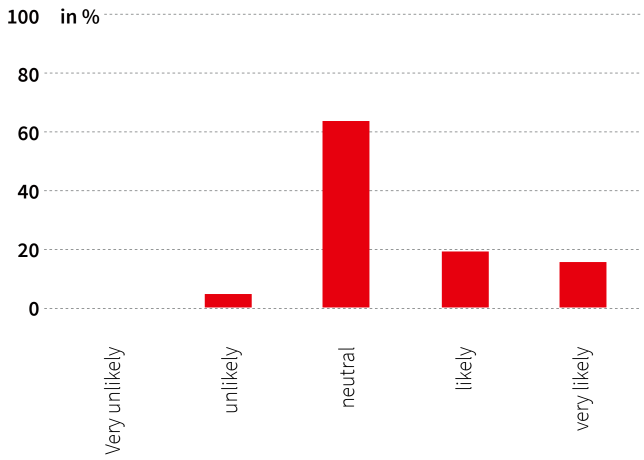
Lending policy

- Lending policies provide a framework that is currently interpreted conservatively and not exploited. The hotel and retail asset categories are exceptions. Their fundability is very restricted.
- Transactions outside of these guidelines, which were quite common in individual cases prior to the crisis, only very rarely gain the approval of committees.

Product

- Equity as well as debt capital investors prefer a similar product, i.e. without change residential, office, as well as logistics properties. The attractivity of hotel and retail assets is significantly lower, unless the latter are a food-based property. Generally, a strong focus is placed on quality products, in particular in excellent micro locations in prime locations, unless desired price reductions tempt toward opportunistic product or comparably less advantageous locations. Investors focus on existing properties. Real properties and developments are assessed more critically due to the inherent risk. Measures in the speculative area are currently in particular very difficult to finance.

How will the coronavirus crisis affect the lending policy?



Investors

- Despite the low-interest-rate environment, which will most likely continue for years, banks focus on high-equity, experienced investors.
- We generally found a focus on existing clients and the predominant part of our respondents (67%) assumes that this will continue for between 6 to 9 months, in part even longer. Three banks finance exclusively known addresses and 45% of respondents chiefly finance established market participants and will prefer transactions with existing clients. 20% of respondents, generally speaking niche players, are proactively using the current rejections for new customer acquisition.
- All-equity buyers are currently still in the driver's seat. This includes open real estate funds and pension schemes, which chiefly act through asset managers. They have a competitive advantage over buyers that must first arrange capital. This advantage will however level off once the enhanced financing terms will come to bear within the scope of downstream debt financing and will affect future bidding processes.

Willingness to provide financing of survey participants

	Office	Residential	Logistics	Retail	Hotel
Existing	96%	96%	93%	52%	33%
Developments (not speculative)	70%	74%	70%	33%	19%
Developments (speculative)	7%	7%	7%	4%	4%

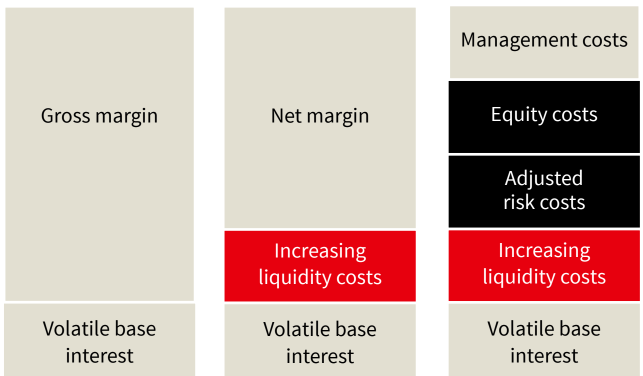
Structuring and pricing

- Capital will consequently be made available with more restrictions and at different terms or through other market participants.
- 65% of banks keep the loan to value ratio stable, 31% expect a reduction and only 4% are willing to take more risks. However, just like pricing, establishing the market value within the scope of the assessment is impeded.
- From the perspective of many banks and insurers, the financing volume is however also chiefly dependent on the mortgage lending value of a real estate. Pursuant to the Mortgage Lending Value Ordinance, this must deliberately be determined independently from temporary — possibly cyclical — value fluctuations in the relevant real estate market.
- The liquidity costs are term-congruent refinancing costs of the bank, which are chiefly determined based on creditworthiness. At the start of the pandemic they first increased significantly, in the mortgage bank segment by approximately 50 to 70 bps, and in deposit refinanciers segment by approximately 10 to 25 bps. Liquidity costs continue to be higher but are currently also decreasing slightly. They are fully passed on to the client. Only one market participant was willing to compensate this to the detriment of its net margin. Insurers and funds use this modified pricing accordingly.
- The net margin, the risk and management fee of the bank itself, will additionally increase financing costs because 73% of respondents expected an increase, whereas 19% did not expect a risk adjustment or a slight reduction (8%).

Existing business

The financing market over the last few weeks was however in a de facto "analysis mode", because potential credit losses affect the profit and loss account of banks more significantly than reduced new business. Therefore, just like investors, they initially focused on the analysis of existing business. The strict regulation over the past years generally speaking however resulted in an expansion of staff in transaction-independent segments, so that they appear to be comparably scarce in the front and back office. This reallocation of human resources was therefore to the detriment of new business. This strain will continue, although to a lesser extent. After conclusion of the scenario analyses, sustainable solutions must be developed jointly with creditors severely affected by the coronavirus crisis. The catchphrase is "consensual de-risking" with the objective of providing equity investors with sufficient incentive to engage in the deal while also avoiding liquidity outflows in order to account for the banks' need for security. With a generally positive forecast, this includes the deferment of redemption payments and the suspension of default financial covenants, which is frequently granted against cash traps.

Interest components



Many banks — 37% of respondents — waived the reassessment of real estate at the current time; or at most will perform this as scheduled (63%). This lies in the limited informative value of “crisis opinions” on the one hand and the lacking evidence of the transaction market on the other hand. Furthermore, the increased outflow would result in a potential deterioration of the rating and thus require the allocation of additional equity. This will increasingly be the case as the crisis progresses and will cause correspondingly increased costs, which in turn will be to the detriment of the cost income ratio of German banks which are in any case tight.

Financers

The effect of the coronavirus crisis on individual financers differs and therefore they also respond differently.

Mortgage banks

Mortgage banks dominate the market in addition to deposit banks like savings banks and credit unions. Refinancing occurs on the money and capital market and is dependent on creditworthiness, which is essentially driven by the quality of the underlying credit book. Based on our survey, the liquidity costs in this segment increased by approximately 50 to 70 bps.

Deposit banks

Deposits are an affordable source of refinancing independent from the money and capital market, the liquidity costs of which increased by only approximately 10 to 25 bps. However, they also change daily and in the current environment are particularly increasingly called in ad hoc to cover liquidity bottlenecks. Therefore, deposit banks can increasingly establish themselves on the market or finance with restraint depending on the performance of their corporate book and the asset development of their private investors.

Insurers and pension funds

Due to the refinancing through stable premiums, insurers offer flexible financing solutions in particular for long-term debt capital. These are increasingly relevant in light of the increased margin level. However, an upward trend is expected with regard to margins that are called in order to prevail over alternative investment options, e.g. the securities market.

Debt Funds

The behavior of debt funds in the crisis depends on their money source. Market participants with discretionary clients have an advantage here because they respond flexibly and can seize opportunities.

Investmentbanks

They manage their credit books through the syndication markets, whose liquidity is currently limited.

Conclusion

Historically speaking, a severe crisis is followed by a strong economic recovery. In the present case this may however result in a new wave of infection which in turn would result in a new discussion of a lockdown, resulting in a W-shaped, drawn-out recovery. In this case in particular, the ongoing uncertainty may have negative effects on consumption and investment decisions. States increase their debt ratio and as well as their investment and aid programs. Businesses however might reduce their investments or suspend them completely because of the great uncertainty in a recession or a W-shaped economic development. Consumption and investments as well as the savings ratio are reduced in the event of a continuing recession or short time work in private households. Households hold cash and watch the economic situation. This results in a continuous downward spiral of the markets. Governments must now set suitable impulses in order to counter these effects.

Temporarily, the pandemic has clear negative effects. For the medium-term however a move toward relatively secure investments might continue to support a positive development. However, the coronavirus crisis may also cause a realignment of real estate portfolios over the medium-term. For example, system-relevant and resilient assets like residential real estate and local suppliers may gain relevance and be preferred by investors, the equity, as well as the debt capital market. It is undisputed that the virus will doubtlessly leave its mark on the real estate markets in Germany. Structural changes will most likely remain for the long-term because real estate is by definition immobile and thus indispensably exposed to local conditions.

Additional opposition from banks is not expected within the scope of functioning existing financing. General performance difficulties are however enhanced by the crisis and exploited selectively. Massive liquidity exists in markets for new business with solid products. Opportunistic product ends up with opportunistic creditors, and this has a price. New business is addressed again in a limited manner depending on available resources — chiefly staff capacity and free equity —, in part with a modified business model and a focus on resilient investments. For the long-term, banks with a solid equity base will profit because they will continue to be able to deliver; shaky candidates are busy with consolidation and workout issues.

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