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European CMBS Creak Under Rising Cost Burden

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Key Takeaways

- More than 70% of the European commercial mortgage-backed securities (CMBS) transactions we reviewed experienced a rise in expenses over the last four years, often in the double- or triple-digit range.
- In a competitive environment, tenants shy away from properties with high operating expenses.
- Borrowers also suffer from high operating expenses, which reduce net cash flow and limit their debt service coverage and their ability to refinance mortgages.
- We expect that loan defaults in European CMBS will rise, albeit from a very low level, and we will continue reflecting our expectations of rising expenses in our reviews of CMBS loans on a loan-by-loan basis.

The past few months have not been easy for European commercial real estate (CRE) borrowers. Property values worldwide have seen the biggest drop in years, rising interest rates have reduced borrowers' interest coverage, and rising operating expenses have made it harder to meet interest obligations. Our recent review of European CMBS transactions revealed a consistent increase in operating costs, both on an absolute (per square foot) and on a relative basis (as a percentage of revenue).

The Reasons For The Rise In Expenses Are Threefold

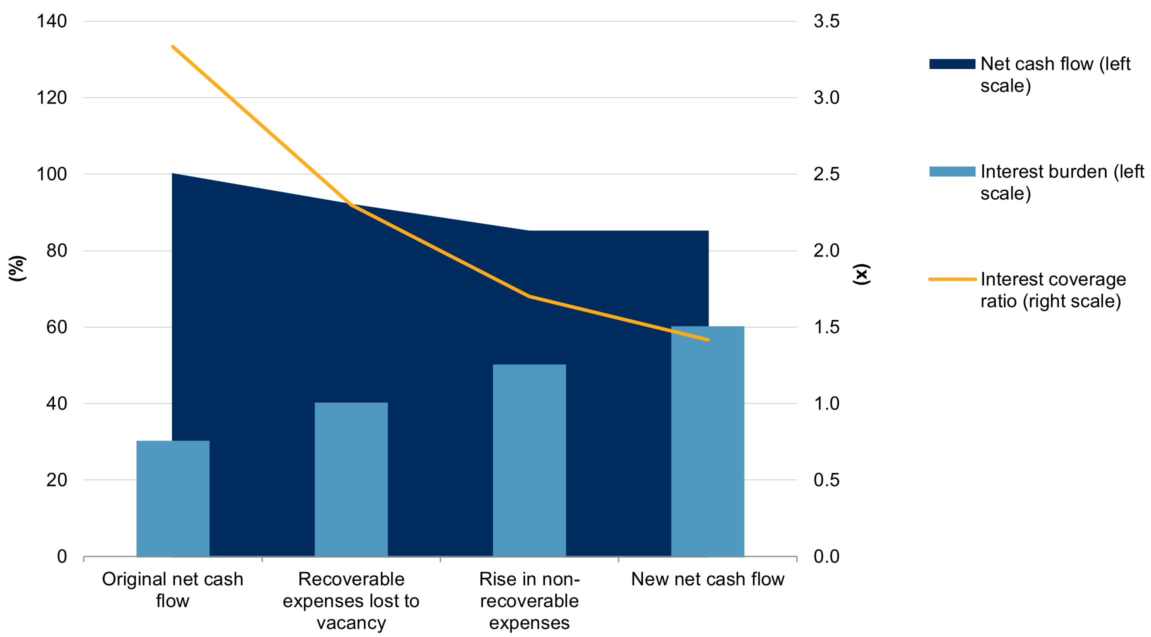
The most notable one is inflation, which has increased the price per square foot, as energy, labor, and materials have become more expensive. Secondly, the uptick in vacancy rates meant landlords had to shoulder costs that usually fall within the tenants' remit. Rising market vacancies have also resulted in more competitive rental markets, with landlords having to compete not only on location, amenities, and rent, but on other expenses that add to tenants' total costs, such as utilities, cleaning, and security. Thirdly, operating expenses account for a larger share of a building's revenue when costs go up and rents go down. In general, rents tend to rise more slowly than inflation or even decline when economic growth is slow or about to decline.

Chart 1 illustrates the relationship between rising expenses and interest rate changes. They have often doubled borrowers' interest burdens and can reduce interest coverage from an initially very healthy level (3.3x in this example) to a level that is tantamount to borrowers running out of funds

(1.4x in this case).

Chart 1

Rising costs and interest rates erode interest coverage ratio



Source: S&P Global Ratings.

All these factors ultimately lower a property's bottom line and reduce borrowers' ability to meet their interest obligations. More importantly, they also reduce the building's value, which is a function of property cash flow and yield. Higher costs diminish property values and reduce borrowers' ability to finance their real estate investments. This results in lower rated CMBS transactions.

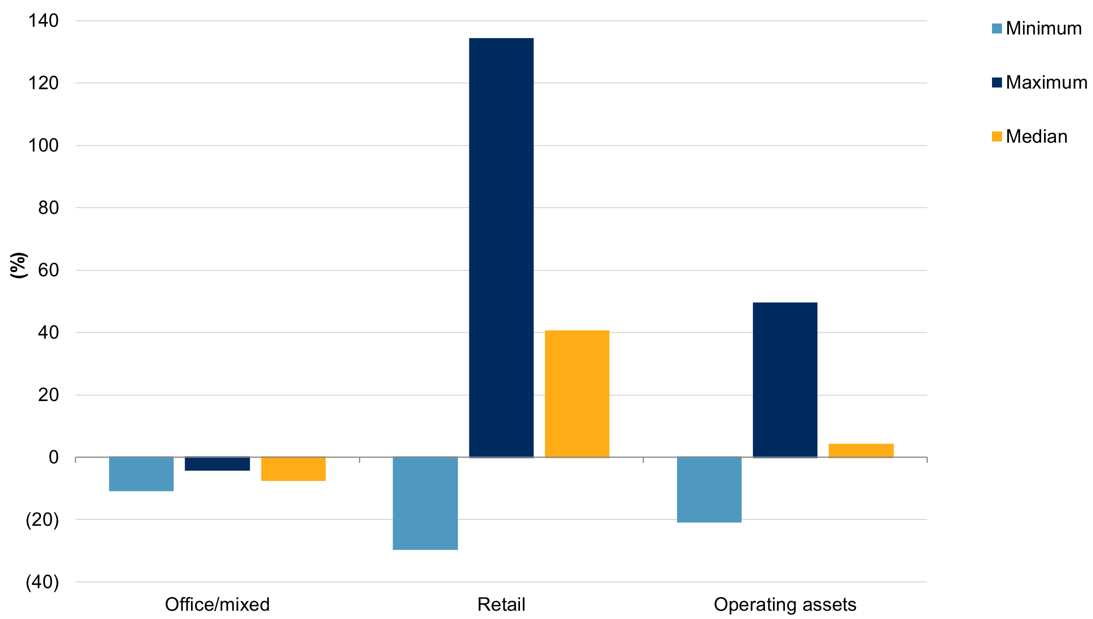
Expense Types In European CMBS

Among the European CMBS transactions we reviewed, expense performance varied widely over time. Some transactions have managed to reduce their non-recoverable expenses since closing or the latest pre-pandemic investor report, depending on which one was more recent. More than 70% have seen expenses increase on a per unit basis (per square meter, square foot, or hotel room) and 85% have seen an expense increase as a percentage of their revenue.

In many cases, the rise in expenses was dramatic (see chart 2). In the retail transactions we assessed, expenses per square foot have more than doubled, in one case quadrupled. Barring the minimum and maximum changes, expenses have increased by 37% on average when calculated per unit over a four-year period. Some of the office transactions we reviewed have fared better in this analysis than operating properties, such as hotels or student housing, but this might change over the next few months.

Chart 2

Change in expenses on a per unit basis

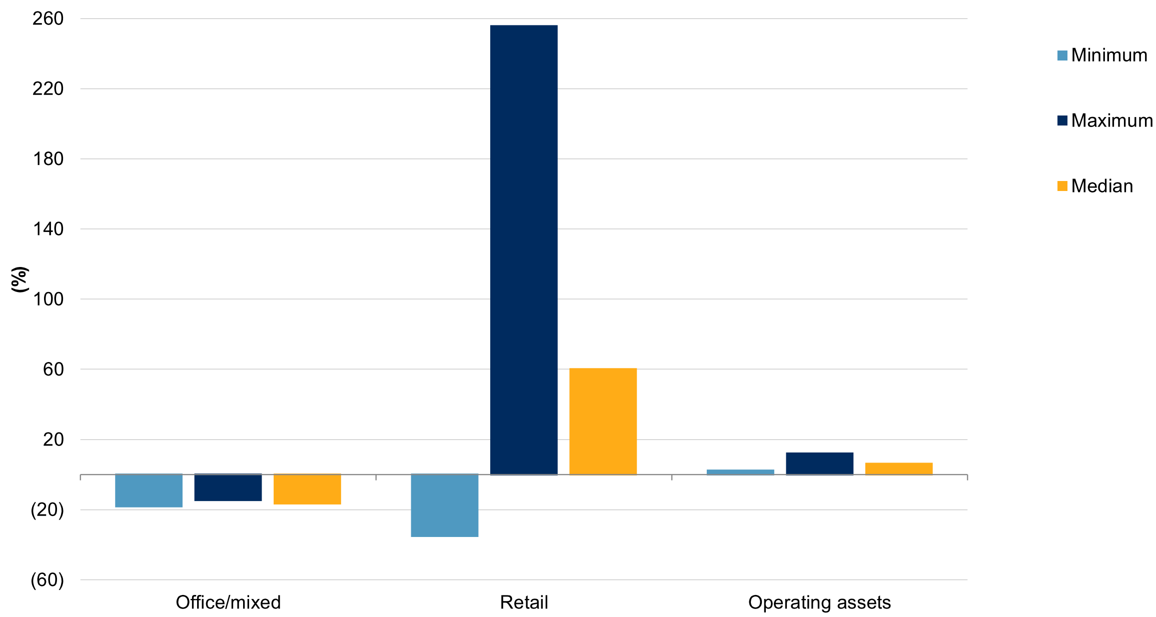


Source: S&P Global Ratings.

Similarly, when looking at expenses versus income, non-recoverable expenses as a percentage of revenue were up 55% over a four-year period, again barring the minimum and maximum changes (see chart 3).

Chart 3

Change in expenses as a percentage of revenue



Source: S&P Global Ratings.

It is worth noting that servicers do not report non-recoverable expenses consistently and that the reporting format often changes. For some transactions, we had to request information on non-recoverable expenses. Since most transactions report quarterly or semi-annually, our underlying data do not capture the most recent price rises either. We therefore expect that the numbers in charts 2 and 3 will increase, based on the investor reports we will receive over the coming months.

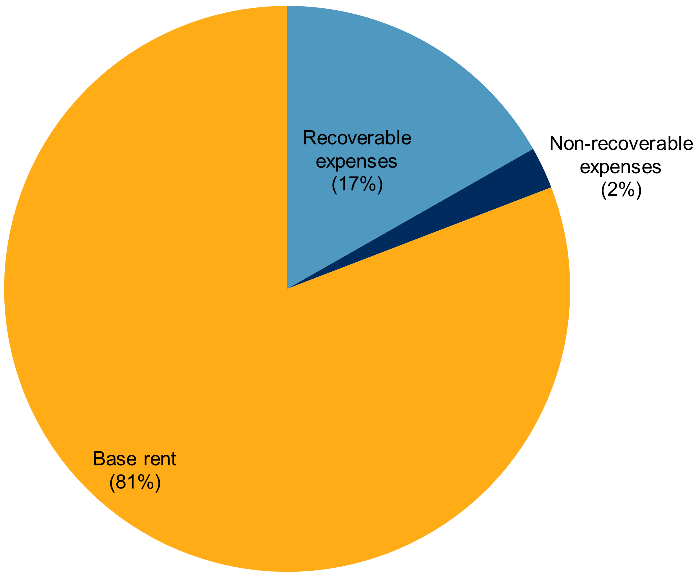
Recoverable operating expenses

Local laws and market conventions mean that we need to assess recoverable costs through a local lens. In the U.K., for example, full repairing and insuring (FRI) leases are common. This means tenants must bear nearly all of the property-related expenses, including the maintenance of common areas.

In other countries, such as Germany, tenants usually only pay for costs directly related to their rental units, such as utilities. In some cases, landlords can bill tenants for other costs, such as insurance, security, or the cleaning of common areas. Yet, exterior maintenance is typically the landlords' obligation. In the case of German office buildings, for example, recoverable expenses typically make up the majority of non-rental cash flows (see chart 4).

Chart 4

Total cost of German office properties

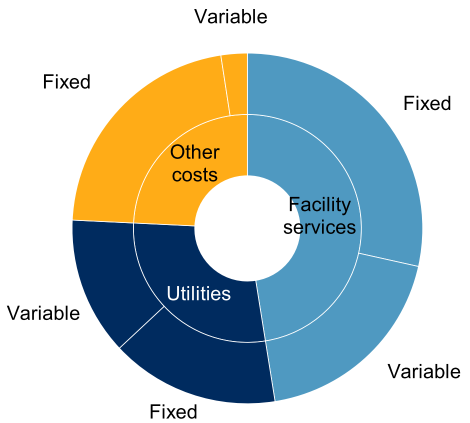


Sources: bulwiengesa AG, RIWIS, Bauakademie Performance Management GmbH.

Within recoverable expenses, facility services account for the largest portion, followed by utilities and other costs, such as taxes and insurance (see charts 5-6).

Chart 5

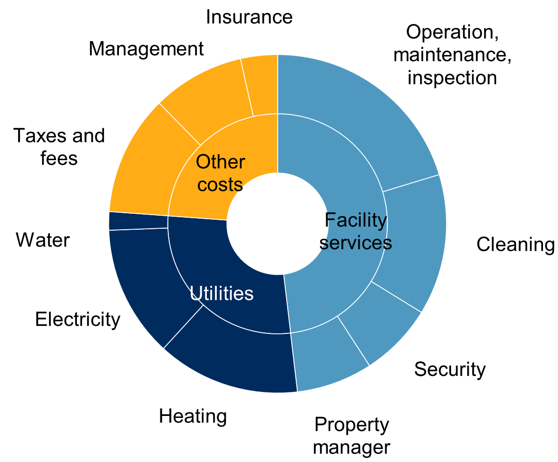
Fixed versus variable recoverable expenses



Sources: Bauakademie Performance Management GmbH, NEO Office Impact Bench Marktl

Chart 6

Recoverable expenses in detail

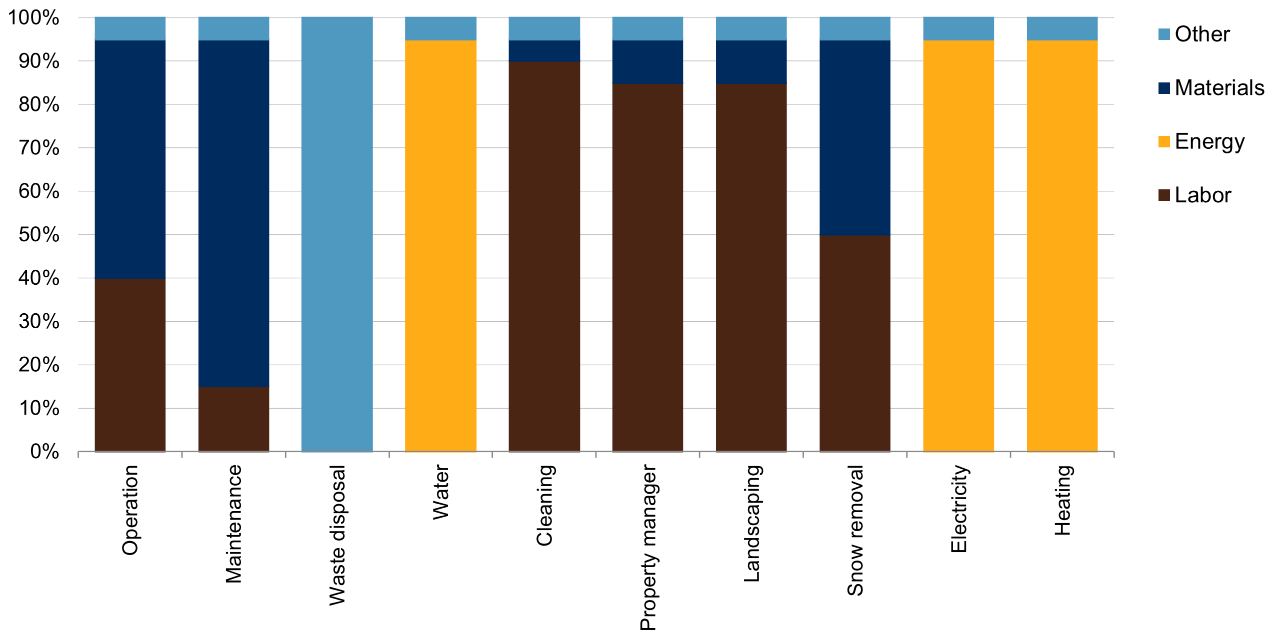


Sources: Bauakademie Performance Management GmbH, NEO Office Impact Bench Marktb

Some of these expenses are more sensitive to changes in energy prices or labor costs (see chart 7). In European CMBS, servicers usually do not report recoverable expenses. Instead, they either include them in the reported total gross rent or just report base rents. We therefore used rental income figures reported between 2013 and 2022 to assess performance changes.

Chart 7

Operating expenses by expense type

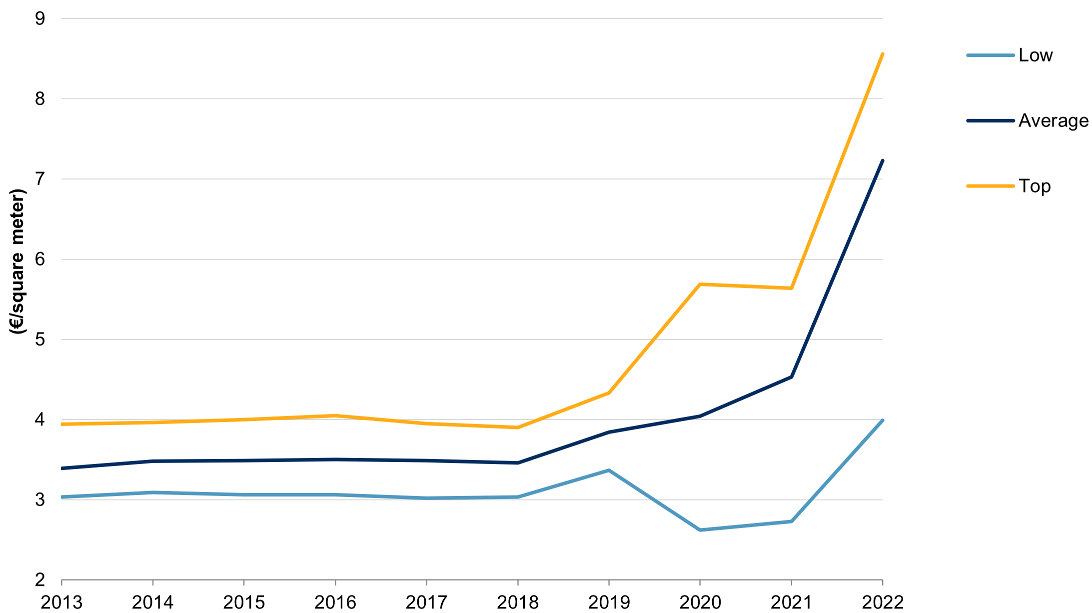


Source: Bauakademie Performance Management GmbH.

Recoverable expenses have not just increased for properties that secure European CMBS loans but also for CRE in general. This increase comes after years of flatlining (see chart 8).

Chart 8

Evolution of recoverable expenses by office quality
2013-2022



Sources: Bauakademie Performance Management GmbH, NEO Office Impact Bench Marktbericht 2022.

The thing tenants really care about, however, is the total cost of their accommodation. If location A has a base rent of €30 per square meter and comes with operating expenses of €5, while location B costs €32 per square meter in base rent and €2 in expenses, tenants, all else being equal, will choose location B, because it is cheaper. Put differently, if landlords can keep expenses under control, their properties are more attractive than their competitors', and they can justify higher base rents.

Non-recoverable operating expenses

Unlike recoverable expenses, non-recoverable expenses directly affect the properties' net cash flows. Our rated universe includes non-recoverable expenses that range from 0% for U.K. buildings under FRI leases to 65% for operating assets, such as hotels. Rising expenses can affect operating assets with lower margins more severely than office buildings (see table 1).

Table 1

Effect of rising expenses on commercial real estate - examples

Office buildings	Base case	20% expense increase	30% expense increase
Passing rent (€)	100,000	100,000	100,000
Non-recoverable expenses (%)	5	6	6.5

Table 1

Effect of rising expenses on commercial real estate - examples (cont.)

Net cash flow (€)	95,000	94,000	93,500
Cap rate	6	6	6
Gross property value (€)	1,583,333	1,566,667	1,558,333
Value decline (%)	N/A	-1.1	-1.6
Shopping centers	**Base case**	**20% expense increase**	**30% expense increase**
Passing rent (€)	100,000	100,000	100,000
Non-recoverable expenses (%)	25	30	32.5
Net cash flow (€)	75,000	70,000	67,500
Cap rate	9	9	9
Gross property value (€)	833,333	777,778	750,000
Value decline (%)	N/A	-6.7	-10
Hotels	**Base case**	**20% expense increase**	**30% expense increase**
Revenue (€)	100,000	100,000	100,000
Non-recoverable expenses (%)	65	78	84.5
Net cash flow (€)	35,000	22,000	15,500
Cap rate	8	8	8
Gross property value (€)	437,500	275,000	193,750
Value decline (%)	N/A	-37.1	-55.7

N/A--Not applicable.

Mitigation strategies to stem the rising expense tide

Based on our conversations with property and asset managers, we believe landlords can benefit from benchmarking initiatives, which will enable them to compare their expenses with their competitors'. In some instances, landlords may do well to lower service levels in accordance with tenants' requirements or to leverage economies of scale by bundling services and properties. Where possible and economically feasible, landlords could also reduce non-recoverable expenses by changing leases and passing on the costs to tenants.

Landlords can, in many cases, even be proactive and help tenants increase office usage, for example by improving amenities or redefining office layouts. Thus, the space can be used more efficiently, while the cost per employee declines.

It's All About Expenses

We believe that the current challenging macro environment demands a stronger focus on expenses. We have already considered higher non-recoverable expenses in our ratings analyses of several European CMBS transactions. We are still concerned that expenses will remain high and that economic pressures will delay the corresponding increase in market rents. It is therefore in the borrowers' best interest to focus on expenses, particularly in the case of low-margin assets. Yet, borrowers who are underwater because they cannot service their debt or refinance their mortgage may be unwilling to invest in cost-saving initiatives. This is when servicers or special servicers will have to step in to maximize recoveries for noteholders.

The current CRE and macroeconomic environment, characterized by a triad of declining demand, falling rents, and rising inflation, does not spell opportunity for borrowers. The increasing pressure to spend cash on upgrading buildings to meet ever-increasing energy efficiency standards does not help either. Many landlords may have no choice but to return the keys to their lenders. We expect that loan defaults in European CMBS will rise, albeit from a very low level. We will continue reflecting our expectations of rising expenses in our reviews of CMBS loans on a loan-by-loan basis.

Related Research

- European CMBS Monitor Q2 2023 , July 21, 2023
- S&P Global Ratings Definitions, June 9, 2023
- Scenario Analysis: European Office CMBS Withstands Vacancy Stress, May 23, 2023
- European CMBS Faces Crunch Time With Loan Maturities Amid Higher Interest Rates; Feb. 23, 2023