

# Wise heads rein in enthusiasm

Strong investment in prime assets is creating a misleadingly positive impression, reports  
**Daniel Thomas**

**I**nvestors have flocked back to real estate after the global crash in 2008, but there are clear differences in the fortunes of the market across the world.

Optimism has returned in many developed markets, which have seen an influx of investors looking for secure returns from physical assets, after the crash wiped as much as half from peak values.

With the realisation that the worst is over, questions are returning as to where and how to generate returns. There is a feeling among the cash-rich investors of sovereign and private family wealth that safety now comes first.

However, the global picture is likely to remain as varied as the pattern of economic growth across the world – unsurprisingly, given the link between gross domestic product and rental growth.

Many analysts expect the strongest increases in property values in fast-growing economies in Asia and Latin America. In Asian centres such as Hong Kong, Singapore and the primary cities of China, investors complain they cannot find the right deals any longer, given the demand for property.

But there are also countries still struggling to lift themselves from the mire of sovereign debt problems and sluggish business activity that are seeing flat or



Go long Hong Kong: rental expectations in markets such as China, Singapore, Poland and Brazil are bullish

Dreamstime

negative results for real estate.

The Royal Institute of Chartered Surveyors in the UK says that rental expectations – a key determinant of value growth – in big markets such as Hong Kong, China, Singapore, Poland and Brazil were among the most bullish, while further rental declines were expected in Greece, Spain, Ireland and Japan. The hard-hit US market is showing signs of recovery, with more investment transactions and bidders per property, although rents are still subdued.

Simon Rubinsohn, RICS chief economist, says: “Solid growth in Asia, Latin

America and parts of eastern Europe is providing significant support for the real estate sector.”

There has already been a strong rebound in the level of transactions. Globally, there was a 53 per cent rise in property deals during 2010, according to Real Capital Analytics, a research company. Europe and Asia recorded similar increases, while activity in the Americas more than doubled.

Average commercial yields have recovered and are now 90 basis points above the 2007 peak for the European Union as a whole, while prime yields for markets such as London and Paris are approaching the 2007 peak. This has meant

activity returning to markets that have been later to recover, such as other French and German cities, and European countries further east.

Turnover in the European real estate investment market totalled €100bn in 2010 – an increase of 35 per cent over 2009. This growth is expected to continue in 2011, according to CB Richard Ellis, the property group, at a rate of 10 to 15 per cent.

So far so good. But why are wiser heads in the industry reining in their enthusiasm?

The recovery of the past 18 months has parallels with a similar bounce in the market after the

crash in the early 1990s.

The cycle always overcorrects during a downturn, and there is usually a corresponding rush of investment once the floor has been found. Afterwards, there tend to be several years of patchy performance.

Sentiment often takes its cue from the fairly restricted markets of the capital cities and then, the prime areas of town.

In these areas, there have been relatively few sales, chased by overseas equity

seeking wealth preservation, not creation, in super-safe assets with stable tenants and long leases.

The effect of this cannot be overstated. Investors ranging from Norwegian sovereign wealth funds to Hong Kong billionaires all want the same prime property.

This has undoubtedly skewed the market, and it is difficult to see that this will change soon. Quite the opposite in fact – prime property in capital cities is likely to continue to

strengthen – but it is leaving the rest of the market in its wake.

Crucial to the feeling that this is not the start of another boom is that values are expected to stay closely linked to rental growth, rather than yield compression, driven by the wall of money. This means that buying in areas of occupier interest is crucial.

DTZ, the consultancy, predicts that occupiers will remain focused on

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prime properties. So markets will mirror economic revival around the world, with stronger economies seeing more tenant demand.

DTZ sees GDP growth in Asian and central European countries as the trigger for demand, strong rental and capital value growth. In contrast, it says, a protracted recovery in the Eurozone with slow GDP growth will produce more subdued increases.

The economic backdrop is not disastrous, but cuts in public spending, tax increases and rising unemployment will have an undoubted effect on markets in the UK and the US, and similar austerity measures could have an impact across Europe.

Central and eastern European markets have bright spots, but these are relatively few outside the remarkably strong Polish property market.

There are other factors. Rising inflation in countries such as the UK could help property, which acts as a modest hedge against this, although any sign that rates are on the rise could damp the market.

There is a long period of deleveraging under way, and this is particularly painful in commercial property with its high levels of debt.

There is still \$6,800bn of debt outstanding in global

commercial real estate, according to DTZ, the majority in Europe and the US. More than one-third is due to mature in the next two years – a huge refinancing burden for the borrowers, as well as a potential windfall for investors seeking distressed stock.

In many places, deleveraging has barely begun, as banks have been supported by low interest rates and quantitative easing programmes that pumped cash into economies.

Banks have been able to sit on bad assets without owning up to losses. This is changing, however, as more leveraged institutions work through their books.

A big problem remains the unwillingness of banks to lend. New capital requirements and a more sober attitude to risk will mean banks will be constrained in lending outside prime markets.

Pricing is moving to reflect this and the threat of rising interest rates. The legacy loans from the property boom do not reflect today's funding costs and that will also need to change. Borrowers will need to find more equity to bridge that gap.

Recent surveys show that there has been a definite shift away from the UK market towards areas that have yet to recover as strongly. But most investors are happiest when focused on the core cities with easy rental growth and demand.