



THE SOVEREIGN DEBT CRISIS AND REAL ESTATE

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INTRODUCTION

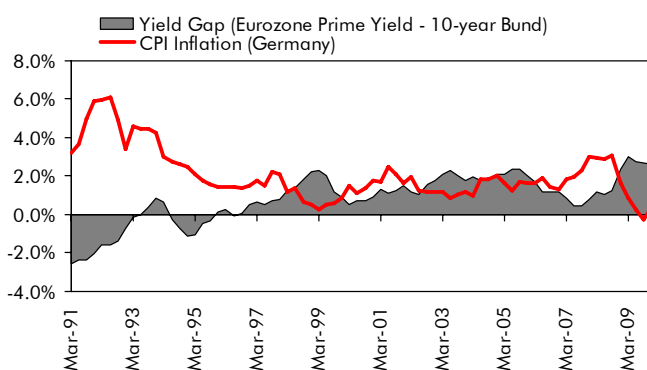
The turmoil in the government bond markets in recent weeks has captured a great deal of attention. However, beyond the political and economic fallout of the Greek debt crisis, real estate investors will want to know what the implications are for their sector.

We have argued that the recent strength in the real estate market has to a significant extent been driven by the yield differential between prime property and government bonds. If that is really the case, then the question must be asked whether the recent increases in government bond yields in a number of European countries will have a negative impact on the property market recovery that we have seen over the last year.

BOND PRICING AND REAL ESTATE

There is a relationship between the pricing of real estate and that of government bonds. However, it is a complex one because of the part bond/part equity nature of property. Previous studies that have looked at the correlation between the two show that as a result the relationship between the pricing of property and index-linked bonds is much closer than it is with fixed-interest bonds^[1]. As the chart below shows, there is a close inverse relationship^[2] between the rate of inflation and the yield gap between government bonds and the average prime property yield.

Property Yield Gap and Inflation



Another complication is the fact that real estate is not a homogeneous asset class. Every property has different characteristics and these (in particular the length of lease and financial strength of the tenant) will make each more, or less bond-like in its performance. This is particularly important in today's market as a high proportion of the properties being traded at the moment, and certainly those for which there is greatest competition, are those with the most bond-like characteristics – long leases to strong covenants.

The simplistic conclusion is that if these properties have bond-like characteristics, and the yield on government bonds increases, then the yield on these properties ought also to increase, driving down the price. However, whether this will in fact be the case will depend on exactly why yields on government bonds are rising.

INFLATION?

There are many factors that might drive up government bond yields, but the expectation and/or fear that bank base rates will increase in the future is perhaps the most common. Put simply, the yield at which investors are prepared to buy a 10-year government bond should be the average of their expectations for short-term interest rates (such as base rate) over that period, plus a margin for tying up their capital.

[1] For example "You were warned", Andrew Baum, I&PE Real Estate, December 2009 (based on his book *Commercial Real Estate: A Strategic Approach*)

[2] The correlation coefficient over the last 20 years is -0.74 based on quarterly data for the average prime yield (all sector) for the Eurozone, the 10-year German government bond yield and CPI inflation in Germany.

If it is rising interest rates that drive up government bond yields, then the yield on all bond-like investments will also need to increase to maintain the balance in terms of risk adjusted returns. The relationship will not always be a straight line. Rising inflation is the most common reason for rising interest rates and even the most bond-like property will normally have some growth potential in the long run if inflation is high, whereas a government bond has none at all. As is shown above, inflation is significant in determining the level of prime yields in Europe.

However, rising interest rates are not the reason why the yield on the government bonds of certain countries is rising at the moment. As members of the Eurozone, base rates in Greece, Portugal, Ireland, Italy and Spain are set by the European Central Bank (ECB) and match those for France and Germany. Yet the rises in government bond yields that have been seen in the last few months have been limited to a selection of countries. Those for German government bonds have actually declined since the start of the year.

The 'spread' between German government bonds and those for most other European countries has increased markedly over the last three years. Before the credit crunch they were very small^[3] and

Ten-Year Government Bond Spread compared to Germany (bps)

	29/9/06	28/9/07	29/9/08	29/9/09	26/2/10
Germany	3.71	4.34	3.96	3.24	3.11
France	2	10	33	27	31
Netherl'ds	3	7	32	25	29
Finland	4	6	36	29	13
Austria	4	9	43	40	45
Spain	1	7	55	54	76
Ireland	5	-1	62	140	142
Italy	29	23	86	76	88
Greece	31	28	92	125	346
UK	82	70	42	37	93
Switzerland	-130	-133	-122	-120	-120

[3] As indeed should be the case in normal market conditions. The government bonds issued in all of the Eurozone countries are denominated in Euro, pay interest in Euro and will ultimately be redeemed for Euro which can then be freely moved between the different Euro countries. In contrast investors in other countries' bonds (such as the UK or Switzerland) are exposed to a different inflationary and exchange rate risk justifying potentially very different yields.

[4] OECD Forecasts November 2009

although there has been an increase, for the majority of countries the spread is still narrow. However, Greece in particular has seen the spread increase markedly. For example in September 2007, Greek 10-year government bonds yielded 28 basis points (bps) more than the equivalent German bond. At the end of January 2010, this gap was nearly 400 bps.

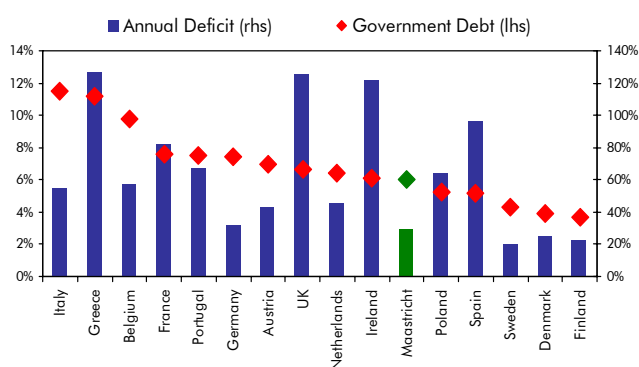
LIQUIDITY OR DEFAULT

There are two main explanations for the very substantial spread between government bonds in some of these different Eurozone countries.

At the lower end of the scale it would appear to represent a premium to reflect the lower liquidity of some countries' bonds. Most of the investors in 10-year government bonds are very highly risk-averse institutions. Even the slightest hint of additional risk will result in some investors completely avoiding them. Germany's long track record of fiscal prudence means that its bonds are the most acceptable of any in the Eurozone. They are thus the most easily converted into cash in large amounts and at short notice, qualities that are highly valued by the market at the moment.

While liquidity risk is a factor in real estate investment, it does not operate in quite the same way. Each city's property market has its own liquidity, completely independent of the county's bond market and it is evident that property in the most liquid cities is currently attracting the most investor interest. This 'risk' therefore, is already priced in.

Government Debt and Deficit^[4] in 2009



However, liquidity risk is not sufficient to explain the very big premium on Greek debt at the moment. To understand this it is necessary to look for other explanations, such as the (still relatively small) possibility of a number of extreme events including outright default and the possibility that the country may be forced out of the Euro. It is easy from the chart to see why Greece is being singled out at the moment as facing the highest risk, with an annual deficit of over 12% of GDP on top of an existing accrued debt of more than 100% of GDP.

Such extreme events would certainly have an impact on the market for bond-like properties, but perhaps not to the same degree as might be expected.

The risk of a tenant defaulting on a rental payment is independent of the credit risk at a country level. A property let on a long lease to a major international company – PWC or HSBC, for example – will continue to generate rent almost regardless of what is happening to the sovereign debt of the country where it is located. In addition, whereas normally in the case of sovereign default an international investor (in whatever type of asset) would also experience a huge loss as a result of the devaluation of the currency, that will not necessarily be the case in this instance and any investor from the Eurozone itself would see no currency loss whatsoever.

Nor is it quite certain what would happen if a country left the Eurozone^[5]. As the Euro will continue to exist, it is possible (although unlikely) that contracts, including leases, written in Euro will continue to be payable in Euro. However, where properties are let to local occupiers, dependent on local revenue streams, the investor is less secure as such businesses may struggle to continue paying rents in Euro in the event of a substantial devaluation.

In fact, the properties most likely to suffer as a result of the current crisis in the government bond markets are those with the least bond-like characteristics. Restoring faith in public finances will require public sector austerity, with substantial cuts in public spending, public sector wages and public sector employment^[6]. This, in turn, will have a negative impact on economic growth in the short-medium term and therefore reduce tenant demand, pushing down rental values and impacting on the income generated from property with vacancy risk. Properties with long, secure incomes will experience these effects eventually. However, the fact that this pain is deferred means that the immediate impact on capital value will be less severe and it is possible that by then economic conditions may have improved.

CONCLUSION

Ultimately, the real estate investor has less to fear from the volatility in the sovereign debt market than might first appear and the investor in prime property probably least of all. Despite all the talk, the risk of sovereign default and/or a country leaving the Eurozone is still very small. The most significant impact on property will come from the measures taken to restore national finances which will depress rental values in the short to medium term. Secondary property, which is more exposed to changes in the market, is therefore more likely to see an impact on its value than prime.

[5] There are examples in the past of countries leaving a currency union in this way. The most relevant is probably Ireland's break from sterling in 1979. However, in the unlikely event of the forced withdrawal of a country from the Eurozone, the process would probably be very different from that long-planned procedure.

[6] Such as those already being implemented in Ireland

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