



THE STRATEGIC CASE FOR PROPERTY IN EMEA

By Michael Haddock, Director Capital Markets Research, EMEA

INTRODUCTION

For the majority of multi-asset investors commercial real estate forms a relatively small part of their portfolio. The vast majority tends to be concentrated in bonds (both government and corporate) and equities. However, the credit crunch and subsequent economic recession have had a dramatic affect on asset values in all sectors. Therefore as they look forward asset allocators will be considering what distribution of assets will produce the best results.

With that in mind, it is worth considering the criteria that they will be using to judge their allocations and whether, after the changes that have taken place over the last year and a half, property still looks attractive as an asset class. In doing so, we are looking specifically at the strategic case for property over the long term, rather than the relative short term performance of the market.

REASONS FOR INVESTING IN PROPERTY

In a traditional approach to asset allocation, there are fundamentally three reasons why an investor might want to put money into real estate:

- High income component of returns,
- Diversification,
- Relative/risk adjusted returns.

High income component of returns: For some investors the distribution of returns between income and capital value is an important part of the investment decision. This is particularly true of asset allocators that are following an asset-liability matching strategy. Such strategies are becoming ever more appropriate as pension funds make the transfer from net cash inflows to net cash outflows. As they do so, current yield will become a more important investment characteristic. The aging of Europe's population should therefore increase the number of investors who value this quality of real estate.

Over the last 15 years, inflation has been relatively low. Moreover, with most of Europe's economies in recession this low inflation environment is expected to continue for at least the next few years. In such periods real estate tends to be the asset class that delivers the highest proportion of its returns in the form of income. The growth potential of equities means that the initial yield that they generate tends to be quite low. For example, the dividend yield on the FTSE 100 is currently around 4.75% and this in turn represents a big increase on the sub-3% yield being generated in mid-2007.

In contrast, the income from bonds is fixed (and should therefore be compensated by a higher initial yield). However, in a low inflation environment the real estate risk premium is often enough to ensure that property produces a higher initial yield even though it has the chance to benefit from future growth. In the current cycle, the average prime office yield in Europe has been higher than the German 10-year bond yield since 1996.

The repricing that has occurred over the last year has reinforced this position. Initial yields from real estate have risen significantly in all European markets, even for prime property. The average prime yield for European offices has increased by nearly 1.25% percentage points since the peak of the market in mid 2007, from 4.76% to 5.99% and the increase in some individual markets has been significantly more.

Prime Office Yields (%)

	At Peak of Market	At end-Q4 2008
Frankfurt	5.00	5.40
Paris	3.60	5.75
London (City)	4.25	6.65
Milan	5.00	5.75
Madrid	4.25	6.00

The income return on equities has also increased, due to the fall in the capital value of shares. However, there is greater uncertainty surrounding that yield, than the income return from property. Many companies are starting to cut dividends due to the recession; while rental income is contractually guaranteed, dividends are discretionary.

At the moment, European government bonds are typically yielding 3-4.5% and equities are showing average dividend yields of 4.5 to 5.5%. Compared to these, therefore, the average initial yield of around 6% for prime real estate (with higher initial yields available from secondary property) will continue to attract investors who favour a high income component to returns.

Diversification: In the past, the returns from real estate have had a low correlation with those from other assets such as bonds and equities. The lack of adequate real estate performance data means that it can be difficult to establish the exact level of correlation. The nature of real estate (its inherent heterogeneity) and the limited number of transactions even in the most liquid markets mean that the sort of indices that are available for bonds and equities are not available for property. The closest alternative is performance data such as that generated by IPD, but this too has problems. For most countries the time period covered is too short, the data frequency (normally annual) means that the number of data points is small, and because it is based on valuation rather than transactions the accuracy is also open to question.

The best available evidence does suggest that real estate can have a low correlation with the other major asset classes. Where long time series of IPD data are available, the correlation of real estate with either bonds or equities tends to be much lower than that between bonds and equities.

The varied lease structures adopted across Europe contribute to this diversification. They make the cash flows generated by property very different from the coupon paid on bonds or the dividend paid on equities. In most European countries rent is index linked (at least in the short term) and in some instances it can be a long time before the rent reverts to open market value. Rent is also contractually guaranteed, unlike a dividend that can be cancelled at very short notice.

Its low historic correlation means that property is regarded as adding considerably to the risk-adjusted returns from a portfolio. However, this diversification case has taken something of a hit over the last year. In the current cycle, the downturn in real estate prices has coincided with a downturn in the equities market.

Stock markets around Europe peaked in mid to late 2007, a date that also coincides with what is probably the peak of the commercial real estate market. Since then both asset classes have seen considerable falls in value, although in most cases equities have seen a greater decline in value than has been the case for property.

Overall, the events of the last year and a half have, if anything, reinforced the position of real estate as offering a cross between bonds and equities. The high income component of returns means that it has many bond like properties, but the ability for income to grow provides a partial inflation hedge which protects the investor in the event of a sudden return to an inflationary environment.

Typical Lease Structures in Europe

	Typical Lease Length	Frequency of 'mark to market'	Annual Indexation
Frankfurt	5-10 years	5-10 year	75% of CPI
Paris	9 years	3-9 years	100% of CCI
London (City)	10 years	5 years	None
Milan	6-12 years	12 years	75% of CPI
Madrid	3-5 years	3-5 years	100% of CPI

CPI – Consumer Price Index

CCI – Cost of Construction Index

Risk adjusted/Relative returns: For most investors the most important reason for choosing to invest in property (or indeed any asset class) is the belief that it will generate higher returns than other asset classes over the investor's time horizon. Depending on the investor that will mean either in absolute terms or more likely on a risk adjusted basis.

Historically the returns from real estate have fallen between those of bonds and equities^[1] and the low risk profile of property means that on a risk adjusted basis the asset class looks very attractive. As in the case of diversification, there is a question mark over whether the data available for real estate shows a true picture of its risk^[2]. Data frequency is also an issue, and the fact that real estate indicators are based on valuations rather than transactions makes them subject to systematic errors (such as smoothing and lagging). There is certainly a perception among asset allocators that real estate is riskier than the raw data shows, although even where adjustments are made they tend just to put risk adjusted real estate returns in line with those of bonds and equities.

Time horizon is crucial to expectations of real estate returns. Looking forward, it is arguable that the extent of the repricing that has occurred is already enough to make real estate look attractive in the long term. Prime office yields in many European cities are now very close to the highs that they reached during the recession in the early 90s. This is particularly noteworthy, as the outlook for rental values does not appear to be as negative as it was then and the risk free rate (government bond yields) is significantly lower. The gap between the average prime office yield and the 10-year German government bond is now at its biggest for at least 20 years.

Prime Office Yields (%)

	End Q4 2008	Increase from peak	Early 90s high
Frankfurt	5.40	40	5.50
Paris	5.75	215	6.00
London (City)	6.65	240	6.75
Milan	5.75	75	6.50
Madrid	6.00	175	7.50

The repricing of real estate has not just been confined to 'prime' property. Average yields have also increased markedly. The average yield in the UK (according to the IPD monthly index - December) is now 8.4%, up from a low of 5.4%, showing that yields for secondary property have increased by more than prime yields.

This increase in initial yield has also happened for several other asset classes (for example equities and some corporate bonds). The initial dividend yield on Europe's major stock markets has increased significantly over the last year and a half.

Stock Market Dividend Yield (%)

	Current (Jan 09)	2007 Market Low
FTSE 100	4.75	2.91
CAC 40	5.30	2.43
DAX 30	5.26	2.22

Different investors take different views of the market, in terms of the returns necessary from particular asset classes and the outlook for future performance. Which asset class therefore represents 'best' value at the moment in terms of relative returns is therefore a matter of opinion. Certainly in the past, it has been a significant buy signal when the dividend yield from the stock market has risen above the 10-year government bond rate. However, the very weak outlook for inflation will certainly limit the potential for growth in dividends over the next couple of years and it can be argued that the credit crunch has left government bonds at artificially low yields.

Although at current prices real estate appears to be offering good value in the long term, this is not the only factor that potential investors are looking at in terms of timing their entry into the market. Short-term price trends are also crucial in a rapidly changing market. Even if they believe that property offers good value in the long term, investors will still choose to wait if they also believe that prices will be lower in the short term. This appears to be the stage that the market has reached at the moment, with many institutional investors reaffirming their long-term commitment to real estate, while still choosing not to be net investors.

[1] Although recent falls in equity markets mean one has to look at the very long term to establish this hierarchy.

[2] In this context risk refers to the volatility of returns.

Short-term price trends are almost impossible to forecast, depending as they do on sentiment rather than fundamentals.

Clearly at present sentiment is very strongly against real estate. The credit crunch itself has had a direct effect by reducing the amount of debt finance available to investors. This has been particularly important, as up to mid 2007 the easy availability of credit meant that real estate had become an increasingly leveraged sector. The subsequent recession has also had a negative impact on sentiment towards commercial property. Falling economic output and falling employment will decrease rental values and increase vacancy rates and tenant defaults, although by differing amounts from country to country and from sector to sector. Finally, the sheer level of uncertainty surrounding all aspects of the future means that investors are applying an increased risk premium to all asset classes other than cash and the safest government bonds.

In the short term, therefore, a turnaround in the real estate market will depend on addressing some or all of these issues. In particular, a significant turn around in the market is unlikely until investors feel greater certainty about the outlook for the economy and therefore rental values and vacancy rates.

CONCLUSIONS

The credit crunch and the subsequent Europe-wide recession have not fundamentally changed the case for property in a multi-asset portfolio. It still provides an important source of diversification, and the high income component of returns is valued by an increasing number of investors.

Whether property currently represents 'good' value is a matter of opinion, but in comparison with the past the current downturn has already brought yields in line with the bottom of previous cycles.

The biggest influence on the recovery of the market, therefore, is investors expectations of the short term market trends. They are unlikely to make a significant move back into the market as long as they perceive that prices will continue to fall in the short term. However, this point may be approaching as although the overall European market slowed further in the last quarter of 2008, investors are starting to express increased interest in some markets. The UK in particular is witnessing increasing levels of interest, particularly Central London where the degree of re-pricing has made much of the core market attractive to the long-term investor.

For more information regarding the ViewPoint, please contact:

Michael Haddock

Director, EMEA Research

CB Richard Ellis

St Martin's Court

10 Paternoster Row

London EC4M 7HP

t: +44 20 7182 3274

e: michael.haddock@cbre.com

Disclaimer 2009 CB Richard Ellis

Information herein has been obtained from sources believed to be reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CB Richard Ellis clients, and cannot be reproduced without prior written permission of CB Richard Ellis.

© Copyright 2009 CB Richard Ellis