July 2010

# European Quarterly

## Market Perspective

### Executive Summary

- Europe's economic recovery appears to have gained traction in the second quarter, although growth forecasts remain downbeat.
- Real estate debt markets are showing signs of life, despite wider pressures on the banking system. The focus of lending activity continues to be on prime real estate in core, Western European cities, although there are some signs that risk appetite is returning. Fears that real estate borrowing costs could rise sharply are probably misplaced.
- Investment activity continues to grow, with retail sector transactions dominating deal flows. However, yields were unmoved in the second quarter, halting the rebound in prime capital values.
- Listed market volatility rose in the second quarter, as the wider equity markets reacted to investors' heightened concerns about sovereign credit risk. Companies with even a small exposure to Southern Europe have been severely punished.
- Prospects for real estate occupier markets are beginning to improve and rent levels have stabilized in most markets. However, the path of the recovery remains uncertain, and the synchronized downturn should make way for a greater divergence in performance across markets and sectors.

### Economic Environment

Despite renewed financial market jitters, Europe's economy appears to be recovering to some degree. Economic indicators such as the Purchasing Managers Index have climbed higher as a weaker euro boosted Europe's exporters, notably trade-driven Germany. In turn, improved demand in Western Europe is having a positive effect on Central and East Europe's economies, almost all of which are running double-digit manufacturing output growth rates.

Despite the recent flurry of better news, the road ahead will undoubtedly remain bumpy. Elevated public debt ratios – particularly in Southern Europe – have sparked growing concern that a sovereign default could usher in a renewed wave of distress in the financial system. Rising bond yields highlight the need for immediate policy action to appease markets, which will weaken near-term GDP growth prospects. Core Europe, which has more breathing room, hopes to foster some recovery in private sector growth before "austerity" measures kick in. Even so, growth forecasts throughout Europe are downbeat and with considerable private sector slack persisting, monetary policy should remain supportive in the near term.

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## Debt Markets

The sovereign debt crisis has put Europe's banking system under pressure. The popularity of the European Central Bank's (ECB) deposit facility suggests that banks are still reluctant to lend to one another in the interbank markets, raising questions about how the system would cope unassisted. The ECB's purchases of government debt on the secondary market and results of the ongoing "bank stress tests" will hopefully help to calm frayed nerves. However, proposed new regulations point to more stringent capital requirements and, ultimately, higher funding costs. Given this backdrop, it is unsurprising that real estate lending terms and conditions remain tough.

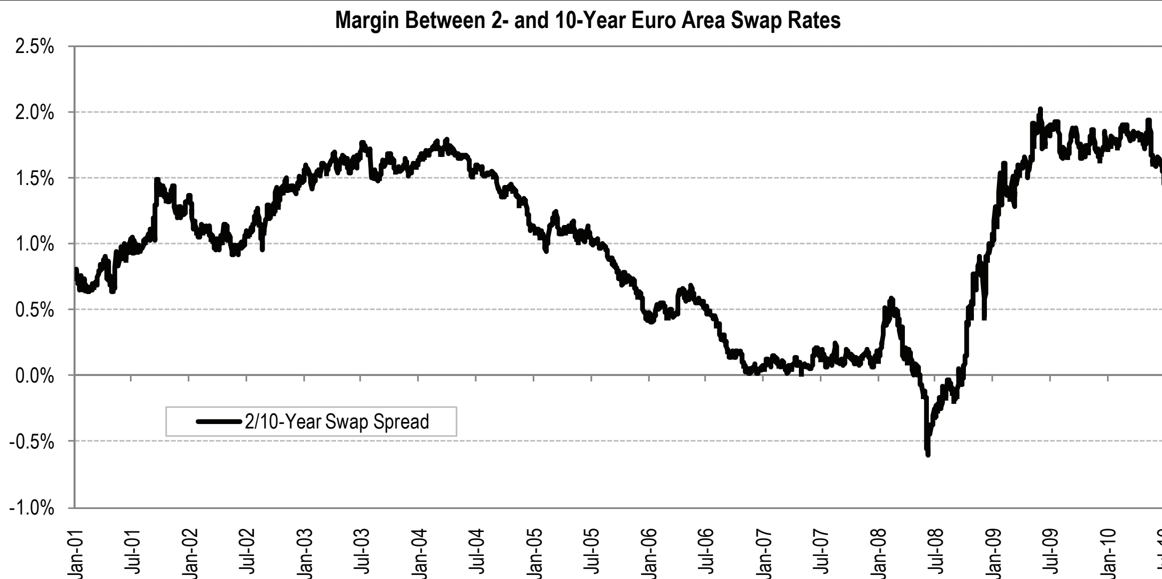
Nevertheless, there are some signs that lending markets are sputtering into life. Interest rates are low, while margins on senior and mezzanine debt appear to be edging downwards and loan-to-value (LTV) ratios are rising. According to Savills, at least 15 major banks, predominantly from the UK and Germany, are back in the market and "consistently" lending on bigger tickets. In a sign that risk appetite is gradually building, banks are once again competing for deals, while spreads in the pfandbrief market are nearly back down at pre-crisis levels. Lending remains focused on prime assets in core Western markets, but debt is becoming more available in Central and East Europe and on secondary assets in the UK and France. Some banks are even reconsidering development finance, although such deals are contingent on having tenants in place.

But the bumpy economic conditions and worries about sovereign default are ensuring that lenders remain nervous. Banks in France and Germany have a combined exposure of nearly €750 billion to Greece, Ireland, Portugal and Spain, according to the Bank for International Settlements. With capital ratios still fragile, an escalation of prospective losses could nip the nascent property lending recovery in the bud. Unwilling to stomach capital write-downs, most lenders remain reluctant to realize losses on property by selling distressed debt. There is risk that property values will decline, which could exacerbate bank losses, but maturing debt by-and-large continues to be extended. Although banks are gradually warming to the idea of restructuring performing loans, it remains unclear how they will approach the estimated €300 billion of real estate loans due to mature by the end of 2011.

With new bank loans limited to a maximum LTV of 65-70%, according to CBRE, the market for mezzanine debt is growing. Many property owners are seeking loans with LTVs of up to 85%, but Basel II rules on capital requirements effectively shut out banks from the 70-85% mezzanine space. With CMBS still off the table for all but a few deals, that creates a gap which is being filled by lenders who provide the additional proceeds through a "tri-party" agreement. Mezzanine debt is attractively priced for lenders, suggesting that capital remains scarce relative to the size of the market. While this situation persists, borrowers will continue to find it hard to access funding for big-ticket deals.

Right now, issues about the functioning of markets are dominating, but at some stage monetary policy will begin to "normalize" and interest rates will rise, triggering fears of higher borrowing costs. However, this fear is probably misplaced. First, the elevated gap between two-year and 10-year swap rates suggests that investors are expecting higher interest rates. Second, lenders' margins essentially reflect confidence in the health of the asset class. If interest rates are raised in response to an improvement in underlying economic activity, then the conditions should be in place for real assets, including real estate, to prosper. In this case, margins would surely move downwards, helping to offset increases in the policy rate.

**Gap Between 2- and 10-Year Swap Rates Suggests Investors are Expecting Higher Interest Rates**




Bloomberg, Pramerica Real Estate Investors Research

## Investment Activity

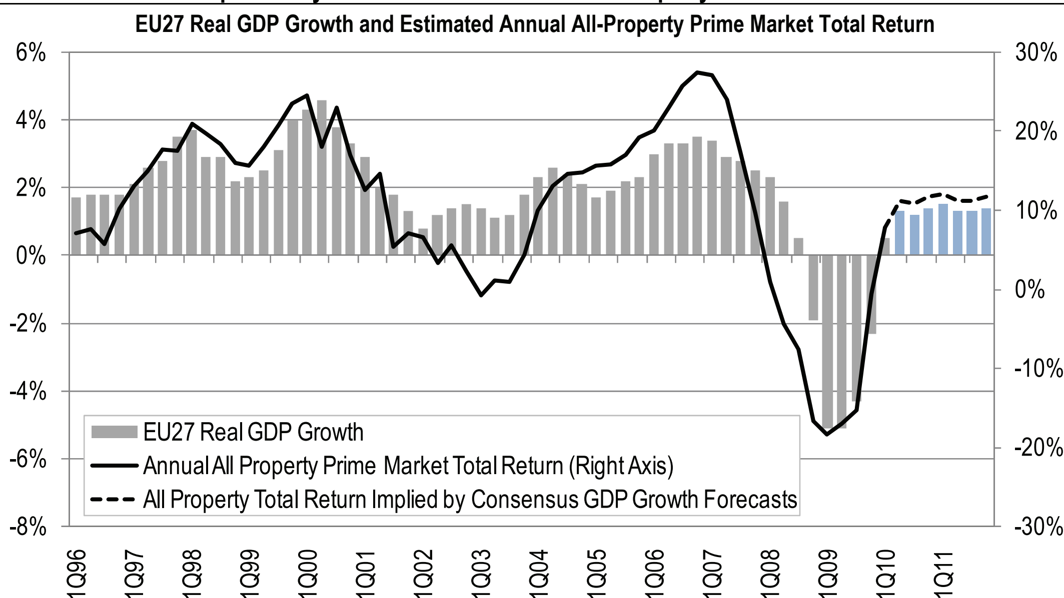
According to DTZ Research, total transaction volume rose to €21.4 billion in the second quarter. The €41 billion recorded in the first half of 2010 is up 85% over the same period a year ago. Most notable has been the increased prominence of retail sector deals. Retail has accounted for one-third of total transaction volume so far this year, compared to an average of about 25% over the past 10 years. Retail has taken the largest share of investment in Germany, Italy, Netherlands and Spain in the first half of 2010, according to DTZ. Although retail transactions are typically “lumpy” and capital-intensive, well-let shopping centers are viewed as a defensive asset and are currently favored by lenders.

Despite the strides made by the investment market, the capital raising environment remains fraught with difficulties. INREV’s latest Capital Raising Survey showed that Europe’s non-listed managers raised just €5.9 billion in 2009, down 60% on 2008’s recession-hit total. Nearly 87% of new capital was placed with core funds, as investors positioned themselves well down the risk curve. While managers expect the focus to remain on core funds this year, there are some tentative signs of risk appetite improving in the wider market. Most prominently, outside investors have stepped up their interest in Central and Eastern Europe, after having been largely absent through the second half of 2009. For example, of the €1 billion of deals completed in Poland this year, €870 million has been provided by foreign investors.

In the absence of rental growth, the pace at which yields fell in a number of markets over the preceding year raised concerns that the recovery may be false. Put another way, the V-shaped movement of values simply didn’t reflect market fundamentals. However, flash estimates from CBRE show very little prime yield movement across most European markets in the second quarter, implying that the recovery in values has paused. Rather than being a cause for concern, the pattern is consistent with the idea of a bumpy recovery.

The numerous pressures on real estate values reflect the uncertainty in the economic outlook. Yields appear to be at or below "sensible" estimates of fair value in many markets, suggesting investors are already pricing in a bullish rental recovery. At the same time, lower LTV limits imply that investors will need to achieve a higher return on equity to hit existing return targets. Over time, prime market real estate returns tend to be correlated to real GDP growth. The poor economic outlook implies that returns could be lower than in recent history, which has the potential to leave some investors disappointed.

**Economic Outlook Implies Only Modest Total Returns From Property**




Eurostat, Consensus Economics, Cushman & Wakefield, Pramerica Real Estate Investors Research

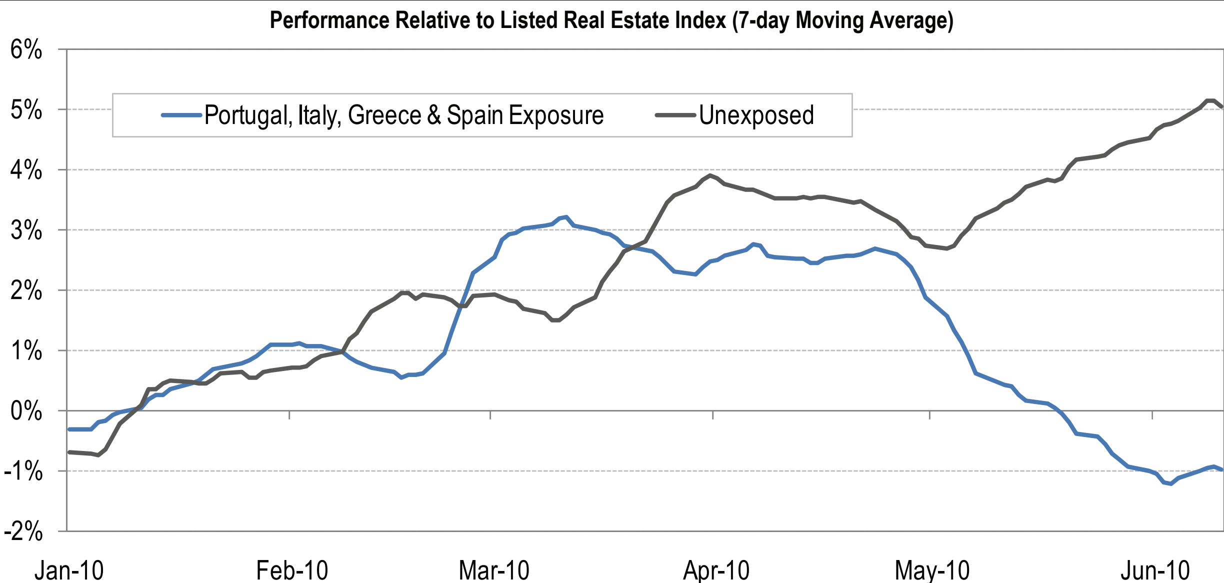
## Listed Sector

In contrast to the private markets, where positive news on current activity has eclipsed concerns about the path of the recovery, the public markets face greater uncertainty. Volatility rose in the second quarter, as markets came under considerable pressure due to investors' heightened concerns about sovereign credit risk and the impact of fiscal tightening. Despite better news from underlying real estate markets, the EPRA Europe price index was unable to defy wider equity market trends, falling 10.4% during the second quarter.

The performance of listed property companies varied widely during the recent sell-off. Some factors that have a bearing on the variations include currency movements and exposure to countries with sovereign credit problems. Markets have demonstrated a preference for companies with assets in "safe-haven" currencies such as Swedish Krona and Swiss Franc. Companies with even a small exposure to Southern Europe have been severely punished.

Following a strong start to the year, there has been something of a retrenchment in capital-raising, as equity issuance fell 50% in the second quarter. In part, this reflects the fact that companies no longer need to raise capital to repair damaged balance sheets, although this does not tell the whole story. In line with the difficulties faced by private markets, several IPOs were pulled due to a lack of investor demand and at least one large bond issuance fell by the wayside as debt capital markets ran out of steam.

**Exposure to Southern Europe Severely Punished**




Note: This has been constructed from two unweighted baskets of real estate stocks. Companies with any exposure to Portugal, Italy, Greece and Spain have been placed into the "exposed" basket. Performance is relative to a wider listed equity index in which 1/1/10 = 100.

Kempen, Pramerica Real Estate Investors Research

## Space Markets

As the economic recovery gains momentum, the prospects for the occupier markets are beginning to improve. Rent levels in the second quarter stabilized in all sectors, particularly in core Europe where the recovery is most firmly on track. However, the path of the recovery remains uncertain, particularly given the potential impact of fiscal austerity on employment and spending. The synchronized downturn looks set to make way for a greater divergence in performance across markets and sectors. Key to this will be the idea of a two-speed Europe as painful economic adjustments in peripheral countries look set to hold back output growth relative to the more competitive core.

*Office:* Most of Europe's major office markets are now recording improved leasing activity, with Dusseldorf, Barcelona, London and Brussels posting the strongest gains. There is a clear distinction between the performance of prime space and everything else, and the bulk of new leases are corporate relocations to better-quality space on attractive terms. At the same time, vacated space is effectively being withdrawn and shortages of top-quality space are appearing in a number of markets. However, only a handful of markets such as Paris CBD, London West End, Oslo and Stockholm recorded headline prime rent growth in 2Q10. Elsewhere, rental growth was broadly flat in core Europe and remains under pressure in Southern Europe. Headline rents fell in Portugal and Greece, while rent-free periods are still climbing in Italian markets.

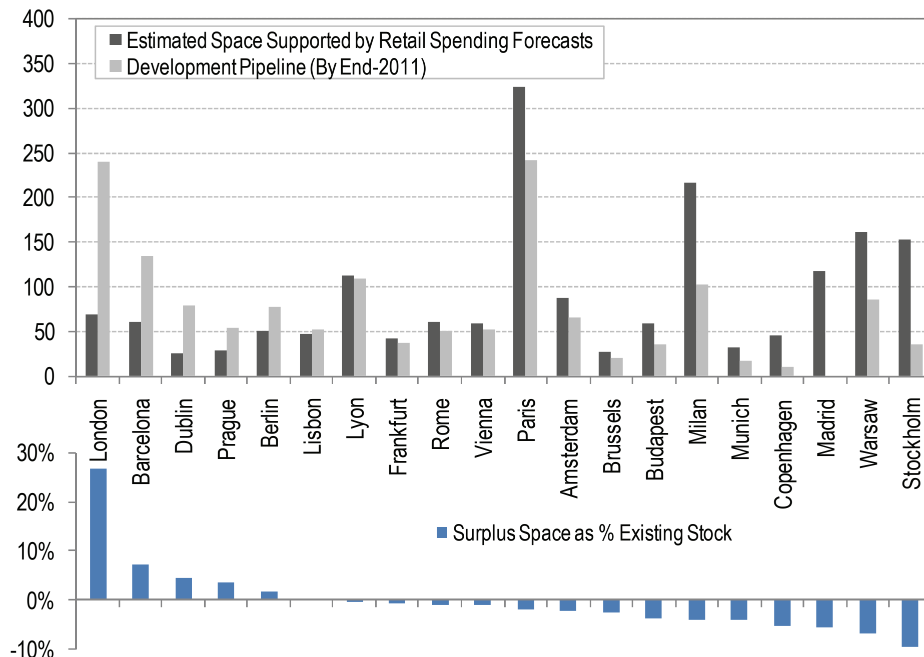
The office market recovery should be diverse across the continent. Vacancy could rise and rents fall in a number of cities this year, with markets in Southern Europe looking particularly vulnerable in light of pressing austerity measures. Headline rental growth will likely remain subdued in high-vacancy markets such as Amsterdam and Frankfurt, where the adjustment will initially be via effective rents. However, most of Europe's major office markets continue to report little in the way of new development starts. A strong

recovery in employment is by no means guaranteed, but a return to anything approaching "normal" levels of leasing activity could quickly translate into shortages of prime space, notably in London and Paris.

*Retail:* Consumer and retailer confidence indicators have improved sufficiently from the depths of 2009 to be consistent with a stabilization of occupier demand, if not some positive headline rental growth. However, the reality is that retailing conditions remain tough across Europe. The household sector is yet to meaningfully contribute to the nascent recovery and retail sales growth remains feeble, squeezing retailers' margins. Major retailers have limited expansion plans, with new development taking longer to lease as a result. Of the formats, retail warehousing is the weakest performer, recording negative year-on-year rental growth as a consequence of Europe's moribund housing market. In contrast, high street and shopping center rents are holding up reasonably well in most major cities.

Given the capital-intensive nature of shopping center developments, it is hardly surprising that the pipeline has slowed significantly. Completions are set to fall by nearly 20% this year to just 6 million square meters, with only another 5 million sqm slated for 2011. Taking prevailing sales densities and projecting forward based on expected growth in retail spending, the pipeline looks sensibly restrained across much of core Europe. Assuming current vacancy rates are manageable, Copenhagen, Stockholm, Munich and Warsaw look to offer rental growth opportunities as supply is limited compared to expected demand. The same does not apply to Madrid, which suffers from high vacancy in a number of shopping centers. At the other end of the scale, Barcelona, Berlin, Dublin and Prague could face oversupply. London's figures largely reflect Westfield's Stratford City, which is the largest development currently in the pipeline.

**Shopping Center Development Pipeline Looks Well Contained**




Cushman & Wakefield, Economist Intelligence Unit, Experian Business Strategies,
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*Logistics:* That the economic recovery is being led by manufacturing and trade should be interpreted as a positive sign for the logistics sector. Trade growth has rebounded but remains below pre-recession volumes, implying that the sector is operating with a degree of spare capacity. With consumer spending also somewhat tepid, it is unsurprising that warehouses have seen limited recovery in rents. Few markets posted marked drops in headline rents during the recession, so it follows that there has been modest rental growth in only one or two markets during the recovery.

Looking at the dynamics of the recovery, it would be tempting to point to Central and East European markets for outsized performance, given the spectacular trade and production growth rates being recorded there. But aside from the fact that markets such as Poland have a large amount of vacant space to absorb new demand, volume matters greatly in a real estate context. To illustrate: Prague or Warsaw airports would need to grow by 50% to achieve the same increase in physical volume in air freight as a 1% increase at Frankfurt Airport. As such, major logistics hubs in Western Europe will continue to dominate investor interest.

**Closing Thoughts**

Recent news on both the wider economy and real estate markets has generally been positive. Real estate values have stabilized or risen in most markets and transaction activity is making a steady comeback as lenders begin to re-establish themselves in the market. Yet there is a rising feeling of uncertainty, stemming from broad concerns about sovereign debt that feed into banking sector jitters and, ultimately, the fear that the economy may run out of steam in the face of public sector austerity.

In a real estate context, this is manifested as a fear that the recovery may be getting ahead of itself. Capital values have improved based on falling yields, which are already leaving return targets hard to achieve in the context of a muted rental value recovery. Whether this plays out in the form of a double-dip or simply a muddling along, one thing is clear: the path will remain bumpy.

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