IPF Research Programme 2011–2015

SHORT PAPER 17

Implications of the Eurozone Crisis for the UK Real Estate Market and UK Investors: A Discussion Paper

This research was commissioned by the IPF Research Programme 2011–2015

JUNE 2012

This research was funded and commissioned through the IPF Research Programme 2011–2015.

This Programme supports the IPF's wider goals of enhancing the understanding and efficiency of property as an investment. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high-quality analysis on a structured basis. It encourages the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The Programme is funded by a cross-section of 22 businesses, representing key market participants. The IPF gratefully acknowledges the support of these contributing organisations:

IPF Research Programme Short Papers Series

The Implications of the Eurozone Crisis for the UK Real Estate Market and UK Investors: A Discussion Paper

IPF Research Programme 2011–2015

June 2012

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1. INTRODUCTION

As the market makes its way to the halfway mark of 2012, Europe's debt crisis rolls on unabated. Nicholas Sarkozy's defeat to Socialist rival François Hollande in the presidential elections at the beginning of May was the first time in 30 years that a French president has failed to secure re-election.

Sarkozy has been embarrassed by an electorate that is dogged by fears for the country's economic future, as unemployment rises and its budget deficit promises to widen to more than 7% of gross domestic product this year and next.

But Sarkozy, at one time the most popular president since General Charles de Gaulle, may take comfort in his defeat; he joins eight other ousted leaders, including those of Greece, Spain and Italy, who have all been caught out by the same breed of discontent.

As Sarkozy so aptly put it himself, this is a "fast-moving world". In the week that France welcomed Hollande as its new head of state, attentions turned to Spain, where fears were brewing about a renewed debt crisis.

In recent weeks, the Spanish government stepped in to part-nationalise real estate lender Bankia as the markets showed concern over hidden losses on the books of the country's major lenders. As June approached, the single currency hit new lows for the year versus the dollar, and markets were losing faith in the ability of eurozone leaders to quell speculation around a Greek exit.

It is not only the faith of the markets that is deteriorating quickly; unemployment rates are soaring fast, as European nations move to bring spending and debt under control. At 10.8%, joblessness in the euro region now stands at its highest for fourteen years. The UK is also now back in recession – the double-dip that many hoped would be avoided.

For even the most optimistic of onlookers, Europe's crisis appears to be only just beginning. EMU states have proven to be anything but unified, a fact borne out by the growing divergence between strong and weak states.

In April, independent research house ECR issued a stark report concluding that such fiscal tension was only set to worsen. "The moment is rapidly approaching when the EMU needs to make a fundamental choice. It can either opt for further integration or accept that the experiment has failed and minimize the fall-out of the collapse of the euro" it said.

Europe's debt crisis has materialised in hard statistics. The values of UK property have been deteriorating consecutively since November, according to the latest IPD UK Monthly Index.

In the context of this 'fast-moving world',in which wholesale break-up scenarios cannot be entirely discounted, it is important that the industry addresses questions of how best to respond to the persistent uncertainty, and prepare business for continuity whatever the outcome, or however severe.

It was these concerns that formed the centre of an IPF debate on 17 April 2012 at Aberdeen Asset Management's London office. The discussion was between a working group made up of a cross-section of key industry professionals – investors, advisors, financiers and researchers – and organised to assimilate a coherent response to the issues that property professionals in the region now face.

This paper is a distillation of those views expressed in the discussion and it is hoped that it will stimulate further debate.

2. OBJECTIVES

The key objective of this discussion paper is to raise issues for further debate among IPF members, the wider industry and related sectors, regarding the impact of the eurozone crisis on the UK commercial real estate market and for UK investors/investment in mainland Europe.

The discussion of the working group explored several different outcomes, and is intended to provide guidance on what the practical issues might be for the industry in the event of differing outcomes of the eurozone crisis.

The discussion points covered in this paper include:

- Issue One – The ways in which continued volatility in the eurozone is impacting and has impacted the recovery of the commercial real estate market in both the UK and mainland Europe;
- Issue Two – The scenarios regarding the future of the single currency and the impact that break-up – either wholesale or partial – would have on the commercial real estate market;
- Issue Three – The structural changes underway in the industry that will not be impacted by the eventual outcome of the eurozone crisis;
- Issue Four – The practical consequences for the property industry to consider in light of the emergence of a variety of differing scenarios, prompting investors to focus on specific ways to future-proof investments going forward;
- Issue Five – The impact of the eurozone crisis on investors' interest in Europe and the arguments for diversification.

3. ISSUE ONE

How is continued volatility in the eurozone impacting the recovery of the commercial real estate market, in both the uk and mainland europe?

- At best, debt finance is set to remain tight for real estate;
- Sustained volatility in the bond markets will continue to frustrate recovery in the property sector;
- Uncertainty over whether Spain and Italy may require bailouts is causing inertia in the investment markets, both in the UK and in mainland Europe.

In its broadest sense, the uncertainty and volatility in the eurozone are rooted in three weaknesses: the long-running sustainability of public finances across Europe, a troubled banking sector that has large exposures to sovereign states and long-term flat economic growth.

The eurozone is now in its second recession in three years. Economic output in the 17 nations sharing the euro is forecast to contract by 0.3% in 2012. Unemployment in the euro region now stands at 10.48%, the highest for 14 years, and Spain is home to more than one-third of the region's jobless.

For the commercial property markets in both the UK and mainland Europe, there are two key problems preventing the market from recovering sufficiently in the context of this persistent economic weakness.

The first obstacle to full recovery is the banks.

Since this debate was held, the health of Spain's banks have been further called into question, as fears grow that its financial institutions are vulnerable to the current recession and the ongoing crisis in real estate.

The concern that Spain may require a multi-billion bailout from the troika of the European Central Bank, the International Monetary Fund and the European Commission is uppermost, as yields on 10-year government bonds of the eurozone's fourth largest economy hover around 6% – a proven trigger point for other troubled nations.

This matters because, as one of the biggest government bond markets globally, should Spain find itself unable to sell bonds to the market at an economically viable level, the European Central Bank may not be able to support it with the liquidity it needs.

In that instance, banks and financial institutions exposed to Spanish sovereign debt would be forced to take significant write-downs on their exposures – a scenario that would require banks to find capital from elsewhere to cover the ensuing losses.

One such impact would be the limiting of new lending to commercial real estate, as has been seen from institutions such as Société Générale and Commerzbank among others. It would also mean that banks could be forced to sell assets quickly to recover capital, which would have a depressive effect on valuations.

Italy, which has government debts of €1.95 trillion, representing 120% of its GDP, is a less likely candidate for bailout since its economy is more diverse than Spain's, but the financial markets are also losing confidence in the country's ability to repay its debts. It is impossible to estimate the costs to the global economy should either default.

3. ISSUE ONE

Due to this, bank liquidity remains tight for most industries, not just real estate. The record €1 trillion of cash the ECB pumped into the financial markets has recently brought eurozone bank-to-bank lending levels to their lowest since June 2010. However, there are fears that pressure is mounting on banks once more as this short-term fillip wears off.

Many banks in the eurozone therefore remain cautious about lending money as they prepare for unplanned defaults and write-downs on sovereign debt. This means continued pain in the debt markets is a guaranteed feature for the medium term at the very least.

A second issue is the future of the single currency. While few analysts anticipate a wholesale break-up of the eurozone, the uncertainty around its prospects is leading to inertia in the investment markets, as well as to nervousness that exposure to assets in eurozone markets may prove problematic should the worst materialise.

If the euro disintegrates, foreign investors would see assets in countries that exit plummet in value as the new currencies fall in value against other currencies (those in the affected country with a purely domestic focus would be unaffected by currency movements, while those invested internationally would see a substantial balance sheet benefit from their non-domestic holdings).

Volatility in the bond markets is not helpful for the real estate industry either and, if Spain and Italy fail to achieve the structural reforms needed, life in the bond market could get even more difficult. This will inevitably impact on property.

4. ISSUE TWO

What are the main scenarios regarding the future of the single currency and what impact would break-up – either wholesale or partial – have on the commercial real estate market?

- The consensus view is that the eurozone crisis will be resolved without a member state withdrawal or break-up;
- Break-up or default would lead to a renewed banking crisis, severe decline in values and impact euro denominated contracts;
- Very few UK property sectors offer defensive qualities in a disaster scenario;
- Economic uncertainty will lead to difficult investment and leasing markets for the remainder of 2012;
- Europe could lose out to higher growth markets such as the economies of Brazil, Russia, India, China and South Africa (the so-called BRICS economies).

It is the consensus view of the working group that the eurozone crisis would be resolved without an entire break-up of the currency, although 10% were inclined to some form of break-up. This is in line with most market commentators.

Many shared the view that the unknown costs and severity of a break-up – which could include sovereign default, corporate default and the collapse of the banking system and international trade – would keep politicians committed to the single currency experiment. UBS estimates that the cost of a weak country leaving the euro would be up to €11,500 per person in that country during the first year. For a stronger country like Germany it would be around €8,000.

Additionally, although the loss of international influence and the potential for civil disorder in such an event are less easy to quantify, it is likely that the unwillingness to jump in to a well of unknown depth is such that Europe will remain together come what may.

In short, Europe's politicians have no alternative but to find a solution. Yet there is lingering concern by some in the working group that a fraught political backdrop between national governments may undermine the need to find consensus; the rise of nationalism was identified as a significant risk.

4.1 Disaster scenario – what to expect

A break-up of the eurozone would wreak untold damage on the real estate industry. If there is a withdrawal from the eurozone by one or more member states, one of the dangers is that the exiting nation would need to introduce new legislation and capital controls to manage the process. This could lead to a redenomination of contracts, as well as private sector debt. Many EU contracts will not have provided for this disaster scenario.

The impact on values would be severe too. Schroders has predicted that given a 'main scenario' of continued union, total returns for real estate would be 0% but if the eurozone does split, then it expects capital values to fall by roughly 15% for 2012 and total returns to be around -10%.

Clearly, in a disaster scenario, the debt markets would be in turmoil. The key impact for the UK commercial property industry of a renewed banking crisis, triggered by a break-up or default in the eurozone, would be a more rapid and severe deleveraging – in the shape of forced sales – as banks seek to recoup losses elsewhere.

4. ISSUE TWO

In this event, a large outward shift of secondary yields into double-digit territory is anticipated, since the majority of bank loan books in the UK are lent against non-institutional grade stock.

A severe recession brought about by a succession of sovereign governments defaulting or countries leaving the euro would hit trade, as well as businesses and consumer confidence – feeding into all sectors of the UK property market. It could especially impact on the ability of tenants to meet commercial obligations under their rental agreements. Those holding assets in eurozone markets, where rents are paid in euros, would suffer greatly.

While no UK property sector would be immune from the worst effects of a default or break-up, given its large exposure to the financial sector, it is anticipated that the London market would be one of the hardest hit (though some argued in the group that residential property, viewed as a safe haven, may well be immune).

Only the UK retail warehouse market and supermarkets are considered by the working group to be more defensive (for reasons of necessity), as well as student housing – given that much occupier demand derives from non-European families sending children to universities in Britain.

In light of such grim projections, there is no clear investment case to be made under a break-up scenario.

As UBS highlighted in a recent paper: "Investing for a break-up scenario has no guaranteed winners within the euro area. The risk of civil disorder questions the rule of law, and as such basic issues such as property rights. Even those countries that avoid internal strife and divisions will likely have to use administrative controls to avoid extreme positions in their own markets. The only way to hedge against a euro break-up scenario is to own no euro assets at all."

The working group does not subscribe to this extreme view.

4.2 Muddle-through scenario

Whether the eventual answer to Europe's debt issues is inflation or austerity, the property industry will struggle as the region adjusts to new fiscal realities. Business projections and decisions are currently very difficult to make with any degree of confidence.

Economically, there is uncertainty for the industry whatever happens. The region faces a long road back to growth – evidenced by fewer jobs, lower consumer spending and public sector cuts – and this will have, and is already having, a depressive impact on both the occupational market as well as on capital value growth.

Politically, the potential for break-up of the single currency over a number of years is also creating insecurity for investors. In this scenario, protectionism in the shape of regulation of capital flows will increase – a symptom of the 'long goodbye' for the union. Solvency II is perhaps one example of this, and signs by newly-elected socialist French president François Hollande that he may seek to renegotiate the EU fiscal discipline treaty signed only in December was evidence to the working group that there are reasons to suspect further steps towards protectionism.

But investors must continue to do business in light of the long-term outcomes for the EU as well as navigate the short-term risks of break-up on today's portfolios.

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This will not be easy. Investment decisions are difficult to make with any sense of conviction; assets may become cheaper tomorrow, the rental income may evaporate as tenants continue to wrestle with new economic realities, while anything denominated in the euro is a risky prospect.

Occupiers are reluctant to make moves across all markets and sectors. And, as even traditionally safe markets like London are struggling to retain their glittering reputation in light of this uncertainty, 2012 is undoubtedly going to be a quiet year for the market. CBRE recently reported that investment in Europe decreased by 31% from the last quarter of 2011, and 18% on the same period last year.

One thing deterring investors is that, with or without the union or the currency, it will prove very difficult to find decent capital value growth in many markets across the region for the medium term.

Economic growth in the eurozone is forecast to fall to 0.5% in 2012, but Ernst & Young predicts that many countries in the region have at least two more years of painful adjustment ahead. Spain, for instance, is only predicted to return to 2% growth per annum in 2015, providing that fiscal consolidation and structural reform are achieved.

Against other regions across the globe, these figures look pale indeed. There is concern in the working group that the attentions of global investors could shift elsewhere, as they look down the barrel of Europe's intransigent economic woes. Policy uncertainty and increased regulation, combined with long-term flat economic growth could lead to a downgrading of exposure to Europe by investors in favour of higher growth markets such as Brazil, Russia, China and India.

In these markets, returns reflect capital value growth rather than what Europe offers at best: a flat income stream.

The sale by Brazil's government of $825 billion long-dated bonds in January is one case in point; demand was so great that the yield came in at a record low of 3.449%, and seven times the anticipated volume as investors take comfort from Brazil's $350 billion in foreign currency reserves, stable economy and strong leadership on both the monetary and fiscal fronts.

The working group also questioned how energy, sustainability and demographics dictate returns in markets around the world in the long term. Europe's ageing population will not help growth rates in the long term, it was argued – and these are considerations investors must not ignore.

There is an alternative scenario, whereby the crisis creates a stronger EU on account of the necessity for radical and forced deregulation of the labour and product markets and lower taxation in order to save both the single currency and the EU – reforms that may not have happened had it not been for the crisis or, at the very least, only taken place over decades.

The creation of the European Financial Stability Facility (EFSF) by the euro area member states in 2010, which can provide loans to countries in financial strife and act to recapitalise financial institutions through loans to governments, could be seen as one example of evidence that the EU is moving towards a fuller monetary union. The permanent bailout facility that will be provided by the European Stability Mechanism is another.

4. ISSUE TWO

Collapse or collaboration - Euro crisis scenarios

With the exception of the UK, European leaders have backed a tax and budget pact aimed at solving the eurozone debt crisis, preventing the implosion of the single currency and disintegration of the eurozone. This approach will either lead to the survival of the currency or a collapse. But within those two broad scenarios are different outcomes to be aware of.

Euro collapses:

1. Weaker countries drop out one by one: Greece exits the currency union, suffering sharp recession, and the freshly-introduced 'new drachma' plummets in value. Other southern European countries, such as Italy, come under pressure to follow;
2. Divorce: Europe's core of economically stronger states agree that the existing eurozone is unsustainable, paving the way for a new, smaller and more tightly regulated currency bloc. In this scenario the 'new euro' would appreciate dramatically. Economies that are excluded suffer a sharp currency depreciation and severe economic contraction.

Euro survives:

1. Inflation: The European Central Bank prints money to support successive bailouts. Inflation makes the eurozone's debts more repayable but as governments continue to rely on support, they spend freely, causing inflation to get out of control;
2. Fiscal union: Greater fiscal and budgetary centralisation is eventually achieved with a degree of loss of national political control. This would raise problems of accountability and be a challenge to national democratic processes but it may be significantly more palatable than political federation;
3. The European Union turns into a political federation: Countries agree a complete union, including a democratically elected government in Brussels, which can borrow with the backing of all 17 member states and spend money where needed. The UK and other EU countries not part of the euro are asked to exit altogether.

5. ISSUE THREE

What are the structural changes underway in the industry that will not be impacted by the eventual outcome of the euro debt crisis?

- The reduction of debt for real estate markets is a long-term structural change that will remain in place despite the outcome of the eurozone crisis;
- The property industry must explore alternative sources of debt capital;
- The UK may be best placed to attract what little liquidity there is available to the real estate market;
- The industry should not expect a turnaround from policymakers over increased regulation for the sector, though lobbying from the industry may improve the outcome;
- The investable universe is shrinking at the prime end of the market.

5.1 Banks

The outcome of the euro crisis – either in the short or long term – is not expected to significantly alter or improve the availability of debt to the property industry.

Even in the main scenario, where the single currency holds firm, bank lending to property will remain difficult for the commercial real estate market to access and this will persist for some time to come.

Not only are lenders facing concerns over their exposure to sovereign debts, but they are also over-exposed to property as a proportion of their total loan books – an imbalance that regulators such as the Financial Services Authority are trying to redress (see below).

In February this year, deputy governor of the Bank of England Paul Tucker issued a stark reminder of the continued fragility of the banking system, warning that there remained a "lingering threat of a severe crisis in the euro area" that leaves banks operating in an "extraordinarily risky environment".

Regardless of the survival of the single currency, and Europe's long-term and endemic financial difficulties aside, it is without doubt that the commercial property industry faces wholesale changes in the way it is financed and it will continue to do so over the short, medium and long term.

As Tucker said: "While in other circumstances it might have been possible to relax capital requirements if the worst had passed, it is not a sensible course when the worst might still lie ahead…gradually building resilience through retained earnings is best for stability and recovery."

These circumstances are leading to a paradigm shift that has only just begun; the working group urges the industry to respond to these broad changes to the very framework of the banking system and to appreciate that the downward pressures on liquidity in the industry are beyond its control.

For the foreseeable future, real estate will find itself struggling to remain relevant to banks as they seek to rationalise businesses, streamlining sectors and geographical exposure.

Property, along with industries such as shipping and aircraft, will find itself too costly and, in an era of flat economic growth, discover that it is too uninteresting for banks. In the meantime, high-yielding growth industries such as metals, energy and mining will steal attention owing to their greater potential to help banks meet increased capital and funding costs.

5. ISSUE THREE

However, there is a view that those in the UK commercial property market have yet to understand fully the ramifications of the step change in costs for the banks – namely the European Banking Authority's requirement that banks establish a Core Tier 1 capital ratio buffer of 9% as part of Basel III. This is not to mention moves by the Financial Services Authority to tighten the oversight of commercial property lending by introducing standardised 'slotting' calculations to assess risk, new rules likely to require banks to hold yet more capital against their property portfolios.

Given these constraints, banks are expected to continue to be highly selective about the markets, sectors and clients they transact business in and with. Capital-intensive projects will find very little interest from banks and, for the 'lucky' ones who do secure debt, it will be at considerably higher margins.

In the context of these broader paradigm shifts however, the working group believes that UK commercial real estate is one of the most defensive sectors of the European market – and that is a positive. Banks value the security, transparency and legal protection of UK property and, therefore, where real estate lending activity is considered, the market is likely to be one of the few to benefit from such interest.

Owing to the availability of attractive risk-adjusted returns, the sector is also experiencing interest from new lenders, such as insurance companies and debt funds.

DTZ estimates that there are currently around 10 life insurers active in the UK and continental Europe investing in or originating debt, and over the next three years that number is likely to double. But the emergence of new sources of finance will take time to establish and they will, undoubtedly, concentrate their capital on prime assets, in the shape of quality institutional assets, and at low loan-to-value ratios.

As a result, the industry needs to consider other sources of financing, including corporate bonds, debentures and private placements as means of diversifying their lending base. REITs that are able to tap any of the public, or private, debt or equity capital markets, and do not rely solely on the banks, are clearly in the best position to access alternative sources of capital. The record $275.5 billion of US corporate bond issuance during the first quarter of 2012, which surpassed the previous high of $272.3 billion set during Q1 of 2007, indicates a broader corporate trend away from bank financing, which the UK property industry is yet to appreciate fully.

In this sense, the retreat of banks from the property industry could create a more stable financing market in the long term, particularly if a new and improved Commercial Mortgage Backed Securities (CMBS) market springs back into life and the interest of new senior and mezzanine lenders in property remains for the long term.

The lending market in the US – which benefits from much more established commercial real estate debt capital markets – is far more diverse by comparison and, therefore, has been able to return to health much more quickly since Lehman's collapse (in September 2008). By comparison, property investors in Europe historically have been almost entirely dependent upon banks to finance their businesses.

The working group is optimistic, therefore, that the banking crisis has created fertile ground for the development of a more diverse, stable market for property finance in the long term.

5. ISSUE THREE

5.2 Regulation and governance

A new era of regulation has dawned in the wake of the Lehman's collapse and the Madoff scandal. The structural shifts, initially directed by the G20, towards increased regulation have been only partially quickened rather than caused by the European debt crisis.

The impact of regulation on the real estate industry will be huge – especially for fund managers, institutional investors and lenders.

One issue for the industry is that property has been caught up in regulatory measures primarily targeted at other asset classes – leading to unintended or ill-considered consequences.

At the coalface, advisors are working to address clients' concerns related to liquidity, transparency and reporting – in order to prepare for this new era of regulation. In relation to the eurozone crisis, advisors are looking at ways of future-proofing against currency issues and the safety of fund deposits.

However, the working group believes a long-term structural change for investors to focus on is that of cost. Advisors indicate that greater focus on cost of operation and efficiency will be paramount going forward and urge managers to look at the efficiency of information flows, decision-making processes and working with internal and external teams to keep operational costs to a minimum.

These efficiencies are expected to be crucial for fund managers during the capital raising stage, as investors will increasingly ask questions about the extent to which operational costs erode returns.

The group recognises that regulators are trying to protect the investment community, encouraging funds to deal with issues such as governance and counter-party risk through measures such as the Alternative Investment Fund Managers Directive (AIFMD).

But it is felt that regulators need educating on how governance or currency risks impact real estate as an asset and, more broadly, there is serious concern that the industry is not being properly consulted over regulations such as Solvency II, the AIFMD and Basel III.

One example is in the regulatory approach to the pan-European risk-based solvency regime Solvency II, whereby UK volatility is being employed as a measure of risk for European markets generally in solvency tests, despite strong evidence that some markets are significantly less volatile.

There is also a concern that the impact of regulation will ultimately put pressure on the industry to be pro-cyclical. That will continue but investors should not ignore the opportunities to invest. Regulation has to be put into perspective; investors must be wary of being too risk averse, the working group argues.

5.3 Shrinking investment universe

As a result of Europe's economic environment – which, at best, is likely to experience low growth for some time to come – it is anticipated that managers will focus on cities and specific asset classes rather than country mandates.

5. ISSUE THREE

Investors are being forced to undertake a far more granular 'micro' approach, which includes rigorous underwriting, cash flow and capital expenditure, since the economic environment cannot be relied on to create returns on its own. Each asset must be analysed on its own merits, as designing strategies around countries or even cities is a difficult task.

One long-term shift in the investor market is the narrowing of strategic opportunities, especially in light of the removal of 'super' prime assets from the investable universe. Given the lack of trust that government bonds reflect a true 'risk-free rate of return' any longer, some investors have been hunting for alternatives and prime property assets in cities such as London, Paris and Frankfurt are considered to be the new government bond-style investment.

However, this dynamic is not seen as a cyclical trend but rather another structural shift. Core investors are concerned that some of these 'super' prime assets will be removed from the investable universe for generations, given their perceived value as wealth preservation tools, leaving them to fundamentally revise their asset allocation approach.

There is also a risk that some secondary property may also disappear from the investable universe, as austerity measures and regional unemployment impact on the weakest assets in terms of quality and location.

Core investors unable to compete, or unwilling to pay the high prices for prime assets paid by sovereign wealth funds or high net worth individuals, are being forced to move further up the risk curve, targeting assets on the edge of prime locations or with some level of vacancy or other types of value-adding opportunity.

Core property is viewed as over-priced by the working group, especially in key markets such as London and Paris, since assets are unlikely to yield much in the way of capital appreciation.

It may be that riskier assets will ultimately prove better value once a more stable economic environment returns, as long-term yields in secondary assets are expected to contract while prime yields are widely anticipated to settle at higher levels.

There was some level of contention over the extent to which secondary yields would eventually contract over the next six months to a year, but the group believes that, given the likelihood of increased supply, and weakening leasing conditions, there may be ample opportunities to yield double digit ungeared rates of return – especially for those with good asset management capabilities.

Investors are also expected to benefit from the emergence of new asset classes such as education, healthcare, data centres and renewable energy.

6. ISSUE FOUR

What are the practical consequences for investors of the ongoing euro debt crisis?

- There is concern over the impact of a eurozone split on cross-border commercial contracts and loan agreements;
- Businesses are advised to carefully analyse contracts and future proof where possible;
- All euro-denominated assets should be assessed in relation to redenomination risk.

Cross-border commercial contracts are unlikely to have been drafted to take account of a break-up of the eurozone and lawyers believe that adverse changes in the markets may trigger force majeure clauses to provide for termination.

This is not to mention the impact break-up or partial withdrawal would have on the ability of parties to meet their commercial obligations under contractual agreements.

The working group therefore urges businesses to analyse investment contracts and financing arrangements in order to mitigate risks, putting businesses in the best position if and when a shock occurs.

6.1 Redenomination risk

One area that investors need to consider is 'redenomination risk'. Analysis must be undertaken on all assets and liabilities according to whether they might stay in the euro or whether they could potentially be redenominated into a new local currency.

The key concern for property investors is obviously the uncertainty over what happens to contracts that perform in euros or reference rates, like Euribor, that are linked to the euro.

Advisors on the working group are very concerned about the impact of rapid currency devaluation on investors in the event of an exit of a weaker country from the single currency.

In a legal context, coping with an exit by Greece is seen as manageable but an exit by either Italy or Spain would severely impact contracts that support investments and sorting out redenomination of payment arrangements would not be straightforward as investors could not count on any outcome other than coping with a devalued currency. This is a major worry, should Europe head down the track of significant meltdown.

In a recent note, Nomura advised investors to consider redenomination risk in three ways. First, investors should consider the legal jurisdiction under which an obligation belongs. A second consideration is the likelihood that a break-up can happen in a multilaterally agreed fashion and the third issue is the type of eurozone break-up that is being considered, including whether the euro would cease to exist in a given break-up scenario.

If a break-up was limited, and the euro remained in place for core eurozone countries, the risk of redenomination would most likely be higher for local law obligations in peripheral countries than for foreign law obligations. In that instance, local law obligations should trade at a discount.

6. ISSUE FOUR

But if a full-blown break-up were to occur, evaluating redenomination risk is more complex because even foreign law obligations would need to be redenominated in some form. In this case, argues Nomura, redenomination could happen either into new national currencies (using the Lex Monetae principle), or into a new European Currency Unit.

The issue of Lex Monetae – the principle that each sovereign determines the currency of its own state – for investors is this: if an investor is seeking to continue to be paid in euros, they may be more likely to succeed if English law governs those assets. However, if Italy or Greece were to leave the euro it is likely they would introduce a new lira or new drachma, meaning that all euro-denominated obligations in either country would be converted to the new currency. This would include items that cannot be renegotiated, such as outstanding VAT refunds, and, accordingly, investors should seek to accelerate such payments wherever possible.

6.2 New contracts

For contracts currently being negotiated or amended, advisors are introducing clauses that deal with the currency and place of payment, as well as the impact of market disruption, and advising clients to turn their attention to whether they or their tenants are exposed to downgrade risk that could be heightened by a eurozone default.

Advisors on the working group believe investors should give thought to the jurisdiction governing a contract and whether additional termination rights should be inserted, as well as clauses that provide for material adverse change. Due diligence must also include exploration of whether the asset or tenant has material exposure to peripheral or weaker eurozone countries. Investors should also ensure that their managers have sufficiently robust systems to deal in new currencies as they are created.

6.3 Hedging

One route for businesses to protect contracts is to enter into currency hedging arrangements at a fund and portfolio level. But the working group believes hedging a euro-denominated asset against a break-up scenario is difficult to achieve in the current environment.

Bankers report that since the cost of capital is rising, committing capital to stand against interest rate swap counter-party positions is inefficient and unattractive to them.

One critical task for investors is to ensure that structures are robust against unexpected currency changes and shift the result of exchange rate movements to the fund vehicle or investor level, where tax is not generally payable.

7. ISSUE FIVE

What are the implications of the eurozone crisis on investment intentions and arguments for investment diversification?

- Europe is likely to remain relevant to global investors despite continued economic malaise;
- New investors from energy-rich countries could become an important source of capital for the region;
- Counter-cyclical investment is not attractive at current values and given the lack of debt;
- London may benefit from investors seeing the city as distinct from the crisis in Europe, but should not expect the market to be stable in the long term.

While investors are less concerned about the break-up of the euro, the outlook for European growth is a worry.

It is almost four years since the outbreak of the global financial crisis and only Austria, Belgium, Germany, Slovakia, Sweden and Poland have seen economic output return to pre-crisis levels. Many European economies are likely to fall back into recession this year.

But it is unlikely, argues the group, that global investors can avoid a big trading bloc such as Europe.

The working group is encouraged by the presence of a new type of investor on the scene that appears to have appetite for the region and could create an interesting dynamic in the industry. Investors from Norway, Angola, Azerbaijan and Chile have all expressed interest in property and some have already committed capital. The growth of energy-rich countries will change the investment universe, the group argues.

But, in today's uncertain climate, how do investors see the immediate future? Undoubtedly, there are opportunities for new investors and others with equity to make counter-cyclical commitments today, given that this point in time could easily represent the bottom of the market.

But one barrier to counter-cyclical investment is that values have not corrected to take account of the lack of leverage in the market. Equity naturally requires a much higher return, but sellers have not yet sufficiently adjusted to the reality that the current high cost and lack of availability of debt means lower property prices.

Another factor preventing many investors from accessing deals at the right price is the issue of swap breakage costs, which have risen dramatically as a result of the on-going eurozone sovereign debt crisis, thus making it more difficult for banks to sell assets at palatable prices.

Research by CBRE shows that the cost of breaking interest rate swaps – a hedging tool designed to mitigate risk of rises in interest rates – has risen over the past few months. The cost of breaking a 20-year swap in euro-denominated markets taken out during the fourth quarter of 2007 had jumped to 31% (of the loan value) by the end of the first quarter of 2012. In the UK, swap breakage costs are slightly lower, but stand at 23%.

The UK market has been a port in a storm for many global investors of late, evidenced by heavy demand for UK government debt from overseas buyers that has caused yields on government-issued bonds to fall to below 2%. This perceived safety is at the root of recent capital flows into the property market, but the dynamic is short-term and the working group expects that volatility could return to the market once bond yields stabilise, or if interest rates rise.

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Investors also raised the question of the impact on London if open-ended funds – which own tens of billions of pounds of assets in the city – came under pressure to dispose of assets.

For this reason, investors still consider diversification out of the UK and into Europe crucial, especially towards stronger northern European markets such as Germany and the Nordic area.

This diversification may even extend to investing in riskier peripheral markets. Despite the potential for large losses on assets in markets in Southern Europe in the event of the break-up of the euro or default, there are opportunities in some cities such as Madrid and Milan today, given that the chances of a disaster event occurring are slim.

Such opportunities, however, are likely to be accessed more easily by owner-managed opportunity funds that do not have to convince investment committees to take such risks, rather than institutional fund managers.

Forced reform of labour markets in countries such as Spain and Italy means that investors are hopeful in relation to long-term opportunities in these markets. Investors say they are positioning themselves to take advantage of signs of recovery, and if distress results in lower prices over the next 18 months then better opportunities than perceived safe havens like the UK might present themselves.

Diversification in terms of route into market was a point of debate between some within the working group. A number believe that investors, given the unresolved issues in the fund management industry, may not return to indirect unlisted property as the long-term evolution of REITs provides increased opportunities to invest in specific sectors, and geographies, as well as providing good liquidity and more reliable management. Will REITs benefit from the difficulties in the indirect geared investment vehicles? There was no agreement on this point; some believe Europe's progression towards a sufficiently unified REIT regime is too glacial to provide any answers for investors' current asset allocation issues.

IPF Research Programme 2011–2015

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