



TIME TO OVERWEIGHT REAL ESTATE – The case for property in 2012

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INTRODUCTION

In the context of the euro zone sovereign debt crisis and sharp downgrades in economic growth forecasts, both prices and investment activity in the commercial real estate sector held up remarkably well in 2011. One might normally expect an illiquid asset such as property to perform relatively poorly under such circumstances, yet investors continue to increase allocations to real estate. This report looks at why that might be and what that means for the prospects for property over the next few years. It argues that at the moment the conventional case for property is being augmented by particular features of the current market.

WHY REAL ESTATE?

Reasons for investing in property can be divided into two categories:

There are portfolio level justifications – its particular risk/reward characteristics and diversification. These make a case for holding at least some real estate at any stage in the economic cycle, but change in importance over time as investors' attitude to risk changes.

Then there are justifications based on pricing – that if property as an asset class is under-priced (relative to other asset classes) there is a case for investment because of the expectation that as a result of this mis-pricing it will generate higher risk-adjusted returns in the short to medium term. High transaction costs, and the time it takes to trade in and out of real estate, mean it can be difficult to take full advantage of such mis-pricing, but this is still an important part of the investment decision. This is also different from the issue of whether a particular property is being correctly priced by the market. A specific investment opportunity can still be over-priced, even if the asset class as a whole is 'cheap' and vice versa.

It is arguable that real estate is attractive in terms of both pricing and its portfolio characteristics at the moment. However, it makes sense to consider them separately as the portfolio case is arguably stronger than usual right now.

RISK/REWARD CHARACTERISTICS

The standard way to consider the risk/reward characteristics of an asset class is in terms of Modern Portfolio Theory – that is the variability/volatility of returns over time and the correlation of those returns with other available asset classes. An asset is considered as attractive if it increases expected portfolio returns without increasing the expected volatility of those returns, or decreases volatility without also decreasing returns.

However, this model of investment strategy does not allow for the asymmetric attitude to risk of many investors. For them the possibility of a 50% fall in capital value has more influence on the investment decision than the chance of a 50% increase in capital value. For an asset such as real estate, this is particularly relevant.

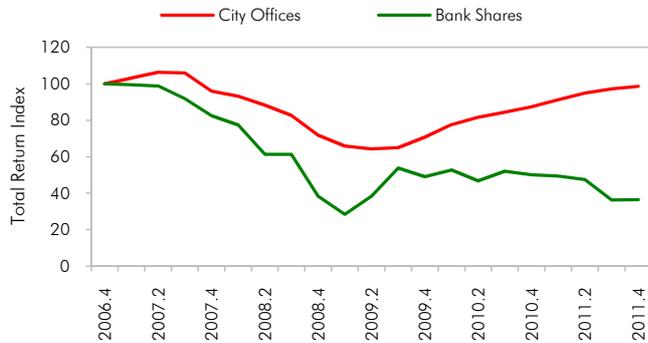
Real Estate Stop-loss

For many properties, a relatively high proportion of the value is in its physical characteristics (land and buildings) rather than its financial characteristics (the lease). This provides the investor with the reassurance that, even in the most extreme circumstances, it is unlikely that they will experience a total loss.

The experience of the Lehman collapse provides a clear example of this. It is unlikely that either bondholders or shareholders will get a substantial return from the winding up process. Even senior bondholders are expected to see a return of less than 25c on the dollar. Contrast this with the position of the former owners of Lehman's UK headquarters. The administrator continued to pay most of the rent while the European operations were being transferred to Nomura, with Lehman's sub-tenants in the building providing additional security of income. Subsequently the building itself was sold to JP Morgan for £495 million.

Extrapolating from this specific example to the general shows that over the last five years investors would have been much better off owning the buildings that were occupied by banks rather than shares in the banks themselves. A comparison of the total return from office property in the City of London with the return from bank shares included in the FTSE 100 Index is a stark illustration of the relative merits of the two asset classes.

City of London offices v UK bank shares

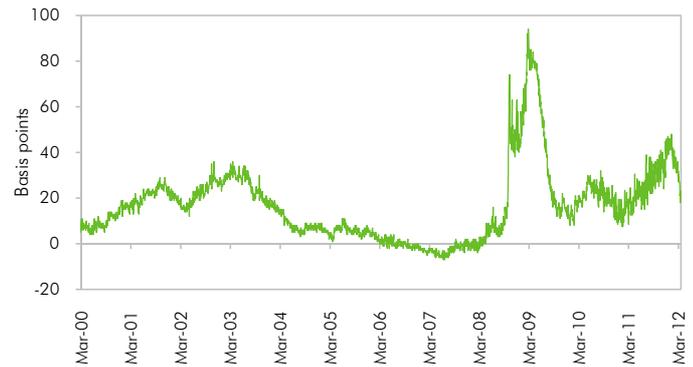


Source: IPD, Macrobond

At times of high market uncertainty and volatility, this downside protection is a quality of real estate that is highly valued by investors. However, the degree of protection does vary greatly from building to building. The newest and best located properties will normally provide the greatest protection and this is being reflected in investor behaviour, which is strongly favouring such assets. This is particularly evident in large shopping centres with a dominant market position in their catchment area. Despite the weakness in consumer spending, such centres have maintained their value very well in the current market cycle.

The investor in real estate debt is the greatest beneficiary of the security provided by the 'real' nature of property. The lower the loan to value (LTV) level, the greater the security. This shows up very clearly in the German covered bond (pfandbrief) market – where by law the loans that back pfandbriefe have a maximum loan to value of 60% at origination. As a result, even at the height of the financial crisis the yield at which investors were prepared to buy into new pfandbrief issues remained within a percentage point of the equivalent swap rate.

Pfandbrief Spread (Mortgage Pfandbrief yield minus 5-year euro swap rate)



Source: Macrobond

In fact for certain groups of investor there is currently a strong case for investment in new real estate debt. At relatively low LTV it offers a high level of security. However, because (among other things) their legacy of bad loans is preventing many traditional lenders from originating new loans, the interest rate on new real estate lending is high relative to other fixed-rate investments.

Compared to an investor in debt, an equity investor in real estate gets only partial security from the underlying physical real estate and in the past this security was often sold-off in the form of secured debt in the hope of generating higher returns on equity. The recent trend has been for equity investors to retain more of this security, with equity-only deals becoming more common.

The Bond-Equity Trade-off

A feature of real estate that is often highlighted by investors as one of its most important attractions is the way in which it combines features of both bonds and equities. In the short term, well-let real estate has the certainty of income that investors also get from bonds, whereas in the longer term, there is potential for that income to increase in line with market rents (providing a partial hedge against inflation). In many countries it is also common for the property owner to benefit from annual increases in income in line with inflation or some other price index for the duration of the lease providing an additional short-term inflation hedge.

In the current investment environment, this ability to provide both certainty of income and the possibility of potential uplifts in rent paid (and thus in capital value) is particularly valuable. Economic uncertainty increases the importance of guaranteed income. However, there is always the risk that policy

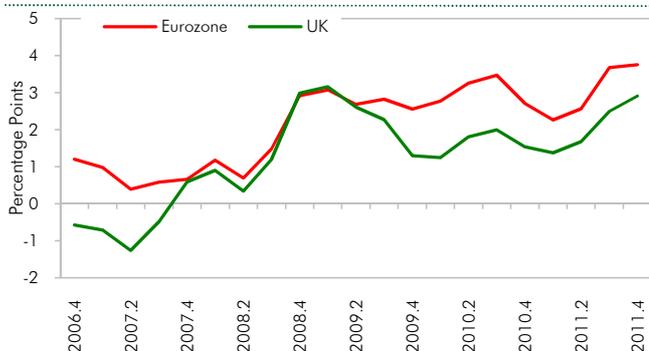
responses to the crisis – such as quantitative easing – will ultimately be inflationary, putting the value of long-term fixed-income investments at risk. Real estate thus provides the investor with protection in the case of both scenarios. The extent to which real estate is a **good** hedge against inflation is a hotly debated subject. However, the fact that there is at least the possibility for income to increase means that it must be a better inflation hedge than a pure bond investment.

Of course individual properties differ in the extent to which they achieve this bond-equity trade off. The creditworthiness of the current occupier will vary even between properties that are otherwise identical. While real estate as an asset class is often described on average as having the equivalent of a BBB credit rating, individual properties demonstrate every point on the scale.

This gives the investor the opportunity to select the level of trade off that they wish to achieve. Within the real estate investment universe will be examples of very long leases to government or AAA rated companies whose investment performance will be very similar to that of bonds, particularly over the short term. There are also properties that are subject to index linked leases and ultimately the opportunity to take on vacant property or development that will have a high degree of equity type risk.

Activity and prices reflect the current risk-averse nature of investors across all asset classes. The most bond-like properties are highly prized by investors at the moment. However, capital has also flowed towards secure government and corporate bonds. As a result, despite the recent fall in prime property yields, the yield gap (the initial yield premium for prime real estate relative to secure bonds) has increased, and by some measures is at a long-term high.

Yield gap evolution (Average prime yield minus 10-year government bond)



Source: CBRE, Macrobond

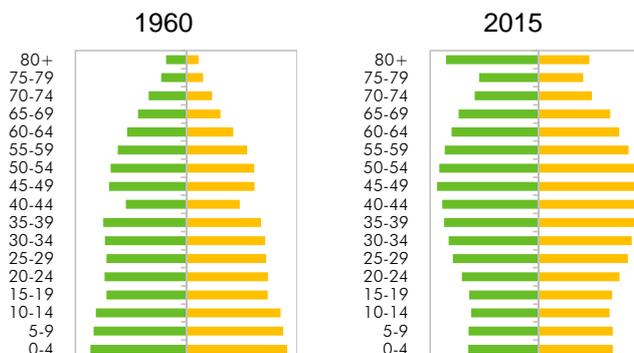
High and stable income return

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 who follow an asset-liability matching strategy. Such strategies are becoming ever more appropriate as pension funds in developed countries make the transfer from net cash inflows to net cash outflows. As they do so, current yield will become a more important investment characteristic than long-term capital value growth.

Once a pension is in payment, the liability takes on the characteristics of an annuity (in many cases it will be an actual annuity). Traditionally this has been met by the pension provider investing almost entirely in bonds or index linked bonds of an equivalent (estimated) duration. However, with the yield on long-dated bonds so low, pension providers are increasingly looking for other options.

The aging of Europe's population through longer life expectancy and a falling birth rate has already increased the ratio of those receiving pensions to those still paying in. In 1960, there were 17 people in Europe over the age of 65 for every hundred of working age, but by 2015 this will have increased to 26 and the ratio will continue to rise in the near term. This should further increase the number of investors who value the high, stable return from real estate.

Population change in Europe

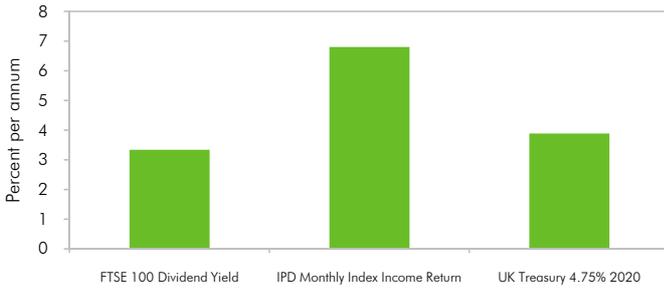


Source: United Nations, CBRE

The growth potential of equities means that the initial yield that they generate tends to be quite low. Looking at the UK for example, the dividend yield on FTSE 100 shares currently averages around 3.4%. The dividend yield is highly dependent on the strength of growth expectations and as a result the current dividend yield is well above the sub 3% yield recorded in the mid 2000s, when growth prospects seemed much stronger.

The income from bonds is fixed (and should therefore be compensated by a higher initial yield), but in the current market security is more highly valued than growth and the yield on secure bonds has fallen to record lows. The redemption yield on a 10-year UK government bond is currently (March 2012) around 2.4% and 2.0% on a German government bond. Depending on the coupon the income component is typically somewhat higher, although this must be balanced against the capital loss that will be suffered at the end of the term.

Income return on major asset classes



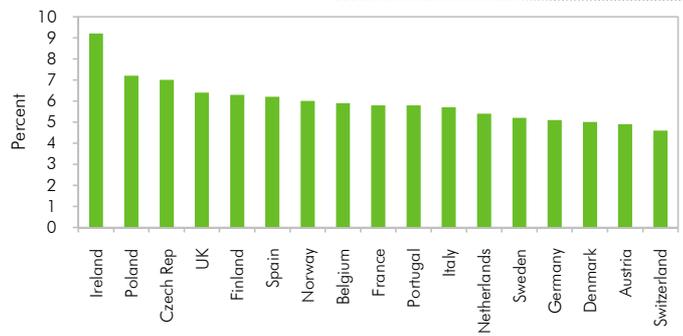
Source: IPD, Macrobond (Feb 2012), Financial Times

Compared to these other asset classes, therefore, the initial yield generated by real estate is high. Based on the IPD monthly index, the average income return from UK property is currently well over 6.5%. It could be argued that this is not comparing like with like in terms of asset quality, but even the most prime properties will normally offer an income advantage over gilts or equities, with the prime West End office yield currently around 4%.

As well as being higher than the income return from other asset classes, rental income is also very stable. From its peak in September 2008 to January 2012 the aggregate rental income generated by the portfolio that makes up the IPD monthly index in the UK fell by just 2.2%. Increased voids have been almost completely offset by rent reviews that captured historic rental growth as a result of the UK's five yearly rent review pattern. This contrasts with the aggregate value of dividends paid out by FTSE 100 equities, which was hit hard when BP and several major banks suspended dividend payments.

This pattern of income return is repeated in many other European countries – although there is obviously a significant variation in the income return from government bonds from country to country at the moment.

Real estate income return in 2010



Source: IPD

CURRENT REAL ESTATE PRICING

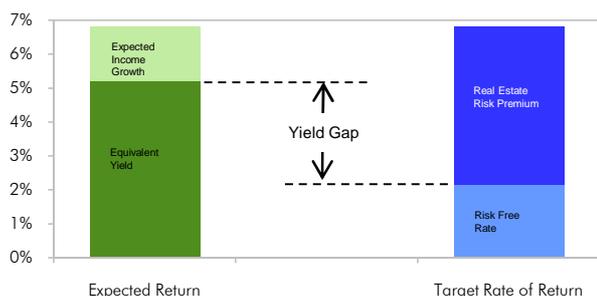
To an extent, issues of pricing are best addressed on a case by case basis. The direct real estate investor cannot 'buy' the market in the same way that a bond or equity investors can. Thus they cannot take advantage of market level mis-pricing without overlaying at least an element of stock selection and specific (property level) risk, although this can be diversified by investing in a large number of properties.

Yield Gap

Probably the simplest way to consider the relative price of real estate compared to other asset classes is the yield gap relative to bonds – referred to briefly above. CBRE have recently produced two quite detailed reports looking at this issue, "The Real Estate-Bond Yield Gap" in September 2011, and looking just at the UK market, "Real Estate: Cheap or not?" in October 2011.

As can be seen from the diagram below, there are a number of potential drivers of the yield gap and the fact that the economic outlook is weakening (thereby reducing expected income growth) means that we would expect the yield gap to be increasing at the moment. Nevertheless, the extent to which we have seen the yield gap increase over the last four years is remarkable, and by some measures the yield gap is at a record high. In much of Europe, therefore, real estate investors need to achieve little or no income growth in the medium term in order to justify current prices for prime property relative to bonds.

Yield gap



The measurement of the yield gap is quite sensitive to what is considered to be the risk free rate. Historically the yield on 10-year government bonds has been used as the benchmark value for the risk free rate. However, if we were to compare the yield on prime offices in Lisbon with the current (over 12%) yield on Portuguese government bonds it would show a big reverse yield gap. This national government bond yield can no longer be considered as a 'risk free' rate and so the Euro swap rate, or 10-year bund yield is now normally used when looking at all euro zone markets. This does seem appropriate where the comparison is being made with prime yields which reflect the price being paid for well let property where the occupier represents a negligible credit risk.

Development Pipeline

Whilst not strictly a measure of pricing, one of the factors that will influence the future returns from real estate is the level of new development.

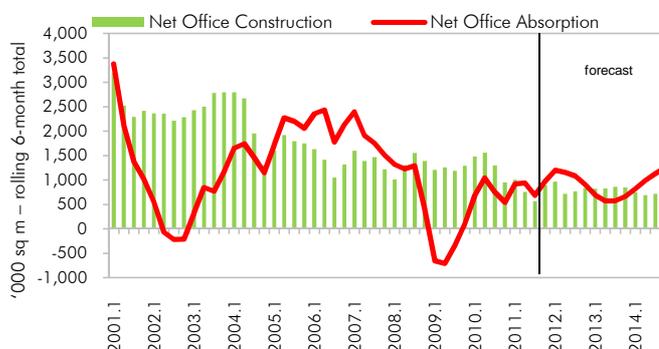
A consequence of the credit crunch in 2007/08 was to cut off the supply of development finance and new development starts across all real estate sectors fell away sharply. There is a lag between the start of development projects and their ultimate delivery, so projects started earlier continued to be delivered in subsequent years. However, these developments have now worked their way through the pipeline and deliveries over the near term are expected to be at record lows.

In Western European cities in particular, the annual level of new office completions is running at historically low levels. Across the region delivery of new space is averaging around 1% of stock per annum at the moment. Moreover, the availability of development finance is yet to recover and development starts remain very low.

Consequently, the level of new completions will not recover until at least the end of 2014. Moreover,

given the current constraints on development finance it may well be even longer than that. Therefore, even with net demand currently at a low level we are expecting that overall vacancy will fall.

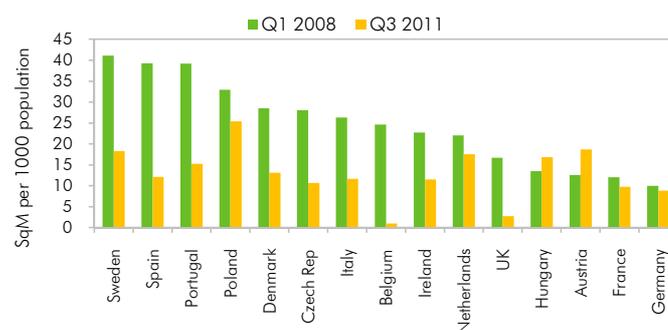
Office development pipeline in major European markets



Source: CBRE

The picture with regard to retail development also shows a much lower level of expected completions in the near term, although with a more pronounced geographic trend. Generally, those markets where in 2008 development activity was quite high (Sweden, Spain, Portugal, etc) have seen development fall back very sharply. In markets where development was already low even at a time of quite strong economic growth, such as France and Germany, development activity has continued despite the economic slowdown.

Shopping centre development pipeline, floorspace under construction



Source: CBRE, PMA

The low level of new development due to be completed over the next few years will help to protect occupancy rates and rental values in the event that occupier demand is subdued (as is the central expectation). If, on the other hand, occupier demand exceeds the expected level it is likely to result in a marked shortage of good quality space and potentially quite strong rental value growth.

CONCLUSIONS

At the start of this report we commented that the nature of real estate makes it difficult to identify a single case for investment across the market as a whole. However, it is clear from the level of real estate transactions being recorded, even during the financial market turmoil in the second half of 2011, that for many investors it is a key part of their investment strategy. Even the resurgence of the sovereign debt crisis in mid 2011 seemed to have little impact on the rate at which commercial real estate investment transactions were being completed.

It seems likely that currently the most persuasive argument in favour of real estate is the fact that it offers a positive investment case not just against the most likely economic outlook, but also against a number of other scenarios for 2012 and beyond. For example, possible alternatives include:

- Euro zone crisis continues with no clear resolution:- Prime property generates a higher income return than bonds, with the lack of new development completions helping to maintain occupancy rates and continued income generation.
- Dealing with the sovereign debt crisis results in inflation:- Continental markets benefit from indexation in the short term. In the longer term real estate is a better hedge against inflation than fixed income bonds.
- Resolution of sovereign debt crisis results in economic recovery:- Occupier demand improves, occupancy rates increase. Longer term, lack of new development completions results in a shortage of good quality space and rental growth, increasing income and capital values.

While other assets might produce better returns under specific outcomes, real estate performs under multiple scenarios making a strong case for investors to overweight property in their portfolios at this time.

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