



C A M B R I D G E A S S O C I A T E S L L C

EUROPEAN MARKET COMMENTARY

BULLISH ON EUROPEAN PROPERTY

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Bullish on European Property

European property is on a roll. Despite posting solid returns over the past several years, continental property looks reasonably priced,¹ particularly compared to other global asset classes, the majority of which remain quite expensive.² Fundamentals such as rental rates have improved markedly over the past year or so, even as prices have risen and yields dropped. Further, while strong capital flows have been a big driver of the recent rally, there is no indication these flows will diminish anytime soon. Indeed, the continued liberalization of European property investment structures is likely to draw further capital to the sector, as cross-border institutional investors, as well as smaller investors who have effectively been shut out of the market due to the lack of suitable investment vehicles, pour cash into the mushrooming number of Real Estate Investment Trusts (REITs) and REIT-like structures. While there are of course risks to the sector, most notably the prospect of a sharp rise in interest rates, we believe continental European property currently represents one of the better values in global financial markets.

Expensive or Cheap?

At first glance, continental property looks somewhat ripe for a fall, with low yields, and strong recent returns (see Table).³ Further, the significant increase in investor interest in the sector, as well as soaring merger and acquisition (M&A) activity, could be viewed as a bit frothy. However, it is important to recognize the depths from which European property is emerging. Indeed, up until very recently even the most sophisticated U.S. investors generally avoided the sector due to its opaque and fragmented nature. Somewhat paradoxically, the continued existence of such problems is a large part of what makes European property so appealing at present. In short, it is far easier to add value in inefficient markets than in efficient ones, *especially when those markets are in the process of becoming more efficient* (provided that market participants do not become too ebullient about future prospects). Thus, if we assume recent reforms are but the leading edge of a long-overdue period of restructuring, European property managers should be able to add significant value over coming years as REITs take root and property management becomes more sophisticated. To cite one obvious example, much of the political support for REITs has come from governments eager to sell off properties and use the proceeds to reduce debt,⁴ clearly there is an opportunity for managers to create value in such situations.

¹ U.K. property looks a good bit more expensive. For details, please see our February 2006 European Market Commentary: *U.K. Property Still on the Boil*.

² For our valuation views, please see our monthly *Notes on Current Valuations* publication.

³ Unfortunately, due to a near complete lack of historical data and lack of comparability between European and U.S. property (discussed below), we are unable to perform analysis on similar periods that might provide clues to how the current environment will play out. Further, the post-2000 data shown in the exhibits should be viewed with a healthy dose of skepticism. According to Investment Property Databank Ltd, which publishes the data, the series shown are not “appropriate” for use as benchmarks due to their lack of inclusion of active management impact (e.g., trading, development, refurbishment) and the fact that historic series will change as more accurate data become available.

⁴ Governments have also supported REITs because of one-time tax payments due when companies convert to a REIT structure.

Follow the Money

As noted above, continental property returns over the past few years have been driven mainly by a flood of capital. Real estate firm Jones Lang Lasalle, for example, recently remarked that “the weight of money coming into European real estate overrides every other factor in influencing pricing.” While this sounds a bit ominous, such a situation is troubling *only if* one assumes such money is likely to dry up soon and/or is largely speculative, neither of which seems to apply in this instance. Indeed, a number of U.S.-based institutions have been taking a hard look at the sector over the past few years, but investment has only recently begun to pick up (and seems to be gaining momentum). The most notable example is CalPERS, which announced earlier this year that it will shift half of its more than US\$10 billion real estate portfolio into non-U.S. investments. Overall, European direct investment volumes totaled €95 billion for the first half of 2006, a 30% increase over the first half of 2005, and more than *full-year* totals for 2000-03. Cross-border investors, meanwhile, made up 68% of volumes, up from 59% for all of 2005.

The ongoing revolution in REITs and REIT-like structures—Sociétés d’Investissements Immobiliers Cotées (SIICs), referred to as the “French REIT,” already exist, while similar vehicles are set to debut in the United Kingdom in January and likely in Germany soon thereafter—is also creating interest among investors, from those simply interested in a tax-advantaged real estate play, to property companies looking to capitalize on the new rules. Indeed, there has been a spate of M&A activity lately among companies looking to improve their competitive position prior to the new structures becoming active. In France, meanwhile, non-SIIC investors are reportedly finding it difficult to compete for assets due to the advantages conferred on SIICs. As a result, many investors, both French and non-French, are setting up their own SIIC structures. Considering that European REITs remain in their infancy, we expect these structures will continue to drive interest in the sector as they evolve and mature. In short, while we cannot quantify the impact of the REIT revolution on future European property returns, it is likely to be significant.

Viva la Difference!

For investors familiar with U.S. commercial real estate, it is also important to understand that the European property market operates according to slightly different rules. U.S. property tends to ebb and flow with the economic cycle, with long periods of strong returns typically leading to speculative building booms that culminate in commensurate busts (and 20%+ vacancy rates) when the cycle eventually turns down. In Europe, by contrast, stringent regulations make it next to impossible for any sort of building boom to occur; rather, vacancies tend to fluctuate around a much lower level in key cities such as London and Paris. Indeed, one of the notable features of the current rise in prices is that it has occurred against a sluggish economic backdrop; thus, the recent pick-up in economic growth, while slight, has nonetheless put significant upward pressure on rents. For the four quarters ended in September, prime office rents across Europe (including the United Kingdom) rose 5.8%, with average vacancies dropping from 9.3% to 8.4%. (Rents in certain areas are rising much faster. For example, European Investors Incorporated, which invests in non-U.S. property companies, expects French office lease rates to rise 20% this year.) Building, meanwhile, remains subdued; while 2006 completions in Western Europe are expected to increase 40% over 2005 levels (to 3mm²), this

would merely be on par with annual completion levels from 2001-03, and completions for 2007-08 are projected to fall sharply from 2006 levels. In short, even subdued economic growth over the next few years appears likely to drive rents higher. Anecdotally, one European property manager recently told us his “worst-case scenario” is not a recession, but rather a sharp rise in interest rates; a recession, he argued, would be unlikely to push rents appreciably lower due to the supply constraints discussed above.

The Bottom Line

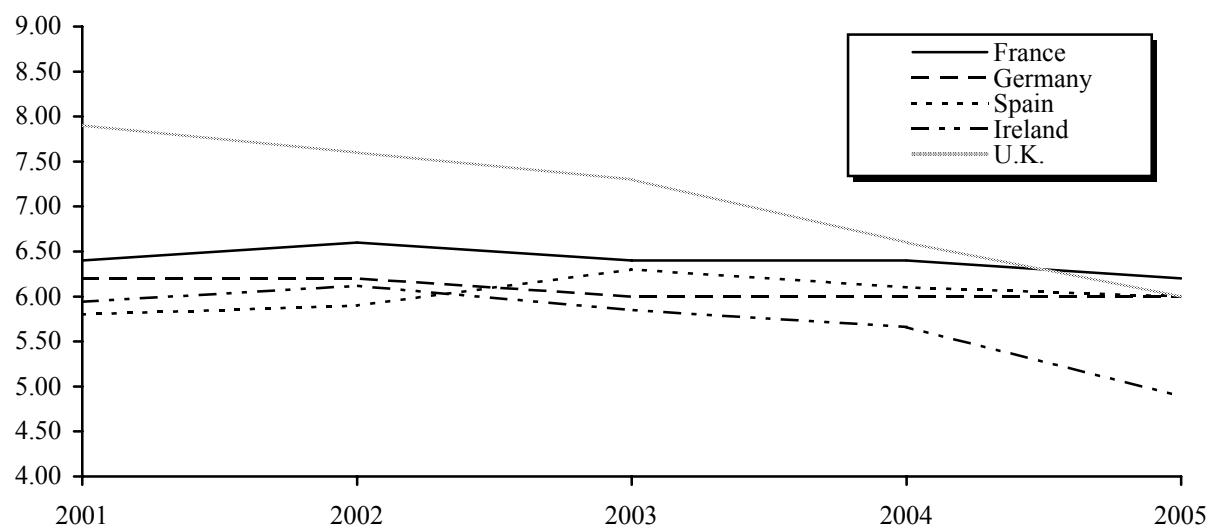
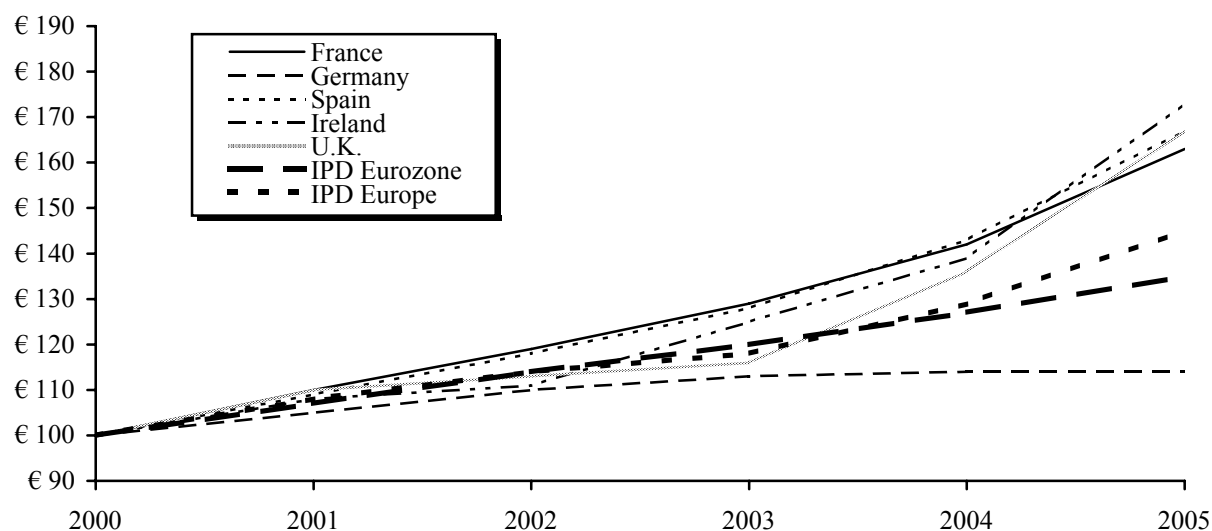
European property has benefited over the past few years from a tremendous influx of capital that has driven yields lower. While there is of course a limit to how low yields can go, the recent surge in demand and uptick in rental rates may prove strong enough to offset any settling of property values. Further, inflows are unlikely to subside anytime soon due to the relative attractiveness of European property, opportunities (and increased interest) driven by new REIT-like investment structures, and a growing belief that the sector is still in the early stages of a significant restructuring process. For managers, the opportunities to add value to formerly government-run and other inefficiently run properties should be substantial for some time.

Table A

HISTORICAL YIELDS AND RETURNS FOR EUROPEAN REAL ESTATE

2001-05

Yields (%)

Cumulative Wealth
2000 = €100

Source: Investment Property Databank Ltd.

Notes: Gross initial yields are used for France, Germany, and Spain. Equivalent yields are used for Ireland and the United Kingdom. The cumulative wealth graph is based on total returns data. Eurozone is defined by the countries that have adopted the euro. These data should be viewed with a healthy dose of skepticism. According to IPD, which publishes the data, the series shown are not “appropriate” for use as benchmarks due to their lack of inclusion of active management impact (e.g., trading, development, refurbishment) and the fact that historic series will change as more accurate data become available.