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EUROPEAN MARKET COMMENTARY

EUROPEAN PROPERTY: IS THE PARTY OVER?

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Introduction

European property stocks were going gangbusters until 2007, not only clobbering European equities but also substantially outperforming U.S. and Asian property issues (Table A). Has the sharp drop in returns in 2007 created a buying opportunity or should investors remain wary of European real estate equities? We conclude that long-term opportunities are good in this sector thanks to a still immature market and expected investor interest. However, since valuations are not compelling today, investors should avoid large bets and should be in no hurry to ramp up their allocations.

What Goes Up . . .

Notwithstanding the FTSE Real Estate Index's[1] 33.9% average annual compound return (AACR) from 2003 to 2006 (in euros), rising central bank policy interest rates, and record-low commercial property yields, sentiment toward European property was generally positive in early 2007. CB Richard Ellis, for example, argued that there was substantial room for upside in transaction activity, even though transaction volumes in European commercial property had almost doubled in the preceding two years.[2] Moreover, foreign investment in the sector was growing rapidly and appeared a likely source of continued demand. And with new real estate investment trust (REIT) legislation coming online in 2007 in the United Kingdom (January), Germany, and Italy, as well as possible revision of existing REIT legislation on the Continent, some believed the investment feast would continue.

However, the repast does not look so inviting today—at least at first glance. While European equities posted solid, if not stunning, returns of 6.7% through July, European property returned -17.0% in euros (-13.8% in US$ and -17.0% in sterling), with all of this (and more) the result of a -18.6% return between April and July. As of July 31, 2007, three quarters of property stocks had experienced a price decline during 2007.

Overview of the European Property Market

The public European property market is small[3] but diverse, not only because it includes both REITs and non-REITs and covers the office, retail, and industrial sectors but also because it encompasses different countries, with each national market composed of different local markets. Encompassing as it does both rural French industrial property and urban Norwegian office space (for example) this makes the market less uniform than even the very broad U.S. market. In contrast to the United States, however, European property firms are not specialized, tending instead to hold a variety of real estate assets.

[1] The full name of this index is the FTSE EPRA/NAREIT Europe Real Estate Index.
[2] CB Richard Ellis Market View: European Investment, Year End 2006 (2007).
[3] Real estate makes up only about 0.9% of the FTSE World Europe Index.

As of July 31, 2007, the FTSE Real Estate Index was composed of 101 stocks from 15 nations and had an investable market cap of €129.5 billion (US$177.2 billion and £87.2 billion).[4] The index's 35 REITs accounted for 60.9% of the investable market cap while its 39 U.K. firms (including 11 REITs) accounted for 44.5%.

The index is highly concentrated, with the top three issues by market capitalization making up 27.5% of the (investable) index and the top five, all of which are REITs, 35.8%. Unibail, a French firm that recently purchased a leading Dutch firm, is the largest constituent, while the next four are British. As of July 31, 2007, these five firms had an average dividend yield (DY) of 2.3%, compared with an average DY ratio of 2.7% for the index as a whole.

Valuations

As in the U.S. property market (and, indeed in equity markets generally), European real estate equities have historically provided the bulk of their returns in the form of dividends (Table B)[5]—although this has *not* been the case in recent years (Table C). However, with DYs hitting record lows by the end of 2006,[6] European property stocks looked expensive on a historical basis relative to other financial instruments, including European equities (Table D). After yields fell in March to only 42% of their February 2003 level, investor flight commenced.

European property company debt levels remain high. As of June 30, 2007, 38 of the 89 companies for which data were available had debt-to-equity ratios higher than 100% (the median for these firms was 156.5%).[7] While financial market turmoil has likely delayed immediate tightening by the European Central Bank and the Bank of England, the market continues to discount further rate increases due to inflation fears. Although inflation could benefit property sector prices, the combination of higher interest rates and a greater aversion to risk on the part of lenders in the wake of the subprime meltdown would likely curtail the use of leverage as well as reduce merger and acquisition activity, which has supported the market. This suggests substantial downside risk for both external growth–focused and more highly leveraged property firms: even though the 38 highly leveraged companies referenced above (median debt-to-equity of 156.5%) had a median price loss of -14.4% in the first seven months of 2007 compared with -8.5% for the less indebted firms, their median price-earnings (P/E) ratio of 11.0 is much higher than that of their counterparts (6.9).

In addition, should slower-than-expected GDP growth on the European continent translate into reduced demand for real estate it would be particularly worrisome given low DYs. Thus, one troublesome aspect of European exposure to the U.S. subprime market is its likely adverse effect on the financial sector, a

[4] Investable market cap was 77% of the total market cap of €168.7 billion.
[5] This assumes reinvestment of dividends. REITs, which constitute the majority of the FTSE Real Estate Index, are required to pay out in dividends the overwhelming majority of their income. According to data from S&P/Citigroup as of July 31, 2007, European REITs had higher DYs but lower returns on equity than other European property stocks.
[6] Our data go back only to the beginning of 2001. CBRE data go back 20 years. CB Richard Ellis Market View: European Investment, Year End 2006 (2007).
[7] Only seven of these 38 firms were REITs.

prime driver of the office market, which accounts for about half of European commercial property. There is also the risk that a sharp fall in the value of the euro and/or pound, both of which have risen substantially against the dollar since 2003, would lead to an exodus of foreign investors and renewed downward pressure on prices.[8]

Some observers take heart from the fact that European real estate equities have been trading at a substantial discount to net asset values (NAV), particularly in the United Kingdom.[9] However, a spike in new equity issuance over the last few years has likely contributed to an overvaluation of the sector[10] and it is unclear when such issuance will subside. NAV also tends to be a lagging indicator so the discount may be overstated if real estate prices have fallen. Finally, although prices should gravitate toward NAVs over the long term, European property has tended to be a highly cyclical sector marked by extreme moves, making it risky to assume rapid regression to NAV levels.

Conclusion

It was, of course, impossible that European property stocks could sustain indefinitely a 33.9% four-year AACR. As always in such cases, the issue was how long the party might continue before guests either wandered away in dribs or drabs or tried to exit all at once when they realized the punchbowl was dry. Now that the party is over, the next question is whether this is a correction in its late stages—suggesting opportunities for investors—or whether the market will decline substantially further.

Certain factors augur well for the health of the European public real estate sector: it is still relatively immature; evolving REIT structures should provide a boost to the market; and investor interest, including from outside Europe, should be a long-term tailwind. On the other hand, slower economic growth would impair demand and, by extension, prices. Moreover, the recent turmoil in the financial markets makes money more expensive and less available, which could cut into the financing of new deals and the viability of existing deals that are highly leveraged.

While DYs have risen slightly in recent months thanks to sharp price declines, European property continues to look expensive on a historical basis both in absolute terms and relative to other investments. It is also worth keeping in mind that despite the sector's woes in 2007, it has still returned a cumulative 166.8% since the start of 2003. Although subsectors may provide savvy investors with some compelling opportunities (and may lead to more specialization among managers), it is hard to make a compelling case today for European real estate as a whole, despite its clear long-term potential. This is particularly true with respect to the United Kingdom, where DYs, P/E ratios, and returns on equity are lower, and interest rates higher, than on the Continent.

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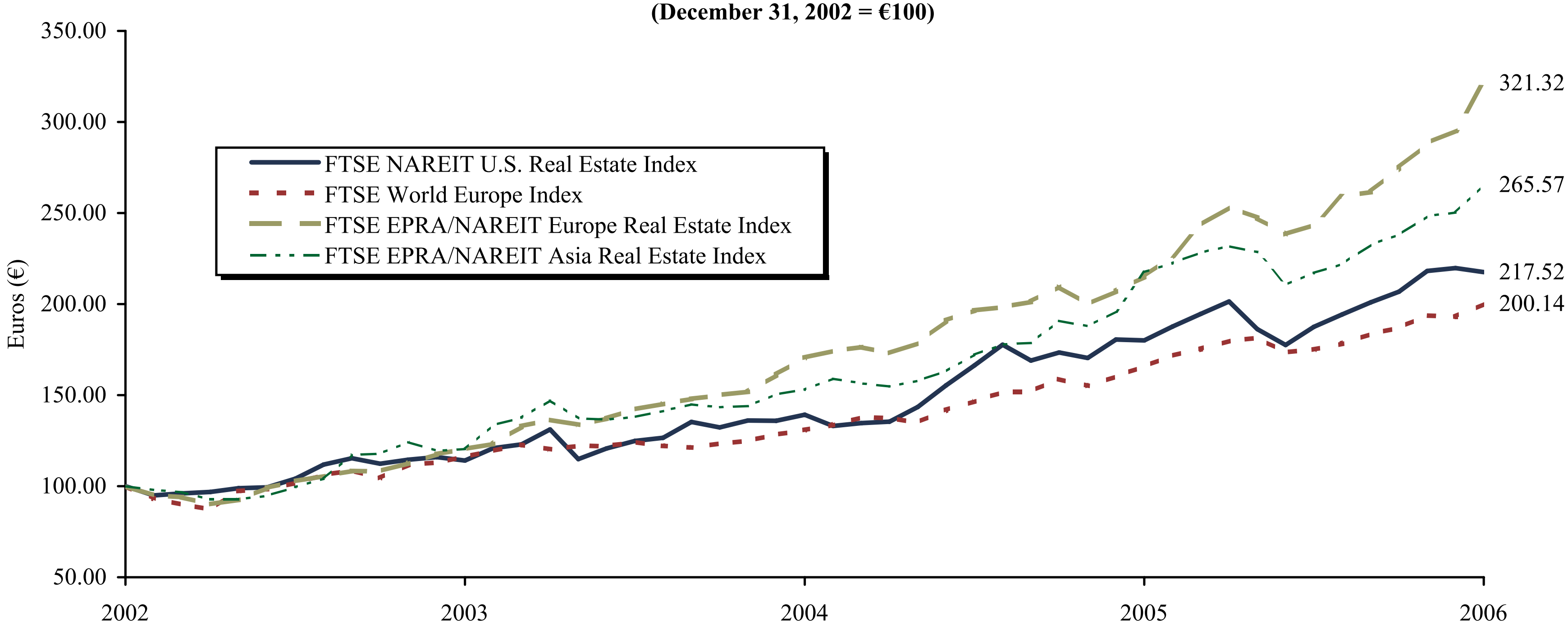
[8] Of course, assuming investor optimism, such a scenario could also result in an influx of new capital seeing more value for the buck (or some other non-European currencies).
[9] For example, Cohen & Steers, using the S&P/Citigroup Europe Property Broad Market Index rather than the FTSE EPRA/NAREIT Index, calculated the discount at -11.9% as of June 30, 2007.
[10] "Property: Don't Catch a Falling Knife," Morgan Stanley, June 28, 2007.

Table A

CUMULATIVE WEALTH FOR VARIOUS INDICES

January 1, 2003 - December 31, 2006

Cumulative Wealth Index
(December 31, 2002 = €100)



	One-Year Return (%) (2006)			Four-Year AACR (%) (2003-06)		
	$	£	€	$	£	€
FTSE NAREIT U.S. Real Estate Index	35.06	18.47	20.82	28.58	22.45	21.44
FTSE World Europe Index	34.92	18.34	20.69	25.93	19.93	18.94
FTSE EPRA/NAREIT Europe Real Estate Index	66.99	46.48	49.38	41.75	35.00	33.89
FTSE EPRA/NAREIT Asia Real Estate Index	36.49	19.72	22.09	35.16	28.72	27.66

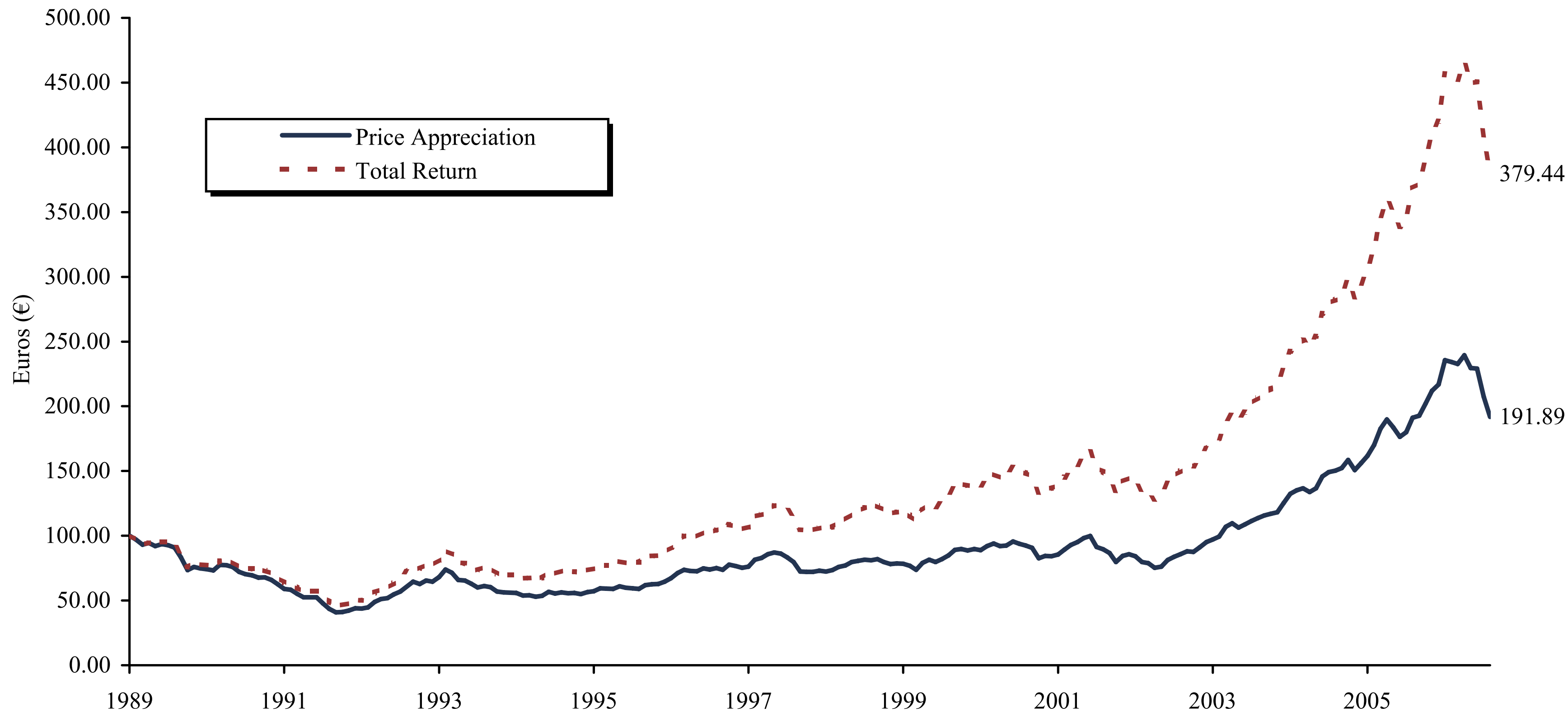
Sources: FTSE International, National Association of Real Estate Investment Trusts, and Thomson Datastream.

Table B

FTSE EPRA/NAREIT EUROPE REAL ESTATE INDEX

January 1, 1990 - July 31, 2007

Cumulative Wealth Index
(December 31, 1989 = €100)



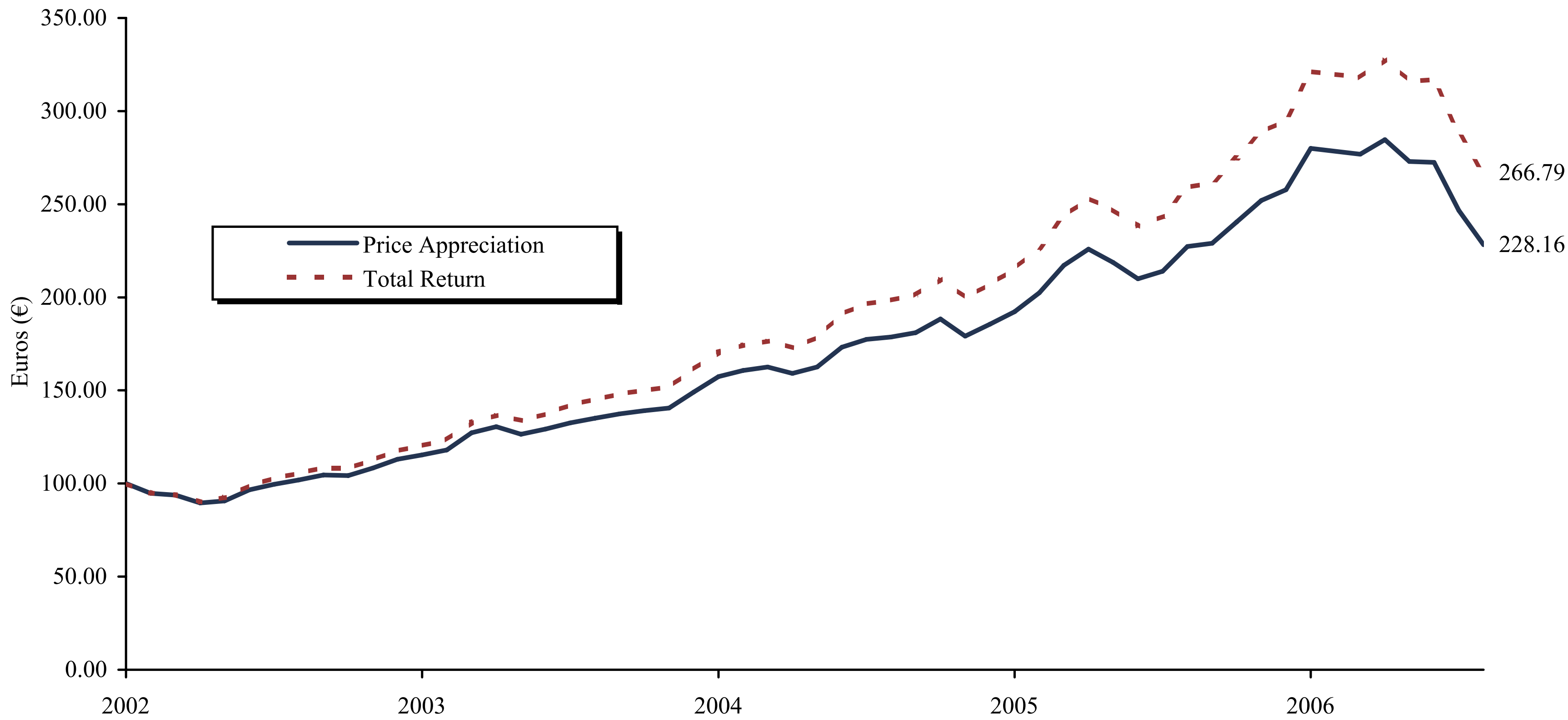
Sources: FTSE International and Thomson Datastream.

Table C

FTSE EPRA/NAREIT EUROPE REAL ESTATE INDEX

January 1, 2003 - July 31, 2007

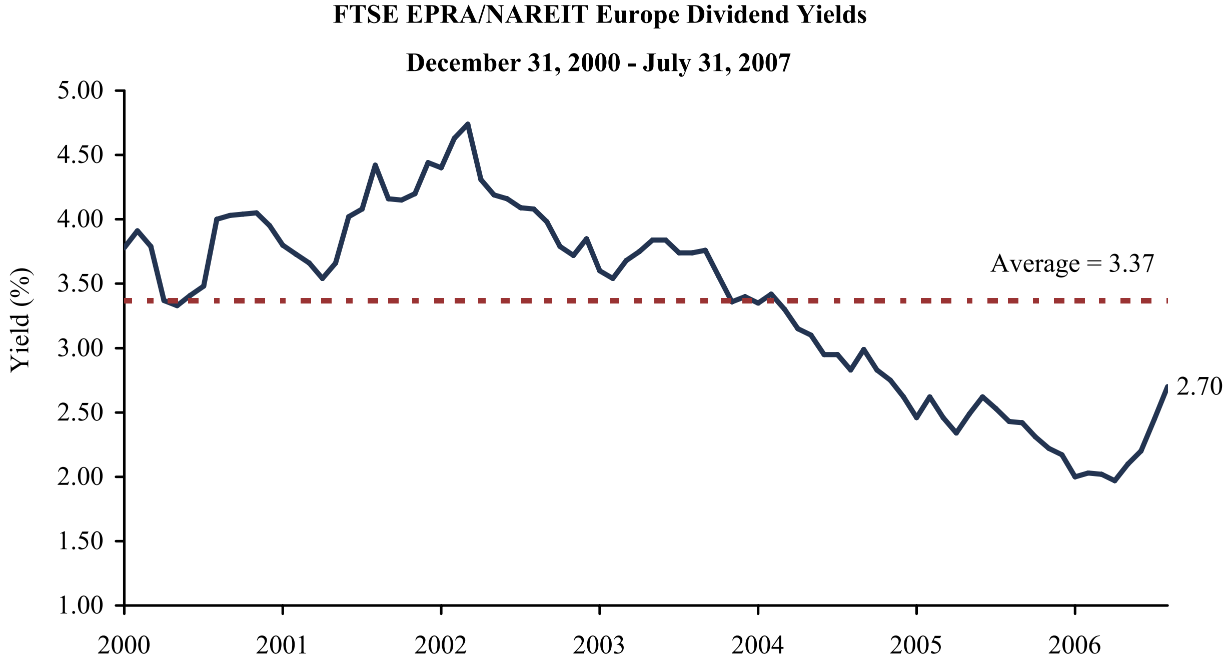
Cumulative Wealth Index
(December 31, 2002 = €100)



Sources: FTSE International and Thomson Datastream.

Table D

EQUITY REAL ESTATE YIELD RATIOS



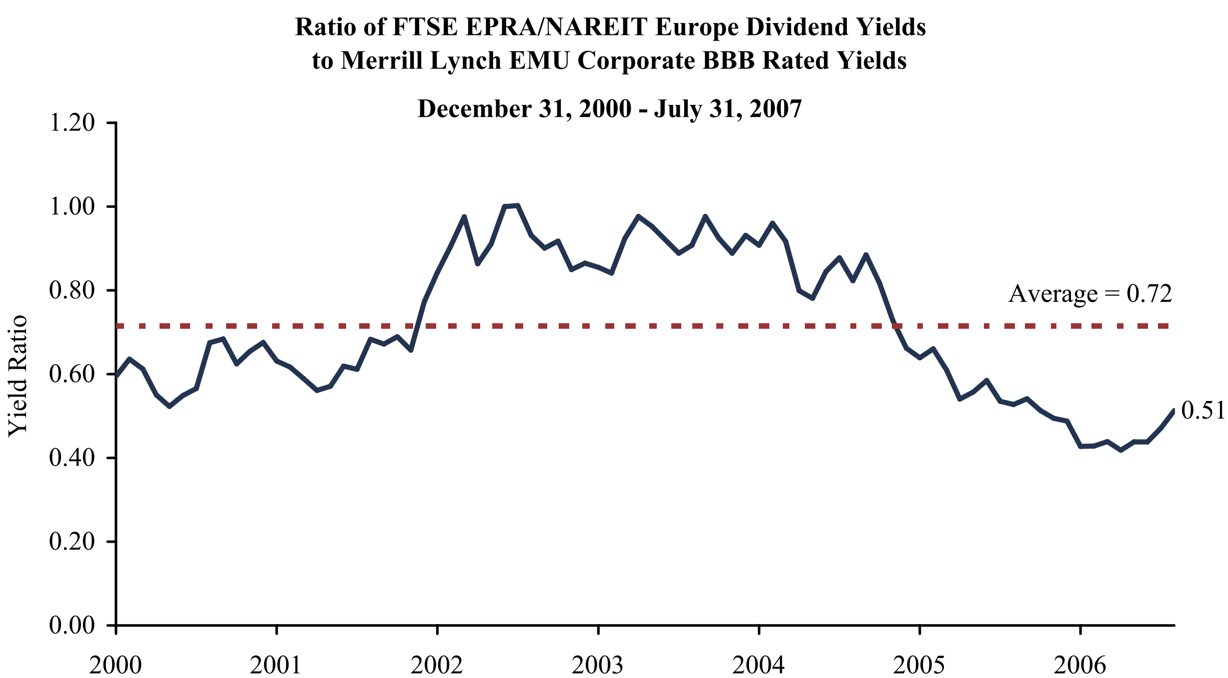
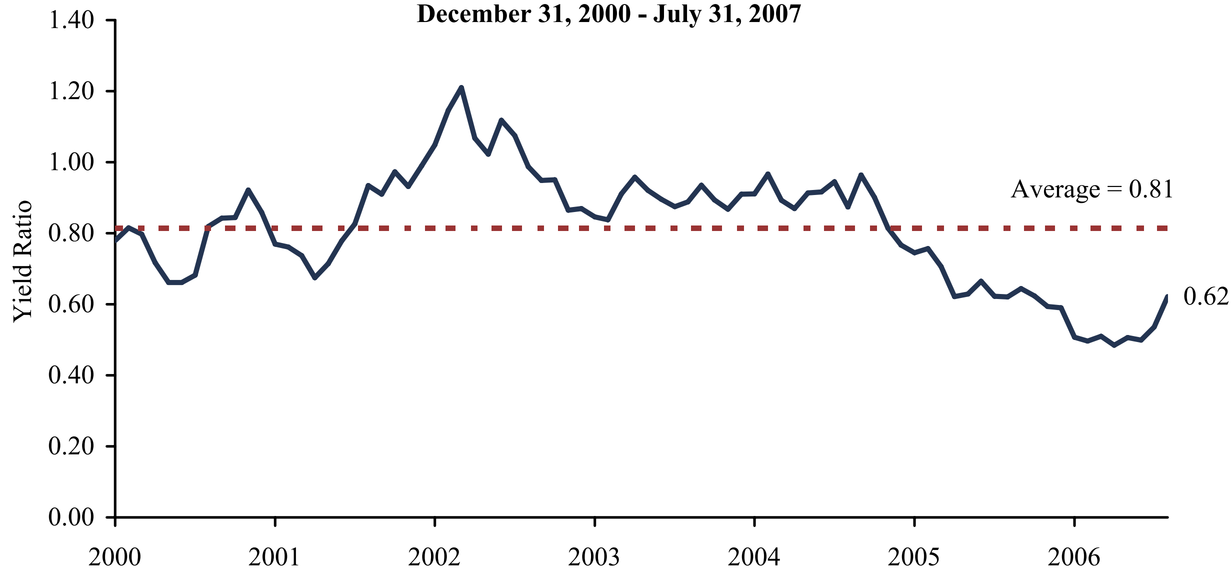


Table D (continued)

EQUITY REAL ESTATE YIELD RATIOS

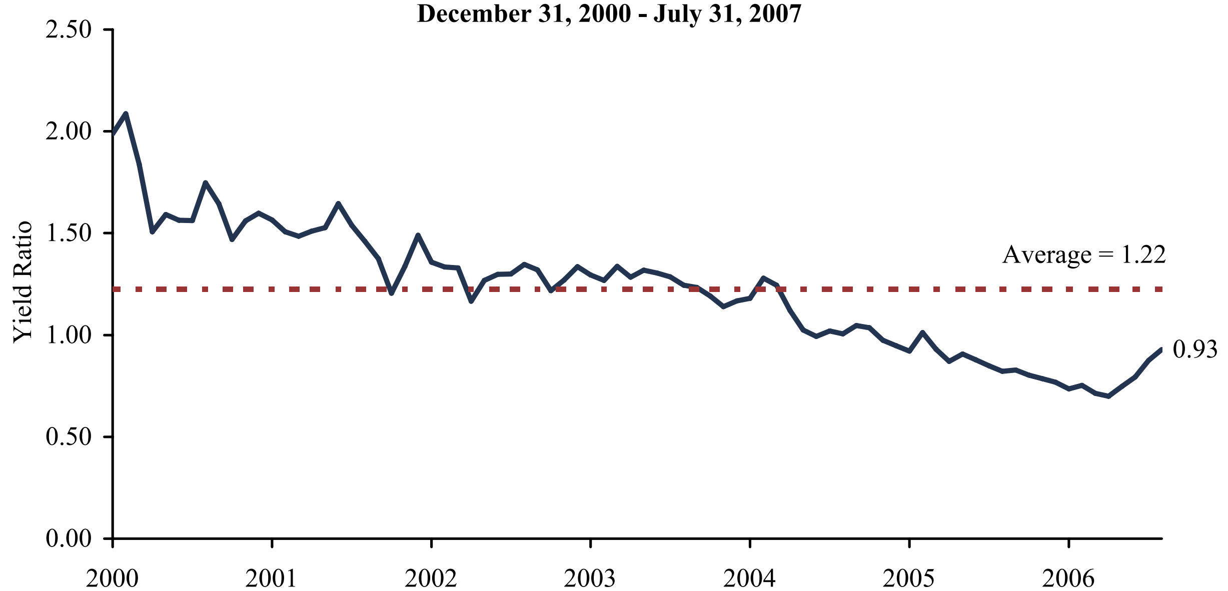
Ratio of FTSE EPRA/NAREIT Europe Dividend Yields to Ten-Year Euro Government Bond Yields

December 31, 2000 - July 31, 2007



Ratio of FTSE EPRA/NAREIT Europe Dividend Yields to MSCI Europe Dividend Yields

December 31, 2000 - July 31, 2007



Sources: FTSE International Limited, Merrill Lynch & Co., Morgan Stanley Capital International, National Association of Real Estate Investment Trusts, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.