August 2012

European Market Commentary

U.K. Property: Time to Top Up on Prime?

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U.K. Property: Time to Top Up on Prime?

U.K. property remains bifurcated, with a large spread between prices and investor interest in prime and non-prime assets. While prime prices are assuredly not cheap, we would view a further softening in capital values as a signal for long-sighted investors to top up allocations.

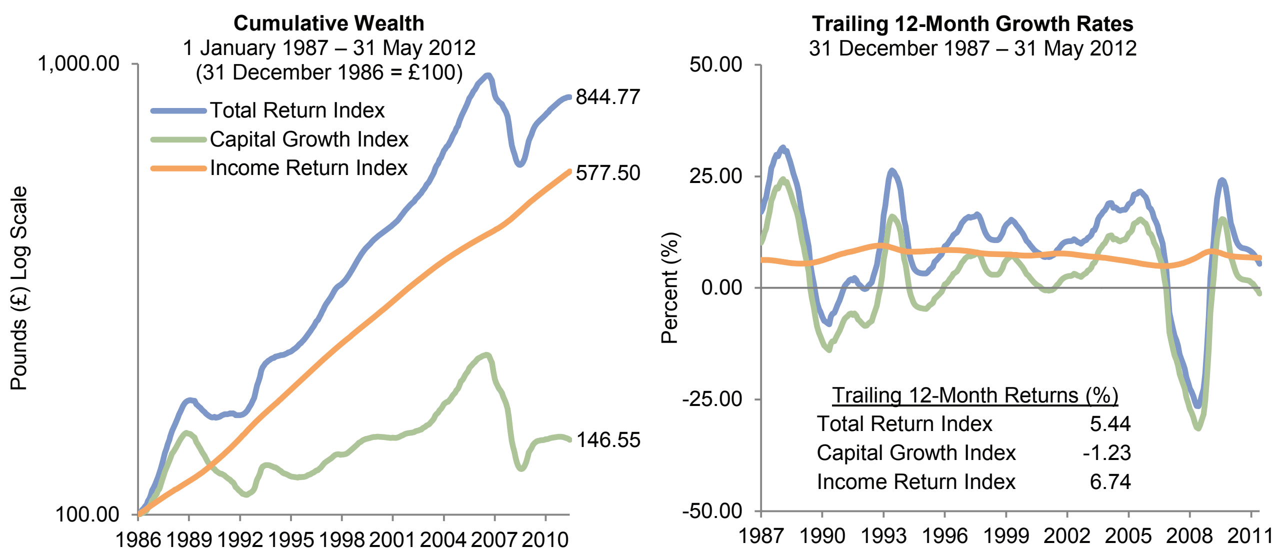
"Prediction is very difficult, especially about the future."—Niels Bohr

Two years ago, we penned a decidedly lukewarm piece about U.K. property, concluding that a dramatic gain in prices was unlikely given the headwinds facing the sector, but also that high yields relative to gilts, coupled with expectations of continued easy money policy, should prevent a sharp *fall* in prices.[1] This advice proved close to the mark—U.K. property has since returned 13.3% (average annual compound return of 7.1%), with 12.9% coming from income, and an almost imperceptible 0.4% from capital growth (Figure 1).

While the current outlook is similarly cloudy, there are some straws in the wind this time round. Future returns will be hampered by the weak economy, depressed bank lending, and an advancing wall of debt maturities (many secured on properties with loan-to-value [LTV] ratios too high to qualify for new loans), but prices should still find support from the wide spread between property dividends and gilt yields, not least because of the lack of attractively priced alternatives. Banks have also made some progress on writing down loans, although this is still in the very early stages.

[1] Please see our August 2010 Market Commentary *U.K. Property: Hold the Champagne.*

Figure 1. Return Trends of U.K. Property



Source: Investment Property Databank Ltd.
Notes: Cumulative wealth returns are shown on a logarithmic scale. Total return is made up of capital growth and income return. Trailing 12-month returns are as of 31 May 2012.

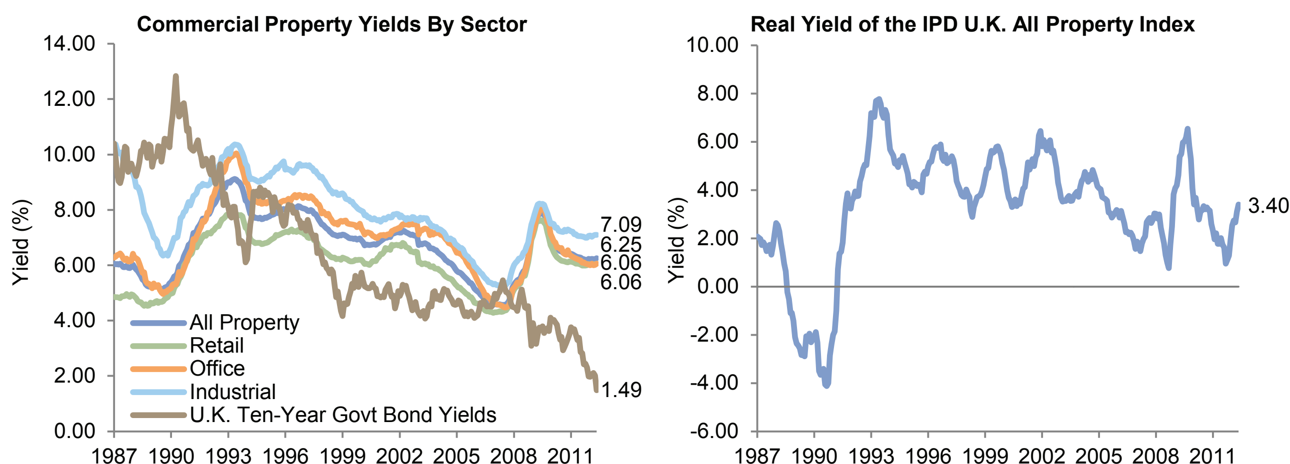
While much of our analysis focuses on aggregate data, we would also note that the spread between prime and non-prime properties (glibly put, London and the South East versus everything else) remains wide, with capital drawn to the former for its solid fundamentals—including reliable cash flow and good economic prospects—while the opposite is true for most of the rest of the country. Thus, while prime prices are assuredly not cheap, the softening in capital values over the past few months could, if it continues, provide an attractive entry point for investors looking to top up on good-quality, income-generating assets.

In the Land of the Blind …

As noted, the bullish case for U.K. property stems mainly from attractive yields, particularly relative to consumer prices (Figure 2) and gilts (Figure 3). We are, of course, cognizant of the old saw that one cannot eat relative returns. Still, nominal yields above 6%—backed by real assets, no less—remain a luxury in the current rock-bottom rate environment. Indeed, U.K. property yields are not only more than 400 basis points (bps) above gilts, bunds, and U.S. Treasuries, but similar to those on offer from Spanish and Italian government debt; we leave it to the reader to assess the relative merits therein.

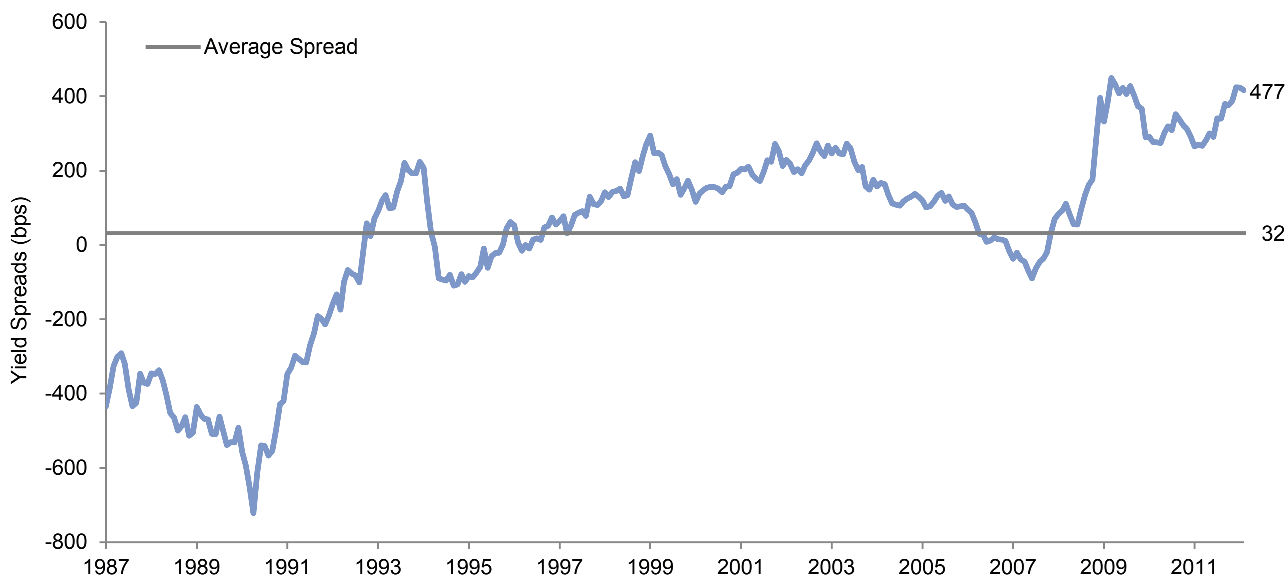
The outlook for property yields, meanwhile, remains benign—Capital Economics, on the more bearish side of forecasters, still projects yields will rise only 20 bps over the balance of 2012. Of course, all such forecasts hinge to a large degree on the ongoing European debt saga, the outcome of which is well-nigh impossible to forecast, as are any potential impacts on U.K. property. Euro disintegration,

Figure 2. Monthly Yields on U.K. Commercial Property Sectors
31 January 1987 – 31 May 2012



Sources: Investment Property Databank Ltd. and Thomson Reuters Datastream.
Notes: Initial yield is used for all of the Investment Property Databank sectors. Initial yield equals annual gross rent minus ground rent, divided by capital value. To calculate the real yield we use the U.K. RPI for the period 1987 through November 2003 and the U.K. CPI from December 2003 to the present, as the official measure of inflation changed to the CPI data series in December 2003.

Figure 3. Spread Between U.K. All Property Yield and Ten-Year Gilts
31 January 1987 – 31 May 2012



Sources: Investment Property Databank Ltd. and Thomson Reuters Datastream.

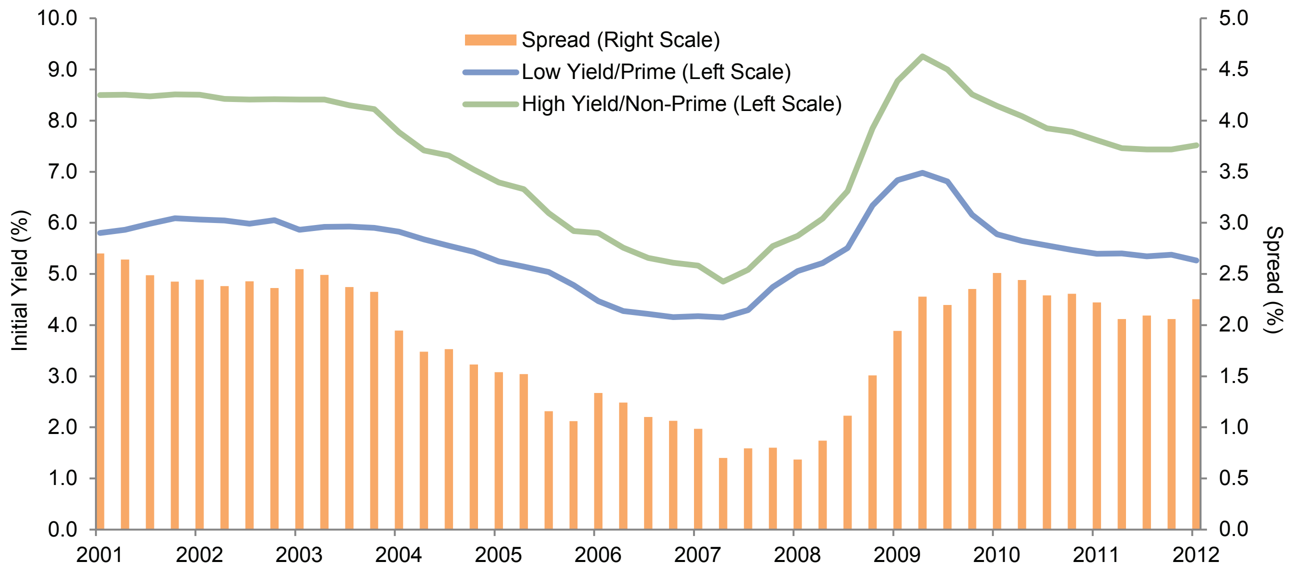
for example, would have obvious ill effects on global financial markets, but might also drive investors to the relative safety of U.K. property, while a more benign outcome would be more generally bullish, but could also lessen European capital flight.

Pro tem, the gap between prime and non-prime properties shows few signs of closing. Some local market commentators say non-prime prices are now low enough to attract buyers, but non-prime yields actually rose slightly in the first quarter even as prime yields dipped (Figure 4). The relative moves were small—about 10 bps in each direction—but underscore the divergent fortunes of the two sectors; the 225 bp gap between prime and non-prime properties is well above its 2008 nadir of 69 bps, and close to the widest in our post-2000 dataset, although still not providing a massive amount of protection on an absolute basis. As discussed above, the gap between prime and non-prime seems to be widening, with the former having enjoyed solid price gains—up 35% since 2009, and 16% above their 2007 peak, according to CBRE—while non-prime properties struggle to attract tenants *or* investors, which are the factors weighing most heavily on recent valuation reports.

Of course, the flip side of the rally in prime prices is that, *ceteris paribus*, price risk is higher. While there is currently no shortage of willing buyers for prime properties (more on this below), the list of "bulletproof" assets that have eventually proven somewhat less so—e.g., the "Nifty Fifty" in the early 1970s, Japanese real estate in the late 1980s, and large tech stocks in the late 1990s—is long.

Figure 4. Initial U.K. Property Yields

First Quarter 2001 – First Quarter 2012



Sources: Capital Economics and Investment Property Databank Ltd.

Fundamental Concerns

Even absent a euro crisis, fundamentals for U.K. property are mixed at best. The sharp second quarter drop in GDP was just the latest number to cast doubt on the prospect that any sort of sustainable recovery is underway—as Capital Economics put it, the government's plan "seems to be unraveling." If recent history is a guide, further monetary intervention will simply exacerbate the debt problems. It might provide another short-term boost to risk assets, but there is no reason to believe it will lay the groundwork for organic economic growth.

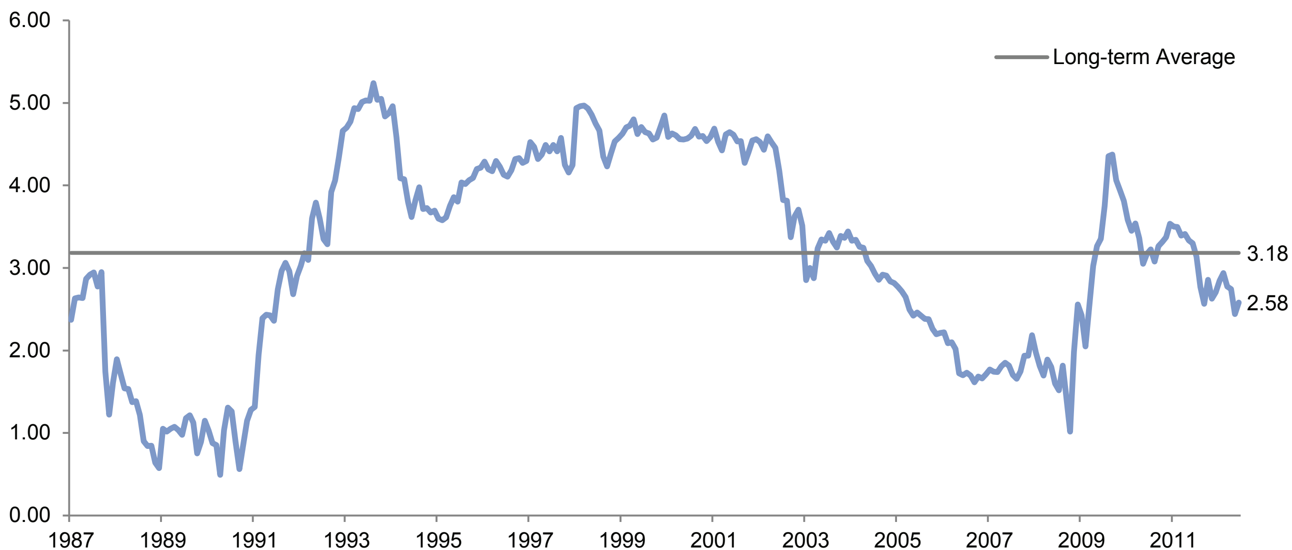
Thus, while headline yields look interesting relative to gilts, we must view them with a slightly jaded eye given the possibility economic growth continues to disappoint. It is also worth noting that real estate yields look a lot less compelling relative to equity *dividend* yields (Figure 5), even as U.K. equities are not particularly rich or cheap in their own right. Finally, the recent uptick in vacancies (Figure 6), while not alarming in and of itself, would almost certainly presage greater rental pressures in a recessionary environment.

Thus, fundamentals look similar to how they did two years ago, but with the very large caveats that the Eurozone seems closer to a true crisis point, and the "best-laid plans" for U.K. economic recovery have more or less failed. That said, such macro concerns, of course, apply to all risk assets, and thus U.K. property *might* look more attractive in the event demand for safe havens explodes.

Bank Lending: Glass Half Full?

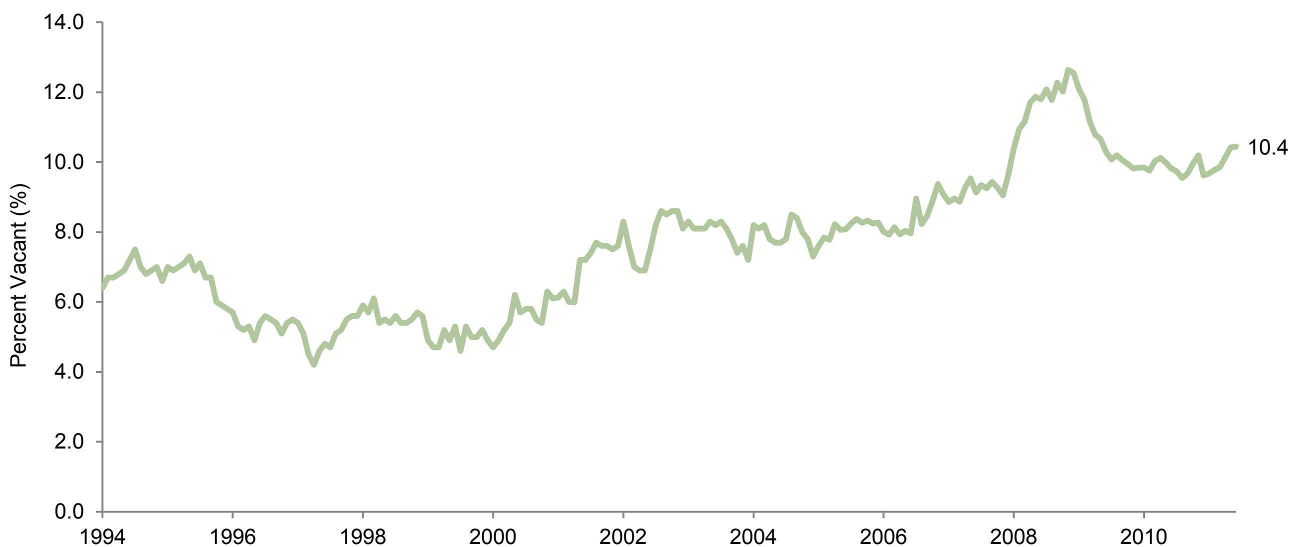
One of the negatives noted in our prior report was banks' lack of progress in reducing the property debt overhang. Thus, the meaningful decline in bank lending since that point surely

Figure 5. U.K. All-Property Initial Yield Minus FTSE® All-Share Equity Dividend Yield
31 January 1987 – 30 June 2012



Sources: Investment Property Databank Ltd. and Thomson Reuters Datastream.
Note: All data are monthly.

Figure 6. Monthly U.K. Vacancies
31 December 1994 – 31 May 2012



Source: Investment Property Databank Ltd.
Note: Data represent all U.K. property types including industrial, office, and retail.

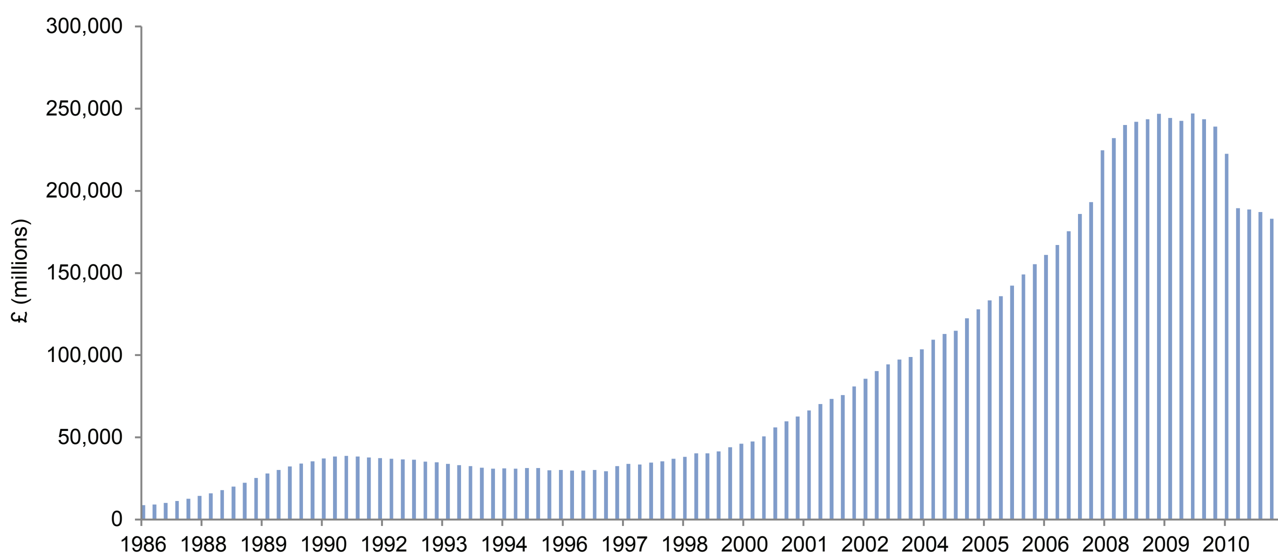
counts as a positive. That said, property loans have merely fallen back to 2007 levels by value (Figure 7), and as a percentage of total bank loans remain far above prior cyclical troughs (Figure 8).

This only serves to underscore the gulf between prime and non-prime properties. For example, while non-prime is off the radar for most investors, things could not be more different for prime properties in London. According to CBRE, the share of London purchases funded by deep-pocketed (and generally long-horizoned) Middle Eastern and Far Eastern investors has roughly tripled in recent years (Figure 9). In large part this is due to the phenomenal liquidity offered by the London market—according to CBRE, from 2009 to 2011, Central London saw more deals of €100 million-plus than Frankfurt, Madrid, Moscow, Paris, and Stockholm *combined*. Again, we view these data with a slightly jaded eye—as the saying goes, liquidity is a coward, never there when you need it—but *for now* there seems a surplus of buyers for prime properties.

Elsewhere in the country, the picture is far different. Indeed, the Bank of England recently reported[2] that not only is about £50 billion of commercial real estate debt due to mature in 2012, but much of it has LTV ratios higher than those currently available from lenders. As the report drily notes: "It is not clear if it will be possible to refinance these loans on current market terms. If not, this could lead to an increase in defaults and reduce the willingness of banks to exercise forbearance." The numbers are sobering—according to the 14th annual De Montfort University *UK Commercial Property Lending* report, of the £212 billion in outstanding property debt, £106 billion has an LTV ratio above 70%, with £42.5 billion above

[2] *Financial Stability Report*, June 2012.

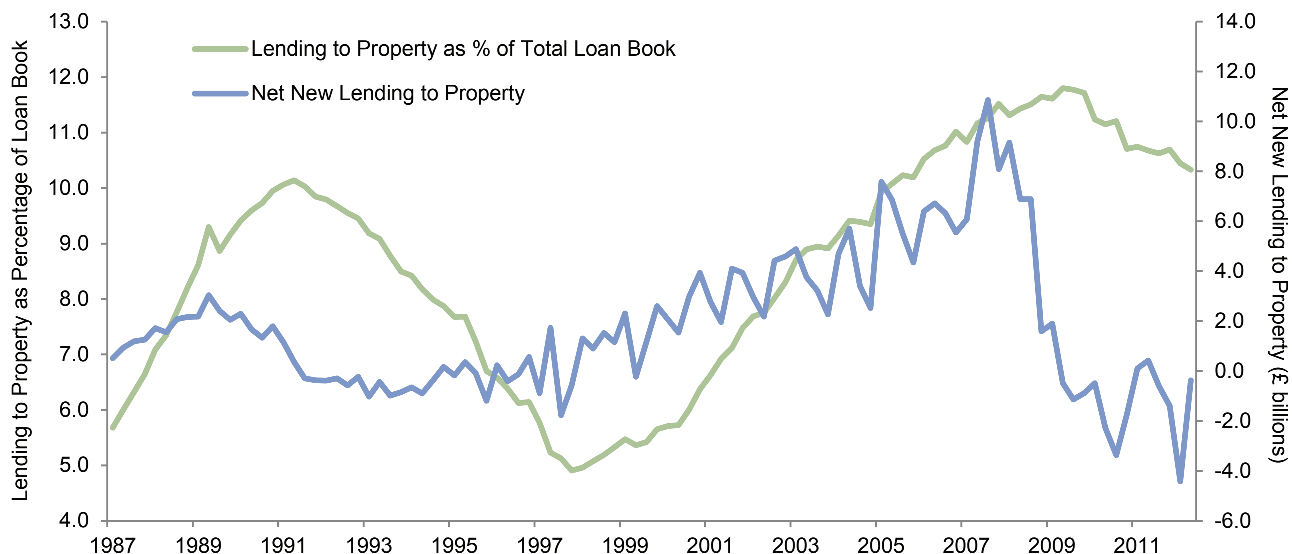
Figure 7. Outstanding Bank Loans to U.K. Commercial Property
Fourth Quarter 1986 – First Quarter 2012



Source: Bank of England.
Note: Data are quarterly.

Figure 8. Bank Lending to Commercial Property

First Quarter 1987 – Second Quarter 2012

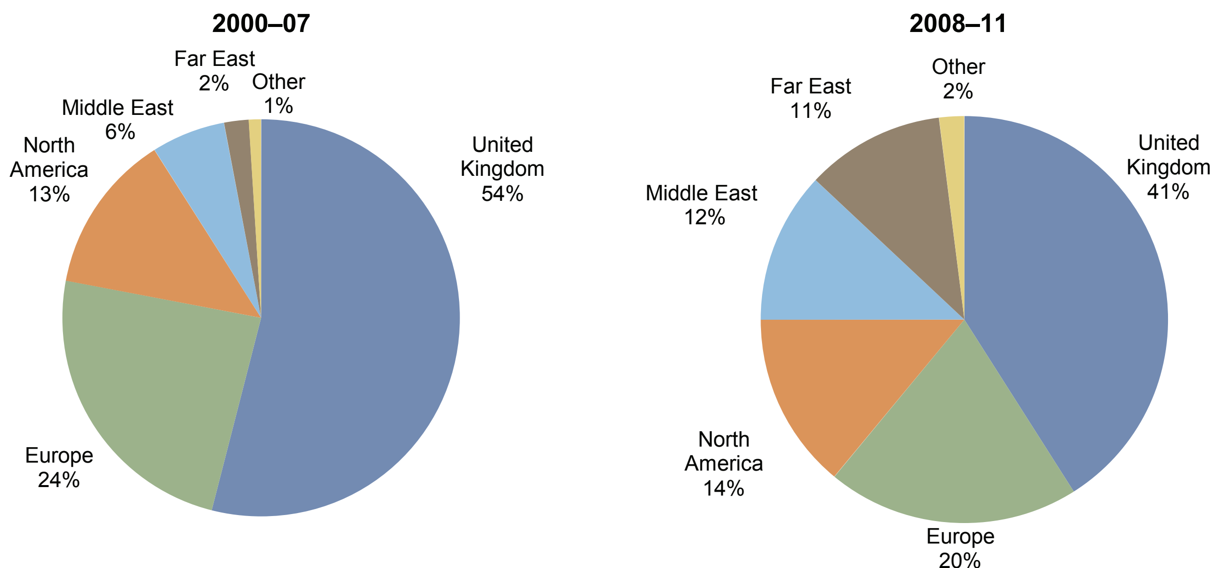


Source: Capital Economics.

Note: All data are quarterly except second quarter 2012, which is as of 31 May 2012.

Figure 9. Share of London Investment Purchases

2000–11



Source: CB Richard Ellis.

100%; the average LTV ratio on which lenders responding to the survey say they are willing to lend, meanwhile, ranged from 59% to 64%. The survey also noted that roughly £100 billion of debt is due to mature during 2013–16.

While the survey points out that gross lending actually rose in 2011 for the first time in four years, the annual total (£37.7 billion) was still below its 2009 level, and less than half its 2007 peak. Further, the percentage of banks looking to increase their loan book was a mere 41% at year-end, compared to 46% a year prior, while interest rate margins are at their highest, and offered LTV ratios at their lowest, since at least 1999.

That said, it is worth noting that other players have taken up some of the slack. According to De Montfort, total real estate debt foots to just under £300 billion, with the balance composed of social housing lending (£20 billion), commercial mortgage–backed securities (£42 billion), and loans held by Ireland's National Asset Management Agency (£21.5 billion.) Anecdotally, certain insurance companies and pension funds have also stepped in to fill the gap—Capital Economics, for example, says some have already proffered loans "well in excess of £100 million." Still, such alternative funding sources seem unlikely to materially offset a continued decline in bank lending.

Conclusion

As Danish physicist Niels Bohr observed,[3] forecasts are tricky things. Capital Economics, for example, had this to say on the Eurozone's potential impact on U.K. property: "The breakup of the euro that we expect could, to some degree, benefit U.K. property via safe-haven flows. But these effects could be outweighed by a more general dislocation in financial markets and *potential failures of major financial institutions*" (emphasis added). Yes, we would certainly view the failure of major financial institutions as a negative!

The need to take macro factors into account, and the degree to which such serious events are already discounted in current prices, underscores the difficulty of allocating assets in the current environment. Thus, while U.K. property may look reasonably attractive when viewed in isolation—and arguably more so relative to other asset classes—we cannot ignore the prospect that the Eurozone may break up, or that the Bank of England may embark on a new, more aggressive "QE" approach, or that the U.K. economy will worsen, etc.

All that said, the market is clearly acknowledging that things look a sight better for high-quality London-area properties. CBRE, for example, recently summed up the prevailing wisdom: "Ultimately, the simple supply and demand dynamics provide very reassuring conditions for investors still seeking both safety and potential for capital appreciation. London has some of the best stock in the world, but there simply isn't enough of it." We tend to agree with this *for the most part*, with the significant caveat, as noted above, that even "safe" assets are only safe at the right price. Nonetheless, we would view a further decline in prime prices, *ceteris paribus*, as a signal for long-sighted investors to top up allocations. ■

[3] There is some dispute about the source of this quote, with some referencing it to Mark Twain and Samuel Goldwyn, and others dating it to Danish artist and writer Robert Storm Petersen. Having no dog in this hunt, we have simply gone with the consensus opinion.