CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

U.K. Property: Hold the Champagne

August 2010

Eric Winig
Christine Farquhar
Lisa Miller

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August 2010 European Market Commentary

U.K. Property: Hold the Champagne

Eric Winig, Christine Farquhar, & Lisa Miller

While property prices have soared over the past year, future returns are likely to be tepid, with gains capped by the huge debt overhang and limited lender capacity, but supported by the accommodative monetary environment.

"The recovery in UK commercial property values since the middle of 2009 has been relatively rapid and impressive at the All Property level, and has confounded predictions of a prolonged and continuing downward drift in values."
—CB Richard Ellis, Anatomy of a Market Rebound, August 2010

In our most recent missive on U.K. property,[1] penned in mid-2009, we concluded that "although one could certainly make a case that prices adequately reflect current fundamentals, we believe it is far better to err on the side of caution, as patient investors are likely to be rewarded with better entry points." In retrospect, this advice was thoughtful, logical, well researched … and wrong. U.K. property has returned 24.2% since July 31, 2009 (Exhibit 1), as falling yields have overwhelmed declining rents, while underlying fundamentals appear to have stabilized.

That said, the worries we voiced last year—including the sector's huge debt overhang and the United Kingdom's weak economic outlook—have not been resolved. Further, although fundamentals have stabilized somewhat, rents remain weak and vacancies—while down from their mid-2009 peak—are elevated relative to history. It is also worth noting that the rise in prices has come almost exclusively in higher-quality properties, and is thus perhaps more indicative of investors looking for safety than of a broad-based, sustainable upturn. Still, while such issues may cap upside for prices, large price *falls* also seem unlikely so long as the monetary conditions that have made property attractive to buyers over the past year—i.e., yields a good deal higher than gilt/policy yields—remain in place. The bottom line is we remain cautious on the sector, as the outlook is muddled at best, and current valuations, while not excessively rich, are not cheap either.

About Those Valuations…

As noted, while the rally over the past year has pushed down yields, they look reasonable relative to history, both in absolute terms and relative to those of gilts (Exhibits 2 and 3). Further, vacancies have fallen materially from their mid-2009 peak, although they remain elevated compared to historical levels (Exhibit 4). Thus, at first glance it appears the rally has simply brought yields down from excessive levels, while the drop in vacancies signals an improvement in fundamentals.

However, things are rarely so simple. To begin with, it is worth questioning to what degree historical comparisons should hold given the unique nature of the current environment, particularly since reliable data on the sector only date to the late 1980s. Capital Economics, for example, recently opined that investors are likely to seek higher-than-usual yield premiums over bonds to compensate for the uncertain economic environment. In their words, "commercial property yields are approaching a floor and … an above-average yield spread will be a feature of the

[1] Please see our July 2009 European Market Commentary *U.K. Property: Patience Required.*

market for at least the next couple of years." (Somewhat paradoxically, it is just this flight to safety that has boosted higher-quality properties over the past year—more on this below.) While the long-term average spread is a mere 8 basis points (bps), this is misleading in that it includes the late 1980s and early 1990s period, when not only were property prices in a bubble, but the United Kingdom raised interest rates dramatically in a (largely successful) effort to combat consumer price inflation. Most observers consider a 150 bp to 200 bp spread to be "normal"; the post-1992 spread is 134 bps, and the current spread is 309 bps. All that said, the current spread is likely to continue to attract buyers for high-quality properties, particularly given the continued hunger for yield among the cash-rich investors that not only sparked the 2009 recovery, but also have historically been among the most active participants in the property market.

The debt overhang discussed in our previous Commentary also has yet to be resolved (Exhibit 5). Indeed, Morgan Stanley notes that banks "are yet to reduce their gross exposure in a meaningful way." While this may be due in small part to the time required to assemble workout teams and document troubled positions, the main reason is that many lenders have continued to extend loans—so long as borrowers are current on interest payments—in the hope that future economic growth will boost values. (Or as industry wags call it, "extend and pretend.") Given that as much as £52 billion of commercial property–secured bank debt is scheduled to mature this year (Exhibit 6)—about 20% of the total stock of commercial property debt—and that more than €75 billion in European commercial mortgage–backed securities mature between now and 2013 (of which about 50% is U.K. property), *and* that bank lending to commercial property is close to peak levels (Exhibit 7), it seems reasonable to conclude that this game can only go on for so long.

The bottom line on valuations, then, is that current prices appear reasonable, but upside is likely to be capped given the many headwinds facing the industry. However, we would also not expect dramatic price falls so long as gilt and/or policy yields remain low, as the market tends to be more sensitive to monetary conditions (at least in the short term) than to fundamental factors such as employment or GDP growth.

A Tale of Two Properties

As noted, the recent rally has been driven largely by "prime" properties,[2] while secondary properties have done less well. According to CBRE, for example, prime properties returned 26.1% for the year ended in June (29.2% from yield, and -3.1% from rents) and secondary properties were flat (4.5% from yield, and -4.4% from rents). While this is an oversimplification—certain non-prime properties have also seen growth in asset valuations, particularly those with solid tenants on long leases, and/or those in areas with limited future supply—it is clear that the market has begun to differentiate between properties with regard to the stability of future revenue streams.

The question, therefore, is what such a rebound says about the underlying health of the market. Obviously, one takeaway is that investors are defensively targeting higher-quality, more stable properties due to high valuations across asset classes, as well as the "unusually uncertain" economic environment. Indeed, CBRE says bluntly that "foreign and institutional investors have targeted quality assets with income security in mind." A more optimistic take is that the market has been very efficient in this differentiation,

[2] We use these definitions as provided by CB Richard Ellis, which took a selection of assets as of June 2009, removed outliers, and took the ten lowest- and highest-yielding properties; the former were classified prime and the latter secondary.

and that the bifurcation of returns says less about the nebulous "overall market" than it does about investors basing decisions on fundamentals as opposed to buying property irrespective of such matters.

It is also possible, of course, that the rally in prime properties will eventually spread to secondary properties. However, such an outcome seems highly unlikely absent a robust economic recovery, and while government spending reforms *may* lay the groundwork for sustainable growth in the future, it seems implausible, to put it gently, that such a recovery will occur without further consolidation in the near term. Capital Economics, for example, forecasts that tax increases and spending cuts will cause employment to fall by an additional 2% to 3% over the next few years, while Morgan Stanley says debt-reduction efforts "will most likely have a significant knock-on effect on tenant demand for commercial property space."

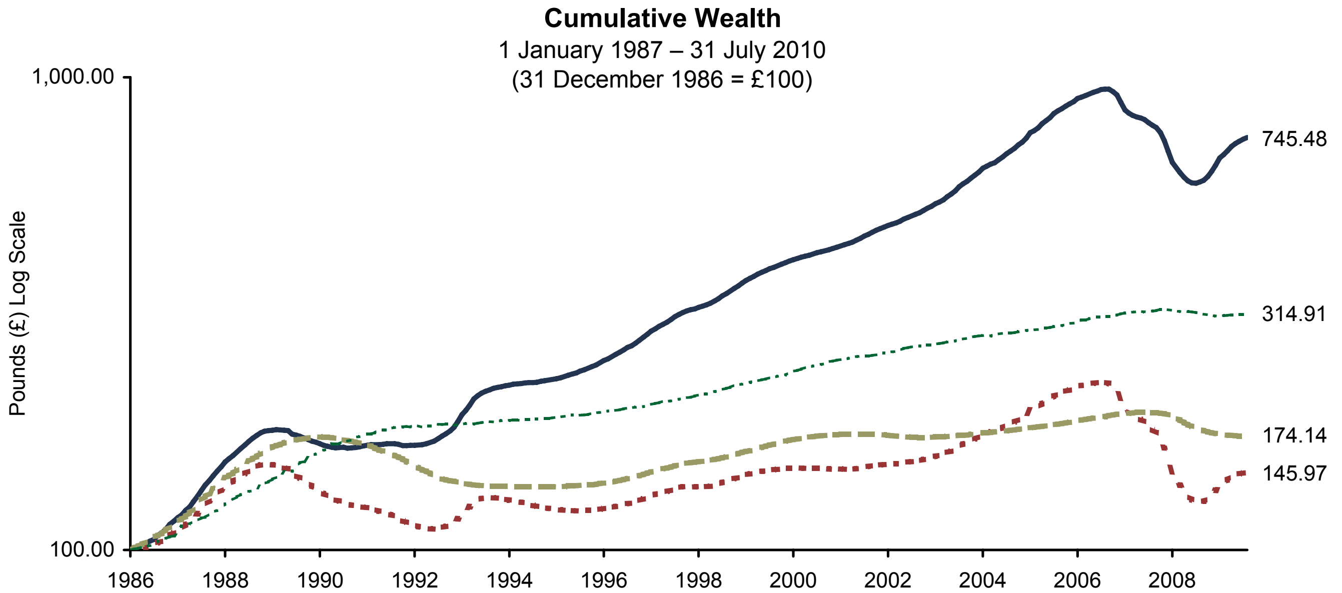
Conclusion

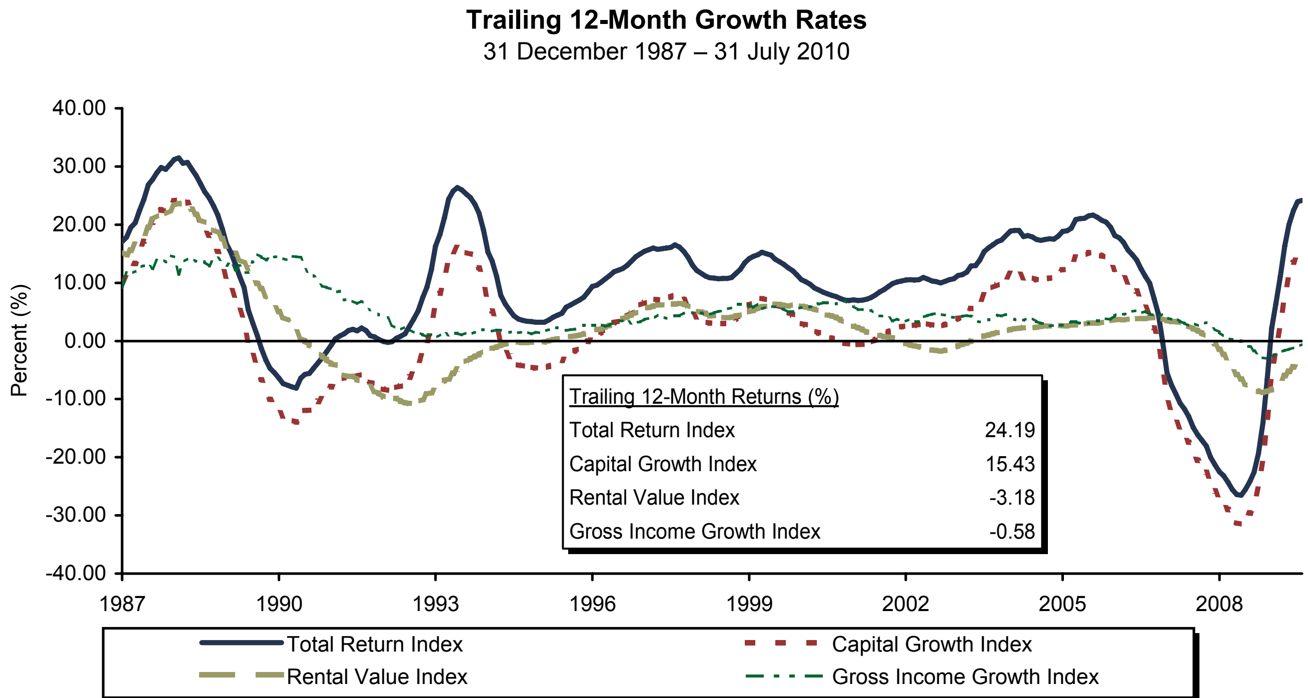
The recent rally in U.K. property has been powerful but bifurcated, with more of the upside captured by high-quality properties sought out by safety-conscious investors. While fundamentals have stabilized, it is unlikely that rents will hold up broadly (and vacancies will stay down) absent a strong economic recovery. Valuations, meanwhile, remain generally reasonable, with above-average yields compensating for higher-than-normal risks.

Looking forward, we remain concerned about the significant debt overhang in the sector—particularly due to the seemingly limited capacity for new bank lending—as well as the potential for economic conditions to worsen, both as a result of the government's "austerity" plan and continued retrenchment from the credit bubble. On the other hand, yields well above those available in the gilt market seem likely to lend support for the foreseeable future, particularly for high-quality properties attractive to cash buyers. Thus, while we believe investors should temper return expectations, the prospect of a dramatic fall in prices seems unlikely so long as current monetary conditions persist. ■

Exhibit 1

Return Trends of U.K. Property





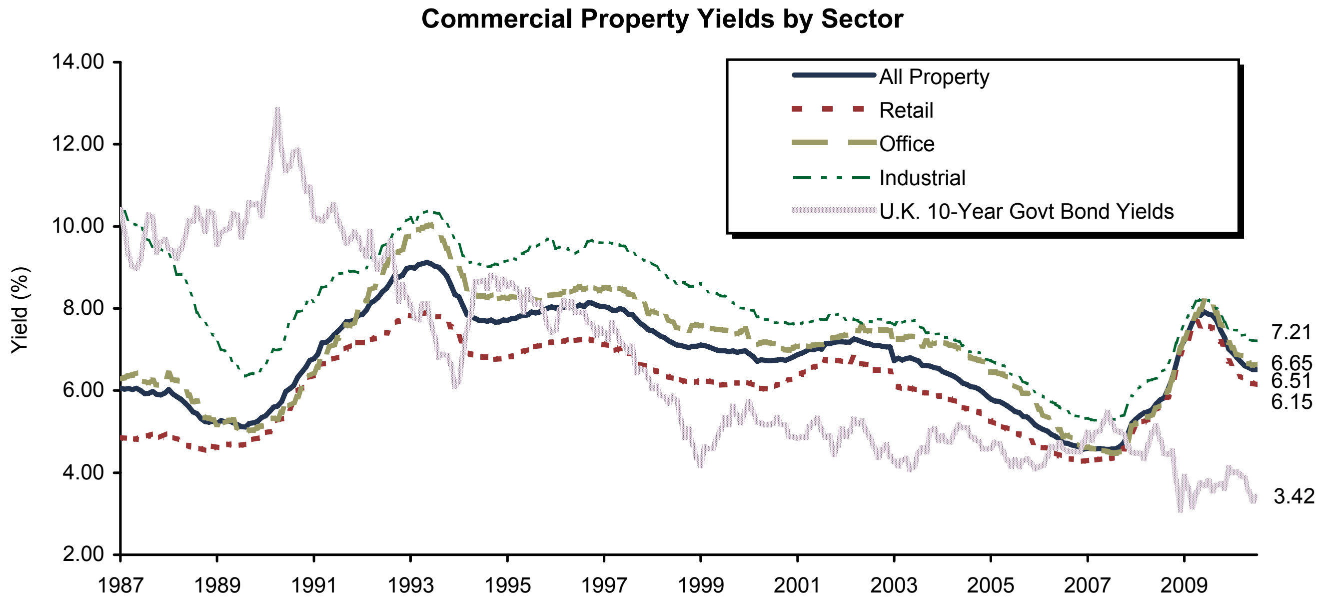
Source: Investment Property Databank Ltd.

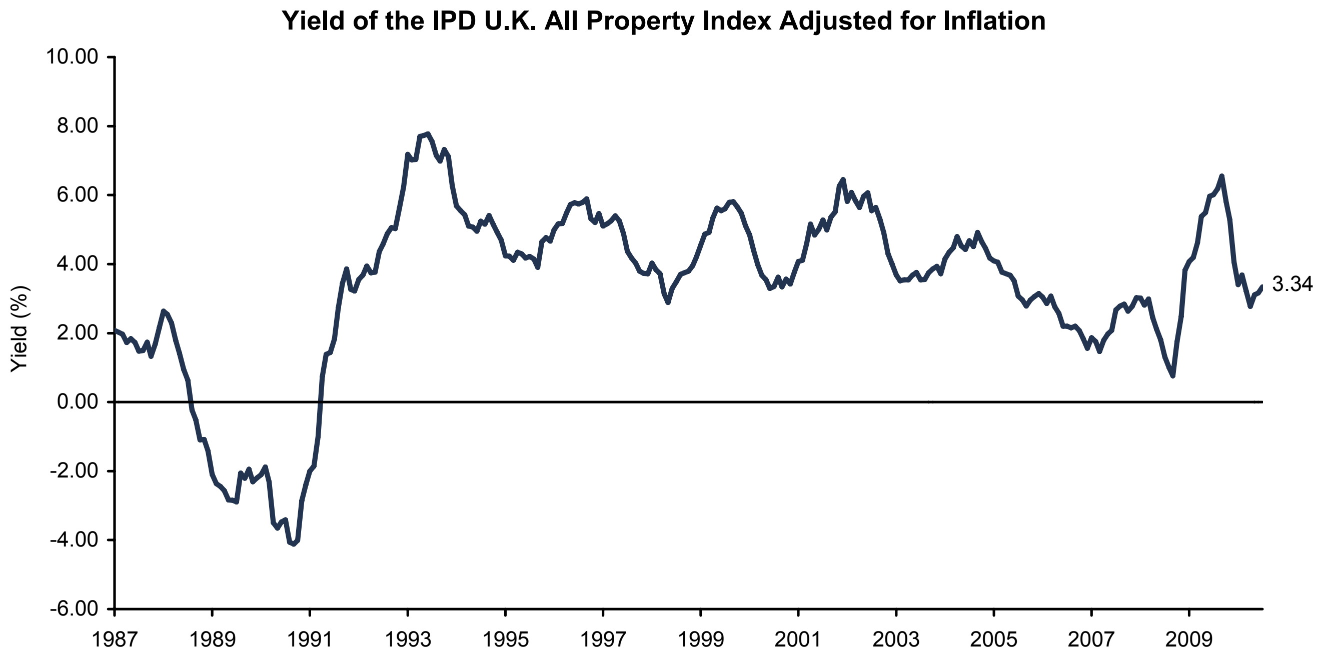
Notes: Cumulative wealth returns are shown on a logarithmic scale. Total return is made up of capital growth, rental value, and gross income growth. Trailing 12-month returns are as of 31 July 2010.

Exhibit 2

Monthly Yields on U.K. Commercial Property Sectors

31 January 1987 – 31 July 2010





Sources: Investment Property Databank Ltd. and Thomson 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. U.K. inflation data are represented by 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. U.K. All Property index yields adjusted for inflation using 31 July 2010 values.

Exhibit 3

Spread Between All Property Yield and Ten-Year Gilts

31 January 1987 – 31 July 2010

Sources: Investment Property Databank Ltd. and Thomson Datastream.

Exhibit 4

Monthly U.K. Vacancies

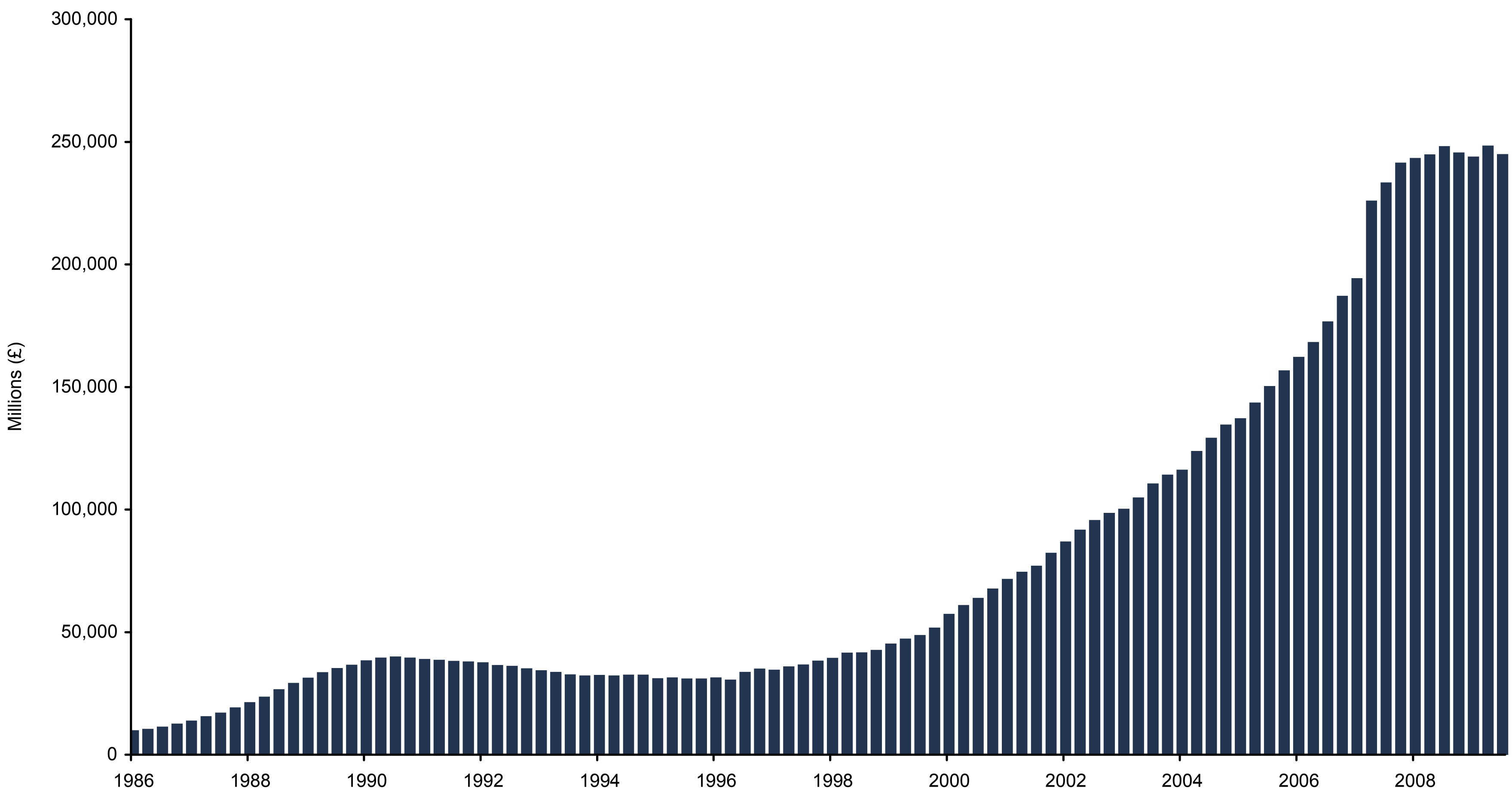
31 December 1994 – 31 July 2010

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

Exhibit 5

Outstanding Bank Loans to U.K. Commercial Property

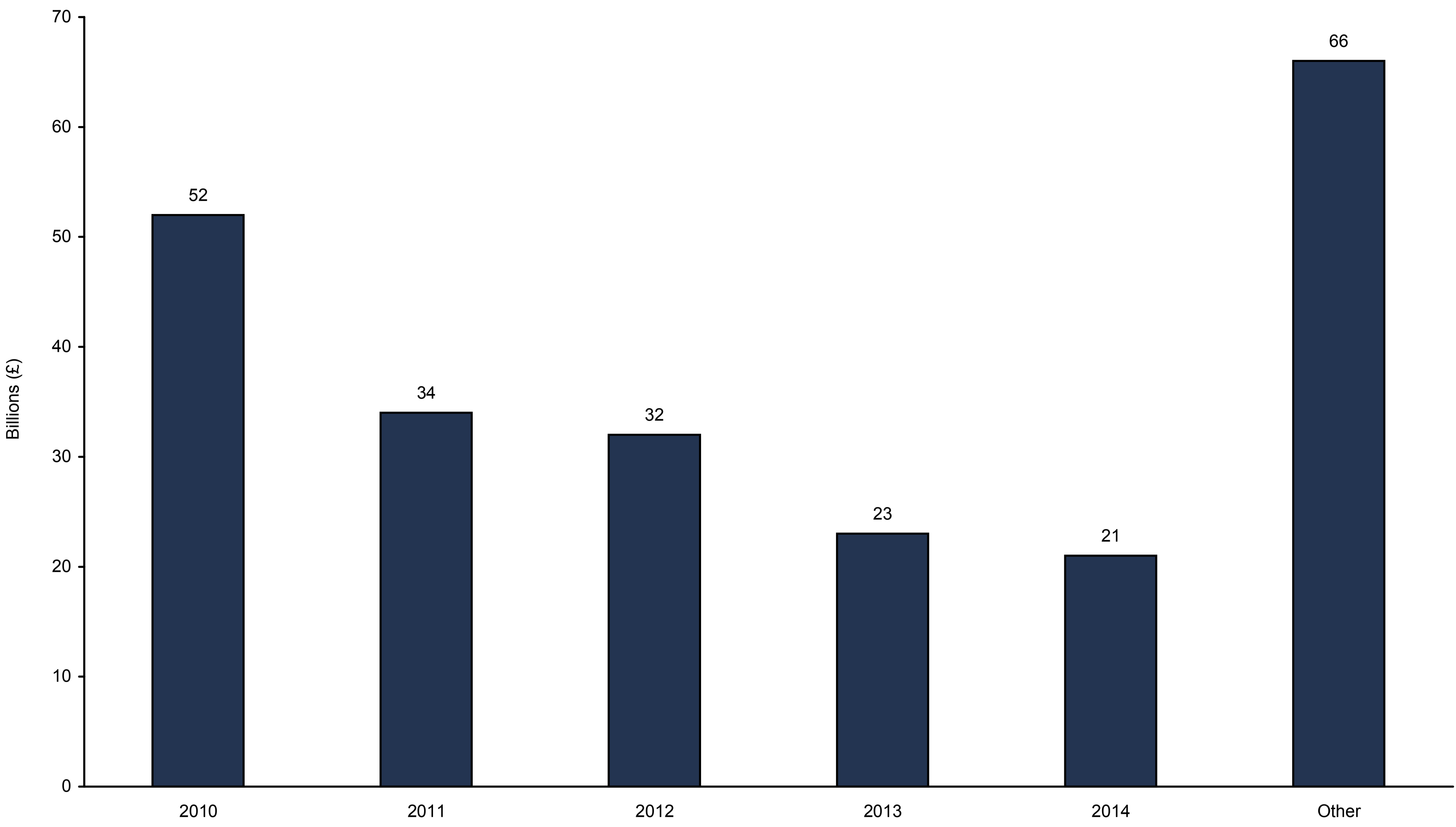
First Quarter 1986 – Second Quarter 2010



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

Exhibit 6

Maturity Profile of Bank Loans to U.K. Commercial Property

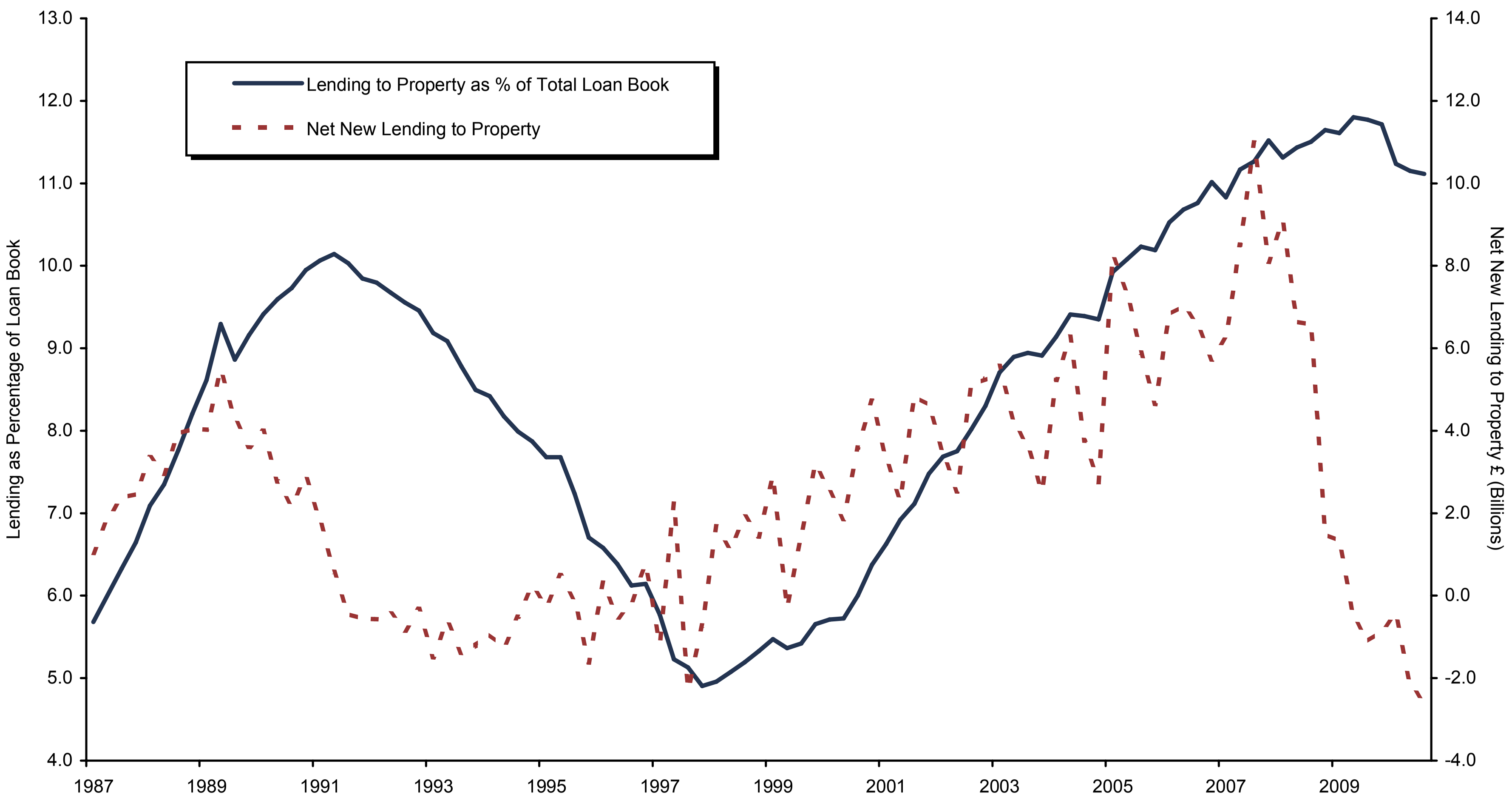


Sources: De Montfort University and Morgan Stanley Research.

Exhibit 7

Bank Lending to Commercial Property

31 March 1987 – 31 July 2010



Source: Capital Economics.
Note: All data are quarterly, except 31 July 2010.