CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

U.K. PROPERTY: PATIENCE REQUIRED

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U.K. Property: Patience Required

Back in January 2007, we penned a piece on the early 1990s property crash and what lessons investors could draw from it, cautioning that “plentiful liquidity today should not be taken as a guarantee of exit possibilities tomorrow.” [1] Since that point, of course, the seemingly endless supply of capital that flowed into the real estate sector from 2004 to 2007 has dried up, while prices have fallen precipitously. The question today is to what degree the re-pricing of commercial property reflects the decline in fundamentals. We believe there is more downside to come. Prices are clearly more attractive than in the recent past, yet the massive debt overhang in the sector will hamper price recovery for some time. Further, despite the fact that the U.K. property market has been among the hardest hit global markets, there are few indications it has hit bottom. Rising vacancy rates, for example, have actually *accelerated* in recent months, while structural changes to commercial property leases enacted over the past two decades or so have increased owners’ sensitivity to market conditions. Thus, we believe there will be significant downward pressure on property prices for the foreseeable future, and it is likely prices will undershoot “fair value” before bottoming. As a result, 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.

Falling Prices, Improving Valuations

Since peaking in June 2007, U.K. property prices have fallen for 24 straight months, posting a cumulative decline of 44.1%—by far the biggest fall in the history of the Investment Property Databank (IPD) Index (Tables A and B). The early 1990s downturn did last longer (43 consecutive monthly declines beginning in November 1989), but prices fell “only” 27.1% from peak to trough. The current decline has taken prices all the way back to 1997 levels, although the total return index—thanks to more stable rental income—has only fallen to 2004 levels.

However, it is worth noting that while the rate of decline of *prices* has moderated lately, *rents* have been falling at an accelerating pace. Given that rents did not peak until nearly a year after prices (and even then the rate of decline was very modest, with rents declining less than 2% in total from May 2008 through the end of the year, compared to a 23% fall for prices), this may be cause for concern. Indeed, rental values have fallen 5.6% year-to-date, compared to 13.2% for capital values.

Rental income tends to be much more stable than capital values. However, structural changes to property leases have changed this equation a bit, as more break clauses have increased owners’ sensitivity to market conditions. Capital Economics, for example, estimates that given a fall in open-market rental values similar to that in the early 1990s, the typical landlord would today suffer twice the fall in income. (According to IPD, rental values fell about 21% peak-to-trough in the early 1990s, compared to 7.4% thus far in the

[1] Please see our January 2007 Market Commentary *A Cautionary Tale on U.K. Property.*

current decline.) Given the sharp rise in vacancies of late (Table C), this is certainly an area that bears watching.

The good news, of course, is that falling prices have driven yields significantly higher, particularly when compared to gilts (Tables D and E). This represents a dramatic improvement from our last report on U.K. property in September 2008,[2] when we noted that the slight premium of property yields to gilts (122 basis points at the time) did not seem to adequately compensate investors given the less-risky profile of gilts and "the exposure of property to what looks increasingly like a U.K. recession." Thus, on a pure valuation basis, we have seen meaningful improvement in the market, and long-term returns should be commensurately higher.

The Fly in the Ointment

As with virtually all asset classes these days, any analysis of the U.K. property market must also take into account the vast overhang of leverage in the sector, and how levered investors and banks will behave in the near future. CB Richard Ellis (CBRE), for example, estimates the total U.K. commercial property market had a loan-to-value (LTV) ratio of 90% at the end of 2008; since then prices have fallen by another 10%. Further, the overall number includes investors with zero leverage; subtract them and CBRE estimates the notional LTV at a whopping 150% *before* the 2009 price drop. As one anonymous banker said in reply to the most recent De Montfort University (DMU) Lending Survey, "The level of maturing debt is scary—there's nothing with which to replace it. We are not getting enough of our money back—so off to the central bank to ask for help."[3]

As shown in Table F, while total bank lending to commercial property has surpassed its early 1990s high, new lending has collapsed. This is particularly problematic since £76 billion of commercial property debt (about one-third of the market) matures in 2009 and 2010, while 37% of outstanding commercial mortgage–backed securities (CMBS) matures in the 2011–13 period. In other words, most banks are looking to shrink their exposure to commercial real estate loans even as a large swath of such loans need to be refinanced. Indeed, we have already seen the effect of this dynamic—not only did 2008 loan originations fall 41% from 2007 (Table G), but 54% of this represented lenders extending or restructuring loans with 2008 maturities. As a result, the amount of debt maturing in 2009 soared from £23 billion at the end of 2007 to £44 billion at the end of 2008.

A further problem is that banks have thus far largely avoided taking writedowns caused by new valuations. This is mainly due to quirks in the regulatory code that allow banks to postpone such revaluations (at least for a time), and means banks' capital cushions are almost surely smaller than they appear. As stated by another anonymous banker to the DMU survey, "We do not test LTV. Why? Well, if the new valuation

[2] Please see our September 2008 Market Commentary *U.K. Property: Still Not Cheap.*
[3] Sabina Kalyan, "*Further UK Property Debt Re-pricing? Debt Markets Hold the Key*," CB Richard Ellis Investors, Summer 2009.

shows a lower value, we have to set aside capital to cover potential losses. This capital cannot be lent out, or used elsewhere in the bank; it becomes idle."[4]

Clearly such games of musical chairs can only go on for so long. As CBRE puts it, "the short-term solution of extending loans for a year or two and hoping that they can then be restructured runs into a wall of CMBS issues coming up for refinancing in 2011. It is unlikely that the U.K. domestic banking sector will have paid down its public debt and returned to the market in big enough volumes to plug the gap. And overseas banks are pulling money back to their home countries."

Conclusion

A few years back we published a Market Commentary on U.K. property titled *U.K. Property: Stretched Valuations and Spotty Fundamentals*, in which we nevertheless said "medium-term returns could continue to surprise on the upside" due to the continued influx of money into the sector. While today's environment is not an exact mirror image—valuations are much improved, but fundamentals are worse—the discussion is similar. In short, we believe investors that buy U.K. property at current valuations are likely to get reasonably good long-term returns given prevailing yields and spreads. *However*, one cannot simply ignore the issues surrounding the mass of debt coming due in the next few years, not to mention the avoidance of writedowns by an overexposed banking sector.

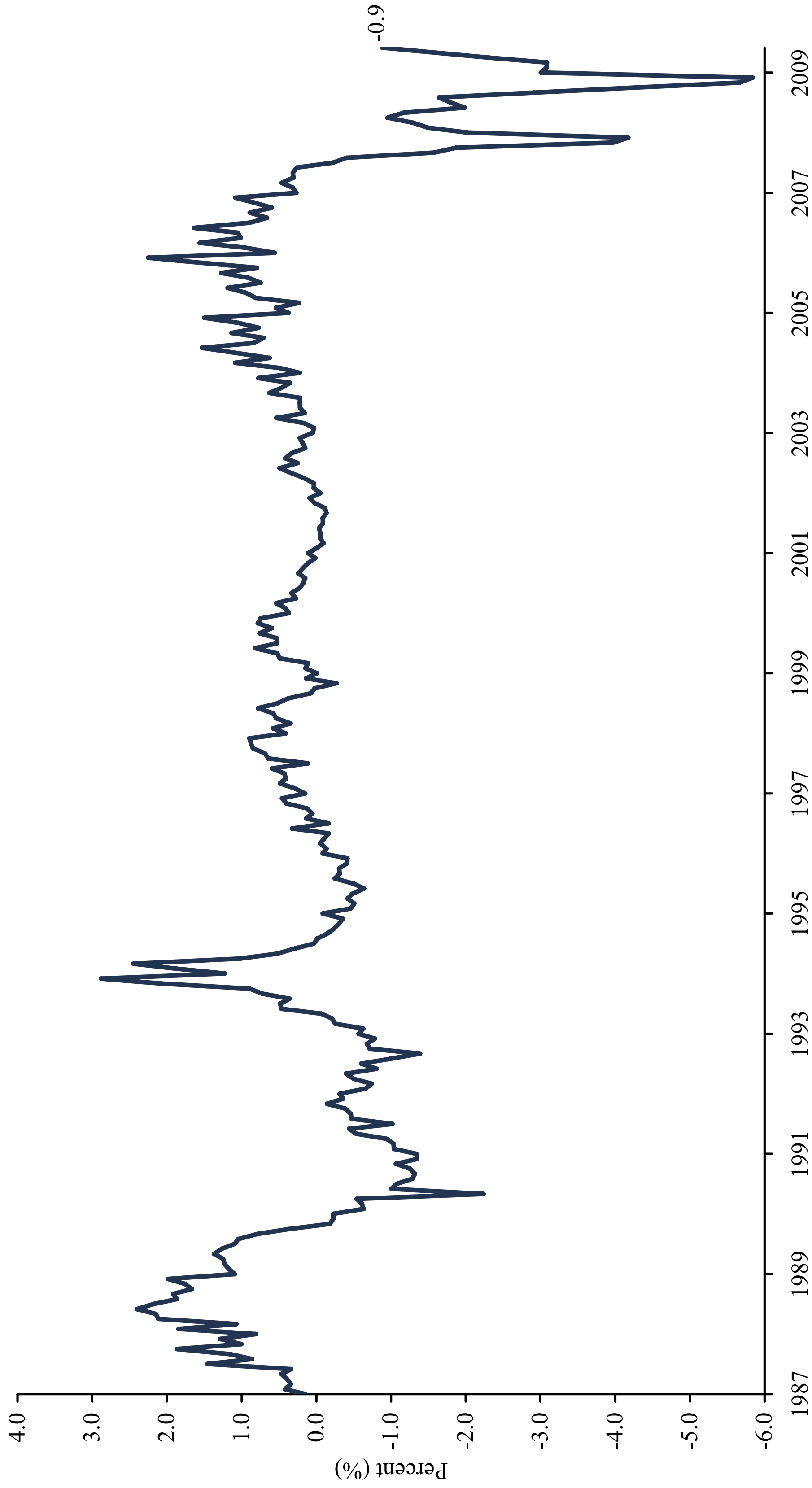
Thus, our advice for prospective investors is to tread cautiously, and preferably to wait for better entry points before committing capital to this sector. The issues summed up so succinctly by CBRE will not simply vanish, and there is a real possibility that a wave of revaluations could beget a wave of selling, triggering further revaluations, ad nauseam. Current valuations are not, in our view, attractive enough to offset such a large and unpredictable short-term risk.

[4] Ibid.

Table A

MONTHLY PERCENT CHANGE OF U.K. COMMERCIAL PROPERTY PRICES

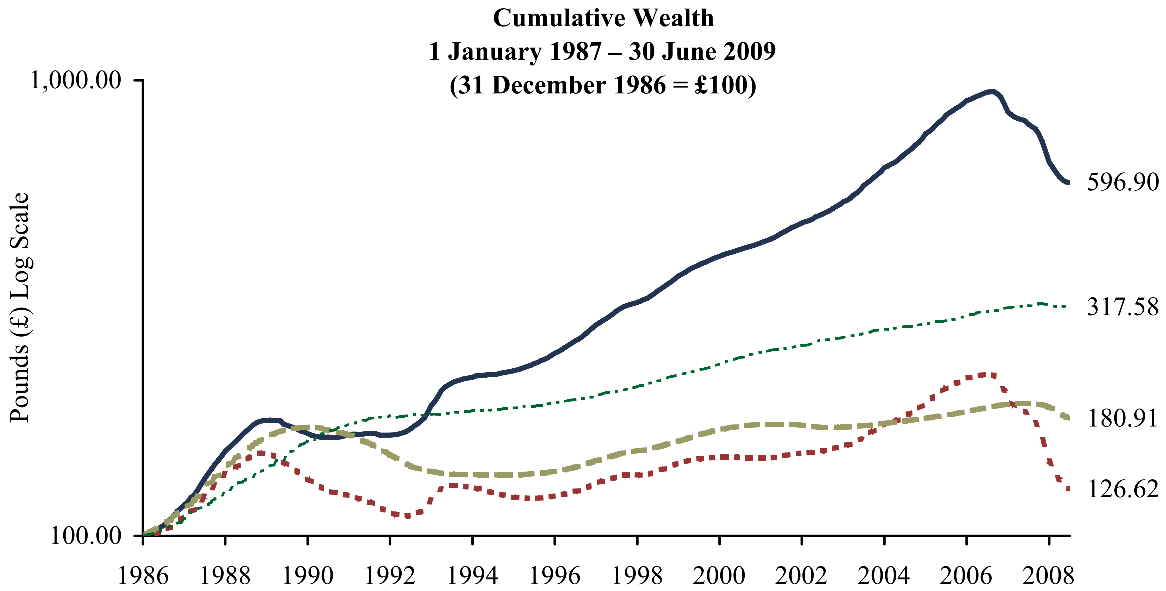
1 January 1987 – 30 June 2009

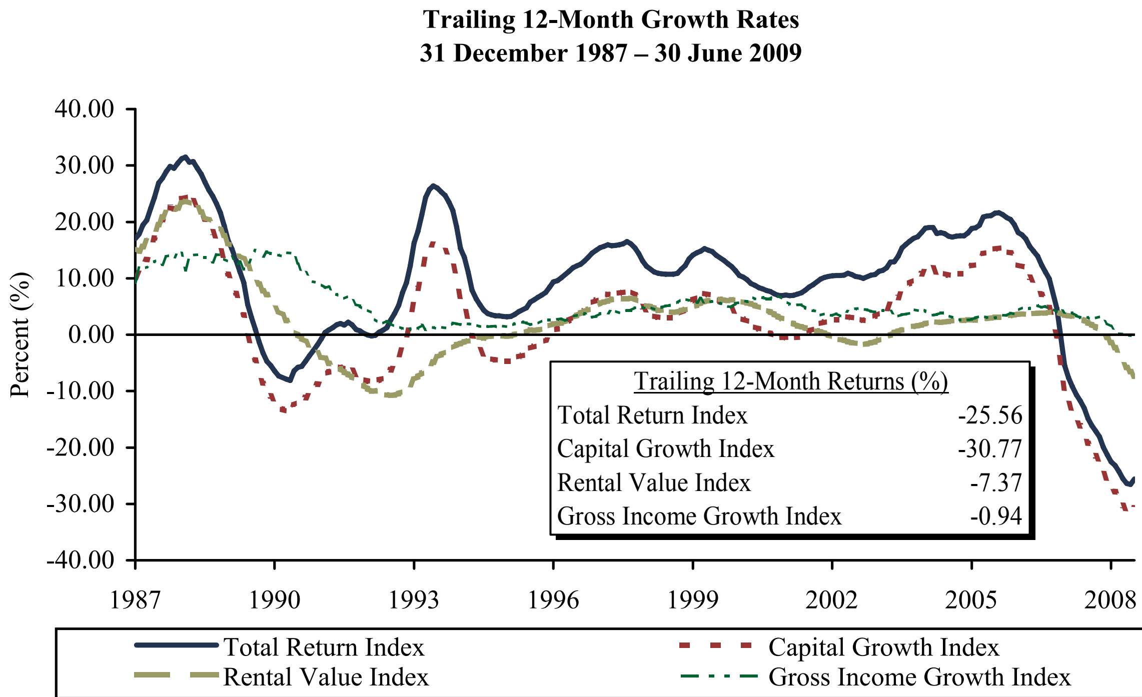


Source: Investment Property Databank.

Table B

RETURN TRENDS OF U.K. PROPERTY





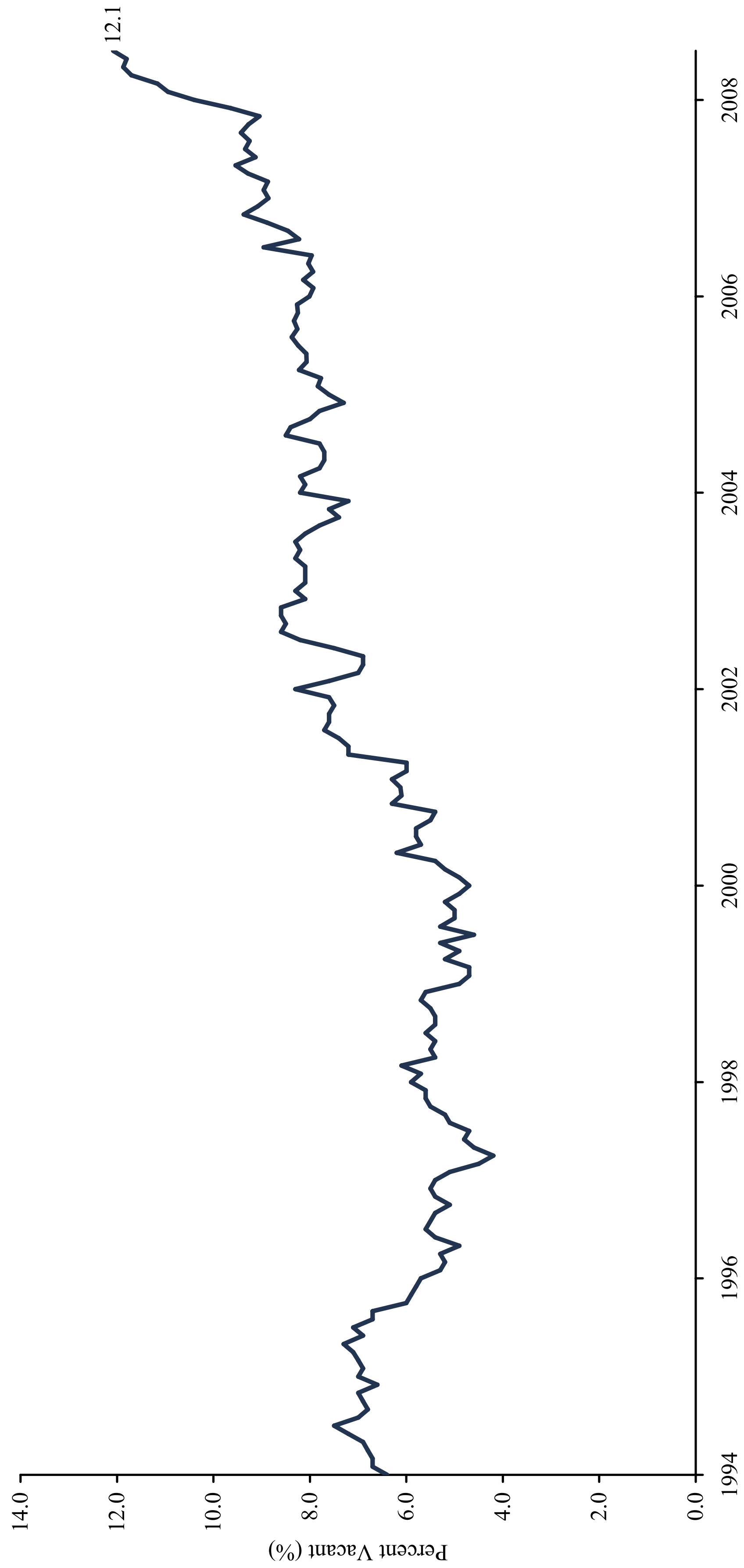
Source: Investment Property Databank.

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 30 June 2009.

Table C

MONTHLY U.K. VACANCIES

31 December 1994 – 30 June 2009



Source: Investment Property Databank.

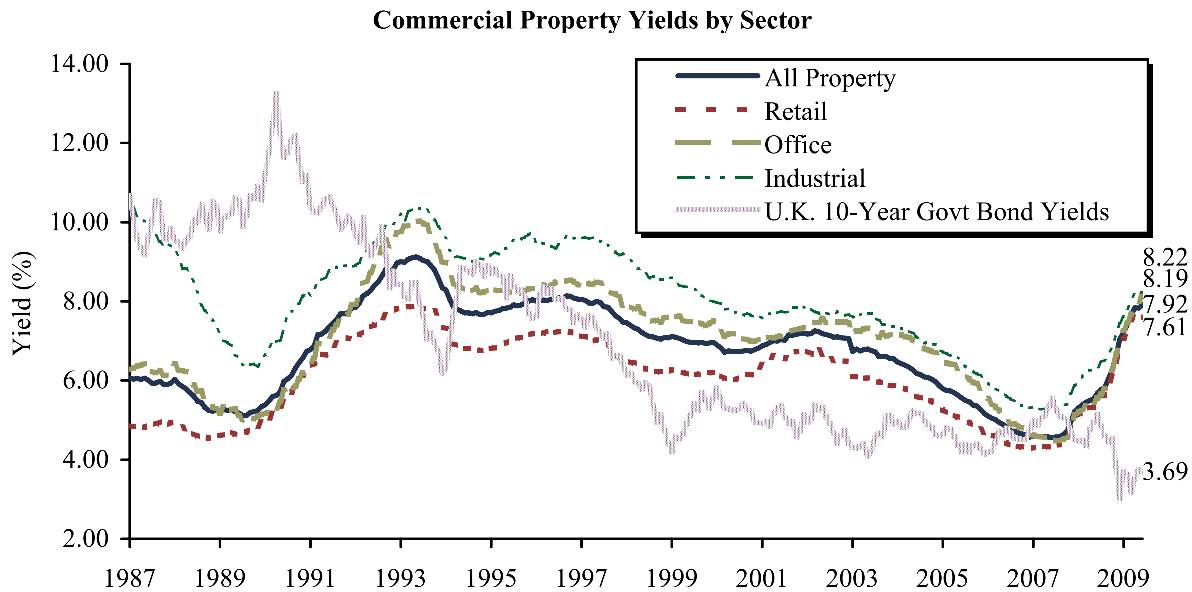
Note: Data represent all U.K. property including retail, office, and industrial.

Table D

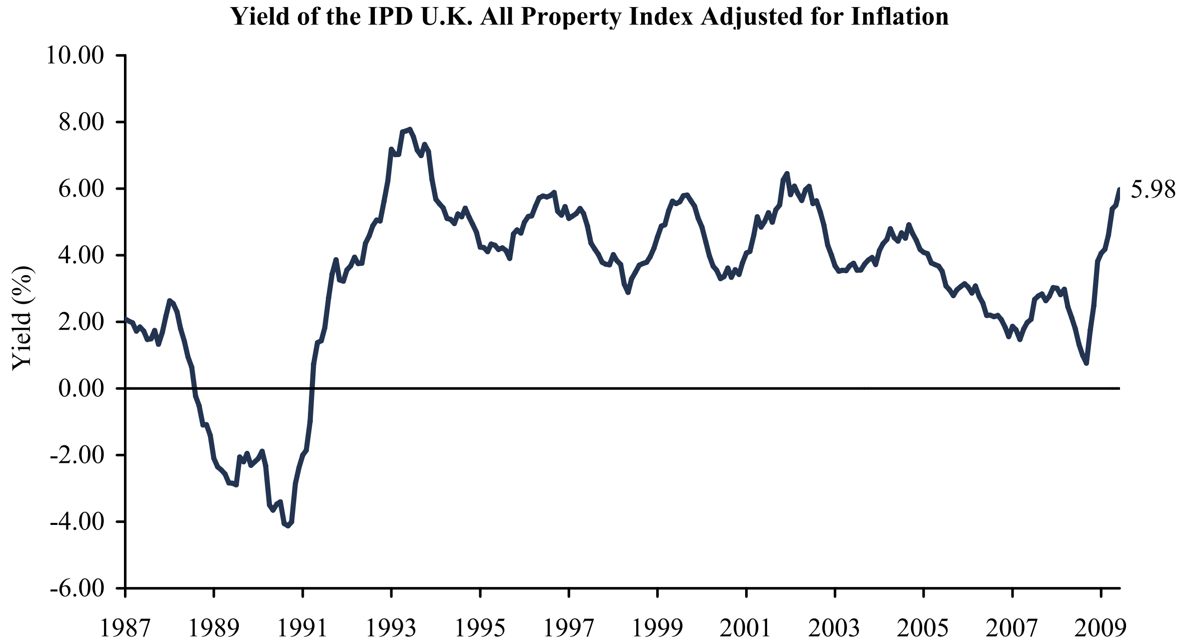
MONTHLY YIELDS ON U.K. COMMERCIAL PROPERTY SECTORS

31 January 1987 – 30 June 2009

Commercial Property Yields by Sector



Yield of the IPD U.K. All Property Index Adjusted for Inflation



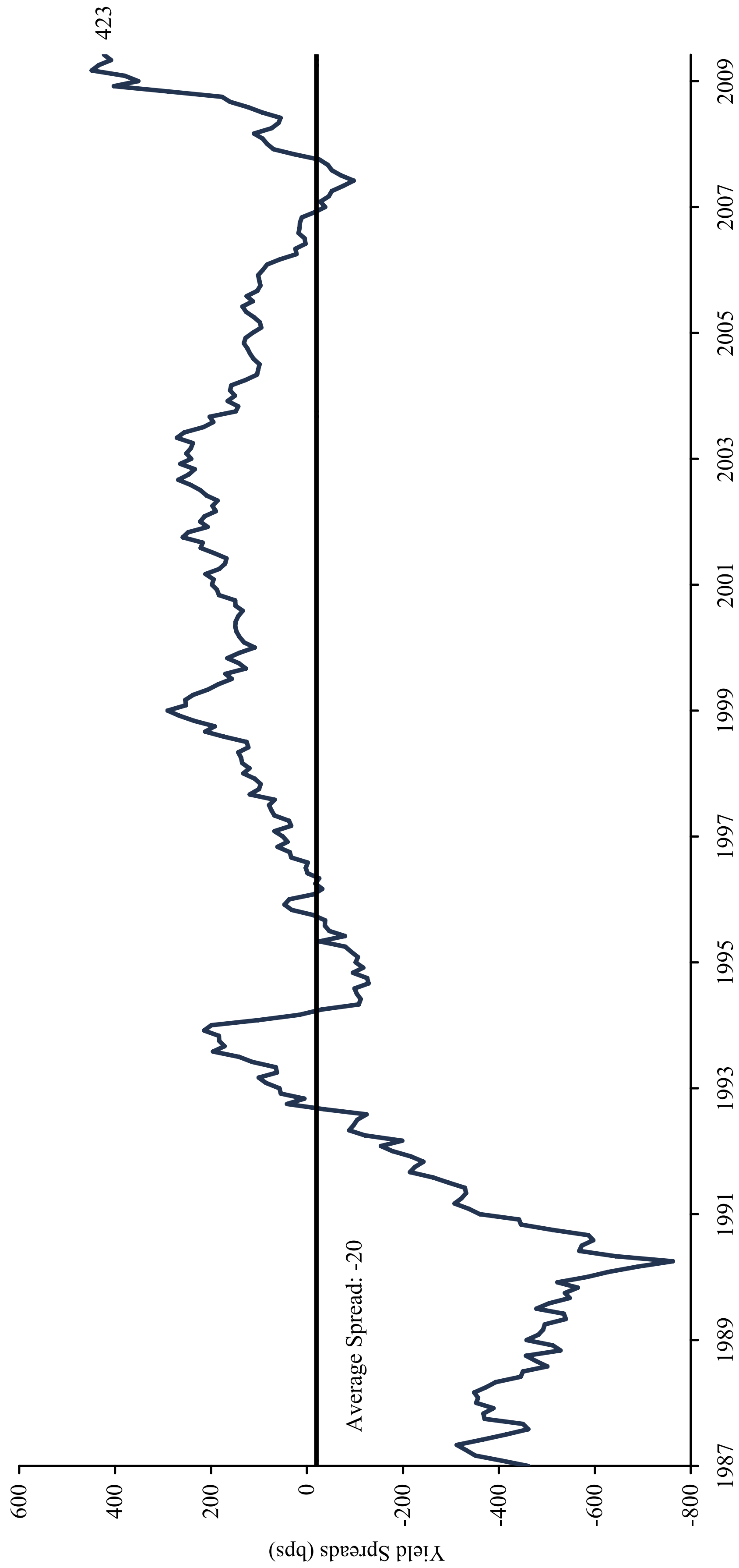
Sources: Global Financial Data, Inc., Investment Property Databank, and Thomson Datastream.

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.

Table E

SPREAD BETWEEN ALL PROPERTY YIELD AND TEN-YEAR GILTS

31 January 1987 – 30 June 2009

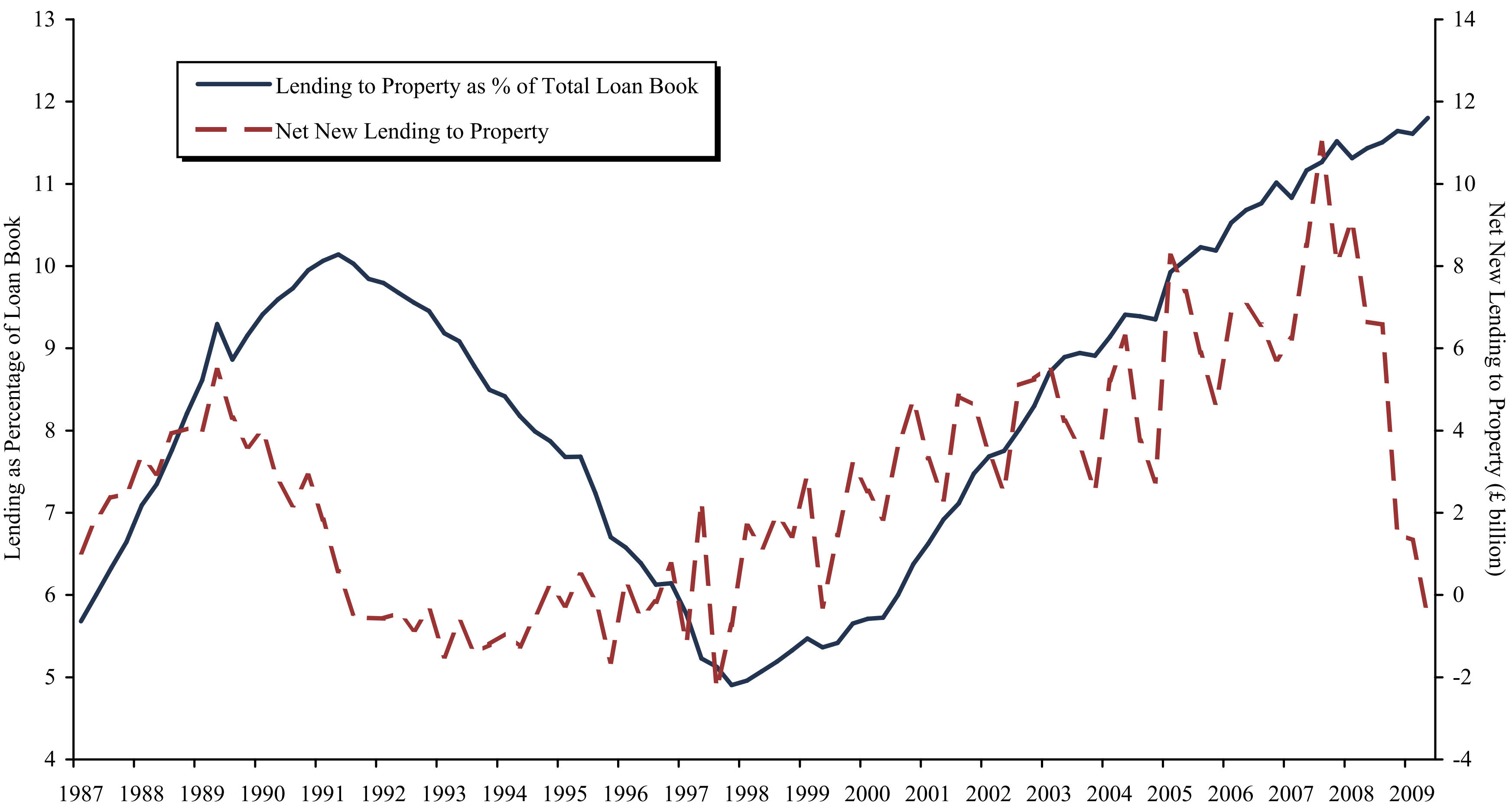


Sources: Global Financial Data, Inc. and Investment Property Databank.

Table F

BANK LENDING TO COMMERCIAL PROPERTY

31 March 1987 – 30 June 2009

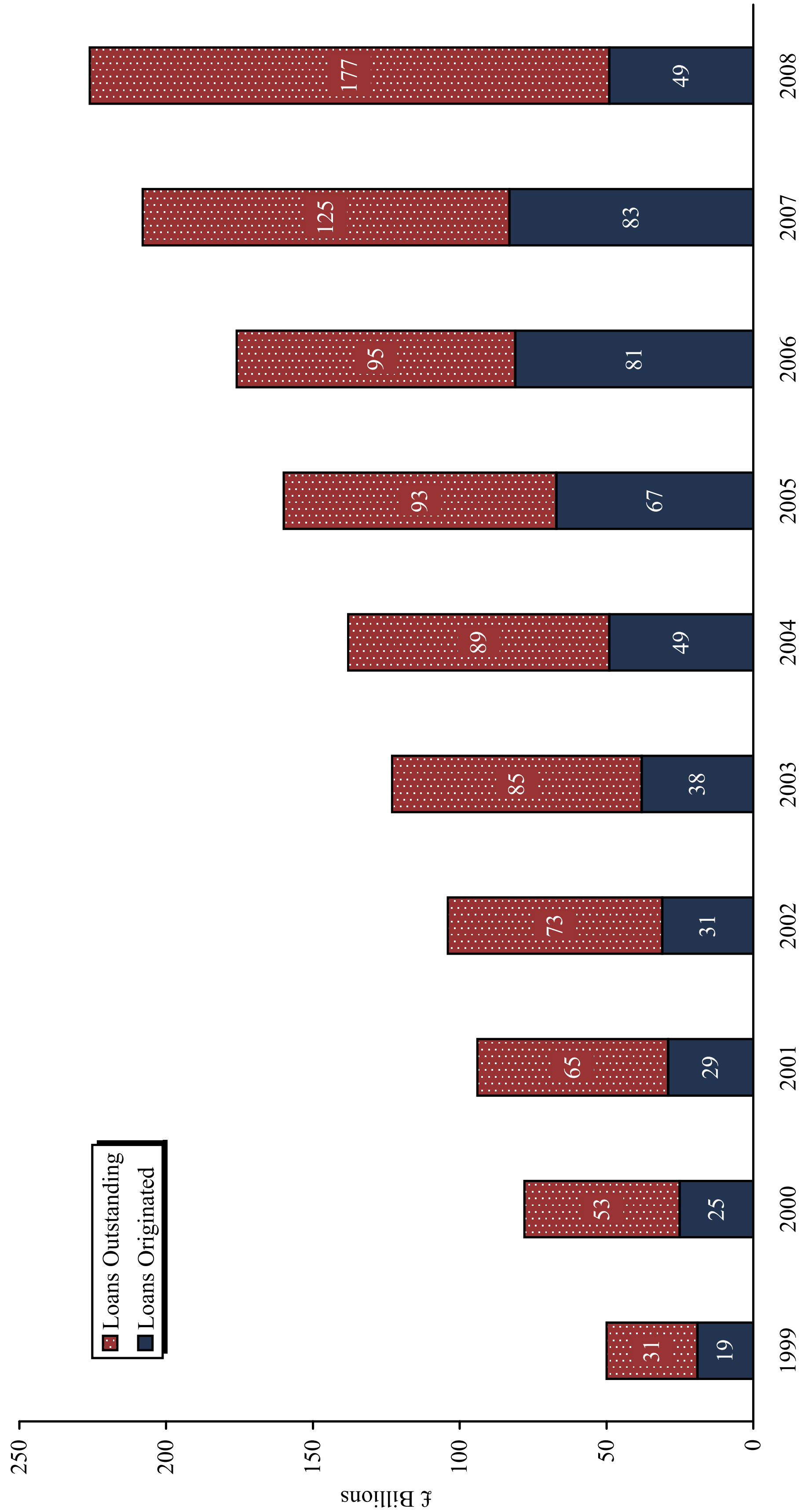


Source: Capital Economics.

Table G

OUTSTANDING LOANS AND ORIGINATIONS

1999–2008



Source: De Montfort University Lending Survey.