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CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENTARY

U.K. PROPERTY: STILL NOT CHEAP

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U.K. Property: Still Not Cheap

"The largest buyers of very top end properties around the world, but especially in London, have been from oil-producing nations. Should their economies turn down, this will most likely depress high-end property prices more than is generally perceived."—Marc Faber, *The Gloom, Boom & Doom Report,* September 1, 2008.

Last October we opined that "it looks increasingly like U.K. property has seen its highs for this cycle," and thus concluded it was "a particularly inopportune time to allocate funds" to the sector.[1] As they say, even a blind squirrel finds a nut once in a while, and we are only too happy to crack ours open and enjoy the spoils. The question now, of course, is to what extent the decline in property prices (and concurrent rise in yields) has restored value to the sector. In our opinion the process still has further to go. While prices are a good deal lower than a year ago, they have hardly fallen precipitously given the scope of the prior run-up, and yields remain relatively low. The U.K. economy, meanwhile, has weakened considerably in recent months, while the property sector has become increasingly reliant on buyers from oil-rich nations in the Middle East. Finally, U.K. property also remains vulnerable (along with virtually all asset markets) to the ongoing turmoil in global financial markets. Thus, we conclude prices are still too high and vulnerable to further declines.

Catch Me I'm Falling…

Since peaking in June 2007, U.K. property prices have fallen 22.0%, by far the sharpest fall in the history of the Investment Property Databank (IPD) Index (Tables A and B). While the cumulative price decline was greater during the early 1990s downturn, it occurred over a much longer timeframe—prices turned down in November 1989 and fell for 43 consecutive months, with a peak-to-trough decline of 27.1%. Put a different way, the average annual compound return of the early 1990s decline was -8.4%, versus -19.2% (thus far) for the current downturn. Still, given the scope of the prior run-up, the recent decline hardly seems extreme—even after shedding one-fifth of its value the IPD Capital Growth Index has only returned to April 2005 levels (coincidentally, the month we published our first commentary voicing concern over valuations), while the total return index, thanks to steady growth in rental values, has merely fallen to March 2006 levels.

Valuations, meanwhile, have shown little improvement. The yield on the overall IPD index, for example, is 5.82%, nearly 100 basis points (bps) below its post-1986 average of 6.73%. Perhaps more significantly, real yields of 1.0% are nearly 200 bps below their long-term average of 3.26%, owing mainly to the recent spike in consumer price inflation figures. While yields do offer a slight (122 bps) premium to ten-year gilts, this hardly seems excessive given gilts' largely risk-free status and the exposure of property to what looks increasingly like a U.K. recession.

[1] Please see our October 2007 Market Commentary *Has U.K. Property Finally Peaked?* For more background information see our respective January 2007, February 2006, and April 2005 Market Commentaries *A Cautionary Tale on U.K. Property*, *U.K. Property Still on the Boil*, and *U.K. Property: Stretched Valuations and Spotty Fundamentals*.

Where Are the Bulls?

Indeed, perhaps the most bullish thing that can be said of U.K. property at the moment is that it seems so universally hated. For example, Capital Economics recently downgraded its view for the sector—the research firm changed its peak-to-trough decline expectation from 30% to 35%—while CB Richard Ellis said, "it is unlikely that Institutions will invest substantially in the short term until there is greater evidence that property values have stabilized." Still, much as high valuations alone are generally insufficient to bring bull markets to an end, a large number of bears is unlikely to precipitate a market bottom unless accompanied by lower-than-average valuations. In other words, while many profess to be bearish, *prices* (i.e., actions as opposed to words) still reflect a great deal of optimism.

Along these lines, it is worth noting that Middle Eastern and German investors have made up a large percentage of buyers in recent months, almost certainly due to the fact that they tend to be cash buyers. According to the Bank of England, lenders have been slashing the amount of credit made available to the commercial real estate sector, not surprising given the huge increase in property loans in recent years (Table C). Indeed, the value of commercial property loans as a percentage of total bank loans is now roughly 12% (Table D), well above the two prior highs of around 10% (in the mid-1970s and early 1990s), while the value of loans as a percentage of commercial property values has increased dramatically and is far above historical peaks (Table E).

As a result, loan growth is expected to be anemic in coming years. Capital Economics, for example, estimates loan growth—which totaled roughly £300 billion for the five years 2003–07—will be only £100 billion over the next five years (2008–12), and could be as low as £50 billion. Given the current size of the commercial property market (about £600 billion), this would represent a significant drag on prices, particularly considering how important debt-financed buyers were to the sector in recent years.

The Bottom Line

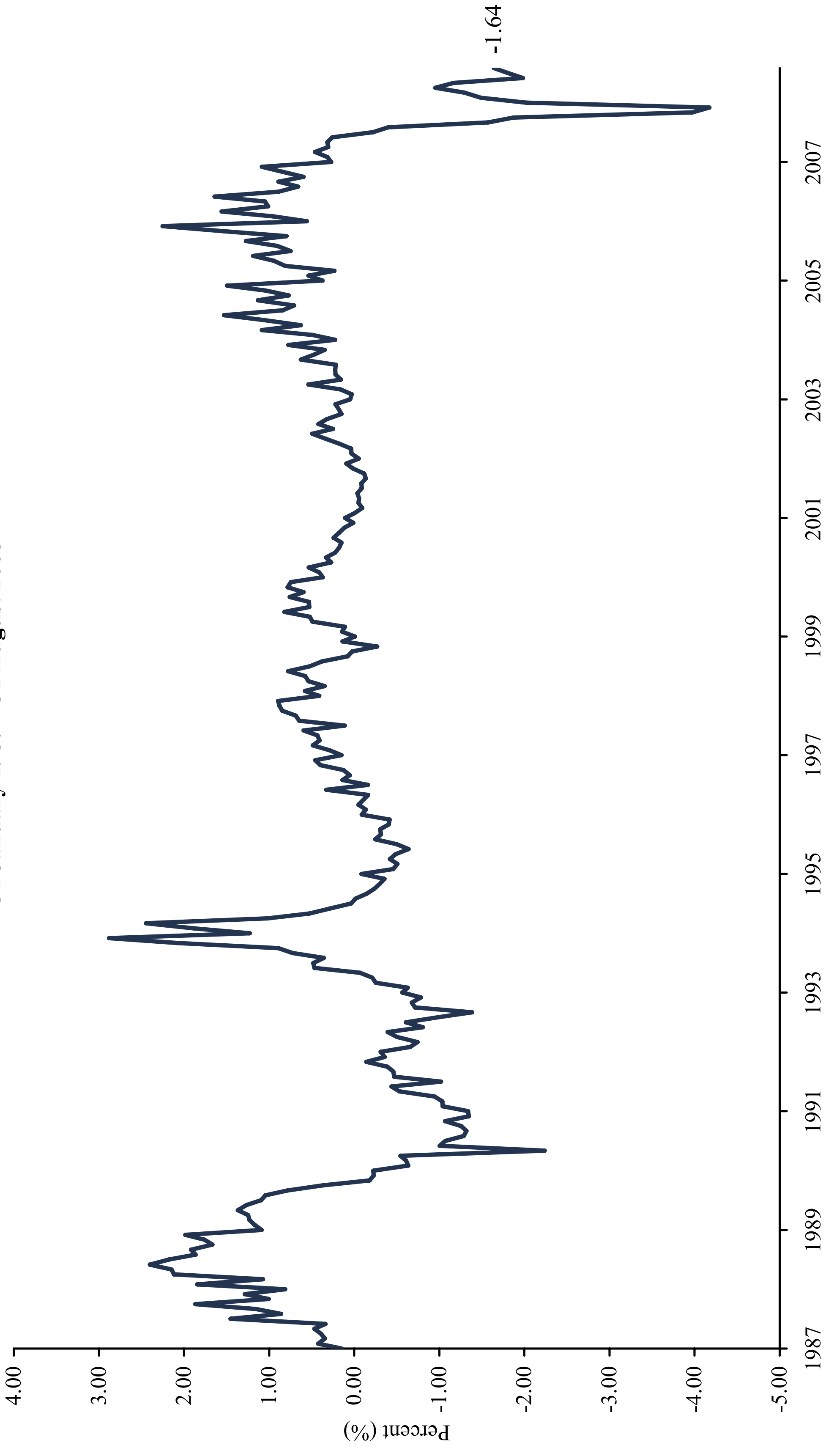
We remain bearish on U.K. property, as recent price declines, while steep, have not only been unremarkable in light of the prior run-up, but have also failed to bring yields up to levels that afford investors a reasonable level of protection. Further, the ongoing curtailment of credit is likely to prove a stiff headwind, as banks already loaded down with property loans appear more interested in shrinking their books than expanding them. While this has been ameliorated in recent months by an influx of cash buyers from the Middle East and Germany, the importance of debt-financed buyers in recent years has been very significant, and it is unreasonable to believe the sector can recover without their renewed participation.

In short, prices remain high, buyers remain scarce, and the U.K. economy looks on the brink of what could be a nasty recession. Thus, despite recent price declines we believe it remains too early to commit fresh capital to the U.K. property sector. However, as noted in our October 2007 Market Commentary, short-term price movements should be of less concern for investors who hold property primarily for cash flow purposes, particularly as rents did not follow capital values on the way up, and are thus unlikely to fall too far even if prices continue to decline sharply.

Table A

MONTHLY PERCENT CHANGE OF THE IPD U.K. CAPITAL GROWTH INDEX

31 January 1987 – 31 August 2008



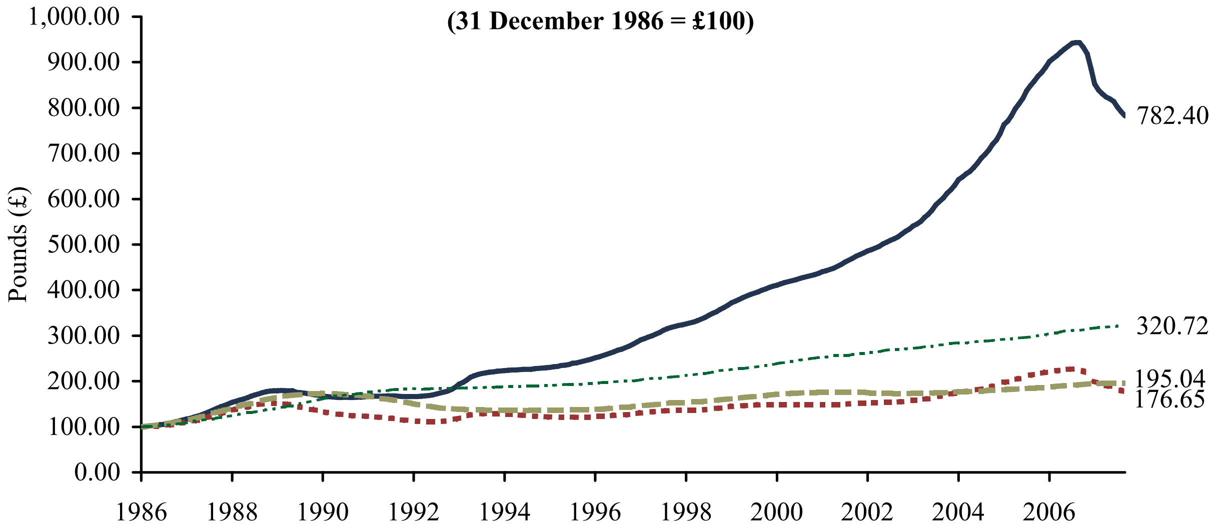
Sources: Investment Property Databank and Thomson Datastream.

Table B

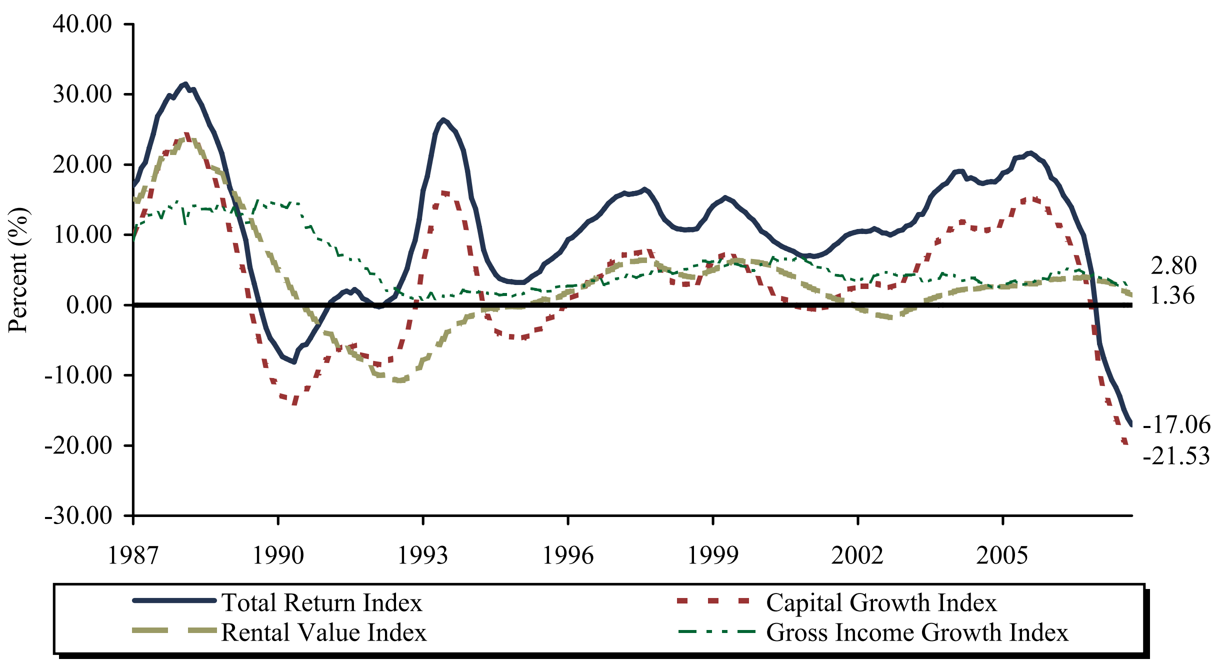
RETURN TRENDS OF U.K. PROPERTY

1 January 1987 – 31 August 2008

Cumulative Wealth
(31 December 1986 = £100)



Trailing 12-Month Growth Rates
31 December 1987 – 31 August 2008



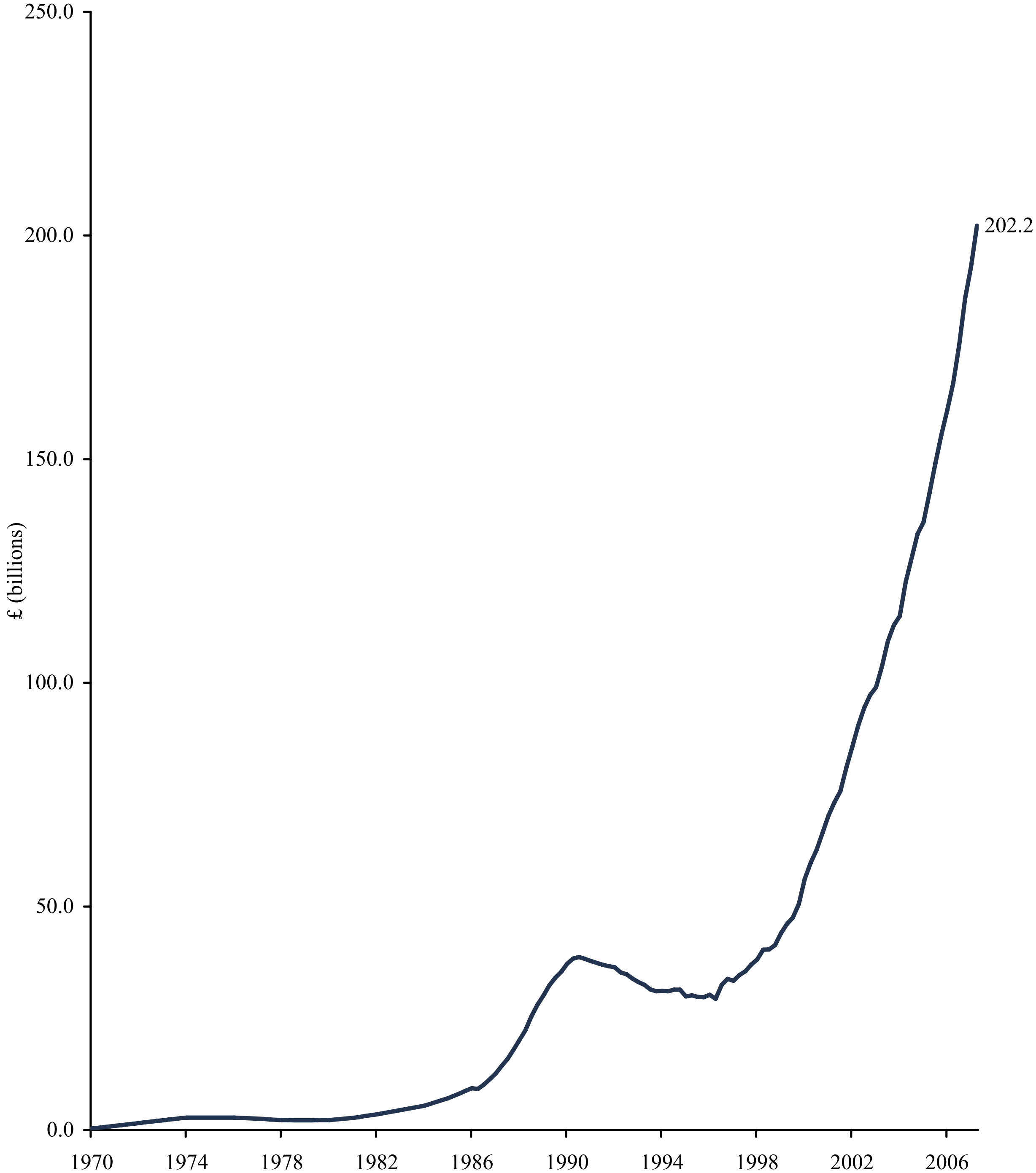
Sources: Investment Property Databank and Thomson Datastream.

Note: Total return is made up of capital growth, rental value, and gross income growth.

Table C

VALUE OF STOCK OF OUTSTANDING COMMERCIAL PROPERTY LOANS

Fourth Quarter 1970 – First Quarter 2008

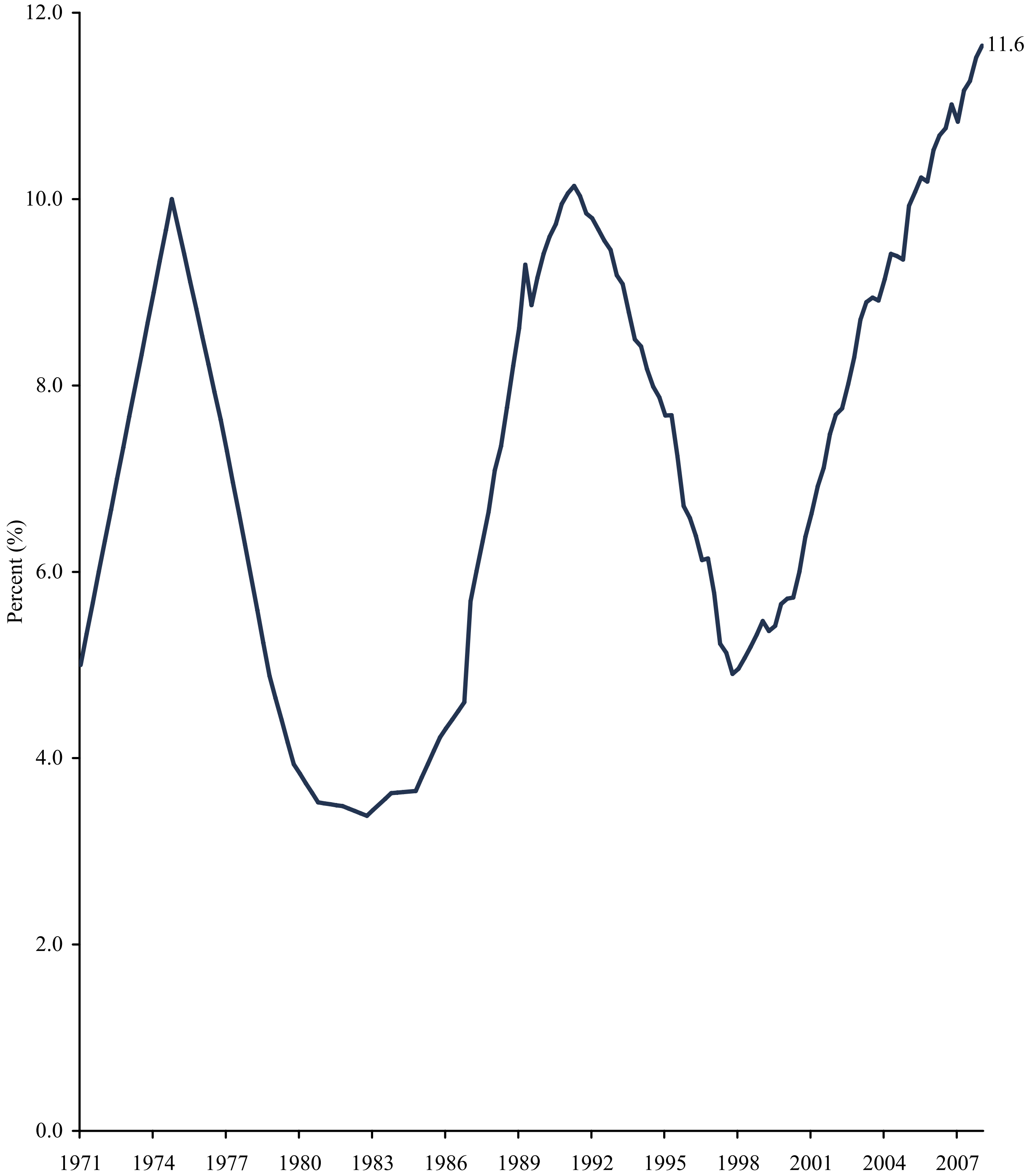


Sources: Bank of England, Capital Economics, and Thomson Datastream.

Table D

VALUE OF OUTSTANDING COMMERCIAL PROPERTY LOANS AS A PERCENT OF TOTAL BANK LENDING

First Quarter 1971 – First Quarter 2008

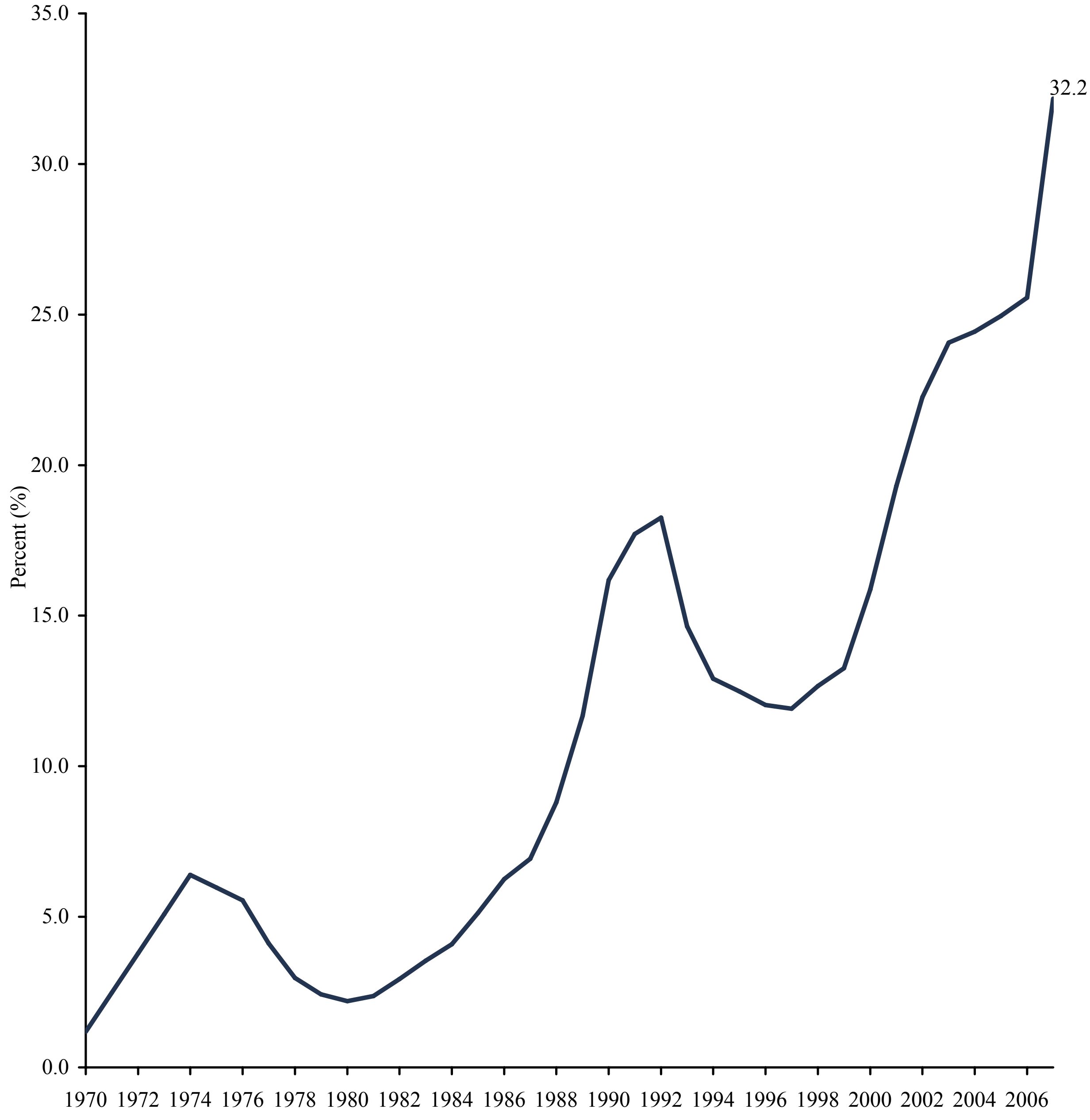


Sources: Bank of England, Capital Economics, and Thomson Datastream.

Table E

**VALUE OF OUTSTANDING LOANS
AS A PERCENT OF COMMERCIAL PROPERTY STOCK**

1970–2007



Sources: Bank of England, Capital Economics, CASS, Investment Property Databank, and Thomson Datastream.