

# EUROMARKET

## HERE WE GO AGAIN

We seem to live in an era of capital induced crises, from the 1998 Russian bonds default through the 2000 Hi-Tech bubble, the 2007 sub-prime debacle and now the Sovereign Debt turmoil. Each past crisis had a significant impact on the real estate sector and more widely on the world economy. This crisis, as it deepens, is unlikely to be different. Things have changed since the summer, most notably on the demand side with regards to accessing finance and significantly reduced property rental growth prospects. Though our central scenario still favours a stagnation of the market in the short term, the duration of the crisis will dictate how bad it is really likely to get. Investors are in for another unnerving year.

## VICIOUS CIRCLE

Financial markets have a short-term view, while macro-economic developments take time to unravel, especially when it comes to debt problems. Back in 2008, a slow economic recovery was expected. At the trough of the market economists warned that, if history was anything to go by, it would take at least 5 to 7 years for economies to recover. Then, a strong first quarter GDP growth rebound led markets to take their eyes off the harsh reality that this was a technical rebound from a very low base and nothing more. This summer, with the front-lining of sovereign debt problems on both sides of the Atlantic, economists suddenly awakened to the fact that this time round things would not be different. Coming out of a deep financially induced recession does indeed take time.

Since then, the financial turmoil (and speculation) has exacerbated the economic woes and fragilities of the periphery of the Eurozone. It started with Greece's Sovereign Debt and is now moving on to Italy, maybe France, Austria and Belgium next, as the widening of the bond spreads (with the German Bund) of these economies seems to be suggesting. The longer the mayhem in the financial markets continues, the wider the contagion (outside of the Eurozone and into the wider banking system) and the weaker the economies through the channel of declining confidence in the real economy, both at the consumer and business levels. The deteriorating economic environment has led to a sharp increase in uncertainty which in turns feeds the decline in confidence. This has become a very vicious circle indeed. In this environment the property market has not been spared. It now seems easier to fathom where the markets might be in 2 years time rather than in 2 months time.

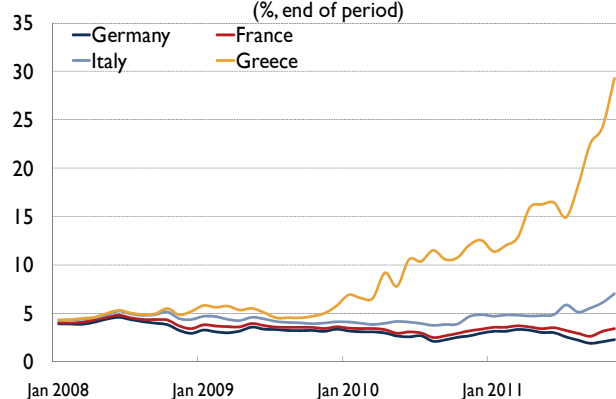
## WHAT HAS CHANGED?

What has changed for the property markets since the summer? The impact of the sovereign debt crisis has been two-fold. The turmoil on the financial markets has hit the real estate market capacity to access financing, while the delay in economic recovery has significantly reduced property rental growth prospects in the short to medium term.

One positive impact of the crisis right after the summer was to postpone any monetary tightening and favour the continuation of a low interest rate environment for a significant period of time thus making real estate investments particularly attractive compared to other asset classes. This argument lost part of its shine recently as the contagion fears steadily took shape. Indeed, speculation on which economy will become the next weak link within the Eurozone combined with banks' balance sheet cleaning is leading to heightened tensions on bond markets. This could potentially lead to higher lending costs to the real estate industry.

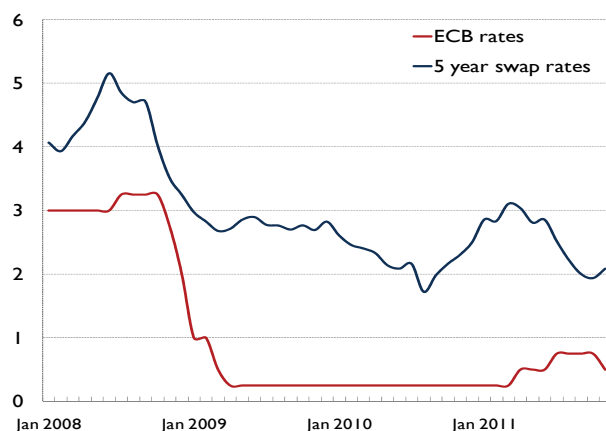
That is when an investor succeeds in gaining access to the debt market. Indeed,

10 year government bond yields (% end of period)

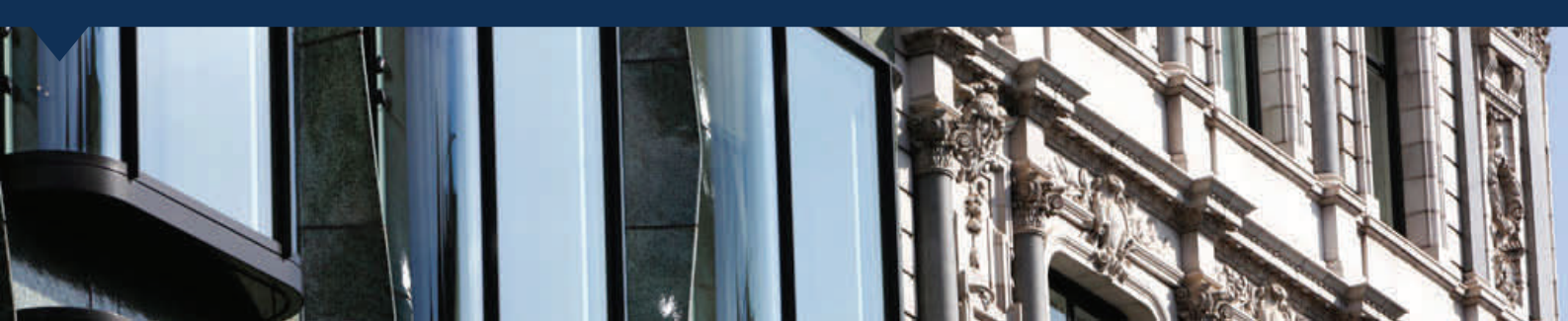


Ecwin, November 2011

European interest rates (% end of period)



ECB, Ecwin, November 2011



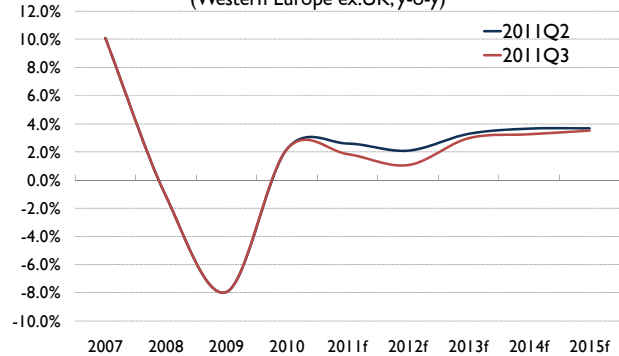
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the increase in uncertainty has already limited the scope of lending of banks which have re-focused their lending requirements to the prime end of the market (or good sponsor track-record, and long-standing relationships with near-core target assets), while the financial crisis has also meant a retrenchment of bank lending to domestic market limiting further the availability of debt. Finally, the increasing instability of the financial system is forcing banks to re-evaluate their position and step up significant bank-wide deleveraging to be able to meet European Banking Authority requirements amid fears over potential write-downs on sovereign debt holdings. As a result, two major European lenders have recently announced they would suspend new property lending: Commerzbank through its real estate arm Eurohypo has suspended new business until at least June next year, while Société Générale Corporate and Investment Banking suspended new UK and Continental European property lending indefinitely. HSH Nordbank has also recently announced that though it would triple new lending in the German market, it would withdraw from international real estate financing. More are likely to follow. The volume of money in the market is therefore likely to decrease even though new lenders such as insurance companies and pension funds are expected to take up some of the slack.

While debt is getting more difficult to access, equity is also likely to record a decline in the coming months. Indeed, the current context of rising economic and financial uncertainties is unlikely to be very conducive of significant new capital raising in the short to medium term, whether at the listed or unlisted levels. Added to that, investors who had managed to raise equity prior to the sub-prime crisis (2007-2008) are now likely to be coming to the end of their investment period and will therefore be coming under increased pressure to place their remaining capital quickly or return it. Overall, the money channelled into Europe is likely to decline significantly in the short to medium term.

The property market is also suffering from the deterioration in rental growth prospects in the wake of a downgraded economic environment. GDP growth forecasts have been revised significantly down across Europe, killing in the bud any hope of an acceleration in employment growth in 2012 which would have fuelled higher office space demand and retail turnover via improving consumer spending. As a result, rental growth forecasts have also been revised down with an acceleration in rental growth now not expected before 2013/2014 after a year of stagnation in the event of a double-dip of the European economies, a probability that is increasing steadily but still not our central scenario, 2012 could even see a decline in rental values. Already, most European markets have seen a stabilisation of prime rents over the third quarter. Total returns are therefore expected to be much more muted over the coming quarters as most of the previously expected growth was driven by rental growth in a stable low yield environment.

European office rental growth forecasts (Western Europe ex.UK, y-o-y)



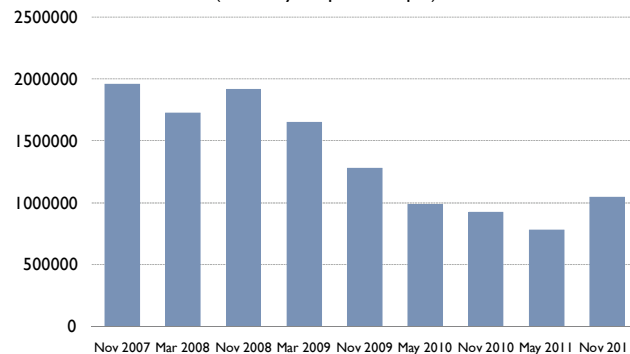
CWI, Cushman & Wakefield, 2011 Q3

## WHAT IS STILL THE SAME?

While the demand side of the equation has changed dramatically since the summer, the supply side situation has remained unchanged whether at the investment or physical market levels. The supply pipeline remains depleted, while the market is still extremely polarised. Both conditions are likely to be exacerbated further by the current market context.

If debt financing is getting more difficult and costly to obtain, development financing has mostly vanished once again. While there was some early evidence that the supply pipeline was starting to increase after relatively good activity in the occupier market in the first semester, a slowdown is expected in the second half as developers put plans on hold or slow down projects again. As a result, the supply pipeline is likely to remain limited in the short to medium term. The scarcity of modern good quality space in the market over the next 2 to 3 years should thus remain a major driver of prime rental growth later in the cycle. At the other end of the spectrum, secondary space is likely to remain abundant thus continuing to depress second hand rents.

Ile-de-France office supply pipeline (Total, 4 year period, sqm.)



Deloitte Driver Jonas Crane Surveys, CWI, November 2011

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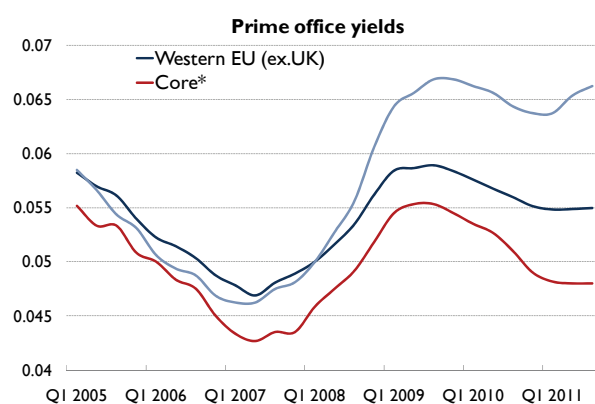
The polarisation of the market is here to stay at the investment level too and is most likely to be exacerbated in the coming quarters. Indeed, the renewed flight to quality has led to a stricter understanding of what is prime, what is near prime but should now be classified as secondary and the rest. Investors are likely to abandon any areas where they cannot guarantee the preservation of their capital. This is leading to a concentration on prime assets in core liquid markets or those perceived to have stronger economic fundamentals. In much of the rest of the market liquidity is shrinking and pricing is getting more uncertain. In the European periphery for instance, pricing is now deemed too high to match the sharp increase in perceived risk. Some vendors have started cutting price on secondary while those holding prime assets are now more likely to withdraw from the market if they are not forced to sell. Finally, banks in the current financial context are likely to have to accelerate disposals, which would mean an increase in secondary stock mostly as banks, in the wake of the sub-prime crisis, have worked through their good quality holdings first. This would penalise further an already beleaguered secondary market.

## IMPLICATIONS FOR INVESTORS

The duration of the crisis will dictate whether capital values take a hit and how big a hit. Indeed, the longer it lasts, the larger the impact on the real economy and the higher the probability of a double-dip. Our central scenario though still favours an unravelling of the crisis sooner rather than later with one quarter of negative GDP growth in Europe followed by a frustratingly slow recovery in 2012. This would imply stagnation for the real estate sector but not a slump comparable to the one following the sub-prime crisis.

In that context, prime yields are expected to remain low or move out slightly as investors grow wearier and withdraw at least temporarily from the market, while rental growth is expected to stall next year. Prime real estate performance is therefore expected to be flat at best, while capital values are likely to resume their fall in the secondary market.

Unfortunately there aren't many options for investors in the current market context: be tactical and play short-term opportunism if you have the equity; or be strategic and bet on long-term capital preservation if you can get financing. The in-between option of a more value-add strategy has once again disappeared for most. The usual knee-jerk reaction to the increase in risk has led to a flight to quality meaning that core liquid markets have become overcrowded. Pricing has become keen in those perceived safe havens and the sourcing of (suitable) assets is getting more difficult. With liquidity expected to contract, equity players may find opportunities outside of the banks' comfort zone to meet their return requirements. With economic forecasts for next year still being cut and the macro environment still not settled, it will take time for stronger investment activity to be seen again.



CWI, Cushman & Wakefield, 2011 Q3

\* Paris, Munich, Stockholm

\*\* Milan, Madrid, Dublin, Lisbon

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