# The Global Financial Crisis and International Property Performance

*The global credit crisis has overwhelmed the local characteristics of international real estate.*

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**COMMERCIAL REAL ESTATE** was not a precipitating cause of the global financial crisis, but it is now caught up in the same vicious cycle of value destruction as virtually every other asset class. Securitized real estate—both debt and equity—has already gone through several rounds of violent and volatile re-pricing. Private equity real estate will also experience significant re-pricing, albeit through a more drawn-out process. The pattern of price discovery, re-pricing, and eventual recovery will play out differently in the major markets of the world. Yet, the global crisis also reveals some surprising similarities across markets. These differences and similarities are worth understanding,

**Table I:** Global real estate performance: Record volatility (large cap REITs and REOCs)

| | UBS Investors Index Global Returns by Country | | | |
|---|---|---|---|---|
| | 2006 | 2007 | 2008 | Peak to Trough |
| Global | 37.5% | -16.9% | -42.6% | -68.2% |
| U.S. | 36.2% | -16.4% | -38.8% | -70.9% |
| Continent | 44.7% | -21.6% | -43.4% | -66.0% |
| Britain | 48.0% | -37.0% | -47.0% | -69.7% |
| Australia | 33.9% | -7.5% | -51.5% | -60.0% |
| Hong Kong | 18.8% | 19.1% | -41.1% | -50.0% |
| Singapore | 49.8% | 0.9% | -53.7% | -67.7% |
| Japan | 26.6% | 2.6% | -43.6% | -66.8% |

Source: UBS Global Investors Index. All data are in local currencies.

since debt and equity now move with relative ease across political borders.

The global financial crisis has pushed the world economy into a severe contraction. No country is immune to the downturn. No major asset class has been spared from severe losses in value, with the exception of U.S. Treasuries and Japanese government bonds. Academic research shows that during a financial crisis all asset classes become highly correlated, and the risk-reducing power of diversification is temporarily lost. The good news is that research also shows that banking crises have happened repeatedly throughout history and they don't last forever.

## NOWHERE TO HIDE

For an industry that is still so highly differentiated—by country, by property type and by management style—it is remarkable how highly correlated the performance of real estate securities was in 2008. Despite record-breaking volatility, the year-end country indices finished the year down by the same order of magnitude: 40 percent to 50 percent. The peak to trough losses in value displayed by the major country indices were also clustered in a tight range of 60 percent to 70 percent. What makes these statistics even more remarkable is that real estate stock prices moved up or down 10 percent in a single trading day a record-setting number of times across a wide number of countries. Yet, after the dust had settled, Chinese development companies, UK REITs, Australian listed property trusts, Japanese real estate operating companies, and U.S. REITs had all lost about the same amount of money for their shareholders. And these parallel movements were much tighter than any previous year of bear or bull markets (Table I).

**Table II:** Global real estate investment trusts: re-pricing similar to broader equity market

| | Annual Total Returns (in USC) | | |
|---|---|---|---|
| All Property | 1 Year* | 10 Year* | 10 Year (as of 3Q08) |
| MSCI Global Stocks | -41.9% | 0.2% | 4.8% |
| EPRA/NAREIT Global | -47.7% | 6.6% | 12.1% |
| North America | -40.6% | 7.2% | 12.5% |
| Europe | -51.1% | 6.1% | 10.7% |
| Japan | -33.4% | 7.8% | 12.9% |

* As of December 31, 2008
** Japan REITs have only 7 years of track record
Source: Bloomberg FTSE EPRA/NAREIT
Total returns (including dividends); 10 year returns are annualized.

What could possibly be the common factor across so many distinctive real estate companies and localized markets? The answer: the global credit crisis was blind to differences between Australian shopping centers, Hong Kong office towers, American apartment communities, or global industrial-logistics companies. Capital market issues—debt refinancing, rising cap rates, de-leveraging, and flight to government bonds and cash—trumped differences in the outlook for net operating income or occupancy across countries and property types. Country-specific differences in cash flows, though significant in 2001 to 2007, were rendered relatively insignificant by the financial market meltdown. In terms of the rapid changes in the valuations of real estate companies and individual properties, yield expansion (or multiple contraction) dominated more subtle differences in net operating income. It is understandable that real estate developers, who rely so much on fresh financing to keep their pipelines moving, would be particularly susceptible to the ravages of the debt crisis. But the data for moderate-leveraged REITs show the same pattern. A comparison of tables I and II shows that REITs actually under-performed the broader UBS Investor Index by 510 basis points, even though REITs are, by far, the largest component of the inclusive UBS index. Table II also shows that global REITs turned in slightly worse performance than the overall large-cap global stock indices in 2008—not much of a diversification benefit there.

Another remarkable similarity across the world is that the ten-year performance of REITs in Europe and North America now varies by a mere 110 basis points, while Japan, with seven years of REIT performance data, is within 120 basis points of the global average. Correlations across countries were in the range of 0.2 to 0.5 through 2006. Correlations in 2008 spiked to 0.9 or

greater (1.0 is a perfect correlation). The effects of 2008 will cast a long shadow—in fact, the ten-year REIT performance numbers lost 500 to 600 basis points in just the last three months of the year. There can be no doubt that investors who sought steady income and diversification through real estate could feel betrayed—after all, real estate securities closely followed the poor performance patterns of the broader equity market.

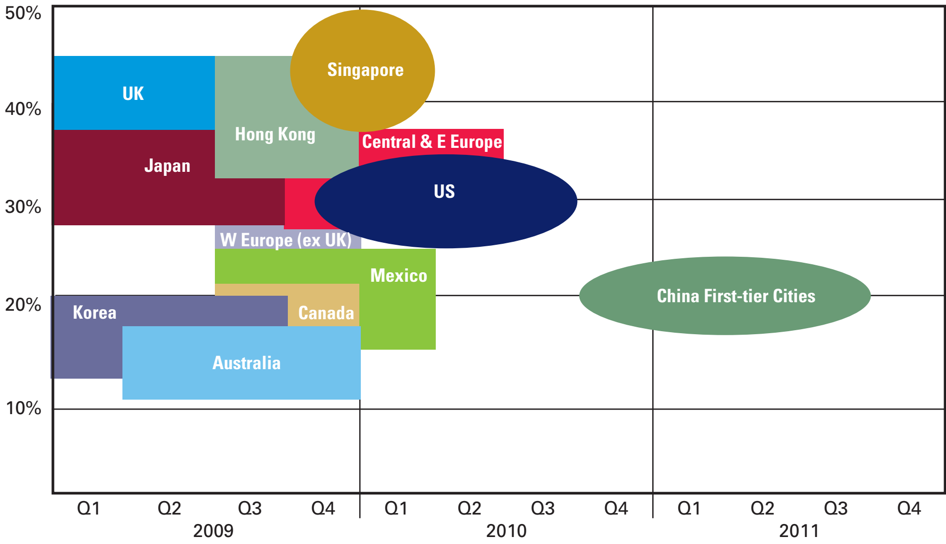
## PRIVATE EQUITY

The highly correlated performance of the world's listed real estate indices in 2008 stands in sharp contrast to the heterogeneity of the private equity indices. Nowhere is this contrast greater than in the United Kingdom and the United States. These countries represent two of the largest and most transparent investment real estate markets in the world, yet they are also at opposite ends of the spectrum when it comes to private equity re-pricing. Through the fourth quarter of 2008, the United Kingdom's private equity indices showed a 36 percent drop from peak valuations. United Kingdom analysts believe that the peak-to-trough drop in unleveraged United Kingdom values will be on the order of 40 percent to 50 percent, after all the transaction evidence works its way into the index.

The U.S. private equity index, by contrast, registered a trifling 2 percent decline in valuations in the third quarter and actually posted a write-up over the same fifteen-month time frame the United Kingdom IPD index posted its first capital value loss. Fourth-quarter write-downs for U.S. open-end funds were 12 percent (equivalent to an 8 percent value drop, when leverage is taken into account). Yet, both the United States and the United Kingdom experienced the same collapse of credit, followed by a rapid slide into recession. If anything, the collapse of credit in the United States was more severe, due to the American market's reliance on securitized debt. What, then, are the reasons for the striking difference between these two countries and what does it tell us about how real estate does or does not hold up during a financial crisis?

Figure 1 shows the wide range of likely differences in both magnitude and timing of private equity re-pricing around the world. The United Kingdom is clearly at the forefront in terms of both the severity and the advanced timing of its price correction. The reasons for this are many. First, unlike the United States, the United Kingdom has transaction evidence upon which new valuations can be based. The open-end funds in the United Kingdom have been forced sellers to meet redemptions, unlike their counterparts in the United States, which generally give the

**Figure 1:** Repricing—magnitude and timing




Peak to trough price declines (vertical axis) versus the quarter(s) when process of re-pricing should be complete.

fund manager discretion regarding when and how to satisfy redemptions. These British transactions are reflected in monthly valuations in the U.K. open-end funds, in contrast to the quarterly or annual valuations of many U.S. funds. More time and effort is put into valuations in the United Kingdom, as a result of the greater scrutiny that the net asset values (NAVs) receive, when investors are moving in and out on a month-to-month basis.

The trigger for a forced-sale process in the United States is harder to discern. The debt markets would be one place to expect to find forced sales. However, portfolio (whole loan) lenders have been extending loans, rather than force over-leveraged owners into foreclosure. Borrowers who tapped into the securitized debt markets are not likely to find the same forbearance, but most of this debt does not come due until 2010 and 2011. REITs have unexpectedly risen to the fore as a possible source of forced sales. Investors are watching the sales process of both ProLogis and General Growth with great interest to see if these transactions will act as the trigger to re-pricing in the United States. However, the complex web of shareholder rights (common and preferred) versus inter-creditor rights could delay the sales process of REITs with refinancing problems. Figure 1 shows that the United States and the large Chinese cities stand out as the two markets where private-

equity pricing will be drawn out through time. In China, the lack of a robust valuation profession and the support of the PRC government to avoid forced-sales by banks will likely elongate the process of price discovery even further than in the United States.

## WHAT SHOULD AN INVESTOR DO?

After the global financial system is repaired and banks begin lending again, commercial real estate will again demonstrate risk-return characteristics that complement those of stocks, bonds, and other alternatives. Until then, investors should rely on these twin themes to guide their investment strategy for 2009 and 2010: first, take a strong defensive position (to survive the crisis), and second, design a rigorous offense (as markets re-price and promising opportunities begin to surface). Patience will be needed in some countries where the re-pricing process will take longer. Alert and nimble investing will be rewarded in other countries where the re-pricing process happens with greater speed.

Looking through the downturn to see what lies on the other side requires an understanding of how closely different real estate markets are connected to the current crisis. Playing offense also requires fortitude. Buying re-priced assets has been compared to "catching a falling knife." No bell rings at a market bottom. Instead of trying to time the next upturn precisely, investors need a clear idea of what risk premium to seek in a highly uncertain market. Then, they must be patient until this premium can be achieved with realistic, conservative underwriting. On the private equity side, this may mean bidding unsuccessfully many times, because sellers will tend to hold rather than sell at sharp discounts. Eventually, though, we expect sellers to capitulate—in a falling market the bid-ask spread tends to get resolved in favor of the "bid," not the "ask." Buying real estate while a market is still digesting bad news can produce strong results (which can only be assessed after the market has recovered), in part because so few buyers are active.

For listed companies and REIT portfolios, the required returns of investors will continue to gyrate based on both deteriorating sector fundamentals and "going concern" issues. Companies that know how to grow earnings through development and leasing in a robust economy may not have the skills to preserve value, manage debt, control expenses, and retain tenants in a recession. By the same token, public or private companies with strong development expertise and land inventories may be

ascribed no or negative value for these skills by investors during a down-market. This allows investors with longer time horizons to effectively "buy" these skills for next to nothing.

### TAKING ADVANTAGE OF PRICE CORRECTIONS

The search for superior investments requires discipline and discernment, even in the best of times. During periods of panic or euphoria, many of the tools of risk-return analysis are neglected by market participants. Emotions start to shape investment decisions more than rational analysis. Neuroscience suggests strong evolutionary reasons why fear and greed were useful emotions for survival at the dawn of the human race. In modern society, too much adrenalin can cloud rational thought and lead to rash investment mistakes. Emotions like fear, distrust, and panic have been surging through the broader equity and fixed income markets on a regular basis. Volatility measures for stocks are in record territory. Measures of trust and counterparty risk (credit default swaps and interbank borrowing rates) must show clear signs of recovery before higher-risk capital can be expected to make a move back into the markets.

Global real estate investors must rely on rational analysis, not emotions, to guide their investment decisions. While this advice holds true in calmer markets, it is especially relevant (and difficult to execute) when markets are in turmoil. "Keep your head, when those around you are losing theirs," wrote Rudyard Kipling. This may be one of those aphorisms that are easier to repeat than to follow. Yet, in the years ahead, many real estate investors will be losing their heads. As they do, we expect to see assets fall into the hands of financial institutions that are unprepared to operate them effectively over the long haul. And panic selling by those who simply need to raise liquidity in a hurry can also be expected. Countries like Australia, Korea, and Germany are likely to move through the re-pricing process faster than the United States. While the price correction process is painful, it is also a necessary pre-condition to a capital market recovery by laying the foundation for stronger performance in the years ahead.

In 2008, global real estate provided almost no diversification or enhanced return benefits. When the capital markets are functioning again, the local characteristics of diverse international markets will re-assert themselves and provide many interesting investment opportunities.