WHARTON REAL ESTATE REVIEW SPRING 2012

Mind the Liquidity Gap

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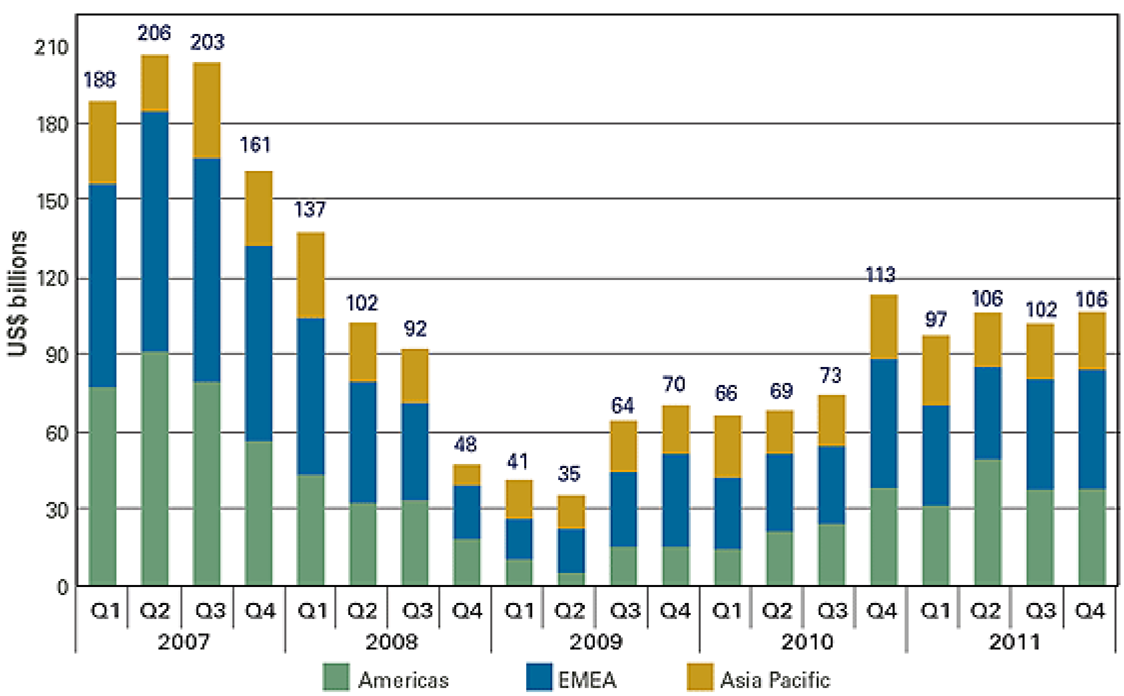
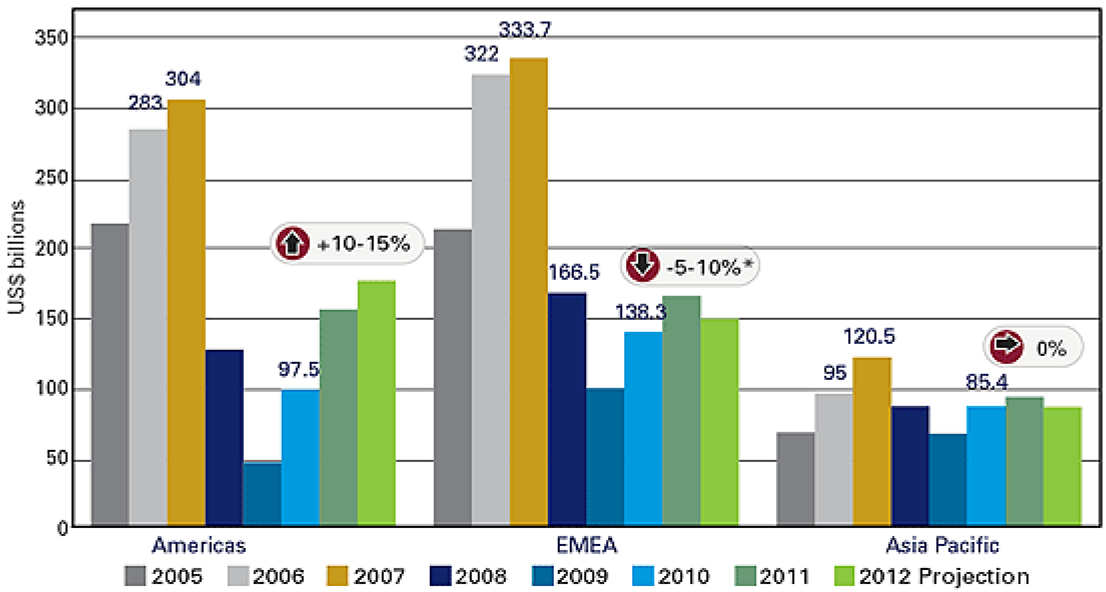
Investors' appetites rise and fall. How and why this happens is a mysterious process in all asset classes. In global property, trader's talk of "risk-on and risk-off" describes the scene as the New Year unfolds. In early 2011, the "risk-on" real estate trade started to make a comeback. After several years of extreme risk aversion, investors of different stripes returned to real estate in larger numbers than any time since before the global financial crisis (GFC). A broadening band of private equity assets and products gained traction after a spate of risk-off trades in the last quarter of 2010 and the year of nearly no trades in 2009 (Figures 1 and 2).

Figure 1: Direct commercial real estate investment , quarterly 2007 to 2011



Source: Jones Lang LaSalle

Figure 2: Direct commercial real estate investment 2005 to 2012



*EMEA: In US$ terms unchanged in Euro terms
Source: Jones Lang LaSalle

In the second half of 2011, the "risk-off trade" became dominant again. In real estate parlance, only "core" assets (fully leased, dominant buildings in major markets) had full access to liquidity. Like investment-grade bonds, core properties traded up in price, even though fundamentals remained weak in many G7 countries. As 2011 came to a close, Europe was clearly headed toward a recession; China might experience a "hard-landing." REIT pricing on four continents was pounded by capital markets turmoil in the third and fourth quarters and several debt securitization deals were put on hold. Chinese development companies, UK REITs and European property companies were hit especially hard. Investors worried about a GFC II.

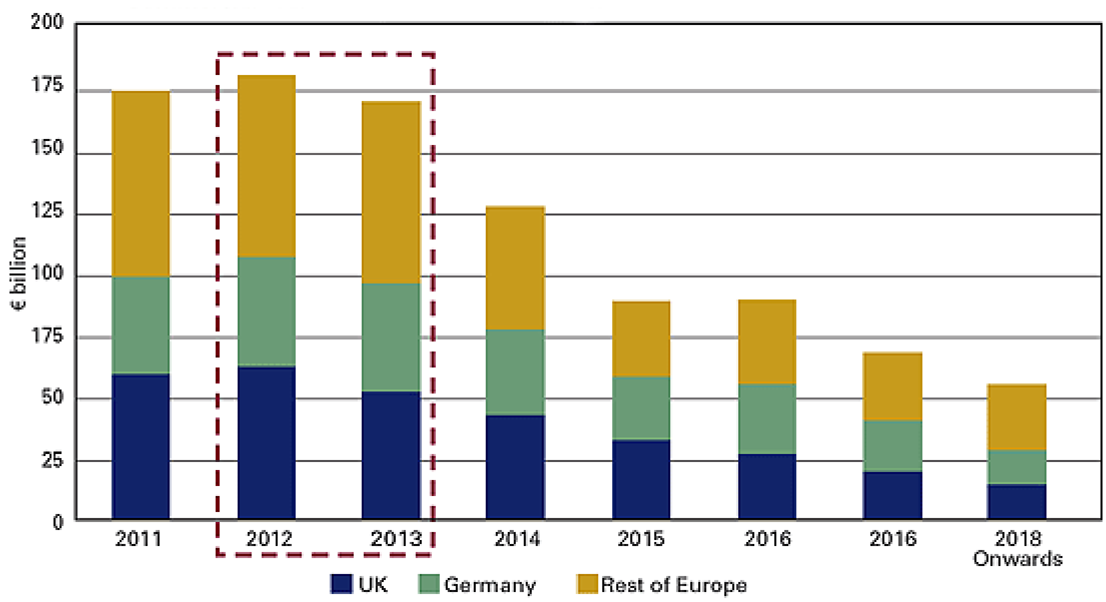
Ironically, as the European crisis heats up, risk averse money seeks safety in the most expensive property markets in Europe and in Asia. But the low-risk reputation of these assets may be illusory. Investors seeking a safe haven in property have bid up the prices and driven down the yields to levels that may be unsustainable, especially if and when interest rates rise again. In London's West End, a luxury retail flagship store traded in January at a record low yield of 2.9 percent. Central Paris real estate continued to attract "safe haven" money at 4 percent yields. Hong Kong residential property trades at record high levels—30 percent higher than the pre-GFC peak. And in Shanghai, while the government tried valiantly to reduce the pressure on luxury residential prices, office buildings traded at 5 percent yields, an all-time low.

Debt for the "Risk-On" Trade

Meanwhile, "risk-on" trading has left equity behind and found a more conducive home in the world of real estate debt. The mountains of mortgages accumulated during the credit bubble era are starting to crumble. NAMA, the Irish government's version of the Resolution Trust Corporation, is auctioning large chunks of its €72 billion (face value) pool of performing and non-performing real estate loans across Europe and North America. In December, large portfolios of discounted real estate loans were sold by RBS and Lloyds. Barclays and HBOS have already exited their North American and Asian loans through secondary market trades. The French and German banks are next to start selling, as the Euro crisis and Basel III force these institutions to pare back to domestic, conservative senior debt.

Some of the most active lenders in Europe (Société Generale and Eurohypo) have stopped making new property loans and other major European banks are likely to follow suit. The German banks have pulled back to make only domestic loans and many will not lend above 55 percent loan to value or in lot sizes greater than €100 million. Like American banks, European financial institutions face a mountain of expiring debt and are steeling themselves to start packaging it up for sale (Figure 3). Meanwhile, the smart money is moving into "mezzanine" real estate finance in the UK and Continental Europe, where yields can be twice, thrice, or even four times as high the yield on senior debt or on direct equity. Dominated by the non-bank and shadow bank financial sector, today's mezzanine financing is positioned in the 55 percent to 75 percent loan-to-marked-down-value range. This position in the capital stack would have been priced as senior, unsubordinated debt in 2005 to 2007.

Figure 3: €350bn of European debt maturing in 2012-13.



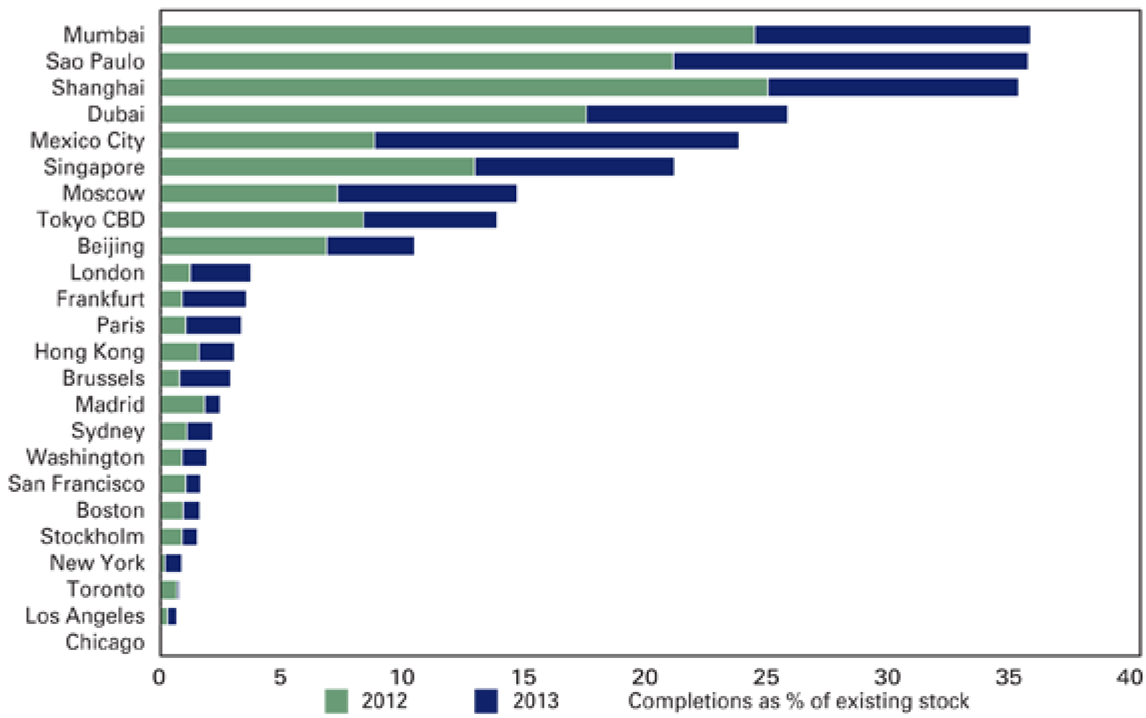
Commercial real estate debt maturity profile
Source: De Montfort University, CBRE, year-end 2010

Where does this leave private equity property investors? Investors willing to take on a degree of complexity, or who are willing to move from Knightsbridge to Hammersmith in London (akin to moving from Fifth Avenue to Third Avenue in New York City), will find much better value. Commercial properties in Europe, North America and Asia Pacific are divided into the "haves" and the "have-nots" when it comes to liquidity. Pricing and returns look quite different on the two sides of this liquidity gap. Jones Lang LaSalle counted up all the trades that took place in 2011 and found that the majority of all investment activity (by value in 2011) took place in the top thirty major markets. In geographic terms, the west of London, mid-town Manhattan, Toronto's Bay Street financial district, Washington, D.C.'s West and East Ends, central Paris and La Defense, Hong Kong-Central, Shanghai's Pudong and Puxi districts, and Singapore-Raffles are all firmly in the "have" category. Yet, there is a wide world of real estate beyond these über-expensive, low-yielding districts. When will the risk-off trade for equity real estate be seen as worth doing? It won't be long; there is only so much Knightsbridge to go around.

New Skylines, New Challenges

Construction pipelines reveal another major trend in 2012. Relative to the rest of the world, the United States has nearly stopped adding to its inventory of major office buildings. The growth markets of India, China, Brazil and the Gulf Cooperation Council (GCC) countries are building new skylines to house their rapidly growing financial and business service sectors. Three cities will increase their office stock by one third over the next two years—Mumbai, São Paulo and Shanghai. Even slow-growth markets like Tokyo, London, Paris and Frankfurt will be adding office space at a faster clip than any major city in the United States (Figure 4).

Figure 4: Office supply pipeline, major global markets, 2012-13.



Source: Jones Lang LaSalle, January 2012. Covers all office sub-markets in each city. Tokyo-CBD-3-kus

In emerging markets, very few prime assets are ever put to auction. Investors wishing to get a foothold in these countries must consider development as the most direct route to building a an international portfolio. Listed companies operating in China, for instance, have very active development pipelines. But many of these companies are now squeezed for liquidity, having temporarily lost their ability to issue shares or unsecured debt. This situation opens up opportunities for "white knight" investing, where private equity infusions can rescue a developer from defaulting on its debt or its promises to tenants and local authorities.

A slowdown in Chinese land auctions could imperil local government finances, which are heavily dependent on the auction proceeds to fund local infrastructure. However, the land use rights that have already been sold do generate thirty-year and forty-year income streams to local governments, so this is not a dire situation. The "go-west" policy of the Chinese government is embedded in the recently-announced five-year plan (Figure 5). This massive infrastructure spending program is a critical component of the continued expansion of Chinese cities, and indeed, its national economy. For years, it has been easier to move goods from the ports of Shanghai and Guangzhou all the way to Los Angeles or Oakland, California than it has been to move goods and people to the interior of China. These infrastructure spending programs are designed to address this imbalance. Based on the ability of the government to deliver on its infrastructure targets in the 10th and the 11th five-year plan, investors should count on most of this spending taking place.

Figure 5: China infrastructure investment.

	2005	2010	2005 vs 2010	2015E	2010 vs 2015
Railway	75,438 km	91,000	21%	120,000	32%
High-speed rail*	405 km	8,358	1964%	45,000	438%
Highway	41,005 km	74,100	81%	105,000	42%
Airports	142	175	23%	220	26%
Coastal port throughput	3 bn tons	6	93%	8	39%
Port docks	1,113	1,774	59%	2,214	25%
Intra-city rail (subway)	486 km	1,400	188%	3,000	114%

Source: China International Capital Corp.

India and Russia are challenging markets for international investors. Both countries have attracted modest but rising flows of international capital, despite lower transparency in the enforcement of property rights and their land title systems. Investors must navigate a thicket of rules and regulations legally, even though locals don't always bother. Brazil, on the other hand has shown that it understands and welcomes foreign capital. Policy makers in Brazil are eager to develop the country's inventory of affordable housing, shopping centers, warehouses and office buildings. Lease contracts favor tenants, which has impeded the development of deep real estate credit markets. But tighter credit in Brazil has also helped impose a tighter discipline on new construction and pricing.