GLOBAL PROPERTY: Hopes build for world property

British real estate was once the darling of European property portfolios. But investors are exiting fast and are looking towards Eastern Europe and even further to countries like Mexico, finds *Angelique Ruzicka*

There seems to be nothing but gloomy days ahead for Britain's real estate market. What was once one of the darlings of European real estate portfolios is now at the bottom of investors' wish lists. Last month, the Royal Institute of Chartered Surveyors (RICS) announced the most sombre of statistics yet. Its Commercial Market Survey highlighted a lull in investment activity and a marked deterioration of tenant demand. New enquiries to occupy business premises fell at the fastest pace in two years and now stand at its lowest level since Q1 of 2003.

"The spiral was started by the sudden withdrawal of bank lending to the sector, as part of a response to the August 2007 credit crunch. Normal service in bank lending practice has still not been resumed, although there is a rapidly growing sentiment that prices have not sufficiently adjusted for value to be obtainable," says Chris Bartram, chairman, Orchard Street Investment Management.

While the retail sector in Britain's real estate market is also under considerable pressure the shift in sentiment over the past few months has been most pronounced in the office sector, says RICS. The office sector has performed poorly for the first time in four and a half years. IPD, a property performance measurer, calculates that since peaking in the middle of 2007, values for all property in the UK have declined by more than 10%.

Investors are exiting the market quickly. Last month UK reports revealed that around £500m (e336.6m) had been withdrawn from New Star's flagship property fund, which had fallen in value from £2.2bn to £1.5bn. Meanwhile, Standard Life admitted that further "aggressive correction" was a possibility.

Opportunities

Matthew Ryall, European property director of BlackRock, says: "The UK market has plummeted in the last couple of months in a way that we've never seen before. The UK market has been incredibly hot before that with nearly 20% per annum returns between 2004 and 2007."

Michael Montebaur, a member of board management of Union Investment Real Estate, comments: "London has seen dramatic price increases and it is the market that is slowing down the most."

But there are opportunities in the unstable UK market. Montebaur says: "We hope for even more corrections. We do see these corrections as opportunities."

Vulture funds are starting to circle UK property to take advantage of the volatility. According to reports, some are being financed by the Middle East and China. Spain has gone through similar pain to the UK, but its market correction has so far been a lot more fierce although it began far earlier than in the UK.

“Historically, we have been struggling in Spain and have never been able to build the portfolio of the size that we’ve wanted to do. The fundamentals of the Spanish market have been very attractive but pricing has always been too aggressive for us,” says Montebauer.

Spain’s correction came about as a result of too much supply in the retail market. “There was too much construction going on,” says Ryall, of BlackRock. To illustrate his point further, Ryall compares the rate of Spain’s construction to that of the UK market. “In 2006 the UK saw 175,000 new homes being built and it has a population of about 60 million. But Spain with a population of about 40 million saw close onto 800,000 of new homes being built in the same year,” he explains.

Investors in Spain’s major cities tried to capitalise from it too but to no avail. “A lot of offices in the city centres in Madrid and Barcelona have been bought to be converted into residential property,” says Ryall. “I don’t think that will now occur because we are seeing a correction in residential property and you will now see an increase in supply from property that has been taken out, so we are very pessimistic. Spain and the UK are markets we’ve been avoiding.”

However it’s not the entire Iberian Peninsula that has been affected. So far, Spain’s neighbour, Portugal, has been unaffected by what has happened next to it, according to Ryall. “Places like Portugal haven’t been affected by the credit crunch. They haven’t seen these dramatic increases in prices because their local banks have all been very conservative. It’s very difficult to see why things should change here,” he says.

Elsewhere in Europe

Some asset managers are now seeing opportunities in other parts of mainland Europe. So far, France has escaped the fates of the UK and Spain. Last year Paris led the year’s list of top real estate investment markets in Europe, according the report Emerging Trends in Real Estate – Europe 2007, published by the Urban Land Institute (ULI) and PricewaterhouseCoopers.

Montebauer says: “The French market has hardly been affected at all by corrections. The price level of France has remained similar. The leasing market has performed very strongly in 2007 and doesn’t show any major weaknesses and we don’t see any weakening of the French market. In Paris it has an extremely effective and successful office market.”

At the time, London rated a close second to Paris as an investment market. But the UK market has changed drastically since then and it has forced managers to look elsewhere in Europe for opportunities.

Central and some Eastern European markets are now looking attractive. Montebaur says: “We are looking at Central and Eastern Europe as it consists of various smaller markets in which we would like to invest more. But we are going about it carefully as we see some of the markets as overvalued.”

Ryall agrees that for this year, Central and Eastern Europe will do far better. “In 2008 you will find that the highest returns will probably be in Central and Eastern Europe. Whether it is sustainable or not is a completely different story, given the pricing correction in the United Kingdom and in Spain,” he says.

Germany and Scandinavia

For years Germany’s real estate market has been sluggish and uninteresting but now investors are revisiting the market as they see real opportunity. “German house prices haven’t changed much over the last 15 years. At the beginning of the 90s you saw dramatic amounts of building in Germany. It’s only picked up again from 2006 onwards,” says Ryall.

Christian Delaire, managing director of fund management of Axa Real Estate Investment Management in France, agrees that Germany has great potential. “Germany will continue to be one of our targets in 2008 because we think the fundamentals are good. The economic performance of the country is really good and we think there will be good opportunities there. We have been very active in terms of healthcare in Germany. You can get stocks where occupancy rates are strong," he says.

Finally Scandinavia is another market that is being keenly looked at by asset management firms. The ULI and PwC survey of real estate trends saw Stockholm in third place. According to the survey, the city continues to move up the list for overall investment ratings, as its redevelopment prospects continue to strengthen.

"In Sweden and Finland we have very high expectations in terms of economic growth and we think that the letting markets will develop strongly there, especially the office sector. We want to be more active and we've set up a platform to be present in the region," says Delaire, of Axa.

Beyond Europe

Beyond Europe there are more opportunities to be had and those with the ability to invest further afield have found benefits in emerging markets.

Montebaur, of Union Investment Real Estate, says: "We have been investing in Mexico for the past two years and we have built up a considerable portfolio there. We are in the process of going into Asia and we have invested in the past 18 months more than e500m in Asia-Pacific and we have done this through setting up a branch office in Singapore one and a half years ago."

Montebaur says his firm has engaged in forward funding deals whereby the investor enters into a development project with cost and time guarantees built in. "This type of product is very familiar to us and we have done such forward funding all over the world," he says.

"We have worked in the Asia-Pacific market and we are about to do something like that in Mexico and Chile. We believe in this concept because you share in the development process and on the other hand you are able to acquire a new product and take a view on the quality of the product."

Alternative tactics

But it's not only different markets that are being explored for opportunities in real estate – more creative strategies are being adopted to chase higher yields in less well known sectors too. "Logistics is increasingly important for institutional investors going forward," says BlackRock's Ryall. "Also I believe leisure property - such as marinas -and doctors' surgeries are mispriced and will do well in the next couple of years."

For now, property asset management firms will have to look beyond the UK for better returns. But the UK's agony could be short-lived. "Present feeling is that total return is likely to pick up strongly in 2009 and beyond, fuelled by some recovery of capital value ratings from their present levels. Therefore there are prospects of high single-digit (8-9%) total returns for 2009 and beyond," says Bartram.

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