

European Real Estate Monitor

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The “credit crunch” and real estate pricing

Outside the UK and Spain, reported yields have barely shifted in the third quarter. Fundamentals suggest this could be sustained, though there are clearly downside risks, especially to the macroeconomy. Indirect markets are however pricing for a downswing in line with the early 1990s, hinting at buying opportunities.

Focus on: The United Kingdom

The UK commercial real estate investment market has stalled. Sentiment is negative; whilst book values have moved down over the last quarter, neither buyers nor sellers are sufficiently confident of valuation to enter into transactions. This article explains why the UK market has seen such a strong reaction to the turmoil in debt markets and looks at the prospects for 2008.

Market Monitor: Europe decouples

The economic shocks of the early 2000s and the more recent surge of interest in real estate as an asset class have created an impression of synchronisation between European real estate markets that we believe to be illusory. As markets slow and the credit crisis bites, careful differentiation between market trends will become an important driver of a successful investment strategy.

European snapshot

Summary of key market data

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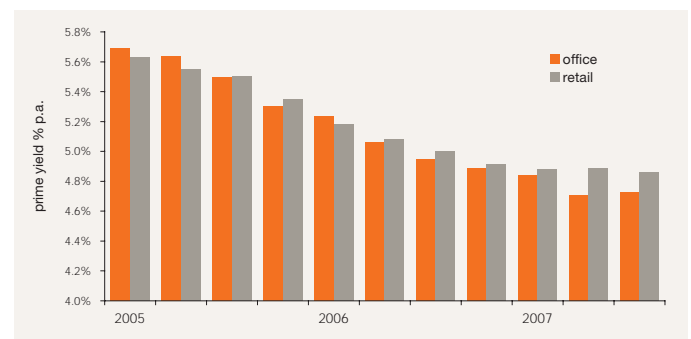
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The “credit crunch” and real estate pricing

From a researcher's point of view, the recent dislocation in credit markets could hardly have come at a less convenient time. Real estate data is thin on the ground at the best of times, but the turmoil hit just as agents were finalising Q2 data, meaning that for most countries analysts would have to wait more than three months before any hard evidence of the effect of the upset on real estate pricing could be gathered.

We now have Q3 data, and it paints a mixed picture. UK and Spanish yields have clearly risen – more so in agents' data than in actual valuations – but overall these yield increases have been balanced by continued compression in markets such as Scandinavia and Central Europe (Chart 1). In fact, so equivocal is the message in these numbers that there is plenty of room for both the optimists and the pessimists to argue their corner.

Chart 1: Weighted average European office and retail yields



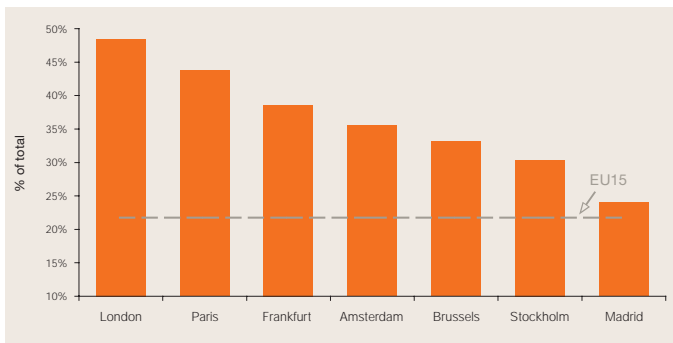
Source: DTZ Research

If we cannot get a handle on real estate pricing from real estate pricing data, what other routes are available to us? One is to look at fundamentals, in both occupier and capital markets. Another is to examine how other markets are implicitly pricing real estate.

Irrefutably, occupier markets throughout Western Europe are in recovery. While the timing and extent varies, taken as a whole the European property cycle is about half way between trough and peak. Vacancy rates are continuing to decline in most markets, partly on the back of growing demand but also as a result of a surprisingly lethargic pick-up in supply. Unlike capital markets, occupier markets are generally quite slow moving. Supply and demand both take time to react to changing conditions; and prices take time to react to changes in supply and demand.

The credit crunch will undoubtedly affect both demand and supply. There will be fairly rapid knock-on effects on office demand from the declines in financial sector employment that are widely predicted over the next few months. Chart 2 shows the percentage of total office-using employment that is accounted for by the financial and business service sector in major European capitals. Clearly on this measure London – and the City in particular – is likely to take a bigger hit than other locations.

Chart 2: Financial and business service employment



Source: Experian, Bundesamt für Arbeit

Even so, the immediate overall effect on employment is likely to be limited. The real danger is that the credit crunch has further knock-on effects on the macroeconomy. This could come about through a number of channels. Confidence measures have taken a measurable hit from the bad news coming out of the financial pages (Chart 3), though so far they remain high in absolute terms. Tightening of credit standards will undoubtedly affect the ability of businesses and consumers to borrow. The US, home of sub-prime default and the world's largest economy, will certainly slow and could move into a period of recession which would impact Europe. All this is rather difficult to quantify up front.

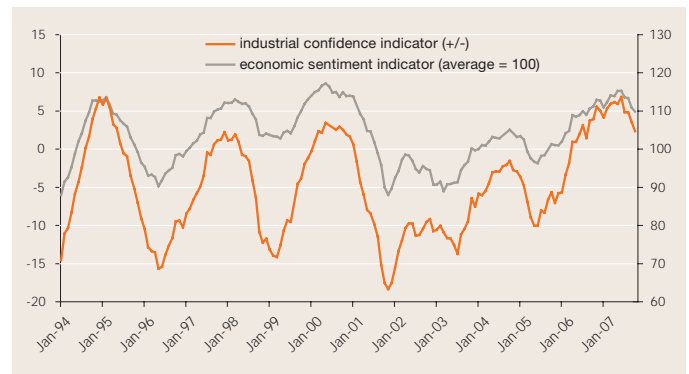
While the effect on demand on rental growth is clearly negative, the effect on supply is equally clearly positive. With risk re-priced, developers and their debt providers will require a higher rate of return which will lead to less new supply coming through.

There is an important point here. In "normal" downturns that are precipitated by an exogenous demand shock, supply rarely adjusts in time or with sufficient vigour to cancel out the negative effect on rents. However, current conditions are unusual in that the shock is internal to the capital markets that price supply. Moreover, unlike in previous cycles it has taken place before the "next wave" of new construction had really gotten underway in more than a few markets; despite recent rental growth and yield compression, new office supply across Europe in 2007 is likely to be at its lowest level for a decade. Unlike in previous contractions therefore, there is a real possibility that the supply response will significantly mitigate the slowdown in demand.

Overall, therefore, we expect occupier markets to slow in response to current market conditions but we do not see a repeat of the huge reversal seen in rental values in previous cycles. At the same time there are risks of a far greater downside impact should the European macroeconomy shift down more than a gear or two.

On the investor markets, there is no doubt that the credit upset has brought to a swift end the downward pressure on yields that has characterised the past few years, and with it the effortless double-digit returns that were available on even core investments. It was clear that certain markets – the UK, Spain, Ireland – had become over-priced; and these are the markets where re-pricing is likely to be most severe in the short term. Moreover the cost of mortgage debt is for the present significantly higher than before the "crunch", and this will inevitably cut back leveraged buyers' ability to pay.

Chart 3: Economic and industrial sentiment indicators

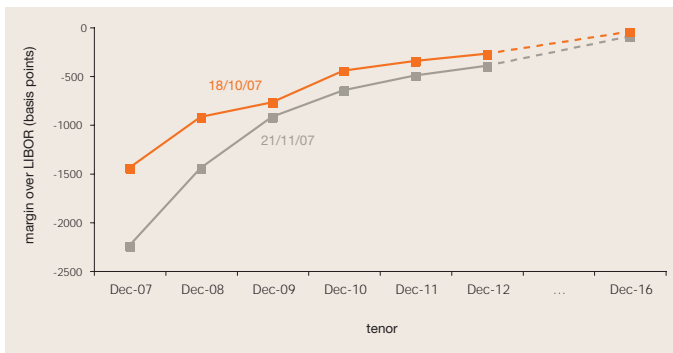


Source: Eurostat

Nonetheless, we believe that the long-run fundamentals of the European investor markets remain sound. Surveys indicate that (i) many institutional investors are still under-weighted in real estate relative to their targets; and (ii) the main driver into the asset class is diversification, rather than returns. Higher borrowing rates will undoubtedly reduce leverage and with it the amount of physical real estate stock required to meet a given allocation target. Nonetheless, we believe that the net demand for real estate will remain positive over the next few years.

On fundamentals, therefore, it is possible to be relatively sanguine though downside risks need to be acknowledged. However, if we look at pricing of real estate in other markets we get a very different picture. Derivatives markets are currently pricing the UK December 2008 swap at LIBOR minus 1450bp (a decline of over 500bp in just five weeks – see chart 4). Thus instead of paying to receive IPD total returns, an investor can be paid around £9 for the privilege of receiving the IPD return on £100 in just over a year's time (the one year sterling swap rate – roughly speaking, the market's current estimate of average LIBOR rates over the next year – is currently around 5%). On one model of swap pricing – not, it must be said, one that the author believes to be correct, but one that the market clearly uses – this implies that IPD returns will be around – 9% next year. Since the yield on the IPD index is around 5%, this in turn implies a 14% decline in capital values. If rental growth were zero next year this would mean a 70bp outward yield shift; in fact rental growth is likely to be positive so the implied yield shift is greater than this, probably in the 75-100bp range.

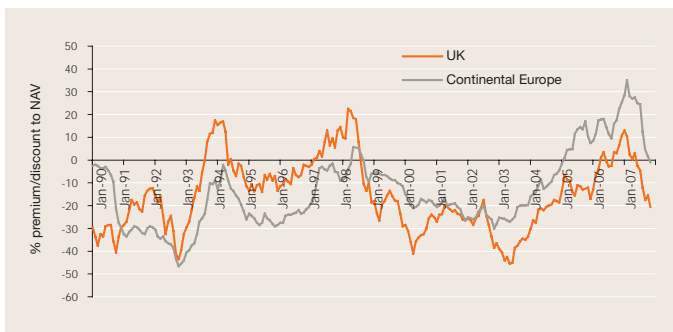
Chart 4: UK IPD swap pricing, October/November 2007



Source: Tullett Prebon

For the UK, this may not seem unreasonable; unfortunately other European real estate swap markets are presently not sufficiently liquid to draw many conclusions. However, every country has a stock market; and it is here that real estate has taken its biggest battering to date. Both UK and continental REIT markets have seen a decline of roughly 35% points in their pricing relative to declared Net Asset Value (NAV) since the start of 2007. This implies a very substantial change in equity market views on value.

Chart 5: REIT premium/discount to NAV in UK and Europe

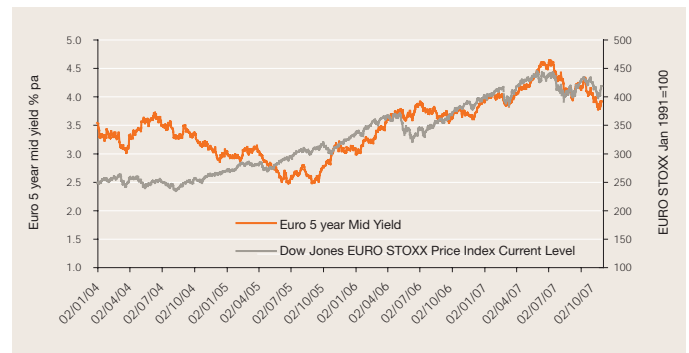


Source: Morgan Stanley Research

Some of the largest UK companies are currently trading at discounts close to 50%. With leverage in the 40-50% range (loan to value), this implies that the markets believe the companies' gross assets are overstated by between 25 and 30%. This implies an outward yield shift of 200bp or more – far more than either the direct or the derivatives markets are allowing. In continental Europe NAV discounts are less dramatic but the change in relative perception of prospective performance is of a similar magnitude.

Of course, this might turn out to be correct. Equally however it is easy to believe that the markets have overshot. Unlike direct property and (for the most part) property derivatives, property shares are not generally speaking traded by people who think about property from a bottom-up perspective. Property is currently the whipping boy of the equity markets, just as mining stocks were in 2006. So long as we believe that the downturn will be less severe than current pricing implies and that pricing and NAV have not lost sight of each other, there seems to be a buying opportunity in public markets at present.

Chart 6: Equity and bond pricing



Source: JPMorgan Asset Management

If direct, equity and derivative markets disagree on the extent of re-pricing, is there anywhere else we can look? We finish by examining a set of prices that, at first sight, might seem to have little relevance for real estate. Chart 6 shows equity prices and government bond yields over recent years. Bearing in mind that a rise in bond yields implies a fall in capital values, what this shows is equity and bond prices moving in precisely opposite directions since the "crunch" took hold. In other words, there has been no re-pricing of risky assets as a whole; rather, there has been a re-pricing of relative risk, with riskier assets falling and less risky assets rising in price. Put another way, capital has not moved wholesale into cash; it is merely shifting along the risk curve.

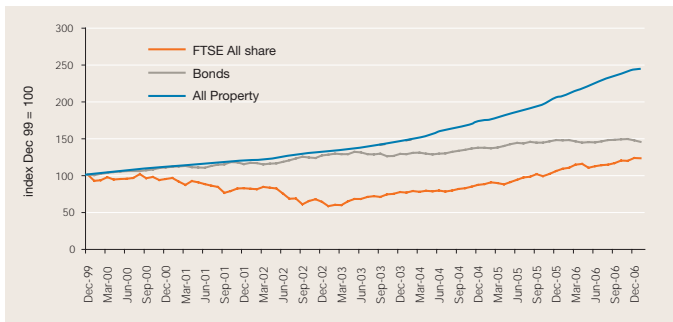
Individual real estate deals can occupy almost any position on the risk curve, but in aggregate real estate is commonly held to lie somewhere between bonds and equities. It is thus likely that, again in aggregate, the net effect of the movements in capital generated by the wake-up call delivered by the US Sub-prime mortgage market will be to leave its pricing more or less unchanged. It's true that real estate is often levered and will thus face higher debt costs for at least the short-term; and it's also true that it is dependent (as are many other assets) on the currently rather fragile prospects facing the macroeconomy. For these reasons it cannot escape the repercussions of the "credit crunch" entirely; and the depth and longevity of the resulting fall in prices will depend on just how debt pricing and economic growth play out over the next few quarters. Yet as a low-to-medium risk asset, there is little reason to think that in the long term it will fare any worse than other risky assets in the price realignment that is currently in progress. In the meantime the current pessimism of indirect markets – and in particular the REIT market – could mean buying opportunities for those who have a little more confidence in the asset class going forward.

Focus on: The United Kingdom

This summer saw the arrival of the phrase "credit crunch" into the financial markets' lexicon as a convenient euphemism for turmoil in the debt markets, caused by a systematic downward re-valuation of US sub-prime mortgage debt. As the phrase itself implies, the primary impact of the credit crunch has been on access to debt. Lenders – struggling to quantify their total exposure to sub-prime and associated losses – have become much more cautious, demanding a higher risk premium to lend against assets or simply refusing to extend their loan books in 2007. As most real estate investors use leverage as part of their strategy, potential returns are sensitive to the price of debt and it was soon clear that the real estate investment market would not be unaffected. However it is in the UK that the impact seems to have been most clearly evident. In this article we examine why the UK commercial real estate market has attracted such negative sentiment and what the prospects are for the future.

At the end of January 2007, real estate was the best performing major asset class in the UK, delivering higher total returns than bonds and equities over one, three, five and ten year periods. Out-performance over the last three full years (2004-06) has been particularly strong with total returns of 17.4%, 19.1% and 18.5% respectively. Much of this out-performance was delivered by capital appreciation through sharp yield compression.

Chart 1: UK Total Returns by asset class: 2000-2006



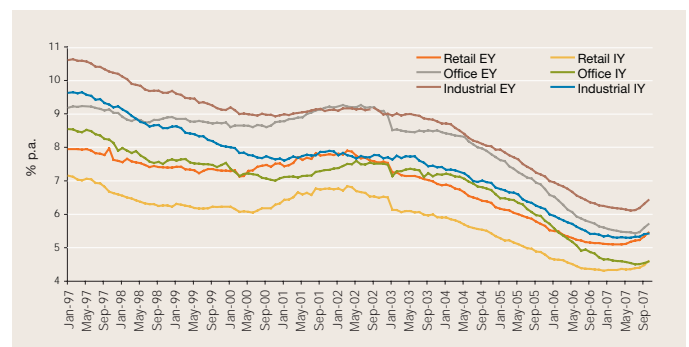
Source: IPD, JPMorgan Asset Management

At the outset of 2007 market expectation was that whilst returns would not match the levels of the previous three, UK real estate would still deliver healthy returns: the Investment Property Forum consensus forecast¹ for All Property total return 2007 made in January was 9.0%. Although capital appreciation was expected to slow as yields bottomed out, an improvement in occupational markets – particularly rental growth – would protect yields from moving out substantially. There was a broad – though not universal – expectation of a "soft-landing."

After the first six months of the year, this looked to be an accurate forecast: total returns year to date in June 2007 were 4.33%.

Although yield compression had manifestly slowed, in markets with the strongest rental growth prospects – particularly Central London – investors were prepared to drive yields lower: West End London office prime yields were 3.75% at the end of June 2007. Perhaps the strongest sign of bullishness in the market was the inward movement of prime warehouse yields at Heathrow to 4% from 4.75% at the beginning of the year. Rental growth was strong with All Property annual rental growth according to the IPD monthly index in June at 3.85%, the strongest annual growth since August 2001. However since June, the IPD monthly index has delivered a return of - 2.38% with capital growth of - 4.07%, producing a year to date total return of 1.85%. Negative capital growth reflects an outward movement in yields or, to put it another way, a fall in pricing in all sectors.

Chart 2: IPD Sector Initial and Equivalent Yields



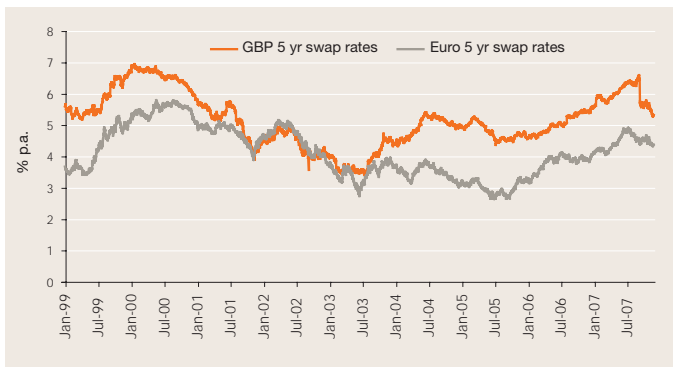
Source: IPD; JPMorgan Asset Management

What is striking about this re-pricing of UK real estate is that it has occurred in the absence – so far at least – of transactional evidence. The turmoil in credit markets over the summer resulted in some large deals failing to complete or being withdrawn from the market. The most notable of these was British Land pulling the sale of a 75% stake in its Meadowhall Shopping Centre, then valued at £1.7bn. In September, the investment market simply stalled: debt backed buyers were unable to source funding for transactions and buyers with sufficient equity were cautious, not wanting to pay now for buildings they could secure more cheaply a couple of months hence. Sellers on the other hand were unwilling to sell beneath book value.

The absence of an active market combined with expectation of a pricing correction presented difficulty for valuers: to what extent should negative sentiment affect valuation? As the above IPD figures demonstrate, the book valuation of property has been written down by valuers over the past three months but this has been uneven. It is widely accepted that values have further to fall into 2008. Whilst the credit market dislocation was the catalyst for the adjustment in pricing in UK property, what is it about the UK market that has caused a larger adjustment in valuations in 2007 than any other European market?

¹The IPF Consensus Forecast is the mean of individual forecasts made by over 30 UK brokers and fund managers providing a reasonable indication of expected market total returns.

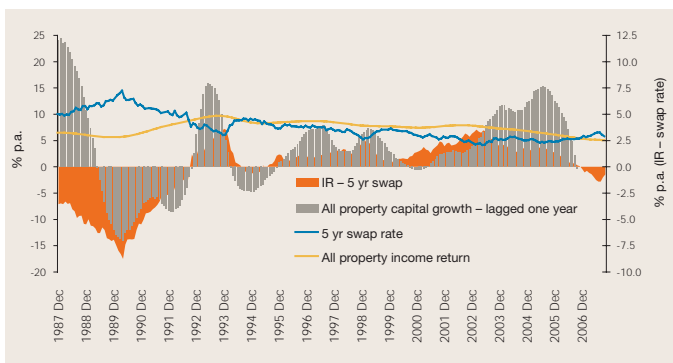
Chart 3: GBP & Euro 5 yr swaps 1999-2007



Source: Bloomberg

JPMorgan Asset Management has been strongly underweight to the UK direct property market over the past two years. This strategic decision was based on the cost of debt and on pricing. Since mid-2003, GBP 5 year swaps have been significantly in excess of Euro 5 year swaps. The higher cost of debt effectively represents a higher risk free rate in the UK; in other words investors in UK real estate required higher returns to compensate them for the higher cost of debt. The impact of this monetary tightening has been exacerbated by the recent turmoil in financial markets which have systematically re-priced credit risk.

Chart 4: Income return, swap rates and capital growth



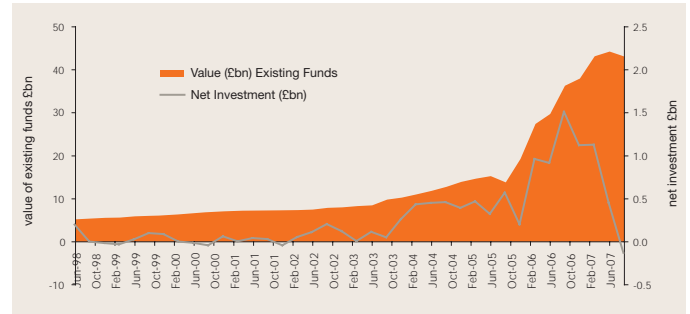
Source: IPD, Bloomberg, JPMorgan Asset Management

Over the past year the cost of debt has exceeded the income return on the IPD All Property monthly index. This was not sustainable: as chart 4 shows, once income return falls beneath the cost of debt, capital growth will respond in a negative direction. In this case, it has taken a year for capital growth to turn negative, but the pattern is clear: values had been driven too high and an adjustment was all but inevitable.

This of course provokes the question why values had been driven too high. Although there has clearly been a structural shift in investors' attitude to and valuation of real estate since the beginning of the decade, recently the "wall of money" coming into UK real estate has been instrumental in driving the market.

As chart 5 indicates, over the last 24 months there has been a huge surge of money into UK real estate funds, chasing the kind of returns seen 2004-2005. Increasing amounts of capital chasing limited amounts of available stock has helped drive prices up and narrow the pricing gap between prime and secondary property.

Chart 5: AREF Quarterly Statistics 1998-2007 Q3



Source: Association of Real Estate Funds

A cyclical improvement in UK occupier markets – most obviously shown in office – has stimulated healthy rental growth over the last 18 months. Exuberance regarding rental growth prospects undoubtedly increased the upward pressure on pricing in the first half of 2007.

It is clear that UK real estate going through a necessary period of re-pricing. Does this mean that a sensible real estate investor should avoid the UK for at least the next twelve months? We would argue the answer to that is "no": indeed the UK should begin to present opportunities over the next 12 months.

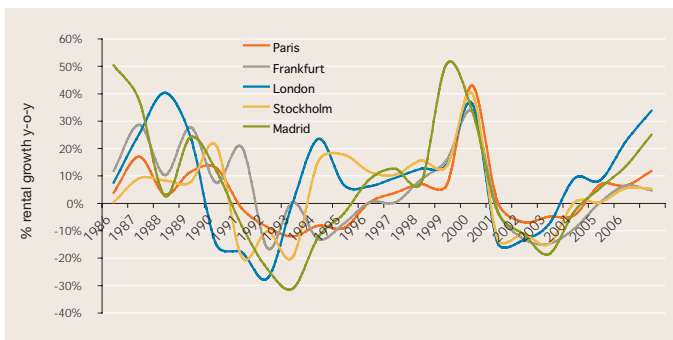
Firstly the cost of debt is heading down: policy rates were cut by 25bps at the start of December and the market expects a further 50bps in the first half of 2008. This brings the cost of debt much closer to that on the continent and improves the relative value of the UK. Secondly pricing will continue to adjust. As the AREF figures show, the third quarter of 2007 saw negative net investment in UK property funds. Redemptions – particularly in retail funds where investors have shorter time horizons and perhaps inflated return expectations – have grown significantly and will continue to grow. We have already seen a strong sell-off in UK real estate securities by funds who invested in these for liquidity purposes. It is now likely there will be some forced selling as funds struggle to meet redemption requirements. Thirdly although we are entering into a more unstable economic environment with uncertainty around the impact of a US slowdown on the global economy the UK occupational market is still in reasonably good shape. The UK is a mature and liquid market with one of the most attractive lease structures for landlords in Europe. Over the next 12 months, as pricing adjusts to more realistic levels, we believe that the UK could become a lot more interesting to pan-European investors.

Market Monitor: Europe decouples

The early 1990s real estate downturn in Europe hit many hard but had one redeeming feature, at least for those boasting a diversified portfolio: it was highly desynchronised. The UK had tipped into a downturn by 1990 while Germany – insulated from other markets and boosted by the afterglow of reunification did not come off the boil until the mid-1990s, and office rents were still falling in 1995 (chart 1). Other markets lined up in between these two. As a result of this, pan-European returns barely ventured into negative territory, despite the severity of the downturn in individual markets.

The early 2000s have been very different. The post-9/11 downturn was a global macroeconomic shock that hit every country in Europe simultaneously and to a more or less equal degree. More recently, pretty much every market has benefitted from the yield compression – again the result of a global trend. This has pushed up returns across the continent and tended to swamp the rather less well co-ordinated occupier market developments. As a result real estate cycles in the last few years have fallen much more closely in line with each other.

Chart 1: Prime office rental growth in selected markets



Source: DTZ Research, JPMorgan Asset Management

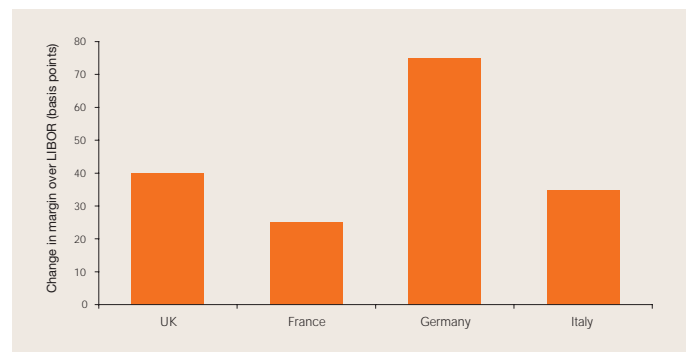
The greater freedom of movement between capital and, to a lesser extent, occupier markets mean that to an extent this is inevitable. Yet there are good reasons to think that European markets will not be quite so well synchronised over the next two or three years.

Firstly, the end of yield compression means that occupier market cycles will come to the fore; and these are by no means synchronised. London, Paris and Madrid have probably seen 75% or more of the rental growth that can be expected in the current cycle, while growth has only recently picked up in Frankfurt or Stockholm. In part this echoes differences in macroeconomic performance; but it is also a muted echo of the pattern of the early 1990s, with the supply cycle still running late in German markets.

Secondly, the "credit crunch" is clearly affecting markets to different degrees. As already discussed in our lead article, some markets – the UK, Spain, Ireland – had become clearly over-priced and the re-assessment of risk appetite has resulted in significant outward yield shift. We believe that Central and Eastern Europe could suffer a similar fate, though these markets have not shown any reaction as yet. This is far less true of many of the core European markets where declining yields can at least in part be explained by a structural change in the risk premium due to increased liquidity and transparency, as opposed to mere exuberance.

In addition, debt margins have reacted with little uniformity across Europe so far; French margins have merely crept up while those in Germany have leapt (chart 2) – a reflection, possibly, of the relative profligacy of those countries' banks prior to the "crunch", as well as their exposure to US sub-prime debt. It is not clear yet whether these differences will be sustained.

Chart 2: Estimated change in lending margins since summer



Source: JPMorgan Asset Management

The implications of this are twofold. Firstly, investors will do well to be far more discriminating in their tactical portfolio choices over the next couple of years. While it was possible to make money in every market until recently so long as the right assets were bought, choosing the wrong markets now could be far more damaging. Insofar as it is possible to predict cycles at all, good top-down research will become increasingly important.

Secondly, and to the extent that such foresight is not possible, diversification will once again become critical, just as it was in the early 1990s. The benefits of a well-balanced and tactically astute portfolio will become increasingly clear as the slowdown bites. And while a repeat of the early 1990s is in our view highly unlikely, the strategies that would have protected investors through the major storms that took place then will be equally valid in navigating the squalls that could lie ahead.

European snapshot

Standard office lease terms

Country	Term length years	Break rights	Transfer tax (approx)	Other notes	Invested stock € billion
UK	10-15	Rare	4.0%	5-yr upward-only review; tenant right to renew	797
Germany	10	Every 5 years	3.5%	Annual indexation	601
France	9	Every 3 years	4.8%	Annual or 3-yr indexation; tenant right to renew	296
Italy	12	Every 6 years	4%	Annual indexation (75% of index)	187
Netherlands	5-10	No	6%	Annual indexation	131
Switzerland	5-10	No	3%	Annual indexation; renewable for a further 5 years	99
Spain	3-5	No	3%	Annual indexation	83
Sweden	3-5	No	3%	Annual indexation; tenant right to renew	80
Portugal	5	No	6.5%	Annual indexation	61
Austria	5-10	No	4.5%	Annual indexation	60
Belgium	12	Every 3 years	12.5%	Annual indexation	59

Major cities – market size

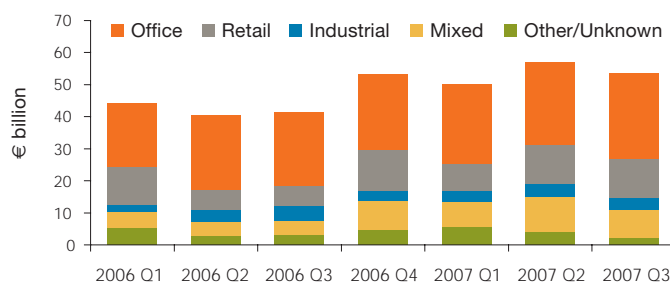
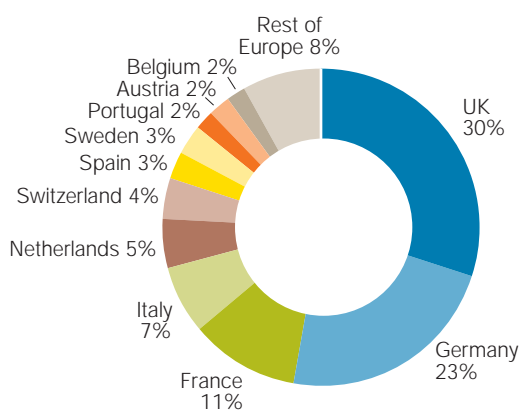
Yields

Rents

Country	City	Market size € billion	% of country	Prime initial yield % pa		Prime rental level €/m ² /year			
				office	retail	office	2008	retail	2008
UK	London	275	34.6	4.25	4.00	1698	↔	8180	↔
	Birmingham	56	7.0	5.00	4.25	502	↑	5016	↔
	Manchester	47	5.9	5.25	4.30	440	↔	4708	↔
Germany	Frankfurt	102	17.0	4.46	4.46	438	↑	2616	↔
	Munich	68	11.2	3.70	3.70	384	↔	3060	↔
	Hamburg	52	8.7	4.50	4.00	276	↔	2340	↔
	Berlin	53	8.9	4.25	4.00	276	↔	2160	↔
France	Paris	201	68.0	3.75	4.00	780	↑	7350	↔
	Lyon	7	2.5	5.50	6.75	230	↔	1820	↔
Italy	Rome	42	22.5	5.30	5.10	400	↔	2200	↔
	Milan	42	22.7	5.15	5.00	500	↔	2400	↔
Netherlands	Amsterdam	19	14.8	5.25	4.85	330	↔	2000	↔
Switzerland	Zurich	32	32.7	4.70	4.50	542	↔	2436	↑
Spain	Madrid	27	32.7	4.25	5.00	430	↑	1800	↔
	Barcelona	11	14.0	4.25	5.00	330	↔	1750	↔
Sweden	Stockholm	51	63.6	4.60	4.25	467	↑	1448	↔
Portugal	Lisbon	30	48.9	6.50	6.50	252	↔	840	↔
Austria	Vienna	30	50.7	5.30	4.50	264	↔	2640	↔
Belgium	Brussels	30	50.0	5.50	4.80	290	↔	1350	↔

Invested stock as % of Europe

Net real estate Capital flows € bn



Sources: DTZ Research, IPD, JPMorgan Asset Management estimates and calculations

