

Global Real Estate Research

Global strategy update – An emerging opportunity set?

By Russell Chaplin



Real assets, real expertise

Global strategy update – 1H09

Just as 2004 through 2007/8 were extraordinarily good years for real estate, much of the last 18 months have been extraordinarily uncertain. For some markets, the unwind of previous gains has been exceptionally sharp, while in other markets and despite the linkages, it was hard to identify that the commercial real estate markets were tied-in to the wider financial markets and prospects for the economy. 4Q08, however, saw values across all regions reacting to the global economic downturn brought about by the financial market crisis and consequent deleveraging and uncertainty. This has continued into 1H09.

Some real estate markets appear to be further through the cycle of capital value declines than others. However, there is also a great deal of uncertainty related to valuations currently and a range of ways in which valuers (appraisers) deal with the current lack of transaction evidence.

Here we argue that there needs to be a degree of capitulation before the real estate markets free up and transactions become more widespread. That point appears to be closer in some markets and for some styles of investment than in others, and this is creating an emerging opportunity set.

Mismatch between buyers' and sellers' expectations generating illiquidity

There are two main sources of illiquidity (the speed at which you can turn an asset into cash and vice versa) in real estate; the necessary trading and time costs of dealing directly in real estate and the gap between buyers' and sellers' expectations of price.

Trading only takes place when buyers and sellers agree on a price. In a falling market, sellers – typically anchored to previous valuations – are inclined to expect a price for an asset which is higher than that which a buyer might offer. When markets are falling rapidly, this spread can be considerable and generate or exacerbate illiquidity in the market. When the spread is large, a transaction is unlikely to take place whereas when the spread falls, negotiation takes place which ultimately results in a trade somewhere between the buyer's and seller's first estimate of price.

One way in which illiquidity can be lessened, or liquidity enhanced, is for valuers to keep values moving down quickly enough that they reflect underlying prices, keeping the spread between a seller's and a buyer's estimate of price small enough that negotiation may begin. *Time for sale* studies have argued that the higher the initial spread, the longer a property remains on the market and ultimately the lower the price achieved by the seller. This suggests that for markets which have moved quickly

to close the gap between buyers' and sellers' expectations there may be a quicker turnaround than in other markets. However, over the past few years, buyers in the real estate markets have been used to operating using debt to enhance returns. The global financial crisis has seen the availability of debt for commercial real estate fall markedly. Loan to value ratios have decreased and margins have increased. Riskier properties, for which debt would have been readily available two years ago, are suffering in particular as are larger lot sizes.

This lack of availability and price of debt appears to be exacerbating market illiquidity.

Valuation uncertainty leading to private real estate index smoothing

In the late 1980s, a debate started in the US regarding the ability of valuation (appraisal)-based indices to reflect quickly and accurately transaction prices. It has been argued that, even when valuers are acting optimally, there is a tendency for valuation-based indices to smooth and lag underlying transaction prices. This tendency arises from the uncertainty surrounding valuations and is not constant across geography, property types or time.

The level of smoothing depends upon two factors: the uncertainties related to actual price-based market movement and transaction information. In essence, when markets are rising or falling rapidly, the smoothing tendency increases. This is perhaps more true for downturns in the market where the market movement may be large but there are limited transactions (in the investment market or occupier market) upon which to base a valuation; in upturns the volume of transactions is typically high, and valuers have better comparable information to hand with which to keep pace with prices.

Behavioral economists, who have studied valuer behavior, have argued that valuers also tend to look back further in time for comparable evidence during a downturn, because of the very lack of contemporaneous information, and again this increases the smoothing tendency. In this way, values tend to suffer from inertia when the optimal strategy would be to use the latest transaction as evidence. Given that we are in a downturn in values and prices what do these observations mean for investors?

- First, investors might wish to be wary of comparing evidence from indices across the globe since valuers appear to approach valuing with a lack of transaction evidence in a variety of ways. This may give rise to the observation that some markets are delivering superior performance to others but this performance may be illusory, especially if owners become forced sellers and transaction prices must be observed.

- Second, investors may not wish to use valuation-based indices as indicators of market turning points. As a purchaser, it may be possible to buy at a level which makes forward-looking returns attractive before the bottom of the market is shown by valuation-based indices. Investors may wish to adjust expectations based upon valuation-based indices to reflect the discount which they believe they can achieve in the market.

There are few markets globally where a robust transaction-based index can be compared to a valuation-based index. Nonetheless, an example from the US highlights the likelihood of valuation-based index smoothing during a period of great uncertainty: the peak in pricing, as indicated by the MIT Transactions Based Index (TBI), was 2Q07 and by end 4Q08 the index had fallen by 21%, whereas the NCREIF NPI valuation-based index peaked a year later and by end 4Q08 had fallen in value by around half of the level indicated by the TBI.

How far might the commercial real estate markets fall in value?

Our central estimate suggests that from peak to trough the global commercial real estate market may fall in value (prices may fall further) by around 35% with some countries, sectors and styles of investment better off, or worse affected, than others. A fall in value to such an extent would be consistent with the yield on global real estate rising to over 8% and income falling by around 10%. How far are we through that cycle? By the end of 1H09, we estimate that on average across the globe, we may be around 60% of the way through the total potential write-down in values in the commercial real estate sector. By end 2009, we may be as far as 80-85% through the total potential write-off in values. There continues to be a downside risk to these forecasts, but we also believe that there are upside risks embedded in these figures.

Some markets appear to be further through the downturn than others and some appear, only recently, to be starting a downturn in values. This may be rapid and sharp given the overlap between the investment market re-pricing and

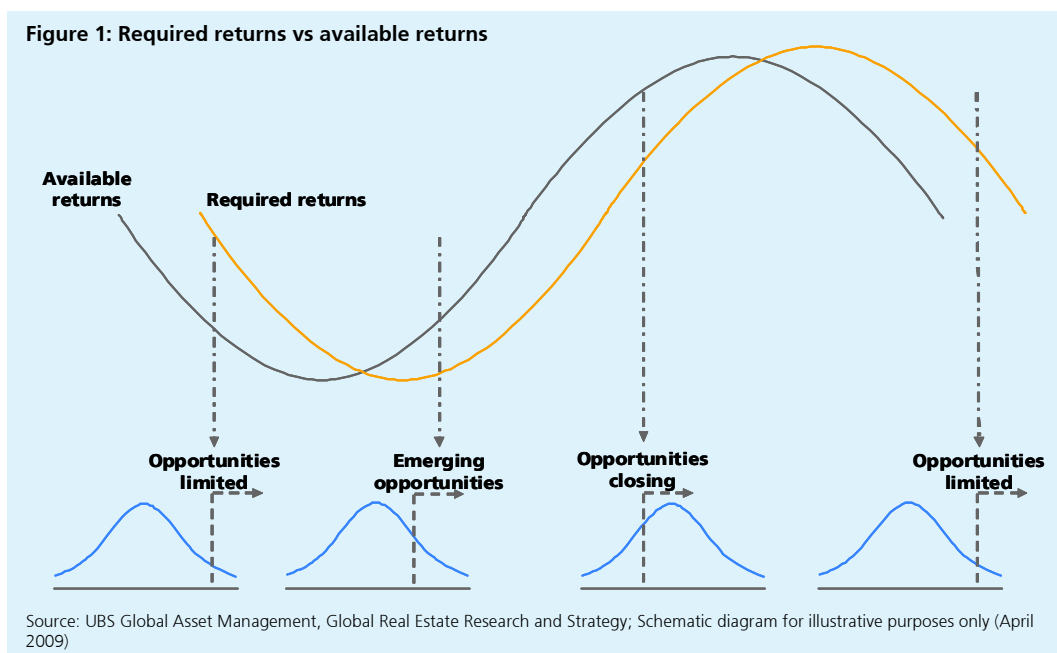
the occupier market cycle. For those markets furthest through the cycle, there is the possibility that, in terms of prices, some assets are beginning to offer the prospective level of returns that they need to given their risk profile. *Figure 1* demonstrates that as available returns begin to exceed required returns opportunities begin to emerge.

However, investors remain risk averse and appear to be demanding a risk premium in excess of that which might be needed in the long term. In this way, both values and prices need to fall further still in order to establish a market price. This is the typical process of overshooting fair value, and it is the following periods that therefore offer excess risk-adjusted returns.

Towards capitulation?

For the real estate market to free up, a number of criteria appear to need to be satisfied:

1. The spread between buyers' and sellers' expectations needs to decrease to a point at which negotiations can start
2. Investors need to understand that debt markets are not likely to re-establish themselves to the highpoint of 2007 at any time soon
3. Buyers need to accept that the vast majority of the downturn is behind them
4. The returns that should be available in the market need to materialize in practice
5. Early, apparently risk-seeking, opportunity-driven buyers need to have been seen to be proven right



An emerging opportunity set?

As we discussed in our 2H08 *Global strategy update – Waiting for consensus?*, investors who wait for such a consensus to form, may miss the opportunity set which offers the highest risk-adjusted returns.

On the basis of these five items, we believe that there is evidence that some opportunities are materializing in some markets and for some types of assets / fund styles. There appears to be some evidence that (at least in the UK which was at the beginning of the downturn in capital values):

- Prices in the auction market for very small lot sizes and open-market prices for prime long-leased stock, let to robust tenants appears to leveling off;
- Buyers are beginning to believe that the vast majority of the downturn is behind them (IPD has recorded a decline in values in the UK of 41% to end March 2009); and that
- The returns that should be available, given the risk, are becoming available in the market.

In other markets across the globe, it is more difficult to identify as much evidence that we are moving towards a point where the real estate markets may free up. In some markets, there still appears to be a general lack of adjustment to where prices might lie, though the pressure in the market, precipitated by, amongst other things, distress due to LTV breaches, is getting to the stage where evidence of prices is likely to increase. This evidence should help values adjust to more realistic levels.

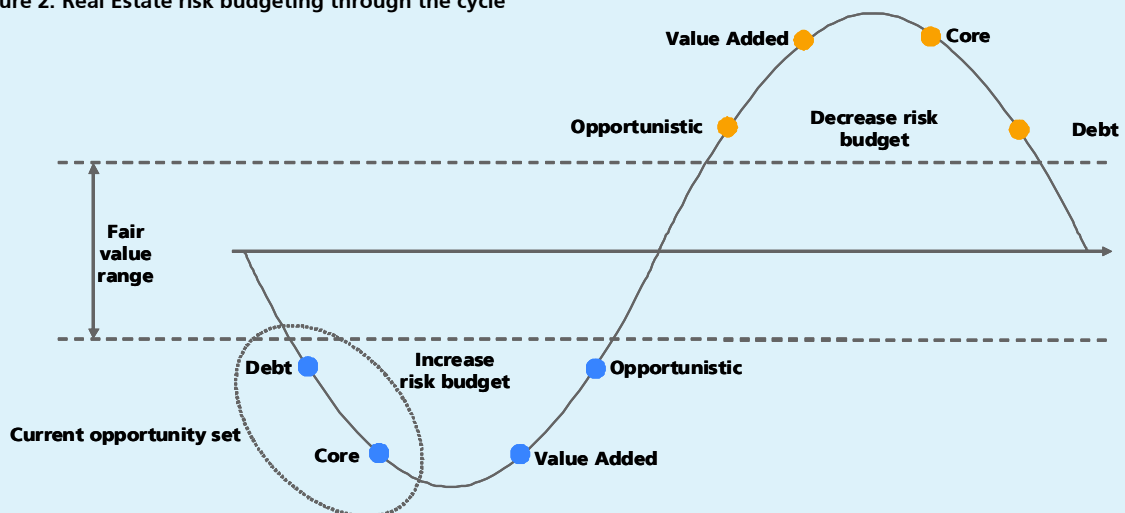
An emerging opportunity set

The last 18 months have been uncertain. For a strategist, uncertainty means that it is appropriate to adopt a scenario-planning approach, as presented in our 1H08 strategy paper *Two schools of thought*. This identified the scenario that significant falls in value were to come. Looking forward, the real estate market cycle that is currently in progress now looks more like a *normal* real estate cycle though we need to accept that the general macroeconomic and financial environment remains unusual. The upcoming cycle looks more normal in the sense that we are experiencing a downturn in demand, leading to an imbalance between demand and supply and hence rental declines. Whilst it would be prudent to continue to run scenarios, we do believe that there is an emerging opportunity set for real estate investment.

As prices adjust through fair value and go on to overshoot, risk-adjusted opportunities emerge. *Figure 2* suggests that there appears to be an emerging opportunity set in debt and core private equity for those willing to increase their risk budget in the face of continuing value falls.

As we move through the cycle, more opportunities in value-added and opportunistic styles should emerge. It is worth noting that we believe that the window for the opportunistic style of investing is relatively short, consistent with high returns over a short period of time. Investors need to remain opportunity-driven at this stage in the cycle with an eye on their strategy to ensure that during an emerging phase of opportunities they do not simply acquire a bundle of specific risks.

Figure 2: Real Estate risk budgeting through the cycle



Source: UBS Global Asset Management, Global Real Estate Research and Strategy; Schematic diagram for illustrative purposes only (April 2009)

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