EUROPEAN PROPERTY UPDATE: III

Thaw?

For the second quarter in a row, European investment volumes have posted an increase. Nearly €14bn of property has been transacted over the 2nd quarter of 2009, which is an impressive 30% increase from the previous quarter. More good news: two €1bn deals were closed (first time this year), one in the UK and one in Spain. This is especially encouraging, for two reasons. The first is that the banks have started lending on large deals again. The second is Spain: investors have re-entered one of the most savagely tattered markets in Europe.

Is the European market recovering at last?

The Banks

Before rushing into conclusions, let's consider the following. Although these transactions are encouraging news, one cannot escape the fact that investment volume is still 55% lower than the average quarterly volume of the last 10 years. The main reason seems to be the unwillingness of the banks to finance new investments. Banks are not selling their 'Non Performing Loans'. Instead, they are busy refinancing existing loans and trying to contain the damage caused by their bad loans. Banks are very skilled at making money out of such situations: higher spreads, higher penalties in case of breach of the new loan-to-value covenants and of course, charging fees for carrying out the exercise. It seems that this 'recycling' of loans generates a fair amount of profit so the banks don't get too anxious to fund new investments in these difficult times. Banks would advance fresh loans only for the safest propositions (in the case of Spain: sale and leaseback of 950 branches of BBVA, the second largest bank in the country).

The rollover of debt has acquired the nickname 'Extend and Pretend'. Extending loans for 2-5 years in the hope that things will improve. The cost of capital that banks face today is substantially lower than during the previous crisis so they can afford that. Furthermore, their balance sheets are quite frail and their capital adequacy is being questioned (European banking regulators may have one or two things to learn from their Turkish counterparts here). Writing off bad loans would create further stress. While some assets can be worked out, many can not so further losses are expected. All in all: the taps of finance are by no means open and this is unlikely to happen any time soon.

The Economy

Following the summer recess, everyone has been longing for good news in the economic front – stabilisation and recovery. The global economy has stabilised somewhat but this is no harbinger for recovery. Being in a coma is a stable condition but no one knows the timing and strength of a recovery. The fragility of recovery is demonstrated by the UK. While positive GDP growth was expected this quarter, a further contraction was announced. This was the sixth consecutive quarter, marking the longest recession since records began. The rest of Europe is not in a much better shape. The Ukrainian economy is expected to contract by 14% this year while Turkey, Russia and Romania will contract by around 7%.

Excess Liquidity

Analysts have been recently warning about a 'too much, too soon' rise in stock markets (case in point: the Istanbul Stock Exchange is 100% up since the beginning of the year). The liquidity that has accumulated, they say, has given rise to a '*bear market rally*'. Could the same thing be happening in the property market?

To a certain extent, yes. In the European market today there is abundant capital scrambling for the same thing: secure income. This is why most of the transactions take place in the UK and Germany, while France, where leases contain breaks every 3 years, is low on the Agenda (by the way this is one of the reasons where foreign capital doesn't even get close to Ataturk Havalimani). Sovereign Wealth Funds from Asia, High Net Worth individuals from the Middle East, institutional investors – they are congregating in that very small corner of long leases to credit worthy tenants in transparent and mature markets.

Bir kanatla kuş uçmaz

In the UK, the property market crisis in 1990-91 was followed by a short-lived recovery in 1993 which only lasted for 1 year. This serves as a stark reminder that recovery can be fraught with one or more false starts. The fundamentals today are considerably worse, while banks will have to battle with non-performing loans for some time to come –which will keep the lid on property lending. The risk premium on emerging markets is likely to be kept at high levels, so the implication for Eastern Europe (including Turkey) is that foreign investors won't be back for some time. These markets will be running on local capital focussing mainly on smaller transactions.

Turkey is probably in a class of its own, as banks have been very prudent and little distress is expected (the hotel / resort sector being a possible exception). Sellers' expectations won't come down by much, a far cry from, say, Ukraine and Russia where yields are now in the mid-teens. This could mean that foreign capital may take longer to return as pricing has not moved in line with the rest of Europe.

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