THE END OF THE 'WORLD'?

Çabuk parlayan, çabuk söner..perhaps nothing can describe the Dubai property market better. Development had got so much out of control that by some accounts, it would take five to seven times the existing population to absorb all the space that had been developed. Eventually, 'Dubai World' which was developing the 'dream' through its subsidiaries Nakheel and Emaar has requested a standstill on its interest payments. Capital markets around the world are reliving the nightmare, reminding everyone that the worst is perhaps not over yet.

The Second Wave

The first wave of the current financial crisis originated in the subprime residential market in the US, which then spread to the corporate credit markets. There are increasing concerns that a second wave is forming - this time in the *sovereign* and *commercial property* lending markets.

The huge public sector imbalances are already hammering the credit rating of a number of nations. In Europe, the biggest culprits, known as PIGS (Portugal, Ireland, Greece and Spain) have already seen the credit rating on their debt slashed. Credit rating agencies such as Fitch have issued warnings that more downgrades are on the cards – and these will not necessary be restricted to peripheral economies in the EU: even the US and the UK are at risk.

Subprime in Commercial Property?

It has been said that if the economy of a country is a motorway, then the property market is a reckless truck driver with a drinking problem, ready to spread havoc. The 'drink' in this instance is of course, credit. The 'stronger' it is (i.e. cheap, plentiful and on loose underwriting criteria) the greater the damage it inflicts. One could of course argue that there is another such driver – the private equity industry-but that's another story...

Over the last few weeks we've seen warning signs appearing more visibly. Towards the end of November, Dominique Strauss-Kahn (chairman of the IMF) was warned that only *half* of the total losses in the global banking system have seen the light of day so far. Many banks, he added, will prove to be undercapitalised. The credit rating agency Fitch (which a few days ago downgraded Greece, sparking massive sell-off of equities and emerging country debt) having already downgraded €47 billion of CMBS in 2009, cautioned that up to €66 billion of commercial property loans in Europe maturing between now and 2014 would need to be refinanced at much more stringent conditions. A few days before that, Moody's had issued its own warning to this effect.

A double whammy on the property market

The commercial property market will suffer multiple blows. In the case sovereign debt: as the most credit-worthy borrower in a country is by definition the state, a sovereign downgrade will automatically drag along the banking sector. The cost of capital for a bank in Spain, Greece etc will now be more expensive. This translates to *less* and *more expensive* borrowing available for (among others) property – implying lower values. The killer blow is delivered by none other, the anaemic economy. The lack of fiscal flexibility rules out the ability to boost the economy through fiscal measures. The result: the occupiers market is drawn further into a vicious circle, rents face downward pressure and the property market recovery moves further away. Investment strategies for property are already ‘underweight’ in Southern and Eastern Europe (Turkey being an exception as it’s less affected by all these).

Reaction from all those involved

The banking sector continues (on a global basis) to *‘extend and pretend’.* Expectations so far have been for a relatively quick recovery and that banks would be able to repair their balance sheets soon, to build buffers for any losses they would have to take on bad loans. But since recovery doesn’t seem around the corner, some banks - especially those living off government support – have started resorting to workouts. Since ‘*Lafla peynir gemisi yürümez’*, they are stepping into the management of properties they have lended against, in order to fix the (numerous) non-market related factors that contribute to the under-performance, such as inexperienced or uninterested borrowers, bad management, ill-prepared business plans etc. They do this through partnerships with external consultants and asset managers, in many cases even replacing the borrower with someone more experienced and better capitalized.

Meanwhile, reports keep coming in on increased transaction volumes and decreasing yields for prime properties. Some commentators (e.g. CWHB) are even talking about tough negotiations and uncompromising sellers..the very prime end of the European market is increasingly busy but this enthusiasm doesn’t seem to be spreading to the rest of the market.

The end of ‘Dubai World’ is clearly not the end of the whole world. It does however serve as a stark reminded that the storm is not over yet.

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