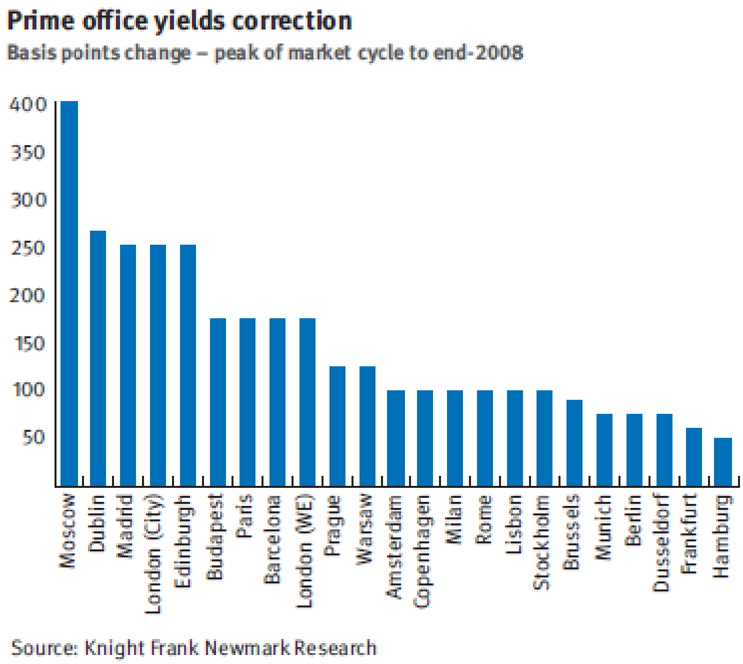
EUROPEAN PROPERTY UPDATE

Property is known to lag the economy – in that a change in economic activity (positive or negative) will impact the property market with some delay. The economic crisis has been gathering momentum over 2008 and 2009. It is still early to tell whether the global economy has bottomed out but there are some voices of tentative optimism (OECD for example now forecast a *flat* 2010, an improvement on their previous forecast of mild contraction). However, even if the 'green shoots' are real, property markets are yet to experience the worst.

The year 2008 was the year of *yield correction*. Yields have shot up everywhere with a breakneck speed. Emerging markets or markets which were fuelled by debt saw the largest corrections (see graph below). The graph below reports yield movements to Dec-2008. The situation today is broadly similar with some notable exceptions –London is such a case – where transactions indicate an improvement in investment sentiment.



Nonetheless, 2009 will be the year when property markets feel the brunt of the economic havoc: the year of *rental correction.* A slowing economy causes reduced demand for most kinds of property – retail, office, industrial etc. This is manifested as increased vacancy rates and falling rents. Fortunately, over-supply (i.e. excessive new development) is not an issue in this cycle. Still, rents are falling at alarming rates. Even supply-restricted markets (like London's West End) have witnessed rents falling by 30-40%. Despite some brave attempts earlier in the year to suggest that the crisis would leave certain markets unaffected, it is now clear that no market can claim immunity. Accounts at a global level (such as RCA Analytics) point to a 67% reduction in transaction volumes.

Unless one subscribes to the Mayan calendar that predicts the end of the world in 2012, the situation will turn, just like summer follows winter. However, the short term outlook for property is convoluted. RCA are reporting that in the EMEA region, there's now USD 50 billion of commercial property loans whose servicing has fallen behind. This is more than 50% up on an annual basis and given the economic circumstances, the situation seems poised to deteriorate further than improve. Contrary to asset tests, which most banks now are forced to ignore, this is a real cash-flow issue. Cash reserves eventually run out. The global economic outlook calls for a very shallow recovery so bluffs will be called fairly quickly. What will happen to those assets? What will happen to bank balance sheets? Surely recovery cannot commence with one cylinder of the engine misfiring. But that's just the tip of the iceberg.

The biggest unknown is the speed and the extend of the so called ***'deleveraging'***. In the heady days of the boom in Europe, Loan-to-Values (the proportion of a property's value that lenders were prepared to advance) went as high as 70-90% (the more 'mature' the market the higher the figure) whereas spreads had reached unsustainably low levels – typically 90-150 basis points. LTV's today are arguably around 45-65% whereas spreads have doubled. The situation might improve slightly but all now agree that the boom years are gone for good. On top of that, lending criteria are now much stricter. There is a very alarming sequitur in all this: what is going to happen to the loans (senior debt, CMBSs etc) that will fall due for refinancing in the next few years? There's hundreds of billions of outstanding loans (the 2006-7 vintages are especially toxic), coming up for refinancing. If the gap in the financial structure is not replenished the market will be facing further write offs. This will be further exacerbated by the higher spreads (let alone increased interest rates), making debt even more expensive and the cost of debt higher. In such a case, the recovery of the property market will be a long and tumultuous affair – to put it mildly.

The current view is that even if the economy turns, deleveraging will have a huge impact on the market. The CMBS market may never return (and if it does it will be in a substantially more conservative mode). Many operators think the market will recover around 2011-2012. Others are talking of a vicious cycle of falling rents, falling values and further defaults in loans which could go on until the system is purged completely – as long as seven years from now.

The consensus is that further trouble is brewing ahead. But as unpleasant it may sound, it is at times such as these that property fortunes are created.

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