

December 2010

# Global Real Estate Outlook 2011



[www.pytheas.net](http://www.pytheas.net)





Uncertainty is the most significant element of the real estate industry in the post-recession environment, as market participants look for a signal that economic and industry fundamentals have hit bottom, and have begun a sustainable recovery. This signal has remained elusive, however, as the current cycle is behaving somewhat atypically, making it challenging for stakeholders to plan and develop forward-looking strategies.

Although sentiment has improved globally with sharp declines showing signs of leveling off, both investors and lenders remain risk averse and investment and lending activity is essentially focused on core property – one thing that is certain, the current downturn is historically significant, and will not go quietly; if past performance is any indication, a decline in real estate prices (of any type) lasting more than four years would be unprecedented. Non-prime property could see further falls in values in the months to come. Lending terms (for well secured assets), which improved at the end of 2009, have not changed much, although lender confidence has improved marginally. In Europe, unemployment continued to increase, albeit at a slower rate, and this will keep tenant demand muted in the short-term. Recent months have seen the pace of rental deterioration slow, although an improvement in labor markets will be needed to support new demand as a condition for any sustainable growth in rental values. Some markets that have suffered steep falls in rental values are now seeing growth once more, such as offices in the City of London and Paris. Commercial property investment activity picked up, with investors more willing to transact, especially at the prime end of the market. There remains a significant amount of debt in global property markets and, estimated at about US\$190 billion of assets which are held by distressed owners. In addition, there is also a considerable amount of CMBS loans, especially in the USA, that are expected to begin maturing in the immediate future. In Europe, the UK, France, Italy and Spain have the highest relative shares of debt and a significant amount of loans will have to be refinanced over the next two years.

Going one step back, one of the main reasons for the unique nature of the downturn is an unanticipated willingness by banks to see beyond signs that real estate loans have soured and to renegotiate. In past cycles, the combination of sharply declining property prices and the comparatively shorter duration of real estate loans has resulted in substantial write-offs for lenders and increased foreclosures for owners. However, this downturn has been characterized by a new willingness by banks to extend the terms of loans unlikely to return full value on principal and interest accrued. This strategy (“extend and pretend”), commonly involves permitting below-market interest rates and stretching out maturities for borrowers with troubled loans; adopting a loan extension strategy amounts to a bet by banks that the economy will rebound in time. A big push by banks in recent months to modify such loans – by stretching out maturities or allowing below-market interest rates – has slowed a spike in defaults. It also has helped preserve banks' capital, by keeping some dicey loans classified as "performing" and thus minimizing the amount of cash banks must set aside in reserves for future losses. **But this practice (of “extend and pretend”) is creating uncertainties about the health of especially commercial property market and some banks. The concern is that rampant modification of souring loans masks the true scope of the commercial property market weakness, as well as the damage ultimately in store for bank balance sheets. More broadly, the failure to get the**

**Prime property shall continue to outperform secondary. Expect double-digit capital value growth for trophy assets in many of the world's high order business hubs for 2011.**

**Eventual shortages of prime product in Tier I cities will encourage investors to widen their search to Tier II.**

**Financial institutions will eventually have to adopt a more aggressive approach to the disposal of non-performing assets leading to the release of more secondary product.**

**The policy of “extend and pretend”, adopted by banks, amounts to a bet that the economy will rebound enough to enable clients to find new demand for the plethora of available real properties. The fact is that the high level of maturing debt remains a significant barrier to recovery and the debt incurred at the top of the market is now coming due at a time when economic uncertainty and weak real estate fundamentals are making it harder for borrowers to generate the income needed to make payments.**



**loans off banks' books tends to deter new lending to others and delaying the inevitable may cause a more severe downturn down the road...** Another consideration is the role of the policymakers in relation to this particular issue! Are they on the same page with banks? Is there consistency in the treatment of non-performing loans? Are the standards applied consistently across the industry? Or is this again a demonstration of the incapability of the policymakers to effectively enforce the law – it is the opinion of Pytheas that the incapability of the policymakers to enforce the law was one of the main causes of the recent global financial crisis (see related article "[Laissez-faire, the "Freer Global Market Economy, the investment banks and the policymakers..."](#)")

Although European investment volumes are down in the last quarter of 2010, the underlying trend is one of growth and it is estimated to see this continue next year with a further increase in investment activity. Europe remains the main target for capital investment with increasing levels of activity expected from overseas investors. European investment volumes are expected to reach about €110bn in 2011, a more than 20% increase on the estimated forecast of approximately €90bn for 2010. There are some recent indications that investors are now considering value-add and better quality secondary opportunities as an alternative to prime, especially in the UK and France.

Within the major European markets, France and Germany registered an increase of investment volumes over the third quarter. In France, volumes increased by 7% from €2.2bn to €24bn. In Germany, there was an increase of 3% from €3.8bn to €3.9bn. Furthermore, volumes in Central and Eastern Europe rose by 43%, although from a much lower base, increasing from €0.6bn to €0.8bn. In contrast other major markets saw a decline in volumes with the UK falling 6% from €9.6bn to €9.0bn.

Within Europe, investors have remained cautious with activity dominated by domestic investors which comprised about 65% of activity and intra-regional investment accounting for about 20%; cross border activity is expected to increase within 2011.

Average lot size during the third quarter of 2010 increased to €30mn from €24mn compared to the previous quarter. Despite the restriction in availability of debt, during the third quarter, there has also been an increase in the number of joint ventures accounting for 21% (€6.7bn) of the market compared to only 10% (€2.0bn) in the first quarter of the year. The majority of joint ventures are focused towards larger lot sizes with the average lot increasing to €84.0mn).

Private property vehicles continue to be the most dominant purchasers, investing €9.5bn over the third quarter accounting €2.9bn of sales.

Offices and retail sectors continue to dominate investment activity. During the third quarter of the year, offices account for 46% (€9.7bn) of investment with a further 34% (€7.3bn) invested in the retail sector, predominantly supermarkets (€2.0bn), shopping centers (€1.3bn) and retail warehousing (€1.3bn). Investment in industrial dropped to 6% (€1.3bn) of activity, the lowest level since the first quarter of 2009.

**The outlook continues to gradually improve for global property market, although the Greek debt crisis has weakened prospects for the smaller, more indebted European markets. Prime capital values look set to continue rising over the remainder of the year, aided by the gradual emergence of the European economies from recession. Pytheas continues to project a two stage recovery in total returns. In 2011, the sluggish nature of the economic recovery, and rising investor risk aversion, are expected to lead to upward pressure on property yields. For 2012 and thereafter, a gradual strengthening of total returns is projected, aided by a gradual improvement in occupier market conditions.**

**In advanced economies, there has been a pick-up in foreclosures and distressed sales, with banks retreating from the lending market as they conserve capital and deleverage their balance sheets. As loans originated in advanced economies during the boom years start to mature, a greater flow of assets is expected onto the market. However, very low funding costs and high margins mean banks are under little pressure to quickly dispose of assets at fire-sale prices, which is a contrast to the situation during the early 1990s recession, when interest rates were much higher.**



Global investment markets saw a recovery during 2010, due to an increase in the amount of capital targeting the property sector. As total investment volumes have fallen significantly in 2009 and 2010, compared to 2008, a year-on-year comparison has seen a stabilization in some markets (USA, Germany, Netherlands) and a strong bounce back in others (France, Canada, Japan, UK).

Some markets are already seeing strong investor competition accompany a shortage of core assets. This is pushing up capital values, as well as moving some investors to the next risk group, while capital placement is becoming one of the biggest challenges. In particular, the markets of Hong Kong and the UK are leading this trend. For the current year, a yield compression is expected to start globally, from 6.7% in 2009 to 6.2% in 2010 (Global Prime Net Yield All Property). Besides this global trend, there are still a limited number of markets which are having an increase in yields, such as Greece (6.0% to 6.1%) which is currently going through significant financial turmoil.

Property returns are set to turn positive across a broad range of markets in 2011, helped by an improved economic climate, and a renewed appetite for lending on core property products since the autumn of 2009. An investment recovery has proceeded ahead of the rental market, which is not unusual in the early stage of the property cycle, although the discrepancy is not sustainable over a long period. Indeed, an ongoing deterioration in the capital markets, sparked by the Greek debt crisis could negatively affect property credit availability and pricing in most regions by the first half of 2011.

Global economic growth is expected to slow below trend in 2011. Along with deteriorating capital market sentiment over sovereign debt risks and concerns regarding continued de-leveraging of bank balance sheets, this will generate a second though modest leg down in property returns next year in Europe and North America. An accumulation of maturing property loans in Europe and the US will also weigh on capital values, as more distressed stock is released onto the market. **A sustainable upturn for global total returns only kicks-in from 2012, by which time, occupier demand will have strengthened and the rental cycle turned firmly positive, underpinned by a huge contraction in new construction activity.**

Asia is expected to escape a dip in values as economic growth in 2011 slows to a pace closer to the long-term trend rather than below. The highest returns on a risk adjusted basis, taking into account factors such as the volatility, transparency and economic risks, are to be found in Asia. Prime capital values, on a long term perspective are low, whilst the growth outlook is by far the strongest globally. However, within the Asian region, there is considerable dispersion of pricing, with,

The deep recession has left its mark on the property debt markets. Even taking into account a modest easing of lending terms in early 2010, overall loan conditions have tightened considerably, compared to mid 2007, in all markets. In advanced economies, there has been a pick-up in foreclosures and distressed sales, with banks retreating from the lending market as they conserve capital and de-leverage their balance sheets. As loans, originated in advanced economies during the boom years, start to mature, we would expect a greater flow of assets onto the market. However, very low funding costs and high margins means that banks are under little pressure to quickly dispose of assets at fire-sale prices, which is a contrast to the situation during the early 1990s recession when interest rates were much higher.

On a global basis, the strongest return projections are for Asia, albeit at a very high level of risk. The key driver of outperformance in Asia is its stronger economic fundamentals, in terms of low debt levels, rapid population growth, urbanization, rising incomes and household wealth. The US is also expected to deliver a stronger performance. Economic growth is also projected to be stronger than in Europe where the strongest total returns are projected to be in the UK, Scandinavian economies and France. The weakest performers are Greece, Portugal, Italy, Romania, Croatia and Hungary, hindered by weak economic growth rates, high and rising government debt and modest investment demand. Although continental Europe offers some of the weakest returns on a global basis, it is substantially less volatile. Finally, the attractions of property to long-term investors have increased, as property is viewed as a good inflation hedge, in an environment where unprecedented liquidity injections are perceived to pose a risk of inflation accelerating.



for example, Hong Kong a relatively expensive market because of substantial yield compression in 2009. Outside of Japan and Australia, the rapid rebound in economic activity and property values, means that funding pressures are less pronounced in the near-term, despite the region also being affected by stricter lending terms.

Latin America will continue to build momentum in 2011 with Brazil taking the lead. There are also bright spots in Emerging Europe, notably Poland, while Russia is now rebounding. Higher oil prices are driving a recovery in some Middle Eastern economies, and there is increasing business interest in its two regional powerhouses, Egypt and Saudi Arabia.

**Latin America shall continue to build momentum, attracting strong corporate occupier and investor interest.**

Sovereign debt problems, unsustainable credit booms and structural economic weakness in southern and central Europe, mean that they offer the lowest property returns globally. Better fundamentals of northern European economies and the Nordic region, with respect to public and private sector debt, should ensure prospective returns are above the Eurozone average over the medium-term.

The UK, despite its fiscal problems and exposure to the financial services sector, will be able to use its independent monetary policy regime to support an economic recovery, unlike southern European members of the Eurozone. With property valuations also historically low, UK is expected to be among the strongest performing markets in the region for the next five years. The US market, similar to the UK, has experienced a sharp fall in capital values from its peak of over 40%, which represents good value. In the near term though, prospects are uncertain due to a huge overhang of maturing real estate debt with substantial negative equity, while the CMBS market remains effectively closed for new financing. Risks are greatest for non-prime assets where credit constraints are most apparent.

**Leasing volumes will be at their highest level since the crisis, with corporate occupiers displaying greater confidence to deals – but they will continue to push for the best possible terms. Additionally, lack of available Grade A stock in many markets will start to limit relocation option for corporate occupiers.**

European banks like their North American counterparts have turned a blind eye to loan covenant breaches, and have pursued a strategy of “extend and pretend” for maturing loans. At the peak of the cycle during 2009, many mortgages were financed at loan-to-value (LTV) ratios exceeding 80%; however, the collapse in property values has wiped out investor equity. On a pan-European level, the total outstanding debt at the end of 2009 was estimated to amount to €1.8 trillion. Loan defaults have been limited to date, as banks have been reluctant to take ownership of property, and have been willing to tolerate LTV breaches as long as interest payments were serviced. **In the coming years, as loans mature, property owners are likely to face a gap between the existing debt balance and that available to replace it.**

An estimated €482 billion of European commercial mortgage loans are due to be refinanced in the next two years, with a funding gap of €115 billion potentially opening up, representing downside risk for property performance. New equity is available to fill this hole. However, investors will be hesitant to commit, given the relatively modest drop in capital values of 15-25% in most continental European markets, compared to 40% to 50% in the UK and the US. **A stand-off between investors and banks will result in further strain on property pricing as loan maturities cannot be extended indefinitely. Low bank funding costs and much higher margins on re-financing, make the status quo sustainable for now, although a renewed softening of the economic climate, which it is envisaged, makes a double-dip in capital values likely by 2011.**

**Global direct commercial real estate investment volumes shall rise by 25-35% on 2010 levels. A significant weight of equity capital will target real estate and fresh capital-raising will further enliven the market.**



According to estimates published by the Congressional Oversight Panel, about US\$1.4 trillion in USA commercial property loans will reach the end of their terms between 2010 and 2014. Similar to Europe, the key concern is that loans originated at the peak of the market will mature with no prospect of new financing. Given the shut-down of the CMBS market, the supply of distressed assets is likely to be high. Valuations, to some degree, reflect the dislocation in capital market financing, although the heavy prospective maturity profile will put a block on a recovery for the market overall. A revival in the CMBS market will be required over the medium term if property market activity is to show any signs of normalization. However, trust in securitization markets is still low, due to the complicated structures and poor oversight on the part of rating agencies.

Across Western Europe, there is a steady supply of funds available for core, LTV lending, mainly due to the ability of German lenders to access the "Pfandbrief" (covered bond) market. Most lending of this nature is sub 60% LTV, as the lenders are required to hold more regulatory capital on their balance sheet for higher LTV loans. This will be an important feature in 2011 as lenders continue to be concerned about the impact of proposed Basel III regulations upon their regulatory capital requirements.

The Asia Pacific region stands apart from Europe and the US as a result of low debt levels and stronger economic fundamentals, which have kept property distress to a very low level. The effective LTV ratio for the invested stock stood at just 55% in 2009, compared to 63% in Europe and 71% in North America. Lower LTV ratios imply that problem loans are likely to be less prevalent, while the availability of new equity capital from domestic and global sources is likely to be strong, given the robust state of local economies, and the widening economic growth differential over Europe and the US.

**Asia Pacific will lead the upswing in leasing markets ahead of Europe and North America while domestic corporate sector will come to the fore in Asia Pacific, particularly in India and China.**

It is estimated that new equity capital targeting the Asia Pacific region should be more than sufficient to cover any shortfall in available lending in the next two years. Note, however, that Asia was strongly impacted by the recent financial crisis despite the region's banks not having any significant exposure to US sub-prime mortgages or the use of structured products. This reflects the strong financial market links with advanced economies through capital flows. If funding markets in Europe and the US were to undergo renewed difficulties on the back of the developing sovereign debt crisis, Asia will once again not be immune, with negative implications for the property debt markets.

**In most mature retail markets prospects for 2011 are mixed. Retailers remain cautious in the light of persistently high unemployment, the need to repair household balance sheets and concerns over the impact of austerity measures. Nonetheless, demand for space in prime locations and well-established malls will be strong, and many large cross-border retailers are back in expansion mode.** Shopping mall completions will be at very low levels in 2011, which should support prime rents and, in the US, help to erode the excess inventory. **Problems will persist in secondary locations, with vacancy rates in many countries showing little sign of receding significantly in the short term. Some mature markets are expected to outperform, notably where employment growth and consumer sentiment is comparatively healthy,** such as in Hong Kong, Australia, Germany and the Scandinavian countries. A combination of favorable demographics, robust economic growth and buoyant consumer markets in 2011 will continue to support dynamic retail markets in the "E7" Most of these markets are now in the middle of a major development cycle, however strengthening retailer demand is expected to absorb much of the new stock. Demand for new mall space is expected to be particularly strong in China as international brands continue to open new stores. For 2011, the largest increases in retail rents are expected in Greater China.

Industrial market fundamentals are anticipated to improve in 2011 on the back of trade and retail sales growth. An upturn in corporate occupier activity will be helped by the faster than expected recovery in global trade flows. However, in general, rental growth prospects will remain subdued in 2011, with the industrial markets of Greater China and Singapore likely to



show the strongest rental growth (of 5-15%). In the US, the industrial property sector still faces considerable slack from a demand overhang that has now lasted two years. Prospects for the US market in 2011 are expected to be relatively flat, although gateway ports and key distribution hubs will outperform. The industrial market in Mexico is rebounding strongly, as US manufacturers shift production south of the border. **Demand for logistics will be driven by structural changes in international supply chains, with corporate occupiers striving for efficiency improvements in order to contain cost levels. This will result in ongoing merger and acquisition activity, space consolidation and upgrading to modern stock.**

**Opinion:** The world economy is maybe not completely on track but toward a recovery! After a fairly prolonged period of inactivity, property markets around the world are starting to ramp up with sales volume increasing moderately. The two-tier real estate market will persist in 2011 and movements in asset prices will be strongly differentiated according to product type, quality and location. Robust competition for trophy assets in the world's high order business hubs will continue to push up capital values – this overall pattern combines two very different pictures, one for economies that have been hit hard by the effects of deflating real estate bubbles and sovereign debt crises and a second for those that suffered more modestly and indirectly from spillovers as global activity declined. Substantially less scope for prime-end yield compression in 2011 than in 2010 will be behind this dynamic. Nevertheless, for a large spectrum of the secondary market, values are likely to continue to flounder near the cyclical bottom with investors more sensitive to risk, price discovery in many markets still far from complete and distressed sales negatively affecting values.

**The bottom line:** Global property markets will continue their broad-based although somewhat uneven recovery... The unbalanced global economy will create several risks including trade and currency tensions, premature policy exit and commodity and asset market bubbles.

**Sources** (Alphabetically)

[Bank for International Settlements](#)

[Colliers International](#)

[DTZ](#)

[Economist Intelligence Unit](#)

[Financial Times](#)

[Foresight Analytics](#)

[Global Edge](#)

[Global Property Guide](#)

[ING Real Estate Investment Management](#)

[INREV](#)

[Jones Lang LaSalle](#)

[Moody's Investors Service](#)

[Mortgage Bankers Association](#)

[National Association of Realtors](#)

[Property Magazine International](#)

[Pytheas Emerging Markets Research](#)

[Standard & Poor's](#)

[The Institute of International Finance](#)

[The Wall Street Journal](#)

[The US Real Estate Investment Trust](#)

[Thomson Reuters](#)

**Disclaimer**

The above notes have been compiled to assist you; however, actions taken as a result of this document are at the discretion of the reader and not Pytheas Limited.

All rights reserved. The material in this publication may not be copied, stored or transmitted without the prior permission of the publishers. Short extracts may be quoted, provided the source is fully acknowledged.