

Schroders Outlook



2012: A year in global property

Jim Rehlaender, Global Property Securities Fund Manager, looks ahead into 2012



- There is generally a short supply of ‘bricks and mortar’ property investments, while demand for real estate assets by private equity investors and institutions remains strong
- These fundamentals are far better than property share prices suggest, which heavily discount macro-economic headwinds
- Politics are going to be the dominant theme, particularly in the first half of 2012. Any resolution to the current European sovereign debt crisis would be an obvious upward trigger for the global property sector.

Today, the disparity between direct property market fundamentals and property securities is as wide as it has ever been. The current rate of bricks and mortar development is insufficient to satisfy even moderate demand levels. Such looming shortages of space would usually lead to potential upside in property-related share prices, but this has not happened as equity markets have been solely driven by the macro picture. Outside of the US, property securities are oversold by 20% to 30%. We are optimistic that the current overriding macro concerns will diminish over the next six months therefore allowing property securities to re-rate to more reasonable discounts to net asset value (NAV).

Where are we now?

In 2011, markets have been driven almost entirely by perceptions of major macro-economic issues: the pace of economic activity in the US, the extent to which China is able to engineer a soft rather than hard landing and – above all – the ongoing eurozone debt crisis. The result has been an environment of ‘risk on’, ‘risk off’ market moves, growing risk aversion and a decline in trading volumes. The ride down over the past 12 months has been disappointing but we believe it will reverse for three key reasons. Firstly, the market has become ‘over-shorted’ and any turn in market sentiment will force a sharp rally to cover the borrowed shares. Secondly, property markets are generally in short supply of product, and demand for real estate assets by private equity investors and institutions remains strong. And finally, companies have managed their capital much more effectively than they did in 2008 and are well-funded to take advantage of market opportunities that now abound.

Macro-economic concerns mask a stellar property investment environment

The critical issues today for the property sector are largely at the macro level, as property markets around the world are generally in good shape. Many of our key markets will soon be suffering from a lack of supply as banks and other financial institutions avoid the sector, which greatly impedes the ability of developers to supply current and prospective demand. In addition, investor demand for property has far outpaced supply and prices have recovered quickly from the lows of 2008. Market fundamentals are far better than property share prices would suggest, as equity prices heavily discount macro-economic headwinds. In fact, if one could ignore the media, one would discover an investment environment that is the best it has been in many years in terms of quality of properties, realistic return assumptions and well-capitalised owner/operators.





Jim Rehlaender CV

Jim is Managing Director of European Investors and is a property specialist with over 26 years' investment experience. He is supported by dedicated property investment professionals, based around the world, including regional managers and specialist analysts. European Investors are one of the pioneers in property security management.

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Asia: China and Hong Kong poised to rebound

Low volumes and shorting have exaggerated negative price moves worldwide in 2011, but nowhere has this been more pronounced than in Hong Kong and China. Average leverage for property companies in Asia is around 20% – lower than in Europe and the US – whilst property share prices trade at an average 50% discount to NAV. Despite operating in solidly growing economies, the value gap between share prices and property company fundamentals is as wide as it was in 2008. In 2009 the value gap was recovered within six to nine months after the lows and, albeit assuming the resolution of macro headwinds, it will not surprise us to see material positive moves to return to more reasonable discounts to NAV. Recent moves by the Chinese authorities (reducing the Reserve Requirement Ratio by 0.5% in November) signal a reversal of the government's tightening stance and support our positive view. While we are not expecting the 100% jumps that we saw in 2008, there is strong potential for significant share price recoveries.

Europe: opportunity in an unfashionable region

Any resolution to the current European sovereign debt crisis would be an obvious upward trigger for the European property sector, which is currently trading at an average 25% discount to NAV on a 5% dividend yield. Our NAV calculations are conservative and assume no rental growth for two years, no economic recovery, and ascribe no value for development or re-development. Given that our favoured companies are running at a vacancy rate of 4-5% we do not assume a loss of tenants, but we also do not assume any growth. In contrast to 2008, there is significant transaction data to support our valuations. Moreover, there is abundant private equity and institution capital waiting on the side lines; it is hard to find good deals and investors must pay up if buildings are fully leased. We project a one year return of up to 20% from European property securities as they recover the lost ground that has been oversold.

UK: London residential market defies gravity

The residential property market in London remains very strong. London has become the city of choice for international investors and it continues to benefit from flight capital. This is great for people who own and want to sell, but not so great for those trying to buy. As a result, the average age of a first-time buyer in London is now 42: this is our primary concern regarding the London market because it means that it is expensive for businesses to grow and hire staff. On the other hand, London has become the clear winner in the battle to be the primary global financial centre. All of our holdings have reported great numbers in 2011 – in fact things could not have been much better. There are also legislation changes in the pipeline that, if passed, could make London the trading centre for the European REIT universe. These positives offset our concerns and we remain overweight London.

US: a safe harbour

Property company fundamentals have vastly improved since 2008. Companies have recapitalised and dividends are well covered. Regulations require US REITs to increase their dividend payments by 10-15% in the coming year. A dividend yield of 4% from US REITs compares very favourably with 2-year US Treasury yields of 0.22%. This factor will continue to support US REITs in 2012.

Whilst there is only modest upside in the US market, US REITs are a solid safe harbour for the moment and provide a decent source of income. With a 4% dividend yield and 4-6% capital appreciation we project an 8-10% return over the coming year.

Health warning

Such positive return forecasts must come with an inevitable health warning. Fears of a European collapse have been responsible for the bulk of the pressure on property securities in 2011. If the acceleration in the eurozone debt crisis is not arrested and banks lose confidence in one another then we are back to where we were in 2008. In Europe a structure that will save the euro and keep the region from falling back into a potentially dire recession is vital, as failure would have serious repercussions around the globe. It follows that the largest risk to our predictions is that the situation deteriorates before its get better.

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