Henderson Global Investors

# The view from Global Property Equities

**FOR PROFESSIONAL INTERMEDIARIES' USE ONLY**

## How property equity markets have emerged out of the financial crisis

**Global equity markets have experienced unprecedented volatility over the last year. At the end of September 2008, the US Treasury's decision to allow Lehman Brothers to go bankrupt caused shockwaves felt throughout the world. For a time it looked like the US financial system might cease to function completely and, as a result, risk premia ballooned to previously unthinkable levels. Property markets were hit hard: in the US, real estate investment trusts (REITs) lost 62% of their market value in two months, with similarly large-scale losses closely following in property markets throughout the rest of the world.**

As governments, central banks and the banks themselves wrestled with plunging confidence and values, the fortunes of property markets were inextricably entwined with those of their sources of finance, both equity and debt. It was not until March 2009 that credible solutions, in the form of government intervention and urgent corporate balance sheet repair measures, finally turned the market around. From this point on the rout turned into a spectacular 100% rally. Nevertheless, the index is still below its level of a year ago and 43% below its peak in February 2007.

Since 9 March the MSCI World Equity index is up 65%, but the FTSE EPRA/NAREIT Global Property Index in US dollars has more than doubled. Europe and Asia have outstripped the US, although the weakness of the dollar has played a large part in comparisons. From such a low base, however, such large numbers can be misleading.

## What can explain such as dramatic reversal in fortune for property equity markets?

As with other asset classes, what we have witnessed has been a sizeable and fast-paced "relief rally". Property stocks, in particular, were priced for destruction, have undergone a rapid readjustment and are now priced instead for survival.

Apart from various measures to repair financial market liquidity, it was the ability of property companies to raise new equity capital that underpinned the relief rally. Many balance sheets faced the risk of breaching loan-to-value covenants, and it remains by no means certain that maturing loans, especially securitised debt, can be refinanced with new facilities. In Australia, the US, UK and, to a lesser extent, Continental Europe and Asia, nearly $50 billion of new equity has been raised in the last year. These emergency repairs have in effect returned power to the engines and reverted control back to the pilots.

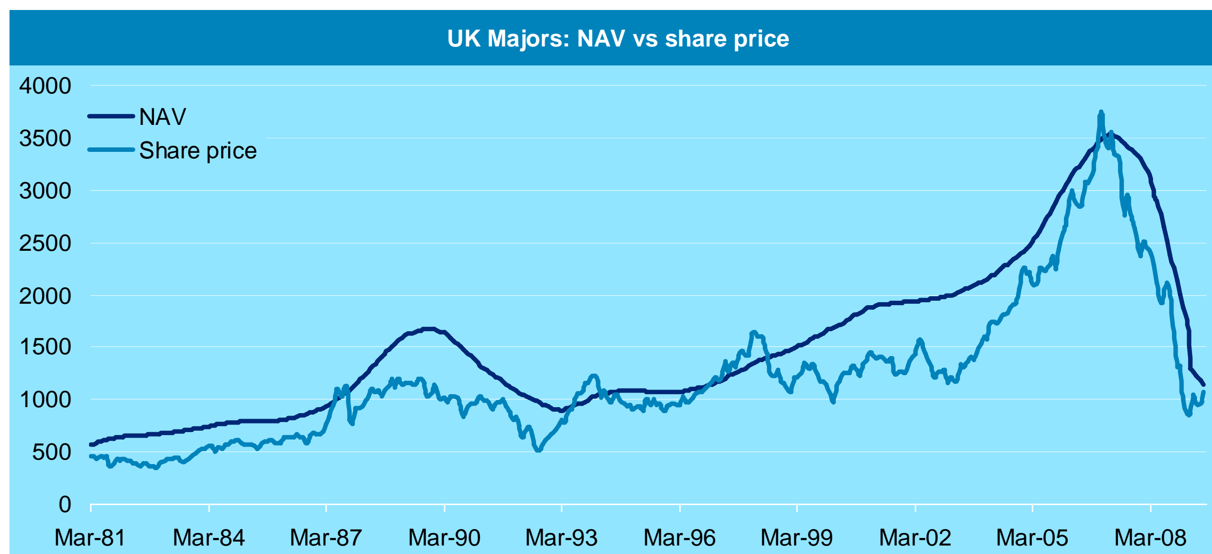
The two key questions for investors now are as follows:

- What are the prospects for property in terms of;
  - i) Investor demand
  - ii) Tenant demand
  - iii) Availability of finance?

Henderson Global Investors

- Do property stock prices over-estimate these prospects?

In previous market cycles share prices have anticipated growth in net asset values and rental income by several months. Accurate data is not universally available, but in the UK net asset values appear to lag stock markets by around six months (see Chart 1). Given the forward-looking nature of equity markets, and the fact that net asset values (NAVs) are estimated by valuers on the basis of historic evidence, this is not a surprise.




Source: Merrill Lynch, as at 31 July 2009

## Physical property investors still appear gun-shy

Investors have so far been reluctant to enter the physical property market, despite apparently attractive prices, for fear of further capital market uncertainty, a lack of debt finance and falling rental values. The first obstacle has largely crumbled and the second can be overcome by the fitter participants. The third remains a considerable threat, but it is not symmetrical. The magnitude of rental risk varies according to location, building quality, tenant quality, lease structure and management skills. In other words, management has little or no control over the macro economy or financial markets, but can distinguish itself through its stock selection and ability to mitigate or enhance fluctuations in income.

Investment values have begun to stabilise in developed markets and even recover in some, notably the UK, where long leases and upward-only rent reviews provide a solid hedge. Funds have been raised to take advantage of distress, but demand so far clearly exceeds the supply of interesting opportunities. There has been an expectation that banks in the US and Europe will be forced to offload huge volumes of assets at knock-down prices, either in the form of loans or repossessed property. So far, the expected deluge has been a mere trickle, with the banks preferring to overlook loan-to-value breaches as long as interest continues to be paid. It is certainly true that large-scale disposals at market prices would crystallise losses that would seriously compromise the very solvency of the banks in question.

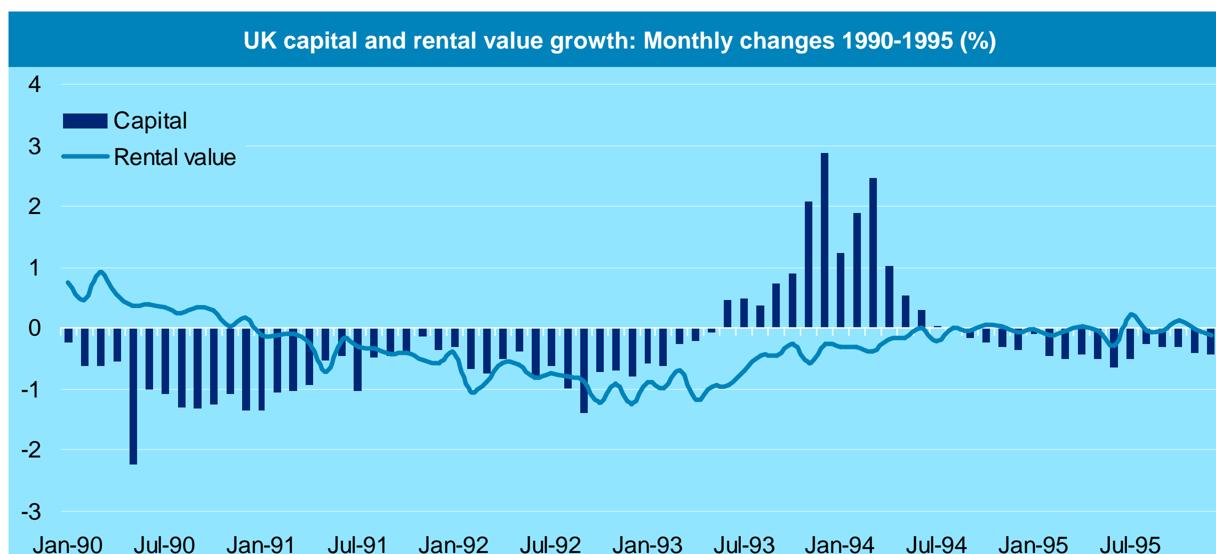
The appetite for new investments is, however, extremely selective. The range of yields has expanded to reflect the very different prospects of assets, prime property is still commanding yields of 5% and lower, while sizeable mixed-use portfolios of secondary assets have changed hands at yields of over 10%. In the growth years before 2007 these same assets were often priced at yields as low as 6%.

There is an emerging and significant interest on the part of cash-rich sovereign wealth funds (SWFs) in prime London and Paris offices,. The common feature is long leases, solid tenants, preferably with some cheap debt attached.

## Concerns about the unwinding of debt obligations persist

A big worry in the US and Europe is the tide of commercial mortgage backed securities (CMBS) approaching maturity that will wash through the sector for the next several years. In the US the REITs themselves are directly exposed, but may take some comfort from the arrival of new mortgage REITs that will provide urgently needed new debt. Whether this new source of supply will be sufficient is unclear. In Europe, the companies themselves have limited CMBS exposure, but distressed selling will have an adverse effect on valuations generally. On the other hand, the unsecured bond market is opening for quality names, illustrated by Unibail-Rodamco, the largest European REIT, issuing €500 million seven-year unsecured bonds with a coupon of just 4.625%.

The key factor, however, in any recovery is going to be tenant demand, which is directly linked to employment and consumer spending. The outlook for both remains poor in the US, the UK, Japan and Germany, as well as in other developed countries. Chart 2 neatly illustrates that it is possible for commercial property values to rise while rental values continue to fall: UK capital values turned the corner in June 1993, but it was two years later that rental values followed suit. However, the interest rate, bond yield and inflation scenario was very different at the time.



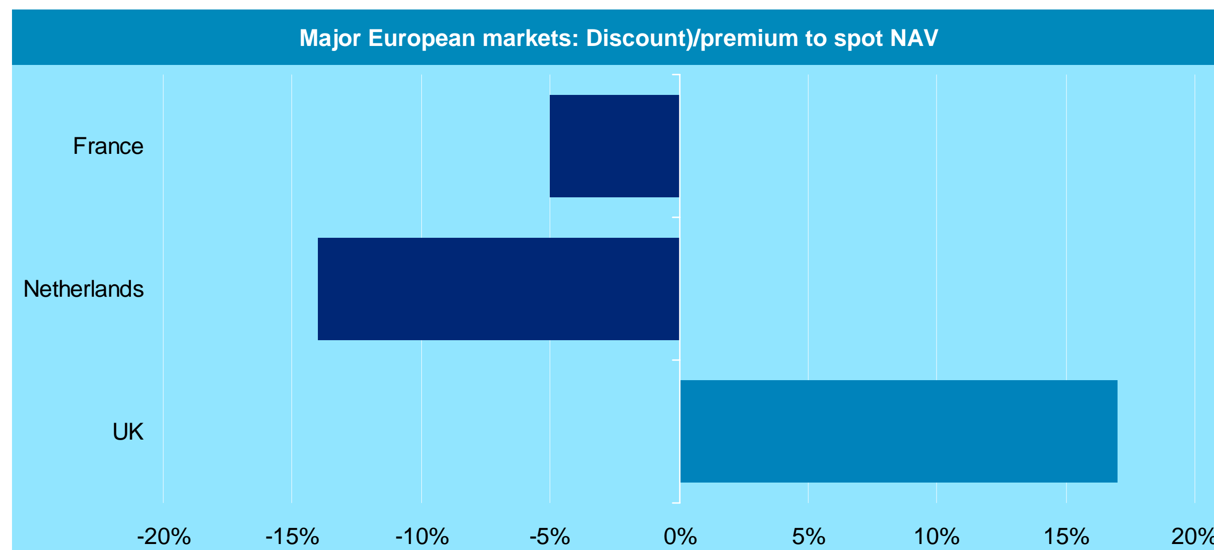
Source: IPD

## Are property equity markets now due a correction?

Any assessment of the prospects for the next 12 months must be hedged around with many caveats. Economists are polarised on virtually every issue, although the stockmarket bulls outnumber the bears right now. On the optimistic side, noises from central banks and policy-makers suggest a prolonged period of low interest rates and quantitative easing, while liquidity is gradually returning to all but the most severely afflicted property markets (eg Spain). Whatever the misdemeanours of investment banks in the past, they are endlessly inventive and are more likely to assist a recovery than to hinder it.

Our current view is that the US and the UK, having been more “distressed” than other developed countries, are now witnessing a greater than average bounce, with momentum overtaking fundamentals.

However, those less liquid markets (such as France and the Netherlands) are still trading at discounts to net asset value, according to Chart 3, and offer attractive dividend yields of 6-7%. Investors in these markets tend to be more focused on long-term dividend yields rather than short-term capital gains.




Source: Henderson Global Investors, as at 11th September 2009
Note: Benchmark: FTSE EPRA\NAREIT Developed Europe Real Estate Index (capped)

## Selective opportunities still present within Europe

The European property equities market is dominated by five countries (the UK, France, Netherlands, Sweden and Switzerland), which make up roughly 85% of the index in terms of market capitalisation. Property companies on the Continent are not as highly geared as their UK counterparts, so valuation write-downs have tended to not been quite as savage. Several European names are trading at a 15 - 25% discount to spot net asset value, this discount is lower in the UK, and in fact, several UK property companies are now trading at premiums to their NAV. However, one could also argue that, as a market rather less transparent than the UK, the region as a whole could still experience considerable further downside. Nonetheless we continue to see significant investment opportunities within European markets, particularly within those companies typically classified as low beta stocks.

Sweden is currently benefiting from an official interest rate of 1.0%, and has a well-managed property sector, with companies benefiting from the lower cost of finance. While we view share prices to be at reasonable values, the dividend yield from our Swedish holdings are around 6% on average and we see good opportunities to generate outperformance. However, in other countries, including Germany, Greece, Spain and Austria, the primary concern is to avoid the highly levered firms that look set for further write-downs and cashflow problems. Therefore, from an investor's point of view, there are pockets of interest within Europe, but no more.

## US showing signs of improvement – despite mixed economic newsflow

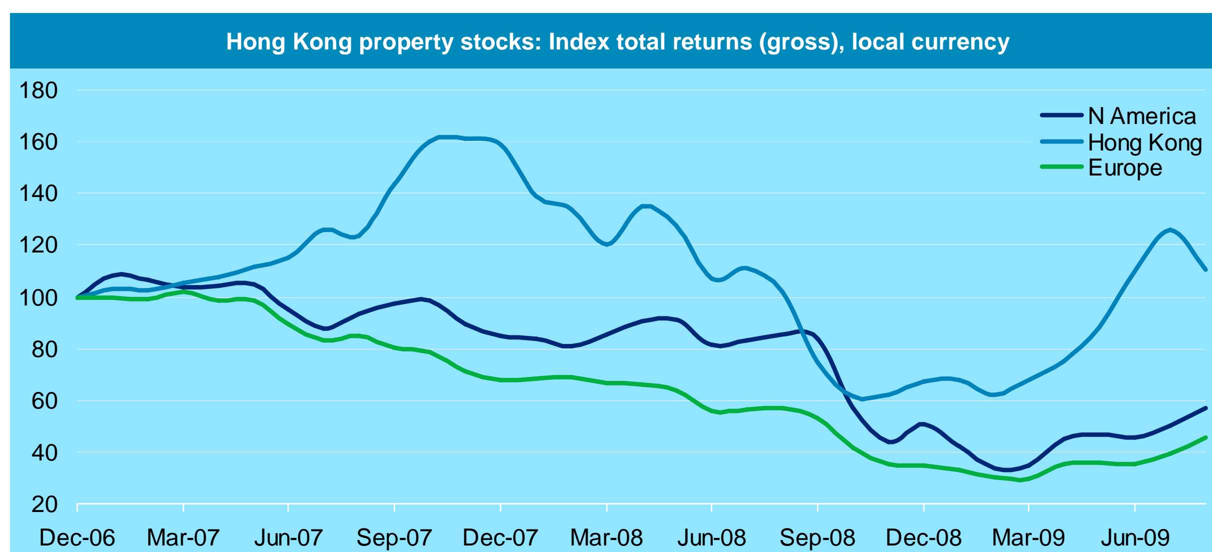
The rally in US property equities has been aided primarily by the relative improvement in macro economic newsflow, which has been mixed as opposed to consistently negative. Earnings in the REIT sector have been in line with expectations but continue to fall, unsurprisingly given the current recessionary problems the country still faces.

On a more long-term view, however, US REITs appear to be positioned relatively well on the path towards recovery, especially given that access to capital has improved markedly, when compared against the far more restrictive access afforded to most private developers and institutional owners of real estate.

We believe that any dividend yield growth will be offset by continuing weakness in fundamental values – leaving average returns in the near-term broadly flat if there is no major recovery in the economic outlook. Nonetheless there are several stocks now trading at or near NAV that we believe offer good long-term investment potential. The next leg up for US REITs will require per share cash flow growth and dividend expansion. Meaningful progress on both fronts, however, could take time.

### Asia remains an area of keen investor focus

Economic prospects in Asia, especially in China, appear more favourable, prompted in large part by the vast sums pumped into the Chinese domestic economy to offset the plunge in exports. But the tap is being gently tightened, and investors have reacted by smartly taking profits. The chart below shows how Hong Kong defied gravity until the end of 2007, caused by the Chinese government's decision in August to allow mainland investors to buy Hong Kong-listed stocks, in order to release some of pressure in the overheated Shanghai stockmarket. The increase in mainland bank lending in 2009 prompted a strong rally in developers, which now seems to have peaked. Since the start of 2007, nevertheless, Hong Kong has outperformed the global index by 50%, Europe by 60% and the UK by more than 70%.




Source: Bloomberg, Henderson Global Investors, data to 31 August 2009
Note: Total return indices, rebased to 100 on 31 December 2006, in local currencies, except Europe, which is in Euros.

Our Asian strategy is currently to retrench into more defensive names, such as the commercial landlords in Hong Kong, and to look for the better recovery plays in Japan and Australia, which have both lagged Hong Kong dismally (by 60% and 80% respectively year to date).

### Appetite for property equities is returning…will it continue?

Funds are beginning to flow back into the property sector, although we believe that it is the generalist investors – rather than specialists - moving prices for the time being. There appears to be more appetite for a diversified global portfolio than for more geographically specific strategies, with Asia-Pacific funds suffering a degree of profit taking.

Our response to the question "Is it time to buy back in?" is: if you are a long-term investor your entry price will become gradually less important than the dividends you receive, and price volatility becomes less significant over time.

The performance of stock prices among the liquid majors suggests a belief in a strong fundamental recovery. We do not share this view. The recovery in property markets is, we believe, going to be gradual. Fortunately, we can see sufficient value elsewhere in the universe of stocks and in new issuance to be confident of positive returns over the next year. If we are wrong, at least the dividend will take the edge off our disappointment.

## Important Information

Henderson Global Investors (Singapore) Limited and its affiliates are referred to herein as Henderson Global Investors. This document has been produced based on Henderson Global Investors' research and analysis and represents our house view which is **solely for the use of professional intermediaries and not for general public distribution. All the information contained in the document is intended for information, illustration or discussion purposes only and should not be relied on for any investment decisions or regarded as a substitute for the exercise of your own judgement.**

**The contents of this document are prepared without consideration to the specific investment objective, financial situation and particular needs of any specific person. It does not constitute an advertisement and should not constitute or form part of any offer or solicitation to issue, sell, subscribe or purchase any investment in any jurisdiction and do not purport to represent or warrant the outcome of any investment strategy, program or product.** Any information and views provided herein is subject to change without further notice. None of the material, nor its content, nor any copy of it, maybe altered in any way, transmitted to, copied or distributed to any other party, without prior express written permission of Henderson Global Investors. The information contained herein is obtained and / or compiled from sources believed to be reliable and current and Henderson Global Investors do not warrant, guarantee or represent, either expressly or impliedly, the accuracy, validity or completeness of such information. Henderson Global Investors or any directors or employees of Henderson Global Investors shall not be liable for any damages arising from any person's reliance on this information and shall not be liable for any errors or omissions (including but not limited to errors or omissions made by third party sources) in this information. Unless otherwise indicated, the source for all data is Henderson Global Investors.

**Past performance of any fund, a security, an investment or manager and any opinions, forecasts, assumptions, estimates or valuations made are not necessarily indicative of the future or likely performance of the fund, the security, investment or manager. An investment in collective schemes/funds, and/or other investment products is subject to investment risks, including the possible loss of the principal amount invested.** The value of the units and the income from the funds may fall as well as rise as a result of market and currency fluctuations. Funds which concentrate their portfolio in a specific sector may carry a higher degree of risk and the portfolio values can be more volatile than other equity funds which invest in more diversified markets. The performance of such funds may differ in direction and degree from that of the overall stock market. **Before investing, please refer to the prospectus of the fund for more details of investment risks.**

**Henderson Global Investors (Singapore) Limited Company Registration No. 199700782N**

**Date of issue: 23 September 2009**