

HOW LONG WILL THE BULL RUN?

Colliers International tackled the key question facing real estate investors during a panel discussion at Mipim

BY JUDI SEEBUS

The title of Colliers International's latest report on global capital captures the burning question on the minds of all real estate investors: how long will this property bull market last? The report begins: 'One great certainty in property markets is that their peaks will eventually be followed by troughs, and their troughs will eventually be followed by peaks. That is to say, that property markets are cyclical.'

But where does that leave us now? 'That is indeed the main question that I am being asked over and over again,' replied Walter Boettcher, head of research and forecasting at Colliers International during an interview following an investment briefing on global capital flows hosted by PropertyEU at Mipim in Cannes last month. 'There's a glib answer and a more serious answer,' he continued. 'The more serious one is I think that there are a lot of indicators making people a little bit nervous, like the possibility of interest rate rises. A lot of investors are thinking about how to plan their exit.'

There's another group, however, that is getting past the issue of volatility, he added. 'These people are going slightly longer term. They're saying, we don't care what happens in the next three or four years because we're in it for 10 years. These people are looking more at development projects, long-term assets and the like.'

Boettcher said he hoped this would be a positive trend. 'I fear if we don't move into longer-term assets we're just going to see a huge pricing bubble and we will find ourselves back in 2007-2008.'

For now, virtually negative interest rates are driving more and more investors into real estate. Indeed, institutional investors are expected to increase their target allocations for real estate investment this year to 9.6% from 9.4%

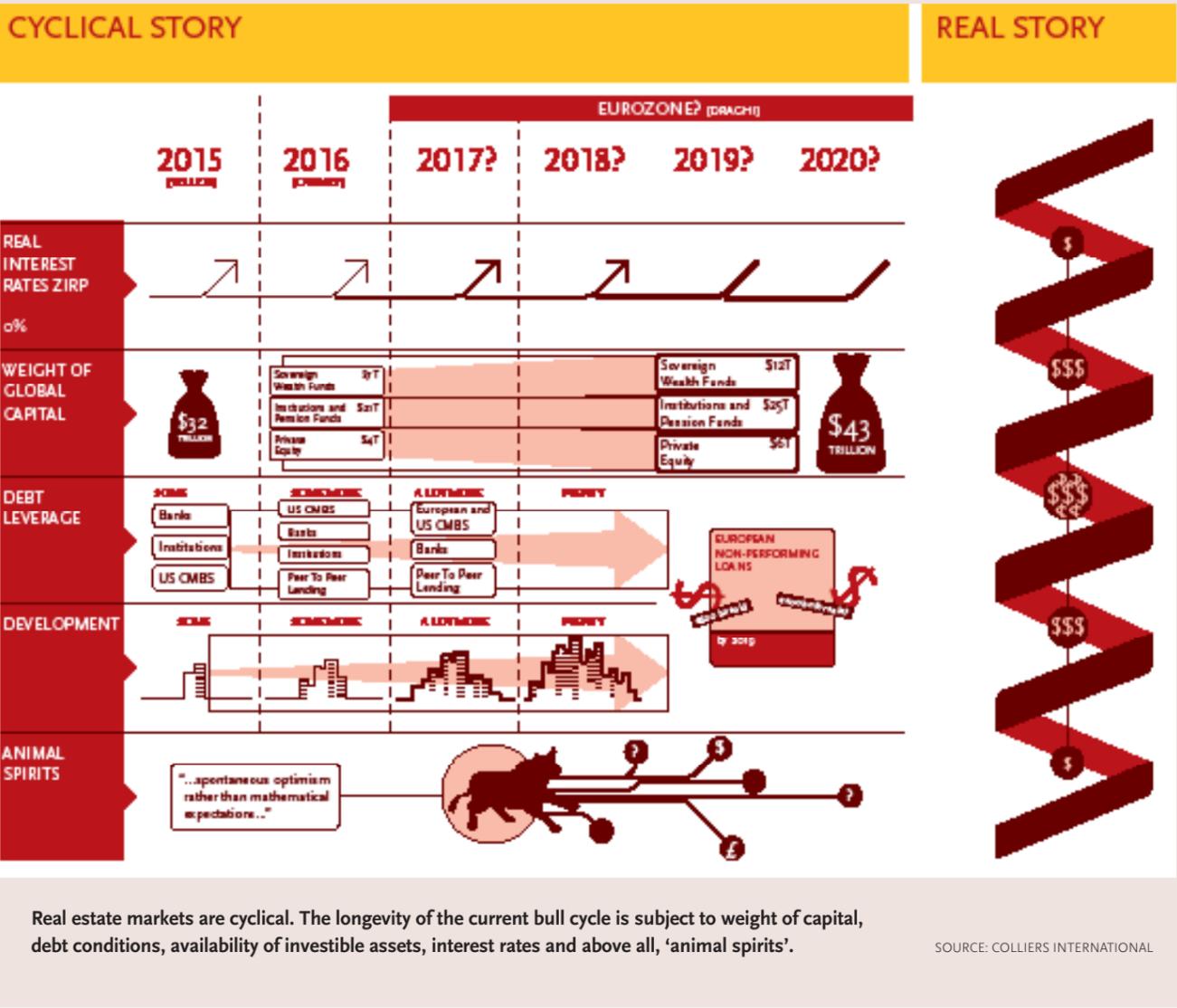
in 2014, Colliers International reported. Boettcher pointed out that this 'seemingly modest increase' amounts to an extra \$52.5 bn (€48 bn) in the market given the size of the capital pools. This gives a significant boost to overall funds targeting global real estate this year. Moreover, it follows a \$105 bn increase on the previous year when target allocations rose from an average of 8.9% of existing portfolios in 2013. If these allocation rate increases are applied more widely across private equity and sovereign wealth funds, the total uplifts would amount to \$160 bn in 2014 and \$80 bn in 2015. Total global funds under management currently amount to \$32 tn.

Commenting on the trend, Boettcher said: 'Weight of capital as an investment driver is certainly not a new phenomenon, but remains undiminished in this particular cycle. What is new is the extent to which property investment has become globalised, with funds needing to reach beyond their domestic borders to satisfy their target allocations to property. This is driven by the extraordinarily low interest rate environment and an international search for yield, with property offering relatively high returns compared to bonds and equities.'

SEARCH FOR YIELD

The search for yield has driven people across borders into all sorts of assets, Boettcher said. 'Maybe pricing hasn't been done quite correctly because the pricing benchmark has been fundamentally shifted by quantitative easing and the like. So the worry is that when interest rates start to rise, how are people going to respond? When they go back and review their property portfolios, does it still add up?'

While concerns persist about pricing both in Europe and



Real estate markets are cyclical. The longevity of the current bull cycle is subject to weight of capital, debt conditions, availability of investible assets, interest rates and above all, 'animal spirits'.

the US, Brian Ward, president of capital markets and investment services for the Americas, believes there's a lot of reason to be optimistic. 'In the United States particularly and the Americas to a slightly lesser degree we have a lot of positive factors going on. We have GDP growth for the last quarter that was at a 5% level which is very, very high and we think that's going to settle into a 3-3.5% level longer term.'

EMPLOYMENT GROWTH

Job growth in the US is also showing very positive trends, he added. 'We're seeing roughly 250,000 new jobs per month right now which is a very, very solid range on an historical basis. One of the things that concerns me a

little bit is that real wage growth right now – or wage growth adjusted for inflation – is showing some signs of weakness. I think that until that trend reverses our US central bank will remain fairly dovish with regard to interest rates.'

That said, strong fundamentals are certainly there in the US or are beginning to show signs of being there, he added. 'So there's a lot of optimism for US real estate. Liquidity remains tremendous, both on the debt and the equity side.' At the same time, more US investors are eyeing Europe, Ward said. The main driver is the wish for diversification: 'It depends on who we're talking about. The larger institutions will have a different thesis than the private equity funds. But I think there's



Walter Boettcher Terence Tang Damian Harrington Richard Divall Rob Wilkinson

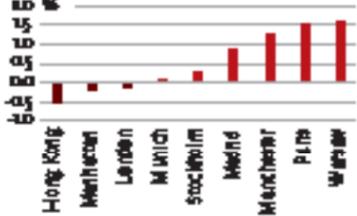
INTEREST RATES AT HISTORICAL LOWS

National Bank	Interest rate	Date
Bank of England	0.25%	Q3 09
European Central Bank	0.25%	Q3 14
US Federal Reserve	0.25%	Q4 08
Bank of Japan	0.00%	Q4 10
Swedish Riksbank	-0.25%	Q4 15
Swiss National Bank	0.25%	Q4 15

Interest rates across the advanced economies remain at historical lows, which has distorted market pricing mechanisms.

SOURCE: GLOBAL-RATES.COM

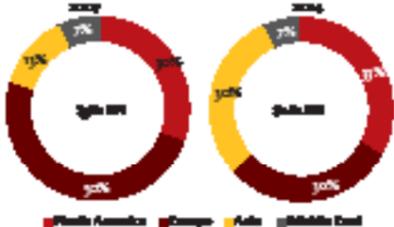
YIELD DIFFERENTIAL BETWEEN 2007/8 AND 2015



Prime markets are looking fully priced, with the scope for further yield compression in secondary markets also diminishing.

SOURCE: REAL CAPITAL ANALYTICS

ASIAN WAVE OF CAPITAL HEADS FOR EUROPE



Cross-border investment amounted to \$262 bn in 2014, compared with the 2007 peak of \$382 bn. Especially noteworthy is the substantial expansion of Asian investment led by the Chinese.

SOURCE: REAL CAPITAL ANALYTICS

a sense to the extent to which capital is going outbound from the US, that there's an opportunity to diversify risk, perhaps take on an opportunity for a little bit more yield in certain markets right now in Europe. Spain is a great example of a market where there's some perception of opportunity.'

Ward does not foresee a major shift in strategy by US investors whereby the majority, say 80%, of their real estate capital allocation would go to Europe. 'I think it's going to be a 10-20% allocation type of situation. It just follows a broader dynamic of our real estate industry today. Today it's a global market, it's not as much a local market as it used to be in past cycles. We're seeing large sophisticated capital move around the globe at a pace and with information not previously seen. And I think that is a trend that is going to last for a generation.'

CROSS-BORDER CAPITAL

The weight of money targeted at real estate is evident in the size and origin of cross-border direct investment flows, said Terence Tang, managing director of Asia capital markets at Colliers. 'Asian capital, largely led by the Chinese, accounted for around 13% of cross-border investment in 2007 and more than doubled to 30% last year; a total increase of \$36 bn, with signs of further growth,' he said.

Richard Divall, head of cross-border capital markets for EMEA at Colliers International, agreed that Europe is becoming a magnet for international investors. London has led the way, but as institutional money starts to flow in the capital has spread out towards Paris, Munich and Madrid. 'As interest rates are so low around the world, real estate is the only alternative sector that a lot of the

capital is looking at to get these higher returns,' he said. 'We all know that Europe is recovering at multi-speed and we've seen a lot of the North American private equity chasing Europe for the last two to three years.'

Following the influx of Asian capital in 2014, this year Divall expects the focus to switch to the US: 'I feel that the market in America is getting quite pricey and they've got a currency advantage at the moment, and I think following the private equity money we're going to see a lot more of US institutional money.'

Rob Wilkinson, CEO of investment manager AEW Europe, identified two contrasting themes in 2014. On the one hand, institutional investors, both within Europe and internationally, looked to increase their real estate exposure by acquiring assets. But there was also an increased appetite among institutional investors for investing in funds. 'That was really the biggest change that we saw last year as institutions increasingly seemed open to investing in new funds as well as existing funds, and that's a trend we expect to continue during 2015 with increasing flows, we hope, towards those sorts of funds,' he said.

Wilkinson added that the choice for individual investors of whether to buy or invest would depend on what kind of experience they had in terms of managing strategy and the make-up of their portfolios. 'You've got to have a track record in that particular strategy, ideally a team that's been in place managing that kind of strategy for some time, and then of course real estate,' he said.

Another trend that will shape the market going forward is the growing availability of debt. In Europe, bank lending remains the main source of debt to the real estate industry, accounting for at least 90% of the corporate

real estate debt held relative to other alternative funding sources, Colliers International's latest global capital flows report shows. By contrast, in the US a variety of sources, including CMBS, prevail.

Indeed, in North America, CMBS issuance has increased significantly over the last five years from \$2.7 bn in 2009 to \$94 bn (€86 bn) in 2014, highlighting the speed at which lending capacity is increasing on that side of the Atlantic. But a number of US investors are becoming increasingly engaged in building CMBS capacity in Europe, which could have an impact by providing an alternative to bank-originated debt, Boettcher said. 'Debt has been the missing ingredient in many markets, due to the prolonged period of deleveraging in response to the credit crisis and subsequent regulatory changes. The availability of debt to allow property investment deals to be leveraged and to develop new assets is critical to prolong this bull market.'

BANK DELEVERAGING

In the current cycle, UK banks have been reducing their exposure to commercial property for 5.5 years from 11.6% to 6.9% at the end of Q3 2014. This suggests that there could be another 12 to 18 months to go before exposures begin to increase in the UK, the Colliers research found. Damian Harrington, regional director of research for Eastern Europe, said: 'Many countries are still seeing active bank deleveraging, but its impact differs significantly by location which has effectively altered the speed at which individual markets move along the current bull cycle. From a UK and European perspective, deleveraging may have taken time but the worst appears to be over, breathing new life and funds into the lending market.'

With the London market becoming increasingly competitive, Colliers predicts that more cross-border investors will extend their horizons to mainland Europe, including Central and Eastern Europe. Poland accounted for one third or €3.2 bn of the €10.5 bn in transactions concluded in CEE last year, and the value of investment transactions in 2015 is expected to be similar to last year, he added. Among the buyers, a further influx of capital is expected from the US, as well as new investors from Canada, Australia, Korea, China and Singapore.

With the exception of Moscow, all CEE markets currently have a 3% spread above government bond rates. This indicates a positive spread between the potential cost of debt and the return on the asset. Even based on the five-year bond rate, the CEE region looks good from a risk-adjusted yield perspective with Sofia, Prague, Bucharest and Warsaw among the better positioned markets. 'While the CEE region may be perceived as being riskier and the scale and quantum of opportunities available may not have always whetted the appetite of some global investors, we could see investors shift their intention to the CEE region as the market opportunity for both distressed sales and well-priced assets diminish across Western Europe,' Harrington said. 'To some extent, you could say that prime yield pricing is an advantage for the CEE region, and the fundamentals supporting growth in occupational demand for both offices and industrial and logistics growth are stronger. It is a region with room for more capital,' he added. ■

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