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Europe - It Was the Worst of Times

Highlights:

- European Central Bank policy is trying to calm bond markets, but is exacerbating the debt crisis.
- European property values are likely to decline due to weakening fundamentals and tighter credit.
- Disappointing European retail sales and unemployment data pressure real estate values.
- Negative surprises likely for US property earnings and valuations in 2012.
- Several special situations likely to have upside in 2012.

Europe No Bazooka in Sight

In early December, we met with numerous European property company executives in London. These talks reinforced the severity of the challenges property companies across the region face as they navigate the European Financial Crises: a tough financing environment, a significantly reduced ability to drive rents and occupancy and an increasing concern about how austerity measures will choke off growth.

European officials have continued to kick the proverbial can down the road and the policy bazookas have largely been left in their holsters, leaving the equity markets to struggle in the second half of 2011. Without the European Central Bank providing cheap liquidity to European banks, and tempting them with an arbitrage opportunity in higher yielding sovereign debt, the crisis would be much more severe as private sector investors continue to shed European financial and sovereign exposure. However, loading up Spanish, Italian and French bank balance sheets with their respective sovereign debt could best be described as a stopgap and at worst a doubling down that considerably increases tail risk. And what if banks do not end up actually gobbling up the unwanted sovereign debt? European bank investors are hostile to the proposition, many bank executives, such as UniCredit CEO Federico Ghizzoni, have nixed the idea and major European financial institutions have sold €65bn of PIIGS sovereign debt in the last nine months in an effort to shore up their balance sheets. If this carry trade does not occur in scale, then we are right back where we started and still in need of a true lender of last resort for the sovereigns.

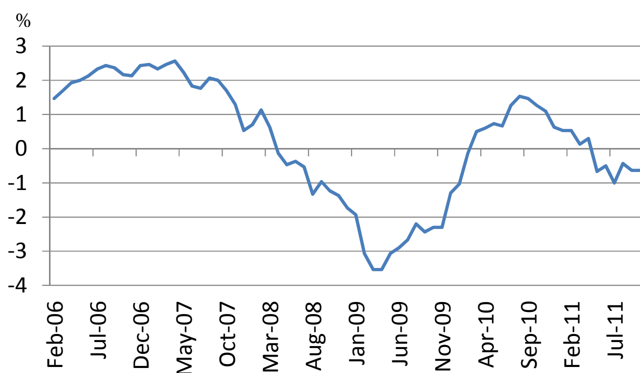
The ECB will likely need to engage in large scale quantitative easing to avoid a bank or sovereign default. The sooner this occurs the less damage the European and world economies should face. Yet, the lack of urgency from the European leaders may mean we need to be on the precipice of a “Lehman” moment before truly bold action is taken. Regardless, a recession in Europe is likely underway. Deleveraging, while faced with significant demand destruction from austerity measures and reduced lending, simply will not foster growth. The ongoing debt crisis is already spilling over to the global economy and developed markets will likely be in recession in 2012.

Europe Property Values to Decline

European property companies are facing the deadly combination of a tighter lending environment and weakening fundamentals. Real estate values will come under pressure and some company balance sheets will not survive the worst case scenarios that could unfold.

Banks are looking to raise capital to meet Basel III requirements and current liquidity needs, causing the financial sector to lend more selectively. Banks are primarily limiting new lending to property owners with superior assets in high quality locations. Non-prime real estate is likely to continue to experience the greatest downward pressure in values. Life insurance companies remain active lenders, but will also be selective. Retail sales have deteriorated notably in many European countries, which will lead to more store closings, increased tenant defaults in the New Year and less pricing power for landlords. Retail sales in the Eurozone in October were down 0.4% year-over-year and have been negative for the past six months on a composite basis. The usual suspects, such as Spain (-6.9% real retail sales in October year-over-year) stick out, but the slowdown is broad based (Figure 1). With austerity measures in Europe just beginning to deal with sovereign debt issues, the consumer is likely to remain weak, and increasingly so, for the foreseeable future. The Eurozone unemployment rate is ticking back up approaching the prior highs from a few years ago, providing a headwind for office property (Figure 2).

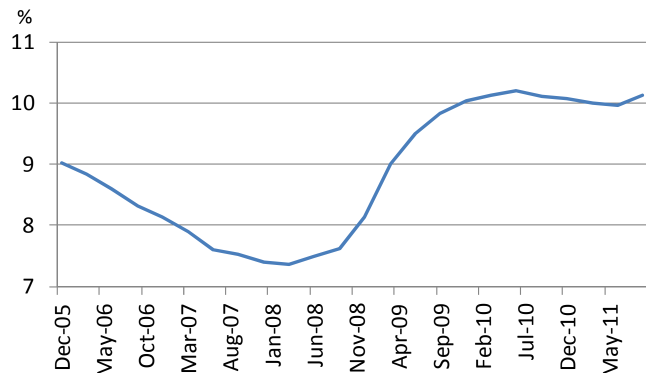
Figure 1: Retail Sales Decline Continues



Note: Trailing 3 month inflation adjusted data.

Source: Bloomberg

Figure 2: Unemployment Remains at Elevated Levels



Source: Bloomberg

United Kingdom property companies have traded down 15% year-to-date on average as their counterparts in Continental Europe have declined approximately 20% year-to-date. Consequently, the UK and Continental European real estate universes are trading at roughly an average 20% discount to company reported NAV. These spreads are steep, however, the appraiser determined NAVs have considerable downside risk, through both decreasing NOIs and increasing cap rates. For example, through the third quarter, prime office rents across Europe have not yet capitulated, with rents over the past 12 months up nearly 5% in London (City), flat in Paris and Rome, and merely ticking down a few percent in Madrid and Barcelona. The fundamentals would imply a more material downward movement needs to occur.

Similar to the U.S., the spread between government bond yields is wide on a historical basis in Western Europe and should be supportive of asset values over time, but in the current environment of tighter credit and weakening fundamentals, cap rates will still rise and real estate values will likely fall (Figure 3).

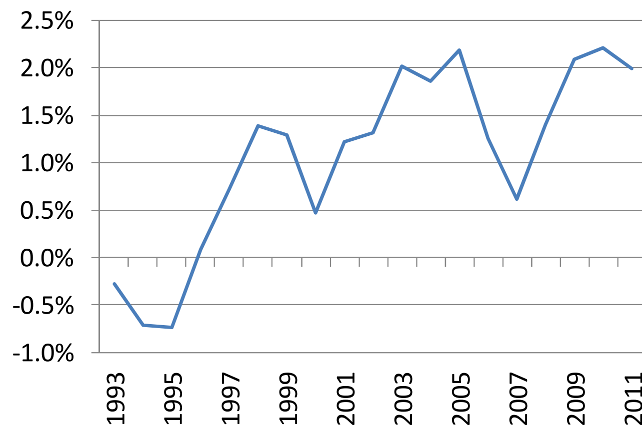
U.S. Property Companies Earnings Expectations Too High and Valuations of Some Rich

In recent weeks, there have been several large cap companies in the U.S. broad market that have had disappointing earnings pre-announcements (e.g. DuPont), which is likely a harbinger of future negative surprises as 2012 unfolds. Currently, the consensus top-down estimate for 2012 earnings growth for the S&P

500 is 5%, well below the bottoms-up company analysts' estimates which calls for 10% growth; our expectation is that growth may fall well short of both of these estimates. European tail risk, a toxic US political landscape and Chinese "hard landing" fears have not abated, simply evolved.

U.S. property companies are also likely to suffer from above average earnings disappointments. Early 2012 guidance announcements have largely surprised to the downside, with 55% of the property companies that have given 2012 guidance falling short of consensus estimates, primarily in the office and shopping center sectors. This trend is likely a function of both overly optimistic analyst assumptions, as well as some conservatism by management. FFO growth expectations for 2012 are currently 9%, which may prove aggressive, the opposite of our view a year ago for 2011 when we anticipated estimates would come in ahead of the Street. There will of course be some bright spots in 2012 earnings growth, specifically the cellular towers, apartments, storage and high end retail. Furthermore, taking a second look at bruised emerging markets (e.g. Brazil) becomes more logical as the slowdown drags on and the prospects for growth in the developed markets become bleaker.

Figure 3: Western European Cap Rates Maintain a Large Spread Over Sovereign Yields, But Real Estate Values Will Still Likely Fall Short-Term



Note: Cap Rates are for Western European office, Sovereign yields are 10 year maturities.
Source: Kempen & Co.

Data through 12/16/2011.

LANDandBUILDINGS Background:

Jonathan Litt is the Founder and CEO of LANDandBUILDINGS, a long/short investment firm that actively invests in securities of global real estate and real estate related companies. Prior to LANDandBUILDINGS, Jonathan Litt was Managing Director and Senior Global Real Estate Strategist at Citigroup where he was responsible for Global Property Investment Strategy from 2000 to March 2008. Jonathan Litt led the #1 Institutional Investor All American Real Estate Research Team for 8 years and was top ranked for 13 years while at Citigroup, PaineWebber and Salomon Brothers. Craig Melcher, Co-Founder and Principal at LANDandBUILDINGS, was a key member of the Citigroup team. Land & Buildings Investment Management is a Registered Investment Adviser with the SEC.

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