

# GLOBAL PROPERTY MARKETS

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In this review we consider two topics:

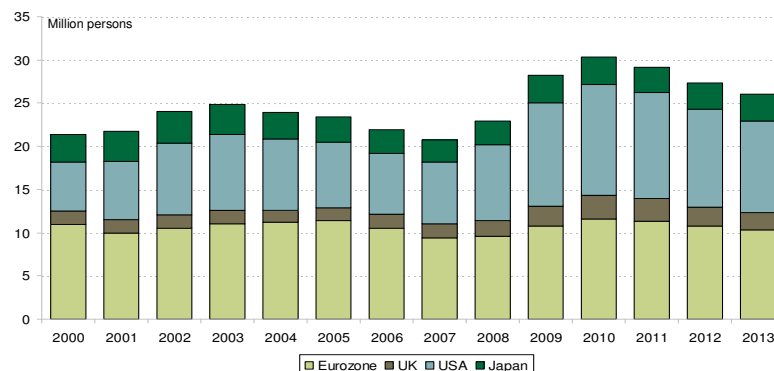
- The economic outlook
- When and where to invest in a post-crisis world?

## The Economic Outlook

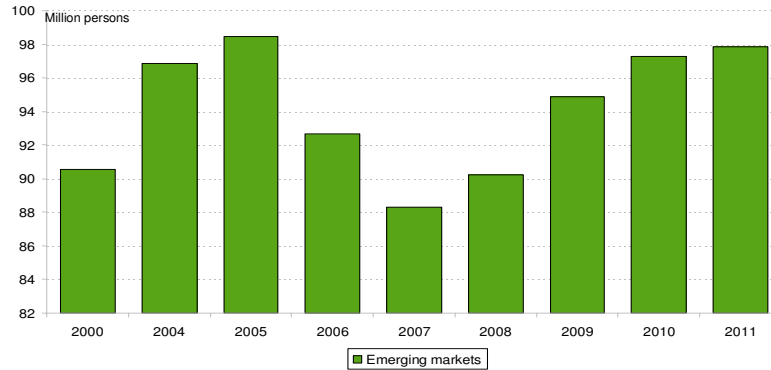
Current conditions are atrocious

- So far banks, mortgage lenders and insurance firms have written down US\$790bn (2.7% of US and Eurozone GDP). It is estimated that a further \$1.2trn of write-offs need to be made (4% of US and Eurozone GDP) so the global banking crisis is far from over, even if it is being effectively managed;
- Falling consumption and investment in the OECD, caused by falling asset prices and a huge loss of confidence, means that global GDP will fall by around 0.5% in 2009. This might not sound much but it is the first fall in global GDP since 1945;
- Surveys indicate that world manufacturing output will fall by around 15%. Investment therefore is collapsing: new orders for capital goods were down 24% year on year in Germany, new machine tool orders down 30% on the previous year in the US and 15% in Japan;
- Loss of consumer demand in the OECD is hitting all of the export orientated emerging markets very hard. Export growth in China has slipped to -2.1% year on year in November from 21.7% at the end of June;
- Over the next three years more than 18m workers will lose their jobs in the OECD and emerging economies (Charts 1 and 2)

**Chart 1: Unemployment in the OECD**



Source: Global Insight

**Chart 2: Unemployment in emerging markets**

Source: Global Insight

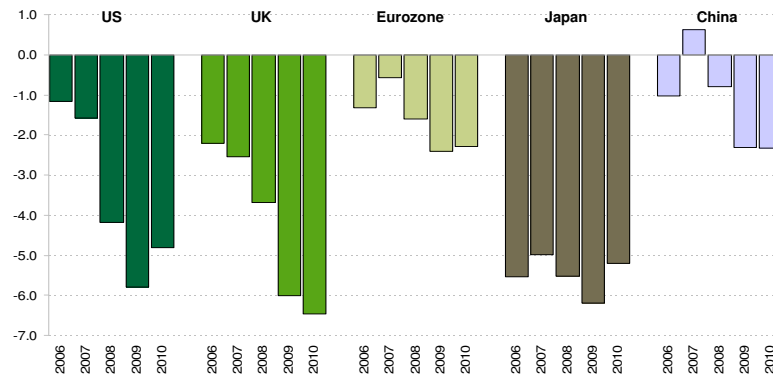
The policy response is huge – and it will probably succeed.

- OECD official interest rates have been lowered to emergency levels as quickly as at any time in history. Some further cuts will be made in 2009 (Table 1). So far this has had only a limited impact on consumer and business interest payment and credit availability but conditions should ease in 2009

**Table 1: Policy Rates**

	End 2007	End 2008	End 2009	End 2010
US	4.50	0.25	0.50	1.96
UK	5.50	2.00	1.00	2.50
Eurozone	4.00	2.50	1.75	2.00
Japan	0.50	0.10	0.10	0.75

- Banks have been recapitalised to the tune of US\$3 trillion (20% of US GDP) with additional funding available. Increasingly Central Banks will resort to 'unconventional' monetary policy (i.e. what you do when interest rates cannot be cut further – quantitative easing). Central banks will expand their balance sheets to provide reserves (cash) to commercial banks. There are some doubts about whether these additional reserves will be used to create business and consumer credit.
- Governments are massively increasing their levels of direct spending in the economy (the US fiscal boost is equivalent to 5.5% of GDP, in China it is 14%, Japan 4.5%, Europe 1.5%). Chart 3 shows the deteriorating fiscal position of a number of OECD countries. A key issue in 2009, for the long term, will be the extent to which central banks buy government debt. This is printing money and it is potentially highly inflationary.

**Chart 3: Fiscal balance as % of GDP (2006-2010)**

Source: Global Insight

- An economic boost of this magnitude will probably have an effect: the key question is when? Our best estimate is that the US economy will begin to respond in Q3 or Q4 2009 with the UK and Asia lagging by three to four months. The Eurozone will only start to recover in 2011 due to the weakness of its policy response and the sluggishness of its labour markets.

Where does this leave us?

- The levels of uncertainty around economic forecasts at the present time are extremely high, so it is best, to think in terms of scenarios:
- **Base case (70%).** Generalised OECD growth resumes in early 2010, albeit weakly, but unemployment continues to rise into 2011. Real estate fundamentals start to improve only in late 2011 but investment demand six to nine months earlier. Taxes up, regulation up, sluggish credit growth, sluggish consumption growth. Inflation is around target.
- **Downside 1: Apocalypse now (20%).** Policy fails. Consumers and businesses hoard cash and unemployment surges. Asset values fall further and remain depressed. Social disruption and political unrest, particular in emerging markets but also in OECD countries. Deflation sets in. Conditions similar to Japan's lost decade, without the social stability. Sovereign defaults (UK, Ireland, Spain, Italy, Russia, Argentina, Korea).
- **Downside 2: Apocalypse delayed (10%).** Weak growth resumes in 2009 but by early 2010 US growth is surging: world growth follows. Inflation picks up strongly in 2011, rates rise and recession ensues. Asset markets reflate in late 2009, growth strongly in 2010 and crash again in 2011.

# Where and when to invest in a post-crisis world?

## Introduction

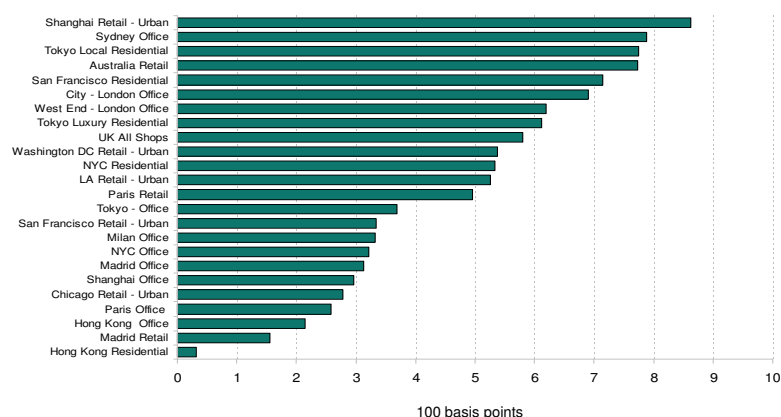
This uses some recent research into market level hurdle rates to provide insights into global investment strategy.

- Grosvenor Research monitors more than 80 property markets around the world. Local rental growth and yield shift forecasts are then used to generate 5-year IRR forecasts. These are updated biannually.
- Over 2008 we have developed a hurdle rate methodology to estimate target returns (or hurdle rates) at the market level for the 80 markets we monitor. Brief details of the approach are in Appendix 1.
- In this paper we have combined the projected IRRs with the hurdle rates to provide an indication of which will be the first markets to provide above target returns.

## Results

Chart 4 shows a selection of market level IRRs as at December 2008 to indicate the range. The average 5-year IRR across all of the markets is 4.15% p.a. This indicates that, in general, real estate investment is an uneconomic proposition. This said, Shanghai retail, Tokyo residential, Australian offices and Australian retail are expected to be leading performers over the period. UK markets are also expected to provide a respectable performance over the next 5 years. Among the worst performers are US offices, Spain, Hong Kong and Shanghai residential.

Chart 4: IRRs Dec 2008-Dec 2013



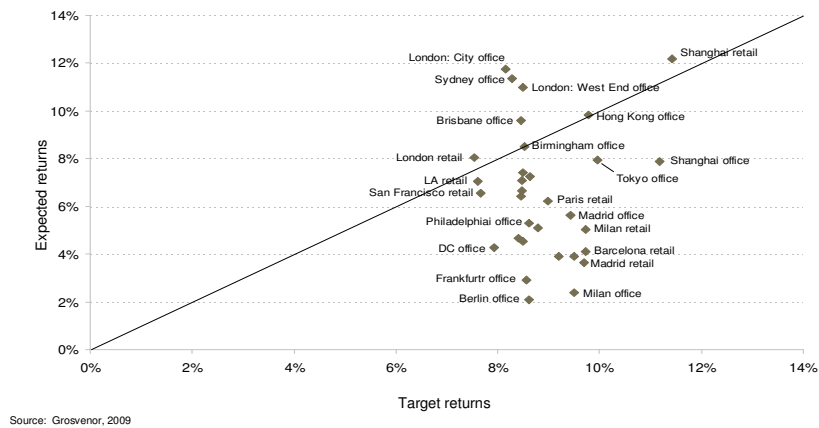
Source: Grosvenor, 2008

In Chart 5 we show the expected 5-year IRRs vs. the target rate of returns for some selected markets. The solid line divides the markets expected to deliver a return above their target rate (those above the line) from the markets expected to deliver a return below their target rate (those below the line) over the next five years. As most of the markets are expected to experience further outward yield shift and declining rents, they are generally found below the line.

**Chart 5: Target returns vs. expected returns  
End 2008 - end 2013**



**Chart 6: Target returns vs. expected returns  
End 2009 - end 2013**



In order to estimate where we will be in one year's time, we have calculated the IRRs assuming purchase 12 months from now. These IRRs are compared against target rates in Chart 6. As the period between end-2008 and end-2009 is excluded from the forecast, the average IRR improves to 6.05%, as more positive rental growth is included at the end of the period and there is no more outward yield shift. As a result, a few markets move above the line. The best of these are

- City of London office
- Sydney office
- West End office
- Brisbane office
- LA retail
- Shanghai retail

## Conclusions

Economic and investment fundamentals will be under strong pressure in most property markets this year. As a result, we do not see any scope for investment activity in 2009.

Even at the end of 2009 the general case for investing in real estate will remain weak. However, projected IRRs will improve for a few markets. The markets that develop positive risk-adjusted cash-flows first are the UK, Asia and Australia.

By calculating target rate of returns, based on the methodology outlined in Appendix 1, we can place projected market level IRRs in an explicit and accessible risk adjusted framework. Comments on the methodology are welcome.

## Appendix 1: Generating market level target rates of return

We have made the following assumptions in developing the hurdle rate model<sup>1</sup>:

- All real estate investment involves risk;
- Non-risk free asset classes have risk premia over the risk free rate;
- An appropriate proxy for the risk-free rate prevailing in a country is the country's 10 year Government bond yield;
- The risk premium for holding real estate is the sum of country risk and property risk, the latter made of both market and sector components.

Hurdle rates are estimated on the basis that:

Real Estate Risk Premium = f (Country risk; Transparency Risk; Liquidity Risk; Business Risk; Depreciation Risk; Income Risk)

Very briefly the main components of the hurdle rates are defined as follows:

- **Country risk:** A country's risk can be roughly divided into two components, economic performance and political risk. An analysis of these factors will produce an overall measure of country risk with countries being typically depicted as being least risky in relatively mature and stable economies such as the US, UK and Western Europe, through to emerging economies of Central and Eastern Europe, Mexico and parts of Asia, and the riskiest underdeveloped countries such as sections of Latin America and parts of southeast Asia. Comprehensive risk scores are available from New York University;
- **Transparency risk** is often mentioned by property investors as a potential additional risk when investing in countries characterised by scarce information on transactions, legal issues, lack of performance indices, valuation issues, etc. Jones Lang Lasalle has created an annual global Transparency Index for property investors;
- **Liquidity Risk** is associated with the uncertainty of exiting an investment, both in terms of timeliness and cost. The indicator we created is a measure that takes into account both the size of the local investment market against the size of the global market and investors' accessibility of the local market by comparing the transacted to the investible stock;
- **Business risk** is the variation in cash flow from one period to another that causes greater uncertainty and leads to the need for greater compensation for investors. The business risk of real estate markets has then been proxied by measuring the standard deviation of long-run market rents for each market;

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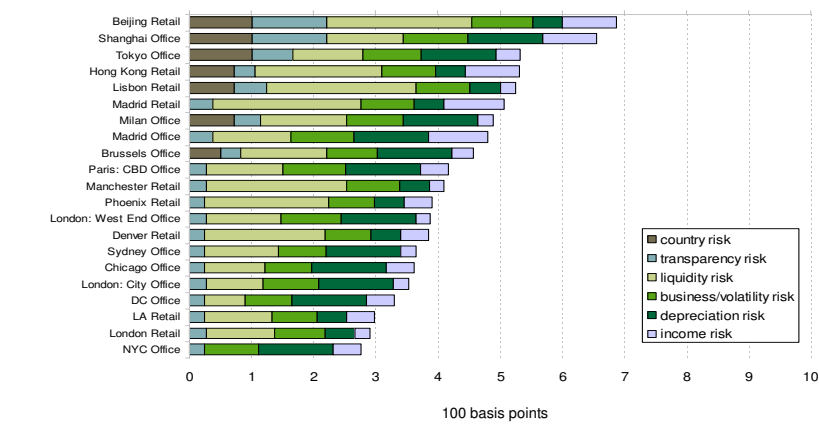
<sup>1</sup> The full paper is available from Maurizio Grilli.

- **Depreciation risk** is the loss in value of an asset/building over time due to wear and tear, physical deterioration and age. It is assumed that the depreciation estimates are based on the following components: land value, lease length and new supply volatility;
- **Income security risk** is based on typical lease lengths for the specific sector, rent guarantee period, recovery of insurance cost from tenant and other variables. Typically, we assume that the longer the contract, the lower is the risk of losing income.

Calculating market level hurdle rates involves scoring each market according to each element of risk and then converting these scores into the risk premium. Finally, the risk-free rate is added to the risk premium.

The risk premia for the markets in the analysis along with their constituent parts are illustrated in Chart 7.

**Chart 7: Real estate risk premia**



Broad conclusions for the analysis are that:

- The overall risk premium for real estate ranges from a minimum of 240 basis points, to a maximum of 690 basis points in the long term.
- There is a broad regional pattern with the overall risk premium lowest in the US and highest in Asia.
- The UK has the second lowest overall risk premium among all countries analysed.
- On an un-weighted basis, the average global real estate risk premium should be around 425 basis points above the risk-free rate.
- This is broadly consistent with Grosvenor's WACC. Our current average global hurdle rate is 8.8%, while Grosvenor's WACC in 2008 was 8%.

## Appendix 2: Generating market level IRRs

5-year IRRs are computed for the markets where Grosvenor is either active or has a potential interest. The IRR calculations are made by using an in-house cash-flow model for each of our markets. Cash flows analysis is updated every six months and incorporated, among other things, into the bi-annual IGIPST Strategy report and the mid-year Capital Allocation report.

Markets to be included and/or excluded in this analysis are normally chosen by both GFM and the OpCos local team. Group Research reviews the markets before starting the process, making suggestions about possible inclusions and/or exclusions.

For each of the input worksheets, the local OpCos researcher fill in the current market data in the following sections:

- Basic Assumptions on rents, yields, lease terms and rent review structure;
- Costs and reletting assumptions;
- Rental growth forecasts (5 years);
- Yield forecasts (5 years).

The forecasting process is then followed by a discussion between Group Research, the local OpCos and GFM in order to understand the dynamics of the results and to guarantee consistency a cross markets.

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