Credit Crisis Has Weakened Global Property Fundamentals

BY SIMON RUBINSOHN

A STRIKING FEATURE OF THE RECENT FLOW OF MACRO DATA IS how the downturn in those economies most directly affected by the credit crunch has spread across the rest of the globe. No longer is there any hiding place, even if a country's banks have been largely untouched by the whole subprime debacle. As consumers rein in their spending and importers seek to reduce inventories, economies that rely heavily on trade to drive growth have experienced a dramatic shock. This impact has been felt most heavily in Asia, with Indonesia seeing exports cut in half over the past twelve months, and Taiwan and South Korea suffering almost as badly. It has, however, also been visible elsewhere with Germany, in particular, taking a big hit as sales of high-end capital goods have ground to a halt.

The worsening global economic picture has, not surprisingly, also been increasingly visible in the real estate market. For much of 2008, while commercial property values were sliding in large parts of the advanced world, real estate in many emerging economies seemed to be largely immune from these problems. Prices were continuing to rise, investors still had the appetite to invest, and rents were being underpinned by healthy tenant demand. That, however, all changed in the latter part of last year.

Market developments in global commercial real estate markets are now clearly reflecting wider macroeconomic forces. In those countries where consumption is the main driver of economic growth, supported in the past by easy access to credit and rising equity and house prices, consumer confidence has been shot and spending is falling. Given the collapse in final demand, manufacturing output is falling in those counties where exports are the main driver of growth. Falling consumption and industrial production is now resulting in a global labour market adjustment. Rising unemployment is feeding back in each country's domestic sphere, in turn impacting on its service sector, and prompting further job losses. As the vicious cycle continues, no part of the commercial property market has remained immune. Falling consumption is hitting the retail sector, falling manufacturing output is hitting the industrial market—and weakness in both of these areas, combined with the fact that the global financial sector is virtually on life support—is now weighing on the office market.

The latest *RICS Global Commercial Property Survey* has just been released, and it predictably makes for fairly grim reading. What it clearly shows is that the synchronised nature of the downturn in the global economy has resulted in a synchronised downturn in global real estate markets. On the occupier side, the survey shows that rents now are falling, even in those parts of the world

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which previously were seen to be showing a fair degree of resilience, including the Middle East, Emerging Asia and Emerging Europe. Rents fell across more than 90 percent of the countries surveyed, with the greatest downward pressure occurring across parts of Asia. Taiwan, Hong Kong, Singapore and India were ranked in the bottom five for rental performance, as the collapse in world trade has damaged export earnings and business confidence. In the previously resilient Eastern European markets, the collapse in lettings activity and worries over financial instability have raised fears that income streams to landlords are likely to come under significant pressure, creating a rise in bankruptcies, prompting growing voids and tenant default.

In the four largest economies that make up 80 percent of the Euro-area economy—Germany, France, Italy and Spain—unemployment is now rising. This is depressing consumer confidence, private consumption and ultimately, retail rents. In Spain, where the labour market adjustment is at a more advanced stage than in the other major economies (unemployment is 14.8 percent), retail rents are falling the furthest. Meanwhile, in Germany, where the labour adjustment has only just begun (unemployment is 7.3 percent), retail rents were still rising in the latest quarter. That said, even in Germany, rental expectations in the retail sector have now turned negative.

As a result of the sinking occupier market, rental expectations are now negative across all world regions, with weaker occupier demand likely to lead to further rises in available space and looser market conditions across all emerging and developed markets. In Western Europe, rental pessimism is bleakest in Ireland, Portugal, Spain, Belgium and the UK. Germany remains a relative outperformer, with less negativity towards both rents and tenant demand as available space continues to decline.

On the investment side, price declines continue at a record pace in Western Europe, driven by steeper drops in the retail and industrial markets, which have overtaken the office sector in terms of weakness. The sharpest falls were registered in Ireland, Luxembourg and the Scandinavian countries. Cyprus was the only European market to resist the negative trend. In the United States and Japan, sharp declines in economic activity have taken their toll across all three sectors of the commercial property market. The U.S. retail market and Japanese office sectors are expected to see the largest downward price adjustment in the coming months as rising unemployment and declining output growth weigh further on investor sentiment. The tide also has now turned in China, with respondents reporting declining capital values despite recent announcements of a huge fiscal stimulus plan to the tune of 10 percent of Chinese GDP (the largest fiscal plan of any individual country as a share of GDP).

Hungary, Poland, Ukraine and Turkey reported price declines at almost double the pace of the preceding quarter. Recession and tough financial conditions are knocking at the door across many Eastern European countries with worries over a systemic crisis across the region gaining traction in recent weeks. No early recovery is expected in terms of deal activity, with transactions expected to fall further from an already anemic level. In Russia, a country also reeling from the oil declines and a plummeting currency, worries over macro stability have weighed further on investment sentiment, sending capital values lower for the second consecutive period.

Whilst the commercial property industry will remain in the eye of the storm during 2009, opportunities now are emerging for those with capital to invest. The correction in developed markets is well underway, pushing yields up sharply in relation to some less mature and transparent property markets. Relative pricing may start to attract interest in the developed economies, with transaction activity expected to slowly pick up, although pricing will continue to slip amid declines in achievable rents. Furthermore, the opportunity to acquire prime performing assets should increase as companies come under pressure to raise cash quickly to repair over-leveraged balance sheets.

In the coming months, expect to see the downturn in emerging markets gather pace, as a result of the withdrawal of capital from higher risk markets and renewed instability. Countries with a high level of external financing needs will be in the spotlight amid signs that many banks will be focusing on domestic concerns as a priority. As such, a refinancing shortfall across the industry will see a greater numbers of distressed assets hitting the market during 2009. Whilst this may stimulate deal activity from recent lows, inevitable declines in pricing will continue. ■