# The Surprises of International Real Estate

*The recovery from the global financial crisis will be more like running a marathon than a sprint.*

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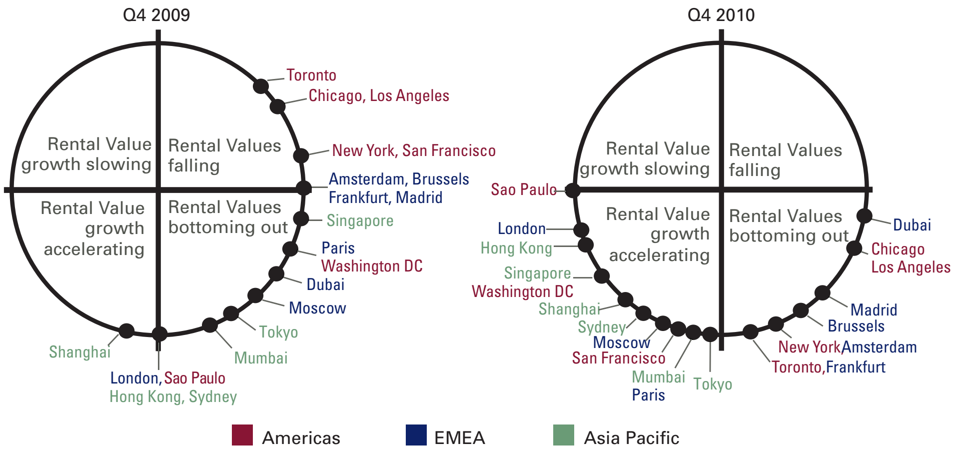
THE MAJOR REAL estate markets of the world are recovering at very different rates from the global financial crisis. The IMF has used the term "a multi-speed recovery" to describe the contrasts in country-by-country macro indicators. The richer G-7 countries, with the most highly developed real estate markets, are expanding in a "low-low-low" fashion characterized by low growth, low interest rates, and low inflation. In contrast, emerging markets in Asia and in Latin America are in a "grow-grow-grow" environment—where higher economic growth, rapid urbanization, higher inflation, and rising interest rates predominate. Real estate investors must adjust

**Figure 1:** Prime offices–Rental cycle clock




Source: The Jones Lang LaSalle Property Clocks SM as of Q4 2010

their strategies to address these very different circumstances.

This "multi-speed" description is also apt for the underlying fundamentals of the world's major property markets. Office rents, for instance, are rising rapidly in Hong Kong and London, but they are still bumping along the bottom in Chicago, Frankfurt and Madrid (Figure 1). Commercial real estate markets around the world fell together in close synchronization, but they are recovering at very different rates.

Multi-speed is not, however, a very accurate description of the global real estate capital markets. Capital markets in nearly all the major economies of the world have recovered at a high speed and faster than many expected. In most countries this capital market recovery is aimed at a narrow range of the market—fully leased, dominant assets. The depth and the breadth of this capital market recovery is remarkable.

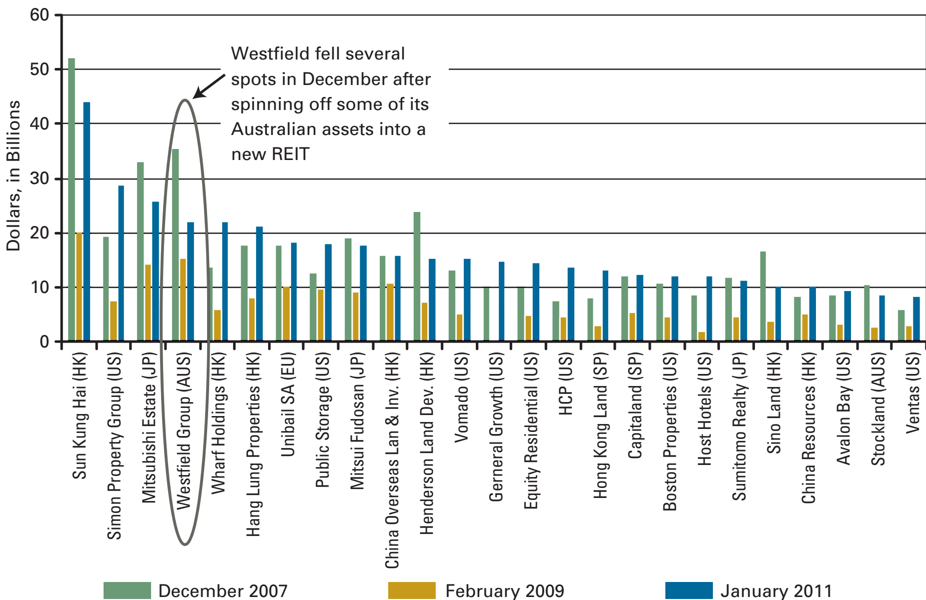
Intense bidding for iconic assets is back again in the direct purchase markets of London, Paris, Hong Kong, Shanghai, Beijing and Singapore. Lenders are also competing to place senior debt on these dominant assets in these same markets. In the securitized markets, strong issuance of debt, equity and preferred equity is taking place by large-cap REITs and REOCs around the globe. The share prices of Hong Kong-based real estate companies were 55 percent above their pre-crisis peak as of January 2011. All G-20 countries have experienced a capital market recovery that is much stronger than their recovery in fundamentals. Capital markets are very focused on prime assets in Tier I cities, but an extension to Tier II cities can be expected in 2011.

The world of commercial real estate, like the financial markets in general, has been filled with surprises. A brief article cannot do justice to all the amazing recapitalization stories that unfolded in both the listed and the private equity markets over the past two years. In fact, many of these “re-cap” deals are still under way as the entire industry de-levers and, in some cases, re-levers. Byron Wein, the chief strategist for many years at Morgan Stanley (and now with Blackstone), produced an annual list of top surprises to get his clients thinking harder about the year ahead. This “top ten” format works well to re-cap the major trends in international real estate markets and to provoke deeper thinking about their future. The first list (past and present) contains items that are no longer really a surprise for anyone who follows international markets closely. But, they would have made a shocking list of predictions just a year or two ago. Today, this list is only mildly surprising, since it consists of undisputable facts. The second list (the future surprises) should provoke readers to see how a U.S.-centric view of the world and of real estate may be changing.

## TOP TEN SURPRISES, 2009 TO 2010

1. The largest listed real estate company (by market capitalization) is now in Hong Kong. Asia Pacific now also

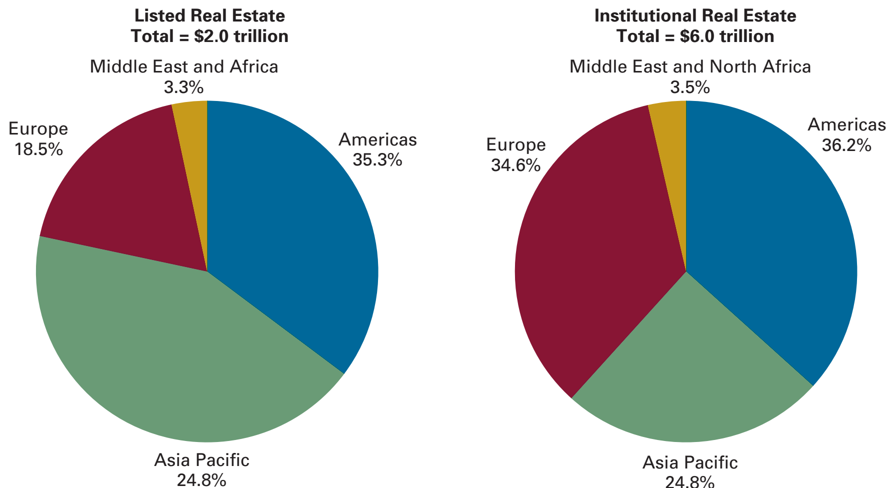
**Figure 2:** Many of the world’s largest public real estate companies are based in Asia




Source: Bloomberg as of 4 January 2011

contains the largest segment of the listed real estate universe and seven of the top ten market cap companies in the world are based there (Figure 2). The Asia Pacific region is also the most rapidly growing component of the total investable universe and its total transaction volume was higher than any other region in 2009 and 2010 (Figures 3A and 3B).

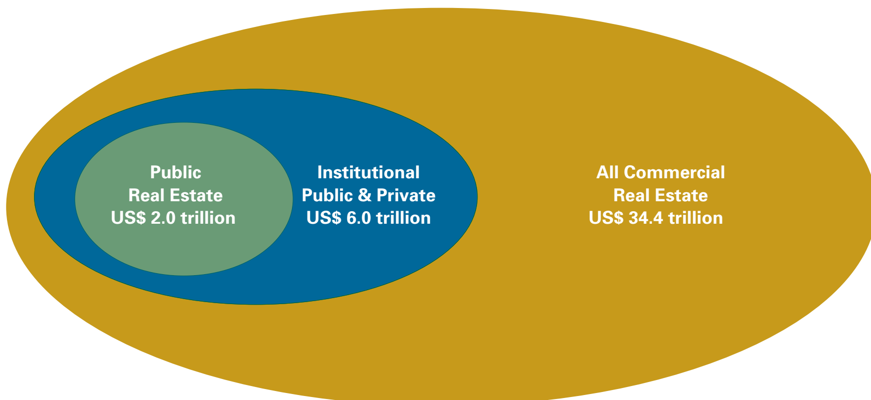
**Figure 3A:** Real estate market cap by region 2010




Source: Investment Property Databank, LaSalle Investment Management. As of 3Q 2010.

Note: The Listed Real Estate Universe includes all publicly listed property companies, primarily REITs and REOC. Diversified development companies are included in emerging markets, but homebuilders are excluded. The Institutional Real Estate Universe includes all institutional investor-owned property, public and private.

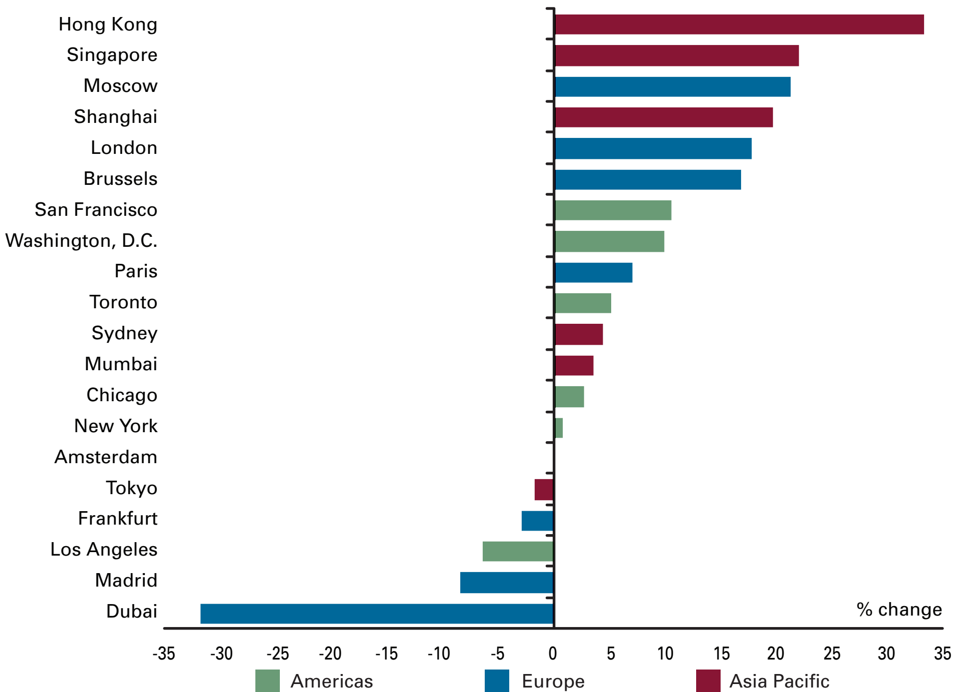
**Figure 3B:** The real estate investable universe 2010




Source: Investment Property Databank, LaSalle Investment Management as of 4Q 2010

2. China led the world in transactions completed in 2010 with just under $200 billion in deals done or 34 percent of the world's total last year. The Shanghai office market experienced the greatest cap rate compression of any major market between 2003 and 2011 (falling from 10 percent to 5 percent).
3. Western European vacancy rates hardly budged during the Global Financial Crisis. Perhaps this is not so surprising given the labor laws, especially in France and Germany.
4. The London property market fell first and furthest during the financial crisis. It then rebounded ahead of any other western market. Private equity indices show that the UK market fell 45 percent (unleveraged) and then bounced back by nearly an equivalent percentage (Figure 4).
5. Of the world's major economies the two that suffered the least problems in their commercial real estate lending were Brazil and Canada, but for very different reasons. In Brazil, commercial real estate suffered from a severe credit shortage while the rest of the world binged on credit. Brazil's tenant-friendly leases tend to dampen

**Figure 4:** Prime offices—rental change, 2009-2010




Source: Jones Lang LaSalle, January 2011. Local currency

the enthusiasm of asset-backed lending using real estate as collateral. In Canada, the banking system was less highly levered, more conservative in its approach to lending and more tightly regulated by the Bank of Canada.

6. Major markets still to hit bottom in terms of pricing and occupancy in early 2011 can be found in Dubai, Spain and Ireland. These were three of the fastest-growing markets in EMEA during the last twenty years, but they have fallen precipitously.
7. The markets where transparency is rising the fastest: Turkey, Poland, and the Tier II cities of China (such as Chengdu and Chongqing) as measured by the Jones Lang LaSalle Transparency Index.
8. The markets where real estate transparency is falling: Pakistan, Kuwait, and Venezuela.
9. Australia is now the world's most transparent commercial real estate market. The United States is tied for fourth place with three other countries.
10. High levels of transparency did not lessen the collapse of the real estate capital markets during the financial crisis. High levels of transparency, though, do seem to be associated with the speed of recapitalization and re-opening of the transaction markets.

## TOP TEN SURPRISES FOR 2011-12

1. *China, Brazil or India will not be the top performing investment markets (risk-adjusted).* Even though these three markets will likely lead the world in terms of new construction of residential and commercial real estate over the next two years, all three are likely to experience rising interest rates ahead of the rest of the world. And all three are already awash in capital from both domestic and international sources. This combination is interesting for fee-generating developers and construction companies. It is not so great for medium- to long-term investors in standing assets.
2. *The top performing investment markets will turn up in one of the low-low-low countries.* This prediction applies to any market where interest rates remain stable and low; yet domestic sources of capital are sidelined and cap rates are at or near an all-time high spread versus the cost of senior debt borrowing. Likely candidates include Germany, Poland and Japan. Tough reserve requirements are proposed by the so-called Solvency II (European insurance companies) and Basel III (international banks) guidelines. The proposed changes create interesting capital gaps around the world that

need filling—even if only temporarily. Stable income, leveraged with low-cost debt, produces strong performance, even in a low-growth country.

3. *The world's largest pools of capital today—sovereign wealth funds (SWFs)—will move markets in surprising ways.* In pursuing geo-political objectives, alongside investment objectives, SWFs may invest more heavily in the real estate of countries that generate a steady flow of commodities and natural resources. Target countries might include an interesting mix of established and frontier markets such as Australia, Brazil, Canada, Indonesia, Malaysia, Nigeria and South Africa.
4. *The fastest-rising pools of capital are those generated by the rising middle class in Emerging Markets (EMs) as they purchase insurance products and start saving for retirement.* But, these pools of capital will likely have very low interest in the real estate of the G-7. Just as insurance companies and pension funds in Europe and North America stuck to their domestic markets at first, these EM pools are likely to focus on their domestic markets for the first ten to twenty years of their growth trajectory. This will put EM pricing for stabilized assets even further out of reach for cross-border investors.
5. *Euro-zone theatrics create buying opportunities.* Even though there is no doubt that the European demographic and long-term economic growth numbers are depressing, investors who thrive on distress will find plenty of it in southern Europe over the next two years.
6. *Mexico looks interesting again, despite its bad press.* Mexico is likely to grow at a 4 percent to 5 percent annual rate over the next two to three years. And domestic sources of capital (including pension funds and REITs) are going to push Mexican cap rates down as they grow in importance. Violence and security issues in Mexico affect the economies of a relatively small handful of cities in the border markets.
7. *Fully-indexed leases will attract capital looking for inflation protection in France, the UK and Latin America.* Although such leases are rare in the United States, they can be found in these countries.
8. *Mezzanine lending out-performs equity in Japan, the UK and Continental Europe.* For the same reasons outlined in Surprise No. 2.
9. *Sustainability and energy conservation—already central to real estate investment decisions in Western Europe, Australia and Canada—become central to investment decisions in the emerging markets also.* In a multi-speed recovery, the cost of energy can only increase. Real estate is by far the largest consumer of non-renewable energy of any industry sec-

tor in comparison to manufacturing, transportation and agriculture. Many other parts of the developed world are already well ahead of the United States in eliminating the profligate use of energy in buildings. The big surprise over the next two years will be that China, Brazil and India are also poised to pass up the United States in making energy efficiency and sustainability a major priority. And since they will be building a higher proportion of their stock relative to the whole (Figure 5), they will be in a better position to surpass the United States in energy efficiency before the decade is through. That is because it is much easier to build an energy-efficient building from scratch than to retrofit an existing, inefficient building.

10. *The United States maintains its position as the world's largest repository of real estate wealth, but it loses market share at a rapid rate.* To paraphrase author Fareed Zakaria, this is not a case of the "decline of the west," but a case of the "rise of the rest."

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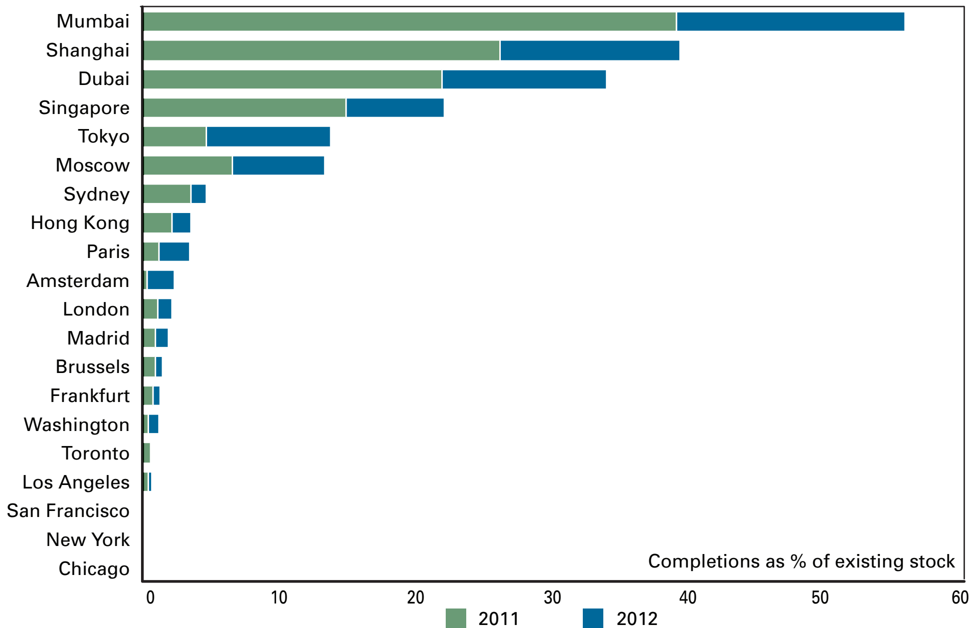
**Figure 5:** Office supply pipeline in major metro markets, 2011-2012




Source: Jones Lang LaSalle, January 2011.

thon than a sprint. The persistence of global imbalances, massive government deficits, deleveraging in the private sector, trade imbalances, and currency wars (perhaps leading to protectionism) are confounding factors that will contribute to a global recovery unlike any ever experienced before. The multi-speed recovery is no longer a great surprise. The implications of an emerging-market-led recovery, though, will lead to surprises. The second list of future surprises is surely not 100 percent accurate. But it will have served its purpose if it gets readers thinking about how real estate might perform in a multi-speed world.