Pearls and PIIGS

EUROPE'S COMMERCIAL PROPERTY MARKET REVIVED LAST YEAR AND THE OUTLOOK IS GOOD – EXCEPT FOR THOSE COUNTRIES CAUGHT IN THE SOVEREIGN DEBT CRISIS. **GRAHAM BUCK** REPORTS.

While the revival in the UK's commercial property market has been an uneven one (see Hot Spots and Cold, The Treasurer, April), DTZ's recently issued report on the prospects for Europe as a whole, Money into Property 2011, adopts a markedly upbeat tone.

The property consultant reports that European real estate markets "turned the corner" last year and expresses confidence in the improved trend being maintained in 2011. DTZ cites recent research suggesting that globally there is $986bn of capital available for investment in commercial property over the three years to 2014. The EMEA region (Europe, the Middle East and Africa) accounts for 35% of that total ($340bn), of which around $140bn will go to Europe.

This should translate into more European deals than anywhere else in the world, as banks attempt to dispose of their lower-grade properties and purchasers find access to funding easier.

While countries affected by the sovereign debt crisis have fallen out of favour with commercial property investors, this is more than offset by strong growth in the main markets of Germany, France and the UK. DTZ's most recent market update shows that investment in commercial real estate across Europe totaled €25.4bn in the second quarter of 2011, which is a 14% increase on the first quarter total of €22.4bn. Investment volumes over the four quarters Q3 2010 to Q2 2011 averaged €27.1bn, against €20.7bn a year earlier. DTZ forecasts that volumes for 2011 as a whole will reach €123bn.

The positive tone tallies with data from Jones Lang LaSalle (JLL), which forecasts an even higher total of €135bn as the volume of equity targeting European markets continues to grow. This figure would represent a 30% rise on the 2010 total of €102bn.

Robert Stassen, head of EMEA capital markets research for JLL, reports that expectations of fire sales by distressed sellers have mostly been disappointed, which has confounded some of the opportunistic investment funds. Banks have carefully managed their portfolios, rolling over loans as they refocused on interest cover ratios rates rather than loan to values (LTVs) in order to avoid setting a downward spiral in asset pricing.

Some commentators have disparagingly referred to this practice as "extend and pretend", whereby properties with imminent loan maturities worth less than the current loan balance can usually have their loan maturity dates extended. The reasoning is that the extension period provides more time for the properties to recover their value and for the loans to be successfully refinanced.

With banks having used the past two years to analyse their property portfolios and exposures, Stassen sees them now selectively

selling assets in liquid markets to reduce their exposure, while the less liquid parts of their portfolios will be retained and the assets managed. He points to Ireland's state-run National Asset Management Agency (NAMA) as a prime example of an institution that has worked its portfolio and has now started to actively implement its workout plans.

INVESTOR CONFIDENCE DTZ reports that two in three investors are confident that they will increase their net investment during 2011, with most encountering few – if any – problems in obtaining debt finance.

The most recent figures suggest that the majority of this money is currently being directed at two sectors – offices and retail premises – with a relatively small 7% going to investment in industrial properties.

Although the credit currently available still falls short of covering all of the property debt maturing through to 2013, the gap has narrowed by 6% since last November thanks to a combination of rising prices and banks making provisions for bad loans. DTZ now estimates a European debt funding gap of $118bn over the next three years.

The continuing improvement in Europe will be assisted largely by the readiness of financial institutions other than banks – primarily insurance companies and pension funds – to lend around €60bn to the sector, according to the group. DTZ bases the figure on the likelihood that the total of $24bn already allocated will have more than doubled by 2014.

INSURERS MOVE IN "Activity is reviving as banks and borrowers work together to address the issue of distressed debt," says Nigel Almond, DTZ's associate director of real estate strategy. "Insurers are investing in a big way – driven partly by Solvency II, as the capital charge for commercial property loans is less than that for capital investments. Axa and Allianz are among those demonstrating a keenness to lend."

At the start of 2011, the real estate investment management division of French insurer Axa raised €350m for a fund to provide debt to commercial property, in response to the banks' "very limited capacity to act". It was able to add a further €180m in April.

Isabelle Scemama, Axa's head of corporate real estate finance, confirms that insurers are likely to increase their share of property lending. "The fact that several other insurance companies have recently announced their intention to invest in senior real estate loans, either directly for their own account or via a fund route, further endorses our belief that the European market will evolve towards the US model, where about 30% of commercial real estate transactions are underwritten by insurance companies," she says.

Scemama confirms that return on risk and Solvency II are key drivers in determining where insurers deploy their funds. The level of spread needs to be generous, and currently Europe's commercial property market compares favourably with other investment options, such as the bond market.

"The prime end in particular offers protection against inflation in a period when interest rates are low," she reports. "The UK is particularly attractive at the moment and offers a consistent level of spread. We're also keen on France and the Netherlands, but more cautious on Italy, while Germany's revival has reduced the number of opportunities in its market."

The UK commercial property market has also attracted British insurers. Aviva has moved in, with a focus on properties such as doctors' surgeries, as have Legal & General and M&G.

"A growing number of smaller insurers are following their lead, usually in conjunction with the banks as many lack the same in-house expertise," says Almond.

European property market invested stock by sources of capital

	2007	2008	2009	2010
Private equity	€1,269bn	€1,176bn	€959bn	€1,095bn
Public equity	€194bn	€158bn	€152bn	€172bn
Private debt	€1,408bn	€1,421bn	€1,377bn	€1,388bn
Public debt	€442bn	€500bn	€492bn	€498bn
Total	**€3,314bn**	**€3,254bn**	**€2,979bn**	**€3,153bn**

Source: DTZ Research, Money Into Property: Europe 2011 – Turning the Corner

RECOVERY BLOCKER Europe's sovereign debt crisis has prevented the recovery from extending to every country. DTZ's data shows that European invested stock rose 4% last year, which only partly reversed the decline of 8% recorded in 2009. The average concealed a wide variation for individual countries, though, with increases ranging from 11% for France and 5% for Germany to 1% for the UK and "one notable area of decline" for the PIIGS (Portugal, Italy, Ireland, Greece and Spain), which collectively showed a further 3% decrease following an 8% drop in 2009.

But overall the data showed Europe returning to a more normal situation last year after two successive years of decline, says Hans Vrensen, DTZ's global head of research, who pencils in a further 4% increase in invested stock for 2011.

"The forecast rise is predominantly a result of capital growth value as some CEE markets are projected to reprice," he says. "On the other hand, the contribution to stock growth from the new development pipeline is modest in Europe, in contrast to Asia Pacific where construction is booming."

Almond believes that as the problems of the sovereign debt crisis-hit countries continue, their commercial property markets will continue to lag behind in the recovery. He adds that recovery in the French and German markets occurred later than in the UK, which repriced very quickly, and so still offer investment opportunities. However, in both cases the prime end of the market has already enjoyed strong growth, which means those opportunities are fewer in number than in 2010 and puts the impetus on investors to be selective.

Germany's strong economic performance means that its major cities have joined London in attracting a big flow of money from the Far East as Korean and Japanese pension funds look for safe locations further away from Asia that offer steady yields.

The commercial property markets of Italy and Spain should also be distinguished from those of Portugal, Greece and Ireland, adds Stassen. Both markets are significantly larger, and while the Italian market has been sluggish there has been a steady flow of deals, particularly in the more affluent north of the country where the concentration of wealth and investors particularly favours shopping centres.

Italy has also avoided the construction boom and bust that has characterised Spain over recent years. "Spain's construction sector has suffered from a multitude of problems; prices are near historically low levels and it is difficult to predict when recovery will occur," says Stassen. "However, there is some nascent interest, particularly in prime Madrid office buildings and the better shopping centres."

According to reports, Barcelona's Splau mall and the Marineda centre in La Coruna are among the retail properties on the market, with respective price tags of €200m and €300m.

And while Spain's stricken residential property market saw local banks and cajas invest heavily in speculative developments that have led to heavy losses, its commercial property market is considerably healthier and backed more by foreign buyers and banks that are well positioned to sit out any downturn.

MARKET SHIFTS EAST DTZ has noted that more investors are showing interest in the commercial property markets of central and Eastern Europe, principally the Czech Republic, where yields are similar to Germany, and Poland where there are signs that the flow of migrants is reversing. Poland also bucked economic trends in the EU by avoiding recession in 2009 and recording growth of 3.5% last year.

"Investors were originally risk-averse when it came to these areas, but volumes have started to pick up and some major deals have taken place," says Almond. Large property funds, many of them German, have been involved in deals. Among the biggest was last year's €300m acquisition by CA Immo, owned by UniCredit, of Austrian real estate group Europolis, which has a €1.5bn property portfolio in Poland, the Czech Republic and Hungary.

"Much of this weight of money waiting in the wings was raised during the boom period before 2008," Almond adds. "There is now pressure on investment managers to begin deploying some of it."

However, Stassen adds that investors are still wary of other countries in the region such as Bulgaria, Romania and Serbia, and Hungary's financial outlook remains uncertain after its recent problems.

Other data for 2010 in DTZ's report shows investment transaction volumes in Europe rose by 64%, although this was a little below the global increase of 76%. As the report notes, while this rise recoups most of the decline in 2009 investment levels still remain a long way off the peak years of 2006 and 2007. The improvement reflects more positive signs from leasing markets, a revival in investor confidence and banks starting to come back into the market.

"Recovery in global transaction volumes has been dominated by domestic investment," suggests Vrensen. "But in 2010, interregional transaction volumes increased by 34% following two years of substantial decline.

"This is predominantly non-Europeans investing in Europe, led by international fund managers, focusing on prime, core office and retail markets."

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operations and controls

US PERSPECTIVE

What's eating America?

THE NATIONAL CONFERENCE OF THE US-BASED NATIONAL ASSOCIATION OF CORPORATE TREASURERS TOOK PLACE IN NEW YORK IN JUNE. **PETER MATZA** WENT ALONG TO SEE WHAT IS KEEPING US TREASURERS ON THEIR TOES.

The National Association of Corporate Treasurers (NACT) is the premier organisation for US-based corporate treasurers and is a member of the International Group of Treasury Associations (IGTA). Its members represent companies across the whole spectrum of US business life. The NACT board includes treasurers from international names such as Boeing and Air Products as well as from substantive but lesser known businesses such as Hershey, Eastman Chemical and Ball Corporation. Members work in smaller organisations too, with turnovers as low as £700m.

Much like the ACT, the NACT believes in facilitating the development of corporate treasury and representing its members to the outside world, especially US federal regulatory authorities. The NACT may lack the ACT's formal process of membership by qualification but there is an undoubted seniority in the quality of the members.

The annual conference between 1 and 3 June brought together 75 NACT members and other participants for a series of presentations, panel debates and networking opportunities involving external speakers – bankers, regulators and others – and members. Topics included loan syndications and regulation, about which more later.

The conference kicked off with a four-hour session called Open Forum but which could be equally appositely named Treasurers' Choice. Delegates brought up a range of topics for possible discussion and then voted on the top few for a debate led by the individual making the suggestion. The healthy surprise for your correspondent was the astonishing variety of topics raised by US treasurers both in the level of detail and breadth of subject. Options included leasing, ratings, calculation of WACCs (weighted average costs of capital), ERM (enterprise risk management), Swiss treasury centres and many others.

The leading issues, however, will have a familiar ring for treasurers this side of the Atlantic:

- **Bank relationships**: issues include "wallet" management, the quality of relationship managers (and their turnover), the surprising presence of "investment" banks in lending syndicates, disparate levels of service quality, and transmission banking pricing.

- **Short-term investment**: duration vs risk, the threat to usage from regulatory changes, the use of "dead" cash balances to offset bank service charges, getting to grips with underlying portfolio make-up, "fund of funds" portals and the fixed vs floating NAV (net asset value) debate.

- **Pensions**: legacy issues of defined benefit funds (a good number of which remain open, even to new joiners), estimated (or, perhaps more accurately, hoped for) returns and the accounting impact, liability driven investment (LDI) vs active management (US funds are comfortable with alternative assets) and the quality of consultants and actuaries.

- **Corporate finance**: offshore vs onshore structures, US tax policy, funding international subsidiaries (India, China, EU via Swiss structures), dividend policy and liability management.

Also interesting were some of the issues not mentioned, such as treasury systems, ethics, treasury policy, supply chain finance and export finance. However, like other topics which didn't make the vote for wider discussion, these subjects were vigorously debated during the refreshment breaks. What is critical to the success of the Open Forum is the instigation of "Vegas Rules" – complete anonymity for delegates, enabling very detailed discussion down to the detail, such as basis point costs and sharp evaluations of the quality of individual bankers and other financial advisers.

The lunchtime speaker on the first day was Gary Gensler, chairman of the US Commodity Futures Trading Commission, a key regulator in implementing Dodd-Frank and the regulation of over-the-counter (OTC) derivatives. He discussed the OTC issue at some length, suggesting that the Dodd-Frank rules will not require non-financial end-users to bring their swaps into central clearing or post margin for their uncleared swaps or restrict customised transactions. Many delegates were sceptical and will be convinced only when all the rules are published – a process due to be finished by late 2011 – because the banks may yet "force" clearing because of their own margin/capital charge to corporate clients.

A subsequent panel debate on regulation threw up many more concerns on OTC usage over regulatory competence, the conflicts between regulators and politicians and even specifics such as why FX swaps might be exempted, as proposed by the Securities and Exchange Commission (SEC), but not non-deliverable forwards. In addition, the delegates were worried about SEC proposals over money market funds and leasing finance.

The evening of the first day of the conference was taken up with a visit to the floor of the New York Stock Exchange and dinner in the NYSE boardroom – very enjoyable and informative.

The second morning saw a panel debate involving bankers and then treasurers looking at loan syndications. The discussion was preceded by a presentation from ratings agency Moody's that suggested US corporates (investment-grade and further down the credit curve) were generally in reasonable financial shape and default rates (and credit default swap spreads) had retreated from post-Lehman highs to nearly pre-2006 levels. In many ways, US corporate cash is supporting the rebuilding of US bank balance sheets.

In general, while the impact of Basel III on the leading US banks is a cause for concern, members of the NACT felt that banks were positive on lending, pricing was at reasonable levels and there were sufficient banks wanting to engage to allow an element of competition in syndicate management. In addition, covenant requirements for sub-investment grade borrowers have reduced somewhat over the past two years, which reflects an easing market. One feature of the US market less prevalent in the UK/Europe is that for credits higher than A- it is now standard practice to have credit default swap pricing (usually with a cap and floor) for back-up lines to cover commercial paper (CP) issuance; credits from BBB+ down predominantly use fixed margin grids usually with ratings triggers.

This conference was open to ACT members in the US (and Canada). To engage with the NACT visit its website at **www.nact.org**. In particular the NACT will welcome ACT members who are corporate practitioners to its next event, the 2011 Fall Day of Technical Discussions, on 3 November 2011 at the Hyatt Regency O'Hare, Rosemont, Illinois.

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