Assessing the Impact of the European Credit Crisis

The same mechanisms that led to the crisis in the US were operating in Europe, resulting in the same issues–instability in the financial system, a crisis of confidence and a fall-off in real estate fundamentals.

NAI Global®

Commercial Real Estate Services, Worldwide.

December 2008

Assessing the Impact of the European Credit Crisis

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates

As effects of the Great Capital Strike took hold, stock markets plummeted and the rest of the world began pointing fingers at the U.S.

Italy's Prime Minister, Silvio Berlusconi, blamed a "capitalism of adventurers" in the United States; Gordon Brown, the British Prime Minister, said the crisis had "come from America"; and France's president, Nicholas Sarkozy said, "This crisis was not born in Europe. This crisis was born in America. It is now a global crisis."

But the truth is that the same mechanisms that led to the crisis in the United States were operating in Europe. In fact, according to one commonly used yardstick to measure borrowing, the ratio of assets to equity, European banks employed more than twice as much leverage as their American counterparts.

Regardless of who is to blame, most of Europe is now grappling with the same issues as the U.S.—instability in the financial system, a crisis of confidence in the investment and consumer markets, zero or negative growth (recession) and the resulting fall-off in real estate fundamentals.

Impact on the Financial Sector

As the rest of the world began to feel the effects, European governments took the reins and pledged to inject billions of dollars into their main banks to shore up their financial system. The Americans then followed suit redirecting the original $250 billion from the new Troubled Asset Recovery Program for similar injections.

On October 13, 2008, the UK government pledged that it would inject £37 billion ($64 billion) into three major banks – The Royal Bank of Scotland (RBS), HBOS and Lloyds TSB. RBS was to receive £20 billion ($34 billion), while HBOS and Lloyds TSB were to receive £17 billion upon their successful merger. Barclays, another major UK bank, refused government help saying it will independently raise the necessary £6.5 billion ($11 billion) in capital from private investors.

In return for government investment in RBS, HBOS and Lloyds TSB (effective nationalization of banks), the government owns part of the banks providing it a say in operations, end-of-year bonuses to management, etc. The UK government decided that no senior directors should get cash bonuses this year and that future bonuses are to be paid in the form of shares in order to encourage senior officials to take a more long-term approach with regard to their institutions. In return for the UK government bailouts, the chief executive and the chairman of RBS were forced to resign immediately without severance. Similarly, HBOS' chief executive and chairman are to both step down from their posts, upon successful completion of the merger with Lloyds TSB, again without severance payments.

The UK government also announced a £50 billion ($88 billion) package to prop up eight of the largest banks and building societies in the UK. In return, the government receives shares in these institutions. A further £450 billion will be made available to provide liquidity to the money markets and loan guarantees for banks. This decision was announced after banking shares took a nose dive on October 7, 2008, and fears of recession grew.

"Yet despite the headlines, not all major banks are facing crises. The French bank BNP Paribas, Santander of Spain and Britain's HSBC have emerged largely unscathed."

The UK was not the only country to assist its banks in mid-October. The Belgian government guaranteed bank deposits of up to $136,000 after Fortis, the country's leading bank, was rescued. The bank was taken apart by the Belgian and Dutch governments by selling assets to French bank BNP Paribas only to find that Fortis owned more than €10 billion worth of potentially toxic securities. Fortis saw problems after taking on a huge debt to finance a $100 billion takeover of rival ABN Amro last year.

The German government also stepped in on October 6, 2008, to avoid the collapse of Hypo Real Estate, one of Germany's three biggest commercial real estate lenders, whose outstanding loans exceeded its deposit base by more than eight times. Angela Merkel's government put up as much as $550 billion in German interbank loan guarantees, and up to $110 billion to acquire stakes in other European banks. The funds are guaranteed until the end of 2009, and were approved Friday, October 17, in what was called "the largest financial rescue package in Germany's post-war history." The government also announced that it was guaranteeing all personal bank deposits in the country.

The two biggest Swiss banks, UBS and Credit Suisse, recorded multi-billion dollar losses in early October. UBS's losses were attributed to tens of billions of dollars in American subprime debt purchased in the search for higher yields, making it one of the biggest losers of the sub-prime crisis. Between the Swiss government and the Swiss National Bank, UBS received $5.3 billion in aid, and is able to transfer up to $60 billion of distressed assets to a Swiss Central Bank fund. Credit Suisse was offered aid as well, but refused and raised $8.8 billion from major global investors to avoid nationalization.

"Recent and longer-term indicators reflect the relative stability of the European industrial market, from both a leasing and investment perspective."

In France, President Sarkozy promised he would do whatever it took to prevent the crisis from further worsening. He proposed $55 billion to acquire stakes in French financial institutions and a guarantee of up to $437 billion on interbank loans that would be available until the end of 2009. In order to capitalize on this offer, banks will have to sign an agreement regarding "ethical" obligations, and as a result of the nationalization, the government will have a say in management salaries and end-of-year bonuses.

In Spain, where a violent shake-out in the housing market hit the banking industry, Prime Minister Jose Luis Rodriguez Zapatero announced he would create a $40 billion fund to buy assets to help stabilize the nation's banks and unfreeze credit. The fund can be raised to $68 billion, and will only buy "healthy" assets. Mr. Zapatero does not believe that Spain's banks have a solvency problem, and therefore feels no need to recapitalize banks. On October 10, Spain increased bank deposit guarantees from $27,200 to $136,000.

Iceland was hit the hardest by far, following years of aggressive lending and buying. The economy was near collapse on Monday, October 13, and by Tuesday, the Reykjavik stock exchange had been suspended for three consecutive days. The Icelandic government requested aid from the International Monetary Fund as well as from Russia, the UK, Norway and Denmark. Russia offered a little over $5 billion in emergency aid and the UK offered a $174 million loan from the Bank of England. As potential investors assessed Iceland's financial situation, Iceland had no choice but to use a "swap facility" to receive $273 million each from Norway's and Denmark's central banks. Landsbanki, Kaupthing and Glitnir, Iceland's three largest banks, were nationalized in October and tight restrictions were imposed by the central bank. Imports into Iceland are being prioritized, with the government focusing on food, medicine and oil. The Icelandic central bank stated that it has only enough foreign currency to supply local business imports for less than nine months. As of October 17, 2008, Icelandic banks inclusive of all foreign assets and investments were still frozen.

Sweden, to date, has barely been affected by the crisis, and unlike the other European governments, the Swedish Finance Minister, Anders Borg, did not feel an urgent need to pump money into its banks. Instead he announced that the government would soon introduce "quite extensive measures" to safeguard its financial system.

Yet despite the headlines, not all major banks are facing crises. The French bank BNP Paribas, Santander of Spain and Britain's HSBC have emerged largely unscathed.

Impact on Commercial Property Markets

In addition to most major financial institutions being hit by the worldwide crisis, the commercial real estate markets also took a hit. Preliminary data for third quarter of 2008 showed investment volume down around the world for all property types, and all regions registered activity declines except for the Middle East and Central and Eastern Europe. There was a sharp drop in quarter-to-quarter transaction volume, partly due to the discrepancy between bid-ask prices. Since the peak in late 2007, property prices have fallen as much as 40%, whereas the lucky are only seeing 10% declines, depending on the location and quality of the property.

After a tumultuous two months on Wall Street, REITs are massively under-valued. As a point of reference, our pricing analyses indicate that U.S. REITs were under-priced by nearly 170% in mid-November based on values implied by the Capital Asset Pricing Model (CAPM). Relative to BBB bond yields, which provide a proxy for the credit of REIT tenants, REITs were under priced by 40%. The disparity between the two valuation proxies reflects the massive over-pricing of "safety" (Treasuries) versus "risk" (stocks in general and not just REITS). As economies weaken, leasing activity and rental rates in the retail, office and industrial property sectors are characterized by flat or declining rental rates. We expect that by the end of 2008 or by early 2009 at the latest, most cities will witness a decline in rental rates and an increase in vacancies, as tenants are increasingly focused on consolidation and cost-efficiency rather than expansion.

Western Europe property markets have been most affected by the global credit crisis, especially those built around financial sector booms (i.e. London, Frankfurt, Paris and Amsterdam). In the UK, rents remained stable with demand expected to recede over the short term as a result of weaker consumption and, hence, reduced retailer requirements for distribution space. Activity in Germany's commercial real estate investment market has already cooled with increasing yields for prime office buildings. Retail yields will rise in 2009, while prime rents have seen very little movement in the main centers over the past nine months as the trend toward shorter leases continues.

In France, tightening credit conditions have had a severe impact on the investment market, as activity is expected to continue to decline. Rents are generally stable but an undersupply of retail property should push prices up slightly while demand in France is mainly driven by logistics companies looking to broaden their network density.

Office investment figures for Spain are even more extreme, as yields have jumped from 5.5% in mid-2007 to 7.5% as of the end of 2008. The country's housing market has collapsed, leading to general economic difficulties. Although demand is relatively stable in the main centers, investors are beginning to show increased caution while large tenants are locating further away from the cities. Rents in Spain have declined, forcing landlords to become more flexible in lease negotiations. For Spain, the outlook is more favorable for large-volume logistics than for general industrial investment, due partly to supply constraints and rental stability.

After a decade-long property boom, house prices are leveling off in the Netherlands. In September 2008, the price index for owner-occupied houses was up 2.5% one year earlier, according to Central Bureau of Statistics. When adjusted for inflation, the index fell 0.5%.

Transactions in the Danish office investment market slowed dramatically as well. Most current deals are between distressed companies while many investors are waiting for prices to drop further. Equally, the Swedish market was in limbo, especially investments with large loan to value ratios.

After two years of exceptional activity, the Norwegian real estate market corrected in the first half of 2008 but was insulated from the worst effects of the credit crunch due to its country's vast oil wealth.

The crisis did not hit real estate as hard in Central and Eastern Europe where foreign interest has remained high due to large rental rate increases. The exceptions are Russia and the Czech Republic; rents in these two countries are now rivaling Western European prices and are therefore deterring those tenants. However, despite a lessening of foreign investment, a dual market in office investments has emerged in Russia with local investors increasingly interested in Class B and C properties. In the Czech Republic as well, logistics developments for the rising manufacturing sector are still in heavy demand. In Poland, rents have increased despite increases in vacancies. Most regional markets are focused on “big box” logistics with minimum unit sizes of 2,500 to 3,000 square meters, many of them dominated by major retailers who have set up national and regional distribution centers.

“The injection of government equity into the banking sector helped to somewhat stabilize the economy and, in the long run, will have positive effects on the property sector as well.”

With falling yields, the Ukraine has a general under-supply of good quality space. Kazakhstan has posted steady economic growth and investment interest from a range of foreign groups. In Turkey, due to foreign investment, there is now more “smart money” going into well-located and constructed retail centers with an under-supply of good Class A office space in the capital keeping the market strong.

Austrian and Israeli investors are especially active in the Serbian market, and retail development is beginning to take off while industrial output grows. Bulgaria has seen a steady increase in demand for commercial real estate investment opportunities, driving yields down and increasing demand for REITs. And despite high inflation rates leading to an economic slowdown in the Baltic States of Latvia, Lithuania and Estonia, both the industrial and retails sectors in the three countries are experiencing strong growth.

Of all the real estate sectors, the European industrial and logistics real estate markets to date have shown the most stability throughout the economic turbulence. The overall investments in the first half of 2008 showed a 46% reduction over the first half of 2007. Industrial investment totaled €6.6 billion for the first half of 2008 and, excluding the UK, showed only a 3% decline from the same period in 2007. Industrial sector investments accounted for 10% of total European turnover. While France and the UK have historically been major contributors to industrial investment activity in Europe, Central and Eastern Europe (e.g., Poland, the Czech Republic and Russia) as well as Germany were the main contributors strengthening the industrial sector in 2008. The Netherlands, Denmark and Italy contributed to a lesser extent.

Yields in the industrial market are rising, having progressively fallen over the preceding five years. Prime yields across Europe are now, on average, around 75 basis points above the low reached in the third quarter of 2007. Recent and longer-term indicators reflect the relative stability of the European industrial market, from both a leasing and investment perspective. The sector’s defensive attributes – relatively high income return and low requirement for rental growth – are increasingly attractive in a lower-growth environment, and investment levels so far this year show the sector’s increasing attraction to investors across a broad range of markets

The industrial sector is not immune to the current economic uncertainties and, with corporate investment and industrial production growth expected to ease, there will be little upward pressure on rents in the short term. Industrial rents softened in the third quarter of 2008, declining for the second consecutive quarter. Europe’s recession has Western European countries suffering either zero or negative growth, with negative growth expected to continue through 2009.

In Central and Eastern European markets such as Poland, a combination of rising construction costs and strong demand is pushing up rents. Many of these countries are

also seeing the evolution of more mature market structures as third party logistics operators extend their networks into new markets. Isolated land shortages in some other markets, such as parts of Belgium, are having the same effect. In these areas, landlord pressure for shorter leases – allowing growth to be captured earlier– is likely to intensify. However, tenant demand in well-established markets such as France and the Netherlands has weakened in the first half of the year due to a range of factors, including a shortage of available quality stock.

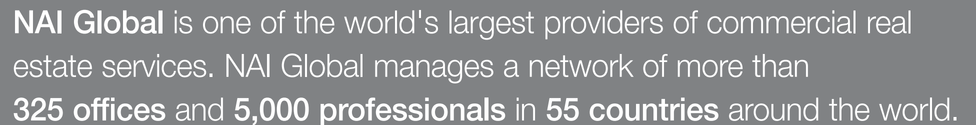
Outlook

Forecasts for the European economy according to the European Commission are bleak through the end of 2009. It expects that Europe's largest economies will come to a standstill or shrink, stating that the UK and the Baltic States will slip into recession while Germany, France and Italy will experience zero growth. The labor market will continue to deteriorate and tourism is to decline significantly, hitting Spain the hardest. Overall it was said that the Euro area most likely shrank in the third quarter of 2008 and may grow only 1.2% for the entire year, 0.1% next year and 0.9% in 2010. The EU gross domestic product is forecasted this year at 1.4%, falling to 0.2% in 2009 and 1.1% in 2010.

The injection of government equity into the banking sector helped to somewhat stabilize the economy and, in the long run, will have positive effects on the property sector as well. However, for the near term, real estate lending is expected to become even more restricted with vacancies rising and rents falling. The combined effects of weaker world trade, the credit squeeze and heightened economic uncertainty have dented both business and consumer confidence resulting in weak forecasts for European real estate. Forecasts for industrial production over the next two years have also weakened to around half the rate of growth seen over the 2006-2007 period. With corporate investment also easing, heightened tenant caution is evident in many parts of the market.

Investors must get "back to basics," focusing on fundamentals including stock selection, property/asset/tenant management and rental growth. Simply put, the focus is now on fundamental demand and supply, rather than arbitraging the credit markets with positive leverage.

NAI Global is one of the world's largest providers of commercial real estate services. NAI Global manages a network of more than **325 offices** and **5,000 professionals** in **55 countries** around the world.



NAI professionals work with leading corporations, property owners, developers, investors and financial institutions to develop investment and occupancy strategies, identify opportunities and maximize returns across the full spectrum of commercial properties.

NAI Global completes over **$45 billion** in transactions annually, providing clients with consistent, high-quality results.

Commercial Real Estate Services, Worldwide.

4 Independence Way
Suite 400
Princeton NJ 08540
tel +1 609 945 4000
fax +1 609 945 4001
www.naiglobal.com

© 2008 NAI Global