DTZ Foresight
2012 Global Outlook
Opportunities on down and upside

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Contents

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- During 2011, commercial property rents, values and volumes continued their recovery, as predicted. However, the 2012 outlook has become less clear as the eurozone debt crisis triggers a lowering of growth forecasts. Also, key indicators show a heightened level of uncertainty for both corporate occupiers and investors alike, causing a return of risk aversion.

- As a result, most market participants are considering alternative scenarios, with most solely focused on the downside, which assumes a break-up of the eurozone. Limited room for further loosening of fiscal and monetary policy supports in the West add to this stance. This has increased most investors' preference for prime property. Many occupiers have also put expansion plans on hold.

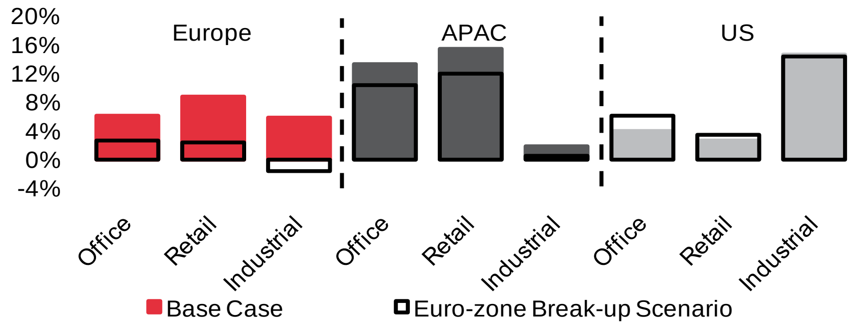
- Few care to focus on the upside potential. This could be from a corporate reawakening, when built-up cash reserves with non-financial corporations would be deployed. This scenario could make good quality non-prime property more attractive for investors, as risk aversion is reduced. Of course, it might also limit occupiers' ability to renegotiate on non-prime leases.

- New capital reserve regulations will trigger deleveraging for European banks of between EUR 1.5 to 3.0 trillion. This will increase Europe's debt funding gap by up to 50% to US$ 249bn. The impact in the US and Asia Pacific is expected to be less severe. The increased gap in Europe can be bridged by the available new equity and debt capital. However, a correction in prices for both debt and equity might be required to attract this available capital.

- Under the downside scenario, the short term impact on Asia Pacific rents is bigger than expected. It proves to be a temporary decline, as the upward economic momentum triggers a strong rebound later in the forecast period. However, it does offer a short window of opportunity for occupiers to re-negotiate their leases. In Europe, the downward pressure on rents and values is more enduring. Surprisingly, US values end up higher under the downside scenario compared to the base case (Figure 1). Long term investor opportunity arises as a result of projected yield tightening. Opportunities are thus present both on the downside and upside scenarios.

Figure 1

Prime capital values 2012-16, cumulative % change



Source: DTZ Research

Europe triggers downgrades

Ireland showing results

We started last year's outlook with the comment 'heading into 2011, the macroeconomic outlook remains uncertain'. In some areas we have seen clarity emerge, at least regarding the size of the issues facing us. All eyes are concentrated on the European sovereign debt crisis. The issue is clearest reflected in government bond pricing (Figure 2). The US, UK and Germany benefit from low yields under their safe haven status. Greece and Portugal have been in serious difficulty for some time now. Ireland shows that early, hard and fast action can reap rewards. From a mid-year bond rate as high as Greece and Portugal, Irish yields have fallen to near those of Italy. Yields have also come down after the ECB announced its LTRO facility in early December. The need remains, however, for a resolution of the sovereign debt issues in 2012.

Asia storms ahead in base case

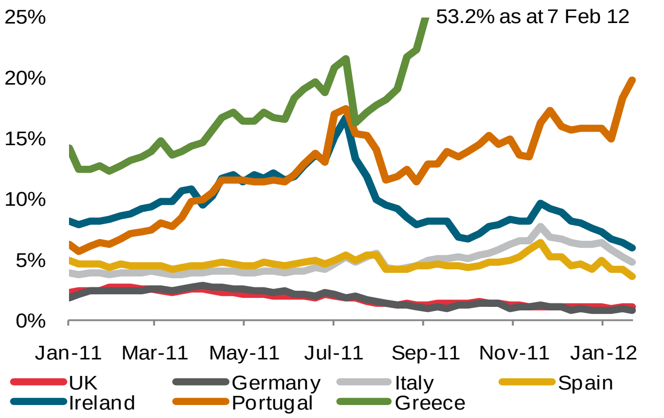
Our economic base case assumes a resolution of the eurozone crisis (Figure 3). European GDP falters in 2012 before slowly recovering over the next 3 years. The UK has a technical recession but narrowly avoids a decline in 2012, returning to trend growth by 2014. The US shows steady improvement. The strongest performance by far remains in Asia. We expect Emerging Asia to show growth 3-4 times as high as the West with China not falling below 8% pa growth in the forecast period. Some parts of Asia, such as Singapore and Hong Kong, which are more exposed to global exports, will have a more difficult year in 2012. Generally though, this bifurcation of growth will lead to a continued reallocation of wealth, resources and real estate development towards Asia Pacific.

Risk aversion returns with uncertainty

Uncertainty re-emerged in 2011 and is expected to be an important factor in 2012, as it triggers a return of risk aversion (Figure 4). Some key indicators illustrate this uncertainty and risk aversion clearly. Europe's BBB corporate bond yields now stand at levels reminiscent of the Lehman Brothers crisis as investors' price in increased nervousness about the economic outlook. There is clear justification for this nervousness. The Baltic dry freight index (the price of shipping goods around the world), which collapsed with world trade in 2008 is now at a point below even that level. Too many ships are finding less raw materials and finished goods required to be shipped, as exports weaken. These leading indicators suggest that the world might be on the brink of another financial crisis.

Figure 2

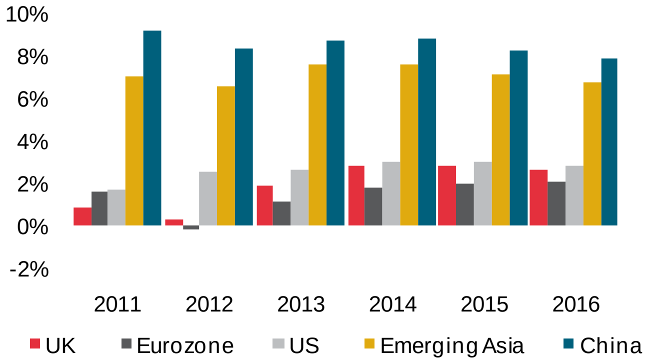
Five-year government bond yields



Source: Bloomberg

Figure 3

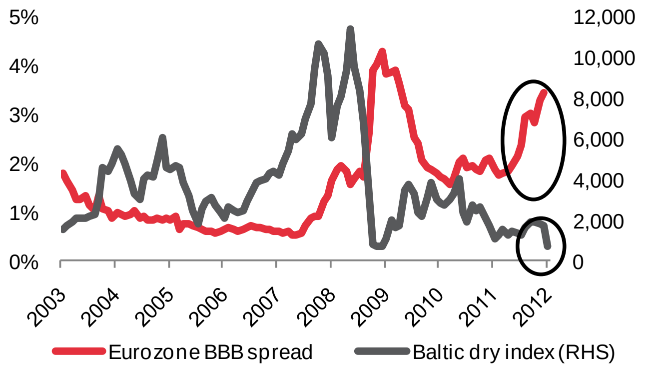
Forecast pa GDP growth



Source: Oxford Economics

Figure 4

BBB corporate bond spreads and Baltic dry index



Source: DTZ Research, Bloomberg

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Scenarios move centre stage

Logically, most focus on downside

Many market participants deal with uncertainty by considering the spread of outcomes, via scenario analysis. To facilitate this, we stress test our view for real estate accordingly. We consider the Oxford Economics probabilities of a base case at 45%, a series of downside scenarios, including a Euro-zone break-up, at 30% and the upside or corporate re-awakening scenario at 10% (Figure 5). The difference between the up- and downside scenarios is most dramatic in Europe where there is a 1.2% spread in pa GDP growth over the period. Conversely, Asia Pacific is relatively robust, with a spread only half that of Europe's.

There could be an upside surprise

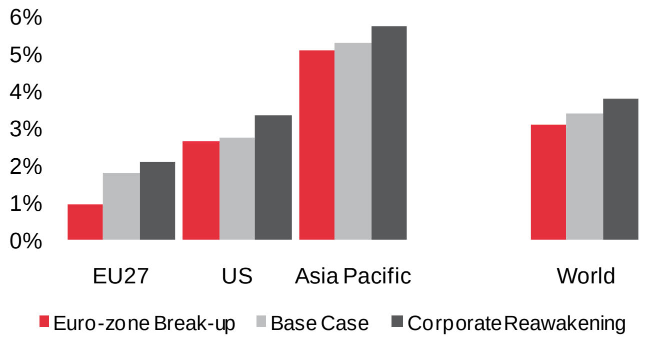
Whilst all eyes are on how bad things could get globally, it is worth highlighting that there is an upside! Cash reserves with US non-financial corporates are at historic highs (Figure 6). Many multi-nationals are sitting on mountains of cash. Lack of confidence and clarity of economic outlook is encouraging firms to sit on their hands and keep money in the bank rather than act to expand or invest. This has become as apparent in real estate investment, development and occupier decisions as in other areas. All it would take is for confidence to return and eurozone debt issues to be successfully resolved for them to spring into a more active mode. This would push forward demand and growth around the world.

Export links drives downside impact

However, the main downside risk is that events in the eurozone will not be resolved resulting in certain countries leaving the currency union. The effect of this, though concentrated within mainland Europe would reverberate around the world due to export dependency (Figure 7). Europe is a major importer of Asian goods, particularly from the developing Asian countries. In addition Europe has close economic links with the US though they are less significant for both parties than in the past. Consequently, no major geographical area in the world would be unaffected. The magnitude of the downside for some countries, particularly if they are forced or choose to leave the Euro-zone, is extreme. This helps explain the present nervousness of occupiers and investors alike. We think this excessive caution is partly misplaced, particularly for decisions involving Asia and, to a lesser extent, the US. Whilst the outcome for Europe is grim, other markets suffer only a temporary pause from long term trends.

Figure 5

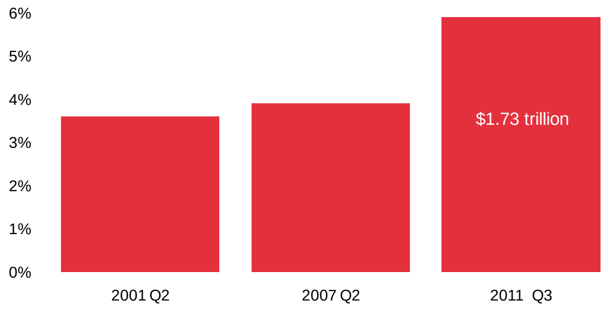
Average pa GDP growth, 2012-16



Source: DTZ Research, Oxford Economics

Figure 6

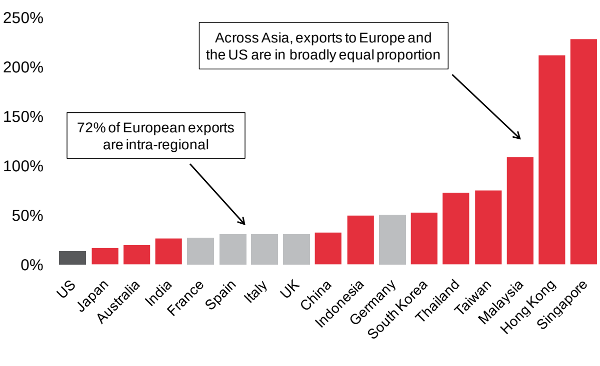
US non-financial corporate cash (as % of assets)



Source: Financial Times, Federal Reserve

Figure 7

Exports as % of GDP



Source: DTZ Research, Oxford Economics

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Prime recovery sustained

Rents continued rise in 2011

Our base case assumption is that prime real estate rents will continue their steady recovery in 2011, albeit at an anaemic rate in Europe (Figure 8). There will be continued strong rental growth within the more dynamic Asian markets, particularly China. The US will show a sustained, if sometimes patchy recovery. Europe will struggle to maintain rental growth as austerity measures and financial weakness takes its toll across the major European countries. We expect to see limited increases in occupier demand across most sectors. Some markets, particularly in Eastern Europe, will buck this trend.

Future values flat outside Asia

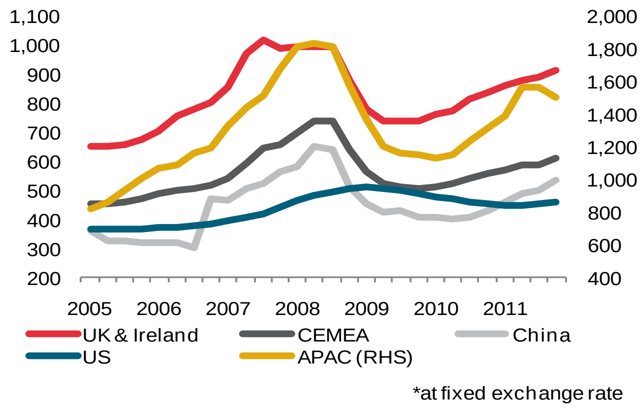
Based on this, we see little to move capital values outside of Asia under the base case (Figure 9). Historically the US has low volatility outside a few space constrained major markets, such as New York and San Francisco, as land is generally freely available. Asia Pacific (ex-China) is expected to show a significant fall. This is on the back of declines in developed markets such as Singapore, where limited increases in office demand will be more than satisfied by the supply pipeline. The Chinese markets continue their strong growth in capital values which we expect will continue for the next few years. It should be noted that even after several years of strong growth in rents and yield compression, China's major cities, such as Shanghai and Beijing do not yet appear in the top 5 most expensive locations. We project further strong capital value growth within Emerging Asia.

Investment volumes hold up

Figure 10 illustrates that 2011 saw a 6% increase in investment volumes mainly on the back of increased activity in the US and Europe. In 2012 we expect activity in Europe to be marginally lower. The strong interest from risk averse investors in prime property will remain. We expect deal volumes for secondary grades of space to increase, but re-pricing will mean overall volumes remain stable. In Asia there is expected to be some growth in overall volumes as Japan continues its post tsunami recovery. China is expected to remain stable with an assumption of a neutral stance by the government concerning real estate policy initiatives. The US, where we have been seeing attractive pricing, but limited stock, will continue to see a marginal increase in activity as the market returns to something like normality. Overall, globally, we expect to see a one per cent fall in volumes.

Figure 8

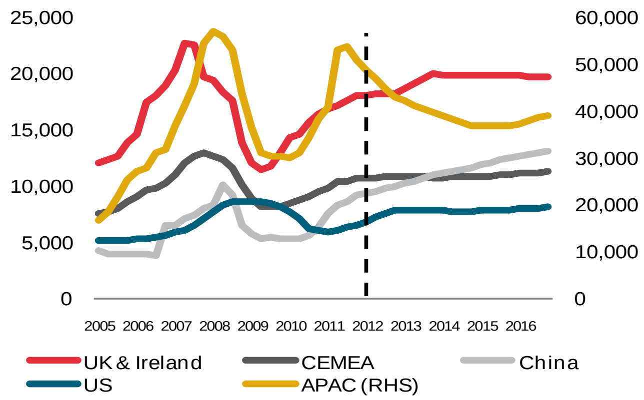
Prime office rents (US$* per sqm pa)



Source: DTZ Research

Figure 9

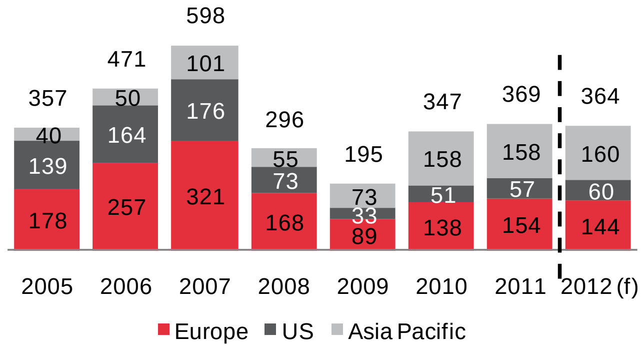
Prime office capital value (US$ per sqm)



Source: DTZ Research

Figure 10

Global investment volumes (US$ billions)



Source: DTZ Research, Property Data, REIS

New rules force deleveraging

Regulators call for deleveraging

In addition to Basel III framework, banks have been confronted with the EBA's stress testing. Furthermore, the ECB has announced the LTRO (a 3-year term loan facility), which will allow banks to deleverage over a longer time period. In our view, this should cushion the impact of the EBA's 9% capital requirements for July 2012. This rule is estimated to require European bank deleveraging of between EUR 1.5 to 3.0 trillion. Non-European bank regulators remain less focused on Basel III implementation. Here, even a delayed implementation is likely to be less severe anyway. This is because US banks are not as dominant within real estate as in Europe (Figure 11), and capital reserves for Asian banks are already much higher.

CRE assumed to suffer proportionally

In quantifying the impact on CRE, we assume a similar percentage impact as on the overall loan book, despite there being valid arguments for a higher or lower percentage impact for property lending. Regardless of this, some of the needed deleveraging is already under way. This is evidenced by the increased number of loan sales and announcements from many banks that they will cease new CRE lending.

Up to 50% rise in debt funding gap

Based on these assumptions, we estimate that Europe's debt funding gap (the difference between maturing legacy debt and new debt available to replace it) will increase by up to 50%. This represents an additional debt funding gap of US$83bn bringing the total for Europe to US$249bn. Despite this increase, new equity capital and non-bank lending capital is expected to be sufficient to bridge the gap over the next three years. (Figure 12)

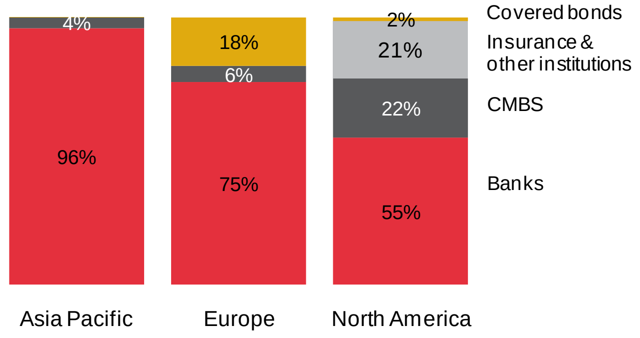
Re-pricing of lending and property

The increase in the debt funding gap will have an impact on both the lending (Figure 13) and property investment markets. This is because we would expect that a pricing correction might be required to sufficiently motivate and attract the available capital.

Apart from a possible re-pricing of lending terms (lower LTV's and significantly higher margins), there is also likely to be more distressed loan sales from banks. These sales in turn will have a negative impact on property yields, as the loans are enforced, worked-out and the collateral is being sold in the market over time. Consequently, yield widening can be expected across the board.

Figure 11

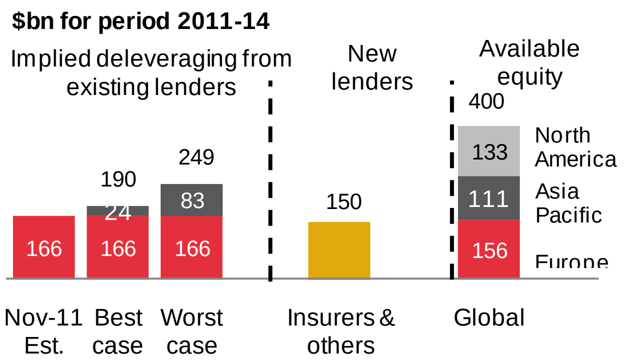
Property lending by source, year-end 2010



Source: DTZ Research

Figure 12

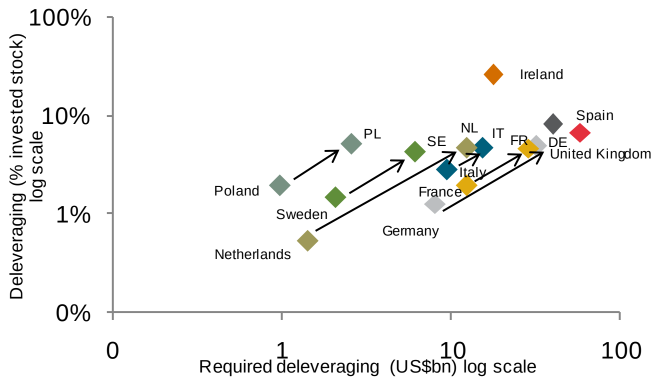
Relative impact of regulations on debt funding gap



Source: DTZ Research, BNP Paribas CIB, Barclays Capital

Figure 13

Changes in debt funding gap by country



Source: DTZ Research, BNP Paribas CIB, Barclays Capital

Challenging the consensus

Non-prime vacancy lower than prime

In this section, we challenge the negative consensus view on non-prime, which runs as follows:

- Recession pushes low credit tenants to lease default
- Increased vacancy to push non-prime rents lower
- Non-prime owners to default on highly leveraged loans
- Banks to sell foreclosed non-prime collateral at high discounts, triggering further yield widening

Our challenge is based on new data as well as specific views. We verify the relevance of the non-prime market based on a recent bottom-up analysis across all UK office markets. This determined that Grade C space makes up near 70% of total stock. However, three years into the global financial crisis, Class C office vacancy was not only well below 5% but also well below Class A and Class B (Figure 14). We accept that retail is a different issue, but this new data dispels the first two points of the consensus view. Also, our forecast for secondary space is only modestly negative for 2012 across all property types (Figure 15). As a consequence, stability of cash flow should be better than implied by consensus.

No evidence on leverage levels

Due to lack of data, the third consensus view point is harder to contest. But, there is no evidence which suggests that defaults on loans secured by non-prime properties are higher than on loans secured by prime properties. We suspect that many owners of non-prime properties, particularly Grade C property, were not sufficiently "savvy" to seek high levels of debt.

Yield spread tightens further in 2011

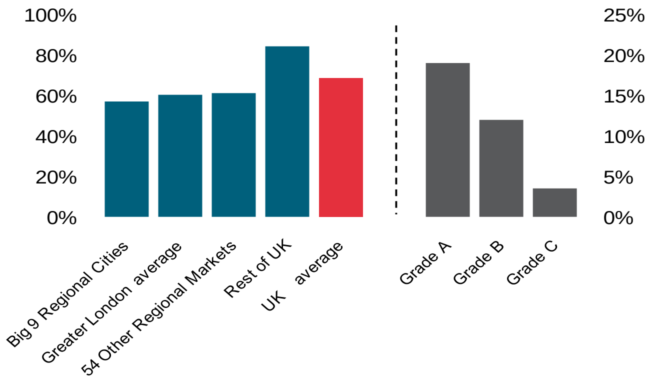
The yield spread between prime and secondary properties doubled between 2007 and 2009. However, since 2009 this spread has tightened slightly, despite the prevailing negative consensus (Figure 16). Therefore, our view is that:

- Low grade C vacancy implies low tenant defaults
- Downward rent pressure limited due to low vacancy
- Leverage on non-prime is not higher than prime
- After doubling, the yield spread has been tightening

Overall, our view is much less negative on non-prime than the consensus. This should be good news for owners, but could limit cost saving opportunities for non-prime occupiers

Figure 14

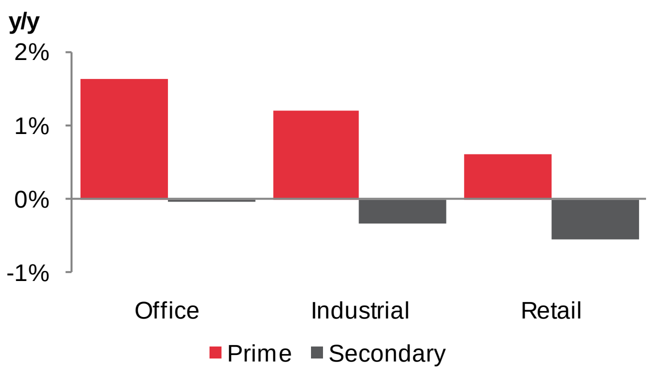
Grade C as % of stock vs % of grade available



Source: DTZ Research

Figure 15

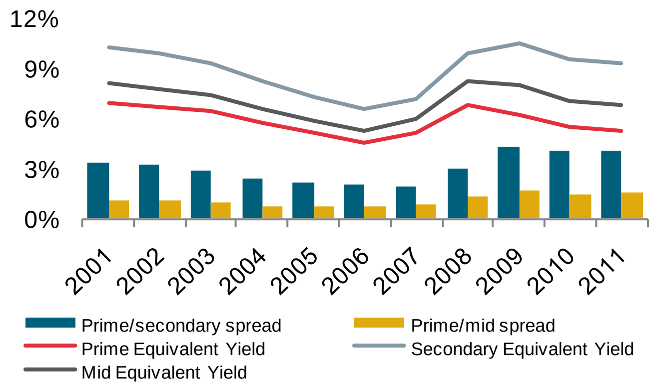
Prime and secondary rental growth forecasts, 2012



Source: DTZ Research

Figure 16

Prime and secondary All Property yield spreads



Source: DTZ Research, IPD

Limited downside outside of Europe in the long term

APAC rents down only in short term

The impact of the downside scenario of a Euro-zone break-up is modelled across global office markets. Surprisingly, the average rents decline more across APAC markets than in Europe and the US in 2012. This is due to the high export dependency and limited size of many APAC markets. Absorption in many of these APAC markets, as a percentage of total stock, is relatively high and shorter term leases will trigger a more dramatic short term rent movement. However, in the long term, economic prospects remain strong for Asia and the decline is temporary as growth momentum in the long term remains strong (Figure 17). This leaves multinational occupiers with a short window of opportunity to take advantage of rent declines should this scenario play out.

Euro-zone exiters' values down most

After considering the impact on rents, we also estimate the capital value impact (Figure 18). Unsurprisingly, the average impact across Europe is more severe than in Asia. European markets especially impacted are the ones that are assumed to leave the euro-zone. Here government bond and property yields (in conjunction) are expected to widen as a result of the new currency launch and affiliated devaluation.

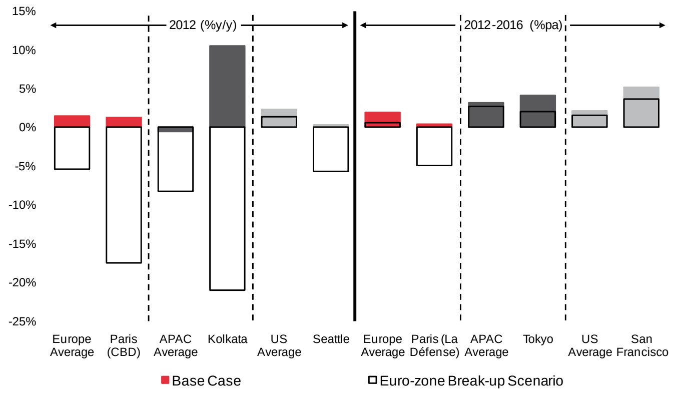
US values benefit as yields tighten

When considering the value impact across all property types and regions, we note that European industrial is worst hit (Figure 19). This offers investors opportunities nearer the end of the period. Asian markets are less impacted and maintain rises above 10% over the next five years, except for industrial. Ironically, the US – having helped cause the global financial crisis to begin with – actually shows a positive impact on values from the downside scenario! This seems perhaps counter-intuitive. However, this positive effect on office and retail values, in particular, is due to the projected tightening of US government bond yields and required property yields (cap rates) and the limited downside in rents, under the euro-zone break-up scenario.

It is clear that both occupiers and investors can interpret these results to identify opportunities, as well as warnings, over the next five years, depending on their views whether the upside, base case or downside scenario will materialize. With greater uncertainty comes greater opportunity.

Figure 17

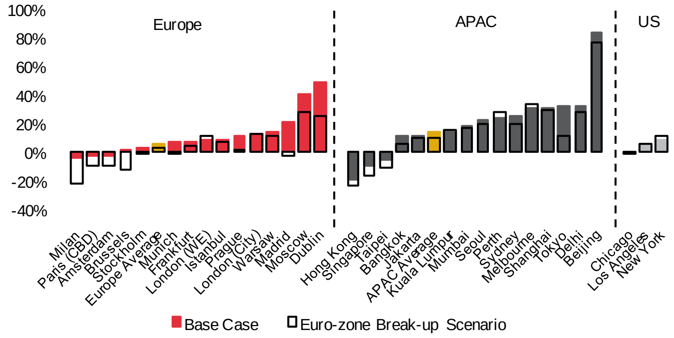
Prime office rents



Source: DTZ Research

Figure 18

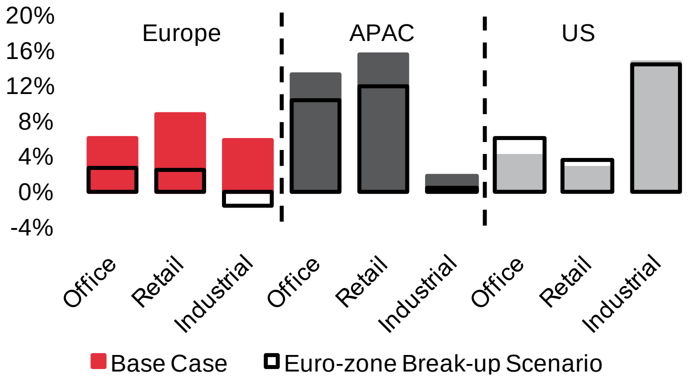
Prime office capital values 2012-16, cumulative % change



Source: DTZ Research

Figure 19

Prime capital values 2012-16, cumulative % change



Source: DTZ Research

Selected Publication List

Insight Reports

Insight Non-prime UK office stock December 2011	Upgrading to trigger more C availability
Insight Global Debt Funding Gap Report - November 2011	Europe struggles despite positive trends
Insight South East Asia investment opportunities - September 2011	Socio-economic factors drive investments
Insight The Great Wall of Money - September 2011 Addendum	Opportunity funds running out of time
Insight The Great Wall of Money - September 2011	Pause in new raising as capital put to work
Insight Impact of Europes Austerity Measures - September 2011	Most exposed markets offer highest returns
Insight German Open-Ended Funds H1 2011	Small steps towards reopening

Foresight Reports

Foresight 2011 Global Outlook February 2011	Measuring downside in two-speed recovery
Foresight Asia Pacific Fair Value Q3 2011	Global turmoil slows growth momentum
Foresight Europe Fair Value Q3 2011	Economic turmoil taking its toll
Foresight UK Fair Value Q3 2011	Economic outlook dampens rental growth
Foresight European Scenario Analysis - November 2011	Non-eurozone office markets most resilient
Foresight Asia Pacific Scenario Analysis - November 2011	Not immune, but more resilient to euro crisis

Money Into Property

Money into Property Global 2011	Two-speed recovery
Money into Property Europe 2011	Turning the corner
Money into Property Asia Pacific 2011	Engine of world growth
Money into Property 2011 UK	Working it out

Investment Market Update

Investment Market Update Asia Pacific Q4 2011	Volumes to be maintained in 2012
Investment Market Update Europe Q4 2011	Positive fourth quarter but outlook deteriorates
Investment Market Update UK Q3 2011	Prime in short supply except in City

Occupier Perspective

Occupier Perspective Global Occupancy Costs Offices 2011	Markets shift from tenant to landlord
Occupier Perspective Obligations of Occupation EMEA 2011	
Occupier Perspective Obligations of Occupation Asia Pacific 2011	
Occupier Perspective Occupancy Costs - Logistics 2011	Low occupier costs for some time to come

Property Times

Property Times Asia Pacific Q3 2011	Sentiment begins to shift
Property Times Europe Office Q3 2011	Outlook still positive but...