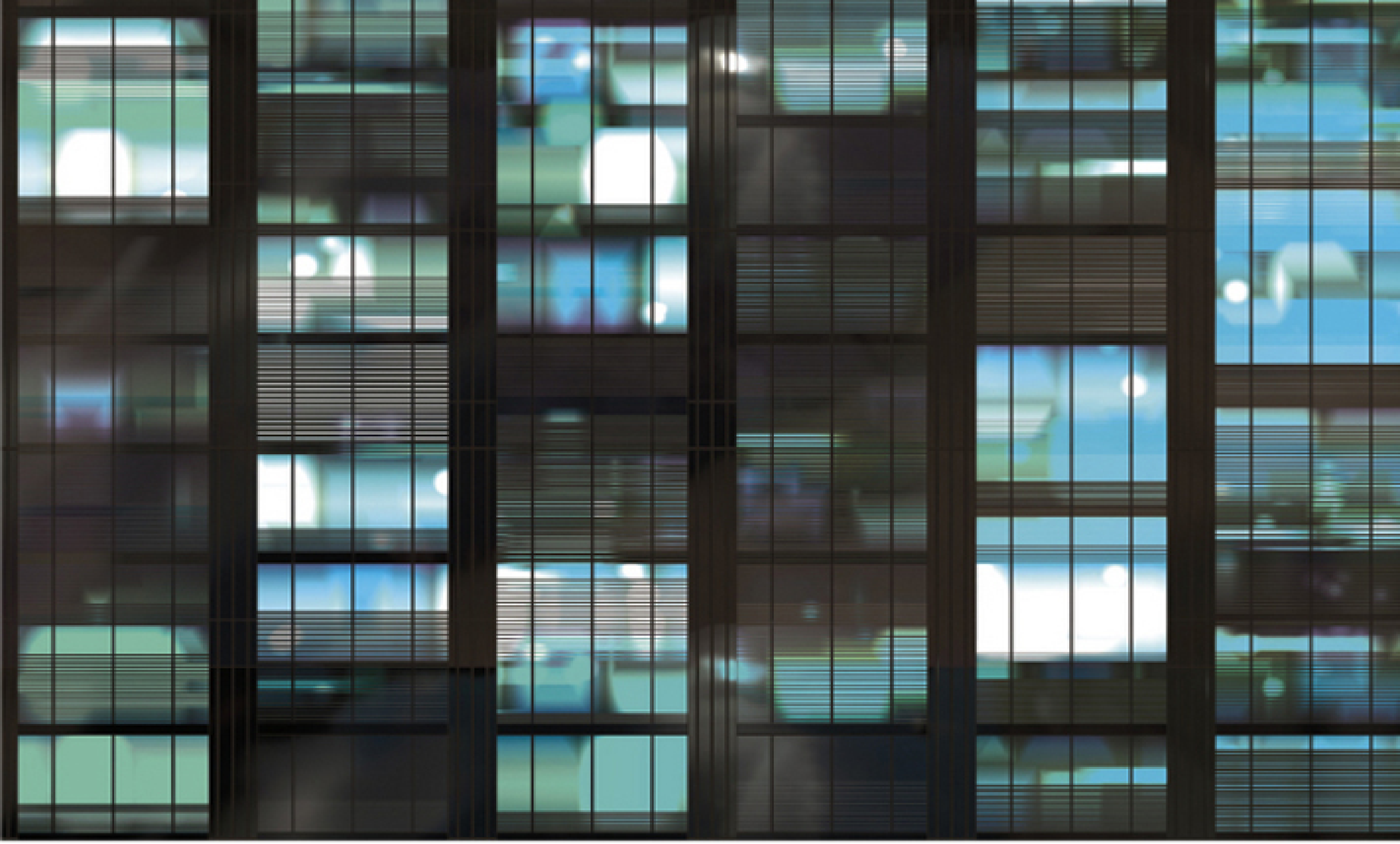

Real Estate and Globalisation

Richard Barkham

WILEY-BLACKWELL

Table of Contents

Are we heading towards global deflation? (December 2001)
Deflationary conditions may be already present in parts of the West (October 2002)
Are buoyant asset markets enough to stimulate recovery? (March 2010)
Has the global economy passed its worst? (July 2001)
How will rising interest rates impact real estate markets? (January 2011)
Is the USA really in recovery? (December 2002)
Investment could lead the recovery – but not yet (July 2003)
UK savings rates have recovered, but the USA still looks out of balance (September 2002)
How to save the world: by not saving (December 2009)
Events to watch – is OPEC about to set off a second oil crisis? (October 2000)
How is this oil shock different from the 1970s? (October 2005)
Global financial markets – remaining challenges to a sustained recovery (August 2010)
The Euro finally arrives – but will that make much of a difference? (January 2002)
Germany (April 2002)
Germany's economic situation (April 2003)

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Group Research Director
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Foreword

There is something unusual – perhaps unhealthy – about an industry in which a 25-year-old with almost no prior experience can make a fortune overnight. The fact is that you can get into property with little more than a telephone and a total disrespect for risk. The industry abounds with stories of a few thousands turned into millions. Property investing attracts, because it is very straightforward and visual. Once we have bought and sold our own home, we have experienced the essential mechanics of property investing. This is reflected around boardroom tables as well, where there is only rarely a specialist but, apparently, many experts.

In large property companies, there should be experts of course. But even here there has been a traditional assumption that it is 'unconscious genius' that will bring greatest success, not dedicated research. I am a great believer in instinct, but when it comes to managing a 300-year old business, something more is needed. So, when we reorganised the property business of the Grosvenor Estate in 2000, we did something which was probably unique at the time for a large property company. We established a dedicated research group around the world. As an internationally diversified investor and developer, we believed strongly in the notion that real local decision-making was essential and that a model of managing from London (as various peers had done) was flawed. The primary role of the centre would be to decide how much capital should be invested in each local business.

The research teams, coordinated but answerable to their local management, would provide a common 'language', as well as the medium through which valuable knowledge could be refined and moved around our business. Part of the output of the team would be a monthly commentary for all the Boards and staff on a single topic of relevance and interest. It is expensive to run such a team and so its establishment was in itself a real example of managing for the long term; something which many profess, but few are really prepared to pursue.

After some years it became obvious that collecting the short papers together would be valuable, as both diaries and refreshers on topics that keep coming back. I am delighted that my wish to do this has been realised in a much more sophisticated way than I ever imagined.

I particularly want to commend Richard Barkham, Grosvenor Group's Research Director, and Darren Rawcliffe, his predecessor, for their work in establishing the team and the intellectual rigour they added to our strategy. While never allowing them to dictate, they and their colleagues have informed every aspect of strategy since 2000. Richard's expert editing and introductory commentaries have provided a fascinating 'look back–look forward' feel to the collection, which I hope will be a worthwhile addition to the rather thin collection of books about the complexity of managing an international property company at the beginning of the 21st century.

Jeremy Newsum

Non-executive Director

Grosvenor

Preface

Grosvenor is an international property company whose roots, in the areas of London known as Mayfair and Belgravia, go back more than three hundred years. In 2000, Grosvenor took the step of creating a research team to support its growing fund management business and international diversification strategy. Each month for the last 11 years Grosvenor's research team, which now consists of 12 real estate economists, has produced an article on an aspect of real estate economics which seemed topical at the time. The series is called the 'Global Economic Outlook' and is distributed internally and to contacts and clients of the company. Sometimes the articles are based on recent macroeconomic developments and the implications for real estate markets and sometimes they attempt longer-term projections or cross-country comparisons. Although the topics covered have varied a great deal, the aim has always been to undertake original analysis using the tools and techniques of economics. Individual articles are produced by Grosvenor's research economists in the UK, North America, Asia and Europe and must be no more than 800 words long. This word limit is stipulated by the board of Grosvenor which requires its economics to be pithy. There has been no particular attempt over the years to develop a long term theme or maintain a particular editorial line. First and foremost the articles are constructed to enable Grosvenor to deploy its own and its clients' capital to best effect, in a very turbulent world.

In reviewing the series it became clear that these articles, though never specifically addressing this issue, told a very interesting story about the impact of globalisation on the volatility and performance of real estate markets. Over the last 10 years national economies have become ever more intertwined. Emerging markets have taken a greater share of production, providing OECD consumers with ever-cheaper manufactured goods delivered through sophisticated supply chains. Capital has flowed from high-savings economies to low-savings ones, not only though public capital markets but also, less obviously, via banks' cross-border investments in the bonds and commercial paper of other banks. All the while, developments in communications technology, including the internet, have increased the volume of data delivered to consumers and businesses so that events in, say, Japan, quickly impact on sentiment and economic activity in the UK. These developments have brought many benefits, but they have also created huge economic distortions. Some countries have over-consumed and built up debt; others have saved too much and built up excess foreign currency reserves. The lack of an appropriate global fiscal and monetary policy framework has meant that the economic power of globalisation has been misdirected. One consequence of this has been very high levels of volatility in asset markets, including the real estate sector. The central purpose of this book is to use the articles to sketch out the link between globalisation, by definition a profound international process, and the dynamics of real estate markets, which until very recently have been dominated by purely local factors.

Although one of the by-products of globalisation is that economic and market data is increasing exponentially, it is still necessary in the real estate sector to spend time and effort ensuring a degree of consistency across markets. Only in this way can valid international comparisons be made for the purpose of asset allocation. Nevertheless, all research requires judgments to be made and nowhere is this truer than in the field of international real estate research. The second purpose of this book is to present Grosvenor's approach to the analysis of international real estate markets and the variety of methods we have used to analyse data and arrive at conclusions. Our hope is that students and possibly others will gain some insights into the way in which research can blend with practice to help shape the strategic agenda of a major company. Many of the research themes in the book need to be followed up, as they seem to us to have social as well as commercial relevance. Grosvenor's research team will continue to explore the impact of global economic change on real estate markets; we hope that others will be inspired to do so as well.

Richard Barkham

Acknowledgements

The monthly Global Outlook was devised by Darren Rawcliffe and edited by him between 2000 and 2005. Richard Barkham has edited the series since 2005. Richard Barkham designed this book and is responsible for the introductory and concluding chapters as well as the individual chapter commentaries. Ruth Hollies managed the global yield project, the results of which are included as an appendix to Chapter 11. Current or former members of the Grosvenor research team who have contributed by producing articles or analysis are as follows:

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David Wasserberg

1

Introduction

A Remarkable Decade for Real Estate

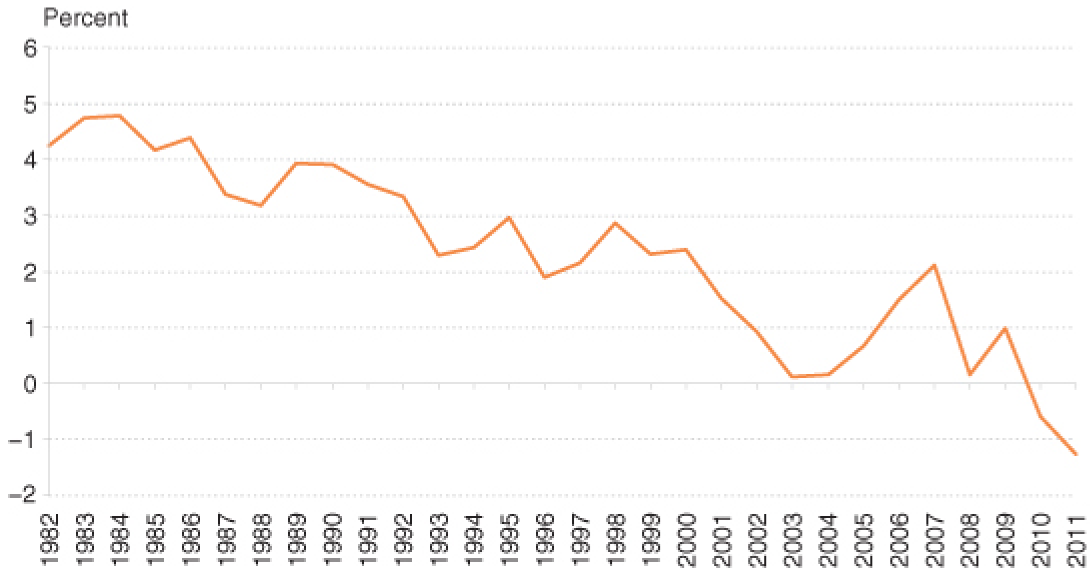
The decade from 2000 to 2010 was the most exciting, remarkable and ultimately disastrous period for real estate since the end of the Second World War. Those dramatic ten years witnessed the world's first coordinated real estate boom and slump. Real estate cycles are a common feature of free market economic development and, from time to time, they badly destabilise individual economies. In the years before 2007, real estate values were driven to peak levels across the greater part of the developed world. When prices collapsed in 2008, by up to 60% in some countries, the global financial system was almost destroyed and a new Great Depression ushered in. At the time of writing (mid-2011), the aftershocks of the great financial crisis (GFC) linger on, in the sovereign debt crisis of Southern Europe and in the moribund housing market of the USA. Unemployment in the developed world, the social cost of the crisis, remains very high.

For real estate, the 2000s started rather unpromisingly amidst the global recession created by the bursting of the 'dot-com' bubble. Between 1996 and the end of 1999, on the back of easy money, buoyant global growth and widespread optimism about the potential of the Internet, global stock markets rose by 24%. Between 2000 and 2003, all of these gains were reversed, as world markets fell by 30%. The swings in value were much greater in the stock markets of the USA and the UK. Investment fell and unemployment rose. Contraction in the corporate sector led to a fall in demand for business and commercial space and a steep drop in rents. The real estate recession of the early 2000s was particularly severe in the office sector, because demand for offices depends directly on the state of the financial markets.

It is worth reflecting on the 'wreckage' of the dot-com slump, because it is here that the real estate story of the 2000s begins. Since the early 1990s, OECD central banks have been haunted by the spectre of Japan. Between 1950 and 1989, Japan was one of the word's fastest-growing and most dynamic economies. Towards the end of its long expansion, its stock market and land market dramatically boomed and slumped. Since then, Japan has been unable to shrug off slow growth, deflation and a chronic inability to create jobs. The reasons for Japan's 20-year deflation are complex, but most agree that monetary policy was too tight in the post-bubble period. This is a mistake that OECD central banks do not wish to repeat. So, in the wake of the stock market crash of 2000, interest rates were cut aggressively to support asset values, boost confidence and revive business and consumer spending. Figure 1.1 shows OECD real interest rates over the period: it is the key to understanding the events of the 2000s and the GFC.

Figure 1.1: OECD real interest rates

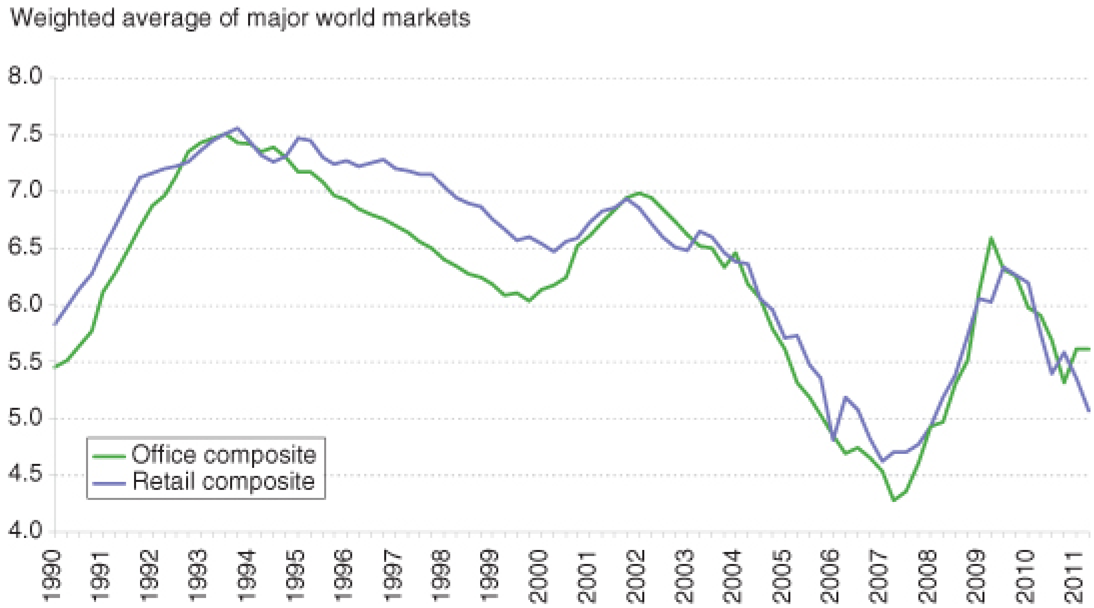
Source: IHS Global Insight



It is often said that using interest rates to stimulate an economy is like dragging a brick with an elastic band: nothing happens for a while and then the brick jumps up and hits you on the back of the head. This is how it played out in the real estate sector. The period 2001 to 2003 saw depression in most asset markets; confidence was weak as the global economy worked its way through the aftermath of the tech-crash. Suddenly, in 2003 a ‘wall of money’ hit the real estate sector. Investors, nervous of the stock market, were not prepared to tolerate the low returns on cash and bonds that resulted from super-loose monetary policy. The ‘search for yield’ was on and real estate was suddenly the most favoured asset class. The long, globally coordinated boom in real estate values had begun. Figure 1.2 shows a global composite yield for the retail sector and the office sector. The period from 2003 to 2008 saw a rapid and continuous appreciation of prices driven entirely by investment demand.

Figure 1.2: Retail and office global composite yields

Source: CBRE

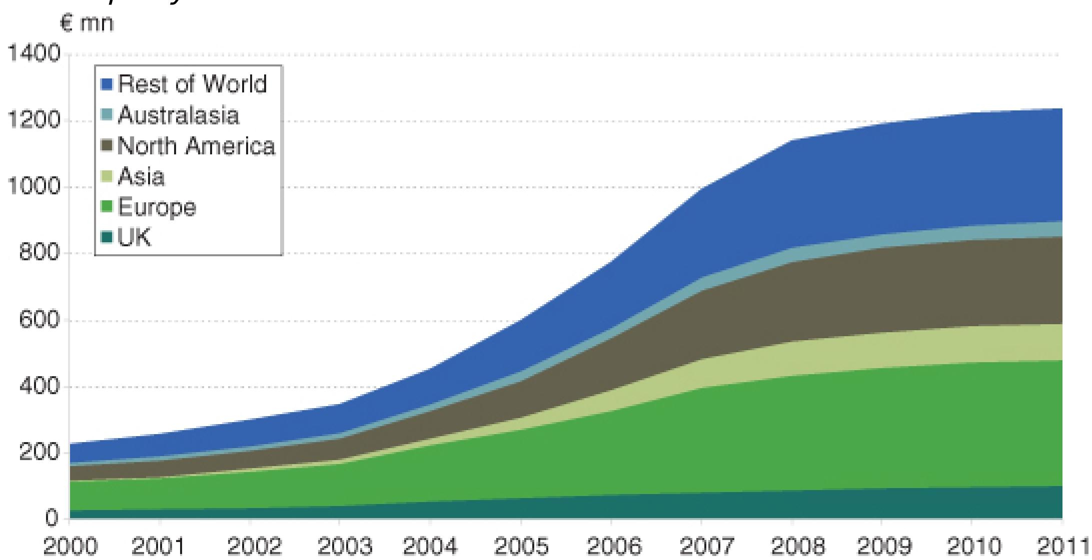


The first wave of investment was primarily driven by ‘equity’ investors; those for whom easy access to bank finance was not a key issue. These included pension funds and insurance companies, high net worth individuals, private equity funds and, increasingly, newly created sovereign wealth funds. Even small investors, through the medium of open-ended funds or other ‘retail’ vehicles, were clamorous for real estate. REITs (Real Estate Investment Trusts) were prominent investors; the ten years to 2007 had seen REITs or REIT-type vehicles approved in over eight jurisdictions (figure 1.3). The period also saw the very rapid growth in unlisted real estate funds (figure 1.4). These tax transparent vehicles provided a convenient means for professional investors to deploy capital in diversified pools of real estate assets run by professional real estate managers.

Figure 1.3: Growth of REITs

Figure 1.4: Growth in non-listed real estate funds

Source: Property Fund Research



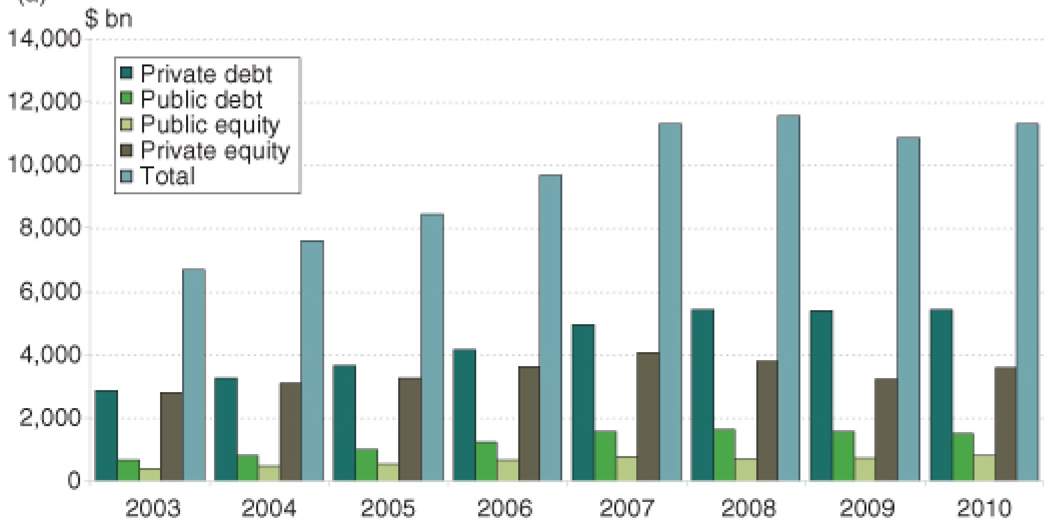
‘Behind the scenes’, it was low interest rates that were fuelling the boom. Low interest rates (or expansionary monetary policy) have a ‘double impact’ on the attractiveness of real estate as an investment. First, they lower the cost of holding the asset. Second, by boosting the cash flow of occupiers, they improve the security of real estate operating income. At the time, the link between booming real estate values and super-loose monetary policy was not widely appreciated. Indeed, many market participants preferred to think about the ‘golden age of real estate’. Real estate, with its long duration and stable cash flows and increasingly good data provision, was the institutional asset of choice.

By 2005, the initial impetus to real estate values from ‘equity’ investors had been replaced by debt-driven buyers; namely, buyers with very high levels of leverage. Such ‘players’ are a feature of any rising real estate market, often originating in markets with low or negative real interest rates (where interest rates are lower than domestic inflation). In the mid-2000s, debt-driven investors from Ireland, Iceland, Spain, the USA and Israel flooded into the marketplace. Figure 1.5 shows money flows into real estate over the period, by type and destination.

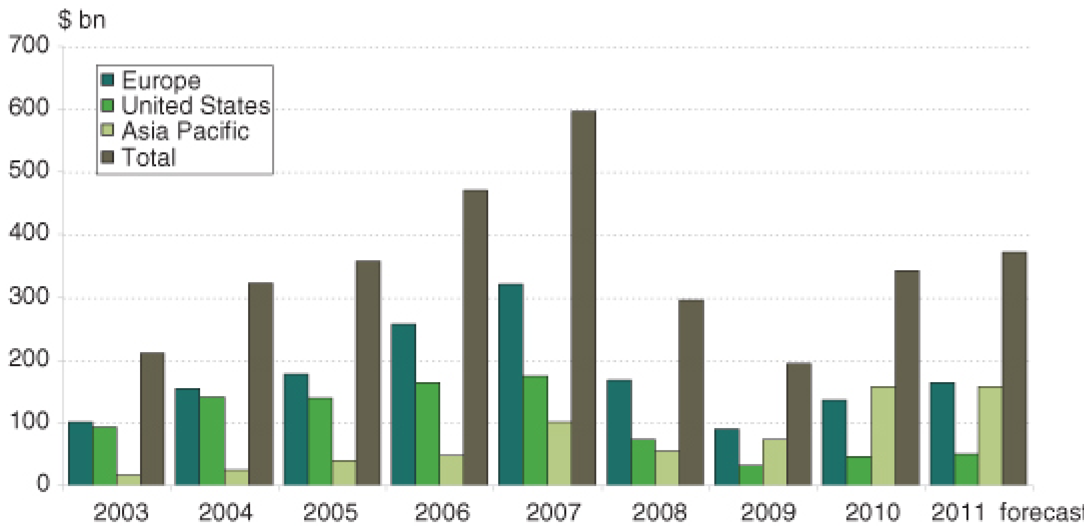
Figure 1.5: (a) Capital flows into real estate by type; (b) Capital flows into real estate by origin

Source: DTZ

(a)



(b)

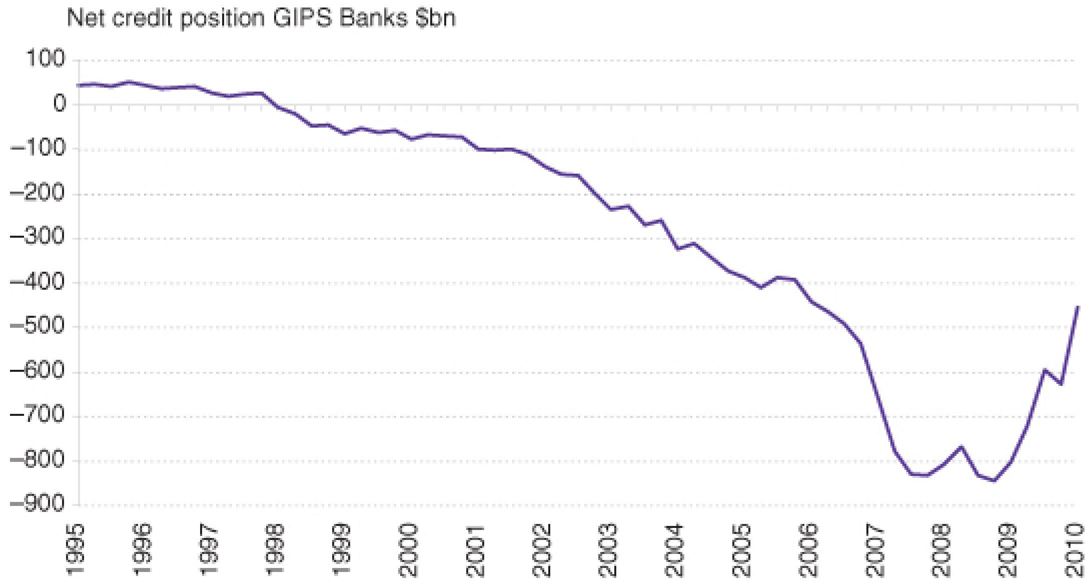


Banks generally find real estate an attractive asset, but particularly when interest rates are low and economic growth is strong. Unlike businesses, real estate assets are relatively easy to appraise and assess for creditworthiness. Moreover, the market is large, and at times of rising values it can create additional lending opportunities very quickly. For instance, we estimate that the total value of real estate in the US is $7.7trn, so a 10% increase in values creates $770bn of additional ‘lending opportunities’. No other sector gives banks the ability to increase their loan books as quickly as real estate. Compounding this, as we now appreciate, banks in the OECD can operate on the assumption that that they will not have to bear the full consequences of risky lending decisions. In any case, in the mid-2000s, it became quite clear that the major lending banks had replaced carefully considered lending with market share as their main objective function. Real estate was the sector of choice.

Two further factors facilitated the flow of debt into the real estate sector in the mid-2000s. One factor related to globalisation was the long-term growth in the usage by banks, in all regions, of the money markets for funding. Since the 1960s, customer deposits have fallen as a share of banks' liabilities and certificates of deposit, repurchase agreements and commercial paper have increased. As long as the money markets were open, the banks could expand lending way beyond the level that would be supported by their own domestic deposit base. During the 2000s, at least until 2007, it was very easy for banks in countries such as Spain, Portugal and the UK to tap the money markets in order to expand lending to real estate. Moreover, on the supply side, 'excess savings' in other parts of Europe and Asia saw the money markets awash with liquidity. This process, which might be called the globalisation of banking, is one of the key mechanisms by which real estate markets which are local in character can be swamped by international money flows. In the lead-up to 2007, banks in high savings areas invested in banks in low savings areas, allowing the latter aggressively to expand lending (Figure 1.6).

Figure 1.6: Net credit position of Greece, Ireland, Portugal and Spain banks with banks in the rest of the world

Source: BIS



Alongside the globalisation of banking was the growth of loan securitisation. Securitisation is the process by which pools of loans, for instance real estate mortgages, are 'bundled' together and the rights to receive the cash flows from these loans are sold to investors. The bank that sells this collection of loans receives cash (asset), which in due course it can recycle into additional lending and it deletes the loans (assets) from its balance sheet. In principle, there is nothing wrong with this; it has been a feature of the US mortgage industry for many years. Non-bank investors get access to stable investments with a good cash yield and banks get cash to help them engage in their primary task to provide loans to those that need them. However, there are two potential flaws in securitisation. First, in the circumstances of lax supervision and extreme monetary stimulation that characterised the early and the mid-2000s, it created an incentive for banks to originate loans for the sake of creating investment products, rather than supporting commercially sensible business transactions. Second, it facilitates the 'unseen' build-up in leverage within a market – in this case the real estate market – because the loans are 'off-balance sheet'. Loan securitisation was a major part of the 'shadow banking sector', which ballooned