MIND THE GAP: BONDS, YIELDS & RETURNS

JUNE 2013

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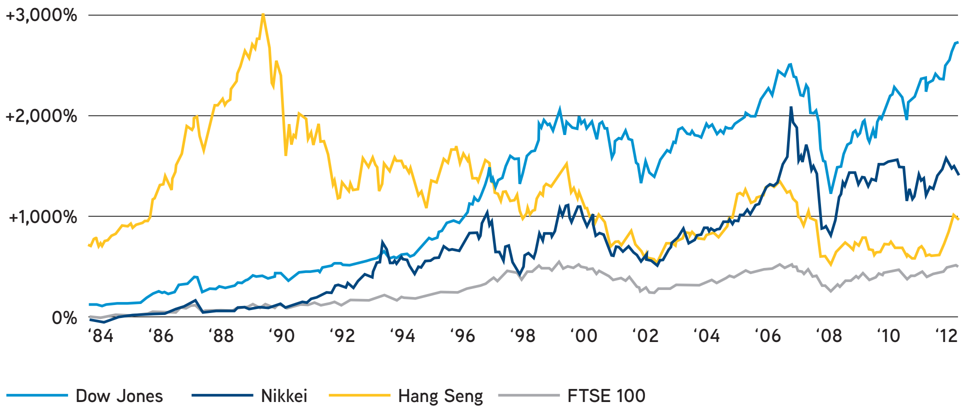
INTRODUCTION

Institutional investors are up against it from all sides at the moment. On the expense side demographics both in terms of population mix and rising life expectancies are piling on pressure to fund liabilities. On the income side weak global GDP growth has turned commodity gains into losses, equities are on thin ice as rumours gather about Quantitative Easing (QE) being tapered off and everyone is getting nervous about a possible bubble in sovereign fixed income securities.

FIGURE 1: GLOBAL EQUITY INDICES



Source: FT.com

Bonds on the Move

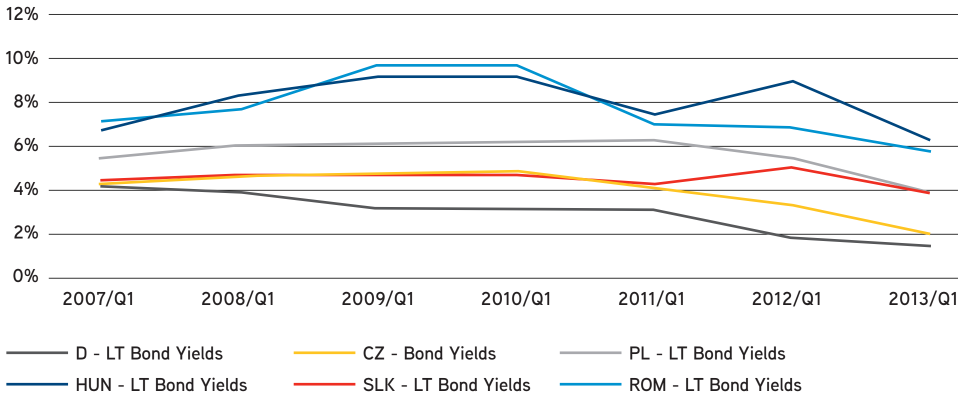
This last point was highlighted when it was revealed that Norway's sovereign wealth fund Norges, one of the world's largest, was getting out of (inflation-linked) bonds having almost halved its holding in the first quarter of this year – amounting to €2.1 billion. On top of that it has been charged with adding €27 billion of real estate to its portfolio in the short term. Norges is only one of several large investors singing a similar tune of reallocation. JP Morgan, M&G Real Estate and the Canadian Pension Plan Investment Board (CPPIB) among others have all been quoted as wanting to increase their exposure to real estate, with the latter aiming at a 20% exposure over the next 10 years.

The argument for reallocating assets is getting a lot of press coverage at the moment, with the focus on headline differences in prime yields. The safe-haven government bonds of the US, Germany and the UK are only yielding between 1.6% and 2.1% at present, while prime office properties in their respective capitals are yielding between 4-6%, creating a 2.5-4% premium over bonds. But this premium is there for a reason - to cover the additional risks and costs of investing in real estate - whereby the risk premium applied to property accounts for the need for capital expenditure, illiquidity risk (transaction lead time and ease of trading) and void/default risk. For prime property this risk premium is typically between 3-4%, but varies by asset type and the need to account for country risk, which is becoming more important.

In this paper we take a brief look at what explains the rush out of bonds and into property in safe-haven locations and the sustainability of the superior yields of commercial real estate over sovereign bonds, particularly in Central and Eastern Europe (CEE).

GERMANY V CEE GOVERNMENT BOND YIELDS

FIGURE 2: LONG TERM GOVERNMENT BOND YIELDS: GERMANY V CEE



Source: Eurostat (Maastrict convergence yields) to 2011, Focus economics thereafter

Figure 2 shows the progression of 10year bond yields in CEE countries compared to German bonds. Germany has traditionally been used as the risk-free rate when comparing bonds and property pricing - although we're not sure risk-free is an appropriate term anymore - least risky is probably more apt. It also acts as a useful asset benchmark for CEE markets due to its proximity, the city variations within the country and the number of large German investors who are active in both the German and CEE markets.

The first observation is that Hungary and Romania significantly diverged from the rest of CEE post-Lehman's. Although they snapped back into line in 2010, the gap is still significant and their volatility reflects country risk. There are of course legitimate reasons for this: the political disruption in Hungary as well as the size of its foreign currency debts are turning core investors off. While the emerging market status of Romania means it is primarily interesting for the bolder investor at present. With this in mind we will cover Hungary and Romania in a separate report as their country risk profiles put these markets into a different risk category to that of core CEE.

WHY GOVERNMENT BOND YIELDS DIFFER

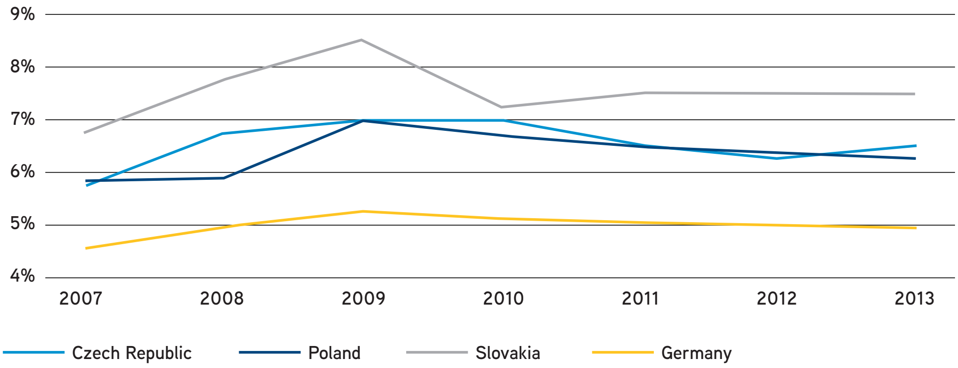
Differences in long-term government bond yield rates are driven by differences in GDP, inflation, currency risk and domestic base interest rates. Of the core CEE countries only Slovakia has adopted the Euro as its domestic currency and hence has no currency risk when comparing it to Germany. The divergence between Slovakia and Germany's bond yields therefore are down to economic growth and country management fundamentals.

The other observation is that the Czech Republic, which does not have the Euro, is the one most closely tracking the haven bond rates of Germany. This is not so surprising for a country oft referred to as the 'Switzerland of CEE', which benefits from a prudently managed banking sector and growing local capital base. Polish bond yields, however, have yet to converge with those of Germany to the same extent creating an interesting country risk pricing scenario which we come on to later.

Overall, however, the trend for all core CEE countries is one of slow convergence towards the low bond yields of Germany from 2011.

HOW DO PROPERTY YIELDS COMPARE?

FIGURE 3: PRIME GROSS OFFICE YIELD DIFFERENTIALS: GERMANY V CORE CEE



Source: Colliers International

Figure 3 shows the difference in prime office yields between the German market and the core CEE markets. At first glance this would justify a shift into CEE commercial real estate (CRE) as country risks converge towards haven status as seen in Figure 2 which would support lower prime office property yields in CEE. Additionally, prime German office yields have gradually hardened post-crisis to below 5%, creating the opportunity for CEE yields to harden in step with those of Germany. Polish office yields have followed this trend the closest.

If we look at expectations of bond pricing in future, however, by 2015 Poland's 10year bonds are expected to be 42 basis points (bps) higher at 4.50% and Czech bonds are expected to add 88bps to go to 3.11% due to the impact of QE and an increased likelihood of inflation. This is in line with recent trends in the haven bonds of Germany and the US, both of which moved out in the last week or so. German 10yr bond yields (Bundesbonds) have risen to around 1.61% (at the time of writing), from lows of 1.37% the week before, a jump triggered by the US 10year bond yield increasing to 2.15% from 1.65% a month earlier (a 12% drop in price) on the back of what is looking like a sustainable US recovery. Bundesbonds followed but the spread between the two widened as Germany continues to be weighed down by the rest of Europe.

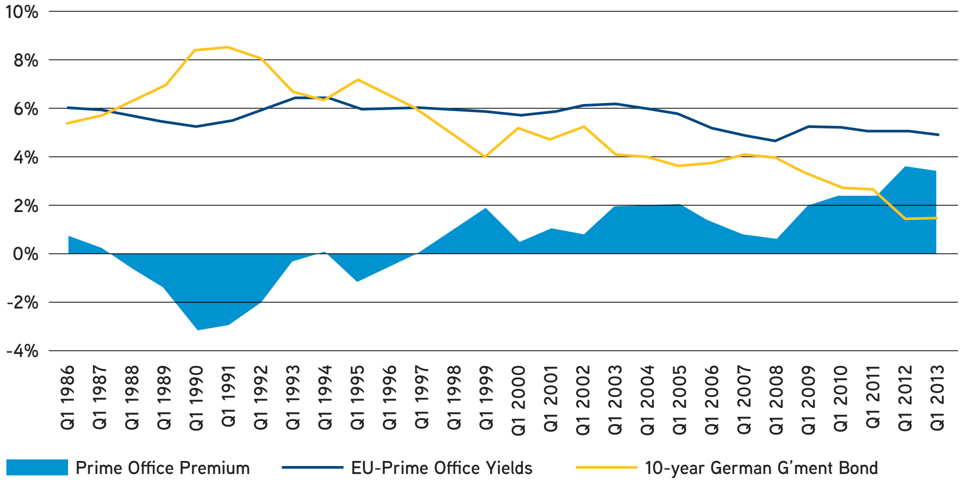
Looking further forward, there is every possibility that Bundesbonds will rise further in line with other haven bonds. In a recent Financial Times report of June 7th Bill Gross (referred to as the 'King of the Bond Market') forecasts the end of a 30-year bond bull market. He cites a sense that a profound change in bond pricing is around the corner as the US economy improves and the Federal Reserve starts to unwind their program of QE. Put simply, if the Fed starts to scale back on bond purchases, bond prices will fall pushing up long-term interest rates. Whilst Mr Gross believes higher bond yields remain a year or two away as the global economy is struggling to grow, an increase in bond rates is a case of when, rather than if.

It would be of little surprise, therefore, for Bundesbonds to go to say 2.5% by 2015 as markets avoid a deflationary trend reminiscent of the 2012/3 situation of when the ECB tried to save Italy and Spain. The big question is what does this mean for prime property yields? Could this add pressure to a softening of yields in future, despite the current hardening trend which has been witnessed in core markets post-crisis?

GERMAN BONDS & PROPERTY YIELDS

A review of Bundesbonds and prime yields shows us there is a very distinct relationship between the two metrics over time. It also reminds us of how low bond rates have fallen relative to their highs of the late 1980s and early 1990s.

FIGURE 4: LONG-TERM GERMAN BOND & PRIME GROSS OFFICE YIELDS: TO DATE



Source: Colliers International

There are several clear trends:

> Up until the end of the 1990s, 1997 to be exact, bond yields had typically been above prime property yields creating a need for rental growth to support target property returns.

> Since 1997, property yields have continued to trade at a premium to government bonds although their paths have come very close to crossing during the 'crisis' periods of 2001 with the dot-com crash, and more recently in 2008 with the financial crisis. During this time, property has traded at a premium to bonds, particularly in recent years, limiting the need for rental growth.

> With bonds rates having peaked again and with a significant premium in place, this suggests that property yields will harden at least in the short-term, as investors allocations switch into the sector.

> Perhaps the most poignant message is that prime yields are far more inelastic than bond yields, fluctuating within a tight range of around 150bps, compared to 750bps in the case of Bundesbonds.

After watching the equity/bond markets recently and their sensitivity to the slightest negative news (such as the US easing of QE and slow Chinese growth) it is worth remembering that CRE is not a market traded asset, aside from 'indirect real estate investment'. It is a negotiated bargain which supports this lack of volatility in pricing. It also means value is rational not reactive.

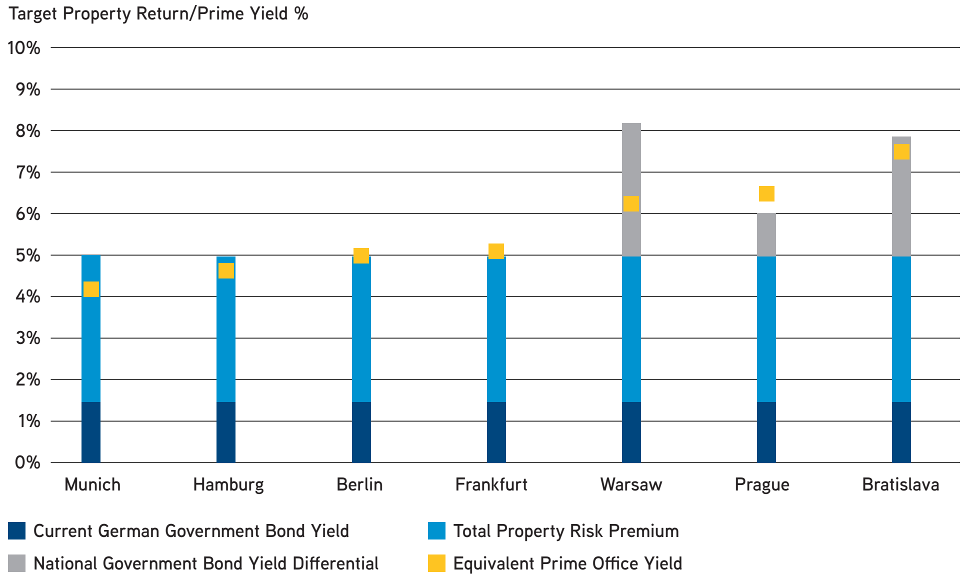
The next question is where to invest?

MARKET PRICING COMPARISONS: ARE THEY RATIONAL?

To compare how rational prime property pricing is at present, let's look at Figure 5 which shows prime office yields across the key office markets of Germany and core CEE, relative to rational target returns. These target returns are represented by the 'two-tone' blue bars in the chart - made up of the current German government bond rate, plus an additional 3.5% property risk premium accounting for capital expenditure, illiquidity and voids/defaults.

It can be seen that in the four major German markets prime yields are very close to, or just below the rational target return rate. This implies the need for rental growth of up to 1% per annum, for example in Munich, to match the rational target return rate of 5%.

FIGURE 5: CEE/GERMAN PRIME GROSS OFFICE YIELDS & TARGET RETURNS



Source: Colliers International

In the CEE markets, we see a mixed picture particularly when accounting for country risk i.e. the difference between each country's long term government bond yields and Germany's. In the case of Poland/Warsaw, it would appear that either country risk is not being entirely priced into property investment decisions based on current yields; or that investors in Warsaw have faith in solid rental growth of around 2% per annum. We suspect it is the former, which suggests pricing in Poland is getting tight when accounting for country risk, especially if pricing in German cities is considered to be close to peak in the current investment cycle. Prague on the other hand has room for prime yields to harden marginally, whilst Slovakian yields appear to be about right.

NET OPERATING INCOME & RETURNS

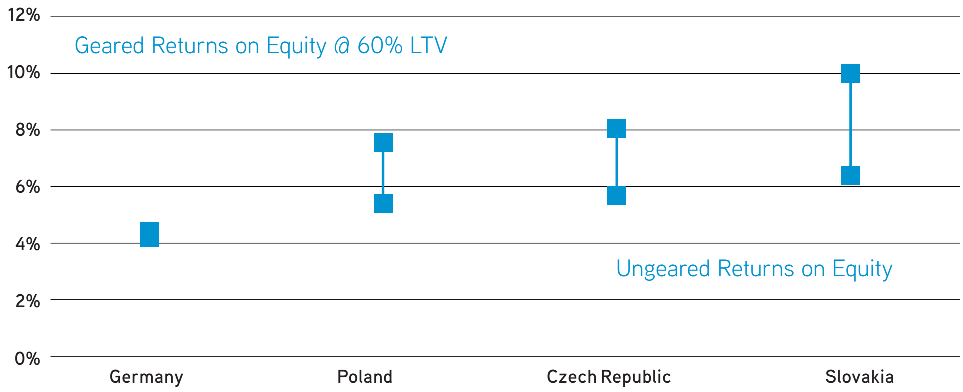
For real comparability between bonds and commercial real estate we have to look at the difference in geared and ungeared 'Cash to Cash' returns and premiums, bearing in mind that bonds do not have operating/holding costs.

We have used a number of assumptions to calculate and compare probable returns in the forthcoming year, including the following:

- Gross Operating Income: By assimilating a real building with different tenant profiles, we have calculated a weighted average net effective rent based on a blend of 5 years leases which have been initiated at different points in time (years), allowing for indexation to the national CPI of the respective market.
- Prime Capital Values: are derived from current prime yields and gross operating income. For the purposes of this report we have assumed that yields will remain constant for the year ahead, based on our previous analysis.
- Net Operating Income: we have used a factor of 15% allowing for non recoverable costs including capital expenditure, fit-out and operating voids to calculate the net operating income.
- Loan to Value Ratios of 60% and Financial Debt Costs of 4% (accounting for Euribor + bank margins) have been used to calculate equity volumes to be invested and subsequent geared and ungeared returns.

The outcome – as highlighted by Figure 6 – shows that solid cash on cash returns are available in prime property at present, with the benefits of gearing at a reasonable 60% LTV ratio being of clear benefit to the core CEE markets, especially Bratislava. If you can find the product.

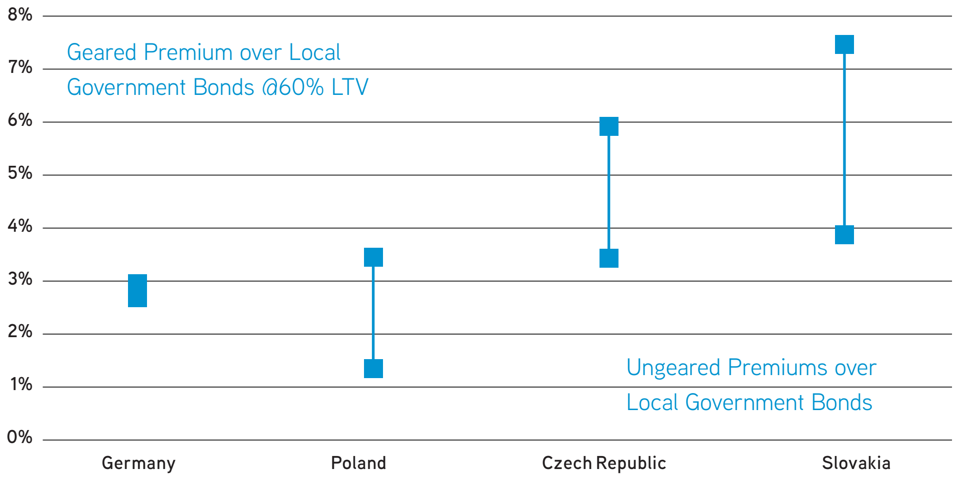
FIGURE 6: CASH ON CASH PRIME OFFICE RETURN FORECASTS BY MARKET: END 2013



Source: Colliers International

When one looks at this from the perspective of the premiums over bonds, the outcome changes again but reflects the earlier rational pricing results shown in Figure 5.

FIGURE 7: GEARED & UNGEARED PROPERTY PREMIUM FORECASTS OVER LOCAL GOVERNMENT BONDS: END 2013



Source: Colliers International

- German cities, whether geared or not, provide a cash on cash return premium over bonds of around 3% after accounting for non-recoverable costs.
- Prime CEE offices demonstrate the benefits of gearing at a reasonable 60% LTV ratio, creating a premium of at least 350bps over local bonds.
- The overall premium over local government bonds differs markedly, however, with Warsaw providing the least attractive risk-adjusted return profile of all the markets (when factoring in country risk). Warsaw, it would appear is getting quite tight from a pricing perspective.
- There are clearly more beneficial premiums available in the smaller markets of Bratislava and Prague. Although their relatively smaller size suggest the need for a higher illiquidity risk to be attached to these locations, reducing their risk-adjusted return advantage over Warsaw.

Overall, however, it is clear that prime property can generate significant risk-adjusted cash on cash returns relative to government bonds. This accounts for bond yields rising and property yields remaining constant in 2013. We also believe that core CEE market rents are quite robust, despite reported increases in vacancy rates in 2013, as our upcoming vacancy distribution report will show.

CONCLUSION

There are two conflicting forces at work with regard to prime yield pricing:

- On the one hand, we see increasing asset allocations to property, a trend which looks set to continue as investors shift out of equities and fixed-income/government bonds in search of lower volatility. This increase in the weight of money compared to a relatively illiquid supply of prime assets will harden real estate prices and ultimately shift money into secondary property assets and locations.
- On the other hand, money switching out of haven bonds (at all time pricing lows) coupled with increasing inflationary pressure in the general economy, should see bond rates continue to rise in the near future. This has the adverse effect of increasing target returns, which will lead to a softening of prime yields in the medium term in order 'to be rational'. Knowing exactly when bonds and yields will move out is the difficult thing to get right - prime property yields tend to lag the real economy and bond pricing by around a year - but happen it will. Timing, as they say, is everything.
- That said, prime yields are unlikely to soften by any significant degree as history shows us. Equally in the case of core CEE office markets, CEE country risk is converging with core German bonds which should help to keep prime yields in their current position, at least for the year ahead.
- On the income side assuming would-be owners of prime property have a long term buy-and-hold (LTBH) strategy income risk is internalised by tenant-mix in terms of rent and lease duration. This risk crystallises if a building's tenants all come up for renewal in a short period of time in a falling market, a real risk in markets where lease terms are relatively short.
- The external risks are of inflation and vacancy, due to market supply and demand rather than building management. In mature core CEE markets, there is a noticeable shift in demand towards high quality buildings to satisfy staffing and productivity gains for the occupier, but for the LTBH owner these should not be of major concern for prime or indeed good secondary assets.

In summary, a short-term mild hardening of yields looks likely in CEE to be followed by a medium term softening in line with bonds some 18-24 months down the line. With no dramatic changes in rents anticipated on the downside, prime office property continues to look a good bet and warrants the shifts in allocations being reported and realised.

Where the money continues to go appears to depend on attitude toward country risk. Increasingly, however, allocations are likely to be driven by the availability of appropriately priced product which are typically found in the larger markets. As pricing really tightens and product dries up, however, we are likely to see a shift into peripheral locations and secondary assets as investors move up the risk curve in search of value.

482 offices in
62 countries on
6 continents

United States: 140
Canada: 42
Latin America: 20
Asia Pacific: 195
EMEA: 85

- €1.5 billion in annual revenue
- 104 million square meters under management
- 13,500 professionals

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> The future role of Banking and the impact on the real estate industry.

> The impact of Latent Capital Gains Tax on commercial yield pricing.

> Generational change and the impact on office space demand and supply.

> The market positioning of the Business Process Outsourcing industry in Eastern Europe.

> Infrastructure change and the impact on the European logistics industry.

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