OAK INVESTMENT MANAGEMENT GROUP

JANUARY (1) 2012: The Prospects for Real Estate in the Sovereign Debt Crisis of Europe

Economic growth will be hampered by the sovereign debt crisis in the Eurozone; uncertainty or even the collapse of the euro will be damaging to all asset classes. Yet this is not the end of the matter. There are some sectors that will do relatively better and some that will do relatively worse during such a scenario.

Real estate is an asset class that has been blamed more than any other (apart from banking itself) for the emergence of the current crisis. But this assessment should not blind investors to the fact that this might be the best asset class to preserve wealth until the end of these uncertain times. Real estate pays a reasonably foreseeable coupon; if it is well chosen to an occupier's preferences, has iterative pricing power; has a barrier to entry (especially in times of poor liquidity for developers); has a relatively low level of working capital requirements (beyond 'installed' or theoretically redeemable value); has relatively low managerial requirements in comparison to other franchises; can absorb a great deal of value easily.

This last quality makes real estate a great asset class into which to re-cycle cash quickly, to diversify away from a central line of business or indeed divert resources quickly from fixed income into hard assets. In this way a sovereign debt crisis scenario could eventually tip investors from the confidence in governments' bond obligations to confidence in judiciously chosen enterprises' bond (or property) obligations, with a fair distance from exposure to their equity value and the uncertainty that that implies i.e. low rent in comparison to revenue derived from the property asset and at a price entry level that is fair distance from their exposure to their vacant possession value.

Clearly, 'fair distance' in this context is a critical but also judgment call based on experience and deep knowledge of the real estate market. From a fundamentals (bottom up) point of view, there is a need to take a view on tenants, their covenants, their buildings and associated capital expenditure *capex*, revenue expenditure *revex,* and operational expenditure *opex* requirements. From a macro (top down) point of view, there is a need to assess generally available capitalization rates in the real estate industry, in the country and region in question, in the sub-sector in question, the supply and demand trends identifiable, the cost and levels of leverage available to transact and the likely liquidity levels on exit.

Overlaid on both analyses is the actuarial element that is always present in investing. The likelihood of scenarios happening, the support levels that kick in at various upper and lower levels and the marginal (or elasticity) of demand and supply all have their role to play in assessing a real estate investment. They, in turn, underpin capital decisions that define the amount of leverage, hedging requirement and term assumptions for an investment.

Value in real estate investing, therefore, comes from 1) operating better than your competitors, 2) understanding the assets and the associated tenants better than others and 3) appreciating the dynamics of the market. A disciplined investment process that incorporates these elements should be able to weather the trials and tribulations of the Eurozone crisis whatever currency the tenant might end up paying in.

Nicholas Frankopan is Managing Director of Oak Investment Management Group pan-European real estate investment manager. To contact the author please email nfrankopan@oakadvisors.co.uk or learn more about the group at www.oakimg.com.