

LaSalle Investment Management

Recovering Europe Ripe for Investment

Recently, **Geoffrey Dobrmann**, publisher and editor-in-chief of *The Institutional Real Estate Letter* – North America, spoke with **Simon Marrison** of LaSalle Investment Management. The following is an excerpt of that conversation.

How far along is the European investment market in terms of recovery?

Some markets, such as France, are well ahead of others, but in general we've seen about 80 percent to 90 percent of what will be the total cap rate expansion. We can definitely see light at the end of the tunnel but the part of the market that hasn't yet fully happened is rental correction. Over the next six months, we'll see that play out first in the prime end of the market and then progressively moving along to the secondary end.

Do you think we are past the worst?

In terms of the credit crunch, the worst is certainly behind us in France, and Italy wasn't as affected because it didn't get so carried away with using debt. However, we still have a little way to go in Germany, and even more so in Spain.

In terms of the actual availability of credit, I think we're over the worst although there is a long way to go before we get back to normal. In France, for example, during the past quarter we've begun to see banks that weren't lending money that are now open for business. That's a hugely positive sign. However, we cannot lose sight of the fact that we are in an economic malaise, where unemployment is rising, and that is obviously having an effect on rents and the demand for space.

Is debt becoming more accessible across Europe?

No. The banks that are willing to lend are very much focused just on core markets where they understand and can control some of the associated risks. That means that for those banks with an appetite to lend, it comes down to the three big European markets — the United Kingdom, France and Germany. Appetite remains limited for anything outside of these markets.

Was LaSalle prepared for the economic downturn?

We were as prepared as it was possible to be for a once-in-a-career down cycle. We have a robust risk management system, where every six months we go through all of our portfolios with a fine-tooth comb, stress testing them against possible downside economic scenarios. During the past two years, our worst downside economic scenario became a reality. But at least we were able to go into it with our eyes open to the challenges that we would face in securing debt and tenants. Because we were prepared, we were able to exhibit a lot of caution on acquisitions, and to focus on existing tenants, keeping occupants in place and trying to secure longer-term income.

What are you doing now?

At this point in the cycle we are focused on taking advantage of the distressed sellers of quality real estate, be they property companies, open-end funds needing liquidity, or banks realizing that they have



Simon Marrison, co-head of Europe, joined LaSalle Investment Management in October 2001 as managing director, European private equity. He was appointed co-head of LaSalle Investment Management, Europe in January 2007. Since joining LaSalle, his responsibilities have included managing the LaSalle Euro Growth II fund and the LaSalle French Fund II, and he has been responsible for investing over €3 billion throughout Continental Europe. Since 2001, he has also overseen the divestment of approximately €1.5 billion of assets throughout Continental Europe.

problems looming on their loan books. Up until now, the emphasis has been on investors who are holding quality real estate with debt pressures. Now, there is greater pressure from simple liquidity issues.

We have a situation today where capital market volumes are a fraction of what they were at the peak of the market. An investor with money today can dictate a lot of terms on an acquisition that we couldn't necessarily dictate in days gone by, which takes quite a lot of the risk out of the deal. Today we might find a quality building in a good location, but we feel the building is over-rented and therefore there is risk on the lease. In the past, we might have had to accept that. Today, we can encourage the seller to renegotiate the lease with the tenants on our terms and actually secure things up front before we go and buy the building.

What types of commercial properties are you looking at right now?

We are looking for quality properties in the classic institutional sectors of office, retail and logistics in mature, transparent and ultimately liquid markets, particularly France and Germany. We're waiting still for Spain to get to the bottom of its pricing correction, and Italy and Sweden to a lesser extent. But at the moment, we're avoiding Central and Eastern Europe.

As ever, we're always focused on who is going to buy the asset in three or four year's time. So sticking with the well established institutional sectors and markets just strikes us as being the most logical way ahead for as long as pricing remains low.

Why are you avoiding Central and Eastern Europe?

We expect further pricing adjustments in the region. With the huge investor appetite and a fundamental lack of grade A space a couple of years ago, the cap rate accelerated well beyond what was ultimately sustainable fair value. There was overbidding on pretty much everything that was grade A.

The cap rates will obviously adjust back, but that process of correction probably only started in October last year, whereas in the more mature markets, it

had started nine months prior to that. So that still has some way to play out. In addition, everyone is wondering if the demand is still there in the occupier market. Demand is less easy to analyze than in the larger mature markets, and so as such, you need a higher risk premium to go there, which means obviously pricing needs to adjust probably a little bit more than elsewhere.

Have the new economic realities resulted in some sectors being more attractive than others?

We see an opportunity at the moment to access quality regional shopping centers at a once in 15 years price because they are in such short supply. You normally can't get your hands on those kinds of investments.

What types of vehicles are you using to access your target markets?

We have a couple of market-specific joint venture vehicles focused on France and Germany. Hence, we are well placed to take advantage of the pressure to sell from some of the operators in those markets. Looking forward, we are focused on closed-end funds. One will be a closed-end fund that is multimarket with a strong bias toward France and Germany, and we will also look at opportunities in Spain when the pricing hits the bottom there as well.

You seem to be a fan of Germany, but not everyone is. Why isn't Germany on everyone's list?

We are currently more keen on France but Germany remains the economic powerhouse of Europe and the largest real estate market in the Eurozone. Despite being a mature market, Germany is difficult to decipher. Buildings there are valued on the basis of replacement costs, rather than market value, and because they depreciate their buildings at a very small percentage per year the indices make it appear to be a very stable market. But the reality is a little bit different.

While in the past, the German open-end funds might have been a bit relaxed on whether a property fits their criteria, today a property must be Grade A with more than five years secure on the lease. On that kind of property, you haven't seen much of a price correction. There's been more of a correction on anything that doesn't fit those criteria, particularly in secondary stock where there has been an enormous correction. Today there is virtually no secondary market in Germany.

Besides trying to determine how the appetite of the open-end funds affects value, investors also need to look closely at location. Germany has six regions, each of them with their own dynamic. Pricing correction has been greater in some of those regions than others. For example, we're expecting more of a correction in a market such as Frankfurt, which is highly dependant on the financial sector. The rental correction there should be quite substantial.

These factors make the German market hard to read and some investors prefer to stay away. Clearly having a local team there is important in as far as it relates to identifying and managing attractive opportunities.

Why should investors be coming into the market now? Why not wait another six months, nine months or even a year?

Investors should come in now because the lack of competition allows us to mitigate much of the risk through tough negotiations, as I mentioned. Capital market volumes are already growing — they doubled in France from Q1 to Q2 this year, for example — but people haven't really recognized what's happening on the Continent, yet.

We can still take out a lot of the risk by demanding concessions from sellers. In six to nine months, we probably won't be able to do that, because there will be more capital looking to get into the market. We can have an exclusive negotiation today with a stressed seller, whereas in six to nine months we will probably be in competition with two or three other investors for that same building and, progressively, we will have to relax our criteria to be able to do an acquisition. That means that ultimately we will be taking more risk, but probably getting the same return.

What specific strengths does LaSalle bring to continental Europe?

Our main strength is that we are located in all of the main markets across Continental Europe and we have experienced teams on the ground. The current market environment and the recovery underlines the importance of having asset managers close to the properties doing what property people always should have done, which is to work with the tenants and to work closely on each property.

In the credit boom many operators forgot these principles. Instead, they simply bought a lease, didn't do anything to the property, tucked it away and figured they would get some cap rate compression.

Today it is all about understanding the market, being local in those markets, sticking close to your tenants and working on your buildings. That is what our philosophy in Europe has always been — be local, have deep teams locally — and when I look at a lot of the competition, I could argue that we are better placed than most.

In addition to our deep roots in Europe and local presence, our dedicated debt procurement team has positioned us well with the banks, which in turn, allows us to procure debt, even in tight markets. This is certainly an advantage and sets us apart from less established operators.

Why should U.S. investors be looking at Europe?

Europe is a major global market to which any serious investor should have some exposure. It's also an efficient property market that can be read from afar. The other thing about Europe relative to the United States is that the supply of property is relatively limited. Getting permission for development, particularly in the Western European market, is much more difficult than anywhere in the United States. As a consequence European vacancy rates are generally significantly lower than in the U.S. That enables property to hold its value more strongly than in some of the U.S. markets. In Europe, retail units are very difficult to build and so if you have this type of property, you have an asset with a long term sustainable value. ♦

CORPORATE OVERVIEW

LaSalle Investment Management is one of the world's largest real estate investment managers, with approximately \$36 billion of assets under management. LaSalle is a wholly owned subsidiary of Jones Lang LaSalle (NYSE: JLL).

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