

BNY MELLON
ASSET MANAGEMENT

Rising from the rubble



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Urdang Securities Management focuses exclusively on real estate, managing both private equity investments and portfolios of real estate securities.



The market meltdown that began in 2008 and continued through early 2009 shook financial markets to the core. Symptoms of an overlevered financial market manifested themselves in almost every form of investment and we watched as all markets fell together, liquidity dried up, and massive financial institutions once considered almost infallible closed their doors.

As we find ourselves in the beginning stages of what looks set to be a long recovery, confidence is being restored and asset values have stabilised. With volatility returning to normal levels, we see an indication of greater trust in the financial markets and even a return of investors' appetite for risk. It is clear, however, that the rise will not be as uniform as the fall – significant decoupling is already apparent and will only continue throughout the recovery.

Keeping the house in order

Luckily, the bad news for real estate securities seems to be behind us. Real estate investment trusts (REITs) have removed the perception of solvency risk with successful industry wide capital raisings over the second and third quarters of 2009. With over US\$47 billion in equity and unsecured debt raised by real estate securities globally, REITs with strengthened balance sheets are now in a position to invest in their current properties, as well as make accretive acquisitions. Market

conditions favour listed property's transparency, liquidity, lower leverage and high quality assets. With little to no supply growth in developed markets and long-term inflation concerns, higher yielding, asset rich REITs should become an attractive asset class once again.

New foundations

The removal of available credit from the market left both private and public real estate reeling, with US direct real estate valuations dropping 25%, as measured by the National Council of Real Estate Investment Fiduciaries, and sales volume down 85% from peak to trough. Although recovery is evident and investor confidence has returned, worldwide deal volumes remain extremely low and bid/ask spreads wide.

The widespread distress expected to hit the real estate market when banks realised their losses, however, has not yet occurred, and we believe there is a growing probability that the commercial real estate collapse predicted by many has been overestimated. Banks are not recognising losses, even in the face of maturity defaults, while capital is being held back. That capital could make its way into the real estate market and be available to refinance commercial real estate assets from the 2005 to 2007 vintage years, which were clearly overlevered. It is becoming increasingly likely that the supply of capital

will converge with the demand for capital, and that commercial real estate values may now be close to the bottom – perhaps only falling another 10% or so, for a total peak to trough decline of 35%, as opposed to the 50% decline predicted by some.

Eastern promise

The investment market is heating up and we are seeing positive momentum across the globe in real estate securities. The comeback has been driven by a number of factors that show little sign of changing, including a low interest rate environment, a growing quest for yield, broad-based improvement in sentiment, and an increasing risk tolerance, particularly for asset backed strategies. As global economic conditions begin to rebound, we believe that the magnitude and timing of the recovery for various asset classes and markets will look materially different. Monetary and fiscal policies around the

world are no longer being orchestrated for the same common goal of trying to save the financial system. We expect central banking systems to begin to rein in expansionary policies due to ballooning deficits, and we believe the US may be one of the laggards in this regard. Hong Kong should continue to benefit from strong local property fundamentals, as well as exposure to GDP growth in China, and that should favourably impact firms with large office/retail exposure. European retail assets should continue to hold up well in the current environment, providing solid risk-adjusted returns. We expect the US direct property market to be one of the last to recover.

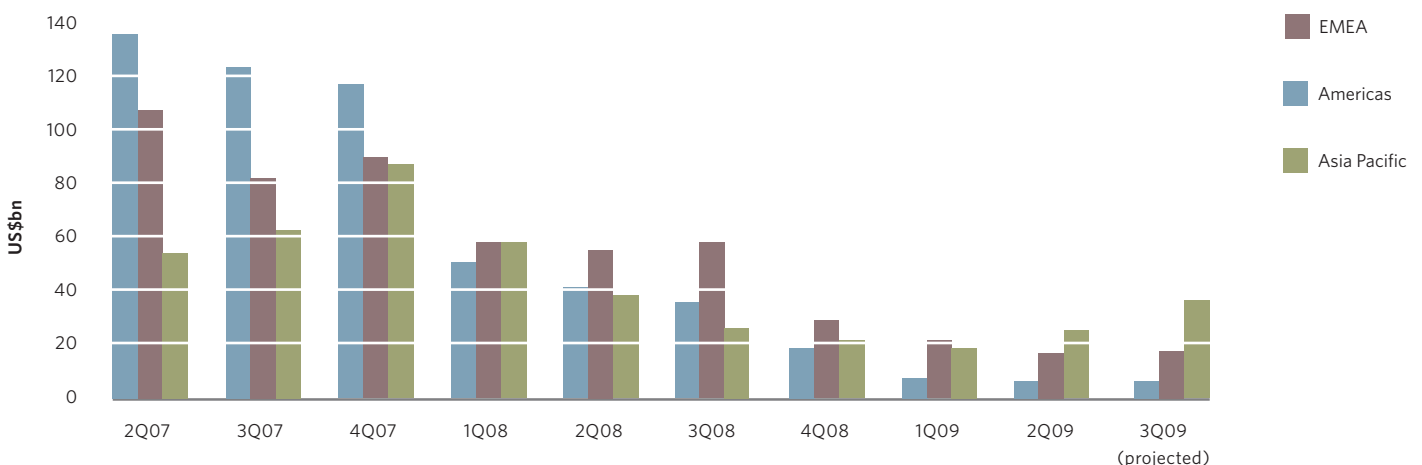
When the dust clears

Although property fundamentals, which ordinarily lag the economic cycle, have been weak, the investment market is definitely heating up, with yields actually falling in traditional investment hubs

such as London and Hong Kong. But interestingly, property values are increasingly determined by the ability to finance the asset as opposed to its rental growth prospects. The alignment between rents and values has, for the moment, become unhinged, but we expect this to change as the market recovery evolves.

There are three primary themes we expect to play out over the coming year. We believe operational excellence is key. Despite fundamental headwinds, some REITs should be able to maintain or even grow occupancy as they take market share from private operators. We also believe that quality assets have an important competitive advantage in the fight for tenants. Lastly, we like companies that can add value through external growth, and REITs' relatively lower cost of capital gives them the advantage in accretive acquisitions.

GLOBAL SALES TRANSACTION VOLUMES



Source: Real Capital Analytics as at 30 Sept 2009

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