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Credit crisis could still create fresh opportunities

This column was warning about irrational exuberance in UK property long before this was a fashionable sentiment.

To quote: "There is a very serious danger that the launch of Reits, at the start of next year, will coincide with the market passing its peak." (FT, April 4, 2006).

Shares in British Land, Land Securities and Hammerson are down by about 30 per cent since January, when they became real estate investment trusts.

In the same contrarian spirit, it is now worth asking whether falling confidence in the sector is throwing up some investment opportunities.

The following suggestions may or may not work, obviously. And readers with better ideas are welcome to send them by e-mail so that I can pass them off as my own in the future.

1] Property derivatives. These new instruments should come into their own in a property market where uncertainty reigns. In three years this has grown from nothing to be worth several billion pounds of transactions.

But the market has always been held back by one problem: everyone thought that property prices would keep going up. Now that there is genuine disagreement, one should expect transaction volumes to grow.

Bear in mind, though, that betting that prices will fall is no longer cheap given that it is the new wisdom.

2] Property-backed bonds. Yes, this one may sound eccentric given everyone's new-found fear of asset-backed securities. But margins on commercial mortgage-backed securities (CMBS) have widened so far that yields are looking pretty thick. One securitisation analyst points out that the yield on typical BBB tranches – ahead of equity and B notes in the credit pecking order if things go wrong – is about 9 per cent. For now that is a theoretical figure, given that no one is managing to issue any CMBS. Worth watching, though.

3] The over-sold commercial property stocks.

Property values seem to be falling in parts of the market. The consensus is that yields are moving up about 25 basis points for primary

and 50-75bp for secondary. That would mean a price fall of 5 per cent and 12.5 per cent on assets, which started out at a yield of 5 per cent. Does it justify a discount to net asset value of 20 to 30 per cent on well-run property companies with low gearing and development pipelines? Perhaps not.

It is too early to judge the permanent impact of the credit squeeze. However, if it leads to lower interest rates by next year, that would be one upside for the sector. Capital & Regional, down by 54 per cent since January, is now cheap. Yes, its retail focus is a worry and its performance fees are drying up as the market slows. But the group does not deserve to be at a discount of 41 per cent to net asset value.

4] The housebuilders. Companies such as Persimmon, Redrow and Barratt are trading on price/earnings ratios of about eight. That looks undemanding, for sure, reflecting a fall in prices in recent months. But if the housing market goes under, those share prices could be vulnerable. In past downturns the sector's p/e ratio has fallen to as little as five, logically or otherwise. It may be too late to short the housebuilders outright. Instead, take advantage of volatility as prices swing up and down on the latest monthly housing data. Even in a bear market, there will be some months where prices fall and others when prices rise. Housebuilder stocks are likely to

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5] Change of use.
Developers can
still make money
even when the
price of property
assets is falling.

Let's say you buy a car park for £2m and
obtain planning permission to turn it into £20m
of flats. Even if development costs £10m - and
prices fall 10 per cent - there is still a potential
profit, if you can find buyers.

6] Some "alternative" sectors based on
long-term demographic trends could withstand
a downturn. Students will still need somewhere
to sleep and Unite, which builds large-scale
university accommodation, still has room for
strong growth. Others may see self-storage or
nursing homes as relatively safe havens.

7] Overseas investments. Avoid putting all
your money in speculative flats in emerging
markets such as Bulgaria where you have little
control over supply and demand. Instead, there
may be opportunities in buying property shares
in developing markets.

Russia is not for the faint-hearted or naive.
But take a close look at PIK, a developer which
recently listed in Moscow and London. Its
straightforward business model is the
construction of vast prefab skyscrapers for
low-income Russians. One of its sites, on the
north-west fringe of Moscow, is set to house
40,000 people. Russia is under-supplied with
housing and its mortgage market is only in its
early days. PIK itself only has about \$800m
(£396m) of debt.

Shares in this \$13bn company are not cheap;
they fell to \$23 in August but have since
jumped to \$27. Yet it is just one example of
opportunities lying further afield.