

Counting Pennies

Fluctuations in the World's Currency Markets Can Play Havoc with Real Estate Investments

In times of volatility there is a flight to quality — investing in what you know. When Lehman Bros filed for Chapter 11 bankruptcy protection in September 2008, the US dollar initially soared in value against a basket of currencies. However, as stability returned, volatility reduced and the dollar retreated. With the equity markets, at the time of writing, up 42 percent since their nadir at the beginning of March, many investors are now feeling that the worst is over and are looking to invest in currencies that are higher yielding than the US dollar.

When loan-to-value ratios (LTVs) were high, high debt levels provided a natural hedge against foreign exchange for externally denominated investors, as smaller amounts of equity were needed to fund transactions.

The current market is very different to that of a couple of years ago. With LTVs now limited to 60–65 percent, much larger equity positions are required within the capital structure of transactions. This inherently exposes the investor to higher foreign exchange risk. Hedging such risk through the use of currency instruments is typically expensive and rarely would (or could) investors buy a hedge to negate the totality of any currency risk.

With a myriad of currencies and increasing investment opportunities in a global market, what is the solution for investors? As investors acquire assets in US dollars, euros, pounds sterling or any other highly traded currency, investors will need to resist the temptation to repatriate back to the respective home currencies. Investors should be able to create diversified holdings of assets (and currencies) that grow over time.

To demonstrate this, at the zenith of the UK property market in the second quarter of 2007, a

Executive Summary

- ◆ **The recent past has seen significant volatility in currency markets as investors have reacted to macroeconomic developments.**
- ◆ **International real estate investors have to take account not just of market fundamentals but also of possible currency movements.**
- ◆ **Not making the right decisions on currency can cause significant reductions in returns, and hedging of currency positions is not the panacea some might believe.**

a foreign exchange rate of approximately \$2 to £1. Assuming that any acquisition was capitalised with all equity and that there has been a drop in values of 40 percent since, the movement in the currency would intensify the fall to more than 50 percent, should the investor decide to repatriate the remaining capital back into US dollars.

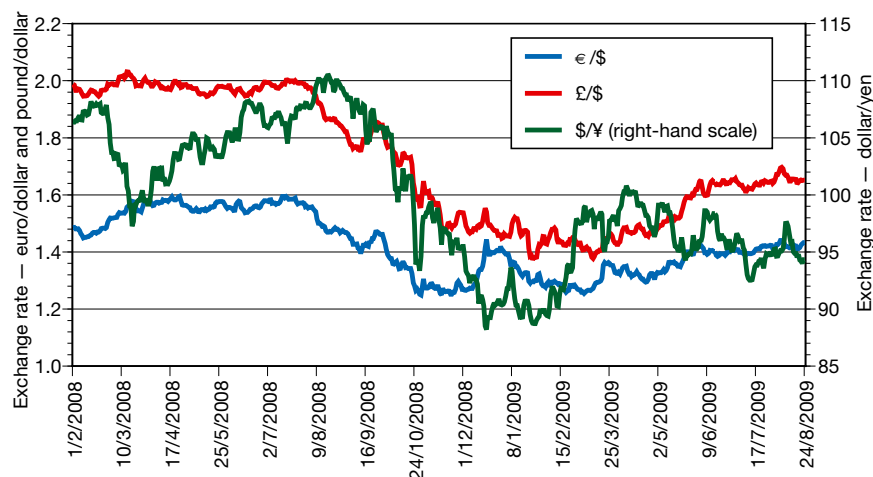
A KEEN FOCUS

The aggregate economy in the European Union is more than 30 percent larger than that of the United States and with a population 60 percent larger. The European Union is a major trading block on the global stage. Europe offers investors diversification away from the United States in largely free market economies. Within the European Union are four of the world's top 10 economies: France, Germany, Italy and the United Kingdom. For real estate investors into Europe, there are only two currencies of any significance: the euro and the British pound.

The advent of the euro in 1999 and the circulation of the

US dollar investor entering into the market would have been achieving

Exchange Rate of the US Dollar Against the Euro, Pound Sterling and Yen, February 2008–August 2009



Source: Oanda

currency in the early part of the decade meant that investing across Europe became much easier, as well as removing currency risk across countries within the euro zone. Initially, 12 members of the European Union adopted the euro, but over the past three years four of the newer entrants to the EU family have also achieved the prerequisite economic requirements to adopt the euro as their unit of currency: Slovenia, Cyprus, Malta and Slovakia.

It is anticipated that other EU members will join the euro in the next few years. Countries hoping to join the single currency club include the Czech Republic, Hungary and Poland. Indeed, many of the aspiring members of the euro zone already use the euro as a unit of currency when it comes to commercial real estate transactions, with buildings leased in euro-denominated rents.

The largest economy in the European Union not to have adopted the euro as its currency is the United Kingdom. The lack of political will means that the situation is unlikely to change. The UK economy is currently going through one of the severest recessions for 60 years; however, it has one of the largest real estate markets in Europe, with 25 percent of all transactions in the European Union in 2008 occurring in the United Kingdom.

The global credit crisis has laid bare government profligacy, and, as governments have moved to inject enormous amounts of capital into the banking system and at the same time tried to stimulate

their economies, currency traders have become concerned with government deficits. The United Kingdom, which is following similar policies to the United States, had the ignominy of having its sovereign debt placed on a negative outlook by Standard & Poor's in May, partly because of fears that the debt ratio to GDP will exceed 100 percent, as the public finances have deteriorated at a much faster rate than that forecast by the IMF. Countries already within the "over 100 percent" club include Japan and Italy, neither of which, in economic terms, has been a beacon of virtue over the past couple of decades.

A COMFORTABLE HOLDING?

The United States has for many years built up huge deficits and relied increasingly on overseas governments to acquire this debt. The Chinese, the largest holders of US dollars, have recently been quite vocal regarding the possible collapse of the value of the US dollar. However, mainly due to the size and liquidity of the US Treasuries market, China is caught in a "dollar trap".

In March this year, China's direct holding of US Treasuries rose by \$23.7 billion (€16.2 billion), to reach a record \$768 billion (€523 billion), up more than 3 percent on the previous month. In terms of China's reserves, it is estimated (by the US Treasury, as the Chinese do not publish these figures) that Chinese US dollar assets are as much as 70 percent of its \$1,953 billion (€1,331 billion) total and that China owns nearly a quarter of the US debt held outside the United States.

The nations of the Gulf Cooperation Council (GCC) — comprising Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates and the Sultanate of Oman — are in a unique position. The main exports from the GCC countries are oil and gas, both of which are priced in the current global reserve currency, the US dollar, and the local currencies are largely pegged to the US dollar.

With export capital, whether held by high-net-worth individuals or sovereign wealth funds, looking to deploy outside the GCC region,

where should this capital go? Without taking foreign exchange risk, GCC investors can tap into the large market of the United States. Due to diversification issues, capital from the region has for many decades invested across the globe and, in particular, in Europe.

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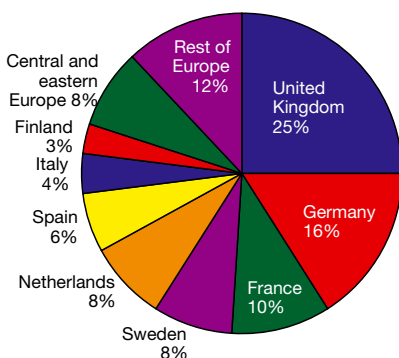
In recent years, an increasing percentage of the capital from the GCC looking to invest outside the region has been Shariah compliant. A foreign exchange hedging instrument is not usually available to Shariah-compliant investors.

Non-UK investors are well placed today to enter the UK market. The pound, even allowing for its recent strengthening against the dollar, is still trading at a 10 percent discount to its three-year average of \$1.85 and against the euro at a 14 percent discount to its three-year average of €1.323. However, investors need to remember that, even if the pound moves back to its average trading position of the past three years, they might be best advised, from a hedging strategy point of view, not to repatriate the capital and rather to create permanent "silos" of global currencies, so as to achieve diversification.

In doing this, investors can negate significant additional costs that can, in extreme instances, not only remove all the returns but create potential losses, should an investor be sitting on the wrong side of a currency position. Although hedging can mitigate these extremes, there can be a significant cost involved and in practice a foreign exchange hedge will not insulate investors entirely. ♦

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European Real Estate Transaction Market Share, 2008



Source: Jones Lang LaSalle