THE COMMERCIAL PROPERTY MARKET

Almost all property companies and property funds using a high margin of leverage have been caught out by the rapid change in the cost of money, many have been refused finance due to the fall in asset book/cost value. Others have had to refinance but at far higher rates, the refinancing is often three times the previous rate and that is what's really driving the property downturn. Looking back at how the markets have reacted, assessing whether it did, or has overreacted, is an arduous task but this is necessary to make a judgment call on whether more pain will come.

Real estate markets are always negatively affected should they encounter any of the two separate, and main influencing factors. One is when the cost of money rapidly rises, and therefore, leverage becomes more expensive; this is always terrible news for the property sector. The second main negative driver is when an oversupply of physical real estate is combined with a collapse in demand - over the past two years, there has been little of that; we haven't had oversupplied markets, and construction hasn't been behind par with demand for many years.

The reason why is simple, following the global financial crisis, banks, in particular, stopped lending speculatively. So, developers were forced to go and find capital elsewhere. This was a genuine constraining factor for the market.

T**he above had been an opportunity for cash rich companies such as RIO.**

With three decades of market experience RIO Property is well versed in this market, in fact the previous two direct property investments products were five-year fixed term products and each had delivered net gains of over 60%. During that time both had beaten their benchmark (average House Price Index) 10 times in the 10-year period. The third version of RIO Property, also a fixed 5-year term is ongoing, and has also beaten its benchmark return every year since its launch in January 2020.

Over the initial 10-year period above, had a member invested with RIO Property they would have seen a return of 126.43%. It's the reason why RIO Property has been, and still is, very popular with our membership.

There are, however, several more reasons for this; one is RIO's proactive structure, and the second main factor for outperforming RIO's benchmark return is how, and what we can invest in. Importantly I am a very seasoned property investor, and as such, I have been through many property cycles. Long-term members may recall that RIO started investing in the UK property market in March 1997 (see appendix I), and I've been in, and out of this market three or four times since then and have also made a profit.

Today, the swift change in the cost of money has been theatrical and has caught many less well-versed property companies off guard. Almost all remain leveraged; many have suffered significant loss and are struggling to attain refinancing; at the current rate many will end up in the red.

RIO Property has never used leverage, nor borrowing of any kind, and have always been cash buyers; this is one of the fundamental differences between RIO, and the run of the mill players in the property market.

Most, if not all, private equity firms out there wish they had leverage lower than 50%. Many property investment companies have significantly higher leverage, next year many more will have to refinance and are already hurting now due to vacant buildings which are producing no rental stream. This problem is mainly due to what's happened in the economies in which they operate, they are not growing, but the price of money has moved dramatically higher. The good news is that this is a blessing for RIO, we unlike most have not been exposed to the negative influences of rapid lending rate changes. The simple reason being we have always elected, where possible, to limit risk.

The UK, and especially Europe, has a situation where a lot of retail businesses have collapsed.

The above is the net result of a bad economic environment, the situation has in turn lead to buildings falling vacant. This is while almost every European economy struggles to build enough houses to meet the demand. It has always been a very simple decision for RIO - if we can't find a suitable tenant for one or more of our commercial properties, then we'll simply apply for a change of use, and turn these properties into a residential developments.

The downside is that this often requires significant time and work; of course, it also requires experience, and extensive knowledge of the required procedures, to produce the desired result - a profitable outcome. But many in the property market have little to no experience nor understanding of the requirements and are unfamiliar with the correct channels. To be successful you need to be very familiar with the legal and planning procedures to achieve the goal; sadly, many lack unleveraged funds and cash is often a crucial and missing ingredient.

I feel that converting existing properties is something that the UK government should encourage more, through for example a permitted development, where, and if you own and have older office buildings, you could be granted permission in advance.

RIO have, over the years, sold several buildings, having successfully attained planning permission for a change use, and we have the benefit of long-standing relationships with residential developers who are usually more than willing to convert these properties; in fact, we have previously gained a 25% profit on property by being granted permission for a change of use. Many office buildings can be worth much more with a residential planning consent than they are as an old office building.

Converting incredibly redundant commercial to residential property is the best way to make money. The conversion cost, particularly for older buildings, is high relative to new builds. Hence, the entry point has to be far lower, and again this is a limited market. Most in this sector are like RIO, cash buyers.

The UK Property Market - an overview

According to recent research, London office values have fallen 26% in the City, and 14% in the West End, which means further sharp falls are likely to occur.

The most significant problem here is the massive gap between what investors believe their assets are worth and what a prospective buyer is willing to pay, which leads me to state that the full extent of painful write-downs has yet to be felt.

Our investment research would indicate that the disparity is likely around 20% to 25% in core office markets; if we're correct, this situation would be far worse than the height of the global financial crisis.

During 2004/5, I was among the first to "ring the alarm bells" and had written a damming report on the US housing market, warning of the increased risk in the property market due to the mortgage market (see appendix II). I was proven correct when this market came crashing down; it emerged that credit agencies had been strongly influenced by the banks who paid their fees. That being so, they had failed to sound the alarm over the fundamental flaws in trillions of mortgage-backed securities.

Problems are lurking in the UK commercial property market.

Today in the UK commercial property market, valuations result from discussions between owners, auditors, and valuation agents. At the moment, it's in no one's interest to mark this stuff down, even though the gap with the actual market is getting wider.

Many property owners hope they can ride out the correction until values rebound because steep write-downs are likely to have serious knock-on effects.

The relationship between property companies and banks is "two drunks propping each other up" – rising rates push down property values and impair banks' loan books. This, in turn, makes them less likely to refinance existing loans. This will soon turn many property owners into forced sellers, pushing values lower.

I would underline the fact that cracks in the commercial property market emerged in the weeks following the Liz Truss-Kwasi Kwarteng mini-Budget fiasco. She was perhaps unaware of the fallout from such sweeping changes which she had suggested. Behind the scenes, a series of large property funds backed by some of the world's largest asset managers were suddenly gated (refusing surrender requests). Blackrock and Schroders restricted withdrawals from funds with a collective value of around £9bn after spooked investment intermediaries ran for the exit.

Last month, another three funds run by St James Place and Canada Life followed suit, saying it will take approximately 18 months for most of its portfolio to be sold in the current climate.

The Commercial property market in the Euro zone remains negative.

The commercial property sector in the Eurozone has struggled for years; a recent report from the European Central Bank proclaimed that it is now posing a threat to the banks and investors that financed this market.

The ECB has released a report that examines threats to financial stability and has now underscored an elevated risk concern amid a property boom that is fast receding, with Germany and Sweden in the spotlight.

I had highlighted in a previous report that commercial property prices would be hit by economic weakness and high-interest rates over the last year; it is now evident that this is indeed the case; in fact, it is challenging the whole sector's profitability as a business model. The industry needs to be bigger to create a systemic risk for lenders. However, it could increase shocks across the financial system and significantly impact financial firms, from investment funds to insurance firms, collectively known as shadow banks.

The sudden reverse in interest rates has forced some developers into insolvency and has put deals and construction on hold. One example is the construction of one of Germany's tallest buildings, which was suddenly suspended midway after the developer stopped paying the builder. The owner of the building had been making steady progress this year on the planned 64-story skyscraper in Hamburg but they fell behind on payments.

The ECB's report noted that a negative outcome of this type would also drive large losses in other parts of the financial system, which are significantly exposed to CRE, such as investment funds and insurers.

Our analysts highlighted that commercial real estate transactions were down 47% in the first half of 2023 compared with the same period in 2022. Until further data is available, it's hard to say how much prices have dropped to date, but the bloc's largest listed landlords are trading at a discount of over 30% to net asset value, their largest such discount since 2008.

RIO Property is doing well it posted a gain of 1.12% during the third quarter and is in the final stages of negotiation to move forward on our latest change of use development. This investment has produced a net gain of 5.75% in the last 12 months, with the performance in the two-year period recording a net gain of 13.43%, in comparison the general UK property market recorded just 5.11% in the figures filed for the period to the end of September.

If the tighter financing conditions persist for two years as markets expect, many property firms will be required to roll over all maturing loans. This will exasperate the issue and create many opportunities for RIO.

William Gray
The RIO Club

Past

March 1997

UK Property Market

The UK Property Market will see Capital Growth over the next five years and as such RIO are incorporating the RIO Property Group Ltd - a property investment company to take advantage of this opportunity. This entity will acquire piece by piece a property portfolio over the next two years. Club members interested in this investment opportunity will be able to acquire shares in this company within the next few months. The RIO Property Group will provide a guarantee of capital on its shares at outset i.e. invest £100,000 minimum return £100,000 in 5 years.

Members should note that each property will have a tenant in position at the time of acquisition, with at least a 10 years corporate lease secured on holding before being added to the property portfolio, this gives a purely upside to this investment. All properties are to be fully insured on an all risks basis. Also insured is the rental income i.e. should the tenant for any reason fail to pay rent the insurance provider would compensate RIO for loss of rental income. For each holding within the portfolio for up to 3 years of the annual rental income on all properties. We predict that the UK Property Market will remain in an up cycle for the next 5 years at least.

William Gray.

US mortgage market collapse.

Could bring down The U.S. housing market?

After nearly 10 years of unprecedented growth, the bottom is about to fall out of the U.S. housing market. The dominoes in this game have already begun to fall and the next significant move will come very soon.

A total of $2.5 trillion or more will be wiped away. But as awful as that sounds that's not the worst of it. Because of the enormous house of cards created by the U.S. government over the past 10 years, the entire U.S. financial system is in jeopardy.

This eye-popping turn of events is actually the spectacular collapse of a consumption bubble that was created nearly a decade ago.

It may have taken years to build up such an enormous bubble but it will only take a few weeks for the roof to cave in. And then 10 years' worth of prosperity will disappear.

The U.S. Housing Market Is on the Verge of a Historic Collapse

Regardless of whether or not Fed Chairman Alan Greenspan wants to admit it or even if he wants you to know about it the United States housing market is an enormous bubble on the verge of collapse.

And this particular bubble will without question be far worse than any in history. Worse than the U.S. stock market bubble of the late 1960s. Worse than the gold bubble of the late-'70s. Worse even than the tech bubble of the late 1990s.

That's because unlike many of the other scenarios throughout history this bubble stands to impact a far greater number of individuals than any other.

Imagine many peoples largest investment their family's home losing 30% or more of its value overnight. Now imagine that same scenario happening to everyone on your street or everyone in your town. In fact, consider for a moment this event will affect almost every resident of every town in the United States.

This financial disaster created entirely by the U.S. government is about to become an enormous tragedy.

That's because this market collapse the total destruction of the U.S. housing market will have a direct impact on more Americans than any other financial event in history.

The Dominoes Have Already Begun to Fall and a Dangerous Rate Hike Is on the Way

Over the past three weeks, seemingly every report coming out of Washington has pointed to the same thing - a conclusion Alan Greenspan himself conceded in his April 21 remarks - like it or not, interest rates will soon be going up.

April 4
'Job gains raise expectations of interest rate increase' - USA Today

April 14
'Largest increase in core measure of prices since 2001 feeds rate hike speculation' - CNN/Money

April 22
'Greenspan Elaborates: Rate Hikes Are Coming' - Investor's Business Daily

May 4
The Fed leaves rates unchanged but plots "the beginning of the end for the lowest U.S. official interest rates in 46 years.' - Reuters

The Slightest Rise in Interest Rates

Will Trigger an Absolute Disaster

Home values will plunge. Debtors will default in record numbers.

Alan Greenspan himself - not exactly a man known for publicly forecasting danger - has even acknowledged this problem in recent testimony before Congress, calling for immediate action to be taken regarding this danger and conceding that a rate hike - the spark that will ignite this historic fire - is a foregone conclusion.

What's worse, however, is that this threat is potentially far more dangerous than simply a reduction in the value of housing.

Because once this crisis begins to build up steam, the entire financial community will be placed in harm's way, including the institutions currently charged with holding the retirement savings of millions of Americans.

Because of the enormous 'credit machine' - created by the U.S. government and now spinning hopelessly out of control - 52% of U.S. household assets are now exposed to an enormous risk.

When you stop to think about it, it's remarkable that more attention has not been paid to just how high housing prices have risen in a short period of time. Fueled by the enormous 'debt engine' known as GSEs - which I'll tell you more about in a moment - housing prices have jumped 51% since 1995. That's a rate of 32 points above the overall rate of inflation!

This dramatic - and unprecedented - rise in housing prices has added an average of nearly $50,000 in wealth for every one of this nation's 72 million homeowners. But the truth is, that $50,000 figure is just an average number

The real exposure for most Americans over the age of 40 is most likely three or four times that amount. That's up to $400,000 or more, money that stands to disappear in just a matter of weeks unless you take action.

Even if you're able to protect your own nest egg imagine the impact on the USA when nearly every homeowner loses a small fortune almost overnight.

Alan Greenspan can call it whatever he wants but I know a bubble when I see one. In fact, long-time followers of my newsletter RIO News know firsthand just how important global trends can be to personal wealth.

We're talking about each and every American homeowner being affected