

## DO THE NORDICS OFFER A SAFE HAVEN?

By David Neil and Philip Björk of Genesta Property Nordic

The fiscal and debt problems in Europe are worse than generally believed. Often overlooked is the fact that repaying public debt is more a matter of will than ability. Countries will default long before their options of repaying are truly expended. Given the amount of the debts, the political will to undertake austerity measures and pay down debt must be exhausted eventually. In addition, a favourable outcome of the sovereign debt crisis would be a complete break with history. The Nordic countries seem to have been able to avoid such troubles and in a turbulent Europe the Nordics offer a safe haven. Is this favourable outlook priced into Nordic real estate?

At the time of writing, at the beginning of September, the sovereign debt and fiscal crises that started with the PIIGS-countries have spread not just to other peripheral countries, but also to France, at the core of Europe. Markets are concerned that a number of these countries will default, in part or in full. We believe these concerns are fully justified.

Firstly, whereas the sheer mathematics of the situation paints a dire picture, defaulting on debt is not merely a matter of maths nor the ability to pay. Unlike a company or private person, a country can choose not to pay. Thus payment of its bills is a matter of will just as much as ability. And the political will to repay debt is often exhausted long before that ability to pay.

Secondly, countries with the credit histories of the likes of the PIIGS have, in the past, been unable to recover from the debt-to-GDP ratios they are currently experiencing. Historical evidence points to defaults at debt to GDP levels that are considerably lower than those experienced in these countries today. Are things different now? To some extent they are. But mostly things are just the way they have always been and these countries will likely default, just as they have in the past. One of the biggest follies in every crisis is to assume that the current situation is different from the past. History does repeat itself.

Thus, we take the bearish view that the sovereign debt and fiscal problems will get worse - potentially much worse - before they get any better. The Nordics, on the other hand, have largely avoided such problems, with all countries having sustainable long-term debt to GDP ratios and little or no deficits. We think that the debt and fiscal problems of Europe will weigh on productivity for a long time to come, and that this points to a comparatively favourable performance for the Nordics.

Does this mean that Nordic real estate is cheap and that high returns can be expected? Not necessarily. The favourable conditions are widely recognized and have already been largely priced in. Due to this, we think high returns in the Nordics are unlikely going forward. However, we also see less risk and a more restricted downside in the Nordics, which sets the stage for decent risk-adjusted returns.

### **If they don't want to pay, they don't need to**

For any country, paying its bills is a matter of will. That such a high number of countries have historically decided to default on debt that is low in comparison to GDP, illustrates this point. A country may decide to pay its debt for various reasons, for example for the benefit of retaining access to international capital markets, or to avoid a breakdown of international trade, or to uphold international relations, to name a few. However, the cost of paying their debt, for many countries, often exceeds these benefits.

Look at Greece with this in mind. Given the current debt to GDP ratio, following the partial default, estimated to be over 100%, it would take decades of austerity and running surpluses before the debt is back at what we consider to be a long-run sustainable level. Sometime during the next decade, probably already within a few years, the elected leaders are going to come to the conclusion (correct or not) that the benefits of repaying the debt are smaller than the benefits of defaulting, and will choose to default. Deciding not to default requires an iron will, but iron wills do not go hand in hand with democracies that have new elections every three to five years. In addition, some economists already seem to think that a default is the best option for Greece.

### Is it different this time?

Most economists would agree that debt to GDP ratios of 100% or more are not healthy and could be a precursor to a sovereign debt crisis. Thanks to the wonderful studies of the likes of Reinhart and Rogoff, we know that, historically, sovereign debt crises occur at debt ratios that are much lower than one would expect.

Reinhart and Rogoff have tracked the amount of foreign debt for countries at the time of a crisis (domestic debt is seldom available). Looking at the most recent crises for medium income countries such as Russia, Mexico, Brazil and Turkey, they find in their sample that only 16% of the crises occurred in countries where foreign debt to GDP ratios were in excess of 100%. More than half of the crises occurred at foreign debt to GDP ratios of 60% or less, and one fifth of all crises occurred at a ratio of less than 40%. To provide some concrete examples, Chile's last default in 1972 took place at a foreign debt to GDP ratio of 31.1%. The crisis in Iran in 1992 took place at 41.8%. Russia defaulted at 12.5% in 1991 and at 58.5% in 1998.

Most countries in the sample have defaulted during the past 40 years. We resist the temptation to believe that things are so different now, just as we do not think they will be different 10 or 20 years from now.

### Debt Does Matter for Growth

Arguably the best analysis of the relationship between real GDP growth and total government debt (both external and domestic debt), is provided by Reinhart and Rogoff. Firstly, it is worth noting, that at least for more developed economies there is no evident relationship between real GDP growth and total debt levels, when debt to GDP is less than 90%. However, where countries have experienced a debt burden exceeding 90% of GDP, median growth has been 1% lower and average growth has been 4% lower, when compared to peer countries that have debt burdens below 90%.

Assume that southern Europe has total government debt at the 90% plus level for five years. Five years, for example, of 1-2% lower growth per annum should have a significant effect on real estate investments.

### Things Up North Are Better

For various reasons the Nordics have all but escaped these types of problems.

Chart 1 shows the deficit and debt to GDP ratios for 2010 for 11 European countries, plus averages for a larger set of European countries (Eurozone 16 and the European Union). From the chart it is apparent that the Nordic countries are very well placed. They enjoy low deficits and low debt in relation to GDP. Norway, which consistently runs large fiscal surpluses, is in a league of its own. Norway does have debt of up to 45% of GDP, but this debt is small in comparison to the country's massive sovereign wealth fund, valued at approximately EUR 370 billion at the end of August.

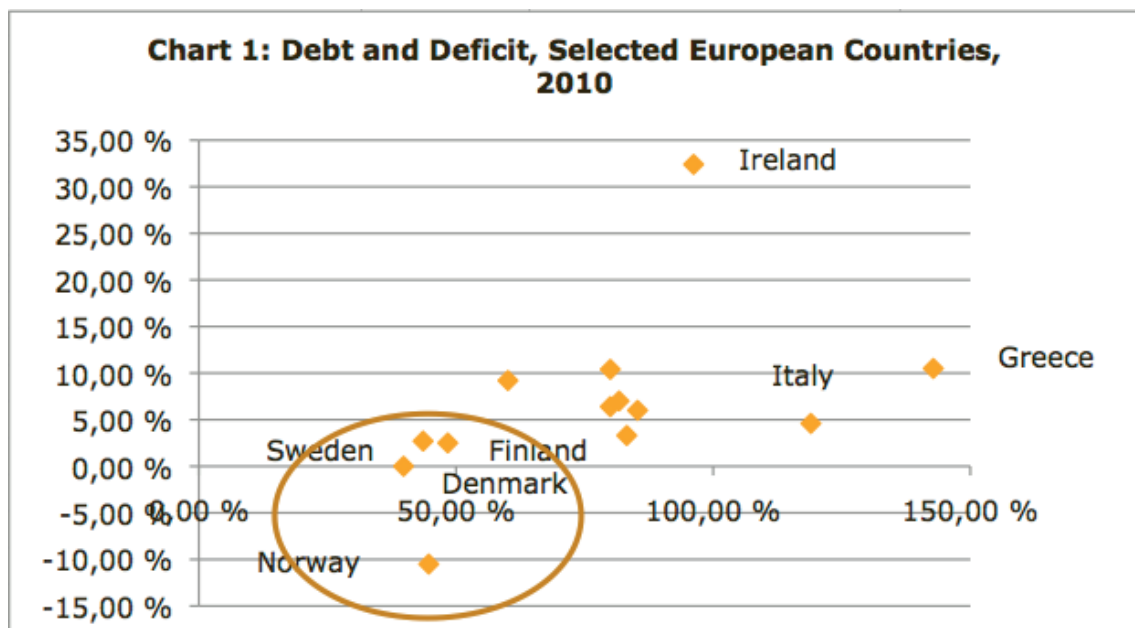
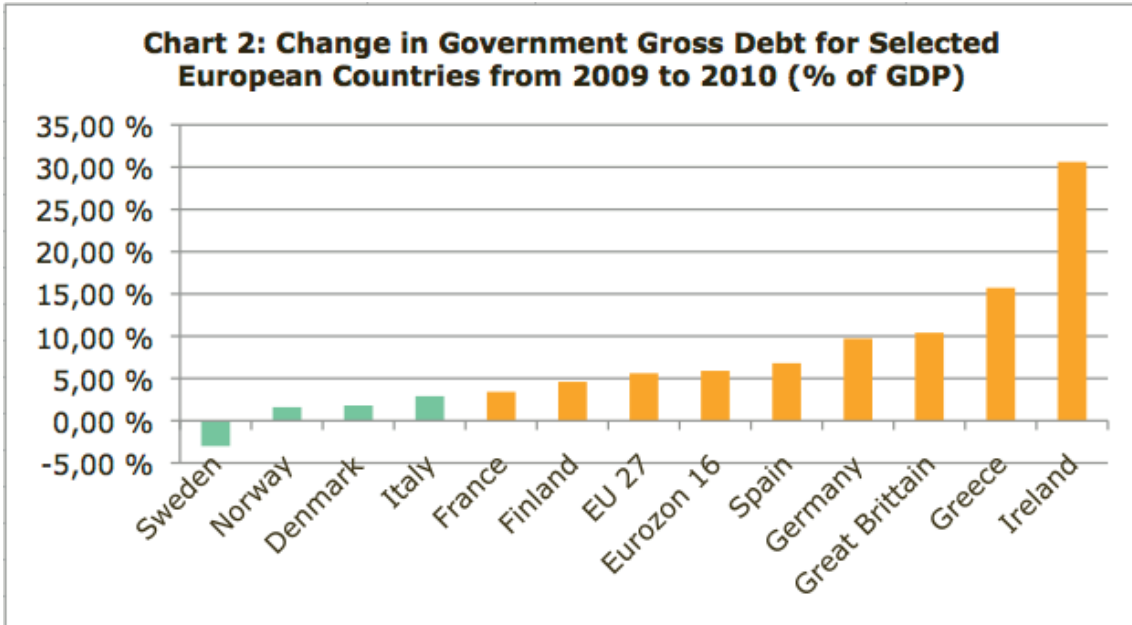


Chart 2 shows the change in government gross debt from 2009 to 2010 as a percentage of GDP. This illustrates that not only is the debt in the Nordic countries low by comparison, but also that debt levels are growing much slower. Debt levels are generally growing quite fast in the countries that are already heavily indebted. Sweden was the only country in the sample to see its gross debt fall, from 42.8% in 2009 to 39.8% in 2010.



The fiscal health in the Nordics does show up in financial markets. Chart 3 shows yields on long term bonds. It is clear that alongside Germany and the UK, the Nordics have some of the lowest borrowing costs in Europe.

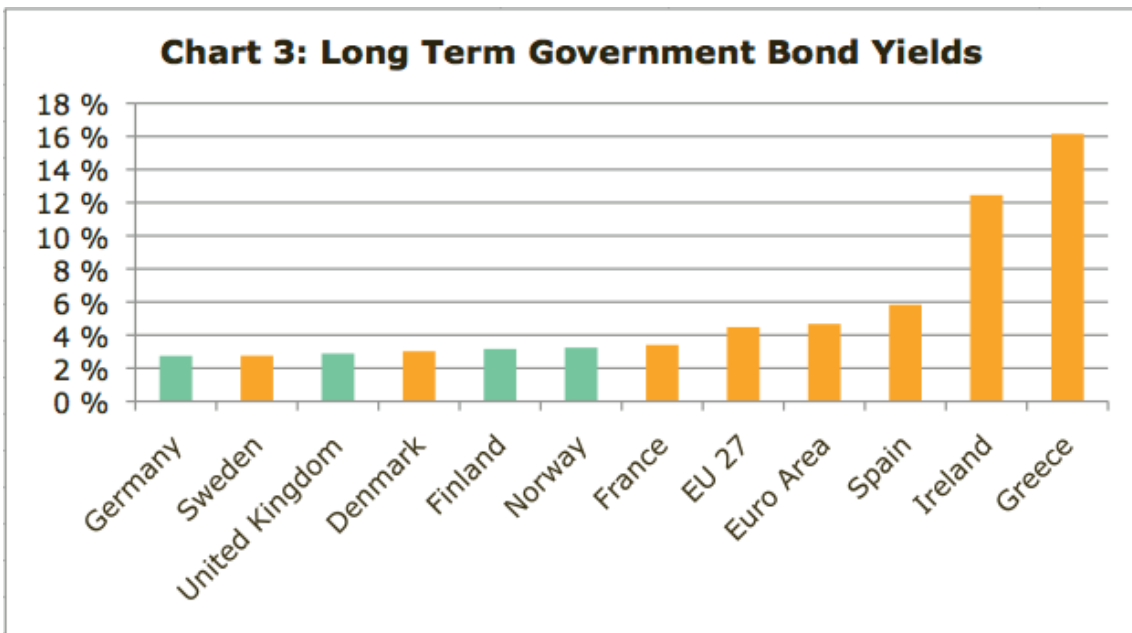
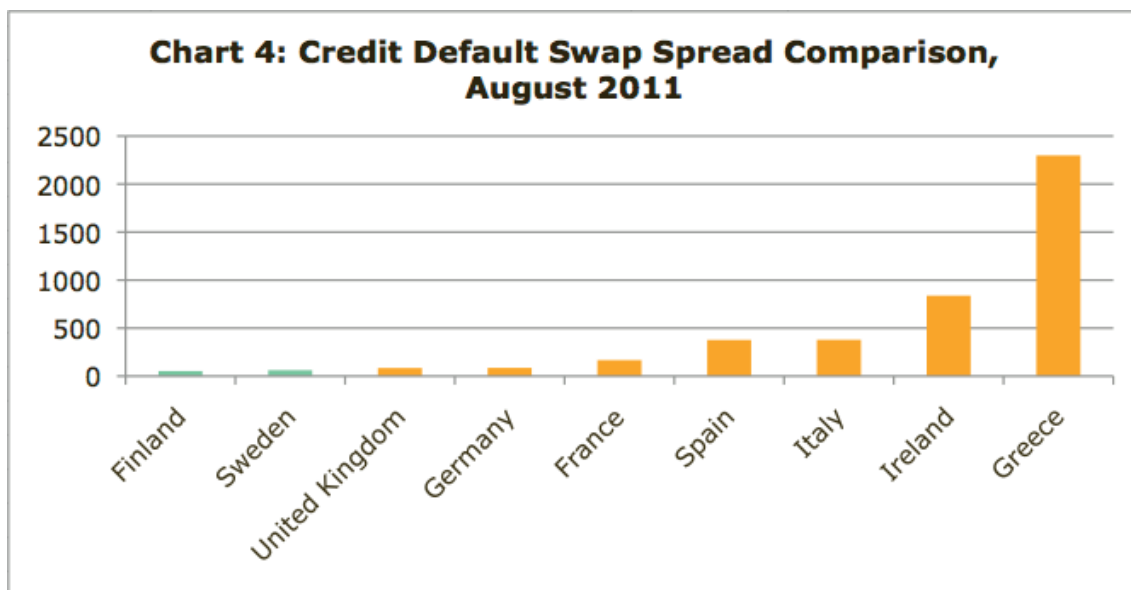
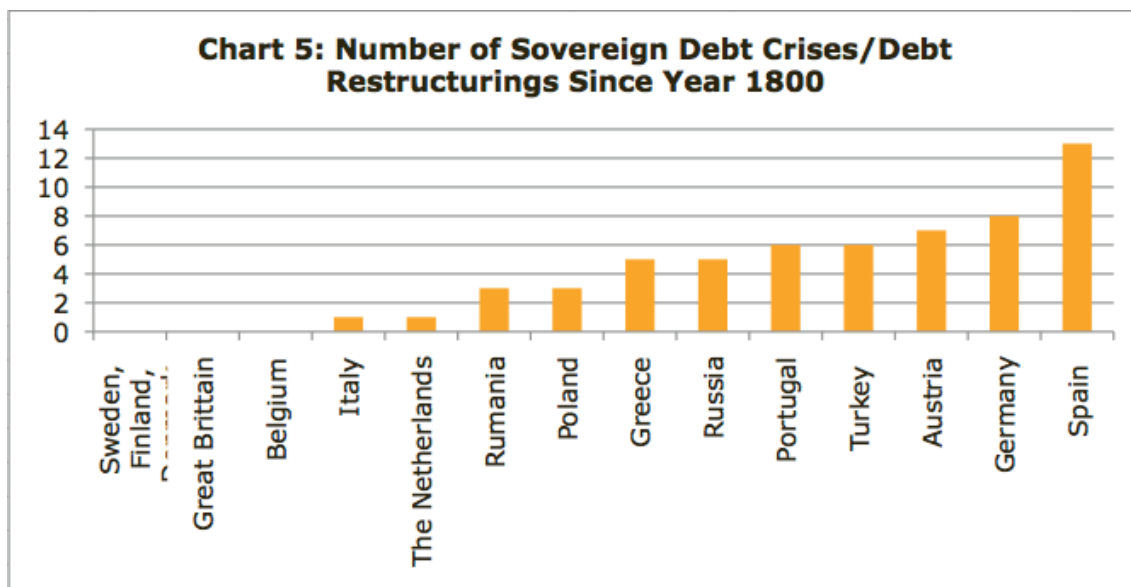


Chart 4 shows a comparison of credit default swap spreads for Finland, Sweden and selected European countries. Due to low liquidity, quotes for Norway and Denmark have not been included.



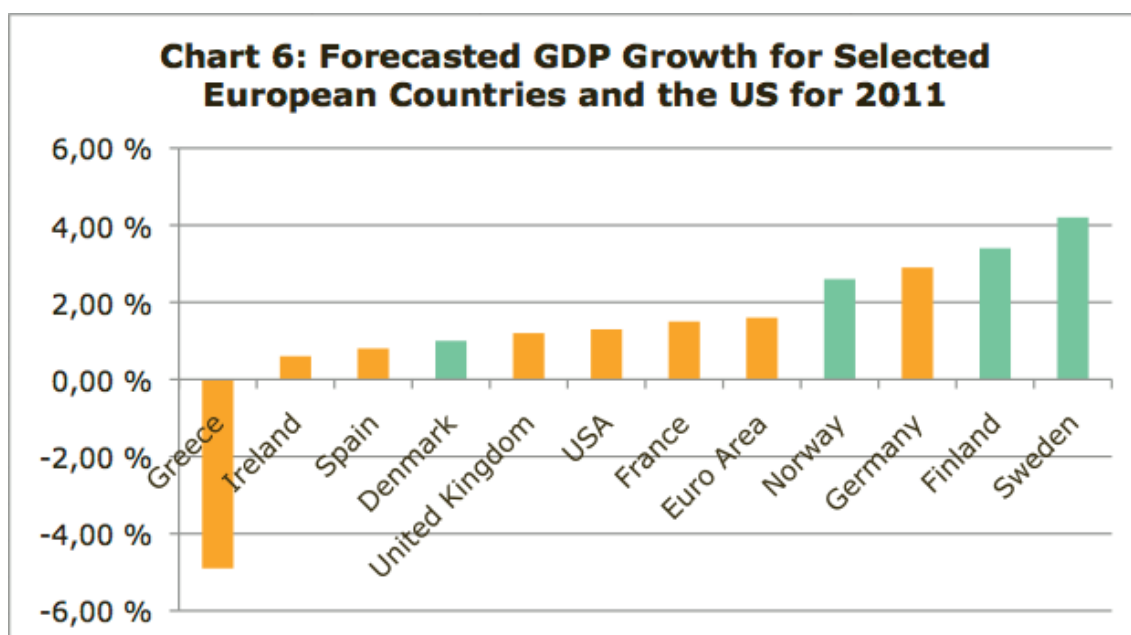
History and track record are also on the side of the Nordics. Reinhart and Rogoff have collected data showing that since the year 1800, the Nordic countries have not suffered a single sovereign debt crisis. The only other west European countries to enjoy a similar track record are Belgium and the UK. During the same period, Spain has suffered thirteen, Germany eight, Hungary and Austria seven, Turkey six, Greece five, and Italy and the Netherlands one each.



Spain, one of the countries that are in the worst shape at the moment, is thus a serial offender and this does not count in its favour in the current crisis. Against this background, we think the probability that a restructuring of Spanish debt will take place in the medium term is fairly significant.

In short, any risk of a sovereign debt problem in the Nordics is infinitesimal by almost any measure; the finances of the Nordic countries are quite sound. That said, the Nordics are, of course, not immune to the developments elsewhere in Europe. By virtue of being small, open economies, a slowdown abroad quickly translates to a slowdown at home. But, whereas an acute drop of economic activity could result if the rest of Europe again slips into a recession, we believe that the long-term GDP growth prospects for the Nordics are much better than for Europe as a whole.

The short-term prospects are also quite favourable on a comparative basis, as can be seen below in the recent forecast from the Swedish bank Nordea.



#### The Nordic Banks Are in Good Shape Too

At the time of writing this there is considerable turbulence in the European banking sector. This includes falling share prices, higher interbank interest rates and increased reliance on governments and short-term debt for financing. Money market funds are staging an exodus out of parts of banking Europe, refusing to roll over debt, or rolling over debt with much shorter maturities than before.

If there was any doubt that the major banks in the western world operate with an implicit government guarantee, such doubts were put to rest in the financial crisis of 2008-2010. Given the severe effects of the default of Lehman Brothers, no government can be expected to take similar risks again, if they are in a position to execute a bail out.

Given the implicit governmental guarantees and the poor health of the banking sector, it is apparent that the strength of banks is very much a function of the countries where they run their operations. We argue that the Nordic banks, backed by their strong countries, are well placed to weather the gathering storm.

In our own experience, the Nordic banks fared well during the financial crisis and were more willing to lend to real estate than banks in most other places in Europe.

Genesta had the privilege of raising debt in the Nordics in the fall of 2009 when we were acquiring a prime office property in central Oslo. Not sure that we would get a single bank to show an interest, we courted eight banks and received a tremendous seven offers. The most competitive bids offered margins in the vicinity of 200 bps at a leverage ratio of 65%-70%. This was very good at that time. In many other European markets it was difficult to raise debt at all, let alone on such good terms. Before the current sovereign debt crisis gathered strength in late July and August, it was possible to achieve margins of 125 bps at a gearing level of 70%, for good products in Norway. In a European perspective, this seems rather favourable. We are willing to bet that if a new serious downturn becomes a reality the Norwegian banks will be the banks in the Nordics that are best placed to weather the storm.

The Nordic banks, especially the Swedish and Finnish banks, showed a lot of restraint during the strong market of 2006-2007. We believe that in part this is the result of the lessons learned from the long and deep recession that took hold of Sweden in 1991-92, where the banks suffered massive losses on commercial real estate. This means they have fewer legacy issues to deal with than many of the foreign banks which lent to Sweden and Finland during 2006-2007.

We are also willing to bet that if the current financial crisis gets any worse, the Nordic banks will be among those best placed to stay out of trouble and will be in a position to lend more to real estate than banks elsewhere.

An exception is Denmark, where the banking sector is anything but healthy. Nine lenders have fallen since 2008, and in July Standard & Poor's issued a report saying that up to 15 more lenders could fail during the next three years, mainly due to the banks' exposures to commercial property and farming. The collapse of the regional lenders Fjordbank Mors and Amagerbanken earlier this year meant haircuts for senior bondholders, and these losses made it more difficult for Danish banks to find international funding. It is going to take time for Danish banks to recover.

### **What Does it All Mean for Real Estate?**

The current European fiscal and debt crisis will weigh on Europe GDP growth prospects for a number of years to come. We believe the legacy of these troubles will still be felt in five years' time. In addition to low GDP growth, the troubles should lead to a lower supply of capital, especially debt capital, for commercial real estate investments.

We expect the Nordics, who have largely avoided these problems, to enjoy higher GDP-growth and to have a higher availability of capital for commercial real estate investments.

The good prospects for the Nordics have not gone unnoticed and as always, there are few free lunches. As we see the situation, demand for good quality real estate is high in the Nordics, both from foreign and domestic investors. Retail properties, whose market values were probably unjustifiably hit during the past crisis, are now in very heavy demand and we have seen an amazing recovery. Some trades during the spring and summer have even been excessively dearly priced, in our opinion. Although we would not say that high quality retail is overpriced, a lot of the office stock is probably comparatively less expensive.

Due to the strong recovery across all sectors and in most cases conservative gearing from the start, the refinancing and debt overhang problems are fairly minute and concentrated into a small number of deals. There have been few distressed sales compared to many other parts of Europe.

Take Sweden as an example. Unless the market falls heavily again, our best estimate is that there is a stock of about EUR 500-800 million left that will be sold under heavy pressure from creditors in Sweden. No more. The bulk of this comes from a former Landic structure and from Danish K/S structures, investment vehicles owned by Danish private individuals, where very little or no real equity was invested but commonly where individuals placed private guarantees with the financing banks.

From an historical and very general perspective, we do not perceive the market to be overpriced, with rents and per sqm prices in real terms only slightly above their long-term averages and below what we perceive to be the long-term trend. It is more difficult to say that nominal yields look attractive when compared to their historical averages, but this needs to be seen in context. Firstly, real interest rates have been in decline in the western world for a long period and thus the running returns on real estate today, in absolute terms, should be lower than during the 1970s, 1980s and 1990s. Secondly, inflation expectations today are much lower than the actual inflation outcome for considerable parts of the historical data, especially for the 1980s. Thus, we would expect yields to be lower now than they have been historically.

Among the Nordic markets, we perceive the Finnish market to be the market that has had the weakest recovery. Liquidity continues to be very low. This is also the country where we expect the best return performance going forward, but it is also a market with a lot of pitfalls for an investor with limited experience of this particular market.

We view Nordic real estate to be relatively attractive and an alternative with smaller downside risks than real estate elsewhere. However, the sovereign debt crises, coupled with stalled GDP growth in many of the major markets, with real estate prices not falling significantly during the past three months, makes it difficult to see real estate as being a bargain anywhere in Europe at the moment.

In this turbulent financial world, we strongly believe that although real estate bargains will be hard to find and returns will be less bountiful, the Nordics offer a safer haven for real estate capital that has Nordic know-how.

### **Biographies**

David Neil is managing director and one of the founders of Genesta. Prior to founding Genesta in 2003, Mr. Neil spent 14 years with Jones Lang Lasalle, working both in the USA and in numerous locations in Europe. He was responsible for starting Jones Lang Lasalle's offices in Moscow, Kiev and Stockholm and has business experience ranging from leading capital transactions and real estate development to leasing and performing valuations. He has a Bachelor of Science degree from the University of Texas, Austin, with finance and accounting as his majors.

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