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FINANCIAL NEWS

Property derivatives market ready to explode

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Comment: Combination of factors signal overdue take-off is imminent

Property derivatives have been on the brink of explosion for years. With tiresome regularity, proponents have proclaimed the efficacy of the instruments and boasted about their numbers. Increased growth rates are a signal of the market's imminent take-off, they have repeatedly cried.

Trading in UK commercial real estate derivatives rose by 70% in the third quarter, according to London-based researcher Investment Property Databank this month.

Derivatives with a face value of £1.7bn (€2.5bn) were traded in the period, compared with just £1bn in the previous quarter. The global notional outstanding value of property derivatives trades also reached its highest point of £11.5bn.

So it came as no surprise when advocates again trumpeted that the market was ready to explode. The difference this time is it might, and it is due to several factors.

First, deals have been struck outside the UK including first-time transactions in Australia, Japan and Italy. Grosvenor, a property development, investment and fund management group owned by the Duke of Westminster, is responsible.

Finance director Nicolas Scarles has experience in pioneering derivatives markets. He has worked at British energy group Centrica, where his responsibilities included establishing the middle office for gas and power procurement and trading.

Centrica was involved in developing standardized documentation for the gas market and also executed the UK's largest weather derivatives trade. Scarles knows what he is doing when it comes to derivatives.

He undertook Grosvenor's overseas property transactions because he believes the instruments will have value at the holding and individual company levels and because he wants the market to grow.

Second, there are signs the US market is overcoming its teething difficulties. The US residential market has shown reassuring signs of life following the launch of a new index.

Trading in derivatives linked to the **Radar Logic Residential Property Index** began in September and in the first six weeks more than a dozen trades were executed worth an estimated notional of nearly $200m, according to estimates from Nasdaq-listed interdealer broker GFI.

Six dealers have been licensed to trade the index and they have dominated flows. But GFI said its expects early liquidity, coupled with the uncertainty hovering over the US real estate market, may encourage investors to the market.

Among the likely participants are hedge funds and portfolio managers as well as asset-backed market participants, who will be able to directly hedge out housing price risk for the first time through the instruments.

The US commercial property market might also be set for growth following the relicensing of the widely followed NCRIEF index. Credit Suisse was granted an exclusive license to trade the index initially in a move that discouraged take-up. The index was licensed in March to six more dealers and a surge of activity followed.

Third, there is more than anecdotal evidence the market is attracting new participants. Information provider IPD's statistics showed non-dealer participation in the market outpaced dealer participation. Among the entrants were hedge funds, institutional investors and property groups.

The involvement by property firms has been disappointing but there are signs of change. Scarles believes other companies should follow Grosvenor's lead. Many are wary about the accounting treatment of derivatives and the challenge to investor relations presented by profit volatility, but Scarles said they should not be.

There is a reassuring level of activity among hedge funds. Among the new protagonists is former banker and derivatives technology specialist Christophe Reech, Having sold Reech Capital to US software group SunGard, he set up an investment firm, Reech AIM.

This business launched last year to develop a next-generation alternative investment management service, providing exposure to new asset classes.

At the development stage, Reech set out to identify large, liquid asset classes that were uncorrelated to equities. It was quickly evident that real estate was one but he needed a closer understanding of the market. He resolved this by seeking a joint venture with commercial property and real estate services adviser CB Richard Ellis.

CBRE took a stake in the company and has transferred staff to Reech's trading floor, where they sit alongside a team of derivatives structurers and quantitative specialists. Since the Iceberg Alternative Real Estate fund's launch on May 1, it has delivered returns of more than 15%. In August, during the market's greatest turbulence, it was up 6%.

Fourth, liquidity held in the synthetic market even when the underlying market stagnated. According to David Slater, head of European property derivatives trading at BNP Paribas, prices on property derivatives were quoted throughout the summer, levels moved and trades took place.

Finally, there is market turmoil. The downward movement and uncertainty that are plaguing the real property market may turn out to benefit its synthetic equivalent.

The volume momentum, the growing number of widely publicized deals, the heady returns produced by firms such as Reech and the evidence that property is no longer a one-way bet should encourage hedgers and speculative players to the market. This could mean it is set for its overdue take-off.