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# UK Commercial Property Market Overview
# Quarterly Commentary
## June 2010

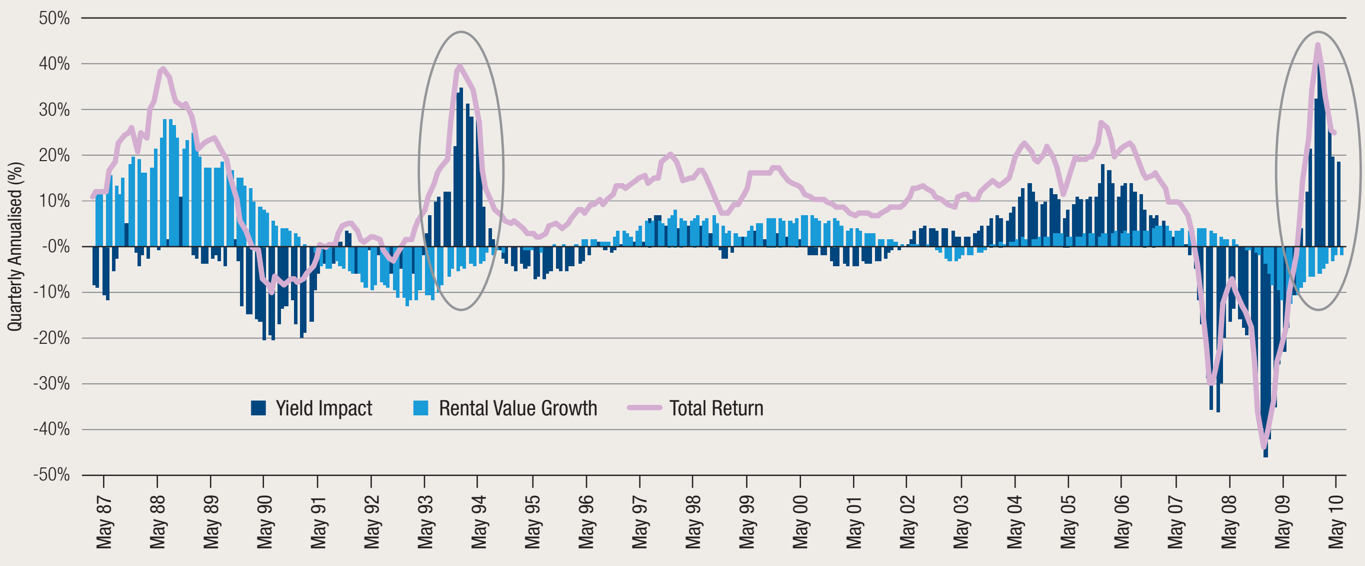
## KEY HIGHLIGHTS

- UK commercial property market values have recovered strongly since July 2009, with the IPD Monthly Index recording ten consecutive monthly increases[1].
- The current investment market-led recovery is losing some momentum as the imbalance between excess demand and lack of supply is increasingly being eroded, leading capital values close to stabilisation.
- The market slowdown is not expected to be as dramatic as seen in the mid-1990s. Despite a rental market that is expected to be weak, the historically high margin between property and government bond yields should protect performance in the short to medium term.
- Risk is almost all on the downside, with the possibility of sharp rises in government bond yields the most significant threat.

# What can we expect over the coming 12 months?

Just as the speed and severity of the downturn shocked many investors in 2007/8 the subsequent rapid recovery in commercial property values has also surprised many. Total returns of 15.7% over the six months to end March 2010 were the strongest recorded since April 1994[1], but with rental values still falling what might happen next?

The recent strong recovery in the UK commercial property market bears a striking resemblance to the early 1990s, when values recovered sharply, despite falling rents, only to fall back again the following year. The question is, are we about to see events unfold now as they did post January 1994 when quarterly annualised returns fell sharply, from 39% to 1% in just 18 months[1]? We believe that while we will see something similar occurring in the next 12 months, there are sufficient differences in the underlying fundamentals to justify adopting Mark Twain's quote, "that history won't repeat itself, but it may rhyme".




Source: IPD

## What can we expect over the coming 12 months?

The table below compares some fundamental economic and property data from the previous peak in quarterly returns (May 1994) and the subsequent 12 months with the situation today and in 12 months time according to our forecast. In 1994, commercial property yields were already running below long-term government bond yields with momentum in the investor market being driven by a belief that strong rental value growth was just around the corner, given the bounce-back in economic output[1]. However, over the following 12 months it became increasingly apparent that rental value growth was being held back not just by a high level of oversupply of new space, which had been released on the market, but also by the 150bp rise in base rates that was subsequently introduced to try and take some of the heat out of the bounce-back in economic growth. As a result, property yields rose over the 12 months to end May 1995 pulling annual total returns down to a below-trend 5%[1].

In contrast, at the end of May 2010, property had a historically high yield margin over long-term government bonds[1] and rental expectations appeared to be relatively muted. Despite the likely positive effects of a subdued pipeline, few investors, this time round, are expecting a speedy recovery to the occupier market because recent economic growth has been weak. While we are likely to see a repeat of the mid-1990s rental picture, it is in the investment market that the outlook, in the near term looks a little more favourable. The Bank of England faces pressure to lift base rates to counter above target inflation, but is wary of the lasting damage this might have on the current fragile economic recovery. Consequently, interest rates may rise over the coming 12 months but not by very much. We believe that government bond yields are, on balance, likely to rise slightly over the coming 12 months, and that property yields should remain flat for much of the next 12 month period. We anticipate total returns of around 7.5% over the 12 months to end May 2011, but the risk lies very much on the downside. Should government bond yields come under severe pressure either from a lack of investor confidence, or as a result of bank rates rising more quickly than expected, upward pressure on property yields could depress returns in the short term.

To summarise, we believe that UK commercial property market returns are set to ease in the coming 12 months, but we are unlikely to see as dramatic a slowdown as we did in the mid-1990s. Although market rental value growth is expected to be anaemic at best, the historically high margin between property and government bond yields should protect performance in the short to medium term. Nevertheless, the risk is almost all on the downside, with the possibility of sharp rises in government bond yields the most significant threat.

| Key indicators at peak property market dates | End May 1994 | One year later | End May 2010 | One year later* |
|---|---|---|---|---|
| Clearing Bank Base Rate[2, 3] | 5.1% | ↑150bp | 0.50 | ↑50bp |
| Government Bond (15 year) Yield[1, 3] | 8.7% | ↓80bp | 4.1% | ↑40bp |
| Commercial Property Initial Yield[1, 3] | 7.8% | ↑10bp | 6.6% | ↓20bp |
| Annual Inflation Rate (RPI)[2, 3] | 2.6% | 3.4% | 5.1% | 3.3% |
| Annual Real GDP growth[2, 3] | 3.3% | 4.0% | -0.2% | 2.3% |
| Commercial Property Annual Total return[1, 3] | 26.4% | 5.3% | 22.4% | 7.5% |

Source: Invista REIM, IPD, Thomson Datastream
* Invista forecasts are indicative only.

# Economic Overview

Economic output expanded for the second consecutive quarter in Q1 2010. The modest 0.3% rise in real GDP over Q1 2010 was primarily driven by growth in manufacturing and business services and finance[4]. Given that the latest Purchasing Manager Indices ('PMI') point to further growth in both sectors, economic output is expected to see further modest growth in the short term[5]. However, this may be jeopardised by the negative impact of the fiscal tightening announced by the new government.

A growing lack of confidence in sovereign markets has been reflected in volatile exchange rates. While the benefits to exporters of weak sterling may finally be feeding through to UK economic growth, the recent weakness in the Euro will not assist exporters whose largest clients are in Continental Europe.

Annual inflation (CPI) fell to 3.4% in May 2010[6]. Higher fuel costs, tax rises on alcohol and the restoration of the standard VAT rate were all blamed for keeping inflation above target for the sixth consecutive month. Concerns that above-target inflation rates could be longer-term than at first thought have resurfaced, leaving the danger that the Bank of England might be forced to raise interest rates to counter this inflation, choking off the economic recovery. With GDP still 5.5% below its peak of two years ago the spare capacity within the UK economy should pull price inflation down[2], but as the Bank of England advised in their latest Inflation Report: "the extent to which inflation will moderate is highly uncertain"[7].

Household spending on a real basis stabilised in Q1 2010 and remained 0.5% below its level 12 months earlier[4]. With unemployment levels arguably yet to peak, job and income security remains fragile as a result households have continued to save more and spend less of their income. The latest retail sales figures portray consumer spending in a more positive light, with the growth in the nominal value of sales rising at a rate above the CPI level of inflation[8]. Nevertheless, the outlook remains uncertain with the fiscal tightening likely to have a significant drag on household spending, particularly in those areas highly exposed to public sector employees.

The consensus view appears to be that the GDP growth is likely to return to trend only by 2013[9], a more pessimistic view than the Bank of England's own central projection of +3% GDP growth by Q1 2011[7]. Credit markets remain constrained; indeed borrowing margins have been expanding over 2010 so far[2]. Economic prospects were made a little clearer once the government had announced details of their fiscal tightening in the emergency budget, but the risk remains largely on the downside in light of the fragile sovereign markets across Europe, high inflation and significant cuts to public sector spending.

# UK Commercial Property Market Overview*

Capital values rose 4.3% over Q1 2010 – the third consecutive quarter of positive growth, albeit at a lesser rate than in Q4 2009. Activity and confidence in the investor market have steadily picked up since the autumn of 2009, although the occupier market remains weak, with rental values having fallen for the eighth consecutive quarter in Q1 2010.

By the end of Q1 2010, the margin between property initial yields (6.50%) and five-year swap rates (2.83%), at 367 basis points, remained historically high[2]. Swap rates, like property yields, have steadily fallen over the past three quarters, so the yield margin has proved relatively consistent over the period.

Commercial property produced a total return of 6.0% over Q1 2010. Despite a weak occupier market, the positive returns were driven by income and the impact of falling yields. Rental values fell further over Q1 2010, contracting by 0.4%, but the pace of contraction has eased across the market and most major sectors, if not all sub-sectors. The main driver of the current rental malaise would appear to be the fragility of the current UK economic recovery, rather than any development-led major oversupply of new space. As a result, should UK economic output levels pick up enough pace over the coming months, rental values and the health of the broader occupier market could follow suit and stabilise some time from 2011 onwards.

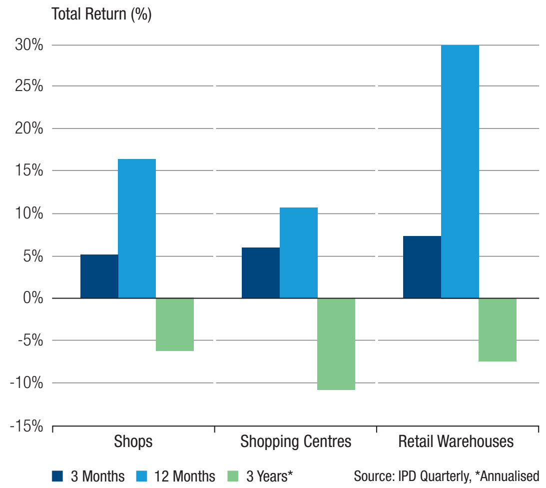
*All data in this section sourced from the IPD Quarterly Index Q1 2010, unless otherwise specified

# Sector Performance to 31 March 2010



## RETAIL

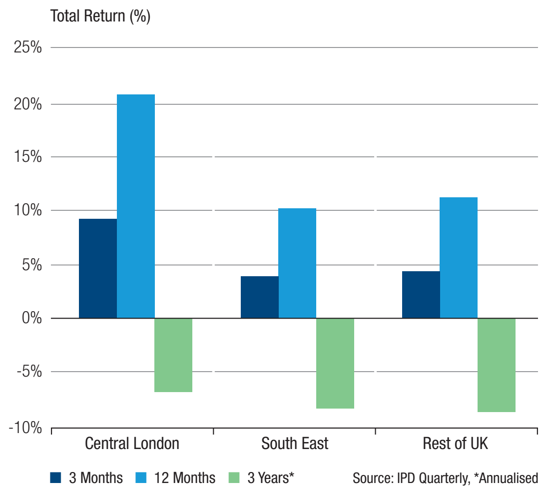
- The retail sector produced total return of 6.3% in Q1 2010 outperforming the industrial sector but marginally underperforming the office sector.
- However, over the 12 months to the end of March 2010, retail total returns of 20.5% were over five percentage points higher than the next best performing sector, offices.
- Retail rental values contracted over the 3 month and 12 month periods to end March 2010. Over the most recent two quarters, rental values have fallen by more than the market average.
- A surge in retail warehouses returns since Q3 2009 have made it the top performer across all sub-sectors of the market over the last 12 months. This outperformance was driven by a relatively sharp fall in absolute yields within the sector.
- Shopping centres remained a relatively weak performer over the 12 month period to end March 2010. However, over Q1 2010 quarterly returns were only marginally below the market average.
- The outperformance of prime assets seen in 2009 has appeared less clear-cut in Q1 2010. Increasingly, values of average quality assets appear to be catching up earlier gains in the prime end of the market, while secondary assets remain relative underperformers.



Source: IPD Quarterly, *Annualised

## OFFICES

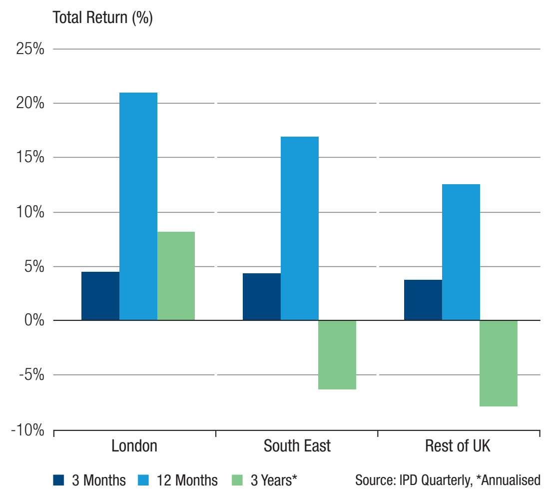
- The office sector was the best performing sector Q1 2010 with returns of 6.6%, driven by a buoyant Central London market.
- Over the 12 months to end March 2010 office sector returns of 15.2% were strong, but only marginally higher than those of the worst performing sector, industrials, at 14.9%.
- Capital values rose across all major regions for the second consecutive quarter in Q1 2010.
- Rental values rose in Q1 2010 for the first time in two years. However, a rebound in rents in Central London masks the continuing rental falls outside of the capital.
- Despite on an annual basis rental values having fallen less outside of London, in the less cyclical Rest of South East and Rest of UK markets, this is likely to be reversed as soon as the end of Q2 2010 if current trends continue.



Source: IPD Quarterly, *Annualised

## INDUSTRIALS

- The industrial sector proved the worst performing sector over the 3 month and 12 month periods to end March 2010 with total returns of 4.2% and 14.9% respectively.
- The sector has performed relatively poorly as the high yields typical of the sector have moved in less than the other major sectors. On a regional basis, London and the South East have noticeably outperformed the Rest of the UK.
- On a sub-sector basis, distribution warehouse total returns of 18.6% over the 12 months to end March 2010 compared favourably with standard industrial total returns of 14.4% over the same period.
- Industrial rental values fell by 4.2% over the 12 months to end March 2010, but, as some consolation, continued to be the most defensive sector.



Source: IPD Quarterly, *Annualised

# UK Commercial Property Market Outlook



Investor demand continues to drive property yields lower, although at a declining rate. Buyers have continued to loosen their investment criteria, with increasing interest outside of prime, well-located, long-let, properties having driven yields down across the less prime market. Nevertheless, secondary property yields remain, for now, anchored by the downside risk implied by the currently fragile economic outlook. Fortunes could change, however, should base rates and gilt yields rise significantly in the next two to three years; lower-yielding assets are likely to be hit harder than higher yielding more secondary ones. The additional uncertainty over how quantitative easing will be reversed, the maturity of a number CMBS loans and the economic consequences of the fiscal tightening all have the potential to impact negatively on property returns over the medium term.

Whilst the UK economy has begun a modest recovery, employment is expected to continue to fall over the next 12 months and, consequently, occupational demand is expected to remain weak. As a result a broad-based recovery in rents is still some way off and we anticipate that in the majority of markets rents will continue to fall.

Despite short term interest rates remaining at historically low levels, bank debt remains difficult to obtain and where available, lending margins remain high. As a result the scope for further yield compression remains limited and we expect capital values to stabilise over the next few months. Looking further forward we expect that falling rental values and increasing vacancy rates will exert modest downward pressure on capital values in 2011 before stabilising as occupational demand begins to recover in 2012. Therefore we are likely to see commercial property market returns driven by income over the next few years.

Over the period 2013-15 we expect a broader-based recovery in economic growth which should be accompanied by rental value growth, although the positive impact of this may be offset by rising interest rates which could also push up property yields.

### RETAIL SECTOR OUTLOOK

Lower government spending and higher taxes are likely to put further pressure on retail spending over the next 24 months, with retailers already reeling from higher inflation and weak sterling.

In the past the retail sector has been the safe haven as retail sales have remained relatively robust through a number of downturns. However, UK retailers have become increasingly reliant on debt with a number of high profile retailers having been acquired by private equity groups. This trend is likely to have injected a significantly greater degree of volatility into the occupational (and hence investment) market than we have experienced before.

Regionally we expect public sector cuts to have a greater impact on spending in Scotland, Wales and the North, where public sector employment comprises a much larger share of household income. We therefore expect rents to come under stronger pressure than the rest of the UK and vacancy rates to increase with secondary retail properties bearing the brunt of the retail market weakness.

Looking forward we expect the outlook for the sale of household goods to remain weak which will impact the performance of the retail warehouse market which already suffers from a relatively high degree of vacancy after the failure of several high profile retailers. We believe the recent strong recovery in values in the sector to have been too broadly based and that falling rental values on secondary properties will drag down the performance of this sector over the next few years.

In contrast we expect shopping centres to be relatively defensive investments largely because of the higher level of income that they generate.

### OFFICE SECTOR OUTLOOK

The office sector remains a two tier market, with Central London markets now seeing a sharp recovery in values and rents as opposed to the rest of the UK where rents continue to fall and value gains are more modest and yield led.

The recovery in Central London rental growth appears to be driven by a spike in demand after a number of years of weak activity as occupiers seek to take advantage of historically low rental levels together with a shortage of new accommodation. We expect prime Central London rents to recover sharply over the next 24 months as development completions remain limited although after 2014 there are a number of large speculative development projects completing in the City. Average rents are unlikely to see as strong growth as there is likely to be less competition for space with domestic demand remaining muted.

In common with the Central London office markets the wider Thames Valley office market's greater exposure to global occupiers and global economic growth in trade is likely to be beneficial to rents over the medium term. However, in the short term high levels of vacancy are expected to hold back performance.

Over the medium term regional office markets are expected to under perform as in relative terms prime rents are at historical high levels compared to their peers in the South East. In addition, the greater dependence on public sector occupiers is expected to add further stress to this market. That said, outside of the prime markets the high level of income generated by run of the mill provincial offices may be sufficient to generate above average returns in the short to medium term.

### INDUSTRIAL SECTOR OUTLOOK

The industrial sector continues to suffer higher levels of vacancy than the other sectors[1], a factor that has had a significant negative impact on performance since the imposition of vacant rates. With little prospect of a strong recovery in domestic demand we expect rents to continue to trend downwards, most especially outside of the South East where higher levels of vacancy especially in poorer quality accommodation persist.

However, the performance of the sector as a whole is expected to be supported by the high level of income return which it generates.

Rental growth is expected to emerge first in London as a greater proportion of occupational demand is linked to financial and business services output, and supply remains constrained. Sterling weakness may help support some parts of the occupational market which are linked to exporters, although the lack of available bank debt is restricting firms' abilities to respond to sterling weakness and low interest rates. That said, the impact of this on the tenanted market is uncertain given the quasi-retail nature of much of the tenant base.

Public spending cuts are expected to weigh most heavily on the North, Wales and Scotland where the additional yield premium generated by these assets is expected to be offset by higher levels of vacancy and falling rental values.

## Portfolio Strategy

| | Segment | Invista House View |
|---|---|---|
| **Retail** | South East Shops | Underweight |
| | Rest of UK Shops | Underweight |
| | Shopping Centres | Overweight |
| | Retail Warehouses | Underweight |
| **Offices** | Rest of UK Offices | Underweight |
| | South East Offices | Neutral |
| | Central London Offices | Overweight |
| **Industrial** | South East Industrials | Overweight |
| | Rest of UK Industrials | Neutral |

**Notes**

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**Source**

1 *IPD, UK Monthly Property Index, May 2010*

2 *Thomson Datastream, June 2010*

3 *Invista REIM, Forecasts, June 2010*

4 *Office for National Statistics, UK output, income and expenditure, Q1 2010*

5 *CIPS/Markit UK Services PMI and UK Manufacturing PMI, May 2010*

6 *Office for National Statistics, Consumer Price Indices, May 2010*

7 *Bank of England, Quarterly Inflation Report, May 2010*

8 *Office for National Statistics, Retail Sales May 2010*

9 *HM Treasury, Forecast for the UK economy, May 2010*