



UK Commercial Property Market Overview Half-Year Commentary August 2009

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KEY HIGHLIGHTS

- Total returns fell by 9.1% over the first half of 2009 according to the IPD Quarterly Index, driven by the 12.4% fall in values¹. However, there is some evidence that capital values appear to be stabilising with the smaller Monthly Index sample showing a deceleration in value falls over the 3 months to end June 2009².
- Rental values are falling but the prospects are encouraging for a quicker recovery than was seen in the 1990s, as the current contraction in rental values is being driven largely by the economic downturn rather than a glut of new space in the market.
- Property market yields have risen sharply and now appear relatively attractive compared to government bonds. There are, nevertheless, two main caveats: that the impact of the economic downturn has yet to be fully realised in the occupational market; and that we are assuming no more major shocks to the system.

Rental trends past and present

UK commercial property rental values fell by 2.7% in the 3 months to June 2009¹; pre-2009 this pace of decline had not been seen since the end of 1992, when the UK was emerging from its last major recession. Despite the initial similarities, the rental landscapes in the two periods are fundamentally different – one a picture of rapid over-development, and the other a reaction to the sharpest and deepest economic contraction in almost thirty years³.

The UK officially entered recession at the end of March 2008³. Prior to this, the last time the UK recorded two consecutive quarters of negative growth was at the beginning of the last recession in 1990. Between 1986 and 1990 UK commercial property rental values rose by a staggering 73%. This was admittedly a high-inflation environment – but in real terms, rental values still rose by 33%. In contrast, in the four years up to the end of 2008, UK commercial property rental values rose by 11% in nominal terms and just 1% in real terms^{2,4}.

The rental bubble that formed in the late 1980s collapsed under the weight of excessive development activity and weak occupational demand; in comparison the last few years haven't seen a rental bubble emerge, with most markets recording only modest levels of rental growth. The changing pattern in rental values can be explained by looking at the drivers of the occupier market. The early 1990s saw a substantial overhang of new supply as developers rushed to cash in on the strong rises in rental value that emerged as the 1980s drew to an end. As Table 1 shows, in the four years up to the end of 1992 150 million square foot of retail and office space had entered the rental market⁵. As the economy entered recession, this glut of new space helped drive rental values down by 30% in real terms². In contrast, just 89 million square feet joined the market in the four years up to the end of 2008⁵. The difference this time round has been in the speed and magnitude of the UK recession. By the end of June 2009, the UK economy had contracted more sharply than at any point in the 1990s recession, and had already surpassed the total economic contraction of 2.5% experienced during the recession 17 years ago³.

Table 1: Comparison of Recessionary Rental Markets

Rising Market	Rental Change		New Space Available*
	Nominal	Real	
1986 – 1990	73%	33%	150 million sq ft
2004 – 2008	11%	-2%	89 million sq ft

Falling Market	Rental Change		Real GDP Change
	Nominal	Real	
1990 – 1992	-21%	-30%	-2.5%
2008 – Now	-7%	-7%	-5.7%

Source: IPD Monthly Index, ONS, PMA. *Retail and office space.

Since the current contraction in rental values is largely being driven by the economic downturn, rather than a glut of new space in the market, the prospects for a quicker recovery than was seen in the 1990s are encouraging. This is reinforced by the fact that rents have not risen sharply over the preceding years and there is no rental bubble to deflate.

Whilst current falls in rental value may be painful for investors with vacant property, the majority of investments will not be immediately directly affected due to the terms of a standard UK lease. Just as occupiers are protected from sudden upward swings in rental values from year to year by the traditional five-year gap between rent reviews, investors are also protected against sharp downward movements in rents by the upward only rent review clause in most leases.

Economic Overview

The second quarter of 2009 saw UK economic output fall for the fifth consecutive quarter, contracting by 0.8%, an improvement on the 2.4% fall in Q1 2009. Services, representing 79% of economic output, fell by 0.6%; whilst industrial production fell by 0.7%³. Encouragingly, there have been recent tentative signs that the contraction in both sectors may be easing, even coming to an end. The latest Purchasing Managers' Indices signalled two consecutive months of positive growth in both the service and the manufacturing sectors⁶; sentiment, it is hoped, which will shortly feed through into a stabilisation in Government production level figures⁷.

Sterling has strengthened since January 2009 but still remains relatively weak against the Dollar and the Euro compared to the same period 12 months ago⁸. As a result, higher import costs have underpinned annual CPI inflation, 1.8% in June 2009⁴, which has fallen below the Government target of 2% for the first time since September 2007.

Government expenditure figures to be released later this month are expected to confirm that household spending fell for the fifth consecutive quarter in Q2 2009. Together with increased import costs, this continues to cause distress for retailers who are being forced to cut prices in order to maintain volumes. Nevertheless, retail sales continue to show positive growth on an annual basis⁹, albeit at a declining rate, and retailers in certain areas of the UK have benefited significantly from the rise in tourist numbers taking advantage of the relatively weak Sterling.

Business and consumer surveys have shown that while confidence has begun to improve it still remains low⁸. These results may have strengthened the belief that the economy could stabilise earlier than originally expected – in the second half of 2009 rather than 2010 – but the signs still appear too weak to promise any significant economic recovery in the medium term. The numbers of unemployed continue to climb¹⁰ and the housing market remains weak, with prices down by 1.9% over the 3 months to end June 2009¹¹.

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Capital values continued to fall in Q2 2009, down 4.0% on the previous quarter – an improvement on the 8.7% fall seen in Q1 2009. While transaction market liquidity has remained low, driven by the lack of availability of reasonably priced new debt, there has been increased evidence that buyers have been re-entering the market for prime, well located, long-let, properties.

Nevertheless, by the end of Q2 2009, the margin between property initial yields (7.77%) and five-year swap rates (3.67%) at 410 basis points, stood at a historical high⁸. The early signs from Q3 2009 so far are of a stabilisation both in property yields and swap rates, keeping the yield margin relatively unchanged.

Total returns fell by 2.2% over Q2 2009, driven for the first time in this market correction by the fall in rental values, rather than rising yields. The contraction in rental values intensified across the retail and industrial sectors, but appeared to ease in the office sector. Rental values fell by 2.7% over Q2 2009 as the economic outlook remained poor and the relatively weak Sterling continued to hit occupier cost bases and revenues.

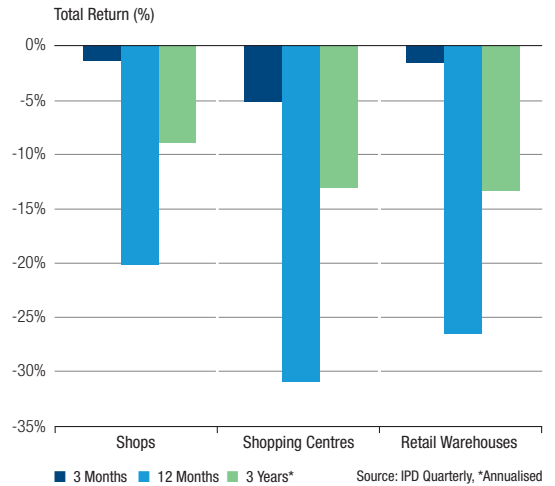
Conditions in the occupational market are expected to deteriorate further in the near term as the current economic downturn continues to put downward pressure on sales and profits.

*All data in this section sourced from the IPD Quarterly Index Q2 2009, unless otherwise specified

Sector Performance to 30 June 2009

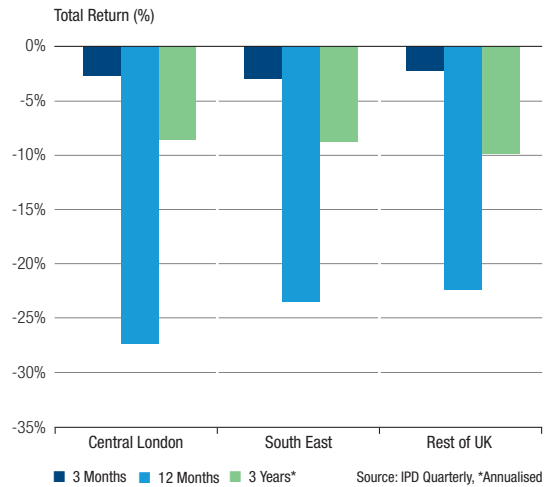
RETAIL

- The retail sector produced a total return of -2.2% in the second quarter of 2009 and only marginally underperformed the best performing sector, industrials, over the quarter.
- Over the 12 months to the end of June 2009, retail was the worst performing sector, alongside offices, recording a total return of -25.4%.
- Retail rental values contracted over the 3 month and 12 month period to end June 2009. Nevertheless, over both periods rental values fell by less than the market average.
- Within the retail sector, standard shops proved again to be more defensive than shopping centres and retail warehouses, generating the stronger returns over the last 12 months on the back of what have been, so far, more stable yields.
- Shopping centres were the weakest performing segment of the market, producing a total return of -30.9% in the 12 months to the end of June 2009, as a result of a relatively sharper outward movement in investment yields over the first half of 2009.
- As expected there is increasing evidence of a divergence in the performance between secondary and prime assets, with secondary assets still experiencing significant outward movements in investment yields whilst prime assets values appear to be stabilising.



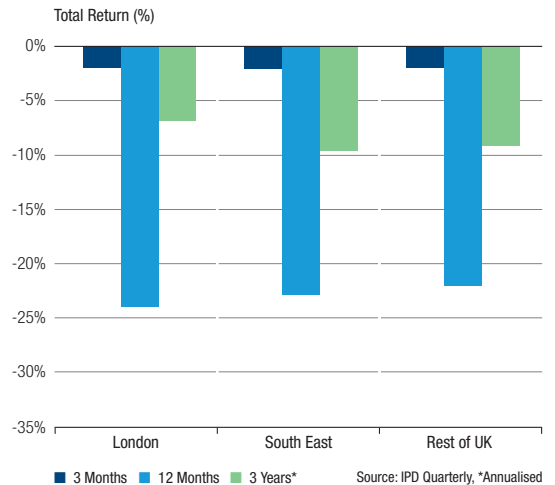
OFFICES

- The office sector was the worst performing sector over the quarter and 12 month period to end June 2009 with returns of -2.7% and -25.4% respectively; over both periods the office sector underperformed the industrial sector.
- All sub sectors saw an easing in the rate of decline in capital values in the second quarter of 2009 as investment yields rose less sharply.
- Rental values deteriorated further in the second quarter of 2009, albeit with the rate of decline easing in those areas where rental values had been falling the fastest. In the space of 12 months the office sector has changed from the strongest to the weakest rental market with rents having fallen by 14.1% over the last 12 months.
- On an annual basis, rental growth remained strongest in the less cyclical Rest of South East and Rest of UK markets. Since June 2008, rental values in the more cyclical Central London office market have contracted by 22.6%.



INDUSTRIALS

- The industrial sector was the strongest performing sector returning -2.0% over the second quarter of 2009, largely as a result of higher rental yields.
- Industrials have also proved to be the most defensive sector over the past 12 months recording a total return of -22.6%. The regional industrial market proved to be the best performing sub-sector over the 12 months to end June 2009 after the earlier outperformance by London industrials was more than cancelled out by its underperformance in the latter 6 months of the period.
- Industrial rental values fell by 3.2% over the 12 months to end June 2009, but, as some consolation, proved to be the most defensive sector.



UK Commercial Property Market Outlook

There has been a noticeable thawing in the near-term outlook for UK commercial property; not just in the trade press, but also from the commercial property derivatives market. This change in sentiment appears to have been driven to some degree by an increasing economic optimism – that the recession may be over earlier than previously thought – but, arguably, more so by tangible signs that buyers, particularly from overseas, have begun to re-enter the UK commercial property market.

Market volatility may have eased and economic sentiment may have improved, but there still remains significant uncertainty about how much further the economic downturn has to run. So far, the bank and consumer responses to Government and Bank of England actions to restore liquidity, confidence and positive growth to the wider economy, have been relatively positive. Yet, despite this, confidence and activity levels ultimately remain historically low.

Until now, the increases in property yields have been indiscriminate of the quality of the asset; but this may have finally come to an end. Foreign investors, in particular, have begun purchasing prime assets in the City, taking advantage of the relatively high yields and the relatively weak Sterling. Indeed, yields on prime, well-located, long-let, properties, not just in the City but across the UK, appear to have stabilised – and in an increasing number of cases, even begun to fall. Yields on more secondary properties, however, are expected to continue to rise over 2009.

The post ‘credit crunch’ lack of debt finance has led to a historically low development pipeline, particularly larger projects in the Central London office market and shopping centres. However, any positive effects of the resulting lack of supply of new space on rental values are not expected to outweigh the negative effects from the ongoing weak occupier demand. Rental values are therefore expected to continue to fall but, as highlighted earlier, we believe they are unlikely to see a repeat of the prolonged decline witnessed in the early 1990s: the underlying economic fundamentals (inflation and bank rates) are much lower, and the near term supply pipeline less imposing. Further falls in rental values are unavoidable in light of the depth and speed of the current economic contraction, yet there is reason to believe that rental values may stop falling within 12 months of the stabilisation in the broader economy.

As investors begin returning to the market, so prime property, and the less volatile property, ie lower beta, sectors such as regional offices and industrial market are looking the best prospect for the coming 12 months. Beyond the middle of 2010, as the economy is expected to return to some positive growth, the higher beta sectors, such as Central London offices, should return to favour.

The commercial property market is, in our view, now looking good value as an investment, with yields where they are. There are, nevertheless, two main caveats: that the impact of the economic downturn has yet to be fully realised in the occupational market; and that we are assuming that we have seen the last major shock of this ‘credit crunch’.

RETAIL SECTOR OUTLOOK

Household spending has been contracting on a quarterly basis since April 2008¹², and at an increasingly negative rate in the last three quarters. This has largely been driven by a change in sentiment as the continued weakness of the housing market and fears over job security force consumers to repair their balance sheets. This trend is expected to continue with rising unemployment likely to restrain household spending over the next 12 months. Although retail sales volumes have continued to grow on an annual basis, this masks heavy falls in household goods stores and other specialist shops, and a slight dip in food stores. In terms of money in the till high street stores have had to continue discounting heavily, with not all sectors seeing positive growth in sales values over the last 12 months⁴⁹. Undoubtedly, retailers and their margins remain under severe pressure and investors are growing increasingly nervous about whether their retailer occupiers can withstand further pressure on sales and costs. With the closely-watched housing market expected to remain weak for the rest of 2009, sales of bulky goods, in particular, are likely to continue to deteriorate as fewer people likely to commit to large purchases.

A growing body of evidence is emerging to support our preference for prime, well-located retail properties where investment yields appear to be stabilising. In contrast secondary property yields continue to rise as the weakening occupier market has begun to hit the more secondary areas of the market harder, increasing vacancy and forcing investors to revise up the level of risk they associate with holding this type of property.

The historical resilience of the retail sector, and in particular shopping centres, is looking increasingly fragile. Shopping centres have been the hardest hit of all property sectors in both Q4 2008, Q1 and Q2 2009, with their valuations finally catching up with the rest of the market¹. Nevertheless, we still believe that the primer, out-of-town, units should prove relatively resilient over the ongoing economic downturn. Unfortunately, for those less prime, secondary units, based in-town, we continue to have concerns over the pricing of this sector of the market given the expenditure which is required to sustain rental income.

Retail warehouses have taken one of the biggest hits to valuations since the onset of the fall in values in July 2007, and investment yields have risen to their highest level for over fifteen years². Within the retail warehouse market the sub-sectors rely on different fundamentally occupier markets: Solus units and bulky goods parks have a high concentration of space let to just a small number of companies selling household goods, who partly as a result of the paralysis in the housing market are trading poorly. In contrast, the more diversified retail parks with the open A1 consent to sell all goods including fashion are expected to see more resilient occupier and consumer demand, along with limited new supply in the pipeline or recently completed. As a result we expect a considerable degree of variance in performance within the retail warehouse sector over the next 12-24 months, and returns likely to be dragged down by the relatively poor outlook for the secondary market with its oversupply of space and high concentration of occupiers in just a dozen or so retailers.

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OFFICES SECTOR OUTLOOK

The financial services market continues to suffer the after effects of the 'credit crunch'. A lack of confidence in the health of the broader global economy, and a general reluctance of lenders to lend, are currently holding back levels of corporate investment. The early encouraging signs of the stabilisation of the UK economy are unlikely to stem the job losses in the office market in the short term. As a result, the near-term outlook for much of the office sector, particularly those in the financial services market, remains weak. Although Central London offices rental values are now falling less sharply than they were at the beginning of 2009², we don't expect a return to positive rental growth until 2011, given the exposure of the occupier base to the financial markets. Offices in other areas of the South East, particularly the Thames Valley, depend heavily on the health of the US economy where, on balance, the outlook appears to be improving. One positive outcome from the 'credit crunch' is the lack of speculative development, driven by the lack of debt finance, that would typically appear at this stage in the City office market cycle. This is expected to lead to a shortfall of new supply over the medium to long term and consequently rental values may bounce back in the City once business sentiment improves and the broader UK and global economies stabilise. Transactional markets may have picked up recently, but it has been largely focussed on particularly prime space. We expect returns in the Central London office market, as a whole, to be dragged down in the short to medium term by the performance in the more average/secondary properties in the region, where property values may still have further to fall.

Outside of the higher beta regional markets, London and the South East, the performance in the lower beta rest of the UK market is expected to remain relatively defensive in the short term. Medium-term performance is likely to pick up as the less cyclical nature of the market works to its advantage. The region usually benefits from the stability brought about by the greater exposure to occupiers from the public sector, but in light of the expected severe fiscal tightening, this may now face some challenges. Nevertheless, the low risk profile of long leases, let to public sector tenants, is expected to remain attractive in the tight economic environment we can expect for the short to medium term.

INDUSTRIAL SECTOR OUTLOOK

The early positive signs that levels of industrial production have begun to stabilise in the UK over Q2 2009⁷ are encouraging for an industrial market that had been hit by a double whammy of a collapse in global manufacturing demand, and a rise in commodity prices. Going forward, there are positive effects from manufacturing companies no longer running down their stock levels, production being restarted, and the relatively weak Sterling aiding export-led companies. Ultimately, though, the contribution of an upturn in industrial output to occupier demand remains limited, with the market increasingly dependent on retail, or quasi-retail, occupiers and retail distribution networks. As outlined above, retailers remain hugely challenged in a market of tight margins and falling consumer spending.

Rental values are expected to continue falling over the coming 12-18 months as vacancy rates and levels of availability remain above-trend across all the sectors and the effects of the Government's removal of tax relief on vacant property units in 2008 continues to be felt. The industrial sector had suffered less than others from the yield correction over the 24 months to June 2009², but with its exposure to relatively high vacancy and company default rates, it may yet catch up with the retail and office sectors. Nevertheless, rental yields relative to the cost of debt have risen to historically high levels.

The strength of the industrial market remains its relatively high income return, but we are concerned that this may be its biggest weakness in the short to medium term. With the industrial sector across the UK particularly vulnerable to falling rents, higher vacancy rates, and tenants with relatively poor covenants, further economic fragility can only increase the risk of shrinking income returns. With the Government's removal of tax relief on vacant property units also continuing to hit income levels, we believe that there remains significant downside risk to investment in the industrial market.

Portfolio Strategy

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

Notes

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Source

- 1 *IPD, UK Quarterly Property Index, Q2 2009*
- 2 *IPD, UK Monthly Property Index, June 2009*
- 3 *Office for National Statistics, GDP Preliminary Estimate, Q2 2009*
- 4 *Office for National Statistics, Consumer Price Indices, June 2009*
- 5 *Property Market Analysis (PMA)*
- 6 *CIPS/Markit UK Services PMI, July 2009;*
CIPS/Markit UK Manufacturing PMI, August 2009
- 7 *Office for National Statistics, Index of Production, June 2009*
- 8 *Thomson Datastream, July 2009*
- 9 *Office for National Statistics, Retail Sales June 2009*
- 10 *Office for National Statistics, Labour Market Statistics, July 2009*
- 11 *Halifax, House Price Index, June 2009*
- 12 *Office for National Statistics, Quarterly National Accounts, Q1 2009*