INVISTA
REAL ESTATE
INVESTMENT MANAGEMENT

RETAIL : OFFICE : INDUSTRIAL

UK Commercial Property Market Overview
Quarterly Commentary
Q3 2010

KEY HIGHLIGHTS

- Income expected to drive returns over the medium term, meaning that valuations of better-quality property could prove surprisingly stable.
- Commercial property yields remain significantly above gilt and equity dividend yields, and such a substantial spread – worth over 400 basis points – should keep property looking attractive as an asset class, supporting capital values[4].
- Valuations of some secondary stock are already beginning to fall because income levels are looking vulnerable, with consumers likely to rein in spending as a result of tax rises and job uncertainty.
- The risk remains on the downside, with the possibility of rising government bond yields the most significant threat – though it appears increasingly unlikely.

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

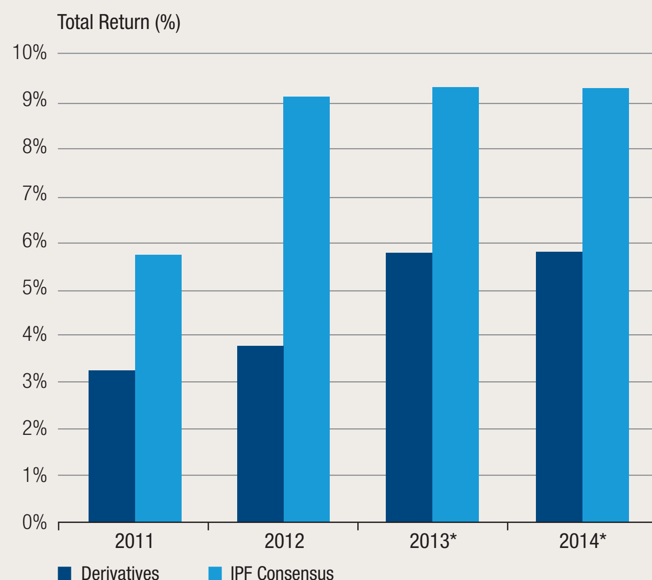
Prime property expected to be in high demand

The outlook for the commercial property market over the coming 12 months is gloomy, but there is hope for investors. Income should drive returns over the medium term, meaning that valuations of better-quality property could prove surprisingly stable. As a result, prime property such as central London offices is likely to face substantial demand for investors hungry for yield, maintaining its capital value through a difficult environment.

Market forecasts emphasise the benefits of secure income. Derivatives pricing[1], along with the Investment Property Forum (IPF) consensus[2], both suggest that income returns in 2011 should offset a decline in capital values, leaving investors with a positive total return. Derivative prices imply a 3% total return, compared with the 6% total return forecast by the IPF, thanks to the latter's more bullish income projections when the consensus was compiled earlier this year. However, the implications are clear: property with secure income will be in high demand over the medium term, and could, therefore, maintain its value.

Property fundamentals also give investors some hope that market values could stay relatively stable over the next 12 months. The yield curve still reflects forecasts of weak growth from market economists, and interest rates are expected to remain low for at least the next year[3]. As a result, commercial property yields remain significantly above gilt and equity dividend yields, and such a substantial spread – worth over 400 basis points – should keep property looking attractive as an asset class, supporting capital values[4].

Forecast/implied UK commercial property market returns



*IPF returns for 2013 and 2014 have been extrapolated from the combined 2013-2014 forecast. Forecasts are indicative only.

However, there are two important caveats. First, spreads over gilt yields could narrow in the short-term if either demand for gilts falls or the fear of renewed quantitative easing subsides. Secondly, it is dangerous to rely on a weighted market average for commercial property, as projected returns from different sectors of the market are expected to vary substantially. As stated above, property returns for the coming 18 months are expected to be driven almost entirely by income return, and so sectors where income is deemed secure, through long leases and strong covenants in prime locations, are most likely to hold their value – while the outlook for property in poorer locations, with more secondary covenants and shorter leases, is looking fragile. Valuations of some secondary stock are already beginning to fall because income levels are looking vulnerable, with consumers likely to rein in spending as a result of tax rises and job uncertainty.

Occupiers dependent on the public sector are also likely to need less space as a result of the plans to slash government spending, announced on 20 October 2010. For example, demand for offices outside London and the South East remains weak, and consumer confidence has taken a battering, particularly in areas that are expected to bear the brunt of public spending cuts, such as Scotland, Wales, the North and Northern Ireland. In the next year and beyond, much will depend on the quality, and the security of income, of each property asset.

Based on current forecasts and fundamentals, therefore, the overall property market is expected to suffer a slowdown over the next 12 months. Investors should target prime properties with secure income, that are more likely to preserve their value in a market desperate for yield.

Economic Overview

Preliminary figures suggest that the economy continued to grow in the three months to the end of September 2010, at 0.8%, albeit at a slower rate than the previous quarter, when GDP grew by 1.2% in real terms[5].

The latest Purchasing Manager Indices suggest weak confidence in the sectors that drove growth in the first half of the year – construction, and financial and business services – and economic output is expected to slow in the short term[6]. Companies have also remained cautious in the face of the spending cuts announced by the government on 20 October, though it will take some time for the cuts to be implemented.

However, there are other signs that economic growth will remain positive. The Bank of England (BoE) is unlikely to take any action in the short term that might interfere with a recovery, despite annual inflation (CPI) remaining at 3.1% in September 2010 for the third consecutive month[7]. While there has been downward pressure from transport, the inflation rate remains above its target rate primarily because of relatively high prices in clothing, and food and drink. Concerns remain that above-target inflation rates could last longer than expected, and rising wheat prices and the looming increase in VAT have fuelled such fears. However, the BoE has continued to emphasise that, with GDP still substantially below its peak of two years ago, the significant spare capacity within the UK economy should pull down price inflation[8]. Such pressure should help to quash any fears that the BoE will raise interest rates to counter high inflation and choke a continued economic recovery.

Separately, while confidence in sovereign markets has improved over recent months, exchange rates remain volatile. Along with near-term strengthening against the dollar, sterling remains weak, and the resulting benefits to exporters have been feeding through to UK economic growth. The recent strengthening in the Euro should particularly help exporters with large clients in Continental Europe[9].

The Office for Budgetary Responsibility has forecast the UK economy to return to long-term trend growth – equivalent to about 2.3% annual growth in real GDP – in 2011[10]. The figure anticipates a significant recovery in the private sector. The consensus view is slightly more bearish, predicting a 2% annual GDP growth up to 2015, with a downside scenario leading to economic growth of 1.2% per annum over the same period[11]. However, the bond markets have reacted positively to the government's proposed spending cuts so far[9].

UK Commercial Property Market Overview*

UK commercial property provided a positive total return over the third quarter, but slowing capital growth and declining rental values meant that the asset class lagged behind bonds and equities. Capital values rose by 0.5% over Q3 2010, marking the fifth consecutive quarter of positive growth, but the rate of capital growth has continued to shrink, as confidence in the investor market has deteriorated. Rental values declined under continued pressure, falling for the tenth consecutive quarter.

Income returns continued to make up the majority of total returns from the asset class. In Q3 2010, an income return of 1.7% pushed total returns from UK property up to 2.2% over the period, compared with equities and bonds which returned 13.6% and 3.7% respectively.

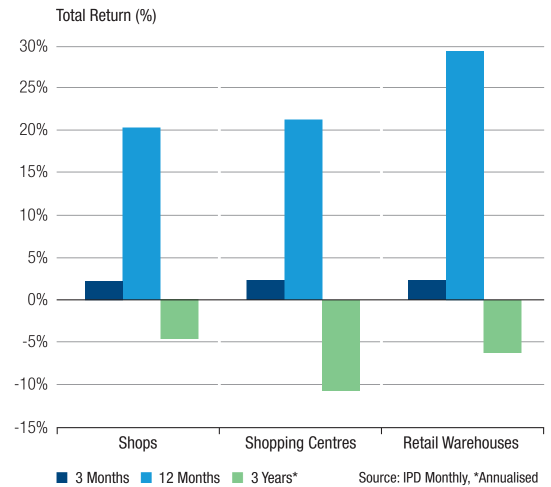
Fears over the UK economic recovery, exacerbated by the government's planned spending cuts, seem to be holding back occupier demand. However, there was a glimmer of hope in the latest figures: voids in the most recent quarter shrank to 9.9% – still above pre-crisis levels, but the lowest since 2008. It is a sign, albeit a small one, that falling rents are coming closer to meeting occupiers' expectations. The cost of borrowing also suggests that UK property is still an attractive proposition. At the end of September 2010, the margin between property initial yields (6.44%) and five-year swap rates (2.07%) remained high against historical spreads, at 437 basis points.

*All data in this section sourced from the IPD Monthly Index, unless otherwise specified.

Sector Performance to 30 September 2010

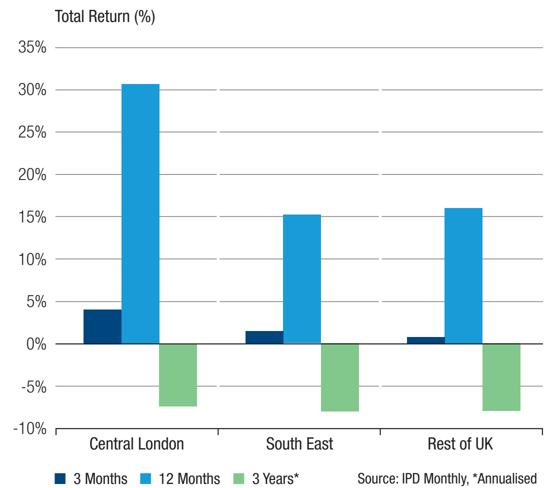
RETAIL

- The retail sector produced a total return of 2.2% in Q3 2010, lagging behind offices but outperforming industrials.
- Over 12 months, retail remains the best performer, with a total return of 25.1%, driven primarily by capital growth.
- Retail warehouses remain the best performing sector over the last 12 months, with a total return of 29.4% over the period, led by a 34.6% return from warehouses in London. However, returns from retail warehouses fell back in recent months as investor demand waned.
- Against expectations, retailers' earnings held up in recent months, despite a fall in consumer confidence. Unemployment has not risen as rapidly as expected, and there are signs that occupier demand is improving. However, in the face of approaching public spending cuts, retailers could come under substantial pressure, particularly in regions with a high proportion of government employees.



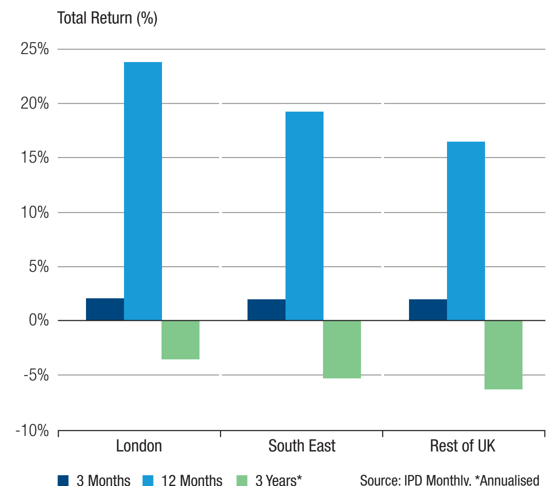
OFFICES

- The office sector produced a total return of 2.4% over Q3 2010, thanks to continuing performance from Central London offices.
- Over 12 months, offices returned 21.7%, with both capital growth and income return settling between industrials and retail.
- Offices in the City of London returned 4.2% over the three months, thanks to the fourth consecutive quarter of positive growth in capital values, and the third consecutive quarter of rising rents.
- Demand for offices remains poor outside London, driven by the concern over approaching cuts in public spending. The picture is more positive in Central London where, despite recent strong demand for offices being partly generated by occupiers who held off from taking up space in 2008 and 2009, longer term demand forecasts remain strong.



INDUSTRIAL

- The industrial sector produced a total return of 1.8% over Q3 2010.
- Industrials returned 17.8% over the last 12 months, less than retail and offices, but the sector posted the greatest income return, at 8.1% over the period.
- Monthly capital growth in industrials slipped into negative territory in September 2010 for the first time in over a year, having lagged far behind offices and industrials every month in 2010.
- Demand for standard industrial space remains weak across the country, compared with historical levels, while demand for big sheds has improved this year – but the situation is expected to reverse. There are rising vacancies in big sheds, while demand for standard industrials is expected to improve from its current low point as the economy recovers.



UK Commercial Property Market Outlook

Investors across the global markets are desperate for yield, and property investors are no exception. Income is expected to drive property returns for at least the next 12 months, and buyers are likely to focus their attention on prime property with strong tenant covenants, which offer a more secure income stream.

Such a focus marks a shift in sentiment from earlier this year, when demand was increasing for non-prime assets. A number of factors have led to the general expectation that secondary and tertiary properties will come under substantial pressure. In particular, the spending cuts announced on 20th October this year are expected to substantially reduce demand for office and retail space, particularly in regions such as the North of England where a substantial proportion of the workforce is employed by the government. Other continuing risks include uncertainty over whether quantitative easing might be reintroduced, the possibility of a rise in interest rates in the short to medium term, and approaching maturities in a substantial number of Commercial Mortgage – Backed Securities (CMBS) loans.

Partially in response to the above factors, overall institutional demand for property has weakened since autumn 2009, when a surge of new money led to substantial growth in capital values. The latest figures suggest that a majority of institutions are planning to reduce their investments in the asset class for the first time in at least a year, and fund managers already seem to be experiencing a substantial decline in flows. Property companies are also pulling back from their buying spree earlier this year.

UK commercial property values are therefore expected to fall, while income keeps total returns positive over the medium term. From now to 2015, we expect economic growth to settle at an annual rate of around 1.5%, taking into account the downside risks mentioned above. However, it may be 2012 before economic growth is accompanied by positive rental value growth across UK commercial property. Some of the more bullish forecasters predict a 6% to 8%[2] total return per annum from now to 2015 for the market, led by large shopping centres and superstores. In the short term, while occupier demand remains subdued and investors remain wary of the impact of public spending cuts, we expect the market to offer less attractive returns, at least for investors holding assets across various regions and sectors.

RETAIL SECTOR OUTLOOK

Government spending cuts are likely to place substantial pressure on retail spending over the next few years. Regionally, the cuts are likely to have a greater impact on expenditure in Scotland, Wales, the North and Northern Ireland, where the public sector accounts for a substantial share of household income[12]. It is likely, therefore, that rents in those regions will come under stronger pressure than in the rest of the UK, and vacancy rates will increase.

In the past, the retail sector has been a safe haven as retail sales have remained relatively stable in the face of several downturns. Sales have proved similarly stable in the latest slump: earnings growth among retailers has been subdued, but their margins have held up surprisingly well, relative to pessimistic forecasts.

A further positive sign is the apparent lack of supply, which could drive rental growth as tenants start to acquire space again. Retailers are also becoming more demanding, and units in towns and cities that meet a retailer's size and configuration requirements are attracting far greater interest when they become available: such sentiment suggests that when rental growth begins to rise, it may be more rapid than expected, as retailers accept better terms for the most attractive assets.

Another factor, which has introduced a level of volatility into the performance of retail, is that a substantial proportion of retailers now have owners that need to appease analysts and investors. They will need to acquire more floor space to support growth targets, and in recent months several major retailers have indicated that they want to acquire new space. However, the greater level of gearing introduced by many of these owners in recent years could introduce greater volatility in returns compared to historical averages.

However, the performance of the sector in the medium term will be most clearly defined by the resilience of consumer spending in the wake of the government's spending cuts. We maintain the view that sales of household goods will remain weak, putting the performance of the retail warehouse market under pressure. We are more positive about shopping centres, which are widely forecast to perform well over the next few years thanks to the high level of income they generate.

OFFICE SECTOR OUTLOOK

The office sector remains a two tier market, with strong performance of Central London offices driven partly by a recovery in the financial sector[5], and performance elsewhere held back by approaching cutbacks in public spending.

The recent upturn in Central London rental values has been driven by a spike in demand from an ongoing recovery in financial services, as occupiers take advantage of historically low rental levels, along with a shortage of new space. We expect prime Central London rents to keep rising in the medium term, and total returns are expected to remain strong for several years yet – though forecasts suggest that West End offices will offer a more stable returns stream in coming years. Returns from City offices are expected to drop back from the sharp recovery last year, and development completions will start to come through in the City after 2014, offsetting increased demand.

The wider Thames Valley office market's greater exposure to global occupiers and global economic growth in trade should continue to benefit the sector in terms of rental growth, though high levels of vacancy are still expected to hold back performance in the shorter term.

Over the medium term, regional office markets are expected to underperform their counterparts in the capital. Vacancies have continued to rise outside London, and prime rents in the regions are, in relative terms, still at historically high levels compared to their peers in London and the South East. Their greater dependence on public sector occupiers will add further pressure.

INDUSTRIAL SECTOR OUTLOOK

Rents are forecast to begin rising again in industrials from 2011, leading to relatively benign prospects for rental growth from the following year. As with retail and offices, industrials in London and the South East will lead a recovery, while regional assets will be hit hard by the cuts in public spending, which are likely to lead to more vacancies and falling rental values.

Overall returns from the sector are expected to be relatively gentle over the medium term. Performance should continue to be supported by the high level of income that it generates. Rental growth is likely to emerge first in London, where expected increasing demand for space will have to fight over a relatively limited supply of space. Sterling weakness is also expected to continue to support occupiers linked to exporters.

More broadly, new developments across the country remain at very low levels, but there remains enough old space on the market to offset any constraints on supply in the near term. On a sectoral basis, the recent recovery in demand for big sheds – assets with over 100,000 sq ft – is expected to fall back while take up of smaller, standard industrial space is rising again, towards historical averages.

Source

1 *RBS, Property Derivative Daily Pricing, 27 October 2010*

2 *IPF, UK Consensus Forecasts, September 2010*

3 *HM Treasury, Forecasts for the UK Economy, October 2010*

4 *IPD, Monthly Index, September 2010*

5 *Office for National Statistics, Gross Domestic Product Preliminary Estimate, Q3 2010*

6 *CIPS/ Markit UK Services, Manufacturing and Construction PMI, September 2010*

7 *Office for National Statistics, Consumer Price Indices, September 2010*

8 *Bank of England, Quarterly Inflation Report, August 2010*

9 *Thomson Datastream, 27 October 2010*

10 *OBR, Budget Forecast, June 2010*

11 *HM Treasury, Forecasts for the UK Economy, August 2010*

12 *CEBR, the State of the Nation, April 2010*

Notes

The data contained in this document is for information purposes only. It is correct to the best of our knowledge at the date of issue and may be subject to change. The client legal agreement will take precedence over this document. This document is not legally binding and no party shall have any right of action against Invista in relation to the accuracy or completeness of the information contained in it or any other written or oral information made available in connection with it.

Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. Invista Real Estate Investment Management Limited accepts no liability for any failure to meet such forecast, projection or target.

This document is intended for investment professionals only and should not be relied upon by private investors.

Any opinions are Invista's own at the date of this document and may change.

Unless otherwise stated, the source of information is Invista Real Estate Investment Management.

Past performance is not a guide to future performance.

Investments in property are relatively illiquid and more difficult to realise than equities or bonds. Yields may vary, and are not guaranteed. The past performance of property funds is not always represented by the performance of the property market as a whole and the value of property is a matter of a valuer's opinion rather than one of fact. Property funds will not contribute diversification where investors already have a substantial proportion of their investments in property.

Issued by Invista Real Estate Investment Management Limited, authorised and regulated by the Financial Services Authority. Registered office 33 St Mary Axe, London EC3A 8AA. Registered in England and Wales Registered number 04459443.

Ref: inv-724.