



## UK Commercial Property Market Overview

NOVEMBER 2007

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### Key Highlights

- The fundamentals underpinning the UK economy remain robust with employment and wages increasing, and the economy growing, at a steady rate. As a result occupational markets remain healthy and rents continue to rise across all sectors of the commercial property market. However against this background, uncertainty in other financial markets is having an impact on the prices of all assets including commercial property.
- Whilst financial markets remain volatile, property is expected to revert to its traditional role of healthy returns, low risk and good diversifier.
- Added value remains available in the market – if funds work their assets, using their management skills effectively, they can add value to both the investor and the occupier

### Six reasons why commercial property remains a good investment

#### Good stable income stream

Commercial property continues to offer stable inflation-hedging income streams. Long tenant leases with five-year upward-only rent reviews remain a foundation of the income generated through commercial property.

#### Diversifier in volatile times

The addition of commercial property to portfolios, whether conventional bond/equity or more diversified modern portfolios, would have consistently reduced risk and often enhanced returns during any of the more volatile periods in the last 40 years. Property's stable income streams and low correlation with the equity and bond markets are significant factors in reducing portfolio risk.

#### Property is a real, tangible asset

An asset can be seen and visited. It has a tangible worth and provides a secure capital base, which, as long as it has a use, has a value – unlike equities or bonds.

#### Long-term returns

Commercial property is a strong long-term performer. Since 1970 UK commercial property has on average produced a total return of 12.6% per year.

#### Rising employment figures coupled with strong positive growth in GDP

The UK is currently experiencing rising numbers of employed, and strong positive growth in GDP. In the occupier market, rental value growth is strong, levels of take up of new/empty space are healthy and there are limited tenant delinquencies. This is in stark contrast to the situation in the early 1990's where high interest rates, unemployment and weak economic growth depressed occupational demand and the performance of the property sector.

#### Potential to enhance value

Investors can enhance the value of a property through refurbishment, redevelopment or innovative asset management. Buying on real estate fundamentals, assets need to be worked. Awareness and understanding of tenant requirements are key to unlocking the added value through increasing the attractiveness of a property for tenants and investors.

## Economic overview

The UK has continued to expand in 2007, growing by 3.3% year-on-year. Economic strength remains driven by the services sector, in particular business services and finance which grew by 5.6% year-on-year. Although uncertainty remains in global financial markets, where “expectations are sensitive to further shocks”, according to the Bank of England, economic growth projections for 2008 are still only marginally below long-term trend.

Buoyant consumer spending has been underpinned by robust retail sales growth of 3.8% in the three months to September 2007, compared to the same period one year earlier. The housing market has showed signs of cooling with mortgage approval numbers falling off, and Halifax

reporting an 8.9% increase in house price growth over the 12 months to September, down from 11.2% three months earlier.

In November, the Bank of England left interest rates untouched for the fourth month in succession. Consumer price inflation has remained around Government target since July 2007 and despite recent oil price rises presenting some near-term upside risk, medium term inflationary concerns have subsided. With inflation close to target and in light of the downward revisions to economic growth projections, financial markets are currently pricing in at least one 25bp cut in interest rates in the first half of 2008.

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The third quarter of 2007 has seen a sharp correction in commercial property yields as the market adjusts to the impact of the higher cost and poorer availability of debt resulting from the global credit crunch. However, the current underlying economy and occupier markets are both healthy and stable, unlike in the early 90's when the last sharp positive yield movement was seen.

Returns fell by 1.1% over the third quarter of 2007, driven by a 2.2% fall in values. The impact of rising yields has been felt across all sectors despite continued rental appreciation. Rental value growth of +1.1% quarter-on-quarter (4.6%

annualised) have been underpinned by broad-based economic growth, healthy levels of take up of new/empty space, limited tenant delinquencies across all sectors, and the strength of the Central London office market.

Borrowing conditions have tightened, making conditions in the investment market more difficult with debt-backed buyers priced out of the market, resulting in a fall in transaction activity. However, opportunities remain in the market-place. UK commercial property continues to offer a superior level of income yield compared to gilts, with the differential now rising as the demand for gilts pushes yields down.

## Sector performance

\*All data in this section sourced from the IPD Quarterly Index September 2007

### Retail

- The retail sector returned -1.8% over the third quarter of 2007, underperforming both Offices and Industrials.
- Total returns of 4.1% over the 12 months to September 2007 were also below those recorded by both Offices and Industrials.
- Rental value growth remained flat over the period, lagging the average for the market as a whole.
- Over the past year, the sector has generated rental growth of 2.1%, compared to 4.7% for the whole market, with retail properties in Central London seeing the strongest growth in rents.
- Within the sector, shopping centres generated marginally stronger returns over the last twelve months.



Source: IPD Monthly

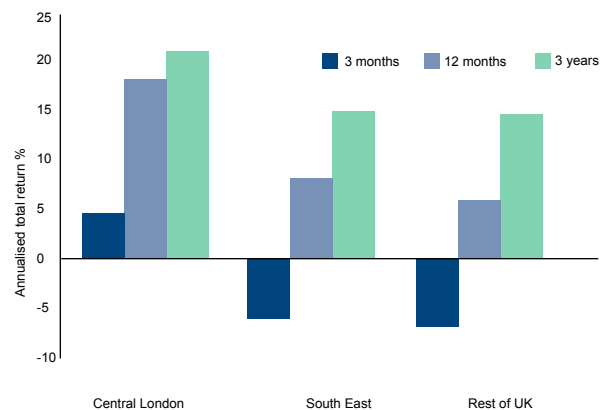
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### Sector performance

#### Offices

- The Office sector outperformed both Retail and Industrials over the three months to September, albeit recording a total return of -0.2%. Offices also outperformed on a 12-month basis, returning a healthy 12.9%.
- Returns continue to be driven by strong rental growth which results from positive business sentiment and declining availability.
- Rental growth in the sector has remained high, generating by far the highest rate of growth of the three main sectors during the quarter. Rents rose by 10.4% over the past 12 months.
- Rental growth remains strongest in the Central London market, notably the West End. Over the last three months, Central London offices recorded annualised rental growth of 18.1%, contrasting with growth of 4.1% in the rest of the South East and 2.2% elsewhere in the UK.
- Central London offices also saw the strongest capital growth over the 12 months to end September at 13.6%.
- The impact of rising rents has been more than offset by rising investment yields which have reined back capital growth across all sub-sectors.



#### Industrials

- The industrial sector returned -1.6% over the three months to September, outperforming Retail but underperforming Offices.
- Over the past 12 months, the sector returned 6.0%, roughly in line with income yields. Returns from London industrials were higher than those in the South East or rest of UK market being driven by stronger rental growth and investor demand.
- Industrials continue to generate relatively modest levels of rental growth compared to the retail and office sectors, with rents growing by 1.5% over the past 12 months. Nevertheless, this is above trend for the full history of the IPD Quarterly Index (from March 2001), reflecting the underlying strength of the UK economy.



Source: IPD Monthly

## UK Commercial property market outlook

We expect the re-rating of yields to continue into the first quarter of 2008 as valuations gradually begin to reflect pricing in the transaction market. However, we expect that falling interest rates and continued rental growth will result in the market offering attractive returns as the financial markets return to normality. The medium-term outlook for the commercial property market appears benign with property offering relatively stable performance.

Offices, especially in Central London, are expected to remain one of the strongest performing markets over the next 12 months, although thereafter development

completions in the City appear likely to dilute performance in this sub-market. In the short-term we also have concerns for the industrial sector where the removal of the exemption from rates when properties are vacant may hit rental growth.

We continue to expect stronger performance from assets located in the South East of the country, given its higher exposure to the faster growing service sector, although we recognise the growing risk to this scenario from weaker economic growth in the US.

### Retail sector outlook

Retail sales over 2007 have proved robust but are expected to moderate over the next 12 months. Households have maintained their spending habits at the expense of savings and increased borrowing, but shortly the cumulative effect of the five interest rate rises since August 2006 is expected to feed through into higher mortgage payments and lower disposable income. House price growth has begun to cool as higher interest rates have reduced affordability and the costs of taking out a mortgage have risen in light of tighter borrowing conditions.

We maintain our preference for prime, well-located retail properties as the current pricing of secondary properties does not adequately reward investors for the higher level of risk and we expect an increasing divergence in performance between prime and secondary assets.

The shopping centre development pipeline remains relatively modest for 2008 and 2009. Effects are expected to be localised with only the two largest schemes, White

City and Liverpool One, likely to have a significant knock-on effect in depressing rental growth. For schemes originally due to complete beyond 2009, developers are pushing back the start dates for some in response to increased funding costs and an expected slowdown in retail sales. However, we remain cautious on shopping centres, as we have some concerns over the pricing of this sector of the market, given the capital expenditure which is required to sustain growth in rental values.

Out-of-town retail properties are expected to continue to outperform town centre properties, where both occupier and consumer demand is weaker. The fundamentals underpinning open A1 retail and fashion parks sub-sectors, rather than Solus and bulky goods parks, remain more positive with stronger occupier demand and low levels of availability. The supply pipeline as a whole remains constrained in the retail warehouse market and space under construction is much lower for this sub-sector compared with town centre retail and shopping centres.

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### Offices sector outlook

The Office sector is expected to outperform both Industrials and Retail over the next few years, supported by sustained rental growth and a low level of development activity.

Central London markets are expected to lead returns in the next two years. Availability has fallen and tenant demand remains strong, boosted by the strength of the finance and business services (FBS) sector. Despite FBS markets being potentially vulnerable to knock-on effects from this autumn's credit crunch, occupier demand in the capital remains healthy.

The West End remains attractive with its limited development pipeline leading to expectations of healthy long-term rental value growth. Strong rental growth in the City office market is expected to moderate over the next 24 months as development completions increase

availability; however, the medium-term outlook for this sector has improved as tighter borrowing costs have pushed back development activity. The surrounding areas of the City and West End, such as Paddington, the South Bank and King's Cross, continue to benefit from an overspill in tenant demand, and are expected to continue to offer relatively attractive performance.

Outside of London the performance in the short term is expected to be less strong with higher levels of availability and less robust demand, resulting in lower levels of rental appreciation. Relative to Central London, performance is likely to pick up in the medium term as the less cyclical nature of the market works to its advantage. The regional office market tends to be more reliant on tenants from the public sector, so returns may be dampened if Government spending declines.

### Industrial sector outlook

Rising vacancy rates and levels of availability across all sectors bar London offer limited scope for rental growth. Positive capital growth is unlikely in the short term as the sector offers such a small yield premium relative to gilts.

The manufacturing sector has proved surprisingly buoyant in 2007 in light of the strong pound and higher interest rates. Industrial surveys now point to a loss of momentum in the sector, which is expected to keep growth rates low as occupiers struggle with rising cost bases. Rental growth in the distribution warehouse market may also struggle in the New Year if consumer spending begins to slow, as expected.

Rental value growth will be damaged by the Government's plans to remove tax relief on vacant property units in 2008. This is expected to reduce rental values, particularly in areas of relatively high vacancy rates such as the regional market, where take-up is weakening and availability rising. Supply constraints and lower vacancy rates in the South East are expected to hold up rental values, and these areas should prove more attractive for investment.

Nevertheless, demand for industrial properties – with their lowest cost land use – should be supported by the potential benefits from change of usage to residential, retail or office space.

### Summary of our sector ratings

| Segment                | Asset allocation position |
|------------------------|---------------------------|
| Rest of UK shops       | SELL                      |
| Shopping centres       | SELL                      |
| Rest of UK industrials | SELL                      |
| South East offices     | BUY                       |
| South East Industrials | BUY                       |
| South East shops       | HOLD                      |
| Retail warehouses      | HOLD                      |
| Central London Offices | HOLD                      |
| Rest of UK offices     | HOLD                      |

## Notes

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