

Commercial property market outlook

Autumn 2011

Comment While efforts continue to stimulate the domestic economy, it is events unfolding outside the UK that are calling the shots. In the face of this uncertainty the London property market continues to show a robust performance, but outside the prime south east both the occupier and investment markets are proving fragile.

Unpacking values to unmask opportunities

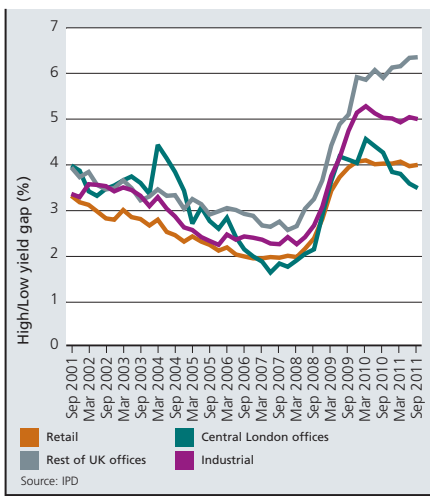
The first estimate of Q3 GDP growth of 0.5%, while positive, shows the UK is not immune to international events. Following a brief improvement, consumer confidence and spending have deteriorated in the face of lower real household incomes and general uncertainty. The manufacturing sector, which was emerging as the star performer this time last year, has also weakened, and while the service sector has remained relatively robust, investment levels are anaemic. These economic dynamics are evident in the occupier environment. Despite this, the property sector continues to attract a strong flow of funds. UK investment transactions in 2011 to the end of October totalled £24.4 billion, marginally down on the same period last year. However demand and cash are focusing on both prime and good secondary assets, although both are limited in supply. The Eurozone turmoil and resulting volatility in the financial markets have reinforced the appeal of well let assets, particularly those with secure bond characteristics.

With the yield led bounce to returns petering out during 2011, rental growth is required for out-performance going forward. Unfortunately there are few markets in which this is likely. Central London is almost unique in its ability to produce genuine rental increases in the office and retail occupier markets. This robust performance has ensured the capital remains the primary focus of interest for both UK and overseas investors. The value of transactions in 2011 to the end of October were 7% ahead of the same period last year, with a slight increase in the proportion of overseas investment. London's economic outperformance has attracted a greater appetite for risk with development opportunities in undersupplied segments of the market being considered by many investor groups.

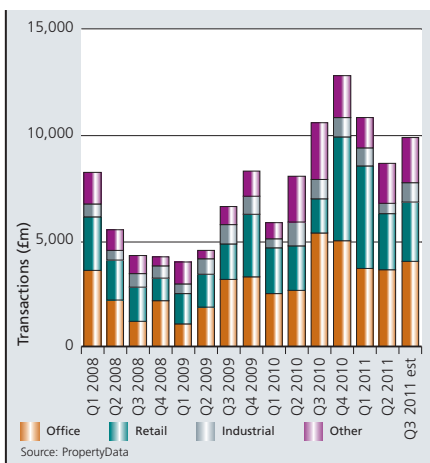
The disparity between prime and secondary yields has widened during 2011, currently standing at a record 400 bps, reflecting the very limited demand for poor secondary assets. This is demonstrated by the recent sale of the Lloyds Banking Group's Project Flagstaff portfolio, which received bids well below expectations. Marketed at £63m, it sold for less than £47m. We expect the disparity between prime and secondary yields to widen further over the next quarter as prices weaken on poorer quality property with significant occupier risk.

In this environment there is a risk of a disconnect between some occupier and investment markets. For example, there are examples of regional investments being marketed as rack rented, supported by letting evidence from headline rents set 12 or 18 months ago. In practice, and given the condition of occupier markets as described above, more recent transactions might show that rental values today may be in some instances more than 25% below the passing level, after allowing for incentives. In addition, if the lease is getting short, the capital value of the investment is likely to be falling as well. While this environment has the potential to convey arbitrage opportunities for investors who have unpacked fully the underlying value of individual assets, it also presents risks to the delivery of future performance.

Gap between prime and tertiary widening



Transaction volumes rising



Offices The service sector recorded a further improvement in September, maintaining positive growth, albeit subdued. Offices have been the best performing sector over the past year, however this masks significant regional variations, reflecting a downturn in business confidence to its lowest level since Q1 2009.

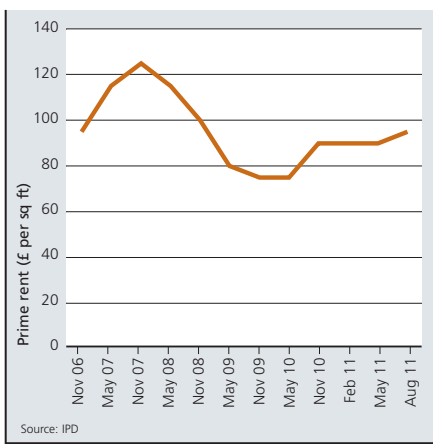
Although Central London has performed better than the rest of the UK, take-up of Grade A office space in the West End, City and Docklands in Q3 2011 is down on the same point last year. Q3 saw the first increase in office availability since Q2 2009. This stalling reflects ongoing business caution in the subdued economic environment, which has been dented further by the current Eurozone difficulties. Businesses are reluctant to commit to expansion, despite signs of improved business investment in recent GDP figures.

Central London's outperformance continues

In the City most new space completing in 2011 remains vacant, while in the West End the majority of new developments have found tenants, with the TMT sector driving the occupier market, albeit in a small number of large lettings. Rental expectations reflect these dynamics. Headline rents in the City now stand at £55 psf, but we forecast a decline in rents in real terms over the next two years. Prime West End rents stand at c.£95 psf with further growth expected, despite the economic environment, due to the constrained supply picture. This pressure is reflected in a further fall in tenant incentives. Outside the capital, the supply of Grade A space in the Western Corridor is falling, although many locations, such as Bracknell, remain significantly over-supplied. Meanwhile, markets and office parks away from the south east are suffering from weak occupier demand which is having a negative impact on rents.

	Prime yields			
	2010 Q4	2011 Q1	2011 Q2	2011 Q3
West End - core	(%) 4.00	4.00	4.00	4.00
West End - fringe	(%) 5.00	5.00	5.00	5.00
City - core	(%) 5.25	5.25	5.25	5.25
South East (M25)	(%) 6.25	6.50	6.25	6.25
Provincial City	(%) 6.00	6.25	6.00	6.00

Prime West End rents rise



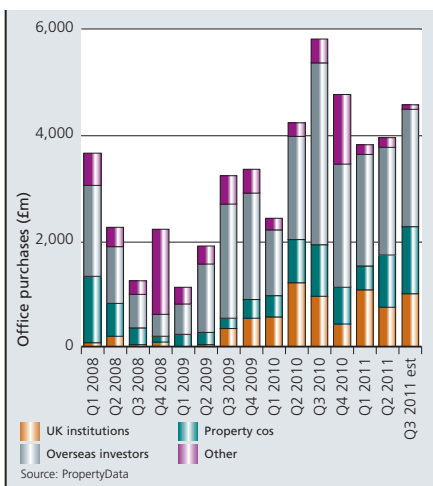
Investment

In the City, against a background of increasing availability and flat rents, many owners of landmark buildings are considering selling, with c.£5bn stock on the market. This extends to Canary Wharf, where Credit Suisse are seeking a 15 year sale and leaseback deal for their HQ at 1 Cabot Square. These trophy buildings may well appeal to wealthy international investors seeking a safe haven, with prime yields stable at 5.25%. The West End continues to attract a significant premium, illustrated by the sale of 63 South Audley Street, comprising a long leasehold retail and office investment, to an overseas investor for a figure ahead of asking, reflecting 3.7% NIY. Similarly 19 Golden Square was acquired by a fund at 4% NIY. Good quality assets in the Western Corridor are also attracting interest. Davidson House in Reading received eight bids and sold to Schroders for £42.6m, reflecting 6.5% NIY and over 7% EY, after taking account of the reversionary income.

Trends

While we expect the office sector to continue to outperform the other markets, the dichotomy of performance will be maintained within the sector during 2012. City rents are likely to plateau, but we expect the West End, Midtown and South Bank markets to continue to benefit from positive rental growth, driven largely by a below trend development pipeline. Yields are expected to remain stable following the recent period of strong capital growth. However even in Central London the majority of take-up will remain in response to lease events rather than an upturn in business activity which we expect to remain positive but subdued over the coming year.

Overseas investors remain key to market



		Past				Future		
		2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q4	2012 Q4

Source: Cluttons, IPD

Rental value growth	(% pa)	-3.0	0.4	1.8	2.2	1.7	5.1	4.9	3.7
Capital growth	(% pa)	14.8	15.0	9.2	5.1	2.7	5.1	3.2	2.3
Yield	(%)	7.4	7.3	7.3	7.2	7.2	7.1	7.1	7.1
Total return	(% pa)	22.7	22.4	16.0	11.5	9.8	11.3	9.2	8.2

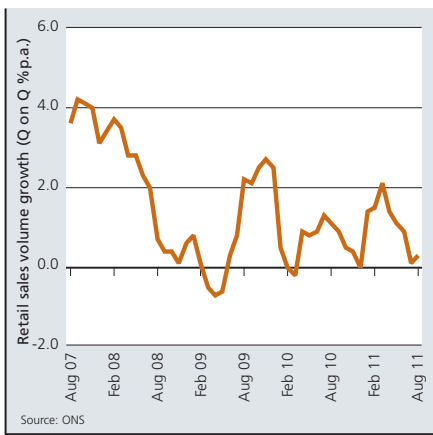
Retail Consumer confidence has fallen sharply over recent months and is close to reaching a historic low according to Nationwide. This is occurring in the face of deteriorating household finances, an unemployment rate edging towards 9% and a weakening housing market, with mortgage approvals falling for the first time in six months. The Eurozone uncertainty and subsequent stock market volatility are adding to consumer caution and containing their predilection to spend.

Consumer confidence falls to near historic low

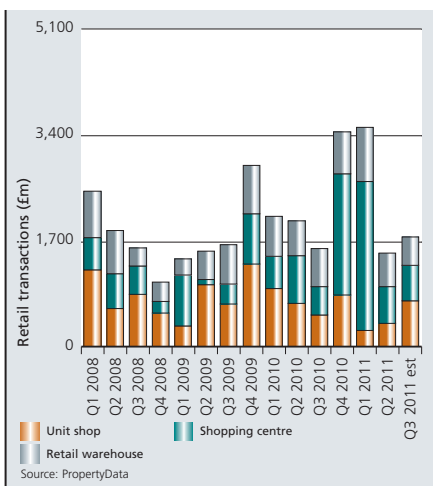
This mute consumer picture is true for the majority of the UK, but Central London continues to prosper, weathering the economic storms. As a result we are still seeing substantial premiums being paid to gain representation in Oxford Street. However the two tier market is not simply a case of north v south. Across the UK the more attractive, accessible and affluent towns are generally weathering the difficult economic conditions. In contrast, weaker high streets have seen a proliferation of discount shops and persistently high vacancy levels. Inevitably, inducements are rising as landlords look to entice tenants. While some retailers have managed to maintain profitability by squeezing suppliers, prospects for landlords to achieve rental growth outside Central London are rare.

	Prime yields			
	2010 Q4	2011 Q1	2011 Q2	2011 Q3
Major high streets	(%) 4.75	4.75	4.75	4.75
Market towns	(%) 6.00	6.00	6.00	6.50
S centres - prime	(%) 5.50	5.50	5.25	5.25
S centres - secondary	(%) 6.75	6.50	6.50	6.75
R w'house - open A1	(%) 5.25	5.00	5.00	5.00
R w'house - bulky	(%) 6.00	6.00	6.00	6.00
Supermarket	(%) 4.75	4.50	4.50	4.25

Retail sales begin to stall



Retail investment slips back



Investment

Yields for the very best shops have remained stable at c.4.75% to 5.0% evidenced by deals in Market Street, Cambridge, George Street, Edinburgh and Stall Street, Bath. Central London remains in a category of its own, with yields of 4.0% to 4.5% NIY being achieved in Oxford Street and c.3.25% NIY in New Bond Street and Knightsbridge.

There has been no evidence for prime shopping centres since Westfield's sale of a 50% interest, for c.5.25%, in Stratford, which recently had its very successful opening. Sentiment appears to remain strong for good quality centres, with Trinity Walk Wakefield believed to be under offer at a price reflecting c.5.75% NIY. However those centres in weaker locations with falling rents, falling occupancy levels and rising service charges are only likely to sell at discounted yields. There are several centres available but attracting less interest than would have been seen earlier in the year. Some transactions have failed to proceed, with buyers withdrawing from purchases at Redditch (c.7.25% NIY, good secondary) and Birkenhead (c.9% NIY, poorer secondary).

Good quality open A1 and hybrid retail parks have 95% occupancy on average and the strongest demand from investors. Three such investments at Chelmsford (Riverside), Edinburgh (Straiton) and Maidstone (South Aylesford) have all sold for prices reflecting 5.7% to 6% NIY. Supermarkets remain as popular, reflecting the positive performance of the major chains. Yields of sub 4.5% NIY are being achieved for income of 15 years plus, illustrated by the recent sales at Tooting (Sainsburys), Winchmore Hill (M&S Simply Food) and Clerkenwell (Waitrose). The strongest prices are paid for leases with RPI uplifts.

Trends

The definition of prime continues to narrow in the retail sector, but yields remain firm for the best quality stock. In view of the headwinds from the downturn in consumer spending and growing availability, we expect yields for secondary and tertiary retail to continue to soften. Rents in most locations outside Central London, Guildford and a handful of other affluent and resilient centres will at best remain static for the next two years driving average total returns of c.6%.

		Past					Future		
		2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q4	2012 Q4	2013 Q4
Rental value growth	(% pa)	-3.7	-2.7	-1.5	-0.8	-0.9	-0.4	0.2	1.7
Capital growth	(% pa)	19.4	18.0	9.3	5.5	2.2	1.7	-1.1	-0.9
Yield	(%)	6.9	6.8	6.6	6.5	6.5	6.6	6.6	6.8
Total return	(% pa)	27.4	25.5	16.1	11.9	8.9	7.7	5.2	5.4



Industrial

A fall in the take-up of both industrial and distribution space over the summer is consistent with survey evidence showing a contraction in the manufacturing sector.

Occupier and investment market disconnect

Demand for large units remains at its strongest in those locations where supply is limited, notably in London and the south east. Elsewhere, take-up remains subdued and patchy with some landlords cutting asking rents. Despite the lack of speculative space under construction, lettings that are occurring are generally at lower rents than in 2010, particularly in regional locations. For example some new and good quality second hand space at Trafford Park, Manchester is letting at rents 15%-30% below previously agreed levels. Similarly in the Midlands some landlords are letting newly developed units at net effective rents under £3.00 psf, well below the quoting rent of £5.25 psf: the profitability threshold. Those sticking to asking rents to secure their profit have seen limited success to date. Empty property rates obligations have added to the incentive to offer occupiers more favourable packages depending on the market. The combination of these factors is resulting in a growing disconnect between the occupier and investment markets.

Investment

There is a divergence in investor demand, with different purchaser groups chasing very different product. For distribution sheds, lease length and covenant is critical. Annuity and life funds seek long term bond type income and may be prepared to bid at below 6% for a long term pre-let to a blue chip covenant, if the lease is 20-25 years or more. In fact prices nearer to 5.5% are achievable if there are RPI uplifts, exemplified by the Tesco unit in Dagenham. When leases have sub 10 years unexpired, the yield discount increases significantly. A 20 year old Tesco distribution unit with 12 years unexpired in Harlow recently sold for £22.9m, reflecting 7.5% NIY. Similarly, at Magna Park, Lutterworth, a 167,000 sqf unit let to DHL with 3 years unexpired sold for £9.1m, reflecting 8.9% NIY.

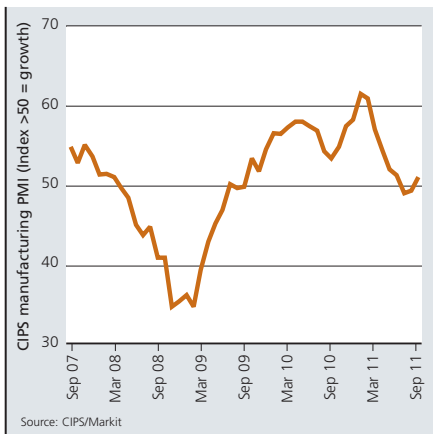
Industrial estates are attracting stronger interest and lower yields, especially in the south east. The Stansted Centre at Bishops Stortford achieved over the asking price at £12.125m, reflecting 6.56% NIY. However, stringent investor requirements are reflected in the market discounts for properties with access/layout issues despite good locations. For example, the Coln IE near Heathrow sold for £7m, reflecting a 9.3% NIY. Meanwhile, London continues to achieve the strongest prices, with the economy boosted by its relationship with the relatively stronger global trade environment. This is illustrated by the sale of a £38m portfolio of six sheds by SEGRO to L&G for £38.2m, reflecting 6.2% NIY. Similarly, a prime freehold distribution unit at Park Royal let off a rent of £10.50 psf to Matthew Clark until March 2023, sold in October for £13.8m reflecting 5.7% NIY.

Trends

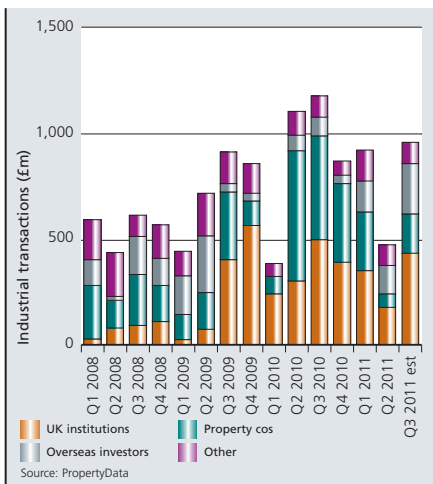
Apart from the usual hot spots around London, and others such as Aberdeen, buoyed by the oil industry, we expect negative real rental growth in 2012/3. Combined with static capital values, total returns are expected to average 6% over the same period.

		Prime yields			
		2010	2011	2011	2011
		Q4	Q1	Q2	Q3
Distribution	(%)	6.75	6.25	6.25	6.25
SE industrial estate	(%)	7.00	7.00	6.75	6.50
Secondary industrial	(%)	8.50	8.50	8.00	8.00

Manufacturing output implied growth rate slows



Industrial investment falls back



		Past					Future		
		2010	2010	2010	2011	2011	2011	2012	2013
		Q2	Q3	Q4	Q1	Q2	Q4	Q4	Q4
Rental value growth	(% pa)	-2.9	-1.9	-1.4	-1.1	-1.0	-0.9	-0.5	0.7
Capital growth	(% pa)	11.7	10.1	3.5	1.2	0.3	0.4	-0.8	-1.1
Yield	(%)	8.6	8.5	8.4	8.4	8.4	8.3	8.4	8.5
Total return	(% pa)	20.3	18.2	10.9	8.3	8.1	7.4	6.3	6.0

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