CLUTTONS

Commercial property market outlook

July 2011

During the first half of 2011 we have seen the contribution of the hardening of yields to total returns lessen as average rental growth slowly returns to more consistent positive territory. During the 12 months to the end of Q1 2011, UK property delivered total returns of 11.2% down from 15.2% in Q4 2010.

Despite a slight upturn in rental growth in the IPD monthly index for April and May, this quarter we expect to see a further slip in returns as the yield impact on capital growth lessens and income returns fail to take up the slack. With the yield led bounce largely petering out, property returns over the next 6 months are likely to be little more than the level of income except in a few select markets. Central London leads the way in this respect, with genuine rental growth being delivered in the office and retail sectors, and hence these sub markets continue to be most popular with both UK and overseas investors.

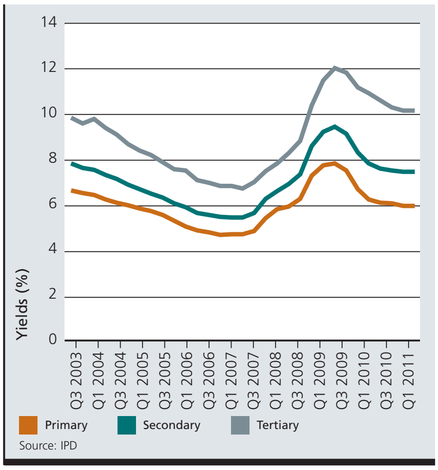
One of the attractions of UK commercial property over the past two years has been its high yield relative to other asset classes; in the main this has been achieved despite a deteriorating rental growth picture. Notwithstanding the total returns plateau, property continues to attract strong investor attention, both domestically and from overseas. Sovereign debt issues overshadowing many European markets, and popular unrest impacting North Africa and the Middle East, have resulted in considerable uncertainty on the global financial markets. Against this backdrop, the UK property market maintains its position as a safe haven, attracting a steady investment flow, offering both transparency and liquidity for the best quality stock. For domestic investors a positive yield gap of over 300 basis points over bond yields and swap rates, almost twice the long term average, maintains the case for property, assuming prudent stock selection.

Core investors, including UK institutions, international sovereign wealth funds and other global equity investors remain focused on prime assets. The excess of capital over supply is inevitably resulting in some stock being traded off-market at what might be considered full prices, while the number of opportunities openly available in the market has proved limited. Central London remains highly popular, but a growing cohort of investors, particularly institutions, are moving up the risk curve to look at south east industrials and offices, perceiving a medium term opportunity. For these purchases to deliver acceptable returns an improvement in occupier markets delivering rental value growth will be required. With little development underway in the south east, in the face of planning and funding restrictions, medium term rental growth prospects are positive.

The discriminating nature of current investor activity is exemplified in the below expectations bids for Lloyds Banking Group's Project Flagstaff portfolio, demonstrating the market's lack of appetite for poorer secondary assets. Marketed at £63m, 9.35% NIY, no formal offers were received on the closing date and if a sale is to take place it is likely to be at a deeply discounted basis. We expect the disparity between prime and secondary yields, which currently stands at a record of 400 bps, to widen further in Q3 as prices continue to weaken on poorer quality assets in markets with significant occupier risk.

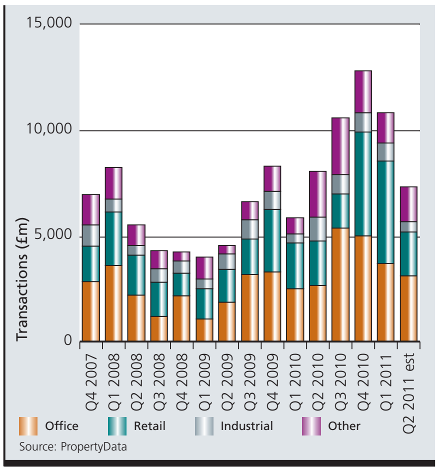
Overall, the two tier market will continue to characterise the sector. Demand and cash for prime and good secondary stock, which is limited in supply, will be maintained, while poor secondary assets are unlikely to see an upturn in interest. The further divergence in prime and secondary yields will continue to present opportunities. Prime and better quality secondary properties in good quality locations with angles will maintain the attention of investors looking at redevelopment potential in the recovery phase of the economic cycle. However, with a reducing discount for such assets, in London in particular, pricing based on achievable future values will become more challenging.

Increasing yield divergence

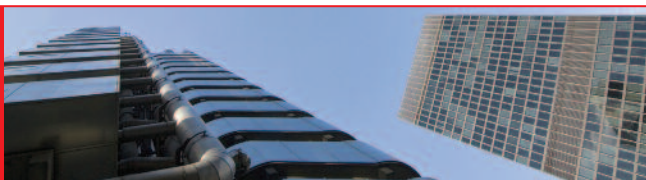


Source: IPD

Transaction volumes rising



Source: PropertyData



Offices

The UK office market continues to be characterised by divergence in conditions between Central London and the rest of the country. Central London offices, with their strong links to the recovering global economy, have out-performed the rest of the UK and are one of the few occupational markets to deliver sustainable rental growth. Capital growth in the City and West End/Midtown, as reported by IPD, over the year to the end of May 2011increased by 5.5% and 3.4% respectively compared with an unremarkable -2.2% for the rest of the UK.

Returns remain polarised

In Central London, availability remains below trend and we expect further upward pressure on rents in both the City and the West End. Prime rents in the West End are at c. £90 psf and in the City, rents have firmed around £55 psf following a very strong performance during 2010, although higher headline rents are possible in new tower developments.

Despite a number of new starts in the capital, the development pipeline remains thin and the shortage of new stock around 2014 will continue to place pressure on prime rents, especially outside the prime core areas, including Marylebone and Covent Garden. In the City there have been a number of high-profile assets which have sold. The Aviva Tower, let to Aviva until 2024 was bought for £288.2m (5.4% NIY) by private Malaysian investors, while 1 King William Street, EC4, let to Rothschild for further 7 years was acquired for £67.5m (5.6% NIY). In contrast investor activity in the West End fell by 45% in Q2, although this was largely due to a lack of stock.

Outside the capital, conditions remain less buoyant. Occupier demand, though recovering, remains weak, while elevated supply and concerns over government austerity measures are adding to uncertainty. We expect rental growth to be slow in returning to most regional and outer south east markets, although there are some positive signs in the least supplied centres where rent free periods remain static or are even reducing.

These tentative signs of improvement have spurred activity in the investment market in the best provincial centres, including interest from international investors. The sale of 1 Piccadilly Gardens Manchester for c. £70m (6% NIY) to Europa Capital is indicative of the trend, while in Frimley, USS acquired 11 years of Siemens income at a rack rent of £17psf for £42.3m (7% NIY). The best quality stock in the south east is also seeing renewed investor interest, even if over-rented. Here, institutions are looking to acquire quality assets at relatively high initial yields with the expectation that rental values will recover in the short to medium term, before expiry, with the improvement in the global economy.

Office parks, less favoured in recent years, have also seen an upturn in investment activity. Trinity House on the Oxford Business Park with 10 years of government income recently sold to a private charity for £6.64m at 7% NIY. Similarly Hyde Park, Hayes, a multi-let office park is under offer for £35.3m (7.5% NIY). These transactions indicate that for the best stock there is potential for yield compression where the assets are not over-rented.

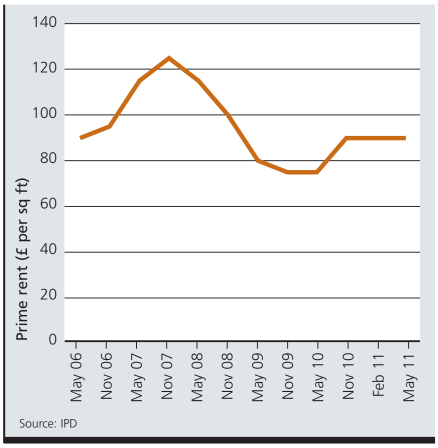
Trends

While the Central London market remains the focus for investor activity there is growing attention on the prime markets outside the capital and assets which appear under priced given a medium term recovery scenario. Our forecasts suggest that on average rents will be slow to recover outside London but there are undoubtedly market and asset specific opportunities. Secondary offices, however, especially those with short term leases in poor locations remain a potential liability and will probably require double digit yields, perhaps at site value, for a sale to proceed.

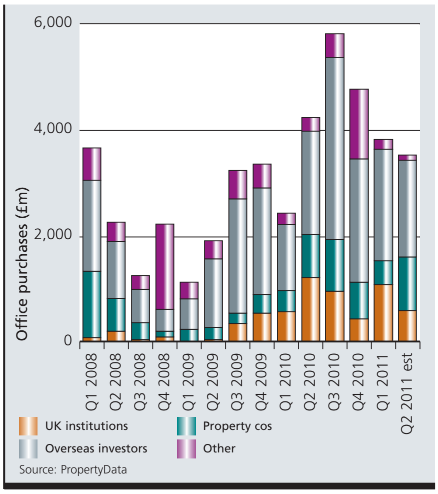
Source: Cluttons, IPD		Past					Future		
		2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q4	2012 Q4	2013 Q4
Rental value growth	(% pa)	-7.8	-3.0	0.4	1.8	2.2	5.0	5.8	2.2
Capital growth	(% pa)	7.4	14.8	15.0	9.2	5.1	4.0	3.8	0.9
Yield	(%)	7.6	7.4	7.3	7.3	7.2	7.1	7.1	7.1
Total return	(% pa)	15.2	22.7	22.4	16.0	11.5	10.2	10.0	6.9

Source: Cluttons		Prime yields			
		2010 Q3	2010 Q4	2011 Q1	2011 Q2
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)	(%)	6.50	6.25	6.50	6.25
Provincial City	(%)	6.00	6.00	6.25	6.00

Prime West End rents remain static



Overseas investors remain key to market



Retail

After the fillip of the royal wedding, the British Retail Consortium reports retail sales volumes fell by 2.1% on a like for like basis in May. Confidence among retailers and consumers is at a low ebb in the face of rising inflation, falling real incomes and an uncertain employment environment. With high street names falling by the wayside, understandable caution prevails in the investment market with an inevitable focus on prime assets and locations.

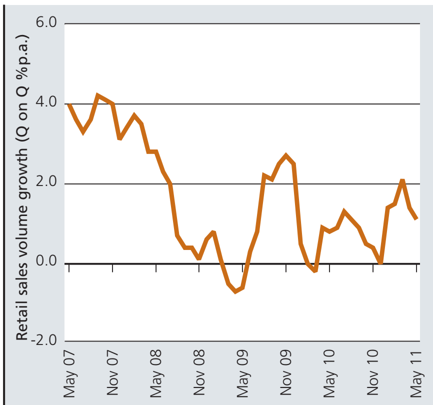
Squeezed consumers and retailers

A limited number of retail locations continue to perform well. Central London leads this select group, buoyed by tourist spend and, on average, the relatively stronger financial circumstances of households in the capital. Elsewhere the true cost of living impact is only now taking effect and this is combining with public sector job cuts that are underway. As a result there is further pain to come in many locations, particularly those with a public sector employment bias. The spending consequences will become evident in the differential performance of retail centres during 2011. However, the impact on relative performance will be complex and very much location and centre specific. CACI's recent Retail Footprint study identified those centres most reliant on "squeezed middle" shoppers as most vulnerable. This group, defined as a mix of white-collar and skilled manual workers that straddle the middle-income spectrum, have felt increasingly nervous about their financial prospects. While London and the south east accounted for 8 out of the 10 most resilient retail centres, they also had 4 of the 10 "most squeezed" retail centres as well.

Prime yields

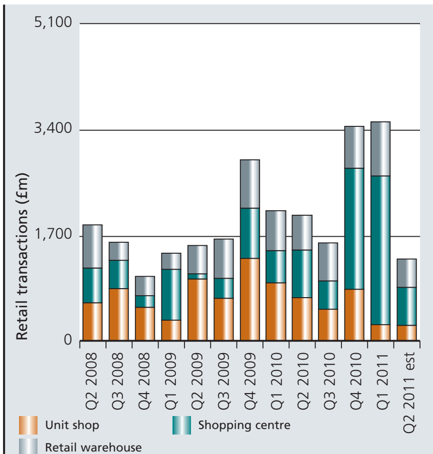
Source: Cluttons		2010 Q3	2010 Q4	2011 Q1	2011 Q2
Major high streets	(%)	4.85	4.75	4.75	4.75
Market towns	(%)	6.00	6.00	6.00	6.00
S centres - prime	(%)	5.50	5.50	5.50	5.25
S centres - secondary	(%)	7.00	6.75	6.50	6.50
R w'house - open A1	(%)	5.50	5.25	5.00	5.00
R w'house - bulky	(%)	6.25	6.00	6.00	6.00
Supermarket	(%)	4.75	4.75	4.50	4.50

Retail sales begin to stall



Source: ONS

Retail investment slips back



Source: PropertyData

Investment

Yields for the very best shops have remained stable at c.4.75% evidenced by deals in Eastgate Street, Chester, High Street, Guildford and Queen Street, Oxford. Similarly, Central London continues to be in a category of its own, with yields of sub 4% NIY being achieved in Oxford St and 3.25% NIY in New Bond Street.

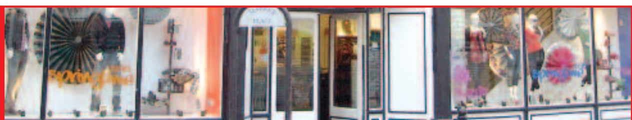
Although there has been no evidence for prime shopping centres since Westfield's sale of a 50% interest in Stratford at c.5.25%, the weight of institutional demand for the best centres indicates further improvement. Sentiment appears stable for better secondary centres, such as Perth at c.£32m (8% NIY), but is weaker for those in poorer locations with falling rents, reducing occupancy levels and rising service charges.

Investor appetite for open A1 retail parks remains strong amongst the funds, with stakes in The Fort, Birmingham achieving c.5.5%NIY (5.2% EY) after allowing for over-renting; while Phase 1 at Ashford Retail Park sold for £14.3m (5.4% NIY) and Trowbridge Retail Park for £20.67m (5.7% NIY). Elsewhere, West 5 Centre in London, with 50% Open A1 and 50% wide bulky planning use, let to Staples and B&Q sold recently for £32.1m, reflecting 6%NIY. Bodmin Retail Park, with a fully wide bulky use, sold for £12m (6.45%NIY).

Trends

The definition of prime continues to narrow in the retail sector and, in view of the headwinds from the downturn in consumer spending, secondary shops are probably over-priced. There appears to be a dislocation between prices achieved in the investment market, at levels that imply rental growth in the next few years, and events in the occupational market, which in the short term indicate static (or even falling) rents in most locations outside Central London, Guildford and a handful of other affluent and resilient centres. However, as always there are opportunities, in particular better secondary centres where occupiers continue to trade well and rents remain affordable.

		Past					Future		
Source: Cluttons, IPD		2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q4	2012 Q4	2013 Q4
Rental value growth	(% pa)	1.5	-3.7	-2.7	-1.5	-0.8	-1.1	0.6	1.7
Capital growth	(% pa)	1.0	19.4	18.0	9.3	5.5	0.9	-1.0	-1.0
Yield	(%)	7.1	6.9	6.8	6.6	6.5	6.7	6.8	6.9
Total return	(% pa)	20.5	27.4	25.5	16.1	11.9	7.1	5.4	5.5



Industrial

The manufacturing sector's strong run is showing signs of faltering: the June Markit/CIPS UK Purchasing Managers' Index reporting activity slowed to a 21-month low. While there is hope that this may prove temporary, there is uncertainty over prospects, as margins fall in the face of higher production costs. Property demand remains at its strongest in locations of limited supply, notably London and the south east. Elsewhere, take-up remains subdued and patchy.

The lack of speculative floor space under construction is driving a steady recovery in lettings of sheds over 50,000 sq ft in better locations. Most of the take-up, including large lettings to retailers, has been pre-let. However, as the supply of new space dwindles, occupiers are more prepared to take good quality second hand buildings. Outside London and the south east, vacancy rates remain high, although this is concentrated in older, more secondary units, where prices continue to fall. Even in good quality regional locations, such as Trafford Park, Manchester, rental levels have grown little over the past decade, while occupier demand is not consistent across the south east. Much of the UK stock remains over-rented and demand is weak for poor secondary space. Furthermore, empty property rates obligations continue to drive down net rents achieved, even in strong markets.

Investment

Investor demand is split, with purchaser cohorts chasing very different product. For distribution sheds, lease length and covenant is critical. Annuity/life funds seek long term bond type income and may be prepared to bid at c.6% for a long term pre-let to a blue chip covenant, if the lease is 20-25 years or more, and may go lower for RPI uplifts. Their interest wanes considerably for leases with less than 10 years unexpired. This is a level at which other funds step in at a higher yield. For example, Henderson acquired a 150,000 sq ft unit in Fareham, let to a good covenant, but with only 11 years left, paying £13.1m (8% NIY). Similarly, a modern 82,000 sq ft unit at Swift Valley, Coventry with only 5 years left to Volvo UK is under offer at a figure reflecting c.8.75% NIY, again to a fund.

Industrial estates attract stronger interest and keener yields, especially in the south east, where prices above asking are being achieved. The Cyrus portfolio, comprising both estates and single units in London and the south east, sold for £50.4m, with a yield profile of 7.1% NIY, rising to 7.5%. Similarly, Bilton Road IE, Chelmsford, with c.7 years average unexpired, was acquired by a fund at £13.82m, (7.09% NIY). We are aware of another SE portfolio currently being acquired by a fund off-market pushing pricing further. However, the highest prices are still paid in London: Commerce Park, Croydon is likely to achieve sub 6.5% NIY.

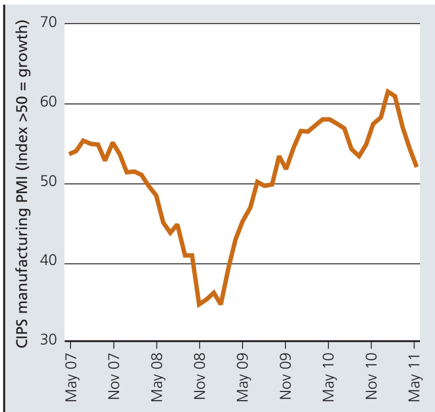
Trends

Although speculative development remains unlikely for a while, there is more active trading of development sites for pre-lets. Design and build packages for occupiers will increase as both the economy and demand improve. Given the imbalance between supply and demand, yields are falling in London and better south east locations, in anticipation of future rental growth.

Source: Cluttons, IPD		Past					Future		
		2010 Q1	2010 Q2	2010 Q3	2010 Q4	2011 Q1	2011 Q4	2012 Q4	2013 Q4
Rental value growth	(% pa)	-4.2	-2.9	-1.9	-1.4	-1.1	-0.6	1.0	2.1
Capital growth	(% pa)	6.5	11.7	10.1	3.5	1.2	-0.9	-0.2	-0.1
Yield	(%)	8.8	8.6	8.5	8.4	8.4	8.5	8.6	8.8
Total return	(% pa)	14.9	20.3	18.2	10.9	8.3	6.3	7.3	7.3

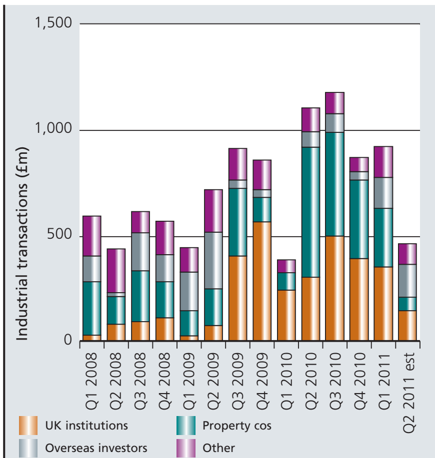
Source: Cluttons		Prime yields 2010 Q3	2010 Q4	2011 Q1	2011 Q2
Distribution	(%)	6.50	6.75	6.25	6.25
SE industrial estate	(%)	7.25	7.00	7.00	6.75
Secondary industrial	(%)	8.50	8.50	8.50	8.00

Manufacturing output implied growth rate slows



Source: CIPS/Markit

Industrial investment falls back



Source: PropertyData

Contacts

John Barrett	Valuations	john.barrett@cluttons.com	020 7647 7218
Sue Foxley	Research	sue.foxley@cluttons.com	020 7647 7023
Richard Moss	Valuations	richard.moss@cluttons.com	020 7647 7226
Ross Owen	Investment	ross.owen@cluttons.com	020 7647 7117

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