



ASSET

THINGS CAN ONLY GET BETTER:

THE UK PROPERTY MARKET

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INTRODUCTION

One of my responsibilities is to advise Colliers CRE's Executive Committee on how I see the market from both

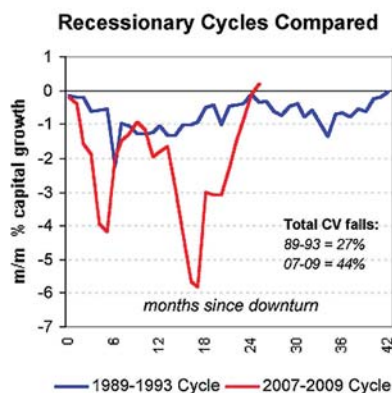
magnitude in terms of the fall in capital values which to date is 45%. Compare this with a total contraction of about 27% in the 90s.

The other noteworthy feature is that the whole cycle has been compressed. This compression and the speed of the downturn are leading some people to say that maybe we will recover from this downturn a bit faster than you would normally expect. A similar argument is also being applied to the general economy too.

The good news is that IPD reported an increase of 0.2% growth in August 2009 and therefore, at least theoretically, we are out of the woods. Critics though are saying that the figures are distorted because they are only based on current market transactions; and at the moment these only include prime transactions with secure income and strong covenants.

I have a theory that valuers have simply run out of steam for the time being and further reductions may not be seen until the end of 2009. The general view is that we are probably going to bump along the bottom for quite a time before a sustained recovery. I am not sure that we will encounter a W, double dip, type recession with a further downturn to come. We are going to have a period of stagnant growth in the short term. It will be interesting to see the year-end valuations and see whether portfolios are marked down significantly.

'Capital growth positive . . .'



- Positive for first time since Jul 07
- Cycle may be compressed
- CVs may represent recovery of the prime market only
- Valuers may have run out of steam
- Year-end valuation will be very interesting

Source: IPD, Collier CRE

an economics and a property point of view. The economy is clearly going through a bumpy period, and I believe that the rate of recovery is likely to be driven in the largest part by the rate at which public spending is reined in. I'm not sure if I can tell you that things can only get better; but I am prepared to say that I do not think they are likely to get worse.

Statistically this graph compares the month-on-month capital value "growth" over the property downturn of 1989/93, with the current downturn of 2007/2009. The latter is of a completely different order of

Here is another bit of good news.

Indirect market showing recovery?



This tracks by red line the FTSE 100 over the last year. The blue line is the FTSE property equivalent. What we seem to see here is that in March both hit the low point and recovery started from that point. The European Public Real Estate Association has done a lot of work on property cycles and recessions and interestingly concluded that a recovery in the indirect equities property market usually means recovery in the direct property market in about 6 months. So here we are 6 months on with 0.2% positive capital growth in August, it is tempting to conclude that we are out of the woods, possibly.

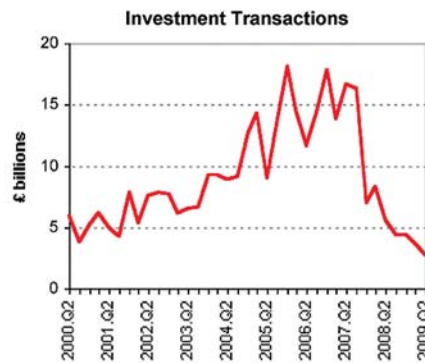
Worryingly the equities market seems to be performing a little bit better than many people anticipated, partly due to the impact of quantitative easing, and the argument is that the property segment of the market is also getting a bit of a free ride, so there is a lot of uncertainty in the message of recovery.

I am a little bit suspicious of most of the forecasts at the moment as most of the econometric models in use have been unable to capture the sheer magnitude of the changes taking place. Most models assume a gradual pace of change in the economy and a stable financial system where lending is normalised. However nothing has been normal for about the past 18 months or so and in my opinion most of the econometric models used by both the Banks and property people are not 100% reliable.

For what it is worth the latest forecast of total returns for all property predicts an upturn generally in 2010 after a negative performance in 2009 with IPF, the industry direct property guide, being more negative than the others at about -12%.

But one thing is clear in that we do see recovery in 2010 and will be back firmly in positive territory by 2011. I do not want to say that we are totally out of

Investment transactions very limited



Source: Property Data, 2009

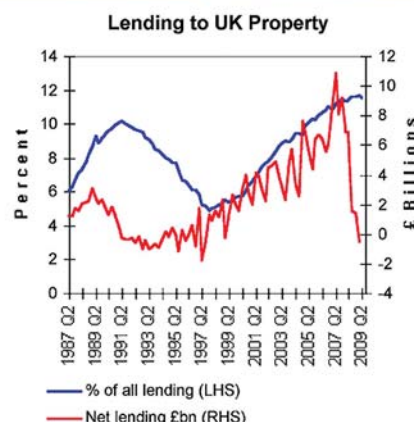
- Lack of product
- Few forced sales
- Auctions quieter
- Lack of finance
- Lending trends suggest further contraction in real estate lending over Q3 09
- Cash transactions continue <£25m
- Liquidity is good at realistic price
- Secure income is sought

the woods, but it would seem that we are moving back to a period of reasonable performance.

Of course working with the investment brokers presents a very different picture. This chart shows the level of investment transactions in the market and currently, in the second quarter of 2009, we are significantly below where we were in 2000.

The big bubble in 2004/2005/2006 was the real 'hey days' of trading. The main reason for the current lack of transactions is lack of product caused partly by the lack of finance from the banks that in turn have been supported to an enormous extent by Government. I believe this could change as we had fairly positive upturn and profitability for the banks in the first half of this year (2009). When the full year results are announced in February/March 2010 we will see balance sheets are a bit

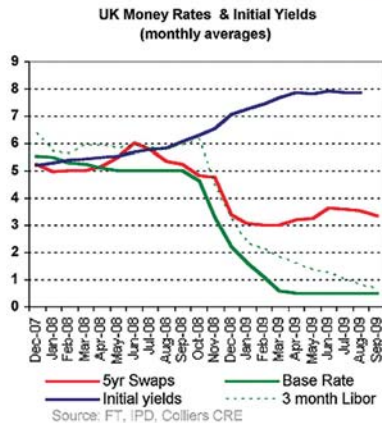
Net lending to property contracting



- Net lending to real estate has contracted for the first time since 1999
- Banks are expected to reduce exposure to real estate from around 11% back to around 6% over the next couple of years

Source: Bank of England

Property should be self-financing



- Financial basis for transactions should be strong
- 400 bps spread between 5 yr swaps and initial property yields
- 3m Libor spread over base at pre-credit crunch levels
- Appetite for bond like property
- Appetite for property with the aim of refinancing when finance conditions improve
- Secure income – bond-like properties

stronger and then the banks are likely to start working through the more troubled assets on the balance sheets and pushing things to market. Nevertheless things are happening and typically the deals being done are those related to long and secure income. For example recently Colliers sold a building in the West End to a cash purchaser for £25 million. In fact there were 30 bids from cash buyers to acquire a building let on long to the Serious Fraud Office, which seems to be a good bet. But current market conditions suggest there have been a few chunkier deals but overall these are fairly limited.

And part of the story is the absence of finance for speculative investors. This chart shows the typical trend of long smooth curves that finally fall off of the table. This is a consistent theme across most current economic indicators. Net lending to property, the red line, contracted in the last quarter for the first time since 1999. The blue line shows the total exposure of banks to real estate. At the moment it is running at about 11% but there is a turn coming and we expect banks will reduce their exposure to real estate, over the next three or four years, down to a more normal level of about 6% to 7%. The message for the property sector is that investment in this sector will be tight for a long time and probably it will need to find a different way to do business. I was talking to a banker recently who said, "The

real issue Walter is not whether the banks are lending, it's whether your clients have some way of accessing the capital markets directly"; an interesting comment.

The fundamentals are still there. Finance on the top line is the initial transaction yield on property that now is just under 8% for all property.

A 5-year swap is an indicator of finance cost and is about 400 points below that, so even if you had a couple of hundred base points for profit margins,

property should theoretically still be self financing, hence the demand for so called bond-like property of this long secure income. The green line is the base rate and dotted one is the Libor rate that everybody has been tracking carefully because the spread between Libor and the base rate is usually an indicator of stress within major bank lending markets and the wholesale money market. Currently the spread is 15 base points and my guess is it will spike at about 150 basis points above base. According to several bankers that I have spoken to this spread is the only thing that you need to track in order to understand the money market.

Well according to this the problems are over whether the money is there and ready to move. I think there are some other more serious problems that we are going to need to work with.

'Secure income sought . . .'



The Bridge, Dartford
£61m @ 8%

- Vendor: Mackay Securities
- Purchaser: German fund
- Let to Sainsbury 18 years unexpired

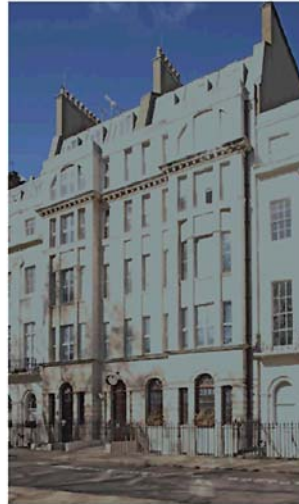


One Old Queen Street, SW1
£17.25m @ 5.75% IY

- Vendor: Mackay Securities
- Purchaser: Private investor
- Fully let to government on 20 year lease (12 year break)

'Secure income sought . . .'

Seller: St Lukes Charitable Trust
Tenant: BMI Healthcare Ltd.
 (D&B rating 5A1)
Lease: 25 year lease with fixed increases linked to RPI with a cap and collar (2% to 5%)



St Luke's Hospital
 (£7.2m at 6.25%)
 (8 bids)

The following are examples of transactions involving the secure income mentioned earlier. One Old Queens Street, sold to a private cash investor with a 20-year lease. A couple of months ago there were so many buildings about this size changing hands in the West End that the Colliers team that specialises in this market described it as something like a sub-£25 million run on West End property.

The Bridge, Dartford was a food distribution warehouse that was purchased by a German company. There have been at least 12 to 15 more deals very similar to this all based on long, secure income streams

This is an example from the Health Care Sector.

There are pretty strong cash flows such as BMI's hospital, but also more generally in the long-term residential care system as a whole. I do not understand why more money is not invested in the Health Care Sector when you can get deals like this.

BMI Healthcare Ltd has a D&B rating of 5A1 and the lease is for 25 years with fixed increases. St. Luke's Hospital is situated in Bloomsbury and there were 8 firm bids.

From the investor point of view the other side of the picture is the risk of voids. This IPD chart

tracks Void Rates over the last 15 years. Void rates in all 3 sectors are increasing.

This chart shows monthly retail sales volume. Sales are highly volatile and are affected by the weather and various other trends. Generally sales have remained positive, which suggests that for the sector as a whole, retailers are getting by.

The red line is retail sales volume and the dotted line is the so-called retail sales deflator, which is an indication of how prices move from month to month.

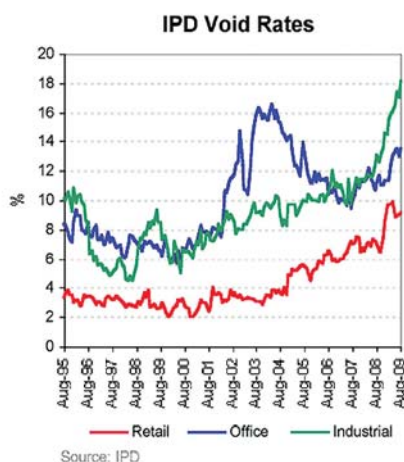
There is close correlation between the two, or at least there appears to be. What the correlation tells us is that whenever prices go down people buy and whenever prices go up people do not buy.

Consequently retailers are doing their best to shift the goods but they are squeezed so much that profitability has been terrible.

This is not the definitive list of retailers in administration there are probably a good few others too but the fact that they have been squeezed so much has made the whole sector difficult.

Rents have collapsed and the

'Property void rates are rising . . .'



- Void rates up significantly in Aug 2009. Industrial up to 18.2%
- Inhibiting investors/lenders
- Security of income stream is paramount



Retail sales: volatile but steady



Source: ONS

- Retail sales remain volatile (food stores strong, clothing and footwear up, household goods remain weak)
- ONS July 0.4% m/m for UK
- BRC: Aug UK like-for-like at -0.1% UK and -5.9% London
- Good weather
- Weak sterling
- Discounting

number of incentive packages to keep people in premises has increased considerably.

The good news is that certainly in the retail sector we believe that administrations have peaked and are on a downwards spiral, there have been fewer over the last couple of months. More generally across the economy we seem to be past the worse.

Recently I spoke to a couple of accountancy firms

by the end of 2010 it will be back in positive territory.

Interestingly if we break down this negative figure for net stock absorption by quality of space you find there is a positive net stock absorption for Grade A space.

This is rental growth to date and forecasts to 2011. The forecast shows negative rental growth bottom-

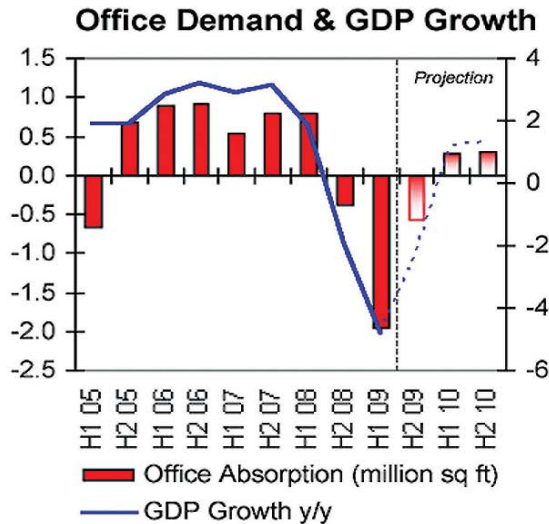
specialising in administrations and asked if this is truly a trend. The answer was no, there are a lot more worse things to come; but I suspect accountancy firms are like property agents, trying to talk up the market so to speak.

This chart is a measure of office occupancy in the City of London. In the first half of 2009 it has gone deeply negative. Then we show a recovery that tracks GDP closely and the forecast is that

Retail administrations have slowed . . .

Administrations			
Adams	Empire Direct	Max Spielman (BC)	Select Retail
Allied Carpets	Envy	MFI	Shoe Studio
Anoushka G	Ethel Austin	Morgan National Schoolwear	Smallbone
Au Naturelle (Ossian)	Faith	Centre	Sofa Workshop
Barratts Shoes	Floors to go	New Heights	SoS Upholstry
Base Menswear	Ghost	Oasis	Stead & Simpson
Blooming Marvellous	Gourmet Foods	Officers Club	The Pier
Card Warehouse	Hardy Amies	Original Shoe Company	The Works
Cardfair	Ilva	Passion for Perfumes	USC
Coast	Internationale (Ossian)	Ponden Mill	Viyella's
Coffee Republic	Jag Communications	Priceless Shoes	Warehouse
Diamond & Pearls	Joy Clothing	Principles	Wedgewood
Dolcis	Karen Millen	Pro Cook	Whittard
Dr & Herbs	Klick (BC)	Qube Footwear	Woolworths
Dr China	Land of Leather	Richleys Stewarts	Zavvi
Elvi	Mark One	Rosebys	

'Office demand remains weak'



Source: Colliers CRE, ONS, CE

- Office demand remains weak with many playing a 'wait and see' game
- Bottom of market may have been reached in the City
- Banks and insurance companies are beginning to hire again
- Legal firms remain steady
- Demand though is not expansionary
- Demand for Grade-A better

ing out in 2009 but still negative in 2010 and in 2011. That is what the econometric model tells us when we run the numbers through it; but I am not so sure. This is strictly a personal point of view but I think things could bounce back more quickly than this.

There are two reasons. One is a deal done last month (August 2009) when a Japanese bank took a letting in the city for just over £40 per square foot. There were a lot of incentives, but the market thinks that leasing rates and incentives are not likely to get any more generous than this. We will only see increases in the Grade A part of the office sector. Secondly the development pipeline for new space in the City has just about been cut off. There is very little new in 2011, although the Shard of Glass is expected to come on line in 2012. By then, hopefully, the economy will be moving forward.

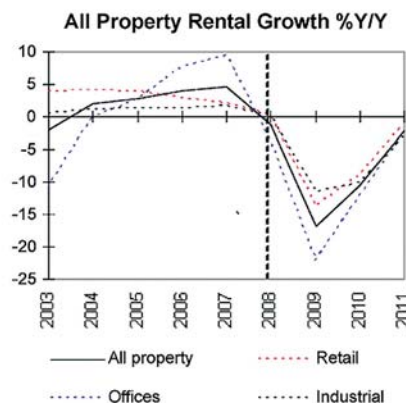
In my opinion the shortage of Grade A space will be the driver of a faster rental recovery in the city, and that could have a knock-on effect on the West End and some other markets.

There are signs too that the residential market may be stabilising. House price growth has returned this year and now mortgage approvals are beginning to pick up.

Let me leave you with one last thought. The public sector net debt is somewhere around 57% at the moment? The debt is, as I understand it, sustainable.

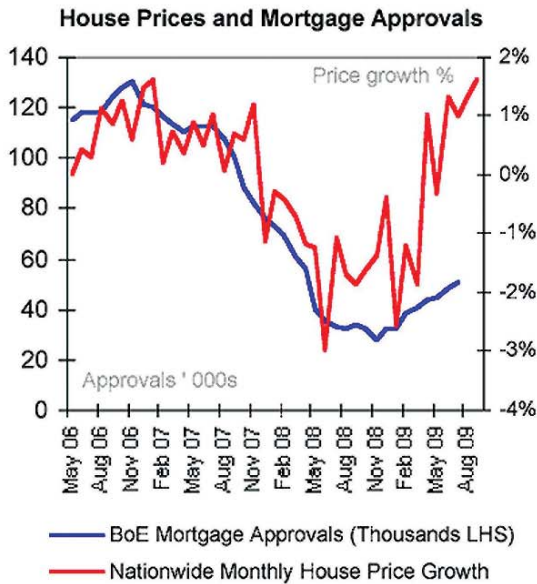
One of the analogies I usually make is if you think that financing of deficit is a problem, then remember that future financing of long-term health care costs

Rental growth: slow recovery



- Rental growth may be bottoming out
- Offices may have over-corrected
- Large incentive packages still on offer
- Incentives may begin to contract
- Retail incentives may begin to disappear in 6 to 12 months

'Residential market is improving'



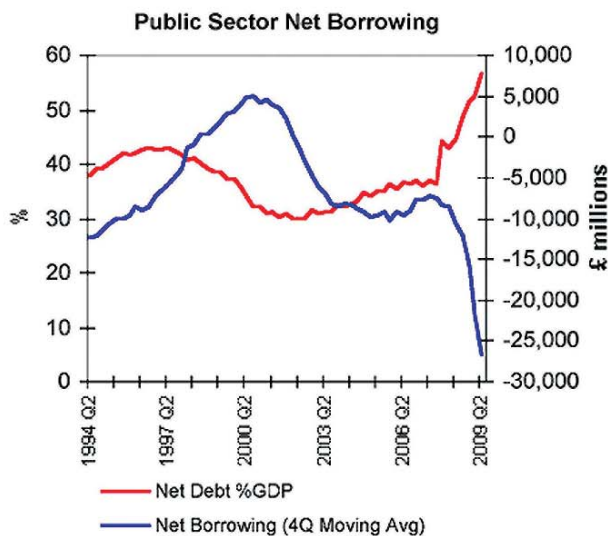
- House prices up for 5 out of the last 6 months (7.5% since February)
- Supply is limited, but demand is improving. Low interest rates help
- House price to earning ratio peaked at 5.84 in 2007 and has fallen to 4.36 in June 2009. Long-term average 4.0
- Mortgage availability is improving but approvals are very slow
- Multi-unit residential investment is dormant
- Auctions have cooled due to lack of product, sales rates remain 70%+

dwarfs the public sector debt by at least a ten-fold. That puts the issue into a little more perspective, but nonetheless the public finance problem must be addressed seriously. The chart illustrates a number of fiscal measures that are likely to be introduced in the

process no matter what government is in power in 2010.

Walter Boettcher
Director Research and Forecasting, Colliers CRE

'Public sector to be squeezed'



- Tax increases likely
- 50%+ income tax to stay
- VAT increase to 20%
- NI increases
- Corporation tax increases
- Other revenue measures
- Cost cutting
- Asset disposals