



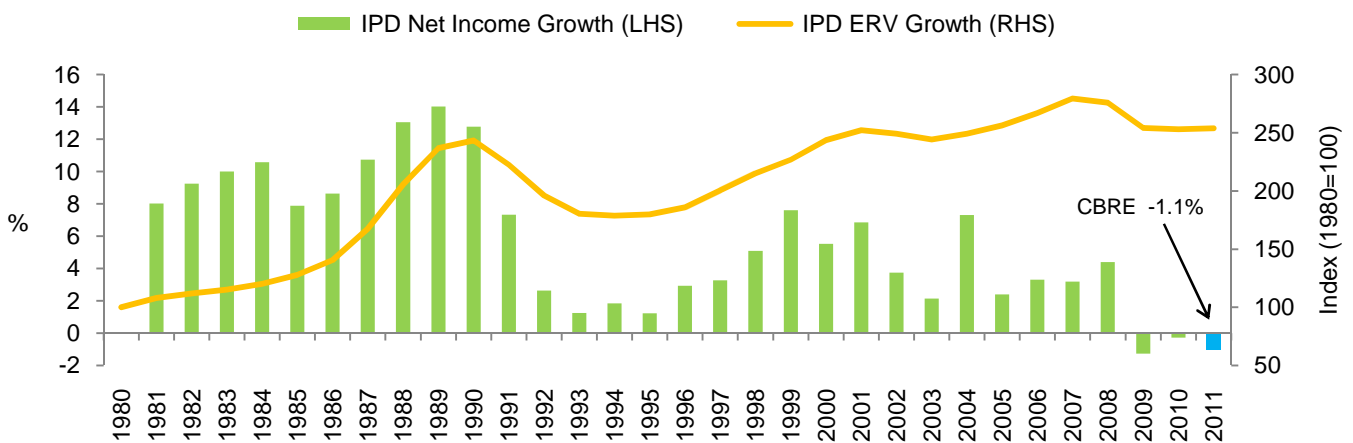
## Property Income - 2011

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### OVERVIEW

With the prospect of renewed economic stresses as we go into 2012, investor focus on income security and covenant strength has intensified once again. Past experience has generally supported the view that property income streams are on average relatively resilient in the face of economic downturn. However, the challenging climate for occupier markets and greater lease flexibility has meant that the stability of property income streams is probably no longer to be considered at worst fixed or otherwise upward only. Analysis of the CBRE Monthly Index over the year to end November reveals an overall decline in gross income or passing rent of 1.1%. As an All Property average this is not a large fall, but it does conceal a degree of variation by both geography and asset type. Income for Central London offices bucked the wider trend, increasing by 7.7%, but a number of other sub-sectors saw income decline by between 3-6%.

### Historic IPD Income Growth



Source: IPD, CBRE

### INCOME CHANGE OVER 2011

Historically, the gross income or passing rent from UK commercial property has been relatively resilient over time. Even through periods of deep recession the protection afforded by lease structures, and in particular the upward only rent review provision, has ensured that income remained stable or rising.

The relative stability of income may have been an illusion to some extent, with past rates of inflation meaning that periods of flat or low growth in nominal income were in effect concealing rather larger real rates of decline.

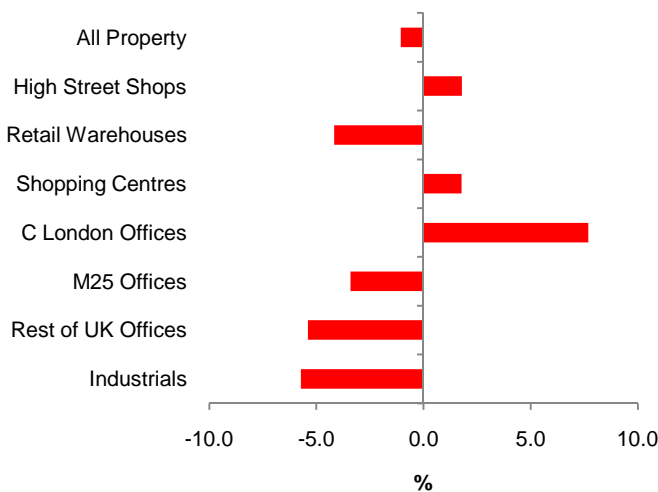
With changed economic conditions, and lower though not negligible rates of inflation, the adjustment now is seeing declining nominal as well as real rents. The rate at which these declines feed through to property income will depend on a number of factors; the pattern and timing of individual lease expiries, the rate of rental growth or decline and the amount of reversion or over-renting. As a result, while it may be tempting to think of property as being close to a fixed income asset in a weak growth environment, this analysis suggests the average case is somewhat worse. Given that a key function of property in multi-asset portfolios is to

provide income, maintaining it and growing it will become an increasing challenge, putting a much greater emphasis on asset management.

**INCOME BY MARKET SUB-SECTOR, 2011**

On the basis of the figures revealed in the CBRE Monthly Index, the pattern of decline across the various property market sectors and sub-sectors is far from uniform. As a consequence, this does imply some scope from a strategic portfolio management perspective for mitigating the full impact of falling income.

**Sub-sector income growth, Year to November**



Source: CBRE Monthly Index

While overall gross income fell by 1.1% over the year to November, there was a very wide dispersion across different parts of the market. Income rose in three of the seven market sub-sectors and fell in the remaining four.

Central London offices were of particular note, seeing passing rents rise by 7.7% over the year

to November. However, It is clear that without the relative strength of income growth in this important market, the decline in overall income at the All Property level would have been more marked. Indeed, by stripping out the upward contribution from Central London offices, All Property gross income would have declined by 2.3% over the year to November rather than the actual -1.1% recorded.

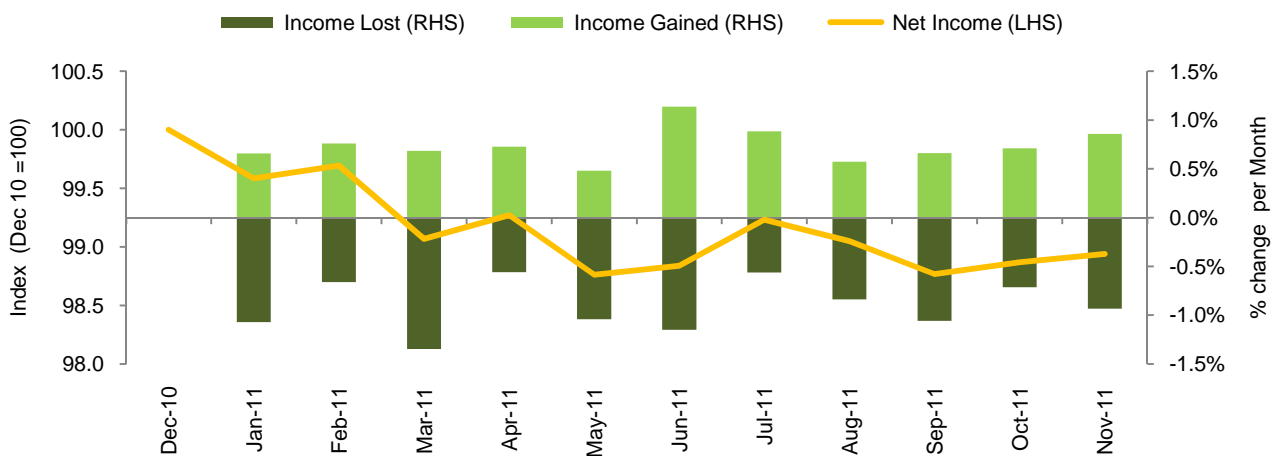
The strong increase in Central London office gross income over the past year is one of the features of the current market cycle which is very different from previous experience. In the past, the highly volatile occupier market cycle in Central London, allied to a substantial degree of over-renting, made it one of the more vulnerable market sub-sectors in terms of income loss during periods of economic weakness.

The other two market sub-sectors to see income growth over the year to November were both in the retail sector. The increase in High Street shop and shopping centre gross income is perhaps slightly unexpected given the highly publicised difficulties the retail sector currently faces. However, in both cases the better quality of assets represented in the index probably helps to explain the buoyancy of gross income to a considerable extent. With a greater bias towards prime assets, and particularly for shopping centres, income has held up relatively well.

The declines seen elsewhere, in the office markets outside the capital and in industrials, are less of a surprise, although the magnitude of the falls, between 3-6%, is quite large by historic standards.

Although it is difficult to be definitive on the basis of these figures, declining property income is likely to become a growing issue, given the lack of rental growth currently being projected by most forecasters. As such, it will continue to pose a challenge for investors and more especially for lenders.

**CBRE Monthly Index, Gross Income 2011 (Passing Rent)**



Source: CBRE Monthly Index

	Over-rented Income (% of Income)		Reversion (% ERV of Income)	
	Dec 2010	Nov 2011	Dec 2010	Nov 2011
Standard Shops	5.6	7.5	9.2	5.7
Retail Warehouses	2.6	3.0	3.2	8.4
Shopping Centres	0.3	0.8	22.6	18.9
Central London Offices	8.5	5.7	17.1	15.3
Outer London / M25 Offices	11.0	10.6	1.0	3.5
Rest of UK Offices	3.5	2.9	18.5	23.5
Industrials	5.3	4.2	4.7	10.8
All Property	4.9	4.7	8.6	9.1

### INCIDENCE OF OVER-RENTING

One of the key risks to gross property income going ahead is the loss of over-rented income on lease expiries or through tenant default.

At the broad All Property level, the unsecured portion of over-rented income in the CBRE Monthly Index (the part of the contractual rent that exceeds the open market rent) was 4.7% of total income at the end of November, having declined slightly from 4.9% at the beginning of the year.

These overall rates of over-renting are not particularly excessive compared to the heights that were reached during previous market cycles. However, the risk in over-rented tenancies depends very much on the security of the income and the duration to the next lease expiry. A level of over-renting may not necessarily have too serious implications for a portfolio if the income is secure and the length of unexpired lease term is sufficiently long to allow for some level of recovery in market rental levels.

While the pattern is mixed across different parts of the market, the slight reduction in the rates of over-renting in the majority of market sub-sectors over the year to November has generally happened for the wrong reason. The reduction in over-renting has occurred not because rental values have risen, but because passing rent or gross income has fallen.

The exception to this has been Central London offices where both market rental levels and gross income rose over the year. With the latter rising at a faster rate than the former, over-renting has declined. Central London offices are the exception, however, and the growth seen in rental values in the capital has not been the experience elsewhere.

The more general lack of rental growth, if sustained for a longer period, will feed the problem of declining income. On average the lease expiries occurring during 2012 would typically have had rent reviews 5 years previously in 2007, when rental levels were at their peak. Market rental values on average are very likely to be lower in all sub-sectors than the current contracted rent.

Given that background, the amount of historic rental reversion providing any upside to income must by now be pretty much exhausted. 2011 will mark the fourth year in which IPD market rental values have fallen or remained flat. As a result the reversion that will exist in portfolios will derive increasingly from the unwinding of rent-free periods, the letting of voids and from other asset management initiatives.

### REVERSION

Despite the decline in income and rental values over the past three years, there remains some overall reversion in the CBRE Monthly Index. The reversionary potential (the proportion by which the open market rent exceeds the current contracted rent) has increased over the year to date from 8.6% of income at the start of 2011 to 9.1%. As with the proportion of over-rented income, however, the slight rise in reversionary potential is more attributable to the decline in gross income than to any increase in rental values, which were broadly unchanged over the past year.

The other point worth making in reference to the possible reversion implied by the above figures is that in some sub-sectors such as Rest of UK offices, much of the 'potential' is in voids or vacant space. Realising this upside to portfolio income growth will not be easy given the challenging economic background.

## CONCLUSION

The pattern of declining gross property income which has been observed over the past three years points to an underlying deterioration in the robustness of property income streams in the face of a fundamental shock to occupier markets. In the full history of the IPD portfolio back to 1981, net property income has always risen, until 2009.

Part of the explanation for the current decline may be attributed to the generally lower level of inflation in the economy now compared to past experience. Real rates of gross income growth have declined previously, most notably in the early 1990s, but nominal income has not.

Declining nominal property income does create specific problems for investors and lenders, however, which a process of real declines masked by stable or growing nominal income does not. Debt and loan repayments are based in nominal terms, and falling property income suggests greater loan impairment or default, creating an ongoing headache for lenders and for investors holding securities supported by declining income streams.

Falling nominal property income is therefore a problem.

While the modest 1.1% decline recorded over the past year to November seems on the face of it relatively insignificant, the pattern revealed here is fairly skewed and points to a marked deterioration in some market sub-sectors.

Adding to the concerns over specific sub-sectors, asset quality layers on a further dimension to the declining income story. The suspicion must be that the rates of income loss on secondary assets is higher than on prime. That being the case, the rates of decline in the gross income of secondary property would look pretty unappealing to most investors and should be reflected in pricing.

The already wide yield gap between prime and secondary property possibly points to some recognition of this on the part of investors. The issues highlighted here underscore investors' flight to prime and the aversion to riskier income streams. At least with prime assets there remains a much higher probability that income can be maintained or grown.

## DEFINITIONS & METHODOLOGY

The definition of income growth used in this viewpoint conforms with IPD's Net Income Growth. This is essentially passing rent less ground or headrents payable. As such, it probably aligns more closely with what most market participants would regard as gross rental income, as it does not allow for the further deductions that are typically taken off to produce net property income. As such, the figures shown here outlining the decline in income are likely to understate the actual impact on net property income, which has probably been more severely impacted owing to the expenditure required to maintain income streams.

From a methodological perspective, the splicing of IPD's net property growth series with CBRE's gross passing rent is broadly acceptable in that they are measuring the same thing. Some inconsistencies could arise from differences in the quality of the underlying stock, and particularly from variations in the prime and secondary mix in some of the market sub-sectors, but as the IPD Annual Index and CBRE Monthly Index have almost identical sub-sector compositions in terms of their relative weights, at the All Property level the two are broadly comparable.

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