



## THE CASE FOR UK PROPERTY

Peter Damesick, Head of Research, UK

### INTRODUCTION

The reduction in commercial real estate prices in the credit crunch began earlier and has gone further in the UK than in other major markets. While recession will weigh on occupier demand and rents in 2009, the radical re-pricing of UK property assets looks likely to offer an attractive value proposition to investors in the coming year. In a debt-constrained market, equity-rich investors will have the field.

### IT'S WORSE THIS TIME

The current downturn in the UK commercial property market has turned out to be both faster and deeper than the last major decline in values in the early 1990s. By January 2009 UK investment property values on the IPD Monthly Index were down by 37.6% from their peak in mid-2007. In the early 1990s the IPD Monthly Index of capital growth took twice as long to record a peak-to-trough fall of only 27%. The larger IPD Annual Index recorded a capital value decline of 30% over the three years 1990-92

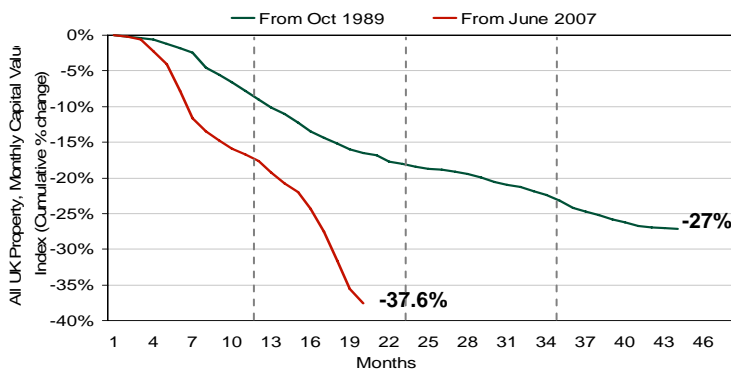
The fall in values accelerated in the final quarter of last year as the volume of the investment market activity remained subdued. From a peak of £19.6 billion in the fourth quarter of 2006, investment purchases had slipped to under £5.0 billion by the final quarter of 2008. The value of acquisitions in 2008 as a whole was 56% down on 2007.

UK market trends are part of a global contraction in commercial real estate values and investment activity, which has seen similar downturns in transaction volumes in a number of other countries. However, the re-pricing in the UK began earlier and has proceeded much further than in other major property markets, pushing the average prime yield on UK property, as measured by CB Richard Ellis, to its highest level in 15 years.

The severity of the downturn since mid-2007 reflects the extent of the preceding inflation of values, which was almost entirely a product of yield compression, with hardly any contribution from rents to capital growth. Likewise, the fall in values over the last 18 months has been driven by repricing in the capital markets triggered by the credit crunch and heightened risk aversion.

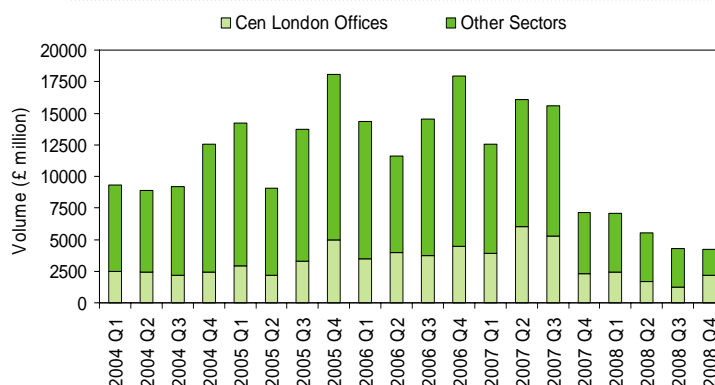
Rents have so far played little part in the market correction, but with the UK economy now in full-blown recession, occupier market conditions and rents are set to have a bigger impact on values in 2009.

### UK Property: Capital Decline is Faster This Time



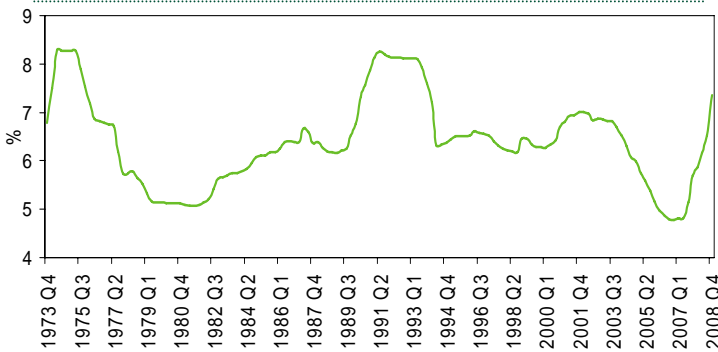
Source: IPD Monthly Index (December 2008)

### Investment Deal Volumes Down Sharply in 2008



Source: CB Richard Ellis, Property Data

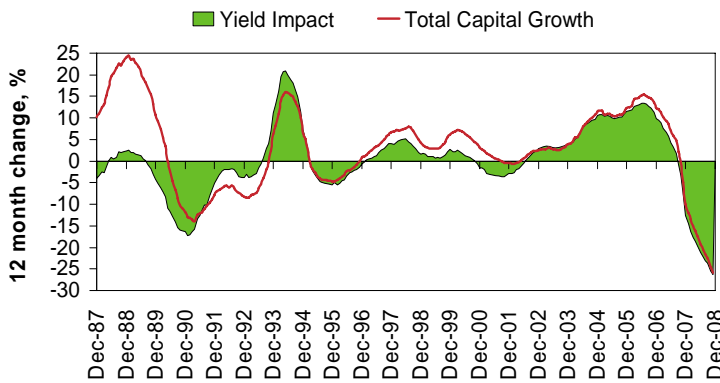
**UK Property: Average Prime Yield**



Source: CB Richard Ellis Prime Rent and Yield Monitor

**All Property: Capital Growth & Yield Impact**

Annual capital growth and change due to yield movements



Source: IPD Monthly Index

**RECESSION BITES**

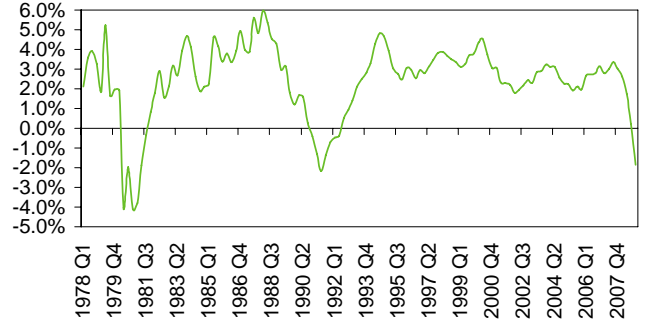
Growth in the UK economy stalled in the second quarter of 2008 as consumer spending began to contract. GDP fell over the second half of 2008 at an accelerating pace, with a sharp weakening in economic activity after the global financial system was traumatised by its 'near death' experience following the collapse of Lehman Brothers last September. The strong downward momentum comes from a conjunction of adverse factors:

- **Credit** – the crisis in the banking sector has sharply curtailed the flow of credit, putting a chokehold on the economy.
- **Confidence** – has plummeted among businesses and consumers, hitting spending and investment.
- **Contagion** – an ever-widening range of sectors and economies have been sucked into the downturn. The world is now seeing a synchronised global downturn involving both developed economies and emerging markets.

In the UK, output, spending and employment will contract further in 2009 as the economy endures a recession as bad if not worse than that of the early 1980s, combined with a more severe housing market downturn than in the early 1990s. The greatest fall in retail spending in the last 40 years was actually in 1975, when non-food sales volumes fell by nearly 8%, and took three years to recover.

**UK GDP Growth**

Quarterly year-on-year change, 1978 –2008



Source: EcoWin

The de-leveraging process and the restricted flow of credit are potent depressants, but we should not lose sight of some potentially powerful countervailing forces to the recessionary trends that are now coming into place. Governments in the UK and in other countries, especially the USA, are responding actively:

- Interest rates have been cut to historic lows, although the transmission mechanism to get the benefits of cheaper money into the real economy is not working properly for the moment. But mortgage rates are down, even if new loans are harder to get.
- Keynes is back - the use of fiscal policy to bolster demand is once more in vogue. The UK has a £20 billion package for 2009, while the US is set to receive a massive fiscal stimulus from President Obama's huge programme of spending and tax cuts.
- Monetary authorities are now ready to use other measures to improve liquidity – the so-called 'quantitative easing' – essentially buying debt in order to lower all interest rates and boost the money supply. The US has led the way in using such measures, with tentative signs that they are starting to loosen the credit squeeze in some parts of the market.

The dramatic fall in oil prices from last year's peak will boost disposable incomes in 2009 – to the tune of over \$300 billion in the US according to ING. In the UK, the typical cost of a tankful of petrol is down by 25% and the AA calculates that the average two-car household is paying £68 less per month on fuel.

The UK will also benefit from the sharp depreciation of sterling over recent months. Potentially this could also be a source of inflation through higher import costs, but recession will curb the scope for price rises. Sterling depreciation played a key role in the UK's recovery from the early 1990s recession, although the positive effect took time to work through.

The UK housing market is almost at a standstill in terms of mortgage approvals and transaction volumes. At least in this respect, if not in terms of prices, the market may already have seen the worst of the downturn. Buyer enquiries are picking up as affordability improves and 2009 should see some gradual improvement in house purchases from currently very depressed levels.

A combination of ultra-low interest rates, fiscal expansion and a highly competitive exchange rate would normally be a recipe for rapid, potentially inflationary, growth. These are far from 'normal circumstances' of course and the biggest single need remains a substantial easing in the flow of credit which, for the present, the banking system will not deliver adequately of its own accord. The UK government is therefore taking further action through extended loan guarantees, further bank recapitalisation and an insurance scheme to neutralise toxic loans on bank balance sheets. Creation of a 'bad bank' to take over toxic loans is another option. The Bank of England is to buy corporate bonds as a further monetary stimulus and other 'unconventional' measures may follow.

It will take time for credit markets to unblock and for monetary and fiscal stimuli to ameliorate the contractionary forces. The US has seen the most forceful policy response among leading economies and assuming President Obama's package achieves swift implementation, the American economy could be the earliest to show improvement. The UK is likely to lag in the turnaround. Meanwhile, in 2009, commercial property will be in the front line of impact from highly stressed lending market conditions. Banks will be seeking to reduce their loan exposure to property, while occupational markets will see tenant demand hit by the full force of recession.

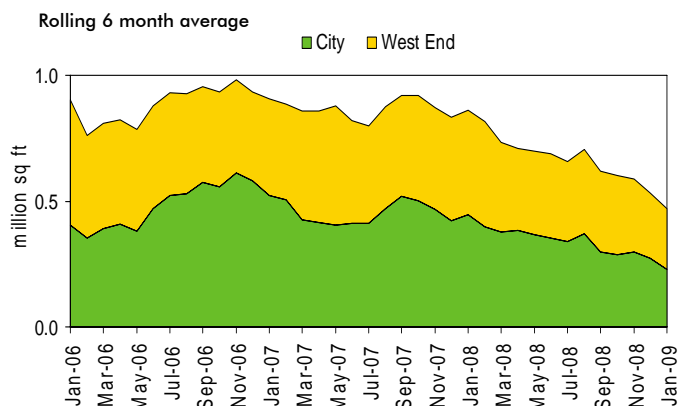
## OCCUPIER MARKET PROSPECTS IN 2009

Rents will be under downward pressure in virtually all sectors of the office, retail and industrial markets through 2009 and 2010 as tenant demand sags in the recession. The most pronounced cyclical decline will be seen in Central London offices, with some parts of the retail market probably next in line to record appreciable falls in rental levels.

### Central London rides the cycle again

Central London offices have shown the greatest impact so far from reduced occupational demand. The City market was an early casualty of the financial turmoil, but as the crisis spread from finance to the rest of the economy the West End market has also weakened sharply. Total Central London office take-up in 2008 was 11.7 million sq ft, 18% down on 2007. However, no less than 1.9 million sq ft of last year's take-up was accounted for by the record pre-let to JP Morgan at Canary Wharf. Elsewhere in Central London, in the City and West End, take-up in 2008 fell by about 26% on the previous year – interestingly, this was almost exactly in line with the reduction in activity recorded last year in the Manhattan leasing market.

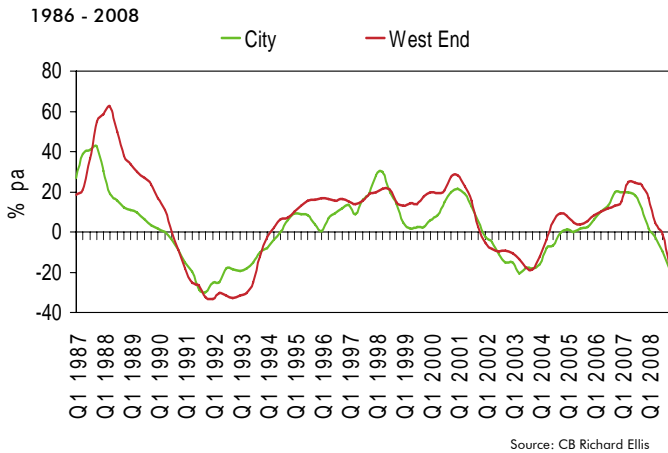
### City and West End Monthly Office Take-up



Total office availability in Central London rose by 33% during 2008 to reach 17.2 million sq ft. In the West End availability doubled, from a relatively low level, while in the City new developments pushed total space on the market to 8.1 million sq ft by the end of 2008, an availability rate of 11.7%.

Prime office rents fell across Central London in the past twelve months, with City top rents down by almost 18% and a doubling of rent-free periods. Prime West End rents slipped sharply in the final quarter of the year taking a tumble of 13%.

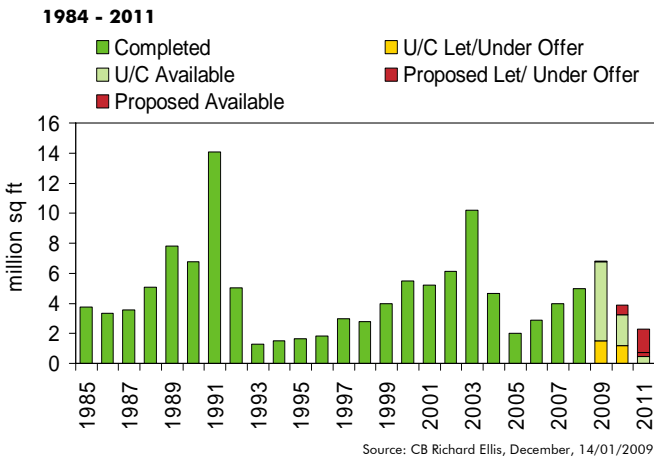
**Central London Prime Rent Index Annual Growth**



The outlook for Central London in 2009 is for more of the same, with financial and business services continuing to shed jobs and office demand remaining weak. One ray of light in the market is that the supply situation is not as adverse as in the early 1990s in terms of the amount of new development. Completions of new schemes in Central London should have peaked in 2008, but timing on several developments has slipped so that the peak will now occur in 2009, at 6.8 million sq ft; this is half the peak of 14 million sq ft reached in 1991.

Development completions will decline sharply over 2010-12, notably in the City where two-thirds of the available space still under construction in Central London is concentrated.

**Central London Office Developments**



The Central London office market is displaying its characteristic cyclical volatility. If the market runs true to form, a sharp rental downswing and dwindling new supply will pave the way for medium-term rental recovery. Office markets elsewhere are typically less volatile and most are not burdened with an overhang of new supply. The recession, however, will weaken office demand in general and rental levels will soften as a result. The Thames Valley and M25 markets suffered weakening trends in the past year, with total take-up in 2008 down by no less than 36% on 2007 and rents flat-lining.

**Retail markets face weaker demand...**

The retail sector looks increasingly vulnerable to rental decline in light of the rapidly deteriorating fortunes of a significant swathe of retailers, following those which have already ceased trading. Shop vacancies will rise over the coming months as retailer casualties mount.

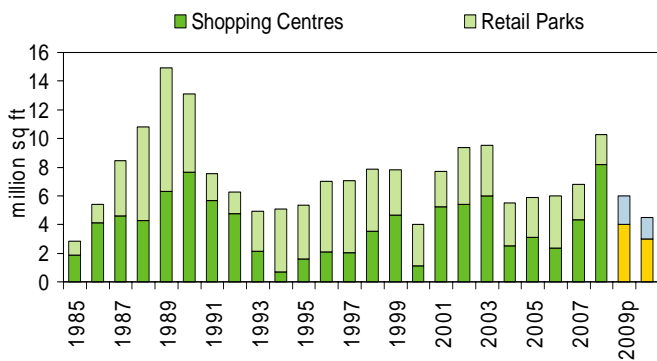
There are significant variations in how different retail markets are faring in the downturn so far. Bulky goods retail warehousing has become a clear weak spot in view of tenant exposure to housing market activity. In contrast, London's West End retail market has so far shown a fair degree of resilience, reflected in superior sales growth relative to the national picture, sustained demand from international retailers, firm rents in prime pitches and the least yield expansion of any market segment.

Elsewhere in the retail sector, the pattern of varying fortunes between trading locations is likely to be one of the "best versus the rest". Dominant centres and destination locations are likely to prove most resilient, but rents are going to come under some pressure in most parts of the market.

**... and a medium term supply squeeze**

The threat to retail rents comes from the demand side rather than an excess of new shopping space. In this respect, current market conditions are more favourable than in the early 1990s. The amount of new space in shopping centre openings saw a peak in 2008, largely due to a handful of very large schemes. Shopping centre space under construction has now fallen sharply, with active schemes in the pipeline totalling barely 8 million sq ft (around 0.6% of total shopping space nationally). With many schemes that have not yet started now being put on indefinite hold, annual shopping centre completions are set to drop sharply over the next 2-3 years. The pipeline of retail warehouse parks has also continued to shrink and park openings have been on a downward trend since 2002. As of September last year there was less than 2 million sq ft of retail park floorspace under construction, down by 32% on a year earlier.

## Shopping Centre and Retail Park Completions



Source: CB Richard Ellis

Contrary to the impression given by some recent commentary associated with the opening of new schemes, the UK is not being blanketed with new shopping space. The development pipeline is dwindling and with more schemes seeing completion dates rescheduled into the indefinite future, the market could face an extended period of low levels of shopping centre openings. The complexity of town centre development schemes typically means that, once plans are interrupted, it can take several years for development activity to recover. Lack of new supply beyond the end of the decade could leave retailers facing a shortage of modern shopping space and renewed rental pressure.

### THE INVESTMENT MARKET IN 2009

Property investment values in the coming year will be adversely affected by the contraction of bank lending to the sector and downward pressure on rents. The market could nevertheless begin to see more liquidity in terms of transaction volumes as the numbers of motivated sellers and active buyers increase.

### Still a debt-constrained market

Despite interest rates at an all-time low, the scarcity of debt for property investment will persist. Banks are repairing their balance sheets and capital ratios, while coming under pressure to maintain lending to business, especially the small and medium-sized enterprise sector. Commercial real estate will not be a preferred area of lending; banks are more likely to try to reduce their property loan books. Refinancing of existing property debt will become difficult for some borrowers.

Problems with property loans are set to grow. Falling property values will have put significant numbers of borrowers in breach of loan to value covenants. Banks seem so far to have tolerated such breaches as long as adequate interest cover remained. With recession raising the risks of tenant default, interest cover will face greater erosion. The extent to which banks take an orderly approach to property loan management in this environment will be a critical market influence in the next 12-18 months.

### More sellers... more buyers

Even with banks taking an orderly approach, contraction of the lending base for property investment will bring more assets to the market, although the speed at which this will happen remains uncertain at present. This will create more buying opportunities in the coming year which are likely to bring more investors who have been waiting for the right time and the right price to arrive to come into the market.

Likely, buyers range from the so-called 'opportunity funds' through to institutional investors and sovereign wealth funds of diverse international origin. There is continuing strong interest in international diversification in property portfolios, evidenced by North American institutions, German open-ended and institutional funds and sovereign wealth funds. In current circumstances this will favour the UK in light of the fall in sterling and extent of re-pricing that has already occurred compared with other markets. According to INREV's January 2009 Investment Intentions Survey, the UK is by some margin now the most favoured European property market among investors. The UK market, having been the first and fastest to respond to the financial crisis, is now therefore seen as likely to be the first to bottom out.

Investor demand will be selective with good quality, well-let stock with longish income streams looking to be most attractive at present. Investor appetite for risk remains limited, so that lesser quality assets with shorter income streams will find it harder to attract buyers without some further price adjustment.

Prime property yields are therefore likely to level out ahead of average yields in the coming months. Our latest forecast shows the IPD portfolio equivalent yield topping 9% in the next twelve months. This may ultimately prove to be an undershoot in pricing.

Property market forecasting, as with economic predictions generally, has recently been even more unreliable than usual, to say the least. It is impossible to say precisely when or where property values will find their floor. It may even be difficult to know exactly when the floor has been reached and it may not arrive simultaneously in all parts of the market. Nonetheless the coming months should be a time when investors should be reasonably confident they can at least buy close to the bottom.

**THE CASE FOR PROPERTY**

How do property pricing and prospects look in comparative terms against other assets in the current climate? How strong a claim on asset allocators' attention should the sector have in 2009?

Looking at other assets, opinions on equities appear fairly divided at present, but corporate credit seems more broadly favoured in light of the historically large spreads over gilts on offer which currently imply default rates several times those ever recorded in the past. Government bond yields on the other hand have dropped to levels that may prove difficult to sustain as public borrowing demands rise.

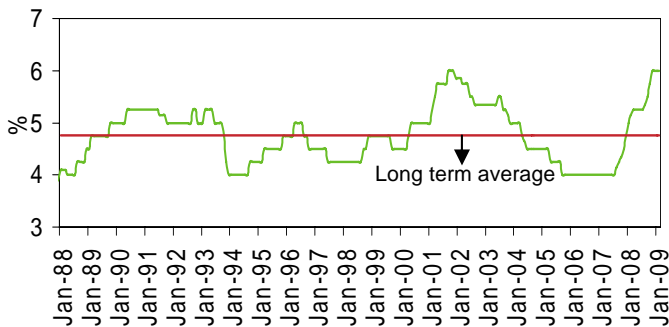
**Relative pricing**

The average equivalent yield on property as recorded by IPD is now around 450 basis points above the yield on ten-year gilts. This is a record positive yield gap and on conventional measures of relative pricing would probably be regarded as a compelling value proposition.

Against historic pricing, prevailing yields are also starting to look favourable in some sectors of the market. Prime High Street shop yields at 6.0% are well above their 20-year average of 4.75%. Good quality bulky goods retail parks can be bought at 8.5%-9% yields. Prime yields on City offices, at 6.75%-7.00%, are close to the top of the band they have moved in for the past 20 years.

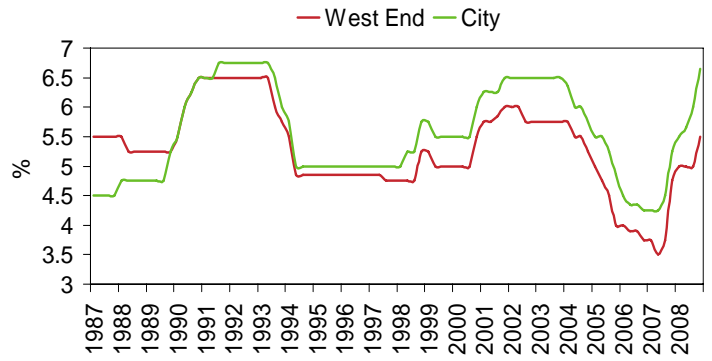
London also looks attractive against other major European cities. On the basis of prime rents and yields, capital values per square metre of prime City of London offices have dropped well below Paris offices over the past eighteen months and are now not much higher than Milan or Frankfurt.

**Prime Yields: Standard Shops**



Source: CB Richard Ellis

**Central London Prime Yields (%)**

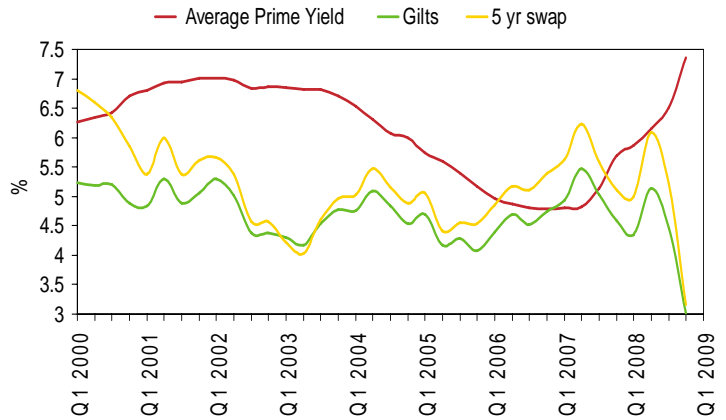


Source: CB Richard Ellis

Of course the attractiveness of current property yields depends on perceptions of the risk of tenant failures and rental value decline. Arguably these risks are increasingly priced in as property yields approach levels where, even with some realistic allowance for tenant fallout in a diversified portfolio, the income will provide a substantial real return whereas yields from cash or government bonds are unappealingly low. Property does not therefore have to base its case on capital appreciation.

**Property: Comparative Pricing**

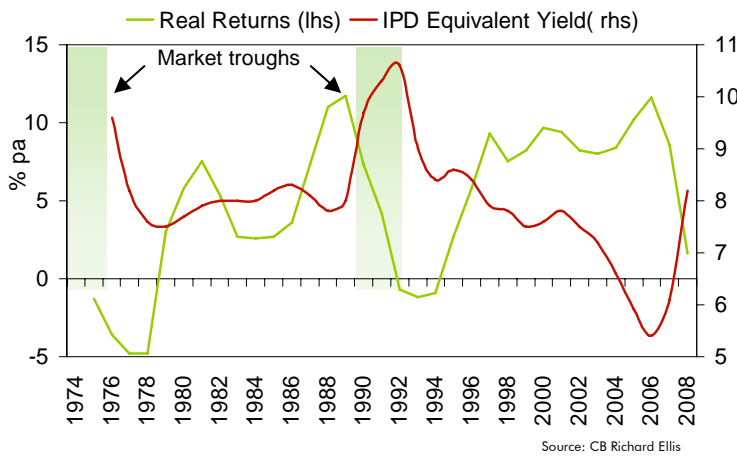
A buy signal for property?



Source: CB Richard Ellis Rent & Yield Monitor, EcoWin

While prospective income returns for property must look attractive against current interest rates and gilt yields, on a medium term view there is also the potential for total returns to get a kick from tightening yields at the bottom of the rental growth cycle. History shows that property, coming off high initial yields, has delivered attractive returns following previous market downturns. The IPD Long Term Index shows that investors who held or bought in 1975-76 were rewarded with 5 year annualised real returns adjusted for inflation of around 6-7.5% by 1980-81. Starting from the market trough in 1992 property delivered annualised real returns of 9.3% over the following five years.

## UK Property: Rolling 5 Year Annualised Returns



### The strategic case

The tactical case for property in 2009 rests on pricing and timing. But what about the strategic case for property in mixed asset portfolios – is this still intact after the recent upheaval in investment markets? The traditional strategic case for real estate had several components – comparative performance, relative volatility and risk diversification.

Looking first at performance, what is striking about recent figures on comparative long term returns, including the current downturn, is the question mark they seem to raise over equities. Over ten years to December 2008, UK equities produced annualised nominal returns of only 1.2%, as many pension fund trustees have great cause to regret. Real estate returned 7.5% pa over the past 10 years and has outperformed equities over 1, 3, 5, 10 and 15 years to 2008. Over 10 and 15 years property also produced higher returns than government bonds.

### Total Returns, % annualised to end 2008

Years	Property	Equities	Gilts
1	-22.1	-29.9	15.0
3	-3.9	-4.8	6.9
5	4.6	3.5	7.0
10	7.5	1.2	5.7
15	8.5	5.2	6.9
20	7.3	8.3	8.9
25	9.1	10.4	9.3
30	9.9	12.5	10.6

Property is a far less volatile asset than equities. The standard deviation in annual returns back to 1971 is only 11.7% for property compared with 30.6% for equities. Recent trends have also highlighted the capacity for extreme volatility in stock markets over very short periods, with sharp swings over weeks or even days. Real estate values show far less dramatic short term movements.

One reason for property's lower volatility is that a higher proportion of its returns come from income rather than capital growth – income produces about two-thirds of property returns over the long term. At the level of individual assets, property also offers more downside protection than equities. Tenant failure does not completely wipe out property value whereas shareholders can suffer a total loss from a failed company. Likewise, individual properties do not normally record short term collapses in value to the same extent as can occur with individual share prices, and as has happened recently with a range of major companies losing 80% or 90% of their stock market value in a short space of time.

Property is also a good risk diversifier within a mixed asset portfolio. Over the long term the correlation in returns with gilts is virtually zero. Property is significantly less correlated with equities than are bonds.

In sum, the traditional reasons for investing in property alongside other asset classes still appear sound. If anything, the abysmal and extremely volatile performance of equities over the past decade would seem to strengthen the case for real estate as a weakly correlated asset offering more stable long terms returns based on income. The fact that over the next 12 months investors will have the opportunity to acquire good quality property assets offering the highest real income returns for many years is a bonus from current market conditions.

### Correlation in Returns, 1971-2008

	Equities	Gilts
Property	0.29	0.02
Equities		0.59

### Risk (Standard Deviation, %), 1971-2008

Property	Equities	Gilts
11.7	30.6	13.9

Source: IPD

**For more information regarding the ViewPoint, please contact:**

Peter Damesick  
Executive Director,  
UK Research  
CB Richard Ellis  
St Martin's Court,  
10 Paternoster Row  
London EC4M 7HP  
**t:** +44 20 7182 3163  
**e:** peter.damesick@cbre.com

---

**Disclaimer 2008 CB Richard Ellis**

Information herein has been obtained from sources believed to be reliable. While we do not doubt its accuracy, we have not verified it and make no guarantee, warranty or representation about it. It is your responsibility to independently confirm its accuracy and completeness. Any projections, opinions, assumptions or estimates used are for example only and do not represent the current or future performance of the market. This information is designed exclusively for use by CB Richard Ellis clients, and cannot be reproduced without prior written permission of CB Richard Ellis.

© Copyright 2008 CB Richard Ellis