RESEARCH

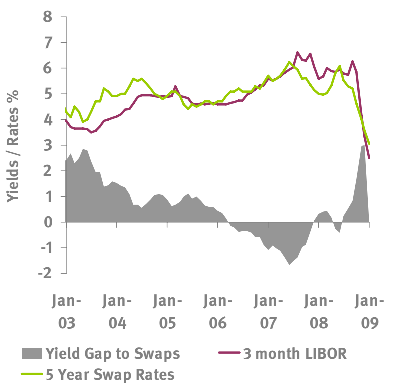
JANUARY 2009
MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Prior to 8 January's additional rate cut, the gap between 3 month LIBOR and the base rate had halved since the last rate decision. Although the spread is still wide in historic terms, it is an indication of banks' increasing willingness to lend to each other.
- 5 year swap rates have also fallen dramatically in the last few months, to 3.21% at the end of last year and further still, following the latest rate cut, to 3.06% as at 8 January.
- With the further 50 bp cut taking the base rate to 1.5%, it would seem inevitable that LIBOR and swaps will fall further. However, until lending on commercial property increases it remains difficult to see how rate changes will impact upon our market, with issues such as LTV and covenant breaches of far greater concern to the banks.

Economic backdrop

- There is little comfort to be taken from the current raft of available figures, with a shrinking economy, rising unemployment and rapidly falling house prices.
- CPI continued its downward trend in November, falling from September's peak of 5.2% to 4.1%. With the economy in recession, prices will continue to fall throughout 2009 making deflation a distinct possibility.
- Official retail sales figures are still only available to November, but nonetheless showed total sales volumes falling to growth of 1.4%. BRC figures for December indicated 2008 was the worst year on its records, with like-for-like annual sales declining by -3.3%.
- The value of Sterling plummeted to record lows against the US Dollar and the Euro during Q4 2008, following poor economic data and prospects of further rate cuts. Parity between the Pound and Euro remains a possibility in 2009.

Key economic indicators

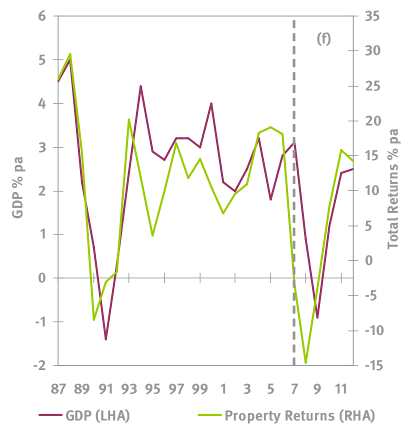
	%	Trend
CPI *	4.1	↓
Retail sales *	1.4	↓
Unemployment *	6.0	↑
Base Rates	1.5	↓
£ : $	1.52	↓
£ : €	1.11	↓
House Prices: Halifax ^	-16.2	↓
House Prices: Nationwide^	-15.9	↓

Source: NS, FT, Halifax, Nationwide, BoE. All figures as at 8 Jan, except * end Nov, ^ end Dec.

Property & the economy

- Commercial property is, of course, intrinsically linked to what is happening in the wider economy. The graph below demonstrates that commercial property returns not only perform fairly closely in line with economic growth, but in fact a down or upturn in property performance often pre-empts a swing in the economy.

GDP v/s Property Returns



Source: Knight Frank Research, NS, HM Treasury, IPD

- The good news to be taken from this is that, with commercial property having already been mired in a downturn for 18 months, 2008 should prove to have been the poorest year in terms of returns. The end is not yet in sight in terms of falling prices and the recession will now have greater impact on the occupational markets. Thus total returns will still be negative this year, but it won't be the level of decline seen in 2008. The worst is now behind us.

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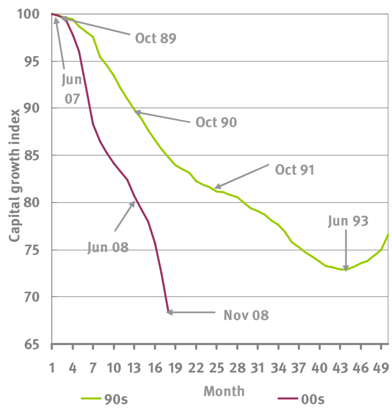
Capital values

- Since the peak of the market in the summer of 2007 we have seen a staggering fall in capital values. By November, IPD showed values had fallen by nearly 32% and a significant further drop is anticipated when December's figures are made available.
- To put this into context, in the 1990s downturn between the peak in October 1989 and the trough of June 1993, values fell by 27%. In other words it took 43 months for the market to reach the bottom. This time we've already exceeded that level of decline and we have done so in only 18 months.
- A further warning note is this analysis' basis in the IPD index, which is the best benchmarking tool available. Nonetheless, many active in the market would argue that even this underestimates the fall in prices.
- However you look at it, we are currently experiencing a much sharper correction than that of the 90s and unfortunately there is undoubtedly further to go – but the duration of this downturn is likely to be far less protracted than the 3 ½ years of decline we went through last time around.

Capital values - 1990s v/s today



Source: Knight Frank Research, IPD

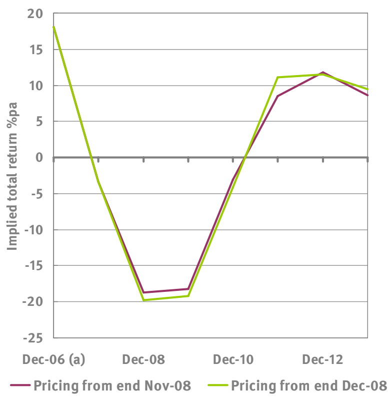
Indicative transactions

- There are already signs that some are seeing this significant drop in value as an opportunity, should the right asset come along.
- The start of this year saw London & Stamford, behind which are experienced players Raymond Mould and Patrick Vaughan, announce its first acquisition.
- After nearly a year on the market, One Fleet Place in the City was bought from Legal & General for £74m, representing a net initial yield (NIY) of 7.75%. The 170,000 sq ft building is let to Denton Wilde Sapte for 17 years at £36.00 per sq ft. Many have interpreted this as a sign that opportunities are there to be had for those bold enough, and financially able, to step in.
- Beyond London, demonstrations of how far prime office yields might have moved have been few and far between. Before Christmas, two deals at Spinningfields, Manchester finally gave an indication.
- HansaInvest paid £56.7m, 6.75% NIY, for 2 Hardman Square while 4 Hardman Square was bought by BP Pension Trust for £21m, 6.95% NIY. As some of the best quality office space available in the regions, these two deals indicate where prime now sits.
- In the shopping centre sector, the purchase of Old George Mall in Salisbury by Doughty Hanson was one of only two shopping centre transactions in the last quarter. Bought for £60m, it equated to 7.5% NIY and an equivalent yield of 8.3%.
- An indication of pricing on quality distribution assets with good income has been provided in January with Curzon's purchase of The Bridge, Dartford. Curzon paid £58.5m, c. 8.15% NIY, for this prime South East distribution warehouse let to Sainsbury for 18 years.

Property derivatives

- The derivatives market continues to reflect an extremely gloomy perspective on the future of commercial property. At the year end, a total return of -19.3% was priced in for 2009, having been set at -16.2% in November.
- Currently, derivatives are telling us we'll have to wait till 2011 to see a positive return. It'll be double digit, it seems – which is interesting as capital growth is implied to be almost marginal, indicating income of unprecedented levels.

Derivative pricing: implied UK total returns



Source: Morgan Stanley

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So, the worst is now behind us. If you don't count the economy. Or the occupational markets. And think of it only in annual terms.

But if, as expected, IPD's annual outcome for 2008 shows total returns of circa -20% (which would be the worst on record by some margin – exceeding 1974 and more than double that of 1990), then 2009 can only be better.

Negative returns remain a given for this year, but if you picture annual returns as a graph then the line is only going one way, and that's up.

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