INVESTMENT *brief*

INbV

Autumn 2001

"Private investors acquire stock as UK institutional funds adopt a more cautious position"

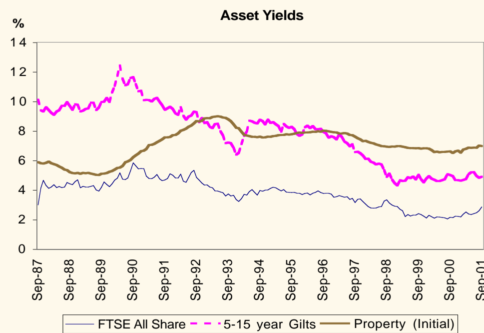
Overview

Relative strength in UK economy

The UK's annualised economic growth rate in the second quarter was 1.7%, representing the highest the rate of any of the Group of 7 nations. Consumers continue to buoy up the economy as retail sales volume rose by 0.2% in September. With underlying inflation running at 2.3% and the base rate standing at 4.5%, the Monetary Policy Committee of the Bank of England still has a fair amount of leeway in cutting the base rate further.

Property leads the market in 2001

Property produced total returns of 5.1% in the first nine months of 2001, out-performing gilts (3.7%) and equities (-19.9%), according to IPD. However, in the third quarter, gilts were the strongest performing asset (4.1%), whilst property total returns stood at 1.5%. Property's twelve-month total return slipped to its lowest level for five years, at 7.3%.



Source: Investment Property Databank

In terms of capital growth, property's twelve-month growth rate slipped to –0.1%, which is the first negative rate since November 1996. The property yield stood at 7%, which is an increase of 10 basis points on the second quarter figure. Gilt yields fell by 30 basis points over the third quarter and stood at 4.9% in September.

Private investors make their presence felt

5-year swap rates fell by 65 basis points from June to the first week in October, when they stood at 5.2%. The fall has stimulated private investor interest in the market. It was this investor group which dominated bids for a £125m portfolio of shopping centres.

UK funds wait and see

UK net institutional investment stood at £1.3bn in the second quarter. Whilst net investment in 2001 is down on last year's figures, the latest data reveals a reluctance to dispose of property amongst UK funds. Overseas investors are finding opportunities to increase their UK market presence.

Offices

Pre-let activity in the Central London occupier market slowed as take-up fell. Whilst the West End prime market experiences a sharp slowdown in rental growth, the City is still experiencing a shortage of Grade A space.

Retail

Retail's quarterly rental growth was stable in the third quarter, as industrial and office sectors drifted downwards. International operators are implementing expansion plans.

Industrial

The Heathrow market remains resilient in the wake of the collapse of the co-location market. Whilst prime rents have fallen, occupier interest from the traditional sectors of the economy remains strong.

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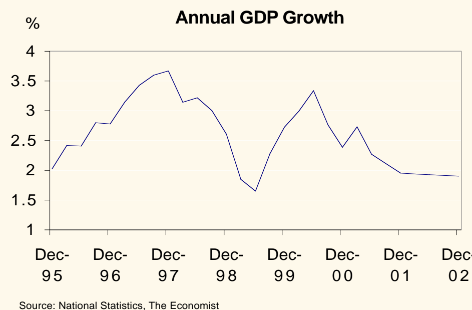
"The UK is well placed to withstand the worst effects of a global slowdown"

Economic Overview

UK faces up to global slowdown

The UK's annualised GDP growth rate in the second quarter was 1.7%, which was the strongest of the G7 countries. Following the terrorist attacks, The Economist forecast that twelve-month UK GDP growth would fall to 1.9% in 2002, down from 2.6%, which was their figure at the beginning of September. A pre-condition for recession is the collapse of consumer confidence and subsequent spending and these measures remain resilient. Retail sales volume rose by 0.2% in September, as survey evidence revealed a bounce-back after a downturn immediately following the terrorist attacks. Furthermore, the Monetary Policy Committee still has a fair amount of leeway in loosening monetary policy in the face of any such drop in consumer confidence, after adopting a cautious stance earlier in the year.



Source: National Statistics, The Economist

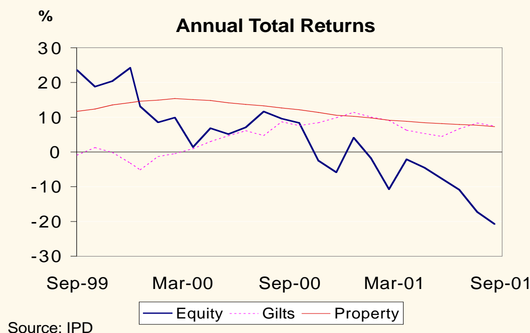
The underlying rate of inflation fell back to 2.3% in September, which is 20 basis points below the government's long-term target rate. With low inflation and sound public finances, it appears that the UK is less likely to experience prolonged economic slowdown than the US, the eurozone or Japan. The severity of the global slowdown is epitomised by US industrial output growth, which is currently experiencing its longest period of decline since 1945. Sir Edward George recently gave a cautious prognosis for the global economy suggesting that its growth rate would be below the long-term trend for the next two to three years.

The most direct effects of weakness in the global economy are being felt in two areas of the UK economy. Firstly, the manufacturing sector, which is already currently experiencing technical recession. The second area is investment spending in the high technology sector. These two areas are closely related as the sharp drop in manufacturing output in the first half of 2001 accompanied the severe downturn suffered by the high technology sector. Goldman Sachs reported that the production of computer equipment has fallen by 26% from its peak last December. The financial services sector is also vulnerable to a sustained period of slowdown in the US. The banking sector in London was bracing itself for a severe round of job cuts in the face of US corporate retrenchment even before the terrorist attacks. In the general labour market, the headline rate of unemployment continued to fall in September, although the government's preferred measure, the Labour Force Survey reported the biggest rise in the unemployed for eight years in the three months to August. The discrepancy in data may reflect the fact that jobs are being created in some parts of the economy, such as retailing although the overall situation is deteriorating. Indeed, over the past year, 123,000 jobs have been lost in manufacturing.

Property Overview

Private investors make their presence felt

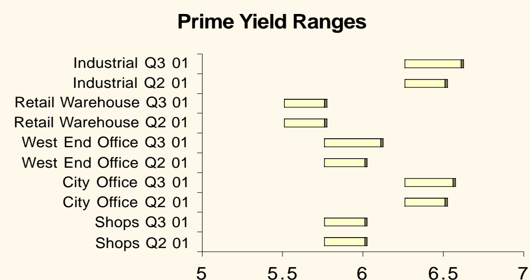
5-year swap rates fell by 65 basis points from June to the first week in October, when they stood at 5.2%. The fall has stimulated private investor interest in the market. It was this investor group which dominated bids for a £125m portfolio of shopping centres held by CIN LaSalle Investment Management, on behalf of Coal Pension Properties. The City office market is also seeing evidence of this trend with Rotch bidding aggressively for 60 Gracechurch Street, EC3. In the auction market, IPD/Jones Lang LaSalle reported yield improvements on stock with high quality covenants.



Source: IPD

Overseas investor activity in the UK

German open-ended funds experienced substantial cash inflows in August, which was factor in Deka's (formerly Despa) decision to pull out of a £250m portfolio sale. Low interest rates on cash balances relative to property returns mean such funds will be seriously considering acquisition opportunities. Irish investors are also expected to remain active in the market. As their domestic economy slows, they perceive the UK to be a 'safe haven'. US-based opportunity funds have been active in the summer and also seem likely to command a heavy presence in the market.



Source: Gerald Eve

Property and gilts vie for top performing position

Property produced total returns of 5.1% in the first nine months of 2001, out-performing gilts (3.7%) and equities (-19.9%), according to IPD. However, in the third quarter, gilts were the strongest performing asset (4.1%), whilst property total returns stood at 1.5%. Property's twelve-month total return slipped to its lowest level for five years, at 7.3%, which was 10 basis points below the gilt return. The equity market slid to -20.8%. Annualised six-month equity returns stand at their lowest level since the 1987 crash. Despite the recent weakness, the UK equity market is by no means cheap in historic terms. Since 1965, the average price-earnings ratio was 14.6 and the dividend yield has averaged 4.6%. On October 12th, the p/e ratio on the market was 19.5 and the dividend yield 2.7%.

"Property is putting in a strong challenge for the position of best-performing asset in 2001 for the second year in succession"

GeraldEve
Chartered Surveyors
& Property Consultants

In terms of capital growth, property's twelve-month growth rate slipped to –0.1%, which is the first negative rate since November 1996. Twelve-month property rental growth fell to 3.7% in September, which is the lowest rate since June 1997. The property yield stood at 7%, which was an increase of 10 basis points on the second quarter figure. Gilt yields fell by 30 basis points over the third quarter and stood at 4.9% in September.

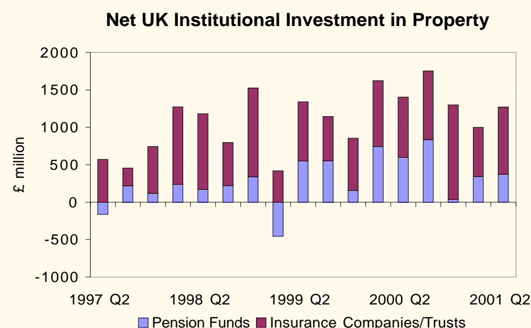
Sector performance

The only areas to produce double-digit twelve-month total returns in September were London offices and Scottish industrials, according to IPD. In terms of twelve-month capital growth, property slid to –0.1%, which is the first negative rate since November 1996. Whilst twelve-month capital growth is trending downwards across all sectors, it is only retail that is suffering negative growth, with its rate standing at –2.3%. As the manufacturing sector shows few signs of recovery in the short term, industrial may well slip into negative territory over the next quarter.

"The second quarter saw a fall in UK institutional disposals of property"

UK institutions hold on to property assets

Institutional net investment reached £1.3bn in the second quarter, bringing the total for the first half of 2001 to £2.3 billion, according to National Statistics. This represents a 26% fall in the figure from the exceptional level of the second half of 2000. Net investment in property represented 5.7% of the total in the second quarter, which is well below the average for 2000 of 9.1%. However, disposals of property were £1.4bn in the second quarter, which represents the second lowest level since 1998. This indicates that institutional asset allocators may be willing to hold higher weightings of property in their portfolios. Poor equity performance resulted in a fall in the asset's portfolio weighting, which automatically increased property's weighting. However, there is little impetus from active property acquisition strategies in this increase in property portfolio weighting as investor purchases stood at £2.7bn in the second quarter compared to a quarterly average of £3.3bn last year.



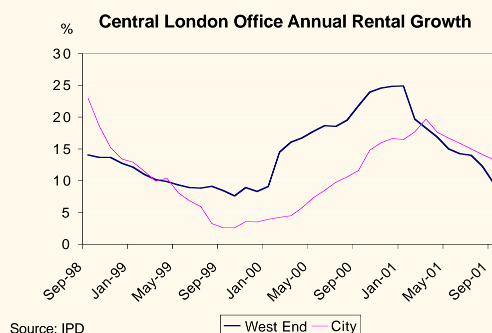
Office

Occupier caution stifles activity

The prime central London occupier market is set to join the M3/M4 corridors in suffering the most direct effects of a US economic slowdown. In Central London, occupier caution has become increasingly apparent as deals have been terminated at relatively late stages of negotiation. Pre-let activity has also dropped back leading to a 50% reduction in the take up of new space over the third quarter, according to CB Hillier Parker.

The prime West End rental level has experienced falls over the last two quarters. Peripheral locations, such as Soho are also experiencing a greater degree of weakness than in the second quarter. In such areas, the tenant base is heavily related to the advertising sector, which is acutely sensitive to an economic downturn.

Annual rental growth in the West End stood at 9.6% in September, according to IPD, and is on a noticeably sharper downward trend than in the City. The prime City rent rose slightly over the third quarter, reflecting the constrained supply of Grade A space with large floorplates. However, the full impact of US corporate retrenchment is yet to be felt in the market. In the City market overall, rental growth slipped to 13.3% in September, according to IPD. There have been reports of rises in the value of incentives offered in the London market with the RICS reporting the highest levels since 1998 over the third quarter.



Source: IPD

Western corridor/M25

In the M3/M4 corridors, Healey and Baker reported a 57% increase in supply in the third quarter. However, the collapse of the high technology sector's requirements has allowed occupiers from more traditional sectors, such as pharmaceuticals, to enter the market. Hence, the lettings market remains active with Insignia Richard Ellis estimating that there is around 89,190 sq m (960,000 sq ft) of space under offer. Although rents at which such space was secured are lower than were achieved last year, despite more generous tenant incentive packages being offered. In the longer term, the market will be underpinned by the fifth terminal at Heathrow, which is expected to formally approved before the end of the year, although it will not be fully operational until 2007. In northern areas of the M25, short-term rental growth still remains a realistic prospect as market fundamentals remain relatively healthy. Rents in Brentwood, Essex stand at a £10 per sq ft discount to locations in the western section of the M25 and do not suffer from such acute staff-sourcing problems as the west. Indeed, the town has seen work commence on the first speculative scheme for ten years recently.

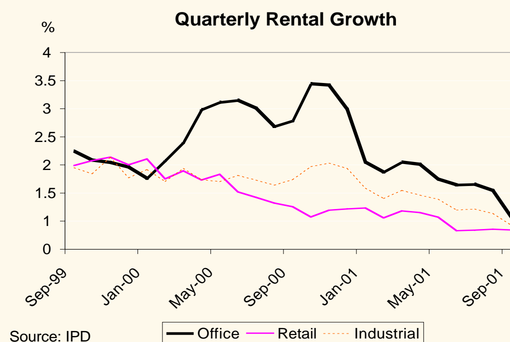
Low-yielding stock

In the West End investment market, the subdued nature of institutional activity means that there is less interest for units in the £20m+ range over the last year than in early 2000. Active management opportunities are also experiencing a dearth of investor interest. Throughout late summer, many deals were put on hold and there appears to be little prospect of many being revived in the short term. The low-yielding, large lot-sized market has subsequently suffered from falls in market value, which has not encouraged potential vendors to market stock. In a recent example of this trend, Ivory Gate withdrew its £60m investment property, Princes House in St James's, from the

"The value of tenant incentives increase in the Central London and M3/M4 corridor markets"

market. The inactivity of institutional funds means that the geared investors are becoming more prominent, though their purchasing activity is being impeded by increased lender caution with regard to covenant strength. This was exemplified by recent negotiations over Shell-Mex House, WC2. The private property companies, Topland and London & Regional, were able to proceed only after strict rental guarantees were in place.

The prime City yield was being subjected to less upward pressure than in the West End as rental growth was present in the third quarter, although this environment is expected to weaken in the final quarter. Active management opportunities have been attracting a degree of interest from property companies, although weakening growth prospects look set to stifle such activity in the short term. The Thames Valley market faces the most acute risk of an upward movement in yields. This area has seen little activity in stock yielding less than 7% and lengthy negotiation periods may be expected for the foreseeable future.



Retail

Selective occupier interest

Selective is the word to describe both occupier and investor interest in the retail sector. Retail's quarterly rental growth trend has been stable since June as requirements for reasonably-priced, prime stock remain buoyant. By contrast growth trends in the office and industrial sectors remain downward. Retail is the only sector, which registered an increase in surveyor optimism regarding fourth quarter rental growth, according to the latest RICS Commercial Property Survey. Although the outlook deteriorated in the Midlands and Wales, where spending patterns are closely related to the fortunes of the manufacturing sector. There have been a number of encouraging trading statements recently. For example, Next are now seeing an upturn in consumer spend, after struggling in the early part of the year. The disposal of the C&A portfolio has been fairly successful in prime locations, though this activity is not necessarily accompanied by any rental growth.

Demand for space remains strong from new entrants to the market. Foreign retailers are taking the opportunity to spread risk and use the low cost of finance to undertake cross-border expansion and the relative strength of the UK consumer sector is proving attractive. This trend is exemplified by the Japanese company, Uniqulo, which has recently announced requirements for 100 units in the next 3 years.

"Foreign retailers are taking the opportunity to spread risk and use the low cost of finance to expand"

A tale of two retail schemes

The rapidly changing nature of occupier requirements is exemplified by the recent opening of two shopping centre schemes. The 60,385 sq m (650,000 sq ft) Touchwood scheme in Solihull opened in

September virtually fully let and is trading well. However, potential occupiers in schemes remain acutely sensitive to tenant mix and unit configuration, as well as cost. If schemes fail to meet retailers' exacting standards, the downside to changing occupier requirements is evident. This is exemplified by another scheme, the 40,875 sq m (440,000 sq ft) Ocean Terminal at Leith Docks in Edinburgh, which opened its doors with only 50% of the units let recently.

Big is beautiful

The focus of occupier requirements on large units continued over the last quarter. For example, Next recently announced requirements for 9,300 sq m (100,000 sq ft) superstores in seven locations. Other retailers have looked closely at their location requirements and rent differentials, with the result that even staunchly high street/shopping centre occupiers have decided to acquire units in edge or out-of-town and even stand-alone locations. Examples of this trend include Laura Ashley, Lunn Poly and Carphone Warehouse. Traditional West End locations still report occupier interest in the face of this trend, with Benetton taking space at £4,682 per sq m (£435 per sq ft) on Oxford Street.

Selective investor interest

The prime high street investment market remains subdued though there are initial signs that institutional vendors are reluctantly accepting yields of around 6%, which a year ago would be agreed at nearer 5%. Chris Bartram, the chief executive of Haslemere, anticipates that caution in terms of portfolio acquisition would continue for the rest of the year, as he preferred to concentrate on active management of existing assets, which is an ever-more prevalent attitude amongst investors. Interest in stock yielding higher than 7% is far more noticeable as private investors exploit cheap finance rates to undertake acquisitions. IPD reported that the inter-quartile spread of total returns is higher for high street retail than any other sub-sector, which highlights the need for investors to be especially careful in stock selection. The terrorist attacks may have affected interest in Central London stock as IPD reported that it was the only sub-sector in the commercial property market to register a yield 'shock' in September, amounting to a 6-basis point increase.

In the prime shopping centre market, there continues to be a dearth of yield evidence. Indeed, valuers are taking a conservative approach in the yield appraisal of property company portfolios. For example, the capital value of Hammerson's retail portfolio in the South East fell by 2.4% despite the fact that its shopping centre rental growth reached 6%. However, secondary stock is attracting the attention of geared investors, mirroring the profile of activity on the high street.

Industrial

Resilience in the South East

The south west M25 market has been resilient in the face of the collapse of telehotel requirements. Take-up stood at 23,500 sq m (253,000 sq ft) in the first half of the year, down slightly on the previous six-month period, according to Rogers Chapman. Whilst rents have dropped from £140 per sq m (£13 per sq ft) seen at the end of last year, Federal Express recently took space on the North Feltham Trading estate, Heathrow for £132 per sq m (£12.25 per sq ft). Market fundamentals remain fairly sound in other lower rented locations, such as along the M3 corridor. Unlike the office sector, industrial landlords along the M3/4 corridors have

"Distributors continue to acquire space which underpins occupier demand around the M25"

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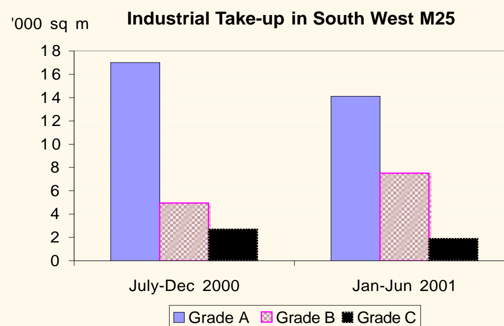
not been forced to give much ground in terms of tenant incentives. However, the imposition of 15-year lease terms is constraining demand for space as occupiers seek flexibility in the face of a more uncertain economic outlook. Moreover, occupiers are becoming increasingly selective in terms of specification.

Across the M25 market, the demand for smaller units has been adversely affected by increased uncertainty in the economic outlook. Nevertheless, several lower-rented locations around the M25 face supply constraints, which may produce short-term rental growth. Improvements in the infrastructure, such as the A13 scheme in Essex, certainly provide a realistic chance of growth in the market for larger units, as distributors continue to acquire space. With a 40% rental discount to the Heathrow market, the A13 corridor is well placed to meet this demand. Enquiries in the south eastern quadrant of the M25 are reported to be holding up, as levels in the western corridor and northern M25 fall back. Such areas are likely to benefit from increased occupier cost-consciousness. Against the background of a manufacturing recession, the market in the North is noticeably weaker than in the South East, whilst Scotland's rent levels have been supported by an influx of interest from the distribution sector.



Source: Rogers Chapman

Investors shun low-yielding stock

Investor interest for stock below 7% has weakened noticeably in the last few months. The Heathrow market may be able to command a prime yield of 6.25%, but in other areas, the level is nearer 7%. Estates which offer yields of around 8% have been attracting continued investor interest. In the South East, for example, the Ashford Industrial Estate, Heathrow, which was built in the eighties, sold for a yield of 7.7%. It is difficult to envisage any sustained downward pressure on yields whilst manufacturing is experiencing a recession. In the current economic environment, reducing void risk may be achieved by minimising exposure to tenants, which are linked to export-oriented activities or the high technology sector. In so doing, investors may still be able to pursue successful active management strategies.

Developer caution required

Whilst tenant demand has weakened, the overall market is not slipping into severe imbalance as developer activity has also been reined in recently in the face of increased caution from funding sources. Speculative developers are, by necessity, often self-funding. Although, speculative development activity remains buoyant around the north eastern section of the M25 and M11, bucking the wider market trend. Across all areas, developers must be aware of the increasingly discerning occupier in terms of specification if over-supply is to be avoided.

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