

#### Economic overview

Interest rates are expected to rise as the economy grows at a faster rate

#### Property overview

We forecast a total return for property of 8.7% in 2004 as sector returns converge

#### Office

There are positive signs in the London market, although vacancies and over-renting are high

#### Retail

Retail will remain the top-performing sector in 2004, although we expect returns to fall

#### Industrial

We forecast a total return of 8.9% for industrial properties in 2004

#### Leisure

The introduction of SDLT and changes to A3 classification will affect the market

Property Investment  
Market

Winter 2003/04

# inv**brief**



GeraldEve

# Summary

"We forecast three-year annualised total returns for property will be 9.5%"

## Property

Property recorded a total return of 11.3% in 2003, the highest since 1999 according to the IPD Monthly Index. The re-weighted IPD Annual Index estimate records 10.5%.

Equities were the top performing asset class in 2003, recording a total return of 20.9%. Property was the top performer over 3, 5 and 10 years.

Capital growth was driven by a fall in valuation yields. The decline in rental values slowed in the final quarter.

We forecast total returns of 8.7% for property in 2004 and 9.5% on a three-year annualised basis.

The recent upturn in finance rates will reduce the affordability of debt financed investment, providing opportunities for institutions to compete for quality stock.

## Office

In the year to December 2003, offices were, again, the poorest performing sector with a total return of 3.4% pa.

The central London office market is showing signs of turning the corner with agents reporting more enquiries and major occupiers retaining space.

Landlords have had to show flexibility to attract quality tenants through reducing rents and extended rent-free periods.

The last two years has seen vacancies and over-renting rise to levels not seen since the early 1990's.

## Retail

Retail was again the top performing sector in 2003, recording a total return of 16.2%.

Performance was strongest in shopping centres and retail warehouses.

Although sector returns will converge, we forecast retails to be the top performing sector in 2004, recording a total return of 9.8%.

## Industrial

The industrial sector continues to provide a consistent level of strong performance, recording a total return of 11.7% in the year to December 2003.

Rental value growth had ground to a halt by the year-end.

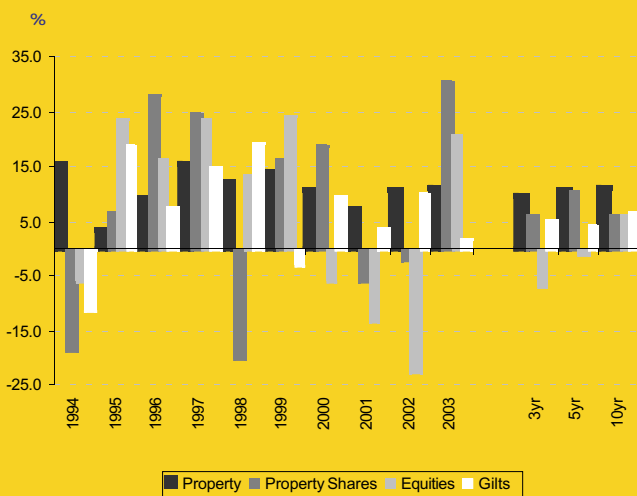
## Leisure

SDLT to increase costs for occupiers in a sector with a long lease structures.

The expected change in A3 Use Class definition is expected to inhibit flexibility and profitability for existing occupiers.

Total Returns by asset over last 10-years

Source: IPD Monthly Index



# Economy

## Accelerating growth

UK GDP grew by 2.1% in 2003 with growth of 0.9% in the final quarter, exceeding consensus forecasts.

GDP growth in 2004 will increase to 2.7% according to the latest Treasury survey of independent forecasts. The recent British Chamber of Commerce (BCC) survey suggests a general improvement in business confidence with orders and investment expected to rise. The Confederation of British Industry (CBI) has said the manufacturing recession is over with strong order and export growth expected over a wide range of sectors.

## Drivers of growth

The principal drivers of UK growth have been consumer spending and the public sector, with sustained increases in healthcare spending. Financial and business services picked up towards the year-end and manufacturing finally started to turn the corner.

Retail sales over Christmas were stronger than had been feared with sales in December increasing by 0.9%, an annual rise of 4.0%.

The position for the private sector was mixed with companies focusing on cost

reduction to restore profitability. The BCC survey suggests companies expect to see earnings growth and investment rise, although without an immediate impact on employment growth.

Concerns over higher than expected government borrowing and the resulting need for greater interest rates or tax rises could act as a drag on economic growth in the short to medium term.

## Interest rates to rise

Interest rates are expected to rise gradually during 2004, but remain low in historic terms.

The continued rise in house prices, higher forecast growth, reasonable December retail sales and concern over record levels of personal debt suggest a modest tightening of monetary policy is required.

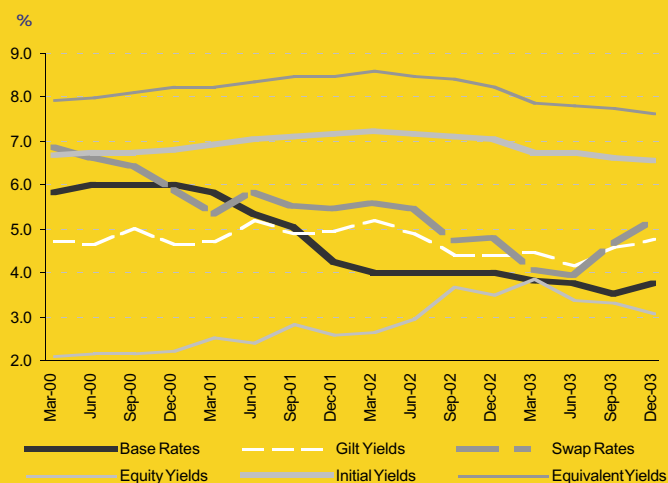
This is expected to offset the continuing low level of inflation and difficulties faced by exporters and manufacturers from the weakness of the dollar.

Rising interest rates may make exports to the Eurozone less competitive, as the European Central Bank (ECB) could cut interest rates to stimulate growth and curb the rise of the Euro.

“GDP growth will increase to 2.7% in 2004”

## Yields & finance rates

Source: Experian, IPD, CLP Finance



# Property

## Performance

Property recorded a total return of 11.3% in 2003, the highest since 1999, according to the IPD Monthly index. The re-weighted IPD Annual Index, with a higher central London office weighting, recorded a comparable figure of 10.5%.

Equities were the top performing asset class in 2003, recording a total return of 20.9%. Gilts were the worst performer, recording a total return of 1.8%.

Property is the top performing asset class over 3, 5 and 10 years by a significant margin.

The rate of capital growth increased each quarter in 2003 rising to 1.6% in Q4. This resulted in an annual growth rate of 3.9%. Capital growth was driven entirely by a fall in valuation yields, which improved capital values by 4.2%, rather than rental values, which had fallen by 0.8% by the year-end.

The decline in rental values experienced up to September 2003 finally ended and positive growth was recorded in the three subsequent months.

Investor confidence and a wider interest in the UK market has driven recent performance, rather than the fundamentals of tenant demand.

## Our forecasts

All property twelve-month forecasts

Total return (%)	
2004	8.7
2005	9.2
2006	10.6
3-year annualised	9.5
Rental growth (%)	
2004	0.8
2005	2.1
2006	2.5
3-year annualised	1.8
Capital growth (%)	
2004	1.5
2005	2.1
2006	3.5
3-year annualised	2.4

Source: Gerald Eve research

We expect property will continue to deliver a strong real return over the next three years. Performance will be mainly driven by rental value growth as yields stabilise.

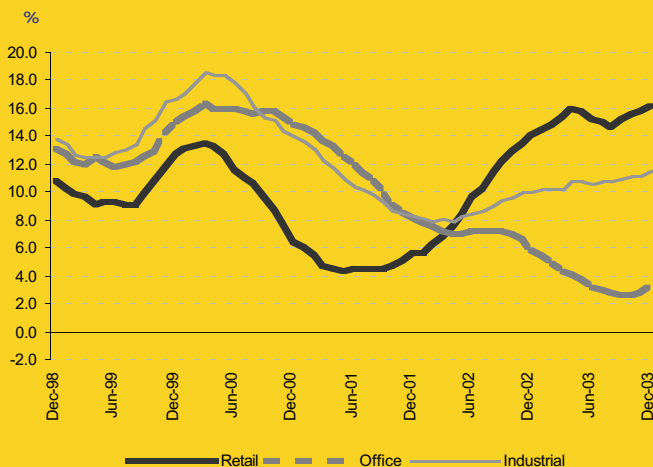
We also expect the wide spread of sector returns, principally between the retail and office markets, to narrow significantly.

The market in 2004 should benefit from economic growth and strengthening occupier demand.

“Property will continue to generate stable real returns in 2004 and beyond”

## Total Returns by sector

Source: IPD monthly index (12 months to)



Property is slowly being reappraised in terms of its qualities as an investment in a multi-asset class framework. The relative security of income return in a low inflationary environment has proved attractive, particularly to overseas and multi-asset class investors. Recently, both CSFB and Merrill Lynch have upgraded the property sector to overweight status.

A recent Mori survey suggested pensioners, informed of property's long-term out-performance, unsurprisingly, wanted pension funds to have a far higher property exposure. While the desired 37% is neither appropriate nor possible, property managers must continue to make the case to increase weighting from around 7% to 10-20%.

**Net investment**

UK institutions were net sellers in 2003, through a combination of being unable to match the prices offered by geared investors, and from taking some of the high prices available to vendors.

International investors and private individuals were the principal buyers in 2003 with overseas investors putting £947m (net) into the market in Q4 alone.

The market proved particularly attractive to German open-ended funds and Irish investors unable to find appropriate stock in domestic markets.

Auctions also had a good year with prime stock usually attracting multiple bids.

There was a rush of completions prior to Stamp Duty legislation in December.

**Finance rates**

Swap rates have risen from a record low in June 2003, but still remain low in historic terms. Base rates are not expected to rise much above 4.5% in 2004. Debt-financed purchases remain affordable, with the exception of the prime market, and activity remains high.

Institutions are keen to acquire stock in 2004, but will have to pay the high prices demanded. There will be a lot of cash chasing any quality, well-let stock that becomes available.

**On the horizon in 2004**

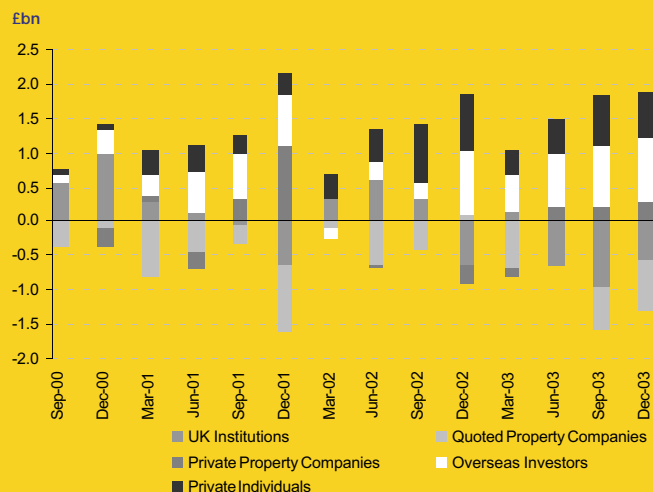
The establishment of tax transparent REIT vehicles in 2004 or 2005 would provide a major source of capital and liquidity to the industry.

SDLT may force investors to demand higher yields for agreeing shorter leases.

“Tax transparent REITs would be a major boost to investment markets”

**Net Investment £bn**

Source: Property Data



## Offices

### Another bad year

Office total returns for the year to December 2003 fell to 3.4% as capital values fell by 4.0%. This fall was driven by a fall in rental values which totalled 7.2% for the year, the worst since 1993. Capital value falls were cushioned slightly by a decline in valuation yields.

The central London markets again recorded the worst performance with West End, combined with Mid Town, and City rental values falling by 11.7% and 9.5% respectively, according to the IPD Monthly Index.

Provincial markets again proved resilient with offices outside London and the South East recording a total return of 11.3%. Rental value growth of 1.8% and a beneficial yield impact improved capital values by 4.7%.

The last two years have seen the level of over-renting and vacancies return to levels not seen since the early 1990s with vacancy rates exceeding 17.0% in the City and 13.0% in the West End.

Landlords have had to show flexibility and imagination to attract quality tenants by reducing rents, offering extended rent-free periods, accepting shorter leases and proactively managing tenant requirements.

### Our forecasts

Office twelve-month forecasts

Total return (%)	
2004	5.2
2005	8.0
2006	11.2
3-year annualised	8.1
Rental growth (%)	
2004	-1.5
2005	1.4
2006	3.2
3-year annualised	1.0
Capital growth (%)	
2004	-1.6
2005	1.0
2006	4.3
3-year annualised	1.2

Source: Gerald Eve research

We forecast rental values will fall, at a lower level, in 2004, turn positive in 2005 and strengthen in 2006.

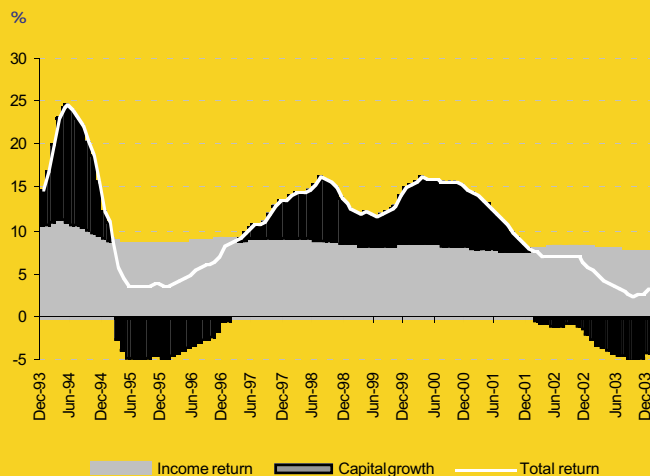
### Shoots of recovery?

The central London office market appears to be starting to turn around with Q4 03 take up at its highest level since Q2 01. Agents are reporting an increase in enquiries whilst major occupiers are retaining surplus space, reflecting a strong upturn in the financial and business service sectors.

“Occupiers are now retaining space as they anticipate growth”

### Components of total return - Office

Source: IPD



Lower vacancy rates combined with a constrained supply pipeline suggests rents will recover more quickly in the West End market than the City.

There should be a quicker recovery than in previous downturns due to the limited level of additional supply expected to come on stream in the short term.

Rents will remain depressed for a period as vacancies are filled and over-rented units soak up any rental value growth.

The development of 10 Grosvenor Street, a joint venture between Hammerson and Grosvenor, represents one of the very few speculative developments in the prime market with asking rents of £70 per sq ft.

#### Investment activity

The investment market, both in 2003 and 2002, was been dominated by overseas investors. German open-ended funds and private Irish investors have had a major impact on the central London office market.

Major deals in Q4 03 included the purchase of Victoria House, Bloomsbury Square by Moritz Holdings for £160m, with solid tenants including the Competition Commission and Sport England. DEKA purchased 15 Newgate St, EC4 for £200m with an initial yield of 6.5%, let to Goldman Sachs until 2020.

The appetite from Middle Eastern investors was also strong, as exemplified by the purchase by the State of Qatar and Consensus Capital (advised by Gerald Eve) of 60 London Wall, for £160m. The building is let to ING for just under 13 years.

#### Outside London

There is evidence emerging of an upturn in the Thames Valley market with availability falling for the second quarter in a row along with several major requirements coming onto the market from the likes of Exxon, GE Capital and Bechtel. This will continue to reduce the level of over-supply in the region and stabilise rents.

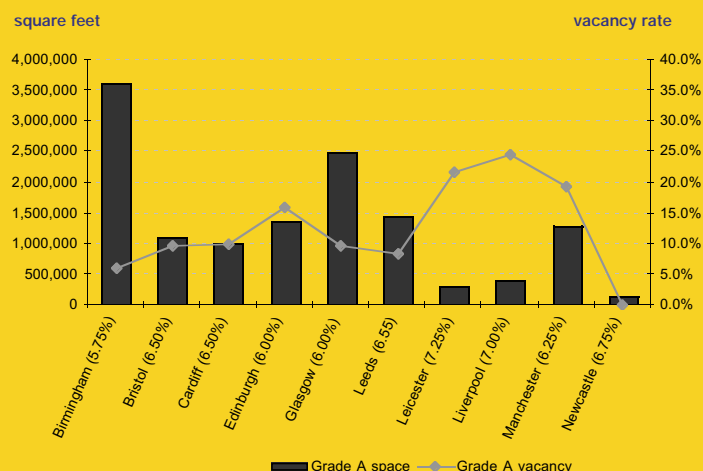
Major regional centres will benefit from the recent decision to relocate civil service employment outside the capital.

We expect rental value growth in Birmingham, Leeds, Cardiff, Glasgow and Newcastle over the medium term, as supply is limited and current vacancy rates are low.

“Rents will fall by 1.5% in 2004, but rise 1.4% in 2005 and 3.2% in 2006”

## Grade A office yields, space and vacancy rates

Source: Gerald Eve research



# Retail

## Top performing sector

Retail was again the top performing sector in 2003, achieving a total return of 16.2%, according to the IPD Monthly Index.

Capital value growth of 9.2% was driven by a combination of falling valuation yields, which improved values by 5.4% and rental value growth of 3.5%. Quarterly trends suggest that capital growth increased significantly in the three months to December, recording an annualised rate of 12.3%, with rents growing at 4.9% pa and yields adding 7.5% pa.

Strong performance was demonstrated across the retail sector with shopping centres, retail warehouses and shops all recording substantial double digit returns

Shopping centres	20.6%
Retail warehouses	16.4%
Standard shops	15.0%

Rental value growth was strongest in retail warehouses and in southern shops outside London. Falling valuation yields improved capital values across all retail property types and regions with a particular impact upon shopping centres and South East shops. This trend also gathered pace in the final quarter.

## Our forecasts

Retail twelve-month forecasts

Total return (%)	
2004	9.8
2005	8.5
2006	10.8
3-year annualised	9.7

Rental growth (%)	
2004	2.4
2005	3.8
2006	3.8
3-year annualised	3.4

Capital growth (%)	
2004	3.3
2005	2.0
2006	4.4
3-year annualised	3.2

Source: Gerald Eve research

We forecast rental values to continue growing over the next three years as economic growth maintains a high level of consumer spending. Yields will remain fairly stable.

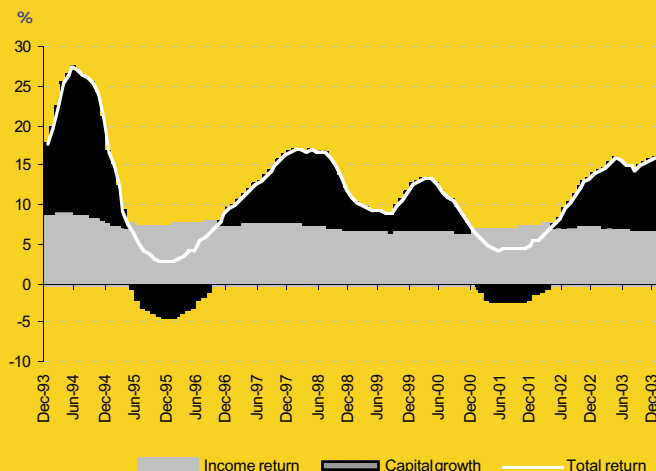
Retail will again be the top performing sector in 2004 and on an annualised basis over the next three years.

We also expect the spread of returns, that has opened up between the retail and office sectors, to narrow over the next few years.

“Yields fell across all types and regions in 2003”

## Components of total return - Retail

Source: IPD



### Occupier update

The successful completion and letting of the Bullring shopping centre in Birmingham was a major factor in that city being ranked the best key centre for retail growth over the next five years, according to *Prime Retail*, a survey of over 1500 retailers undertaken by Gerald Eve. Manchester and Southampton were rated 2nd and 3rd respectively.

A recent CBI sponsored Survey of Property Trends suggested a positive balance of 9% of retailers expecting to increase holdings in the first half of 2004. The weak Christmas period described by the press was overstated with sale volumes recording an annual growth rate of 4.0%.

Major brands such as Tesco, Boots, Next and Mothercare all demonstrated strong sales growth and profit growth over the Christmas period.

Retailers in town and city centres have to combat accessibility, parking issues, street cleanliness and crime as they compete against clean, purpose-built environments provided by out-of-town shopping centres and retail parks.

The great number of 25 year leases signed in the 1980s is reaching the stage where occupiers will be deciding to renew or begin planning exits. This

may result in major retailers rationalising their outlet portfolios. Investors in secondary towns may find it difficult to secure income of a similar level and security. This will push yields upwards. Current void rates in such towns may significantly overstate quality market demand.

### Investment

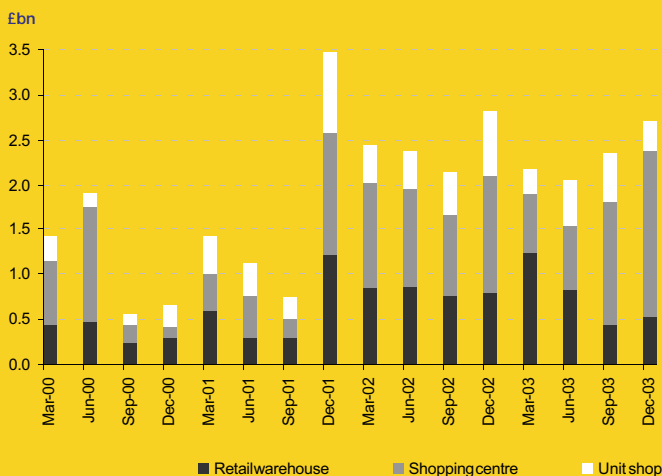
Shopping centres continued to attract a lot of interest with 92 deals recorded at over £4.0 bn for the year. Property companies and overseas investors were the principal buyers. The lack of new schemes nearing completion suggests competition will be intense for those centres which come onto the market. Developing and modernising existing centres appears a more immediate, cost effective method, of generating performance.

The retail warehouse market continues to benefit from major retailers demanding an increase in space outside city centres. Planning restrictions will limit supply and support rental values. Existing sites will become even more valuable as they present one avenue for possible expansion through quality mezzanine restructuring.

“Prime Retail identifies Belfast as top regional investment prospect”

### Retail investment activity

Source: Property Data



# Industrials

## Consistency

The industrial sector continues to provide a consistent level of strong performance, recording a total return of 11.7% according to IPD. This comprised an income return of 8.3% and capital growth of 3.3%.

The principal driver of industrial performance remains the high level of income return, relative to other sectors and asset classes. Industrial income returns continue to provide a substantial real return in a low-inflationary environment.

Investors can add value by generating rental income growth through actively managing assets, focusing on achieving above-average settlements at expiries, renewals, rent reviews and through lease restructuring,

Capital growth in 2003 was mainly driven by a fall in valuation yields as rental growth ground to a standstill by the year-end. Yields fell across all regions and improved values by 2.4%.

Although vacancy rates increased from 8.0% to 9.4% in 2003, there is minimal evidence of an excess of supply impacting upon values in the short to medium term.

Whilst not recording the levels of 2002, interest in the sector has remained strong with Property Data recording £2.1bn investment in 2003.

Demand is particularly strong for large distribution centres. Standard Life acquired a portfolio of 15 centres, from Prologis, for £191m, at a yield of 7%.

## Industrial twelve-month forecasts

Total return (%)	
2004	8.9
2005	9.5
2006	10.2
3-year annualised	9.5

Rental growth (%)	
2004	0.5
2005	1.0
2006	1.8
3-year annualised	1.1

Capital growth (%)	
2004	0.9
2005	1.7
2006	2.3
3-year annualised	1.6

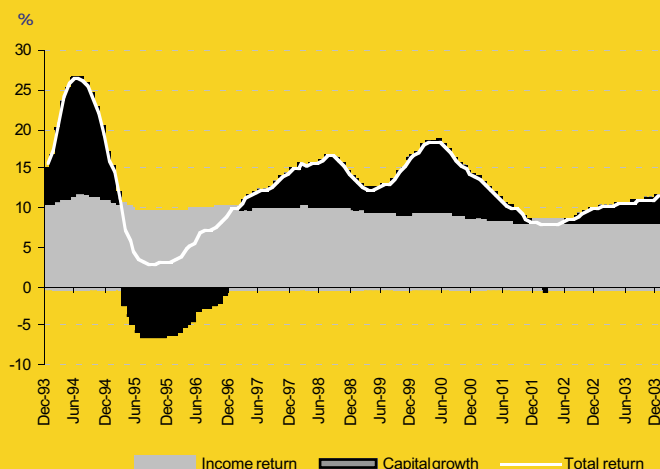
Source: Gerald Eve research

Industrial performance should be sustained over the next three years as rising occupier demand offsets the slowing decline of valuation yields, which cannot go much lower.

“Being on top of the leases in your portfolio can improve investor returns”

## Components of total return - Industrial

Source: IPD



## Leisure

### Commentary

Winter 2003 and the start of 2004 has been a fairly quiet time in the corporate leisure market compared to the frenetic activity that took place during the majority of last year.

The introduction of Stamp Duty Land Tax (SDLT) will have an adverse impact on the leisure sector as long leases suit occupiers keen to amortise high initial outgoings over a longer period. As lease terms become shorter with less instances of guaranteed rental growth, we expect some investors to become more cautious in their approach.

Sale and leaseback transactions will be exempt from SDLT as this would effectively be double taxing a single transaction.

The other government led change that is expected to take place in 2004 is the restriction of A3 use class to restaurants and cafes, reducing the flexibility of pubs and bars to adapt to customer demands.

### Corporate activity

The biggest news is the potential takeover of ASK restaurants (operators of the ASK and Zizzi brands with over 160 outlets). The Restaurant Group

(operators of Garfunkels, Caffe Uno, Est Est Est, Chiquitos and Frankie & Benny's) are competing with TDR Capital (owners of Pizza Express), with the deal valued at £170m.

After its successful acquisition of Scottish & Newcastle Retail, The Spirit Group has announced that it is considering carrying out a sale and leaseback on approximately £600m worth of pubs. It is not currently clear whether this will be in one package or split into smaller portfolios.

Other pub news was the acquisition of Pubmaster by Punch for a reported £1.2bn at the end of 2003. This virtually doubles the size of the company to around 7,350 leased and tenanted pubs.

### The investment market

As a result of the recent fall in finance rates, prime yields have strengthened again to sit in the 6% to 6.75% range with the strong auction market for A3 units underpinning these prices.

With SDLT having been in effect since 1st December 2003, we expect to see average lease terms on new lettings in the leisure market fall to 15 years. Whilst this reduces the short term appeal for investors, long leases may become scarce and sought by investors.

“Recent and forthcoming legislation will have a major impact”

### Recent leisure investment deals

Source: Gerald Eve

Property	Location	Tenant	Passing Rent (£)	Sale Price (£)	Yield (%)
Quebecs	Leeds	Quebec Town House Hotel	221,500	3,650,000	6.07%
Griffin	Church Road, Reading	Chef & Brewer	130,000	1,955,000	6.65%
45 Lavender Hill	Battersea	Regent Inns plc	123,917	1,900,000	6.52%
10 Canal Street	Manchester	Lyceum Restaurant Co Ltd	110,000	1,680,000	6.55%
Malvern Tavern	Southampton	Chef & Brewer	93,700	1,500,000	6.25%
The Griffin	Warmley, Bristol	Chef & Brewer	95,820	1,425,000	6.72%
Bar Oz	Bayswater	Chef & Brewer	68,500	1,400,000	4.89%
Copperfield	Catford	Chef & Brewer	83,111	1,265,000	6.57%
Prince	High St, Crowthorne	Chef & Brewer	70,000	1,120,000	6.25%
Ossington	Newark	Provence Ltd	71,900	1,050,000	6.85%

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