

Economic overview

There are tentative signs that the structural imbalance between consumer and corporate sectors is being rectified

Property overview

We forecast total returns of 7.9% in 2003, up from 6.5%, which was our January figure

Office

The sector is forecast to underperform in the short term before a recovery in rental growth

Retail

Retail is forecast to be the top performing sector in 2003, notwithstanding a slowdown in consumer spending

Industrial

The sector is forecast to be the top performer in 2004

Leisure

Polarisation in the investment market is expected to continue

Property Investment
Market

Summer 2003

inv**brief**



GeraldEve

Economy

Recovery in growth

GDP growth in the first quarter of 2003 dropped to 0.1%, its weakest level since the recession of the early nineties. However, service sector survey data suggests a stronger performance in the second quarter. The year-end forecast for 2003 is 2.1%, according to Business Strategies, compared to 1.9% in 2002, though the Treasury survey of independent forecasts is less bullish with a year-end forecast of 1.8%.

Whilst London's economy slipped into technical recession in the first quarter of 2003, and underperformance is expected for the rest of the year, recent evidence suggests a turnaround. The Royal Bank of Scotland reported that London's output growth in June outperformed the national average for the first time since November 2002.

There was increasing evidence of a slowdown in household spending in response to weaker disposable income growth and housing market activity. Meanwhile corporate investment shows signs of improvement, though growth rates are forecast to be subdued until 2005. As such, it does appear that the slow process of readjustment in the structural imbalance in the economy is commencing.

Prospects for the global economic recovery remain uncertain, with consensus forecasts for 2003 US growth marginally above 2%, which is well below the long-term trend, whilst the eurozone is forecast to see just 0.9% growth.

Base rates

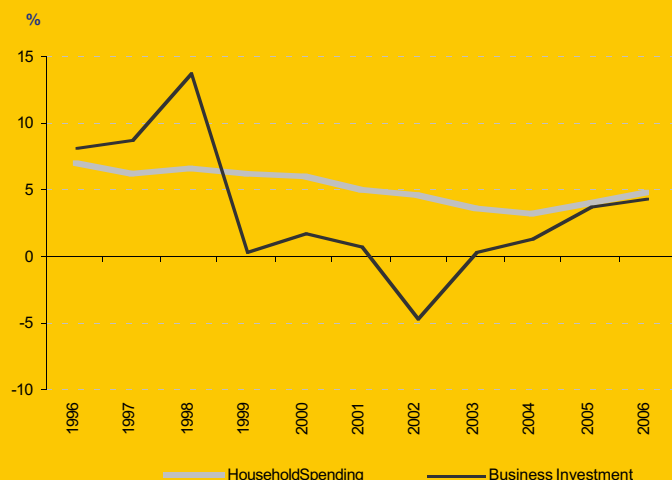
Although inflation remains above the long-term government target of 2.5%, the base rate was cut to 3.5% in July. The MPC voted 8 (including Mervyn King) to 1 in favour of a cut. The subdued nature of global economic recovery was a key factor in the decision, combined with a partial reversal of the slide in sterling's value. The Council of Mortgage Lenders stated that it was unlikely to further stimulate demand for mortgages. The UK base rate is now 1.5 percentage points above the euro-zone level and some economists are now forecasting that the MPC will cut again this year.

The harmonised measure of inflation, HICP, which is set to be the MPC's target for inflation from November, fell to 1.1% in June. This lies below its likely target rate of 2%, unlike the current RPIX measure, which is above its target. Furthermore, if the new measure was adopted in wage settlements, consumption growth would drop. Thus, the MPC may be prompted to cut rates more quickly under the new measure.

“We see an increasing likelihood of a further cut in the bank base rate in 2003”

Twelve-month business investment & household spending growth

Source: National Statistics, BSL Ltd



“UK institutional investors and property companies continue to dispose of central London office stock”

Property

Performance

Property total returns (2.7%) outperformed gilts (1.9%) in the second quarter of 2003 but failed to match equities (14.5%), which continued to recover strongly. On a twelve-month basis, property total returns stood at 10.3% in June, according to IPD. The growing disparity in sector performance is illustrated by the fact that retail produced higher total returns in the second quarter (3.7%) than offices in the twelve months to June (3.2%).

All property twelve-month rental growth remains on a downward trend and stood at -1.6%. There are, however, signs of stabilisation as the RICS reported the slowest decline in demand for commercial property in over a year in its second quarter market survey.

Stamp duty boost

Property's performance in the second quarter was boosted by the abolition of stamp duty in so-called 'disadvantaged areas' in the April Budget. Property saw capital value growth of 0.9% in the second quarter of 2003, compared to 0.2% in the first quarter according to IPD. The change affected prime locations such as parts of central Birmingham, Leeds and Docklands. However, it has only been approved until 2006 when a review of European Union

state aid rules is planned.

Net investment

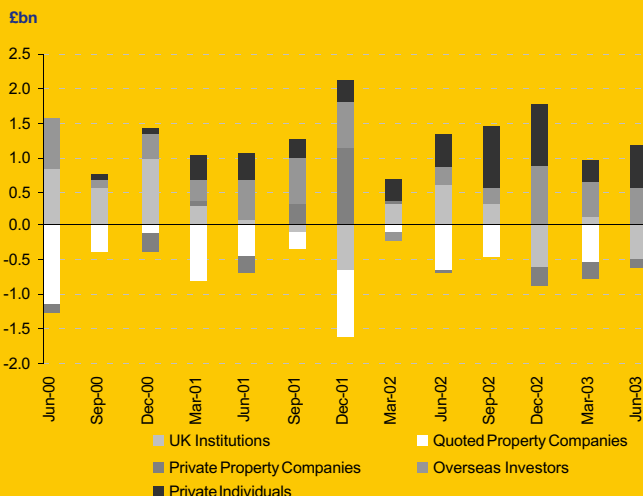
Overseas investors and private individuals constituted virtually all net investment in the second quarter. German open-ended funds continue to receive large cash inflows and remain especially active in the central London office market. DEKA's recent purchase of Salisbury Square House, EC4 for circa £65m, reflecting a yield of 6.75%, illustrates this trend. Private investor syndicates continue to be active with aAIM acquiring 70 Gracechurch Street, EC3 for £160m in one of the year's largest City investment deals. The deal also illustrates the large discounts that are being applied to vacant property in many areas of the market. The now fully-let building was bought in June for £115m when vacant.

UK institutional funds are not committing capital to direct property as they continue to anticipate a recovery in the equity market. Another factor is the commitment of funds to indirect property investment vehicles. In 2002, insurance companies committed £1.2bn to limited partnerships, compared to £5.4bn for direct property.

The UK funds have, however, been active in the out-of-town retail and industrial sectors recently. Both retail and industrial sectors saw net

Net property investment

Source: Property Data



investment by UK institutional funds in the second quarter of 2003. The overall trend though remains dominated by the central London office market where funds continue to take advantage of strong demand by selling.

Finance rates tick up in July

The 5-year swap rate stood at 4% in mid-July, which is a 2.8 percentage point discount to the all property initial yield. The 5 to 15 year gilt yield dropped to 4.2% in June, which was a record low, though July has seen an upward move. This trend may be reinforced by increased levels of gilt issuance in the wake of disappointing public finance figures recently.

Nevertheless, the auction market received a boost from the cut in base rates. This area has seen a recent influx of investors wary of the buy-to-let residential market. Subsequently, auction yields are reported to have fallen from 7.6% in March to 7.5% in June, according to ARAS. This is only a 0.7 percentage point premium to the institutional yield.

The auction market is also widening in terms of sector activity from the traditional focus on retail. Industrial and office deals in the first half of 2003 (£113.8m) have already exceeded the total for 2002 (£94.7m). This, facilitates portfolio rationalisation by the funds.

All Property twelve-month forecasts

Total Return (%)	
2003	7.9
2004	7.1
2005	8.6
3-year annualised	7.9
Rental Growth (%)	
2003	-1.6
2004	-0.7
2005	0.4
3-year annualised	-0.6
Capital growth (%)	
2003	1.0
2004	-0.4
2005	1.2
3-year annualised	0.6

Source: Gerald Eve Research

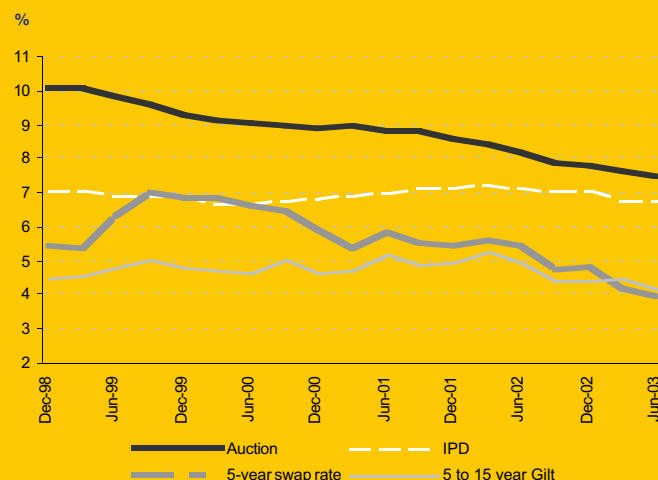
We have increased our year-end total return forecast from 6.5% to 7.9%. Factors driving this increase included a benign financing environment and resilience in the retail sector's investment market in the face of an anticipated slowdown in consumer spending. The 3-year forecast annualised rate of 7.9%, falls below the level seen in the three years to 2002 (8.9%).

Positive rental growth is not forecast until 2005, which is reflective of weak corporate activity and a deflationary environment on the high street. Investor demand, however, remains resilient with capital growth of 1% forecast this year.

“Our total return forecast for 2003 has been raised from 6.5% to 7.9%”

Yields & finance rates

Source: IPD, ARAS, CLP Finance



Office

Investment performance

Twelve-month total returns stood at 3.2% in June, according to IPD. The Central London market continues its downward trend, slipping below zero in June (-0.5%) for the first time in over ten years.

Occupier update

Despite rising levels of available stock in major provincial markets since the start of the year, twelve-month rental growth rates in regions outside the south east of England were marginally positive in June, according to IPD.

Whilst demand for prime stock across many locations remains subdued, activity in secondary areas remains less affected. Government departments and quangos support the market for medium-sized units whilst demand for larger sized units of 40,000 sq ft or above is weak, as the corporate sector remains inactive.

In the City of London, the vacancy rate continues to rise as the market is expected to remain oversupplied until at least late 2005. In a rare large unit letting, White & Chase pre-let 100,000 sq ft at Lion Plaza, EC2 in June at a rent of £50 per sq ft with a rent-free period of 4 years, illustrating the widening headline-net effective rent gap.

Investment activity

Whilst UK institutional funds remain cautious, some have sought stock with shorter leases yielding in excess of 8%, in response to aggressive bidding by foreign funds and geared investors for units offering long term income streams.

Private Irish clients have become more active in the regional office market in recent months. This is exemplified by the purchase of Direct Line House, Livery Street, Birmingham for £24m, reflecting a yield of 5.7%. The unit was eligible for stamp duty exemption.

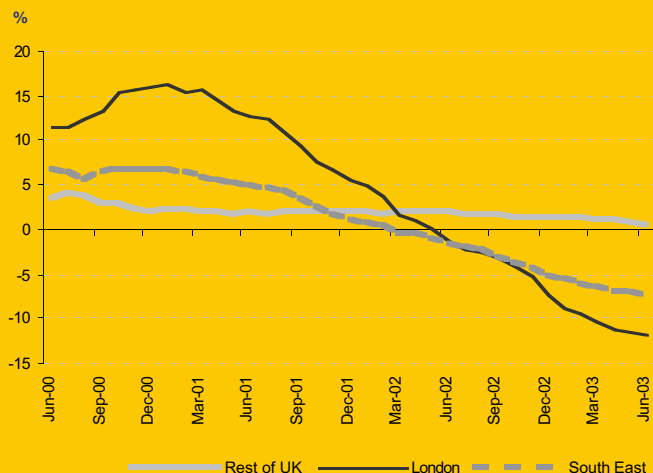
The outsourcing of corporate occupier services, particularly by government departments, will lead to investment opportunities in areas outside the institutional mainstream market. Such stock should appeal to geared purchasers who place less emphasis on location and rather more on the quality and security of income stream.

In central London and the South East, twelve-month capital growth stood at -7.2% and -6.3% respectively, in June. Debt-driven investors are exposed to the risk that falls in capital value will require them to inject more equity to meet loan-to-value covenants. With nearly 50% of loans to commercial property scheduled for repayment within 5 years, according to De Montfort University, there is an increased risk that the amount of

“Investors in central London markets are becoming more conscious of residual value risk ”

Twelve-month rental growth

Source: IPD



residual debt outstanding at the end of the original loan term rises to the point that it exceeds the value of the property. Provincial markets are less exposed to this risk as capital growth was 0.4% in June.

In the City of London, the weak tenant market continues to adversely affect the valuation of properties with voids as exemplified by the sale of the refurbished 85 Gracechurch Street, EC3 which has three floors vacant. This property, purchased by Britannia three years ago for £27.8 million, has been sold to an overseas investor for a figure in the order of £22 million.

Demand for properties with medium-term income streams remains robust, though they are increasingly conscious of residual value risk. Subsequently, yields must reflect a level of amortisation. This was evident at 42 Southwark Bridge Road, SE1, a property let to Schroders for 10 and a half years. The rental reflects approximately £25 per sq ft overall and the building was purchased for a figure in the order of £30 million by an overseas investors, reflecting a yield of 7.85%. Gerald Eve advised the purchaser. In the West End, demand for well-let stock continues to strengthen, exemplified by Steel House, SW1. It was bought by private Irish investors for £31m, reflecting a yield of 5.5%.

Office twelve-month forecasts

Total Return (%)	
2003	1.8
2004	4.0
2005	8.1
3-year annualised	4.6
Rental Growth (%)	
2003	-7.9
2004	-4.0
2005	-0.6
3-year annualised	-4.2
Capital growth (%)	
2003	-5.3
2004	-3.5
2005	0.2
3-year annualised	-2.9
Source: Gerald Eve Research	

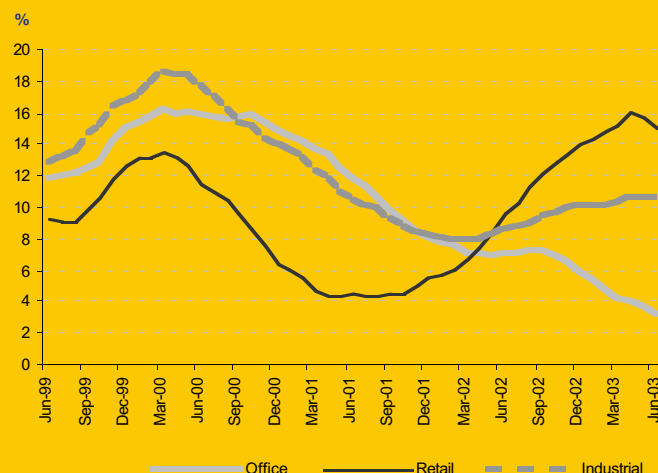
With business investment remaining subdued, we do not foresee positive office rental growth over the period to 2005.

The 3-year annualised forecast total return of 4.6% is some way behind the figure for three years to 2002 (8.7%). Total return performance is impaired by the weak occupier markets in the Thames Valley and central London in the short term. A strong recovery is anticipated in central London in 2005, in response to an upturn in the investment cycle. Regions in the Midlands and North are forecast to produce less volatile growth rates.

“The office sector is forecast to lag behind retail and industrial”

Twelve-month total returns

Source: IPD



Retail

Strong performance continues

Twelve-month total returns stood at 15.2% in June, according to IPD. Capital growth continues to provide an important impetus to performance, with twelve-month growth of 7.9%, whilst rental growth was 2.4%.

Whilst high street price growth remains subdued, the June British Retail Consortium shop price index reported its fastest rise (1.3%) since it began in 1998, as retailers offered less aggressive discounts than in last year's summer sales. Nevertheless, consumer spending is expected to weaken as we move into 2004.

Overall, rental growth prospects for prime in-town stock are constrained. Margin pressure will continue to force retailers to take larger units in secondary locations or retail warehouse schemes where higher sales volumes can be generated by increased floorplates. Furthermore, the government's desire to see retailing in town centre locations will lead to an additional 23m sq ft of new town centre development opening in the period to 2008, according to Colliers CRE.

Twelve-month Central London high street rental growth was negative

(-0.5%) in June for the first time since 1994. On Oxford Street, five flagship units are currently available, including the former Vodafone unit in a prime location. This reflects an increased cost consciousness amongst retailers. Luxury retailers in Bond Street have inevitably suffered in the light of a fall-off in tourist trade and City redundancies and several retailers are taking landlords to arbitration to settle disputes regarding rental increases.

The RICS report the strongest increase in tenant inducements in London in their second quarter market survey. In yet more evidence of a slowdown in the capital, Focus reported a 5% fall in occupier demand in London in 2003, compared to a marginal increase in the whole of the UK. This may represent the first phase of a ripple-out effect across the UK as consumers rein in spending.

The 1.2m sq ft Bullring shopping centre opens in Birmingham in September and is now 95% let. This has resulted in a number of units becoming available in existing prime areas of the city. In many of these cases, landlords have been required to offer incentives.

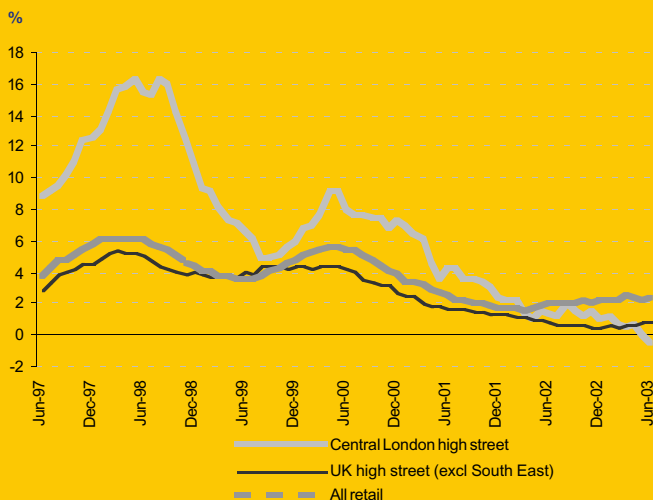
Investment

Whilst our opinion of the prime shop yield remains unchanged at 5.5% since September 2002, downward pressure is

“Central London rental growth continues to weaken more sharply than in other areas”

Twelve-month rental growth

Source: IPD



growing. Reflecting the strength of geared investor demand, the auction yield for prime retail stock stood at 5.9% in June, according to ARAS, compared to 6% for the IPD retail sample.

The preponderance of geared investors acquiring high street stock exposes certain areas of the market to interest rate risk. This is particularly applicable to units in regional markets that are being sold at sub-5% yields. Geared purchasers are taking advantage of the fundability of stock, but have less regard for medium-term rental growth prospects or residual value risk.

Despite the difficulties in the central London occupier market, twelve-month total returns stood at 10.7% in June. Investors have targeted retail in the face of poor performance in the office sector and this area of the market is obviously benefiting from this trend.

Retail warehouses

Whilst the sector has benefited from retailers' desire to increase efficiency by increasing floorplate size, there has been evidence that retailers are baulking at asking rents on some prime schemes. The retail warehouse sector continues to offer the best performance of all, with a total return of 16.8% in June. The strength of investor demand is illustrated by the reliance upon capital growth, which was 10.2%.

Retail twelve-month forecasts

Total Return (%)	
2003	11.7
2004	8.1
2005	8.8
3-year annualised	9.5
Rental Growth (%)	
2003	2.4
2004	1.4
2005	1.0
3-year annualised	1.6
Capital growth (%)	
2003	5.2
2004	1.6
2005	2.1
3-year annualised	3.0
Source: Gerald Eve Research	

Rental growth is set to fall sharply in 2004 and 2005 in response to the slowdown in consumer spending.

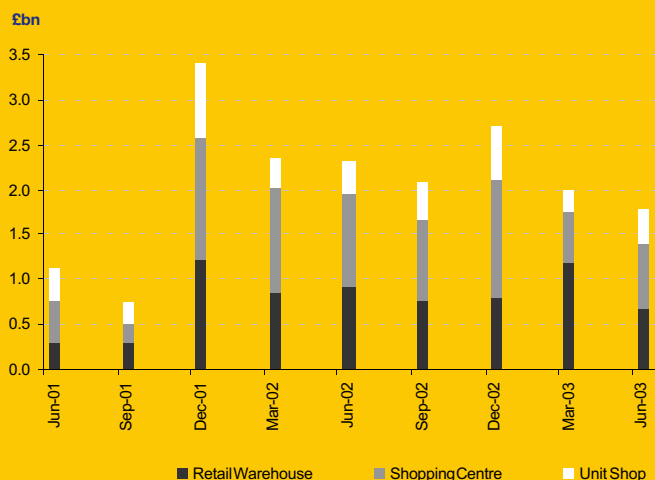
Next year, interest rate increases are expected to adversely affect capital growth.

We forecast that retail will provide the best performance in 2003 and over the three-year forecast period. The strength of investor demand, which drove performance last year, has not yet abated. Despite the anticipated consumer slowdown, the 3-year annualised forecast (9.5%) exceeds the rate for the 3 years to 2002 (8.7%).

“Retail is forecast to be the top-performing sector again in 2003”

Retail investment activity

Source: Property Data



Industrial

Resilient performance

Twelve-month total returns were 10.7% in June, according to IPD. Rental growth slipped to 0.3%, its lowest level for 7 years.

Demand for freehold property is likely to remain strong with the abolition of stamp duty in disadvantaged areas, such as around Birmingham.

Subsequently, agents report that the majority of enquiries are now for freehold rather than leasehold stock. The trend has so far applied to smaller units of circa 25,000 sq ft but demand is becoming more evident for larger units.

Development schemes financed by institutional funds continue to demand leases of around 15 years, which does not accord with occupier requirements for flexibility. Rental premia continue to be demanded by landlords in exchange for shorter leases. This results in occupiers taking secondary space where lease requirements are met.

Despite increasing lease flexibility and incentive packages, asking rents remain under intense pressure, even in the South East. Landlords have been increasingly willing to compromise covenant strength in order to maintain an income stream.

Industrial twelve-month forecasts

Total Return (%)	
2003	9.5
2004	8.4
2005	8.9
3-year annualised	8.9
Rental Growth (%)	
2003	0.1
2004	0.3
2005	1.0
3-year annualised	0.5
Capital growth (%)	
2003	1.4
2004	0.3
2005	0.6
3-year annualised	0.8
Source: Gerald Eve Research	

A recovery in the manufacturing sector is expected to provide an underpin for the market. Rental growth, however, is inhibited by an over-supply of space in the north and cost-consciousness of occupiers in the South East.

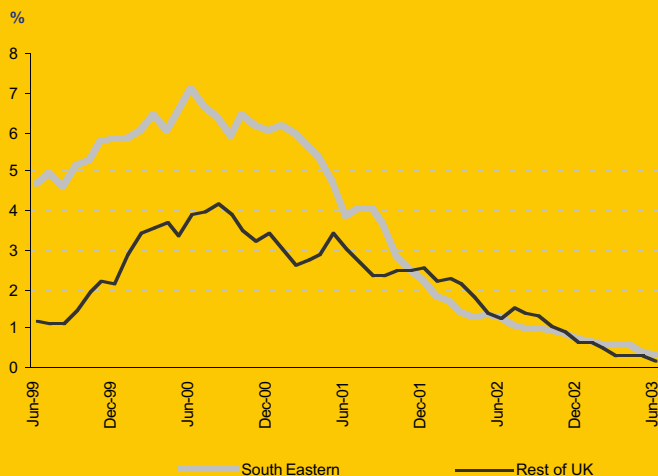
Despite the low rental and capital growth rates, total returns over the forecast period are relatively strong, reflecting the substantial income return.

In historic terms, the 3-year annualised forecast total return (8.9%) underperforms the equivalent period to 2002 (10.9%).

“Whilst rental growth is forecast to be subdued, the substantial income return will compensate investors”

Twelve-month rental growth

Source: IPD



Leisure

Recent recovery in activity

The second quarter of 2003 has seen a slowdown in the hotel and leisure markets relative to the last 18 months. However, recent weeks have seen the levels of activity rising again, with private investors in the auction room in particular keeping the market buoyant.

Lenders have been reducing gearing levels on many non-prime leisure products. This has resulted in investors inputting higher levels of equity than in other markets. The Bank of England's recent decision to cut the base interest rate to 3.5% should help to rekindle activity in the leisure investment market. Subsequently, there should be more good deals to be done in this sector over the coming months as the leasehold occupier market remains steady and long lease terms with guaranteed rental growth continue to be the norm on new lettings.

Private investor activity

The benign financing environment continues to drive the continuing appetite for private investors in the leisure market. This was illustrated recently with the portfolio of five pubs held in a joint venture between British Land and Scottish & Newcastle and let on leases to Chef & Brewer (guaranteed

by Scottish & Newcastle) realising a combined total of £7.2m. This is well above original estimates, which were in the region of £6m. The largest single unit was the Queens Hotel in Crouch End, N8 which was sold for £2,100,000 off an income of £126,000 (£28,000 pa coming from a separate letting of the residential upper floors) reflecting a gross yield of 6%.

Finance rates

Reduced interest rates have pushed yields on good quality A3 units down into the 6-7% range, with some auction properties achieving yields of sub-6%. However, the fickle nature of the market was demonstrated at another auction with a portfolio of 17 Little Chef restaurants being offered, only 8 of which reached their reserve prices. However, the lots sold reflected strong yields of between 6% and 6.4%.

We expect polarisation in the market between prime and non-prime stock to continue with yields on the best hotel and leisure opportunities holding firm. The continued reluctance of debt funders to lend on non-prime opportunities means that yields on these properties look set to move out. However, as stated previously, this should mean attractive returns for opportunistic investors with higher levels of equity to invest.

“Polarisation between prime and non-prime stock became more evident in the investment market”

Recent leisure investment deals

Source: Gerald Eve

Property Type	Property	Tenant	Price (£m)	Yield (%)
Cinema & Public House	7 Renfrew Street, Glasgow, G2	UGC Cinema & Regent Inns	20.65	6.3
Roadside Restaurant	Burger King, 276 Stratford Road, Solihull, B90	Burger King Ltd	2.26	7.4
Restaurant/Public House	25-29 High Street, Guildford, GU1	Mitchells & Butlers Retail Ltd	2.13	6.1
Public House	Queens Hotel, Broadway Parade, Hornsey, London, N8	Chef & Brewer Group	2.10	6.0
Leisure Park Restaurant	Carr Road, Peterborough, PE1	Pizza Hut (UK) Ltd	1.67	5.7
Public House	Hogshead, 120-123 Oxford Street, High Wycombe, HP11	Laurel Pub Co Ltd (AGA Whitbread Group plc)	1.58	6.0
Restaurant/Public House	22-28 Lloyds Avenue, Ipswich, IP1	Pizza Express & Whitbread plc	1.50	6.0
Restaurant	46 Hampstead High Street, London, NW3	McDonald's Property Co. Ltd	1.40	6.1
Roadside Restaurant	Little Chef, North Orbital Road, St Albans, Herts	Travelrest Services Limited	1.32	6.1
Public House	Kings Arms, Church Road, Sandford-on-Thames, OX4	Chef & Brewer Group	1.28	5.1

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