

September 2009

## UK Real Estate Quarterly: Q2 2009

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### Summary

This quarterly review of the UK's property market includes an economic outlook covering the latest events in the macro economy before covering the fundamentals of the real estate markets and the capital markets. This includes both a review of the second quarter and an overview of our latest forecasts for the markets. The 'Research Topic' section explores a real estate related issue in more detail each quarter, focusing on timely, relevant subjects and their likely impact on the UK real estate market. In this quarter, the topic focuses on office rents and highlights some of the current trends in the UK market and the likely implications for both existing landlords and potential investors.

Headline office rents across the UK reached a cyclical peak in Q4 2007 but, as the UK plummeted into recession in 2008, fundamentals across all sectors weakened as demand dropped away at an alarming pace. This has created an increasingly difficult environment for both existing landlords and potential investors. Existing landlords face the challenge of falling rents and rising vacant space, while potential investors face the difficulty of acquiring buildings where there is a greater prospect of over renting.

It is within this context that this quarter's 'Research Topic' section provides an overview of some of the key office market trends including the extent of reductions in asking rents, the impact of increasing incentives on effective rents and some of the key trends seen in UK occupancy leases over recent years. The section concludes by assessing the likely impact of these issues for both existing landlords and potential investors.

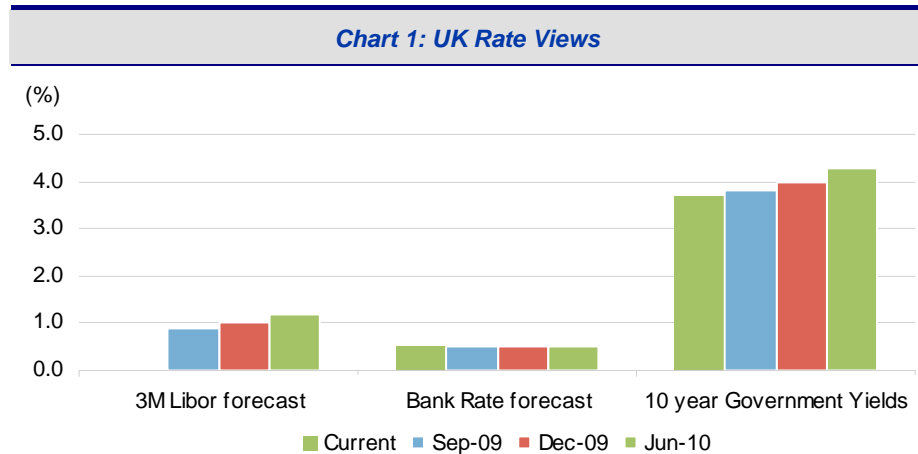
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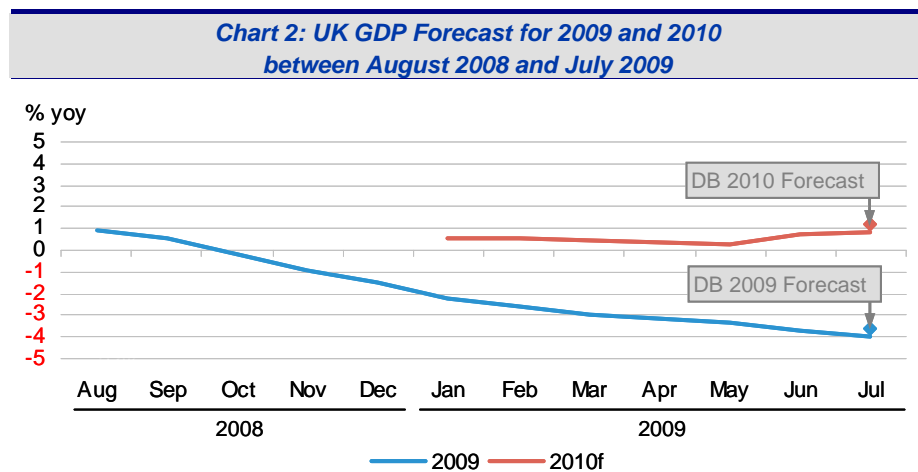
## 2. Economic Outlook

While the rate of decline in UK GDP slowed in Q2 2009, the Bank of England surprised the markets by extending its quantitative easing programme by opting to purchase a further £50 billion of bonds. The Bank appears unwilling to take any chances with the fragile recovery that is currently being seen. The Deutsche Bank (DB) Global Markets team<sup>1</sup> believe the impact of the extension may be that the Bank takes longer to raise rates; as Chart 1 shows they are forecast to remain at 0.5% until at least June 2010, but when policies are eventually tightened the rise in rates may be more substantial.



Source: DB Global Markets, August 2009

The magnitude and sustainability of economic growth in the second half of 2009 and into 2010 does therefore remain doubtful. DB<sup>2</sup> currently expects GDP to decline by 3.6% in 2009 followed by a return to weak growth of 1.2% in 2010. As Chart 2 shows, the consensus forecasts have struggled to keep up with economic developments.



Source: Consensus Economics; DB Global Markets, July 2009

f = forecast

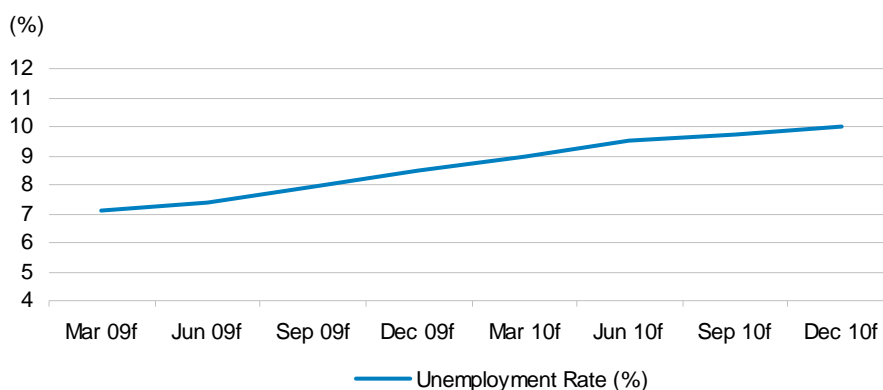
In this uncertain environment we remain cautious about the extent of any economic recovery and while 2010 is expected to see an improvement in most areas, recovery

<sup>1</sup> Deutsche Bank Global Markets Research, *Taking No Chances with Recovery*, August 2009

<sup>2</sup> Deutsche Bank Global Markets Research, *Focus Europe*, August 2009

is likely to be muted. While the Bank of England appears to be attempting to ensure the economy is capable of sustaining growth when its stimulus measures are withdrawn, this remains a major hurdle which still needs to be overcome. Of particular concern to both the general economy and the real estate markets are the expectation of further job losses and the limited availability and take up of debt finance. While unemployment to date has not risen as much as in the early 1980s and 1990s, possibly due to greater labour flexibility, further job losses are expected through 2009 and into 2010. This will continue to have a major impact on all the real estate sectors.

**Chart 3: UK Unemployment Rate (%)**



Source: DB Global Markets, July 2009

f = forecast

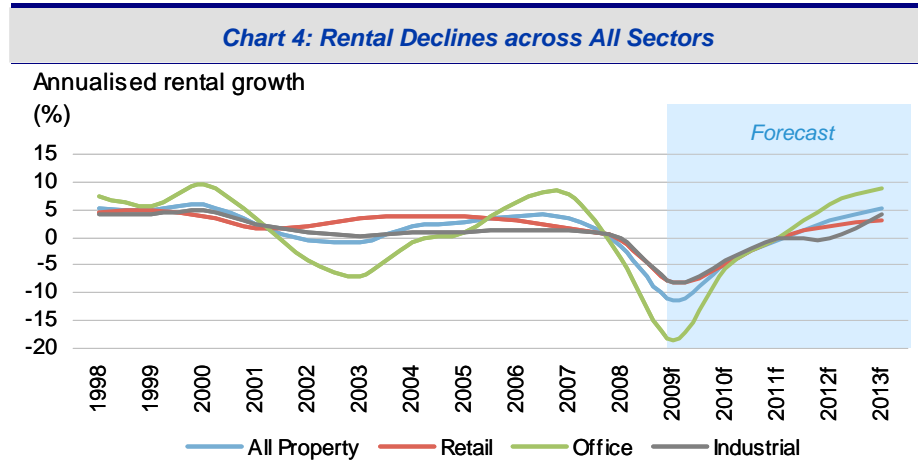
Recent survey evidence<sup>3</sup> has provided some cautiously encouraging signs for the industrial sector. Trade conditions appear to be improving with global trade ceasing to contract at the end of the first quarter in 2009. The quarterly rate of contraction in UK export volumes has improved from as low as -10% at the start of the year but trade continues to fall. Declines in industrial production have also moderated but remain negative.

The recovery of many key drivers for both the real estate occupational and capital markets is likely to take longer to materialise as unemployment, consumption, manufacturing, trade and the debt markets remain weak in the near term.

<sup>3</sup> Deutsche Bank Global Markets Research, *Caveats to Recovery*, June 2009

### 3. Market Fundamentals

As the UK economy endured another quarter of economic contraction, fundamentals across all property sectors continued to decline. At the end of Q2 2009 All Property rental value growth over the previous 12 months, as measured by IPD, had reached -7.4%<sup>4</sup>, down from -4.9%<sup>5</sup> at the end of Q1 2009. This trend is expected to continue through the remainder of 2009 as shown by our forecasts in Chart 4.



Source: Annual ERV growth is IPD, forecasts by RREEF Research, August 2009

f = forecast

IPD data<sup>6</sup> suggests office rents have been the hardest hit of the three major sectors to date and we believe this will remain the case with a 2009 office rental value decline expected to be around -17%. While office markets are suffering from reduced occupier activity the extent of rental value decline to date, and our expectation for the magnitude of the peak to trough decline through this cycle, varies considerably across the country. The City of London and West End markets have been at the forefront of the decline as occupier activity has been hard hit by both the credit crunch and subsequent global recession. Our current expectations are for prime headline rents to decline by 42% and 46% respectively from their peaks in 2007. As Chart 5 shows, the majority of this decline is expected to have been seen by the end of 2009, but in both markets rents are forecast to weaken further in 2010 before stabilising into 2011.

<sup>4</sup> IPD UK Monthly Index, June 2009

<sup>5</sup> IPD UK Monthly Index, March 2009

<sup>6</sup> IPD UK Monthly Index, July 2009

**Chart 5: Prime Office Rents**

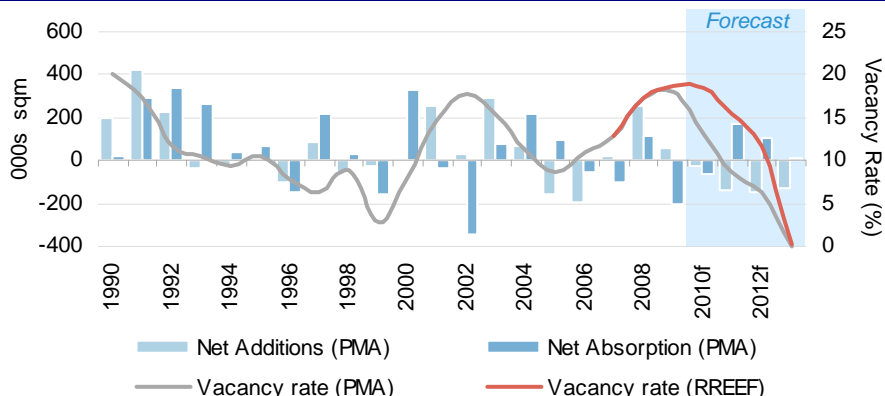


Source: History is CBRE, forecasts by RREEF Research, June 2009

f = forecast

While the sustainability and magnitude of the recovery in the UK economy will be crucial to restoring the demand side of market fundamentals, which have dropped away dramatically in this downturn, supply side fundamentals are expected to play an increasingly important role over the longer term in both major London markets. As has historically been the case, the West End currently has a relatively low level of development. In contrast, as Chart 6 shows, the City of London has a chronic oversupply of large units arriving on the market between 2009 and 2011. The absence of new starts - 2009 is expected to see just one new development initiated - will however filter through into negative net additions<sup>7</sup> in 2011-2013. It is quite feasible that development finance and fundamentals will remain weak for long enough to stretch this period of low supply further into the next decade. This is likely to result in a pick up in demand coinciding with a period of low new supply but high availability. As availability reduces, there should be scope for rental growth to return before another development cycle gathers pace.

**Chart 6: City of London Fundamentals 1990-2013**



Source: PMA; RREEF Research, July 2009

f = forecast

Elsewhere across the UK the picture of low levels of take up and declining rents typifies the office sector. Rental declines in 2009 are likely to be less severe than in the London markets and typically in the range of 10% to 20%. The Big 6<sup>8</sup> markets are

<sup>7</sup> Property Market Analysis, *European Office Occupier Forecasts*, April 2009

<sup>8</sup> Big 6 markets consist of Birmingham, Bristol, Edinburgh, Glasgow, Leeds and Manchester

expected to see further single digit rental declines in 2010 before largely stabilising in 2011. Many of these markets lack the fundamental drivers to generate a strong bounce back in rents in the outer part of the five year forecast.

Rents in UK shopping centres remain under pressure having started to weaken in 2008. While individual assets continue to see a wide divergence in performance, the IPD All Shopping Centre 12 month rental value growth index<sup>9</sup> currently stands at -6.4%. RREEF Research expects prime rents to decline by around 15% between 2008 and 2010.

The severity of the UK recession and the global slowdown in both economic growth and trade has had a major impact on industrial markets across Europe. In the UK leasing activity has been reduced but landlords who have been willing to negotiate and offer reasonable concessions have been able to close deals. Rents have come under downward pressure in 2009, with incentives also increasing significantly. This situation is likely to persist into 2010. While the performance of rents will differ markedly across the country, due in part to the oversupply of units in areas such as the Midlands and North West, even markets where fundamentals are better and long term drivers remain intact are likely to see rents decline by 10-15% through 2009 and 2010. Recent economic news has pointed to an improvement in a number of key industrial drivers but the economic environment remains weak and occupiers continue to take a cautious view in assessing their space requirements.

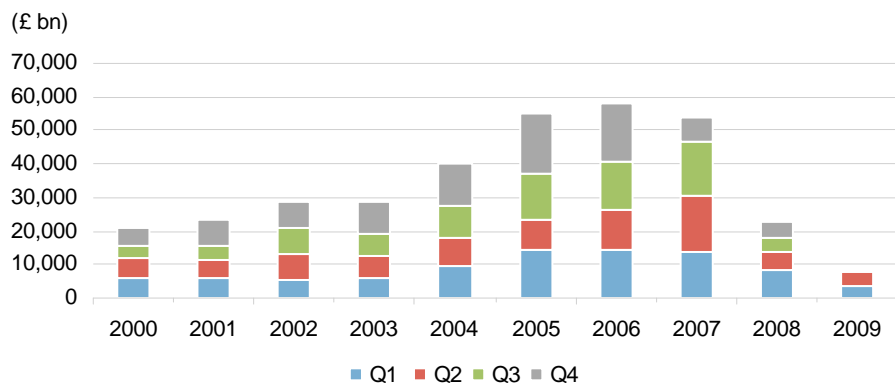
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<sup>9</sup> IPD UK Monthly Digest, July 2009

## 4. Capital Markets and Performance

UK investment activity in Q2 2009 totalled £3.7 billion<sup>10</sup> which was in line with the first quarter of the year but low compared to previous years. UK office property accounted for £1.65 billion<sup>8</sup> of investment activity which is up on Q1 2009 and in line with the longer term average as a percentage of all investment activity. While quarterly data can be easily skewed by specific transactions, office investment tends to be dominated by central London where, while the market remains thin and highly focused on specific products, there has been a noticeable increase in interest in good quality office units. With the UK institutions and REITs remaining net sellers through the year to date, second quarter office investment in London was dominated by overseas purchasers who accounted for 76% of the city's £1.37 billion of activity<sup>8</sup>. These purchasers are typically looking for buildings with attributes suitable to provide them with sustainable income returns. In a market where this type of product is not widely available, competition for prime units has caused yields for the very best product to compress marginally across the quarter. This situation is however very much confined to good quality, well located product with tenants deemed financially secure and with long unexpired terms on the lease.

**Chart 7: Investment Volumes**



Source: PMA, July 2009

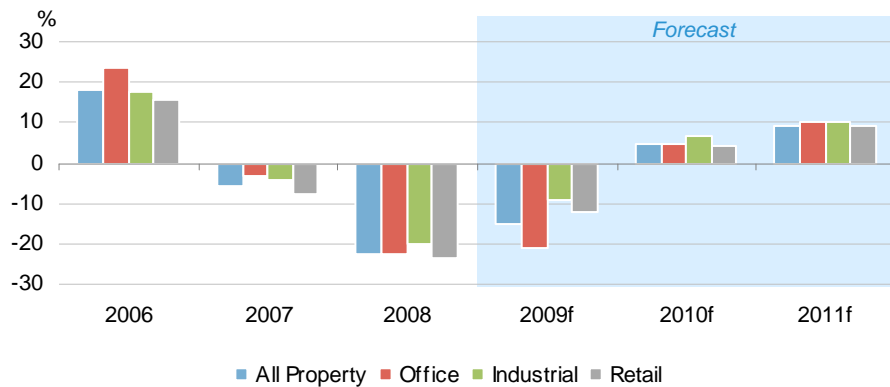
Unit shops continue to attract an above average proportion of all investment activity. With the exception of Q1 2009, this has been the case since the beginning of 2008. This is partly a result of their typically smaller lot size making them more liquid in the current environment. UK funds have also selectively taken the opportunity to acquire good quality, well located units at historically attractive prices as competition has been limited and the lot sizes are often too small for the major overseas investors. While in absolute terms investment activity in the industrial sector remains below the average level since 2000, the sector continues to attract a higher proportion of all activity than has historically been the case. The resilient performance of occupiers such as the supermarket chains remain attractive to investors who are looking for good quality property let to tenants providing strong covenants on long unexpired lease terms.

July 2009 saw the first positive monthly IPD All Property total return<sup>11</sup> since July 2007. The improved performance has been driven by a reduction in the pace of capital decline combined with an income return which on a 12 month basis has risen from 4.9% in mid 2007 to 7.5% in July 2009. While the rate of decline in UK values has slowed in recent months we still expect to see a further fall in value, driven largely by the extent of negative rental value growth.

<sup>10</sup> Property Market Analysis, July 2009

<sup>11</sup> IPD UK Monthly Index, July 2009

**Chart 8: Total Return Expectations**



Source: IPD; RREEF Research, August 2009

f = forecast

The UK investment market is now polarised between prime and non prime stock. Moreover what qualifies as prime, from a buyer's perspective, has tightened considerably as investors require good quality, well located assets with long unexpired lease terms let to tenants with strong covenants. Activity is picking up in the prime end of the market because investors are attracted to what they perceive to be secure income returns with limited near term expenditure requirements. Income returns are now high in both a historic context and in comparison to other major European markets. This is helping attract overseas capital to London. While the currency benefit, which was a further compelling advantage earlier in the year, has receded since the spring and hedging costs remain an issue, the UK is still a relatively attractive market at the current time. While investor interest does appear to be picking up, existing managers are generally reluctant to offer very prime products to the market as a sale is only likely to dilute the quality of the remaining portfolio. The end result is that when prime units are made available there are enough interested parties to make pricing increasingly competitive; this is resulting in a small degree of yield compression in the very prime end of the market. As the availability of this type of product is scarce, investors are beginning to show signs of relaxing their investment criteria marginally; this is typically being done by considering a slightly shorter unexpired lease term, rather than compromising on location, building quality or covenant strength.

The scope and volume of activity in the investment market over the medium term depends largely on the strength of any economic recovery and the ability of key market participants, such as the REITs and institutional funds, to re-enter the market. These investors are unlikely to return in any volume until fundamentals and pricing, across more than just the very prime segment, stabilise. At this point investors will be able to begin to consider a wider range of products which potentially allow asset management initiatives to be undertaken in future years when fundamentals are conducive to such activity. The ongoing rental declines do however remain a key barrier to such investors. Uncertainty about the extent of peak to trough value declines and the degree to which potential acquisitions may be over rented continues to be a major impediment to those looking for more than a predominantly income play. This situation is explored in more detail in Section 5 of this paper.

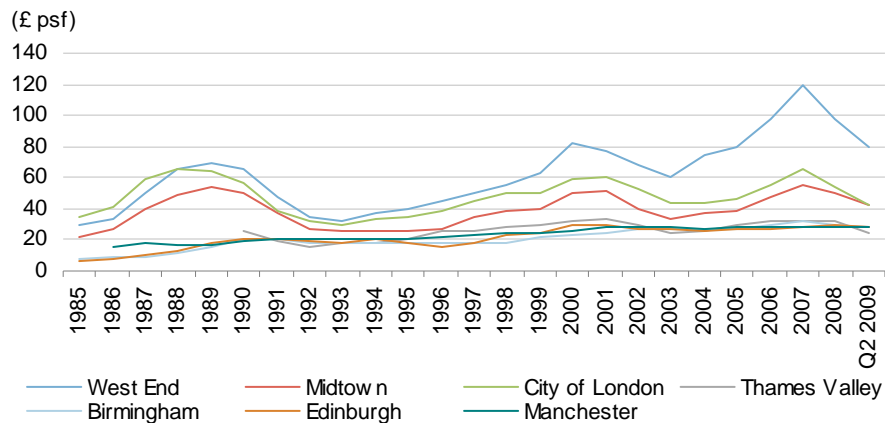
## 5. Rental Trends Through the Office Cycle

The topic covered in this section focuses on how rents and terms of occupancy in the office sector have changed through 2009 and our expectations for the key occupier related trends over the coming years. Our forecasts for prime headline rents across the UK have been outlined in the market fundamentals section. This topic explores the impact of declines in effective rents<sup>12</sup> and the implications of weakening fundamentals for both existing landlords and potential investors.

### Trends and expectations for the occupier market

Headline office rents across the UK reached a cyclical peak in Q4 2007<sup>13</sup>. The subsequent 18 months have seen a period of rental decline, albeit with significant differences in intensity across the UK markets. As Chart 9 shows, Central London has led the way with the general double digit growth seen in 2007 being replaced by double digit declines in 2008 and through 2009 to date. Elsewhere across the country, prime headline rents have started to edge lower across most regional markets but a general absence of transactions has made establishing market rents a difficult and more subjective task than in recent years.

Chart 9: Prime Headline Rents



Source: CBRE; RREEF Research, August 2009

### Asking rents

In markets such as the City of London, there is clear evidence that headline prime rents have fallen by almost 35% from their peak in 2007, but it is also likely that rents have fallen across all quality bands. ITK data<sup>14</sup> for 2009 highlights over 300 instances of landlords cutting asking rents within the City and City fringe market on a combined floor space of over 4 million square feet. When weighted by floor space, asking rents have been cut by an average of 17% from £44 per square foot to just under £37 per square foot. When considered by percentage decline in asking rent, the largest falls have generally been seen for cheaper floor space where the original asking price was under £30 per square foot. In some cases the reduction in asking rent has been extremely severe as landlords look to find tenants in order to avoid paying building rates. Where this has been the case owners have been prepared to offer extremely low rents, highly flexible terms or short leases.

Another noticeable trend through the first half of 2009 has been the reduction in asking rents on large units around the city. Asking rents were reduced on six properties where over 100,000 square foot was available and in all cases the

<sup>12</sup> The actual rental rate to be achieved by the landlord after deducting the value of concessions from the base rental rate paid by a tenant.

<sup>13</sup> CBRE, *ERIX – Global Research Portal*, August 2009

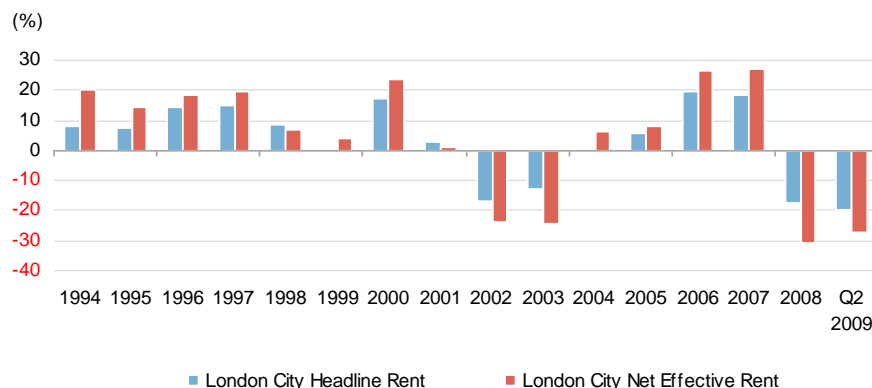
<sup>14</sup> Ingleby Trice Kennard, *City Floorspace Survey*, July 2009

magnitude of the decline (10-24%) will result in a loss in income of over £1 million per annum. This income loss comes before the impact of incentives that will further reduce the cash flow of the buildings. Five of these six properties are located within the EC2 (Bank-Moorgate-Liverpool Street) postcode where Drivers Jonas' recent Crane Survey<sup>15</sup> suggests 883,000 square foot of new speculative space arrived on the market between Q4 2008 and Q1 2009. A further 1.7million square foot of speculative space is still under construction in this area. This environment is making competition for tenants extremely intense at a time when the majority of potential occupiers are likely to be reducing head counts and looking to rationalise their property requirements. With the global financial crisis and subsequent global recession impacting typical City of London occupiers extremely hard, large floor plate requirements are likely to remain thin on the ground through 2009 and 2010. As a consequence, many of the schemes with available space that are still quoting headline rents in the mid to high forties are likely to have to reduce their asking prices further and incentivise tenants to vacate existing space in order to occupy their buildings.

## Effective rents

While headline rents in the City of London market have always been volatile, the presence of rent free periods as part of a typical lease agreement dramatically increases the potential volatility of rents on individual assets. While prime headline rents rose by 110% and 50% in the periods 1994-2001 and 2005-2008 respectively, effective rents rose 192% and 85% in the same period due to the contraction of rent free periods. As Chart 11 shows, the current downturn further demonstrates this volatility with effective rents currently 50% lower than they were at the end of 2007. Headline rents are down 34% in the same period.

**Chart 11: London City Rent Growth – Headline v Effective**



Source: CBRE; RREEF Research, August 2009

In the West End market, rent free incentives have generally been less prevalent but, according to CBRE<sup>16</sup>, the current rent free period of 21 months on a ten year lease matches the highest on record since 1993. Rent free periods in this market have averaged 12 months since 1993. This lower volatility has resulted in effective rents only marginally out and under performing headline rents in periods of growth and contraction respectively. While effective rents have historically fluctuated less around the headline figure than in the City market, top West End rents remain volatile as demonstrated by the 18% decline in rents during the first half of 2009.

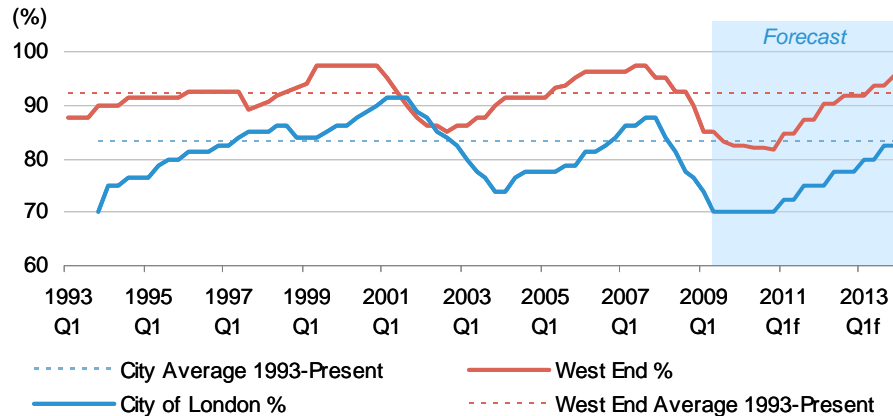
The large movement in rent free periods also creates significant variations through the rental cycles in the proportion of the headline rent a landlord is able to capture. In the City of London the average effective rent as a percentage of the headline since 1993 has been 83% with only limited periods existing when the net effective exceeds 90% of the headline. These points coincide with the peak of the market when landlords

<sup>15</sup> Drivers Jonas, *Central London Crane Survey*, Q1 2009

<sup>16</sup> CBRE, July 2009

have been able to command effective rents in excess of £50 per square foot over the course of a ten year lease. The volatile nature of the market means that periods tend to be short lived; in the previous cycle this environment lasted just six months in the second half of 2007. These golden periods for landlords have historically been followed by extremely rapid declines in effective rents which generate extreme challenges in being able to capture these cyclical peaks in market rents.

**Chart 12: Effective Rent as a Percentage of Headline**



Source: CBRE; RREEF Research, August 2009

f = forecast

At the other extreme, the CBRE data<sup>17</sup> highlights the issues landlords face when trying to let space into weak markets and just how poor the current market is. Net effective rents on a prime ten year lease in the City of London dipped below £30 per square foot in Q2 2009, the first time this mark has been breached since Q4 1995 . With 33 months rent free and a likely three month fit out period landlords are currently looking at sacrificing an unprecedented amount of time on a lease to secure a tenant. While landlords have been prepared to forego near term income, ahead of offering capital commitments, the cash flow impact is now so severe that it is difficult to see rent free incentives moving out further. While retaining cash remains a high priority for many managers the risk aversion is perhaps not as great as it was 3-9 months ago. Going forward we are likely to see greater concessions in areas such as funding basic fit outs, rather than sacrificing more income. This has been seen in recent deals with Estates Gazette highlighting the case of 107 Cheapside where the letting of 45,000 square foot on a 15 year lease to a US law firm at £42.50 per square foot included 18 months rent free but total incentives equivalent to 5 years rent free. How far landlords will be prepared to go in terms of contributing capital to secure tenants will largely depend on the quality of the prospective tenant and the length of lease being agreed. This means that for most tenants a basic fit out is still likely to be the extent of a landlord's commitment.

### Effective Rent Forecasts

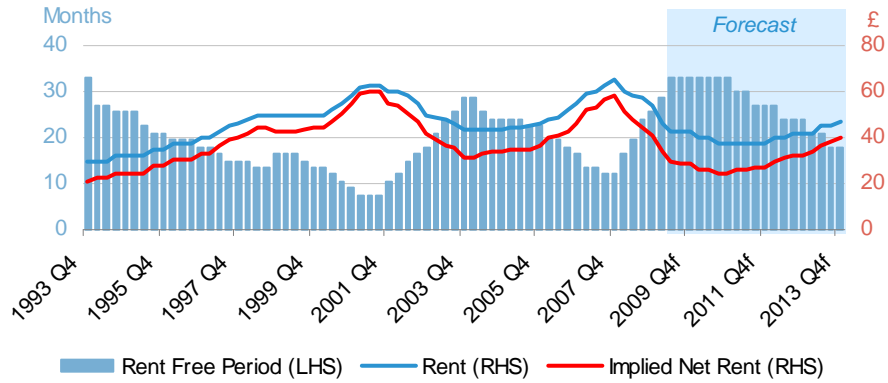
RREEF forecasts for City of London prime net effective rents over the next five years suggest that the majority of the rental value decline has already been seen, with incentives moving out from 12 to 33 months on a ten year lease and rents falling from £65 per square foot to around £45 per square foot. Despite this, rental declines are set to continue, with a trough not likely to be reached until the second half of 2010. From the low point of late 2010 our base case scenario suggests the recovery in headline rents will be slow to gather pace. This is consistent with the previous two City of London cycles where rent free periods have needed to fall to around 24 months before headline rent growth resumes in earnest. From this point rents have increased and rent free periods declined in tandem to generate the high effective rent growth rates mentioned earlier. Our current forecasts suggest that while headline rents in the City of London may rise 25% from 2011 to 2013, effective rents will see growth in the

<sup>17</sup> CBRE, July 2009

region of 65%.

In the City of London market, under our base case scenario, effective rents will be below their long term average (1993-present) throughout the next five years. The extent of rent free incentives currently available does however provide a significant upside scenario should incentives reduce more rapidly than forecast, as may be the case if an economic recovery gains substance.

**Chart 13: City of London Rent Forecasts**

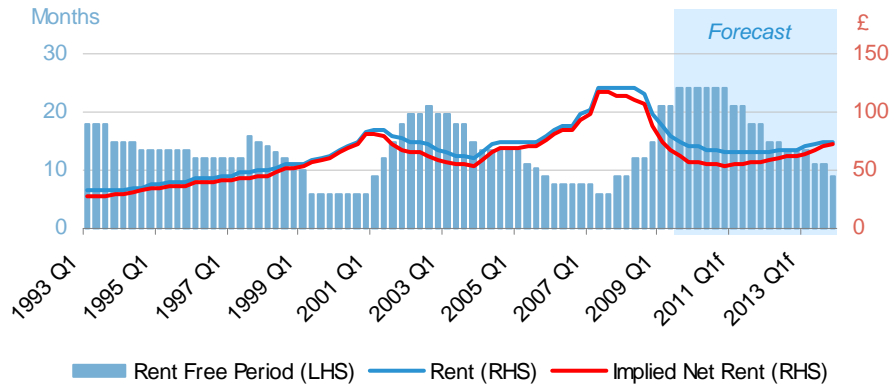


Source: CBRE; RREEF Research, August 2009

f = forecast

In the West End, effective rents have historically diverged less from headline numbers than in the City and we expect this to again be the case in this downturn. With rent free periods already at or even marginally above historic highs this downturn is expected to see a greater impact on effective rents than previous cycles.

**Chart 14: London West End Rent Forecasts**



Source: CBRE; RREEF Research, August 2009

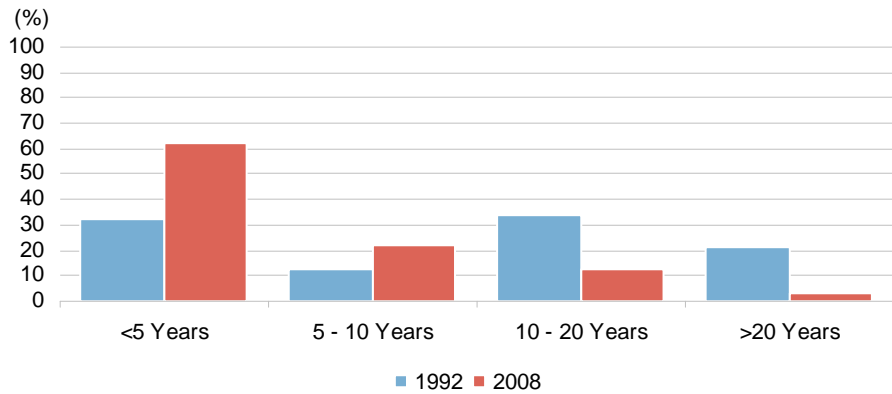
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## Lease Trends

Alongside the dramatic decline in rents, the recent IPD/Strutt & Parker annual lease review<sup>18</sup> highlights a number of trends which are likely to have a significant impact on the UK real estate market over the coming years. They include:

- An ongoing reduction in the unexpired lease terms (Chart 15);

**Chart 15: UK Offices – Unexpired Lease Terms**

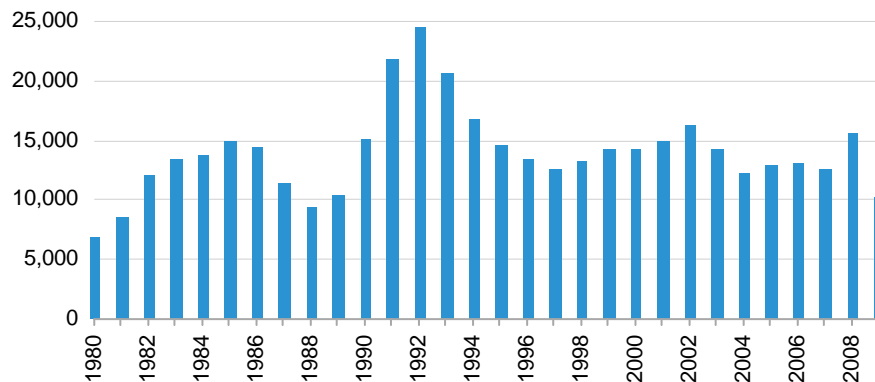


Source: Strutt & Parker / IPD, July 2009

- A lower proportion of office leases being renewed compared to the case with retail or industrial sectors;
- The majority of new lettings and renewals in 2008 achieved the same or higher rents. This is however unlikely to be the case through 2009-2010;
- In 2008 the propensity to break a lease was significantly reduced compared to previous years but the office sector saw a higher proportion of breaks than either retail or industrial;
- As shown in Chart 16, the rate of company liquidations rose in 2008 and liquidations have already exceeded 10,000 in the first half of 2009. Offices saw lower levels of defaults compared to retail or industrial, and
- The average office void length rose 44% in 2008 to 21.4 months.

<sup>18</sup> Strutt & Parker / IPD, *Annual Lease Events Review*, July 2009

**Chart 16: Company Liquidations**



Source: *The Insolvency Service, August 2009*

The first two points are particularly pertinent for the current market as both investors and landlords are currently looking for longer lease lengths in order to weather weak market conditions. Suitable assets are however quite scarce. With only around 30% of office leases being renewed, landlords face an increasing likelihood of their units falling empty on lease expiration. Compounding this situation is both the increasing number of tenant insolvencies and the increasing length of time it is taking to re-let units. For both these measures the data for 2009 is expected to be worse than that of 2008 which will make for an increasingly difficult environment for real estate investors.

## Implications

The current market fundamentals are creating a difficult environment for real estate owners and potential investors alike. From the landlord's perspective the emphasis is very much on retaining tenants and maintaining a dialogue with occupiers to allow proactive asset management to limit the impact of any lease event. Where the opportunity arises landlords are likely to be keen to re-gear leases, especially if it eliminates the risk of a near term break. As has been seen in the City market this year, landlords are prepared to work with tenants in order to retain them within their portfolio, even if it means making a short term sacrifice to close a deal.

In 2009 a number of cases have occurred where landlords and tenants are agreeing to more innovative terms which not only reflect the current environment (of giving tenants significant incentives) but allow landlords to structure a lease in a way that is financially viable from their perspective. This is typically being done by writing fixed uplifts into the lease agreement, which helps provide longer term viability to the cash flow.

With the IPD data suggesting lease expiries are likely to increase as terms are shortened; aggregate cash flows may be reduced over the coming years. This is likely to create a wider differential in performance between assets, with underperforming units becoming increasingly difficult to offload. If aggregate cash flows do decline, it may limit the scope for landlords to undertake building improvements and therefore their ability to improve the performance of a weak asset.

The importance of assessing over rented positions and the impact of more complex lease structures is becoming increasingly significant. With leases generally becoming shorter and in many cases more complex, properties are likely to become more difficult to value. This is likely to lead to greater diversity in investor's assessment of value, leading to a wider range of bids and potentially filtering through to transaction prices. The reduction in lease length has been an established trend in the UK over the last 15 years. At the current time, with lease length being so crucial in the investment appraisal, shorter leases are adding a notable yield premium to any potential deal and in many cases preventing a transaction taking place altogether. Over time, with long leases becoming increasingly difficult to source, market pricing is expected to adjust accordingly to recognise this established trend.

The over rented position of many properties is becoming an increasingly important issue as market rents continue to decline. Many overseas investors are currently looking to acquire units which provide long term cash yields which are attractive in comparison to most other European markets. While the investment case appears sound, the impact of an extraordinary event, such as tenant insolvency, could be terminal to the viability of a deal given the potential over rented position investors are assuming. As such the strength of covenant and leasing structure of the building (for example single or multi let) is currently of crucial importance and needs to be accurately reflected in the purchase price.

Acquiring an over rented property may not be the preferred option but it is likely to become increasingly common as market rents fall to levels not seen for years. Aside from pricing the deal appropriately, investors will require many other factors, such as location, building quality and tenant mix to be truly prime in order to mitigate the risk. This situation will rightly continue to encourage investors to focus largely on the core markets. However, as fundamentals stabilise through 2010, it is also likely to give rise to further opportunities for equity rich investors to buy over discounted prime stock with slightly shorter income profiles.

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