REAL ESTATE
INVESTMENT
MANAGEMENT

# UNITED KINGDOM

## REAL ESTATE PERSPECTIVE

4TH QUARTER 2008

Part of the M&G Group

PRUPIM

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## ABOUT PRUPIM

PRUPIM is one of the leading real estate investment managers in the United Kingdom. We form part of the M&G Group of Companies which is the asset management arm of Prudential plc in the UK and Europe.

We manage around US$37 billion of real estate assets, of which US$6 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with approximately 6,000 property occupiers.

We manage real estate investments for a wide variety of clients, providing core services and expertise in fund management, asset management and property management. These services are offered individually, or on a fully integrated basis.

Our major activities are driven by powerful research, managed by the Global Property Research Team. Our considerable scale and diversified activities allow us to draw on our own multi-dimensional inputs which give us an unrivalled information advantage.

We evaluate the macro-economic environment working as part of the global research capability of Prudential. We receive detailed property related data generated by our on-the-ground surveyors. This is fed into proprietary modelling systems which form the basis of our analysis.

The 10-strong Global Property Research Team was formed in 1987 and is comprised of property economists and performance measurement analysts who work together to provide leading property analysis and commentary on the UK and international property markets.


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Unless otherwise specified all data and commentary is as at end September 2008.

For further information please visit our website: **www.prupim.com**

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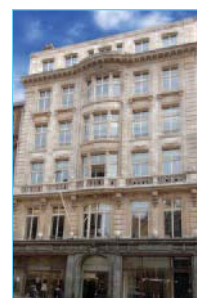

Washington House
London

# EXECUTIVE SUMMARY

## PERFORMANCE

- The third quarter of 2008 saw a reacceleration of the property market downturn, with the IPD Quarterly Index recording All Property returns of -4.8%, compared to -2.7% for the second quarter. On an annual basis, the 12 months to September saw a return of c.-17%, with capital growth of -21.5%.

- Occupier demand has weakened, causing rental growth to turn negative. The downswing of the rental cycle in the Central London office market is now fully in evidence, with the City seeing rental declines of almost 5% over the last six months. Industrials and retail have held up slightly better, recording quarterly rental growth of -0.1% and 0.1% respectively. All Property rental values fell by 0.2% over the quarter, taking rental growth to 1.2% for the 12 months to September.

## REVIEW

- The fallout from the credit crisis intensified as corporate failures and government bailouts reached unprecedented levels. GDP fell by 0.5% over the third quarter of 2008, and interest rates have recently been slashed by a total of 2%.

- Occupier markets are generally weakening as tenant demand comes under pressure. Across all sectors take-up levels are easing while void rates are rising. On the upside, the current cycle has not seen the same magnitude in its rental growth upswing as that seen in previous cycles; hence the downswing is not expected to be as severe as those seen in the past.

- Additionally, restrictions on lending are helping to curtail the development pipeline. With the exception of City offices, overall supply is not highly spiked. Unlike previous downturns, the UK property market is now entering an environment of under-demand rather than oversupply.

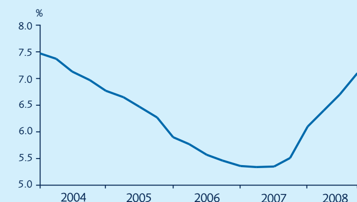
## OUTLOOK

- It is now generally accepted that the UK will experience a recession. Most expect it to last well into 2009, before relatively modest economic growth returns in 2010. Flagging consumer spending, a battered financial sector and weak construction and production output are all likely to contribute to the decline.

- The property market is clearly impacted by the deteriorating economy. On the occupier side, all sectors are now seeing the first evidence of falling rents, and the outlook sees rental declines gathering pace over the next year as the recession deepens.

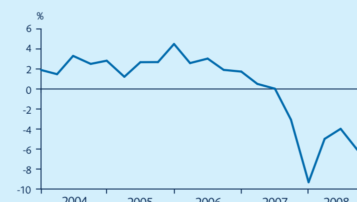
- Yields are expected to continue rising well into next year, though this will move property into positively "cheap" territory, with greatly improved longer-term return prospects. As such, the recovery period is likely to see high positive returns.

**IPD Equivalent Yield for All Property**



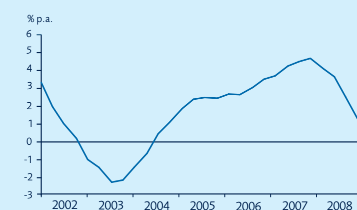

Source: IPD September 2008 (Quarterly Index)

**All Property 3-Month Yield Impact**



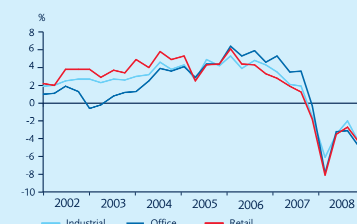

Source: IPD September 2008 (Quarterly Index)

**UK All Property Annual Rental Growth**




Source: IPD September 2008 (Quarterly Index)

**3-Month Total Return**



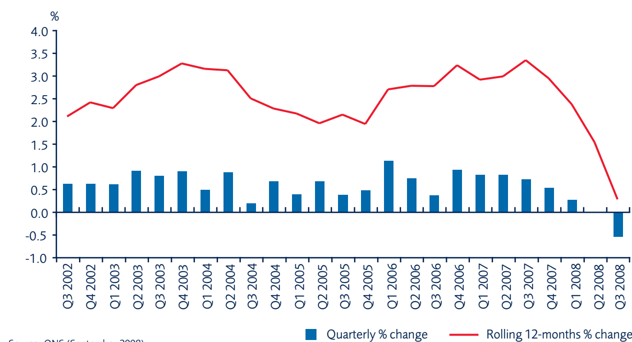

Source: IPD September 2008 (Quarterly Index)

# UK PROPERTY REVIEW

**The third quarter of 2008 saw a reacceleration of the property market downturn, with the IPD Quarterly Index recording All Property total returns of -4.8% over the quarter, compared to -2.7% for the previous quarter. The third quarter of 2008 alone saw capital values fall by over 6%, the largest quarterly decline since the final quarter of 2007. On an annual basis, the 12 months to September saw a return of c.-17%, with capital growth of -21.5%. This has been driven by yields rising by around 160bps since September 2007. Offices have been the poorest performing sector recently, while retail has held up slightly better.**

The deterioration in the economy has led to weakened demand for space from occupiers, causing rental growth, which was previously supporting capital values, to turn negative. The downswing of the rental cycle in the Central London office market is now fully in evidence, with the City seeing rental declines of almost 5% over the last six months. The industrial sector is also now seeing falling average rents, though at a much lower rate of -0.1% over the quarter. On the whole, the retail sector has held up marginally better, with quarterly rental growth still positive at 0.1%. In turn, All Property rental values fell by 0.2% over the third quarter of 2008, taking rental growth to 1.2% for the 12 months to September.

**UK Real Economy Contracts in Q3 2008**




Source: ONS (September 2008)

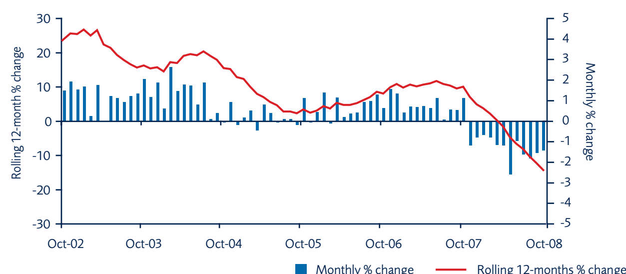
In the third quarter of 2008, the fallout from the credit crisis intensified; Western economies saw corporate failures and government bailouts reach unprecedented levels. Weaker service industries, construction, and production output caused UK Real GDP to contract by 0.5% over the quarter, after economic growth stalled in the previous quarter.

### "Unlike previous downturns.... the UK property market is now faced with the issues of under-demand rather than oversupply."

UK interest rates saw 50bps shaved off as part of a globally coordinated emergency response to economies teetering on the brink of recession. In a triumphant and deftly unexpected move, rates were slashed by a further 150bps in early November. The magnitude of this cut demonstrates how inflationary pressures have waned, and that central bankers understand the depth of concern about the current crisis. At 3%, rates are at their lowest level in more than half a century and are only 1% away from the all-time low of 2%.

The slew of news on the UK economy has been unrelentingly grim: falling house prices, weakening consumer expenditure, unemployment rising and industrial output contracting. As the focus of the credit crisis shifts to the effects on the real economy, the property market is also seeing attention diverted away from the yield decompression story, with the rental growth story stepping into the spotlight. With occupier markets weakening, expectations for rental growth are worsening in the short term as tenant demand comes under pressure. Across all the sectors, take-up levels are easing while void rates are rising and demand for space falls.

**12 Consecutive Months of House Price Falls**




Source: Nationwide (October 2008)

On the upside, the current property cycle has not seen the same magnitude in its rental growth upswing as that of previous cycles; the extent of this cycle's downswing is, therefore, not expected to be as severe as those seen previously. Additionally, one of the few positive effects of the current crisis is the restriction on lending, which is helping to curtail the development pipeline. Under current market uncertainties, schemes are either being delayed or developers are failing to acquire the level of funding required. With the exception of the City office market, overall supply is not highly spiked and is expected to fall back to slightly below historical averages after 2008. Unlike previous downturns, the nature of the current environment means the UK property market is now faced with the issues of under-demand rather than oversupply.

# UK INVESTMENT MARKET DYNAMICS

**Despite the substantial rises already seen, yields have continued to move out over the third quarter of 2008. Increases in transactional yields vary between 25bps to 75bps, depending on the sector. In part, this has been fuelled by concerns over deteriorating rental prospects. However, it is clear that many investors perceive there still to be better investment opportunities outside property and, although property is now at 'fair value', are in no rush to buy property when it is still relatively unattractive compared to other investable assets. In this environment, property yields are likely to drift higher.**

The market remains quiet, with levels of transacting around a third of that 12 months ago. Given debt is still difficult and expensive to come by, equity buyers dominate what market there is. Leveraged buyers are largely absent. Investors who do not need to refer to banks for funding can gain further discounts in the market. In an environment of greater caution and more due diligence by banks, deals dependent on debt are taking longer to complete and some are collapsing for want of bank support.

**IPF Consensus Forecasts Capital and Rental Growth % 2008 – 2010**

| | 2008 | 2009 | 2010 |
|---|---|---|---|
| Forecast Capital Growth | -15.7 | -5.5 | 1.8 |
| Forecast Rental Growth | -0.9 | -3.2 | -0.8 |
| Implied Yield Shift | +91bps | +14bps | -16bps |

Source: IPF Consensus Forecasts September 2008

Interestingly, there is a growing perception that, following recent price falls, UK property now stands as one of the most competitively priced markets globally. Perhaps it is not surprising, therefore, that overseas investors (Germans, Middle Eastern and some US opportunity funds) dominate buying activity. Domestic institutions remain the dominant sellers and, if retail fund redemptions pick up again, could continue to bring stock to market. Sovereign wealth funds still appear to be watching from the sidelines, not wanting to "catch a falling knife". However, as yields continue to rise, value is still improving, and soon will be in "cheap" territory. In this respect, once signs of stabilisation appear, it is anticipated that investors, both in the UK and overseas, will buy into the market to take advantage of the good long-term value that UK property will offer.

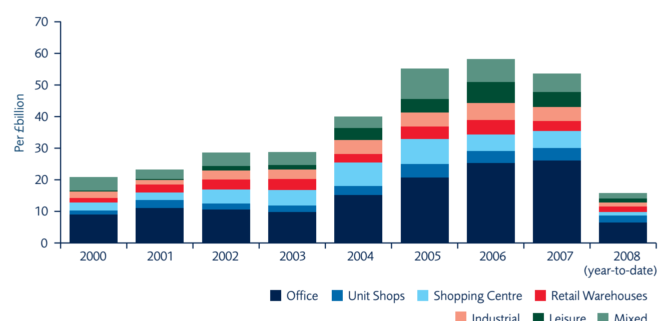
**"…providing rental income continues to cover the interest payments, most believe that banks are unlikely to call in loans and trigger further property sales in an already distressed market."**

Given recent financial market turmoil and the dramatic recent intervention by the UK government in the banking sector, there is little further clarity as to what the banks might do with properties where loan covenants have been breached. Though under pressure to rebuild their balance sheets, most believe that banks are unlikely to call in loans and trigger further property sales in an already distressed market, providing rental income continues to cover interest payments. However, as property prices begin to bottom out, and a recovery in the market emerges into view, a harder line may be taken by the banks. This could prolong the time it takes before prices begin to rise again, having the effect of pushing the eventual recovery further back.

Everywhere, the flight to quality is clear. Investors are in no mood to take risks and can buy good quality assets, which they expect to recover first, at reasonable prices. Prices for prime property are still falling but much less than that experienced by secondary and tertiary assets. Indeed, some suggest that, beyond a certain level of quality, it is hard to discern whether any buyers for such stock exist currently. Larger lot sizes are proving less attractive given higher specific risk and greater difficulties for funding them.

Investor surveys suggest the retail sector is the most favoured and the office (particularly business parks and City offices) and distribution warehouse sectors the least. Importantly, these surveys imply an emerging belief that stability in the market is approaching.

**Sharp Fall in Investment Volumes in the UK**




Source: Property Data (September 2008)

Those still active in the direct market are pursuing a range of different strategies, including buying and working quality assets bought at distressed prices from cash-strapped entities and investigating "niche markets" (from hotels, to healthcare, to housing land).

# RETAIL

## PERFORMANCE

- The retail sector outperformed both offices and industrials this quarter. Based on the IPD Quarterly Index, total returns for the retail sector were -4.6% over the quarter, bringing 12-month returns to September to -17.8%. The fall in returns was, in part, driven by a reacceleration of yield expansion, but also a marked slowdown in rental growth.

- The retail sector on average recorded a capital value decline of 5.9% over the third quarter of 2008, compared with -4.0% for the previous period. Rental growth was barely positive at 0.1%, while equivalent yields rose by 40bps over the quarter.

- With quarterly returns of -1.6%, Central London shops and supermarkets were the most resilient segments, having seen relatively stronger rental growth and capital values falling to a lesser extent. Meanwhile, retail warehouses saw the largest quarterly decline in returns of 5.2%. Rental growth for the segment stalled at 0% over the quarter, whilst capital values fell by 6.5%.

## OCCUPATIONAL DYNAMICS

- Amid worsening economic conditions, occupier demand for the retail sector is weakening. House prices fell for the twelfth consecutive month in October, and mortgage approvals plunged. Meanwhile, consumer confidence fell to its lowest level on record, but has since improved marginally as oil prices have dropped.

- Until recently, widespread discounting by retailers has helped to maintain sales growth. However, with disposable incomes being increasingly squeezed and consumers adopting greater caution, retail sales are now easing. In turn, there is increasing concern over tenant failures as profit margins come under greater pressure.

- As such, retailer demand for space has fallen, and expectations are for the retail occupier market to weaken further. This said, on the upside, the difficulties in the lending markets means that the supply pipeline is relatively constrained. A large amount of space is due for completion this year but, thereafter, supply levels fall back to historical long-run averages.

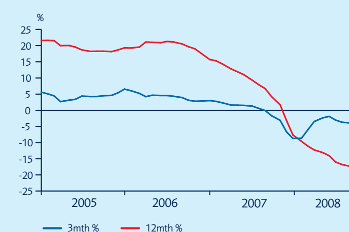
## INVESTOR SENTIMENT

- The retail sector is probably the most favoured of the UK property sectors. There is still noticeable interest from private property companies and some UK institutions for "pretty" prime shops, representing quality at reasonable price.

- By contrast, the shopping centre market is experiencing a later run on pricing. Transactions are infrequent and yields are rising, especially for secondary assets. These trends are expected to continue for some time, as concerns persist over fundamentals. Given their large lot sizes, worries continue over who is there to buy these assets.

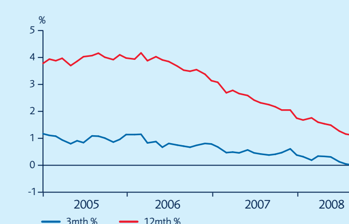
- In the retail warehouse market, investor demand remains weak, especially for "bulky goods" assets. Older solus assets are also being hit badly. Elsewhere, the leisure property market is clearly in distress: specialist funds have stopped buying and concerns for income growth, in this most discretionary of activities, are mounting. By contrast, supermarkets on long leases with fixed rental uplifts remain in demand for secure income and annuity-oriented property funds

**Retail Sector Total Returns**



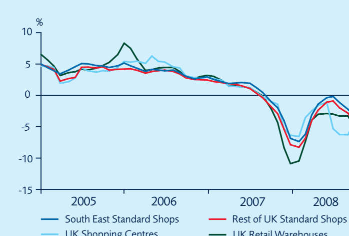

Source: IPD September 2008 (Monthly Index)

**Retail Sector Rental Growth**



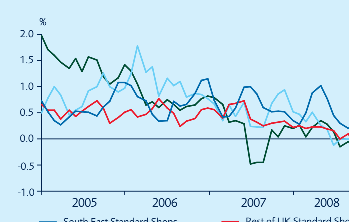

Source: IPD September 2008 (Monthly Index)

**Retail Sector 3-Month Total Returns**



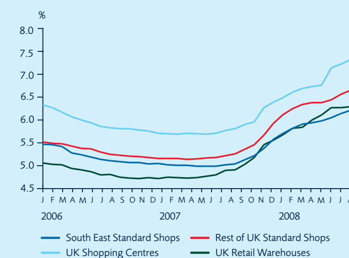

Source: IPD September 2008 (Monthly Index)

**Retail Sector 3-Month Rental Growth**




Source: IPD September 2008 (Monthly Index)

**Retail Sector Equivalent Yields**




Source: IPD September 2008 (Monthly Index)

# OFFICES

## PERFORMANCE

- Offices maintained its status as the worst performing sector over the third quarter of 2008, recording total returns of -5.1% on the IPD Quarterly Index. This implies an annualised return of -15.3% for 2008, which will be the lowest figure in the history of the IPD Index for the sector.

- Contributing to the rapid deterioration of total returns is the quarterly capital value fall of 6.4% as well as rental growth contraction for the second consecutive quarter. Even though yield expansion remains the key driver of poor performance, rental decline is starting to take its toll, further dampening prospects for the sector.

- The Central London office market, especially the City, continues to perform badly, seeing total returns sliding to -5.6% from -3.5% for last quarter. As for regional office markets, big cities such as Manchester, Bristol and Glasgow are being hit hard, while Reading appears to be relatively more resistant.

## OCCUPATIONAL DYNAMICS

- Being strongly affected by the ongoing economic turmoil, office occupational markets inevitably continue to weaken. For a number of regional markets, rental growth either turned negative or is now on the brink of falling. Unsurprisingly, Central London persisted as the worst performing segment with rents falling by 1.9% over the quarter.

- Mirroring the fall in rents, take-up continued to slow, particularly in Central London where active demand fell by 23% over the nine months to end September.

As economic conditions continue to deteriorate and further job cuts are expected, especially in the financial and business services sector, demand for office space is set to worsen.

- On the supply side, while the development pipeline is moderate in the regional markets, the City market remains under pressure from high levels of supply. Clearly, the downside risks are intensified within this segment, suggesting further and greater falls in rents are to come.

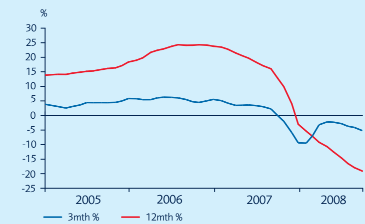
## INVESTOR SENTIMENT

- Offices are generally out of favour with investors, especially in Central London. In the City, transaction levels are at their lowest for four years: there is a large overhang of stock for sale and large lot sizes over £50 million are proving difficult to sell.

- Even the West End market is quiet with investors, mostly international, sticking to prime assets and exhibiting little appetite for secondary stock. Investors are playing a game of "wait and see" as values fall and concerns rise that fund redemptions and bank-led sales could increase stock coming to the market.

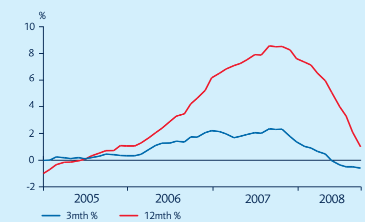
- Outside Central London, office markets are struggling and yields are rising. Prime is holding up reasonably well but secondary is being hit badly. Some overseas buyers have been active, but domestic institutions and leveraged buyers are not. The South East appears to be holding up better than provincial office markets. The business park sector is clearly in distress.

**Office Sector Total Returns**



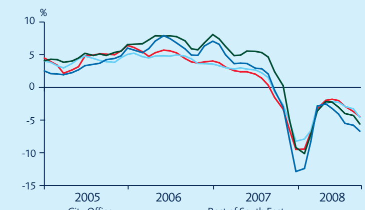

Source: IPD September 2008 (Monthly Index)

**Office Sector Rental Growth**



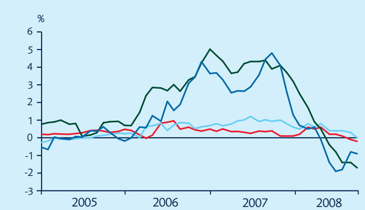

Source: IPD September 2008 (Monthly Index)

**Office Sector 3–Month Total Returns**



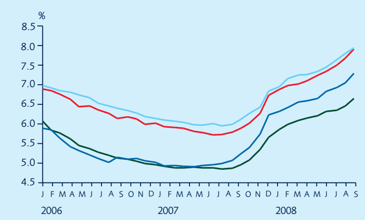

Source: IPD September 2008 (Monthly Index)

**Office Sector 3-Month Rental Growth**




Source: IPD September 2008 (Monthly Index)

**Office Sector Equivalent Yields**




Source: IPD September 2008 (Monthly Index)

# INDUSTRIALS

## PERFORMANCE

- The quarterly capital decline had slowed last quarter to -3.4%, but it reaccelerated over the three months to end September and now stands at -6.2%. Although this reversal in trend is dramatic, the rate of capital decline has not reached the level of -7.4%, seen in the fourth quarter of 2007: however, this is a distinct possibility for the final quarter of this year.
- The reacceleration in capital decline has been caused by a step up in the rate of yield shift from earlier in the year, compounded further by deterioration in rental growth, which turned negative over the summer.
- Combining capital growth performance with income return, the quarterly total return for the third quarter of 2008 was -4.7%, down from -2.0% in the previous quarter. With the economy weakening and sentiment remaining bearish, we can expect returns next quarter to deteriorate further, as rental growth becomes more negative and yield shift continues at a similar rate.

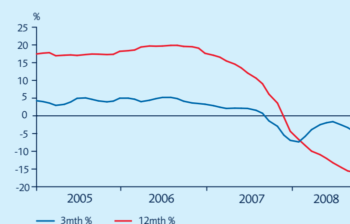
## OCCUPATIONAL DYNAMICS

- Availability levels in the industrial sector remain highly elevated and the amount of available space in the UK has even edged up slightly. This stubbornly high level is driven by lower levels of demand coinciding with schemes under construction coming to the market. Speculative development has dropped dramatically, with construction falling by 43% over the six months to end July.
- Over the next few years, as the market moves into a weaker demand environment, and with the effects of the empty rate legislation being felt particularly keenly in this sector, availability levels are expected to remain elevated. The financial impact of empty property is leading landlords to take aggressive action in cutting rents to let vacant space. However, reduced development as a result of higher risk premia being applied to development projects suggests that, in time, the empty rates legislation may perversely cause upward pressure on rents through lower levels of future developments.

## INVESTOR SENTIMENT

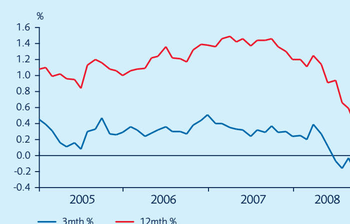
- Despite its typically higher income yield profile, investor sentiment towards the industrial sector is generally negative. Investor surveys suggest that this is particularly so for the distribution warehouse sector which has seen a conjunction of oversupply meeting with difficult times for the retail sector, that provides much of its tenant base.
- There is a clear flight to quality in the sector. Secondary and tertiary assets have seen major yield rises. This has been less so in the prime market where German funds, in particular, have been active and until recently at least, have provided it with a measure of underpinning.
- The level of transactions in the market currently stands at around a third to a quarter of the level observable last year. For any deals that are done, there is far greater scrutiny and due diligence being done. There is still a modest level of interest in buying and working good industrial park-type assets.

**Industrial Sector Total Returns**



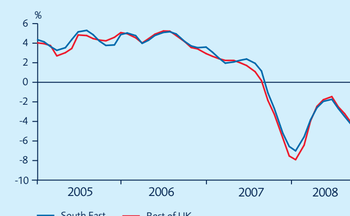

Source: IPD September 2008 (Monthly Index)

**Industrial Sector Rental Growth**



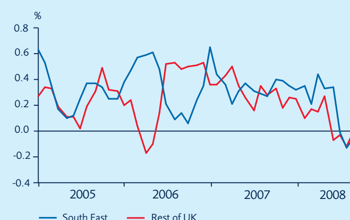

Source: IPD September 2008 (Monthly Index)

**Industrial Sector 3-Month Total Returns**



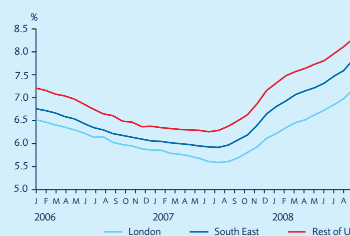

Source: IPD September 2008 (Monthly Index)

**Industrial Sector 3-Month Rental Growth**




Source: IPD September 2008 (Monthly Index)

**Industrial Sector Equivalent Yields**



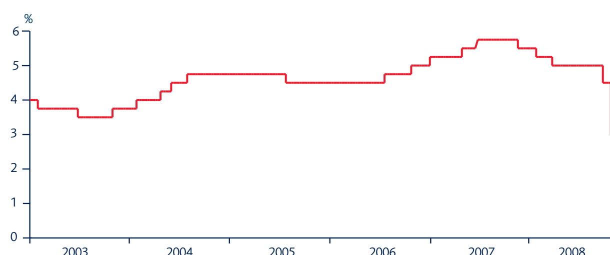

Source: IPD September 2008 (Monthly Index)

# UK PROPERTY OUTLOOK

**After an extraordinary run of 63 quarters of uninterrupted economic expansion, the second quarter of 2008 saw UK GDP growth stall, while the third quarter saw the economy actually contract for the first time since early 1992, with real GDP falling by a worse than anticipated -0.5%. As the fallout from the "credit crunch" and the turmoil in the financial markets feeds through into the real economy, sentiment has greatly deteriorated and expectations of economic growth have been revised downwards. It is now generally accepted that the UK will experience a recession (and is likely already in one) – the current debate among forecasters is on how long it will last and how deep it will be. Comparisons are now being made with the downturn of the early nineties, although the recent action of policymakers around the globe has gone some way to killing the possibility of another "Great Depression".**

The current consensus view expects a recession lasting well into 2009, before relatively modest economic growth returns in 2010. Flagging consumer spending, a battered financial sector and weak construction and production output are all likely to contribute to the decline. On a brighter note, it is expected that inflation, which recently reached its highest rate since 1991, has peaked and will now trend downwards, particularly with oil and other commodities having seen rapidly falling prices over the last few months. This has enabled the Bank of England to slash interest rates in an effort to combat the economic headwinds, with further cuts expected, possibly down to record lows. The cut at the beginning of November of a shock 150bps illustrates the Bank's newfound gusto, which may go some way to stimulating a stronger-than-anticipated recovery. A fiscal stimulus from the government may also help in supporting the economy.

**UK Interest Rates – 150bps Cut in One Fell Swoop**




Source: Bank of England (November 2008)

As the UK falls into recession, the property market is clearly impacted. On the occupier side, demand for space has weakened, causing rental growth to slow. All property sectors are now seeing the first evidence of falling rents, and the outlook sees rental declines gathering pace over the next year as the recession deepens. The more volatile Central London office markets are set to record the largest falls in rents. On a less sombre note, the upswing in rents in recent years has not been as strong as in past rental cycles, and with relatively constrained supply currently, today's downward cycle is not expected to be as deep as that of the early nineties.

> "It is now generally accepted that the UK will experience a recession (and is likely already in one) – the current debate among forecasters is on how long it will last and how deep it will be."

On the investment side, the intensification of the credit crisis, along with the poorer prospects for rental fundamentals, has driven a reacceleration of yield expansion. With the deteriorating economy and weak investor sentiment, yields are expected to continue rising well into next year, with signs of stabilisation beginning to be seen only by the end of 2009.

The most recent IPF consensus forecasts, published in September, were downgraded significantly from the previous quarter to a -10.6% total return for 2008. This said, with the downturn picking up speed again, commentators are moving their forecasts lower still; most now expect total returns worse than -15% for 2008, with negative returns continuing into 2009. However, with a much sharper downturn than originally anticipated, property moves into positively "cheap" territory, with greatly improved longer-term return prospects. As such, the recovery period is likely to see high positive returns.

**IPF Consensus Forecasts for Total Returns September 08 vs June 08 % 2008 – 2010**

| | 2008 | | 2009 | | 2010 | | 2008/12 | |
|---|---|---|---|---|---|---|---|---|
| | Sep (08) | Jun (08) | Sep (08) | Jun (08) | Sep (08) | Jun (08) | Sep (08) | Jun (08) |
| Standard shops | -7.9 | -4.5 | 1.7 | 5.7 | 8.2 | 8.4 | 4.1 | 5.5 |
| Shopping centres | -9.6 | -4.3 | 2.1 | 5.4 | 7.9 | 8.1 | 3.9 | 5.5 |
| Retail warehouses | -11.6 | -6.3 | 0.8 | 5.2 | 8.4 | 8.9 | 3.5 | 5.7 |
| Offices | -11.6 | -5.7 | -1.7 | 3.0 | 7.2 | 7.5 | 2.7 | 4.8 |
| West End offices | -10.9 | -6.1 | -3.4 | 3.0 | 7.4 | 7.6 | 2.5 | 4.8 |
| City offices | -16.1 | -9.5 | -6.2 | -2.0 | 6.1 | 6.0 | 0.4 | 2.3 |
| Industrial | -9.1 | -4.8 | 2.1 | 5.5 | 8.9 | 8.4 | 4.2 | 5.7 |
| All Property | -10.6 | -5.2 | 0.5 | 4.7 | 8.0 | 8.2 | 3.5 | 5.4 |

Source: IPF Consensus Forecasts June 2008 and September 2008)

# IN-FOCUS

## HAVE RECENT YIELD MOVEMENTS BEEN UNPRECEDENTED?

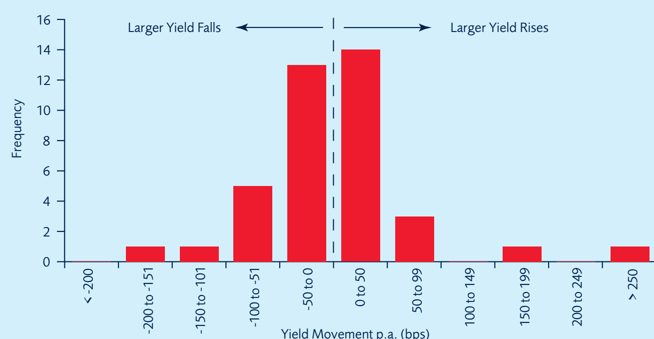
Richard Gwilliam

The recent downturn in property markets across the globe was widely expected to happen. After years of stellar performance, yields had been driven down to unsustainably low levels and property was so overpriced that many felt that a correction was inevitable. However, what has been surprising is the sharpness of that correction, particularly in the UK, which has led the rest of the world in the downswing of the property cycle. While some markets have seen yields begin to drift upwards steadily, the UK has, since the summer of 2007, seen yields shift up at a rapid pace, causing capital values to plummet.

How extreme have these yield movements been, and what were the causes? How does the current downturn compare to others that we have seen in the past? Are we witnessing a property crash?

Over the five years between 2001 and 2006, investor demand drove down UK equivalent yields by a total of more than 240bps to record low levels, with IPD recording an all property average of 5.37% at the end of 2006. However, a reversal of this trend around the summer of 2007 saw yields begin to rise rapidly, reaching 6.05% by the end of 2007 – a movement upwards of 68bps over the year. After three years of 18% plus total returns, 2007 saw the performance of the UK property market pushed into negative territory, with a -3.4% return, despite rental growth adding 4.6%. The impact on capital values from the rise in yields amounted to -11.1%.

**Distribution of Annual Yield Movements (1968–2007)**




Source: IPD, Jones Lang LaSalle (September 2008)

Comparing this yield movement of 68bps over 2007 to movements seen in the past reveals that smaller movements have been more frequent over the last 40 years, with larger movements of +/-100bps or more occurring on only four separate occasions. Indeed, the distribution chart above shows that movements appear to be distributed normally, resembling a bell curve with a peak frequency around zero/very little movement. With a standard deviation of 72bps, statistically there has been roughly 68% probability of seeing a movement between +/-72bps, and a 95% probability of seeing one between +/-144bps. In this respect, if normally distributed, 2007's yield rise of 68bps has not been extreme, although it has been the third highest rise seen over the last 40 years, with only the crashes of 1974 and 1990 experiencing greater shifts upwards.

**"Previous periods with extreme yield movements were generally during times of very volatile rental growth..."**

It is when comparing the current downturn with these two previous downturns that a question arises – are we witnessing another crash today? To answer this, we need to define what a crash entails. Unfortunately, while it is generally regarded to be a dramatic fall in a market's value, an agreed specific numerical definition does not appear to exist. If we take the definition given by Investopedia.com, "the market decline must be evidenced as a 20% drop in an index's total value", then the UK commercial property market is now technically in the throes of a crash, with capital values at the end of September 2008 (the most recent data published by IPD at the time of writing) more than 20% lower than 12 months earlier, and still falling. Of course, the UK equity market has fallen far faster in recent times, with the FTSE 100 Index recording a drop of 21% in just a single week (3rd to 10th October).

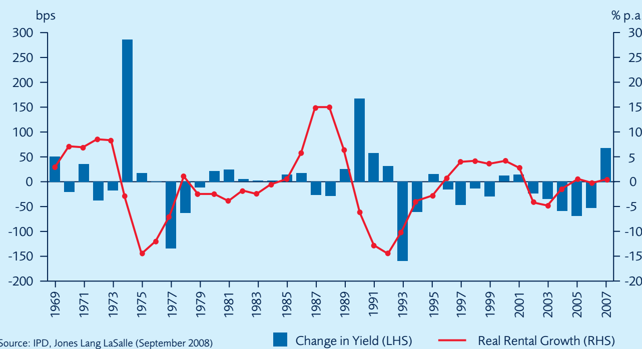
If we look at property yields so far in 2008, we see that the upward shift has extended far further than the 68bps over 2007. On a rolling 12-month basis, the period of September 2007 to September 2008 has seen a rise of 169bps, equalling the shift during 1990. In fact, due to the lower level of yields today, the last 12 months have actually seen a sharper decline in capital values due to yields rising (a yield impact of almost -24%) than during the early 1990s (-17% yield impact over the worst 12 months).

With the benefit of hindsight, it is easy to understate how unprecedented the recent dramatic rise in yields has been. Certainly yields were expected to correct, but few expected them to correct at a rate even approaching that of the early 1990s.

Previous periods with extreme yield movements were generally during times of very volatile rental growth, like in 1974 and 1990, when rental growth has peaked and begins to fall as investor demand reacts to poorer future cashflows. Conversely, when rental growth swings up from a deep trough, yields have fallen significantly (1977 and 1993). The last few years have seen relatively stable rental growth. Previous property cycles have been marked by a surge in

demand for space being met by a boom in development, resulting in oversupply when demand falls back as the economy weakens. This process has resulted in a pronounced rental growth cycle, with booming rents as demand grows, followed by plunging rents during the economic downturn and period of oversupply. The last few years have seen not only a more stable economic environment, with less "boom and bust", but also a relatively constrained amount of development. As such, rents have not been particularly volatile, displaying far more stability than past cycles. Despite this, fairly significant yield movements have occurred so there seems to have been a disconnection between rental growth signals and yield movements recently.

**Yield Movements and Real Rental Growth**




Since the turn of the millennium, rental growth appears to have been overshadowed by the state of the capital markets in influencing investor demand for property and its pricing. In the few years before the "credit crunch" hit, capital poured into property as a "wall of money" (fuelled by increased globalisation of capital and property markets, cheap debt, and a rise in retail funds offering property investment to "the man on the street") drove down yields year-by-year.

**"There seems to have been a disconnection between rental growth signals and yield movements recently. Since the turn of the millennium, rental growth has been overshadowed by the state of the capital markets in influencing investor demand for property and its pricing."**

With a broader investor base today, it could be argued that the greater spread of investor requirements and motivations should have helped to provide more stability in the market. However, we have also seen larger flows of "hot money" which, combined with herding behaviour, has contributed to making the market less stable and more prone to pricing swings. In addition, with higher frequency of property valuation, improved analysis and transparency of the property market and increased prevalence of marking-to-market, there is arguably less lag in valuation indices, potentially making re-pricing sharper and quicker than historically.

**"It was the arrival of the "credit crunch" that provided the driving force behind the extent of the recent rise in yields, causing extreme shifts in a relatively stable rental growth environment for the first time."**

It was the arrival of the "credit crunch" that provided the driving force behind the extent of the recent rise in yields, causing extreme shifts in a relatively stable rental growth environment for the first time. Debt availability dried up, leaving many would-be property investors without financing. Debt-backed buyers withdrew from the market, unable to enter into deals, while equity-backed buyers refused to buy at such high prices. As such, demand for property fell away and yields began to rise. The continuation, and indeed intensification, of the credit crisis has meant that this trend has persisted, not helped by the natural reluctance of investors to "catch a falling knife" and re-enter the market as prices still drop.

Few people, particularly within the property market, anticipated the "credit crunch". Furthermore, with the few extreme yield movements seen historically being restricted to times of volatile rental growth, it is not surprising that many originally expected yields to correct only gradually.

By the time the "credit crunch" struck, the UK was perhaps the most overpriced property market. Yield compression had already ended; indeed yields were beginning to edge up. Other markets globally were generally less overpriced, and were still seeing yields being driven down. Initially, in most of these markets, the "credit crunch" seemed merely to slow or halt yield compression. As the UK has corrected so much since the summer of last year, it is now priced attractively relative to other markets. Indeed, we are now beginning to see some evidence of dramatic yield rises in more countries, following Britain's lead. The UK's experience over the last year has made global property investors more aware of what they could expect.

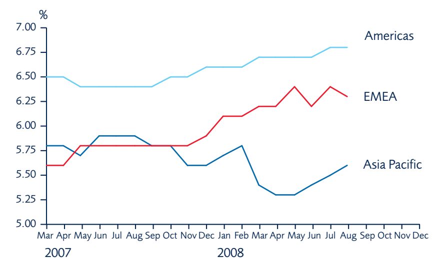
# INTERNATIONAL PROPERTY MARKETS

## GLOBAL REVIEW

The global financial crisis intensified in recent months, and the economic outlook has deteriorated across the world. Weakened rental fundamentals, particularly in North America and Europe, have contributed to waning investor sentiment, with yields rising in almost all markets.

Vendors everywhere seem shocked by the speed and scale of price falls and are readjusting mentally to significantly lower price regimes. Juxtaposing this against the relatively modest number of predatory opportunists looking to drive hard bargains means transaction volumes globally are a mere fraction of levels 12-18 months ago. Not surprisingly in this environment, there is a flight to quality with better located and better let assets the obvious preferences for investors.

**Transaction Yields**




Source: Real Capital Analytics (October 2008)
Note: Figures are average 90-day rolling transaction yields for office, retail and industrial properties (not consistent samples)

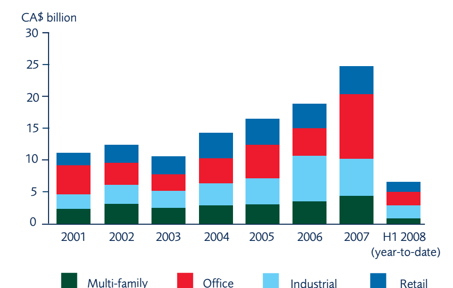
## NORTH AMERICA

With the fallout from the credit crisis intensifying to almost unprecedented levels, many economists are now expecting a recession for the US. On the positive side, inflationary pressures are waning, and policymakers' actions should go a long way to alleviating the capital market troubles and thawing the freeze on lending.

The lack of financing available to real estate investors has been the determining factor in the commercial property downturn, although the rental market has also recently deteriorated as the economy has slowed.

Canada's property market has also seen substantially lower transaction volumes this year, and yields have begun to move out marginally. A slowing economy has caused rental growth to moderate as demand weakens.

**Canadian Property Investment**



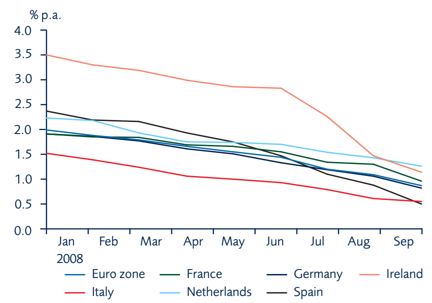

Note: Only includes closed transactions of CA$1 million+ in Vancouver (Q1 2008 only), Toronto, Calgary & Edmonton (Q1 & Q2 2008)
Source: RealNet, CB Richard Ellis, LaSalle Investment Management (September 2008)

## EUROPE

Across all sectors, occupier demand is waning as recession hits the Eurozone. Retail spending has been hit by weakened consumer confidence, and retailers' profit margins have been squeezed. As such, prospects for both retail and industrials are weakening. For offices, troubles in the banking industry are exacerbating already softening demand, especially in regions where take-up has been largely dominated by the financial sector.

Investors remain gloomy about most European markets. Weakening rents, rising yields, a dearth of buyers and uncertainty over bank lender intentions on current loan stock are undermining confidence, while transaction volumes remain low. In general, office markets are the least favoured by investors. Everywhere, there is a flight to quality.

**Evolution of European GDP Forecasts for 2009**



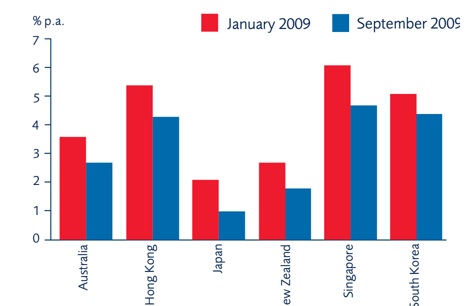

Source: Consensus Economics (January 2008 to September 2008)

## ASIA PACIFIC

Asia is now experiencing a similar reversal in investment sentiment that the other regions have been through. Rental growth is expected to continue slowing – partly through supply delivery, but also through fading demand, driven by declining demand for exports and weakening domestic consumer and economic confidence. The financial crisis itself has been felt less keenly in Asia due to more conservative banking business models – lending is still available, but restricted.

Australian property yields have shifted out more sharply than elsewhere in Asia – largely as a response to the financial conditions. The country's economic and financial model is similar to the West and, hence, similar effects have been felt.

**Changing GDP Forecasts for 2009 in the Asia Pacific Region**




Source: Consensus Economics (January 2008 to September 2008)

# GLOBAL ECONOMIC AND MARKET OUTLOOK

**During the third quarter, two major developments had a big impact on global financial markets. The first was an escalation in the credit crisis which resulted in the demise of several major banks. Governments were forced to bail-out financial institutions, through massive cash injections and, in some cases, nationalisation, to help stave off a collapse in the US financial system. The impact was felt across the Atlantic Ocean when, following the failure of Lehman Brothers, barometers of financial stress rose to the highest levels in decades and lending between banks virtually ceased. In response, global stockmarkets fell significantly over the quarter as risk aversion rose and investors expected the financial crisis to plunge the world economy into a deep recession.**

This gloomy outlook undermined commodity prices, the other major influence over the quarter, which fell sharply as weaker growth prospects reduced the anticipated level of future demand. This hurt the performance of mining and oil & gas shares, which, along with financial stocks, were the worst performing sectors over the quarter. However, it helped boost the returns from government bonds since it offered hope that inflation, which had been running at elevated levels in most economies, would finally decline, opening the door to interest rate cuts. In comparison to government bonds, which were seen as a safe haven amidst the stockmarket turmoil, corporate bonds suffered since default rates were expected to rise. Commercial property was also harmed by the tightening in credit, and valuations fell further during the quarter.

As we enter the last quarter of 2008, the most pressing task for governments and central banks is to restore confidence in the financial system. October has already seen significant progress on this front as governments both boosted banks' capital bases and guaranteed bank deposits. Furthermore, central banks around the world, including the Bank of England and the ECB, surprised the markets when they announced an unscheduled and coordinated series of interest rate cuts, in an effort to steady the faltering global economy.

Nonetheless, interbank lending has continued to operate at substantially higher levels than official interest rates as banks remain extremely reluctant to lend to one another. Following the authorities' moves, the first small signs of an improvement have been seen. However, there remains a long way to go before the money markets can be considered to operate in anything near a "normal" way.

With valuations in most major markets down to multi-year lows, equities are undoubtedly looking highly attractive. Most investors are expecting the worst profit recession in 20 years – an event that is possible though unlikely. In most economies, worries about higher inflation should fall away in the coming year on the back of the fall in commodity prices. Moreover, in a number of Asian countries, governments are in a strong fiscal position, and may increase public sector spending to boost economic growth.

The downside risk for equities, therefore, is not inflation, but rather the possibility of a worse-than-expected global recession. The key is resolving the serious issues within the global banking system. Therefore, even though equities are good value at present, the worry is that earnings might still fall below expectations. From current depressed valuations, this should not necessarily be bad news as long as interest rates are falling; policymakers are taking action to get credit markets functioning again and equity markets can see "light at the end of the tunnel" for next year and beyond.

UK and European bonds are also attractive. The economic situation in both the UK and on the continent is as weak as in the US, but with inflationary pressures from commodities prices receding, there is a lot of room for policymakers to cut interest rates which should be positive for their bond markets. Furthermore, corporate bonds offer better value than government bonds, given the considerable rise in their risk premium.

Turning to commercial property, returns across the industrial, retail and office sectors are expected to converge, meaning that stock specific performance will be the central driver of returns. Commercial property yields, which rise when property prices fall, are expected to peak in 2009.

**10–Year Government Bond Redemption Yields**

Source: Datastream (September 2008)

**FTSE World Index**

Source: Datastream (September 2008)

# DATA AND STATISTICS

## PROPERTY PERFORMANCE METRICS (%)

| Index | Frequency | Date | 1 month | 3 months | Calendar YTD | 1 year | 3 years* |
|---|---|---|---|---|---|---|---|
| IPD Monthly Index | Monthly | Sep-08 | -2.4 | -4.8 | -10.4 | -18.1 | 2.0 |
| CBRE Monthly | Monthly | Sep-08 | -2.3 | -5.2 | -9.7 | -18.0 | 2.4 |
| IPD Quarterly Index | Quarterly | Sep-08 | – | -4.8 | -10.5 | -17.2 | 2.4 |
| IPD Annual Index | Annual | Dec-07 | – | – | – | -3.4 | 10.8 |

Source: Various (compiled by PRUPIM performance measurement team)
* Annualised

## PRIME HEADLINE RENTS - £ PER SQUARE FOOT PER YEAR

| | Shops | | Offices | | Business Parks | | Retail Warehouses* | | Industrials | |
|---|---|---|---|---|---|---|---|---|---|---|
| Region | Sep-08 | % change over quarter | Sep-08 | % change over quarter | Sep-08 | % change over quarter | Sep-08 | % change over quarter | Sep-08 | % change over quarter |
| Central London | 525.0 | 0.0 | 110.0 | -8.3 | – | – | – | – | – | – |
| Sub London | 310.0 | 3.3 | 38.0 | 0.0 | – | – | – | – | 8.5 | 0.0 |
| London | – | – | – | – | 28.5 | 0.0 | – | – | 13.0 | 0.0 |
| South East | 275.0 | 0.0 | 28.0 | 0.0 | 27.5 | 1.9 | 42.0 | 0.0 | 7.5 | 0.0 |
| South West | 230.0 | -4.2 | 27.5 | 0.0 | 22.5 | 2.3 | 70.0 | 0.0 | 7.8 | 0.0 |
| East Anglia | 200.0 | 0.0 | 21.5 | 0.0 | 22.5 | 0.0 | 32.5 | 0.0 | – | – |
| East Midlands | 245.0 | 0.0 | – | – | – | – | 35.0 | 0.0 | 5.3 | – |
| West Midlands | 250.0 | -5.7 | 30.0 | 0.0 | 21.5 | 2.4 | 35.0 | 0.0 | 6.0 | 0.0 |
| Wales | 310.0 | 0.0 | 20.0 | 0.0 | 17.0 | 0.0 | 26.5 | 0.0 | – | – |
| North East | 315.0 | -4.5 | 23.0 | 0.0 | 16.0 | 0.0 | 30.0 | 0.0 | – | – |
| North West | 330.0 | 0.0 | 30.0 | 0.0 | 20.0 | 0.0 | 55.0 | 0.0 | 5.5 | -8.3 |
| Yorks & Humbs | 300.0 | -3.2 | 27.0 | 3.8 | 20.0 | 0.0 | 40.0 | 0.0 | 5.5 | 0.0 |
| Scotland | 250.0 | -2.0 | 29.0 | 0.0 | 20.0 | 0.0 | 45.0 | 0.0 | 6.5 | 0.0 |

Source: PRUPIM
Data refers to PRUPIM's estimates of prime rents and yields for the best locations in the regions in question
*Rents refer to a prime restricted use retail park

## INVESTMENT YIELDS (%) FOR PRIME PROPERTIES

| | Shops | | Offices | | Business Parks | | Retail Warehouses* | | Industrials | |
|---|---|---|---|---|---|---|---|---|---|---|
| Region | Sep-08 | % Change over quarter | Sep-08 | % Change over quarter | Sep-08 | % Change over quarter | Sep-08 | Change over quarter | Sep-08 | % Change over quarter |
| Central London | 5.0 | 0.3 | 5.5 | 0.3 | – | – | – | – | – | – |
| Sub London | 5.5 | 0.3 | 7.3 | 0.5 | – | – | – | – | 6.8 | 0.5 |
| London | – | – | – | – | 8.0 | 0.5 | – | – | 6.5 | 0.8 |
| South East | 5.8 | 0.3 | 7.3 | 0.5 | 8.0 | 0.5 | 6.5 | 0.3 | 7.0 | 0.5 |
| South West | 6.0 | 0.3 | 7.3 | 0.5 | 8.0 | 0.5 | 7.0 | 0.5 | 7.0 | 0.3 |
| East Anglia | 5.8 | 0.3 | 7.5 | 0.5 | 8.5 | 0.5 | 6.5 | 0.3 | – | – |
| East Midlands | 6.0 | 0.3 | – | – | – | – | 7.0 | 0.5 | 7.0 | 0.3 |
| West Midlands | 6.0 | 0.3 | 7.3 | 0.5 | 8.5 | 0.5 | 7.0 | 0.5 | 7.0 | 0.5 |
| Wales | 5.5 | 0.0 | 7.8 | 0.5 | 8.8 | 0.5 | 7.0 | 0.3 | – | – |
| North West | 5.8 | 0.3 | 7.3 | 0.5 | 8.5 | 0.5 | 7.0 | 0.5 | 7.0 | 0.5 |
| Yorks & Humbs | 6.0 | 0.3 | 7.5 | 0.5 | 9.5 | 0.5 | 7.0 | 0.5 | 7.0 | 0.3 |
| North East | 6.0 | 0.3 | 8.0 | 1.0 | – | – | 7.0 | 0.5 | – | – |
| Scotland | 5.8 | 0.3 | 7.3 | 0.5 | 8.5 | 0.5 | 7.0 | 0.5 | 7.3 | 0.3 |
| Northern Ireland | 5.8 | 0.3 | 8.0 | 0.5 | – | – | – | – | – | – |

Source: PRUPIM
Data refers to PRUPIM's estimates of prime rents and yields for the best locations in the regions in question. Yields rounded to nearest 25bp
*Yields refer to a prime restricted use retail park

# CONTACTS

## CONTACTS

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## ABOUT THE GLOBAL PROPERTY RESEARCH TEAM

PRUPIM's well known and widely respected Global Property Research Team, based in London and Singapore, comprises of 10 staff including six property economists and three performance measurement analysts. The team engages in three main types of work namely; assessing the attractiveness of UK and international property markets, providing strategic recommendations and risk control measures for clients' funds, and conducting ad-hoc property related analyses on key issues as they emerge. The research team also assists in buy, sell and hold decisions by working closely with colleagues across PRUPIM to create a holistic approach to asset management.

## BIOGRAPHIES

### Paul McNamara, Director, Head of Research BSc (Hons) PhD ASIP FRSA OBE

Paul is responsible for the overall direction of property research within PRUPIM. He is also a member of the PRUPIM Board. Paul joined Prudential in 1987. He is a Visiting Professor with the Centre for Estate Management at Oxford Brookes University. Paul was appointed Chairman of the Investment Property Forum (2005-6). He is Honorary President and a past Chairman of the Society of Property Researchers and a non-executive director of IPD Holdings Limited. In June 2003, Paul was awarded an OBE in the Queen's Birthday Honours List for services to the property industry.

### Scott Girard, Director, Research and Investment Strategy, PRUPIM Singapore, B.Comm MAF

Scott has been active in Asian real estate capital markets since 2002. Previously based in Korea and Japan for Jones Lang LaSalle, he has been involved at senior levels in investments, corporate finance, research and property advisory for a wide range of clients. Scott started his career in Australia in 1995 with ANZ Funds Management before moving into the consultancy business. He graduated from Curtin University of Technology with a Bachelor in Commerce and holds a Master of Applied Finance and Investment from Macquarie University.

## REGULATORY INFORMATION

**For Investment Professionals only. No other persons should rely on any information contained in this document.**

Past performance is not a guide to future performance and the value of investments can fall as well as rise. Property is valued by an independent valuer. However, valuations are subjective and may vary between valuers. Commercial Property is a specialised sector and has different characteristics to investments in equities, bonds or residential property.

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