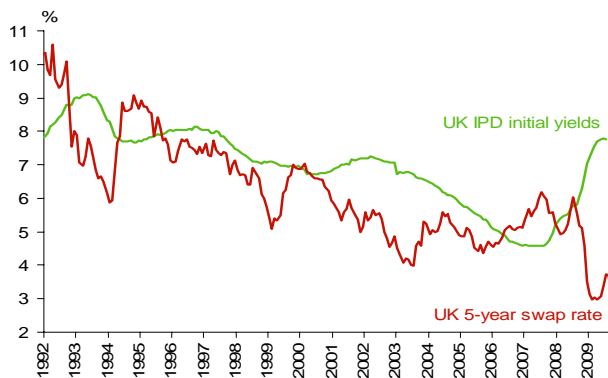


UK Commercial Property Outlook

Cautious optimism returns

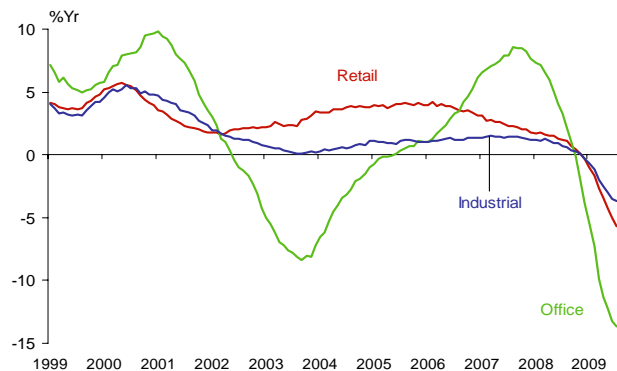
- Capital values in the UK commercial property sector have fallen more than 40% from mid-2007 peaks, according to IPD data. However, there are some tentative signs that more attractive valuations, combined with a return of risk appetite, have led to a gradual return of confidence in the sector, particularly for prime property. The weaker pound has also made the sector more attractive to foreign investors.
- All-property initial yields have risen to near 8%, well in excess of the 5-year swap rate currently around 3.3%. This is despite falling rental values, which are down 7.8% in the year to July. Rental values are expected to continue to fall next year, even though the recession may have ended in Q2. This is because the economic recovery is likely to be gradual, with employment, consumer spending and corporate profits not expected to recover significantly until late 2010 or 2011. After a contraction of 4½% this year, we currently expect GDP growth to rise 0.7% in 2010 and 2.3% in 2011.
- Therefore, despite historically attractive valuations, investors remain cautious about the outlook for capital values. Although prospects for the economy and the financial sector have improved, they remain dependent on highly accommodative policies. Households and firms will continue to deleverage over the medium term, while balance sheet repairs in the financial sector is ongoing, therefore constraining the availability of credit. Moreover, highly accommodative official policies cannot remain in place indefinitely.
- Office rents have underperformed, falling 13.7% in the year to July, compared with declines of 5.7% and 3.7% in retail and industrial rents, respectively. Looking ahead, the office sector should benefit from an eventual recovery in employment. The rebalancing of UK growth away from consumers towards exports in the coming years, helped by a weaker pound, should also support industrial properties relative to retail. Nevertheless, for the commercial property sector as a whole, we expect rental values to fall 7% next year, but capital values may stabilise and recover on a more sustainable basis in 2011. It will take a considerable period of time before capital values recover back to levels before the credit crisis.

Chart a: Initial property yields have risen back above 5-year swap rates



Source: IPD, Thomson Datastream

Chart b: Office rents have underperformed retail and industrial



Source: IPD

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