London & Capital
intelligent investors

Commercial Property Market Overview

Economy

Since our last update, there has been improving news on the global economic slowdown. Japan recently became the latest major economy to emerge from recession as its GDP grew at close to 1% for the second quarter. Earlier this month both France and Germany surprised forecasters with their return to growth; indicating that the global slowdown is easing.

Britain's economy, however, has contracted by a record 5.6% over the past year and figures released in July showed that output was down 0.8% in the three months to June. There has also been a downward revision to the output in Q1 which now shows that it fell by 2.4% (instead of -1.9%). Following recent signs of a pickup in the housing market and strong growth in high street spending the size of the drop surprised the City and dashed hopes that the UK had already pulled out of recession, although the pace of contraction has moderated.

Minutes from its most recent meeting show the Bank of England is still very concerned about weak growth prospects and money supply growth, although it noted that,

"there have been increasing signs that output in the UK's main export markets is stabilising. Financial market strains have eased and banks' funding conditions have improved a little, although financial conditions remain fragile. Household and business confidence has picked up, albeit from the very low levels experienced in the wake of the financial crisis last autumn."

The Bank of England also surprised the City by announcing that it would pump an extra £50bn of new money into the economy. This increased the total programme to £175bn. The Governor, Mervyn King, had been pushing for a bigger increase in the quantitative easing programme to an extra £75bn to stimulate lending and spending in the economy.

Following this news, expectations in the City were that interest rates would remain at historic low levels for some time to come. The Bank base rate remains at just 0.5%.

The Consumer Price Index (CPI) in July was unchanged from June, keeping the annual rate of inflation at 1.8%. Inflation has been stickier than expected, but most analysts anticipate inflation will dip lower in the coming months. The Retail Price Index (RPI) which includes volatile items, such as housing costs and oil prices, moved to -1.4% from -1.6%.

The economic situation is putting considerable pressure on occupiers and rents have deteriorated further this quarter as a result, although this trend has eased. The occupational market also continues to see incentives increasing on new lettings.

Retail

According to the Office for National Statistics (ONS) retail sales volumes rose twice as fast as expected in July. The official data showed that sales volumes rose 3.3% on a year-by-year basis and 0.4% on the month. The food store subsector increased by 1.4% in the three months to June and the non-food sector (which tends to sell more non-essential items) also saw an increase of 1.0%. The data boosted economists hope that the recession was beginning to ease.

IPD

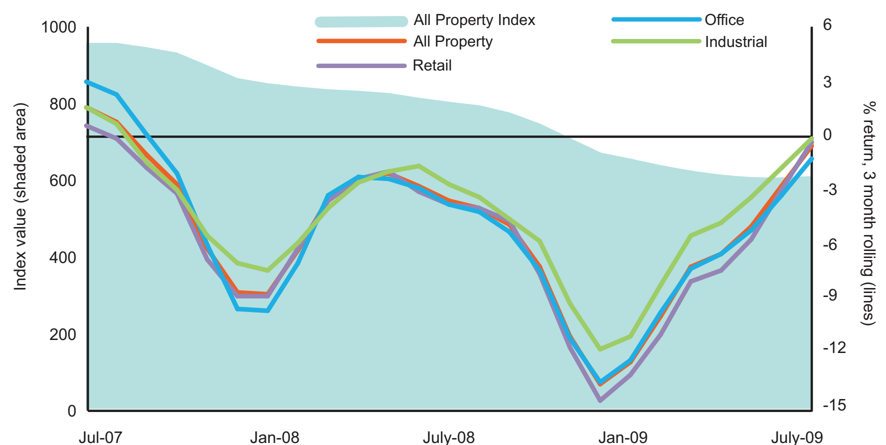
According to the IPD UK Monthly Index to the end of July, yield compression coupled with an easing in rental pressure has produced the shallowest negative capital growth decline for two years and a positive total return. (source: IPD). The latest IPD monthly index figures are summarised below.

IPD Monthly Index – July 2009			
Capital Values (%)		Total Return (%)	
June	July	June	July
-0.88	-0.13	-0.19	0.56

Source, IPD

Although capital growth was negative when all sectors are included, there was fractional positive growth from the Retail sector (+0.05%). Retail was the first sector to fall back in June 2007 and has become the first to reverse the trend. The office and industrial sectors fell by about 0.25%.

Historical Performance



The IPD UK Monthly Property Index measures ungeared total returns to directly held standing property investments from one open market value to the next and in July 2009 returned **0.56%**

Source: IPD, data to 31/07/09

Vacancy rates have also been climbing steadily but this months' data has reversed, indicating vacancies may have peaked. The IPD all property void rate (void rental value as a percentage of total income) has fallen to 11.8%, from June's record high of 12.1%.

Malcolm Frodsham of IPD said "Yield compression and a deceleration in rental pressure is indeed a fillip for the commercial property market. However, we should be careful in reading too much into one month's numbers: we may have to wait a long time before rental growth actually turns positive and this will continue to put downward pressure on values."

General Property Market Update

Investors are returning to the market, while availability of stock is limited, leading to an improving outlook for prime commercial property yields, which are stabilising and increasingly even falling across all sectors. Demand for secondary property, with shorter leases or poorer covenants, remains weak and yields are anticipated to continue to rise in this area. The rental outlook has continued to weaken.

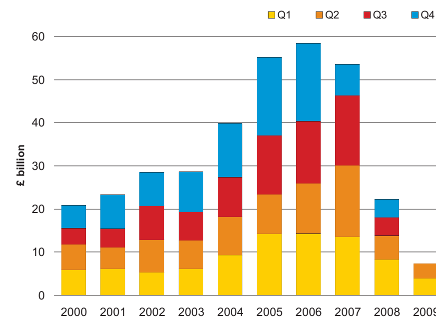
Property yields in the UK have corrected more rapidly and are now higher than in many other markets on the continent. Historically the UK property market, being more transparent, has been at lower yields. The full spectrum of property companies, privates, funds and opportunity funds have re-entered the market to exploit the opportunity presented and in particular, UK institutions are targeting long let property. Foreign investors also continue to support the market with cash purchases as the weakness of sterling has made the UK even more attractive to overseas purchasers. There are an increasing number of funds launching to exploit the opportunities in the market - The Association of Real Estate Funds (AREF) noted that there was a net inflow into property funds of £52m, which is the first net inflow since the second quarter of 2008.

Investment activity amongst private investors has also continued at a pace and the commercial auction houses have had some successful sales (for smaller lot sizes averaging £664,000 in Q2 2009, source ARAS). Initial yields have fallen as capital values have increased for prime properties with long leases (10-14 years) let to blue chip tenants. Low interest rates and limited returns on cash deposits has led to private investors using cash to seek out good quality long term income.

On the supply side, there is little evidence of the distressed selling that has been expected. Generally there is a lack of available stock coming to the market as many property owners are reluctant to sell assets; and it is this shortage of supply which is, once again, resulting in yield compression for the most prime property.

Transaction volumes remain subdued. In the second quarter of 2009 the investment activity amounted to £4bn which was a 4% increase on the first quarter of 2009. The level of activity over the 12 months totalled £16.9bn; this compares to about £17bn of transactions per quarter that were being completed at the peak of the market. (Source: property data).

UK Transactional Levels



Source: Savills Property Data

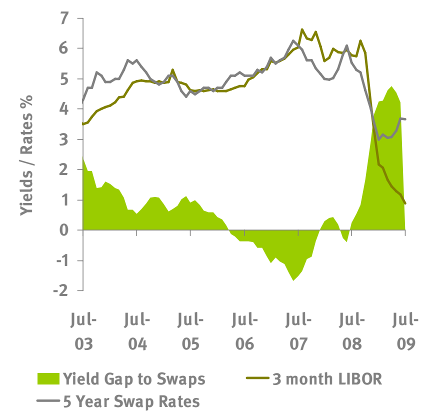
UK Investment Market Activity

Bank finance was key to the growth of property in the last cycle and until debt becomes available there will not be a significant increase in turnover volumes. Transactions now require a significant amount of equity. Banks are more risk averse, require a greater level of due diligence and will only finance lower loan to value ratios of 50/60%.

The latest Bank of England Credit Conditions Survey dating from June indicated that credit to property was unlikely to expand in Q3 2009. Net real estate lending in absolute terms contracted in Q2 for the first time since Q2 1999. Banks are continuing to reduce their exposure to real estate. This comes despite LIBOR falling to 0.77%, 27bps above the base rate which is indicating a degree of normality returning to the banking system. Over the last six months 5 year swap rates have been rising from 3.0% but have now stabilised and are at around 3.45%.

Lending Rates and Property Yield Gap

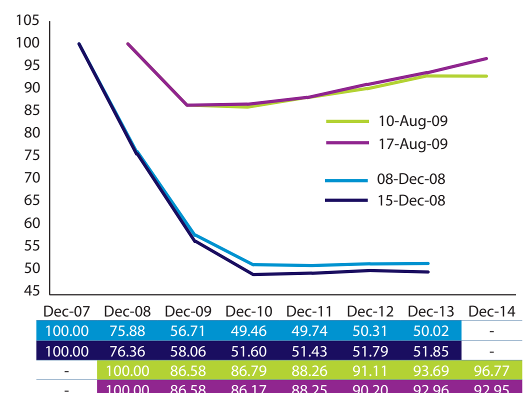
The property derivatives market is reflecting this improvement in sentiment for UK



Source: Knight Frank Research, FT & IPD

property. At the start of the year derivatives were implying a total return of about -20%. This edged up to -15% by the end of June and is now pricing in a drop of less than 10%.

UK IPD All Property Index - implied capital values



Dec-07	Dec-08	Dec-09	Dec-10	Dec-11	Dec-12	Dec-13	Dec-14
100.00	75.88	56.71	49.46	49.74	50.31	50.02	-
100.00	76.36	58.06	51.60	51.43	51.79	51.85	-
-	100.00	86.58	86.79	88.26	91.11	93.69	96.77
-	100.00	86.58	86.17	88.25	90.20	92.96	92.95

Source: Morgan Stanley indicative pricing.
Assumption: Calculations for Dec 08 figures are based on assumed initial yield of 5.14%. Calculation for Aug 09 figures are based on assumed yield of 6.86%.

Although recent data shows that initial yields have reduced for certain prime properties, indicating a recovery in the real estate market, this trend is being driven primarily by a lack of available prime product and we expect it could be short-lived. There are encouraging signs that the market is bottoming, but the availability of debt finance and the strength of the occupational market will drive the outlook for the commercial real estate market over the longer term.

The occupational market will continue to have an impact on investors and predicted falls in headline rent in 2009 and 2010 are likely to have a detrimental impact on investment values, especially where leases have 5 years or less remaining. The risk of tenant default and falling rental values could have a further impact on specific values. Without economic recovery and increased bank lending there are still risks that this recovery will not take hold.

Fund Update

- 7 freehold properties in the Fund
- 16 leases in place
- Lease lengths (weighted average) is 15.4 years

Over 77% of the total fund, is subject to alternative means of achieving income growth, with guaranteed minimum increases in rent. Just under 25% is adjusted in line with the market on an upward only open market review basis. The Fund has been structured to include a broad allocation across the various sectors, a good geographical spread and strong rental income flows.

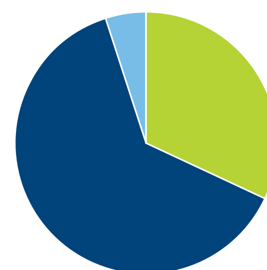
Despite continued concerns across the property market, the Fund remains well protected against the harsh conditions of the current environment.

London & Capital has an experienced Property Team with significant expertise in the asset management of property portfolios. We expect long-term investors to be rewarded over the coming years as the market rebalances. The Board still acknowledges that in the short term it is still not a viable option for the Fund to re-open.

Fund Holdings

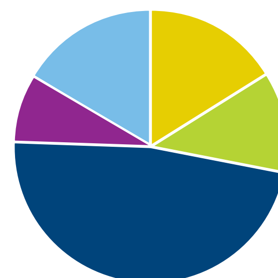
Top 5 Holdings	% Holding
Liverpool	47.4%
Loughborough	16.3%
Caernarfon	16.0%
Hamilton	8.3%
Sheffield	7.1%
TOTAL	95.1%

Sector Breakdown



- Offices - 64%
- Court Houses - 31%
- Driving Test Centres - 5%

Geographical Breakdown



- North West - 49%
- Midlands - 16%
- West - 15%
- North East -12%
- South - 8%

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