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Contents

Overview	1
Fair Value Index	2
Fair Value Categories	3
UK Market Classifications	4
UK Versus Global Forecasts	5
Office Market Forecasts	6
Retail Market Forecasts	7
Industrial Market Forecasts	8
Economic Drivers	9

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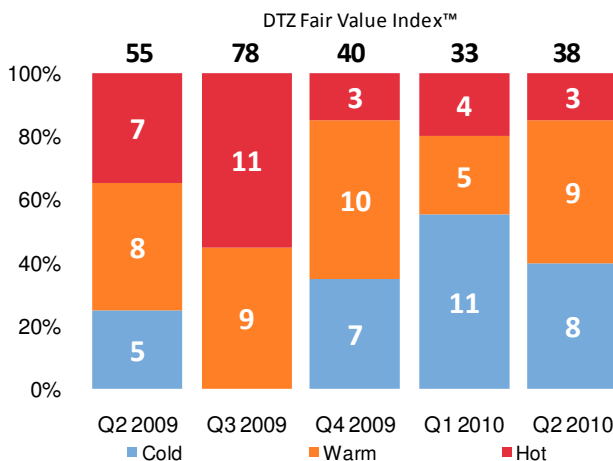
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- Many UK commercial property markets are over-priced, as indicated by the DTZ Fair Value™ Index score of 38 in Q2 2010. The index rose from 33 in Q1 2010 (Figure 1).
- Eight markets were classified as COLD in Q2 2010, in which expected returns are below required returns, while only three markets were classified as HOT, in which expected returns are above required returns. Given that COLD markets outnumbered HOT markets, the index remained below 50 (Figure 1).
- Compared to Q3 last year, when the majority of markets were HOT, and no markets were classified as COLD, there are now only limited attractive investment opportunities in the UK. Strong investor interest and the resulting yield compression have reduced the scope for yield-driven capital growth.
- At the same time, although required returns have also dropped, due to a decline in the property risk premium and a decrease in bond yields, they have, in general, fallen by less than expected returns, making many markets which seemed fairly valued last year now look over-priced.
- Office is the least attractive sector, and its index score of 25 in Q2 2010 dragged down the all property index. By contrast retail and industrial property, which make up the rest of the all property index, look to be around fair value.
- Only three markets in the UK still offer attractive opportunities. They are London City offices, Manchester retail and London West End retail. Expected returns in these markets are boosted by reasonable rental growth prospects. By contrast, office markets outside of London look overpriced, due to limited scope for capital value rises driven by either yield compression or rental rises.
- The UK index has moved ahead of the global index. A rapid re-pricing saw value emerge in the UK first, but subsequently wane as attractive investment opportunities were exploited. By contrast, at 62, in Q2 2010 the global index score remained above 50, boosted by many hot markets in the US and Asia Pacific.

Figure 1

UK All Property Fair Value Index



Source: DTZ Research

Fair Value Index

UK commercial property remains overpriced

- The DTZ Fair Value Index for the UK commercial property market was 38 in Q2 2010 (Table 1). Markets in which expected returns over the next five years were below required returns outnumbered markets in which they were above them and, consequently, the index remained below 50. This is in sharp contrast to Q2 last year, when the UK index was 55, reflecting more hot markets than cold markets.

Table 1

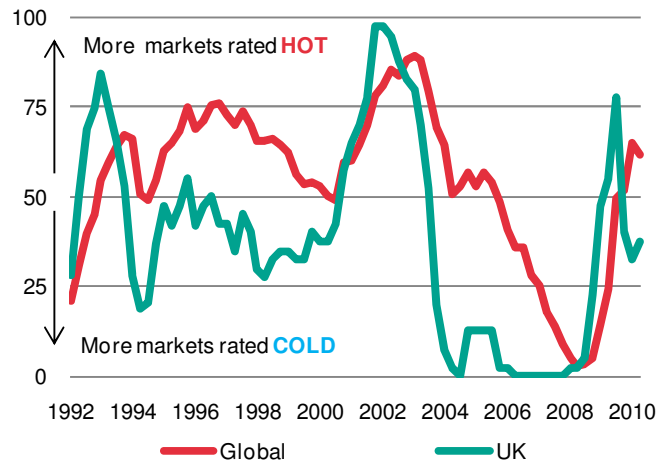
Global Fair Value Index Q2 2010 Fair Value = 50			
	Q2 2010	Q1 2010	Q2 2009
UK All Property	38	33	55
UK Office	25	17	46
Global All Property	62	65	24
Global Office	56	60	20
Global Retail	73	72	36
Global Industrial	58	67	14

Source: DTZ Research

- Although the UK index remained below 50, it did rise slightly compared to Q1 2010. This was because some markets which were classified as COLD in Q1 2010, and as such looked overvalued, moved to the WARM category in Q2 2010. This indicates that these markets are now fairly priced and that expected returns are more-or-less equal to required returns.

Figure 2

Global and UK All Property Fair Value Index



Source: DTZ Research

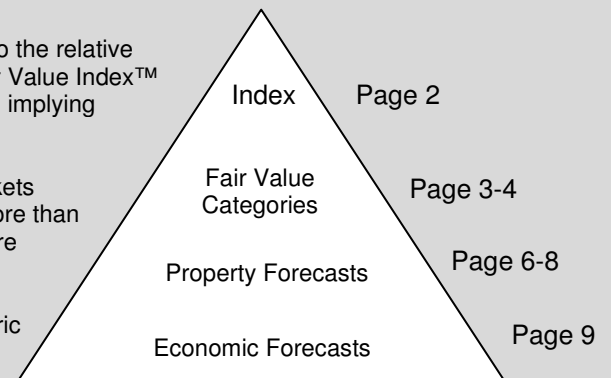
- The DTZ Fair Value Index for UK commercial property has moved ahead of the index for commercial property at the global level. This is because commercial property in the UK saw the most rapid re-pricing during the financial crisis, which resulted in value emerging in the UK ahead of other markets. However, since then strong investor interest has seen yields fall in some markets, and made the UK market look less attractive (Figure 2).
- By contrast the DTZ Fair Value Index for commercial property at the global level, although dipping slightly in Q2, remained above 50, indicating that markets looking under-priced outnumbered markets in which commercial property seemed over-priced. The global index was boosted by significant pockets of value in the US and Asia Pacific.

Box 1: Guide to DTZ Fair Value Index™

The DTZ Fair Value Index™ is intended to provide investors with insight into the relative attractiveness of current pricing in global commercial property markets. Fair Value Index™ scores reflect the proportion of HOT and COLD markets, with higher scores implying more HOT markets.

Markets are categorised by comparing expected and required returns. Markets estimated to be more than 5% under-priced are classified HOT; markets more than 5% over-priced are classified as COLD; and, markets between this range are classified as WARM.

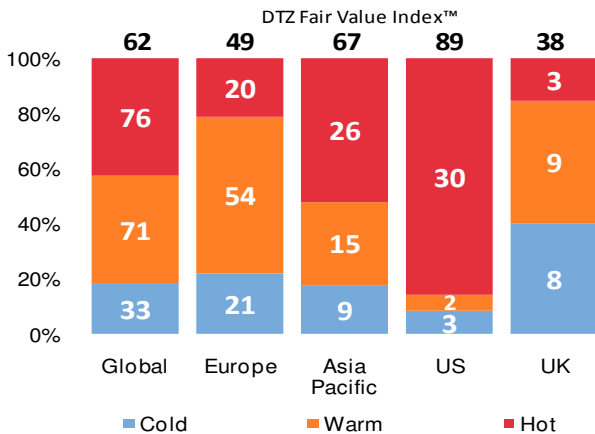
The DTZ Fair Value Index™ is a forward looking index based on econometric forecasts incorporating local econometric drivers and local market knowledge.



For further information on the methodology used for classifying different markets and calculating Fair Value Index scores, see the DTZ Research report: DTZ Fair Value Index™ Methodology

Figure 3

Regional Fair Value Classification Q2 2010



Source: DTZ Research

UK leads other markets around the world

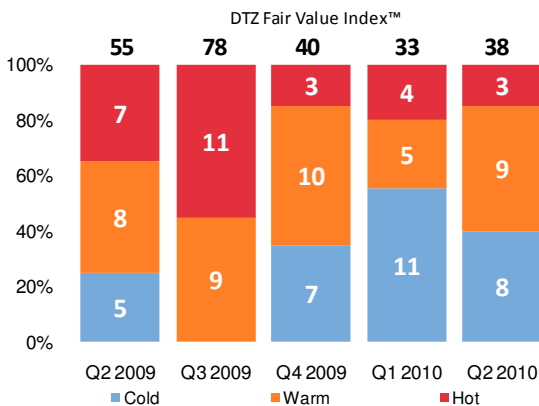
- The UK commercial property market has moved ahead other property markets around the world. In the first half of 2009, a rapid re-pricing had generated large pockets of value in the UK. However, in Q2 2010 the UK had the highest share of COLD markets, and the smallest share of HOT markets which present attractive investment opportunities (Figure 3).
- The UK is slightly ahead of Europe as a whole. By contrast, the US and Asia Pacific have the largest proportion of HOT markets, in which expected returns are above required returns. Furthermore, most other markets in Asia Pacific look to be WARM, around fair value.

More UK markets classified as COLD than HOT

- More UK markets were classified as COLD than HOT in Q2 2010, and consequently the DTZ Fair Value Index remained below 50. This is in sharp contrast to Q3 2009 last year, when the majority of markets were classified as HOT, indicating that expected returns exceeded required returns (Figure 4).
- Over the past three quarters, strong investor interest pushed yields lower, and reduced the scope for yield-driven capital appreciation and returns. Consequently, attractive investment opportunities have dwindled, and the number of HOT markets has fallen sharply, while a significant number of markets are now rated as COLD.
- However, the number of COLD markets fell in Q2 2010, indicating that some over-pricing in the market has disappeared. If that trend is maintained, the UK market as a whole could approach fair value later this year.

Figure 4

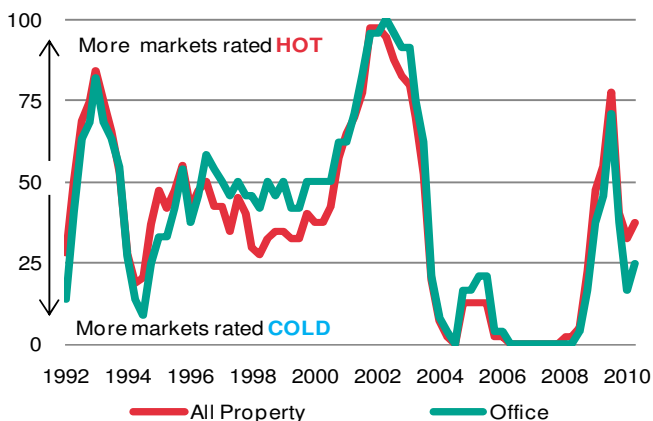
UK Fair Value Classification Progression



Source: DTZ Research

Figure 5

UK Fair Value Classification by Sector



Source: DTZ Research

UK offices more over-priced than retail and industrial

- The DTZ Fair Value Index for UK commercial property is being dragged down by the office sector (Figure 5). Most office markets outside of London are classified as COLD, indicating that expected returns fall short of required returns.
- By contrast, the retail and industrial sectors, which make up the rest of the index for all property, look to be around fair value. The majority of markets in these sectors are classified as WARM, with a small and more-or-less equal number of markets being classified as either HOT or COLD.

UK Market Classifications

Limited number of UK markets attractively priced

- In Q2 2010, of the 20 UK markets covered by the DTZ Fair Value Index, nine were categorized as WARM and eight as COLD. However, only three markets were classified as HOT, in which expected returns exceed required returns (Table 2). Overall, the bias is towards COLD markets over HOT markets.
- Disaggregation of the figures reveals that nearly all of the COLD markets were in the office sector, while only one office market was classified as HOT. The picture for the rest of the UK property market, which includes retail and industrial property, was slightly better, with most markets being categorised as WARM, indicating that they are around fair value.

Attractive investment opportunities exist in London

- Two of the three markets rated as HOT, in which expected returns exceed required returns, are located in London. They are London City offices and London West End retail, both of which offer good rental growth prospects which boost expected returns. The only other market categorized as HOT is Manchester retail (Table 3).
- The markets categorized as COLD are predominantly office markets outside of London, where expected returns fall short of required returns. This is due to the fact that rental growth prospects in these markets are minimal.

London City office market remains hot

- The expected return on London City offices has fallen over the past year, but is still above the required return, implying that London City offices remain an attractive investment opportunity. However, the difference between expected and required returns has narrowed considerably (Figure 6).
- Very low yields on five year government bonds, which we use as the risk-free rate, along with a fall in the property risk premium, mean that the required return on London City offices has dropped over the past year.
- The expected return on London City offices has also fallen following a 17% rebound in rents from Q3 last year. This has reduced the scope for future rental growth, while strong investor interest has pushed down yields, lowering the capital growth component of expected returns (Figure 6).

Table 2

UK Market Classifications Q2 2010			
	HOT	WARM	COLD
UK All Property	3	9	8
UK Office	1	4	7
Rest of UK All Property	2	5	1

Source: DTZ Research

Table 3

Ranking of Prominent UK Markets for Q2 2010		
	Market	under/over valuation
HOT markets	London City offices	-12%
	Manchester retail	-9%
	London West End retail	-9%
WARM markets	London Heathrow industrial	2%
	Glasgow retail	2%
	London West End offices	2%
	Edinburgh offices	4%
COLD markets	Glasgow offices	6%
	Birmingham retail	8%
	Manchester offices	13%

Source: DTZ Research

Figure 6

London City Office Required vs. Expected Return

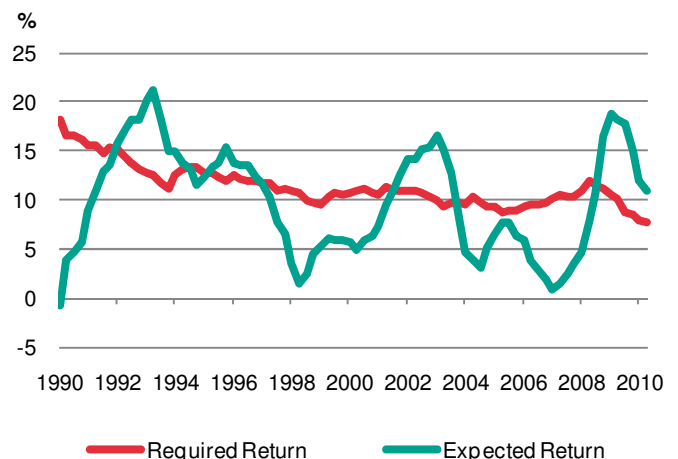
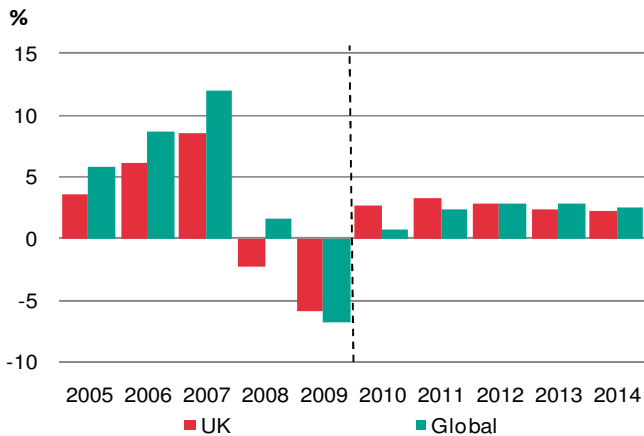


Figure 7

UK vs. Global Rental Growth



Source: DTZ Research

UK rents to show modest rises over next 5 years

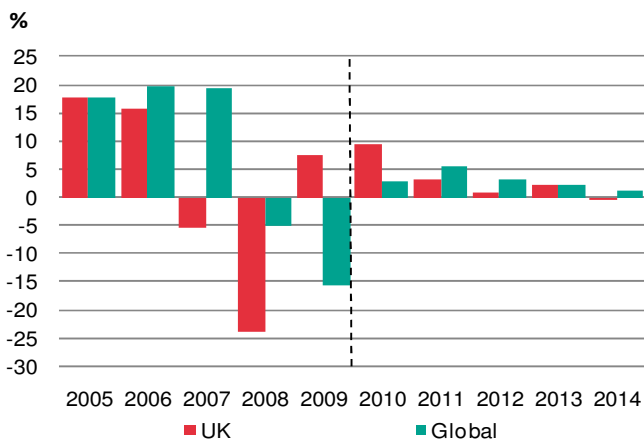
- Following declines of 2.3% in 2008 and 5.9% in 2009, all commercial property rents in the UK are forecast to resume growth in 2010. However, rents are only expected to increase by 2.8% this year and 3.3% in 2011. Thereafter rental growth is forecast to slow to 2.2% by 2014 (Figure 7).
- The subdued forecast for rental growth reflects the fact that the economy is expected to recover only slowly rather than bounce back rapidly. As such, occupier demand for commercial premises will not be as strong as it was immediately prior to the financial crisis, when rental growth was robust.

2010 strongest year for rises in UK capital values

- Strong investor interest in UK commercial property has pushed yields down this year. From 2011 onwards though, yields are forecast to be broadly flat, and capital values are forecast to receive only a modest boost from increases in rents. Consequently, growth in UK capital values is forecast to peak in 2010 (Figure 8).
- In contrast to the UK, at the global level, capital value growth is forecast to peak in 2011, due to a lag in the recovery in investment markets in other regions. From 2011 onwards, growth in capital values in the UK is forecast to be slightly below growth in capital values at the global level.

Figure 8

UK vs. Global Capital Growth



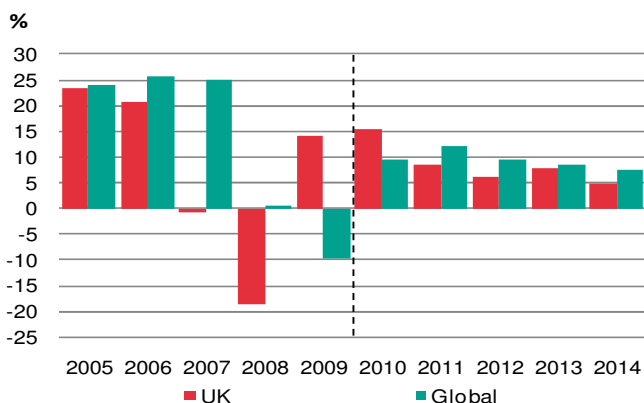
Source: DTZ Research

2010 peak year for UK commercial property returns

- The sharp rise in UK capital values in 2010 will drag total returns this year up to around 15%. Thereafter, investors will become increasingly reliant on the rental income component of total returns as capital value growth slows (Figure 9).
- However, although total returns are forecast to bounce back this year, from 2011 onwards they are expected to be relatively low and stable.
- From 2011 onwards, total returns are forecast to be below 10%, dropping to around 5% by 2014. This is in stark contrast to the double-digit returns recorded in the run-up to the financial crisis.

Figure 9

UK vs. Global Total Returns



Source: DTZ Research

Office Market Forecasts

Office rental growth prospects strongest in London

- Office rents in London City have already rebounded 17% from their low in Q3 last year, while rents in London West End and cities outside of London have levelled off. However, forecasts for office rental growth in London differ greatly from other UK cities.
- Supply shortages and improved conditions in the financial sector mean that London City office rents are forecast to rise at an annualised 9.2%pa over 2010 to 2014, while rents in London West End are forecast to rise by an annualised 4.0%pa (Figure 10).
- In cities outside of London, rental growth prospects are more subdued due to small forecast rises in employment in business services. Over the period 2010 to 2014, office rents in Leeds are forecast to fall 0.8%pa, while in the other cities, rents are forecast to rise by 1.5%pa or less.

Yields stabilizing before rising over medium term

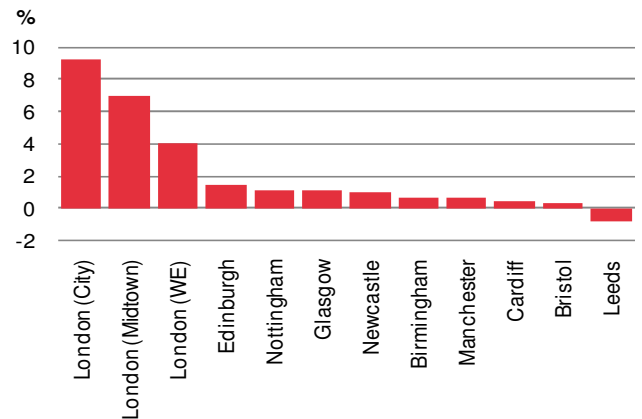
- Following falls this year due to strong investor demand, office yields in the London West End are then forecast to rise in 2011, while in London City, office yields are forecast to be flat in 2011, before rising in 2012 (Figure 11).
- Towards the end of the forecast period, when the economy normalises and bond yields increase as monetary stimulus is withdrawn, office yields are forecast to come under modest upward pressure, particularly in London markets.

Total returns forecast highest in London City

- In the majority of UK office markets, average annual total returns over the period 2010-14 are forecast to be greater than over 2005-09, when sharp drops in capital values in 2008, due to the financial crisis, offset strong returns prior to the financial crisis (Figure 12).
- Total returns are forecast to be highest in London City and London Midtown, at 14.7%pa and 12.7%pa respectively, followed by Edinburgh and London West End at 9.3%pa and 8.9%pa respectively. Higher total returns in these markets reflect stronger rent rises feeding through to capital values.
- In other UK office markets, total returns are forecast to be in the range of 5.5%pa to 8.5%pa. Although income returns are higher in these markets, rental growth, and hence capital value growth, given the absence of yield shift, is forecast to be subdued.

Figure 10

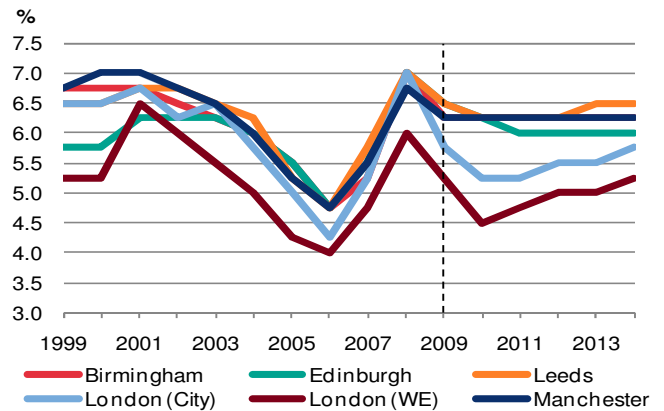
UK Office Rental Growth Forecasts 2010-2014 %pa



Source: DTZ Research

Figure 11

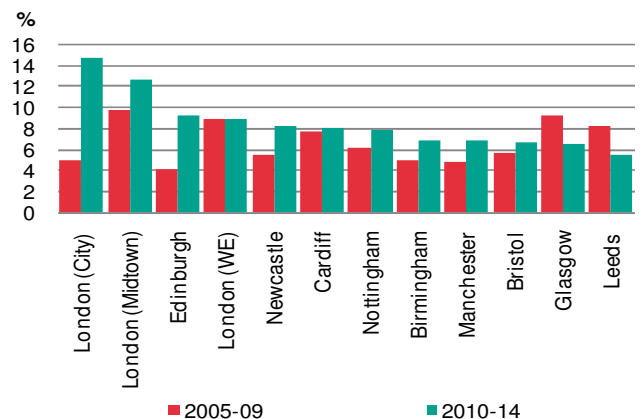
UK Office Yield Forecasts



Source: DTZ Research

Figure 12

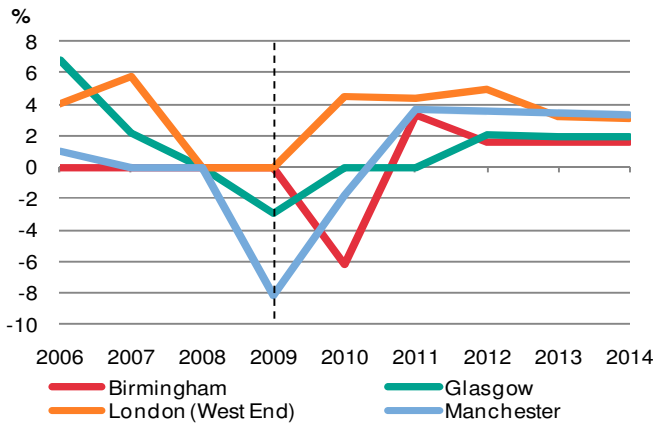
UK Office Annualised Total Returns



Source: DTZ Research

Figure 13

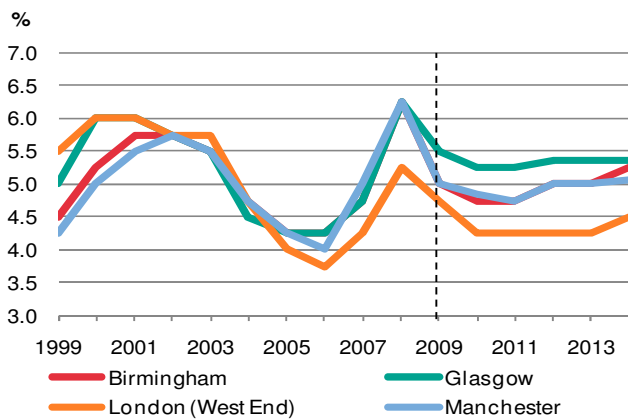
UK Retail Rental Growth Forecasts



Source: DTZ Research

Figure 14

UK Retail Yield Forecasts



Source: DTZ Research

Figure 15

UK Retail Annualised Total Return Forecasts



Source: DTZ Research

London to lead retail rental recovery

- The consumer sector of the economy remains weak due to high household debt levels and high unemployment. Consumer spending is forecast to show a modest recovery, although nevertheless underperform GDP growth for the whole economy.
- London, where prime retail rents did not fall during the recession, is expected to lead the recovery. Firm retailer demand is expected to result in rental growth of around 4%pa from 2010 onwards (Figure 13). Birmingham, on the other hand, is lagging the other cities, and rents are still expected to drop by 6.2% this year, before resuming modest growth of around 2%pa.
- In Manchester, where retail rents dropped by 8.2% in 2009, we expect rents to be flat this year, before recovering to growth of around 2%pa from 2011 onwards.

Yield compression nearly over

- Following strong investor interest in the UK market in the second half of 2009 and early 2010, retail yields are forecast to fall in 2010. However, the declines expected are not as large as those in 2009. (Figure 14).
- Between 2011 and 2013 we expect retail yields to show little change as bond yields remain below historical averages.
- Not until 2014, do we think that there will be pressure on retail yields to rise, as the effects of higher bond yields feed through. We expect yields in Birmingham and London to increase, although any rises will only be small.

Total returns forecast highest for London West End

- With the exception of Birmingham, we expect annualised retail total returns to be significantly higher over the period 2011 to 2014 than 2005 to 2009 (Figure 15).
- We expect total returns to be highest in London over the period 2010 to 2014, at an annualised 9.5%pa, supported by firm rises in rents that will push up capital values. We expect total returns in Birmingham to be lower, reflecting the weaker rental growth profile.

Industrial Market Forecasts

Industrial rents to stabilise in 2010

- Following declines of between 2.0% and 12.5% in 2009, industrial rents in the main UK cities are forecast to stabilise or show only small falls in 2010 (Figure 16). This reflects improved conditions in the manufacturing sector, which has led the recovery in the wider economy this year
- From 2011 onwards, growth in industrial rents is expected to pick up, but only modestly. In Glasgow, rents are not forecast to rise again until 2013, while rental growth in Birmingham is forecast to show a more steady pick-up.
- However, in all locations, we expect rental growth to remain below 5% over the forecast period, reflecting the fact that, on an historical basis, industrial rents have tended not to show large fluctuations.

Yield compression nearly over

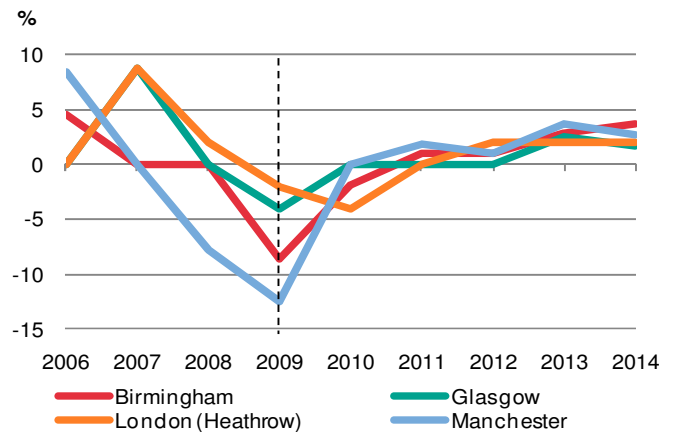
- Following declines in 2009, industrial yields are forecast to fall in 2010 in Birmingham, Glasgow, London Heathrow and Manchester. In London, we think that modest yield compression will continue into 2011, while yields are forecast to stabilise in the other cities (Figure 17).
- Following stronger investor interest in 2009 and 2010, between 2011 and 2013 we expect industrial yields to show little change. Financing rates will remain low, and the manufacturing sector of the economy is forecast to show reasonable growth.
- In the medium term, from 2013 onwards, we expect rises in government bond yields to gradually feed through, exerting some modest upward pressure on industrial property yields. However, we expect any rises in yields to be modest.

Total returns forecast highest in Manchester

- Industrial property is forecast to yield a higher total return over 2010 to 2014 than the period 2005 to 2009, when total returns were hit by large capital value declines due to the global economic crisis, (Figure 18).
- We expect total returns in Birmingham, Glasgow and Manchester to be between 8%pa and 9%pa over 2010 to 2014, supported by modest rises in capital values as rents increase. We expect total returns on industrial property in London to be lower, at 7.1%pa, reflecting the lower income yield on industrial property in London.

Figure 16

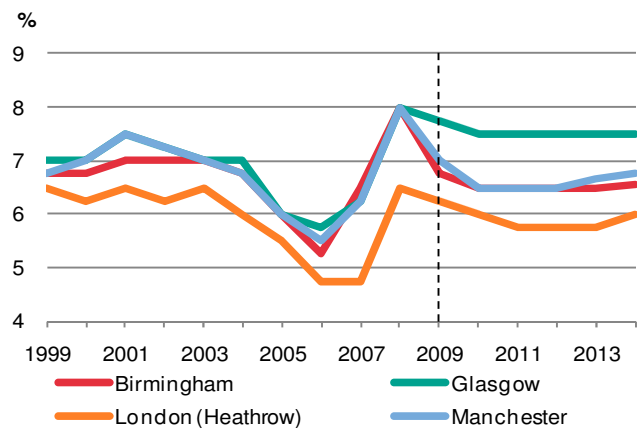
UK Industrial Rental Growth Forecasts



Source: DTZ Research

Figure 17

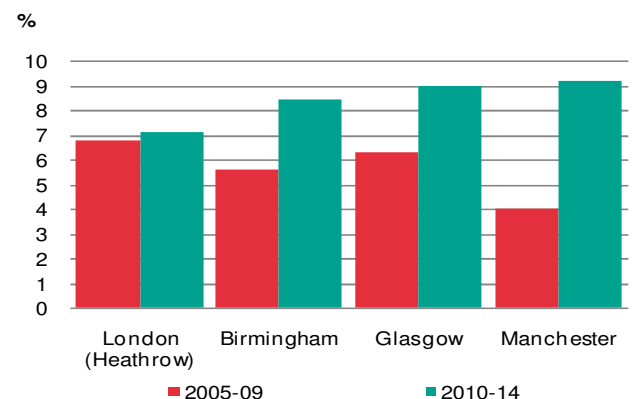
UK Industrial Yield Forecasts



Source: DTZ Research

Figure 18

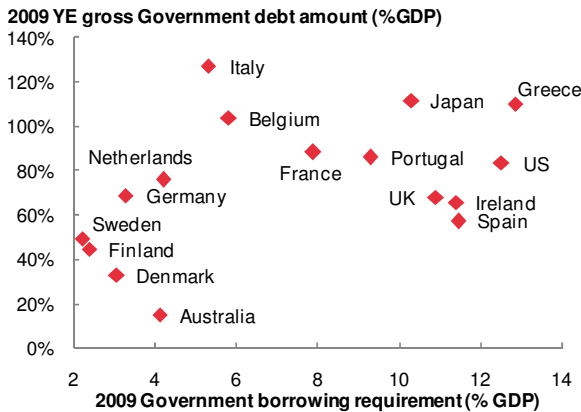
UK Annualised Industrial Total Return Forecasts



Source: DTZ Research

Figure 19

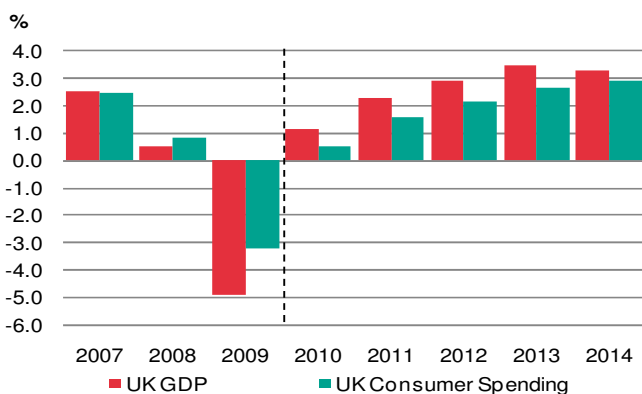
European Sovereign Debt Positions



Source: Oxford Economics/DTZ Research

Figure 20

UK GDP and Consumer Spending



Source: Oxford Economics

Figure 21

UK 10 Year Government Bond Yield



Source: Oxford Economics

UK Economy shows a strong rebound in Q2

- The UK economy showed a strong rebound in Q2. GDP rose by 1.1% during the quarter, supported by a particularly large increase in construction output of 6.6%. Service sector output rose by 0.9%, while in the manufacturing sector, which has received some benefit from sterling's depreciation, output rose 1.6%.
- However, business surveys suggest that the rapid growth will not be sustained into Q3, particularly in the service sector. Although there was a record rise in employment in Q2, at 7.8%, the unemployment rate remained high. Consumer confidence has slipped since the start of the year, while the housing market is slowing.

Government's austerity budget will weigh on growth

- At above 10% of GDP, the UK had one of the largest budget deficits in Europe in 2009 (Figure 19). To reduce the deficit, in its June Budget, the new coalition government announced a package of austerity measures. Through a combination of spending cuts and tax increases, the government aims to bring the cyclically-adjusted current budget back to balance by 2014/15.
- Of the £40bn of additional fiscal tightening announced, over 70% is expected to come from spending cuts. With the exceptions of health care and international aid, which have been ring-fenced, this will require real spending cuts of 25% over four years. Furthermore, public sector wages of £21,000 and above have been frozen for two years.
- The major tax announcement was in relation to VAT, the consumption tax, which will increase to 20% at the start of 2011 from its current rate of 17.5%. In two concessions, the income tax threshold was increased for lower rate taxpayers, while the rate of corporation tax will be cut progressively.

Slow recovery in the economy expected

- The cuts in public spending are set to weigh on GDP growth. Not until 2012 is GDP growth expected to rise above 2.5% again, with further downward revisions possible due to the measures announced in the Budget (Figure 20).
- Given the slow recovery in the economy, 10 year government bond yields are forecast to remain around 4% in 2010, and not to rise above 5% until 2011 as monetary stimulus is slowly withdrawn (Figure 21).

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