



JANUARY 2010

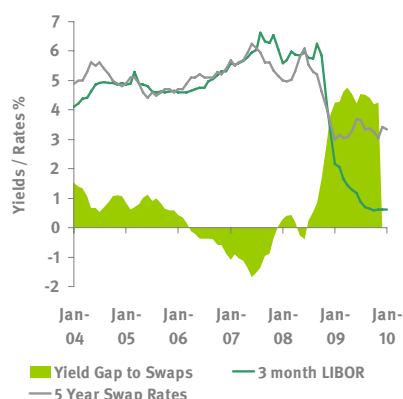
UK MARKET OUTLOOK

Commercial property review

Knight Frank

Financial indicators

Lending rates and property yield gap



Source: Knight Frank Research, FT, IPD

- Another year, another BoE decision to maintain the base rate at 0.5%. But January was always going to be merely a pause. February's decision will be one that requires real debate, as year end figures start to appear.
- 3 month LIBOR moved to 0.61% in early November and stayed there. It made a bold effort to do something different for Christmas by moving in to 0.60%, but clearly felt uncomfortable and had returned to 0.61% by year end, where it has remained ever since.
- Interbank rates have been consistently within the long term margin of 20bps over base since the start of September, indicating banks have restored their faith in each other on a sustainable basis. Now if only they could be persuaded to show similar confidence in the rest of us.

Economic forecasts

- 2009 will undoubtedly be the worst on record in terms of economic performance. Since 1950, our previous low was a contraction of -2.2% in 1980. By end Q3 last year, we were already running at -3.4%.
- All those commentators who had expected us to exit recession in Q3 are now saying that it will have happened in Q4 instead.
- Surprising, then, that the current consensus remains for us to have seen a decline of -4.5% throughout 2009, requiring a steep fall of c. -0.9% in Q4. Which seems pretty unlikely.
- Perhaps less surprising is the medium term forecast for a steady return to trend in the UK economy. That's an economist's way of saying they don't really know what's happening, but they reckon it will turn out alright in the end.
- This does disguise the somewhat more disparate views of the 35 organisations inputting to the consensus. Forecasts for next year still range between a rather radical contraction of -0.5% and a near trend-like rebound of 2.0%. The average of 1.3% implies more optimists than pessimists, but clearly there remains a great deal of uncertainty. 2010 is going to be quite an interesting year.

Economic forecasts

	2009	2010	2011	2012	2013
GDP	-4.5	1.3	2.0	2.3	2.7
CPI	1.8	1.8	1.6	2.0	2.3
RPI	0.0	2.8	2.5	3.1	3.1
B/Rate	0.5	1.3	1.8	3.0	3.8

Source: HM Treasury Consensus, Nov & Dec 2009

Property performance

Key performance indicators

Borrowing yield gap*	425 bps	↓
Risk yield gap**	460 bps	↓
Investment purchases (to Nov)	£18.00bn	
- of which, from overseas	44%	↑
All Property void rate	12.5%	↑
	Initial yield	20yr average
Retail	7.0%	6.3%
Office	7.6%	7.3%
Industrial	7.7%	8.0%

Source: IPD, FT, Property Data, Knight Frank Research

*5 yr Swap rates to All Property initial yield

**Gilt redemption yield to All Property equivalent yield IPD and matching data as at end November 2009

- IPD figures for November noted the biggest monthly improvement in capital values for 15 years. The monthly rise of 2.36% pushed the year-to-date decline in pricing back into single figures, now standing at -8.4%.
- Perhaps even more intriguing was the reduction in the rate of decline in rental values. By which I mean they still went down, but not as much. This is somewhat counter-intuitive in a recessionary market which lags unemployment trends, where you'd expect all things occupational to be getting worse, not better. It feels like a monthly blip to me, but perhaps December will have proved me wrong.
- All in all, the total return for the 11 months to November stood at a rather modest -1.4%.
- However, all this does mean that yields are being pushed in significantly once again. Although average retail and office initial yields remain above the long term average, it's not by much. Industrial yields are already lower.

Commercial Research

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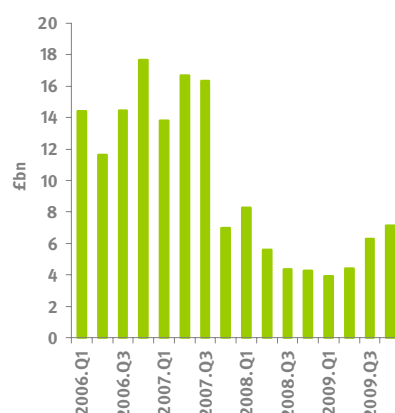
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UK investment volumes

- The average quarterly volume of investment transactions in the last decade has been £8.8bn, according to Property Data.
- Admittedly, the last decade has seen some pretty turbulent levels of activity, ranging from a peak of £17.7bn in the last quarter of 2006 to a low of just £3.9bn in the first quarter of 2009.
- Still, that's not necessarily different to any other decade. The property market does like to keep us on our toes.
- The annual volume for last year is currently thought to be c. £21.7bn - about the same as 2008 - but significantly a third of that took place in Q4.
- Thus an estimated £7.1bn of transactions in the final quarter of 2009 doesn't look too bad. Not quite up to par, but very much in line with the sort of levels we saw in the early 2000s, before things started getting a little crazy.
- What has been particularly interesting is not just the level of transactions, but the source.

UK quarterly investment volumes

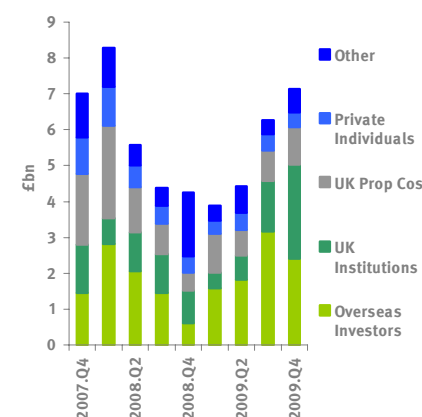


Source: Property Data

- Overseas investors have pretty much dominated throughout the downturn. If we take the market trough as being from the start of Q4 2007 onwards, overseas investors made 34% of all UK commercial property purchases. By comparison, the next largest investor group was the UK institutions, which purchased 20% of the total.

- However, one quarter of the purchases made by UK institutions throughout this entire period took place in Q4 2009.
- In fact, purchases by UK institutions outstripped those of overseas investors and accounted for 37% of the quarterly volume. Assuming they can continue to find anything to buy (a pretty big assumption), it's fair to say the UK institutions are back.

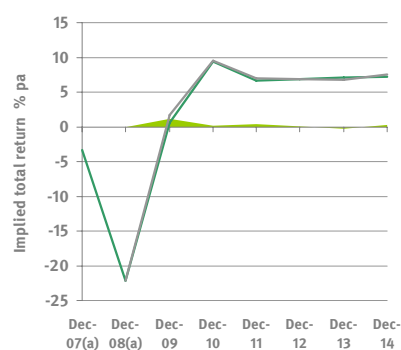
UK purchases by investor type



Source: Property Data

Property derivatives

Derivatives pricing: implied total returns



Source: Morgan Stanley

- Not much variation is showing in those lines, bar a very (very) modest improvement in views on the 2009 outturn.
- The derivatives market is now indicating a positive outcome for last year, pricing in a total return of 1.8%, up from the 0.6%

anticipated at the end of November.

- Now remember, just one year ago derivatives pricing was set at -19.8% for 2009. Somebody out there has made a lot of money. And someone else is getting their belongings handed to them in a cardboard box.
- Current pricing for next year implies a total return of 9.6%, followed by several steady years bobbing around the 7% mark. If only property did perform that consistently.
- Returns of 7% are a bit of a non-view, really. Without programming in a significant bounceback in values beforehand, 7% is really just income. No yield improvement, no rental growth. Just 4 consecutive years of nothing but income.
- Which leads me to think that, in a couple of years' time, somebody is going to have made a lot of money. And someone else is going to

be stocking up on their supply of cardboard boxes.

KNIGHT FRANK COMMENTS

And so we enter the new year with a certain amount of trepidation. Investment volumes are up and yields are coming down (at least at the prime end) but the occupational market has still to turn the corner. In fact it's not even on the same street yet.

Add in a general election and the spectre of a hung parliament – the worst possible outcome from the point of view of trying to stabilise our economy – not to mention the ongoing difficulties of securing lending, and 2010 is looking like it's going to make for a very interesting 12 months indeed.