RESEARCH & FORECASTING UK

# REAL ESTATE INVESTMENT FORECASTS Q4

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"Bank funding costs and ongoing deleveraging continues to constrain debt availability for new real estate lending."

RESEARCH & FORECASTING
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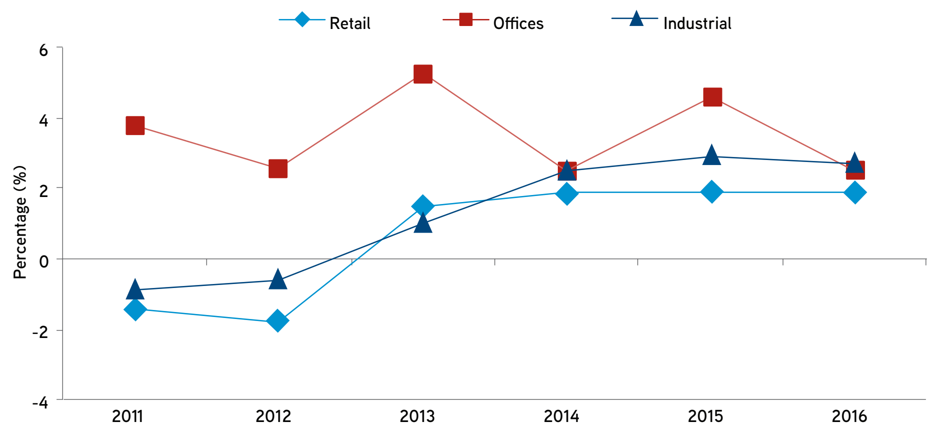
## Executive Summary

- Risk aversion is affecting all asset classes with safe haven asset yields falling, including UK gilts. In contrast, eurozone uncertainty has pushed the German bund up to over 2%. UK initial yields fell marginally in October from 6.23 to 6.20 on the IPD monthly index. UK property capital value is being supported by eurozone instability.
- The UK three-month LIBOR rate continues to rise and reached 1.05 in early December reflecting increased stress (counterparty risk perception) in interbank funding. Bank funding costs and ongoing deleveraging continues to constrain debt availability for new real estate lending.
- In October and November, commercial real estate investment reached a modest £3bn with 137 completed deals, down from £5.7bn and 231 deals over the same period of 2010. Despite this significant slowdown, levels are higher than in the post-Lehman period of 2008.
- UK economic performance downgrades have resulted in some downgrading of Colliers International forecasts. Total return for All Property has been cut from 8.2% to 5.4%. The total return forecast over the time horizon of 2012 to 2016 is 7.9% pa, unchanged from Q3.
- Our retail forecast for 2012 has been slashed from 6.7% to 3% due to falling capital values of shopping centres and high street shops by 7.2% and 3.2% respectively. Supermarkets' capital values should increase by 4.1% as investors continue to seek strong covenants and avoid riskier properties.
- City and West End offices have fared better with total returns forecast to be 11.9% and 12.9% respectively in 2012. Central London rents will grow by about 5% next year, with stronger growth coming in 2013 and then tailing off later on in the horizon.

FIGURE 1: RENTAL VALUE GROWTH BY SECTOR




Source: Colliers International/IPD

# All Property Forecasts

"Political paralysis has led to economic paralysis as businesses hold back on making investments, which are needed to establish the level of growth desired by politicians."

"Q3 GDP growth came in at 0.5% q/q, beating the market expectations, but is still off the target needed by the current government coalition to achieve their deficit reduction plans."

The uncertainty created by the lack of a credible political solution for the future of the eurozone continues to be a significant factor affecting decisions by investors in commercial property. Political paralysis has led to economic paralysis as businesses hold back on making investments, which are needed to establish the level of growth desired by politicians. Risk aversion remains prevalent in the bond market, although the "safe haven" German bund yields rose by 50 bps over the month of November. Risk aversion is consistently climbing in the interbank lending market as well – three month £Libor has increased since mid-June from 82.5 bps to 105 bps in early December.

Q3 GDP growth came in at 0.5% q/q, beating the market expectations, but is still off the target needed by the current government coalition to achieve their deficit reduction plans. To compound the problem, GDP growth numbers for Q4 are expected to be weak even with the asset purchasing stimulus programme restarted by the Bank of England. More evidence suggesting weakness is the overall CIPS/Markit Purchasing Managers Index, which fell slightly from October's 47.8 to 47.6 in November, indicating that manufacturing isn't providing the boost to the economy that is needed.

As a result of the pessimistic outlook provided by the government and market sentiment, Colliers International's All Property total return for 2011 has been marked down since Q3, dropping from 8.0% to 7.1% in Q4. The likelihood of a recession in early 2012 is increasing and has pushed our total return expectations significantly lower to 5.4% from 8.2% previously. Colliers International's total return forecast is 7.9% pa over the time horizon of 2012 to 2016, unchanged from Q3.

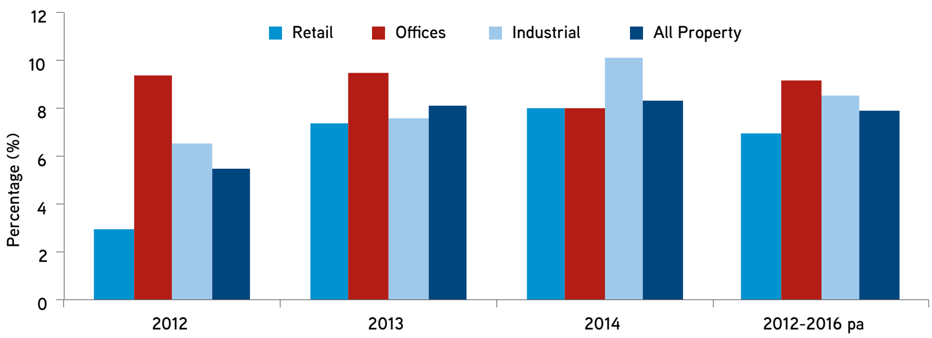
Rental growth projections for 2012 will contract slightly for All Property but will rebound in 2013 as the economy recovers and investment picks up. We expect demand for commercial space to increase later in the horizon, as the unemployment level slowly returns to long term trend. This progression will lead to rental growth of 2.0% pa between 2012 and 2016. We have pushed out capital growth expectations, which are now expected to peak in 2015, led by the office sector.

ALL PROPERTY FORECAST SUMMARY

| | 2012 | 2013 | 2014 | 2012-2016 pa |
|---|---|---|---|---|
| ERV Growth (% pa) | -0.4 | 2.5 | 2.3 | 2.0 |
| Equivalent Yield (% end period) | 6.7 | 6.7 | 6.6 | 6.5 |
| Capital Growth (% pa) | -0.8 | 1.6 | 2.0 | 1.5 |
| Total Return (% pa) | 5.4 | 8.1 | 8.3 | 7.9 |

Source: Colliers International/IPD

FIGURE 2: FORECAST TOTAL RETURN FOR ALL PROPERTY




Source: Colliers International/IPD

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# Investment Activity

Libor is rising because global banks with excess reserves are demanding more interest on funds lent to banks with precarious exposure to peripheral nations' debt. Increasingly expensive bank funding will lead to a credit squeeze, thus blocking investment by the private sector. Nevertheless, six major central banks are working together to open the credit lines to banks in need of liquidity. This united action should help boost market confidence in the short term and will hopefully last into the new year.

## CASH WILL REIGN IN 2012

Unless the eurozone governments come to viable short and long term solutions for the sovereign debt crisis soon, the efforts of the central banks will be fruitless. Eurozone banks face an uphill task over the next few years of deleveraging without hindering capital values. This has two impacts on the UK commercial real estate industry – potential oversupply coming to the market and lowered ability to absorb the assets due to less debt financing available. Eurohypo and Societe Generale have already suspended new lending to the sector; 2012 will be tipped in favour of cash buyers.

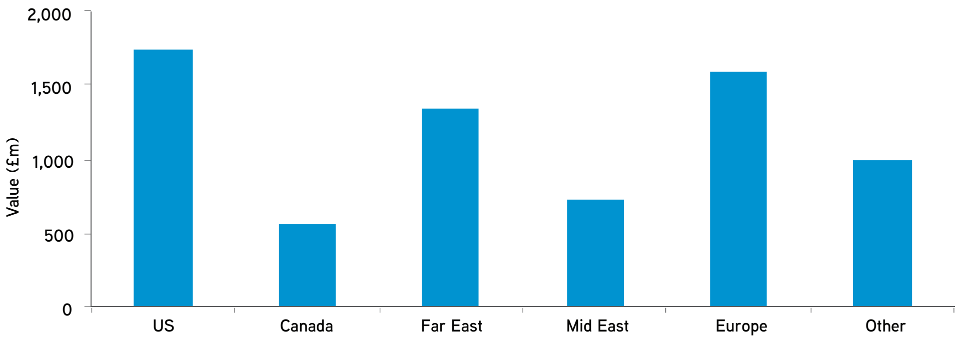
## VALUE AND VOLUME TURNED DOWN

Market sentiment is waning and the likelihood of a strong Q4 to make up for a challenging year is fading. For the first three quarters, 2011 transaction values were only 0.6% lower compared to 2010, while volume was down 14%. This is evidence of investors taking prime assets at relatively higher valuations than the previous year. In October and November, the value traded was £3.0bn on 137 deals completed – down from £5.7bn on 231 deals over same two months in 2010. Nevertheless, the activity over the two months this year is 112% higher by value than immediately after the Lehman Brothers' collapse in 2008.

## OFFICE PARKS ATTRACT FOREIGN CAPITAL

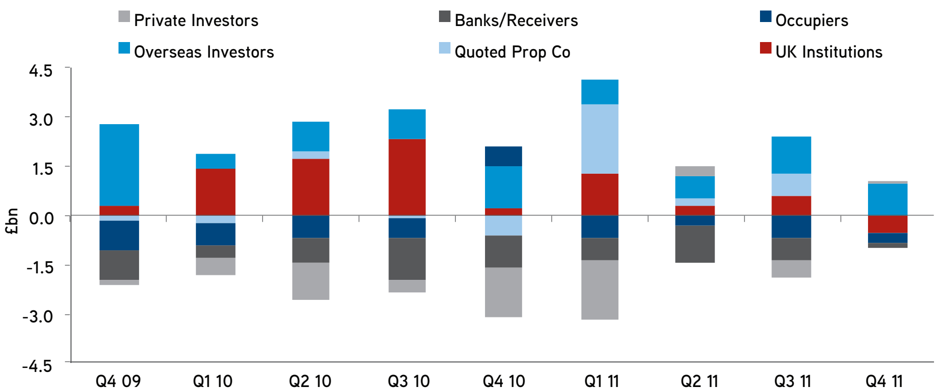
Over the first two months of Q4, overseas investors continue to be the largest net investors for the third straight quarter, taking £1.6bn worth of property so far, while selling £614m. Offices accounted for 63% of foreign investment, with the majority going to office parks. This has bucked the trend of City and West End taking the lion's share of foreign investment. For the first time since Q3 2009, UK institutions are net sellers, having so far disposed of £562m more than purchased. Occupiers continue to be net sellers, with sale and leasebacks being popular in the management pub and supermarkets sector.

FIGURE 3: OVERSEAS INVESTMENT IN UK OFFICES IN 2011




Source: Property Data Ltd

FIGURE 4: NET INVESTMENT BY INVESTOR TYPE




Source: Property Data Ltd

"Increasingly expensive bank funding will lead to a credit squeeze, thus blocking investment by the private sector."

"Eurozone banks face an uphill task over the next few years of deleveraging without hindering capital values."

"For the first time since Q3 2009, UK institutions are net sellers, having so far disposed of £562m more than purchased."

# Retail

The retail sector has struggled in 2011, highlighted by several high profile administrations earlier in the year, all the way up to the Arcadia Group announcing plans to close 260 stores over the next few years. The BRC/Springboard footfall monitor reported high street footfall dropping 2.5% in Q3 in comparison to last year, with an equivalent drop for shopping centres. Out-of-town retail performed slightly better with a 2% contraction. November's GfK NOP Consumer Confidence Index showed a small improvement from October at -31, the fifth straight month of -30 or worse. High street retailers are bracing themselves for a subdued Christmas period as eight out of ten respondents to a Legal & General survey said they will spend less or the same as last year.

## TOUGH START TO THE NEW YEAR FOR RETAIL LANDLORDS

Retail landlords will have a difficult start to 2012 with several big retail groups announcing store closures. Best Buy will be closing 11 big box stores by the end of this year, Game Group has plans to close up to 150 shops in a bid to restructure its business and Thomas Cook is closing up to 200 stores to cut costs. Furthermore, Ernst & Young recently warned that the UK could see more retail insolvencies after this Christmas than at the end of 2008. EGi reports that landlords are looking to minimise losses by letting some outlets for nominal amounts to avoid business rates on empty property. Nevertheless, speciality players (Hotel Chocolat, Schuh and Majestic) and restaurant groups (Gondola and TRG) continue their expansion plans.

## INFLATION TO MODERATE IN 2012

With RPI above 5% in every month of 2011, consumer spending has fought strong headwinds since the increase in VAT at the beginning of the year. HM Treasury's November independent average forecast for RPI in 2012 is 3.5%, which means it is still above the 10 year average of 2.8%. However, the painful "VAT effect", reflected by the 2.5% increase this year, will disappear from the year on year inflation numbers in 2012.

## CAPITAL VALUES TO FALL ON THE HIGH STREET AND IN SHOPPING CENTRES

Colliers International's total return forecast for the retail sector in 2012 has been slashed from 6.7% in Q3 to 3%, due to falling capital values of shopping centres and high street shops of 7.2% and 3.2% respectively. Supermarkets' capital values are expected to increase by 4.1% as investors continue to seek strong covenants and avoid riskier properties. Rental growth for the sector is expected to contract by 1.8% next year, but growth should return in 2013 and continue until 2016. Supermarkets will return 8.7% in total next year and have modest capital growth over the horizon, allowing for an annualised total return of 6.7% between 2012 and 2016.

RETAIL FORECAST SUMMARY

| | 2011 | 2012 | 2013 | 2012-2016 pa |
|---|---|---|---|---|
| ERV Growth (% pa) | -1.4 | -1.8 | 1.5 | 1.3 |
| Equivalent Yield (% end period) | 6.4 | 6.5 | 6.4 | 6.3 |
| Capital Growth (% pa) | -1.0 | -3.0 | 1.1 | 0.9 |
| Total Return (% pa) | 4.8 | 3.0 | 7.4 | 7.0 |

Source: Colliers International/IPD

FIGURE 5: FORECAST TOTAL RETURN FOR RETAIL SUBSECTORS


Source: Colliers International/IPD

"The BRC/Springboard footfall monitor reported high street footfall dropping 2.5% in Q3 in comparison to last year, with an equivalent drop for shopping centres."

"Retail landlords will have a difficult start to 2012 with several big retail groups announcing store closures."

"Supermarkets' capital values are expected to increase by 4.1% as investors continue to seek strong covenants and avoid riskier properties."

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"Central London should see rents grow next year, but not as robustly as previously thought, with stronger growth coming in 2013 and then tailing off later on in the horizon."

"Office park investments have amounted to £770m in the past two months, higher than the £681m for 2010 as a whole."

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# Offices

## CITY OCCUPIER DEMAND TO SLOW IN 2012

The short term outlook for occupiers in the City has softened recently with demand correlating to what happens in the eurozone debt crisis. Space demanded by banks is likely to shrink in 2012 as financial services hiring slows down as banks try to abide by the new regulations for capital requirements. One City recruiter reported that the number of jobs filled in November is down by 30% from September's total. Furthermore, eurozone banks deleveraging balance sheets will likely their long term demand for space in London. On a positive note, the Walbrook is now getting some attention for the right reasons as a letting deal could see Schroders take 250,000 sq ft and Delancey take over its current lease-liability for 160,000 sq ft on Gresham Street.

Colliers International's forecast for offices in 2012 sees the West End achieving a total return of 12.9%, down slightly from 13.4% in Q3, while the City was also revised down from 13.4% to 11.9% for next year. Central London should see rents grow in 2012, but not as robustly as previously thought, with stronger growth coming in 2013 and then tailing off later on in the horizon.

## FOREIGNERS TAKE OFFICE PARKS

Over the first two months of the fourth quarter the office sector has acted out of step with the first three quarters of 2011. So far in Q4, two of the largest transactions have been outside the capital and have been office parks – Reading's Green Park (£408m) and Reading International Business Park (£140m). However, both parks were purchased by foreign interests. Furthermore, in the rest of the UK, offices and office parks have attracted over £1bn of investment in October and November, in comparison to £571m in London offices. Office park investments have amounted to £770m in the past two months, higher than the £681m for 2010 as a whole. Going forward, Colliers International does not expect a significant number of blockbuster deals in the office parks subsector, but rather sees yields move outwards by 30 bps as the supply of secure income producing parks declines. 2012 is expected to be a difficult year for secondary and tertiary parks due to rents falling and capital values slipping slightly.

## REGIONAL OFFICES STILL AN OCCUPIER'S MARKET

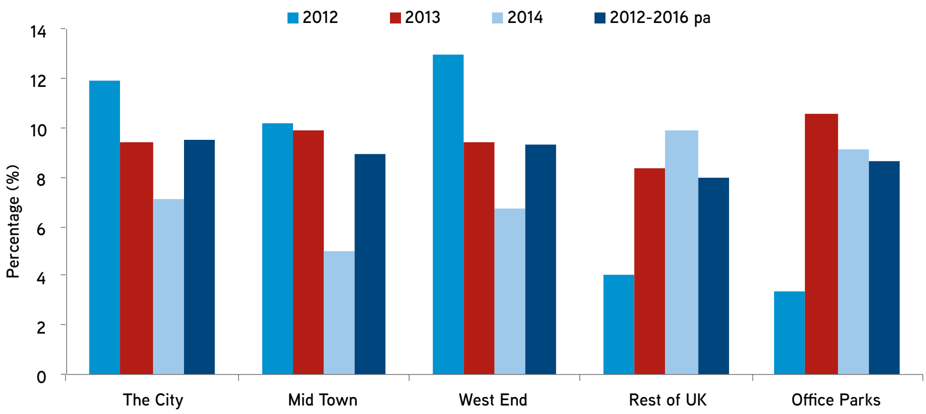
Regional markets' take-up reached 2.06m sq ft in Q3, compared to 1.97m sq ft in Q2. Birmingham's The Cube will likely let 55,000 sq ft to the Law Society, making the building fully let, as take-up in the city increased 43% in Q3 q/q. Q3 saw take-up rise in Liverpool, Newcastle, Cardiff, Swansea, and Edinburgh City Core. Demand for and supply of regional offices continues to work against landlords. There is evidence of occupiers looking to secure tenancy for use in the future (KPMG, BUPA, Jacobs Engineering, Aviva in Manchester and Assay Office in Birmingham), suggesting firms are expecting rents to rise by the time their leases expire. For the rest of the UK office market, Colliers International's forecast for rental values expects rents to fall by 1.4% in 2012, but grow by 1% pa over the 2012 to 2016 time period. Furthermore, total return will be hindered by capital value losses next year, but average 8% pa over the period.

OFFICES FORECAST SUMMARY

| | 2011 | 2012 | 2013 | 2012-2016 pa |
|---|---|---|---|---|
| ERV Growth (% pa) | 3.8 | 2.6 | 5.3 | 3.5 |
| Equivalent Yield (% end period) | 6.7 | 6.6 | 6.7 | 6.7 |
| Capital Growth (% pa) | 4.4 | 3.1 | 3.4 | 3.2 |
| Total Return (% pa) | 10.6 | 9.4 | 9.5 | 9.2 |

Source: Colliers International/IPD

FIGURE 6: FORECAST TOTAL RETURN FOR OFFICE SUBSECTORS




Source: Colliers International/IPD

# Logistics & Industrial

## INVESTMENT ACTIVITY DOWN IN Q4

The logistics and industrial sector has seen a slowdown in investment activity over the first two months of Q4 in comparison to 2010, down from £508m to £271m. The uncertainty caused by the eurozone crisis is partly to blame, but internal economic weakness is the main cause of the slowdown. November's CIPS/Markit Purchasing Managers Index slid slightly further into negative territory, with the output balance falling from 48.1 to 47.2 due to a drop in consumer goods demand. Furthermore, the employment balance of PMI fell from 49.6 to 46.2 in November, suggesting there will be jobs lost in the manufacturing sector in the near term.

## NEW DEVELOPMENT COMING THROUGH

Despite the negative economic sentiment surrounding the economy, several positive deals have taken place recently. The coalition government's push to increase manufacturing helped the Rolls Royce-Harworth Estates deal to develop a manufacturing facility within the Sheffield Enterprise Zone. Wilson Bowden is building a distribution centre of over 600,000 sq ft for Asda in Rochdale while the supermarket looks for 400,000 sq ft of additional space to supply its northern stores. Blackstone is expected to close a deal with ProLogis that will see the private equity firm purchase a shed portfolio of 3.5 million sq ft for £215m. Lastly, Sports Direct is adding 300,000 sq ft to its 525,000 sq ft warehouse in Derbyshire.

## TOTAL RETURN DOWNGRADED FOR 2012

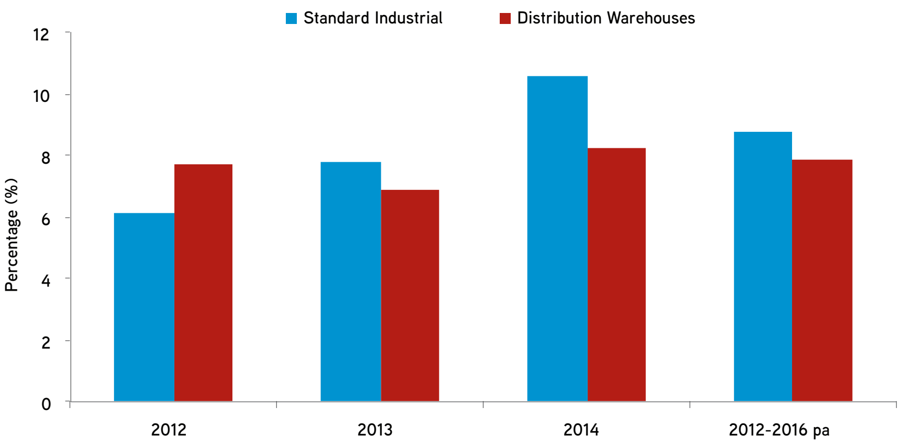
Colliers International's forecast for the logistics and industrial sector total return in 2012 has been revised downwards from 8.4% to 6.5% due to the likelihood of lower rents next year. Distribution warehouses should outperform standard industrial as demand from growing internet retailers continues to target proven distribution properties. After falling in 2012, rental growth should turn positive in 2013 and beyond, growing at 1.7% pa between next year and 2016. Furthermore, yields will see some compression by the end of 2014. Total return is expected to average 8.6% pa from 2012 to 2016, with standard industrial returning more than distribution warehouses in the latter years.

LOGISTICS & INDUSTRIAL FORECAST SUMMARY

| | 2011 | 2012 | 2013 | 2012-2016 pa |
|---|---|---|---|---|
| ERV Growth (% pa) | -0.9 | -0.6 | 1.0 | 1.7 |
| Equivalent Yield (% end period) | 8.3 | 8.3 | 8.3 | 8.2 |
| Capital Growth (% pa) | 1.9 | -0.9 | 0.0 | 1.5 |
| Total Return (% pa) | 8.9 | 6.5 | 7.6 | 8.6 |

Source: Colliers International/IPD

FIGURE 7: FORECAST TOTAL RETURN FOR INDUSTRIAL SUBSECTORS




Source: Colliers International/IPD

512 offices in 61 countries on 6 continents

United States: 125
Canada: 38
Latin America: 18
Asia Pacific: 32
ANZ: 182
EMEA: 117

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