RESEARCH & FORECASTING UK

REAL ESTATE INVESTMENT FORECASTS Q2

Contents

RESEARCH & FORECASTING

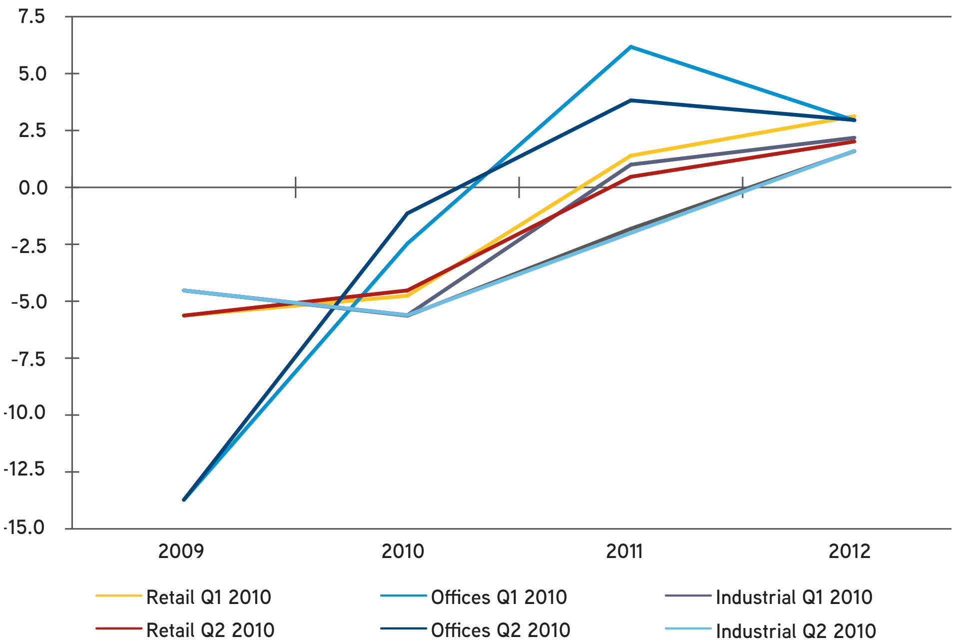
Kiran Raichura
+44 20 7487 1691
kiran.raichura@colliers.com

Walter Boettcher
+44 20 7344 6581
walter.boettcher@colliers.com

Executive Summary

- Colliers International is forecasting a total return of 10.0% on commercial property in 2010; a downward revision from our Q1 2010 forecasts, but in line with recent derivative pricing.
- Following a strong start to the year for investment activity, political and economic uncertainty has unsettled investors in recent months.
- The build-up to the recent emergency Budget saw expectations of tax rises, benefit cuts and public sector pay and job freezes severely dent business and consumer confidence.
- The anticipated occupier market recovery has been put on hold for now as business sentiment has yet to return to expansionary levels.
- While we expect risk free rates to rise over the forecast horizon, economic growth will also return toward trend, thereby supporting a five year annualised total return of just over 10%.
- On the whole, the risks to our forecasts remain weighted to the downside as the economy and property market seeks to negotiate its way through the post-recessionary landscape.

FIGURE 1 – REVISIONS TO OUR Q1 2010 RENTAL GROWTH FORECASTS



Source: IPD / Colliers International

All Property Forecasts

	IPD ACTUAL	COLLIERS INTERNATIONAL FORECASTS		
	2009	2010	2011	2012
ERV growth (% pa)	-7.9	-3.7	1.2	2.3
Equivalent yield (%)	8.0	7.6	7.4	7.2
Capital growth (% pa)	-3.6	3.3	2.7	4.0
Total return (% pa)	3.5	10.0	9.7	10.8

- 'All Property' returns will reach double digits this year, despite a downward revision to economic forecasts and faltering investor confidence.
- Yield compression will come to an end in the short term, with indications that some transactional yields are already rising slightly.
- The longer term picture will be one of rising gilt yields, but also improving economic growth, which should support occupier and investment markets.

We forecast total returns of 10.0% and 9.7% over the next two years as yields remain steady and low, supported by historically low interest rates and healthy demand for property as an asset class. Economic growth is likely to return to trend by the end of 2011. Steady growth in the latter years of the forecast period will help annualised total returns reach 10.4% in 2010-14.

The IPD May monthly index showed equivalent yields fell by 170 bps over the past 12 months as 'All Property' yields fell from 9.3% to 7.6% in this period. Strong competition for limited prime product drove this shift as the so-called 'wall of money' began to pour back into the UK market, enticed by weak sterling, perceived mis-pricing of risk and the transparent and liquid nature of the UK commercial property market. However, IPD noted that the last time yields fell at this rate was the mid-1990s and that in the following month, yields moved out again. In fact, in the last couple of months there have been signs that there could be holes in this 'wall of money' with retail funds and pension funds taking a step back from current pricing levels. In some markets yield movement has gone into reverse, with a slight rise being noticed in transactional yields in April and May and, in other cases, stock has been taken off the market where the asking price has become unlikely to be met.

Despite gilt yields falling following the successful Coalition Agreement, there has been an apparent realisation that risks still remain in the economy and, therefore, the occupier markets. However, as the year draws to a close, we may see some fund managers come under renewed pressure to put cash to work in property assets. As a result we anticipate equivalent yields ending the year at similar levels to those they reached at the end of Q1 2010.

The emergency Budget of June 22nd provided, as expected, a number of hard hits to spending and taxes, but managed to also provide some upside for many small and large businesses, although banks will surely be wary over the new bank balance sheet levy. The overriding theme was that of fiscal austerity and the need to gain control over the public finances in order to reduce the UK's debt repayments, which currently account for over a quarter of all Government spending. However, while the fiscal tightening led the Office for Budget Responsibility to revise its GDP growth forecasts down slightly for 2010 and 2011, we see the longer term positives of the Chancellor's actions. We also take an upbeat view on the implications the Budget has for monetary policy, ensuring that interest rates will stay lower for longer. Furthermore, higher rate taxpayers will now pay a Capital Gains Tax rate of 28%, which is far lower than the 40% that was widely mooted.

In 2011 and 2012, we expect to see gilt yields return towards long term trend (thereby rising by circa 100 bps) alongside a steady return to trend economic growth, which will aid the rental growth recovery. These two factors are likely to counteract each other, ensuring that equivalent yields show limited movement in these two years.

CONTRIBUTORS: INVESTMENT

Valuation
Russell Francis
+44 20 7344 6801
russell.francis@colliers.com

Fund Management
Nigel Holroyd
+44 20 7487 1719
nigel.holroyd@colliers.com

Adrian Payne
+44 20 7487 1784
adrian.payne@colliers.com

Investment Marketplace
André James
+44 20 7344 6707
andre.james@colliers.com

Indirect Market and Long Term Value

PROPERTY DERIVATIVE PRICING

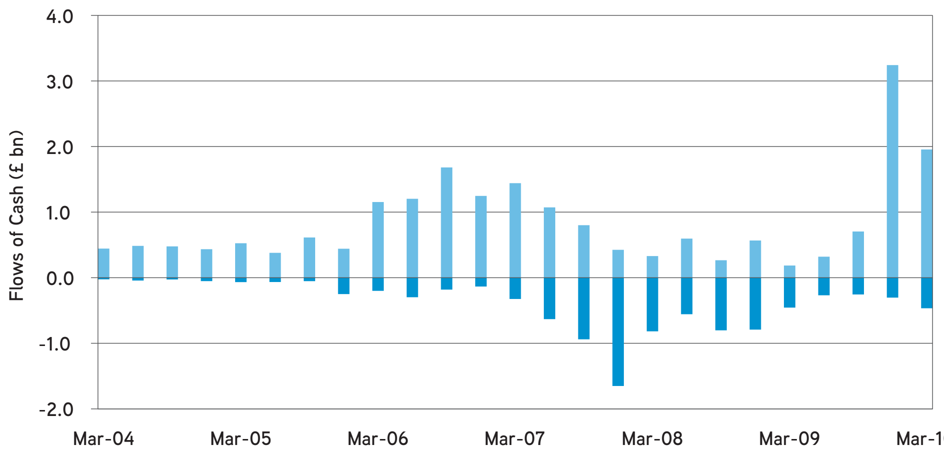
Our forecast for total returns in 2010 is exactly in line with property derivatives pricing at the time of going to print. Both of these numbers are substantially lower than those reported by the IPF and Capital Economics in their latest outputs. This partially reflects the change in sentiment and activity over the past month or so, which would not have been reflected in forecasts produced before the end of May. The table also highlights a huge difference between medium term derivatives pricing and our latest forecasts. Some academics are quick to explain away the apparently low returns implied by derivatives by comparing the market to other functioning derivative markets. They state that the margins over Libor should tend towards a small band above and below zero. This band should be larger than for other, more liquid, assets because of the specific costs and drawbacks of investing in real estate, although this argument is partially reliant on the market having a critical mass of activity. We would be inclined to argue that the total return swaps market is yet to have reached this point. Therefore, perhaps the low implied returns are a mixture of spreads reducing with longer contracts, as well as softer sentiment about the years ahead.

REAL ESTATE FUND CAPITAL FLOWS

Data from AREF (The Association of Real Estate Funds) shows the huge inflow of capital that occurred in the fourth quarter of 2009 as retail and institutional investors apportioned funds to real estate. This helps to explain the strong improvement in activity in the sector in the run up to the end of 2009. Q1 2010 also saw a large inflow of cash, although outflows picked up slightly during this period. Nevertheless, there remains a large volume of cash that needs to be deployed to real estate and the proportion of cash held by a number of funds remains high at well above 15%. **Figure 3** shows the relationship between net flows of cash into real estate funds and IPD quarterly capital growth for 'All Property'. Over the period shown, these two datasets show a correlation of over 74%, implying a strong positive relationship. While neither turns out to be a leading indicator, it is possible to draw a couple of conclusions from this. First, that over the past nine years, there has been an overall net increase in the volume of capital tied up in commercial property funds. It is also worth noting that a slight downturn in sentiment in early-mid 2007 was then far surpassed by the rate of capital growth decline that accompanied it over the period of falling values. Second, that for quarterly capital growth to be positive, net inflows of funds over the same period need to be close to £0.5 bn.

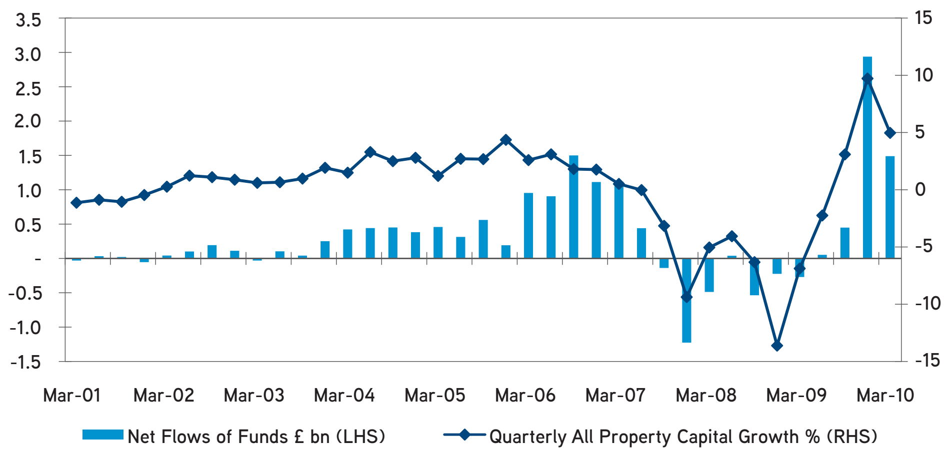
	2010	2011	2012	Annualised 2010-2014
Colliers International	10.0%	9.7%	10.8%	10.4%
Morgan Stanley Derivatives	10.0%	4.0%	4.0%	5.8%
IPF Consensus Forecasts	15.3%	6.0%	9.5%	9.8%
Capital Economics	17.8%	7.5%	7.2%	9.1%

FIGURE 2 – INFLOWS AND OUTFLOWS FROM REAL ESTATE FUNDS



Source: Association of Real Estate Funds

FIGURE 3 – FUND FLOWS AND ALL PROPERTY CAPITAL GROWTH



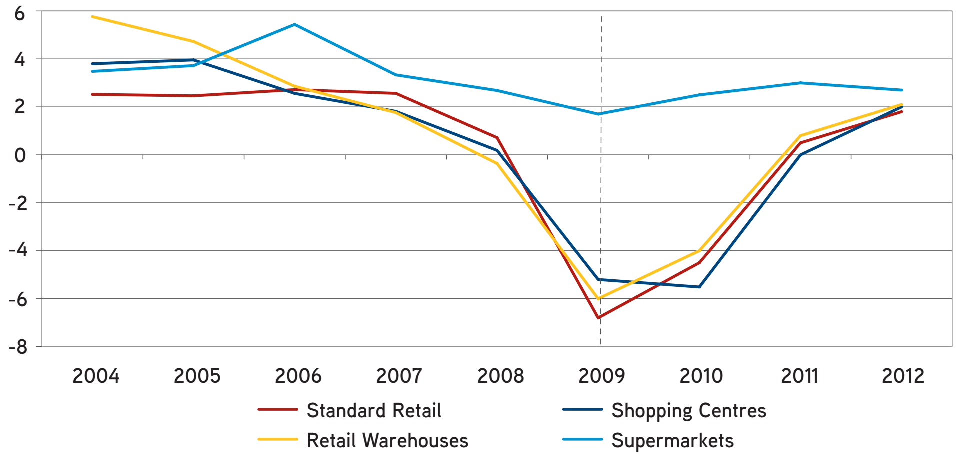
Source: IPD / Association of Real Estate Funds

Retail

- We forecast double digit returns for the retail sector in 2010, although much of this return stems from performance already witnessed in the first half of the year.
- In-town, demand for space will focus on large prime sites in central locations, ensuring a growing discrepancy between the performance of prime and secondary assets.
- Food store covenants remain in demand and these assets are transacting for initial yields of below 4.5%.

	IPD ACTUAL	COLLIERS INTERNATIONAL FORECASTS		
	2009	2010	2011	2012
ERV growth (% pa)	-5.6	-4.5	0.5	2.0
Equivalent yield (%)	7.5	7.1	7.0	6.8
Capital growth (% pa)	-2.4	4.5	2.9	4.4
Total return (% pa)	4.6	10.8	9.2	10.6

FIGURE 4 – RETAIL SUB-SECTOR RENTAL GROWTH



Source: IPD / Colliers International

Total returns to the retail sector are forecast to reach double figures in 2010, recording 10.8%, comprising a 4.5% capital gain and a 6.0% income return. This overall figure hides the vast divergence between our total return forecasts for supermarkets (16.0%) and high street shops (8.4%), with shopping centres and retail warehousing falling in-between.

Since IPD retail capital values bottomed-out at the end of June 2009, retail capital values have risen by 17.8% to end-May 2010 as yields fell sharply (208 bps) across the sector. We anticipate a slight rise in yields over the next few months as investor caution dominates, before improving activity causes them to fall again by year-end. This will ensure that yields finish the year roughly where they were at end-Q1, having already fallen by 44 bps according to the IPD Quarterly Digest. This aspect of 2010 performance and the limited nature of further rental value falls for stronger stock will ensure that capital values rise for the year as a whole across all retail sub-sectors.

IN-TOWN

During 2010, with investment demand staying focused on prime sites with large international tenants and long unexpired leases, we anticipate that Central London and the top tier of towns will outperform the UK average. Second and third tier locations have already experienced a slight easing in demand in the past couple of months and we anticipate a small rise in yields as a result. Shopping centres experienced a large yield shift in the first quarter (falling by 40 bps) and these should experience a certain degree of catch-up against the other sub-sectors as the year progresses. Occupier markets have seen a similar polarisation between large units in prime centres and smaller units in weaker locations. Our forecast for average high street units is for rental growth to turn marginally positive in 2011, before a gradual recovery as consumer spending and retail sales improve in 2012 and beyond; although for shopping centres, we do not anticipate there being much support from rental growth over the next five years, with annualised growth during 2010-14 of only 0.3%.

OUT-OF-TOWN

Our forecasts envisage the food store investment market being tested as interest rates rise during 2011 and beyond, but for now at least, they remain a sub-sector very much in demand. Transactional yields on bulky goods parks eased out a little earlier this year and, although there continues to be plenty of demand, there is a feeling that this is less pronounced than it was before Christmas. Open A1 fashion parks are likely to have also seen a slight softening in demand with investors again becoming more wary of the outlook for rental growth, although we do not envisage another noticeable dip in capital values.

We anticipate food stores continuing to post 2.5-3.0% rental growth over the next couple of years, while retail warehousing will produce the best rental growth of the other retail sub-sectors over the forecast horizon. Both will produce double digit returns this year, although in the following years an improving economic outlook will be counter-balanced by a rise in the risk-free rate.

CONTRIBUTORS: INVESTMENT

Retail – In-Town
André James
+44 20 7344 6707
andre.james@colliers.com

Retail – Out-of-Town
Charles Watson
+44 20 7344 6696
charles.watson@colliers.com

CONTRIBUTORS: AGENCY

Retail – In-Town
Paul Moody
+44 20 7487 1796
paul.moody@colliers.com

Retail – Out-of-Town
Colin Dunkerley
+44 20 7344 6809
colin.dunkerley@colliers.com

Offices

- Colliers International forecasts a total return of 11.0% for 'UK Offices' in 2010, although this hides a strong divergence between Central London and the rest of the country.
- In many markets, yield movement is likely to move into reverse over the next few months as investors take a step back from current pricing levels.
- Investment activity in the regions accounts for a larger proportion than recent years, although demand for business parks remains weak.

Our forecasts indicate total returns of 11.0% for all offices, with the City and the West End enjoying the strongest performance this year at 15.7% and 14.7% respectively. On the other hand, office parks and offices outside of London will each return only 4.7% and 6.9% in 2010. These differences are driven by improvements in occupier markets in Central London and further deterioration in the regions and in business parks. This relative performance continues throughout much of the forecast period.

Prime initial yields in the City edged in further in Q2 as investment demand continued to outpace the volume of new supply being brought to market. We expect this market to hold up relatively well over the next six months, although assets in some fringe locations and with weaker covenants may see a slight weakening in demand. However, a number of available properties being removed from the market highlight the worries that surround the sustainability of current prices. In the occupier market, capital contributions and lengthy rent-free periods remain a feature, particularly for smaller Grade B space (5,000-10,000 sq ft) where there is an excess of supply. Conversely, there is a definite lack of Grade A space, with some landlords looking to take stock back given the opportunity, with a view to re-letting at higher rents with reduced incentives. In Mid-Town, there is still a lack of supply of new space.

The West End saw a rise in the amount of investment stock coming to market in the second quarter, some of which was driven by the expected rise in Capital Gains Tax, whilst there were other attempts to realise profits from purchases made at the bottom of the cycle. Assets have begun to take a little longer to shift, although the number of viewings remains high. The market has certainly cooled slightly, with investors becoming more stock-selective, although this could be partially attributed to the uncertainty in the run-up to the emergency Budget. Occupier market positivity has been driven more by a lack of supply than by any strong uptick in demand, with the number of prospective occupiers roughly matching the number of available units, meaning there is no real competition for space. The apparent dichotomy between the West End and City occupier markets is predominantly driven by the headline rents and large headline deals being achieved in the City, although also by the continued recovery of the financial and legal sectors.

Regional investment activity has accounted for a greater share than usual in the office sector during 2010, making up 34% of activity compared to the 28% average of the past three years. This reflects both a relative improvement in the volume of available stock in the regions, but also the realisation by some investors that a prime asset let to strong tenants with long leases in a major regional centre may provide a lower risk, as well as a higher income yield, compared to parts of the London market. Regional occupier markets remain sluggish though, with rents unlikely to rise until at least 2011 and incentives on secondary stock still growing. However, Birmingham and Bristol in particular are leading the way and are likely to see vacancy drop fairly quickly over the next 12-18 months. Most centres have limited supply pipelines, but all stand to suffer more than London when full details of public sector cuts are announced.

CONTRIBUTORS: INVESTMENT

Offices – City of London
Andrew Whitaker
+44 20 7487 1869
andrew.whitaker@colliers.com

Offices – West End
Nick Pemberton
+44 20 7487 1617
nick.pemberton@colliers.com

Offices & Industrial – National
Stuart Atkinson
+44 20 7344 6723
stuart.atkinson@colliers.com

CONTRIBUTORS: AGENCY

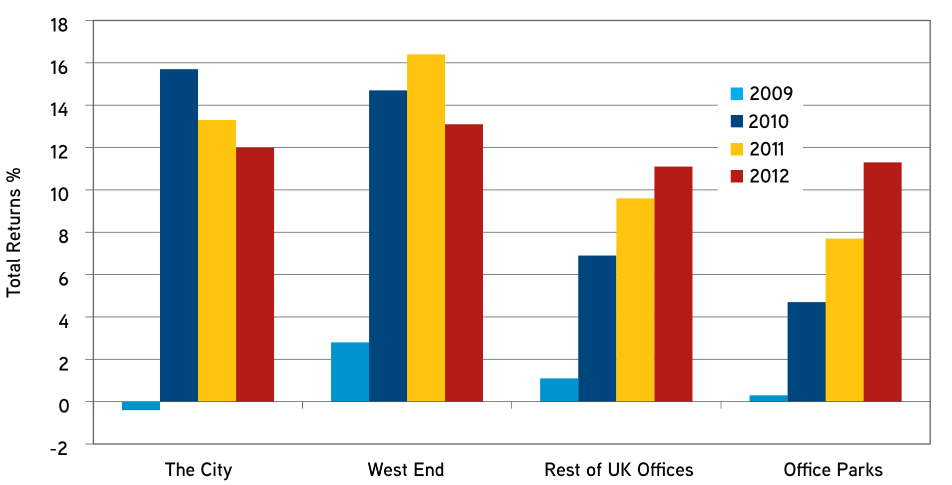
Offices – City of London
Julie Rees
+44 20 7487 1789
julie.rees@colliers.com

Offices – West End
Robert Few
+44 20 7487 1971
robert.few@colliers.com

Offices – National
Jonathan Mannings
+44 20 7487 1827
jonathan.mannings@colliers.com

	IPD ACTUAL	COLLIERS INTERNATIONAL FORECASTS		
	2009	2010	2011	2012
ERV growth (% pa)	-13.7	-1.1	3.8	3.0
Equivalent yield (%)	8.0	7.6	7.4	7.1
Capital growth (% pa)	-5.9	3.7	4.9	5.1
Total return (% pa)	1.0	11.0	12.3	12.1

FIGURE 5 – COMPARATIVE SUB-SECTOR PERFORMANCE



Source: IPD / Colliers International

Logistics & Industrial

- Total returns will reach only 5.6% in 2010 as rental values fall by more than the previous year and yield compression goes into reverse in the second half of the year.
- While prime stock will continue to be targeted by a wide range of investors, demand for secondary assets and industrial parks will experience a pause for breath.
- Occupier markets have begun to report flat headline rents and improvements in vacancy, but in most locations new demand will not support rental growth for the next 12 months.

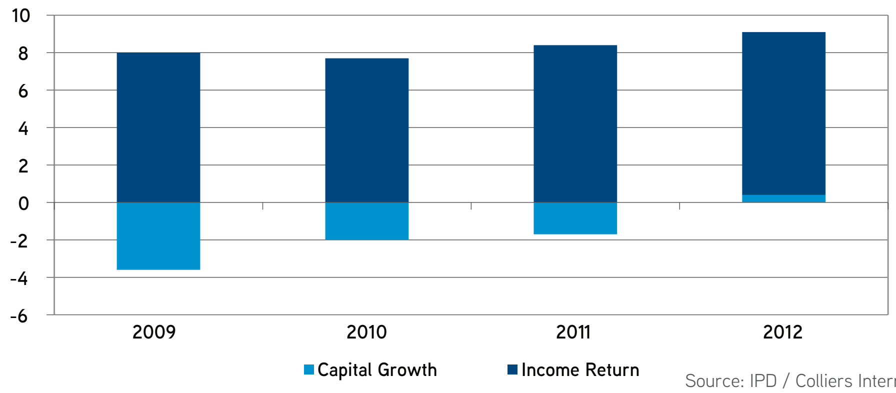
The industrial sector is forecast to be the weakest performer during the forecast period (2010-2014), producing annualised returns of 9.6%, although this is only marginally below the 9.7% forecast for retail property. Underperformance in this sector is driven by two years of weak returns in 2010 and 2011, with total return forecasts of 5.6% and 6.6% respectively. Within the sector, distribution warehouses will outperform this year, as IPD rental values fall by only 4.0% and yields decline by 20 bps, helping capital growth for this sub-sector to remain marginally positive. Multi-let industrials and industrial parks will see a bigger fall in rental values (6.0%) and will see capital values for the year as a whole decline by 2.5%.

Prime industrial and logistics assets continue to transact at low yields, representing a healthy degree of competition for the best stock. However, secondary distribution has experienced a noticeable weakening in the second quarter as risks over the economic recovery have grown. We anticipate that the investor caution being witnessed at present will stretch into the second half of the year and is likely to lead to yields drifting slightly outwards for all but the very best prime stock. As a result, all industrial yields will end the year only 20 bps below those of 2009.

Speculative development remains on hold as the occupier market continues to exhibit weakness. Activity remains muted for most occupiers, with the exception of the food store operators who continue to seek out new distribution centres. Although headline rents bottomed out in the last quarter, rent-free periods remain long. With rents in the actual market having dropped by more than 30-40% in some locations, IPD rental declines have significantly lagged behind. As such, we expect IPD rental values to fall throughout 2010 and into 2011, with the first positive growth being seen in the second half of 2011. This will be supported by a declining overall vacancy rate, although this has yet to fall as quickly as would have been hoped. However, with no large developments in the pipeline, the availability of new space will begin to fall, putting upward pressure on rental values in locations with tight supply and improving occupier demand.

	IPD ACTUAL	COLLIERS INTERNATIONAL FORECASTS		
	2009	2010	2011	2012
ERV growth (% pa)	-4.5	-5.6	-1.8	1.6
Equivalent yield (%)	9.2	9.0	9.0	9.0
Capital growth (% pa)	-3.6	-2.0	-1.7	0.4
Total return (% pa)	4.1	5.6	6.6	9.1

FIGURE 6 – CONTRIBUTIONS TO INDUSTRIAL TOTAL RETURNS



Source: IPD / Colliers International

480 offices in 61 countries on 6 continents

United States: 95
Canada: 17
Latin America: 17
Asia Pacific: 52
EMEA: 85

LONDON - WEST END

9 Marylebone Lane
London
W1U 1HL
+44 20 7935 4499

CONTRIBUTORS: AGENCY

Logistics & Industrial
Len Rosso
+44 20 7487 1765
len.rosso@colliers.com