



RESEARCH & FORECASTING UK

REAL ESTATE INVESTMENT FORECASTS Q3

Contents

- 1 Executive Summary
- 2 All Property Forecasts
- 3 Market Comment
- 4 Retail
- 5 Offices
- 6 Logistics & Industrial

Executive Summary

- Our latest forecasts predict a total return of 11.3% in 2010 as our expectations of further rental value declines this year have receded and we have revised upwards our forecasts for Central London office rental values.
- These forecasts still imply that capital growth in the second half of the year will be mildly negative as rents continue to fall and yield movement stagnates.
- The Colliers International outlook for 2011 has been downgraded as we do not expect to see a strong driver of positive net investment activity over much of the year.
- Our forecast for 2011 total returns is 7.2%, although we anticipate an improvement to 12.0% in 2012 as yields come under downward pressure and rental values improve.
- Over the five year forecast horizon we anticipate annualised total returns of 9.9%. Commercial property performance will be driven by low gilt yields in the first half of this period and by improvements in rental growth during the second half.

SUMMARY FORECASTS

	2010	2011	2012
Economic Forecasts			
GDP growth (%)	1.3	2.0	2.2
RPI (%)	4.2	3.4	2.7
CPI (%)	2.9	2.4	1.8
Base rate (% Year End)	0.5	1.0	1.9
Commercial property forecasts			
Rental growth (%)	-2.1	0.1	1.6
Capital growth (%)	4.5	0.4	5.1
Total return (%)	11.3	7.2	12

Source: HM Treasury, Colliers International

RESEARCH & FORECASTING

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All Property Forecasts

- Despite many investors taking a step back from the UK market in recent months, we still expect total returns to reach 11.3% in 2010.
- Positive medium-term views of property as an asset class will ensure that demand for good quality product keeps yields on a downward trend over the next few years.
- Economic recovery will drive five year annualised rental growth of 1.3% during 2010-2014.

COLLIERS INTERNATIONAL FORECASTS

	2010	2011	2012	Annualised 2010-2014
ERV growth (% pa)	-2.1	0.1	1.6	1.3
Equivalent yield (%)	7.6	7.5	7.2	7.1 (2014)
Capital growth (% pa)	4.5	0.4	5.1	3.3
Total return (% pa)	11.3	7.2	12	9.9

PROPERTY MAINTAINS ITS ALLURE AS CASH LEVELS REMAIN HIGH

Colliers International forecasts total returns of 11.3% in 2010, followed by 7.2% in 2011. Performance in 2010 is driven by the first half of the year, in which the downward pressure on yields continued. However, this has since come to an end as many investors are being priced out of the market and others are less certain about the pace of economic recovery. Nevertheless, with gilt yields remaining historically low – having passed under 3.0% in mid-August – property yields still have room to fall, despite the lack of rental growth forecast for this year and next. Given the number of property funds that still have higher than usual cash holdings, we expect there to be an increase in activity towards the end of 2010. Moreover, because we do not expect to witness particularly strong economic growth in 2011, we anticipate that inflation will remain low; thereby keeping gilt yields at long-term lows. As a result, we believe that property yields will, at worst, stay flat in 2011, but potentially fall in some segments.

LONGER TERM PERFORMANCE TO BE DRIVEN BY ECONOMIC RECOVERY

Over the forecast horizon we expect to see a gradual return to trend economic growth as banks re-capitalise and consumer and business confidence grows. We would also anticipate a steady positive contribution to output from Government expenditure in the latter years of the current Parliament. Therefore, while we expect rental growth to be anaemic in 2010 and 2011, at -2.1% and 0.1% respectively, we forecast a gradual improvement in 2012-2014, resulting in five year annualised rental growth reaching 1.3%. The only sub-sectors we believe likely to outperform this figure are supermarkets and Central London offices. Expectations of future rental growth will drive further yield falls in 2012 and 2013, but by 2014, we anticipate that higher gilt yields and a reduction in rental growth expectations for the years ahead will lead to diminished demand for commercial property. As such, we have pencilled in slight rises in yields in some sectors in 2014, ahead of a further outward shift in 2015.

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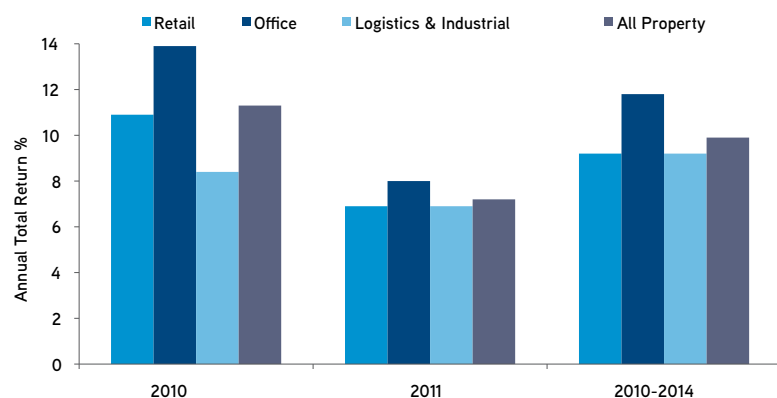
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FIGURE 1: FORECAST TOTAL RETURNS BY SECTOR



Source: Colliers International

Market Comment

REAL ESTATE FUNDS LIKELY TO STAY ACTIVE OVER THE NEXT 12 MONTHS

Investment activity continues to stem from a range of overseas and institutional investors. While the major German funds have recently become net sellers of UK property, Middle Eastern and Far Eastern investors continue to pursue opportunities to buy into the UK market. Meanwhile, the UK institutions continue to experience net inflows of funds. Although these are at far lower levels than seen in Q4 2009 and Q1 2010, the flows remain positive and, with investment activity drying up, cash levels are likely to still be rising for some fund managers. Activity remains focused on good quality product and we expect this to continue. Some listed funds have recently acquired secondary buildings and other assets with development potential, but, for the most part, investors are not yet ready to brave secondary product or locations. While there is the potential for greater reward if and when the prime-secondary yield gap begins to close again, the risk of further rental decline and even vacant assets is not currently outweighed in most cases. We would anticipate an improvement in secondary yields once a full economic recovery is underway and when the risk-return ratio appears better balanced for secondary assets. In the short-term, we anticipate there being sufficient demand for good quality product to ensure that yields stabilise between now and the end of 2010. During 2011, we expect to see further stability for the year as a whole, before improved fundamentals drive another wave of investment into the property sector.



Surrey, Stratford-upon-Avon in Warwickshire and Morpeth in Northumberland have all seen prime high street rents rise since mid-2008. Office markets such as Bristol, Leeds, Derby and many smaller markets around West and South West London have also all held up well. Nevertheless, on a national basis, the rental falls we have recorded have tended to dwarf those reported by IPD and other valuation indices, particularly for the retail and industrial sectors.

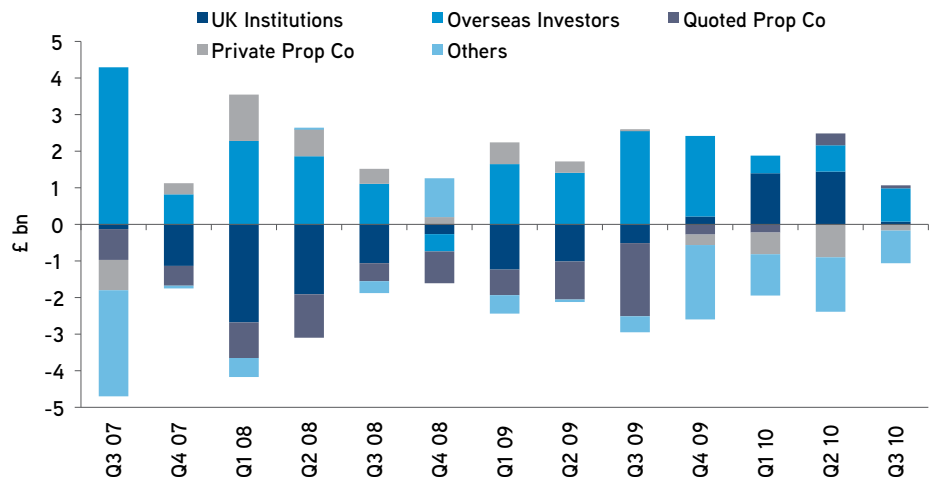
In our view, rental values have simply not been marked down sufficiently in line with market rumours and reports. There may be an

argument in the suggestion that landlords have managed to blur the lines through maintaining headline rents by offering incentives packages with fit-out costs, cash incentives and long rent-free periods. In some cases, the incentives agreed upon have in actual fact halved the net effective rent being achieved on a new letting. Thus, when a valuer sits down to determine a rental value for an asset and sees headline rents on similar nearby buildings holding up, it becomes easy to pen a valuation with zero or limited rental value decline. Unfortunately, this leaves us as analysts trying to work out how the market has actually performed and ensures the job of forecasting becomes even trickier.

THE RENTAL VALUE CONUNDRUM

Since all property rental values peaked on the IPD index in June 2008, a 10.8% drop in values has been recorded. This breaks down to -9.2% for retail property, -17.1% for office properties and only -6.6% for the industrial sector. These figures compare extremely favourably to the falls in rents reported in the property press and in market rumours. Moreover, they are also extremely divergent from the rental falls Colliers International has reported in almost all markets. Clearly there have been some outperformers where rental values have not fallen significantly. For example, prime rents for both small and large sheds in Heathrow fell by only 4%. High street rents in a number of Central London locations held up particularly well in both 2009 and 2010, while Guildford in

FIGURE 2: NET INVESTMENT BY BUYER TYPE



Source: Property Data

Retail

- Retail investment activity has slowed over the summer months, but performance is likely to remain robust.
- The Central London retail market is buoyant, with lettings setting new rental value highs and investment transactions being driven by overseas cash.
- Outside of London, the UK retail market remains a tough one. Landlords are forced to offer concessions on rents and incentive packages.

COLLIERS INTERNATIONAL FORECASTS

	2010	2011	2012	Annualised 2010-2014
ERV growth (% pa)	-3.3	-0.4	1.3	0.5
Equivalent yield (%)	7.2	7.1	6.8	6.8 (2014)
Capital Growth (% pa)	4.6	0.6	5.6	3
Total return (% pa)	10.9	6.9	11.9	9.2

RETAIL SECTOR FORECASTS SUGGEST NEAR-TERM RELATIVE STRENGTH DESPITE GLOOM

Our latest forecasts show the retail sector outperforming the industrial and logistics sector over the next two years, yet being outperformed by UK offices. However, when Central London office markets are removed from this analysis, the retail sector is set to outperform the remainder of the office sector. During 2010, the retail sector is forecast to return 10.9%, followed by 6.9% in 2011 as rental values continue to decline slightly. The robust nature of these forecasts may come as a surprise, but investment in the retail sector was particularly strong in the first half of the year, totalling around 38% of transactions by value. This has fallen significantly in Q3, with retail accounting for only 12% of all transactions, but this may be more of an indictment of the strength of office market activity, as well as a general seasonal fall-off in investment activity. Deals continue to transact, but the volume of activity is most certainly down compared to the first half of the year across all retail sub-sectors. Yet there is still enough pent up demand to keep pricing stable in the short term.

CENTRAL LONDON EXHIBITS STRENGTH

Demand for prime retail floorspace in Central London continues to drive vacancy rates lower and rental values upwards. The reports of Chanel's new lease on Bond Street and the large premium it is said to have paid for this attest to the strength of the West End market. In this specific market, investment transactions are dominated by overseas investors. During 2010, these investors have accounted for 95% of West End retail activity, spending £405m out of a total £427m transacted. This is up from 80% in 2009 and 35% in 2007. The other major buyers in this sub-sector over the past few years have been private UK investors.

OCCUPIER MARKETS REMAIN TOUGH FOR LANDLORDS

Central London aside, the retail market continues to exhibit weakness. While market rents have largely stabilised in recent months, conditions generally remain in favour of tenants. Virtually all landlords are finding that in order to keep tenants with break options, they have to offer cash incentives and further rent-free periods. However, this dynamic exists because investors are striving to maintain headline rental values, irrespective of the reduction in net effective rents they receive. Moreover, many smaller and less trendy locations have seen void levels rise as multiples have sought to reduce branch networks. One of the few beneficiaries of the economic downturn has been the discounters, with shops such as Poundland and 99p Stores entering and expanding in many high streets up and down the country. Out-of-town, retailers such as Next and John Lewis continue to expand their homewares offer.

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Offices

- Offices will be the strongest performer over a one year, three year and five year investment horizon.
- Ahead of the anticipated cyclical upswing in rental values, the popularity of the West End, Midtown and City markets is growing amongst investors.
- Outside of the best prime Central London and Glasgow office stock, rental growth is largely non-existent.

OFFICE SECTOR OFFERS HIGHEST RETURNS IN EACH OF THE NEXT FIVE YEARS

Colliers International Q3 forecasts point to the office sector exhibiting the strongest performance every single year for the next five years. This is predominantly driven by a 50 bps inward yield shift in 2010 and a cyclical uptick in rental values in 2012-14. The performance of the sector is, in reality, based on a two-tier market in which the Central London market sees strong occupier and investor demand, but the regional markets see less investor interest and most certainly see a smaller rise in rents. Over the five year forecast period, we predict

just over 6.0% annual rental growth across the Central London market, but 0.1% annualised growth outside of London. Moreover, we expect rental values in office parks to decline by 0.8% per annum over the same period.

INVESTOR FOCUS RETURN TO CENTRAL LONDON OFFICES

Sales of City of London offices by overseas investors have not outweighed purchases since 2006, but they are extremely close to doing so this year; sales are running at £845m compared to purchases at £863m. It is interesting to note that German, Far Eastern and US investors have all been active in trying to recycle assets in Central London. However, based on a poll taken at the recent IPD quarterly breakfast, the overriding investment destination amongst fund managers turned out to be West End and Midtown offices, with City offices coming joint second in the voting. This hierarchy was presumably driven by the view that the Central London office market will benefit from a cyclical upturn in rental values over the next three to four years, while the West End in particular offers an extremely liquid and open market.

OCCUPIER MARKET RECOVERY STAGNATES AWAY FROM PRIME

In the City, there have been fewer headline lettings over the summer, but demand remains strong enough to support the rental levels already achieved this year. However, the rental uplifts seen at the prime end of the market have not been replicated elsewhere and this fact helps to explain the relatively limited rental growth we are forecasting for 2010 and 2011. Meanwhile, the West End occupier market remains in balance. Letting activity has slowed over the past quarter and the hope is that this improves in Q4 and into the New Year.

Glasgow has witnessed strong prime rental growth in 2010, but, just like the City, this has not spread beyond the best product. Generally speaking, after a small bounce over the last 12 months, most regional office markets are seeing take-up plateau, with no signs of any major expansionary demand. As a result of this situation and development funding remaining tight, few new schemes are likely to be built over the short-term. Moreover, poorer quality stock or poorly located stock is still seeing leasing terms weaken and landlords are likely to remain accommodating.

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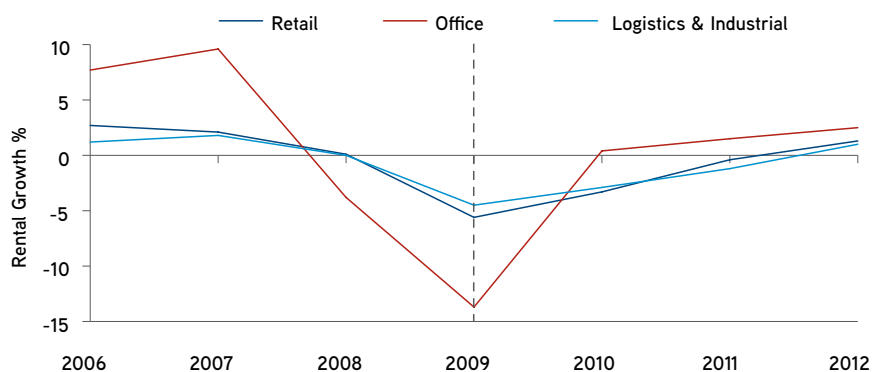
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COLLIERS INTERNATIONAL FORECASTS

	2010	2011	2012	Annualised 2010-2014
ERV growth (% pa)	0.4	1.5	2.5	3.3
Equivalent yield (%)	7.5	7.4	7.1	6.9 (2014)
Capital Growth (% pa)	6.6	0.9	5.7	4.9
Total return (% pa)	13.9	8.0	12.8	11.8

FIGURE 3: RENTAL GROWTH BY SECTOR



Source: IPD/Colliers International

Logistics & Industrial

- The logistics and industrial sector will produce a total return of 8.4% in 2010 as yield movement goes into reverse in secondary locations.
- Over the five year forecast period, rental growth and capital growth will both be marginally positive and annual total returns will reach 9.2%, supported by strong income.
- Rental values are yet to have troughed for secondary stock and in locations with demand and supply imbalances, but the best prime rents will improve this year.

COLLIERS INTERNATIONAL FORECASTS

	2010	2011	2012	Annualised 2010-2014
ERV growth (% pa)	-2.9	-1.2	1	0.2
Equivalent yield (%)	8.9	8.9	8.8	8.7 (2014)
Capital growth (% pa)	0.9	-1.2	2.3	1.1
Total return (% pa)	8.4	6.9	10.7	9.2

LOGISTICS AND INDUSTRIAL STILL SET TO UNDER-PERFORM

Our forecast for 2010 total returns has been revised upwards for the logistics and industrial sector as we now expect capital growth to turn marginally positive on the back of increased inward yield shift and smaller rental value declines than previously predicted. Nevertheless, equivalent yields in this sector will not fall significantly over the forecast horizon and this will prevent returns for the sector reaching double figures on an annual basis over the period, instead reaching 9.2% on an annualised basis. Over the full period, we expect rental values to rise by 0.2% per annum, but it should be noted that we forecast these to fall in both 2010 and 2011, before staging a limited recovery from 2012 onwards. As a result of these dynamics, the sector will be the worst performer over the period for both rental value and capital value growth. The high income returns enjoyed by the sector bring it back into line with our forecasts for the retail sector over the five year period.

OCCUPIER MARKETS YET TO RECOVER AWAY FROM THE SOUTH EAST HUBS

Occupier market activity remains limited on the whole. Demand tends to be focused on the established major locations and we would expect this to continue as firms seek to move to better located and better quality premises at low rental levels. In weaker locations, net effective rents continue to decline as landlords are forced to offer softer terms and lower rents in order to fill units and avoid paying empty property rates. On the other hand, incentives being offered in prime locations are falling and rents are stable. We expect this to continue over the next 12-18 months, with some limited rental uplift in the best locations. In other regions and locations where excess supply still needs to be absorbed, rental growth will take longer to emerge as demand is likely to remain sluggish. IPD annual rental value growth will not turn positive until 2012 and we do not anticipate a particularly strong rental recovery for this sector.

480 offices in
61 countries on
6 continents

United States: 135
Canada: 39
Latin America: 17
Asia Pacific: 26
ANZ: 168
EMEA: 95

LONDON - WEST END

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