

UK Commercial Property

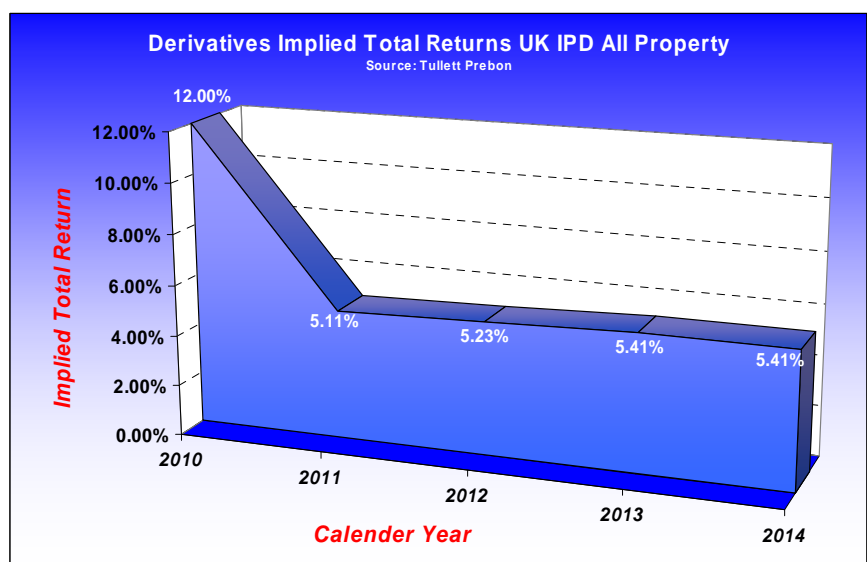
Gordon's Gaffes and Greece Slacks.

- As election day looms, the country's attention has been gripped (at times!!) by some enthralling campaigning. Never before have we had such all consuming coverage of every address, sound bite and tweet. Never before has politics been so accessible. Last week even the PM was kind enough to broadcast his scoldings to the voting public, a privilege usually saved for members of his cabinet. There I go again! It is very easy to get swept up in the circus sideshows when the real focus should be on what's going to happen in the big top!.....
- With many pollsters predicting a hung parliament, there's real concern about the effect this will have on the UK economy and the property market in turn. If a coalition government cannot quickly establish consensus on how to tackle the UK's national debt (at £1.4trillion and 12% of GDP – just behind Greece at 14%) there could be a sterling crisis, a run on UK gilts and a rise in interest rates. Even after the **Greek bailout** following its downgrade last week, exposure concerns add to an environment that seems far from ideal for a stable commercial real estate market.
- There is an argument however, that **commercial property** provides a **safe haven** for one's money at the moment. The stock market is still volatile – it sits well below 5500 after losing ground yesterday – and is making prime property assets look ever more attractive with their 'long and strong' returns resulting in a squabble for the limited supply.
- This competition in the investment market is pushing prime office yields ever lower – they are currently 5.75% in the City and 4.5% in the West End (CBRE). There's also continued **optimism in the Central London office** occupational markets with Q1 take-up at a three year high, the vacancy rate dropped to 6.7% and there's only 1.3m sqft of space pipelined for 2011 which would be the lowest on record! This supply squeeze is set to fuel strong growth, with Colliers CRE forecasting City rents to increase by 10% in 2010 to c. £55sqft.
- The **retail market** remains under pressure as margins remain thin with consumers extremely price sensitive, although we saw positive Q1 retail sales figures up 4.3% (food) & 4.1% (non-food) and the leasing market is also firming. London and regional town centres with strong covenants have traded at sub 5%, but there is still a distinct gap to the secondary market. There has been an increased demand in the **logistical and industrial** investment market, although transactions remain limited. Early signs of a leasing market recovery have passed and given way to more moderate remainder of 2010.
- The **derivatives market** reacted to the uncertainty caused by the Greece downgrade. After rallying 150bps this month to 1250 mid, the dec10 contract now sits at 1200 as would be bidders wait on the sidelines to see what fallout results. The longer contracts are also better offered with the calendar year contracts for 2011 through 2014 having slipped downwards to a market of 475/575 (bid/offer).
- When we break this all property, total returns figure down it is quite revealing. With an assumed equivalent yield of c. 7%, these figures imply **annual capital growth of c. -2%**. Despite the uncertain future of the economic environment, future interest rates hikes, a tougher retail climate and a cooling investment market; this appears good value. So, perhaps the UK IPD All Property Total Returns Index might be the safe haven that investors are looking for?

Figure 1. UK IPD All property Swap Mid Prices.

Calendar Year Forward	Swap Price as at 30/03/10 (bps)	Swap Price as at 30/04/10 (bps)
2010	1100	1200
2011	625	511
2012	622	523
2013	621	541
2014	640	541

Figure 2 UK IPD All Property Swap Prices as at 30/04/10



UK Residential Property

Outperformance: Residential vs Commercial, London vs UK.

- Residential investment property **outperformed all asset classes in 2009** with total returns of 11%, Investment Property Databank (IPD) reported this month. This was split between 8.1% capital growth and 2.7% income return. The results compare with just 3.5% total returns for commercial property last year. The figures also suggested longer-term out performance with the index suggested annualised 3y returns of 3.1% and 6y returns of 6.8%.
- The **Halifax HPI** saw it's highest monthly increase since 2007 with a figure of 1.1% (seasonally adjusted), taking the average price to 9.1% above April 2009's low point – quite some rally! We await April's print with interest. This week saw the quarterly print for the regional index. With the UK average at +0.3%, London's performance of +5.1% is significant. Can post-election Britain buck this building momentum?
- Our spotlight on London continues [from sublime to ridiculous!] Candy & Candy this month launched the final phase of their 'One Hyde Park' development. Release prices – rumoured to be in the **£6,000sqft region** – are approaching levels achieved at the very peak of the global market. Having lost developments at Chelsea Barracks, Middlesex Hospital and in Beverly Hills, this scheme takes on a new significance for the brothers. However, one doubts these prices will affect the HPI as there will be very few Halifax mortgage applications filled out to complete the purchases!
- In the **mortgage market**, the British Banker's Association reported the number of mortgages approved edged up by five per cent during March as the housing market returned to normal following the end of the stamp duty holiday, but Q1 levels were down on Q4 2009. The BBA said that this is indicative of a 'cooling housing market' and expects a flat market for the remainder of the year. Meanwhile lending conditions appear to be improving with 75% mortgages reportedly at a five and a half year low of 4.01%.
- The flat forecasting for the housing market is certainly priced into the **derivatives contracts**. Despite trading activity down the curve up to 8y during the month, there has been relatively little effect on mid-levels. The 2y contract, the month biggest mover, at one stage rallied to 103.25 but has since come off a little and currently sits at 102.5.
- Since the recent Q1 **Greater London print** there have been no firm markets made here. Once the figure of +5.1% is extrapolated and levels are refreshed, presumably the pricing will start becoming attractive for developers, investors and prime home owners alike that are looking to hedge out the risk of an uncertain economy over the next 2 to 5yrs.

Fig 3. HPI forward contract prices and implied annual capital growth, 31/03/10. (Source Tullett Prebon)

Contract Dec09-	Forward Price (mid)	Annual Capital Growth (%)
Dec 10 / 1y	101.5	1.5
Dec 11 / 2y	102.5	0.00
Dec 12 / 3y	105	3.45
Dec 13 / 4y	107.5	2.38
Dec 14 / 5y	109	1.40
Dec 16 / 7y	115	2.68
Dec 19 / 10y	124	2.48

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