



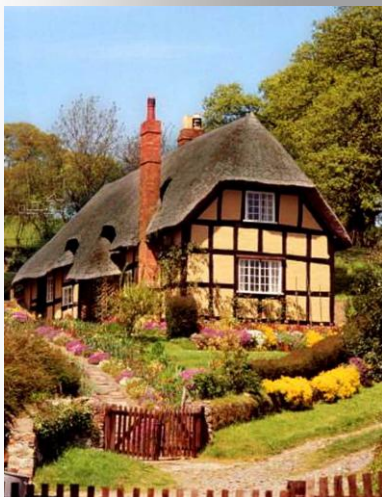
Property Market Overview

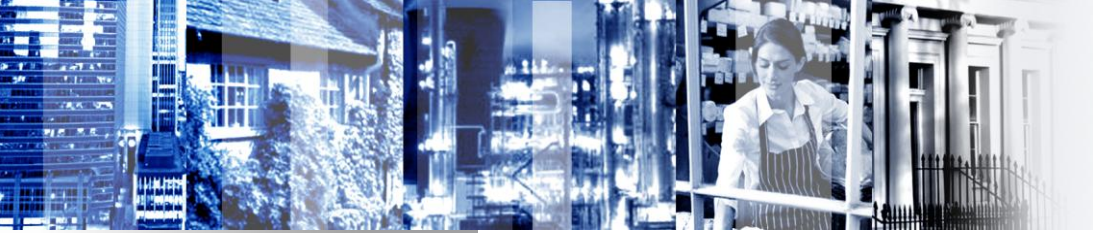
MAY 2011

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Introduction

The property market at present is completely directionless. To draw a seafaring analogy, you are navigating through waters a little choppy close to harbour when your rudder breaks. You start to happily pirouette. You could always radio the harbourmaster and ask for a tow, or you could wait while the weather improves and dive down below and repair your rudder. And while all this is happening, there is the niggling worry in the back of your mind that if you set sail onto the high seas, rudder repaired, this could all happen again and then, where would you be?

Thus proving that in times of uncertainty, we all like safe havens. However, as we all know, a little risk-taking can open up an ocean of possibility. In the same way that John Cabot, Vasco da Gama, Christopher Columbus and others did in the golden age of exploration, putting unfeasibly small ships at the mercy of gigantic waves for an unknown benefit in the New World, we need to break out of our current very parochial mindsets and take calculated risks if we want property, as an asset class, to perform to its historic long-term average.

The readership of this Property Market Overview is diverse, and includes people who develop property, people who invest in property, people to manage property day-to-day and also people who lend the money in order that the first three groups of people can go about their daily business. It's this latter group, the bankers of this world, who now, in our opinion, have to take on the role of mould-breakers. We're not looking for a return to 2004-2007, with the economy awash with debt, the scale of which was only apparent to an enlightened few, but an incremental relaxation in lending criteria which should, in hindsight, be a reverse of what should have been an incremental tightening of criteria in 2008-2009. Instead, certainly in the field of residential property (and as 90% of all property is residential, this is a good place to start) to decrease loan-to-value ratios from near 100% to 75% almost at a stroke rather than, say, a 5% tightening every quarter, proved immensely damaging not only to the residential sector but also to business as a whole, as a considerable proportion of commercial advances are secured against residential property not to mention the level of inter-bank debt backed by securitised portfolios.

You will probably now try and jump to the particular section of the publication that interests you. However, bear in mind that we live in a connected world and the pearls of wisdom contained within these pages also connect with each other. The banker lends the money to, say, the developer, who goes to the planning officer to approve his scheme and then to the investor to find a tenant to pay the rent to pay the developer and ultimately the banker back for having lent the money in the first place. So step on the treadmill and although the market may not be going anywhere fast, we hope you find something in this quarter's edition that will set you thinking.

Offices

A flight to quality

As we mentioned in last quarter's Overview, it is very easy to be overwhelmed by the apparent, glitz, glamour and buoyancy of the central London market place, but, as we said at the time, this is completely illusory, if, like 80% of the population your business is either not located in London or doesn't do most of its business there. Sure enough, rents rose and yields tightened in London in the first quarter of the year but it is more pertinent to look at regional markets, and especially the south-east, where there are tentative signs of life.

In most regional centres it is the big players who have taken the first step; Virgin Money and Regus in Edinburgh, HSBC in Glasgow, Deloittes, Hammonds and Walker Morris in Leeds. However, deals are still taking time to complete and the regional market place is dominated by a small number of themes:

- The rise of short-term, flexible agreements rather than conventional leases. Those occupiers with good covenant strength who have been able to commit to longer lease terms are well-placed in rent review negotiations. However, the underlying lack of occupier demand linked to the unwillingness to commit to extended lease terms in an uncertain market (taking that first step again) is leading to, to use as an example the shortest duration case we have experience of, three-year leases with a tenants-only break clause after eighteen months.
- An increase in lower quality, second-hand office space rather than new build. This is partly a product of a very limited development pipeline with those completed offices being occupied at the expense of older buildings. Town centre office development remains largely stagnant, limiting the supply of new, modern space. A number of towns in Kent (Chatham, central Canterbury, for example) are dominated by second-hand stock.
- Demand for leasehold rural offices remains reasonably buoyant. We don't intend to be permanent prophets of doom; there are some bright lights on the horizon in the office market. The ability of rural offices to buck the trend is the subjective perception by occupiers of an overall improved quality of working life in a rural setting. This is immensely difficult to quantify and its subjective nature means that it could evaporate, but it has been a fairly steady feature of the market over the past two years.

One of the big talking points in offices, especially from public companies conscious of their public image is the development of environmentally-friendly "green" offices, such as Beechwood Business Park in the Port Zone in Dover. In current financially-constrained times, paying a considerable premium for a building, claimed to be 80% more efficient than conventional designs, with triple-glazed windows and an external wall insulation system is likely only to be for those with significant capital budgets and hence is unlikely to alter the supply and demand picture across the whole market unless a lot of the surplus lower-grade office space is either occupied or demolished in short order.



Retail

The rise of the mega-mall

The uncertain, should-I-set-sail-or-not attitude is most clearly seen in retailing. Retail sales in the UK registered a surprise pick-up of 0.2% in March, led by strong food sales. However, the picture is far from clear and supposed “experts”, including the British Retail Consortium expected far worse figures, as did City analysts after the revised 0.9% drop in retail sales in February was announced. This, of course, does nothing for the sentiment of occupiers of retail property or those who are contemplating investing in the same.

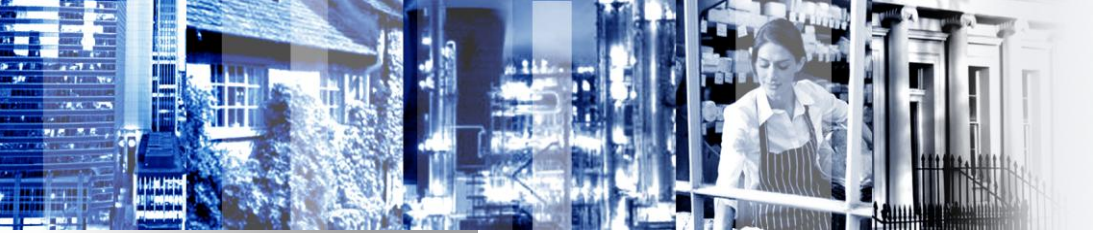
There are other interesting threads developing – the Office for National Statistics estimates that internet sales now comprise 9.8% of all non-fuel retail sales in the UK by value. The consensus view is that there are “fundamentally weak conditions likely to undermine consumer confidence for some time yet.” In its Monetary Policy Committee minutes for April, the Bank of England indicated that the strength of recovery in consumer spending was a key question for them. The increases in retail sales seen in January and March this year are very modest and the underlying impression remains that consumers are less able and willing to spend.

Which begs the question, if you want to buy, let, invest in or lend to a retail property, should you now and what sort of property should it be? We’ve looked at two opposing ends of the retail scale: the small shopkeeper and the Bluewater-style (and size) large shopping centre, to see if there are any trends that can be discerned.

Small, independent retailers in suburban high streets are doing better than you think though some features of the more successful parades of shops are pertinent. Being close to public transport, and having a product range that is not necessarily recession-proof but certainly not wholly luxury orientated, helps. Technological change, we have found, works both ways – shoppers will search the internet first then maybe buy all at one shop but the rapidly falling price of computer parts means that shops selling computers are having a hard time.

As far as shopping centres are concerned, the biggest impact on north-west Kent could be Westfield’s Stratford City, around the Olympic Park site, which is developing 176,500m² of retail space and which is due to open in September. Compare this with Bluewater (153,000m²) and the largest shopping centre in Europe, the Metro Centre in Gateshead at 190,000m². This alone will increase shopping centre provision in London by 12% upon completion. This shows that demand for prime space with an acceptable consumer catchment area still exists, albeit at a price. A 50% stake in the development was recently sold for £871 million.





Investment

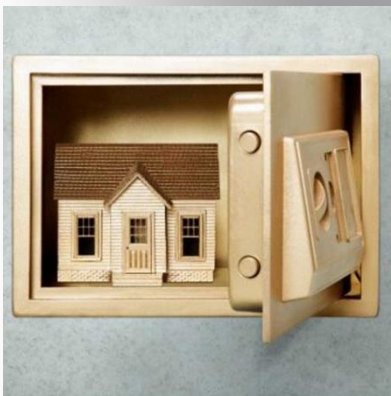
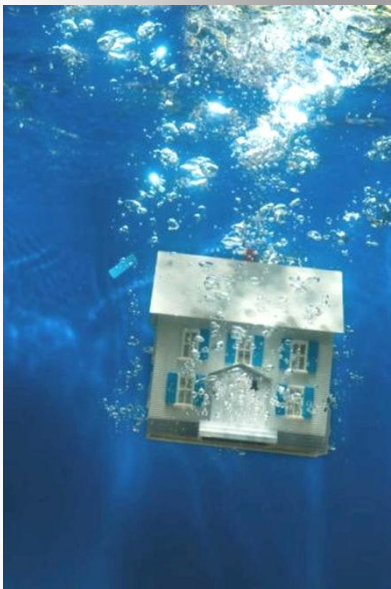
The discount to history

The investment market (and we are sorry about the nautical analogy again) ended the quarter pretty much “steady as she goes”. The key buzzword in property investment of late is the lack of “quality” supply of property. Whether this refers to location, building or tenant it has assumed an even greater importance now there is a limited development pipeline of new buildings, and now that transaction volumes in the occupier market have declined.

The current prime average yield across the country, according to Cushman & Wakefield, is 5.68%, 1.99% above 10-year government bond yields. However, this naturally varies greatly according to property usage and two points stand out: a still cautious attitude towards secondary retail property, where distress is again evident from some occupiers (e.g. HMV, Oddbins) and the need for fresh equity to refinance debts taken out with typical five-year maturities at the height of the commercial property market in 2006-2007 as more banks leave the market when refinancing falls due. To compensate for reduced supply, some investors are entertaining unrealistic expectations of rental growth.

This publication tries not to bore you with statistics, but investment is a fairly dry subject and therefore a few numbers are unavoidable. The directionless nature of the overall property market is clearly evident in yields, which for nearly all classes of real estate have been flat for a full twelve months now – prime yields in Kent vary from 6.5% for shops to 7% for offices and 7.5% for industrial or warehouse property. By way of an interesting historical perspective, Cushman & Wakefield’s research which produced the yield figure in the previous paragraph, also looked at the really long-term historical trend going way back to the 1950s (which some of the readers of this publication may remember). The following may give you food for thought; if returns are foremost in your mind, now is not necessarily the best decade to invest:

	Prime property yields:				Other yield rates:			Inflation
	Shops	London Offices	Industrial	Headline Average	15 yr Gilts	Base rates	Equities	RPI
1950's	5.5%	7.0%	10.0%	7.5%	4.5%	4.0%	6.5%	4.2%
1960's	6.0%	6.6%	9.5%	7.3%	6.7%	6.3%	4.5%	3.7%
1970's	5.6%	5.9%	7.7%	6.4%	12.0%	9.6%	5.3%	12.7%
1980's	3.9%	5.1%	7.1%	5.3%	11.1%	11.7%	4.8%	7.4%
1990's	4.7%	5.5%	7.4%	5.8%	7.9%	7.8%	3.9%	3.7%
2000's	4.9%	5.3%	5.9%	5.4%	4.6%	4.3%	3.2%	2.6%
2010's	5.0%	4.7%	6.2%	5.3%	4.0%	0.5%	3.1%	4.7%
1950-2011	5.1%	5.9%	7.9%	6.3%	7.7%	7.1%	4.7%	5.7%
Mar 2011	4.8%	4.5%	6.0%	5.1%	4.2%	0.5%	3.0%	5.5%
Premium to history	-33p	-135bp	-190bp	-119bp	-356bp	-663bp	-171bp	-20bp



Planning

The Localism Bill

In December 2010 the Localism Bill was published. The Bill is now progressing through its Parliamentary stages and is expected to be enacted by the end of 2011. As far as land use planning is concerned the main matters covered in the draft legislation are:

- **Abolition of Regional Strategies.**
- **Reform of the plan making process.** Planning Inspectors will have reduced powers available to them when examining Local Development Framework (LDF) documents, to maintain the local focus of documents prepared by Councils.
- **Duty to Cooperate.** Local Authorities or other public bodies will be under a duty to work with one another as part of the plan making process or when planning applications are being processed.
- **Neighbourhood Development Plans.** Voluntary neighbourhood level plans formulated by Parish Councils or newly constituted "Neighbourhood Forums" that will identify the location and quantity of development local communities would like see implemented. Local Planning Authorities will be expected to provide technical support to groups preparing neighbourhood plans. If a draft plan complies with national policy and the strategic vision for an area set out by the relevant Local Planning Authority, it can be voted on in a local referendum and adopted (by the planning authority) if it receives more than 50% of the votes cast. Local communities will be given the right to grant full or outline planning permission for development that accords with an adopted neighbourhood Development Plan.
- **Duty to consult on very large planning applications.** Before submitting planning applications for very large scale development, developers will be required to consult with the local community.
- **Determination of applications for nationally significant infrastructure projects.** The Infrastructure Planning Commission is to be abolished and the determination of planning applications for new airports, power stations railway lines etc will revert to Ministers. Decisions will be based upon National Policy Statements to be voted on in Parliament.
- **Reforming proposals for the collection of the Community Infrastructure Levy (CIL).** The last Government introduced the CIL as a way to fund the provision of infrastructure necessitated by new development. The Localism Bill contains proposals to amend the CIL so that: the levy can be used to fund the maintenance of infrastructure as well as providing it



from new; Councils will have the freedom to set the rate of the levy paid in different areas; and a proportion of the levy will be earmarked to fund infrastructure work specifically within the neighbourhood where the development will take place.

- **Strengthening of planning enforcement powers.** It proposed to introduce powers to enable planning authorities to decline to deal with retrospective planning applications and enforcement notice appeals that are being “twin tracked” with the service of Enforcement Notices. Extended powers are to be introduced to enable local authorities to take enforcement action when the normal time limits for taking action have expired but the breach of control has been concealed by the perpetrator.
- **Rules on Predetermination by Councillors to be clarified.** Under the current Code of Conduct for Councillors, Councillors who sit on a Council’s planning committee cannot give an indication of their voting intentions to anyone in advance of a decision being made because they run the risk of being considered to have predetermined the application. It is proposed that Councillors will be able to make known their voting intentions in advance of a committee meeting, but they will need to be prepared to listen to all of the arguments and evidence before actually making their decision.

Comment

The Government is proposing quite a hotchpotch of amendments to the planning system under the Localism Bill. Apart from the abolition of Regional Strategies, potentially the most significant of the proposed changes are:

- Reforms to the plan making (LDFs), which should speed the production process up for LDF documents. However it remains unclear as to whether the Government is simply intending to tweak the existing LDF system or completely overhaul it and possibly revert to something closer to old style Local Plans.
- The introduction of Neighbourhood Development Plans has the potential to be quite divisive at the local level and could become a significant logistical burden for local planning authorities resulting in their resources being diverted away from more strategic level plan making. It remains to be seen whether the existence of this type of local level plan will provide any more certainty for developers.
- Reforms to Community Infrastructure Levy (CIL). It is clear that the Government proposes to retain the CIL to provide new infrastructure, but its use as a maintenance fund as well has the potential to dilute the delivery of the new facilities, with the result that the provision of new infrastructure will not be able to keep up with the pace of new development.

The Government’s move towards more locally focused plan making and decision making, is plain to see from the draft legislation, but whether this produces a more responsive and certain land use planning regime remains to be seen.





Residential

The inflation/interest rate conundrum

Like one of those old vinyl records stuck in its groove, the themes that have surrounded the residential market ever since the bubble burst, in more ways than one, in the last quarter of 2007, have returned with, again, no clear sign of long-term direction for the market.

There remains very low transactional activity. Nationally, there were around 890,000 transactions in 2010; although marginally up on the previous year, sales trailed off towards the year-end and remain around 60% of the long-term average. In addition, there were less than 600,000 mortgage approvals for the third consecutive year, suggesting cash transactions now represent over 33% of the market, instead of the long-run 25% normally expected. Low levels of activity are reflected in house prices. According to the Nationwide Building Society, house prices were flat, a modest fall of 0.1% in the year to March. In contrast, Halifax reported a fall of 2.9%; evidence of a directionless market if one were needed.

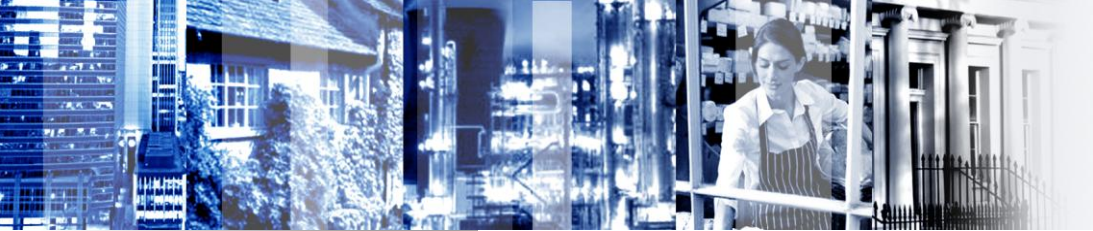
Persistently high inflation threatens to further weaken market prospects, by restricting disposable household income and the ability to service debt. Reading between the lines of its March and April minutes, the Bank of England Monetary Policy Committee is now seeing a significant risk of inflation rising above 5% in the coming months, though they seem to think it right to assess the impact of higher oil prices on economic growth before changing monetary policy. Consensus appears to be for a 1% base rate by year-end.

The lack of available mortgage credit remains the most significant challenge for the housing market and first-time buyers have, of course, been affected disproportionately. As a result, the deposit needed locally can be in the region of £30,000; higher than annual average earnings of £25,000, which has long-term structural implications for the market. The Council for Mortgage Lenders reports that there have been less than 200,000 first-time buyer mortgages for the past three years, less than half the long-term average; 12,400 in February 2011, 11% lower than February 2010.

This has led to an increase in rent-to-buy schemes and initiatives such as that between Barratt Homes and Hitachi Capital, where buyers put down a 5% deposit and then Hitachi Capital will then lend up to 15% unsecured (maximum £50,000) over 12 years at 5.4% fixed interest to the buyer's parents or legal guardian to meet the rest of the cost, reflecting the realities of a market where it is estimated 84% of buyers under 30 do so with some form of parental financial support.

Uncertainties remain on the horizon: credit constraints suddenly loosen and demand leads to another boom scenario. If current trends continue the number of potential first-time buyers squeezed from the market could reach two million within four years. The Bank of England's Special Liquidity Scheme, which propped up mortgage banks during the crisis, comes to an end early next year, creating a





liquidity issue as lenders concentrate on repaying the c£95 billion still outstanding under the scheme. Watch this space.

LPA Receivership

Insolvency rates improve

Yes, we know this is something of a niche market whose characteristics go against the grain of the potentially optimistic tone of the rest of this publication. However, it is a reality that we live in uncertain times and the product of uncertainty can be insolvency for businesses and the property they occupy or trade from. This is not designed to be wholly pessimistic - the latest PricewaterhouseCoopers analysis into corporate insolvency numbers demonstrates that the decline in the level of insolvencies witnessed in 2010 has continued into the first quarter of 2011. In total, 3,657 companies became insolvent in the first quarter of 2011 compared to 3,829 in the last quarter of 2010 – a 4.5% decrease. The level of insolvencies fell by 14% compared to the first quarter of 2010. Also a comparison of the level of corporate insolvencies in the last 12 months to the first quarter of 2011 compared to the last 12 months to the last quarter of 2010 again points to a decreasing trend (15.7% fall).

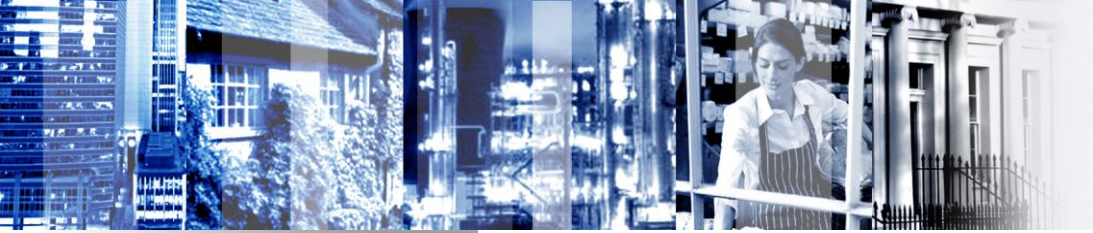
As we have alluded to earlier, the UK economy is by no means “out of the woods” and it would be foolish to think insolvencies are no longer a feature of the corporate landscape. There are a number of factors¹: the as yet fully unfelt impact of the Government’s public sector spending cuts, persistently low interest rates, increased time to pay agreements by Revenue & Customs, and a supportive attitude from secured lenders anxious to avoid the potential crystallisation of losses on their balance sheet, have all helped in producing what may be artificially low insolvency figures over the first quarter of the year.

Real estate insolvencies, numerically, were the fifth worst sector in the economy in the first quarter, with construction leading the way. Geographically, and for LPA receiverships our work covers the whole of the UK, and not just London and south-east England, Wales, in particular, appears to be showing a worsening trend with insolvency levels this quarter increasing by 29.5% compared to the same quarter in 2010. The most improvement has been recorded in the East where the number of insolvencies has dropped by 17.1% since the last quarter.

Whilst it is easy to become a bit schizophrenic trying to discuss positive traits in the property industry on one hand and then suggesting that from a business perspective we are just as happy with a comfortably high level of insolvencies on the other we trust you’ll understand.

¹ PricewaterhouseCoopers analysis.





Summary

Fundamentally, there remains too much debt in the economy – both in the private and public sectors. The inflated property asset prices that this created in the period from 2002-2007 will take an equally long period of time to correct and the Government’s timescale for putting the public finances of the country in order by 2016 should indicate the long-term horizon over which decisions on property by buyers, sellers, managers, investors and lenders should be taken.

However, business has never historically operated on cycles of this length and in property has always sought rental and capital growth over a much shorter term. There are opportunities in property for all types of market participants – it’s merely the collective unwillingness to take that first step that is holding the market back.

NOTE

The views expressed in this Overview, unless they quote external research, relate to the south-east of England. They are general views, which should not be applied to individual properties, without professional advice.

Edited by Denise Ford MRICS who would be pleased to respond to any comments.

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