COMMERCIAL
RESEARCH

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PROSPECTS FOR SECONDARY COMMERCIAL PROPERTY

Waiting for the tide

Knight Frank

HIGHLIGHTS

- Recent months have seen the tide of investor sentiment turn against lesser quality and short income secondary assets.
- The 2008-2009 downturn was a combination of recession and fundamental price imbalance. This downturn is more about the external economy, with property reasonably priced compared to gilts and equities.
- We expect the tide of investor sentiment to come in again to lift secondary demand when the current economic slowdown has run its course, and good quality secondary will be the first to reap the benefit.
- We advise a 'sit-it-out' strategy combining asset management with selected sales of poor quality assets, which face a long road to recovery.

Secondary property is that which is neither prime (i.e. rackrented, long-let to a strong covenant tenant, well located, and best in-class specification) nor tertiary, which is effectively obsolete and very poorly located vacant stock. Secondary encompasses a wide array of property types; effectively a rainbow of qualities.

This makes secondary a difficult type of stock to assess, benchmark, and speak of in general terms. The ambiguity has made it particularly prone to shifting market sentiment. Lately, the tide of sentiment has moved out, leaving lesser quality secondary assets 'high-and-dry'.

This beckons the question, what should investors holding secondary do while waiting for the new tide to come in?

A shift in buyer priorities

Early in 2011 interest was starting to re-emerge for secondary assets, however, in recent months investors have turned risk averse again, as the UK economy slows. Buyers are seeking long and secure income streams, which suggest a shift in buyers' priorities back towards prime is underway.

For instance, yields for secondary shopping centres, having dropped to 7.25% back in May, are in excess of 9.00% at the time of writing. Yields for prime regionally dominant shopping centres, however, have remained steady at 5.35% over the same time period. Secondary high street yields have also increased since the summer.

Where now for secondary?

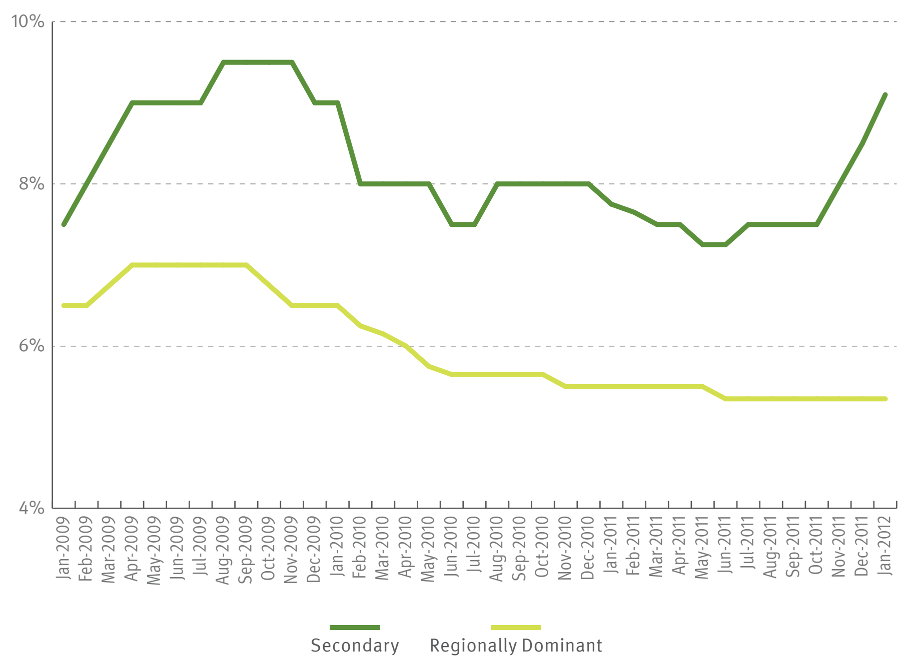
Investment strategies are adjusting in response to the expectation that economic growth for the next 18 to 24 months will be much lower than previously supposed. At the start of this year, the consensus UK GDP growth forecast for 2012 was 2.1%, rising to 2.5% for 2013. Now the consensus is 1.0% next year, and 2.1% the year after.

Moreover, a vibrant secondary market tends to require a fluid debt market, which is certainly not the case at present. Also, the elephant in the room is the UK banks and the assets they are now holding in their workout vehicles. The majority of such assets are believed to be secondary or tertiary, although exact information is thin.

This raises the question, where does the market for secondary assets go from here, and what strategies are open to those holding such stock?

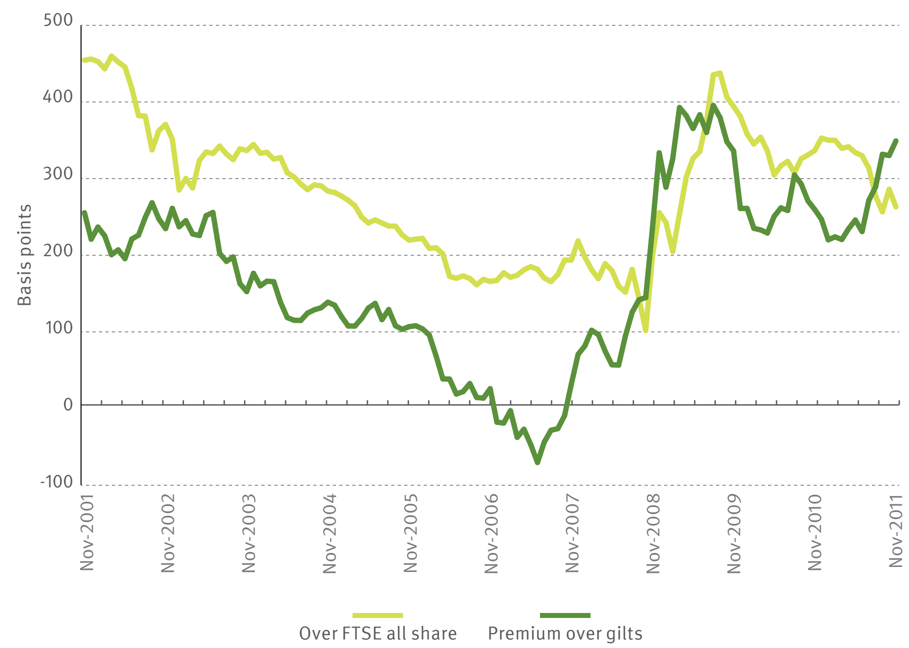
The 2008 to 2009 downturn was a combination of external shock (the credit crisis and global recession) and the bursting of a property bubble. The IPD capital growth index increased by 41% from 2003 to 2006, then fell 29% from 2007 to 2009. Property was heading for a bear market in 2007, but the credit crunch made it a severe downturn. The 2011-12 slowdown in the secondary market – prime is holding up relatively well – is far more externally influenced (the Eurozone crisis, and fading UK growth).

Shopping Centre Yields



Source: Knight Frank

All property initial yields basis points premium over gilt and FTSE yields



Source: IPD

A shift in buyer priorities

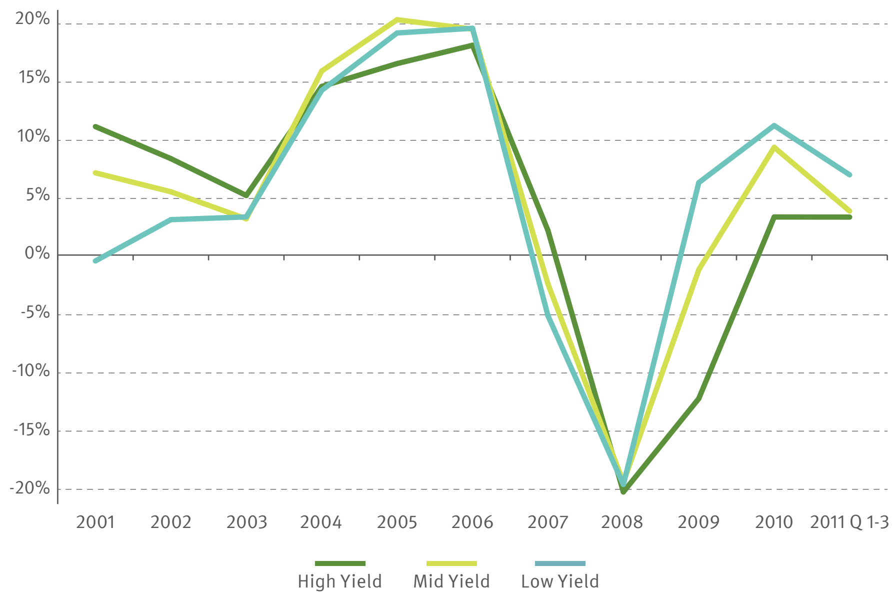
In 2007, IPD all property initial yields were lower than gilt yields, and were just circa 180 basis points over FTSE all share dividend yields (having averaged 292 basis points in the preceding five years). As at November 2011 all property yields were 349 basis points over gilts, and 263 points over the FTSE.

So, pricing appears reasonable when benchmarked against the other asset classes, which suggests recent price falls reflect a lack of confidence in the economy and the possibility of further falls in rent, not a fundamental over pricing of the market.

In regard to the volume of secondary stock being held by the banks, many opportunist investors have grown bored waiting for a flood of distressed sales coming to the market. The banks appear to be pursuing a very long-term strategy of drip feeding assets to the market, and there is no sign of a change of direction in recent months.

How will this impact demand for secondary? At times like this, it is well to remember the blurred and shifting nature of the borders between prime and secondary, which are governed by confidence levels in the market. For instance, three years ago in the central London office market an asset required at least ten years on the lease to be considered prime. Yet, as yields fell back from their early 2009 heights, and assets offering at least ten years income became scarce, buildings with eight or seven years on the lease became acceptable to buyers seeking prime.

IPD total returns for South East offices for high, mid and low yield properties



Source: IPD

In downswings the borders shift in the reverse direction, raising the benchmark for what constitutes prime. This makes good quality secondary harder to sell, and freezes up demand for lesser quality secondary. This is what is happening today in the face of the economic slowdown; hence, our 'sit-it-out' where possible recommendation to those holding secondary. In our view, the best approach for secondary is to divide assets into three categories:

1. Assets there is a market for – such as better quality secondary with a reasonable length of unexpired term. As assets that would trade as almost prime in a better market, they should only be marketed at a price that reflects the potential for a return of investor confidence in the medium-term. Sentiment is very volatile in the property industry, and grinding gloom can give way to optimism with remarkable speed.
2. Those assets that need a better economic backdrop to draw buyer attention – such as stub leases outside London, which are well located and in 'normal' economic conditions would trade. Active asset management should improve long-term prospects, and in some cases even lift the property into category 1.
3. The basket cases – empty properties in markets that will take years to recover, such as suburban shops in towns with high unemployment. An investor could find themselves having to wait for the next market boom for a face-saving exit; so better to take the pain now, and sell at an aggressive price, as everything sells at the right price. Perhaps find a local landlord who wants to consolidate the market.

For investors, the need to sell assets in category 1 will be in proportion to the volume of assets in category 3 which are held in the portfolio. The easier to sell buildings will provide the cash to carry the business through the longer marketing process for the poorest assets, and establish the financial cushion ahead of taking the inevitable hit from selling category 3 buildings at a loss.

So the secondary market is currently a matter of waiting for the tide to come back in. While there is little doubt the current economic situation is difficult, there is also an element of exaggeration on how bad things are. The OECD's prediction that the UK economy will contract in Q4 2011 and Q1 2012 has attracted a lot of attention. However, the recession the OECD is forecasting is relatively mild and short-lived. Quantitative Easing will in our view ensure that is the case.

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Secondary Asset Yield Guide

Correct as at 4th January 2012.
Based on rack rented properties.

SECTOR	SEPTEMBER 2011	JANUARY 2012	MARKET SENTIMENT
Offices			
Good City of London*	5.75%	5.75%	Stable
Major Regional Cities	7.00% +	7.00 - 8.00%	Softening
Secondary	8.50 - 10.00%	8.50 - 10.00%	Softening
Tertiary	10.00% ++	10.00% +++	Softening
High Street Retail			
Good Secondary	5.75%	6.50%	Softening
Secondary/Tertiary	7.75%	8.50% +	Softening
Shopping Centres			
Good Secondary	6.25%	7.50%	Softening
Secondary	7.50% +	9.00% +	Softening
Retail Warehousing			
Good Secondary Open A1 Parks	5.85% +	6.00% +	Softening
Good Secondary Bulky Goods Parks	7.25 - 8.50%	7.25 - 8.50%	Softening
Good Secondary Solus Open A1	6.25%	6.25% +	Softening
Good Secondary Solus Bulky	6.50 - 7.50% +	6.50 - 7.50% +	Softening
Warehouse & Industrial Space			
Good Secondary Distribution	8.00% +	8.00% +	Stable
Secondary Distribution	9.00%	9.00% +	Softening
SE Estate (exc London & Heathrow)	6.50%	6.25%	Stable
Good Modern RoUK Estate	7.25%	7.50%	Stable
Secondary Estates	8.50% +	8.50% +	Softening
Tertiary Estates	10.00% ++	10.00% ++	Softening

Definitions

Asset Type	Location / Pitch	Quality Of Building / Obsolescence	Lease Length	Demand / Supply	Tenant / Covenant Strength
Good City of London	City core	Building over 10 years old	FRI lease; medium term (sub 7 years)	Reasonably strong letting demand	Institutionally acceptable lease; tenant covenant considered to be "sound"
Good Secondary	CBD; good location with transport links; regional centre	Good quality; well maintained; capital expenditure may be required; alternative use also considered	FRI lease; medium to long unexpired term (5 - 12 years)	Reasonably strong letting demand	Institutionally acceptable lease; tenant covenant considered to be "sound"
Secondary	Edge of CBD; fringe location	Average quality; some capital expenditure will be required; alternative use also considered	FRI lease; Short to medium unexpired term (2 - 5 years)	Average letting demand	Average covenant strength
Tertiary *(Yield is merely a guide, more focus on capital value per sq ft)*	Poor location; lacking in profile; poor transport links	Dated; nearing end of economic life - significant capital expenditure will be required; alternative use?	FRI lease; Short unexpired (2 year term or less); vacant	Short term lettings at reduced rents; vacant and unlettable	Poor; unrateable; lacking in financial detail; impossible to determine covenant strength

* market rent; City core location; lease sub 7 years; building over 10 years old

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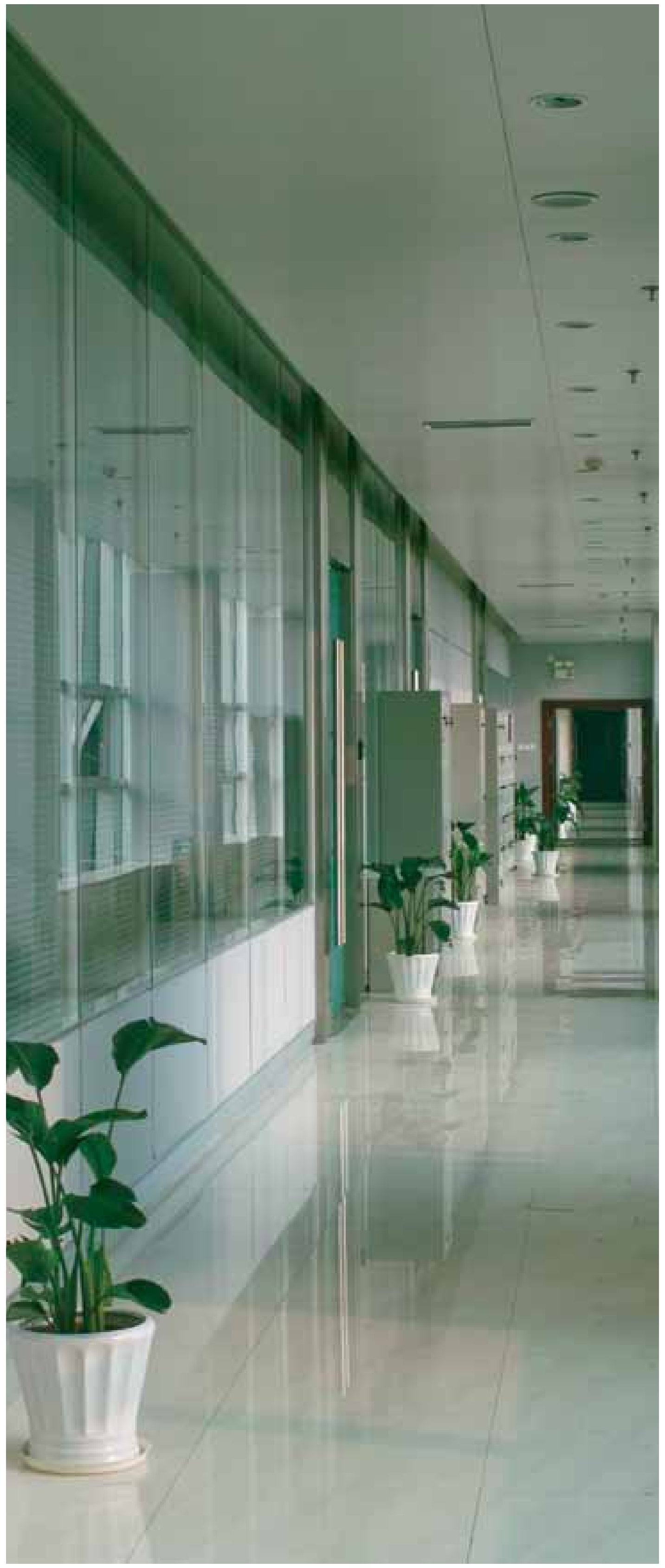

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