Commercial Property Newsletter

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Inside: Irish Commercial Property Commentary
UK Commercial Property Commentary - Irish Life UK Property Fund Information
European Commercial Property Commentary

Irish Commercial Property Commentary

Summary

- **The pace of capital value falls in the last three quarters is well below those in 2009.**
- **There have been notable lettings in both office and retail markets as activity in the market has picked up.**
- **Vacancy is very high and rent levels remain under threat because of this.**

Property values dropped 2.6% in the third quarter and total returns were -0.3%. These falls pale in comparison with the 60% decline in values since the peak, and it appears as if Irish commercial property values are beginning to bottom out.

Property agent CBRE recently reported an encouraging level of letting activity in the Dublin office market with large lettings to the Central Bank, AOL and Betfair. Office market watchers will keenly observe the decision on corporation tax in the upcoming budget. Large foreign companies such as AOL and Betfair rely heavily on the 12.5% corporation tax rate as an incentive to locate in Ireland and any increase would have negative consequences for the Irish property market.

The retail market continues to suffer from poor retail sales as consumers tread carefully with spending ahead of the budget. In spite of this there has been a marked pick up in leasing activity. US shoe manufacturer Skechers has opened a store on Henry Street, Dublin and Next have expanded in Blanchardstown. Disney has agreed a deal on Grafton Street and Homestore&More are opening new stores in Tralee and Carlow. Marks and Spencers are planning a large new store in Douglas, Cork.

There are also signs that the investment market for commercial property is beginning to pick up. The sale of the Liffey Valley Shopping Centre is expected to complete in the coming weeks and Green Property are looking at purchasing a portfolio of 16 properties in Ireland. Property agents are reporting interest from income seeking international investors for prime well-let assets but there is limited availability of such properties on the market.

International investors are interested in Ireland at present as the yield Irish properties are offering are attractive when compared to the return offered by investing in core-European government bonds.

However investing in property with a high yield is not the only relevant consideration when looking at property as an investment. Property values are also driven by rent levels and the key driver of rents is the economy. As we are all aware, the Irish economy remains in a precarious position. Retail sales and consumer confidence are low but there has been some positive signs. Unemployment numbers fell in September for the second consecutive month, with unemployment falling from 13.8% in August to 13.6% at present. This is the first time since early 2007 that back to back falls in unemployment numbers have occurred.

Even when the economy does pick up, the prospect of a recovery in rental values is some way off as there is very large vacancy in Irish markets, particularly there is an abundance of empty office properties.

In summary, it appears that the majority of the capital value declines are over. From a value perspective Irish property is beginning to look reasonably priced, but further falls may occur if rents continue to fall in the face of high vacancy.

UK Commercial Property Commentary

Summary

- **Q3 returned 0.5% in capital gains, a much smaller gain than Q1 and Q2.**
- **Inflation is proving to be very stubborn and will be a threat to the property market in the UK.**
- **Well located assets with excellent tenants are the types of property in demand. Peripheral properties will not do as well.**

With continuing doubts about the timing and strength of the economic recovery the UK commercial property market has been quiet over the past three months. There were less transactions in July and August combined than in June alone. Commercial property values rose 0.5% in Q3 2010 (year to date 6.4%). This is a marked slowdown from growth of 4.3% and 1.8% recorded in Q1 and Q2 respectively. Commercial property capital values have now increased 15% since last year's market trough, but remain 35% down from their peak in 2007.

The slowdown in the pace of growth in the commercial property market can be attributed to weakening investor sentiment and uncertainties around rent levels, which are very closely linked to the health of the overall economy. Demand is largely for well located assets with very good tenants as investors look for alternative income sources to the low yield provided by UK government bonds.

In economic news, the data on the UK economy has been mixed. On the negative side, inflation has remained stubbornly high and the housing market is weak. On a more positive note employment has risen by the fastest pace on record and growth in the manufacturing sector remained robust. As a result the Bank of England has mentioned the possibility of further policy easing and potentially buying government bonds in the markets, hence reassuring investors that interest rates will remain unchanged for the foreseeable future.

If interest rates remain low this will increase the attractiveness of higher yielding property as an investment. However, there is a big threat posed from a further round of quantitative easing in that inflation could rise. This will lead to higher yields being demanded by property investors and is a real threat to the market. [For an explanation of quantitative easing in the U.S. (the same principles apply in the UK) see http://www.irishlife.ie/investments/infocus/quantitative-easing-explained.html.]

Returning to the nitty gritty of the property market; there has been a surge in take up of office space in London's financial district known as the City. This reflects a large number of lettings over 100,000 sq ft, as occupiers look with concern at the falling construction pipeline. City and West End prime rents have experienced strong rental growth since the end of 2009 and average rents are also recovering. Markets outside Central London are unlikely to see much of a recovery in rents over the next few years due to government spending cuts.

In the retail market, consumer confidence has held up remarkably well despite economic conditions. Consumer spending is expected to remain robust up to the end of the year. However with falling house prices, spending cuts and constrained credit, spending by the consumer is likely to be more subdued in the medium term. Consumer spending has a big impact on the performance of the retail sector for obvious reasons and we will be closely watching sales over the Christmas period.

Irish Life UK Property Fund Information

- **No. of Direct Holdings: 19**
- **No. of Indirect Holdings: 5**
- **Vacancy Rate versus IPD index: 5.83% v 10.1% IPD**
- **Current yield: 6.17%**
- **Is the fund fully or partially currency hedged: Fully Hedged**

Property in Focus

Units 1-3, Wells Court, Albert Drive, Woking

Location: Woking is situated approximately 30 miles south west of Central London. The property is located in the established Sheerwater office district and situated approximately 1.5 miles east of Woking town centre.

Tenant: The property is let to Independent Technology Systems Ltd, with Intec Telecom Systems Ltd as the Guarantor.

Lease: The property is currently let to one tenant on three leases. The three leases are due to expire in July 2015. Recently the tenant has downsized its UK business and plans to consolidate into Unit 2 and sub-let the other units.

Brief Description: The premises comprise 3 interlinking office buildings constructed in the mid 1980's and extensively refurbished in 2005. The buildings can easily be adapted to create self-contained office units.

Building 2 sits between Buildings 1 & 3 and is a 3 storey structure planned on ground and two uppers floors. Buildings 1 & 3 are arranged over ground and first floor only.

Dedicated on-site surface parking is available for 148 vehicles.

Asset Management Initiatives: The value of the property has been discounted over the past twelve months due to the tenant having less than five years term certain on the lease (expiry 2015). In addition, the value has been further effected by the decision of the tenant (albeit very strong) to downsize into building 2 (leaving units 1 and 2 vacant) but continues to pay rent on all three leases.

The fund managers will continue to work with the tenant during the remaining years of their lease in order to find a longer term occupational solution. One important factor which will help market the building to potential occupiers is that the existing tenant extensively refurbished the buildings in 2005.

European Commercial Property Commentary

Summary

- **Economic growth of 1.6% is expected in 2010.**
- **Investment volumes are now stabilizing at a moderate level due to limited credit.**
- **Employment growth and consumer spending will be important factors in the recovery of the property market.**

Europe exceeded expectations with a strong economic performance in recent months driven by a thriving German economy. Some of the factors that drove this growth, such as inventory restocking and government stimulus, are not sustainable and therefore the pace of growth will flatten. The consensus growth rate for Europe in 2010 is now 1.6%, up from 1.1% in the second quarter.

Real estate activity in the third quarter was around the same level as Q2 as a lack of credit limited the number of potential investors. Cash rich investors are dominating the market as a result. These tend to be large institutional, public or mutual funds and generally demand high quality prime assets. According to CBRE, in the first half of 2010 about 25% of office transactions in H1 2010 took place in prime locations like Central London, Paris, Berlin and Stockholm, where supply is limited.

European real estate funds experienced growth for the second quarter in a row in Q2 2010, largely driven by declining yields. Yields in most European cities are now below their long term averages, meaning rental growth will likely have to be the prime driver of returns in the next twelve months. Given the uncertain economic backdrop this creates uncertainty in the European commercial property market as it is difficult to see the drivers of rental growth at present.

That said, an argument could be made that further yield decreases could occur as the spread of European prime yields above government bond yields is at a very high level compared to historic averages. It is more likely this reverses from government bond yields rising, as opposed to property yields declining, but it may drive demand among income seeking investors in the coming months.

Europe's office markets will be driven by employment prospects and the vacancy rates in the markets. Employment numbers are not very strong but there is limited space due to be delivered to most markets in the next two years. If employment numbers pick up, rental growth will be better in markets with lower vacancy rates, such as Paris.

In the retail market, retail sales have held up better than expected throughout the financial crisis, largely due to government stimulus packages. Prime, high street retail rents have been stable in central and core Europe (Germany and France) as prime units are always in demand from tenants due to limited space. The worst performing markets have been the Spanish and Irish retail markets where rents plummeted from the highs of 2007.

September 2010 – Stephen Cass, Investment Analyst

Sources: Irish Life, ILIM
Other Sources: Bloomberg, Capital Economics, CSO, CBRE, DTZ, ESRI, IPD, Jones Lang LaSalle, Knight Frank, Prudential Research