Commercial Property Newsletter

March 2011

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

Irish Commercial Property Commentary

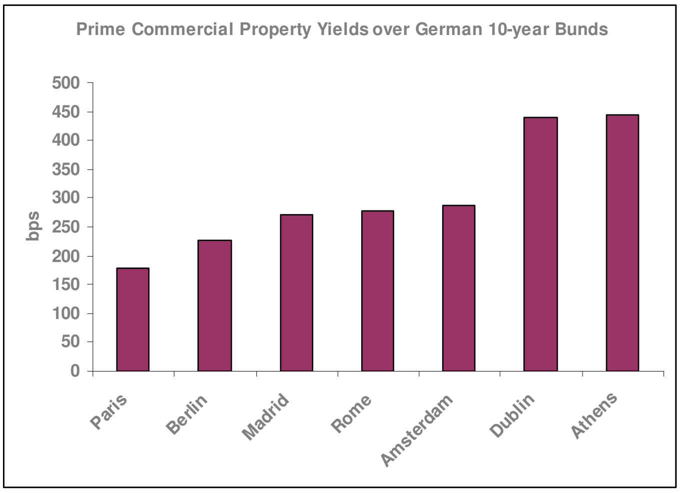
Summary

- **Rents showing signs of stabilising in office and retail markets.**
- **Leading commentators now forecasting good returns for Ireland.**
- **Market will be in limbo until the new government clarifies retrospective rent review position.**

There has already been plenty of activity in the Irish office market in the early part of 2011. Google purchased Dublin's tallest office building while the ESB, Tullow Oil and LinkedIn took up large amounts of space in the periphery and centre of the city. Property agent CBRE reported that rents have stabilised in the office market to date in 2011, about 50% below their peak level.

The retail sector has seen something of a mixed story. Closures of Celtic Bookmaker outlets, Waterstones, Toni & Guy and Zhivago in Galway have been balanced by new store announcements by Abercrombie & Fitch, Centra and Poundstretcher (the latter two will be nationwide expansions). Similar to the story with office rents, CBRE are reporting retail rents appear to be stabilizing at a level 50% below their peak.

The big issue currently facing the Irish property market is the proposal by the new government to retrospectively review existing rent agreements in leases. Until clarity emerges over this proposal the investment market will remain frozen. With yields in Ireland being very high (see chart opposite) there is an argument that some rental reductions for existing leases are already built into valuations. Any directive from Leinster House should be clear and quickly forthcoming in order to prevent market paralysis.



As the chart above shows Irish commercial property looks quite attractive based on simple valuation measures. There are naturally economic concerns to be worried about (not to mention very high vacancy rates) but the great majority of falls in commercial property are almost certainly over and some expert commentators are now beginning to make a case for Irish commercial property. One such leading commentator, Capital Economics, forecast that Irish commercial property total returns will average 9.2% between 2011 and 2014. This was the highest forecast return of eleven countries reviewed.

The Irish economy continues to splutter onwards towards a renegotiation of the EU/IMF bailout. With higher oil prices likely to curb growth, the EU and IMF have recently forecast growth of 0.9% in 2011; well below the 1.7% forecast in December's austerity budget. With inflation now running at 2.2% in Ireland, and higher in the euro area, interest rates will increase sooner than expected and this will not help the economic recovery. On the plus side unemployment declined again to 13.5% in February, and Irish exports surged again in January. The economic backdrop cannot be regarded as a positive for commercial property in the short term, but we are confident the worst is over and investors should begin to think about dipping their toes in the Irish market in 2011.

Irish Life Irish Property Fund – news update –

Below is an article which appeared in the March 1st edition of the Irish Independent.

An Bord Pleanala has given the green light for a new 11-screen cinema on top of the car park at Stephen's Green Shopping Centre.

While last year sources close to the developers said that they hoped to start work on the project in 2011, a spokesperson has said that it is "still at the very early stages of the process. "

The cinema is being developed by the shopping centre's landlords in conjunction with Ward Anderson, the country's long-established and largest cinema chain. Irish Life Assurance is the majority shareholder in the shopping centre with Ventasker Ltd, owned by Pierce Moloney and Aidan Masterson, also a shareholder.

Ward Anderson operates the only other commercial south-city cinema, The Screen, and is also planning to re-open the cinema at The Square in Tallaght.

Irish people are some of the most regular cinema-goers in the world, with audiences of around 17 million people per year.

Irish Independent

UK Commercial Property Commentary

Summary

- **UK property capital growth was slightly positive in January.**
- **Inflation has continued to rise in the UK with inflation running at over 4% in January.**
- **The disparity between prime and secondary assets looks set to intensify in 2011.**

The IPD 'all-property' index again recorded capital growth (albeit muted) for January. This brings the number of consecutive month's growth to eighteen. The same index has now recorded an all-property equivalent yield decline of 1.93% since June 2009.

While capital growth has been strong in the past eighteen months, fundamentals suggest returns will be driven by income returns in the coming year. From a valuation perspective, the gap between government bonds and property yields has significantly narrowed, given one has been moving up (government yields) and the other down (property yields) in the past twelve months. On a historic basis, this spread suggests the vast majority of the capital gains are completed.

Inflation has also risen, which means the net yield returned to property investors has fallen. Rising inflation will temper any further yield falls and if inflation continues increasing there is a strong case to suggest yields may start rising again in the future. This raises the question of the future direction of inflation. The argument for inflation to continue rising is based on higher oil and food prices and the quantitative easing practiced by the UK authorities during the financial crisis. On the other hand, UK consumer and government spending account for the lion's share of economic activity and these are currently experiencing sub-trend growth. This may help curb inflation down the line.

While inflation can be a bad thing for property yields, there can be positives with property acting as an "inflation buffer" as increases in rents are generally linked to inflation.

Within the office sector, Central London offices remain the out-performing market due to a decline in availability and further rental increases in both the City and West End. This is due to strong investor demand and low levels of current development. Outside Central London conditions remain challenging, with over-supply and muted demand. Conditions in the regions are expected to worsen in the short term as the government rolls out its office rationalisation programme. As a result, the gap in returns between prime property and secondary property will likely continue in 2011.

In retail property market news, the recent increase in VAT has added to household pressures and any hope for a strong pick-up in retail sales now seems unlikely in the near term. In fact Capital Economics expects a contraction in consumer spending of c.0.5% this year which the market expects may lead to a modest rental decline in 2011. Given high vacancy rates and the current high levels of household debt it is unlikely consumer spending will recover in 2012 and on this basis it is hard to see rental growth staging a recovery in retail markets in the short term.

Irish Life UK Property Fund Information

- **No. of Direct Holdings: 19**
- **No. of Indirect Holdings: 5**
- **Vacancy Rate versus IPD index: 5.5% v 9.8% IPD**
- **Current yield: 6.29%**
- **Hedging: Fully Hedged**

Property in Focus

Blackfriars House, 379 South Row, Milton Keynes

Location: The property is situated in an established central location in the heart of Milton Keynes. Milton Keynes is situated 55 miles north of London and 70 miles south of Birmingham, adjacent to the M1 motorway.

Tenant: The property is currently vacant.

Lease: n/a

Brief Description: The property comprises a 4 storey office building of traditional construction, built in the 1980's and planned on ground and 3 upper floors. The property is served by a passenger lift to all floors.

The property is in a poor state of repair and would require significant refurbishment in order to attract tenant(s).

Asset Management Initiatives: With the Milton Keynes leasing market in a depressed state the prospects for leasing the space (either refurbished or in its current condition) remain remote. For property specific reasons including significant cost implications for holding the property (empty rates liability and general management expenses) a decision has been made to offer this property for sale.

European Commercial Property Commentary

Summary

- **Recent rise in European bond yields has reduced the attractiveness of property from a valuation standpoint.**
- **Economic growth is muted in most of Europe which will dampen rental income growth.**
- **Investment levels have continued to steadily increase, particularly in Germany and France.**

Recent months have seen a rise in government bond yields. Additionally the fourth quarter of 2010 saw property yields on a European wide scale reduce by 0.10%. Both these factors have served to reduce the gao between government bond and property yields; which has led to a reduction in the attractiveness of commercial property. This isn't to say property is now overvalued. On a long-term historical basis the yield spread is still quite attractive in most European markets, but the burgeoning inflation threat in Europe means government bond yields are likely to continue rising in 2011, decreasing the valuation spread.

Investment activity in Europe increased substantially in the fourth quarter as investors appetite for risky assets continued to increase. Germany and France saw an additional €6bn invested in commercial property in the fourth quarter compared to the previous quarter. Taking a longer term view investment volumes are not particularly high. Additionally, restrictive credit conditions will continue to act as a drag on investment activity so a demand fuelled property boom is not a likely outcome for the European market.

Office markets now appear to have seen the end of rental value declines, including in peripheral markets like Greece and Spain, and some markets are now even beginning to see a rise in rental values. However, slow economic growth and sub-trend employment growth will restrict rental growth in most markets. Vacancy rates are lowest in France and Germany, so rental growth is more likely in these countries; particularly Germany where the economy is performing better than the rest of Europe.

The retail market is not as well positioned as the office sector. Tight fiscal policy and high unemployment will subdue consumer spending, which is a key driver of the retail commercial property sector. Thankfully, there is little new retail space set to be added in European markets in the next two years, and this will help support rental levels at their current rates.

In economic news, the ECB is now expected to begin raising interest rates in April, given the threat of rising inflation. This will put the brakes on growth somewhat, and increase bond yields, which all told will be a slight negative for European commercial property.

We expect a quiet year for European property, with little in the way of capital value changes. Returns will be driven by rental income as opposed to changes in yields, so moderate total returns are a reasonable expectation.

March 2011 – 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