

Credit crunch and the property market



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Greater London Authority
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Since July 2007, GLA Economics has been monitoring and assessing the impact of the credit crunch on London's economy. To help understand the impact on London's property market, GLA Economics commissioned CB Richard Ellis to write this report.

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CREDIT CRUNCH AND THE PROPERTY MARKET

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LONDON

MAY 2008

FINAL REPORT

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EXECUTIVE SUMMARY

The report provides an assessment of the consequences of the credit crunch for property in London and the implications for policy. It demonstrates that:

- The credit crunch is having a far-reaching impact on investment, development and occupational markets.
- Given the effect of the credit crunch on the wider economy is still unfolding, the result for property markets and, especially occupational demand, is uncertain.
- Downward pricing adjustments and significant falls in transaction levels have already occurred in office, residential and retail markets. However, in all markets there are many reasons to believe the current environment is more favourable than at a similar stage in previous downturns.
- With its heavy reliance on the financial and business service sector, the Central London office market is more exposed than other sectors to the implications of the credit crunch.
- The deterioration in London's property markets makes meeting policy objectives regarding affordable housing provisions and commercial offices more challenging although the impact on transport-related schemes is likely to be relatively light.

CREDIT CRUNCH AND PROPERTY MARKETS

Property investment in the UK was extremely strong over the period from 2004 to the early part of 2007. This was driven by:

- Explosive growth in cheap debt.
- A strong flow of money from private investors diversifying from other asset classes.

The collapse of the US sub-prime mortgage market in mid-2007 caused widespread contamination in world financial markets, with effects felt across a wide range of banks and investors with exposure to what proved to be highly opaque and risky securities debt.

In the UK, the aftershocks of the sub-prime mortgage crisis have hit financial sector activity, so far particularly in structured credit and leveraged buy-out activity. The equity markets have weakened and the general outlook for the financial services sector has deteriorated rapidly. Whilst there have been job cuts in banking and finance, the losses as yet have been fairly limited.

The full impact of the credit crunch on property markets will be felt through the inter-related effects that it is having on investment, development and occupational demand. The effects in the property investment market were among the first to appear and have already

resulted in sharp changes in investment activity and pricing. The impact on development will become more apparent going forward in the amount of new construction activity. Impacts on occupational demand will be a consequence of the effect that the credit crunch, alongside other economic influences, has on real economic variables including business investment, employment, consumer spending and retail sales. These in turn will feed through to occupational demand for commercial property, interacting with property supply to determine rental levels. The demand/supply balance in the market and resulting rental trends will in turn feed-back to pricing and decisions in both the development and investment markets.

CURRENT OFFICE MARKET CONDITIONS

Nine months from the onset of the credit crunch, the impact has already been felt in the London property market.

Office leasing activity, as measured by the take-up level, was relatively healthy for 2007, however, the impacts of the credit crunch was discernible on leasing levels by the fourth quarter. The fall in leasing activity was most apparent in the City with its high concentration of banking and finance companies. This trend continued into the first two months of 2008, with the decrease in occupational demand spreading to the West End.

The impact on the investment market has been more immediate and deeper. Investment volumes, which had set consecutive records in the second and third quarter of 2007, fell back sharply in the final quarter of the year, only to recover slightly in the first quarter of 2008.

The impact on yields has been more marked, with prime investment yields in the West End and the City drifting out from their summer level. Whilst yields have stabilized since then, the investment market remains fragile and a gentle outward movement of yields is likely. In the market outside Central London, where yields have not moved out as far, there is scope for outward movement to maintain the relative pricing to prime.

COMPARISONS WITH OTHER DOWNTURNS

Despite the gloomy outlook there are reasons to suggest that the current downturn will not be of the same scale as the 1990s. These include :

- *Balance of investors:* There are a wider range of investors, particularly from overseas, active in the London investment market. In marked contrast, in the period leading up to the 1990s downturn, domestic investors dominated. Only once the recession took hold did overseas investors enter the market in any large numbers.
- *Less pronounced development cycle:* The strong market conditions that have prevailed over the last two years have provoked a strong response by developers. However, we have seen quite a swift reaction from developers to the

change in market conditions. As a result, although the development pipeline will peak this year, the potential for a sharp rise in development and therefore supply has been removed. This contrasts with the 1990s when there was an uninterrupted build up of development before demand collapsed.

- *Cost of borrowing:* The recent fall in the cost of borrowing aligned with the outward movement in yields have made debt-financed investment easier than in the recent past, although tighter lending conditions have offset this to some extent.
- *Macroeconomic environment:* Despite a deteriorating economic outlook, the economy is on a much better footing than it was in the 1990s. The US might be in a recession, but the UK economy is forecast to grow this year, albeit significantly below trend. The London economy, with its high concentration of banking and finance companies, remains highly susceptible to the fall-out from the credit crunch however. Interest rates have passed their peak and are on a downward trajectory, sitting at historically low levels.

RETAIL MARKET

Indicators have started to point to some weakening of activity in UK and London retail markets; the sector is well placed relative to this stage in previous cycles. There are a number of factors that will sustain the retail sector:

- *Recent rental growth:* Retail rents have not experienced the same level of volatility as they have in the past. Although they have increased recently, rents have not hit the peaks seen in the late 1980s and 1990s. The lack of strong rental growth limits the potential for any sharp downward correction in retail rents.
- *Investment activity:* Activity in the investment market has been quite stable over the last three years without the large increases that the office market experienced.
- *Consumer expenditure:* the consumer is facing rising costs, more expensive and restrictive debt, and falling house prices. It is therefore unsurprising that consumer confidence is in decline. However, in contrast with previous occasions such as the 1990s, consumer expenditure is supported by growing employment and GDP.

RESIDENTIAL MARKET

After a sustained period of growth, the residential property market is now experiencing a widely anticipated slowdown. In comparison with the 1990s, there are a number of factors that are fundamentally different, these include:

- *MIRAS removal:* The removal of mortgage relief in 1988 contributed to the surging house price growth of the period as householders brought forwards transactions to avoid the loss of tax relief.
- *Interest rates:* The UK's membership of the European

Exchange Rate Mechanism (ERM) forced interest rates to 14.75% in 1990 and they remained above 10% until May 1992. By comparison, interest rates today are at historically low levels and falling.

- *Economic backdrop:* the UK economy was in recession and unemployment high in the 1990s which was a major factor behind the large number of forced house sales. Unemployment is currently low and the economy is forecast to grow, albeit modestly for the next few years.

PROPERTY MARKET OUTLOOK

The forecasts for the London property markets are set against a backdrop of weaker economic prospects and greater uncertainty. To reflect these, forecasts have been prepared to include:

- A modest slowdown in economic growth;
- A downturn, comparable with the dot.com downturn in 2000/01); and
- A deep recession, comparable with the 1990s recession.

The impact on rents and capital values across the Central London office and retail markets is considerable.

	Central London Office			Central London Retail		
	Base	Downturn	Recession	Base	Downturn	Recession
Annual Rental Value Growth						
2008	3.9	-8.1	-10.9	2.5	0.6	0.2
2009	-1.5	-13.9	-18.3	1.1	-2.4	-7.9
2010	-2.8	-4.8	-17.7	3.4	-0.3	-4.6
Average 08-10	-0.1	-8.9	-15.6	2.3	-0.7	-4.1
Annual Capital Growth						
2008	-11.6	-21.8	-25.2	-10.2	-13.3	-16.6
2009	-0.8	-14.5	-19.4	2.0	-7.3	-13.7
2010	1.5	-0.6	-14.1	3.4	1.4	-3.1
Average 08-10	-3.6	-12.3	-19.6	-1.6	-6.4	-11.1

POLICY IMPLICATIONS

The implication of the credit crunch on the property market will depend very much on the extent to which the wider economy is impacted. It is still quite early to predict the potential policy implications, although consideration needs to be given to the potential impacts on:

Commercial offices in regeneration areas: A culmination of factors, including tighter credit conditions, weakening occupation markets and falling capital values, have meant that development has become increasingly unviable. The development pipeline for 2009 and 2010 has already been curtailed significantly since the summer; additionally developments currently at the start of the development process are less likely to proceed. In the present climate, developments in regeneration areas, such as Opportunity Areas, are at risk.

Transport related schemes: Transport is an important factor determining the viability of a location. Whilst the credit crunch will make development more costly and difficult, with returns lower, it is unlikely to have any significant implications on developments related to transport due to the long timeframes associated with these schemes. Where the credit crunch has an impact it will be on timing rather than the long-term viability of such developments.

Residential market: There are a number of constraints on the housing market, which the credit crunch will exacerbate, including:

- *Lengthy, complex and potentially onerous Section 106 agreements:* Our research shows that there is wide variation in the time it takes to negotiate a Section 106 agreement. This creates uncertainty for developers in relation to planning and financing their development programmes. In a more onerous credit environment, this uncertainty affects a developer's ability to secure finance.
- *Affordable housing provisions:* The market weakening is likely to cause a fall in the number of affordable homes being built, although the proportion of affordable units being built in London might increase. The credit crunch will have differing effects across London. Sites close to transport hubs, for example, King's Cross and Elephant and Castle, will outperform those not. Well established locations will be less affected, so Waterloo and London Bridge will benefit. Additionally, sites in Stratford and the Lower Lea Valley will be less exposed to the credit crunch as they will benefit from the Olympic effect.
- *Increasing land costs:* A weaker residential market might mean that developers are unable to cover the total development cost (including land), reducing the prospects of achieving housing targets. A problem exacerbated by the difficulty developers now have securing finance.

1.0 INTRODUCTION

RESEARCH OBJECTIVE

The primary objective of the overall study is to provide a clear understanding of the impacts of the credit crunch on the property markets, in particular, to identify the implications for certain policy goals.

SCOPE AND STRUCTURE

The scope of the study is limited by the availability of data as well as the practicalities of forecasting rents and capital values for a number of areas across London with broadly similar characteristics. This has meant that our approach has been driven by data and as a result we have limited forecasting the retail market to Central and Outer London, whilst our forecasts for the office markets covers both these areas as well as the City and West End, both key Central London markets.

The structure of this report is as follows:

- Chapter Two sets out a framework for assessing the implications of the credit crunch on the property market and the different channels through which impacts might occur.
- The third chapter provides a review of recent trends in the property market and compares these with previous downturns. This analysis is done for the office and retail markets as well as residential property.
- Forecasts for rental and capital value growth in the office and retail sectors are presented in Chapter Four. Results for retail and offices are provided for Central and Outer London, additionally forecasts are produced for City and West End offices.
- The final chapter of the report provides an assessment of the potential policy implications of the credit crunch with a particular focus on the impacts on commercial office space in regeneration areas and transport related developments, and housing related targets.

2.0 CREDIT CRUNCH & PROPERTY: INTRODUCTORY OVERVIEW

INTRODUCTION

The purpose of this report is to provide an assessment of the implications and consequences of the credit crunch for property in London. In this initial section, we set out a framework for examining the impact of the credit crunch on the property market and the different channels through which impacts occur. Firstly, to set this in context and consider how the credit crunch has and will affect market drivers, we review briefly recent trends in the UK property market before the credit market crisis unfolded.

PRE-CRUNCH MARKET DRIVERS

Property investment performance in the UK was extremely strong over the period from 2004 to the early part of 2007, in the context of exceptionally high liquidity in world financial markets. Trends in property investment mirrored, and were shaped by, conditions in other investment markets.

In the period following 9/11 and the dot.com crash, central banks responded by cutting interest rates to very low levels. At the same time, high volumes of savings in the world economy, partly generated by huge Asian trade surpluses, attempted to secure the highest possible returns and a 'hunt for yield' developed which pushed down bond yields and flattened yield curves¹.

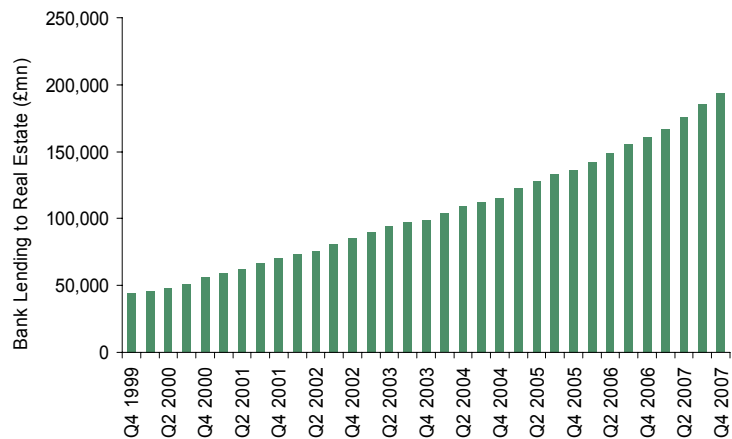
This global 'hunt for yield' by investors compressed yield spreads in a range of markets – emerging market debt, corporate bonds and property. Risk premia were eroded as investors projected conditions of cheap money and low volatility into the future.

The UK recorded a surge in investment into commercial real estate, powered by:

- Explosive growth in cheap debt, with property showing a positive yield differential over borrowing costs that created self-financing investments.
- A strong flow of money from private investors (large and small) diversifying from equities, producing rapid expansion in a range of pooled funds investing in UK property.

¹ The yield curve shows the interest rates on government bonds maturing at different times. The slope of the yield curve is upward to reflect the greater reward required by investors to compensate for holding investments for a longer period. In recent years, the slope has been relatively flat reflecting the change in investors' attitude towards risk.

Bank Lending to UK Real Estate



Source: Bank of England

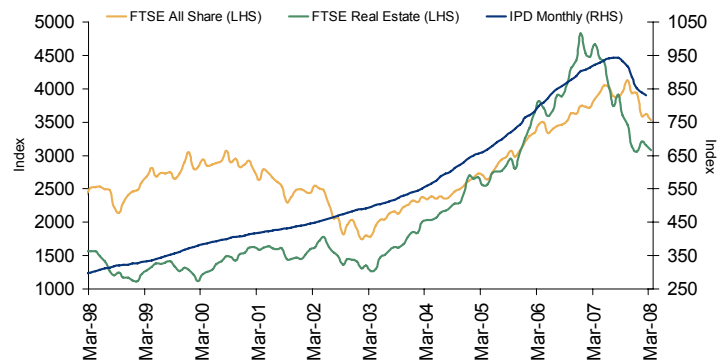
CBRE
CB RICHARD ELLIS

Low inflation and low interest rates (both nominal and real) lead investors to reduce their target returns and accept lower risk premia. Property investment yields² reached historic lows and the sector became 'priced for perfection', as investors failed to take into account any future downside risks.

UK property performance, measured by total returns on the Investment Property Databank (IPD) Index, peaked in 2006 and by the second quarter of 2007 was showing the effect of higher interest rates and weaker demand from domestic sources. Investment demand in 2007 became more focussed on the Central London office market, the only sector showing substantial rental growth, and more dependent on foreign buyers with a series of very large acquisitions (including two transactions of around £1 billion at Canary Wharf). Meanwhile, net inflows into UK pooled property funds eased sharply in the second quarter of the year. Yield compression came to an end and began to reverse in some secondary parts of the market, notably for retail property. By July, yields were moving out in virtually all segments of the market.

² An overview of property yields is provided in the section below.

Asset Performance



Source: Ecwin, IPD

CBRE
CB RICHARD ELLIS

The quoted UK property sector, including the newly created Real Estate Investment Trusts (REITs), experienced a sharp decline in share prices over the first half of 2007. This was partly a correction to the excessive rise the sector enjoyed in 2006, when returns were over 40%, but it also reflected investor reaction to the prevailing low dividend yields in the sector and the recognition that capital growth was going to be much harder to achieve.

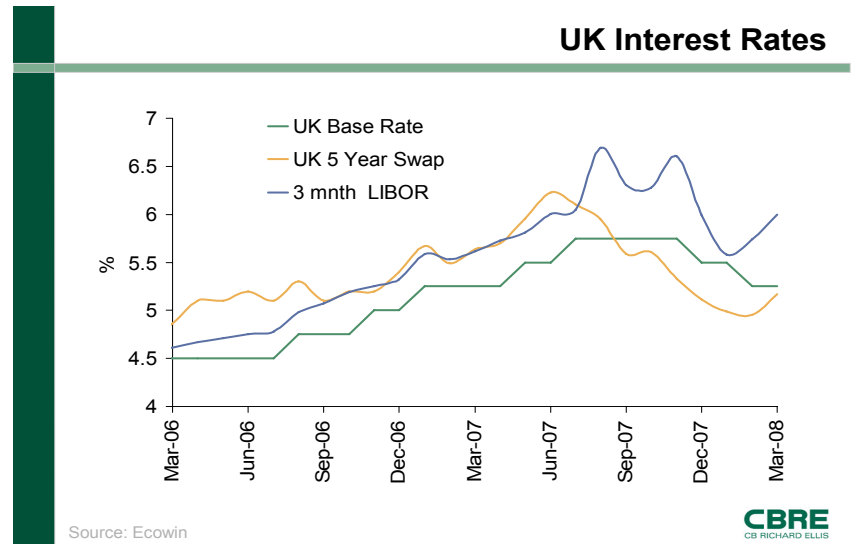
In sum, capital growth in UK property had peaked, pricing had weakened and investor demand was easing in the UK before the major dislocation in credit markets began in the summer of 2007. Occupational market conditions in property, on the other hand, were generally robust in mid-2007 against a background of strong economic growth and, in the London office market, reducing availability and strong upward pressure on rents.

THE CREDIT CRUNCH

The collapse of the US sub-prime mortgage market caused widespread contamination in world financial markets, with effects felt across a wide range of banks and investors with exposure to what proved to be highly opaque and risky securitised debt products. Estimates of the total losses resulting from sub-prime mortgage problems vary but \$400 billion has been cited. The lack of transparency over the scale of the potential losses in sub-prime mortgages and over where the impact will fall resulted in a major loss of confidence in credit markets and a sharp reappraisal of the riskiness of debt packages, with greatly reduced interest in asset-backed securities of any kind. The 'originate and distribute'³ model of bank lending has broken down.

³ Traditionally, banks operated under an 'originate and hold' banking model, when banks held loans to maturity. Most banks have moved toward an 'originate and distribute' model where loans are made but then sold to investors.

In the UK Northern Rock was the most prominent casualty of the sharply reduced liquidity in short term lending markets which emerged. The damage to bank profits and balance sheets has led several major investment banks to seek new sources of capital. Lending capacity in the banking system overall has been significantly impaired.



The credit market turmoil began against a background of strong growth in the UK and the world economy over the first half of 2007. Some initial comparisons with previous financial market crises (e.g. 1987, 1998), suggested that problems could be contained to financial markets without transmitting substantial adverse effects to the economy. It has, however, become progressively more apparent that there will be wider economic consequences of the deflation of the credit bubble. This is most evident in the US where the impact of the credit squeeze is compounded by a serious downturn in the housing market. In the UK, the Bank of England's monitoring of credit conditions shows clear signs of tighter finance afflicting mainstream businesses, the consumer and the housing market.

In the UK, the aftershocks of the sub-prime mortgage crisis have hit financial sector activity, so far particularly in structured credit products and leveraged buy-out activity. The equity market generally has weakened. Financial services business volumes, optimism and employment expectations were all down in the latest CBI/PwC survey. Recruitment in banking and finance in London has slowed, with job losses announced by a number of investment banks, although as yet on a fairly limited scale.

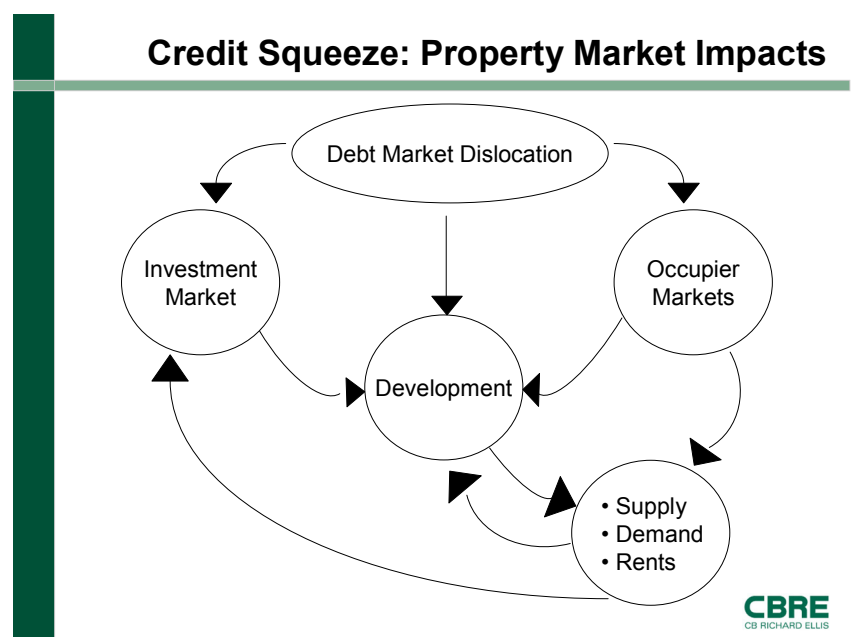
Significantly weaker growth in UK financial services will come on top of a slowdown in consumer spending and business investment already expected to result from earlier increases in interest rates. The London economy and property market is particularly exposed to the reduced growth prospects in financial and related business services.

The Bank of England and the consensus of independent forecasts now indicate the UK will experience a slowdown in growth to below its trend rate over the next 2 years. In the near term, inflationary pressures from higher energy and food prices will militate against significant reductions in UK interest rates, in contrast to the forceful action taken by the US Federal Reserve.

THE CREDIT CRUNCH AND PROPERTY

The full impact of the credit crunch on property markets will be felt through the inter-related effects that it will have on investment, development and occupational demand. The effects in the property investment market were among the first to appear and have already resulted in sharp changes in investment activity and pricing. The impact on development will become more apparent going forward in the amount of new construction activity. Impacts on occupational demand will be a consequence of the effect that the credit crunch, alongside other economic influences, has on real economic variables including business investment, employment, consumer spending and retail sales. These in turn will feed through to occupational demand for commercial property, interacting with property supply to determine rental levels. The demand/supply balance in the market and resulting rental trends will in turn feed-back to pricing and decisions in both the development and investment markets.

The diagram below illustrates the flow of effects from the debt market to the property market and the feed-back loops involved.



**THE CREDIT CRUNCH
AND PROPERTY
INVESTMENT**

As noted above, the credit market turmoil in 2007 hit the property investment market which was already experiencing some reduction in liquidity and a peak in capital growth. The effect of the sharp dislocation in debt markets was to accelerate a sharp adjustment in both activity levels and re-pricing in the property investment market, with a large and sudden shift in investor sentiment against the sector.

The credit crunch has reduced the availability of debt for property investment and made its cost more closely related to risk. Issuance in the commercial mortgage-backed securities (CMBS) market sharply reduced, removing a relatively low cost route to borrowing. Highly leveraged investment activity has been sharply curtailed.

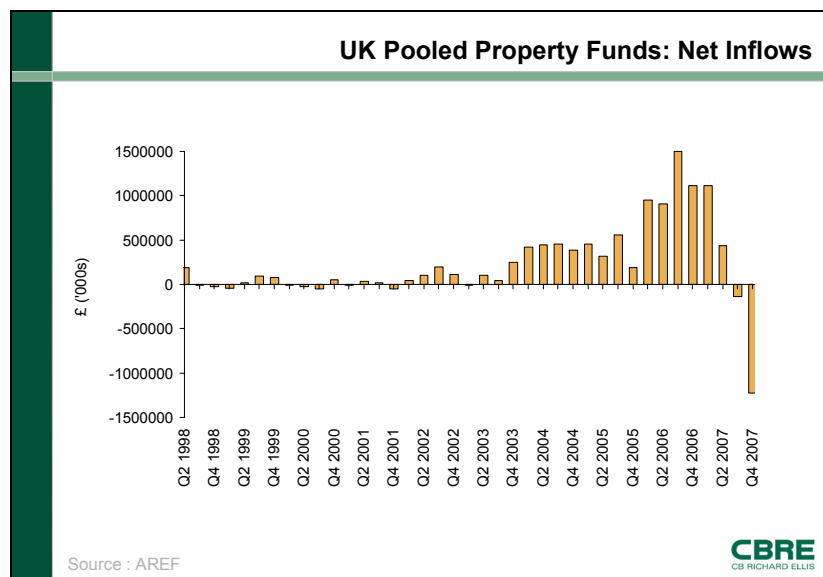
The CMBS market has been a less important source of finance for property investment in the UK compared to the US, although syndication of large loans has been significant and has now become much more difficult. A clear consequence is that the availability of debt for very large transactions, such as those involving big Central London offices, is greatly reduced.

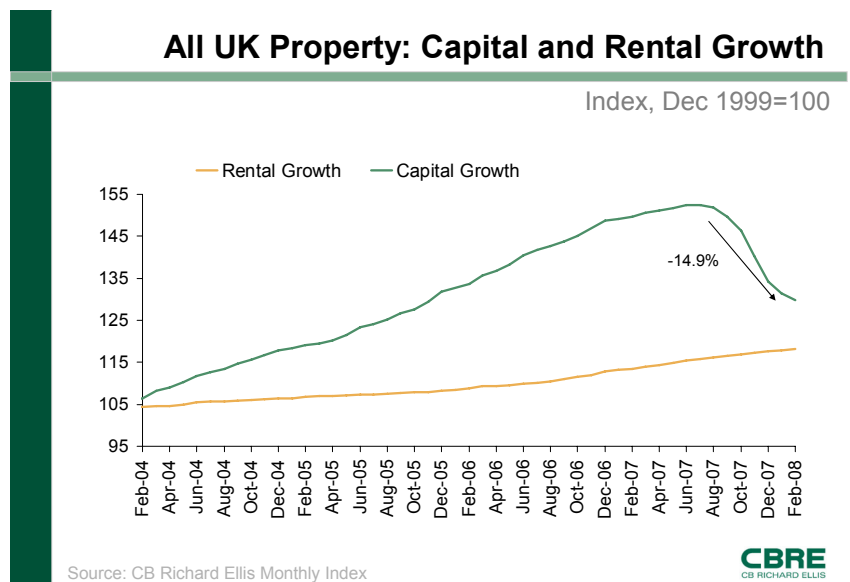
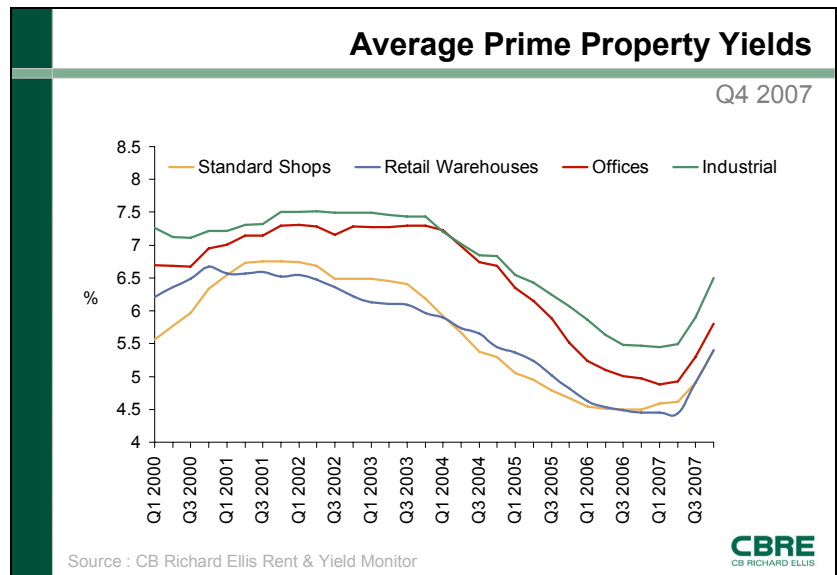
Across the market generally, lending conditions have tightened and loan to value ratios have reduced. Fewer banks wish to expand their property loan books and in general banks have become more selective with respect to borrowers they will support. To an extent, bank lending to the sector has re-focussed on established relationships.

The stock of bank loans outstanding to UK real estate has more than doubled over the past five years, reaching £193 billion at the end of 2007 on the Bank of England's figures. This underestimates total lending to the property sector as it excludes loans from certain categories of lenders, including German mortgage banks and building societies. Bank lending policies will clearly be crucial to market liquidity going forward. Merrill Lynch has estimated that around £60 billion of property loans require repayment or re-financing by the end of 2009. Any adverse shift in bank policies which lead to re-financing problems in relation to this level of debt will have serious market implications.

The onset of the credit crunch was also followed by a sharp reduction in demand for commercial property from un-leveraged investors, particularly those in pooled property funds. Data from the Association of Real Estate Funds show that the UK pooled property funds sector experienced a major reversal in net inflows of money in the course of 2007. From a net inflow of £1.1 billion in the first quarter of 2007, a sharply increased level of redemptions in pooled funds took them to a net outflow of £1.2 billion by the fourth quarter. The scale of redemptions has led a

number of funds to extend the period for meeting redemptions and to liquidate assets.

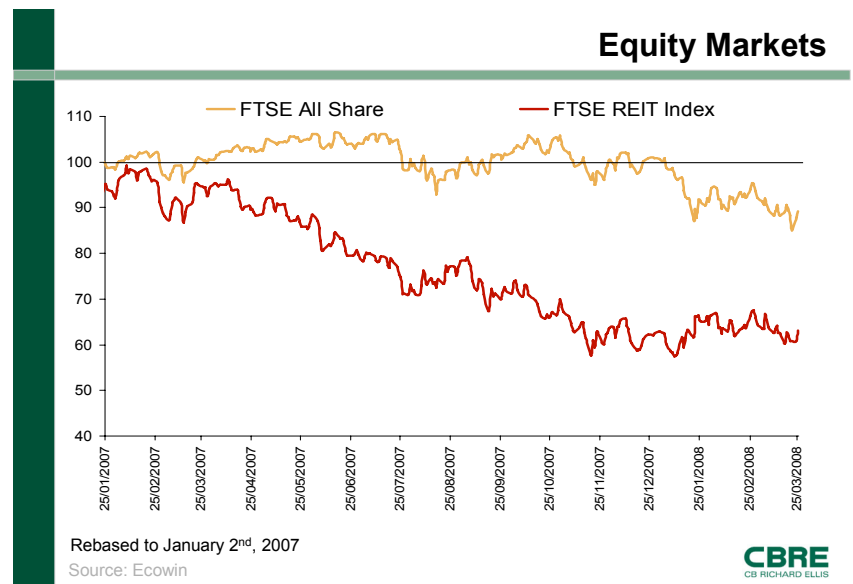




With the sharp pullback by investors from the market over the second half of 2007, investment transaction volumes slumped in the fourth quarter across the UK property market. From a peak of almost £18 billion of investment transactions in Q4 2006, activity fell to only £7.2 billion in Q4 2007 (a figure which was inflated by completion of a single £1 billion transaction in Canary Wharf that was agreed earlier in the year). Transaction levels over the first six weeks of 2008 indicate a continuation of activity at levels broadly similar to the previous quarter.

The contraction in investor demand was accompanied by a sharp fall in property investment values affecting all sectors of the UK market and both prime and secondary property. On the CBRE Monthly Index, capital values were down by 14.9% at the end of February 2008 compared to the previous June. Investment yields have risen sharply in virtually all sectors of the market and the current trend for most segments is towards further weakening.

The correction in values that has occurred has been faster than in previous downturns, reflecting in part the willingness of pooled fund managers to see realistic pricing of portfolios given their need to undertake sales. That said, transactional evidence in various parts of the market has been relatively thin and valuations may not have yet fully captured the extent of the pricing adjustment that has occurred.



The UK-listed property sector experienced a major fall in share prices over the past year, underperforming the wider stock market and leaving the leading REITs trading at substantial discounts to their net asset values. The UK REITs sector was created by conversion of existing property companies into the new tax-transparent vehicles and they in large part entered the new regime on the basis of 'business as usual within a new tax wrapper'. In other REIT markets, REITs are typically higher yielding defensive stocks but the initially low dividend yields, gearing levels and development exposure characteristic of the newly created UK REITs appear to have worked against them in their first year of operation.

THE CREDIT CRUNCH AND PROPERTY DEVELOPMENT

The credit crunch and its consequences have significantly changed the climate for property development in the UK. It is important here to distinguish between developments which are already in progress and will complete over the next year or two and those not yet started that were planned for implementation in the short term. The credit crunch will not greatly affect the amount of new development that will be completed in the next two years or so, which principally comprises schemes already under construction, but could have a significant effect on the amount of new construction that is initiated over this time period and hence strongly affect medium-term completion levels.

The credit crunch is a potentially significant influence on development activity directly and indirectly:

- Tighter credit conditions are impacting the availability and cost of finance for development. This not only includes debt, but also the readiness of institutional investors to commit resources to new development schemes in present market conditions and greater risk sensitivity.
- The assumptions used in appraising potential developments in financial terms will be changed in light of the credit crunch and its wider impacts. Rental projections will be more cautious in the context of greater uncertainties over the strength of occupational demand, as will the assumptions about voids before letting and the extent of rent free periods that will be needed. At the same time, assumptions about the end value of completed developments will need to reflect the upward movement in investment yields.

These impacts will also have a negative effect on development land values.

Property developers are also facing the prospect of significant construction cost inflation as a number of large projects converge. Shortages of key skills and specialist contractors are emerging as key potential constraints on new development.

In this context, developments which have not started will become subject to increased scrutiny with revised development appraisals and potential reconsideration as to design, timing or whether a scheme should proceed on a speculative basis or be made contingent upon securing a substantial pre-letting commitment.

In this environment, developers will look further afield for sources of finance for development schemes, with overseas funding likely to be pursued in more cases. As an example, the 'Shard of Glass' development at London Bridge is now set to proceed with financing arranged with Qatari partners.

The net effect of the credit crunch on development activity is likely to be that the initiation of new schemes in the short term will be substantially less than was envisaged 12 months ago. The London office market has a large pipeline of proposed schemes for completion in 2010 and beyond. The timing of a number of these has now become more uncertain. We discuss in more detail our expectations for future development supply later in this report.

**THE CREDIT CRUNCH
AND OCCUPATIONAL
DEMAND**

The extent to which the credit crunch will depress activity in the real economy remains a major uncertainty at present, as well as being the area of greatest risk to property market performance. Experience of previous property market cycles shows that the most severe downturns have been a product of the coincidence of increased supply with a severe contraction in demand caused by substantial reductions in employment.

The fall in capital values in 2007 was unusual in that in previous downturns, such falls have typically followed or coincided with negative year-on-year growth in GDP and rising unemployment. In 2007, UK GDP rose by 3.1% and unemployment fell. The re-pricing of property investments that occurred in 2007 seems principally to have been the result of capital market adjustments rather than a transformed view of the fundamentals of the occupational market or the prospects for rents going forward.

The credit crunch has weakened the outlook for office demand in London. The downside risk is that a downturn in financial services would generate a demand/supply imbalance sufficient to depress rental levels substantially. If investor perceptions of the occupational market outlook change significantly then that could trigger a further adjustment in investment pricing. A weaker occupational market would also further dampen new development activity.

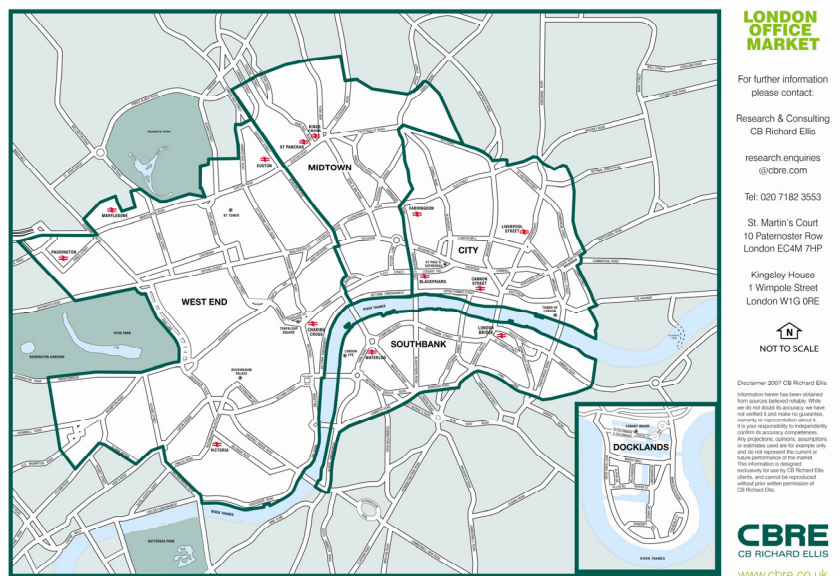
3.0 RECENT LONDON PROPERTY MARKET TRENDS

INTRODUCTION

This section reviews trends in the property market over the last few years, making comparisons with previous downturns where appropriate.

BACKGROUND

CBRE's Central London office market is shown in the map below along with its main markets. This area forms the basis for much of the subsequent analysis with one notable exception. Outer London refers to the London region as defined by the LDA boundaries, excluding the Central London area.



OFFICE

CURRENT OFFICE MARKET CONDITIONS

Based on the annual take-up⁴, the Central London office market reached the end of 2007 in good health. Over recent years, the determining features of the market have been high levels of demand and tight supply. However, the take-up figures for the final quarter indicate a distinct change in levels of market activity. Annual take-up in the past two years has been above the ten-year average of 13.1m sq ft. At 13.9m sq ft, take-up was strong in 2007, but 12% down on the level seen the previous year.

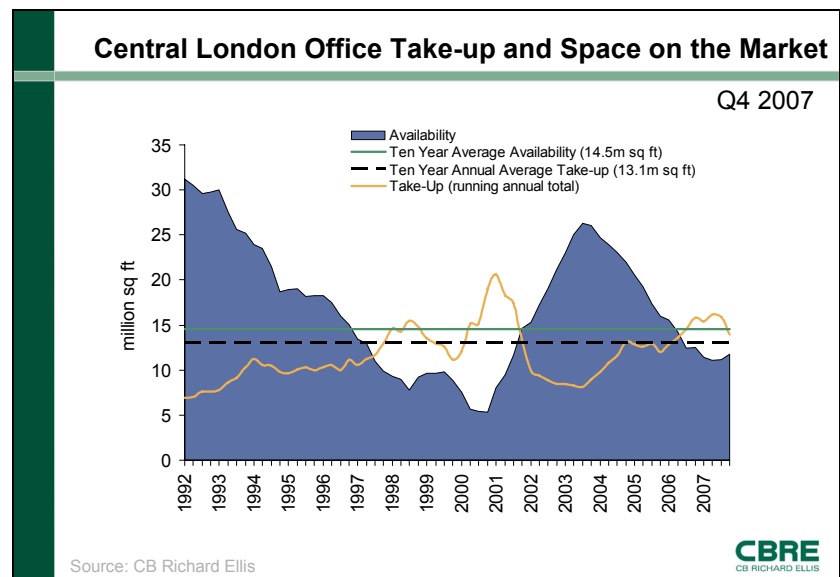
Whereas the transaction volume in the City fell to 5.0m sq ft in 2007, take-up in the West End market rose, totalling 4.7m sq ft, the highest result since 2000. Take-up in the fourth quarter was low, totalling 2.6m sq ft across Central London, well below the ten-year average of 3.3m sq ft and the lowest result since 2005. All sub-markets except Midtown experienced a fall in take-up

⁴ Take-up is a transactional indicator of the property market that measures all leasing activity over a given period, usually quarterly or annually.

during the fourth quarter. Take-up in the City was subdued with 0.8m sq ft being transacted, well below the ten-year average of 1.2m sq ft. Although figures can vary significantly from month-to-month, there is increasing evidence of City tenants being more cautious, either putting requirements on hold or being slow to close deals.

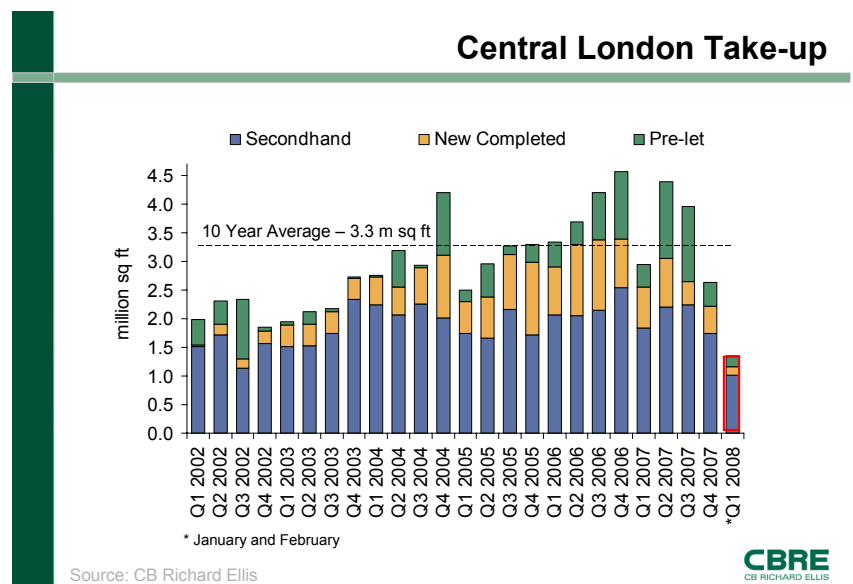
Availability has been on a downwards trajectory since late 2003 and stood at 11.8m sq ft at the end of the fourth quarter, significantly below the ten-year average of 14.5m sq ft. Although Central London supply conditions remain very tight, availability has increased slightly by 0.7m sq ft during the final quarter. This rise was driven by an increase in available space in the City of 0.9m sq ft while West End availability fell slightly.

Early-marketed space contributes significantly to availability so the total figure hides the scarcity of ready-to-occupy stock. The vacancy rate in Central London at the end of the fourth quarter was very low at 3.0%, with 3.5% in the City and 2.3% in the West End respectively. Although this ticked up to 3.3% by the end of February (City: 3.5% West End: 2.9%), tight supply means that many occupiers with large requirements have to turn to pre-lets.



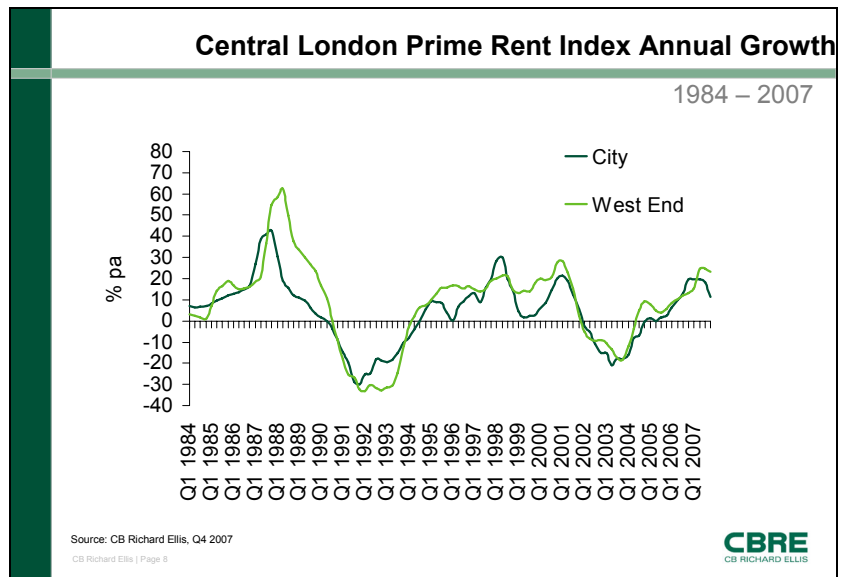
In response to the strong market conditions between 2006 and 2007, rental growth picked up quite strongly in the West End and the City. In the second half of 2007, the rate of growth slowed, more markedly in the City. This trend continued into the first quarter of 2008 with City prime rents falling to £60.00 psf. Whilst rental growth had been strong, it has not been as strong as in the period leading up to the 1990s recession when rents grew by around 60% in the West End and 40% in the City.

The weakness in the leasing market, first observed in the final quarter of 2007, persisted into the first two months of 2008. Some 1.4m sq ft has been transacted in Central London for the year to date, a monthly average of 679,000 sq ft, down on the monthly average of 1.2m sq ft for last year, although take-up in January and February is over 200,000 sq ft higher than the same period last year.



These figures mask key trends within the main Central London markets however. Having escaped from the worst effects of the credit crunch over the summer, leasing activity in the West End has been particularly hard hit this year with only 306,000 sq ft of lettings, compared with 1m sq ft in the fourth quarter of 2007. Most other markets are hovering around the low levels recorded towards the end of last year with the exception of the Docklands which began the year with a sizeable letting.

In contrast to the final quarter of last year, occupiers with large requirements were more active at the start of the year. There were two deals of over 80,000 sq ft in the City, comprising 83,900 sq ft to Lockton International and 80,100 sq ft to Deutsche Bank, and one at Canary Wharf with Moodys taking 165,000 sq ft, although this is unlikely to set a trend for the rest of the year.

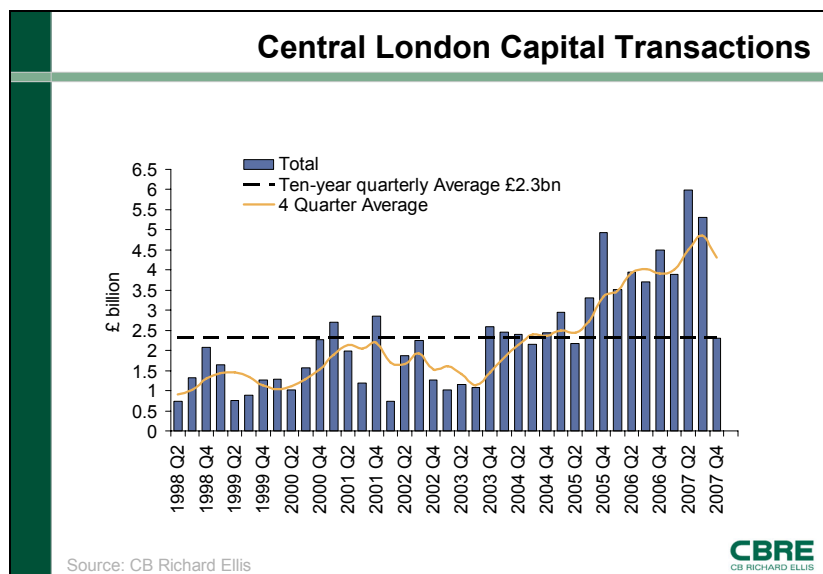


Initially, the impact of the credit crunch was confined to the banking and finance sector, mostly located in the City or Canary Wharf. Recently however, the credit crisis has spread to hedge funds with the collapse of Peloton, based in the West End, and the default of Carlyle Capital Corporation heightening concerns that more hedge funds will follow. In both cases, increased margin calls were the triggers for the collapse, bringing into sharp focus how credit providers have tightened their terms.

Against this backdrop, there is currently an estimated 14.5m sq ft of demand in Central London, up from 13.0m sq ft at the same time last year. In spite of the large stock of outstanding requirements, occupiers will be slower to close larger deals or pursue them less actively reflecting the deterioration in economic conditions. As a result, the outlook for the market is weaker than at any point over the last two years, although there was 3.6m sq ft of space under offer (albeit c1m sq ft is a single transaction).

INVESTMENT TRANSACTION LEVELS

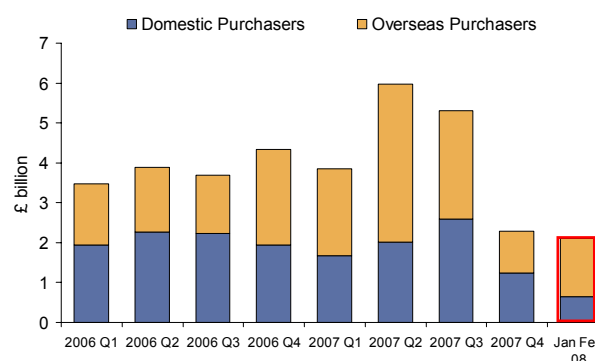
The Central London investment market has enjoyed three years of very high activity levels. It was clear that the market had peaked in the second quarter of 2007 with sentiment starting to turn more negative. The dislocation in the capital markets over the summer was a major factor in the subsequent market correction which was much deeper and quicker than initially envisaged.



Transaction volumes were initially unaffected by the sub-prime crisis due to the strong market momentum and the time required to close a deal. It was not until the fourth quarter of 2007 that transaction volumes fell significantly. In contrast yields reacted almost immediately.

Activity levels in the investment market, which were particularly hard hit by the credit crunch, are still relatively subdued; however, there are signs of renewed interest in Central London. Around £2.1bn was invested in the first two months, a little below the level achieved for the whole of the fourth quarter last year. Overseas buyers have returned quickly to the Central London, accounting for around £1.5bn of transactions in the first few months of the year.

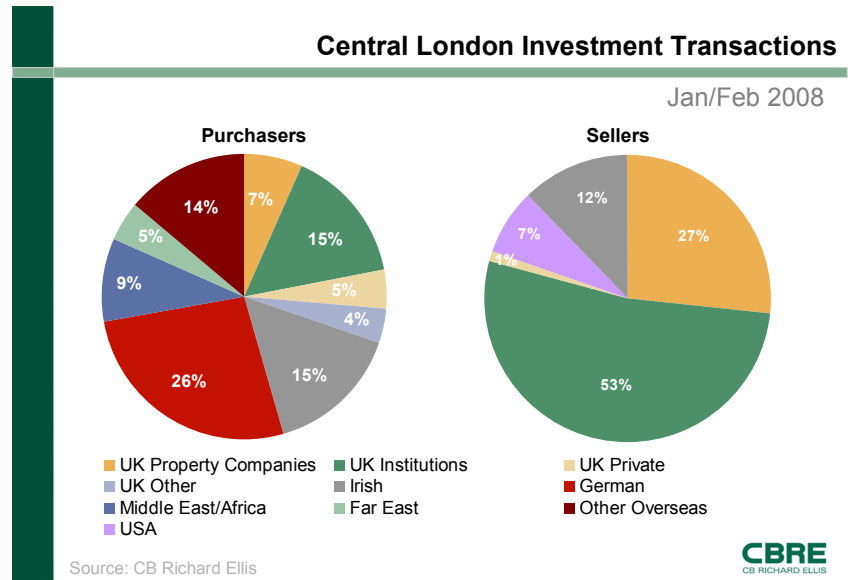
Central London Offices: Investment Transactions



Source: CB Richard Ellis

CBRE
CB RICHARD ELLIS

German investors, primarily open-ended funds, have been some of the most active in the market accounting for over a quarter of all transactions. Investment, however, has come from a variety of other sources, including Irish (15%), other overseas (14%) and Middle East / Africa (9%) investors, as well as UK institutions (15%).



In contrast, domestic investors have dominated the selling side, accounting for 81% of transactions. Retail funds, such as Standard Life, New Star and Morley, have been amongst the most active sellers. REITs, such British Land and Hammerson, have also been active sellers.

AN INTRODUCTION TO YIELDS

Property yields are a key measure of property investment pricing. In its simplest terms, the yield on a property investment is equal to the annual rent divided by the capital value. Hence, a property showing a 5% yield has a capital value twenty times the annual rent; a 4% yield means the capital value is twenty-five times the annual rent.

Hence, the market value of a property can thus change, without any change in its rental value, according to the level of investment yield that the acquiring investor will accept. Values rise when yields fall or “compress” – indicating that investors are paying more for a given income stream from the rent. Conversely, a rise or “moving out” of property yields means a reduction in values; the same income stream is valued less highly by investors.

The simplest yield calculation applies when a property is let at a market rent at the beginning of a lease. This is the assumed basis on which benchmark yields for particular categories of property are typically quoted.

UK property leases normally run for a period of years with rent reviews at 5-yearly intervals, when the rent payable is revised to the current market level, usually upwards only. The 'upwards only' provision means that if, by the time of the review, the market rent has fallen below the current rent, the rent payable remains the same.

Where a property is part way through a lease and between rent reviews, the market rental value of the property may be higher than the current rent being paid. In these circumstances, the valuation of the property, reflecting the price an investor would be prepared to pay, would typically take account not only of the current rent but also allow for the expectation that, at the next rent review, the rent will rise to the market rent.

Thus the property will be valued with an initial yield reflecting the ratio of the current rent to the capital value and an 'equivalent yield', which will be somewhat higher, taking account of the expectation of a higher income in future when the rent is reviewed upwards to the market level. The measure of equivalent yields can thus be used to compare the valuation of properties at different points in the rent review cycle and with varying amounts of 'reversionary potential', i.e. the amount by which the market rental value of the property exceeds its current passing rent.

Individual property characteristics will influence the price in the market that investors will pay for assets, and hence the level of yield. Overall property market conditions as they affect the potential for rental growth and income security (e.g. the frequency of tenant defaults and duration of vacancies) will influence the general level of property prices and yields. Other things being equal, in conditions of strong rental growth and low vacancy rates, property yields will come under downward pressure. Conversely, weak occupational demand and/or excess supply will be likely to see higher property yields – values will suffer from lower expectations of income growth and weaker prospects for income security.

Property investment pricing is also influenced by capital market conditions as well as occupational market conditions. For property investors using large amounts of debt, the level of borrowing costs relative to the level of property yields is a key factor. Unleveraged investors investing in property as part of a multi-asset portfolio will typically have regard to the expected returns from property relative to the risk-free rate from government bonds or sometimes a target real return.

Property investment values can therefore be seen as a function of a combination of influences:

- Expectations of rental growth
- The risk-free rate of return
- The amount of excess return over the risk-free rate that investors require to compensate for property's illiquidity, management costs, depreciation and tenant default risk.

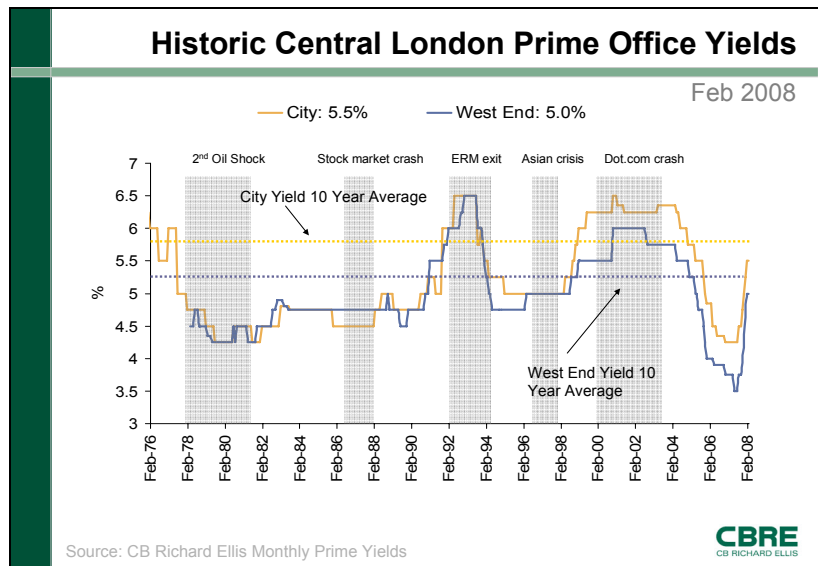
Changes in any of the above can impact on property pricing and the level property investment yields.

RECENT TRENDS IN YIELDS

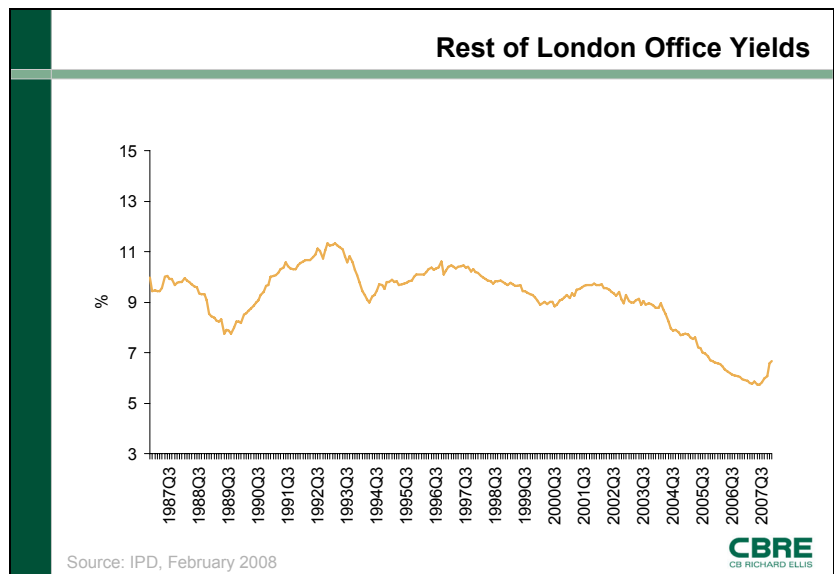
At the start of 2007, prime City yields were at 4.25% and 3.75% in the West End. As the chart below illustrates, this represented a historic low. This followed three years of yield compression resulting from cheap and readily available debt, and optimism surrounding future rental streams.

The credit squeeze has impacted significantly on the Central London investment market. The era of cheap debt and highly leveraged deals is over with finance harder to obtain and more expensive. Across all investment markets, risks are being reappraised and the Central London office market is no exception.

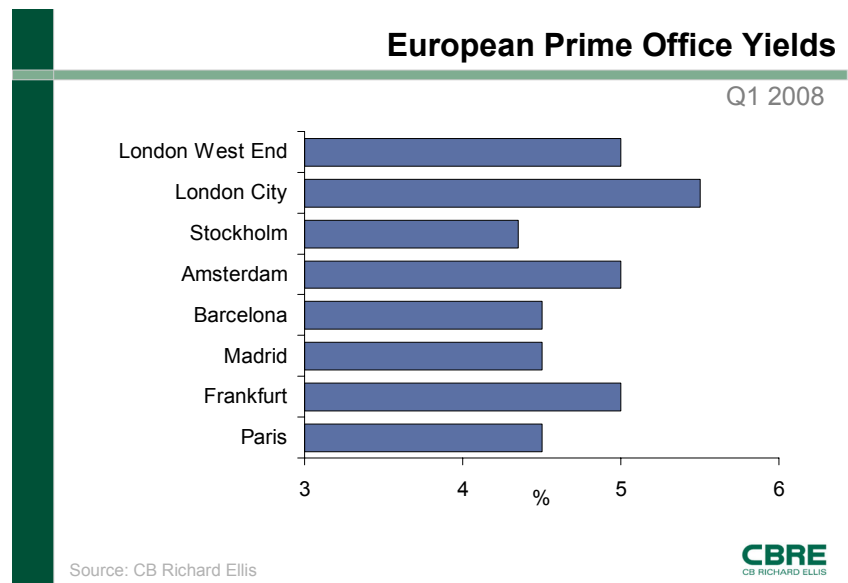
Prime City yields started moving out in August and reached 5.25% by the end of the year. Since then a further outward movement led to prime yields of 5.5%. In the West End, the yield compression continued until May with prime yields reaching 3.5%. Since August the prime yields moved out to currently 5%. Such re-pricing has brought some purchasers to the market to take advantage of opportunities. Based on evidence from the start of the year, transaction levels have recovered from their fourth quarter level. However, the investment market remains fragile and a gentle outward movement of yields is likely. Even with further easing, prime yields should remain below the long-term average.



Office yields in the rest of London have not moved out as dramatically as Central London prime yields. This reflects the over-pricing in the Central London market and the lagged impact on secondary stock. We would expect yields in the rest of London to move out as secondary stock is repriced relative to prime.



The sharp repricing since the summer has made Central London offices a more attractive investment opportunity. In the two main markets, the West End and the City, yields have remained at their current level for the last three months and the market appears to have reached some tentative equilibrium, although concerns remain. Relative to other locations, Central London is now more competitively priced.



Recent transactions have, in part, been driven by some sellers, such as retail funds, needing to restore their cash balance to meet redemptions. A number of deals highlight the change in capital values and nature of the current market. By way of example, a UK retail fund, much in need of cash, has sold a City office investment for £127.5m in February at a yield of 5.5%, compared with a purchase price of £145m and yield of 4.75% in November 2006. Again in February, a private investor purchased a West End investment for £38.1m off a yield of 4.75%, a similar property in the same location sold for a yield of 3.5% only 18 months earlier.

IMPACT OF THE CREDIT CRUNCH ON THE OFFICE MARKET

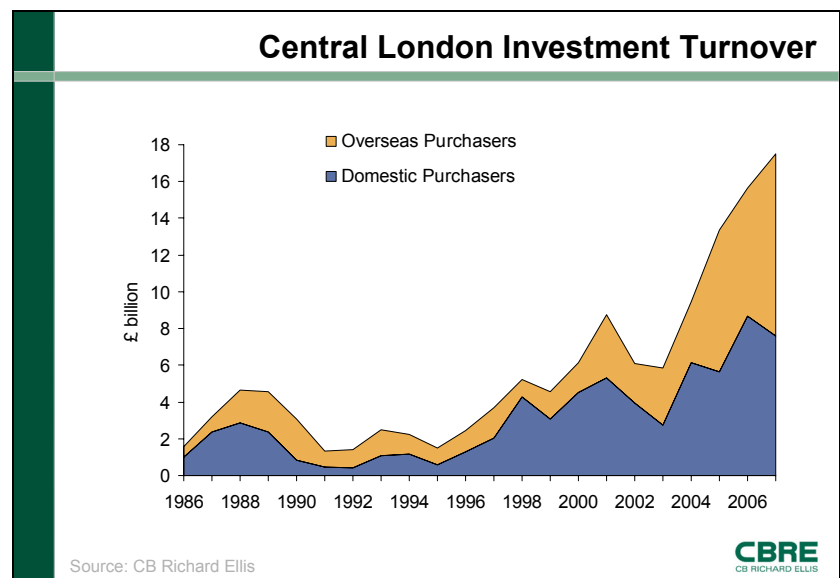
The US sub-prime crisis of last summer has evolved into a wider global credit squeeze, which has started to impact the real economy. There are fears that it could provoke a downturn in the commercial property market similar in scale to the 1990s. Whilst it is true that the outlook is much bleaker than for some time, there are characteristics of the market and external factors that make it unlikely that such a scenario will develop. These include:

- Sources of investment
- Future supply
- Cost of borrowing
- Macroeconomic environment

SOURCES OF INVESTMENT

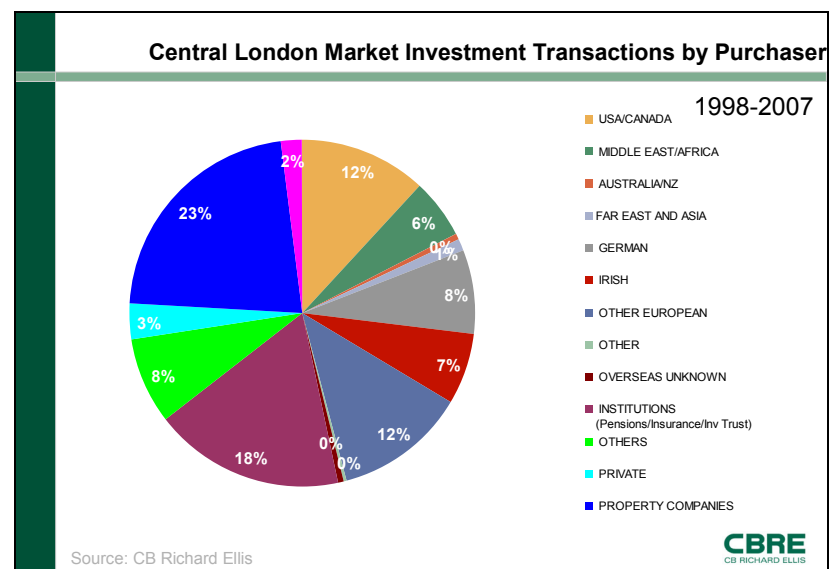
One of the most significant changes in the Central London investment market over the last few years has been the increased activity of overseas buyers. Domestic purchasers accounted for a clear majority of acquisitions until 2004. Ever since, overseas purchasers have become more dominant with the exception of 2006. In 2007, they accounted for 57% of Central London transactions. Of the ten largest deals in 2007, nine were entirely or partly done by overseas investors.

In contrast, in the four-year period leading up to the property crash of the 1990s, domestic investors accounted for 63% of the investment market compared with 51% in the last four year. As the 1990s recession took hold, UK investors became less active, whereas overseas investors were more opportunistic, accounting for 57% of purchases when the market started to recover in 1993. UK investor gradually re-entered the market in greater numbers as the recovery gathered pace. The diverse range of investors attracted to the UK is a fundamental difference between the 1990s downturn and the current one.



The combination of 9/11 and the dot.com crash in 2000/01 were not sufficient to trigger more than a minor correction in capital values. There was no discernible change in the mix of domestic and overseas buyers, with transactions dominated by UK buyers.

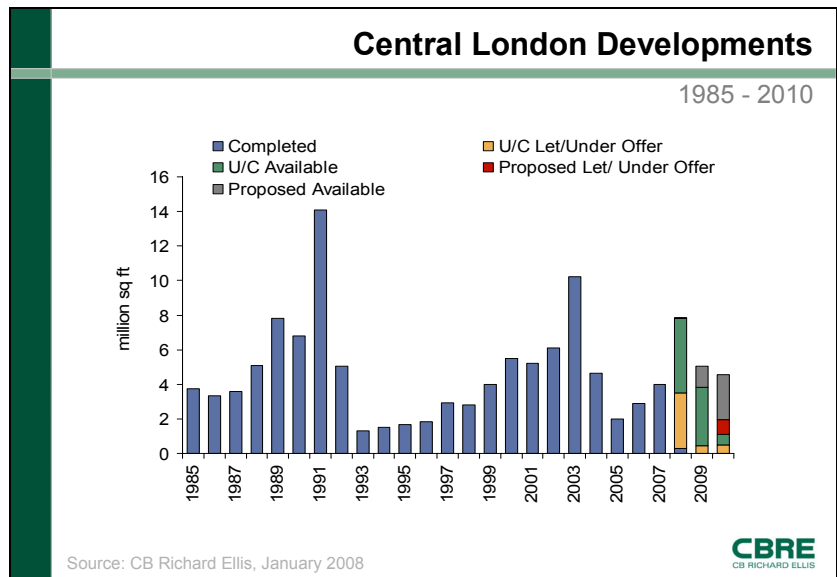
North American and European investors are the most prominent sources of foreign capital. Middle Eastern investors are also quite active in the market. A breakdown on European investors shows that German and Irish investors are particularly active in the market. While German interest in the UK market may have waned slightly in the last two years, Irish and other European investors have retained a key interest. Over the last two years North American stabilised their share of the market at around 20%.



FUTURE SUPPLY

The upswing in the development cycle is well established with the peak due this year. There is currently 8.8m sq ft under construction on a speculative basis in Central London. However, the amount of space to be delivered to the market over the next few years has fallen considerably due to a number of factors. As a result of the credit crunch, finance conditions are much tighter and estimates of future demand and rental levels are much less optimistic. Construction cost inflation has also played a role. Increasingly schemes are experiencing 3-6 months delays associated with labour or material shortages, which are affecting estimated delivery times.

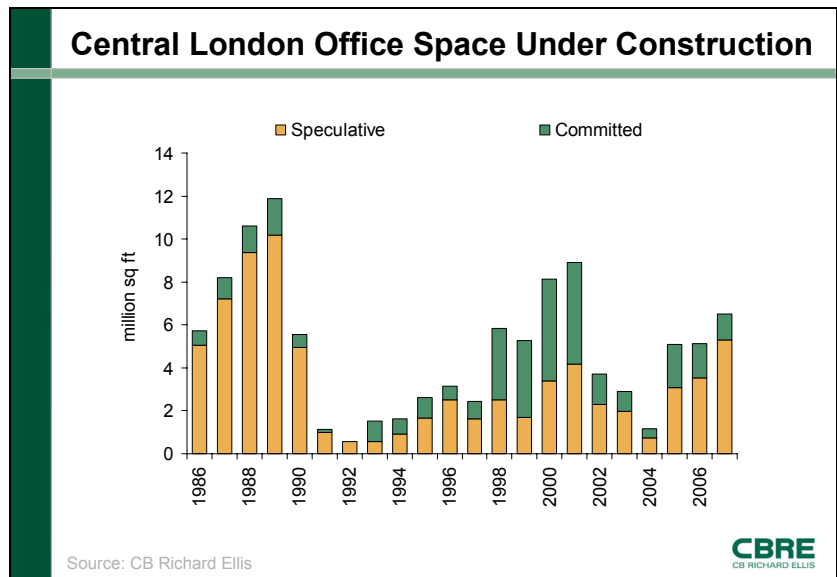
The combination of these factors might mean that the development pipeline will be lower than currently envisaged. A significant proportion of development scheduled for 2009 and 2010 is still at proposal stage, some of which will not proceed to their proposed timescale if market conditions worsen. As some schemes are quite large, there is potential for a significant curtailment of the pipeline in these years.



The amount of space under construction points to a robust response from developers to the strong market conditions. With the development pipeline due to peak this year and take-up weakening, it appears as if history is repeating itself. However, there are two main factors that differentiate the current episode with previous downturns. The volume of space under construction is lower than that in the period leading up to the 1990/92 and 2001/02 downturns. This year will see 7.9m sq ft of space completed, in contrast 14.1m sq ft was delivered in 1991 and 10.2m sq ft in 2003.

The scale of speculative development is much smaller this time around. There was just over 5.3m sq ft of speculative space started in 2007, just over half that in 1989 (delivered in 1991) and in line with the 2001 level (delivered in 2003). In the five years leading up to 1991, there were speculative starts of more than 5m sq ft each year, reaching a peak of 10m sq ft in 1999. In comparison, there has been 11.9m sq ft of speculative starts over the last three years.

The vacancy rate in Central London is low, comparable with the downturns of 1990/92 and 2001/02; however, the potential for sharp rises in availability is limited due to the more restrained response from developers during the current cycle. Another offsetting factor is the demand outlook. Demand is not expected to weaken to the same extent as on previous occasions which limits the downside.

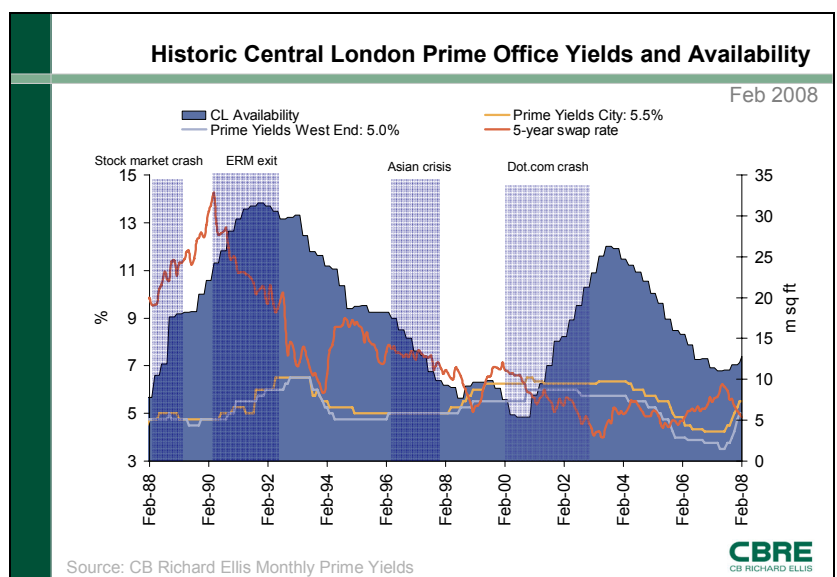


COST OF BORROWING

The five-year swap rate is a general measure of the cost of corporate borrowing. As a result of recent yield movements, a gap has opened between the income received from property (i.e. the yield) and the cost of borrowing.

Prime yields in both the City and the West End have been below the cost of borrowing since early 2006. Debt financed investors were priced out of the market unless willing to make optimistic assumptions relating to future rental growth. Despite this, yields and swap rates continued to move in opposite directions until the middle of last year. Since July, the five year swap rates have been falling.

The swap rate is currently below the ten-year average of 5.5%. However, in general, finance is only currently available if short-term rates of well over 6% are paid. In historic terms, it is at quite low levels however.



**MACROECONOMIC
ENVIRONMENT**

Following several years of rapid global economic growth up to the latter part of 2007, many economies now apprehensively await any evidence of an anticipated slowing of output growth. Whilst the credit squeeze will undoubtedly exert a dampening effect on demand throughout 2008, its ultimate impact on growth remains, as yet, uncertain.

Recessionary fears in the US have emerged following a raft of weak economic data, although the Fed's aggressive monetary easing and fiscal stimulus should bring some relief later in the year. US output growth will likely remain below trend in 2008 given a downturn in household spending, whilst signs of slower growth in Germany, alongside an appreciating Euro, will likely dampen Eurozone growth.

Economic data shows that London performed well in 2007 as a whole. Growth in the capital was expected to be around 3.9%, which compares favourably with a national growth rate of 3.1%. The London economy faces a tough 2008. Whereas the capital has particularly benefited from the expansion of the financial services sector in recent years, it is now likely to be worse affected by their stagnation or even contraction. However, this is not expected to be the start of a prolonged recession. The consensus view is that the London economy will be on the path to recovery by 2009 with growth rates of 2.0%. The medium-term outlook for the capital remains positive. As things stand at the moment, there is no suggestion that the UK will experience an economic recession of the severity seen in 1990/92, nor even comparable with the dot.com collapse.

In February, base rates were cut by 25 basis points for the second time in three months to stand at 5.25%. Inflationary risks remain, however. CPI annual inflation was 2.5% in January, maintaining an upwards trajectory.

In spite of the worsening economic conditions, the capital is much better placed to ride out the weaker conditions. Despite concerns about inflation, it does not present the same threat as it did during the 1990/92 recession, whilst interest rates appear to have peaked towards the end of last year. Persistent inflation constrains the MPC's ability to reduce interest rates further, yet worries about the slowing housing market and weaker economic activity might force through further cuts.

INVESTMENT OUTLOOK

The credit crunch has already had a significant impact on the Central London investment market. Yields have moved out quickly and transaction levels have plummeted. Up until recently the movement in yields have been driven by a change in sentiment and events in the credit market, however, property market fundamentals have now started to change. Rental growth has slowed over the past few months and more recently declines in the City prime rent have been recorded.

Estimating where yields are in such an environment is fraught with difficulty, but there is a widespread expectation that they will continue to move outwards. Only when the market has very clear indicators that prices offer value will investors return on a large scale. This may not occur until well into 2008 or 2009.

Investment activity in the first two months of the year provides some evidence, albeit tentative at this stage, of a recovery in the investment market.

The recent changes in yields along with further outward movements have made London a more attractive investment proposition. Renewed interest has emerged from a variety of sources including, amongst others, German open-ended funds, North American funds, Sovereign Wealth Funds (Norwegian, Singaporean, UAE, Qatari) as well as a growing list of opportunity funds, held by the likes of Land Securities, Evans Randall and Helical Bar. In part this has been triggered by the shift in yields, which have moved beyond the threshold level of some funds, whilst other investors are simply responding to lower capital values and the expectations of acquiring prime property cheaply.

Activity will be much more subdued over the next two years compared with the previous two years, when an average of £16.6bn was transacted. The first part of the year has seen nearly £2bn invested in Central London just below the total for the final quarter of 2007; expectations are that investment levels for the total for the full year will be below £10bn.

RETAIL

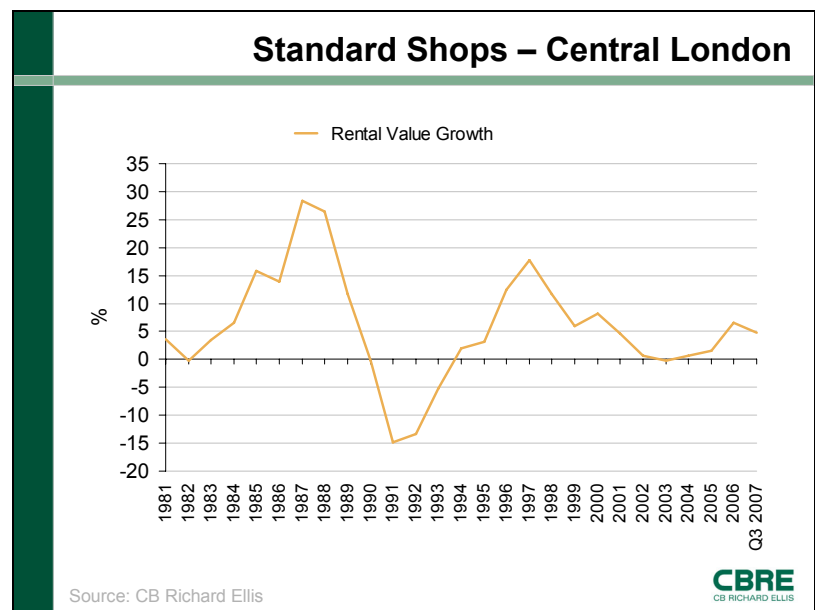
There are a number of factors that are supporting the UK and London retail markets, whilst these have started to point to some weakening of activity, we are still some way off reaching the levels set in previous downturns. In particular, we can point to a some factors that will sustain the retail sector:

- Recent rental growth
- Investment activity
- Consumer expenditure

RENTAL GROWTH

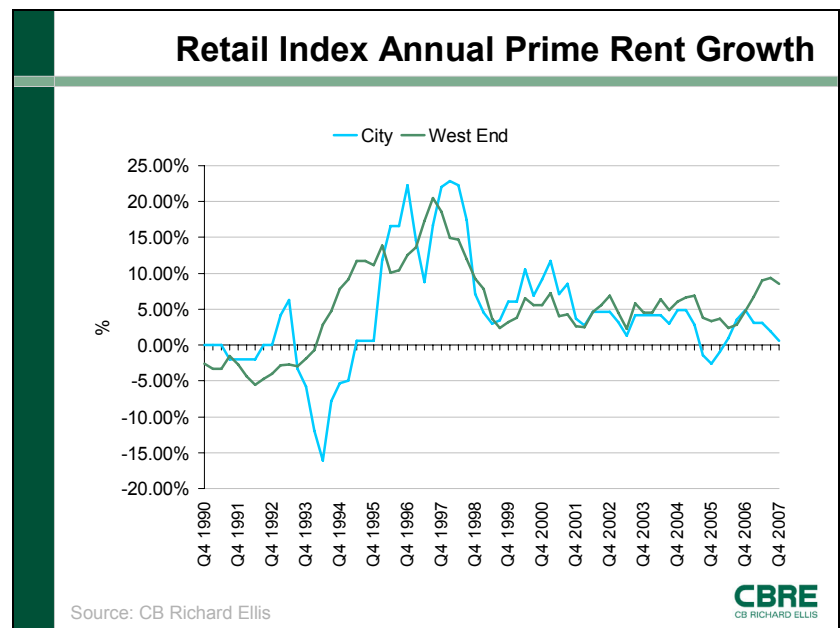
Rental growth of the IPD index of Central London standard shops has increased from the last low in 2003, where annual rental growth dipped into the negative. During 2006 rental growth reached 7% before falling back slightly by the third quarter of 2007 when it stood at 5%. These values are still well above that seen in the early 1990s when rents fell by 15%. Current rental growth remains below the last peak in the late 1990s when rental growth reached 17.7%.

The fall in rental growth in the early 1990s was coupled with a decline in domestic consumer spending; the further decline in the early part of the 2000s was linked to the fall in international visitors, particularly from the US, in the wake of the dot.com crash and 9/11. International visitors are strong contributors to the luxury goods market which is a strong driver of rental values. The current downturn in the US may have an impact on the number of overseas visitors and lead to a corresponding decrease in retail sales and rental values. However, recent weakness of the pound may encourage other overseas visitors and increase their spending power.



Retail prime rents in the West End – Oxford Street increased by 8% over the 12 months to the end of 2007, in contrast to the City – Cheapside rents which remained static during the same period. Prime rents in the West End have been increasing over the last five years, whilst the City rents have remained relatively stable.

The CB Richard Ellis index of prime retail rents for the West End recorded annual growth of 8% at the end of 2007, slightly down on the third quarter but significantly above the levels seen over the last 10 years. The last significant peak in the West End occurred in 1997 when annual rental growth exceeded 20%. This also coincided with the City rental growth peak of 23% at the beginning of 1998.



CONSUMER EXPENDITURE

The last time rents fell significantly was in the early 1990s with West End rents declining by 6% year-on-year in 1992 and City rents falling 16% year-on-year in 1994. The falls in rents during the early 1990s corresponded to negative GDP growth in London of -3.4%. Consumer confidence remained in negative territory for a period of nine years according to the European Commission, and declined as far as -25%. Currently GDP growth for London is forecast to slow to 2.3% in 2008 but not to fall into negative territory.

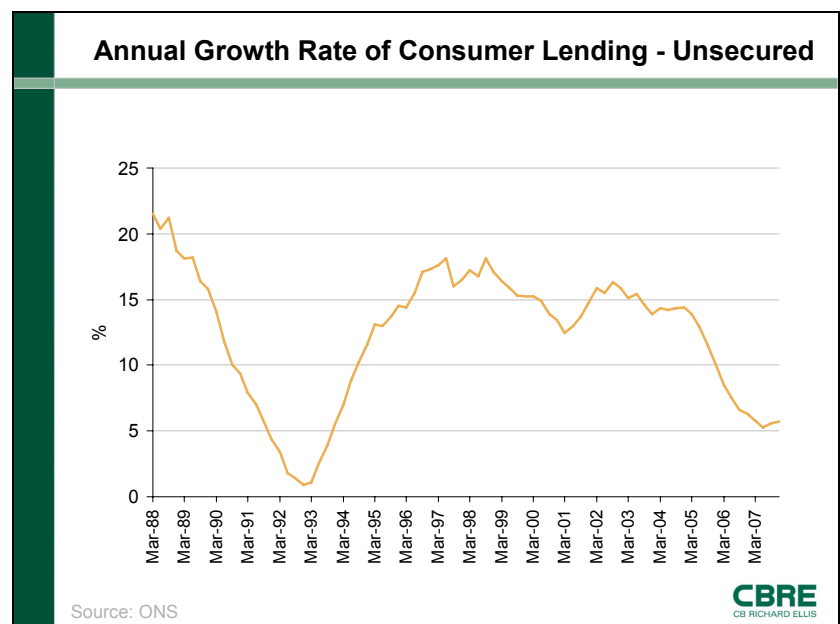
The current decline in consumer confidence has been triggered by more restrictive consumer credit lending, stagnating house prices, increasing household bills and lower income growth expectations. The impact of these on consumers spending could be more severe than currently expected and rents, particularly in high street shops, may decline faster.

The availability of credit has a strong influence on consumer spending. Following the US, the UK housing market appears to be slowing, with mortgage approvals reaching a 12-year low at the end of 2007. House prices have shown definite signs of softening with the Nationwide index recording four consecutive monthly falls, although annual house price inflation still remains in positive territory. Slowing house price inflation is expected to reduce mortgage equity withdrawal, impacting on the outlook for consumer spending.

The cost of unsecured loans and credit card lending is rising with interest rates on unsecured lending increasing by 15 basis points between August and December 2007, bringing rates above 9%. Credit card lending has also been reduced with the big banks including Egg and Barclays reducing credit limits and cancelling some cards. Lending growth has reduced to around 1.7% on a quarterly basis; this is in contrast to the early 1990s where the growth in unsecured lending was dramatically terminated (-0.3%).

Data recently released by the ONS show that sales volumes in December slowed to 3.7% annually, the slowest rate in 2007, although high street price deflation has helped to support retail sales volumes despite the squeeze on consumer incomes. Retail sales growth is expected to reduce further to 2.1% in 2008 before improving slightly in 2009.

The shortage of retail stock, particularly in the West End may help to hold up rents in Central London but declining consumer spending has already led to some casualties in clothing/footwear retail.

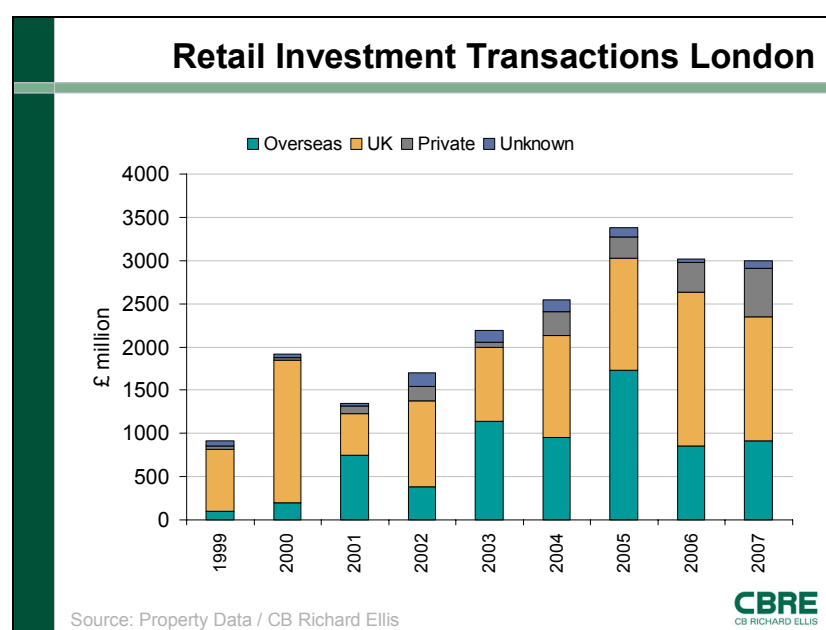


INVESTMENT

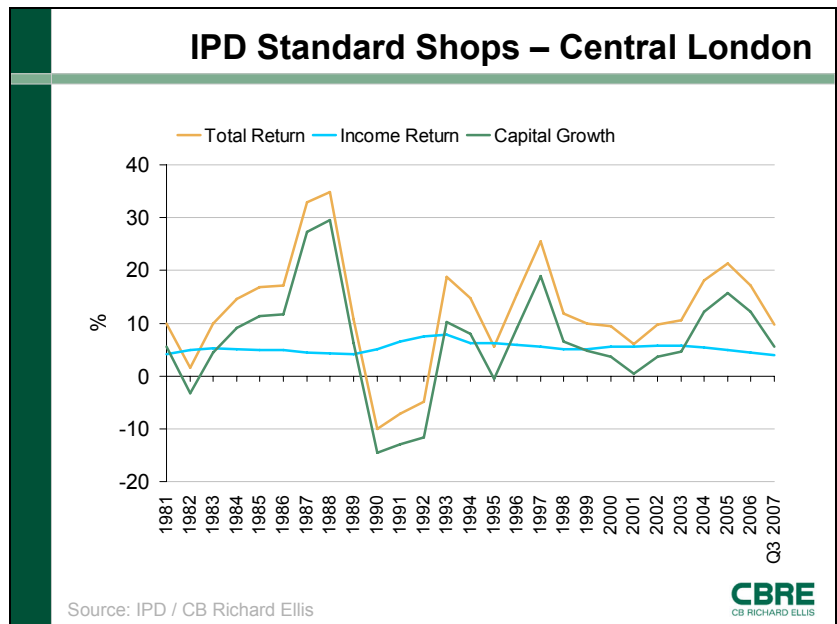
Central London retail investment has been relatively stable over the last three years at £3bn per year. In 2007, investment slowed during the second half of the year reaching £1.1bn, down from £1.9bn during the first half.

During the last two years domestic purchasers have been more active than their overseas counterparts. UK investment and property companies bought £1.7bn of assets in 2006 and £1.4bn in 2007. Overseas investors purchased £855m in 2006 and £918m in 2007.

Current levels are more than twice the low points of retail investment seen in 1999 and 2001 where £920m and £1.7bn were transacted.

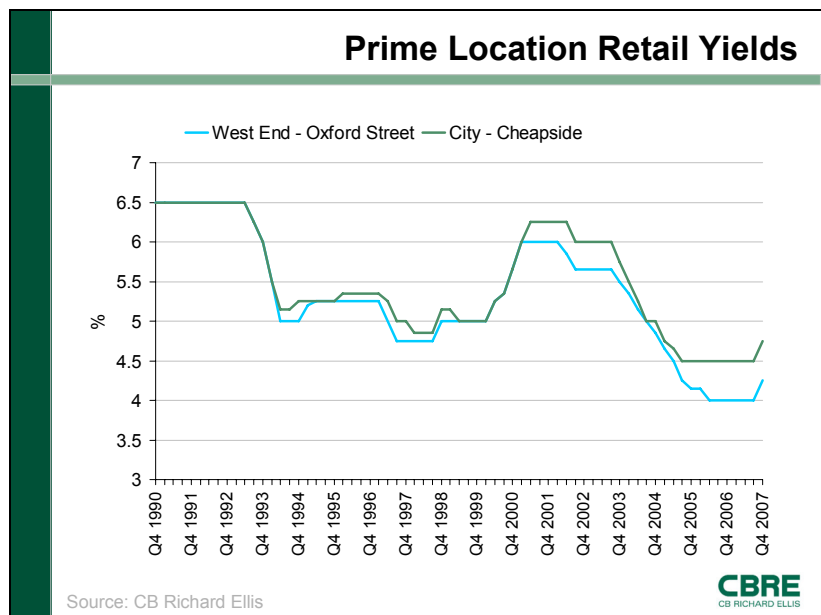


Total returns on standard shops in Central London as measured by the IPD index have declined since 2005 when the last peak occurred at 21.7%. In the third quarter of 2007, total returns had decreased to 9.7%. The last trough of total returns was -10.1% in 1990.



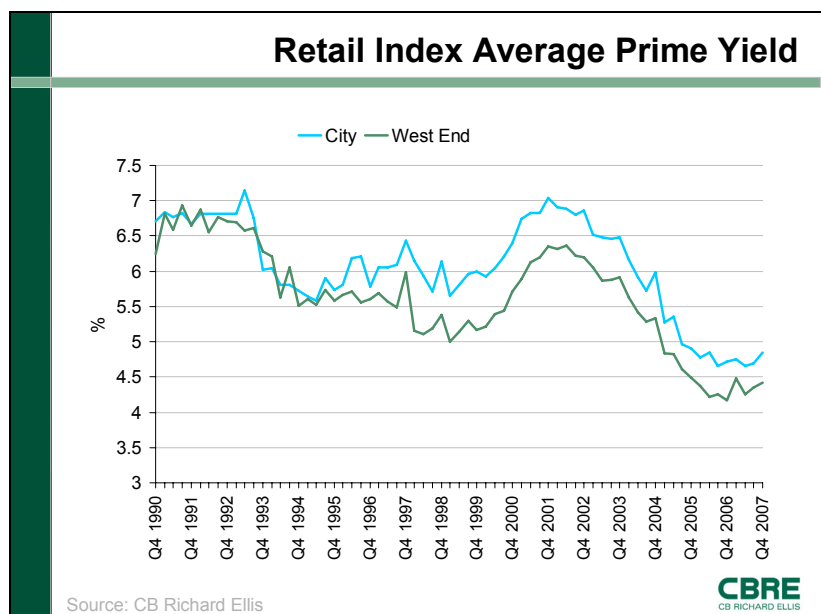
Prime yields have been compressing over the last five years, as measured by the IPD index of standard shops for Central London and prime location yields for West End and City shops. This has been as a consequence of the easy availability of credit and low interest rates. However, over the last year prime yields for Oxford Street in the West End moved out to 4.25% at the end of 2007 from 4% at the start of the year. In the City (Cheapside) prime yields also moved out by 25 basis points to 4.75% at the year end. The increase in yields has been primarily as a result of the credit crunch drastically reducing the securitisation market and thus restricting banks ability to lend. Re-pricing of assets has been a consequence of banks re-evaluating lending risk.

The last time yields increased was during the aftermath of the dot.com crash in 2000/2001. Prime location yields increased from 5.0% in the City and West End in 1999 to a peak of 6.5% and 6.25% respectively in 2001. This was as a consequence of a reduction in consumer spending and rental growth, despite relatively low interest rates. This is in contrast to the situation in the early 1990s; yields reached 6.5% in both markets and the reduction in consumer spending during the recession following the Lawson boom was exacerbated by high interest rates having a negative impact on commercial borrowing.



The average yield indices for the City and West End show similar increases during the periods of economic fragility with average yields moving out in both the early 1990s and 2000s.

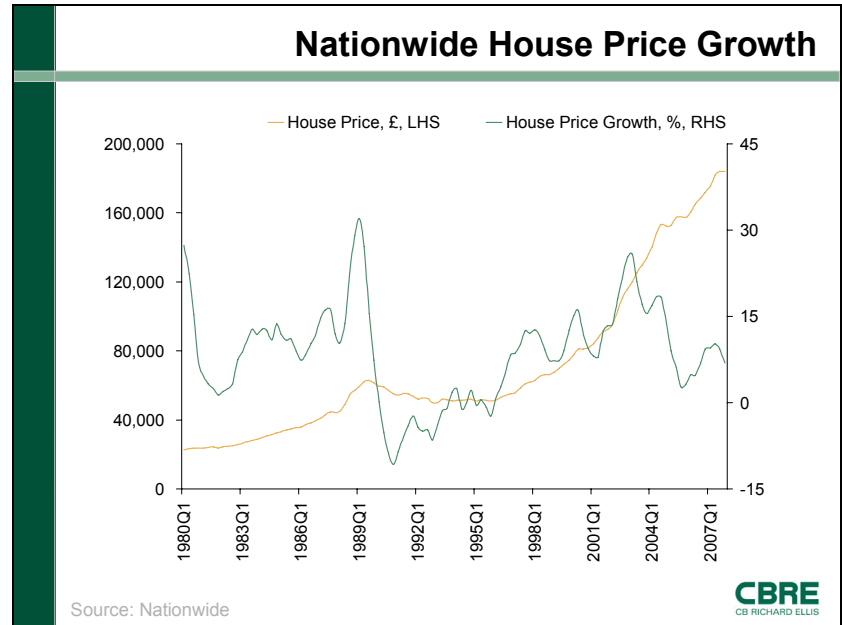
The average prime yields from the CB Richard Ellis prime yield index for retail begin moving out again from the second quarter of 2007. This was undoubtedly as an impact of the credit crunch on the financial markets over the summer. Average yields have continued to move out in both the City and West End currently standing at 4.9% and 4.5% respectively.



RESIDENTIAL

A COMPARISON OF THE EARLY 1990s AND TODAY

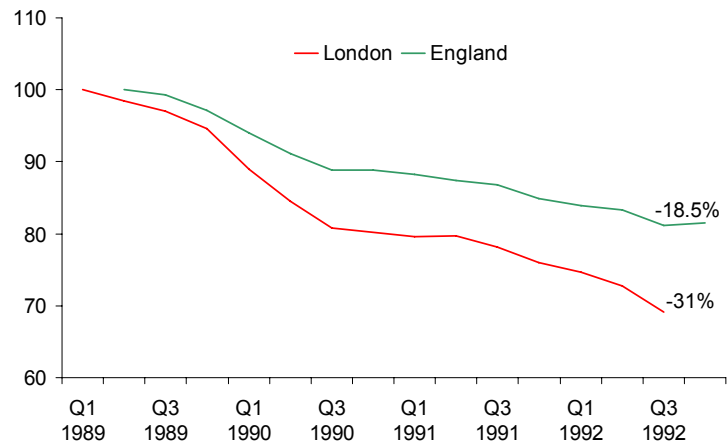
Following a sustained period of rapid growth, the residential property market is now experiencing a slowdown. This has been widely anticipated for the last eighteen months.



During the later part of 2007, activity in the residential property market became substantially weaker. The number of buyers fell significantly; we estimate there were around seven buyers per seller at the end of the year, which compares with nine at the beginning of the year. This in turn has fed through to house prices. Nationwide reported house price growth of 6.9% in 2007, down from 9.3% in 2006. In addition, according to Nationwide, house prices have fallen consecutively for the last four monthly reviews. House price growth in London has exceeded that of the rest of the UK; house prices grew by 12.8% in 2007; up from 11.34% in 2006.

Some commentators suggest this downturn will escalate and result in an early 1990s type crash. At that time, house prices fell around 18%, from £63,000 to £50,000 over a four year period. The downturn was even more severe in London with price falls of over 30%. This crash followed a six year house price boom, where prices had risen by around 130%; house price growth peaked at 32% in the first quarter of 1989.

Peak to Trough in House Prices During 90s (Indexed)



Source: Nationwide, CBRE

CBRE
CB RICHARD ELLIS

Despite the current downturn, we do not expect a housing market crash similar to that of the 1990s. This is because the fundamental market backdrop is now more supportive of the housing market. In particular, there were a number of factors behind the crash of the early 1990s. These include:

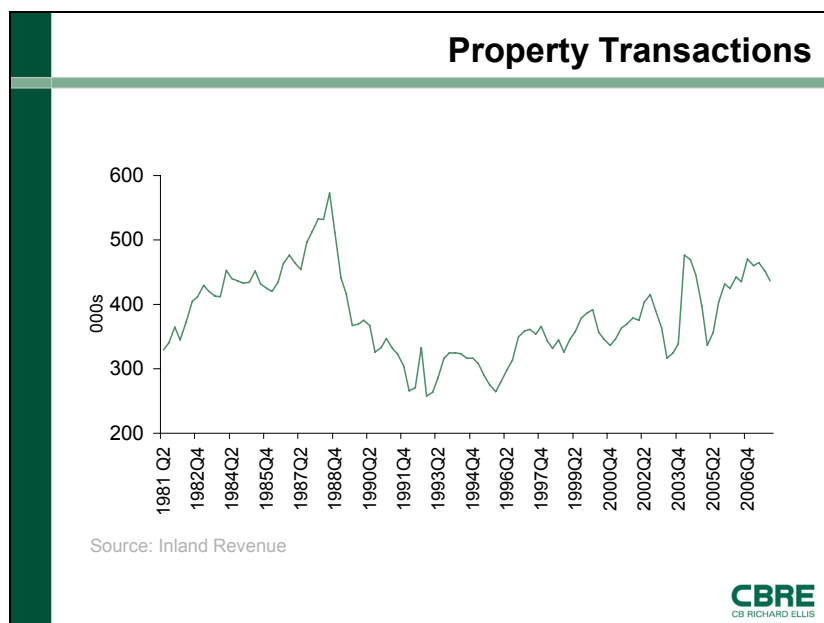
- The removal of MIRAS;
- High interest rates and the ERM; and
- The economic recession.

In contrast, the market is currently characterised by:

- Low interest rates and Bank of England independence;
- Weak economic conditions and credit crunch;
- Affordability / extent of house price overvaluation; and
- The underlying demand and supply imbalance.

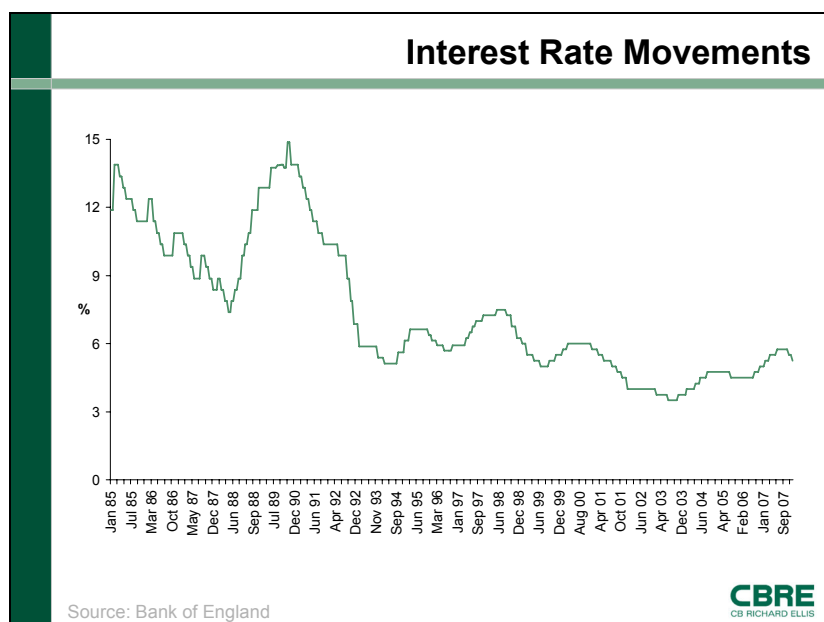
MIRAS REMOVAL

At the beginning of 1988 the Government announced the entitlement to double MIRAS (mortgage tax relief) was going to be removed in August (only one person per household would become eligible). This led to a huge market distortion with households bringing transactions decisions forward to take full advantage of the tax relief. This caused a sharp pick up in transactions; in the third quarter of 1988 transactions totalled 616,000; a 15.5% increase in one year. In an already over heated market, this put further pressure on prices, which inflated by 22.3%. Following the removal of the double MIRAS, transactions fell back by over a third.



INTEREST RATES

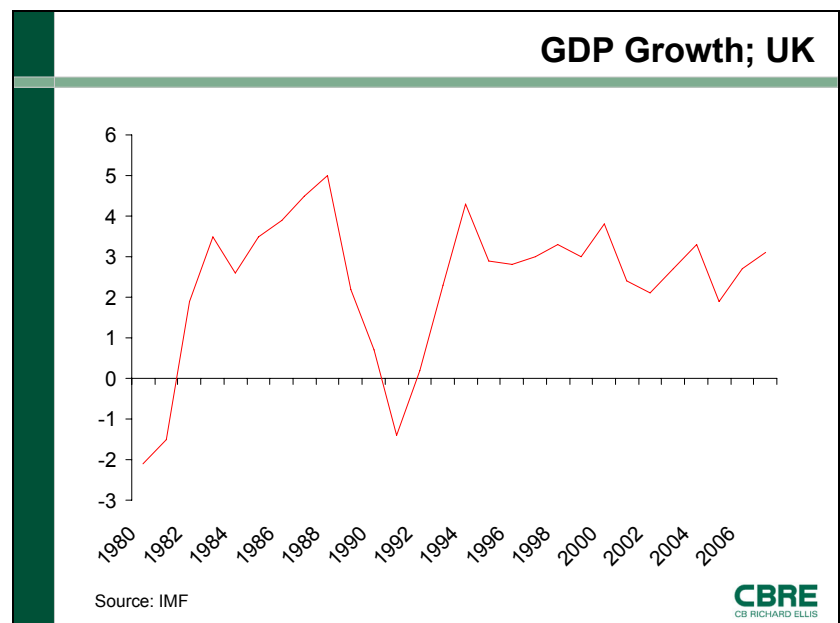
In 1990, the UK joined the ERM at an exchange rate many felt was unsustainable. The Bank of England spent the next two years maintaining the value of the pound within the ERM by raising the interest rate. The base rate peaked at 14.75% in 1990 and remained above 10% until May 1992. This clearly affected the ability of households to service mortgages. Interest rates fell sharply once the UK left the ERM in 1992.



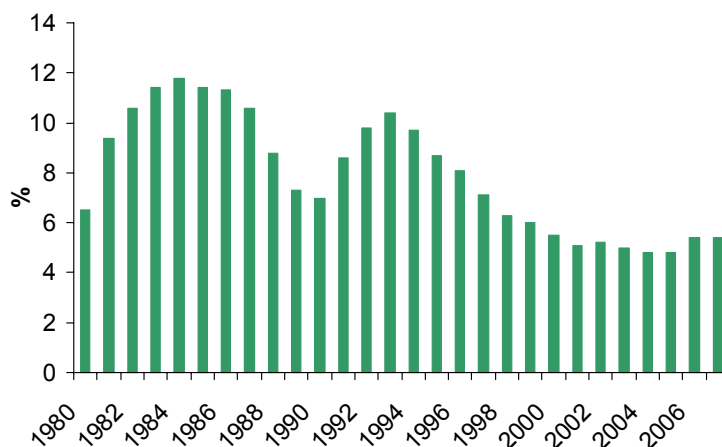
In contrast, we currently have a low interest rate environment. In the 1980s the interest rate averaged 11.5%, in the 1990s it averaged 7.3%, and since 2000 the rate has averaged just 4.75%. This partly reflects the decision by the Government to grant the Bank of England the freedom to set the base rate independently of the political arena. The rate is set in response to inflationary pressures and since this took effect interest rates have remained historically low. In the last half of 2007, they reached a six year high of 5.75%. However, there have been two rate cuts since December with further cuts expected in 2008.

ECONOMIC BACKDROP

At the time of the last housing market crash, the economy was in recession. GDP growth fell 1.4% and the unemployment rate peaked at 10.4%. The strong linkages between the housing market and economy deepened both recessions. For example, as unemployment worsened, there was an increase in the number of "forced sellers" (who had to sell for financial reasons), which in turn worsened the housing market recession.



Unemployment

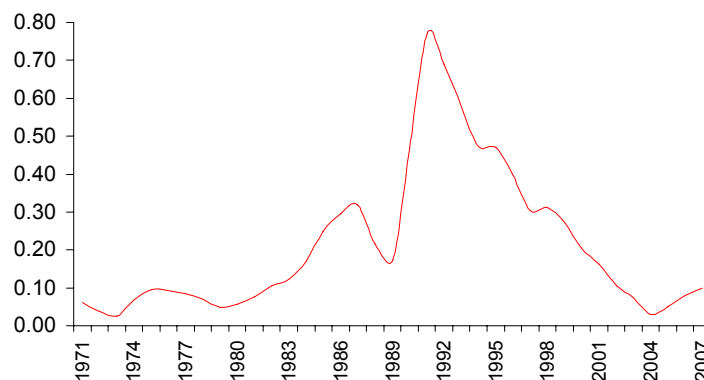


Source: IMF

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"Forced sellers" often end up as repossessions, although some try to sell on the property before it runs to court action. The higher the number of forced sellers, who are prepared to accept significant losses, the larger the possibility of significant house price falls. In 1991 repossessions reached a historic peak of 0.77%. In contrast, in the 2000s repossessions have remained historically low with only 0.1% of loans ended in repossession in 2007.

Mortgage Repossessions (as % of All Loans)



Source: CML

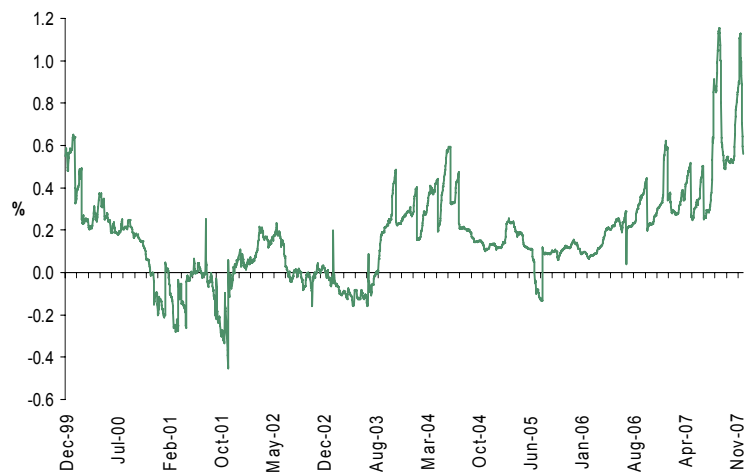
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THE CREDIT CRUNCH

Although the economy is stronger than at the time of the last recession the residential market slowdown has been exacerbated by current inter-bank lending difficulties - referred to in the media as the "credit crunch".

Northern Rock was a high profile casualty. It was particularly sensitive to the credit squeeze because its business model relied on inter-bank lending. The Bank of England agreed to act as lender of last resort to Northern Rock, but this knocked confidence in the lender. The result was a run on the bank, the first in the UK since 1866, with £2 billion of savings withdrawn in two days. The share price fell by a third in a day. It has been subsequently nationalised.

Difference between LIBOR and Base Rate



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Although the LIBOR has fallen from the peaks seen in August and December 2007, banks have remained increasingly risk averse. They remain less willing to lend because of the higher costs and reduced availability of credit. This has resulted in banks and building societies tightening their lending criteria when providing mortgages. For example Abbey, Alliance and Leicester and Coventry Building Society have announced that they will no longer provide mortgages at over 100%. Similarly, Nationwide have recently announced an increase in the minimum deposit, from 10% to 25%, in London for borrowers to be eligible for the best rates of interest.

This tightening of banks' lending criteria combined with weaker demand has had an impact on the residential market. However, it is too early to tell the extent of the impact that they will have. Persimmon, residential developers, reported a rise from 20% to 30% of reservations being cancelled and has seen a decline of 13% in the number of people viewing houses so far this year.

The impact on developers is twofold; inaccessibility of mortgage finance for consumers, as well as the inaccessibility of finance for developers. Recent media reports state:

- Persimmon is planning to close three regional offices;
- Barratt has sold 51 of its homes in Kent at below market value to Hyde Housing association to try to bolster its sales;
- Bellway Homes has asked for a 2.5% discount on all subcontract and supplier accounts;
- Taylor Wimpey withdrew from a 7,000 unit scheme in East London earlier this year and mothballed a £100 million scheme for 800 units in Leeds towards the end of last year;
- Barratt and Taylor Wimpey are looking to cut supply chain costs by 5%. Redrow and Crest Nicholson are also talking to suppliers.

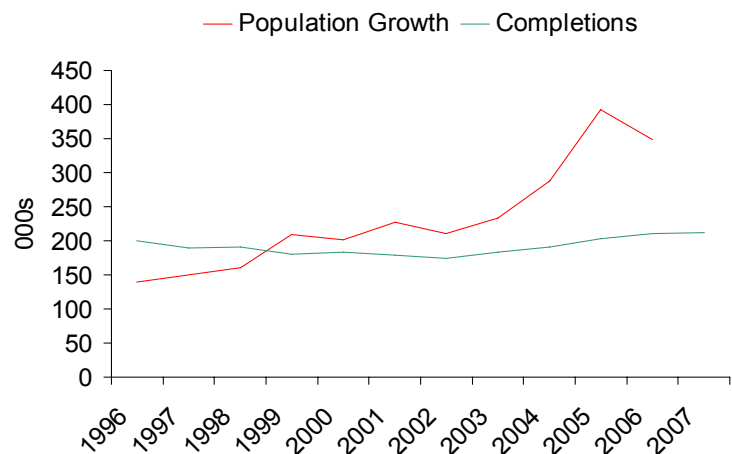
Although the economy is considerably weaker than a year ago, we do not expect an economic recession. The economic fundamentals remain sound – for example, Experian suggest unemployment will only rise marginally from 5.3% to 5.4% this year - and this should continue to support the housing market.

DEMAND AND SUPPLY IMBALANCE

Within the UK's housing market there is a fundamental supply and demand imbalance. This is the major contributor to the enormous growth in house prices seen over the last 20 years. The level of completions in the new build residential market has fallen dramatically since the beginning of the 1990s. Since this time the rate of house building has remained relatively constant at around 150,000 completions per annum. Over the same period there has been considerable growth in the population; increasing by 6% between 1990 and 2006.

A reason for this emerging gulf between population growth and new build completions is largely attributable to the housing contribution made by the Local Authorities. Their provision of new social housing has virtually ceased since the early 1990s compared with its 40% share of all new housing during the 1960s and 1970s.

Housing Completions and Population Growth

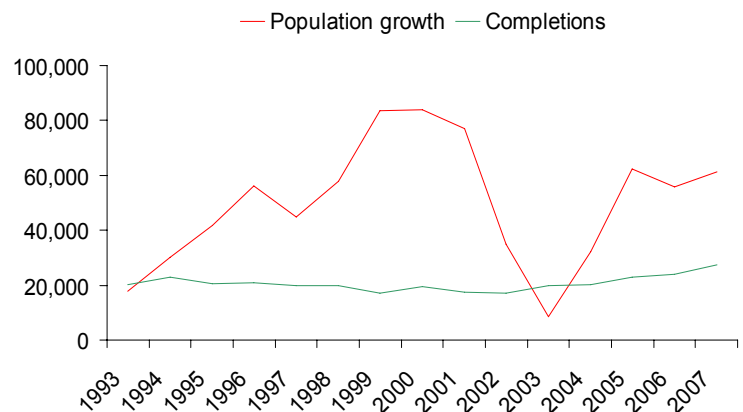


Source: DCLG

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The situation in London is particularly acute. As with the rest of the UK, the number of completions has remained relatively constant; around 20,500 per annum since the early 1990s. However population has grown at an average of 50,000 per annum over the same period. In the last ten years the population growth has outstripped the number of housing completions by over 400,000.

London; Completions and Population Growth



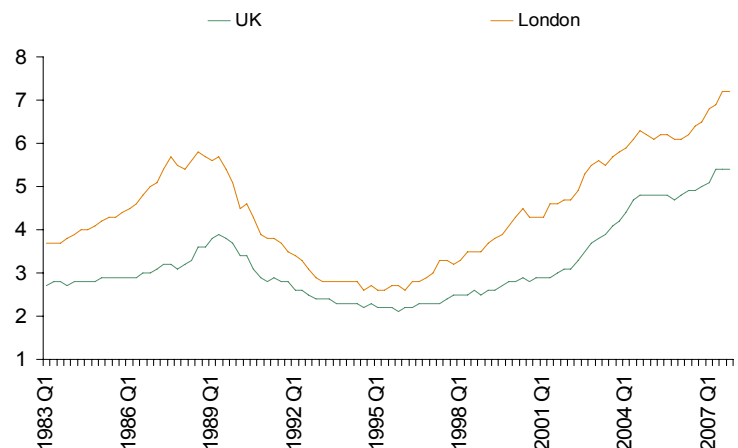
Source: GLA

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AFFORDABILITY

There are many concerns in the residential market about affordability. Over recent years higher house prices have caused a progressive worsening of affordability. The house price to earnings ratio is at its worst level since records began, with house prices, in 2007, reaching over seven times the average earning.

First Time Buyer House Price to Earnings Ratio



Source: Nationwide

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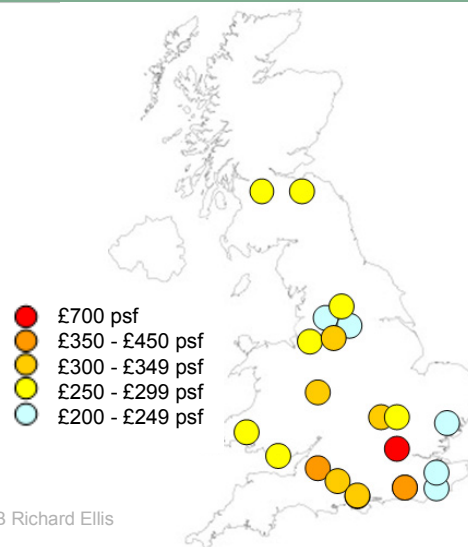
However, because interest rates affect the level of repayment, a preferable measure is the proportion of income used to service a mortgage. At current house prices and interest rates, 23.6% of gross income is used to service a mortgage. This compares with 27% at the time of the last peak and a long term average of 18.9%.

LONDON

London is relatively unique in terms of the residential market. It can support far higher prices than anywhere else in the UK. This is due to a number of reasons which include:

- The average wage in London is around 44% above the national average;
- London's bonuses were estimated to have increased by 16% in 2007, reaching a new record of £8.8 billion;
- London's population is now about 7.5 million and is expected to increase by around 54,000 pa up to 2016;
- London has a younger than average demographic. In particular there is a much higher proportion of 25-34 year olds, and fewer children and people over the age of 50. This is because urban locations attract younger workers and students, but tend to be less desirable for prosperous families, who frequently migrate to suburban areas;
- London's economy is expected to have grown by around 4% in 2007; 0.7% more than the UK as a whole;
- London's market has a lower share of owner occupiers (35% of the central London market) when compared with the UK (69%). The resulting higher share of the private rental sector in London reflects the more transient nature of London's population;
- London attracts a substantial amount of foreign investment in the residential sector.

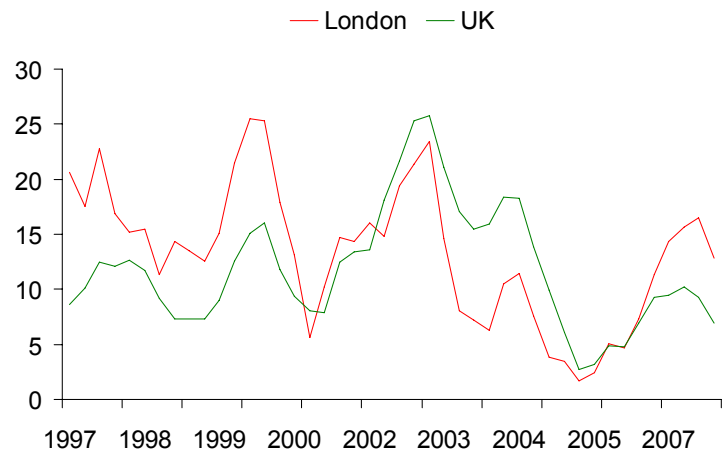
Heat Map of New Build Prices



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In line with longer-term trends, London house price growth outpaced national trends in 2007. According to Nationwide, London's house price growth peaked in the third quarter of 2007 at 16.5% - in line with wider trends, growth declined towards the end of the year (to 12.8% by the year end).

House Price Growth



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INVESTMENT MARKET

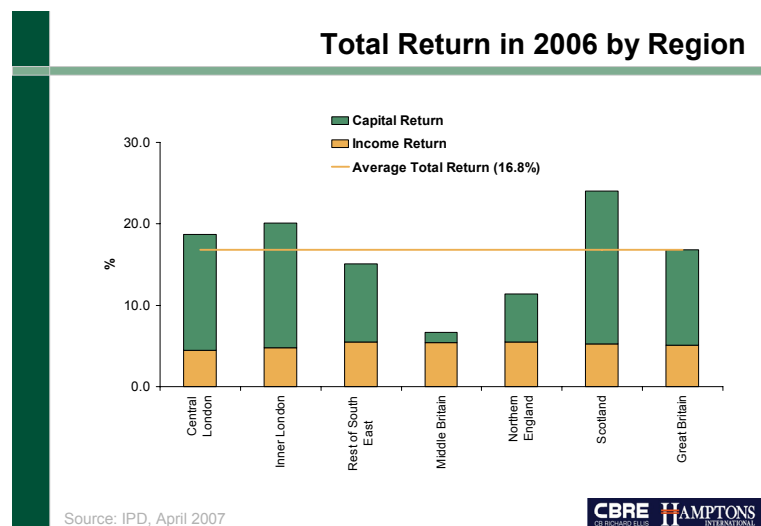
The private rental market makes up around 9% of England and Wales's housing stock (around 30% in prime Central London). This is an estimated three million households and conservatively worth between £450 and £500 billion. Despite the massive size of this market, institutions currently hold less than 5% of this market. Small lot sizes, opacity of reliable market information and an unfamiliar regulatory environment are some of the reasons given for institutional reluctance thus far.

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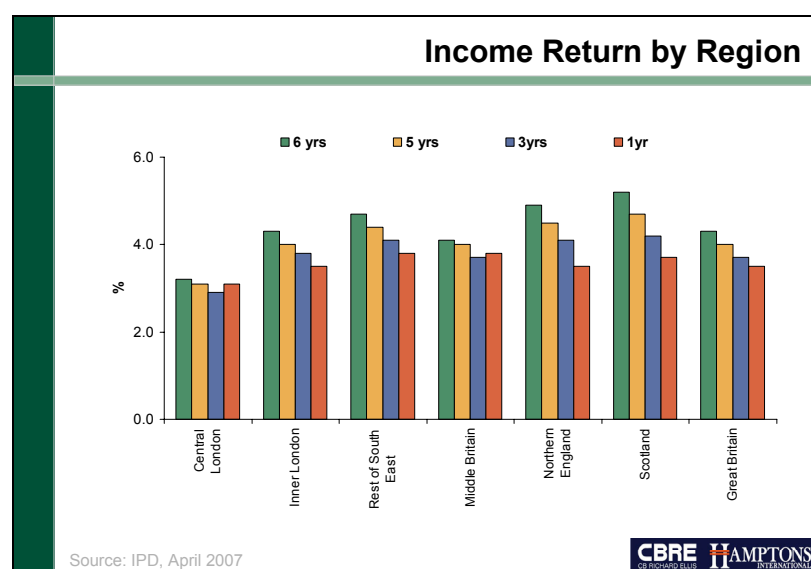
The UK residential investment market is quite opaque and dominated by the buy-to-let sector. According to Professor Michael Ball and the British Property Federation, property investment companies hold around 5% of all private rental stock (with a value of £1 billion in London and £750 million in the South East). Other institutional landlords and private companies hold well below one-fifth of the market each. The remaining rental properties (between 50% and 60%) are held by buy-to-let investors.

The buy-to-let sector expanded rapidly following the introduction of buy-to-let financing in 1996. Buy-to-let refers to the type of mortgage finance that allows investors to buy residential property and rent it out. This sector is largely made up of private individuals, most with a medium to long-term strategy. 75% hold less than four properties and only 15% own more than ten, according to the Association of Residential Letting Agents (ARLA). Despite this, landlords of ten or more properties represent the majority share of the buy-to-let market. The latest Council of Mortgage Lenders (CML) data suggests there are around 1,038,000 buy-to-let loans outstanding. This is just under 23% up on the same period in 2006 and reflects 46,400 new advances in the fourth quarter of 2007 alone.

According to Paragon Mortgages, average total returns in the UK reached 21.3% in December 2007, for the year; the highest level since August 2005. Regionally, performance was led by London (39%), with the South East performance being weaker at 17%.



Income returns were broadly consistent across all regions during 2006, with net yields of 3.3%, see the table below. The average gross yield was 5.1%, which is 45 basis points lower than in 2005. Data from the IPD Index is based on approximately £2 billion worth of assets under management, or less than 1% of the total private rental market. This small market sample is of principally institutional or corporate portfolios; 22 funds own the 8,520 properties measured, with over 80% in London and the South East.



IPD research suggests that the net yield compression is largely due to the growing buy-to-let market, which relies on strong capital growth and an income return to cover the cost of borrowing. During 2007, London and the South East continued to generate strong positive rental income growth at 31% and 9% respectively. Continued demand for rental property is expected to drive rental growth going forward. Rental returns will become an increasingly important part of total return as capital returns moderate in 2008.

OVERALL SUMMARY

There are fundamental differences between the early 1990s and the current slowdown, the table below highlights the key differences for a range of sector specific and general indicators.

Variable	Early 1990s	Current
General		
Interest Rates	The BoE interest rate peaked in the 1990s at 14% as a result of entry into ERM.	Interest rates set by MPC; Historically low at 5.25%; further cuts expected in 2008
Inflation	RPI – Peaked in 1991 at 7.4%.	RPI was 4.1% in January 2008. Slight rises are expected but only in the short term.
UK GDP	The economy contracted and GDP fell by 1.4% in 1991.	GDP growth is currently at 3.1%, a slowdown is expected but no contraction in the economy.
London GDP	GDP fell by -4.4% in the early 1980s (1980 and 1982) and -3.4% in 1991.	Most recent GDP forecasts are for growth of 2.3% in 2008, likely to be revised downward; however, growth slowing but not expected to go negative.
Office		
Investment	Market dominated by domestic investors before 1990/92 recession – overseas investors less active.	Overseas investors accounted for the majority of purchases in 2007 and remain active in the market.
Scale of Development	Nearly 14m sq ft of development was placed on the market in 1991 as the UK and London economies were in recession.	Development pipeline expected to peak at 7.9m sq ft this year.
Speculative Development	In the three years preceding 1990, there was 26.8m sq ft of speculative starts.	In the three years preceding 2008, there was 11.9m sq ft of speculative starts, less than half of the 1990s level.
Retail		
Unemployment	Peaked at 10.4 % in 1993.	Currently 5.3% and forecast to fall to 5.4% in 2008.
Overseas Tourists	Declined in 1990s due to recession in US and in early 2000s as a result of the dot.com crash and 9/11.	US downturn may reduce tourist numbers but market now less reliant on the US and fall in the value of sterling may encourage spending.
Equity Release	Not a large factor in the boom and subsequent crash in the 1980s but became more prevalent in the late 1990s. As house prices have increased rapidly over the last five years this has been a major driver behind consumer spending.	Stabilisation and the threat of declining house prices have reduced the equity release market. The continued uncertainty in house prices and the more restricting mortgage lending with the removal of 125% mortgages and requirement for 25% equity for the most attractive interest rates will reduce this form of credit further.
Lending to Individuals	Unsecured lending reduced in the early 1990s as interest rates peaked and consumer confidence fell.	Lending criteria tightening for unsecured borrowing and credit cards. Lending growth reduced but not yet in negative territory. Increasing interest rates despite BoE base rate cuts.
Commercial Lending	The impact of high base rates during the early 1990s reduced commercial borrowing.	Securitisation market virtually closed with risk assessment and lending criteria more heavily scrutinised.
Residential		
House Price Growth	Between 1989 and 1992 house prices fell by 18.5 % across the UK and 31% in London.	House prices have fallen over recent months, but annual growth remains at 6.9%.
Mortgage Approvals	Peaked in 1988 and fell by 65% over the following two years.	The interest rate rises of 2006/07 and the credit crunch resulted in approvals falling by 35% in last half of 2007.
Property Transactions	Peaked in 1988 and fell by 35% the following year.	The market is thinning but the peaks and troughs of the late 1980s and early 1990s are not as distinct.
Repossessions	Peaked in 1991 at 0.77% (as a % of all loans).	Risen recently but remain historically low. Reached 0.1% in 2007.

4.0 MARKET FORECASTS

INTRODUCTION

This section presents the forecasts of the impacts on commercial office and retail rents and valuations for Central and Outer London out to 2010 under three alternative economic scenarios. The three scenarios adopted are not symmetrical around the base case assumptions, with equal upside and downside outcomes. These reflect what we might expect if the economy slows down modestly, or experiences a downturn or a deep recession.

METHOD

The Central London office forecast employs a model that captures the historical relationship linking movements in rents to changes in the level of demand and supply of office space. The demand variable is employment in financial & business services (FBS). On the supply side, the model incorporates the level of development completions.

The Central London retail forecasts are derived from the relationship between household spending levels and visitor expenditures, and the associated change in rents.

The relationship and interaction of these variables are interpreted with the use of econometric models, which capture the rate at which rents adjust to changes in demand and supply.

The historic relationships between these input variables are then used as the basis for forecasting rents going ahead, using different hypothetical scenarios for the economy provided by the GLA and CB Richard Ellis. CB Richard Ellis projections of the future level of development completions are used as the supply variable for the office market forecasts.

The levels of rental growth derived under the three economic scenarios are then indexed to current prices and capitalised at the prevailing and projected market yields. Throughout the forecast period, yields are adjusted according to CB Richard Ellis' projections of the level of investor demand under the three alternative scenarios. These combined projections for rents and yields allow the impact on capital values to be derived.

The yield shifts assumed in the base case are in line with CB Richard Ellis forecasts of the IPD portfolio, whilst the scenario yields are projected according to judgements based on the overall economic and financial environment suggested by the input variables.

ECONOMIC & PROPERTY MARKET INPUTS

The three alternative economic scenarios can be broadly categorised, as a slowing of economic growth, a downturn, and a deep recession. Under these three broad scenarios, a set of input assumptions consistent with these overall patterns has been employed for each of the key demand drivers which influence the office and retail property markets. These demand drivers are financial and business services output for the office market and household expenditure for retail. These are summarised in the table below.

	FBS Employment - Central London			Household Expenditure - Greater London		
	Base	Downturn	Recession	Base	Downturn	Recession
2008	0.7%	-5.4%	-6.9%	1.6%	0.6%	-1.2%
2009	0.4%	-2.2%	-3.7%	2.1%	1.1%	-3.7%
2010	0.8%	4.5%	-1.3%	3.2%	2.2%	0.5%

The Base Case assumptions assume FBS employment would continue to grow, albeit modestly, over 2008-10, and that household expenditure would slow in 2008, but regain momentum from 2009.

Under the downturn scenario, FBS employment would fall by 47,000 over the next two years. With a significant loss of employment from one of the capital's leading employment sectors, the retail economy and housing market would be expected to show signs of weakness as well.

Under the more extreme recession scenario, the financial and business services sector would see a serious contraction in employment of around 70,000 jobs spread over the next three years. This would be broadly similar in impact as the recession of the early 1990s, and would be accompanied by falling service sector demand and sharp declines in house prices. Household expenditure would be much more severely impacted than in the downturn scenario and would be expected to decline over this year and next.

These three alternative scenarios would produce varying degrees of distress for the occupiers of office and retail space. The Base Case would imply relatively mild impacts on the demand for space from occupiers, with rents declining fairly modestly in the office sector and still growing in the retail sector. The downturn scenario would see a more significant contraction in the demand for space, a larger increase in the quantity of unoccupied or vacant space and consequently a sharper downturn in rents, and the recession would produce similar effects, but on a larger scale, for longer and with greater severity.

The effect on the values of office and retail property could be expected to be substantial under all three scenarios. With the value of property assets largely dependant on the multiples of current and future income investors are willing to pay, the value

of properties with sharply declining rental values will clearly suffer to a greater extent than those showing a more stable and secure future income stream.

The repricing of Central London office and retail property has been underway since the immediate credit market dislocation in late summer 2007. This has already seen property values across Central London fall by approximately 10%. The current estimates for a further rise in yields (correction in values) are in addition to the above. The projected rise in valuation yields for Central London offices and retail are shown in the table below.

Yields	Central London Offices			Central London Retail		
	Base	Downturn	Recession	Base	Downturn	Recession
2007	6.0	6.0	6.0	5.0	5.0	5.0
2008	7.1	7.1	7.2	5.7	5.8	6.0
2009	7.0	7.1	7.3	5.6	6.1	6.4
2010	6.7	6.8	7.0	5.6	6.0	6.3

For the Outer London office market, yield movements are anticipated to be less severe than for Central London offices, based on their historically lower yield and valuation volatility. Outer London retail yields are anticipated to experience a similar level of yield correction to those in Central London.

RENTAL AND CAPITAL OUTLOOK

We have forecast the implied rental and capital value movements for the three scenarios under the above assumptions. These are outlined below, in summary form, covering Central London offices and retail, and in the subsequent section, in greater detail, covering the City and West End submarkets, as well as Outer London offices and retail.

In the base scenario, office rental values are expected to hold up relatively well this year with growth of 3.9%. However, rents are forecast to fall over the next two years as FBS employment growth slows. Capital values are predicted to suffer sharp falls this year as yields continue to move outwards, a further fall in values of 0.8% is expected in the following year as rents decline. Capital values are finally expected to rise by 2010 despite the fall in rents, as investors anticipate improved market conditions going ahead and yields compress.

Under the downturn scenario, FBS employment is expected to slow considerably, falling both this year and next. This translates into rental declines averaging 8.9% over the next three years. Capital values are forecast to fall more quickly than under the base case in response to the sharper decline in rents. This year will see the largest fall in values as yields move out by 105 basis points.

The recession scenario has employment falling by 4.0% pa over the next three years. Rental growth is forecast to average -15.6% pa over the period under this scenario with rents anticipated to

fall by 40% cumulatively. Capital values are expected to fall by an average of 19.6% pa over the period, translating to falls of approximately 50% over the next three years as yields shift outwards by 125 basis points.

Retail rents are expected to grow by an average of 2.3% under the base case over the next three years, compared with -0.7% and -4.1% in the downturn and recession scenarios. Retail rents are not as volatile as offices, and are therefore not expected to see as large corrections as those projected for the Central London office market.

In view of the lower rental volatility, the impact on retail capital values is less pronounced, with capital values forecast to fall by an average of -1.6% pa for the next three years under the base case, compared with a fall of -6.4% pa in the downturn scenario and -11.1% pa in the recession scenario.

Capital values are expected to fall this year under all three scenarios. Under the base case assumptions values could stabilise in 2009, but under the weaker demand conditions of the downturn and recession scenarios further falls would be anticipated in 2009 and into 2010 in the latter case. Under the downturn and recession scenarios Central London retail capital values would be roughly half as badly affected as their office market counterparts. In the worst case recession scenario the values of Central London shops would fall by approximately 30% compared to nearly 50% for offices over the next three years.

	Central London Office			Central London Retail		
	Base	Downturn	Recession	Base	Downturn	Recession
Annual Rental Value Growth						
2008	3.9	-8.1	-10.9	2.5	0.6	0.2
2009	-1.5	-13.9	-18.3	1.1	-2.4	-7.9
2010	-2.8	-4.8	-17.7	3.4	-0.3	-4.6
Average 08-10	-0.1	-8.9	-15.6	2.3	-0.7	-4.1
Annual Capital Growth						
2008	-11.6	-21.8	-25.2	-10.2	-13.3	-16.6
2009	-0.8	-14.5	-19.4	2.0	-7.3	-13.7
2010	1.5	-0.6	-14.1	3.4	1.4	-3.1
Average 08-10	-3.6	-12.3	-19.6	-1.6	-6.4	-11.1

SUB MARKET OUTLOOK CITY OFFICE MARKET

In the base scenario, which incorporates modest financial and business services employment growth over the next three years, City office rental growth is expected to be positive this year, before declining -5.1% and -6.7% respectively in 2009-10 in response to weaker occupier demand and an increasing supply. In turn, weaker investor sentiment will translate into higher yields, dragging capital values down 13.8% in 2008, and continuing to

descend over the remainder of the forecast period, albeit more moderately.

Reflecting the weaker economic backdrop, the downturn scenario delivers a significant and immediate downgrade to rents, coupled with greater outward yield movements driving capital values lower. Over the three-year period, rental and capital values decline by -10.6% pa and -13.4% pa respectively, although a rebound in financial and business services employment growth in 2010 generates a moderation in the falls recorded.

The impact of a recessionary environment unsurprisingly produces a more pronounced and elongated fall in both rental and capital values across the City office market. A major downturn in occupier prospects results in rental values declining 17.4% pa over the next three years, with capital values falling 50% in total by 2010.

	City Offices			West End Offices		
	Base	Downturn	Recession	Base	Downturn	Recession
Annual Rental Value Growth						
2008	1.3	-10.9	-13.1	6.2	-4.9	-7.4
2009	-5.1	-14.6	-20.6	2.5	-10.1	-15.8
2010	-6.7	-6.3	-18.5	1.3	-2.9	-16.3
Average 08-10	-3.5	-10.6	-17.4	3.3	-6.0	-13.2
Annual Capital Growth						
2008	-13.8	-24.2	-26.0	-9.6	-19.0	-21.2
2009	-4.4	-14.0	-20.0	3.2	-9.5	-15.2
2010	-2.6	-2.1	-14.8	5.8	1.4	-12.5
Average 08-10	-6.9	-13.4	-20.3	-0.2	-9.0	-16.3

WEST END OFFICES

Positive financial and business services employment growth in the base scenario delivers positive rental growth throughout the next three years, the bulk of which would occur in 2008. This contrasts with a fall of 9.6% in capital values projected this year in response to an outward yield shift of 100 basis points. However, unlike the City office market, capital values would recover 3.2% and 5.8% respectively in 2009 and 2010 ensuring values return to 2007 levels by the end of the forecast period.

Under the downturn scenario, rents fall continually over the three-year period, from this year onwards, responding to weaker occupier demand in light of the declining financial and business services employment and increasing availability of office space. However, rental declines of -6% pa in the downturn scenario are moderate by comparison with the rental falls that are projected to occur under a recessionary outlook. In this setting, West End rents would fall 35% cumulatively over the next 3 years, the equivalent of -13.2% pa.

The impact on values in the West End office market are far more pronounced in the downturn and recessionary profiles, with higher yields and negative rental forecasts ensuring capital values fall -9% pa and -16.3% pa respectively over the next three years.

The West End office market could be expected to suffer somewhat less than the City overall in either of the downturn or recession scenarios, given that the market is more supply constrained; current availability is low and immediate future completions are relatively constrained. By contrast, the City has higher current availability and has a potentially larger overhang of newly completed space in the next three years, both of which will tend to add to downward pressure on rents.

OUTER LONDON OFFICES

Although rental value movements in Outer London offices across all three scenarios are far less dramatic and volatile than either the City or West End office markets, the correction in capital values is likely to run in parallel, although it is not projected to be as severe as in the Central London markets.

Each of the economic scenarios produce double digit re-pricing in 2008, although the severity and longevity of the capital falls escalate in the recessionary environment. Under the weakest economic growth and rental scenario, capital values would fall 12.4% pa over the three-year horizon, against -8.4% and -3.5% respectively in the downturn and base scenario. Rental values are expected to remain flat under the base case outlook between 2008 and 2010, compared to a fall of -6.2% pa under the severe employment contractions attached to financial and business services in recessionary circumstances.

	Outer London Offices			Outer London Retail		
	Base	Downturn	Recession	Base	Downturn	Recession
Annual Rental Value Growth						
2008	2.0	-0.5	-2.3	2.2	0.5	0.0
2009	0.0	-4.1	-7.6	1.5	-1.7	-3.4
2010	-2.0	-5.2	-8.6	2.1	-0.5	-4.0
Average 08-10	0.0	-3.3	-6.2	2.0	-0.6	-2.4
Annual Capital Growth						
2008	-10.7	-15.3	-18.5	-10.4	-13.4	-16.7
2009	-2.1	-7.4	-12.5	2.5	-6.6	-9.4
2010	2.4	-2.5	-6.1	2.1	1.2	-2.5
Average 08-10	-3.5	-8.4	-12.4	-2.0	-6.3	-9.6

OUTER LONDON RETAIL

Retail rents and capital values are projected to react broadly similarly whether in Central London or in Outer London under the three scenarios, although the correction in values in the two more negative scenarios is unlikely to be as severe as in Central London.

Under the base scenario, retail rents are projected to grow steadily at 2% pa over the three-year period, compared to -0.6% pa and -2.4% pa respectively in the weaker scenarios which suffer contractions in household spending growth. In the recessionary scenario, household expenditure falls 4.4% cumulatively over the next three years, against growth of 7% in the base projection.

Sharp outward yield movements trigger substantial capital value declines across all three scenarios this year. However, whilst values improve in 2009 under the base scenario to produce a three year annualised rate of -2%, the combination of further, prolonged upward yield movements and negative rents deliver annualised capital value falls of -6.3% and -9.6% respectively in the downturn and recession projections.

5.0 POLICY IMPLICATIONS

INTRODUCTION

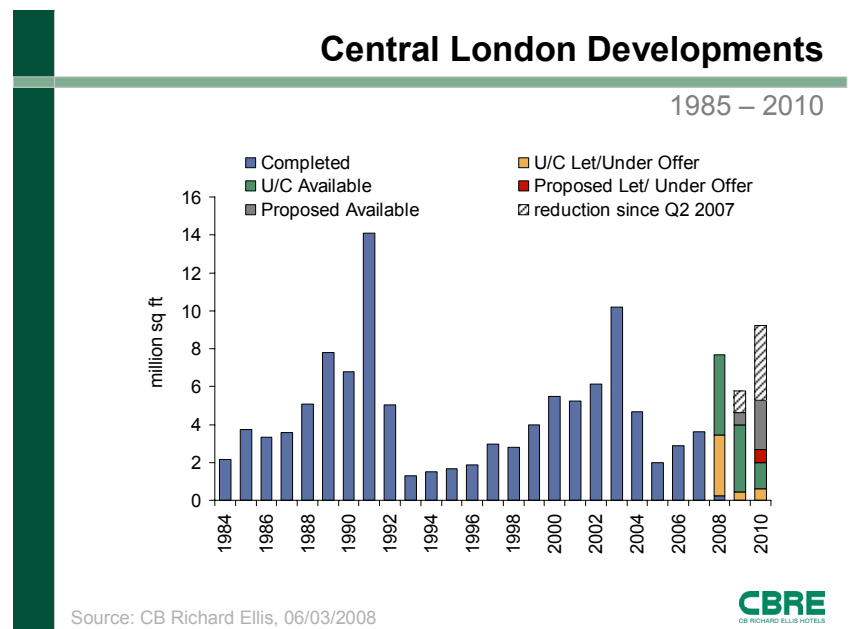
The credit crunch has had a dramatic impact on the property market already, but the full impact has yet to materialise fully. Only once the credit crunch and its consequences for the wider economy have completely unwound will its true scale be evident. The credit crunch has implications for property-related policy which need to be taken into account and understood.

In assessing these implications we have considered the following:

- impact on commercial offices in regeneration areas;
- impact on development linked to major transport schemes; and
- implications for the residential market, including Section 106 agreements, affordable housing provisions; land and build costs, and the costs of going green.

IMPACT ON COMMERCIAL OFFICES IN REGENERATION AREAS

As indicated in the introductory overview to this report, the credit crunch has already had consequences for property development in London. Since the summer, developers have taken a hard look at their development portfolio and we have already seen the number of schemes planned for the next three years reduced. The chart below shows the scale of change with over 5.1m sq ft of proposed development deferred in 2009 and 2010.



A culmination of factors, including tighter credit conditions, weakening occupational markets and falling capital values, have created an environment particularly hostile for development. This is acting as a significant deterrent.

The example below highlights how changes to the property market and financial markets have affected the feasibility of development schemes.

THE DEVELOPMENT APPRAISAL PROCESS

The development appraisal as the initial point in the development process tests key parameters such as rents, incentives, yields, construction costs and profit to establish whether a scheme is viable.

Since the summer these parameters have undergone major shifts:

- Prime yields in the City of London shifted upwards by 125 basis points to settle at 5.50% in March 2008. Whilst development yields are typically higher than prime investment yields, reflecting the greater risk associated with development, they generally follow a similar pattern.
- The occupational market has weakened since the third quarter of last year with the result that prime rents in the City fell by £5.00 to stand at £60.00 per sq ft.
- The rent-free period offered by landlords has also moved outwards from 12 months to between 15 and 18 months for a 10-year lease.
- The risk of longer voids has also increased in line with the weakness in the occupier market.
- Construction costs have risen as a result of global forces affecting the price of inputs such as steel and concrete, and by local factors affecting the cost and availability of labour and materials.
- The cost of borrowing has risen and credit is more difficult to secure now. Typically banks are offering tighter lending conditions and higher margins, although some have halted lending for speculative development altogether.

In the following example we have taken a hypothetical 200,000 sq ft speculative development in the City to illustrate the impact of changes to key variables in the development process. The results show how these changes affect capital values and ultimately on the decision if, when and where a development will go ahead.

	Scenario A	Scenario B	Scenario C
Rent (£ per sq ft)	55.00	50.00	50.00
Rent (per annum)	11,000,000	10,000,000	10,000,000
Yield	5.50%	6.00%	6.00%
Capital value (per sq ft NIA)	£1,000	£833	£833
Rent Free Incentive	21 months	27 months	27 months
Construction Costs (excluding fees and finance)	£69.33m	£69.33m	£69.33m
Profits as % of costs	15%	15%	-4.95%
Residual Land Value	£37.89m	£18.91m	£37.89m (fixed)

As our starting point, Scenario A outlines a hypothetical development appraisal, assuming rents of £55.00 per sq ft overall with a rent-free period of 21 months and a yield of 5.5%. These inputs produce a capital value of £1,000 per sq ft and a residual land value of £37.89m. Assuming a hurdle return of 15% profit on cost, the scheme will be viable if the developer can acquire the land at this price or lower.

Scenario B is more representative of a weaker occupational and investment market. The rent has fallen to £50.00 per sq ft, the rent free period has lengthened to 27 months, and the yield has moved to 6.0%, producing a capital value for the completed building of £833 per sq ft. The result, assuming a hurdle return of 15% profit on cost, is that the residual land value has halved to approximately £18.91m.

Scenario C assumes that land has already been acquired following the Scenario A appraisal when the market outlook was favourable, at £37.89m. It assumes that market conditions subsequently deteriorated and the developer is faced with re-appraising the scheme using assumptions in line with Scenario B. As such the land acquisition cost is now a fixed input, and in this instance results in a loss to the developer of -£7.18m, equal to -4.95% profit on cost.

Under Scenario C the developer has a number of options, including:

- selling the land or scheme, potentially crystallising a loss immediately.
- proceeding with the scheme and run the risk of realising a loss if market conditions do not improve
- proceeding with an alternative, lower cost scheme, but still risk lower profit levels than the target 15% profit on cost.
- delaying the development until the market improves or a pre-let can be found.

The latter option is risky due to the potential cost of holding the

land, particularly in respect of finance costs. It may be possible to mitigate these holding costs by securing a short-term letting of the space until the market recovers. Alternatively, as we have seen in the City, some developers have opted to proceed with demolition of the existing building, therefore avoiding any potential business rates liability, and prepare the site for development. This then enables construction to commence as soon as an occupier is found or market conditions improve, reducing the potential delivery timetable.

OPPORTUNITY AREAS

The effect of the credit crunch on development will be felt across all of London; however, in terms of policy it has significant implications for regeneration areas, such as Opportunity Areas.

Opportunity Areas have been identified as capable of accommodating substantial new jobs or homes. Typically, each can accommodate at least 5,000 jobs or 2,500 homes or a mix of the two, together with appropriate provision of other uses such as local shops, leisure facilities and schools. These areas generally include major brownfield sites with capacity for new development and places with potential for significant increases in density⁵.

The practical implications of the credit crunch on regeneration areas will become apparent in a number of ways. For existing schemes or properties, the effects on rents and capital values will be broadly in line with those set out in the market forecasts above. On the development side, the risks are that:

- marginal developments will no longer be viable in the current climate.
- development on brownfield sites, typically the most marginal of development, will be at risk, particularly schemes with high remediation costs.
- phased developments become more common, as speculative development becomes too risky.
- difficulty in securing funding places even good development schemes at risk.
- schemes in non-core locations are considered more risky than centrally located ones.
- scheme start dates will slip as developers manage exposure to downside risk.

Recent events suggest that some of these are impacting on the development market already.

⁵ The London Plan, February 2004.

The Shard at London Bridge experienced problems raising funding from banks in spite of a significant pre-let to TfL, finally securing funding from Qatari sources. That a development in such a prime location with a pre-let is affected by the credit crunch suggests that developments in more peripheral areas will find it at least as difficult, if not more so.

Recent announcements by developers provide further evidence of the impact of the credit crunch. In these instances, the developer has sought to limit its risk by postponing or considering the postponement of key developments.

Brixton⁶ have announced that they will not start any further development for six months until there is more clarity about the occupier market. This means that the redevelopment of the old Guinness brewery site at Park Royal, in West London, has been put back at least six months.

No clear trend has emerged suggesting that development in core locations is being prioritised over non-core locations; however, previous downturns suggest this might happen this time around. This would certainly jeopardise any planned office developments in peripheral locations such as Barking Reach or Ilford. It would also place in doubt the timing of schemes closer to the centre such as King's Cross. It is worth noting that the developer of the King's Cross scheme, Argent, has already planned for this contingency by phasing the schemes based on markets conditions, so whilst the first phase will proceed (substantially pre-let to Sainsbury's) the other phases might well be delayed.

This will become a recurring theme over the next year or so as developers seek to balance the risks associated with current and future developments.

IMPACT ON POLICY

The extent to which these factors will have a bearing on development in regeneration areas depends on the scale of the downturn. At the lower end of the scale, we would expect some minimal impact under the Base Case as developments become slightly more difficult through to the recession scenario when only a few developments will start.

It is unlikely that the credit crunch will have significant implications for regeneration areas except to delay some schemes; this impact will be more pronounced in peripheral areas.

The credit crunch will also force some developers to reconsider construction costs with a view to redesigning more costly developments – an issue that policy needs to mitigate.

⁶ A property investment and development company specialising in the South East industrial, warehouse and business space markets.

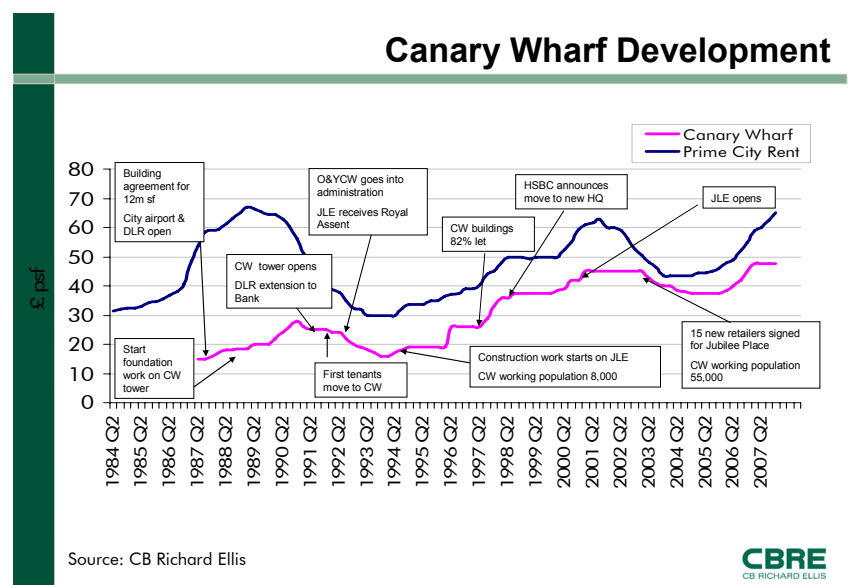
However, on a more optimistic note the lessons from previous London office market experiences show that no matter how severe the downturn, the recovery can be quite quick. In the 1990s, the worst recession in recent years, development activity was depressed for about four years. Once the recovery was underway, construction activity picked up pace swiftly.

IMPACT ON TRANSPORT RELATED SCHEMES

A strong relationship exists between transport and development, with successful developments generally characterised by good accessibility among other things. There is a strong body of evidence supporting this. Research suggests that transport improvements could affect the property market in two main ways: affecting the value of existing properties along the route, and creating property development or redevelopment opportunities by raising land values.

The scale of value uplift is difficult to assess but empirical evidence points to a figure in the region of 5% to 10% as realistic. In areas where there is a dense transport network before the infrastructure upgrade - typically the areas close to the centres of metropolitan areas - there is often virtually no effect.

The figure below highlights the importance of transport to development. The construction of the Docklands Light Railway and the Jubilee line extensions were vitally important to the success of Canary Wharf, allowing it to secure high profile tenants from the City and in the process become a serious rival for international financial and professional services. This is reflected in the small rental discount to the City rents that Canary Wharf now commands. The narrowing of the differential coincides with the opening of the DLR extension and again with the opening of the Jubilee Line extension.

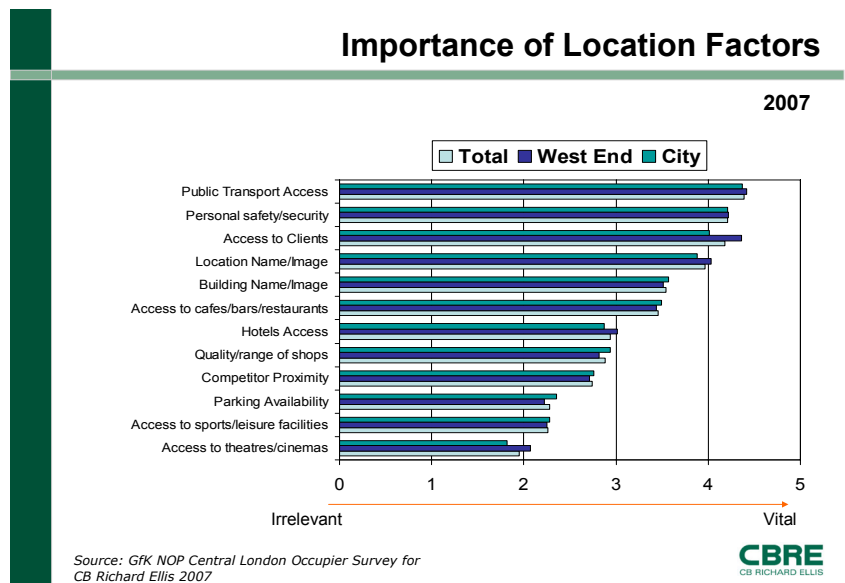


Transport is important to the success of a specific development or

development area, but it is not sufficient by itself. There are instances when a location with exceptionally good accessibility has failed to attract or sustain development. King's Cross is a notable example of such a case. Until recently, it was severely blighted by image and perception issues. The development of a clear masterplan by Argent, establishing a blueprint for the area and commercial intent has been critical in transforming the perception of the location.

OFFICE LOCATION FACTORS

In a survey of office occupiers, we asked occupiers to rate the importance of location factors on a scale from 1 (irrelevant) to 5 (vital). Respondents ranked "public transport access" as the most important factor influencing firms' location decisions. "Access to clients" as well as "personal safety/security" also scored highly. Occupiers across Central London valued a prestigious address as indicated by the high scoring attached to "location name/image" and "building name/image". The least important factor was "access to theatres/cinemas", although "parking availability" and "access to sports/leisure facilities" were not considered as particularly important.



The credit crunch has certainly made development more costly and riskier. As a result, returns will be lower than previously envisaged. As we have seen, transport improvements can make development more likely due to the uplift effect on land values, rendering marginal or unviable land developable.

Whilst the credit crunch will affect how viable schemes are, it will not materially change the likelihood of schemes linked to transport improvements going ahead more so than other schemes. To the extent that transport improvements boost the profitability of schemes over and above other schemes, then it is likely that these will be less affected by the credit crunch than other similar schemes in areas where no transport changes are planned.

An additional consideration is the long timeframe of many transport schemes, for example, Crossrail due 2017 and Thameslink, expected to complete by 2012 at the earliest. As the final decision on many developments has not been made, the credit crunch is unlikely to have any significant influence unless the developments are due to commence within the next three to four years.

Four Opportunity Areas are centred around transport interchanges: King's Cross, Paddington, Waterloo and London Bridge. As noted earlier, London Bridge is a key location with scope to accommodate a significant increase in office stock supported by plans to upgrade the station and create a better interchange. Paddington and King's Cross will see significant improvements to accessibility from CTRL, Thameslink and Crossrail, which should further enhance these areas' ability to support further office developments and regeneration of the wider areas. The credit crunch will affect the timing of these schemes rather than the entire scheme itself.

In East London, Crossrail and CTRL will significantly improve the accessibility and capacity of the Docklands and Stratford. In the case of the Docklands, it will enable further development around and beyond Canary Wharf. In all likelihood most significant schemes, if not all, will start long after the credit crunch and its economic consequences have receded.

IMPLICATIONS FOR THE RESIDENTIAL MARKET

THE HOUSE BUILDER'S BUSINESS MODEL

The housebuilders' business model is the key to understanding the potential effects of the credit crunch and the subsequent market weakening in residential development. Housebuilders tend to follow a "current trader" business model which consists in essence of a cycle of land acquisition, development and outright sale.

The developer estimates the best price which can be earned from development of a given site, and uses this as a starting point to determine the price to be offered for the development of land. The housebuilder is taking the risk that prices will meet their estimate. Housebuilders look to mitigate this risk, particularly in the case of apartments by selling them "off-plan".

Faced with a weak economic outlook, a developer will alter their priorities. Instead of focussing on achieving the best price for the units they will simply focus on securing forward sales, often at the expense of price. Where a scheme has not started, a housebuilder will often put the development on hold until the economic outlook has improved.

In a severe market downturn this can cause a serious market

shake up. For example, in the build up to the economic crash of 1973/74 there was a long period of house price growth. The crash resulted in housing prices halving and land prices falling sharply. With little support from the banking system, many housebuilders failed and others retrenched or withdrew from the market altogether. By the end of the 1970s the number of firms building over 1,000 units per annum had halved.

We do not consider that this worst case scenario is applicable to the current climate. As the Callcutt Review (2007) comments the “current trader” business model has served housebuilders well. However, there is increasing pressure from both the supply side, as land prices rise and land supply diminishes, and the demand side as the residential market slows down.

Fortunately, housebuilders have accumulated substantial land banks over the last ten years. For example Persimmon’s land bank has increased by 25% in the last two years alone. Persimmon also currently have 21,425 acres of strategic land. This will mitigate the effects of market slowdown in the short term. However, in the medium to longer term, if pressures do not ease, housebuilders are unlikely to be able to continue to deliver returns at the current level and this will only be compounded by the credit crunch.

This in turn will mean that the Government’s target for the construction of 3 million new homes by 2020, or 240,000 per annum will become increasingly hard to achieve. This target is already around 30,000 units above current construction rates and will obviously stretch developers to their limits when the market is in their favour.

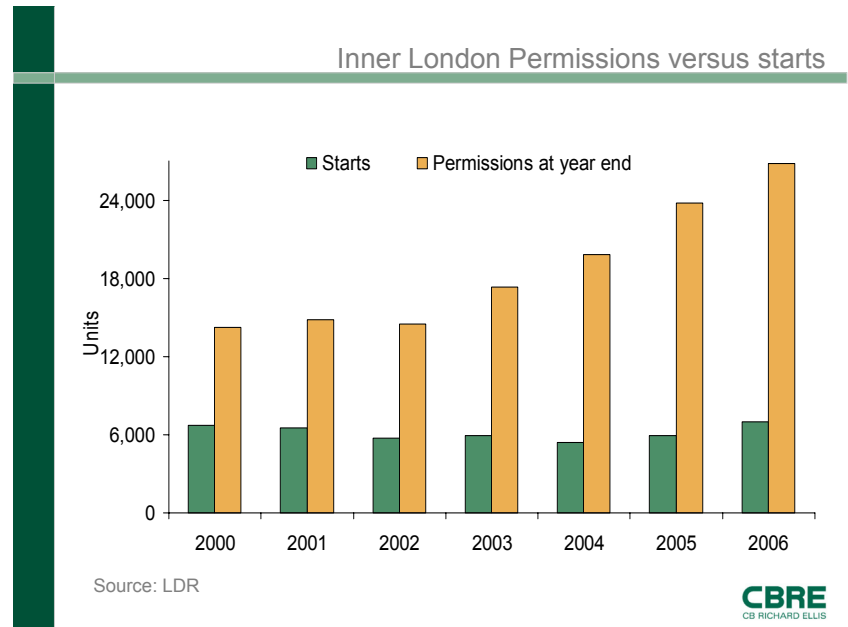
We have identified a number of barriers to building which have been slowing down the rate of completions even before the general market slowdown and the credit crunch emerged. These include:

- Lengthy, complex and potentially onerous Section 106 agreements;
- Affordable housing provisions;
- Increasing land costs;
- Increasing build costs; and
- The costs of going green.

Obviously, the credit crunch is going to have a dramatic impact on the house building industry as a whole, making it even harder to achieve the government’s targets. We are of the opinion, that the slowing market will make developers particularly more sensitive to onerous Section 106 agreements, affordable housing provisions and increasing land costs.

SECTION 106 AGREEMENTS

In London the large increase in planning permissions for new housing has not been reflected in the number of new homes being built. This is in part due to the often lengthy process of negotiating Section 106 agreements once outline permission has been granted.

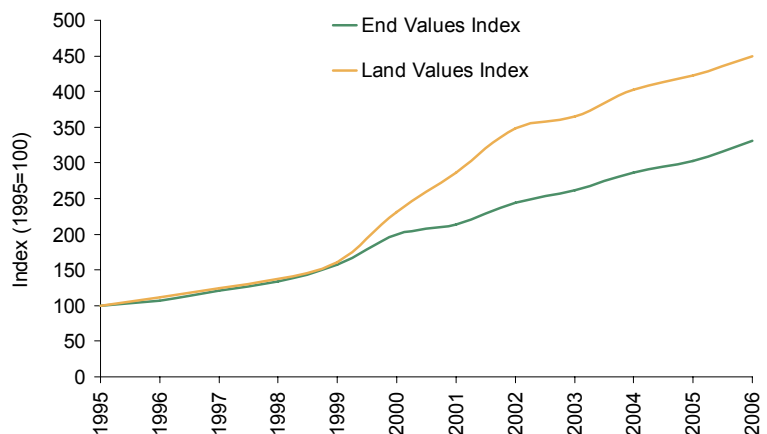


Our research shows that it takes on average 345 days to negotiate a Section 106 agreement in London; although there is a wide variation around this figure. For example, in our sample it took between one month and four years to successfully complete the agreements. This uncertainty creates problems for developers in relation to planning and financing their development programme. This is obviously particularly onerous with the currently tight credit conditions where developers require more certainty of timescales to be able to finance a scheme.

LAND VALUES

Between 1999 and 2003, land values doubled in London. This growth was not reflected in house prices. The sudden increase in land prices was largely underpinned by the Government's White Paper, "Towards an Urban Renaissance". The resulting planning guidance encouraged higher density development and tall buildings.

A Comparison of Land Values and End Values in London



Source : VOA, Land Registry, CB Richard Ellis



A weaker residential market may mean developers are unable to achieve the prices required to cover the total development cost (including land). As a result some current schemes with planning permission may become unviable. This problem will only be exacerbated by the lack of credit in the market with developers finding it increasingly hard to borrow and finance schemes. Therefore, the combination of the housing market slowdown and the credit crunch could seriously hinder the chances of achieving Gordon Brown's target of 3 million new homes by 2020.

AFFORDABLE HOUSING

The Government's target of 50% of residential development in London to be affordable housing was always going to be a tough target to achieve. This is because redevelopment in London is abnormally expensive due to land costs and contamination issues. Therefore very few large private schemes make the 50% target.

In a downturn the number of houses being built is likely to decrease as the large developers slow or stop their rate of building. As a result, there will be fewer Section 106 agreements being negotiated and in turn less affordable housing being built. However, the proportion of affordable homes being built, in relation to private homes, may start to creep up on sites as a result of the slowdown in the overall output in the private sector.

Over the last ten years there has been an overwhelming tendency for developers to undercut the prescribed affordable housing threshold (otherwise known as "cutting the cap"). The threshold for the provision of affordable housing was lowered in February 2008 from 15 units in London to 10 units. Our research suggests that this will lead to an increase in developers "cutting the cap".

Developers' inclination to design small schemes under the affordable housing threshold largely stems from the added costs

associated with their provision. When developers' margins are already squeezed by increasing land values and a weakening residential market, they will be more inclined to "cut the cap". The credit crunch will obviously bolster developers' desire to develop under the threshold on the smaller sites because of the lack of credit in the market, and the resulting difficulties in financing these schemes. This will lead to developers seeking to build larger, family units on smaller sites in order to reduce the number of units to be built below the affordable threshold. This was clear when the 15 unit threshold was introduced. If planners feel robust enough they may prevent this from happening by claiming the sites are being under developed. This is something only time will tell.

Overall, the weakening market is likely to cause a fall in the number of affordable homes being built. However, as development slows down throughout the industry the proportion of affordable units being built in London may increase.

The combination of the market slowdown and the credit crunch will affect some of the regeneration schemes taking place across London more than others. In general developers of schemes that are well under way are changing their focus from achieving highest possible prices to simply selling the stock. Schemes where development has not started may be delayed or in some extreme cases mothballed. This largely depends on the type of development and their location.

Developments in London that will be least effected will benefit from some or all of the following factors:

- Sites that are close to transport hubs will out perform those that are not. This is particularly true of Opportunity Areas such as King's Cross, and Elephant and Castle which have excellent connectivity.
- Well established, desirable and/or prime residential areas are less likely to be affected by the softening market and the credit squeeze due to the underlying strong demand in these locations. For example, we would expect the Opportunity Areas at Waterloo and London Bridge to benefit from their location close to such desirable and well established centres.
- Areas associated with the 2012 Olympics will also be less affected by the current market conditions, particularly the area around Stratford and the Lower Lee Valley. This is because these areas will be the focus of the global media in four years time and will offer developers the opportunity to show case what they can do.

Of particular note are the opportunity areas at London Bridge

and Paddington which, in our opinion, benefit from all three of the factors listed above.

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Chinese

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Vietnamese

Nếu bạn muốn có văn bản tài liệu này bằng ngôn ngữ của mình, hãy liên hệ theo số điện thoại hoặc địa chỉ dưới đây.

Greek

Αν θέλετε να αποκτήσετε αντίγραφο του παρόντος εγγράφου στη δική σας γλώσσα, παρακαλείστε να επικοινωνήσετε τηλεφωνικά στον αριθμό αυτό ή ταχυδρομικά στην παρακάτω διεύθυνση.

Turkish

Bu belgenin kendi dilinizde hazırlanmış bir nüshasını edinmek için, lütfen aşağıdaki telefon numarasını arayınız veya adrese başvurunuz.

Punjabi

ਜੇ ਤੁਹਾਨੂੰ ਇਸ ਦਸਤਾਵੇਜ਼ ਦੀ ਕਾਪੀ ਤੁਹਾਡੀ ਆਪਣੀ ਭਾਸ਼ਾ ਵਿਚ ਚਾਹੀਦੀ ਹੈ, ਤਾਂ ਹੇਠ ਲਿਖੇ ਨੰਬਰ 'ਤੇ ਫ਼ੋਨ ਕਰੋ ਜਾਂ ਹੇਠ ਲਿਖੇ ਪਤੇ 'ਤੇ ਰਾਬਤਾ ਕਰੋ:

Hindi

यदि आप इस दस्तावेज की प्रति अपनी भाषा में चाहते हैं, तो कृपया निम्नलिखित नंबर पर फोन करें अथवा नीचे दिये गये पते पर संपर्क करें

Bengali

আপনি যদি আপনার ভাষায় এই দলিলের প্রতিলিপি (কপি) চান, তা হলে নীচের ফোন নম্বরে বা ঠিকানায় অনুগ্রহ করে যোগাযোগ করুন।

Urdu

اگر آپ اس دستاویز کی نقل اپنی زبان میں چاہتے ہیں، تو براہ کرم نیچے دیے گئے نمبر پر فون کریں یا دیئے گئے پتے پر رابطہ کریں

Arabic

إذا أردت نسخة من هذه الوثيقة بلغتك، يرجى الاتصال برقم الهاتف أو مراسلة العنوان أدناه

Gujarati

જો તમને આ દસ્તાવેજની નકલ તમારી ભાષામાં જોઈતી હોય તો, કૃપા કરી આપેલ નંબર ઉપર ફોન કરો અથવા નીચેના સરનામે સંપર્ક સાધો.

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