FOCUS ON THE UNITED KINGDOM

The State of the UK Property Market: Key Drivers

BY BARRY GILBERTSON, CRE, FRICS

THIS IS THE FIRST OF A SHORT SERIES of four articles with my personal perspective on the state of the property market in the United Kingdom. Initially, I will focus on some of the key drivers and the macro-to-micro picture, then look at the commercial and residential property markets before mopping up the remains of the marketplace, with some clues for lenders and investors (the seeds of doubt) in the final article. Things will inevitably change over the course of the year between the start and finish of the publication of these articles, but I hope they will be of interest to the international readership especially if you, as reader, are able to compare and contrast my views with your own thoughts about the marketplace in which you ply your trade.

It was, interestingly, a CRE who kick-started my current thought processes. My chum, Ken Riggs, said in the winter of 2005: "Something has to give; or does it?" Many other experienced commentators and players keep saying, privately and in the media, that we must be approaching the peak of the market's values. The key word is *must*. Seeing it written down does not show the emphasis that, when said aloud, implies we *must*, *mustn't we?* Note that they do not say *are* at the peak. Is this a fear that they might not be asked again if they get it wrong, or a concern that they do not want to be seen to be merchants of doom?

A long time ago, a very experienced property player said to me that one should always "leave something in the deal for the next owner." What a wise and pragmatic phrase that has turned out to be. His thinking was that we operate in a very small world, and that treating people well on the way up will pay dividends on the way down, when paths inevitably cross again. Squeezing the pips from a deal generally leaves a bad taste in the mouth of the other party.

However, I feel that the same maxim also applies to the actions of market players who successfully navigate the peaks and troughs of our usually volatile market environment. After all, if there is a good profit to be taken from a deal now, why wait until the market has moved along, maybe up or maybe down. In the past, very few have called the market exactly to the moment. One or two superstars got it right last time round; sold all their property and went liquid until the storm abated sufficiently to wash up fresh opportunities on their shore. Alternatively, perhaps they were lucky.

About the Columnist

Barry Gilbertson, CRE, FRICS, *a partner at PricewaterhouseCoopers, is past chair of the United Nations Real Estate Advisory Group's International Valuation Forum, a member of the Bank of England's Property Committee and Visiting Professor of the Built Environment at the University of Northumbria, England. He earned the CRE designation in 2000. Gilbertson also is a past president of the Royal Institution of Chartered Surveyors, a standards and membership organization for property professionals with whom The Counselors of Real Estate has a formal alliance to promote information exchange and foster an internatonal network of like-minded professionals. Read more about RICS at www.rics.org.*

BANKS SEEM EAGER TO FINANCE SPECULATIVE DEVELOPMENT

For a year or more, I have been saying to those who ask me what I think about the market, that "if you can't make money when interest rates are at this (historically) low base, when will you ever make a profit?" Milan Khatri, the chief economist at the Royal Institution of Chartered Surveyors said earlier this year: "Low interest rates have been the primary fuel for a surge in property demand, though by the end of 2006 these will rise."

So, what will we do if interest rates do rise? By how much will the rates have to rise for demand to slow, or even stop? These are difficult questions to answer. Each reader will have his or her own view, but I am influenced by the growth in speculative development over the last few years, driven not only by developers' desire, but also by an increasing willingness by banks and other funders to be more aggressive in their lending terms.

A survey by de Montfort University, in Leicester, England, has shown that in 2005 there was £23 billion of development finance out of a total market size of property lending in the UK thought to be between £164 billion and £175 billion. Six years earlier, though, at the turn of the millennium, there was only £9 billion of development finance. In that year, £3 billion was for residential development for sale, and £6 billion was for fully pre-let commercial real estate development. There was nothing for speculative commercial real estate development. Though this category hovered between zero and £3 billion for the five years up to 2004, it shot forward to £5 billion in 2005. What will it be in 2006, I wonder?

In May 2006, *The Times* newspaper of London said of this news that "banks have rapidly stepped up their exposure to speculative development finance, from virtually nothing five years ago to £5 billion at the end of 2005." The respected journalist, Jenny Davey, continued: "Lending to speculative commercial developments, where no business tenants have been signed up in advance to rent the building, is regarded as risky. In the early 1990s, excessive bank lending to speculative projects came unstuck when the economy crashed and developers could not repay their loans."

INTEREST RATE HEDGING REDUCES RISK

The £5 billion of lending to speculative development projects represents only some 5 percent of the total value of outstanding debt secured on commercial real estate. Nonetheless, Davey comments that "the rapid increase in lending to these (speculative) projects is beginning to cause concern among some property analysts, who fear that banks should be more careful not to repeat past mistakes."

If interest rates do rise in the short term, will it matter? Yes, of course it will. Many people—individuals and corporations—will be affected. They may not be able to afford their monthly repayments, though that does not necessarily predicate a crash. After such a long bull run, many borrowers should be able to refinance by extending their length of term, or by infilling the loan to value ratio.

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A significant number of borrowers, though, will be less affected than most for one good reason—in fact, for one single word: hedging. In 2005, some 71 percent of new commercial real estate loans in the United Kingdom had interest rate hedging in place.

DEARTH OF OFFICE SPACE COULD FORCE LARGE FIRMS TO BECOME PSEUDO-DEVELOPERS

One more observation about developments before discussing some of the macro-economic issues driving or reacting to the market shifts. The latest research from DTZ shows a dramatic leap in the city office development pipeline from less than 1 million square feet in 2006 to some 4 million in 2007 and a further 4 million in 2008.

When these startling statistics are combined with the knowledge that there are 13 occupiers in the city who currently occupy 1 million square feet or more, one can only wonder what may happen as they grow their need for space. Hotelling and hot-desking can only be taken so far. If some of these occupiers fulfill their stated aims to grow their businesses at 5 percent per annum, they will each need a further 200,000 square feet of space within a few short years—that is another 2.5 million square feet of extra office space.

At this time only one building (a new, rather than second-hand one) is available at more than 100,000 square feet. There is nothing currently available, new or second-hand, at more than 200,000 square feet, and there will not be any building available to let at this size for at least another year.

What this means, of course, is that any large firm looking for space in the City will have to identify a location, and probably fuel a site assembly plan, together with a commissioned architect design before pre-letting the accommodation from a friendly partner developer. Essentially, the firm will be forced to become property developers to generate the most efficient deal in the search for new real estate.

INVESTOR CONFIDENCE IS KEY TO DRAMATIC GROWTH RATE

So what are some of the macro-economic factors driving this predicted growth in business space requirements, especially at the top end? Observations from the Bank of England have recently highlighted that, with rates unchanged, inflation below target has been achieved. Worldwide oil price pressures continue to exert influence, and now non-oil commodity prices are also on the rise. The United Kingdom's gross domestic product growth remains robust, and the general international outlook remains positive, despite some of the war-torn traumas around the globe several thousand miles from home.

Asset price growth has been rising over the past two years. As an example, though things obviously fluctuate and change, the FTSE All Share index showed an annual growth rate of 26 percent in April this year. Investor confidence is key to this growth, dramatic by most standards. The renewed number of corporate mergers has reinforced this view. United Kingdom real—or "safe"—rates reaching a 10-year low earlier in 2006 has encouraged the search for yield that many players, commentators and advisers have seen across world markets rather than just here in the United Kingdom.

Money supply, often referenced at least here in the UK as M4, has seen a consequential rapid growth to reach a 12-year high. It is likely, of course, that increases in the quantity of money are also likely to be contributing to asset price growth.

As with equity prices, commercial real estate prices have also been rising rapidly. For example, in the year to March they rose 14 percent. Put simply, an investment worth £1 million rose £140,000 in that period—a good return, and one that is far better than can be found by putting the money in the bank or under a mattress. This sort of rise is also consistent with the worldwide search for yield and the growth in money supply. Consequently, and you probably have observed it in your marketplace, the rapid growth in commercial real estate pricing is not a UK-specific phenomenon.

IS STABILIZATION ON THE HORIZON?

Having said all that, some of the latest data suggests that real rates and money supply growth are apparently stabilizing. Might this suggest, I wonder, that asset price growth might also begin to stabilize? With the arbitrage between, for example, Eurozone interest rates and UK interest rates, small though it may be, there are opportunities for the Eurozone borrowers to outbid UK or U.S. borrowers.

During the past 10 or 12 years, rental income cover has been increasingly under pressure, leading to a situation where projected capital growth may have become the only reason to buy. However, this theory is threatened by the current anomaly of the retail sector, where many retailers are finding trading conditions difficult, yet the property from which they trade is becoming increasingly expensive in rental and yield terms.

At a recent cocktail party, in a summery marquee in one of London's great and historic garden squares, I was chatting to a real estate investor who specializes in retail property. I asked him what he thought about the current trend of sub-4 percent yields. "Sub-4" he said. "I am currently paying sub-3 for the best!" Just to remind you, a sub-4 percent yield is, in simple terms, 25 years purchase—or, without rental growth it will take 25 years to get your money back. Extend that to sub-3 and it becomes more than 33 years. The chances are that I will not still be in the market in 33 years' time.

All that said, these are exciting times to be in the real estate market, whether as player, commentator or adviser. Would you want to do anything else?