FOCUS ON THE UNITED KINGDOM

Are Commercial Property Yields Fully Compressed?

BY BARRY GILBERTSON, CRE, FRICS

THIS IS THE SECOND IN A SERIES OF FOUR ARTICLES providing my personal perspective on the state of the property market in the United Kingdom. The first article, which appeared in the Fall 2006 edition of *Real Estate Issues*, focused on some of the more generic key drivers and the macro-to-micro picture. This article focuses on the phenomenon of seemingly ever-rising values in the commercial property sector. The third and fourth articles will review the residential property market and the seeds of doubt: key issues, words and phrases that trigger a response when they crop up in conversation, and cause property funders, lenders and investors to stop and think about their assets.

One of the reasons for writing these articles is to draw, in the mind of the reader, a similarity or contrast between the UK and the property market in which the reader operates. It seems to me that property markets function in very similar ways around the world, and we can all benefit by experienced practitioners and commentators sharing their opinions and expertise. There are exceptions, of course, and the United Nations is doing what it can to help to create and re-order property markets in some of the globe's transitioning economies, especially those that are moving from a state-owned asset base to the free- (or at least more free) market economy.

This task, of course, is not easy. However, drawing on the experiences of many individuals and governments, and synthesizing the ordinary from the extraordinary, the United Nations is beginning to make progress. One bonus of the change is starting with a clean slate, and the newly successful economies are leaping ahead of established real estate markets in the use of today's technology and transparency in information exchange. From satellite

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mapping to comparable evidence, knowledge management in many of these countries is better than in countries with mature economies.

SPECULATION, RECENT TRENDS MAKE UK MARKET A TOUGH READ

Meanwhile, back home in the UK, the commercial property market has emerged from the safe world of pre-let construction into the heady atmosphere of speculative development. Of the £152 billion lent to property-backed securities in 2005, about £5 billion is to property developments where no tenant has been identified or signed up before beginning construction. Another identifier of market growth and activity is the "crane survey."

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Industry observers have long been aware of the correlation between the number of visible cranes over a property market and the prospects for the future of that market. One firm, London-headquartered Drivers Jonas, has captured this bellwether in a quarterly report. Extracts from third quarter 2006 show some 90 sites in central London where development is underway. An aerial view would show this activity in three distinct groupings: the West End, focused on Mayfair; Mid-town, centered on Holborn; and, naturally, central London, also known as the Square Mile. Looking at the statistics generated by this report, there is a total of 9.7 million square feet under construction, with about one-third let and two-thirds available space. This statistic indicates more than 6 million square feet of speculative development.

The previous article sought to demonstrate that the UK property market was extremely difficult to read at the moment. An analysis of the Drivers Jonas data bears out this sentiment. Though there remains a seemingly large volume of space unlet, the fact is that the past two years have seen dramatic increases in rental levels—up by about 26 percent in the West End alone—and the prediction for 2006 is strong growth of 25 percent or more.

The difficulty in reading the market is compounded by a growth of only 5 percent in the amount of available space under construction during fourth quarter 2006. One would have expected many more developers to bring forward their proposed schemes to capture this rental growth and thereby enhance their portfolios, or their profits. Perhaps this sluggishness points to an unwillingness among developers, who must undergo an arduous process to gain necessary planning permissions and comply with regulations. The struggle commonly delays the launch of construction by an average of two to three years.

At a recent meeting of the Bank of England's Property Forum, attendees were treated to an exposition of these difficulties by the chief executive officer of a development company trying to bring forward some 67 acres of urban regeneration in the London district of Kings Cross. He showed a chart of the statutes, regulations and bylaws that had to be satisfied before receiving permission to move forward. In all, there were 350—a huge number and one that guarantees compromise because many of the edicts are contradictory. This company has, so far, spent seven years and more than £25 million, and the CEO thinks they are still a short stroll from receiving the paperwork that will be the cause of considerable celebration. Almost there, but not quite.

SEVERAL FACTORS PROMPT SPIKE IN RENTAL RATES

So what is fuelling the surge in rental levels? The Mayfair district, for example, recently crested at £90 per square foot. Many consider this an astonishing rate, but if the financial markets are any indicator, it does not normally take long to gallop past a milestone once it is in sight. So how long before rates reach £100 per square foot? Of course, tenant demand is key. In this age of hot-desking and hotelled office schemes, why are firms expanding their space requirements? This dichotomy is yet another indicator of the difficulties of reading the market.

However, if a major investment bank decides to increase its staff by just 5 percent a year, and they occupy 1 million square feet, then over four years they will need more than 200,000 square feet of extra space. To put such a requirement into context, there are 22 schemes under construction in city of London's financial district, yet only five of those schemes would be able to accommodate our hypothetical bank's space requirement. Also, about 13 organizations in London lease more than 1 million square feet

each. If one bank expands, the others will, too. The competition for space will continue to drive prices higher.

Yield compression is a buzz-word that is echoing around the world's real estate markets. What does it mean? Well, given that a yield is an inverse multiplier of the rent received, in simple terms it means that when the income from rents goes up, the yield-to-capital value goes down—or is compressed in today's jargon. So, what is compressing the yields? To compress something, one normally needs a heavy weight. In the world of real estate investment, pension funds and insurance companies are the heavyweights.

In recent years these strong investors in grade-A property have made a decision, individually or with a herd-like instinct, to increase the proportion of real estate in their portfolios. It used to sit at about 8 percent, but now their targets are to reach between 15 percent and 18 percent of funds invested. This objective could effectively double of their already massive property holdings. Apart from questioning whether there is enough grade-A property, with triple-A tenant covenants, available to slake this desire, it is not rocket science to recognize the effect that demand from wealthy, acquisitive buyers could have on market prices.

The consequential effect is that some non-institutional buyers cannot afford to stay in the heat of this particular kitchen, and move their sights to slightly lesser-quality property with slightly lesser tenant covenants, and so on down the food chain of the property market as normal secondary buyers shift their sights on to tertiary quality property investments. This fuels the market at all levels, but does not necessarily recognize the fundamental truth: as quality goes down, risk goes up. The risk of finding tenants, the risk of tenant default and the risk that a turn in the economy will leave the investor holding a particularly messy baby just when liquidating one's assets seems the most attractive option.

Normally, of course, the riskier the asset, the lower the price. Just as with the gold-rush, or south sea bubble, investors sometimes forget the basics when the feeding-frenzy of desire for quick profits sees the heart ruling the head.

IS RETAILER'S DEAL A PORTENT OF THINGS TO COME?

A sobering thought has just begun to percolate the minds of the astute. It was announced recently that B&Q, a massive home improvement store chain, had managed to negotiate for no rent increases on two of its largest out-of-town stores. In a report by Laura Chesters in the November 2006 issue of *Property Week*, the group argued that there was no demand from other retailers and, therefore, there should be no rise in rent.

Freezing rents in the retail property market should send a shiver down the spines of those working or investing in other real estate areas, too. The do-it-yourself market seems as strong as ever. With residential property continuing to increase in price across the country, many home owners are either improving their properties with a view to sell, adding personal touches after buying, or deciding to stay in their homes and enlarge or enhance them. On the strength of this enthusiasm, fuelled in part by the plethora of home improvement programs on television, B&Q embarked on an expansion drive, opening a scheduled 18 stores a year, as a defensive move against the potential entry into the UK of the U.S.-based Home Depot.

Still, even with these contrary indicators, the real estate market is a vibrant and challenging environment in which to earn a crust. Would you have it any other way? Why not email your views to me at barry.gilbertson@uk.pwc.com. ■