



## Gatehouse View

## Q2 2011

### Property Overview | Q2 2011



During times of market volatility, the UK government continues to pursue additional policy reforms to boost enterprise growth for business. These initiatives and more, allows Gatehouse Bank to remain optimistic that the economy will prove resilient. We are pleased to announce that we have successfully completed more than £250,000,000 in Real Estate acquisitions to date. These transactions have continued our strategy of securing high quality properties let on long leases to tenants with undoubted covenants, most recently Rolls-Royce on 17 years and Fujitsu, which offers an exceptional annuity-like return on a lease of 70 years. In this challenging environment, Gatehouse Bank continues to deliver transactions that generate sustainable returns for risk-averse investors to drive wealth preservation.

**Adam Cavanagh**  
Head of Real Estate

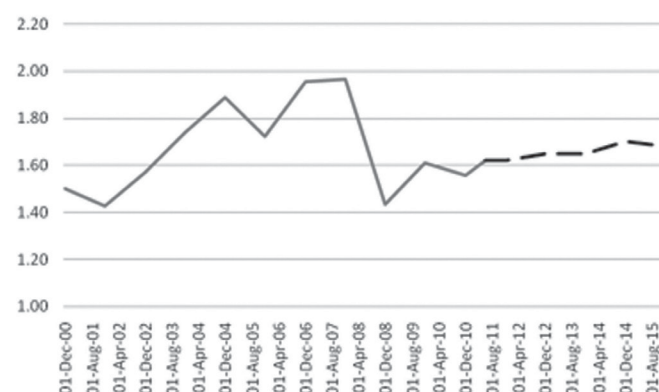
### Economy

- The UK economic recovery continues, albeit slowly, as the Office for National Statistics latest GDP numbers report the economy growing by 0.5% for the first quarter of 2011. The June consensus forecasts for growth published by HM Treasury have softened slightly to an annual rate of 1.6% for 2011, however the 2012 forecast of 2.1% remains unchanged.
- Pressure has continued on the MPC to raise rates to combat inflation, although recent data has supported the committee's decision to delay hikes. Latest CPI data for June showed an unexpected drop in the year on year rate from 4.5% in May to

4.2%. We, like many other analysts are now expecting the base rate to remain on hold until earliest March 2012 at record lows of 0.5%.

- GBP/USD continues to trade within a broad range of 1.55-1.65, trading mid range as a result of market pressures amidst the European debt crisis and fears of a downgrade to USA's AAA credit rating. We regard any fall in Sterling against the Dollar as a good opportunity to invest as we see fundamentals for the UK remain durable. We anticipate a push higher for the pound into Q4 to test the upper end of the range as the long term downtrend for the Dollar resumes.

£ to US\$ Exchange Rate (Historic and Projected)



Source: FT, Bloomberg

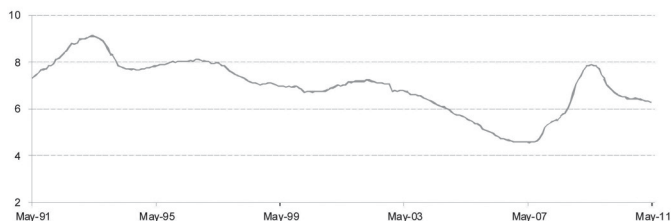
Economic Indicators	Value	Trend
CPI	4.2%	↓
Retail Sales	0.4%	↑
Unemployment	7.7%	=
Base Rate	0.5%	=
£:\$	1.62	↑

Source: ONS, FT, BoE: 21/07/11

## Commercial Market

- The overall outlook for commercial property remains positive. Total returns for this year are projected to be in the 7% to 10% range. Investment Property Databank data continue to show total returns on commercial property running at an annualised rate of 9.5%.

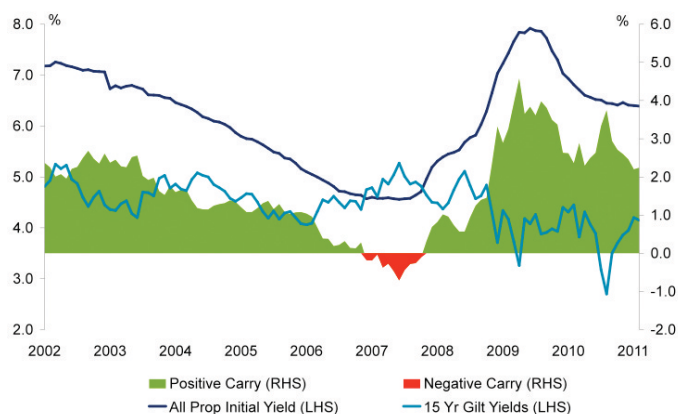
### Initial property yield %



Lombard Street Research, Property Economics May 2011 issue

- Property yields of 6.25% look good relative to the yield from other assets. Commercial assets remain 30% below their 2007 peak despite a growth of 8% since the start of 2010. Consequently, investors, sovereign wealth funds and cash rich pension funds continue to be attracted by high yields, relatively low sterling and the UK's "safe haven" status. Despite British banks still having considerable exposure to underperforming assets, investor demand remains strong and there are signs of improving credit availability. The margin of property over gilts also continues in positive territory as shown in the following chart:

### IPD All Property Initial Yields against 5 – 15 year Gilt Yields:



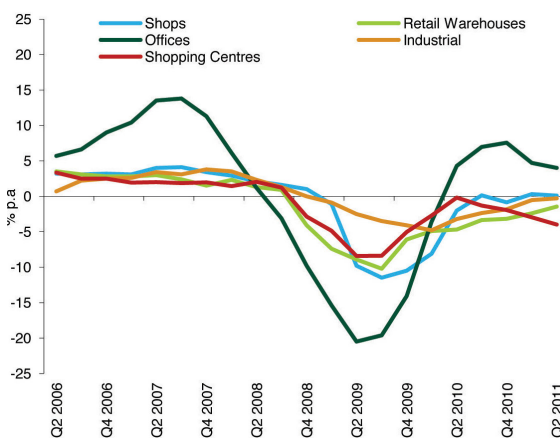
Source: IPD / Drivers Jonas Deloitte

- Commercial property continues to look attractive relative to the risk-free rate, the long run average of the index linked property yield gap is close to 400bps, and well below the current level of 560bps as index linked yields continue to remain artificially depressed by institutional factors.
- It is expected for the valuation gap between prime and secondary assets to increase further, as investor demand for prime assets in London remains – illustrated by foreign investors injecting fresh equity in the market to account for £5.3bn in Q4. The Times recently reported that The Hong Kong Monetary Authority is set to buy \$500m of office properties in London, and the KIA has instructed its property investment unit to invest £1.5bn into the City.
- A continued lack of speculative development in recent years has limited the downside risk to rental growth, resulting in further yield compression, particularly in London. The increasing willingness of investors to look beyond London offices saw retail warehouses located in leisure parks and industrial multi-lets as a sector expected to see downward pressure on yields over the short term.

## Office Market

- Prime office rental growth outperformed the wider real estate market in Q2 2011, as overall prime office rents grew by 0.6% in Q2, representing a 4% growth over the year. The West End was the strongest performing subsector in Q2, with growth of 1.4% compared to the City market which grew by 0.7%.
- Prime office yields hardened again largely due to the London markets which continued to experience capital values increasing. Prime yields across all lot sizes in the City and West End remained unchanged at 5.25% and 4.25% respectively. Yields generally were quite flat across most other regions, however continued to show signs of encouragement and investment opportunity.
- Although UK region-wide availability edged up in Q1 2011, Grade A space fell, maintaining average prime headline rents and rental levels are expected to remain stable during H2 2011. The M25 office market grew by 10%, bolstered by 68% increase in the Thames Valley market alone. Investment demand for regional areas outside London continues to stem from overseas investors, particularly German funds, who have been active in bidding for larger lot sizes of £50m+.
- After a subdued Q4 2010, Glasgow property investment more than doubled in Q1 2011 to 115,000 sq ft as companies sought skilled labour and availability of government grant assistance for qualifying projects. Total availability is expected to fall back gradually in H2 2011 as stock for grade A stock falls more sharply, supporting headline rents with modest increases through to 2013.
- Equally, Bristol benefitted from a strong start to 2011, with city take-up increasing more than 50% in Q1 2011 to 155,000 sq ft. Despite lower grade space being quite abundant, yields are expected to harden for centrally located Grade A stock due to limited construction activity in the pipeline. Other regions such as Manchester are becoming increasingly important for commercial investment, as highlighted in the multi-million pound relocation for the BBC's Headquarters to the North West region.
- Growing confidence in the SE region market is also evidenced in recent acquisitions, namely the Forbury Square building in Reading at £42.5m, with a net initial yield of 6.5%; to establish a new benchmark for office yields on the M4 corridor.

### Annual Sector Rental Growth



Source: CB Richard Ellis

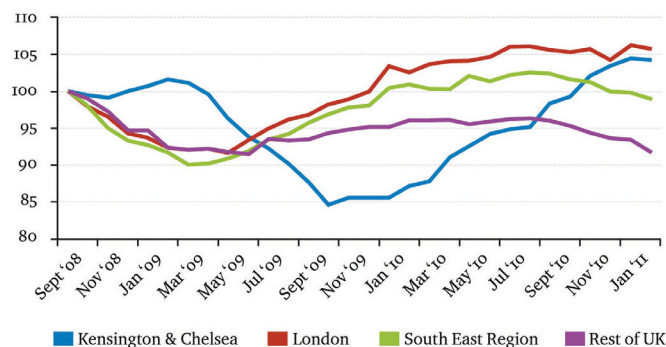
## Logistics Real Estate

- Prime retail distribution warehouses have been of key focus, particularly those let to supermarket chains such as Marks & Spencer and Tesco in South East England regions and in industrial parks. RPI-index linked leases, with long term secure income, excellent communication links to airports, train stations and main roads are increasingly being seen as highly prized assets.
- Rebound in export growth fuelled by a relatively weaker sterling, has resulted in relative growth in UK manufacturing and industrial production in H1 2011. Combined with the shortage of high specification distribution space, these investments are being viewed favourably on a deal by deal basis versus in a fund as there could be more risky characteristics such as no fixed uplifts and little capital appreciation. To note, the shortage of high specification distribution space is sufficient to have generated a few high profile 'design and build' forward funding deals which may affect long term holds.
- The latest purchasing manager indices suggest that growth is forecast to continue and will support small and medium size industrial occupiers. Distribution warehouse total returns are expected to reach 9.7% in 2011 as yields harden in response to competition increasing for limited stock presenting a growing opportunity in a maturing Real Estate sector.

## Prime Residential

- The Prime London residential market remains robust, alongside embedded supply constraints, to favour long term asset value growth. The relative weakness in sterling is delivering discounts for dollar-based buyers of approximately 25% compared to peak levels accomplished in September 2008, and the compression of prices resulting from the limited credit availability has rebalanced acquisition values presenting significant opportunities.

### House price performance peak, Indexed



Source: Hamptons – Prime Central London Residential Market

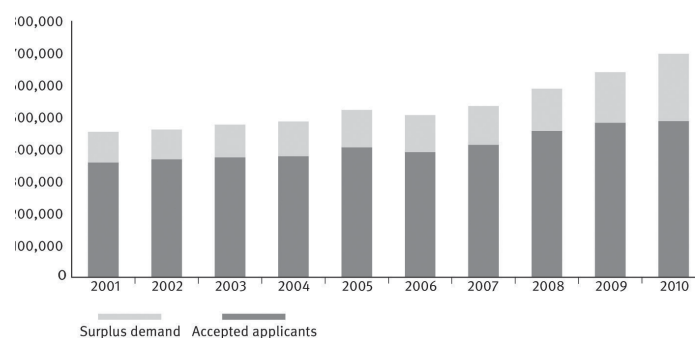
- The demand for properties in Prime Central London locations continued unabated, with prices rising £767 every day over the preceding 12 months equating on an annual growth rate of 8.3%. Prime London prices reached a new record high of 2% higher than the previous market peak in 2008, rising by more than a third in two years and have risen 34% since March 2009.
- Activity in this market shows little sign of slowing, as interest from domestic and overseas buyers remains strong. International buyers accounted for 72% of all Hamptons International properties sold in Q1 2011, viewing figures were up 8% on the year in June, and the volume of properties under offer in June was 52% higher last month than in June last year.
- Stock volumes in Prime Central London rose by 12% in the year to June; however demand remains far greater, meaning that prices will continue to rise, although at a slightly slower pace than H1 2011. Despite this, property agent Knight Frank, revised up its conservative forecast for price growth in the prime London market from 3% to 9%.

- Prices have risen by nearly 4% in the last three months, led by properties in the £1m to £5m price bracket, with the strongest geographical locations being Mayfair, Marylebone, St John's Wood and Kensington – achieving more than 10% growth over the last year. With values of £3,000 per sq. ft. and above secured at The Lancasters on the north side of Hyde Park and similar levels on Cornwall Terrace overlooking Regent's Park, the boundaries of Prime London residential continue to push out.
- London's South Bank is fast becoming the focus of new upscale residential projects targeting city professionals, international students and also attracting strong demand from Asia where signs that the house price bubble in China is beginning to deflate. Projects such as Neo Bankside and the Shard, boast contemporary architecture and physical landscape commanding prices of £1,250 and £3,500 per sq ft respectively.
- It is anticipated that there is real potential for prime London price growth in H2 2011. This view is supported by greater demand for tangible assets, which are in limited supply, as well as contributing factors such as the perception of London as a 'safe-haven' environment, against US and Eurozone economic difficulties and inflationary pressures in Asia.

## Student Accommodation Market

- Strength and optimism persists in the student accommodation market as a result of an ongoing structural undersupply of affordable accommodation in London and other UK regions. The University and Colleges Admissions Service (UCAS) reports that the number of applicants is up 1.4% on last year, which includes a 5.7% increase in the number of applicants from the European Union (EU) and 3.7% increase in non-EU applicants, on the same time period.
- Rental growth in the UK regions has outperformed London's markets into H1 2011, largely due to pressure on London's high-end studio rents. During 2010, average rental values rose by 4.1% (YoY) in regional cities compared to across London, which experienced an average 3.6% fall. In Q1 2011 direct let yields for prime student accommodation assets were 6.5% (regional) and 6.0% (London). Analysts have identified areas outside London such as Edinburgh, Brighton and Durham as key areas of growth potential.
- Investments let to Higher Education Institutions (HEI) covenants have become attractive for investors seeking annual uplifts. Q1 2011 has experienced greater yield compression in the HEI lease segment of the market, with yields typically filling in the 5.00% to 5.73% range for the best prime investments.
- The number of student applications continues to rise, showcasing resilience in Student accommodation in a challenging domestic economic climate. General consensus suggests key cities across the UK are expected to witness a significant demand and supply imbalance, presenting investment opportunities as private sector funding grows. It is estimated that in 5 years universities will generate £500 million through the disposal of their existing halls of residence to the private sector.

### Student demand for university places exceeds supply



Source: UCAS

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