DTZ Research

Money into Property
UK 2012
Filling the Gap

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- Despite a weaker external environment, global invested stock grew by 7 % in 2011, setting a new record of USD12.1tn. Asia Pacific grew fastest, at 13%, followed by Europe at 8%, while North America stood still.
    - UK invested stock was down 1% to GBP 537bn. This was driven by a 4% fall in debt. Equity rose, but not sufficiently to outweigh the decline in the debt component. This decline in debt marks the UK out from most other major markets.
    - Deleveraging continued globally, the average UK loan to value ratio (LTV) was 61%, in line with the 60% global average. Opposite to the UK, debt growth resumed in most markets. But, as equity growth was faster, the net effect was a reduction of the LTV ratio.
    - In the UK, investment volume fell back 10% in 2011, primarily due to a shortage of prime stock. In contrast the US and Europe showed a strong recovery in investment volumes, whilst Asia declined. Europe returned as the most actively traded region in 2011.
- Our global investors' and lenders' surveys show that market players are generally less optimistic compared to one year ago; but sentiment in Europe and the UK is much less positive than in the other regions.
    - Lenders expect less new lending and tighter conditions, with a further decline in existing loan performance. Investors expect less net investment activity and fear a decline in bank lending. Prime property is still distinctly preferred, by both investors and lenders, but non-prime is becoming more accessible.
    - New European banking regulations are not helping matters as we expect them to force more deleveraging. This forced deleveraging will increase the existing debt funding gap across key European markets. The impact on the UK will be less pronounced. However, increased activity from non-bank lenders is expected to bridge the gap, in part.
- The remaining uncertainty with the current outlook has triggered a return of risk aversion. Therefore, we consider alternative economic scenarios.
    - In the base case, UK invested stock is expected to grow at a moderate pace of 0.4% in 2012 and 3% in 2013. However, in the downside scenario, invested stock is projected to decline by 18% in 2012 and return to 1% growth in 2013. UK investment volumes are projected to register a 12% increase in 2012 under the base case.
    - DTZ's latest Fair Value analysis shows that all 20 UK prime markets are classified as HOT or WARM and offer good value compared to the rest of Europe. With prime property difficult to access however, investors will need to move into non-prime.
    - Risk aversion has prevented most investors to make this move so far. However, we would like to challenge the conventional wisdom by taking a closer look at non-prime risk. DTZ research shows that non-prime void rates are lower than for prime office properties. This means that perceived risks could be significantly higher than actual risks. Therefore, non-prime should offer attractive opportunities for UK investors.

Introduction

We are very pleased to present the 38th year of *Money into Property*. The focus of this report is the UK. We have published similar reports for Europe and Asia Pacific, together with a Global summary report. This report has three main sections.

The first section provides a detailed review of year end 2011 invested stock and transaction volumes. Invested stock is defined as investment-grade commercial real estate held by investors. Invested stock is differentiated from owner occupied real estate, both investment and non-investment grade (Figure 1 and Box 1). A large share of owner occupied stock is non-investment grade and therefore not of interest to investors. In fact, 36% of the global total stock is considered to be non-investable. The majority of investable stock (which is the focus of this report) is already invested (Figure 2).

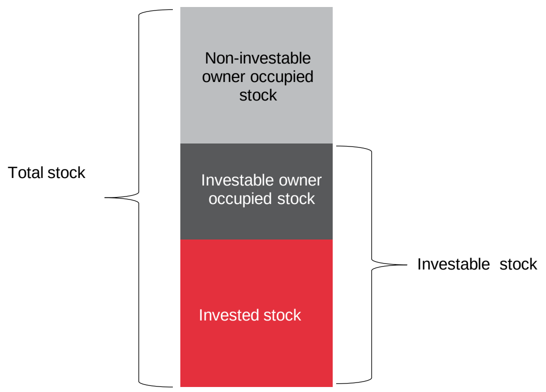
In the second section we share the findings of our investors' and lenders' surveys which were undertaken between February and March 2012. The surveys provide an insight into current sentiment and together with our Fair Value methodology provide an indication of opportunities in real estate throughout the UK.

In the final section we provide our outlook for invested stock and capital flows in 2012 and also consider key policy changes and their potential impact on the markets.

The appendix provides an overview of definitions and methodologies used.

Figure 1

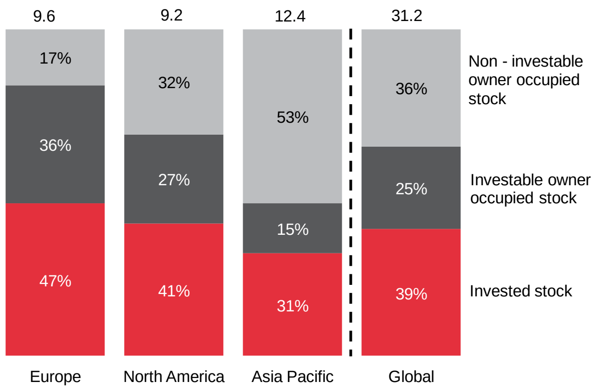
Conceptual breakdown of total stock



Source: DTZ Research

Figure 2

Breakdown of total stock, 2011, USD tn



Source: DTZ Research

Box 1: Stock definition

Total stock is the total value of the commercial real estate universe. Total stock comprises non-investable owner occupied stock, investable owner occupied stock and invested stock.

Non-investable owner occupied stock is the value of commercial real estate that is not available to investors due to use or quality of the property.

Investable owner occupied stock is the value of commercial real estate stock that is currently held by occupiers but is attractive to investors in terms of use and quality of the property. This represents potential for investors as occupiers sell their properties or undertake sale and leasebacks.

Invested stock is the value of commercial real estate held by investors in the relevant country. As a consequence the invested stock should:-
a) Rise as owner occupiers sell property to investors
b) Rise as new developments are unveiled and added to the invested stock
c) Rise with the general rise in capital values
d) Be negatively impacted by depreciation and retirement of stock.

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Section 1 – Sizing of the market

Invested stock trends

Global invested stock sets new record in 2011

Global invested stock grew by 7% in 2011, setting a new record of USD12.1tn. When measured in fixed exchange rates, invested stock grew at a more moderate pace of 4%, similar to 2010 (Figure 3). In floating US dollar terms, Asia Pacific grew 13% followed by 8% for Europe and 0% in North America. Our forecasts last year proved accurate for Europe and Asia Pacific, while our expectation that invested stock in North America would grow was disappointed.

UK and North American growth disappoints

Growth in invested stock in both the UK and North America was weaker than forecasted last year. UK growth actually moved into negative territory in local currency terms (Figure 4). Meanwhile, a weak US dollar boosted growth across all other markets. Europe saw 8% growth in US dollar terms compared to 5% growth in local currencies. Similarly, nearly half of Asia Pacific's 13% headline growth was due to the weakness of the US dollar.

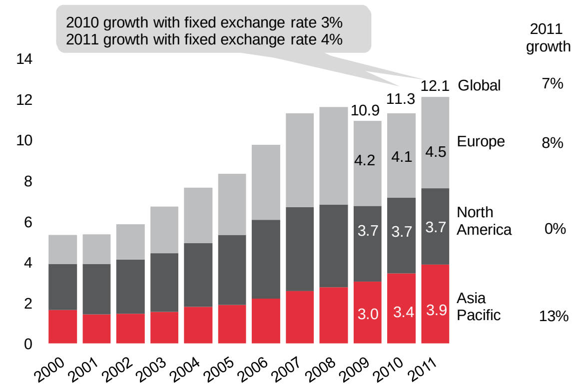
UK stock decline driven by deleveraging

In the UK, invested stock fell back by 1% in sterling terms (Figure 5). This decline was the result of a continuing contraction in the debt component, which fell by 4%. Unlike 2010, this was not balanced by a corresponding rise in equity. Equity growth moderated in 2011 to 4% versus 12% in 2010. As equity is the smaller portion of invested stock, the overall result was a net decline. This deleveraging marks the UK out from most other major European markets, where debt is still growing, just. Since 2008, total real estate debt has declined by over 9%. This has been only partially offset by an 8% increase in equity over the same period.

Figure 6 (on next page) provides a detailed view on the individual country level performance as well as a breakdown by source of capital which we will discuss later in the report.

Figure 3

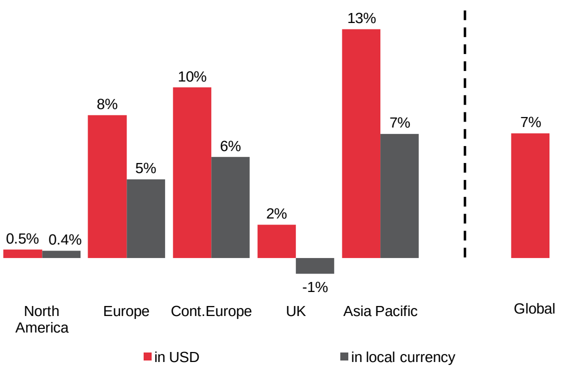
Global real estate invested stock, USD tn



Source: DTZ Research

Figure 4

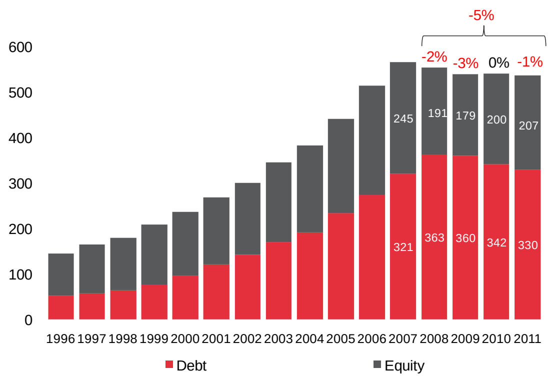
Change in invested stock, 2011



Source: DTZ Research

Figure 5

UK invested stock, GBP bn



Source: DTZ Research

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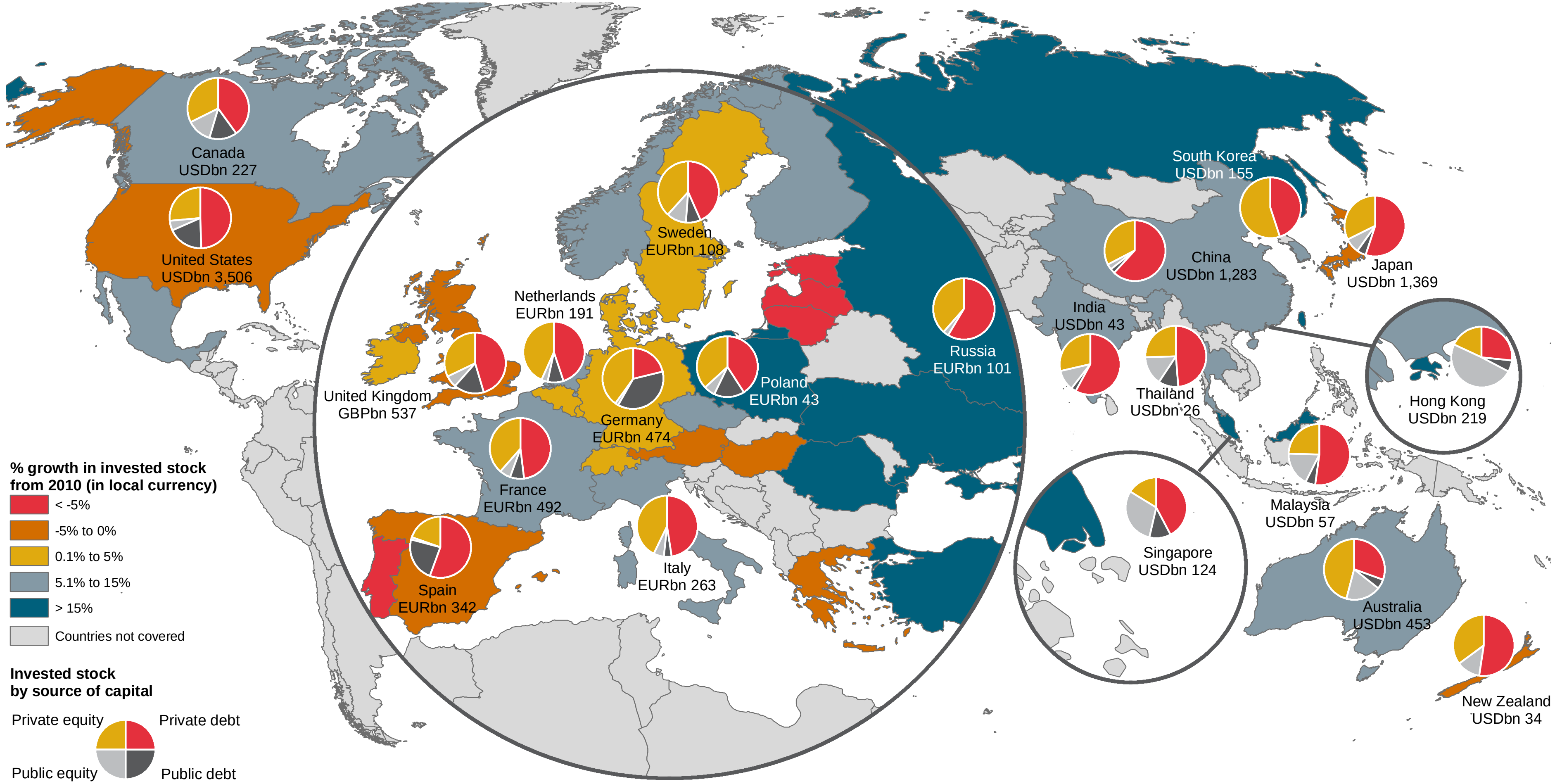
Figure 6

Global real estate invested stock, 2011



Source: DTZ Research, ESRI

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Sources of capital

Global debt returns to growth, but equity still stronger

Private debt returned to growth in 2011, joining both equity quadrants in their continued resurgence (Figure 7). Private debt added USD 330bn to total invested stock in 2011, a tenfold increase from the previous year. Even so, this was still significantly below the USD 493bn of added equity, predominantly private. In contrast, public debt continued to stagnate, falling by 1% during the year.

Deleveraging slowing, but Asia Pacific joins in

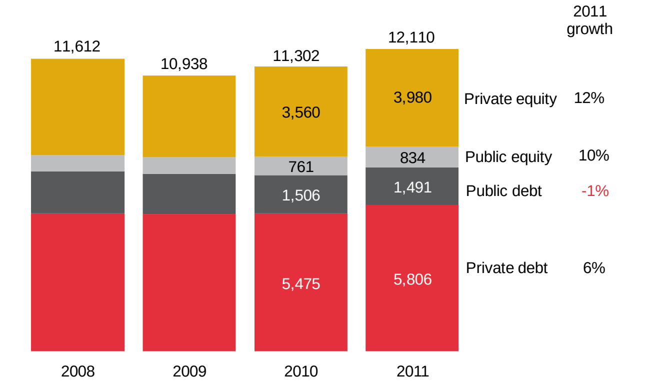
All regions are now reducing the share of debt in invested stock, including Asia Pacific (Figure 8). The speed of deleveraging has fallen in North America from 5% in 2010 to 2% in 2011.The UK has shown a similar pattern, with a decline of 2% to 61% in 2011 compared to 4% in 2010. Despite this recent deleveraging, outside Asia Pacific, loan to value ratios (LTVs) remain higher than they were in 2007, near the peak of the cycle.

UK and North American leverage down as debt continues decline

Even though debt growth has turned positive in 2011, faster growth in equity has driven regional leverage ratios down. This is especially the case in Asia Pacific, where debt growth has remained strong, but is still surpassed by equity (Figure 9). The UK and North America showed continued decline in debt. Debt fell more strongly in the UK than in North America. UK equity showed a slower rate of growth (3%). In contrast, last year leverage was down, as debt declined while the equity component rose.

Figure 7

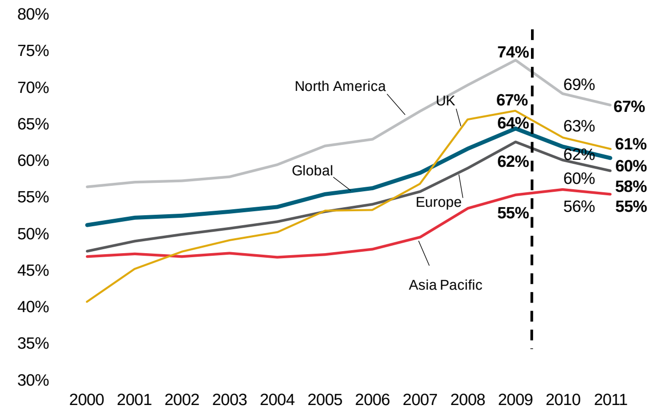
Global invested stock by capital source, USD bn



Source: DTZ Research

Figure 8

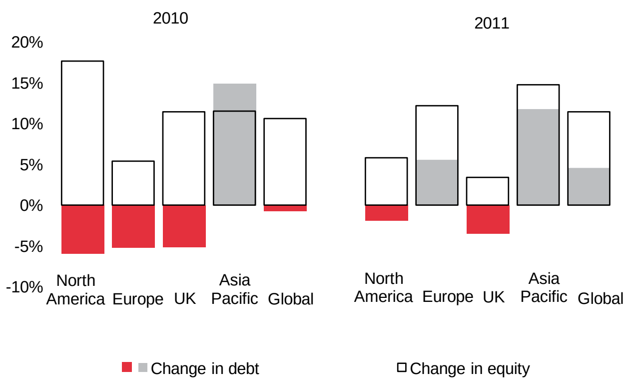
Total debt as percentage of invested stock



Source: DTZ Research

Figure 9

Change in debt and equity



Source: DTZ Research

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Second year of decline in both debt quadrants

Both private and public debt quadrants declined for a second consecutive year at -3% and -4%, respectively. This is, however, a slowing rate of decline compared to last year's report (Figure 10). The growth of private equity also slowed, from 12% in 2010 to 2% in 2011. Public equity showed the highest growth rate at 11%, but it remains the smallest quadrant.

Banks continue to reduce exposure to UK commercial property, as non-bank lenders emerge

Bank deleveraging, as implied by the 3% decline in private debt, continued in 2011. This followed the 5% decline in 2010 (Figure 11). However, this is a net measure of lending secured by real estate. There is still some limited new lending to UK commercial property being undertaken by banks, and this implies a greater underlying level of gross deleveraging. Notably, there has also been some new lending by non-banks, particularly insurance companies and debt funds.

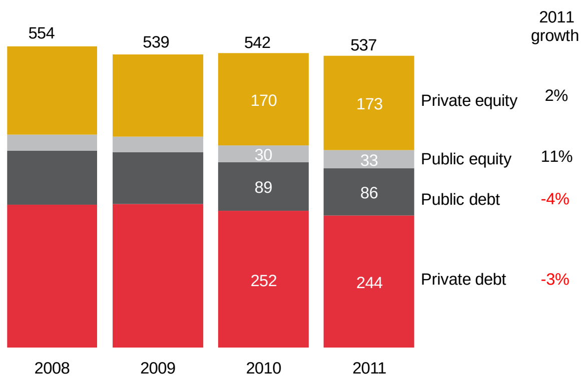
Public debt funding remains shut

Funding through public debt issuance remains effectively shut (Figure 12). There was some marginal growth in corporate bonds in 2011, but from a very low base. All other sub-categories continued their decline of last year. In particular, CMBS pay downs continued, and substantially outweighed the few new primary offerings coming to the market. Declines in covered bonds reflected the continued retreat of German lenders (Pfandbrief) from the UK.

The importance of attracting new sources of debt funding has increased, with banks continuing to delever and public debt being largely unavailable. It is our opinion that more attractive pricing will be required to attract enough new debt providers.

Figure 10

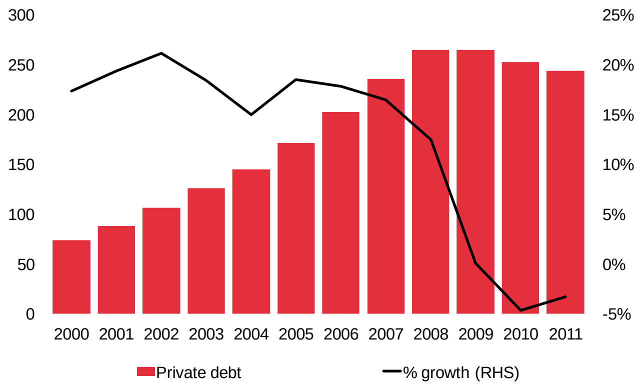
UK invested stock by capital source, GBP bn



Source: DTZ Research

Figure 11

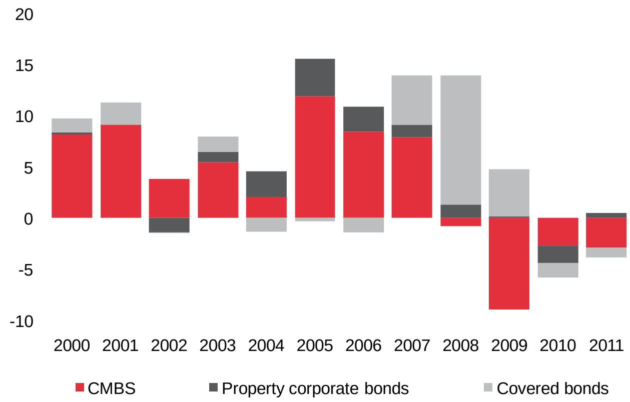
UK private debt, GBP bn



Source: DTZ Research

Figure 12

Change in UK public debt, GBP bn



Source: DTZ Research

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Transaction volumes

Global investment volumes up 9% in 2011

Despite an increase in invested stock, total transaction volumes in Asia Pacific in 2011 were below 2010 levels (Figure 15). During the year, North America and Europe showed a strong recovery in volumes with Europe overtaking Asia Pacific as the most actively trading region.

UK investment volume in 2011 disappoints

UK investment performance disappointed as investment volumes fell to GBP30bn in 2011, compared to GBP34bn in 2010 (Figure 14). This decline stemmed from a shortage of the prime stock favoured by equity investors, a shortfall in the expected volume of loan-related stock, and a lowered appetite by investors in an atmosphere of increased uncertainty.

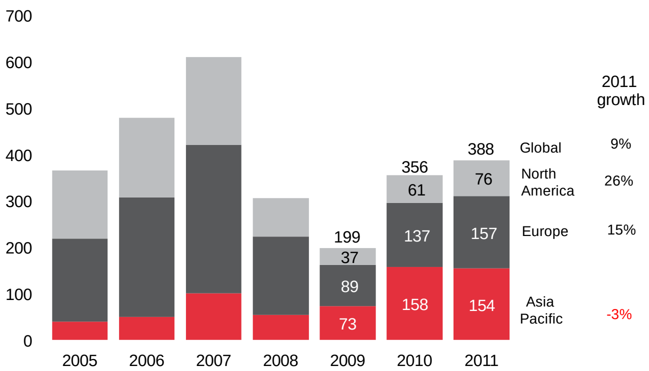
Domestic investors increased their share of investment volumes again, to 66%. But 2011 also showed a 5% increase from inter-regional capital. Thus it was intra-regional or Continental European investors which severely reduced activity. This was mostly driven by a retrenchment to domestic markets in the face of the continuing eurozone crisis. In addition, the forced German-open-ended fund divestments also played a part.

Non-UK capital led by Asia Pacific investors

Asia Pacific investors were the most important net purchasers of UK property in 2011 (Figure 15). In fact, Asia Pacific investors turned from net sellers in 2010 to the largest net buyers of 2011. New Asian entrants came predominantly from Hong Kong, mainland China and Malaysia. International global fund managers were also strong net purchasers during 2011. These funds are the most active on both the buy and the sell sides, after domestic investors.

Figure 13

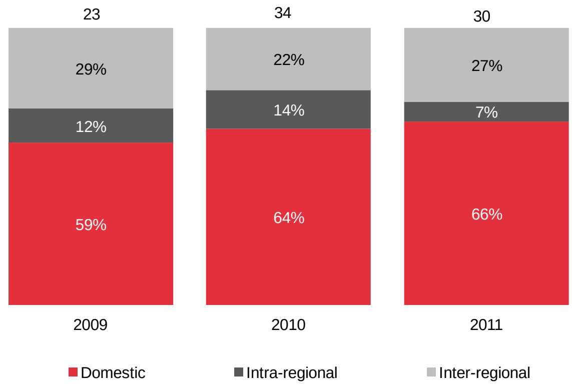
Global investment volumes, USD bn



DTZ Research, Reis Services LLC, RealNet, Property Data

Figure 14

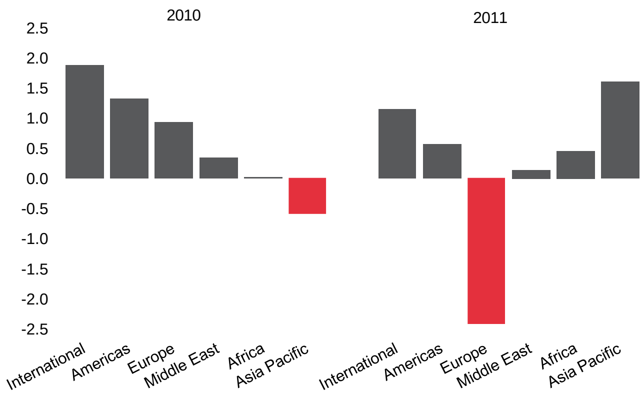
UK investment activity, GBP bn



Source: DTZ Research, Property Data

Figure 15

UK cross-border net investment, GBP bn



Source: DTZ Research, Property Data

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Central London activity main focus for inter-regional investors

Cross-border investment has been critical to Central London investment activity. In 2011 foreign investors split the market evenly with domestic purchasers. Foreign investors' investments outside Central London by contrast comprised only 15% of total cross-border activity in both years (Figure 16).

UK second most liquid European investment market

At 6%, the UK has one of the highest liquidity ratios[1] in Europe (Figure 17). This is well above the European average and is mostly driven by Central London sales activity.

However, the UK ratio is still lower than pre-2008 levels. Lack of debt availability, as is the case at present, is restricting activity. At the same time other issues, such as the continuing mismatch of bid and ask yields may well also be playing a part.

Quoted property vehicles followed by institutions were biggest net buyers

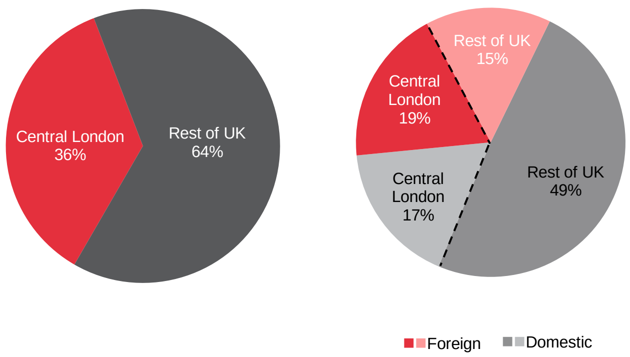
Institutions and quoted property vehicles were the largest net buyers in 2011 (Figure 18). The latter were largely REITs, and their prior recapitalisation is now being deployed. The most actively trading investor type in 2011 was private property vehicles. But, divestment and acquisition activity was more or less balanced for them.

Investment in property was not just restricted to direct purchases in 2011. Banks' increasing propensity to dispose of loan portfolios at a discount to equity buyers was evident in 2011. It should be noted that bank loan sales are not included in our transaction volumes, as the equity title of the property does not change, unless, that is, the collateral is enforced.

[1] Defined as the turnover of the investment market in relation to total invested stock

Figure 16

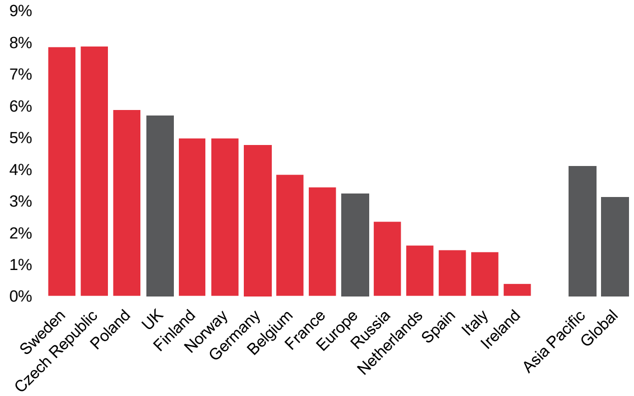
UK investment activity, 2011



Source: DTZ Research, Property Data

Figure 17

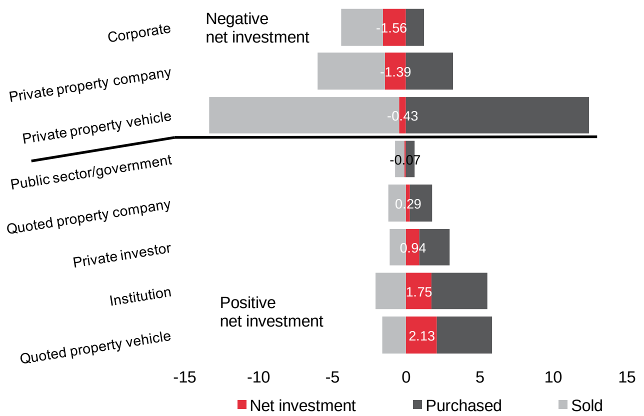
Liquidity ratios, 2011



Source: DTZ Research

Figure 18

Net investment by investor type, GBP bn



Source: DTZ Research, Property Data

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Section 2 – Current sentiment

Our lenders' and investors' surveys illustrate the prevailing market sentiment, which we expect to impact actual future performance.

Lenders' survey

Lenders expect less new lending and tighter conditions

Existing lenders, predominantly banks, expect future lending to decrease and terms and conditions to tighten. Compared to the 2011 survey, those expecting lending to increase have more than halved, while those expecting it to decrease have more than doubled (Figure 19). In addition, 2012 lending terms and conditions ("T&C") deteriorated acutely between the 2011 and 2012 surveys, with a more than six fold increase in tighter T&C's. The current survey view on 2013 is that T&C's will relax to a similar level to those expected for 2012 in last year's survey. Expectations in 2011 for a relaxation in T&C's did not materialise.

Lenders expect loan performance to further deteriorate

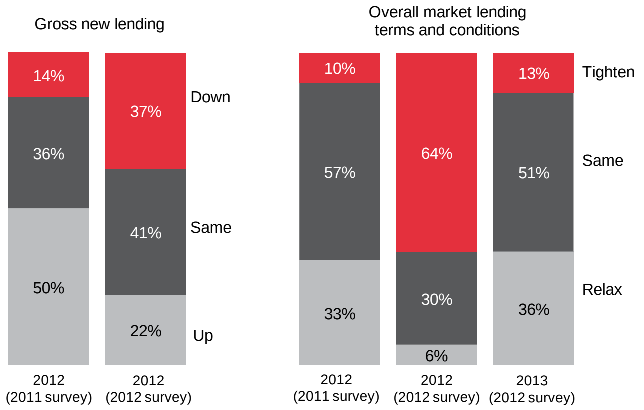
Lenders expect loan performance to further deteriorate in 2012 (Figure 20). This is in contrast to last year's results, when lenders expected all categories of loan performance to improve in 2012. But, this year's survey responses indicate a expectation of a doubling for defaults, a tripling of arrears and an expectation of a near quadrupling of losses, when compared to their 2011 expectations in last year's survey. Figures 19 and 20 combined show how great a deterioration there has been in lending sentiment for 2012.

More progress on non-prime workouts during 2011

On a positive note, the working out of loans is well underway for prime property (Figure 21). Lenders' view of progress in 2012 is similar to the responses of the 2011 survey: only 15% of respondents state that the prime asset workouts are left to do, compared to 20% last year. With non-prime property, 43% of the workout is not yet started. This is 10% less than in last year's survey. In short, our lenders' survey indicates that the prime workout is largely complete and emphasis is now turning to non-prime property.

Figure 19

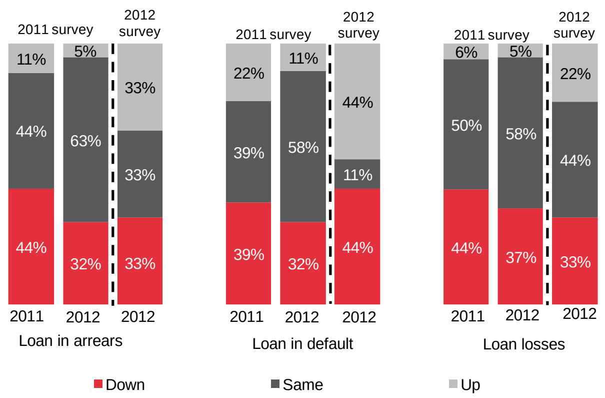
Expectations for new lending and changes in terms and conditions



Source: DTZ Research

Figure 20

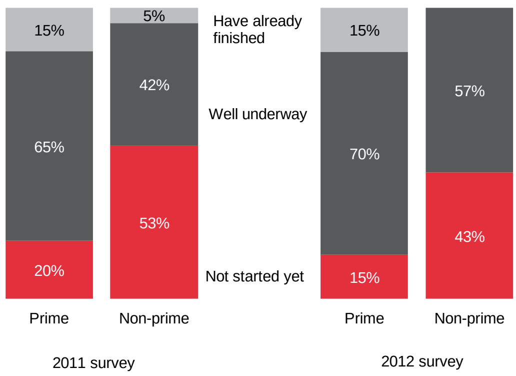
Expectations for loan performance



Source: DTZ Research

Figure 21

Lenders' assessment of progress in working out



Source: DTZ Research

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Lenders shift preference to prime asset lending

Lenders intentions for exposure by asset class favour prime by a wide mark. 64% of lenders plan to increase their lending secured on prime, up from the 40% in last year's survey. In contrast no lenders wish to increase their non-prime exposure, a response that illustrates a continued 'flight to quality'' in lending (Figure 22). On the contrary, 64% of lenders want less exposure here, compared to 33% last year. Aversion to lending for speculative development has deepened. There is very little development finance being made available, and only for pre-let schemes. Even here positive intentions have reduced since last year's survey.

Basel III expected to have the largest negative impact on lending

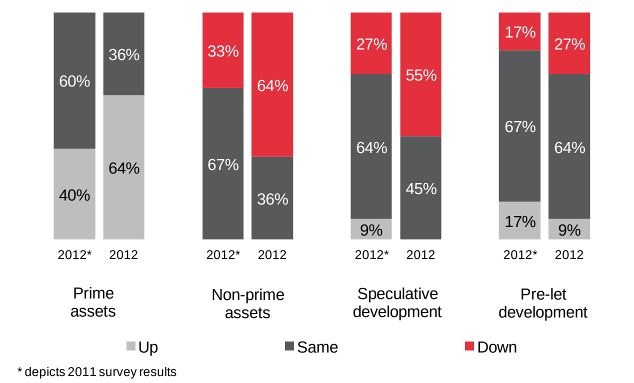
When comparing the survey results of both lenders and investors, it is clear that both for the majority of lenders (76%), and investors (60%), Basel III will have the largest negative impact among the reforms proposed (Figure 23). The impacts of Solvency II and the EBA capital adequacy regulation are less, but still substantial, at an average of 50% and 42% respectively. In general, however, lenders seem much more downbeat than investors on these reforms.

Lenders more negative than investors on impact from regulatory changes

Looking forward, there are an increasing number of regulatory reforms being put in place as a response to the global financial crisis. Both lenders and investors now expect regulatory reforms to have on balance a negative impact on property markets (Figure 24). Compared to 2011, both lenders and investors have become more negative. However, lenders are now nearly twice as negative compared to investors. This is a worrying sign for investors going forward, as we suspect that lenders may be in a better position to assess the impacts of pending regulations on lending than investors.

Figure 22

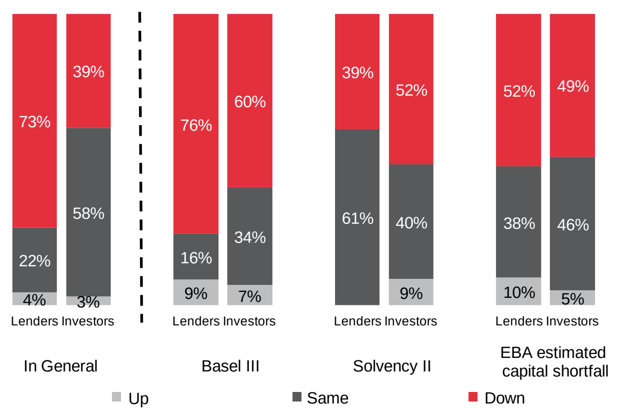
Lender intentions for loan book exposure, 2012



Source: DTZ Research

Figure 23

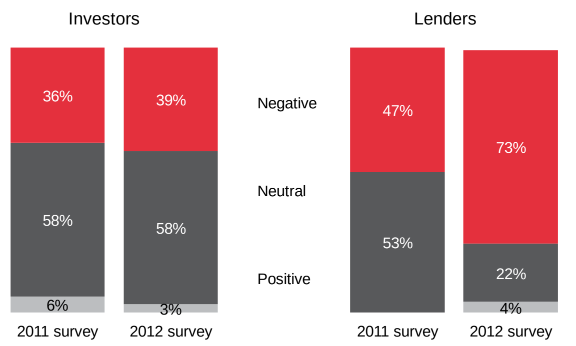
Impact of regulatory reforms on lending, 2012



Source: DTZ Research

Figure 24

Impact of regulatory reforms on lending



Source: DTZ Research

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Investors' survey

Investors become less optimistic on net investments

Our survey findings show that on balance net investment globally is expected to increase in 2012 (Figure 25). However, the proportion of respondents expecting to increase net investment has declined since 2010, from 76% to 57% in 2011. Five times as many investors expected net investments to decrease (31%) compared to a year ago (6%). This reflects mounting caution in the market due to increased risk on the back of the continuing European sovereign debt crisis, the difficulty in sourcing the right product, and declining availability of finance.

More competition in sourcing opportunities for prime

The increased risk aversion with investors has lead to increased competition for the best properties. Investors in EMEA are finding it much more difficult to buy prime properties in 2012 compared to 2011 (Figure 26). Difficulty in sourcing prime has soared, from 3% to 61%.

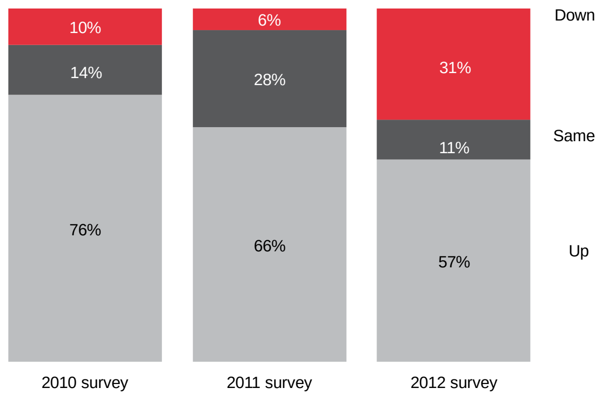
In last year's survey, opportunities in the non-prime market were seen as more difficult to access. While a significant portion of investors (39%) still regarded non-prime as difficult to access, now a slightly greater proportion (40%) see it as easy to source in 2012, up from 28% last year. This suggests that, with prime product keenly priced and very competitive, non-prime property has already become a more important target to a bigger section of the investor base. Nevertheless, lender aversion to non-prime lending (Figure 22 above) means that financing will be very difficult to access.

Decline in bank debt offset by increase from institutions

Nearly 70% of investors expect bank debt to decline during 2012, a near tripling from the 25% in last year's survey. The only category of debt expected to increase is from institutions, with 58% of investors projecting an increase (Figure 27). In fact, debt from institutions is expected to increase more than any other source of finance. Expectations for bonds and mezzanine finance have declined from last year's survey, but they are still positive on net basis.

Figure 25

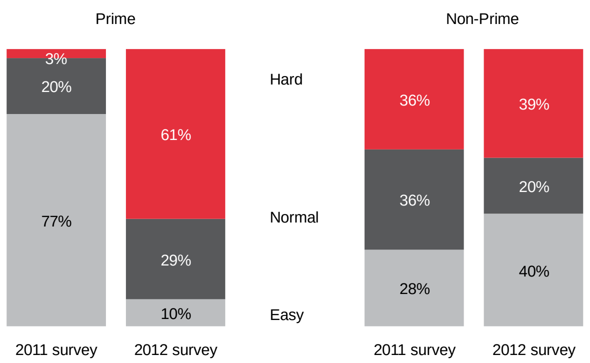
Net investment expectations in real estate



Source: DTZ Research

Figure 26

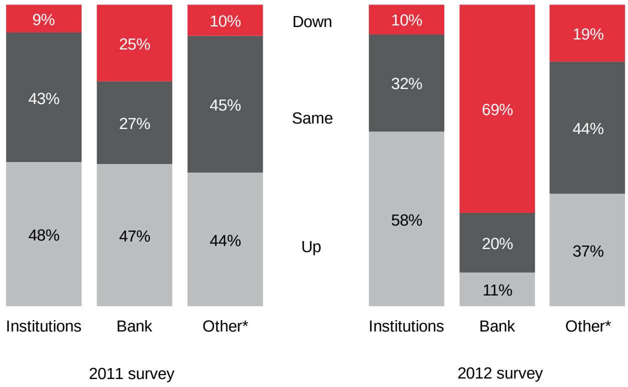
EMEA buying opportunities by property grade



Source: DTZ Research

Figure 27

Expectations for availability of finance by lender



*Other covers corporate bonds, CMBS and mezzanine finance

Source: DTZ Research

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Bank lending is expected to drop most in EMEA

The global decrease in commercial bank lending is largely explained by the expected decrease in EMEA, and to a significant extent in North America as well (Figure 28). In EMEA mezzanine finance and debt from institutions are expected to compensate for this reduction. In North America expectations for institutional funding are evenly balanced between growth and decline. In Asia Pacific debt from institutions is viewed as less important than bank lending, but it is corporate bonds which are expected to increase the most out of any source of finance.

Most investors in talks with banks on loan amendments

Half of investors in EMEA and 75% in North America are in talks with banks on loan amendments and/or extensions (Figure 29). This contrasts with Asia Pacific where just over a quarter of investors are in a similar position, in turn reflecting the lower level of leverage in this market. This is consistent with the global leverage ratios shown earlier.

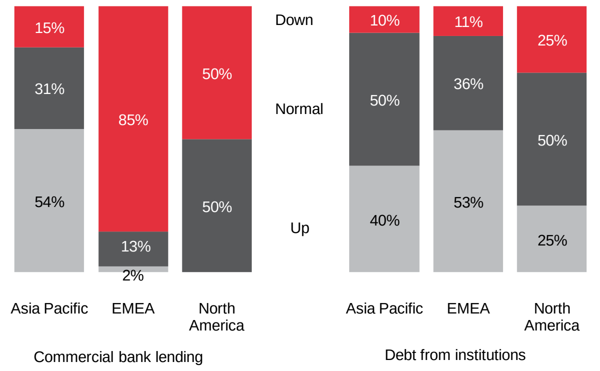
When asked further in the survey if loans are unable to be refinanced or extended, then investors continue to favour equity injection as their preferred solution. Partial loan repayment comes second, followed by consensual asset sales.

Equity investments in property loans likely to be part of solution going forward

Equity investors own involvement in bridging the overall market's financing gap is gradually increasing. 42% of investors acknowledge that they have invested in property loans or engaged in partial equity positions. This is up by over a third from the 31% in 2011 (Figure 30). And among those who responded positively, the balance between investment in loans and in equity positions has now shifted to the former. Further movement of investors into property loans seems a possibility, but may be limited as the proportion of those not involved due to a lack of capacity, as opposed to a lack of interest, is increasing.

Figure 28

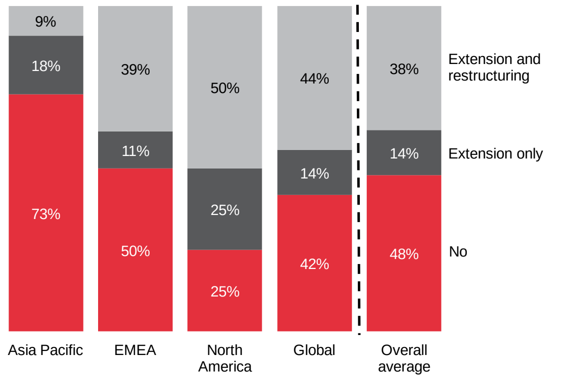
Expectations for availability of finance by region, 2012



Source: DTZ Research

Figure 29

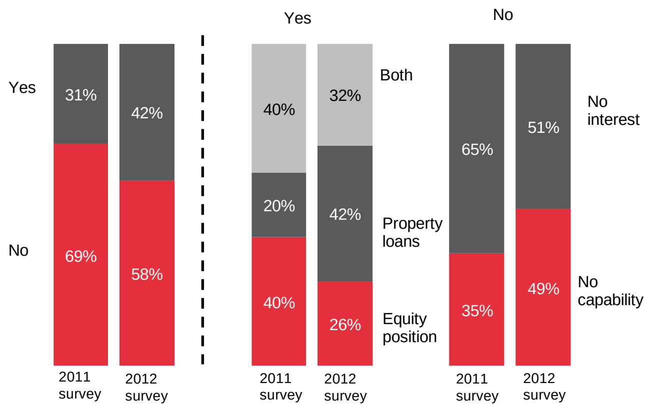
Investors' exposure to loan workout, 2012



Source: DTZ Research

Figure 30

Investors' exposure to loan and equity positions



Source: DTZ Research

Section 3 – Our key views

New European banking regulations are expected to accelerate deleveraging

In addition to the Basel III regulation mentioned above, banks have been confronted with the European Banking Authority's (EBA) stress testing results. Furthermore, the European Central Bank has announced the LTRO (a 3-year term loan facility), which allows banks to deleverage over a longer time period. In our view, this should cushion the impact of the EBA 9% capital reserve requirements for July 2012. This rule is estimated to require European bank deleveraging up to EUR3tn[2].

Rules will increase the UK debt funding gap

Based on the assumption that the commercial real estate loan book will be impacted in the proportion similar to the overall loan book, the European debt funding gap (the difference between maturing legacy debt and new debt available to replace it) will increase by up to 50%, i.e. an additional USD102bn bringing the total for Europe to USD226bn. Despite this increase, new equity capital and non-bank lending capital is expected to be sufficient to bridge the gap over the next three years (Figure 31).

The impact will be rather less in the UK (Figure 32). But despite this limited impact, we re-emphasise that the UK continues to have the largest absolute debt funding gap of any country covered. A gap, moreover, which has remained at between GBP 25-30bn since at least May 2011. Here too we can expect the impact of the new rules to accelerate the rate of deleveraging.

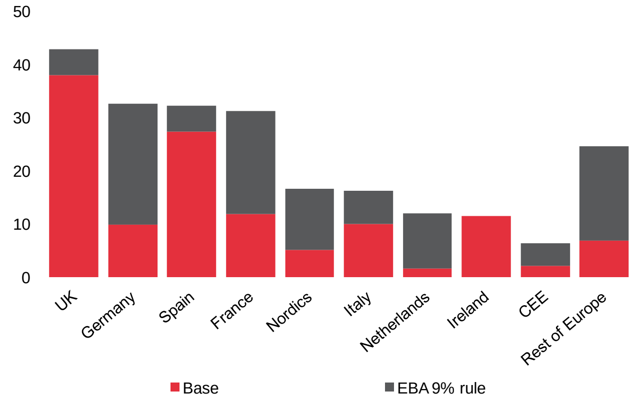
Insurers are on track to bridge some of the gap

More pension funds and insurance companies have been entering the market on the refinancing side or stepping up their new lending activity. Based on this activity, we expect them to provide an additional USD150bn (EUR110bn) of new lending capacity over 2012-14. This capacity on its own would be more than sufficient, if successfully placed in Europe, to fill the debt funding gap (Figure 33). The UK appears as the most attractive and interesting place for entrants, but especially for new North American institutions. This would be fortunate for UK property given that it has the largest funding problem.

[2] DTZ Foresight, 2012 Global Outlook, 9 February 2012

Figure 31

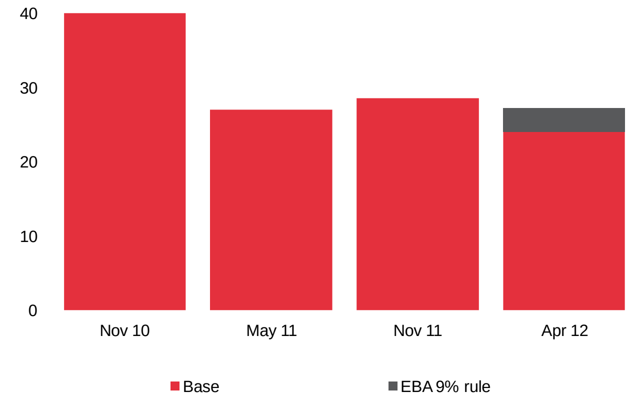
European debt funding gap, 2012-14, USD bn



Source: DTZ Research, Barclays Capital

Figure 32

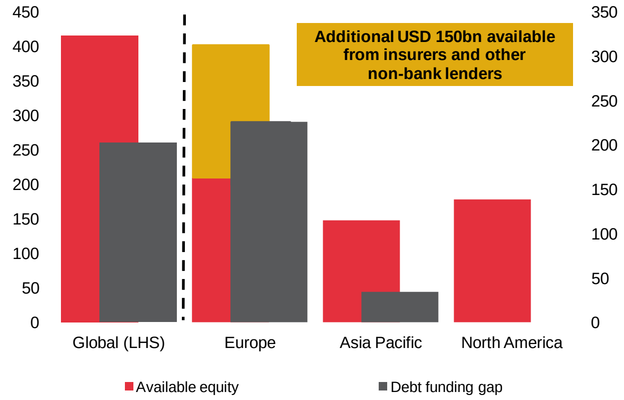
UK debt funding gap, 2012-14, GBP bn



Source: DTZ Research

Figure 33

Debt funding gap and available equity, USD bn



Source: DTZ Research

Money into Property
UK 2012

Non-prime property is less risky than currently viewed

Investors are becoming more interested in non-prime property. But while secondary property is becoming more available, as reflected in our survey, there remains a pricing mismatch between buyer and seller. Investors are more risk averse and do not regard pricing to have adjusted sufficiently.

This stems in part from a negative consensus view on non-prime which assumes that poorer property is more vulnerable to increased voids, which in turn push underlying loans into default. The expectation is then that banks' will dispose of defaulting collateral at high discounts, triggering further yield widening.

Our recent bottom-up analysis extending across all UK office markets challenges this view. While Grade C space makes up near 70% of total stock, its vacancy rate was found to be not only well below 5% but also well below that of both Class A and B (Figure 34). This makes it clear that the above consensus view is misleading, although this may not extend to the retail sector, where the occupier market is worse than for offices.

No evidence on leverage levels

Our forecast for secondary rental growth is only modestly negative for 2012, across all property types (Figure 35). As a consequence, stability of cash flow should be better than implied by the consensus view.

In addition, there is no evidence available which suggests that defaults on loans secured by non-prime properties are higher than on loans secured by prime properties. We suspect that many owners of non-prime properties, particularly Grade C property, did not load up on debt as heavily as other investors.

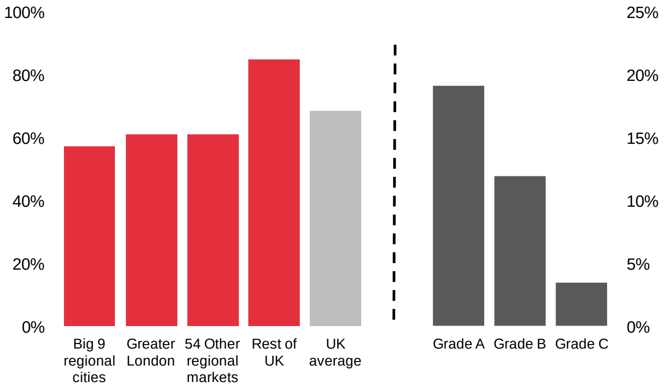
Yield spread tightens further in 2011

The yield spread between prime and secondary properties doubled between 2007 and 2009 (Figure 36). However, since 2009 this spread has tightened slightly, despite the prevailing negative consensus. The DTZ view is that low grade C vacancy implies low tenant defaults and downward rent pressure is limited due to low vacancy. There is no evidence that leverage on non-prime is higher than on prime. And while the yield spread doubled in the downturn, it has now tightened.

Thus our view is much less negative on non-prime than the consensus. As investors investigate the market more actively they should find opportunities for acquisition. This still may require a pricing adjustment, but not as deep as is currently anticipated.

Figure 34

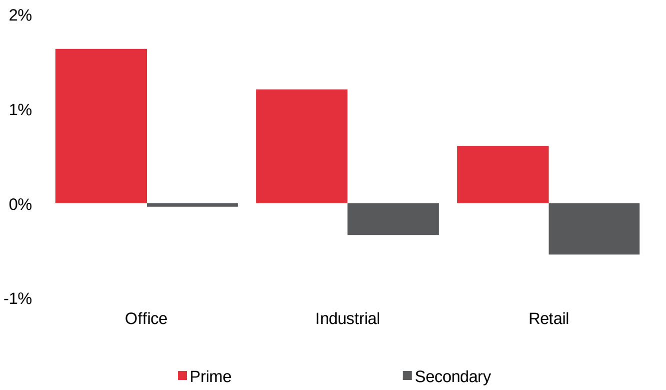
Grade C as % of stock vs. % of grade available



Source: DTZ Research

Figure 35

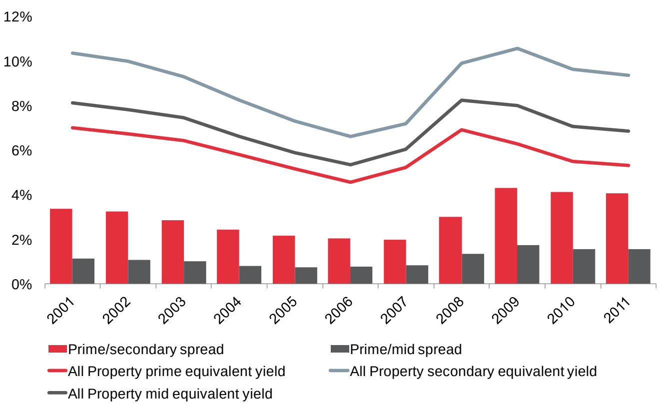
Prime and secondary rental growth forecasts, 2012



Source: DTZ Research

Figure 36

Prime and secondary all property yield spreads



Source: DTZ Research

Money into Property
UK 2012

Continued uncertainty triggers return of risk aversion

Despite a solid recovery in 2011, the outlook for 2012 remains unclear as political, economic and regulatory changes continue. The related uncertainty has triggered a return of risk aversion from both corporate occupiers and investors alike.

In Europe, sentiment deteriorated further over the final quarter of 2011. Despite efforts to contain the banking and sovereign debt crisis, there remain real concerns that one or more European economies will default on their debt leading to contagion across the region. In particular, after the Greek bail-out and the LTRO facility, concerns have shifted to the capacity of Italy and Portugal, Spain and Italy to reduce their budget deficits as announced (Figure 37).

Europe most affected by range of scenarios

To deal with this remaining uncertainty, we continue to consider alternative economic scenarios. The base case assumes a slow and steady recovery. After the recent downgrading, eurozone GDP growth forecasts remain weak in this base case scenario. This scenario assumes no disorderly default in the eurozone. The probability for the base case is low at 45%. The high level of global uncertainty is further confirmed by two downside (oil price spike and China hard landing) and one upside scenario (corporate reawakening). Probability for each of these is at 10%. As a result, the eurozone shows the widest range of GDP forecasts of any region across the scenarios.

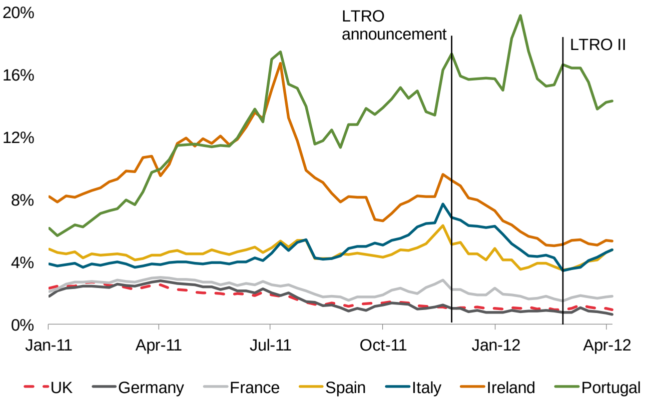
However, the downside is best represented by the eurozone break-up scenario, which assumes up to five countries leave the eurozone. It has a 5% to 25% probability. The impact of the eurozone break-up scenario is more severe on Europe than any other region in the long term (Figure 38). It also has a significant though lesser impact on the UK.

Significant impact across UK markets in downside scenario

Unsurprisingly, as a result European property markets show larger downgrades in capital values over 2012-16 than other regions in the downside scenario (Figure 39). And in the industrial sector returns will actually turn negative. In the UK, although the downgrade is not as acute, it is still significant. The sectoral impact varies between regions; and in the UK office and retail fall proportionately, while industrial is reduced almost to no growth.

Figure 37

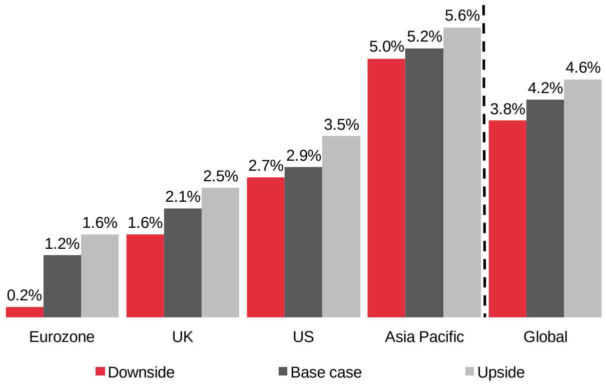
Five-year government bond yields



Source: Bloomberg

Figure 38

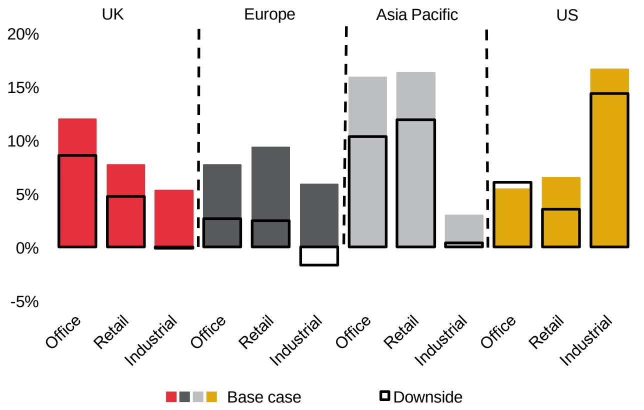
Annual average GDP growth in %, 2012-16



Source: Oxford Economics

Figure 39

Prime capital values 2012-16, cumulative % change



Source: DTZ Research

Money into Property
UK 2012

Invested stock forecasts

Moderate growth forecast to continue, while downside scenario causes contraction in 2012

Based on our analysis of equity and debt flows across the globe, we forecast global invested stock to continue to rise in the next couple of years with moderate growth of 4% in 2012 and 6% in 2013 (Figure 40). This compares to 7% growth in 2011.

However, in the downside scenario, global stock is projected to decline by 7% in 2012 with the three regions expected to register declines, from -1% in North America to -14% for Europe.

UK stock growth forecast to pick up in 2013

With little or no rental growth, capital growth under our base case will be weak in 2012, and, in combination with minimal development outside Central London, stock growth will remain flat at 0.4%. Capital growth will not recover much in 2013 either, but development will be more active, and together with some capital growth raise invested stock by 3% (Figure 41).

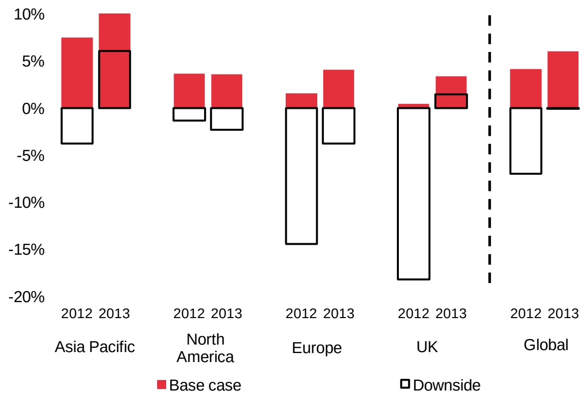
As in Europe more generally, UK stock is hit hard in the downside scenario (values are marked to market in this approach). Within the latter, however, the UK recovers positively in 2013, and is the second best performer to Asia Pacific.

Forecast regional invested stock growth rates vary significantly

The pace of the invested stock growth under our base case will be significantly different across the regions, with Asia Pacific expected to post the fastest rate in 2012 (7%) and 2013 (10%), boosted by a strong stock growth (Figure 42). In North America, the ongoing recovery of capital values will be the main driver of the invested stock growth (4% each year) as development pipeline remains limited in this region. In Europe in particular capital growth has largely taken place already, but an increase in physical stock will ensure overall growth improves in 2013.

Figure 40

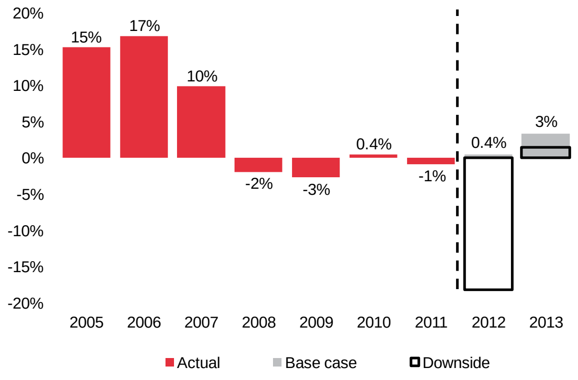
Forecast growth in invested stock



Source: DTZ Research

Figure 41

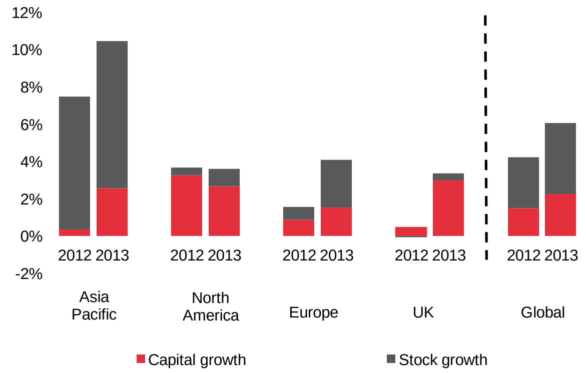
Forecast growth in UK invested stock



Source: DTZ Research

Figure 42

Forecast growth in invested stock by region and its constituent parts



Source: DTZ Research

Money into Property
UK 2012

Investment volume projections

Global investment volumes expected to fall in 2012

Our expectation for 2012 is for global investment volumes to decrease due to lower activity in Europe and Asia Pacific, partly offset by moderate growth in the US. Investment volumes in Europe grew strongly in 2011, but activity in 2012 is expected to be impacted by weaker sentiment and the broader economic slowdown. Global investment activity is forecast to drop back to USD365bn in 2012, followed by a rebound in 2013 to USD395bn (Figure 43).

In the UK activity is expected to recover

In a departure from Europe as a whole, DTZ expects UK investment volume to increase in 2012 (Figure 44). The first quarter's level of activity, which totalled GBP7.5bn, is expected to increase into the second half of the year, so that the outturn reaches GBP34bn, a 12% increase on 2011. Increased investment activity in secondary property, accompanying continuing activity with prime, will drive up volume. The increase in activity will outweigh a likely fall in values in secondary property. And finally, transaction volume in 2013 will continue to grow, to reach GBP37bn.

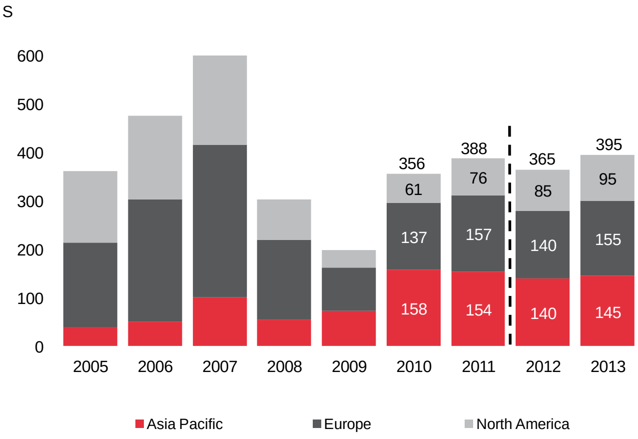
UK markets offer good value as European Fair Value Index stabilizes

The DTZ Fair Value Index™ score for Europe stood at 46 at Q1 2012, reflecting the fact that few markets offer investors the prospect of clear out-performance. But, opportunities are still plentiful across Europe, with all 20 UK markets in the hot and warm categories. There are no more cold markets in the UK (Figure 45). In short, prime property across all UK sectors is providing investors with a relatively attractive proposition in a challenging economic climate.

Other selected European markets in Germany, CEE and Nordics region offer significant growth potential also. While the retail and industrial sectors are identified as the most attractive property types.

Figure 43

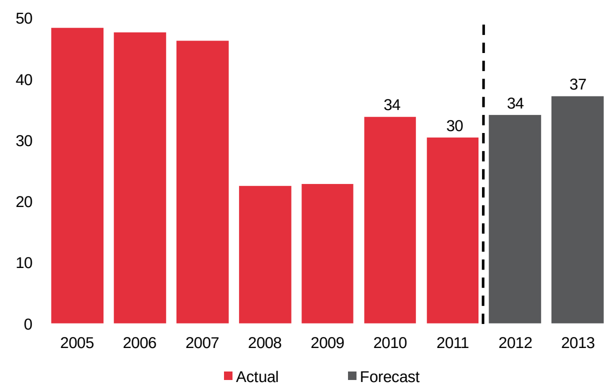
Forecast of global investment volumes, USD bn



Source: DTZ Research

Figure 44

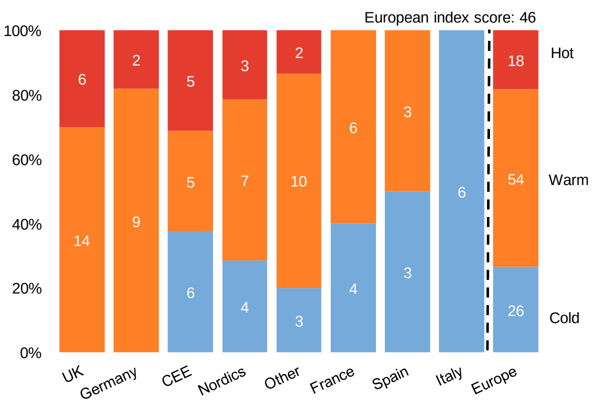
Forecast of UK investment volumes, GBP bn



Source: DTZ Research

Figure 45

Fair Value Index ratings, Q1 2012



Source: DTZ Research

Appendix

Definitions

Invested stock refers to the value of investment grade commercial real estate held by different investor groups. The total value of the real estate capital market is defined as the total value of commercial real estate debt outstanding plus the total value of equity in commercial real estate holdings.

Private debt refers to the total outstanding loan value to the real estate sector that is not held in the form of listed financial securities. Loans granted and subsequently securitised prior to maturity are not included in this data. Private debt relates to the activity of all participants involved in the provision of commercial real estate loans including institutional lenders, commercial bank lending and insurance companies.

Public debt refers to the total outstanding loan value to the real estate sector held in the form of listed financial securities, i.e. property company corporate bonds, covered bonds with commercial property as collateral and commercial mortgage backed securities (CMBS).

Private equity refers to the equity proportion of the commercial real estate holdings of insurance companies, pension funds, private property companies, high net worth individuals and unlisted property vehicles. The debt proportion has been stripped out by applying a different gearing ratio for each investor group.

Public equity refers to the equity proportion of the commercial real estate holdings of listed property companies, REITs and other listed property vehicles. The debt proportion has been stripped out by applying a different gearing ratio for each investor group.

Gearing (or LTV) ratio is defined as debt/(debt+equity). The various investor groups have different gearing levels based on their risk profile, investment strategy, as well as their capital sources.

Investment volumes refer to the total value of investment transactions in the commercial direct real estate market. Hotel and residential deals are excluded from the analysis.

Money into Property methodology

Private debt allocation In order to capture the value of commercial real estate loans issued by domestic banks to fund cross-border investment and likewise by foreign banks to fund domestic property investment, private debt is allocated based on the pattern of cross-border investment transactions.

Cross-border allocation in invested stock The value of the commercial real estate held by different investor groups is allocated based on the location of the property rather than the origin of investor.

Currency conversions Invested stock and its components are converted by using the average quarterly exchange rate for each year under review.

Transaction volumes

Transaction volumes represent the buying and selling of property and are independent of stock. For example there can be a lot of transactions, but if price does not change and the property is already in the invested stock figures then there will be no change in invested stock. The only change is the owner of the property, which could trigger a change in quadrant (say public to private). Higher transaction volumes do indicate interest in the market, they tend to imply more development activity or capital values are rising.

Money into Property
UK 2012

Fair value methodology

The DTZ Fair Value Index TM was launched in August 2010 and has now been rolled out for all 192 markets covered by DTZ forecasts.

Fair value is the value at which an investor is indifferent between a risk free return and the expected return from holding property, taking into account the extra risk of investing in the property asset class.

When the property price is at fair value, an investor is being adequately compensated for the risk taken in choosing to purchase real estate; similarly, when the property price is below the fair value price, an investor is being more than compensated for the risk taken in choosing to purchase real estate.

When buying at or below fair value, an investor does not necessarily buy at the bottom of the market.

Our fair value analysis focuses on prime assets and a five-year investment horizon, and hold for the market overall; individual transactions may provide opportunities and risks beyond the average market view.

For more information see the note DTZ Fair Value Estimates – Methodology and Examples at www.dtz.com.