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Real estate predictions 2012
New realities, new perspectives

Contents

Introduction 1

Economic conditions in the year ahead 3

Commercial property values to fall in 2012 4

Big rise in investors holding empty retail units 5

REITS will be the new UK property investment platform for overseas institutional investors 6

Times set to get even tougher in the lending market 7

London offices will be more positive than many predict 8

A challenging year for real estate fund managers 9

The green agenda could hit the unaware hard 10

Big push from investors into the Private Rented Sector 11

Key contacts 13

Introduction

Making constructive predictions in the current market is not easy. The huge uncertainty and overbearing gloominess makes it all too easy to predict the end of the world as we know it. However, the one thing that the past tells us is that however stormy the current conditions, things will improve and more often than not, create significant opportunities.

We cannot, however, ignore the current climate. Commercial property values are likely to fall during 2012 as secondary property is hit again by risk aversion and tenant default. Retail in particular is due to suffer with the March quarter date a likely trigger point for a raft of retail failures. Both lenders and borrowers will see little respite in 2012 with the year likely to see more banks withdrawing from the UK market and others reducing their balance sheets more aggressively than seen so far this cycle.

Away from the short term market dynamics there are other threats to owners and managers of property. The increasing legislation heading towards property fund managers is likely to add costs at a time when fees are already under pressure. The green agenda is becoming more visible with significant implications for those not fully considering the forthcoming energy performance standards. The acceleration of building obsolescence will be a key issue.

However, in some cases we feel the pessimism is overdone and opportunities do exist. The fall in prices will throw up value for those with cash and the nerve to buy. London offices in particular have seen a huge negative shift in the outlook over the last few months with take up expectations and rental growth forecasts heavily downgraded. We believe that this bearishness will create opportunities for purchasers and for developers.

We hope that you find our predictions for the year ahead informative and useful. Please contact us with any questions, comments or predictions of your own to share!

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Economic conditions in the year ahead

Anaemic economic growth is the expectation for 2012 but this will provide opportunities for those with cash, nerve and a long term perspective. High quality safe haven assets will continue to be in high demand, especially those which can provide a positive yield.

The UK ends 2011 facing a possibly severe downside shock to export demand and a renewed squeeze on banks and on credit supply. The central view for most forecasters is that the UK will either stagnate or dip into recession in the early part of 2012. The economy is, at best, expected to show anaemic growth in the latter half of 2012 as household spending picks up and the crisis in the Euro Area abates.

Such views are not held with great conviction. Most economists see the risks to their forecasts as lying squarely on the downside. The range of possible outcomes for the UK economy in 2012 is wide. A break-up of the Euro Area would probably spell a deep UK recession – a prospect few economists are currently forecasting but most see as a real possibility. Equally, a dramatic policy response from the European Central Bank could swing market sentiment positively and bolster prospects for the Euro Area and the UK.

As happened in late 2008, market participants are adjusting to the crystallisation of a major downside risk to global growth – a Euro Area sovereign and financial crisis that threatens the Single Currency. As in 2008, the risk is that things will get worse. We would expect market participants to respond in three ways:

Firstly, they are waiting to be convinced that policymakers have the determination and the policies to preserve the Euro Area. Following the failure of Lehman Brothers in September 2008 it took over five months, until March 2009, before the equity market revived, as it sensed that policy easing would save the day. It wasn't until June 2009 that economists joined in and started raising their forecasts for GDP growth. Financial markets are less confident today that European policymakers will do whatever it takes to save the Euro.

Secondly, without a decisive resolution to Europe's debt crisis much of the UK private sector is likely to be stuck in defensive mode. Capital expenditure, M&A and hiring will suffer. Cash preservation and cost control are likely to be the order of the day. For those with cash, nerve and a long term perspective there will be opportunities to take market share and to acquire assets on the cheap. High quality safe haven assets will be in demand, especially those which promise some level of yield.

Thirdly, the market will focus on those things of which it can be reasonably sure. UK inflation should drop like a stone in the first half of 2012 as 2011's VAT rise and soaring commodity price rises fall out of the published numbers. The Bank of England sees CPI inflation falling from around 5% in late 2011 to 1.5% by mid 2013. Lower inflation would provide some support to the hard pressed UK consumer in 2012. Volatility and uncertainty are likely to be here to stay. Coupled with falling inflation, this points to the Bank of England undertaking further Quantitative Easing in an attempt to bolster growth. Monetary policy is likely to remain ultra loose. Without a convincing upturn in growth prospects, and with the Bank of England buying more of them, gilt yields could well head lower in 2012.

The UK's recovery in 2010/11 was far weaker than those of the 1980s and 1990s. This is consistent with international experience which shows that recoveries after banking crises are slow and faltering. What always looked like a slow burn recovery may well turn into renewed recession. As in 2008/09, we think the best guide to whether policymakers have found the right response will come from financial markets. What will be the signal to turn more bullish on growth and risk assets? For us it is a marked easing of financial and sovereign stress in the Euro Area.

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Commercial property values to fall in 2012

The weight of money from overseas and UK investors will continue to support prime commercial property pricing, but risk aversion will mean further value falls in secondary real estate.

With the global economic environment promising further turbulence in 2012, competition for safe haven property assets will remain fierce. There are very few property markets that can match prime UK property for transparency, liquidity, or quality of stock, and values for the best properties will therefore be supported by an increasingly disparate and globalised demand base.

Indeed, all but the biggest domestic investors will find it harder to compete with overseas buyers such as Sovereign Wealth Funds, or established pensions providers, especially as Sterling's relative weakness means that these institutions continue to benefit from significant pricing advantages when considering UK property priced in their own local currencies.

On balance however, solid demand for prime property is unlikely to be enough to counteract softer demand for the much larger pool of secondary properties, meaning that an overall fall in property values is expected. The same desire for risk aversion that drives the prime market has led to both a lack of investor demand for secondary properties, as well as difficulties in financing it. Weak occupier demand and higher vacancy rates will mean falling rents. Values will come under sustained downward pressure as a result.

Consequently, those seeking the higher returns traditionally offered by such properties may have to pursue less traditional real estate investment classes. This is likely to involve a move towards alternative assets, which include residential development, student housing, serviced apartments, care homes and, with an ageing population, we are seeing an increasing interest in assets such as crematoria and mortuaries!

For others, 2012 will be another significant buying opportunity for traditional real estate. Those with equity, expertise and nerve will be able to access the market at a pricing level which is likely to provide the bedrock for outperformance in the short and medium term.

Big rise in investors holding empty retail units

With Deloitte retail experts forecasting zero growth in retail sales this Christmas or even until 2013 at the earliest, and the online medium taking a greater share of sales, the future of the High Street will come under increasing focus in 2012.

Retailers will be under huge pressure in 2012. Economic turmoil and technological advances are combining to reshape the retail landscape faster than some are able to react. The sector is experiencing short term retailer pain, together with long term structural changes. We estimate that over 40% of all retail sales by value are now digitally influenced.

Consumer demand has been softening through 2011 as the impact of the government's debt reduction strategy has started to take a bite out of household spending. 2012 will be the first full year to feel the impact of the spending cuts and it is unlikely that there will be any growth in retail sales during the year. Indeed, Christmas is likely to have been a difficult period for retailers and it is certain that some retailers will have struggled with their quarterly rent bills due at the end of December. However, the real crunch is expected to come at the end of Q1 2012 when cashflow levels are at their lowest and there are likely to be a number of significant casualties.

Those retailers that do survive will be looking for further cost savings and exiting underperforming stores is likely to be high on the agenda. This will put even further pressure on the weaker, secondary locations where re-leasing prospects are weak.

We will be releasing a series of reports on *The changing face of retail* in 2012. The first, *The store of the future* due in January, will discuss how physical retail space and the experience it provides will need to adapt to the multi-channel environment. Further research will cover topics such as *Rightsizing the Retail Estates*, investigating the challenges involved in defining and reconfiguring the store portfolio. These themes will be key to both retailers and investors/developers as the market and shift in shopping habits continue to alter the retail environment.

RETAIL UNIT
TO LET
PRIME RETAIL UNIT
TO LET

REITs will be the new UK property investment platform for overseas institutional investors

New Real Estate Investment Trusts (REITs) legislation will prompt a number of conversions and UK and overseas institutional investors will take advantage of the relaxations to use REITs as a UK property investment platform. Pressure on pricing for prime assets alongside the huge capital allocations to UK prime commercial property, may make significant stakes in one or more of the large REITs an attractive proposition for Sovereign Wealth Funds.

The UK REIT sector will start a period of significant growth during 2012. Proposed changes to the REIT regime are far-reaching and will greatly increase its attractiveness to a wider pool of property investors and providers of capital.

The government's hope is that the changes will encourage more capital to be invested in the UK built environment and, in particular, in residential property. It's likely that 2012 will see the UK's first Residential REIT.

From July 2012 the 2% REIT entry charge will be abolished, so access to the benefits of REIT status will be available for free. Those benefits include access to the global REIT 'brand' and to the significant sources of international capital allocated purely for investment in REITs. REIT status also gives enhanced shareholder returns through tax exempt rental income and capital gains, a competitive pricing advantage on corporate acquisitions and the ability to make divestment decisions in a tax free environment.

For some companies and offshore structures, a speedy REIT conversion will become a 'no brainer'. Existing REITs are likely to face increased pricing competition on corporate acquisitions of portfolios as the number of REITs grows.

Relaxation of the diverse ownership rule for certain institutional investors will enable a REIT to be owned by a small 'club' of institutional investors, or potentially by a single institutional investor. The 'white list' of institutional investors currently includes Sovereign Wealth Funds and UK pension schemes, insurance companies, unit trusts and open-ended investment companies (and each of their overseas equivalents).

These changes will open the door for overseas institutional investors to use REITs as a UK property investment platform. Ongoing pressure on pricing for prime assets alongside the huge allocations to UK prime commercial property, will make the ability to take significant stakes in one or more of the large REITs an attractive proposition for Sovereign Wealth Funds.

Other relaxations to the rules include a three year grace period from the diverse ownership rule for new REITs and allowing AIM and PLUS market (and overseas equivalent) traded companies to obtain REIT status.

The proposed regime changes for REITs could really change the UK property landscape as we know it. We expect the first new REITs to be straightforward conversions, allowing companies to take advantage of the beneficial tax structure. Others will follow when capital markets and economic conditions improve.

Times set to get even tougher in the lending market

The lending environment will remain tough with little appetite for new advances and some lenders exiting the UK market entirely. While banks will be looking to refinance borrowers where appropriate, they will be also looking to take control if necessary.

Whilst the UK lending situation had been gradually improving in recent times with more banks joining the list of active lenders, the impending June 2012 deadline for banks to meet new Core Tier 1 capital ratios has hit the market hard. An estimated €106 billion (Source: The Financial Times) needs to be raised by Europe's banking industry in order to comply, although this figure could rise further. Banks will either need to issue Core Tier 1 capital or reduce their balance sheets in order to bring their capital ratios into line.

The most recent and high profile victim of this is Eurohypo, one of the biggest and most consistent lenders to the property investment market. Its parent company, Commerzbank, announced in November 2011 that it would suspend all new business at Eurohypo as it looks to try to comply with European Banking Association guidelines. The bank has a property loan book of circa €72 billion.

We expect other banks to follow suit and also to begin to take a tougher stance with regard to their non-performing or covenant breached loans. The pressure to de-lever alongside a realisation that the market will no longer be working in their favour in terms of the level of writedown required will spur lenders to force sales of either the assets, or, more likely, the debt.

One glimmer of light for those seeking debt is Solvency II, the review of the capital adequacy regime for the European insurance industry. This could encourage insurance companies to lend to the property market rather than holding direct property investments. It is estimated that insurers' new lending to the UK property market could be between £9 billion and £25 billion (Source: Property Week – Property Finance 2012).

However, this lending pot will be focussed on prime long-term income that matches their liabilities and it is very unlikely that it will work its way into the wider property market. Also, whilst positive, it is some way off the estimated £118 billion real estate funding gap (the difference between existing debt secured on commercial property as it matures, and the debt available to replace it) in Europe. It is going to be another tough year for both borrowers and lenders.

London offices will be more positive than many predict

The negative sentiment towards the London office market is overdone, with low levels of construction, upcoming lease events in obsolete buildings and growth sectors driving opportunities for value increases and prime rental increases next year.

The last few months have seen a sharp turn-around in views on the state of the London office market with commentators and investors becoming increasingly bearish. We believe that this sentiment is overdone and 2012 will provide opportunities for investors and developers looking to buy and/or build.

While it is clear that demand levels in Central London are currently weak there are a number of reasons for investors to be positive. The reality is that the next two years will see a record undersupply of new office development. Admittedly, our latest *London Office Crane Survey* (Winter 2011) records a further increase in construction in the capital, but even with these new starts the delivery of new floorspace in 2012 is expected to be amongst the lowest on record.

At the same time demand from lease expiries, in particular the end of leases taken 25 years ago on what is now old, tired and 'old-tech' real estate, means occupiers are looking to upgrade their space irrespective of the weak economic conditions. In addition, a number of business sectors remain active and are looking for space to house their growing businesses. The TMT sector, new financial boutiques and those looking to service London 2012 are a few examples.

These tenants will be looking for new space at a time when the options are becoming more and more limited. This provides the opportunity for prime rental increases and development/refurbishment activity. Indeed, the negative sentiment is likely to reduce the level of new development activity planned for 2012, providing a chance for those with cash and, importantly, confidence in the quality of their sites, to enter the market at a time when competition will be limited.

However, while we remain more positive on the outlook for new space we are much less confident than some on the performance of secondary offices, even in London. Low levels of demand and high supply will mean falling rents and values over the next 12 months. Indeed, we believe a proportion of this secondary space is likely to be unable to attract tenants at any rent and owners will need to consider alternative uses as buildings become obsolete as offices.

Finally, our regional *Crane Surveys* are also beginning to highlight increasing instances of undersupply of new space with very little office development activity in any of the major centres. While we are not expecting a surge in demand or rents there will certainly be opportunities in 2012.

A challenging year for real estate fund managers

2012 is likely to be a tough year for real estate fund managers as they deal with the pressures of a challenging equity raising environment and a raft of forthcoming regulation. This is already driving lower fees on new mandates and with the increase in costs from regulation, will accelerate further consolidation in the sector.

Equity raising has been challenging over the last couple of years for all and only a very select group of the best managers have navigated the process successfully through to closing. This is unlikely to change in the year ahead and, indeed, for most managers, funds raised in 2011/12 will be smaller than the funds they are replacing from the 2007/8 vintage; for others, there will be no replacement funds at all.

A key part of this dynamic is that many investors are opting to grant managers less discretion, either seeking club deals, joint ventures or segregated mandates rather than pooled funds, as they look to retain greater control of the ultimate direction of their equity. In addition, the imperative for many banks to shrink balance sheets and rebuild capital buffers will see investments decline. Furthermore, the impact of Solvency II regulation, may increase insurance companies' ability and appetite to become real estate lenders, possibly at the expense of their holdings of direct property or funds.

Already, this is having a knock on impact on fee levels which will continue to come under pressure as fund managers compete for mandates and, even in pooled funds, fees will be ratcheted downward. Managers will need to manage their costs closely to live with these lower fee levels whilst at the same time find resources to manage new regulation impacting on their business (e.g. Alternative Investment Fund Managers Directive (AIFMD), Dodd-Frank etc). Those that can afford to do so, may seek to make a virtue out of necessity and invest to ensure that they have the systems and resources to meet the regulatory challenges, whilst improving investor reporting to maximise transparency. Others may seek to side-step the costs that new regulation will impose on investors by domiciling funds outside the EU or the US entirely.

The bottom line is there is likely to be further consolidation amongst managers and the disappearance of some well-known names.

The green agenda could hit the unaware hard

Legislative focus on the energy performance of property has been ratcheting slowly in recent years, but at the end of 2011 it suddenly entered uncharted territory with the passing of the Energy Act 2011. Property owners will now need to get to grips with the implications of minimum energy performance standards that are planned from 2018 or before. This will create opportunities for the savvy, but also pitfalls for the unaware.

The recent passing of the Energy Act could have a significant impact on the unaware. From 2018, or before if government so decides, it will become unlawful to rent out business premises or residential property which fall below the 'E' rating for energy efficiency. Make no mistake, the implications of this are significant – properties currently falling into the lower 'F' & 'G' bands of energy rating account for nearly a fifth of all stock. Moreover, the scope of the legislation is unclear in terms of the definition of 'letting' – at the moment there is nothing in the Act to limit the provision to those properties at which there is a pause in occupation during which improvement works can be carried out; in theory it could even apply to existing lettings (although we think this is unlikely to be the case on the grounds of basic practicality).

It is possible that quick-fire owners will simply look to sell out of environmentally poorer performing assets rather than interrogate underlying causes or face the hassle and expense of corrective action. Whilst, strictly speaking, this minimum performance threshold will only apply to the extent that properties can be improved through the Green Deal, for a good number of properties, raising the rating will prove uneconomic and impractical, with many in both the occupational and investment markets choosing to steer clear of the 'bad apples' as a result. It seems inevitable that sentiment regarding these properties will be weakened, and, although the cut off date is currently some way off, we anticipate the emergence of a material risk to value for those properties which become unlettable or struggle to raise their game in an increasingly energy-conscious market. So a strategy – potentially involving exiting certain holdings – should be considered well in advance.

It is certainly the case that asset management strategies, taking account of leasing and service charge provisions concerning liabilities for statutory compliance and the recoverability of cost, will need to be substantially re-tuned. Also worth considering is the possible knock-on effect of these sales, that the unsuspecting buyers could pick up properties facing the spectre of overnight obsolescence. Equally, prospective occupiers may see their ability to underlet space significantly impeded. Purchasers and prospective tenants need to reflect on this possibility in their due diligence process.

For those with the skills this legislation may drive an opportunity to purchase 'unwanted' property at discounted prices with a view to using asset and property management expertise to reposition them and therefore enhance – or rejuvenate – their appeal to the general market.

This is an issue that prompts the wider question: 'Do you really know what you own?' Current market conditions are very likely to expose 'holes' in weak portfolios and it is key to monitor and 'health-check' property holdings regularly to stress-test issues such as a building's functional, environmental and locational obsolescence, changing sector/industry dynamics, tenant's financial health, as well as sustainability requirements and changes to legislation, especially in relation to the allocation of liabilities in leases and the recoverability of capital expenditure through service charges.

Big push from investors into the Private Rented Sector

A major restructuring of the ownership of residential property is under way. Foreign investors are dominating new home purchases in London, institutional investors are showing real interest, and a lack of affordability is pushing more people into the rental market – all at a time when new household formation continues apace.

Despite the government's attempts to get the market moving it looks like 2012 will be the point where it is recognised that house ownership is no longer the sole preserve of the UK private homebuyer. While buy-to-let has been around for some time and, more recently, a huge wave of overseas buyers have entered the London market, the UK residential market has continued to be dominated by individuals buying a home.

The UK's housing stock is already under significant pressure and with 4.1 million new households forecast to be created over the next 15 years (CLG data), the pressure on housing will become even greater at a time when residential construction is at its lowest level for over 50 years. With acute affordability issues and, crucially, the shortage of debt finance not expecting to ease any time soon, households will continue to be forced into the rental market and, as demand increases, rents will continue to grow.

What we are beginning to see is that residential is becoming the asset class of choice across all parts of the investment market, attracting a wide variety of non-traditional purchasers looking to get exposure to this previously overlooked sector.

This is driven by a number of reasons, not least because the performance of other types of real estate looks weak. Changes to tax regulation, the expected increase in renters and rents, greater general acceptance and, more importantly, better understanding of residential investment as an institutional investment tool are all key drivers. 2012 may even be the year the UK gets its first residential REIT and we expect it to be followed by a number of others.

At the same time the recognised need for greater levels of affordable housing means that Registered Providers are becoming ever more important owners of UK housing stock. Indeed, as our *London Residential Crane Surveys* have shown over the last few years, they have been propping up housebuilding levels, accounting for nearly half of all construction across Greater London this year.

The landscape for residential property is changing and 2012 is likely to see a number of new players entering the market. As well as being the year that residential is accepted as an institutional asset class, this could be good news for the supply of housing in the future.

The Real Estate Group

The Real Estate Group at Deloitte consists of over 900 professionals, with specialist real estate knowledge across all areas of the business. The breadth and depth of our practice allows us to assemble expert teams with specific skills to address our clients' needs.

If you would like to discuss any of the issues raised in this report, or our real estate services, then please get in touch with your usual Deloitte contact, or one of our industry experts as listed on the next page.

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