Investment Bulletin

SAUNDERSON HOUSE

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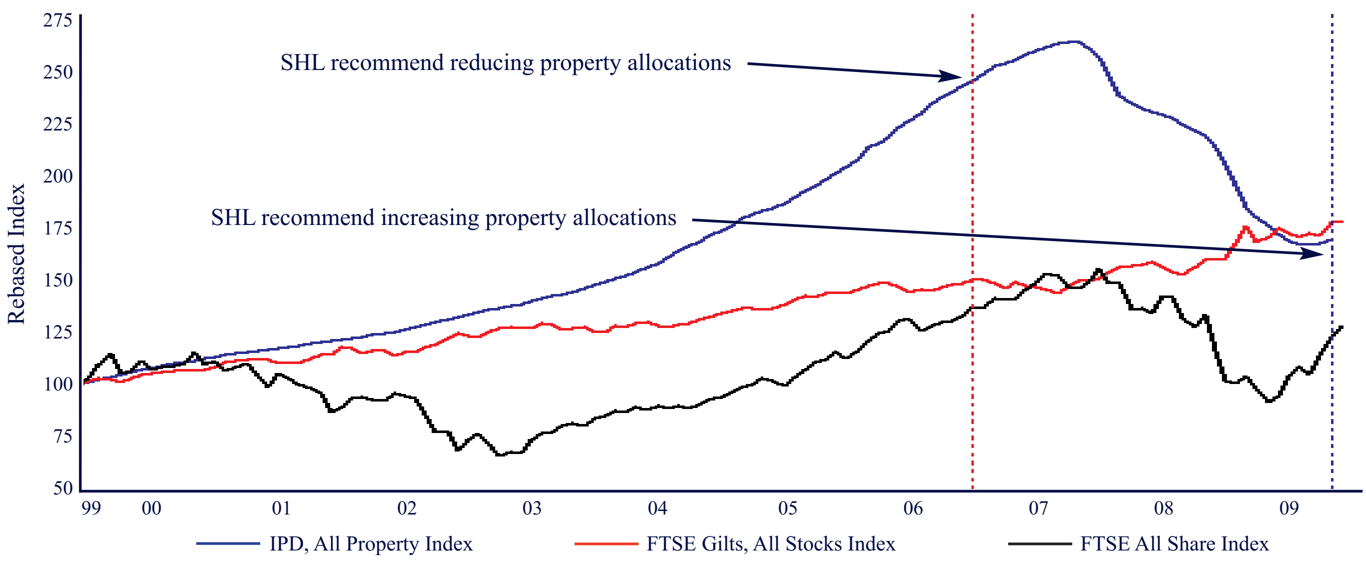
CONFLICT-FREE FINANCIAL ADVICE

UK COMMERCIAL PROPERTY - TIME TO MOVE BACK IN?

Investors in UK commercial property have had a torrid time over the last two and a half years. According to data compiled by Investment Property Databank (IPD), UK commercial property prices have fallen by almost 36% from their summer 2007 peak. This correction has been much larger than those experienced in either of the last two property bear markets, which were triggered by the recessions of the early 1980s and 1990s. Having recommended significantly reduced allocations to commercial property in late 2006, is it now time to move back in?

To answer this question we need firstly to consider the causes of the steep falls in commercial property prices. Put simply, prices were driven to unsustainable levels during the period of easy credit market conditions that prevailed in the years before the financial crisis. The attractions of commercial property - a tangible asset with steady cash generation - made it ideal for purchasers using leverage. Property speculators, developers and investors took full advantage of plentiful and cheap debt funding to gear the returns from both residential and commercial property, here in the UK and overseas. From 2003 onwards, UK commercial property prices climbed strongly and returns comfortably exceeded those from both equities and bonds (see chart below). This encouraged more optimism, more borrowing and more leveraged purchases. At its low point, the yield on the IPD Index touched 4.3%, signalling perhaps that investors were counting on continuing strong capital returns. Such investors were disappointed.

UK commercial property values have come back down to earth



Source: Reuters EcoWin. All series rebased

Having examined the causes of the correction, we must secondly consider whether property prices have still further to fall. Here the key factor, in our view, is yield. The sharp fall in prices has driven yields up once more and, at close to 8%, they are now higher than at any time since 2003. Moreover, with the Bank rate at just 0.5%, the relative attraction of this yield is even more marked. These factors provide us with the conviction to recommend that clients now increase allocations to commercial property, albeit in well established funds of predominantly prime UK properties. This is because we suspect that the recession may have further pain to inflict on property that is secondary in location, quality or strength of covenant. We believe there are a number of well diversified funds of high quality property through which to implement this portfolio reallocation.

If you would like a copy of our October 2006 note, *'UK Commercial Property – High-rise valuations will come back down to earth*', do please contact us at the address detailed below.

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