

# Property Investment

Where's the supply going to come from?



## Property Intelligence

Spring 2010

# Executive Summary

Commercial property values have risen over 10% since their low point last Summer and prime property has seen even larger increases. There is strong demand from investors but a marked lack of supply. This bulletin examines the potential supply of investment property – what is owned and by whom, its quality, how much is likely to be sold and when it might be sold.

Institutional and private investors are keen buyers rather than sellers of property. The main potential sources of supply are therefore the banks and the public sector.

## The Banks – Stick or Twist?

### The Problem

- The total amount of outstanding bank lending to UK real estate is huge, at over £220 billion (even excluding CMBS), and as a result of the exuberance of the investment boom during 2004-2008, the banks have a considerable exposure to secondary property.
- Although a high proportion of properties on banks' loan books will be in 'technical' breach of their loan-to-value covenant most are not in outright default. In such cases, banks are generally taking little action as long as the rental income covers the interest charges.
- Where some or all of the interest or principal is not being paid, the bank can either force a sale of the asset, or attempt to increase the income generated.
- The decisions made by the banks on how to deal with their 'distressed assets' will have a major influence on the commercial property investment market over the next few years.

### The decision-making process

- **Property-specific factors** – the quality of the physical asset and its covenant strength are key. In the current market, prime assets are attracting significant interest and selling an asset now may therefore be an attractive option. However, at the more secondary and tertiary end of market, there is little buyer interest.
- Also important are the scope to increase the income of a property through better management, the level of outstanding debt relative to the current property value, and how close a loan is to maturity.
- **The policy of individual banks** – banks will formulate strategies for their 'distressed' portfolios based on how they view the outlook for the property investment and occupier markets, and in particular on how much longer they think the current high levels of investor demand for prime and good quality secondary property will last.
- Policy regarding future exposure to the commercial property sector will also be important, and will be influenced by the financial position of individual banks. For most banks, the process of planning what to do with their problem assets is now completed. Some banks are taking a long-term view, and have placed the long-term relationship with the borrower at the core.
- **Market-wide factors** – The banks will react to any changes in occupier and investment market conditions.

### What will the banks do?

- Banks are more likely to sell any prime properties they hold that are distressed, as this is where investor demand is currently high. However, the actual amount of property released will be limited, as prime assets are less likely to be distressed than secondary/tertiary assets.
- 2010 will see a rise in the number of properties entering a default situation, in line with continued challenging conditions in the occupier market. The majority of 'distressed' properties will be of secondary/tertiary quality, of which the banks lent substantial amounts of money during the later stages of the property boom, as these will have the weakest covenants and be harder to re-let.
- In some cases, a bank will become a 'forced seller', although this should be the exception rather than the rule. In most cases, the banks should be able to turn on and off the tap of properties coming to the market as they see fit, meaning a steady flow of properties coming to the market over a period of several years.
- There is likely to be an increase in supply coming to the market during 2010, and this will be a broad mix of quality but a flood of properties entering the market is unlikely.

## What does the public sector own and what will it sell?

- The government estate is estimated to have a total book value of £386 billion. Of this total, the central government estate accounts for around a third, with the remainder comprising local government property, of which around half is council housing.
- HM Treasury's Operational Efficiency Programme (OEP) which was launched in 2009 recommended the establishment of a new central property function and estimates the potential for savings from improved efficiency over the next 10 years to be around £20 billion in receipts from property disposals (excluding council housing).
- Running in parallel with the recommendations of the OEP, in the 2009 budget the government detailed plans for the sale of £16bn of assets over the period 2011-2014. Central government's share of this total is £5bn, £3bn from real estate, with local authorities expected to find £11bn.
- Alternatives to straight-forward asset disposals are reportedly being considered by the government such as state-sponsored REITs and encouraging sale-and-leasebacks and other joint venture agreements with the private sector.

### Local Authorities

- Most local authorities will be forced to consider further outsourcing, sharing of facilities between authorities, cutting services where possible, hot-desking, home working and how they can reduce the space they occupy and use it more efficiently. This may well mean investing in new or refurbished buildings with larger (more flexible) floorplates and disposing of older, smaller, less efficient buildings.

- Establishing the business case for such "invest to save" initiatives will be difficult where disposal values are low. But the scope to reduce property running costs is significant, especially where high maintenance backlogs exist. Increasing energy costs and carbon costs will also play a part in decision making.
- A survey for the Audit Commission in late 2008 found that 'over 40% of councils rated their portfolios in poor or very poor condition'. Much of it, therefore, will be more suitable for major refurbishment or redevelopment and this is not a good time in the market cycle to be selling secondary property or development sites.
- Conversely, rather than selling off buildings or sites, local authorities may be more likely to consider acquiring property sites and redeveloping or refurbishing existing buildings, taking advantage of lower prices and low interest rates, to achieve longer term floorspace efficiency aims, so saving on future rental payments.
- Some local authorities argue that freehold ownership gives them greater control over the use of buildings they occupy. A contrary view is that having to pay rent concentrates the mind and provides a constant pressure to use space efficiently.
- The opportunity for local authorities to sell assets they own and occupy, and lease them back, as a way of realising capital receipts, has its attractions, but may be resisted due to the poor state of the market for secondary property. However, newer, well located property, subject to a long lease back to a local authority, would be attractive to investors and high prices would be payable in the current market.
- Tension is emerging between government plans to make fundamental long-term changes to the way in which public property is owned and managed and the timescale pressures to deliver savings and receipts from property disposals in the short-term.
- Local authorities, health trusts and central government departments are not likely to immediately increase disposals significantly above current trend levels. But with deep cuts to government spending on the horizon, the need to make more efficient use of public sector property is becoming a priority.

- A renewed drive to improve property asset management may result in a significant increase in disposals over the medium term, but the types and locations of sites that become available will have only a limited impact upon the commercial investment market. However, we do expect to see an increase in sale-and-leaseback transactions and other joint venture agreements with the private sector.

## Private Sector Sale and Leasebacks

- In the present climate, where many corporates are under pressure to improve the position of their balance sheets, a sale and leaseback has the potential to raise debt finance which might otherwise be difficult to obtain.
- We are optimistic that this will provide a valuable source for investors over the next few years, although there are many potential reasons why individual organisations may be reluctant to enter into such arrangements. For investors, the quality of portfolios owned by corporates is a problem, and this will be the key limiting factor. We can expect some investment supply to come forward from this source over the next few years, but not a significant amount.

## New Development (Funding & Forward Sales)

- The collapse in development activity over the last two years has been dramatic and it will take some time for development to become an attractive and financeable prospect. Even once schemes are under way there will be a time lag of typically 1-2 years at least before a development is completed.
- Therefore, only a very limited supply of completed new build investment opportunities will be brought to the market over the next three to five years, but forward sales and forward funding opportunities will be more plentiful, once the occupier market has improved.

# Introduction

The recent rise in investment demand and capital values must be put in context as it follows a two year period of dramatic falls in capital values, which in turn followed a longer period of equally dramatic rises in capital values.

## Investment Boom

Between 2004 and 2007 a healthy, stable economy, low interest rates and plentiful credit helped create a property investment and development boom, (but not an occupier boom). In the three years to the peak of the market in June 2007, real estate bank lending increased 75%, commercial property capital values rose by 36% (IPD), and there was a 50% increase in commercial construction orders (ie development activity), yet rental values increased by only 9.5%.

Like most strong property upturns investment and development activity overheated and for the latter half of 2005, 2006 and early 2007 property yields became increasingly out of step with the cost of borrowing and the yields on medium/long dated gilts.

## The Recession

The credit crunch which started in 2007, followed by a long and severe recession in 2008 and 2009, necessitated a huge monetary and fiscal stimulus to avoid the recession turning into a depression. This has resulted in very low interest rates, a steep fall in the value of the pound relative to many currencies, particularly the Euro, and a rapid deterioration in public sector finances.

The overheated property boom, not surprisingly, reversed, capital values fell 45% overall from peak to trough, investment and development activity collapsed and banks ended up with charges over a large amount of property where lending terms were breached by borrowers.

By Spring 2009, equivalent yields had increased 400 basis points from the peak of the market two years before. Some investors thought the market had over corrected and that there was an excellent long term, once-in-a-lifetime, buying opportunity for good quality property, even though occupier demand was weak and rental values were falling. For many overseas investors the attraction of low capital values was accentuated by the fall in the value of the pound. Property investor demand, therefore, increased and was further stimulated by the high yields available relative to the low interest rates available on alternative investments.

## Limited Investment Supply

The problem that investors faced, and still face, is a limited supply of appropriate investments. No-one wants to sell close to the bottom of the market unless they have to. Institutional and private investors, having realised the favourable pricing, are keen buyers rather than sellers and are holding on to stock. The main potential sources of supply are therefore the banks and the public sector.

The fall in values was so great that banks cannot afford to crystallise large losses and so are holding onto property, actively managing it until there is a marked improvement in market prices. On existing loans to investors where rental income matches interest payments, banks are turning a blind eye to breaches of loan-to-value covenants and not foreclosing.

This contrasts with what happened in the early/mid 1990's when the fall in capital values was much less and the banks' problems were less acute. Then banks did sell problem assets and investment supply did therefore increase. The initial rise in capital values that occurred in 1993 after the recession ended was partly driven by a marked fall in long dated gilt yields, but reversed in late 1994/1995 when

investment supply increased and gilt yields rose. Values then increased again when rental values started to increase in 1996.

Another source of possible property investment supply is the public sector. The inevitable cutbacks in public spending will mean pressure on local authorities and other parts of the public sector to sell assets that are surplus to requirements and to consider sale and leasebacks on properties they occupy in order to release capital.

But this is not likely to occur until after the election at the earliest and the public sector will be reluctant to sell assets at the bottom of the market. Also relevant is how many assets that are eventually put up for sale will be of appropriate quality to meet investors' requirements?

Demand is strong and supply is weak, so capital values are rising, even though rental values are still falling (although the rate of decline is now lessening as economic recovery is underway). How long will this demand supply imbalance continue, what are the prospects for an increase in supply, how marked might it be, what quality might the properties be, where could it come from and what overall effects might it have?

# The Banks – Stick or Twist?

## How much UK commercial property debt is there, how much might the banks wish to dispose of, and over what timescale?

### How much do banks own?

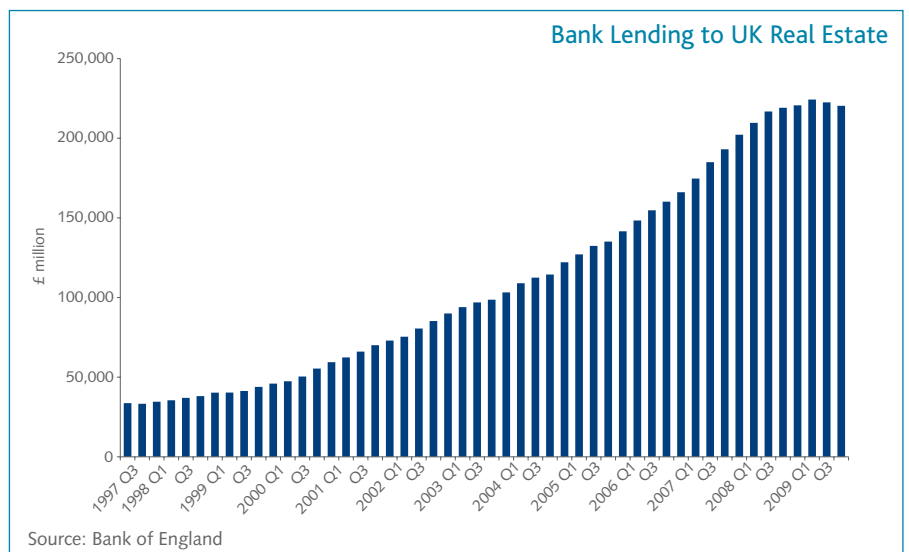
The total amount of outstanding bank lending to UK real estate has risen steeply over the last decade from £41.9 billion in Q4 1999 to £220.4 billion in Q4 2009 (Bank of England figures), as the chart illustrates. This is a staggering 500% increase over the 10-year period, compared with general RPI inflation of only 30%!

£220 billion is clearly a huge level of debt. To put it in context, the value of property in the IPD Annual Index (which includes the property portfolios of most UK institutional investors and major property companies) is currently around £120 billion. In fact, the total scale of debt is considerably bigger, as some sources of debt finance are not included in the figures, most notably that provided through CMBS.

Total debt may now have peaked. The rise in outstanding debt slowed markedly during the second half of 2008 and into 2009, and actually fell slightly in Q3 and Q4 2009, the first fall in outstanding debt over any quarter since Q4 1997.

Most of the debt has been used to fund investment in existing buildings, in contrast to the late 1980s boom, where a much higher proportion was used to fund speculative development. A very considerable slice of the commercial property market is now funded by the banks, and the decisions made by the banks on how to deal with their loan books will have a major influence on the market over the next few years.

But total bank lending should not be confused with the level of 'distressed assets' that the banks now effectively control. HSBC recently estimated that 85% of commercial property loans made in the last five years are in breach



of covenant. However most of these properties will have incurred a 'technical' breach of their loan-to-value (LTV) covenant rather than an outright default.

### What quality of asset do banks control?

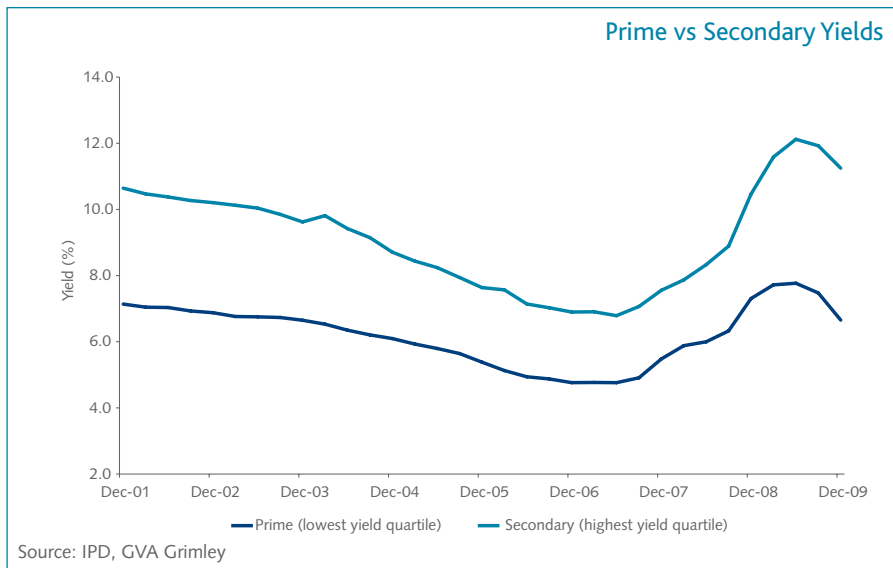
The commercial property boom brought about an unprecedented level of investor demand. With only a limited number of prime opportunities, investors became increasingly prepared to buy poorer quality stock. As values continued to rise, demand for such assets increased further, fuelling more value increases.

In a rising market, many investors became focussed purely on increasing exposure to the commercial property market, and paid little attention to the fundamental qualities of what they were buying. The banks were only too willing to provide financing for such investors in an environment of low interest rates, strongly rising capital values and a low pricing of risk.

The result was a compression of prime and secondary yields, as the first chart on the next page illustrates. When boom turned to bust, the yield compression reversed rapidly, with secondary yields moving upwards much faster than prime yields. We believe that the yield gap between prime and secondary is likely to remain wider than before the property boom.

As a consequence of the property boom, and the rush by investors to purchase secondary property, the banks now have a considerable exposure to such property, much of it originating from the period 2005-2007 when the level of investment transactions was at its peak.

We believe that property that could be considered to be of poor quality accounts for more than a quarter of the total UK commercial property outstanding loan book. Stripping out those loans which originated from before the property boom, approximately half of the value of loans due to mature within the next five years are likely to be on what could be considered secondary/tertiary property.



as the rental income covers the interest charges. However, they may stipulate that some of the loan must be repaid or alternatively they may increase the interest rate margin on the loan.

Of most concern to the banks are those properties where some or all of the interest or principal is not being paid (as rental income is insufficient), and here there is little choice but to take action. The bank can either force a sale of the asset, or can attempt to increase the income generated.

Both of these routes are potentially problematic for the banks. As we have seen, if the loan was made during 2004-2007, a sale of the asset will almost certainly mean selling at a loss, with the value not likely to cover the value of the debt. However, if the bank holds the asset, it will probably have to make a bad debt provision against the loan, under the Basel II accounting rules.

### What factors will affect the decisions made by banks?

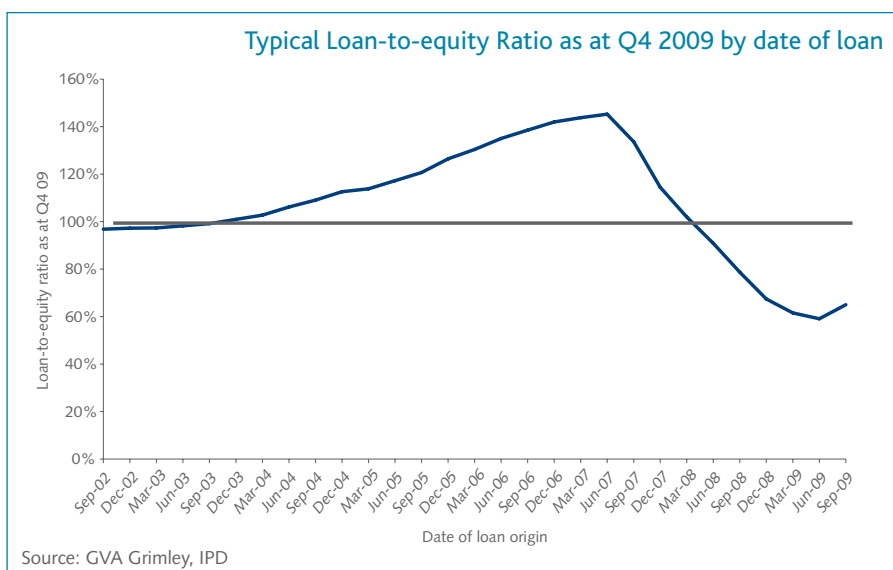
The rate at which properties are disposed of by the banks will be determined at three levels – property-specific level, the overall policy of individual banks, and industry and market-wide factors.

#### Property-specific factors

The perceived scope to increase the income of a property through better management will be an important factor for banks to consider. If a bank decides to hold an asset, it will encounter significant challenges in maintaining or increasing the income that assets are generating, due to the challenging conditions in the occupier market.

Some 'quick wins' in terms of performance may be achieved in those instances where properties have not been professionally managed, and the bank is able to bring in experienced managers. Joint ventures between banks and asset managers may be a good option, as this gives the asset managers a clear incentive to improve performance.

A key consideration will be the quality of the asset, in terms of the specification and condition of the building, its location and, importantly, the strength of the covenant, and the length of time to break options and lease expiries. In the current market, prime yields are falling and prime assets are attracting significant interest and achieving good prices. Selling an asset now may therefore be an attractive option. This is in sharp contrast to the



### How have changes in values affected loan-to-value ratios?

The 2007 GVA Grimley Bank Lending Survey showed that, pre-credit crunch, a typical LTV was 80-85%, which fell to around 70-75% in the immediate aftermath of the recession. The latest De Montfort survey suggests that LTVs had fallen to typically around 65% by mid-2009. However, this was an improvement on the figure recorded six months previously of under 60%.

The second chart indicates what the current loan-to-value ratio might be on a typical commercial property, based on the date at which a loan originates. It has been calculated based on how typical loan-to-value ratios and capital values have changed (using capital values from the IPD Quarterly Index).

This chart illustrates how the level of debt to equity for commercial property has changed since the peak of the investment

market in 2007. Typically, a property purchased during 2004-2007 will have a higher amount of debt than the current value of the property. The worst point is a loan originating in June 2007, where the value of the loan would typically be 45% higher than the value of the property.

Since mid-2007 LTV ratios have reduced and values have not had so far to fall, so any loans are less likely to be in a negative LTV situation. However, the number of debt-funded transactions reduced sharply over this period, as banks either massively tightened up their lending criteria or withdrew from the sector.

### Which properties are banks most concerned about?

Whilst a large number of properties are now inevitably in breach of covenant, these are by no means all of immediate concern for banks. Where this is a 'technical' breach of the LTV ratio banks are generally taking little action as long

more secondary and tertiary end of market, where there is little buyer interest.

Clearly, the level of outstanding debt relative to the current property value, and how close a loan is to maturity will need to be considered. The higher the outstanding debt and the nearer a loan is to maturity, the smaller the chance of values recovering sufficiently to cover that debt.

### Bank policy

Individual banks will adopt their own strategies to deal with their portfolios. This will be determined in part by their view of what will happen to the market – in particular what they believe will happen to capital and rental values over the next few years. There is an element of feedback here - what happens to the market will be affected by the strategy that banks adopt. The banks will also be trying to 'second-guess' what their competitors will do so that they are not bringing their properties to the market just as others are doing so.

Policy regarding future exposure to the commercial property sector will also play a role. Whilst dealing with distressed assets is clearly at the top of the priority list for banks, they may also take the decision to reduce their exposure to UK commercial property for wider policy and financial reasons. This will be influenced by the financial position of an individual bank in terms of the overall level of exposure to bad property debt (and bad debt in general), its level of capitalisation, and independence from state aid, amongst many other factors.

### Market-wide factors

The occupier market cycle – The occupier market is forecast to be weak over the next two years, due to the lag between the economy and the property occupier market. Thus, the risk of tenant defaults will continue to be a concern, and tenants may be more likely to exercise break options and less likely to renew at lease expiry. Upward-only rent reviews will protect income from those tenants tied in to leases to a certain extent, but ultimately, a landlord may be forced to accept lower rental levels to lower the risk of outright tenant defaults. Clearly, the view adopted by individual banks on the outlook for both the commercial property occupier and investment markets over the next few years will be important, as well as actual market movements.





Refinancing - the level of refinancing for the UK commercial property sector as a whole required during 2010 is huge at probably more than £30 billion. The availability of finance will still be limited, and it will be those assets towards the prime end of the spectrum that will be first in the queue, leaving potential problems for more secondary stock requiring finance. The number of banks prepared to lend against UK commercial property has declined substantially since the 'credit crunch' and the CMBS market has vanished and is not likely to return in the near future. This will result in the forced sale of some properties.

It is not only UK banks who are holding significant amounts of stock. Irish banks have lent a very considerable amount against UK commercial property in recent years, and a large number of distressed loans are now owned by the Irish government's National Asset Management Agency (a so-called 'bad bank'). The NAMA is likely to come under pressure to begin in earnest the sale of these assets during 2010.

## Conclusions

Banks are more likely to sell any prime properties they hold that are distressed, as this is where values have seen the most recovery, and where investor demand is currently high. Our forecasts anticipate further capital value growth for commercial property this year, notably at the prime end of the market, and we therefore expect this situation to continue during 2010. However, the actual amount of property released will be limited, as prime assets are less likely to be distressed than secondary/tertiary assets.

2010 will see a rise in the number of properties entering a default situation, in line with continued challenging conditions in the occupier market. The majority of 'distressed' properties will be of secondary/tertiary quality, of which the banks lent substantial amounts of money during the later stages of the property boom, as these will have the weakest covenants and be harder to re-let.

In some cases, a bank will become a 'forced seller' of such properties, although this should be the exception rather than the rule. In most cases, the banks should be able to turn on and off the tap of properties coming to the market as they see fit, in line with the considerations at individual property and portfolio level, plus market-wide factors. This should mean a steady flow of properties coming to the market over a period of several years.

For these reasons, there is likely to be an increase in supply coming to the market during 2010, and this will be a broad mix of quality. However, the banks are likely to release space in a 'controlled' manner. A flood of properties entering the market through this route seems unlikely.

### **Bob Barnett, Director and Head of Corporate Recovery, GVA Grimley**

"Banks have huge problems and will do their best to work with their customers, keeping their trust, modifying debt terms and restructuring loans. So long as interest payments are covered by rental income, restructuring is preferable to appointing a receiver, selling assets and crystallising losses. As most problem loans are on secondary assets, where the market is weak, a sale is very much a last resort when everything else has been tried. This means that there will not be a flood of properties coming onto the market in the short term.

The main problem is what will happen when loans come up for renewal in a few years time. The banks have a medium/long term aim to reduce their exposure to property and will be reluctant to continue restructuring loans when existing terms mature. Many properties will have leases close to expiry, and research shows that there is a significant fall in value when leases have less than five years to run. For secondary properties this fall in value will be magnified as there could be the prospect of either not being able to relet or reletting at a lower market rent, unless the occupier market strengthens much more than expected over the next few years. In a few years time there could, therefore, be a large increase in supply of properties on the market, many of them secondary properties."

# What does the public sector own and what will it sell?

How much of the vast central and local government estate is likely to become available to investors in the short-term? And will any additional disposal of property assets impact significantly upon the wider commercial property investment market?

## The Public Sector Estate

There is no one comprehensive, detailed and authoritative record of public sector property assets. The best estimate available of the total size of the government estate in terms of value comes from the Office for National Statistics, which reports a total book value of £386 billion. Of this total, the central government estate accounts for around a third, with the remainder comprising local government property.

The central government estate is extremely diverse but it can be separated into the two broad categories: 'general' and 'specialist' property. 'General' property includes: property and land owned, leased and occupied by central government departments, agencies and non-departmental public bodies. 'Specialist' property includes: laboratories, museums, power stations, port facilities, infrastructure (e.g. roads, railways and canals), English Heritage Estate, Royal Palaces, the Defence Military estate, Prisons estate and NHS estate plus the Defra, Foreign and Commonwealth Office and Home Office overseas estates.

In terms of floor space again there is no comprehensive record, however, the central government civil estate (i.e. central government property excluding Defence, Prisons, NHS, Defra and F&CO overseas estates) is known to cover some 13.5 million square metres, of which 72% is designated as offices or office/mixed use. The civil estate is managed and used by over 300 separate central government organizations. 43% by area is freehold or long leasehold, 29%

is held leasehold, 27% delivered under PFI arrangements, and 1% is serviced office accommodation, i.e. only 43% is available for potential sale.

The local government estate accounts for approximately two thirds of the £386bn total book value. As at March 2008, English local authorities collectively owned £232bn of operational assets of which around half is comprised of council dwellings (£100bn). The remainder is made up of land and buildings used to deliver direct services to the public e.g. schools, town halls, libraries, social services facilities, parks etc (£104bn), Infrastructure assets (roads and footpaths) (£23bn) and 'Other' assets (mainly plant, vehicles and community assets) (£5bn) plus a £19bn investment portfolio.

## Public Sector Disposals

The current strategy for the disposal of surplus public sector property assets is largely derived from the recommendations of the Lyons and Gershon reviews of 2004 and 2006. They concluded that public bodies should prepare strategies to rationalise and improve the use of their property assets, disposing of those which are under-utilised or under-performing. Following on from this the Office of Government Commerce in 2006 introduced the High Performing Property initiative, with the aim of transforming the central civil government's estate, targeting annual savings of at least £1bn annually by 2013.

Local government meanwhile is expected to contribute at least £4bn per annum from the disposal of assets during the period 2005 – 2011 as part of the 2007 Comprehensive Spending Review. The next spending review has been postponed until after the general election, but the likely future direction of public sector property asset disposals is outlined in HM Treasury's Operational Efficiency Programme (OEP), which was launched in 2009.

The OEP estimates the potential for savings from improved efficiency over the next 10 years to be around £20 billion in receipts from disposals (excluding council housing). In order to achieve this it recommends reducing central government office accommodation by 30%, to be achieved largely by increasing density of space occupancy and in addition a 20% reduction of local authority property assets (excluding council housing) over an initial 10 year period.

A further recommendation of the OEP was the creation of a new central property function to coordinate and drive through efficiency improvements across the whole of the public sector. The government acted quickly on the recommendation to set-up the unit, appointing its head in December 2009. The new property unit is part of the Shareholder Executive, which sits within the Department for Business Innovation and Skills.

Its remit includes: reviewing public sector estate management and ownership options including the feasibility of creating one or more property companies that



could own and manage portfolios of public sector properties, for example grouped by geographical location, asset class or department. It will also assist government departments and local authorities in identifying opportunities and realising property disposals as well as challenging asset management decisions made.

The new unit is likely to consider alternative options to straight forward asset disposals such as state-sponsored REITs and sale-and-leaseback agreements. There is also to be a renewed drive to re-locate civil service posts out of London with the government announcing in March that a further 15,000 jobs are to move over the next five years. Such strategies would help to avoid press accusations of 'selling the family silver' at the bottom of the market while allowing the government to share in some of the potential upsides to a market recovery.

Running in parallel with therecommendations of the OEP, in the 2009 budget the government detailed plans for the sale of £16bn of assets over the period 2011-2014. Central government's share of this total is £5bn, £3bn from real estate. A list of assets earmarked for disposal was published in

late 2009, which included the Dartford Crossing, the High Speed 1 rail link and Tote bookmakers.

The remaining £11bn of the £16bn announced by government is expected to come from local government. Considering the existing rate of asset disposals under previous spending reviews (£4bn pa), this does not represent a substantial increase in 'background' levels.

If there is a change in government after the spring election, the plans of the existing administration may well be substantially revised. Local authorities may be forced to sell assets, including ground rent and investment portfolios as well as operational property, and restrictions on borrowing may be reintroduced. This might also coincide with interest rates increasing, changing the buy/sell equation.

At the time of writing, the Conservative party is yet to announce specific plans for the public sector estate, other than a plan to transfer central government property into a publicly owned asset company. This company will charge departments for their use, thus encouraging rationalisation of space, leading to the potential for the disposal of surplus property.

## Local Government Disposals

Local government property disposals are presently directed by the property asset management plans of individual organisations. The majority carried-out during the latest comprehensive spending review period were residential, with relatively few sales of investment grade commercial properties. Housing asset disposals accounted for over half of council's £4billion pa property sales between 2000/01 and 2007/08, while in 2007/08, councils sold office property worth only £325 million, a small sum when compared with the overall size of the UK office investment market.

Looking ahead, the government's new Total Place Initiative, is emerging as a new strategy likely to influence the future of local authority asset management. A recent pilot programme conducted in Kent estimated potential gross value from the disposal of under-used property assets of £700m, or 14% of the total book value for the county. A March 2010 HM Treasury report estimated that, at the national level, the total place initiative could generate up to £35bn of gross capital receipts over the next 10 years from sales of surplus assets, supporting the OEP target for disposals.

However, there would be significant financial, legislative, cultural and political barriers to be overcome, and the re-provision costs of making such a huge transformation would be substantial.

Nonetheless this figure provides us with a rough indication of the book value of potential property disposals that remain 'untapped'. At this stage it is impossible to say how much of this total will be sold to the private sector. Much will depend upon the decisions of the new central property unit which is still in its infancy and may take on an entirely new form in the event of a change of government after the forthcoming election.

### Implementation challenges and solutions

There is some concern about the current arrangement with local authorities facing major challenges in their attempts to manage their property assets. A critical Audit Commission report found that only half of councils were assessed as having sufficient information about their estate. Just one in five directors of finance said their council had all the information it needs to manage the estate properly. Furthermore many councils were found to lack the capacity to manage property sufficiently well.

However, anecdotal evidence suggests that there has been a marked change in recent years, with most local authorities anticipating the need to utilise their property assets more effectively and the need to make cuts. Most local authorities are improving their property databases so that they know what they own and occupy and how their estate can be managed more effectively. Property management staff retention was a problem a few years ago, which hindered the management process, but this is no longer such a problem and the use of outside consultants is also more commonplace.

Most local authorities will be forced to consider further outsourcing, sharing of facilities between authorities, cutting services where possible, desk sharing, hot desking, home working etc and how they can reduce the space they occupy and use it more efficiently. This may well mean investing in new or refurbished buildings with larger (more flexible) floorplates and disposing of older, smaller, less efficient buildings.



Establishing the business case for such “invest to save” initiatives will be difficult where disposal values are low. But the scope to reduce property running costs is significant, especially where high maintenance backlogs exist. Increasing energy costs and carbon costs will also play a part in decision making.

A major difficulty with the government's plans for property disposals is that the recent property downturn will make local authorities reluctant to sell at what is considered to be close to the bottom of the market, particularly for the more secondary property that local authorities would want to dispose of. Conversely, rather than selling off buildings or sites, local authorities may be more likely to consider acquiring property sites and redeveloping or refurbishing existing buildings, taking advantages of lower prices and low interest rates, to achieve longer term floorspace efficiency aims.

There are also examples of some local authorities with a leasehold asset purchasing the freehold at an advantageous price close to the bottom of the market, taking advantage of low interest rates and strong local authority covenants, and so saving on future rental payments. Some local authorities argue that freehold ownership gives them greater control over the use of buildings they occupy. A contrary view is that having to pay rent concentrates the mind and provides a constant pressure to use space efficiently.

The opportunity for local authorities to sell assets they own and occupy, and lease them back, as a way of realising capital receipts, has its attractions but may well be resisted due to the poor state of the market for secondary property. However, newer, well located property, subject to a long lease back to a local authority, would be attractive to investors and high prices would be payable in the current market.

Under a sale and lease-back transaction the local authority sells a long leasehold interest (typically 100 years) in the building to a private investor/fund and, in return for a capital receipt, signs a 25-35 year lease to rent the building. Once the occupational lease period has expired the private equity investor could obtain a new tenant, although, the Council may wish to extend the lease or purchase the building back. At the end of the ground lease the Council would receive the building back without cost and so can argue that it has not sold the ‘family silver’.

Much council property likely to be sold is old and in poor condition, needing investment to bring it up to date. A survey for the Audit Commission in late 2008 found that ‘over 40 per cent of councils rated their portfolios in poor or very poor condition’. Much of it, therefore, will be more suitable for redevelopment but this is not a good time in the market cycle to be selling development sites.

Looking ahead there will be significant cuts to local government spending following the forthcoming general election. The scale and timing of cutbacks is as yet unclear, but a recent survey of 49 English councils by the BBC found that local authorities expect to make at least 25,000 job cuts over the next 3 - 5 years, a 10% workforce reduction. The report found the areas most at risk of cuts to be roads, libraries, the arts and leisure. On its own this will not directly result in widespread property disposals, but it does indicate the pressure local authorities expect to come under to reduce their operational costs, which will push the issue of property asset management further up the agenda.

## Conclusions

Other than the £3bn worth of central government asset sales announced in the 2009 budget, there is unlikely to be a flood of good quality, investment grade property assets into the commercial investment market. Despite government announcements appearing to indicate a desire to raise funds through property sales, local authorities, health trusts and central government departments are not likely to immediately increase disposals significantly above current trend levels.

But with deep cuts to government spending on the horizon, the need to make the most efficient use of public sector property is becoming an increasing priority. A renewed drive to improve property asset management may result in a significant increase in disposals, but the types and locations of sites that become available will mean only a limited impact upon the commercial investment market in the short-term.

However, we do expect to see an increase in sale-and-leaseback transactions and other joint venture agreements with the private sector. In addition, there remains a huge untapped potential for public sector asset disposals, which has not yet been fully explored by local authorities.

This situation may well change with the formation of the government's central property function and the adoption of the ‘total place’ initiative which may influence local authority property asset management, promote efficiencies and encourage greater disposals. But even then many of the assets considered for disposal are likely to be older, smaller, sub prime properties which will have limited appeal to the private investment sector, unless they are subject to a leaseback, or other public-private joint venture.

### Andrew Screen, Director Sector Projects, Sector Treasury Services Ltd (part of Capita)

“Investment Funds are now keen on investing in local authority and government assets by way of sale and leasebacks or in undertaking joint ventures with local authorities. This is primarily due to the good covenant, low level of risk and long lease period (typically 25-35 years) that local authorities offer. As such, there has been an increase in demand from opportunistic funds, sovereign wealth funds and pension funds at investment yields of 5.5% - 6%. With pressure from central Government to raise funds from property disposals, we expect to see more sale-and-leasebacks taking place over the next 2-3 years.

Local Authorities can undertake sale and lease-backs on various accommodation types including town halls, leisure centres, crematoria, depots, libraries and further education institutions. But there are a number of risks to local authorities as leaseholders that should be taken into account such as, repairing and insuring liabilities, the loss of control over tenanted space and future transfers of ownership, and potentially unpredictable future rental payments with annual rent increases linked to RPI inflation.”

# Private Sector Sale and Leasebacks

With only around half of the UK commercial property market already owned by investors, sale and leasebacks could offer an important source of new investment supply. But will corporates want to sell and will investors want to buy?

There are numerous variations, and sale and leaseback deals can be tailored to meet the needs of the corporate occupier. For example, companies can separate the ownership of their property portfolio into a separate company (an 'opco/propco' arrangement) – in effect an in-house sale & leaseback.

Around half of the UK commercial property market is owned by investors. The other half is therefore potentially available for a sale and leaseback (although in practice, not all of this will be available). The scope for this area as a potential source of a large volume of investment supply would therefore appear to be very considerable. The problem for investors is in terms of quality – by its nature much of the stock owned by corporates is secondary or tertiary, though by no means all.

Sale and leasebacks are another potentially important source of supply for investors, but what are the prospects of corporate occupiers wanting to enter into sale and leaseback agreements?

In the present economic climate, where many corporates are under greater pressure than normal to improve the position of their balance sheets, a sale and leaseback can provide a way of raising debt finance which might otherwise be difficult to obtain. And there are many other generic benefits for occupiers. For example, capital tied up in property can be used more efficiently in a company's core business area. 'Opco/propco' deals involving venture capitalists who want to de-leverage a business could be a particularly productive source of transactions.

During the period when commercial property capital values were falling sharply, most corporates would probably not have wanted to sell their property until values recovered, even if they were attracted in principle to the idea of a sale and leaseback. However, as this bulletin's introduction outlines, we are no longer at the bottom of the market, and the pricing dynamics for portfolios with good covenants and long leases are now good.

However, much depends on the situation of an individual organisation, and there may be many reasons why organisations may be reluctant to enter into sale and

leaseback transactions. For example, some companies may not want to 'sell the family silver'. The internal discount rate used by a company can also be an important factor.

It is difficult to judge the level of supply that might come forward from sale and leasebacks, but we are optimistic that this will provide a valuable source for investors over the next few years. However, the quality of portfolios is a problem, and we believe that this, rather than a willingness of corporates to consider sale and leasebacks, will be the key limiting factor.



# New Development (Funding & Forward Sales)

With the collapse in commercial property development, what is the potential for the funding and forward sale of development schemes as a route for property investors?

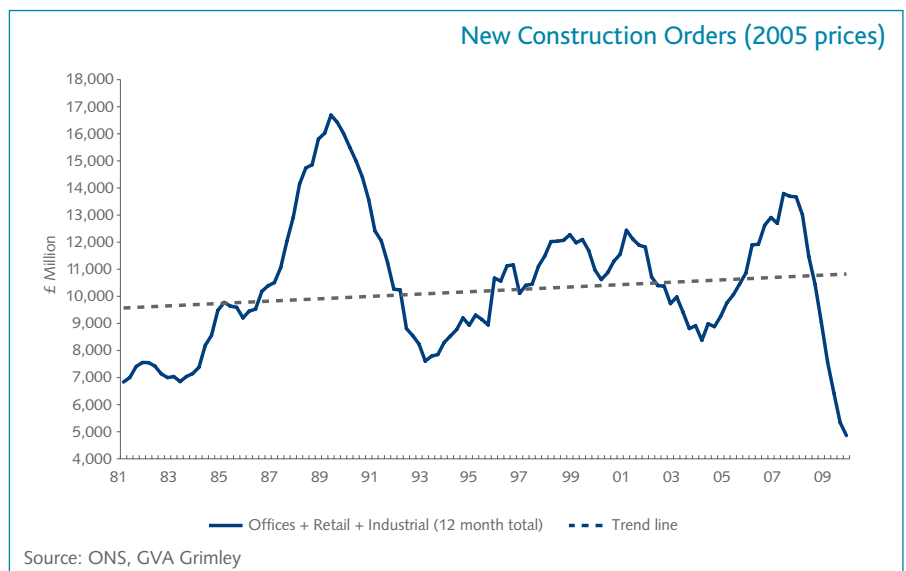
The recent property investment boom did not see the surge in development activity that characterised the late 1980s/early 1990s period, although activity still increased to a level well above trend. However the collapse in activity over the last two years has been dramatic.

This can be seen in the chart below, which shows the value of new construction orders (a proxy for the level of construction activity at the start of the development process) placed over the previous 12 months in the retail, office and industrial sectors. This is shown in constant (2005) prices, which strips out the effect of inflation to provide a consistent comparison over time.

The value of orders placed over the 12 months to Q4 2009 was £5.4 billion (2005 prices), compared with a low of £7.6 billion over 12 months in the early 1990s recession (and a similar low figure in the early 1980s recession). The current short term trend remains downwards. These figures are even more striking when one considers that the UK economy and property market have expanded considerably over the last two decades, and hence the long term trend line is upwards.

The development tap will not be quickly turned on again as viability will take some time to improve, there will be continued uncertainty over the recovery in the occupier market and the availability of development finance from banks is likely to remain restricted.

Even once development starts to become an attractive and financeable prospect, it will take time for the construction industry to gear up, and once schemes are under way there will be a time lag of typically 1-2 years at least before the



development is completed, depending on the scale and type of scheme.

The extent of the collapse in construction starts, poor viability and the lag between starts and completions will inevitably mean that only a very limited supply of new build completed investment opportunities are brought to the market

over the next three to five years. New build development is not likely to be a major source of properties coming to the market, except where institutional funding (forward sales) is used to fund new development.

# Consequences and Conclusions

Institutional and private investors of property are keen buyers rather than sellers and are holding on to their stock. The main potential sources of supply are therefore the banks and the public sector.

## The Banks

- Banks are more likely to sell any prime properties they hold that are distressed, as this is where values have seen the most recovery, and where investor demand is currently high. Our forecasts anticipate further capital value growth for commercial property this year, notably at the prime end of the market, and we therefore expect this situation to continue during 2010. However, the actual amount of property released will be limited, as prime assets are less likely to be distressed than secondary/tertiary assets.
- 2010 will see a rise in the number of properties entering a default situation, in line with continued challenging conditions in the occupier market. The majority of 'distressed' properties will be of secondary/tertiary quality, of which the banks lent substantial amounts of money during the later stages of the property boom, as these will have the weakest covenants and be harder to re-let.
- For most banks, the process of planning what to do with their problem assets is now completed and a clear structure and strategy is in place. Some banks are taking a long-term view and whilst the type, location and quality of property are all important in determining what is sold and when, at the core is the quality of the borrower and the long-term relationship that exists between the bank and the borrower.
- In some cases, a bank will become a 'forced seller' of such properties, although this should be the exception rather than the rule. In most cases, the banks should be able to turn on and off the tap of properties coming to the

market as they see fit, in line with the considerations at individual property and portfolio level, plus market-wide factors. This should mean a steady flow of properties coming to the market over a period of several years.

- For these reasons, there is likely to be an increase in supply coming to the market during 2010, and this will be a broad mix of quality. However, the banks are likely to release space in a 'controlled' manner. A flood of properties entering the market through this route seems unlikely.

## Public Sector

- Other than the £3bn worth of central government asset sales announced in the 2009 budget, there is unlikely to be a flood of good quality, investment grade property assets into the commercial investment market in the short term. Despite government announcements appearing to indicate a desire to raise funds through property sales, local authorities, health trusts and central government departments are not likely to immediately increase disposals significantly above current trend levels.
- With great pressure for deep cuts to government spending, the need to make the most efficient use of public sector property is becoming a higher priority and a renewed drive to improve property asset management may result in a significant increase in disposals over the medium term. But the types of asset and locations of sites that become available will have only a limited impact upon the commercial investment market. However, we do expect to see an increase in sale-and-leaseback transactions and other joint venture agreements between the public and private sector.

- There remains a huge untapped potential for public sector property disposals, which has not yet been fully explored by local authorities. But this situation may well change with the formation of the government's central property function and the adoption of the 'total place' initiative which may influence local authority property asset management, promote efficiencies and encourage greater disposals. Although even then, many of the assets considered for disposal are likely to be older, smaller, sub prime properties which will have limited appeal to the private investment sector unless they are subject to a leaseback, or other public-private joint venture.

## Private Sector Sale & Leasebacks

- It is difficult to judge the level of supply that might come forward from private sector sale and leasebacks, but we are optimistic that this will provide a valuable source for investors over the next few years. However, the quality of portfolios is a problem, and we believe that this, rather than a willingness of corporates to consider sale and leasebacks, will be the key limiting factor.

## New Development (Funding & Forward Sales)

- The extent of the collapse in construction starts, poor viability and the lag between starts and completions will inevitably mean that only a very limited supply of completed new build investment opportunities are brought to the market over the next few years. New build development is not likely to be a major source of properties coming to the market, except where institutional funding through forward sale agreements can be achieved. This will depend on improved occupier demand and positive rental growth.

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08449 02 03 04

Published by GVA Grimley Ltd – 10 Stratton Street, London W1J 8JR  
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