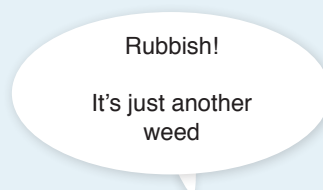


The UK Outlook

Dove and Hawk present their views



April 2012

Social and Economic Outlook

Dove and Hawk are in an argumentative mood. Will or won't the Government's austerity measures kill off any hope of a return to growth in the near term?



Dove: It is going to be a great summer... The Queen's Jubilee, the Olympics and Paralympics, test cricket against the West Indies and South Africa, Wimbledon...

Hawk: Are you completely cuckoo? We are slap-bang in the middle of an unprecedented economic disaster and all you can talk about is taking time off work to watch sport.

Dove: Stop being so grumpy. It will be fun.

Hawk: Fun! We can't afford fun. The UK is half-way down the tubes and we are only going to recover if we all buckle down to some seriously hard work. And that includes you.

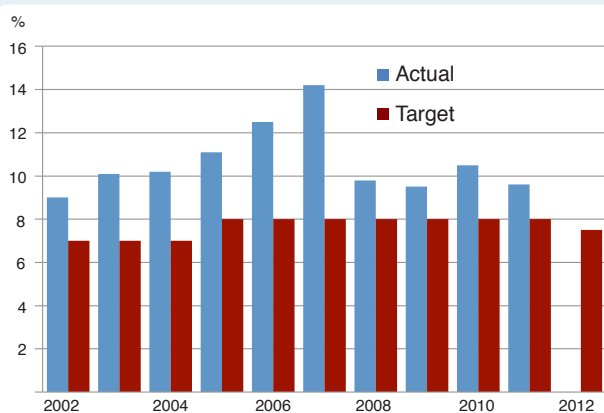
Dove: It is not all bad news you know. The Eurozone / Greek crisis is resolved, US unemployment is falling, corporates have huge cash piles, the banks are back to rude health and China is still going gang-busters.

Hawk: Dolly. You are normally so measured in your thinking but this time you seem to have completely lost it! You have conveniently overlooked the simple facts that Europe is in recession, the Middle East is in turmoil, China has lowered its growth target, the US budget deficit is still growing and the Euro-crisis is just patched up with sticky-tape.



Dove: Okay. Let's just deal with a couple of those issues then, shall we? Those nice chaps at St Bride's have just come back from a visit to China and they say the place is absolutely 'rocking'.

China GDP Growth v Targets



Source: Economist Intelligence Unit

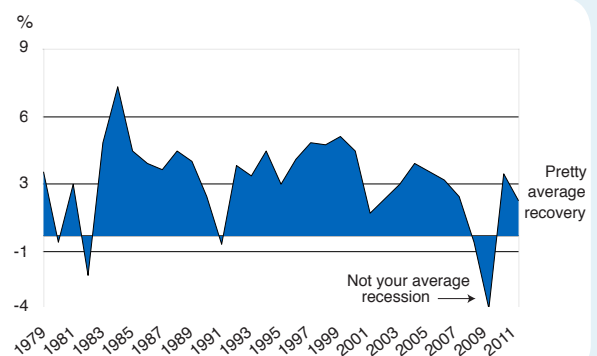
China has consistently exceeded its growth target

Hawk: I can't believe they would ever use a word like 'rocking'.

Dove: Well... the younger ones did. And anyway, if you track back, you will see that over the last 10 years China has consistently surpassed their stated growth targets. And do you know what, if they did only achieve their targeted 7.5% this year, that would still be pretty darned good.

Hawk: Okay, I concede that point. But the US economy is still really fragile. Compared to previous cycles this recovery looks anaemic. And we all know that global growth depends upon strong US demand.

US GDP Track Record



Source: Eurostat / Bureau of Economic Analysis

US Recovery appears to be rather less emphatic than in previous cycles

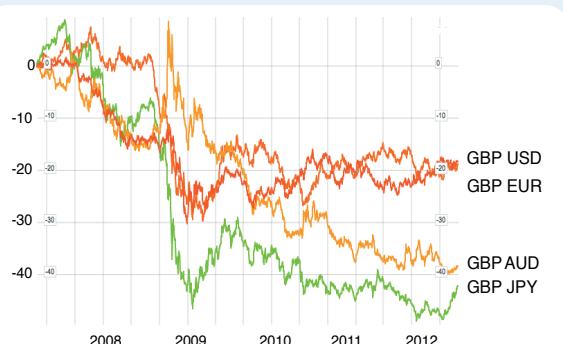
Dove: Fair enough. But US consumer confidence is up, equities have done well and corporates are poised to make the most of their enormous cash piles.

Hawk: That's true, but only time will tell whether Mr Bernanke or Mr Osborne have got their long games right. The US have just injected the best part of \$1 trillion of liquidity into the market. One day, someone is going to have to pay that money back.

Dove: Anyway, the UK is doing okay in its own right. Exports have been holding up really well...

Hawk: I am not surprised. Look how sterling has crashed over the past 4 years, particularly against the Asian currencies. At this rate, we will be effectively giving our stuff away! It has even fallen against the Euro, which is supposed to be a basket-case.

Sterling Exchange Rate 2008-2012



Source: Bloomberg Market Data

Sterling has fallen dramatically in value over the past 4 years



Dove: Yes, but look on the bright side. At least the UK still looks attractive as an investment destination. We have some terrific businesses, our language and time zone are on our side and we still have our AAA rating (unlike our Gallic cousins on the other side of the Channel!).

Hawk: Talk about tempting fate! The Government's bust, our local authorities are bust, we have 2.67 million people (8.4%) unemployed, including 1.04 million youngsters. And the number of pot holes that have been left unrepaired in my road is a complete joke.

Dove: But, unlike parts of Europe, we still have a growing population. For instance, did you know that the population of London is projected to grow by about 1 million over the next 20 years. That is equivalent to adding on the current populations of Glasgow and Manchester.

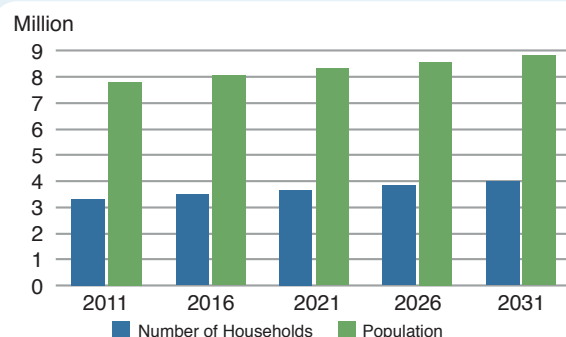
Hawk: Have you thought for a moment about the implications of this? They are already thinking of converting former MFI warehouses and Woolies stores into primary schools and we don't have a bean to spend on new hospitals or the elderly. In short, we are beginning to look like a Third World country.

Dove: But think of it this way... the additional people will require an extra 4 million sq ft or so of offices and another 2 million sq ft of retail. And that is good for rental growth. And if rents keep on going up... well, that's good for investors.

Hawk: On the other hand, my children are looking for first time nests. And even as things stand now they cannot find anything they can afford.

Dove: I know and it's going to get worse, especially in London. They project the number of additional households that will be formed between now and 2031 will be around 670,000. And if we continue to develop only 18,000 per annum as we did in 2010, we are going to have a massive shortfall.

London's Projected Growth (2011-2031)



Source: London Office Policy Review

There is an impending housing crisis in London

Hawk: Aaark! I can see the Bank of Mum and Dad being raided big time.

Dove: I am afraid so.



Hawk: But seriously. All this means that we are going to need a stack of new space over the next 10-20 years. Where are we going to find the land and who exactly is going to fund it all, especially as our domestic property owners are hocked up to their eye-lids.

Dove: There's plenty of land. It just needs to be unlocked. Funding on the other hand is a different issue.

London's Opportunity Areas



Source: London Office Policy Review

There are plenty of sites for development

Capital Markets Review

Where will the future source(s) of investment come from? Home or Away? Whichever... prospective returns will need to be attractive in order to compete with other global investment opportunities.



Dove: The good news is that the UK, and most particularly London, is a top investment destination. Our property market is transparent, our legal system is stable...

Hawk: Just hold on there. I am getting a bit tired of people rattling on about how transparent our market is. It just isn't true. Tell me, what are top City office rents at present?

Dove: Most agents would reckon on about £55 per sq ft.

Hawk: Yes, but what about the give-aways, the contributions to fit-out costs, the rent free periods, the break clauses etc. The question everyone should be asking is... What is the 'effective' rent? And I bet the answer is nearer £45 per sq ft. Where is the transparency in that? For my part, if you can't measure 'effective' rents, how can you properly measure rental growth. It's all just smoke and mirrors!

And while I am on my high horse, let's talk about valuations too. They just don't reflect reality... particularly in the case of secondary assets.

Dove: Are you pointing your claw at the valuers?

Hawk: No. On the whole they do a pretty good job. And certainly better than anywhere else in the world.

But the current spread between what buyers are prepared to bid and the price that vendors are prepared to accept is unsustainably wide. The gap is often as much as 20% and in my judgement valuations will fall sharply over the rest of this year.

Dove: But not for prime, surely?

Hawk: No. Prime assets should hold their own, especially if they have international star quality. And I am sure that the Germans and the Asians will continue to buy in London if they can see fair value.

The most important thing though for the Germans is a decent income return. They have never 'bought' into the growth story and they aren't going to start now.

Dove: Yes, I understand their insurance companies are obliged to deliver at least 3.3% pa to their policy holders but with German 10 year bonds yielding less than 2% pa at present, real estate looks comparatively attractive.

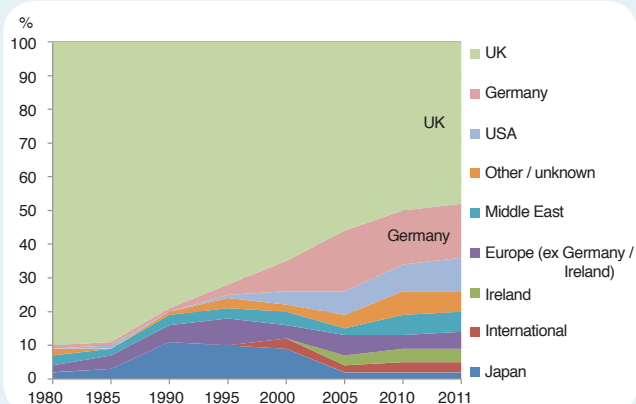
Hawk: Historically, they have been great fans of the UK – well City offices anyway – and collectively they are the largest participants after our own domestic investors. But leases are much shorter now and yields on prime assets have hardened significantly since the aftermath of the financial crash. Prices just aren't that compelling.



Dove: So what about the Asian investors? They've got plenty of money, haven't they?

Hawk: Yes, but just like the Germans, they want long leases and a decent yield. Probably the distinction between them though is that the Asians can still get terrific returns investing in their own back-yard. For instance Tokyo, Beijing and Jakarta are all expected to deliver double digit returns in 2012.

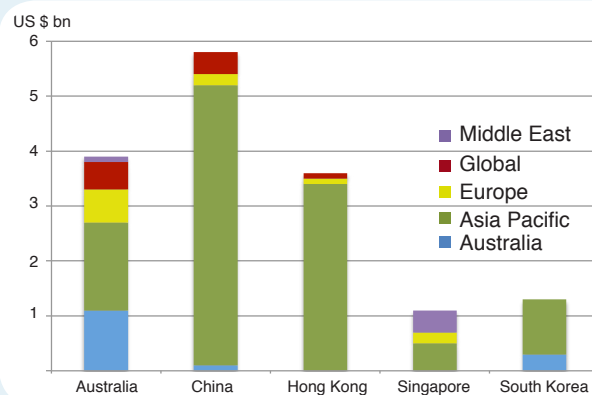
Ownership of City Offices



Source: University of Cambridge

The Germans are the largest overseas owners of City offices

Asia Pacific Cross-Border Purchases 2011



Source: Jones Lang LaSalle

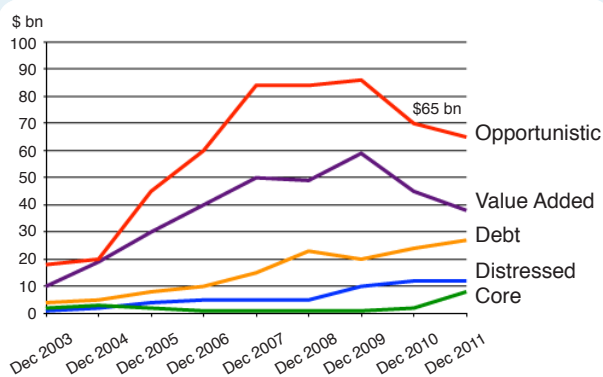
Asian institutions are very comfortable investing right cross the AP region

Dove: However, these markets are much more volatile. Just as some Asian markets will do really well, Hong Kong and Singapore are likely to fall sharply this year.

Hawk: That's true... but once values come down we could easily see renewed buying activity. Investors over there just love to bottom-fish.

Dove: Just like the US opportunity funds, who have an absolute shed load of cash to invest. At the last count, their 'dry-powder' was the best part of \$65 billion. And the good news is that a good part of this is headed for the UK and Europe.

Closed-End Funds 'Dry-Powder'



Source: Preqin

US Closed end funds have a significant amount of 'dry-powder'

Hawk: You mean they are going to take us to the cleaners!

Dove: No. The Americans are a great source of capital. We need them on-side. And what most people don't know is that they are backed by the big US state pension funds who expect a decent risk premium for investing off-shore.

Hawk: So what do they want, apart from blood?



Dove: Broadly, they have three strategies... 1) big direct deals / developments etc, 2) loan portfolios and 3) public to private acquisitions.

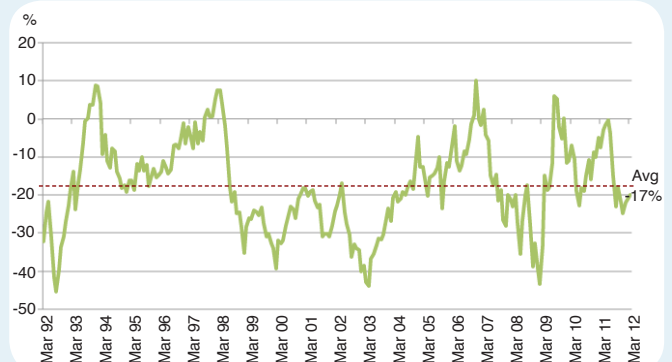
Hawk: You mean take-overs?

Dove: Well... yes, I do! The fact is that our UK property companies and REITS are so small now compared to theirs and especially with the opportunity funds fire-power in tandem, even Land Securities and British Land are exposed. This is all the more so now as the sector is currently trading at a whopping great discount to asset values.

Hawk: And you classify this as good news? It would be a catastrophe if one of our Big Boys was raided and it would massively undermine the UK's fledgling REIT sector.

Dove: Then they should do something about it... and fast.

Property Co's Discounts to Asset Value



Source: EPRA

Discounts to asset value make our property companies and REITS vulnerable to take-over

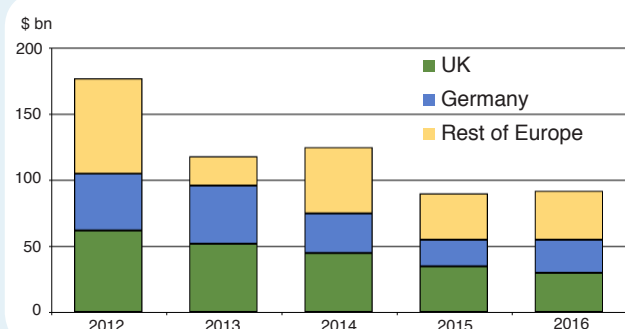
Hawk: It's all academic anyway. We're doomed by an unbelievable overhang of debt. We have absolutely no chance whatsoever of avoiding a complete melt-down in our capital markets.



Dove: You don't get it do you? The US funds are desperate to wade in there too. In fact, the two largest debt deals to date (Lloyds \$1.4 bn and RBS \$2.1 bn) were picked up by the Americans. They have been managing debt portfolios for years and they could be the UK property market's saviour.

Hawk: What rubbish! All they want to do is pick up cheap debt portfolios from the banks and then terrorise the equity investment holders so that they can make a handsome profit from breaking up the assets.

Debt Maturities



Source: EPRA

The US are leaders in debt strategies

Dove: At least it would provide some liquidity. And heaven knows... we need some of that in the secondary market.

Hawk: Hmmm! If we aren't careful I will soon be calling you 'buddy' and everyone will be hugging each other and the MCC will be taken over by the New York Yankees.

Retail and Regions

The principal focus of overseas investors has historically been directed towards London... with the exception of some key regional shopping centres. Will that remain the case?

Dove: That's the strangest thing isn't it? Overseas property investors have focussed almost exclusively on London, but when it comes to football clubs, they have been very happy to venture out into the regions – Manchester United (US) Manchester City (Middle East), Liverpool (US), Derby (US) and Aston Villa (US).

Hawk: Those Americans are getting everywhere. Their retailers are swarming all over our High Streets too. Did you know that over 10% of the stores at Bluewater are US brands? And it's about the same percentage in Bond Street.

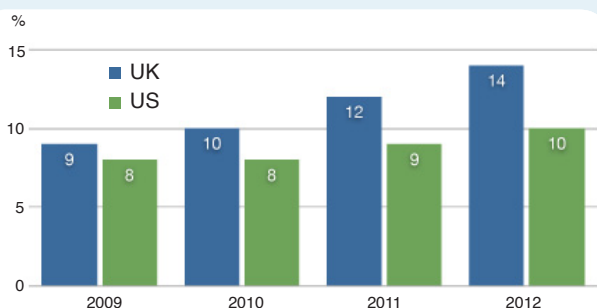
Dove: So what? They have some great concepts.

Hawk: The point is that retailers are having a really rough time of it over there and their shareholders are demanding clinical action on their portfolios both in the US and abroad. And that will inevitably mean some closures in the UK at some stage. The last thing we need now are more boarded-up shops.

Dove: You really are in a 'glass half-empty' mood at present aren't you? The Americans love Britain, not least as they see it as their gateway to Europe. And there are a whole bunch more US retailers poised to come over here too.

Hawk: I don't know why they are bothering. The internet is destroying our high streets. The latest estimate is that about 14% of all our sales are now done on-line.

% of Internet Sales



Source: ICSC

Internet sales are impacting on retail models worldwide

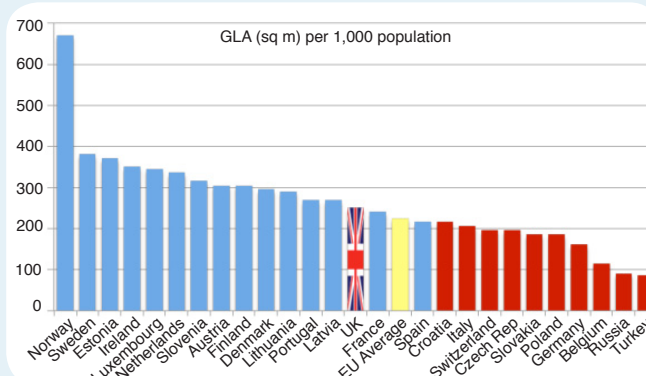
Dove: That's true, but it's not all gloom and despondency. For instance, Athleta, an on-line division of Gap, are planning to open 300 stores in the US over the next couple of years, and Amazon are going to open stores too. And no doubt they will be over here in due course. It's all about evolution, Harry.

Hawk: Well, let's face it... we have more than enough retail space to accommodate them. Some high streets have one in three shops empty.

Dove: Yes, but on the other hand, some are still really thriving. And you might be surprised to see that the UK sits in the middle of the European pack in terms of retail offer per head. A little bit of economic growth and another 10 or 11 million people in the country by 2035, will see the vacancy rate fall right back down again.



% Shopping Centres Penetration



Source: ICSC

The UK is far from having the most saturated retail market in Europe

Hawk: But not in time to save retail rents being slashed.

Dove: True, but the chipboard industry and hoarding companies will be having a field day! And remember, we are only talking about secondary / tertiary centres. Genuine prime, versatile space will still be in demand.



Hawk: However, I assume that you will accept that current valuations on secondary centres / units are simply too high. And it will be the worst of all worlds for our town centres if landlords continue to bury their heads in the sand and fail to get a grip of their responsibilities. Shopping centres are living businesses, and they need to be managed as such.

Dolly, I hate to say it, but we could learn a lot from the Americans on running shopping centres.



Dove: Harry, do you know what? It is coming up to five years now since the Northern Rock collapse. And do you remember that after that we predicted that it would take a good ten years for the property market to recover properly? We are almost half way through.

Hawk: What are you saying? We have another five years of pain?

Dove: Sort of. But I think we are just starting to see some green shoots of recovery peeping through.

Hawk: Well, whilst we are reminiscing, do you remember that report we wrote in October 1989 when we said that we could see the light at the end of the tunnel?

Dove: Yes. Unfortunately it wasn't daylight at all. It was an ugly express train tearing towards us. But this time, I might be right.

Hawk: Hmmm! I might go along with you... but only once valuations have been properly marked to market and we have dealt with the inevitable consequences this will have on the banking system... particularly in the regional markets.

Dove: You haven't still got that hang-up about the regions, have you?

Hawk: I must admit that until St Bride's had done their piece of research just before Christmas, I thought the world stopped at Watford. But now I can (sort of) see the potential.

Dove: Yes. Out of their top 30 Long Term Sustainable Locations (with populations of 100,000+) eighteen are outside the South East. And if the population hurdle is lowered a bit, you capture some terrific places like Harrogate and Bath too.

St Bride's Long Term Sustainable Locations

Ranking	Location	Overall Score
1	Edinburgh	62
2	Cardiff	60
3	Wokingham	59
4 =	Reigate & Banstead, St Albans, Windsor & Maidenhead	58
7	Warwick	57
8	Cambridge	56
9	Macclesfield	55
10 =	Leeds, Manchester	54
12 =	Aberdeen, Guildford	53
14	Oxford	52
15	Norwich	51
16	Bristol	50
17 =	Bracknell, Chelmsford, Glasgow, Warrington	49
21 =	Exeter, Milton Keynes, Sheffield, York	48
25	Basingstoke	47
26 =	Brighton & Hove, Wycombe	45
28 =	Derby, Reading, Solihull	44

Source: St Bride's Managers / Ramidus Consulting

UK Regions should be treated with respect

Hawk: But what I don't really get is how St Bride's can 'big up' the regions and at the same time slash their recommended weightings.



Dove: Oh.... That's easy enough. It's simply a result of investors having a much larger and deeper universe to play with.

1. Allocations by UK institutions to overseas property are pathetically low. St Bride's reckon weightings should be 30-35% given better performance prospects outside the UK.
2. Over the past ten years or so, London has really exploded onto the global scene. It is now unequivocally the Number 1 World City. It isn't just about finance anymore, it is just a great place to work, live and play. The place has completely re-invented itself.

However, the problem is that we have all been too close to it to see its transformation and we have been too slow to buy into it. Given its new-found status though, St Bride's recommend a higher weighting for domestic investors of 30-35%.

3. The 30-35% weighting to the regions most certainly is not an apology for the rest of the country. In fact, as the latest figures show, there are some places currently generating more GVA growth than London. But investors' strategies need to be much more focussed. The slavish approach adopted by some investors over the past 40 years of simply modelling their portfolios in line with the IPD Regional Index should be binned. And now!

Hawk: The trouble is Dolly, unlike you, my feathers have been flustered and I am still not completely convinced that we are out of the woods yet. But I am encouraged by your enthusiasm.

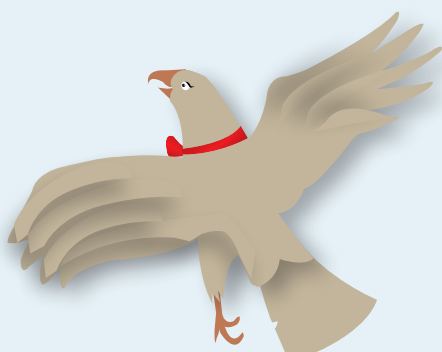
Dove: Well, I will keep on trying.



After nearly 5 years of pain, the UK property glass is beginning to look half-full

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