

Commercial Investment Property – A Minefield?

Presentation to The Rugbeian Society
by Ben Habib – CEO of First Property Group plc

INTRODUCTION

- Agenda:
 - Drivers of commercial investment property
 - Credit crunch
 - The future

- Commercial investment property consists of:
 - Retail
 - Offices
 - Leisure
 - Industrial

- Commercial property is generally valued on its yield, which is equal to the income generated by a property divided by its purchase price or value

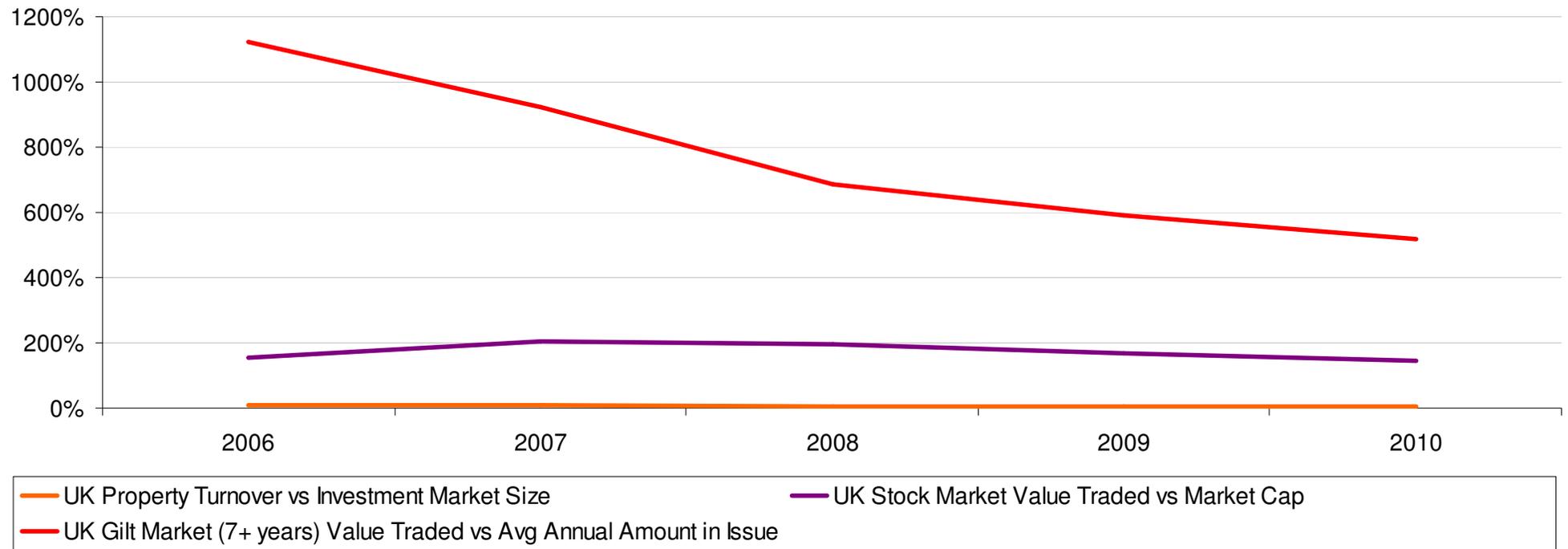
MARKET SIZE

- UK commercial property investment market is worth some £813 billion
- The value of all stock listed on the LSE is some £1,720 billion and the value of long dated gilts in issue in 2010 was some £564 billion
- Turnover in the UK commercial property investment market in 2010 was some £28 billion or 3.5% of the value of the market
- Turnover in all listed stocks in 2010 was some £2,500 billion or 146% of the value of the market
- Turnover in long dated gilts in 2010 was some £2,900 billion or 517% of the value of the market
- At its peak, the commercial property investment market turned over 9.76% in 2006
- At the best of times property is relatively illiquid
- This lack of liquidity has to be addressed

Source: CBRE, Equiniti, UK Debt Management Office (DMO)

LIQUIDITY

Liquidity - Investment Property vs. Stock Market vs. Gilt Market



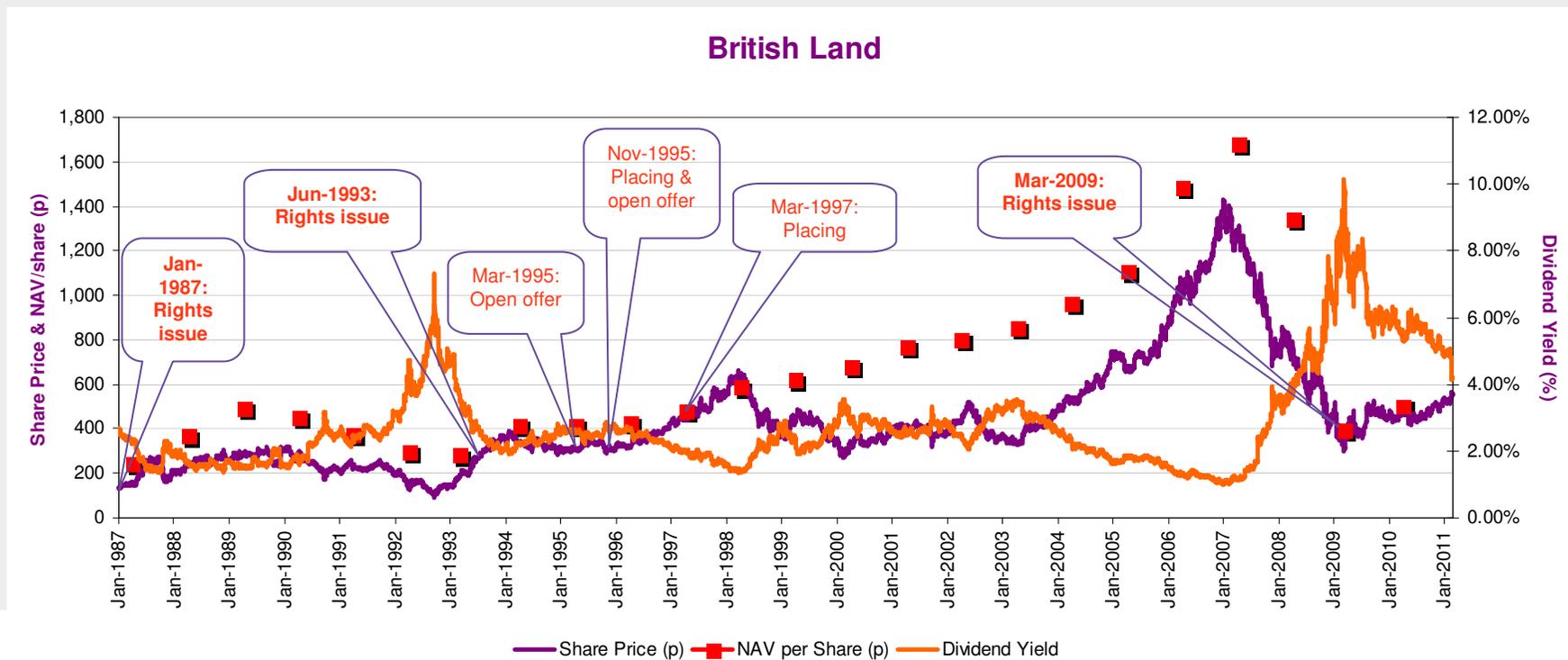
Source: CBRE, Equity Trading Tracker from Equiniti, UK Debt Management Office (DMO)

TRANSACTION COSTS

- The cost of trading property is relatively high:
 - 4% stamp duty
 - 1% agent's fees
 - 0.8% legal and valuation fees
 - 5.8%
- The cost of trading publicly quoted stocks is relatively low:
 - 0.5% stamp duty
 - 0.25% broker's fees
 - 0.75%
- Just to break even on an investment, a property's value must increase by at least 6%
- But relying on capital gain for such an inherently illiquid asset may be risky
- These frictional costs have to be addressed

ADDRESSING ILLIQUIDITY

- How can illiquidity and large transaction costs be addressed?
- Clever structures do **not** work:
 - Public companies



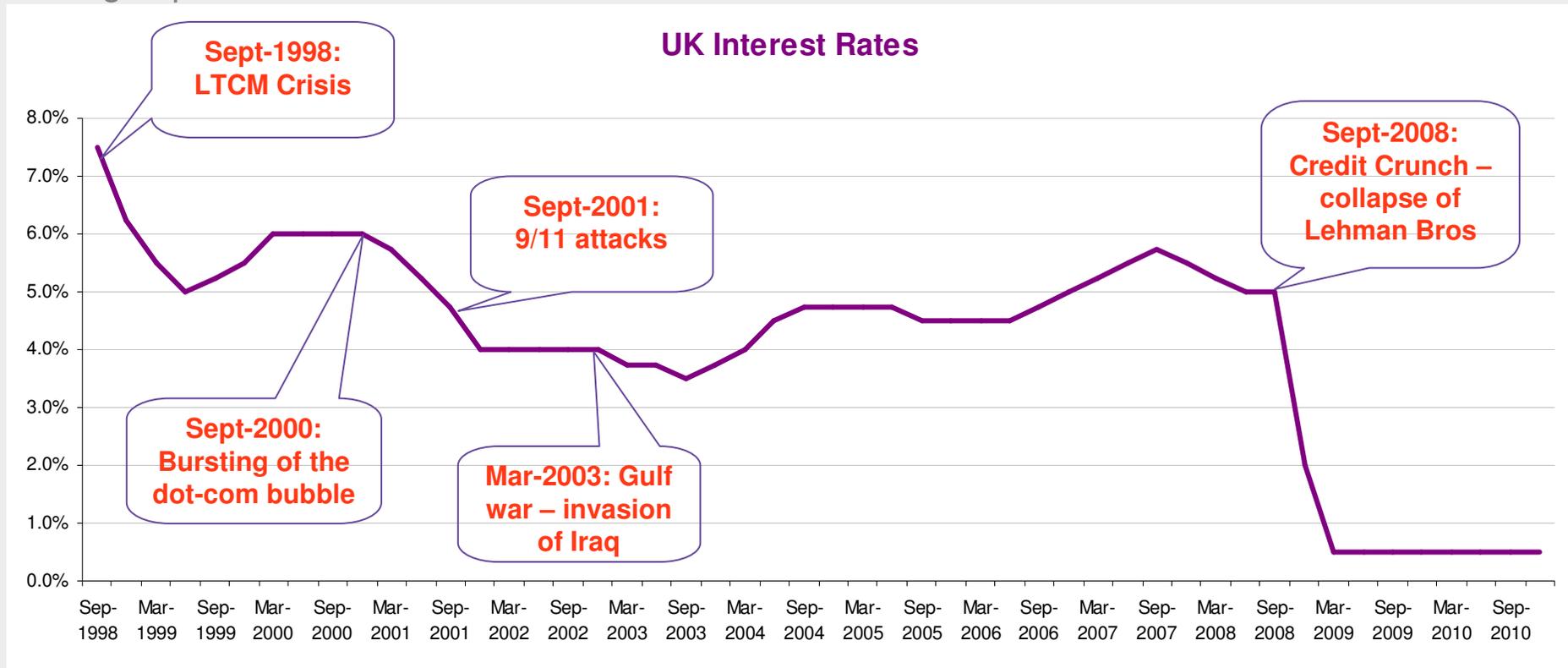
Source: Datastream, British Land

ADDRESSING ILLIQUIDITY

- Clever structures do not work:
 - Open ended funds
- There is only one reasonably certain way; the property must generate sufficient income to:
 - create its own liquidity; and
 - allow transaction costs to be met
- If the property is leveraged (as is often the case), the need for high income becomes even greater
- There must be a clear gap between the costs of borrowing and the yield generated from rent

WHAT CAUSED THE CREDIT CRUNCH FOR PROPERTY?

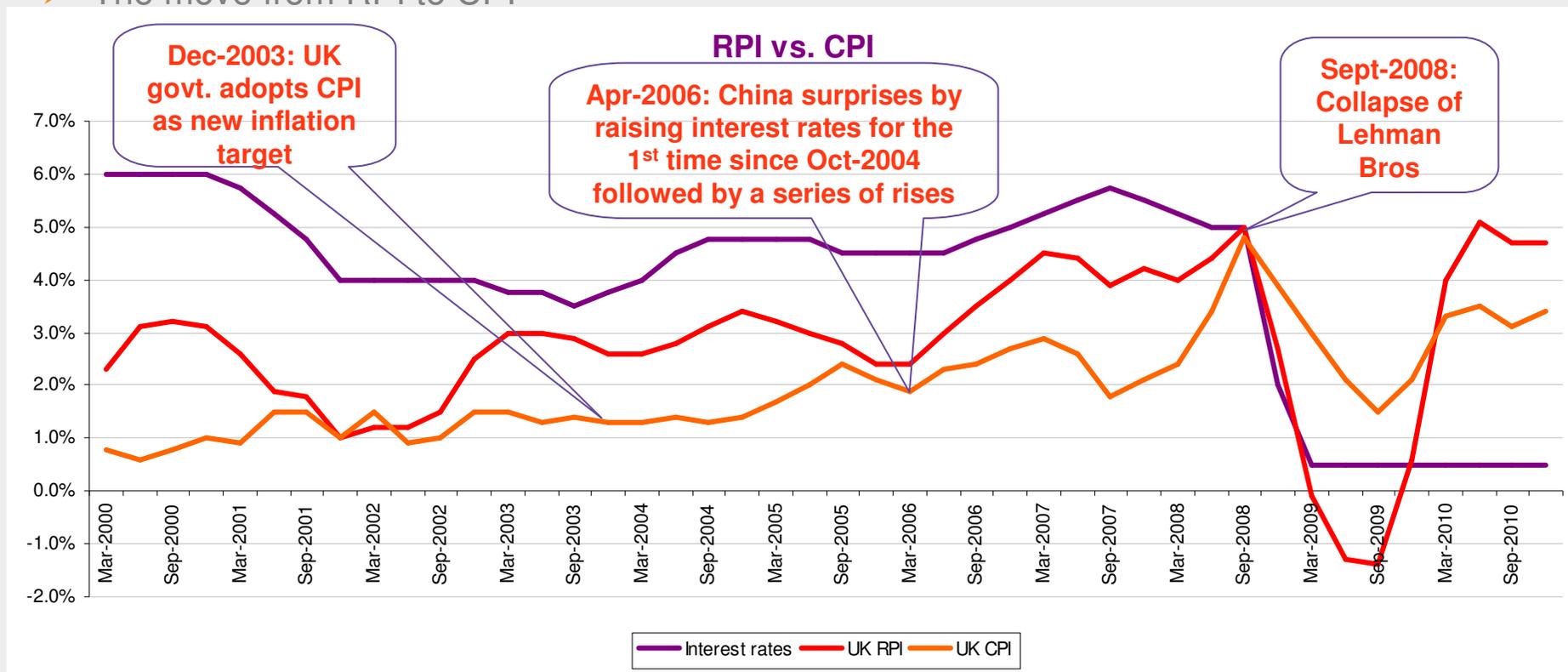
➤ Prolonged period of low interest rates



Source: CBRE, BoE

WHAT CAUSED THE CREDIT CRUNCH FOR PROPERTY?

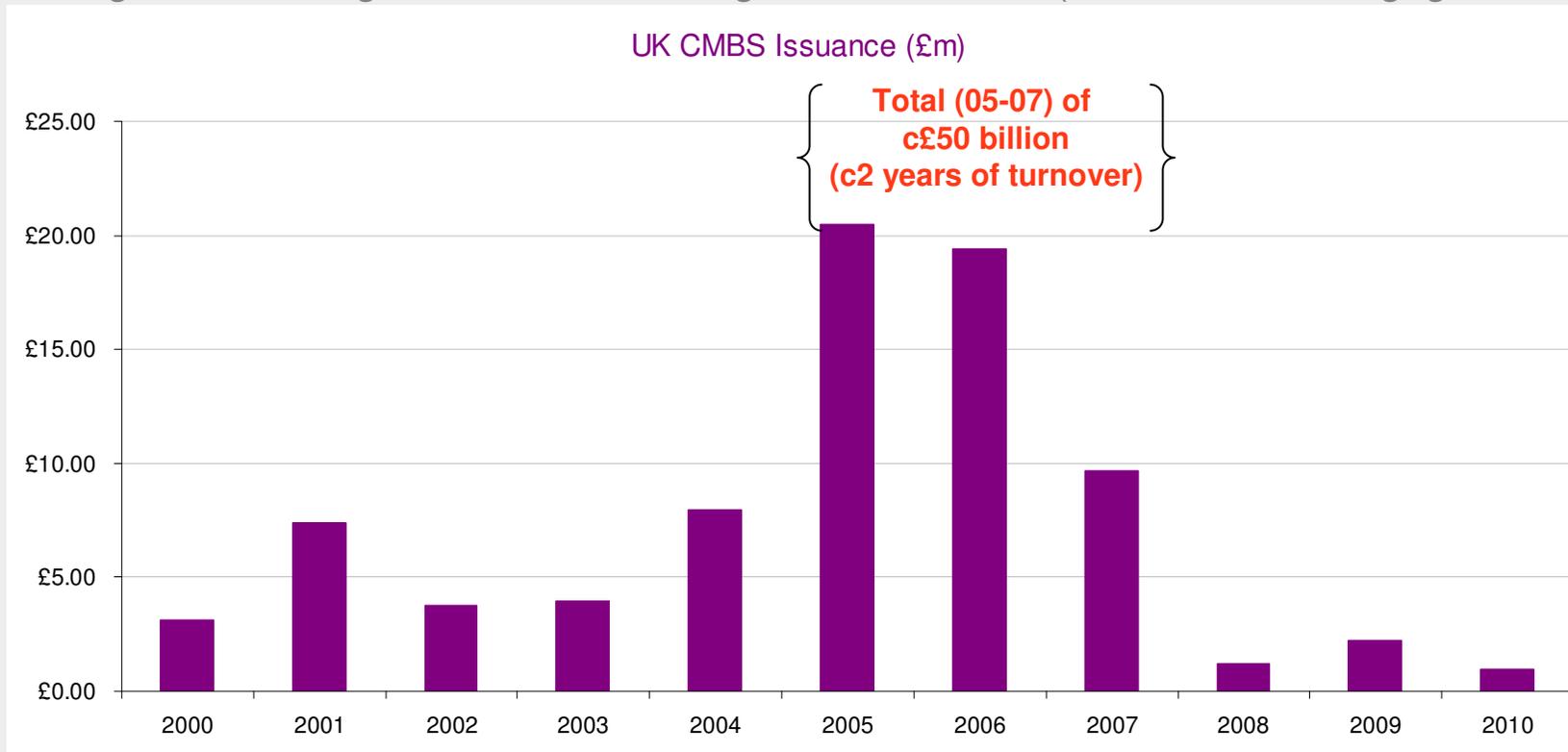
- Prolonged period of low interest rates
- The move from RPI to CPI



Source: CBRE, ONS

WHAT CAUSED THE CREDIT CRUNCH FOR PROPERTY?

- Emergence of a large alternative banking sector – CMBS (Commercial Mortgage Backed Securities)



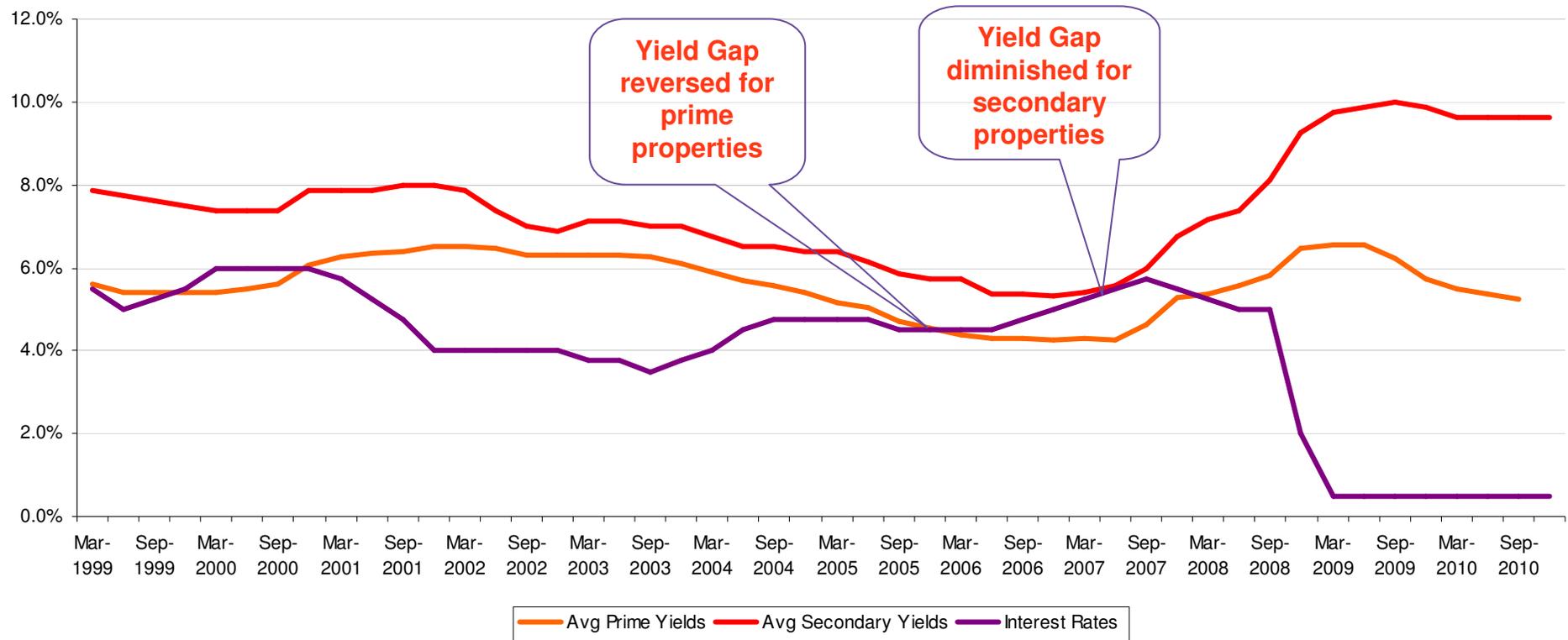
Source: CRE Financial Council

WHAT CAUSED THE CREDIT CRUNCH FOR PROPERTY?

- Fund managers – the shift from Return on Equity to Internal Rates of Return
 - Return on Equity (RoE) measures the cash percentage return of a real estate investment on the equity invested (after accounting for borrowing/ interest costs) and is comparable to the dividend yield earned on stocks; it is calculated by comparing the net income generated from a property versus the cash invested in it
 - Internal Rate of Return (IRR) is the average annual yield on an investment over a period of time; it is generally forecast using the initial amount invested, series of projected cash flows and an estimated exit value
- Irresponsible lending

WAS THE PROPERTY CREDIT CRUNCH PREDICTABLE?

The property credit crunch was VERY EASY to predict



Source: CBRE, BoE

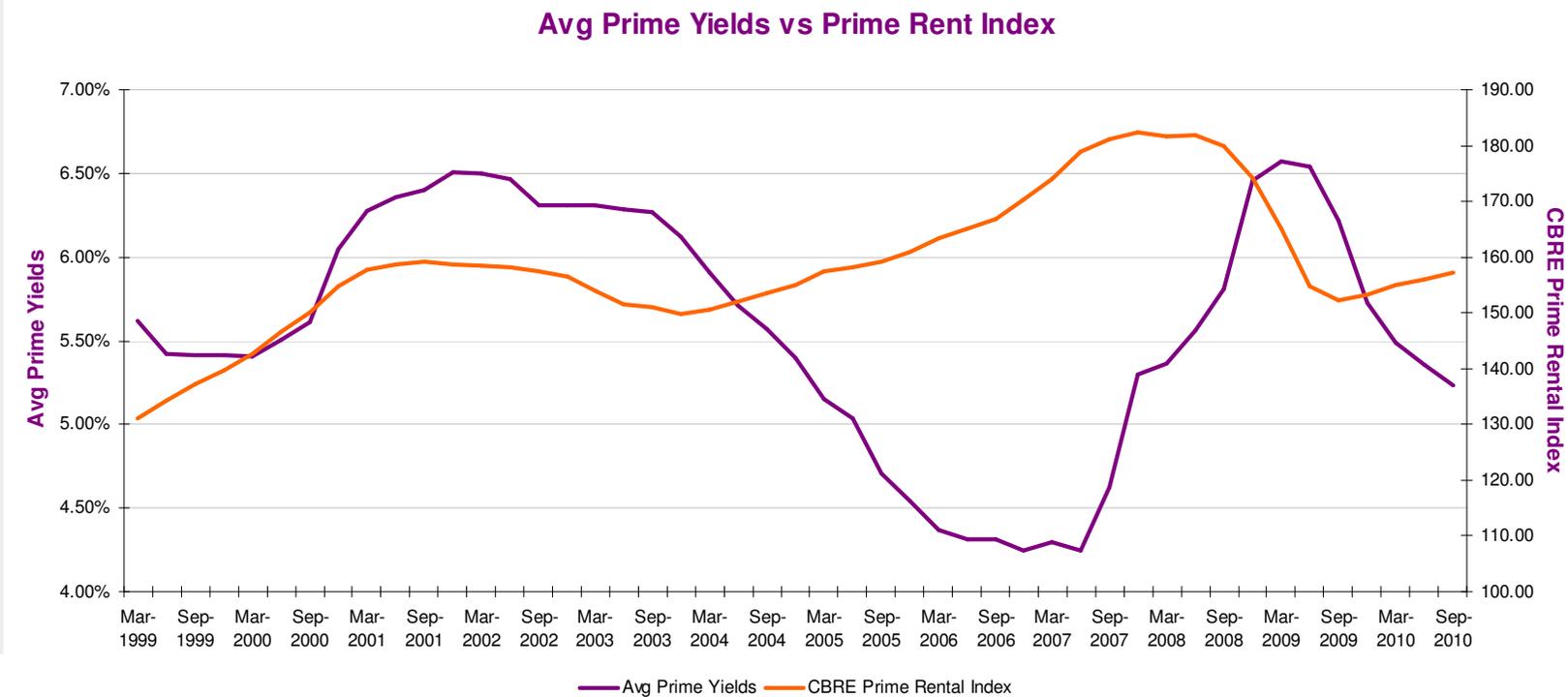
NB: Average yield is average of retail and office yields

THE INFLATION MYTH

- Commercial property is not an obvious hedge against inflation
- Supply side led inflation is BAD for property
- Rampant demand led inflation is ultimately BAD for property
- Mild demand led inflation is good for property

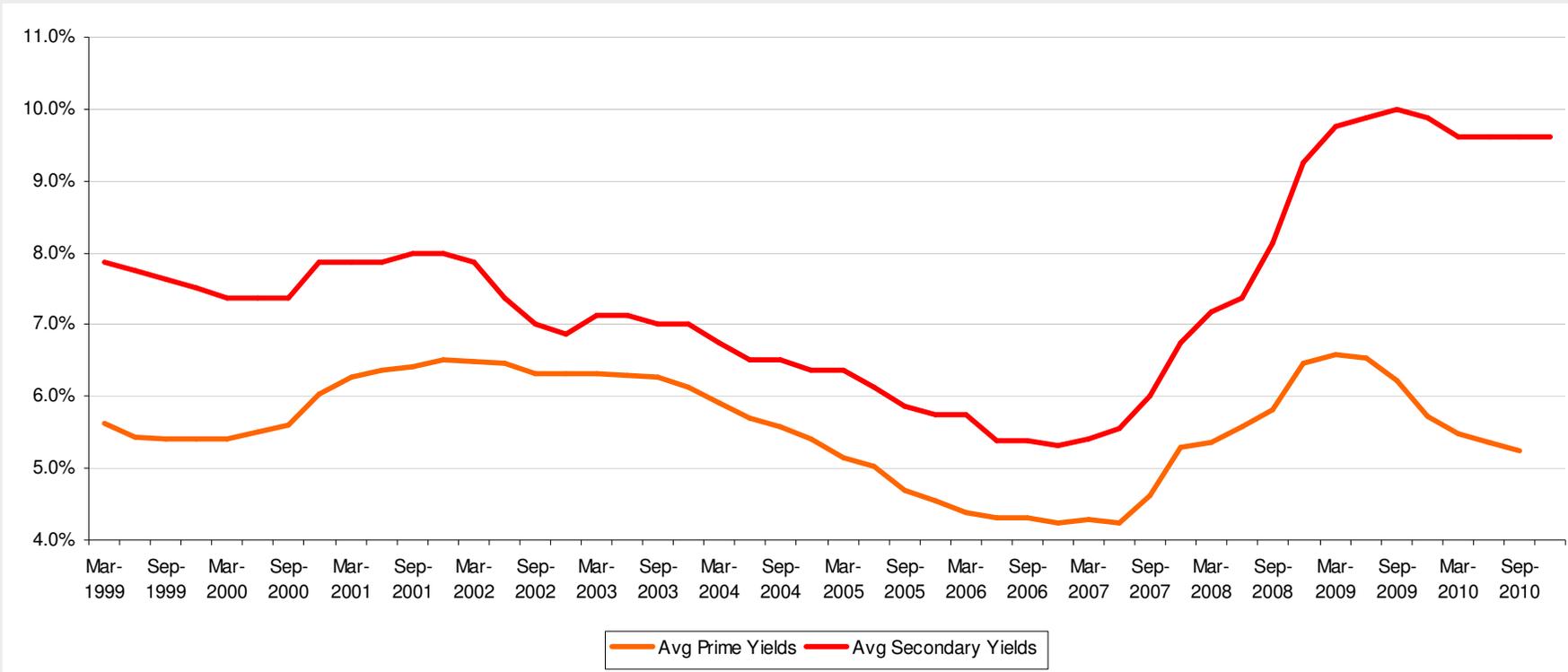
WHAT DOES THE FUTURE HOLD?

- Rush to prime or core property
- Values of prime property closing in on 2007 levels
- A bubble in prime property?



WHAT DOES THE FUTURE HOLD?

➤ The opportunity is in secondary properties



Source: CBRE

➤ BUT TREAD VERY CAREFULLY

WHAT DOES THE FUTURE HOLD?

- Commercial Investment Property is, or at least should be, all about income
- Income is under pressure and will remain so as long as the macro picture remains weak; fundamental rental growth is still some way away
- CMBS and senior bank debt is still unwinding
- Basel III and other regulatory moves will constrain debt finance
- Inflation could prove to be the market's Achilles heel
- Need to buy very judiciously

THE OPPORTUNITY



THE OPPORTUNITY

- The property can be considered to be a prime asset in a secondary location
- It previously transacted in Jun-2004:
 - Was predominantly let to Woolworths Plc
 - Passing rent of £12.46 per sq.ft
 - Transacted for £11.80 million (including bank debt of £7.67m), a net initial yield of 5.1%
- We recently purchased the property in 2010:
 - Now predominantly let to Poundland Ltd
 - Passing rent of £9.96 per sq.ft
 - Purchased for £6.34 million in mid-2010, a net initial yield of 7.73%

The Polish Case Study Office Building (Class B), Warsaw's CBD



The Polish Case Study

Office Building (Class B), Warsaw's CBD

Multi let class B office building in which First Property Group Plc acquired 28% shareholding for 3 principal reasons (asset management intensive):

- Rents passing were some 25% below market rents.
- Potential existed (and still does, albeit to a lesser extent, following some successful asset management initiatives) to extend the leases.
- Costs being levied by the management company, for the management and maintenance of the building, were substantially above market levels, which we intended to attempt to reduce over time.

Financial Summary:

Purchase Price (Dec 2008)	\$12,500,000 (8.7% gross yield) – includes 2 legacy units in a separate building, also in CBD
Current Value (Nov 2010) ⁽¹⁾	\$18,100,000 (8.2% gross yield)
Equity at Purchase	\$2,289,000
Debt at Purchase	\$10,605,000
Overall Net Operating Income at Purchase	\$1,086,122 p.a.
Current Net Operating Income (Nov 2010)	\$1,477,601 p.a.
ROE	48% p.a. (including earnings from 68% shareholding in building management company)
IRR	N/A – not sold yet

⁽¹⁾ Independent valuation by JLL, Nov 2010