Autumn 2008

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GVA Grimley

CBI/GVA Grimley Corporate Real Estate Survey

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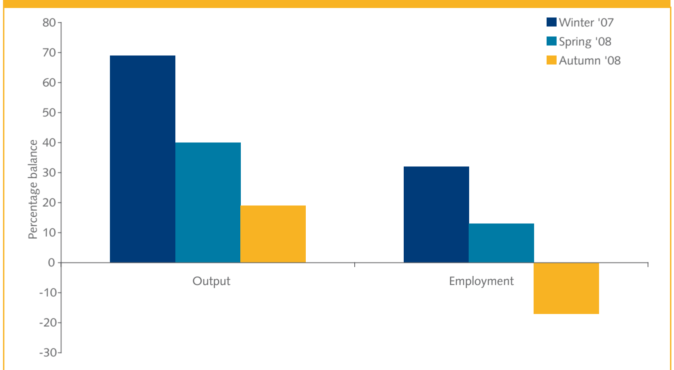
Business confidence continues to fall, with a number of occupiers looking to make cut backs in output, employment and property.

Introduction

This survey was carried out in August and September 2008 and reflects the views of a wide range of businesses across the UK. It reveals how senior management teams are adapting to the current climate to provide the best competitive advantage for themselves and how that translates to their real estate needs.

The survey was predominantly completed before the tumultuous events of October 2008, and whilst there was considerable turmoil in the financial markets it had not turned into the crisis that we had in mid October. As such, the survey in general reflects the views of businesses largely before the intervention of a number of national governments in the banking sector during that month. The survey shows that businesses see the credit crisis and the economic slowdown as having a major effect which will not only be impacting upon employment and output, but also companies' real estate needs. Whilst firms are understandably pessimistic about business prospects and are planning to reduce their property holdings, this may also lead to greater efficiencies and a reduction in surplus property.

Output and Employment Expectations Source: GVA Grimley



Executive Summary

- Business confidence has continued to fall since the Winter 2007 survey.
- Significant job losses are expected across many sectors as output expectations have weakened.
- Occupier demand for property has eased in the last six months and looks set to fall in the next six months.
- The majority of sectors are reporting significant effects from the credit squeeze and the economic slowdown.
- Over half of Corporate Occupiers would ideally shed up to a quarter of their leases.
- Corporate Occupiers are intending to exercise a significant number of breaks and not renew leases expiries.
- Half of all Corporate Occupiers are carrying surplus property, and over three quarters of those have vacant property.
- The changes to vacant rates are having the biggest impact on medium size firms and those in the engineering and transport sectors.
- Business is being driven by profitability and reducing costs.
- Property decision making is based on cost reduction and the contraction or expansion of the business.

Impact of the Credit Squeeze & Economic Slowdown

Business Confidence

The business outlook has deteriorated since the Spring 2008 Survey, with output and employment expectations markedly weaker. Financial services and the consumer-facing sectors of leisure and retail are the most downbeat.

Whilst businesses remain marginally optimistic about prospects for the next two years, with a balance of +5%, there is a downward trend. Extraction & chemicals was the most upbeat sector, and there was surprisingly strong optimism in the construction sector. The most pessimistic sector was leisure, which includes hotels, bars & restaurants, followed by financial services and retail.

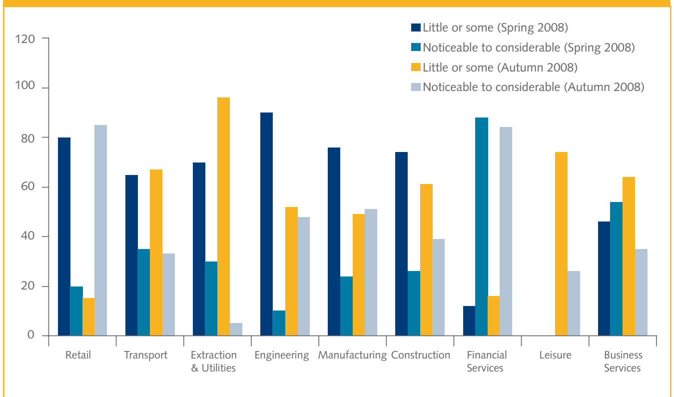
Output expectations are considerably weaker than Spring 2008 and, whilst a marginal rise is still expected, the balance of +6% is well down from +40% in the previous survey and +70% in Winter 2007. Declines in output are expected in five of the nine sectors covered (financial services, leisure, manufacturing, engineering and transport). Employment prospects have also fallen and have now turned negative, with the balance of +30% in Winter 2007 falling to +13% in Spring 2008 and then to -17% in this survey. Job losses are expected across most sectors, with a particularly sharp decline likely in leisure industries.

Economy

Businesses are feeling the effects of tight credit conditions and the economic recessionary pressures differently.

The effects of the credit squeeze have not diminished since the previous survey, with 42% gauging it is having a noticeable to considerable effect on their business, unchanged since the spring. The economic slowdown is of greater concern, with 59% reporting it as having a noticeable to considerable effect to their business.

Imapct of credit squeeze on sectors Source: GVA Grimley



The impact varies across the different sectors. 85% of retailers are reporting a noticeable to considerable impact of tighter credit conditions, with a slightly higher proportion (91%) for the economic slowdown. Very similar figures were recorded for the financial services sector. Transport, warehouse and distribution is only seeing the impact of the economic slowdown (74% compared to 33% for tighter credit conditions), whereas the extraction, chemical and utility sector was reporting little effect of either. Engineering and manufacturing are reporting a similar pattern with the credit squeeze having a noticeable to considerable impact for around half of firms, whereas the economy is marginally higher (59%/65%). There is a surprisingly low effect being reported in the construction sector of either the credit crunch (39%) or economic slowdown (31%).

Operational Property Portfolio

In the past six months there was a slight expansion in property portfolios. Expectations are for a decline in the coming half-year period, with cost reduction the main driver for change in property requirements.

The trend for property holdings has continued downwards. The balance of those reporting an expansion was +3%, a fall from +22% in Winter 2007 and +15% in Spring 2008. The expectation for the next six months shows a significant fall from +7% in the Spring Survey to -24% now, an overall contraction. Larger companies have been reducing the amount of space they occupy, with net declines recorded in each size group above 500 employees. The change for the next six months is that there is a significant increase in the number of companies with over 2,000 employees shedding space.

By sector, the biggest changes in trends between the past six months and expectations for the next six are in retail, financial services, leisure and manufacturing. Retailers reported quite a sharp increase over the past six months, but that has changed looking forward to a virtually static portfolio. Meanwhile, marginal growth in the leisure sector is expected to be followed by a strong contraction over the next six months, whereas financial services and manufacturing were contracting but that rate of contraction is expected to increase significantly.

Commentary

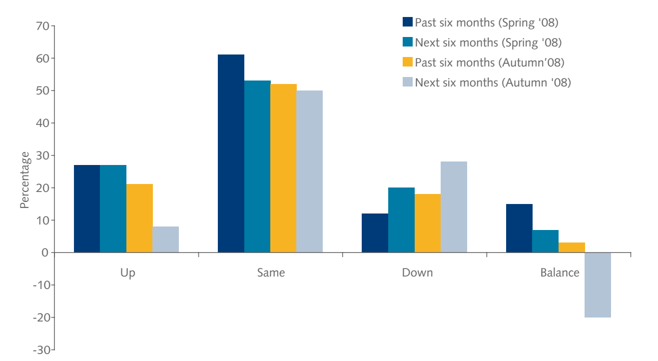
Businesses are now much more pessimistic than they were in Spring 2008 and considerably more pessimistic than Winter 2007. The effects of the credit squeeze and the economic slowdown appear to be being felt differently by the different sectors.

For those businesses with secure lines of credit and that are not quoted the effects of the credit squeeze may well be relatively modest compared to the slowing economy, and the impact it may have had on sales. How this will look in Spring 2009 will be important for the economy overall.

What is clear is that the twin effects of the credit squeeze and the slowing economy are being felt widely across the business spectrum. The effects of this pessimism are seen in static output expectations and with job losses predicted across many sectors.

In Spring 2008 the picture was one of a gradual easing in growth of property portfolios. However, that looks set to change to one of a significant downward adjustment as firms attempt to cut costs and contract their business to fit in with current economic conditions. The property investment market has continued to see a fall in capital values primarily because of an easing of yields. The occupier side of the market had held up well compared to the investment side of the market, witnessed by rents that have only started to fall over recent months in a number of markets. Demand for space from occupiers looks set to slow quickly as firms respond to the economic slowdown, and this will put further pressure on investment values.

Changes in property portfolio Source: GVA Grimley



Operational Property

Drivers of Property Change

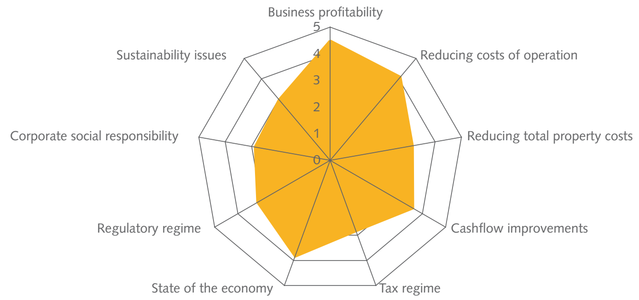
Profitability and reducing costs are the primary drivers for businesses, and these are reflected in the main decision making criteria for property - cost reduction and business contraction/expansion.

In the Winter 2007 Survey we looked at what is important for a business, and profitability and reducing costs scored the highest. In the Autumn 2008 Survey these two remain most important for firms, with business profitability scoring 4.4 and reducing costs 4.0, where 1 means it is of no importance, 3 of noticeable importance and 5 of considerable importance.

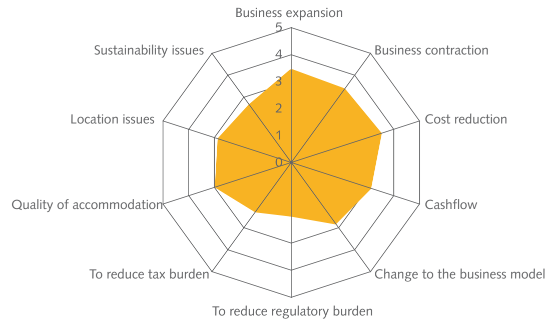
The second tiers of drivers are closely aligned to the first tier. Those that are of noticeable to material importance are the state of the economy (3.8), cash flow improvements (3.5), reducing property costs and the regulatory regime (both at 3.1). The state of the economy has moved from noticeable importance to material importance over the last year. Looking back to Summer 2007, there is an apparent move of sustainability and corporate social responsibility down the agenda of the Boardroom over the intervening period.

Property decision-making mirrors the overall focus of business, with cost reduction (3.6), business expansion (3.4) and business contraction (3.3) the primary drivers. This represents a material change from the Winter 2007 survey where business expansion stood alone as a driver of material importance. The second tier drivers are cash flow (3.0), and then changes to the business model, quality of accommodation and location issues (all 2.9).

Average All Divisions - Business drivers



Average All Divisions - Property decision making criteria



Commentary

The relationship between business needs and drivers, and those for property is not always explicitly clear. At the current time there appears to be a clear link between the two, suggesting that at times when there are recessionary pressures in the economy, management and property issues become more aligned. Business is becoming more focused on profitability and costs and this is flowing into decision-making on the property portfolio.

Why is business expansion still an issue for property strategy at a time when there is a focus on profitability and cutting costs? The long timescales associated with property may be the answer, in that business may be reacting to the short term cyclical nature of the economy but overall are still looking at how to expand in the future. There are bound to be opportunities over the next few years for property because of the poor state of the market.

Sectoral Differences

In looking at the responses, there are some differences between the aggregated figures and those for the various business sectors:

Retail

The four primary business issues for retailers are profitability, reducing costs, state of the economy and cash flow. These are reflected in the property drivers of business contraction, cost reduction and cash flow.

Commentary

The pattern in retail reflects the overall results but is more pronounced and indicates a sector that is trying to deal with the slowdown of the economy which is putting pressure on profitability and providing a focus on cost. As a consequence, the decisions on property are based on the contraction of the business and probably the portfolio itself. Cashflow for retailers is a problem and leading retailers have launched a high profile effort to persuade landlords to accept monthly rent payments. Their approach is a direct response to the pressure on margins that they are experiencing in their business.

Sustainability as an issue for retailers is of marginal importance at present, possibly reflecting the shift in priorities. When businesses come under financial pressure, less immediate matters move down the agenda.

Financial services

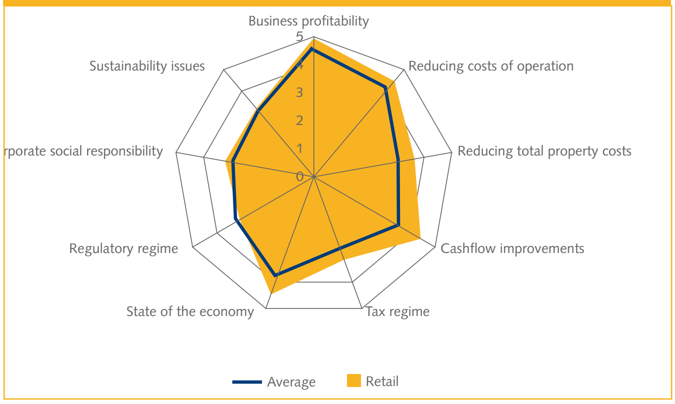
The principal concern for financial services businesses in general is profitability (4.8). Reducing costs and total property costs are both above the overall average.

The key property driver is business expansion at 4.5 compared to the overall mean of 3.4. There is also more focus on location issues and changes to the business model, as well as the quality and cost of accommodation.

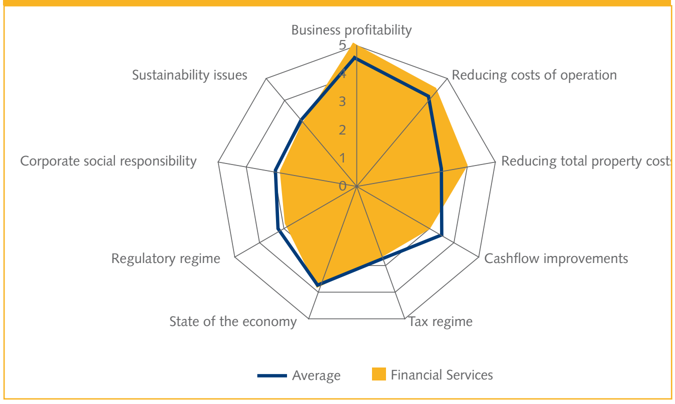
Commentary

This profile would appear to suggest that “cash is king” in the financial services sector at the moment, with focus on profitability and reducing costs. There is a degree of congruence with the focus on expansion indicating that, despite everything else that is happening in the financial market at the moment, property decisions are being driven with the future in mind.

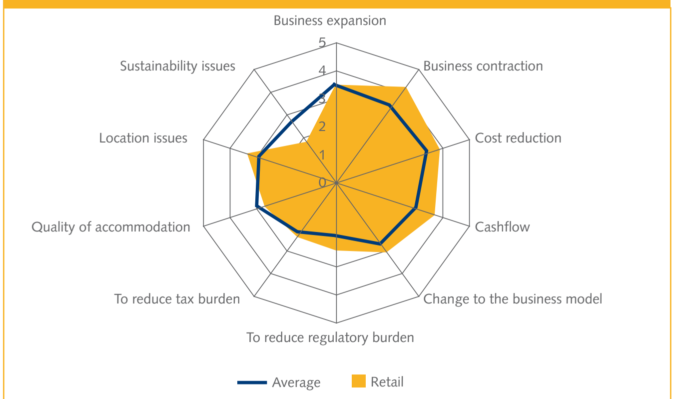
Retail - Business drivers



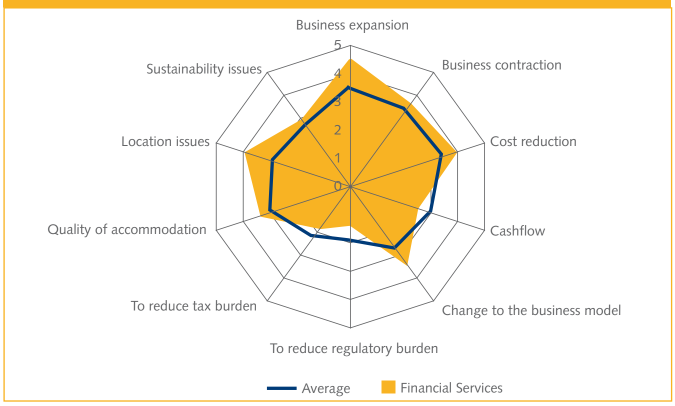
Financial Services - Business drivers



Retail - Property decision making criteria



Financial Services - Property decision making criteria



Leisure

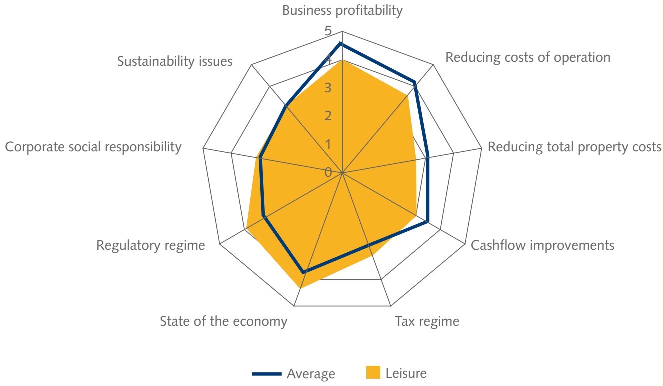
The state of the economy and the regulatory regime is very important to this sector, whilst property decisions are focussed on business contraction and expansion in equal measure.

Commentary

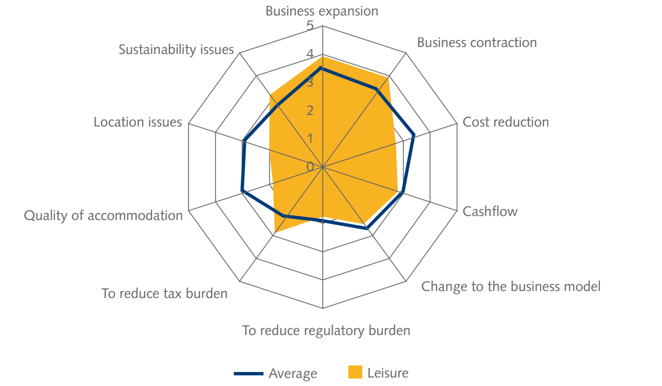
The concern over the state of the economy no doubt reflects the risk that the sector will face if there are prolonged recessionary pressures which further depress consumer spending. Although companies are not asked to comment on specific regulatory concerns, recent calls for increased regulation to combat alcohol abuse and anti-social behaviour may partly explain why the regulatory regime is high on the agenda for the leisure industry at the moment.

From a property perspective it would appear that there are two groups in this sector, the 'haves' and the 'have nots' with business expansion and business contraction both scoring 3.9, well above the population mean and therefore of material importance. This would suggest that companies in equal measure are looking to expand and to contract their property portfolios.

Leisure - Business drivers



Leisure - Property decision making criteria



Operational Property Issues

In an ideal world, corporate occupiers would change the shape of their portfolios over the next two years.

Given free reign, over half of all Corporate Occupiers (57%) would want to shed up to a quarter of their leases. For retailers this rises to 90% and for the financial services sector it is 83% who want to dispose of up to 25% of their properties, whilst the remaining 17% of respondents in that sector would look to dispose of 26% - 50%. This is similarly mirrored in extraction industries with 71% looking to dispose of up to a quarter and 24% looking to dispose of between 26% and 50% of their portfolio.

For most occupiers shedding of space is not a matter of changing the nature of the space they occupy but for many it is a case of reducing the space they have. Overall 39% would not replace any of the space they could dispose of and 44% would only replace a quarter of it. The extraction and utilities industry would not replace 75% of the property they would like to dispose of.

This pattern is repeated with break clauses and lease expiries over the next 24 months, with 40% of occupiers proposing to exercise up to a quarter of their breaks and a third are proposing not to renew expiring leases. In the financial services sector 84% of respondents will be exercising up to a half of their breaks, whilst they will be selective in renewals. Nearly one in five (17%) will not be renewing any of their expiries, 45% will renew 51% to 75% and only a third would renew 75% or more. The leisure industry will be the largest reducer of property through breaks and expiries with 53% reporting that they are not going to renew leases and two thirds planning to exercise up to a quarter of break clauses.

Commentary

This indicates a strong desire by Corporate Occupiers to dispose of a substantial part of their portfolio permanently and to re-structure a large element of the remainder of their property holdings.

The desire of occupiers to reduce the size of their property holdings is not unexpected taken in the context of overall pessimism, falling output and a likely strong reduction in employment. The exercising of breaks and non-renewal of leases is likely to put a downward pressure on rents as the supply of space increases.

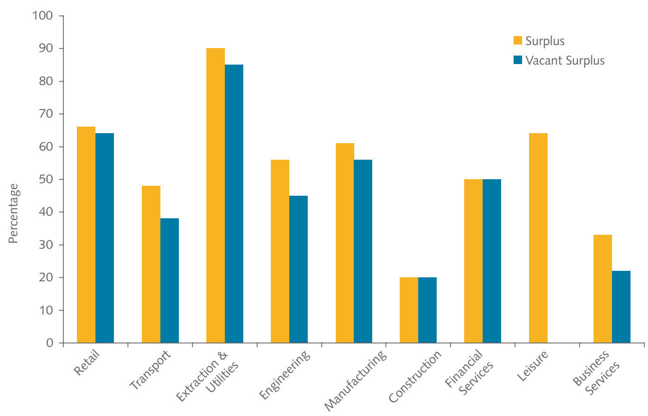
One issue for occupiers will be their ability to exercise breaks. Conditional breaks still cause problems for occupiers and can frustrate their attempts to dispose of surplus property, and with it the costs associated with it. The negative for occupiers for both exercising breaks and not renewing leases is the cost of dilapidations which will have an adverse impact on cashflow in the short term.

Surplus Property

Surplus property remains an issue for half of all businesses, and with it the costs of holding empty property, especially vacant rates.

Overall, 50% of respondents have surplus property and 40% have vacant surplus space. Those sectors with a material amount of surplus space are retail (66%), extraction, chemicals & utilities (90%), manufacturing (61%) and leisure (64%). The hardest hit by the problem are large firms, with more than three quarters of all firms with more than 500 employees reporting that they have surplus space.

Do you have surplus property?



The exposure to vacant surplus space and the costs associated with it are primarily extraction, chemicals & utilities (85%), retailers (64%) and manufacturing (57%) holding vacant surplus space.

Over the last 12 months there has been a small decline in the size of the surplus portfolio, although there are sectoral differences. The extraction, chemicals & utilities sector has seen a large fall, and there were also falls in the engineering and transport sectors. There has been a large increase in manufacturing. Companies with 200 to 1,999 employees have seen the biggest increases in vacant space.

Of the respondents 16% do not make a provision for their surplus leasehold property, but for manufacturing this is 52%, engineering 35% and transport 24%, with the largest number of firms not making provision being in the 200 to 499 employees range.

The Winter 2007 Survey indicated that many businesses were not particularly concerned over the potential impact of the impending change to vacant rates. That is except for the manufacturing and distribution sectors, who believed it would have a severe impact on them. This survey shows that half of respondents believe vacant rates are having a noticeable to considerable impact on their business. Transport and engineering report the biggest effect, together with the mid size companies of 200 to 499 employees. The approach to dealing with the cashflow problems of vacant property remains the focus on expediting surrenders or improving incentives to potential sub-tenants or assignees.

Commentary

Surplus space remains a major issue for business and with it the cost of vacant rates. Whilst the scale of surplus property does not appear to have changed significantly over the last year, the prognosis for reduced output and employment suggests that there may be an increase in surplus property during the coming months. How much of that will be space that the corporate occupier still has a liability for, and how much will be handed back to landlords because of expiries not being renewed and the exercising of breaks, remains to be seen. By not providing for their surplus space, occupiers will have to use cashflow to fund the cost of disposals and this may fetter their ability to achieve permanent solutions.

It is not surprising that engineering and transport are being hardest hit by the effects of the changes to vacant rates. Prior to the change they would have had no cost from vacant space on industrial and warehouse space, but now have to pay the full rates liability. The results of the survey do demonstrate that the change to empty property rate relief is having an impact outside of those companies in the property sector. The negative effects are not restricted to just large companies as medium size companies are reporting the biggest effect.

We invite your comments on this survey and also look forward to your continued support and participation in the future. If you would like extra copies of the report or would like to take part in the next survey, please contact us on the details below.

The business sectors used in the survey are:

Retail

Transport – Transport, Warehousing and Distribution

Extraction & Utilities – Extraction, Chemicals, Energy and Water Supplies and Telecommunications

Engineering

Manufacturing – Manufacturing other than Engineering

Construction

Financial Services

Leisure - Hotels, bars and restaurant

Business Services – Real Estate, Business and Other Services

The survey was carried out over August and early September 2008 and had 152 respondents

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