GVA Grimley

Core Issues

Recessionary pressure continues to dominate occupiers thoughts

November 2008

The unexpectedly large cut in interest rates by the Bank of England highlights the scale of the problems facing the economy.

The Business

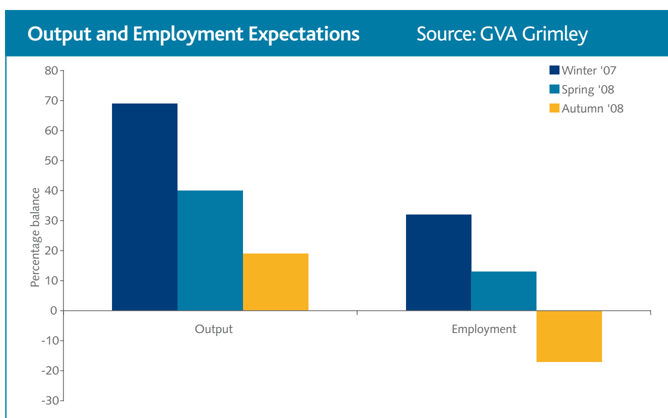
The crisis in the financial markets across the globe has led to government bail outs of a number of financial institutions generally in exchange for shares in the company.

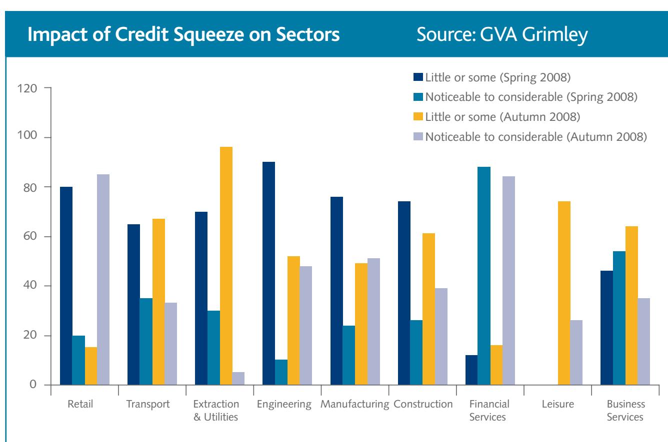
While this part nationalisation of banks and the likes has served to restore some confidence, it remains to be seen what the long term impact will be. The consequence of this worldwide approach was a leap in stock market values across the globe. The Dow Jones had fallen by 20% in the week preceding the announcement but the day after it recovered 11% while the FTSE 100 similarly jumped 8.3% on the day, some of the biggest one day moves recorded. Having seemingly stabilised the market turmoil resulting from the financial crisis, traders then woke up to the fact that the world economy is slowing and some countries are plunging into recession – which has prompted further falls in the market.

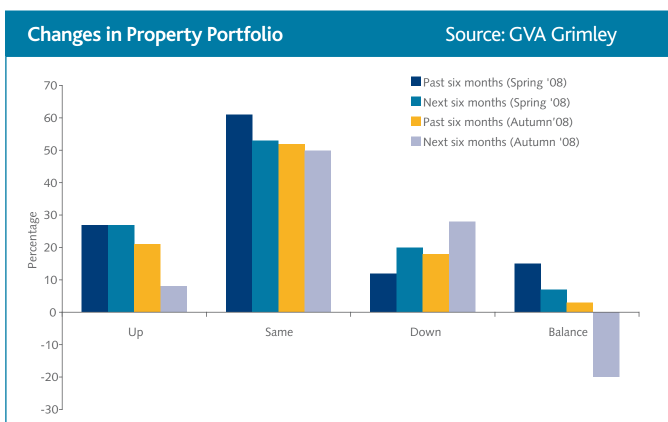
UK

The probability of a recession in the UK appears to have moved to a certainty. Andrew Sentence, a member of the Monetary Policy Committee (MPC), has said that it seems likely that there will be a fall in GDP in the third and fourth quarters of 2008, and Mervyn King has finally uttered the 'R' word. The third quarter figures have confirmed a fall of minus 0.5%. The nine to nil vote in favour of the half point cut in interest rates by the MPC in October indicates that they have recognised that inflationary pressures have fallen and that they now need to stimulate the economy to mitigate the downside. This has led the Chancellor of the Exchequer to state that the Bank of England had the discretion to determine over what period of time it should meet its inflation targets and therefore it can support the government's wider economic objectives. The US Federal Reserve cut rates to 1% and the continued downward trend of the economy has led the MPC to cut rates by 1.5% to 3%, the lowest level since the early 1950's. This is a clear sign that the recession is going to be difficult and protracted.

The downward pressures on the economy are currently being manifested everywhere. Like-for-like retail sales have fallen for the fourth consecutive month, with a fall of 1.5% against last September according to the British Retail Consortium. Only food sales showed a rise, while sales volumes fell for the seventh month in a row according to the CBI. The Office of National Statistics shows a rather different picture, with sales volumes fluctuating from month to month and being 2.6% lower in September than their peak in May. House sales have continued to slump with an average of just one sale per week being recorded by estate agents, the lowest since the RICS survey commenced in 1978. The overall effect is looking like a fall in house prices of nearly 15% year on year in October. This suggests a fall in 2008 of 17-20%, with a further 10-15% likely next year, although with a low level of demand it is difficult to fully judge the state of the market. Values will be further depressed as the rise in repossessions, up 71% for the three months to June compared to the same period the year before, brings more housing stock onto the market.







Unemployment has risen at its fastest pace in 17 years in the three months to August with the ILO measure showing an increase of 164,000, taking the jobless rate up to 5.7%. There is also the issue of the rise in the number of overseas workers returning home because of the poorer economic climate here, and therefore the true fall in jobs is much higher.

The prognosis for the UK looks poor in the short term as the CBI/GVA Grimley Real Estate Trends Survey shows, with employment and output falling, and with it a fall in the demand for space.

The reaction of businesses to the turndown in the economy has been slow and research indicates that it will take about a year for many to implement restructuring programmes. The knock-on effect will be to put pressure on liquidity of businesses at a time when they need to be able to react quickly and conserve cash. The potential effect on property will be a shortage of cash to deal with property issues.

Europe

German inflation dropped to 2.4% from 2.9% in September, the third consecutive monthly fall. The European Central Bank reduced interest rates in November by 0.5% to 3.25%. This is the first time ECB rates have been higher than UK.

USA

Business failures rose in the USA throughout the summer and are looking set to accelerate further. This is not only small scale operations but also corporate borrowers who are defaulting on high yield bonds. It is estimated that about 5% of all issues will default this year, up from 0.9% the previous year. The pricing of bonds in the market place is anticipating a default rate of closer to 25%. The number of companies failing may be artificially low because of a large number of companies re-financing on advantageous terms during recent years. However, the risk is that these companies will fail to refinance when they need to in the next couple of years, which is estimated to push the default rate to circa 10%. The impact on the UK is likely to be the loss of buyers of goods and services putting further pressure on companies.

The Federal Reserve has now taken interest rates back to 1.0%, last seen in 2003/2004, but that is likely to drop further in the coming months. The speculation is that 0.5% will be reached by the end of the year, with rates then at a level not seen since the 1950s.

Property Market

Rents in the City are now about ten percent less than a year ago but are predicted to drop further over the next 18 months. West End rents are also starting to ease down with deals not completing, creating a market similar to that of 1990, when there was a paucity of actual deals on which to judge rental values. The level of vacancy in the City is starting to rise but will increase more sharply as new developments complete and space is put on the market by occupiers who have shed staff.

The supply of retail space coming on the market will continue to grow as schemes that are already underway complete. Even if no further schemes start, it is going to be 2011 before the end of the tranche of new shopping centres open, such is the quantity underway. In 2008 alone, approximately 7.5m sq ft of new retail space will have opened.

The High Street remains under pressure with annual retail sales growth dropping. The quantity of goods sold in September fell by 0.4%, putting the annual growth at 1.8%. In many ways this is more robust than expected but the numbers are buoyed up by food sales. Non-specialised retailers saw a drop of 2.4% in sales volumes in the last quarter compared with the same period the year before.

One consequence of this is that many retailers are now cutting back on investment. For example, DSG, the electrical retailer, announced a 16% cut in spend. This is likely to be repeated across the occupier side as businesses hold on to cash. This may impact on the property market in a number of ways including reduced take up of space; less frequent fit out; slower take up of deals; and more time settling dilapidations, etc. It is also surely the time to look at how the portfolio can generate cash and capital with a review of strategy and looking at occupational levels etc in the recognition that property can add value.

The campaign to change the pattern of rent payments in the retail sector seems to have changed and a number of landlords have agreed to let those tenants with fewer than four stores to pay rents monthly without any financial penalty.

The CBI/GVA Grimley Survey has also highlighted the intention of tenants to exercise breaks and not to renew leases in fairly substantial numbers. Given free rein, occupiers would get rid of 57% of their current space. Four in ten would not replace any of that space, while a similar amount would only replace a quarter. With breaks, 40% are proposing to exercise up to a quarter of their breaks and nearly a fifth will not be renewing leases that expire.

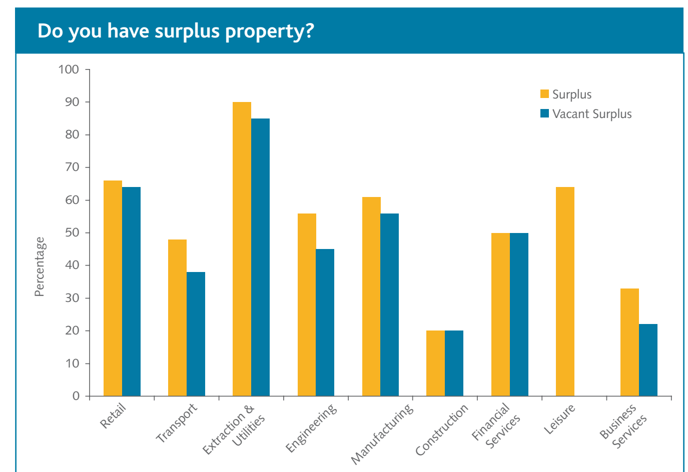
There are going to be a number of knock-on effects as a consequence of all this. From the landlord's perspective, it will increase the amount of space in the market and will depress rents. From the tenants' viewpoint a number of things follow. Firstly, it does mean that for breaks there is a need to make the decision well in advance and plan the whole process. Unless a clause is absolutely clear that there is no compliance required, an occupier has to assume, especially in a tough letting market, that the landlord will seek to frustrate the tenant. So a two year timescale needs to be adopted to ensure that works can be done in good time and that the correct level of advice is taken. Too often it is too little too late, resulting in a failed break.

Secondly, for those leases that are to be renewed and breaks not to be exercised, occupiers should be proactive in gaining value from them. Thirdly, it is likely to become a buyer's market, so getting open breaks and flexible leases should be the order of the day. The over-arching issue is that the Corporate Occupier needs to have a portfolio strategy mapped out and a tactical approach agreed for each property.

Surplus space remains a problem with over 50% of businesses carrying surplus space – the bulk of whom having vacant space. Businesses with more than 500 employees and in the extraction and utilities, retail, manufacturing and leisure sectors are currently the worst affected by this problem. How that will change over the coming months of the slowdown remains to be seen.

Properties bought for development at the height of the boom are causing problems for a number of purchasers as the price paid is now substantially above the current value and with falling demand the economics of commencing developments do not appear to be viable. The Middlesex Hospital scheme would appear to be one site that looks like it might be empty for some time to come.

Do you have surplus property?



Company Info

Here are some extracts from the press on activity within the corporate sector that has property ramifications:

Bagur – The Icelandic company that owns or has large stakes in a number of British High Street brands, including House of Fraser, is under pressure as a consequence of the banking crisis and, in particular, the problems in the Icelandic banking system. As a consequence, it is facing potential loss of control of its companies with Sir Philip Green looking at gaining control by buying up the debt in the company.

Motor World - Has gone into administration with the loss of 300 jobs and the closure of 95 of its 237 car parts stores. The remaining 142 stores have been sold.

Goldman Sachs – Having initially appeared immune to the troubles in the financial markets, the investment bank has announced that it will shed 10% of its worldwide work force of 33,000 with the biggest cuts likely in London and New York.

Hedge Funds – A clutch of hedge funds are likely to fail as the returns from funds turns negative and investors start to withdraw funds. In September, funds lost 4.6% as a consequence of volatile markets and the ban on short selling. A number may well shut up shop as their funding disappears, with the consequent issues around properties they occupy.

Merrill Lynch – John Thain, Merrill Lynch's chief executive, announced that thousands of jobs would be lost after the take over of Merrill by Bank of America.

Co-operative Group – The Office of Fair Trading is making the retailer sell 126 stores following the Co-op's takeover of Somerfield. While there is not a concern at the national level about competition, there is in certain local areas.

UK Government – OGC has announced its strategy for the period to 2010/11. The intention is that savings of up to £1.5bn will be made by 2013 from running the civil estate, which will see 20,000 jobs move from London and the South-East.

Celebrations Group – The card shop retailer that is in administration has notified landlords that rent will not be paid until January, despite the 288 shops continuing to trade. Buyers are being sought for the stores and the company wants to remain as licensee until then. This is the second time that the company has gone into administration having previously been the Greeting Card Group when it went into administration in 2006.

Network Rail – It appears from press comment that a site in Milton Keynes has been chosen for building a 350,000 sq ft hub for 3,000 people. The next stage will be a design competition and then construction to enable staff to move in during 2011.

Legal issues

The House of Lords has overturned the judgement in the Scottish & Newcastle case that required landlords to make former tenants aware of the potential increase in a rent due within six months of each rent due date beyond the review date. The plethora of Section 17 notices under the Landlord and Tenant (Covenants) Act 1995 can now be avoided in place of just one within six months of the review being finalised.

Rates continue to be in the headlines. Firstly, there is the issue of the back-dated rates for port occupiers following changes in the rules allowing the Valuation Office Agency to assess ports based on an individual business basis rather than it being through the port operator. This has led to claims of multiple business failures and, while the government is looking at providing some flexibility on payment, it is citing EU rules on state aid as a means of not changing the rules before the next revaluation in 2010.

The second aspect on rates is the continued pressure on the government to change the rules on vacant rates, especially in light of the economic slowdown which will see more occupiers carrying vacant space.

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