

# **King Sturge Property Predictions 2010**

## **1. Economic and property market review**

## **2. Sector reviews**

**2.1 Residential**

**2.2 Retail**

**2.3 Offices**

**2.4 Industrial**

**2.5 Investment**

**2.6 Planning**

**2.7 Building**

## **1. Economic and property market review**

Angus McIntosh, Partner, Head of Research

+44(0) 7711593244

[angus.mcintosh@kingsturge.com](mailto:angus.mcintosh@kingsturge.com)

**2010 will be a boom year for commercial property investment - the best returns for four years – but is it a false dawn? Total returns may well stay positive but capital values may fall again by 2012.**

### **The Economy**

The recession has been one of the deepest since 1929. The emerging economies of China and India have been remarkably resilient. Sovereign Wealth Nations, based mainly on oil wealth, will do particularly well.

A combination of monetary policy, fiscal expenditure and quantitative easing in the UK has averted a major crisis but left a legacy of problems:

- Rising unemployment (especially for the under 30s), weak consumer expenditure and a lack of public sector finance will slow down the recovery
- Rising commodity prices (especially oil and food) – driven by demand from the emerging Asian economies and crop failure/climate change – will dampen the economic recovery. Mild stag-flaion in Europe may persist.
- Retail price inflation is unlikely – although it will be slightly higher in the USA and UK and will hold down the value of US\$ and £ sterling.
- A change of Government or hung parliament in the UK may make these problems worse.

There will be a two speed economy; low income households will widen the wealth differential, potentially leading to greater social unrest.

### **The Property Markets**

- There are clear signs that the property investment market has started to recover.

- The danger is that the property investment market will have a false dawn.
- 2010 will produce the best returns for four years but capital values may collapse again in 2012.
- All commercial occupational markets across Europe will remain soft for 2-5 years; rents will continue to fall.
- Take-up of office space (as with others including industrial and retail space) will be very selective over the next year or two.
- A lack of demand for space in both the private and public sectors will result in very few new development projects for 2-5 years.
- The “green agenda” will have to re-focus on retro-fitting buildings and places to save energy.
- Investment yields hardened during the boom years and converged across Europe; in the next few years there will be an on-going divergence: well let prime investments *versus* the rest.
- A two-tier commercial property investment market will persist.
- Average house prices fell further, faster and earlier in the USA than other economies. The UK is almost unique; house prices have started rising.
- In 2010 average house prices will see very modest decreases in value.
- As with the commercial property market, a two tier housing market will persist.
- Urban regeneration and Eco-Towns in the UK will be a non-starter in most markets where land values will be “below water”. The Community Infrastructure Levy in the UK will not work but TIFs (Tax Increment Funding) and LABVs (Local Asset Backed Vehicles) offer urban regeneration solutions

- A lack of Government finance will mean “gap funding” will not be available. Private sector projects will not be able to finance new urban regeneration.

### **The Global Economy**

There is a growing consensus that the recession will now not be as long as forecast; recovery may be sooner than predicted.

**The emerging economies of China and India have been remarkably resilient.** There is also evidence that the Indonesian economy is prospering and the concept that the BRICs (Brazil, Russia, India and China) will lead the world out of recession has now become the BRIICs.

Equally, **the Sovereign Wealth Nations, based mainly on oil wealth, will do particularly well.** Brazil has recently made a major oil find, and the economies of the mid-east OPEC and even Russia will rebound in 2010 very strongly.

### **The European Economy**

The European economies are also likely to recover by 2010, the exceptions perhaps being Hungary and Spain.

**The combination of monetary policy and fiscal expenditure, (together with quantitative easing) have averted a major crisis but left a legacy of problems**

It started by being as deep as the 1930s collapse, but that collapse has now been arrested by monetary & fiscal policies.

Although the recession is considerably deeper than 1990/93, it will last about the same period of time; by 2012 positive economic growth should have pushed output above the level of 2007.

**The Recession legacy:** the recession leaves in its wake a number of major problems. Unemployment is a lag indicator. Although unemployment in the UK has been far less pronounced than in the USA or the Euro-Zone, it may continue to rise for another year or two.

**Consumer expenditure** collapsed in many of the developed economies this last year. This has had a major impact on household goods, not general consumer and convenience expenditure; the worse will be over by 2010 with modest growth in 2011 onwards.

**Public sector finance** has bailed out the banking system. The UK went into the recession in a worst fiscal position than other parts of the world – expenditure against tax revenue (as a percentage of GDP) will be far worse next year in the UK. It will take some years for this **public expenditure** debt to correct itself.

**Interest rates** (part of the very active fiscal and monetary strategy which has averted a worse recession) are likely to remain at 1% or below in the developed economies for the next year – perhaps even longer. Only Australia and Norway (two mineral economies) have raised short-term interest rates so far.

In addition to the worries over Government debt and rising unemployment, **commodity prices** are beginning to rise at an alarming rate. **Oil prices** peaked in the middle of 2008 but then collapsed. By the third quarter of 2009 they were on an upward path, significantly higher than two or three years earlier, partly caused by demand from the fast growing Asian economies.

The same pattern can be detected in the **food price index, made worse by crop failures due to climate change**. There is inflation in world commodity prices which could lead to stag-flation (very modest economic growth with cost-push inflation).

### Regional UK outlook

The regions generally follow the UK

#### **Economic Growth - GVA % per annum**

*Source: Oxford Econ Nov 09*

|        | 2008 | 2009 | 2010 | 2011 |
|--------|------|------|------|------|
| UK     | 0.9  | -4.6 | 0.9  | 2.3  |
| London | 3.0  | -5.1 | 0.2  | 2.5  |
| SE     | 1.2  | -4.8 | 0.5  | 2.2  |
| SW     | 1.2  | -4.4 | 1.0  | 2.4  |
| E      | 0.2  | -3.5 | 0.7  | 2.4  |
| EM     | -1.5 | -4.2 | 1.2  | 2.1  |
| WM     | 0.3  | -5.4 | 1.3  | 2.2  |
| NW     | 0.2  | -4.0 | 1.4  | 2.3  |
| YH     | -0.3 | -4.6 | 1.5  | 2.2  |
| NE     | -0.4 | -4.3 | 1.1  | 1.9  |
| Wa     | -0.8 | -4.7 | 1.4  | 1.9  |
| Sc     | 1.9  | -4.2 | 0.8  | 2.0  |

## Overall Economic Outlook

The result of this recession indicates that **the values of the US\$ and £Sterling are likely to remain relatively low (compared with the Euro).**

The fiscal stimulation (particularly “cash for clunkers” whereby Government money has been available for trading in old cars), quantitative easing and **lower interest rates** have come to an end. In the UK the VAT reduction to 15% reverts back to 17.5% in 2010.

Economic growth remains weak and the **cost and availability of bank debt** will remain difficult for some time to come making new investment less likely.

There will be a **two speed economy**; those with equity to invest will prosper. Only modest consumer expenditure growth is likely to continue.

Welfare payments will be considerably constrained and unemployment will remain uncomfortably high for the next year or two. **The disparity between low income households and the general economy will widen.**

|                             | 2008  | 2009  | 2010  | 2011 |
|-----------------------------|-------|-------|-------|------|
| UK                          | 0.9%  | -4.6% | 0.9%  | 2.3% |
| Finance & Business Services | 3.1%  | -3.8% | 0.9%  | 3.5% |
| Manufacturing               | -2.9% | -     | 1.1%  | 3.0% |
| Consumer Expenditure        | 0.6%  | -     | -1.2% | 2.9% |
| Public Sector               | 1.5%  | 1.4%  | 1.5%  | 0.2% |

|                                 |        | 2008 | 2009 | 2010 | 2011 |
|---------------------------------|--------|------|------|------|------|
|                                 |        |      |      |      |      |
| GDP                             | % year | 0.9  | -4.6 | 0.9  | 2.3  |
| Consumer spending               | % year | 0.9  | -3.1 | -0.5 | 1.5  |
| Unemployment rate               | %      | 2.8  | 4.8  | 5.8  | 5.9  |
| Inflation                       | % year | 2.3  | 3.6  | 2.0  | 1.2  |
| Unemployment rate change % year | % year | -3.1 | -9.9 | 0.5  | 2.4  |

## **The Property Market**

With a general lack of bank debt and rising unemployment, **all occupational markets across Europe will remain soft. Throughout the UK and in most major European markets rents will continue to fall until 2012.**

In the office market the worst rental falls will be in Germany, Ireland and Spain. In the industrial market Spain and Hungary will do particularly badly.

In the UK, offices and leisure will do worse, but there already signs that rents in the City of London may have stabilised and may grow modestly.

Frankfurt rents, which never recovered from the dot.com burst in 2000, have been the least volatile.

Moscow rents have been the most volatile in Eastern Europe.

**A lack of demand for space in both the private and public sectors AND falling rents will result in very few new development projects for 2-5 years.**

- **Investment Markets**

**There are clear signs that the UK property investment market has started to recover;** the annualised figures from the UK IPD Index imply that the first three months produced a positive total return. After the double dip (October 2008 and March 2009) the stock market has produced a much better performance in 2009.

**The danger is that the property investment market will have a false dawn.** The collapse of the property market in 1990 was not as severe as in 2008 but the full recovery did not take place until 1996. The false dawn was in 1993 (after devaluation in October 1992) when capital values accelerated dramatically but then slowed down again in 1995. **History will repeat itself.**

Current forecasts suggest that average capital values will stop falling in 2010; a positive total return will be achieved in 2010 and 2011 but capital values may then fall again in 2012 when vacancy levels will remain high.

Average mainland Europe and secondary markets in the UK are only likely to recover from this trend when unemployment falls and occupational demand increases.

There will be a thin letting market. **Take-up of office space (as with others including industrial and retail space) will be very selective over the next year or two** having, reached a modest peak back in 2007.

Office vacancy rates will also remain remarkably high in many markets across Europe, holding down secondary investment values, having increased from a low point in 2006.

- **A two-tier commercial property market**

At the prime end of the market there will be investment activity where long leases are available, providing investor income in very good locations. **Whilst yields hardened during the boom years (2004-2007) and converged across Europe, in the next few years there will be an ongoing divergence of yields.**

Only long let investments in the UK and a few prime locations, such as London and Paris, will demonstrate much lower investment yields and higher capital values. Much higher investment yields (where there is evidence of market activity) will generally be available across the rest of the UK and on mainland Europe – but all yields and capital values will stabilise in 2010.

This scenario will only change as and when a) bank debt becomes more readily available at a fair price, b) the overall economies of Europe accelerate, c) unemployment falls and d) property occupational levels (and rents) start to increase again.

- **The Residential Market**

The credit crunch and financial crisis lead the developed economies into recession. **Average house prices fell far further and faster in the USA than other economies from 2005 onwards (when Spain also peaked), but the UK (from 2006) and Ireland (from 2007) were not far behind.**

It is suggested that the worst of the collapse of the house prices is now behind us; a very mixed picture remains. **In 2010 average UK house prices will see a very modest decrease in**

**value with more growth detectable by 2011/12. A two tier housing market will persist for some time.**

Construction costs are likely to rise faster than very modest increases in value, especially driven by the green agenda and the need in the UK to build to Code 4 or better. Meeting ever increasing “green” sustainable benchmarks will push up construction costs – made worse by rising commodity prices and energy costs.

**Urban regeneration and Eco-Towns in the UK will be a non-starter in most markets where land values will be “below water”. The Community Infrastructure Levy in the UK will not work, but TIFs (Tax Increment Funding) and LABVs (Local Asset Backed Vehicles) offer urban regeneration solutions.**

A lack of Government finance will mean new “gap funding” will not be available. The private sector will not be able to sustain urban regeneration projects and even funding to Registered Social Landlords via the Homes and Communities Agency in the UK is likely to be restricted for several years. Both bank finance and government finance will be in relative short supply and expensive. The volume of transactions will remain low.

## Annual house price change (%)

|                   | Actual | Forecast |      |      |      |      |
|-------------------|--------|----------|------|------|------|------|
|                   | 2008*  | 2009     | 2010 | 2011 | 2012 | 2013 |
| London            | -15.1  | 4.7      | -0.6 | 5.2  | 8    | 6.4  |
| South East        | -15.4  | 4.5      | -0.7 | 4.6  | 6.8  | 5.7  |
| South West        | -15    | 3.6      | -1.1 | 3.8  | 6    | 4.8  |
| East              | -16.6  | 3.9      | -1   | 3.9  | 6.2  | 5.2  |
| East Midlands     | -14.2  | -0.3     | -2.9 | 2.4  | 6.3  | 6.3  |
| West Midlands     | -14.2  | -0.4     | -3   | 2.2  | 5.8  | 5.7  |
| Yorkshire & Humbs | -13.7  | 0.3      | -2.9 | 1.9  | 5.6  | 5.9  |
| North West        | -14.5  | 1.2      | -2   | 2.1  | 5.9  | 6.1  |
| North             | -11.2  | -2.5     | -2.8 | -0.3 | 5.4  | 6.4  |
| Wales             | -12.2  | -0.4     | -2.5 | 1.8  | 6    | 6.7  |
| Scotland          | -8.1   | 2.1      | 0.8  | 4.2  | 5.3  | 5    |

Source: \* - Nationwide, Real Estate Forecasting (Nov 09)



Although the recent collapse of house values is only the second since 1955, the recovery will be slow. The fall in prices has made land values fall dramatically, averaging 40% year-on-year - but in secondary locations land values are negative.

There is some evidence that the market has started to recover; both the number of private development starts and the sale-to-stock ratio, have started to improve.

### **Some conclusions**

- A two-tier commercial property investment market will persist but 2010 will produce a false dawn. Capital values will fall in 2012.
- All commercial occupational markets across European will remain soft for 2-5 years; rents will continue to fall this year.
- A lack of demand for space in both the private and public sectors will result in very few new development projects for 2-5 years.
- Whilst yields hardened during the booms years and converged across Europe, in the next few years there will be an on-going divergence. Well let prime vs. the rest.
- As with the commercial property market, a two tier housing market will persist for sometime.
- Urban regeneration and Eco-Towns will be a non-starter in most markets where land values will be “below water”. The CIL (Community Infrastructure Levy) will not be viable but TIFs (Tax Increment Financing), perhaps via the issue of a bond, hold the potential to be successful when used as part of LABVs (Local Asset Back Vehicles) for urban regeneration.

**UK Investment Forecasts – 70% scenario (25% is on the upside side in 2010)**

|                                     | <b>2008</b>  | <b>2009</b> | <b>2010</b> | <b>2011</b> |
|-------------------------------------|--------------|-------------|-------------|-------------|
| <b><i>All UK Commercial</i></b>     |              |             |             |             |
| <b>Rents</b>                        | <b>-1.2</b>  | <b>-8.0</b> | <b>-4</b>   | <b>-1</b>   |
| <b>Capital</b>                      | <b>-26.3</b> | <b>-9.0</b> | <b>5</b>    | <b>4</b>    |
| <b>Total Return</b>                 | <b>-22.1</b> | <b>-2.0</b> | <b>12.8</b> | <b>11</b>   |
| <b><i>Offices</i></b>               |              |             |             |             |
| Rents                               | -3.8         | -14         | -6          | -2          |
| Capital                             | -26.61       | -11         | 4           | 4           |
| Total Return                        | -22.4        | -3          | 12          | 12          |
| <b><i>Retail</i></b>                |              |             |             |             |
| Rents                               | 0.1          | -7.0        | -3          | -1          |
| Capital                             | -26.7        | -8.5        | 5           | -4          |
| Total Return                        | -22.6        | -2          | 13          | 11          |
| <b><i>Industrial</i></b>            |              |             |             |             |
| Rents                               | 0            | -5          | -2          | -1          |
| Capital                             | -26.0        | -7          | -5          | 4           |
| Total Return                        | -21.2        | -1          | 14          | 12          |
| <b><i>London Office Rents %</i></b> |              |             |             |             |
| <b>West End – Prime</b>             | <b>-20</b>   | <b>-28</b>  | <b>0</b>    | <b>3</b>    |
| West End – Average                  | -7           | -22         | 0           | 3           |
| <b>City of London – Prime</b>       | <b>16</b>    | <b>-20</b>  | <b>2.5</b>  | <b>5</b>    |
| City of London - Average            | -22          | -12         | -2          | 2           |

Source: King Sturge – based on Real Estate Forecasting Ltd, November 2009

### Sub-sector Investment Returns - for 2010 – 70% chance scenario

|                                | <b>Rental Growth</b> | <b>Capital Growth</b> | <b>Total Return</b> |
|--------------------------------|----------------------|-----------------------|---------------------|
| <b><i>Shops</i></b>            | -4                   | 6                     | 14                  |
| Central London                 | -3                   | 8                     | 15                  |
| Outside S. England             | -5                   | 4                     | 12                  |
| <b><i>Shopping Centres</i></b> | -3                   | 4                     | 11                  |
| In-Town                        | -3                   | 3                     | 11                  |
| Out-of-Town                    | -2.5                 | 6                     | 13                  |
| <b><i>Retail Warehouse</i></b> | -2                   | 6                     | 14                  |
| Retail Parks                   | -3                   | 6                     | 14                  |
| Fashion Parks                  | 0                    | 7                     | 14                  |
| <b><i>Offices</i></b>          | -6                   | 4                     | 12                  |
| Central London                 | -7                   | 6                     | 14                  |
| Inner S.E.                     | -6                   | 2                     | 12                  |
| Outer S.E.                     | -5                   | 2                     | 12                  |
| Office Parks                   | -5                   | 2.5                   | 11                  |
| <b><i>Industrial</i></b>       | -2                   | 5                     | 13                  |
| London                         | 0                    | 7                     | 15                  |
| Outside S. England             | -2                   | 4                     | 13                  |
| Distribution Warehouse         | -2                   | 6                     | 15                  |

Source: King Sturge – based on Real Estate Forecasting Ltd November 2009

## **2. Sector reviews**

**2.1 Residential**

**2.2 Retail**

**2.3 Offices**

**2.4 Industrial**

**2.5 Investment**

**2.6 Planning**

**2.7 Building**

## **2.1 Residential**

Tim Wright, Partner, King Sturge

+44 (0) 7968605990

[tim.wright@kingsturge.com](mailto:tim.wright@kingsturge.com)

### **Headlines**

- Tax - we are entering a high-tax environment. Most significant price restraint is likely to be in the South East and Prime Central London; however we think that the impact will be marginal because buyers will see houses for owner occupation as a tax shelter.
- We anticipate Sterling will remain weak and therefore support continued inward investment from European and Asian buyers.
- Land values will remain depressed. Most house builder refinancing has been dedicated to balance sheet repair and funds for development / construction. SPV project finance for development will only be available from private equity sources, the returns required will contrive to depress land values.
- We expect to see more stressed stock especially in the sub-£20 million (released to the market as the main property lending banks get to grips with their portfolios and manage assets more proactively).
- Government legislation - green agenda will continue to add to the cost burden on development land.
- HIPS - white elephant, has no value added for either vendor or purchaser, should be scrapped.

### **1. LONDON & SE LAND MARKET**

- We feel that there will be an increase in receivership disposals during the first 2 quarters of 2010 as banks and receivers react to the recent transaction evidence from July - December 2009.
- 2010 will be characterised by numerous frustrated cash-backed purchasers who were unsuccessful in acquiring sites during the back-end of 2009 - those who were

unsuccessful are either subscribers to the double-dip theory, or simply remained overly cautious. In the short term they could be proved right, but the buyers who successfully bought land had their sights on land banking for 2011 and ahead.

- Most 2009 land sales have reached or exceeded the sellers' expectations.
- It follows that the first quarter of 2010 could be a prime selling time - there are many would-be buyers with unfinished business wanting to benefit from the debt-starved climate.
- Paradoxically, if too many sites do come forward, or secondary / poorly located sites try to cash-in on the improved sentiment, success is not guaranteed. London's *renaissance* has been founded upon a flight to quality locations.
- Registered Social Landlords could return as buyers to the land market - they now have access to the transactional data which was not evident at the beginning of 2009 - and they can feel more confident of the receipts that will be generated from private sale and shared ownership sales.
- Housing sites rather than apartment sites have been highly sought after during 2009 - many will want to land bank *marginal viability* apartment sites in 2010 while the construction funding markets remain tight, or closed.
- Nationally, land prices will remain stable until there is clear evidence of increased transactions, i.e. justifiable more demand-led development. London and the South East has already enjoyed some recovery during 2009, and if this remains stable - early 2010 could experience some fall in land values, but 2010 is likely to end on an UP, as *Demand* clearly out-strips *Supply*.

## 2. LONDON RESIDENTIAL INVESTMENT

- The question for overseas buyers is: "is Sterling going to start a fight back?" If it does, interest in London Property Markets may be more limited.
- Developers and house builders no longer need to heavily discount standing stock.

- Continued flight to quality within London - Zones 1 & 2.
- The big issue will be limited stock in the new build market and limited new starts, we are unlikely to see big bulk off-plan investment deals until the return of the developers (as opposed to the House builders).
- Developers are going to have to find a way of gaining development funding from the banks, be this by forward seeing the affordable housing and some of the private sale units (30% to 50%).
- The return of mortgage product to the investment markets is going to be limited.

### **3. LONDON ESTATE AGENCY & LETTINGS**

#### Canary Wharf & South East London

- Sales to continue steadily growing, by those whose mortgages are typically 65% or less of LTV. People in this category are taking full advantage of what is perceived to be the bottom of the market.
- Number of first-time buyers increasing slowly as new mortgage products release in the second half of 2010.
- Reluctant landlords reducing in numbers as a more viable market opens for sales. With strong demand remaining for rented property for some time, rents and yields will start to increase due to the lack of available stock.
- Professional / mid-level UK investors will return to the market in the light of increased yields.

#### Prime central London

- Small stock increase leading up to election, prices will hold up.

- If / when interest rates rise, more stock will come to the market, although PCL is less affected by interest rate rises than other areas.
- More stock/higher interest rates and tax after election will mean no price increases and possibly reductions.
- A weak Sterling will continue to benefit the market.
- The rental market is to remain stable and may benefit from a weaker sales market in the second half.

#### **4. NORTHERN VIEW**

- 2009 has been the year of the Lettings Agent. As the price of property continued to fall, first-time buyers found themselves wary of a market that they were not able to buy in, even if they wanted to. Forced to rent, they boosted the rental market to highs never seen before.
- Sales and lettings - overall there is a shortage of stock in both sectors. Sales picked up in the second half of 2009. We predict more sales stock will come into the market in the New Year.
- It is a brave person who says we are nearly out of the quagmire, but the Northern markets are quirky markets in which to trade. There is a real potential that in the coming 12-24 months we will see a lack of residential stock, and with developers changing their sidelined residential schemes to office or retail-led we could see further supply issues in time. Rather than a country-wide market-led increase, prices could rise locally due to the lack of stock and with price rises comes the confidence to build more.
- Land market - still very quiet with very few transactions taking place. However there are a few signs of recovery. Smaller sites in better locations are selling and some of the larger house builders are now looking at larger sites but often on deferred terms. Finance still an issue.

- We doubt there will be any significant residential development launched in the coming 12 months, which is wrong - as this is the intelligent and informed thing to do.
- Investment - Some interest in bulk purchases. Yields of 8% + required. People are buying income and the focus is therefore on yields rather than capital value

## **5. SOUTHERN VIEW**

- Land market - Increasing transactional levels. Provision of affordable housing will remain almost impossible without impacting adversely on the schemes' viability. Without recognition of this fact by LAs, development will be held back.
- Hard sales & rental market - CML predict only £150 billion to be lent in 2010. If this is fact, the figure is historically low and will hold back any form of house price inflation. Rental demand will remain strong as First Time Buyers find it increasingly difficult to get on the property ladder.
- Investment market - Outside of London this will remain weak.

## **2.2 Retail**

Charles Miller, Partner, Head of Retail  
+44 (0) 7970808272  
[charles.miller@kingsturge.com](mailto:charles.miller@kingsturge.com)

### **Headlines**

- **Damaging air bubbles in the supply pipeline.** The short-term response to a difficult market and finance constraints mean a significant lull in new development for the next two years. This will then transform into an overactive hive of activity in 2012 and 2013. The market would benefit from a more measured pipeline and financial means to facilitate this – notably a UK version of Tax Incremental Financing (TIF)
- **Christmas but a temporary respite for retailers.** A positive outturn on the back of recession-defying consumer demand and savvy, margin-protecting strategies on the part of retailers (eg planned promotions, non over-stocking) is likely to have resulted in a robust Christmas. But underlying retail sales will remain fragile and erratic, whatever the macro-economic environment. Key downside risks are rising interest rates and unemployment.
- **Occupier fall-out will recede in 2010.** Accordingly, vacancy rates will slowly start to recover from their near 20% nadir. However, the rates will be higher in some centres as the recession continues to cruelly expose towns that are failing and highlight the ongoing need for regeneration.
- **Occupier demand is not dead – merely very selective and opportunistic.** It is still a tenants' market and underlying rents are forecast to decline for another two years (2010: -3.1%, 2011: -1.3%).

\*\*\*

### **Retail Sales**

- 1 A year ago, with retail markets apparently in meltdown, no-one could have predicted how resilient retail markets would prove in 2009. Retail sales have not tracked GDP performance - for the year as a whole, retail sales have been up on 2008 in both volume and value terms.

- 2 Christmas 2009 has encapsulated the year as a whole – better than expected. However, this was obviously against weak comparatives. However, a strong Christmas does not herald a measured recovery in retail markets. There are still ominous downside risks to the retail market. Interest rates will inevitably rise going forward, VAT will revert to its higher rate and the full effects of unemployment have yet to filter through to retail sales, even as the wider economy recovers. Rather than recover universally, retail sales will remain erratic throughout 2010 and beyond.
- 3 The rise of Internet shopping continues, with online sales now accounting for around 6% of all retail sales. This figure is forecast to hit 10% by 2013, but the rate of growth is decelerating as the online market matures. As ever, it's not merely a case of the Internet versus the high street – many of the key winners in the market are multi-channel as opposed to pure-plays.

### **Fall-out and Vacancy**

- 1 The key shake-out amongst occupiers occurred a year ago as the onset of recession weeded out weaker players and those exposed to onerous finance structures. However, a number of players remain vulnerable and further casualties are to be expected. Encouragingly, vacated space is being re-absorbed back into the market. Overall vacancy rates may have risen as high as 20% during 2009, but are now starting to recede. We predict that they will be as low as 10-12% by the end of 2010.
- 2 This headline figure does not do justice to disparities between individual centres. In some secondary and tertiary markets, the figure may well exceed 30%. The onset of recession has served to place a microscope over those centres that were failing anyway. The regeneration needs of these centres is more apparent now than ever. In stronger centres, vacancy rates may well be less than 5%. Despite negative headlines that continue to surround the retail sector, space is still very hard to come by in many markets, where, despite fall-out, occupier demand is not met through current provision.

### **Occupier Demand and Rents**

- 1 Occupier demand has not simply evaporated. Retailers are constantly striving to optimize their respective portfolios, even if they are not expanding aggressively. There

has been a discernible increase in out-of-town retailer demand. We have identified more than 60 retail warehousing operators that are on the expansion trail (including high profile names such as John Lewis Home, Best Buy, Next Home and TK Maxx Homesense).

- 2 Despite signs of activity in both the in-town and out-of-town arenas, it will remain an occupiers' market. As a result, we expect rents to continue declining for two more years to come, albeit at a slower rate than in 2009. Bucking trends of recent years, retail warehouses are forecast to outperform standard shops and shopping centres.
- 3 Supermarkets will continue to provide some salvation for the retail sector. Despite lower price inflation, they remain highly expansive, and will continue to absorb some of the over-supply in bulky goods retail warehousing and fall-out from high street, as well as increasingly offering 'anchor' options for new developments. Foodstores are also the only commercial property sub-segment to see positive rental growth throughout the recession.

## **New Supply**

- 1 In a very tight market, the supply pipeline has been derailed. Around 3 million ft<sup>2</sup> of new shopping centre space came on-stream in 2009. Although a significant proportion of this was let, it was on very favourable and incentivised terms to retailers. The pipeline will slow to a trickle over the next two years in the wake of financing issues and perceived occupier weakness. However, the next wave of development is already being lined up for 2012/2013, when market conditions are forecast to be far more conducive to new supply.
- 2 However, a 'lumpy pipeline' serves limited benefit. Despite current market conditions, there is still an underlying need for new floorspace in selected towns and markets in the short to medium term. Longer term, problems could arise through excessive new floorspace being delivered at the same time.
- 3 In the interests of achieving a balanced pipeline, we would endorse the recent submissions of the British Council of Shopping Centres (BCSC) to encourage rapid roll-out of a UK variation of Tax Incremental Financing (TIF) and, more generally, ensure that local authorities work with their development partners in constructive and

progressive ways. In particular, more than ever, regeneration issues require innovative and proactive approaches.

## 2.3 UK Offices

Mark Bourne, Partner, Office Agency  
+44 (0) 7703234284  
[mark.bourne@kingsturge.com](mailto:mark.bourne@kingsturge.com)

### Headlines

- **The great divide...** the gap between the capital and the rest of the country will widen, with London experiencing a reversal of fortune, leading the office market recovery in 2010 – led by the traditional financial sector.
- **Demand will remain under pressure outside London...**as the public sector squeeze begins, though central government relocations and banking may provide upside. Of the major centres, Manchester and Bristol are best placed for recovery.
- **Worst is over for rents...** London will be the only market to see prime rental growth in 2010 (after 35-40% peak to trough fall). In the regions, the correction has been milder (only 7-10%), so growth will take longer to return, though next year's drop is expected to be less steep.
- **London hotspot - Canary Wharf...** Healthiest London sub-market occupier appetite set to drive vacancy back to single figures within the year.
- **Developers will begin to look beyond the downturn...** Speculative starts set for a return particularly in London where shortages of prime space will emerge by 2012. In Central London we may well see occupiers return to pre-letting to satisfy their future requirements.

\*\*\*

- 1 Vacancy has risen in most markets during 2009, but despite the high levels of availability, grade A space remains in short supply in some key locations. After the completion of existing developments, little new supply is planned, bringing the **potential for space shortages and pressure on rents during the recovery.**
- 2 Prospects for demand have improved, but **there are risks to the outlook.** Regional markets have relied heavily on **local public sector deals** to support take-up in the downturn and may be hit harder, as the government battles to cut its huge fiscal deficit

- post-election. **Relocations from central government in London provide potential opportunities** for larger regional centres, but plans are currently unclear and experience suggests that this will be a slow process.
- 3 **Private sector deals** - notably corporates, business and professional services, and TMT's - **should help offset any weakness**. There may also be regional opportunities within UK banking, as Lloyds and RBS are forced to sell off brands and networks.
  - 4 On the basis of past demand and current supply, Manchester and Bristol are most likely to lead the regional recovery after 2010. The Scottish cities have fared better than expected during the recession, but are likely to be slow to revive. Currently the biggest concerns are for Birmingham and Leeds, however, where over-supply and a reliance on the public sector make for the weakest prospects.
  - 5 Outside of London, falls in office rents have been less aggressive. Nonetheless, prime rents dropped in all markets this year at an annual rate of 7-10%, with Birmingham worst hit. **Regional rents are set to fall further** in 2010, though the worst of the adjustment is now over and the **rate of decline is expected to slow**.
  - 6 In H1 2009, regional office property markets saw a further sharp slowdown in demand. But in Q3 2009, office take-up rebounded unexpectedly strongly and **the latest evidence suggests that the revival has continued into the final quarter**. Markets outside of London made a strong contribution, with demand in Manchester, Glasgow, Liverpool, Nottingham and Newcastle holding up best.
  - 7 **Regional markets were also well represented in the biggest UK office deals of 2009**. The largest involved the Co-op (325,000ft<sup>2</sup>) and Greater Manchester Police Authority (240,000ft<sup>2</sup>) (both in Manchester), Birmingham City Council (196,000ft<sup>2</sup>), Nottingham City Council (213,619ft<sup>2</sup>) and Npower (220,000ft<sup>2</sup> in Sunderland).
  - 8 While London's short-term future is bright, longer-term uncertainties remains. Political pressures to tax bank bonuses are currently intense and it is likely that other EU nations will follow (temporary) UK moves. Moves to tighten bank regulation are also expected in the wake of the financial crisis. London's position as Europe's financial capital is not likely to be undermined, but these moves will have an impact.

## CENTRAL LONDON OFFICES

- 1 London has reached this cycle's nadir, with rental recovery to begin in 2010 predominantly on prime rents where landlords will tighten incentives and hold out for higher rents.
- 2 In the City supply will reduce, but the proportion of Second-hand space will increase as tenants "trading up" release space back to the market – the proportion of second-hand space will move from 20% to 40% by year end. We forecast prime City rents to reach £47.50ft<sup>2</sup> (10.5% uplift) by end 2010 and incentives to harden to 24 months rent-free (33-36 end 2009) on a 10 year lease.
- 3 Following the sharpest office rental declines in the UK last year, West End prime rental growth will be driven by the limited development completions beyond 2010 and the resulting two-tier market of scarce Prime Grade A new builds and oversupplied Secondary Grade B.
- 4 The West End will see a return of the boutique financial organisations, coupled with an acute shortage in supply, will drive rental growth on new Grade A space in Mayfair and St James's. For the West End we forecast prime rents to approach £70.00ft<sup>2</sup> (7.6% uplift) by end 2010 and incentives to harden to 18 months rent-free (24 end 2009) on a 10 year lease, with continuing evidence of "froth rents" in excess of £80.00 ft<sup>2</sup>.
- 5 Some confidence has returned amongst financial occupiers, consequently City office demand is in its healthiest shape for at least 2 years, with at least 3 million ft<sup>2</sup> of active requirements looking to be satisfied within the City from a variety of business sectors. Therefore we anticipate City office take-up to improve towards 3.5 million ft<sup>2</sup> in 2010 – with the majority of the prime surplus being absorbed by the traditional financial sector.
- 6 We will see further internationalism of the City occupier and investor base
- 7 Selective shortages of prime space will emerge following the improving levels of demand during 2009; therefore we will see the return of the Pre-let together with a number of brave speculative starts.

- 8 Business rates – with the 2010 rating list coming in to effect, London occupiers will see significant increases in Rateable value for 2010 – City prime uplifts to be in the region of 15-20% compared to 5-10% previously.
- 9 City prime yields will return to the long-term average of 5.8% and will harden further if the scarcity of supply continues.
- 10 Central London take-up in 2010 is forecast to reach the levels seen in 2008 rising back towards the long-term trend from 2011.
- 11 Take-up next year will come from a variety of sectors thus reducing the market's exposure to a single business area. Recent signs of improvement in demand figures suggest there will be further activity from the TMTs and Financials, as well as the return of the Professional and Service sectors keen to take advantage of lower rents and improved incentives.
- 12 London hotspots - Canary Wharf will see a surge of major transactions during 2010 which will rapidly drive vacancy downwards with shortages of space emerging next year. Active tenants include BarCap, MF Global and Blackrock.

## **2.4 Industrial**

David Brooks, Partner, Head of UK Industrial and Logistics Group  
+44 (0) 7710887203  
[david.brooks@kingsturge.com](mailto:david.brooks@kingsturge.com)

### **Headlines**

- Notwithstanding the slight improvement in activity seen in the last two Quarters of 2009, occupational demand is likely to remain flat throughout 2010.
- "Flight to quality" - most activity will be confined to new/modern stock in prime locations.
- Lack of speculative development activity may lead to shortage of quality stock in certain locations - mainly in the South, but particularly the South East may also lead to some upward pressure on rents, towards the year end in those areas.
- Rise in the number of demolitions of large industrial complexes following closure, due to growing obsolescence factor and to avoid empty rates liability.
- Landlords will have to continue to offer flexible terms to secure deals.

\*\*\*

- 1 Whilst enquiry levels are still down on previous years, there was a slight improvement in 2009, commencing Q3.
- 2 Most activity continues to be at the smaller end of the scale, sub 20,000 ft<sup>2</sup>, but in the last two Quarters of 2009, there was considerably more activity in the BIG BOX market for warehouses over 100,000 ft<sup>2</sup>. In contrast to previous years, when food retailers have been the major drivers of this market, more recently the waste management and recycling sector has been a growing source of demand.
- 3 Most activity has been confined to prime locations initially, where supply is generally tighter.
- 4 Lower pricing is attracting more occupiers back into the market - cash rich occupiers have started to return.

- 5 Perception that occupiers who are still prospering, do not want to miss out on the bargains available now ("the window of opportunity").
- 6 Falling rents/capital values, but headline rents are generally holding up better than expected, due to longer rent free inducements being offered by landlords (they have largely doubled in the last 18 months).
- 7 Tenant's preference to conserve cash and look to landlords to incur substantial fit out costs, is resulting in longer leases being achieved in certain instances, particularly in the rapidly growing waste treatment/recycling sector.
- 8 Speculative development tap firmly turned off for foreseeable future - will lead to shortage of stock in prime locations and eventually, upwards pressure on rents.
- 9 Speculative development will not return until it becomes viable again and investor confidence returns. Build to Suits will be the way forward, for the foreseeable future.

## **2.5 Investment**

Neville Pritchard, Partner, Head of UK Investment

+44 (0) 7889896872

[neville.pritchard@kingsturge.com](mailto:neville.pritchard@kingsturge.com)

### **Headlines**

- **The current investment “bubble” will soften.** The current investment “bubble” for prime real estate is likely to soften in the first quarter. Fuelled by cash inflows from the public into the retail funds (the very funds which were undertaking sales to meet redemptions a short while ago) prime property has shown circa 20% value increase over last year. Investors are adopting a chartist approach – what goes down must go up – they are by definition optimists. However the impact of an end to quantitative easing, higher tax rates, election uncertainty, unemployment, Dubai, potentially Greece, and better savings rates will take the steam out of the market at the sharp end. Whether it is a VW, or a “corrugated” recovery, it is not a straight line up from here.
- **Secondary stock will continue to languish.** Those who anticipate a substantial rebound in poorer quality stock are mistaken. There is not a piece of strong elastic linking prime and secondary property, so that it is dragged up along with the quality stock. Buyers are focused on fundamentals of quality and income stream. The occupational markets are, and will remain, in a dire state for the next couple of years. Poorly located or elderly property, with short lease profiles exhibit risk that institutions and bank finance will continue to avoid. Landlords already suffering with empty secondary stock may be hoping for a gradual improvement in the occupier market, but the reality is that the impending rating revaluation and sustainability agenda will further devalue their buildings.
- **Core Central London offices a good prospect.** Central London offices in core locations will continue to find favour as quality vacant accommodation becomes more scarce and rents recover. As the UK lags other economies in recovery from recession, Sterling will remain low, and overseas investors will seize their opportunity to gain a foothold in the Capital. Outside of London the major provincial centres will see all but the most prime buildings suffer from increasing investor awareness about the capital expenditure needed to offset depreciation, and take account of this in the returns they demand.

- **Second hand distribution affected by supply.** With the highest supply of industrial and warehouse stock in England and Wales recorded at 23.31 million m<sup>2</sup>, of which 3.42 million m<sup>2</sup> comprises new stock, investors in distribution warehousing will become more cautious. With the exception of those buildings exhibiting bond style characteristics with long leases, to strong tenants, the majority will be subject to short term leases in line with 3PL 5 year contracts and intermittent voids. Distributors will upgrade building with contract renewals, severely impacting on the lettability and ERV of second-hand buildings.
- **Post Christmas hangover, but gentle recovery for Retail investment.** After an upbeat Christmas period, retailers will find early 2010 much harder as the VAT rise bites, and consumers are affected by uncertainty over the election, higher taxes and reduced Government expenditure in the economy. Further CVAs will occur amongst mid market retailers, though the budget and “trusted” brands should fare better. In 2009 we recorded one retailer failure a week. 2010 will not repeat this level of attrition. Rental growth in this sector will be first to return though this will only be evident in the very best of towns. Unit shops will be most sought after by investors, though a slow return of institutional investors to shopping centres will occur.
- **Scarcity of Open A1 Retail warehousing will prove a positive.** Investors will continue to embrace the best quality retail parks, once again attracted by the value of limited Open A1 planning consents. There is a sense now that the occupiers who remain are likely to be survivors and that the scarcity of good parks is such that buying now for the medium term will not be regretted.
- **Operational premises with fixed growth sought after.** Increased interest will occur in fringe sectors such as student housing, medical, hotels and other occupational property. Such sectors offer the long leases, and often fixed or indexed rental increases, which are increasingly rare in the mainstream of retail office and industrial.
- **“Pretend and extend” will continue to be the prevailing bank policy.** Bank finance will slowly become increasingly available, but with £32.6 billion of debt due for redemption in 2010, refinancing this amount will prove impossible without a continuation of the “pretend and extend” policy the banks are exercising. Not wishing to write off significant debts to their balance sheets, toleration of all but the most serious breaches will be necessary, extending existing loan agreements. As balance sheets strengthen,

the worst loans will be called in, but every opportunity to restructure with new equity will be taken, so the flood of distressed sales some are expecting may largely be averted.

## **2.6 Planning**

James Owens, Partner, Planning  
+44 (0) 7831312516  
[james.owens@kingsturge.com](mailto:james.owens@kingsturge.com)

### **Headlines**

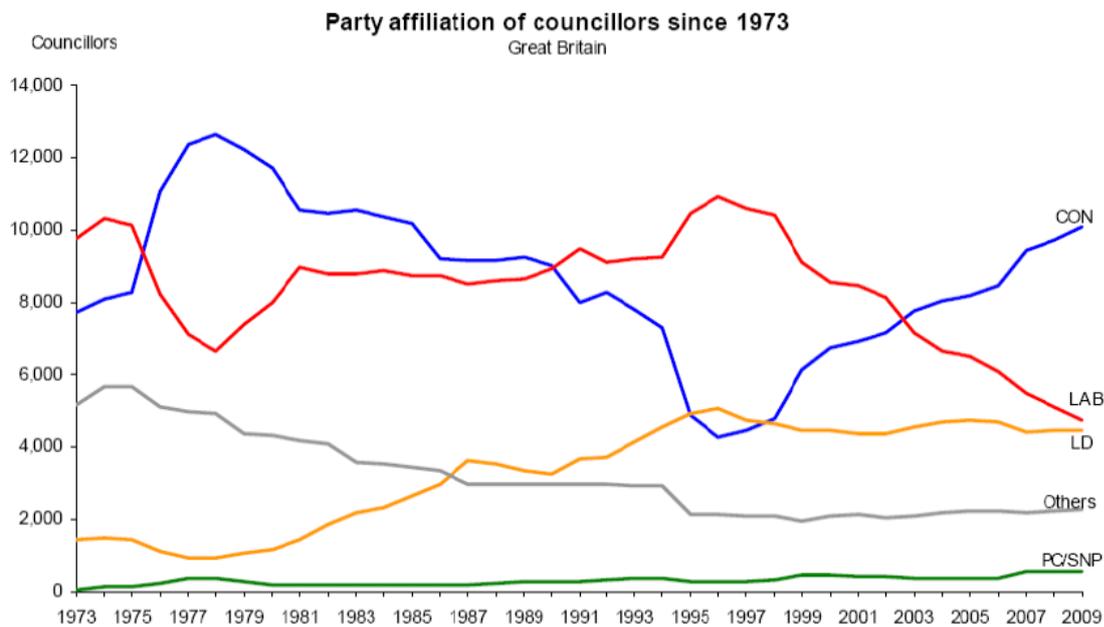
- **Planning will become more political** – The outcome of the election is uncertain. Furthermore, many of the new MPs will be ex-local Councillors who have been campaigning against development.
- **New tax on all development is coming** – Do not be fooled by the friendly sounding name, the Community Infrastructure Levy (CIL) is a tax that will be levied on virtually all new development.
- **Wave of renewable energy and sustainability requirements will hit in 2010**
- **Those who can, plan for the upturn** – Conventionally, developers and land owners use recessions to line up planning permissions for the upturn.
- **Renewal of permissions offers a quick and easy route for some**

#### 1 Planning will become more political

The Tories need a 6.5% swing to win an overall majority (a gain of 150+ seats). This has only been achieved once in a UK election since the War (Blair in 1997). The Tories are way behind where Blair was at this stage in the opinion polls.

There is a massive opportunity for the Tories to deliver the development they want if they win, as they would then be in power across all levels of government for the first time in 30 years (when Margaret Thatcher first came to power in 1979). In London there is a Conservative Mayor. The Conservatives already hold most local Councils, with Labour holding only 10%. The graph below shows the substantial lead in the number of Tory Councillors. It also shows that historically such leads have tailed off after that party has got into Government nationally. The Conservatives should therefore make the most of their early years.

## The Political Balance



Source: The Saint Consultancy Group

However, there is a substantial risk that the opportunity may be wasted. The bulk of the 300+ Tory MPs that could make up a governing majority would have entered Parliament in 2005 and 2010, with a large number of these being ex-local Councillors. These are the same local Councillors who have spent the last decade trying to win favour at the local level, often by opposing schemes, as there have been few votes in supporting development. National surveys have found that 85% of the population say that they want no new development. Indeed, in London and the South East, these figures are 91% and 92% respectively who are against development.

There is a particular risk in the housing sector with the Tories having stated that they will scrap Regional Spatial Strategies, which set out the housing requirements for each local authority area. Shadow Communities Secretary, Caroline Spelman has already written to Conservative Councils advising them not to “rush ahead with implementing controversial elements that have been foisted on them by Regional Spatial Strategies”, indicating that they will be able to undo those elements which they consider to be undesirable. Councils may even be left to set their own housing figures!

There is considerable uncertainty as to what would replace the Regional Spatial Strategies, with some suggesting that future housing requirements would be left for

individual local Councils to decide, whilst others have indicated that a return of the planning function of County Councils is another option that is being considered. Either way, caution is needed in relying upon major housing allocations set out in the Regional Spatial Strategies. Caroline Spelman has declared that a new government “will not pay a penny of compensation to speculative developers as a consequence to changes in planning policy”. Governments never have compensated developers in the past, so this is nothing new, but it further suggests that a Conservative Government will be pulling back from many controversial housing schemes.

## 2 New tax on all development is coming

The legislation for the Community Infrastructure Levy (CIL) was introduced in 2008. The draft regulations were consulted upon in July to October. The regulations will be coming out in their final form in April 2010.

Under CIL, virtually all developments over 100 m<sup>2</sup>, excluding householder applications and change of use applications, will have to pay a set charge/tax that is likely to be based on each square metre of development. It will therefore affect many, many more proposals, since at present only an estimated 7% of applications have Section 106 agreements.

Once the new legislation is in place, local planning authorities who wish to charge CIL will need to prepare an Infrastructure Schedule, which will set out the amounts it wishes to charge. This will be calculated on an estimate of the total amount of infrastructure that a Council considers will need to come forward over the plan period and the number of developments anticipated over the same period. This will clearly be an enormous and complicated task for Councils to try and undertake, but as tariff based charges adopted by some Councils are to be removed, many local planning authorities who want to raise additional revenue, will have little choice but to take CIL up.

Although the amounts raised are intended to fund the new infrastructure needed, Councils will actually have complete discretion on how and when the money could be spent. Indeed, it could be used to refund money that Councils have already spent or even could just sit in the local authority's bank account.

Once in place, there is no appeal because a developer thinks the rate is too high. Likewise, a local planning authority will have no discretion to waive or reduce the CIL for

development that it wants to come forward. The CIL would have to be charged on implementation, even if that would render a development unviable and thereby prevent it coming forward.

Furthermore, the draft legislation still makes no allowance for major schemes which provide their own infrastructure such as new schools etc on site, as the costs of such works in kind cannot be deducted from the CIL liability.

Developers will still have to pay for planning obligations under S.106 for the site specific requirements that arise from the development itself. The development industry may therefore end up paying twice for some items. The total bill is therefore likely to be substantially greater in the future.

### 3 Wave of renewable energy and sustainability requirements will hit in 2010

New Government guidance will be rolled out nationally during the course of 2010, imposing ambitious levels of renewable energy and a range of sustainability initiatives that new development will have to comply with. This will include setting minimum levels under the Code for Sustainable Homes and ambitious targets under BREEAM for all commercial buildings. These will be reinforced with the revised requirements under Part L of the Building Regulations that are due to come into effect in October 2010.

### 4 Those who can, plan for the upturn

Conventionally, developers and land owners use recessions to line up planning permissions for the upturn. Those who are able to afford it will continue to do just that, but with the costs of preparing the considerable amount of information that now has to support larger planning applications having increased many times since the last big recession in the early 1990s, some can simply not afford to line up permissions for the future.

### 5 Renewal of permissions offers a quick and easy route for some

During the course of 2010, extensive use is likely to be made of new legislation that came in in October 2009, which allows existing permissions that are nearing the end of

their life to be renewed without the need for plans and new supporting reports. This could help provide a lifeline where there have been no substantial changes.

## **2.7 Building**

Jim Rowland, Partner, Head of UK Building Consultancy

+44 (0) 7850047517

[Jim.Rowland@kingsturge.com](mailto:Jim.Rowland@kingsturge.com)

- **Construction Tender Price Costs have fallen by 13% in 2009, we predict a further fall of 3% in 2010, bottoming out in late 2010 and a slight rise in 2011.**

**Narrow or non-existent profit margins will put more building and trade contractors nearer insolvency as the industry reduces capacity still further in 2010.**

Tender price costs have fallen further in 2009 than everyone predicted, with a fall of 13% (BCIS). More than half of this occurred in the first quarter 2009 but continued throughout the year as a lack of demand dampened contractor's preliminaries profits.

Material prices were volatile throughout the year with some materials now rising, particularly as the rest of the world comes out of recession. 2010 is however likely to still see depressed demand for new construction and we predict a further fall of 3% (BCIS), with costs levelling out later in 2010 as material prices rise across the globe, and a modest increase in demand in 2011 gives rise to an increase of around 3%.

- **The Carbon Reduction Commitment will be introduced in April 2010 which marks the introduction of a link between energy consumption and carbon emissions and a financial reward or penalty for good or bad performance respectively.**

During the introductory phase (2010-2013) the cost of carbon credits required to cover actual emissions is set at £12/tonne of CO<sub>2</sub> (the sale of which does not begin until April 2011). In subsequent years the cost of credits will be determined by the marketplace and therefore the cost has the potential to increase significantly as the number of available credits diminishes and demand remains constant or increases. It is envisaged that over the next year the property market will undertake measures to a) assess and monitor energy and carbon performance and b) evaluate and undertake measures to reduce energy use.

Many organisations are yet to take the impact of the CRC seriously and have failed to put together a programme of ongoing refurbishment and management that will be required to deliver a consistent reduction in carbon. Failure to implement such a plan

will lead to increased upfront investment in credits and heavy penalties, up to 50% in year 5, as a result of a consistently poor performance in the league table.

Additionally, the revised implementation guidelines released in November have failed to address the landlord-tenant issues brought about by the scheme. This will inevitably lead to service charge disputes and the introduction of more stringent green lease clauses as the property industry gets to grips with how to balance the scheme between landlord and occupier.

The UK Government sees itself as a leading force as pressure mounts for all Governments to accelerate the pace of carbon reduction resulting in the “stick” rather than the “carrot” being more in evidence.

- **The introduction of small scale renewable technologies will increase with the introduction of Feed-in Tariffs planned for April 2010.**

Incentivising the small scale investment in green energy may allow householders as well as commercial property owners to contribute but just how significant this may prove to be will need to be seen.

While the detail of the scheme is still under consultation, Feed-in tariffs (FITs) will be available for small-scale low-carbon electricity generation and provide a guaranteed price for a fixed period for generating electricity. This scheme should see an increase in the introduction of small scale renewable technologies and a further engagement and awareness in the energy performance of property.

- **Revisions to Part L of the Building Regulations are due to be introduced in 2010. The current consultation indicates a 25% decrease in target emissions across domestic and non domestic property.**

**The impact of this change is more likely to be felt initially in terms of building cost increase particularly in the domestic sector.**

Buildings account, directly and indirectly, for 44% of the UK's carbon emissions which has led the government to fix firmly on the property sector to help meet its commitment to cut carbon emissions by 80% by 2050. The proposed regulations impose a further 25% aggregate decrease in target emissions for new non domestic property, ranging from 11% for supermarkets to 36% for warehouses. New domestic property will be

subject to a further reduction of 25% (flat) to bring about the introduction of The Code for Sustainable Homes Level 3. Additionally, the revised regulations seek to provide a more refined definition of the refurbishment of existing building stock and remove the exemption, most notably for conservatories (under 30m<sup>2</sup>) and historic buildings. In this way the revisions seek to make Part L applicable to a higher percentage of the existing building stock, a sector where carbon emissions are currently under regulated.

The latest changes to the Building Regulations signify an ineffective attempt at tackling carbon emissions in existing buildings, with the 'improved' definition still lacking real bite. A further tightening in regulation of the refurbishment sector will be required to capture and significantly improve the efficiency of existing property.

- **In 2010 The Code for Sustainable Homes Level 3 becomes mandatory for all new private residential housing and Level 4 mandatory for all new social housing as the next steps towards zero carbon buildings.**

**Achieving Code 5 and 6 demands fundamental changes in the way domestic buildings are used and occupied. Restrictions in water consumption and higher provisions for recycling are amongst some of the measures included.**

In 2006 the Government announced a 10-year timetable towards a target that all new homes from 2016 must be built to zero-carbon standards. This was to be achieved through a step by step tightening of the Building Regulations, the first of which was to be the introduction of Code Level 3 in 2010. Level 3 of the code corresponds to a 25% increase in energy efficiency compared to 2006 Building Regulation and Level 4, a 44% increase. The DCLG assessment for English Partnerships and the Housing Corporation (2008) suggest that the cost of achieving the higher levels of the code can vary substantially. The cost increase depends heavily on dwelling type, development type and site characteristics but range from 4% to 7% per dwelling for Code level 3 and 7% to 13% for level 4.

House builders have been attempting to solve the potential problems caused by achieving Code level 5 and 6 since its announcement in 2006. With the recent slump in housing construction this process of design development has effectively come to a standstill and the ability to achieve these Code levels at a commercially viable cost is at risk. In addition, at a time when the Government is trying to kick-start the housing

market, many believe that enforcing the Code and thereby increasing build costs will ultimately delay the upswing of this sector.

- **With the wealth of sustainability policy and legislation being introduced by the UK Government, Public Sector demand for 'greener' property looks set to increase in 2010 as internal pressure to demonstrate leadership by example increases.**

**The Public Sector will have to lead by example during a period of enforced reductions in public spending. Estate rationalisation will be the main thrust as cut backs push the higher efficiency agenda.**

The public sector is subject to a wide range of policies and drivers both internally and externally and as a result are under increasing pressure to demonstrate leadership in delivering energy efficiency, carbon savings together with an overall improvement in the efficiency of the Government Estate and as a result, Governmental departments will look to consolidate their property portfolios and move to more efficient property. The property market should see an increased demand for green property as a result of this, a sector which is currently under-supplied particularly with a downturn in new commercial developments.

With the increased pressure on government finances many believe that the green agenda will start to move down the list of priorities in this sector. However, failure to act will leave the government open to scrutiny as the CRC league table provides real transparency to public sector performance against energy efficiency targets. Failure to act, while simultaneously stealth taxing carbon emissions from property in the private sector, will constitute an embarrassing inconsistency.

## **Summary**

In summary, moving forward into 2010 the issues discussed are likely to result in an overall increase in construction and refurbishment costs as energy efficiency starts to feature more heavily. However, with a further decrease in construction costs predicted for 2010, we may see developers take advantage of these historically low costs to capitalise on the increased demand for greener property.

The property market has been attempting to find a capital or rental uplift in 'green' or 'greener' property for a number of years but it has thus far been difficult to demonstrate. However, with investors, landlords and some occupiers beginning to prioritise their property requirements for the reasons discussed above, the market should see an increase in the demand for greener, more efficient property.

Smart investors and property funds will start to re-evaluate their property portfolios and look for ways to cost-effectively improve the environmental performance of their building stock through refurbishment and effective management. In this way, they will be able to capture key occupier markets including public-sector and blue-chip organisations that will be looking to improve their own sustainability performance by moving to these properties.