

# Commercial Property Market Summary

ATIS REAL Weatheralls Limited

The comments below reflect our views as at 31 March 2003 and underlie our approach to the valuation of the portfolio.

## General

Commercial property has enjoyed another year of strong performance compared to other asset types. This has arisen principally from the high income returns available relative to today's low interest rate environment, combined with capital increases due to yield movements across the retail spectrum where further rental growth is still anticipated.

By contrast, over the period leading up to the valuation date, there have been continuing declines in the stock markets, and over a three, five or ten year view, lack-lustre performance from fixed income investments such as Gilts.

Although overall future property investment performance in some areas is forecast to be more modest than in recent years - reflecting declining occupational markets - the appeal of well let property with long leases should continue.

We suspect that shorter leases will become more prevalent in the future. Although these may in time become the "norm", longer term income streams, particularly those which cover current vagaries in the occupational market, will continue to command a premium. Exceptionally long income streams, due to increasing scarcity, are, and will be, correspondingly even more sought after.

We therefore see a polarisation of the market with, on the one hand, investments with long term income streams which appeal to, for example, pension providers concerned principally with certainty and the ability to match liabilities. On the other, there will be those with shorter term income where strong property fundamentals will become crucial.

Much of the British Land portfolio benefits from both characteristics. It includes a substantial number of prime High Street retails, and significant investments located "out of town" where the fundamentals of demand and supply are favourable. Central London offices, although experiencing short term occupational difficulties, are also strategically sound propositions.

Looking forward, we expect some upward movement in Gilt yields but do not necessarily subscribe to the often quoted view that property and Gilt yields are, or should be, linked. Empirically the evidence is scant. We therefore see this as another 'plus' for property with the potential for continuing out-performance compared to other asset types.

## Offices

Declining stock markets have continued to erode confidence and activity in The City. The problems of other European centres have also had negative consequences for occupational requirements amongst the many international banks and other organisations who make up the City office market. Although, as always, the return of demand will probably be more sudden than expected, forecasts are

now that this will not now happen until, say, 2006. As a consequence, the value of City development sites and other shorter leased investments here have reduced as, respectively, schemes are deferred and both yields and rental values have moved in an adverse direction.

In contrast, yields for well let long leased investments, which make up the majority of British Land's City holdings, moved favourably during the final quarter of 2002 with an upward impact on values. Examples of this in the market include the sales of Winchester House, London Wall and One Great St Helen's, Bishopsgate. This reflects a flight to certainty, and more immediately the ability of such properties to provide a secure return with a duration that exceeds the current short term problems in the lettings market.

Notwithstanding this, we have reduced the valuation of the Broadgate Estate to reflect much more conservative estimated rental values. Whilst the letting to ICAP demonstrates the continued appeal of Broadgate, even in the thinnest of markets, we have, nonetheless, adopted lower rental values for reviews looking forward over the next few years. As a consequence, the valuation of the Estate is now largely initial yield driven. There is, therefore, limited risk attached to current reversions and any subsequent increases in reversionary value should feed through to improved capital values.

In the West End, although the occupational market is thin, sentiment is currently more favourable than in the City. This is in part thanks to a more diversified tenant base and the shortage of supply as a consequence of planning and more precisely defined geographical boundaries.

Occupiers are typically looking for well specified buildings that offer reasonable value for money. The company's substantial stake at Regent's Place satisfies these requirements and, as a consequence, progress with lettings has been made at 350 Euston Road.

Meanwhile, the majority of the Regent's Place Estate offers well secured long term income in top quality buildings let to tenants such as Bank One and Abbey National. In the medium term there is also significant development potential at the North East corner, which in a more benign climate could offer some 500,000 sq ft net of additional office space.

The landmark Euston Tower, currently let to the Government for another 16 years, was recently substantially refurbished by the tenant at no cost to British Land, and longer term has a number of potential alternatives including, subject to planning, residential on the upper levels.

In the investment market, as in the City, yields for well secured long income streams have improved since our last valuation in September 2002. Examples of this in the market include the sale of 151 Buckingham Palace Road, SW1 and 3-8 Whitehall Place, SW1.

Provincial offices have generally held steady as progress with lettings and active management initiatives have proceeded.

## Retail

Retail Warehousing has yet again out-performed all other investment classes. The Company has invested significantly in this sector over

recent years and continues to make carefully chosen purchases, an example being the Orbital Shopping Park in Swindon.

Rents have moved on in many locations across the country and parks offering scope for active management are very strongly sought after, an example being Pillar's purchase of the former Chartwell Land portfolio. This transaction suggests that prime yields have improved over the last few months reflecting investors' perceptions and expectations of future rental growth.

With rents regionally achieving £35 per sq ft or more, and in excess of £25 per sq ft in a large number of locations, British Land's retail warehousing portfolio such as Homebase, spread across Greater London and the South East, should also produce a rising income. The Homebase covenant has been enhanced since its acquisition by Great Universal Stores.

Furthermore, in terms of future rental growth, it has been suggested that many occupiers of out-of-town stores have not refined their "offer" to the extent that they have in the High Street. As the out-of-town market reaches maturity these factors should enable the better retailers to increase their ability to pay higher rentals, despite the pressure on margins in the current climate.

Supermarkets are rarely available as investments but given the eagerness of investors (of many types) to secure long income streams with longer term robust residual values, we are confident that a modern long let food-store, rack rented, would command an initial yield of 5.75%, possibly less.

Department store values have improved, particularly those within the BL Fraser joint venture where guaranteed minimum increases are now approaching. We have adjusted the emphasis of our approach to the near reversionary yields and reflected the unusually long unexpired term (around 30 years) remaining at that time. Yields adopted reflect the popularity of long, secure incomes.

In the High Street, there are mixed signals coming from retailers and rental growth prospects are therefore variable. Underlying strength of location and rent affordability remain key considerations. More recent sales figures create some uncertainty as to the extent of rental growth anticipated in the short term.

Despite this, yields for prime shops fell by around 25 basis points between September last year and March 2003 and small lot sizes continue to attract very aggressive bids from a range of private investors. Some centres still offer scope for an uplift in rentals, and these naturally find most favour.

Shopping Centre values have generally improved, in line with the High Street. At the Company's Peacocks Centre, in Woking, rental values have increased by around 20%. Progress continues at the recently completed Centre West, adjoining the established Plaza Centre at East Kilbride, Scotland. Here, 26 tenants have been secured so far including Next and Debenhams, with a further nine units already under offer. There should be a reflected benefit to Plaza Centre as uncertainty and delay on the part of retailers, pending the opening of Centre West, has now passed.

At Meadowhall, active management initiatives have continued including a number of strategic tenant relocations within the centre. Reversions and income have remained broadly in line with expectations. For both in, and out of, town retail, we have sharpened yields reflecting also the quality and length of the income stream and the positive attitude to prime retail.

Budget proposals to exempt a number of areas in the UK from stamp duty, including the area within which Meadowhall is located, have been announced by the Government. This measure would produce potential savings to an incoming purchaser, which could in this case be reflected in an increase in the price achievable, of up to £50m. This has not been reflected in our current valuations as the budget measures occurred after the date of our valuation.

#### Other Sectors

Demand remains strong for Industrial Property, which offers steady rather than volatile performance. Although in Greater London, where a number of developments have been successfully completed, let and sold on, values have probably peaked. The relatively high yield available, in this low interest rate environment, means that we have been able to improve the value of regional estates such as Clifton Moor in York.

A number of Public Houses held within the joint venture with Scottish and Newcastle have sold recently at auction and have achieved prices ahead of previous valuations, reflecting the beneficial yield shift that has occurred since then. Several others have been sold out of the joint venture, back to Scottish and Newcastle. Our current valuation of those remaining reflects these factors.

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