28 September, 2009

- **Four reasons to sell your commercial property stocks now**
- **Why rising unemployment will hurt property developers**
- ***Recommended article:* The end may be near for the dollar...**

From David Stevenson, across the river from the City

Dear Pau Wiltshire,

Britain's commercial property cheerleaders have been finding their voices again recently.

And this month they've finally got something to shout about. The overall level of British commercial property prices has climbed for the first time in more than two years. What's more, it seems buyers have started crawling over each other to 'bag a bargain' while stocks last.

So is it time to get back into the market? We're not so sure – here's why...

A chink of light for commercial property holders

The Investment Property Databank (IPD) Capital Growth All Property index, the best-regarded barometer of UK commercial property prices, has collapsed over the last 25 months. Between June 2007 and July this year it plunged by nearly 45%, completely erasing all the gains it had made since 1997.

But last month saw a modicum of relief for care-worn commercial property landlords. The index finally flipped up. Not a lot, mind you - we're only talking a 0.2% bounce in August - but if you've been holding commercial property over the last few years, even tiny rises are welcome.

And after reading many of the recent headlines about the sector, you could reasonably expect the worst of the pain to be over. You might even conclude that a decent recovery is on the way. After all, in recent months "foreign investors have snapped up a string of high-profile UK properties", as Phillip Inman and Elena Moya pointed out in last Monday's Guardian.

The Qatari sovereign wealth fund has upped its stake in the Canary Wharf tower in London's Docklands in a deal that also saw the China Investment Corporation make its first major UK property deal. US private equity group Blackstone recently took a slice of the Broadgate office development in the City. And now "the string of property deals has culminated in the sale of Land Securities' slice of Birmingham's Bullring for £210m to the Australian government fund… marking a turning point in the fortunes of a battered property sector".

Should you pile in to commercial property?

So should you pile in?

Well, any market that's fallen as far as this - by three times as much as UK residential property - must be worth a look. And more buyers could step in at current levels.

Big British property companies have been raising plenty of money recently. They've been able to cash in on their rising share prices by rattling their rights issue tins in the direction of their shareholders. That "suggests that net buying is a distinct possibility over the remainder of the year", says Kelvin Davidson of Capital Economics. "And if overseas buyers continue to show a high degree of interest in the UK, the weight of equity poised to (re-)enter the market could lead to a sharp rally in total returns over the next 12-15 months".

In other words, a chunk of the cash from property sales over the last couple of years could soon be making its way back into the market.

But before we all get too excited, there are at least four reasons why the commercial property market could yet fall further.

Firstly, despite all the upbeat chat, UK institutions have actually continued to be net sellers of UK commercial property throughout this year, dumping £128m-worth more than they bought in the second quarter. They then sold a further net £260m of property in July and August, according to Propertydata.com. So having the market firmed up by a mix of friendly media comment and foreign buying interest has been very handy. These investors are selling on the rallies, not buying on the dips.

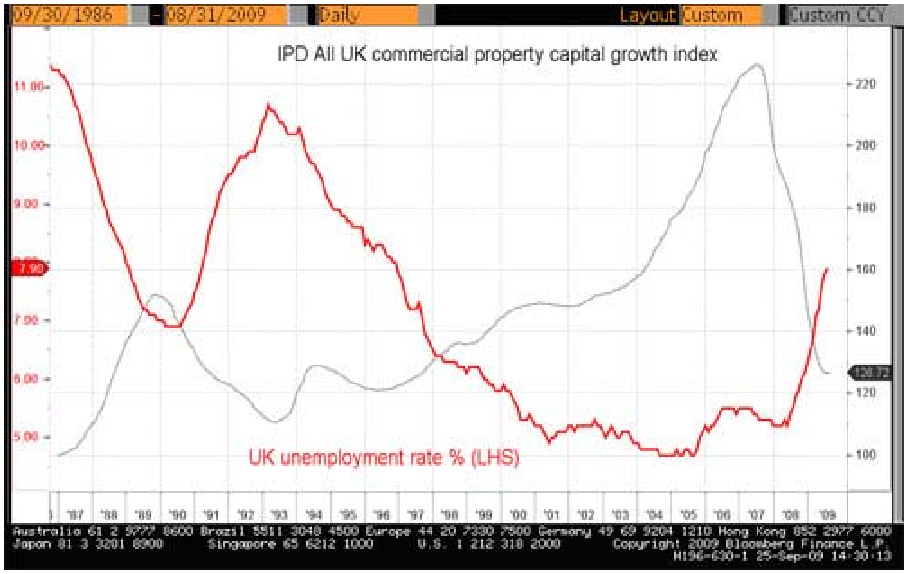
Secondly, property companies are unloading what some "might think were some of the better properties in their portfolios", says Anthony Hilton in the Evening Standard. "It's a sign of a seller under pressure when the good stuff is tossed overboard… at values as pitifully low" as recent deals. You only sell the family silver when you're desperate.

Third, overall rental levels are still falling, dropping 0.5% in August. Capital values only increased last month because rental yields – which are used to calculate these – fell.

Why does this push up prices? Because yields on competing investments, such as corporate bonds, have been falling, causing property investors to place more value on those rents (in other words, they'll pay more for that income stream), even though they were also still dropping. But there's no guarantee that, for example, corporate bond yields will continue to fall and buttress property values.

Fourth – and we've made a similar point about UK residential property (The unemployment figures mean carnage for the property market) – future prices will depend on how long Britain's dole queues grow.

Take a look at the Bloomberg chart below.



The grey line shows the collapse in the IPD All UK commercial property capital growth index. The red line is Britain's headline unemployment rate, which now stands at almost 8%. If this hits 10% as has been widely predicted, it will mean less demand for office and factory space, and less spending in the shops. So more tenants will go bust. That will cut demand for property, and will lead to further falls in rents, which could hurt capital values yet further.

So while the worst of the falls may have passed, and there could be a short-term rally, the market hasn't finally turned the corner.

Reits are nowhere near as cheap as they were

As for UK property stocks – now known as Reits or Real Estate Investment Trusts – they're nowhere near as cheap as they were. The FTSE 350 Property index has soared 90% from its March low.

And although some of these Reits' balance sheets may look a bit healthier after some of that cash raising, "how anyone can call the turn in the market at this stage is bizarre", says Hilton. CB Richard Ellis reckoned this week "the sector needs £150bn of equity to recapitalise. Set against that, the amount raised in rights issues is minuscule". It all points to more cash raising and "long and continuous pain".

If you were smart enough to buy Reits back in March, now looks a good time to take your profits.

Turning to the wider markets...
dips.