FIRST THERE WAS A SLOWDOWN THEN CAME THE CREDIT CRUNCH NOW PROPERTY IS IN PARA

THE UK PROPERTY MARKET WAS ALREADY SLOWING down rapidly this year before an unpalatable cocktail of liquidity crisis, rising interest rates, falling consumer spending and lower economic growth left it with the nastiest of hangovers from the five-year party.

This has manifested itself in the disappearance of a large part of the debt-funding market, a clutch of failed deals and some dreadful performance statistics. In short, the investment market is paralysed.

Deal flow has virtually dried up because, even where debt is available, investors are too uncertain about property values and interest rates. As Citi real estate analyst Harry Stokes says: 'Nobody wants to be the one who buys for 100 today, only to have the property valued at 80 tomorrow.'

It is almost three months to the day since the credit crunch began, initiated by a subprime mortgage implosion in the US. Its effect on the slowing UK property market has been severe.

Property Week today reveals the extent of the hangover and predicts when the nausea will finally ease.

Although the pain began in July, the first hard evidence did not emerge until three weeks ago when UK Commercial Property Trust reported a 3.15% fall in the value of its £871m portfolio in the three months to 30 September. Since then, fellow listed property investment trusts Isis Property Trust, Isis Property Trust 2, ING UK Real Estate Income Trust and F&C Commercial Property Trust have all reported similar quarterly drops of between 2.3% and 3.7%.

RECESSION REMINDER

The worst news, however, came at 3 pm last Friday, when Investment Property Databank published its eagerly awaited September index, which indicated that performance had sunk to the lows of the 1990s recession.

The monthly total return was the second worst in its history, only 'beaten' by May 1990. Representing 16% of the UK market, the index showed a return of -1.2%. Capital growth of -1.6% offset the positive income return of 0.4%. There was a negative return in the three main sectors for the first time since September 1992. Retail and industrial had their worst-ever monthly returns of -1.3% and -1.4% respectively, and the office sector delivered -1%.

Looking at the two components of capital growth, rental growth continued to accelerate at 0.4% but the impact of a fall in yields was a hefty -2%. The yield correction was broadly the same across the sectors, at -1.9% for retail and industrial and -2.1% for offices.

The yield impact has only been worse in two other months: May 1990 and January 1991. Nevertheless, IPD's chief economist, Sabina Kalyan, says valuers have not held back, as many had feared they would.

'This suggests that valuers are marking down the market as a whole,' she says. 'It is also interesting to note that we rarely see such a big movement in monthly returns from one month to the next. This suggests that we have

■ **James Whitmore** analyses the market three months into the credit crunch

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seen an unprecedentedly fast change in sentiment.' Between July and September the yield impact was -3%.

The net result is that the annual total return on UK property decelerated to 7.2% in September – the lowest rate since March 2002 and a shock to those who have only lived with healthy double-digit returns.

Alex Watt, the property head of one of the UK's largest institutional investors, Standard Life Investments, says he has lowered his forecasts for UK property returns over the coming three years to 'no better than cash'.

'We had already factored in an outward movement in property yields in last quarter's forecasts, reacting to the continued tightening of monetary policy by central banks until the summer,' he says. 'Market sentiment has changed over the last quarter, exacerbated by the recent credit market tightening.'

Although the investment market has come to an abrupt halt, statistical evidence does not yet reflect this, because the latest figures are for deals that were tied up before the credit crunch began in July. The third quarter figures from Property Data, which collates investment deal volumes for many of the big property services firms, reveal a healthy market.

Director Chris Bullock says that sales between July and September are £14bn and rising, since some secondary property and off-market deals have yet to be accounted for. This compares favourably with £15.6bn in the second quarter, £12.1bn in the first quarter and £15bn in the third quarter of last year.

TIME LAG

Bullock says the investment market paralysis will not show through until the fourth-quarter figures are published. 'The third-quarter figures don't support what's going on in the market because of the time lag,' he points out.

Anecdotal evidence suggests that most of the large sales have faltered since mid-July. These kicked off with the Mailbox in Birmingham and the Printworks in Manchester, followed by Mitchells & Butlers' £4.5bn joint venture with Robert Tchenguiz, Morrisons' £750m joint venture and Marylebone Warwick Balfour's £700m hotels division, and culminated earlier this month in British Land's £1.6bn Meadowhall shopping centre.

The next big moment for the market will be in the middle of November, when the half-year results of the UK's two largest listed property companies, British Land and Land Securities, will reveal the first hard evidence of prime property values as at 30 September.

British Land's figures in light of the failed sale of a 75% stake in Meadowhall will be particularly interesting for the size of the writedown of the centre. Analysts believe this will be anything from £100m (Citi's Harry Stokes) to £200m (Lehman Brothers' Mike Prew).

Meadowhall was valued at £1.6bn off a 4.76% equivalent yield at the end of June. 'The yield looks unattractive relative to the 10-year benchmark rate of 5.0%, the five-year swap rate at 5.6% and the base rate at 5.75%,' →