Smith & Williamson

Property survey 2012

Confidence remains an issue

Contents

Executive summary

> "Caution is very much the watch word of the day."

Property executives, aware of the headwinds and hidden reefs ahead, are cautious about those aspects of the real estate sector that don't have clearly visible means of support and inherent resilience. Caution is very much the watch word of the day.

- The demand for and value of prime Central London residential property continues to defy gravity, seemingly held up by an endless supply of overseas money in search of a safe harbour.
- The retail sector, especially secondary high streets, appears to be in for a choppy ride, with some landlords particularly exposed.
- Regional imbalance continues to be a feature of the landscape and the primacy of location remains a dominant feature of the UK economy as a whole, and the property market in particular.
- Consumer and business confidence remains crucial to performance in the commercial property sector, where investors remain cautious if not actually pessimistic.
- Banks are still unenthusiastic about the real estate sector, so the lack of debt finance may need even more government participation before it is resolved.

Thank you to all contributors who have taken the time to share their views and thoughts, which is much appreciated.

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Introduction

"...sure enough years of excess is taking years to unwind."

The UK economy is by all accounts pretty static and looks to be heading for a long stay in the doldrums. Compared to the drama across the channel, the Government seems to have settled for 'steady as she goes'. This autumn the euro crisis, though not actually over, seems to have re-entered a period of calm, which may have settled some nerves for now. However the economic prospects are not perceived to have improved over the last 12 months, so confidence remains an issue.

The property boom fuelled by the lending boom lasted several years and sure enough years of excess is taking years to unwind, with a lack of finance coupled with low economic growth being very bitter medicine indeed.

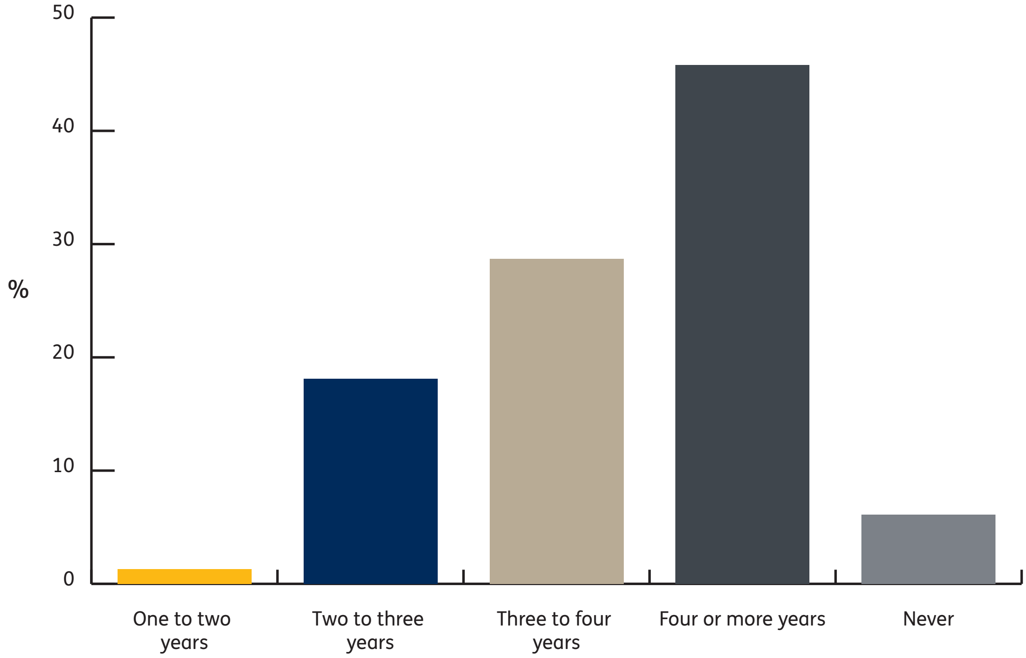
This backdrop has tempered enthusiasm and continues to make UK real estate a challenging sector.

The UK property industry

Last year we were interested to note that 96% of respondents expected the UK property sector to return to pre-crash levels of profitability. In 2010 the predicted timescale in which to see that recovery was fairly equally split between three to four and more than four years.

A year later, those expecting profitability to remain permanently lower and never recover to pre-crash levels has increased marginally from 4 to 6%. In terms of timescale, 46% of respondents now think that the time required for profitability to recover will be four years or more, whereas 29% of respondents were more optimistic and expected a recovery of profitability within three to four years, with only 18% expecting a two to three-year timeframe. Only six respondents anticipate recovery to pre-recession profitability in as few as one or two years.

Taking the UK property industry as a whole, when do you expect it to return to pre-recession levels of profitability?



These figures provide a good indication of how far our respondents think we are through the process of recovery, which on average is a little over half way.

When asked what they thought will be the key issues facing the UK property industry as a whole over the next 12 months, 84% selected UK economic performance and the availability of bank finance.

“The Government needs to stop dithering, cut taxes and stimulate growth.”

The number of respondents concerned about the impact of government spending cuts has declined from 43% last year to 26% this. That may be due to the respondents taking the view that the forthcoming cuts will not be as significant as previously thought or that in the scheme of things, there are bigger issues to be concerned about.

Our respondents remain vexed by planning, with 38% selecting new planning regulations as a key issue for the sector as a whole.

Recent announcements by the Government clearly indicate its intention to ease the passage of commercial developments, large scale housing developments and even residential development on greenfield land. This will be welcomed by developers and particularly those that identify planning restrictions as holding back their businesses.

The availability of equity finance was selected by 28% of respondents as a key issue over the next 12 months, which indicated that while the lack of debt finance is the key factor, the lack of equity finance is also a significant problem for the sector. Those involved with the promotion of property funds will be only too aware of these restrictions.

Other issues specifically mentioned include: European economic performance, EU stability, occupier demand and consumer confidence.

When asked what they would do to assist the UK property industry, the key initiatives selected by our respondents were: yet again in first place, enhance bank lending to the sector, then in equal second: simplify planning regulations, use public funds to finance infrastructure, and cut property taxes and rates.

As one respondent put it “The Government needs to stop dithering, cut taxes and stimulate growth.”

In terms of taxation, many respondents called for: stamp duty land tax reductions rather than increases and business rates reliefs, along with reductions to the section 106, community infrastructure levy and social housing requirements in particular.

Commercial property sector

> "Uncertainty has increased significantly, with a substantial 40% of respondents unsure about the outlook for the next 12 months..."

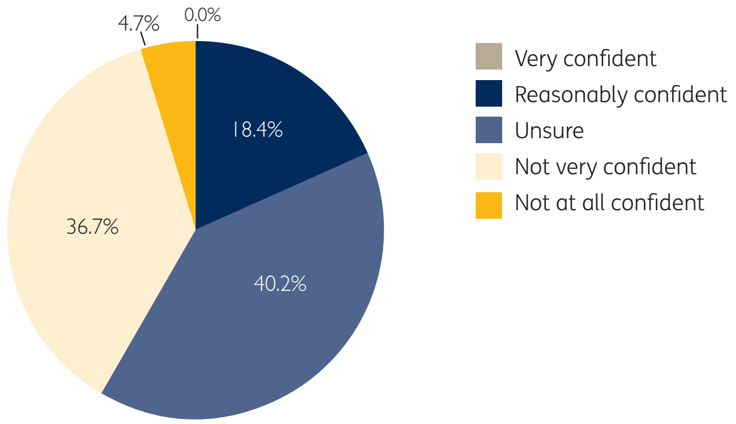
There has been a tiny increase in the recorded level of confidence about the near-term outlook for the UK commercial property sector since last year. This year 18% of respondents were reasonably confident about its prospects, compared to 16% in 2011. That may be due to less anxiety about the euro crisis and economic stagnation in the UK, or it could just be a statistical blip.

Uncertainty has increased significantly, with a substantial 40% of respondents unsure about the outlook for the next 12 months, compared to 33% being unsure last year. This continuing uncertainty may be a reflection of the uncertainty about the prospects for the UK economy as a whole, or uncertainty specific to the outlook for the commercial property sector for the next 12 months.

Not one respondent was very confident about the outlook for the commercial property sector for the next 12 months, which was not a huge surprise. There has, though, been a significant decrease in those not confident about the outlook from 50% last year to 'only' 41% this year.

Overall therefore, if you were an optimist you could interpret the shift in sentiment from not confident about the prospects to uncertain about the prospects as good news, starting, that is, from a low base.

How confident are you about the outlook for the commercial property sector over the next 12 months?



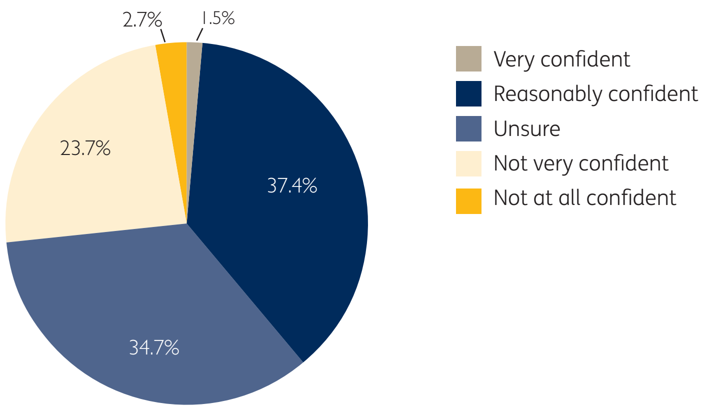
Residential property sector

When asked how confident they are about the outlook for the residential property industry over the next 12 months, our respondents were, as with last year, divided into three evenly sized groups of those that were: confident, not confident and unsure.

This year the largest group, 39%, were confident about the outlook for the residential sector, whereas last year there was a slight bias towards a lack of confidence.

While prime property prices are being pulled up by investor demand, first-time buyers are not supporting the market from below, due to the need for significant financial resources or backing in order to step onto the property ladder. Furthermore, prices in London are now only just below their 2007 peak, a statistic which you may either view with glee or anxiety – either way it has an impact on affordability.

How confident are you about the outlook for the residential property sector over the next 12 months?



Opinion is clearly divided, which in view of the conflicting, variable and unpredictable factors that will have an effect on the sector over the coming year, is hardly surprising.

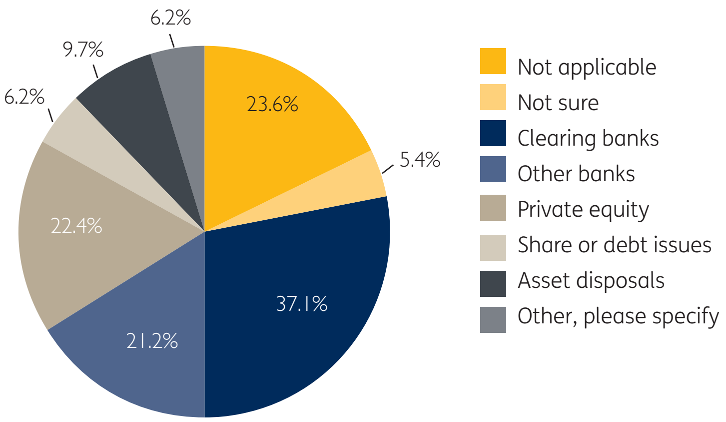
Raising finance

"Businesses are continuing to raise funds from share and debt issues, as well as asset sales."

This year, 39% of respondents reported that they expected their business to be constrained during the next 12 months due to a lack of finance, with 17% being unsure on the matter. If your aspiration was to create economic growth in the UK, a good place to start would perhaps be to enhance funding to those businesses constrained by a lack of finance. The Government and the Bank of England have certainly strived to keep the cost of borrowing low but efforts to enhance supply to businesses have so far been inadequate. Perhaps this year intervention will have more impact.

When asked which sources of finance would be most relevant to their businesses, 37% of respondents nominated clearing banks, which was down from 44% last year and follows a trend of decline. A further 21% of respondents indicated that other banks would be the most relevant source of finance for them compared to 23% last year. Private equity was nominated by 22% of respondents as the third main source of finance, down from 26% last year.

If raising finance in the next 12 months, which sources do you think will be most relevant to your business? (Please select all that apply.)



Businesses are continuing to raise funds from share and debt issues, as well as asset sales. Companies are, it appears, going to the bond market to raise finance both here and overseas.

Retained profits and funds contributed by partners and shareholders are, we understand, being used to shore up and provide the capital needed to maintain and also develop property businesses.

It has been observed that the banks are, despite a constant stream of problems, slowly getting their balance sheets in order and clearing out their bad loan books, which should perhaps give us hope for the future. This clearing out of the stables does though leave secondary property rather exposed when occupier demand is under threat. Some observers note that while the lack of bank finance is restricting the market at the moment, there is a case for property values to be rebased downwards.

UK property sectors

For the second year in a row the sector about which the greatest number of people are most pessimistic is retail, receiving just under a third of all nominations as the sector most at risk.

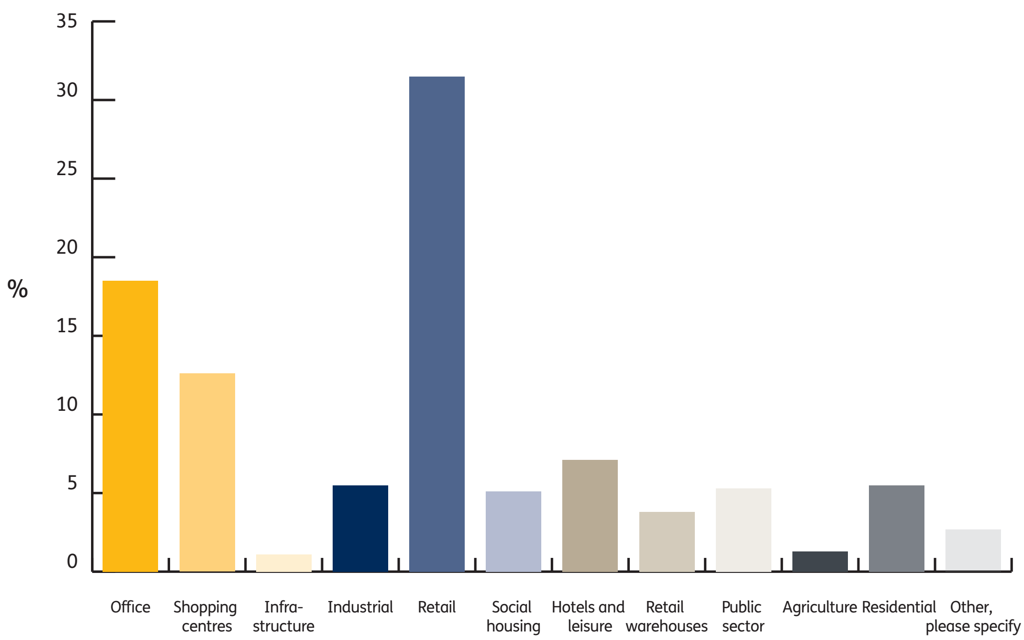
There has been an across the board drop in optimism about the prospects for the shopping centre, retail and retail warehouse sectors for the next 12 months. There is little good news for consumers at the moment, which has detrimental consequences for the retail industry. Furthermore, since last year there have been several high profile failures on the high street and very little good news for landlords outside of prime locations, so this continuing pessimism is perhaps not very surprising.

Our commentators observe that when retailers have been stuck with loss making units that they cannot afford to operate, that situation rapidly turns into a problem for landlords. As one respondent put it, “on secondary high streets the majority of incoming tenants are charity shops, pawnbrokers and bookmakers”.

Again, for the second year running only about 5% of respondents were most pessimistic about the outlook for the social housing sector for the next 12 months. However, the recorded optimism about the social housing sector has fallen away slightly this year, with 10% of respondents being most optimistic about it compared to 12% last year.

The need for affordable housing remains and in sufficiently large units; the sector is attracting some institutional investment.

Which property sector are you most pessimistic about for the next 12 months?



“The residential sector is again the sector which the greatest numbers of respondents are most optimistic about, and has increased its share of votes from 24 to 26%.”

Infrastructure has remained relatively popular with 15% of respondents being most optimistic about that sector over the next 12 months.

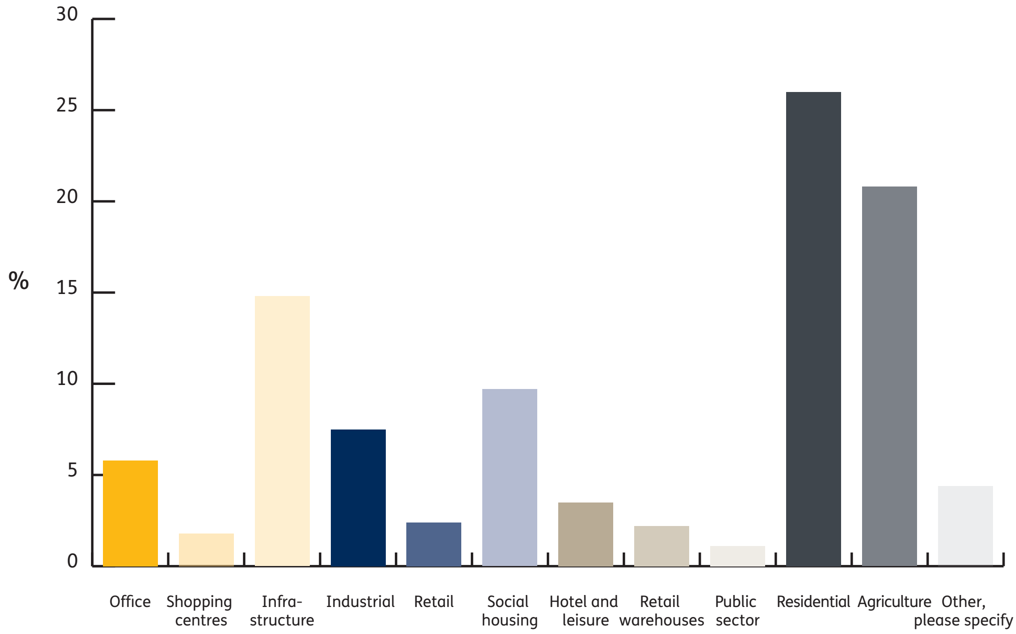
More respondents were most pessimistic about the office sector than last year, which received 18% of nominations compared to 16% last year. Optimism about the office sector has deteriorated yet again, with only 6% of respondents being most optimistic about the sector compared to 8% last year. These small shifts in sentiment may be a function of anticipated over supply and/or reduced occupier demand.

Interestingly, people are a lot less pessimistic about public sector property, only 5% of respondents this year compared to 15% last year. This ties in with the reduced concern about government spending cuts.

The residential sector is again the sector which the greatest numbers of respondents are most optimistic about, and has increased its share of votes from 24 to 26%. The agricultural sector is a close second, receiving 21% of nominations.

There has been a further cooling off in sentiment about the industrial sector; this year those most optimistic about the sector declined from 14 to 8%. This continuing decline may be as much due to concerns about weak economic growth in the UK as purely property-specific factors.

Which property sector are you most optimistic about for the next 12 months?



These sentiments, while not location specific, do give a good indication of which sectors the respondents expect to see improvement or decline in over the next 12 months. Again residential, agriculture and infrastructure top the poll for positive expectations. Conversely retail, office and shopping centres are most out of favour.

Secondary property received special mention for pessimism this year and, in particular, secondary retail and high streets.

Asset classes singled out for special mention for optimism included: convenience retailing, student housing and high-end residential.

Regional variations

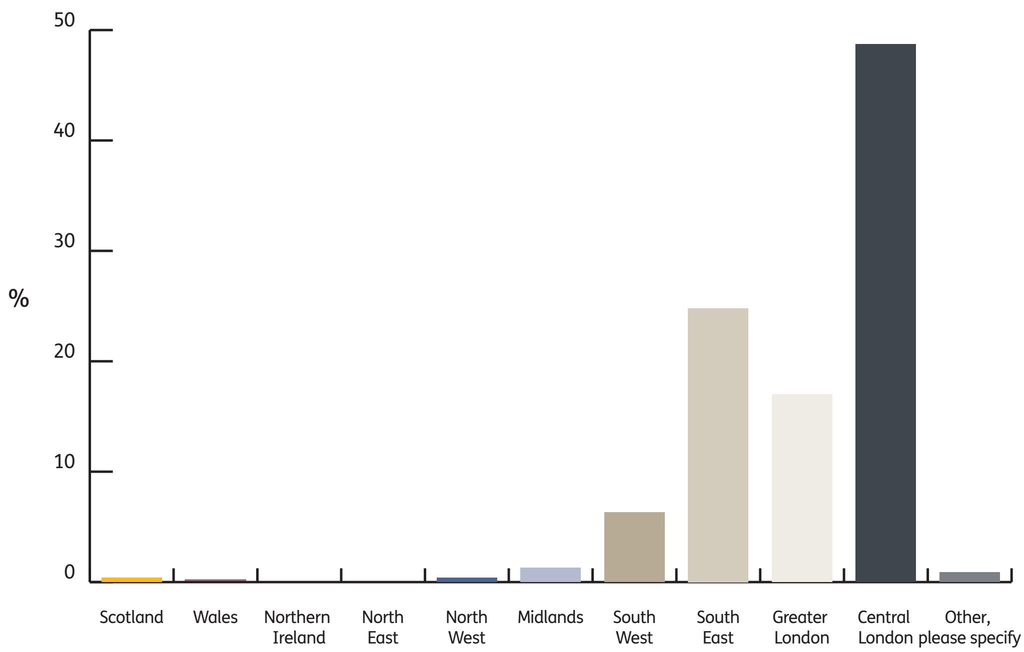
“90% of respondents were most optimistic about London and the South East.”

There have been some subtle changes since last year but the overwhelming schism between London and the South East, and the rest of the UK remains the stand out feature of regional sentiment.

90% of respondents were most optimistic about London and the South East. For the second year running 48% of all respondents nominated Central London as the region they are most optimistic about for the next 12 months. There has though been a shift in sentiment away from Greater London in favour of the South East, with 5% of respondents changing allegiance between the two.

The ‘other’ regions selected for optimism were abroad!

Which region are you most optimistic about for the next 12 months?



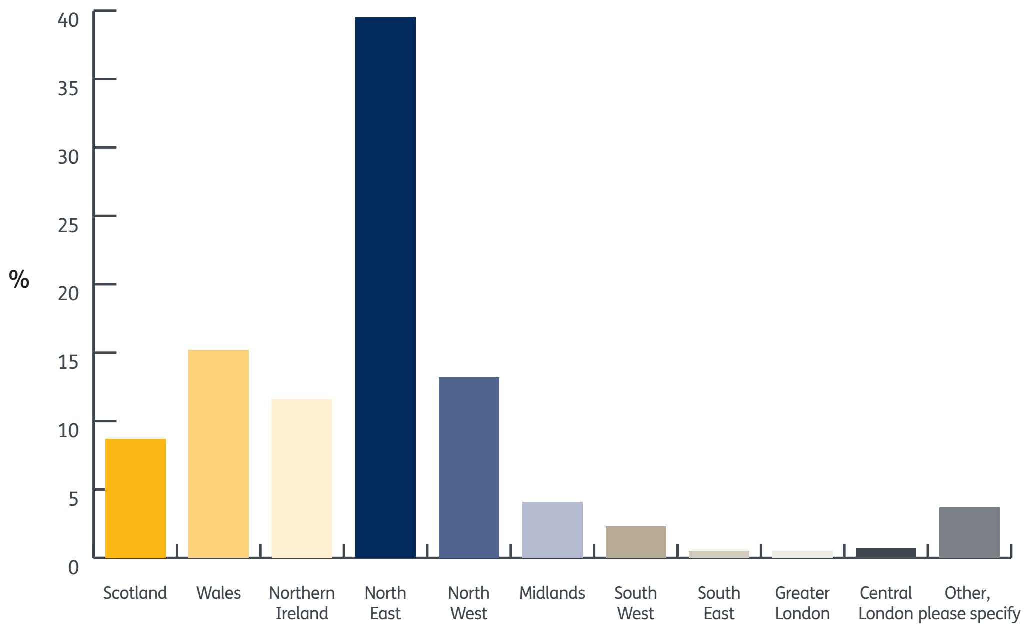
“Of note though was the increased level of pessimism about Wales up from 9% last year to 15% this year.”

Yet again the region of the UK that most respondents are most pessimistic about is the North East, which received 39% of nominations.

Of note though was the increased level of pessimism about Wales up from 9% last year to 15% this year. The sentiment about the Midlands improved marginally, with it receiving 4% this year rather than 6% last year of the votes for the region to be most pessimistic about. Far fewer respondents were most pessimistic about the South East this year compared to last.

As observed last year, the pessimism for “anything outside of London and the South East” is a clear message of where government assistance could be directed if there is an appetite to rebalance the geographical distribution of UK economic activity.

Which region are you most pessimistic about for the next 12 months?



Commercial property investment

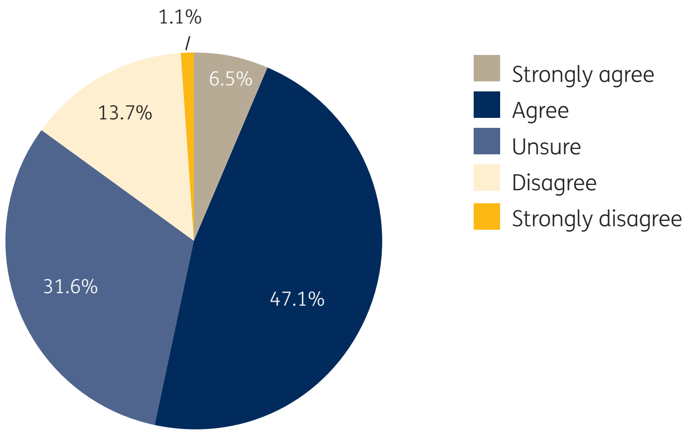
"...prices may have moved ahead of economic reality."

The enthusiasm for commercial property investment has deflated since last year. This year 53% of respondents (compared to 63% last year) are of the opinion that taking a five-year view now is a good time to make a commercial property investment in the UK.

There has also been an increase in the number of respondents who were uncertain in this respect, up from 24% last year to 32% this year, which may indicate an underlying concern that prices may have moved ahead of economic reality.

The main reasons stated for pessimism about making a commercial property investment now (apart from the economy as a whole) were over supply of shops and a lack of occupier demand. Again, away from Central London, lack of visibility of future demand and residual values are real issues for investors.

Taking a five-year view now is a good time to make a commercial property investment in the UK.



Residential property investment

"...several commentators are predicting asset value to increase in the foreseeable future."

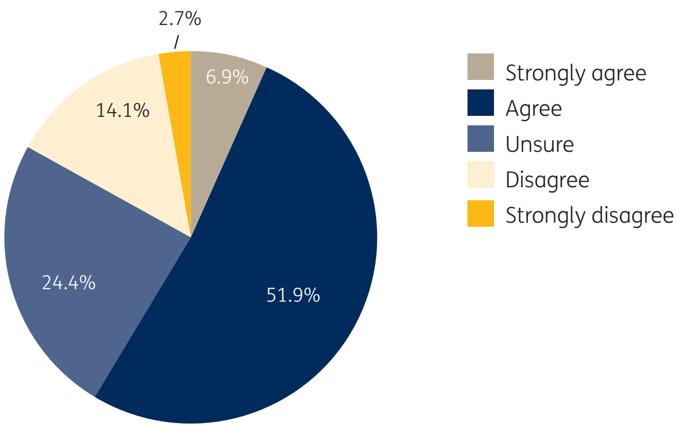
This year 60% of respondents were of the opinion that taking a five-year view now is a good time to make a residential property investment in the UK, which is a significant increase from 51% last year.

The number of respondents who were unsure has declined from 29 to 24%, and those who disagreed with the premise have declined in number from 20 to 15%.

Some of those who do not agree that now is a good time to make a residential investment take that view because their perception is that apart from in 'hot spots' investors do not need to buy now as there is downward pressure on rents.

Those of our respondents who have in mind residential property investment in London are not alone in their enthusiasm, as several commentators are predicting asset value to increase in the foreseeable future.

Taking a five-year view now is a good time to make a residential property investment in the UK.



Environmental initiatives

"In particular, energy performance certificates were viewed by many as a waste of time and money."

Environmental issues are still out there but have in the recent past understandably been off the agenda for a lot of businesses. When asked which environmental initiatives have a material impact on their business, 32% responded 'none'. One-quarter of respondents indicated that energy performance certificates and the carbon reduction commitment would have a material impact on them.

In particular, energy performance certificates were viewed by many as a waste of time and money. The initiative identified by 37% of respondents as having a material impact was energy efficiency. While the Government is pressing on with the green agenda, we do not sense the same level of engagement in business as there was prior to the financial crisis.

Conclusion

“The availability and cost of funding, along with poor economic growth, remain the key issues for the property industry.”

The availability and cost of funding, along with poor economic growth, remain the key issues for the property industry. The same is no doubt also true for the majority of UK businesses, which after all are the occupiers or employers that drive demand for most property in the UK.

Transaction, ownership and development taxes (including green initiatives) are perceived to be acting as a dead weight on the real estate sector when it is least able to shoulder the burden. The call is for simplicity and consistency.

Sentiment is most positive in the residential, agricultural and infrastructure sectors and yet again Central London, the South East and Greater London are the regions that most expect to prosper in the near future. Retail seems to be for the brave or committed.

Our service

The property and construction industry continues to operate in a challenging environment. Smith & Williamson has in-depth knowledge of the real estate sector and we understand the issues faced by property executives.

The Smith & Williamson property and construction group provides a partner-led, cross-discipline approach. We aim to ensure that clients receive bespoke and innovative advice relevant to their particular circumstances. Our methodology is to deliver solutions that optimise the tax, accounting and commercial outcomes for clients.

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About us

Since our foundation over a century ago, Smith & Williamson has been managing the financial affairs of private clients and their business interests. We are one of the top ten largest firms of accountants* in the UK and our investment management business has over £12bn of funds under management and advice (as at 31 June 2012).

Our focus is on wealth creation, wealth management and wealth preservation – a unique approach that singles us out from our peers and larger competitors.

- **Wealth creation services** – working with entrepreneurs, families and their businesses to create sustainable income and capital value.
- **Wealth management services** – working with clients and their businesses to coordinate and plan their affairs, including dealing with regulatory and fiscal filing.
- **Wealth preservation services** – including assurance services, financial planning, investment management and private banking services, with bespoke services for individual clients, families and trusts.

In an award-winning business as diverse as ours, professionalism and teamwork are key. We recognise that clients and intermediaries take comfort from knowing that they can easily reach senior people and decision-makers in our organisation who are able to understand their needs and objectives.

Smith & Williamson thrives on its people – a pool of highly talented and enthusiastic individuals who deliver a broad and innovative range of services, but without compromising on delivering a genuinely partner-led service. Technical excellence underpins how we deliver our services and our teams are dedicated to offering practical financial solutions.

Our business spans 11 principal offices in the UK and Ireland, with locations in the City of London, Belfast, Birmingham, Bristol, Dublin, Glasgow, Guildford, Manchester, Salisbury, Southampton and Worcester. We have an international capability in over 100 countries through membership of Nexia International (the tenth largest international accounting and consulting network**) and M&A International.

* *Accountancy Age* 2012
** *International Accounting Bulletin World Survey 2011*