

SCOTLAND on SUNDAY

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## Cracks begin to appear in commercial property

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AS THEY walked into the grand foyer of Edinburgh's Balmoral Hotel, some of the most influential people in Scottish property amicably chatted about business and deals they hoped to tie up before Christmas.

The 50 fund managers and property executives from firms including Standard Life, Kenmore, Buccleuch and Hunter Fund Management were full of pre-Christmas cheer but had delayed going home to attend a seminar which would assess prospects for the commercial property sector in 2007.

Some of the UK's highest profile business figures, including Sir Tom Hunter and David Murray, have made a fortune out of buying and selling buildings and land in recent years.

But as the industry's representatives sat down in a seminar room in the hotel earlier this month, all were aware of a dark cloud hanging over the industry.

In June, the Bank of England had warned that 35% of the value of Britain's commercial property market could disappear over the next three years as the market corrects itself. The warning was a "worst case scenario", but nonetheless it was a flashing light that no one in the industry could afford to ignore.



As the seminar began, it became clear the message was being repeated, as executives were warned that the strong performance of Britain's commercial property market - which averaged a total return of as much as 20% last year - was unlikely to be sustained in 2007.

Assets would have to be "sweated" by rent reviews and refurbishment to increase value, they were told. The days of buying a building, "sitting" on it for a couple of years and selling for profit were all but gone.

Charles Woollam, a partner at the property agency that organised the seminar, Donaldsons, said the UK industry had become a victim of its own success, with prices being pushed ever higher as would-be buyers chase a finite amount of quality bricks-and-mortar assets.

Investor appetite had been so strong, he said, that the difference in price between well-let properties in good locations - offering stable, long-term returns - and those of lesser buildings in secondary locations - offering more risk and lower returns - had been virtually eliminated. "This means people have been paying too much for some types of property," he concluded.

As attendees left the Balmoral two hours later, the mood was described as "positive" by one, but for the first time there is a growing consensus in the industry that the UK market has now peaked.

Chris Dougray, managing partner of Donaldsons in Scotland, says: "It's been remarkably easy to make money out of commercial property over the past few years. As the market moves into the next phase of its cycle, the best performing funds will be those best able to identify and then manage out some of these risks. Passive investors have had their day."

The British commercial property sector has in the past five years become front page news thanks to a series of remarkable deals, big personalities and the sheer amount of money flying around.

Sir Tom Hunter, previously known for his retailing prowess, has reinvented himself as a major property player through his West Coast Capital business, heightening public interest in the market.

New businesses, such as the Northern Irish group WG Mitchell, have seemingly sprung up from nowhere to become major players in Scotland and south of the Border, building a portfolio of assets worth £500m in under 10 years.

The reason for this growth can be traced back to the bursting of the dotcom bubble in 2000, when bricks and mortar became the investment of choice for institutions and private investors badly burned in the equity crash.

The Royal Institution of Chartered Surveyors (RICS), reported recently that total returns on commercial property in 2005 had remained close to 20% for the second consecutive year. According to property agency Cushman & Wakefield, sales of commercial property in Scotland in 2006 will comfortably exceed last year's total of £3.1bn.

Foreign investment is playing an increasingly large part in this, with overseas money counting for some 30% - £15bn - of all British property purchases last year.

But it seems that after five years, equities may be set to outperform property once more. RICS is forecasting total returns from commercial property of 17% this year, but slowing to 9% in 2007.

Interest rate rises have played a major part in the shift, narrowing the gap between the cost of borrowing money and what you can make selling on the building.

But not everyone believes the UK market has peaked. David Davidson, partner at Cushman & Wakefield, says: "We underestimate the amount of new capital coming into the market. The UK is seen as an exceedingly safe and robust market.

"There are large sums of money coming in from the Middle East and Australia."

One of the most eye-catching deals of 2006 was the purchase in May of the St James Centre in Edinburgh by Henderson Global Investors for £184m. Henderson bought the centre from two Irish businessmen. Michael Herbert - who made his fortune from the Kentucky Fried Chicken franchise - and his partner Pat McCormack had acquired the eyesore building four months earlier for £169m - making them a paper profit of almost £15m in four months.

According to Dougray, these sorts of deals will become less common. "The opportunity to take an early exit at very substantial profit appears less likely as we move forward."

Property agents warn that buyers will have to be much more selective about which

buildings they buy, and choose places where there is a clear opportunity to add value.

For example, CBRE recently paid £12.8m for the Lochavullin Retail Park in Oban, and agents say it is likely to be a good investment because demand for retail space in the town is high and future retail development in the area is limited. Offices in Edinburgh, Glasgow and Aberdeen are also expected to perform well in 2007 - but only the most attractive properties.

Meanwhile, the introduction of capital gains-tax free REITs (Real Estate Investment Trusts) is likely to entice investors to keep putting cash into commercial property. Davidson says REITs will tempt people already investing in the sector to invest more, but is unlikely immediately to attract legions of new investors.

A number of Scottish companies are looking further afield for bargains. Kenmore and Miller are two of the better-known Scottish companies investing in Europe and moving steadily east. Agents say there is money to be made overseas, where prices are often lower, properties older - which means they can be refurbished and value increased - and economies are expanding, increasing demand for commercial space.

Bob Stevenson, managing director for Europe at Donaldsons, says Poland and Czech Republic are "hot spots" for investment and the safest way to get a slice of the pie is by putting money into specialist overseas property funds run by major institutions. He says: "Investors are now looking at Bulgaria, Romania and Turkey and some are looking even further afield to Ukraine and Russia."

It all means Scotland's property professionals will have to work a bit harder, and probably look a bit further afield, to find their bargains in 2007.

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