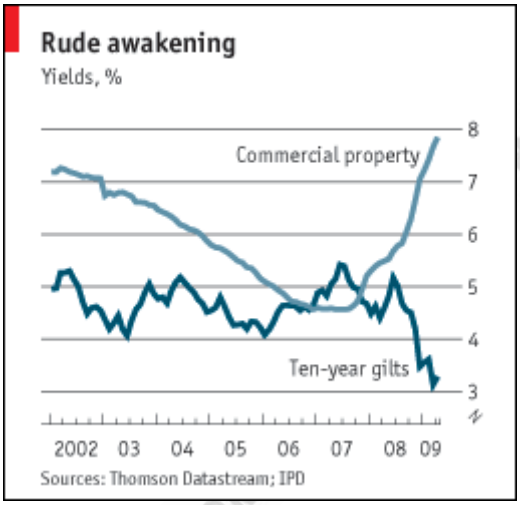
Still blighted

The market has taken a terrible drubbing and will not recover soon.

THE pain has been excruciating. Commercial-property values have dropped by 43%, a record decline, since their peak in June 2007. In western Europe, only Ireland has experienced a bigger fall, according to IPD, a data provider.

The immediate prospects for the British market remain grim. The Royal Institution of Chartered Surveyors (RICS) says that 59% more surveyors expect capital values to fall than to rise in the second quarter of this year. Gloomy though such sentiment seems, the mood is even darker in a majority of the 40 other countries surveyed and compared in a report released on May 19th. Britain is further advanced in the commercial-property cycle, explains Oliver Gilmartin, an economist at RICS.



Values lurched downward as investors in British property woke up and stopped accepting ever lower yields: at one stage these had dropped below even yields on risk-free government bonds (see chart). After falling to just 4.6% in the first half of 2007, property yields have since rebounded to 7.8% this April, their highest in almost 12 years. Since values are inversely related to yields, this turnaround has been the main factor in the decline of the market, says Kelvin Davidson of Capital Economics, a consultancy.

On the face of it, yields of close to 8% should be enough to steady the market, provided investors start to regain their nerve. After all, property remains a hedge against inflation, an attraction to those worried that the Bank of England is creating money through its "quantitative easing" to fight the economic downturn. But official figures released this week suggest that such inflationary fears are exaggerated. Retail prices dropped by 1.2% in the year to April, the biggest fall in the 60-year history of the index, while the narrower measure of consumer-price inflation sagged to 2.3%, only a bit above the 2% target.

The property market is experiencing its own version of deflation as rents decline. This will add another twist to the misery, forcing capital values down further even if yields do stabilise. Compared with those in other countries, surveyors in Britain are especially gloomy about the short-term outlook for rents, finds the RICS report. And rental values have already dropped by 6% in the year to April, according to IPD.

Commercial-property woes have hurt not just investors but also banks. Losses from poor lending decisions on office blocks, retail outlets and the like by HBOS are a big reason why its shotgun takeover by Lloyds proved so disastrous. Sir Victor Blank, the chairman of Lloyds who

pushed through the deal on which Gordon Brown was keen, paid the price for angering shareholders. On May 17th he said he would step down sooner than expected.

Loans on commercial property were some £225 billion ($349 billion) at the end of 2008. A third is due to be repaid this year and next, according to a forthcoming report from researchers at De Montfort University. That overhang of debt—and the need to refinance so much of it swiftly—is another reason why the outlook for commercial property remains blighted, says Bill Maxted, one of the authors.

Capital values are now dropping less steeply than in late 2008, when they were in virtual free fall. But a panel of experts convened by Reita, a trade body, thinks that the market is unlikely to hit bottom until next year. The trough will probably come towards the end of 2010, says Mr Davidson, when capital values will be 55% lower than their peak in 2007.

Until now, the decline in the market has been fairly uniform across its three main sectors—retail, offices and industrial. But looking ahead, industrial property is likely to outperform retail, which is in turn likely to do better than offices, says Mr Gilmartin. The prospects for the London office market look especially bleak as financial firms cut back and new developments are finished.

This outlook is consistent with an eventual economic recovery that will favour manufacturers and exporters, thanks to sterling's big depreciation, while domestically oriented providers of services fare less well than before. But whatever sector does best, the overall prospects are dull. Tenants rather than landlords are calling the shots in a chastened market.

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