CB RICHARD ELLIS

Rating Revaluation ViewPoint

www.cbre.co.uk/research

June 2009

2010 Rating Revaluation: Central London

Gary Martin, Analyst, Central London Research, UK

INTRODUCTION

The rating revaluation across England, which will be introduced on 1 April 2010, will produce large rises in business rate bills in areas where rents have risen sharply in recent years. This report focuses on the Central London office market, where some of the largest increases from the revaluation are expected. Following revaluation, business rates across each of the main Central London markets will be markedly higher, although the West End, particularly the core, is expected to experience the largest rises.

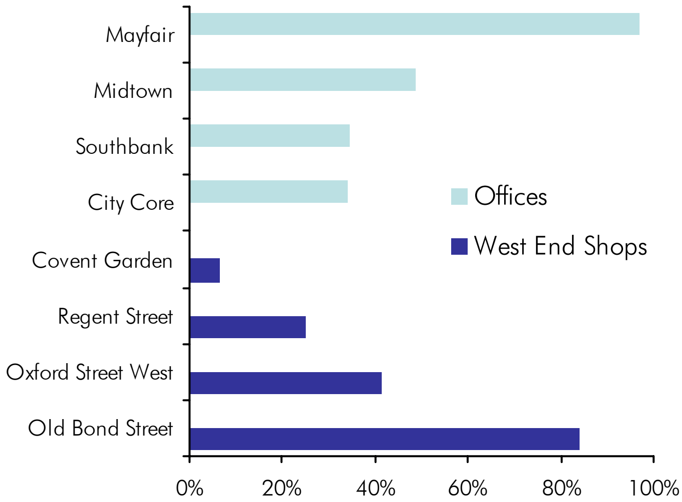
Retail property in the West End is also covered by the analysis. This provides an indicative guide to the impact of the revaluation on Central London retail occupiers, although there will be greater variability across individual property than is the case with offices due to marked differences in rental changes by location within the retail sector.

OVERVIEW

In September 2009, the Valuation Office Agency will publish the new list of all rateable values for non-domestic property in England. This list will form the basis for the new business rates that commercial property occupiers will face from 1 April 2010. This review of rateable values is based on a 5-year cycle and takes into account market rental value changes between 1 April 2003 and 1 April 2008.

To allow for the effects of rent incentives on the true value of rental income, our analysis has used net effective rental growth – which is adjusted for the impact of rent-free periods on rents – for each of the Central London office markets.

Prime 5 Year Rental Growth, Q1 2003 – Q1 2008



Source: CB Richard Ellis

THE NEUTRAL LIABILITY THRESHOLD

The concept of neutral liability threshold plays an important role in determining the extent to which a property's rates liability will change. Upon revaluation, the change in an occupier's rates bill will be dependent on the rate of rental value growth recorded for that property since the last valuation and its relationship with the growth at the aggregate level across England. For a property where the rental growth was higher than the national average the rates liability will increase. Similarly, properties where rental growth was lower than the national average will see their rates liability fall. However, due to the annual allowance for inflation-linked increases, even if a property's rental growth is comparable to the aggregate list and the liability remains unchanged, the rates bill will still increase.

On our calculations, the national average of non-domestic property rental growth over the five years to April 2008 was 21%, implying that this is the neutral liability threshold. However, the total income from business rates is likely to be adjusted down by 5% in order to account for the impact from appeals and phasing on the income raised. Thus, the actual level of rental growth at which a property will enjoy a neutral impact upon revaluation is estimated to be in the order of 16%.

CBRE
CB RICHARD ELLIS

IMPACT ON CENTRAL LONDON OFFICES

The 2010 revaluation has fallen at a particularly vulnerable time for firms in the UK. In the present recessionary climate, any increase in rates liability will add to costs and have a detrimental effect on business. The largest increases in rateable values are anticipated among offices and particularly those in Central London. Given the financial nature of the current downturn, the widespread weakness in the economy and the high cost of occupation in Central London, these occupiers are particularly vulnerable to further cost shocks.

With unfortunate timing, the 2010 revaluation has followed the rental cycle of Central London offices very closely. Based in 2003, current rateable values will reflect the trough of the previous rental cycle, when following the dot.com downturn there was a notable slump in demand and excess supply; in addition, rent free periods had also risen considerably. However, by the next valuation date in 2008, rents had surged reaching peak values in 2007 and incentives had more than halved.

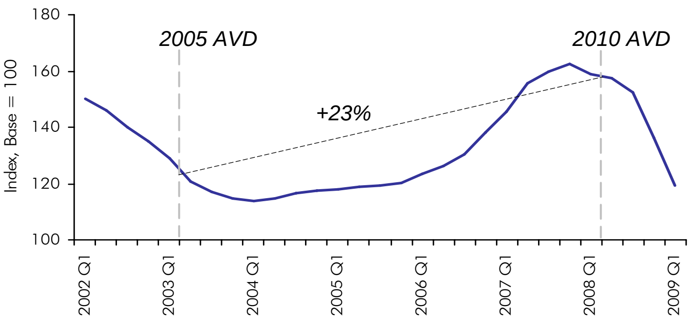
However, by Q1 2009, rental values across Central London had fallen by more than 25% and rental incentives had also increased considerably. Rents are expected to fall during 2009-10, but the next revaluation is not due until 2015. Hence, occupiers in the bulk of the existing stock of office space in London will be burdened with rates based on 2008 values throughout the downturn.

ADDITIONAL CONSIDERATIONS

The upcoming revaluation will have a dramatic impact on the commercial property market and occupiers of all non-domestic property. However, it will also be accompanied by a range of business rates measures that will have a significant impact on businesses, these include:

- RPI inflation, which determines the rise in rates between revaluations, was particularly high in September 2008 at 5.0%, and has since receded sharply. Under pressure from industry groups, the government recently announced that the impact of this increase will be limited to 3% this year and the remaining uplift deferred until next year. As this is independent of the impact from revaluation, it has not been accounted for in our analysis.
- As of April 2008, landlords or tenants of empty properties are no longer able to claim full or partial relief from business rates.
- Recent legislation now allows local authorities to levy additional business rates to support local infrastructure and initiatives; adding a further potential burden on occupiers. Previously, the City of London was the only local authority with this power. In London, we assume that this will be used to charge the maximum supplement of 2p in the £ on all rates bills in order to support Crossrail. City of London occupiers will also pay an additional supplement of up to 5p in the £ in 2010.

Central London Headline Rent Index



Source: CB Richard Ellis

ANTECEDENT VALUATION DATE (AVD)

The date on which the 2010 Rateable Values list is based for valuation purposes. In this case it is 1 April 2008, from which the rental growth in the previous 5 years is used to approximate growth in the rateable value.

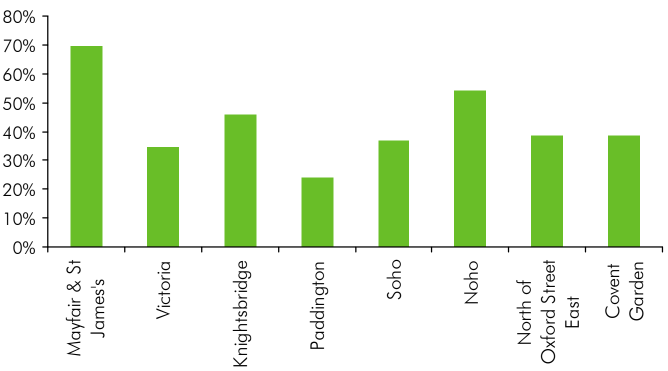
CBRE
CB RICHARD ELLIS

WEST END

The West End recorded exceptionally strong rental growth throughout the last five years in response to above trend economic growth. In particular, low interest rates and increased global investment flows supported the emergence of a substantial number of specialised financial firms, for whom the West End core is the traditional home. As a result, the West End overall will be subject to the largest increase in rates liabilities of all Central London office markets, and in fact all property in England. On average, the West End will likely see an uplift of around 45% in rates liabilities, however this figure does not accurately reflect the large differences between individual locations and sub-markets.

The Mayfair and St James's core will undoubtedly experience the largest increase across the board on account of the large rental growth recorded following the dot.com downturn. Strong demand from high-margin financial occupiers like hedge funds and private equity groups, all vying for a severely limited stock of high-spec space at a prestige address, caused rents to double from 2003-2008, even more for those properties considered 'top prime'. This means that rates liabilities in the West End core are likely to increase by c70%, although there is evidence to suggest increases greater than 90%.

West End Forecast Rates Liability Change



Source: CB Richard Ellis

Given the growth recorded in the West End core, it is no surprise that two of the markets traditionally considered as close alternatives, Knightsbridge and North of Oxford Street, are also expected to see very sharp increases in rates liabilities, with rises of around 46% and 54% respectively.

In both the Covent Garden/Strand and Soho markets the uplift will be smaller at around 37%, albeit still quite strong within the context of the wider Central London market.

Despite Victoria's success as a rejuvenated office market, the uplift will also be around 34% because much of the growth occurred just before the previous AVD.

Perhaps surprisingly for an emerging market, the average rate of rental growth in Paddington is the lowest of all sub-markets. The average rates burden will rise by 24%.

Since the 2008 AVD, the CB Richard Ellis prime rent index for the West End has recorded a fall of 28%, the greatest of the Central London markets.

TRANSITIONAL RELIEF

It is anticipated that the government will introduce a transitional ceiling as it has for previous revaluations. Those properties experiencing a particularly large increase in rateable values will be eligible for a phased introduction of the impact over the first four years of the revaluation. Under previous transitional arrangements, annual increases were limited as follows:

Year 1: 12.5%	Year 3: 20%
Year 2: 17.5%	Year 4: 25%

Our research shows that for a well-specified property in Mayfair or St James's recording an increase in rateable value of around 90%, transitional relief will save c20% of the rates bill over the first four years.

WEST END RETAIL

On average, West End retail recorded more muted rental growth between 2003 and 2008, resulting in a typical uplift in rates liabilities of 9.5%. However, given the substantial increase in both domestic and tourist spending that has occurred in recent years, and particularly in London's West End – the centre of shopping in the capital – this will likely be higher for some key trading locations.

There is a clear preference by international retailers towards the prime locations of Old and New Bond Street, which has pushed rents up significantly in this area and will cause a higher liability. Areas such as Regent Street and Covent Garden may also see a greater increase than is initially implied from headline rents because there was very strong headline rental growth prior to the 2003 AVD, but most other properties will have this impressive growth reflected in the 2010 revaluation.

CITY

The City also recorded substantial rental growth over recent years, although below the rates for the West End. Over the last five years, there was little difference between rental growth in the core and fringe areas.

The core is likely to see an uplift in rates liability of around 16.1%. Whilst this remains high compared with the national aggregate, it is much lower than in other Central London markets due to the higher incentives that are traditionally available in the City and the strong competition provided by a high level of development completions. Rental depreciation is quite high in the City and therefore those properties that have failed to modernise and keep up with tenant demands are more likely to see a muted change, or in fact decreased liability.

The outer City should see a similar average uplift of 13.6% upon revaluation. With only certain buildings in City fringe enjoying potentially lower increases.

Since April 2008, the City prime rent index has fallen 24%.

SOUTHBANK

As a result of an improved perception as a viable alternative to the City, prime net effective rents on the Southbank grew quite strongly up to April 2008. This should result in a typical uplift of around 15.7% in the Southbank which will apply to newly completed developments that command rents competitive to those in the City.

As there has not been much new development on the Southbank thus far, and rents for most properties are reflecting the market's secondary status, the majority of properties will likely underperform, and the wider market will actually see a negligible impact on liabilities.

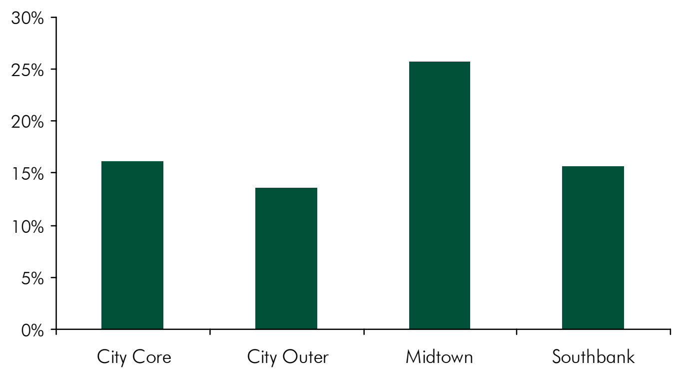
So far in the downturn, Southbank has remained the most resilient market with the prime rent index falling just 13%.

MIDTOWN

Midtown has recorded the strongest rental growth outside the West End, resulting in a 25.8% increase in rates liability. As this is higher than the potential transitional relief ceiling, the Midtown is the only market overall, outside the West End, which may require transitional relief upon revaluation. Those properties on the western edge of the market, that may have benefited from spill-over demand from the West End, are likely to see the greatest increases in rates liability.

In the year since the 2008 AVD, the Midtown prime rent index has declined 19%.

Forecast Rates Liability Change



Source: CB Richard Ellis

DOCKLANDS

The Docklands is anticipated to see a change in rates liabilities broadly similar to that of the City.

CONCLUSION

The upcoming rating revaluation will have a significant impact on the occupation costs of all office occupiers in Central London and West End shops. However, it will be the West End that will see the most dramatic increases in rates liabilities in 2010. The Mayfair & St James's core will see the largest increases by a substantial margin as strong demand from high margin financial firms such as Hedge Funds and Private Equity made the West End core the world's most expensive office location.

Throughout the rest of the Central London office market, and West End shops, certain properties will also experience substantial uplifts and very few properties will enjoy a reduced or unchanged rates liability. However, given the current market climate, and the precipitous fall in rental values that has occurred across the Central London market since the antecedent valuation date, property in London will be overburdened through the downturn and business rates will play an increasingly relevant role in occupiers' location choices.

CBRE
CB RICHARD ELLIS

METHODOLOGY

This analysis examines the impact on English commercial property that will result from the Non-Domestic Rating Revaluation taking place in 2010. It takes into account the impact of the Revaluation itself, which will redistribute the overall burden of rates across the country to reflect the changes in rental value that have occurred since April 2003, the antecedent valuation date (AVD) for the 2005 Rating Revaluation.

It also allows for the inflationary increase that occurs every year. The impact figures quoted therefore represent estimates of how rate liabilities will change in 2010/11 relative to liabilities in the previous year. It should be noted that the forecasts take into account a transitional phasing scheme broadly similar to that under the 2005 rating list.

For the majority of property, movement in rental values is taken as a proxy for movement in rateable values. Data on rental value change is drawn from the CB Richard Ellis Rent Database, which provides comparable prime rental value information on over 1,000 locations across the UK. This information was used to calculate regional average rental growth (and thus changes in rateable value) from April 2003 to April 2008, for each sector-region and the rating list as a whole.

Because the government limits rises in rates income to the rate of inflation, the Revaluation distributes the burden of rates between all occupiers. The overall effect should be neutral in real terms. The impact of the revaluation on a building, location, sector or region is the relationship between its change in rateable value and the change in the national list.

When actually calculating the multiplier during the 2000 and 2005 Revaluations, the DoE reduced their estimate of new list value by 5% to allow for losses arising from appeals. This approach results in a higher multiplier for the first year than would otherwise be the case. It is assumed that a similar approach will be adopted for this Revaluation and the impact forecasts take account of this adjustment.

In calculating the UBR multiplier estimate of 0.417 for 2010/11, it is assumed that inflation as at September 2009 will be below the Government target of 2.5%, RPI is forecast to be -1.0%.

For more information regarding the ViewPoint, please contact:

Gary Martin
UK Research and Consulting

t: +44 20 7182 3911
e: gary.martin@cbre.com

Tony Dann
Rating & Taxation

t: +44 20 7182 3757
e: tony.dann@cbre.com

Timothy Johnson
Rating & Taxation

t: +44 20 7182 3705
e: timothy.johnson@cbre.com

CB Richard Ellis
St Martin's Court
10 Paternoster Row
London EC4M 7HP
t: +44 20 7182 2000