

# UK REITs boxed into a corner

Rental value plunge to keep them on the ropes

The UK REITs are powerless in the face of the onslaught of the record peak-to-trough fall in capital values that we forecast at 50% for prime commercial property. We estimate most of the REITs are set to breach their most onerous debt covenants and not all of them are likely to avert earnings and asset-dilutive rights issues through less dilutive disposals.

We project an average 17% fall in the UK REITs' share prices, fuelled by our 20-45% peak-to-trough forecast plunge in prime rental values. We expect the fall to be a paradigm shift that will leave most portfolios over-rented and force most REITs to cut dividends by up to 50% by 2009-10 from reported levels.

We are reducing all our target prices and reiterating our Underweight stance (V on most) on nearly all stocks in our coverage: Brixton (TP 110p from 210p), Derwent London (TP 430p from 720p), Great Portland Estates (TP 180p from 240p), Hammerson (TP 375p from 610p), Land Securities (TP 555p from 840p), Liberty Intl (TP 320p from 555p) and SEGRO (TP 160p from 325p). We are downgrading to Underweight (V) on British Land (from Neutral (V), TP 435p from 615p) and Shaftesbury (from Neutral, TP 255p from 460p). We reiterate our Overweight (V) rating on Workspace Group (TP 75p from 140p).

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**Disclosures and Disclaimer** This report must be read with the disclosures and analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it

# Summary

We project an average 17% fall in the UK REITs' share prices over 12 months, fuelled by our forecast 20-45% peak-to-trough plunge in prime rental values. We expect the fall to be caused by a paradigm shift that will leave most portfolios over-rented and force most REITs to cut dividends by up to 50% in 2009-10 to reflect a lower rental base and the dent to earnings from increased vacancy and capital preservation

## Stock valuations

	Ticker	Share price (p)	Market cap (GBPm)	Target price	Total potential return	Margin over/ (under) 8.0% Benchmark	FY1 Dividend Yield %	Rating	Previous rating	Previous target price
<b>British Land</b>	BLND.L	474	2,423	435	-8.2%	-16.2%	7.9%	UW (V)	N (V)	615
<b>Brixton</b>	BXTN.L	120	324	110	-8.3%	-16.3%	10.6%	UW (V)	UW (V)	210
<b>Derwent London</b>	DLN.L	690	695	430	-37.7%	-45.7%	3.3%	UW (V)	UW (V)	720
<b>Great Portland Estates</b>	GPOR.L	236	426	180	-23.7%	-31.7%	5.2%	UW (V)	UW	240
<b>Hammerson</b>	HMSO.L	446	1,290	375	-15.9%	-23.9%	2.9%	UW (V)	UW	610
<b>Land Securities</b>	LAND.L	712	3,307	555	-22.0%	-30.0%	8.6%	UW	UW	840
<b>Liberty International</b>	LII.L	440	1,654	320	-27.3%	-35.3%	7.8%	UW (V)	UW	555
<b>SEGRO</b>	SGRO.L	190	826	160	-15.8%	-23.8%	8.9%	UW (V)	UW	325
<b>Shaftesbury</b>	SHB.L	292	397	255	-12.7%	-20.7%	2.8%	UW (V)	N	460
<b>Workspace</b>	WKP.L	45	78	75	66.7%	58.7%	10.5%	OW (V)	OW (V)	140

UW = Underweight, N=Neutral, OW=Overweight, (V) indicates a volatile stock  
Priced at market close on 19 January 2009  
Source: HSBC estimates

## Rental value plunge to fuel further sector slide

### No respite in sight

UK REITs have faced a harrowing two-year infancy since their birth in January 2007, six months ahead of the turn in the 2004 to mid-2007 commercial property boom. Direct property was the bubble asset class in the last 12 months of the boom, exposing the sector to a vicious 35% correction to date that has left the quoted sector scrabbling to make sufficient asset disposals to avoid breach of debt covenants.

The elevation in prime property prices has left the REITs producing cash returns below their cost of capital and buoyant tenant demand from 2004 up to mid-2007 encouraged the REITs to embark on speculative development programmes that are currently being completed into a thin occupier market. We forecast the development programmes will be earnings and asset-dilutive in the next two years.

## Projecting average 17% further share price declines

The stock market started anticipating the turn of the cycle from the beginning of 2007. The 70% fall in the FTSE 350 Real Estate index to date has been fuelled by an unrelenting 35% peak-to-trough fall in prime commercial property prices since Q4 2007, the availability of debt finance moving from feast to famine and the onset of a deep recession.

Our reduced DCF valuations and target prices imply an average 17% share price downside on our Underweight-rated stocks. In those valuations we reflect an increase in our peak-to-trough prime rent fall forecasts to 20-45% up to the end of 2010 from 15-35% previously, which we published in *Stay in the trenches* on 23 June 2008. We project that these rent falls will eliminate almost all the REITs' existing rent reversions and leave 70% of their portfolios up to 21% over-rented. We believe these rent reductions are a paradigm shift as the NICE (Non Inflationary Consistently Expanding) decade has given way to a sharp economic contraction and sub-trend growth, which we expect to prevail for many years as the global economy is weighed down by a monumental increase in sovereign debt.

## Profits and dividends under pressure

The outturn of our rental value forecasts would shatter the REITs' foundations for profit and dividend growth and leave the over-rented REITs suffering a decline in rental income over the period of lease maturity of up to ten years.

We forecast adjusted PBT for the REITs under our coverage to fall an average 11% from the 2008 peak to 2010, which results from our revised forecasts for increased vacancy in investment portfolios, unlet developments exacerbating the increase in voids and the ill-timed increase in empty buildings business rates.

Our profit forecasts leave reported dividends uncovered for 60% of our coverage. We expect those REITs to cut their dividends by 20-30% or to minimum levels required under Property Income Distribution (PID) rules in 2009-10, in order to re-establish a base from which progressive dividends can be paid at lower levels of prospective rental income.

## UK REITs boxed into a corner

### Shift in the balance of power to the occupier

The UK REITs are currently offering cash returns below the cost of capital, which we forecast will depreciate with stagnant or receding rental income. We believe the medium and long-term prospects for a recovery in rental values are weak as the current recession is likely to confirm that the balance of power has shifted from the landlord to the occupier. We believe that landowners are price-takers on rental values and that the cyclical strength for most of the decade to mid-2007 has masked a structural weakening in the economic role of commercial property.

We expect technology to continue to undermine the quantum of space occupiers require to service their customers into the long term. Moreover, the outlook for a recovery in rental values from our forecast trough in 2010 is tepid as we expect vacancy levels to remain elevated for at least three years from that trough and 15-100% business rates increases from 2010 are set to dilute occupiers' rental budgets. Our trend rental growth forecasts from 2010 are between 1% and 2%.

## Scrambling to avoid debt covenant breaches

We expect most REITs to breach their debt covenants on our 50% peak-to-trough fall in prime property values. Almost all our coverage REITs have disposal programmes underway to alleviate the necessity for earnings and asset-dilutive rights issues. We calculate that our coverage would need to make GBP3.7bn property sales to avoid a breach of their most onerous covenants, which looks a remote prospect to us given that most buyers in the market are fishing for distressed assets.

The spectre of rights issues is weighing on the sector and we calculate that GBP1.8bn would need to be raised without further property disposals to keep the most onerous debt covenants compliant. We expect the banks to offer pragmatic solutions to curing covenants on improved margins. Moreover, the banks most exposed are part-Government owned and they are unlikely to perpetuate the downward spiral in prices that would follow distressed sales and require further Government investment. We calculate that the banking sector's negative equity exposure to commercial property will be GBP97bn by the end of 2009 on the basis of our peak-to-trough fall in values.

## Our DCF valuations are agnostic to rights issues

We recognise that rights issues would dilute earnings and assets by up to 15% depending on issue prices. However, our DCF valuations and target prices would be unchanged in the event of equity raisings, as our beta estimates and discount rates would fall to reflect lower financial risk.

## Weak investment proposition

### Dividend yields set for a correction

Our 20-30% forecast dividend cuts in 2009-10e reduce our forecast sector average dividend yields from 7.4% in the current year to 6.1% at the trough. Although this yield is higher than the 2009 5.5% consensus estimate for the wider stock market, we believe the REITs will need to offer a yield premium to compensate for weak growth prospects as some portfolio rental incomes seem set to remain in reverse gear for up to 15 years.

### Balance sheet weakness preventing earnings recovery

The UK REITs do not have the balance sheet flexibility to purchase distressed assets currently available at yields that would enhance earnings and revive dividend growth prospects. On the contrary, the disposal programmes are likely to further dilute earnings with income yields prevailing in the market of at least 6.5% versus the REITs current cost of debt averaging around 5.5%.

### NAV valuations offer scant respite

We forecast an average 32% portfolio fall from balance sheet dates, versus the market implying a further 25% fall at current share prices to a 15% discount to adjusted NAV. Our NAV valuations at a 15% discount to trough adjusted NAV imply an average 8% downside at current share prices and 10-36% downside for the six REITs whose NAV valuation is lower than the share price.

We use our DCF valuations exclusively to value the shares and we do not believe that those REITs trading below our 15% discount to trough NAV valuations will rally given the possibility of dilution to those NAVs in the event of rights issues. We also believe that the prospects for takeovers and MBOs are remote in the short term given the thin availability of debt finance and the uncertainty over the longevity of the economic contraction.

## Ratings and target prices

### **British Land (BLND.L, downgrading rating to Underweight (V) from Neutral (V), target price cut to 435p from 615p)**

Share price downside limited to 8% with 8.6% prospective dividend yield projected on our 435p target price. The 20% over-renting impact is restricted by just 8% of portfolio subject to lease break or expiry to 2010.

### **Brixton (BXTN.L, reiterating Underweight (V), target price cut to 110p from 210p)**

Further 8% share price downside projected with forecast 37% fall in adjusted PBT to 2009. Dividend reduction forecast 2007-2009 at 43%, reducing the yield to 6.5% on our 110p target price.

### **Derwent London (DLN.L, reiterating Underweight (V), target price cut to 430p from 720p)**

Projecting 38% share price downside. The low prospective dividend yield of 3.3% has limited growth prospects with a fringe London office portfolio set to be heavily over-rented and vacancy likely to stick.

### **Great Portland Estates (GPOR.L, reiterating Underweight, adding (V), target price cut to 180p from 240p)**

Projecting 24% share price downside. Refurbishment business model is redundant for at least the next two years and fringe West End portfolio set to be over-rented.

### **Hammerson (HMSO.L, reiterating Underweight, adding (V), target price cut to 375p from 610p)**

Projecting 16% share price downside with over-renting and unlet office developments set to drag on profits. Dividend yield forecast at 2.9% in 2009, recovering to 5.5% by 2013e (1.8x cover).

### **Land Securities (LAND.L, reiterating Underweight, target price cut to 555p from 840p)**

Projecting 22% share price downside with portfolio set to be heavily over-rented and one-third of it due for lease expiry by 2010. Dividend yield projected at 8.1% for 2010 on our target price post 30% cut.

### **Liberty International (LII.L, reiterating Underweight, adding (V), target price cut to 320p from 555p)**

Share price downside projected at 27% with UK shopping centres set for sharp increase in vacancies and long-term sub-inflation rental growth. Possibility of rights issue with forecast interest cover at just 1.5x.

### **SEGRO (SGRO.L, reiterating Underweight, adding (V), target price cut to 160p from 325p)**

Projecting 16% share price downside. Defensive 8.5% 2009e dividend yield after our 41% forecast cut.

### **Shaftesbury (SHB.L, downgrading to Underweight (V) from Neutral, target price cut to 255p from 460p)**

Share price downside projected at 13% on increased vacancy forecasts and 15% projected fall in ERV. Relative defensiveness of the portfolio overvalued, in our opinion.

### **Workspace Group (WKP.L, reiterating Overweight (V), target price cut to 75p from 140p)**

Balance sheet risk provides outstanding opportunity to buy a solid business at a distressed price. Projecting 67% share price upside on a cyclical recovery by 2012.

Stock performance statistics

	Share price (p)	Free float (%)	Trading volume (m)	2008 Performance			YTD Performance		
				Absolute (%)	Sector relative (%)	FTSE 350 relative (%)	Absolute (%)	Sector relative (%)	FTSE 350 relative (%)
British Land	474	100	3.0	-42%	8%	-14%	-14%	0%	0%
Brixton	120	100	1.0	-55%	-17%	-34%	-9%	6%	6%
Derwent London	690	100	0.2	-48%	-7%	-27%	-5%	9%	-24%
Great Portland Estates	236	100	0.9	-45%	2%	-18%	-9%	6%	6%
Hammerson	446	100	1.0	-48%	-3%	-23%	-17%	-3%	-3%
Land Securities	712	100	1.2	-39%	13%	-10%	-23%	-10%	-10%
Liberty Intl	440	79	1.7	-56%	-18%	-34%	-8%	8%	8%
SEGRO	190	100	0.9	-47%	-3%	-22%	-23%	-10%	-10%
Shaftesbury	292	100	0.4	-30%	33%	7%	-19%	-5%	-6%
Workspace	45	100	0.2	-77%	-58%	-66%	-27%	-22%	-15%

Source: Thomson Reuters Datastream

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## Sensitivity to our DCF valuations

### Perpetuity growth rates and beta sensitivity (GBPm)

	British Land			Brixton				Derwent London				Great Portland Estates				Hammerson			
	Perpetuity growth rate			Perpetuity growth rate				Perpetuity growth rate				Perpetuity growth rate				Perpetuity growth rate			
Beta	1.0%	1.5%	2.0%	Beta	1.0%	1.5%	2.0%	Beta	1.5%	1.8%	2.5%	Beta	1.5%	1.8%	2.5%	Beta	1.0%	1.7%	2.0%
<b>1.20</b>	602	749	930	<b>1.20</b>	149	180	218	<b>1.00</b>	667	739	1011	<b>1.00</b>	246	268	351	<b>1.00</b>	547	741	869
<b>1.40</b>	510	641	799	<b>1.40</b>	124	151	184	<b>1.20</b>	565	628	861	<b>1.20</b>	215	234	305	<b>1.20</b>	449	617	728
<b>1.60</b>	427	543	683	<b>1.60</b>	101	125	154	<b>1.40</b>	474	530	731	<b>1.40</b>	187	204	266	<b>1.40</b>	361	509	605
<b>1.85</b>	334	<b>435</b>	556	<b>1.73</b>	88	<b>110</b>	136	<b>1.63</b>	383	<b>430</b>	603	<b>1.58</b>	164	<b>180</b>	234	<b>1.69</b>	251	<b>375</b>	455
<b>2.00</b>	282	376	487	<b>2.00</b>	63	82	104	<b>1.80</b>	322	365	519	<b>1.80</b>	140	153	201	<b>1.80</b>	210	327	401
<b>2.20</b>	219	304	404	<b>2.20</b>	47	64	83	<b>2.00</b>	256	295	432	<b>2.00</b>	119	131	173	<b>2.00</b>	146	250	316
<b>2.40</b>	161	238	328	<b>2.40</b>	31	47	64	<b>2.20</b>	197	232	353	<b>2.20</b>	101	112	149	<b>2.20</b>	87	180	239

Source: HSBC estimates

### Perpetuity growth rates and beta sensitivity

	Land Securities			Liberty International				SEGRO			Shaftesbury				Workspace				
	Perpetuity growth rate			Perpetuity growth rate				Perpetuity growth rate			Perpetuity growth rate				Perpetuity growth rate				
Beta	1.0%	1.5%	2.0%	Beta	1.0%	1.5%	2.0%	Beta	0.8%	1.3%	1.8%	Beta	2.0%	2.5%	3.0%	Beta	1.5%	2.0%	2.5%
<b>1.20</b>	720	882	1079	<b>1.20</b>	455	582	737	<b>1.20</b>	235	294	364	<b>1.00</b>	334	407	501	<b>1.20</b>	124	157	196
<b>1.40</b>	622	766	939	<b>1.40</b>	366	478	613	<b>1.40</b>	188	240	301	<b>1.20</b>	285	347	426	<b>1.40</b>	99	127	161
<b>1.60</b>	534	662	816	<b>1.60</b>	287	386	504	<b>1.60</b>	147	193	246	<b>1.40</b>	241	295	362	<b>1.60</b>	76	101	131
<b>1.83</b>	442	<b>555</b>	690	<b>1.76</b>	230	<b>320</b>	427	<b>1.75</b>	119	<b>160</b>	209	<b>1.57</b>	207	<b>255</b>	313	<b>1.84</b>	53	<b>75</b>	100
<b>2.00</b>	380	484	606	<b>2.00</b>	150	229	321	<b>2.00</b>	76	112	154	<b>1.80</b>	168	209	259	<b>2.00</b>	38	58	81
<b>2.20</b>	313	407	517	<b>2.20</b>	91	161	244	<b>2.20</b>	45	78	115	<b>2.00</b>	138	174	217	<b>2.20</b>	22	39	59
<b>2.40</b>	251	336	436	<b>2.40</b>	36	100	174	<b>2.40</b>	17	47	80	<b>2.20</b>	110	142	180	<b>2.40</b>	7	22	40

Source: HSBC estimates

- ▶ Central case beta derived from a two-year adjusted Bloomberg beta and adjusted for HSBC assumptions regarding timing and delivery of developments, reversionary yield gap of the portfolio and actual level of gearing

# REIT valuations reduced by up to 50%

- ▶ Reduction in DCF valuations by 25-50% on increased rent falls and WACC
- ▶ Stocks discounting insufficient portfolio falls
- ▶ Projecting an average 7.8% trough dividend yield on lower target prices and dividend cuts

## Rental shift pole-axes DCF valuations

### Structural downward shift in rents

The downward revisions in our prime rental value falls underpin reductions in our DCF valuations and target prices ranging between 25% and 50%. Our revisions reduce the cash flows in our explicit forecast period and the terminal value and are substantially below consensus.

We believe our forecasts represent a structural downward shift in rental values to reflect an ongoing lower level of economic activity and the surge in supply of new space conceived in the 2004-07 boom.

We do not envisage a cyclical rebound in rental values for many years as we expect increased vacancy rates in 2010 will take at least three years to return to equilibrium levels without further new development. We expect the following factors to reduce occupier demand for commercial property:

- ▶ 15-100% increases in business rates from April 2010, which form approximately 30% of occupiers' property costs
- ▶ Technology advances that are enabling an increasing amount of shopping and service-based commercial activity to be independent of premises
- ▶ Emergence of a culture of cost reduction and risk aversion to new expansion projects in the foreseeable future

The impact of the rent falls on our forecast free cash flows form the lion's share of the substantial reduction in our DCF valuations and target prices, as shown below in exhibit 1.

**Exhibit 1: Changes to DCF valuations and target prices**

Company	New TP	Old TP	Change
British Land	435	615	-29.3%
Brixton	110	210	-47.6%
Derwent London	430	720	-40.3%
Great Portland Estates	180	240	-25.0%
Hammerson	375	610	-38.5%
Land Securities	555	840	-33.9%
Liberty International	320	555	-42.3%
SEGRO	160	325	-50.8%
Shaftesbury	255	460	-44.6%
Workspace Group	75	140	-46.4%

Source: HSBC estimates

## Reassessment of DCF assumptions

We have also reassessed the cost of capital and perpetuity growth rates in our valuations in the light of the new economic paradigm. Our previous WACC and perpetuity growth rates were published in February 2008 in *UK REITs wake up to a false dawn*, when different capital costs and debt/equity ratios were considered sustainable.

The changes to our WACC discount rates and perpetuity growth assumptions are shown below and detailed in the company sections:

- ▶ Perpetuity growth rates reduced to a 1.25-1.75% range from a universal 2% previously.
- ▶ Cost of equity increased from an 8-9% range to 9-11% based on a tiered risk profile to account for financial gearing, portfolio diversification, over-renting and speculative development exposure.
- ▶ Cost of debt broadly unchanged with a lower forecast trend five-year swap rate at 3.0% offset by margin expansion.
- ▶ Decreased debt proportion of capital based on target level in a 50-60% range, reduced from significantly higher levels of REIT reported specific debt previously.

The net effect of our cost and allocation of capital assumptions is that our WACC range has increased to 7.3-8.4% from 7.0-7.7%. The FTSE 100 REITs are at the lower end of the range and the midcaps at the higher end.

## Low cash returns restrict dividends

### Share prices offer modest cash yields

Exhibit 2 supports our view that the prospective free cash flow yields are unattractive and below the UK market average, we estimate, at just over 9%.

**Exhibit 2: Free cash flow yields**

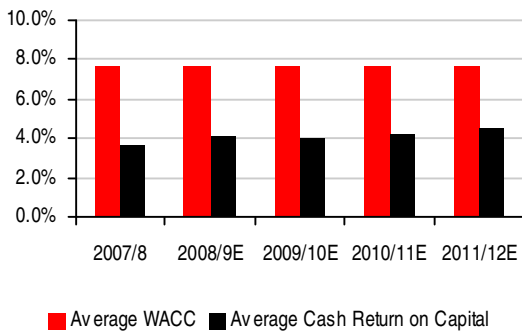
	2008/09e	2009/10e	2010/11e
British Land	11.2%	9.1%	9.7%
Brixton	8.1%	10.5%	9.2%
Derwent London	6.7%	6.8%	6.9%
Great Portland Estates	5.7%	6.2%	7.0%
Hammerson	9.8%	7.0%	7.1%
Land Securities	9.7%	6.8%	7.7%
Liberty Intl	3.8%	6.5%	7.0%
SEGRO	4.0%	11.5%	10.8%
Shaftesbury	1.9%	1.2%	2.5%
Workspace Group	14.4%	6.5%	11.2%
UK REITS average	7.5%	7.2%	7.9%

Source: HSBC estimates

The unattractive prospective free cash yields are a function of the weak cash return on capital employed that we show in exhibit 3. These low cash returns reflect:

- ▶ the modest rental margin over the cost of debt finance
- ▶ dilution from unlet speculative developments
- ▶ cyclical increases in vacancy and associated holding costs.

Exhibit 3: Coverage REITs cash return on capital employed



Source: HSBC estimates

The average free cash flow yield increases to a more acceptable 8% on our DCF valuations and target prices, increasing the return above the average 7.6% of our coverage's Weighted Average Cost of Capital (WACC).

### Higher dividend returns required for a low-growth sector

Our forecast for 70% of the portfolios to be up to 20% over-rented by the end of 2010 would dilute dividend growth to a sub-trend rate economic growth rate for up to ten years. In this context, we believe that the average 5.5% prospective dividend yield in 2009/10e for UK REITs is unattractive, particularly in the light of more attractive dividend yields from international REITs (see exhibit 4).

We expect the combination of rising vacancy, falling rents and the threat of covenant breach to restrict most dividend payouts to the Property Income Distribution (PID) from hereon.

The 5.5% average dividend yield for the UK REITs post our 20-50% cuts in 2009/10 (from 2007 levels) shown in exhibit 4 increases to an average 6.1% on our target prices. We regard this as a more appropriate return for an ex-growth sector.

Exhibit 4: International dividend yield comparison

	2008/09e	2009/10e	2010/11e
British Land	7.9%	8.3%	8.7%
Brixton	10.6%	6.5%	6.8%
Derwent London	3.3%	3.6%	3.9%
Great Portland Estates	5.2%	3.9%	4.0%
Hammerson	2.9%	3.2%	4.8%
Land Securities	8.6%	5.2%	6.0%
Liberty	7.8%	4.3%	6.5%
International SEGRO	8.9%	7.2%	7.5%
Shaftesbury	2.8%	3.3%	3.7%
Workspace Group	10.5%	9.0%	14.0%
<b>UK Average</b>	<b>6.8%</b>	<b>5.5%</b>	<b>6.6%</b>
US	8.0%	6.5%	6.7%
Australia	14.2%	12.3%	16.0%
France	6.4%	6.9%	6.9%
Netherlands	7.7%	7.8%	8.0%
Hong Kong	13.7%	12.3%	12.4%
<b>FTSE 350</b>	<b>5.5%</b>	<b>5.5%</b>	<b>5.9%</b>

Source: Thomson Reuters Datastream, HSBC estimates

## NAV valuations support Underweight ratings

### Substantial reduction in trough adjusted NAV forecasts

We have reduced our trough adjusted NAV forecasts by an average 36% to reflect our increased rent falls and projected peak prime capitalisation yields at 7.0% to 7.5% in 2009. We expect these yields to recover by 25-50bps in 2010 and settle at 6.5-7.0% for prime property.

Exhibit 5: Implied portfolio falls vs. HSBC forecasts

Stock	Share price (p)	HSBC portfolio forecast fall	HSBC fair value equilibrium NAV (15% discount) (p)	Projection to NAV valuation	Implied portfolio fall to 15% discount to adj NAV	Implied portfolio fall to par adj NAV
British Land	474	-26%	411	-13.3%	-18%	-25%
Brixton	120	-36%	144	20.8%	-32%	-40%
Derwent London	690	-41%	529	-23.3%	-27%	-36%
Great Portland	236	-36%	200	-15.4%	-23%	-33%
Hammerson	446	-34%	475	6.7%	-30%	-39%
Land Securities	712	-30%	593	-16.7%	-23%	-32%
Liberty	440	-28%	325	-26.2%	-19%	-26%
SEGRO	190	-35%	204	7.2%	-32%	-41%
Shaftesbury	292	-27%	210	-27.9%	-13%	-21%
Workspace Group	45	-30%	72	60.5%	-35%	-43%
<b>Average</b>		<b>-32%</b>			<b>-25%</b>	<b>-34%</b>

Source: Thomson Reuters Datastream, HSBC estimates

Our NAV valuations are based on a 15% discount to trough adjusted NAV and are shown in exhibit 5. The 15% discount is just above the long-term average sector discount that we demonstrate in exhibit 8.

## Takeovers unlikely in the short term

Exhibit 6: NAV takeover valuation (p)

Company	Share price	Takeover NAV valuation (5% discount to trough)	Potential return
British Land	474	459	-3.1%
Brixton	120	161	35.0%
Derwent London	690	591	-14.3%
Great Portland	236	223	-5.4%
Hammerson	446	531	19.2%
Land Securities	712	663	-6.9%
Liberty	440	363	-17.5%
SEGRO	190	228	19.9%
Shaftesbury	292	235	-19.5%
Workspace Group	45	81	79.4%
<b>Average</b>			<b>8.7%</b>

Source: HSBC estimates

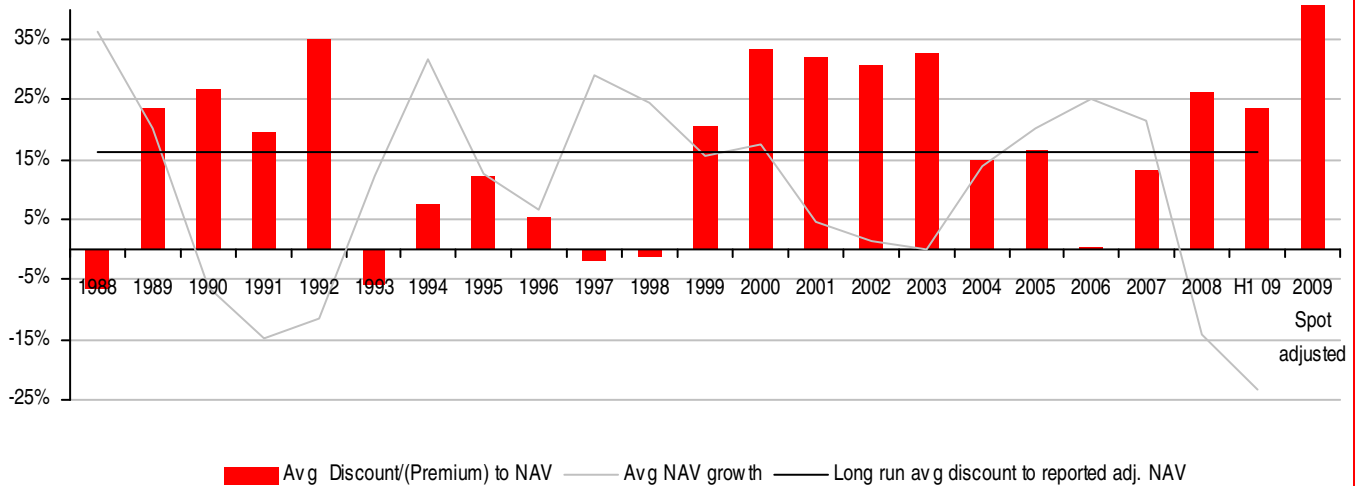
We also use our NAV forecasts for our hypothetical takeover valuations that are struck at a 5% discount to trough adjusted NAV. We do not foresee significant takeover or MBO activity in

Exhibit 7: Peak-to-trough adjusted NAV forecasts and changes

Company	Peak adjusted NAV (p)	Last reported adj. NAV (p)	% change	Trough NAV forecast (p)	% change from last reported	% change from peak
British Land	1,730	1,043	-40%	484	-54%	-72%
Brixton	595	448	-25%	170	-62%	-71%
Derwent London	1,931	1,637	-15%	622	-62%	-68%
Great Portland	660	493	-25%	235	-52%	-64%
Hammerson	1,635	1,353	-17%	559	-59%	-66%
Land Securities	2,236	1,552	-31%	698	-55%	-69%
Liberty	1,385	975	-30%	382	-61%	-72%
SEGRO	811	623	-23%	240	-62%	-70%
Shaftesbury	646	567	-12%	248	-56%	-62%
Workspace Group	354	232	-34%	85	-63%	-76%
<b>Average</b>			<b>-25%</b>		<b>-59%</b>	<b>-69%</b>

Source: Company data, HSBC estimates

Exhibit 8: Average coverage REITs NAV discount/(premium) to NAV 1988-2009 (headline NAV to 1996 and from 2007, triple net NAV from 1997 to 2007)



Source: Company data, HSBC estimates

the short term. Debt availability is likely to remain scarce, cost saving opportunities are minimal and risk appetite is likely to remain thin until greater visibility regarding the depth and length of the economic downturn is apparent.

## Forecasting 24-41% further portfolio falls

### Debt covenant breaches possible

#### Forecast peak-to-trough falls at average 50% for REIT portfolios

We forecast a further 24-41% capital fall in the REITs portfolios from the balance sheet dates at June and September 2008. These forecasts would increase the falls from peak values in H2 2007 to between 41% and 55%, which is 7% below the level the market is currently discounting.

Our forecasts are based on our expectations for prime equivalent yields to move out an average 60bps from January 2009 and our rental value fall forecasts.

#### LTV covenant breaches pending

The consequence of our below-consensus portfolio fall forecasts is that most REITs would breach their bank facility LTV covenants. We

demonstrate later in the section “*Debt covenants under threat*” that our ten covered REITs would require a total GBP1.8bn of equity capital to cure our forecast breaches or GBP3.7bn of asset disposals.

Workspace, SEGRO and Liberty International are under the most pressure to reduce equity gearing and LTV covenants.

### Yield risk premium set to be consolidated

#### Further yield rise in store

We expect prime yields to rise a further 85bps from the CBRE January 2009 index to peak at 7.0-7.5% in 2009 before dipping 25-50bps in 2010 as property investors anticipate a floor in rental falls.

The CBRE prime yield index premium over the five-year swap rate is 356bps, 333bps higher than the average 23bps premium since that index began in March 1999. The 75% secondary Investment Property Databank (IPD) index is currently 545bps higher than the five-year swap rate, compared to the average 210bps premium since 1988. We show the IPD time series in exhibit 10.

### Record risk premia to five-year swap rate justified

We believe the record risk premiums of CBRE prime yield index and IPD over the five-year swap rate are required to justify the following factors:

- ▶ Heightened prospects of tenant default, which we expect to remain for at least two years
- ▶ Increased prospects of void periods at lease break or expiry due to the extended period of cost rationalisation
- ▶ Reduction in rental income on our forecast rent falls. This would lead to rack-rented properties providing a higher initial yield than the reversionary yield

### Equity investors to determine pricing

The pool of potential buyers of commercial property has shrunk considerably with the retrenchment of new bank finance. Moreover, the deleveraging of the banks from the existing bloated GBP225bn exposure could extend up to five years, propping yields at elevated levels relative to finance costs.

Our expectation for the further outward movement in yields is influenced by our expectation of a pick-up in bank loan foreclosures on loans in breach of covenants as vacancy rates increase. We also expect the banks' deleveraging and consequent scarcity of new loan finance to leave asset pricing to equity investors at a higher cost of equity.

### Premia on gilt yield in all sub-sectors

Exhibit 11 shows that all sub-sector prime equivalent yields offer a 50-235bps premium at January 2009 relative to the 10-year gilt yield. We deduct the costs of property ownership to provide a net yield to the investor and add our forecast trend rental growth, before comparison with the return from the risk-free rate.

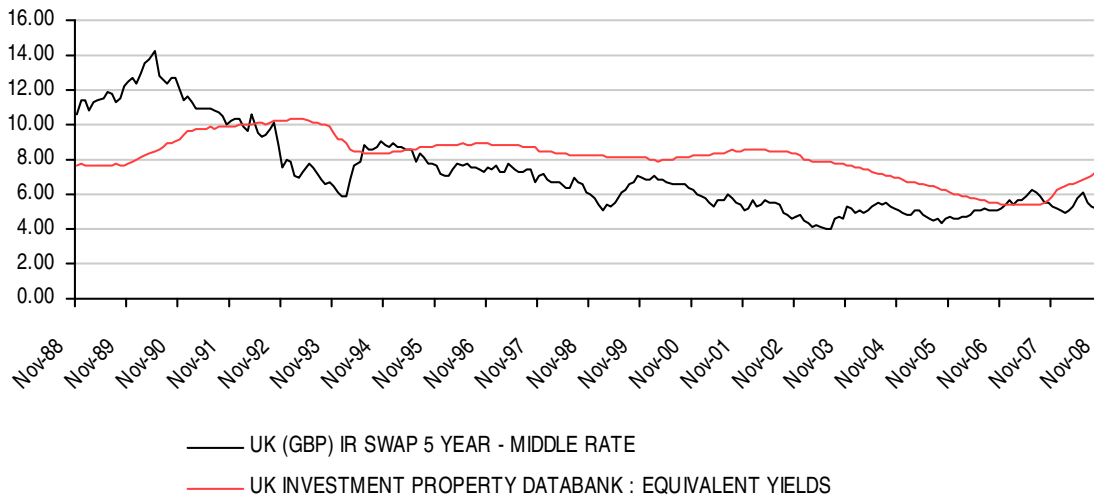
The depreciation rate has been derived from the Investment Property Forum paper, 'Depreciation in Commercial Property Markets', July 2005. We have increased the required risk premium to 200bps from 100bps since HSBC's last published gilt premium analysis in *Keep the tin hats on*, 21 April 2008.

Exhibit 9: Sub-sector capital value forecasts: Dec-08 to Dec-10

	Fringe West End offices*	Core West End offices	West End shops	City offices	Open A1 retail parks	UK shopping centres	Industrial (West London initial yield)*
<b>2009</b>							
Equivalent yield, Jan 09	6.25%	5.50%	5.50%	6.65%	6.50%	6.50%	6.50%
Forecast rent reduction	20%	20%	10%	16%	10%	15%	16%
Forecast yield shift	1.25%	1.50%	0.75%	0.85%	0.50%	0.75%	1.00%
Forecast yield	7.50%	7.00%	6.25%	7.50%	7.00%	7.25%	7.50%
Capital value movement	-23.0%	-27.0%	-17.0%	-18.0%	-12.0%	-18.0%	-20.0%
<b>2010</b>							
Forecast rent reduction	19%	13%	6%	11%	6%	6%	11%
Forecast yield shift	-0.50%	-0.25%	-0.25%	-0.25%	-0.50%	-0.25%	-0.50%
Forecast yield	7.00%	6.75%	6.00%	7.25%	6.50%	7.00%	7.00%
Capital value movement	-4.0%	-1.0%	1.0%	-2.0%	3.0%	1.0%	0.0%
Market capital value reduction peak to date	-22.0%	-32.0%	-33.0%	-36.0%	-41.0%	-27.0%	-42.0%
<b>Peak-to-trough capital value forecast</b>	<b>-50.0%</b>	<b>-60.0%</b>	<b>-49.0%</b>	<b>-56.0%</b>	<b>-49.0%</b>	<b>-44.0%</b>	<b>-61.0%</b>

Source: CBRE, HSBC estimates\*

Exhibit 10: IPD All property yield vs five-year swap rate (%)



Source: Investment Property Databank, Thomson Financial Datastream

## Debt investors back in profit

We show in exhibit 10 the restoration of the premium of the IPD All Property yield over the five-year swap rate. The 545bps margin over the five-year swap rate of 3.0% provides a positive cash flow, after allowing for an increase in bank lending margin to 250-350bps.

Exhibit 11: Property returns versus the 10-year gilt

CBRE yields, prime (%)	Core West End offices	City offices	Shopping centres	Open A1 retail parks	Industrial (West London initial yield)
Equiv yield Jan 09	5.50	6.65	6.50	6.50	6.50
Management	-0.25	-0.25	-0.50	-0.25	-0.25
Depreciation	-0.90	-0.90	-0.90	-0.40	-0.40
Risk premium	-2.00	-2.00	-2.00	-2.00	-2.00
Yield to investor	2.35	3.50	3.10	3.85	2.35
Trend rental growth	2.00	0.50	1.00	2.00	1.00
Sum return	4.35	4.00	4.10	5.85	3.35
10yr gilt	3.50	3.50	3.50	3.50	3.50
Yield gap	0.85	0.50	0.70	2.35	-0.15

Source: CBRE, HSBC estimates

# Seismic downward shift in rental values

- ▶ Increasing prime rent fall forecasts to 20-45% peak to trough
- ▶ Void rates set to escalate to end-2010
- ▶ REITs are heavily weighted in sectors with highest speculative development

Exhibit 12: REITs UK sector exposure

	City	Shopping centres	Shops/ stores	Retail Parks	Fringe West End	Industrial	Other	Total
British Land	29%	16%	16%	26%	13%	-	-	100%
Brixton	-	-	-	-	-	100%	-	100%
Derwent London	20%	-	-	-	74%	-	6%	100%
Great Portland Estates	17%	-	25%	-	58%	-	-	100%
Hammerson	15%	27%	-	17%	4%	-	36%	100%
Land Securities	24%	27%	11%	13%	25%	-	-	100%
Liberty International	-	73%	23%	-	-	-	4%	100%
SEGRO	-	-	-	3%	-	97%	-	100%
Shaftesbury	-	-	100%	-	-	-	-	100%
Workspace Group	14%	-	-	-	-	-	86%	100%

Source: HSBC estimates

## Rents set to fall in new paradigm

### Rent forecast falls increased

We have increased the scope of our forecast falls in prime net effective rental values across all sub-sectors to reflect our expectation of a material rise in vacancy in 2009-10.

Company downsizing and industry rationalisation are underway across the economy and have coincided with a surge in new development conceived in the 2004-07 boom. Developers are now competing for occupiers at lower effective rents and the pace of rent reductions should continue to accelerate as vacated space competes

with new development for a dwindling pool of occupier demand.

The onset of weaker occupational demand was made apparent in the autumn 2008 CBI/GVA Grimley Corporate Real Estate Survey. The report stated that over half of corporate occupiers would ideally shed up to a quarter of their leases and that a 24% balance of companies surveyed expected to contract the space they occupy in the six months to spring 2009.

Exhibit 13: Prime net effective rent reduction forecasts

		West End office	City office	Shopping centres	Open A1 parks	Indus- trial
<b>New forecast</b>	<b>To Q3 2008</b>	-19%	-26%	-30%	0%	0%
	<b>2009</b>	-18%	-17%	-15%	-10%	-10%
	<b>2010</b>	-10%	-10%	-5%	-5%	-10%
	<b>* Total</b>	-40%	-45%	-20%	-15%	-20%
<b>Old forecast</b>	<b>2008</b>	-12.5%	-25%	-10%	-10%	-10%
	<b>2009</b>	-7.5%	-5%	-5%	-5%	-5%
	<b>2010</b>	0%	-5%	0%	0%	0%
	<b>Total</b>	-20%	-35%	-15%	-15%	-15%

\* Cumulative fall  
Source: Jones Lang Lasalle, HSBC estimates

The supply of commercial property increased in all sub-sectors during the 2004-07 boom as prospective profit margins widened with the rise in capital values. The supply increases are featured below. The most significant are in the City of London, non-core London office markets and shopping centres, the sectors to which the UK REITs are most exposed.

## Rent falls underway

### Central London offices in the vanguard

We show in exhibit 13 that effective rental value falls started in 2008. The significant falls to date have been in the Central London office markets, particularly the City of London, where the mismatch between demand and new supply has been most pronounced.

### Prime retail and industrial falls are pending

We believe that a 10-15% reduction in retailer and industrial space occupancy in the UK is underway in the current recession, which we expect to lead to 20% prime net effective rent falls.

Leasing incentives in these sectors increased in 2008, yet effective rents remained broadly stable with headline rents nudging higher.

## Economic contraction underpins rent fall forecasts

### Extended period of recession and sub-trend growth

We forecast the UK recession will continue into 2009 and be followed by an extended period of sub-trend growth, as shown in HSBC economists' GDP and consumer spending forecasts below.

Exhibit 14: UK GDP and consumer spending forecasts

(%)	2007	2008f	2009f	2010f
GDP	3.0	1.0	-1.6	0.8
Consumer spending	3.2	1.9	-2.4	-0.4

Source: HSBC estimates

We believe that household and banking sector deleveraging in the UK is set to continue for at least three years and that economic activity will be modest in that time.

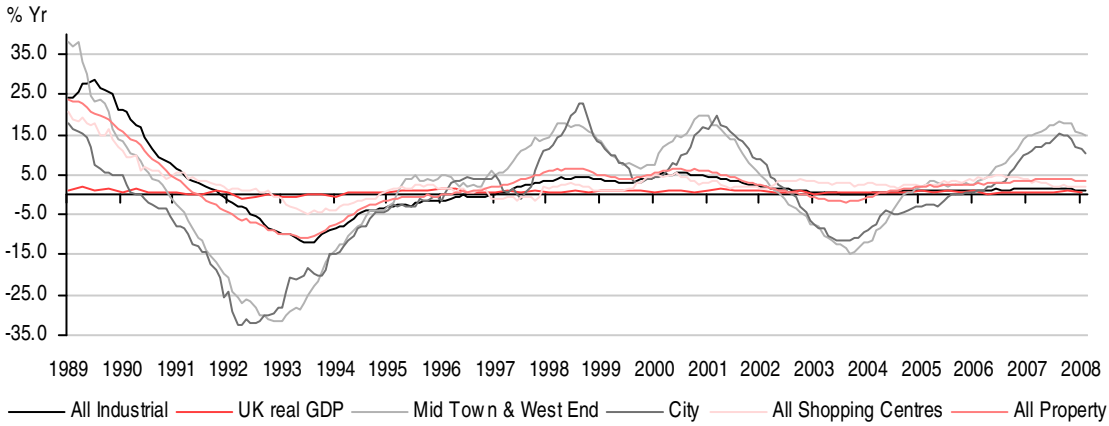
We show in exhibit 15 that rental values have lagged GDP historically, which we expect to be no different in the current recession, extending our forecast rent falls into 2010.

### Expect higher rent falls than in the last recession

Exhibit 15 shows that Investment Property Databank rental values fell by 6% for shopping centres, 23% for industrial and 59-66% for London offices in the early 1990s. We believe the IPD rent reductions were based on headline rents, which do not include the significant increase in incentives in all markets at that time.

HSBC also expects the current recession will be deeper than the last recession, in which GDP fell 2.5% between August 1990 and August 1991. We believe that the period before recovery will take at least as long as the early 1990s recession, when the economy did not return to trend economic growth until 1994.

Exhibit 15: Rental value movements versus GDP 1989-2008



Source: Investment Property Databank, Thomson Financial Datastream

## UK shopping centre developers building into a downturn

### Retailer space retrenchment underway

The slowdown in retailer expansion plans in 2008 has been overtaken by the onset of recession and the start of major retailer insolvencies. Woolworths and MFI were the first insolvent major retailers and we are expecting a torrent of failures in H1 2009 to make a major dent in the occupancy ratios of shopping centres across the UK.

The table below lists the retail insolvencies to date, which amounts to 2,500 shops, mostly seeking new tenants.

Exhibit 16: Retailer insolvencies since Q4 2008

Retailer	Number of stores
Adams	260
Blooming Marvellous	14
Jonathan James*	approx 40
MFI	180
Morgan (inc. France)	570
Officers Club*	150
Passion for Perfumes	45
The Pier	31
Textile World*	47
USC	58
Viyella (including concessions)	100
Whittard of Chelsea	40
Woolworths	813
Zavvi	125

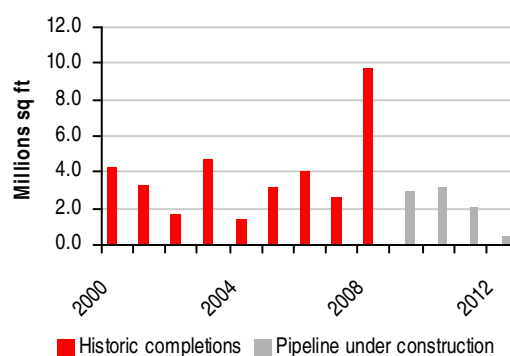
\*subject to prepackaged administration deal  
Source: Property Week, January 2009

### Development supply escalating

Exhibit 17 shows the escalation of the shopping centre development completions in 2008, whose inelasticity is set to be punished by the fall in retailer space demand.

The total shopping centre development pipeline under construction amounts to 8.8m sq ft, which follows 9.7m sq ft that was delivered in 2008. The completions in 2008 and the pipeline under construction amount to 18.5m sq ft, representing some 11% of end-2007 UK shopping centre stock.

Exhibit 17: UK Shopping centre completions 2000-2012e



Source: Colliers CRE

The scale of the 2008-10 development programme is a consequence of developers' complacency with regard to tenant demand in 2005-07. This was induced by 14 years of unbroken economic

growth and the yield compression to summer 2007, which provided the prospect of supernormal capital gains.

### Historic rental growth to prompt business rates rises

The 2008 completions were at record highs and in our opinion, will take at least five years of demand and obsolescence of secondary stock to restore equilibrium and restore rental growth prospects.

UK shopping centre rental growth has averaged 3% per annum in the last 20 years, with low volatility. This rate of growth in the last five years will increase retailers' business rates by 16% from 2010, which we regard as a key component in determining rental growth at a sub-inflation rate after our forecast correction.

### Secondary rental value to feel the impact

We expect secondary shopping centre rents to feel the brunt of the overall space retrenchment as retailers take the opportunity of rent stagnation to trade up into the prime centres.

The vacancy level has already risen to alarming levels in secondary shopping centres, with vacancy (including tenant controlled space) rising to 14.6% at September 2008 according to Property Market Analysis.

We forecast prime shopping centre net effective rents to fall by 20% and expect that secondary net effective rents could fall by between 30% and 50%, depending on supply in the specific market.

## UK retail warehouse rents under pressure

### Fashion park rents exposed to a correction

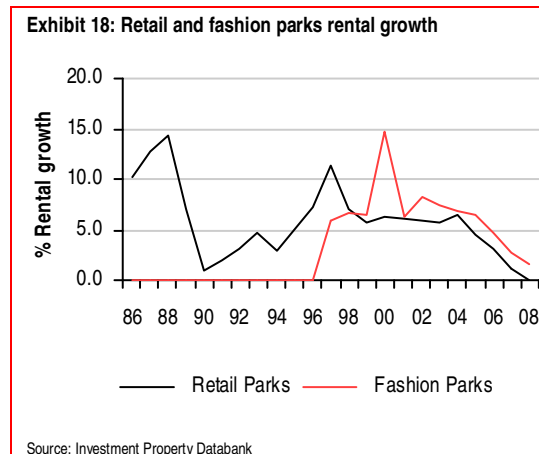


Exhibit 18 shows that retail park rents have grown by an average 5.2% per annum in the last 10 years and fashion (open A1) parks have exceeded that growth rate at 7.2% as retailers have concentrated expansion plans on out-of-town retail parks. Retail parks offer a lower cost to sales density that we believe is in the order of 70%-80% of the town centre.

### Supply restrictions on new fashion parks

New development of unrestricted planning use parks stopped at least three years ago, which has effectively restricted new supply to extensions of existing fashion parks. The consumer downturn is increasing the failure of bulky goods retailers, who we expect to vacate space on higher rental value open A1 retail parks.

The existing UK fashion park void was measured by Property Market Analysis at Q3 2008 at 5%, and we expect the transfer of tenants from bulky-user-controlled space to be sufficient to offset a slowdown in incremental demand at reduced effective rents.

### **Demand-led rental correction for fashion parks**

Our forecast for a 15% fall in open A1 rental value in 2008e-09e is based on our expectation of a slowdown in demand and a continuation in the trend towards 'right-sizing'. Demand has shifted from the first phase 10,000-15,000 sq ft units to 3,000-5,000 sq ft units with a mezzanine, where the retailer can generate similar sales densities at lower rent.

The 'right-sizing' process in the last two to three years has enabled landlords to continue to achieve rental growth with the expanding fashion retailers including Marks & Spencer, TK Maxx, Next, Asda and Tesco. In the course of a two-year downturn in consumer spending, we expect the level of demand for new stores to subside, with selective retrenchment from existing occupiers enabling the expanders to drive effective rents down.

We forecast the bulk of the 15% fall in effective net rents in 2008e-10e to be in the form of increased incentives.

### **Carnage in bulky goods retail parks**

We expect the bulky goods parks rent reductions on average to be in excess of 35%, with at least a 10% reduction already secured, and incentives on a 10-year lease doubling to 24 months in the year to date. The national vacancy for secondary retail parks is 14%-15% according to PMA, which excludes leases that are on the market for re-assignment by the residual struggling furniture, DIY and electrical retailers.

## **City of London office rents in freefall**

### **Rents set to slide towards record lows**

Prime net effective City office rents fell by 25% in 2008 according to Jones Lang Lasalle. The cyclical increase in new supply was met by a reversal since the end of 2007 in occupier demand. City occupiers across most industries have abandoned their expansion plans.

We expect the thrust of most leasing activity in the next two years to be churn with negative absorption as occupiers rationalise space utilisation at increasingly more attractive terms.

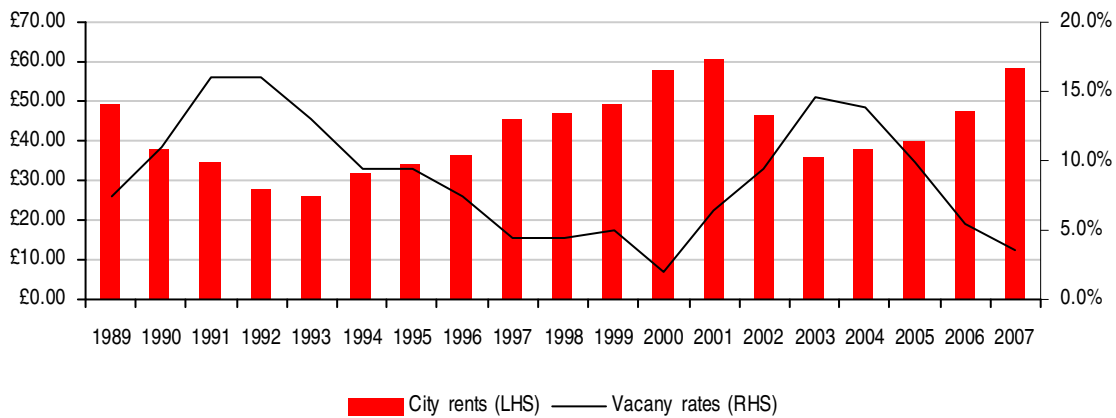
### **Forecasting 45% peak-to-trough fall**

We forecast a peak-to-trough fall of 45% in City of London office rents to Q1 2011, based off an increase in the vacancy rate from 4% at the peak of the market to our forecast of 14%, which assumes that 10% of the existing stock of space is returned to the leasing market as a result of occupier space rationalisation and business failure.

Exhibit 19 shows the historical context of our trough GBP33 per sq ft rent forecast towards the record lows in the early 1990s. This forecast is set against a vacancy rate that we expect to climb as space returned by tenants is released onto the market.

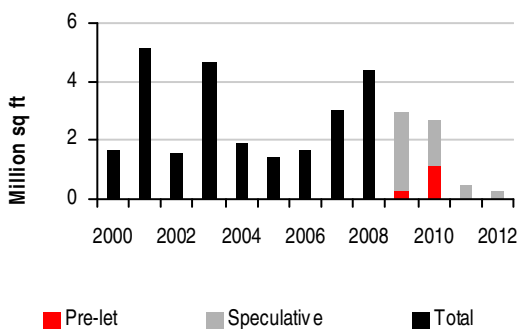
The scheduled completion of 10.5m sq ft of completed and committed space in the City in 2008-11e has enabled a smaller field of prospective tenants to negotiate effective rents down from the peak at December 2007, with incentives increasing in 2008 from six months rent-free for every five years' lease commitment to 13 months. The Jones Lang Lasalle Grade A net effective rent fell 25% in 2008 from GBP59.60 to GBP44.50 per sq ft.

Exhibit 19: City of London rental values and vacancy rates



Source: CBRE, GVA Grimley

Exhibit 20: City of London office completions



Source: Jones Lang Lasalle

Exhibit 21: City office vacancy forecast Q4 2008 to Q1 2011 (m sq ft)

Completions	8.7
Average take-up (at 6m sq ft for 2.5 years)	15.0
Forecast take-up (new & existing)	9.75
Forecast take-up of average	65%
Less prelets	-3.0
Residual take-up	6.75
Residual % take-up that is new developments	80%
New development take-up	5.44
Take-up of new space (includes pre-lets)	8.4
Net availability of new space	0.3
Space returned	10.0
Space removed for development	-0.5
Existing void space	5.6
Net available space	15.3
Total stock (post completions-space removed)	110.6
Void rate	13.9%

Source: Jones Lang Lasalle, HSBC forecasts

## Vacancy forecast peaks at 14%

Our forecast for overall vacancy to rise from 5.5% at end-September 2008 to 14% is shown below in exhibit 21.

The level of active demand fell 35% in Q3 2008, according to Jones Lang Lasalle, and we forecast that these lower levels of demand produce total take-up in Q4 2008 to Q1 2011 at 65% of the 10-year average of 6m sq ft per annum.

The key problem we envisage for the City office market is negative absorption with occupiers likely to rationalise total occupied space through downsizing and mergers, leading to churn of

occupiers from older buildings into the new stock at attractive rental packages.

We expect 10m sq ft of space to be returned to the market by tenants to the end of 2010, and 0.3m sq ft of unlet completions in that period to lead to a jump in vacancy to 14%.

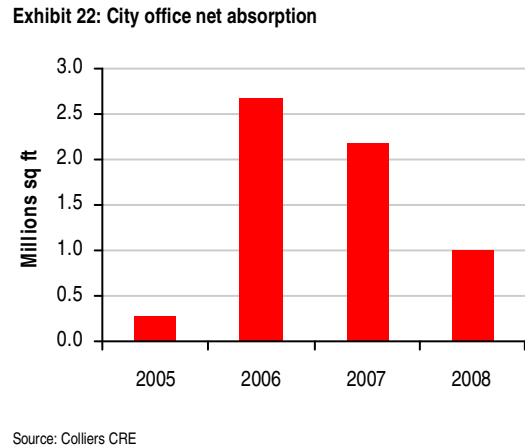
### Increased rent reduction forecast

We are increasing our peak-to-trough rent reduction forecast to 45% from 35% to March 2011 against the backdrop of tenants being able to drive down effective rents with increasing availability. Tenants' bargaining power is set to increase as speculative buildings complete from H2 2008, assisted by landlords' facing empty rates bills at 45% of rental value after a three-month exemption period.

### Prolonged period of low rents in store

#### Vacancy set to remain high for at least 5 years

Even though developers are deferring non-committed schemes, we expect vacancy to remain in double-digit territory for at least five years. We forecast negative absorption for the next two years and we demonstrate below that positive absorption in buoyant economic times was 2.1-2.6m sq ft. An average 1m sq ft from 2011 to 2014 would reduce the vacancy rate to 9% at 2015, at which point rents would have a prospect of resuming growth.



### Business rates increase set to put brakes on recovery

The latest Business Rates five-yearly valuation at April 2008 coincides with the upswing in London rental values, which we expect to lead to a doubling in business rates in the West End and a two-thirds increase in the City of London, with a transitional period from 2010 to 2014.

Business rates comprise 30% of occupiers' occupational costs and we expect the increases from 2010 to negate any prospects for rental recovery.

### London's West End facing demand reversal

#### Rent reduction underway

Core net effective Grade A West End office rents fell 26% in 2008 to GBP79.90 per sq ft according to Jones Lang Lasalle. We forecast a peak-to-trough fall of 40% for core West End (Mayfair and St James') in the two years to December 2010 and a 45% fall in prime fringe West End rents.

The 26% reduction to date in the core has been weighted towards a 17% reduction in the prime headline rent to GBP96. Incentives have increased from four months to nine months for every five-year term certain, according to Jones Lang Lasalle.

**Exhibit 23: West End rent fall forecasts Q4 2008-Q1 2011**

Core prime	-40%
Core average	-30%
Fringe prime	-45%

Source: HSBC estimates

**Demand-led rent reductions**

Our rental forecasts for the West End sub-markets follow a doubling in both prime and average West End rents since the bottom of the last downward cycle at the end of Q4 2003. Our forecast falls reflect our expectations for demand to reverse from all sectors, led by the financial services sector, which comprises just under 20% of the West End occupier base.

**Fringe West End set to fall further than the core**

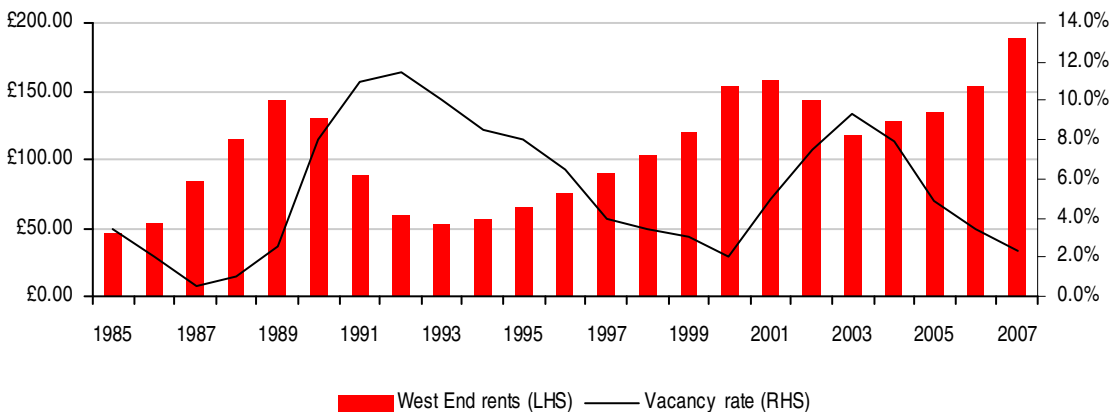
We expect fringe West End rents to fall further than the core, which we expect to attract greater marginal demand once rental values have corrected. This has been the case in previous recessions, as shown in exhibit 25, reflecting tenants’ preference for core locations at lower price points.

The weaker performance of the fringe is likely to be exacerbated by a concentration of two-thirds of West End development completions in the fringe.

**Grey space more threatening than development pipeline**

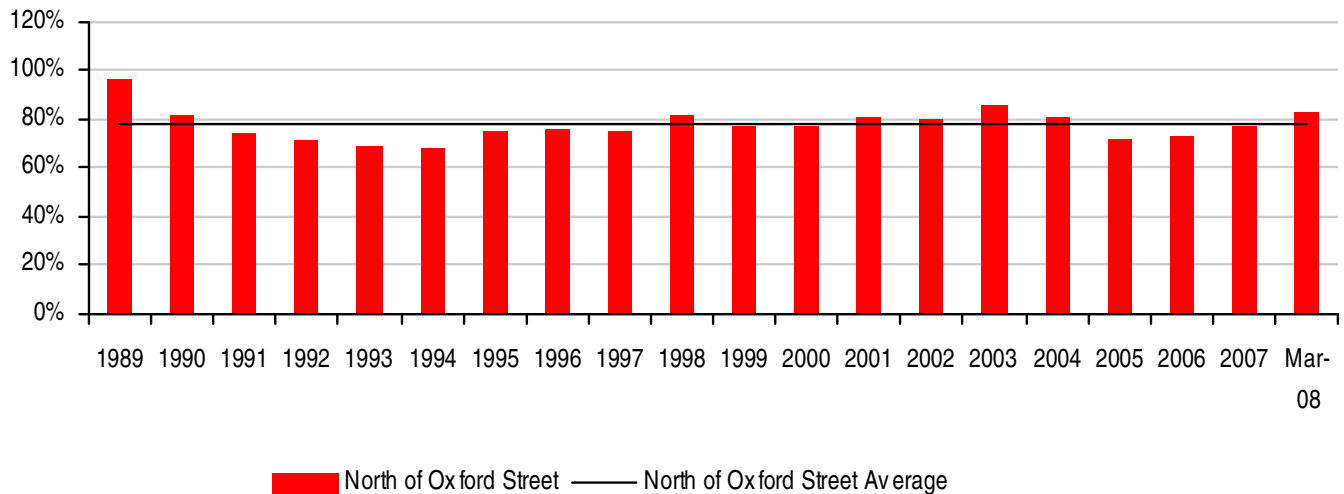
We show in exhibit 26 our forecast for vacancy rates in the whole West End market to rise from 3.5% at Q3 2008 to 8.4% by Q1 2011.

**Exhibit 24: West End rentals and vacancy rates**



Source: CBRE, HSBC estimates

Exhibit 25: North of Oxford Street rents as % of Mayfair rents



Source: CBRE, HSBC estimates

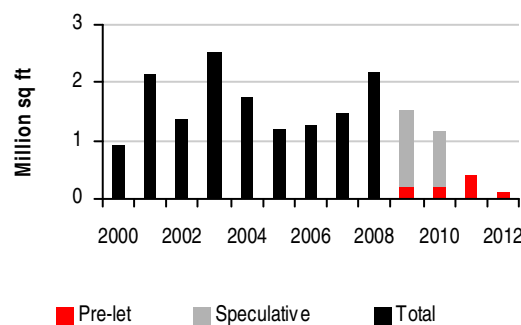
Exhibit 26: West End vacancy forecast 2008e-09e (m sq ft)

<b>Completions</b>	<b>2.6</b>
Average take-up (at 6m sq ft for 2.5 years)	10.9
Forecast take-up (new & existing)	7.07
Forecast take-up of average	65%
Less prelets	-0.37
Residual take-up	6.7
Residual % take-up that is new developments	20%
New development take-up	1.34
Take-up of new space (includes pre-lets)	1.71
Net availability of new space	0.9
Space returned	4.0
Space removed for development	-0.5
Existing void space	3.0
Net available space	7.3
Total stock (post completions-space removed)	87.6
Void rate	8.4%

Source: Jones Langs Lasalle, HSBC forecasts

We project that completions of unlet developments at 2.2m sq ft will marginally exceed our projections for take-up of new space by GBP0.5m sq ft, increasing vacancy by less than 1%. The most significant component of our forecast rise in vacancy to 8.4% is our projection for negative absorption of nearly 5% of existing stock as tenants rationalise or exit.

Exhibit 27: West End completions



Source: Jones Lang Lasalle, HSBC estimates

## Business rates increases to restrict rental recovery

The pending doubling of business rates in the West End from 2010 to 2014 is likely to dilute any recovery in rental value from 2011, as business rates comprise around 30% of occupiers' total property costs.

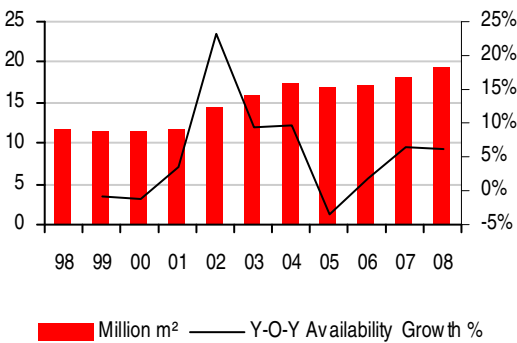
## Industrial rents set for a fall

### Development supply misjudged the economic downturn

We increased our forecast fall in prime industrial rents in 2008e-09e to 20% from 15% in our report *Stay in the trenches*, published on 23 June 2008.

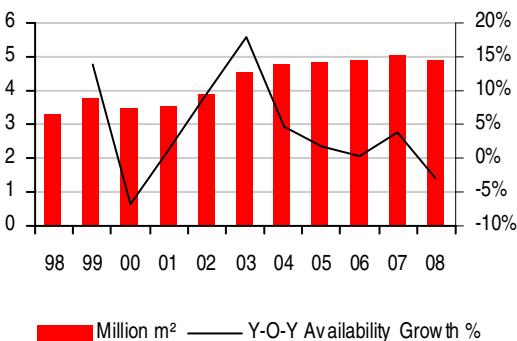
We expect the slowdown in the economy to lead to reduced take-up and space rationalisation against a backdrop of increased supply, as is evident from the King Sturge industrial floorspace availability survey. Availability for the UK and Greater London is at elevated levels and comfortably in excess of 10% of stock, the equilibrium void level.

**Exhibit 28: Availability of industrial floorspace, England & Wales (Sept 08)**



Source: King Sturge

**Exhibit 29: Availability of industrial floorspace, South East (Sept 08)**



Source: King Sturge

## West London over-supply is pronounced

The supply increase is nowhere more pronounced than in West London and specifically the Heathrow market, which has coincided with a dearth of large lettings in the last nine months. The market is particularly poignant for both Brixton, which has 38% of assets in Heathrow and

c.35% elsewhere in West London, and SEGRO, which has 4% of UK assets in London of which at least half are in West London. We show in exhibit 30 the developments in the Heathrow market where around a dozen large units are available. The supply is significant against a backdrop of a single letting over 50,000 sq ft in the last 10 months, which was Brixton's letting at Polar Park to the Metropolitan Police in Q1 2008.

**Exhibit 30: Heathrow vacancies**

Address	Size (sq ft)	Developer	Completion date
LHR1, Faggs Road, Heathrow	95,000	SEGRO	Mar-07
Polar Park, Bath Road, West Drayton	120,000	Brixton	Late 2006
X2, Halton Cross	241,000 (potentially 8 units)	Brixton	Apr-08
Prologis Park, Heathrow	3 available at 68-96,000	Prologis	Jun-07
South Cargo Centre, Ascot Road, Feltham	120,000	Scottish Widows	
Central Park Estate, Staines Road, Hounslow	55,000	Scottish Widows	

Source: Company data, HSBC estimates

We expect developers' incentives offered to secure occupiers on the above available units to increase substantially from 10% of headline rent at the end of 2007 to up to 25% in 2009.

## Empty Rates strengthens tenants' hand

The 2007 Empty Rates Relief Rating (Empty Properties) Act, maintains industrial buildings' empty rates relief at 100%, but the relief period has been shortened to six months from an indefinite period. The key consequence, in our opinion, is that landlords will seek to restrict their potential liability by increasing pre-leasing and ceding rental value in the knowledge of looming liability and ample competing space in most sub-markets.

# Rent falls to put an axe to dividends

- ▶ Over-renting forecast on 70% of coverage to reduce LFL rental income
- ▶ Vacancy rises projected to peak at end-2010
- ▶ Dividend cuts in 2009-10 for half of our coverage

## Forecasting material adjusted PBT falls

We show in exhibit 31 that we are forecasting an average 16% fall in adjusted PBT in the two years to December 2009/March 2010.

These profit falls are a result of the factors below, mitigated by Hammerson and British Land through earnings-enhancing disposals in 2007-08:

- ▶ A shift from reversionary to over-rented portfolios
- ▶ Loss of rental income from reduced occupancy

- ▶ Indirect costs of increased vacancy
- ▶ Unlet developments when interest capitalisation stops on completion

## Rent reductions to reshape the dividend outlook

### Rent reversions to fall to over-renting

We forecast an average 22% fall in the Estimated Rental Values of our coverage UK REITs that we believe will undermine the existing progressive dividend policies.

The REITs have reported an average 17% rental reversion at the last balance sheet date (excluding

Exhibit 31: Forecast adjusted PBT

	Adj PBT			% Change			% Change in forecast		
	08/09e	09/10e	10/11e	08/09e	09/10e	10/11e	08/09e	09/10e	10/11e
British Land	273.0	246.9	264.7	-4%	-10%	7%	-4%	-11%	4%
Brixton	41.3	31.4	30.0	-11%	-24%	-5%	0%	0%	0%
Derwent London	27.7	35.8	41.2	-22%	29%	15%	0%	0%	14%
Great Portland Estates	23.4	12.7	17.8	-2%	-46%	40%	-2%	-51%	35%
Hammerson	121.8	114.7	120.4	4%	-6%	5%	0%	0%	3%
Land Securities	382.5	259.7	279.6	-3%	-32%	8%	-10%	-33%	-4%
Liberty International	101.9	103.2	114.3	-22%	1%	11%	0%	-2%	3%
SEGRO	129.3	91.6	96.0	-2%	-29%	5%	0%	0%	0%
Shaftesbury	15.3	14.7	13.6	0%	-4%	-7%	0%	1%	6%
Workspace Group	11.6	11.4	16.2	8%	-1%	42%	8%	-11%	38%
<b>Average</b>				<b>-5%</b>	<b>-12%</b>	<b>12%</b>	<b>-0.8%</b>	<b>-10.6%</b>	<b>9.7%</b>

Source: HSBC estimates

Workspace) that we forecast will reduce to an average 14% over-renting for the seven over-rented REITs. Exhibit 32 shows that we forecast 70% of our coverage REITs to be over-rented by the end of 2010.

We believe that the pending removal of rental income growth will be the principal factor behind decisions to cut dividends, exacerbated by the uncertainty of the longevity of increases in vacancy and requirements to preserve cash.

## Vacancy increases to squeeze profits

### Void rates rising from record lows

We expect our forecasts for weakening demand and rising supply of space to increase the REITs' void rates from record lows.

We show in exhibit 33 the current vacancy rate of the REITs and our forecast rises.

### VOIDS TO DILUTE PROFITS IN 2009-10

#### Direct impact on profits and cash

Exhibit 34 shows our forecast of an average 21% reduction in adjusted PBT in the two years to 2009-10e (excluding Workspace) as a result of our increased vacancy forecasts. Our bad debt forecasts are included as effective vacancy.

### Indirect costs of rising vacancy

Our forecast cyclical increases in vacancy follow the government's increase in empty buildings business rates in the 2008 Empty Buildings Business Rates Act, effective from April 2008.

The Act reduced the exemption period for empty buildings business rates to three months for offices and shops (six months previously) and to six months for industrial property (exempt previously).

Exhibit 34 shows that higher empty business rates have a significant impact on the industrial REITs Brixton and SEGRO. The 2009-10 exemption for industrial premises with a rateable value below GBP15,000 has a minimal amelioration in the impact of the Act on these companies.

Exhibit 33: REITs' forecast vacancy

	Reported vacancy of passing rent (%)	Forecast vacancy at peak 2009-2011 (%)	Date of peak
British Land	3.5	5.3	Mar-10
Brixton	11.6	16.4	Mar-10
Derwent London	4.8	11.1	Dec-09
Great Portland Estates	4.2	12.9	Mar-10
Hammerson	4.9	8.0	Dec-09
Land Securities	5.1	12.2	Mar-10
Liberty International	1.7	12.9	Dec-09
SEGRO	9.7	14.2	Dec-09
Shaftesbury	2.2	5.2	Sep-10
Workspace Group	12.4	21.9	Mar-10

Source: Company data, HSBC estimates

Exhibit 32: REITs rental reversion/over-renting

(GBPm)	Balance sheet date	Passing rent	ERV let portfolio	Forecast ERV fall	Forecast ERV	Forecast reversionary-(over-rented) (%)
British Land	Sep-08	635.0	672.0	-24%	510.7	-20%
Brixton	Jun-08	91.4	101.2	-20%	81.1	-11%
Derwent London	Jun-08	122.2	157.4	-27%	114.1	-7%
Great Portland Estates	Sep-08	47.2	60.2	-29%	44.0	-7%
Hammerson	Jun-08	320.1	346.8	-22%	270.4	-16%
Land Securities	Sep-08	542.4	592.5	-28%	426.6	-21%
Liberty International	Sep-08	348.0	450.3	-20%	364.7	5%
SEGRO	Jun-08	197.3	200.8	-20%	161.4	-18%
Shaftesbury	Sep-08	60.4	80.2	-15%	74.1	23%
Workspace Group	Sep-08	53.1	88.9	-15%	66.2	25%
<b>Average</b>				<b>-22%</b>		<b>*-14%</b>

\* only over-rented REITs  
Source: Company data, HSBC estimates

## Developments to exacerbate short-term vacancy rate

### Short-term profit dilution

The REITs' development programmes started physical completion from the middle of 2008, comprising some of the major shopping centres and City of London office blocks.

The big shopping centres such as Hammerson/Land Securities' JV shopping centre in Bristol and Hammerson's Leicester extension are opening 85-90% occupied, whereas the City of London office schemes are completing without tenants in some cases.

### Medium-term profit enhancement

We expect 2008-09 development completions to attract tenants over a prolonged letting period as they displace older stock in the lease cycle churn.

We forecast gross development yields on cost at an average 6.5%, in excess of the average cost of debt finance at 5.5%, which we expect to provide a modest boost to earnings and cash flow on complete letting.

## Opportunities to mitigate profit falls

### Historic yields on cost underpin profits

Exhibit 35 demonstrates that our estimated historic yields on cost are at the heart of the profitability of the REITs.

### Potential to decrease cost ratios

Administration cost ratios have been on a rising trend to date, which we expect to reduce modestly as development teams are laid off and staffing levels are cut. Brixton, Hammerson and SEGRO have already announced staffing reductions, albeit that these costs comprise a low percentage of profits, as shown in exhibit 35.

### Finance costs in neutral gear

In our modelling we expect the REITs to sustain their current average cost of debt finance. We expect the current five-year swap rate to remain around 3% through to 2010 and the fall from the 2008 level to be offset by a widening in lending margins of between 200 and 300bps.

We assume that these factors will counter-balance from 2010 and that low cost of money will accompany sub-trend growth in the coming years.

Exhibit 34: Impact of increased vacancy, empty rates and bad debt assumptions

	Forecast vacant income increase (GBPm)	Bad debts increase (GBPm)	Empty rates charge (GBPm)	Combined reduction reported adj. PBT 2008-2009/10	% reduction to 2008 adj. PBT
British Land	2.0	8.0	8.0	18.0	6.6
Brixton	3.5	1.0	3.0	7.5	18.2
Derwent London	3.0	3.0	3.5	9.5	34.3
Great Portland Estates	3.4	1.5	2.0	6.9	29.5
Hammerson	2.5	6.0	5.3	13.8	11.3
Land Securities	12.0	23.6	18.6	54.2	21.4
Liberty International	8.0	18.0	4.0	30.0	29.4
SEGRO	6.4	2.0	9.0	17.4	13.5
Shaftesbury	2.0	1.0	0.9	3.9	25.6
Workspace Group	4.6	1.0	2.0	7.6	65.5

Source: Company data, HSBC estimates

Exhibit 35: REITs' portfolio yield on cost, cost/income ratios and free cash flow yields

	Gross yield on historic cost	Cost/Income ratio				Weighted average cost of debt	FCFE yield *			WACC
		2007/08	2008/09e	2009/10e	2010/11e		2008/09e	2009/10e	2010/11e	
British Land	7.8%	17.1%	15.0%	16.6%	15.6%	5.3%	11.2%	9.1%	9.7%	7.3%
Brixton	6.1%	21.7%	22.9%	29.2%	28.7%	5.3%	8.1%	10.5%	9.2%	7.9%
Derwent London	5.9%	26.3%	35.9%	30.5%	28.2%	6.1%	6.7%	6.8%	6.9%	7.5%
Great Portland Estates	5.7%	32.4%	29.5%	31.9%	28.3%	6.0%	5.7%	6.2%	7.0%	7.5%
Hammerson	7.6%	20.2%	21.1%	21.7%	20.9%	6.1%	9.8%	7.0%	7.1%	7.4%
Land Securities	8.0%	36.2%	32.9%	36.3%	35.2%	5.4%	9.7%	6.8%	7.7%	7.3%
Liberty Intl	6.1%	42.6%	39.7%	37.9%	38.1%	5.8%	3.8%	6.5%	7.0%	7.5%
SEGRO	9.4%	31.8%	30.9%	35.6%	34.6%	5.7%	4.0%	11.5%	10.8%	7.9%
Shaftesbury	7.1%	30.0%	32.3%	31.8%	30.4%	6.2%	1.9%	1.2%	2.5%	7.5%
Workspace Group	7.8%	44.7%	44.8%	47.1%	44.7%	6.4%	14.4%	6.5%	11.2%	8.4%
UK REITs average	7.1%	30.3%	30.5%	31.9%	30.5%	5.8%	7.5%	7.2%	7.9%	7.6%

Source: Company data, HSBC estimates

## Acquisitions offer profit-enhancement potential

Prime property yields have risen to a level in the last 18 months where net yields would enhance profits.

Most of our coverage REITs are unable to exploit this opportunity with their current balance sheets and we do not believe that the asset and earnings dilution justifies raising equity capital to reverse the current situation.

## Increasing our dividend cut forecasts

### Expanding forecast dividend cut club

We are increasing the breadth and extent of our dividend cut forecasts to reflect the falls in our earnings forecasts. Exhibit 36 shows we expect

most of our coverage to cut dividends in 2009-10, compared to 30% when we published *Stay in the trenches* on 23 June 2008.

### REIT dividend rules restrict dividend cut capacity

The REIT legislation requires that REITs pay out 90% of profit on rental income-producing assets less capitalised interest and capital allowances. This dividend is known as the Property Income Distribution (PID) and any supplement is at the discretion of the directors.

The guiding principle of our dividend forecasts is that we have reduced them to our estimate of the PID in the first prospective year, to constrain capital. Thereafter our dividends reflect PID movements or progressive growth where capital is not a constraint.

Exhibit 36: Dividend forecast changes

	Actual	Dividend/share (p)			% Change in dividend			PID Cover 2009/10e
		2008/09e	2009/10e	2010/11e	2008/09e	2009/10e	2010/11e	
British Land	35.0	37.5	39.3	41.3	7.0%	5.0%	5.0%	1.1
Brixton	13.7	12.7	7.8	8.1	-7.1%	-38.9%	5.0%	1.0
Derwent London	22.5	22.5	24.8	27.2	0.0%	10.0%	10.0%	1.1
Great Portland Estates	11.9	12.3	9.2	9.5	3.0%	-25.0%	3.0%	1.2
Hammerson	27.3	12.8	14.2	21.3	-53.2%	11.3%	49.8%	1.0
Land Securities	64.0	61.1	37.2	42.8	-4.5%	-39.1%	15.0%	1.0
Liberty International	34.1	34.1	19.1	28.6	0.0%	-44.1%	50.2%	1.0
SEGRO	23.0	16.9	13.6	14.3	-26.4%	-19.5%	5.0%	1.0
Shaftesbury	11.0	8.2	9.7	10.7	-25.7%	18.7%	10.0%	1.0
Workspace Group	4.6	4.7	4.1	6.3	3.9%	-14.2%	55.1%	1.0

Source: Company data, HSBC estimates

# Debt covenants under threat

- ▶ Record fall in property values puts LTV covenants in jeopardy
- ▶ Average 35% forecast portfolio fall set to breach covenants
- ▶ Disposal programmes unlikely to avert rights issues, in our view

## Severity of price correction puts covenants in jeopardy

### 36% fall in average prime values to January 2009

The severity and speed of property price corrections in the UK are unprecedented with the IPD All Property index falling 43% since its peak in July 2007 and CBRE average prime property yields moving out 240bps to 6.65%, implying a 36.5% fall in prime capital values, without allowing for rental value movement.

The net consequence is that REIT Loan to Value and balance sheet gearing ratios have soared, putting the listed REITs' banking covenants in jeopardy of breach.

#### **GBP837m working capital needed**

Exhibit 37 shows our calculation of working capital required by the REITs under current committed capital expenditure compared with reported cash and available undrawn facilities.

Workspace, Brixton and Liberty International require working capital investment in excess of available facilities, and with facilities expiring in 2010, Derwent London and Land Securities are close behind, with Land Securities remaining just short of further working capital investment.

The aforementioned REITs with working capital investment requirements, to end-2010 also have the heaviest capital expenditure commitments as a proportion of cash and undrawn facilities.

We expect that all the REITs will be looking to defer capital expenditure and that bank facilities are likely to be renewed subject to covenant breaches, albeit at an increased cost.

British Land stands out in respect of capital needs. Available undrawn facilities and cash net of committed capex amount to GBP2.2bn, which should provide sufficient headroom over covenants to weather the recession without a rights issue, in our view.

#### **Average 27% minimum fall for first covenants to be breached**

Exhibit 35 demonstrates that on average, REITs have headroom of 27% in capital value reduction from last reported values before their most onerous bank or bond covenants are breached.

This would imply 12% headroom from January 2009 for those that have reported valuations to the end of September 2008, after a 15% fall in prime values in Q4 2008.

Exhibit 37: UK REITs working capital requirements to 2010e

GBPm	Cash & Committed Undrawn Facility	Committed Capital Facilities Maturing by 2010 Expenditure	Net Capital Available/ (Required)
British Land	2,700	300	2,230
Brixton	185	3.6	(299)
Derwent London	290	199	(34)
Great Portland Estates	338	33.4	255
Hammerson	600	285	261
Land Securities	874	728.5	40
Liberty International	335	248	(251)
Segro	808	400	192
Shaftesbury	308	25	283
Workspace Group	25	18	(313)

Source: Company data, HSBC estimates

We show a full list of our coverage REITs' covenants in the Appendix.

Exhibit 40 also shows that Workspace, SEGRO and Liberty International are the most vulnerable to a covenant breach on bank debt.

#### Forecasting a peak-to-trough fall in prime capital values of 50%

Our peak-to-trough forecasts imply a further 22% fall in market values from January 2009 or 32% from September 2008.

In Exhibit 44 we give our projections for covenant breaches across our coverage with the exception of British Land, Great Portland Estates and Shaftesbury which are either better capitalised or

have less restrictive covenants. Land Securities' breach on our 30% fall in the portfolio is a liquidity fund threshold of 55% LTV in the debt security pool. This requires the injection of up to 18 months' interest in a liquidity fund between 55% and 70% LTV.

We forecast that our falls to trough values breach covenants on bank debt only with most bond covenants secure. The exceptions are Brixton and SEGRO, where our forecast 36% and 35% portfolio falls from June 2008 would lead to gearing covenant breaches on both bank and bond debt.

#### Great Portland most defensive to covenants

On our sensitivity analysis, with 10% greater falls than we are forecasting, the only REIT under

Exhibit 38: Minimum portfolio value falls to breach most onerous covenants

REIT	Debt to which covenants are related	Most onerous covenant(s)	% Fall in portfolio value/income to breach
British Land	Securitisations & Debentures	Net borrowings/adjusted capital and reserves not to exceed 175%	34%
Brixton	Bank debt	Unsecured property assets/unsecured borrowings ratio at minimum of 1.67x	28%
Derwent London	Covenants not disclosed		
Great Portland Estates	Bank debt	Net gearing not to exceed 125%	44%
Hammerson	Not disclosed	Net gearing not to exceed 150%	29%
Land Securities	Bank and Public debt	Liquidity fund threshold at 55% in LTV security pool	16%
Liberty International	CMBS - Metrocentre	LTV not to exceed 90%	29%
	CMBS - Lakeside	LTV not to exceed 90%	36%
	Bank debt	LTVs (secured non-recourse investment property to non-recourse debt ratio) ranging from 70-90%	14%
SEGRO	Bank debt	Net gearing not to exceed 125%	21%
Shaftesbury	Bank debt	Net gearing not to exceed 175%	27%
Workspace	Bank debt	LTV not to exceed 61%	22%
	Bank debt	Net gearing not to exceed 150%	18%
<b>Average</b>			<b>27%</b>

Source: Company data, HSBC estimates

Exhibit 39: Equity capital required to restore most onerous gearing and LTV ratios

(GBPm)	HSBC central case portfolio fall	HSBC central case gearing	Gearing covenant	HSBC central case LTV	LTV covenant	Impact	Equity capital required (GBPm)	Capital required on 10%+ fall to HSBC forecast (GBPm)
British Land *	-26%	155%	175%	24%	70%	No breach	0	481
Brixton *	-36%	183%	175%	66%	60%	Breach LTV & Gearing	79	285
Derwent London	-41%	135%	n/a	59%	n/a	n/a	n/a	n/a
Great Portland Estates *	-36%	100%	125%	45%	60%	No breach	0	0
Hammerson	-34%	201%	150%	60%	n/a	Breach of Gearing	498	1463
Land Securities ***	-30%	136%	n/a	65%	55%	Breach of LTV	293	390
Liberty International	-28%	284%	n/a	85%	80%	Breach of LTV	230	763
SEGRO	-35%	234%	125%	77%	n/a	Breach of Gearing	545	1228
Shaftesbury	-27%	165%	175%	60%	66%	No breach	0	134
Workspace Group	-30%	274%	150%	66%	61%	Breach LTV & Gearing	125	210
<b>Total/average</b>	<b>-32%</b>						<b>1,770</b>	<b>4,953</b>

\* LTV is used as an equivalent various debt/asset covenants such as Inner borrowing for Great Portland or unsec borrowings/unencumbered assets for British Land

\*\* LTV covenant may apply to either bank or bond debt

\*\*\* Breach does not trigger an event of default, rather it restricts operating conditions by requiring cash to be set aside. We assume disposals to a 65% level with cash set aside.

Source: Company data, HSBC estimates

coverage which would not suffer a covenant breach is Great Portland Estates, due in large part to one of the lowest LTV ratios among the REITs (at 41% as at December 2008) and the ability to transfer unsecured assets to satisfy the inner borrowing covenant.

## Asset disposals may not avert equity issuance

### GBP1.8bn of equity required to restore gearing and LTV ratios to covenant levels post our projected portfolio falls

Almost all of the REITs are scrambling to avoid debt covenant breaches through property disposals. Land Securities' sale of Trillium and Hammerson's marketing of GBP510m Bishop's Square in the City (E1) are evidence of this need.

We show in exhibit 40 that GBP3.7bn of property sales are required under our forecasts to restore projected LTV ratios to covenant levels. This quantum may prove impossible in a thin investment market, leaving the REITs at the mercy of debt re-financing or, on a worst case, equity issues.

### GBP3.7bn of property disposals needed

Exhibit 40 shows our calculation that GBP3.7bn of property disposals would be required to cure the most onerous covenants after our forecast portfolio falls. Liberty International, SEGRO, Hammerson and Land Securities would all have to dispose in excess of GBP500m of property before capital raising or transfer of uncharged assets.

### REITs have certain manoeuvrability within the covenants

Our forecasts of breaches are made on the assumption of our portfolio falls, dividend cuts and sales completed post balance sheet dates.

We have not made allowances (with the exception of Land Securities) for uncharged assets that can be transferred into security pools in the calculation of our breach. For illustrative purposes, we estimate that in the case of Great Portland Estates and Derwent London, uncharged assets represent approximately 20-30% of the portfolio at the last reporting date.

In the case of British Land there is no LTV covenant and instead the restriction is based on a maximum 70% ratio of net unsecured borrowings to unencumbered assets. We are forecasting that

Exhibit 40: Property disposals required to restore most onerous gearing and LTV ratios

(GBPm)	HSBC central case portfolio fall	HSBC central case gearing	Gearing covenant	HSBC central case LTV	LTV covenant	Impact	Property disposals required to satisfy most onerous covenant(GBPm)	Property disposals required to satisfy most onerous covenant on 10%+ sensitivity (GBPm)
British Land	-26%	155%	175%	24%	70%	No breach	0	150
Brixton	-36%	183%	175%	66%	60%	Breach LTV & Gearing	200	400
Derwent London	-41%	135%	n/a	59%	n/a	n/a	0	0
Great Portland	-36%	100%	125%	45%	60%	No breach	0	0
Hammerson	-34%	201%	150%	60%	n/a	Breach of Gearing	825	1375
Land Securities	-30%	136%	n/a	65%	55%	Breach of LTV	500	1700
Liberty International	-28%	284%	n/a	85%	80%	Breach of LTV	1100	3100
SEGRO	-35%	226%	125%	77%	n/a	Breach of Gearing	860	1160
Shaftesbury	-27%	165%	175%	60%	66%	No breach	0	162
Workspace	-30%	274%	150%	66%	61%	Breach LTV & Gearing	188	240
<b>Total/average</b>	<b>-32%</b>						<b>3,673</b>	<b>7,975</b>

Source: HSBC estimates

this ratio does not exceed 24%, even on our 26% portfolio fall forecast.

### Brixton and SEGRO most susceptible to equity capital raisings due to forecast breach of bond covenants

On our projected 36% and 35% respective portfolio falls from June 2008, Brixton and SEGRO's gearing ratios would breach covenant levels on outstanding bonds.

We expect a breach of bond covenant to require a redemption of bonds, which would have to be refinanced with bank debt at punitive margins.

Given the lack of appetite for property financing and the additional pressure this would place on profits, it is possible that rights issues become the only path to a secure balance sheet. On this basis, we forecast SEGRO's would require approximately GBP545m with Brixton's slight breach leading to a relatively modest GBP37m requirement.

## Debt drought to support price falls

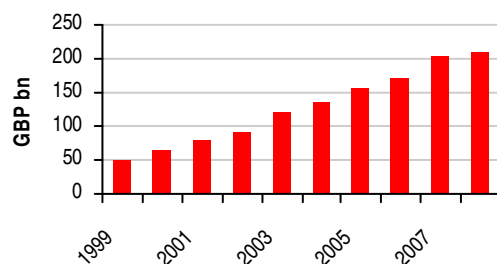
### Lending conditions and defaults increase

De Montford University's 'The UK Commercial Property Lending Market: Mid Year 2008', reported that the value of loans in breach of

financial covenant represents approximately 3.3% of the total aggregated loan book of organisations that contributed data. This is more than treble the proportion reported at 2007 year-end.

Although bank lending to commercial real estate grew by 3% since the 2007 year-end, the survey notes that this is the slowest rate of growth since the survey began in 1999.

Exhibit 41: Reported net aggregated value of commercial property loan books (GBPbn)



Source: De Montford University, HSBC estimates

The average LTV ratio offered by the lenders in the survey secured on prime office property fell from 76% to 72% in the first two quarters of 2008. The average margin charged on all categories of property increased by 33bps to 207bps.

We expect banks will continue to renew facilities with long-standing borrowers, concentrating on de-risking existing exposure by refinancing at higher rates. Lending margins have already risen

Exhibit 42: Private debt and LTV exposures

GBPm	IPD All property capital value		HSBC Forecast for prime property	
	30-Jun-07	31-Dec-07	fall 2008 = (-31.1%) 31-Dec-08	average fall 2009-10E (-32%) 2009-10 Forecast
Aggregate Property value	329	289	199	135
Aggregate Private debt	198.7	213.1	226.7	226.7
LTV	76%	74%	114%	167%
Amount of debt above 72% LTV threshold	0		-77.8	-150.3
<b>Collateral value</b>	<b>79</b>	<b>76</b>	<b>-28</b>	<b>-91</b>

Source: De Montford University, Investment Property Databank, HSBC estimates

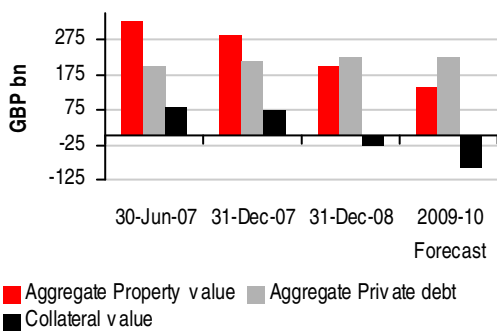
to a range of 200bps-300bps and above for new facilities, which compares to 75-100bps before summer 2007 according to the DMU survey.

## Banks heading for GBP91bn negative equity

### Average 32% forecast further fall in prime property prices to 2010

We have updated our calculation of loans in breach of LTV covenant in exhibit 42, first published in “Keep the tin hats on” on 21 April 2008.

Exhibit 43: Banks' residual equity value following property price falls



Source: De Montford University, HSBC estimates

We estimate the impact of property price falls to December 2008 will eliminate the value of banks' collateral, which we estimate was a negative GBP28bn at that date. We forecast that the banks' negative equity to UK commercial property rises to GBP91bn on our 50% peak-to-trough forecast fall in capital values.

### Negative equity set to rise to GBP91bn on prime capital value forecast

We estimate that GBP78bn of debt (or 34%) of UK bank commercial property debt is currently in breach of LTV covenants, based on the 31% fall in the Investment Property Databank index in 2008, and an average LTV ratio of 72% in 2008, as reported in the De Montford University survey.

This would rise to GBP91bn on our forecast of a further 32% fall in prime values. However, we expect banks to renegotiate balance sheet covenants as long as interest obligations continue to be met and comfortably covered.

The consequence of these projected property price falls is that we expect investment property transactions to remain the preserve of equity investors until bank capital constraints are reversed.

### Modest breaches of covenant set to trigger distressed sales

Our forecast 32% average fall in prime capital values from reported implies only modest covenant breaches, which we expect can be partly cured with property disposals. We also expect the banks to be flexible at the expense of higher margins on both new and existing debt.

Our sensitivity analysis shows severe breaches at a 60% peak-to-trough fall. This represents 10% more than our forecasts, under which most REITs under coverage would need substantial equity to cure covenants.

Exhibit 44: Sensitivity to debt covenants

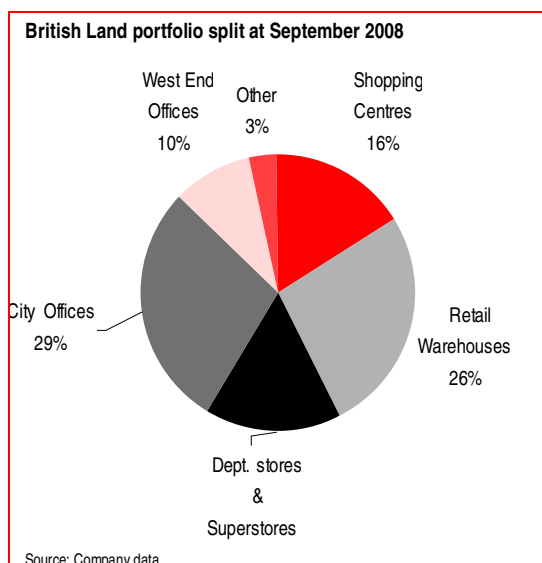
	HSBC forecast Portfolio fall	Portfolio fall to breach most onerous covenant	HSBC Central case - at trough property values		HSBC central case + 10% property value fall		Covenant implications under central case	Covenant implications under sensitivity
			LTV	Gearing	LTV	Gearing		
British Land	-26%	-32%	25%	155%	28%	196%	No breach of covenant	Breach of the net borrowings/adjusted capital and reserves (Gearing) covenant. Potentially lead to a waiver fee and a higher margin applied to existing debt.
Brixton	-36%	-28%	66%	183%	80%	351%	Breach of both bank debt and bond covenants	Severe breaches of covenants on bank facilities and bond. Potential for the bonds to be downgraded to sub-investment grade status by the rating agencies.
Derwent London	-41%	n/a	59%	136%	71%	221%	Covenants not disclosed	Covenants not disclosed
Great Portland Estates	-36%	44%	44%	100%	53%	148%	No breach of covenant	No breach of covenant
Hammerson	-34%	-29%	64%	201%	71%	290%	No LTV covenant. Gearing covenant would be breached	Breach of the gearing covenant could possibly lead to a breach on the bonds.
Land Securities	-30%	-15%	65%	-174%	76%	285%	Breach of Tier 1 and Tier 2 which implies setting cash into a liquidity facility reaching 18mths of interest charge by 70%. Also, from 65%, Tier 3 asset covenants are invoked requiring debt amortisation (accounting adjustment) approximating GBP25m per quarter.	This would constitute a severe breach of the thresholds although not an event of default (100% LTV) in the security group and would place further restrictions on the operating conditions of the company. Potential is for an aggressive disposal programme or further funding.
Liberty International	-28%	-14%	85%	284%	102%	464%	Severe breaches of bank debt covenant on secured pool of properties with LTV covenants between 70-90%	Severe breaches of both bank debt and (Lakeside and Metrocentre) CMBS covenants requiring a wholesale refinancing at significantly higher margins or asset disposal programme + rights issue
SEGRO	-35%	-14%	77%	232%	85%	372%	No LTV covenant. Gearing covenant would be breached on both bank debt and bond. Potential for waiver fee and higher margin on existing debt.	Gearing covenant on bank debt in severe breach - potential for asset disposal programme and higher margins on existing debt
Shaftesbury	-27%	-33%	61%	165%	73%	270%	No breach of covenant	Breach of both LTV and gearing covenants. Banks would still have 50% more income than required to service Group debt and charge over assets 50% more value than Group debt. Potential for asset disposals
Workspace Group	-30%	-18%	70%	274%	81%	627%	Breach of both gearing and LTV covenants before any property disposals completed. Potential for asset disposal programme and covenant renegotiation.	Severe breaches of both covenants putting into question the company's balance sheet. Potential for rights issue.

Source: Company data, HSBC estimates

# British Land

- ▶ Over-renting to stem free cash flow growth
- ▶ NAV downside on forecast 26% fall in the portfolio
- ▶ Downgrading rating to Underweight (V) from Neutral (V) and reducing target price to 435p from 615p

## Downside on all valuation measures



## Share price under pressure

The shares have fallen 72% since the sector peak in January 2007, including a 14% fall since the beginning of January 2009. We project 8% further downside as the fall in effective rental values spreads more widely from City offices into the rest of portfolio.

## DCF valuation projects further downside

### British Land summary valuation

Share price (p)	474
DCF valuation & target price (p)	435
Potential return	-8.2%
Benchmark	8.0%
Versus benchmark	-16.2%

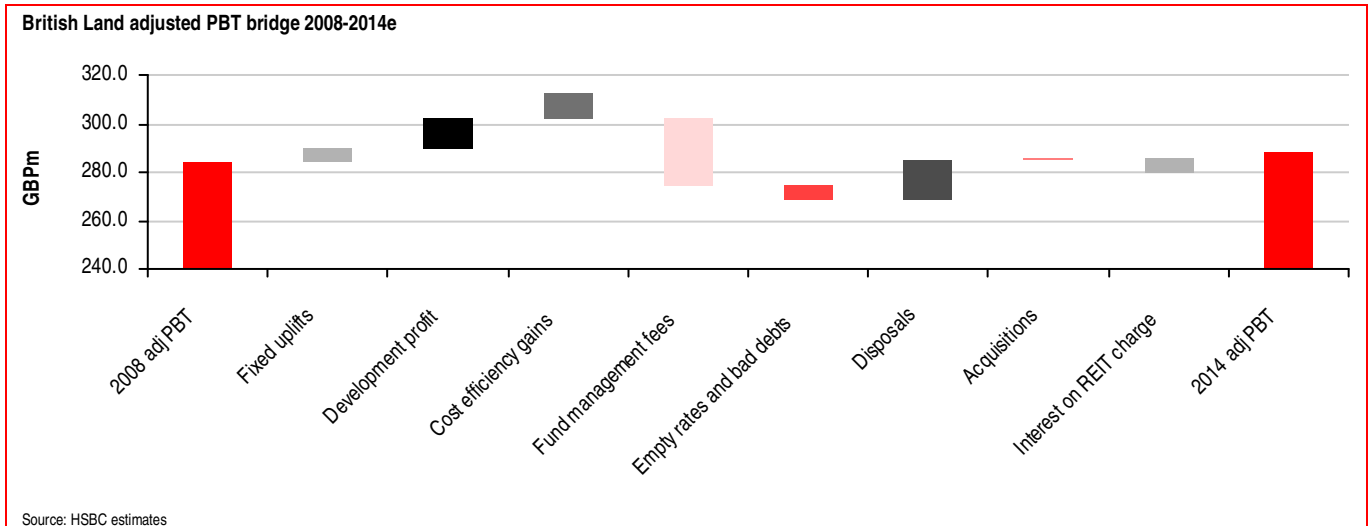
Source: HSBC estimates

Our new 435p target price (previously 615p) implies 8% share price downside from current levels, which reflects our valuation of cash flows that we think have peaked, given our forecast for a 24% fall in Estimated Rental Value. This leaves the current rent roll 20% over-rented.

The group's rental income is protected from the impact of our rental value reduction by just 2% of passing rental income subject to lease break or expiry to March 2010 and just 8% of rental income exposed to March 2013.

Our key DCF valuation assumptions are:

- ▶ 4.9% (previously 5.4%) cost of debt with a 60% (previously 68%) target gearing level
- ▶ 11% (previously 10.52%) cost of equity with a 1.85x (previously 1.72x) beta adjusted to reflect relatively high financial gearing and development exposure.



- ▶ 1.5% (previously 1.8%) free cash flow growth from 2014 to perpetuity.

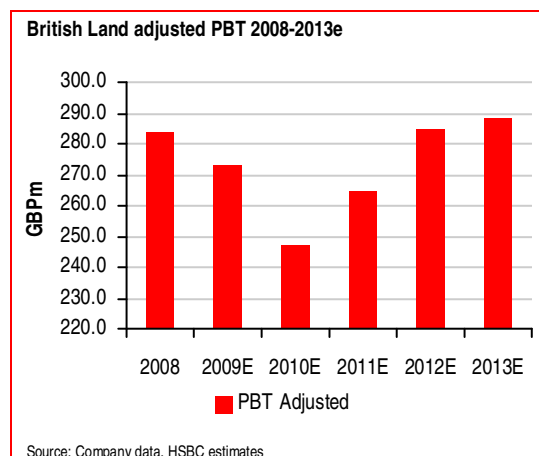
Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 435p implies a negative potential total return of 8.2%, which is outside the Neutral band of -2.0% to 18.0%, we downgrade our rating to Underweight (V) from Neutral (V).

### Dividend yield supportive at lower level

The shares provide a 7.9% prospective dividend yield that we project will rise to 8.6% on our target price.

We believe that this level of dividend income is required by investors, given that growth prospects are limited by our assumption that capital will be preserved in the light of financial covenant restrictions.

### Profit consolidation forecast



We forecast a 1.5% gain in adjusted PBT over the course of the five years to 2013, with adjusted PBT set to dip 13% in the next two years on lower forecast fund management fees before a pick-up in 2011e-12e, when we expect the recession-induced bad debts to have eased and the Ropemaker and Osnaburgh Street developments to become income-producing.

Our forecast for a 13% fall in adjusted PBT to 2010 is the result of a 10% dent to profit from lower fund management fees at GBP12m (GBP40m peak in 2008), and increased vacancy/bad debt charges. These are offset by cost savings and profit enhancements from

disposals and developments. Approximately GBP2.6bn profit-accretive disposals were made in 2008 (average 4.1% exit running yield) and development income is secured at our projected 6.6% gross yield on cost versus a 5.3% fixed debt finance cost.

## Dividend forecast reduced to preserve capital

We are reducing our forecast dividend growth from 7% to 5% per annum from 2010. This growth rate aligns our forecast dividends with our estimated PID requirement in 2009. This reflects our assumption that capital will be conserved to ensure that the financial gearing covenant on unsecured debt remains intact. We forecast that consolidated debt on adjusted net assets peaks at 155% at March 2010, compared to the gearing covenant requirement to remain within 175%.

Adjusted earnings per share are capable of supporting a higher rate of dividend growth than we are forecasting, given dividend cover at 1.5x in 2008, which we forecast will fall to 1.1x by 2014.

## Downside on NAV valuation

### Further 53% NAV downside

We expect NAV to fall by a further 53% to 486p at a trough in March 2010 value from the 1043p reported at September 2008. Our trough forecast is 72% lower than the peak at June 2007.

We forecast that the portfolio initial yield rises to 7.9% from a top-up 6.0% at September 2008, accompanied by an average 24% fall in the ERV of the portfolio. We are forecasting a 7.1% reversionary yield at March 2010.

Our NAV forecast includes a GBP318m deficit from a London development programme that is just under 15% pre-let and that we estimate has a GBP1.2bn end value.

## NAV reduction not reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is now 410p, which is a 13% discount to the current share price.

## Financial covenants should be safe

### Long average debt maturity and low debt costs

#### British Land key debt statistics at September 2008

Net gearing	93%
LTV	51%
Weighted average cost of debt	5.3%
Interest cover	2.0
Net debt (GBPm)	5,926
Debt maturing by December 2010	170
% of total debt	2.9%
Weighted average maturity (WAM) - (years)	12.9
Cash & Committed undrawn facilities (GBPm)	2,700

Source: Company data, HSBC estimates

British Land has minimal short-term financing issues with:

- ▶ 100% of the debt fixed at 5.3%
- ▶ GBP170m of debt maturing in the next two years
- ▶ LTV of 51% including share of funds and JVs, which would increase to 70% after our forecast 26% portfolio fall to March 2010.

### Financial covenants look secure

The most onerous financial covenants are on the unsecured net borrowings of GBP571m at September 2008. We expect the ratio for net consolidated borrowings to adjusted net assets to rise to 155% from 78% at September 2008, within the 175% maximum covenant level.

We calculate that the ratio for unsecured borrowings to unencumbered assets rises to 23% at March 2010 from 17% at September 2008, well within the 70% maximum ratio covenant

### **Interest cover forecast to remain strong to 2013**

We forecast that interest cover falls marginally in the year to March 2010e on a proportionally consolidated basis, well above the 1.25x minimum required by REITs regulations.

### **Risks**

A sudden recovery in City occupational demand and flat portfolio market rental values would positively affect our DCF valuation, target price and rating.

The successful proposed sale of Meadowhall Shopping Centre and other assets would clear the low risk to financial covenant breach and increase prospects for a higher dividend payout than we are forecasting.

## Financials & valuation: British Land Co

Underweight (V)

### Financial statements

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	596	645	639	667
EBITDA	552	575	555	585
Depreciation & amortisation	18	12	10	10
Operating profit/EBIT	534	563	545	575
Net interest	-290	-290	-298	-311
PBT	-1,609	-2,508	-902	434
HSBC PBT	284	273	247	265
Taxation	38	-11	-10	-11
Net profit	-1,571	-2,519	-912	424
HSBC net profit	276	263	237	255

### Cash flow summary (GBPm)

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Cash flow from operations	532	549	525	560
Capex	-523	-359	-200	0
FCF enterprise	67	205	345	575
Cash flow from investment	0	0	0	0
Dividends	-161	-176	-178	-211
Change in net debt	-1,372	-599	114	-54
FCF equity	-223	-85	47	264

### Balance sheet summary (GBPm)

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Tangible fixed assets	10,504	7,262	6,244	6,377
Current assets	382	145	145	142
Cash & others	0	1	2	1
Total assets	10,886	7,407	6,389	6,519
Gross debt	5,032	4,434	4,549	4,494
Net debt	5,032	4,433	4,547	4,493
Shareholders funds	6,790	3,669	2,500	2,684
Invested capital	10,504	7,262	6,244	6,377

### Ratio, growth and per share analysis

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Y-o-y % change</b>				
Revenue	-0.2	8.2	-0.9	4.4
EBITDA	0.7	4.1	-3.4	5.5
EBIT	0.2	5.4	-3.1	5.6
PBT	-226.7			
HSBC EPS	34.1	-4.7	-9.9	7.5
<b>Ratios (%)</b>				
Revenue/IC (x)	0.0	0.1	0.1	0.1
ROIC	4.5	6.5	8.2	9.3
ROE	3.6	5.0	7.7	9.8
ROA	-12.3	-27.5	-13.2	6.6
EBITDA margin	92.6	89.1	86.9	87.7
Operating profit margin	89.6	87.3	85.3	86.2
EBITDA/net interest (x)	1.9	2.0	1.9	1.9
Net debt/equity	74.1	120.8	181.9	167.4
Net debt/EBITDA (x)	9.1	7.7	8.2	7.7
CF from operations/net debt	10.6	12.4	11.5	12.5

### Per share data (GBPp)

Year to	03/2008a	03/2009e	03/2010e	03/2011e
EPS Rep (fully diluted)	-304.46	-488.23	-176.72	82.15
HSBC EPS	53.49	50.97	45.92	49.36
DPS	35.00	37.45	39.32	41.29
NAV	1325.00	709.71	483.53	519.09
NAV (adjusted)	1344.19	709.71	483.53	519.09

### Key forecast drivers

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Shopping centres cap growth (%)	-9.2	-22.9	-13.0	1.0
Retail warehouses cap growth (%)	-15	-24	-11	1
Superstores cap growth (%)	-14	-14	-8	2
City office cap growth (%)	-3	-16	0	2
Development surplus/(loss) (£m)	0	-47	-34	-16

### Valuation data

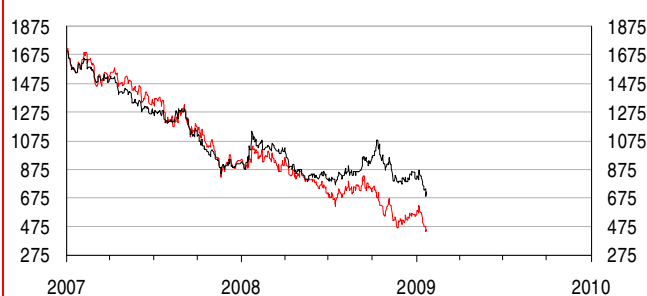
Year to	03/2008a	03/2009e	03/2010e	03/2011e
Premium/ (discount) to NAV	-64.2	-33.2	-1.9	-8.6
Premium/ (discount) to NAV (adj)	-64.7	-33.2	-1.9	-8.6
PE*	8.9	9.3	10.3	9.6
FCF yield (%)	-8.3	11.2	9.1	9.7
Dividend yield (%)	7.4	7.9	8.3	8.7

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	474	Target price (GBPp)	435	Potent'l tot rtn (%)	-8.2
Reuters (Equity)	BLND.L	Bloomberg (Equity)	BLND LN		
Market cap (USDm)	3,523	Market cap (GBPm)	2,426		
Free float (%)	100	Enterprise value (GBPm)	6859		
Country	United Kingdom	Sector	Real Estate		
Analyst	John Fraser-Andrews	Contact	44 20 7991 6732		

### Price relative

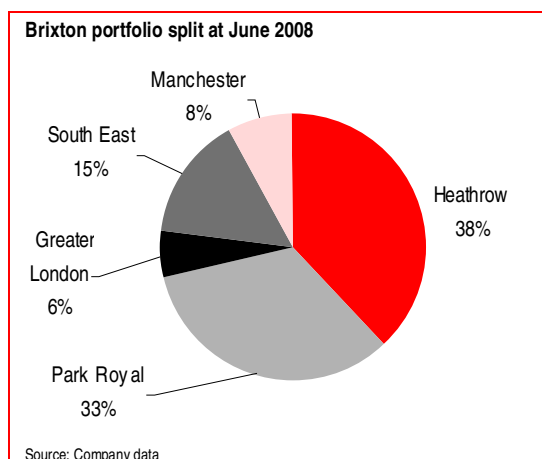


Source: HSBC

Note: price at close of 19 Jan 2009

# Brixton

- ▶ Vacancy has soared and over-renting pending
- ▶ Forecasting a 45% dividend fall 2007-2009e
- ▶ Reiterating Underweight (V) rating and reducing target price to 110p from 210p



## DCF valuation implies downside

### Brixton summary valuation

Share price (p)	120
DCF valuation & target price (p)	110
Potential return	-8.3%
Benchmark	8.0%
Versus benchmark	-16.3%

Source: HSBC estimates

We have reduced our target price to 110p from 210p. This reflects our valuation of cash flows, which we project have peaked given our forecast for a 20% fall in Estimated Rental Value, leaving the current rent roll 11% over-rented on our estimates.

The group's rental income is exposed to the impact of our rental value reduction as 18% of passing rental income is subject to lease break or expiry to December 2009 and 44% of rental income is exposed to December 2012.

Our key DCF valuation assumptions are:

- ▶ 5.25% (previously 5.75%) post-tax cost of debt with a 50% (previously 58%) target gearing level.
- ▶ 10.5% (previously 8.98%) cost of equity with a 1.7x (previously 1.28x) beta adjusted to reflect relatively high development letting risk and over-renting.

## Share price under pressure

The shares have underperformed the FTSE 350 Real Estate index by 27% since the sector peak in January 2007, with a 79% fall including a 9.5% reduction since the beginning of January 2009. We project 8.3% further downside due to the impact of an 11% over-rented portfolio and vacancy that we expect to rise to over 22% in 2009 and remain above that level until 2011.

- ▶ 1.5% (previously 2%) free cash flow growth from 2014 to perpetuity.

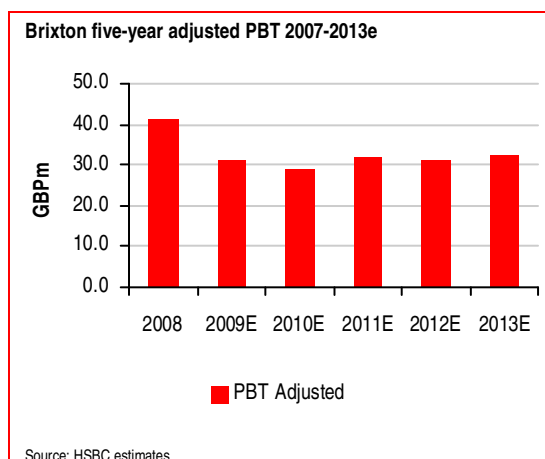
Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 110p implies a negative potential total return of 8.2%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Underweight (V) rating.

### Dividend yield set to fall

The shares provide 10.6% prospective dividend yield that we project will reduce to 6.5% in 2009 on our forecast dividend fall of 43% from 2007.

We are forecasting the minimum PID payout in the context of a breach of financial covenants, following our forecast 33% fall in adj. EPS from 2008e to 2010e.

### Profit compression to 2010e



We forecast a 31% fall in adjusted PBT over the course of the five years to 2012, with adjusted PBT set to fall 35% in the three years to December 2010. The reduction in adjusted PBT to 2010 is a result of unlet developments completed in H1 2008, leading to a ballooning in the overall vacancy rate to over 18%. This increase in vacancy has been exacerbated by a cyclical

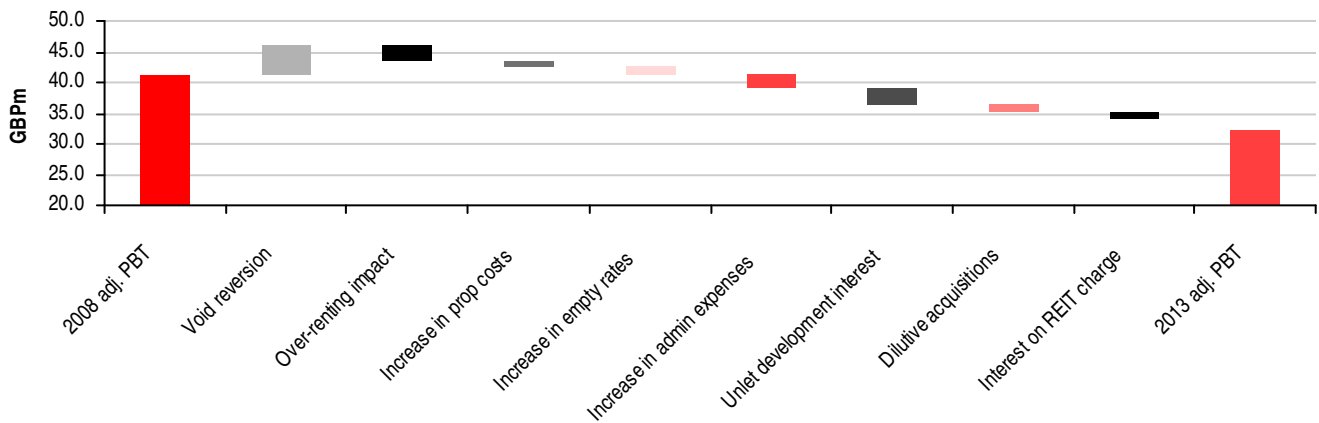
increase in underlying vacancy to 11% at November 2008.

Over the five-year horizon, adjusted profits are squeezed by the following:

- ▶ Unlet developments that are complete and carry interest and empty rate charges
- ▶ Over-renting of the portfolio
- ▶ A deterioration in the cost/income ratio as income slides and property costs increase

The vacancy increase to date has coincided with the introduction of empty buildings business rates on industrial property that we forecast will reduce 2009 adjusted PBT by GBP7.5m (16% of 2007 adjusted PBT).

Brixton adjusted PBT bridge 2007-2013e



Source: HSBC estimates

We forecast a 10% pick-up in adjusted PBT in 2011 from the 2010 trough with a partial recovery in vacancy from a 22% trough in 2010, partially offset by the portfolio reverting 12% lower on lease expiries to our ERV forecast.

### Dividend forecast reduced to preserve capital

We have reduced our 2009 dividend forecast by 30% from 20% in 2009e given our anticipation of breaches of both bond and bank debt covenants.

We forecast gearing to peak at 183% at December 2009 and the unsecured property assets to unsecured borrowings ratio falling to 1.51x, thereby breaching gearing covenants on both bond and bank debt.

Our forecast dividend in 2009 is 43% lower than the 2007 payout, on our assumption that the dividend will be restricted to the mandatory payout.

### Upside on NAV valuation

#### Further 62% NAV downside

We forecast NAV to fall by a further 62% to 170p at a trough value in December 2009 from the 448p reported at June 2008. Our trough forecast is 72% lower than the peak at June 2007.

We expect the portfolio initial yield to rise to 7.0% at December 2007 from 4.6% at June 2008, which assumes a 5% reduction in passing rental income.

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 145p, a 21% premium to the current share price.

### Precarious financial position

#### Relatively low leverage insufficient to protect covenants

##### Brixton key debt statistics

Net gearing	70%
LTV	43%
Weighted average cost of debt	5.0%
Interest cover	1.8
Net debt (GBPm)	858
Debt maturing by December 2010	480
% of total debt	56%
Weighted average maturity (WAM) - (years)	5.5
Cash & Committed undrawn facilities	185

Source: Company data, HSBC estimates

Brixton has no immediate financing needs, with the earliest maturity of debt in December 2010 when GBP275m of bond debt and GBP205m of bank facilities mature. The salient points are:

- ▶ 87% of the debt fixed at 5.0%
- ▶ GBP480m of debt maturing in the next two years

- ▶ LTV of 43% at June 2008, which would increase to 67% after our forecast 36% portfolio fall to December 2009e.

#### **Financial covenants under threat**

The most onerous financial covenant is on the unsecured bank loans of GBP415m, which have a 60% group LTV covenant, which we forecast rises to 67% at December 2009. The unsecured bonds of GBP630m at September 2008 have a 175% maximum ratio for net consolidated borrowings to adjusted net assets which we forecast rises to 183% from 69% reported at June 2008, above the 175% maximum covenant level.

We calculate that the ratio for secured borrowings (in the JVs) to adjusted net assets rises to 24% at December 2009, from 9% at June 2008, well within the 50% maximum ratio covenant.

#### **Dwindling interest cover**

Our rent reduction forecasts and empty-rate costs reduce interest cover to a trough multiple of 1.68x in the year to December 2009e on a proportionally consolidated basis, which is just above the bank debt covenant and well above the 1.25x minimum required by REITs regulations.

#### **Risks**

A sudden improvement in the industrial occupier markets in West London and Heathrow would positively affect our rating and target price.

## Financials & valuation: Brixton Plc

Underweight (V)

### Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	82	91	88	89
EBITDA	66	73	65	65
Depreciation & amortisation	-1	-2	-2	-2
Operating profit/EBIT	64	70	63	63
Net interest	-22	-33	-35	-37
PBT	58	-621	-328	55
HSBC PBT	47	41	31	30
Taxation	2	2	0	0
Net profit	60	-620	-328	55
HSBC net profit	48	43	31	30

### Cash flow summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Cash flow from operations	76	75	68	68
Capex	0	-1	-1	-1
FCF enterprise	67	74	64	65
Cash flow from investment	0	0	0	0
Dividends	-37	-34	-21	-22
Change in net debt	320	41	2	3
FCF equity	44	40	29	27

### Balance sheet summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Tangible fixed assets	2,185	1,601	1,279	1,300
Current assets	174	99	161	178
Cash & others	6	0	0	0
Total assets	2,359	1,700	1,440	1,478
Gross debt	810	845	847	849
Net debt	804	845	847	849
Shareholders funds	1,433	725	463	498
Invested capital	2,185	1,601	1,279	1,300

### Ratio, growth and per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Y-o-y % change</b>				
Revenue	-13.8	11.3	-3.1	0.4
EBITDA	-8.9	10.6	-10.9	1.0
EBIT	-8.0	9.6	-10.9	1.1
PBT	-71.6	-1167.4		
HSBC EPS	-65.9	-11.3	-26.8	-4.6
<b>Ratios (%)</b>				
Revenue/IC (x)	0.0	0.0	0.1	0.1
ROIC	3.1	3.7	4.4	4.9
ROE	4.0	5.3	6.2	6.6
ROA	2.1	2.0	2.0	2.1
EBITDA margin	80.0	79.5	73.1	73.6
Operating profit margin	78.3	77.1	70.8	71.3
EBITDA/net interest (x)	2.9	2.2	1.8	1.7
Net debt/equity	56.1	116.6	183.0	170.5
Net debt/EBITDA (x)	12.3	11.6	13.1	13.0
CF from operations/net debt	9.4	8.9	8.0	8.0

### Per share data (GBPp)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
EPS Rep (fully diluted)	22.09	-228.14	-120.85	20.23
HSBC EPS	17.81	15.79	11.56	11.03
DPS	13.67	12.70	7.76	8.14
NAV	529.24	266.73	169.84	182.63
NAV (adjusted)	544.61	286.73	169.84	182.63

### Key forecast drivers

Year to	12/2007a	12/2008e	12/2009e	12/2010e
UK industrial cap growth (%)	2	-29	-20	2
West London industrial cap growth	2	-29	-20	2

### Valuation data

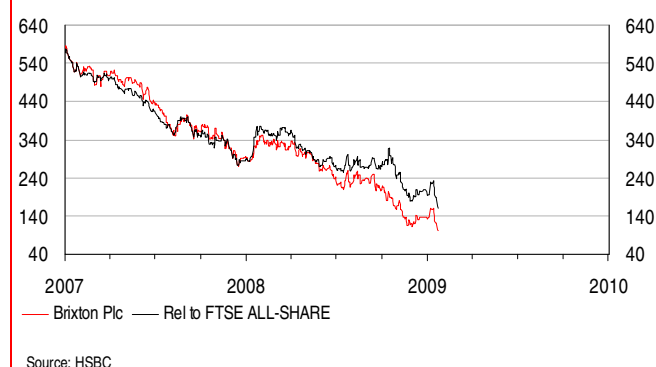
Year to	12/2007a	12/2008e	12/2009e	12/2010e
Premium/ (discount) to NAV	-77.4	-58.3	-29.6	-34.6
Premium/ (discount) to NAV (adj)	-78.1	-58.3	-29.6	-34.6
PE*	6.7	7.6	10.3	10.8
FCF yield (%)	4.6	8.1	10.5	9.2
Dividend yield (%)	11.4	10.6	6.5	6.8

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	120	Target price (GBPp)	110	Potent'l tot rtn (%)	-8.3
Reuters (Equity)	BXTN.L	Bloomberg (Equity)	BXTN LN		
Market cap (USDm)	471	Market cap (GBPm)	324		
Free float (%)	100	Enterprise value (GBPm)	1169		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	John Fraser-Andrews	Contact	44 20 7991 6732		

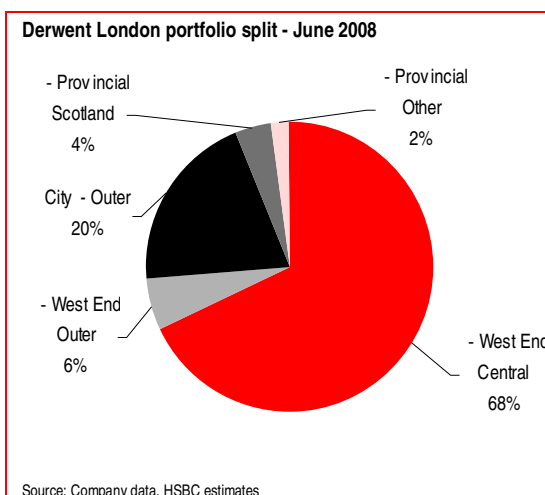
### Price relative



Note: price at close of 19 Jan 2009

# Derwent London

- ▶ Fringe London portfolio vulnerable to rent falls and rising vacancy
- ▶ Forecasting 41% portfolio fall and 62% NAV downside
- ▶ Reiterating Underweight (V) rating and reducing target price to 430p from 720p



## Share price outperformance set to reverse

The shares have broadly matched the FTSE 350 Real Estate index since January 2007, with a 67% fall, including 9% outperformance in the year to date, with a fall of 5%.

We project a further 38% downside as we expect rental value falls to accelerate in Derwent London's fringe locations of Fitzrovia, Paddington, Midtown, Islington and others.

## DCF valuation implies further downside

### Derwent London summary valuation

Share price (p)	690
DCF valuation & target price (p)	430
Potential return	-37.7%
Benchmark	8.0%
Versus benchmark	-45.7%

Source: HSBC estimates

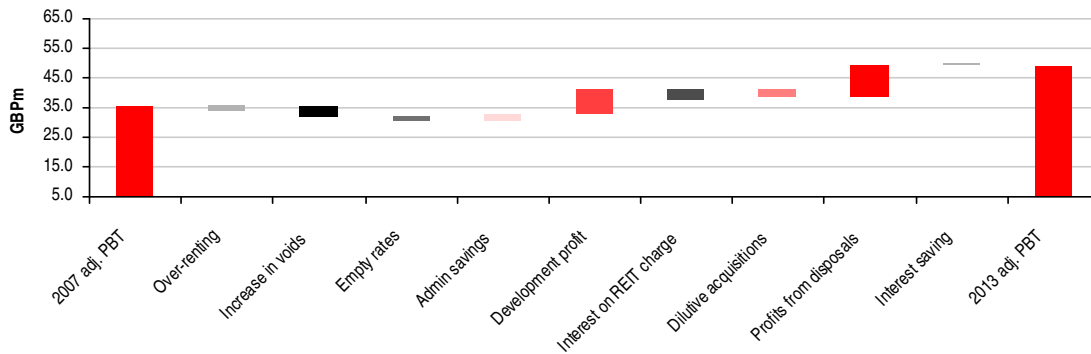
Our 430p target price reflects our valuation of cash flows, which we project have peaked given our forecast for a 29% fall in Estimated Rental Value. This leaves the current rent roll 7% over-rented by December 2010 on our estimates

Our key DCF valuation assumptions are:

- ▶ A target capital structure comprising 55% (previously 40%) debt and a 5.3% (previously 5.76%) post-tax cost of debt.
- ▶ 10.2% (previously 8.81%) cost of equity with a 1.6x (previously 1.23x) beta adjusted to reflect the over-renting and relatively high development exposure.
- ▶ 1.75% (previously 2%) free cash flow growth from 2013 to perpetuity.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of

Derwent London profit bridge 2007-2013e



Source: Company data, HSBC estimates

8.0%. As our 12-month target price of 430p implies a negative potential total return of 37.7%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Underweight (V) rating.

### Dividend held to preserve capital

The shares provide a 3.3% prospective dividend yield that we project will rise to 5.2% on our target price.

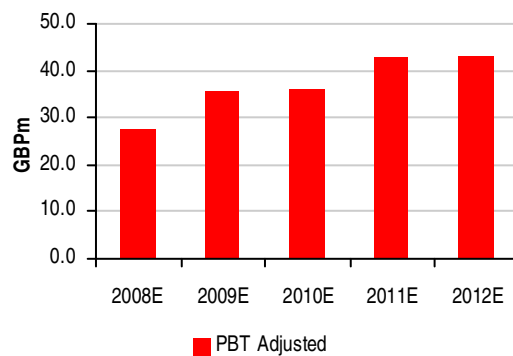
We forecast the dividend is held in 2008 for capital preservation reasons and earnings pressure from the dilutive Hanson lease surrender in H1 2008.

We expect 10% dividend growth from 2009, which would provide an 8.4% dividend yield (1.2x cover) on our target price.

We believe this level of dividend income is required, given that growth prospects are neutered by the necessity to preserve capital in the light of restricted credit markets.

### Underlying profit flat to 2010e

Derwent London five-year adjusted PBT chart



Source: Company data, HSBC estimates

We project underlying adjusted PBT flattens in 2009 and 2010 (stripping out the Hanson lease surrender). We expect the investment portfolio vacancy rate to rise from 7.4% at June 2008 to 11.5%, offset by an estimated 100bps profit margin on the development programme.

### NAV heading downhill

#### Further 62% NAV downside

We forecast that the portfolio falls 41% from June 2008, leading to a further 62% fall in adjusted NAV to 622p at the December 2009 trough from the 1637p reported at June 2008. Our forecast is 68% lower than the peak at June 2007.

We forecast that the portfolio's initial yield rises to 7.5% from a 4.9% as at June 2008,

accompanied by a 29% fall in the ERV (excluding voids) of the portfolio.

Our adjusted NAV forecast includes a GBP13m valuation deficit for the current developments at Gresse St (W1) (currently unlet) and the Angel building (EC1), which is 53% let and in the process of redevelopment.

### NAV reduction not reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 530p, which represents a 23% discount to the current share price.

### Reasonable average debt maturity and potential savings in debt costs

#### Derwent London key debt statistics

Net gearing	50%
LTV	33%
Weighted average cost of debt	5.5%
Interest cover	1.4
Net debt (GBPm)	879
Debt maturing by December 2010	125
% of total debt	14%

Source: Company data, HSBC estimates

### Derwent London has relatively few financing needs in the short term

- ▶ A GBP125m facility (11%) of debt maturing in November 2009 with no further maturities until December 2011.
- ▶ 63% of debt (at nominal value) at fixed rates with the remainder linked to base rates (vs. LIBOR) or variable, which helped lower the spot weighted cost of debt to 5.5% as at September 2008.
- ▶ Relatively low LTV ratio, which could provide significant headroom over industry standard covenants

### Security in relatively low level of leverage

We forecast financial gearing reaches 136% and the LTV rises to 59% by December 2009 on our forecast 41% portfolio fall from June 2008.

Derwent London has not disclosed its banking covenants but we believe the company will be seeking to renegotiate terms on the bank debt that make up 85% of debt facilities as our forecast property price reductions crystallise.

Management reported in the November 2008 Q3 IMS that portfolio values would have to fall by 38% (from June 2008) before the group would reach the LTV covenant on secured assets.

Assuming that a further GBP250m of uncharged property transferred into the security pool, the LTV on this scenario would rise to 53%.

### Interest cover to remain strong throughout our forecast period to 2013

Our rent reduction forecasts, increased void assumptions and empty rates liabilities reduce interest cover to a trough multiple of 1.7x in the year to December 2009, which is significantly above the 1.25x minimum required by REIT regulations.

### Risks

Unchanged portfolio market rental values in fringe West End locations and stable occupier demand through the recession would positively affect our DCF valuation, target price and rating.

Higher than expected savings in costs would positively impact our rating and target price.

## Financials & valuation: Derwent London

Underweight (V)

### Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	112	119	125	128
EBITDA	82	76	87	92
Depreciation & amortisation	0	0	0	0
Operating profit/EBIT	82	76	87	92
Net interest	-46	-48	-51	-51
PBT	-100	-681	-458	71
HSBC PBT	36	28	36	41
Taxation	201	-10	-1	-2
Net profit	101	-691	-459	69
HSBC net profit	236	18	34	40

### Cash flow summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Cash flow from operations	83	76	87	92
Capex	-68	-87	-81	-26
FCF enterprise	215	-20	4	64
Cash flow from investment	0	0	0	0
Dividends	-23	-23	-25	-27
Change in net debt	433	94	-24	10
FCF equity	168	-69	-47	14

### Balance sheet summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Tangible fixed assets	2,655	1,953	1,441	1,496
Current assets	108	118	118	111
Cash & others	10	0	0	0
Total assets	2,762	2,071	1,559	1,608
Gross debt	793	877	853	863
Net debt	783	877	853	863
Shareholders funds	1,842	1,116	628	666
Invested capital	2,655	1,953	1,441	1,496

### Ratio, growth and per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Y-o-y % change</b>				
Revenue	117.7	6.7	4.6	2.4
EBITDA	126.7	-7.1	13.5	5.7
EBIT	126.7	-7.1	13.5	5.7
PBT	-141.1			
HSBC EPS		-92.5	94.0	15.0
<b>Ratios (%)</b>				
Revenue/IC (x)	0.1	0.1	0.1	0.1
ROIC	12.6	3.2	4.9	6.0
ROE	18.0	1.2	3.9	6.1
ROA	4.9	-28.6	-25.3	4.4
EBITDA margin	73.7	64.1	69.5	71.8
Operating profit margin	73.7	64.1	69.5	71.8
EBITDA/net interest (x)	1.8	1.6	1.7	1.8
Net debt/equity	42.5	78.6	135.9	129.7
Net debt/EBITDA (x)	9.5	11.5	9.8	9.4
CF from operations/net debt	10.6	8.7	10.2	10.6

### Per share data (GBPp)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
EPS Rep (fully diluted)	100.20	-685.45	-455.56	68.59
HSBC EPS	234.75	17.58	34.11	39.21
DPS	22.50	22.50	24.75	27.22
NAV	1829.04	1106.51	622.42	660.04
NAV (adjusted)	1862.30	1106.51	622.42	660.04

### Key forecast drivers

Year to	12/2007a	12/2008e	12/2009e	12/2010e
West End offices cap growth %		-26	-25	2
Outer City cap growth x%		-31	-25	2
Provincial cap growth x%		-34	-25	2

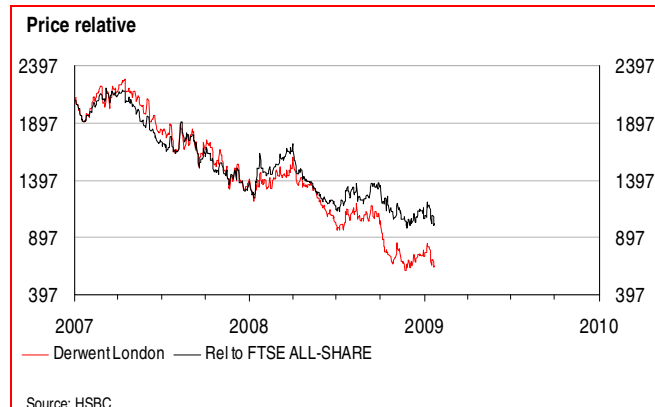
### Valuation data

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Premium/ (discount) to NAV	-62.3	-37.6	10.9	4.5
Premium/ (discount) to NAV (adj)	-62.9	-37.6	10.9	4.5
PE*	2.9	39.3	20.2	17.6
FCF yield (%)	2.5	6.7	6.8	6.9
Dividend yield (%)	3.3	3.3	3.6	3.9

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

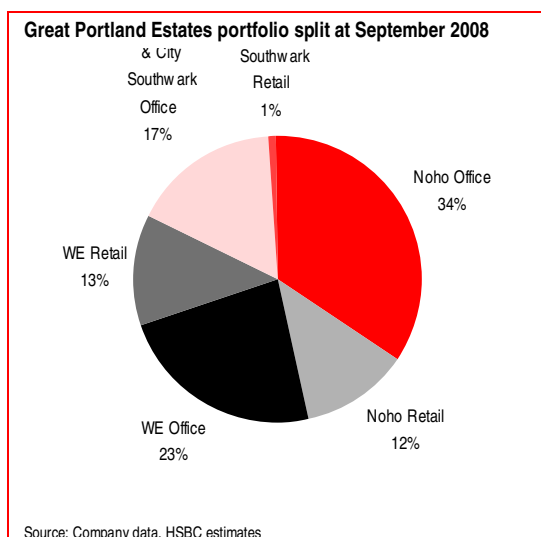
Share price (GBPp)	690	Target price (GBPp)	430	Potentl tot rtn (%)	-37.7
Reuters (Equity)	DLN.L	Bloomberg (Equity)	DWV LN		
Market cap (USDm)	1,008	Market cap (GBPm)	694		
Free float (%)	100	Enterprise value (GBPm)	1571		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	Nicolas Lyle	Contact	+44 (0) 20 7992 1823		



Note: price at close of 19 Jan 2009

# Great Portland Estates

- ▶ Development freeze to erode profit growth in the short term
- ▶ 52% NAV downside from September 2008
- ▶ Reiterating Underweight rating (adding V) and reducing target price to 180p from 240p



## DCF valuation implies further downside

### Great Portland Estates summary valuation

Share price (p)	236
DCF valuation & target price (p)	180
Potential return	-23.7%
Benchmark	8.0%
Versus benchmark	-31.7%

Source: HSBC estimates

Our new 180p target price (previously 240p) reflects our valuation of cash flows, which we project have peaked given our forecast for a 27% fall in Estimated Rental Value, which leaves the portfolio 8% over-rented.

The group's rental income is exposed to relatively rapid reductions in rental levels as just under 45% of rent roll expires by September 2011, coinciding with the most pessimistic outlook for the London office occupier market since the early 1990s recession.

Our key DCF valuation assumptions are:

- ▶ 5.3% (previously 5.94%) post-tax cost of debt with a 55% (previously 46%) target gearing level.
- ▶ 10.0% (previously 9.02%) cost of equity with a 1.6x (previously 1.29x) beta adjusted to reflect relatively low gearing and development exposure.

## Share price outperformance subject to erosion

The shares have outperformed the FTSE350 Real Estate Index by 19% since January 2007, having lost 66% of their value. The outperformance has continued in the year to date, with a 9% fall, versus the sector's 5% fall.

We project 24% further downside as the fall in effective rental values spreads more widely from City offices into fringe locations such as Southwark and Noho.

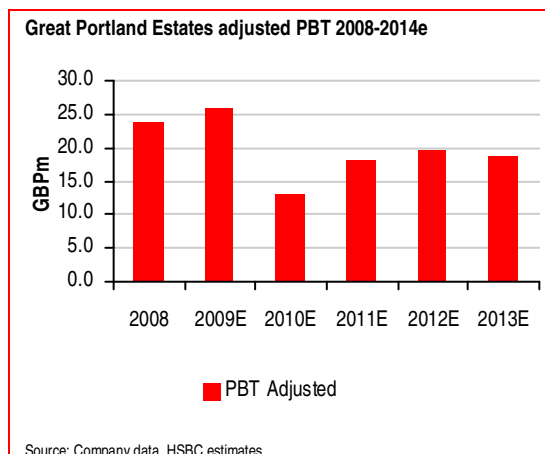
- ▶ 1.75% (previously 2%) free cash flow growth from 2014 to perpetuity to reflect limited future supply growth in the West End.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 180p implies a negative potential total return of 23.7%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Underweight rating and add a volatility indicator.

### Dividend yield still relatively low on lower price target

The shares provide a 5.2% prospective dividend yield that we project would remain flat at 5.1% on our 180p target price and forecast 2.5% reduction in the dividend in the year to March 2010.

### Adjusted PBT forecast set to fall 47% to 2010



### Underlying fall excluding development contract profit is more modest, at 6%

We forecast a 30% fall in adjusted PBT over the course of the five years to 2013, with adjusted PBT set to fall by 47% between 2008 and 2010e, stripping out development contract profit and the projected underlying fall is 24%.

The underlying fall in the five-year forecast period is more modest at 6% and can be largely attributed to the impact of over-renting, increased voids with associated empty rates.

### Growth in income from 2011 to come from developments

We project that the portfolio becomes 8% over-rented post our forecast 27% fall in ERV (excluding void ERV) to March 2010.

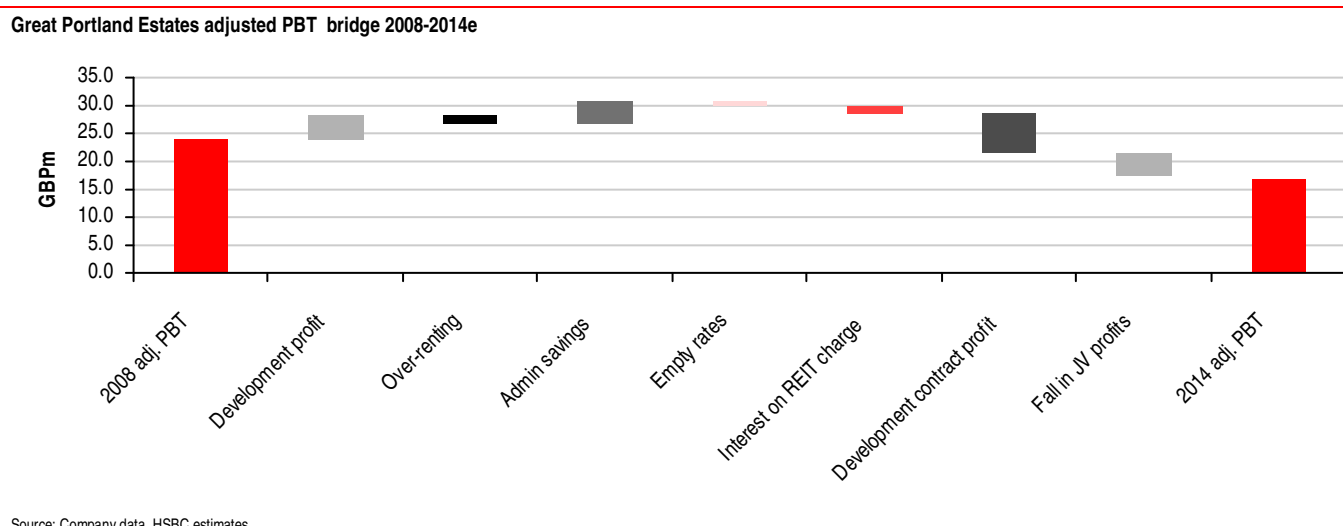
This leaves income growth at the mercy of developments, with Wells & More accounting for GBP4.7m of prospective income in our forecasts, three-quarters of the income of schemes currently in progress.

We expect vacancy to peak at 7.6% of ERV (or 9.8% of rent roll) in 2010 before falling back to a long-term trend of 4.0% of the ERV (or 5.1% of rent roll) underlying rate from 2012.

We project nil development contract profits from 2010 onwards as this is highly dependent on a buoyant occupier market.

### Fall in JV profits act as further brake on growth

We project that Great Portland's JVs profit contribution is set to be neutered by our projected 27% fall in ERVs, leading to flat JV profits from 2009 onwards.



## Dividend uncovered in year to March 2010

We project a 3% rise in the dividend for the full year to 2009, which represents a 100% adjusted EPS payout. We estimate a 25% cut in 2010 on our 46% forecast fall in earnings, rebasing the dividend for our 3% growth forecast from 2011e to 2013e at 1.0x cover.

## Downside on NAV valuation

### Further 40% NAV downside

We forecast a further 40% fall in NAV to 236p at a trough value in March 2010 from the 392p reported at December 2008. Our trough forecast is 64% lower than the peak valuation at September 2007.

We expect the portfolio initial yield to rise to 8.6% from 5.0% at September 2008 (5.4% at December 2008), accompanied by an average 27% fall in the ERV of the portfolio (18% from December 2008).

Our NAV forecast assumes the development programme is broadly neutral after a 25% average reduction is applied to company projected income of GBP9.6m on a total cost of GBP130.8m.

We expect the projected profit on cost of the Wells & More (Mortimer St, W1) development, which completes in January 2009, to be offset by

losses on Metropolitan Wharf (E1) and Bermondsey St (SE1). Wells and More is currently unlet and we estimate the end value to be GBP67m vs. a GBP54m development cost.

### NAV reduction not reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 201p, which is a 15% discount to the current share price.

## Financial covenants look safe

### No short-term debt maturity and low use of leverage

#### Great Portland Estates key debt statistics

Net gearing	53%
LTV	41%
Weighted average cost of debt	6.0%
Interest cover	2.3
Net debt (GBPm)	375
Debt maturing by March 2011	50
% of total debt	7%
Weighted average maturity (WAM) - (years)	
Cash & Committed undrawn facilities	327

Source: Company data, HSBC estimates

Great Portland Estates has one of the strongest balance sheet positions in the sector with:

- ▶ 94% of the debt fixed or hedged at 6.0%
- ▶ A GBP50m undrawn facility maturing in November 2010 with no further maturities

until 2012 when GBP261m worth of bank facilities expire

- ▶ A 38% LTV on the Great Capital Partnership JV (Sep 08), rising to 54% to March 2010 under our 36% portfolio fall forecast.

#### **Financial covenants protected**

The most onerous financial covenant is the net debt to equity covenant of 1.25x, which we project will rise to 1.0x (from September 2008) after our forecast 36% portfolio fall to March 2010, well within the covenant level.

The inner borrowing covenant is further secured by the ability to transfer unsecured assets to the security pool if this ratio came under pressure. The company has guided that a 40% fall in portfolio values would be necessary to trigger this covenant before uncharged assets are transferred.

#### **Risks**

A sudden recovery in fringe West End office occupational demand and flat portfolio market rental values would positively affect our DCF valuation, target price and rating.

Higher than expected savings in costs would positively impact our rating and target price.

## Financials & valuation: Great Portland Estates

Underweight (V)

### Financial statements

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	55	56	58	62
EBITDA	37	37	32	38
Depreciation & amortisation	0	0	0	0
Operating profit/EBIT	37	37	32	38
Net interest	-30	-25	-30	-31
PBT	-3	-395	-192	36
HSBC PBT	24	24	14	19
Taxation	-1	-1	-1	-1
Net profit	-4	-396	-193	35
HSBC net profit	23	23	13	18

### Cash flow summary (GBPm)

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Cash flow from operations	47	55	38	44
Capex	0	-27	-5	-5
FCF enterprise	36	9	26	32
Cash flow from investment	0	0	0	0
Dividends	-22	-22	-17	-17
Change in net debt	35	-45	15	11
FCF equity	7	-16	-4	1

### Balance sheet summary (GBPm)

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Tangible fixed assets	1,073	739	538	559
Current assets	440	315	312	319
Cash & others	1	0	0	0
Total assets	1,513	1,054	850	878
Gross debt	425	379	395	406
Net debt	425	379	395	406
Shareholders funds	1,054	635	425	442
Invested capital	1,073	739	538	559

### Ratio, growth and per share analysis

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Y-o-y % change</b>				
Revenue	1.1	1.3	3.5	7.3
EBITDA	5.1	-0.7	-13.9	18.3
EBIT	5.1	-0.7	-13.9	18.3
PBT	-100.9			
HSBC EPS	-69.4	0.5	-41.6	36.1
<b>Ratios (%)</b>				
Revenue/IC (x)	0.0	0.1	0.1	0.1
ROIC	3.1	3.9	4.8	6.6
ROE	2.1	2.7	2.5	4.2
ROA	-0.3	-30.8	-20.3	4.0
EBITDA margin	67.6	66.3	55.2	60.8
Operating profit margin	67.6	66.3	55.2	60.8
EBITDA/net interest (x)	1.3	1.5	1.1	1.2
Net debt/equity	40.3	59.8	92.9	91.9
Net debt/EBITDA (x)	11.4	10.2	12.3	10.7
CF from operations/net debt	11.0	14.6	9.6	10.8

### Per share data (GBPp)

Year to	03/2008a	03/2009e	03/2010e	03/2011e
EPS Rep (fully diluted)	-2.27	-218.75	-106.69	19.15
HSBC EPS	12.54	12.60	7.36	10.03
DPS	11.90	12.26	9.19	9.47
NAV	582.39	350.92	234.89	244.07
NAV (adjusted)	584.55	350.92	234.89	244.07

### Key forecast drivers

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Offices cap growth	0	-30	-20	2
Retail cap growth	0	-29	-20	2

### Valuation data

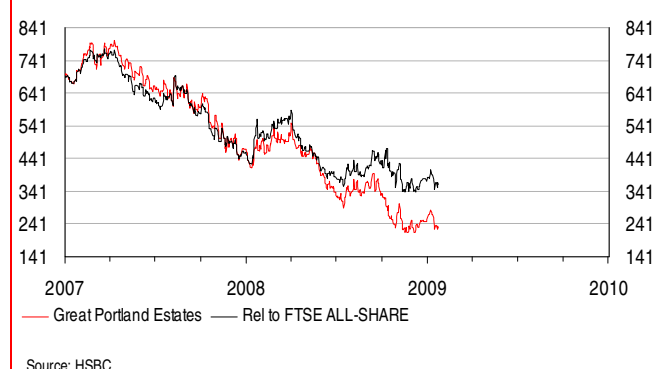
Year to	03/2008a	03/2009e	03/2010e	03/2011e
Premium/ (discount) to NAV	-59.5	-32.7	0.5	-3.3
Premium/ (discount) to NAV (adj)	-59.6	-32.7	0.5	-3.3
PE*	18.8	18.7	32.0	23.5
FCF yield (%)	-4.7	5.7	6.5	7.0
Dividend yield (%)	5.0	5.2	3.9	4.0

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	236	Target price (GBPp)	180	Potent'l tot rtn (%)	-23.9
Reuters (Equity)	GPOR.L	Bloomberg (Equity)	GPOR LN		
Market cap (USDm)	620	Market cap (GBPm)	427		
Free float (%)	100	Enterprise value (GBPm)	807		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	Nicolas Lyle	Contact	+44 (0) 20 7992 1823		

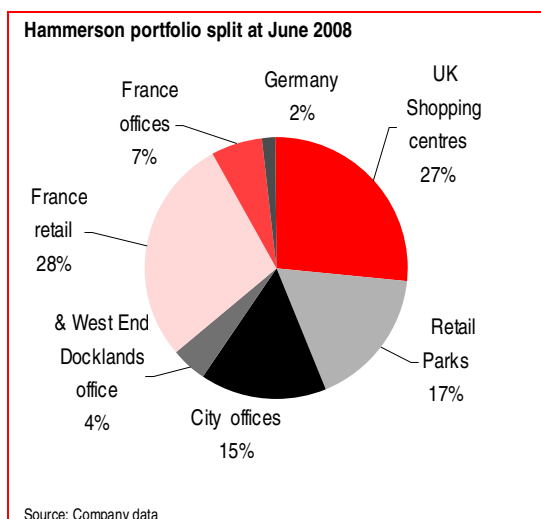
### Price relative



Note: price at close of 19 Jan 2009

# Hammerson

- ▶ Development model redundant in our forecast horizon
- ▶ Downside to NAV valuation on our forecast 28% fall in the portfolio
- ▶ Reiterating Underweight rating (adding V) and reducing our target price to 375p from 610p



## Share price under pressure

The shares have fallen 72% since the beginning of January 2008, in line with the sector. We project 16% further downside as the fall in effective rental values spreads more widely from City offices into the West End and retail holdings.

## DCF valuation implies further downside

### Hammerson summary valuation

Share price (p)	446
DCF valuation & target price (p)	375
Potential return	-15.9%
Benchmark	8.0%
Versus benchmark	-23.9%

Source: HSBC estimates

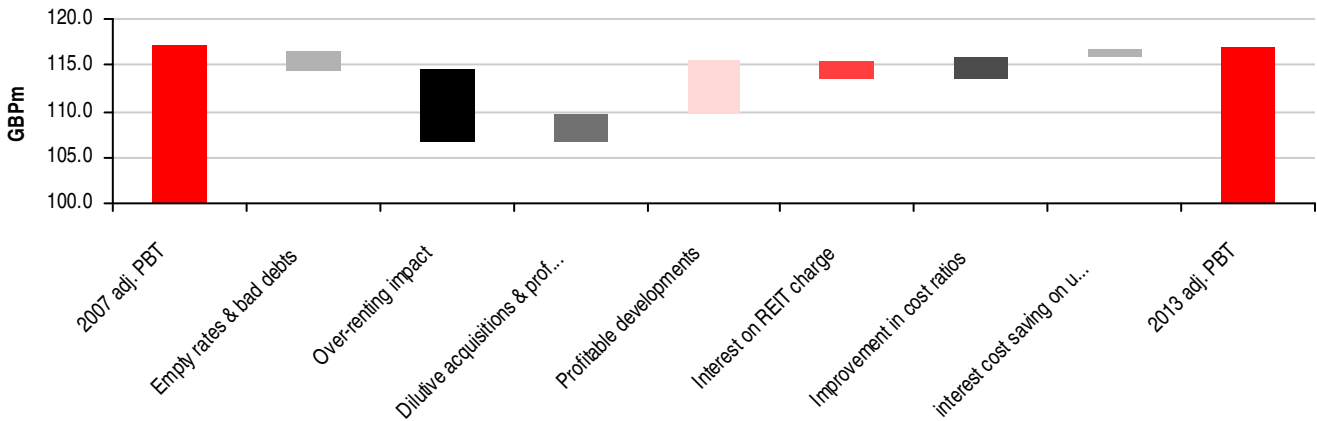
Our new 375p target price (previously 610p) reflects our valuation of cash flows, which we project have peaked in our forecast horizon. We forecast a 22% fall in Estimated Rental Value. This leaves the current rent roll 16% over-rented, on our estimates.

The group's rental income is exposed to the impact of our rental value reduction as 16% of passing rental income is subject to lease break or expiry to December 2010.

Our key DCF valuation assumptions are:

- ▶ 5.0% (previously 5.5%) cost of debt with a 55% (previously 60%) target gearing level.
- ▶ 10.4% (previously 10.17%) cost of equity with a 1.69x (previously 1.62x) beta adjusted to reflect relatively high financial gearing and development exposure.

Hammerson adjusted PBT bridge 2007-2013e



Source: HSBC estimates

- ▶ 1.65% (previously 2%) free cash flow growth from 2014 to perpetuity.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 375p implies a negative potential total return of 15.9%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Underweight rating and add a volatility indicator.

### Low dividend yield

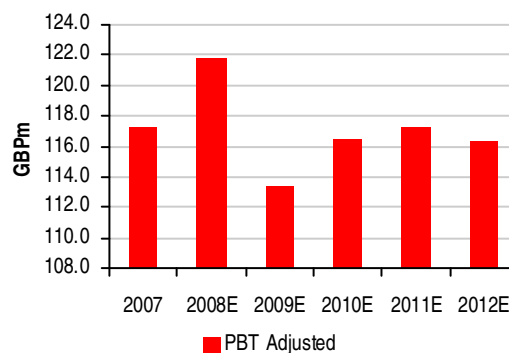
The shares provide a 3.8% prospective dividend yield on our target price, after a forecast 48% dividend cut.

We assume that the dividend is cut to preserve capital to minimise the net gearing financial covenant breach.

Our forecasts assume 5% progressive dividend growth from 2010, which we think can comfortably be sustained or exceed given 1.7-2.0x cover forecast through to 2013e.

### Profit consolidation ahead

Hammerson five-year adjusted PBT – 2007-2012e



Source: HSBC estimates

We forecast a 2.8% gain in adjusted PBT between 2007 and 2013 with a 5.9% gain in 2008e offset by modest reductions thereafter. The rise in 2008 is due to the impact of GBP573m profit accretive disposals (c4.5% blended exit yield) in 2007/08.

We expect the GBP1bn development programme to be modestly profit accretive once fully let in our assumptions by 2012, whilst contributing to the modest profit reductions up to 2012 as capitalised interest is run down with a time lag on rental income.

Profits also fall due to:

- ▶ The gradual fall in rental income on a portfolio we forecast will be 16% over-rented
- ▶ Impact of an increase in vacancy with associated costs

## Downside on NAV valuation

### Further 59% NAV downside

We expect NAV to fall by a further 59% to 551p at a trough value in December 2009 from the 1353p reported at June 2008. Our trough forecast is 66% lower than the peak at June 2007.

We forecast the portfolio initial yield to rise to 7.9% at December 2010 from 4.9% at September 2008, and that an average 22% fall in the ERV of the portfolio reduces the reversionary yield to 6.7%.

Our NAV forecast includes a GBP89m deficit from a development programme that is just under 55% pre-let and that we estimate has a GBP1.1bn end value.

### NAV reduction indicates further share price downside

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 469p, which is 5% higher than the current share price.

## Forecasting gearing covenant

### Long average debt maturity and low debt costs

#### Hammerson key debt statistics at June 2008

Net gearing	77%
LTV	42%
Weighted average cost of debt	5.9%
Interest cover	1.7
Net debt (GBPm)	2,988
Debt maturing by December 2010	54
% of total debt	2%
Weighted average maturity (WAM) - (years)	8.0
Cash & Committed undrawn facilities	600

Source: Company data, HSBC estimates

Hammerson is set to benefit from 43% variable debt at June 2008.

### Gearing covenant breach forecast

The most onerous financial covenants for the company are 150% financial gearing and 1.25x of interest cover ratio. We forecast that the ratio for net consolidated borrowings to adjusted net assets rises to 204% at December 2009 from 77% reported at June 2008, assuming no further sales.

### Interest cover to remain strong throughout our forecast period to 2013

We expect interest cover to remain in a 1.7x-1.9x range throughout our forecast horizon. This is well above the 1.25x minimum required by financial covenant and the REIT regulations.

## Risks

Successful execution of planned disposals could alleviate the potential financial covenant breach and increase the dividend payout.

The prospect of a takeover at or above our NAV valuation is a risk to our rating and our target price.

## Financials & valuation: Hammerson

Underweight (V)

### Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	156	173	365	385
EBITDA	205	261	288	303
Depreciation & amortisation	-29	8	0	0
Operating profit/EBIT	235	254	283	298
Net interest	-117	-117	-168	-178
PBT	110	-1,491	-680	186
HSBC PBT	117	122	115	120
Taxation	1	-1	-1	-1
Net profit	101	-1,502	-691	175
HSBC net profit	117	121	114	119

### Cash flow summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Cash flow from operations	208	289	288	303
Capex	-380	-321	-155	0
FCF enterprise	-174	-61	132	302
Cash flow from investment	363	-50	0	0
Dividends	-73	-81	-37	-41
Change in net debt	252	675	81	-80
FCF equity	-291	-178	-36	124

### Balance sheet summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Tangible fixed assets	7,441	5,776	5,101	5,162
Current assets	152	233	231	207
Cash & others	293	293	294	294
Total assets	7,594	6,009	5,332	5,369
Gross debt	2,789	3,463	3,546	3,466
Net debt	2,496	3,170	3,252	3,172
Shareholders funds	4,355	2,385	1,622	1,739
Invested capital	7,441	5,776	5,101	5,162

### Ratio, growth and per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Y-o-y % change</b>				
Revenue	-44.0	11.0	110.8	5.6
EBITDA	8.8	27.3	10.1	5.5
EBIT	16.5	8.2	11.4	5.6
PBT	-86.1	-1450.5		
HSBC EPS	20.1	3.1	-5.9	5.0

### Ratios (%)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Revenue/IC (x)	0.0	0.0	0.1	0.1
ROIC	2.1	3.6	4.7	4.7
ROE	2.7	3.6	5.7	7.1
ROA	0.0	0.0	0.0	0.0
EBITDA margin	131.6	151.0	78.9	78.8
Operating profit margin	150.4	146.7	77.5	77.5
EBITDA/net interest (x)	1.8	2.2	1.7	1.7
Net debt/equity	57.3	133.0	200.5	182.4
Net debt/EBITDA (x)	12.2	12.1	11.3	10.5
CF from operations/net debt	8.3	9.1	8.8	9.6

### Per share data (GBPp)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
EPS Rep (fully diluted)	34.88	-518.00	-238.37	60.21
HSBC EPS	40.40	41.64	39.19	41.16
DPS	27.30	12.79	14.23	21.32
NAV	1503.66	822.36	559.16	599.49
NAV (adjusted)	1544.82	822.36	559.16	599.49

### Key forecast drivers

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Shopping centres cap growth (%)	-3	-28	-18	1
Retail parks cap growth (%)	-5	-34	-12	3
London offices cap growth (%)	-1	-34	-22	1
Continental Europe cap growth	15	-19	-18	1

### Valuation data

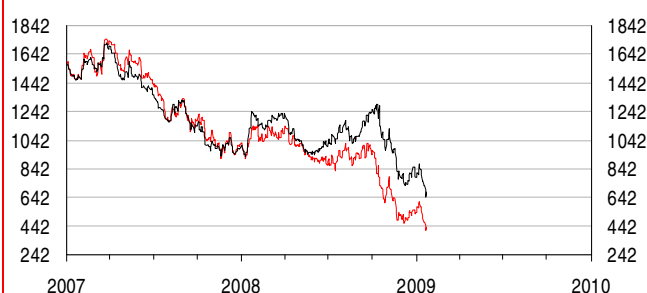
Year to	12/2007a	12/2008e	12/2009e	12/2010e
Premium/ (discount) to NAV	-70.4	-45.8	-20.3	-25.7
Premium/ (discount) to NAV (adj)	-71.2	-45.8	-20.3	-25.7
PE*	11.0	10.7	11.4	10.8
FCF yield (%)	-2.3	9.8	7.0	7.1
Dividend yield (%)	6.1	2.9	3.2	4.8

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	446	Target price (GBPp)	375	Potentl tot rtn (%)	-15.8
Reuters (Equity)	HMSO.L	Bloomberg (Equity)	HMSO LN		
Market cap (USDm)	1,879	Market cap (GBPm)	1,294		
Free float (%)	100	Enterprise value (GBPm)	4464		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	John Fraser-Andrews	Contact	44 20 7991 6732		

### Price relative



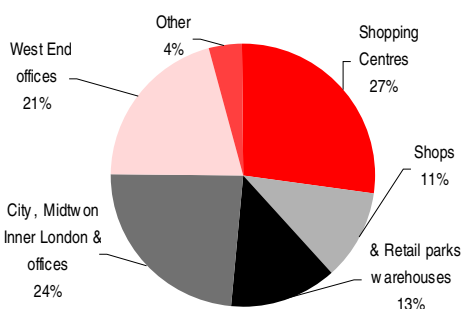
Source: HSBC

Note: price at close of 19 Jan 2009

# Land Securities

- ▶ Portfolio vulnerable to increased vacancy
- ▶ Expect one-third underlying profit fall in 2008-2010 to spark 30% dividend cut
- ▶ Reiterating Underweight rating on a target price reduced to 555p from 840p

Land Securities portfolio split at September 2008



Source: Company data

## Share price under pressure

The shares have matched the 70% fall in the FTSE 350 index since the sector peak in January 2007. This fall includes a 23% slide in the year to date and we are projecting 22% further downside as the fall in profits impacts on dividends.

## DCF valuation implies further downside

### Land Securities summary valuation

Share price (p)	712
DCF valuation & target price (p)	555
Potential return	-22.0%
Benchmark	8.0%
Versus benchmark	-30.0%

Source: HSBC estimates

We project 22% share price downside to our 555p DCF valuation and target price, which we have reduced from 840p.

### Portfolio exposed to ERV forecast fall

Our reduced target price reflects our valuation of cash flows, which we project are on a downward slope from the current year given our forecast for a 28% fall in Estimated Rental Value. We project this fall leaves the investment portfolio 21% over-rented.

The group's rental income is exposed to the impact of our Estimated Rental Value reduction as 14% of passing rental income (including leases under negotiation at September 2008) is subject to lease break or expiry to March 2010 and 27% of rental income exposed to March 2012.

We forecast an average 13% tenant exit rate on lease expiry or break clause through to March 2010, which increases portfolio vacancy by 2%

from 4% at September 2008, and we expect a further 8% increase in effective vacancy due to bad debts on retail tenants in administration. Associated empty buildings holding costs further dilute profits until occupancy recovers in our projections in 2011.

Our key DCF valuation assumptions are:

- ▶ 4.9% (previously 5.5%) post-tax cost of debt with a 60% (previously 52%) target gearing level
- ▶ 10.19% (previously 8.98%) cost of equity with a 1.83x (previously 1.28x) beta adjusted to reflect relatively high financial gearing and reversionary gap/over renting.
- ▶ WACC at 7.3% (previously 7.12%).
- ▶ 1.5% (previously 2%) free cash flow growth from 2014 to perpetuity.

Under our research model, for stocks without a volatility indicator, the Neutral band is 5ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 555p implies a negative potential total return of 22%, which is outside the Neutral band of 3.0% to 13.0%, we reiterate our Underweight rating.

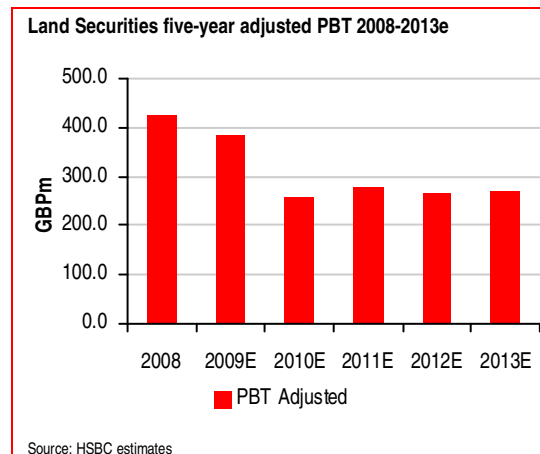
### High dividend yield required for ex-growth cash outlook

The shares provide a 9.0% prospective dividend yield that we project will reduce to 6.3% on our 30% dividend cut forecast to 2010.

Our dividend forecast assumes the requirement to preserve capital and re-establish a level of cover at 1.2x in 2010 to resume a progressive growth policy.

Our 555p target price implies a dividend yield of 8.1% on our reduced 2010 forecast and 9.8% on our 2013 forecast. We regard this level of income as necessary given our forecast for over-renting impact to continue until 2027.

### Profit reduction in store

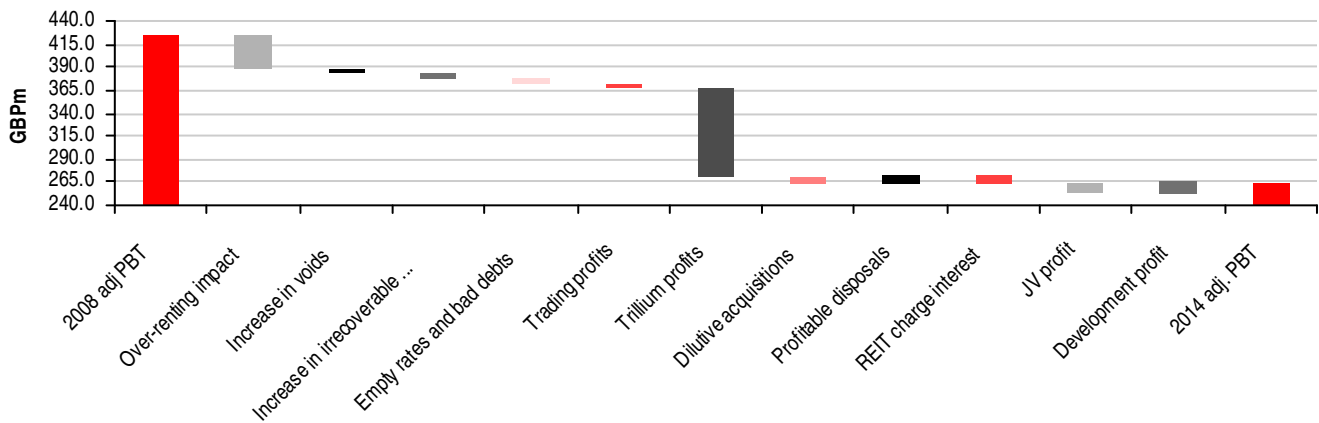


We forecast a 36% fall in adjusted PBT over the five years to 2013, which breaks back to a 18% underlying fall after stripping out GBP49m profit in 2008 from non-recurring gains by Trillium and a JV land sale.

We project a 32% dip in underlying adjusted PBT in the two years to March 2010 stripping out Trillium. The principal components of this forecast fall are:

- ▶ GBP12m loss of occupancy
- ▶ GBP24m bad debt change with tenants in administration
- ▶ GBP18m increase in empty buildings business rates charge.

Land Securities adjusted PBT bridge 2008-2014e



Source: HSBC estimates

## Downside on NAV valuation

### Further 55% NAV downside

We forecast that NAV falls by a further 56% to a trough 687p value in March 2010 from the 1552p reported at September 2008. Our trough forecast is 69% lower than the 2236p peak at June 2007.

We are forecasting that the portfolio falls 30% between September 2008 and March 2010 and that the initial yield rises to 8.4% from a 6.1% at September 2008, accompanied by a 28% fall in the ERV of the portfolio. We are projecting a reversionary yield of 6.8% at March 2010.

### NAV reduction not reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 583p, which is an 18% discount to the current share price.

## Financial covenants under pressure

### Land Securities key debt statistics pro forma sale of Trillium

Net adjusted gearing	68%
Security pool LTV post LST sale	46%
Weighted average cost of debt	5.0%
Interest cover	2.2
Net debt (GBPm)	5,187
Debt maturing by December 2010	106
% of total debt	2%
Weighted average maturity (WAM) - (years)	10.7
Cash & Committed undrawn facilities	874

Source: Company data, HSBC estimates

Land Securities' 2004 re-financing placed almost all its debt in an innovative security pool on LTV covenants that were deemed extremely conservative at the time.

The rapid fall in capital values since September 2007 and our forecast for a further 30% fall in values from September 2008 puts those covenants in jeopardy.

Post the GBP518m cash proceeds and retired debt from Trillium, we estimate the secured debt group reaches 65% LTV at March 2010 on our 30% forecast fall in the portfolio. We expect this to require a GBP293m cash injection into the fund to cover two-thirds of 18-month interest payments required in a 55-70% LTV band.

We forecast that the 65% third-tier threshold will be just reached on the basis of a 30% portfolio fall

and the GBP213m sales made in Q3 2009. Additional sales should avert this eventuality, failing which, a GBP25m cash injection into a liquidity fund is required for each month in the third-tier threshold.

We project that the group LTV of 53% at September 2008 on adjusted assets including share of JVs will increase to 65% after our forecast 30% portfolio fall to March 2010.

**Interest cover to remain strong throughout our forecast period to 2013**

Our rent reduction forecasts and empty-rate costs reduce interest cover to a trough multiple of 2.0x in the year to March 2012e on a proportionally consolidated basis. This is well above the 1.25x minimum required by the REIT regulations.

**Risks**

A sudden recovery in London office and retail occupational demand and flat portfolio market rental values would positively affect our DCF valuation, target price and rating.

Significant asset sales would avert some of the rental and asset value downside in our forecasts and DCF valuation.

## Financials & valuation: Land Securities Group

Underweight

### Financial statements

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	790	780	742	759
EBITDA	658	618	472	509
Depreciation & amortisation	46	31	20	20
Operating profit/EBIT	612	586	452	489
Net interest	-232	-232	-223	-239
PBT	-889	-3,950	-1,210	445
HSBC PBT	425	382	260	280
Taxation	11	-8	-3	-3
Net profit	-878	-3,957	-1,212	443
HSBC net profit	436	375	257	277

### Cash flow summary (GBPm)

Cash flow from operations	699	554	472	509
Capex	-546	-417	-220	-200
FCF enterprise	123	193	250	306
Cash flow from investment	0	0	0	0
Dividends	-308	-298	-284	-173
Change in net debt	297	-489	276	144
FCF equity	-109	-39	27	67

### Balance sheet summary (GBPm)

Tangible fixed assets	12,915	8,713	7,684	8,049
Current assets	2,289	772	675	680
Cash & others	20	35	35	35
Total assets	15,205	9,485	8,359	8,730
Gross debt	5,405	4,931	5,207	5,352
Net debt	5,385	4,896	5,172	5,316
Shareholders funds	9,083	5,120	3,718	3,944
Invested capital	12,915	8,713	7,684	8,049

### Ratio, growth and per share analysis

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Y-o-y % change</b>				
Revenue	-6.8	-1.3	-4.9	2.4
EBITDA	4.8	-6.2	-23.5	7.7
EBIT	2.9	-4.3	-22.8	8.0
PBT	-144.9			
HSBC EPS	49.6	-13.9	-31.4	7.7
<b>Ratios (%)</b>				
Revenue/IC (x)	0.1	0.1	0.1	0.1
ROIC	4.8	5.8	5.8	6.5
ROE	4.4	5.3	5.8	7.2
ROA	0.0	0.0	0.0	0.0
EBITDA margin	83.3	79.2	63.7	67.0
Operating profit margin	77.5	75.2	61.0	64.4
EBITDA/net interest (x)	2.8	2.7	2.1	2.1
Net debt/equity	56.2	95.6	139.1	134.8
Net debt/EBITDA (x)	8.2	7.9	10.9	10.4
CF from operations/net debt	13.0	11.3	9.1	9.6

### Per share data (GBPp)

EPS Rep (fully diluted)	-189.13	-852.10	-261.09	95.33
HSBC EPS	93.82	80.75	55.35	59.61
DPS	64.00	61.11	37.24	42.83
NAV	2063.29	1102.60	800.52	849.34
NAV (adjusted)	1955.88	995.84	697.57	750.06

### Key forecast drivers

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Shopping centres cap growth(%)	-11	-35	-16	2
Retail parks cap growth (%)	-16	-32	-8	2
West End offices cap growth (%)	-5	-31	-20	2
City offices cap growth (%)	-20	-45	-15	2
Development surplus (£m)	0	0	0	0

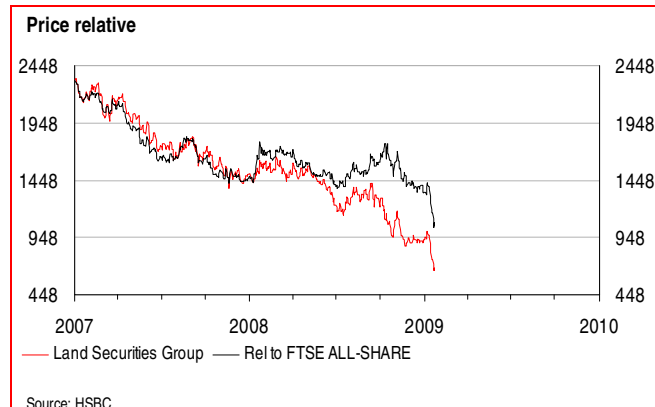
### Valuation data

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Premium/ (discount) to NAV	-65.5	-35.4	-11.1	-16.2
Premium/ (discount) to NAV (adj)	-63.6	-28.5	2.1	-5.1
PE*	7.6	8.8	12.9	11.9
FCF yield (%)	9.6	9.7	6.8	7.7
Dividend yield (%)	9.0	8.6	5.2	6.0

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

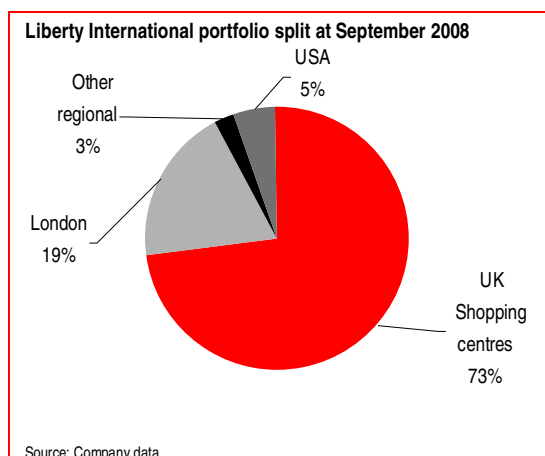
Share price (GBPp)	712	Target price (GBPp)	555	Potentl tot rtn (%)	-22.0
Reuters (Equity)	LAND.L	Bloomberg (Equity)	LAND LN		
Market cap (USDm)	4,810	Market cap (GBPm)	3,312		
Free float (%)	100	Enterprise value (GBPm)	8208		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	John Fraser-Andrews	Contact	44 20 7991 6732		



Note: price at close of 19 Jan 2009

# Liberty International

- ▶ Increasing forecast dividend cut to 25% in 2009 on profit collapse
- ▶ NAV downside and potential financial covenant breach on forecast 28% fall in the portfolio
- ▶ Reiterating Underweight rating (adding V) on target price reduced to 320p from 555p



## Share price under pressure

The shares have matched the sector's 70% fall since the beginning of January 2008.

We project 27% further downside as the consequences of the retailer wipe-out impact on rental values in regional shopping centres and Covent Garden.

## DCF valuation implies further downside

### Liberty International summary valuation

Share price (p)	440
DCF valuation & target price (p)	320
Potential return	-27.3%
Benchmark	8.0%
Versus benchmark	-35.3%

Source: HSBC estimates

We have reduced our target price to 320p from 555p, implying 27% share price downside. This reflects our 20% forecast fall in regional shopping centre rental value, reducing the portfolio rental reversion to 5% (27% at September 2008) on our estimates.

Our key DCF valuation assumptions are:

- ▶ 4.9% (previously 5.7%) post-tax cost of debt with a 55% (previously 65%) target gearing level.
- ▶ 10.65% (previously 10.5%) cost of equity with a 1.76x (previously 1.72x) beta adjusted to reflect relatively high financial gearing.
- ▶ 1.5% (previously 2%) free cash flow growth from 2014 to perpetuity.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt

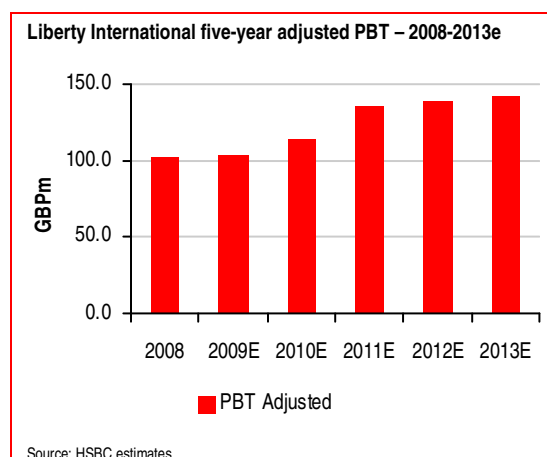
above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 320p implies a negative potential total return of 27.3%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Underweight rating and add a volatility indicator.

### Forecasting 25% dividend cut in 2009

The shares provide a 7.8% prospective dividend yield that we project will fall to 5.8% after our forecast dividend cut of 25% in 2009e.

We project an uncovered dividend in 2008 and that maintaining this level of payout will be untenable in 2009 as the run-down in rental reversion unfolds and as the likelihood of a necessity for an equity capital raising becomes apparent.

### Profit slide set to reverse from 2010



We forecast a 22% adjusted PBT fall in 2008 due to the impact of profit-dilutive acquisitions in Covent Garden and Earls Court (GBP1bn invested in 2006-07 at around 4.5% blended yield), increased vacancy/bad debts and empty rates accounting for 5% of regional shopping centre annualised rent and significantly higher administration costs.

We forecast a modest recovery in 2009 due to administration cost savings from recent headcount savings, which we expect to be offset by an

increase in vacancy, bad debts and empty rates charges to 11% of the regional shopping centres' current annualised rental income.

We estimate 2007 adjusted PBT will recover by 2011 on the assumption that the recession-induced decrease in occupancy is recovered by 2012, alongside the resumption of rental reversion from 2011.

### Downside on NAV valuation

#### Further 61% NAV downside

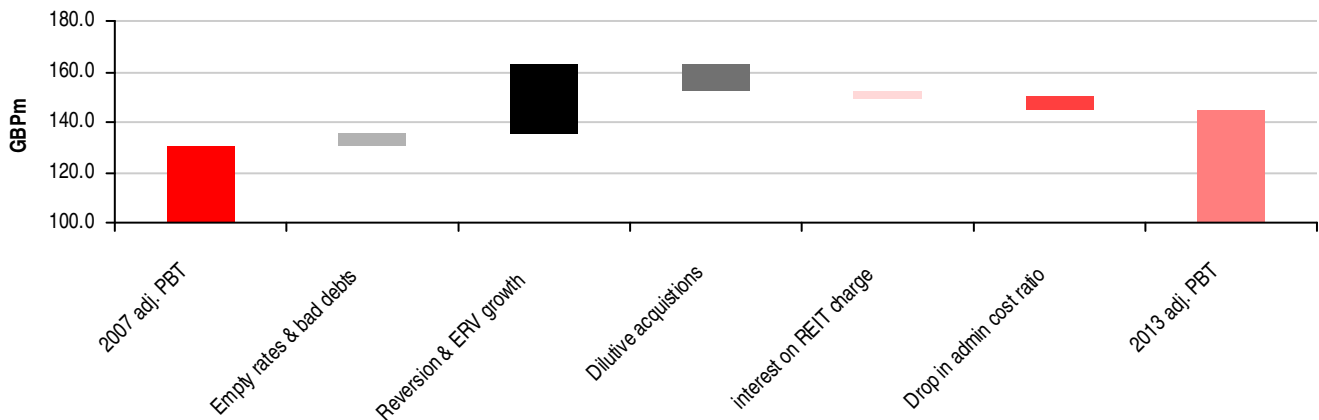
We expect NAV to fall by a further 61% to 382p at a trough value in December 2009 from the 975p reported at September 2008. Our trough forecast is 72% lower than the peak at June 2007.

We forecast that the equivalent yield on the regional shopping centre portfolio rises to 7.25% from 5.86% at September 2008, accompanied by an average 20% fall in the ERV of the portfolio. These factors combine to produce our projection of a further 28% fall in the portfolio from September 2008.

#### NAV reduction not reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 327p, which is a 26% discount to the current share price.

Liberty International adjusted PBT bridge, 2007-2013e



Source: HSBC estimates

## Financial covenants under pressure

### Gearing covenants squeezed on our asset projections

#### Liberty International key debt statistics

Net gearing	110%
LTV	50%
Weighted average cost of debt	6.0%
Interest cover	1.4
Net debt (GBPm)	4,040
Debt maturing by December 2010	338
% of total debt	5.6%
Weighted average maturity (WAM) - (years)	6.4
Cash & Committed undrawn facilities	335

Source: Company data, HSBC estimates

### Financial covenants in jeopardy

The most onerous financial covenants are on the GBP4bn non-recourse secured debt, ranging from 70% to 90% on the non-recourse bank loans, whose requirements are specific to each loan. We expect some of the loans to be in breach of covenants as the LTV ratio would rise from 61% at September 2008 to 85% on our forecast 28% portfolio fall and to 76% if all investment properties were in the security pool.

The public CMBS debt is also at risk of breaching LTV covenants with a 28% fall in regional shopping centres implying that the LTV on the Metrocentre loan rises from 64% at September

2008 to 88% at December 2009, just below the 90% LTV covenant level.

We expect the net debt to shareholders funds ratio to rise to 284% at December 2009 from 122% at September 2008, which is likely to reaffirm the requirement for an equity injection.

### Interest cover forecast to remain within covenants

Our rent and cost forecasts indicate that the interest cover will remain stable at a trough multiple of 1.50x in the year to December 2010e, which is above the 1.25x minimum required by REITs regulations and 1.20x required by some of the debt covenants.

### Risks

Greater resilience in shopping centre portfolio rental values than we are forecasting would positively affect our DCF valuation, target price and rating.

Following strategic stake-building in 2008 by Westfield and Simon Property Group, the prospect of a takeover prior to our projected trough in asset values is a risk to our rating and our target price.

## Financials & valuation: Liberty International

Underweight (V)

### Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	575	548	548	548
EBITDA	331	338	325	357
Depreciation & amortisation	0	22	1	1
Operating profit/EBIT	331	316	324	356
Net interest	-201	-214	-221	-242
PBT	-264	-2,085	-965	191
HSBC PBT	131	102	103	114
Taxation	-30	-2	-2	-2
Net profit	-292	-2,085	-965	191
HSBC net profit	128	100	101	112

### Cash flow summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Cash flow from operations	228	372	325	357
Capex	-230	-203	-100	-63
FCF enterprise	71	134	222	291
Cash flow from investment	34	0	0	0
Dividends	-128	-128	-72	-108
Change in net debt	595	265	156	47
FCF equity	-130	-81	2	50

### Balance sheet summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Tangible fixed assets	8,624	6,769	5,828	5,969
Current assets	360	418	369	373
Cash & others	293	294	294	294
Total assets	8,984	7,188	6,198	6,342
Gross debt	3,961	4,227	4,384	4,431
Net debt	3,668	3,933	4,090	4,137
Shareholders funds	4,507	2,532	1,438	1,556
Invested capital	8,451	6,621	5,631	5,801

### Ratio, growth and per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Y-o-y % change</b>				
Revenue	2.1	-4.7	0.0	0.0
EBITDA	-2.9	2.1	-4.0	9.9
EBIT	-3.0	-4.4	2.4	9.9
PBT	-129.3			
HSBC EPS	1.5	-26.3	1.3	10.7
<b>Ratios (%)</b>				
Revenue/IC (x)	0.1	0.1	0.1	0.1
ROIC	4.5	4.6	5.4	6.3
ROE	2.8	2.8	5.1	7.5
ROA	-0.7	-24.3	-10.8	7.0
EBITDA margin	57.7	61.8	59.3	65.2
Operating profit margin	57.6	57.8	59.2	65.0
EBITDA/net interest (x)	1.7	1.6	1.5	1.5
Net debt/equity	81.4	155.3	284.4	265.9
Net debt/EBITDA (x)	11.1	11.6	12.6	11.6
CF from operations/net debt	6.2	9.5	7.9	8.6

### Per share data (GBPp)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
EPS Rep (fully diluted)	-77.60	-554.48	-256.55	50.92
HSBC EPS	36.03	26.56	26.91	29.80
DPS	34.11	34.11	19.07	28.64
NAV	1212.40	672.77	381.92	413.17
NAV (adjusted)	1263.53	672.77	381.92	413.17

### Key forecast drivers

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Shopping centres cap growth (%)	0	-41	-17	2
Capco UK cap growth (%)	23	-42	-14	1
US cap growth (%)	8	-8	-10	1

### Valuation data

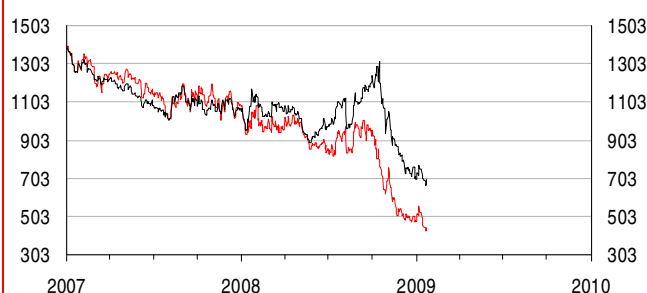
Year to	12/2007a	12/2008e	12/2009e	12/2010e
Premium/ (discount) to NAV	-63.7	-34.6	15.2	6.51
Premium/ (discount) to NAV (adj)	-65.2	-34.6	15.2	6.5
PE*	12.2	16.6	16.4	14.8
FCF yield (%)	0.2	3.8	6.5	7.0
Dividend yield (%)	7.8	7.8	4.3	6.5

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	440	Target price (GBPp)	320	Potentl tot rtn (%)	-27.2
Reuters (Equity)	LII.L	Bloomberg (Equity)	LII LN		
Market cap (USDm)	2,318	Market cap (GBPm)	1,596		
Free float (%)	100	Enterprise value (GBPm)	5529		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	John Fraser-Andrews	Contact	44 20 7991 6732		

### Price relative



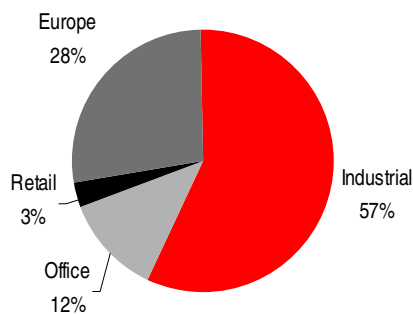
Source: HSBC

Note: price at close of 19 Jan 2009

# SEGRO

- ▶ Breach of debt covenants on the horizon
- ▶ Dividend yield to tumble on 29% forecast profit fall
- ▶ Reiterating our Underweight rating (adding V), on target price reduced to 160p from 325p

SEGRO portfolio split at June 2008



Source: Company data, HSBC estimates

## DCF valuation implies further downside

### SEGRO summary valuation

Share price (p)	190
DCF valuation & target price (p)	160
Potential return	-15.8%
Benchmark	8.0%
Versus benchmark	-23.8%

Source: HSBC estimates

Our new 160p target price (previously 325p) reflects our valuation of cash flows which we project have peaked given our forecast for a 20% fall in Estimated Rental Value, which we project leaves the current rent roll 18% over-rented.

We forecast a sharp correction in profit and cash generation in 2009 followed by stagnation to 2013e. This results from the earnings-enhancing gearing of the development programme offset by loss of rental income to our projected reversion.

Deteriorating trading conditions, over-renting and a squeeze on development margins have, in our view, neutered profit growth prospects in the near term.

Our key DCF valuation assumptions are:

- ▶ 5.2% (previously 5.7%) post-tax cost of debt with a 50% (previously 56%) target gearing level.

## Share price under pressure

The shares have underperformed the FTSE350 Real Estate index by 10% in the year to date, falling 23% and bringing the total fall in value to 75% since the sector peak in January 2007. We project 10.5% downside as prospects for the industrial occupier markets in the UK and Continental Europe deteriorate.

We expect the shares to remain under pressure as speculative developments are put on hold and with them, the prospect for profit growth.

- ▶ 10.6% (previously 9.24%) cost of equity with a 1.75x (previously 1.36x) beta adjusted to reflect relatively high financial gearing and development exposure.
- ▶ 1.25% (previously 2%) free cash flow growth from 2014 to perpetuity.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 170p implies a negative potential total return of 15.8%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Underweight rating and add a volatility indicator.

### Dividend yield supportive at lower level

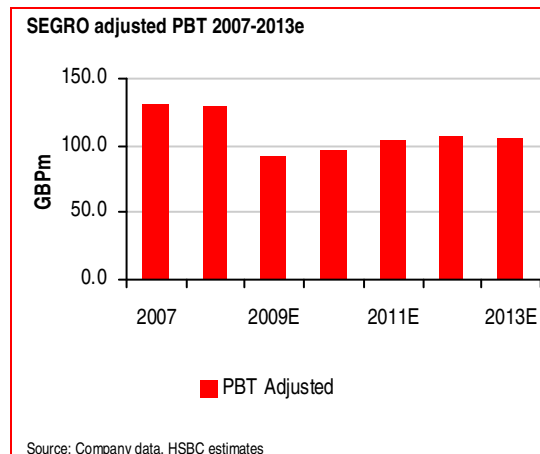
The shares provide a 12.1% historic dividend yield that we project will fall to 7.2% on our target price and dividend forecast in 2009E.

We believe this level of dividend income is required, given that growth prospects are neutered by the necessity to preserve capital in the light of financial covenant restrictions.

We have reduced our forecast dividends for 2008 and 2009 to our estimate of the PID payout, which represents a 41% cut. This reflects our expectation that capital needs to be conserved to mitigate financial gearing covenant breach

We forecast a resumption to 5% growth from 2010 with payouts just ahead of PID and covered 1.4-1.5x by our adjusted earnings forecast.

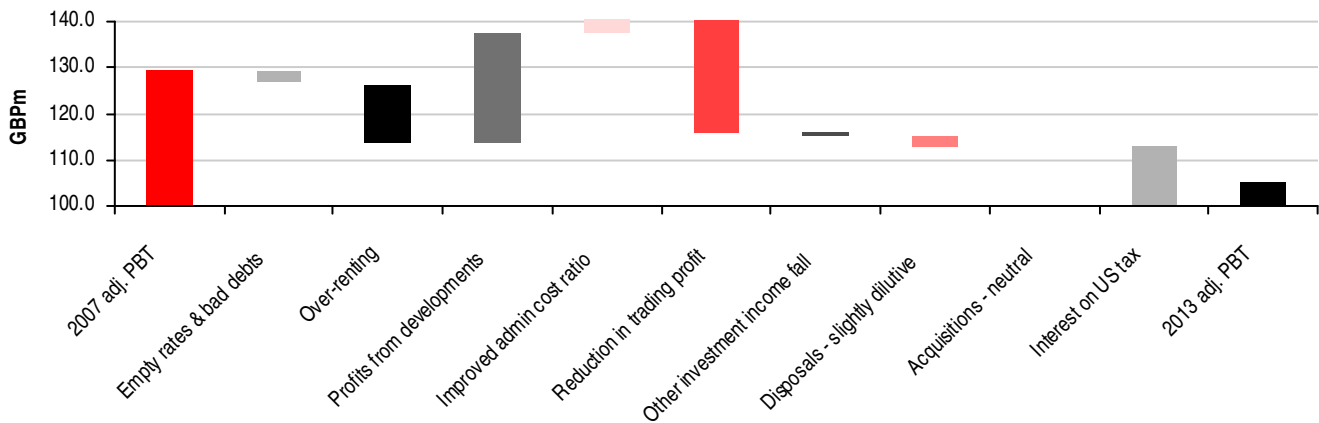
### Profit fall pending



We forecast a 19% fall in adjusted PBT over the course of the five years to 2013, with adjusted PBT set to dip 29% to 2009e on lower trading profits and under the weight of the interest on the tax paid on the US disposal in June 2007.

From 2010, a modest recovery is set to take place as recently completed, high-yielding developments become fully income-producing. However, our projected over-renting, along with empty rates and associated costs, will diminish growth prospects significantly.

SEGRO adjusted PBT bridge, 2007-2013e



Source: HSBC estimates

## Downside on NAV valuation

### Further 61% NAV downside

We estimate NAV falls by a further 61% to 240p at a trough value in March 2010 from the 623p reported at June 2008. Our trough forecast is 70% lower than the peak at June 2007.

We project the portfolio initial yield will rise to 9.4% at December 2010 from 6.3% at June 2008, accompanied by an average 20% fall in the ERV of the portfolio, which reduces our forecast reversionary yield to 8.4% at 90% occupancy.

### NAV reduction reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 204p, which is a 7% premium to the current share price.

## Financial covenants under threat

### Long average debt maturity and low debt costs

#### SEGRO key debt statistics

Net gearing	79%
LTV	43%
Weighted average cost of debt	5.5%
Interest cover	2.1
Net debt (GBPm)	2,190
Debt maturing by June 2010	216.1
% of total debt	10%
Weighted average maturity (WAM) - (years)	9.5
Cash & Committed undrawn facilities	808

Source: Company data, HSBC estimates

SEGRO's short-term financing issues are covered with GBP216m of debt maturing by June 2010, and GBP400m committed capex comfortably covered by GBP800m cash and committed facilities. The LTV of 43% would increase to 66% after our forecast 35% portfolio fall to December 2009.

### Financial covenant set to be breached

The most onerous financial covenant is the net gearing to adjusted net assets at 125% on bank debt and 175% on bond debt. We forecast that gearing levels will rise to a peak of 234% by December 2009, which is well above covenant limits.

We believe that SEGRO will be forced to raise equity to reduce the gearing level within the bond covenant of 175%. We estimate the required equity at GBP1.1bn to the 125% bank debt

covenant and approximately GBP600m to the bond covenant.

**Interest cover to remain strong throughout our forecast period to 2013**

Our rent reduction forecasts and empty-rate costs reduce interest cover to a trough multiple of 1.85x in the year to December 2009e but this is well above the 1.25x minimum required by banking covenants and REITs regulations.

**Risks**

Stronger than expected industrial occupier markets in the UK and Europe would positively affect our DCF valuation, target price and rating.

Moderation of the Empty Building Business Rates Act would positively impact our cash flows and target price.

## Financials & valuation: SEGRO

Underweight (V)

### Financial statements

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	259	307	311	328
EBITDA	215	240	212	225
Depreciation & amortisation	5	2	0	0
Operating profit/EBIT	210	238	210	223
Net interest	-83	-107	-122	-130
PBT	-247	-1,087	-494	169
HSBC PBT	131	129	92	96
Taxation	2	-4	-3	-3
Net profit	-244	-1,091	-497	166
HSBC net profit	133	125	89	93

### Cash flow summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Cash flow from operations	181	187	212	225
Capex	0	0	0	0
FCF enterprise	217	236	209	222
Cash flow from investment	1,119	205	0	0
Dividends	-336	-102	-110	-110
Change in net debt	-522	551	169	115
FCF equity	134	129	87	92

### Balance sheet summary (GBPm)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
Tangible fixed assets	4,486	3,585	3,149	3,322
Current assets	791	650	650	634
Cash & others	348	75	76	76
Total assets	5,276	4,234	3,799	3,956
Gross debt	2,049	2,327	2,498	2,613
Net debt	1,701	2,252	2,422	2,537
Shareholders funds	2,990	1,621	1,042	1,084
Invested capital	4,486	3,585	3,149	3,322

### Ratio, growth and per share analysis

Year to	12/2007a	12/2008e	12/2009e	12/2010e
<b>Y-o-y % change</b>				
Revenue	-15.1	18.5	1.3	5.5
EBITDA	-10.4	11.7	-11.8	6.2
EBIT	-10.7	13.4	-11.9	6.3
PBT	-135.7			
HSBC EPS	19.1	-0.9	-29.2	4.8
<b>Ratios (%)</b>				
Revenue/IC (x)	0.1	0.1	0.1	0.1
ROIC	4.2	5.9	6.3	6.9
ROE	4.2	5.4	6.7	8.8
ROA	0.0	0.0	0.0	0.0
EBITDA margin	83.0	78.2	68.1	68.6
Operating profit margin	81.1	77.5	67.5	68.0
EBITDA/net interest (x)	2.6	2.2	1.7	1.7
Net debt/equity	56.9	139.0	232.4	234.0
Net debt/EBITDA (x)	7.9	9.4	11.4	11.3
CF from operations/net debt	10.7	8.3	8.7	8.9

### Per share data (GBPp)

Year to	12/2007a	12/2008e	12/2009e	12/2010e
EPS Rep (fully diluted)	-53.39	-251.14	-114.26	38.23
HSBC EPS	29.14	28.87	20.45	21.42
DPS	23.00	16.93	13.63	14.31
NAV	689.03	390.55	239.71	249.41
NAV (adjusted)	704.10	390.55	239.71	249.41

### Key forecast drivers

Year to	12/2007a	12/2008e	12/2009e	12/2010e
UK industrial cap growth (%)	-10	-25	-20	3
Continental Europe cap growth(	9	-12	-15	2

### Valuation data

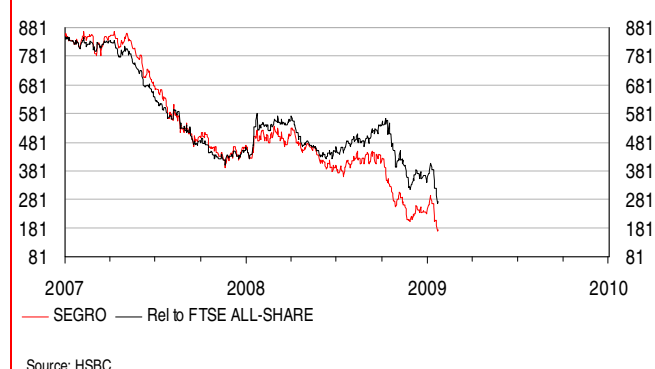
Year to	12/2007a	12/2008e	12/2009e	12/2010e
Premium/ (discount) to NAV	-72.4	-51.4	-20.7	-23.8
Premium/ (discount) to NAV (adj)	-73.0	-51.4	-20.7	-23.8
PE*	6.5	6.6	9.3	8.9
FCF yield (%)	9.5	4.0	11.5	10.8
Dividend yield (%)	12.1	8.9	7.2	7.5

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	190	Target price (GBPp)	160	Potentl tot rtn (%)	-15.5
Reuters (Equity)	SGRO.L	Bloomberg (Equity)	SGRO LN		
Market cap (USDm)	1,195	Market cap (GBPm)	823		
Free float (%)	100	Enterprise value (GBPm)	3075		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	John Fraser-Andrews	Contact	44 20 7991 6732		

### Price relative

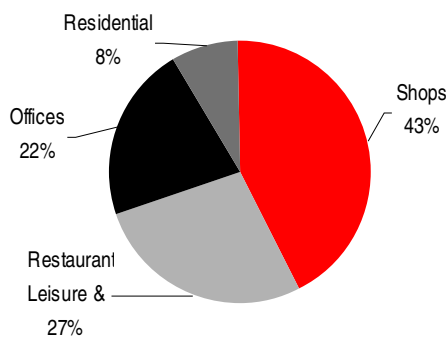


Note: price at close of 19 Jan 2009

# Shaftesbury

- ▶ Low free cash and dividend yields are overvalued
- ▶ Balance sheet resilience maintains headroom over covenants
- ▶ Downgrading to Underweight (V) from Neutral and reducing target price to 255p from 460p

Shaftesbury portfolio split at September 2009



Source: Company data, HSBC estimates

## DCF valuation implies further downside

### Shaftesbury summary valuation

Share price (p)	292
DCF valuation & target price (p)	255
Potential return	-12.7%
Benchmark	8%
Versus benchmark	-20.7%

Source: HSBC estimates

We have reduced our DCF valuation by 45% to reflect a reduction in our perpetuity growth rate, modestly higher vacancy and an increase in our WACC discount rate to 7.5% (7.0%). Our new target price is 255p from 460p previously.

We project mild increases in void to a peak of 5.1% of rent roll from the reported 3.5%. We believe the voids will be re-let relatively quickly, reducing vacancy back to an underlying level of 3% by 2013.

Our key DCF valuation assumptions are:

- ▶ 5.5% (previously 5.94%) cost of debt with a 55% (previously 56%) target gearing level.
- ▶ 10.0% (previously 8.37%) cost of equity with a 1.6x (previously 1.11x) beta adjusted reflecting the relatively low reversionary gap offset by a significant development exposure.

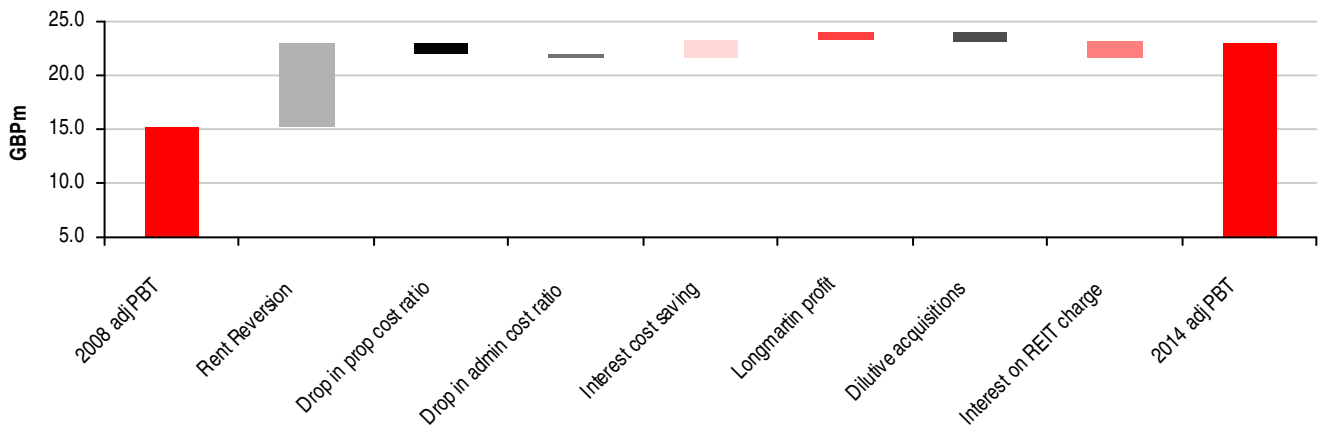
## Share price set to weaken further

The shares have outperformed the FTSE350 Real Estate index since the sector peak in January 2007, with a 64% fall, including an 18% reverse in the year to date.

We project 13% further downside on our projected 15% average fall in ERV.

We believe that the core locations of Shaftesbury's portfolio in the West End should outperform the UK economy as international tourism absorbs falling domestic spending.

Shaftesbury adjusted PBT bridge, 2008-2013e



Source: Company data, HSBC estimates

- ▶ 2.5% free cash flow growth from 2014 to perpetuity reduced from 3.0% to reflect deteriorating global economic conditions.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 255p implies a negative potential total return of 12.7%, which is outside the Neutral band of -2.0% to 18.0%, we downgrade our rating to Underweight (V) from Neutral.

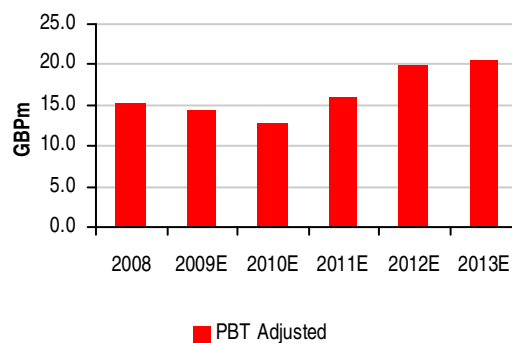
### Lower target price underpinned by dividend yield

The shares provide a 2.8% prospective dividend yield on our forecast 26% fall in the dividend in 2009e. We project the yield will rise to 4.4% by 2013e (1.2x cover) and to 5.4% at our 255p target price.

Our projections for reduced reversion and increased vacancy leave the 2008 dividend uncovered. We are projecting that the dividend is reduced to the PID in 2009e and 2010e (1.3x cover) before resuming double-digit growth through to 2013e as earnings recover.

### Profits to fall in short term

Shaftesbury five-year adjusted PBT, 2008-2013e



Source: HSBC estimates

We forecast 50% growth in adjusted PBT over the five years to 2013, with adjusted PBT set to dip 11% in the two years to September 2010 as the interest carry cost on the Longmartin development and increased vacancy offset modest reversion, and lower interest cost.

Our forecast 68% growth in adjusted PBT from 2010 to 2014 is a result of 13% forecast rent reversion in the existing portfolio, reduction in vacancy from the peak in 2010 and small profit accretion on the JV development. We project a development yield on cost of 6% on the GBP25m capex post our 15% effective rent reduction from ERV versus an average cost of debt at 5.5%.

## Downside on NAV valuation

### Further 47% NAV downside

We expect adjusted NAV to fall by a further 47% to 248p at a trough value in March 2010 from the 471p reported at September 2008. Our trough forecast is 62% lower than the peak at September 2007.

Our forecast is based on a 27% fall in portfolio values from September 2008, which increases the portfolio initial yield to 6.6% from 5.2% at September 2008.

### NAV reduction not reflected in the share price

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 210p, which is a 28% discount to the current share price and supports our DCF valuation.

## Financial covenants appear safe

### Long average debt maturity and low debt costs

#### Shaftesbury key debt statistics

Net Gearing	79%
LTV	43%
Weighted average cost of debt	5.8%
Interest cover	1.7
Net debt (GBPm)	524
Debt maturing by December 2010	0
% of total debt	0%
Weighted average maturity (WAM) - (years)	8.9
Cash & Committed undrawn facilities	308

Source: Company data, HSBC estimates

Shaftesbury has minimal short-term financing issues with:

- ▶ 81% of the debt fixed
- ▶ No debt facilities maturing in the next two years (earliest is April 2016)
- ▶ LTV of 43%, which would increase to 61% after our forecast 24% portfolio fall to March 2010.

### Financial covenants are protected

The most onerous financial covenant net borrowings to shareholder funds (at 175%) and LTV covenants at 67%. We forecast that gearing rises to 174% from 79% at September 2008 and that the LTV rises to 61%, which would avoid covenant breach.

### Interest cover to remain strong throughout our forecast period to 2014

Our rent reduction and increased vacancy forecasts reduce interest cover to a trough multiple of 1.6x in the period to March 2010e, which is above the 1.5x minimum required by the banking covenant.

## Risks

A recovery in consumer spending leading to flat portfolio market rental values would positively affect our DCF valuation, target price and rating.

A resumption in rental growth in excess of our 2.5% perpetuity assumption would enhance our valuation.

## Financials & valuation: Shaftesbury

Underweight (V)

### Financial statements

Year to	09/2007a	09/2008e	09/2009e	09/2010e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	62	65	68	68
EBITDA	43	46	46	46
Depreciation & amortisation	0	0	0	0
Operating profit/EBIT	43	46	46	46
Net interest	-30	-31	-31	-33
PBT	124	-221	-260	-25
HSBC PBT	13	15	15	14
Taxation	141	5	0	0
Net profit	265	-216	-260	-25
HSBC net profit	153	20	14	13

### Cash flow summary (GBPm)

Year to	09/2007a	09/2008e	09/2009e	09/2010e
Cash flow from operations	43	27	0	48
Capex	-10	-15	-15	-10
FCF enterprise	174	36	31	36
Cash flow from investment	0	0	0	0
Dividends	-10	-15	-11	-13
Change in net debt	35	30	29	15
FCF equity	143	5	-1	3

### Balance sheet summary (GBPm)

Year to	09/2007a	09/2008e	09/2009e	09/2010e
Tangible fixed assets	1,394	1,208	949	954
Current assets	25	15	15	15
Cash & others	0	0	0	0
Total assets	1,419	1,223	963	969
Gross debt	495	525	554	568
Net debt	494	524	554	568
Shareholders funds	867	774	642	642
Invested capital	1,394	1,208	949	954

### Ratio, growth and per share analysis

Year to	09/2007a	09/2008e	09/2009e	09/2010e
<b>Y-o-y % change</b>				
Revenue	6.2	4.7	3.8	-0.3
EBITDA	8.2	6.9	0.2	0.4
EBIT	8.2	6.9	0.3	0.4
PBT	-33.8	-277.9		
HSBC EPS		-87.1	-28.4	-7.4
<b>Ratios (%)</b>				
Revenue/IC (x)	0.0	0.1	0.1	0.1
ROIC	3.1	3.4	4.2	4.8
ROE	20.8	2.4	2.0	2.1
ROA	19.7	-16.4	-23.8	-2.6
EBITDA margin	68.8	70.2	67.9	68.4
Operating profit margin	68.6	70.0	67.7	68.2
EBITDA/net interest (x)	1.4	1.5	1.5	1.4
Net debt/equity	57.0	81.6	146.5	154.1
Net debt/EBITDA (x)	11.5	11.4	12.0	12.3
CF from operations/net debt	8.7	5.1		8.4

### Per share data (GBPp)

Year to	09/2007a	09/2008e	09/2009e	09/2010e
EPS Rep (fully diluted)	195.24	-157.53	-189.33	-18.15
HSBC EPS	113.05	14.63	10.47	9.70
DPS	7.66	11.00	8.17	9.70
NAV	471.35	278.52	272.08	290.56
NAV (adjusted)	481.96	278.52	272.08	290.56

### Key forecast drivers

Year to	09/2007a	09/2008e	09/2009e	09/2010e
Shops cap growth %		-2	-8	-8
Restaurants cap growth %		5	0	0
Offices cap growth %		-5	-10	-5
Residential cap growth %		5	-5	-5

### Valuation data

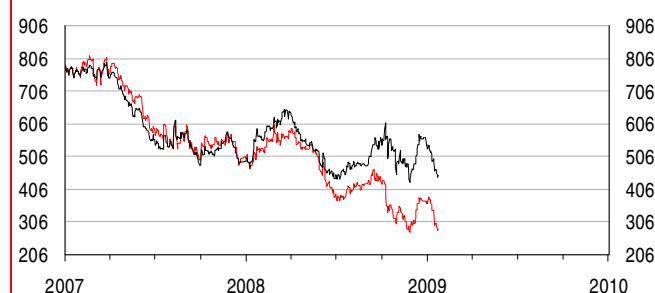
Year to	09/2007a	09/2008e	09/2009e	09/2010e
Premium/ (discount) to NAV	-38.1	4.8	7.3	0.5
Premium/ (discount) to NAV (adj)	-39.4	4.8	7.3	0.5
PE*	2.6	20.0	27.9	30.1
FCF yield (%)	1.1	1.9	1.2	2.5
Dividend yield (%)	2.6	3.8	2.8	3.3

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	292	Target price (GBPp)	255	Potentl tot rtn (%)	-12.6
Reuters (Equity)	SHB.L	Bloomberg (Equity)	SHB LN		
Market cap (USDm)	573	Market cap (GBPm)	395		
Free float (%)	100	Enterprise value (GBPm)	919		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	Nicolas Lyle	Contact	+44 (0) 20 7992 1823		

### Price relative



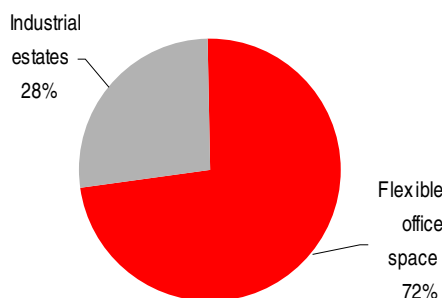
Source: HSBC

Note: price at close of 19 Jan 2009

# Workspace

- ▶ Balance sheet risk provides outstanding opportunities
- ▶ Severe covenant breaches in prospect
- ▶ Reiterating Overweight (V) rating on target price reduced to 75p from 140p

Workspace portfolio split at September 2008



Source: Company data

## Share price slump

The shares have fallen 91% since their peak in February 2007, including a 21% fall since the beginning of January 2009.

We project 67% upside to our 75p DCF valuation that would be unchanged in the event of an equity raising. The earnings and free cash flow dilution would be offset by a lower beta and discount rate to reflect lower financial risk.

## Substantial upside on our DCF valuation

### Workspace summary valuation

Share price (p)	45
DCF valuation & target price (p)	75
Potential return	66.7%
Benchmark	8.0%
Versus benchmark	58.7%

Source: HSBC estimates

Our 75p target price (previously 140p) implies 67% share price upside, which reflects our valuation of cash flows into perpetuity after a 15% reduction in ERV to March 2010. We assume 2% perpetuity growth from 2014E and have discounted the cash flows at a WACC of 8.4%.

We assume that LFL occupancy falls to 80% by March 2010 (87.6% at September 2008) before recovering to 88% in 2014e.

Our key DCF valuation assumptions are:

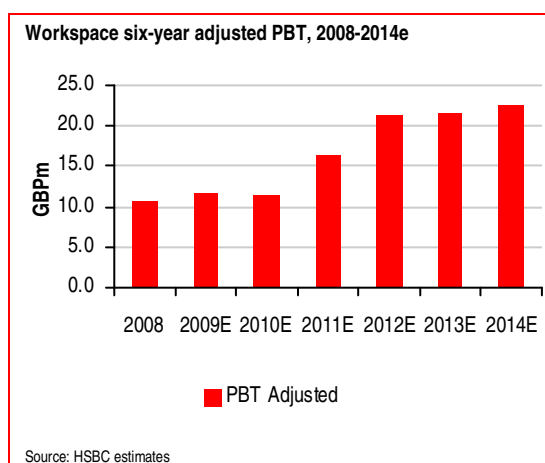
- ▶ 5.9% (previously 6.13%) cost of debt with a 50% (previously 73%) target gearing level.
- ▶ 10.9% (previously 12.17%) cost of equity with a 1.8x (previously 2.19x) beta adjusted to reflect high financial gearing.
- ▶ Retained the level of 2.0% free cash flow growth from 2014 to perpetuity reflecting the long-term growth prospects of the London economy.

## Dividend yield supportive at lower level

The shares provide a 12.8% prospective dividend yield on our forecast of a 4.7p PID payout with that yield rising to 20.7% by 2014 on our forecast for earnings to double in that time period. Our target price projects the dividend yield at 12.4% in 2014e.

Under our research model, for stocks with a volatility indicator, the Neutral band is 10ppt above and below the hurdle rate for UK stocks of 8.0%. As our 12-month target price of 75p implies a potential total return of 66.7%, which is outside the Neutral band of -2.0% to 18.0%, we reiterate our Overweight (V) rating.

## Strong profit growth from the trough



We forecast a doubling in adjusted PBT over the course of the six years to 2014, falling to our trough forecast of GBP11.4m by March 2010 reduced occupancy, empty rates and bad debt costs through the recession.

We expect an upturn in occupancy from our assumed 80% trough (87.6% at September 2008).

We project that the portfolio remains GBP4.9m reversionary after a 15% fall in ERV to 2010. This should enhance the operational gearing impact of recovery in occupancy of the like-for-

like portfolio and the six properties that have been refurbished in the last 12 months.

Workspace is set to be a net beneficiary in a lower interest rate environment with only 57% of debt fixed at 5.3% at September 2008. The balance is hedged with interest caps and collars, therefore allowing reductions in LIBOR to feed through to profits. We have assumed an average cost of debt at 5.75% from 2010.

We project a refurbishment yield on cost of approximately 8.0% on the six completed projects to provide a further GBP2m to adjusted profit.

## NAV valuation supports DCF

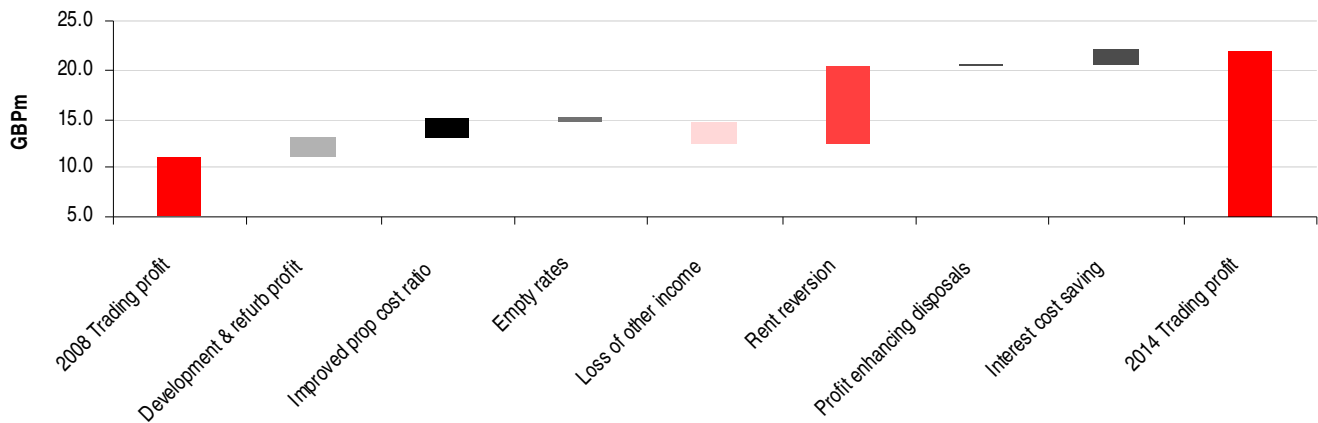
### Project a further 63% fall in adjusted NAV

We forecast that the portfolio will fall a further 30%, leading NAV to fall by a further 63% to 85p at a trough value in March 2010 (232p reported at September 2008). Our trough forecast is 76% lower than the peak at June 2007.

We expect the portfolio initial yield to rise to 8.0% from 6.1% at September 2008 and the reversionary yield to rise to 9.5% on 88% long-term occupancy and our 15% fall in the ERV of the portfolio.

Our NAV forecast does not include any value for alternative use potential, included in the September 2008 valuation at GBP15m. We expect residential demand in London to resume at some point, providing additional upside on our NAV valuation.

Workspace adjusted PBT bridge, 2008-2013e



Source: HSBC estimates

### NAV reduction oversold

Following our adjusted NAV forecast reductions, our equilibrium NAV valuation at a 15% discount to trough NAV is 72p, which is a 60% premium to the current share price.

### Financial covenants set to be severely breached

#### Short debt maturities and high interest costs

##### Workspace key debt statistics, September 2008

Net gearing	111%
LTV	51%
Weighted average cost of debt	6.4%
Interest cover	1.4
Net debt (GBPm)	445
Debt maturing by December 2010	320
% of total debt	72%
Weighted average maturity (WAM) - (years)	2.1
Cash & Committed undrawn facilities	25

Source: Company data, HSBC estimates

Workspace has immediate financing needs. At September 2008, 95% of facilities were drawn. The facilities with GE Capital (72% of total) are maturing in two parts, GBP50m in June 2009 and GBP270m in August 2010.

We expect facilities to be renewed at significantly higher margins of at least 300bps over LIBOR with the potential condition of an equity injection to cure existing covenants.

### Financial covenants breached by property price falls

The most onerous financial covenants are calculated on the LTV and gearing requirements. Our forecast 30% portfolio fall from September 2008 projects an LTV of 62% and a gearing ratio of 176%, against our estimate of 61% on wholly owned debt and 150% gearing.

We calculate that the minimum fall required for the portfolio to breach the LTV covenant is 22% while for a breach of gearing covenant, the required fall is 18% on our projected net debt estimates for 2009 and 2010.

### Glebe Joint Venture requires re-financing

We estimate that the JV will require approximately GBP25m to restore the LTV ratio to 85% post our forecast 30% fall in values and 15% fall in ERV from September 2008. This values the portfolio at circa 9%, assuming unchanged drawn facilities of GBP134m from the interim accounts.

We expect the LTV covenant will be renegotiated given that HBOS is a 30% equity investor and that additional capital is set to be injected post an expected capital raising.

### **Interest cover to remain above covenant during the recession**

Our rent reduction forecasts and increased vacancy assumptions reduce rent roll by a maximum of GBP5m (or 11% of net rental income). This is well within the GBP8-9m of rent roll headroom (or 18% of net rental income) guided by management in November 2008 and well above the 1.25x minimum required by REITs regulations.

### **Risks**

The key risks to our valuation and rating are:

- ▶ We have overestimated a cyclical recovery in the London economy
- ▶ Like-for-like occupancy falls below 80% in the recession and our 15% ERV fall assumption proves optimistic
- ▶ The debt re-financing is unsuccessful and the equity market rejects a capital injection, forcing liquidation.

## Financials & valuation: Workspace Group

Overweight (V)

### Financial statements

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Profit &amp; loss summary (GBPm)</b>				
Revenue	67	69	67	72
EBITDA	40	40	36	40
Depreciation & amortisation	-1	-1	-1	-1
Operating profit/EBIT	39	39	35	40
Net interest	-28	-27	-23	-23
PBT	-42	-308	-79	36
HSBC PBT	11	12	11	16
Taxation	2	2	0	0
Net profit	-39	-306	-80	36
HSBC net profit	13	13	11	16

### Cash flow summary (GBPm)

Cash flow from operations	44	43	37	40
Capex	-19	-8	-5	-5
FCF enterprise	24	34	31	35
Cash flow from investment	0	0	0	0
Dividends	-8	-8	-7	-11
Change in net debt	58	-20	-2	4
FCF equity	-5	7	7	12

### Balance sheet summary (GBPm)

Tangible fixed assets	994	675	594	612
Current assets	36	21	22	37
Cash & others	3	3	3	3
Total assets	1,030	696	616	649
Gross debt	437	418	416	421
Net debt	435	415	414	418
Shareholders funds	541	229	151	180
Invested capital	994	675	594	612

### Ratio, growth and per share analysis

Year to	03/2008a	03/2009e	03/2010e	03/2011e
<b>Y-o-y % change</b>				
Revenue	11.7	3.5	-3.5	8.1
EBITDA	17.0	0.6	-10.3	11.8
EBIT	17.4	0.6	-10.4	12.0
PBT	-132.9			
HSBC EPS	-86.0	4.2	-16.9	41.8
<b>Ratios (%)</b>				
Revenue/IC (x)	0.1	0.1	0.1	0.1
ROIC	4.1	4.6	5.5	6.4
ROE	3.5	5.9	9.6	10.9
ROA	-35.5	-12.1	5.7	6.3
EBITDA margin	59.6	58.0	53.9	55.8
Operating profit margin	58.6	57.0	52.9	54.8
EBITDA/net interest (x)	1.4	1.5	1.5	1.7
Net debt/equity	80.4	181.0	274.3	232.4
Net debt/EBITDA (x)	10.9	10.3	11.5	10.4
CF from operations/net debt	10.1	10.3	8.9	9.6

### Per share data (GBPp)

EPS Rep (fully diluted)	-22.67	-177.05	-46.04	20.74
HSBC EPS	7.49	7.81	6.49	9.20
DPS	4.56	4.74	4.06	6.30
NAV	309.33	130.61	84.99	101.67
NAV (adjusted)	311.06	130.61	84.99	101.67

### Key forecast drivers

Year to	03/2008a	03/2009e	03/2010e	03/2011e
Property capital growth %	-5	-34	-13	3
Rent reductions %	17	-5	-10	2
Occupancy %	86	85	80	83

### Valuation data

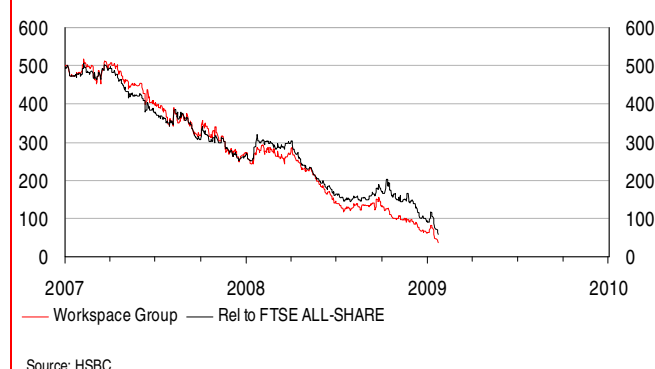
Year to	03/2008a	03/2009e	03/2010e	03/2011e
Premium/ (discount) to NAV	-85.5	-65.5	-47.1	-55.7
Premium/ (discount) to NAV (adj)	-85.5	-65.5	-47.1	-55.7
PE*	6.0	5.8	6.9	4.9
FCF yield (%)	26.7	14.4	6.5	11.2
Dividend yield (%)	10.1	10.5	9.0	14.0

Note: \* = Based on HSBC EPS (fully diluted)

### Issuer information

Share price (GBPp)	45	Target price (GBPp)	75	Potentl tot rtn (%)	65.8
Reuters (Equity)	WKP.L	Bloomberg (Equity)	WKP LN		
Market cap (USDm)	114	Market cap (GBPm)	78		
Free float (%)	100	Enterprise value (GBPm)	494		
Country	United Kingdom	Sector	REAL ESTATE		
Analyst	Nicolas Lyle	Contact	+44 (0) 20 7992 1823		

### Price relative



Note: price at close of 19 Jan 2009

# Appendix

- ▶ Covenant list conveys uniqueness of each restriction
- ▶ Top 10 tables support our ratings

Ranking by debt maturity		
Rank	Company	% of debt facilities maturing by Dec 2010
1	Shaftesbury	0.0%
2	Hammerson	1.8%
3	Land Securities	1.9%
4	British Land	2.9%
5	Liberty International	5.6%
6	Great Portland Estates	7.2%
7	SEGRO	9.9%
8	Derwent London	14.2%
9	Brixton	55.9%
10	Workspace Group	71.9%

Source: Company data, HSBC estimates

- ▶ Workspace and Brixton have the highest proportion of facilities (drawn/undrawn) expiring in the next two years

Ranking by lease expiries		
Rank	Company	% of Leases expiring by Dec 10 / Mar 11
1	British Land	2.0%
2	Liberty International	11.0%
3	Hammerson	11.2%
4	Land Securities	14.1%
5	Brixton	18.3%
6	SEGRO	18.8%
7	*Great Portland Estates	22.5%
8	Derwent London	24.4%
9	Shaftesbury	28.0%
10	Workspace Group	49.5%

Source: Company data, HSBC estimates

\* from January 2009

- ▶ British Land faces the recession with the least vulnerable rent roll in our coverage

Ranking by EV/EBITDA multiple		
Rank	Company	EV / EBITDA (last full yr reported)
1	SEGRO	11.4
2	Workspace Group	12.5
3	Land Securities	12.9
4	British Land	13.3
5	Liberty International	15.9
6	Brixton	16.4
7	Derwent London	17.3
8	Hammerson	18.2
9	Shaftesbury	19.7
10	Great Portland Estates	22.3

Source: Thomson Reuters Datastream, HSBC estimates

- ▶ Great Portland Estates and Shaftesbury look expensive on EBITDA multiples whereas Workspace looks relatively inexpensive

List of debt covenants

Company	Type of debt	Financial gearing covenant	Interest cover covenant	LTV covenant	Comment
British Land	Secured Debt - £1 billion Debentures		1.0	66.7%	Debentures are secured against a combined pool of assets. Company has the flexibility to add or substitute other assets in order to manage the covenants effectively.
	Securitisations	-	1.0	-	- It includes securitisation of Broadgate estate and Meadowhall
	Unsecured Debt	175%	-	70%	LTV indicates Unsecured borrowing to Unencumbered assets. Gearing is defined as Net borrowings to Adjusted Capital Reserves, the latter including approx GBP475m of exceptional refinancing charges.
	Funds & JVs	-	-	-	Funds and JVs include a variety of LTV covenants, with maximum levels ranging from 55% to 90% (except for one Fund in which the LTV is 35%) and several of them also have debt service cover requirements.
Brixton	Secured Non Recourse Financing	-	-	60%	Includes financing within Equiton and Heathrow Big Box.
	Unsecured Bonds - £630 million	175%	-	50%	No interest covenants. LTV covenant indicates secured borrowing to adjusted net assets.
	Unsecured Bank Loans - £415 million	-	1.2	60%	ICR covenant is NRI/Net Interest (incl capitalised interest) at 1.2x. This was 1.8x at H1 08. Unsecured prop assets (wholly owned portfolio)/unsecured borrowings must be a min of 1.67x.
Derwent London	Covenants not disclosed				
Great Portland Estates	Bank Facilities	125%	1.3	60.2%	LTV indicates Unsecured borrowing to Unencumbered assets.
	GCP Loan	-	-	70.0%	This loan also has Interest cover covenant which is higher than GPE covenant. Both of the facilities have substitution or cash trap mechanisms which facilitate covenant compliance.
	GPE 2029 Debenture, GVP1 non-recourse loans	Not Disclosed			
Hammerson	Borrowings	150%	1.25	-	These are tightest conditions amongst the loan categories. Covenants to specific debt type not disclosed.
Land Securities	Secured Debt - £5,336 million Tier 1	-	1.85	55%	If it breaches first two tiers, putting in place progressively a liquidity facility is required.
	Tier 2	-	1.45	65%	
	Initial Tier 3	-	1.2	80%	In Tier 3 operating environment is more restrictive with provisions designed to encourage a reduction in gearing including mandatory debt amortisation.
	Final Tier 3	-	1.0-1.2	80%-100%	
	Default trigger	-	1.0	100%	Triggers an event of default if LTV exceeds 100% or ICR goes below 1.0x.
Liberty International	Non Recourse Secured Debt - £2.1 billion Bank Loans	-	1.0x-1.2x	70%-90%	In CMBS debt and non-recourse bank loans, covenant breaches can be rectified by various remedies ranging from additional security, temporary cash deposit or partial repayment before an event of default occurs.
	Unsecured revolving credit	-	1.25	-	
	CMBS Debt				
	Lakeside	-	1.2	90%	
	Metrocentre	-	1.2	90%	
	Braehead	-	1.2	-	
	Watford	-	1.2	-	
SEGRO	Bank Debt	125%	1.25	-	
	Bonds	175%			
Shaftesbury	Group Borrowings - Banking Facilities	125%	1.5	67%	LTV indicates borrowings to charged assets
	Debenture Stock £61 million	-	1.25	66.7%	Secured by first charged assets.
Workspace Group	Group Borrowings	175%	1.39	61%	For LTV, current valuation to go down 25% to breach covenant, and for gearing, valuation should go down 20% for breach of covenant for a target level of debt of £400m

Source: Company data, HSBC estimates

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	3M	1Y	2Y	3Y	4Y	5Y	6Y	7Y	8Y	9Y	10Y	15Y	20Y	30Y	AVY	5YV
Spot	4.36	5.38	5.30	5.32	5.14	5.09	5.05	5.02	5.01	5.02	5.04	5.05	5.03	4.90	4.82	4.75
1M	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
3M	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
6M	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
9M	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
1Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
2Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
3Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
4Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
5Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
6Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
7Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
8Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
9Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
10Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
15Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
20Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74
30Y	5.00	5.41	5.37	5.30	5.22	5.14	5.09	5.04	5.02	5.02	5.04	5.05	5.03	4.90	4.81	4.74

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# Notes

# Disclosure appendix

## Analyst certification

The following analyst(s), who is(are) primarily responsible for this report, certifies(y) that the opinion(s) on the subject security(ies) or issuer(s) and any other views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: John Fraser-Andrews and Nicolas Lyle

## Important disclosures

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HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its equity research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies on a 12 month time horizon; and 2) from time to time to identify short-term investment opportunities that are derived from fundamental, quantitative, technical or event-driven techniques on a 0-3 month time horizon and which may differ from our long-term investment rating. HSBC has assigned ratings for its long-term investment opportunities as described below.

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## Rating definitions for long-term investment opportunities

### Stock ratings

HSBC assigns ratings to its stocks in this sector on the following basis:

For each stock we set a required rate of return calculated from the risk free rate for that stock's domestic, or as appropriate, regional market and the relevant equity risk premium established by our strategy team. The price target for a stock represents the value the analyst expects the stock to reach over our performance horizon. The performance horizon is 12 months. For a stock to be classified as Overweight, the implied return must exceed the required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). For a stock to be classified as Underweight, the stock must be expected to underperform its required return by at least 5 percentage points over the next 12 months (or 10 percentage points for a stock classified as Volatile\*). Stocks between these bands are classified as Neutral.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

\*A stock will be classified as volatile if its historical volatility has exceeded 40%, if the stock has been listed for less than 12 months (unless it is in an industry or sector where volatility is low) or if the analyst expects significant volatility. However,

stocks which we do not consider volatile may in fact also behave in such a way. Historical volatility is defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility has to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

Prior to this, from 7 June 2005 HSBC applied a ratings structure which ranked the stocks according to their notional target price vs current market price and then categorised (approximately) the top 40% as Overweight, the next 40% as Neutral and the last 20% as Underweight. The performance horizon is 2 years. The notional target price was defined as the mid-point of the analysts' valuation for a stock.

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Prior to 15 November 2004, HSBC's ratings system was based upon a two-stage recommendation structure: a combination of the analysts' view on the stock relative to its sector and the sector call relative to the market, together giving a view on the stock relative to the market. The sector call was the responsibility of the strategy team, set in co-operation with the analysts. For other companies, HSBC showed a recommendation relative to the market. The performance horizon was 6-12 months. The target price was the level the stock should have traded at if the market accepted the analysts' view of the stock.

## Rating distribution for long-term investment opportunities

**As of 23 January 2009, the distribution of all ratings published is as follows:**

<b>Overweight (Buy)</b>	42%	(30% of these provided with Investment Banking Services)
<b>Neutral (Hold)</b>	37%	(34% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	21%	(21% of these provided with Investment Banking Services)

Information regarding company share price performance and history of HSBC ratings and price targets in respect of its long-term investment opportunities for the companies the subject of this report, is available from [www.hsbcnet.com/research](http://www.hsbcnet.com/research).

## HSBC & Analyst disclosures

### Disclosure checklist

Company	Ticker	Recent price	Price Date	Disclosure
BRITISH LAND CO	BLND.L	4.55	22-Jan-2009	2, 5, 6, 11
BRIXTON PLC	BXTN.L	1.01	23-Jan-2009	6, 7, 11
DERWENT LONDON	DLN.L	6.41	23-Jan-2009	11
GREAT PORTLAND EST	GPOR.L	2.27	23-Jan-2009	6, 11
HAMMERSON	HMSO.L	4.30	22-Jan-2009	2, 4, 5, 6, 7
LAND SECURITIES	LAND.L	6.64	22-Jan-2009	2, 5, 6, 7, 11
LIBERTY INTL HLDGS	LII.L	4.40	22-Jan-2009	2, 5, 6, 7
SEGRO	SGRO.L	1.71	22-Jan-2009	6, 7, 11
SHAFTESBURY	SHB.L	2.82	23-Jan-2009	11

Source: HSBC

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