

UK Commercial Property Market Overview

MAY 2007

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The benefits of investing in UK commercial real estate remain compelling

By the end of March 2007, UK commercial property provided higher returns than UK equities and fixed interest over a one, three and ten year period (Source: FTSE All Share index, FTA 5-15 year gilt index ,UK IPD Annual index). Commercial real estate also tends to perform differently to equities and fixed interest, so can help to diversify a portfolio. The strong stable returns that commercial property can offer are particularly attractive to investors with a medium to long term horizon.

Commercial property is an attractive asset because it generates income and capital growth in a strong economy, but can preserve its value when economic fortunes are less healthy and more unstable. The property market's long-established lease structure benefits the investor too as the pattern of regular upward-only rent reviews affords protection from high rates of inflation as well as potential deflationary pressure.

Returns on UK commercial property may well have peaked at just over 18% in 2006 but rather than turn negative, they are far more likely, in our view, to revert to more sustainable levels over the next few years with returns in the range of 6-9% (Source: IPD). The key difference now is that, for the first time in recent years, there will be losers in the UK market as well as winners. These are just normal market conditions. Winners must enhance value through strong management skills, through refurbishment or redevelopment of properties, in so doing, making them more attractive to tenants, current and potential. Winners must find areas of the market where their specialist skills can exploit previously untapped areas of growth, explore developing new markets and capitalize on structural changes in consumer and occupier trends. Winners must keep up with the ever-evolving property market, exploiting the array of developing property investment instruments.

Looking ahead performance in the UK property market is likely to be underpinned by rental growth, particularly in Central London offices, and it is rental growth which is expected to be the key differentiator of performance going forward. In the short term the Central London office market continues to benefit from strong service sector growth, in particular finance and business services, which along with supply-side constraints is driving rents higher.

Investors who are looking to broaden their real estate investment portfolios beyond the UK domestic commercial market should do so not only for long term performance but more importantly to diversify. This may mean both overseas and continental European markets as well as alternative UK sectors such as parts of the residential market (e.g. student accommodation) and properties related to emerging subsectors. These may include properties providing health services and other expanding areas with strong occupational demand. The alternatives should however be part of a balanced strategy and the UK commercial sector remains a strong medium and long term investment as one of the most transparent and liquid property markets in the world.

Economic overview

The UK economy continued to expand briskly in 2007, according to preliminary figures from the Office for National Statistics (ONS), growing by 0.7% in the first quarter and 2.8% year on year. Economic strength continues to be driven by the services sector, in particular business services and finance which grew by 5.2% year on year.

On the consumer front, retail sales remained supportive, with growth steady at 4.5% in the first quarter of 2007 compared to the same period one year earlier. The housing market also strengthened, with the Halifax House Price Index reporting an 11% increase over the 12 months to March, and mortgage approval numbers remaining strong.

The Bank of England increased interest rates in May to 5.5%, but, according to Reuters the majority of economists expect interest rates to peak at that level and to have fallen back by the end of 2007. Similarly, current high consumer price inflation, which stood at 3.1% in March, should prove to be a turning point as lower utility bills bring inflation back towards its 2% target by the end of the year.

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The pace of growth in the UK commercial property market continued to moderate in the three months up to the end of March, following strong returns over 2006. The IPD Monthly Index recorded a total return of 2.3% (9.3% annualised).

Over the past 12 months, capital growth has been largely driven by strong investor demand, which has continued to push yields lower (and prices higher). However, rental growth is now making an increasing contribution to overall returns, with the rate of growth in rents in both the office and industrial sectors having accelerated in 2007.

Investor demand for commercial property remains strong, according to Property Data, with total investment volumes of £10bn seen in the three months to 31 March 2007. However, investors are becoming more selective, as appetite for secondary (lower quality) properties has diminished.

Commercial property continues to offer a superior level of income yield compared to fixed interest* but the differential has narrowed considerably, as property yields have continued to fall and fixed interest yields have risen.

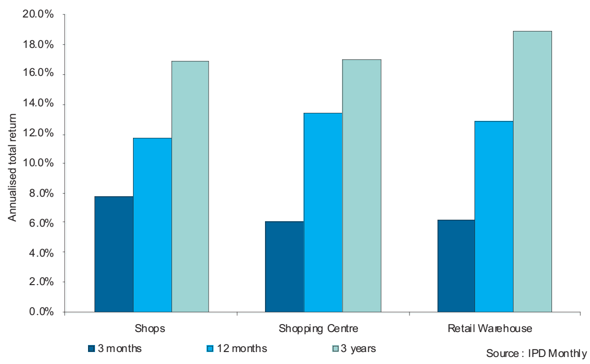
**Source: FTSE, IPD Monthly*

Sector performance

Retail

- The Retail sector returned 1.6% over the first quarter of 2007, underperforming both Offices and Industrials.
- Total returns of 12.8% over the 12 months to March 2007 were also below those recorded by both Offices and Industrials.
- Over the three years to March retail property recorded an annualised total return of 17.9% per annum, but this was not enough to retain the top spot for a fourth consecutive year due to the strength of the performance of the office sector.
- Falling investment yields which over the previous three years have been a key driver of the relative out performance of the retail sector are rapidly diminishing with investment demand now focused on the office sector.
- Investor demand has driven up prices in the sector over the past few years, with the higher-yielding investments attracting particular attention from private investors. This has resulted in the income yield differential between good and poor quality properties narrowing significantly, most especially in the shopping sector market.

Performance of the retail sub-sectors



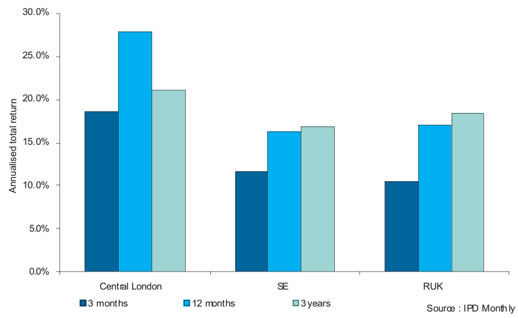
- Over the past year, the sector has generated rental growth of 2.8%, as compared to 3.8% for the whole market, with properties in Central London seeing the strongest growth in rents.
- Within the sector, shopping centres generated the highest total returns over the last twelve months edging out retail warehouses by virtue of a higher level of income return.
- Rental value growth slowed during the last three months, slightly lagging the average for the market as a whole.

Source: IPD Monthly

Offices

- The office sector outperformed both Retail and Industrials over the three months to March, returning 3.7%. Offices also outperformed on a 12-month basis, returning 21.5%.
- Returns have been driven by positive business sentiment, declining availability and strong investor demand.
- The sector has also seen a clear pick-up in rental growth, generating the highest rate of growth of the three main sectors during the quarter. Rents rose by 7.1% over the past 12 months.
- However, the increase in rents has been almost entirely driven by the Central London market, notably the West End. Over the last three months, Central London offices recorded annualised rental growth just short of 14%, contrasting with growth of 3.1% in the rest of the South East and 1.4% elsewhere in the UK.

Performance of the industrial sub-sectors

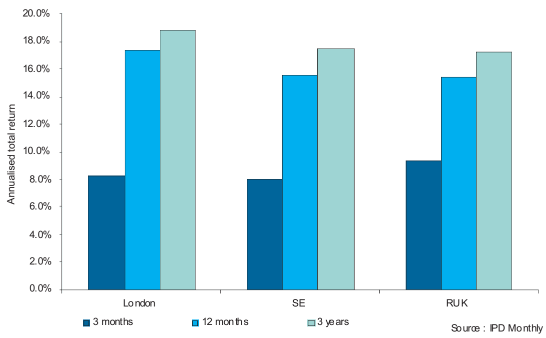


- Central London offices also saw the strongest capital growth over the 12 months to end March at 22%.
- Rental growth outside London was relatively subdued but falling investment yields continue to support capital growth outside the South East.

Source: IPD Monthly

Industrials

- The industrial sector returned 2.1% over the last three months, outperforming Retail but underperforming Offices.



- Over the past 12 months, the sector produced a total return of 15.5%, with investor demand being the key driver of performance.
- The performance of London industrials was significantly stronger than that of the rest of the country being underpinned by relatively strong rental growth.
- The performance of the industrial sector continues to benefit from a relatively high level of income return, although this has been partially offset by relatively modest rental growth. Nevertheless, rental growth of 1.5% over the past 12 months is the highest rate of rental growth in the sector for five years.

Source: IPD Monthly

UK Commercial property market outlook

Invista forecast total returns of around 9% from UK commercial property in 2007. Despite some upwards pressure on interest rates, strong economic and employment growth remain supportive of further rental appreciation. Investment yields are unlikely to play a significant role in boosting returns over the next few years, although investor demand is expected to remain robust and supply limited.

Over the next few years rental growth is expected to be the main driver of capital appreciation, although this is likely to be partially offset by a modest outward movement in secondary yields. Investor demand for high yielding (secondary) assets has resulted in significant compression of the yield premium relative to average. However, as interest rates increase, it is these properties which are likely to be most at risk as the current level of pricing on secondary assets does not adequately compensate investors for the higher risk associated with holding them. Prime (high quality) assets look a better option, being more attractively priced in relative terms with better rental growth and letting prospects and as a result less susceptible to any outward movement in yields.

Invista forecast that the South East is likely to outperform the rest of the country as a result of its higher exposure to the relatively strong growing service sector. In addition, weaker government expenditure growth over the next few years is expected to rein back the growth of provincial areas outside London and the South East, where it accounts for a larger proportion of employment. London in particular should benefit from stronger performance as a result of its exposure to finance and business services and its popularity as a tourist destination.

Retail sector outlook

The retail sales data for 2007 so far has only served to reinforce the robustness of the retail market – with healthy sales growth across all sectors. The residential housing market too has maintained strong rates of growth and should provide further support to the consumer as the year progresses. Recent interest rate rises may soon begin to feed through to consumers' pockets and has already dampened consumer confidence. However with rising employment and earnings we believe that the fundamentals underpinning this market remain strong.

The environment for retailers remains challenging but there are positive signs - retailer margins remain tight but, with quarterly retail sales value growth exceeding sales volume growth for the last six months, retailers appear to be regaining some pricing power. The supply pipeline remains a concern as an excess of secondary accommodation continues to restrict rental growth. However, with planned completions in 2008 largely represented by two particular schemes (White City and Liverpool One), the impact of new supply is likely to be limited. This said, there is significant potential for oversupply in coming years, especially in the North West, with the weight of money trying to access the property sector over the next few years potentially resulting in an oversupply of accommodation if directed towards development activity.

Out-of-town retail properties are likely to continue outperforming town centre properties, where demand remains weaker. We maintain our preference for prime, quality assets, as the current pricing of secondary properties does not adequately reward investors for the higher level of risk and we expect an increasing divergence in performance between prime and secondary assets.

Among the sub-sectors, retail warehouses are expected to generate the best returns over the next few years, both in terms of rental value growth and total returns. Space under construction is much lower for this sub-sector compared to town and shopping centres. Although rental value growth from warehouses has slowed in the first quarter 2007, particularly among secondary properties, we expect it to pick up again in the sub-sectors, such as fashion parks, where occupier demand remains high and retail sales figures are looking considerably healthy.

We remain cautious on shopping centres, as we have some concerns that they are holding back on capital expenditure, which is necessary to sustain growth in rental values. Furthermore, certain areas of the market are beginning to look overpriced.

Office sector outlook

The office sector is expected to outperform both Industrials and Retail over the next few years, supported by robust rental growth, strong occupier demand and relatively low levels of availability.

The Central London office market is expected to continue to lead returns - availability has fallen in recent years and tenant demand remains strong, boosted by the strength of the business and financial services sector. Prime rents in the West End have soared due to the mismatch between strong occupier demand and limited supply. The City office market also faces limited supply in the short-term, although there are a number of schemes due to complete in 2009 and 2010. Sustained growth in both the City and more particularly in the West End is likely to result in an overspill of demand to surrounding areas (e.g. Paddington, Hammersmith, South Bank, Docklands), supporting relatively attractive rental growth in these areas over the medium term.

The strength of the cyclical out-performance of Central London markets is expected to outshine the relatively steady performance which the rest of the office market is expected to produce. Vacancy rates in the regional office markets are falling but nonetheless remain higher than the Central London markets, particularly in the Thames Valley. The South East market is likely to be a key beneficiary of overspill demand from Central London office markets, which is likely to have a positive impact on rents.

Provincial office markets are expected to under-perform the rest of the sector - demand in these areas is weaker and take-up is slowing. Moreover, the Government is beginning to rein in its spending growth which is likely to have negative effects on the regions more reliant on the public sector as drivers of their local economy.

Industrial sector outlook

The industrial sector may be a victim of its own success, with substantial falls in investment yields over the past ten years leaving some areas of the industrial market looking overpriced. Strong investor demand and weight of money has increased the supply of industrial space, resulting in increasing availability of poorer quality secondary space. London remains the one area of the market where this is not the case, with strong competition from other sectors actually reducing the supply of available industrial space as investors enhance value through change of use. Regional occupier demand is expected to weaken as a result of higher interest rates and the appreciation of sterling relative to the dollar. With the sector currently offering such a small yield premium relative to gilts, there is limited scope for further capital growth through yield compression, and rental growth outside of London remains modest. On the positive side, industrial properties in London should benefit from the more favourable balance of supply and demand, as well as stronger economic growth in the South East. The prospects for the logistics market are also relatively promising, given the changes in EU working time regulations which could change the structure of the entire UK logistics market.

Summary of our sector ratings

Segment	Asset Allocation Position
South East shops	SELL
Rest of UK shops	SELL
Shopping Centres	SELL
Rest of UK industrials	SELL
Central London offices	BUY
South East offices	BUY
Rest of UK offices	HOLD
South East industrials	HOLD
Retail warehouses	HOLD

Important notes

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Past performance is not necessarily a guide to future performance. An investment's value and the income deriving from it may fall as well as rise, as a result of market fluctuations. You may not get back the amount originally invested.

The past performance of property funds may not be the same as performance of the property market as a whole.

The value of property is a matter of a valuer's opinion rather than one of fact.

Investments in property are relatively illiquid and more difficult to realise than equities or bonds. Commercial property will not contribute diversification where investors already have a substantial proportion of their investments in property.

The content of this document is valid for one month from the time of publication. The investment forecasts contained within the document have a time horizon of between three and twelve months, unless otherwise stated.

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