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UK Commercial Property Market Overview

AUGUST 2007

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August 2007

Key Highlights

- The UK commercial property market is returning to normal longer run performance levels.
- Returns for 2007 are likely to be 7%.
- The key to future performance is active management creating future rental growth.
- Offices to outperform as the returns from sub sector assets polarise with increasingly different fortunes.
- Some disposals will create buying opportunities at discounted prices.
- The underlying fundamentals of occupational demand remain firm.

Commercial property offers stability in volatile markets

In recent years the UK property market has benefited from a high level of investor interest and a heightened understanding of the nature of the market. Between 2003 and 2006 property outperformed both equity and gilt markets as a result of strong capital value growth, according to the IPD Annual Index. Since the start of the year the performance of the property sector has slowed from annual returns in the high teens. The wider equity markets appear to be of the view that "What goes up must come down" and the performance of the listed property market since the start of the year has suffered as a result. However, it is much more likely that performance will settle back to more sustainable long term levels.

One of the key drivers of the out performance of UK commercial property over the last ten years has been a re-rating of the investment yields on property compared to other assets. This has largely been driven by debt-backed and overseas investors but more recently institutions have also played a role as they have begun to realise the significant performance and diversification benefits which property can add to multi-asset portfolios.

Concerns over sub-prime mortgages in the US, and the potential knock-on effect this may have, hit global equity and bond markets in August. Such uncertainty manifests itself in increased volatility in commodity, currency, equity and bond markets, something which the developed derivatives markets appear to amplify. Market turbulence may not disappear quickly as the full impact of the credit squeeze unwinds but it brings some perspective on concerns over the state of the UK property market.

In the short term the moderation of property returns is largely a reflection of market expectation following rising interest rates. But the performance of property stems not just from current income but also from rental growth. Over the long term we expect rents to rise by around 2% per annum, roughly matching inflation. The IPD Quarterly Index currently shows rents rising by around 4% per annum on the back of strong occupier demand and localised shortages of available accommodation. Whilst rental growth does provide a significant degree of support to property performance, we do expect that there will be winners and losers over the next few years. It is likely that secondary (poorer quality) property is likely to be a loser partly because of lower rental growth. But this is only part of the story as secondary properties tend to also have higher maintenance costs and higher tenant default and re-letting risk. In contrast prime (better quality) properties look better value with their stronger rental growth prospects and better quality tenants.

An additional attraction of property is that it remains a fundamentally low volatility asset class. From 1970 to 2006, returns in the equity market were three times as volatile as those in the commercial property market. While the equity market did provide a higher average return just 150 basis points separated the two markets. Over the more benign economic conditions since the early 1990s equity returns have been twice as volatile as property, but property has actually out performed.

The last time we witnessed a major decline in the property market the economic fundamentals were less attractive and stable. The last period of poor performance from property was in 1990 when unemployment and interest rates were double the current rate, inflation was 10%, house prices and domestic demand were falling and there was oversupply of accommodation. In contrast over the last 12 months the UK economy grew by 3%, earnings and employment have risen and inflation appears to be falling back toward its target. Such strong messages from the underlying drivers of occupational demand should not be ignored and support a return to long run stable returns.

Economic overview

The UK economy has continued to expand in 2007 growing by 3.0% year on year. Economic strength continues to be driven by the services sector, in particular business services and finance which grew by 4.8% year on year.

On the consumer front, ONS retail sales figures remained supportive, albeit slowing slightly, with growth steady at 4.0% in the three months to July 2007 comparedto the same period one year earlier. The housing market strengthened further, with Halifax reporting an 11% average increase over the 12 months to July and despite rising interest rates, mortgage approval numbers remain strong.

In August, the Bank of England decided not to raise interest rates for the fourth time in 2007. Consumer price inflation also fell back dramatically in August to below the Government's target and well below analysts' forecasts. It remains unclear whether this is indicative of a more sustainable period of lower inflation. An upside risk to price inflation over the medium term remains a concern for the Monetary Policy Committee. Despite turbulence in the financial markets the governor of the Bank of England, Mervyn King, made it clear that this will not influence interest rate decisions, saying: "Interest rates are not a policy instrument for protecting unwise lenders from the consequences of their past decisions." (Source: Observer 12 August 2007) Financial markets still anticipate one further 25bp move upwards before the end of 2007.

UK commercial property market overview

The pace of growth in the UK commercial property market continued to moderate in the three months up to the end of June, following strong returns over 2006. The IPD Quarterly Index recorded a total return of 2.1% (8.8% annualised).

Over the past 12 months, the market has seen the driver of capital growth swing from strong investor demand, pushing yields lower and thereby raising prices higher, to rental growth as the effect of the former diminishes.

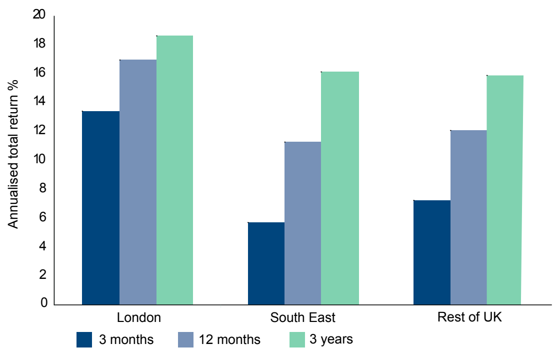
But this is principally the result of remarkable rental value growth in the Central London office sector – only in the last six months has the retail market seen such a change and the industrial market has yet to see a shift at all.

Investors are becoming more selective, as appetite for secondary (lower quality) properties has diminished partly as debt backed investors are priced out of the market by higher interest rates. UK commercial property continues to offer a superior level of income yield compared to gilts but the differential has narrowed considerably, as property yields have stabilised while bond yields have risen.

Sector performance

Industrials

- The industrial sector returned 1.9% over the three months to June, outperforming Retail but underperforming Offices.
- Over the past 12 months, the sector returned 12.4%, with investor demand the key driver of performance, but with its influence diminishing as time progressed. Returns from London industrials were higher than those in the South East or Rest of UK market.
- Industrials generated a rental growth of just 1.6% over the past 12 months. Nevertheless, this is the equal highest level of rental growth reached since March 2002.

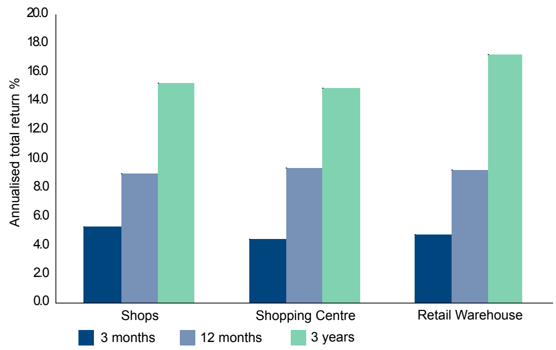


Source:IPD Monthly

Sector performance

Retail

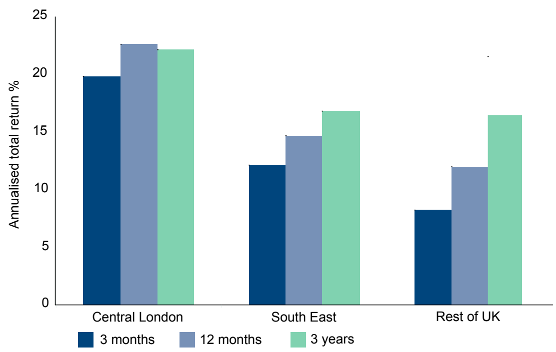
- The retail sector returned 1.2% over the second quarter of 2007, underperforming both Offices and Industrials.
- Total returns of 9.4% over the 12 months to June 2007 were also below those recorded by both Offices and Industrials.
- Over the three years to June retail property recorded an annualised total return of 16.0% per annum, the same as the industrial market but some way behind the office sector which significantly outperformed in the back-end of the period.
- Rental value growth took over from falling investment yields as the key driver of the capital growth of the retail sector at the start of 2007 as the focus of investment demand moved on to the office sector.
- Rental value growth slowed during the last three months, lagging the average for the market as a whole.
- Over the past year, the sector has generated rental growth of 2.5%, compared to 4.5% for the whole market, with properties in Central London seeing the strongest growth in rents.
- Within the sector, shopping centres marginally generated the highest total returns over the last twelve months edging out retail warehouses courtesy of a higher level of income return.



Source:IPD Monthly

Offices

- The office sector outperformed both Retail and Industrials over the three months to June, returning 3.6%. Offices also outperformed on a 12-month basis, returning 18.3%.
- Returns have been driven by positive business sentiment, declining availability and strong investor demand.
- Rental growth in the sector has remained high, generating by far the highest rate of growth of the three main sectors during the quarter. Rents rose by 9.4% 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 18%, contrasting with growth of 5.4% in the rest of the South East and 1.9% elsewhere in the UK.
- Central London offices also saw the strongest capital growth over the 12 months to end June at 17.8%.
- Rental growth outside London was relatively subdued but falling investment yields have supported capital growth, albeit to a diminishing effect.



Source:IPD Monthly

UK Commercial property market outlook

Invista expect the commercial property market to produce returns of around 7% in 2007 but with significant variance in performance between the different sectors and regions. This variation will offer significant scope for tactical out performance. Rental growth, which remains positive across all sectors of the UK market, will be the main differentiator of performance with the Central London office market expected to significantly outperform the rest of the UK market over the next 12-18 months. Economic growth may cool over 2008 as consumers respond to the interest rate rises this year.

Industrial sector outlook

Vacancy rates, particularly in the more secondary properties have increased. With the sector offering such a small yield premium relative to gilts, there is limited scope for further capital growth and the modest levels of rental growth being generated appear insufficient to justify current pricing levels.

The manufacturing sector has proved surprisingly buoyant over the first half of 2007 in light of the strong pound and higher interest rates. This revival is expected to lose momentum over the second half as the economic conditions remain challenging and will impact on industrial rental values, keeping growth rates low as occupiers struggle with rising cost bases. Distribution warehouses too may struggle as a tightening of consumer spending from the second half of 2007 is expected to dampen the health of the retail sales market.

The most positive outlook is for the South East and more particularly London, supply constraints and lower vacancy rates are expected to continue to drive rents upwards and make these areas more attractive for investment. However, the Government is planning to remove tax relief on vacant property units in 2008, which is expected to reduce rental values, particularly in areas of relatively high vacancy rates. This is expected to have a significant impact on the regional market where take-up is weakening and vacancy rates are growing.

Nevertheless, demand for industrial properties – with their lowest cost land use - should be supported by the potential benefits from change of usage to residential, retail or office space.

Retail sector outlook

Retail sales over 2007 have proved robust but are expected to moderate over the next 12 months as consumer spending growth reverts to more sustainable levels. House price growth is expected to cool over the next twelve months as higher interest rates have further reduced affordability. Nevertheless in some regions, particularly London and the South East, the housing market is expected to remain strong, supported by strong employment and earnings growth and low levels of supply.

The development pipeline remains relatively low for 2008 and 2009 with only the localised impact of two large schemes White City and Liverpool One likely to have a knock-on effect in depressing rental growth. Thereafter there is a relatively high level of planned development in the pipeline, although there are early signs that developers may be pushing back the start dates for schemes in response to expectations of weaker retail demand.

Out-of-town retail properties are likely to continue to out performing town centre properties, where occupier demand is 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, through the retail and fashion parks. Supply remains constrained in the retail warehouse market and space under construction is much lower for this sub-sector compared to town and shopping centres. We still remain cautious on shopping centres, as we have some concerns over the pricing of this sector of the market given the capital expenditure which is required to sustain growth in rental value growth. Furthermore, certain areas of the market are beginning to look overpriced and the margin between average and secondary yield margins in the sector has begun to increase.

Office sector outlook

The Office sector is expected to outperform both Industrials and Retail over the next few years, supported by sustained rental growth and a low level of development activity.

Central London markets are expected to continue to lead returns - availability has fallen in recent years and tenant demand remains strong, boosted by the strength of the finance and business services (FBS) sector. Potential knock-on effects from the US sub-prime crisis and the global credit squeeze have yet to be seen and are hard to forecast, let alone quantify – but they do introduce a downside risk to returns.

The West End remains attractive with its limited development pipeline leading to expectations of healthy long-term rental value growth. The City faces limited supply too, in the short-term, but there are a number of completions scheduled between 2009 and 2012 which cumulatively are likely to result in an excess of supply in the medium term. Sustained growth in both the City but more particularly in the West End is likely to bring on an overspill of demand to surrounding areas (e.g. Paddington, South Bank, Docklands), supporting relatively attractive rental growth in the medium term.

Outside of London performance is expected to be less strong with higher levels of availability and less robust demand expected to result in lower levels of rental appreciation. The prospects for offices in the Thames Valley are improving as availability of space and vacancy rates fall, but overall the wider regional market returns will be dampened by weaker Government spending growth that is expected to have an impact on the more public sector-heavy regions of the UK.

Summary of our sector ratings

Segment	Asset allocation position
Rest of UK shops	SELL
Shopping centres	SELL
Rest of UK industrials	SELL
Central London offices	BUY
South East offices	BUY
South East shops	HOLD
Retail warehouses	HOLD
Rest of UK offices	HOLD
South East industrials	HOLD

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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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