



UK Commercial Property Market Overview

MARCH 2008

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Key Highlights

- The decline in capital values in the UK commercial property market has begun to ease. Whilst investor confidence remains subdued there are early signs that investors, most especially those from overseas, are viewing the sector favourably once more.
- Further cuts in base rates over 2008 are expected to make property investment increasingly compelling as the year progresses.
- While the economic health of the US remains the source of much debate, the resilience of the fundamentals underpinning the UK economy offer sound evidence to believe that a recession can be avoided.

Impact of yield correction expected to ease by end of Q2 2008

The decline in capital values in the UK commercial property market has already begun to ease as the market absorbs the full impact of the “credit crunch”. Whilst values continued to fall in early 2008 the rate of decline eased significantly compared to the fourth quarter of 2007. Rising property yields and falling interest rates have resulted in the positive funding gap re-emerging – where property income yields are higher than the cost of debt¹. Whilst investor confidence currently remains subdued there are early signs that investors, most especially those from overseas, are viewing the sector favourably once more. This may be evidenced by the improvement in transaction values after the sharp downturn in activity in October 2007².

After a relatively torrid time in 2007 property equities appear to be out-performing the wider equity and direct market. Since the turn of the year to the time of writing (1 April 2008), the FTSE Real Estate index had risen by 5.4% in comparison with an 8.6% fall in the wider FTSE-All Share index³.

In a market anticipating further cuts in base rates over 2008, property investment is expected to become increasingly compelling as the year progresses. Base rates are set to fall as the Bank of England strives to address the wider economic slowdown, albeit within their remit to keep inflation at target. Inflation risks on the upside over the coming six months mean that while base rates may not fall as much as the market currently anticipates - we believe they are likely to fall a further 25-50 basis points by the end of the year.

This said, much remains dependent on the wider global economic environment and whether the mid-cycle slowdown turns into a full-blown recession. While the economic health of the US remains the source of much debate, the resilience of the fundamentals underpinning the UK economy offer sound evidence to believe that a recession can be avoided.

Economic overview

Economic growth in the UK moderated in Q4 2007, but at 2.8% year-on-year, remained marginally above long-term trend⁴. The services sector remained strong, with business services and finance, in particular, a significant driver of the UK economy with output up 4.4% year on year⁴. With uncertainty remaining in global financial markets, the Bank of England anticipate a further modest deceleration in activity in 2008 before growth picks back up towards the end of the year⁵.

Consumer spending in Q4 2007 has also moderated, with quarter-on-quarter growth of 0.1%⁴. Retail sales growth have proved resilient over the three months to February 2008, at 1.0% quarter-on-quarter, but that growth will have been propped up by discounting across non-food stores⁶. The housing market has begun to cool with mortgage approval numbers moderating while Halifax reported a 4.2% increase

in house price growth over the 12 months to February 2008, down from 6.3% three months earlier⁷.

Since October 2007, the Bank of England has cut interest rates twice, most recently by 25 basis points in February 2008. Consumer price inflation (CPI) had remained close to Government target since July 2007, but there were concerns that higher prices for energy, food and imports would drive annual inflation materially above target by the end of February 2008. These concerns proved justified – annual CPI rose to 2.5% that month⁸. However, combined with the potential downside risk to prices from the expected economic slowdown, there will be inflation risk in both directions. This leaves the Bank of England with a fine balance of conflicting risks over the coming 12 months, where we forecast a further two 25 basis point cuts in interest rates.

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*All data in this section sourced from the IPD Quarterly Index December 2007

The fourth quarter of 2007 saw a sharp correction in commercial property yields as the market continued to adjust to the impact of the higher cost and poorer availability of debt resulting from the global “credit crunch”. However, the underlying economy and occupier markets remained healthy and stable over the period.

Returns fell by 7.6% over the fourth quarter of 2007, driven by an 8.7% fall in values. The impact of rising yields was felt across all sectors despite continued rental appreciation. Rental value growth of +0.8% quarter-on-quarter (3.3%

annualised) has been underpinned by broad-based economic growth, healthy levels of take up of new/empty space, limited tenant delinquencies across all sectors, and the strength of the Central London office market.

Borrowing conditions remained tight, squeezing investors out of the market, particularly debt-backed buyers. Transaction levels fell in the fourth quarter of 2007 as a result, with total transaction values under half that seen twelve months earlier². The continuing correction in capital values has left UK commercial property offering a high level of income yield compared to gilts, with the differential rising.

Sector performance

Retail

- The retail sector returned -8.2% over the fourth quarter of 2007, underperforming both offices and industrials.
- Total returns of -7.1% over the 12 months to December 2007 were also below those recorded by both the office and industrial sectors.
- Rental value growth remained relatively flat over the year, lagging the average for the market as a whole.
- Over 2007, the sector generated rental growth of 1.8%, compared to 4.1% for the whole market, with retail properties in Central London seeing the strongest growth in rents.
- Within the sector, shopping centres generated stronger returns over the last twelve months.



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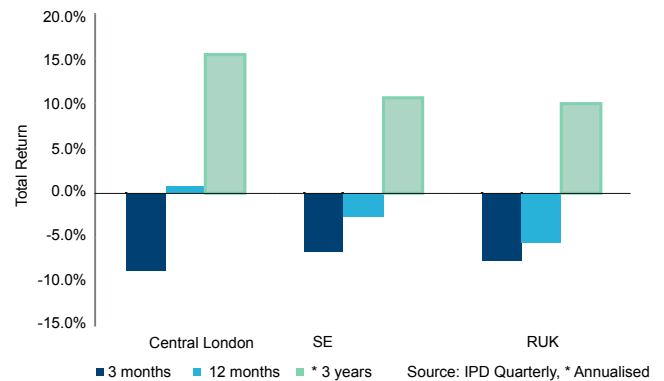
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Sector performance

Offices

- The office sector outperformed retail but not industrial over the fourth quarter of 2007, recording a total return of -8.0%. Offices did outperform all sectors on a 12-month basis, albeit with a return of -1.4%.
- Rental growth weakened slightly in the fourth quarter but remained relatively high, generating by far the highest rate of growth of the three main sectors. Rents rose by 9.2% over the past 12 months.
- Rental growth remained strongest in the Central London market, notably the West End. Over the last three months, Central London offices recorded rental growth of 2.2%, contrasting with growth of 0.9% in the rest of the South East and 0.4% elsewhere in the UK.
- Central London offices also saw the least negative capital growth over the 12 months to end December 2007 at -3.0%.

- The impact of rising rents was offset by rising investment yields across all sub-sectors.



Industrials

- The industrial sector returned -6.3% over the fourth quarter of 2007, outperforming both retail and offices.
- Over the past 12 months, the sector returned -3.9%. Returns from London industrials continued to be higher than those in the South East or rest of UK market, being driven by stronger rental growth and investor demand.
- Industrials continued to generate relatively modest levels of rental growth compared to the retail and office sectors, with rents growing by 1.4% over the past 12 months. Nevertheless, this was above trend for the full history of the IPD Quarterly Index (from March 2001), reflecting the underlying strength of the UK economy.



UK commercial property market outlook

We expect the re-rating of yields to continue into the second quarter of 2008, with values stabilising by the end of the third quarter. In part this is likely to be driven by falling interest rates but it also requires liquidity to return to the market. Despite the downside risk from a global economic slowdown in 2008, we believe the UK economy should prove resilient enough to continue to provide positive nominal rental value growth over the coming two years. The medium term outlook for the commercial property market appears benign with property offering relatively stable performance.

There are no clear sector winners in the outlook for the commercial property market in the short to medium-term. Although markets with tangible supply constraints, such

as London industrials and West End offices, may continue to offer potential out-performance in the medium to long-term, near-term out-performance will instead be driven by asset management, stock-picking value buys, longer leases and stronger tenant covenants. City offices look vulnerable to slowing occupier demand in light of the fall-out from the "credit crunch", as well as a relatively heavy pipeline of space due on the market from the end of 2008. Sluggish rental values in the retail sector are likely only to pick up only from 2009 as the UK economy recovers from its mid-cycle slowdown. We also have concerns for the industrial sector where the removal of the exemption from rates when properties are vacant may hit rental growth this year.

Retail sector outlook

Retail sales volumes in the three months to February 2008 compared favourably with the same period twelve months earlier, growing by 4.7%; however, this growth has been supported by discounting in non-food stores⁶. The housing market has cooled down, with house prices expected to be flat or slightly down by the end of 2008. Alongside tighter borrowing conditions currently making it harder for households to get credit in the year, a slowdown in consumer spending is widely anticipated as the year progresses. Early reports from trade surveys have also pointed to subdued retail sales growth over the second quarter of 2008.

We continue to maintain our preference for prime, well-located retail properties as, despite the ongoing correction in yields, the current pricing of secondary properties still does not adequately reward investors for the higher level of risk and we expect an increasing divergence in performance between prime and secondary assets.

The shopping centre development pipeline remains relatively modest for 2008 and 2009. Only the two largest schemes, Liverpool One and Westfield London

(White City) are likely to have a significant knock-on effect in depressing rental growth when they are expected to open in May and November respectively. Persistent tighter borrowing conditions have taken some heat out of the development pipeline beyond 2009, with developers pushing back the start dates for some in response to increased funding costs and an expected slowdown in retail sales. However, we 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 values.

Retail warehouses took the hardest hit to valuations of any sector in the fourth quarter 2007, and yield levels currently look relatively good value. With out-of-town retail properties expected to continue to outperform town centre properties, where both occupier and consumer demand is weaker, the A1 retail and fashion parks sub-sectors, rather than Solus and bulky goods parks, look a potential buying opportunity in the near term. Despite the expected slowdown in consumer spending in 2008, constraints on new supply remain tight, with space under construction much lower for this sub-sector compared with town centre retail and shopping centres.

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Offices sector outlook

We expect mixed fortunes for the office sector over the coming few years. Regionally, average West End offices and those in overspill locations, such as Paddington, South Bank and King's Cross may offer relatively strong rental value growth in the near term, while the fortunes of offices in other areas of the South East, particularly the Thames Valley, depend heavily on whether the US can stave off a prolonged recession in 2008.

We have concerns about prime West End offices, where the occupier base is heavily weighted to a hedge fund market nervous about further fall-out from the "credit crunch". City offices also look vulnerable to slowing occupier demand in the financial services market in light of the "credit crunch", but have also a relatively heavy pipeline of space due on the market from the end of 2008. However,

tighter conditions in the borrowing market may provide some consolation – driving delays in expected completion dates, and in so doing, easing the development pipeline.

Outside of London and the South East the performance in the rest of the UK in the short-term is expected to be relatively fair. Performance is likely to pick up in the medium-term as the less cyclical nature of the market works to its advantage. The negative effects of higher levels of availability and less robust demand are expected to be countered to some degree by the benefits of stability brought about by the greater exposure to occupiers from the public sector. Much depends on levels of government spending, however, and currently levels of government debt do not offer much room for fiscal manoeuvre.

Industrial sector outlook

With above-trend vacancy rates and levels of availability across all the sectors bar London, there is limited scope for rental growth. Although the sector sustained less negative impact than the other sectors from rising yields in the fourth quarter of 2007, significant positive capital growth is unlikely in the short to medium term as the sector still offers only a relatively small yield premium relative to gilts.

Activity in the manufacturing sector was relatively flat in the final quarter of 2007, a reasonable show of resilience in light of the strong pound and higher interest rates⁹. Recent survey evidence points to a slowing in output growth in 2008, partly due to material weakening in export orders. With consumer spending expected to ease, and occupiers struggling with rising cost bases, rental growth across the sector market may be limited.

Rental value growth is also expected to be damaged by the government's removal of tax relief on vacant property units that came into effect on 1 April 2008. Rental values, particularly in areas of relatively high vacancy rates such as the regional market, are expected to fall where take-up is weakening and availability rising. Supply constraints and lower vacancy rates in the South East are expected to hold up rental values, and these areas should prove more attractive for investment.

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.

Summary of our sector ratings

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

Notes

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Source:

1 IPD, *UK Monthly Property Index, February 2008*

2 *Property Data, Property Investors Bulletin, March 2008*

3 *Thomson Datastream*

4 *Office for National Statistics, Quarterly National Accounts, Q4 2007*

5 *Bank of England, Quarterly Inflation Report, February 2008*

6 *Office for National Statistics, Retail Sales February 2008*

7 *Halifax, House Price Index, February 2008*

8 *Office for National Statistics, Consumer Price Indices, February 2008*

9 *Office for National Statistics, Index of Production, January 2008*



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