



UK Commercial Property Market Overview

NOVEMBER 2008

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November 2008

Key Highlights

- As the credit crisis has deepened its impacts are spreading to affect the real economy with economic output and employment falling. Confidence in all asset markets remains fragile although there are signs that Bank of England and government intervention is beginning to stabilise markets.
- There is a lack of liquidity currently in the commercial property market driven not just by nervousness in the lending markets, but also by uncertainty over pricing. Although borrowing markets remain effectively shut off, the yield premium on commercial property has been rising. With interest rates predicted to fall further over the course of the next 12 months the property yield premium is likely to become increasingly healthy.
- Weaker economic growth is likely to adversely affect occupational demand, although, with the notable exception of the City office market, the low level of development activity suggests that its impact will likely be limited to the next 12-24 months.

Financial contagion working its way through the market

The banking crisis came to a head in September 2008 with highly volatile overnight lending rates and widening longer term borrowing margins tightening credit availability even further. Subsequent actions from the Government and the Bank of England to restore confidence to the lending markets appear to have had some, albeit limited, success – the margin of three-month LIBOR to base rate has steadily fallen from its peak of around 180 basis points in early October 2008 to 91 basis points at the end of November¹.

Nevertheless, the fall-out from the banking crisis in Q3 2008 has struck all asset markets. Equity markets have seen unprecedented volatility: since September 2008 the FTSE 100 index has witnessed four of its five highest daily rises on record, as well as three of its five lowest¹. Bond yields have risen as markets have reassessed risk premia across the board. Commodity prices have fallen as the outlook for global demand has darkened considerably. Finally, in the property market there is anecdotal evidence to suggest that UK commercial banks have closed their books to new business in 2008, leaving debt-backed buyers completely out of the picture. This lack of liquidity has been driven not just by nervousness in the lending markets, but also by uncertainty over pricing.

However, in the midst of what feels like a relentless release of negative news, it has been easy to lose sight of some fundamental issues. In the commercial property market there is increasingly room for cautious optimism over the medium term. Although borrowing markets remain effectively shut off, the borrowing margin and effective risk premium on commercial property have quietly been returning to attractive levels, and the asset class is approaching fair value again. With interest rates predicted to fall further over the course of the next 12 months the property yield premium is likely to become increasingly healthy. All that is left to restore some shine to property yields is a recovery in sentiment in the financial markets. When this is likely to take place remains subject to much debate – lending markets may still remain relatively muted but it is hoped that continued action from the Government and the Bank of England will make significant inroads into restoring liquidity over the next 12 months.

Economic overview

The third quarter of 2008 saw the UK economy contract for the first time in over 16 years, as the impact of the crisis in financial markets rippled out into the real economy. Government figures suggest that output fell by 0.5%, down from 0.0% three months earlier². Economic output has been hit on all fronts with rising prices, tighter borrowing conditions and rapidly declining confidence, and restricted investment, household spending and export growth. Business services and finance saw quarterly growth of -0.4%, its weakest for six years, while a decline in the value of sterling came too late to prop up the manufacturing sector, which contracted by 1.3% over the quarter². The latest survey evidence suggests that the UK economy will contract further over coming quarters with business and consumer confidence indicators at historical lows³.

Whilst interest rates remained unchanged over Q3 2008, extreme financial market volatility resulted in

unprecedented Government intervention to stabilise the global financial system. As a result there was a decisive change of stance from the Bank of England which cut interest rates twice: first, by 50 basis points in October 2008, then an unprecedented cut of 150 basis points in November 2008 in order to stave off the risk that inflation would materially undershoot its inflation target.

Retail sales growth in Q3 2008, at 0.0% quarter-on-quarter, began to tell a more rational story of consumers tightening their belts, compared to the surprisingly buoyant figures published earlier in the year⁴. Falling house price indices continue to gather much media attention which no doubt exacerbated concerns and, together with the loss of confidence in financial markets, has paralysed the housing market. Mortgage approvals for new house purchases fell 67% in the 12 months to September⁵ with house prices down by 12.4% over the same period⁶.

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**All data in this section sourced from the IPD Quarterly Index Q3 2008, unless otherwise specified*

A significant deterioration in the outlook for economic growth in the third quarter of 2008 saw a re-acceleration in the yield-led correction in the commercial property market, as prospects for rental growth worsened. Near paralysis in debt markets is further tightening its grip on property transaction markets: such low levels of transactions have not been seen for six years⁷. Nevertheless, by the end of Q3 2008, five-year swap rates had fallen 88 basis points to 5.2%; by the end of November 2008 they had fallen a further 153 basis points to 3.66%⁷. With property yields continuing to rise, and swap rates continuing to fall, the property yield premium appears increasingly attractive.

Total returns fell by 4.8% over Q3 2008, driven by a 6.2% fall in values. Rental value growth slowed and the impact of

rising yields continued to be felt across all sectors. Rental values on a quarterly basis contracted (-0.2% quarter-on-quarter) as rising inflation and the deteriorating economic outlook hit occupier cost bases and revenues. The occupier market has in recent years proved resilient with healthy levels of take up and relatively low tenant default rates, but this will be tested as the current economic downturn continues to run its course.

Transaction levels in Q3 2008 were low and there is anecdotal evidence to suggest that UK commercial banks have closed their books to new business in 2008, leaving debt-backed buyers completely out of the picture. This lack of liquidity has been driven not just by nervousness in the lending markets, but also by uncertainty over pricing.

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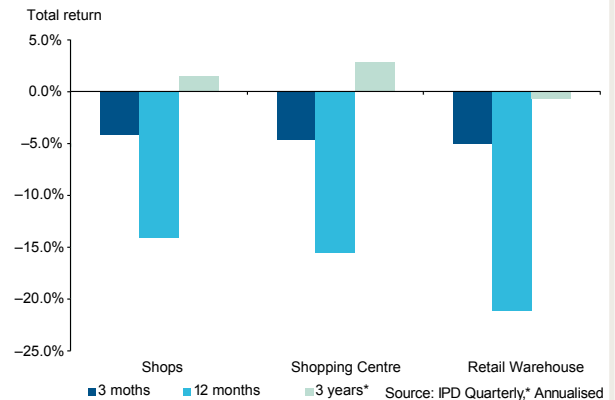
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Sector performance to September 2008

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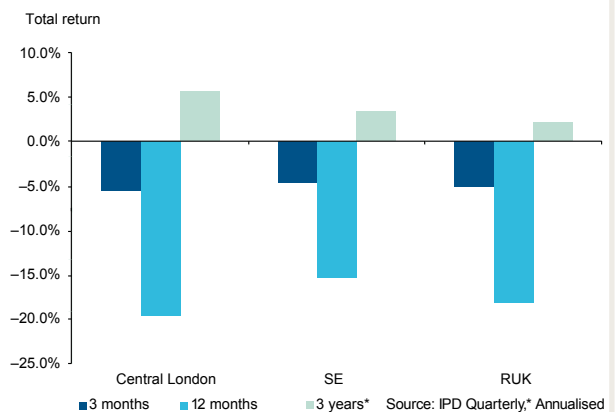
Retail

- The retail sector returned -4.6% over the third quarter of 2008. For the first time since Q3 2005, retail proved the best performing sector.
- Total returns of -17.8% over the 12 months to September 2008, were only marginally better than the worst performing sector, offices.
- Rental value growth on a quarterly basis has edged down over the year so far, but remains positive and above the market average.
- Over the 12 months to September 2008, the sector generated rental growth of 1.2% , the same as the whole market, with retail properties in Central London continuing to see the strongest growth in rents.
- Within the sector, standard shops generated marginally the stronger returns over the last 12 months on the back of what have been, so far, more stable yields.



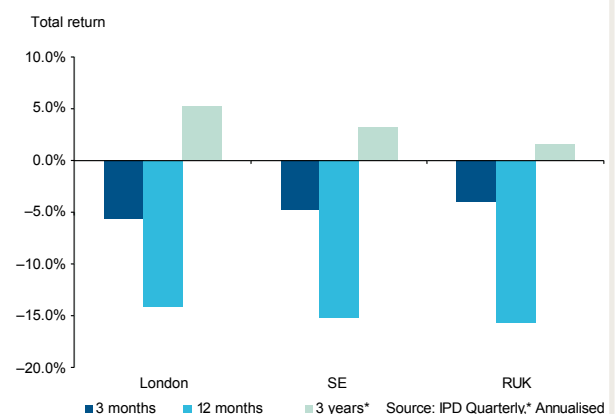
Offices

- The office sector underperformed retail and industrial over the quarter and 12-month period to end September 2008 with returns of -5.1% and -18.1% respectively.
- All sub sectors saw the rate of decline in capital values accelerate as investment yields continued to rise.
- Rental growth deteriorated further in the third quarter and in the space of six months the office sector has changed from the highest growth to the lowest. Over the past 12 months office rents rose by an average of 1.0% .
- On an annual basis, rental growth remained strongest in the less cyclical Rest of South East market. Since March 2008, after a strong six months of rental value growth, the more cyclical Central London office market has seen rental values fall.



Industrials

- The industrial sector returned -4.7% over the third quarter of 2008, outperforming offices and marginally underperforming retails.
- Over the past 12 months, the sector returned -15.4% , the best performing sector. Despite a relatively poor Q3 2008, London industrials outperformed those in the South East and Rest of UK market, being driven by stronger rental growth and investor demand.
- Industrials continued to generate relatively modest, yet less volatile, levels of rental growth compared to the retail and office sectors, at 0.9% over the past 12 months. Over Q3 2008, however, rental values fell for the first time in the history of the IPD Quarterly Index (December 2000).



UK commercial property market outlook

A worsening economic outlook coupled with a persistent lack of confidence in financial markets is expected to keep liquidity levels low for the rest of 2008. Debt has become increasingly difficult to obtain, despite cuts in interest rates, as banks attempt to recapitalise after the turmoil of the last few months. Concerns that the worsening economic outlook would damage rental values across all major sectors have also proved justified – rental values are now falling quarter-on-quarter⁹.

However, in the midst of what feels like a relentless release of negative news, it has been easy to lose sight of some fundamental issues. There is increasingly room for cautious optimism over the medium term. Although borrowing markets remain effectively shut off, the borrowing margin and effective risk premium on property have quietly been returning to attractive levels, and commercial property approaching fair value again. With interest rates predicted to fall further over the course of the next 12 months the property yield premium is likely to become increasingly healthy. All that is left to restore some shine to property yields is a recovery in sentiment in the financial markets. When this is likely to take place remains subject to much debate – lending markets remain relatively muted despite the unprecedented actions of the Bank of England and growing pressure from the Government on the banks to resume lending.

Retail sector outlook

The retail sector has been struggling for a number of years under the burden of falling prices and increased competition from the internet. Household spending is widely expected to contract over the next 18 months as: rising unemployment, the weakness of the housing market and fears over job security force consumers to repair their balance sheets. Retail sales volumes have increasingly been propped up by discounting in non-food stores – for example, clothing and footwear prices fell by 7% in the 12 months to October 2008⁹ – while food stores were the only main sector to see any major growth in the value of retail sales³. In the near to medium term, we expect falling inflation to have a positive effect on retailer costs, although this could be counterbalanced by the negative effects of falling demand and higher prices on imported input goods in light of the recent weakness of sterling. Sales of bulky goods, in particular, are likely to suffer as fewer people commit to large purchases. However, with interest rates and inflation already falling, fortunes could change quite sharply – pent-up demand could prompt a recovery in housing markets which could fuel a rebound in consumer confidence.

We continue to maintain our preference for prime, well-located retail properties. The ongoing correction in yields has begun to catch up with the more secondary properties and we believe there is more divergence to come over the next 12 months with secondary yields some way off adequately rewarding investors for the higher level of risk.

Rental values are declining but there are sound reasons why we are unlikely to see a repeat of the large falls seen in the early 90s: the underlying economic fundamentals (inflation and base rates) are much lower, and the near term supply pipeline less imposing. We expect rental values to begin to pick back up in 2011, as effects of the broader economy recovery begin to trickle through.

While markets remain illiquid, it is uncertain where value can be found. Fundamentals would suggest properties let on longer leases, in good locations, with a high level of income yields and tight supply should be the most defensive. As a result good quality town centre retail investments are expected to fare better than many other investments. The reverse is likely to be true of markets where there is an excess of supply and where demand is weak; as a result the City and Canary Wharf office markets look particularly susceptible to underperformance.

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, but for the next 12 months weak demand may outweigh the benefits of supply constraints. The industrial sector remains particularly vulnerable to the impact on rental values of the changes to empty property rates relief on rents, introduced earlier this year.

Shopping centres have proved relatively resilient in previous economic downturns and we expect that the primer, out-of-town, units will again prove resilient over the coming 18 months. Unfortunately for those less prime, and based in-town, we continue to have concerns over the pricing of this sector of the market given the capital expenditure which is required to sustain rental income. The outlook for rental value growth may look more positive in light of the dampening effect the tighter borrowing market has been having on the longer-term pipeline of new shopping centre schemes, but conditions in the occupier market are increasingly challenging and are likely to remain difficult for the near to medium term.

Retail warehouses took the hardest hit to valuations of any sector in the 15 months from the onset of the fall in values to the end of the third quarter of 2008; equivalent yields returned to levels last seen five years previously⁸. Some sub-sectors now look better value than others – out-of-town retail properties, the A1 retail and fashion parks are expected to see more resilient occupier and consumer demand than solus and bulky goods parks. Constraints on new supply are expected to remain tight, and 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 continue to expect mixed fortunes in 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 defensive rental values in the near term. In contrast, prime West End offices may see significant weakening in rental values as their occupier base remains muted in light of the continuing nervousness in financial markets. Offices in other areas of the South East, particularly the Thames Valley, depend heavily on the health of the US economy where the outlook has deteriorated in recent months. The outlook for City offices in the near term is particularly weak due to slowing occupier demand in the financial services market and a relatively heavy pipeline of space due on the market between now and 2010. Tighter conditions in the current borrowing market have put paid to much speculative development and delayed completion dates, so in the

medium to long term a shortfall of new supply, along with a recovery in business sentiment, is likely to help rental values bounce back in the City.

Outside of London and the South East the performance in the rest of the UK in the short term is expected to be relatively defensive. Medium term performance is likely to pick up as the less cyclical nature of the market works to its advantage. Despite higher levels of availability and less robust demand, the benefits of stability brought about by the greater exposure to occupiers from the public sector are expected to be felt. Although current levels of Government debt do not offer an encouraging outlook for further spending, in a tighter economic environment the low risk income streams provided by long leases to public sector occupiers look increasingly attractive.

Industrial sector outlook

The weakening economic outlook is impacting on industrial demand with rental values expected to continue to fall over the coming 12-18 months. Vacancy rates and levels of availability remain above-trend across all the sectors bar London. Early effects of the Government's removal of tax relief on vacant property units earlier this year are beginning to be seen and we expect the change in policy to ultimately have a negative effect on rental values. The sector had suffered less impact from the yield correction over the 15 months to September 2008, but the industrial sector has shown a small lag on other sectors in the market. Given that there is still some correction to go, the sector may still catch up with the retail and office sectors. Nevertheless, yield premiums relative to swap rates remain some of the highest in the UK property market and continue to grow.

The manufacturing sector contracted for the second quarter running in Q3 2008² and the latest survey evidence points to a continuing slowdown in the coming months¹⁰. While the

benefits of a weak pound on export-led manufacturers will take more time to have an effect, rising input prices and slowing demand are likely to be a brake to growth in the short term. While we expect input prices to stabilise, or even fall, over the medium term, the dominant effects are likely to come from an ease in consumer spending that will negatively affect all areas of the market. As a result, the outlook for rental values across the market remains weak in the short term.

We continue to favour the more supply-constrained South East industrial market. With lower vacancy rates, rental values in the South East are less likely to be damaged by the Government's removal of tax relief on vacant property units. The broader effects of the Government's actions in the longer term remain to be seen. Nevertheless, demand for industrial properties across the UK – 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
South East shops	OVERWEIGHT
Rest of UK shops	OVERWEIGHT
Rest of UK offices	OVERWEIGHT
Shopping centres	NEUTRAL
Retail warehouses	NEUTRAL
South East offices	NEUTRAL
South East industrials	NEUTRAL
Central London offices	UNDERWEIGHT
Rest of UK industrials	UNDERWEIGHT

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Source

1 Thomson Datastream, 28 November 2008

2 Office for National Statistics, UK Output, Income & Expenditure, Q3 2008

3 CBI Survey, Optimism Balance; European Commission, Consumer Confidence, October 2008;

4 Office for National Statistics, Retail Sales October 2008

5 Bank of England, Lending to Individuals, September 2008

6 Halifax, House Price Index, September 2008

7 Capital Economics, UK Commercial Property Monthly, November 2008

8 IPD, UK Quarterly Property Index, Q3 2008

9 Office for National Statistics, Consumer Price Indices, October 2008

10 CBI Industrial Trends Survey, November 2008



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