



UK Commercial Property Market Overview

Quarterly Commentary

December 2009

UK Commercial Property Market Overview

Quarterly Commentary

KEY HIGHLIGHTS

- The recovery in UK commercial property market values which began in July 2009 has continued into the fourth quarter with the IPD Monthly Index recording four consecutive monthly increases in value up to the end of November 2009¹.
- The current recovery is being driven by strong investor demand as the high level of income generated by property has become increasingly attractive.
- The occupational market remains weak and rental values are expected to continue to fall over the next 12-24 months. As a result there is a risk investor enthusiasm for property that may push up values to unsustainable levels and values may have to fall again over the medium term.
- Nevertheless property remains attractively priced vs. other assets both in the short term and over longer time horizons.
- The direction of capital value movement has changed and point of inflection has occurred. Capital values are likely to stabilise over the next 6 months and thereafter remain broadly stable, although within the market there will remain a number of peaks and troughs as alternative sectors and regions of the UK perform quite differently moving forwards.

Is this a sustainable commercial property market recovery?

Capital values rose 1.5% over the third quarter of 2009 – a return to positive growth after eight consecutive quarters of falling values². On a monthly basis the 2.4% rise in values over November 2009 was the biggest since March 1994¹. Activity and confidence may have steadily returned to the transaction market over 2009, but there was a tangible shift in investor sentiment in mid 2009. In between the end of June and the beginning of December 2009, the implied total returns for the 2009 calendar year from the derivatives market moved from -15% to 2%³; sentiment improved dramatically in the listed property market too, where, over the same period, share prices on the FTSE EPRA/NAREIT real estate index rose by 29%⁴.

The change in sentiment has, arguably, been driven less by increasing economic optimism – that the recession may be over earlier than previously thought – and more by the high level of property yields vs. other assets, growing investor demand and a lack of stock on the market. Buyers, particularly foreign ones, are keen to take advantage of a weak Sterling and attractive-looking property yields on a relative and an absolute basis. The occupier market, however, for the time being, remains weak. Given the lack of bank credit and the impending tightening of the UK's fiscal policy, there remains substantial risk that the UK will be operating below capacity for some years to come, stifling any significant recovery in the occupier market across the UK over the next few years.

Given the investor supply/demand imbalance and the continuing weakness in the occupier market, the sustainability of the current market recovery is finely balanced. Over the long term, property values should appreciate, as rents track inflation upwards and the historically high yield margin over other assets reduces. However, while values may continue to rise into 2010, there is a possibility that values may fall again in some areas of the market in 2011.

Quantitative easing appears to have successfully re-introduced some liquidity into financial markets, but this cannot continue indefinitely, and the Bank of England may begin to reverse this policy as soon as 2011. With this comes a great degree of uncertainty over what kind of effect this will have on broader

asset markets and the economy as a whole. For example, as the Bank of England acts to reduce liquidity in the market, bond yields could begin to rise as investors demand a higher risk premium; or, the upside risk on inflation could drive Consumer Price Inflation ('CPI') sufficiently away from target to force the Bank of England to raise interest rates. Either of these scenarios could force property yield margins to close in, potentially putting downward pressure on property prices.

A further risk to the health of the market in the near term is banks' exposure to property. In the UK, as in a number of other markets, bank debt to property remains at record high levels. To date lending banks have remained relatively composed and patient with their borrowers, although this may reflect that, this time round, their interest is being kept current. However, any recovery could be destabilised should the market be flooded with stock from banks seeking to benefit from advantageous price levels to deleverage/derisk their balance sheets.

We believe commercial property offers attractive long term performance prospects underpinned by a high level of income return. To date the current recovery in values reflects return towards fair value after a period of excessive risk aversion. However, over the short term there is a risk that the current recovery in values runs ahead of the underlying asset class fundamentals, which may result in values dropping back when interest rates increase or the impact of a weak occupier market reasserts itself.

Economic Overview

Economic output contracted for the sixth consecutive quarter in Q3 2009. The 0.3% fall in GDP over Q3 2009 took many by surprise – a positive figure had been expected⁵. However, early GDP estimates are prone to revision, and the figure for UK economic growth in Q3 2009 could yet turn positive as more supporting economic data for the period feeds through. As it stands, services, representing 76% of economic output, fell by 0.1%; whilst industrial production fell by 0.8%⁵.

There are encouraging signs that the UK economy may return to positive growth in Q4 2009: business surveys indicate a rise in output⁶, and activity indices for the manufacturing and service sectors have shown continued recoveries in November⁷. UK exporters are beginning to enjoy the increasing trade⁸ as a recovering global economy seeks to take advantage of the relatively cheap Sterling.

Annual inflation (CPI) rose to 1.5% in October 2009⁸. Higher petrol price inflation and the impending reversal of the reduction in VAT are expected to drive a sharp increase in prices in the short term, before the spare capacity within the UK economy re-exerts its downward pressure. As the Bank of England advised in their latest Inflation Report: “there are significant risks to the inflation outlook in each direction”.⁹

Household spending, having fallen for five consecutive quarters, stabilised in Q3 2009⁵. In a climate of rising unemployment, fragile job security and weaker expected incomes, households have been saving more, and spending less, of their income. As a result, retailers have continued to struggle. Retail sales may have continued to show positive growth on an annual basis¹⁰, but it is not universal across all types of retailer. Retail sales also continue to be propped up by certain areas of the UK benefiting significantly from the rise in tourist numbers taking advantage of the relatively weak Sterling.

The consensus view appears to be that the Government and Bank of England stimulus should lead to a recovery in economic activity. However, the strength of the recovery is expected to be held back by a constrained credit market, and households and companies continuing to save, thereby reinforcing their balance sheets.

Nonetheless, the improvement in the economic outlook over the past 12 months should not be underestimated, and there is some optimism that the UK economy has seen the worst of the recession.

UK Commercial Property Market Overview*

Capital values rose 1.5% over Q3 2009 – a return to positive growth after eight consecutive quarters of falling values. While activity and confidence has steadily returned to the transaction market over 2009, there was a tangible shift in investor sentiment in the third quarter. At the end of June 2009, pricing in the derivatives market was implying -15% total returns in the UK commercial property market for 2009; by the end of September, implied returns were up 10 percentage points at just -4%. At the time of writing, implied returns had risen further, turning positive at the beginning of December 2009³.

By the end of Q3 2009, the margin between property initial yields (7.58%) and five-year swap rates (3.24%), at 434 basis points, remained historically high⁴. Swap rates, like property yields, have steadily fallen over the second half of 2009 so far, so the yield margin is likely to remain at around 400 basis points by the end of this year.

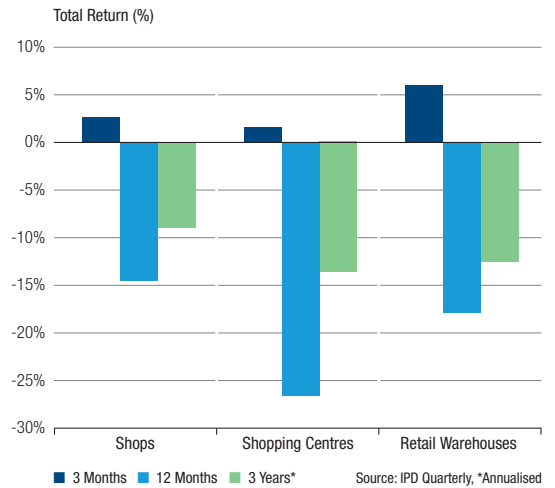
Commercial property produced a total return of 3.4% over Q3 2009. Despite a weak occupier market, the positive returns were driven by income and the impact of falling yields. Rental values fell further over Q3 2009, contracting by 1.6%, but the pace of contraction has eased across the market and all major sectors, if not all sub-sectors. The main driver of the current rental malaise would appear to be the steep contraction in UK economic output, rather than any development-led major oversupply of new space. As a result, should UK economic output levels stabilise in the final quarter of 2009, rental values and the health of the broader occupier market could follow suit and stabilise some time towards the end of 2010.

*All data in this section sourced from the IPD Quarterly Index Q3 2009, unless otherwise specified.

Sector Performance to 30 September 2009

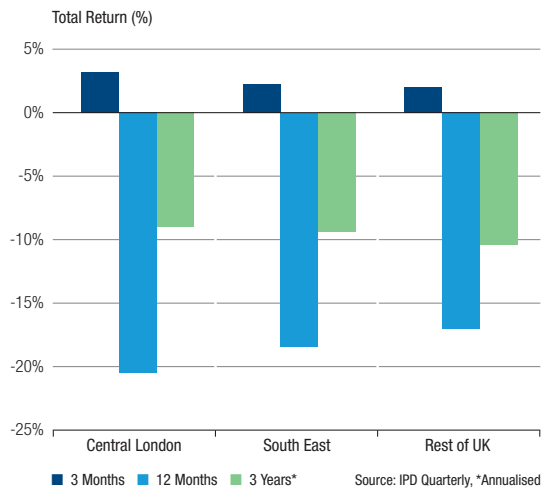
RETAIL

- The retail sector produced total return of 4.0% in the third quarter of 2009 outperforming all the other major sectors.
- However, over the 12 months to the end of September 2009, retail total returns at -18.7% were not enough to match the top performing sector, industrials.
- Retail rental values contracted over the 3 month and 12 month periods to end September 2009. Nevertheless, over both periods, rental values fell by less than the market average.
- A surge in retail warehouses returns over the third quarter of 2009 made it the top performer across all sub-sectors of the market. This outperformance was driven by a relatively sharp fall in absolute yields within the sector.
- Shopping centres remained the weakest performing segment of the market, over the 3 month and 12 month period to end September 2009, largely as a result of less inward movement of yields relative to other sectors over the latest quarter.
- There is some evidence that on the high street prime assets continue to significantly outperform more secondary assets, but the signs are less clear in the shopping centre and retail warehouse markets where returns in Q3 2009 appear less discriminating.



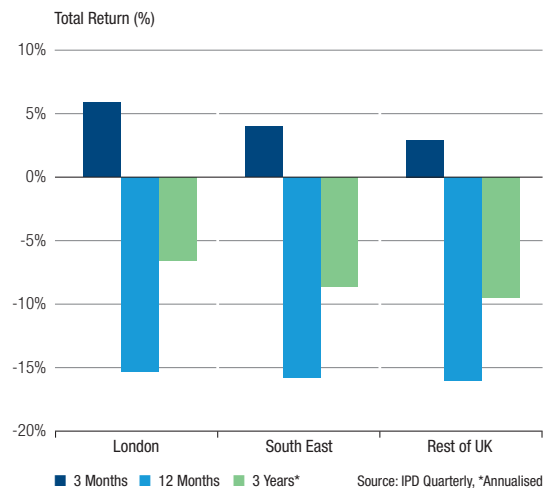
OFFICES

- The office sector was the worst performing sector over the quarter and 12 month periods to end September 2009 with returns of 2.6% and -19.3% respectively.
- Despite positive total returns across all sectors in the third quarter of 2009, capital values continued to fall across all major regions outside of Central London.
- Rental values deteriorated further in the third quarter of 2009, albeit with the rate of decline easing across Central London and the rest of the South East. The office sector has now proved the weakest rental market for each of the previous six quarters.
- On an annual basis, rental values proved more defensive in the less cyclical Rest of South East and Rest of UK markets. In the 18 months from the end of March 2008 to the end of September 2009, rental values in the more cyclical Central London office market have contracted by 26.6%.



INDUSTRIALS

- The industrial sector provided a total return of 3.5% over the third quarter of 2009, underperforming the retail sector but outperforming offices.
- Industrials proved the most defensive sector over the past 12 months recording a total return of -15.9%.
- On a regional basis, there was little to differentiate between London, the South East and the Rest of the UK. On a sub-sector basis, distribution warehouse total returns of -14.5% over the 12 months to end September 2009 compared favourably with standard industrial total returns of -16.2% over the same period.
- Industrial rental values fell by 4.2% over the 12 months to end September 2009, but, as some consolation, continued to be the most defensive sector.



UK Commercial Property Market Outlook

Property yields have been falling across all sectors^{1,2}. Buyers appear to have loosened their investment criteria, with increasing interest outside of prime, well-located, long-let, properties driving yields down across the less prime market. Nevertheless, secondary property yields remain, for now, anchored by the downside risk implied by the currently fragile economic outlook. Fortunes could change, however, should base rates and gilt yields rise significantly in the next two to three years, hitting lower-yielding assets harder than those more secondary. The uncertainty over how the quantitative easing will be reversed, its effects on the money markets, and the broader inflation outlook, make it difficult to predict just who will be the winners and losers out of prime and secondary over the next five years.

With the UK economy showing signs of an emergence from the global recession, albeit later than most countries, there are now signs that economic activity has finally begun to stabilise. The recovery is likely to be driven by the quantitative easing and the weak Sterling, but may remain constrained by the lack of bank credit and the impending tightening of the UK's fiscal policy. As a result, there remains substantial risk that the UK will be operating below capacity for some years to come, stifling any significant recovery in the occupier market across the UK.

One of the more certain features of the current property market is that the post 'credit crunch' lack of debt finance has led to a historically low development pipeline, particularly larger projects in the Central London office market and shopping centres. In the short term, the positive effects of the resulting lack of supply of new space on rental values may not outweigh the negative effects from the ongoing weak occupier demand. However, by 2011, we expect rental values to begin to rise as the improvement in the underlying economic fundamentals (inflation and bank rates) filters through.

RETAIL SECTOR OUTLOOK

Household spending stabilised over Q3 2009, after five consecutive quarterly falls⁵. Consumer sentiment may be picking up¹¹, but continued job losses and pay freezes appear to have driven households to save more of their regular income than they did at any point in 2008^{12,13}. Since unemployment is expected to rise into 2010, household spending is likely to remain constrained for the next 12 months at least. Although retail sales volumes have continued to grow on an annual basis, this masks falls in household goods stores and other specialist shops. In terms of money in the till high street stores have had to continue discounting heavily, with some sectors seeing falling sales values over the last 12 months¹⁰.

Undoubtedly, retailers and their margins remain under severe pressure and investors should not be complacent about whether their retailer occupiers can withstand further pressure on sales and costs. The rising house prices reported by all the major indices across the summer and autumn of 2009 may offer some encouragement to households across the UK to loosen the purse strings, and revive the relatively stagnant housing market⁴. Sales of bulky goods may therefore pick up in the short term, but the recovery in the housing market, largely founded on limited, relatively prime, stock on the market, is widely expected to peter out in 2010. With economic fragility expected to continue, an increasing amount of average residential stock is likely to appear on the market, and house price indices are, as a result, expected to fall over 2010 before a longer term recovery can begin from 2011 onwards.

Yields in the retail market are expected to continue to fall across all sectors the second half of 2009, and the beginning of 2010, but there are signs that the momentum in the seemingly more attractive sectors may begin to wane in 2010. For example, retail warehouse yields have seen the sharpest inward movement in Q3 2009², despite its occupier base remaining thin and highly exposed to a fragile housing market and broader economy. It remains to be seen whether investor preference for prime property begins to be eroded, although there are already signs that investor criteria have begun to loosen, with interest growing on relatively short-let prime properties. Nevertheless, while the economic outlook remains weak for the short to medium term, we maintain our preference for prime property.

The retail warehouse market may look in danger of overheating, but in contrast shopping centres appear relatively attractive. Yields remain well above long-term averages, vacancy rates now appear to be falling², and the sector continues to benefit from a large and diverse occupier base. Primer, out-of-town, units remain our preference, but some of the more average centres may have seen off the worst of the recession and as long as occupancy rates are high, may continue to see strong income returns.

High Street shops continue to offer a steadier return, but are less likely to benefit from any significant unwinding of the overcorrection in values that took place in the two years to July 2009. The appeal in such a 'low beta' sector, ie with relatively less variation in returns than other sectors, remains with its relatively stable income, than its room for capital growth.

UK Commercial Property Market Outlook

6

OFFICE SECTOR OUTLOOK

With no sign of any real momentum returning to lending markets, corporate investment remains relatively subdued, particularly in the financial services market⁵. Although confidence in the health of the broader global economy is beginning to improve, the UK has so far lagged most of the other major Western economies. What's more, further job losses are expected in the office market in the short term as cost-cutting and consolidation of the major banks continues to work its way through the system. As a result, the near-term outlook for much of the office sector, particularly areas dependent upon the financial services market such as Central London, remains weak. Over the longer term, the private sector should see some recovery; however, areas such as the regional markets which are more dependent upon the Public Sector as occupiers, are expected to suffer as deep fiscal cuts look likely to prompt significant job losses in an area of the market which, until now, has proved relatively recession-proof.

Although Central London offices rental values are now falling less sharply than they were at the beginning of 2009², we do not expect a return to positive rental growth until 2011, given the exposure of the occupier base to the financial markets. Office markets which are typically more exposed to the relatively healthier global occupier base, such as the City and the Thames Valley, may see a faster and stronger rental recovery than those areas more exposed to the Public Sector or local occupiers. The City may also benefit substantially from a 'credit crunch'-driven lack of speculative development which is expected to lead to a shortfall of new supply over the medium to long term, and, consequently, a bounce back in rental values. Such a scenario remains predicated, however, on improving business sentiment and some kind of global and national economic recovery. Despite improving transaction markets, we expect returns in the Central London office market, for the short term at least, to be dragged down by the performance in the more average, secondary properties in the region, where economic uncertainty continues to hold back any significant upturn in valuations.

Outside of the higher beta regional markets, London and the South East, the performance in the lower beta rest of the UK market is expected to remain relatively defensive in the short term. Medium-term performance, however, is likely to be held back by both the lagging economic recovery typical to the regional market, and the over-exposure to the Public Sector where conditions will be much less stable than in the last ten

years. Long leases, let to private sector tenants with strong covenants, are expected to remain the most attractive option to investors in light of the continued economic uncertainty.

INDUSTRIAL SECTOR OUTLOOK

Industrial production levels have continued to fall on a quarterly basis⁵. However, the recent turnaround in the monthly production figures¹⁴, along with positive results from recent industry surveys⁷, looks set to presage a return to positive growth in Q4 2009. The signs for the industrial occupier market still remain mixed. With the global economy beginning to recover, and Sterling remaining weak, conditions for those export-led industrial occupiers are looking increasingly positive; those occupiers heavily dependent on imported input are likely to continue to suffer from the relative high import prices. Ultimately, though, the contribution of an upturn in industrial output to occupier demand remains limited, with the market increasingly dependent on retail, or quasi-retail, occupiers and retail distribution networks. As outlined above, retailers remain hugely challenged in a market of tight margins and falling consumer spending.

Rental values are expected to continue falling over the coming 12-18 months as vacancy rates and levels of availability remain above-trend across all the sectors and the effects of the Government's removal of tax relief on vacant property units in 2008 continues to be felt. The industrial sector had suffered less than others from the yield correction over the 24 months to June 2009², but with its exposure to relatively high vacancy and company default rates, the recovery in values may come at a slower pace than the retail and office sectors. Nevertheless, rental yields relative to the cost of debt remain at historically high levels.

On balance the strength of the industrial market remains its relatively high income return. Despite the threat of falling rents, higher vacancy rates, and tenants with relatively poor covenants; if bank rates were to begin rising in the medium term, the sector returns could prove more stable than those of other sectors/assets operating from much lower income yields. However, the Government's removal of tax relief on vacant property units continues to hit income levels, so we still believe that there is a significant downside risk to investment in the industrial market.

Portfolio Strategy

	Segment	Invista House View
Retail	South East Shops	Underweight
	Rest of UK Shops	Underweight
	Shopping Centres	Overweight
	Retail Warehouses	Underweight
Offices	Rest of UK Offices	Neutral
	South East Offices	Overweight
	Central London Offices	Neutral
Industrial	South East Industrials	Overweight
	Rest of UK Industrials	Neutral

Notes

The data contained in this document is for information purposes only. It is correct to the best of our knowledge at the date of issue and may be subject to change. This document is not legally binding and no party shall have any right of action against Invista in relation to the accuracy or completeness of the information contained in it or any other written or oral information made available in connection with it.

Any forecast, projection or target where provided is indicative only and is not guaranteed in any way. Invista Real Estate Investment Management Limited accepts no liability for any failure to meet such forecast, projection or target.

This document is intended for investment professionals only and should not be relied upon by private investors.

Any opinions are Invista's own at the date of this document and may change.

Unless otherwise stated, the source of information is Invista Real Estate Investment Management.

Past performance is not a guide to future performance.

Investments in property are relatively illiquid and more difficult to realise than equities or bonds. Yields may vary, and are not guaranteed. The past performance of property funds is not always represented by the performance of the property market as a whole and the value of property is a matter of a valuer's opinion rather than one of fact. Property funds will not contribute diversification where investors already have a substantial proportion of their investments in property.

Issued by Invista Real Estate Investment Management Limited, authorised and regulated by the Financial Services Authority. Registered office 33 St Mary Axe, London EC3A 8AA. Registered in England and Wales Registered number 04459443.

Source

- 1 *IPD, UK Monthly Property Index, November 2009*
- 2 *IPD, UK Quarterly Property Index, Q3 2009*
- 3 *Tradition Property, Property Derivative Price Report, 7 December 2009*
- 4 *Thomson Datastream, 8 December 2009*
- 5 *Office for National Statistics, UK output, income and expenditure, Q3 2009*
- 6 *BCC, Quarterly Economic Survey, Q3 2009; CBI, Quarterly Industrial trends Survey, October 2009*
- 7 *CIPS/Markit UK Services PMI and UK Manufacturing PMI, November 2009*
- 8 *Office for National Statistics, Consumer Price Indices, October 2009*
- 9 *Bank of England, Quarterly Inflation Report, November 2009*
- 10 *Office for National Statistics, Retail Sales October 2009*
- 11 *European Commission, Business and Consumer Survey Results, November 2009*
- 12 *Office for National Statistics, Labour Market Statistics, November 2009*
- 13 *Office for National Statistics, Quarterly National Accounts, Q2 2009*
- 14 *Office for National Statistics, Index of Production, October 2009*