



UK Commercial Property Market Overview

JUNE 2008

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Key Highlights

- We expect the yield-led correction in the commercial property market to come to an end in the third quarter of 2008.
- There are now signs of liquidity returning to the market. If the occupier market remains sufficiently resilient, and some confidence returns to the borrowing markets, property yields could look attractive towards the end of 2008.
- Optimism for the near-term outlook must remain cautious in light of the existing downside risks. Unprecedented high oil prices, rising utility and food bills are all threatening the ability of the Bank to respond to any slowdown by reducing interest rates.

Room for cautious optimism but downside risks remain

“The heart of the problem is not in the real economy; it is in the financial sector itself”. This was the Governor of the Bank of England’s view at the end of March 2008¹. Financial markets have remained fragile post-“credit crunch” with borrowing margins remaining stubbornly high. As a result, despite commercial property yields rising back above the cost of debt, activity has been muted as investors remain cautious. Early signs that the correction in property market pricing may be coming to an end were boosted by a slowing in the rate of decline in capital values that was reported by the IPD Monthly Index². However, risks remain that any prolonged economic slowdown could affect the occupational market causing a further de-rating of property.

The Bank of England surprised many with its optimistic tone in May 2008, reasoning that an improvement in market conditions was just around the corner, and that as uncertainty falls and market liquidity improves, it should become clearer that some assets appear cheap relative to credit fundamentals³. In that environment, firms may find that previous mark-to market loss estimates have been overstated and some write-backs of reported losses may occur.

But how vulnerable does the commercial property market remain? There are now signs of liquidity returning to the market. Transaction levels remained low in Q1 2008, according to Property Data⁴, but the Investment Management Association reported a return of positive net inflows to property funds in March 2008 after five consecutive months of net outflows⁵. The fortunes of the occupier market lie in the balance, being highly dependent on the length and depth of the economic slowdown in the UK. If the occupier market remains sufficiently resilient, and some confidence returns to the borrowing markets, property yields could look attractive towards the end of 2008.

Nevertheless, such optimism for the near-term outlook must remain cautious in light of the existing downside risks. Unprecedented high oil prices, rising utility and food bills are all threatening the ability of the Bank to respond to any slowdown by reducing interest rates.

Economic overview

The economy grew 0.4% in the first three months of the year, down from 0.6% in Q4 2007⁶. Lower consumer and business confidence, rising input prices and tight borrowing conditions were thought to be responsible for the squeeze on output growth. Business services and finance saw quarterly growth of 0.4%, while a weaker pound helped the relatively small manufacturing sector outperform, with growth of 0.5%⁶. With uncertainty remaining in global financial markets, a further deceleration in activity in the UK economy is expected in 2008 before growth is expected to recover in 2009. Employment intentions surveys have pointed towards rising job losses over the coming six months³, although to date the labour market has remained remarkably robust with employment numbers at a record high⁷.

Retail sales growth, at 2.0% quarter-on-quarter, has appeared surprisingly resilient but discounting especially across non-food stores has propped growth up⁸. Broader figures for consumer spending have supported this, with growth in spending up 1.3% over the first quarter of 2008⁶. The cooling in the housing market over the same period has been exacerbated by the contraction of the personal lending markets. By March this year the number of

mortgage approvals for new house purchases had fallen 44%⁹, while Halifax reported a -0.9% fall in house price growth over the 12 months to April, down from 4.5% three months earlier¹⁰.

The Bank of England has cut interest rates twice since January 2008, most recently by 25 basis points in April, although rising margins meant that effective interest rates have fallen little. At the same time, higher prices for energy, food and imports drove annual consumer price inflation (CPI) to 3% (1% above target) with more expected to come over the course of the year^{11,12}. With their key priority being to restore inflation to its target level, the bank has now found itself in the uncomfortable position of facing a slowing economy with above-target inflation. If the employment market were to deteriorate markedly, then stagflation would become a real threat. Much depends on how resilient employment levels can remain in the medium-term in the face of declining consumer and business confidence. Despite the Bank of England's limited flexibility we still expect them to cut rates to 4.5% by the summer of 2009 as they tread the difficult path between maintaining economic stability and avoiding stoking either inflation or, perhaps more damagingly, inflation expectations.

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The first quarter of 2008 saw an easing in the yield-led correction in the commercial property market. While markets continued to adjust to the impact of the higher cost and poorer availability of debt resulting from the global "credit crunch". Property investment looked more attractive by the end of the quarter in an environment of stable occupier markets and, in the wider economy, falling interest rates and volatile equity markets.

Returns fell by 3.3% over Q1 2008, driven by a 4.6% fall in values. The impact of rising yields was felt across all sectors despite continued rental appreciation. Rental value growth of +0.6% quarter-on-quarter (2.4% annualised)

remained underpinned by broad-based economic growth, healthy levels of take up of new/empty space and limited tenant delinquencies across all sectors.

Borrowing conditions remained tight, keeping debt-backed buyers out of the market. Transaction levels in the Q1 2008 were low, with total transaction values less than half that seen twelve months earlier. The lack of liquidity was not just down to nervousness in the lending markets, but also uncertainty over pricing.

Source: IPD Quarterly Index

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Sector performance to March 2008

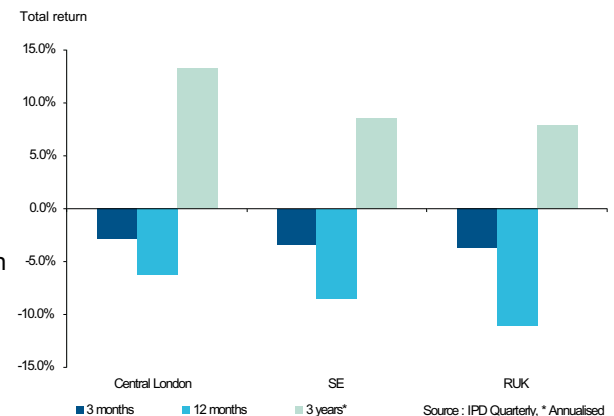
Retail

- The retail sector returned –3.5% over the first quarter of 2008, marginally underperforming offices and matching the performance in the industrial sector.
- Total returns of –11.8% over the 12 months to March 2008 saw a more marked underperformance in the retail sector than in office and industrials.
- Over the 12 months to March 2008, the sector generated rental growth of 1.6%, compared to 3.6% for the whole market, with retail properties in Central London continuing to see the strongest growth in rents.
- Within the sector, shopping centres generated stronger returns over the last twelve months on the back of better rental growth and what have so far been more stable yields.



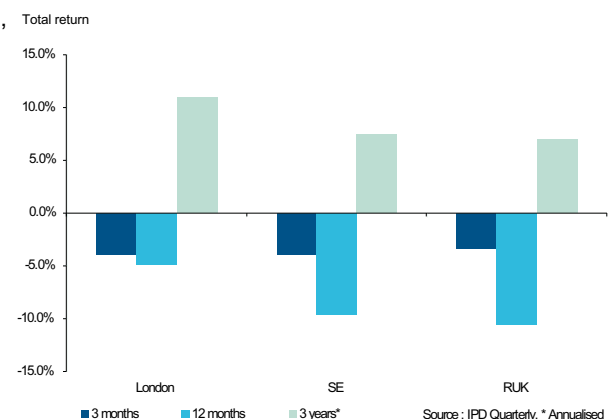
Offices

- The office sector outperformed retail and industrial over the first quarter of 2008, albeit recording a total return of –3.1%. Offices also outperformed all sectors on a 12-month basis, with a return of –7.8%.
- Rental growth weakened further in Q1 2008 but remained relatively high, generating the highest rate of growth of the three main sectors. Office rents have risen by 7.4% over the past 12 months.
- Rental growth remained strongest in Central London, principally in the West End of London. Over the last three months, Central London offices recorded rental growth of 1.4%, contrasting with growth of 0.6% in the rest of the South East and 0.5% elsewhere in the UK.
- Central London offices also saw the least negative capital growth over the 12 months to end March 2008 at –9.8%.
- All sub-sectors have seen the diminishing impact of higher yields on capital values partially offset by positive rental value growth.



Industrials

- The industrial sector returned –3.5% over the first quarter of 2008, underperforming offices and matching the performance of the retail sector.
- Over the past 12 months, the sector returned –9.0%, slightly better than the all property average of –9.7%. Despite a relatively poor Q1 2008, London industrials still outperformed 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, at 1.5% over the past 12 months. Nevertheless, this was above the trend level of rental growth for the IPD Quarterly Index (since March 2001), reflecting the underlying strength of the UK economy.



UK commercial property market outlook

We expect the yield-led correction in the commercial property market to come to an end in the third quarter of 2008. Liquidity levels are expected to improve as confidence in borrowing markets begins to pick up, and effective interest rates come down. However, should illiquidity persist there is significant risk of a “double-dip” later in the year as highly leveraged transactions may fail to secure re-financing. Nevertheless, we expect the market to recover from 2009.

The downside risk from a global economic slowdown in 2008/2009 is expected to reduce levels of rental value growth, but we believe the UK economy should prove resilient enough to continue to provide positive nominal rental value growth over the coming eighteen months. The medium to long term outlook for the commercial property market continues to appear benign with commercial property offering relatively stable performance.

Clear sector winners still appear elusive in the outlook for the market in the short to medium-term. 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 out-performance will have to be driven by asset management, stock-picking value buys, longer leases and stronger tenant covenants.

City and Docklands offices look particularly vulnerable to slowing occupier demand as a result of the job cuts expected in the financial sector this year and a relatively heavy pipeline of space due on the market from the end of 2008. Rental values in the retail sector are expected to prove sluggish until the end of 2009 in line with expected flat household spending growth. The impact of changes to empty property rates relief on rents from April 2008 on the industrial sector have yet to be measured but a recent Lambert Smith Hampton survey found that rental values are expected to fall in the short term as landlords try and fill empty properties¹⁴.

We continue to favour assets located in the South East of the country which, in a near-term economic slowdown, should offer a softer landing than assets in the rest of the UK. Despite the higher exposure in the South East to the finance and business sector, we still believe their occupier and investment markets in this region to be more defensive.

Retail sector outlook

Retail sales volumes in the three months to March 2008 appeared surprisingly robust when compared with the same period twelve months earlier, having grown by 5.6%⁸. However, as in recent months, growth has been propped up by discounting in non-food stores, a trend expected to continue throughout the rest of 2008. Tighter credit conditions are expected to continue to have a cooling effect on the housing market, with the number of mortgage deals on offer and approvals given remaining low in the near term. As a consequence, house price growth is generally expected to be negative over 2008. Such tighter lending criteria, less activity in the housing market, as well as higher costs of living are all expected to slow consumer spending over the next 12 months.

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.

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. The medium term outlook for rental value growth may have improved slightly in light of the dampening effect the tighter borrowing market has been having on the longer-term pipeline of new shopping centre schemes. Nevertheless, conditions remain challenging as the occupier market absorbs the expected impact of flat consumer spending over the near to medium term.

Retail Warehouses took the hardest hit to valuations over the 9 months to Q1 2008, with equivalent yields returning to levels last seen in Q4 2004. Parts of this market arguably look good medium term value, especially properties with long leases in areas of limited availability and future supply. However, weaker retail sales numbers over the coming months are likely to hit profit margins, which in the retail warehouse sector are already some of the thinnest.

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Offices sector outlook

We 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 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 recession.

Prime West End offices are a cause for concern with continued fallout from the "credit crunch" expected to dent demand for space from an occupier base heavily weighted to the hedge fund market. City offices also look increasingly vulnerable to slowing occupier demand in the financial services market and a relatively heavy pipeline of space due on the market from the end of 2008. Tighter conditions in the borrowing market may drive delays in expected

completion dates, or even rule out some developments, in the medium to long term. In the short term, however, a glut of new office space in the City appears unavoidable.

Outside of London and the South East the performance in the rest of the UK in the short term is expected to be more stable. 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 to be felt. Although current levels of Government debt do not offer an encouraging outlook for further growth in 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

There is limited scope for rental value growth in the industrial market. Vacancy rates remain above-trend across all the sectors bar London, and, in the short term, at least, the industry expects the Government's removal of tax relief on vacant property units to have a negative effect on rental values¹³. While the sector had suffered less impact from the yield correction up to the end of 2007, this trend reversed in the first quarter of 2008 as the industrial sector, caught up with the rest of the market. Significant positive capital growth in the short to medium term remains unlikely as the sector still offers only a relatively small yield premium relative to interest rates.

The outlook for the manufacturing sector is mixed – growth picked up in Q1 2008⁶ but recent survey evidence points to a slowdown in the coming months¹⁴. In light of the ongoing weakness in sterling, some areas of the market are

expected to benefit from increasingly attractive export prices, while others will suffer from the rising input prices. With easing consumer spending expected to negatively affect all areas of the market, rental growth across the sector market may be limited.

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 adversely affected 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
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 Bank of England, Treasury Committee Opening Statement, March 2008
- 2 IPD, UK Monthly Property Index, May 2008
- 3 Bank of England, Financial Stability Report, April 2008
- 4 Property Data, Property Investors Bulletin, April 2008
- 5 Investment Management Association, Investment Fund Statistics, March 2008
- 6 Office for National Statistics, UK output, income and expenditure, Q1 2008
- 7 Office for National Statistics, Labour Market Statistics, May 2008
- 8 Office for National Statistics, Retail Sales March 2008
- 9 Bank of England, Lending to Individuals, March 2008
- 10 Halifax, House Price Index, April 2008
- 11 Office for National Statistics, Consumer Price Indices, April 2008
- 12 Bank of England, Quarterly Inflation Report, May 2008
- 13 Lambert Smith Hampton, Empty Property Rates Survey, March 2008
- 14 CBI Industrial Trends Survey, Q1 2008



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