

Institutional Investment in Property

Even before the deficit reduction programme was properly under way, a combination of falling confidence and wintry December weather has caused the UK economy to shrink by 0.5% in the fourth quarter of 2010. Over the whole year output grew by 1.6%. The Office for Budget Responsibility recently said that, "the economy will continue to recover from the recession, but at a slower pace than in the recoveries of the 1970s, 1980s and 1990s. This relatively sluggish medium-term outlook reflects the gradual normalisation of credit conditions, efforts to reduce private sector indebtedness and the impact of the Government's fiscal consolidation." But even this gloomy prognosis may be too optimistic.

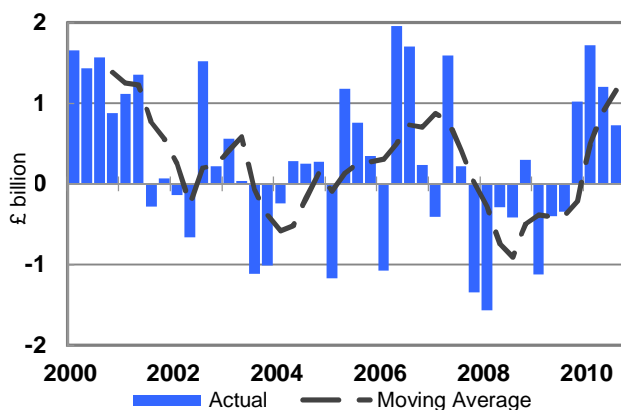
Investment in UK property Q3 2010 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts ¹	Total
Purchases	686	785	176	1,647
Sales	244	597	82	923
Net Investment	442	188	94	724

1. Includes Investment Trusts

In January, the PMI index constructed from surveys of the services, manufacturing and construction industries suggested that outside of manufacturing, business confidence had slumped. Expectations regarding business activity in 2011 were at levels associated with economic crises and falling activity indicating that the UK appears to be on course for disappointing growth in early 2011.

Net institutional investment in property



Source: National Statistics

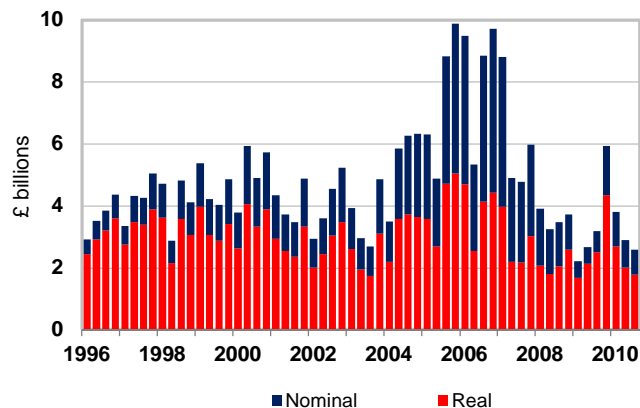
The commercial property market was stable over the course of Q4. Capital values as measured by the IPD Monthly index grew by 0.5% in the 3 months to the end of December and total returns on commercial property amounted to 2.2%. Both numbers matched Q3's performance. Total returns in the 12 months to December were 14.5% compared to 22.6% in the 12-months to September.

Institutional investment in commercial property fell back further from the levels achieved in Q1 and Q2. Institutions acquired property assets worth £1.6 billion in Q3 and recorded sales of £920 million. As a result, net investment in Q3 was £720 million compared to £1.2 billion in Q2. In the 12 months to September, net investment by institutions amounted to £4.7 billion compared with net disinvestment of £1.6 billion in the 12 months to September 2009.

In the third quarter, pension funds invested a further £442 million and have been net investors for the last fourteen

quarters. Total investment by pension funds in the 12 months to September amounted to £1.71 billion compared to £1.68 billion in the 12 months to June and £1.57 billion in the year to September 2009. Life companies were net investors for the fourth consecutive quarter in Q3 having previously been net sellers of property assets for the previous nine quarters. Their net investment in Q3 amounted to £130 million. Total investment by Life Companies in the 12 months to the end of September amounted to £1.1 billion compared to £250 million in the 12 months ending June and a net disinvestment of £2.5 billion in the year to September 2009. Property Unit Trusts were net investors for the fourth consecutive quarter in Q3 as the Association of Real Estate Funds continued to report net cash inflows. They invested £94 million in Q3 and £1.6 billion in the 12 months to the end of September compared with a net investment of £1.4 billion in the 12 months ending June.

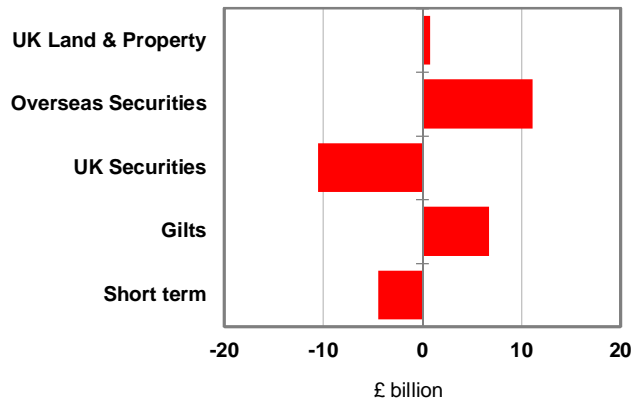
Property market liquidity



Source: National Statistics & Fletcher King

Total institutional investment grew by £15.4 billion in Q3 having previously shrunk by £6.4 billion in Q2. In addition to the net investment of £720 million in UK Property noted above, institutions also made net purchases in Q3 amounting to £6.7 billion of UK government gilts and £11.1 billion of overseas equities. However, they sold £10.6 billion of UK equities and holdings of cash and other short term instruments decreased by £4.5 billion.

Net institutional investment by asset type, Q3 2010

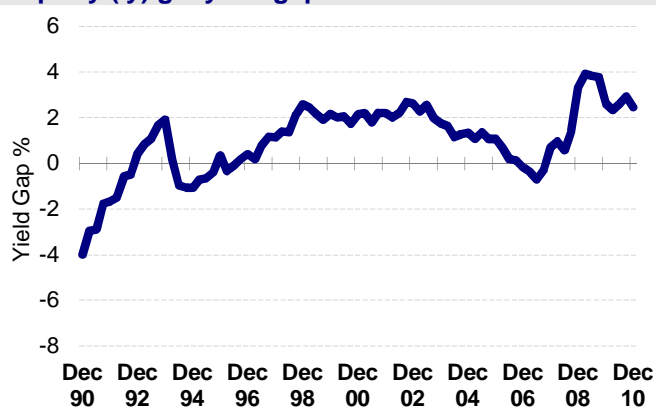


Source: National Statistics

The Outlook for Property in 2011

The commercial property market entered 2010 in an optimistic mood. The calendar 2010 All Property swap was priced at 10.2% but by February the IPF Consensus Forecast had climbed to 13.5% from 9.3% in November. Capital values continued a robust recovery which had started in the previous year. In the first six months of 2010 capital values grew by 6% as initial yields hardened by 50 bps. But in the second half of the year doubts began to emerge about the sustainability of the recovery and capital values only grew by 1% in the last six months of the year. The total return for the whole of the year amounted to 14.5% which equalled the return from the Equity All Share index after it had enjoyed a strong end to the year, and bettered 9.1% from a basket of 5 to 15 year gilts.

Property (iy) gilt yield gap



Source: National Statistics

2010 witnessed strong levels of demand for commercial property investments from both domestic institutions and overseas investors throughout the year. In the fourth quarter property investment as measured by Property Data rose to £11.6 billion representing the largest quarterly turnover since the third quarter of 2007.

However, there are some signs that this level of demand may be abating. Net investment into property funds and unit trusts as measured by the Association of Real Estate Funds decreased to £275 million in the three months to September. This was the lowest quarterly total since the start of the market recovery in June 2009. According to the Investment Managers Association net sales of property funds to retail investors amounted to just £64 million in November. Nevertheless this was an improvement on net disinvestment of £5 million in October. Together these two months were the weakest for sales in the whole of the last year.

The yield on Central London offices has decreased to the level seen at the top of the market in June 2007. Across all other segments of the market yields for prime property have decreased to the average levels prevailing for the last ten years. It is hard to see prime yields hardening further at this stage in the cycle. Despite the growth in values seen since the market's trough in June 2009, secondary property is more comfortably priced especially shopping centres, offices outside Central London and industrials.

At the All Property level, property remains attractively priced relative to other assets. The initial yield on IPD's December monthly index has decreased to 6.4%. The dividend yield on the FT All Share is currently 2.9% and the resulting property equity yield gap of 3.5% remains above the long run average of 3.0%.

Compared to a basket of gilts along the yield curve the property initial / gilt yield gap has decreased slightly to 2.5% from 2.6% in December 2009 but this still compares favourably to the long run average of 1.7% which arguably puts a floor under property pricing.

An alternative view which highlights the uncertain outlook was voiced by Nick Leslau, the chairman and chief executive of Prestbury Group and co-founder and non-executive director of Max Property Group. Writing in Property Week, he expressed the view that whilst equity remained available for investment in prime and the very best secondary properties; there was limited fresh debt available to finance transactions in the leveraged private market. He also said that, "At present the values at which secondary properties are held on the books of many are simply too high. A lack of transactional comparable evidence is preventing the necessary downward shift to reflect rapidly diminishing available debt and pricing levels at which cash buyers can and will buy."

A further threat to the outlook for property in 2011 comes from the policy response to inflation which has been above its 2.0% target in every month since November 2009. It is possible that the Monetary Policy Committee (MPC) could increase the Bank Rate from its historically low current level "to reinforce expectations that inflation would fall back to target." However, in January the MPC considered that, "the margin of spare capacity was likely to bear down on inflation and bring it back towards the target in the medium term" once the temporary impact of one-off petrol and commodity price rises and the increase in VAT to 20% had waned.

All property rental values fell by under 1% in 2010 and a return to positive levels of rental value growth might normally be expected. But the slow paced nature of the recovery expected in 2011 and 2012 makes positive rental growth across all sectors of the market highly unlikely. In the retail sector it is estimated that 15% of all High Street shops are vacant. British retail sales have just suffered their worst December since 1998. Data from the Ordnance Survey indicates that since October 2008 there has been a 28% decline in the number of building societies, a 9% decline in estate agencies and a 5% decline in the number of pubs across the UK's High Streets. High street bookmakers were the only category to see significant growth, with their numbers up 5% over the two-year period. Vacancy rates also remain high across the office and industrial sectors and large scale job losses and office closures will add to existing levels of supply.

The exception is Central London. Rents on New Bond Street rose by 32% in 2010 and a "Zone A" rental in excess of £1,000 per sq. ft. has recently been achieved. This trend is likely to continue for the foreseeable future on the basis that there are still a large number of retail requirements that remain unsatisfied. Central London offices have seen headline rents increase by an average of 13% in 2010 with City office rents climbing 25%. This is another trend that is likely to continue into 2011. Across Central London just 1.8 million sq. ft. of newly developed space is scheduled for completion in 2011 and less than 200,000 sq. ft. in 2012. Historically Central London development completions have averaged 4 million sq. ft. a year and annual take-up has averaged 11 million sq. ft. over the last three years.

The outlook continues to be uncertain. Our central All Property forecast projects negligible rental value growth and yield movement. But the risks to this outcome are many and include inflation and rising bank rates, weak or perhaps falling economic growth, sovereign defaults in the Eurozone and rising risk free rates, limited new debt finance for property and large sales of distressed property by the banks.