October 2010

Institutional Investment in Property

Fletcher King PROPERTY FUND MANAGERS CHARTERED SURVEYORS

The UK economy grew by 0.8% in Q3 which was double the rate of growth indicated by September's PMI index constructed from surveys of the services, manufacturing and construction industries and predicted by most economists. The economy has now enjoyed four consecutive quarters of growth following the end of the recession and may well be in its fifth consecutive quarter. However, as businesses face up to the economic impact of the public sector austerity measures announced in the Comprehensive Spending Review, doubts regarding the future strength of the recovery are now being aired.

Investment in UK property Q2 2010 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts [1]	Total
Purchases	931	882	373	2,186
Sales	266	538	62	866
Net Investment	**665**	**344**	**311**	**1,320**

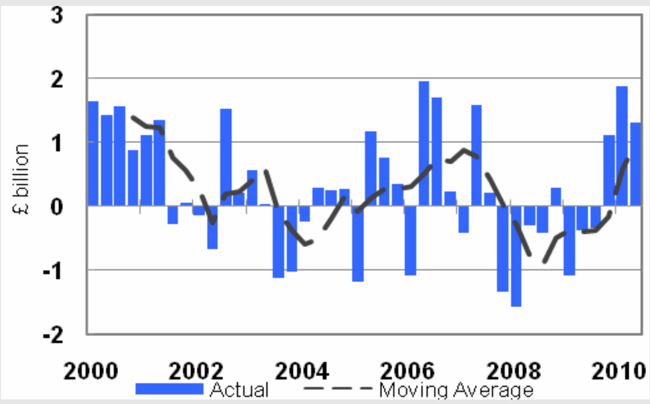
1. Includes Investment Trusts

Nationwide reported that UK house prices fell by 1% in Q3. The British Retail Consortium reported weak sales growth in September 2010 and commented that the sector now had six straight months of low growth thanks to persistently weak consumer confidence and worries about the future.

The commercial property market recovery eased further in Q3. Capital values as measured by the IPD Monthly index grew by just 0.5% in the 3 months to the end of September and total returns on the commercial property market, amounted to 2.2% in Q3 compared to 3.6% in Q2.Total returns in the 12 months to September were 22.6% compared to 23.9% in the 12-months to June.

Institutional investment in commercial property fell back from the record level achieved in Q1. Nevertheless, institutions acquired property assets worth £2.2 billion in Q2 and recorded sales of £870 million. As a result, net investment in Q2 was £1.3 billion compared to £1.9 billion in Q1. In the 12 months to June, net investment by institutions amounted to £4.0 billion compared with net investment of £2.3 billion in the 12 months to March.

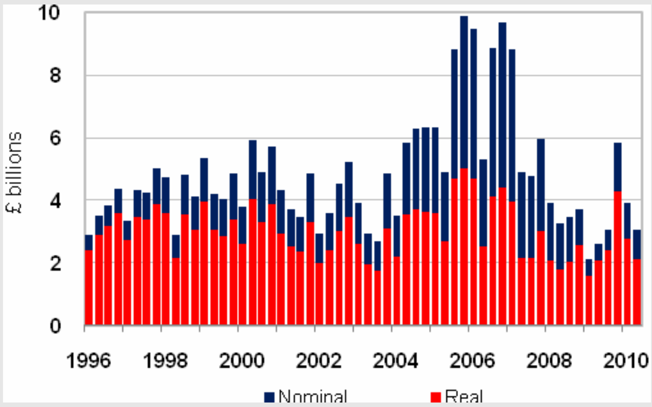
Net institutional investment in property



Source: National Statistics

In the second quarter, pension funds invested a further £665 million and have been net investors for the last thirteen quarters. Total investment by pension funds in the 12 months to June amounted to £2.1 billion compared to £1.8 billion in the 12 months to March and £1.3 billion in the year to June 2009. Life companies were net investors for the third consecutive quarter in Q2 having previously been net sellers of property assets for the previous nine quarters. Net investment in Q2 amounted to £303 million. Their total investment in the 12 months to the end of June amounted to £260 million compared to a net disinvestment of £490 million in the 12 months ending March. Property Unit Trusts were net investors for the third consecutive quarter in Q2 as the Association of Real Estate Funds continued to report strong net cash inflows. They invested £312 million in Q2 and £1.4 billion in the 12 months to the end of June compared with a net investment of £760 million in the 12 months ending March.

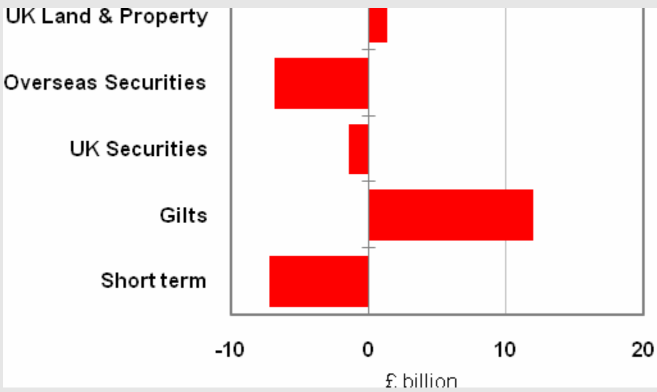
Property market liquidity



Source: National Statistics & Fletcher King

Total institutional investment in all asset classes shrank by £7.7 billion in Q2 having previously grown by £14.9 billion in Q1. In addition to the net investment of £1.3 billion in UK Property noted above, institutions also made net purchases in Q2 of £12.0 billion in UK government gilts. However, they sold £6.8 billion of overseas equities as well as £1.4 billion of UK equities demonstrating an increasing aversion to risk. Holdings of cash and other short term instruments were decreased by £7.2 billion.

Net institutional investment by asset type, Q2 2010



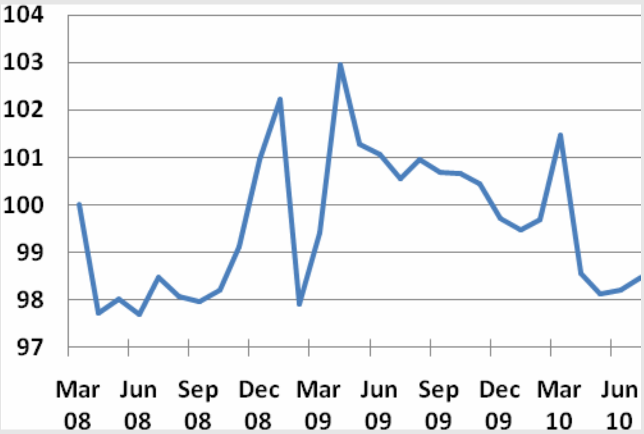
Source: National Statistics

The retail market, retailers and the UK's high streets

The current macro-economic environment is challenging for the retail market, retailers and the UK's high streets. Even before the announcement of the results of the Spending Review, falling house prices, declining real wages, and increased levels of part time work at the expense of full time work have caused consumer confidence to fade. On the High Street, weak levels of retail sales growth are being squeezed by robust on-line sales growth. But some retailers are thriving and some High Streets are faring better than others.

UK house prices fell by 1% in Q3 leading to a fall in the annual rate of growth from 9.5% to 4.5% with the northern and midland regions generally seeing weaker price growth than the southern regions Nationwide thinks that developments in the labour market will be a key determinant of housing market performance. Although growth in the number of people in employment reached a record 286,000 in the three months to July, the increased use of part-time labour has helped employers to limit recession-related redundancies but has had a weakening effect on earnings growth which in turn has contributed to denting consumer confidence in the outlook for future incomes.

Real average earnings index



Source: National Statistics

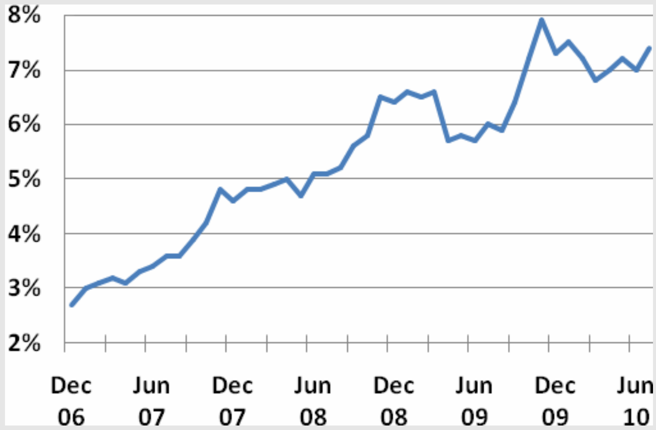
In the year to July, the latest month for which data is available, average earnings grew by 2.6%. But in the same month the annual rate of retail price inflation was 4.8% reflecting the reinstatement of the 17.5% VAT rate together with increased food, energy and commodity prices compared with a year earlier. Consequently average earnings shrank in real terms. In fact, since the start of the recession in March 2008, average earnings have decreased by 1.5% in real terms.

These trends seem to have been reflected in Nationwide's Consumer Confidence Index which recorded a notable drop in confidence in September.

The BRC has now written to the Chancellor ahead of The Comprehensive Spending Review warning of the weak economic outlook for its members. Ordinarily, this might be discounted as the lobbying of a special interest group on behalf of its members but the views of the BRC have been lent extra weight by recent reports.

According to research by accountants BDO, more than 26,500 retailers will be forced to close by 2015, as the UK's economy slowly crawls back to health. The expected rate of business failures is significantly higher than in the post-recession period that followed the downturn in the early 1990s. Then, 0.6% of all retailers went bust. This time, 0.9% are expected by BDO to fail.

Internet sales as a percentage of total retail sales



Source: National Statistics

In its Mid-Year 2010 Shop Vacancy Report, the Local Data Company reported that town centre vacancy rates in Great Britain have risen from just over 12% at the end of 2009 to 13% at the end of June 2010. The research shows the weak state of the retail markets in many large northern and midland cities. There are only three southern towns included amongst a list of the 25 worst hit large centres, namely Watford, Bristol and Reading but Bristol, for example, has only half the vacancy rate of the worst large centre which is Blackpool with a vacancy rate of nearly 30%.

The latest results from the IMRG Capgemini e-Retail Sales Index reveal that British shoppers spent a total of £4.8 billion online during September; equivalent to £79 per person and reflecting year-on-year growth of 24%. When compared with the latest BRC figures which show that like for like non-food sales declined by -0.4% in the year to September, it seems that the rise in online spending is coming at the expense of high street sales.

In spite of the weak outlook one of the biggest representatives on the UK's high streets has recently reported strong results albeit accompanied by cautions regarding future prospects. Marks and Spencer's latest trading statement announced a 5% increase in like for like sales, but also said that with economic uncertainty putting a strain on household budgets, customers are returning to quality in areas such as men's suits and knitwear. This is a view that was repeated in BDO's report which suggested that the recession had been a catalyst for change. People are becoming much more demanding and post-credit crunch consumers are looking for better value for money and better quality.

Unsurprisingly, we are cautious about the outlook for high street shops. But there are a number of trends that can be drawn out of this brief analysis. Firstly, the South has weathered the recession better than the North or the Midlands and the spending cuts are likely to widen that division further. Secondly, those retailers and centres that can offer quality products and stores with good levels of service will outperform. Thirdly, internet sales continue to grow strongly and will continue to take business from high streets that have a limited breadth of offer and poor facilities.

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