

Institutional Investment in Property

In Q4 the stock market paused for breath as investors realized that the strength of the economic recovery remained in doubt. By the end of September 2009 the FTSE100 index had risen by 46% since early March but in Q4 growth slowed to a more prosaic 5%.

Investment in UK property Q3 2009 (£ millions)

	Pension Funds	Insurance Companies	Unit Trusts ¹	Total
Purchases	708	550	177	1,435
Sales	248	1,209	235	1,692
Net Investment	460	-659	-58	-257

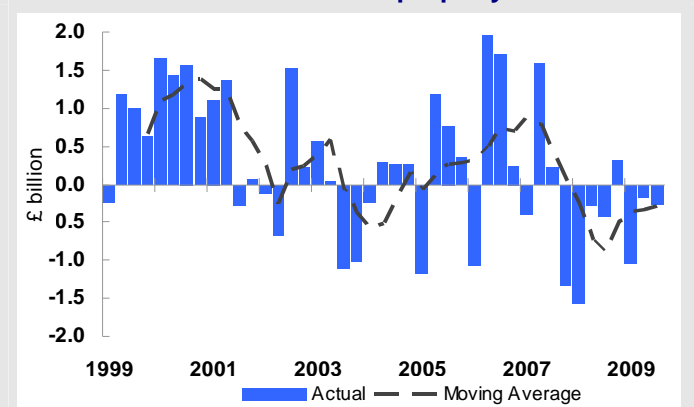
1. Includes Investment Trusts

The latest GDP figures indicate that the UK economy expanded by 0.1% in the fourth quarter of 2009, compared with a decrease of 0.2% in the third quarter. However, the figure was much weaker than expected. The loose monetary policy of low interest rates and quantitative easing seems certain to remain in place for some time yet.

Indications are that the recovery will not be a strong one, at least in its early stages. House prices have been increasing since March last year but the Nationwide believes that the outlook over the next 12 months is uncertain. The British Retail Consortium welcomed the best December sales growth figures since 2005 but consumer confidence is now weakening. Meanwhile surveys of the financial services sector suggest activity increased slightly in Q4 but expect volumes to fall back in Q1.

Having ended its run of 25 consecutive months of declining capital values in the third quarter, the commercial property market shrugged off any concerns over the mixed outlook for the economy. Capital values as measured by the IPD Monthly index grew by 7.4% in the 3 months to the end of December and total returns on the commercial property market, amounted to 9.5% in Q4 compared to 3.3% in Q3. These were the strongest quarterly performance figures since the inception of the monthly index in 1987.

Net institutional investment in property



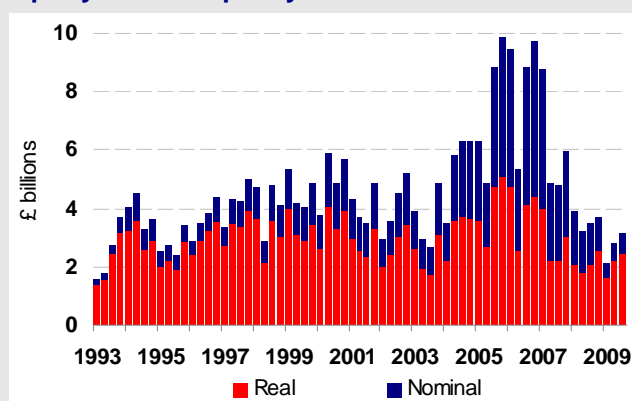
Source: National Statistics

The latest figures published by National Statistics show that although market activity increased by 16% in the third quarter of 2009 compared to the second quarter it still remained subdued by historic standards. Property assets acquired in Q3 amounted to £1.4 billion but institutions also sold £1.7 billion. As a result, net disinvestment in Q3 was £257 million compared to net disinvestment of £182 million in Q2. In the 12 months to September, net disinvestment by

institutions amounted to £1.2 billion compared with net disinvestment of £1.3 billion in the 12 months to June. In the light of Q4's investment performance we expect the Q4 figures which will be released in March to show much greater levels of activity.

In the third quarter, pension funds invested a further £460 million and have been net investors for the last ten quarters. Total investment by pension funds in the 12 months to September amounted to £1.8 billion compared to £1.5 billion in the 12 months to June and £839 million in the year to September 2008. Life companies made a net disinvestment of £713 million in Q3 and have been net sellers of property assets for the last nine quarters. Their total disinvestment in the 12 months to the end of September amounted to £2.4 billion compared to a net disinvestment of £2.1 billion in the 12 months ending June. Property Unit Trusts disinvested a further £58 million in Q2 and have been net sellers of £799 million in the 12 months to the end of September compared with a net disinvestment of £883 million in the 12 months ending June.

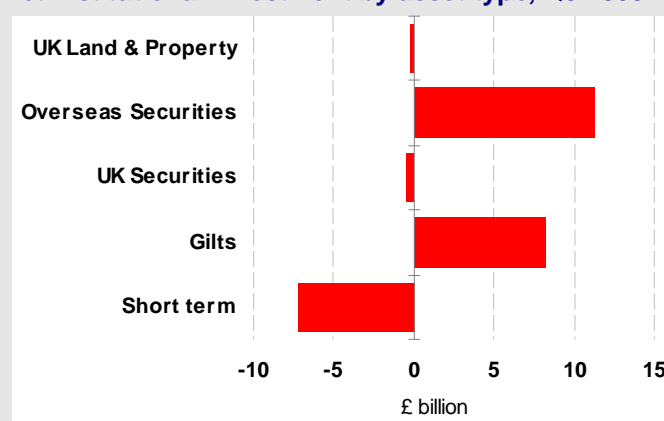
Property market liquidity



Source: National Statistics & Fletcher King

Total institutional investment grew by £19.4 billion in Q3 having previously grown by £31.6 billion in Q2. In Q3 institutions made net purchases of £8.2 billion in UK government bonds but sold £504 million in UK equities. They also reduced their holdings of cash and other short term instruments by £7.2 billion and increased their holding of overseas equities by £11.2 billion.

Net institutional investment by asset type, Q3 2009



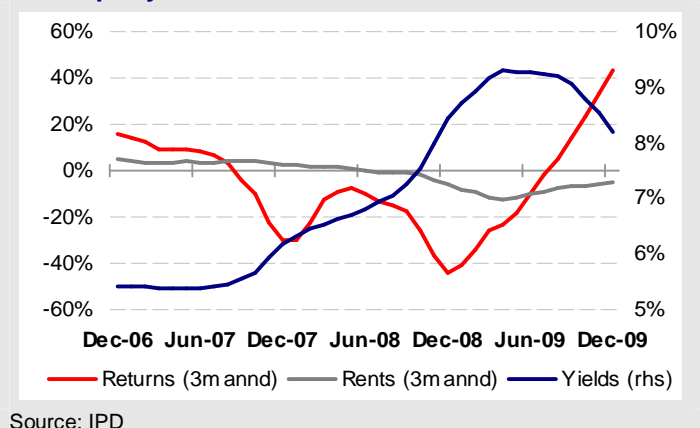
Source: National Statistics

The Outlook for Property in 2010

Twelve months ago recession ceased to be a threat and became a reality. In the UK, USA and the Eurozone, governments and central banks mounted a costly but necessary re-capitalisation of the complete banking system. Interest rates fell to near zero in an effort to boost economic activity and the Bank of England embarked on its programme of quantitative easing which saw it acquire £200 billion of assets from the banks in an attempt to encourage them to lend more and further reduce the cost of borrowing.

At the start of the year, performance expectations for the commercial property market in 2009 were bleak. However, after an almost unprecedented second half to the year; the outcome was very different from the earlier expectations. In the first half of the year capital values declined by a further 13% and the cumulative fall since the start of the collapse in values grew to 44%. But in August values started to recover and by the end of the year had grown by 8.8% from the trough. Back in January, the pricing of the 2009 property swap suggested a total return of -18% making 2009 the second worst year ever after 2008. In fact the total return on the IPD All Property index in the year to December was 2.2%.

All Property Performance



This strong recovery has been led by robust levels of investment activity from both domestic institutions and overseas investors reacting to a combination of low interest rates, weak sterling and property's attractive pricing compared to all other assets. We expect momentum alone to carry this recovery into Q1 and possibly Q2 2010.

Liquidity continues to improve. Institutional investors expect to increase their exposure to the sector and having been re-financed the REITS and are now moving from selling assets in 2009 towards adding to their portfolios. The Association of Real Estate Funds reported positive cash flows in Q3 after eight quarters of disinvestment. The retail investor has also returned. Property funds were the highest-selling sector for the second consecutive month in November, according to the Investment Management Association, with £417m in net retail sales. This was the highest level achieved since the last days of the previous property boom in March 2007.

It has been suggested that the current situation in the property market represents another bubble fuelled by low interest rates. However, a near 9% recovery in prices in response to a peak to trough decline of 44% seems like a rational response to an over-correction rather than a bubble. After all, a year ago we expressed the view that property was valued at or below fair value. Current market levels are sustainable. But the sustainability of any ex ante growth depends on how much further ahead values go and the level of property yields relative to the risk free rate represented by gilts.

For the moment investors are only targeting prime well let property in the best locations. Loan finance is available for such assets but the terms are very different from those prevailing in 2007. Typically, a loan at 50% loan to value (ltv) will cost a margin of 200 bps above LIBOR and an upfront fee of 80 – 100 bps of the loan. The margin goes to 225 bps and the fee to 120 bps for 65% ltv. Finance is not available above a 65% ltv or for secondary properties and values in that market remain flat.

The duration of the present investment led recovery must be limited by the lack of any support from the occupational market. All property rental values fell by 8.4% in 2009 and a return to positive levels of rental value growth will lag any sustained macro-economic recovery by at least 12 months. Vacancy rates are still increasing. At the end of December the rental value of vacant units on the IPD monthly index amounted to 12.1% of income.

Vacancies can be expected to rise further as historic data indicates that company insolvencies continue at above trend rates well into the recovery phase of the cycle. The net absorption rate is also likely to remain below trend as the take-up of new space is likely to be muted throughout 2010. Faced by reduced demand in the recession, employers have been cutting overheads through a reduction in staff numbers. This has resulted in the under utilisation of existing accommodation. Businesses will need to feel confident that the recovery of the economy and their profits is well entrenched before they consider re-hiring staff and filling empty desks. Identification of a need for any additional space is likely to be some time beyond that. From the middle of this year and pending the return of rental value growth we expect the property market to revert to a situation where there is little scope for further yield compression and income is paramount.

There are also a number of downside risks to this outlook. Some of these were highlighted by the Bank of England in December's Financial Stability Report and include any adverse impact of the exit from policy support. Concerns about sovereign risk have increased. Ireland and Greece have already been downgraded and further downgrades resulting from prolonged economic weakness or the absence of credible fiscal consolidation plans could prompt capital flight, potentially raising the cost and availability of bank funding. A slower-than-anticipated recovery could lead to financing difficulties among overstretched borrowers and larger-than-expected bank loan impairments. Higher risk-free rates or heightened economic uncertainty could lower asset prices. Further UK specific risks include the forthcoming election and an increased number of property related loan defaults. In the election anything other than a clear victory for either party could see gilt yields rise and the appetite for UK sovereign debt diminish. So far as bank lending is concerned there is a risk that falling property income or scheduled refinancing could trigger a growing number of repossessions leading to asset sales and further falls in property values.

The outlook continues to be particularly uncertain and the path of recovery will not be smooth. It is likely that some regions or segments of the market will outperform. In particular, the Central London office market could see robust levels of rental growth this year through a combination of a much reduced development pipeline and increasing levels of demand. However, this is only likely to apply to Grade A space and not to space in unrefurbished second hand buildings. In addition, any regional centre that has a large number of government related occupiers may face a prolonged recovery as fiscal tightening necessitates a reduction in public sector employment. And finally, for the record the pricing of the 2010 property swap is currently 9.75%.

