

# UK real estate market report

Q2 2009



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## Real estate market outlook

### *Recent market movement*

The decline in commercial real estate values has continued in 2009, although the pace of decline has not been as sharp in Q1 as it was in Q4 and there are tentative signs of yield stabilisation in some sections of the market. As measured by the Investment Property Databank UK Monthly Index (IPDMI), values declined by 15% over Q4 and by 27% over 2008 as a whole. In Q1, values also fell sharply, although the pace of decline was not as severe. The IPDMI registered a fall in capital values of 8.9% across Q1 and total returns for the quarter were -7.1%. To date, yield shift has been the major driver of negative returns, caused by heightened investor risk-aversion against a background of financial market instability. There are however some signs of improvement in investor sentiment and levels of transactional activity, in common with some other risky assets, notably equities. As a consequence, pricing has stabilised somewhat for prime properties with long-leases and strong covenants. The UK REIT market has performed strongly following a series of successful equity raisings.

### *Retail*

Retail sales remain extremely weak, as consumers have reined back spending as their wealth falls, unemployment and job insecurity increase while credit conditions remain severely restricted. Retailers are also being squeezed by the decline in sterling adding to their import cost-base and, with the exception of food retailers, have been unable to pass these on to a struggling consumer. Several high-profile defaults have now occurred among high street names, releasing significant amounts of space into the market. Bulky goods and non-discretionary purchase retailers have been sharply impacted, while value retailers and discounters have performed relatively well, with some continuing ambitious expansion plans. Despite some improvement in consumer and retailer confidence since the start of the year, both remain near historic lows. With unemployment rising and a reduction in the willingness and ability of consumers to take on debt, the immediate outlook for the sector is poor and there is increasing downward pressure on rents.

### *Offices*

Rents continue to fall in the City as the impacts of ongoing job losses in the financial sector are felt. Output and employment in the financial and business services sector are contracting at an accelerated pace and the prospects for the City market appear bleak. The impacts of the financial downturn have also spread to the real economy, impacting the West End market and tenant weakness is likely to remain a feature of these markets for some time to come. The fact that development levels didn't reach the levels of their previous cyclical peaks will however provide some underlying support for rents in the capital. Outside of London, the big-6 provincial markets appear more exposed than they have been in previous downturns, due to their increased financial services exposure and recent high levels of speculative development. Conversely, the Thames Valley markets appear more robust and should be less sharply impacted than they were during the overdevelopment of the dot-com boom.

### *Industrial*

The UK has been sharply impacted by a synchronised global slowdown in the industrial cycle. Exports of manufactured goods have fallen sharply, despite the decline in sterling improving price competitiveness. The sector has experienced high levels of speculative development in recent years and now faces a supply overhang, which is unlikely to be absorbed quickly given the low levels of occupier demand. Distribution warehouses appear particularly exposed to the current downturn due to their reliance on retail sales volumes, which have been sharply impacted by the ongoing economic downturn.

### *Summary*

Commercial real estate has undergone a sharp price decline since July 2007, although there are signs that the pace of yield movement is now moderating in some sections of the market. Whilst credit conditions remain tough, the low returns available on cash and government securities, alongside a rally in other risky assets, notably equities, have supported an increase in investor demand for some real estate assets. Yields on prime, long-lease assets, with strong covenants have firmed, and even moved back slightly in some cases, providing hope that the first phase of capital decline is nearing an end. However, the sector is still likely to undergo a second phase of contraction, as rental declines impact returns. Rental growth is turning increasingly negative in all sectors and, with further economic weakness likely in the near term, it is highly probable that tenant defaults will rise and the pace of rental decline will increase. As a result, the near-term outlook for commercial real estate remains weak, with returns likely to remain poor into next year. Returns thereafter depend upon how quickly and strongly the economy and financial conditions recover. Real estate values will have moved to levels that are cheap on a historical basis and relative to cash and gilt yields, suggesting that there is potential for yields to move lower once the worst of the occupier market downturn passes. We expect that 2010 will see stabilisation in property values and that returns can recover robustly thereafter.

	Dec 05	Dec 06	Dec 07	Dec 08	Mar 09
<b>All-Property Rental Growth (YOY%)</b>	<b>2.6</b>	<b>3.6</b>	<b>3.5</b>	<b>-1.4</b>	<b>-4.9</b>
Retail – total	4.0	3.1	1.8	-0.4	-2.6
Retail warehousing	5.5	2.9	0.2	-0.6	-2.7
In-town retail	3.0	3.2	2.1	-0.1	-2.6
Offices	1.1	6.2	7.6	-3.8	-9.9
Industrial	1.0	1.4	1.2	-0.3	-2.0
<b>All-Property Initial Yield</b>	<b>5.2</b>	<b>4.6</b>	<b>5.2</b>	<b>7.0</b>	<b>7.7</b>
Retail – total	4.7	4.3	5.0	6.9	7.5
Retail warehousing	4.1	3.8	4.7	6.6	7.3
In-town retail	5.2	4.7	5.2	7.1	7.6
Offices	5.7	4.6	5.1	7.0	7.7
Industrial	6.0	5.3	5.9	7.5	8.0
<b>All-Property Void Rate</b>	<b>7.6</b>	<b>8.0</b>	<b>8.8</b>	<b>10.4</b>	<b>11.7</b>
Retail	5.1	5.7	6.6	8.5	9.7
Offices	11.2	10.3	11.2	11.4	12.7
Industrial	10.0	11.1	11.4	14.6	15.9
<b>All-Property Total Return (YOY%)</b>	<b>18.8</b>	<b>18.1</b>	<b>-5.5</b>	<b>-22.5</b>	<b>-25.5</b>
Retail – total	19.3	15.7	-7.6	-23.6	-27.1
Retail warehousing	21.9	15.5	-10.4	-24.5	-27.9
In-town retail	17.0	15.7	-5.1	-22.4	-25.9
Offices	18.4	23.8	-3.0	-22.7	-25.9
Industrial	18.2	17.6	-4.4	-20.2	-21.4

Source: IPD Monthly Index March 2009

## Economic overview

- Recent months have seen a pronounced shift in expectations for the global economy as the slowdown of early 2008 turned into a rout in Q4. The Q4 weakness was truly remarkable both for its scale and its synchronised global nature - and Q1 was little better if at all. All major developed and many emerging economies saw significant declines in output in Q4. UK GDP fell by 1.6%, its third consecutive quarterly decline and biggest fall since Q2 1980.

Global economic prospects have been downgraded markedly
- Another remarkable feature of the downturn has been that the countries that were judged most vulnerable – the highly indebted, “over-consuming” countries with large current account deficits such as the US and UK – have so far suffered less than those countries on the flip side of these imbalances – the high-saving, “over-producing” countries with current account surpluses notably Germany, Japan and China. GDP declined by 2.1% in Germany in Q4 and by 3.6% in Japan for instance. However, with economic weakness so far coming largely through a collapse in manufacturing production and trade, it is in fact unsurprising that the countries that have suffered most are those with heavy exposure to manufacturing and the global trade cycle, notably Germany and many Asian economies.

Surplus countries suffering most at present
- But the global fiscal and monetary policy response has also been exceptional. Governments have moved to shore up the banking sector and prevent a re-run of the chaos that followed the collapse of Lehman Brothers in September. Central banks have made unprecedented rate cuts and some are now engaged in quantitative easing in an effort to support economic activity and prevent a debt-deflation cycle from taking hold. Fiscal policy has been loosened to try to fill the gap left by the cuts to investment and consumer spending. Whilst there have been some tentative signs that the pace of decline is moderating, the global economy is expected to see considerable further weakness over the next couple of quarters at least, with lagging indicators such as unemployment proving particularly weak. The Aviva Investors view remains that policy measures do succeed in breaking the current downward cycle and that growth in the major economies resumes in late 2009 to early 2010.

Aggressive policy response expected to break the downward spiral
- And there are some considerable headwinds facing the global economy that suggest that the recovery phase from this recession is likely to be muted. In most respects the dynamics of current recession is different to previous post-war recessions; for the most part, it has not been driven by central bank monetary tightening in response to runaway inflation, but by the breakdown in the banking sector caused by a massive (realised and prospective) deterioration in the value of their assets and the resultant collapse in credit to an over-leveraged private sector. In many respects, the dynamics bear more relation to Japan in the 1990s or the depression of the 1930s – both of which were long and painful affairs.

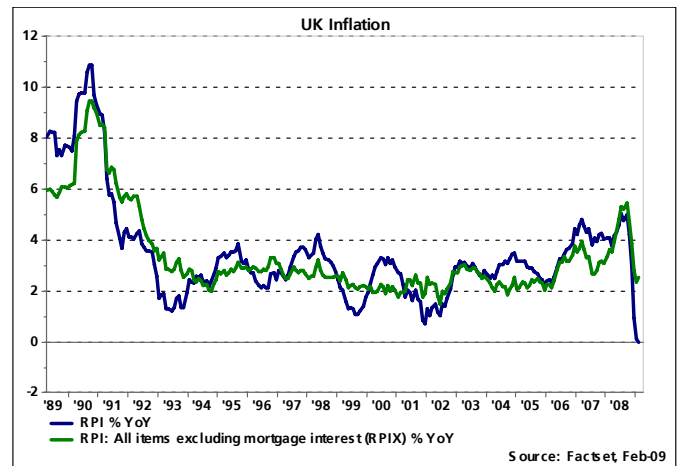
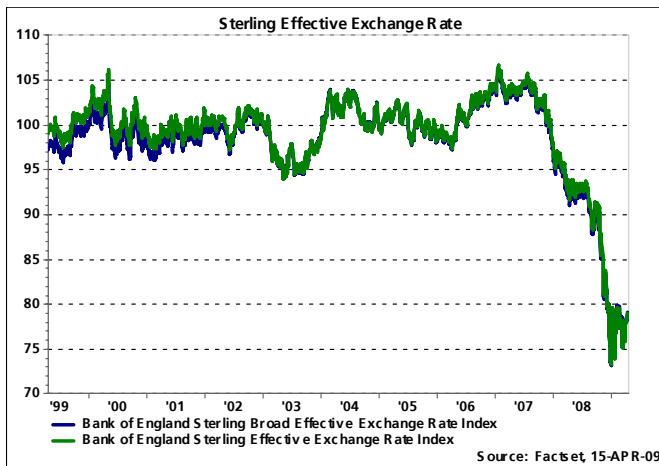
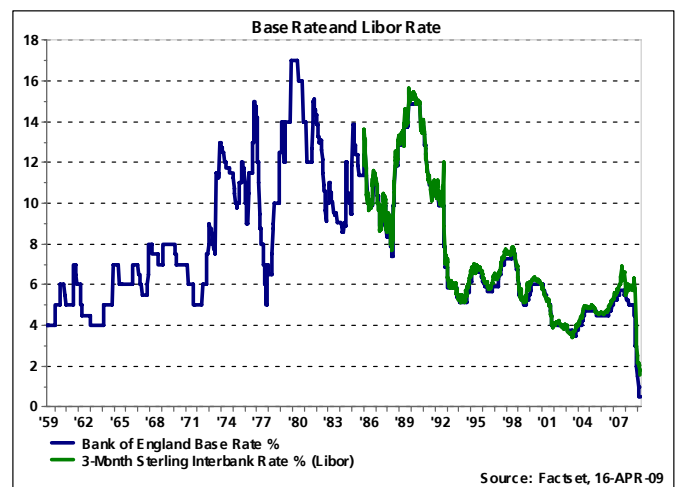
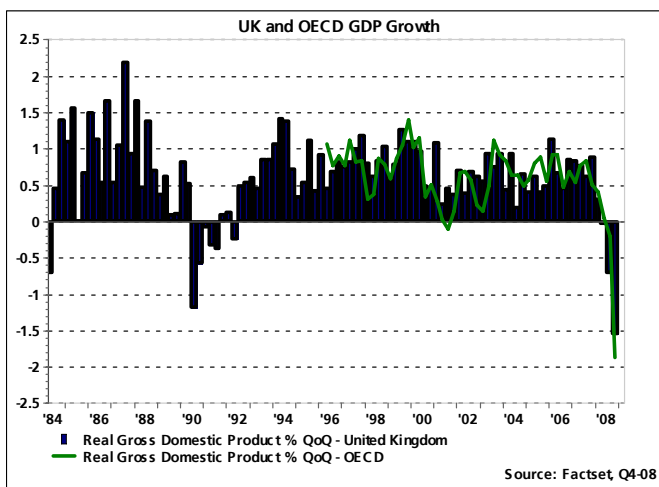
But recovery phase is likely to be muted
- At present, most developed economies are stuck in a negative loop where banks tighten lending in the face of falling asset values, which leads to retrenchment on the part of consumers and companies, which weakens economic activity and adds further downward pressure to asset prices and so on. The aim of many recent policy measures is to try to break this loop, by reducing capital constraints on banks and shoring up economic activity. Even if these measures succeed in stabilising financial and economic conditions, a return to the strong global growth rates of 2002-7 is unlikely, with growth in the over-leveraged economies such as the US and UK particularly likely to be muted. The current crisis has demonstrated that the unbalanced global growth model of the past ten years or so is unsustainable and, whilst policy is seeking to lessen the pain of adjustment to more sustainable growth, it cannot eliminate the necessary adjustments.

Pre-crunch global growth model unlikely to be recreated
- In the case of the UK, these adjustments include a shifting of growth from consumption to manufacturing and exports and the associated rebuilding of savings and paying down of debt on the part of households. The marked decline in sterling will help to facilitate the shift. The policy measures in place to lessen the impact of this shift include low interest rates (which transfers much of the pain of adjustment from borrowers to savers), quantitative easing to prevent deflation taking hold and increasing the real burden of debt and a big increase in government spending and borrowing to in effect shift the debt burden from the private to the public sector. Despite these measures, an extended period of weak growth is likely for the UK and the downside risks are considerable.

Shifts in UK growth pattern also likely

UK economic forecasts	2007	2008	2009 (f)	2010 (f)
Real GDP Growth (YOY% change)	3.0	0.7	-3.3	1.2
Consumer spending growth	3.0	1.6	-1.8	0.8
YOY change in CPI (Q4/Q4)	2.1	3.9	0.6	1.9

Source: Aviva Investors Q2 2009



## Equity and bond markets

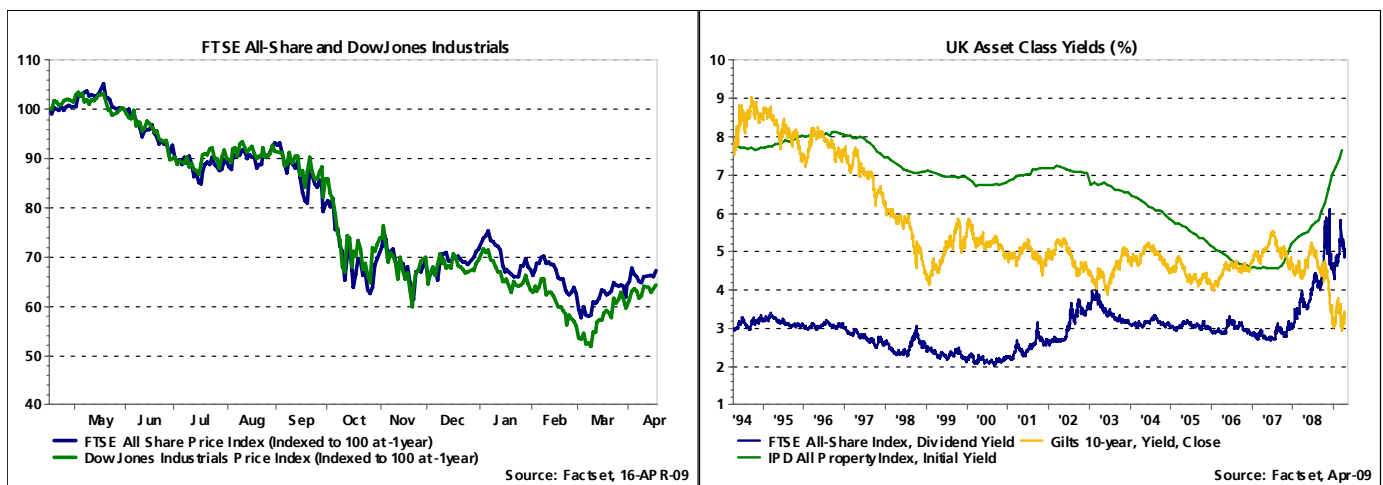
	31 Dec 06	31 Dec 07	31 Dec 08	Latest (16/04/2009)
Nominal 10Yr Bond Yield (UK)	4.7	4.6	3.0	3.2
Nominal 10Yr Bond Yield (US)	4.7	4.1	2.2	2.8
Nominal 10Yr Bond Yield (GER)	4.0	4.3	2.9	3.2
Yield Spread (UK-US)	4	52	80	41
Yield Spread (UK-GER)	78	27	7	7
UK FTSE-100	6,221	6,457	4,434	4,053
PE Ratio	13.3	11.8	8.9	8.5
DOW Jones Industrials	12,463	13,265	8,776	8,125
NASDAQ	2,415	2,652	1,577	1,670

Source: Factset Apr-09

- Global equity markets have enjoyed a robust bounce in the past couple of months, though whether the rally is sustainable or not is keenly debated. The FTSE All-share Index, for instance, rose by over 15% in price terms from the beginning of March to mid-April. Those arguing that this rally can be sustained point to equity markets' attractive valuations and historical evidence that equities rally in advance of economic recovery. Those who suggest that this is just another bear market rally argue that the economic recession guarantees a collapse in earnings making it too soon for a meaningful recovery in equity pricing.
- Sceptics also point out that neither government nor corporate bonds have shared in the rally. Government bond yields remain at relatively low levels. The 10-year gilt yield, for instance, at c3.25% in mid-April, remains close to its recent lows. This may be suggesting that bond investors do not share equity investors' confidence that economic recovery is assured. Alternatively, however, yields may be reflecting the actions of some central banks, including the Bank of England, in purchasing government bonds to prevent yields moving higher. Likewise pricing in corporate bond markets, where, spreads remain at elevated levels, may not necessarily reflect extreme pessimism on the economic outlook, but reflect ongoing disfunction and illiquidity within this market.

Equity markets have recovered of late

Rally not generally shared by bond markets



## Real estate investment conditions

- There are tentative signs that credit conditions for real estate investors are improving. The cost of debt is moving lower following aggressive rate cuts by the Bank of England. Libor rates have continued to move lower, with the 3-month rate dropping from c2.75% at the beginning of the year to c1.5% by mid-April. 5-year swap rates meanwhile have been reasonably steady at c3% in the same period, the lowest level on record. And whilst current lending conditions continue to tighten, there are signs that the pace of tightening is moderating. According to the Bank of England, bank lending to real estate is weakening and the Bank's Q1 credit conditions survey also showed that lenders were tightening credit conditions for real estate borrowers. The survey also suggested, however, that in the near term lenders intend to only marginally tighten credit conditions further.

Tentative signs of stabilisation in real estate credit
- There has been a noticeable increase in investor demand for prime property let on long leases to good covenants and for small lots where financing is less of an issue are also attracting investor interest. Some of the driving forces behind this trend include the marked decline in the return available on cash, the wider improvement in sentiment in financial markets and perhaps the desire to use real estate as an inflation hedge – as well, of course, as the improved value in property markets. The focus on long leases lessens the need for investors to take a view on the extent and duration of rental decline. The active buyers are drawn from fairly diverse groups – German funds, private individuals & property companies and opportunity funds with financing in place – but tend to be long-run, valued-focused investors.

Increased investor demand for prime secure income streams
- With investor appetite for most other property types still very weak, there has not yet been any appreciable pickup in transaction activity however. Propertydata.com recorded c160 transactions in Q1, down from a quarterly average over 300 transactions in 2008. Overseas investors, occupiers and private property companies and individuals remained net buyers of real estate in Q1. UK institutions and quoted property companies remain the main net sellers of real estate. Transaction activity remains skewed towards the office sector, accounting for almost 30% of transactions by value in Q1. The purchase of the Meadowhall shopping centre by London & Stamford from British Land, in a transaction worth almost £600m, helped the shopping centre sector to be the second most active sector in Q1 in value terms.

Transaction levels still low however
- The refinancing risk overhanging the property market remains considerable. To date, the much-feared flood of re-possessed property coming to the market has not materialised, partly because lenders are aware of the weakness of the transaction market and partly because of policy measures such as interest rate cuts and bank recapitalisations which have lowered the carrying cost of debt for borrowers and lessened the pressure on banks to reduce their balance sheets. These trends are at danger of reversal however as occupier markets deteriorate and ongoing asset value declines put further pressure on bank balance sheets. In addition, there remains a significant risk of a wave of properties coming from defaulting CMBS deals. Overall, the risk of forced sales overwhelming the limited improvement in investor demand remains considerable.

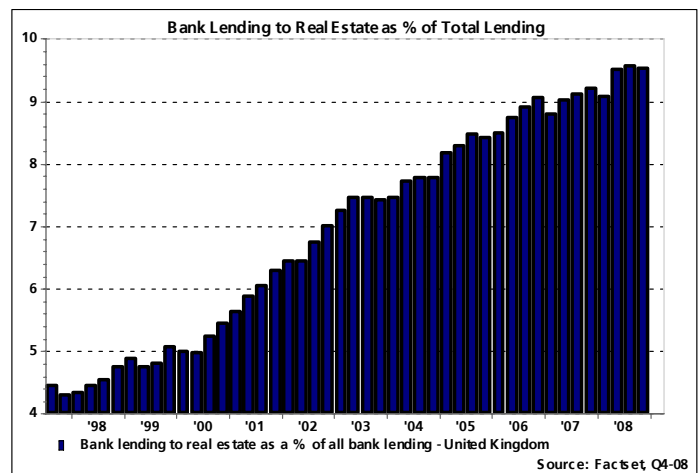
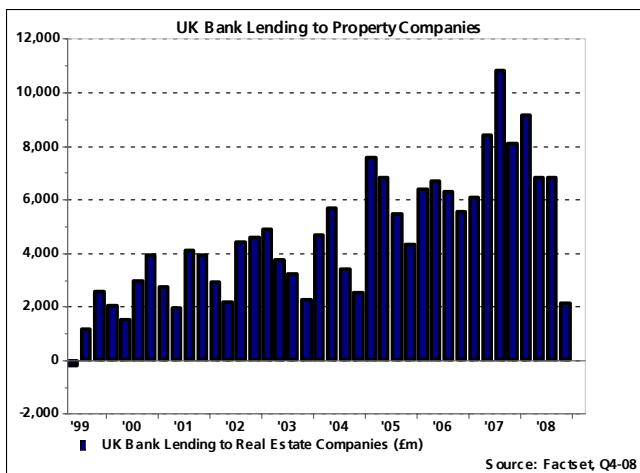
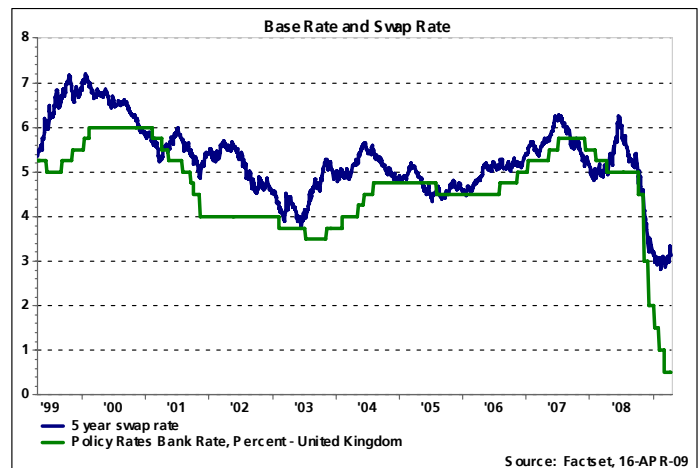
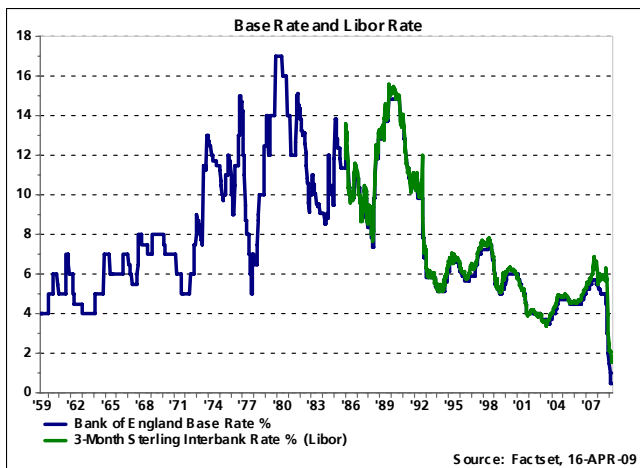
Refinancing risk remains elevated
- Outward yield movement remains a feature of the market, though yield shift was less in Q1 than in Q4. The IPDMI recorded outward equivalent yield movement of 70bps over Q1, compared to 123bps in Q4 at an all-property level. We expect that yield shift will continue to moderate in the coming months, particularly for prime property. Capital values will continue to decline once yield shift has ended, however, as a result of deteriorating income fundamentals.

Yield shift showing signs of easing
- Real estate derivatives pricing has strengthened considerably in recent weeks. According to brokers Tradition, as at 16<sup>th</sup> April, derivative pricing implies an IPD all-property total return of +3.4% per year over 2009-13. This compares to implied returns of +1.15% per year at the end of February.

Derivative market pricing has strengthened

Net investment in direct property £m	2002	2003	2004	2005	2006	2007	2008	2009 YTD
UK Institutions	585	-2,624	3,770	2,442	4,657	-2,158	-5,961	-1,080
Quoted Property Companies	-1,149	-2,224	-3,071	899	-1,453	-1,480	-3,517	-885
Private Property Companies	-790	373	-3,155	-1,736	-2,404	-713	2,522	464
Overseas Investors	1,414	4,035	2,875	6,100	3,422	11,786	4,806	1,630
Private Individuals	2,514	2,629	2,343	591	1,315	1,149	1,851	272
Occupiers	-3,019	-1,848	-3,263	-6,829	-3,942	-5,948	297	154
Others	446	-341	501	-1,466	-1,594	-2,636	2	-557
Bank net lending to property companies	14,154	14,157	16,350	24,284	25,003	33,432	25,009	N/A

Source: Propertydata.com April 2009, ONS Q4 2008



## Real estate equities

UK Majors							
Company	Sector	Market Cap (local currency m)	Discount to NAV (Spot)	Dividend Yield (E1)	LTV	3m return	1yr return
LAND SECURITIES	diversified	4,075	(10%)	5.2%	33%	(14%)	(62%)
BRITISH LAND	diversified	3,805	5%	5.4%	37%	17%	(37%)
HAMMERSON	retail	2,071	(32%)	5.1%	50%	7%	(57%)
LIBERTY INT	retail	1,698	(31%)	3.6%	57%	24%	(53%)
SEGRO	industrials	1,377	(93%)	5.7%	52%	(16%)	(71%)
BRIXTON	industrials	87	(87%)	15.9%	51%	(62%)	(89%)
DERWENT LONDON	office	852	(24%)	2.9%	40%	38%	(38%)
GREAT PORTLAND	office	496	(18%)	4.5%	28%	19%	(40%)
SHAFTESBURY	retail	477	(9%)	3.3%	43%	29%	(35%)
HELICAL BAR	office	377	32%	1.3%	39%	13%	4%

Source: Bloomberg, Aviva Investors, Mar-09

- The UK REIT market fell another 30% in the first quarter of 2009. The UK market underperformed relative to Continental Europe and the Asia Pacific region, which delivered returns of -14% and -13% respectively. North America delivered returns of -32%. Over the same period, direct property delivered a return of -7.1%, equities -9.1% (FTSE-All Share Index) and gilts +2.2% (5-15 year gilts). After a difficult beginning to the year, the UK REIT market recovered somewhat in late February and into March, though not by enough to outweigh the effects of the falls in January and early February.

Negative REIT returns in the first quarter
- The first quarter of 2009 was characterised by a spate of rights issues. The first two issues were notable owing to the contrasting fortunes of the two companies carrying them out. Helical Bar raised £28 million of equity to take advantage of buying opportunities that the market is likely to deliver in the coming months. In addition the company is looking to buy senior debt positions to get hold of the underlying properties. By contrast, the second one, Workspace, tapped the market for additional equity as the fall in property values had brought them in breach of their loan covenants. The preceding fall in share price forced them to place the shares at a discount of 70% to last price. The company had to issue more shares to raise the required amount of equity, resulting in a greater dilution to existing shareholders and was not sufficient to fully cover future expected falls in property values.

REITs raising equity through rights issues
- We believe the majority of the UK REITs could have been more proactive in securing their solvency last year in light of falling property values. Now the equity issues have come at a significant cost to shareholder value. All major companies like Land Securities, British Land, Hammerson and Segro have engaged in preventive rights issues, raising £2.7 billion in equity. They are anticipating further falls in capital values and have acted now to avert future breaches of LTV covenants. New equity in these companies was issued at an average discount to theoretical ex-rights prices of 40%. The steep discounts reflect an expected 25% fall in commercial property values this year as well as the unwillingness of the underwriters to commit to rights issues that might not succeed. In fact, with the discounts so high, existing shareholders had little choice other than to subscribe, to avoid extreme dilution of their holdings.

Equity issues impacted shareholder value
- British Land's £740m rights issue provides it with balance sheet security and gives it the largest war chest for potential acquisitions among the UK majors. The issue provides it with headroom against at least a further 30% fall in property values from the end of 2008. But importantly, it also gives it substantial equity that can be used in combination with £2.4bn of undrawn committed debt facilities to acquire distressed properties or portfolios.

British Land now well placed in our view

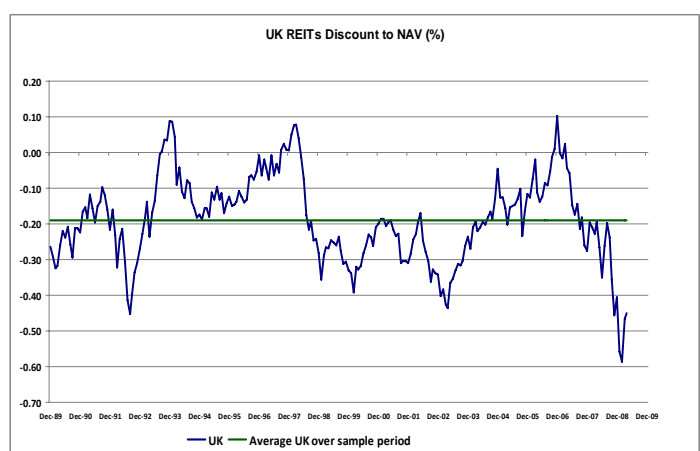
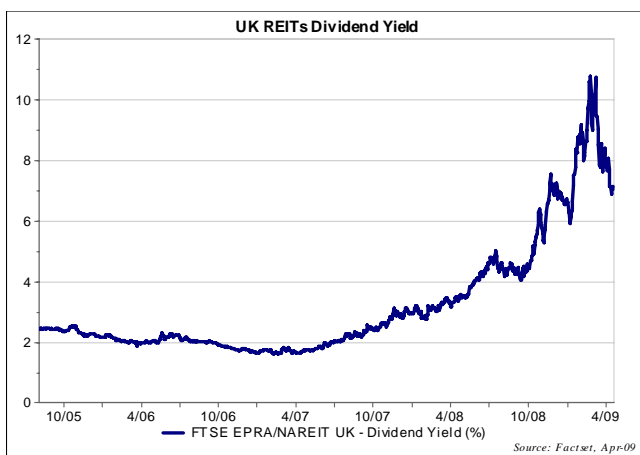
- There are, however, other companies in need of capital that may not be able to tap their shareholders. We believe that companies belonging to this group still face significant challenges. For example, Brixton currently has a market capitalisation of c. £60 million with assets under management valued at more than £2 billion. We expect current shareholders to see a significant dilution of their holdings through debt-to-equity swaps. Liberty has also announced a willingness to raise equity but their largely South African shareholder base isn't able to support a rights issue. Given the weakness of both shares, the equity market is becoming very difficult to tap.
- The UK REIT market recovered in the second half of February, continuing into March. This performance was strongly correlated with the performance of the financial sector, and supported by the potential effects of new stimulus plans. A number of other factors have underpinned the recent recovery in UK REITs' share prices. The Geithner plan has enabled banks to offload bad debt from their balance sheets. In combination with quantitative easing, this has reduced long-term bond yields. REITs have also been boosted by their ability to find willing banks to finance new loans and refinance existing facilities. With property loans generally still delivering stable cashflow, banks are being cooperative. Loans to other sectors of the economy are proving to be more problematic. In addition, the increased activity of opportunistic property buyers in the market and the growing number of transactions is indicative of rising confidence.
- Although the economic situation continued to deteriorate in the first quarter of 2009, the outlook for UK REITs is relatively positive. The effects of a thawing credit market are positive for the sector. We have seen indications that property lending is slowly gathering momentum. Shares of REITs that have taken proactive steps to secure their solvency will benefit. Although there is a group of real estate companies with excessive leverage that will struggle for quite some time, the broad range of REITs that have recapitalised will be well-placed to benefit from a recovery in real estate fundamentals – if and when that occurs. Companies with leverage in the mid-range look particularly attractive. The well-capitalised companies could be well-placed to exploit opportunities emerging from distressed sales.
- In the coming months, there will be a shift in emphasis from issues concerning their solvency to the sustainability of REITs' dividends, which will be brought into focus by falling rents and occupancy levels. In general, we believe that REITs' cashflow will be more robust than that of other many other sectors represented in the equity market, which will attract investor interest. The long leases that characterise the UK market are likely to attract particular interest. With discounts to NAV at around 17% and dividend yields at c5.5% on a forward-looking, post-rights issue basis, we think REITs are an attractive alternative to other asset classes.

Some debt for equity swaps likely

UK REITs have rallied strongly

REITs that have recapitalised set to benefit from recovery

Focus now on dividend sustainability as rents fall



Source: Aviva Investors, Mar-09

## Retail

- Since the start of last year, individuals have been saving more and spending less. The household saving rate rose from a low of -1.2% in Q1 2008 to 4.8% by the end of the year, its highest level since early 2006. This increase in savings has been helped by three consecutive quarterly declines in consumer spending up to Q4 2008, for a cumulative fall in spending of 1.2%. From mid-2007 to the end of 2008, consumer confidence fell very rapidly down to all time lows. There has been some improvement in sentiment so far in 2009, but consumer confidence remains at historically low levels.

Consumer spending is down and saving is up
- This reflects the fact that unemployment is increasing and job security is falling. Meanwhile marked equity and house price falls mean consumers' real and perceived wealth is falling. The reduction in access to consumer credit and a widespread desire to reduce debt obligations further limits household consumption.

Multiple pressures on household expenditure
- Retailer confidence has shown some improvement since the start of the year but remains at levels lower than experienced since the early 1980s. Retailers margins are falling, emphasizing the fragility of the sector. Heavy discounting has been required to maintain volumes and the fall in the value of sterling has significantly increased import costs. Unsurprisingly, numerous businesses have failed in the retail sector over recent months and many remain at risk.

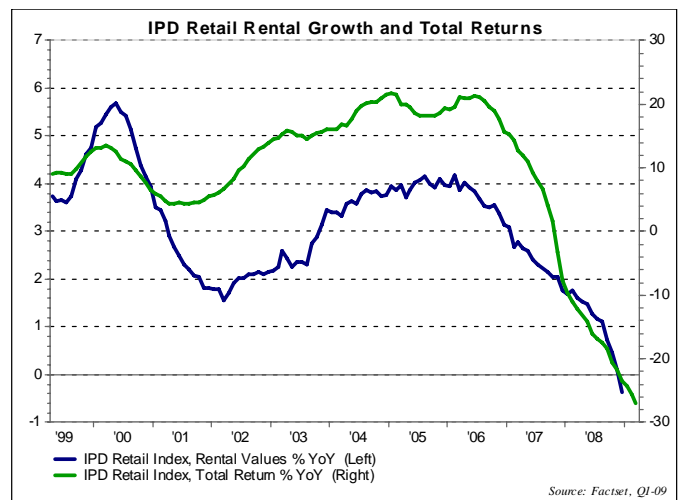
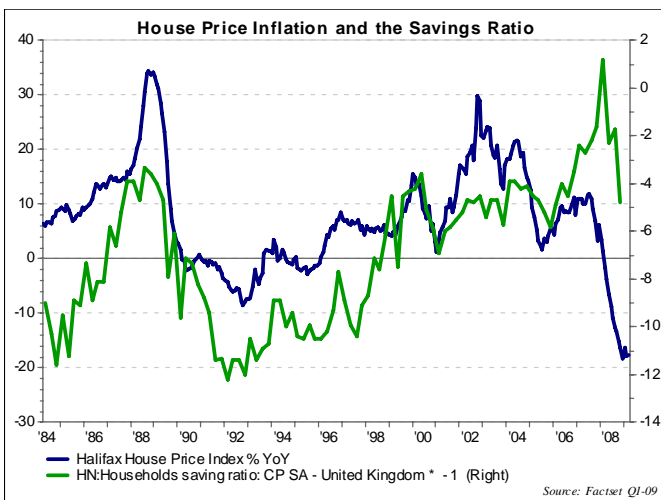
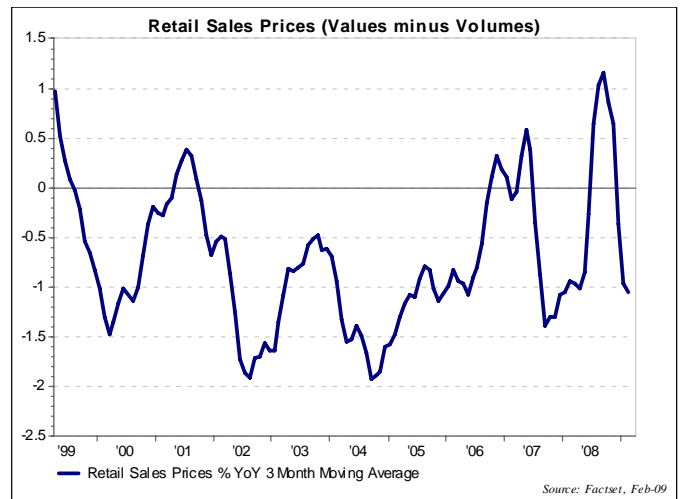
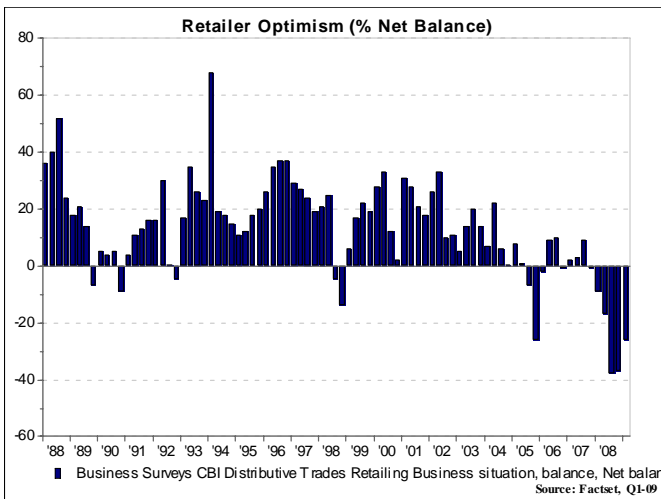
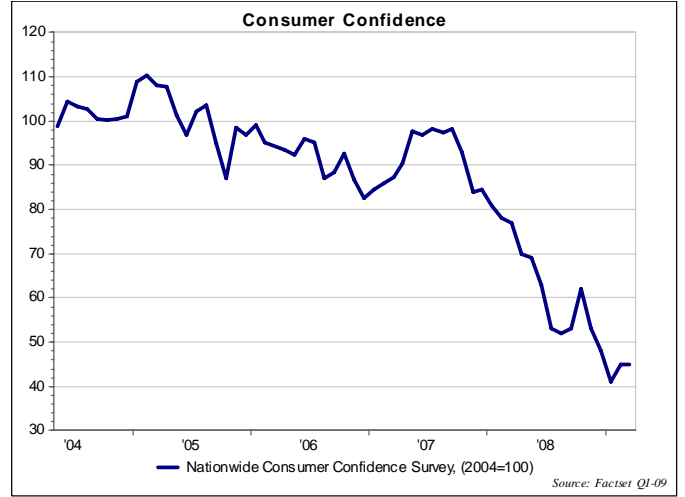
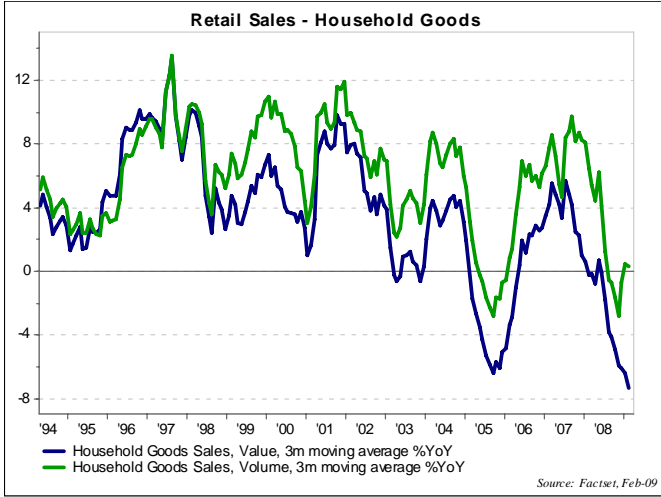
Retailers showing increasing fragility
- This period of weak demand is coinciding with a period of plentiful supply. According to CBRE, 8m sq ft of shopping centre space opened in 2008, more than in any single year since the building boom of the late-1980s. A significant amount of space remains in the pipeline, the majority of which is in town centre locations. Late last year CBRE reported that 4.7m sq ft was likely to complete in 2009. However, given market conditions, many future schemes are likely to be postponed. Furthermore, we expected construction starts to run at minimal levels over the short-to-medium term as developers and lenders remain risk averse.

Supply levels are currently high
- According to Cushman & Wakefield, in 2008 prime high street rents in the UK fell for the first time in 15 years, down 0.5%. According to CBRE, retail rents were stable in Central London in the first quarter of 2009. In the West End, rents are at the same level as they were 12 months ago although they are 7.4% lower in the City. In the West End, the retail market appears to have been supported by high levels of tourist shoppers taking advantage of the falling value of sterling. In Glasgow, rents fell by 3.0% in the first quarter and in Manchester they were down 6.7%. Rents were stable in Edinburgh and moved up 9.1% in Birmingham.

Rents are generally declining
- The retail warehouse sector is under particular pressure. According to CBRE, rents in retail warehouses fell by 0.7% in February, a faster decline than high street shops (-0.5%) and shopping centres (-0.3%), and the same rate of decline as seen in the whole of the last three months of 2008. The environment is likely to remain difficult for retail warehouses in the short-to-medium term. Demand for bulky goods such as audio-visual equipment and furniture and household goods is often the hardest hit in a recession. Retailers in these areas will also be hit by the lack of consumer credit and the low level of house purchases will also constrain the market. On the supply side, retail warehouse completions in 2008 were the lowest since 2009 and we expect low completion levels in the next few years. However, some parts of the sector still face a long-standing problem of oversupply.

Prospects for retail warehouses
- In the short-to-medium term, the prospects for the UK retail sector are gloomy. We expect prolonged consumer weakness in the economy and significant further rental declines now look inevitable.

Gloomy prospects for the retail sector



## Office

- Output and employment in the financial and business services (FBS) sector are contracting at an accelerated pace. FBS output contracted by 0.6% in each of the last two quarters of 2008 and FBS employment – a key driver of office demand, especially in Central London - shrank by 220,000 over the course of last year, equivalent to a 3.3% decline. This represents the first contraction in FBS employment since the early 1990s and, worryingly, the pace of decline is currently much faster than in the early 1990s when FBS employment fell by 3.4% over a period of about two years. At present, it is unclear whether the sector is experiencing just a large cyclical downturn, or is also in the early stages of a structural shift in which the FBS sector becomes a less important part of the UK's economy. Between 1992 and the onset of the credit crunch in September 2007, FBS employment expanded by 55%. In the near term, at least, strong, continuous FBS employment growth has ended.

Service sector output and employment are contracting
- Office occupier markets continue to weaken at a pace. Following two years of strong growth, rents declined significantly in 2008 across Central London markets. Last year, rental growth was -7.9% in the City and -6.8% in the West End, according to the IPD Annual Index. And in Q1, rents declined a further c10% according to the IPDMI. Provincial office markets tend to display a lagged and more muted cycle in comparison to Central London, but it is becoming increasingly clear that what began as a crisis concentrated in the financial sector has become a phenomenon impacting on all sectors across the country. Rents were flat across 2008 in offices outside the South East, according to the IPDMI, as take-up remained robust up until Q4. In the fourth quarter, rents fell 0.7% as the extent of the economic downturn became more apparent, and the correction continued in Q1 2009, with rents falling a further c2-3% according to the IPDMI.

Rents are now falling rapidly across the country as well as Central London
- The immediate prospects for the Central London office sector appear bleak. The provision of many of the financial services that Central London firms have specialised in may cease or remain at historically low levels, due to either a lack of demand or tightened regulation. However, London retains long-standing advantages as a financial centre, such as its time zone, infrastructure including international transport connections, the English legal system and its deep and wide pools of skilled labour. Once the global economy resumes growth and trade levels recover, the international focus of the capital's companies will sustain business activity. Given the reduced value of sterling, London should benefit from the enhanced price competitiveness of financial services exports. The capital's diversity will also add to the defensive qualities of the office market. Even within the finance sector, London homes globally important centres of international insurance and foreign exchange dealings. Over the medium term, such areas should prove resilient, even as corporate banking and hedge fund activity dwindles. Nevertheless, tenant weakness is expected to be a persistent feature in the Central London market in the next couple of years and further significant rental declines are likely over this period.

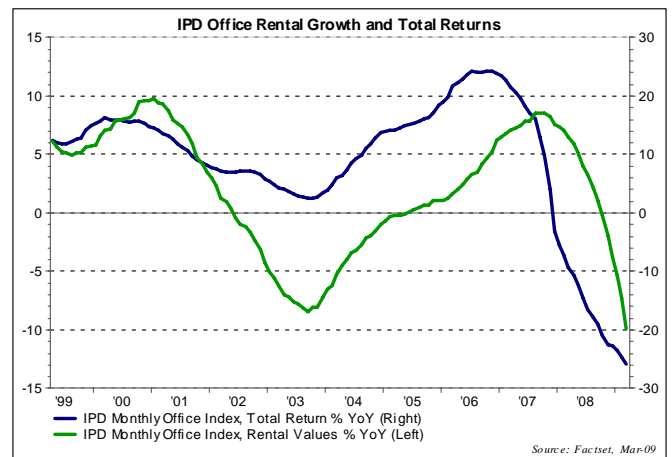
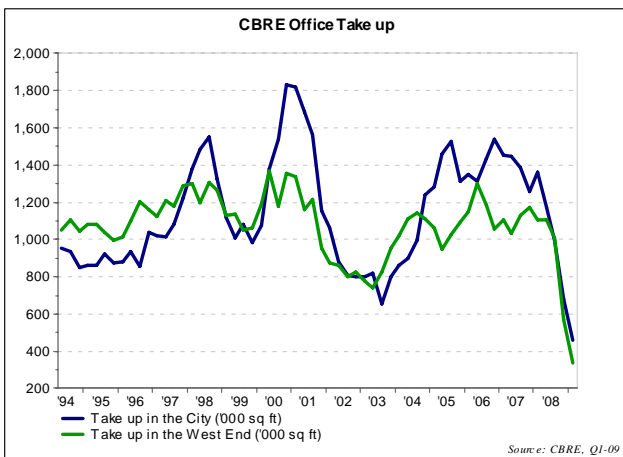
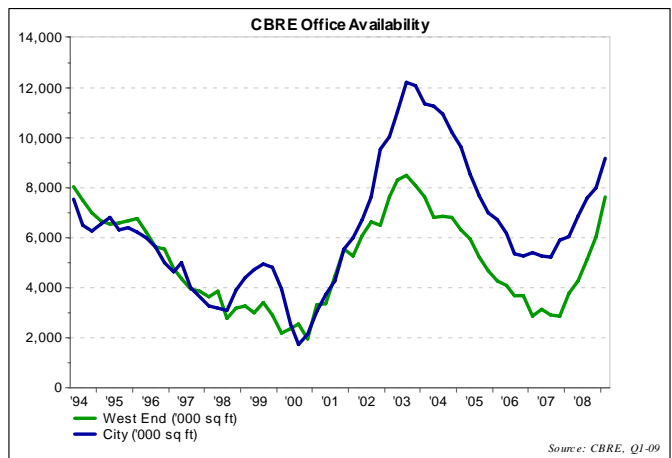
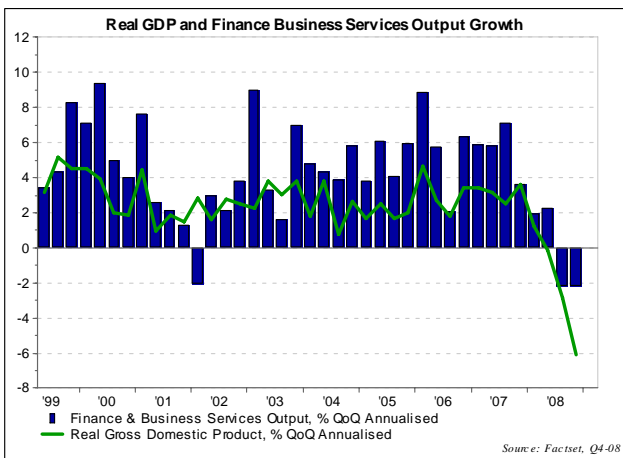
Bleak immediate outlook for Central London but core advantages remain
- The big 6 provincial office markets appear more exposed to the current downturn than they have been in previous cycles. These centres have increased their reliance on FBS employment significantly over the last ten years and will suffer from ongoing job losses at troubled financials. In particular, the Edinburgh out-of-town market, as home to both RBS and HBOS, is vulnerable. Manchester and Birmingham also have significant exposure to the financial sector. In terms of public sector employment, it is not clear that the relocation of government departments and state-owned companies to provincial centres will continue at its recent rate, given mixed-results. In the medium term, constraints on public spending in the aftermath of the current fiscal expansion are likely to reduce government's ability to act as an agent of regional development.

Provincial cities exposed to declining FBS employment

- There is also significant over-supply in most of the big 6 markets, with above average levels of speculative space due to reach town centre markets across 2009, except in the case of Glasgow. Following over-development in the late-80s, these markets remained relatively stable until 2005. However, growing demand from the financial sector, including several inward relocations, prompted a spike in development. With demand falling and vacancy rates already elevated, it may take some years for the resulting overhang to be absorbed. As the prospects of the real economy worsen, there is also the risk of significant amounts of grey space (unused let space that is potentially available) exacerbating this over-supply. By contrast, the Thames Valley markets, which sit in the M40/M3 corridor to the West of London with ready access to the M25, are less exposed than they were during the previous downturn. Since the over-development of the dot com era these markets have undergone little development and recent strong demand has led to vacancy rates trending downwards, though there remains significant variation by local market.
- The outlook for office rents is very weak and we expect the extent of the rental correction to be comparable to that of the early 1990s downturns when provincial office rents fell by c.20% and Central London rents fell by over 50% according to the IPD Annual Index. On a more positive note, falling demand and a lack of finance availability have prompted developers to 'turn off the tap', meaning that very little new space will be delivered beyond 2010. This has the potential to support recovery in these markets once the current economic downturn has passed.

Oversupply is a threat in big 6 markets

Further significant rental declines expected



## Industrial/Warehousing

- Despite the UK running a large trade deficit, it remains one of the world's top 10 exporters, with manufactured exports accounting for 13% of GDP. It has therefore been heavily affected by the synchronised global slowdown in the industrial cycle. Industrial production, of which 79% is accounted for by manufacturing, fell 2.6% in January and a further 1% in February and now stands down 9.9% since September, when Lehman's collapse destabilised the global financial system. This represents the worst downturn in UK industrial output in almost 30 years. In time, the decline in sterling, which is down c25% on a trade-weighted basis since mid-2007, should boost price competitiveness and mitigate the fall in exports somewhat. The March manufacturing PMI did offer some positive news, rising to 40.5 from 34.7 in February, however it remains well below the level of 50 which is consistent with sector growth. It may, however, indicate that the pace of decline in output has moderated somewhat.

UK industrial production has collapsed despite sterling weakness
- The collapse in global activity has started to feed through to occupier markets. Tenants are coming under increasing pressure as businesses across the supply-chain suffer. Requests for rent holidays are increasingly common from distressed tenants and defaults are expected to increase. The distribution sector looks particularly vulnerable as occupier demand is closely linked to retail sales. With consumer confidence falling, trading figures weak and unemployment set to rise further, the outlook for distribution warehouse rents in the near term is weak. Industrial rents fell by 1.3% in Q1 according to the IPDMI. As a result of the heightened economic uncertainty, companies looking to move or expand are deferring decisions in order to secure the best possible deal and until there is greater visibility on their growth prospects. The most likely source of take-up in the short-term will be firms seeking to consolidate their existing space in order to make efficiency savings, although this is likely to result in the release of second-hand space.

Increasing tenant distress putting pressure on rents
- The sector also faces a significant over-supply issue, following several years of significant speculative development. Availability has been trending upwards since mid-2005 according to King Sturge, and now stands at 22.6 million m<sup>2</sup>, an increase of 5.4% in the 6-months to December 2008. Much speculative space comprises units of more than 10,000 m<sup>2</sup>, and availability among larger units consequently rose 21.7% in the same period. A significant proportion of availability constitutes new space, which has reached the market over the last year and failed to let. On a more positive note, speculative development has now virtually stopped, as developers respond to falling demand and tighter credit conditions. The government is also rumoured to be considering a budget package of supply-chain insurance to combat the contraction in credit insurance, which may go some way to support the sector. However, with occupier demand likely to weaken further, it may take some years for the existing supply over-hang to be absorbed.

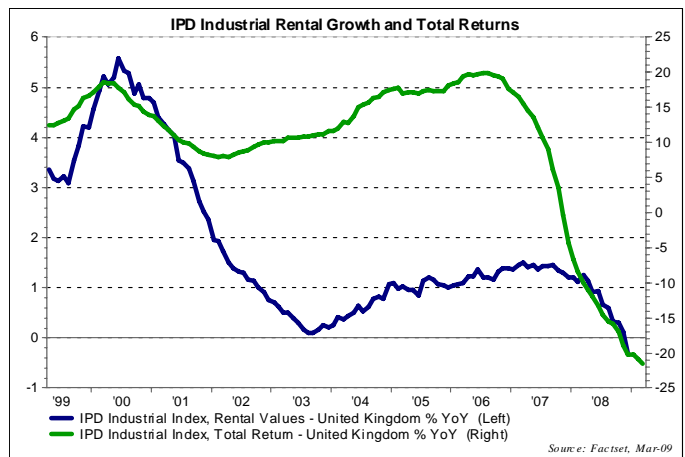
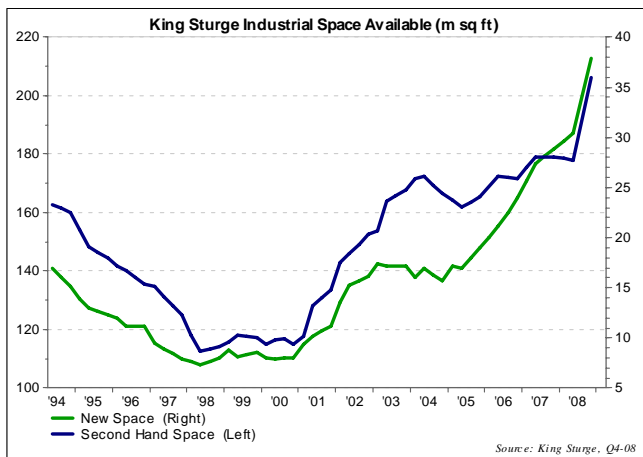
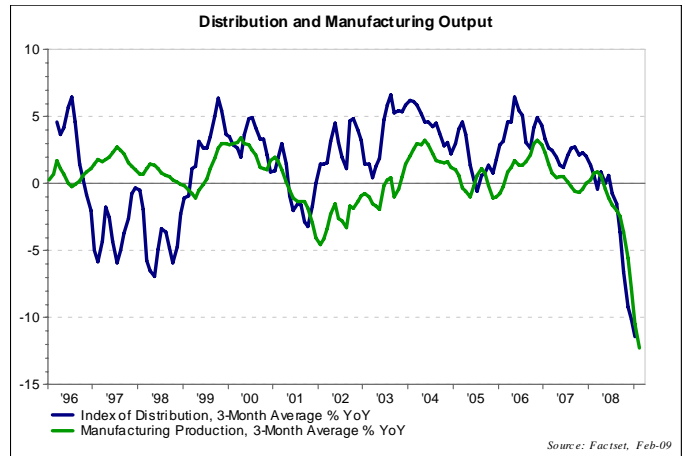
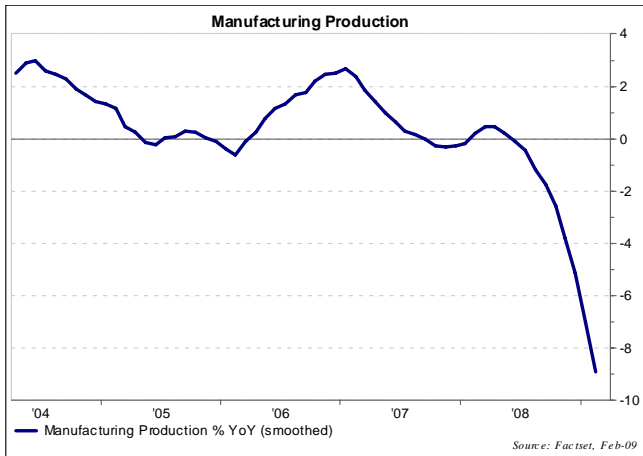
Availability continues to rise, although speculative development has fallen
- This current supply demand dynamic has shifted the market balance firmly in favour of occupiers and rents are likely to fall significantly further as a result. As well as headline rents coming down, landlords will have to become increasingly flexible to secure lettings. Incentive periods are likely to remain elevated and lease lengths are likely to shorten and offer more flexibility to tenants. Some developers are now paying for tenant fit outs, a significant expense usually borne by the incoming occupier. An additional pressure on landlords has been the abolition of empty rates relief in April 2008, meaning landlords pay rates on buildings vacant for more than six months. It has affected industrial property particularly sharply as the only sector which previously enjoyed 100% relief. This additional cost to the landlord of holding vacant space will add further downward pressure on rents. This liability is also likely to create incentives to demolish space that would previously have been held for refurbishment, as well as more creative solutions, such as short-term rent-free tenancies while a landlord seeks to secure an occupier.

Lease terms likely to become more flexible & empty rates have put further pressure on landlords

- In the medium term, there is likely to be some support for the industrial sector if the UK experiences a re-balancing of activity towards manufacturing, supported by a weaker pound. Additionally, globalisation continues to enhance the importance of the logistics sector and prime logistics in key strategic locations are likely to perform strongly. The UK is well placed in terms of its ability to transport goods on time and at low cost. In the World Bank's Logistics Performance Index, which considers factors such as transport infrastructure and logistics service, the UK is ranked 9th.
- There is also likely to be the development of a two-tier market in the new build sector. Although speculative development has largely stopped, the high availability of new space means speculative space will continue to get cheaper, with lease terms increasingly flexible. However, some larger firms will still commission built-to-suit schemes to meet specific requirements, and rents, covenant requirements and lease terms (a minimum of 15 years in length) will be less flexible in this specialised sector.

UK logistics strength should benefit sector in medium term

Two-tier market to develop in new build sector



## Residential

- The housing market downturn that began in late 2007 ended the longest and strongest boom on record. Prices had risen continuously for over a decade, increasing by a factor of 2.5 in nominal terms according to the Nationwide index. On the same index, house prices have now been falling for over a year and a half and in February the average house price slipped below £150,000 for the first time since May 2004. The Nationwide house price index suggests a fall of 16.5% in the twelve months to the end of March and a -4.2% fall in the first quarter. Sales levels are also very low. The February RICS Housing Market Survey records that the average number of sales per surveyor continued to fall, down to just 9.5 from an average of 24 a year earlier. The number of residential transactions was 53,000 in January and 52,000 in February. In 2006 and early 2007, monthly transactions typically totalled between 140,000 and 150,000.

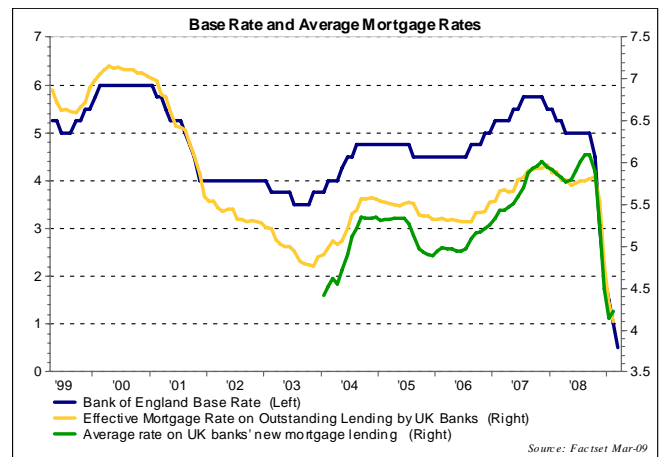
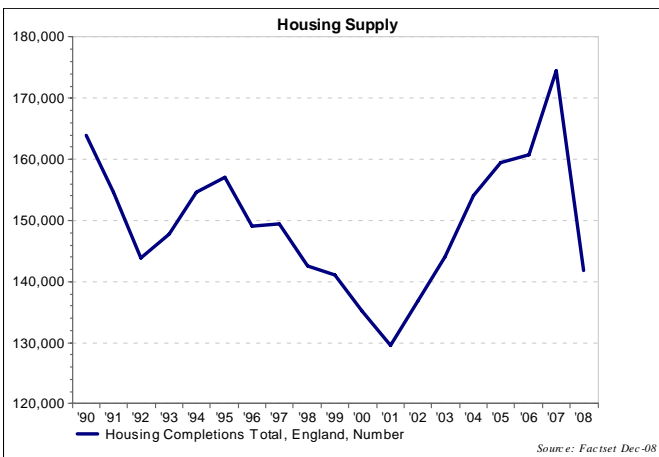
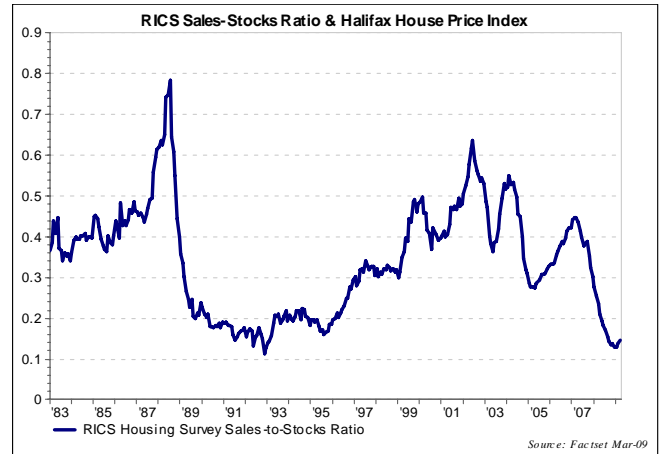
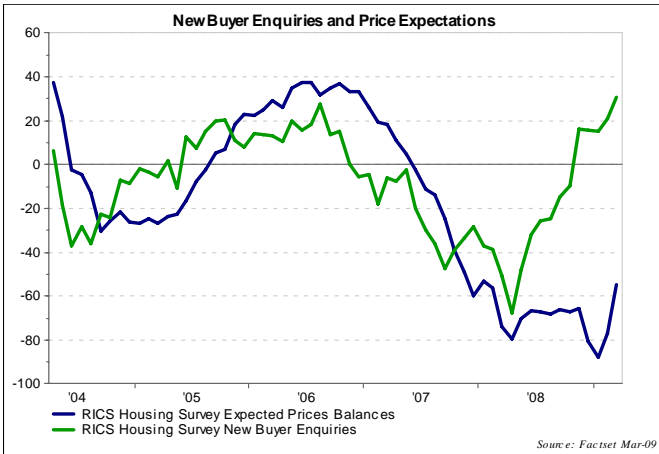
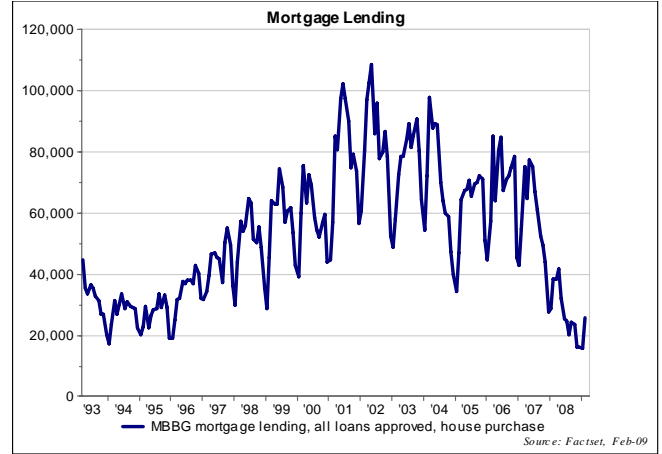
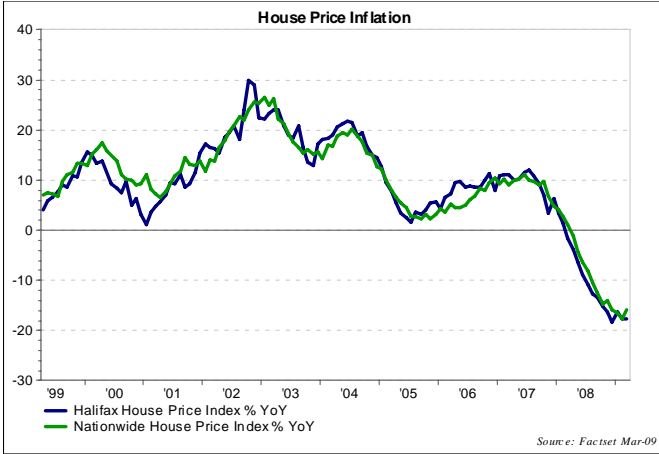
House prices declining rapidly and sales numbers are low
- The contraction in the supply of mortgage debt has affected the housing market severely. According to the Bank of England, mortgage approvals reached a low of just 27,300 in November 2008, recovering to 38,000 by February 2009, but down by about two thirds on the levels that prevailed in the decade prior to the downturn in late 2007. This sudden decline followed a prolonged period in which mortgage debt increased greatly. It rose from around 85% of average household income in 2000 to nearly 140% in 2007 – amongst the highest levels of major economies. In part, this increase in mortgage debt was made possible capital markets' enthusiasm for mortgage-backed debt. The UK mortgage market was very reliant on residential mortgage backed securities (RMBS). According to RICS, around 40% of mortgage lending was financed through RMBS, more than in any other European country. Indeed, UK lenders were responsible for over half the total issuance of RMBS across Europe. When the credit crunch hit, the mortgage-backed securities market effectively closed. Across the banking sector, the ability and desire to lend to residential property has reduced greatly. As the economic backdrop deteriorates and prices continue to fall, we expect lenders to maintain caution in mortgage lending, though some improvement is likely from current very weak levels.

The fall in the supply of mortgage debt has been a key driver
- Whilst the market was set on its downward spiral primarily by deteriorating supply of mortgage credit, the market now has a negative momentum that would probably persist even if the supply of mortgage debt improved. Firstly, prices are a clear negative trajectory. Secondly, unemployment and job insecurity are increasing. Thirdly, households' attitudes to debt are changing with a strong desire to reduce burdens evident. Indeed, equity withdrawal turned negative in the second quarter of 2008.

Demand for mortgage debt also greatly reduced
- In response to market weakness, housing construction activity has slowed significantly. National Statistics data shows that housing completions fell by 25.5% in 2008 and the number of housing starts fell by 57.6%. We expect the building slump to persist for a considerable time. Unlike the US and some European countries the UK is not over-supplied. Indeed, a long-term problem of undersupply persists, especially in the South East. The UK's per capita house building rates are low by international standards due to the tight regulation of land use and other state controls over green-field development and building densities. Much higher rates of house building than currently exist are required, especially as government projections suggest that in the period to 2031, the number of UK households will increase by an average of c250,000 a year. In the long-term, under supply should provide a floor to pricing.

The UK housing market remains supply constrained
- In the near term, the outlook is highly uncertain. Low interest rates and lower prices are prompting an increase in buyer interest. But it is difficult to know if this interest can be sufficient to stabilize the market with unemployment rising sharply and availability of mortgage debt still limited. March's RICS housing market survey shows that price expectations amongst surveyors remain comfortably in negative territory but have recovered from their extreme lows of mid and late 2008. We expect further declines in prices in the coming months at least. Derivative markets suggest a further fall of close to 20%.

Uncertain prospects in the short term



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