

# UK Quarterly Property Snapshot



## The economy

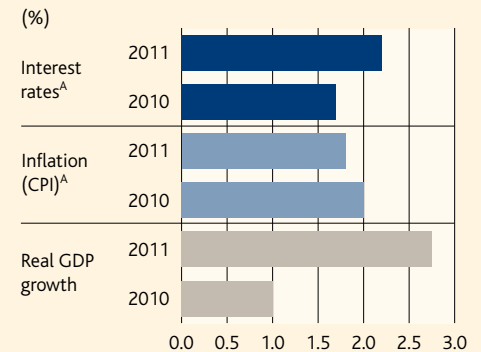
### Recent performance

- The second estimate saw real GDP growth in Q1 2010 of 0.2%, down from 0.4% in the previous quarter. The slowdown mainly reflects the impact of adverse weather conditions on the distribution industry, without which, growth is likely to have been stronger. A positive picture, painted by private sector business surveys, indicates that underlying growth was back above trend by April.
- The cumulative fall of 84,000 in claimant count unemployment, since last October, confirms that the labour market has turned positive. Strength in the labour market is limited to London and South East England, which have benefited from a strong revival in business and financial services activity. Retail sales and manufacturing output were disrupted by January's poor weather, although have recovered to some extent in subsequent months. In the case of consumer spending, the re-imposition of the 17.5% VAT rate also depressed sales of durable goods, having surged at the end of 2009. With companies continuing to pay down debt, business investment has collapsed and was almost 25% down on a year earlier in Q4 2009.
- The recent rebound in house prices has faltered, with both the Nationwide and Halifax indices reporting monthly declines of more than 1% in February, although with a modest rebound in March. The weather, and end to the stamp duty holiday may account for some of the slowdown. A recovery in owner-occupier demand is still in place, and banks report greater competitive pressures on margins and mortgage rates which is positive for new borrowers.
- CPI inflation rose to 3.4% in March due to stronger energy prices. Core price inflation remains relatively firm, reflecting the impact of a weak sterling exchange rate on goods prices and a higher VAT rate. Weak wages though, are helping to curtail inflation in the more dominant service economy and will keep inflation low in the next 12 months.
- The Budget booked an undershoot in public borrowing in the 2009/2010 fiscal year, helped by higher tax revenues and lower spending on social security. The budget deficit though, is extremely high, at 11.8% of GDP. The Budget was light on how the projected halving of the deficit in the next five years will be achieved, while the GDP growth forecast for 2011 and 2012 seems unrealistically high, at 3% and above.

### Outlook

- Stable house prices, historically low interest rates, and lower-than-expected unemployment should all help to support consumer confidence and a modest rise in spending this year. The sharp rise in the savings rate, to an above average level, should mean the risk of a further major decline in consumer spending is limited. In the medium term, highly-indebted households are vulnerable when interest rates eventually start to rise, from some time in 2011.
- As in previous recessions, we expect the business investment pick-up to lag the wider recovery, particularly given the ongoing restrictions in credit conditions. As such, the corporate sector will provide little support to the upturn. With a fiscal squeeze also starting in earnest, the recovery will hinge on stock-building and exports.
- Reiterating our previous view, we expect a modest rise in GDP in 2010, led by exports and re-stocking activity. Consumer spending will also be positive, having taken a big hit in 2009. Near term growth will be moderate and we expect the Bank of England (BoE) to keep interest rates low for a prolonged period of time, most likely now until 2011. A further extension of quantitative easing is possible, although the process was put on hold earlier this year. Low interest rates will provide an offset to the tightening of fiscal policy from next year. The other factor helping to hold down interest rates will be excess capacity in the economy. There is uncertainty over the extent of spare capacity, as some skills and capital stock will have been permanently lost, while future trend growth in the economy will be lowered by constrained access to finance. A large loss of capacity is backed up by the fact that ease of recruitment and capacity utilised by firms, never plumbed the depths achieved in the shallower recession of the early 1990s. As such, we still see strong upside risks to inflation over the medium-term.

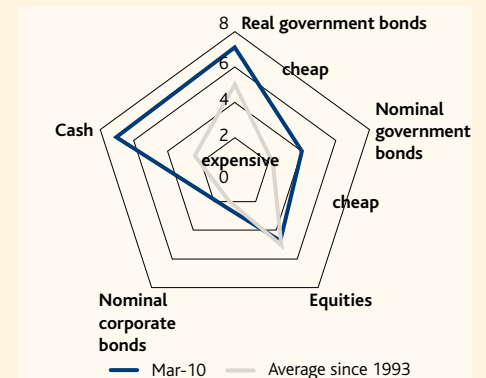
### UK economic forecasts



<sup>A</sup> Year end forecasts

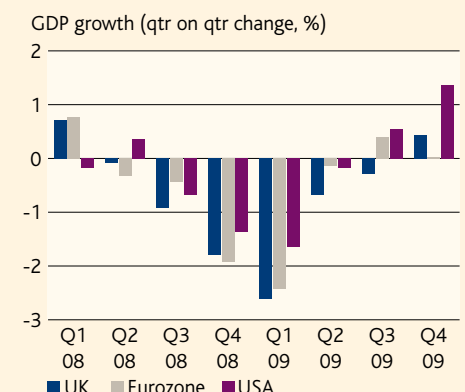
Source: Aberdeen Property Investors, Reuters EcoWin

### Property still offers an attractive yield premium over other asset classes



Source: Aberdeen Property Investors

### UK recovery finally underway



Source: Aberdeen Property Investors

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## Property market overview

### Recent performance

The sharp pick-up in capital values for UK property is continuing. Following a rise of 3% in December 2009, the strongest performance in the history of the IPD Monthly Index which dates back to 1986, strong capital growth continued through Q1 2010, with capital values increasing by 1.6% in March. Capital values, as reported by IPD, have risen by 13% since July 2009. Fierce competition for investment product continues to drive prices higher. Overseas investors, aided by the weakness of sterling, the UK institutions, retail funds and property companies/REITs, are all trying to increase their exposure to UK property.

Retail funds have experienced rapid inflows of cash over the past six months and are resuming purchasing activity, after being net sellers of property in the last two years. Pooled Property Funds raised £3.2 billion of new money in Q4 2009, according to figures from the Association of Real Estate Funds. The figure was the highest in its history which dates back to 1998, dwarfing the peak of £1.7 billion raised in the previous upturn during 2006. In Q4 2009, net investment from the UK institutions also turned positive for the first time since Q4 2006.

Although rental values continue to decline, the pace has slowed dramatically, from over 12% on an annualised basis in the spring of 2009 to less than 2% in spring 2010. Rental values are stabilising more rapidly than would be expected, given the weakness of the economic recovery. Development has been more subdued in the last few years than in previous property market upswings, such as the late 1980s, and construction levels across the office, retail and industrial sectors are currently exceptionally low. This has resulted in generally lower levels of oversupply than in previous downturns.

### Retail

- The pace of rental decline has continued to slow, with the annualised pace falling from 9% in spring 2009 to less than 3% currently. Availability across the retail warehouse sector has fallen in spring 2010, aided by record low completion levels. Just two new retail parks are due to complete in 2010, the lowest since the development of the sector in the mid 1980s. Retail sales, in the Capital and the South East, have held up relatively well given the boost from tourist trade, aided by the weaker pound and the fact that the South East region has experienced a weaker economic downturn than the rest of the UK.
- Yields have been falling for all retail segments, for both prime and secondary property. However, the pace of decline has varied between segments, with retail warehouses, which had seen some of the sharpest inward yield shift at the end of last year, seeing a slower pace of decline in Q1 2010. Some of the stronger yield falls over the quarter were seen in good secondary retail warehouses and standard shops, rather than prime, showing that investors are more willing to move up the risk curve.

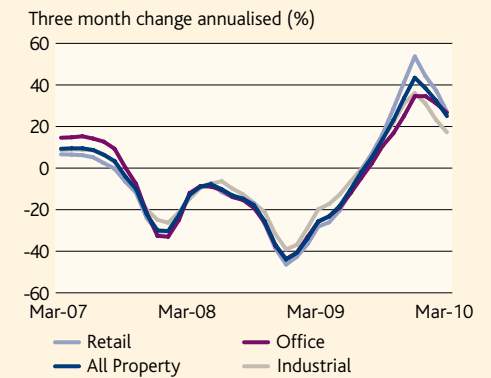
### Office

- Rental decline in the office sector has come to a halt over the past few months. Office rents fell at an annualised rate of just 0.2% over the three months to March 2010, compared to a rate of over 20% in spring 2009. Prime rents in central London have started to rise. For example, prime City rents have risen to £47.50 per square foot, compared to the low point of £42 per square foot a year ago, which was the lowest level since Q4 1996, in nominal terms. With vacancy rates shrinking and future supply levels remaining low, upward pressure on prime rents is returning and incentives are falling sharply. In the South East and Rest of UK segments, rental values continue to decline, but at a much slower pace.
- Prime yields continue to fall, albeit at a more modest pace than seen in the last quarter. In the City and West End, prime yields are falling particularly rapidly, and stand at 5.75% and 4.5% respectively.

### Industrial

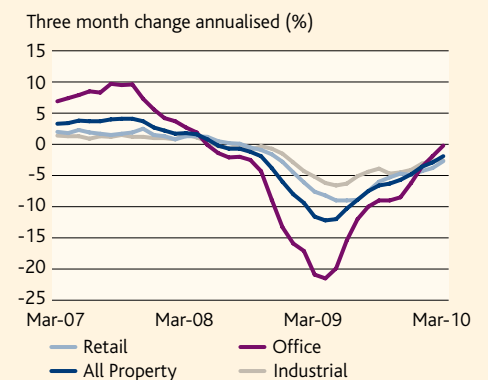
- Industrial rents fell by 2.6% on an annualised basis over the three months to March 2010. Although demand has remained subdued and availability is at record levels, the pace of rental decline has continued to slow. Although overall availability levels have continued to rise, availability of prime, newly constructed property has fallen in all regions of the UK, reflecting the fact that completion levels have fallen dramatically, and distributors continue to rationalise their supply chains into larger, more efficient modern units.

### Total return



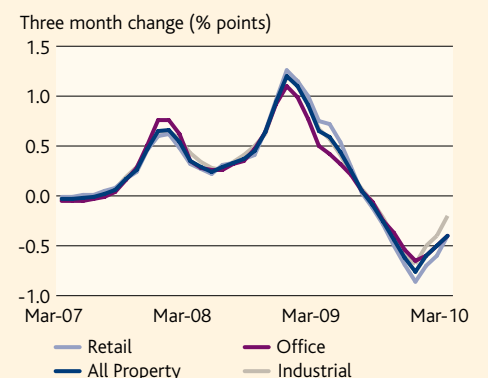
Source: IPD Monthly Index, March 2010; Aberdeen Property Investors

### Rental value growth



Source: IPD Monthly Index, March 2010; Aberdeen Property Investors

### Yield shift



Source: IPD Monthly Index, March 2010; Aberdeen Property Investors

# UK Quarterly Property Snapshot

## Sector prospects

### Outlook

A strong total return of 16% is projected for 2010. This will be driven by continued capital growth, particularly in the first half of the year. Investment demand is currently strong from institutional investors, retail funds, overseas investors (with the exception of the Irish), REITs/property companies and private investors. Although property yields have fallen by 150 basis points since the bottom of the market in summer 2009, there still exists a significant yield premium of property yields over the yields on other asset classes compared to the long term average. This is particularly the case against nominal government bonds, index-linked government bonds and cash. Property yields are in line with the long term average against equities, and remain above the long term average against corporate bonds.

After a particularly strong total return in 2010, which will be concentrated in the first half of the year, we expect total returns to drop back sharply in 2011, as interest rates and bond yields rise, while rental growth struggles to resume, with the exception of the central London office market. By late 2010, UK property yields will have fallen by over 200 basis points since the summer of 2009, and property's yield premium over other asset classes will look less attractive. Interest rates are projected to start increasing in earnest from early 2011.

In addition, while UK yields will have fallen dramatically by this point, yields in continental Europe are only projected to come down slightly, and property in continental Europe will look more attractive as a consequence. The extremely strong investment demand currently being experienced from overseas investors looks likely to switch to continental Europe, a trend already noted in early 2010.

As a consequence, we project yields to increase in 2011, and total returns to dip back sharply, although still remaining in positive territory. The abrupt slowdown in total returns in 2011 would be similar to the correction experienced in 1995, which also followed a sharp bounce in capital values in the preceding two years. From 2012, rental growth resumes in earnest across all sectors, and total returns are projected to pick up once again.

A five year annualised 'All Property' total return of 9% is forecast, based on pricing at the end of March 2010. The majority of this (approximately 7%) will be delivered by income return, with the remainder coming from some strong capital returns over the next year, and rental growth at the back end of the forecast period.

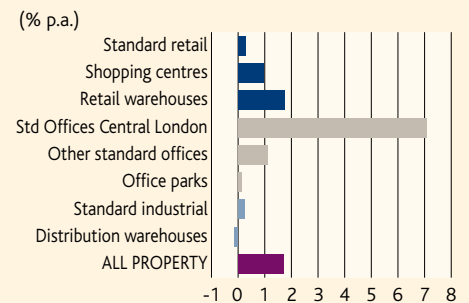
Over the next five years, the best performing sector is projected to be central London offices, driven by much stronger rental growth than in any other segment. Prime rents are already starting to rise in London, while even average rents are stabilising after falling at a pace of as high as 30% in spring 2009. Availability of Grade A space is declining rapidly, and completion levels will be exceptionally low over the next three years. South East offices are also projected to outperform, aided by a historically high yield, and recovering rental growth at the prime end in the medium term.

The standard shop sector is projected to be one of the worst performing sectors, as it is substantially lower yielding than most other segments. In the past, this has been compensated for by much stronger rental growth. However, in the future, strong rental growth is much less likely, due to a combination of the further growth of internet shopping, supermarkets' continued expansion into non-food, further expected rises in VAT, income tax/National Insurance increases, rising interest rates and record high vacancy rates.

The key risk in the short term, involves projecting the strength and duration of the current surge in UK property capital values. We have projected a sharp slowdown in the pace of capital uplift over the remainder of 2010. Nevertheless, demand for investment property remains strong from a wide variety of sources, and AREF data showed a record volume of new capital raised for commercial property investment in Q4 2009. There remains a risk that the surge in capital values continues for longer than projected, particularly with interest rates forecast to remain low for the remainder of 2010.

The more pronounced performance profile could be compounded by the banks dramatically increasing the amount of investment property they sell back into the market, taking advantage of increasing prices. Nevertheless, as a sudden glut of commercial property appearing on the market and depressing prices would compound the banks' own problems, this has been relatively slow to occur so far, and the risk of a large volume of investment stock being dumped onto the market is receding. Banks seem content to drip feed stock into the market, and are seeking to exit some distressed assets via joint ventures with property companies. Nevertheless, if a sudden glut of investment stock did come onto the market, this may cause capital values to fall again in 2011.

### Five year annualised rental growth (to March 2015)



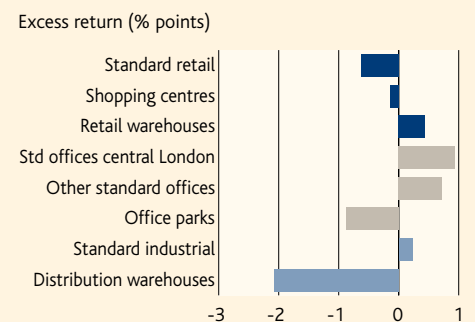
Source: Aberdeen Property Investors

### Five year annualised total returns (to March 2015)



Source: Aberdeen Property Investors

### Market pricing over five year horizon relative to benchmark



Source: Aberdeen Property Investors

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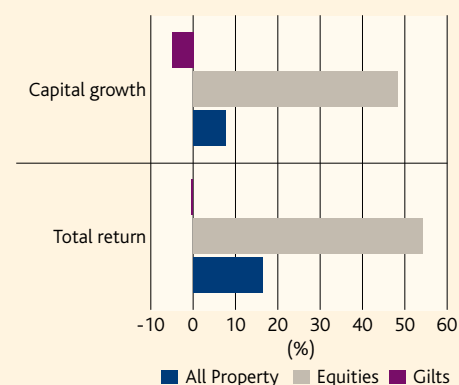
### Investment policy

The table below shows Aberdeen's recommended positions, relative to benchmark, in order to achieve outperformance over a five year period.

Sector	Strategy
Standard retail	Underweight
Shopping centres	Neutral
Retail warehouses	Underweight
City offices	Overweight
West End offices	Neutral
Rest of South East offices	Overweight
Rest of UK offices	Underweight
Office parks	Neutral
Industrial	Neutral
Other	Neutral

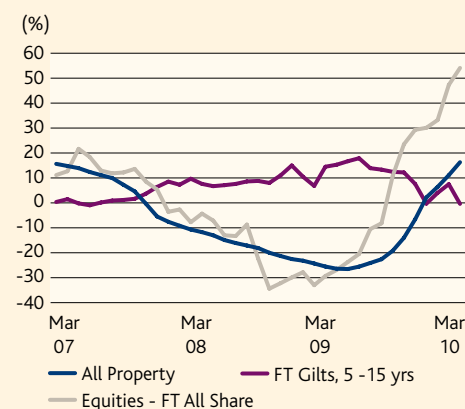
Source: Aberdeen Property Investors

### Asset classes – 12 month total return and capital growth (to end March 2010)



Source: Aberdeen Property Investors, IPD

### Asset classes – 12 month rolling total return (to end March 2010)



Source: Aberdeen Property Investors, IPD

### Important information

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