UK Quarterly Property Snapshot

Aberdeen

The economy

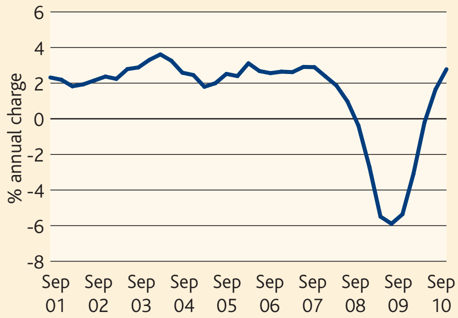
Recent performance

- UK GDP in Q3 2010 showed a strong increase of 0.8% following a sharp jump of 1.2% in Q2 (Figure 1). Construction continued to make a particularly strong, positive contribution though and even excluding this sector the recovery has been robust.
- Manufacturing activity and goods exports were solid in Q2 and the UK share of world trade has improved. However, a larger trade improvement, as in the aftermath of the early 1990s sterling devaluation, has been prevented by weak demand in key European export markets.
- This contrasts with surprisingly strong consumer spending, growing by 0.7% on the quarter in Q2. The good performance of consumer spending may be a reflection of the recovery in employment, which rose by 0.8% in the year to July. Much of the increase in employment has come from part-time positions, while more recent labour market indicators point to a levelling off in unemployment.
- Inflation continues to run at above the government's target rate at 3.1% in October, though it is down from a recent high of 3.7% in April. Upward price pressures have eased, with non-energy goods inflation on a noticeable downtrend. This mirrors a stabilisation in import prices for finished goods as the bulk of sterling's declines on prices looks to have come to an end.
- Public sector borrowing in the fiscal year to September reached £73.5 billion. Excluding the impact of operations to support the banking sector, borrowing is £3.8 billion less than in the previous financial year. The improvement mostly reflects higher tax receipts following a rise in VAT in January and a tax rate increase for high earners since April.

Outlook

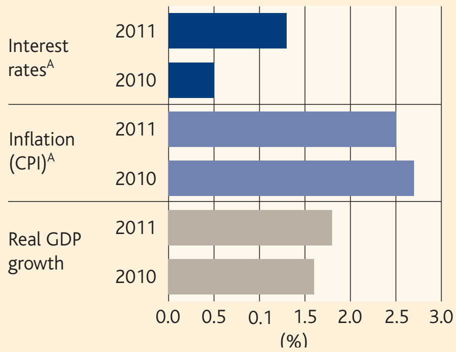
- After a strong GDP showing in Q2 and Q3, we expect growth to slow in the final quarter of 2010 and into 2011 (Figure 2). Moreover, we expect unemployment to begin drifting upwards again over the next 12 months as the effects of public sector job cuts begin to bite. The government plans substantial cuts in the budget deficit in coming years, equal to 5.5% of GDP between 2009-10 and 2012-13, which requires strength elsewhere if the economy is not to stagnate.
- Robust export growth should be sustained for the rest of the year, with ongoing support to competitiveness from a low sterling exchange rate. However, given the public sector financial difficulties in the eurozone periphery, strong exports are likely to be difficult to sustain.
- UK consumer demand is expected to be weak for the next year, with the savings ratio expected to revert to more normal levels, as households reduce debt burdens from exceptionally high levels. Extremely low interest rates though should provide a cushion, preventing a deeper and more serious adjustment to spending.
- A sharp improvement in corporate balance sheets and liquidity gives plenty of scope for a ramp-up of activity, with business investment spending up by approximately 9% in the first half of 2010. However, the environment of a fiscal spending squeeze (Figure 3) and economic uncertainty emanating from the eurozone, will most probably put a ceiling on the scale of a recovery in corporate spending.
- As business and consumer confidence is still fragile, in the medium term, the risks to the economy are on the downside. Recent weaknesses in activity data have sparked a debate within the Bank of England (BoE) over the merits of re-starting the quantitative easing policy. Above target inflation is a barrier to looser monetary policy, particularly in the absence of a sharper slowdown in growth. However, a softer global economy and tighter domestic fiscal policy should lead the BoE to expand its asset purchase programme next year.
- Monetary expansion represents an upside risk to price stability over the medium term. Moreover, the eventual withdrawal of monetary stimulus in the years ahead could

Figure 1: GDP has bounced back rapidly in recent quarters



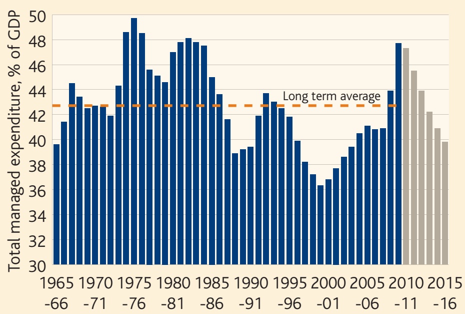
Source: Reuters Ecowin, November 2010

Figure 2: Consensus economic forecasts (%)



^A Year end forecasts
Source: Aberdeen Asset Management, HM Treasury, November 2010

Figure 3: Government spending to decline relative to GDP



Source: HM Treasury, November 2010

contribute to continued volatility in the economic cycle. Trend growth is also likely to have fallen as conditions generated by excess credit growth during the boom years are unlikely to be repeated. As a result, the 5 year growth outlook is a moderate 2.2% per annum compared to growth of 3.1% following the recessions of the early 1980s and 1990s.

Property market overview

Recent performance

The pace of capital uplift slowed to just 0.2% in September, as yields have stabilised (Figure 6), and total returns have weakened (Figure 4). There have been signs of capital values starting to fall slightly for some property segments, such as bulky goods retail warehousing and provincial office markets. The downward pressure on capital values has been concentrated in the more secondary asset classes. Demand remains reasonable for prime property. There remains a large degree of uncertainty over the impact of the government's spending cuts and tax rises and how these will affect occupier demand and the investment market. Transaction volumes have stabilised in the third quarter and inflows into retail funds have slowed from exceptionally high levels earlier in the year.

Although sentiment has weakened in the investment market over the past quarter, the occupier market has continued to improve gradually. The pace of rental decline has slowed to just 0.5% on a quarterly annualised basis (Figure 5). Although rents continue to fall gradually in the retail and industrial markets, they are increasing again in the office sector. However, within the office sector, rents are only rising for the central London office market.

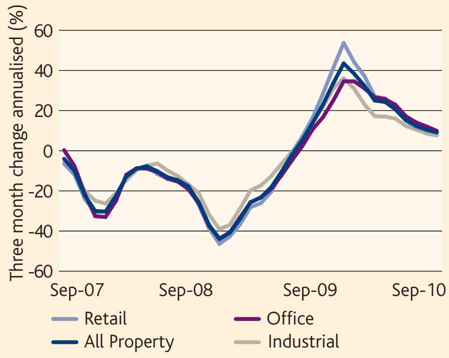
Office

- Office take up in the UK during the 12 months to Q2 2010 was 15% below the 12 month historic average. However, in the central London submarkets, take up was 9% higher on the same basis. There is a stark difference in performance between London and the rest of the UK's office markets, with the latter being considerably slower to recover. Take up in central London in Q2 2010 was in line with the long term quarterly average, 2.4 million square feet. The key deal in the City submarket was the 700,000 square feet pre-let to UBS at Broadgate.
- Central London has been performing far better than the rest of the UK. On a 3 month annualised basis to August 2010, average rents in the City submarket grew by 5.8% and by 3.6% in the Midtown and West End submarkets. In contrast, rents in the South East and Rest of UK markets continued to fall, albeit at a slower pace. The strong recovery seen in central London has been driven by growing demand from the finance and business services sectors, while new availability rates and construction levels are very low, and rents are also growing from a low base relative to history.
- Upward pressure is particularly strong on prime rents in London and incentives are falling sharply. Headline rents in the City submarket have increased by 24% from £42.50, at the trough, to their current level in September 2010 of £52.50 per square foot, while West End and Midtown rents have each grown by 20% since their trough, to stand at £90 and £50 per square foot respectively.

Retail

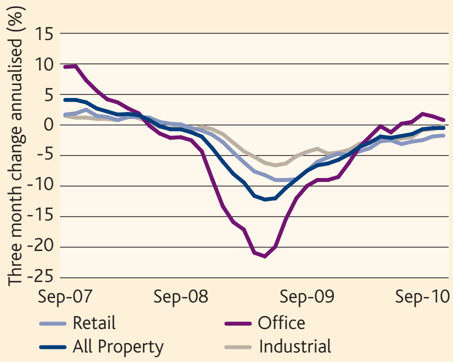
- On a quarterly annualised basis to September retail delivered a total return of 9.1%, which was in line with 'All Property'. After the sharp slowdown in inward yield shift, particularly in the retail warehouse sector, there has been little difference in total returns between standard shops, retail warehousing and shopping centres.
- Yields stabilised over the quarter across all the retail segments, with only secondary retail warehouse yields seeing an outward yield shift of 25 basis points. Yields on prime retail warehouses currently stand at 5.25%, compared to yields of 4.85% and 5.5% on prime high street units and shopping centres respectively. On average these yields are just under 100 basis points higher than where yields were at the peak of the last cycle. Secondary retail unit yields are more than 250 basis points higher than at the peak of the last cycle.

Figure 4: Total returns weaken



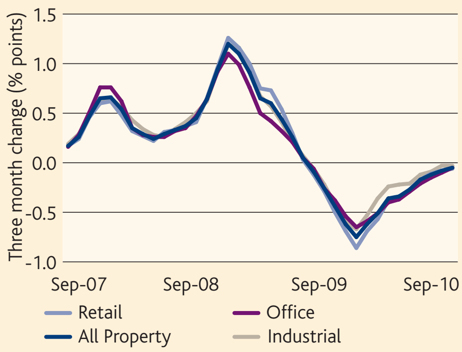
Source: IPD Monthly Index, September 2010

Figure 5: Rental values stabilise



Source: IPD Monthly Index, September 2010

Figure 6: Inward yield shift comes to an end



Source: IPD Monthly Index, September 2010

Industrial

- Industrial rents have stabilised, falling by just 0.2% on an annualised basis over the 3 months to September 2010. As the economy has picked up, demand has strengthened and availability of new space has fallen dramatically, and rents have stabilised as a consequence.
- Take up levels in the UK industrial market remain 30% below the long term average. UK-wide total availability has however fallen for the first time since June 2005. Supply of brand new space, as measured by King Sturge, has fallen by 14% over the last 6 months across the UK. This trend is set to continue as demand gradually strengthens and new construction remains minimal, due to a continuing lack of development finance. New development starts remain at just 30% of the long term average.

Sector prospects

Outlook

In the short term, we project some slight falls in capital values over the final quarter of 2010, particularly for more secondary property types. A total return of 12% is projected for 2010, which has not changed since our forecast in June.

We are not expecting a sharp decline in capital values, especially after the renewed fall in government bond yields over the past six months, which has continued to highlight the attraction of property's income return. Interest rates are projected to remain low throughout 2011. There still exists a substantially higher yield premium of property valuation yields over the yields on most other asset classes compared to the long term average low risk asset classes: nominal government bonds, index-linked government bonds and cash, and property looks attractive from an income perspective as a consequence.

Rental growth should turn fractionally positive over the next year, as the economic recovery continues. Although a slowdown in the pace of economic growth from Q2 is projected, a double dip in terms of renewed negative growth is not forecast. Above inflation rental growth is only projected to occur in the London office market and this will be concentrated at the prime end of the market.

The recent pattern of performance bears a striking resemblance to the two stage recovery of the early 1990s, where a sharp initial rebound of capital values (a stage which, in this recovery, is now ending) was followed by a more sustained recovery as rental growth returned to positive territory. The weakening of total returns in late 2010/early 2011 would be similar to the correction experienced in 1995, which also followed a sharp bounce in capital values in the preceding two years.

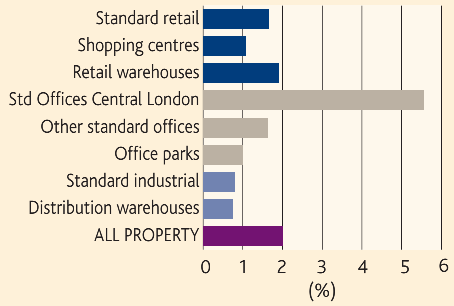
We project a slight rise in yields and fall in capital values in the first half of 2011. Due to the sluggish pace of the economic recovery, hindered by large cuts in public spending and tax increases, rental growth is projected to be very slow to resume everywhere except for central London offices. Investor risk aversion is forecast to continue until the economic recovery becomes more entrenched, which we project will occur in late 2011-12. From 2012, we project a renewed improvement in total returns, aided by gradually improving occupier market conditions. Nevertheless, rising interest rates and bond yields mean downward pressure on property yields is likely to be minimal. The majority of total return is projected to come from income return, aided by some rental growth at the back end of the forecast period. A pronounced capital uplift resulting from a renewed sharp fall in yields is not currently projected.

A 5 year annualised 'All Property' total return of 7.7% is forecast, based on values at the end of September 2010 (Figure 8). The majority of this (approximately 7%) is projected to be delivered by income return.

Over the next five years, the best performing sector is projected to be South East offices, aided by a historically high yield and recovering rental growth at the prime end in the medium term, off a very low base in historic terms. Yields for South East offices are at their highest ever level relative to the 'All property' yield. Development completions are currently at an all time low.

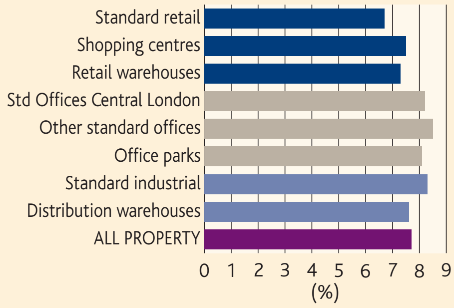
Central London offices are also projected to outperform marginally, although this is projected to be concentrated in the short term. The outperformance is projected to be

Figure 7: Five year rental growth (per annum basis to September 2015)



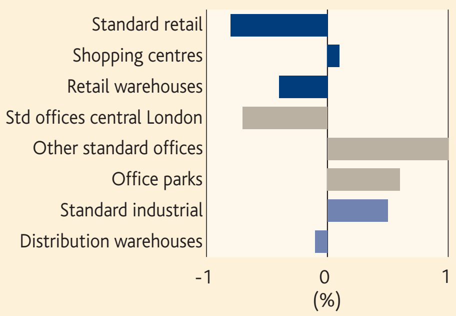
Source: Aberdeen Asset Management, November 2010

Figure 8: Five year total returns (per annum basis to September 2015)



Source: Aberdeen Asset Management, November 2010

Figure 9: Market pricing over five year horizon relative to benchmark



Source: Aberdeen Asset Management, November 2010 driven by much stronger rental growth than in any other segment, concentrated in the next three years (Figure 7). The resumption of rental growth is forecast to be driven more by a shortage of space at the prime end, rather than particularly strong demand. Availability of both average as well as prime stock has already fallen sharply, in contrast to all other segments. Our forecast of the extent of outperformance by central London offices has been reduced since our last forecast round however, as yields have now fallen dramatically for this sector, and the prospect of further capital uplift from further inward yield shift looks unlikely.

Provincial UK offices are projected to underperform. Regional offices have a high dependence on the public sector and with public sector spending set to fall dramatically over the next few years, these markets should be disproportionately affected. Many of the UK's major regional cities already have availability rates at record levels.

The standard shop sector is projected to be one of the worst performing sectors, particularly outside London and the South East where development has been more modest in recent years. Standard shops have a substantially lower yield 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, a further rise in VAT, rising interest rates and the current record level of retail vacancy rates.

Investment policy

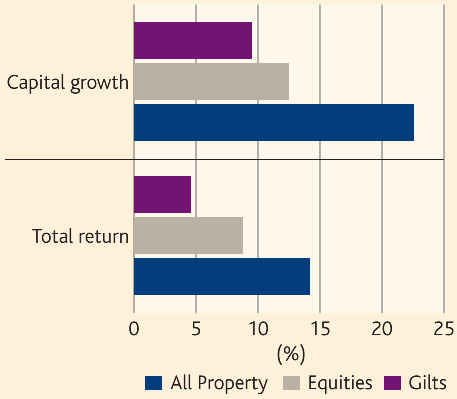
The table below shows Aberdeen's recommended positions, relative to the IPD Annual Universe, in order to achieve outperformance over a five year period.

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

Source: Aberdeen Asset Management, November 2010

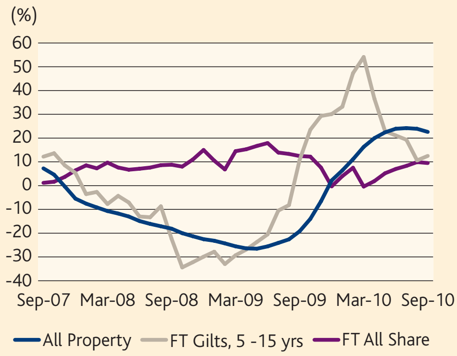
Property is now the best performing asset class relative to equities and gilts over the past 12 months, aided by a very strong performance in Q4 2009 (Figures 10 and 11).

Figure 10: Asset classes – 12 month total return and capital growth (to end September 2010)



Source: IPD, October 2010

Figure 11: Asset classes – 12 month rolling total return (to end September 2010)



Source: IPD, October 2010

Important information

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