

"Property's out-performance of other asset classes reinforces its position as a key component of a balanced portfolio"

Overview

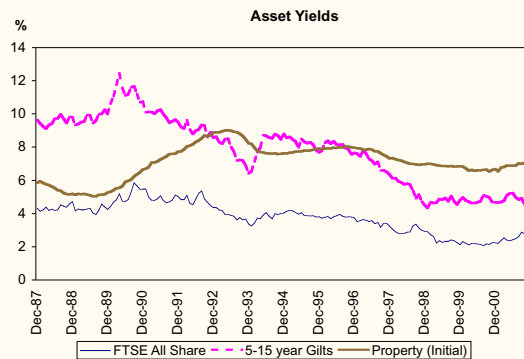
Property is top-performing asset

Property was the best-performing asset in 2001 for the second successive year, according to the IPD Monthly Index. The annual total return was 7.1%, compared to 3.9% for gilts and -13.3% for equities. Property's performance was entirely income-based, as annual capital growth was -0.4%. The latest estimate of the Annual index total return is 6.6%.

Property is also the best-performing asset in pension fund portfolios on both an annual and 5-year basis. Despite its out-performance, property constitutes only 5.6% of pension fund portfolios.

Yield gap

Property yields stand at 7.1%, compared to 5-15 year gilts at 5.0% and equities at 2.6%. The current property-gilt yield gap should act to restrain adverse shifts in property yields. Debt-funding will remain a viable strategy to boost returns as property yields remain above 5-year swap rates.



Source: Investment Property Databank

Weak corporate sector

Corporate profitability is weak which is subduing future rental growth. This will be the main impediment to investment performance in 2002. Overall, we forecast negative rental growth on an inflation-adjusted basis this year.

Lender caution rises

Lenders are becoming increasingly cautious in the terms they are offering because of the short-term outlook for occupier demand. Consequently, loan-to-value ratios are being lowered and margins are being increased. Despite this, the short-term outlook for the bank base rate is benign.

Retail to out-perform

We forecast that retail will out-perform other sectors in 2002 as the upward movement in yields seen throughout most of 2001 has now largely been played out. The sector is also less exposed to the uncertain global economic outlook.

Office

Markets in the South East see declining rental growth prospects, whilst the outlook for provincial centres is brighter. Investors' pricing

decisions will become increasingly focused on the longevity and security of income stream.

Industrial

Prime yields have weakened over the last quarter. Nevertheless, demand for higher yielding stock remains strong. Landlords will need to be flexible in lease negotiations as tenant's demand for freehold property is increasing.

"Corporate profitability is weak which results in a subdued outlook for many areas of the letting market"

Economic Overview

The bottom of the cycle?

The National Institute of Economic and Social Research reported that the economy had stopped growing in the final quarter of 2001 for the first time since the recession of the early nineties. However, many economists believe that this will represent the bottom of the economic cycle. The latest Treasury survey of economic growth forecasts for 2002 is 1.9%.

Interest rate increase deferred?

The possibility of a short-term bank base rate increase in the UK has receded with concerns regarding the international outlook. Data from the Beige Book in the US showed that the economy remains weak in early January, whilst Alan Greenspan warned of 'significant risks in the near term' to the US economy.

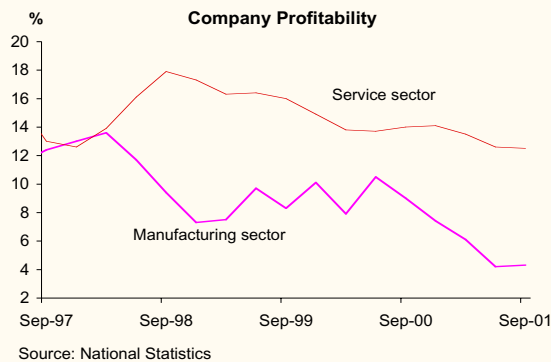
Hence, as the US economic recovery is expected to proceed slowly, the risk of sharp increases in base rate, which catch out consumers in the UK who are borrowing heavily, remains low. Indeed, Eddie George has adopted a more dovish attitude towards future interest rate movements. He referred to any rise in interest rates in the 'medium term' if a consumer boom was created.

There certainly appears to be a benign inflationary outlook as the underlying rate stood at 1.9% in December. Furthermore, the latest Treasury survey of forecasts

reported a rate of 2.1% by the year-end, well below the long-term government target rate of 2.5%.

Confidence for consumers but not corporates

The strength of consumer confidence is indicated by the fact that total household debt is now 107% of disposable income compared to 70% in 1987. Such levels are unsustainable in the long-term but two factors mitigate the effect. Firstly, lower personal debt servicing costs, which currently represent 8% of incomes, compared to 14% in the nineties. Secondly, a consistent ratio of households' assets to liabilities, as the housing market maintains its strength. In the face of a slowing housing market, consumers look set for a round of retrenchment.



Confidence in the corporate sector remains far more fragile than that shown by consumers. Annual business investment growth was -2.7% in the year to September

2001, which is its sharpest fall for 8 years, with few signs of a recovery expected. Manufacturing investment fell 13% as demand for high-tech products fell.

Weak profitability

Manufacturing profitability, as measured by net rate of return, has dropped to levels last seen in the early nineties recession, according to official figures. The thin margins point to further job losses in the sector to control its cost base. Although margins in the service sector are healthier, they have fallen to their lowest level in eight years.

Property Overview

Second year of out-performance

Property is the best-performing asset for the second consecutive year, according to the IPD Monthly Index. The annual total return of 7.1% exceeded that for 5-15 year gilts (3.9%) and equities (-13.3%). It also out-performed other assets on 3 and 5-year annualised bases. The latest estimate of the IPD Annual Index is a total return of 6.6%. Industrial was the best-performing sector last year with a total return of 8.3%, closely followed by offices (8.1%), whilst retail trailed behind on (5.3%).

Yields rose by 39 basis points in 2001 although we anticipate that upward pressure will subside over 2002 as a sizable property-gilt yield gap

continues to exist. Although the gap has narrowed since October to 2.1 percentage points in December, it remains well above the five-year average of 1.6.

Capital growth prospects are limited in 2002 although an improvement in yields

should produce positive growth following a fall of 0.4% in 2001. Indeed, the office sector was the only one to produce positive growth in 2001.

Diminishing prospects for rental growth will impair investment performance in the year ahead. Annual growth stood at 2.5% in December, compared to 6% twelve months ago and we forecast inflation-adjusted

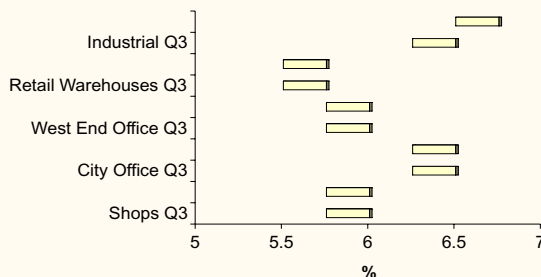
growth will be negative in 2002. The office and industrial sectors bear the brunt of subdued letting prospects. As rental growth declines, the yield will no longer be seen as the main

impediment to property performance. By 2003, we anticipate that growth rates will recover to levels seen last year, if the technology and financial sectors recover enough to stem the flow of sub-letting activity.

Investors continue to pay yield premia for stock offering longevity of income with strong

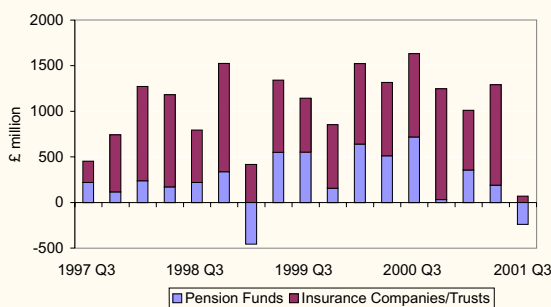
covenants. Landlords have become increasingly flexible in terms of lease lengths offered as a response to increasing void risk. Demand for property will also remain strong from special purpose vehicles, reflecting increased concern regarding stamp duty.

Prime Yield Ranges



Source: Gerald Eve

Net UK Institutional Investment in Property



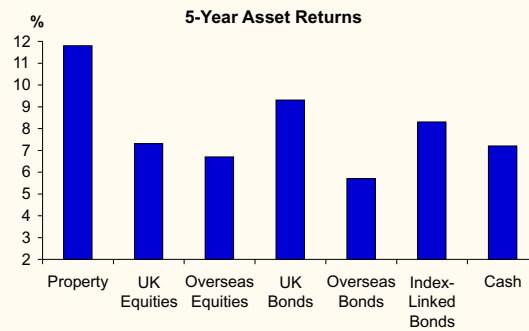
Source: National Statistics

"Property out-performs on a 5-year annualised basis despite the bull run in equities in the late nineties"

"Despite the consistent out-performance by property, it still constitutes only a small part of pension fund portfolios"

Institutional investment falls

Net investment in property in the third quarter of 2001 was -£169m, which was the first negative level since the first quarter of 1999. At £2.97 billion, investment turnover was well below the four-quarter average to June of £4.35 billion. Whilst insurance company investment dropped off in the third quarter, pension funds have been investing less throughout 2001. However, pension fund investment in indirect vehicles continues. This is exemplified by the BP Fund's recent addition to its existing interest in BAA McArthurGlen's factory outlet limited partnership.



Source: WM Company

Property is pension funds' best-performer

Property was the best-performing asset in pension fund portfolios in 2001, with a total return of 6.2%, according to provisional figures from The WM Company. This exemplified property's role as a diversifier of portfolio risk as overall returns sank to -9.6%, which was the lowest recorded by pension funds since 1990 and the second successive year of negative figures. Property also produced the strongest 5-year performance, despite the bull run in the equity market in the late nineties, with an annualised return of 11.8%. Despite the recent period of strength, property's portfolio weighting rose only marginally from 5% in 2000 to an estimated 5.6% in 2001. This is 20 basis points lower than Pacific Rim equities, which have produced negative returns over one and five years.

The volatility of assets being held to meet company pension schemes' liabilities is an issue being addressed by the new

accounting standard, FRS 17.

Contractual liabilities, such as minimum payout guarantees, reinforce this emphasis on matching assets and liabilities. In property, the upward-only rent review and institutional lease enable it to provide a stable, long-term income stream. Furthermore, in the current low-inflation environment, the value of the initial rent constitutes a larger part of the property's value. This emphasises the income-producing component of total return, rather

than more unstable capital growth. Because property is a bond-type investment, it matches pension fund contractual liabilities quite closely. However, landlords may

need to be aware of the new lease code. Its adoption is pencilled in for the end of March and proposes that priced alternatives to upward-only reviews are offered.

Pooled property funds produced strong performance last year, with a total return of 6.6%, according to IPD. The FTSE Real Estate sector produced -6%. The figures for pooled funds are not directly comparable with direct property as pooled fund returns are net of fees and costs.

Institutional funds have been attracted by the opportunity to increase the running yield through gearing indirectly. The shift to indirect methods of investment may stimulate the secondary market in limited partnership interest. The sale of a 50% interest in the Castlepoint retail warehouse development in Bournemouth is a recent example of this market, which is at a nascent stage. Partnerships may wish to realise profits in order to fund further acquisitions.

Banks tighten terms

Debt-financed investors face more stringent lending criteria from the banks as loan to value ratios are cut back and margins over cost of funds rise. Nevertheless, the positive gap between property yields and banks' borrowing costs is still in place and this has been an important factor in driving the sharp increase in property lending.

Office

Negative rental growth

Monthly rental growth slipped to -0.1% in December, which is the first negative rate since September 1996. The Central London market saw a surge of second-hand stock being released on to the market in the final quarter.

Consequently, annual rental growth in Central London slipped to 7% in December, from 19.1% twelve months ago. This is approaching the trough in terms of the

long-term rent cycle. However, corporate demand for property will not be driven by organic growth, which will stifle any strong trend reversal.

As lenders become increasingly cautious in terms of occupier demand, speculative development in Central London has subsided. Cash-rich developers, or those with secure credit lines already in place, may take advantage of the less aggressive negotiating environment. Nevertheless, there is potential for supply constraints to emerge in the market in 2 or 3 years' time, which may be encouraging opportunistic acquisitions.

City

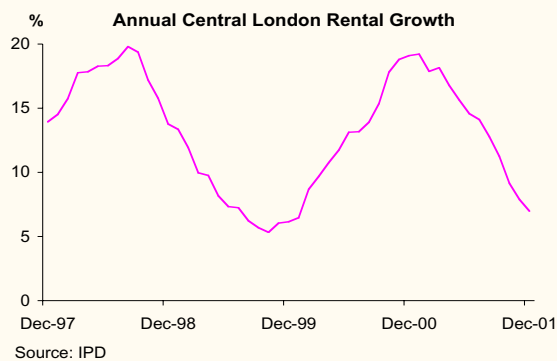
The pre-let market has seen a number of transactions postponed or cancelled, although the prime rent of £673 per sq m (£62.50 per sq ft) is being maintained in the market. However, the asking rent on a sublet at 20 Old Broad Street has been cut from £70 per sq ft to £57.50 per sq ft, which is a £7.50 per sq ft discount to the rent at which space was originally taken in October. There is a strong likelihood that further second-hand stock will come on to the market. The assignment of surplus space looks set to hold back rental growth throughout the first half of this year. A market gauge may be provided by CSFB's current attempt to dispose of space at 111 Old Broad Street.

Few investors are willing to price in any rental growth over the next twelve

months, which will reduce demand for highly reversionary stock and units, which have short term lease expiries. Supply-side pressure is expected to be most intense for second-

hand, sub-2,000 sq m (21,500 sq ft) stock and could result in a drop in rents of around 15% for this sub-sector in 2002.

With 5-year swap rates standing at 5.4% in mid-January, the benign environment for finance rates attracted geared investors to the market. Subsequently prime yields in the City were unchanged over the final quarter of 2001 at 6.25% for well-let stock offering unexpired lease lengths of 20 years. Stock with only 15 years unexpired may be expected to sell at slightly higher yields of around 6.75%.



"Investors are reining back rental growth expectations in Central London and Thames Valley markets as the sub-letting of surplus space by occupiers continues"

"Overseas investor activity, both equity and debt-funded, has supported prime yields for Central London stock which offer longevity of income"

Unit-linked funds remain more active than main life funds, ensuring a degree of activity for lot sizes of up to £30m, above which there is less institutional interest. The market for £30m plus stock has mainly been made up of private buyers seeking solid income and the more entrepreneurial property companies whose focus is upon active management. However, Standard Life's acquisition of 8-10 Old Jewry for £32m, was an indicator that this trend may be about to change. The deal reflected a yield of 7.2%.

A recent example of a private investor purchase is 1 Plough Place, EC4 acquired by an Irish consortium for £42m, reflecting a yield of 6.35%. This also exemplifies the demand for well-let stock with longevity of income.

German open-ended funds have received substantial capital inflows in the final quarter of the year. Consequently, they are now returning to the market. DEKA Immobilien acquired Abacus House, Gutter Lane, EC2 for £46m, reflecting an initial yield of 7%.

Speculative developers are becoming more cautious in terms of projected rent/yield profiles and so the pipeline is extremely thin at present.

West End

The West End investment market is even more cautious about rental growth prospects than in the City. A strong component of availability is 'see-through space' from tenants willing to assign or sublet at rental discounts not currently on offer from traditional landlords. As such, falling headline rents have been evident since last year. Whilst the prime market bears the brunt of the downturn, rental levels on all grades of building are being subjected to downward pressure. Prime yields are unchanged from 5.75% over the quarter.

Central London Investment Deals in December			
City	Purchaser	Price £m	Yield
Abacus House, 33 Gutter Lane	DEKA Immobilien	46	7%
56-58 Cheapside	Private investors	6.95	n/a
8-10 Old Jewry	Standard Life	32	7.2%
77-80 Gracechurch Street	Private overseas	28.5	7.75%
1 Plough Place	Irish consortium	42	6.35%
West End			
25 Buckingham Palace Rd	Merivale Moore	5.2	7.1%
Morley House, Regent St	Derwent Valley	11.5	6.4%
110 Wigmore St	Strategic Real Estate	9.25	6.25%

Thames Valley market

Occupier demand for large units has collapsed following the bursting of the technology bubble. Pre-let activity has been very rare throughout the second half of 2001, with few prospects of a revival in the short term. There was a notable increase in the amount of confidentiality agreements in lettings deals, which indicates a decline in headline rents.

M25 yields are weakening as growth prospects have diminished and security of income becomes the focus of investors' attention. An example is Wellcroft House, Slough which sold for £17m reflecting a yield of 8%. The current occupant, an e-banking company, is hoping to sub-let half the space. The building was reported to be under offer at 6.5% last year. Despite the gloom, speculative developments have commenced recently, most notably on a 9,300 sq m (100,000 sq ft) scheme at Aviator Park, Addlestone in Surrey. The developer, Brixton Estates, is confident that such stock will be in demand when it becomes available in early 2003.

Provincial outlook is brighter

Whilst the outlook for the South East market is uncertain, fundamentals in the provincial market are more secure. This will result in the rent differential between

Central London and provincial markets closing over the next year. In contrast to the moribund state of the market in the South East, a pre-let at 1 Colmore Square, Birmingham

recently achieved a record rent of £291 per sq m (£27 per sq ft). There is downward pressure on prime yields in Birmingham, although there is a problem in finding available high quality units, as in other provincial centres.

Retail

Strong sales growth?

A British Retail Consortium survey showed that trading in December was the strongest for five years. Next announced like-for-like sales increased by 9% in the six months to January, although the company cautioned that it was planning for growth to return to more normal levels of 3-5% by the autumn, which also applied to Marks and Spencer.

Contradicting survey evidence, official data reported a 5.7% annual increase in retail sales volume in December, sharply down on November's figure of 7%. However, this data series has been revised upwards in the past.

Polarised occupier market

Tenant activity is relatively buoyant with strong demand for flagship stores, although there is a very discerning attitude in the choice of location. The polarised nature of tenant demand between prime units, which are amenable to re-configuration, and less flexible, small units will be reinforced over the next year.

In the budget hotel sector Whitbread, Scottish & Newcastle and

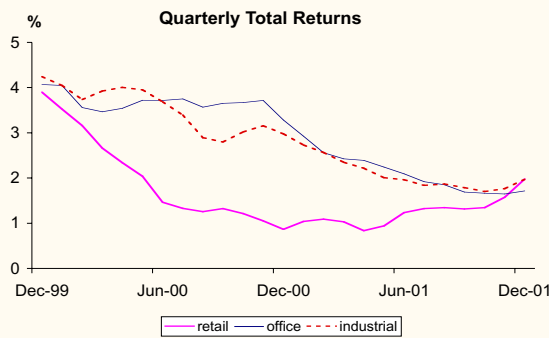
Six Continents have ambitious acquisition targets. In the fashion sector, Next continue to acquire large stores and we believe that significant demand will come from continental retailers. In the food sector, many retailers have strong requirements for convenience stores, whilst LA Fitness and Fitness First are looking to expand in the healthclub sector.

However, there is still a deflationary environment on the high street, which will stifle rental value growth. Occupiers will continue to seek longer rent-free periods. In shopping centres, lower base rents and turnover percentages will also be sought.

The five-year rental forecast for the out-of-town market is 32.2%, significantly stronger than the high street and shopping centre sector, at 13.2%, according to Verdict Research.

Retail stages recovery

Quarterly total returns have converged across the sectors with retail staging a rally in the final quarter of 2001. The sector did see a noticeable outward shift in yields over much of 2001 and this process may have been played out as investors recognise the defensive quality of the sector in the face of an uncertain global economic outlook. Indeed, retail accounted for 59% of acquisition activity by investors in December, compared to 32% for the whole year, according to Property Data.



Top performer in 2002

We forecast that this sector will be the top-performer in 2002, as it recovers from a recent period of

under-performance. There are signs that prime stock is returning to the market following an inactive period throughout most of 2001. This should increase the chance that retail produces satisfactory investment performance in 2002 as pricing uncertainty had been weighing on investors' minds, which dragged yields upwards last year.

"Retail is forecast to be the top-performing sector in 2002, as adverse yield movements subside"



London: West End
Charles Gardner
Tel: 020 7493 3338

London: City
Michael Riordan
Tel: 020 7489 8900

Belfast
Nick Rose
Tel: 028 9043 4300

Birmingham
David Dudley
Tel: 0121 616 4800

Cardiff
Simon Rees
Tel: 029 20388044

Glasgow
Michael Barclay
Tel: 0141 221 6397

Leeds
Michael Roberts
Tel: 0113 244 0708

Liverpool
Martin Howard
Tel: 0151 236 3009

Newcastle
David Johnson
Tel: 0191 260 2555

Investment *brief* is a short summary and is not intended to be definitive advice; no responsibility can be accepted for loss or damage caused by reliance upon it. If you have any queries concerning Investment *brief* or you would like to know more about Gerald Eve's services, please contact **Charles Gardner** in the Investment Department (cgardner@geraldev.com) or **Guy Weston** (gweston@geraldev.com) in the Research Department.

To add your name to the INVESTMENT *brief* mailing list or to amend your mailing address, e-mail: investmentbrief@geraldev.com

Industrial

Occupier demand

Rental growth in London has slipped below levels seen in other regions for the first time since 1995. This may reflect the one-off shock caused by the events of September 11th, which added to occupiers' cost consciousness. There does not appear to be over-supply on a regional basis. Speculative developments around Heathrow appear

to be enjoying occupier interest, with Eagle Global Logistics taking 129,000 sq ft at a rent of £118 per sq m (£11 per sq ft) on a 20-year lease at British Land and Madison Land's Heathrow Gateway development in Feltham. There appears to be little evidence that tenant incentives are increasing.

Demand for bespoke distribution units continues unabated, focussing on the South East and Midlands. Argos recently announced its intention to take 52,400 sq m (564,000 sq ft) at Burton on Trent, whilst ASDA are in talks to take 15,800 sq m (170,000 sq ft) in addition to the 65,000 sq m (700,000 sq ft) already announced at Magna Park, Lutterworth. The North East, and particularly Yorkshire is also likely to see further take up with B&Q rumoured to have a 46,450 sq m (500,000 sq ft) requirement. There is an increase in the supply of modern second-hand units stifling rental growth, particularly in secondary locations.

Development

The general economic slowdown is resulting in a reduction in speculative

development schemes, which should support rental values. We can expect limited speculative development outside of the South East in the year ahead. Those schemes which do progress will tend to be self-funded.

The built product is likely to become available on a variety of tenure options. Low finance costs coupled with tax-efficiency and occupier's expectations of capital growth will continue to highlight the

attractiveness of freehold property. Indeed, refurbishment opportunities of all ages have been offered to the freehold occupier market. Subsequently, many developers

are addressing the owner-occupier market, such as Countryside's Urban Hive schemes. The anticipated change in accounting for a long lease on the balance sheet may also make traditional institutional leases less favourable. These developments add further pressure on landlords to adopt a flexible attitude in lease negotiation.

Investor market

The market for prime stock has been subdued over the last quarter as its geographical focus at Heathrow experienced investor uncertainty following September 11th. Demand for distribution will continue to be healthy as this property type offers long leases.

As the manufacturing industry continues to suffer, yield discounts are available in the North. The demand for stock yielding in excess of 8% remains buoyant.

