INVESTMENT *brief*

Spring 2001

"Double-digit returns for property do not look attainable this year as retail continues to perform poorly"

Overview

Benign environment for base rates

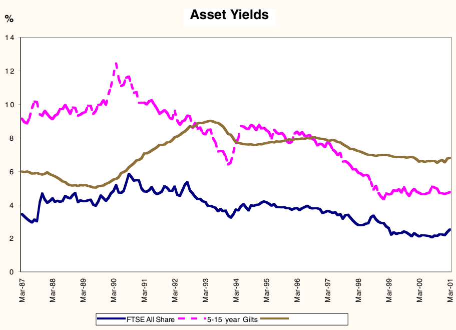
The UK economy faces only a modest slowdown in growth this year as HM Treasury survey forecasts produced a year-end figure for GDP growth of 2.4%. Expectations of further bank base rate cuts this year strengthened, following the latest reduction to 5.5%. The consumer remains in buoyant mood as homeowners use equity in their houses to finance borrowing.

Property returns to fall short?

Double-digit returns for property do not look attainable this year as retail continues to perform poorly. The first quarter of 2001 produced total returns of 1.8%, according to IPD. This was entirely made up of income return as capital growth was zero in the first quarter. At 9.1%, annual total returns for property now stand at a 3-year low but are higher than gilts (9%) and equities (-10.8%), which are at a 6-year low.

Yield gap

March IPD property yields stand at 6.8%, which is two percentage points above the gilt yield and represents the widest gap for 12 months.



Source: IPD

Net investment tails off

In the fourth quarter, institutional investors reined back net investment in property which fell by nearly 50% on the previous quarter. Nevertheless, 2000 saw the highest level of net institutional investment in real terms so far recorded by National Statistics.

Cheap finance

5-year swap rates have fallen by 56 basis points since January and now stand at 5.32%. The low cost of capital is encouraging debt-funded investor interest in the property market.

Sector returns

The office sector produced the best performance in the first quarter of 2001 with a total return of 2.4%, marginally ahead of industrial (2.3%), whilst retail languished behind at 1%.

Economic Overview

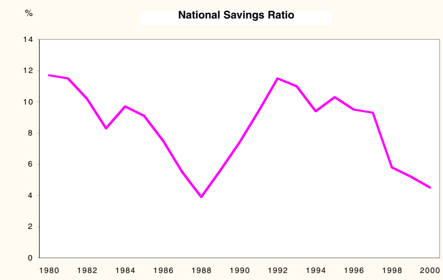
US and UK outlook

Fourth quarter US GDP data revealed an annualised rate of 1%, compared to a third quarter figure of 2.2% and near the five-year low of 0.8% in the second quarter of 1995. Consensus Forecasts have radically revised year-end forecasts from 3.6% six months ago, to 1.7% in April. In response, the Federal Reserve cut its Fed funds rate by a half-point to 4.5%, which is two percentage points below the level at the start of the year. The Federal Reserve is expecting

"With the recent cut in US interest rates to 4.5% and subdued inflation, a further UK base rate cut in the short term is likely"

consumer spending and business investment to pick up in the second half of the year.

UK GDP grew by 2.6% in the fourth quarter of 2000. The latest survey of forecasters compiled by HM Treasury predicts a current year-end figure of 2.4%. The impact of foot and mouth disease on tourism may shave an extra 0.1 to 0.2% off this figure. Manufacturing production rose by just 0.1% in February after a fall of 0.9% in January. The drop was mainly accounted for by a steep decline in the output of information technology and telecommunications equipment. This has been viewed as the first sign of the global slowdown affecting the UK economy.



Source: National Statistics

Official statistics revealed that profitability in the services sector remained healthy, with a net rate of return of 14.4% in 2000. However, manufacturing profitability slumped to 5.3%, the lowest rate since 1993. This is reflected in the industrial occupier market, which is analysed later. A downturn in the hi-tech sector may hit manufacturing particularly hard. Over the past five years, output in the electronics and telecommunications equipment sector of manufacturing has risen by 37%, whilst the rest of manufacturing has seen output growth of -1%.

The manufacturing sector may find solace in a further bank base rate cut in the near future. The Monetary Policy Committee decided on a quarter-point cut to 5.5% in April but with underlying inflation running well below the government target of 2.5% and the recent US rate cut, there is scope for further reductions.

Consumer confidence remains...

The outlook for interest rates is certainly bolstering consumer confidence. The national savings ratio (personal savings as a percentage of personal disposable income) fell to a 12-year low of 4.5% last year.

...bankrolled by the housing market

The strength of the housing market is a crucial support for consumer confidence as lending secured on dwellings is currently at record levels. The value of approved loans has increased by 20% to £9.5bn in the year to February. However, transactions fell by 10% over the same period as activity in the market fell to a 2-year low. This suggests that homeowners are using the equity in their houses to finance borrowing. The shift to secure lending looks set to become more pronounced over the next few months as competition between mortgage lenders intensifies.

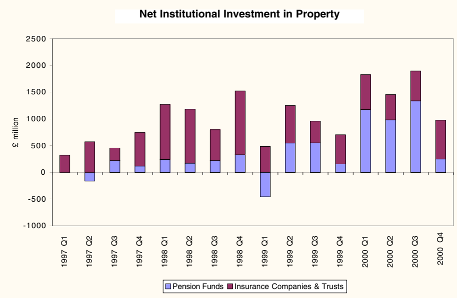
Tech share slide hits expansion plans

In the telecommunications sector, a swathe of job cuts have been announced. The slide in US telecom share prices is forcing their European expansion plans to be scaled back. The South East Economic Development Agency estimate that the number of overseas businesses setting up in the region has fallen by 40% in the first quarter.

Property Overview

Double digit returns in 2001?

The latest Investment Property Forum survey of forecasts for the 2001 IPD Annual Index total returns produced a figure of 10%. The range of forecasts runs from 5% to 14%, which is the highest since November 1998, at the time of the international currency crisis.



Source: National Statistics

2001 has so far seen steady rental growth but this has been offset by increases in yield levels across all three sectors. First quarter total returns on the Monthly Index are 1.8%, which is the lowest quarterly growth rate since January 1999. It equates to an annualised rate of just 7.4%. The first quarter total return was entirely income-driven as capital growth was zero. IPD also provide an estimate of the Annual Index which produced even weaker performance over the first quarter at 1.6%, equating to an annualised rate of 6.6%. We do not expect to see double-digit returns this year.

Institutional Investment

Net institutional investment amounted to £974 million in the final quarter of 2000, which was a 49% fall on the previous quarter. Nevertheless, 2000 saw the highest amount of net investment in property in real terms ever recorded. The level of acquisitions fell by only 4.5% over the fourth quarter to £3.5 billion. This is actually a higher level than the first quarter figure of £3 billion. The percentage of total net investment accounted for by property fell back to 6.6% in the fourth quarter, from 8.5% in the third quarter.

Pension Fund net investment fell sharply from £1.3bn to £246m. Funds have been rationalising their portfolios in response to structural consolidation in the industry. Meanwhile Insurance Company and Trust net investment rose over the quarter by 30%, to £728 million.

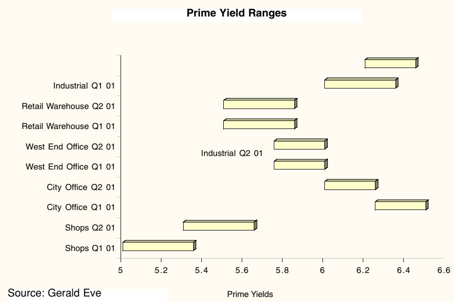
March 2001 IPD monthly data on net investment by sector reveals that retail has consistently suffered net disinvestment since August last year. Over the same period, both the office and industrial sectors attracted net investment. Hence, it appears that institutions are disposing of under-performing retail stock.

The fourth quarter saw institutions pulling back from the UK equity and gilts

"Institutional activity is subdued as they watch other markets"

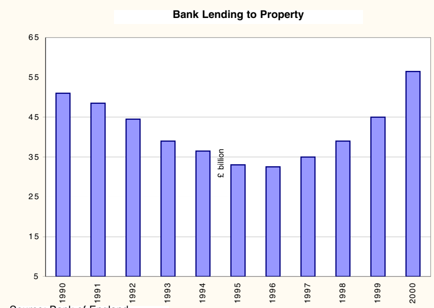
Charles Gardner

markets. The equity market experienced a sharp fall in net investment to £0.7 billion, down from £12 billion in the third quarter. Last year, the gilts market saw three quarters of net disinvestment. The fourth quarter net disinvestment stood at £3.8m.



Source: Gerald Eve

Institutional investors appear to be relatively inactive so far this year. As equity markets suffer falls in value, properties relative institutional portfolio weighting rises, by default, to an overweight level in terms of asset allocation. This leads to a slowdown or halt in property acquisitions, as occurred in the wake of the international currency crisis in autumn 1998. However, the March Merrill Lynch fund managers' survey showed a slight increase in buyers of property, to its highest level since the fourth quarter of 1999.



Source: Bank of England

Lending reached record high

Bank lending on commercial property increased by 25% last year to £56.5bn, according to the Bank of England. The last quarter of 2000 saw a 9.5% increase in the amount lent, which is the largest quarterly increase ever recorded. The level of lending by UK regulated banks is now 7.5% higher in real terms than the amount at the peak of the last cycle in 1990. Whilst this may initially appear alarming, the current situation does not represent a return to the relatively irresponsible lending policies seen 11 years ago. Average loan-to-value ratios may be rising but are below 85-90%, which was seen at the time of the last lending peak. Funding for speculative development now constitutes only 10% of total lending, compared to 30% in the late eighties and early nineties. Furthermore, interest rates are currently low with little upside risk whilst 1989 saw a hike in interest rates in response to surging inflation.

Minimum Funding Requirement

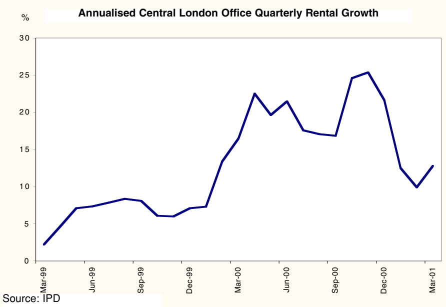
The government has backed the recommendation of the Myners report to scrap the Minimum Funding Requirement (MFR). The MFR requires funds to value holdings using gilts which created an artificial demand, driving yields down. There appears to be little scope for pension funds to increase their equity weighting, which currently averages 75%, compared to the US fund average of 60%. So far, the Chancellor has focussed on venture capital as a potential alternative. However, the relative security of properties income stream may attract funds once it becomes clear what the alternative to MFR is to be. Gilts analysts have not yet reported any aggressive selling in the market but the aforementioned net investment data has been weak in this asset class.

Office

Central London cools down

The central London office market has seen a return to more sustainable levels of rental growth. The quarterly growth rate on an annualised basis peaked at 25.4% in November 2000 and has since slipped back to 12.8% in March.

West End agents are reporting that interest for ‘trophy buildings’ has fallen back this year in the light of growing uncertainty in the international economy.



Source: IPD

Moreover, internet companies, such as 360networks, are assigning leases in prime Mayfair locations in the light of funding difficulties. However, this process may be seen as ‘froth’ being removed from the market. The top rent in the West End has been pushed up by small companies experiencing bursts of sharp increases in space requirements, which is now abating. Meanwhile, blue chip companies’ requirements that are subject to more strategic consideration continue to remain strong in slightly lower-rented sub-sectors of the West End. The Orange pre-let of the Point building at Paddington Basin at a rent of £377 per sq m (£35 per sq ft) illustrates the desirability of quality space offering rental discounts to the traditional core. Overall, it appears that supply constraints are of more importance to the Central London market than the US economic slowdown.

City Market

Availability in the City office market dropped to 179,950 sq m (1.9m sq ft) by year-end 2000, which is just 33% of the level seen 12 months earlier and equates to just three months of take-up at current levels, according to King Sturge. This has driven the vacancy rate to its lowest level for several years. The limited options available to occupiers has meant a headline rent of £646 per sq m (£60 per sq ft) was reported for secondhand space, which is nearly equivalent to the level for new space. RR Donelly took the space at 55 Bishopsgate. The deal not only reflects a new benchmark for secondhand space but also illustrates the importance of location and quality to support service occupiers as the company is a printer of financial documentation.

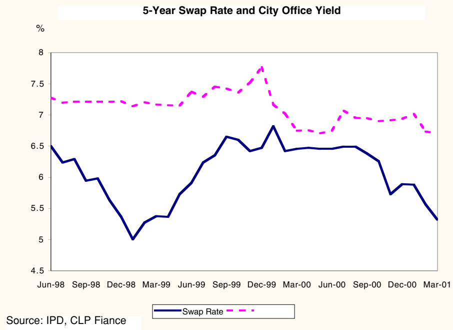
The gap between property yields and cost of capital is providing ever greater opportunities for arbitrage which has been most clearly manifested in the City office market. The City is increasingly perceived as being under-rented relative to the West End. The five-year swap rate fell to 5.32% in March, 1.4 percentage points below the IPD yield on City offices.

Cheap debt has lured private property companies and individuals into the higher value (£25m plus) end of the City office market, previously dominated by

" Whilst debt-driven investors have dominated the higher lot size end of the City market, institutional investors remain more competitive on prime, reversionary properties exemplified by Morley's purchase of Earl Place, Appold Street and Royal Liver's purchase on King Street"

Michael Riordan

institutions. In some cases, investors will put in less than 10% equity. This market is beginning to resemble the US where debt outweighs equity by two to one as a source of capital in the property market. The inflow of debt-funded investors is pressuring yields down on units with long (20-year), unexpired lease terms let to financeable covenants as lending criteria emphasizes the need for security of income. Institutions have shifted attention to multi-let units or to those with a medium-term income stream to boost returns. The fundamentals on the supply-side certainly increase the attractiveness of active management opportunities as the risk of voids is low. Furthermore, the long-term, passive investments will be marketable to European investors who may enter the market if the euro strengthens against sterling.



Source: IPD, CLP Fiance

Maidenhead saw rental growth of circa 17% though such growth rates appear to be unsustainable. As such, the £40 per sq ft deal does not appear to be likely in the short term in the mainstream, institutional market.

"*Investor demand for prime, high street retail stock is scarce*"

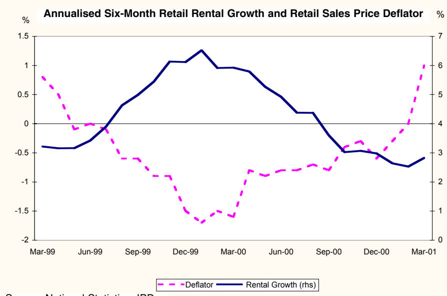
Retail

Disinflation disappears

Further evidence that pressure on retailer profit margins may at last be easing emerged. Retail sales volume rose strongly in the first quarter by 1.5% but, more importantly, high street prices also rose, for the first time since April 1999. The March retail sales price deflator, which is a measure of inflation in retail outlets, stood at 1%, which is a 2-year high. Tentative signs that this is feeding through into the occupier market may be seen as the annualised six-monthly rate of growth has shown a less marked downward trend in the last six months.

M25 market

The M25 market is experiencing a slowdown in demand after a year of high-profile lettings of over 100,000 sq ft to telecom companies. Market fundamentals still remain healthy for smaller units as lack of supply means demand is being maintained for well-located, high-specification stock. Last year,



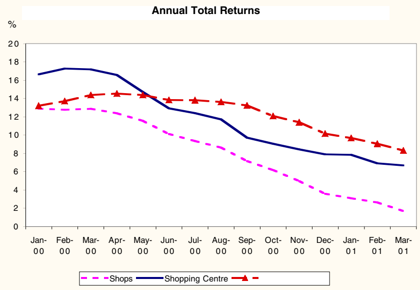
Source: National Statistics, IPD

Subdued investor interest in high street stock...

With continued poor rental performance, investor demand for prime high street stock at yields of sub-6% has been very weak. Interest in stock yielding around 7% is stronger, with larger lot sizes attracting most attention. The fall in the cost of borrowing has supported the secondary market with yields remaining fairly steady over the last quarter.

...is mirrored in the shopping centre sector

Private firms have been dominant in the market for shopping centres in the first quarter as institutions largely disposed of stock. Cheap finance rates and investments offering a self-financing return of 8% are attracting private funds. The relative absence of institutions and publicly-quoted companies from the market has lead to a sharp fall in investment turnover. The value of transactions in the first quarter of 2001 stood at £165m, compared to £750m in the same quarter last year, according to Jones Lang LaSalle. Funds appear to be taking a view that smaller shopping centres are as management-intensive as their larger counterparts but offer no performance premium. However, a trend towards co-ownership of larger lot sizes, in the form of the limited partnerships and joint ventures, may present opportunities for smaller funds.



Source: IPD

Shops under perform

In terms of performance, annual standard shop unit total returns, at 1.7%, continue to fall further behind other sub-sectors of the retail market. Retail warehouse and shopping centre returns stand at 8.3% and 6.7% respectively. When compared to the double-digit total return growth in other sectors, there was little surprise when IPD data revealed that retail's share of total portfolio value had fallen to its lowest level since 1996, at 47.5%.

Verdict Research did little to dispel the gloomy outlook for the high street as it forecast that sales in out-of-town parks would climb by 34% through to 2005, which is nearly twice the growth expected for retail sales in total. Occupiers tend to be shying away from smaller units in favour of premises providing more flexibility. Shopping centre units are more likely to satisfy this demand rather than those in the town centre.

Industrial

Distributors drive demand

The majority of take-up in England is accounted for by the distribution sector, according to Fuller Peiser data. Distribution accounts for 50% of take-up even in the Scottish market where it has historically not been a large part of the local economy. In the East Midlands, the distributor share of the market rises to 80%. The West Midlands provides a microcosm of the market as it contains a concentration of both distributors and manufacturers. The region is characterised by requirements for 'mega-warehouse' developments such as the 51,100 sq m (550,000 sq ft) unit at Radial Park, Stoke-on-Trent recently taken by Sainsbury. Retailers are rationalising distribution networks in an effort to improve efficiency. Demand from distributors means new units in the region are especially scarce and currently account for only 7% of total available space. On the supply-side, land-hungry distributors add to pressure from alternative land uses such as residential and office. As the distribution sector

"The supply of modern industrial stock is limited whilst demand from the distribution sector remains strong"

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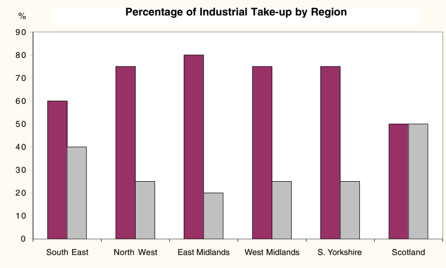
expands and development site supply diminishes, rents for modern units are driven upwards. Birmingham saw rental growth of 12% in the year to January, according to King Sturge. In the South East, supply constraints are at their most acute which prompted Land Securities to focus its portfolio on the area.

In the face of these developments, manufacturers are finding it increasingly difficult to secure modern accommodation. The aforementioned, low profitability relative to other sectors means that they are priced out of the market.



Source: Fuller Peiser

Distributor requirements are driving forward speculative development of large units, for example, three units are being developed by Prologis at Prologis Park, Coventry, two of which are under offer. In the South East, development sites for speculative purposes are in demand even in secondary locations. One such example is on Crossways Business Park, Dartford, which recently attracted 16 bidders.

Institutional interest for prime stock is strong as both single and multi-let opportunities are sought. An example of this is the Prologis acquisition of Bromford Gate, Birmingham at a yield of around 7%. The Heathrow area continues to be a focus for investor demand as the Horton Road

Industrial Park, West Drayton was sold reflecting an initial yield of 6.2%.

Nasdaq fall out hits telehousing

Following high profile cutbacks in occupier requirements by telecoms companies recently, the telehousing/co-location sector almost inevitably suffered its own setback with capital-intensive, roll-out plans cut back. Three operators announced a reduction in expansion plans, which mirror internet company withdrawals from the West End office market. Digiplex originally announced that it would open 22 facilities by the end of the year before stating that it would not be growing beyond its five current sites. Global Switch has cut its expansion plans by a quarter. At Heathrow, Colo.com put 4,600 sq m (50,000 sq ft) of space it had signed for back on to the market without ever occupying it. Telehousing occupiers have secured space at 30-40% above prevailing market rates. Such premium payments look set to appear less frequently. In the Europa Boulevard development, Warrington, telehousing unit rental levels reflect the local market rate of £56.50 per sq m (£5.25 per sq ft).

South East strength

Investors continue to target the South East market and IPD locational data backs their judgement. The best-performing location in the UK in 2000 was Islington with a total return of 28%. The top location for rental growth was Slough, at 11.6%. The South East occupied the top 20 positions in terms of rental growth and the top eight positions in terms of total return.