

“Negative capital growth did not prevent property out-performing other assets in the last quarter”

Overview

Economic sector divide

Interest rate cuts have not yet allayed manufacturing sector difficulties. The consumer sector continues to strengthen as retail sales value growth reaches the windfall-induced levels of 1997. The ‘two-speed’ nature of the economy continues to weigh heavily on the Monetary Policy Committee (MPC) of the Bank of England.

Property’s relative strength

Property showed strong performance relative to the other asset classes in the second quarter, with a current annual total return of 8.1%, according to IPD. As capital growth over this period was -0.1%, income return and rental growth drove performance. The property yield currently stands at 6.9%, whilst the gilt yield rose by 47 basis points over the second quarter to stand at 5.2%.

Thames Valley slowdown

Whilst the prime West End letting market slowed over the second quarter, demand for mid-priced space remains strong. Finance rates moved up affecting the City’s geared investors. The Thames Valley office market suffered a marked weakening of sentiment as occupiers in the telecommunication sector withdrew from the market in the light of funding difficulties.

Retailer difficulties easing

Evidence continues to emerge that pressure on retailer profit margins is

easing. Prime high street retail stock continues to suffer a degree of investor aversion but higher-yielding units with longevity of income are securing yield premia.

Telecoms fallout hits industrial market

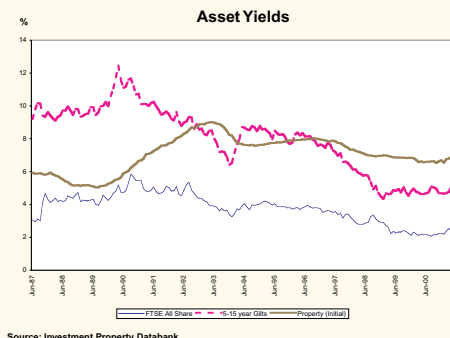
The West London industrial market suffered from the telecom slowdown, though to a lesser extent than the office sector. Investor demand weakened over the second quarter, though the market for larger units was resilient as it offers advantages in terms of covenant strength and lease length.

Economic Overview

‘Two-speed’ economy

The latest year-end forecast for GDP growth from the HM Treasury survey is 2.2%, which is amongst the strongest of the leading economies. However, GDP growth for the second quarter was 0.3%, which is the lowest rate since the final quarter of 1998. The bifurcated nature of the UK economy remains a

concern, as was highlighted by the debate surrounding the July base rate decision, presenting the Monetary Policy Committee with what it termed ‘a policy dilemma’. In the first quarter, manufacturing output fell 0.7%, while services output rose by 0.9%. Profitability in the manufacturing is now at a nine-year low as pressure on margins is increased. Output price inflation dropped from 0.7% in May to 0.4% in June in the face of lower demand and competition



Source: Investment Property Databank

“The corporate sector has suffered persistent problems in certain areas, which have not been allayed by interest rate cuts”

from cheaper imports. This is some way below input price inflation, which stood at 4.4% in May, though it slowed to 2.6% in June. Sub-markets of the service sector are also suffering, most notably in telecommunications. Compounding the effect of a US slowdown, technology analysts comment that European telecommunication companies are only now running in synchronicity with the global technology cycle, which is forecast to see a 1 to 2-year downturn. The slowdown in both manufacturing and service sectors is concentrated in those areas, which rely on corporate demand as well as those exposed to overseas markets. The Monetary Policy Committee concluded that interest rate cuts were deemed likely to exacerbate the imbalance between manufacturing and service sectors by encouraging further borrowing and overly exposing the economy to a sudden change in sentiment.

There was a 15% increase in the business failure rate in the second quarter, though foot-and-mouth disease appears to have been partially responsible in certain regions. Moreover, figures for the first half of the year were 0.5% down on the equivalent period in 2000. However, other evidence emerged of corporate sector difficulties with data on the management buy-out market from Nottingham Trent University revealing that the proportion of deals resulting from receivership more than doubled to 11% in the first half of 2001.

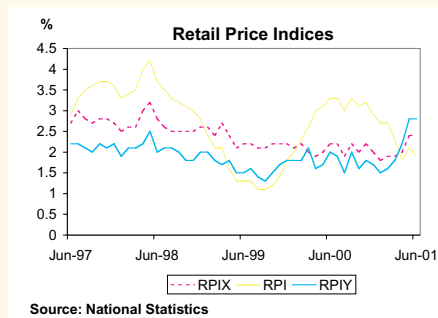
Consumers are enjoying themselves

Meanwhile the consumer sector continues to show strength. Retail sales value is growing at its fastest rate since the windfall-induced levels of July 1997. Whilst house price growth is up to 9.3% in June, with London reaching 10.4%, according to Nationwide, who have announced that their year-end growth forecast of 7% may be overly conservative if the capital's growth continues at double-digit rates. One may question the sustainability of such growth as the London house price-earnings ratio is now 4.5 well above the 17-year average of 3.9. Nevertheless, house price rises have insulated the consumer from the worst effects of the global economic slowdown as household wealth has only fallen 3% from its peak last autumn, according to the National Institute for Economic and Social Research.

Inflation update

The theory that UK inflation is structurally low may require revising as underlying inflation reached 2.4% in May and was unchanged in June. RPIY (excluding mortgage interest payments and cuts in excise duties introduced in the Budget) is regarded as a good leading indicator of the headline rate

(RPI) and has now reached 2.8%, the highest rate since January 1997. Despite slowing economic growth, the MPC remain wary of further base rate cuts without stronger evidence that consumer spending is also slowing. Data from the labour market reduced the pressure for



whose funding sources are drawn from the London economy, which is proving more resilient than the high-technology sector. Recent examples include Telegis, which acquired the 5,390 sq m (58,000 sq ft) Cumberland 40 building, paying one year's rent as key money but then never occupied the unit. They are now attempting to surrender the lease, after an unsuccessful attempt to sell the UK arm of the business. XO Communications were set to take adjoining units totalling 5,295 sq m (57,000 sq ft) but withdrew from the deal and subsequently aborted all plans to enter the European market. The space is now under offer for B8 distribution and storage. Indeed, demand from traditional occupiers is sufficiently strong to push Park Royal prime rents higher in the short term from their current level of £102.26 per sq m (£9.50 per sq ft). Sector rotation in terms of occupier demand has left prime yields steady over the last quarter, though downward pressure is still evident.

Another Thames Valley slowdown

Away from locations with easy access to the London market, tenant demand weakened over the three months to June. Quarterly rental growth in the South East (excluding London) slipped to 0.3% in June, down from 2% a year ago, according to IPD, which raises the question of whether real growth will be achieved this year, bearing in mind the latest RPIY data. Though the current market is by no means over-supplied, the slowdown was particularly noteworthy in June, which registered annual growth of just 2.8%.

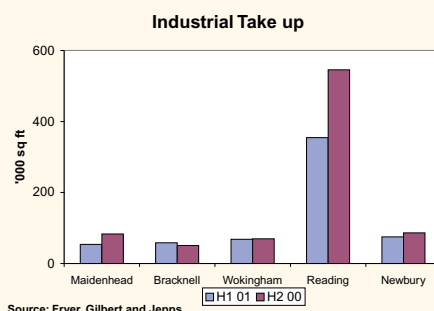
Fryer, Gilbert & Jepps recorded a 27% fall in take up in the Thames Valley industrial market in the first half of the year on the previous six months. Units with a high proportion (30%+) of office content are more resilient in the face of a slowdown as tenants continue to demand high-specification units.

Lower-rented locations

Occupiers may be re-focussing attention on cheaper areas such as the eastern and south eastern quadrants of the M25 market, which saw a significant amount of activity. Speculative developments continue to be let successfully with space at Optima Park, Crayford under offer at circa £73 per sq m (£6.75 per sq ft). Developer/investor interest is concentrated upon larger scale units (20,000 sq ft+), which are less problematic in terms of covenant strength and lease length. Developers remain confident as industrial land values have not been unduly pressured by economic

woes. In the less tightly-supplied provincial markets, investors remain wary as capital growth is currently running at 0.4%, according to IPD, compared to the South East's rate at 3.3%.

In the North West, land shortages around the M6 corridor and infrastructure improvements, in the form of the A50 link road, have stimulated tenant activity in the Potteries recently. One deal represents one of the largest development site acquisitions so far this year for a J Sainsbury distribution facility, at Stoke-on-Trent. This illustrates that provincial tenant demand for high-specification units is strong outside major motorway routes.



Source: Fryer, Gilbert and Jepps

“Occupiers from traditional sectors are no longer being crowded out of the Park Royal industrial market by telecom companies”

1.2%, triple April's rate. However, this is still some way behind the headline rate of inflation. Furthermore, price deflation is still evident in the non-food sector, according to the British Retail Consortium.

Although the organisation does report that retailers have started their summer

sales later and the discounts have not been so deep, like for like sales rose by 5.7% in June, the second highest increase since April 2000.

Retailers have reacted to the squeeze on margins by reining back orders, which

has improved stock overhang. Arcadia released an impressive trading statement and analysts commented that a general improvement in the retail market, rather than company-specific factors, had driven the subsequent share price growth in the second quarter of the year.

Investor demand weakens

In the market for small units, mobile phone operators have been driving occupier demand. However, this area of the market is moving out of a growth phase as sales slow and costs rise, with market penetration reaching 60% of the population. The smaller independent outlets have been under particular pressure recently as fashion rather than technological innovation is driving the market, though retailers are pinning their hopes on the introduction of GPRS-enabled units early next year. As such, the impetus to rental growth previously provided by this occupier group is expected to weaken an already fragile market for smaller outlets, no matter what new technology is offered.

Selective investor interest

There are few signs of interest in prime high street stock as yields have moved out by one percentage point in the last year and now stand at 5.75-6%, though vendors are unwilling to release prime stock at such yield levels. The position of prospective vendors may well prove

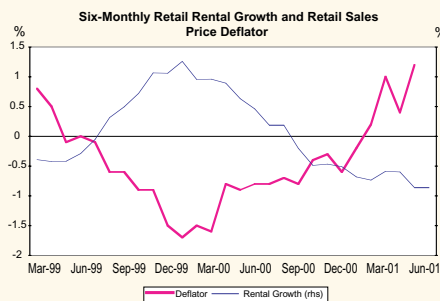
overly-optimistic as prime yields may well move outward by a further quarter point this year. Transaction costs and uncertainty over the future of the upward-only rent review reinforce investor caution over rental growth prospects,

which are likely to be negative in real terms beyond 2001. Investor demand for stock over 7% remains markedly stronger. Higher yielding stock with unexpired leases of twenty years or more and covenant strength are able to secure quite large yield premia. Thus, it appears that yield-hungry investors are also increasingly assigning scarcity value to stock offering longevity of income.

Industrial

The changing Park Royal occupier market

Telecommunication-driven lettings, which drove prime rental growth in many areas of the Thames Valley, have dropped off dramatically since the first quarter. Park Royal was a hotspot of telecommunication-related activity and illustrates the changing nature of the market. Here, previously acquired buildings have been returned to the market but there is a ready demand from distributors and food manufacturers



Source: National Statistics, IPD

short term increases as headline average earnings growth slowed to 4.5% in May, from 5.2% in April, which means that it is now in line with the Bank of England's rule of thumb limit for pay rises.

Property Overview

Property out-performs

Property enjoyed a strong period of strength relative to the other assets in the second quarter, with the annual total return standing at 8.1%. The equity market performed poorly and with the US economy showing little sign of a rebound, the period of under-performance looks set to continue. Gilt performance dropped off in the three months to June, and now stands at 4.5% on an annual basis. With property's capital growth falling by 0.1% over the second quarter, the asset's out-performance is driven mainly by income return. Only the London office and industrial markets are showing any appreciable (4% plus) levels of annual capital growth. The annualised rate for the Annual IPD Property Index estimated year-end total return currently stands at 6.7%, which may well be sufficient to maintain property's position as the strongest-performing asset class.

Institutional investment

Net institutional investment in the

first quarter of the year amounted to £1.1 billion, according to National Statistics data. This represents an increase of 8% on the previous quarter, but is 42% down on the equivalent period in the record-breaking year of 2000. Pension Fund net investment increased strongly on the previous quarter, to £556 million, whilst Insurance Company and Trust net investment dropped back to £499 million. Gilts saw a record £7 billion of net

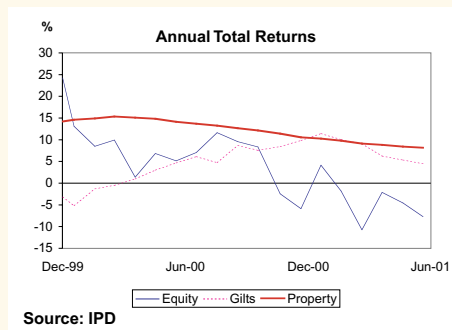
disinvestment in the first quarter. With continued uncertainty in other asset classes, disposals of property (£1.6 billion) were at their lowest level since the first quarter of 2000. Despite property's steady

performance relative to other assets, it appears that funds are remaining in cash awaiting an opportunity to re-enter the equity market. Furthermore, the proportion of total net investment accounted for by property has fallen from 8.5% in the third quarter of 2000 to 4.2% in the latest data set.

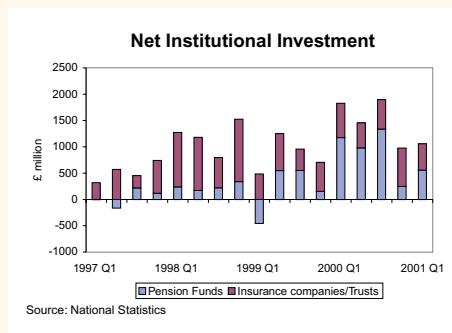
Indirect attraction

A recent DTZ Debenham Tie Leung study estimates that UK pension funds now hold a quarter of their property assets indirectly. One of the fastest growing methods of investing indirectly is the limited partnership. There is currently just over £8 billion worth of property held in the major limited partnerships, of

“Whilst total returns trend downwards over the second quarter, prospects for property maintaining its’ position as the year’s top-performing asset improved”



Source: IPD



Source: National Statistics

“As debt-funded investor activity remains strong in the City, the prime yield is currently closely related to finance rates”

which 26% is held in the retail sector. Limited partnerships have been especially popular for large lot-sized units, such as St Thomas More, the £160 million City office complex. The vehicles' tax-transparent status makes them a near-proxy for direct ownership. It also allows exposure to management-intensive sectors, which are increasingly demanded in the current environment of low capital growth. Though there is a lack of liquidity in the market for partnership interests, innovative methods of structuring the fund may mitigate the problem.

Phillips and Drew Fund Management included an authorised unit trust as a feeder vehicle in their second limited partnership and offered investors the opportunity to redeem their units. As a result, between last November and March 2001 more than 10% of the units have been traded.

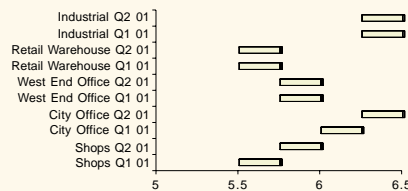
Office Central London

Whilst availability for second hand space rose, Grade A stock remains under-supplied as vacancy rates stand near historically low levels in both the City and the West End. Indeed, the shortage of prime, small units was emphasised by the City's highest rent this cycle being paid at CityPoint where 1,200 sq m (13,000 sq ft) was taken at a rent of £737.30 per sq m (£68.50 per sq ft).

In the West End, Mayfair saw its largest pre-let ever as HSBC's private banking arm took 11,320 sq m (120,910 sq ft) at 74 St James's St with rent on the best space believed to be around £898.79 per sq m (£83.50 per sq ft). The collapse of several prime lettings invariably involving US hi-tech companies, should not distract attention from the fact that demand for lower-rented stock (£45 to £55 per sq ft) remains robust. Investors generally

appear to be exercising a degree of caution in the pricing of refurbishment opportunities, with less aggressive positions on anticipated rental growth and void periods.

Prime Yield Ranges

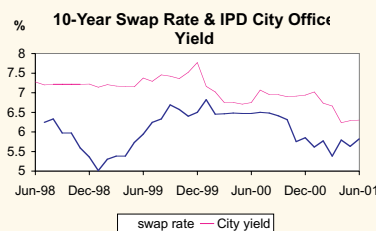


Source: Gerald Eve

Geared up in the City

In the investment market, institutional demand remains weak and although property fund managers are generally forecasting bullish returns, the lacklustre performance of the stock markets is causing property-weighting problems with few funds able to commit new money to the market. One or two of the smaller funds have been active but are generally seeking stock where yield improvements can be shown through rent reviews or re-letting within a three-year period.

Debt finance rates, though low in historic terms, have increased in recent weeks, with the ten-year swap rate standing at 5.9% on July 19th, from 5.4% in March. As the prime end of



Source: IPD, CLP

the market continues to be driven by private investors, the swap rate is currently exerting a strong influence upon the prime City office yield, which we believe has increased by 25 basis points to 6.25-6.5% over the last quarter, whilst the IPD yield now stands at 6.3%. Private investors currently have a number of buildings under offer including 21 Lombard Street (circa £102m) and Millennium Bridge House (circa £94.5m).

Developments in the City

The lack of speculative development this cycle has been well documented yet it is clear that there remains a shortage of new Grade A office space. Indeed of all the accommodation currently being developed in the City, some 70% is already pre-let. The most visible sign of this trend was Lehmans taking 95,081 sq m (1 million sq ft) at HQ2, Docklands for £441 per sq m (£41 per sq ft). The paucity of available Grade A space means that pre-letting looks set to be a prominent characteristic of the market in the future. Property companies continue to chase speculative refurbishment opportunities where they can achieve a quick turnaround. Although it is clear that the lending market is becoming more cautious on such schemes the prices paid for such buildings continue to surprise the market as the development cycle has enjoyed a protracted growth phase. Where competitive bidding situations can be achieved one or two bidders are generally well ahead of the more conservative pack.

Thames Valley downturn

There has been a noticeable weakening in sentiment in the Thames Valley market since March as technology companies, which accounted for the majority of take up last year, face drastic down-sizing measures. Take-up dropped by 66% in

the second quarter, according to CB Hillier Parker, with Grade A, large (20,000 sq ft+) floorplate units, favoured by hi-tech occupants, suffering an even sharper slowdown. In the light of such developments, construction was halted on the third phase of the Stockley Park scheme at Heathrow, which was specifically targeted at hi-tech occupiers with floorplates of up to 3,250 sq m (35,000 sq ft). The series of re-structuring exercises by telecom occupiers in the Thames Valley is likely to continue, resulting in more pre-let space being returned to the market for subletting. There has been an increase in take up from pharmaceutical companies, which, to a limited extent, counteracts the telecom-induced fall-out. With a vacancy rate of around 4%, the market is not overly exposed to such a downturn in tenant demand. The key risk is faced by speculative development, which amounts to 180,000 sq m (1.9 million sq ft), especially along the M3 corridor where land availability is less constrained. Nevertheless, prospects for an upward move in the region's prime-located locations over the remainder of the year appear remote. Consequently, prime investment yields have drifted out by a quarter of a percentage point to 6.75% in the second quarter. Another consequence of the technology sector's problems is that towns further west of the M4, such as Swindon, may not prove as attractive to investors. Earlier in the year, investors were beginning to focus attention on such locations but one would now expect a more cautious attitude to prevail.

Retail

Occupier focus

The May annual increase in the implied deflator - a measure of inflation on the high street - rose to a three-year high of

“Higher-yielding stock is the focus of investors’ interest in the high street”

**London: West End**

Charles Gardner
Tel: 020 7493 3338

London: City

Michael Riordon
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

Milton Keynes

Peter Brown
Tel: 01908 685950

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), **Mark Wist** (mwist@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 for the brief, e-mail: investmentbrief@geraldev.com

Dynamic distributor market

Elsewhere in the distribution sector, there continues to be no let up in the strength of occupier demand. Comet and Argos are searching for nearly 278,700 sq m (2.5 million sq ft) of space as they look to expand and upgrade existing services. Amongst other deals, Argos looks set to sign up for 65,030 sq m (700,000 sq ft) of remaining space at Severn Trent's Daventry International Rail Freight Terminal (DIRFT) at a rent of around £54 per sq m (£5 per sq ft). The electrical and computer retailer, Comet, has a 114,480 sq m (1.2 million sq ft) requirement for design-and-build warehouse space in Warrington and the South East because its 23,255 sq m (250,000 sq ft) facility near Wigan cannot cope with current business volumes. The pressing need to upgrade its distribution service means that the company remains open-minded as to whether it rents from a developer or buys land, which appears to be a common attitude for many occupiers.

The high level of demand for third-party distributors is prompting further speculative development. Prologis secured the UK's biggest letting for a speculative industrial scheme on the first phase of its Coventry distribution park as logistics specialist, Exel, took the majority of space on the 55,740 sq m (600,000 sq ft) scheme. The developer is to build a 50,166 sq m (540,000 sq ft) speculative, second phase, signalling a great deal of market confidence. The company is also one of several developers fiercely competing to develop a total of 65,030 sq m (700,000 sq ft) in Croydon, which looks set to become a leading distribution centre in south London. Such schemes could push the area's rental high to £97 per sq m (£9 per sq ft).

Investor demand weakens

In the market overall, investor demand for estates and solus units has weakened since the spring, placing upward pressure on yields. Concerns over rental growth prospects have meant investors have been reluctant to pay full value for reversions. With industrial yields at 11-year lows, according to IPD, the downward trend evident since 1997 appears to be bottoming out.

Indirect investment opportunities

Industrial property makes up 15% of the capital value of the major limited partnerships. The strong investor demand for both actively managed industrial property and tax-efficient vehicles has prompted recent initiatives by asset managers. Firstly, PRICOA Property Investment Management and the io Group have launched an innovative industrial property fund. Initial equity commitments amount to £75.5 million with gearing boosting the fund value to £150 million. This offers tax-exempt institutions the opportunity to gain exposure to io-branded, multi-let industrial estates in the UK. Target rates of return are 12-15% per annum, which would comfortably out-perform our projections for the IPD industrial portfolio into the medium term. Meanwhile, Ashtenne set up a £360 million limited partnership with Morley Fund Management into which it is injecting £249 million of its £364 million portfolio. The fund carries a yield of 8.8%, which should prove attractive to income-seeking, institutional investors, especially as it is combined with Ashtenne's specialist management skills.