

"Institutional funds increase portfolio allocations to property but an illiquid market for prime stock remains a problem"

Summary

Funds target property

Institutional investors have substantial funds targeted at property but are having difficulty sourcing stock as there is an absence of forced sellers in the market. This problem is exacerbated by low capital growth, high transaction costs and stiff competition from geared investors.

Stamp duty

The closure of stamp duty loopholes will further constrain liquidity in the market. Debt-driven deals will be especially affected as geared investors have had more freedom than institutional funds in employing mitigation schemes.

Total returns remain resilient

Property has maintained consistent performance throughout recent uncertainty in the occupational market. It produced a total return of 1.9% in the first quarter of 2002, according to the IPD Monthly Index, which is in line with the final quarter of last year. We forecast total returns of 8-8.5% at the year-end.

Yield gap

The property-gilt yield gap narrowed slightly and stood at 1.9 percentage points in March. Gilt yields stand at their highest level since August 1998 with issuance levels set to increase.

Funding costs

The 5-year swap rate rose to 5.5% in April, from a recent low of 4.8% in November. However, debt-backed investors will remain active in the market as they are still able to achieve competitive IRRs relative to equity-based investors.

Office

There are tentative signs that tenant activity in the City is reviving as postponed requirements return to the market. Investor interest in Central London stock remains high despite lacklustre rental growth prospects in the short term.

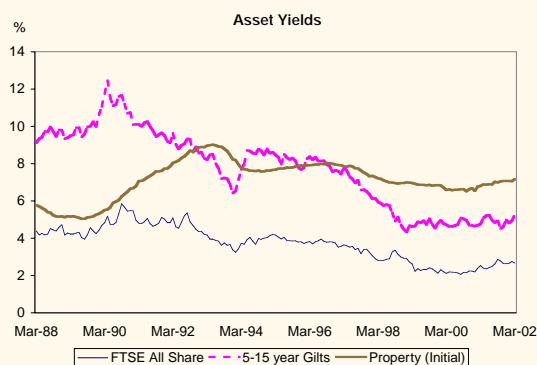
Retail

Institutional investor interest in prime high street stock continues to revive.

Retail warehouses remain at the top of the shopping list for investors. Whilst the prime investment market suffers a stock shortage, indirect methods of investment are developing. This sub-sector provides real prospects of double-digit total returns this year.

Industrial

This was the best-performing sector in March with a twelve-month total return of 8.1%, according to the IPD Monthly Index.



"Policy-makers do not see the need to increase the base rate yet despite a consumer binge "

Economic Overview

Recovery underway

This year has seen a slight revival in the UK's economic fortunes after growth stagnated in the final quarter of 2001. The National Institute for Economic and Social Research's estimate of economic growth in the quarter to March was 0.2%. Moreover, official statistics showed that UK manufacturing output increased in February for the first time since August 2001. Surveys from the Chartered Institute of Purchasing and Supply and the Institute of Directors report buoyancy in the service sector. The latest Treasury survey of economic growth forecast for 2002 is

unchanged over the quarter at 1.9%.

There is little sign that consumer spending is slowing down. March figures from the British Retail Consortium

reported the strongest retail sales value growth for over 6 years. However, this consumer binge is having little inflationary effect, which has allowed the MPC to maintain an expansionary monetary policy, so far. Indeed, the minutes of the April MPC meeting revealed a unanimous view that the base rate did not need to rise to restrain consumption growth.

The April Budget may act as a drag on consumer spending in the medium term by increasing the tax burden on the private sector. However, consumer spending does not react quickly to tax

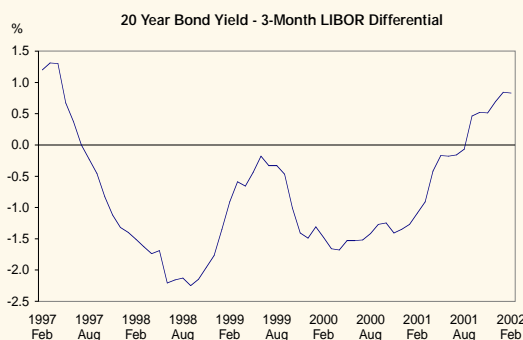
risks and so monetary policy is preferred as a tool to manage short-term spending growth.

Shift in yield curve

The UK has experienced an inverted yield curve throughout most of the past five years, whereby the yield on long-dated bonds has been below that on short-dated paper. However the degree of inversion on the yield curve is now slowly declining and there is still leeway for further increases in long-dated yields.

The movement may be explained in terms of demand for long-dated gilts abating, in the light of the decision to scrap the

Minimum Funding Requirement for pension funds and, on the supply-side, by increased levels of gilt issuance by the government. The target for gilt sales in the current fiscal



Source: National Statistics

year is £23bn, compared to £13.7bn in 2001-2 and £10bn in 2000-1.

The process of re-adjustment may still have some way to go as any move towards euro integration will require convergence with German long-dated bonds which currently stand at 5.6% compared to 5.0% for 30-year UK bonds. This may prove to be significant as Gordon Brown's Budget comment mentioned that economic policies were in line with Maastricht criteria for euro entry. Consequently, gilts face a less benign environment than in the last five years.

Property Overview

Total returns

Property's twelve-month total return stood at 7.2%, according to the March IPD Monthly Index. Figures for the equity and gilt markets were -3.2% and 1.8% respectively. Gilts have experienced a 27 basis point increase in yields this year.

Fund activity

The level of net investment by UK institutions reached £214m in the first quarter of 2002, compared to £159m in the whole of 2001.

Investment turnover levels were low in the first quarter, at £1.8bn. The amount of institutional activity remains subdued for two reasons.

Firstly, poor nominal returns on cash holdings are constraining disposal strategies which means that purchases must be confirmed before sales take place. Secondly, funds continue to be out-bid by debt-backed purchasers.

Nevertheless, financing investment deals is becoming more problematic for debt-backed purchasers. Five year swap rates have risen to 5.5% in April from 4.8% in November and lender margins have increased whilst loan to value ratios have dropped. Subsequent IRRs may still exceed those achievable by equity-based investors but the margin is falling. We still anticipate strong demand from debt-

backed investors but the competitive edge has eroded.

There is some evidence of a return by institutional investors to the market as Scottish Widows placed a portfolio valued at £107m under offer in March. The fund fought off stiff competition from property companies as the total amount of bids stood at around £1bn.

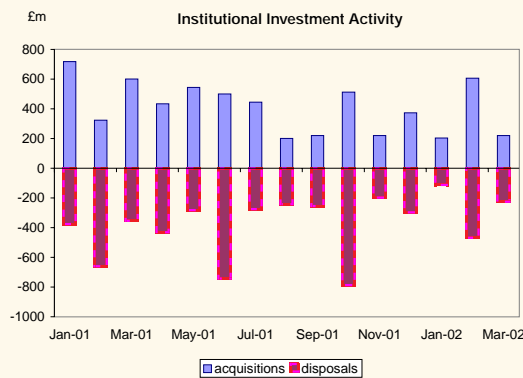
Year-end corporate valuations report price stability with the FTSE Property Index comfortably out-performing the wider market. The indirect sector is often viewed as a lead indicator of the direct market and the average sector price discount to NAV has improved from -40%

in January, to -25% in April.

Overseas investors remain an important source of funds. Lone Star from the US is reported to be holding investment funds of \$8

billion, which are being targeted at the UK and Europe.

Funds have increased their allocation to property, with Salomon Smith Barney estimating that additional institutional allocations amount to over £2 billion. One example is Standard Life, which plans to spend £600m this year, up from £250m spent in 2001. The issue is whether market liquidity can develop to accommodate such capital inflows. Increased institutional allocations do not necessarily solve the problem of sourcing product as a combination of low capital growth and high transaction costs result in a lack of active sellers in the market.



Source: Property Data

"Continued out-performance by property attracts investors"

"The shift in fund portfolios towards property may be seen as part of a strategy to minimise asset-liability matching risk"

Prime yields across all sectors were unchanged in the first quarter of 2002. Their resilience in the face of an uncertain lettings market is based upon the premium that property yields command over funding costs. In many areas of the market, marginal pricing movements are being set by this premium rather than rental growth prospects.

We are forecasting a year-end total return of 8-8.5%. This is based upon a slight inward shift in the yield base to produce marginal capital growth, which will supplement a solid income return in 2002. This puts us in a bullish position relative to the Investment Property Forum (IPF) survey of investor intentions in March, which reports an average forecast total return of 6.9%.

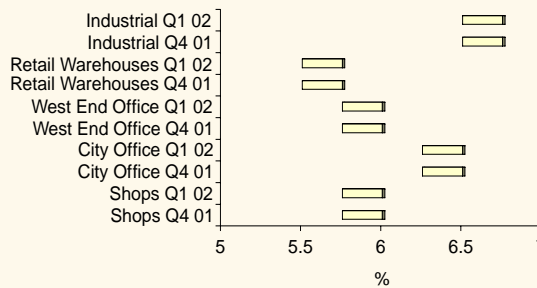
It is interesting to note that the IPF's survey viewed property returns as being driven solely by income with no inward yield shift, which we would view as a conservative assumption. Yet 47% of respondents believed that property's short-term performance would be better than equities or gilts. Thus, the case for investing in property is increasingly being viewed in terms of performance as well as upon the long-standing basis of security of income stream.

The decision to increase allocations to property should be seen as a strategic, rather than a tactical move. Property is being viewed as a bond-type investment, which allows institutions to minimise

asset-liability matching risk, as well as providing strong performance. Indeed, the Watson Wyatt 2001 Manager Survey predicts that property will out-perform UK gilts and UK equities over the next ten years with a total return of 9%.

Consequently, any recovery in the equity market will not trigger a withdrawal of funds from property back to equities. This should ensure that pension fund portfolio weightings in property will increase further from 5.6% reported in the WM All Funds Universe in 2001.

Prime Yield Ranges



Source: Gerald Eve

The trend may be facilitated by the introduction of FRS 17 in the medium term, which has focussed pension funds' attention on the importance of a steady income stream, rather than capital growth. However, it may be premature to expect any direct reaction in terms of re-allocation of assets as funds are only now seeing the effect of FRS17 on their balance sheets.

Lease code

The consultation period for the draft code of practice for commercial leases ended in March. A point of contention is the recommendation that landlords should offer a choice of lease terms with differential rents priced accordingly. Like the 1995 code of practice, this version is voluntary, which meant that market forces were the sole determinant of lease terms. However, without landlord concessions, government intervention is possible.

Office

Geographical trends

Quarterly total returns stood at 1.5% in March, according to the IPD Monthly Index. A geographical breakdown of the sector shows a downward trend in south eastern markets, whilst provincial areas maintain steady performance. Rental growth prospects remain limited to certain provincial centres.

City

The City market continues to suffer from a bout of tenant sub-letting. This space is being offered on short-term leases, which meet with little tenant demand even at discounts. Consequently, rents have fallen by 5-10% in the second-hand market. However, this supply may be quite quickly absorbed if business confidence returns, which appears likely after the re-activation of several dormant requirements recently. Indeed, BH2 report an increase in active demand from a January low of 371,600 sq m (4m sq ft) to 436,640 sq m (4.7m sq ft). Whilst requirements for units above 4,645 sq m (50,000 sq ft) have been subdued, the 70,000 sq m (750,000 sq ft) pre-let secured by Hammerson on its development at Bishops Square, E1 to the lawyers, Allen and Overy, indicated growing tenant confidence. We believe that prime rents in the City remain at £673 per sq m (£62.50 per sq ft) as

Grade A space constitutes only a small proportion of available stock.

There was a rush to conclude investment deals before the April Budget, which closed stamp duty loopholes. Increasingly, properties coming to the market have been packaged in such a way as to minimise stamp duty costs - typically by way of separating the legal and beneficial titles to the property and creating a company structure. This provided a further competitive advantage to private buyers who were more able to take advantage of such schemes than UK and German open-ended funds, who are bound by actuarial restrictions and governance. Institutional funds are responding to competition from debt-funded investors by targeting stock with

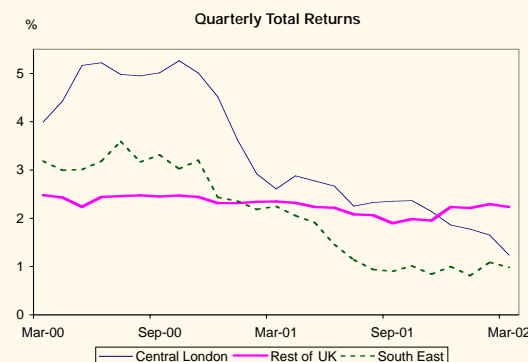
shorter income streams. For instance, following on from Standard Life's acquisition of 8-10 Old Jewry in December, Legal and General acquired 117 Houndsditch, a multi-let unit with lease

expiry lengths varying from five to ten years. We would anticipate more such deals being signed in the mainstream market.

West End

The West End letting market continues to suffer the after-effects of an outbreak of 'irrational exuberance' as IPD report twelve-month rental growth of just 0.5% in March, down from 24.9% in January 2001. Prime rents look set to fall further

"Whilst funds are beginning to show renewed appetite for City property, they still find it difficult to justify the levels paid by debt buyers who are able to gear up and hence obtain IRRs that would otherwise be unachievable"



"Prime rental growth prospects are confined to provincial centres as the Central London lettings market is subdued"

from a current level of £818 per sq m (£76 per sq ft). As such, the differential between prime City and West End rents looks set to fall further.

Peripheral locations, such as Soho, are expected to see steady prime rental levels in the short term. The Paddington Central development provides signs of active tenant interest with two lettings of 3,600 sq m (38,700 sq ft) to Prudential at £484 per sq m (£45 per sq ft) and 5,016 sq m (54,000 sq ft) to Kingfisher at £457 per sq m (£42.50 per sq ft) in the spring.

Despite relatively subdued letting activity in the West End, investors remain eager to secure prime stock with the yield range remaining unchanged at 5.75-6% over the last quarter. Debt-funded, private buyers are making their presence felt, as is exemplified by the Dutch property company, Redevco, who paid 10% above the guide price of £25m for 50 Pall Mall, SW1, which implies a yield of less than 6% from a 15-year lease. This illustrates the competitive environment which institutional prospective investors face. Those investors who do not gear up are often confined to sourcing stock from the higher-yielding end of the market.

Development

The Central London development pipeline is responding to weaker rental growth prospects as construction orders have dropped by 10% in the final quarter of 2001. This is the result of a cut-back by lenders, which should ensure medium-

term market equilibrium. The Docklands market has been identified as being exposed to the risk of over-development. Developers have exercised caution which is illustrated by Capital and Provident's recent decision to abandon plans for a 27,870 sq m (300,000 sq ft) office scheme at The World Trade Centre London site in favour of a residential scheme.

Provincial

In the M25 market, occupiers are increasingly successful in negotiating 10-year leases and rental growth prospects are poor. Consequently, institutional investors remain cautious about this area.

Central London Investment Deals in February/March

	Purchaser	Price £m	Yield
City			
Royal Mint Court, EC3	Irish investors	97	8.2%
113-117 Farringdon Road	Royal London Asset Mgt	5.5	7.2%
CU Tower, EC3	Abu Dhabi Investment	30	n/a
48 Gracechurch Street, EC3	Henderson Investors	15	7.2%
West End			
7-10 Waterloo Place, SW1	WJB Mondiale	19	7.25%
21/22 Grosvenor Street, W1	Gort Securities	4.03	6.75%
17/19 Maddox Street, W1	Overseas fund	4.45	5%

The provincial market is benefiting from rationalisation in the finance sector. In marked contrast to Central London, the pre-let market has been buoyant with both Manchester and Leeds achieving

record deals of 46,450 sq m (500,000 sq ft) and 32,250 sq m (350,000 sq ft) respectively in recent months both let to the Royal Bank of Scotland. The company is continuing its search for regional headquarters in Bristol and Leeds.

In a bid to diversify portfolios and secure high-yielding returns, UK funds have been bidding fairly aggressively on stock offering longevity of income and strong covenants in provincial centres. They are meeting with limited success as there are few forced sellers in the market.

Retail

Investor interest on the high street...

Low-yielding high street stock has enjoyed a resurgence in investor interest over the last quarter. The growing numbers of prospective purchasers provides further evidence of the return of institutional funds to the market place.

...and out of town.

The retail warehouse sub-sector remains top of the shopping list for institutional investors but the sector is largely owned by property companies. As such, institutions are being forced to source secondary stock in response to the lack of prime product and available new

development. Some investors are responding to the problem by undertaking joint ventures with property companies. For instance, Capital & Regional's Junction partnership with Morley Fund Management which recently acquired a £141m portfolio from Burford and has a target value of £1.2bn. The strength of indirect investment into the sector is also illustrated by the Hercules Unit Trust, which now has a value of £1.65bn and is the largest in the UK.

With 25-year leases remaining common, retail warehouses appear to offer the greatest chance of a yield re-rating. We forecast that retail warehouses will be the top-performer in 2002 with prime stock achieving double-digit total returns.

High street rental growth

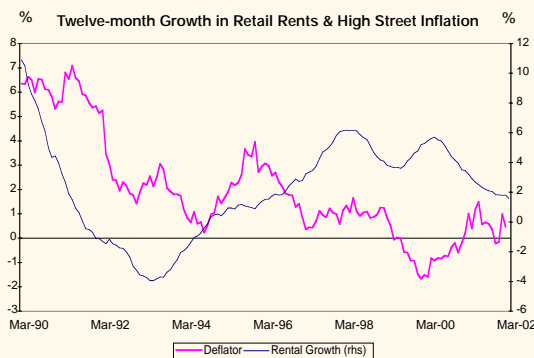
Inflation on the high street continues to remain at low levels. It is interesting to compare the levels of high street inflation (6.6%) seen towards the end of the last consumer boom with current levels (0.5%). Fashion retailers, such as Next and Gap have been at the forefront in demanding prime space. However their pricing policy faces strict competition from operators such as Uniqlo, which constricts their ability to bid rents upwards.

Six months ago, the buzz words seemed to be 'big is beautiful' on the high street with fashion retailers such as Zara and

Mango having requirements for large units. Landlords were therefore trying to reconfigure mall space and high street shops to meet these requirements. This strategy has only met with limited success and many of these

retailers are being forced to settle for smaller units. This has impaired rental growth, which stood at 1.4% on a twelve-month basis in March, according to IPD.

Research from Mintel Retail Intelligence on sales densities illustrates an important determinant of tenant demand. Dixons, a primarily retail warehouse-based operator, achieved annual sales densities of £10,222 sq m (£950 per sq ft) which compares to Currys, which is more orientated towards the high street, at £4,455 per sq m (£414 per sq ft). Tenant demand in the retail warehouse sub-sector is likely to produce the strongest rental growth in 2002 and probably 2003 as well.



Source: Investment Property Databank, National Statistics

"The retail warehouse sub-sector provides the best prospects for rental growth"



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Industrial

Steady performance

Quarterly IPD industrial total returns stood at 2.1% in March, which is equal to the retail sector. The recent trend has been fairly stable and we expect this performance profile to continue throughout 2002.

Despite stabilisation in the manufacturing sector, distribution is expected to continue to drive the lettings market. The South East lettings market

has recovered from a quiet period at the end of 2001. In the corporate sector, Brixton's year-end valuation reported robust rental growth of 5.7% in its industrial portfolio, which is based in the South East.

Outside the South East, the buoyant consumer sector is producing demand from retailers for smaller distribution space. In the North West, JJB Sports and Allsports have been actively acquiring space. With subdued demand from the area's manufacturing sector, this activity has been especially welcome in the market for sub-4,500 sq m (48,400 sq ft) units. There have been reports of a slowdown in demand for speculative, larger units of 9,000 sq m (96,900 sq ft) in the North West. However, this may be the result of a failure by developers to recognise the increase in third party distributors' size requirements with Aldi, Comet and Kelloggs all searching for units over 27,900 sq m (300,000 sq ft).

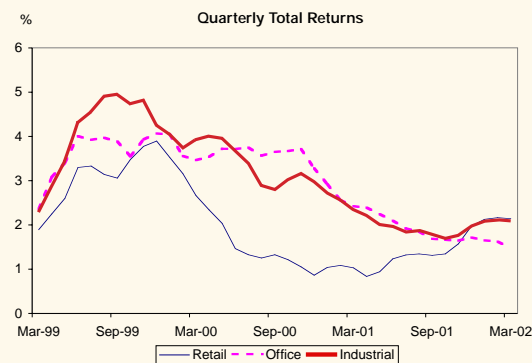
Funds may well be targeted at the West Midlands as the M6 Toll Road is due for completion in 2004. Areas around the route are attracting developer and occupier interest as distributors face continued difficulty in finding stock around the existing motorway infrastructure. Elsewhere in the West Midlands, speculative development continues apace

even in larger sized units which are normally design-and-build projects. At Prologis Park, Coventry, a 30,460 sq m (326,000 sq ft) scheme is under offer with plans to commence construction of

a second 27,870 sq m (300,000 sq ft) unit. In the North West, developers are finding funds for speculative development more difficult to source.

The general trend towards joint ventures is illustrated in the industrial sector by Astral Developments and the US opportunity fund, Blackstone Group. They have created a £200m 'big shed' fund to speculatively develop warehouse schemes of 9,290 sq m (100,000 sq ft) around the South East and Midlands.

Infrastructure developments, such as around the A14 corridor in East London, open opportunities for investors to obtain stock which offers more growth potential than existing hot spots. Demand for industrial estates remains focussed on stock offering security of income rather than active management opportunities. Overall, investment activity is not expected to reach the levels anticipated in the retail sector.



Source: Investment Property Databank