

Economic overview

GDP is growing at its strongest level for four years

Property overview

Property has delivered strong performance relative to other asset classes in the last quarter

Offices

Several major 'flagship' deals indicate improved investor sentiment, although vacancies remain high in central London

Retail

Retail is still the only sector to show any significant rental value growth

Industrial

Industrial returns continue to improve and are now chasing retail for top spot as yields fall

Leisure

Major corporate acquisitions and management buyouts were a major feature of the market in Q2 04

Property Investment
Market

Summer 2004

inv**brief**



Summary

Property

Property recorded a total return of 4.9% in the three months to June 2004, significantly up from the 3.5% recorded in Q1 04. On a 12-month basis, total return stood at 15.4%, the highest since the end of 1998.

Equity markets have struggled this year, recording a total return of 2.8% in the six months to June 2004. This was significantly below property, which recorded a comparable total return of 8.6%, but ahead of gilts, which recorded a mere 0.1%.

The familiar story continues with capital values rising almost entirely due to the continued decline in valuation yields, reflecting the re-rating of property relative to other asset classes. Institutions are back in the market as major investors as property weightings increase.

Rental values increased modestly over Q2 04, reflecting a sharp fall in the decline of office rents.

The industry has responded to the Government consultation paper on establishing Property Investment Funds (PIFs). The overwhelming conclusion was that the successful establishment of

PIFs is dependent on a light regulatory framework.

The incorporation of Statement of Standard Accounting Practice (SSAP) 21 is likely to shorten occupational leases.

Offices

Once again, offices were the poorest performing sector in Q2 04, although total returns improved significantly from the 2.3% recorded in Q1 04 to 3.5%. Rents declined at a much slower rate whilst yields continued to fall.

Retail

Retail has been the top-performing sector since Q3 01 and recorded a total return in Q2 04 of 5.6%. Falling valuation yields improved capital values by 3.4% and rents grew by 0.8%.

Performance was strongest in outer London standard shops. Shopping centres were the poorest performing sub-sector.

Industrial

Industrial continued to benefit from falling yields and recorded a total return in Q2 04 of 4.9%. Standard industrial out-performed distribution centres.

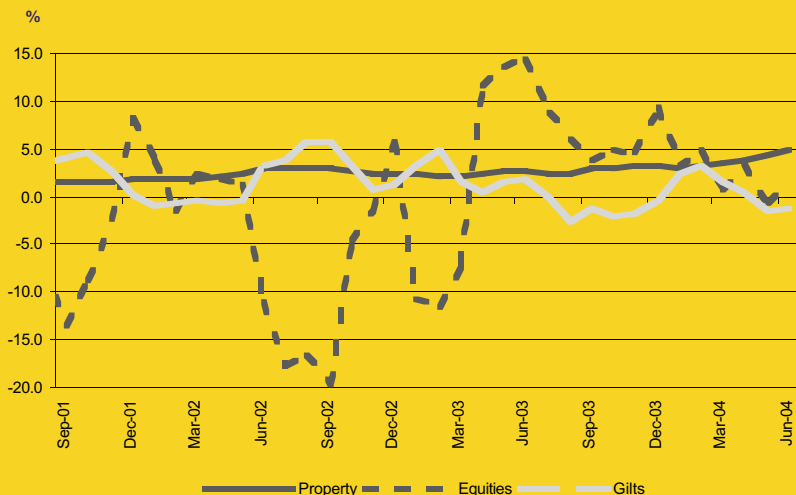
Leisure

Q2 04 was very busy as corporate and portfolio transactions exceeded £1.4bn.

“Equity markets and gilts have struggled this year, recording a total return of 2.8% and 0.1% respectively”

Quarterly total return by asset class

Source: IPD



Economy

Expansion continues

UK GDP grew at a rate of 0.9% in Q2 04, up from the 0.7% recorded in the previous quarter, according to the Office of National Statistics (ONS).

Manufacturing and services both contributed to economic expansion. The latest Treasury survey of independent forecasts estimates growth of 3.2% in 2004, the highest rate of growth for four years.

A recent CBI sponsored Survey of Property Trends suggests that although demand for property is currently subdued, stronger business and employment growth in the short to medium term will have a positive effect on demand.

The British Chamber of Commerce (BCC) survey suggests business confidence, although still strongly positive, has fallen slightly over the last quarter reflecting some concerns over rising interest rates.

The lack of spare capacity within the economy runs the risk of stoking inflation as growth accelerates. Employment is high and some sectors within the economy are experiencing problems in recruiting staff.

Spending review

The Government published its spending review in July, with health and education being the primary beneficiaries of increased spending. These increases are to be financed principally through a major reduction in civil service staff and by relocating other Government employees from central London.

Interest rates to rise

Interest rates now stand at 4.5% with at least two further 25 basis point increases forecast for 2004. Consumer spending remains strong, although there may be some evidence that house price inflation is finally slowing down.

Global

Commodity prices, most notably oil and metals, have risen significantly in 2004. This trend may contribute to increasing global inflation.

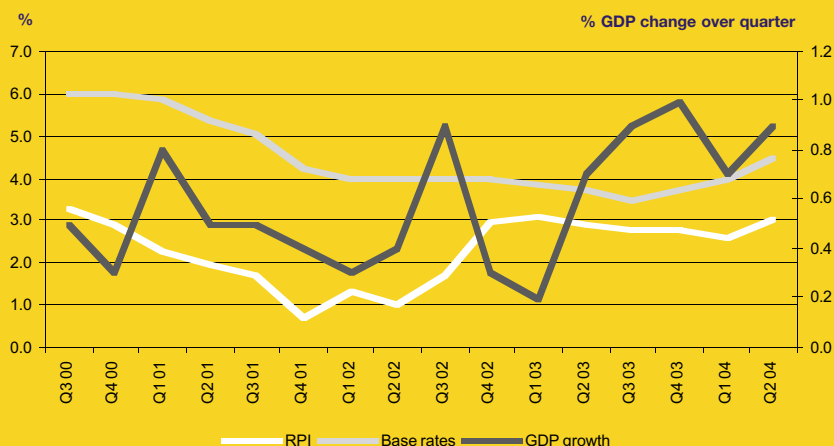
The US continues to drive the global recovery, although data released for June was below expectations. Interest rates are expected to rise, long term rates already have, and the US continues to rely on overseas markets to fund its massive trade deficit.

Economic growth remains sluggish in the recently expanded European Union, with concerns over labour market flexibility and costs continuing, particularly in France and Germany.

“Stronger business and employment growth will have a positive knock-on effect on occupational demand”

UK economic trends

Source: ONS, CLPUK, IPD



Property

Performance

Property recorded a total return of 4.9% in the three months to June 2004, according to the IPD Monthly Index. On a 12-month basis, total returns stood at 15.4% as property continued to deliver sustained performance.

Equities and bonds trailed behind property in Q2 04, recording quarterly total returns of 2.2% and -1.3% respectively. Equity markets have barely moved in 2004 to date.

The continued strong performance of property resulted from both strongly accelerating capital value growth of 3.3% and an income return of 1.7%.

Performance continued to be driven by the fall in valuation yields across all market sectors, which improved capital values by 3.0%.

The last quarter continued to see retail as the top-performing sector, although industrial was catching up fast. The office market continued to recover.

Rental value growth measured 0.4% over Q2 04.

Asset markets

We have amended our forecasts to take account of continued investor demand for property and predict that total returns in 2004 will reach 15.3%, up from the 8.7% we suggested in Q4 03.

The traditional rationale for purchasing commercial property i.e. rental growth, has been replaced with sentiment, primarily linked to the poor performance of other asset classes.

Global equity markets are sluggish and still look fairly expensive when analysed on a price/earnings basis. Bond investors face the prospect of rising interest rates offsetting the increase in demand for secure income. Property will therefore remain attractive to investors in the foreseeable future.

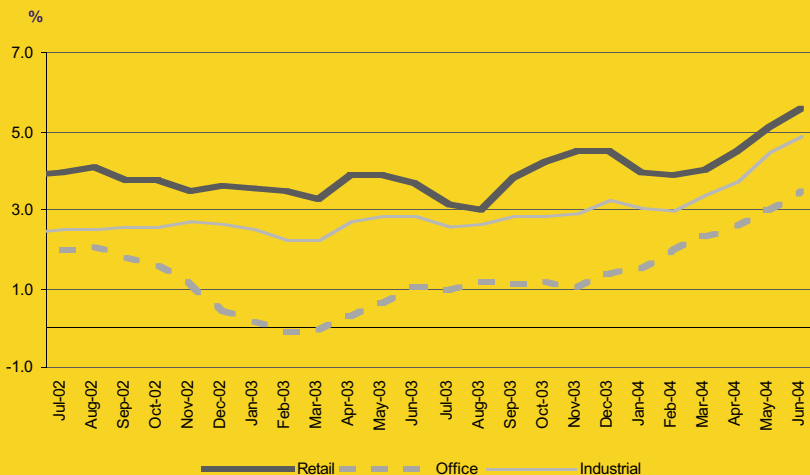
What is a 'fair or reasonable price' must be considered in this context. Yields have been lower, historically, and real yields, despite rising interest rates and inflation, can fall further.

The weight of money flowing into the market, with continued interest from institutions, private and overseas investors, continues to drive prices higher. What was considered an appropriate property risk premium has to be evaluated in the wider investment context. The establishment of PIFs in the UK will also have an impact as

“We forecast total returns for property in 2004 to reach 15.3%”

Quarterly total returns by sector

Source: IPD



liquidity should prove less of a problem for multi-asset investors.

Net investment

UK institutions were strong net investors in Q2 04, purchasing £722m according to Property Data, the highest since 2000. Quality stock is attracting multiple bids. Successful parties are often paying a significant premium with unsuccessful bidders prepared to pay more next time. Pooled property funds are struggling to spend the money they are receiving.

Swap rates have fallen back somewhat with the five year rate standing at 5.4%. Interest rates however, are set to rise further, meaning that easy gains made by debt-driven investors should be squeezed as costs rise to a point where arbitrage is no longer possible – except for certain deals. At this point, institutions should start to replace debt-driven investors as the major buyers.

Current issues

There are three major ongoing issues we wish to comment on. First, in its submission to the Government's proposals to establish PIFs, the investment industry (unsurprisingly) has requested a flexible structure with minimal restrictions on gearing, investment, management structure and development. Although there is substantial interest within the investment community, most are awaiting further

details before committing to any change, including conversion.

A second major issue is the possibility of legislation on leases, preventing the use of upward only rent reviews. This continues to concern investors. Currently, we are undertaking a major survey of our clients to ascertain whether there is any common ground between landlords and occupiers.

A third issue is the adoption of Statement of Standard Accounting Practice (SSAP) 21 which comes into effect in January 2005. It will have major implications for occupational leases and push average lease lengths lower. Occupiers will have to record the full net present value of the lease as a liability on their balance sheets.

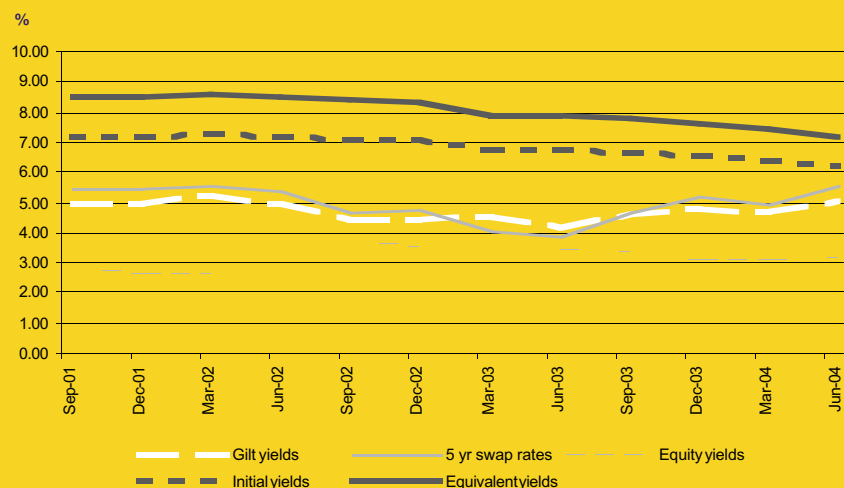
A combination of lease restrictions, Stamp Duty Land Tax and SSAP 21 suggests investors will have to get used to shorter leases and a less secure income stream, increasing the risk of holding property.

In theory, these fundamentals should make yields rise, but they are not feeding through into current prices. A market driven purely by yield shift and a sheer weight of money seeking to gain entry into a market in which the dynamics and risks are not understood, creates a very uncertain environment.

“PIFs – the devil is in the detail”

Asset yields and swap rates

Source: IPD & CLP Finance



Offices

Office returns improve

Office total returns continued to improve in Q2 04, rising to 3.5%, up from the 2.3% recorded in Q1 04. On a 12-month basis, total returns rose to 8.5%, the highest since Q3 01.

The components of office total returns comprised 1.7% capital growth and 1.8% income return. Capital growth was driven by a significant fall in yields which improved capital values by 2.0%. Yields fell across all regions with the greatest impact recorded in the Mid Town/West End market, where capital values increased by 2.7%.

Rental values fell by a mere 0.1% over the quarter with positive growth in the Mid Town & West End and in English markets outside the South East. Rents, however, continued to decline in the City, the South East and Scotland.

With the exception of the Mid Town & West End market (a total return in Q2 04 of 4.3%), there was a distinct north-south divide in office performance over the last quarter, with the north of England out-performing southern markets by a considerable margin. The City of London market again recorded weak performance with a total return of 2.1%. Scotland was placed second from bottom, recording a total return of

3.0%. Performance was strongest in the north of England and in Midlands & Wales, which recorded total returns of 4.7% and 4.5% respectively.

The sheer weight of investor demand for property has had an impact on the office market and we have adjusted our total return forecast for 2004 accordingly. We forecast total returns will reach 10.4% by the end of the year.

Sentiment vs fundamentals

Even though vacancy rates remain high, investors continue to demand office properties.

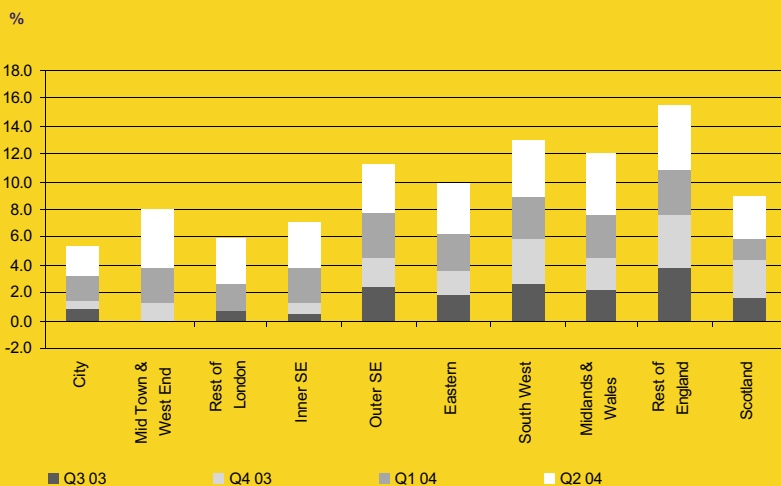
Whilst vacancies remain historically high in some cities, most notably central London, supply is falling. Improved sentiment amongst occupiers has resulted in withdrawals, improved take-up and a reduction in inducements in newly signed deals. Investors thus perceive that the sector has bottomed-out.

Based on the prices currently being paid, investors are betting on rental values rising in the medium term to generate capital value growth. Do those investors buying now have an exit strategy if growth fails to materialise?

“We forecast total returns will reach 10.4% by the end of the year”

Quarterly office total returns by region

Source: IPD



Investment activity

Institutions continue to be the driving force in the office investment market as debt-driven investors no longer have the leeway provided by the yield/financing gap to aggressively outbid institutions, as was the case throughout 2003.

The central London market also continues to attract overseas and private investors, notably Irish, German, US and Middle Eastern.

Major transactions in the City included Credit Suisse Asset Management buying the Corn Exchange, EC3 for £95.5m at a 6.5% yield, with leases running for five to six years. Investor demand is further illustrated by the ongoing bidding for 10-12 Eastcheap, EC3, which attracted over 20 bids, raising the initial asking price of £8.6m to in excess of £10.6m.

The purchase by DB Real Estate of The Helicon, South Place, EC2, for £91m illustrates continued demand for multi-let stock.

There is renewed confidence in the West End market with property companies and institutions looking for quality stock. It remains to be seen how much additional supply will come onto the West End market, as a result of the Gershon report. The abolition or relocation of more than 84,000 civil service posts will expose some redevelopment opportunities.

Outside London

The recent RICS commercial market survey for England and Wales suggests that occupier activity is strengthening with demand at its strongest in the North West and North East markets. The East Midlands, Yorkshire & Humberside and the South West markets showed increased expectations of rental value growth. The value of inducements fell most notably in the East Midlands.

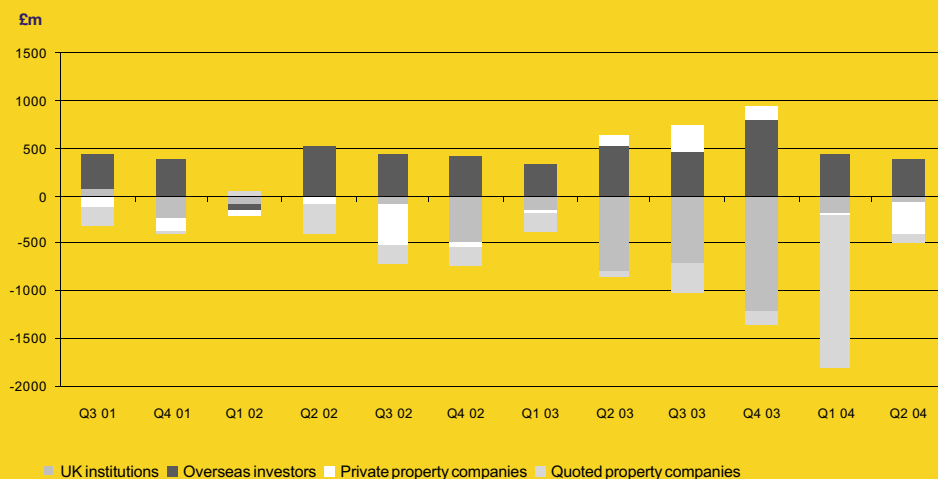
There are signs that overseas and private investors are starting to look towards other office markets outside London. Irish investors in particular have had a major impact, with the private syndicate Jaguar fund bidding strongly for 1 Colmore Square, Birmingham, for approximately £98m.

In many provincial cities, a combination of the lack of available stock, increased occupational demand and the massive weight of money flowing into property will ensure that any quality stock should attract multiple bids at ever increasing prices.

“Overseas and private investors are looking for opportunities outside London”

Office net investment

Source: Property Data



Retail

Top performing sector

Retail was again the top-performing sector in Q2 04, achieving a total return of 5.6% according to the IPD Monthly Index. This was a further improvement on the 4.0% total return recorded in Q1 04 and represented the strongest quarter of retail performance in over ten years. In the 12 months to June 2004, retail total returns rose to some 19.1%.

Total return in Q2 04 combined accelerating capital growth of 4.0% and an income return of 1.5%.

Capital growth was again principally driven by falling yields, which improved values by 3.4% over the quarter. Yields continued to fall as investors continued to demand retail property as this sector offered the greatest growth prospects within the property market. Yields fell across all retail property types and regions with the greatest impacts recorded in outer London standard shops.

Rental values also increased by 0.8% over Q1 04 with retail warehouses generating the strongest growth of 1.4%. Shopping centre rents were static.

As with other sectors, we have adjusted our forecast for 2004 and now predict retail to remain the top-performing sector and record a total return of 17.4% by the year end.

Fundamentals

The retail equivalent yield recorded by the IPD Monthly Index now stands at 6.52%, the lowest ever recorded and falling retail yields have improved capital values by a massive 9.9% in the 12 months to June 2004. Rental incomes for the quarter, however, grew at the slowest rate recorded since Q2 02. Re-rating of retail property therefore, is the principal driver of performance, rather than rental value and income growth.

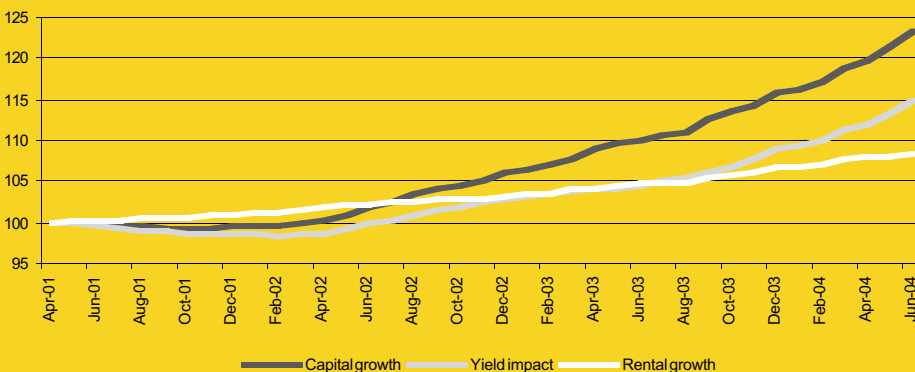
We thus continue to raise our concerns on some of the prices being paid for retail property, which are not supported by underlying fundamentals.

That aside, the signals for the retail sector remain positive. Retail sales volumes increased to 1.1% in June 2004 with the 12-month rate of sales growth running at 7.2%. Annualised sales growth over the three months to June 2004 is at its strongest since mid 2002.

“Q2 represented the strongest quarter of retail performance in over ten years”

Components of capital growth (April 2001=100)

Source: IPD



Investment market

Buoyed by generally positive retailer trading statements, investors have continued to acquire aggressively on the High Street, even in secondary trading locations. In Kingston, a non-prime retail block let to Virgin, Jessops and Pizza Hut was sold to Credit Suisse Asset Management for £10.75m, reflecting an initial yield of just under 5%. Five of the top six bids were funds. Gerald Eve acted for the vendor, clients of CBRE Investors.

In Southsea, Portsmouth City Council recently sold an unbroken parade of 21 retail units with the residential upper parts sold off for around £9.75m, reflecting an initial yield of 5.05% rising to 5.4% on the settlement of an outstanding rent review.

Although the return of the institutions to the High Street was originally focused on buying blocks, they are now replacing private investors as the dominant force for prime High Street investments, even for single let units. In Guildford for example, the Clinton Cards unit let at £200 per sq ft Zone A is currently under offer to a major institution for a price reflecting an initial yield of 4.05%, eclipsing the 4.18% recently paid by clients of Bank of Ireland for the River Island unit, which is a more reversionary property.

24-26 Union Street in Bath, let to Dixons for a further 4fi years, is rumoured to be under offer for a price reflecting a net initial yield close to 4.25%. The majority of bidders were funds.

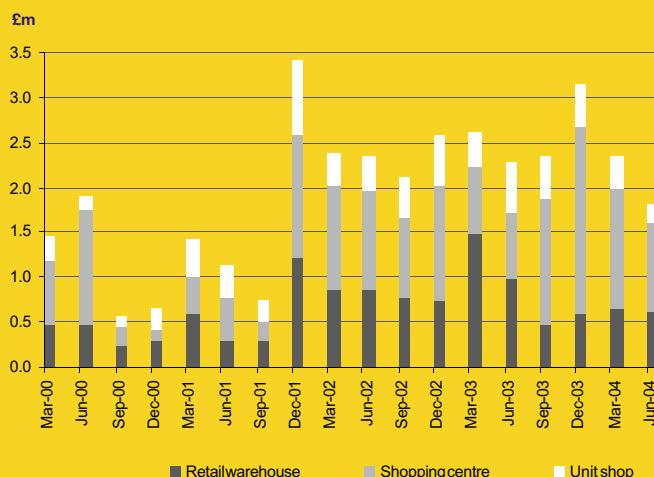
Recent and ongoing High Street transactions such as these provide irrefutable evidence of renewed investment activity on the High Street by institutional investors at much fiercer initial yields than private investors were paying a couple of years ago.

The key rationale has been poor performance of other asset classes and property subsectors, rather than any fundamental improvement in rental value growth expectations. The the resultant yield compression caused by the sheer weight of money has created a worrying self-fulfilling prophecy.

“Institutional investors are bidding at much fiercer initial yields than private investors were paying a couple of years ago”

Retail investment activity

Source: Property Data



Industrial

Accelerating performance

The industrial sector strengthened and recorded a total return of 4.9% in Q2 04. This comprised an income return of 1.9% and capital growth of 3.0%, representing the highest performance delivered by the sector over a quarter since Q3 99. In the 12 months to June 2004, industrial recorded a total return of 15.2% and is now closing the gap with the retail sector.

As with retail and offices, capital growth over the quarter was driven by a positive yield impact which improved capital values by 2.8%. Yields fell across all regions and across standard industrial and distribution centres. In many areas of the country, industrial yields are now matching office yields.

Rental values recorded modest growth of 0.3%, as both manufacturing and business sector output improved, according to the ONS. Continued uncertainty however, was demonstrated by the vacancy rate rising from 9.6% in Q1 04, to 10.3%, according to IPD.

Industrial has traditionally been seen as a high yielding investment, providing a solid income return. Performance is being driven more by sentiment than income growth, as illustrated below.

As with other sectors, we have adjusted our total return forecast for 2004, factoring in the continued demand for stock. We believe industrial will record a total return of 17.2%, only slightly behind retail.

Current issues

The value of transactions in industrial property slipped somewhat in Q2 04 after the record level recorded in the previous quarter, with Property Data recording £649m of investment. One major story was the decision of Land Securities to sell its entire industrial portfolio, valued at approximately £400m. Slough Estates is showing interest in acquiring the portfolio, possibly through swapping some of its shopping centres.

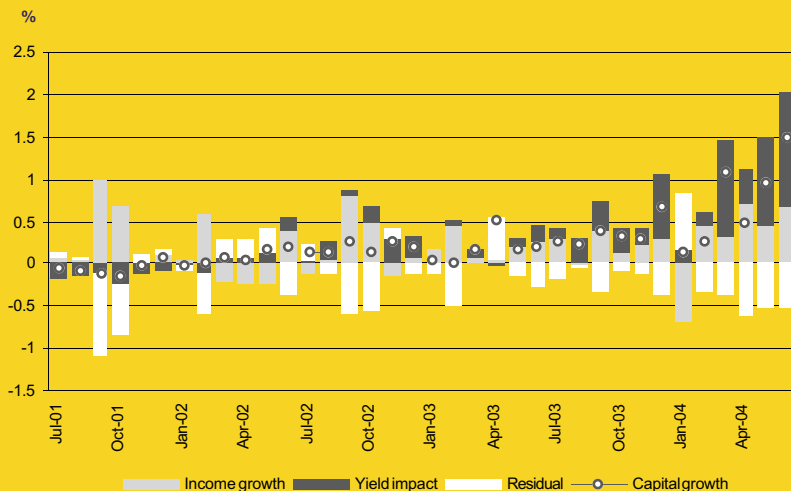
Confidence of a strengthening occupier demand for large units in the logistics sector is illustrated by the speculative development by Gazeley of almost 2m sq ft at five UK sites. Demand has picked up significantly in the east London market.

The logistics sector may see further consolidation as major organisations look at acquisitions as one way of reducing costs and increasing market share, following the example of the takeover of Tibbett & Britten by Exel.

“Industrial is catching up retail, fast”

Components of capital growth – Industrial

Source: IPD



Leisure

Corporate activity

Q2 04 has seen strong activity in the leisure market with more than £1.4bn in large corporate and portfolio transactions. Deals worth in excess of £1.26b are expected to be agreed in Q3 04.

Wolverhampton & Dudley has acquired Wizard Inn's 64 unbranded managed houses from Nomura for around £90m after beating off competition from the Laurel Pub Company. Laurel has also been busy. After looking at Wizard Inns and Yates Group, it has sold 432 community pubs to Greene King for £652m allowing it to concentrate on developing its 170+ High Street bars. Gerald Eve and DTZ advised Laurel.

Another management buyout was the sale of 22 of the 26 former First Leisure nightclubs for around £40m. The company has been in receivership since May 2004. The new company will also manage the remaining four nightclubs for the receivership.

The battle for Premier Lodge finally ended with Whitbread acquiring the portfolio of 132 Lodges, nine pipeline sites and 19 co-located pub restaurants for £536.2m. It has been confirmed that Whitbread will sell 11 of its Courtyard by

Marriott Hotels to concentrate on its upmarket hotels and Travel Inns. Gerald Eve advised Whitbread.

At the time of writing, 12 preferred bidders have been selected to enter the second round for Odeon with bids exceeding £380m.

Investment market

Travelodge has announced the sale and leaseback on 136 sites which it anticipates will raise over £400m. Examples of recent deals include the acquisition of two Thistle Hotels in London's King's Cross area which reportedly involved a simultaneous sale and leaseback to Kirkmore Securities paying £55.5m at yields of 5.75% and 6.05% with 35-year leases.

WG Mitchell has agreed the forward funding of a four star 270-room Hilton Hotel in South Quay, near Canary Wharf. The deal equates a yield of 5.35% at £60m, the scheme is expected to be completed within two years.

TDR Capital, the owner of Pizza Express and Ask Central, has announced the sale and leaseback of 17 sites. A private investor has acquired 12 Ask sites at an initial yield of 5.75% for 25-year leases with fixed 2.5% p.a. increases at a price reported to be near £20m. In a separate deal, five Pizza Express sites sold for £8.5m at an initial yield of 5.6%.

“By the end of September, over £2bn in leisure deals will have been agreed in 2004”

Recent leisure investment deals

Source: Gerald Eve

Rose & Crown	79 Kew Green, Kew, Richmond, Surrey	Chef & Brewer Group Ltd	70,604	1,520,000	4.65%
Crown & Sceptre	Bridens Camp, Hemel Hempstead, Hertfordshire	Chef & Brewer Group Ltd	126,000	2,430,000	5.19%
Plough & Harrow	120-124 King Street, Hammersmith, London, W6	JD Wetherspoon	156,240	2,790,000	5.60%
LA Fitness	Summerlock Approach, Salisbury, Wiltshire	LA Fitness	129,000	2,150,000	6.00%
LA Fitness	6 Moscow Place, London, W2	LA Fitness	261,375	4,300,000	6.08%
Old Post Office	34 Kirk Gate, Newark, Nottinghamshire	Regent Inns	68,500	1,075,000	6.37%
Carpenters Arms	Miserden, Stroud, Gloucestershire	Admiral Taverns (Relax) Ltd	29,000	420,000	6.90%
Abbey Mills	Colliers Wood, London, SW19	Various inc Virgin Active, Premier Lodge	1,151,829	15,560,000	7.00%
I-scene	Clements Road, Ilford, Essex	Various inc Esporta & Travelodge	1,500,000	21,000,000	7.14%
UK Superbowl	Tower Street, Harrogate, North Yorkshire	UK Bowling Services Ltd	66,250	920,000	7.20%
Magic Box	135/137 Cheltenham Road, Bristol	London & Edinburgh Inns Ltd	101,000	1,400,000	7.21%

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