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JUNE 2011

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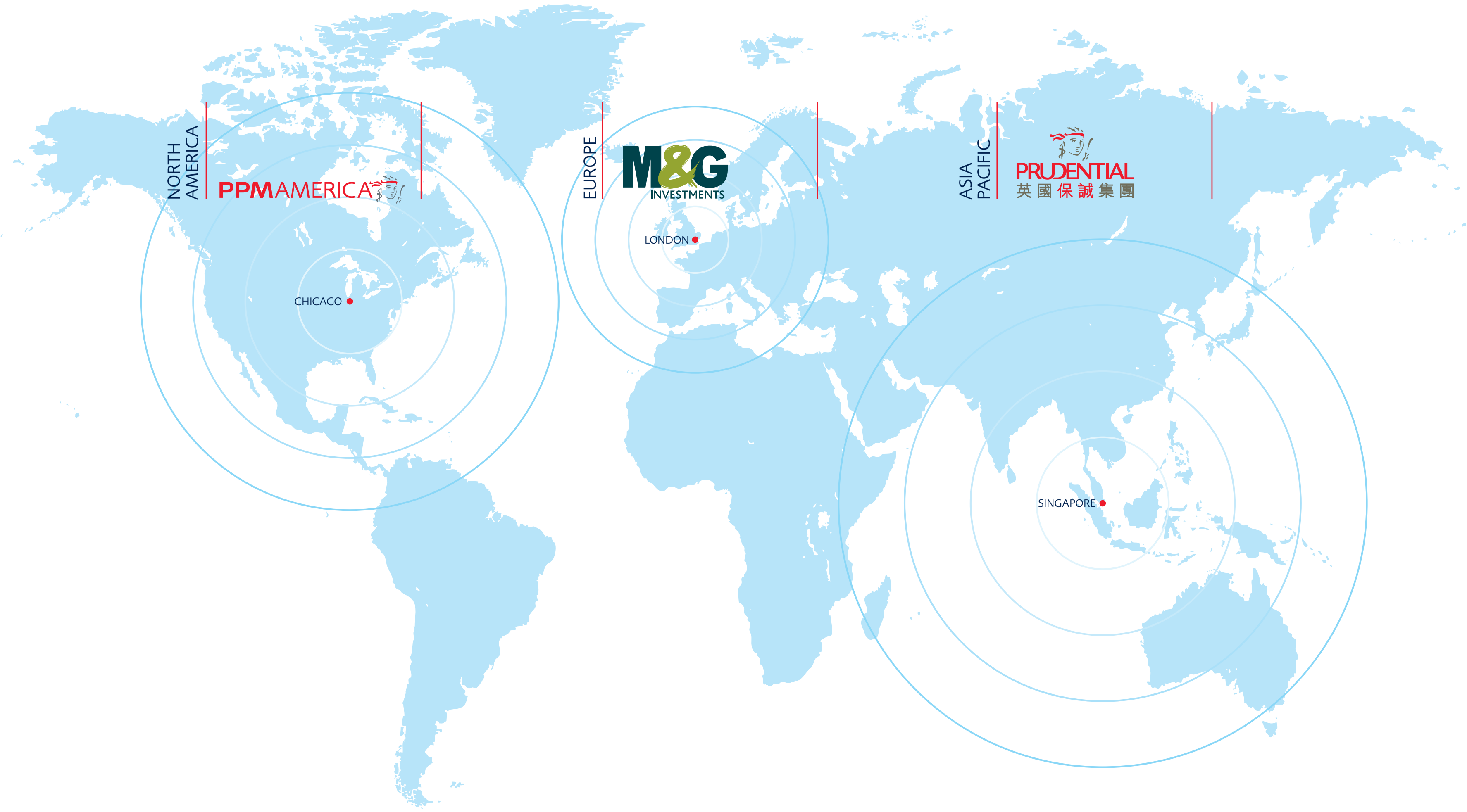
GLOBAL PRESENCE

PRUPIM is a significant force in UK real estate investment management and its global influence is growing rapidly.


NORTH AMERICA
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ASIA PACIFIC
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SINGAPORE

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Toronto
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ABOUT PRUPIM

PRUPIM is one of the leading real estate investment managers in the United Kingdom. We form part of the M&G Group of Companies which is the asset management arm of Prudential plc in the UK and Europe.

We manage around £15.6 billion* of real estate assets, of which over £2.6 billion* is invested internationally in North America, Continental Europe and Asia Pacific. We are invested in over 800* properties with more than 4,000* property occupiers.

We manage real estate investments for a wide variety of clients, providing core services and expertise in fund management, asset management and property management. These services are offered individually, or on a fully integrated basis.

Our major activities are driven by powerful research, managed by the Global Property Research Team. Our considerable scale and diversified activities allow us to draw on our own multi-dimensional inputs which give us an unrivalled information advantage.

We evaluate the macro-economic environment working as part of the global research capability of Prudential. We receive detailed property related data generated by our on-the-ground surveyors. This is fed into proprietary modelling systems which form the basis of our analysis.

The 13-strong Global Property Research Team was formed in 1987 and is comprised of property economists and performance measurement analysts who work together to provide leading property analysis and commentary on the UK and international property markets.

*As at end of April 2011.

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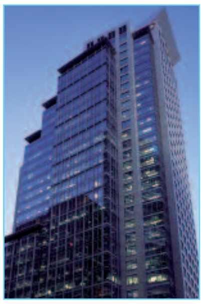
Unless otherwise specified all data and commentary is as at end of May 2011.

For further information please visit our website: **www.prupim.com**

Seattle


Sydney

Los Angeles

Cannes

EXECUTIVE SUMMARY

EUROPE

- The one-size-fits-all economic policy in Europe has recently shown signs of strain with the pace of recovery varying significantly across countries, crudely along a north-south divide. The recent increase in interest rates by the European Central Bank has added to the problems of the struggling peripheral economies, but seems perfectly sensible for the likes of Germany.

- Property occupier markets generally seem to have put the worst behind them, broadly following the wider economic picture with Northern Europe seeing stronger rental markets compared to Southern Europe. Many prime office markets have seen robust growth, while industrial and retail rents have lagged.

- Yield compression has continued in selected markets since the start of 2011, although the pressure on pricing seems to have eased compared to last year; retail and industrial yields have been largely stable recently. Secondary assets have been left behind during the recovery, with the focus of investor interest definitely on prime.

ASIA PACIFIC

- Despite the impact of the earthquake in Japan, major economic indicators remained robust across the Asia Pacific region. The combination of positive business sentiment and strong employment markets continued to support private domestic consumption, partially offsetting the moderating demand from developed economies.

- In the property markets, fundamentals are becoming more diverse. Strong employment markets continue to underpin demand for office space in Singapore and Hong Kong, whilst take-up in Seoul remains weak. In the retail sector, sub-regional and non-discretionary retail segments are expected to continue to perform well, but rental growth momentum appears to be stronger in prime and high street retail.

- The Japanese earthquake did not cause significant damage to buildings in Tokyo, but the resulting disruption is negatively affecting corporate profits and the labour market. Demand for commercial space is, therefore, set to weaken, dampening prospects for a recovery in rental markets in the short term.

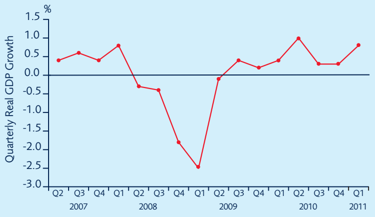
NORTH AMERICA

- The US economy has continued to recover, albeit at a relatively muted rate. Job gains and corporate profits have fuelled consumer confidence, leading to a better picture for occupational fundamentals across the main commercial property sectors. Rents have generally bottomed or are very close to their cyclical trough and, for prime properties, rental growth is now expected to materialise.

- Within the investment market, there remains fierce competition for prime assets in top-tier cities. However, as the pricing gap between trophy assets and relatively secondary properties widens further, assets in non-core locations with a solid income stream are now being increasingly considered as investors search for yield.

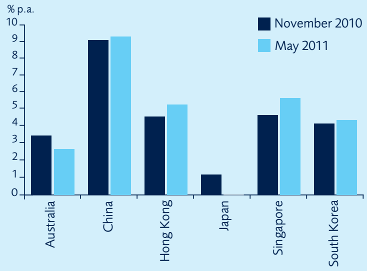
- Led by the retail sector, the Canadian real estate market has seen a further recovery. Falling vacancy rates have driven rents up, while significant yield compression has been seen across all the sectors due to the improving investment climate and increasing risk appetite.

Eurozone GDP Growth



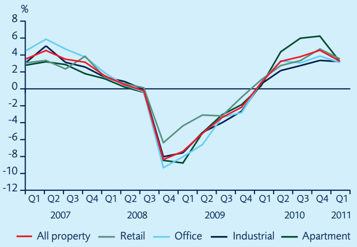
Source: Eurostat (May 2011)

2011 GDP Forecasts Evolution



Source: Consensus Economics (November 2010 and May 2011)

US Quarterly Total Returns



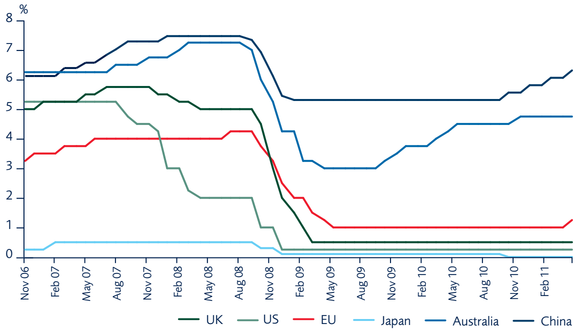
Source: NCREIF (May 2011)

GLOBAL REVIEW

The global economic recovery continued into the first half of 2011, though its path was rocky and bifurcated. Asia Pacific economies, led by the emerging markets of China and India, continued to grow rapidly (notwithstanding Japan which had to cope with a catastrophic natural disaster), while the advanced Western economies experienced much weaker growth. Europe, in particular, struggled with the significant burdens presented by its sovereign debt issues which refused to subside, while austerity measures dragged down the region's growth prospects.

Against this background, monetary policy in the developed economies remained very loose. However, there was increasing talk of "exit strategies" as the end of quantitative easing programmes approached. Furthermore, the Eurozone responded to above-target inflation by following the Scandinavian economies in starting to raise rates. Elsewhere, fears of overheating also caused policymakers in Asia to apply the brakes as they took steps to tighten in the hope of achieving a relatively soft landing for their economies.

Global Official Interest Rates



Source: Bloomberg, Central banks (May 2011)

With concerns over risks to future growth, and pitiful returns from cash and government bonds, property around the globe continued to be perceived as an attractive place for investors' money, offering relatively high yields but with less risk than equities. That said, not all property investments benefited from investor demand since prime assets with secure income were overwhelmingly targeted, while riskier secondary and tertiary property in non-core locations was largely shunned.

> "…not all property investments benefited from investor demand since prime assets with secure income were overwhelmingly targeted, while riskier secondary and tertiary property in non-core locations was largely shunned."

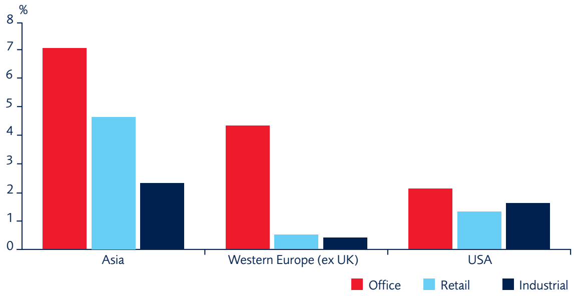
Rental fundamentals across almost all global property markets have seen improvements since last year, with demand gradually picking up and the supply of new space being relatively low. Most rental markets have now turned the corner and are seeing rental rises, or at least no further declines. However, there is a marked difference across regions; rental growth in the Asian markets has, by and large, continued to outstrip that of Europe and North America, while within each region some markets are powering ahead, leaving others in their wake. It is notable that core locations which are more globally facing are doing better than smaller cities that are more reliant on their domestic economy, particularly within Europe and the US.

> "It is notable that core locations which are more globally facing are doing better than smaller cities that are more reliant on their domestic economy, particularly within Europe and the US."

Looking at trends by property type, prime rents for the retail sector have been affected by below-trend spending in the shops by squeezed consumers. As a consequence, rental growth for prime retail has generally trailed behind that of the more resilient office sector, which has seen a more robust bounce back in demand from corporates looking to take quality space. Meanwhile, industrials in the Western world have trundled along relatively slowly, although rapid export growth in Asia has fuelled increasing demand for manufacturing and warehousing space in the region.

On the investment side, yield compression has continued, but at a much slower pace than a year ago. Yields in many markets have more or less stabilised recently, with supply being balanced by demand. In selected markets, prime yields have now fallen close to the low levels seen before the downturn. With capital still waiting to get into property, investors are finding it tough to find attractively priced prime stock, and are beginning to opt to take on a bit more risk in their search for value. That said, the primer end of secondary is being targeted far more than the weak secondary or tertiary end.

Forecasts of 2011 Prime Rental Growth



Source: DTZ (April 2011)

EUROPEAN MARKET DYNAMICS

	RENTAL	INVESTMENT
Office	- Europe's labour markets currently vary significantly: the peripheral economies are struggling with soaring unemployment, while Northern European economies are in far better positions. As a "global city", Paris is also benefiting from multinational businesses looking for new space. - Muted construction since 2008 has caused a lack of suitable prime space in some locations, helping to push up rents, although demand has been insufficient to drive rental growth across the board.	- The office sector is generally the most liquid in Europe, and sees the greatest investment volumes. Combined with upturns in rental prospects for some markets, investors have targeted offices, forcing yields down by the most of all sectors during the recovery. - The core office markets of the Northern economies have seen yields tighten significantly over the last year or more, although some Southern European markets are belatedly seeing yields fall, albeit from much higher levels.
Retail	- Retail sales have generally been weak, not just in the struggling peripheral economies but across most of Europe. Recent inflationary pressures have contributed to a squeeze in real spending power. - While the recovery in retail demand is modest at best, there has been very little new space added to the market and, by and large, rental falls are behind us. Indeed, prime rents in an increasing number of (mainly Northern European) markets are rising.	- Prime retail is viewed as a safe haven by many investors and, in stronger economies, the sector has been one of the main beneficiaries of the appetite for prime stock. Yields in some markets have reached levels close to the lows of 2007, although stabilisation has been seen more recently. - Retail yields in Ireland, Spain and Portugal remain elevated. There has been an increase in appetite for regional shopping centres, particularly extending into Eastern Europe.
Industrial	- Driven by strong external demand, new Eurozone industrial orders have continued to increase; manufacturing and export growth has been particularly buoyant in Germany. Despite this boost, industrial leasing activity has remained relatively slow as businesses continue their vigilance over costs. - Speculative supply has fallen to very low levels, bringing some relief to weaker markets. Declines in prime rents appear to be behind us for almost all markets, although strong growth is unlikely.	- The industrial sector has generally lagged in terms of the recovery in pricing. Yields still seem elevated, having not fallen as much as other property types. Most industrial markets appear to have stabilised recently, with only Eastern Europe seeing yield hardening over the first quarter of this year. - There remains a divergence between investor appetite for, and the pricing of, prime and secondary stock. Well-positioned, highly-specified buildings are targeted, while secondary assets are shunned.
Residential	- The bursting of house price bubbles across Europe, notably in Ireland and Spain, has led to a greater number of households living in rented accommodation. With economic recovery being accompanied by tightened availability of mortgages, apartments could see some rental growth. - The rental market is still largely regulated in countries such as the Netherlands. While regulation may lead to higher returns, secure tenancies in combination with an inflation-linked income element provide low-risk opportunities for institutions.	- Most European housing markets have seen either some degree of recovery, or have at least reached their bottom, supported by low interest rates. With rates rising, it will be interesting to see whether an increase in foreclosures and reduced mortgage affordability leads to another slump in prices. - Institutional investor interest returned to the residential sector last year, resulting in a number of large portfolio deals. Investment in student accommodation has also proven popular.

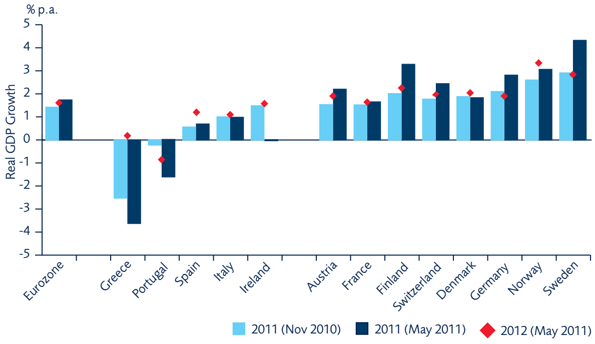
EUROPEAN OUTLOOK

Although Eurozone GDP growth improved in the first quarter of the year, the underlying trend continues to indicate that the recovery from recession remains fragile and blighted by the hangover from the financial crisis.

Within the region, the pace of recovery has varied significantly across countries, crudely operating on a north-south divide. Germany and the Nordics are experiencing relatively robust growth, while the peripheral economies of Southern Europe and Ireland (collectively labelled as the PIIGS) are still struggling with very low or even negative growth. Consensus forecasts in May for the Eurozone as a whole were for below-trend GDP growth of 1.7% for both this year and next.

Sovereign debt concerns have continued to weigh down on confidence in the PIIGS. Three of these countries have had to resort to bailout funding – with the possibility of Spain and/or Italy to follow. All of these economies have largely recognised the need to contain government debt and spending, although the resulting austerity measures are a significant drag on growth and unemployment has soared – more than a fifth of Spain's labour pool is currently out of work. By contrast, Germany, whose economy is almost equal to the combined size of the PIIGS, is currently in a relatively strong position, buoyed by booming exports and an unemployment rate which is at its lowest since reunification more than 20 years ago. With this in mind, it is perhaps not so surprising that the European Central Bank has started to raise interest rates, particularly with inflation above target, and further rate hikes are expected this year.

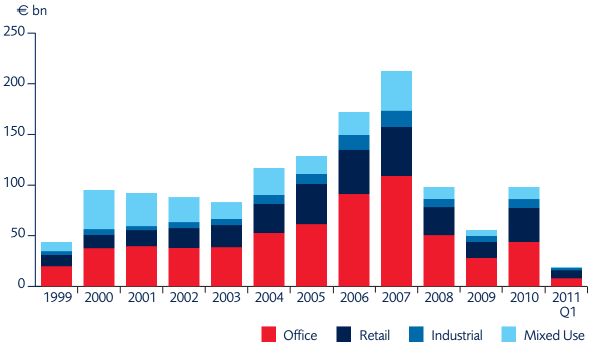
GDP Forecast Evolution



Source: Consensus Economics (November 2010 and May 2011)

Property occupier markets seem to have put the worst behind them, with very few seeing further falls in prime rents. With the exception of Dublin, high street retail rental markets have been either flat or have risen over the 12 months to March. Indeed, the only market outside of Dublin to see a prime rental decrease this year was Barcelona industrials. Generally, Northern Europe has seen stronger rental markets compared to Southern Europe. Looking ahead, office rents are expected to see stronger growth earlier, with retail rental growth lagging, hamstrung by squeezed consumers restricting retailer demand for space. Industrial rental growth is generally forecast to be fairly modest going forward.

European Investment Volumes



Source: DTZ Research (May 2011)

Property investment activity in Europe increased significantly during the final quarter of last year, but the volume of deals fell back again in the first quarter of this year to the levels seen earlier in 2010. Yield compression has continued in selected markets during the first three months of 2011, although the pressure on yields seems to have eased compared to last year - prime retail and industrial yields have been largely stable recently. The strongest investor demand has been in Paris, Germany and the Nordics, while property markets in the peripheral economies still have relatively high yields, reflecting greater investor concern over risk and weak fundamentals. Indeed, across all of Europe, investors have continued to target prime assets with secure income, and there has been little recovery in pricing for secondary property.

> **"…demand is likely to remain concentrated on prime assets in core markets with sound fundamentals. However, many investors are struggling to find attractive pricing for such property."**

Looking ahead, the fragility of European economic growth coupled with its very apparent risks mean that demand is likely to remain concentrated on prime assets in core markets with sound fundamentals. However, many investors are struggling to find attractive pricing for such property. As such, it is certainly possible that braver investors searching for better prospective returns will increasingly target riskier properties in weaker markets, potentially bringing about a closing of the gap in pricing that has opened up. However, the majority are likely to wait until confidence in sustainable robust economic growth returns before moving up the risk curve.

ASIA PACIFIC MARKET DYNAMICS

	RENTAL	INVESTMENT
Office	■ Supported by strong domestic employment markets and the continued expansion of international firms, demand for office space in Hong Kong and Singapore remains robust. Rents continue on the cyclical upswing with both markets witnessing 8-9% rental growth over the first quarter of 2011. ■ By contrast, occupational market fundamentals in Tokyo have deteriorated following the earthquake. Grade A office vacancy is starting to rise again after stabilising in late 2010.	■ The earthquake in March brought investment activity in Japan's property markets to a standstill. In the short term, investment sentiment is expected to soften further reflecting worsening market fundamentals. ■ Prime office yields remain very tight in Singapore and Hong Kong, leaving capital appreciation to be largely driven by rental growth. ■ Australian offices continue to attract both domestic and regional investors, helped by their strong fundamentals and relatively high income yields compared to other core markets.
Retail	■ Retail market fundamentals remain robust in Hong Kong and Singapore. As economic conditions strengthen, demand for prime retail space is recovering solidly. Whilst suburban malls and non-discretionary retail will continue to perform well in these markets, rental growth momentum is expected to be stronger in the prime retail segment. ■ Occupational market sentiments are weakening in Japan as retail sales continue to decline. Rents are under mounting pressure to fall further.	■ Supported by strong fundamentals and favourable rental growth prospects, Hong Kong and Singapore remain among the most attractive and tightly held retail markets in the region. ■ Retail's share of total transaction volumes in Australia over the first quarter of 2011 declined noticeably compared to the previous quarter. Investors are becoming more cautious amid weakening rental growth expectations. ■ Further capital depreciation in the short term is expected for retail assets in Japan.
Industrial	■ On the back of strong export growth and domestic consumption, demand for industrial space remains positive across the regional markets, except for Japan. ■ Rental growth in the modern logistics segment is expected to be particularly strong in Singapore. ■ In Australia, market fundamentals remain favourable in resource-rich markets such as Perth and Brisbane. Increased trade activity on the back of the strong Australian dollar continues to support the demand for logistic and warehouse space.	■ The industrial sector continues to attract strong interest from investors, with a noticeable increase in transaction volumes recently. Sentiment is expected to remain positive in the short term, supported by continued growth of international trade activity. ■ Against the backdrop of favourable fundamentals, prime industrial assets in Singapore and Australia should perform well, while Japan may struggle in the short term. ■ Yields are expected to strengthen further in Singapore and selected Australian markets.
Residential	■ The resumption of expat recruitment, particularly in Singapore and Hong Kong, is supporting residential markets. Rental growth is expected to stay strong, particularly in the mid to high-end segments. ■ Poor affordability, high mortgage costs and uncertainty in the housing markets are expected to contribute to the increase of rental demand in Australia. ■ As foreign direct investment resumes, emerging markets like Vietnam and Malaysia are also witnessing a strong recovery in demand for serviced apartments.	■ Whilst cooling measures are showing early signs of results in selected markets in China, investment sentiment remains strong in Hong Kong and Singapore. House prices continue to rise, particularly in the high-end segments, supported by strong demand from Chinese buyers. ■ In Japan, residential land prices are starting to stabilise which is expected to support housing market sentiment. Prices of new condominiums in Tokyo rose in April after a sharp decline in March.

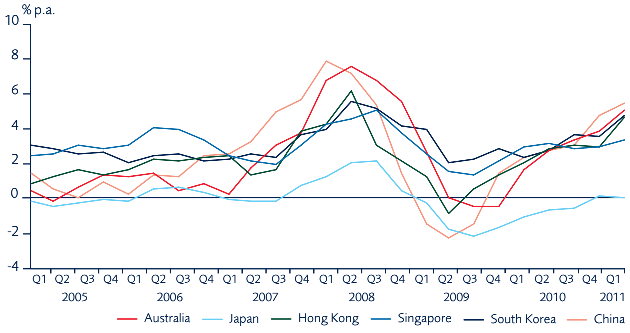
ASIA PACIFIC OUTLOOK

Despite the impact of the earthquake in Japan, major economic indicators have remained robust across the Asia Pacific region. Over the first quarter of 2011, Singapore GDP grew by 8.5% year-on-year while China led the region's economic performance with a 9.7% year-on-year growth.

The combination of positive business sentiment and strong employment markets continue to support private domestic consumption. Unemployment rates have fallen to pre-crisis levels in Singapore and Hong Kong, while retail sales remain strong in most economies except Japan. However, signs of overheating are starting to materialise in a number of economies. Tighter monetary policy in response to rising inflation could potentially dampen the region's growth momentum in the short term. Additionally, moderating US demand and the resurgence of Eurozone debt issues could increase the downside risks to the regional growth outlook. Nevertheless, increased intra-regional trade activity and supportive domestic demand are expected to partially offset any weakness in final demand in developed economies.

Property fundamentals are becoming more diverse. Strong employment markets continue to underpin demand for office space in Singapore and Hong Kong. Robust take-up in these markets has pushed average Grade A rents up by 8-9% over the first quarter of 2011. By contrast, demand for office space in Seoul remains relatively weak; as take-up fails to offset the increase of new supply, vacancy rates are rising across Seoul's major sub-markets, particularly in the CBDs. Against this backdrop, rental markets are expected to soften further over this year and next.

Retail Sales Growth is Recovering across Asia Pacific Economies



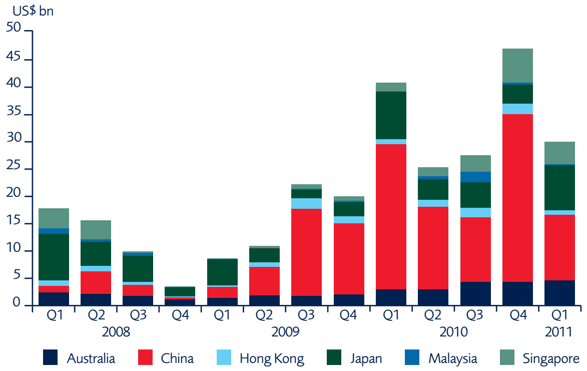
Source: Bloomberg (April 2011) * Consumer price index growth (Y-o-Y)

The retail sector paints a similar picture. On the back of robust domestic consumption and strong growth of intra-regional tourism, fundamentals within the Hong Kong and Singapore retail markets remain strong. Sub-regional and non-discretionary retail segments are expected to continue performing well, but rental growth momentum appears to be stronger in prime and high street retail. Despite solid economic performance in recent years, retail sales growth in Australia has been relatively sluggish over the last few quarters. Continued household deleveraging and uncertainties in the housing market are leading to a weakening in consumer sentiment, which will have a negative impact on retail demand and the rental growth outlook.

> "…the Tohuku earthquake has not caused a significant loss of physical buildings in Tokyo but the resulting disruptions are having a negative effect on corporate profits and the labour market… dampening prospects for a recovery in the rental markets in the short term."

In Japan, the Tohuku earthquake has not caused a significant loss of physical buildings in Tokyo, but the resulting disruptions are having a negative effect on corporate profits and the labour market. Demand for office space is, therefore, set to weaken in the short term. The industrial and retail sectors are also expected to experience similar drawbacks, dampening prospects for a recovery in the rental markets in the short term.

Quarterly Transaction Volumes



Source: DTZ ITD data (Q1 2011)

Looking at the capital markets, despite significant falls in investment activity in China, the region's total transaction volume has held up well over the first quarter. Supported by favourable market fundamentals and robust economic prospects, Hong Kong and Singapore remain attractive to regional and global investors. Competition to access these tightly held markets continues to support asset prices. However, after a period of strong compression, property yields have now stabilised at tight spreads over government bonds, leaving capital appreciation to be primarily driven by rental growth going forward.

In other core markets, Japan witnessed a strong pick-up in transaction volumes earlier in the year, helped by increased activity from J-REITs and domestic investors. However, the earthquake has brought the Japanese markets to a standstill with little transaction activity being reported since March. Foreign capital flows into the Japanese market could also be severely impacted as investors reconsider the risk premium. In the short term, asset values in Japan could correct further. However, continued support by the Bank of Japan for the J-REIT market is expected to support sentiment and underwrite market liquidity.

NORTH AMERICA MARKET DYNAMICS

	RENTAL	INVESTMENT
Office	■ As US corporate profits and the labour market improve, cautiously confident office tenants are gradually returning to the leasing market. Positive absorption was recorded in the final quarter of 2010. Vacancy rates have trended down, helped by improved fundamentals and restricted supply, and office rents have generally bottomed, with some rebound in the strongest CBD markets ■ Supported by falling unemployment, rents in some core Canadian office markets have stabilised or increased.	■ Robust demand for trophy assets in the "Gateway" office markets has led a two-tiered recovery in the investment markets. The cap rates of the top-tier core offices have continued compressing, widening the pricing gap between the prime and more secondary assets. ■ Yield levels in Canada have moved in for both CBD and suburban offices. Further compression is likely to be seen as resilient fundamentals and low interest rates are providing a supportive environment for investors.
Retail	■ Occupational demand for retail space picked up towards the end of 2010. Although rents in secondary locations moved slightly lower, top retail centres saw significantly better store profitability. Such dynamics will drive the outperformance of prime asset rental growth. ■ Boosted by improved fundamentals and the strong Canadian dollar, retail sales growth in Canada continues, although the pace has slowed recently. Bright prospects still attract foreign and domestic retailers, with further rental increases expected.	■ The concern over high vacancy rates continues to cast a shadow over the investment interests in the secondary markets. However, competition for limited prime stock remains fierce with renewed interests from listed and non-listed REITs buyers. Further cap rate compression has therefore been recorded. ■ In Canada, retail has been the best performer over the past two years. Substantial yield compression has driven the total return to 17.4% in the year to March 2011 according to IPD.
Industrial	■ Absorption for this sector has been positive for the last three quarters. Demand has been strongest in the national distribution hubs, while leasing activity in more regional markets has seen no substantial improvement. Industrial vacancy has declined, offering scope for rental stabilisation. ■ In Canada, a strong currency and soaring energy prices have affected industrial sector demand. Rents bottomed out last year following negative absorption in 2009; new completions should increase the availability of quality space.	■ Transaction activity for industrial properties surged towards the end of last year. This was led by the West Coast market, reflecting investor preference for international trade-related space. Pricing of the sector has shown some clear improvement with much keener cap rates being achieved. ■ Despite deteriorating rents, Canadian industrials have seen yields moving in over the last year, especially in the prime end of the market. Transaction volumes continue to rise.
Residential	■ Falling homeownership and a modest rebound in the labour market have led to strong apartment demand. Vacancy rates have fallen and rents are increasing on a national level; above-inflation rental growth is expected for the next few years. ■ In Canada, rental growth has accelerated, helped by little new supply and an improving job market. However, in some areas, such as Vancouver, the rush to homeownership is anticipated to have a negative impact.	■ Helped by their strong occupational fundamentals, multi-family assets have attracted great investment interest and meaningful rental growth. Cap rates have compressed, and REITs and other developers are quickly moving to begin new projects in an attempt to capture the relatively high expected investment returns. ■ In Canada, the best performing area over the first quarter was Lower Mainland, where the soaring demand from Asian buyers boosted a dramatic increase in unit sales.

NORTH AMERICA OUTLOOK

Helped by the Federal Reserve's monetary easing, the US economy managed to shrug off talk of a renewed dip in economic activity and the risk of deflation, expanding by an above-trend growth of 2.8% in 2010. However, the release of a low estimate for first quarter 2011 GDP renewed doubts over the sustainability of the recovery, and highlighted the risks posed by fading support from the government, a weak labour market, the struggling housing market and inflationary pressures from various sources.

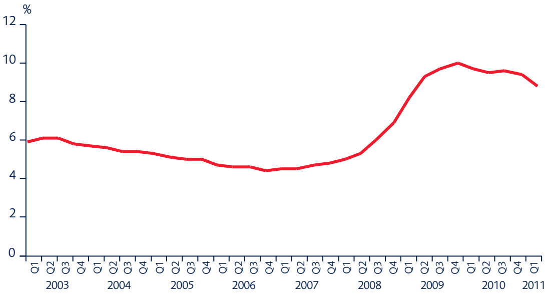
The true strength of the underlying economy might have been overestimated, but it seems most likely that the economy is still on track for a recovery, albeit a slow one; the Purchasing Managers' Index for the non-manufacturing sector indicated growth for the seventeenth consecutive month in April, while the unemployment rate has edged down below 9% due to job gains being made in multiple sectors. Such confidence has fed through into consumer confidence and retail sales, and international trading activities have increased as internal and global demand recovers.

Helped by the progress being made within the economy, real estate fundamentals are starting to improve for all property types. Apartments remain the best performer with strong occupational demand and positive rental growth. For other property types, vacancy rates have shown signs of improvement and rental cycles are approaching their troughs. Some rental growth has been seen in a few selected markets, and the expectation is now for rental growth to become more widespread as stronger demand for space is anticipated.

"On the financing side, debt is becoming more available for a wider range of assets. As investment conditions improve across a wider array of markets, lenders are now more capable and willing to realise losses, and are increasingly inclined to liquidate troubled loans."

Investment activity continues to improve in the US, but the increase in both transaction volumes and pricing remain concentrated in prime assets in the core markets. Secondary and distressed assets are still trading 50% below their peak values according to the CPPI index, confirming the persistence of a two-tier market which places great emphasis on underlying occupational strength and the risks to income. On the financing side, debt is becoming more available for a wider range of assets. As investment conditions improve across a wider array of markets, lenders are now more capable and willing to realise losses, and are increasingly inclined to liquidate troubled loans. In addition, since fierce competition has pushed the pricing of prime assets to levels which are less attractive to investors, the market is now expecting activity to increase for non-core assets, as well as for assets in secondary and tertiary markets.

US Unemployment Rate

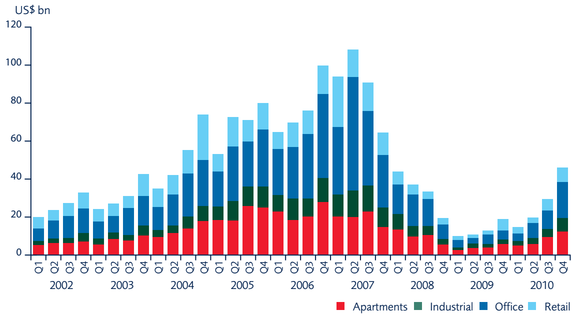


Source: US Bureau of Labor Statistics (April 2011)

Canadian GDP growth has seen a shaky increase so far this year following an impressive recovery to an annualised rate of 3.1% in 2010. Elevated energy prices and the Canadian dollar have posed a major challenge to manufacturing, wholesaling and transportation. Retail sales volumes have been dragged down slightly, not helped by inflation squeezing real spending power. The Bank of Canada still holds its target rate at 1% but, according to consensus opinion, rates are anticipated to rise again fairly soon. Fortunately, improvements in the labour market are cause for more optimism – the rate of unemployment has fallen steadily to 7.6%, while full-time employment growth has outpaced part-time.

Led by the retail sector, real estate markets in Canada have seen further recovery. Falling vacancy rates in the office and retail sectors have driven rents up. Significant yield compression has been seen across all the sectors due to the improving investment climate, with a strong preference for prime property. However, the pace of recovery in pricing is expected to slow. Indeed, further yield compression may only really be justified if a further material improvement in the fundamentals is seen.

US Transaction Volume Rising



Source: Real Capital Analytics (March 2011)
Note: Excludes privatizations. Only includes transactions of $5 MM and greater.

IN-FOCUS

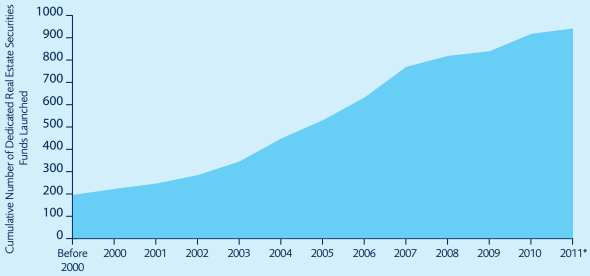
REAL ESTATE SECURITIES – A GLOBAL OPPORTUNITY?

Richard Gwilliam

The last decade has seen an explosion in the number of real estate securities funds that have been launched around the world. This has, in no small part, been aided by the rapid growth in REIT (Real Estate Investment Trust) legislation in recent years, opening the gates to tax efficient investment for real estate security investors. As recently as 1994, only five countries globally (most notably the US and Australia) had legislation in place; this has now grown to 20 countries, with 13 being added just in the last ten years, including in the Far East, the UK and other major European economies.

With REIT structures relatively immature in many markets, and many more countries looking to legislate and adopt REITs in the next few years, the securitisation of real estate is likely to continue growing. In their latest *Money Into Property* report, DTZ estimates that the total capital invested in property globally through public (i.e. listed) equity was around $800 billion in 2010, making up more than 7% of the total real estate invested stock – a fairly significant, and growing, share. With this in mind, and considering the growth in popularity of real estate security funds, what do investors need to know about the characteristics of real estate securities as a route to investing in property?

An Explosion of Real Estate Securities Funds Around the World



Source: Bloomberg, Macquarie Research (May 2011)
*2011 = January-April

Typically, investors in property look for high and stable income, good diversification characteristics compared to other assets, relatively low volatility and reasonable returns (though lower than they would expect from equities). The security of capital in real estate, including real capital during times of high inflation, is often cited as a significant motivation too.

Looking at this list of desired values, historic evidence shows that direct real estate investment globally has generally delivered these characteristics over the last 20 or 30 years (it is important to note that the relatively high volatility seen during the recent cycle has been significantly lower than comparative volatility seen in equity markets). However, it is useful to consider how the characteristics of real estate securities match up against this property investor wish list.

At a crude level, real estate securities as an investment asset class are a blend of direct property and equity investments. As such, they share many characteristics with both, but also have important distinctions.

For example, the illiquid nature of direct investment in bricks and mortar is well known, with the heterogeneous nature of assets obscuring pricing and valuation, "lumpy" lot sizes prohibiting direct investment for smaller investors and transactions taking months to complete and incorporating hefty fees to swallow.

> **"Real estate securities offer investors that are keen to access property a method of investing in bricks and mortar with liquidity."**

Real estate securities offer investors that are keen to access property a method of investing in bricks and mortar with liquidity; i.e. their liquidity characteristics have far more in common with equities – transparent pricing of property shares in easily digestible chunks that are quick, easy and cheap to transact. As such, it would appear that real estate securities potentially offer investors many of the desired attributes, but with the added advantage of liquidity.

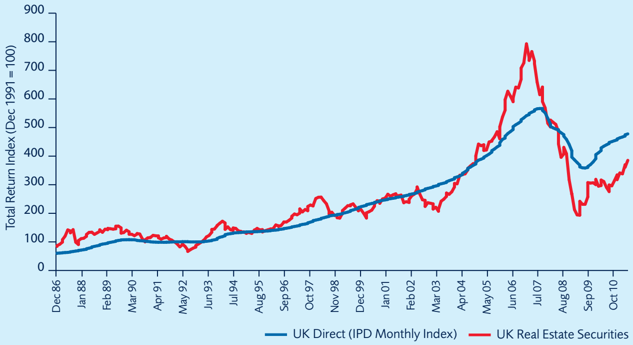
However, while real estate securities share liquidity characteristics with equities, they also share the short-term volatility common to equities. Indeed, the last few years has seen a particularly volatile cycle, with the 12 months to March 2009 seeing UK real estate security prices fall by almost 65%, before bouncing back by almost 60% in the following 12 months. Indeed, the single month of October 2008 saw a fall of 22%, when direct property fell by only 4%.

But real estate securities are distinct from general equities too. They are indeed recognised as an income-generating asset class, with investors benefiting from consistently higher income yields compared to the wider equities markets; a yield premium of around 2.5% has been averaged over the last 20 years when comparing global real estate securities (with an average yield of almost 5%) to the equities in the MSCI World Index. Investors are less focused on capital growth and instead are cognisant of the reliable, steady income stream. This is particularly the case for REITs, whereby the entities that own and manage the underlying income-producing properties distribute at least 90% of taxable income straight through to investors, thereby allowing exemption from corporation tax.

When looking at the diversification potential of real estate securities, it is important to note a distinction between the short term and the longer term. Analysis of the evidence globally suggests that over a relatively short period of months or a year, returns correlate pretty strongly with wider equity returns. This suggests poor diversification ability. However, over the longer term, say five or ten years, the correlation with equity performance generally falls, while a corresponding rise is seen in the correlation with direct property returns.

This dynamic extends to the volatility characteristics of real estate securities. As mentioned earlier, short-term volatility can be quite high, in line with wider equity volatility. This is largely a result of high liquidity enabling pricing to reflect short-term changes in sentiment, leading to large movements in prices away from the underlying property portfolio's Net Asset Value (NAV); i.e. periodically quite a large premium or discount to NAV. However, over the longer term, volatility of performance for real estate securities tends to track movements in the value of the underlying property.

Historic Performance Compared:
Direct Property vs Real Estate Securities



Source: IPD (April 2011)

Of course, looking at it another way, property valuations are known to lag transaction pricing and smooth out true volatility, so the premia/discounts implied by real estate security pricing can theoretically be used as a guide to inform how the values of direct property are likely to move. Analysis has been conducted on direct property values compared to real estate security pricing six months or a year earlier, which has shown that real estate security pricing is a fairly good lead indicator, with a 70-80% (or even higher) correlation with resulting direct property pricing movements.

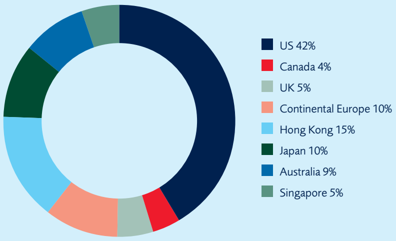
The smoothing of property returns that results from direct property valuation-based indices is well known. In addition, such performance indices are generally calculated on an ungeared basis, i.e. they show the returns of the underlying property and exclude the effects of leveraging. Clearly, using leverage increases risk for investors (while simultaneously increasing long-term return). Real estate securities often use gearing in their ownership of the underlying properties. A conclusion that can be drawn from this is that, over the longer term, real estate securities are effectively leveraged de-smoothed versions of direct property, with risk and return characteristics that reflect this.

So, while in the short term real estate security performance displays higher volatility than direct property, due in large part to liquidity, long-term investors can usually see through this volatility - indeed, in equity markets it often creates buying opportunities. Furthermore, investors worried about inflation can exploit the long-term fundamental link with property values to benefit from rising real estate security prices over a medium to long-term period if the economy undergoes a sustained period of high inflation.

"With a fully liquid securitised market operating in almost all major developed property markets, this route for investing in real estate opens the door to global diversification to otherwise frustrated domestic investors."

Finally, the liquidity constraints of investing directly in property are compounded when looking to invest overseas, outside of the familiar domestic market. Real estate securities offer relatively easy access for investors seeking diversification opportunities, particularly for investors wanting a balanced exposure to a large variety of global markets rather than a token lumpy direct asset in only a few. With a fully liquid securitised market operating in almost all major developed property markets, this route for investing in real estate opens the door to global diversification to otherwise frustrated domestic investors. In addition, specialised REITs (for example, those running shopping centres) allow investors to target particular areas of interest.

Global Real Estate Securities – Regional Breakdown



Source: CBRE FTSE EPRA/NAREIT Global Developed Index (as at the end 2010)

In summary, investing in real estate securities, potentially via burgeoning real estate security funds, offers investors an opportunity to invest in property with many of the desired characteristics, but with additional liquidity. Furthermore, it can be considered in a multi-asset portfolio, in conjunction with direct real estate, in order to boost diversification, particularly with regard to global diversification. With an increasing number of funds offering investment in global real estate securities, the popularity of the asset class is clear – and is likely to continue.

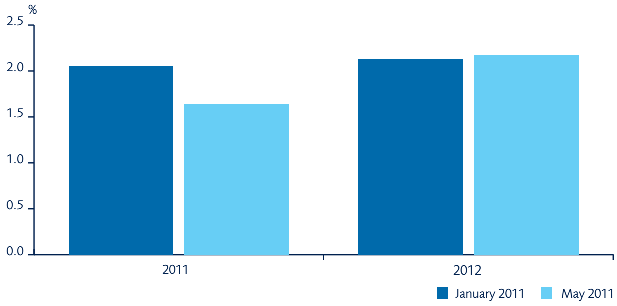
Many thanks to Gillian Tiltman, Fund Manager of M&G's Global Real Estate Securities Fund, for her contributions to this article

UK PROPERTY OUTLOOK

UK commercial property has maintained its modestly positive capital growth trend over the first quarter of 2011 according to the IPD Monthly Index and combined with the steady income return, a double digit 12-month total return was still achieved in the early part of 2011. The three main sectors of offices, retails and industrials are now performing roughly in line with each other. However, underlying these results, there is a significant geographical bias with London proving robust, but the rest of the UK remaining weak.

Such divergence is set to continue, at least in the short term, driven by occupational fundamentals. The Central London office and retail markets have seen rents rebound strongly since the beginning of 2010, while most other markets have continued to suffer from rental declines. However, there is increasing evidence that the falls in rents in other sectors are continuing to abate and, in some segments such as retail warehousing, rental growth is slowly returning. This stabilisation and return to modest rental growth is expected by most commentators to take another year (or more) to become widespread.

Forecasts of UK GDP Growth for 2011 and 2012



Source: Consensus Forecasts (January 2011, May 2011)

The occupational market conditions are indeed a reflection of the unbalanced recovery within the UK, where the provincial regions lag behind a resurgent London. Given the disappointing GDP estimates so far in 2011, the overall economic growth of the country is expected to be only around 1.5% for 2011. This is some way below trend growth over the past two decades, and it is also lower than the expectation for much of Europe. The major cutbacks in government expenditure, muted consumers' expenditure growth related to weak household finances, limited consumer credit, current inflationary pressure and employment concerns all overshadow the strength of the recovery. These factors have limited the revival of the real estate fundamentals, particularly in the regions.

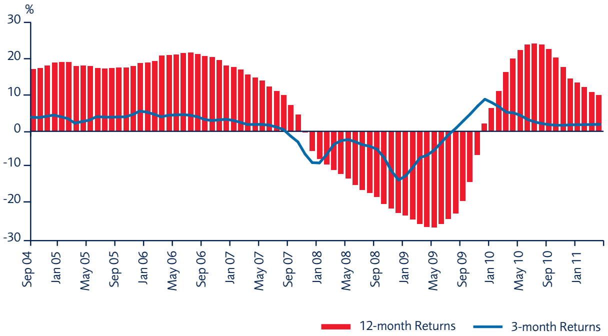
The transaction market remains active as a great variety of domestic and overseas investors continue to expand their property exposure in the UK. Recent data has seen UK institutional and overseas investors' appetite become more modest, and activity is now dominated by listed companies. The focus on prime, better quality assets with strong covenants continues to dominate investors' strategies. Meanwhile, pricing levels for prime assets have become even keener under fierce competition - even expensive in some selective markets. More aggressive pricing implies an even less attractive relative return from prime assets, and frustrated capital has started to cascade down into better quality secondary assets as investors search for yield.

At the other end of the spectrum, secondary assets suffering from shaky income prospects in less core markets continue to see only limited interest from investors, not helped by cautious bankers restricting funding. With economic fragility and downgrades to rental prospects recently, the risks over fundamentals for more secondary assets are likely to remain very much at the forefront of investors' minds. Therefore, the preference for prime is set to continue, and may only start to change when stronger rental dynamics become more widespread.

> **"With economic fragility and downgrades to rental prospects recently, the risks over fundamentals for more secondary assets are likely to remain very much at the forefront of investors' minds. Therefore, the preference for prime is set to continue, and may only start to change when stronger rental dynamics become more widespread."**

On a multi-asset level, UK property is still perceived as being more secure than equities and offering better value than bonds, and as a consequence, a wide range of investors are willing to stay engaged with property. The weakness of sterling certainly makes UK commercial property look significantly cheaper to overseas investors than in the past, and concerns over the potential for high inflation are also in favour of property investment due to its real asset characteristics and scope for inflation-hedging.

UK All Property Returns



Source: IPD Monthly Index (April 2011)

Looking ahead, with rental growth gradually improving and capital still targeting property, returns are likely to stay positive. Furthermore, differences in the attractiveness of pricing across the market, in terms of property type, location, quality of income and lease characteristics, mean that there is plenty of scope for investors to capitalise on the potential for outperformance.

GLOBAL PROPERTY OUTLOOK

With almost all property markets around the world having experienced some recovery, the salient questions to ask are to what extent they will continue to recover, and how this will vary. While it is impossible to answer these with complete certainty, recent events and the current economic backdrop should help to identify likely trends going forward.

The global economy continues to evolve, with the composition and drivers of growth changing on an ongoing basis. Developed Western economies have seen their power decline. Meanwhile, emerging economies, driven by China and India, have grown at an astonishing pace, gaining in terms of their share of global GDP and in their influence on the global stage. Increasingly, countries have had to consider the demands of these emerging markets – economies that have ignored them have suffered, while others have benefited by exploiting the trading opportunities.

According to DTZ's Money Into Property report, an important milestone was reached in 2010 in terms of the global property markets. For the first time, the Asia Pacific region saw the largest share of global transaction volumes, at almost $160 billion compared to $137 billion for Europe and only $47 billion for the US. In terms of market size (invested stock), Asia Pacific is not that far behind the US and Europe. The increasing size, and maturity, of the Asia Pacific property market has benefited investors who have targeted the region.

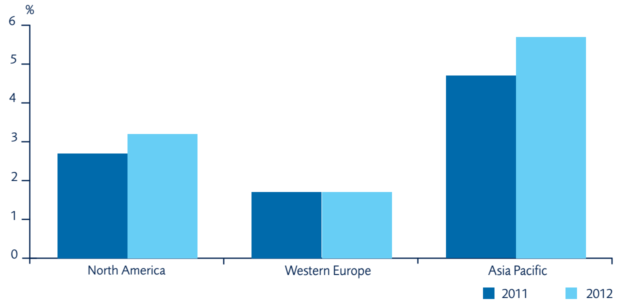
Economic and rental fundamentals for much of the Asia Pacific region still appear superior to those of North America and Europe. Very apparent risks such as sovereign debt issues weigh down on the European economies, while the US is also heavily indebted. A still fragile banking sector poses another risk to growth. Austerity measures are a large burden holding back growth in these regions too. The Asia Pacific economies, by contrast, are largely free of these characteristics (Japan excepted). Indeed, many economies in the region are aware of the risks of overheating, particularly in terms of inflation, and have already taken steps to tighten policy and slow breakneck growth – while interest rates are still extremely low in almost all developed Western economies. Consensus forecasts see the region's GDP growth outstripping Western Europe's by a factor of three over the next couple of years.

These economic dynamics positively impact demand for space from occupiers in Asia Pacific. While the construction of new space is generally much higher than in the West, rental growth projections still heavily favour the region. There are, however, some bright spots within Europe and North America, especially prime property in supply-constrained "global cities" where an increasing volume of tenants are expected to fight over a very limited amount of new quality space.

> **"These economic dynamics positively impact demand for space from occupiers in Asia Pacific. While the construction of new space is generally much higher than in the West, rental growth projections still heavily favour the region."**

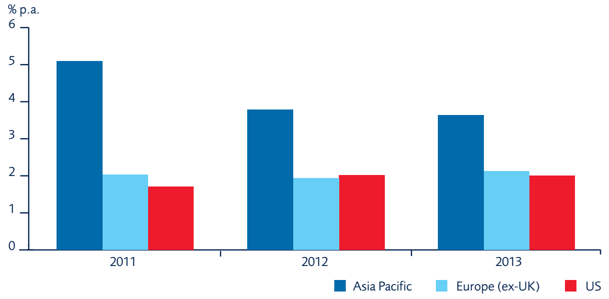
On the investment side, following the strong recovery in pricing of most global real estate markets, prospects for further yield compression are tentative. While most markets appear fair value (or better) when compared to current abnormally low risk-free rates, many actually appear overpriced against more normal long run "equilibrium" rates. A period of yield expansion is certainly possible in many markets, particularly if confidence over growth prospects weakens. It is notable that yields in many Asian markets are at very low levels – while relevant rental growth prospects are undoubtedly strong, investors need to be mindful that they aren't without risks, and that such yields may not be sustainable going forward.

Consensus GDP Real Growth Forecasts



Source: Consensus Economics (May 2011)

Forecasts of Global Property Rental Growth



Source: DTZ Research (May 2011)

GLOBAL ECONOMIC AND MARKET OVERVIEW

The first few months of 2011 saw investors' appetite for risky assets reduce amid a series of economic and geopolitcal events.

The year started with optimism over the global economic recovery, but this was replaced by uncertainty as the troubles in the Middle East and North Africa led to fears that higher oil prices might damage growth. Investors' resilience was tested again following the earthquake and nuclear problems in Japan and by the collapse of Portugal's government amid fears that the country would need a bail-out. News at the end of March that Irish banks would require an extra €24 billion in funding proved yet more unsettling. Against this backdrop, both equity and bond markets struggled to make progress.

After a dismal end to 2010, European equities posted some of the strongest regional returns over the first three months of 2011, helped in part by the strength of the euro which was boosted by expectations that the European Central Bank would raise interest rates soon. Investors appeared confident that markets had fully priced in any more bad news regarding the peripheral eurozone economies, while robust economic growth in the stronger Northern economies, particularly Germany, helped to underpin share prices.

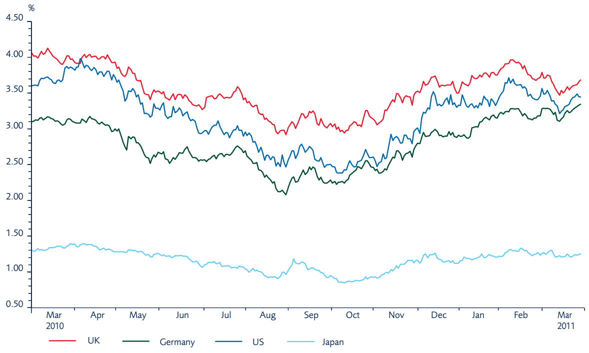
The US stockmarket also ranked among the best performers worldwide in the first quarter of 2011 thanks to a favourable combination of improving economic data and strong corporate earnings. However, in the UK, the FTSE 100 Index hovered around the 6,000 mark for most of the quarter, although this masked periods of severe volatility. Despite a positive contribution from UK manufacturing, GDP and unemployment statistics continued to paint a picture of an economy struggling to gain traction, and inflation remained a major problem.

Asia's stockmarkets came off worse than most as investor appetite for riskier assets dwindled and rising global commodity prices continued to feed through into domestic inflation, forcing policymakers to hike interest rates. However, Japanese equities proved to be the global laggards, recording the lowest returns over the quarter: the stockmarket lost 16% in the two days immediately following the earthquake and tsunami as investors focused on the economic repercussions of this disaster and awaited an update on the problems at the Fukushima nuclear plant. With a large number of factories shut, fears grew that constraints on supply would halt activity, while the Bank of Japan intervened to reduce the strength of the currency.

A tug of war emerged in the UK government market: better global economic data and the prospect of an interest rate rise pulled gilt yields higher, only for risk aversion amid uncertainty over the problems in Libya and Japan to push them lower. Gilts were also underpinned by investors' demand for safer assets because of concerns over the eurozone. Performance was better in the credit market where lower default rates, decent corporate earnings and reasonable economic data helped credit spreads to tighten. High yield bonds also did well, supported by investors' bias towards higher yielding assets, while index-linked gilts outperformed conventional gilts due to concerns that inflation might prove to be a longer term problem. In overseas bond markets, yields between short and longer dated US Treasury bonds widened, making the US yield curve even steeper. Meanwhile, 10-year German Bund yields finished the quarter at their highest level since January 2009 after the European Central Bank gave a strong signal that it would need to raise interest rates as early as May to stem inflation.

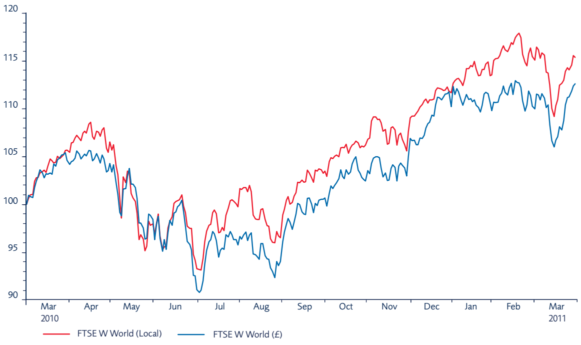
Looking ahead, inflationary pressures remain a key concern – and not just in Asia, since headline inflation in the UK and Europe remains above target. The European Central Bank has indicated that it will raise rates very soon. While stronger economies like Germany might be able to handle monetary tightening, the same cannot be said of the periphery where government spending cuts remain the order of the day. Meanwhile, in the US, despite the recent improvement in North American manufacturing and employment, the prospect of the end of the Federal Reserve's quantitative easing scheme is also causing uncertainty.

10–Year Government Bond Redemption Yields



Source: Thomson Reuters Datastream (March 2011)

FTSE World Index



Source: Thomson Reuters Datastream (March 2011)

DATA AND STATISTICS

PRIME RENTS

Region	Residential	Industrial	Office	Retail
Belgium	←→	←→	←→	←→
France	←→	←→	↑	←→
Germany	←→	←→	↑	←→
Italy	←→	←→	←→	←→
Netherlands	←→	↑	←→	↑
Spain	←→	↓	←→	←→
Sweden	←→	←→	↑	↑
Australia	↑	↑	↑	↑
Hong Kong	↑	↑	↑	↑
Japan	←→	←→	←→	↓
Singapore	↑	↑	↑	↑
South Korea	←→	←→	←→	←→
USA	↑	←→	←→	←→
Canada	↑	←→	←→	←→

Source: PRUPIM research drawing on various sources based on data available at end April 2011, reflecting recent trends

PRIME INVESTMENT YIELDS

Region	Residential	Industrial	Office	Retail
Belgium	←→	←→	←→	←→
France	↓	←→	←→	←→
Germany	↓	←→	↓	←→
Italy	←→	←→	↓	←→
Netherlands	←→	←→	←→	←→
Spain	←→	←→	↓	←→
Sweden	←→	←→	←→	←→
Australia	↓	↓	←→	←→
Hong Kong	↓	↓	←→	←→
Japan	←→	↑	↑	↑
Singapore	↓	↓	←→	←→
South Korea	←→	←→	←→	←→
USA	↓	↓	↓	↓
Canada	↓	↓	↓	↓

Source: PRUPIM research drawing on various sources based on data available at end April 2011, reflecting recent trends

Key				
Up ↑	Down ↓	Strongly up ↑↑	Strongly down ↓↓	Stable ←→

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ABOUT THE GLOBAL PROPERTY RESEARCH TEAM

PRUPIM's well known and widely respected Global Property Research Team, based in London and Singapore, comprises of 13 staff including nine property economists and three performance measurement analysts. The team engages in three main types of work namely; assessing the attractiveness of UK and international property markets, providing strategic recommendations and risk control measures for clients' funds, and conducting ad-hoc property related analyses on key issues as they emerge. The research team also assists in buy, sell and hold decisions by working closely with colleagues across PRUPIM to create a holistic approach to asset management.

BIOGRAPHIES

Paul McNamara, Director, Head of Research BSc (Hons) PhD ASIP FRSA OBE

Paul is responsible for the overall direction of property research within PRUPIM. He is also a member of the PRUPIM Board. Paul joined Prudential in 1987. He is a Visiting Professor with the Centre for Estate Management at Oxford Brookes University. Paul was appointed Chairman of the Investment Property Forum (2005-6). He has been Honorary President and Chairman of the Society of Property Researchers and is a non-executive director of IPD Holdings Limited. In June 2003, Paul was awarded an OBE in the Queen's Birthday Honours List for services to the property industry.

Scott Girard, Chief Executive Officer, PRUPIM Singapore, B.Comm MAF

Scott has been active in Asian real estate capital markets since 2002. Previously based in Korea and Japan for Jones Lang LaSalle, he has been involved at senior levels in investments, corporate finance, research and property advisory for a wide range of clients. Scott started his career in Australia in 1995 with ANZ Funds Management before moving into the consultancy business. He graduated from Curtin University of Technology with a Bachelor in Commerce and holds a Master of Applied Finance and Investment from Macquarie University.

REGULATORY INFORMATION

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PRUPIM'S GLOBAL EXPERTISE

- PRUPIM takes a disciplined approach to real estate investment management, supported by high quality research and analysis.
- We have a long history of investing directly in international property markets, which provides a depth of experience to our current operations.
- Our international operations have been built on tried and tested processes that have made us one of the UK's leading real estate investment managers.
- We benefit from the local presence of Prudential's international asset management businesses by working closely with M&G, PPM America and Prudential Corporation Asia.
- As part of Prudential, we are recognised worldwide and share a reputation for size, strength and integrity. This is a considerable advantage in developing relationships and initiating deals.
- We have established a worldwide infrastructure, partnering with the best regional advisers who bring expert local knowledge and exceptional asset management skills.
- The size of the assets we manage makes us a significant and recognised participant in the markets we invest in.
- We have developed a considerable in-house strength in structuring property deals and tax planning; processes which are critical in maximising the returns available.

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REAL ESTATE
INVESTMENT
MANAGEMENT

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