REAL ESTATE
INVESTMENT
MANAGEMENT

UNITED KINGDOM

REAL ESTATE PERSPECTIVE

1ST HALF OF 2009

Part of the M&G Group
PRUPIM

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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 £15.8 billion of real estate assets, of which £3 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 800 properties with approximately 4,500 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 11-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.

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Unless otherwise specified all data and commentary is as at end December 2008.

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

Manchester Arndale
Manchester

Oxford Science Park
Oxford

Cribbs Causeway
Bristol

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EXECUTIVE SUMMARY

PERFORMANCE

- The fourth quarter of 2008 saw the property market downturn accelerate to an unprecedented pace, with All Property total returns of -13% over the quarter – the worst three months on record, significantly sharper than the slump of the early 1990s. This caps off a terrible year for UK property, with returns over 2008 of -22.1%, the poorest nominal return in the 37-year history of the IPD Annual Index.
- The reacceleration of the downturn was driven by the double whammy of declining rents (down 1.4% over the quarter) and reignited yield expansion. Equivalent yields rose by more than 115 bps over the three months, bringing the overall increase during 2008 to well over 2%. Due to these two forces, capital values declined by more than 26% over the year, with values falling by 14.4% in just the final quarter.

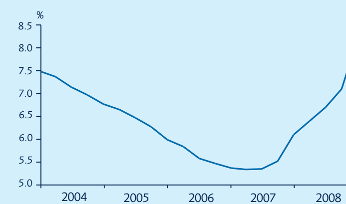
REVIEW

- With the UK officially in recession, and the last few months seeing a torrent of bad financial and economic news, demand for space by occupiers has declined rapidly and rents have started to see considerable downward pressure. Vacancy rates have risen and rental falls were in evidence across all property sectors over the fourth quarter, though retail and industrial rents held up far better than those in the more volatile office sector.
- On the investment side, sentiment has weakened further over the last few months as investors dealt with the escalation of the "credit crunch" and factored in a greater rental downturn than previously anticipated. With little interest from buyers, yields rose sharply over the last quarter, with an impact on values of almost 14%. Central London offices are beginning to show signs of being hit most, as the downturn progresses.

OUTLOOK

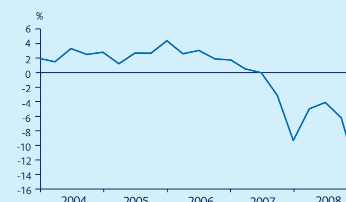
- The current consensus view sees the UK economy contracting significantly over 2009, with a downturn worse than the early 1990s recession. This drives falling demand for space, as retail sales plunge, companies fail or downsize and job losses mount. The Central London office market, in particular, will feel the effects from the hit to the financial and business sector, and rents here are expected to see the biggest declines.
- The latest consensus forecasts expect negative returns throughout 2009, before a modest recovery begins in 2010 at the earliest. However, the risk exists that, if banks act to call in loans and begin to work stock back onto the market as it begins to stabilise, the bottom of the market may be extended, leading to a more U-shaped recovery.

IPD Equivalent Yield for All Property



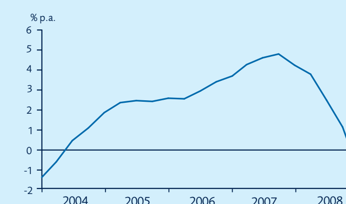
Source: IPD Quarterly Index (December 2008)

All Property 3-Month Yield Impact



Source: IPD Quarterly Index (December 2008)

UK All Property Annualised Rental Growth



Source: IPD Quarterly Index (December 2008)

3-Month Total Return

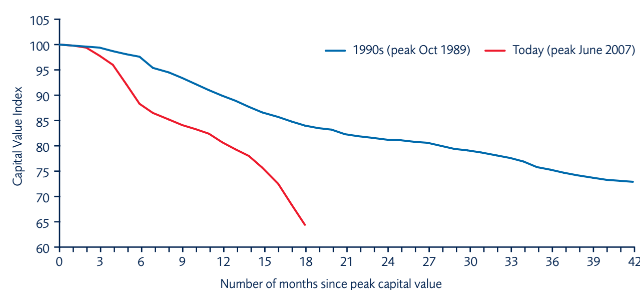
Source: IPD Quarterly Index (December 2008)

UK PROPERTY REVIEW

The fourth quarter of 2008 saw the property market downturn accelerate to an unprecedented pace, with the IPD Quarterly Index recording All Property total returns of -13% over the quarter – the worst three months on record, significantly sharper than the slump of the early 1990s. This caps off a terrible year for UK property, with returns over 2008 of -22.1%, the poorest nominal return in the 37-year history of the IPD Annual Index, and probably the worst since 1921 when earlier measurements began.

The reacceleration of the downturn was driven by the double whammy of declining rents (down 1.4% over the quarter) and reignited yield expansion, fuelled by plunging investor sentiment. Equivalent yields rose by more than 115 bps over the three months, bringing the overall increase during 2008 to well over 2%. Due to these two forces, capital values declined by more than 26% over the year, with values falling by 14.4% in just the final quarter. Values have now fallen by more than a third since the peak of summer 2007.

Current Downturn: Sharper than the 1990s



Source: IPD Monthly Index (December 2008)

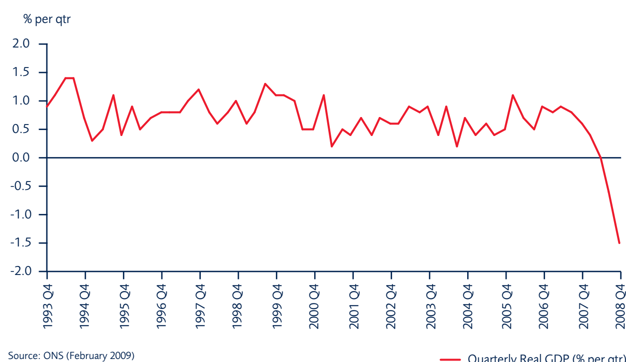
The dramatic deterioration in the economy is behind the events of the last quarter. With GDP contracting by 1.5% over the fourth quarter, the UK officially fell into recession. The global "credit crunch" entered a new phase with the bankruptcy of Lehman Brothers in September, and the following months were characterised by a torrent of bad financial and economic news. Stockmarkets plunged, and business sentiment and consumer confidence plummeted. The housing slump continued, with prices down around 16% over 2008, and weak consumer spending and retail sales have forced many famous high street fixtures, such as Woolworths, into administration. Job losses have mounted and unemployment is rising rapidly.

The property occupier market has clearly been hit by the economic downturn, with demand for space rapidly declining. With companies cutting back on their expansion plans and many downsizing or even going bust and vacating existing properties, rents have started to see considerable downward pressure. Central London offices, hit by the downturn in financial and business services, have moved fully into their rental downswing, with average rents 7-8% lower than a year earlier and the pace of decline accelerating. Rental falls were in evidence across all the property sectors over the fourth quarter, though retail and industrial rents held up far better than those in the more volatile office sector. However, while the demand side of rental markets is rapidly faltering, the supply pipeline has been relatively constrained compared to previous cycles, partly due to the lack of credit availability restricting financing for development. This has limited the downside potential for rents, though vacancy rates have already risen to levels not seen in many years.

"Despite interest rates being slashed to the lowest in the Bank of England's 315-year history, lending to property investors remains expensive and scarce."

On the investment side, sentiment has weakened further over the last few months as investors dealt with the escalation of the "credit crunch" and the impact on the economy, and factored in a greater rental downturn than previously anticipated. Despite interest rates being slashed to the lowest in the Bank of England's 315-year history, lending to property investors remains expensive and scarce. With little interest from buyers, yields rose sharply over the last quarter, with an impact on values of almost 14%. Shopping centres and retail warehouses were hit particularly hard, due to investors shunning large lot sizes, and secondary bulky goods type assets were at particular risk from the housing slump. These two segments saw the worst total returns over both the fourth quarter and the whole of 2008, while standard retails fared best. This said, Central London offices are beginning to show signs of being hit most as the downturn progresses.

UK in Recession



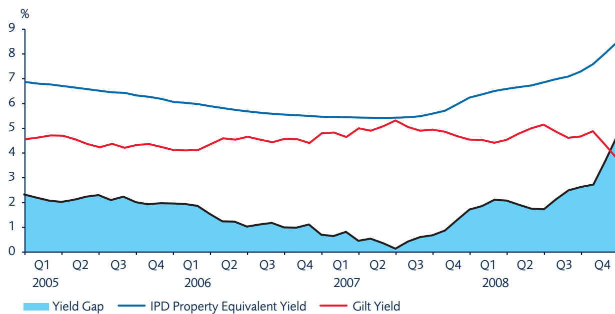
Source: ONS (February 2009)

UK INVESTMENT MARKET DYNAMICS

The current balance of factors still makes for a difficult environment for UK commercial property. There are some positive signs, such as the scale of the already realised re-pricing of the market, the substantial yield premium over government bonds and the weakness of sterling. However, these are still more than offset by the prevailing array of negative factors.

First, whilst it is true that UK direct property is now "fairly valued" or better in absolute terms, there are still a number of other asset classes and forms of involvement in property investment that are even cheaper. Many see equities, including real estate equities, and asset-backed bond instruments as unfairly marked down in price, and thus offering excellent investment value. This value will probably need to be mopped up first before capital returns to direct property in any scale.

Yield Gap Widens



Source: IPD Monthly Index (December 2008)

Second, notwithstanding the increased tales of growing interest in the market, little capital has yet to be committed. In part, this is attributable to persistent concerns over prospective rental growth, now that the financial crisis is affecting the real economy and reducing tenant demand for all types of property. It is also a realisation that a lot of the much-vaunted opportunity capital requires access to debt in order to be deployed. While debt remains hard to come by and expensive, much of this new capital will remain sidelined.

Not surprisingly in such an environment, the UK commercial property market remains quiet and cautious. Transactions remain at a very low level. Short-term expectations are for the market to remain difficult and under pressure over the first half of 2009. With rental falls becoming increasingly evident and widespread, capital falls still marked, continuing uncertainty (nay scepticism) over valuations and indices in a barely liquid market, restricted access to costly debt and the existence of many other competing investment opportunities, it is not surprising that the active demand for property remains thin.

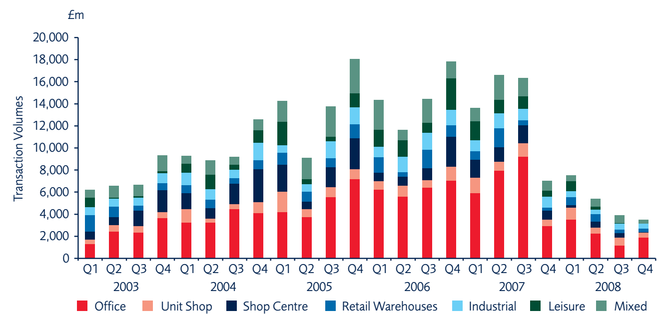
In such an environment of property price deflation and underlying risk, it is hardly surprising that those with equity are staying their hand to see how far prices will fall, whilst those who are currently braving the market are focusing on the best and safest assets available. As such, the current market is most active at the smaller lot size, primer end. Good high street shops are probably the most active property market at present. By contrast, larger lot size assets, secondary and tertiary properties and assets with weak covenants, or shorter unexpired lease terms, are all being shunned by the market.

In this respect, the shopping centre market is particularly hard hit combining large lot sizes, poor news flow on prospective tenant demand and localised spikes in supply. Central London offices face similar pressures, but at least have the advantage of international recognition and prestige at a time when sterling is weak.

"...larger lot size assets, secondary and tertiary properties and assets with weak covenants, or shorter unexpired lease terms, are all being shunned by the market."

Differential liquidity across the market is, in part, driven by the availability of bank debt. For smaller lot size high street assets, high net worth individuals are operating successfully, using their own capital. However, at only £20-50 million, it is said there are only a handful of banks willing to lend alone, and even then at a fairly demanding interest rate. Above £75 million, commentators suggest there are no banks willing to lend alone, resulting in the need for complex and time consuming syndications.

Sharp Fall in UK Investment Volumes



Source: PropertyData.com (January 2009)

At a sectoral level, most market commentators are favouring high street retail and industrials over offices. Almost everyone sees Central London offices facing short-term distress, with West End offices experiencing a material switch in investment sentiment. Everywhere, the focus is on initial yields and cash today, rather than equivalent yields and rent rises tomorrow.

RETAIL

PERFORMANCE

- Having remained relatively resilient for quite some time, retail underperformed offices and industrials over the fourth quarter. A sharp rise in yields, combined with rental growth turning negative, led to a return of -13.7% for the quarter, against an All Property average of -13.0%

- The retail sector ended 2008 with a 12-month return on the IPD Quarterly Index of -22.8%, the worst annual performance recorded in IPD's history. Yields rose by an unprecedented 120 bps in the final quarter alone and rents began to fall, leaving capital values down by 15.1% over the three months.

- Among the retail segments, variations in returns were largely driven by capital value falls. Retail warehouses continued underperforming, with retail park returns plunging 15.6% over the quarter. Central London shops and supermarkets saw capital and rental values fall to a lesser extent and, hence, were the only property segments where quarterly returns did not plummet into double digits.

OCCUPATIONAL DYNAMICS

- Unemployment is rising as house prices continue to fall, leaving consumer confidence low. Strict lending conditions persist and, with a nation of highly leveraged homeowners, repossessions in the UK are on the rise. Consequently, consumers remain cautious and unwilling to spend, and retail sales are declining.

- Against this backdrop, occupier demand for retail space is under pressure. Retailers have offered unprecedented discounts in an effort to boost sales, but the rise in import costs due to the weaker pound is eroding their already thin profit margins. The number of retailer casualties, both those operating in the high street and out of town, has surged, and more are expected to go into administration over the year.

- New supply for the sector is relatively constrained. The real concern is over existing space being pushed back onto the market as retailers collapse. This "shadow supply" faces falling demand, indicating a sharp increase in vacancy rates and downward pressure on rents.

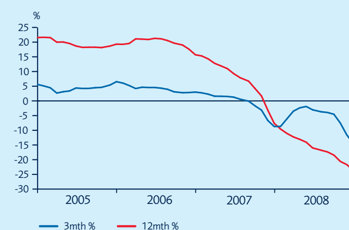
INVESTOR SENTIMENT

- Given their pricing has already moved a long way, high street shops have seen the least yield movement of all sectors recently, despite rising vacancy rates and the costs of incentives. They remain generally the most active part of the market, attracting high net worth individuals using their own equity.

- Transacting has almost ground to a halt in the shopping centre sector, due to a dearth of buyers rather than sellers – c.£2 billion of stock has been available for purchase, but only £150 million actually transacted in the final quarter of 2008. Large lot sizes, in particular, make accessing this market difficult. Similarly, retail parks are generally out of favour with investors, especially those of bulky goods type due to poorer rental prospects.

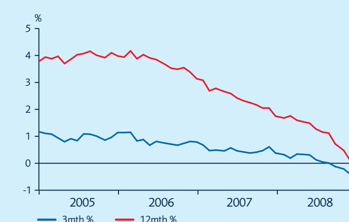
- Foodstores with inflation-linked rental growth and long leases to strong covenants are, hardly surprisingly, the most favoured of all property sectors. By contrast, there is little or no demand for leisure-related assets.

Retail Sector Total Returns



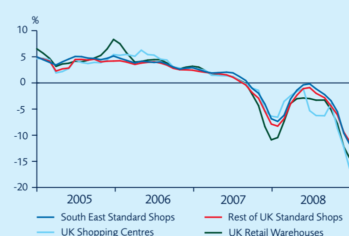
Source: IPD Monthly Index (December 2008)

Retail Sector Rental Growth



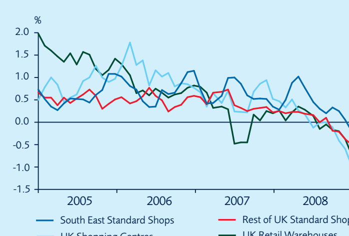
Source: IPD Monthly Index (December 2008)

Retail Sector 3-Month Total Returns



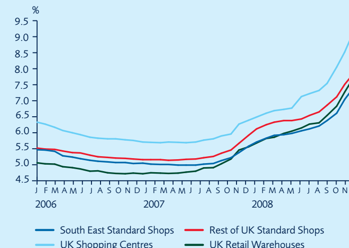
Source: IPD Monthly Index (December 2008)

Retail Sector 3-Month Rental Growth



Source: IPD Monthly Index (December 2008)

Retail Sector Equivalent Yields



Source: IPD Monthly Index (December 2008)

OFFICES

PERFORMANCE

- In the last quarter of 2008, the office sector was overtaken by retail as the worst performing sector. On the IPD Quarterly Index, annualised total returns for offices ended the year at -22.3%, while retail performed slightly worse.

- Office capital values declined by over 14% over the fourth quarter, driven largely by a rise in equivalent yields of around 100 bps. However, the rental side is increasingly adding to the misery and detracting from performance – the sector recorded average rental declines of 3.3% over the quarter, with the pace picking up.

- Central London continues to be badly hit; City office capital values fell by nearly 30% over 2008, and the rental downswing has now fully taken hold. The larger regional office markets are not faring much better – in Manchester, total returns were -14.6% in the last quarter alone. However, smaller markets in the South East, such as Windsor and Maidenhead, seem to be holding up a little more.

OCCUPATIONAL DYNAMICS

- With businesses severely impacted by the current economic downturn, the occupier office market continues to weaken. Business confidence reached an all-time low in the final months of 2008, which is reflected in a near stand-still in tenant demand. Over the year, Central London take-up fell to its lowest level in five years.

- Particularly notable in the fourth quarter was the worsening occupier market in the West End as negative rental growth accelerated to -8.4%. In the current environment, landlords' bargaining power is weak, and tenants, seeing narrowing profit margins, increasingly use break clauses to enter renegotiations.

- As credit remains tight, most of the development pipeline has dried up, easing the supply side. However, as some new product is expected to complete in 2009 at a time when demand is thought to be weakest, availability in Central London and the largest regional markets is likely to increase into 2010 – putting more downward pressure on rents.

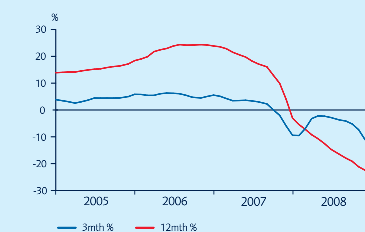
INVESTOR SENTIMENT

- Only those offices in the best locations, with long unexpired lease terms, little need for capital expenditure and strong covenants, are finding any favour with investors. This situation is most pronounced in the City where short-lease assets are being heavily discounted; steep rental falls and an emerging surfeit of space are facing the market short term, so covenant and long leases are critical to value.

- In the West End, conditions are challenging, but there is still some limited demand from cash-rich overseas private investors. However, mounting fears over rental prospects and the growing competitiveness of the neighbouring City market cause concern.

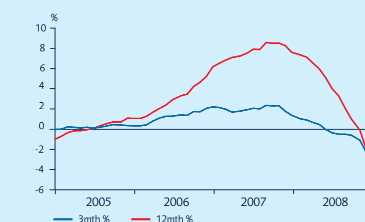
- The prevailing feeling is that the regional office markets will see rent falls but, having been less oversupplied, less so than in London. Nevertheless, transaction volumes are very low as overseas investors show little interest. As elsewhere, long lets to strong covenants (especially to Government) are very much preferred.

Office Sector Total Returns



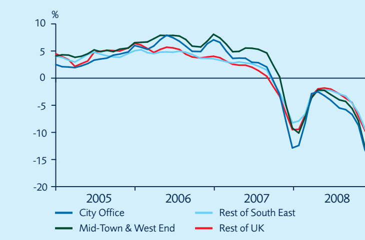
Source: IPD Monthly Index (December 2008)

Office Sector Rental Growth



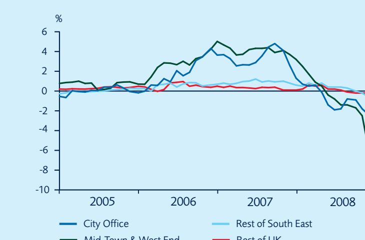
Source: IPD Monthly Index (December 2008)

Office Sector 3–Month Total Returns



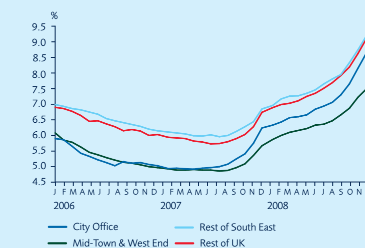
Source: IPD Monthly Index (December 2008)

Office Sector 3-Month Rental Growth



Source: IPD Monthly Index (December 2008)

Office Sector Equivalent Yields



Source: IPD Monthly Index (December 2008)

INDUSTRIALS

PERFORMANCE

- Capital decline for industrial properties accelerated sharply over the last quarter, with values on the IPD Quarterly Index falling by 13.7% – more than twice as fast as the -6.2% rate over the third quarter of 2008, and a record during the 23 years since IPD began recording monthly performance. The quarter drew to a close a year of terrible performance, with annual industrial capital growth of -25.7%.
- The quarter's dramatic decline in capital value is mainly attributed to a significant outward shift in yields, amounting to 130 bps. However, rental growth also deteriorated, with rents falling by 0.2% over the quarter, though the sector is holding up better than others.
- Total return worsened to an unprecedented -12.1% over the fourth quarter, compared to -4.7% over the third quarter. However, this compares favourably with offices and retails, partly as the higher yields we are now seeing for the sector offer better income returns.

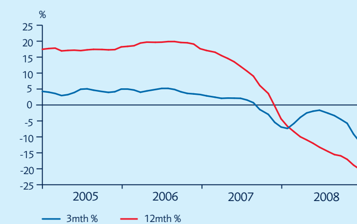
OCCUPATIONAL DYNAMICS

- Availability in the industrial sector has remained high. Moreover, it is still on an upward trend as the demand for space has started to show significant softening in line with the UK's rapidly contracting industrial output and economy. However, the supply pipeline is being choked off and speculative development is much reduced.
- Large industrial units have seen demand particularly affected as companies cut back on expansion plans, and incentives offered by landlords have increased. The hit to the country's retailers will also have a direct negative impact on industrial rents in the coming year.
- With the Government failing to meet the public expectation of empty rates relief, distressed landlords have started to take action either by filling the vacancies with weaker covenants paying lower rents, or by demolishing to avoid the cost liability. Short-term rental growth prospects are, therefore, dragged down. However, scarce development activities in the foreseeable future contribute to more robust longer-term rental growth prospects.

INVESTOR SENTIMENT

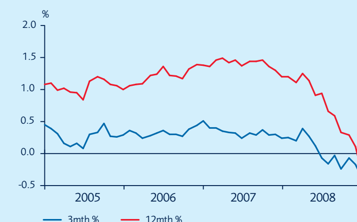
- Southern industrial assets are generally favoured over northern but, everywhere, there is concern over rental growth prospects as vacancies and the costs of incentives rise. The empty rates issue is increasing the risks relating to holding such assets in difficult letting times. Prime assets, let on long leases to good covenants, are seeing values holding up much better. Secondary assets are already on high yields and, in some northern towns, are almost unsaleable even at yields in the mid-teens.
- Distribution warehouses in southern markets can occasionally attract limited investor interest, even leading to some competition for the very best assets. However, pricing is almost entirely dependent on length of covenant; assets with 15 years unexpired terms are 300 bps lower than those with only five years unexpired. In the short term, there is still stock being delivered into the market, but the tap is now being turned off quickly.

Industrial Sector Total Returns



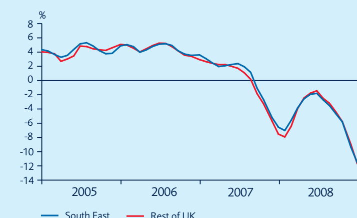
Source: IPD Monthly Index (December 2008)

Industrial Sector Rental Growth



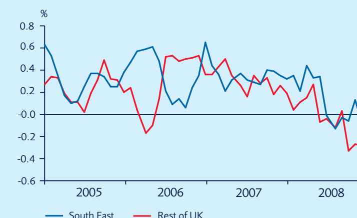
Source: IPD Monthly Index (December 2008)

Industrial Sector 3-Month Total Returns



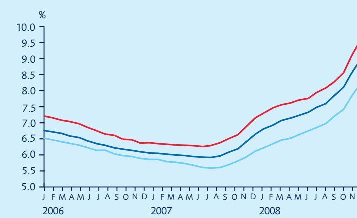
Source: IPD Monthly Index (December 2008)

Industrial Sector 3-Month Rental Growth



Source: IPD Monthly Index (December 2008)

Industrial Sector Equivalent Yields



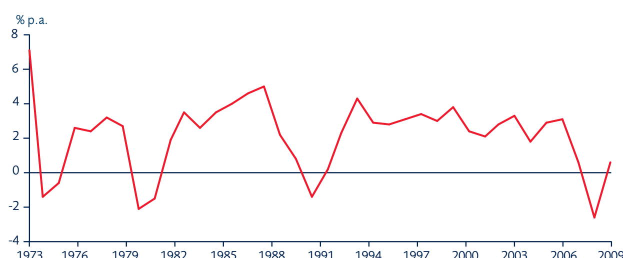
Source: IPD Monthly Index (December 2008)

UK PROPERTY OUTLOOK

By the end of 2008, the UK was officially in recession and, in line with falling indicators, the outlook for 2009 has deteriorated further. The current consensus view is that the UK economy will contract by -2.6% in 2009, which represents economic performance worse than the early 1990s recession. Moreover, the current recession is increasingly global in character, with the ongoing credit drought in the financial markets as its catalyst. Given the importance of the financial sector to the global economy, all eyes are currently on the measures taken by governments to keep the sector afloat.

In the autumn of 2008, the British government led the world by announcing its emergency package to recapitalise the banks, thus staving off a wholesale collapse of the financial system. However, only three months later, despite cutting base rates to a record low, Gordon Brown was pressed to launch yet another set of initiatives. The main part of the new plans is to provide the banks with an insurance against their worst losses on their worst assets. However, the announcements failed to stabilise the markets as they rattled over speculation of the total costs involved for the Government and taxpayer. While opinions differ on the effectiveness of the proposed measures, it is hardly surprising that the UK Government targets its many resources at the banking sector, given its importance to the whole of the UK economy: the output of financial and business services almost tripled over the past 20 years and its contribution to total output increased to approximately 30% in 2008.

UK GDP Growth



Source: Bloomberg (up-to-2007), EBS (2008 estimate, December 2008), Consensus Economics (2009 and 2010 forecasts, February 2009)

In the occupier market, the economic downturn is driving falling demand for space as retail sales plunge, companies fail or downsize, and job losses mount. Vacancy rates have been increasing rapidly, pushing down rents. Going forward, the Central London office market, in particular, will feel the effects from the hit to the financial and business sector, and rents here are expected to see the biggest declines. Events in the financial sector have also led to uncertainty as to what the banks might do with their commercial property loan portfolios going forward. The prevailing view is that, for a fee and an increase in borrowing rates, most banks will continue to roll over those loans that are covering their interest payments, even if they have breached other covenants. To do otherwise, and call loans in and recycle stock onto the market, is seen by many as a prospective "own goal" (as well as a potential "triple whammy" for the market, pushing values lower).

> **"...the Central London office market in particular will feel the effects from the hit to the financial and business sector, and rents here are expected to see the biggest declines..."**

The latest IPF consensus forecasts, published in November 2008, show how much contributors have been behind the curve; with only two months until year-end, total returns for 2008 were estimated at -16.8%, against an outturn of -22.1% on the IPD Quarterly Index. Given this, the expected returns for 2009 and 2010 may be revised downwards too. Indeed, a survey of leading commentators suggests that most feel the UK property market will not stabilise until at least the second half of 2009, while the majority see the likelihood of any signs of recovery now stretching into early 2010 at the earliest. However, the risk exists that, if banks begin to work stock back onto the market as it begins to stabilise, the bottom of the market could be extended, leading to a more U-shaped recovery.

IPF Consensus Forecasts for Total Returns November (08) vs September (08) % 2008 – 2010

	2008		2009		2010		2008–2012	
	Nov (08)	Sep (08)	Nov (08)	Sep (08)	Nov (08)	Sep (08)	Nov (08)	Sep (08)
Standard shops	-14.3	-7.9	-3.4	1.7	6.9	8.2	2.9	4.1
Shopping centres	-16.6	-9.6	-3.4	2.1	7.1	7.9	2.3	3.9
Retail warehouses	-18.4	-11.6	-4.7	0.8	6.3	8.4	1.6	3.5
Offices	-17.8	-11.6	-7.3	-1.7	4.5	7.2	0.5	2.7
West End offices	-19.0	-10.9	-10.5	-3.4	4.3	7.4	-0.6	2.5
City offices	-20.7	-16.1	-9.7	-6.2	3.8	6.1	-0.8	0.4
Industrial	-15.4	-9.1	-3.3	2.1	7.0	8.9	2.6	4.2
All Property	-16.8	-10.6	-5.3	0.5	6.2	8.0	1.7	3.5

Source: IPF Consensus Forecasts (November 2008 and September 2008)

IN-FOCUS

UNDERSTANDING THE VALUE OF "GREEN"

Paul McNamara

Obscured by recent cyclical market turbulence, a more long-term secular trend has been developing in the world of property investment; namely, the growing appreciation that the issues of climate change and sustainability are changing the context within which property investment and occupational decisions are made. Questions about sustainability are increasingly entering the decision making process about which properties should be occupied and bought, and how those properties should then be operated and managed.

This article briefly reviews the background to this changing context and reviews how and why it is beginning to impact property valuations and performance going forward.

SOME BACKGROUND

Through its development, use and ultimate demolition, commercial and domestic real estate is believed to be linked to approximately 50% of all carbon dioxide emissions in developed economies. As such, it is an obvious focus for both policymakers and activists concerned about sustainability and global warming. Policy development in this area is rapid at European, national and local government level, and embraces a very wide range of issues to do with, amongst other things, lowering carbon dioxide emissions, the efficient use of energy, water and other natural resources and reducing waste generation.

"...commercial and domestic real estate is believed to be linked to approximately 50% of all carbon dioxide emissions in developed economies."

Most significantly in Europe, we have recently seen the introduction of Energy Performance Certificates which, like the scheme used for refrigerators and cookers in our shops, grade and inform prospective purchasers and tenants about the energy efficiency of commercial buildings and what can be done to improve them. They allow tenants and investors, whether acting through their own volition or under pressure from activist shareholders and more demanding social values, to make more informed choices about what assets they rent and buy.

The effects of these policy and attitudinal changes have been most evident to date in the new development and construction sector, where the property industry has shown the greatest innovation and industry-led labelling schemes are being used increasingly to rate the environmental credentials of new buildings. Here, financial debate has tended to revolve around the scale of any potential additional costs of "responsible" construction, and the extent to which these are subsequently offset by lower running costs through the life of the building.

FOCUS ON EXISTING STOCK

However, the real estate industry is increasingly aware that, when considering how to react to the burgeoning sustainability debate, to focus solely on new buildings would be to miss the point – both from an environmental and an investment perspective. Developers deliver around 2% new stock per annum over a cycle. So, even if all new stock was as sustainable as possible, it would still form only a small part of the built environment and investment portfolios for some time to come.

Yet, until recently, there has been a general reluctance amongst investors to materially address the environmental impacts of existing property holdings, since many felt it might undermine investment performance. This was not wholly irrational, given precious little evidence to show tenants are prepared to pay higher rents for more sustainable accommodation. Clearly, expending capital to retro-fit buildings to reduce their environmental impacts, without recompense though higher rents or improved asset valuations, will harm investment returns and fund managers everywhere are highly focused on short and medium-term performance.

However, this is changing rapidly now, and property fund managers are increasingly wrestling with how to account for these new found concerns in their investment decisions and strategies, and what financially viable actions they can take.

Some have suggested that property "sustainability" represents a "third dimension" (additional to risk and return) for investors considering property investments[1]. However, the effects of sustainability can be reviewed in risk and return related terms and, in this regard, represent simply a new addition to the wide range of considerations property investors regularly make when evaluating property investments. "Sustainability" should simply be embraced into the appraisal process through an appreciation of how it impacts worth.

PRUPIM's GreenPark in Reading exemplifies how property can be sustainable

UNDERSTANDING THE IMPACTS

A simplified equivalent of the Gordon's Growth Model offers us a reasonable framework to illustrate how sustainability impacts property value:

$$P = \frac{R}{(Rf + Rp) - G}$$

Where,

P = property value

R = Rental income over the forthcoming year

Rf = Risk free rate

Rp = Risk premium

G = net rental growth rate (accounting for asset obsolescence)

If tenants become more concerned about environmental issues (or their corporate image through their "corporate responsibility policies"), they may increasingly exercise a preference to occupy "sustainable" properties[2]. This will inevitably lead to a differentiation in rental levels achieved between "sustainable" and "non-sustainable buildings". The resultant differences represent a form of accelerated depreciation leading to lower net income growth (G) in less sustainable buildings. Furthermore, less sustainable buildings are likely to be less energy (or water or waste) efficient. If this increases tenant costs, then less will be available to the landlord for rent. Consequently, rent levels fall for less sustainable properties or, over time, net rental growth (G) is lowered.

Not only will less sustainable properties command lower rents, they will take longer to re-let at lease end. This extended break in cash flow increases risk to an investor, for which an increased risk premium (Rp) should be demanded.

Similarly, if investors begin choosing assets more on sustainability grounds, then less sustainable properties will become more illiquid in comparison. If illiquidity is a form of opportunity cost, investors will naturally demand a higher risk premium (Rp) for these more illiquid, less sustainable assets.

So, using our Gordon's Growth Model framework, if, for less sustainable assets, net rental growth (G) and net rental levels (R) are lowered, and asset risk premia (Rp) are raised, then the price (P) for such assets must fall relative to more sustainable comparators. As these effects take hold over a number of years and "sustainability" issues contribute to new equilibrium pricing regimes for real estate, these effects cause less sustainable assets to underperform.

Clearly, when considering the scale of the impact of sustainability on property values, much depends on how much tenants and investors will care about such issues. The more they care, the greater the impact on value. Early impressions suggest they are going to care a lot! So, despite there being limited evidence to date of impact on value, most feel it is inevitable. The search is now on to calibrate and parameterise these effects and seek strategies to best cope with this changing investment context.

INVESTOR RESPONSES

It is the fiduciary duty of property fund managers to understand how sustainability impacts differentially on the varied forms of property they hold or might acquire for their portfolios. Smart investors are beginning to look at how to bias their funds towards more sustainable assets. "Responsible" investors are additionally looking for ways to improve the environmental credentials of current assets by all economic means available. Evidence suggests[3] that many simple asset management initiatives help reduce the environmental impact of properties. If these are low or no cost then, by definition, they can not threaten managers' fiduciary responsibilities. Amongst many other initiatives, PRUPIM is running an "Improver Portfolio" to explore such solutions on £500 million of existing assets. Clearly, as energy costs rise and technology costs fall, this range of cost-effective actions will grow and property owners should be able to do even more to reduce the impacts of their existing stock.

"It is the fiduciary duty of property fund managers to understand how sustainability impacts differentially on the varied forms of property they hold..."

There are also signs of this area maturing as an investment sub-sector. A number of green real estate funds of various types are now actively being considered or promoted. Socially responsible property investment funds will soon be entering our investable universe.

NOTES

1. For more information visit www.upstreamstrategies.co.uk

2. There are various definitions of a sustainable buildings, but generally they will include energy efficiency, water efficiency, good accessibility by modes of transport other than the car and good waste disposal facilities.

3. UNEPFI Property Working Group (2007): Responsible Property Investing: What the Leaders are doing. UNEPFI CEO Briefing. Visit www.unepfi.org/publications/property

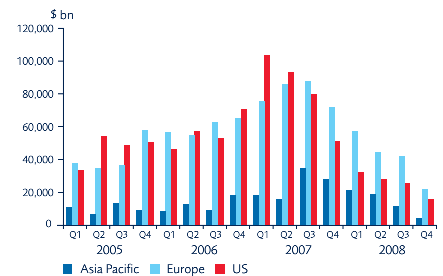
INTERNATIONAL PROPERTY MARKETS

GLOBAL REVIEW

The escalation of the global "credit crunch" has spread recession to all corners of the world, even to the previously surging emerging economies of Asia. As such, occupier demand has weakened and rental prospects in all property markets have deteriorated, with offices in financial centres being hit hardest. Most markets are beginning to see evidence of rental declines.

Deteriorating sentiment for property fundamentals, along with difficulties in accessing financing and general risk aversion by investors, has driven property re-pricing around the globe, with yields rising in all major markets. Investors have reverted to favouring prime assets in core markets. These entered the downturn first and will likely emerge into recovery earlier.

International Transaction Volumes



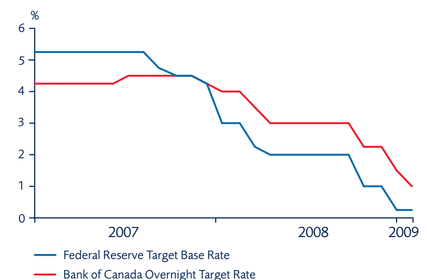
Source: DTZ Research, Real Capital Analytics (January 2009)
Note: Transaction volumes exclude hotel and residential investment transactions

NORTH AMERICA

Both the US and Canada are officially in recession and are seeing falling consumer spending and rising unemployment. With demand for space weakening, rental declines are beginning to be seen, particularly in those markets in the US where the housing slump is most acute. The outlook sees the rental downswing intensifying this year as recession continues to bite, despite interest rates being slashed – now down to effectively zero in the US.

On the investment side, with transaction volume way down, there is still a gap between the prices that buyers are willing to pay and those sought by holders of property. Yields are moving upwards, particularly in the US and for more secondary type assets.

Interest Rates: US and Canada



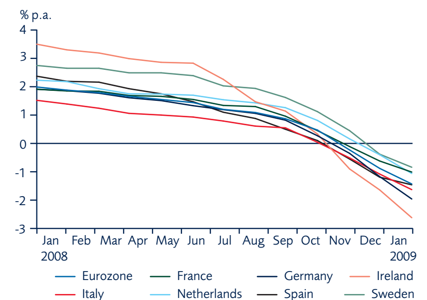
Note: Bloomberg (January 2009)

EUROPE

In 2009, expectations are for the large eurozone economies to be in or near recession. The financial sector already started contracting in 2008, and consumer and retailer confidence deteriorated rapidly. Against this backdrop, occupier demand is weakening. Prime rents are poised to fall most across all office markets, while retail and industrials will also experience downward pressure on rental growth.

Across Europe, there is little appetite for investment in property markets, and thus transaction volumes have fallen dramatically. Yields are generally following the upward trend led by the UK market, though to a lesser extent. Capital values for prime shops, while falling across the board, are holding up compared to the office and industrial sectors.

2009 GDP Forecast Evolution



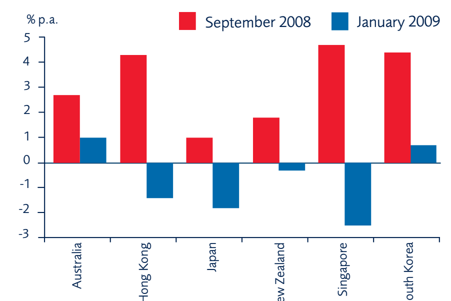
Source: Consensus Economics (January 2008 to January 2009)

ASIA PACIFIC

It has become clear that Asian economies are no longer immune to the impacts of widespread economic retrenchment in the West. More developed economies such as Singapore, Japan and South Korea are appearing to suffer the most, seeing their growth forecasts being downgraded significantly.

Mirroring the economic weakness, property markets are clearly under much pressure. Mounting evidence is suggesting that yields are starting to rise in some mature markets even though the pace, in general, is relatively subdued. Demand in occupier markets is also waning markedly, particularly in the office sector. On the back of new stock in the pipeline, rents are expected to fall almost everywhere across the region.

2009 GDP Forecast Evolution



Source: Consensus Economics (September 2008 to January 2009)

GLOBAL ECONOMIC AND MARKET OUTLOOK

As the full extent of the global banking and credit crisis was revealed during the fourth quarter of 2008, the downturn in the global economy gathered pace and spread to all areas of activity.

The collapse in credit availability and consumer demand triggered by the failure of US investment bank Lehman Brothers in September deteriorated further during the quarter. A breakdown in trust led to a virtual halt in interbank lending in financial markets, and the escalation of the credit crisis seriously undermined investor confidence around the world.

Despite state recapitalisation of banks in many countries and a series of central bank interest rate cuts, it became clear that the global financial turmoil had seriously damaged the world economy and that a sharp downturn was in prospect. Surveys of both service and manufacturing activity fell to record low levels, exports plummeted as global demand retreated and companies began to announce jobs cuts and plant closures. The magnitude of the slowdown prompted governments from leading economies, including the US and China, to propose multi-billion dollar stimulus packages in an effort to soften the economic gloom.

Commodity prices continued to decline through the three-month period, led by the oil price, which fell back to below $40 a barrel – a level last seen in 2004. As a result, inflationary pressures retreated, and market commentators began to consider that deflation was a distinct possibility.

With the outlook for company profits deteriorating sharply, and business and investor confidence plunging, global stockmarkets fell and volatility reached extreme levels. The flight to perceived safe havens such as government bonds drove yields down to their lowest levels in 30 years. US corporate bonds, however, continued to be weighed down by expectations that defaults could potentially exceed levels seen during the Great Depression in the 1930s. Against this adverse market environment, commercial property saw further falls in value during the quarter.

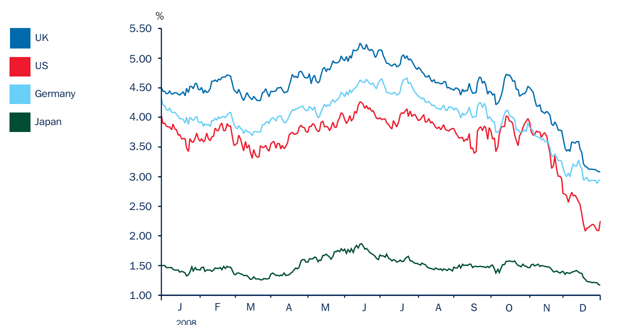
The world enters 2009 with most major economies already in recession – the severity of which will depend largely on the effectiveness of government efforts to recapitalise the banks and to restore the flow of credit to businesses and housing markets. Admittedly, the size of the various public sector stimulus packages announced to date has been impressive, and more is expected. However, much of the stimulus will not come into effect until the second quarter of 2009 at the earliest.

The markets' anaemic response so far suggests that investor confidence has been paralysed by worries about joblessness and business failures. It seems that investors' investment time horizon has shortened so dramatically that they cannot see beyond the immediate future as fear overtakes rational behaviour. Stockmarket valuations, as a result, have fallen to levels not seen in decades, driven by a massive liquidity preference among investors.

Meanwhile government bonds, most notably US treasuries, have become expensive. In most cases, government bond yields have fallen to levels lower than the prevailing level of inflation. However, with risk aversion still prevalent in the market, government bonds should continue to perform well against a background of falling interest rates. Indeed, on 7th January, the Bank of England reduced the base lending rate still further, this time by 50 bps to 1.5% – the lowest level in over 300 years. Nevertheless, investment grade corporate bonds are in a position to do even better, in view of where their respective yields are currently.

In conclusion, risky assets have fallen to extremely attractive levels: current equity valuations are very depressed and already appear to be pricing in a fairly severe recession whilst corporate bonds have priced in an extremely pessimistic default outlook. Although investors should be well compensated for taking on risk, fear remains the hurdle that needs to be overcome before any significant recovery can be seen. Therefore, until there are firmer signs that the situation has stabilised through the efforts of state and central bank intervention, investors are likely to continue to prefer the security of government bonds and cash, and shun riskier assets such as equities and corporate bonds even though better value is to be found in these given the considerable rise in risk premium.

10–Year Government Bond Redemption Yields



Source: Datastream (December 2008)

FTSE World Index

Source: Datastream (December 2008)

DATA AND STATISTICS

PROPERTY PERFORMANCE METRICS (%)

Index	Frequency	Date	1 month	3 months	Calendar YTD	1 year	3 years*
IPD Monthly Index	Monthly	Dec-08	-5.3	-13.5	-22.5	-22.5	-4.7
CBRE Monthly	Monthly	Dec-08	-4.3	-13.7	-22.1	-22.1	-4.3
IPD Quarterly Index	Quarterly	Dec-08	-	-13.0	-22.1	-22.1	-4.2
IPD Annual Index	Annual	Dec-07	-	-	-	-3.4	10.8

Source: Various (compiled by PRUPIM performance measurement team)
* Annualised

PRIME HEADLINE RENTS - £ PER SQUARE FOOT PER YEAR

	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
Region	Dec-08	% change over quarter	Dec-08	% change over quarter	Dec-08	% change over quarter	Dec-08	% change over quarter	Dec-08	% change over quarter
Central London	525.0	0.0	97.5	-11.4	-	-	-	-	-	-
Sub London	315.0	1.6	32.5	-14.5	-	-	-	-	8.3	-2.9
London	-	-	-	-	28.5	0.0	-	-	13.0	0.0
South East	275.0	0.0	28.0	0.0	28.0	1.8	42.0	0.0	7.5	0.0
South West	250.0	8.7	27.5	0.0	22.5	0.0	60.0	-14.3	7.0	-9.7
East Anglia	200.0	0.0	21.5	0.0	23.5	4.4	27.5	-15.4	-	-
East Midlands	245.0	0.0	-	-	-	-	35.0	0.0	5.3	-
West Midlands	250.0	0.0	28.5	-5.0	21.5	0.0	50.0	0.0	5.5	-8.3
Wales	320.0	3.2	20.0	0.0	17.0	0.0	25.0	-5.7	-	-
North East	300.0	-4.8	23.0	0.0	16.0	0.0	27.5	-8.3	-	-
North West	300.0	-4.8	28.5	-5.0	20.0	0.0	55.0	0.0	5.5	0.0
Yorks & Humbs	280.0	-6.7	27.0	0.0	20.0	0.0	35.0	-12.5	5.5	0.0
Scotland	250.0	0.0	29.0	0.0	20.0	0.0	40.0	-11.1	6.5	0.0

Source: PRUPIM
Data refers to PRUPIM's estimates of prime rents and yields for the best locations in the regions in question
*Rents refer to a prime restricted use retail park

INVESTMENT YIELDS (%) FOR PRIME PROPERTIES

	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
Region	Dec-08	% Change over quarter	Dec-08	% Change over quarter	Dec-08	% Change over quarter	Dec-08	Change over quarter	Dec-08	% Change over quarter
Central London	5.3	0.3	6.0	0.5	-	-	-	-	-	-
Sub London	6.0	0.5	8.0	0.8	-	-	-	-	8.0	1.3
London	-	-	-	-	8.0	-	-	-	7.5	1.0
South East	6.5	0.8	7.8	0.5	9.0	1.0	7.0	0.5	8.0	1.0
South West	6.3	0.3	7.8	0.5	9.5	1.5	8.3	1.3	8.3	1.3
East Anglia	6.3	0.5	8.0	0.5	9.0	0.5	7.5	1.0	-	-
East Midlands	6.3	0.3	-	-	-	-	7.5	0.5	8.0	1.0
West Midlands	6.3	0.3	7.8	0.5	9.5	1.0	7.3	0.3	8.0	1.0
Wales	6.3	0.8	8.3	0.5	9.5	0.8	7.5	0.5	-	-
North West	6.3	0.5	7.8	0.5	9.0	0.5	7.3	0.3	8.0	1.0
Yorks & Humbs	6.3	0.3	8.0	0.5	10.0	0.5	7.3	0.3	8.0	1.0
North East	6.3	0.3	8.5	0.5	-	-	7.8	0.8	-	-
Scotland	6.3	0.5	7.8	0.5	9.0	0.5	7.8	0.8	8.0	0.8
Northern Ireland	6.3	0.5	8.5	0.5	-	-	-	-	-	-

Source: PRUPIM
Data refers to PRUPIM's estimates of prime rents and yields for the best locations in the regions in question. Yields rounded to nearest 25bp
*Yields refer to a prime restricted use retail park

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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 11 staff including seven 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 is Honorary President and a past Chairman of the Society of Property Researchers and 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, Director, Research and Investment Strategy, 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

For Investment Professionals only. No other persons should rely on any information contained in this document.

Past performance is not a guide to future performance and the value of investments can fall as well as rise. Property is valued by an independent valuer. However, valuations are subjective and may vary between valuers. Commercial Property is a specialised sector and has different characteristics to investments in equities, bonds or residential property.

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