UK Quarterly Property Snapshot

The economy

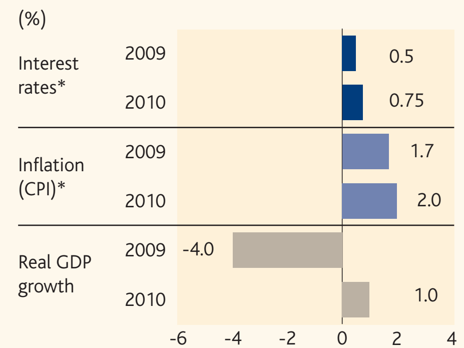
Recent performance

- In light of the deepest recession in the post-war period, the Bank of England left interest rates unchanged at a historic low of 0.5% for the fourth consecutive month in July. The Bank announced that it would continue with its £125 billion programme of quantitative easing, which aims to boost demand for riskier assets by financial institutions and encourage banks to increase lending.
- Output levels have followed the negative trend of the previous two quarters. GDP declined by 2.4% in Q1, following a 1.8% drop in Q4 2008. The large fall in output was driven by a sharp decline in business investment, as firms struggle to access credit. Moreover, firms have reacted to plummeting demand by liquidating excess inventories on a large scale, accounting for a large portion of the decline in GDP.
- The unemployment rate reached 4.8% in June, though the pace of increase is beginning to slow. Surprisingly, the fall in employment is yet to rival the recession of the early 1990s, despite a much deeper drop in economic activity, possibly reflecting greater flexibility of the labour market. Consumer spending fell by 1.2% in Q1, the largest decline since 1980, mainly driven by a substantial decline in car sales. Car sales have shown signs of stabilisation in the recent months. Expenditure on discretionary consumer services are still weak, particularly in the leisure and the restaurant trade.
- House prices rose by 0.2% in June following a 1.9% rise in May, while estate agents have reported that buyer enquiries are rising strongly off a low base. The number of loans for house purchases is rising gradually as mortgage credit restrictions limit the flow of new loans. A distinct lack of forced sales, amid very low interest rates, has helped to put a floor under house prices.
- Inflation declined to 1.8% in June on the CPI measure, dropping below the 2% government target. Excluding indirect taxes like VAT, inflation is however higher at 3.1% on an annual basis. Falling energy and food costs account for below target inflation, but deflationary trends in the goods sector have eased because of sterling's devaluation. There are few signs of economy wide deflation, with negative RPI inflation skewed by mortgage interest rate cuts and falling house prices.

Outlook

- The prospects for the UK economy are difficult in view of the large relative size of the financial sector and high household indebtedness. However, the pace of contraction is expected to slow significantly in the quarters ahead. While manufacturing activity has bottomed out, private demand conditions remain weak and are expected to stay so throughout the year, with only a gradual recovery expected in 2010.
- We expect sterling's large devaluation to boost exports and manufacturing activity next year, although unemployment will not peak for at least 12 months. This will restrain household spending, as will a sharp reduction in household wealth. A flat outlook for consumer spending in 2010 is still a relatively good performance in view of the large debt overhang that households are bearing. Very low interest rates have given a considerable boost to household finances.
- A mild housing market rebound shows that interest rate cuts have been partially successful in mitigating the damaging effects of de-leveraging. The pace of decline in house prices is likely to be significantly less going forward than the near 20% drop recorded since 2007. However, corporate activity is unlikely to gain traction as improvements in credit market conditions have yet to translate into better availability of bank lending. For this year we expect GDP to fall by 4.0% and show a subdued 1% increase in 2010, but this is still a better performance than the eurozone.
- Confidence in UK policy has taken a severe knock from an explosion of the budget deficit. Net public debt will more than double in the next few years from a relatively low 36.5% of GDP in 2007/08. We expect the Bank of England to compensate for necessary fiscal tightening by raising the quantitative easing target of £125 billion. However, we expect the bank rate to rise to 0.75% in the second half of next year, as current policies will sow the seeds for above trend growth and higher inflation from 2011.

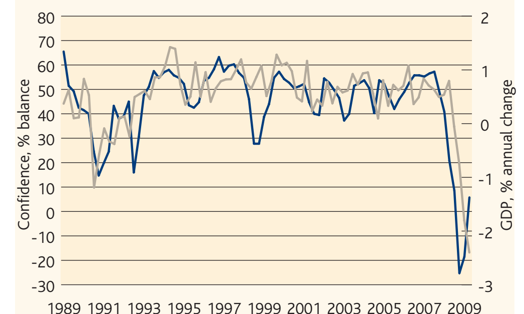
Economic forecasts



* Year End

Source: Aberdeen Property Investors, EcoWin Reuters

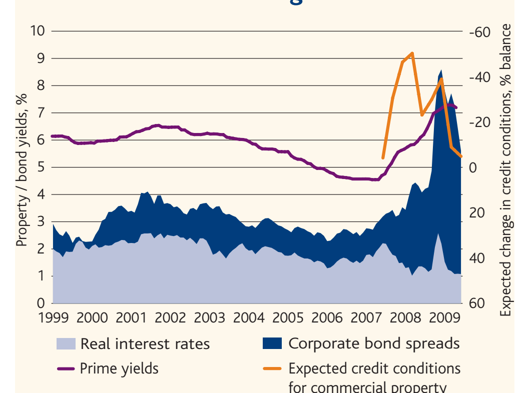
Business confidence rebounds, but is still weak



Confidence in future activity — GDP (RHS axis)

Source: Aberdeen Property Investors, EcoWin Reuters

UK credit conditions begin to ease



Source: Aberdeen Property Investors, EcoWin Reuters

UK Quarterly Property Snapshot

Property market overview

Recent performance

The pace of capital value decline has slowed dramatically in Q2 2009. Prime yields in all sectors have been stable for as long as six months now, and have started to fall in some markets. Secondary property values have continued to decline, but much more slowly than was experienced earlier in the year.

In the occupier market, the pace of rental decline has begun to show signs of stabilising. Rents are currently falling by an annualised 9% and 6% respectively in the retail and industrial sectors. The office sector is experiencing a sharper pace of decline, at an annualised 15%, although this is down from the 20% seen last quarter.

Investment transaction levels started to pick up in June, off a very low base. The depreciation of sterling over the past year (despite its recent uptick) has supported more overseas investor interest. Demand has been strongest for small lot sizes of less than £20 million, let on long leases to blue chip tenants.

There has not been the flood of investment stock onto the market that many commentators feared at the start of 2009, which would have triggered a more pronounced decline in capital values. Property companies and REITS have raised over £3 billion over the past six months via new share issues. This has reduced the need for them to sell property. Institutional investors are now reluctant to sell at what they perceive as 'bottom of market' prices. Finally, banks are generally turning a blind eye to loan-to-value covenant breaches on loans where interest costs are well covered, and restructuring and extending the life of these loans. They are mostly taking the view that they would only achieve a 'fire sale' price if they disposed of the asset, which would force valuations lower again, and compound their problem.

Retail

- Retail rents are falling at the fastest pace since monthly records began in 1986, but more slowly than in the office sector. Retail parks are seeing the sharpest decline at an annualised 10.7%.
- The gap between prime and secondary yields continues to widen. Yields for prime shops and retail parks have stabilised and started to fall in the last quarter, with increasing demand seen for high quality stock, let on long leases to strong tenants.

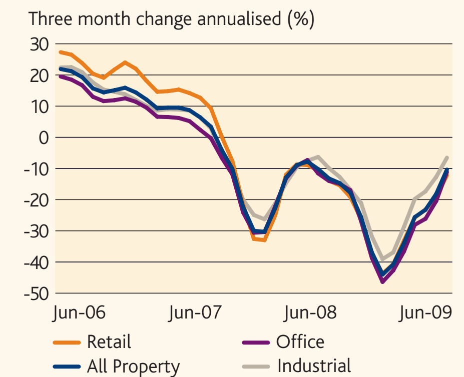
Office

- Office rents fell at an annualised rate of 15% in June 2009. Rents in the City fell at an annualised rate of 19% for the three months to June. This represents a slowdown in the rate of decline, with prime rents having already fallen dramatically to approximately £40 per square foot from £67.50 two years ago. Availability has risen sharply over the quarter, as a number of speculative schemes completed without letting, and has now reached 14%.
- Prime yields, for the best properties with long and secure income streams, have stabilised at 6.75% in the City and 5.5% in the West End, unchanged over the last quarter. Prime yields for major provincial centres, as well as the M25 West market have also stabilised, at 7% and 7.5% respectively.

Industrial

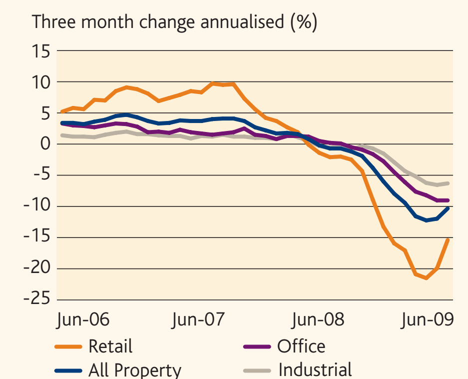
- Availability in the industrial sector has reached an all-time high. Rents were falling at a quarterly annualised rate of 6% in June 2009, although this was still more subdued than other sectors. Development starts have reached a record low, and this lack of new supply coming onto the market will help rents to recover in the longer term.
- While investment transaction levels remain subdued, as with other sectors, there is increasing evidence that prime properties let on long leases to high quality tenants, have seen yield stabilisation. Equivalent yields on prime distribution warehousing stand at 8%, having remained stable over the last quarter.

Total return



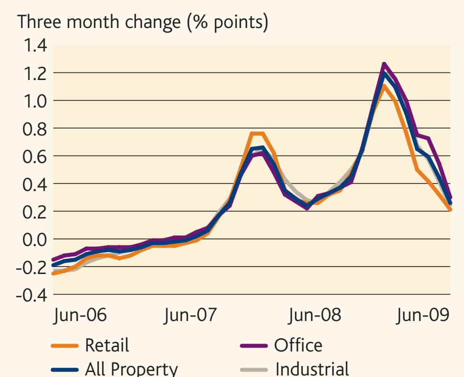
Source: IPD Monthly Index, June 2009; Aberdeen Property Investors

Rental value growth



Source: IPD Monthly Index, June 2009; Aberdeen Property Investors

Yield shift



Source: IPD Monthly Index, June 2009; Aberdeen Property Investors

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Sector prospects

Outlook

While total returns for 2009 will remain firmly in negative territory, the bulk of the anticipated capital value decline occurred in the first half of the year. Yields have already stabilised and are starting to fall again for prime property let on long leases to high quality tenants, and for smaller lot sizes in particular. Risks have now increased that the outturn could be stronger than this forecast, as the pace of capital decline has slowed so dramatically in the last two months.

Property equivalent yields in the UK have risen sharply to stand at 9.3% in June 2009, the highest since 1993. This reflects a record yield premium over nominal government bonds, cash and index-linked government bonds, and is looking very attractive to investors. Even against equities and corporate bonds, property's yield premium is now above its long-term average, with corporate bond yields in particular falling sharply in the past two months.

Over the next 12 months, capital values will stabilise. The benefits of steadily increasing investment demand will be offset by continuing falls in rental values across all sectors, particularly in the more volatile office market. However, the pace of rental decline will start to moderate by the end of 2009, as the economy emerges from recession. A total return of 7% is projected for 2010.

We expect the strengthening appetite from investors for UK property already witnessed to continue. In the short term this, coupled with a lack of stock, will result in some competitive bidding, and capital growth for sought-after, well-secured assets.

We expect an attractive five year annualised 'All Property' total return of 9.7% from the end of June 2009. The majority of this return will be delivered by income return, as opposed to capital growth. We are also not projecting rental value growth to turn positive again until 2012.

Whilst more general capital growth is projected from 2011, and yields are forecast to fall by 150bps over the next five years, yields are not forecast to fall to the exceptionally low levels experienced in 2006/7. This is largely because debt-backed financing is likely to remain in short supply for many years to come, with the banks' appetite for fresh property lending subdued.

Retail

- Over five years retail assets are projected to perform in line with 'All Property' delivering an annualised total return of 9.7%. Retail warehouses and shopping centres are expected to outperform 'All Property'. Both these segments have seen sharp outward yield movements over the past two years, and now look good value, aided by a stronger income return. Standard shops are projected to underperform. Yields for standard shops have not risen as much as the other retail segments, and they offer a much weaker income return as a consequence.

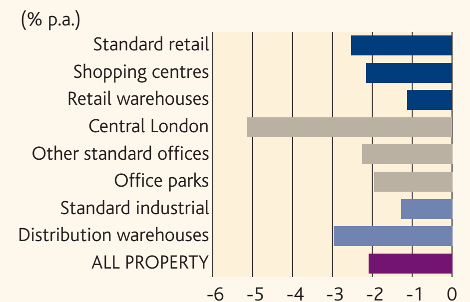
Office

- The office sector is forecast to underperform 'All Property' over the next five years. Central London offices are projected to underperform, particularly in the short term. Rents are expected to have fallen by approximately 50% in the City by the end of 2010 since the peak of the market in 2008. London is expected to see a substantially stronger rental recovery at the back end of the forecast period, and will outperform in 2012 and 2013 as a consequence.
- The best performing segments are projected to be the 'Rest of South East', 'Rest of UK' and 'Office Parks' markets, boosted by their higher income returns and a more modest rental decline.

Industrial

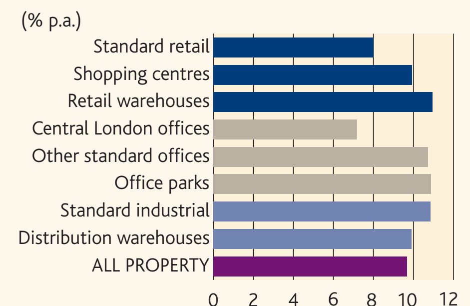
- Over the next five years, the industrial sector will outperform both offices and retail property, with stronger income returns and lower falls in rental levels helping to support the performance of the sector. However, while industrial is less volatile, rental growth in the office and retail sectors is set to recover more strongly towards the end of the five year forecast period.

Five year annualised rental growth (to June 2014)



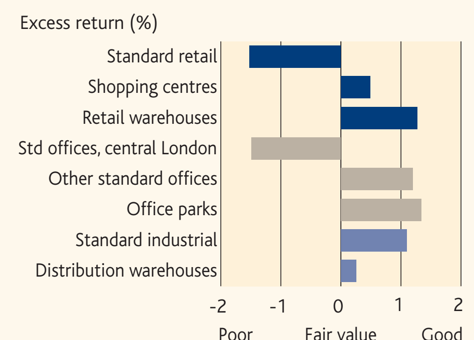
Source: Aberdeen Property Investors

Five year annualised total returns (to June 2014)



Source: Aberdeen Property Investors

Market pricing over five year horizon



Source: Aberdeen Property Investors

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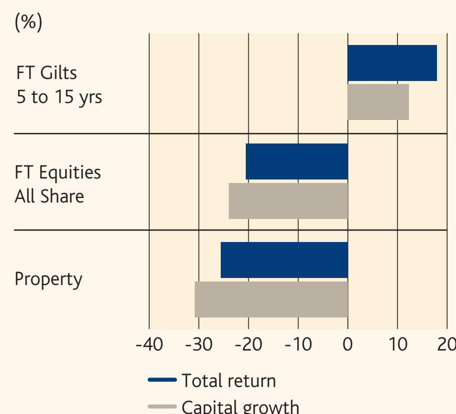
Investment policy

The table below shows Aberdeen's recommended positions relative to benchmark in order to achieve outperformance over a five year period.

Sector	Strategy
Standard retail	Underweight
Shopping centres	Neutral
Retail warehouses	Overweight
City offices	Underweight
West End offices	Underweight
Rest of South East offices	Overweight
Rest of UK offices	Overweight
Office parks	Overweight
Industrial	Overweight
Other	Overweight

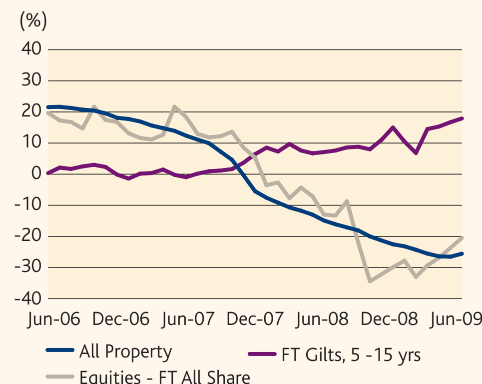
Source: Aberdeen Property Investors

Asset classes – 12 month total return and capital growth (to end June 2009)



Source: Aberdeen Property Investors, IPD

Asset classes – 12 month rolling total return (to end June 2009)



Source: Aberdeen Property Investors, IPD

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