

# UK Quarterly Property Snapshot



## The economy

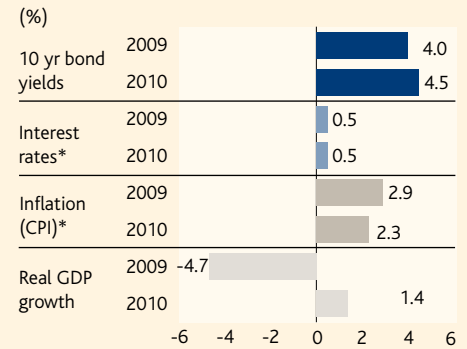
### Recent performance

- The UK economy is finally pulling out of recession according to Q4 2009 GDP statistics. Output rose by a weak 0.1% compared to a fall of 0.2% in Q3. The sub-par pace of recovery conflicts with evidence from business surveys and the labour market that the upturn has been more substantial in recent months.
- Business investment is close to stabilising, an indication that credit conditions are not bearing on the corporate sector to the same extent as at the turn of the year, when capital spending had collapsed. Government spending remains very firm, rising a sharp 1.3% in Q3 on surging capital investment. Construction activity rebounded in Q3, although in the area of repair and maintenance. New building projects continue to decline.
- A weak sterling exchange rate is yet to make any significant impact on exports, which are rising at a subdued pace in comparison to global trade. Firms have used a more competitive currency to raise profit margins.
- The labour market is stabilising, with the claimant count measure of unemployment falling in November. Consumer confidence is above its long-term average, primarily because of low interest rates, although fears over the prospect of unemployment remain high.
- Headline inflation is picking-up sharply, reflecting the impact of higher oil prices and based on effects from the temporary reduction in VAT rates at the end of 2008. By December, CPI inflation stood at 2.9%, which is above the government mandated target of 2%. Outside the erratic items of food and energy, inflation pressures have gradually been building, as a weak currency has fed into rising goods prices.
- The Chancellor of the Exchequer announced in the Pre-Budget Report that the budget deficit will be halved by 2013/2014, from a mammoth £178 billion in the current financial year. Little has been revealed on how the deficit will be curtailed in future years, with no announcements likely until after the general election.

### Outlook

- The UK economy will return to growth in 2010, although expansion will be modest after an expected contraction of 4.5% in 2009. Moderate growth in the UK's main trading partners, together with high household debt, credit constraints and fiscal tightening, all mean that growth will be sub-par.
- The government fiscal deficit is the main negative issue clouding economic prospects in 2010, with any significant progress in dealing with the problem effectively postponed until after the election. Despite the overhanging possibility of a credit rating downgrade, we do not see the poor state of public finances preventing a modest economic recovery.
- Our relatively upbeat stance reflects two key factors. Firstly, sterling's sharp depreciation of 25% over the past two years should be a major stimulus to activity once the UK's main trading partners return to firmer growth. The UK does not have a sizeable manufacturing sector, but the service economy is the second largest exporter globally.
- Secondly, consumer spending is likely to be more resilient than many expect in 2010. Share and home prices are up 51% and 8% respectively, since spring 2009. As such, we expect firm high street spending, particularly in the first half of 2010, although with a weaker outlook further out, as positive wealth spillovers wane.
- We are optimistic that interest rates will stay low well into next year, with no significant tightening envisaged until 2011. However, concerns over inflation are likely to intensify because of huge liquidity injections by the Bank of England, and over-estimation of the amount of spare capacity in the economy. Any prospect of liquidity withdrawal will be viewed as negative by asset markets, and bad news for government and borrowing costs more generally. As such, GDP growth in 2010 and 2011 is expected to stay below trend.

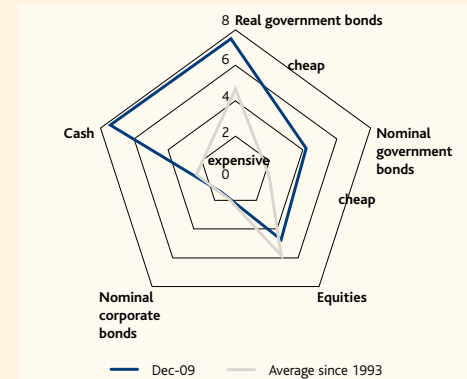
### UK economic forecasts



\*End 2009 level and end 2010 forecast

Source: Aberdeen Property Investors, EcoWin Reuters

### Property offers a high yield premium over other asset classes



Source: Aberdeen Property Investors

### Property yields should continue to fall sharply



Source: Aberdeen Property Investors

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## Property market overview

### Recent performance

The recovery in the UK property market is now gathering pace. Capital values rose by 3% in December 2009, the strongest performance recorded in the history of the IPD Monthly Index, which dates back to 1987. Total returns on a three month annualised basis have now reached an astonishing 43%. The fastest falls in yields are for prime assets, although average property yields are now falling rapidly as well. The pace of yield decline remains weaker for poorer quality secondary and tertiary assets.

Transaction levels are now increasing sharply, albeit from a low base, having increased by 50% since the low point in early 2009. Competition for investment product has become increasingly fierce over the past six months. Overseas investors, the UK institutions, retail funds and property companies/REITs are now all trying to increase their exposure to UK property. The retail funds have also experienced rapid inflows of cash over the past six months and are set to resume buying in earnest, after being under strong pressure to sell over the last two years. In Q4, net investment from the UK institutions has turned positive for the first time since Q4 2006.

Overseas investors have been the biggest net purchasers of UK property, with net investment of £7.3 billion over the past year, attracted by the fact that the UK market has been one of the fastest markets internationally to correct, and offered some of the strongest return prospects in Europe as a consequence. The depreciation of sterling over the past year has also made UK property substantially cheaper in foreign currency terms.

### Retail

- On a quarterly annualised basis to December, the drop in retail rents was 4.9%. This represents a slowing in the pace of decline since the record rate in July 2009 of 9% annualised. Although landlords continue to offer generous incentives, stronger locations are experiencing a fall in the size of inducements offered. Yields on prime and secondary shops and shopping centres have continued to fall over the last quarter. Retail warehouses, in particular, have experienced very strong returns as capital values rose rapidly. Some of the sharper reductions were on secondary units, as investors' appetite for riskier, higher yielding assets starts to return.

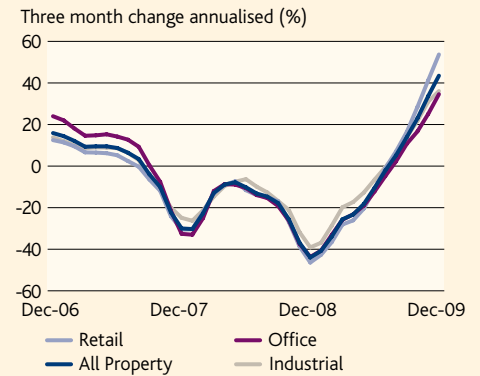
### Office

- Rental decline in the office sector has continued to slow in recent months. Office rents fell at an annualised rate of 6% over the three months to December 2009. This represents a continued slowdown in the rate of decline, having peaked in April 2009 at 22% on the same basis. The slowdown in the pace of decline has been most pronounced in central London, where prime rents are now close to stabilising at approximately £45 per square foot, although average rents continue to fall, albeit at a much reduced pace. Average rents in the City office submarket fell at a rate of 5% on a three monthly annualised basis to December 2009, compared to the 31% fall seen to March 2009. Take up levels in central London have risen in the last two quarters, as occupiers have sought to upgrade accommodation as prime rents are at such low levels. The slowdown in the rate of decline has been much more modest in the UK's major provincial markets.
- While the pace of prime office yield falls has slowed in central London in the last month or two, inward movement continues. Prime yields have fallen from their peak by 75 basis points in the City and West End, while provincial markets are now following suit with some strong inward movements. Secondary yields are now also falling.

### Industrial

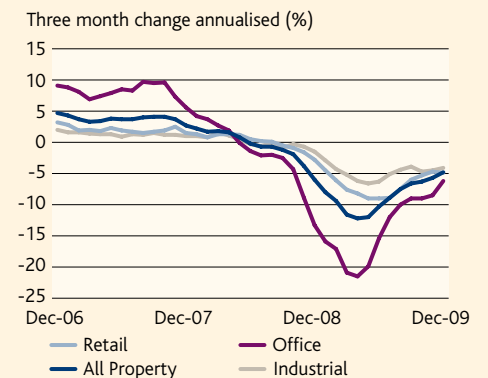
- Standard industrial rents fell by 4.1% on an annualised basis over the three months to December 2009. While there has been a continued weakness in demand, combined with record levels of supply, the latest data show a stabilisation in the rate of rental decline. Development levels have fallen dramatically in the industrial sector, as with the retail and office markets, to all time lows. The lack of new development has been exacerbated by empty rates legislation, as well as the absence of bank finance for speculative development. The lack of new supply coming onto the market will aid the eventual recovery of rental growth.

### Total return



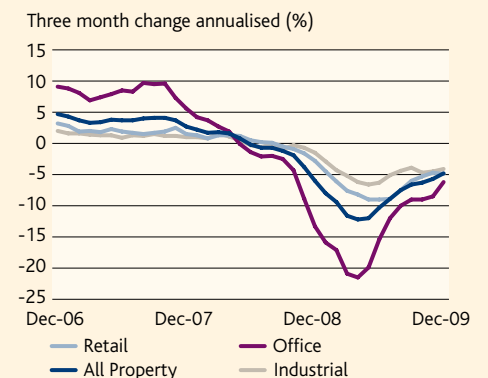
Source: IPD Monthly Index, December 2009; Aberdeen Property Investors

### Rental value growth



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

### Yield shift



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

# UK Quarterly Property Snapshot

## Sector prospects

We continue to project a two-stage recovery in total returns. This would be reminiscent of the mid-1990s, with an investment market driven surge in 1993/4, followed by a rental market driven improvement in returns thereafter.

Total returns for 2009 have not yet been published for the broadest measure of the market, although are expected to be close to 2% at the 'All Property' level. A particularly sharp uplift in capital values, of approximately 7%, is expected to be recorded for the last quarter. We expect 2010 to be a very strong year for performance, as yields continue to fall sharply in the first half of the year, despite rents continuing to decline, albeit more slowly.

Investment demand from UK pension funds, the retail funds, private UK investors, overseas investors, REITs and property companies is expected to continue rising over the next few months, leading to increasingly competitive bidding which will drive up capital values further. UK property looks very attractive, relative to other asset classes, from a yield perspective. Property's yield premium over low risk asset classes such as nominal government bonds, index-linked government bonds and cash has remained at a historically high level. In addition, property's yield premium over equities, and corporate bond yields in particular, has increased as the yields on these assets have fallen sharply over the past year.

After a particularly strong total return in 2010, which will be concentrated in the first half of the year, we expect total returns to drop back sharply in 2011, as interest rates and bond yields rebound, while rental growth struggles to resume. By mid to late 2010, UK yields will have fallen dramatically, by almost 200 basis points from their peak in mid 2009. Property's yield premium over other asset classes will be much reduced, while UK yields will not look so attractive relative to continental Europe.

The abrupt slowdown in total returns in 2011 would be similar to the correction experienced in 1995, which also followed a sharp bounce in capital values in the preceding two years. From 2012, rental growth resumes in earnest, and total returns are projected to pick up once again.

A five year annualised 'All Property' total return of 9% is forecast, based on pricing at the end of December 2009. The majority of this (approximately 7%) will be delivered by income return, with the remainder coming from some strong capital returns over the next year, and rental growth at the back end of the forecast period.

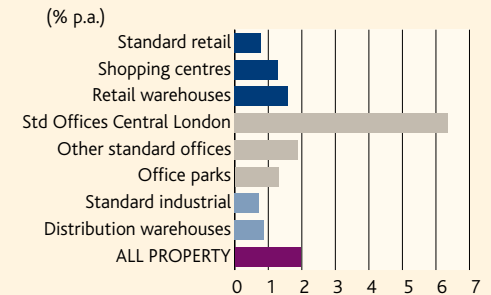
Over the next five years, the best performing sector is projected to be central London offices. Central London markets have the most volatile rental cycle, and prime rental values are already stabilising. Total returns will be boosted by very strong rental growth off a very low base. Shopping centres, office parks and South East offices should also perform reasonably well, boosted by a very strong income return. Yields rose more rapidly for shopping centres than for the other retail sectors, and did not fall as much as other property types in the second half of 2009. The large lot size of the shopping centre sector, and the absence of the debt-backed financing, meant that capital values fell much more than other sectors in the downturn.

The standard shop sector is projected to be one of the weakest performing sectors. For standard shops, the upward yield shift was far less substantial, and consequently, there is now less potential for a significant decline, particularly as rental growth prospects are muted, with oversupply an ongoing issue in many markets. Nevertheless, standard shops, with their smaller lot size, have been very popular with private investors who have been attracted by their yield premium over cash.

The key risk in the short term involves projecting the strength and duration of the current surge in UK property market recovery. We have projected a total return of 16% for 2010. This is well above the current IPF consensus view of 10%, and a similar total return anticipated by derivatives prices. However, with monthly total returns running at over 3% in late 2009, our forecasts already factor in a substantial slowdown for the second half of 2010.

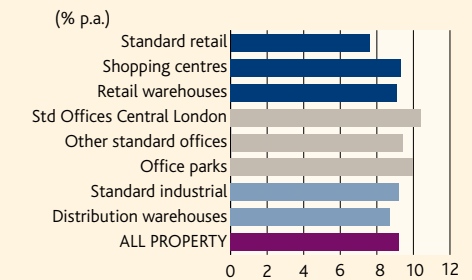
Additional risks continue to include a slower than projected recovery in the UK economy and consequently in occupier markets, driven by sharply reduced government spending and higher taxes to curtail the huge UK budget deficit. This would result in an even slower rate of rental recovery, and a weaker performance at the back end of the forecast period.

## Five year annualised rental growth (to December 2014)



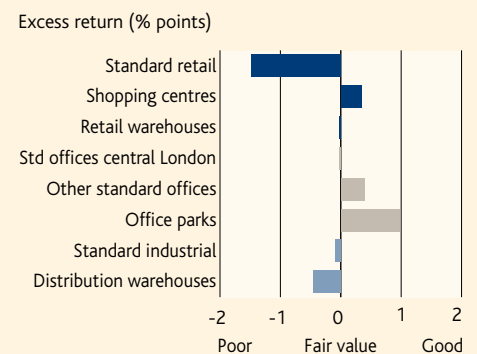
Source: Aberdeen Property Investors

## Five year annualised total returns (to December 2014)



Source: Aberdeen Property Investors

## Market pricing over five year horizon relative to benchmark



Source: Aberdeen Property Investors

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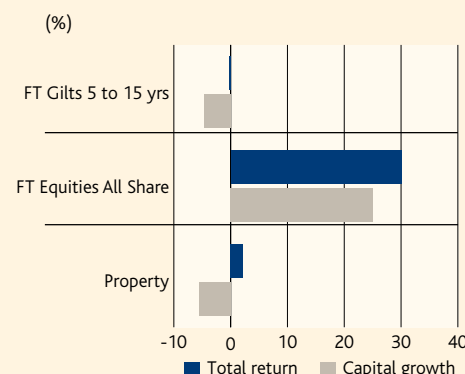
## Investment policy

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	Neutral
City offices	Neutral
West End offices	Neutral
Rest of South East offices	Overweight
Rest of UK offices	Underweight
Office parks	Overweight
Industrial	Neutral
Other	Underweight

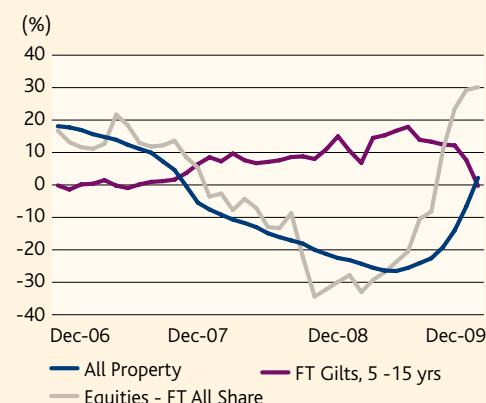
Source: Aberdeen Property Investors

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



Source: Aberdeen Property Investors, IPD

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



Source: Aberdeen Property Investors, IPD

## Important information

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