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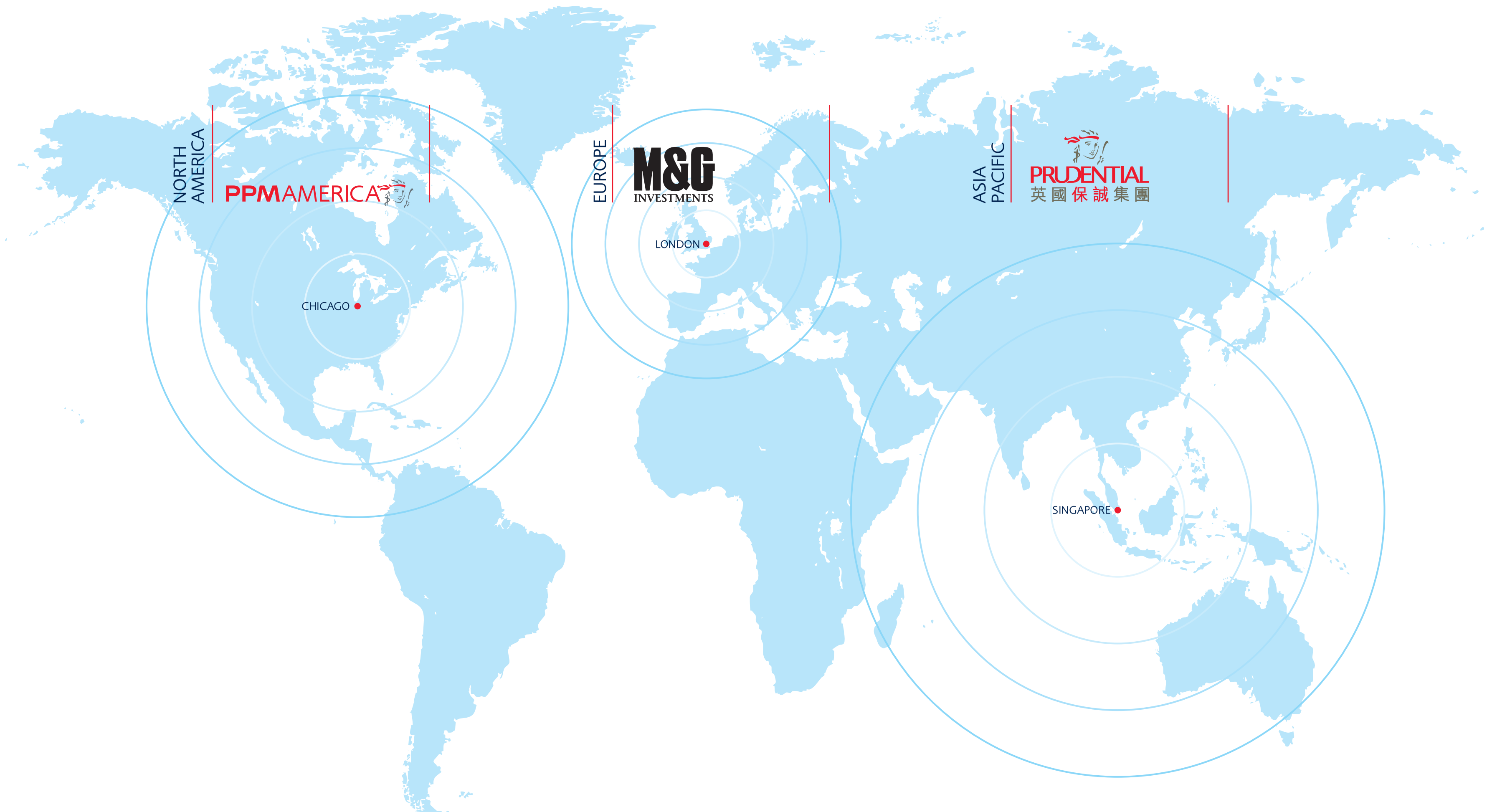

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ABOUT PRUPIM

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 £19.5 billion of real estate assets, of which £1.5 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with more than 6,000 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 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 quality 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 2007.

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

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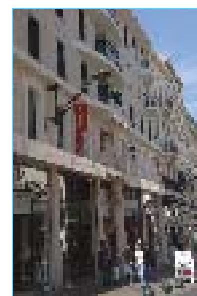

Cannes

EXECUTIVE SUMMARY

EUROPE

- As a result of global economic uncertainty, sentiment about the European economy has weakened and growth forecasts across most western European countries revised downwards. Albeit much of this relates to its substantial exposure to financial and business services, there has been little knock-on effect as yet reflected in European office property markets. By and large, robust occupier markets are still supporting strong rental growth across the region.

- The investment pressure on European commercial property markets eased markedly in late 2007 after leveraged buyers were forced into retreat. This said, it is still generally believed that a significant amount of un-deployed capital remains for investment. Yields were generally flat or starting to rise over the third quarter of 2007 and are thought to have risen 20-30 basis points over the final quarter; most so in Spain, least in the Benelux. As uncertainty grows, investors are exhibiting a definite preference for defensive assets, with secondary assets, larger lots and "exotica" increasingly out of favour.

ASIA PACIFIC

- Rather than flirting with recession, many Asia Pacific economies are struggling with inflationary pressures given their strong economic growth, consumer confidence and corporate profits. Although rental growth is set to moderate from the very elevated levels seen recently, new supply will not start to come through in any significant way for another year or two. As such, there is still potential for healthy rental growth short term.

- Asia Pacific property markets have also been somewhat insulated from the effects of the sub-prime crisis and related "credit crunch". This is because of their relatively low exposure to, and dependence on, public debt markets. Although base rates have been rising in Asia, sharp rises in the cost of borrowing associated with sub-prime are less of an issue for property yields here than elsewhere in the world. Clearly, any monetary tightening may damage lending conditions further and could lead to yields moving out a little.

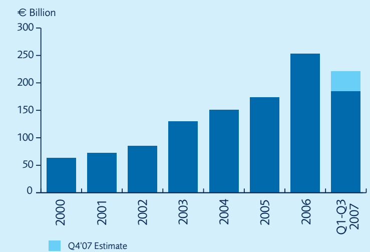
NORTH AMERICA

- The US economy is heading for a significant slowdown as the housing slump continues and the "credit crunch" bites. Though still reasonably robust, tenant demand is weakening, particularly in the retail sector. However, limited construction, in part fostered by increased borrowing costs, means rental growth should hold up, especially for offices.

- Debt-backed buyers of property have certainly struggled in recent times, though borrowing is still possible, albeit at lower levels and higher costs. Investment demand has weakened dramatically since the summer of 2007, and yields have begun to rise, but only by modest levels as owners have generally refrained from offloading assets.

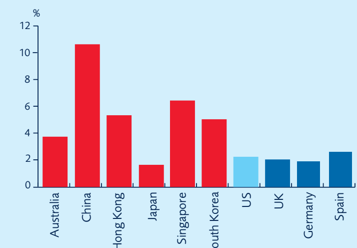
- Canada's economic performance continues to be one of the strongest among the developed nations, and property fundamentals are healthy, particularly in the West. Yield compression has finally come to an end but pressure remains on pricing from investors with capital still to invest in property.

European Investment Volumes



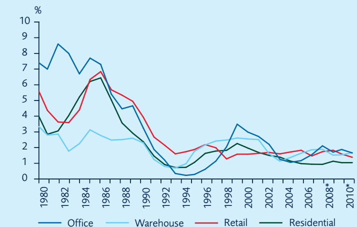
Source: Jones Lang LaSalle (November 2007)

GDP Forecasts 2008: Asian Focus of Global Growth



Source: Consensus Economics (December 2007)

US Construction: New Supply (% of Stock)



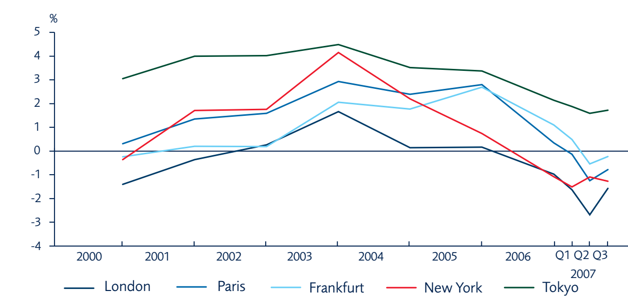
*Forecast
Source: Torto Wheaton Research, REIS (US Top 50 Metros), LaSalle Investment Management Research (December 2007)

GLOBAL REVIEW

Despite there being noticeable variations across the globe, there is little question that commercial property markets are, in general, slowing. The financial turmoil experienced in the latter half of 2007 has injected a further note of caution into markets that were, through a lengthy period of yield compression, looking stretched in terms of price. Recent cuts to lending rates in some key economies have eased the situation but have, by no means, reversed it.

Outside the financial and retail sectors in the US and, to a lesser extent, Europe, the occupational demand for commercial property has remained relatively robust. Employment growth has been solid, supporting office markets around the world. Elsewhere, structural changes in the retail and logistics sectors in both mainland Europe and Asia continue to support the need for modern space and new formats.

Key Centre Office Yield Spread over Borrowing Rates



Source: Jones Lang LaSalle (December 2007)

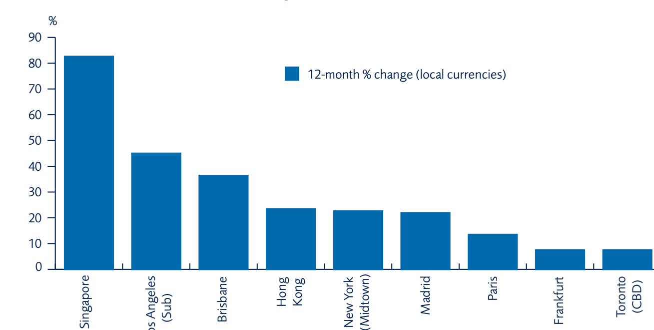
We have commented before that the combination of a robust demand environment and high prevailing prices for property assets was tempting some developers to begin bringing stock to the market speculatively. Consequently, the pace of development was beginning to pick up around the globe. However, the "credit crunch" has increased the overall cost of money, especially for risk-bearing activities like development and this, plus a general increase in the cost of building materials, has meant that construction levels have been kept in check.

> **"Despite there being noticeable variations across the globe, there is little question that commercial property markets are, in general, slowing."**

Hence, with demand largely robust and development levels kept in check, vacancy rates have generally been decreasing over 2007. As such, rental growth showed itself reasonably solid around the world; most so in Asia, least so in Europe and US.

This relatively benign picture in the global occupational market has not been paralleled in global investment markets. Following the re-pricing of risk in the second half of 2007, a distinct note of uncertainty has entered property investment markets around the world. It would be wrong to infer from this that the "credit crunch" has somehow created this market slowdown; rather, it accelerated trends that were already well in train. For example, it placed an even greater squeeze on leveraged buyer activity. It further highlighted the extent to which prime and secondary assets and markets had been pressed closer together in terms of pricing, leaving secondary investments vulnerable to an increasing "flight to quality" amongst investors.

Office Rental Growth (to September 2007)



Source: CBRE Global Market Rents (November 2007)

> **"With demand largely robust and development levels kept in check, vacancy rates have generally been decreasing over 2007."**

So, it is clear that, at the end of 2007, some national real estate markets are in real distress. The Spanish market, especially the owner occupied residential market, appears to be in severe difficulties. The UK market is likely to end the year with a rare negative total return outcome. The US REIT market may well end the same way - albeit the particular quirks of the US NCREIF index might well mean that, by contrast, the US direct real estate market might still record high double-digit returns for 2007. However, in other markets, yield compression is only now coming to a close. Asian markets in general are underpinned by excellent fundamentals and markets in resource-rich areas, like Western Canada, remain in robust health.

EUROPEAN MARKET DYNAMICS

	RENTAL	INVESTMENT
Office	■ Despite the usual cyclical slowdown through the summer period, take up levels across Europe in the first three quarters of 2007 were 16% higher than for the comparable period in 2006. ■ Availability has continued to fall despite a slight increase in supply, pushing vacancy rates lower whilst placing upward pressures on rents. Prime rents have increased and rental growth remained positive across almost all European cities, with many enjoying double-digit rental growth over 2007.	■ Despite a rise of c.20-30 basis points across most markets since the summer, office yields remain very low by historic standards. The "credit crunch" is accelerating a widely expected pricing correction. ■ More substantial yield rises have been seen in Paris and the major German and Spanish markets, where investment activity had typically been led in recent times by highly leveraged investors who have now been forced to scale their operations back.
Retail	■ On the back of improving growth in consumer spending, rental market dynamics remain encouraging. ■ Demand for prime units is strong, especially from international retailers and luxury brands. This has been helping to drive rents forward, particularly on the high street. ■ Meanwhile, retail warehouses are becoming increasingly popular, with the greatest demand being for high quality space. This is particularly evident in France, where new parks are attracting an increasingly wide occupier base.	■ Despite a belief that sector fundamentals remain strong and an emerging preference for the sector being exhibited amongst investors, yield compression in the European retail sector is thought to have stalled. ■ Yields may even be rising in some secondary markets across Europe, especially in Germany and Spain. ■ The general lack of stock across many parts of the market is leading to greater levels of development and increasing exploration of novel retail formats.
Industrial	■ The balance between supply and demand remains broadly in line in the European industrial market: take up levels are solid whilst rental growth is relatively muted. ■ According to the European Commission, confidence in the industrial sector has fallen back from the highs recorded earlier in 2007. The strength of the euro against the dollar is no doubt a contributing factor. In turn, as profitability continues to be squeezed, occupiers' purchasing power is diminishing.	■ The industrial sector in Europe has seen some of the greatest levels of yield compression in recent years. However, with investors now requiring more security from their investments, it is thought to be potentially more vulnerable to yield expansion than the retail or office sectors. ■ In some countries, the industrial sector is experiencing radical change as logistics networks and stock are rapidly being modernised. This helps underpin demand and development.
Residential	■ A stretched owner occupation market could prove advantageous to the rental market as owner occupation is rendered relatively less attractive. House prices have grown most compared to rents over the past decade in Spain and least in Germany and Austria. ■ However, the availability of investable stock varies widely across the Europe. Whilst in Sweden and Denmark, rented accommodation constitutes over 50% of stock, in Spain, Portugal and Norway it is less than 25%.	■ Across much of the Eurozone area, valuations appear stretched and capital value growth is slowing. ■ Given an extensive construction pipeline, Spain is probably most affected; Germany and Austria are least so. Merrill Lynch, in a recent report, suggested that house pricing in Ireland carried the highest risk.

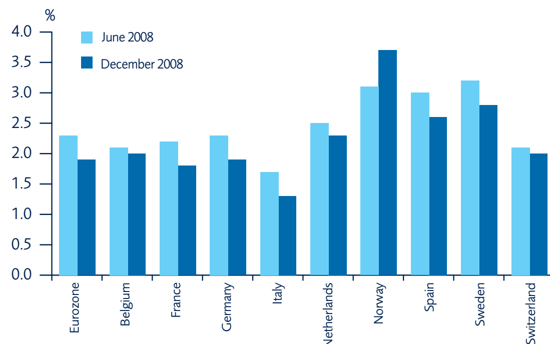
EUROPEAN OUTLOOK

Although still relatively robust, the European economy has not emerged completely unscathed from the recent credit crisis. Six months ago, growth in the European economy was steadily improving. There were high hopes that Germany, Europe's largest economy, would continue to recover from earlier doldrums and confidence had grown such that interest rates could be raised to control inflation. Now, however, interbank borrowing rates have been pushed higher, the euro exchange rate has strengthened against the dollar and the latest inflation figures show an unsettling spike. With confidence indicators dipping, growth expectations have been moderated. Consensus forecasts now expect Eurozone GDP growth of 1.9% in 2008, down from 2.3% in June.

However, taken in the round, the picture is far from disastrous. In general, the European manufacturing sector is doing well, unemployment is at record lows, interest rates are supportive and in Spain, despite the construction industry slowdown, growth remains robust. For the time being, this sturdiness continues to feed through into European property occupational markets.

With respect to the retail sector, despite an easing in confidence, European consumer expenditure is still generally set to improve from current levels (particularly in Germany). Although France, Spain and Italy are all poised for the arrival of new supply, the expansion into these markets by cash-rich international retailers should help keep pressure on prime rents. Retail warehousing provision remains low and, with traditional retailers now also looking out-of-town, decent growth prospects exist for large modern space.

GDP Growth Forecast 2008



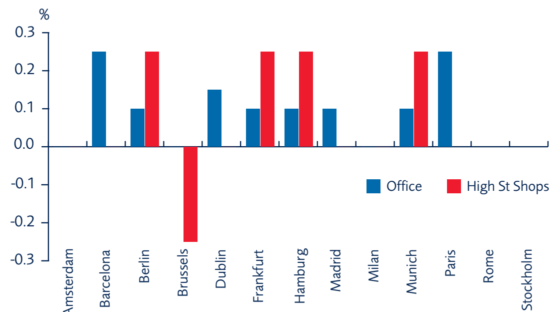
Source: Consensus Economics (June & December 2007)

In the industrial sector, in line with growing levels of international trade, future demand is expected to remain healthy. However, competition from Central and Eastern Europe combined with relatively elastic supply will constrain material levels of rental growth in Western Europe as a whole.

Meanwhile, it is in the office sector where the greatest uncertainties lie. High levels of take-up combined with limited availability have been driving healthy rental growth recently. However, if the US moves into recession, it will be the office sector in Europe, with its greater exposure to international and domestic financial and business services, that will feel the greatest pinch. Concerns are rising that firms may start cutting-back on staff, leading to a waning of occupier demand and a dampening of rental growth.

By contrast to the generally healthy occupational markets, it is clear that the pressure on European investment property markets has eased markedly in the second half of 2007. Debt is increasingly costly and difficult to obtain and this has materially diminished one major source of capital for the market.

Yield Movements Q3 2007



Source: Jones Lang LaSalle (November 2007)

This said, the general feeling, expressed by nearly all the main agents, is that there was a significant amount of capital raised in 2007 for investment in European property, which remains as yet un-deployed. It is also felt that equity rich investors, like the German open ended funds, sovereign funds, petro-dollar funds and underweight pension and insurance companies, retain an appetite for property which they can more easily satisfy now that the heavily leveraged buyers are less prevalent in the market.

"By contrast to the generally healthy occupational markets, it is clear that the pressure on European investment property markets has eased markedly in the second half of 2007."

Yields were generally flat or had started to rise over the third quarter of 2007. This trend is thought to have continued in the fourth quarter. The pattern is not uniform - Spain is experiencing noticeable yield rises whereas Belgium and Luxembourg were, until recently, still seeing limited yield compression. As uncertainty begins to grow, investor preference is very much for quality or defensive assets, with secondary assets, larger lot sizes and "exotica" increasingly out of favour.

ASIA PACIFIC MARKET DYNAMICS

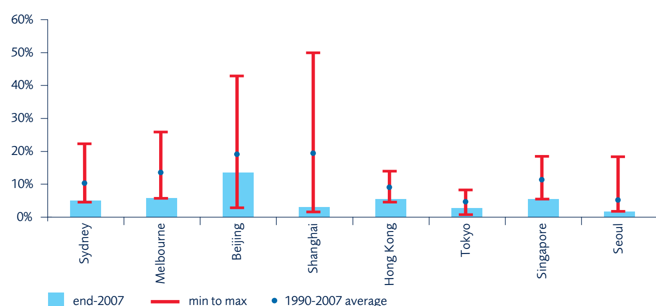
	RENTAL	INVESTMENT
Office	■ Vacancy rates are close to record lows. Recent astonishing levels of rental growth will soon ease but the potential remains for healthy rental growth short term before any significant supply response emerges. ■ Following such rapid rises in rents, questions are increasingly being asked about affordability. Fortunately, whilst it is generally true that office occupation costs have risen rapidly, so has the level of production attained from using the space.	■ The office sector still ranks highly amongst investors' preferences. However, yields have now stabilised and pricing is adjusting to more modest expectations. Yields could even start to drift out in some of the more volatile markets, now heading into much weaker growth phases. ■ Despite new supply coming through in a year or two, vacancy rates are likely to remain low. This will provide relatively benign conditions for office investors in the short term.
Retail	■ Buoyed by strong economic growth, consumer sentiment remains relatively robust across Asia. ■ Supply is tight in many markets and, with ever more international brands looking to establish themselves in the region, rents have been placed under upwards pressure. Even in Korea where the retail market has been experiencing some stress recently, GAP has just entered the market with other retailers, such as Zara, looking to enter in the near future.	■ With long-term structural changes and good long-run fundamentals, supported by a growing consumer class, investors will continue to be attracted to the retail sector in the Asia Pacific region. ■ Although investor interest is still there, retail yields have now stabilised in Asia. This is more to do with changing capital market conditions and the extent to which pricing had become extended, than a change in view regarding retail sector fundamentals.
Industrial	■ Robust intra-regional trade will be balanced by declining exports to developed countries. However, the Asian consumer market now requires its own sophisticated network of modern logistics facilities. ■ In Singapore, high-tech sector demand is spilling over into business parks which are increasingly being used for back office functions. In Japan, industrial developers are becoming increasingly active, attracted by robust demand. This activity may weaken rental growth towards the end of the decade.	■ The launch of a new J-REIT, focusing on the industrial sector in Japan, highlights the growing level of acceptance amongst investors of industrials as a viable asset type in Asia. This is further underlined by the expanding development pipeline in markets, such as Japan, where some foreign investors are looking to increase exposure to the sector. ■ As industrials become more widely accepted by domestic institutional investors, there is still scope for further modest yield compression in the region.
Residential	■ High inflows of foreign workers into Singapore have exacerbated the problem of tight supply in the residential market. With the government's economic growth target dependent on continued levels of immigration, this situation is expected to persist. ■ A recent policy change, allowing mainland Chinese to invest in overseas equity markets, will increase fund flows into the Hong Kong banking system, boosting this sector of the economy and leading to strengthening leasing demand.	■ In Hong Kong, the sub-prime crisis has done little to dent investor enthusiasm for the residential market. In fact, in such an inflationary environment, the recent interest rate cut has had the effect of accelerating the market. ■ In the luxury residential market of Singapore, extremely strong rental growth of nearly 40% to the end of the third quarter of 2007 continues to attract investors to the sector. Consequently, yields are extremely low at 2.6% according to Jones Lang LaSalle.

ASIA PACIFIC OUTLOOK

The Asia Pacific region remains the focus of global economic growth. On the whole, this growth was stronger throughout 2007 than forecasters had expected and regional momentum has carried through into 2008 with forecast upgrades for the region's economies. This is in contrast to elsewhere in the world, where most forecasts have tended to be downgraded. In Asia Pacific, it has been the battle against inflation that has been at the forefront of central bankers' minds, with worries about weak economic growth much less of an issue generally. Interest rate levels are one manifestation of this. China raised interest rates five times during the first 11 months of 2007 and Australia's rates are at an 11-year high. This said, the region's biggest economy, Japan, generally seems to buck this trend with both declining consumer and business confidence.

Strong economic performance has, and will for some time, continue to translate into strong office occupier markets. Extremely strong rental growth in many Asia Pacific markets has been experienced and this is now starting to induce development activity on a meaningful scale. Given lead-in times, however, much of this new stock will not reach the market until the end of the decade.

Asia Pacific Vacancy Rates

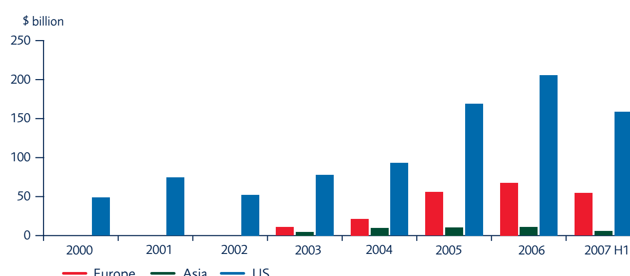


Source: PMA (December 2007)

Vacancy rates are at, or close to, record lows in many office markets and, as such, with occupier demand still strong, we can expect healthy rental growth for the next couple of years, albeit not as strong as over the last year or so. This more modest growth could even continue into the early part of next decade although rental decline may, by this time, be seen in some of the more volatile markets.

Given the massive run up in office rents in Singapore and Hong Kong recently, affordability has been cited as a potential constraint to future growth. However, a recent analysis by property consultants PMA concluded that, whilst high, the overall costs of office production in these markets were not exceptional. Indeed, a more pressing challenge for these markets over coming years would be to source suitable staff, rather than source office space at a reasonable rent. Many Asian economies will continue to rely on high levels of immigration in the medium term to support current levels of economic growth. Should the required levels of employment fail to be sourced, they may become less attractive as locations for global or even domestic occupiers and, in this way, rental markets could suffer.

CMBS Issuance



Source: PMA, Barclays Capital, RCA, Bloomberg, Commercial Mortage Alert (November 2007)

Asian property markets would appear to be less exposed to the sub-prime crisis than those in the western hemisphere. Far less property investment is supported by debt, especially public debt. Commercial mortgage-backed securities (CMBS) issuance in Asia has been miniscule to date compared with the US and Europe. Asian property is funded more heavily with public equity. These characteristics have given Asian property markets some structural insulation from the effects of the credit crisis. Also, with strong economies and very tight supply, the fundamentals of the markets have also been visibly much stronger.

"With relatively good growth prospects and arguably less potential for a pricing correction, Asian real estate would seem to provide good return prospects relative to other global markets."

Investment yields seem to reflect this. On the whole, yields have remained stable over the last quarter. Whilst pricing has not become more aggressive, this shows investment sentiment is still positive relative to other global markets where yields are rising. Indeed, the region could be a beneficiary of the problems in the US and Europe as investors allocate more of their funds towards Asia Pacific, looking for higher risk adjusted returns. With relatively good growth prospects (especially in the shorter term) and arguably less potential for a pricing correction, Asian real estate would seem to provide good return prospects relative to other global markets.

NORTH AMERICA MARKET DYNAMICS

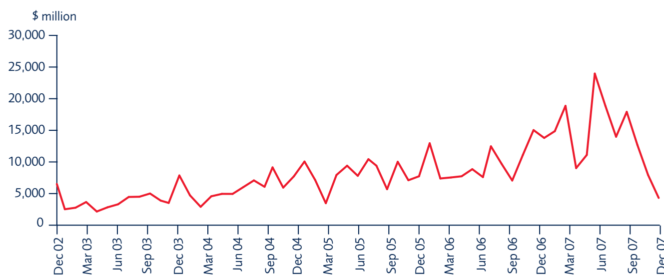
	RENTAL	INVESTMENT
Office	■ Demand for office space in the US remains solid. This is exemplified by the soon-to-be-completed 2.1m sq ft Bank of America Tower in Manhattan being almost fully let on healthy rental rates. With construction generally subdued, rental growth is expected to remain healthy, although it is likely to moderate. ■ Although Canada has a significant amount of space in the pipeline, vacancy rates remain low as continued strong demand keeps net absorption high.	■ Though the number of deals concluded has plummeted in recent months, offices remain the primary target of investors in the US. However, yields have started to rise, particularly for suburban offices. ■ Yields are stabilising across Canada's office markets. However, pressure remains on pricing, particularly in the West but also in some downtown markets elsewhere. This means that significant yield expansion is not expected in the short term.
Retail	■ Despite the widely anticipated contraction in consumer spending not yet having fully taken hold, prospects for US retail rents continue to look bleak. Landlords favour large national operators over local independent traders and low-end (value) retailers over mid-range ones. ■ North of the border, sustained economic and population growth in the West continues to drive retail sales growth and, in turn, attract aggressive US-based retailers into the Canadian market.	■ Despite the Fed's attempts to bolster a stalling US economy, hotel and retail assets are generally perceived to be the weakest investment sectors going into 2008. Even with further rate cuts expected, a prolonged consumer retraction is priced in, with discretionary spending in all areas being curbed. ■ In Canada, prospects for newer big box and power centre formats are favoured, as increases in retail construction activity are rapidly rendering many older community malls obsolete.
Industrial	■ US import growth has slowed recently, as retail demand for goods has weakened. Demand for logistics and warehousing space is consequently abating. However, a large amount of oversupply is not expected as construction has been kept under control. ■ With Canada's strong dollar hurting exports, demand for manufacturing space (centred in the East) has weakened. However, in the West, stronger demand for warehousing space has meant average vacancy rates across the country are stable.	■ With fundamentals for US industrial assets fairly robust, and viewed as more able to "weather the storm" than other property sectors, pressure on pricing remains, particularly with a limited supply of available stock. As a result, the sector is perhaps less at risk of significant cap rate expansion. ■ Yields for industrial assets in Canada have now stabilised although, with vacancy rates low and rental growth steady, pressure remains on pricing.
Residential	■ The placing of unsold condo-conversions onto the letting market is keeping vacancy rates high in many sunbelt markets such as Phoenix and Houston. Nationally, the market appears healthier, with 12-month rental growth (to the end of the third quarter of 2007) of 4.3%. ■ The average Canadian apartment vacancy rate remains low at 2.6%. The biggest rent increases continue to be seen in the West where renters are attracted by the booming economy.	■ Outside of the sunbelt markets, there is a sense that US apartment fundamentals are becoming attractive. Metro markets such as New York, Washington and Seattle retain keen investor interest, fuelled by tight occupancy levels and strong rental growth. ■ Investors continue to see the demand and supply fundamentals in Canada's western provinces as favourable. Yields are now stabilising after a prolonged period of compression. However, no significant movements upwards are expected.

NORTH AMERICA OUTLOOK

It is now clear that the US economy is heading for a significant slowdown, as the housing slump continues and the "credit crunch" bites. This said, a full-blown recession is still generally not expected, although the risks have perhaps increased as the fallout from the sub-prime issues continues and the squeeze on credit continues to affect both investment and consumption. As such, for the first time in post-war history, US GDP growth is forecast to underperform all other advanced economies in the G7.

The Federal Reserve is trying to alleviate matters by putting interest rates on a firmly downward trajectory. However, the state of the credit markets means that the cost of borrowing from lenders still operating in the marketplace remains significantly higher. Furthermore, with oil prices hitting $100 per barrel recently, there is a danger of inflationary pressures adding to existing problems.

US Office Transaction Volumes (monthly closed transactions)



Sources: Real Capital Analytics (December 2007)

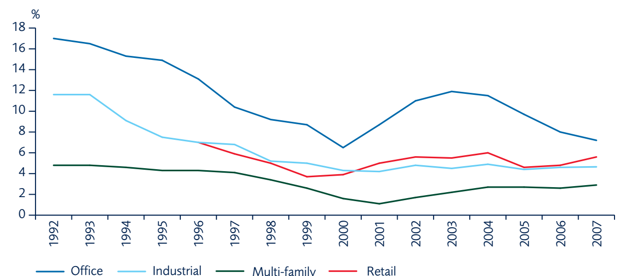
Debt-backed buyers of property have certainly struggled in recent times, though borrowing is still possible. Lenders have reduced the amount they are willing to lend, typically to less than 50% loan-to-value, and are charging more for any financing that is done. Strong covenants can still obtain reasonable loans and conditions, but weaker borrowers are undoubtedly feeling the squeeze.

"Owners have not been offloading assets and US multi-asset managers have generally held firm in their allocations to real estate. As such, recent rises in yields have been relatively modest. "

The volume of investment deals fell dramatically over the second half of 2007, with a gap opening up between buyers, expecting significant discounts to property prices after the "credit crunch", and sellers, clinging to pre-August pricing levels. The yield compression that had continued into the first half of 2007 certainly stopped as pressure on pricing eased. Though buyer demand has fallen dramatically since the summer, this has not resulted in any significant excess supply of stock coming onto the market. Owners have not been offloading assets and US multi-asset managers have generally held firm in their allocations to real estate. As such, recent rises in yields have been relatively modest.

Across the spectrum of investments, there is now an acute difference observable between conditions in core markets and more "opportunistic" markets. While core investment still interests a wide range of investors, sentiment for higher-risk investment has fallen away dramatically. Across the property sectors, offices are still thought to exhibit the best prospects with investors recognising the relative strength of sector fundamentals. Retail is expected to fare worse.

Canadian Vacancy Rates



Source: Altus Insite, CMHC, Cushman & Wakefield LePage, ICSC, LaSalle Investment Management (December 2007)

Canada's economic performance continues to be one of the strongest among the developed nations, with GDP growth estimated to be around 2.5% to 3% for 2007. This is in addition to a low and stable inflation environment and surplus fiscal balances. However, the weakening US and global markets are posing a challenge and economic growth is expected to slow to about 2% in 2008. In response to this situation, the Bank of Canada recently cut interest rates by 0.25% and there is the possibility of more cuts to come.

Canadian labour markets are holding up well, with significant job growth in the services and (largely western) resources sectors offsetting (largely eastern) manufacturing job losses. The construction industry, including commercial and residential building, continues to grow steadily.

The geographical divide in Canada's economic fortunes also influences its property markets and investors have not been slow to recognise the West's stronger fundamentals. Total returns for property in the western provinces remain high, but rental growth is now past its double-digit peak and yields have stopped falling. This said, continued pressure to invest, particularly from Canadian pension funds and foreign buyers, will continue to support yields and returns in the medium term.

IN-FOCUS

UK RESIDENTIAL: AN ATTRACTIVE HOME FOR CAPITAL?

Malcolm Hunt

Whilst UK house prices and "buy-to-let" investors often make front page headlines, large-scale property fund managers have shown scant interest in the UK residential sector. Having seen a comprehensive deterioration in UK commercial property market sentiment in recent quarters, we take a moment to reflect on the changing nature of the residential sector and consider its place within such funds in future.

According to Office of National Statistics data, the entire UK housing stock weighed in at a mighty £3.9 trillion at the end of 2006. Housing represents approximately 60% of UK wealth and over three times its GDP but the volume of "investable" residential stock open to landlords in the UK is limited. Of the UK's 26 million households, approximately 70% are owner-occupied. A further 18% of dwellings are rented from social landlords with "non-market" motivations. Nevertheless, the remainder of the market is still vast enough to offer significant opportunity. This residual 12% contains three million homes and forms a £460 billion asset pool whose tenants, for reasons of flexibility, affordability or lifestyle, choose to rent.

"In practice, large-scale property fund allocations to residential have fallen throughout the post-war period, representing less than 1% of average capital employed today."

So, it is the characteristics of this Private-Rented Sector (PRS) that we focus on here. In comparison to commercial property's retail, office and industrial sectors that were estimated to be valued at £246 billion, £180 billion and £77 billion respectively at end 2006, one might expect PRS's £460 billion of assets to feature significantly within the average property fund's domestic exposure. In practice, large-scale property fund allocations to residential have fallen throughout the post-war period, representing less than 1% of average capital employed today. This compares with average IPD retail, office and industrials allocations of 47%, 35% and 15% respectively.

The virtues of commercial property as an asset class are widely recognised and the key performance indicators for the PRS market would appear to be equally strong. Beyond the newspaper headlines, accurate indicators of residential total returns are not straight-forward - partly due to the absence of the vast financial funds that helped bring transparency to the UK's commercial property market. Nevertheless, with some assumptions for unrecorded management and capital expenditure costs, it is possible to construct long-term residential total return estimates from published house price and rent series data. Such methods indicate long-run total return performance is on a par with commercial property.

Apart from expanding the investable universe, one of the major attractions of the PRS sector is the potential diversification benefits since the market responds to different rent and pricing drivers. In recent years, large-scale investment funds have dominated commercial property pricing, but even their considerable war-chests would have limited scope to shift residential capital values when diluted by the collective impact of owner-occupiers' transactions on prices. Although no asset class – save perhaps cash – can purport to being risk free, UK residential typically exhibits shorter and less pronounced market downturns than the corresponding commercial property sectors. Like commercial property, however, residential returns are weakly correlated with equities and gilts. Analysis suggests a negative, -7%, correlation of residential prices with the FTSE All-Share over the last 23 years and just 56% co-movement with the full IPD Property Index. Such diversification gains are attractive within both a multi-asset allocation and pure property framework.

UK Asset Correlations, 1984 - 2006

	Residential Property	Commercial Property	Equities	Gilts
Residential Property	1.00	-	-	-
Commercial Property	0.56	1.00	-	-
Equities	-0.07	0.19	1.00	-
Gilts	-0.30	-0.05	0.27	1.00

Source: PRUPIM; HBOS plc, FTSE, IPD (December 2007)

Looking back, the trigger for dwindling institutional allocations to UK residential through the second half of the twentieth century was post-war legislation establishing rent controls, tipping the balance of power away from residential landowners. Whilst Assured Shorthold Tenancy legislation firmly reintroduced market-let residential rent levels from 1988 (for fixed six-month leases), the relative management and scale economies that had been achieved within the commercial sector by that time had made re-entry into large-scale PRS investment seem relatively risky and resource hungry. Unlike commercial property's Full Repairing and Insuring (FRI) leases, standard residential landlords remain liable for all such expenses. Typical operating costs measured by IPD's Residential Index average 28% of gross income (before voids) – a stark contrast to the sub 2% fees within commercial property accounts. Fortunately, barriers to entry are also being lowered on that front, with the rise of respected residential management agencies reducing the requirement for directly employed local representation (one of the reasons that many private landlords purchase close to home). However, a more enduring setback for fund managers has been the delivery of PRS returns, which tend to rely on a significant price appreciation elements accruing in the background.* This contrasts with commercial returns which have been entirely driven by income streams over the long run, with flat to negative capital values in real terms. Residential rental levels have consequently appeared disappointingly low to many large liability matching funds.

**Estimated at 2.4% real within the Barker Review of Housing Supply*

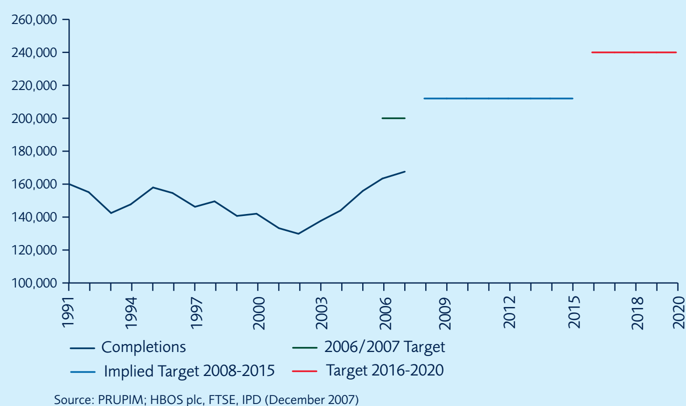
In the short term, it is clear the UK housing market is now cooling. Vendors' asking prices and mortgage approval rates have fallen and are being reflected in transaction prices across most regions. By contrast, rental demand, which tends to come into force at the end of residential cycles, is going from strength to strength, improving yields. It is important to stress that few UK residential market analysts foresee a US-style collapse in prices. Purchaser demand has been tempered in the UK but the supply of space remains characteristically tight. Whilst both the UK and US markets have been subject to constricting credit markets and rising interest rates, the Bank of England's uplifts from record lows of 3.5% in 2003 contrast favourably with the five-fold hike (from 1%) that has occurred in the US over a similar period. UK lending criteria has also remained tighter, with UK underwriting criteria assessing affordability beyond periods of introductory "teaser" rates.

"...one of the major attractions of the PRS sector is the potential diversification benefits since the market responds to different rent and pricing drivers."

Further out, economic, demographic and labour market fundamentals can be expected to assert themselves. According to the Department for Communities and Local Government (DCLG), a 15% growth in English household demand is expected by 2021, fuelled by 6% population growth and a 7% decrease in the average household size. On the housing supply side, structural shortfalls show no signs of abating either and future additions (even assuming government targets are hit) remain below projected additions to overall demand. The pattern is similar across the UK, although the North-South pricing gap is likely to grow wider and demand growth is anticipated to be 3% higher in London and the South where building land is also at its most scarcest.

In the July 2007 Housing Agenda, Gordon Brown announced ambitious targets to introduce a further three million English homes into dwelling stock by 2020. Those additions would represent a c.12% increase in the housing stock over the next 12 years, compared to the 15% increase in household demand projected by the DCLG to 2021 (which includes just one extra year of demand growth). Until 2016, the Housing Agenda has raised annual completion targets to 212,000, rising to 240,000 p.a. thereafter. Putting these targets in perspective, completions in the 12 months to March 2007 came in at 167,577. Given developer caution regarding short-term pricing, the UK's Construction Products Association expects new start figures to have lowered in 2007, plateau in 2008 and rise modestly through 2009-2011. Whilst they should not be treated as cast-iron certainties, these statistics do far more to suggest a supply response struggling to keep pace than one capable of satiating the growing household demand (or improving affordability). Within that context, one would expect an increasing number of households to move towards the rented sector, sustaining pressure on rents.

New Dwelling Completions in England



Source: PRUPIM; HBOS plc, FTSE, IPD (December 2007)

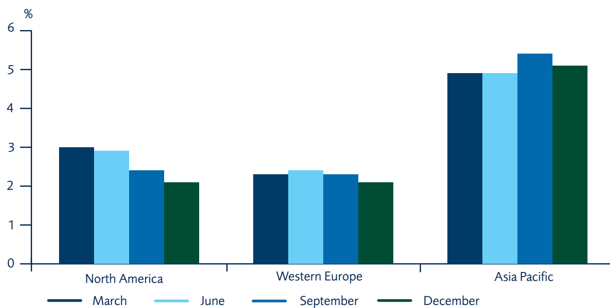
In September 2007, London Mayor Ken Livingstone announced his backing for institutional investment into London's private rented residential sector and his desire to minimise the problems arising from fragmented ownership. An intention openly welcomed by the British Property Federation's director of residential policy, Ian Fletcher, who believes Britain needs "massive corporate investment" to build quality rented accommodation. With barriers to entry for large investment funds coming down, rents rising, prices falling and diversification opportunities as attractive as ever, it seems property investment houses may soon be tempted to look again at UK residential.

GLOBAL OUTLOOK

It is often simply a cliché to talk of uncertainty in economies and markets. However, there are a number of significant unknowns likely to affect global real estate markets going forward. These include the depth and longevity of the sub-prime and related "credit crunch" crisis, the potential for recession in the US, the spiralling cost of oil and the chance for a resurgence of "stagflation".

Generally, whether from a cyclical slowing in US, European and Japanese economies or the need to manage down some fast growing Asian economies, the expectation is for lower economic growth medium term. This will be more obvious in financial and consumer sectors and will lessen demand in many major city office markets and retail markets across mature economies. Thankfully, one bi-product of the "credit crunch" is to make development more costly. The trend for some investors to acquire quality stock in a tight market by developing it, sometimes speculatively, has been undermined. With supply under control, economic slowdown will simply reduce rental growth rates from recent robust levels, rather than send them into a tailspin.

GDP Forecasts 2008: Global Regions



Source: Consensus Economics (March to December 2007)

However, there are also uncertainties evident in global investment markets and these are more likely to determine medium-term total returns than the rental outlook. In the same way that property's recent "bull run" had little to do with rental fundamentals, the return to normal pricing will have similarly little relationship. Around the globe, the recent sustained period of yield compression led many to argue that commercial property prices were stretched and insufficiently linked to underlying risks inherent in properties. These shortcomings appear to be unwinding.

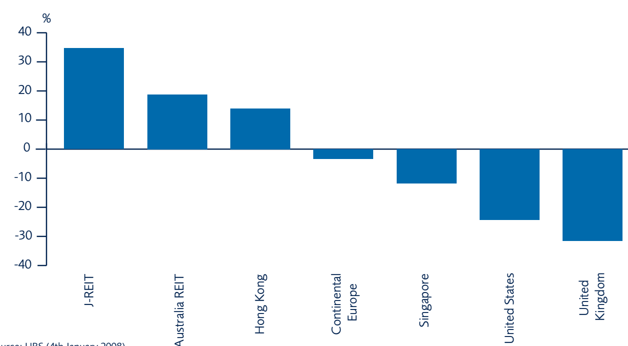
"In the same way that property's recent "bull-run" had little to do with rental fundamentals, the return to normal pricing will have similarly little relationship."

The UK is in the course of a very rapid correction. Here, however, the level of pricing and the squeezing of risk premium were both taken to extremes. It seems unlikely that many other markets will experience as dramatic a reversal in fortunes. However, pricing in the securitised property markets suggests many believe capital values in Europe and the US are too high. Many current commentaries reveal a belief that yield compression is now over and that some secondary markets are already seeing yield expansion. Asia, with good fundamentals and benefiting from a cascade of capital exiting weakening markets, may be the exception to this in the short term.

"...on a risk-adjusted return basis, property may still appeal to many investors as "safer than equities, more rewarding than bonds"."

The UK situation could un-nerve investors about real estate generally. However, in nearly all markets, commentators are talking confidently about substantial allocations of capital waiting for deployment into property. They could be from opportunists but there is also a belief that cash rich funds, like the burgeoning sovereign funds, the petro-dollar funds and the major pension funds, still feel underweighted to property and will enter the market now that the leveraged buyers are gone and prices are more reasonable.

Net Asset Value Premium/Discount (by region)



Source: UBS (4th January 2008)

Property also needs to be seen in context with other investable assets. For many, diversification and high income returns remain sound reasons for continuing to invest in property and, on a risk-adjusted return basis, property may still appeal to many investors as "safer than equities, more rewarding than bonds". In these increasingly well understood markets, investors will know when property markets offer sound value and they have capital to take advantage of it. One possible implication of the UK potentially (over)correcting first is that it may move from being relatively unattractive to relatively attractive.

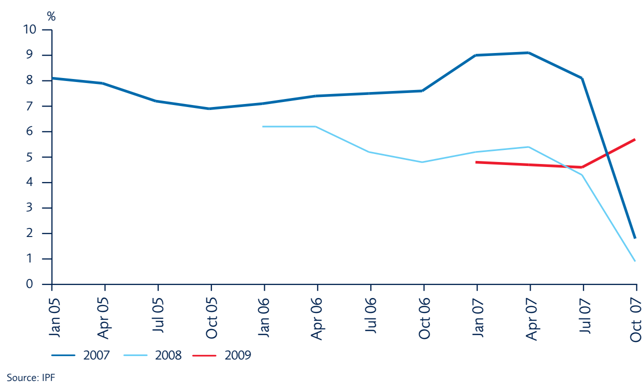
UK PROPERTY OUTLOOK

The UK property market has seen exceptional returns over the last few years and it was felt by many that the "party" had gone on far longer than could be justified. As yield compression continued relentlessly, pricing became more and more stretched, prompting many commentators to argue that the inevitable "hangover" would prove increasingly painful.

This said, a crash was by no means anticipated generally. Indeed, most commentators were forecasting a more gradual correction for the market, with previous yield compression reversing slowly and steadily over a number of years. The IPF Consensus Forecasts, published in August 2007, projected a total return of 8.1% for 2007, anticipating broadly flat yields over the course of the year. Fairly mild yield expansion was forecast thereafter, causing returns to moderate to between 4% and 5% for 2008 and 2009 respectively.

Against this backdrop, the actual pace and strength of yield expansion caught investors and commentators by surprise. Given a rapidly accelerating pace of yield expansion over the second half of the year, the August IPF consensus forecasts quickly became out-of-date and when, in November, a further set of numbers was published, the forecast for 2007 had been slashed to 1.8%. As we stand at the turn of the year, even this figure now looks markedly optimistic, with most commentators now forecasting a rare negative total return for the IPD Index in 2007.

Evolution of UK Total Return Forecasts

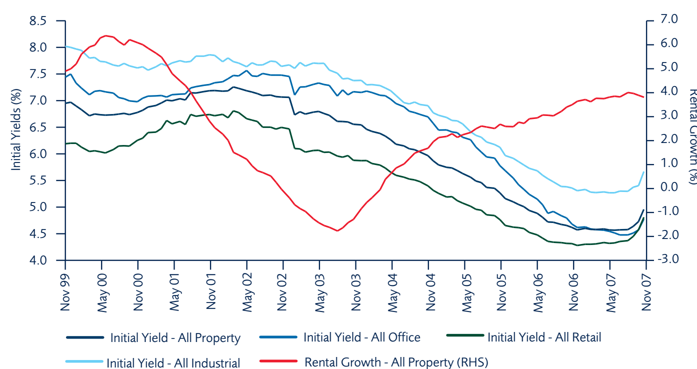


Source: IPF

However, while the main movements in the market have been generated through changes in investor sentiment, rental growth prospects and the economic fundamentals supporting UK commercial property remain robust. GDP growth, while expected to slow slightly, should remain reasonably healthy, and consensus forecasts see rental growth at a relatively strong 4.3% over the year 2007.

Rental growth has mainly been driven by the Central London office markets, which have experienced a strong cyclical upswing for much of 2007. However, as more supply is delivered (particularly in the City) and demand begins to moderate, with some occupiers baulking at such high rents and others putting off new occupation plans until the current financial uncertainties abate, rental growth is expected to slow as the market works its way through its cycle. Retail rental growth is currently on a downward trend and, with consumer spending constrained by higher interest rates and housing prices under pressure, a significant reversal of trend is not expected. Industrial rents are forecast to see only modest growth.

UK Property Initial Yields and Rental Growth



Source: IPD Monthly Digest (November 2007)

The All Property average rate of rental growth is therefore expected to moderate over the next few years, precipitated by an ebbing away of the Central London office driver. Most recent forecasts expect a rate of c.3% p.a. on average over the next five years. This is broadly in line with the long-run trend.

Despite the gloom and sense of shock pervading the UK market currently, we must recognise that the current downturn is different to that of the early 1990s. The economy was in recession then; demand for space was weak and development had oversupplied the market. Not surprisingly, rental values plummeted. At the same time, investor sentiment turned strongly negative, causing yields to rise. Today's situation sees only one of these elements in play - yield expansion. Rental growth is currently supportive, helping to limit the extent to which yields might move out.

"Despite the gloom and sense of shock pervading the UK market currently, we must recognise that the current downturn is different to that of the early 1990s."

We expect the market to clear and reach a new equilibrium reasonably speedily in 2008. Thereafter, returns should recover to acceptable levels after a relatively short period of time. Many believe that there is plentiful capital waiting to be deployed into property investments once prices have corrected. On balance, offices are expected to outperform in the short term, supported by better rental growth but, as the market corrects we expect a crossover, with retail beginning to offer better value.

GLOBAL ECONOMIC AND MARKET OUTLOOK

The prospects for equities have become less positive compared with three months ago, as the "credit crunch" deepens and global growth slackens. However, as core inflation is still benign, policymakers have room to manoeuvre on monetary policy.

Compared with the third quarter of 2007, investors' sentiment towards the end of 2007 was markedly more subdued and there is generally more caution in financial markets. Recent corporate news and surveys of consumer and business confidence have been weak, suggesting that the possibility of a US recession has also become more likely. The US jobless rate rose to 5% in December, the highest rate since 2005.

Unsurprisingly, the US Federal Reserve is now under greater pressure to make further cuts to interest rates, although some fear that the Fed will be constrained by lingering concerns on inflation. However, it would seem that core inflation, which excludes volatile food and energy costs, is still under control, giving US policymakers a little more room to manoeuvre on monetary policy.

The expectation, therefore, is for further rate cuts in early 2008, with similar moves a likely prospect in the UK. At the moment, UK monetary policy is still restrictive and, given tighter credit conditions and US weakness, interest rates may have to come down much more to see off a severe downturn in the economy. The latest government data showed headline average earnings rising 4% on the year in the three months to October, indicating little immediate danger of inflationary pay growth. However, the Bank of England remains far more reticent to cut interest rates than the Fed, holding the official bank rate at 5.5% at its January meeting.

Given the increased risk to growth, the current weakness in sterling does not come as a surprise. Indeed, the British currency has fallen to its lowest against the euro since its creation in 1999. With interest rates likely to be reduced further in 2008, further downward pressure on sterling seems likely.

The overall attractiveness of equities has declined compared with three months ago as corporate earnings expectations have fallen. European equities still look attractive, but there are risks. European banks are vulnerable to substantial writedowns due to their exposure to US sub-prime mortgages and, despite signs of increasing weakness in the economy, the ECB is still more worried about inflation rather than growth risks.

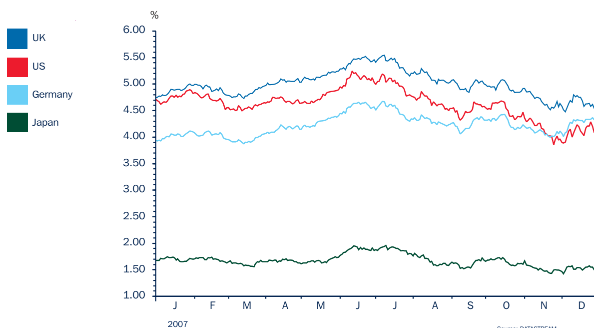
Emerging markets like Brazil are still strong, buoyed by commodity prices, although there has been some easing in base metals such as copper. Asian stocks, on the other hand, have probably peaked although, on a valuation basis, Thailand, Taiwan and Korea continue to offer relatively good value. The Japanese market remains a laggard, with poor prospects of a significant turnaround in the near term. However, its currency, the yen, is relatively strong, despite the weak economy, as it is considered a safe haven amidst a weakening US dollar. Nevertheless, the yen's rising trend is not expected to continue.

Given the prospects for slowing economic growth and lower interest rates, government bonds continue to offer good value. With widening yield differentials between German and US government bonds, European government bonds and AA or higher rated investment grade corporate debt seem particularly interesting investment opportunities.

The recent turmoil in financial markets has clearly accelerated the correction in the commercial property market and, while it is proving to be sharper than many expected earlier in the year, it is likely that the adjustment period will now also be significantly shorter. Returns are expected to remain negative in the short term but with a stabilisation earlier in 2008 than previously expected.

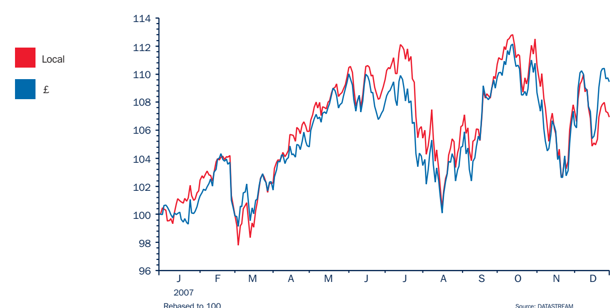
The last "credit crunch" in the US took place in the early 1990s when over a 1,000 savings and loan institutions went out of business. The so-called "Savings & Loan Crisis" was estimated to have cost the US government over US$120 billion and took the economy around three years to recover. While it remains to be seen if the latest crisis deepens to something of a similar magnitude, it is certain that the first half of 2008 will be a period of consolidation for investors.

10-Year Government Bond Redemption Yields



Source: Datastream (December 2007)

FTSE World Index



Source: Datastream (December 2007)

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 December 2007, 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 December 2007, 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 11 staff including nine property economists and two 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

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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.

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
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