REAL ESTATE
INVESTMENT
MANAGEMENT

UNITED KINGDOM
REAL ESTATE PERSPECTIVE
3RD QUARTER 2008

Part of the M&G Group

PRUPIM

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ABOUT PRUPIM

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

We manage around US$37 billion of real estate assets, of which US$6 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with approximately 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 10-strong Global Property Research Team was formed in 1987 and is comprised of property economists and performance measurement analysts who work together to provide leading property analysis and commentary on the UK and international property markets.

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

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

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EXECUTIVE SUMMARY

PERFORMANCE

- Over the second quarter of 2008, the downturn in the property market continued to decelerate, with IPD recording quarterly total returns of -2.7%, compared to -3.3% in the previous period. Most segments witnessed an improvement; shopping centres and City offices were the only exceptions.

- Although yield impact has reduced, rental growth which has, until now, been supporting returns, fell to zero. Ths is the lowest level since 2003. While quarterly growth was modest in the retail and industrial sectors (lower on the monthly index), it was offset by falling office rents, primarily in the City.

- Additionally, although having improved on a quarterly basis, the latest monthly figures were less encouraging. Capital falls were recorded at double the rate of the previous two months resulting in a monthly return of -1.5%, the poorest performance since January.

REVIEW

- Over recent weeks, further concern has returned to the property market. The deterioration in the outlook for the economy is having a direct impact on the rental market, but is also affecting the investment market. So far, there has been little evidence of investors returning to the market. A recovery from the "credit crunch" does not appear to be in sight and there are mounting questions as to whether banks will move against poorer lending covenants.

- Until now, prime assets appear to have suffered more than secondary assets. This, perhaps, reflects a lack of transactional evidence for the secondary part of the market. However, according to a recent survey, secondary yields are now thought to be rising faster than prime.

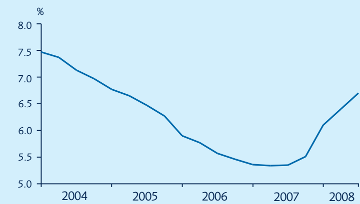
OUTLOOK

- Against the rising concerns about the gloomy outlook for the UK economy, short-term total return forecasts for All Property have been downgraded significantly. The downturn is now expected to last longer than previously thought.

- Rental market prospects have been weakening; negative rental growth is now forecast for both this year and next. Offices are likely to be the weakest occupier market, while retail is expected to be the most defensive. However, for the retail sector, depending on how well consumer spending holds up amidst the currently troubled housing market, rental growth risks are on the downside.

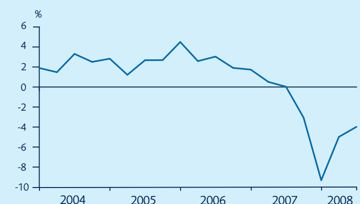
- Looking forward, yields are expected to continue to rise before stabilising during the second half of next year. However, given the already substantial yield correction, the UK property market remains the most attractive relative to other international markets.

IPD Equivalent Yield for All Property



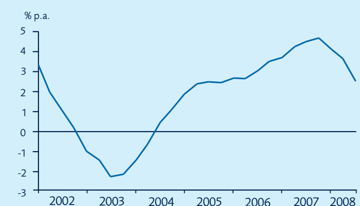
Source: IPD June 2008 (Quarterly Index)

All Property 3-Month Yield Impact



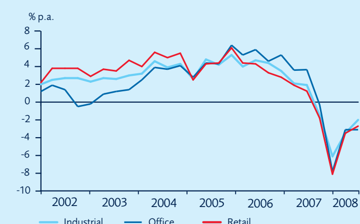
Source: IPD June 2008 (Quarterly Index)

UK All Property Annual Rental Growth



Source: IPD June 2008 (Quarterly Index)

3-Month Total Return



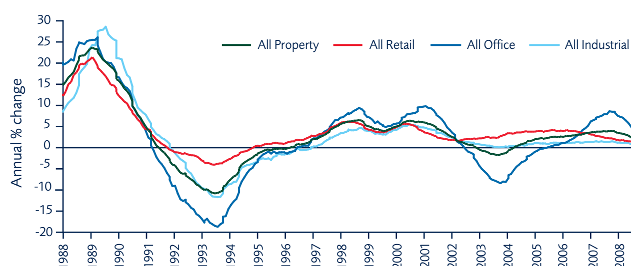
Source: IPD June 2008 (Quarterly Index)

UK PROPERTY REVIEW

Following the sharp correction in the property market during the final quarter of 2007, the downturn has since been showing signs of slowing. According to the IPD Quarterly Index, the fall in total returns was -2.7% in the second quarter of 2008; a deceleration from -3.3% in the first quarter and -7.5% at the end of last year. With little difference between the sectors, yields moved out 28 basis points at the All Property level, down from 34 basis points in the first quarter, leading to a reduction in the impact of yields on capital values. All Property total returns now stand at -14% on an annual basis.

However, the IPD Quarterly figures hide some detail since, although having improved on a quarterly basis, the latest monthly figures point to a modest reversal of this trend. In June, capital declines re-accelerated to 2%; close to double that recorded in April and May, reducing three-monthly returns to -2.7% from -2% in May. Although still early days, this reversal is providing evidence for what many investors have feared; that the recent improvement will level off and that we may witness a second dip in property market returns.

Rental Growth Comparisons: Early 1990s and Now



Source: IPD June 2008 (Monthly Index)

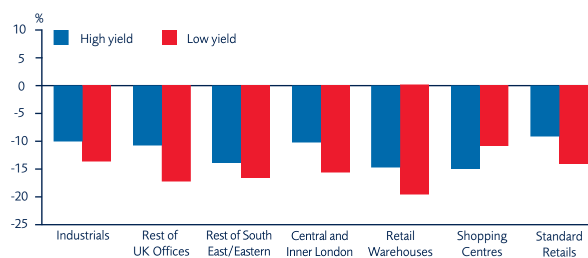
Furthermore, while the negative impact that yields have had on returns has reduced, so has the opposing positive impact from rental growth. While remaining positive on an annual basis, All Property rental growth to June on a quarterly basis fell to zero in the second quarter of 2008, its lowest level since 2003. This flat growth reflects falling rents in the office sector being offset by slightly positive (but weakening) rental growth in the retail and industrial sectors. Hence, while rental growth, until recently, has helped support property returns, this is no longer the case.

> **"...rental growth peaked at c.4% in 2007, far less than growth in excess of 20% per annum at the end of the 1980s. Even for the office sector, rental growth has been far less extreme."**

Going forward, with the deterioration in the overall economy, rental growth is set to worsen. This is the case for all three sectors, most prominently in the office market, and in particular in the City where a large proportion of demand is from the volatile, and currently downbeat, financial and business services sector. However, with house price falls, rising fuel inflation and record low consumer confidence, retail and industrial rental growth is also suffering.

On a more positive note, the oncoming rental weakness is not expected to be as severe as in previous cycles. These beliefs are partly drawn from the recent upturn in rental growth being far less extreme than in the late 1980s; rental growth peaked at c.4% in 2007, far less than growth in excess of 20% per annum at the end of the 1980s. Even for the office sector, rental growth has been far less extreme. Additionally, levels of future development completions are expected to be lower than in previous cycles. This is partly because the "credit crunch", the catalyst of the economic slowdown, is restricting finance and, hence, is acting to curtail developments.

12-Month Total Returns by Segment and Yield Band



Source: PMA Spring 2008

One interesting dimension of the current market is that, according to IPD, lower yielding assets have suffered more over the past year than higher yielding assets; a surprise given that lower yielding assets are recording stronger rental growth. The only sensible explanation for this is that fund managers have been forced to sell their favoured assets in order to ensure a sale. In turn, this has resulted in only limited amount of transactional activity for secondary stock dampening the extent of their recorded upward yield movements. A recent Colliers CRE/EG Capital Pricing survey said, however, that secondary yields are climbing four times faster than prime yields. If this is true, evidence of the normal relationship of secondary suffering worse than prime stock will soon re-assert itself.

UK INVESTMENT MARKET DYNAMICS

After a lengthy period in which the fall in capital values seemed to be abating, concern appears to be re-entering the UK commercial property market this summer. With no obvious relief to the "credit crunch" in sight and worsening economic conditions threatening tenant demand for properties of all kinds, talk of a "double dip" in the market is increasingly prevalent. Everywhere, market commentators are reducing their forecasts for 2008 and 2009.

Investment opportunities offering superior returns, such as bank debt or CMBS and other asset-backed markets, are diverting institutional capital away from the direct property market. There is still little evidence of the much vaunted opportunity funds and equity holders entering the market. Fears are rising that, if their entry into the market is based on being backed by debt to achieve their promised high returns, their support may be increasingly hard to secure.

As has been the case for the past 12 months, leveraged buyers have been squeezed out of the market and, to make things worse, industry data appears to suggest that the retail investors are again redeeming more than they are investing in commercial property funds which, should it persist, could lead retail funds to re-enter the market to sell stock.

IPF Forecasts Capital and Rental Growth % 2008 - 2010

	2008	2009	2010
Forecast Capital Growth	-10.2	-1.0	2.3
Forecast Rental Growth	0.4	-0.9	0.6
Implied Yield Shift	+71bps	1bp	-11bps

Source: IPF Consensus (June 2008); IPF Forecasts Capital and Rental Growth 2008 - 2010

With few investors buying and prospective vendors still baulking at the levels to which pricing has fallen, it is not surprising that transaction levels are very low, standing at a third of the level 12 months ago. What is being transacted tends to be at the primer end of the spectrum; properties with any question marks or perceived blemishes are requiring substantial discounts to secure transaction. Any seller, whether it is the case or not, is treated as though in distress and price chipping has become the market norm.

The market is highly focused on today rather than the medium term. Investors are looking at initial rather than equivalent yields and rental reversions. Sellers prefer to trade with equity buyers and will accept pricing discounts to trade with them rather than with buyers who need to secure debt.

In general, investor preferences, such as they can be discerned, remain distinctly risk averse. Southern assets are generally preferred over Northern; small lots are preferred over large; long leases are preferred over short; pre-determined future cashflow growth patterns are preferred over open market determined patterns and, generally speaking, the greatest fears currently revolve around all forms of secondary stock.

"With no obvious relief to the "credit crunch" in sight and worsening economic conditions threatening tenant demand for properties of all kinds, talk of a "double dip" in the market is increasingly prevalent."

Looking to the immediate future, more and more analysts are attempting to discern how banks might act with respect to the increasing numbers of loan breaches. By calling in bad loans and recycling properties in a low demand environment, banks could end up boosting investable stock in the market and forcing capital values lower. Hence, the general view seems to be that, where they can, banks will keep existing loans going. However, as the market begins to revive, action might then be taken with problem loans and properties recycled. This would avoid a further precipitate fall in prices, but could delay any pricing recovery.

IPF Consensus Forecasts for Total Returns June (08) vs March (08) % 2008 - 2010

	2008		2009		2010		2008/12	
	Jun (08)	Mar (08)	Jun (08)	Mar (08)	Jun (08)	Mar (08)	Jun (08)	Mar (08)
Standard shops	-4.5	-2.4	5.7	6.9	8.4	8.4	5.5	5.9
Shopping centres	-4.3	-2.5	5.4	6.9	8.1	8.4	5.5	6.0
Retail warehouses	-6.3	-3.6	5.2	7.0	8.9	9.0	5.7	6.1
Offices	-5.7	-2.2	3.0	5.9	7.5	8.4	4.8	5.9
West End offices	-6.1	-1.9	3.0	6.4	7.6	8.5	4.8	6.1
City offices	-9.5	-4.8	-2.0	2.4	6.0	6.9	2.3	4.1
Industrial	-4.8	-1.8	5.5	7.3	8.4	8.8	5.7	6.5
All Property	-5.2	-2.6	4.7	6.5	8.2	8.4	5.4	6.2

Source: IPF Consensus (March 2008 and June 2008)

RETAIL

PERFORMANCE

- With total returns of -2.7% over the second quarter of 2008, as recorded in the IPD Quarterly Index, the retail sector outperformed offices and improved on its performance over the first quarter of 2008. It continues to underperform against the industrial sector.

- Yield expansion remains the main driver of poor returns as retail capital values fell by a further 3.9% over the quarter, performing only slightly better than the All Property average of -4.0%. Rental value growth continued to moderate and is now running at a quarterly rate of only 0.2%.

- Within the sector, shopping centres have now overtaken retail warehouses as the poorest performing segment. Both stronger yield expansion and weaker rental growth, especially for the in-town centres, have driven shopping centre returns to -3.5%, compared with -3.1% for retail warehouses. Central London shops remain the best performing segment with quarterly returns at -0.2%, boosted by stronger resistance to yield expansion and relatively higher rental growth.

OCCUPATIONAL DYNAMICS

- In an environment of rapid economic slowdown, where inflation is a concern and non-food retail sales have seen a marked slowdown in activity, prospects for the occupier market are weakening. Credit restrictions, combined with surging fuel and energy prices, are squeezing disposable incomes.

- The gloomy outlook is characterised by falling house prices, a sharp decline in mortgage approvals and consumer confidence hitting a record low. All factors are highly indicative of a consumer slowdown despite retailers' widespread discounting and the strong retail sales figure "blip" recorded in May, which has since been offset by a sharp fall in June, particularly for household goods.

- Against this backdrop, demand for space is falling while availability is rising. Retailer casualties have increased and many are downsizing or halting expansions. With a large amount of new supply (mainly shopping centre space) due to complete this year, landlords are forced to increase inducements to encourage lettings.

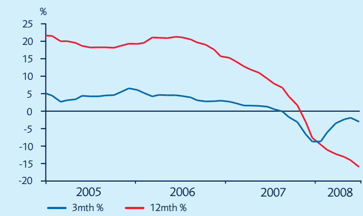
INVESTOR SENTIMENT

- Yields for high street shops are generally seen as having expanded earlier and are now standing close to long-term levels. As such, despite worsening news on tenant demand, they remain a more favoured investment sector. This said, investors' focus is on prime assets, the definition of which is narrowing markedly. Off-prime and secondary asset yields are continuing to rise steadily.

- With very few deals until recently, valuations in the shopping centre sector have held up remarkably well. However, worries are mounting as more stock is brought to market and tenant demand remains weak. Shopping centres represent large lot size assets and many secondary assets have been bought by now struggling leveraged investors. Both issues give cause for concern.

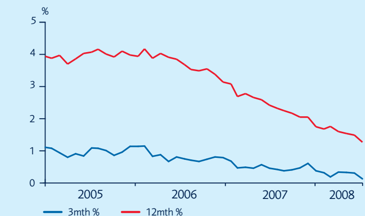
- The retail warehouse sector continues to see yield gaps widening between prime and secondary assets; large and small lot sizes; and Open A1 and "bulky goods" uses, with the former preferred by investors in each case.

Retail Sector Total Returns



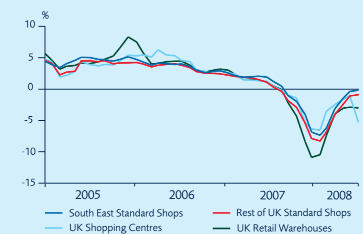
Source: IPD June 2008 (Monthly Index)

Retail Sector Rental Growth



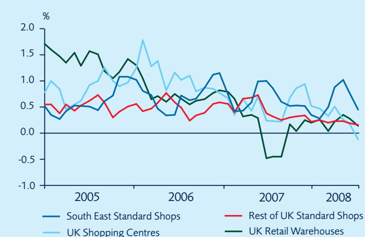
Source: IPD June 2008 (Monthly Index)

Retail Sector 3-Month Total Returns



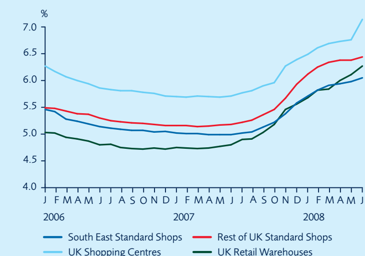
Source: IPD June 2008 (Monthly Index)

Retail Sector 3-Month Rental Growth



Source: IPD June 2008 (Monthly Index)

Retail Sector Equivalent Yields



Source: IPD June 2008 (Monthly Index)

OFFICES

PERFORMANCE

- Offices were the worst performer over the second quarter of 2008, recording returns of -3.1%, taking annual returns to -13.8%. In contrast to the retail and industrial sectors, where quarterly total returns have improved recently, returns were at a similar level of decline to that recorded in the first quarter.

- The lack of improvement reflects a deterioration in rental growth which, until now, has held up far better than for the other sectors, boosting performance. However, in the second quarter of 2008, rents for All Offices fell for the first time since 2004. With yields continuing to move out, the office sector suffered more.

- The City market, where rents were hit most, saw the weakest quarterly performance of -4.9%, far worse than in the first quarter of 2008. Yorkshire and Humber, where yields moved out by over 50 basis points in the second quarter, were also hit particularly hard.

OCCUPATIONAL DYNAMICS

- Over the quarter, office occupational markets continued to weaken significantly, particularly in the Central London markets. Being at the heart of the credit turmoil, the banking and financial sector will clearly account for a large proportion of jobs lost, which is likely to further dampen the already weak demand environment.

- For the City, the second quarter of 2008 take up was the lowest since 2002 and, according to IPD, rents fell 2.1% over the period. For the West End and Mid-Town markets, which have held up relatively well in previous quarters, take-up has been resilient but rents are now also falling, albeit less so than in the City.

- In contrast, out-of-London markets have so far been performing better, thanks to relatively sturdy demand conditions, supported by less-pressured regional economies. However, with development completions coming through, future vacancy levels are expected to rise.

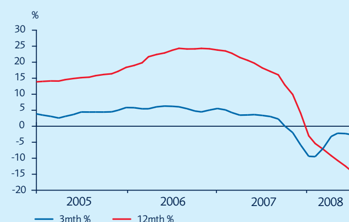
INVESTOR SENTIMENT

- Despite grave short-term concerns over rental prospects in the market, the general view is that there are still buyers, especially from overseas, for City offices. Not surprisingly, these investors, particularly if they are using their own equity, have an abundance of assets to choose from and are driving hard bargains.

- To-date, the West End market has held up well with a diverse set of investors operating in a smaller lot size, together with being more supply-constrained and a better rental growth oriented market. This said, investment volumes remain thin and yields are beginning to rise.

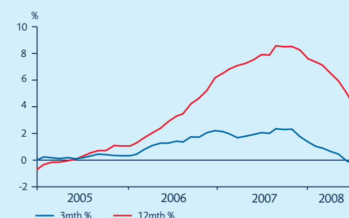
- Outside London, trading remains very thin. Investor preferences remain very much for primer, longer-leased assets and there is a growing feeling that Southern markets may have corrected earlier than Northern markets and are now better priced. Independent of this, secondary assets in South Eastern towns and regional capital markets are seeing yields rise dramatically.

Office Sector Total Returns



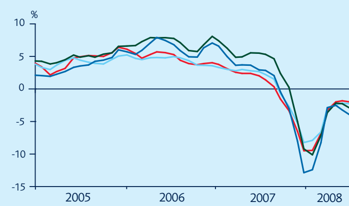
Source: IPD June 2008 (Monthly Index)

Office Sector Rental Growth



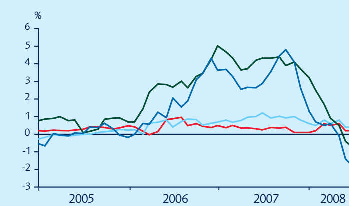
Source: IPD June 2008 (Monthly Index)

Office Sector 3-Month Total Returns



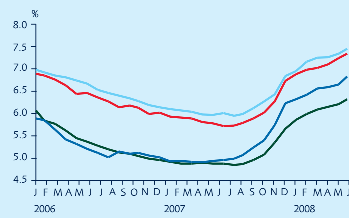
Source: IPD June 2008 (Monthly Index)

Office Sector 3-Month Rental Growth



Source: IPD June 2008 (Monthly Index)

Office Sector Equivalent Yields



Source: IPD June 2008 (Monthly Index)

INDUSTRIALS

PERFORMANCE

- Capital values continue to fall in the industrial sector, but at a decelerating rate; the IPD Quarterly Index shows that capital decline slowed to -3.4% from -5% in the previous quarter. Total returns now stand at -2% on a quarter-on-quarter basis, compared to -3.5% at the end of the first quarter of 2008.

- Yield shift is becoming more muted despite rental growth starting to soften. Growth remains positive but further weakening is expected, which will obviously feed through into total return figures.

- Although, in the quarterly index, the negative momentum in yield shift seems to have declined, the weakening occupier market may lead to a reacceleration. Indeed, in the monthly index, negative yield impact stepped up again in June, having decelerated each previous month in 2008. It is hard to say, at this time, whether this is the usual quarter-end spike or an indication of a further weakening of sentiment.

OCCUPATIONAL DYNAMICS

- Availability rates have remained stubbornly high throughout the year-to-date and have actually edged up from the already elevated levels witnessed at the start of the year. Although speculative development seems at last to be easing, vacancy remains high due to weakening on the demand side, which is compounding the significant supply problems in this sector.

- In this weakening demand environment and with significant levels of supply, empty rates legislation is heightening landlords' sensitivity to the deterioration in fundamentals. With the cost to landlords of empty property increased, we are already seeing landlords beginning to accept lower rents to weaker covenants, just to fill the vacancies. In the short term, this will act as an extra drag to rental growth although, in the longer term, the opposite effect will be apparent with developers already announcing that they are scaling back development activity, partly as a result of the change in legislation.

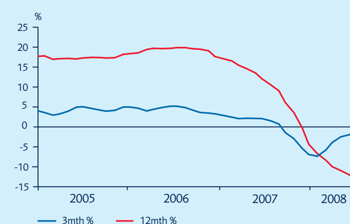
INVESTOR SENTIMENT

- The demand for prime industrials is modest and there is still weaker demand for secondary assets. Transaction activity is far lower than normal and, for industrial units and estates at least, yields are rising modestly in prime assets and considerably more so in secondary.

- The only bright spot in the sector is the localised market around Heathrow airport, near London. Given the general fortunes of the sector (and indeed the market generally) the prices being paid in this market seem to be defying gravity.

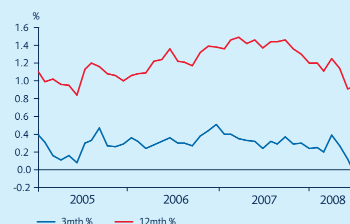
- The distribution warehouse sub-sector is distinctly out of favour with investors who perceive that demand is weakening as retailer support for the sector ebbs away, and the effects of oversupply in key markets become apparent. Longer-leased assets, especially if let to supermarket chains, are preferred currently. Anything with a short lease is seeing pricing weaken materially.

Industrial Sector Total Returns



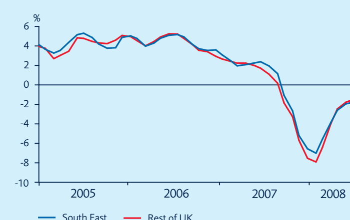
Source: IPD June 2008 (Monthly Index)

Industrial Sector Rental Growth



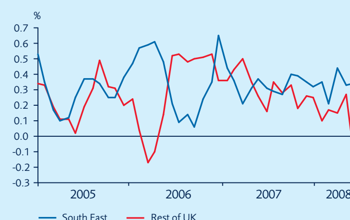
Source: IPD June 2008 (Monthly Index)

Industrial Sector 3-Month Total Returns



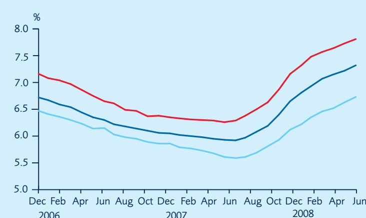
Source: IPD June 2008 (Monthly Index)

Industrial Sector 3-Month Rental Growth



Source: IPD June 2008 (Monthly Index)

Industrial Sector Equivalent Yields



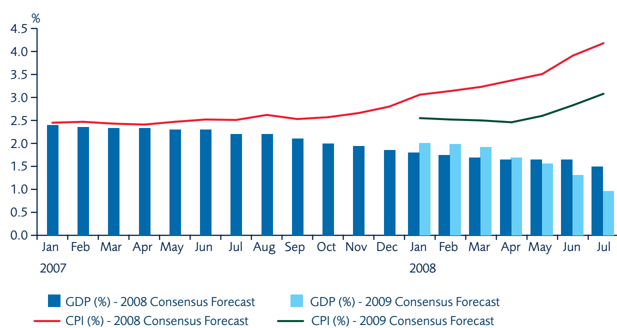
Source: IPD June 2008 (Monthly Index)

UK PROPERTY OUTLOOK

In the second quarter of 2008, the economy continued to weaken, growing by just 0.2% compared with 0.8% for the same quarter last year. The IMF has downgraded their growth forecasts to 1.4% for 2008 and a mere 1.1% for 2009, significantly lower than 1.75% it was forecasting in May. Weak construction and production output are likely to contribute most to the deceleration in growth. However, the main worry is rising inflation, which climbed to 4.4% in July, over double the target rate. As a result, the Bank of England finds itself caught between a conundrum of lower growth and higher inflation. Henceforth, interest rates are expected to be kept unchanged at 5% until price pressures are back under control.

For the property market, the June IPF Consensus forecasts for total returns also showed significant downgrades. For 2008 and 2009, total returns now stand at -5.2% and 4.7% respectively. However, with economic and financial market sentiment having worsened in recent weeks, these forecasts already seem behind the curve. Fears are growing that banks may move against poor lending covenants to strengthen their balance sheet which could eventually lead to a further surge of stock entering an already weak market. The property market survey, published by RICS in July, showed that the market confidence is at the lowest level since the survey started in 1998. As such, analysts are downgrading their forecasts swiftly and many are now expecting total returns worse than -10% for 2008 before the market starts to recover the following year. The implied returns from the derivatives market also suggest a total return of -12.5% for this year and -2.25% for the following year.

Evolution of GDP and Inflation Forecasts



Source: Consensus Economics, (July 2008)

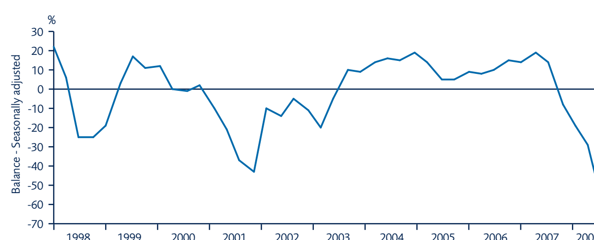
Against the potential of a prolonged economic downturn, the rental market prospects have also been weakening. Negative rental growth for All Property is now forecast for both this year and next. The office sector, which has outperformed other sectors in terms of rental growth in recent years, is likely to be the worst occupier market along the five-year forecast horizon. Clearly, being hit hard by weak fundamentals due to a significant increase in supply and sharp deterioration in demand, Central London offices, especially the City, would be the major force behind the overall fall.

In the retail and industrial sectors, rental fundamentals are also weakening. Though supply, in general, isn't posing too much of a problem, it is clear that downside risks lie with the state of demand. This said, the combination of rising fuel and material costs and substantially weakening retail sales will take its toll on retailers and, henceforth, rental growth prospects.

> "The office sector, which has outperformed other sectors in terms of rental growth in recent years, is likely to be the worst occupier market along the five-year forecast horizon."

In summary, evidence is mounting that, rather than being driven solely by investment sentiment, the current cycle will be more significantly impacted by the occupier market than previously thought. Nevertheless, it is worth noting that rental market fundamentals remain better than those experienced in the previous downturns.

Surveyor Confidence in Occupier Sales and Lettings for the Next Quarter



Source: RICS Commercial Market Survey (Q2 2008)

With little sign so far of a recovery in either the economy or investor confidence, looking forward we expect yields to continue to rise before stabilising by the second half of next year. Across the board, the industrial sector looks the most attractive over the longer term due to yields having already substantially corrected. In contrast, the Central London office segment remains gloomy, having suffered from both heavy downgrades in rental growth forecasts and adverse market sentiment. However, given the already substantial yield correction, the UK property market is now the most attractive relative to other international markets.

IN-FOCUS

CENTRAL LONDON OFFICES

Leanne Finesilver

In recent times, the UK, and in particular the London economy, has grown successfully. Growth for the UK economy as a whole has been at or above trend, with the London economy, boosted by the financial and business services sectors, a substantial driver. In turn, employment growth has been strong and company profits healthy, leading to increased demand for office space in the capital.

Over much of this period of strong demand, the supply of office space has been limited. According to Property Market Analysis, in 2005 and 2006 combined, less than 2.5million sq ft of office space was delivered into the Central London office market. With the long-run average of completions in this market just under 4million sq ft per year, these two consecutive years of undersupply, which neither followed nor preceded a year of high completions, resulted in a shortage of space.

This strong demand combined with a lack of space resulted in a sharp rise in Central London office rents. IPD recorded rental growth in both 2006 and 2007 in excess of 10% across each of the Central London market segments. The cost of office space, therefore, increased substantially, particularly in the West End where rents were higher to start with and IPD recorded combined rental growth in 2006 and 2007 of 38%. This took top prime rents to well in excess of the £100 per sq ft mark for the very best properties.

"....for the West End, new space is still constrained and the speculative pipeline is much lower...."

The extent of the rental growth and the scarcity of new space resulted in cost-conscious occupiers increasingly being pushed out from the traditional City and West End markets to less core locations.

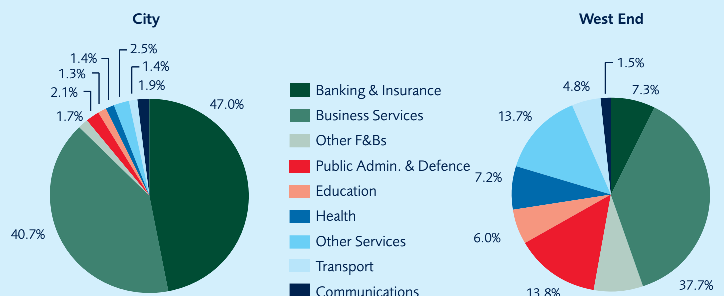
However, with the arrival of the credit crisis during the summer of last year, the Central London occupier market was thrown into turmoil. Initially, there was anticipation that this would be short lived but, with a continual stream of bad bank debts being revealed, this is no longer expected to be the case. Sentiment has now weakened substantially and the volatile financial and business services sector has already seen a sharp slowdown in growth. With London's, and especially the City's, high exposure to this sector, demand for office space has weakened dramatically with a further deterioration expected during the remainder of 2008.

This fading demand for office space is coinciding with the delivery of the large amount of Central London office completions which the market had, until the end of last year, been so desperately in need of.

According to PMA, a total of 11.5million sq ft of Central London office space is expected to complete either this year or next. Some of this space is pre-let, but the greater part is not.

However, this aggregate statistic hides a disparity between submarkets within Central London. The majority of speculative space is bound for the City (c.6million sq ft for 2008 and 2009 combined), which has a high exposure to the financial and business services sectors. With supply high and demand weakened, vacancy rates in this market have already started to rise and it is expected to struggle in the short term. However, for the West End, new space is still constrained and the speculative pipeline is much lower at 1.5million sq ft. Furthermore, relative to the City, the West End benefits from a more diverse range of occupiers. While it does have exposure to the financial and business services sectors, they represent a far smaller share of its employment at c.7% compared to 47% in the City.

Office Employment 2007 (by sector)



Source: Experian Business Strategies (Spring 2008)

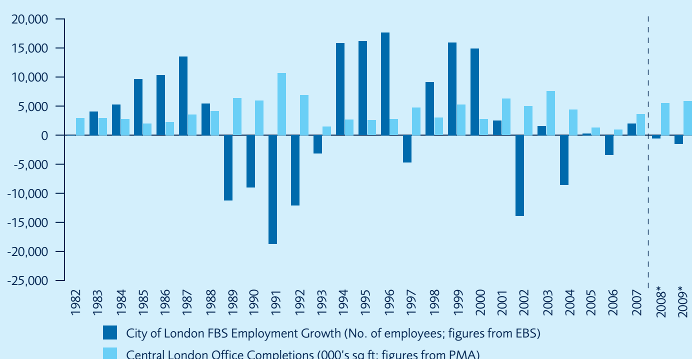
Speculative completions for this year and next outside of the City and Docklands markets sum to c.3.3million sq ft, according to Drivers Jonas, which, if compared to an annual average level of take up for the West End and Mid-Town markets of 4million sq ft, doesn't look so bad. Even if we make a bearish assumption that take-up this year and next will be at a similar level to the weakest take-up recorded over the past 20 years (c.2.2million sq ft recorded in 2002), this will total 4.4million sq ft, still higher than expected completions. Of course, this is a simplified example, as no account is taken of the release of second hand space or space already completed, but it does illustrate that the West End (and to a lesser extent Mid-Town) are likely to be riding a different cycle to the City.

What about the other Central London markets? The Docklands market, like the City, has a high exposure to banking and finance, and especially to the fragile US economy. New supply is low but the greatest concern relates to the potential release of second hand space. As yet, little space has been released but, given the concentration of

US banks in this market, if realised, the consequences would be similar to those in the City. In the smaller peripheral markets, speculative completion levels are also low, c.300,000 sq ft in Southwark, Kings Cross and Paddington combined.

However, in contrast to previous downturns, job losses are expected to be far less this time around. While job cuts have made dramatic headlines, so far the scale of these has been relatively small. According to Experian Business Strategies, net financial and business service job losses in the City of London are expected to be c.2,000 for this year and next. This compares to a total of 50,000 over five years in the 1990s and 21,000 between 2002 and 2004. There are of course downside risks to this forecast but a partial explanation of this low number is that, over recent years, job growth has been fairly flat, meaning that companies now have fewer workers to cut than they did in the past.

City of London Employment Growth Vs Central London Office Completions



* Forecast
Source: Property Market Analysis, Experian Business Strategies RPS (Spring 2008)

An additional important factor for us to remember is that, while there is a link between jobs and the occupier market, there is also a measure of independence. Since demand for office space is lumpy, in the same way that job growth does not always translate into demand for more space (as companies squeeze employees into existing space until they can no longer do so), job losses do not always imply a return of office space to the market. In contrast to previous cycles, due to the high costs associated with searching for new premises and relocation, anecdotal evidence to date suggests that companies would currently rather hold excess space until they expand again, rather than release it. Although this can't drive demand for new space, it goes part way to reduce the likelihood of "grey space" flooding the market, as it has done in previous cycles.

Another contrasting feature of the current market environment to previous times is that the reduction of credit, which in large part instigated the weakening in the occupier market, is simultaneously having a constraining effect on development supply. This is different from previous cycles when the driver of the slowdown has impacted only the demand side. The consequences of this are that developments, which do not yet have financing and/or have not yet started onsite, are less viable to build. This in turn will result in a lower level of completions in the medium term, allowing the balance of supply and demand to be re-established more quickly.

"....in the same way that job growth does not always translate into demand for more space.... job losses do not always imply a return of office space to the market."

However, what are the implications of all this? Given the current demand-supply imbalance in the City, it is clear that, for this market, there will be a tough couple of years ahead. For the West End (and to a lesser extent in Mid-Town), given the supply of space is still constrained and that demand is more diverse, rental growth is unlikely to suffer to the same extent. In fact, with the West End occupier market remaining robust and the rental differential between this market and others still large, this dynamic may well continue to assist rental performance in the smaller submarkets. Rents in Victoria, Paddington and Southwark currently range between £45 and £65 per sq ft compared to locations in core West End of above £100 per sq ft. West End occupiers may also be attracted by the lower rents and quality of new supply in the City, perhaps helping to cushion its fall.

Finally, the restrictions on finance having a dampening effect on construction, combined with the general rise in construction costs (likely to come under further pressure before the Olympics in 2012), should ensure that this period of bleaker Central London rental growth is a shorter one compared to previous cycles.

INTERNATIONAL PROPERTY MARKETS

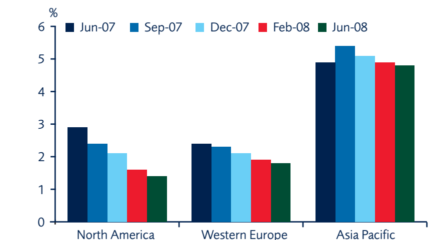
GLOBAL REVIEW

The slowdown in economic growth which commenced in the US has continued to spread to both Europe and Asia. This is weakening future rental growth prospects across the globe, particularly in office markets which are more exposed to the slowdown in the financial services sector.

However, so far, fundamentals in the occupier market remain relatively robust and it is instead the change in investor sentiment which is having the greatest impact on property market returns.

With credit difficult to obtain and investors fearful of capital value falls, transaction volumes have contracted sharply. Yields are now moving out but, to date, corrections have been to a lesser extent than the UK.

2008 GDP Forecast Evolution



Source: Consensus Economics (June 2007 to June 2008)

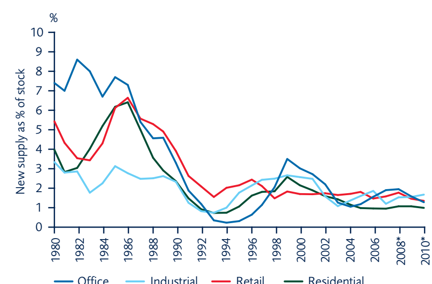
NORTH AMERICA

The economic slowdown is now clearly feeding through into weakening demand for real estate space. However, new supply of commercial space has been fairly restrained, causing low vacancy rates and helping to boost future rental growth prospects.

While property's rental fundamentals are holding up reasonably well, it is the capital markets that have had the biggest impact on real estate's return prospects. Pressure on pricing has eased and cap rates have risen by around 50 basis points since summer last year.

Canada's robust economy means that its property markets are fundamentally sound. Demand and supply remain balanced, suggesting positive rental growth going forward. However, investment sentiment is weakening, and yields are expected to drift outwards.

US Additions to Space



* Forecast
Source: Torto Wheaton Research, REIS (US Top 50 Metros), LaSalle Investment Management (June 2008)

EUROPE

In line with the global slowdown, the economies of Western Europe are also decelerating. For the moment, their occupier markets remain fairly robust, with healthy take-up in retail and logistics, and to a lesser extent offices. However, forecasts for future growth are being downgraded.

In the investment markets, yields continue to move out, particularly in Spain and Ireland. To-date, the correction across Europe has been far less dramatic than that seen in the UK. This reflects pricing being less stretched initially, but also sellers not yet being willing to crystallise lower prices. With financing being difficult and costly to obtain, transaction volumes have contracted sharply compared to the same period last year.

Eurozone Economic Confidence

Source: European Commission (June 2008)

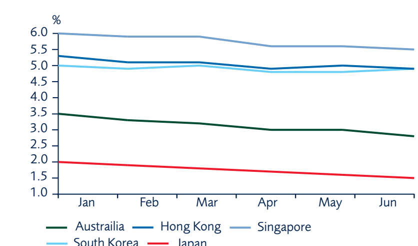
ASIA PACIFIC

Real estate fundamentals remain pretty robust, with demand side variables still relatively solid and supply pipelines in most markets fairly subdued.

Economic weakness has not yet come through significantly in the data. However, the belief that the region is insulated from current global weakness is fading which, combined with higher inflation, is providing the rationale for economic downgrades.

These factors combine with a heightened level of risk aversion and uncertainty in the debt markets to create upward pressure on yields in many of the region's property markets. This momentum, in general, is much more subdued than in the UK, but markets such as Australia and Singapore have the potential for momentum to gather pace.

GDP Forecast Evolution 2009



Source: Consensus Economics (January 2008 to June 2008)

GLOBAL ECONOMIC AND MARKET OUTLOOK

Financial markets had a difficult second quarter of 2008. Having started the period worrying about a potential US recession affecting growth around the rest of the world, a surge in the price of oil, fuels and food caused the main focus of attention to switch to inflation. As inflationary pressures rose, investors started to believe that central banks would have to tighten, rather than loosen, monetary policy. Against this background, equity markets generally recorded modest losses while conventional bonds and property were the main casualties.

As we enter the second half of 2008, the dilemma facing many central banks is whether interest rates should be rising or falling. With inflation running well above target in most major economies, central banks are under pressure to increase interest rates. On the other hand, growth is undoubtedly slowing around the world, quite substantially in Western economies, as the "credit crunch" continues to play out and, with the exception of the US where interest rates have already been lowered significantly, there is an argument which calls for future cuts to stimulate growth.

This conundrum is demonstrated by the policy choices available to the Bank of England who are trying to balance the conflicting pressures of inflation at almost double its official target, a falling housing market, depressed consumer confidence and a slowdown in both manufacturing and service sectors. Putting up interest rates would slow the UK economy even more severely while reducing interest rates, or leaving them unchanged, may well fuel increased wages leading to even higher inflation. The government has stressed that it is imperative to ensure that rising inflationary expectations do not become embedded in wage settlements, and average earnings data may well hold the key to the future direction of monetary policy.

However, since rising commodity prices are, in effect, a tax on income, they should have a deflationary effect. As long as commodity prices do not continue to rise but generally stabilise then, in 12 months time, providing wage growth is under control, headline inflation should start to fall back closer to central banks' target levels. The threat of interest rate increases should, therefore, fall away by 2009. This means that the risks to growth are more likely to stem from rising unemployment, rather than inflation.

Turning to the implications for financial markets, both bonds and equities look good value following their recent falls. The markets' focus on headline inflation numbers is probably overdone, given that higher fuel and food costs have the effect of reducing disposable income. After their excesses, banks are slowly rebuilding their balance sheets although borrowing conditions remain very tight. Meanwhile, growth in major economies is slowing, as evidenced in weakening retail spending and falling house prices. Consequently, interest rates probably do not need to rise as much as investors are currently expecting. The focus in the coming months is, therefore, on markets where massive investor pessimism is reflected in asset prices.

Furthermore, current share valuations suggest that investors are generally overly gloomy about companies' profitability. In Europe, in particular, earnings are expected to fall sharply in view of potential increases in interest rates. While the European Central Bank has, in fact, raised its benchmark lending rate by 25 basis points at the beginning of July, President Jean-Claude Trichet has played down prospects of further interest rate increases.

The stockmarkets of Europe and UK are trading well below their historical average, and US stocks have also fallen to attractive levels. In Asia, markets in Singapore, Hong Kong, Taiwan, Thailand and Korea remain desirable, as do resource-rich countries such as Brazil and Australia. Japan, on the other hand, has been surprisingly strong in recent months and the market is not particularly cheap at this juncture given the weak economic fundamentals.

There are attractive opportunities too in the bond markets where investors may have exaggerated the need for monetary tightening over the next 12 months. Furthermore, prevailing credit spreads (difference in yield between government and corporate bonds) look interesting since they suggest levels of default similar to a depression scenario.

Given the situation, both equities and fixed income investments now offer good value, although commercial property probably still has some way to go.

10-Year Government Bond Redemption Yields

Source: Datastream (June 2008)

FTSE World Index

Source: Datastream (June 2008)

DATA AND STATISTICS

PROPERTY PERFORMANCE METRICS (%)

Index	Frequency	Date	1 month	3 months	YTD	1 year	3 years
IPD Monthly Index	Monthly	Jun-08	-1.5	-2.7	-6.0	-14.9	16.3
CBRE Monthly	Monthly	Jun-08	-0.8	-1.6	-4.7	-13.9	18.2
IPD Quarterly Index	Quarterly	Jun-08	-	-2.7	-5.9	-14.0	17.7
IPD Annual Index	Annual	Dec-07	-	-	-	-3.4	35.8

Source: Various (compiled by PRUPIM performance measurement team)

PRIME HEADLINE RENTS - £ PER SQUARE FOOT PER YEAR

	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
Region	Jun-08	% change over quarter	Jun-08	% change over quarter	Jun-08	% change over quarter	Jun-08	% change over quarter	Jun-08	% change over quarter
Central London	525.0	0.0	120.0	-4.0	-	-	-	-	-	-
Sub London	300.0	0.0	38.0	0.0	-	-	-	-	8.5	0.0
London	-	-	-	-	28.5	0.0	-	-	13.0	4.0
South East	275.0	0.0	28.0	3.7	27.0	1.9	42.0	0.0	7.5	0.0
South West	240.0	-2.0	27.5	0.0	22.0	0.0	70.0	-	7.8	0.0
East Anglia	200.0	-	21.5	0.0	22.5	0.0	32.5	1.6	-	-
East Midlands	245.0	0.0	-	-	-	-	35.0	0.0	4.5	-
West Midlands	265.0	3.6	30.0	0.0	21.0	5.0	35.0	2.9	6.0	0.0
Wales	310.0	0.0	20.0	0.0	17.0	0.0	26.5	0.0	-	-
North East	330.0	0.0	23.0	0.0	16.0	0.0	30.0	0.0	-	-
North West	330.0	0.0	30.0	0.0	20.0	0.0	55.0	-	6.0	-4.0
Yorks & Humbs	310.0	0.0	26.0	4.0	20.0	0.0	40.0	0.0	5.5	4.8
Scotland	255.0	0.0	29.0	0.0	20.0	0.0	45.0	0.0	6.5	0.0

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

INVESTMENT YIELDS (%) FOR PRIME PROPERTIES

	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
Region	Jun-08	% Change over quarter	Jun-08	% Change over quarter	Jun-08	% Change over quarter	Jun-08	Change over quarter	Jun-08	% Change over quarter
Central London	5.00	0.25	5.25	0.00	-	-	-	-	-	-
Sub London	5.50	0.25	6.75	0.75	-	-	-	-	6.25	0.00
London	-	-	-	-	6.50	0.50	-	-	5.75	0.00
South East	5.50	0.25	6.75	0.50	7.50	0.75	6.25	0.25	6.50	0.00
South West	5.75	0.50	6.75	0.50	7.50	0.50	6.50	0.75	6.75	0.00
East Anglia	5.50	0.25	6.50	0.00	8.00	0.50	6.25	0.25	-	-
East Midlands	5.75	0.25	-	-	-	-	6.50	0.75	6.75	0.00
West Midlands	5.75	0.25	6.75	0.50	8.00	1.00	6.50	0.75	6.50	0.00
Wales	5.50	0.25	7.25	1.00	8.25	1.00	6.75	0.75	-	-
North West	5.50	0.25	6.75	0.50	8.00	0.75	6.50	0.75	6.50	0.00
Yorks & Humbs	5.75	0.50	7.00	0.75	9.00	1.00	6.50	0.75	6.75	0.00
North East	5.75	0.50	7.50	1.00	-	-	6.50	0.75	-	-
Scotland	5.50	0.25	6.25	0.50	8.00	0.75	6.50	0.75	7.00	0.00
Northern Ireland	5.50	0.25	7.00	0.50	-	-	-	-	-	-

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

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ABOUT THE GLOBAL PROPERTY RESEARCH TEAM

PRUPIM's well known and widely respected Global Property Research Team, based in London and Singapore, comprises of 10 staff including seven 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

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

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

Scott Girard, Director, Research and Investment Strategy, PRUPIM Singapore, B.Comm MAF

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

REGULATORY INFORMATION

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

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