REAL ESTATE
INVESTMENT
MANAGEMENT

UNITED KINGDOM
REAL ESTATE PERSPECTIVE
MARCH 2010

Part of the M&G Group

PRUPIM

CONTENTS

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 £14.5 billion* of real estate assets, of which £3 billion* is invested internationally in North America, Continental Europe and Asia Pacific. We are invested in 800* properties with approximately 4,000* 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 leading property analysis and commentary on the UK and international property markets.

* As at end of December 2009.

EXECUTIVE SUMMARY	2
Performance	
Review	
Outlook	
UK PROPERTY REVIEW	3
UK INVESTMENT MARKET DYNAMICS	4
RETAIL	5
OFFICES	6
INDUSTRIALS	7
UK PROPERTY OUTLOOK	8
IN FOCUS – PROPERTY DERIVATIVE TRADES: PERFORMANCE REPORTING	9
INTERNATIONAL PROPERTY MARKETS	11
Global Review	
North America	
Europe	
Asia Pacific	
GLOBAL ECONOMIC AND MARKET OUTLOOK	12
DATA AND STATISTICS	13
CONTACTS	14

Unless otherwise specified all data and commentary is as at end December 2009.

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

Manchester Arndale
Manchester

Oxford Science Park
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EXECUTIVE SUMMARY

PERFORMANCE

- 2009 was a year of two halves. The six months to June saw a continuation in rental and capital value declines, as well as further yield expansion. But, in the summer, UK property markets experienced a dramatic turnaround as investor interest returned with a vengeance, driving yields sharply down, capital values up and turning total returns positive.
- All Property total returns increased by an astonishing 10% over the final quarter of 2009. This is the largest quarterly return ever recorded in the history of the IPD Quarterly Index, bringing total returns for 2009 into positive territory at 3.4%. Rental value growth continued to decline, but the pace of falls decelerated from a quarterly rate of -3.1% in quarter one to just -1.1% in quarter four. The contrast in capital values was starker, from a 8.7% decline in quarter one to 8.1% growth in quarter four.

REVIEW

- Following six consecutive quarters of contraction, the UK economy emerged from recession in the final quarter of 2009 with preliminary data showing that the economy grew by an underwhelming 0.1%. Various indicators signalled renewed optimism about future prospects with manufacturing output rising, unemployment easing and house price growth returning. While risks remain on the downside, this is welcoming news for property occupier markets where rental declines prevail, albeit at a much decelerated pace.
- The second half of 2009 saw a sudden recovery in UK investment markets. Commercial real estate looked increasingly attractive as capital-rich investors, recognising value in the high-yielding markets, sought opportunities beyond other asset classes which had already rallied strongly. Investor sentiment improved in quarter three and remained strong throughout the final quarter, pushing prime yields down and total returns into positive territory.

OUTLOOK

- With the economy having suffered the most severe recession in decades, occupier demand for space has plummeted. Although it is ticking up now, a strong recovery in demand remains tentative at best, in line with a subdued economic revival. Generally, any significant rental growth is not expected until demand has recovered enough to fill the high number of vacant units currently on offer and the effect of the constrained development pipeline works its way into the system. This may be another couple of years away.
- The recent resurgence in investor sentiment continues, and very strong investor demand shows no sign of stopping soon. The long-term value on offer from property is at present still viewed as better than fair but, with yields falling at such a fast pace, this value is deteriorating and there is a danger that the market could return to 'expensive' territory, if current trends continue. Consensus forecasts are expecting strong, double-digit returns this year.

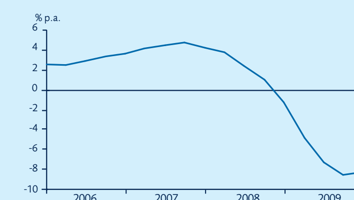
IPD Equivalent Yield for All Property

Source: IPD Quarterly Index (December 2009)

All Property 3-Month Yield Impact

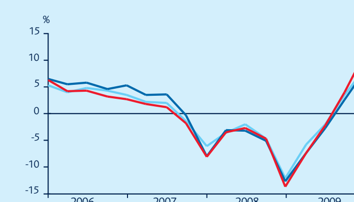
Source: IPD Quarterly Index (December 2009)

UK All Property Annualised Rental Growth



Source: IPD Quarterly Index (December 2009)

3-Month Total Return



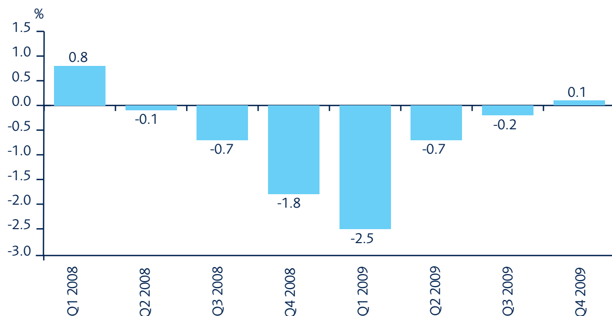
Source: IPD Quarterly Index (December 2009)

UK PROPERTY REVIEW

The UK emerged from recession at the end of 2009 with preliminary estimates of quarter four GDP showing an underwhelming growth of 0.1%. Having recorded six consecutive quarters of contraction, the UK economy was slower to come out of recession than most other major economies which saw the recessionary tide turn slightly earlier in quarter three.

Encouraging signs that the UK economy was on its road to recovery appeared during the second half of the year: unemployment fell for the second month in a row in December, manufacturing output increased and house prices ended the year 5.9% higher than the previous year according to figures from Nationwide. Consumer spending also held up reasonably well given the tough conditions and December's retail sales figures showed an increase on the previous year.

Quarter-on-Quarter GDP Growth



Source: Office of National Statistics (December 2009)

However, with an estimated public deficit approaching £200 billion and a similar sum of quantitative easing pumped into the system, the UK is barely limping out of recession. Clearly there are various risks surrounding the strength and speed of the recovery which are highly dependent on the stance that the government decides to take on budget and policy tightening. Nonetheless, economic expansion of any magnitude is welcome news for property occupier markets where rental declines prevail.

The onset of the recession led to significantly weaker occupational demand. Take-up figures plunged, vacancy rates spiked and rents spiralled into decline. The first half of last year delivered more of the same punishment, but the second half showed marked improvement in the fundamentals. Across all sectors take-up levels have edged higher and the rise in vacancy rates has eased slightly. Tenant demand for offices and industrials has seen a relatively more robust pick-up than for retails.

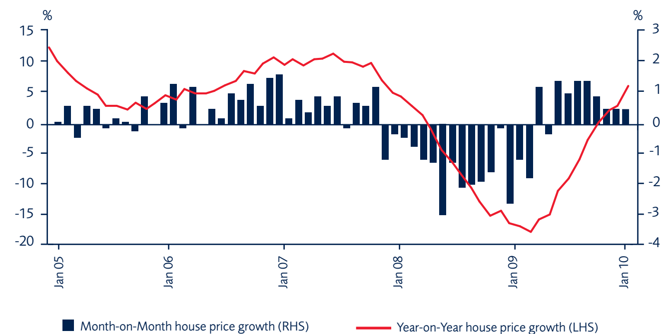
In turn, the pace of rental decline has markedly decelerated, in particular for the office sector. West End office rents, having fallen by almost 18% over the six months to June, fell by a relatively modest 5% over the six months to December, according to the IPD Quarterly Index. Nearly all market segments saw similar improvement, though not to the same magnitude. Less volatile segments, such as industrials and standard retails, saw relatively less reduction in the pace of their rental declines.

However, occupier demand for space remains vulnerable and hangs in the balance of the strength of the economic recovery. Positively though, the precipitate decline in new development has placed a supply squeeze on many parts of the market, helping to cushion the impact of weak demand during this downturn and perversely limiting the extent of falling rents.

"...the pace of rental decline has markedly decelerated, in particular for the office sector. West End office rents, having fallen by almost 18% over the six months to June, fell by a relatively modest 5% over the six months to December..."

While the occupier market is struggling to recover, the investment market has snapped back into action with very strong yield compression driving the best quarterly returns in the history of the IPD Quarterly Index. After a dire 2008 and early 2009, total returns turned sharply positive again in the summer and gathered rapid momentum, culminating in an All Property Quarterly total return of 10% over the final three months of the year. This took 2009 returns to 3.4% – a remarkable result considering the derivatives market at the beginning of last year was pricing in a return of -20%.

UK House Prices



Source: Nationwide (December 2009)

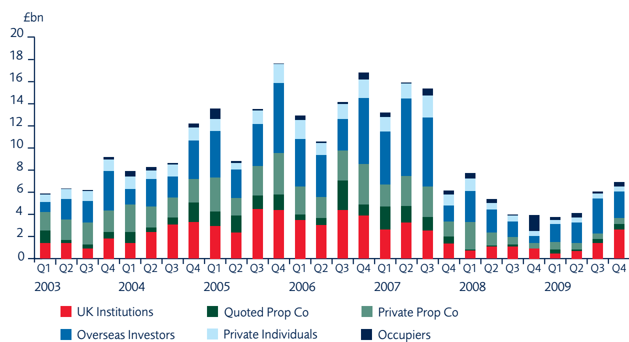
This extraordinary rally in the market has been driven by resurgence in investor demand amidst a shortage of stock, pushing prices sharply upwards. Average equivalent yields fell by around 80 basis points over the fourth quarter of 2009, with the positive yield impact on capital values amounting to 9.6% for the quarter. Transaction volume has picked up since the dearth experienced in the early part of last year, but remains less than half of the abnormally buoyant pre-credit crunch levels.

UK INVESTMENT MARKET DYNAMICS

With the growing feeling that the worst is over for the UK and global economy, life has returned swiftly to selected parts of the UK property market. It seems clear that investors are seeking out good risk-adjusted returns by focusing on reasonably priced, low risk prime assets in preference to deeply discounted, but fundamentally risky, assets.

As such, in the final quarter of 2009, we witnessed dramatic yield compression for prime assets, but only a limited pricing recovery for secondary assets. The market is wrestling with the issue that few want to buy what most want to sell, and few want to sell what most want to buy. In a more vibrant economic environment, it would seem natural for investor demand to cascade into 'next best' markets. However, given the modest expectations for economic recovery and the range of risks that prevail currently, this is occurring to only the most limited extent. Indeed, the more 'tertiary' end of the market is said to be hardly functioning at all. If this situation persists, one possible outcome is that mobile international demand could increasingly look outside the UK for opportunities in other recovering markets.

Purchase by Investor Type



Source: Property Data (January 2010)

Nowhere has this reversal in market sentiment been seen more strongly than in the Central London office markets. It is here that international investors, with their general confidence in UK property as an asset class, have historically naturally been drawn. However, helped by the exaggerated discounts at which they can now buy UK property, given recent exchange rate movements and the recently improved sentiment about short-term rental growth, especially in the City office market, international investors have been extremely active buyers. Indeed, they are currently dominating these markets.

It is also clear that high net worth individuals and a swathe of retail investors are increasingly viewing property as attractive because it can provide superior income returns to cash and sovereign bonds whilst carrying less obvious risk than equities. As such, UK retail funds again find themselves under pressure to evaluate and purchase acceptable assets. Whilst in Central London offices such funds might struggle to compete with aggressive international investors, elsewhere across the UK they are once again the dominant force in the market.

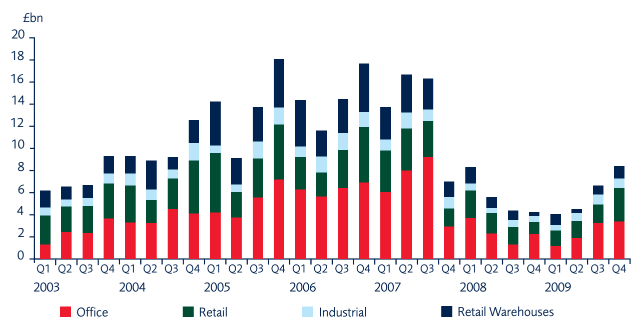
Indications are that many recently recapitalised major UK REITs are now actively re-working their portfolios, shedding weaker or 'drier' assets in the search for more value added activities. UK pension fund activity has also picked up but there is little sign of UK life funds increasing investment activity.

"The market is wrestling with the issue that few want to buy what most want to sell..."

Over and above the continuing uncertainties of economy and politics in the UK, there is still much uncertainty about the likely future supply of investable stock to feed the current frenzied levels of investment demand. All eyes remain on what the banks will do with their loan portfolios. Their 'workout' teams are now in place and the current rapid improvement in prices is thought to be accelerating bank plans for releasing stock and rebuilding their balance sheets. However, the general view remains that they will not do anything precipitate and will certainly avoid selling their better assets at anything other than competitive prices. They also hold a lot of secondary assets that current investors will not want to buy until such time that greater confidence returns to the UK economy.

Investor preferences continue to be dominated by risk concerns, with little diversion from this. So, prime is preferred over secondary, long lease over short lease, and so on. Where this has eased is mainly in respect of lot size. Such is the enthusiasm to get money into the market, larger lot size multi-let Central London offices, shopping centres and open A1 retail warehouse parks are not being disadvantaged.

Quarterly Investment Volume



Source: Property Data (January 2010)

RETAIL

PERFORMANCE

- The retail sector comfortably outperformed other property types over the second half of last year, with a 4% total return in the third quarter being followed by 11.5% in the final quarter. This record performance was driven by very strong growth in capital values (almost 10% in the fourth quarter alone), itself driven by a rapid hardening of yields.

- While pricing has staged a resounding recovery from the depths of mid-2009, retail's rental fundamentals are still far from healthy. Average ERVs in the sector continue to fall and, contrary to other sectors, the pace of decline worsened slightly over the fourth quarter. At 1.3%, retail rental decline was worse than both industrials and offices in the fourth quarter.

- Retail warehouses have been the star performer in recent months. With average equivalent yields tightening by almost 120 basis points over the fourth quarter, total returns reached 15.6%. Shopping centres lagged behind at 'only' 8.1% over the three months.

OCCUPATIONAL DYNAMICS

- With eight consecutive months of growth by December, UK house prices surprised on the upside, rising 5.9% over 2009 according to Nationwide. A record low interest rate has markedly reduced the burden of servicing a mortgage for many households, helping to stimulate housing demand.

- Despite tough conditions putting a general damper on consumer spending, retail sales rebounded in December, recording the strongest rise for that month since 2005, according to the British Retail Consortium. On a like-for-like basis, sales rose by 4.2% over the year, boosted by food sales growth and clothing and footwear sales. However, bad weather subsequently drove the poorest January retail sales growth in 15 years.

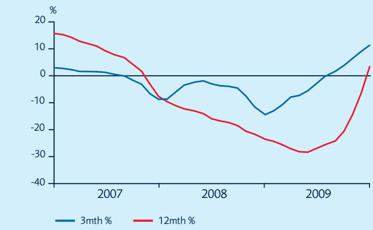
- Insolvencies in the third quarter of 2009 fell by 4.7% on the previous quarter but still increased by 14.6% on the same period a year ago. In reflection, retailer demand continues trending down as profit margins remain squeezed. As a result, vacancy rates as a percentage of units reached its highest on record at the end of 2009.

INVESTOR SENTIMENT

- The tail end of 2009 saw a pricing frenzy as investors chased limited stock: retail warehouses, in particular, benefited from a sense that the sector had become oversold and very under-priced during the trough earlier in the year. However, some investors now feel that the recovery in pricing has closed the opportunity, with buying interest starting to ebb away towards other sectors or moving up the risk curve towards secondary assets for bolder investors.

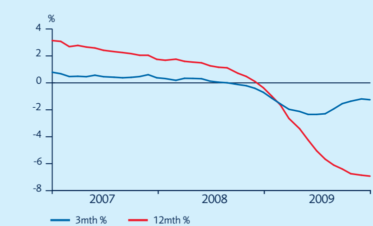
- Though there has been renewed investor interest in prime shopping centres, as exemplified when the sale of Silverburn in Glasgow garnered far more bidders than was expected, there is still scant evidence of where pricing is. Therefore, the lags in shopping centre yield compression compared to other markets may be down to the difficulty of valuation. This said, the secondary and tertiary end of this market is still viewed very poorly, with very few investors looking to buy these assets.

Retail Sector Total Returns



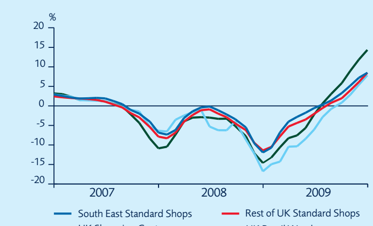
Source: IPD Monthly Index (December 2009)

Retail Sector Rental Growth



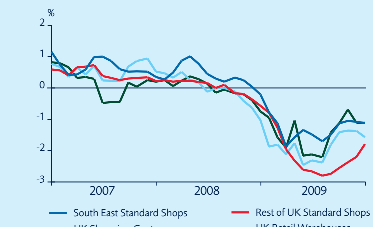
Source: IPD Monthly Index (December 2009)

Retail Sector 3-Month Total Returns



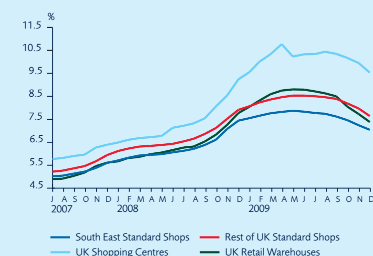
Source: IPD Monthly Index (December 2009)

Retail Sector 3-Month Rental Growth



Source: IPD Monthly Index (December 2009)

Retail Sector Equivalent Yields



Source: IPD Monthly Index (December 2009)

OFFICES

PERFORMANCE

- Since the summer of 2009, the performance of UK office markets has seen a phenomenal turnaround. The market improvement in the second half of the year increased total returns from an annualised rate of -26.8% in May 2009, an all-time low, to -0.7% by the end of December.

- The last three months of 2009 represents one of the strongest quarters recorded on the IPD Monthly Index, both in terms of office total returns and capital growth. Driving this strong performance was the substantial hardening in yields as competition over limited prime stock intensified in the months leading up to Christmas.

- By contrast, rental value growth decline eased since the early months of 2009, though falls were still being recorded at the end of the year across markets. Annualised rental growth ended the year at just below -13% on the IPD Monthly Index – only a small improvement from the trough recorded in October at -14.7%.

OCCUPATIONAL DYNAMICS

- The deal on Watermark place, in August of last year, where Japanese bank Nomura received six years rent-free on a 20-year lease, marked the height of the occupier-driven market in Central London. While occupiers' interest has been awoken by low rental levels, landlords have pushed up incentives to unprecedented levels.

- However, there are some signs that the tables might be starting to turn in the prime end of the market. The supply of grade A space in the City in particular is already limited and, with the development pipeline almost dried up, expectations of rental growth are beginning to feed through to landlords and investors alike.

- Beyond Central London, the outlook for the office market is far worse. The public sector drove much of the rental growth over the last decade but, with a probable cut-back in services going forward, this source of demand seems exhausted – impacting negatively on the outlook for rental growth across the regions.

INVESTOR SENTIMENT

- According to figures from Property Data, investment volumes in the office sector reached almost £10 billion in 2009, almost 41% of the total volume transacted. Importantly, roughly 70% of the total was transacted in the last two quarters of the year when quarterly investment in the office sector exceeded £3.2 billion.

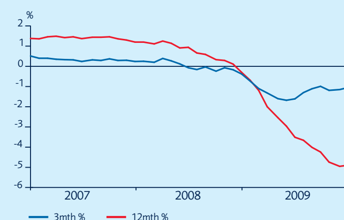
- Throughout the downturn, prime Central London office stock has proved popular with cash-rich foreign investors taking a positive view on the current exchange rate. Indeed, overseas buyers represented around 70% of all Central London offices purchases in the second half of 2009.

- Central London has been the focus of much of the buying frenzy, although prime buildings in the larger regional centres also saw much interest. Typically, the largest investment deal in the second half of 2009, at just over £1 billion, was the purchase of the Broadgate Estate in the City by US investors Blackstone Group.

Office Sector Total Returns

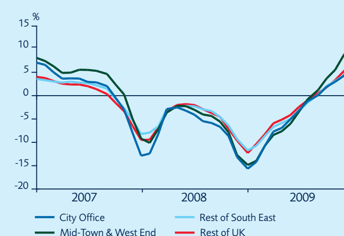
Source: IPD Monthly Index (December 2009)

Office Sector Rental Growth



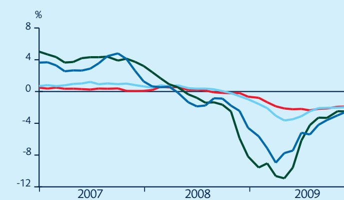
Source: IPD Monthly Index (December 2009)

Office Sector 3-Month Total Returns



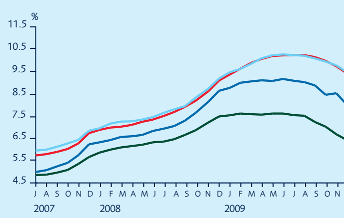
Source: IPD Monthly Index (December 2009)

Office Sector 3-Month Rental Growth



Source: IPD Monthly Index (December 2009)

Office Sector Equivalent Yields



Source: IPD Monthly Index (December 2009)

INDUSTRIALS

PERFORMANCE

- The last six months of 2009 saw a dramatic rebound in UK commercial property markets. According to the IPD Quarterly Index, All Industrials achieved a total return of 12.4% in the second half of the year, completely offsetting the decline realised in the previous six months and resulting in an annual return of 3.9% for 2009.

- This positive return was largely attributed to an improvement in yields as investor interest returned. Capital growth resumed in the third quarter and the IPD Quarterly Index recorded a significant rise of 6.7% in industrial capital values in the fourth quarter of 2009, contrasting to the 7.6% fall over the first quarter.

- Meanwhile, rental value decline decelerated with South Eastern segments performing better than the rest of the UK. In contrast to the 1.7% aggregated fall in the second quarter of 2009, three-month rental decline eased to just -0.8% in the final quarter.

OCCUPATIONAL DYNAMICS

- The leasing market remains weak as an unfavourable business climate prevails despite modest improvements in economic growth expectations. Availability continues to rise, and the number of demolitions has risen as the empty rate liability places a financial burden on landlords.

- The last six months of 2009 have seen some improvement in leasing activities at both the smaller and the larger ends of the scale. Occupiers with long-term business plans see opportunities to enter the prime end of the market as landlords continue to offer flexible terms and longer rent-free inducements as a result of poor demand during, and after, the recession.

- Given the dramatic cut-backs in speculative development, many commentators are anticipating the bottom of selective prime markets this year due to a shortage of quality stock. The waste management and recycling sector is emerging as a new source of demand, taking 'big boxes' off the market.

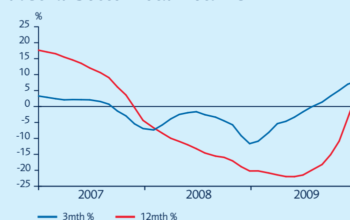
INVESTOR SENTIMENT

- The industrial sector also saw a dramatic turnaround in investor sentiment as interest flooded back, seeking the attractive returns on offer. Indeed, some segments were offering double-digit yields.

- However, transaction volumes remain thin as only a limited amount of quality stock is available to match investors' appetite and rental fundamentals remain fragile. It appears that less attractive secondary properties dominate the sell-side of the investment market and it is unlikely that the availability of quality stock will improve in the near term with such limited speculative development. As such, significant yield compression at the prime end is likely to continue as a result of a mismatch between excessive demand and restricted supply.

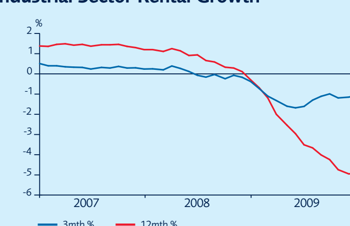
- Unlike offices and retails, foreign investors have shown little interest in industrial and warehouse units outside the M25. Meanwhile, UK institutions have been the main source of capital, driving the pricing in the rest of the UK.

Industrial Sector Total Returns



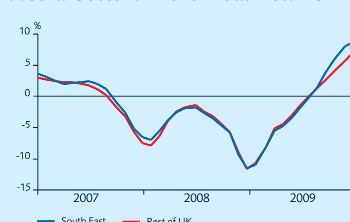
Source: IPD Monthly Index (December 2009)

Industrial Sector Rental Growth



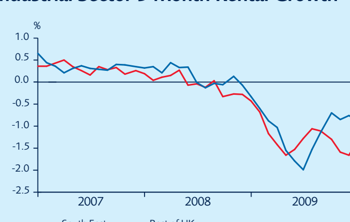
Source: IPD Monthly Index (December 2009)

Industrial Sector 3-Month Total Returns



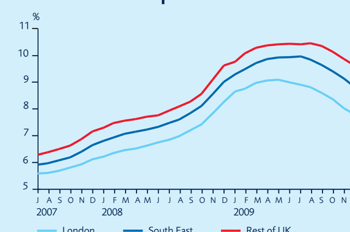
Source: IPD Monthly Index (December 2009)

Industrial Sector 3-Month Rental Growth



Source: IPD Monthly Index (December 2009)

Industrial Sector Equivalent Yields



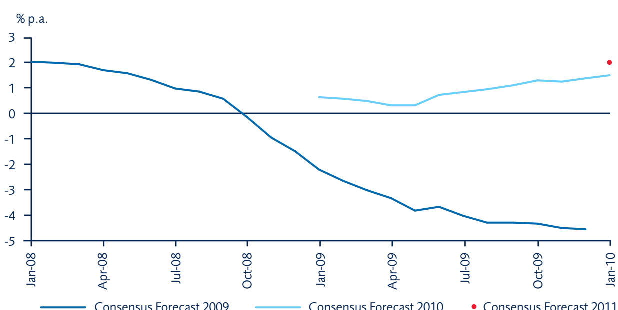
Source: IPD Monthly Index (December 2009)

UK PROPERTY OUTLOOK

Though the UK has finally emerged from recession, economic recovery is currently progressing at a snail's pace. Most forecasters are expecting the meagre 0.1% growth in GDP over the final quarter of 2009 to be followed by fairly tepid growth rates throughout 2010, and on into 2011, before any meaningful return to 'normality' is reached. The reasoning behind this is the belief that the economy is still lumbered with a few burdens that will likely restrain growth; such as indebted consumers, an ongoing restriction in credit availability, the likelihood of tax rises and/or government spending cuts and the prospect of increased regulation.

While the UK unemployment rate may have seen its peak, with so many hurdles for the economy to overcome, some commentators struggle to see where new jobs will come from to drive a bounce-back. Consumption remains hamstrung as households battle with periods of unemployment or pay cuts/freezes, whilst inflation rates are relatively high. Meanwhile, households continue to pay down debt and build up their savings. However, the resurgent housing market does offer some support in this respect, though question marks remain over how sustainable the current house price growth is, considering the restricted mortgage conditions and availability, and the inevitable eventual rise in interest rates. The only relatively bright light in the near term is that the global economic recovery, combined with the weakness of sterling, should drive growth in exports.

UK GDP Growth Consensus Forecasts



Source: Consensus Forecast (January 2010)

With the economy having suffered the most severe recession in decades, occupier demand for space has plummeted and remains weak in line with the anaemic economic revival. Average rental values are still falling although, for some prime markets, a pick-up in tenant demand amongst relatively tight supply has already caused some forecasters to speculate about a return to strong rental growth by the end of this year. More generally though, any significant rental growth is not expected until demand has recovered enough to fill the high number of vacant units currently on offer, and the effect of the constrained development pipeline works its way into the system. This may be another couple of years away.

"...for some prime markets, a pick-up in tenant demand amongst relatively tight supply has already caused some forecasters to speculate about a return to strong rental growth by the end of this year."

Investor sentiment for the property market has improved dramatically over the last few months, and very strong investor demand shows no sign of stopping soon. Many funds are struggling to find a home for the 'wall of money' that continues to be ploughed back into the sector, and overseas capital is expected to carry on taking advantage of exchange rates and the UK market's comparative value. Furthermore, though gilt yields are creeping up, they remain low by historic standards, and corporate bond spreads have largely corrected so as to reduce their competitiveness against other asset classes. As such, property remains good value, particularly with an improving (if still subdued) outlook for the rental fundamentals. However, with property yields falling at such a fast pace, the long-term value on offer is deteriorating and there is a danger that if the strength of investor demand continues unabated while chasing scarce stock, then the market could return to 'expensive' territory.

There remain concerns that a second downturn may be brought about by a surge in stock availability caused by banks moving to call in loans and offload properties now the market has come back to life. However, there have been encouraging signals that this is a minority view, with consensus forecasts expecting strong, double-digit returns this year.

IPF Consensus Forecasts for Total Returns November (09) vs August (09) % 2009 – 2011

	2009		2010		2011		2009-2013	
	Nov (09)	Aug (09)	Nov (09)	Aug (09)	Nov (09)	Aug (09)	Nov (09)	Aug (09)
Standard shops	0.0	-8.1	10.4	7.1	8.7	10.9	7.2	6.1
Shopping centres	-8.3	-13.8	10.4	6.4	10.1	11.6	6.6	5.0
Retail warehouses	0.3	-10.9	11.5	7.6	9.7	11.6	8.1	6.2
Offices	-5.1	-14.2	8.7	4.1	9.7	10.3	7.0	4.8
West End offices	-6.5	-17.9	5.7	2.1	9.6	10.1	6.4	3.9
City offices	-5.6	-16.2	6.4	1.9	10.1	8.5	7.0	3.8
Industrial	0.7	-8.8	11.4	7.4	10.1	11.8	8.6	6.7
All Property	-2.6	-11.9	10.0	6.1	9.4	10.9	7.4	5.7

Source: IPF Consensus (November 2009 and August 2009)

IN-FOCUS

PROPERTY DERIVATIVE TRADE: PERFORMANCE REPORTING

Nick Blakemore

Until very recently commercial property was an asset class without an efficient tool for managing market risk – even though it was arguably one with a great need. The illiquid nature of commercial property investments makes it hard to allocate capital when relying solely on trading underlying assets.

For this reason, almost the only option available for property fund managers without derivatives capability, who were seeking to protect capital during the last two years, was to sell parts of their portfolio. Many property fund managers did sell significant portions of their portfolios ahead of the market falls, but this was a lengthy and costly process.

In the latest downturn, a handful of the largest institutions were able to hedge portions of their portfolios using index-based commercial property derivatives. Some of these produced double-digit positive returns in a falling market. They were a perfect illustration of potential risk management benefits for institutional investors and the derivatives market is likely to grow as a result, not least as they will be equally valuable in an upturn.

"… delays in the production of market data… result in distorted annual returns being achieved which can often bear little resemblance to a market sector return."

So property derivatives can be a cost effective alternative to trading directly in the property market, but some investors expect that they will deliver identical returns to the bricks and mortar equivalent. In fact, volatility in mark-to-market values (MtM), combined with delays in the production of market data required to calculate the swap leg of a trade, result in distorted annual returns being achieved which can often bear little resemblance to a market sector return.

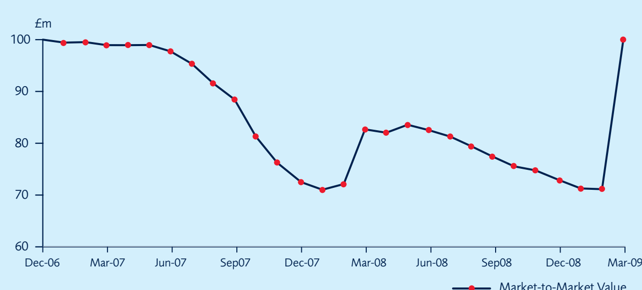
This is important for investors to be aware of and it is also complex in the abstract. The following is an example of the implications of this lag in calculating returns. It should not be read as critical of the concept of property derivatives – they are a very valuable financial instrument for the reasons outlined above. But as the use of these derivatives increases, investors should be aware of the potential lag in returns.

Transaction Timing – based on an example

An investor enters into a contract to buy (receive) the All Property Total Return on IPD's Annual Index in return for 6.8%. The contract is for two years with exposure commencing 31 December 2006 and has a notional value of £100 million.

The reporting and annual calculation of the total return achieved is reliant on two pieces of key data, namely the MtM of the derivative (which can be calculated monthly using data provided by an independent third party) and, second, the annual total return achieved on IPD's All Property Annual Index.

Movement of MtM Value over full time period



Source: CBRE/GFI, PRUPIM, ICAP (December 2009)

Using live data, the chart above details the movement in the MtM over the full period, highlighting the deterioration of property returns towards the end of 2007 as the MtM Value declines to a price of £72.5 million in December, reflecting the price the investor would pay to enter an offsetting contract should they wish to dispose of the contract. Based on the figures above, the movement in the MtM delivers the investor a total return of -27.5% over the first year.

2007	Jan	Feb	Mar	Apr	May	Jun
MtM Value (£m)	99.43	99.52	98.94	98.93	98.97	97.73
Return (%)	-0.60	0.10	-0.60	0.00	0.00	-1.30

2007	Jul	Aug	Sep	Oct	Nov	Dec	Overall (%)
MtM Value (£m)	95.33	91.57	88.45	81.30	76.25	72.50	
Return (%)	-2.50	-3.90	-3.40	-8.10	-6.20	-4.90	**-27.50**

The contract also requires the payment/receipt of the swap leg (6.8% vs IPD Annual Index), but publication of IPD's Annual Index for the year 2007 is not available until the end of February of the following year, making it physically impossible to calculate and pay/receive the swap leg of the trade until three months into the year 2008.

Unable to financially transact the swap leg in 2007, comparables therefore show the derivative achieving -27.5% in the first year (based on the movement of the MtM only), compared to the IPD Annual Index of -3.4%.

In the 2008 (and final) year of the transaction, the MtM continues to account for market conditions, but also takes into account any physical payments. With the publication of the 2007 Annual Index in February 2008, the first payment leg can be computed, which equates to a net payout by the investor of £10.2 million (based on the Index return of -3.4% vs 6.8%).

Despite the swap leg payment relating to the year 2007, the MtM has to account for the payment in March 2008 (as highlighted in the graph) and continues to reach a price of £72.87 million by December 2008.

As before, the 2008 total return achieved by the derivative will take into account the movement of the MtM (from £72.5 million to £72.87 million), but in addition will take into account the physical payment of the swap leg of £10.2 million which actually related to the calendar year 2007.

Allowing for the swap payment, the derivative returns -11.9% for the year 2008, compared to IPD's Annual Index return of -22.1%.

Despite the investor acquiring a two-year contract, the swap leg applicable to the year 2008 cannot be paid out until the following year. A MtM is therefore required for part of the third year at which point there is a complete return to the notional value of £100 million.

2008	Jan	Feb	Mar	Apr	May	Jun
MtM Value (£m)	71.03	72.12	82.68	82.04	83.57	82.52
Swap Leg (£m)	–	–	-10.2	–	–	–
Return (%)	-2.00	1.50	0.50	-0.80	1.90	-1.30

2008	Jul	Aug	Sep	Oct	Nov	Dec	Overall (%)
MtM Value (£m)	81.29	79.40	77.41	75.54	74.77	72.87	
Swap Leg (£m)	–	–	–	–	–	–	
Return (%)	-1.50	-2.30	-2.50	-2.40	-1.00	-2.50	**-11.90**

In 2009, whilst the contract on the derivative has actually expired, the investor still has to pay out the net swap leg applicable to the year 2008 (-22.1% vs 6.8%) of 28.9% of the notional £100 million value. With the MtM rising from £72.87 million in December back to the notional price of £100 million in March, the investor actually achieves a return of -2.5% due to the swap payment of £28.9 million.

Clearly the contract itself was not advantageous in its own right (from a relative return perspective) to the investor. However, more importantly to our consideration here, the returns delivered by the index are materially different to that from the underlying physical, which is due to the delay in payments and different potential for movement in the MtM value:

Returns actually delivered	2007	2008	2009
Derivative Trade	-27.50	-11.90	-2.50
IPD Annual Index	-3.40	-22.10	0.00

Overall, for the period 1 January 2008 to 31 December 2008, the net cashflow impact of the trade cannot be fully reported in the 2008 year end figures. Furthermore, the actual net cashflow, which physically takes place in March 2009, has to be accounted for in the 2009 performance return, even though it relates to the performance of the 2008 IPD Annual Index.

This results in the 2008 performance return being calculated solely on the MtM value delivered throughout the year, with 2009 performance based on the movement of the MtM value through the year, plus the net cashflow delivered on the swap leg relative to the first year of the trade. Naturally, a further complication occurs when the investor has to report a derivative net cashflow and a MtM value based on the expected cashflow in 2010, even though the derivative itself expired in 2009.

Commercial property derivatives give investors the opportunity to manoeuvre fund structures or make calculated bets against other markets in a timely and costly manner. However, the returns achieved cannot be co-ordinated with the financial transactions actually achieved and will, therefore, result in a reported annual return which will be difficult to compare with a benchmark over any 12-month period.

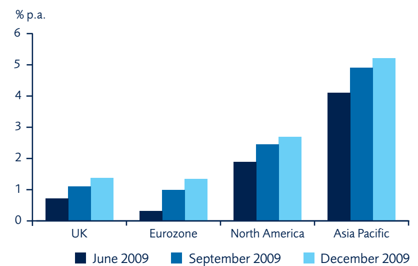
This is not to say that the value of property derivatives in the future cannot be huge. The emergence of contracts and the potential growth of exchange-traded commercial property derivatives both offer the potential of a significant increase in trading efficiency. They allow property fund managers and investors to invest and disinvest in the market more easily and precisely – but there are timing issues which investors will want to be aware of.

INTERNATIONAL PROPERTY MARKETS

GLOBAL REVIEW

- 2009 ended on a positive note as the major economies emerged from recession during the latter half of the year, including the UK which eventually returned to growth in the fourth quarter. For many economies, recovery remains fragile and the severity of the global downturn will massively influence policies and economic prospects over the coming years.
- Evidence of yield stabilisation is widespread in real estate markets. Although global property markets have lagged the UK's sudden recovery, it seems clear that the worst is over for most. Being highly dependent on economic revival, a slow recovery is expected, but with startling divergences in pricing and leasing dynamics around the world.

2009 GDP Forecast Evolution (Global)

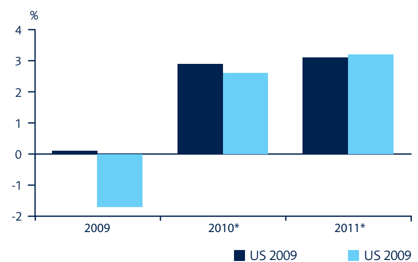


Source: Consensus Economics (June to December 2009)

NORTH AMERICA

- US GDP grew by an annualised 5.7% over the fourth quarter following an emergence from recession in the third quarter of 2009. Consumer spending and industrial production have picked up and house prices rose by almost 5% over the six months to November. However, the fragility of the economy will impair the recovery as the high level of consumer and corporate indebtedness imply that consumption and investment remain hamstrung.
- The outlook is bleak for tenant demand in the short term and falls in rents are likely to continue into 2010. For the investment market, the large falls in values over 2009 suggest that the US and Canadian real estate markets appear to be reaching a level of price stabilisation.

GDP Growth Consensus Forecasts (US & Canada)

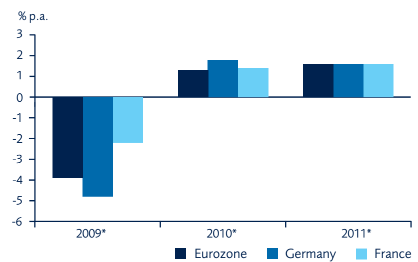


* Values are forecasts
Source: Bloomerg, Consensus Forecasts (January 2010)

EUROPE

- Major European countries emerged from recession in the second quarter of 2009, driving modest GDP growth of 0.4% for the eurozone over quarter three. Economic recovery is being driven by demand-supporting policy measures, robust consumer demand and a strong positive contribution from inventory adjustment, but revival remains too timid to halt the continuing rise in unemployment which reached 10% in November.
- However, recovery in property occupier markets is lagging as some markets are still seeing rents fall. While core markets are benefiting from an upsurge in investor interest, widespread yield stabilisation is evident. Going forward, economic and investment prospects have generally improved, boosted by slightly quicker-than-expected economic recovery and by less prohibitive borrowing.

Unemployment on the Rise (Europe)

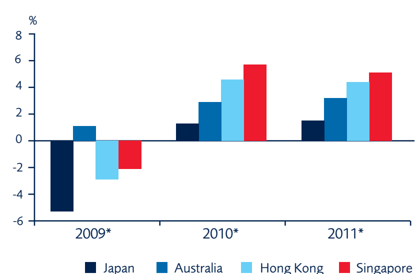


* Values are forecasts
Source: Concensus Economics (December 2009 and January 2010)

ASIA PACIFIC

- The economies in Asia Pacific are in many ways leading the recovery and in the third quarter all countries in the region returned to growth. Unemployment is stabilising, industrial production growing and export declines rapidly easing. Consumer and business sentiment continues to improve, reflected by the revival of capital markets.
- Clearly, this impressive resurgence has been largely supported by the policy interventions and stimulus packages implemented by governments. However, the region's strong dynamics have also driven the rebound. The worst of the commercial property downturn in Asia Pacific has passed, replaced in some markets by a rebound in asset prices which has already raised concerns about overheating.

GDP Forecast Evolution (Asia Pacific)



* Values are forecasts
Source: Consensus Economics (December 2009 and January 2010)

GLOBAL ECONOMIC AND MARKET OUTLOOK

Following one of the deepest recessions since World War II, the last few months of 2009 saw growing signs of a steady revival in global economic activity and business confidence. Much of this rebound could be attributed to the unprecedented efforts of central banks around the world to stimulate recovery. In particular, growth in emerging countries, especially China and India, returned almost to pre-2008 crisis levels.

Inflation remained subdued as the impact of rising prices of commodities (notably oil) was countered by the lack of pricing power among manufacturers and retailers. Against this background, monetary authorities such as the US Federal Reserve and the Bank of England were able to maintain interest rates at record lows for an extended period.

As a consequence of the improving outlook for non-inflationary growth and abundant supplies of cheap liquidity from central banks, investors' risk appetite increased. Share prices made further advances, ending 2009 on a strong footing with a number of major indices hitting highs for the year. Sentiment was also boosted by hopes that the worst of the banking crisis was over, as well as better-than-expected corporate results and the return of merger and acquisition activity.

Equities in the US, the UK and the emerging markets were among the best performers, while Japan was the distinct laggard. Across the sectors, mining stocks were particularly strong as robust economic data from China spurred expectations of renewed demand for basic materials. Financial stocks, in contrast, declined as debt problems in Dubai sparked fresh uncertainties about the banking sector.

In the fixed income market, corporate bonds also benefited from the higher appetite for risk, with BBB rated issues the best performers. Meanwhile government bonds fell out of favour as increased debt issuance and growing concerns about central banks' strategy to withdraw the extra liquidity from the financial system placed additional pressure on yields. Furthermore, demand for inflation protection was evident as yields on index-linked gilts fell, resulting in a significant outperformance of conventional gilts.

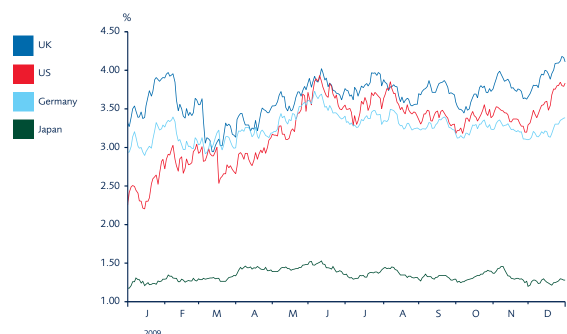
Looking ahead, the robust rally in equities and corporate bonds since March 2009 has meant that risk premia have come down from their previously extremely elevated levels. To an extent this is justified since corporate debt defaults have been lower than initially feared while stock valuations have been helped by the improved business fundamentals, which in turn has led to upward revisions in analysts' estimations of corporate earnings for 2010.

However, this is not to say that the year ahead will be without challenges: governments' burgeoning budget deficits and record debt issuances, especially in the UK and the US, have given market participants some cause for concern. Increasingly, there has also been growing unease about the central banks' exit strategy from the unprecedented quantitative easing programmes. The need to rein in government spending and the prospect of tax increases have cast a cloud over the consumers' optimism about the new year. Nonetheless, it is arguable that government finances should improve once a sustained recovery gets underway. Furthermore, core inflation remains benign due to excess capacity and weakness in the labour market. And hence, given the fragility of the current recovery, interest rates are likely to remain low perhaps until 2011.

Overall, equity valuations, though not at the bargain basement level of early March 2009, are still quite modest by historic standards. Developed economy markets such as UK, US and European equities in particular, due to their earlier underperformance, present good opportunities. Furthermore, they also represent a play on emerging market growth due to the multinational exposure of the companies in developed countries.

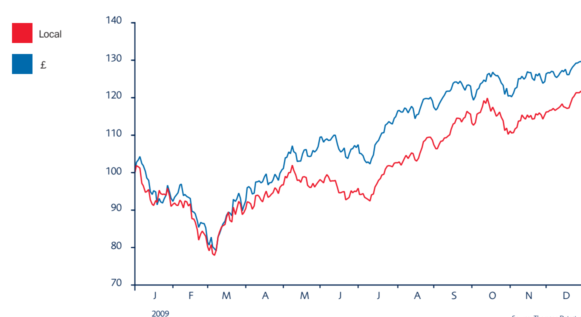
Similarly, there is still value in credit even though prices have rallied significantly. In government bond markets, however, it is a more mixed picture. Given the expected low inflation risk environment and the steepness of yield curves in Western markets, long-dated bonds continue to offer good value to long-term investors. However, short-dated bonds offer poor value since they are priced off the very low levels of official interest rates.

10-Year Government Bond Redemption Yields



Source: Datastream (December 2009)

FTSE World Index



Source: Datastream (December 2009)

DATA AND STATISTICS

PROPERTY PERFORMANCE METRICS (%)

Index	Frequency	Date	1 month	3 months	Calendar YTD	1 year	3 years*
IPD Monthly Index	Monthly	Dec-09	3.6	9.4	2.2	2.2	-9.2
CBRE Monthly	Monthly	Dec-09	3.9	10.3	4.0	4.0	-8.4
IPD Quarterly Index	Quarterly	Dec-09	-	10.0	3.4	3.4	-8.3
IPD Annual Index	Annual	Dec-08	-	-	-	-22.1	-3.9

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

PRIME HEADLINE RENTS - £ PER SQUARE FOOT PER YEAR

	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
Region	Dec-09	% change over quarter	Dec-09	% change over quarter	Dec-09	% change over quarter	Dec-09	% change over quarter	Dec-09	% change over quarter
Central London	-	-	77.5	0.0	-	-	-	-	-	-
Sub London	320.0	-3.0	33.0	0.0	-	-	-	-	-	-
London	-	-	-	-	24.0	-4.0	-	-	11.0	0.0
South East	250.0	-7.4	27.5	-1.8	27.0	-3.6	37.5	-6.3	7.5	0.0
South West	250.0	0.0	25.0	0.0	20.0	0.0	55.0	-4.3	5.5	-8.3
East Anglia	-	-	21.5	0.0	23.5	0.0	27.5	0.0	-	-
East Midlands	240.0	0.0	-	-	-	-	-	-	5.0	0.0
West Midlands	250.0	0.0	27.5	1.9	21.0	0.0	47.5	-5.0	5.0	0.0
Wales	300.0	0.0	21.0	5.0	17.0	0.0	30.0	-36.8	-	-
North East	290.0	0.0	27.0	0.0	17.0	-2.9	45.0	-10.0	4.0	0.0
North West	250.0	0.0	27.0	0.0	18.0	0.0	35.0	0.0	5.3	0.0
Yorks & Humbs	275.0	-1.8	19.5	-2.5	14.0	0.0	27.5	0.0	-	-
Scotland	250.0	0.0	27.0	-3.6	17.0	-5.6	40.0	0.0	6.5	0.0
Northern Ireland	285.0	0.0	14.0	0.0	-	-	-	-	-	-

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

INVESTMENT YIELDS (%) FOR PRIME PROPERTIES

	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
Region	Dec-09	% Change over quarter	Dec-09	% Change over quarter	Dec-09	% Change over quarter	Dec-09	Change over quarter	Dec-09	% Change over quarter
Central London	4.60	-0.15	-	-	-	-	-	-	-	-
Sub London	5.00	-0.75	7.00	-1.00	-	-	-	-	-	-
London	-	-	-	-	7.50	-0.50	-	-	6.25	-0.75
South East	5.25	-0.75	-	-	7.75	-1.00	6.00	-0.50	7.00	-0.75
South West	5.50	-0.25	6.50	-1.25	9.50	0.00	5.75	-0.75	7.00	-0.50
East Anglia	5.00	-0.50	7.00	-1.00	7.50	-1.75	6.00	-0.50	-	-
East Midlands	6.00	-0.25	-	-	-	-	-	-	6.75	-0.50
West Midlands	6.00	0.00	6.00	-1.75	9.00	-0.50	6.00	-0.50	7.00	-0.50
Wales	5.75	-0.75	7.50	-0.75	8.50	-1.00	6.00	-0.75	-	-
North West	5.75	-0.25	6.75	-1.00	8.50	-1.25	6.00	-0.25	7.00	-0.25
Yorks & Humbs	5.00	-0.75	7.50	-0.50	9.00	-2.00	6.00	-0.25	7.00	-0.25
North East	6.00	-0.25	8.00	-0.50	9.00	-0.75	6.50	-0.50	-	-
Scotland	5.25	-0.50	-	-	9.25	-0.25	6.00	-0.25	7.00	-0.50
Northern Ireland	6.00	-1.25	9.00	0.00	-	-	-	-	-	-

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

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ABOUT THE GLOBAL PROPERTY RESEARCH TEAM

PRUPIM's well known and widely respected Global Property Research Team, based in London and Singapore, comprises of 11 staff including seven property economists and three performance measurement analysts. The team engages in three main types of work namely; assessing the attractiveness of UK and international property markets, providing strategic recommendations and risk control measures for clients' funds, and conducting ad-hoc property related analyses on key issues as they emerge. The research team also assists in buy, sell and hold decisions by working closely with colleagues across PRUPIM to create a holistic approach to asset management.

BIOGRAPHIES

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

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

Scott Girard, Chief Executive Officer, 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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