

REAL ESTATE
FUND MANAGEMENT

UNITED KINGDOM
REAL ESTATE PERSPECTIVE
SEPTEMBER 2011



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ABOUT PRUPIM

PRUPIM is one of the leading real estate fund 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 £16 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 13-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 June 2011.

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Unless otherwise specified all data and commentary is as at end of June 2011.

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



Manchester Arndale
Manchester



Oxford Science Park
Oxford



Cribbs Causeway
Bristol



Apex Plaza
Reading

EXECUTIVE SUMMARY

PERFORMANCE

- The UK commercial property market has continued to recover so far this year; the IPD Monthly Index recorded positive capital growth each month, although at an average rate of only 0.2% per month. Yields have edged down, slowly pushing up capital values, while average rental values have seen only very marginal growth. Driven by a steady, high income return, the IPD Quarterly Index recorded a total return of 2.0% over the second quarter.
- These figures mask a significant geographical bias reflecting starkly divergent rental performance, with London proving strong but the rest of the UK remaining weak; offices and shops in Central London have seen strong rental recovery for the best part of two years now, while the rest of the country continues to suffer from (modestly) falling rents. Prime markets have driven the recovery in both rents and pricing, while the secondary end has lagged.

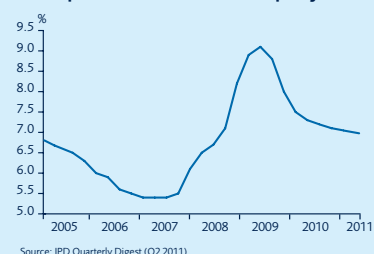
REVIEW

- The UK economy has experienced a tough few quarters since the tail-end of last year, so it is perhaps unsurprising that property markets in the majority of the country are still experiencing falling rents. However, while this fairly bleak picture can be painted for much of the UK, London stands in stark contrast, with fierce competition among occupiers for prime shops and offices driving rents up rapidly.
- While restrained development has led to a lack of availability of prime space, it has been apparent that secondary property is still suffering from weak occupier demand and, if anything, oversupply – a hangover from the casualties of the recession leaving units empty.
- Despite distinct differences in rental performance, virtually all property markets have benefited from investors pushing down yields. More recently though the pace of yield compression has been slow, with some markets seeing (modest) yield expansion.

OUTLOOK

- The outlook for the UK economy remains muted, with a few obvious downside risks. This will inevitably act to restrain occupational demand going forward; the gulf in rental performance between resurgent London and the rest of the country is likely to persist in the short term.
- Yields in London, particularly on prime assets, are looking increasingly expensive – domestic investors have been all but priced out of the West End office market and there is likely to be a greater transfer of investor interest from London to the South East, and then to the regions.
- In the short term, caution and a focus on prime is likely to continue. However, once robust sustainable economic growth returns, investors are likely to look further afield, taking advantage of the current attractive yield premiums offered by regional and also secondary assets.

IPD Equivalent Yield for All Property



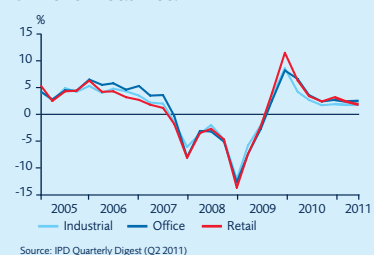
All Property 3-Month Yield Impact



All Property 3-Month Rental Growth



3-Month Total Return



UK PROPERTY REVIEW

The UK economy has experienced a tough few quarters since the tail-end of last year: GDP growth has stuttered, unemployment has failed to fall and real consumer spending has declined again. To add to the squeeze, inflation has been relatively high (driven by the VAT hike at the beginning of the year and high energy and commodity prices), and public sector spending has started to be cut back.

Given this background, it is perhaps unsurprising that property markets in the majority of the country are still experiencing falling rents. Office occupiers in the regions are only hesitatingly taking space, retailers struggling with weak sales are closing units and cutting back on expansion plans, and warehouse demand is only gradually picking up.

Quarter-on-Quarter UK GDP Growth



Source: Office of National Statistics (July 2011)

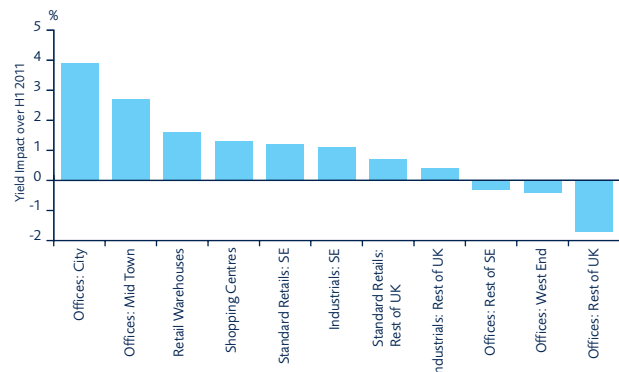
However, while this fairly bleak picture can be painted for much of the UK, London stands out in stark contrast. A much brighter story has been apparent in the capital, as fierce competition among occupiers fighting for a tight supply of prime space within Central London has driven rents rapidly upwards over the last year or two. Landlords of shops in prime Central London locations have achieved record high rents from retailers keen to tap the pockets of tourists lured to the city, while businesses hunting for prime office space in the resurgent City and, more recently, in the West End have been willing to pay increasingly high rents to secure space.

"...while a fairly bleak picture can be painted for much of the UK, London stands out in stark contrast."

To some extent, this Central London growth story has rippled out into the surrounding areas. However, much of the South East, while in better shape than the provinces, remains subdued. Furthermore, even within London, it has been apparent that secondary property is still suffering from weak occupier demand and, if anything, oversupply – a hangover from the casualties of the recession leaving units empty. Thankfully, this has not been increased much through development since new completions have remained at very low levels over the last couple of years, providing a supply-side cushion supporting rents.

Despite distinct differences in rental performance, virtually all property markets have benefited from rises in capital values since the dark days of 2009. Yields generally have edged downwards so far this year, though the pace of yield compression is slow and some markets have seen yields rise recently. Perhaps surprisingly, this includes West End offices where yields were approaching historic lows; despite strong rental growth prospects, investors, particularly those based in the UK, have become increasingly reluctant to pay such low yields for these assets. Rest of UK offices have also seen yields rise recently, though for very different reasons – investors have shunned the segment, even at high yields, over concerns over weak fundamentals, while banks have been steadily offloading their distressed property assets.

Yield Impact over H1 2011



Source: IPD Quarterly Digest (June 2011)

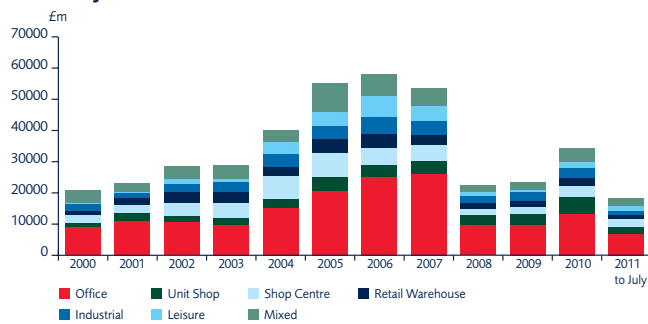
There is still a feeling that good quality property investments are more secure than equities, which continue to be volatile, and better value than bonds, which currently yield very little. Indeed, as capital growth has faded, the still relatively high income return has been the predominant driver of property performance recently, providing 1.5% of the 2% total return recorded over the second quarter. With investor nervousness returning with the wobbles in the economy and financial markets, prime property has been viewed as a safe haven, though pricing now appears on the expensive side when considering a long-term view of value; secondary may offer more attractive returns to braver investors willing to move up the risk curve. Geographically, in spite of weak rental prospects, the unloved office and industrial markets outside of the South East offer perhaps the best long-term value in the UK, due to their elevated yields.

UK INVESTMENT MARKET DYNAMICS

Continuing economic and financial market uncertainties have helped maintain broad interest in prime UK real estate. With its reasonably generous levels of income return, there is still a general feeling among many investors that good quality property offers more stable returns than equities, and higher returns than bonds.

However, notwithstanding this persistent interest, few if any commentators now claim UK prime property as a "bargain". Many international investors pursuing best quality assets in the West End are seeking wealth protection in an uncertain world. Indeed, a recent press piece (Sunday Times 24/07/11) reported some property agents likening prime London property to gold "because of its scarcity and reliability".

Quarterly Investment Volume



Source: Property Data (July 2011)

Recent performance data suggests that offices continue to outperform other sectors but by nowhere near the margins seen in previous recent quarters. More significant is the geographical bias which still underlies property market preferences and performance. In every respect, the London property markets continue to prove strong, with those outside of the capital remaining weak. After Central London offices, the next best performing sectors were South Eastern retail and industrial properties. By contrast, the weakest performing market segments were provincial retail, industrial and office markets.

International investors and UK REITs remain net buyers of UK commercial property. That said, the former (notably Irish investors) have been selling quite actively recently. In contrast, REITs are selling far less stock now than 18 months' ago, while increasing their propensity to purchase. UK institutions, in the round, are broadly neutral in terms of purchases and sales. However, within that classification, retail funds are still seeing modest net cash inflows – £32 million in May 2011, down from £110 million the previous month – and are still net buyers.

In the City of London office market, there is continuing excitement over the steady stream of Asian capital now entering the office market, which is keeping prices high. In the West End office and retail markets, foreign interest has been described as "excitable", with best quality assets pursued aggressively. However, we have noticed that attention, from both domestic and international investors, is subtly shifting

towards offices in the motorway corridors around London since prime assets in these locations are viewed as offering good relative value compared to counterparts in London.

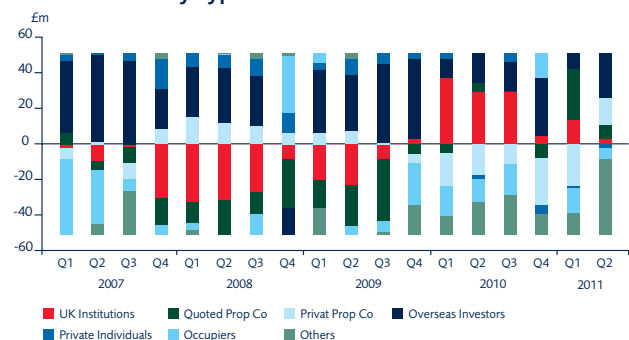
Certainly, as prices continue to rise in Central London, domestic investors seem increasingly concerned about avoiding overpaying for prime assets and are showing growing discernment over what they buy and pay. Interestingly, just as market commentators were beginning to observe investors' burgeoning willingness to take increased risk and switch capital into better quality secondary assets, the recent resurgence of concern over global monetary and economic stability seems to have induced a short-term retreat to greater risk aversion, renewing pressure on prime assets over the past month.

"...as prices continue to rise in Central London, domestic investors seem increasingly concerned about avoiding overpaying for prime assets..."

Hence, the market has taken a temporary small step backwards towards its previously "crossed" state, with investors wanting to buy what others do not wish to sell, and sell what others do not wish to buy. Even accounting for the Trafford Centre mega-deal in Manchester earlier this year, transaction levels in the market have taken a step back in the second quarter of the year. Overall, Central London remains the most lively transaction market.

Expectations continue to grow that more bank loan stock will soon be arriving on the market, but the general view remains that this will be through a carefully controlled process of release. Given the lucrative lending deals now possible at modest levels of risk, other commentators are suggesting we will see the availability of debt for property investment start to increase in the coming months.

Net Investment by Type of Investor



Source: Property Data (July 2011)

RETAIL

PERFORMANCE

- The retail sector has performed in line with the All Property average over the first half of 2011, recording a total return of 4.3% and capital growth of 1.4%. This performance was driven entirely by yield compression – average equivalent yields were 10-15 basis points lower at the end of June compared to December – while, on average, rents were flat for the sector.
- However, this hides significant differences in regional performance. London shops have lifted up the sectoral average

performance, while the rest of the retail sector has underperformed, reflecting rental differences; average Central London shop rents have grown by over 5% in the last six months while, within the rest of the sector, only supermarkets, and to a marginal extent retail warehouses, have seen any growth. Shopping centres and shops outside of London have continued to see rental declines. Indeed, capital values for provincial shops have actually declined since the beginning of the year.

OCCUPATIONAL DYNAMICS

- Real consumer spending declined again over the last year, with shoppers reluctant to spend due to weakened confidence in the economy, continued high unemployment, a stagnant housing market and household incomes failing to keep pace with inflation. Retailers' margins have been under increasing pressure, not helped by high import costs, and profits have generally been disappointing – though far better than during the dark days of recession.

- To add to the pain suffered on the high street, growing competition for retail sales has come from the internet and supermarkets consolidating their non-food retail offerings. Out of town retail warehousing has also benefited from some diversion of sales from the high street. Though improved from a year or two ago, vacancy rates remain high, particularly for secondary retail locations; demand for space is improving, though there is not yet much upwards pressure in rents, except in Central London.

INVESTOR SENTIMENT

- Investors have continued to target the primer end of retail, with yields for trophy retail assets in the West End of London having been driven to sub-4% levels; individual deals involving foreign buyers have achieved yields around the 3% level. However, outside of London, overseas buyers have been much less active, meaning more sensible pricing from UK-based investors. Yields remain elevated for poor quality stock in secondary locations, due to an increase in supply coming to market from the banks, and

continued reticence from investors concerned about the prospect of "terminal decline" for this type of retail property, with the risk of rental income never recovering.

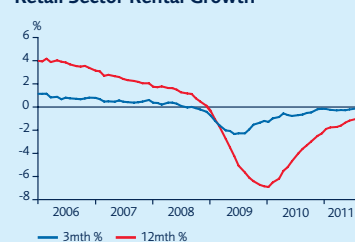
- There has been an increase in shopping centres being put on the market, which may lead to an increase in observable evidence regarding where pricing is; many expect upcoming deals to confirm weak yields at the secondary end, but firm yields for prime stock.

Retail Sector Total Returns



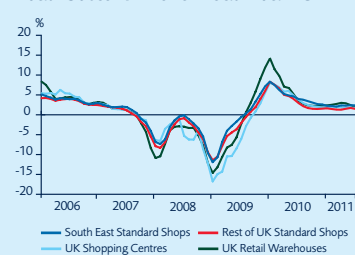
Source: IPD Monthly Digest (June 2011)

Retail Sector Rental Growth



Source: IPD Monthly Digest (June 2011)

Retail Sector 3-Month Total Returns



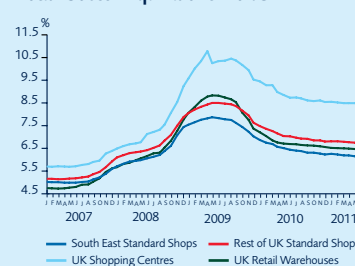
Source: IPD Monthly Digest (June 2011)

Retail Sector 3-Month Rental Growth



Source: IPD Monthly Digest (June 2011)

Retail Sector Equivalent Yields



Source: IPD Monthly Digest (June 2011)

OFFICES

PERFORMANCE

- The office sector remains the best performer out of the main property sub-sectors, recording a total return of 5.0% over the first half of the year compared to 4.4% for All Property. This relative strength is, however, solely due to the Central London office market, where total returns have been significantly higher. The performance of the South East and regional markets, meanwhile, has been weaker than in all other property sub-sectors.
- Total returns on a rolling 12 month basis have slowed significantly since the start of the year, largely due to a tailing off in the rate at which yields are hardening. The majority of office sector performance is now coming from the income return.
- Nevertheless, the three-month trend in total returns has actually improved since the start of the year, rising to 2.5% by June. This reflects an improvement in the short-term performance of the non-London markets, while, in London, returns have remained relatively stable.

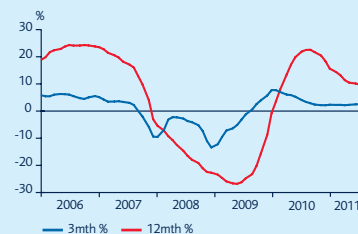
OCCUPATIONAL DYNAMICS

- Take-up has been relatively subdued so far this year, particularly when compared with the final quarter of 2010. Demand also remains highly polarised, with occupiers seeking Grade A space, meaning that vacancy rates for prime space are trending downwards in most markets. Secondary space, however, remains much harder to let and this is likely to remain the case in the short term.
- Demand for space remains strongest in Central London, although even here there are signs that rental growth is starting to slow. The relatively weak economic outlook is forcing occupiers to remain cautious and on-going concerns regarding further redundancies in the financial sector also likely to restrain demand for space this year.
- Demand in the regions remains patchy and highly focused on Grade A space. Most requirements continue to be driven by lease events, rather than occupier expansion, and, as such, prospects for rental growth remain muted in these markets.

INVESTOR SENTIMENT

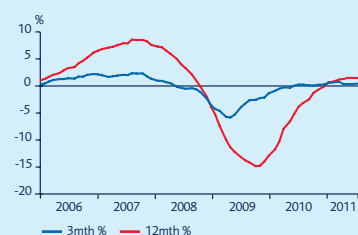
- Investor demand has remained firmly focused on Central London in recent months, with prime yields having been driven down to 4% (or even lower) in the West End and not much higher than 5% in the City. Prime West End yields are now at most only 50 basis points above their mid-2007 low. Yields are also hardening on secondary assets. Much of the pressure on yields has been driven by foreign investors looking for a financial safe haven and taking advantage of the continued weakness of sterling.
- With overseas investors dominating the London markets, many UK-based investors are instead focusing on the South East. The lack of available prime stock is forcing investors to look further up the risk spectrum, with recent deals starting to test the less secure three to 10-year income bracket. There is still comparatively weak investor interest in the regional markets, although prime buildings in the best locations remain attractive to UK-based buyers.

Office Sector Total Returns



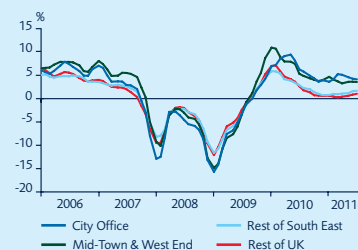
Source: IPD Monthly Digest (June 2011)

Office Sector Rental Growth



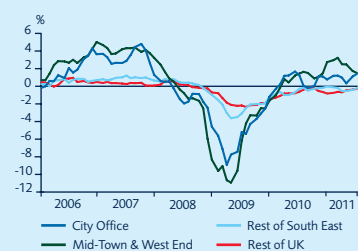
Source: IPD Monthly Digest (June 2011)

Office Sector 3-Month Total Returns



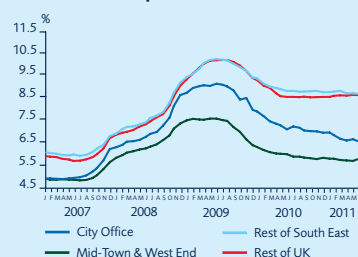
Source: IPD Monthly Digest (June 2011)

Office Sector 3-Month Rental Growth



Source: IPD Monthly Digest (June 2011)

Office Sector Equivalent Yields



Source: IPD Monthly Digest (June 2011)

INDUSTRIALS

PERFORMANCE

- During the past six months, performance for the industrial sector has remained steady, recording a return of 3.6% on the IPD Quarterly Index – slightly lower than that of the All Property average of 4.4%. Since September 2010, capital growth for industrials has continued, albeit at a marginal rate, leaving income return to drive almost all of the total return. However, average rental values have continued to decline, by 0.5% over the past six months, while the All Property average has seen positive rental growth since the final quarter of 2010.
- The gap between the South East and the rest of the UK persists, with London leading capital growth at 1.4% over the six months. Distribution warehouses have performed very much in line with standard industrials. The warehouse rental growth momentum seems to have slowed recently, after a bounce-back in take-up pushed rental growth back to positive territory at the end of last year.

OCCUPATIONAL DYNAMICS

- Following record high take-up last year, the first half of 2011 has seen the recovery trend continue, though the strength of demand has slightly weakened. The occupational market is still dominated by retailers such as the big supermarkets and internet retailers who are the major source of demand for large logistic space and who are benefiting from soaring online retail sales. Another major tenant source is the manufacturing sector, which has seen increased output and exports this year; manufacturers have become more active in terms of looking for space compared with a year ago.
- Given there has hardly been any speculative development, the availability of prime large sheds has fallen significantly during the past six months. However, despite the subdued outlook for consumer spending, there has not been a negative impact on take-up numbers, though further growth in demand is constrained by the shaky recovery in fundamentals.

INVESTOR SENTIMENT

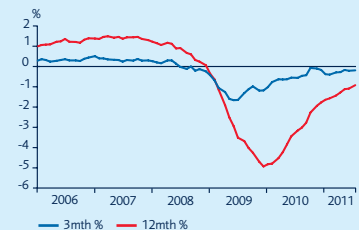
- The industrial sector, particularly in London, is increasingly being targeted by investors, lured by attractive high yields. Good quality assets are in strong demand and transaction volumes in the first six months of this year already exceed that seen over the full 12 months in 2010. Foreign investors have become much more active compared to last year, although major investors are still UK institutions and property companies.
- However, in general, the number of investment transactions still edged lower over the past six months, mainly because investors are very cautious and concentrating on prime stock which is very limited in supply. As a result, there has been little evidence of industrial yields moving much recently, particularly at the more secondary end. The disposal of distressed properties from banks remains a concern to investors considering moving up the risk curve.

Industrial Sector Total Returns



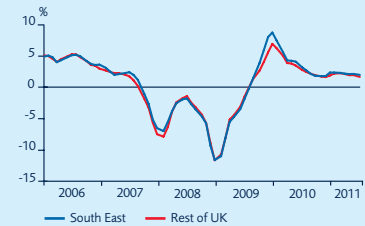
Source: IPD Monthly Digest (June 2011)

Industrial Sector Rental Growth



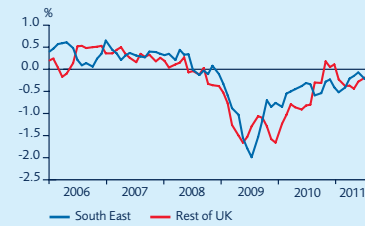
Source: IPD Monthly Digest (June 2011)

Industrial Sector 3-Month Total Return



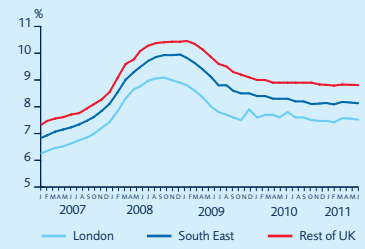
Source: IPD Monthly Digest (June 2011)

Industrial Sector 3-Month Rental Growth



Source: IPD Monthly Digest (June 2011)

Retail Sector Equivalent Yields



Source: IPD Monthly Digest (June 2011)

UK PROPERTY OUTLOOK

The UK economy is continuing to expand, although its recovery remains very muted, hamstrung by issues such as declining real disposable incomes and constraints on public sector spending. In contrast to past recessions, the outlook for GDP growth also remains weak – most forecasters expect economic growth to remain well below trend throughout the next five years, with stronger growth only starting to come through from 2014 onwards. Furthermore, there are obvious downside risks from possible contagion from the Eurozone debt problems.

Below-trend economic growth will inevitably act to restrain occupational demand going forward. The gulf in rental performance between the resurgent capital and the rest of the country is likely to persist in the short term, though the supply side has begun to react, with a dearth of new space supporting prime rents in the regions (selected prime non-London markets are already starting to see some rental growth, largely due to shortages of Grade A space), while construction planned and underway in London is likely to limit rental growth from 2013 onwards.

Differences in short-term prospects for rental growth, particularly in those regions which remain highly dependent on the public sector for both output and employment, are likely to maintain the current polarisation of the investment market. With non-London occupier markets lagging, investors are likely to continue to favour London-based assets. However, it is unlikely that this polarisation and significant yield gap will last beyond the short term.

Yields in London, particularly for prime assets, are looking increasingly expensive – domestic investors have been all but priced out of the West End office market in particular. When economic conditions show more stabilisation and sustainability, it is likely that there will be a greater transfer of investor interest from London to the South East, and then to the regions, in order to take advantage of markets which have experienced a much smaller amount of yield compression.

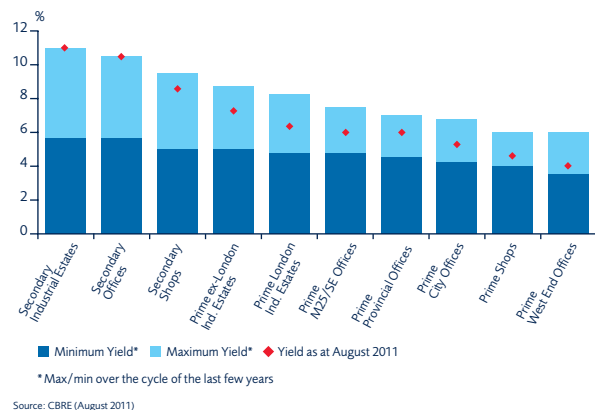
Similarly, investors will have to look further along the "quality" risk curve in order to obtain stronger performance prospects. Indeed, there are already signs that this is happening, albeit selectively. Although secondary/tertiary assets may see a further weakening in yields in the short term, reflecting concerns over weak rental growth prospects and renewed investor nervousness, these assets are likely to see more yield compression in the medium term as investors look to take advantage of the significant discounts of these assets relative to their long-run fair value. Prime yields, meanwhile, are unlikely to be able to compress much further over the next few years since, in some

areas of the market, yields are not much higher than levels recorded during the heady pre-crash days of 2006 and 2007.

"Although secondary/tertiary assets may see a further weakening in yields in the short term, reflecting the current weakness of rental growth prospects, these assets will almost certainly see renewed yield compression in the medium term."

The outlook for property in the short term is likely to be one of continued caution, with investors remaining focused on those areas of the market that have a much more secure and stable near-term outlook – largely prime, or perhaps good secondary, assets, with London and, to an extent, the South East favoured over the regions. Nevertheless, once confidence over stronger stable economic growth returns, investors are likely to look further afield, taking advantage of the current yield premiums being seen on regional and also secondary assets as these appear to offer the most attractive long-run value.

The Property Yield Spectrum



IPF Consensus Forecasts for Total Returns May vs February % p.a., 2011-2013

	2011		2012		2013		2011-2015	
	May (11)	Feb (11)	May (11)	Feb (11)	May (11)	Feb (11)	May (11)	Feb (11)
Standard shops	4.1	3.6	6.1	6.8	7.7	8.4	6.8	7.1
Shopping centres	5.1	4.5	6.6	7.6	8.7	9.4	7.7	8.2
Retail warehouses	6.5	5.2	6.9	8.4	8.2	9.5	7.8	8.1
Offices	8.4	8.1	9.5	10.0	9.2	9.7	8.6	8.9
West End offices	11.4	9.6	10.7	11.0	8.7	9.9	8.9	9.2
City offices	12.3	10.9	11.0	11.9	9.7	9.9	9.3	9.4
Industrial	5.5	4.8	7.3	8.5	9.0	9.5	8.0	8.4
All property	6.8	5.7	7.3	8.6	9.0	9.4	7.8	8.4

Source: IPF Consensus (February 2011 and May 2011)

The Institutional Investment Disconnect

As part of a nation that is obsessed with home ownership and buy-to-let investing, it seems surprising that there is no significant institutional presence in the UK investment market. This has, in fact, not always been the case - in the first half of the 20th century, a flourishing private rented sector (PRS) did exist which was dominated by institutional investors. However, the establishment of rent controls in 1954 led to the withdrawal of institutional and large-scale landlords from the market, decimating the PRS and leading to the era of the owner-occupier.

Inevitably, with every period of falling house prices comes a re-emergence of interest from such large-scale investors in the residential market looking to profit from a potential market recovery. A recent change to stamp duty legislation has also increased investor interest in the asset class. However, the case for residential property extends well beyond the tactical supernormal return chased by the inevitable prime Central London vulture fund.

Strong Returns and Diversification Potential

Purely on a historical return basis, the argument for investing in residential property is compelling. Residential has outperformed commercial property in each of the past three decades on both a total return and risk-adjusted return basis and has also outperformed the equity and gilt markets over this 30-year period. In addition, residential property shows extremely low (or negative) correlations with equities and gilts. Although, as would be expected, it has a stronger correlation with commercial property, this is still well below 100%. Residential property's correlations even remain relatively low during a downturn, when all asset class correlations trend towards 100%, partly reflecting its better relative performance during periods of economic weakness. This suggests that residential property would prove to be a good diversifier for other asset classes.

Total Returns by Decade – Residential vs. Commercial Property



Source: IPD Annual Digest, IPD Residential Index; (July 2011)

Equally, adding residential property into a pure commercial property portfolio could prove to be highly beneficial. Over the long-term, the total returns of commercial property's sub-sectors have shown strong correlations of around 85% with each other. The corresponding correlations with residential property range from a much weaker 55% (industrial) to 70% (offices), suggesting that residential property could prove to be a suitable portfolio diversifier for commercial property investors.

"...the argument for investing in residential property is compelling. Residential has outperformed commercial property in each of the past three decades on both a total return and risk-adjusted return basis..."

No discussion on institutional investment in residential property would be complete without mentioning the Central London market. While institutional investors have shied away from regional markets, they have nevertheless shown interest in the capital. This partly reflects the fact that Central London residential has proven to be the best performing market in the UK by a notable margin. However, it must be noted that this sector of the market has a strong relationship with the Central London office market, moving closely in line with the latter's capital and rental cycles, albeit with the advantage of seeing significantly less downside volatility. Arguably, therefore, rather than offering a "true" residential return, Central London residential property could perhaps be considered a proxy for the Central London office market.

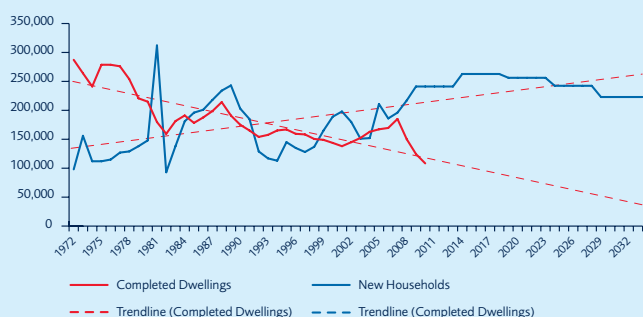
Future Performance: Demand and Supply Imbalances

As with any top-performing investment, it is important to consider whether the fundamentals that have driven strong historic performance will remain in place in the future. In the case of the residential market, this seems extremely likely.

Current estimates suggest that the number of new households, the demand for housing, will rise by around 245,000 per year on average for the next 25 years, against an historic average of 160,000 per year. This reflects a combination of an increasing population and a falling average household size. Meanwhile, the number of houses being built in the UK has decreased significantly since the 1970s, both due to the reducing role played by social housing and the highly restrictive nature of the UK's planning system. The onset of the credit crunch has also had a damaging effect on construction numbers, with housing starts remaining well below average even now, a few years on.

This combination of strong, and rising, demand and limited supply will place massive pressures on the UK housing market. This will, most likely, lead to significant long-term house price growth, quite possibly in excess of the real growth of 2.4% per annum estimated in the Barker Report (2004) to be the long-run trend in house prices (a substantial improvement over the commercial property market's historic long-run real capital decline of around 1% per annum).

The UK's Housing Demand – Supply Imbalance



Source: CLG, PRUPIM

The UK's Housing Demand-Supply Imbalance

In addition, a significant demand-supply imbalance is building up in the private rented sector (PRS). A combination of a lack of affordability of housing and a lack of availability of mortgage finance are pushing ever-greater numbers of people, particularly young professionals, into privately rented housing – it is suggested that by the end of the decade, 20% of households will be living in the PRS, up from 15% currently. However, there is not enough supply to absorb this additional demand, especially in those parts of the country where demand will be greatest, such as London.

Although previously provided by increasing numbers of buy-to-let investors, the current issues surrounding the mortgage market mean that the supply of privately rented housing is being restricted at a time when demand has started to accelerate, leading to a major gap in the provision of rented housing. This is already leading to significant rental growth and, with the imbalance set to worsen, a massive opportunity exists for investors to take advantage of strong rental growth in the future.

Despite all of the extremely positive reasons for investing in residential property, and declared interest in the sector, there remains very little large-scale investment in the asset class. It is, therefore, important to consider what is preventing such investors from entering the market.

Barriers to Investing

One of the primary attractions of commercial property has always been its high and stable income stream. Residential property, however,

is a low-income asset class and this income is inevitably less stable and secure because of the Assured Shorthold Tenancy (AST) structure. As a result, the bulk of its performance has always resulted from strong capital growth. Inevitably, the unpredictability of this growth means that institutional investors deem residential property to be much higher risk – even though residential tends to retain much of the capital growth that has accrued over time.

Of more concern is the fact that around one-third of the gross yield on residential property is "lost" because of operating costs, a significantly higher proportion than on commercial property. This reflects the higher management and maintenance costs associated with the property type, issues that will not be easily resolved. Nevertheless, such costs do, in part, depend on the type of building and the way that building is managed so the potential for reducing this "loss" does exist.

"This combination of strong, and rising, demand and limited supply will place massive pressures on the UK housing market. This will, most likely, lead to significant long-term house price growth..."

An element of reputational risk is also associated with investing in privately rented property. However, this risk could easily be mitigated by careful targeting of the fund, tenant and building types that are accessed. Additionally, investible market issues have also hampered the emergence of residential as an asset class. These include a lack of suitable stock, limited market liquidity and issues surrounding the way which residential property is valued. The inevitable "chicken and egg" nature of these barriers causes additional problems. However, with there now being general, and political, recognition that large-scale investment in the PRS is both vital and beneficial, it may not be long until these issues are resolved.

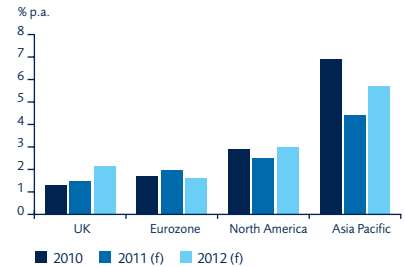
Whether or not institutions should invest in residential property will likely remain a subject of significant debate. However, the advantages to doing so are both clear and compelling and so the asset class should not be dismissed out-of-hand because of historic difficulties or because it does not share some of the characteristics of commercial property. Instead, residential property must be considered in terms of its own fundamentals and future growth potential (albeit with a view to whether or not current pricing justifies an investment), both of which seem to lend support to the argument for institutional involvement in the asset class.

INTERNATIONAL PROPERTY MARKETS

GLOBAL VIEW

- Commercial real estate markets around the world have seen continuing recoveries so far in 2011. Economic growth has brought pick-ups in occupier demand, and many rental markets have moved into the growth phase of the cycle, helped by a lack of new space. Generally, the Asian markets are seeing stronger rental growth, while quite a few markets in Europe and the US remain weak.
- The recovery in pricing of real estate globally has been almost exclusively at the primer end, which has benefited from on-going investor risk aversion and "flight to safety". Some prime assets now appear overpriced and braver investors are beginning to consider secondary stock with riskier fundamentals which has seen much less yield compression.

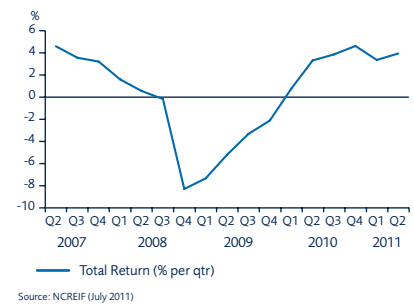
GDP Outlook



NORTH AMERICA

- In the US, recent revisions to GDP figures showed the recession was deeper and the economic recovery more muted than previously thought. Protracted negotiations regarding the debt ceiling symbolised uncertainty over the outlook. Property markets have continued to recover, with NCREIF recording a total return of 7.4% over the first half of 2011 while transaction volumes are significantly higher than a year ago; the occupier markets are steadily improving.
- In Canada, the resilient economy, combined with gradual falls in the unemployment rate, has supported steady growth in the property markets. The retail sector, which has been the best performer since 2009, has started to see capital growth momentum slow.

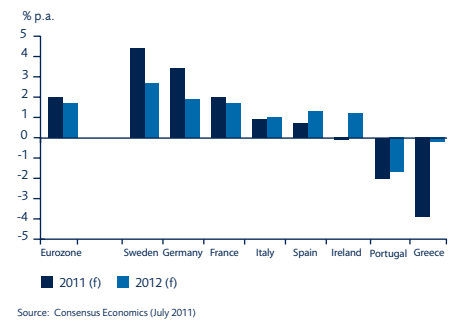
US All Property Total Return (% per qtr)



EUROPE

- Eurozone sovereign debt issues remain a major source of concern; Greece's second bail-out deal only temporarily calmed the markets before contagion fears regarding Spain and Italy intensified. Nevertheless, the economies of Germany and the Nordics have been strong, though sentiment surveys suggest that activity is starting to slow across the region.
- Prime yields in most Eurozone markets remained stable or hardened slightly in the second quarter of 2011. Dublin was the exception due to on-going concerns over the local economy which pushed prime industrial and office yields up by 25 basis points. Occupier markets are also showing signs of stabilisation, with a lack of available Grade A supply pushing up rents in an increasing number of European markets.

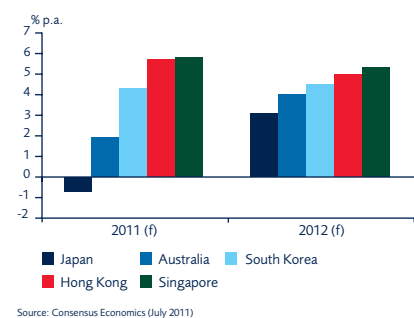
GDP Growth Outlook for Selected Countries in the Eurozone



ASIA PACIFIC

- Fragile economic growth in the US and Eurozone coupled with the impacts from the recent natural disasters in Japan and Australia have started to weigh on exports and the economic growth momentum of the Asia Pacific region. Nonetheless, resilient domestic consumption and robust intra-regional trade are expected to offset moderating global demand and continue to support regional economic growth.
- In the property markets, fundamentals are becoming more diverse. Strong economic performance continues to underpin demand for commercial space in Singapore and Hong Kong, while take-up rates in Seoul and Tokyo are weakening. As investors remain risk averse, competition for prime property is expected to continue to support prime yields in the short term.

Consensus Forecasts of Asia Pacific GDP Growth



GLOBAL ECONOMIC AND MARKET REVIEW

There was no denying that the pace of expansion in the global economy slowed during the second quarter of 2011. Most of the data released showed that growth had weakened in the West, China and Latin America, albeit most economies avoided recession.

The quarter proved to be a game of two halves for financial markets. April started well as investors became convinced that the Japanese disaster would not tip the economy back into recession. But risk assets, especially cyclical sectors, quickly lost their appeal when anxiety over Greece's ability to adhere to its austerity package came to a head. For most market commentators, it was no longer a question of whether Greece would default but when. In a similar trend to the same period last year, worrying signals from the US economy coincided with the Federal Reserve's planned exit from quantitative easing. This time around, however, worries over the US were accompanied by fears about the effect of tighter monetary policy on China. Investors' nerves finally calmed in the last week of June when the Greek government won a crucial vote on its austerity package and stockmarkets subsequently recovered their poise to end the quarter little changed.

Somewhat surprisingly, given this backdrop, for a UK investor European equities were one of the strongest performing regions, helped by the strength of the euro versus the pound. However, this stockmarket performance masked a significant divergence in returns between the relatively healthy "core" and the troubled periphery. For example, while Germany's economic prowess was demonstrated by its flourishing export sector and by the growth in company profits, Greece, Portugal, Spain, Ireland and Italy all continued to battle high unemployment and sluggish economic activity as well as tax rises and stringent public sector spending cuts.

Despite disappointing economic news, UK equities also managed to post modest gains, supported by solid returns from more defensive sectors such as consumer goods, utilities and pharmaceuticals. In general, medium-sized stocks fared better than their larger counterparts, helped by the good performance of industrials and the absence of major commodity producers in this area of the market. In contrast, despite robust profit growth from the corporate sector, the US was one of the worst performing developed stockmarkets during

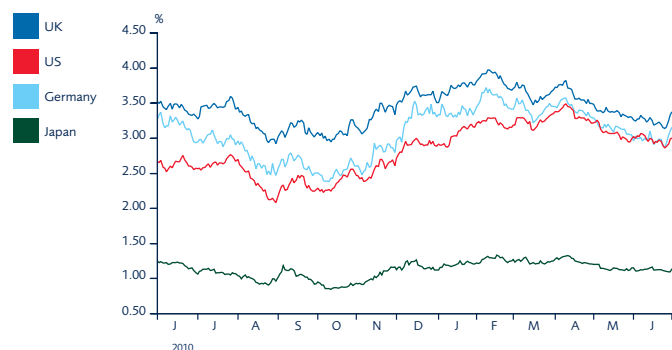
the second quarter due to a raft of poor data from nearly all corners of the economy, especially the housing market, manufacturing and consumer confidence.

In the East, Japanese equities struggled to make headway as the devastating earthquake and tsunami took their toll on the country's economy, which fell back into recession. However, there were signs of future improvement when many factories restarted production. Elsewhere in Asia, inflation was never far from investors' thoughts in the second quarter. As a result, two of the countries most affected by this issue – China and India – suffered losses, although some countries did much better; for example, Indonesia gained 8.6% in sterling terms to rank as one of the best performing equity markets overall.

For government bonds, the fragility of the global economy replaced inflation as the number one concern for investors during the quarter, with yields within core markets falling as a result. At a time of poor risk appetite, government bonds also outperformed credit, particularly high yield bonds, while the combination of weak economic growth and high inflation readings helped index-linked government bonds to outstrip their conventional counterparts.

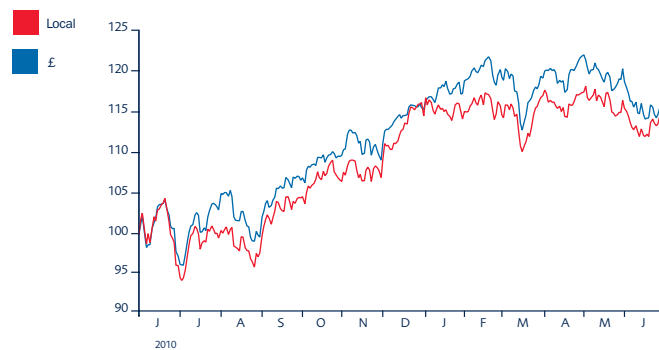
Looking ahead, the Federal Reserve has already said that more quantitative easing is not an option especially since inflation has now become an issue in the US. Indeed, inflation is a problem worldwide with most central banks taking action to curb rising price levels. The fight against inflation in Asia continues and growth, although still relatively strong, is suffering as a consequence. For Europe, tighter monetary policy comes at a time of tighter fiscal policy, and unsurprisingly, the heavily indebted peripheral countries are feeling the pain the most. In comparison, the Bank of England has left interest rates on hold despite high headline inflation readings, wanting to see a steady recovery first.

10-Year Government Bond Redemption Yields



Source: Thomson Reuters Datastream (June 2011)

FTSE World Index



Source: Thomson Reuters Datastream (June 2011)

DATA AND STATISTICS

PROPERTY PERFORMANCE METRICS (%)

Index	Frequency	Date	1 month	3 months	Calendar YTD	1 year	3 years*
IPD Monthly Index	Monthly	June-11	0.7	2.1	4.4	9.1	0.2
CBRE Monthly	Monthly	June-11	0.7	1.9	4.7	10.1	1.1
IPD Quarterly Index	Quarterly	June-11	-	2.0	4.4	9.8	1.0
IPD Annual Index	Annual	Dec-10	-	-	-	15.1	-2.5

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

PRIME HEADLINE RENTS – £ PER SQUARE FOOT PER YEAR

Region	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
	June-11	% change over quarter	June-11	% change over quarter	June-11	% change over quarter	June-11	% change over quarter	June-11	% change over quarter
Central London	700.0	0.0	95.0	5.6	-	-	-	-	-	-
Sub London	330.0	0.0	35.0	0.0	-	-	-	-	-	-
London	-	-	-	-	27.0	0.0	-	-	11.5	0.0
South East	240.0	0.0	29.0	0.0	27.5	0.0	35.0	-6.7	7.5	0.0
South West	240.0	0.0	27.5	0.0	19.5	-7.1	55.0	0.0	5.5	0.0
East Anglia	180.0	0.0	29.0	0.0	26.5	0.0	25.0	-9.1	-	-
East Midlands	220.0	0.0	-	-	-	-	-	-	5.0	-4.8
West Midlands	217.0	0.0	28.5	1.8	19.0	0.0	47.5	0.0	5.0	0.0
Wales	280.0	0.0	21.0	2.4	15.0	7.1	30.0	0.0	-	-
North West	270.0	-1.8	28.0	0.0	16.5	0.0	42.5	0.0	4.0	0.0
Yorks & Humbs	220.0	0.0	25.0	0.0	17.0	0.0	35.0	0.0	5.5	0.0
North East	240.0	0.0	19.0	0.0	14.0	0.0	27.5	0.0	-	-
Scotland	255.0	0.0	30.0	3.4	17.0	0.0	35.0	-12.5	5.5	-1.8
Northern Ireland	180.0	-2.7	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

Region	Shops		Offices		Business Parks		Retail Warehouses*		Industrials	
	Jun-11	% change over quarter	Jun-11	% change over quarter	Jun-11	% change over quarter	Jun-11	% change over quarter	Jun-11	% change over quarter
Central London	4.00	0.00	4.00	0.00	-	-	-	-	-	-
Sub London	4.60	0.00	6.25	0.00	-	-	-	-	-	-
London	-	-	-	-	6.50	0.00	-	-	6.00	0.00
South East	4.75	0.00	6.25	-0.25	6.50	0.00	5.75	0.00	7.00	0.00
South West	5.00	0.00	6.25	0.00	7.25	0.00	5.25	0.00	6.75	0.00
East Anglia	4.75	0.00	6.00	0.00	7.00	0.00	5.50	-0.25	-	-
East Midlands	5.00	0.00	-	-	-	-	-	-	6.50	0.00
West Midlands	5.25	0.00	6.25	0.00	7.75	0.00	6.00	0.00	6.75	0.00
Wales	5.25	0.00	6.75	0.00	7.50	0.00	6.25	0.00	-	-
North West	4.75	0.00	6.25	0.00	7.75	0.00	5.00	0.00	7.00	0.00
Yorks & Humbs	5.00	0.00	6.50	0.00	8.00	0.00	5.00	-0.25	7.25	0.00
North East	5.00	0.00	6.75	0.00	7.75	0.00	5.25	0.00	-	-
Scotland	4.75	0.00	6.00	0.00	7.75	0.00	5.00	0.00	7.50	0.00
Northern Ireland	5.75	-0.25	8.00	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 25bps
*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 13 staff including nine 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 has been Honorary President and Chairman of the Society of Property Researchers and is 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.



Richard Gwilliam, Deputy Head of Property Research, BSc (Hons.)

Richard is the Deputy Head of Property Research at PRUPIM. His responsibilities include analysis of the UK and global property markets, the formation of in-house views, and determination of strategy for PRUPIM's funds. Richard has more than eight years of analysis and research experience within property investment; prior to joining PRUPIM in 2006, he spent three years at Investment Property Databank (IPD). Richard has a BSc (Hons.) in Economics from the University of Nottingham, and also holds the Investment Management Certificate. He is a member of the committee of the Society of Property Researchers.



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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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