

# THE UK REAL ESTATE MARKET

## OVERVIEW – THE UK REAL ESTATE MARKET IN 2007

2007 has seen a distinct change in sentiment for UK commercial property with a 15-year bull run coming to an end. The market has fallen back more rapidly than anticipated, and faster than the corresponding corrections of the early 1970s and 1990s.

With UK commercial property achieving total returns approaching 20% over each of the previous three years, 2007 began optimistically with the UK industry's consensus forecast anticipating low double-digit returns. The first six months of 2007 confirmed this as the upward trend of previous years continued, albeit at a slower pace. Debt buyers were all but shut out of the market as the weight of money from institutional investors, overseas buyers and retail funds sustained unprecedented high prices and values. Growth, however, began to moderate against a backdrop of mounting inflationary pressure and expectations of higher interest rates.

At the same time, the newly launched UK REIT market (Jan '07) witnessed strong negative sentiment that became a catalyst to an exodus from the sector. Share prices began sliding as the underlying assets continued to rise, and significant discounts to NAV started to emerge in REIT share prices. Cracks began to appear over the summer as investment transactions failed to complete, and property valuation yields, particularly in secondary properties, began to rise.

The onset of the credit crunch in the second quarter of 2007 confirmed the poorer sentiment across all property sectors; investors increasingly withdrew from the property market, open-ended property funds suffered net redemptions that exceeded their ability to sell property assets, and published property valuations began falling month-on-month from June.

Empirical evidence shows that many institutions are simply refusing to sell properties at lower prices, demonstrating a firm commitment to remain invested in the asset class. Secondly it appears that a significant number of property transactions are being completed but away from public scrutiny at prices that are undisclosed. This suggests that those professional investors who sold out of the market in 2006 may be re-entering the market as bargain opportunities on high quality properties emerge.

## FTSE UK COMMERCIAL PROPERTY INDEX

In more challenging market conditions and without the benefit of large transaction volumes in the open market, it becomes increasingly difficult to understand what is truly happening to real estate values. Considerable confusion arises from the array of differing industry research reports, pressure on retail funds caused by accelerating volumes of redemption requests and sensationalised press reports.

FTSE Group's UK Commercial Property Index Series is the only objective index measuring investment performance in institutional commercial property on a daily basis.

FTSE All Property Total Return (inclusive of income return) continued to be positive from 1 January until the end of August, delivering 6.23% YTD (GAV). The total return (GAV) results for the first three Quarters of 2007 showed 3.06%, 1.55% and 1.55% respectively. The fourth quarter total return (GAV) result of -5.57% showed the dramatic change in market sentiment, all but wiping out the previous quarters' gains and bringing the total return (GAV) result for the 2007 calendar year to just 0.35%.

The FTSE All Property Total Return Index measures the performance of around £16 billion of prime institutional real estate on an ungeared basis. The index performance data come from the FTSEpx Fund, which invests directly into UK real estate in accordance with weightings representative of the UK institutional investment universe set by FTSE Group. Where the Fund invests in geared assets, it retains additional cash to effectively 'de-gear' those assets. As a result of the Fund's asset selection processes, the index series tends to contain a lower proportion of 'secondary' properties, a sector of the property market that is witnessing more severe price corrections.

In order to use the results of the FTSE UK Commercial Property Index as a comparison for the performance of a particular property investment, it is important to consider whether the property investment is geared and whether the property investment is in primary, secondary or perhaps a specialist sector of the market. These factors can have a significant leverage effect on investment performance, which in a market downturn can feed through to dramatic falls in NAV.

The FTSE UK Commercial Property Index shows that for 2007, commercial property performance was beaten by equities (FTSE 100 Index 7.4%) and Gilts (FTSE UK Gilts All Stocks 5.3%). Over the past three years the results have been FTSE All Property 13.95% pa, FTSE 100 14.1% pa, and FTSE UK Gilts 4.6% pa. Also on a risk-adjusted basis the FTSE UK Commercial Property Index shows the low volatility of commercial property returns (2.9% against 15.7% for equities) and a Sharpe ratio of 3.61%, which is six times greater than equities at 0.62 and over seven times greater than REITs at 0.49.

In 2007 the Association of Private Client Investment Managers and Stockbrokers (APCIMS) added the FTSE UK Commercial Property Index as part of the portfolio performance benchmark for private investors. This applies to the APCIMS income, growth and balanced indices.

## FTSE EPRA / NAREIT UK INDEX

For the listed real estate market 2007 has been a challenging year. After reaching an all-time high in February 2007, the UK, which accounts for approximately 40% of the total listed European market, was among the worst performing countries, with a loss of more than 30% outweighing the positive influence of the newly launched tax efficient UK REIT structure. Over the course of the year, 17 UK companies converted to REIT status with more to follow in 2008.

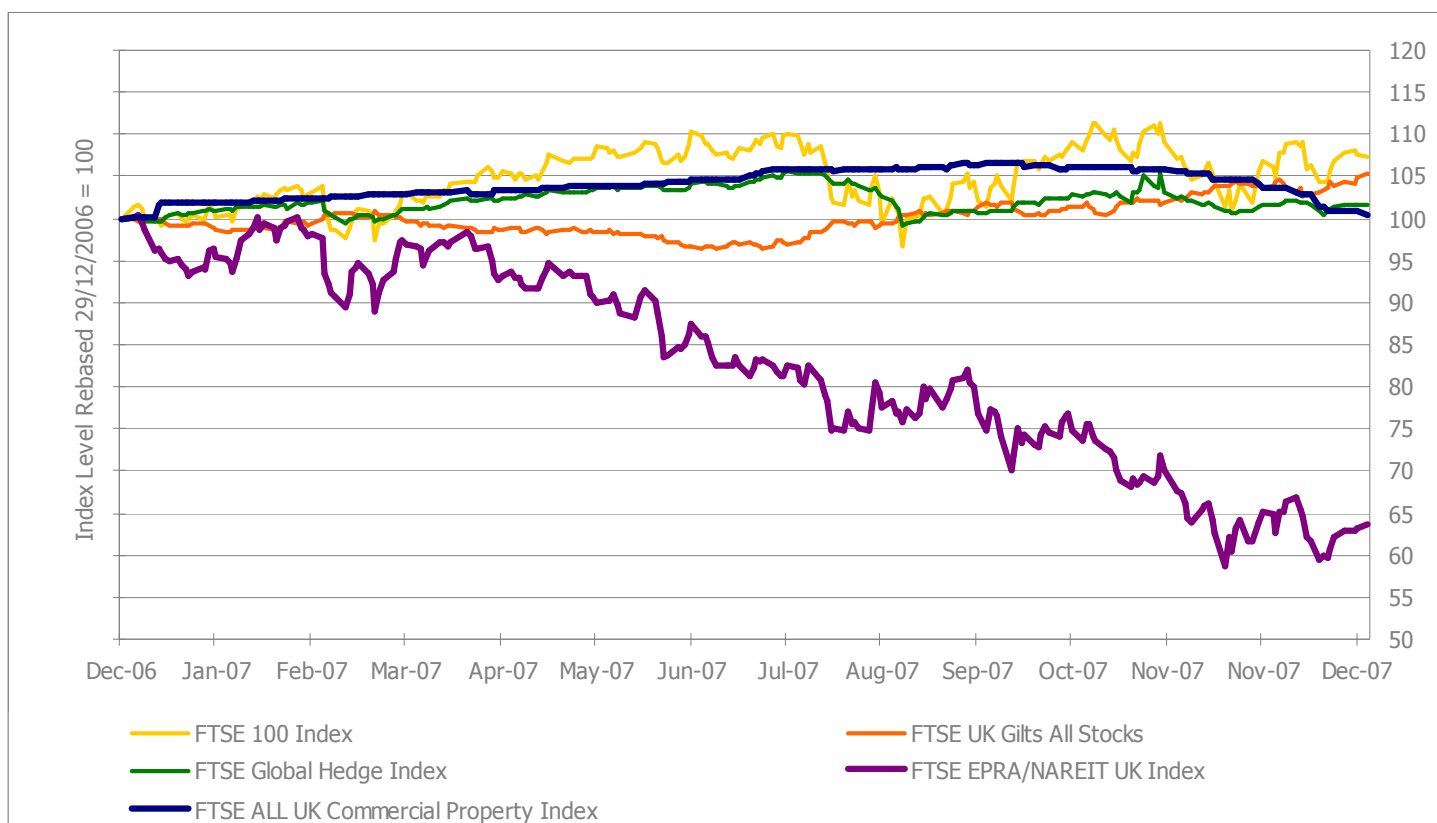
The market correction in the UK came after several years of steady growth. Among the worst performers were the retail property investor Capital and Regional (-62%), the diversified company Minerva (-60%) and office investor Mapeley (-58%), indicating that the correction was sector wide. Lodging company Marylebone Warwick Balfour was the best performer with a return of 3.63%.

This market turbulence did have a number of consequences regarding corporate activity as each company reacted differently to the apparent undervaluation. Land Securities, one of the largest UK real estate companies, announced in November that it would de-merge into three separate companies in order to seek better shareholder value. Numerous other companies were either taken over, such as London Merchant Securities, or were subject to similar speculation. Other companies decided to fully withdraw from the sector.

However, following the decline in valuation, new opportunities have started to appear with investors from the Middle East announcing their entry into the UK REIT market in an effort to gain from the undervaluation and to seek international diversification. Real Estate companies from Eastern Europe and Russia also decided to raise cash in the London AIM market, underlining the opportunities in the current market.

All in all, 2007 has been a difficult year from a share valuation point of view. However, the underlying real estate market still offers steady diversification benefits for portfolio managers, and with the decline in share price, the discounts to NAV has risen substantially, offering an upside potential for the coming years.

### PERFORMANCE CHART (TR/GBP/%)



Source: FTSE Group, data as at 31 December, 2007

## FTSE UK COMMERCIAL PROPERTY INDEX VALUES

Index Name	TRI	12M (%)	3Y (%)	3Y (%pa)	12M volatility* (%)	Sharpe-Ratio**
FTSE ALL UK PROPERTY INDEX (NAV)	5395.31	-1.15	41.69	12.32	2.79	4.40
FTSE ALL UK PROPERTY INDEX (GAV)	5520.93	0.35	47.97	13.95	2.83	4.92
FTSE UK RETAIL PROPERTY INDEX (NAV)	5221.51	-4.89	33.56	10.13	3.17	3.18
FTSE UK RETAIL PROPERTY INDEX (GAV)	5343.08	-3.44	39.48	11.73	3.17	3.69
FTSE UK OFFICE PROPERTY INDEX (NAV)	5632.00	5.04	52.08	15.00	5.46	2.74
FTSE UK OFFICE PROPERTY INDEX (GAV)	5763.14	6.63	58.81	16.67	5.46	3.05
FTSE UK INDUSTRIAL PROPERTY INDEX (NAV)	5749.53	3.55	54.16	15.52	6.08	2.54
FTSE UK INDUSTRIAL PROPERTY INDEX (GAV)	5883.40	5.12	60.98	17.20	6.09	2.82

## FTSE EPRA/NAREIT UK INDEX VALUES

Index Name	TRI	Market Cap (£m)	Dividend Yield (%)	12M (%)	12M volatility* (%)
FTSE EPRA/NAREIT UK INDEX	2,527.18	30,957.28	2.94	-36.27	17.63
FTSE EPRA/NAREIT UK REITS INDEX	649.40	25,545.15	0	-35.06	17.17
FTSE EPRA/NAREIT UK NON-REITS INDEX	569.99	5,412.12	0	-43.00	21.13
FTSE EPRA/NAREIT UK NON-RENTAL INDEX	947.28	1,441.68	1.56	-29.37	20.16
FTSE EPRA/NAREIT UK RENTAL INDEX	882.80	29,515.59	3	-36.53	25.44
FTSE EPRA/NAREIT UK SPECIALTY INDEX	886.96	436.28	0.7	-34.74	25.77
FTSE EPRA/NAREIT UK RETAIL INDEX	988.65	7,637.22	2.7	-30.46	22.88
FTSE EPRA/NAREIT UK RESIDENTIAL INDEX	631.74	337.20	1.78	-49.47	29.11
FTSE EPRA/NAREIT UK INDUSTRIAL INDEX	763.33	2,825.84	3.97	-39.96	29.99
FTSE EPRA/NAREIT UK OFFICE INDEX	889.99	3,091.67	1.99	-38.21	29.65

Source: FTSE Group, data as at 31 December 2007

\* Volatility calculated daily from 29/12/2006, using sqrt(250)

\*\* Sharpe-ratio as historic 3 year annualised return - risk free at 4.5% divided by volatility of 12 monthly on daily basis

## COMPARATIVE PERFORMANCE (TOTAL RETURNS, GBP)

Index Name	12M (%)	3Y (%pa) <sup>1</sup>	5Y (%pa) <sup>1</sup>	Volatility <sup>2</sup> (12M/%)	Sharpe-Ratio <sup>3</sup>	Correlation with FTSE UK Commercial Property
FTSE ALL UK COMMERCIAL PROPERTY INDEX (GAV)	0.35	13.95	14.87	2.87	3.61	1.00
FTSE EPRA/NAREIT UK INDEX	-36.27	4.02	16.52	24.35	0.49	0.09
FTSE HEDGE	1.70	4.01	6.50	4.86	0.41	0.05
FTSE 100 INDEX	7.36	14.06	14.24	15.69	0.62	0.06
FTSE UK GILTS ALL STOCKS	5.27	4.59	4.48	4.15	0.00	-0.07

Source: FTSE Group

<sup>1</sup> Performance inclusive of backcast history

<sup>2</sup> Volatility calculated daily from 22/06/2006, using sqrt (250)

<sup>3</sup> Sharpe-ratio as historic 5 year annualised return - risk free at 4.6% divided by volatility on daily basis p.a.

## VENDORS CODE

Index Name	Bloomberg	Reuters	Thomson
FTSE ALL UK COMMERCIAL PROPERTY INDEX (GAV)	FTMSAGTR	.TFTP101S	FTUPALG
FTSE ALL UK COMMERCIAL PROPERTY INDEX (NAV)	FTMSANTR	.TFTP100S	FTUPALN
FTSE EPRA/NAREIT UK REITS INDEX	ENUKR		
FTSE EPRA/NAREIT UK NON-REITS INDEX	ENUKNR		

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