

PROPERTY PANEL



THE PANEL

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UBS Global Asset Management

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HOW FAR TO FALL



Panelists discuss looking beyond the cyclical downturn, and the lessons they have learned regarding their approach to property investment and management

JOHNSTON: Sir John Ritblat recently suggested lack of finance and a deteriorating economic background would defer any property recovery until next year. Is there still not enough value to attract the long-term providers of capital, such as life assurance and pension funds, which can look beyond the cyclical downturn?

BALFOUR: The current investment market is characterised by low transactional volumes as buyers and sellers find reasons not to trade. Expensive debt and concerns over the economy are undoubtedly contributing factors. Of the activity that is taking place long term investors are in evidence and we believe this will continue to be the case as more spot long-term value in rising yields.

We believe there is already value to be found for long-term investors, although values will probably continue to fall in the short term as the market overcorrects. Whereas in recent years investors have looked for reversionary potential, the primary criteria now is income security. In the current economic climate, rental growth is likely to be subdued or even negative in the short term. However, falling capital values are an opportunity for long-term investors to achieve very attractive initial yields on prime assets secured by long leases.

YEOMANS: We certainly agree with Sir John's thoughts and do not perceive much optimism to indicate a recovery before next year at the earliest. We see the main risk on the occupational side.

While property has been re-priced and now looks "fair value" this is predicated by the view that occupational demand for property will ensure rental levels increase above the rate of inflation. If rental prospects diminish in the light of a weakening economy, property values may well fall further. No investor, no matter how long-term a thinker they may be, wants to be the one that leads the way, only to suffer poor performance as the value of its purchases continue to fall.

DENNIS-JONES: Long-term investors are likely to look at the relative attractiveness of property relative to other

options given their future economic expectations. In the UK, the April 2008 IPD Monthly Index initial and equivalent yields now stand at 5.5pc and 6.6pc respectively, compared to current yields of approximately 5.0pc on the 10-year gilt and the FTSE All-Share dividend yield of 3.6pc. The current property income return is approximately 6pc. The economic outlook seems to be one of both rising inflation and low growth, possibly even stagflation.

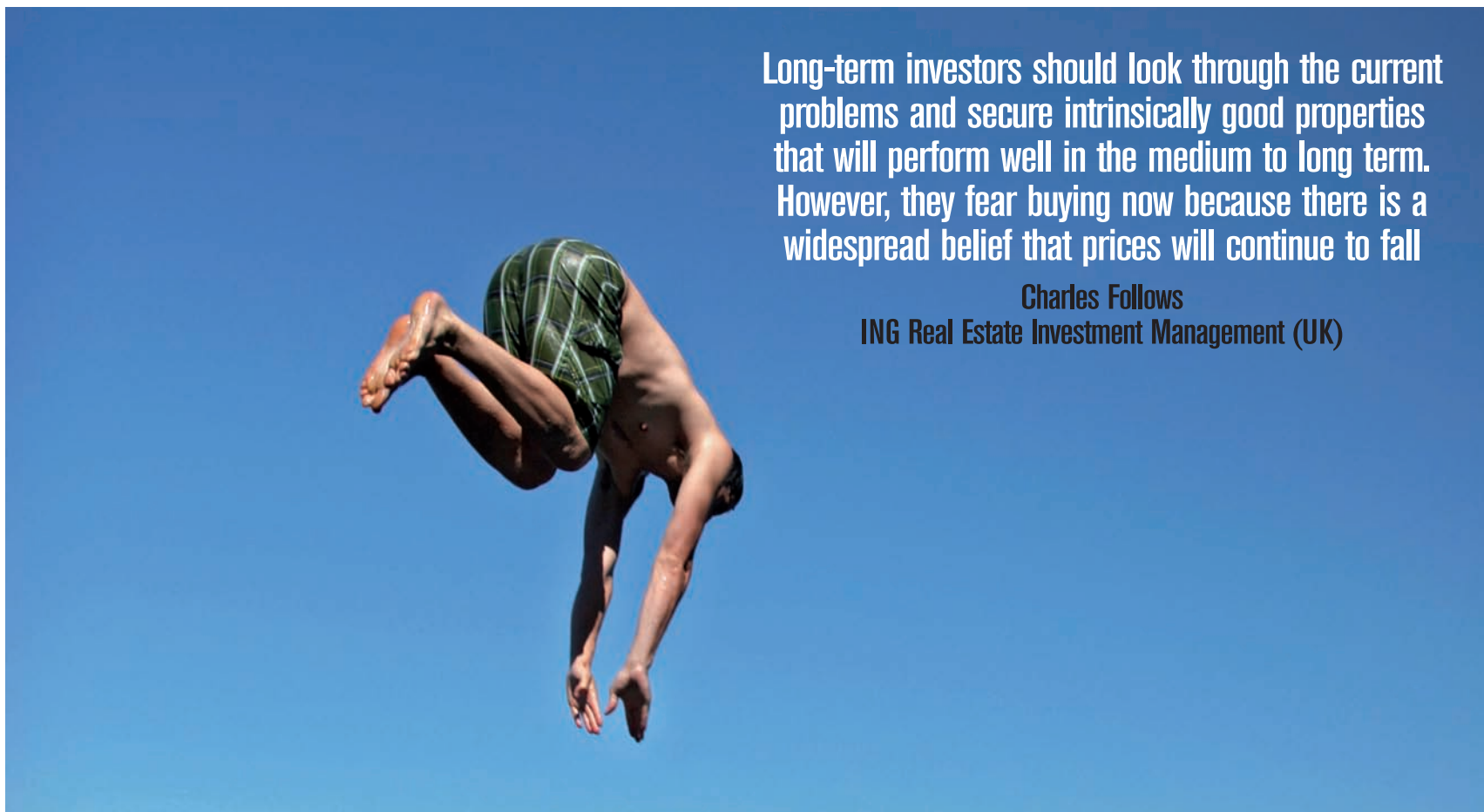
The yield gap between property and gilts has been narrowing since January as gilts yields have risen faster than property yields in response to rising inflation expectations. Looking back to the 1970s, the last time that these similar economic events occurred, a "reverse yield gap" with gilts started in 1967 and lasted until 1995. A similar reoccurrence is not inconceivable again given property's inflation hedging qualities compared to gilts.

In addition, property's hybrid bond/equity characteristic mean that it can provide secure income flows, attractive in poorer economic times, and income growth potential, attractive in more buoyant economic conditions. Thus, for long-term UK investors property may offer sufficient value now.

From a global perspective, we are witnessing increased activity and interest from non-UK based investors. They seem to perceive value relative to other global real estate markets with the weak pound, particularly encouraging European investors.

FOLLOWS: The phrase widely used is "don't catch a falling knife". Long-term investors, often using equity or low levels of debt, should look through the current problems and secure some intrinsically good properties that will perform well in the medium to long term. However, they fear buying now because there is a widespread belief that prices will continue to fall.

The insights from behavioural economics are illuminating when considering market dynamics and the behaviour of investors. Just as the market had upward momentum it now has downward momentum. Theories about market pricing vary, but we do know that markets do not stabilise at fair value. Just as the market went above long-term fair value in the last couple of years so it will fall below fair value in



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Charles Follows
ING Real Estate Investment Management (UK)

this phase of the cycle. So I think the property recovery will be delayed.

To date we have seen only a limited number of forced sellers and distressed sales. There is a clear mismatch between asking prices and the price purchasers are willing to pay. More distress will appear later on in 2008 as the rental value growth cycle ends. Property owners with high levels of debt will see banks taking action on covenant breaches, and they will find it difficult to refinance.

MARTIN: There is no doubt that once weaker economic growth in the UK over the next two to three years is factored in, the pricing of commercial property is less attractive from a cyclical perspective. This may dissuade some UK institutional investors from increasing their exposure to the sector for some time yet. But we continue to see good demand from international investors, who are more focused on the medium-term prospects for the economy, which remain sound.

It is also important to recall the wider asset class context; elevated levels of inflation are generally negative for bonds while equity earnings are likely to be at or past their peak; on a relative basis, therefore, property may be better value than the headline risk premium analysis would suggest.

FRANCIS: In our view, an increasing number of segments of the UK commercial property market are passing through what we would consider to be "fair value", even after factoring in weaker rental growth expectations. In the very near term, momentum may well cause the market to overshoot on the downside – as often happens in a correction. Should this happen, however, we would expect long-term investors to be rewarded with above trend returns in subsequent years while the market rebalanced.

In the first quarter of 2008 most UK institutions appeared more content to gain exposure to the market via derivatives, exploiting the implied discount they offer to most market forecasts. Similarly, there have been some opportunities in the commercial mortgage backed securities market but volumes are well down.

ELLIS: We would agree that the lack of finance for debt-driven investors and the deteriorating economic background, which is now beginning to impact on some occupational markets – particularly City of London offices – is looking to delay a recovery in the UK commercial property market into next year.

However, after the recent pricing adjustments UK property is looking a better medium to long-term investment, on a risk-adjusted basis, compared to other asset classes. Parties without the need to recourse to debt markets can be far more opportunistic in their approach and there are some (though certainly not widespread) examples of this happening. Some of our clients have looked at this as an opportunity to be buying from distressed sellers where their cashflow permits.

SMITH: Despite the recent repricing, UK property yields are still 100 basis points below their historical average, and faltering economic growth suggests letting markets, which so far have been quite resilient, will weaken. However, the property risk premium over government bonds is now close to levels seen during recessions over the last three decades, and that puts underlying valuations on a much firmer footing than a year ago. Because of the pace of the adjustment in the UK, the market looks better value against most other European countries than has been the case for the past three years.

Nervousness regarding the outlook for the economy and uncertainty over the state of the banking sector means though that institutions will not be looking to re-enter the market until late 2008 or 2009 at the earliest. By next year banks will have made progress in cleaning up their balance sheets, and credit market conditions are likely to have improved, but a return to the finance-fuelled market of recent years is not in the offing.

JOHNSTON: The early phase of a downturn in financial markets can often be indiscriminate and throw up some bargains. Is this true for property and, if so, where is the relative value starting to appear?

BALFOUR: The market adjustment has certainly been fairly indiscriminate so far. Although City offices and retail warehouses have led the way, most sectors have fallen broadly in line with the market regardless of varying rental growth prospects. With yields moving out by 100bp and more across almost all parts of the market, risk premia in some sectors are well above historic averages.

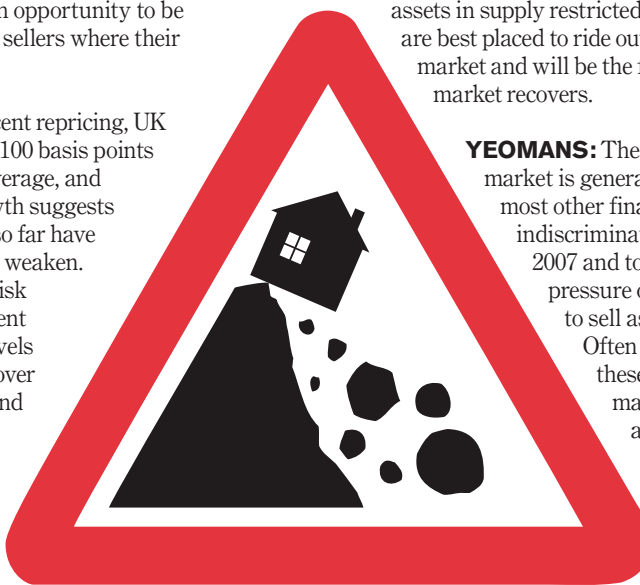
We believe that there is already good value to be found in prime high street retail, and certain specific office locations. The overriding tenor of our strategy is a focus on quality assets in supply restricted locations. We believe these assets are best placed to ride out a downturn in the occupier market and will be the first to bounce back when the market recovers.

YEOMANS: The volatility of values in the property market is generally less pronounced than in most other financial markets and, therefore, indiscriminate falls in value are less likely. In Q4 2007 and to a lesser degree Q1 2008 there was pressure on Unit Linked Funds, particularly, to sell assets to meet redemption demands. Often the best properties were sold as these were more liquid in a falling market. Long-term investors were able to take advantage and acquire good quality investments at much more attractive prices than had been available for some years.

Unless vendors are forced to sell, they will be reluctant to do so at heavily discounted prices. So the current mismatch of buyer and seller expectations has caused market inertia and transaction levels are well down.

Fears over the economy mean values are most likely to be heavily discounted in the retail sector. But a bargain is only a bargain if the market has bottomed out and values are likely to rise.

DENNIS-JONES: Yes we believe that there are some property bargains, particularly when property owners have to sell and there are only one or two buyers. We believe that



Continued on page 22

PROPERTY PANEL

Continued from page 21

relative value is starting to appear in those assets that are let on long leases to good covenants at attractive initial yields of 5pc-6.5pc but where the occupational fundamentals are strong. Such properties offer downside protection as well as long-term rental growth prospects.

FOLLOWS: With the limited number of open market transactions valuers have moved yields across the market. There is some discrimination between quality and locations, but the highest quality properties had the lowest yields so they have seen the largest impact from the across the board increase in yields. Within this there has been a noticeable quality decompression, with investors demanding higher yields from riskier properties. With increasing risk aversion, investors are now discounting prices for every worry or perceived problem in a property. It is remarkable how the asset management opportunities of early 2007 have become the “warts” of 2008.

In this environment there is some mis-pricing occurring, although at this stage it is difficult to precisely identify where it lies. So far the capital value falls have been largely attributable to changing capital market conditions and increasing yields. We now believe that we are entering an economic slowdown and this will curtail rental value growth, and in some markets lead to falling rental values. Until this plays out further, mis-pricing will be hard to spot with any confidence.

MARTIN: While it is certainly true that the downturn in capital values for direct property has been relatively indiscriminate, there has been relatively little forced selling thus far, which often provides the best opportunities for accessing stock that has been underpriced. That may well change, the most likely source being disposals by highly-leveraged investors who experience problems with making debt repayments or refinancing. That should put equity buyers into a comparatively strong position.

The area where relative value has emerged first is on the indirect side – prices for both real estate investment trusts and unlisted vehicles currently discount a substantial degree of further downside while offering access to a number of vehicles with high-quality portfolios and proven management skills.

FRANCIS: If the current market downturn is indiscriminate, this is only in directional terms, not magnitude. On the upswing, we saw higher yielding assets pursued aggressively, particularly by leveraged buyers. As a result the yield gap between prime and secondary property became too narrow. The current repricing of risk is on the way to re-establishing these yield gaps. As such, investors should prefer to hold better covenanted, better located longer leased stock. There are markets that are now “cheap” in fundamental terms (some parts of the prime retail and retail warehouse market and some areas of the industrial market), and these can be pursued by those with equity – and there are a few bargains around.

ELLIS: Like other markets, property can be over-sold as well as over-bought and this should result in some attractive pricing and investment opportunities. Property is also a very “bottom-up” and stock-specific asset class, where the differences at the property level mean that individual buying opportunities and potential “bargains” often appear. In some markets, like healthcare and student accommodation, we have seen pricing being more resilient than in the traditional retail, office and industrial sectors.

Relative value has certainly started to emerge in some derivatives, secondary unlisted property funds with large discounts to net asset value and some property listed securities; in time we believe more direct property opportunities will also come to the fore in the UK. Outside the UK we believe there are many interesting opportunities, particularly in Asia, where it is our view that China and Japan are well-placed to deliver attractive returns.

SMITH: Heavy redemptions by retail investors from property funds led to some distressed selling at the turn of the year, and meant that even assets with good income producing potential have had to be sold. Leveraged owners have also come under pressure as financing costs rose. A degree of forced selling has created some interesting buying opportunities for equity-financed buyers.



During sustained growth, some investors ignore flaws in the fundamentals in their desperation not to miss out. Then, in a downturn, the value of flawed investments falls fastest and furthest

Nick Yeomans, Wilky Fund Management

Taking into account rental growth prospects and sector risks, retail property looks relatively resilient at this stage in the cycle, although older, out-of-town retail warehouse schemes look vulnerable. South-east offices are priced more favourably than much of the rest of the sector. The market has seen low development activity in recent years, while the region's economy is less exposed than Central London to the financial service sector.

JOHNSTON: Property values are back at levels seen in the second half of 2005. Have the lessons learned during the intervening rise and fall changed anything in your approach to property investment and management?

BALFOUR: We continue to adhere to the same robust investment process that we follow at any phase of the market. Nonetheless, the market cycle has moved on, and in recognition of this we are now more focused on initial yields and income security. We are more cautious with regards to potential reversion, and are concentrating our efforts on income growth through asset management.

YEOMANS: No. Our investment approach has always been to seek properties that meet the fundamentals of location, covenant strength and lease length at supportable long-term values. We had grown increasingly concerned that prices

had become unsustainable and we sold assets where we believed our clients would get value in excess of true worth.

In terms of management, we have concentrated on engaging with our tenants to ensure we understand their strengths, weaknesses and market opportunities and have also emphasised active portfolio management to exploit added value opportunities. This leaves us well positioned to continue to drive income and growth from the portfolios, even as the economic downturn bites and values continue falling.

DENNIS-JONES: Through the property cycle we have maintained our bottom-up, total return approach to property investment and management, which focuses on the fundamentals and risks of a property investment.

We would say that the key lessons learned from the recent rise and fall seem to have been similar to the ones that have been witnessed in previous market cycles: a significant amount of cheap debt seems to cause property price bubbles; markets tend to overshoot. Debt is not a one-way bet, and in the long term, risk and return are correlated.

FOLLOWS: I think investors will take a number of lessons. Principally they have been reminded that any investment decision is a trade-off between risk and return. The emphasis until mid-2007 was on return, while risk was under assessed. I expect investors to be more challenging and questioning about prospective investments. Stress testing of appraisals and values is likely to be more rigorous and extreme.

The stability and value of secure income return will be more appreciated in future. It is worth reflecting that unless a property market participant has more than 15 years' experience (so perhaps approaching their forties) they will never have worked in a falling market so today's market is bound to be a learning experience.

MARTIN: This is an interesting question. If anything, the period since 2005 has allowed us to relearn old lessons rather than pick up new ones – most importantly a) if a market has moved away from fundamentals, it will at some

point move back towards them and b) that process is likely to take a lot longer than you expect.

But an area we would highlight is that the available options for UK institutional investors to access commercial property returns have multiplied in recent years and now include derivatives, CMBS, REITs, a wider array of unlisted indirect vehicles and international markets. We believe these are all here to stay and crucially, by increasing the potential for arbitrage, they add to the ability of skilled managers to deliver performance for clients even when overall market conditions are poor.

FRANCIS: When a cycle is driven by investment behaviour and an evolving and sometimes erratic pricing of risk rather than by the more predictable forces of supply and demand for stock and related rental growth, it is hard to forecast and plan for, or to develop new predictive processes for the next bout of unrealistic market over or under confidence.

However, we have been able to exploit the risk pricing anomalies and, notwithstanding the high levels of correlation seen between property markets around the world, the spreading of investment across both geographies and the debt-equity spectrum has helped to mitigate the worst of the downswing.

ELLIS: The main lesson learnt has probably been to expect the unexpected. The impact of the credit crunch, the liquidity crisis and the effect that this has had on the property market has been far more widespread than had initially been expected and the impact of global factors on UK commercial is probably now firmly established. Historically, there has not been a strong correlation between individual property markets around the globe but in time it looks as though correlations are likely to increase.

SMITH: The pace of recent capital value decline was, for a short period, faster than anything previously measured for UK property, even including the sharp recession of 1990-92. Valuations were adjusted much more quickly than in previous cycles, and as the property investment industry has moved towards more frequent valuations, with rapidly expanding markets in unlisted funds and property derivatives, pricing has become more transparent.

Since 2005 many UK institutional investors, encouraged by international investment managers, have made their first significant moves to develop international property portfolios, and are now reaping the benefits of greater diversification. This approach will be pursued further.

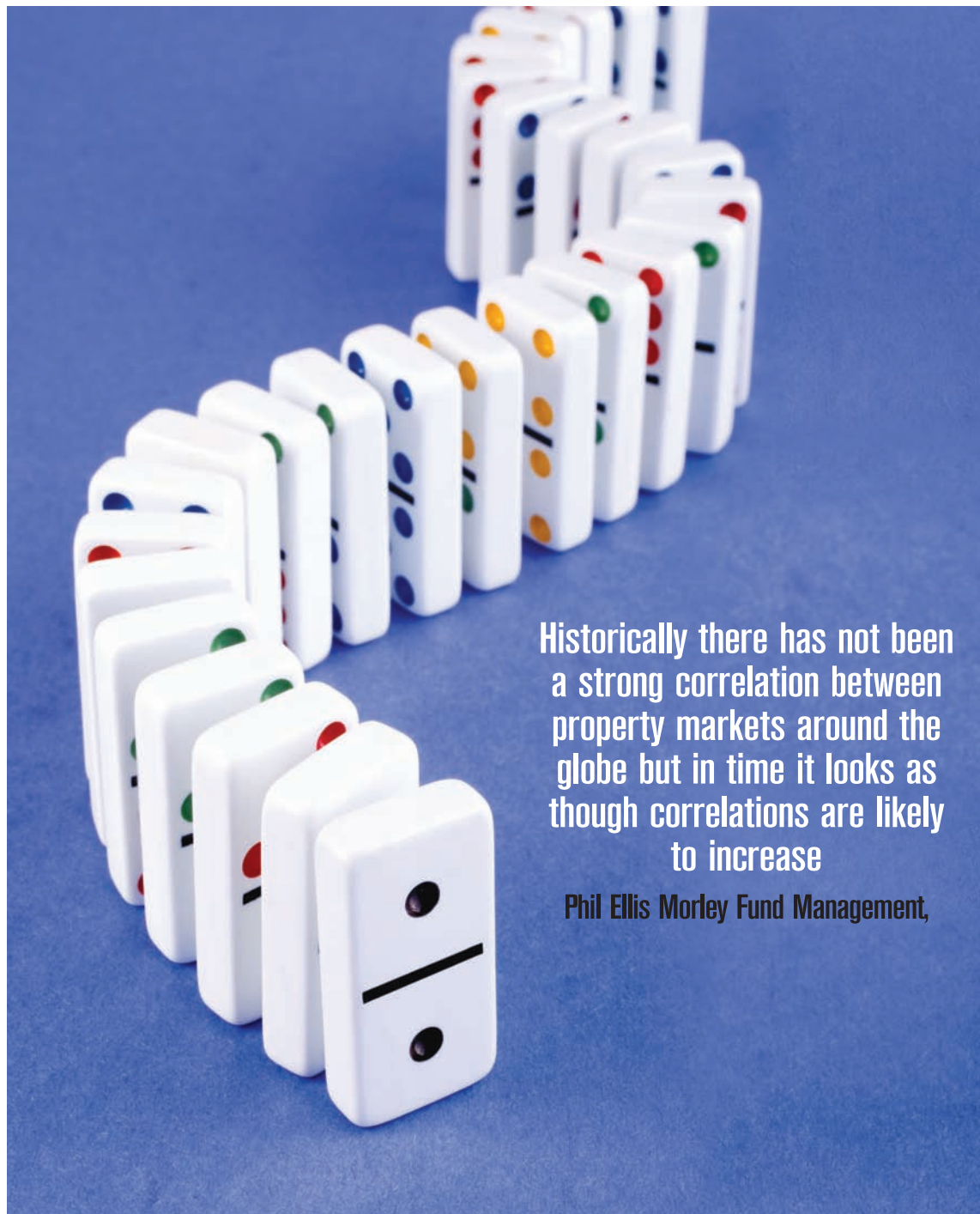
JOHNSTON: What has it been important not to change?

BALFOUR: What has not changed is our commitment to a research-led investment philosophy. At a strategic level we are guided by tailored macro-economic sector forecasts. This allows us to focus our efforts on the parts of the market with the best prospects for growth.

However, within this framework every property is assessed on its individual merits. The appraisal process takes into account not only local market rental forecasts, but also individual property characteristics such as specification, lease length and covenant strength. This consistent and objective approach is even more vital in current market conditions.

YEOMANS: We believe in sticking to basic investment principles in good times and bad. During sustained growth, some investors ignore flaws in the fundamentals in their desperation not to miss out. Then, in a downturn, the value of flawed investments falls fastest and furthest. Only acquire property that meets the fundamentals of location, covenant strength and lease length.

Income generation remains the key component of our clients' investment strategies. As little or no short-term growth is expected currently, income will drive investment performance and our client funds are well placed in that regard.



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Phil Ellis Morley Fund Management,

DENNIS-JONES: We believe it has been important not to change your fundamental approach and style during the different stages in the debt cost cycle.

FOLLOWS: The principles of good portfolio management and tenant care have remained unchanged and central to consistent performance. Properties must be well managed and tenants given top class service – indeed, tenant retention and satisfaction is even more important during a weaker occupational market.

MARTIN: It has been important to retain a focus on the fact that the performance of direct property is a function of income and growth and maximising the combination of the two is the only way to ensuring outperformance for a clients' direct portfolio over the course of the cycle.

In the hot investment market in the several years up to June 2007, we worked hard to maintain a focus on property fundamentals. In the more discriminating investment market we face today and in an environment where income and rental growth will account for the majority of total return, this should deliver strong relative performance.

FRANCIS: In a market of the type experienced recently, it would be all too easy to panic and be swept away in the emotion and sentiment of the moment. However, by understanding the tendency of markets to oscillate around some rational level of pricing, investors who are able to take a medium-term view can continue to prosper. The opportunities,

which the drivers of "fear and greed" in the market inevitably throw up, are there in the downturn as well as the upturn.

ELLIS: It has never been more important to have a disciplined investment philosophy and process underlying every fund and every transaction. A strong research capability, with the ability to produce regular and thorough market updates, is a huge advantage. Having sufficient resources to ensure that each and every underlying property asset is managed pro-actively and opportunities to add value through active asset management are all rigorously pursued is crucial. An optimistic outlook doesn't do any harm either.

SMITH: Active asset management is a core skill, but is sometimes forgotten in extreme bull markets, such as the UK experienced until the early part of 2007. Nevertheless, it is a key way to boost investment returns and to drive income growth.

During the upturn, investors were able to make substantial capital returns from property without significant active management. Many properties – particularly those recently owned by investors without specialist property skills – will have been under-exploited as a result, offering good opportunities for skilled asset managers. These include redevelopment and refurbishment projects, or securing improved lettings.