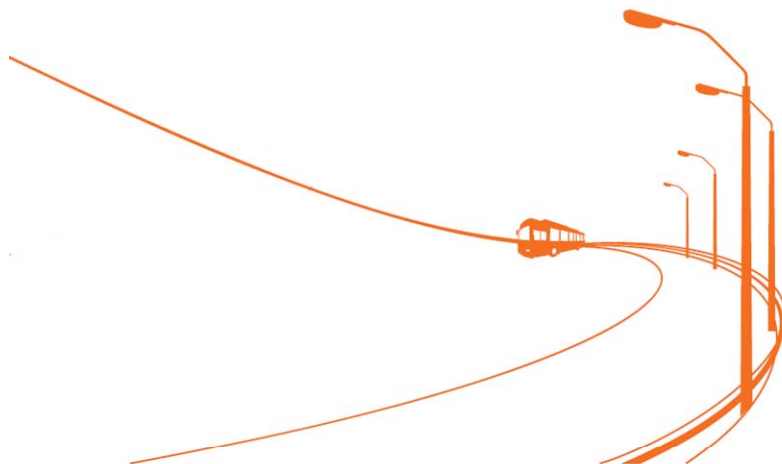


A Light at the End of the Tunnel or the Southbound Express?



THE FALL IN PROPERTY YIELDS: A LIGHT AT THE END OF THE TUNNEL OR THE SOUTH BOUND EXPRESS?

For the first time in two years the price of property is rising again (note I have used the word price to denote market bids rather than values since valuations have yet to reflect what is currently taking place in the market). At first confined to prime property (long leases backed by strong covenants) it is becoming apparent that the extent of the increases in values is spreading. The question everyone would like answered is, "Is this another bubble or can these improved values be sustained?"

Our view is that they can, the rationale being as follows. There are two drivers of capital value; first, the expected rate of rental growth, second, the cost and availability of capital. Those clients who have received presentations from us in this calendar year will be aware that whilst not a central case in our forecasts, we did outline the possibility of a positive improvement to yields irrespective of an improvement in the outlook for growth. This was predicted on a change in sentiment in the capital markets. This was possible because the markets were not just priced for a lack of growth but also for a lack of capital.

In the period that followed the collapse of Lehman Brothers in September 2008 and the conclusion of the G20 meeting at the end of March 2009, the chief fear in the investment markets was the possibility of a collapse in the banking system. With the exception of an imminent war, that's about as scary as it gets for an investor! As investors sought security above everything else, yields on cash deposits and government bonds were forced down whilst the yields on virtually everything else including equities, corporate bonds and property rose as investors declined to take the risk of investing. In the property market this was co-incident with a significant degree of deleveraging of property funds and companies which increased the amount of stock to be sold at a time when there was a dearth of investment.

Since the conclusion of the G20 meeting at the end of March it is clear that the risk appetite on the part of investors has improved. Share values are up, corporate bond yields are down and we believe the effect is now manifesting itself in the UK commercial property market. The principal factor underpinning our view that at least some of the improvement in values is permanent is our belief that *the pricing of investment assets is different if the threat of a widespread banking failure is removed.*

The evidence of an improvement is getting stronger. Of the thirteen properties that we have under offer at the moment, seven of them are at prices above valuation whilst three are at valuation. The June quarter valuations saw an increasing number of properties either holding or improving their values. Finally we find that when bidding for properties, whereas in Q1 we would probably have been alone in our bid now there are five or six other bidders. There is quite a sharp difference in pricing when there are two bidders for each property rather than one bidder for every two properties.

UNITED KINGDOM

CHIEF INVESTMENT OFFICER'S
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If we are right, the IPD Monthly Index should record an initial yield of something between 8.0% and 8.25% in the next few months which would mark the high point for yields during this cycle.

Whilst we appreciate that bid prices do not necessarily reflect yields and returns recorded in the index, the extent of the pricing movement is, in my view, likely to be reflected in a sharp improvement in the index return by the end of the year. Positive quarterly returns are a distinct possibility by the year end.

This should produce a short term spike in returns as the correction takes place before returns subside in the face of further rental value falls. Whether returns go negative again will depend on the pace and extent of further falls in rental values. We are forecasting a circa 15% decline between now and the end of 2011. The smart strategy is to avoid those parts of the market most exposed to rental decline during this period.

The main risks around this scenario are a sharp rise in bond yields, possibly caused by the government experiencing difficulty in selling further quantities of gilts. This would go some way to closing the large gap between government bonds and property yields which would erode the relative long term value of commercial property. However bond yields would have to rise significantly (e.g. a plus 5% yield) to get anywhere near eroding the historically wide differential between bond and property yields which is currently in property's favour.

The other risk is that unsuccessful bidders broaden their investment target to include more secondary properties that have occupational market risk. *The improvement in the capital markets should be differentiated from the occupational market where the worst is yet to come.* Rental values are still expected to fall at least until 2011 and therefore the risk to rental levels and tenant default remains high. In our opinion it is too early to take risks in this market. There is a danger that investors in their enthusiasm to get back into the market become over excited in their bidding and when the correction is over yields might edge out again. However, barring another shock to the functionality of the capital markets, (which remains possible if not probable), we feel that at least some of the re-rate is permanent and we are likely to have seen the bottom of the market in terms of yields.

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