UK Quarterly Property Snapshot

Aberdeen

The economy

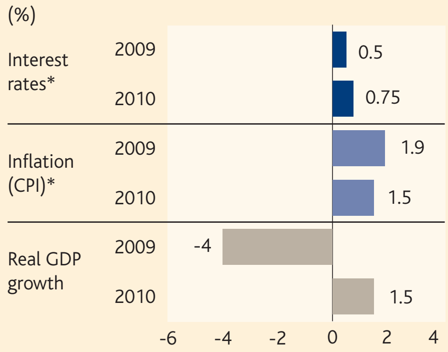
Recent performance

- The Bank of England (BoE) has kept interest rates unchanged at an unprecedented low of 0.5% since March. Taking into account the degree of space capacity in the economy, interest rates would need to be negative to ensure inflation meets the Government's 2% target over the medium term. The BoE's asset purchase programme is supplementing normal monetary operations by injecting £175 billion into the economy.
- UK GDP showed a 0.4% drop in Q3, marking the longest recession in the post-war period. The pace of decline has abated from a quarterly pace of 1.8% and 2.5% respectively for Q4 2008 and Q1 2009, reflecting better financial market conditions. Consumer and business investment expenditure have been the weak links of the economy in the past year. Unemployment rose to 5.0% in September on a claimant count basis, the highest in almost 12 years. Nonetheless, the pace of increase has slowed from earlier in the year, while employment levels and job vacancies are stabilising, albeit at low levels.
- House prices are up 6% from their April lows. The rise in prices though is not consistent with the level of activity in the market, which is well below its historical average. Despite a poor economic climate, the number of forced home sales has been limited, as mortgage rates have fallen sharply for existing owners.
- Headline inflation has decelerated rapidly to below the 2% government target level, to just 1.1% in September from over 5% in late 2008. Much of the fall has been driven by a collapse in oil and commodity prices. Wages are rising at a much slower pace compared to a year ago, dampening inflation in the service sector and keeping overall price pressures subdued.
- The public sector fiscal deficit continues to soar, hitting £65.3 billion in the current financial year to August, compared to £26.1 billion in the previous year. Tax revenues have taken a beating due to the recession, while social security spending has jumped. There are few signs of curbs being put on overall public spending so far, despite the very poor fiscal outlook.

Outlook

- In the short term, the UK economy is likely to show a sharp upturn in Q4. The main growth drivers will be re-stocking activity in the manufacturing sector, and the bringing forward of consumer expenditure ahead of an expected increase in VAT rates. A more sustainable driver of the economic recovery is likely to be exports.
- Sterling has depreciated by 20% on a real trade weighted basis, giving the UK a large competitive advantage. Due to still depressed demand conditions in the main trading partners of the eurozone and the U.S., exports are subdued. We expect exports to rise firmly over the next 12 months.
- For this year, we expect GDP to fall by 4.0% and show a moderate 1.5% increase in 2010, led by exports and re-stocking activity. Consumer spending will be virtually static. Government spending plans are unlikely to shift significantly, particularly if elections are held at the last possible date of 3 June 2010. However, deep cuts in subsequent years will be needed, not least to prevent a marked deterioration in financial sentiment towards sterling assets.
- The outlook for growth in the next six months is reasonably positive, although there are substantial medium-term challenges. The main issue will be the re-balancing of the economy away from consumer spending and financial services, towards one which is more export-led. This process is already underway, as household savings rates rise and as sterling weakness lifts exports. Cuts in public spending will encourage sterling to stay weak, as the BoE compensates with sustained low interest rates and an expansion of the quantitative easing programme. However, very loose monetary policy entails significant inflation risks.
- The process of economic re-balancing is unlikely to be smooth, given the scale of resource re-allocation required to the manufacturing sector. We expect trend economic growth to be lower than in the past decade. Our overall view is that the UK medium-term economic path will be volatile, and more so than for the eurozone, due to the higher inflation outlook, which necessitates a need for large interest rate rises from 2011.

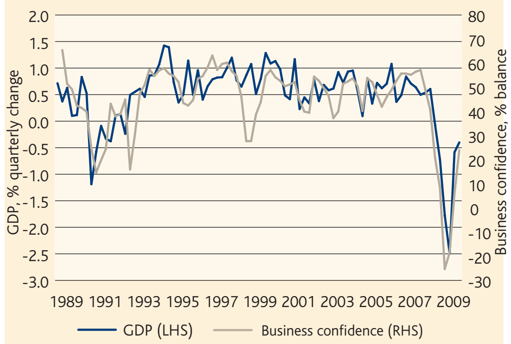
UK economic forecasts



* Year End

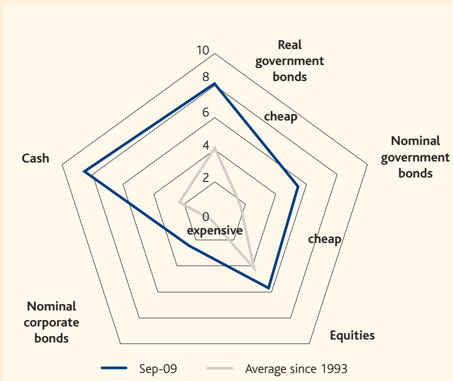
Source: Aberdeen Property Investors, EcoWin Reuters

UK economic recovery still in early stages



Source: Aberdeen Property Investors, EcoWin Reuters

UK property has a historically high yield premium relative to other asset classes



Source: Aberdeen Property Investors, EcoWin Reuters
Chart highlights property's yield premium over the yields on other asset classes (in %)

UK Quarterly Property Snapshot

Property market overview

Recent performance

A dramatic improvement in the UK property market has occurred since the middle of the year. Capital values are now rising sharply, with the IPD Monthly Index recording capital appreciation of over 1% in September, the strongest performance in over three years. Yields are falling sharply for prime property in particular, but also now for average property, especially for smaller lot sizes. Investors are becoming increasingly tolerant of shorter income streams and weaker covenant strength, as prices for prime assets are starting to rise quickly.

Transaction levels are starting to pick up substantially. The market capitalisation of the listed sector has doubled over the past six months, aided by the raising of over £5 billion in new share placings. Most property companies and REITs are now trading at premiums to net asset value, and are no longer selling property. The institutional market is unwilling to sell with average equivalent yields at over 9%, and is now increasing its allocation to the property sector. In addition, in recent months, overseas investors have been the biggest purchasers of UK property, aided by the depreciation of sterling.

Finally, banks have not been disposing of property assets on a major scale. They are more typically restructuring loans, helped by substantially lower LIBOR and swap rates, and taking a significantly higher margin instead. The number of banks prepared to lend more than £25 million for property investment has also virtually doubled in the past six months, to 23, because of more favourable funding conditions.

There have also been some encouraging signs from the occupational market, where the pace of rental decline is slowing. Incentives have risen strongly over the past two years, although look to be peaking. As much as 3 years' rent free is currently being offered by landlords on a 10 year lease for central London offices.

Retail

- Retail rental decline, on a quarterly annualised basis to September, was 6%. This represents a slight improvement on falls experienced earlier in Q2. Retail warehouses are seeing a slightly slower pace of decline, at an annualised 5%. In previous recessions, retail rents have proved much more resilient than the other sectors. However, structural changes have occurred to the retail sector, such as the growth of the internet and strong retail price deflation, resulting in a poorer rental performance in this cycle. Despite this, capital values are now rising sharply for standard shops, prime shopping centres and retail warehousing in particular.

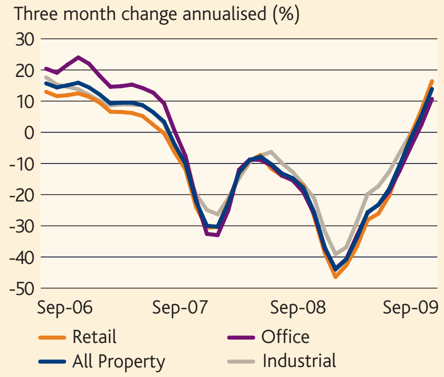
Office

- In the office sector, the pace of rental decline has slowed markedly from over 20% on an annualised basis to 9% currently. This has predominantly been due to an abrupt slowdown in the pace of rental decline in central London, to 13% on an annualised basis, from a rate of over 30% earlier in the year. In central London, prime rents have fallen to an exceptionally low level in historic terms. Prime rents in the City, at approximately £42 per square foot, have fallen to 1987 levels.
- Prime yields in the City, West End and major provincial markets have all fallen by 25 basis points over the last quarter, to 6.5%, 5.25% and 6.75% respectively.

Industrial

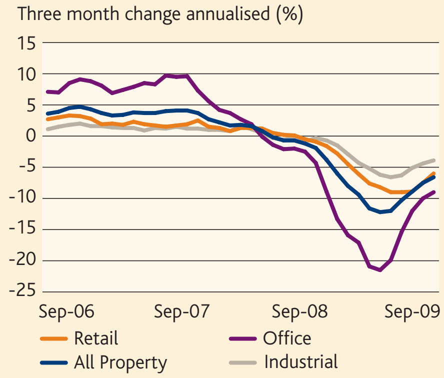
- Standard industrial rents fell by 4% on an annualised basis, over the three months to September 2009. While there has been a distinct weakening of the occupier market combined with record levels of availability, the latest data shows a slowdown in the rate of rental decline. Larger vacant industrial units continue to cause significant problems for landlords, especially with the added cost of empty rates bills.
- Recent investment activity has focused on large distribution units, let on long leases. Yields on prime distribution warehouses have fallen significantly as a consequence.

Total return



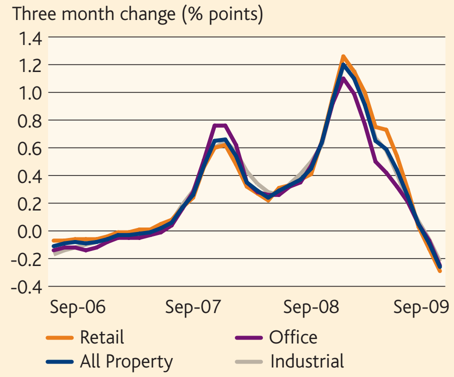
Source: IPD Monthly Index, September 2009; Aberdeen Property Investors

Rental value growth



Source: IPD Monthly Index, September 2009; Aberdeen Property Investors

Yield shift



Source: IPD Monthly Index, September 2009; Aberdeen Property Investors

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Property market outlook

Total returns for 2009 are projected to be close to zero. This represents a sharp increase from our June 2009 forecasts, and reflects the rapid rise in investment demand that has been experienced since then, and the limited supply of investment product available, particularly at the prime end. We expect a strong rebound in returns over the next nine months, as investors seek to take advantage of property's high income return.

Over the past quarter, property has looked increasingly attractive, relative to other asset classes, from a yield perspective. Property's yield premium over low risk asset classes, such as nominal government bonds, index-linked government bonds and cash have remained at record highs over the past quarter. The yields on higher risk assets, such as corporate bonds and equities, have fallen sharply over the past quarter, as investor risk aversion has receded, and property's yield premium over the yields on these assets has risen dramatically.

Corporate bond yields have fallen by over 300 basis points in the last quarter. Property yields tend to track equity and corporate bonds yields, with a lag of approximately six months. This suggests that property yields are set to fall sharply over the coming year, with equivalent yields forecast to drop to 7.5% at the end of 2010, from their current level of 9.2%.

Institutional investors are starting to re-enter the market. Overseas investors are also raising their purchasing activity, with the UK widely perceived as being the first market to recover in Europe, and aided by the sharp falls in sterling against the euro and the dollar. Finally, the property companies and REITs are also starting to buy again, as their share prices have risen by 80-100% over the last six months, and are now trading at a 20% premium to NAV on average. Competitive bidding, combined with a lack of stock, will drive capital values up in the short term.

This results in a very strong level of projected performance in 2010, with total returns of 16% projected, driven by investor demand driving values strongly higher, despite rents still falling in all sectors. Such a strong investment-led bounce in total returns is not unusual however, and we have flagged this as a likely outcome for some time. After the 1990-1992 downturn, total returns in 1993 were 20%. Rental values are forecast to continue falling in 2010, although the pace of decline will continue to slow.

After a particularly strong total return in 2010, we expect total returns to drop back in 2011, as interest rates and bond yields rise sharply, while rental growth remains in negative territory. From 2012, rental growth will eventually recover and total returns pick up again, with capital value appreciation accelerating. This two-stage recovery would be reminiscent of the mid-1990s.

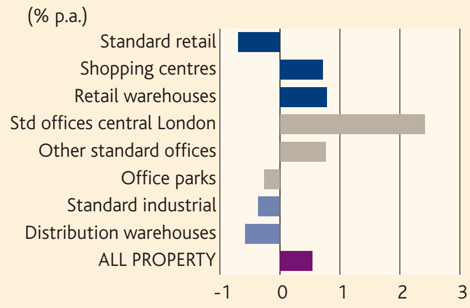
We expect an attractive five year annualised 'All Property' total return of 11.9%, based on pricing at the end of September 2009. The majority of this (approximately 8%) will be delivered by income return, with the remainder coming from some strong capital returns over the next year. Rental growth at the back end of the forecast period will be aided by sharp falls in completion levels, from 2010 onwards.

Over the next five years, the best performing sector is projected to be shopping centres, aided by a very high income return. Shopping centre yields have risen by substantially more than other sectors over the last two years, with their large lot size and the lack of available debt hindering purchasing activity. However, over the next five years, there is more potential for yields to fall in this sector than standard shops for example, which is projected to be one of the worst performers. Yields on standard shops have not seen the same increases in yields as some of the other retail segments.

Central London offices are projected to outperform strongly at the back end of the forecast period, aided by very strong rental growth off a very low base. While the Rest of UK market is projected to outperform the office sector as a whole, due to their high yield levels, some regional cities have experienced exceptionally strong development levels. For example, Leeds and Manchester, are subsequently suffering from oversupply, with rents projected to continue falling sharply for the next couple of years.

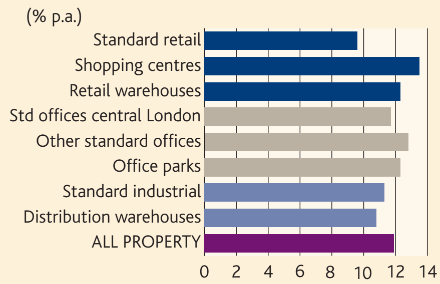
As has been the case historically, the distribution warehouse sector is projected to underperform the wider industrial sector. The lower income returns than the other industrial sectors reduces performance, and it does not benefit from a higher rate of rental growth to compensate.

Five year annualised rental growth (to September 2014)



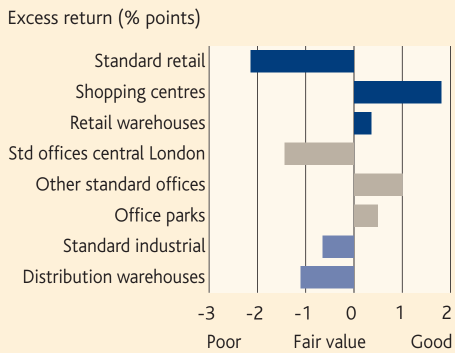
Source: Aberdeen Property Investors

Five year annualised total returns (to September 2014)



Source: Aberdeen Property Investors

Market pricing over five year horizon



Source: Aberdeen Property Investors

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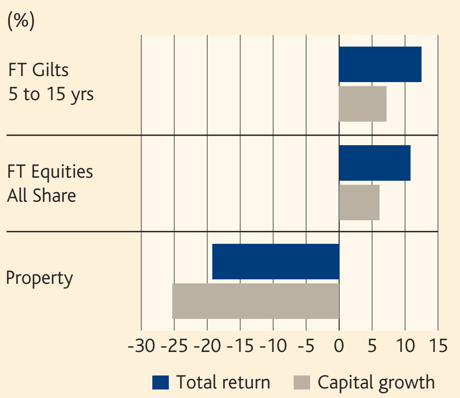
Investment policy

The table below shows Aberdeen's recommended positions relative to benchmark in order to achieve outperformance over a five year period.

Sector	Strategy
Standard retail	Underweight
Shopping centres	Overweight
Retail warehouses	Neutral
City offices	Underweight
West End offices	Underweight
Rest of South East offices	Overweight
Rest of UK offices	Neutral
Office parks	Neutral
Industrial	Underweight
Other	Neutral

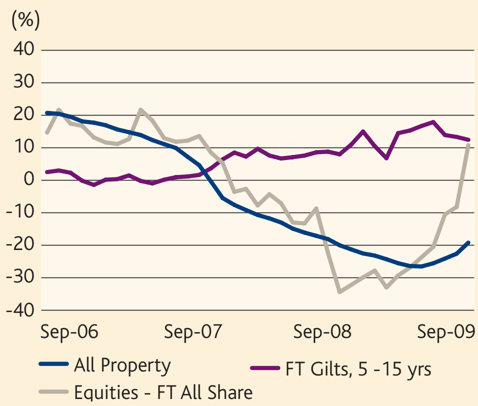
Source: Aberdeen Property Investors

Asset classes – 12 month total return and capital growth (to end September 2009)



Source: Aberdeen Property Investors, IPD

Asset classes – 12 month rolling total return (to end September 2009)



Source: Aberdeen Property Investors, IPD

Important information

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