

## Laying the foundations for recovery

After reaching great depths in 2008, the performance of the UK Commercial Property market has turned. As a result money has steadily flowed back into the asset class through the second half of 2009 as investors are now witnessing much more attractive returns. However, while returns have been attractive at the index level, uncertainty surrounding the pace of economic recovery and supply and demand dynamics continue to weigh on the outlook for this asset class. In this edition of Fundamentals, Legal & General Property's (LGP) Head of Research, Robin Martin, explains how selective exposure to commercial property will be critical in generating strong returns in the future – and outlines where these returns may be found.

### Where have we been?

Commercial property has recently endured one of the sharpest and deepest declines in value in modern history; nominal total returns in 2008 were the most negative in the post-war period. But by mid-2009, the gap in the yield between commercial property and gilts, a key measure of relative value, was the highest since 1945. This relative value story, along with the opportunity to access the asset

class at a cyclical low, combined to attract a large volume of investment into the sector during the second half of 2009. The increase in demand contrasted with a shortage of openly marketed stock, resulting in a jump in property prices during the second half of 2009. The improvement in investment pricing and relatively high income yield combined to offset the impact of falling rents, enabling a positive total return of 3.5% in 2009,

compared to a loss of -22.1% in 2008 (Figure 1).

Against the backdrop of such seismic shifts in the market, it is understandable for investors to focus more on market prospects than managers' strategies in forming their views on allocations to commercial property. But one of the most interesting stories of the past several years has been a broadening in the range of returns



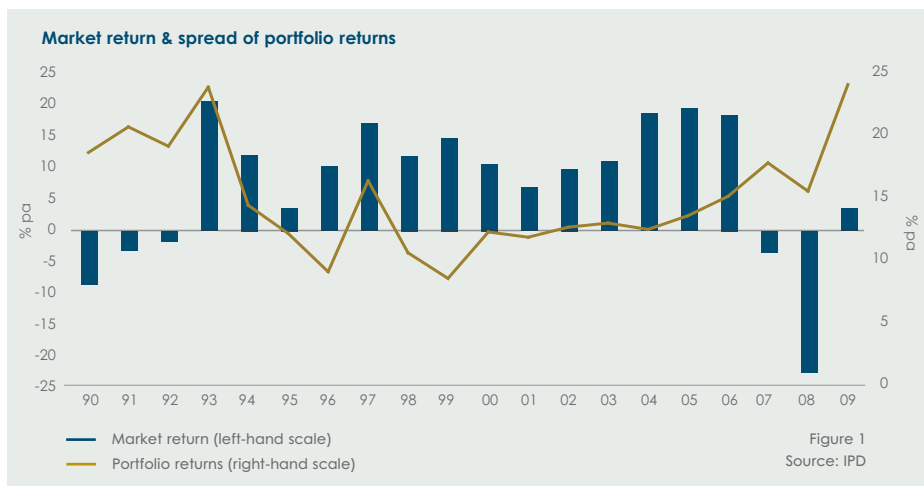
### Inside:

Market Overview

Snapshot: Some scope for a positive surprise in the euro area

UK Forecast: Rates on hold

# Article Contd.



achieved by individual portfolios. For the funds covered by Investment Property Databank (IPD), the gap between the best and worst performing funds has been rising since 2005; this culminated in a 24% spread between the 5th and 95th percentile fund in 2009, the highest figure since 1993. Even before the crash, it is clear that the quality of portfolio and of the manager is becoming even more important. What distinguished these portfolios from each other and what lesson does this hold for the future?

In the April 2009 edition of Fundamentals, we commented that relative exposure to risk would be a key determinant of portfolio performance in the downturn. The experience of 2009 bore this view out. One of the key measures of risk for commercial property is lease length. Longer leases (subject to the covenant strength of the tenant) bring greater certainty of income, though the upside potential to income flows can be limited. Against the backdrop of challenging occupier markets and falling rents, long let property significantly outperformed vacant and short lease property in both 2008 and 2009 (Figure 2). This was backed by research from IPD which showed that the proportion of vacancy in a portfolio was a key discriminator of fund performance in 2009 i.e. the lower the exposure to vacant property, the better the fund return.

Another take on this was demonstrated by the performance of development sites

relative to the average property return. The performance of these development sites is a geared play on the property cycle; the value of the sites is driven by the value of the property that can be built on them less the costs of development, which are relatively fixed. IPD figures show that sites underperformed average commercial property by an average of 20% per annum during the weakest phase of the cycle in 2008 and 2009.

These risks relate to cash flow fundamentals. But property performance is also differentiated by investment lot size in a different way from other asset classes. Direct property assets are by their nature indivisible and the effect is that the relative pricing of large and small assets is highly geared to the flow of market liquidity. When capital is seeking to enter the market, demand often focuses on large assets which offer the ability to place capital

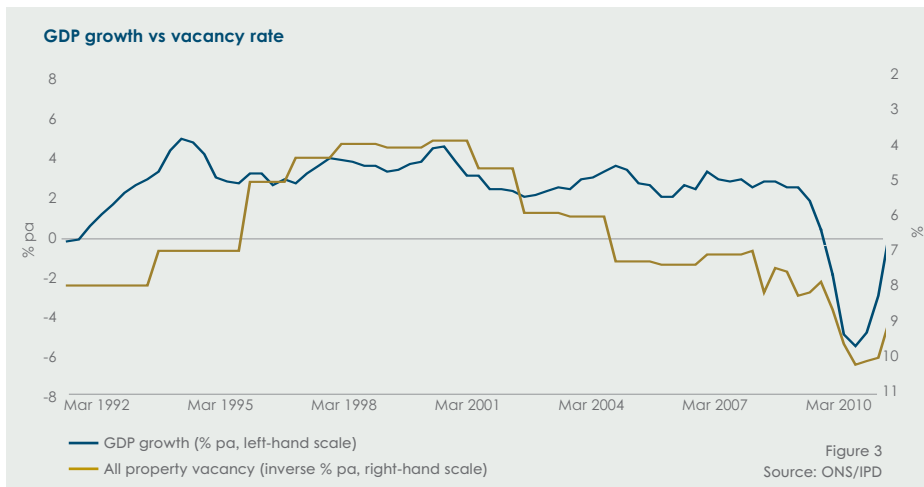
quickly. The reverse has been true over much of the past two years; a shortage of liquidity has led to a relative drying up of demand for large assets. In the second quarter of 2007 (the peak of the commercial property cycle) there were 32 investment transactions involving assets worth more than £100 million. In the first quarter of 2009, with investment demand for a range of risky asset classes including property at a low ebb, there were just three transactions. The impact of this on large assets was significant – by our estimates, the negative impact of changes in the investment yield was 14% more severe for £100+ million assets than the sub-£5 million assets at the other end of the scale.

In short, our view in early 2009 was that the factors which would drive performance differentials between different funds would be driven by exposure to risk, rather than the conventional sector/region splits that are often used to express fund positioning. This view was borne out in 2009.

This very strong performance for low risk vs high risk assets in 2009 has had a very significant impact on the relative pricing of risk. Prices for higher risk stock have fallen significantly more than those of low risk stock. Put another way, the risk premia now available for taking on risk have risen to historically high levels. So, do these represent value or value trap?



# Article contd.



### Where do investors go now?

Much will depend on the economy. The Legal & General Investment Management (LGIM) economics team was one of the first to predict an inventory-led bounce in economic activity in Q3 / Q4 2009. The most recent data show that the UK economy grew slower than expected during the first quarter of 2010 (at 0.2% versus market expectations of 0.4%). However, this was the first estimate and upward revisions may follow. LGIM's view is that UK GDP growth will reach 1.6% for 2010. But following on from that, there are a number of forces which will bear down on the economy in the medium-term. Consumer spending growth will be held back by weak earnings momentum and the fading stimulus from interest rate cuts; corporate investment is likely to remain relatively weak against a backdrop of uncertain demand conditions. Hanging over the economy as a whole is the tighter fiscal and monetary policy that will be necessary as policy makers move to address high debt levels. Hence, LGIM expects a relatively weak economic recovery compared to those seen in previous cycles.

That will create a tough backdrop for commercial property; demand for space is tightly linked to economic activity. The recession has led to a weaker balance of supply and demand, and a substantial increase in average vacancy rates (Figure 3). The vacancy rate has now started to come down, in line with the improvement in GDP performance. But given the scale of

the decline in GDP in 2009 and the modest pace of recovery expected, LGP's view is that it will take some time before vacancy is eroded back to pre-recession levels and we expect letting conditions to remain relatively challenging in 2010-11.

It appears that we are in an environment where investors have been willing to take on greater investment risk in order to benefit from the potential for higher returns. However, this is heavily reliant on an improving economic backdrop. We have seen similar trends in equity and bond markets for some time. A greater appetite for risk tends to lead commercial property and though the IPD valuation based data do not yet reflect it, LGP is seeing evidence in the transactional market of a similar shift towards more risky investments (Figure 4).

However, our expectations of a relatively slow economic recovery implies that taking

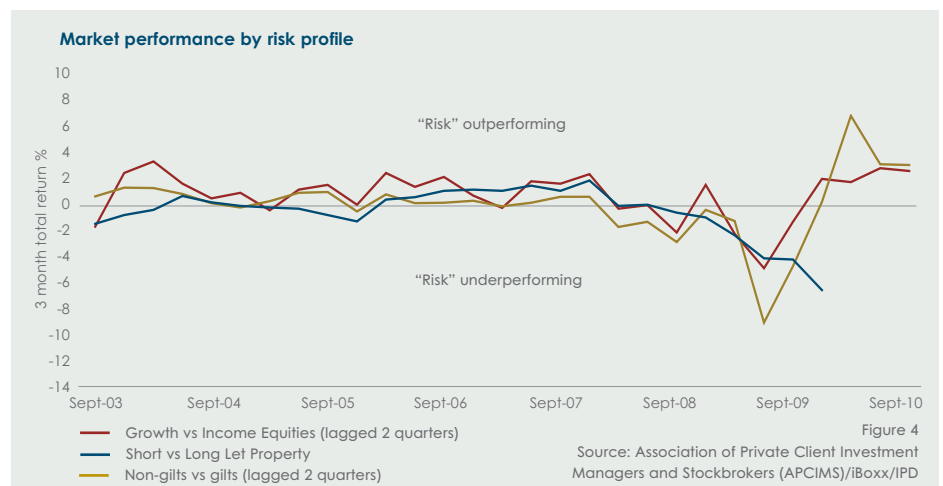
on more risk (moving up the risk curve) must be done with a careful eye on the fundamentals of each asset. Put another way, whilst high risk premia offer the potential for generating outperformance, it is only the underlying quality of those assets which can turn that potential into reality. Stock picking remains critical.

### Delivering the strategy

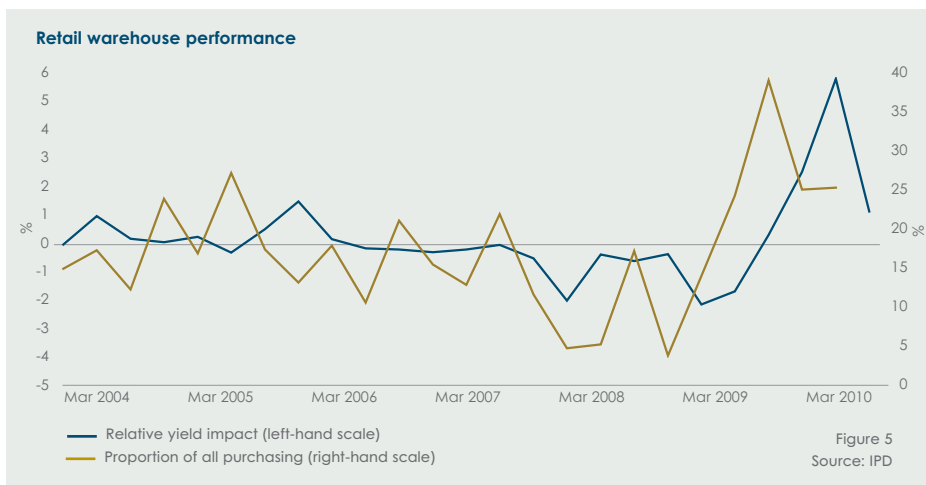
Given that many investors have made new allocations to commercial property to access the cyclical low, much of the transition up the risk curve will be achieved through the balance of purchases and sales. There are a number of features of commercial property which mean that strong expertise in executing transactions is vital. These include:

- Relatively high transaction costs – 'Round-trip' transaction costs for UK commercial property are in the region of 7%
- Extended timescales to complete transactions – property transactions, particularly for more complex assets, take significant time and resource to complete
- Relative opacity of investment markets – there is no central exchange for commercial property. Hence the amount of stock seen by managers is dependent on their connections with the key agencies and stakeholders.

The extended timescales taken for commercial property deals can contribute



## Article contd.



to imbalances in terms of supply and demand and hence sharp shifts in pricing. As an example, Figure 5 shows the proportion of purchases by investors in the IPD sample that were in the retail warehousing sector and the relative shifts in pricing of that sector compared to the average property. A relative weakness of demand for retail warehouses in 2007-8 led to harsher declines in pricing than for the overall property market. Conversely, when this sector was identified by a number of investors as offering good value in 2009 and purchasing increased, pricing rose rapidly, as there was relatively little stock on the market to satisfy those requirements at the prevailing prices.

However, this also highlights a risk. In a market like commercial property, with lower levels of liquidity than other asset classes, managers looking to place allocations have to avoid paying inflated prices which offset the original rationale for accessing the stock/sector. There are a number of ways of doing this, including seeking stock which has not been openly marketed ('off-market') and by competing with other purchasers on more than price e.g. given the complexity of some transactions, being able to prove a capability to analyse and complete on deals in a tight timeframe is a real advantage. But above all there are major advantages in being countercyclical in terms of the characteristics of stock that will be considered. As an example, LGP purchased nearly £100 million of prime offices across the South East in 2009.

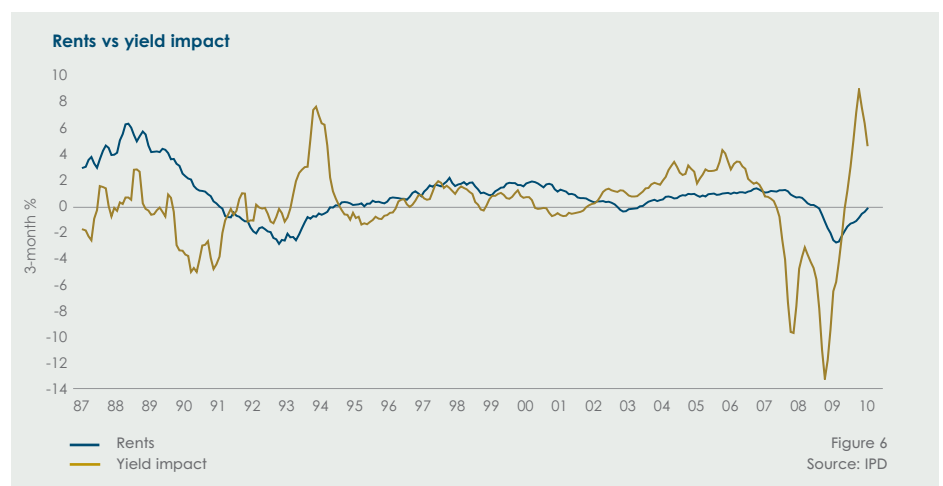
Relatively high yields were secured on these assets, as they were let on shorter lease lengths than most investors were willing to consider at the time. LGP's decision to take the leasing risk on those assets was driven by an appreciation of the positive supply/-demand dynamics in the local markets and the quality of the specific assets.

Ironically, the benefits to being countercyclical are greater in periods of relative turbulence than in more settled market conditions. Plotting rents against yield (Figure 6) impact (the key metric of the investment pricing of property) demonstrates this; the equivalent for equities would be to plot earnings growth against the price-earnings ratio. The key lesson for our purposes is a familiar one from equity markets; shifts in investment pricing show significantly greater volatility than changes in the underlying cash flows. By maintaining conviction in their assessment

of the cash flow fundamentals against shifting sentiment and risk appetite, managers can consistently secure relatively favourable pricing for clients and create a source of relative outperformance. LGP expects an extended phase of volatile sentiment to weigh on commercial property as the UK transitions from a phase of very low interest rates/low rental growth to one in which growth is better but financing conditions more demanding. That implies that the potential benefits from the purchasing disciplines outlined above will if anything be greater than they have been in the past.

### Summary

Against the backdrop of one of the most extreme periods of financial turbulence in living memory, the level of exposure to risk was a key driver of relative performance for commercial property portfolios in 2009. This has driven risk premia to multi-year highs and with the worst of the crisis now behind us, LGP's view is that there are excellent returns available for selectively going up the risk curve. That said, with economic recovery expected to be an extended process, the benefits to risk-taking will rely on good stock-picking to find the assets that will be the first to benefit from gradually improving demand/supply dynamics. With a significant amount of equity targeted at commercial property, strong transactional capabilities and a countercyclical approach to purchasing are important components in driving relative outperformance.



# Market Overview

Following healthy gains during February and March, global equities paused for breath during the month of April. As we go to print, significant volatility has swept through equity markets during the start of May, spurred by ratings agencies downgrades of Greece, Portugal and Spain. With the election failing to produce a victorious party, uncertainty surrounding the UK's plans to address its own deficit has also added to the discomfort of the markets.

Despite further evidence of global economic expansion through the past month, investors have become increasingly nervous surrounding the ability of a number of indebted nations to service their growing debt burdens. In particular, Greece's ongoing financial difficulties have been heavily under the spotlight. On Friday, 7 May, the German Parliament officially agreed to provide Greece with a contribution of up to €22.4 billion in emergency loans. This was a significant development and the money forms a vital component of a €110 billion, three year bailout plan backed by the European Union and International Monetary Fund (IMF). This lifeline does not come freely, however, with Greece now under tremendous pressure to implement severe austerity measures to bring its deficit under control.

## Equity Overview

### UK

#### Equities hang in the balance

A hung parliament outcome at the recent election has heightened concerns surrounding the need for prompt action to address the UK's gaping budget deficit. Official numbers showed that UK public borrowing hit a record £163.4bn in the last financial year; though this was marginally lower than predicted in the recent Budget, the figure nevertheless represented the biggest annual borrowing total since World War II.

Other data released during the month of April offered little reassurance that the recovery had yet gained any real momentum. Provisional data showed that the economy expanded by a modest 0.2% during the first three months of 2010, falling short of expectations. Retail sales rose less than market participants expected and unemployment topped 2.5 million, the highest in 16 years. These developments prompted unease over the prospect of an anaemic, 'jobless' recovery. Meanwhile inflation unexpectedly jumped from 3.0% in February to 3.4% in March, partly due to rising petrol costs.

UK equities slipped during the month of April and have weakened further during

### EQUITY OVERVIEW

as at 30 April 2010

Market return (denominated in £)	April (monthly) return %	Rolling 12 month % return
UK	-1.4	36.6
US	0.6	35.4
Europe	-4.0	28.0
Japan	-1.0	21.2
Asia	0.8	51.2

Source: Datastream, FTSE® indices shown

Major Equity Markets – Total Returns £ 2009/2010



the beginning of May alongside their leading global peers as investors reassessed their risk appetite following solid recent gains. The tobacco sector underperformed last month as the Office of Fair Trading fined two manufacturers in relation to price fixing. Mining stocks also succumbed to profit-taking, following strong returns since the end of January, as commodity prices came off their highs.

### US

#### Recovery touches softer patch

Following a string of fairly robust monthly readings, some signs emerged during the month of April that US economic activity may have hit a slightly softer patch over recent weeks. There was mixed news on the US jobs front. Though the employment report released on 2 April showed the biggest jump in payrolls in three years, Federal Reserve (Fed) Chairman Ben Bernanke's view that the labour market will recover only gradually was subsequently vindicated by news that weekly jobless claims climbed to two-month highs. Meanwhile the latest industrial output data rose only

modestly, adding weight to the view that the world's biggest economy is undergoing a subdued recovery.

However, though the Fed has kept interest rates at near-zero for over a year and has expressed a commitment to this policy for an 'extended period', some state Fed officials are becoming increasingly uncomfortable with rates at their present ultra-accommodative levels. Concerns rose last month that rising energy and metals costs could be feeding inflationary pressures as wholesale prices climbed ahead of forecasts. Nevertheless, US equities extended their winning streak to eight weeks amid optimism that the economic recovery can reassert itself. Sentiment was boosted by good results from companies such as American Express and Microsoft, though the financial sector was briefly rocked by news that investment banking powerhouse, Goldman Sachs, was facing fraud charges. However the biggest year-on-year new homes sales numbers in almost five years raised hopes that confidence is returning to the housing market.

## Equity Overview Contd.

### ▶ EUROPE

#### Struggling Greece grabs EU/IMF loans lifeline

Despite Greece's efforts to persuade investors that it could navigate its own way out of trouble, another run on confidence - after news emerged that the national finances were in an even more dire situation than had been admitted - prompted a further surge in Greek bond yields during April. The sheer scale of the debt rollovers required this year left the cash-strapped country with little option but to request a further loan package from the European Union and the International Monetary Fund. A lack of clarity over the proposed solution weighed on European equities through most of April as concerns grew that countries such as Portugal could yet be dragged into the mire.

Other economic developments earlier in the month suggested that the eurozone faces considerable challenges as southern states continue to struggle. The latest revised figures showed that the 16-nation bloc failed to grow in the final quarter of last year. However, the latest industrial output data raised suggestions that the global recovery is spurring demand for eurozone exports, with another robust Ifo survey reflecting growing optimism among German manufacturers.

Nevertheless, European domestic consumption remains relatively weak, with worries over the possible spread of the Greek debt crisis across further eurozone countries unlikely to help European consumers to regain their confidence in the near-term.

### ▶ JAPAN

#### Recovery battling deflation

Fresh evidence emerged showing how the Japanese economy is benefitting from a combination of rising export demand - largely from emerging economies - and the impact of the government's stimulus packages. Japan's Ministry of Finance upped its assessment of the country's economic conditions - for the first time in six months - as the recovery in industrial output and rising car exports continued.

The Ministry also noted that the government's stimulus package has helped to underpin consumer confidence and the jobs market, with the latest data showing that consumer sentiment grew for the third successive month in March. Meanwhile the International Monetary Fund (IMF) upped its growth forecast for Japan to 1.9% this year, compared to the 1.7% expansion forecast in January. However, the IMF noted that even as some other countries look to tighten interest rates this year, Japan may even have to go against the trend by cutting interest rates as it battles against deflationary pressures.

### ▶ ASIA/EMERGING MARKETS

#### Slowing China's runaway economic train

While most developed economies struggle to muster sustainable levels of economic growth, China's economy continues to boom, boosted by rising exports and a soaring domestic consumption, with demand spurred by state-funded infrastructure spending. Data released in April showed that the economy grew by a stronger-than-expected 11.9% in the first quarter compared to a year earlier, prompting renewed speculation that the yuan could be revalued. Though March's consumer price inflation figure of 2.4% was a little lower than forecasts, concerns persisted over underlying inflationary pressures and possible bubbles in sectors such as property. The China State Council sought new restrictions on mortgage lending, with measures including bars on the purchase of third homes and restrictions on 'self cert'-style mortgages, with taxes on property transactions also likely to be extended.

A report from the IMF noted the important role emerging countries such as China and India are playing in the global economic recovery. Upping its global economic growth forecast from 3.9% to 4.2% for 2010, the IMF predicted growth of 10% and 8.8% in the Chinese and Indian economies respectively this year, highlighting how both emerging giants' final domestic demand is having positive spill over effects for Asian economies generally.

## Fixed Income

Major government bond markets ended April largely flat as the latest evidence supported the view that the developed economies are undergoing a very subdued recovery. However, US bonds marginally underperformed their peers as March producer price inflation rose to 0.7% (compared to the 0.4% forecasts), while the biggest jump in food prices for 26 years added to concerns over the outlook for inflation.

Nevertheless, sovereign risk concerns were the overarching theme in bond markets during the month as investors lost patience and confidence in Greece's ability to service its obligations. As soaring yields left Greece with little option but to plunge headlong into the EU/IMF safety net, Portuguese and Irish bonds also underperformed as investors took the view that other deficit-burdened countries could yet find themselves in the same trouble as Greece.

#### Major Bond Markets – Total Returns £ 2009/2010



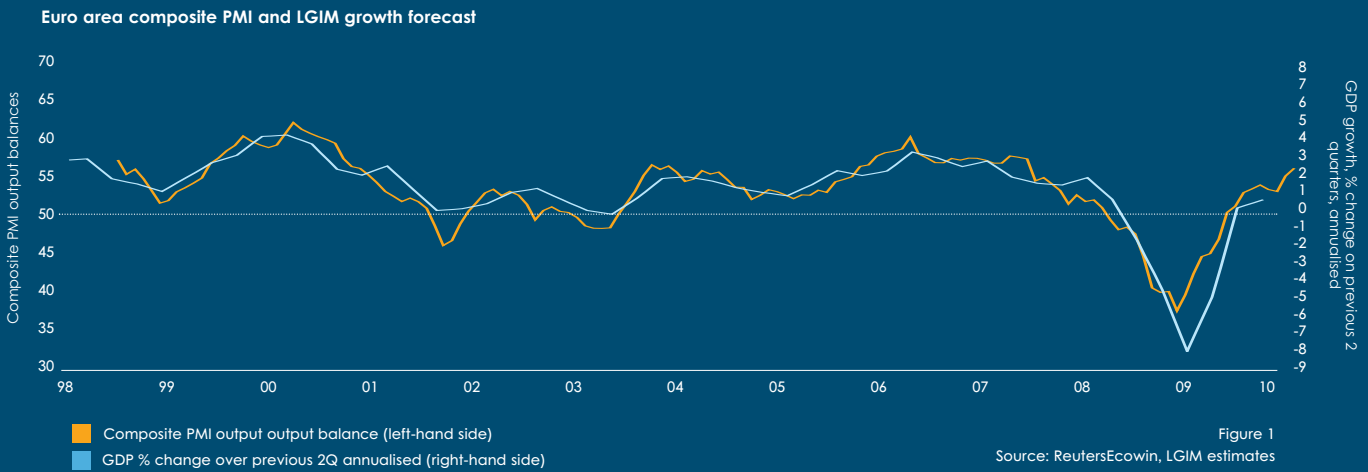
Figure 2  
Source: Datastream

# Snapshot

## Some scope for a positive surprise in the euro area

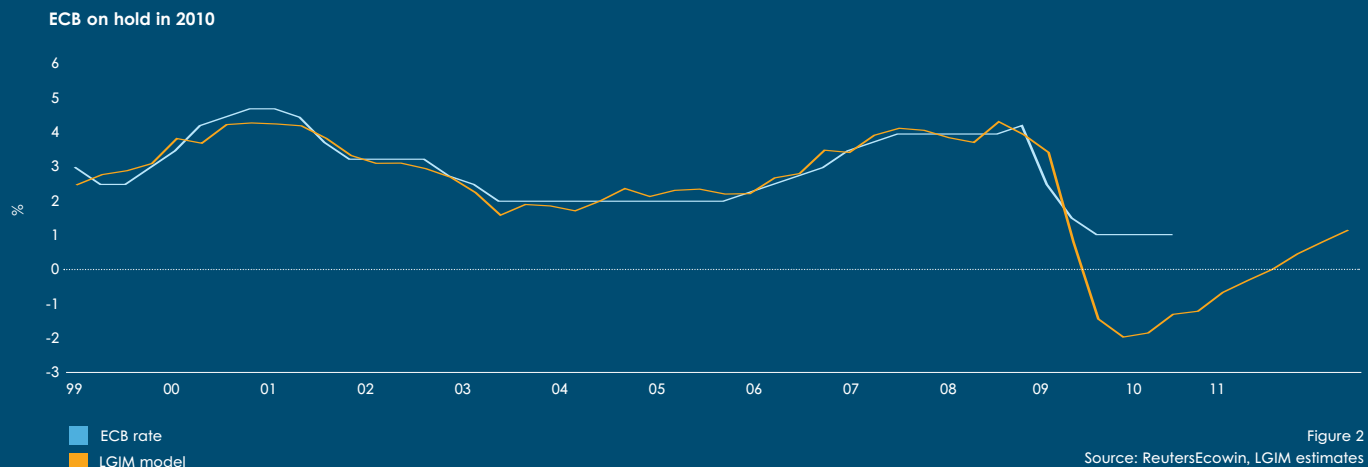
The uncertainty surrounding Greece has cast a shadow across the euro area. Drastic fiscal tightening will inevitably depress Greek growth whatever the outcome of the crisis. There is a risk of contagion to other countries within the euro area and this has led to a marked weakening of the euro. But for the majority of the euro area this will provide an added boost at a time when underlying growth is improving.

The composite euro area Purchasing Managers Index (PMI), an indicator of economic activity, is now signalling decent growth ahead (figure 1). This includes measures of both manufacturing and services confidence. Other confidence surveys are also showing a significant improvement and industrial production has recently been revised higher, although this is yet to be reflected in official GDP statistics. First quarter GDP might be affected by cold weather early in the year, but this could lead to a strong rebound in the second quarter.



The latest inflation figures were a little stronger than expected, but largely reflect higher food and energy prices. Wage pressures remain subdued across the major euro-area economies and deflation appears to be intensifying in the peripheral countries as they attempt to regain the competitiveness they have lost against Germany over the previous decade. Despite the recovery in manufacturing activity, the level of output remains well below previous peaks. This implies ample spare capacity which should put further downward pressure on core inflation.

Improving economic data are likely to cause the ECB to worry less about the downside risks to growth and fret about inflation dangers. This might lead to a change in rhetoric, but we doubt there will be any change in interest rates this year (figure 2). Our model to forecast the ECB, which is based on various measures of economic slack, casts some doubt on whether rates should rise next year as well. We think unemployment should begin to fall more meaningfully in 2011 and so the ECB might consider some tightening, but this will depend on their judgement as to how much spare capacity still remains in the euro area.



## UK Forecast

## Rates on hold

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2010	2011	2010	2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	3.10	2.60	2.00	3.20	5.10	5.30	1.50	3.00	1.71	1.81	0.97	1.04
	Low	2.20	0.70	0.80	1.20	3.60	4.10	0.50	0.50	1.31	1.39	0.82	0.77
	Median	2.70	1.65	1.30	2.00	4.47	4.78	0.75	2.00	1.53	1.56	0.86	0.83
	Last month median	2.60	1.90	1.20	2.25	4.60	4.75	0.75	3.00*	1.54	1.60	0.87	0.85
<b>Legal &amp; General Investment Management</b>		<b>3.10</b>	<b>1.90</b>	<b>1.60</b>	<b>2.00</b>	<b>4.50</b>	<b>5.00</b>	<b>0.50</b>	<b>1.00</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>

\*Based on a small sample size at time of going to print

Source: Bloomberg and LGIM estimates

The forecasts above are taken from Bloomberg and represent the views of between 20-40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

The UK economy emerged from recession during the fourth quarter of 2009 with a quarterly expansion of 0.4%. The economy expanded 0.2% during the first three months of 2010 according to provisional data. This reading fell short of expectations, with most economists anticipating slightly stronger growth (0.4%).

Our economic forecasts for UK economic growth remain unchanged from what we published in last month's Fundamentals. At 1.6% our GDP estimate continues to be ahead of the market average forecast (which was revised up to 1.3% from 1.2%).

Consumer Price Index (CPI) inflation continues to track above the Bank of England's target of 2%. While we believe inflation will reach 3.1% during 2010 (revised up from our forecast of 2.4% last month), we expect inflationary pressures to ease as the economic recovery remains weak. Our model suggests inflation will fall back to around 1.9% in 2011. The median market participant anticipates a reading of 1.65%. With growth weak and inflation pressures moderating, our Bank of England model is not suggesting any need for official interest rate hikes this year. While we cannot rule out some tightening in 2011, we maintain our view of no official rate rises in 2010.

For further information on Fundamentals, or for additional copies, please contact Lindsey Brooks at [lindsey.brooks@lgim.co.uk](mailto:lindsey.brooks@lgim.co.uk)

For all IFA enquiries or for additional copies, please call 0845 273 0008 or email [cst@landg.com](mailto:cst@landg.com)

For an electronic version of this newsletter and previous versions please go to our website <http://www.lgim.com/media-centre/fundamentals.shtml>

#### Important Notice

This document is designed for our corporate clients and for the use of professional advisers and agents of Legal & General. No responsibility can be accepted by Legal & General Investment Management or contributors as a result of articles contained in this publication. Specific advice should be taken when dealing with specific situations. The views expressed in Fundamentals by any contributor are not necessarily those of Legal & General Investment Management and Legal & General Investment Management may or may not have acted upon them and past performance is not a guide to future performance.

"FTSE®", "FT-SE®", "Footsie®", "FTSE4Good®" and "techMARK" are trade marks jointly owned by the London Stock Exchange Plc and The Financial Times Limited and are used by FTSE International Limited ("FTSE") under licence. "All-World®", "All-Share®" and "All-Small®" are trademarks of FTSE."

© 2010 Legal & General Investment Management Limited. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the publishers.

**Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA**  
[www.lgim.com](http://www.lgim.com)

Authorised and regulated by the Financial Services Authority