

Communiqué

Time for a fresh look at Commercial Property

November 2009

Legal & General Property (LGP) delivered an award-winning performance in 2008/09 despite economic decline and the fallout from the credit crisis. With the income yield from Property above its long term average and the economic backdrop improving, we firmly believe the property market as a whole offers an excellent investment opportunity. Furthermore, Legal & General Investment Management's (LGIM) innovative new LPI Distribution Property Fund will offer pension investors a higher yielding alternative to long-dated index linked gilts.

Judges comments:

“Simply the best”

“L&G Property has managed to deliver performance whilst maintaining liquidity – a rare feat in these markets”



1. The investment opportunity

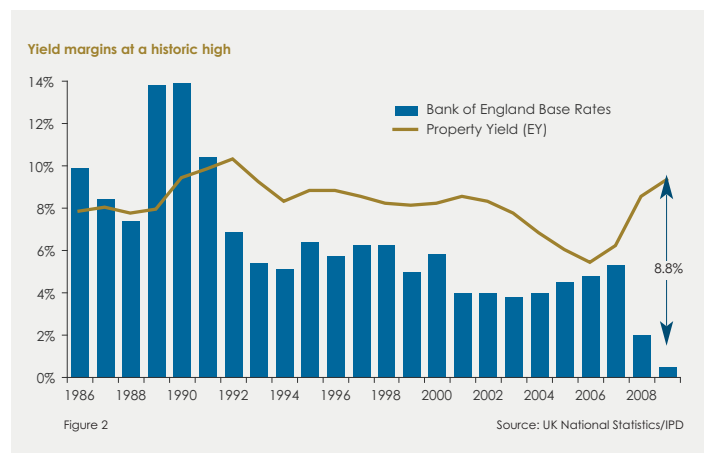
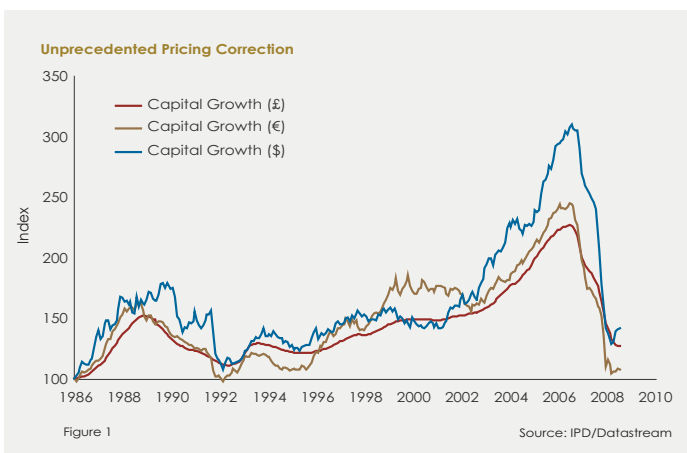
Sharpest correction on record

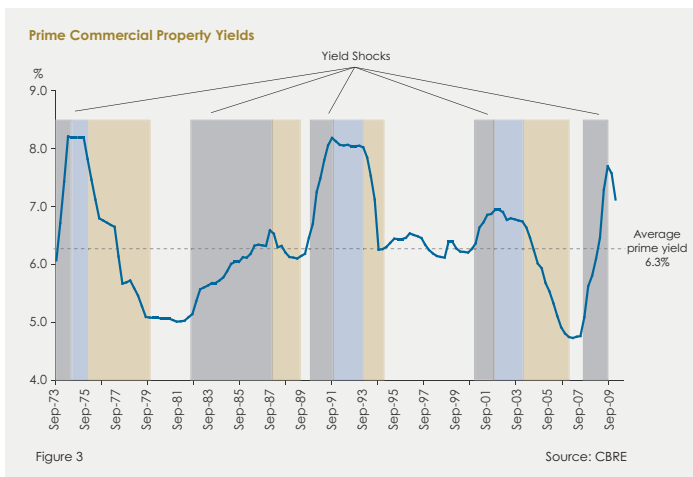
Commercial property has historically been considered a very stable asset class, with volatility significantly less than that of bonds or equities. However, the onset of the credit crunch coincided with a natural peak in the UK market causing the most severe correction on record. Capital values fell from their peak in June 2007 by 44.2% reaching a trough in August 2009.

The correction has been driven by a sharp upward movement in property yields, reflecting weak sentiment and a withdrawal of capital from the investment market. With this large shift in property yields, most metrics of value imply that UK commercial property is either fairly or underpriced relative to its own history, wider UK asset markets, and other major international real estate markets.

This summer, the spread for Property yields over UK government gilt yields was at its highest point since 1946, meaning that investors were being rewarded with an income yield at its highest point relative to a risk free rate in more than sixty years. Since the summer, strengthening investor demand has also caused capital values to start to rise, generating yield compression in the sectors of the market where demand has been strongest - particularly relevant to the prime stock in LGIM's Managed Property Fund.

Throughout the recent downturn, unlike most of our peer group LGP have continued to provide liquidity for their clients, with no redemption queues or additional penalties. As a result, our funds are now well-placed to benefit from a subsequent recovery, being free from overhanging queues of redemptions that result in forced sales of prime assets near the bottom of the market.





A Recovery in returns

The analysis presented in figure 3 (which shows a comparison of yield cycles in the UK since 1973) suggests that the severe correction presents a significant opportunity for investors. The chart demonstrates that the current yield cycle has had the most severe impact on capital value on record. Prior experience has shown that prime yields tend to stabilise 8-9 quarters after the initial shift. Historically, this would imply that prime yields will continue to stabilise (shaded blue) in the near-term and then move to a period of inward yield shift (shaded gold), generating positive movement in capital values.

We are already witnessing this trend in funds such as LGIM's Managed Property Fund which has experienced its first quarterly positive returns since the start of the downturn, with positive capital value movements in August picking up in September. This view is supported by LGIM's economics team and economists at Capital Economics, who have described the downturn in commercial property values as "all but over".

In particular, LGIM have not been waiting idle for such an opportunity however, and we have been developing sophisticated new products that provide investors with an alternative means of accessing exposure to this market opportunity. In particular, LGIM's new LPI Distribution Property Fund will deliver a return profile more akin to a very long-dated index-linked government bond or a secure inflation-linked corporate bond while benefiting from a significantly higher income yield. The Fund aims to use property investments to provide greater portfolio diversification, a more appealing yield compared with government bonds, and greater security of capital in case of default than many corporate bonds. This is outlined in more detail in section 4.

2. The risks

Weak occupier markets and risk re-pricing

Despite positive news on the investment pricing, there remains clear pressure on occupier markets in the UK. Our forecasts indicate that vacancy rates will not peak until 2010, continuing the downward pressure on rents. Consequently, prices for property exposed to the rental cycle - that is, properties that are vacant or assets on short leases - are likely fall in value relative to assets with long let, secure income streams.

Yields for secondary assets that are exposed to the rental cycle could well rise further as potential purchasers take account of the full impact of rental decline. This re-pricing of income stream risk is already leading to a divergence in property prices for defensive versus more risky assets. The magnitude of difference is forecast to become more pronounced, with prime, defensive assets performing more strongly in the next two to three years. Market data supports this hypothesis; rents have fallen and longer-let, prime properties (such as those in LGIM's funds) have performed better than secondary-quality stock on short leases.

UK Commercial Real Estate

- The UK is in the top five institutional-grade commercial real estate markets in the world by volume
- Diversity of the investor base and a history of institutional investment ensure that the market is one of the most transparent
- UK leases are unusual in a global context because they have the benefit of upward-only rent review clauses. This means that at review, rents can usually only be revised upwards, creating a floor in income and ensuring that investors can benefit from growth in market rents, while being protected from cyclical declines
- UK commercial property therefore combines the income security of a bond with the potential for growth in both income and capital value offered by equities

3. Attractive relative to other asset classes

There are a number of characteristics which make commercial property particularly attractive as an asset class. Within the UK market the value of investors' assets is underpinned by embedded supply constraints. As a densely populated island with limited availability of land, long-term asset value growth can be derived from the fundamental disparity between demand and supply. Furthermore, the UK's planning system is both comprehensive and rigorous, acting as a barrier to entry for new real estate developments and thus further restraining supply.

With an element of uncertainty in the current economic climate, an advantage of commercial property over corporate bonds and equities is that if a tenant/issuer goes into liquidation the landlord can take the property back to re-let and generate additional income, whereas a bond or shareholder's paper may be worthless. (See following Woolworths case study.)

Case study: Woolworths

An example of what happens when a tenant defaults

- LGP is in regular contact with LGIM's bond and equity teams and was closely monitoring the financial difficulties faced by Woolworths
- LGP became aware of a requirement from Waitrose to increase their exposure within Central London
- Fund team proactively included its Woolworths store in Clapham within a portfolio of acquisitions, assigning the lease from Woolworths to Waitrose
- Since the assignment, the portfolio has leveraged off the excellent fundamentals of the store to agree terms for a new 20 year lease to Waitrose, increasing the rent in the process
- On completion this will add approximately £2 million to the value of the store, while maintaining the income stream with no capital expenditure

4. A new way to invest in property

A source of government-backed, inflation-linked income

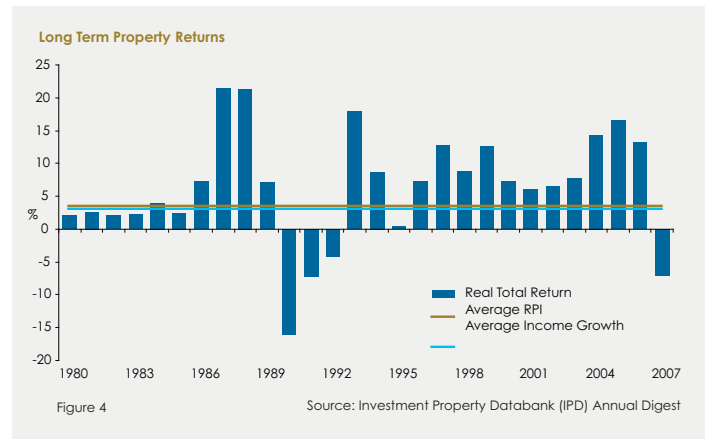
During the downturn, LGP has worked closely with LGIM to structure property solutions that meet client requirements whilst enabling them to benefit from a broader market recovery.

While property is a diverse asset class, its fundamental qualities of income in excess of gilts, historic income growth in line with inflation (see Figure 4), and an ability to choose from a variety of tenant risk profiles have multiple applications for today's pension schemes.

A conventional property fund is focused on generating a return in excess of the broader market return through a blend of equity-type and bond-type returns. UK Commercial property exhibits a combination of defensive and growth characteristics, meaning that as an asset class it has the capacity to perform better than equities in a deflationary world and better than bonds in an inflationary scenario. This is due to the fact that in addition to potential capital gains, UK commercial property leases are relatively long and generally have upward-only clauses which protect against reductions in rent. Therefore, even in the depths of the early 1990s recession, IPD data show that property net income growth remained in positive territory, despite the sharp reduction in market rents.

LGIM's new Limited Price Inflation (LPI) Distribution Fund aims to deliver a return profile similar to very long-dated index-linked gilts or secure index-linked corporate bonds. To achieve this, the portfolio will be structured so that it consists of properties whose value is predominantly derived from their leases. These properties are primarily let to government and quasi-government tenants (providing a stable yield) for a minimum of 20 years, with their income streams linked to inflation. In comparison to the average property asset, the assets to be held in this Fund are less volatile (approximately 50% less volatile in fact). They also exhibit a long modified duration and low convexity, ideal for pension schemes.

This Fund aims to take commercial property investing one step further than traditional property funds. While also benefiting from the potential capital gains currently on offer, the LPI Distribution Fund gives pension investors looking for inflation protection an alternative to index-linked bonds. The Fund will



seek to deliver a real yield of at least 4% per annum, which compares very favourably with index-linked gilt yields of around 1.5%. On a £10 million investment, at current inflation swap pricing this generates at least £12.1 million of additional income over an index-linked gilt during the life of a typical 25 year lease. Furthermore, even with a government's ability to pay its debts being brought into question lately, the knowledge that a physical asset lies behind this competitive yield provides even greater security in case of default.

5. Summary

Following the rapid rise in prime property yields since the end of 2006 (with values falling by more than 40%) the market currently offers an excellent opportunity for investors to gain exposure to prime UK real estate. Values for these assets are believed to be near their floor. Since they are largely insulated from short-term rental decline, they are believed to be best positioned to benefit from a re-rating of the asset class.

The income yields currently available from commercial property, allied to its traditional benefits of low volatility, diversification, and capital value growth, strengthen the case for its inclusion in any pension scheme. Furthermore, LGIM's new LPI Distribution Property Fund offers an attractive alternative to index-linked gilts: generating secure, inflation-linked income streams with long maturities and significant additional returns.

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