PROPERTY MARKET DIFFERENTIALS.

Q1 2010

QUARTERLY TOPICAL RESEARCH REPORT AND MARKET UPDATE FROM LEGAL & GENERAL PROPERTY.

A NEW LOOK AT THE CENTRAL LONDON OFFICE MARKET

BY MICHAEL TATE, RESEARCH ANALYST, LEGAL & GENERAL PROPERTY

THE CENTRAL LONDON OFFICE (CLO) MARKET IS AGAIN IN FAVOUR AMONGST REAL ESTATE INVESTORS. YIELDS HAVE COMPRESSED MARKEDLY OVER THE LAST THREE QUARTERS AND IN Q1 2010, RENTAL VALUES INCREASED FOR THE FIRST TIME IN TWO YEARS.

AFTER UNDERPERFORMING THE WIDER COMMERCIAL PROPERTY MARKET THROUGH THE DOWNTURN FROM MID-2007 TO MID-2009, CLO RETURNS OUTPERFORMED THE BROADER PROPERTY SECTOR BY APPROXIMATELY 3% IN THE SIX MONTHS TO MARCH 2010. SO HOW SHOULD INVESTORS RESPOND?

CITY AND WEST END RELATIVE RETURNS, %

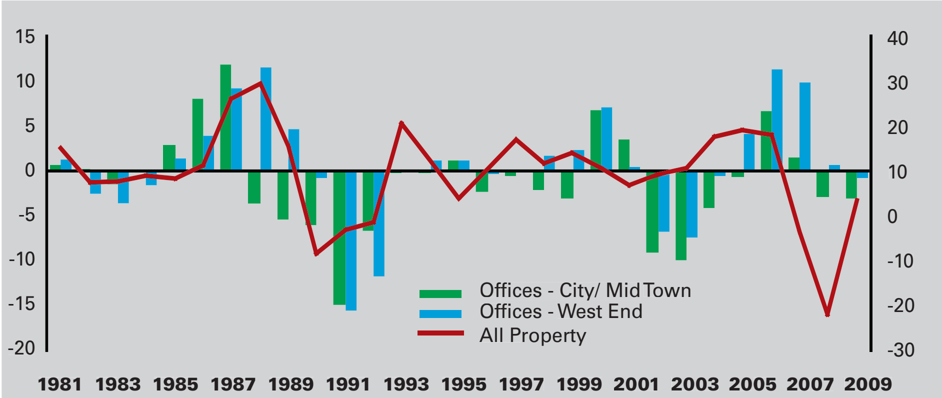


Figure 1. Source: Investment Property Databank (IPD)

THE CENTRAL LONDON STORY

The historical volatility of Central London Office (CLO) investment returns is well documented in the market place. Over the 29 years to 2009, the standard deviation of CLO returns was nearly 1.5 times higher than that of the wider commercial property sector.

Through the cycles CLO assets have typically outperformed other property types during market upswings and underperformed through market corrections. By implication, relative to other property sectors, investment into Central London carries a higher degree of risk. The magnitude of the rewards on offer in the good years however has kept investors attracted.

In the years in which the City and West End returns outperformed the wider property sector, the average margins of outperformance were 4.3% and 4.2% respectively. Most other sectors outperformed by closer to 3% in the good years.

Aside from the lure of outperformance, the relative liquidity of Central London versus other property markets has also appealed. Central London is one of the most transparent and accessible markets in the world, attracting a wide and deep pool of investors.

Last year the relative weakness of sterling and the fact that the CLO market was further through the downturn in the property cycle (relative to other global office markets) were big motivators for offshore investors to take on significant CLO exposures.

These two market features; cyclicality and liquidity; have encouraged some real estate investors to pursue a strategy of trading in and out of the market rather than buying to hold for the longer term.

CITY AND WEST END RENTAL GROWTH, %

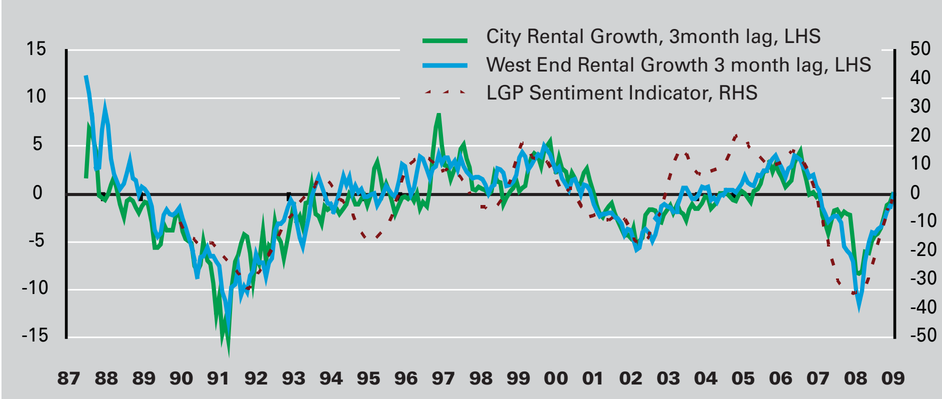


Figure 2. Source: Investment Property Databank (IPD)/ LGP

WHAT MAKES THE MARKET TICK?

Real estate buy/hold/sell decisions will ultimately be based on the potential for income growth measured against current prices. However, where timing is critical, the scale and position of investment entry and exit indicators will be given more weight and scrutinised more carefully.

Pricing signals which put current yields and relative pricing into an historical context are the first port of call. In the last quarter, several CLO pricing indicators moved from above (cheaper) to below (more expensive) long term average levels.

Real initial yields for instance moved 120 and 80 basis points below long term trends in the City and West End markets respectively and relative to corporate bonds and other property sectors, CLO exposure has started to look more expensive. A judgement therefore needs to be made on whether the scale and certainty of income growth prospects justifies these pricing movements.

As a major global financial hub, demand for office space in Central London has historically been allied to conditions in the finance and business services (F&BS) sectors, in which approximately 50% of London workers are employed.

Principal among indicators of demand therefore are surveys of F&BS employment expectations and F&BS optimism. The CBI/ PwC Indicators of F&BS trends in sentiment have been reasonably successful indicators of real rental growth. LGP's composite of these indicators has typically corresponded with similar directional shifts in the rental cycle with a 3-month lead (Figure 2).'

However sentiment is not always a reliable indicator and an equally keen eye should be kept on actual F&BS production and employment rates to monitor the extent that optimism leads to output.

> "...AT PRESENT THE SIGNALS PROMPT SOME CAUTION AROUND YIELDS HOWEVER ON BALANCE THE POSITIVE NEAR-TERM PICTURE FOR RENTAL GROWTH PROSPECTS WOULD APPEAR TO JUSTIFY AN OVERWEIGHT POSITION.".

Indicators of demand can be combined with projections of near-term supply (the CLO development pipeline is widely covered in the market) to allow projections of occupancy rates and in turn income growth prospects.

Historically, rental growth has displayed a strong relationship with occupancy rates (the inverse of vacancy rates). Positive real rental growth has tended to occur in tandem with a rise in occupancy rates above 90% in the City and 93% in the West End. Occupancy rates have been trending higher over the last few quarters and at end March moved to 89.0% and 93.0% respectively.

Pulling these signals of current pricing, yield movements and rental growth potential together allows for an informed buy/hold/sell call to be made.

At present the signals prompt some caution around yields however on balance the positive near-term picture for rental growth prospects would appear to justify an overweight position.

STOCK SELECTION

Timing market entry is one thing, choosing the right assets is another. In the absence of an established and liquid derivatives market, the bulk of investment into CLO is made via the direct purchase of physical assets.

Consequently investors are exposed to a high degree of asset-specific risk. Variations in the physical characteristics of an office building, e.g. quality of fit-out, age, location, etc and factors affecting an asset's income stream, i.e. lease length and covenant strength, mean that performance for a specific asset will differ from that of the wider market.

Most recently, performance has been limited to prime assets while secondary and tertiary stock with short lease profiles has lagged substantially.

In our experience the variance of historic returns amongst assets held in central London has been greater than most other UK property sectors. There is a risk then that any benefit from astute timing of entry into the CLO market may be eroded by poor stock selection.

As such when considering investment alternatives it is essential that the risk associated with this broader range of possible outcomes is priced appropriately.

THE BOTTOM LINE

The results highlight both the cyclical nature of CLO returns and at the same time the potential outperformance on offer through astute timing of CLO investment. Success hinges largely on the effectiveness of the signals used to guide buy/hold/sell decisions.

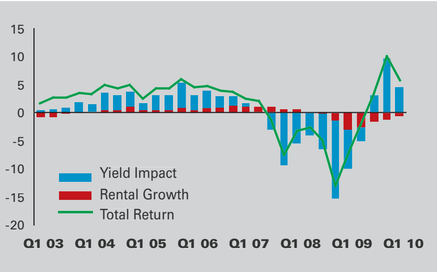
However volatility is only one feature of the CLO market. Heterogeneity of the underlying asset pool is another leaving a wide variance of returns within the sector. So while timing is key, there is no substitute for good stock picking.

"...WHILE TIMING IS KEY, THERE IS NO SUBSTITUTE FOR GOOD STOCK PICKING.".

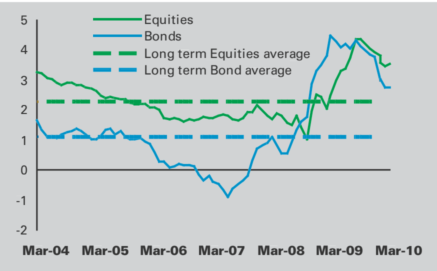
PROPERTY MARKET UPDATE Q1 2010

BY ROB MARTIN, HEAD OF RESEARCH, LEGAL & GENERAL PROPERTY

COMMERCIAL PROPERTY TOTAL RETURNS, %



COMMERCIAL YIELD GAPS WITH OTHER ASSET CLASSES, %



Source: Investment Property Databank (IPD), Ecowin, LGP

A BRIEF RUNDOWN

After the largest capital value increase in December 2009 since monthly records began in 1987, Q1 2010 saw less activity in the investment market and more moderate price rises. Capital values still rose by 4.3%, which combined with income delivered a 6.0% total return. A key theme of the quarter was further evidence of recovery in the cyclical central London office market, where prime City of London rents grew by 8%.

IN MORE DETAIL

After the surge of transactional activity to £8.4 billion in Q4 2009, volumes slowed to £5.1 billion in Q1 2010. There was a particular slowdown in purchasing by overseas investors, who have been a major source of demand throughout the past 3-5 years.

UK institutional fund managers were the key net investors during the quarter, with less selling by property companies, occupiers and banks. The continued positive balance of demand and supply in the investment market led to a further improvement in pricing, with the IPD average initial yield falling by a further 40 basis points to 6.5%.

Combined net inflows into Authorised Property Unit Trusts and the wider basket of funds covered by the Association of Real Estate Funds (AREF) totalled £2.5 billion in Q1, down on the £4.3 billion received in Q4 2009.

These cover the majority of flows into funds managed by UK investment houses. Given that there is often a lag between allocation and transaction, this implies that there may be some reduction in the amount of purchasing by UK fund managers in Q2.

At the subsector level, demand from a number of UK fund managers has continued to focus on out of town retail warehouses, which were heavily oversold at the bottom of the market in 2009 and have since enjoyed a strong rerating, delivering total returns 10% ahead of the wider market in the 12 months to Q1 2010.

With the rapid reduction in retail warehouse yields, a number of investors are becoming more cautious about the sectors potential for relative outperformance in the short term. The other major focus of interest in Q1 was the central London office sector. Having seen severe rental declines in 2008 and much of 2009, vacancy rates have started to decline and prime rents in the City of London rose by 8% in Q1. This has spurred renewed investor demand in the sector, with 3 transactions with a value over £100 million completed during the quarter, contributing to a 40 bps reduction in City initial yields.

The most recent data show that the UK economy grew more slowly 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.

Detail aside, compared to conditions in the first half of 2009 economic momentum has clearly improved. Commercial property is seeing some benefit from that, with a reduction in vacancy rates across the subsectors in Q1 2010.

However, outside of central London, there is little evidence yet of rental recovery, with retail and industrial rents falling by a further 0.7% and 0.8% respectively in Q1. Despite the gradual improvement in demand conditions, LGP's view is that it will take some time before vacancy is eroded back to pre-recession levels and we expect letting conditions across many of the markets to remain challenging in 2010.

SUMMARY

Avoiding risk was a key driver of relative performance for commercial property portfolios in 2009. This drove risk premia to multi-year highs and LGP's view is that there are excellent returns available for selectively going up the risk curve. But with economic recovery expected to be a matter of years not months, the benefits to risk-taking will rely on good stock-picking to find the assets that will be the first to benefit from improving demand / supply dynamics.

England N0.166055. Registered office: One Coleman Street, London EC2R 5AA

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Unless otherwise stated all data is as at end December 2009.

Legal & General Property, One Coleman Street, London EC2R 5AA

www.lgim.co.uk

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