



# Investing in UK Property

## Introduction

This report considers the prospects for the UK commercial property market. Over the last two years, the UK has experienced a sharp correction in property values, whereas in continental Europe, the correction has so far been more limited in extent. However, the correction in the UK market has been so rapid that yields are now looking very attractive, in historic terms, relative to both European property and to other asset classes. As a consequence, UK property offers some very attractive total return prospects.

The size, transparency, liquidity and maturity of the UK property market, relative to many international alternatives, remain appealing. In addition, the generally higher level of familiarity (although this will depend on investor origin), and the greater range of indirect investment products available, are also attractive.

This paper is intended as a brief introduction to some of these issues. The following sections look at:

- the size and structure of the UK property market
- correlation with other markets
- recent performance
- performance prospects.

## The size of the market

### The global investment universe

The UK accounts for the largest portion of the property investment market in Europe and remains the most mature and most liquid property market in Europe. The UK now accounts for around 11% of invested stock globally, and around 30% of the estimated £2.1 trillion invested stock in Europe.

### Diversification benefits

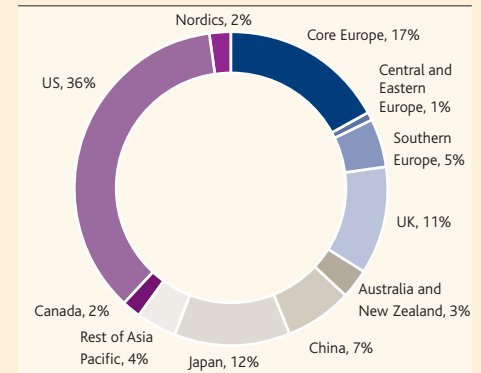
The UK has exhibited a very weak correlation with other countries' property returns over the past decade on a global basis. UK returns have shown a positive correlation with Ireland and the U.S., but very weak correlations with other countries. As a consequence, investing in the UK offers a greater diversification opportunity, enabling the risk/return profile of a portfolio to be improved. Generally, higher cross-correlations between non-UK markets reflect, to some extent, higher levels of cross-border investment within continental Europe, and more similar economic structures.

**Figure 3: Cross-correlation of 'All Property' returns, 1999-2008**

	UK	Sweden	Ireland	Finland	Netherlands	France	Germany	Australia	USA
UK	1.00								
Sweden	0.47	1.00							
Ireland	0.86	0.82	1.00						
Finland	0.19	0.89	0.64	1.00					
Netherlands	0.52	0.91	0.84	0.84	1.00				
France	0.62	0.82	0.82	0.79	0.72	1.00			
Germany	(0.39)	0.15	(0.06)	0.34	0.40	(0.17)	1.00		
Australia	0.57	0.59	0.68	0.58	0.45	0.90	(0.28)	1.00	
USA	0.82	0.71	0.88	0.53	0.60	0.86	(0.35)	0.87	1.00

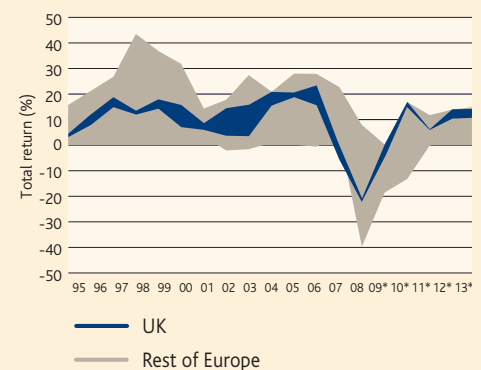
Note: A coefficient of 1 implies matched performance. 0 indicates no relationship, and negative numbers imply an inverse relationship.  
Source: IPD, Aberdeen Property Investors

**Figure 1: Invested stock by country**



Source: DTZ Research

**Figure 2: Range of returns across UK and European sectors**



Source: IPD; KTI; Aberdeen Property Investors

\*Projected  
Note: The number of countries covered has increased over this period, as data availability has improved. Returns are in local currencies.

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## Recent performance

The UK experienced the weakest returns globally in 2007, with capital values falling sharply as yields rose dramatically. In 2008, this process continued, with UK property delivering a total return of -22%. Only Ireland delivered weaker returns. The UK market has been the first and fastest to correct in Europe, and our forecasts suggest that it will also be the first market to recover, with total returns amongst the strongest in Europe for 2009 and 2010.

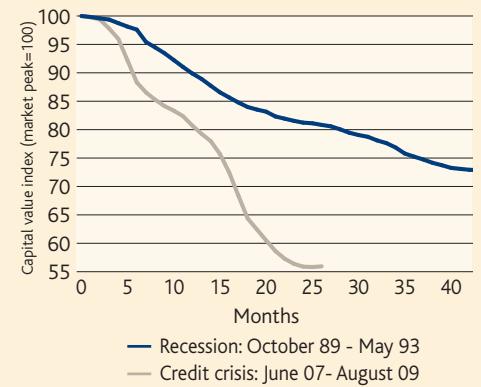
The pace of the UK downturn was dramatic. A capital fall of 44% has occurred in two years since the peak of the market. In the recession of the early 1990s, it took almost three years for a fall of just 25% to occur. However, capital values have now stabilised, and in August 2009, increased for the first time in two years.

The UK market has also corrected far further and faster than markets in continental Europe. The effect of this has been that UK property now looks better value relative to continental European property. For example, the yield premium for prime office property in the UK, relative to its continental European counterparts, has now reached a high level in historic terms, of almost 100 basis points.

The following chart plots yields in Q2 2009, the high point, against the lowest level reached during the peak of the recent market in 2007 (the UK) or early 2008 (most continental European markets). The City of London and Birmingham have seen some of the sharpest yield rises in Europe, and now have prime yields higher than many other major office markets in Europe. Historically, the UK has had lower yields than most European markets, reflecting in part, the greater liquidity and transparency of the UK market.

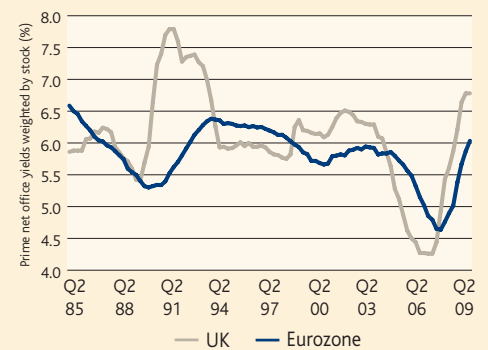
Overall, investment transaction levels in the UK have been weak over the past two years. However, with the UK widely perceived as being the first market to recover in Europe, overseas investors have been increasingly strong purchasers of property, investing a net £4.8 billion in 2008. In 2009, overseas investors have spent a net £5.4 billion on UK property, up to and including August. Overseas investors have been aided by the sharp fall in sterling against the euro and the dollar of up to 20% over the past year.

**Figure 4: UK correction has been extremely rapid, but is now complete**



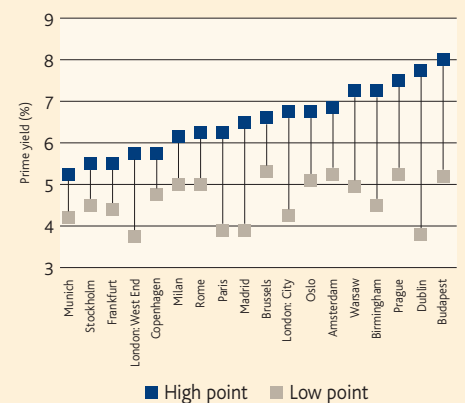
Source: IPD, Aberdeen Property Investors

**Figure 5: UK market has corrected much more rapidly than continental Europe**



Source: Aberdeen Property Investors

**Figure 6: UK prime yields now look attractive in a European context**



Source: Aberdeen Property Investors

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## Position versus other asset classes

Over the last two years, property has experienced a sharp rise in yields as capital values have fallen. As a consequence, property's equivalent yield premium has reached an historically high level over nominal 10 year government bond yields of approximately 600 basis points. Historically, a yield premium of 200 basis points has been thought to be fair value to compensate for the risk and illiquidity of the property sector.

Versus inflation-linked government bonds (remembering that property is also a real asset, as rental growth tends to marginally exceed inflation over the long term), property's yield premium also looks good value, being 400 basis points above the average over the past 15 years. Against cash, property's equivalent yield is almost 600 basis points higher than its long term average. The huge yield premium of property yields over cash yields has caused a pronounced increase in demand for smaller lot size UK property from private investors, and capital values are starting to rise sharply for such assets. Finally, property's yield premium over the yield on higher risk assets, such as corporate bonds and equities, has risen dramatically over the past six months, as yields on these assets have fallen dramatically, whilst investor risk aversion has receded.

## Prospects

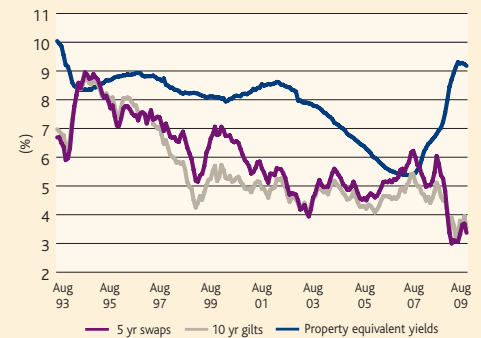
Over the next five years, we forecast an attractive annualised UK 'All Property' total return of 12%, based on pricing at the end of September 2009. The majority of this (approximately 8%) will be delivered by income return. The remainder will come from some strong capital returns over the next year in particular, and rental growth at the back end of the forecast period. Total returns for 2010 are projected to be particularly strong, reflecting the rapid increase in investment demand that has been experienced since the summer, which will continue to increase, and the limited supply of investment product available, particularly at the prime end.

Institutional investors are starting to re-enter the market in earnest, as property is looking very good value relative to other asset classes, and widespread acceptance that the bottom of the market has been reached. Overseas investors are also starting to increase purchasing activity, with the UK commonly 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, property companies and REITs will also start 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 net asset value on average. They have also raised over £5 billion via new share placings. Competitive bidding, combined with a lack of stock with many owners unwilling to sell at the bottom of the market, will drive capital values up considerably in the short term.

Rental values will continue to fall in 2010, although at a substantially slower pace as the economy emerges from recession. This slowing pace is already apparent in autumn 2009. In the office sector, for example, it has slowed from an annualised pace of over 20% in spring 2009, to 10% in the autumn. One encouraging note for rents, which may limit the extent of their decline, is that rents are 12% below their long-term average in real terms since 1960. Previous property market recessions have been preceded by periods of exceptionally strong rental growth, of over 40%, even in real terms, in the early 1970s and late 1980s. In nominal terms, rental growth was substantially stronger. However, over the last five years, rental growth has been flat in real terms. The lack of a preceding boom may limit the extent of the rental decline over the next few years, given that rents are coming off a historically low base.

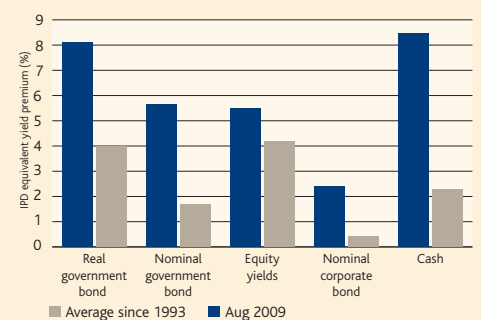
Although rental levels will continue to fall going into 2010, income will also, to some extent, be protected by the upward only clauses on rent reviews on UK leases. In the recession of the early 1990s, although rents fell by as much as 12% in 1992, income growth remained positive throughout.

**Figure 7: Pricing of UK property has become very attractive in the last six months**



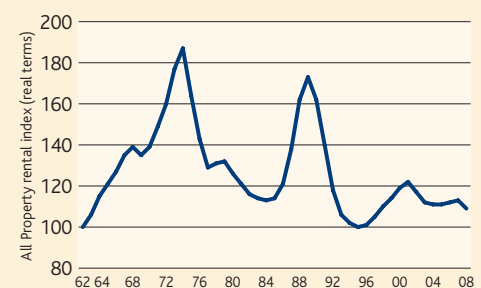
Source: Aberdeen Property Investors, Reuters Ecowin

**Figure 8: Property looks good value versus other asset classes**



Source: Aberdeen Property Investors, Reuters Ecowin

**Figure 9: Rents look affordable in historic terms**



Source: IPD, Aberdeen Property Investors

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## Conclusions

Our forecasts suggest that the UK commercial property sector offers some very attractive prospective returns, off a high yield base. Income returns of 8%+ will be very attractive to institutional investors, especially with interest rates close to zero. The UK offers a healthy yield premium over many overseas markets, in contrast to history, as the UK has usually exhibited lower yields due to the transparent and liquid nature of its market. Overseas investors, in particular sovereign wealth funds, will also be attracted as the UK market has corrected most rapidly internationally.

It is quite likely that there will be a sharp improvement in returns, now investors perceive that the market is stabilising. A strong recovery in performance is not unusual after a property market correction. Following severe weakness in the mid 1970s and early 1990s, commercial property delivered double-digit returns in real terms during the recovery phase. Parallels with the 1993/94 experience, when interest rates fell sharply after sterling was ejected from the Exchange Rate Mechanism, are already apparent. UK interest rates are already the lowest since the Bank of England began setting interest rates in 1694. As with the mid-1970s and mid-1990s recoveries, capital values are also recovering before any improvement in underlying letting markets and the resumption of rental growth.

Research consultancy, Property Market Analysis's most recent survey of international investor intentions, in autumn 2009, has revealed that overseas interest has increased dramatically, with a positive net balance of 61% of investors planning to invest in UK office property. The UK and France are currently the most popular investment destinations in Europe. This reflects a dramatic turnaround since autumn 2007, when investment intentions were most negative towards the UK - a net 52% of investors planned to disinvest. In addition, INREV's 2009 investment intentions survey revealed that the UK is now by some margin the most favoured European property market.

Finally, the rapid fall in sterling against the euro and the dollar over the past 18 months will further aid the attraction of UK property in an international context.

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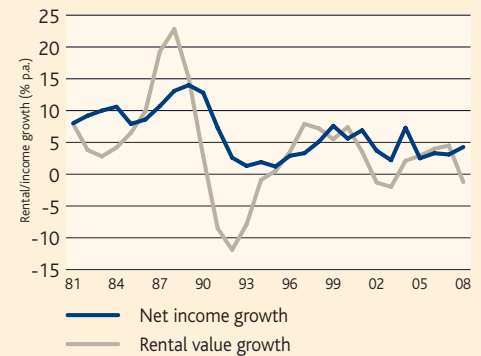
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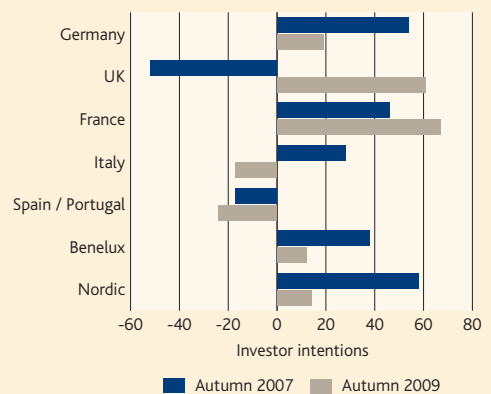
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**Figure 10: Upward only rent reviews will protect portfolio income growth**



Source: IPD, Aberdeen Property Investors

**Figure 11: UK returns to favour with international investors**



Source: Property Market Analysis

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