

A Tale of Two Markets

“It was the best of times, it was the worst of times...”

— *A Tale of Two Cities*

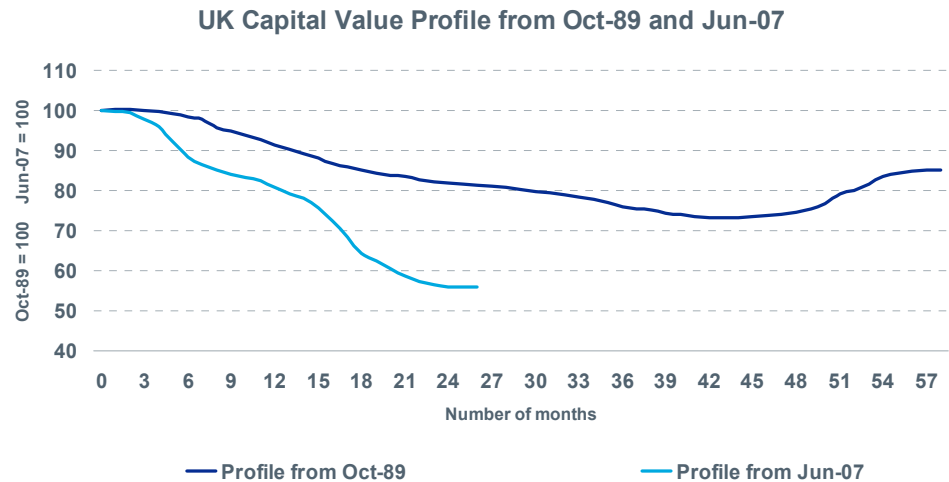
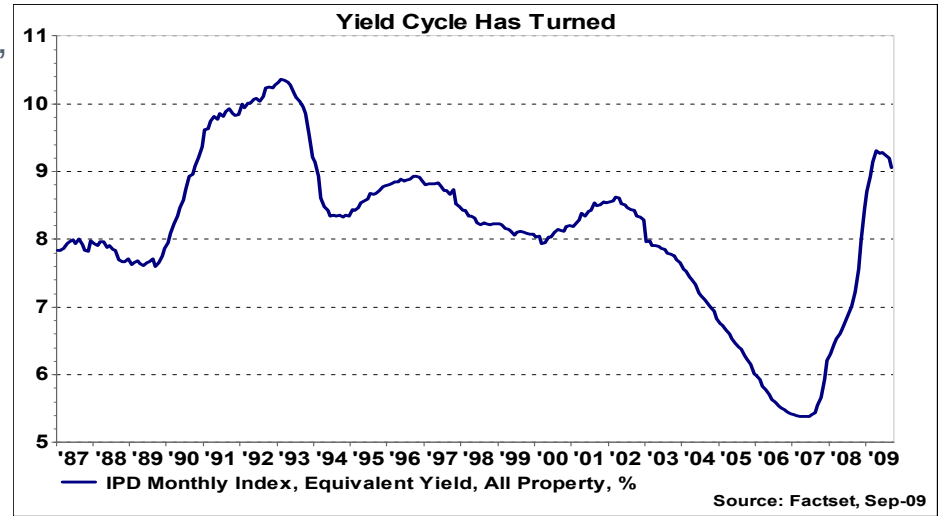
David Skinner – Investment Strategy and Research Director, Real Estate
4th November 2009



The Best of Times - Investment Markets

The yield cycle has turned

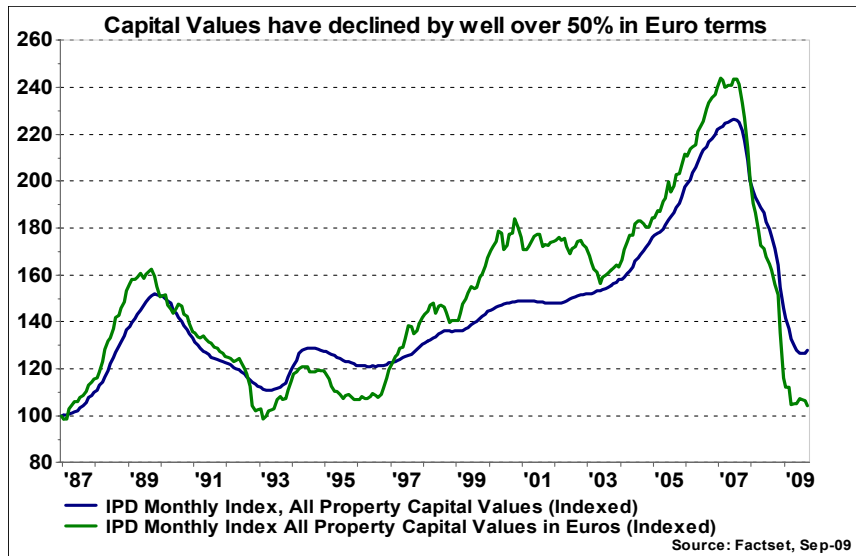
- Following two years of relentless increases, yield cycle turned over course of Q3
- On much increased investor demand for real estate assets
- Turnaround has been most pronounced for prime assets



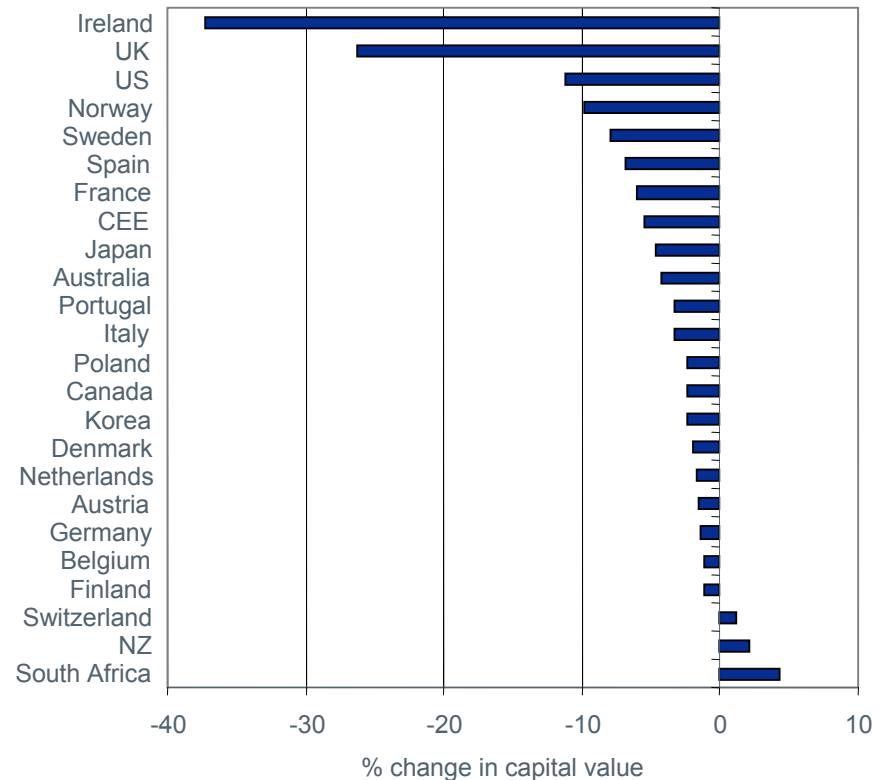
Source: IPD Monthly Index Sept 2009

Investment market rally driven by.....

- **Rapid adjustment of real estate pricing:**
 - Relative to previous cycles
 - In an international context
 - In foreign currency terms
 - Versus other markets



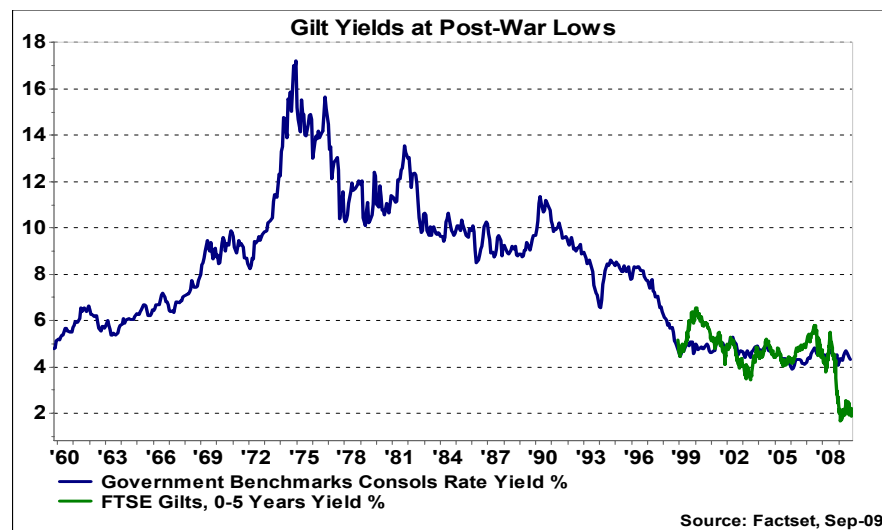
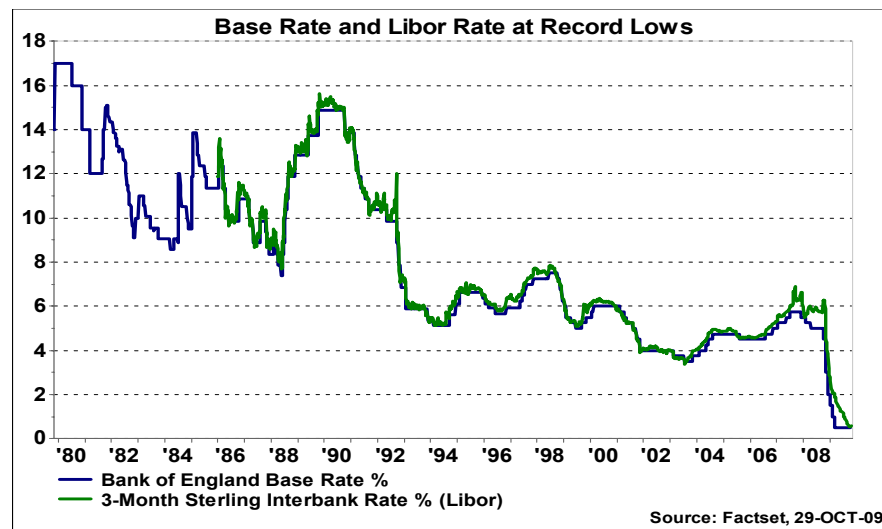
IPD Capital Values: % change in 2008



Source: IPD

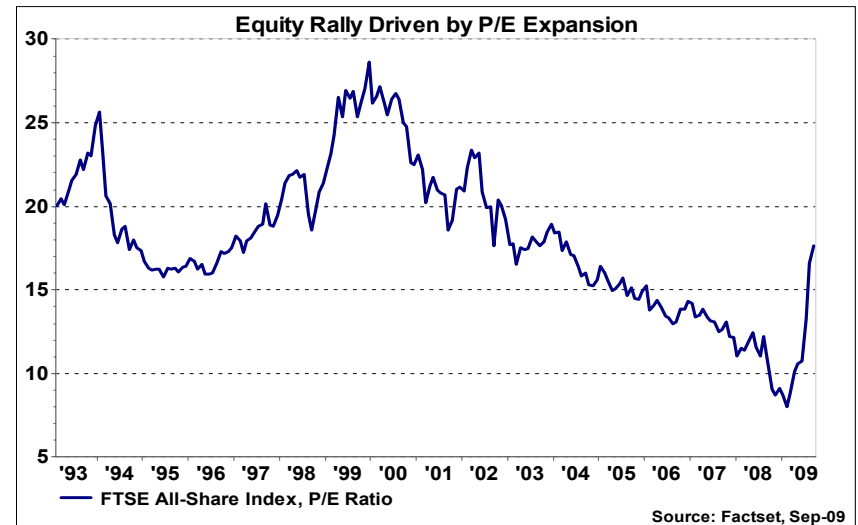
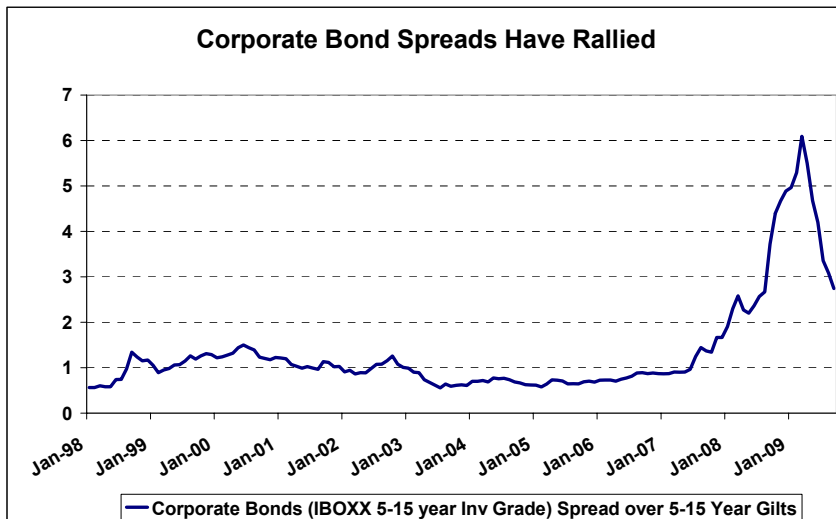
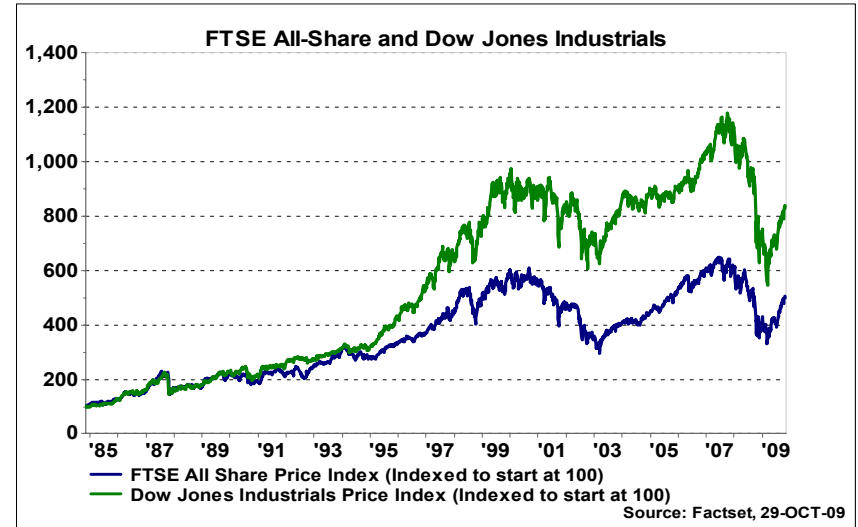
Investment market rally driven by.....

- Declining attractiveness of low-risk alternatives:
- Cash returns at close to record lows
- Gilt yields being manipulated (lower) by BoE
 - Exit strategy implies upward pressure on gilt yields



Investment market rally driven by.....

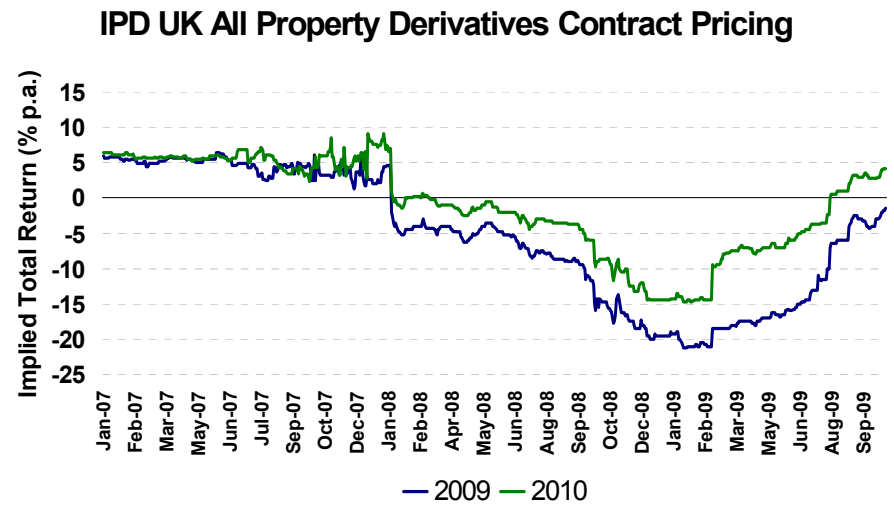
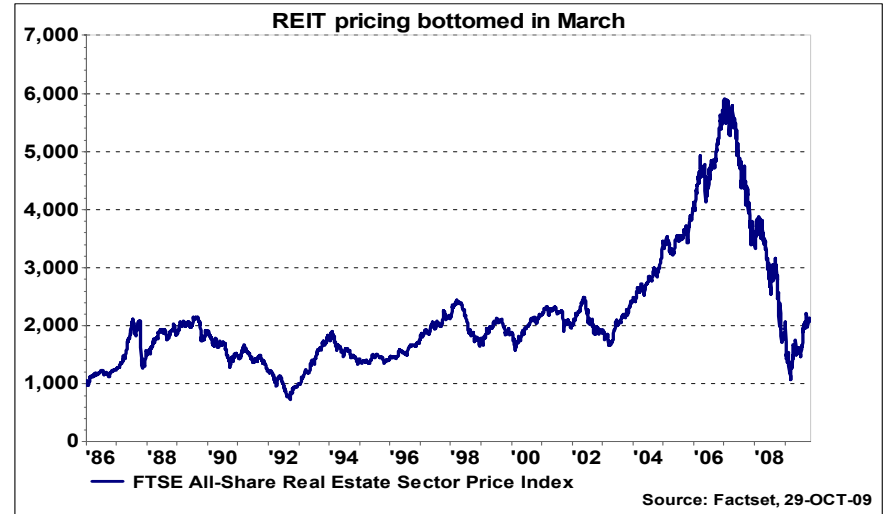
- **Declining attractiveness of higher-risk alternatives:**
- Strongest global equity rally in post-war period
 - All-Share up over 50% since March
 - Driven by P/E expansion – not earnings
- Credit spreads have moved in sharply



Investment market rally driven by.....

- **Avoidance of Great Depression II:**
 - Massive policy response
 - Growing confidence in (sluggish) recovery

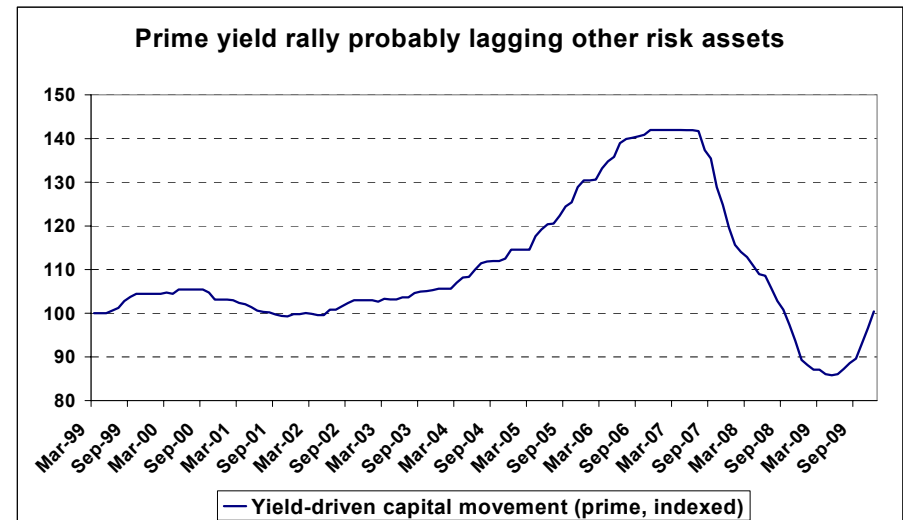
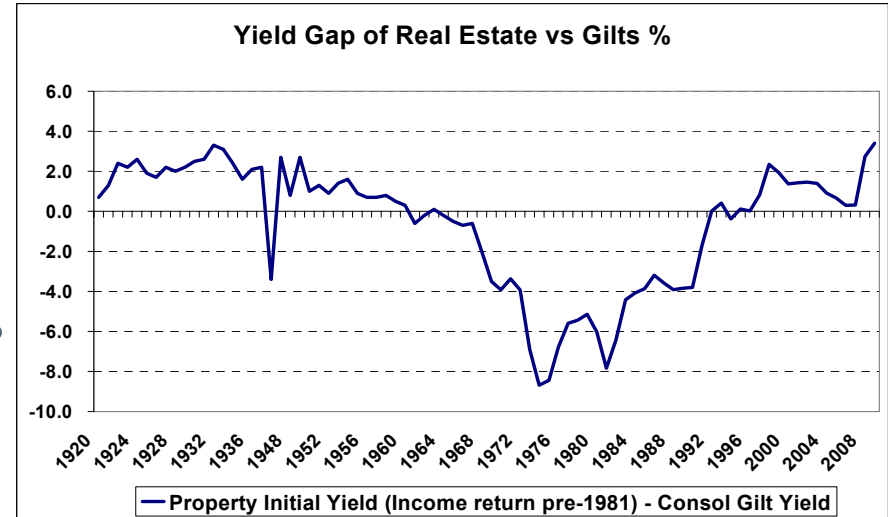
- And more liquid forms of real estate investment turned in March also:
 - REITs have rallied by almost 100%
 - Derivative pricing has rallied gradually



Source: Tullett Prebon October 2009

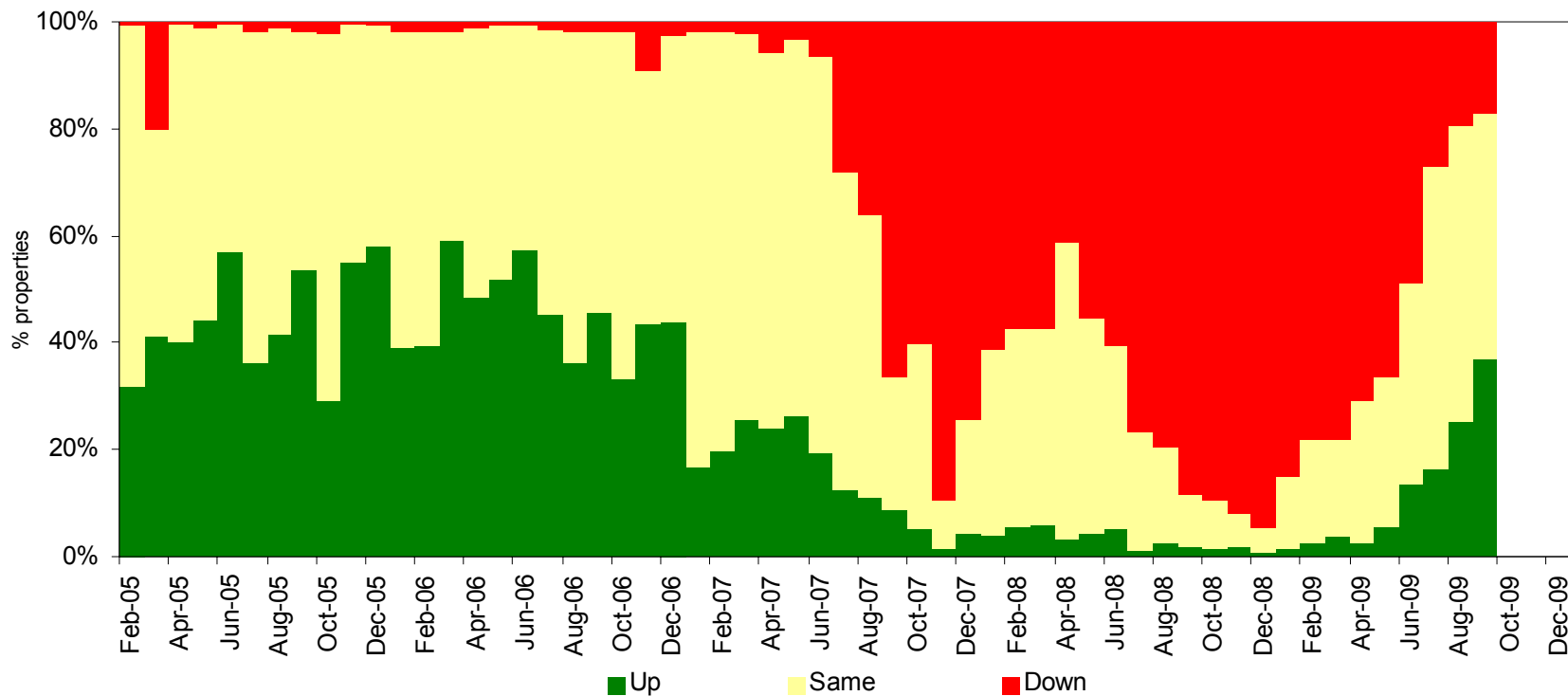
Best ever value?

- Adds up to best-ever value in direct market?
 - Yield gap over gilts and cash widest on record
- Real estate market rally is largely just catching up with rally in other risk and real estate assets?



The best of times returning?

Value changes (Aviva Investors managed monthly valued OEFs)



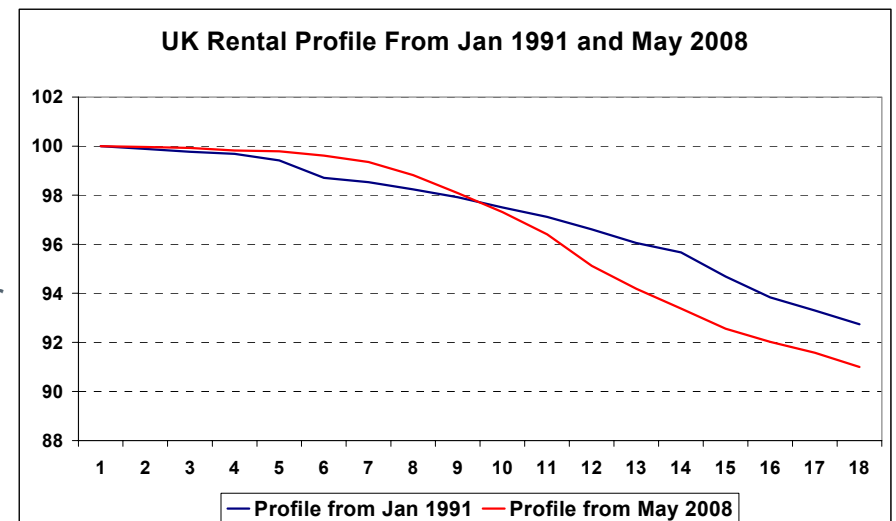
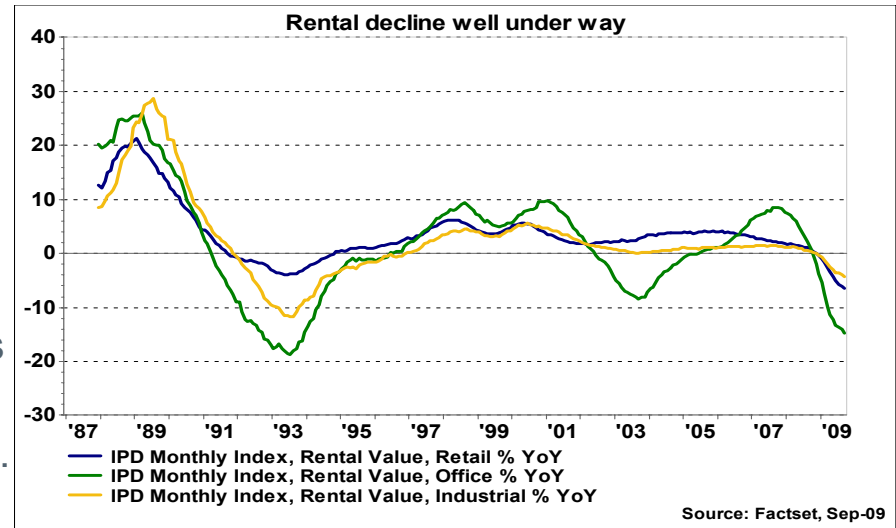
Conclusion.....yields likely to rally further

- Significant room for real estate yields to rally
- Supportive conditions look set to remain in place well into next year
 - Monetary policy to be gradually tightened
- Key risk – the response of banks to breaches of ICRs
- And occupier markets.....

The Worst of Times - Occupier Markets

Rental decline well under way

- IPD ERVs have fallen c10% so far
- But gauging level of ERV very difficult in this environment
- Some very soft deals being done by landlords developers:
 - Oversupply in some parts of market – e.g. City offices, distribution sheds, shopping centres
 - Empty rates a big driver
- Incentives taking much of the strain currently
- But plenty of time for ERVs to respond further

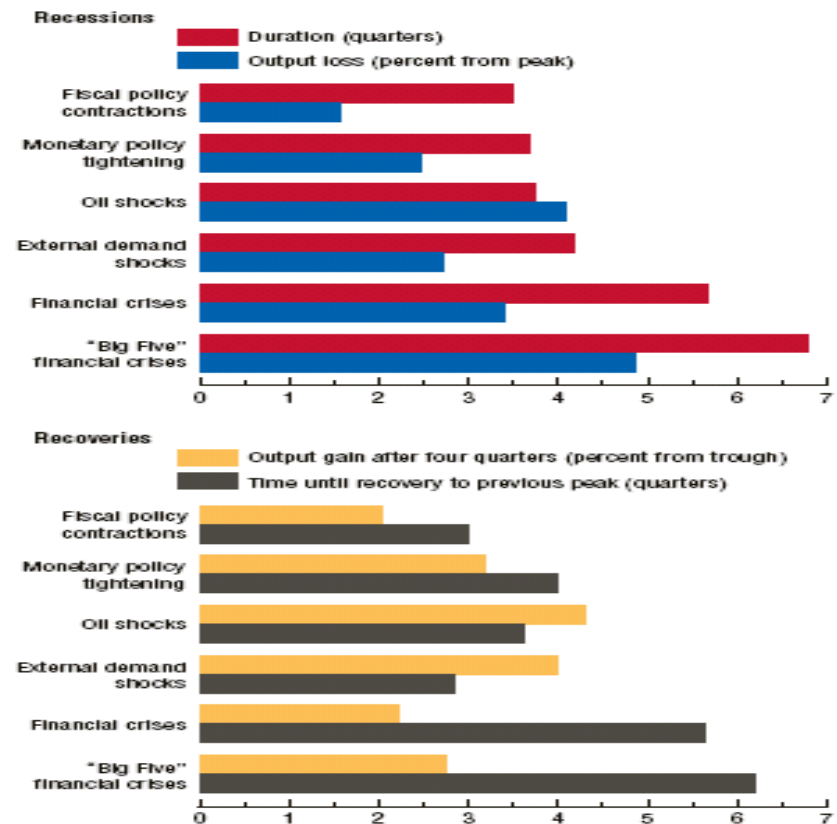


Extended period of economic weakness expected

- Recovery from this recession widely expected to be muted
- Policy must be reversed at some point
 - Fiscal constraints probably most binding
 - Monetary policy to tighten gradually
- IMF study found that synchronised & financial-crisis driven recessions tend:
 - To be unusually severe and long-lasting
 - To give way to weak recovery
- Economic growth expected to average 2% over next 5 years, significantly below “trend”

Figure 3.4. Average Statistics for Recessions and Recoveries

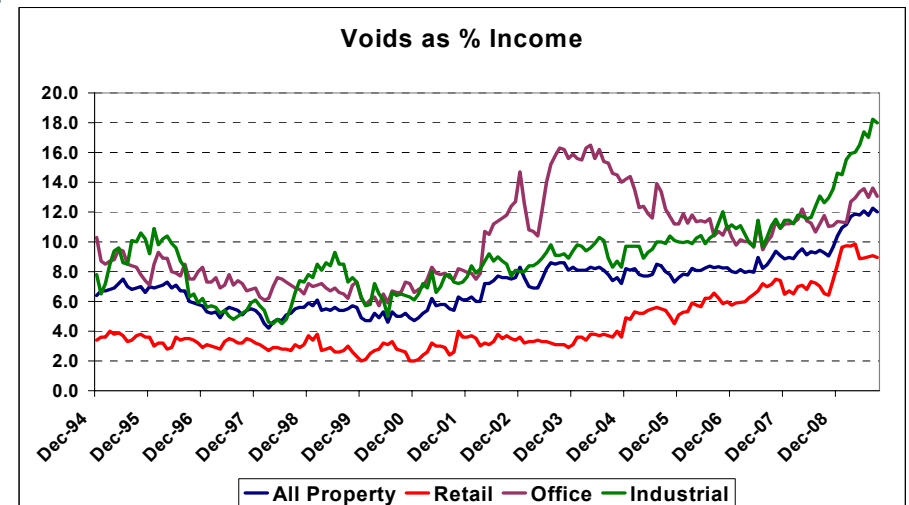
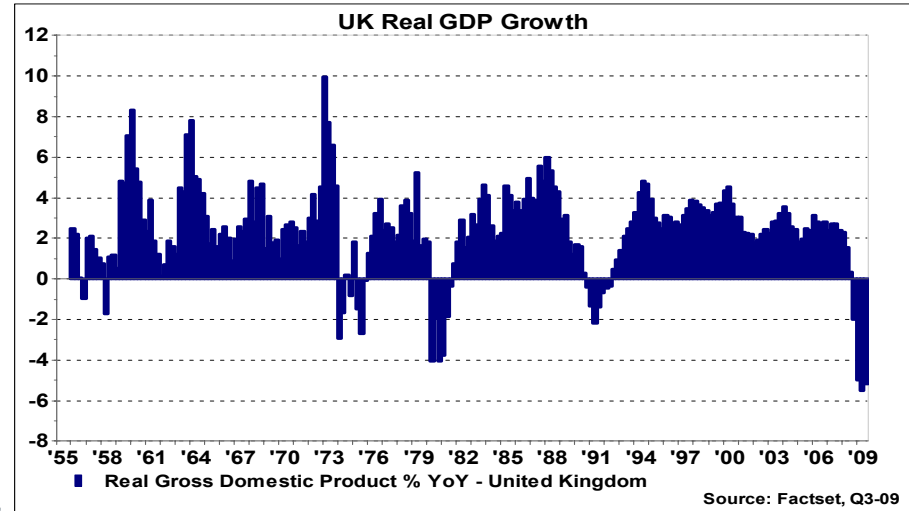
The severity of most recessions is closely related to their duration. Recessions following financial crises are longer than average. Recessions following oil shocks are relatively severe but not very long. The bounce-back from financial crises is weaker than average. The time for output to recover to the level of the previous peak is longer.



Source: IMF staff calculations.

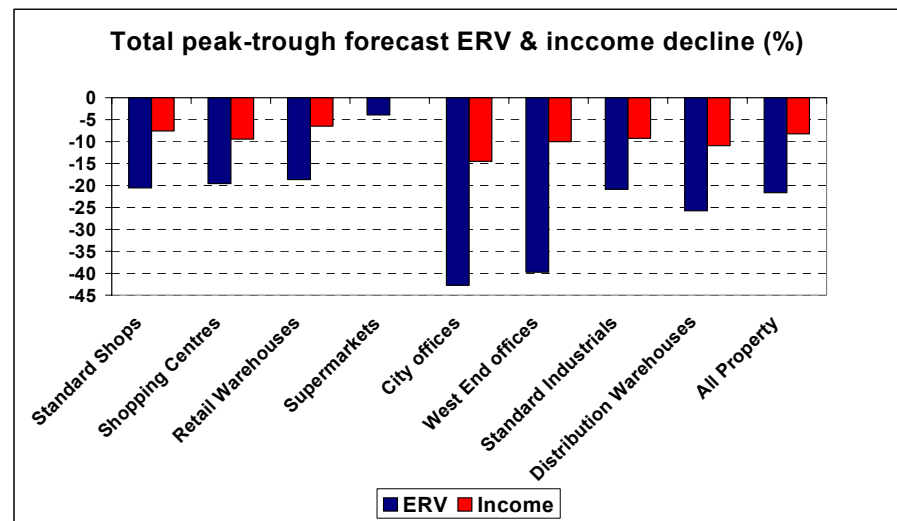
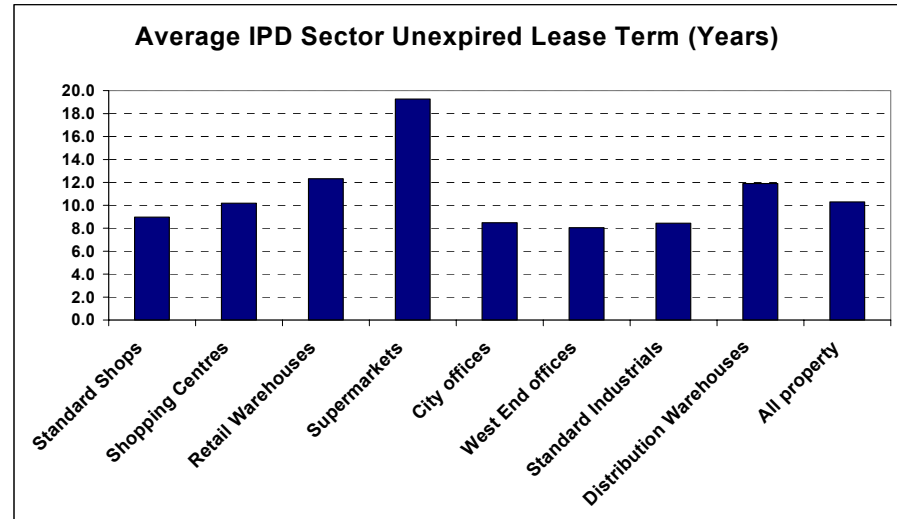
Rents still a long way from recovery phase

- Economic weakness typically feeds through to occupier market with a lag:
 - In early '90s, rents declined for three years after GDP turned
- ... and only now are we emerging from the deepest recession since WWII
- We expect further c15% ERV decline over next 1-2 years
- Upward-only reviews provide protection to income
 - ERVs expected to fall 22% peak to trough, but income decline limited to 8%



Conclusion.....rents likely to fall a lot further

- Economic recovery does not yet mean rental recovery
- Economic recovery likely to be weak
- Oversupply and empty rates considerable issues
- Further ERV declines likely
- Some sectors more defensive



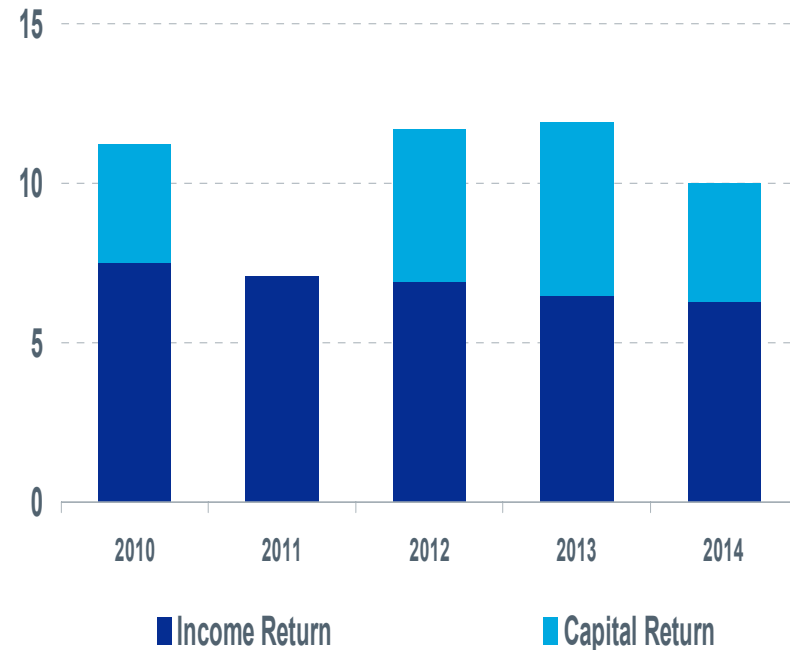


Return Outlook

Yield cycle to dominate rental cycle in near term

- Yield rally to drive strong returns in near term
- Policy tightening and occupier weakness to take wind out of sails - returns to ease
- Returns to pick up again with occupier market recovery in 2011/12
- Attractive returns anticipated over the next five years, but
 - Significant income risk in occupier markets
 - Response of banks to ICR breaches can still destabilise recovery

All-Property Total Returns 2010-14 (% p.a.)



Source: Aviva Investors, October 2009

Strong total returns driven by income component

Aviva Investors strategic preferences...

Where we see value:

- Good quality assets:
 - location
 - building quality
 - covenant strength
 - lease length
- Sector preferences:
 - Open A1 retail warehouses
 - High street shops in top locations
 - West End/Mid Town offices
 - Other e.g. Hotels, Healthcare, Leisure
- Deal led opportunities

Where we are more cautious:

- Secondary investments
- Substantially over rented properties
- Assets with high voids
- Over-rented Central London offices
- Shopping centres
- Single occupier assets (except supermarkets)
- Speculative development

Focus on good quality assets, cautious on secondary