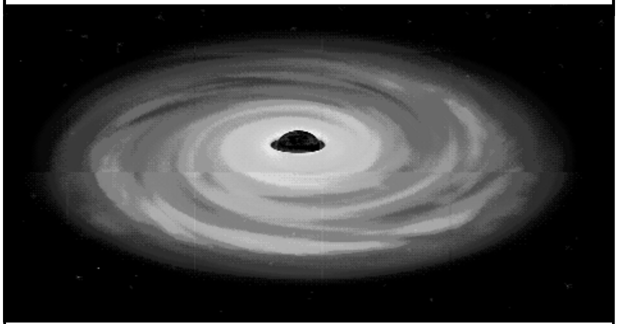
Charles Follows, Director, Head of UK Research & Strategy, ING Real Estate

A commercial property black hole?



Source: NASA Images.org, 2003 "Illustration of Spinning and Non-Spinning Black Holes

REAL ESTATE ING

Charles Follows, Research & Strategy

Agenda

- ► The economic background.
- ► Prospects for rental value growth.
- ► Prospects for property yields.
- ► Prospects for property total returns.
- ► The silver lining.

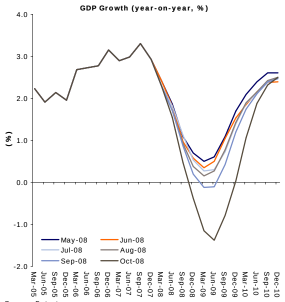
REAL ESTATE ING

Charles Follows, Research & Strategy

"It's the economy, stupid"

Forecasts downgraded again….

- ► *"The economy has been living beyond its means for too long and a prolonged period of pain now seems inevitable"* – James Knightley, ING FM 9th October 2008.
- ► Slower household consumption and business investment.
- ► Government spending unabated.
- ► ING FM have heavily revised downward their forecasts this month with even more negative implication for occupational demand and thus rental growth.



Source: Datastream
Forecasts: ING Financial Markets

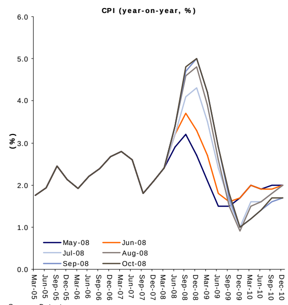
REAL ESTATE ING

Charles Follows, Research & Strategy

The doves slay the hawks

Inflation concerns???

- ► The BoE was hesitant to cut base rates.
- ► Overtaken by poor economic news.
- ► ING FM forecasts CPI down from a peak of 5% in Dec-08 to just 1% a year later.
- ► BoE to slash base rates to 2.75% by mid 2009.
- ► Weak inflation and lower base rates imply a gilt yield temporarily as low as 3½-4% next year, rising back to 5% by late 2010.



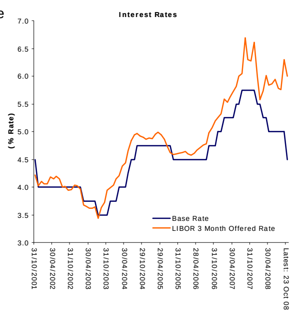
Source: Datastream
Forecasts: ING Financial Markets

REAL ESTATE ING

Charles Follows, Research & Strategy

Even the banks don't trust the banks

- ► 3 month Libor is persistently above the base rate.
- ► Special liquidity reserves have helped … but have not solved the problem.
- ► Rights issues and capital restructuring will continue.



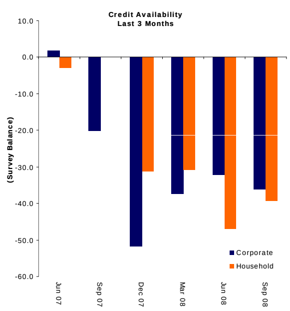
Source: Thomson Datastream, Bank of England, British Bankers Association

REAL ESTATE ING

Charles Follows, Research & Strategy

"Buddy, can you spare a dime?"

- ► Credit availability has tightened.
- ► Loan to values have increased.
- ► Borrowing costs are higher.



Source: Bank of England Credit Conditions Survey, Q3 2008

REAL ESTATE ING

Charles Follows, Research & Strategy

Where are we now?

The World Changed…

1. Risk aversion has increased.
2. Banks must rebuild balance sheets.
3. Credit conditions will remain tight.
4. Psychological reaction to the “Boom to Bust.”
5. Inflation awakened.
6. Fear overwhelmed greed.

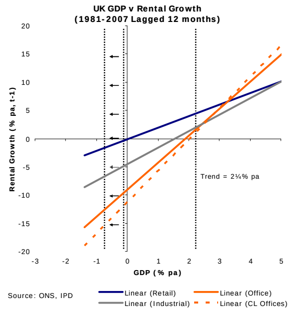
Capital preservation rather than growth!

Charles Follows, Research & Strategy

The demand side

Rent sensitivity to GDP….

- Rental growth lags 12-18 months behind economic growth. Not perfect but a circa 0.7 correlation between the all three sectors.
- ING FM downgrade for 2009 from previously close to zero to around – ¾% on average during 2009.
- The duration of the downswing has also shifted from two quarters to 12 months!
- Note Central London offices increase sensitivity of offices to GDP.
- The increased magnitude and duration of recession means the gap between sector growth projections should widen.



Charles Follows, Research & Strategy

Retail rental value growth

It a consumer sector slowdown….

- Falls in rental values are anticipated across the three core retail property sectors.
- Retail is highly location specific and there will be exceptions.
- Supermarkets to hold up best. Rents remain cheap relative to turnover (latent value) and everybody’s got to eat.
- Retail warehousing is polarised between more resilient true open A1 and bulky parks with their heavy reliance on housing market.
- Active management in shopping centres means you are not fully at the mercy of occupational market movements.

This chart has been intentionally removed from the printed copy

Charles Follows, Research & Strategy

Office rental value growth

Rising vacancy rates, falling rents…..

- The central London office vacancy rate will continue to rise over the next twelve months, reflecting both a financial sector employment downswing and a rise in development completions.
- The West End will NOT be immune!
- The South East has seen a very limited upside in recent years, with an accordingly more limited downside.
- Conditions vary across the regions, look for high income and stability. Avoid locations with high financial sector exposure or unusual heavy reliance on single employer/business sectors.

This chart has been intentionally removed from the printed copy

Charles Follows, Research & Strategy

Industrial rental value growth

Stay overweight…

- We expect London and the South East to under perform regional stocks from a rental perspective, but the difference is negligible.
- Land use pressures on London estates from competing residential will have eased off already, but will remain a longer term factor.
- The attraction remains high yield and lower volatility. This is the best performing UK sector over the very long term!

This chart has been intentionally removed from the printed copy

Charles Follows, Research & Strategy

Rental value growth

The rental prospects are…

- Reduced economic projections impact occupier activity.
- We now expect rental falls.
- The central London office sector is most directly exposed to the economy.
- A silver lining of the credit crunch is that future supply was terminated early in its cycle. The property market need not suffer a 5-6 year supply ‘hangover’ like the early 1990s.
- As the economy begins to recover in 2010, abnormally low development completions provide a foundation for eventual recovery.

This chart has been intentionally removed from the printed copy

Charles Follows, Research & Strategy

Property yields

Some influences on pricing…

- Rental Growth (Economy).
- Risk Free Rates (Gilts/Cash).
- Capital Flows (Cost & Availability).
  - Equity
  - Debt
- Other Markets (Relative Pricing).
  - Other Asset Classes
  - Other Property Markets
- Property Market Sentiment.

REAL ESTATE ING

Charles Follows, Research & Strategy

How far will yields go?

A consensus might be emerging…

- It is possible that we will move our peak yield out from current 6¾% to perhaps 7¼%, yield effects become increasingly less painful the higher you go.
- The September IPF consensus implies a peak yield of just 6.25% - but these will be forecasts from May and June.
- Market pricing may well outpace this at the very bottom of the cycle, just as it did at the very top?

This chart has been intentionally removed from the printed copy

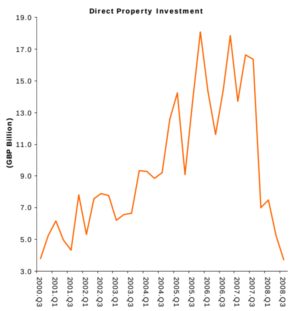
REAL ESTATE ING

Charles Follows, Research & Strategy

Where have all the deals gone?

Reduced market turnover…

- Limited investment activity continues into 2008. A lack of deals and thus evidence has meant that valuations remain sentiment driven.
- IPD initial yields have risen circa 150bps, wiping over 20% off values since mid 2007, with actual market yields likely to have risen further still.
- Sources of capital are likely to remain limited while banks attempt to repair balance sheets and equity investors wait for distress or stability in values.



Source: Property Data

REAL ESTATE ING

Charles Follows, Research & Strategy

More capital value falls to come

- Retail Warehouses had 1 year peak to trough period of 1989 to 1990 where capital values fell -19.4%.
- Residential also had a 2 year peak to trough period of 1989 to 1991 where capital values fell -14.1%.
- Offices in the Rest of UK took longer to recover than the other sectors. Peak to trough period of 1989 to 1997 with a total capital value fall of -16.4%.

This chart has been intentionally removed from the printed copy

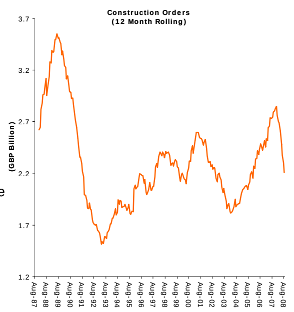
REAL ESTATE ING

Charles Follows, Research & Strategy

The silver lining - reduced development

A foundation for recovery….

- The prospect of a slower economy means greatly reduced occupational demand.
- On the supply side, the credit crunch has cut short the development pipeline. It also remains well below late 1980s to early 1990s levels.
- Most new supply is concentrated in the City office market and a highly limited number of larger shopping centre schemes.
- The implication is that occupational markets will not suffer a persistent supply hangover like the first half of the 1990s.



Source: Property Data

REAL ESTATE ING

Charles Follows, Research & Strategy

What are the known unknowns?

Upside

- Buyers to the rescue.
- Economic out turn improves.
- Bank recapitalisations signal the start of the recovery.
- UK looks relatively cheap.
- Property looks relatively cheap.

Downside

- Forced sellers flood the market.
- Economic out turn worsens.
- Credit crunch persists longer than expected.
- Disillusionment with property.
- Values to fall further.

REAL ESTATE ING

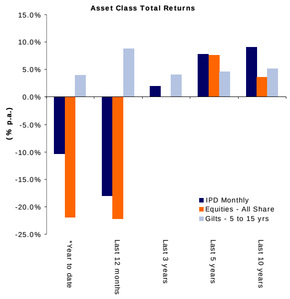
Charles Follows, Research & Strategy

It not just property

► In the long term property is still meeting investors return needs and providing diversification.

► Property should produce a lower return than equities.

► The current under performance is paying back some of the excess returns recently enjoyed.



*9 Months total return (not annualised)

Source: IPD Monthly Index, September 2008

Charles Follows, Research & Strategy

Performance including our projected returns

All Property Total Returns to 2012

	Total Returns (% p.a.)	Standard Deviation (%)
10 Years	6.8	11.3
15 Years	8.1	9.3
20 Years	9.1	8.7
25 Years	8.4	10.1
30 Years	9.0	9.7

Source: IPD Annual Digest & ING REIM Forecasts, Q3 2008

Charles Follows, Research & Strategy

The outlook – emerging from the dark in 2010

ING Real Estate

Important Information

ING Real Estate Investment Management (UK) Limited
Registered office: 2nd Floor, 25 Copthall Avenue, London, EC2R 7BP.