Executive Summary

> Total return of +1.9% from UK commercial property in Q2 2013, outperforming gilts (Q2 2013: -4.1%), UK corporate bonds (Q2 2013: -3.2%) and UK equities (Q2 2013: -1.7%).

> Offices were the best performing sector over the quarter (Q2 2013: +2.4%), led by Central London, followed by Industrial (Q2 2013: +2.4%) and Retail (Q2 2013: +1.4%).

> GBP 8.1bn of investment transactions in UK commercial property in Q2 2013, -11.6% down on Q1 2013 but +2.4% vs. Q2 2012. London remains the focus, particularly for international capital, but limited supply in the West End office market restricted activity. There was a notable increase in investment activity for Industrial and certain Retail properties also.

> Uneven performance between prime and secondary property to date but prime assets, particularly in Central London, are now looking restrictively expensive and difficult to acquire.

> Better yields and value available ex-London, especially for leveraged investors. Downside risks remain though.

> Listed property outperformed UK equities and other asset classes over the quarter. UK REITs remain better positioned than their private counterparts, particularly regarding the availability of finance, and offer investors diversification benefits and immediate exposure to prime property assets.

> Loan origination and distressed debt opportunities are a high conviction. Returns are attractive relative to equity participation in prevailing conditions.

> There has been a rise in co-investment / joint venture opportunities due to difficult finance and fundraising environment.

> Investment in alternative real estate has been attractive due to low correlation / counter-cyclicality to wider property markets; but the attraction diminishes if mainstream market experiences a sustained recovery.

Quarterly Market & Sector Performance

<table>
<thead>
<tr>
<th></th>
<th>All Property</th>
<th>Office</th>
<th>Retail</th>
<th>Industrial</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>3-mth Total Return %</strong></td>
<td>+1.85%</td>
<td>+2.39%</td>
<td>+1.38%</td>
<td>2.35%</td>
</tr>
<tr>
<td><strong>3-mth Capital Growth %</strong></td>
<td>+0.18%</td>
<td>+0.82%</td>
<td>-0.26%</td>
<td>+0.40%</td>
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<tr>
<td><strong>3-mth Income Return %</strong></td>
<td>+1.67%</td>
<td>+1.56%</td>
<td>+1.65%</td>
<td>+1.94%</td>
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<tr>
<td><strong>YTD Total Return %</strong></td>
<td>+2.95%</td>
<td>+3.65%</td>
<td>+2.16%</td>
<td>+3.88%</td>
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<tr>
<td><strong>YTD Capital Growth %</strong></td>
<td>-0.41%</td>
<td>+0.50%</td>
<td>-1.11%</td>
<td>-0.04%</td>
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<tr>
<td><strong>YTD Income Return %</strong></td>
<td>+3.37%</td>
<td>+3.14%</td>
<td>+3.31%</td>
<td>+3.93%</td>
</tr>
</tbody>
</table>

Source: IPD, 2013
Market Summary

UK commercial property produced a total return of +1.85% in Q2 2013 outperforming gilts (Q2 2013: -4.11%), bonds (Q2 2013: -3.15%) and equities (Q2 2013: -1.66%) over the period¹. Year to date, property has produced a total return of +2.95%, outperforming fixed income (Gilts Q2 2013: -3.11%; Corporate Bonds Q2 2013: -0.81%) but underperforming versus equities (Q2 2013: +8.50%), in particular, listed real estate companies (Q2 2013: +9.49%). May 2013 marked a turning point for the UK market with positive capital value growth for the first time in 18 months, reflecting better sentiment in the asset class in line with tentative improvements in the UK economy.

Office

Offices were the best performing sector in Q2 2013 with a total return of +2.4%. Central London offices continue to dominate the investment market with 34% of total UK purchases, mainly from overseas investors². London has experienced a marked increase in activity over the period with take-up rising by +33% between Q1 2013 and Q2 2013 to 3.4m sq ft, over +14% above the 10 year average and the best numbers since Q4 2010³. The majority of this leasing activity was in the City (47%) and West End (29%) sub-markets. Supply increased marginally over the quarter due to the completion of a number of key developments. These factors resulted in robust rental growth in Q2 2013, particularly in the tight West End market⁴. The rest of the UK office market has also experienced resurgent tenant demand so far this year. Take-up in H1 2013 was 2.4m sq ft, +43% above the equivalent period last year and +38% above the five-year average⁵. The majority of this activity was in Yorkshire & Humberside and the South East of England where rents rose over the quarter by +3.9% and +2.1% respectively.

2. Source: Property Data, 2013  
4. Source: CBRE, 2013  
5. Source: Jones Lang LaSalle, 2013
Industrial was the next best performing sector over the quarter with a total return of +2.4%. Like offices, there was a significant surge in take-up from industrial/logistics occupiers from 5.4m sq ft in Q1 2013 to 9.4m sq ft in Q2 2013, the highest quarterly total for 3 years. Combined with a slowly improving supply situation this has led to quarterly rental value growth of +0.11%, the largest increase for the sector since May 2008. Improved fundamentals and a high relative income return has also led to a +24.4% increase in investment activity over the period.

Retail was again the worst performing sector with a total return of +1.4%. Similar to offices and industrial, the market remains highly polarised with Central London and prime, regionally dominant ‘destination’ shopping centres and retail warehouses maintaining customer footfalls and retail sales (and therefore tenants and rental growth) whilst the remainder of the market experiences declines as consumers and retailers remain under pressure in the challenging economic environment. However, there were some minor improvements in both UK retail sales and consumer confidence over the period.

UK Retail Administrations as at Jul-13

<table>
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<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies Failing</td>
<td>38</td>
<td>54</td>
<td>31</td>
<td>26</td>
<td>37</td>
<td>54</td>
<td>25</td>
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<tr>
<td>Stores Affected</td>
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<td>944</td>
<td>6536</td>
<td>5793</td>
<td>2600</td>
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<tr>
<td>Employees Affected</td>
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<td>48142</td>
<td>24025</td>
<td>10930</td>
<td>26688</td>
<td>74539</td>
<td>14083</td>
</tr>
</tbody>
</table>

Source: Centre for Retail Research, 2013

7. Source: IPD, 2013
8. Source: Property Data, 2013
Investment Transactions

Investment volumes in Q2 2013 were GBP 8.1bn, an -11.6% decrease on Q1 2013’s total of GBP 9.1bn. However, transactional activity over the quarter is marginally (+2.4%) higher than the equivalent period last year.9

Overseas Investors remain the most active buyers, purchasing over GBP 3.6bn of property, or 45% of total purchases in Q2 2013. They were also the largest sellers with GBP 2.4bn of sales. UK Institutions were again the second most active buyers with GBP 1.9bn of purchases, mostly ex-London, retaining a slightly positive net position with just under GBP 1.9bn of sales. Perhaps reflecting better sentiment on the prospects for UK commercial property, this is the first time that UK buyers have been net purchasers in over a year.

Private Property Companies and Occupiers also remained net sellers over the quarter with GBP 0.8bn and GBP 200m of net disposals respectively. Continuing assets sales from Banks (Q2 2013: GBP 0.5bn) are symptomatic of their wider de-leveraging initiatives resulting in the current restrictive financing environment for UK property.

Central London Offices continue to dominate UK investment activity with GBP 2.8bn or 34% of total transactions; though proportionately this has been declining steadily since the beginning of last year (Q1 2012: 52%, FY 2012: 44%). Investment in the City, the largest office market in the Capital and its financial centre, rose +27.4% from Q1 2013 to GBP 1.0bn; whilst activity in the West End market declined considerably (Q1 2013: GBP 1.2bn vs. Q2 2013: GBP 671m) principally due to a shortage of available stock, not for want of investor interest. Overseas investors dominate the London office market, accounting for 70% or GBP 1.9bn of transactions including the five largest for the period.

There was also a notable increase in purchases of industrial property assets in line with improved fundamentals for the sector. There was GBP 0.9bn of purchases of industrial and logistics assets in Q2 2013, the largest of which was a GBP 250m portfolio acquisition by ProLogis and Norges Bank Investment Management. This represented a +24.4% increase on Q1 2013’s GBP 0.7bn and the highest total for 18-months. Surprisingly, there were also significant increases, albeit from a low base, in acquisitions of high street shops and retail warehouses where investment rose by +62.3% and +224.6% to GBP 0.8bn and GBP 0.6bn respectively. These figures also represented 18-month highs.10

Transactional yields compressed (i.e. prices increased) slightly over the period in line with IPD data. The only exceptions were South East Industrial (+129 bps), South East Offices (+39 bps) and Shopping Centres (+85 bps). The biggest gains were experienced by Distribution Warehouses (-193 bps), UK Office Parks (-164 bps) and Retail Warehouses (-68 bps). Overall, the All Property net initial yield declined by 3 basis points to 6.86%.11
Listed Property Companies

The FTSE 350 Real Estate Index produced a total return of +6.1% in Q2 2013, significantly outperforming the wider UK equities market, as measured by the FTSE All Share Index, by +7.7% over the period\(^\text{12}\). However, year to date, listed UK real estate companies have only outperformed UK equities by +1.0% after heavy underperformance in Q1 2013.

The UK equities market had a poor quarter after a correction in Mid-May due to weaker than expected economic numbers from China and some inconsistent policy statements from the US Federal Reserve. Resource producers were particularly affected. However, UK REITs\(^\text{13}\) outperformed due to a combination of good financial results, attractive yields, high quality portfolios and a slightly improved economic outlook in the latter part of the period.

After being busy in previous periods, UK property companies were relatively quiet in the capital markets in Q2 2013 with only healthcare specialist Primary Health Properties (“PHP”) and student accommodation developer Unite Group tapping the markets for GBP 68.5m (original target GBP 60m) and GBP 50m respectively via share issues in early June. PHP have subsequently used proceeds for further additions to its portfolio whilst Unite’s monies will help fund its development programme.

Q2 2013 remained an active period for acquisitions and disposals. Hammerson plc, in a 50:50 JV with the Canada Pension Plan Investment Board, made one of the largest acquisitions of the period with the purchase of a 33.3% stake in the Bullring shopping centre in Birmingham from Australia’s Future Fund for GBP 307m. Hammerson’s GBP 153m share was funded from existing resources. The 1.4m sq ft Bullring is the 2nd busiest shopping centre in the UK with over 40 million visitors in 2012\(^\text{14}\). Elsewhere, it was a busy period for industrial with SEGRO adding a portfolio of warehouses and distribution centres in Poland to its portfolio for EUR 43m whilst LondonMetric Property sold a GBP 248m portfolio of eleven UK industrial assets to a 50:50 JV between Prologis Europe and Norges Bank Investment Management at a premium to the most recent valuation.

\(^{12}\) Source: Morningstar, 2013

\(^{13}\) Virtually all of the large UK listed property companies have elected to take REIT status for tax efficiency; thus the term REIT or REITs is generally used when referring to individual listed companies or the sector as a whole.

\(^{14}\) Source: Hammerson, 2012
2013 Outlook and Investment Themes

> Prime property continues to be an attractive destination but is expensive and difficult to acquire
> Better yields and value available ex-London, especially for leveraged investors. Downside risks remain though.
> Debt opportunities remain a principal high conviction investment theme
> Rise in availability of co-investment opportunities due to a difficult fund-raising and credit environment
> Investment in alternative real estate offers low correlation or counter-cyclical opportunities but the attraction diminishes if the mainstream market experiences a sustained recovery

Prime Property and Central London

Prime property remains an attractive destination for international capital in H1 2013. Investment in prime assets with bond-like characteristics, particularly in an internationally desirable market like London and its hinterlands, represents a ‘flight to quality’ for those seeking security of income and capital in difficult financial and economic conditions.

The general low interest rate environment throughout much of the developed world means that the attraction is self-evident: premium locations with long-term leases to high grade tenants provides a stable yield, which is often at a premium to that of equivalent equities, corporate and government bonds. The UK’s landlord-friendly lease structure, the tangible nature of bricks and mortar and the perception that real assets are generally a good hedge against inflation are also key attractions. In addition, overseas investors have benefitted from a weak British pound although their continuing exuberance (see Investment Transactions above) remains a cause for concern.

To date, the recovery from the bottom of the market in July 2009 has been highly uneven with investor interest focused almost solely on prime property in Central London and a few other select locations due to better liquidity, supply/demand fundamentals and superior rental growth. There has been little interest in secondary and regional assets due to deteriorating economic conditions, rising vacancy and declining rents due to limited demand from occupiers. However, the resultant high prices, intense competition and acutely low yields, particularly for commercial real estate in the West End, has led many investors to start seeking value outside of Central London. Leveraged investors would undoubtedly be concerned about purchasing assets at very low initial yields with current bank loan margins considering the rising risk of increases in UK interest rates over 5-years (a typical loan term).

Conversely yields ex-London are currently far more attractive for income focused investors, especially when factoring in debt interest, with a substantial enough risk premium to give comfort in the event of softening property values, a decline in rents or a rise in interest rates. Competition is also considerably lower in these markets. Although market momentum, near-term forecasts and underlying numbers have recently improved, a sustained recovery for commercial property is by no means certain and downside risks remain, not least limited credit availability and its associated problems and real estate’s dependence on the health of the overall British economy.
2013 Outlook and Investment Themes

Nevertheless, risk adverse investors will still be attracted to prime property assets, even if they are overpriced with little capital upside, as these would likely prove more resilient and, crucially, liquid in any market downturn. In practice though, increasingly limited availability and persistent competition from leading global investors makes acquiring prime property at financially sensible prices extremely challenging at present.

A more efficient solution, particularly for smaller (sub USD 15m) investors, would be an investment in a REIT, listed property company or mutual fund. These offer immediate exposure to an existing diversified portfolio of property assets with greater liquidity and, in some cases, lower costs compared against owning directly\(^{15}\). Diversification ensures a more stable income stream for investors as individual lease expiries or the failure of any one tenant or property would have a negligible impact on overall distribution levels or portfolio value.

The added attraction of listed entities is that, unlike private investors, they have been able to access the public markets for both equity and debt. As a result, they were able to quickly recapitalise after experiencing distress in the early part of the financial crisis and UK REITs have been on the ‘front foot’ for some time. Not only has this allowed them to avoid the financing issues mentioned in the following section, but enabled them to, importantly, continue paying dividends, make significant acquisitions and/or undertake developments to further enhance their portfolios. In Central London, REITs and listed companies dominate the major West End and City of London development schemes and are far better placed than many of their contemporaries (via pre-lets etc.) for current and future conditions in these key markets.

\(^{15}\) Standard purchaser’s costs for UK commercial property are 5.80%. Bid/offer spreads on more liquid REITs and listed companies are generally lower. Mutual fund bid/offer spreads tend to reflect purchaser’s costs. Source: Emirates NBD, 2013; IPD, 2013
Debt Opportunities

The lead up to the financial crisis in 2008 was characterised by an excess of borrowing (or leverage) from all parties, leading to a prolonged, but unsustainable inflation of asset values. Property, in general, is a capital intensive asset class and was a significant beneficiary of the sustained credit boom. The on-going dysfunction in the financial system has therefore hit the sector hard.

The principal problem is that UK-based banks have lent an estimated GBP 164bn\(^{16}\) to commercial property and values are still -37% below their June 2007 peak, even after a sustained, albeit highly uneven, rally in prices between August 2009 and November 2011\(^{17}\). As a result, it is estimated that there is approximately GBP 39bn\(^{18}\) of commercial property loans currently in negative equity (i.e. the value of the property is less than the outstanding loan amount).

In order to avoid another potential collapse, financial regulators have imposed tough new capital requirements on banks, principally under regulation known as “Basel III”, that are set to be implemented between 2014 and 2019. Tighter capital requirements - an increase in the ratio of bank reserves against risk-weighted loans - means that more capital has to be set aside for riskier assets on the balance sheet such as property loans. Persistent concerns about the long-term health of the banking sector has led to limited enthusiasm from private investors for further bank recapitalisations (at any price) which leaves little option but to significantly reduce risk-weighted assets. The easiest way to do this is via loan sales to third parties. This bank ‘de-leveraging’ has fundamental implications not just for the UK, but for global real estate.

Banks are the main providers of real estate finance in the UK and Europe and the on-going reduction of their balance sheets inhibits further loans which, when combined with virtual paralysis in the European securitisation market, means that new lending to real estate is severely restricted. In addition, many of these banks have been recapitalised by taxpayer funded bailouts leading to intense political pressure to focus on core markets and businesses, usually through increased lending to consumers and small and medium sized businesses (“SMEs”) in order to support the national economy, and therefore far less on real estate speculation.

This is problematic if you 1) require finance to acquire an asset, 2) your existing property loan requires refinancing or 3) you are a bank that is relying on repayment of your existing loan from another lender. These more or less cover everyone with an interest in commercial property. Due to widespread and persistent losses, the simple solution of the existing borrowers injecting further equity in order to pay down the loan is not a realistic option. Likewise, notwithstanding the impact of crystallising losses, a large scale sale of assets by lenders on the open market would further depress prices and exacerbate the current problem as it did in the 1990s.

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17 Source: IPD, 2013
18 Source: De Montfort University, 2012; CoStar, 2013

Source: Bloomberg, 2013
Debt Opportunities

Although banks have made some progress in reducing their legacy real estate exposure (outstanding loans are down -4.6% YTD\(^1\)) and there are some tentative signs of improvement in the lending market, limited credit availability and a large number of distressed borrowers presents significant downside risk to any sustained recovery in commercial property values.

However, the current turmoil does create some compelling opportunities for new lenders and those that can capitalise on the distress in both the property and financial markets. New Europe-wide legislation for insurance companies, known as “Solvency II”, is having the opposite effect to Basel III by making secured lending a more attractive proposition and insurance companies are now some of the most active lenders to real estate\(^2\). Combined with dedicated funds, other financial institutions and even sovereign wealth funds, these ‘non-bank’ lenders have an estimated current capacity of circa USD 173bn\(^3\) to be deployed over the next few years.

Participation in these loan origination opportunities is an area of high conviction - presenting investors with the opportunity to capitalise on the current distress and to gain superior, ‘equity like’ returns (i.e. returns from being an equity participant in the property’s capital structure) by making new loans on prime assets at highly attractive margins in the absence of traditional sources of finance. Participating lower down the capital structure also provides greater security against any potential decline in values, as any equity in the property would be in the ‘first loss’ position.

Another debt opportunity presented by current bank deleveraging is the acquisition of loans, both public and private, secured against property at a deep discount to original or ‘par’ value. Investors receive discount-adjusted coupons (interest on the loan) and holding to maturity or foreclosing on the borrower can lead to a potential capital value ‘uplift’. However, this is a complex strategy requiring specific expertise, large pools of capital and high-level relationships within banks or government agencies (for the so-called ‘bad banks’) to execute effectively.

The current lack of finance combined with limited investor interest in more core property funds and a desire by investors to be more active in the management of their investments has led to increased co-investment or joint venture opportunities alongside leading asset managers or developers. However, these are generally higher risk from a property perspective as they often involve development and lease-up risk.

Select UK & European Real Estate Loan Sales YTD 2013

<table>
<thead>
<tr>
<th>Date</th>
<th>Seller Closed</th>
<th>Project</th>
<th>Country Name</th>
<th>Purchaser</th>
<th>Face Value GBPm</th>
<th>Sale Discount to Par</th>
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</thead>
<tbody>
<tr>
<td>Jan-13</td>
<td>Lloyds Banking Grp</td>
<td>Project Chamonix</td>
<td>Germany</td>
<td>Marathon Asset Mgmt</td>
<td>725</td>
<td>53%</td>
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<tr>
<td>Jan-13</td>
<td>Lloyds Banking Grp</td>
<td>Moran Hotel Loan</td>
<td>Germany</td>
<td>Canyon Capital Advisors</td>
<td>120</td>
<td>70%</td>
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<td>Feb-13</td>
<td>RBS</td>
<td>German Resi Mort</td>
<td>Germany</td>
<td>Macquarie</td>
<td>75</td>
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<tr>
<td>Mar-13</td>
<td>RBS</td>
<td>Harold Center</td>
<td>Germany</td>
<td>Deutsche Euroshop</td>
<td>160</td>
<td>-</td>
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<td>Mar-13</td>
<td>RBS</td>
<td>Pegasus Portfolio</td>
<td>Germany</td>
<td>AXA REIM / Norges Bank</td>
<td>670</td>
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<td>Apr-13</td>
<td>Allied Irish Bank</td>
<td>Project River</td>
<td>UK</td>
<td>Davidson Kempner</td>
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<td>Lloyds Banking Grp</td>
<td>Project Thames</td>
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<td>Cerberus</td>
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<td>Jul-13</td>
<td>EuroHypo</td>
<td>UK Loan Book 1</td>
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<td>TBC</td>
<td>IBRC</td>
<td>UK &amp; Irish Loans</td>
<td>UK/Eire</td>
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</tr>
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</table>

Source: DTZ, Cushman & Wakefield, 2013

20 Source: DTZ, Savills, 2013
21 Source: DTZ, 2013
Alternative Real Estate

Alternative real estate is a wide-ranging term that refers to real estate outside of the four main sectors: office, retail, industrial, and residential. Valuations and income from these properties has little or even no correlation to wider economic, financial and/or property market conditions and may even run counter-cyclically to them. A good example would be rising student numbers during a recession as redundant workers seek new qualifications or graduating students remaining in further education due to limited employment opportunities leading to increased demand for bespoke accommodation.

The main forms of investable alternative real estate in UK are:

1. **Infrastructure**: Infrastructure is perhaps better classified as ‘real assets’ (as opposed to real estate proper) that can either support economic activity and economic growth, such as through utilities or transport, or important social functions such as education or healthcare.

   Infrastructure revenues are considered to be extremely defensive as they are typically generated from long-term contracts to local, state or national government entities or regulated utility companies. They are also often inflation-linked or contain fixed uplifts.

2. **Healthcare**: As per above; although it may also refer to property assets leased directly to public or private healthcare providers.

3. **Leisure**: Usually means hotels but, in this case, it refers to holiday destination sites such as camping and leisure parks. Although unglamorous, it capitalises on reduced consumer spending on overseas holidays\(^{22}\) and presents plenty of consolidation opportunities. Many parks also have residential conversion potential.

4. **Residential ground rents**: Specific to the UK, ground rents are the regular payments made by leaseholders to the underlying owner of the land, known as the ‘freeholder’. Although individually they are nominal amounts (GBP 100 to GBP 200 per annum per property are typical), it is a highly defensive income stream as default by the leaseholder would result in cancellation of the lease – effectively allowing the freeholder to reclaim the property for virtually nil value. Likewise, lease expiry would result in reversion of ownership. In practice, these are extremely rare events.

   Additional ‘value-add’ opportunities are available via management or insurance charges and lease extension payments or sale/partial sale of freeholds (known as “enfranchisement”).

5. **Student accommodation**: Purpose built student accommodation either let to a university or directly to students through a specialist management company. As per above, student numbers can bear little relation to wider economic or financial market conditions\(^{23}\). Also, rental payments are, in many cases, effectively underwritten by a parental guarantee (either implicitly or explicitly). Like other residential property, rents can be reviewed on an annual basis or even at the end of every semester.

Student accommodation has, over recent years, become a much more accepted and popular investment class. In 2012, GBP 1.3bn of student accommodation was purchased or forward funded for development, an 80% increase from 2011\(^{24}\). This was logical given the sector’s (expected) countercyclical performance versus mainstream commercial property and other asset classes over the past few years.

However, there are rising concerns about oversupply in a number of regional markets and softening on the demand side\(^{25}\) due to a substantial rise in tuition fees and tighter visa restrictions for overseas students. A raft of new entrants to the sector, little long-term evidence of liquidity for completed properties and the forthcoming Community Infrastructure Levy add to these concerns.

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\(^{22}\) In 2012, UK visits abroad were down -18.1% vs. 2008. Source: ONS, 2013

\(^{23}\) UK university applications and UK GDP have a -0.6 correlation. Source: UCAS, ONS, 2013

\(^{24}\) Source: Lambert Smith Hampton, 2013

\(^{25}\) UK university applications were down -6.6% between 2011 and 2012 though have recovered slightly by +2.7% in 2013. Source: UCAS, 2013

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