

# Viewpoint

## F&C REIT managed portfolio scoops top award for second consecutive year

**F&C REIT are celebrating success for the second year running at the influential IPD European Property Investment Awards. The Friends Provident Life and Pensions With Profits Fund property portfolio won the IPD Balanced Fund: Highest total return annualised over 3 years to December 2010 for the UK.**

The fund, which is managed by F&C REIT, also won the award for Insurance Company Life Funds above £100m and below £1000m, for the highest 3 year annualised return to December 2010.

Richard Kirby, Property Director at F&C REIT, who manages the portfolio, commented: "We are delighted to have won such a prestigious award based solely on performance which is further validation of the successful track record of F&C REIT. The Friends Provident With Profits fund property portfolio has been significantly reshaped in recent years and this recognition validates our conviction sector holdings and strong asset management initiatives throughout this period."

F&C REIT, as a house, has continued to deliver superior performance across its IPD monitored funds. A hypothetical "house fund" would have out-performed the IPD average over the past quarter, year, three years, five years and ten years.



*Richard Kirby, manager of the award winning Friends Provident Life and Pensions With Profits Fund.*

## F&C REIT market activity



*Zvi Noé, European Investment Director at F&C REIT*

F&C REIT has continued to invest heavily in 2011 as evidenced by a recent club deal for our clients including AREA Property Partners and ESAS Holding (Turkey), for whom we have completed three acquisitions in a transaction totalling some £120m. The three investments consist of an unbroken parade of retail units and office suites in Stevenage, Halton Lea shopping centre in Runcorn and a portfolio of regional offices purchased from St Martins. These properties have been purchased for a yield in excess of 8%.

Zvi Noé commented "The assets acquired are fundamentally good quality, well-located properties that offer a variety of value creation opportunities, through targeted asset management initiatives"

Established funds in the F&C REIT stable, both in the UK and in Europe, have also seen success in acquiring assets at realistic prices, despite a shortage of stock which is especially acute at the prime end.

## Stocking up

F&C REIT is actively seeking property for its various funds in all sectors of the market, including both prime and secondary, and has reviewed c. £5bn of real estate in 2011 to date. Given our ongoing coverage and ability to source opportunities we have been further encouraged by what we see as a recent uptick in the flow of stock onto the market that we hope will lead to a greater opportunity to purchase stock throughout the rest of 2011.



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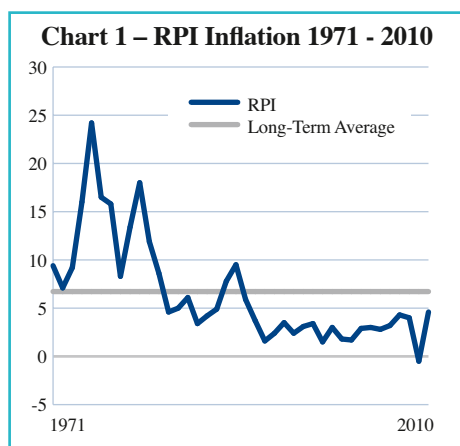
*Passionate about adding value*



# Property in an inflationary environment

**The inflation rate, as measured by the CPI, is now 4.5%, more than double the target rate. This has raised concerns that inflation may once again become endemic in the UK economy. In turn, this has led some investors to look towards property as a hedge against inflation. Will property offer protection against inflation this time?**

The upturn in inflation needs to be placed in context. Compared with the rates seen in the mid 1970s, inflation is still running at very modest levels, as Chart 1 below shows.



Source: ONS

There is a widespread belief that the recent acceleration in prices has been boosted by temporary factors such as higher taxes, especially VAT, and rising commodity prices. The consensus view is that the CPI will peak in 2011 and will be 4.1% by the end of 2011. It is expected to exceed the target thereafter but stay below the 3% that triggers an explanatory letter from the MPC. So this may be a problem that never happens and it may be that other factors such as the economic cycle and property fundamentals outweigh the impact of inflation in determining property performance.

Supposing that it does happen; what evidence is there that property protects the investor against inflation? Theoretically, it should have some influence with rents being adjusted to take account of price rises and feeding through to higher capital values. In practice, this is less certain. When total returns are considered over the period back to 1971, the correlation

between the retail price index (RPI) and total returns falls to virtually zero. The 1971-2010 period contained many years when inflation was not really an issue for investors. Considering only the years of above average inflation, total returns delivered a better than average performance in six out of eleven cases.

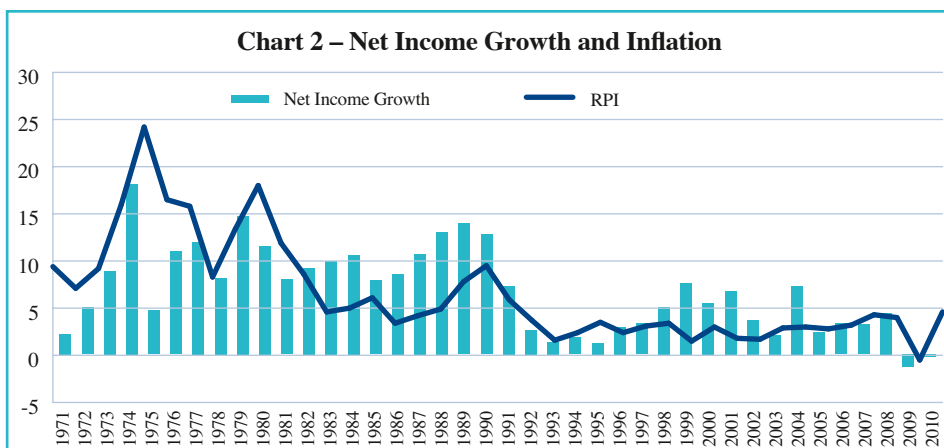
The performance of the past may not hold during the future. This has two aspects with regard to inflation and property.

- Is the 2011 inflation the “right sort of inflation”?
- Is the 2011 property market the “right sort of property market”?

The “right” sort of inflation for property is one where price increases will lead to higher nominal rental values and hence boost performance. That will typically be in periods where the economy is growing, economic capacity is strained, firms are competing to take space and supply cannot meet demand. In these circumstances, there is upward pressure on rents, rising income from property and higher capital values. The wrong sort of inflation would be the “cost push” variant where prices are rising

at the input level but firms cannot pass the increase on fully due to lack of demand and so they have to cut back elsewhere in their operations to balance the books. In this situation, not only will inflation fail to feed through to rents but it could put downward pressure on rental values. At present, with the economy struggling to shake off a sharp economic downturn, output is not forecast to return to 2008 levels until end 2012, austerity policies in place restricting growth potential, and producer input prices up 17.6%, the balance of probability favours the less favourable cost push variant of inflation. It could be, if inflation levels remain high, that second round effects could kick in and undoubtedly the Bank of England is monitoring that aspect closely, but at present there seems little sign of this.

A positive second round effect for property would be if wage growth moved up to match price increases, boosting retail sales but employment and wage data provide little support for this, at least in the short-term. Indeed, if inflation hits margins and intensifies occupiers’ problems of slow growth, low demand and restricted credit,



Source: IPD, ONS



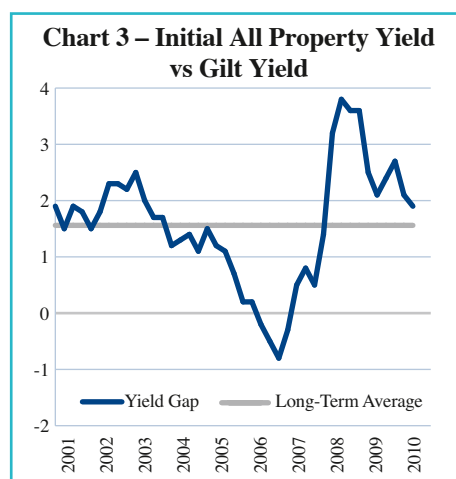
this could precipitate a rise in tenant failures and put further pressure on an already fragile occupier market, especially if higher prices also lead to higher interest rates.

This leads to the second point. Is the property market in the right place to benefit from an upturn in inflation? This looks doubtful. Apart from Central London, rents remained under pressure in most parts of the property market at the end of 2010. Incentives are substantial and the vacancy rate is still high by past standards. Occupier demand remains linked to lease events rather than expansion. The scope for landlords to push rents higher in this environment is limited. The one exception may be in areas where supply is very tight.

As well as the cyclical element, an upturn in inflation may not yield longer-term benefits on structural grounds. Since the 1980s, lease length has shortened dramatically and the five year rent review period may soon be obsolete in an era where 72% of new leases are for less than five years. While this may allow rents to be re-set more frequently, which would be beneficial as inflation accelerates, other things being equal, it also increases the risk of voids and reduces the post inflation boost to income witnessed in earlier cycles. (Chart 2).

Concern about the impact of higher inflation is not limited to the occupational market. At present, property is fairly priced against the risk free rate given the historic risk premium but as gilt yields have moved up, attributed by some to fears of higher inflation, this gap has narrowed. This rise in gilt yields restricts the ability of property yields to fall further and could put upward pressure on yields

soon. This is especially true if the risk premium today, after the credit crisis and in a time of economic and financial uncertainty, is above its ten year average. If yields were forced outward, either by a rise in interest rates or a closing of the yield gap against gilts, this clearly would be negative for the performance of property. (Chart 3).



Source: IPD

Inflation can be beneficial by cutting the real cost of debt repayment. This holds if borrowing costs do not move up in line with the rise in prices. The scale of the banks' problem loans and their desire to

cut back their lending on property may act to limit the benefit to property from this aspect of inflation and there is no guarantee that capital values will rise in inflationary times.

For investors seeking a hedge against inflation, it may be helpful to look at which asset classes were the best performers during periods of more rapid inflation. During the period 1971-2010, inflation was above average in fourteen years, in two time periods. In those years, among the three asset classes, equities held the top position five times, property five times and gilts four times in terms of total return. Property delivered top performance only in the inflationary period of the 1970s-1980s. In the smaller inflationary blip of 1989/90 – equities and gilts both had their day – but not property.

It would therefore appear that the theoretical justification for investing in property to protect against persistently high inflation is stronger than that the empirical evidence would warrant. Inflation is only one element in the investment decision process and investors need to consider all aspects and focus on the fundamentals.

Property versus Equities and Gilts in Inflationary Times – Years of Top Performance – Total Returns			
	Equities	Gilts	Property
1971-82 inclusive	4	3	5
1989-90 inclusive	1	1	0
Total	5	4	5

Source: IPD Annual Index



# Fund Updates

## FOSCA

The original French office SCA, FOSCA, which was launched in 2004 in partnership with OFI REIM, has begun the process of realising its investments for distribution to investors.

Two assets have been sold to date realising a total of €40.1m. The proceeds have been applied to reduce the funds gearing towards 50% and to pay back investor interest and capital.

Distributions totalling €17.1m or 8% of capital were paid in 2010.

The fund has outperformed the IPD's ePPFI index over 6 months, 1 year, 3 years and 5 years. The one year performance to June 2010 was 16.9%, compared with the ePPFI average of 10.4%.

Many of the assets still have some value to extract and as the Paris office market is still strengthening, the assets will be sold in tranches during 2011 to maximise the return to investors.

## FOSCA II



*The first purchase for the FOSCA II fund, 27 Rue Jean Goujon, Paris*

Having raised €156m from two closings, the fund has now drawn down €101.7m and has acquired three assets valued at €104m.

- 27 Rue Jean Goujon, in the 8ème arrondissement in central Paris, is located south and west of the Champs Elysées, famous for elite fashion retailers, and close to Avenue Montaigne, a globally renowned retailing street.

The buildings in rue Jean Goujon are generally offices occupied by leading fashion businesses and the tenant, Moët et Hennessy, is a subsidiary of LVMH, a French company dedicated to luxury goods.

- 7 Rue Mornay, in the 4ème district of Paris, is a 3000 sq metre office building with Haussmanian architecture, and is fully let to the city of Paris.
- 40 Rue du Louvre, in the corner of the Jardin des Halles in the 1er district of Paris, is a 9000 sq metre office and retail building with 19th century classic style architecture, is also fully let to the city of Paris.

There are discussions with investors for a final close and we look forward to making an announcement shortly.



*7 Rue Mornay, Paris*

## Future

After the capital raising for FOSCA II is complete, the OFI REIM / F&C REIT partnership remains a key strategic relationship with F&C REIT's stated intention to evolve future products across Europe with OFI REIM, our partner of choice in France.

## German Best Value I

We have received further indications from German investors that a final close of the Best Value Fund I of c. €160m will take place in June; the team are now heavily focused on investing across Germany. The fund has now invested / has property with the notary of €43.8 million and a further €91.2 million in due diligence. In addition, the team has reviewed offers with a value of more than € 5.6 billion as at April 2011 across Germany. Iris Schöberl commented: "We are excited about the ongoing opportunity in Germany and with the increase in deal flow we have seen, are confident of achieving the returns set out for our investors"



*40 Rue du Louvre, Paris, a FOSCA II property*



## The F&C UK Property Fund



*Empire Court, Trafford Park, a new acquisition for the F&C UK Property Fund.*

The F&C UK Property Fund, a UK open-ended fund, was launched barely a year ago and has seen strong flows, taking the fund size past the £30m mark due to an ever widening investor base. The fund continues to purchase properties with attractive yields throughout the UK. The latest acquisitions include a standalone office in the centre of Reading, Adelphi House, which offers government backed income until 2018 at a yield of 7.65%, twice the current gilt yield. Diversification is also being achieved by the acquisition of Empire Court in Trafford Park, Manchester, pictured, a recently constructed industrial / distribution unit which is securely let to Macfarlane Group UK Ltd and produces an attractive property yield of 8%. The fund provides exposure to all the major sectors spread over a variety of locations from Chichester to Edinburgh. A number of new opportunities are being reviewed to continue allocation of the cash inflows into good quality property providing a healthy income return for the investors.

*60/61 Grafton Street, Dublin 2 – This retail property is a single let to Disney and is over 11,600 sq.ft. Grafton Street is a prime retail shopping street in Dublin city centre.*



# The View From Ireland

Des Dennehy, pictured above, has recently been appointed Director, Property Funds for F&C REIT in Ireland. Here he discusses his approach to property investment and the outlook for Irish commercial real estate.

On the 31st March 2011 a great friend and mentor decided to retire and thus this exciting and challenging opportunity of heading up the F&C REIT office in Ireland was passed to me. Some might think, and actually some have commented on the timing of this appointment with regard the prevailing economic climate and property markets in Ireland. However, unlike the past we see this as a great opportunity for well advised real estate investors to enter an established and developed market with fundamentally strong future prospects.

The F&C REIT office in Ireland has been established for almost 30 years providing real estate advice and fund/asset management services to various institutional and private clients across Ireland, the UK and the Netherlands. Currently the Dublin office manages in excess of €350million of



real estate investments. While modelling the macro influences on the markets is important, real estate is a tangible asset with its own unique risk profiles and value drivers thus demanding a more holistic approach than used for other asset types. This clear knowledge and deep research led approach has seen F&C REIT in Ireland win numerous awards including the IPD “Best Balanced Fund Ireland annualised over 3 years” in 2009.

At the height of the boom, domestic investors dominated the market, making it difficult for foreign buyers to access stock. The market had provided strong returns with good sustainable growth prospects. However, the advent of cheap and easily accessible credit caused an overheating of the market, as the emergence of private and syndicate debt investors fuelled unrealistic pricing. The subsequent real estate and banking crash and Ireland’s economic problems have been well covered by the media and despite negative sentiment, this fundamental and painful rebasing of the economy and market uncertainty, the real estate sector has, and will, produce opportunities.

As we enter this new era, F&C REIT in Ireland has continued with its sustainable business model; working with and advising clients on issues and opportunities. We are one of the few European houses with a long standing, influential presence in Ireland. This enables us to identify, deliver, advise and manage new opportunities for F&C REIT clients, as various existing property owners seek to dispose of assets, rebalance their businesses or seize the opportunities presented in the current market.

With this solid base and strong presence we will continue to identify and create opportunities for F&C REIT clients to take advantage of what is a strong investment prospect.



# Turning Round a Troubled Asset: The Star City Experience

**The next 12 months are expected to be challenging for real estate but there are areas of opportunity. The banks are starting to release stock onto the market. Some of these assets will have been bought and traded during the upswing with quick turnover enabling profits to be realised but at the expense of under investment in the asset itself. The problem was compounded as the property downturn gained force and the credit crisis intensified, with highly leveraged owners sometimes unable to pursue asset management initiatives for financial reasons.**

Property needs to be managed effectively on an on-going basis to deliver performance, it is a “real” asset and without the investment of time, money and skill, it will depreciate. The unwinding of property loans is a major initiative and the banks, which currently hold more than £200bn of commercial property loans on the books, are seeking to reduce their exposure significantly. The banks and indebted buyers are not selling at fire sale prices, so the key will be to identify “hidden gems” within the stock being made available, assets where the true potential has not been realised.

There are two elements to adding value from this source. One is to identify stock that has the potential to benefit from such a strategy; some assets will simply be obsolete. Secondly, a successful value enhancement policy needs to be pursued; one which weighs the costs incurred against the financial benefits. Given the potential issues associated with long-term under-management, this may involve, but also go well beyond, initiatives such as re-gearing leases. The asset may need substantial investment to re-position it in a changed marketplace or to align it more closely with the current market and future outlook. There

are very few organisations with the necessary skill set and financial clout both to select the asset capable of benefiting from a “turnaround” strategy and to implement that strategy over what may be a fairly long time horizon.

F&C REIT has had significant experience in buying and asset managing unloved property and Star City in Birmingham is a case in point.

Star City was built on the site of a disused power station two miles north east of Birmingham, and opened in 2000 with an adult-orientated offer themed for nightlife, with a casino and nightclub. The 390,000 sq ft centre had a variety of occupiers but also its share of problems, and different managers, in the early years. A tram service which it was hoped would link the centre with surrounding areas, failed to materialise while the Las Vegas themed open-air design posed problems when translated to the Birmingham climate. Security and safety at the centre became a major concern. F&C REIT bought the complex in 2007 for £85.5m, in time for the credit crisis and economic recession to make the situation still more challenging.

A three point strategy was adopted. There was a thorough review of security, including introducing the UK’s first automatic number plate recognition system. The second element was to re-position the scheme away from late night entertainment and towards a more family friendly offer whilst the third policy was to spread the news of the changes widely throughout the property world and the local community.

The security measures bore fruit almost immediately. In conjunction with the police, the Serious Organised Crime Agency (SOCA) and the DVLA, measures were put in place, which reduced criminal activity by two-thirds between 2008 and 2010. The security staff now has a dual role, still ensuring that the problems of the past do not recur but also increasingly adopting a supportive and protective role; acting as ambassadors for the scheme and illustrating that it is now a safe and secure environment.

Star City benefits from 2400 free car parking spaces. This was a major potential attraction for customers and measures were taken to improve lighting levels and safety, by replacing obsolete fittings with longer lasting and more cost effective products.





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In 2010, Star City won the Safe Car Parking Award. The scheme itself needed to be radically re-shaped and re-positioned in order to appeal to a different demographic; the car owning family orientated consumer. The atrium was radically re-modelled. The ski slope placed there was deemed too big for the space and hence too steep and dangerous. It also blocked lines of sight which affected pedestrian flows. F&C REIT replaced this with a centrally located coffee area with the aim of increasing the dwell time. This change makes a feature of the 120 ft atrium allowing light to flood in and creating a sense of space. The centre also uses the atrium for family friendly events and activities particularly at holiday periods such as Christmas and Eid to boost footfall. Other initiatives have included live music including a jazz festival, a pantomime, theme rides, funfairs, firework displays and even high profile attractions such as the Chinese State Circus and Cirque de Soleil.

Any centre though needs more than this to attract repeat visits. The tenant mix has been overhauled. Star City now comprises a wide range of leisure attractions. England's first Indoor Mini Golf Complex opened in 2008, together with lettings to Laser Quest and Climbing Wall in the same year. With football, bowling and a gym also available, the centre can offer a wide range of activities, complemented by a 24 screen cinema showing Hollywood and Bollywood films and including three luxury "Gold Screens".

F&C REIT is committed to working with tenants to improve the centre further. Income generating space can detract from a scheme if it is vacant and F&C REIT has been proactive in identifying securing new tenants for areas where tenants have vacated but still have lease obligations. The company is prepared to make every effort to turn around a troubled asset.

Tenants have also benefited from a rigorous system of cost control and the service charge regime has been overhauled and kept at the same level for three years. Money has been invested where it can be justified in order to add value. The largest single item of expenditure was the construction of a McDonalds restaurant. This is open 24 hours a day, seven days a week and raises the profile of the scheme, bringing in new customers who can see how Star City has been re-vitalised. Catering is a major element of the scheme and Star City offers Indian, Chinese, pan Asian, American, Italian and vegetarian options as well as more casual dining. Recent lettings in this area have included Kebabish Original, Real China, KFC and Espresso Emporium.

The third plank of the strategy was to publicise the scheme to raise its profile among both potential occupiers and customers, stressing the changes made. Star City has a website, circulates a newsletter, assists in tenant run promotions



*The new-look Star City*

and also has a membership scheme which hosts competitions and special offers. It is running an advertising campaign with Trinity Mirror and going into partnership with a major local radio station. Star City sponsors the Lord Mayor's Family Day and supports local schools thereby raising awareness among families.

The transformation is not yet complete and there is still a long way to go. The former nightclub remains "dark" and options are being explored to utilise some under used space in line with the strategy of attracting a more affluent and child friendly demographic. Progress is being made and with current tenants praising the scheme and average customer spend increasing, this troubled asset appears to be on the road to recovery.

The coming few years will see schemes coming to the market which have been under-managed. F&C REIT is one of the few organisations with the skills and the experience to identify areas of opportunity and to invest in under-performing assets and re-position them to deliver superior performance.



*Star City panorama*

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