AVIVA INVESTORS

on the up?

May 2010

Luke Powell tells us why he believes things are looking up for European commercial property.

It's been an interesting few years for the commercial property market. In the UK, boom was followed by bust and now we're in the middle of a mini-boom in capital values. So, is the same about to happen to European commercial property too?

At Aviva Investors, it is our belief that the rapid rise in UK capital values might not have much further to go. The recovery has been driven by investors recognising that commercial property had become over-sold and represented good value compared to other asset classes, like bonds or equities.

Whilst a similar recovery has not yet taken place in the rest of Europe, it may just be a matter of time before it does. Investors looking for a potentially attractive investment opportunity in the form of capital value growth and reliable income streams from rents might look no further than European commercial property.

why invest in European commercial property?

We believe there are three key drivers:

1. The sector seems well-placed to deliver attractive returns in the coming years.
Real estate is a sector whose fortunes are closely tied to those of the wider economy. Since we appear to be at the beginning of an economic recovery, commercial real estate markets could be set to experience an upturn. In general, most European commercial property markets are close to, or at, the bottom of the cycle. Just as UK values have rebounded rapidly, so continental European real estate could now experience recovering capital values. We do not expect this recovery in values to be as sharp as we have seen in the UK in the last 6-9 months – mainly because much of the rest of Europe did not experience the same highs and lows as the UK has in the most recent economic cycle – but there is still potential for attractive returns. We forecast average annual returns of 7.4% per annum for continental Europe over the period 2010-2014.* Moreover, we expect the majority of this return to come from rents rather than capital value growth, which is generally a more sustainable and reliable source of returns.

2. Continental Europe real estate can offer strong diversification benefits.
Continental Europe is a very diverse market and different countries and sectors are likely to perform differently in the coming years. For example, while we believe that 'core' Europe – by which we mean France, Germany, Scandinavia and the Benelux countries – is likely to offer appealing investment opportunities, we are far more sceptical about the current potential of other countries in the region. For example, the severe economic problems currently facing countries like Greece, Spain, Portugal and Ireland make us believe that their real estate markets could be troubled for some time yet. With such variable economic performance and projected commercial property market returns within continental Europe, many investors are wary. However, for the informed and knowledgeable investor there's the potential to outperform the wider market by investing in those markets likely to deliver strong performance and avoiding those others that are likely to be sluggish. In the commercial property market, this can make a big difference to the returns that investors receive.

3. Lower economic risk profile.
In general, the economies of 'core' Europe (with France and Germany to the fore) do not have fiscal problems comparable to those of the UK. Their budget deficits are lower and they will not have to increase taxes and/or reduce government spending to the same extent as the British Government will have to. Quite simply, their economies are not as saddled with

debt as the UK is. With an export base that will support their economies in the recovery, they do not look as vulnerable to the dangers of a double-dip recession. This means that their commercial property markets are likely to be less volatile.

what are the risks?

Given the severity of the recession we've just had, there are some risks relating to the ongoing weakness of the occupier market. The economic recovery across the whole of Europe is likely to be rather restrained. This is not expected to be a 'v-shaped' recovery with a return to rapid economic growth. This means that there could be further job losses and this will affect the property market.

Companies will be less likely to take out new space or could even look to reduce the amount of space they rent. Other companies could go bankrupt. The net effect is that we do not expect rents to rise quickly for the time being. A real recovery in the occupier market will only take place when the European economy is growing quickly enough to generate strong employment growth.

Aviva Investors is forecasting average annual rental growth in the commercial property market of only 1.3% between 2010 and 2012. More substantial rental growth is not expected before 2013. The risk of continued weakness in the occupier market means that it will be important for investors to be selective about the kind of property in which they invest.

As we look forward to the end of 2010, we believe that now is an opportune time to look again at the benefits of investing in continental European commercial property. Given that the UK has seen a rapid and substantial increase in capital values in recent months, reflecting the slightly improved economic backdrop, continental Europe offers greater opportunities for investors looking to enter the real estate market in the coming months.

We believe that this is a chance to get ahead of the curve and invest at a favourable time in the property cycle.

Luke Powell is Client Portfolio Manager at Aviva Investors.

being selective

So-called 'prime' property – that is, well-located, high-quality properties let to reliable tenants on long leases – is likely to be most attractive owing to its likely resilience in the face of any economic weakness. We believe poorer quality stock will be a riskier investment, as it will be more vulnerable to companies going bankrupt. In short, it will pay to invest in quality properties and with managers who know how to cope with the challenges that a difficult economic environment presents.

The Aviva Investors European Property Fund is available through the Skandia Investment Solutions platform and Skandia's Life & Pensions fund ranges.

*Source: Aviva Investors as at January 2010.

The performance of the Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

www.skandia.co.uk

Calls may be monitored and recorded for training purposes and to avoid misunderstandings.

Skandia provides you with access to its investment platform, known as Skandia Investment Solutions. Within this platform you can open an ISA and Collective Investment Account provided by Skandia MultiFUNDS Limited, a Collective Retirement Account and Collective Investment Bond provided by Skandia MultiFUNDS Assurance Limited and an Offshore Collective Investment Bond, distributed by Skandia MultiFUNDS Limited but provided by Old Mutual International (Guernsey) Limited.

Skandia Life Assurance Company Limited, Skandia MultiFUNDS Limited and Skandia MultiFUNDS Assurance Limited are registered in England & Wales under numbers 1363932, 1680071 and 4163431 respectively. Registered Office at Skandia House, Portland Terrace, Southampton SO14 7EJ, United Kingdom.

All companies are authorised and regulated by the Financial Services Authority with FSA register numbers 110462, 165359 and 207977.
VAT number for all above companies is 386 1301 59.

Skandia Investment Group is a trading name of Skandia Investment Management Limited. Skandia Investment Management Limited is registered in England & Wales under number 4227837. Registered Office at Skandia House, Portland Terrace, Southampton SO14 7EJ, United Kingdom. Authorised and regulated by the Financial Services Authority with FSA register number 208543, VAT number 386 1301 59.

Old Mutual International (Guernsey) Limited is regulated by the Guernsey Financial Services Commission and is licensed to write long-term business under the Insurance Business (Bailiwick of Guernsey) Law 2002. Registered number 2424. Registered Office at The Beehive, PO Box 121, Collings Road, St Peter Port, Guernsey GY1 3HE, Channel Islands.