

Chairman's Statement



Peter Crook Chairman

2008 was a difficult year for UK commercial property with negative total returns of 22.5 per cent for the period, according to the Investment Property Databank Monthly Index ('IPD'), the worst annual performance on record. In such a difficult environment the portfolios total return (as measured by IPD) was -18.7 per cent, ahead of the IPD index. However, after accounting for the effects of gearing and the fall in the valuation of the interest rate swap, the Company's Net Asset Value ('NAV') had a negative total return for the year of 30.9 per cent as the NAV fell to 96.6 pence per share from 149.2 pence per share as at 31 December 2007.

The Company's share price fell by 39.1 per cent during the year to 67.0 pence per share, with the discount to NAV widening to 30.7 per cent as at 31 December 2008, compared with 26.3 per cent at the previous year end. The fall in the share price reflects the general sentiment towards UK commercial property and the level of discount reflects concerns of further declines in capital and rental values and increasing tenant defaults.

In September 2008 the F&C Asset Management property team combined with REIT Asset Management to form F&C REIT Asset Management ('F&C REIT'), 70 per cent owned by F&C Asset Management. As part of this new arrangement the investment management of the Company has been delegated to F&C REIT, although the individuals

responsible for managing the portfolio have remained unchanged.

Property Market and Portfolio

Property is now in the midst of a downturn as severe as those of the 1970's and 1990's. The lack of liquidity in the capital markets is not helping recovery but there are also wider concerns about prospects for the economy and its impact on occupiers.

There was significantly less investment activity in the commercial property market during 2008, falling to £24.8 billion worth of transactions from £55 billion the previous year. Institutions remained net sellers, primarily in response to funding redemptions from investors, with overseas and private investors remaining net buyers of property, although at very much reduced levels.

As a result of property values falling, property yields, as measured by IPD, moved to over 7 per cent by the end of the year, an increase of more than 180 basis points during 2008. Rental values began to fall towards the end of the year with increasing occupier uncertainty. By the end of 2008 the IPD level of empty property was in excess of 10 per cent of rental income, up from 7 per cent at the end of 2007, beginning to reflect the weakness in the occupational market. With this very difficult background it is pleasing to note that the level of vacant property in the Company's portfolio remains very low at 0.2 per cent of rental income and the Company's tenant arrears is similarly negligible.

The property portfolio had a negative total return for the year of 18.7 per cent, made up of negative capital returns of 23.8 per cent and a positive income return of 6.6 per cent. This compared favourably with IPD which reported negative capital returns of 27.1 per cent during the year and income returns of 6.1 per cent. This out-performance can be attributed not only to the robust income profile of the portfolio but also the quality of the properties, the tenants and the length of leases.

The Company did not enter into any property transactions during the year, being under no pressure to sell properties given its healthy cash position. The Company also did not enter into any purchases of property as real estate values continued to fall and the timing of any purchase was deemed to be too early in the cycle. The Manager did however, review many potential opportunities and conducted a thorough analysis of investment prospects on a case by case basis.

The income profile of the portfolio continues to be of high quality with 72.8 per cent of tenant income rated by IPD as negligible to low risk, 11.6 per cent of which is let to the government. This, combined with an average lease length of 10.4 years, provides great comfort as to the reliability and sustainability of a high proportion of the rental income stream.

Dividends

The Company is currently paying an annual dividend of 8.0 pence per share in the form of quarterly interim dividends of 2.0 pence per share with the fourth interim dividend for the year ended 31 December 2008 being paid in February 2009. The Board remains comfortable with the Company's position relative to its banking covenants and with its level of income collection. It is therefore pleased to confirm that, in the absence of unforeseen circumstances, it intends to continue to pay quarterly dividends at this rate.

Borrowings

The Company is in a strong financial position with a long term facility of £50 million available until 2017. Of this facility, £40 million has been drawn down to date and, as at 31 December 2008, the loan to value ratio ('LTV') was 22.0 per cent, net of current assets and liabilities of £11 million. This is comfortably within the LTV restriction of 60 per cent. The other important covenant is the amount by which rental income covers interest, with a minimum restriction of 150 per cent. As at 31 December 2008 the interest rate cover was 266 per cent, providing significant excess capacity.

The interest rate on the £40 million loan has been fixed with an interest rate swap at 5.655 per cent. The valuation of the swap has turned significantly negative as interest rates have fallen, with a liability being shown on the balance sheet as at 31 December 2008 of £5.4 million. This valuation is a fall of £5.1 million since 31 December 2007 and reduced the NAV by 6.8 pence per share for the year. This liability will reduce as the loan facility gets closer to its expiry date in 2017 and as interest rates increase from their current very low levels.

In the current environment, where new finance is proving difficult to achieve and re-financing extremely expensive, the Company is well placed, with a loan facility which extends to 2017 at a margin of 50 bps, reducing to 45bps next year and with £10 million of the facility un-drawn and available on the same terms.

Outlook

The outlook for UK commercial property is very uncertain, with forecasts varying considerably across the industry. Consistent with the pessimistic predictions for the economy, both in the UK and abroad, the Manager's forecast for 2009 continues to be cautious, predicting further falls in capital and rental values. There are signs that the economic downturn could be deeper than originally thought with consensus forecasts now predicting a fall in GDP for 2009 in excess of 2 per cent. It is unclear whether the stimulus measures put in place by the UK government will be sufficient or timely enough to bring about economic recovery in the short term.

If the banking and economic packages which have been put in place do not succeed, the economic downturn could be extended, affecting property's recovery prospects. Given the weakness of the UK economy, it is likely that the occupational market will weaken further, putting additional strain on rents, voids and income streams.

However, the current market turmoil does bring opportunities and those with cash and available finance can purchase superior stock with yields significantly above where they were a year ago.

The Company has been in the relatively strong position of being able to wait for such opportunities to arise and has not been forced into selling any of its investments to satisfy banking covenants or pay out redemptions. This continues to be the case, with the Company sitting on cash reserves and remaining comfortably within its banking covenants. It will continue to take a prudent approach to portfolio management, concentrating primarily on its relations with its tenants and protecting its income stream. The Company will remain cautious with regards to investing its cash reserves until it is evident that positive total returns are achievable.

Peter Crook

Chairman
3 April 2009

Investment Managers



Ian McBryde
Investment Manager

Ian McBryde Investment Manager joined F&C Asset Management plc in 1982 and is a director of F&C REIT Asset Management. He is a fellow of the Royal Institution of Chartered Surveyors.

Investment Managers

F&C Asset Management plc ("FCAM") is a leading asset manager in both the UK and Europe and has approximately £98.6 billion of assets under management (as at 31 December 2008). The shares of FCAM are traded on the London Stock Exchange.

FCAM's parent company is Friends Provident plc, whose shareholdings in the Company are disclosed on page 14.

As part of an internal re-organisation, F&C Investment Business Limited "F&C", a wholly owned subsidiary of FCAM, was appointed as investment managers of the Company with effect from 31 December 2006. On 3 September 2008, the FCAM property team combined with REIT Asset Management to form F&C REIT Asset Management ("F&C REIT"), 70 per cent owned by FCAM and with a combined total of £8.5 billion of real estate under management. As part of the new arrangement, F&C has delegated the investment management of the Company to F&C REIT, who manage property investments on behalf of a wide range of clients including ISIS Property Trust Limited, IRP Property Investments Limited and F&C Commercial Property Trust Limited.

Manager's Review

Property Market Overview

The past year has seen total returns fall by 22.5 per cent, according to the IPD Monthly Index; the worst ever annual IPD performance. Capital values fell by 27 per cent in 2008 and by year end had fallen 36 per cent from their peak.



14 Berkeley Street, London W1

Whilst values fell throughout the year, the downgrades were most pronounced during the latter months of 2008. Of the 27 per cent fall in capital values during the year, 20 per cent was recorded in the second half and 15 per cent in the final three months of 2008.

This was due to the intensification of the banking crisis and the recognition that the problems were global, that major reform was inevitable and that it would take some time to achieve. This has had an effect on both the occupational and investment property markets.

The occupational market had held up reasonably well in the initial stages of the market downturn, helped by a growing economy. Annual rental growth was positive in all sectors with the all property average above 3 per cent at the start of the year. As the year progressed, rental growth slowed and was flat by mid year. The second half saw downward pressure on rents, especially for Central London offices, as concerns grew about the financial markets. By October, consensus estimates for GDP growth in 2009 had turned negative as the UK moved into

recession. Within property, this acceptance that problems in the banking sector and its effect on global economies would affect the wider UK economy contributed to more broadly based pressure on rental values. By year end, all property rental values were down 1.4 per cent. Offices were the worst affected sector, showing a 3.5 per cent fall in rental values but all sectors saw lower rents. The more difficult economic conditions have led to sharply reduced demand for new space by occupiers and requests for rental concessions and incentives from existing and potential tenants. Lease breaks are becoming more common and void levels are increasing.

Yields moved up sharply during 2008 with secondary yields seeing the greater outward yield shift as investors became increasingly risk averse. The definition of "prime" was also drawn more tightly. Over the course of 2008, initial yields rose by over 180 bps to more than 7 per cent – the majority of the increase taking place in the final three months of the year. The equivalent yield moved up even more sharply – by 226 bps to 8.45 per cent but investors were focused on initial yield only, such was their aversion to risk.

The investment market was subdued throughout 2008. Transactions totalled £24.8 billion during the year, representing a 56 per cent fall from 2007 levels. This was partly due to a lack of liquidity as the credit crunch continued. However, it also reflected investor concern about market prospects. With sellers unwilling to crystallise losses and buyers holding back in anticipation of further price falls – the active investment market has been characterised by forced selling, from funds needing cash to meet redemptions or from those at risk of breaching banking covenants, and opportunistic buying. In such a limited and distorted market, it becomes difficult to value property accurately.

Retail was the weakest performer during the year with total returns of minus 23.6 per cent – hit by above average yield increases. Offices delivered minus 22.7 per cent with lower rental growth taking a toll. Industrials were the most resilient sector at minus 20.2 per cent but this was a year when external factors, the

Manager's Review (continued)



Maxi Centre, Theale

economy and the credit markets, dominated property performance.

Property Portfolio

In what was the worst year on record for returns from UK commercial property, the market value of the Company's portfolio fell by 23.8 per cent to £107.5 million in the year to 31 December 2008. This fall compares with the IPD Monthly Index of capital values which fell by 27.1 per cent during the same period. Together with an income return of 6.6 per cent, the total portfolio return for the year was -18.7 per cent, ahead of the IPD Monthly Index total return of -22.5 per cent.

Liquidity in the UK commercial property market has been severely constrained during the year with few deals being transacted. Where deals have been concluded these were often a result of forced sellers needing cash to meet redemptions in open ended funds, or where banking covenants have been breached. Whereas the Company sold several properties at the peak of the market in 2006 and 2007, thereby reducing borrowings and improving the quality of the portfolio, the Company has not sought to sell or purchase any property during the year, seeking instead to maintain and enhance where possible income streams and lease lengths.

Without a doubt the economic situation has a major impact on occupational markets and the collection of rent is certainly becoming more challenging,

particularly with the number of retailers going into administration. However, the Company has continued to engage with its tenants on current and future expiries and as a result of proactive approaches continues to maintain a low level of voids. The Company's level of vacant property as a proportion of estimated rental value ("ERV") at 31 December 2008 was 0.2 per cent. This compares very favourably with the current IPD average of 10.4 per cent.

The average weighted unexpired lease length is currently 10.3 years, compared to 12.0 years on the launch of the Company in 2003. Despite the natural effluxion of time the unexpired term has been maintained at a comfortable level as a result of a number of lease restructures over the life of the Company and a total of 34.4 per cent of rents are reserved on lease with lengths in excess of 10 years. The public sector is responsible for paying 11.6 per cent of the total rents receivable and 72.8 per cent of the Company's rental income is from tenants rated as 'low' or 'negligible' risk, compared to the average of 65.7 per cent, according to IPD Rental Income Service.

The environment for negotiating and settling rent reviews has become very much more difficult, with occupiers seeking to limit any increases to a minimum. According to IPD, rental value growth turned negative during 2008 and forecasts are for



21/22 Long Row/King Street, Nottingham

falling rental values in future. However the relatively long term nature of the lease expiry profile, coupled with upward only rent reviews and some fixed rental increases negotiated in the last two years means that net income in the portfolio is likely to prove more resilient than ERV growth. During the year the Company completed two lease renewals and seven rent reviews. As a result, the Company achieved uplifts in rents of £187,125pa, an increase of 13.5 per cent over the previous passing rents. Of particular note is the rent review of the multi-storey car park at King William House where the rent review, effective from October 2006, was agreed at £225,000pa, an increase of 25 per cent.

Outlook

The outlook for the property market remains uncertain and forecasts vary significantly as to the further extent of the downturn or the timing of an upswing. Much will depend on the health of the UK economy and companies. There is, however, some activity in the commercial property market and values and yields being achieved are looking relatively attractive. However, with little ability to finance acquisitions through bank funding, only those with cash or access to capital are able to take advantage of the position.

The Managers believe that the Company is well positioned for the future. Its low level of borrowings, combined with its cash reserves and undrawn facility, will allow the Company to make new purchases to complement and improve the quality of its existing portfolio. However this will only take place once the Managers believe that the timing is right and that the defensive position of the Company will not be prejudiced.

Ian McBryde

F&C REIT Asset Management

3 April 2009



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