For Professional Clients and/or Qualified Investors only

UK Property
Market Trends

November 2019

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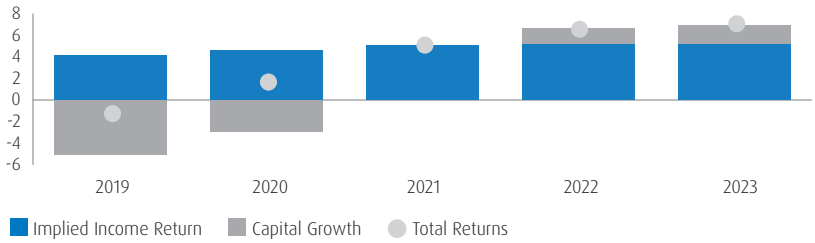
BMO REP is predicting that total returns will average 3.8 % pa over the five years to end-2023.

We see the UK commercial property market reaching its trough in 2019 hit by Brexit fears and retail restructuring. Although 2020 is expected to see a below par performance, a recovery to more normal levels of total returns is anticipated as the forecast period progresses and confidence improves as Brexit uncertainty fades. Performance is likely to be underpinned by income.

Components of BMO REP Forecast All-Property Total Returns – per cent



Source: BMO REP October 2019

Forecasts are provided for illustrative purposes; are not a guarantee of future performance; should not be relied upon for investment decisions; and are subject to change without notice.

Key Risks

Our review and outlook is a marketing communication providing an overview of the recent economic and property market environment. It should not be considered as advice or a recommendation to buy, sell or hold investments. Nor is it investment research and has not been prepared in accordance with legal requirements designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of its dissemination.

The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.

The value of directly held property reflects the opinion of valuers and is reviewed periodically. These assets can also be illiquid and significant or persistent redemptions may require the manager to sell properties at a lower market value adversely affecting the value of your investment.

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Economic and Property Market Overview

The UK commercial property market is delivering positive total returns but the pace has slowed.

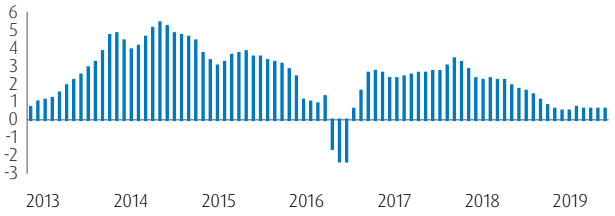
Market Snapshot Q3 2019	All	Retail	Offices	Industrial	Alternatives
Total Returns	0.6	-1.5	1.4	1.7	1.5
Income Return	1.3	1.6	1.2	1.2	1.3
Capital Growth	-0.7	-3.1	0.2	0.6	0.3
Rental Growth	0.2	-0.9	0.7	1.0	0.1
Gross Rent Passing	0.8	-0.4	1.7	1.3	1.3
Net Initial Yield	5.1	6.2	4.7	4.6	4.7

Source: MSCI UK Monthly Property Digest September 2019. The definition of Alternatives is the Portfolio Analysis Service definition of "other" which includes hotels, residential, leisure etc.

Past performance is not an indication of future performance.

Brexit remained at the forefront of investors' minds with the political dimension perhaps gaining greater prominence. Economic growth estimates are muted but positive and inflation is below target. Slower economic growth in the Eurozone and beyond, together with concerns regarding tariff wars has affected sentiment. However, changes in Fed and ECB policy have also led to a view that interest rates may now remain low for a prolonged period.

Three Month Rolling Average All-Property Total Return – per cent to September 2019



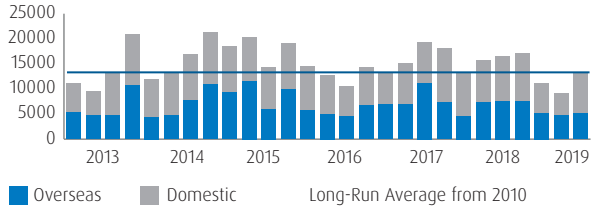
Source: MSCI UK Monthly Property Digest September 2019

Past performance is not an indication of future performance.

The quarter again saw retail property dragging down the all-property average. The three main sub-markets of standard retail, shopping centres and retail warehousing all recorded negative total returns. Offices recorded a quarterly improvement, across all segments and with City and provincial offices the strongest performers. Industrial/distribution continued to out-perform, with standard industrials out-performing distribution warehousing. The performance of alternatives was broadly unchanged overall but with residential driving total returns in the quarter.

Investment transaction levels rose in the third quarter to be broadly in line with the long-term average. The third quarter numbers were boosted by higher transaction levels in the alternatives sector and for regional offices, with most parts of the market seeing stable or lower levels of activity. Net investment from overseas is positive, while institutions are still net sellers of property. Retail property funds have seen persistent outflows and the issue of liquidity in open-ended funds has come back into focus. However, local authorities are still net buyers as are REITs. Bank lending to property, although volatile, is generally positive.

UK Property Investment Activity – £ million



Source: Property Data November 2019

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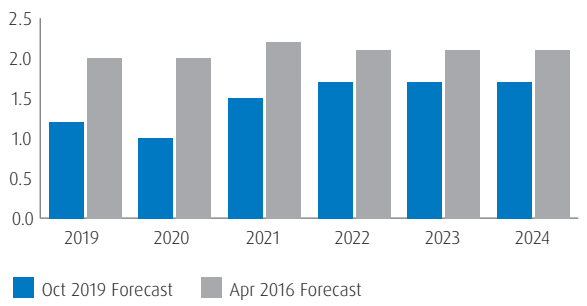
The Economic and Property Market Outlook

We predict single digit all-property total returns after this year under-pinned by the income return.

The economic and political outlook continues to be dominated by Brexit as the second deadline for departure has passed without agreement. The political situation is unprecedented in modern times and the forthcoming general election adds a further element of uncertainty to the outlook.

Consensus forecasts indicate that GDP growth would be lower in 2020 than 2019 and the 2020 estimates numbers are being revised down. Forecasters expect a recession to be avoided for the full year and for economic growth to improve thereafter. However, Brexit is expected to result in a long-term reduction in economic growth from pre-referendum estimates.

UK Real GDP Consensus Forecasts – per cent



Source: Consensus Economics

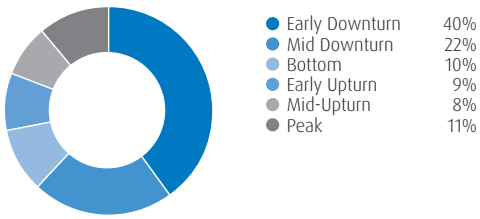
BMO REP forecasts are based broadly on the consensus economic outlook. They assume that some sort of deal is concluded within the next few months but acknowledge the considerable uncertainty surrounding forecasting in the current environment.

We have downgraded the all-property total return estimate for 2019 further to minus 0.9%. The prediction for 2020 has also been revised slightly lower. Both estimates are below the latest Investment Property Forum (IPF) consensus forecasts. However, we now anticipate a stronger recovery, helped by a regime of low interest rates. For 2021-23 inclusive, BMO REP is more upbeat than the IPF Consensus.

This is conditional on some sort of Brexit deal being secured. We would expect further uncertainty or no deal to be negative for property, as would a Labour Government.

With economic growth and inflation expected to be muted, we anticipate a continued focus towards protecting and enhancing long-term, secure income streams. There could be some activity in the more opportunistic space if open-ended funds and shopping centre owners, in particular, are forced to sell stock.

Perceived Stage of Property Market Cycle



Source: RICS October 2019

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The latest RICS survey shows respondents seeing property entering a more mature phase of the cycle but the majority also see the asset as fairly priced. Taking the past ten years as a base, this would appear to be the case at the current low levels of interest rates. If the period of low interest rates is prolonged, this could extend the cycle. However, the scope for further yield compression would appear to be limited, especially if the risk premium were to rise post-Brexit, and some upward pressure on property yields, extending beyond retail, could occur in due course.

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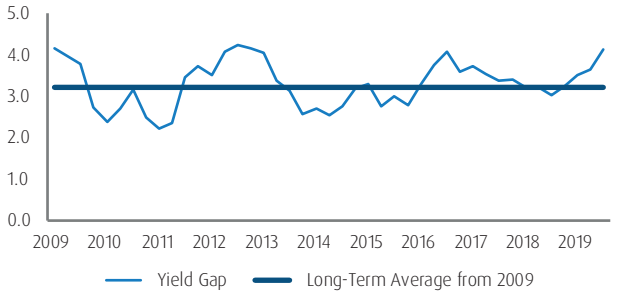
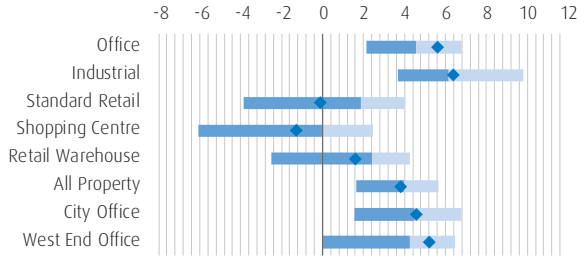
Yield Gap – All Property Initial Yield versus 10 year Gilt Yield percentage points September 2019



Sources: MSCI UK Monthly Property Digest September 2019, Bank of England

BMO REP Forecasts versus IPF Consensus Forecast Range. Total Returns end 2018-2023 – per cent per annum



Sources: BMO REP October 2019 (marked as diamonds), Investment Property Forum (IPF) Consensus Forecasts August 2019

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The all-property average has been pulled lower by the weakness in the retail market. This under-performance by the retail sector, especially in town centres, is expected to continue. As well as predicting further falls in rents and capital values in the regions, we have become more cautious about the near-term outlook for Central London retail as well. Retail as a whole is seeing a structural readjustment to rents and a major shift in investor perception of where the true market value lies.

We are forecasting that industrials and distribution will continue to out-perform the all-property average, helped by the growth on online shopping but we believe that the sector is now facing some headwinds both in the occupational and investment markets. Stock specific investment will be a key discriminator.

Central London offices have not experienced the reduced demand anticipated after the referendum and a shortage of supply could help this market in the medium-term, while regional offices may benefit from low supply and some relatively high yields by global standards. Notwithstanding the problems at WeWork, we would argue that changing working practices and the increase in small business start-ups could further boost demand for smaller offices and shorter leases

Alternatives are expected to continue to grow in importance for investors. Hotels and student accommodation are both relatively mature components of this segment. The diversity and risk profile of the assets which comprise the segment needs to be recognised.

Investment activity is expected to see some recovery as the economic and political situation clarifies, helped by the UK's position as a large, mature, transparent relatively liquid property market.

We see the UK commercial property market reaching its trough in 2019 hit by Brexit fears and retail restructuring. Although 2020 is expected to see a below par performance, a recovery to more normal levels of total returns is anticipated as the forecast period progresses and confidence improves as Brexit uncertainty fades. Property is expected to deliver an income return averaging close to 5 % pa. and with little volatility. We are predicting that all-property total returns over five years will be under-pinned by the income return

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Key Investment Transactions Data

Quarry House, Leeds

8 Finsbury Circus, London

Vita student accommodation, Manchester

Provincial office investment is holding steady

In Leeds, L&G will forward fund 7-8 Wellington Place for £211m at a 4.3% yield and has bought Quarry House for £243m.

In Bristol, Alpha Real Capital bought Temple Quay for £73.3m at a 4.02% yield and a pension fund purchased 1 Queen St for £35m at a 5.15% yield.

Topland bought two Manchester assets.

There was a pickup in Central London office investment deals in the quarter

8 Finsbury Circus was sold to overseas buyers by Mitsubishi for £260m at a 4.0% yield.

Nine deals were over £100m, with more than half being bought by overseas buyers.

Some property, such as Orion House and 21 St James' Square, are failing to sell or deals are aborting.

Alternatives accounted for around half of third quarter activity

DWS bought the Swift portfolio from Vita for £600m. Unite is set to buy a £1.4bn student accommodation portfolio at a 5.3% yield.

The Medical Properties Trust bought eight hospitals from the Secure Income REIT for £347m at a 4.3% yield.

There were few hotel deals. These were generally focused on occupiers buying or for future conversion to hotels.

Local authorities are still buying

Portsmouth City Council has bought Lakeside North Business Park in the Portsmouth area for £138m.

Cambridgeshire County Council has acquired a Tesco in the area for £51m at a 4.5% yield.

Warrington Borough Council has purchased an industrial property at Haydock Green for £45m at a 4.2% yield.

Industrials – no megadeals but still some keen yields

Royal London bought The Tower in Thurrock for £56m at a 3.9% yield.

The Icon (Unit 4) in Manchester was bought for £15m at a 4.25% yield in a forward funding deal.

Warehouse REIT bought an 8 asset portfolio from Aviva for £70m at a 7.2% yield.

Long-leased and indexed assets are still in demand

Knight Frank IM has bought a Waitrose in Newmarket for £17m at a 4.2% yield let for 20 years to break, with a measure of indexation.

The Supermarket Income REIT bought a Sainsbury unit in Preston for £54.4m at a 5.1% yield for a 22 year lease with cap and collar indexation of 1-4%.

A weak town centre market with few deals occurring

There was only one shop deal above £10m in the quarter and the eight shopping centre transactions averaged only £8m apiece.

Alternative uses are being considered including residential.

Retail warehousing – some overseas and opportunistic buying

Retail warehousing in Basingstoke, Liverpool, Paisley, and Poole has been bought by overseas investors.

Sports Direct has bought Brookfield Park in Cheshunt for £25.4m, which is less than half the price achieved at its 2015 sale.

Residential remains in favour

The quarter saw major deals from Schroders and from Riverstone Living focused on retirement housing.

Large BTR schemes were forward funded at Nine Elms and Colindale in London and Birmingham and Sheffield in the regions.

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