For Professional Clients and/or Qualified Investors only

UK Property
Market Trends

February 2020

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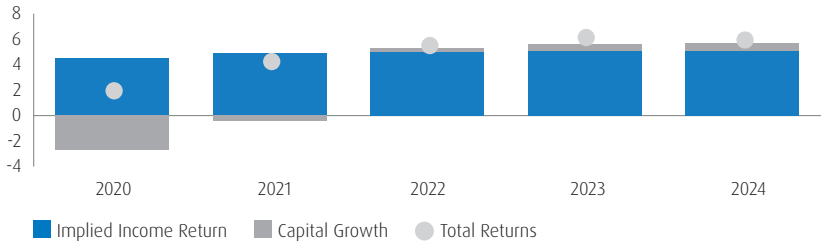
BMO REP is predicting that total returns will average 4.6% pa over the five years to end-2024.

Sentiment has changed since the conclusive December election and with Brexit triggered. We expect some headwinds for property in 2020 and continued weakness in retail but, a recovery to more normal levels of total returns is anticipated as the forecast period progresses. Performance is likely to be underpinned by income.

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



Source: BMO REP Jan-20

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

Performance has slowed but sentiment improved by year-end.

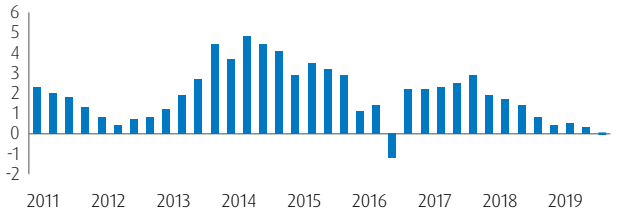
Market Snapshot Q4 2019	All	Retail	Offices	Industrial	Alternatives
Total Returns	0.0	-2.9	1.2	1.7	1.3
Income Return	1.2	1.3	1.0	1.1	1.1
Capital Growth	-1.1	-4.2	0.2	0.6	0.1
Rental Growth	-0.4	-2.0	0.4	0.7	0.1
Gross Rent Passing	0.4	-0.4	-0.1	1.5	1.8
Net Initial Yield	4.7	5.6	4.1	4.3	4.5

Source: MSCI UK Quarterly Property Digest Dec-19. 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 a major source of uncertainty for much of the quarter. A full Budget, due in the Autumn, was postponed until 2020. The election in December delivered a conclusive result and a belief that some clarity was emerging. UK economic growth has been weak, although employment data presented a rosier picture. Sentiment towards the likely trend of interest rates shifted in the quarter as Bank of England statements became more dovish. Slow economic growth abroad and concerns about tariff wars continued to affect sentiment.

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



Source: MSCI UK Quarterly Property Digest Dec-19

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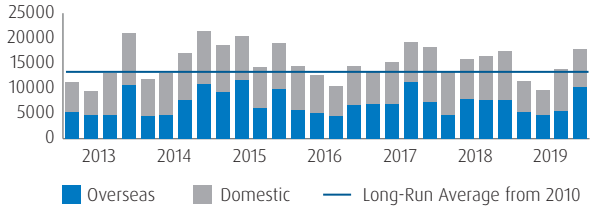
The past year has been characterised by retail property dragging down the all-property average and this persisted in the fourth quarter, with regional shops and shopping centres faring especially badly. Industrial/distribution continued to be the top performing sector in 2019, with standard industrials out-performing distribution warehousing. All the office sub-markets delivered above average performances. Alternatives eased back in the final quarter but total returns were above the all-property average.

Investment activity improved in the second half of 2019 to move above the long-term average. This was primarily due to a sharp rise in overseas net investment in the final quarter but institutions remained net sellers and the outflows from the retail open-ended funds persisted. For the year, all-property investment was around the long-term average but with considerable polarisation by sector with industrials and alternatives seeing strength and other parts of the market, most notably shopping centres, being less favoured. Bank lending for standing investments, although volatile, is generally positive.

UK Property Investment Activity – £ million



Source: Property Data Feb-20

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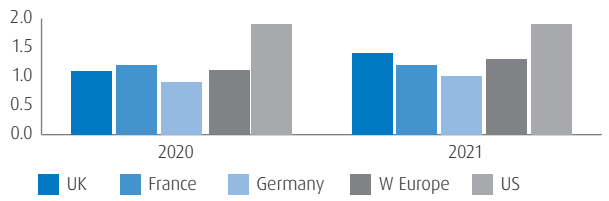
The Economic and Property Market Outlook

The outlook for UK commercial property has brightened. We are forecasting recovery with most parts of the market, retail excepted, delivering a solid performance and with total returns under-pinned by the income return.

Sentiment has changed since the December election. A conclusive result has led to Brexit being delivered at the end of January. However, the transition may still present problems and the post-Brexit landscape is unknown. Policy appears to be moving towards an easing of austerity on the fiscal side and the Budget scheduled for 11th March may provide further clarification. The Bank of England seems predisposed to keep interest rates at low levels and the consensus (mode forecast) is for no change in base rates in 2020.

Consensus Real GDP Forecasts – per cent



Source: Consensus Economics, Jan-20

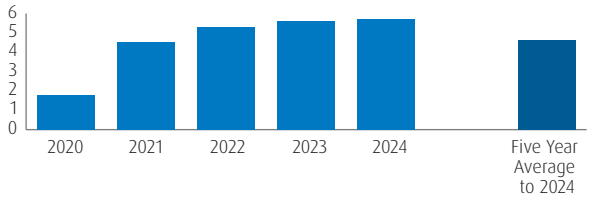
Both UK and global economic growth has been subdued. The Fed and the ECB are both expected to adopt a relaxed monetary policy to help stimulate growth in their economies. There are downside risks if tariff wars intensify or the coronavirus becomes widespread.

Consensus forecasts are for positive but muted GDP growth in 2020 with the UK delivering a sub-par 1.1%. UK growth is expected to improve after 2020 and by 2021 it will be out-performing the Western European average.

BMO REP forecasts are based broadly on the consensus economic outlook. They assume that a Brexit deal is successfully concluded, but acknowledges that there is a downside risk.

We anticipate that total returns will reach a floor in 2019/2020 before staging a recovery to deliver mid-single digit total returns, supported by the income return.

All-Property Total Return Forecast – per cent per annum



Source: BMO REP, Jan-2020

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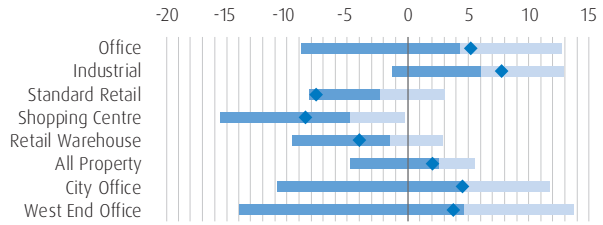
The BMO REP estimates are below the latest Investment Property Forum (IPF) consensus forecasts. This in part reflects our more downbeat view about the prospects for retail property.

BMO REP Forecasts versus IPF Consensus Forecast Range – per cent per annum



Sources: BMO REP Jan-20 (marked as diamonds), Investment Property Forum (IPF) Consensus Forecasts Nov-19

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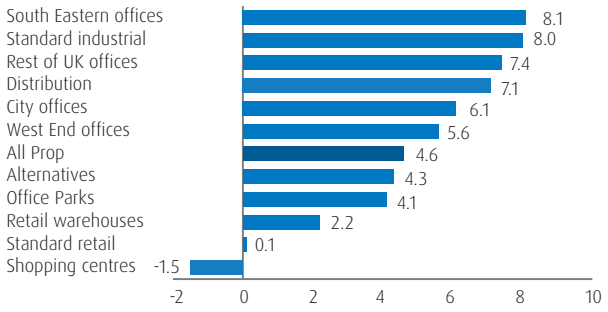
The problems in the retail sector are intensifying as stronger retailers demand rent cuts to level the playing field. Although shopping centres and regional shops have seen the greatest losses, the weakness has spread to prime property and Central London. Some retail property is being re-purposed and certain investors are waiting to capitalise on distressed retail assets but opportunities may be limited.

The all-property average is being pulled lower by retail weakness. We are forecasting that industrials and distribution will continue to out-perform. The near-term could see a robust market if Brexit uncertainty moderates and latent demand is activated. However, investor demand is expected to be discriminating and focused on income and there could be some headwinds towards the end of the forecast period.

In the next five years, standard offices in the South East could see out-performance helped by low supply and its popularity with international businesses. However, this is likely to be focused on city and town centres and the performance of offices parks may be less impressive. Regional UK offices are also expected to benefit from low new supply and interest from yield conscious investors. 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 together with renewed investor interest from overseas.

BMO REP Forecast Total Returns by Segment Five Years to end 2024 per cent per annum



Source: BMO REP Jan-20

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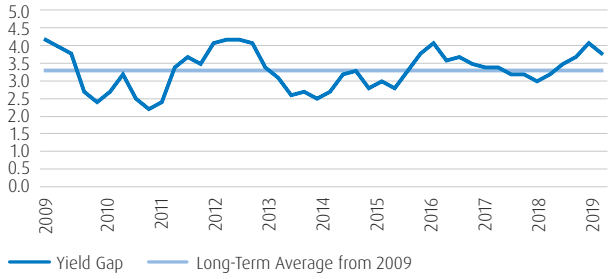
Alternatives are expected to grow in importance for investors, especially involving large deals by overseas buyers, but rental growth prospects could be modest. Investors may be attracted to the sector by a lack of stock in traditional markets but it can be less liquid and covenant risk needs to be considered.

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.

The scope for rental growth is likely to be limited at the all-property level. Retail rents are expected to remain adversely affected by structural change in the sector and then stabilise at a lower level rather than recover. Industrial rental growth is predicted to be consistently positive over five years but front-loaded. The standard office market is also expected to see positive rental growth both in London and the regions over five years, helped by resilient occupier demand and low new supply. Alternatives could see nominal rental growth but this could be patchy and may not translate to growth in inflation-adjusted terms.

Yield Gap – All-Property Initial Yield versus 10 Year Gilt Yields – percentage points



Sources: MSCI UK Quarterly Property Index Dec-19, Bank of England

Our forecasts are based on fairly conservative economic assumptions. There is upside potential if a post-Brexit economy outperforms market expections. Property in particular could benefit from a prolonged period of low interest rates and gilt yields. There are signs that the investment market is recovering and the UK property market could be attractive to overseas investors seeking a mature, transparent and liquid market with yields that can look quite competitive on a global basis.

Property would appear fairly priced at the current low levels of interest rates. The scope for further yield compression may be limited, but any upward pressure on non-retail property yields could also be weak if interest rates remain low and investor sentiment improves.

Over the five years to end-2024 we predict, on average, single digit all-property total returns under-pinned by the income return.

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Key Investment Transactions Data

Nexus Place, Farringdon, London

Twenty Kingston Road, Staines

Hilton Garden Inn, Bristol

Overseas investment is increasing, but the sources of capital are changing for London offices

North American investor Brookfield has bought Nexus Place in Farringdon for £169.4m at a 4.78% yield.

Deka of Germany has bought 51 Moorgate and 40 Chancery Lane for £180m in total.

REInvest Capital of Switzerland has bought 30-32 Lombard St for £76.5m at a 4.16% yield.

There has been some selling by open-ended funds

M&G sold Twenty Kingston Road in Staines to CLS for £19m following the fund suspension.

M&G also sold Ravenside Retail Park in Edmonton for around £51m to Prologis and six Travelodge hotels for £22.8m to Investra at a 5.65% yield.

The Moor in Sheffield was marketed by Aberdeen Standard in December.

Major deals, often involving overseas buyers, are occurring in the alternatives sector

DTGO of Thailand has bought a portfolio of 17 UK hotels for £450m.

Singapore Press holdings has bought a student accommodation portfolio for £448m.

The Medical Properties Trust (US) has bought the BMI Healthcare portfolio for £1.5billion.

Long-leased and indexed assets still in demand

W P Carey has bought a Poundstretcher warehouse for £28m with 24 years on this lease and some rental indexation.

The Supermarket Income REIT bought a Sainsbury unit in Cheltenham for £60.4m at a 5.25% yield with a 2032 lease expiry, and indexation.

Local authorities are still buying

Gloucester City Council has bought St Oswald's Retail Park in the city for £54m at an 8.5% yield.

Shopping centres in Blackpool, Canvey Island and Knowsley have been bought by their local councils.

Torbay Council bought in Didcot, Worthing Council in Swindon and Luton Borough Council in Bristol.

Assets are being re-purposed

In London, Earl's Court has been bought by a consortium for £425m and CC Land has bought Whiteley's shopping centre for £182m and plans a hotel/ apartment conversion.

The shopping centre in Orpington is to be reconfigured to include a cinema and a hotel and an office building on St Vincent St, Glasgow is to be repurposed as a hotel.

Industrials are still in demand

Morgan Stanley and Thor Equities bought the Tudor Big Box portfolio for £241m at a 3.93% yield from SEGRO.

Starwood Capital has bought ten industrial estates for £200m.

Institutional interest in regional offices

Royal London has bought in Birmingham's Church St at £61m reflecting a 5.32% yield

Aviva has acquired 40 Spring Gardens in Manchester for £55m.

Residential remains in favour

Grainger is to forward fund BTR schemes in Cardiff and East London

M&G is forward funding BTR schemes in Bournemouth and Sutton.

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