For Professional Clients and/or Qualified Investors only

UK Property
Market Trends

February 2019

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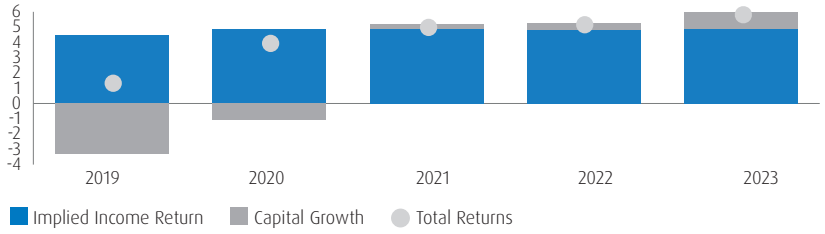
BMO REP forecasts show positive total returns, averaging 4.3% over the five years to end-2023, underpinned by the income return.

The BMO REP forecasts are based broadly on the consensus economic outlook. A no deal Brexit would adversely affect these forecasts but a soft or no exit could have limited upside potential as economic and political uncertainty would remain. The 2019 all-property forecasts have been downgraded reflecting both this and an expected re-rating of pricing in the retail sector.

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



Source: BMO REP January 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 has continued to deliver steady positive total returns but the pace is slowing.

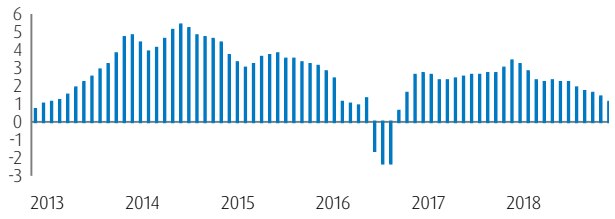
Market Snapshot Q4 2018	All	Retail	Offices	Industrial	Alternatives
Total Returns	1.1	-1.9	1.8	3.4	2.6
Income Return	1.3	1.5	1.1	1.2	1.3
Capital Growth	-0.2	-3.3	0.6	2.2	1.3
Rental Growth	-0.1	-1.5	0.6	1.1	0.0
Gross Rent Passing	0.7	-0.4	0.5	2.5	1.3
Net Initial Yield	4.9	5.8	4.4	4.4	4.8

Source: MSCI UK Monthly Property Digest December 2018. 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.

The economy is continuing to grow at a modest rate but concerns about Brexit are now intense as the March 2019 deadline approaches. Given the lack of clarity, some disruption would appear inevitable and this uncertainty is affecting business decisions. Elsewhere, global economic growth appears to be slowing. And political uncertainties persist within the US administration and in several European countries.

Three Month Rolling Average All-Property Total Return – per cent to December 2018



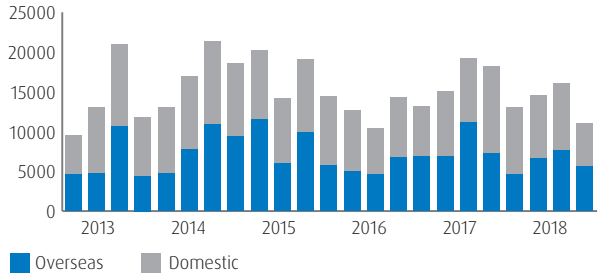
Source: MSCI UK Monthly Property Digest December 2018

Past performance is not an indication of future performance.

The industrial and distribution sectors have continued to drive the UK property market, but alternatives and much of the office market also out-performed. In part, this reflects a weakening retail market driving down the all-property average. Compared with the previous quarter, alternatives and City offices saw an improved performance. For the year, industrials strongly out-performed at 17.4% versus 7.5%, with offices outside the West End and alternatives doing well but retail delivering a marginally negative total return.

Investment moderated in 2018, although yearly data remains close to the long-run average. Early indications point to a quiet year-end. Net investment by institutions and overseas investors was positive during the quarter but this, in part, was due to lower sales. This may reflect caution ahead of Brexit, a desire to hold on to quality stock and the anticipation of future lower prices in some segments, notably retail. Most parts of the market experienced reduced levels of investment in 2018 compared with 2017. Flows to retail property funds are modest and some re-pricing occurred after quarter-end in two funds. Bank lending is subdued reflecting market uncertainty.

UK Property Investment Activity – £ million



Source: Property Data January 2019

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The Economic and Property Market Outlook

There could be a period of volatility in values ahead as Brexit uncertainty intensifies but property is still expected to deliver a stable income return.

Brexit is now dominating the economic outlook and this is affecting the macro-economic picture, the likely political landscape and the financial markets, including property.

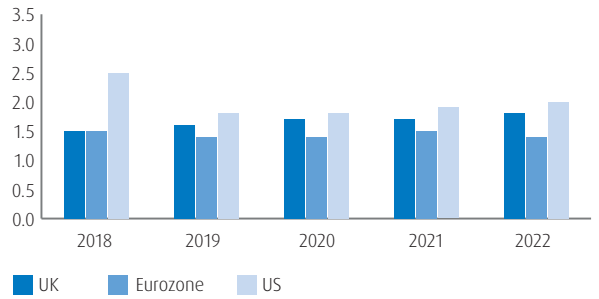
Despite this, macro-economic consensus forecasts point to slower but still positive GDP growth of 1.5% in 2019 and 1.6% in 2020. Inflation is predicted to be close to the Bank of England target, the unemployment rate to be stable, real wage growth is forecast to occur and official interest rates predicted to rise gradually with 1.25% being the modal prediction for year-end 2019.

In the event of a no deal Brexit or hard exit, we would expect the consensus to be downgraded but a soft or no exit may have limited upside potential, as issues could still be unresolved both economically and politically.

The UK economy also faces headwinds from potentially slower global economic growth and political uncertainty overseas. GDP growth estimates for the Eurozone and for the US are being revised lower for 2019 to 1.5% and 2.5% respectively.

BMO REP forecasts are based broadly on the consensus economic outlook. We have downgraded the all-property total return estimate for 2019 to 1.3%. Brexit, and its ramifications, is not the only factor behind the revision.

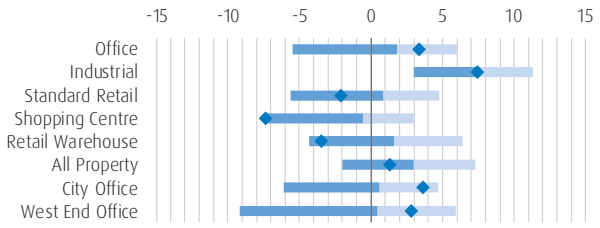
Consensus Real GDP Forecasts – per cent



Source: Consensus Economics January 2019, October 2018.

We are increasingly concerned by the weakness in the retail market, which we expect to persist in 2019. The RICS has indicated that valuers need to widen their supporting evidence beyond pricing in the very thin investment market. The 2018 numbers may not fully reflect the problems in retail and a re-rating could occur in 2019. BMO REP retail forecasts are pessimistic when compared with the latest IPF Consensus Forecasts published in November 2018.

BMO REP Forecasts versus IPF Consensus Forecast Range Total Returns 2019 – per cent



Source: BMO REP January 2019 (marked as diamonds), Investment Property Forum (IPF) Consensus Forecasts November 2018.

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Retail is expected to continue to suffer from administrations, store closures and the unwinding of lease commitments. This will occur across the board, but with Central London and some affluent towns relatively resilient, and shopping centres and secondary towns, and shops and department stores being more vulnerable.

There have been some upgrades. We had been conservative in our forecasts for Central London offices in the aftermath of the Brexit vote but upgraded our forecasts three months ago,

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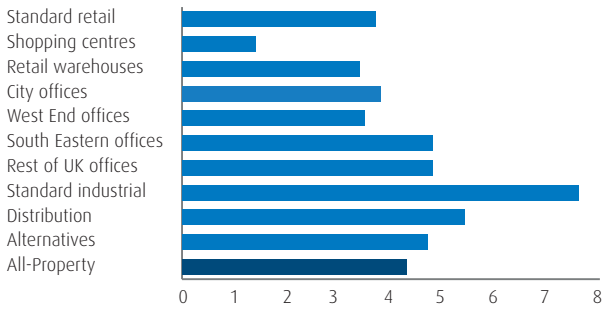
reflecting investment activity, supported by overseas buying, and reasonable occupational demand. We are still fairly cautious given the uncertainty around Brexit, but have upgraded further. Short-term forecasts for offices outside London have been slightly downgraded, but total returns are still expected to out-perform the market as a whole.

We expect standard industrials and distribution to be a major driver of the market, helped by the growth of e-commerce. However, there may be little scope for further yield compression and some rental growth expectations could prove optimistic. With brokers now seeing yields in the sector trending stable following a prolonged period of strength, the extent of the out-performance may narrow in future years.

We believe that alternatives will continue to grow in importance and as a class may deliver out-performance in terms of total returns, although the diversity of the assets which comprise the segment needs to be recognised.

BMO REP Forecast Total Returns by Segment end 2018-end 2023 – per cent per annum



Source: BMO REP January 2019

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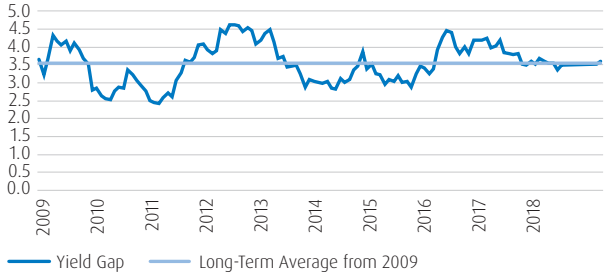
The income return is predicted to edge slightly higher after 2019.

Given the muted economic outlook and market uncertainty, rental growth is expected to be fairly subdued and focused on industrial/distribution and some alternatives.

Taking the past ten years as a base, property would appear fairly priced at the current low levels of interest rates. Interest rates are expected to rise over time but in small stages. The scope for further yield compression would appear to be limited, and a general upward pressure on property yields, extending beyond retail, could occur later in the forecast period with a smooth Brexit transition and perhaps sooner if not.

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



Source: MSCI UK Monthly Property Digest December 2018, Bank of England

The longer-term issues affecting property have been noted in earlier reports, including changes in technology, infrastructure, working and shopping patterns and demography. Brexit may over-ride these considerations in the next few months but their importance cannot be ignored.

There could be a period of volatility in values ahead as Brexit uncertainty intensifies and if fund redemptions increase. The recent poor performance of property equities could be indicative of headwinds. Property is still expected to deliver a stable income return. We anticipate a shift towards long-term, secure income streams and for investors to hold on to these assets. We are predicting single digit all-property total returns under-pinned by the income return.

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Key Transactions Data

15-17 Market Street, York

Solihull Retail Park, Solihull

30 Gresham St, London

A weak town centre market but a few deals occurring

Superdrug in York was sold for £4.725m at a 5.1% equivalent yield.

Glover's Walk, Yeovil a 28-unit shopping centre was marketed at £3.5m and sold for £1.6m.

Local authorities are buying – sometimes at keen yields

Croydon Council has bought Colonnades Leisure Park for £53m at a 2.5% yield.

The London Borough of Southwark has bought an industrial unit for £12m at a 2.95% yield.

Residential growing in importance

Barings is buying rental schemes in Manchester and Liverpool.

Grainger has taken full control of the GRIP rental portfolio, buying out APG for £396m.

Retail weakness has affected retail warehousing

Solihull Gate Retail Park, was originally marketed at 5.75%, but went under offer at 7.75% before the transaction was aborted.

The Homebase in Bath was bought by L&G for conversion to retirement housing.

Regional office markets attracting investor interest

The Hayhill portfolio of largely government-let regional offices was sold to an overseas buyer for £282m at a 7.8% yield.

The Bank of London and the Middle East has bought 1 Atlantic Quay, Glasgow for £52m at a 5.2% yield.

Industrials – still in demand but possibly some profit-taking?

Clipstone has sold a Midland distribution warehouse portfolio to UKCP REIT for £85.4m at a 5.5% yield and is to focus on standard industrials.

Royal London has bought an industrial estate from Harbert for £134m at a 4.03% yield.

Overseas investors acquiring, but also selling, large assets in Central London

30 Gresham St sold by Samsung to overseas investors for £425m at a 4.25% yield.

Blackstone has sold 125 Old Broad St and 12-26 Great Smith St to overseas investors from Singapore and Korea.

Alternatives in demand

Arlington has bought the Stellar Portfolio of student accommodation for £232m.

The Midland Hotel in Manchester was bought by overseas investors for £115m at a 5.7% yield.

Long-leased assets in demand

LondonMetric bought a long-leased, index-linked industrial unit in Orpington for £7.78m at a 3.84% yield.

LSH has bought a unit let to Wickes for 15 years with no breaks at a 4.95% yield.

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