For Professional Clients and/or Qualified Investors only

UK Property
Market Trends

August 2019

Contact us

UK, London – Head Office

BMO Real Estate Partners
7 Seymour Street
London
W1H 7JW

020 7499 2244

Research

Sue Bjorkegren

sbjorkegren@bmorep.com

Business Development

Jamie Kellett

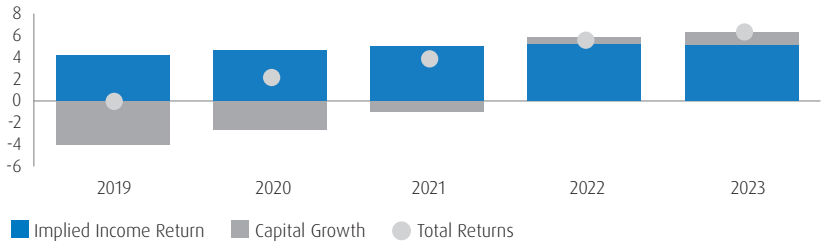
jkellett@bmorep.com

Telephone calls may be recorded.

BMO REP is predicting single digit all-property total returns under-pinned by the income return over the five years to end-2023.

The near-term outlook is likely to be affected by Brexit and the structural problems in the retail sector. Once the political situation clarifies and the retail market readjusts in value, the benefits of continued low interest rates by historic standards, fiscal easing and the opportunities offered by technological, demographic and infrastructure change may assume greater importance in investor decision-making.

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



Source: BMO REP July 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.

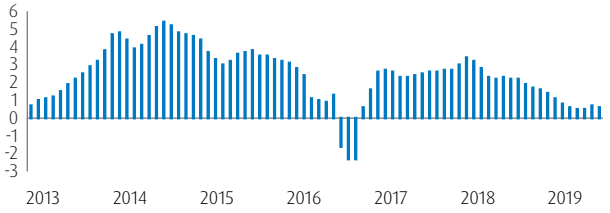
Market Snapshot Q2 2019	All	Retail	Offices	Industrial	Alternatives
Total Returns	0.6	-0.9	0.9	1.7	1.4
Income Return	1.3	1.6	1.2	1.2	1.3
Capital Growth	-0.7	-2.4	-0.2	0.5	0.2
Rental Growth	0.1	-0.8	0.4	0.8	-0.1
Gross Rent Passing	0.5	-0.2	0.8	1.0	1.5
Net Initial Yield	5.1	6.0	4.6	4.5	4.8

Source: MSCI UK Monthly Property Digest June 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.

The postponement of the initial Brexit deadline and the change in the Premiership have kept political issues in the forefront of investors' minds. Slower economic growth in the Eurozone and beyond has also been a concern. However, consensus estimates for UK GDP growth remain positive, if modest, and the prospects of an extended period of low interest rates and some fiscal easing may help sentiment.

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



Source: MSCI UK Monthly Property Digest June 2019

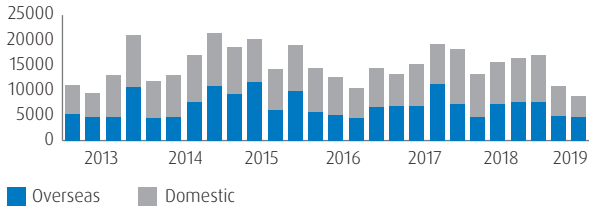
Past performance is not an indication of future performance.

The quarter continued to see negative total returns from much of the retail sector but the pace has moderated in comparison with the previous three-month period. Industrial/distribution is out-performing with quarterly total returns unchanged at 1.7%.

Alternatives out-performed the all-property average and showed a modest quarterly improvement. The quarterly performance of offices weakened to 0.9% from 1.1% three months earlier, with the regions out-performing London.

Investment activity in the June quarter remained at a reduced level. Some high profile deals have failed to complete which has affected sentiment. Net investment from overseas is positive while institutions are net sellers of property. Local authorities are still buying and bank lending to property is generally positive. Virtually all segments of the market experienced reduced levels of investment in the first half of 2019 compared with a year earlier and every sector saw activity below the long-run average in the quarter. UK direct property retail property funds are seeing outflows and the issue of liquidity in open-ended funds has come back into focus following the problems with the Woodford equity funds.

UK Property Investment Activity – £ million



Source: Property Data August 2019

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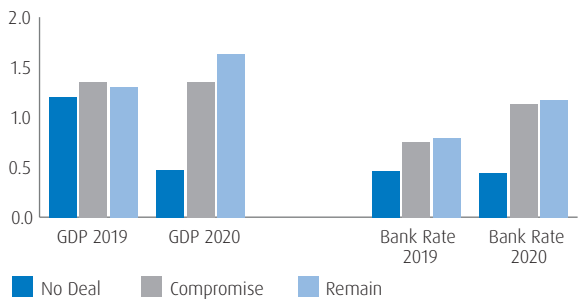
The Economic and Property Market Outlook

We are predicting single digit all-property total returns under-pinned by the income return.

Brexit continues to dominate the economic outlook and this is affecting the macro-economic picture, the political landscape and the financial markets, including property. Consensus forecasts indicate that GDP would be hard-hit in 2020 if there was no deal but would be marginally positive although the Office for Budget Responsibility is more pessimistic.

Consensus Forecasts – GDP and Bank Rate Under Different Brexit Scenarios



Source: Consensus Economics June 2019

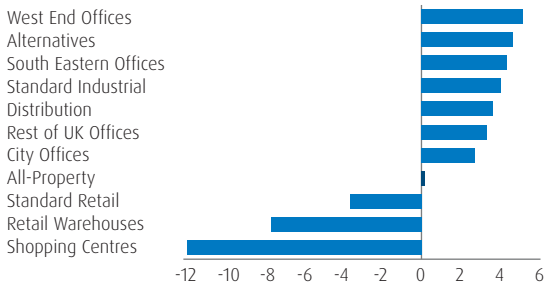
The prospects for some easing in fiscal policy have improved given the change in the premiership and this could have positive implications for property, depending on the measures being implemented. Similarly, if interest rates are cut or kept lower for longer, this could potentially act to limit pressure for any rise in property yields, benefiting performance and sustaining interest from investors seeking a higher-yielding alternative to gilts.

The consensus GDP forecasts are for 1.3% growth in both 2019 and 2020, with consumer spending marginally out-performing but manufacturing lagging. Inflation is still predicted to be close to the Bank of England target. Mode consensus forecasts are for the bank rate to remain unchanged until mid-2020. The market is predicting that sterling will fall by more than 7% against the US dollar over the coming two years, potentially benefiting exports. Over the longer-term, the market is not expecting a cyclical upturn, with GDP plateauing at 1.7% pa on consensus estimates.

BMO REP forecasts are based broadly on the consensus economic outlook. The forecasts assume that some sort of Brexit deal is concluded within the next few months, but there is a significant risk of no deal or post-Brexit dislocation which could affect the forecasts. We have downgraded the all-property total return estimate for 2019 further to 0.2%. The prediction for 2020 has also been revised slightly lower. Both estimates are below the latest Investment Property Forum (IPF) consensus forecasts.

Notwithstanding possible changes to monetary and fiscal policy, the uncertainty surrounding Brexit is expected to be negative for property.

BMO REP Forecast Total Returns by Segment 2019 – per cent



Source: BMO REP July 2019

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Brexit, and its ramifications, is not the only factor behind the downgrades in 2019 and 2020. We remain concerned by the weakness in the retail market, which we expect to persist in 2019 and into 2020. We have further downgraded our forecasts

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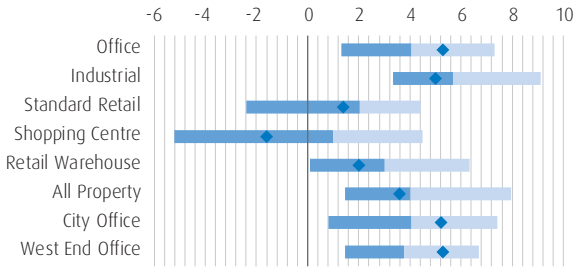
BMO REP Forecasts versus IPF Consensus Forecast Range. Total Returns end 2018-2023 – per cent



Sources: BMO REP July 2019 (marked as diamonds), Investment Property Forum (IPF) Consensus Forecasts May 2019.

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for shopping centres and retail warehousing in 2019 and 2020 compared with three months ago and are negative regarding regional shops.

Although we are forecasting that industrials and distribution will continue to out-perform the all-property average, we believe that the sector is now facing some headwinds both in the occupational and investment markets and so have downgraded our forecasts for 2019 and 2020 accordingly. Central London offices have not experienced the reduced demand anticipated after the referendum and a shortage of supply could help this market, while regional offices may benefit from low supply and some relatively high yields by global standards.

We believe that alternatives will continue to grow in importance and as a class could deliver out-performance in terms of total returns. Hotels and student accommodation are both relatively mature components of this segment and are attracting significant investor interest. The diversity and risk profile of the assets which comprise the segment needs to be recognised.

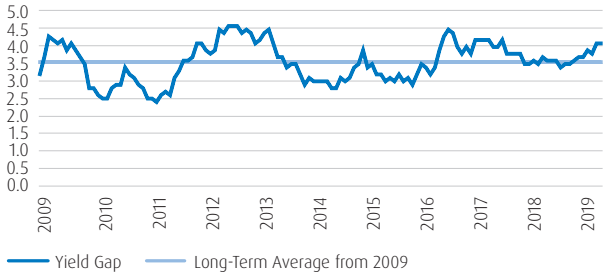
We anticipate a continued focus towards long-term, secure income streams and for investors to hold on to these assets.

There could be some activity in the more opportunistic space if open-ended funds and shopping centre owners are forced to sell stock.

Given the muted economic outlook and market uncertainty, rental growth is expected to be fairly subdued. Town centre retail rents are expected to fall further and then stabilise rather than recover.

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 some upward pressure on property yields, extending beyond retail, could occur in due course.

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



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

The longer-term issues affecting property have been noted in earlier reports. We believe that online shopping will continue to grow and evolve and that changing working practices and the increase in small business start-ups could further boost demand for smaller offices and shorter leases. Flexibility and prospects for alternative use will becoming increasingly important considerations in stock selection and retention.

The next two years are expected to see weak but positive total returns, affected by a sluggish economy and by Brexit. We see the market reaching its trough in 2019 and then gradually recovering. Property is still expected to deliver a stable income return. We are predicting single digit all-property total returns under-pinned by the income return.

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Key Investment Transactions Data

25 Canada Square, London

Allied Way, Acton

Leonardo Innovation Hub, Edinburgh

Few Large Central London office investment deals

Only one deal was above £250m in the quarter.

Citigroup paid £1.1bn to buy its Canary Wharf HQ at a 4.23% yield.

The Citigroup deal accounted for around an eighth of all UK investment activity in the quarter.

Industrials – keen yields but fewer deals

Valor is buying Allied Way, Acton in London for £18.88m at a 3.5% yield. M&G is buying in Northampton at 4.6%.

Blackstone/M7 bought the R32 portfolio for £100m at a 6.7% yield.

No deals from major investor Tritax were concluded in the quarter.

Overseas interest in regional UK property

South Korean investors have bought the Leonardo Innovation Hub in Edinburgh for £100m at a 5.91% yield.

A Malaysian investor has bought the Sports Direct Shirebrook HQ for £120m in a sale and leaseback deal.

Other £100m plus overseas investment deals occurred in Edinburgh, Birmingham and Derby.

Local authorities are still buying...and now selling too

Only two deals were over £30m – Reading Borough Council at Thames Valley Park and Medway Borough Council buying the shopping centre in Chatham.

Stevenage Borough Council has sold a former Matalan in the town to the Guinness Partnership and Tameside has sold an industrial site in Hyde to the occupier.

Long-leased and indexed assets in demand

Realty Income bought 12 Sainsbury superstores for £429m at a 5% yield on 15-year leases.

The Tesco Extra at Mansfield was bought by the Supermarket Income REIT for £45m at a 5.2% yield with 20 years unexpired and annual RPI-linked reviews subject to cap and collar.

Alternatives have wide appeal

Aberdeen Standard, Axa, Aviva and Schroders all bought alternatives in the quarter.

Student accommodation saw two portfolio deals over £100m.

Hotels recorded interest from a wide range of investors and buying at sub-5% yields.

Residential remains in favour

Greystar/Henderson Park are to build almost 900 Build to Rent (BTR) units at Nine Elms in London.

L&G is to forward fund more than 300 BTR units in Edinburgh.

A thin town centre market but still some interest in London

172 New Bond St was sold to a Chinese investor for £74m at a 1.58% yield.

Shopping centres in Orpington and Newbury are being marketed stressing their alternative use potential.

Retail warehousing – limited interest focused on higher-yielding stock

East Kilbride Retail Park was sold at a 10.49% yield. NewRiver bought a portfolio of four parks for £60.5m at a 9.8% yield.

Landsec has appointed agents to sell their parks in Poole and Bracknell at 7.5% and 8.5% yields respectively.

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