UK CAPITAL VIEW:

OUTLOOK SPRING 2018

2018: a stronger year than many forecast. We expect returns of 7.0%, ahead of the consensus view of 4.0%.

Prime time? As predicted, the switch to prime is gaining momentum. But are good secondary assets an opportunity?

Key risks are evolving: 2018 will see greater focus on inflation and the potential impact on base rates.

The range of capital targeting the UK remains diverse: Buoyant overseas demand is joined by rising UK fund activity, and a greater appetite to lend.

CONFOUNDING THE CONSENSUS

The market underestimated the upside in 2017 – will it do so again this year?

- **Uncertainty risks clouding a benign outlook...** A rebound in deal volumes, double-digit returns, and a recovery in rental prospects: 2017 was unexpectedly strong on multiple fronts. In the wake of significant political uncertainty, commentators could be forgiven for underestimating the vigour of the market last year. Yet as 2018 unfolds, the consensus outlook is once again more defensive than we believe is warranted.

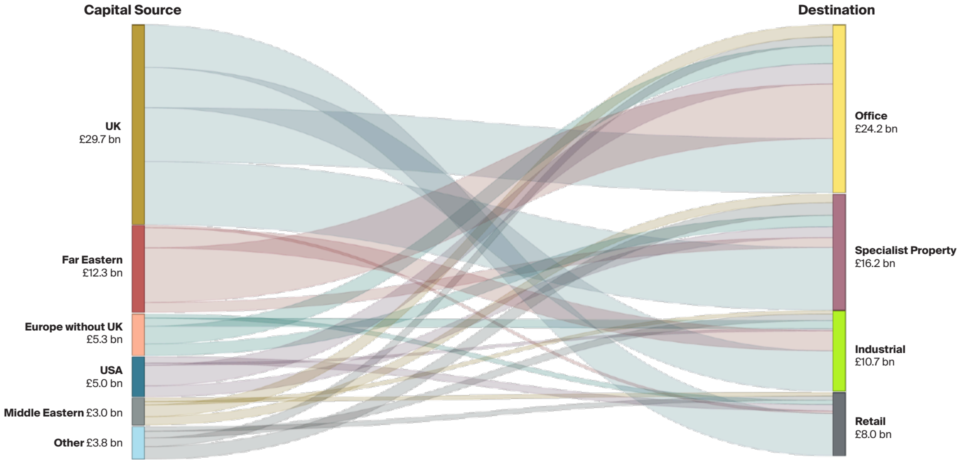
- **...the facts on the ground give us cause for greater optimism.** We agree in most sectors, significant further yield compression is unlikely. But, we also see healthy rental prospects for key parts of the market, a significant weight of UK-focused capital, and a generally more supportive global macro environment. This mix could push returns to around 7.0% this year – below the 11.2% seen last year, but above the November IPF consensus of 4.0%.

- **We remain alive to multiple risks.** Ongoing prospects for a step-change in political uncertainty, an excessive inflationary impact or policy error on base rates, or higher equity market volatility remain firmly on the radar. While not our central scenario, we recognise these, and similar concerns, as drivers of greater focus on prime assets with income security.

- **At £55bn, deal volumes will remain robust in 2018.** 2017's unexpectedly high level of investment may prove hard to beat, but from overseas investors to domestic funds, listed equity, and councils, there will be no shortage of capital targeting direct property. M&A, private equity, platform acquisitions and the rise of debt funding will unlock additional opportunities. We argue that lack of stock, not demand, will be the greatest impediment to activity.

- Ultimately, there are valid reasons to expect 2018 to be a year of gently easing performance, and that is reflected in our lower asset class return forecasts. While it is still too early to point to a market-wide plateau in values, performance will undoubtedly become far more nuanced by sector, geography and quality.

UK INVESTMENT BY CAPITAL SOURCE 2017



Source: Property Data/Knight Frank

UK CAPITAL VIEW:

OUTLOOK SPRING 2018

Global growth is in full swing, countering a weaker UK outlook.

Property is still an attractive asset class in what remains a low yield world.

UK returns will slow to 7% – still healthy in the wider context of weakening fixed income markets.

Base rate rises will have a limited direct impact on returns this year.

ENVIRONMENT FOR REAL ESTATE INVESTMENT

Global optimism overrides the UK's economic moderation

- **Global growth: the cycle rolls on.** Recent forecasts from the OBR show UK growth dipping to 1.4% in 2018. Yet support will come from a global economy still expanding, with the IMF predicting a rise in output growth to 3.7% this year. Financial markets reflect this: major stock markets remain buoyant, with volatility matching post-GFC lows; commodities are on the rise; and even bonds are afforded a soft landing, as central banks remain hyper-sensitive to the risks of unwinding QE too quickly.

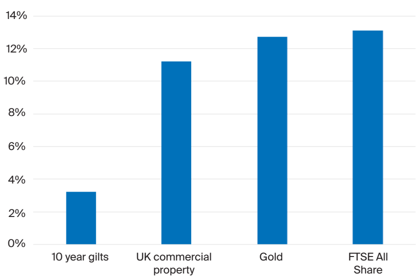
- **Real estate remains compelling on a multi-asset comparison.** But this year, the asset class will be seen increasingly as a source of income yield rather than capital growth for many investors. Others will be seeking safe-havens abroad, as although easing, geopolitical risks remain elevated. Globally, UK real estate remains favoured thanks to liquidity, transparency, and high quality stock in large lot sizes, combined with long leases and upward only rent reviews.

- **UK base rates will rise slowly, and the impact on returns will be modest.** Weaker forecasts for growth and inflation in 2018 point to a slow-motion normalisation in base rates. November's 25bps rise to 0.5% had no discernible impact on CRE values, and long-dated gilt yields fell. This backs our view that monetary tightening will have limited direct impact on UK property values this year. However, investors will keep a keen eye on the US, where treasury yields are on the way up, for any early signs that values start to be affected.

- **Performance outlook: wider polarisation ahead.** Consensus forecasts underestimated CRE returns last year, and we expect them to do the same in 2018. At 7.0%, we predict headline UK performance will be lower than last year's 11.2%, but broadly in line with long-run averages, and ahead of the current 4.0% consensus view. More importantly, we see 2018 as a year in which returns become even more polarised by sector, geography and quality.

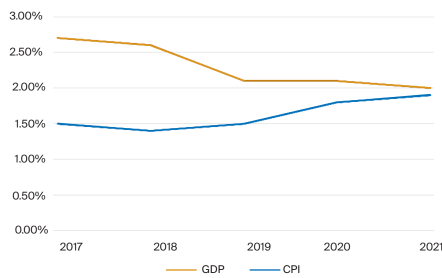
- **Regulatory change watch:** Autumn's budget proposed changes to CGT for overseas buyers, Wales will replace SDLT with a Land & Buildings Transaction tax in April, and councils may face restrictions on borrowing for property. Longer term, lease accounting changes due in 2019 are coming into focus.

Asset class returns 2017



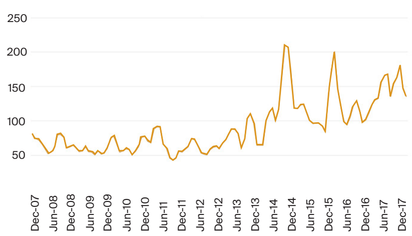
Source: MSCI/Macrobond

Consensus outlook: GDP growth and CPI inflation



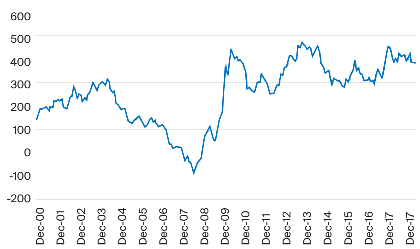
Source: HM Treasury

Geopolitical threats index



Source: Macrobond/Boston College

All property yield premium over 10 year gilt



Source: MSCI/Macrobond

UK CAPITAL VIEW:

OUTLOOK SPRING **2018**

Another year of robust investment volumes awaits.

The focus on prime stock remains, but good secondary will attract those seeking income.

Overseas investors will remain dominant, but demand from UK institutions is accelerating.

The return of debt will support the value of prime assets.

INVESTMENT MARKET DYNAMICS

Another solid year of activity ahead

- **At £55bn, we expect 2018 trading volumes to be in line with last year.** But this will be more dependent on supply than demand: prime assets with attractive income will be sought, yet will not necessarily be available in abundance. The challenge that sellers of such property face in effectively recycling capital means some will only sell at premium pricing, and absent this, will prefer to hold.

- **Confounding the prime consensus?** The rotation towards core is being rewarded – prime performance overtook secondary from H2 '17, and save for some retail warehouse and industrial sectors, we see this gap widening. However, with such a strong consensus on the logic to this shift, we also see value in good secondary property: pricing is less competitive, the potential to redevelop to prime may exist, and income returns are higher.

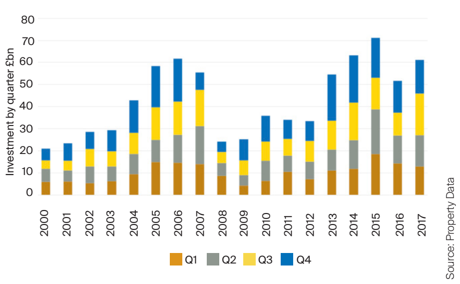
- **Continental drift:** Asia accounted for over 20% of UK deals in 2017, with Europe and the Middle East at 9% and 5% respectively. We don't see this ratio changing materially, but do see a greater appetite for income plays. High pricing in all of our global super cities adds another dimension by making UK prime property comparatively good value – in particular, we expect this will divert at least some of the vast wave of global capital targeting continental Europe to the UK.

- **UK funds return.** Pressure is on to deploy further capital, and this saw institutional funds turn net purchasers in Q4 '17 for the first time in almost two years. This trend will continue to support regional demand, albeit for a relatively narrow band of prime and good quality secondary assets.

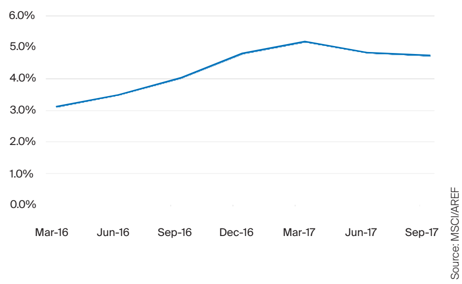
- **M&A: the game is on.** 2017's raft of deals went beyond 'typical' private equity purchases to include CRE funds and REITs too. Corporate matchmakers will chase further tie-ups, citing deep NAV discounts in the REIT sector. Major global real estate investors will continue to favour the acquisition of platforms as a way to access markets quickly and with scale.

- **Lending is firmly back on the agenda.** Debt provides an alternative source of returns as market performance slows, with the added cushion of sensible LTV ratios should capital values reverse their upward drift. Opportunities to lend will see fierce competition, especially as more non-traditional lenders perceive debt as a way to access real estate but on a more secure basis.

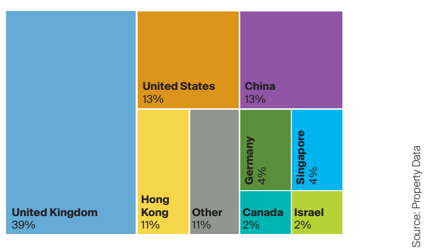
Investment by quarter



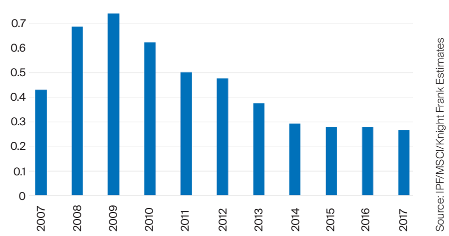
UK property fund cash allocations



Major source of capital into UK



Outstanding debt as a share of investible property



UK CAPITAL VIEW:

OUTLOOK SPRING 2018

London's dominance as the leading destination for global capital is undiminished.

Demand for regional markets has returned with force.

The rotation towards prime may result in opportunities for good secondary.

OFFICES

Far from slowing post-referendum, investment remains remarkably resilient

- **Can 2018 beat last year's 33% rise in volumes?** Ca. £24bn of office investment was recorded last year, fuelled both by foreign capital as well a resurgence in domestic demand. The current consensus implies a decline in values, and by implication a less active market, but we believe this view may prove too pessimistic – indeed, the weight of demand is increasing as we start the year.

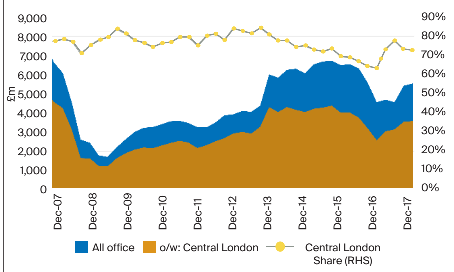
- **London: still calling.** Overseas capital drove 85% of central London volumes last year, and this dominance is not in question for 2018 – in particular, we see ongoing demand from China and Hong Kong joined by other sources such as Japan, and the Middle East, where appetite for prime London stock remains buoyant. Meanwhile, the wider context of very low European prime yields make London comparatively attractive for the significant weight of capital theoretically focused on the continent.

- **Nationally, we see a greater mix of buyers.** Both overseas investors and UK institutions have upped their share of office transactions in key regional cities during H2 '17, both targeting prime assets. Momentum will be maintained this year, and we expect demand to be truly national, extending beyond Birmingham and Manchester to smaller key regional cities too.

- **Another year of strong performance for prime...** The increasing weight of capital targeting prime offices in London and nationally should keep yields stable, or even under further downward pressure for the very best stock, and where increasingly rare 15 year+ leases are in place. Robust take-up combined with shortages of new supply mean the stable outlook for stable prime rents remains warranted too.

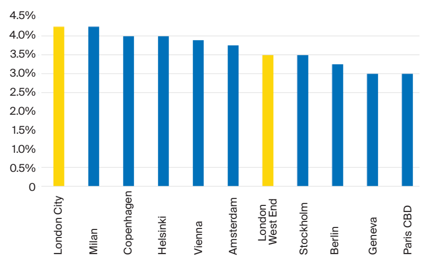
- **...but don't write off secondary too quickly.** The consensus is that a less assured rental outlook will reduce – or reverse - prospects of further yield compression for secondary stock. We recognise this as the logic behind the rotation towards prime, but argue that there may yet be good secondary opportunities. Slowing construction will reduce the volume of new stock delivered, and could result in development opportunities in the right locations.

Office investment



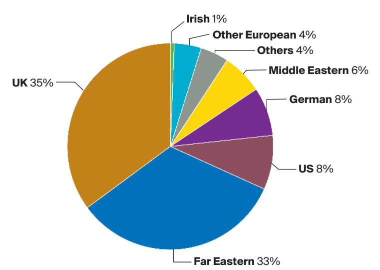
Source: Property Data

Prime office yields UK vs Europe



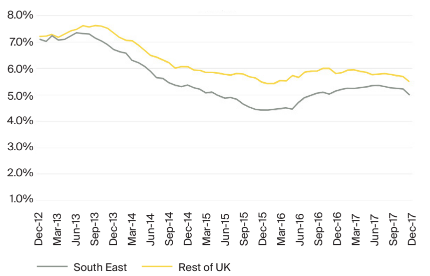
Source: Knight Frank

UK office investment by investor location 2017



Source: Property Data

Regional office market yields in decline



Source: MSCI

UK CAPITAL VIEW:

OUTLOOK SPRING **2018**

The sector's operational challenges are no secret, but pessimism may have gone too far.

As yields on other sectors fall, retail's income return looks increasingly attractive.

M&A deals could support shopping centre liquidity by providing new pricing evidence.

RETAIL

2018 could be the year that investment activity turns the corner

- **Always darkest before dawn?** For a sector that represents ca. 35% of investible UK commercial property, retail trading has been underrepresented, accounting for less than 15% of activity in 2017. However, we expect liquidity to start to rise in 2018. Calling a more active market in a year beginning with mixed trading reports, rising administrations and potential store closures may seem overly contrarian. Yet retail's evolution towards an 'income stock' fits the current desire for income return, pricing expectations are gradually becoming more realistic, and portfolio streamlining following recent international and listed market M&A will provide useful evidence.

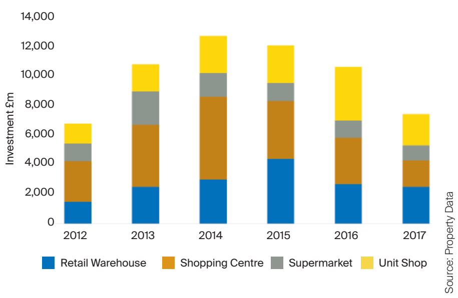
- **Who will buy?** We see institutional demand for good quality secondary towns, where the yield arbitrage versus the best prime locations will prove compelling. Local authorities, relatively active buyers of retail in 2017, are likely to face tighter regulations on borrowing to finance acquisitions, but we expect they will remain purchasers within their own jurisdictions.

- **The REIT shopping spree will aid market clarity.** The M&A activity seen at the end of 2017 has been generally well-received, and adds significant scale to European shopping centre REITs. Overlap between merging businesses will, in time, see assets brought to market by motivated sellers. This may be the catalyst required to shift pricing to levels that entice more investors into the market.

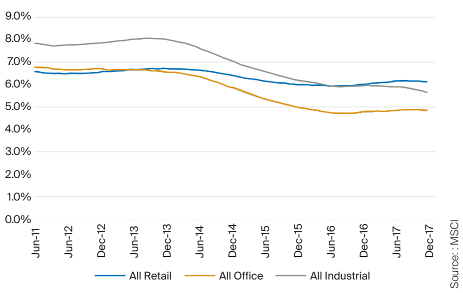
- **The operational backdrop will remain challenging.** Treasury forecasts suggest consumer spending growth of 0.9%, lower than 2017's 1.5% estimate. Recent trading updates demonstrate the disparity between the fortunes of winners and losers, but in general, retailers will be on the defensive, sensitive to business rate revaluations, and increases to the national living wage: cost cutting and portfolio rationalisation is high on the agenda.

- **Expect a widening dispersion in performance.** In general, prime and secondary yields are diverging, but there is significant variation in the strength of this movement depending on subsector. For standard shop units, we expect this trend to become more visible. In contrast, we note that secondary retail warehouse yields have sharpened and remain under downward pressure.

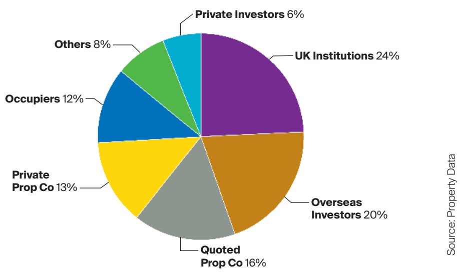
Investment volumes by retail subsector



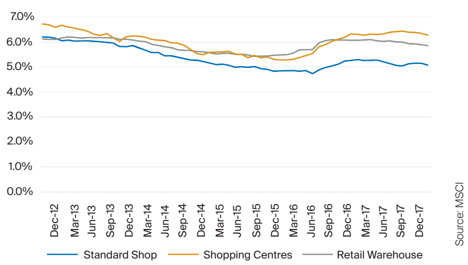
Income return by sector



Investment by investor type 2017



IPD retail yields



UK CAPITAL VIEW:

OUTLOOK SPRING 2018

At 20%+ in 2017, performance is rivalling peak 2015 levels.

Annual investment volumes exceeded £10bn for the first time.

Reversionary expectations are being pushed hard, driving down both prime and secondary yields.

Despite falling yields, the sector remains attractive as an income play.

INDUSTRIAL

Momentum shows little sign of abating – another year of healthy performance ahead

- **2017: a tough year to beat.** Investment exceeded £10bn, beating the previous peak by almost 50%. Annualised returns for the sector ended the year above 20%, as yields hit a record low of 5.1% on the IPD index and 4.00% for long-let warehouses on our prime yield series. The occupational market continues to benefit from the structural shift towards e-commerce, but more recently, a combination of healthy global growth and Sterling weakness is boosting exports, and is supporting the output of 'traditional' occupiers too.

- **No let-up in the variety of capital targeting the market.** A mix of Asian and US capital have been the driving force in the big-box market, accounting for purchases of £4.7bn in 2017. The listed sector saw purchases of £1.5bn, boosted by capital raised from IPOs and new issues, some of which is still to be deployed in 2018.

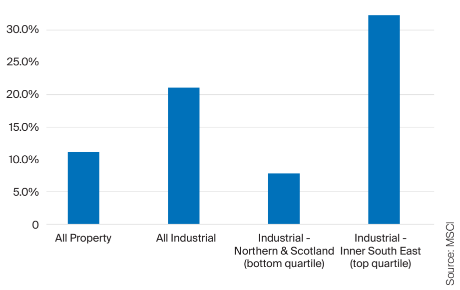
- **What is the outlook for prime yields?** 2017's record pricing makes it hard to envisage much further yield compression in 2018. However, such is the supply/demand imbalance, very low initial yields will continue to be seen, underwritten by ambitious rental growth assumptions, which in many cases, are nevertheless being met.

Therefore, while we believe that the years of 20%+ returns are over for now, the momentum behind demand means we still expect performance to hit double-digits this year.

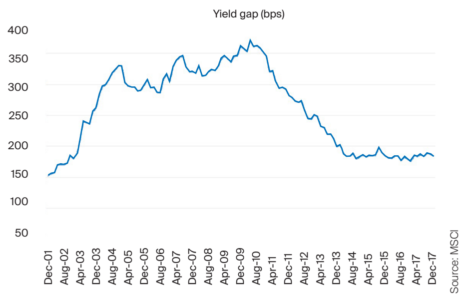
- **Secondary stock remains in favour.** A lack of prime assets is driving demand for good secondary in favoured locations: our secondary yield series dropped 150bps for distribution 125bps for multi-lest estates last year, but strong demand and rental growth may push this further in 2018. Less evident from the strong headlines is the widening divergence in performance by geography, with IPD returns on the best Inner South East assets running at almost four times the weakest quartile assets in the North and Scotland.

- **Income returns down, but lease lengths up.** Yield compression has challenged the sector's traditional role as property's default income play: at sector level retail income returns are now higher. But industrial stock remains in demand from income funds, aided by a defensive occupier story and average lease lengths which have risen by above those of the office and retail sectors.

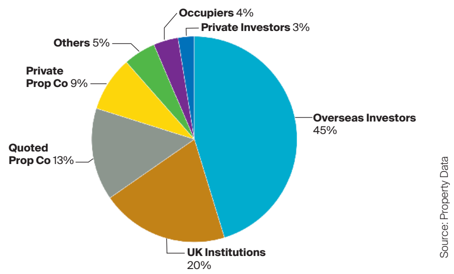
Annualised total returns by sector and best/ worst performing quartiles, 2017



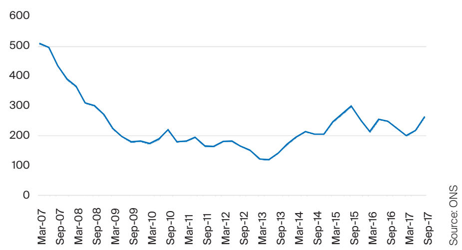
Gap between highest/lowest industrial property yields



Investment by purchaser type 2017



Construction output volumes by quarter, £m: warehouses



UK CAPITAL VIEW:

OUTLOOK SPRING **2018**

Another year of specialist sector outperformance ahead.

Greater focus on rental growth will favour a deep understanding of operational drivers.

There is scope for funds to re-weight further towards the sector.

SPECIALIST SECTORS

Rapidly becoming a major part of the market

- **Specialist (inc. leisure) property accounted for 25% of 2017 investment.** This activity is driving ongoing yield compression (our prime yields fell by 25bps across most subsectors in December), a trend which pushed total returns to roughly 15% and 13% for hotels and leisure in 2017 respectively. As in the wider market, we expect returns to slow as yield compressions wane, but the specialist sectors still offer opportunities for healthy performance ahead of our forecast of 7% for the UK real estate as a whole.

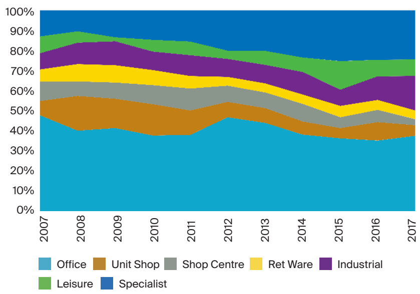
- **Value uplifts will be increasingly dependent on rental growth for most specialist sectors.** Prospects are fair for leisure given forecast real wage growth and the trend for diverting retail spend to experiences, and hotels could benefit further from ongoing growth in inbound tourism (latest figures show 8% annual growth). But it will be sectors facing structural undersupply, such as healthcare, where we estimate 6,600 bedspaces are at risk of closure over the next five years, that are likely to have the greatest pricing power.

- **Institutions increase net acquisitions.** The transfer of assets from private property companies and owner occupiers to UK institutional investors remains in full swing. Institutions made net acquisitions of over £0.5bn in both hotels and student housing last year, with momentum accelerating in the second half of the year. On average, UK funds hold an 18% weighting in specialist property, a figure that is edging higher.

- **Lease lengths: the long game.** While some investors will target specialist property for above average returns, as the wider commercial property market eases, we expect there will be greater focus on the defensive nature of such assets which comes from what can often be very long leases. More defensive still are income strips – which were already popular in 2017 – and debt.

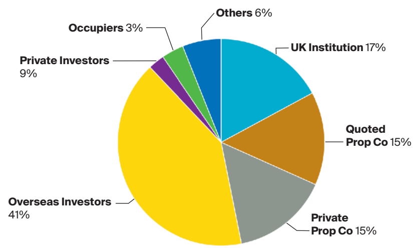
- **A mixed outlook for debt.** 2018 will face no shortage of appetite to lend to UK commercial property generally, but the picture for specialist sectors remains more nuanced. Student accommodation is seen as established and defensive, attracting interest from lenders both on investment and development. The PRS sector is dominated by a need for development finance, which is being met by a range of commercial and alternative lenders.

Investment share by sector



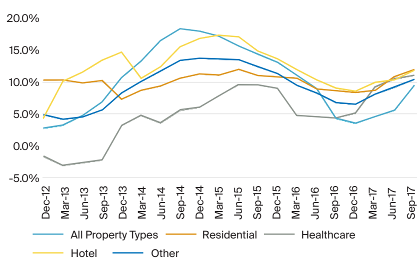
Source: MSCI

Share of investment by investor type, 2017



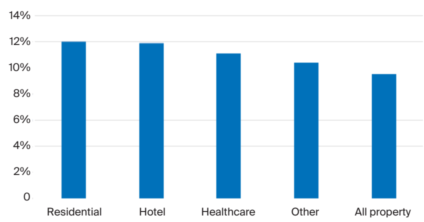
Source: Property Data

Specialist property annual total returns



Source: MSCI

Specialist property total returns year to Sep-17

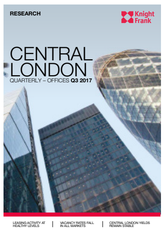


Source: MSCI

UK CAPITAL VIEW:

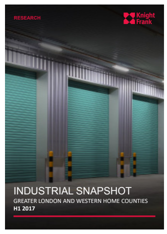
OUTLOOK SPRING **2018**

Global Capital Markets



London Offices

Retail



Logistics and Industrial

Specialist Property

KNIGHT FRANK YIELD GUIDE

	Dec-16	Sep-17	Dec-17	Market Sentiment
High Street Retail				
Bond Street	2.25%	2.25%	2.25%	STABLE
Oxford Street	2.25%	2.25%	2.25%	STABLE
Prime Shops (excludes central London)	4.00%	4.00%	4.00%	STABLE
Regional Cities high street	4.50%	4.25%	4.25%	STABLE
Good Secondary high street	6.00%	6.00%	6.00%	STABLE
Secondary & Tertiary high street	10.00%	10.00%	10.00%++	NEGATIVE
Shopping Centre				
Regionally Dominant shopping centres	4.25%	4.25%	4.25%	NEGATIVE
Dominant Prime shopping centres	5.00%	5.00%	5.50%	NEGATIVE
Good Secondary shopping centres	6.50%	7.00%	7.50%	NEGATIVE
Secondary shopping centres	9.00%	9.50%	9.50%++	NEGATIVE
Out of Town Retail				
Open A1/Fashion retail warehouses	4.50%	4.50%	4.50%+	STABLE
Secondary A1 retail warehouses	6.00%	6.00%	5.75%	STABLE
Bulky Goods Parks	6.00%	6.00%	5.75%	STABLE
Secondary Bulky Goods Parks	7.00%	7.00%	7.00%	STABLE
Solus Open A1	5.00%	5.00%	4.75%	STABLE
Solus Bulky	6.00%	6.00%	5.75%	STABLE
Specialist sectors				
Department Stores	5.25%	5.25%	5.25%	STABLE
Car Showroom (with fixed uplifts & manufacturer covenant)	4.50%	4.50%	4.50%	STABLE
Car Showrooms (with fixed uplifts & dealer covenant)	5.25%	5.00%	4.75%	POSITIVE
Budget Hotels (Fixed/RPI uplifts 20 yr+ term, Strong Covenant)	4.75%	4.50%	4.25%	POSITIVE
Student Accommodation (Prime London – Direct Let)	4.50%	4.50%	4.25%	POSITIVE
Student Accommodation (Prime Regional – Direct Let)	5.50%	5.50%	5.50%	POSITIVE
Student Accommodation (Prime London – 25 yr lease Annual RPI)	4.00%	4.00%	3.75%	POSITIVE
Student Accommodation (Prime Regional – 25 yr lease Annual RPI)	5.00%	4.50%	4.50%	POSITIVE
Healthcare (Elderly Care 30 yrs indexed linked reviews)	4.50%	4.50%	4.25%	POSITIVE
Foodstores				
Annual RPI increases (lY)	4.25%	4.25%	4.25%	POSITIVE
Open market reviews	5.00%	5.00%	5.00%	STABLE
Warehouse & Industrial Estates				
Prime Distribution/Warehousing (20 yr fixed RPI)	4.25% - 4.50%	4.25%	4.00%	POSITIVE
Prime Distribution/Warehousing (15 yr)	5.00%	4.75%	4.75%	POSITIVE
Secondary Distribution (10 yr)	6.50%	5.75%	5.00%	POSITIVE
SE Estate (exc London & Heathrow)	4.75% - 5.00%	4.50% -	4.25%	POSITIVE
Good Modern RoUK Estate	5.50%	5.00%	5.00%-	POSITIVE
Secondary Estates	7.00%	6.50%	5.75%	POSITIVE
Offices				
City Prime	4.25%	4.00-4.25%	4.00%-4.25%	STABLE
West End Prime	3.50%	3.50%	3.50%	STABLE
Major Regional Cities	5.00%	5.00%	4.75%	POSITIVE
SE Towns	5.25%	5.25% -	5.00%-	POSITIVE
SE Business Parks	5.35%+	5.35% -	5.00%-	POSITIVE

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