UK CAPITAL VIEW: Spring 2019

Knight Frank

Key themes for 2019…

- **Go long on income and core UK assets (**Page 3)
- **UK Cities:** Strong rental reversions in regional office markets **(**Page 4)
- **Industrial:** Focus on markets which will benefit from tenant displacement **(**Page 5)
- **London Office:** take the development risk and get the reward **(**Page 6)
- **Retail Warehousing:** trading conditions remain difficult, but a counter cyclical opportunity may present itself in 2019 **(**Page 7)
- **Value-add** by taking on the operational risk **(**Page 8)
- **Real Estate Debt:** Senior lending in the specialist sectors **(**Page 9)

The State of Play

- **UK politics is stoking uncertainty, but we believe the downside risks are overstated.** Brexit turmoil cannot be ignored, but neither should we overlook steady GDP growth, robust labour markets and falling inflation. Consensus forecasts for all property total returns in 2019 are currently just 3.0%. Our view is that annual total returns will be in the region of 4-4.5%

- **Strong macroeconomic fundamentals will support UK real estate investment.** Easing inflation implies a more modest outlook for interest rate rises, both in the UK and globally. Domestic and overseas borrowing costs have fallen notably since the end of last year. Ultimately this is a more helpful environment for property values than previously anticipated.

- **Most UK listed property companies are now trading at a significant discount to the net value of their assets.** We expect this will prompt some to consider non-core asset sales as share buybacks continue to be ineffective at boosting share prices for certain listed groups. The extent of the discounts seen also reignites the prospect of M&A activity and we have already seen a number of transactions at the start of 2019.

- **Retail funds are in a far sturdier position if redemption requests increase.** In order to maintain their current strong cash position, some UK retail funds may seek to release stock selectively. However, there will be far less immediate pressure for owners to sell assets, compared to previous times, if redemption requests do increase.

- **The bigger picture is that appetite for property remains strong.** Rising levels of unspent commitments and fresh capital raising amongst PE funds, increased target allocations to real estate amongst institutions, the prospect of greater outflows of Middle Eastern capital, and strong interest from private wealth will all contribute to a broad-based demand for the asset class this year.

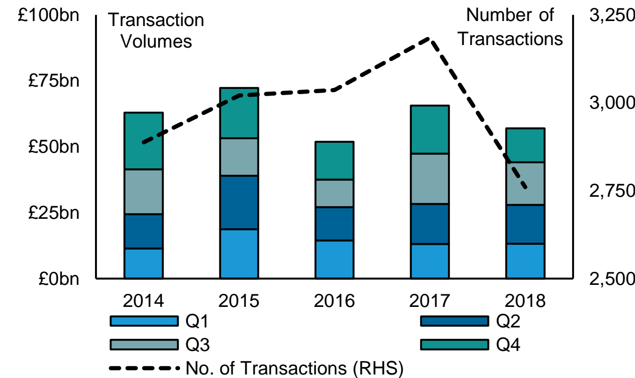
- **In a global context, UK real estate appears increasingly appealing.** The immediate outlook for the UK is of course dependent on the outcome of Brexit negotiations. But, assuming a no-deal scenario can be averted, current pricing on UK real estate would be compelling, especially to investors currently considering the increasingly expensive mainland European markets.

UK CAPITAL VIEW: Spring 2019

- Despite a modest annual decline, transaction volumes remained strong in 2018 at ca. £60bn.
- There was a contrast in performance across all the UK property sectors during 2018. The industrial sector outperformed with an annual total return of 17.4%, while retail underperformed with an annual total return of -0.1%.
- The stable and secure cash flows that commercial real estate offers have helped it outperform other asset classes during a volatile year for financial markets.
- While UK GDP growth remains robust, Brexit related uncertainty continues to hold back business investment in the economy.
- Political uncertainty has exerted downward pressure on the value of the Pound. For those investors who are bullish on the long-term prospects of the GBP, the current discount of the pound provides a good incentive to invest in UK real estate.

Despite the annual decline, transaction volumes remained strong in 2018…

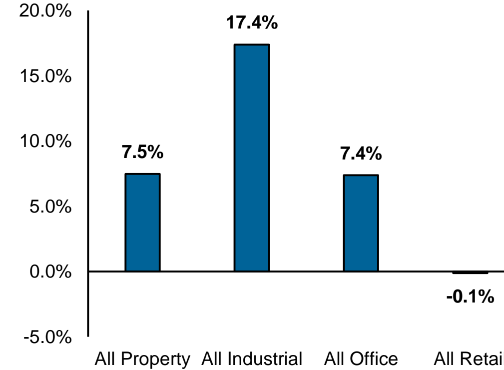
Figure 1: UK Property Transaction Volumes by Quarter



Source: PropertyData, Knight Frank

Contrast in performance across UK sectors..

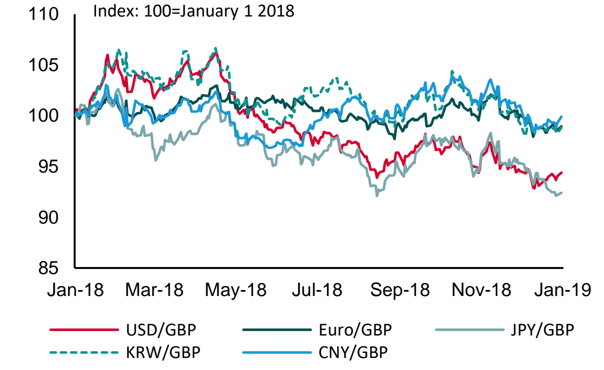
Figure 2: UK Annual Total Returns, 2018



Source: MSCI, Knight Frank

Political uncertainty dragging on the strength of the Pound…

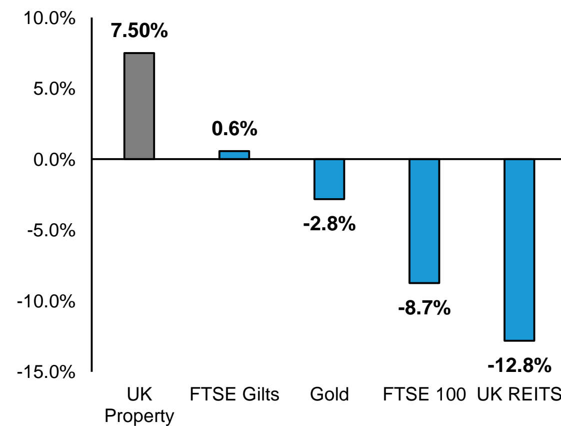
Figure 3: GBP currency index



Source: Bank of England, Knight Frank

Direct UK Property Outperforms during a volatile year…

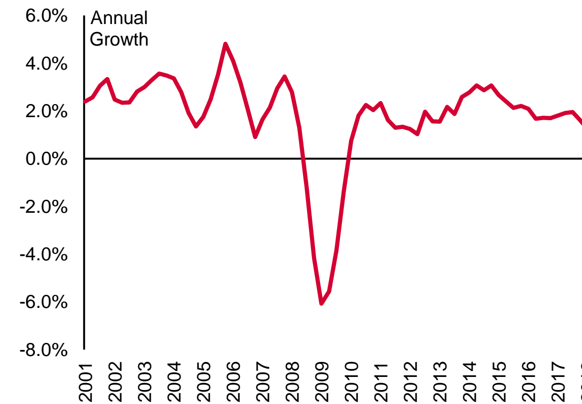
Figure 4: 2018 Annual Total Returns by Asset Class



Source: Macrobond, Knight Frank

GDP growth held back by political uncertainty…

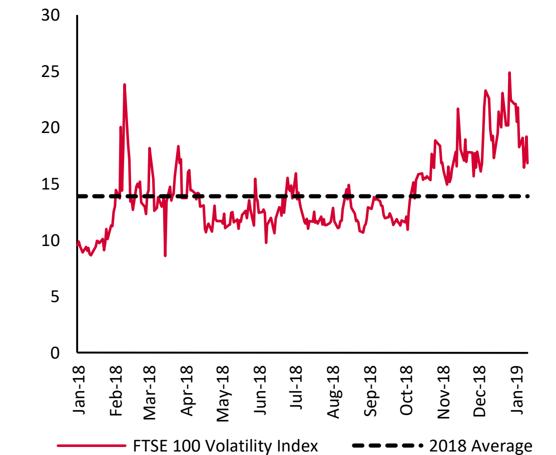
Figure 5: Annual UK GDP growth



Source: ONS, Knight Frank

Volatility across financial markets spiked at the end of 2018...

Figure 6: UK FTSE 100 Volatility Index



Source: Macrobond, Knight Frank

UK CAPITAL VIEW: Long-Income

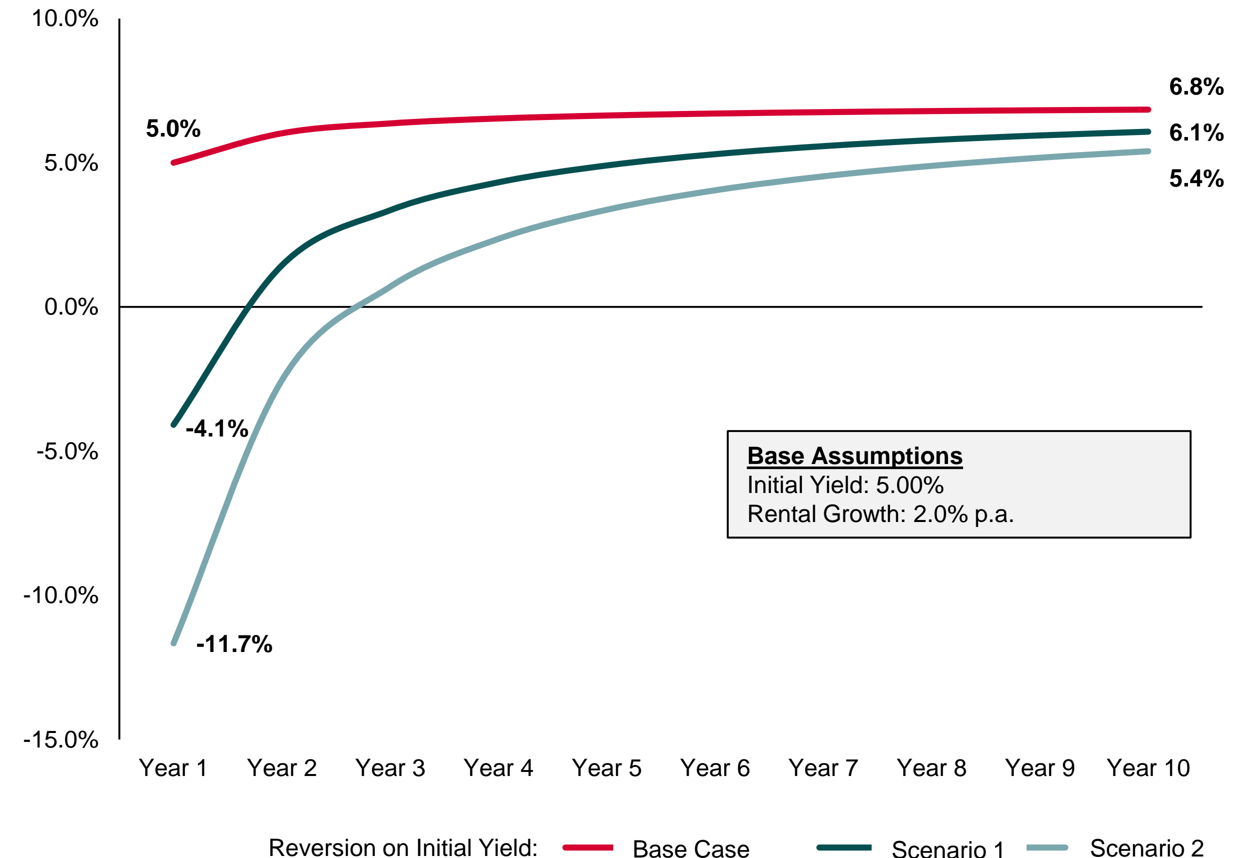
Knight Frank

Go long on income and core UK assets…

- **Long-term investors chasing annuity style income streams are less affected by any potential yield reversions and should focus on the income profile of the asset rather than capital growth prospects.**
- Short-term political uncertainty risks clouding sentiment towards UK real estate, despite the long-term fundamentals remaining strong in many markets.
- In order to best mitigate the risk associated with any potential upcoming short-term volatility, long-income assets with guaranteed rental increases over the life of the lease provide attractive risk adjusted income returns.
- Given the maturity of the current global real estate yield compression cycle, most prudent investors would be pricing in some form of yield reversion into their asset underwriting.
- Although asset pricing may fluctuate, for assets with a strong tenant covenant, the income component of real estate provides a stable and predictable return for investors when capital growth fades.
- As illustrated in Figure 7, long-term investors are best equipped to minimise any potential downside risk from yield reversion while benefitting from a strong cash flow during volatile periods.
- The challenge for long-term investors is the limited availability of appropriately leased assets. Given the weight of money targeting these assets, investors may need to look at alternative sectors like healthcare, hotels or student accommodation in order to place capital.

Over the long-term, IRRs converge even if terminal yields move out…

Figure 7: Unlevered IRR by exit year and reversion of terminal yield



**The above chart illustrates the effect a yield reversion has on the IRR curve of an investment over 1-10 years. Three scenarios have been applied, a base case of no reversion upon asset disposal, a +50bps reversion and a +100bps reversion upon asset disposal. Across all three scenarios it can be seen that investment returns are affected less by movements in yields over the long-term than in the short term.*

Source: Knight Frank

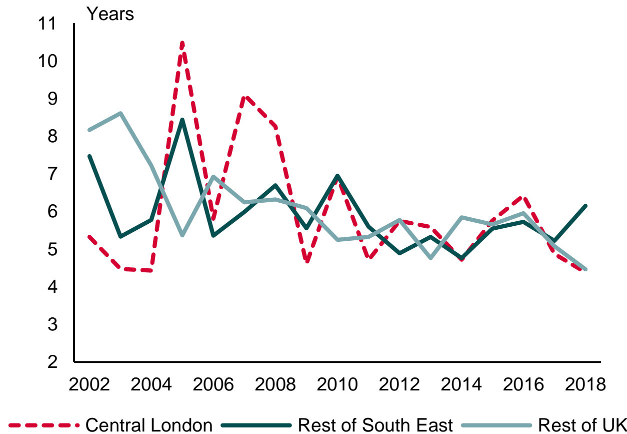
UK CAPITAL VIEW: UK Cities

Strong occupier markets provide opportunity and value…

- **Following the trend of the Central London office market, lease lengths in the UK's regional cities have also been on the decline. The average lease length before break outside the South East has declined from 8.2 years in 2002 to 4.5 years in 2018…**
- However, given the lower number of high quality alternative buildings for tenants, the re-leasing risk in the regional office markets is much lower than that of Central London.
- Compounding the prospect that tenants are likely to re-sign with their existing landlord is the limited supply of Grade-A office space in the development pipeline across key UK cities.
- Furthermore, recent take-up activity across these markets suggests that the scarcity of available good quality office space will continue in the medium-term.
- Given the strength of the occupier markets in the regional cities, assets with lower Weighted Average Unexpired Lease Terms (WAULT) provide an attractive investment proposition given the strong potential reversionary income that could be on offer.
- Investor demand for long-income assets has pushed pricing in regional cities to historical highs. Consequently, investors are having to move further up the risk curve to reach their target investment returns (i.e. development and forward-funding).
- Higher quality assets are the most likely to benefit from any potential upward rental reversions, however pricing on such assets will be competitive.
- Although opportunities do lie in refurbishing secondary assets, investors need to be wary of not underestimating the cost of the capital works that would need to be undertaken in order to bring the quality of the asset up to standard for prospective tenants.

The average length of Regional UK office lease lengths continues to decline outside the South-East…

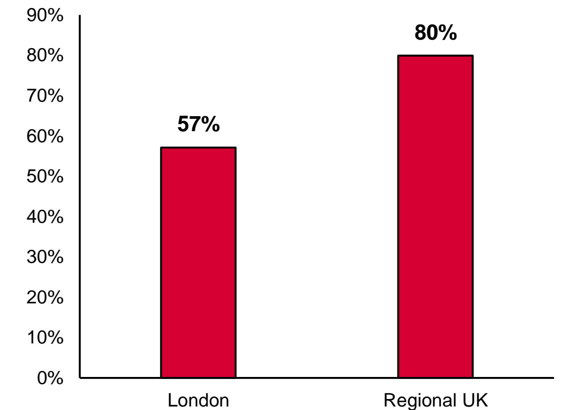
Figure 8: Office lease lengths by region – period to first break



Source: MSCI, Knight Frank

…However, re-leasing risk is minimal compared to London

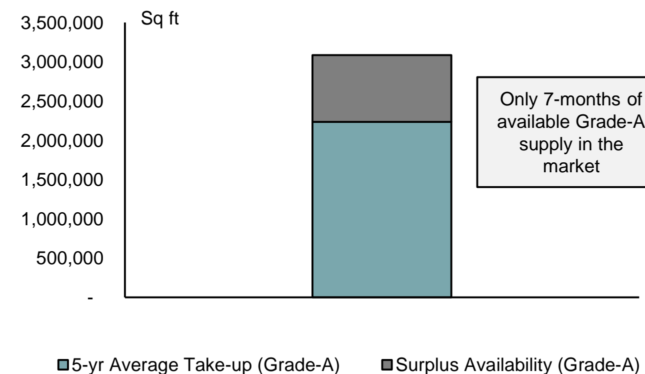
Figure 9: Percentage of tenants not exercising lease-break



Source: MSCI, Knight Frank

Limited upcoming Grade-A office supply to help maintain momentum in the occupier markets…

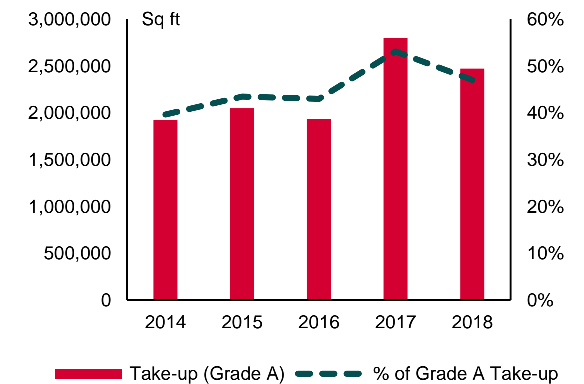
Figure 10: UK Big 6 2019 supply-demand profile



Source: Knight Frank

Recent take-up activity suggests a strong medium term outlook…

Figure 11: UK Big 6 City Grade-A Office Take-up



Source: Knight Frank

UK CAPITAL VIEW: Industrial

Focus on markets that will benefit from tenant displacement…

- **While many landlords have benefitted from the strength of the South-East industrial rental market, some occupiers are being displaced from their existing buildings as reviewed rents or rents on new lettings are too high…**
- Strong rental growth across the South-East industrial market has benefitted a number of landlords as values have soared across the region.
- However, any upcoming upward rental reversions could have a negative effect on small to medium sized occupiers who are more sensitive to movements in their fixed operating costs.
- This displacement has been apparent over the last 12-18 months and we expect it to continue as occupiers who are not as constrained by the needs of their business to be based in a certain location, or simply cannot afford the new rental rates, are likely to seek cheaper alternative locations to operate from.
- Neighbouring areas which offer similar locational characteristics and cheaper rents are likely to benefit from increased tenant demand as a result.
- Upcoming supply constraints from stock being removed to facilitate the construction of infrastructure projects like Cross-Rail and the new Heathrow runway are likely to increase rental rates in the affected regions.
- In addition, the Valuation Office Agency estimates that the Greater London area has already lost 14% of its industrial zoned land to alternative uses (predominantly residential) in the last 10 years.
- Markets in the Northern M25 corridor may become more appealing to occupiers looking for a more affordable place to be located. In the South, occupiers within the increasingly expensive Croydon area are likely to look to areas like Crawley for more affordable rental rates.

Higher rental rates in key South East industrial markets will have a trickle down effect to neighbouring areas…

Figure 12: South-East industrial property rental map (£psf)

Source: Knight Frank

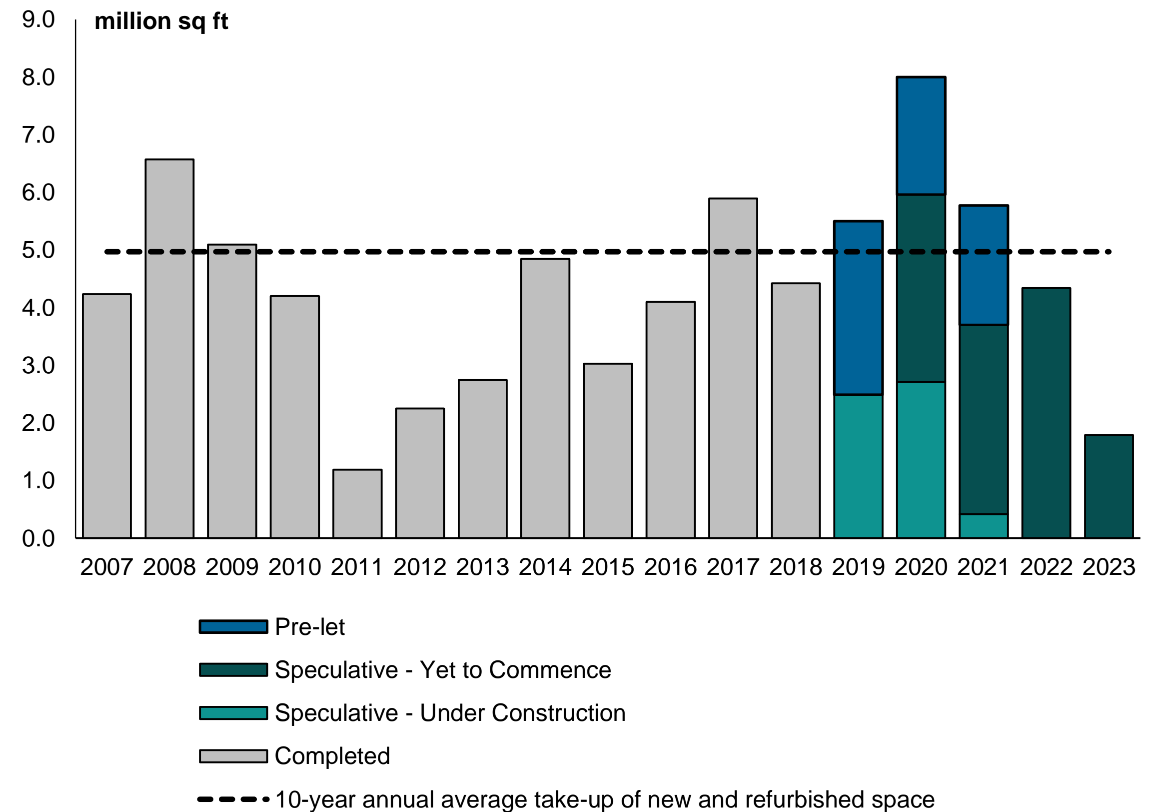
UK CAPITAL VIEW: Central London Offices

Take the development risk and get the reward…

- **There is a shortage of appropriately priced core assets within the Central London office market that will generate the required rates of return for many investors…**
- The rise in the number of investors being priced out of core real estate has resulted in pricing on value-add assets increasing as investors move up the risk curve. However, given the number of assets where owners are undertaking refurbishment projects, this market is quickly becoming competitive.
- The strongest demand for office space is stemming from occupiers seeking high quality Grade-A space. This kind of product cannot always be achieved from a refurbishment of an existing asset and needs to be built.
- Given the strength of the occupier market, and shortage of future supply, the opportunities to de-risk projects by pre-letting is greater than ever.
- A building of around 200,000 sq ft with circa 25,000sq ft floor plates is ideally placed to compete for a pre-commitment from either a few medium sized tenants or become a trophy headquarters for one large tenant.
- The focus on medium and large tenants will ensure that the asset does not encroach on the small tenant market that is currently dominated by the numerous flexible workspace providers.

Strong speculative development pre-letting has limited the available options for tenants in the medium term…

Figure 13: Central London office development pipeline by status



Source: Knight Frank

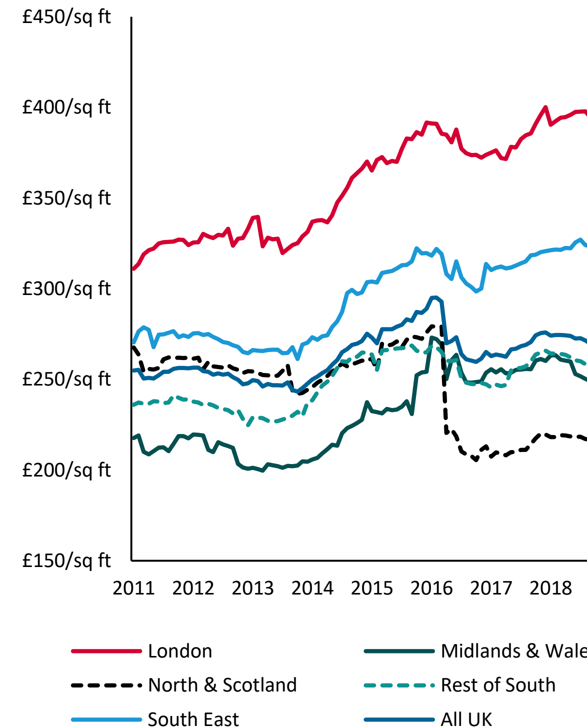
UK CAPITAL VIEW: Retail Warehousing

Trading conditions remain difficult, but a counter cyclical opportunity may present itself in 2019…

- **For counter-cyclical investors, retail warehousing offers one of the biggest opportunities for investors seeking an attractive income return at a severely discounted price. It is however also a sector that hasn't yet reached the bottom of its decline…**
- Although the entire sub-sector has been tainted with the same levels of negative sentiment, opportunities do still lie in areas (particularly London) that offer protection to investment returns on the downside due to strong underlying land values.
- While in many cases, vendor expectations are yet to fully realign with what the market is willing to pay for retail warehouse assets, recent valuation evidence is likely to bring values more inline with what purchasers perceive assets to be worth.
- However, it is paramount that investors focus on the trading performance of an asset, not the perceived value derived from its location, to ensure the income component of the asset is stable and attractive.
- In order to lower the downside risk of the income profile of an asset, investors should focus on those which have a strong exposure to non-discretionary spending like food, and avoid weaker performing non-discretionary retailers such as fashion.
- But, be aware that there are conservatively over 2,000 lease events in the next three years which retailers will almost certainly use to lower rents and introduce more flexible and/or shorter lease terms.
- Given the recent poor performance of the sub-sector, there is potential for a number of distressed sales to come to market (especially from private owners) if and when any debt covenants are breached by owners. UK Institutions, who own the vast majority of the assets in this sector, will be nervous to sell in such a weak market, but nearly all of them will be 'overweight' in retail in 2019.

Retail warehousing capital values holding up where underlying land values are the highest…

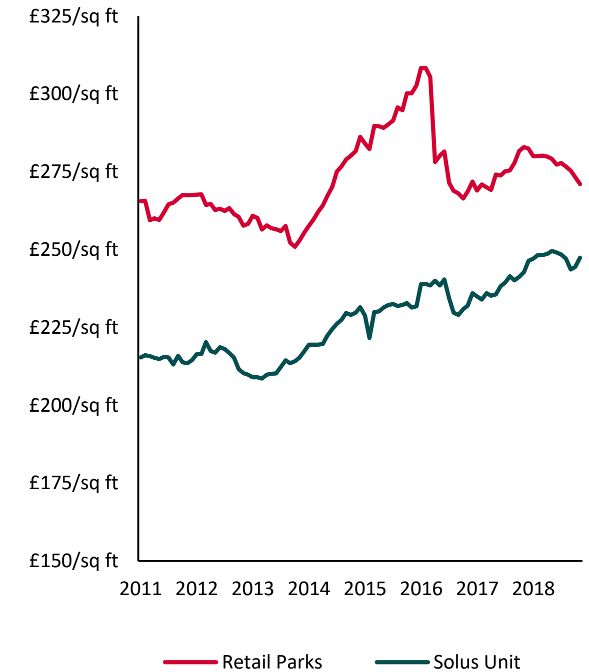
Figure 14: Retail warehouse capital values by region



Source: MSCI, Knight Frank

Solus Unit assets outperforming retail parks…

Figure 15: Retail warehouse capital values by type



Source: MSCI, Knight Frank

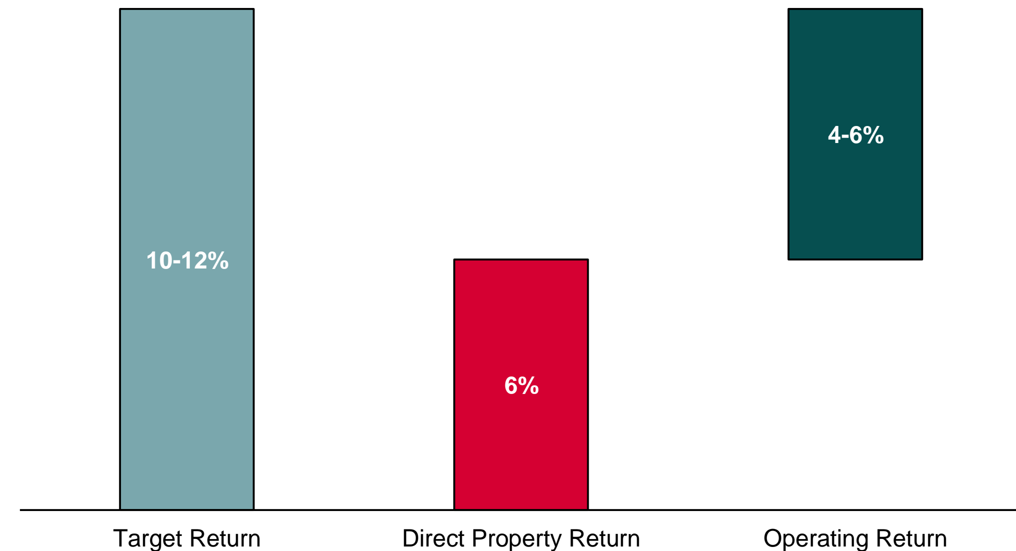
UK CAPITAL VIEW: Value-add

Value-add by taking on operational real estate

- **For some investors, it is becoming difficult to reach target investment returns from direct property investment alone. Such investors are increasingly looking to absorb the operational component of real estate into their business plans in order to reach their target returns…**
- By taking on the operational component of real estate, investors are able to increase their investment returns. They can also potentially de-risk any development pipeline or improve the underlying fundamentals of existing assets by installing their own operating companies as a tenant.
- It does need to be noted that investors will need to take on the adherent operational risk associated with the operating business. Furthermore, it can be difficult to efficiently undertake the operating component without building a platform to scale.
- The office (through co-working), hotel and PRS sectors are best positioned to offer attractive risk adjusted returns for investors willing to take on the operational risk. However, each sector requires its own specific expertise in order to be successfully implemented and be accretive to a building's earnings, not a drain.
- Those who can successfully limit any Net Operating Income (NOI) leakage and combat business inefficiencies currently plaguing some operating companies in these sectors are likely to profit.

Investors looking to take on operational risk in order to reach target investment returns…

Figure 16: Value-add investment return profile



Source: Knight Frank

UK CAPITAL VIEW: CRE Debt

Senior lending in the specialist sectors

- With lending margins for debt on core office and industrial assets currently averaging ca. 150bps, lenders are having to diversify their lending book in the pursuit of yield.
- Lenders could obtain a higher return by moving up the capital stack to a stretched senior or mezzanine loan position. However, given the number of established mezzanine and whole loan providers already in the market, it makes sense for lenders to diversify by geography or asset class.
- Given the structural undersupply of the healthcare sector, coupled with an historic lack of finance (compared to other sectors) there is plenty of scope for lenders to deploy capital to fund both stabilised assets and development projects.
- The healthcare sector covers both care homes and retirement living. With lending margins available at ca. 250bps for stabilised assets or 350bps for development projects.
- The biggest barrier for lenders seeking to fund investments in the healthcare sector is the technical nature of how value is derived from these assets and the complex operating components that go with them. The sector also brings additional risk considerations such as, regulatory compliance, reputational risk, and a national shortage of nurses which drives the need for agency staff and therefore higher operational costs.
- An alternative for those lenders wanting to engage in a more mainstream asset class is the UK student accommodation sector. Where, lenders can still achieve a premium to fund these projects. Debt on stabilised assets tends to reach ca. 200-240bps, while development lending is currently in the region of 300bps.

Alternative lenders are diversifying their lending book in the pursuit for yield…

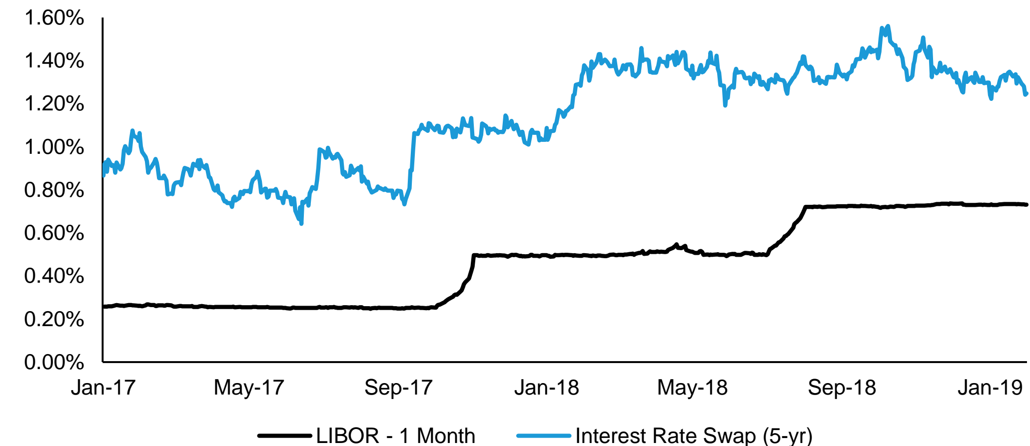
Figure 17: Real estate debt lending margins

	Core - Stabilised	Development
Office	150bps	300bps*
Industrial	150bps	300bps*
Student	200-240bps	300-350bps
Healthcare	225-275bps	350-450bps

*assumes asset is pre-let, if not pricing would be closer to 500bps for speculative development

Source: Knight Frank

Figure 18: UK lending rates



Source:Macrobond, Knight Frank

UK CAPITAL VIEW:

UK CAPITAL MARKETS

Richard Claxton
Partner - Head of UK Capital Markets
+44 20 7861 1211
richard.claxton@knightfrank.com

COMMERCIAL RESEARCH

William Matthews
Partner - Head of UK Commercial Research
+44 20 3909 6842
william.matthews@knightfrank.com

John Watts
Senior Analyst – Capital Markets
+44 20 7861 1345
john.watts@knightfrank.com

Knight Frank

	Nov-18	Dec-18	Jan-18	Market Sentiment
High Street Retail				
Bond Street	2.25%	2.25%	2.25%	Stable
Oxford Street	2.50%	2.50%	2.50%	Stable
Prime Shops	4.50% +	4.50% +	4.50% +	Negative
Regional Cities	5.00% +	5.00% +	5.00% +	Negative
Good Secondary (Truro, Leamington, Spa, Colchester etc)	6.25% +	6.50% +	6.50% +	Negative
Secondary & Tertiary	10.00% ++	10.00% ++	10.00% ++	Negative
Shopping Centre				
Regionally Dominant (£200+ psf Zone A)	5.00%	5.25%	5.25%	Negative
Dominant Prime	6.75%	7.25%	7.25%	Negative
Town Dominant	8.50%	9.00%	9.00%	Negative
Secondary	10.00% ++	10.00% ++	10.00% ++	Negative
Out of Town Retail				
Open A1/Fashion Parks	5.25%	5.50%	5.50%	Negative
Secondary Open A1 Parks	6.25%	6.75%	6.75%	Negative
Bulky Goods Parks	5.75% +	6.00%	6.00%	Negative
Secondary Bulky Goods Parks	7.00% +	7.50%	7.50%	Negative
Solus Open A1	4.75% +	4.75% +	4.75% +	Negative
Solus Bulky (c.50,000 sq ft let to strong covenant)	5.00% +	5.00% +	5.00% +	Negative
Specialist sectors				
Dept. Stores Prime (with fixed uplifts IY)	7.00%	7.50%	8.00%	Negative
Car Showroom (20-yrs with fixed uplifts & dealer covenant)	4.50%	4.50%	4.50%	Stable
Budget Hotels London (Fixed/RPI uplifts 20 yr+ term, Strong Covenant)	3.50%	3.50%	3.50%	Stable
Budget Hotels Regional (Fixed/RPI uplifts 20 yr+ term, Strong Covenant)	4.25%	4.00%	4.00%	Stable
Student Accommodation (Prime London - Direct Let)	4.25% -	4.25% -	4.25% -	Positive
Student Accommodation (Prime Regional - Direct Let)	5.25% -	5.25% -	5.25% -	Positive
Student Accommodation (Prime London - 25 yr lease Annual RPI)	3.50%	3.50%	3.50%	Stable
Student Accommodation (Prime Regional - 25 yr lease Annual RPI)	3.75%	3.75%	3.75%	Stable
Healthcare (Elderly Care 30 yrs indexed linked reviews)	3.75%	3.75%	3.75%	Positive
Foodstores				
Annual RPI increases (IY) (25 yr Income)	4.25%	4.25%	4.25%	Positive
Open market reviews	5.00%	5.00%	4.75%	Positive
Warehouse & Industrial Estates				
Prime Distribution/Warehousing (20 yr income with fixed uplifts IY)	4.00%	4.00%	4.00%	Positive
Prime Distribution/Warehousing (15 yr income)	4.25%	4.25%	4.25%	Stable
Secondary Distribution (10 Yr income)	5.00%	5.00%	5.00%	Stable
SE Estate (exc London & Heathrow)	4.00%	4.00%	4.00%	Stable
Good Modern RoUK Estate	4.50%	4.50%	4.50%	Stable
Secondary Estates	4.75%	4.75%	4.75%	Stable
Offices				
City Prime	4.00% - 4.25%	4.00% - 4.25%	4.00% - 4.25%	Stable
West End Prime	3.50%	3.50%	3.50%	Stable
Major Regional Cities	4.75%	4.75%	4.75%	Stable
SE Towns	5.00% -	5.00%	5.00%	Stable
SE Business Parks	5.00% -	5.00%	5.00%	Stable