UK CAPITAL VIEW:

OUTLOOK SUMMER 2018

Performance remains solid. We expect returns of 7%, ahead of the consensus view of 4.6%.

Financial market volatility returns for 2018, highlighting the comparative stability of property.

More money is being directed towards property. Debt funds have raised more capital than ever.

Investment activity to remain robust. We expect turnover to reach £55bn this year.

A THEORY OF RELATIVITY

UK real estate remains attractive in a world of higher volatility and lower returns

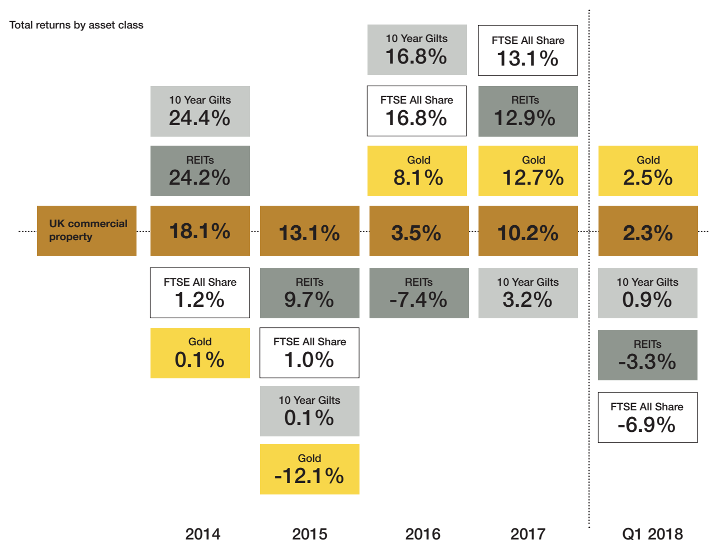
- **Real estate continues to attract capital...** Globally, more money is being allocated to real estate, both via funds for direct purchases and debt. Significant volumes of international capital continue to target the UK, albeit from an evolving mix of buyers as demand from Chinese sources slows.

- **...despite an easing in returns**. As an asset class, we still expect property to return 7% this year, and the latest consensus forecasts have edged closer to our view. However, as predicted, performance is slowing as yield compression finally comes to an end for most – but not all – property sectors. Polarisation will be the watchword as the market divides between sectors such as industrial and specialist property, where some capital growth may still be seen, and others, which are now largely reliant on income return.

- **The macro environment is proving more challenging.** Fundamentally, the outlook for both global and UK economic growth has improved, but the picture is obscured by protectionist trade rhetoric, distress amongst retailers, and ongoing Brexit uncertainty. Meanwhile, 2017's stable environment is over as financial market volatility has jumped from merely one of many potential risks to accepted reality. Looking ahead, the equity rally is mature, and bond investors are increasingly wary of central bank tightening: against this backdrop, the comparative safety of real estate is compelling.

- **Strategies for a lower return environment.** As near term returns from direct property ease, we expect investors will consider a variety of ways to enhance performance. While a focus on prime will remain attractive to those seeking long term liquidity and stability, others will look higher up the risk curve towards non-prime assets, or development opportunities. Alternatively, the abundance of debt may prove an opportunity to leverage returns.

RISING TO THE TOP: PROPERTY'S RELATIVE PERFORMANCE AGAINST OTHER ASSETS



Source: Macrobond/Knight Frank

UK CAPITAL VIEW:

OUTLOOK SUMMER 2018

The global economic backdrop remains fundamentally supportive...

...but financial market volatility is back.

Interest rates are on the rise – domestically and abroad, but we see minimal direct impact on values for now.

Property returns are gradually slowing, but remain compelling against other asset classes.

THE ENVIRONMENT FOR REAL ESTATE INVESTMENT

Financial market uncertainty bolsters the case for property

- **Volatility is back for 2018...** The equities bull run is looking more fragile as 'fear' indices spike, while bond yields are embarking on a bumpy upward path; safe haven assets such as gold and commodities are outperforming. In this context, real estate's promise of modest capital growth combined with healthy income yields is proving compelling for global asset allocators.

- **...against a backdrop of rising macro risks.** Protectionist trade rhetoric is fuelling global uncertainty, while monetary conditions are beginning to tighten for many large economies via rising interest rates and reduced central bank asset purchases. Domestically, Brexit negotiations are progressing slowly despite less than a year until the UK is set to leave the EU. A transition period until the end of 2020 has been agreed, potentially softening the impact for some businesses, but doing little to address broader political uncertainty.

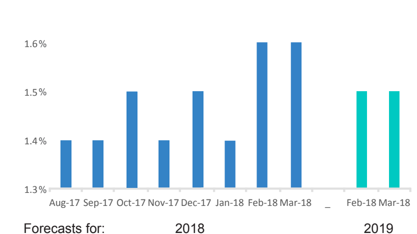
- **Despite headwinds, the global outlook is improving, benefitting the UK economy...** The IMF and OECD have revised up global growth forecasts this year, and this stronger sentiment is buoying the UK outlook too: in his March Spring Statement, Chancellor Philip Hammond raised official growth forecasts to 1.5%, with other forecasters following suit more recently.

- **...and supporting the next rate hike.** The resilience of the UK economy is particularly clear in the labour market, where unemployment is just 4.3% and wages are up 2.8% p.a., the fastest pace for over two years. This, combined with its forecast for inflation remaining above 2% until at least 2021, suggests the Bank of England will raise base rates at least once in 2018, and possibly as early as May. We do not consider this gradual tightening to have a material effect on UK property values in 2018, as money markets have already priced it in, although there could be a transmission via increased debt financing costs longer term.

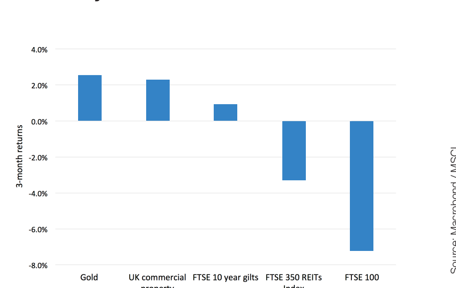
- **UK real estate outlook: the consensus improves.** The IPF's consensus forecast for all property returns in 2018 has increased to 4.6%, closer to our expectation of 7.0%. In our view, further yield compression will be limited to certain parts of the logistics and specialist property markets, where near term rental growth can still be realistically expected.

Equity market volatility

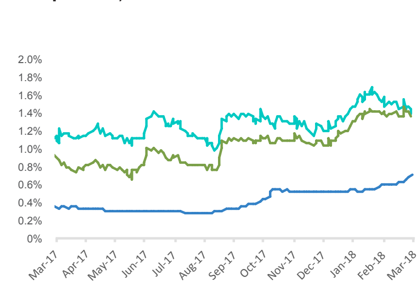
Consensus forcasts for GDP growth made at different times



Returns by asset class – three months to March 18



Swap Rates, Gilt Rates and LIBOR



UK CAPITAL VIEW:

OUTLOOK SUMMER **2018**

At £55bn, we expect another year of strong investment, albeit with a focus on larger deals.

The polarisation in performance between sectors will grow even wider.

Good investment opportunities will still be available for those taking a forensic approach to acquisitions.

Knight Frank

INVESTMENT MARKET DYNAMICS

More capital, but lower returns

- **At £11bn in Q1, UK real estate investment remains robust.** Analysis of the detail highlights three trends we expect to remain in place throughout 2018: a greater focus on scale, demonstrated by the number of portfolio and platform deals; rapid growth in specialist property purchases; and strong demand from overseas, but with a mix less heavily weighted towards Chinese capital, as investors from other countries become more prominent.

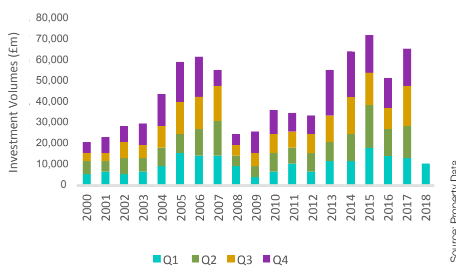
- **Private equity is raising capital faster than it can be spent.** Globally, more real estate focused money was raised in Q1 2018 than in any first quarter since 2007, and $0.25trn is now waiting to be deployed. Much of this is being channelled towards Europe, and INREV reports that the UK tops the list of preferred destinations. Many continental markets undoubtedly have stronger rental growth prospects than the UK, but this is balanced by ultra-low yields. UK pricing therefore remains compelling, especially for the rising number of funds specifically seeking income returns.

- **Strategies for a lower return environment.** As near term returns from direct property ease, we expect investors will consider a variety of ways to enhance performance. While a focus on prime will remain attractive to those seeking long term liquidity and stability, others will look higher up the risk curve towards non-prime assets, or development opportunities. Alternatively, the abundance of debt may prove an opportunity to leverage returns.

- **We await the next mega-merger.** Another approach to staving off lower performance is via mergers and acquisitions, which can offer economies of scale (and should throw off some interesting stock opportunities). A number of such deals are currently in play in the UK and Europe, and we expect further announcements this year. We also predict further M&A-style deals from major institutions and private equity funds seeking to deploy capital in large tranches.

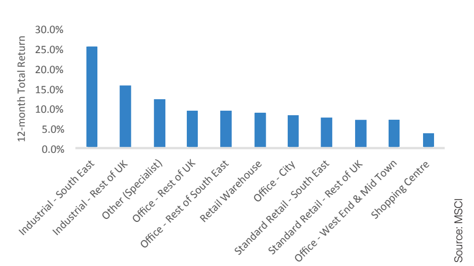
- **Distress creates opportunities.** What alternative uses can a property have? A question long asked by office and industrial investors with an eye to higher residential values is now valid for the retail sector too following the collapse of several retailers in Q1. Can investors repurpose retail warehouses as urban logistics hubs, capturing a significant tightening of yields in the process? More generally, we expect the polarisation in returns between property sectors to cause investors to be more flexible in the type of property they target.

All Property Investment Volumes



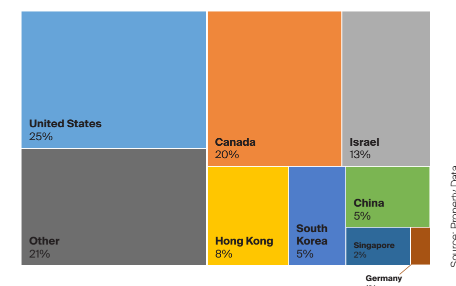
Source: Property Data

Total Return by sector to March 2018



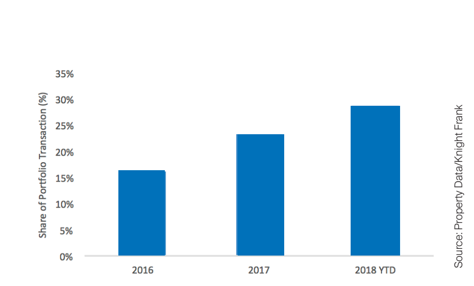
Source: MSCI

Major sources of overseas capital year to Q1 2018



Source: Property Data

Portfolio deals' share of total transactions



Source: Property Data/Knight Frank

UK CAPITAL VIEW:

OUTLOOK SUMMER **2018**

London investment slows after a strong year, regional markets remain active.

A new mix of overseas buyers is emerging.

Returns are easing for most of the market, but there are still pockets of potential for yield compression beyond Central London.

OFFICES

Demand for stock remains active, despite easing returns

- **A slower start to the year.** At £4bn, UK-wide office investment in Q1 2018 was below the almost £6bn recorded in the equivalent quarter of 2017 (which saw the £1.15bn Leadenhall Building sale) albeit only ca. 10% below the long run average. This reduction reflects both a combination of fewer buyers from China and Hong Kong, but also a smaller volume and variety of available stock on the market. It also masks an ongoing shift towards office investment beyond London, driven primarily by domestic institutions, but increasingly overseas purchasers too.

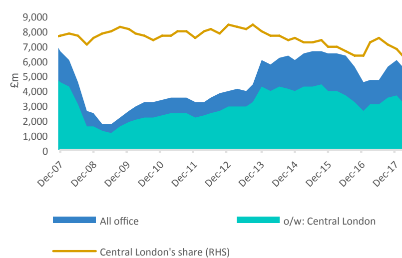
- **London attracts an evolving mix of buyers...** Restrictions on outbound capital are subduing demand for London assets from mainland Chinese purchasers, although in some cases funds are already domiciled elsewhere, reducing the initial impact of the restrictions. Meanwhile, a new wave of buyers from South Korea, Singapore, Japan, South Africa and elsewhere is emerging and complementing the investor pool, albeit with generally a more conservative approach to bidding.

- **...despite some evident challenges.** Take-up is running at above average levels, availability is low and construction is slowing. However, with little scope for yield compression, or rental growth, prime assets will see near term returns slow. This may be an acceptable trade-off for investors seeking the security of world-class offices, but those with a focus on shorter term performance may consider non-prime assets or development opportunities.

- **UK cities and major South East towns account for a growing share of deal activity,** favoured by both institutional funds and increasingly, overseas investors. Although compressing, prime yields are yet to reach previous lows, but the strength of demand means we believe this is a possibility for 2018 in some cases. Even then, the comparison to continental yields would remain attractive.

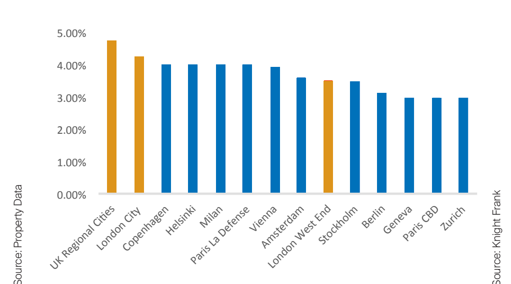
- **Evolving working practices have implications for investors.** Accelerated by technological progress, tenants are changing the way they want to use office space. For the longer term, office investors will need to understand the potential impact of these changes on returns, be it via the cost of fit-outs, more intensive management, or the impact (or not) of flexible workspace providers as tenants on valuations.

Quaterly office investment in the UK



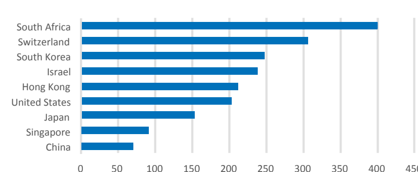
Source: Property Data

Prime office yields UK vs Europe



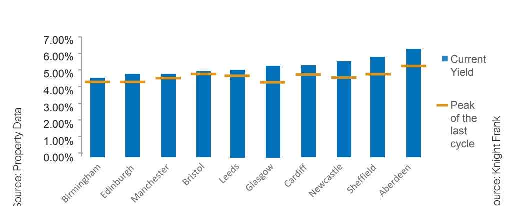
Source: Knight Frank

Overseas Investment into UK Offices – Q1 2018 £m



Source: Property Data

Current prime yield vs previous low



Source: Knight Frank

UK CAPITAL VIEW:

OUTLOOK SPRING 2018

The sector is clearly troubled, but the blanket negativity from press is obscuring some brighter news.

Polarisation is now becoming evident in out of town retail as well as in town.

Pricing is becoming more realistic, although we still expect some further yield movement this year.

RETAIL

Winners vs. losers

- **A challenging start to the year for retailers.** 2018 has already seen a mixture of high-profile CVAs, profit warnings and emergency cash injections amongst retail businesses. However, headlines generated by these events have obscured other retail news, including ongoing sales growth (1.1% year on year in February), stronger trading updates, and expansion plans. Even so, while we expect a period of greater stability to emerge this year, a genuine recovery is still a way off, and this is reflected in a weak Q1 for investment, with volumes down over 50% on Q4 2017.

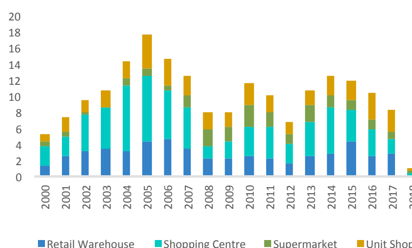
- **Out of town: out of favour, or opportunity?** In contrast to previous years, some of the names involved in the current phase of distress are retail warehouse occupiers. We expect that a greater sense of caution will increase the availability of investment property in this market, but also provide good opportunities for those able to take a forensic approach to stock selection: as always, some assets will continue to trade very well despite the uncertain retail market.

- **The bigger picture is performance polarisation.** This is taking hold both between, and within, the retail subsectors. We continue to witness downward pressure on foodstore yields, which are particularly desirable for investors seeking longer income. Certain regional high streets look good value at 5.5%+ yield, but these are not the obvious cathedral towns, rather good next tier locations. In contrast, we have raised our yield guidance on shopping centres in recent months and expect further outward yield movements this year.

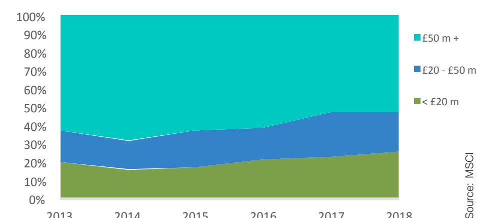
- **Prime assets will ultimately offer the best long term prospects.** In the short term, however, there is potential for income volatility as tenants exert their influence to obtain the best deal from landlords. Non-prime propositions remain riskier at a time when tenants have the upper hand in negotiations, although in some cases this can be mitigated by a strong alternative use value, or simply the residual value of the land.

- **Retail's income advantage.** At the sector level, retail yields remain higher than those for offices or industrial, meaning retail remains attractive to the growing share of investors focusing more closely on income return.

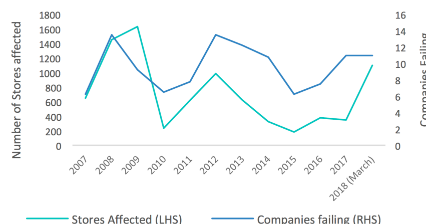
Retail sector investment by subsector (£bn)



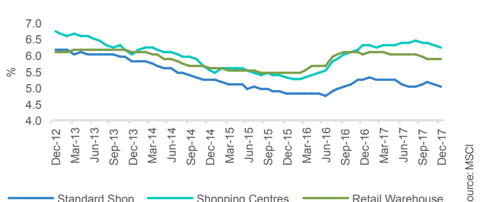
Share of investment by sizeband



Companies failing vs. stores affected (avg / quarter)



Retail yields



UK CAPITAL VIEW:

OUTLOOK SUMMER 2018

Despite easing returns, industrial is still set to outperform.

Stock remains scarce, and competition strong – further yield compression could be seen.

Occupier demand remains healthy but not beyond question.

INDUSTRIAL

Another year of outperformance ahead

- **Demand for assets is unrelenting...** Yields have compressed to historic lows on the strength of competition, but this is one of the few parts of the market in which we still see potential for further yield compression this year.

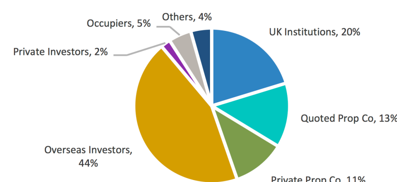
- **...and the range of investors remains diverse.** Along with regional offices, industrial property remains top of the allocation list for many domestic institutions, but they face significant competition from private equity and specialist REITs. The desire to deploy capital at scale, combined with a relative shortage of available stock, has reignited the market for portfolio deals, which in some cases now attract a small premium, and may therefore represent an attractive exit strategy for current owners.

- **Is peak performance finally in sight?** In contrast to most other sectors, annualised total returns have climbed even higher during the first few months of 2018, although polarisation is wide: at 26% in March, London was twice as strong as the North and Scotland. We expect performance to slow this year, but for the sector as a whole to see returns of 10%, with outperformance in areas of particular shortage. Ongoing scope for rental growth will stand out in the context of the wider real estate market.

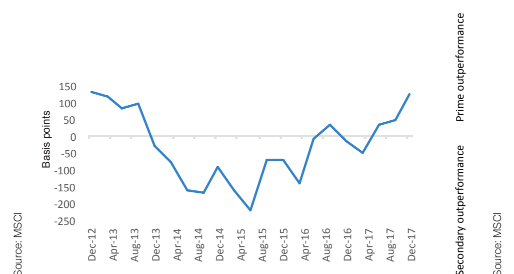
- **How deep is occupier demand?** The fundamental drivers are clear: a lack of stock combined with evolving retailer demand is supporting the strong rental expectations used to underwrite aggressive pricing. London and surrounding markets continue to reflect this with significant growth in take-up and rental levels. However, regional take-up on units of 50,000 sq ft or more has been easing. We believe that much of this can be explained by a lack of stock, yet it is clear that the depth of local tenant demand still needs to be rigorously evaluated on an asset by asset basis, and that longer term, landlords will increasingly need to consider the potential implications of trade disruption following the UK's departure from the EU.

- **Can retail warehouses become local logistics facilities?** There is a well-documented lack of logistics stock suitable for servicing the growing parcel delivery market, with the shortage most acute in London and the South East. The conversion of well-located retail warehouse units is one opportunity gaining traction, fuelled by the chance to narrow what is currently a 150bps+ gap between much of the industrial warehouse and retail warehouse sectors.

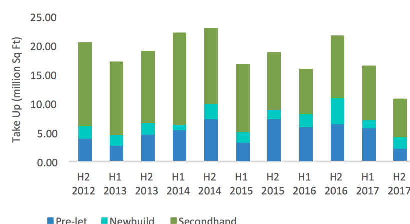
Industrial investment – 12 months to Q1 2018



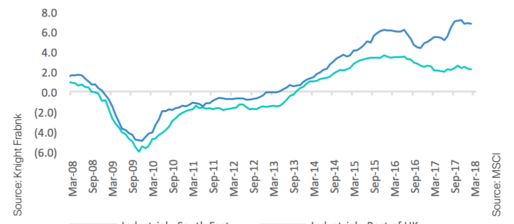
Quarterly total returns by asset quality



Industrial Take Up (50,000 sq ft +)



Annual rental growth



UK CAPITAL VIEW:

OUTLOOK SUMMER 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

No longer 'alternative'

- **Over £4bn was invested in specialist sectors in the first quarter of 2018.** This is a greater volume to that seen in the office sector, and more than industrial and retail investment combined. Over £1bn of this activity involved hotel assets and a number of large portfolio transactions have taken place (with more in discussion). The broad mix of institutional capital targeting these sectors highlights their increasingly mainstream appeal, alongside demand from private equity and overseas investors.

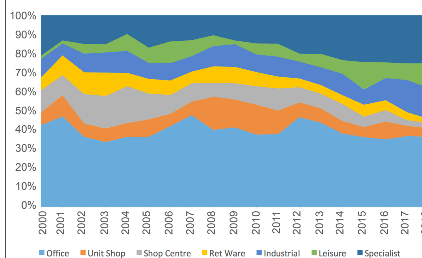
- **Specialist sectors attract more capital.** Institutional funds are gradually increasing allocations to specialist property, and we note that listed real estate businesses targeting specialist sectors have raised growing volumes of capital in recent years and continue to do so. This is in sharp contrast to the wider market, where major REITs and public property companies were net sellers of assets in 2017.

- **Yields still under downward pressure.** We have already lowered our house view of yields on prime regional student accommodation by 50bps and by 25bps for prime healthcare property this year, highlighting growing demand for specialist property. This ensures that these sectors are likely to be amongst the top performers in commercial real estate this year. Indeed, part of the current demand reflects specialist property's relatively defensive performance, which has typically been less volatile than many other sectors and is therefore attractive at this point in the cycle.

- **A lack of investible stock could hamper liquidity.** For example, we estimate that there is over £20bn of capital targeting the healthcare property market, against an annual deal volume of £1.3bn in 2017. Although new schemes are under construction, a relative lack of modern operational stock is limiting volumes for now.

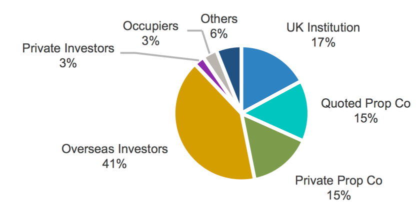
- **The long income angle.** The variety of ways to derive long term inflation linked income from specialist property gives the sectors particular relevance in the current market, in which fewer long-term commercial property lease are being signed. We also expect to see further interest from fixed income investors grappling with the negative real yields offered by index-linked bonds.

Investment share by sector



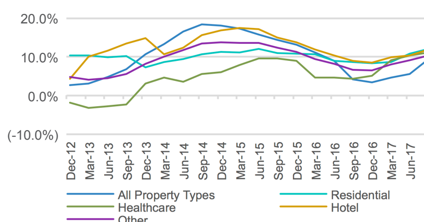
Source: Property Data

Share of investment by investor type, 2017



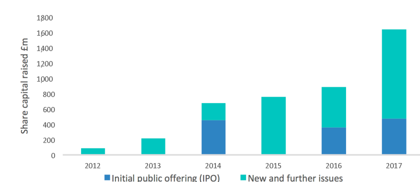
Source: Property Data

Specialist property annual total returns



Source: MSCI

Specialist sector share capital raising



Source: LSE

UK CAPITAL VIEW:

OUTLOOK SUMMER **2018**

An increasing volume of capital is choosing to target real estate exposure via debt.

Globally, real estate debt funds raised more capital than ever in 2017.

Lenders are typically risk averse, favouring traditional property over development and specialist sectors.

REAL ESTATE DEBT

A borrower's market

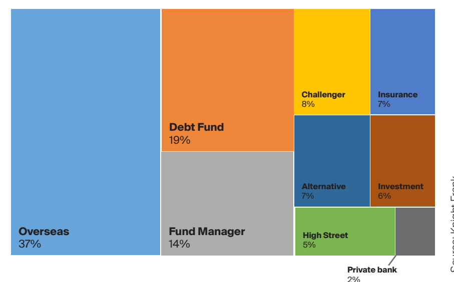
- **A growing range of lenders are targeting the UK commercial real estate market...** With loan to value limits remaining conservative, investors (in particular institutions) see debt as an attractive way to gain real estate exposure at a time when capital growth is slowing and concerns over macro risks are rising. Competition comes mainly from overseas lenders, and increasingly from debt funds, which raised more capital than ever in 2017 (globally and for Europe specifically).

- **...but interest rates are on the rise.** The growing prospect of base rate hikes is being reflected in higher money market interest rates. Lenders face a choice: pass this cost on to borrowers, or reduce their margins. For now, competition to lend is sufficient that in some cases lenders are taking a hit on margins, softening the impact of higher interest rates for borrowers. However, this margin squeeze can only go so far, and once the limit has been reached, higher borrowing costs could ultimately reduce the amount that those purchasing with debt are able to pay for assets.

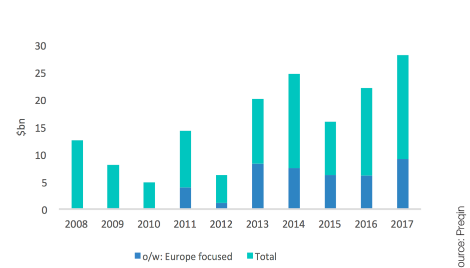
- **Will the focus remain on prime?** Competition to lend has been strongest for existing prime offices, although more recently there has been widening margin disparity between sectors and asset qualities – prime is still favoured by lenders, but while margins on lending to secondary offices have shown a steady rise, those for secondary industrial have fallen.

- **The alternative opportunities.** Reflecting trends in the market for direct purchases, more capital is being made available for specialist property, although not in every subsector: of 100 lenders recently approached by Knight Frank, only 37% had appetite to lend into the healthcare sector.

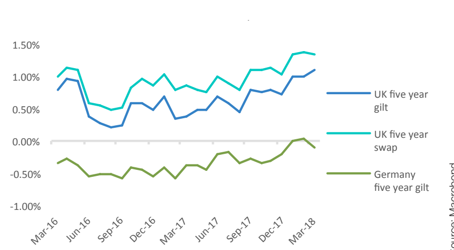
UK lender types currently active



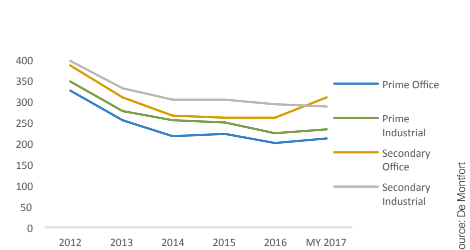
Private equity debt capital raised



Interest rate comparison



Lending margins - selected property types



UK CAPITAL VIEW:

OUTLOOK SUMMER 2018

Global Capital Markets

London Offices

Retail

Logistics and Industrial

Specialist Property

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KNIGHT FRANK YIELD GUIDE

	Dec-16	Dec-17	Mar-18	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%	4.50% +	STABLE
Good Secondary high street	6.00%	6.00%	6.00%	POSITIVE
Secondary & Tertiary high street	10.00%	10.00%++	10.00%++	NEGATIVE
Shopping Centre				
Regionally Dominant shopping centres	4.25%	4.50%+	4.50%+	NEGATIVE
Dominant Prime shopping centres	5.00%	5.50%	5.75%+	NEGATIVE
Good Secondary shopping centres	6.50%	7.50%	7.75%+	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%	5.75%	5.75%	STABLE
Bulky Goods Parks	6.00%	5.75%	5.75%	POSITIVE
Secondary Bulky Goods Parks	7.00%	7.00%	7.00%	POSITIVE
Solus Open A1	5.00%	4.75%	4.75%	STABLE
Solus Bulky	6.00%	5.75%	5.75%	POSITIVE
Specialist Sectors				
Department Stores	5.25%	5.25%	5.50%	NEGATIVE
Car Showroom (with fixed uplifts & manufacturer covenant)	4.50%	4.50%	4.50%	STABLE
Car Showrooms (with fixed uplifts & dealer covenant)	5.25%	4.75%	4.75%	POSITIVE
Budget Hotels (Fixed/RPI uplifts 20 yr+ term, Strong Covenant)	4.75%	4.25%	4.25%	POSITIVE
Student Accommodation (Prime London – Direct Let)	4.50%	4.25%	4.25%	POSITIVE
Student Accommodation (Prime Regional – Direct Let)	5.50%	5.50%	5.25%	POSITIVE
Student Accommodation (Prime London – 25 yr lease Annual RPI)	4.00%	3.75%	3.50%	POSITIVE
Student Accommodation (Prime Regional – 25 yr lease Annual RPI)	5.00%	4.50%	4.00%	POSITIVE
Healthcare (Elderly Care 30 yrs indexed linked reviews)	4.50%	4.25%	4.00%	POSITIVE
Foodstores				
Annual RPI increases (IY)	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%	4.00%	4.00%	POSITIVE
Prime Distribution/Warehousing (15 yr)	5.00%	4.25%	4.25%	POSITIVE
Secondary Distribution (10 yr)	6.50%	5.00%	5.00%	POSITIVE
SE Estate (exc London & Heathrow)	4.75% - 5.00%	4.25%	4.25%	POSITIVE
Good Modern RoUK Estate	5.50%	5.00%	5.00%-	POSITIVE
Secondary Estates	7.00%	5.75%	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%	POSITIVE
Major Regional Cities	5.00%	4.75%	4.75%	POSITIVE
SE Towns	5.25%	5.00% -	5.00%-	POSITIVE
SE Business Parks	5.35%+	5.00% -	5.00%-	POSITIVE